

# Options for 1988: The Green Budget

January 1988

Edited by  
Bill Robinson

In collaboration with



Goldman  
Sachs

# **Options for 1988**

## **The Green Budget**

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# Preface

The Green Budget is, as always, a collaborative effort. In addition to the written contributions from the named authors, we are grateful for outside advice and help from Geoffrey Dicks of the London Business School, and Jeremy Hale and David Walton of Goldman Sachs. We would also like to acknowledge the contribution of other IFS staff, notably Edmund Crooks and Michael Saunders. We are grateful to Chantal Crevel-Robinson and Judith Payne for turning a mass of material into a finished product in an extremely short space of time.

As usual, we would stress that IFS has no corporate views. Any opinions expressed are those of the named authors.

# 1 Introduction

The 1988 Budget promises to be the most interesting for many years. It is also the hardest to predict. The scope for action, both for macro-economic policy and for tax reform, has rarely been wider.

Budgetary options were narrowed in the 1980s with the adoption of the Medium-Term Financial Strategy (MTFS), which aimed to reduce the role of discretionary "demand management". By setting out medium-term guidelines for the public sector borrowing requirement (PSBR), the MTFS took away the fun of double-guessing the Chancellor's "Budget judgement" – the overall change to taxes and public spending that used to be determined by the state of the macro-economy. That was laid down in advance, in the so-called "fiscal adjustment".

But last year, as the Budget season approached, it became clear that revenues were way above forecast. The Chancellor had to decide how to use his extra room for manoeuvre, whether to spend it on vote-winning tax cuts or use it to reduce borrowing. That choice was the main item of interest in what was otherwise a very tightly constrained Budget. So late in the Parliament, many options had already been explicitly ruled out and with the election looming, many others were "politically impossible".

This year we are witnessing another surge in revenues, and so for the second year in a row the Chancellor has considerable discretion over the level of the PSBR he announces in March. The inaccuracy of the two-year-ahead revenue forecasts has restored the "Budget judgement". Moreover, the decision about the PSBR will certainly be influenced by old-fashioned considerations like the state of aggregate demand: does the economy need boosting after last October's financial crash or restraining in response to the inflation risk?

In addition to this new-found room for manoeuvre on the overall size of his Budget package, the Chancellor also has considerable discretion over its composition. Major reforms, which affect many voters and make the losers unhappy, are generally judged more kindly in the history books than at the ballot-box. They are therefore more likely when the next election is a long way off. Thus it was in his first Budget that Sir Geoffrey Howe enacted a major switch from direct to indirect taxation. And it was in *his* first Budget that Mr Lawson introduced a major reform of corporation tax.

These precedents, together with the buoyancy of tax revenue, have raised expectations about the 1988 Budget. It is widely believed that Mr Lawson will wish to crown his achievements with a reform of personal taxation. But the revenue costs of enacting such a reform in a way which minimises the number of losers may be unacceptable given his macro-economic objectives. It is Mr Lawson himself, prudent housekeeper, inflation-fighter, and architect of the MTFS, who may yet prove the main obstacle in the path of Mr Lawson, the tax-reforming Chancellor with an eye on the history books.

In this Green Budget we look at the revenue background and assess how much the Chancellor might have to spend. We review the macro-economic forecasts in order to judge whether the economy needs boosting or restraining. We thus arrive at a view about the global constraints on any package. We then consider in detail a number of tax reform options that we regard as genuine political possibilities for March.

## 2 The Economic Background

### 2.1 Economic Prospects

#### The world economy

OECD forecast Many of the most significant risks now confronting the Chancellor stem from the world economy, the outlook for which is genuinely more uncertain than usual. Although the 1987 Budget forecast of 2.5% real GNP growth and 2.75% inflation for the major economies looks likely to be approximately correct for last year, this out-turn hides a multitude of unexpected events. For example, the sudden pick-up in world activity around mid-year, especially in continental Europe, probably came as a surprise, as did the firmness of commodity prices and global bond yields over the summer and autumn months. More important, the collapse in worldwide equity prices, and the subsequent renewed weakness in the dollar, imparted major shocks to the world system, and their eventual impact is still far from clear. The OECD calculates that the drop in equity prices may depress real GNP in the developed economies by around 1% in the next two years, much of which would take effect in the second half of 1988.

Table 1. Forecasts for the World Economy

(% change from previous year)	1986	1987	1988	1989
<b>OECD Real GNP</b>				
HMT	2.8	2.5	2.0	-
OECD	2.8	2.8	2.3	1.8
Goldman Sachs	2.6	2.8	1.5	-
<b>OECD Consumer Prices</b>				
HMT	2.0	2.8	2.8	-
OECD	2.9	3.5	3.8	3.5
Goldman Sachs	1.9	2.7	3.5	-
<b>UK Export Markets</b>				
HMT	4.8	3.5	3.5	-
OECD	3.5	4.5	4.5	3.8
Goldman Sachs	6.3	4.0	3.0	-

Sources:

HMT - Her Majesty's Treasury, Autumn Statement, November 1987.

OECD - Economic Outlook, December 1987.

Goldman Sachs - UK Economics Analyst, December 1987/January 1988.

Notes:

Goldman Sachs and HM Treasury figures for GNP and inflation relate to major 7 only.

OECD inflation forecasts relate to consumers' expenditure deflators.

HMT figures for world trade are not weighted by UK shares; OECD figures relate to manufactures only.



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However, revisions to previous OECD forecasts for world activity have been less than is implied by this figure, partly because global monetary conditions have been eased and partly because the momentum of the major economies in the second half of last year was significantly greater than expected earlier. Hence, the OECD still expects real GNP in the developed world to be up by 2.3% this year, somewhat more than the forecast published by the Treasury last November.

**Downside risks** The Chancellor is probably aware, however, that the variance around these relatively sanguine forecasts is substantial. Some observers believe that the negative effects of Black Monday on the American consumer, and knock-on effects to inventories and capital formation in the US, may be greater than estimated by the OECD. In consequence, OECD GNP may grow significantly less rapidly than forecast by the Treasury, even if an outright global recession seems somewhat improbable. A further risk is that equity markets and/or the US dollar will suffer further precipitous falls, depressing world activity relative to the consensus forecast. (A lower US dollar does not necessarily have this effect, but probably would do so if the fall became uncontrolled.)

**Implication for UK policy** Risks from the world economy may therefore be skewed towards lower rather than higher activity levels. But the problem for Mr Lawson is that the correct UK policy response to a sharper-than-expected global slow-down is far from clear. UK activity already seems unusually high relative to that in similar economies, and any widening of the gap which developed in 1987 threatens to lead to a deteriorating UK balance of payments deficit, unless offset by a depreciation in the real exchange rate – something which is ruled out by both the Chancellor and the Governor of the Bank of England at present. Although the UK's sustainable growth rate relative to the OECD average has undoubtedly risen sharply during the 1980s, any cyclical slow-down in the world, starting from the present position, would need to be matched to some extent in the UK. It would be one thing for the UK to join in a concerted fiscal expansion by the G7 countries outside the US; it would be quite another for the UK to act alone to avoid a cyclical slow-down. The UK balance of payments is in too fragile a state to permit such a luxury.

Overall, therefore, the rather sluggish world background does not necessarily argue for a more expansionary fiscal stance at this juncture. It does, however, suggest that there should be a willingness to act with other countries if global activity later deteriorates. Given the modern aversion to mid-year "mini-Budgets" in the UK, the timing of any fiscal response could prove difficult, though the Chancellor would certainly wish to allow the automatic fiscal stabilisers to work in full under such circumstances, and he is likely to make this clear in the Budget speech.

### Domestic considerations

If the global background is fragile, what about the domestic picture? Here, there seems little doubt that domestic demand has recently been growing too fast for comfort, despite vastly improved supply-side responses in the UK. But the Chancellor will need to consider whether this is likely to continue before setting his budgetary policy for 1988/89.

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**Recent developments** Recent indicators are inconclusive. CBI survey data have remained encouraging since the equity crash, especially on investment intentions, and the labour market still seems to be tightening. Manufacturing output has been growing at 6–7% annualised rates since last summer, with retail sales volumes rising slightly faster than this. Consumer credit growth may have peaked out around mid-1987, but the total outstanding is still almost 20% higher than a year ago, and the savings ratio fell to a 20-year low of 5% in 1987Q3, only half the 1983/84 average. Several indicators of activity relating to the two months immediately after the stock market crash (including industrial production, retail sales volume and unfilled vacancies) suggest that a mild set-back to economic activity may have taken place in November/December, but it is far too early to judge the importance of this.

**Domestic demand** Most of the major forecasters (including the Treasury in the Autumn Statement – see Table 2) expect domestic demand growth to remain very buoyant in the 1988 calendar year. The consumer is still benefiting from unusually rapid growth in pre-tax real incomes. Average earnings are widely expected to go on growing at around 8% p.a., and employment is still increasing. With consumer prices generally predicted to rise by no more than 4% in the present calendar year, real incomes may gain by 3–4% even before allowing for tax cuts.

The likely behaviour of the savings ratio is more problematic, in view of the cut in personal sector financial wealth implied by the equity crash. The National Institute and Goldman Sachs have both calculated that, in the long run, this may increase savings (and depress consumption) by around one percentage point, but have argued that the first year effect (0.3%) may be entirely offset by recent cuts in interest rates. So although real consumption growth may slow compared with its 1986/87 rates, most forecasts still predict expansion of 3.5% or more this year, which could still be above long-term sustainable rates. There is also a high degree of confidence among forecasters that the sharp pick-up in private investment observed during 1987 will be maintained this year, especially in manufacturing, and this is backed by survey data. Overall, domestic demand is thought likely to grow by 4% or more in 1988.

**Net trade** It is true that some slow-down in the pace of domestic demand growth is expected to take place through the year, but this will probably not be enough to prevent a further worsening in net trade volumes. In 1987, export volume (of goods and services) rose by around 5.5%. This was about 1 percentage point slower than import growth, and the gap between the growth rates of the two series grew from zero in the first half of the year to 2 percentage points in the second half. The current account of the balance of payments therefore deteriorated from approximate balance in the first half of 1987 to a deficit of around £2–2.5bn in the second half (if the official statistics are to be believed). The sterling exchange rate index in early 1988 was around 7% higher than in the second half of 1986, and the associated loss of competitiveness (which has been fractionally greater) does now seem to be dampening export orders. Virtually all of the major forecasters are expecting the gap between export growth and import growth to widen this year to 3 percentage points or more, and a further trend deterioration in the current account deficit is generally predicted (see Table 3), though the recent strength of sterling against the dollar could mask this by depressing import prices early in the year.

Table 2. Demand Prospects

Annual % change, volume	1986	1987	1988
<b>Private Consumption</b>			
HMT	5.8	4.8	4.1
LBS	5.8	4.0	3.9
NIESR	5.8	4.9	3.5
Goldman Sachs	5.8	4.9	3.5
<b>Total Fixed Investment</b>			
HMT	0.3	5.4	4.5
LBS	0.3	6.0	6.4
NIESR	0.3	3.9	3.8
Goldman Sachs	0.3	3.5	4.9
<b>Exports Goods/Services</b>			
HMT	3.1	5.5	2.1
LBS	3.1	5.4	3.9
NIESR	3.1	5.3	3.4
Goldman Sachs	3.1	5.9	3.0
<b>Imports Goods/Services</b>			
HMT	6.2	6.5	5.1
LBS	6.2	6.5	6.5
NIESR	6.2	6.5	6.7
Goldman Sachs	6.2	7.1	6.7
<b>Real GDP</b>			
HMT	3.1	4.0	2.8
LBS <sup>a</sup>	3.1	3.7	2.2
NIESR	3.1	4.0	2.4
Goldman Sachs <sup>a</sup>	3.1	4.4	3.3

<sup>a</sup> Output - based.

Sources:

HMT and Goldman Sachs - as Table 1.

LBS - The Outlook for 1988, Forecast Release, November 1987.

NIESR - Economic Review, November 1987.

**Output** The general picture this year therefore seems likely to involve strong growth in domestic demand, slowing slightly through the year, along with a significant worsening in net trade. The combination of these events is expected progressively to cut the rate of real GDP growth during the forecast period. Recent official statistics have been dogged by large discrepancies between expenditure, income and output estimates of GDP which complicate interpretation of events and have probably resulted in the average estimate of GDP understating the true rate of growth in the economy. Nevertheless, even in terms of this estimate, the 12-month rate of economic growth in 1987Q3 was recorded as 5.2%; this may, on past evidence, be revised upwards by perhaps 1 percentage point. No-one expects such growth rates to be maintained this year. The consensus view is for 12-month growth to slow from around 3-3.5% in the first half of this year to 2-2.5% by the second half. (Growth in the non-oil economy would be about 0.5 percentage points higher than this.) Unemployment should continue to fall for much of the year if these projections

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prove accurate, but at a decreasing rate. There is no clear consensus about prospects for 1989, though several forecasters expect a further slow-down, while none expect any acceleration in growth.

**Inflation** Turning to inflation, the Treasury's 1987 Budget forecast (4%) was almost exactly correct for the fourth quarter out-turn. Recent cuts in mortgage rates and petrol prices may reduce retail price inflation below 3.5% in the early months of 1988, but the forecasting range for the year-end is quite wide, with the LBS predicting only 3.6% and NIESR expecting 4.9%. The underlying rate of average earnings increases has risen to 8.25% in November, and basic pay deals appear to be running some 0.5-1 percentage points higher than a year ago. With productivity growth likely to slow from the cyclically-high rates recorded in 1987, unit labour costs in the whole economy could rise by around 5% or more this year. Many forecasters expect the GDP deflator (which is unaffected by mortgage rates or import prices, both of which will be tending to hold down retail prices) to rise by more than 5.5% in 1988/89, compared with the Treasury's forecast of 4.5%. It must be said, however, that there has been a tendency for outside forecasters to be too pessimistic about inflation trends for some years, and that the Treasury's relative optimism has generally been well founded.

**Table 3. Other Key Indicators**

	1986Q4	1987Q4	1988Q4
<b>Price Inflation (%)</b>			
HMT	3.4	4.0	4.5
LBS	3.4	4.1	3.6
NIESR	3.4	4.1	4.9
Goldman Sachs	3.4	4.0	4.0
<b>Current Account (£bn)</b>			
HMT	-1.0	-2.5	-3.5
LBS	-1.0	-1.8	-2.6
NIESR	-1.0	-1.6	-2.8
Goldman Sachs	-1.0	-1.7	-3.6
<b>Unemployment (million)</b>			
NIESR	3.1	2.7	2.6
Goldman Sachs	3.1	2.7	2.5
LBS	3.1	2.7	2.7

Sources:

As Table 2, except for LBS unemployment (October forecast).

## 2.2 Policy Aims

### Avoiding excess demand

**Nominal GDP targets** The Chancellor's underlying policy objective is presumably to keep the economy growing fast enough to secure further reduction in unemployment, while preventing it from "overheating". In the formal language of the MTFs, "overheating" should be related to the nominal GDP forecasts, since overall macro-economic policy is (officially) now set so as to achieve a desired path for this aggregate. (The output/prices split is not thought to be amenable to measures on the demand side of government policy.) Any major deviations from the GDP path are theoretically offset by expansionary or contractionary shifts in fiscal and/or monetary policy – the mix has never been made clear. Nor is it clear whether, in practice, the Government is pursuing objectives for nominal GDP or, more simply, for price inflation. In 1987/88, nominal GDP growth will overshoot its forecast growth by at least 1 percentage point, but this has not yet resulted in any tightening in macro-policy, and does not appear to concern the Chancellor. This is because almost all the increase in money GDP has come through higher output growth, rather than higher inflation. The policy response would probably be very different if inflation threatened to rise.

**Asymmetric risk** Although the Government has officially abjured short-term "demand management" – at least when it is a question of managing demand upward – it is keenly aware of the inflationary dangers of allowing the economy to run at an excessive pressure of demand. Its willingness to contemplate a touch on the brakes – when it has been so unwilling to use (or at least take credit for using) the accelerator – reflects the asymmetrical consequences of policy error when the economy is close to full capacity. If the economy is now over-extended, the consequent rise in inflation could take years to eradicate. On the other hand, if domestic demand growth slows more than expected this year, policy can later be eased without much irrevocable damage being caused.

**Consequences of excess demand** Preoccupation with the dangers of excess demand is a reaction to the events of the 1970s. The now-infamous Heath-Barber boom, and the ill-fated attempt by Mr Healey to plug the demand gap caused by the first oil price shock, caused the economy to run at a high demand pressure from 1972 to 1974. That experience suggests that excess demand is first met from abroad, and leads to a balance of payments deficit. Second, if demand remains strong and the deficit persists, it becomes increasingly hard to finance, so the exchange rate falls and interest rates rise. If, third, demand continues to expand despite these signals, the fall in the exchange rate generates inflation. The general lesson is that if policy is too expansionary, the economy's own corrective mechanisms are called into play, with increasingly unwelcome consequences. The denouement of the Barber-Healey episode was the 1975 recession, which showed the previously underestimated contractionary power of rapid inflation and took unemployment to a (then) record post-war high.

**Growth potential** There is now fairly wide agreement about the unpleasant consequences of hitting the supply-side limits. But how close really are we to the precipice? In giving evidence to the Treasury Select Committee in December, the Chancellor said that the long-term trend rate of growth in the UK economy may now be around 3% p.a., not dissimilar from the growth rate achieved from 1964 to 1973. If this is true, then recent rates of GDP growth, and predicted growth

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rates in domestic demand this year, are not indefinitely sustainable. Certainly, few believe that the non-oil economy is capable of expanding at the 5% rate experienced in 1987 for very long without this causing problems with inflation and/or the balance of payments (depending on exchange rate policy). The contribution of net trade to total demand is already falling and the main reason for the probable slowing in GDP growth as 1988 progresses is a further deterioration which would be made worse by an unexpected global slow-down. Under such circumstances, unilateral attempts by UK fiscal policy to buck the international trend could, like Mr Healey's efforts in 1974 (and those of M. Mitterrand in 1981), cause problems.

**Comparison with 1972-73** However, the parallels between the present situation and 1972-73 should not be stretched too far. Although cumulative GDP growth of 10% in 1972-73 was only a little faster than in 1986-87 (after allowing for likely data revisions), there were much clearer signs of overheating in the earlier period.

Table 4. Comparisons between 1972-73 and 1986-87

	1972	1973	1986	1987(est)
<b>Calendar year growth (%)<sup>a</sup></b>				
Consumption	6.1	5.1	5.8	4.9
Investment	-0.3	6.5	0.3	3.5
Public Consumption	4.2	4.3	0.9	-0.1
Stockbuilding <sup>b</sup>	-0.3	2.9	0.0	0.0
Exports	0.9	11.7	3.1	5.9
Imports	9.7	11.8	6.2	7.1
Real GDP	2.6	7.3	3.1	4.1
Manufacturing Production	2.2	9.3	1.0	5.2
<b>To fourth quarter (%)</b>				
Retail Prices	7.7	10.4	3.4	4.0
Average Earnings	15.5	12.5	7.7	8.0
M3	27.7	27.1	19.2	21.3
M0	10.7	11.4	5.2	4.9
<b>As % of GDP</b>				
Current Account	0.3	-1.4	-0.3	-0.6
Public Sector Financial Deficit <sup>c</sup>	3.2	4.7	2.5	1.0

<sup>a</sup> At 1980 prices.

<sup>b</sup> Change as % of GDP.

<sup>c</sup> Financial years.

Imports rose by over 20% in the two years, compared with 13% in 1986-87, and very large differences can be seen on price inflation and earnings growth between the two periods, despite the operation of a statutory pay and prices policy under the Heath Government. Furthermore, both fiscal and monetary policy were more expansionary during the 1972-73 episode: the most telling difference is in public consumption, which grew by over 4% p.a. in the earlier period compared with less than 1% p.a. recently. In consequence the fiscal deficit increased by 1.5% of GDP despite above-trend growth. The 1972-73 débâcle was therefore caused by a much greater policy boost than we have seen

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in 1986-87, coming at a time when the economy's supply response was generally weaker and under more initial strain than at the start of the present growth surge.

### Controlling the money supply

This Government has always attached great importance to the control of inflation, which is why the prospect of excess demand is now of major concern. Up to now, the key intermediate target in the counter-inflationary strategy has been the money supply. Monetary targets lay at the heart of the first MTFS. What will be their role in the MTFS for the Third Term?

**Monetary overshooting** Their importance currently appears to have been severely downgraded. Sterling M3 has expanded by 20-25% over the past years and even the hitherto well-behaved M0 has accelerated towards the top of its 2-6% target range. Both have been signalling the need to tighten policy for some time. Yet interest rates have been coming down, partly to stop the exchange rate breaching its informal ceiling against the Deutsche Mark, and partly to forestall a financial panic in the wake of the stock market crash.

Some of the excuses for too-rapid monetary growth are wearing thin. One argument was that we have been witnessing a stock adjustment: liquid balances become more attractive when inflation falls. So the fall leads to a once-for-all increase in the stock of money holdings, which implies a period of rapid monetary growth. However, inflation has been fairly stable since 1983, so the stock adjustment should surely be over by now, yet monetary growth remains rapid. Another explanation for the recent rapid monetary growth is that people whose stocks and shares and houses have increased in value also want to hold more cash. If that is so, we should now expect a flight from money in the wake of the stock market crash. Yet sterling M3 continues to expand. Where will those presumably now unwanted liquid balances go?

**Need to curb borrowing** That question points up the central worry, which is the continuing buoyancy of borrowing. Last year much of that borrowed money found its way onto the stock market and the housing market. The risk this year is that more spills over into the market for real goods and services and pushes up prices. The "melting glacier" of liquidity could thus add to the already strong demand pressures in the economy.

**New monetary targets** Curbing total borrowing via higher interest rates is ruled out as long as the exchange rate remains strong. The alternative is to offset high private borrowing by reducing public borrowing. The effect on inflationary expectations of lowering the PSBR target would be reinforced by the announcement of a new set of monetary targets. The well-behaved M0 will probably be retained, but the first Budget of a new Parliament is probably the right moment to abandon the now-discredited sterling M3 target. The deregulation of financial markets makes the distinction between clearing-banks and other financial institutions - notably building societies - increasingly artificial. It would therefore be sensible to adopt the widest possible definition of "money" - M4 or M5 - for the broad money target.

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### Increasing supply

Avoiding the problems of excess demand is not the only aim of policy, and restricting total demand is not the only way of pursuing it. The Budget is the occasion for the Chancellor's annual review of the mix of fiscal and monetary policy. It is also his opportunity to improve the supply side of the economy.

**Incentives** In the 1960s, tackling the supply side meant measures to boost investment. In the 1970s, the focus was on getting the exchange rate down to improve competitiveness. In the 1980s, "supply-siders" are famous for advocating tax cuts, deregulation and competition. Mr Lawson is a modern supply-sider whose main strategic aim is tax cuts to improve incentives (he also probably favours more competition, but that is not primarily a matter for the Treasury, which will continue to be as concerned by the revenue raised by privatisation as by the competition engendered by it.) But though the Chancellor rejects 1960s "growthmanship" - e.g. special investment incentives - he would like to encourage capital formation via lower interest rates. And though he regards the exchange rate as the first defence against inflation rather than as an instrument for improving competitiveness, he does not want it to go higher at present.

**Policy mix** These considerations suggest that if the overall stance of policy is to be more restrictive than in the past two years, so as to encourage some slow-down in domestic demand, the tightening should not occur via monetary policy, since that would induce the real exchange rate to rise. Tighter fiscal policy might be preferable. Second, measures should be preferred which tend to increase investment at the expense of consumption, since this will, in the longer term, increase supply relative to demand. Again, a tighter fiscal/looser monetary policy might be indicated (to get interest rates down), unless public investment is to be specifically boosted. (The 1988 Public Expenditure White Paper shows public sector capital formation flat or falling over the medium term.) Third, there might be a case for preferring those fiscal measures that have a low domestic demand weight but a high tendency to reduce domestic costs, so that competitiveness can be assisted. Such measures will be discussed later.

### Hitting MTFS targets

**The MTFS** Although the balance of supply and demand for real goods and services will certainly be an important consideration for the Chancellor in framing his Budget, it will not be presented that way. That sort of old-fashioned Budget judgement was formally made redundant by the adoption of the Medium-Term Financial Strategy. The purpose of the Strategy was to make room for tax cuts and lower borrowing by steady reductions in public spending (absolute reductions in the first instance, now relaxed to a falling share of GDP). The key supply-side aims of improving incentives and getting long-term interest rates down were therefore built into the Strategy itself.

To pursue these aims the Chancellor should in principle simply stick to the MTFS targets, in which case the size of the Budget give-away is predetermined by the identity:

$$\begin{aligned} \text{Change in taxes} &= \text{Forecast revenue} \\ &+ \text{Announced borrowing} \\ &- \text{Planned spending.} \end{aligned}$$



## The Economic Background

Since the spending plans are announced (in cash terms) in the White Paper, and the borrowing targets are laid down in previous Budgets, the scope for tax cuts depends crucially on the revenue forecasts.

**PSBR guidelines** In practice the link is not as tight as all that. The PSBR figures are only "guidelines" and can be changed. Last year saw a massive overshoot in revenue which posed a dilemma for the Chancellor. Should he stick with the MTFS guidelines and give away the extra revenue, at the risk of over-stimulating the economy? Or should he let demand management objectives override the MTFS and face charges of inconsistency? He chose the latter course – rightly, it turns out, given the subsequent buoyancy of demand – and faced with a similar dilemma this year he may do the same again. The first Budget of a new term is an obvious opportunity to set new MTFS guidelines, tailored to the prevailing circumstances.

**Return of fiscal activism** This illustrates the tensions that exist in any attempt to set medium-term objectives for intermediate variables such as the PSBR. If underlying economic circumstances change, then the Chancellor must choose whether to accept, or attempt to offset, the consequences for the PSBR. The original MTFS in 1980 was imposed against a background in which most shocks had been inflationary; in fact, negative supply-side shocks, causing both higher inflation and reduced output, seemed endemic in the UK. The idea of imposing a rigid fiscal strait-jacket in nominal terms was to make it clear that the Government would no longer accommodate inflationary shocks and, by so doing, it was hoped to lessen the likelihood of such shocks occurring (especially in the labour market).

The situation in the 1980s has been radically different. Most surprises have been pleasant, involving both higher output and lower inflation than expected. These have tended to reduce the PSBR relative to plans. The Government has seen no reason to offset these PSBR changes fully (by cutting taxes or raising public spending) since demand has usually seemed adequate to ensure that the economy could take full advantage of its supply-created opportunities. Hence the PSBR has fallen, and existing medium-term targets have been declared redundant. This has gradually created a situation in which the Chancellor has had more room to manoeuvre from year to year, since the battle to control the upward march of inflation and public borrowing no longer needs to take priority.

The success of the MTFS has, paradoxically, enabled policy activism to return to the Treasury's agenda. Whatever may be said in public, the Chancellor now clearly forms a judgement on the short-term state of the economy before setting his PSBR targets from year to year. However, the fact that the MTFS can be overruled does not mean it has been totally abandoned. Government revenues are still perhaps the most important single factor determining how much the Chancellor decides to spend in March. For that reason we analyse them in considerable detail, and it is to that analysis we now turn.

## 2.3 The Government's Financial Position

### The accounting framework

The Medium - Term Financial Strategy brings together medium - term *forecasts* of revenue, medium - term *plans* for public spending (in cash terms) and medium term *guidelines* for public borrowing. To the extent that planned spending is less than the sum of forecast revenue and permitted borrowing, there is scope for tax cuts (or extra spending). This room for manoeuvre is the so - called fiscal adjustment. The fourth column of Table 5 shows the derivation of the fiscal adjustment of £3bn for 1988/89 in the 1987 Budget.

Table 5. Calculating the Fiscal Adjustment

£bn	1987/88			1988/89		
	Budget projection	Autumn Statement	IFS estimate	Budget projection	Autumn Statement	IFS estimate
General govt. receipts	169	171	173	178	178	187
<i>plus</i> General govt. borrowing <sup>a</sup>	5	2	0	5	5	5
<i>equals</i> Available to spend	174	173	173	183	183	193
<i>less</i> Planned spending	174	173	173	180	183 <sup>b</sup>	183
<i>equals</i> Fiscal adjustment	0	0	0	3	0	9

<sup>a</sup> The PSBR is officially estimated at £1bn less than the general government borrowing requirement.

<sup>b</sup> Planning total for 1988/89 revised upwards by £3.3bn in Autumn Statement.

**Official forecasts** If nothing had changed since March 1987, that £3bn would be the figure available for tax cuts or spending increases at the March 1988 Budget. However, a year is a long time in fiscal affairs (especially when it is an election year) and every element in Table 5 has changed. On the spending side, the Government announced a new set of plans last November, increasing the planning total by over £3bn. In principle this has completely used up the fiscal adjustment previously available for 1988/89, as the fifth column of Table 5 shows.

However, this is far from the end of the story. On the revenue side, recent receipts data suggest that the official projections were too low, and the fiscal consequence for the current year is recognised in the Autumn Statement by an official £3bn reduction in the PSBR projection (for 1987/88) (Table 5, column 2). This could well signal a similar downward revision to the PSBR announced for 1988/89 in the coming Budget.

Table 6. Revenue and Expenditure Forecast

£ bn	1987/88 Budget forecast	IFS estimate	1988/89 % change	IFS estimate
<b>RECEIPTS</b>				
Income tax	39.9	42.0	13.3	47.6
NI contributions	28.5	29.0	9.7	31.8
On-shore corporation tax	13.5	14.5	4.1	15.1
<i>of which</i> MCT		10.4	4.8	10.9
ACT		4.1	2.4	4.2
Capital taxes	3.3	3.3	12.1	3.7
<b>Taxes on income &amp; capital</b>	<b>85.3</b>	<b>88.8</b>	<b>10.6</b>	<b>98.2</b>
VAT	23.3	23.7	9.3	25.9
Local authority rates	16.9	16.9	8.3	18.3
Petrol, derv etc.	7.8	7.8	7.7	8.4
Alcohol	4.3	4.4	9.1	4.8
Tobacco	4.9	4.9	4.1	5.1
Stamp duties	2.1	2.2	4.5	2.3
Other	8.5	8.7	6.9	9.3
<b>Taxes on expenditure</b>	<b>67.8</b>	<b>68.6</b>	<b>8.0</b>	<b>74.1</b>
North Sea corporation tax	1.4	1.3	-46.2	0.7
Petroleum revenue tax	1.7	2.0	5.0	2.1
Oil royalties	0.8	0.9	-22.2	0.7
<b>Total North Sea</b>	<b>3.9</b>	<b>4.2</b>	<b>-16.7</b>	<b>3.5</b>
Adjustments	-0.8	-1.0		-0.6
Interest & dividends	5.7	5.6		5.5
Gross trading surplus & rent	3.3	3.3		3.1
Other	3.5	3.4		3.4
<b>General government receipts</b>	<b>168.8</b>	<b>172.9</b>	<b>8.3</b>	<b>187.2</b>
<b>EXPENDITURE</b>				
Total departmental spending	150.1	151.7	4.4	158.3
Privatisation proceeds	-5.0	-5.0		-5.0
Reserve	3.5	0.6		3.5
<b>Public expenditure planning total</b>	<b>148.6</b>	<b>147.3</b>	<b>6.4</b>	<b>156.8</b>
Gen govt debt interest	17.9	17.8		18.0
LESS pub corps borrowing	-0.8	-0.7		-1.0
Nat a/cs adjustment	6.2	6.8		7.2
<b>General government expenditure</b>	<b>173.5</b>	<b>172.6</b>	<b>6.0</b>	<b>183.0</b>
<b>BORROWING</b>				
Gen govt borrowing reqt	4.7	-0.3		-4.2
Pub corps borrowing	-0.8	-0.7		-1.0
<b>Public sector borrowing requirement</b>	<b>3.9</b>	<b>-1.0</b>		<b>-5.2</b>

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### Revenue and expenditure forecasts for 1988/89

**IFS estimates** The size of such a revision depends above all on the prospects for public revenues. Our calculations suggest that the last published official forecast of £178bn (made at the time of the 1987 Budget) *understates probable revenues by at least £9bn*. If this is the case, then (since the previously forecast fiscal adjustment has been absorbed by extra public spending) this is the sum of money that the Chancellor will have to play with at Budget time.

**Current year out - turn** Perhaps the simplest justification for the superficially startling assertion that revenues have been underestimated by £9bn is that the out - turn for the current year has proved so much higher than expected and, all things being equal, this revision carries over into future years. We also believe the Government has seriously underestimated the rate of growth of non - oil revenue in 1988. In general, revenues should grow faster than nominal GDP. Last year the Government inexplicably forecast *slower* growth in revenue than in GDP for 1988/89. In the event, GDP has grown faster than expected and tax has accordingly grown faster still, as Table 6 shows.

On our estimates, revenue rises by over 8 per cent next year from a base which we estimate to be £4bn higher than the Budget projection. Very broadly, therefore, half of the extra revenue comes from the already largely admitted upwards revision to the base, and half from higher - than - forecast growth. (See Appendix 1 for further details.)

**Official underestimate of revenue** It is worth noting in passing how very conservative the official revenue projections have been over the past two years. Table 7 shows the successive upward revisions to the official forecasts for 1987/88 and 1988/89. The official response to each overshoot has been to raise the revenue projections for future years, but not always by as much as the base. In fact in both the 1986 and the 1987 Budget the forecast *growth* of revenue in year 2 was *reduced*, even though the nominal GDP growth forecast was raised. In this context, the fact that revenue growth looks like turning out nearly 3 per cent higher than forecast, worth £5bn in extra revenue, is not entirely surprising.

Table 7. Non - Oil Revenues and Nominal GDP

Forecast made in:	1987/88			1988/89		
	£bn	Revenue % growth	GDP % growth	£bn	Revenue % growth	GDP % growth
Budget 1984	155.0	5.4	5.7	163.0	5.2	5.2
Budget 1985	158.5	7.5	5.7	167.0	5.4	5.0
Budget 1986	160.0	7.0	6.5	170.0	6.2	6.0
Budget 1987	165.0	7.1	7.5	174.0	5.4	6.5

**Expenditure forecasts** On the expenditure side of the accounts, we rely heavily on the Government's own figures, which we review briefly in Appendix 2. Although the Government has increased its spending *plans* for 1988/89, there is little evidence of loss of control. Indeed *this* year's spending total was revised down in the Autumn Statement, and again in the White Paper. So despite continuing worries about the buoyancy of public sector pay, we have accepted the official estimates for 1988/89 – the reserve of £3.5bn should be adequate to cover the likely wage drift. However, the political pressure for more spending on the National Health Service may result in further raids on the contingency reserve and this could be a further argument for fiscal caution.

**Borrowing requirement for 1988/89**

**PSBR target** From the revenue and expenditure estimates discussed above we can, in principle, put together the summary of the public finances with which the Government usually concludes its review of the MTFS. To do this we need a target for the PSBR. Although we have the £4bn target announced last year, the authorities are unlikely in practice to stick to this. For reasons which we discuss below, they will probably wish to announce a lower figure – and the bottom of the range could be as low as –£2bn (i.e. a budget surplus, or debt repayment, of £2bn). So, as Table 8 shows, the fiscal adjustment could lie anywhere in the range £3–9bn, depending on what PSBR target is adopted.

Table 8. Limiting Options for Public Finances in 1988/89

	£bn	£bn
PSBR target	4	–2
<i>plus</i>		
Public corporations' market and overseas borrowing	1	1
<i>plus</i>		
Forecast general government receipts	187	187
<i>equals</i>		
Available to spend	192	186
<i>less</i>		
Forecast general government expenditure	183	183
<i>equals</i>		
Scope for extra spending on tax cuts (fiscal adjustment)	9	3

To make matters worse, the revenue figures are themselves subject to a wide margin of error. To illustrate the full range of possibilities, we conclude this discussion of the Government's financial position with a table which sets out four possible figures for the PSBR target and a £3bn range of revenue outcomes. As a matter of simple arithmetic, it follows that the fiscal adjustment could lie in a £2–11bn range – though the outcomes are more densely clustered in the £5–7bn range and this accurately reflects their greater probability.

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The Chancellor is unlikely to announce a £4bn target if revenues are very buoyant, or a -£2bn target if they are at the lower end of the range. He will in practice choose the fiscal adjustment which best meets all his objectives and then arrange the revenue projections and PSBR target accordingly. We turn in the next section to the difficult but interesting task of deciding what that announced fiscal adjustment might be.

Table 9. Illustrative Ranges for the Fiscal Adjustment (£bn)

Forecast receipts	Announced PSBR			
	4 <sup>a</sup>	1 <sup>b</sup>	0 <sup>c</sup>	-2 <sup>d</sup>
	Fiscal adjustment			
186	8	5	4	2
187	9	6	5	3
188	10	7	6	4
189	11	8	7	5

<sup>a</sup> Current official target for 1988/89.

<sup>b</sup> Current official forecast for 1987/88.

<sup>c</sup> "Balanced budget".

<sup>d</sup> Likely out-turn for 1987/88.

# 3 The Budget Strategy

## 3.1 Choosing the PSBR Target

### The case for fiscal prudence

In deciding how large a PSBR to announce for 1988/89, the Chancellor will seek to balance the demands of tax reform, which are easier to implement in the context of overall tax cuts, against the continuing need for fiscal prudence to combat the risk of inflationary overheating.

**A lower PSBR** To avoid the risk of overheating in an election year, the Chancellor last March used half of his extra revenue to reduce the PSBR. And in the Autumn Statement he explicitly revised down his PSBR projection for the current year. Since the Chancellor generally announces at Budget time a PSBR target for the coming year that is generally lower than the estimate of the PSBR for the year just ending (see Table 10), it must now be considered very unlikely that he will stick to the £4bn PSBR for 1988/89 laid down in the MTFs projection. At the very least, we will see a revision down to £1bn to match the latest official estimates of the projected out-turn for 1987/88.

Table 10. The PSBR in Current and Coming Year

Forecast made in	1980	1981	1982	1983	1984	1985	1986	1987
Current year estimate	9.1	13.5	10.6	7.5	10.0	10.5	6.8	4.1
Coming year target	8.5	10.6	9.5	8.2	7.2	7.1	7.1	3.9
Change	-0.6	-2.9	-1.1	+0.7	-2.8	-3.4	+0.3	-0.2

However, there must be a strong chance that the downward revision goes further. The lure of a "balanced budget" is strong to a government of the radical right. A zero PSBR would impress the markets even though the balancing act is only achieved with the help of £5bn of privatisation receipts. If the fiscal arithmetic allows it, the zero option must be a strong runner. But, unfortunately for Mr Lawson, the arithmetic may not prove so convenient. For the reasons discussed above, buoyant revenues may well point to a negative PSBR (i.e. a public sector lending requirement) as the central possibility. What could the Chancellor do under these circumstances?

**Cautious revenue projections** If the experience in recent years is anything to go by, he will be strongly tempted simply to conceal the revenue. Most well-run institutions remain solvent by taking a persistently conservative view of future income, and one should not automatically castigate the Government for doing likewise. The under-forecasting of revenue has proved a very useful addition to the more formal built-in margins for error, such as the contingency reserve and the fiscal adjustment itself. It has helped the Chancellor to stay on course despite the loss of oil revenue in 1986 and the overshoot on the planning total in each of the last two years.

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Perhaps the most helpful way of looking at the issue is to assume that the Chancellor has decided how much he can safely spend. The choice at the margin is then between using the revenue to reduce the PSBR, or not admitting that it is likely to exist. If he admits it, he can impress the financial markets by announcing a very conservative fiscal stance for 1988/89, but he runs a corresponding risk of losing credit in later years if the revenue dries up and he is forced either to raise the PSBR targets or to miss them. The Chancellor's well-known prudence will probably make him inclined to keep some shots in his locker by again taking an extremely conservative view of future revenue.

**A new guideline?** However, the revenues are currently so buoyant that even on the most conservative view it may be necessary to announce a zero or negative PSBR for 1988/89. Under these circumstances the Chancellor would, if he followed his practice of steadily reducing public borrowing, be committed to a medium-term programme of negative PSBRs. This is not unthinkable. As a matter of presentation, the MTFS for the Third Term could be couched in terms of the PSBR excluding privatisation receipts or (much less likely) in terms of the public sector financial deficit, with the aim of reaching a genuinely balanced budget by the 1990s. This approach would imply a strong new commitment to the longer-term objective of zero inflation, of which we have heard rather little recently. But such an approach would make it difficult to implement tax reforms.

It is more likely therefore that the Chancellor will seek a compromise – a conservative estimate of revenues, and a lower PSBR in the short term to reassure the markets. He may also contemplate some easing in the medium term which would enable him to spend more on a phased programme of tax reforms. This would depart from the previous practice of monotonic changes (i.e. only reductions) in the PSBR. But changed circumstances require changed policies.

### Coping with the economic cycle

**Cyclical variations** When inflation was high, the central feature of the MTFS was a medium-term reduction in the PSBR. But superimposed on the trend there are cyclical variations – a modern economy with its many built-in stabilisers produces a more than proportional increase in tax revenue (and some fall in expenditure) in the upswing, and the converse applies in the downswing. The PSBR will thus tend to fall in a boom and rise in a recession. To take account of this, Mr Lawson when Financial Secretary proposed a "stepped" PSBR profile – down in booms, flat in recessions – as an objective for the First Term.<sup>1</sup> In the Second Term no further progress was made in reducing inflation, and growth was so steady that the Chancellor was credited with abolishing the economic cycle. In place of the stepped profile, we had the steppes of Russia – flat as far as the eye could see.

But the Third Term already looks quite different. The economy is clearly in the middle of a major boom and the current growth rate may not be indefinitely sustainable. The so-called imbalances in the world economy, and the associated fragility of financial markets, threaten a period of below-trend growth, some

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<sup>1</sup> Financial Times Euromarkets Conference, January 1980.



time in the not-too-distant future. This will inevitably affect revenues. The new MTFs to be announced in March will need to take account of this contingency.

**A supply-led boom?** The immediate question is whether to use the extra revenues now being generated to reduce borrowing or to cut taxes. This depends on several elements, of which the most important is whether the economy seems capable of generating this revenue indefinitely. This is most likely if a supply-side gain has taken place, in which case the extra output and tax revenue will not be subsequently lost by a cyclical downturn. In these circumstances, the Chancellor can choose either to reduce the PSBR permanently, or to reduce taxation (also permanently). Either way, there would be no reason to expect the decision to be forcibly reversed in future years.

**Unexpected downturn** However, a cautious Chancellor may want to allow for an unexpected cyclical downturn. The problem that may arise is as follows: expenditure totals have already been set for the next few years, and they have been set so as to reduce expenditure as a proportion of GDP. However, if GDP does not grow as planned, expenditure may end up rising at a faster rate than GDP. Given that tax revenues tend to rise slightly faster than GDP, this extra expenditure can probably be met by increased revenues. However, in an extreme case, expenditure may rise faster than revenues. In particular, the recent Public Expenditure White Paper set out plans for nominal increases in general government expenditure over the next three years of 6.0% (1988/89), 5.6% (1989/90) and 4.6% (1990/91). If nominal revenues rise by less than these amounts, then either the PSBR or taxes would need to be raised. To pre-empt a possible increase in taxation, the Chancellor may be cautious in reducing taxes in 1988, and therefore aim to reduce the PSBR.

**Flexible PSBR targets** This view is reinforced by the arguments in Section 2.1 that, on balance, the acceleration in GDP growth in 1987/88 cannot be entirely explained by supply-side gains, so there is a presumption that a *temporarily*-reduced PSBR should absorb the excess growth shock which has hit the economy. In other words, fiscal policy should be fairly restrictive in 1988/89, but with provision for subsequent relaxation. This provision might take the form of a higher planned PSBR for later years than for 1988/89 but more likely is a repetition of the reassurance that the MTFs "provides as firm a guarantee against inadequate money demand as it does against excessive money demand" (*Financial Statement and Budget Report*, March 1986). We should then expect to see further discretionary changes in the PSBR in later Budgets to cope with the effects of the cycle.

### Demand-light, supply-friendly measures

The macro-economic situation is likely to influence not just the size of the fiscal adjustment, but also the kind of measure adopted. At a time when demand is buoyant and risks hitting supply limits, the Chancellor will be looking for tax measures that are demand-light and supply-friendly. With the deterioration in the balance of payments the most obvious policy problem on the immediate horizon, he will also be looking for ways of reducing the trade deficit and/or making it easy to finance.

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- The rich** The requirement for demand-light ways of disposing of revenue makes it highly likely that this Budget will reform the taxes paid by the better-off. The rich save a high proportion of their income, especially at the margin. So tax give-aways which benefit them, though politically dangerous, are in present circumstances economically safe: pound for pound they are among the tax changes least likely to push demand above capacity limits. On this argument we are likely to see reform of the higher personal tax rates and capital gains taxation featuring prominently in the list of Budget measures.
- The company sector** The requirement for supply-friendly measures points towards the corporate sector. It is companies which make most of the investment decisions that influence the long-run supply capacity of the economy. Moreover, any money given to the corporate sector will certainly not be spent on personal consumption. It will either be saved (demand-light) or invested (supply-friendly). The corporate sector was off-limits for most of the Second Term, while the four-year programme of pre-announced changes was being implemented. But in the first Budget of the new Parliament, the macro-economic arguments could persuade the Chancellor to reduce the corporate tax burden.
- The balance of payments** Balance of payments considerations reinforce all the above arguments. The current weakness is caused by a combination of strong demand and a strong exchange rate. Demand should therefore be reined back via fiscal policy rather than by raising interest rates which would put further upward pressures on the exchange rate. A tighter fiscal/looser monetary policy might also improve the terms on which any deficit is financed, by shifting the pattern of demand from consumption towards investment. Lenders generally look relatively kindly on borrowing that finances investment rather than consumption, and an import bill that is swollen by capital goods is less damaging to international confidence than one boosted by consumer spending. Moreover, if investment was encouraged by channelling money to the corporate sector in a way which cut costs - e.g. by a reduction in employers' National Insurance contributions - there would be a direct benefit to competitiveness which might limit the deterioration in the current account.

### 3.2 Presenting the Budget

**Tax cuts and fiscal prudence** The Budget is always conditioned by the state of the economy. We have argued that the Chancellor will probably want to present the Budget as fiscally neutral or restrictive – at least to the City audience. But he will also want to be seen as a tax-cutting Chancellor. Our fiscal system gives him the chance to meet both these apparently conflicting objectives.

There are two important reasons for this. One is the built-in buoyancy of tax revenues (which occurs for reasons explained in Appendix 1). The other is the planned reduction in public spending as a share of GDP. With taxation rising and spending falling as a share of GDP, there is a structural tendency for the PSBR to fall. Since the MTFS guidelines show an unchanged PSBR, there is always scope for tax cuts (fiscal adjustment) in the official projections. If we define a neutral Budget as one in which the PSBR as a share of GDP is *unchanged* from one year to the next, this implies that the tax cuts shown in the MTFS are also consistent with a neutral fiscal stance: taxes must be "cut" to bring down the otherwise too-buoyant growth of public revenues in line with the planned growth of public spending.

After the battered brief-case has been opened on 15 March, the news headlines will focus on these "cuts". Tax rates will fall, and the Chancellor will stress the supply-side effects on incentives. But he may also wish to stress that he is largely putting back into taxpayers' pockets the money that would otherwise be taken from them by a progressive tax system.

In assessing the thrust of the Budget, tax is only half the story. The financial markets may also be worried by the fact that £3bn of additional public spending has been announced for 1988/89. Although this antedates the Budget, it clearly constitutes an easing of the fiscal stance since last year. To reassure the markets, the Chancellor will stress the fact that the proportion of GDP devoted to public spending is unchanged compared with earlier plans, and down compared with earlier years.

**Lower share of GDP** The year-on-year comparison is perhaps the most interesting. To maintain his reputation for prudence, the Chancellor will certainly wish to show that his Budget is neutral in the sense defined above. He may point out that any reduction in the overall burden of taxation (which will be much smaller than the reduction in tax rates) has been "paid for" by the reduction in the "burden" of public spending – in other words, both taxes and public spending will fall as a share of GDP between 1987 and 1988, implying no fiscal stimulus to aggregate demand.

To meet this objective he will have to announce a PSBR/GDP ratio for 1988/89 equal to the out-turn for 1987/88. We estimate this at –£1bn, but the margin of error is such that a government forecast of zero would be quite credible. If the Budget speech announces a PSBR maintained at that level in 1988/89, then on our calculations tax "cuts" of £4bn will be possible. Anything less would certainly mean a tighter fiscal stance and, if we are right in our revenue projections, even £4bn cuts could result in a fall in public borrowing as a share of GDP over the coming year.

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A **£4bn fiscal adjustment** The merit of the £4bn figure is that it neatly bisects the extra £8bn of revenue which the Government could reveal. Around £1bn of revenue will be concealed, and the Chancellor will be able to claim that half of his windfall has been spent on tax cuts while half has been put away for a rainy day. Our interpretation, based on £9bn of extra revenues, would be slightly different, as shown in Table 11.

**Table 11. Disposing of the Revenue Surplus (£bn)**

Revenue overshoot	9
<i>less</i>	
Estimating margin	1
<i>and</i>	
PSBR reduction	4
<i>leaves</i>	
Available for tax cuts	4

### 3.3 Tax Reform

#### Designing a strategy

**Phased reforms** If the Chancellor goes for a modest fiscal adjustment of only £4bn, does that rule out the chances of introducing a radical reforming Budget? In our view it does not. In the first Budget of a Parliament, it has frequently been pointed out, he might contemplate reforms from which some voters lose. But much more important, in our view, is that he can contemplate a programme of phased reforms. He can reform the *structure* in March 1988, and change the *rates* gradually in succeeding years, tailoring his pursuit of long-term reform objectives to the dictates of the economic cycle. We believe it is by this route, rather than by raising other taxes, that he will implement reforms.

What are likely to be his strategic aims? We can distinguish three major themes:

- Incentives** (1) Mr Lawson clearly takes the view that lowering taxes improves economic performance. There is little evidence either to support or refute this view, but economic theory tells us that it is marginal tax rates, not average rates, which matter. If allowances are also cut, making some people worse off, the incentive structure of the tax system can be further improved at relatively low revenue cost. The 1984 corporation tax reforms were claimed to achieve a similar effect on business activity. We explain in detail in Part 4 how the Chancellor might adopt a similar approach to higher personal tax rates – simplifying and reducing them while reducing the value of allowances by limiting reliefs to the basic rate only.
- Neutrality** (2) Taxes are necessary to raise revenue, but it is important they do so in a way which does not distort economic behaviour. The tax system is non-neutral if it encourages people to act, for tax reasons, in ways that they would not otherwise contemplate. There are plenty of examples of non-neutrality in the present system. The existence of mortgage interest relief makes it much more attractive to purchase a house than any other asset. Different rates of tax on income and capital gains largely influence the choice of savings instrument made by individuals, especially higher-rate taxpayers. The treatment of interest and dividend payments encourages firms to finance their activities by borrowing rather than by new issues of equity or retained profit.
- Fairness** (3) Finally the Chancellor will almost certainly wish to return to the taxation of husband and wife, which he broached in the 1986 Green Paper. The treatment of women in tax law is archaic and the present pattern of personal tax allowances is unjustifiably generous to two-earner couples.

#### Implementing the strategy

Before considering any detailed reforms, it is worth mentioning one important point about costs. Changes which do not require structural alterations can be implemented almost immediately, and thus their cost in the first year of existence is close to the long-run "full-year" cost. However, any change which requires structural reform takes time to implement. For example, the 1985 National Insurance changes were only introduced six months after the relevant Budget, and Personal Equity Plans after nine months. This point reduces the cost to the Chancellor of introducing reform in the 1988 Budget, at least in

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terms of his 1988/89 fiscal adjustment. It is also worth remembering that some taxes, such as capital gains tax (CGT), have very long lags between liability arising and payment occurring. Thus, even if CGT were abolished in the 1988 Budget, the cost in 1988/89 would be relatively slight, since much of the revenue would anyway relate to previous years. The same is true, to a lesser extent, of any change to corporation tax.

**Basic rate** The easiest starting-point is the basic rate of income tax. As already noted, the long-standing aim is a basic rate of 25p. While some reduction seems certain, the Chancellor may stop at a 1p reduction to 26p. The next election is a long way off, the Chancellor may be concerned about further fuelling the consumer boom, and he may wish to restrict his expenditure here to allow reforms elsewhere. In particular, as there have been no reductions in the higher rates of income tax since Sir Geoffrey Howe's first Budget in 1979, further reductions now seem likely.

**Higher rates** The main concern in the Chancellor's mind appears to be reducing the top rate of 60%. A reduction to 50% would cost relatively little (around £0.5bn), and pave the way for further reductions in the number of rates in subsequent budgets. A long-term objective of a two-rate structure with a basic rate of 25% and a higher rate of 40% seems plausible. At the same time as cutting the top rate, the Chancellor seems likely to raise the threshold at which higher rates first become due. Such an increase would reduce the number of higher-rate taxpayers, and mean that further reduction in the rates in future Budgets would have a less "sensational" impact on the net incomes of the rich. While restricting the value of mortgage interest relief and the personal allowances to the basic rate has many attractions, both in terms of costs and incentives, such a change seems unlikely (because it creates some losers, as we explain on pp.28-31), and anyway becomes less important as higher tax rates fall.

**National Insurance ceiling** Another reform in this area which has been discussed recently is the abolition of the employees' National Insurance ceiling. The ceiling currently stands at gross earnings of £15,340, beyond which no further employees' National Insurance (NI) is due. This is some way below the higher rate threshold of £17,900 of *taxable* income (i.e. after deducting relief for personal allowances, mortgage interest, and pension contributions). Thus, for a married man, higher-rate tax might well not be due at gross earnings of less than £25,000, leaving a £10,000 gap between the NI ceiling and the 40% rate of income tax. One possibility would be to start the higher rates of income tax at the NI ceiling. Such a reform would hit all those above the NI ceiling and thus seems unlikely. Simply abolishing the NI ceiling would create substantial problems with the administration of the State Earnings-Related Pension Scheme (SERPS), which is calculated by reference to the level of the ceiling. Thus, although abolition is attractive in principle, it seems unlikely outside the context of an overhaul of the whole system of National Insurance contributions.

**Taxing married couples** Within the income tax system, the other obvious target for reform is the taxation of married couples. On Budget Day 1986, Mr Lawson published a Green Paper which advocated fully transferable allowances. This proposal was not well received, and now appears to have been dropped. The opposite extreme, of fully independent taxation with non-transferable allowances, has never been attractive to the Government. This leaves partially transferable allowances as the natural middle way - we discuss the options in detail on

pp.31 – 34. Although such a route has much to recommend it, not least that it is both feasible and relatively cheap, Mr Lawson may not wish to introduce a reform which differs from the proposals that he initially made and vigorously supported. Nonetheless, some change in this area seems very likely in the Budget; if not a substantive change in the allowance *system*, then at least administrative and legal changes to remove the sexual discrimination inherent in the current legislation, and some change in the relative *sizes* of the different personal allowances.

- Indirect taxes** Turning to indirect taxes, there seems little scope for reform in the Budget. Even if the Chancellor wanted to use pressure from the EC as an excuse to broaden the VAT base by extending VAT to food and fuel, the pressure is as yet inadequate. We can expect all excise duties to be indexed in line with inflation this year, and if we see selective over-indexation, the prime candidate must be tobacco tax.
- Corporation tax** The Chancellor may return his attention to the corporate sector this year. His 1984 reform provided a programme of change for the whole of the last Parliament. That has now been worked out, and corporation tax can reasonably be further changed. The most straightforward change would be a reduction in the tax rate from its current level of 35%. Such a change could be phased over a number of years and would be consistent with the 1984 aim of reducing the burden of tax on companies. A reduction in the corporation tax rate towards the basic rate of income tax would aid neutrality. Were the two rates equal, the tax bias in favour of equity ahead of debt finance would be removed.
- Oil tax** One important area within the corporate sector is North Sea taxation. The 1987 Budget contained some measures to compensate oil companies for the effects of the 1985/86 oil price crash on cash flow and profitability. However, problems remain, especially in the way the tax system discourages important incremental investment on existing fields. Two possible measures that might be introduced in 1988 are a special incremental investment allowance for PRT and the final abolition of licence royalties.
- Employers' NI contributions** A further possibility is that the Chancellor may choose to spend some of the available revenue on reducing rates of employers' National Insurance contributions (NICs). In the earlier years of this Conservative period in office, the National Insurance surcharge was steadily reduced, and finally abolished. The surcharge was described on its abolition as having been a tax on jobs; and the same criticism can be applied to all NI contributions.

Reducing employers' NICs would reduce industry's costs, and therefore presumably be good for competitiveness. It would come into the "demand – light" category of reforms, while at the same time encouraging growth in employment. A 1% cut in the rate, from 10.45% to 9.45%, costs approximately the same as a 1% cut in the basic rate of income tax from 27p to 26p. The one disadvantage from a Chancellor's point of view is that such a change is not likely to be much noticed by the public. If the Chancellor genuinely has an embarrassingly large amount of money to spend, is concerned about overheating, wants to help industry and is little worried about his Budget's public reception, reductions here have much to recommend them. But the key argument against (which will probably win the day) is that the same reduction in industry's costs could be achieved by lower pay, while cutting employers' NICs might simply make it easier for industry to concede higher settlements.

## Green Budget 1988

**Capital taxation** We come finally to capital taxation. Further reductions in the burden of the so-called inheritance tax seem to be a part of the Government's strategy. Major reform of this tax only a year after its rebirth seems unlikely. Stamp duties on stocks and shares may be further reduced, indeed abolished, since the rate is at present only 0.5%. Such a change would encourage the City in the wake of the crash, and further strengthen London's position in the international financial markets. But the main candidate for real reform must be capital gains tax. Despite, or perhaps because of, indexation provisions introduced in the 1982 and 1985 Budgets, CGT is horrendously complex, and still taxes inflationary gains made before 1982 (see pp.35-37). A number of options are available here. The most dramatic is abolition, since the tax raises relatively little revenue. However, such a change would lead to enormous tax avoidance opportunities, and can be almost completely ruled out. A second possibility would be to extend indexation to gains made before 1982, but the administrative consequences of this seem unacceptable. Perhaps most likely is the simple abolition of tax on gains made before 1982. Such a change would cost relatively little and enormously simplify the tax.

**Abolish oil royalties** As ever, the Chancellor is likely to want to abolish at least one tax. The most likely candidate is oil licence royalties. Since these are an allowable expenditure for both corporation tax and PRT, the net annual cost would be less than £200 million, although it may be slightly higher in the short run.

If the Chancellor aims to spend £4bn in the Budget, he is likely to have to accept some constraint on his scope for reform. Reducing the basic rate of income tax to 25p would cost some £2.5bn in 1988/89. Cutting the top rate of tax to 50% would cost a further £0.5bn, increasing to perhaps £1.0bn if the higher rate thresholds were raised. A minimal package of partially transferable allowances would cost some £1.5bn, although this could be phased in over a number of years. Turning to the corporate sector, a reduction in the rate from 35% to 25% would cost £4bn in a full year; this could be reduced by phasing it over four or five years and/or reducing the rate to 30% rather than 25%. Clearly, Mr Lawson cannot do everything he wants to. To launch all of his reform objectives, even if some are only slowly phased in, he will need either to raise money from other sources or to delay for one more year the achievement of the 25p basic rate.



# 4 Analysis of Tax Options

## 4.1 Personal Taxes

In his 1984 Budget speech Nigel Lawson told us that he had "embarked on a radical programme of tax reform". As a description of the 1984 Budget, his statement seemed plausible, but as the Parliament progressed, the programme of radical tax reform did not. Indeed, this section of last year's Green Budget began with a lengthy list of measures which had been ruled out by the Chancellor and/or the Prime Minister during the preceding years.

But 1988 is the first Budget of a new Parliament, there is substantial financial scope for tax cuts/reform, and Mr Lawson seems unlikely to introduce many more Budgets. All this points to an exciting and perhaps genuinely radical Budget.

### Income tax: rates versus allowances

As ever, the focus of attention is likely to be income tax. This year, the long-standing Conservative Party target of a basic rate of income tax of 25% is within reach. In the 1979 Budget, the first of the nine recent Conservative Budgets, the basic rate of tax was reduced from 33% to 30% (see Table 12). The income tax burden was raised in 1980 by the abolition of the reduced rate band and in 1981 by reductions in the real level of tax allowances. Over 1982-5 the burden of income tax was again reduced each year, but by increasing the real level of allowances rather than reducing the rate. However, 1986 saw a return to rate reduction, from 30% to 29%, and 1987 a further cut, from 29% to 27%.

Table 12. Tax Rates and Allowances, 1978/79 to 1987/88

	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Basic rate	33	30	30	30	30	30	30	30	29	27
Index of real allowance*	100	102	104	93	99	108	115	119	122	122

\* Single person's allowance.

A cut in the 1988 Budget from 27% to 25% would cost some £2.5-£3bn. If this money were spent on increasing the real level of allowances, we would see an increase of some 10%, in addition to the increase of around 4% to adjust for inflation. The distributional effects of these two main options for reducing income tax are very different. Increasing allowances produces the same cash gain for all who continue to pay tax when the allowance is increased, except for the small group (around 5% of taxpayers) who are higher-rate payers, who gain more. Reductions in the basic rate of tax, on the other hand, produce higher gains for those with higher income. Thus, increases in allowances are a much more progressive way of cutting the burden of income tax than reductions in the basic rate.

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Despite the flirtation with allowance increases from 1982 to 1985, and the redistributive properties of this route compared with rate reduction, the 1988 Budget seems likely to favour rate cuts – though allowance increases may also occur, perhaps in the context of reform of the taxation of husband and wife (see below), when the Government has achieved its goal of a 25% basic rate of tax.

### Restructuring higher rates

Perhaps the most significant feature of the UK income tax structure is that some 95% of all taxpayers pay tax at the basic rate only. For this group, feasible cuts in their tax rate seem largely irrelevant to their incentives to work. But the effect of the tax system on the work effort of higher-rate taxpayers could be appreciable (though evidence is hard to come by). This is therefore an area which could be high on the Chancellor's agenda for reform.

A number of arguments might reasonably be advanced in favour of reduction in the higher rates of UK income tax. The most straightforward is simply that at present the gap between the basic rate of 27% and the first higher rate of 40% is a large one. In 1978, the basic rate was 33%; if it is reduced to 25% in the Budget, the gap would have more than doubled from 7 percentage points to 15. Although this argument is largely presentational, it may carry some weight in the run-up to the Budget. A reduction in all higher rates by 5%, thus giving a first higher rate of 35% and a top rate of 55%, would cost around £750 million.

A second argument is that the existence of high marginal tax rates encourages tax avoidance and the distortion of behaviour in such a way as to reduce what would otherwise be large tax bills. If the top marginal income tax rate came closer to the basic rate of income tax, the corporation tax rate of 35% and the capital gains tax rate of 35%, the gain from many avoidance activities, and thus the activities themselves, would be reduced.

A third argument, and the one which may weigh most heavily with the Government, suggests that current levels of marginal tax rates are a disincentive to work effort, risk-taking, and entrepreneurial activity, and that this depresses the overall level of economic activity. The extreme version of this argument suggests that the disincentive effects are so strong that a cut in tax rates could *increase* tax revenue, because so much extra work would be called forth. A weaker version is that the combined effect of harder work and less evasion raises revenue.

These arguments are all related to reducing marginal rates of tax. Any cut in taxes has two effects on work effort – an income effect which depends on the *average* rate of tax, and a substitution effect which depends on the *marginal* rate. A cut in taxes increases net income, which will tend to make individuals increase consumption of all goods, *including leisure*. Consuming more leisure means working less hard. Thus the income effect of a tax cut, if it affects work effort at all, will tend to reduce it. The substitution effect results from the change in the marginal rate of tax. When this falls, the net gain from extra work increases, thus raising the "price" of leisure relative to other goods. Therefore, again to the extent that it has any effect, the substitution effect of a tax cut will tend to increase work effort. The two effects tend to offset each other, so to maximise the incentive effect of a reform we would wish to

maximise the substitution effect and minimise the income effect. We can do this by reducing *marginal* rates of tax while holding as nearly constant as possible *average* rates. Such a change would maximise any incentive and anti-avoidance effects while minimising the cost and the potential political problems of large gains for the rich.

The obvious way to keep average rates up while cutting higher rate taxes is to reduce the value of tax allowances. There are various ways of doing this. The most widely canvassed is the restriction of mortgage interest relief to the basic rate. But this is just a special case of a more general reform. The same restriction could be applied to all the allowances enjoyed by higher rate taxpayers – e.g. relief for pension contributions, and even the personal allowance. Under present arrangements, the value of all allowances increases in line with the marginal rate of tax, so they are worth more to higher-rate taxpayers. The general reform would be to limit the value of allowances to a tax credit equal to the existing allowance multiplied by the basic rate of tax. The cost and impact of reforms to the structure of higher rates are difficult to assess without empirical analysis, and it is to this that we now turn.

Although IFS has for many years modelled the UK tax and benefit system, we have previously been wary of making statements about the cost and impact of changes to the structure of the higher rates of income tax. Only some 5% of the UK taxpaying population pay income tax at the higher rates. This small group is significantly undersampled in the Family Expenditure Survey (FES) data which we have used for tax-modelling up to now. This undersampling presumably results from an unwillingness to reveal income and/or spend the time involved in responding to such surveys, and is a deficiency common to all voluntary surveys.

We now have access to a data set which removes much of this difficulty – the Survey of Personal Incomes (SPI). The SPI is a sample of some 60,000 tax units taken from Inland Revenue records. This survey is the basis of the published Survey of Personal Incomes (although the anonymised Public Use Tape to which we have access contains only 53,000 less-detailed records). The SPI has two enormous advantages over the FES. First, its size: the FES covers only around 7,000 households per year, so even with no undersampling the sample of higher rate taxpayers would only be 350. The SPI, being so much larger, provides a far better source of information. Moreover, the SPI is a stratified sample which concentrates on richer taxpayers. Second and probably more important, the SPI is taken from tax returns and is therefore "compulsory", so the problem of undersampling higher-rate taxpayers should not exist.

The one major problem with the SPI is that, unlike the FES, we so far have access to only one year's data, 1982/83, which is rapidly dating. Although we can deflate tax systems back to 1982/83, and reflate results back to 1987/88 levels to allow for changes in the tax system over the period, we have not attempted to take account of changes in the structure of the earnings distribution. Since the distribution of earnings certainly has changed, this inevitably introduces error to our results. The figures below should therefore be taken as illustrative only, but should provide a reasonable picture of the impact of the reforms we discuss.

Table 13. Effects of Income Tax and Higher-Rate Tax Changes

Reform package	1	No. of losers		No. of gainers	
	Cost	2	3	4	5
		With higher marginal rate	With lower marginal rate	With higher marginal rate	With lower marginal rate
	£bn	Thousands of taxpayers		Thousands of taxpayers	
Basic rate to 25%	2.7	-	-	-	19100
All higher rates abolished	2.6	-	-	-	900
25% basic rate, 50% top rate, 10% on higher-rate thresholds	3.4	-	-	-	19700
As (3) but with allowances restricted	2.1	800	40	-	18860
As (4) but with 25% on higher-rate thresholds	3.0	340	20	-	19640
As (4) but with 40% on higher-rate thresholds	3.6	30	-	-	20100

Table 13 shows the cost and impact of a number of possible changes to the income tax system. We split the effects on the income tax system into four, to help in analysing any likely impact on work effort. Our model allows us distinguish between the effects of changes in average rates ("income" effects) and marginal rates ("substitution" effects) following any particular reform. A higher average rate (the "losers" in columns 2 and 3) tends to imply increased work effort to replace lost income, and vice versa. On the other hand, a higher marginal rate (columns 2 and 4) tends to imply decreased work effort, since there is less incentive to work an extra hour. We must consider income and substitution effects together in predicting the likely labour supply responses to a particular tax reform. Those in columns 3 and 4 face income and substitution effects which reinforce each other: those in column 3 will unambiguously work harder - higher average tax rate and thus less income, but a lower marginal rate on an additional hour's work; those in column 4 will unambiguously work less hard, for the opposite reasons. The people in columns 2 and 5 (the vast majority of taxpayers) have income and substitution effects working in opposite directions. We cannot say whether the income or substitution effect will dominate and thus cannot predict their labour supply response.

The first reform considered is simply a reduction in the basic rate to 25p in the pound. There are no losers and no marginal rate increases. The second reform abolishes all higher rates of tax, setting all income tax rates to 27%. This reform would cost some £2.6bn in our model, but this is probably an underestimate by some £0.5bn, because, as outlined above, we have not attempted to take into account changes in the earnings distribution since 1982/83. Again, there are no losers. While the Chancellor has enough revenue to carry out such a reform, it seems unlikely, for two principal reasons. First, the abolition of all higher rates without abolishing the employees' National Insurance contribution ceiling would mean that all those over the NI ceiling

would face a lower marginal direct tax rate than those below that level. Second, the gains which would accrue to the rich would be enormous, and perhaps politically damaging.

A more likely reform to higher rates involves reducing the top rate to 50% as part of a phased reduction to a single higher rate of perhaps 40%. Cutting the top rate to 50% would cost some £500 million. A reform package which might fulfil some of the Chancellor's aims would be a reduction to 25p in the basic rate, a reduction in the top rate to 50%, and an increase of 10% in the threshold at which higher-rate tax first becomes payable.<sup>1</sup> Such an increase in the threshold has the attraction of reducing the number of people paying higher rates, and thus making future reduction in higher rates less costly and less dramatic. All subsequent thresholds are increased by the same absolute amount. This reform would cost some £3.4bn, and produces no losers.

An alternative to this reform which would reduce the cost, and the gain for the rich, would be to restrict mortgage interest relief and personal allowances to the basic rate.<sup>2</sup> This reduces the cost to £2.1bn, but produces 0.8 million losers. These are individuals who are not at present higher-rate taxpayers, but are only kept out of higher rates because mortgage interest and the personal allowances are subtracted from taxable income. To reduce the number of losers, the higher rate thresholds would need to be increased by more than 10%. We illustrate two options, one of an increase of 25% in the first higher rate threshold, which would take the threshold from £17,900 to £22,375, and one of 40%, which would take the threshold to £25,060. The latter reform removes almost all losers, but brings the cost of the package back up to £3.6bn.

The small numbers in columns 3 and 4, relative to column 5 especially, imply that there are very few taxpayers whose labour supply response we can predict with any degree of certainty. We believe it would be difficult to justify any of our reform packages on the grounds of dramatic improvement in work incentives. However, the main thrust of these results is to show that Mr Lawson could achieve a basic rate of 25p, a top rate of 50% and an increase in the higher rate threshold, all for less than £4bn. Such a give-away would, however, largely preclude much else on our assumption of a £4bn fiscal adjustment.

### Husband and wife

The taxation of husband and wife has been high on the tax reform agenda since the publication of the 1986 Green Paper which proposed fully transferable allowances between husband and wife. There are two aspects of the present system which, it is widely agreed, cry out for reform: the system of *aggregating* spouses' incomes for tax purposes, and the relative sizes of the different personal allowances.

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1 These increases are in real terms, i.e. over and above indexation to allow for (price) inflation.

2 Under the present tax system, allowances and mortgage interest relief are worth more, the higher one's marginal tax rate. The married man's tax allowance is worth  $£3795 \times 0.27 = £1025$  to a basic-rate payer, but  $£3795 \times 0.60 = £2277$  to a top-rate taxpayer. Under reforms 4, 5 and 6, allowances and reliefs would be worth the same to all taxpayers, whatever their marginal rate.

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The aggregation rule, expressed in a famous clause which can be traced back to the Napoleonic wars, states that the income of a "married woman living with her husband [shall] be deemed for income tax purposes to be his income and not to be her income". Apart from reflecting totally outdated views about the status of women, this obliges wives to reveal their incomes to husbands but not vice versa. It is manifestly sexist and unfair.

This points to the abolition of the aggregation rule, which could be achieved by adopting a system of independent taxation (i.e. taxing husbands and wives separately as two individuals). However, this immediately opens up the question of the size of the tax allowance each should receive. The present system is shown in Table 14, which shows the existing pattern of allowances: if the single allowance is worth 1, the married man currently enjoys an allowance worth 1.6, and if his wife works as well, the couple receive allowances worth 2.6. This pattern could be maintained under a system of independent taxation, e.g. by keeping the married man's allowance. But such a proposal would defeat one of the main objects of reform, which is to arrive at a more symmetrical treatment of men and women.

The simplest way of achieving symmetry would be to give the married man no more than a single person, while the two-earner couple would simply get two single allowances. All married couples would thus be worse off, as Table 14 shows. This is an unlikely reform for a tax-cutting Chancellor to introduce.

A more likely alternative would be to raise the single allowance to 1.3. Two-earner couples would then get 2.6 and be as well off as under the present system. Raising the single allowance in this way so that the only beneficiaries are single people (and not two-earner couples) would be relatively cheap. And if the modest cost of £1.5bn was considered too high, it would be easy enough to phase in the increase in single allowances, while freezing the allowances of two-earner couples at present levels to ensure they did not lose by the change.

However, raising the single allowance does nothing to tackle the much more difficult problem of the relative size of single-earner and two-earner couples' allowances. The 1986 Green Paper tackled the problem by proposing in effect that the married couple get two allowances, whether the wife works or not. That proposal provoked a storm of criticism, on four main grounds. First and foremost was the cost. "Levelling up" allowances to ensure that there were no losers cost some £5bn under the original Green Paper scheme, most of it going to single-earner couples. That was a lot to spend on a scheme whose redistributive consequences were of doubtful benefit. Some preferred to spend the money on families with children. Others preferred across-the-board tax cuts.

The second, closely linked, objection was that the scheme was far too generous to single-earner couples. Under the present system, single-earner couples are treated less generously than two-earner couples, but this can be justified. At the same level of income, the single-earner couple will probably enjoy a better living standard than the equivalent two-earner couple (generally because of the wife's unpaid work about the home). So there is nothing obviously inequitable about taxing them more heavily - e.g. by giving them lower allowances, as at

## Analysis of Tax Options

present. This argument against fully transferable allowances can be used to justify almost any lower level of allowances for single-earner couples - i.e. anywhere in the range 1-2 times the single allowance.

There are two other arguments, both of which depend on the fact that the wife will, once her allowance has been transferred to her husband, pay tax at the full marginal rate on the first pound of her earnings. This has adverse consequences for work incentives, since there is good econometric evidence that female labour supply is sensitive to changes in the marginal tax rate. It also has adverse administrative consequences: small amounts of the wife's earnings, which can be ignored under the current system or under a system of independent taxation (because they fall below the tax threshold), are brought within the tax net.

Table 14. Reforming Personal Allowances

	Level of allowances			Total cost
	Single person	Single-earner couple	Two-earner couple	£bn
Present system	£2425	£3795	£6220	
	Index 1	1.6	2.6	
<b>Reform Options</b>				
1. Independent taxation, no married man's allowance	1	1	2	-4.5
2. Independent taxation, fully transferable allowances	1	2	2	0
3. Independent taxation, full transferability, no losers	1.3	2.6	2.6	4.5
4. Independent taxation, partial transferability, no losers	1.3	1.6	2.6	1.2

None of these objections carries the same force if only part of the wife's allowance is transferable. The non-transferable part will be available to the wife only if she works, which means that small amounts of earnings will be under the threshold. The administrative benefits of taking them out of the tax net are retained, as is the incentive to work. By the same token, the fact that only part of the allowance is transferable limits the benefit of the arrangement to the single-earner couple and limits the cost.

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Perhaps the greatest intellectual attraction of partial transferability is its generality. Each of the reforms shown in Table 14 can be presented as a system of independent taxation with transferable allowances, and described with just two parameters: the level of the single allowance and the proportion of the allowance which is transferable. In Reform 1, this proportion is zero. In Reforms 2 and 3, it is 1. In Reform 4 it is set at 0.23, so that a single-earner couple obtains an allowance equal to the present married man's allowance ( $1.6 = 1.3 + .23 \times 1.3$ ). Reform 4 is probably the cheapest available way of tackling the problems posed by the taxation of husband and wife. The three key components are (i) independent taxation to deal with the asymmetrical sexism of the present nineteenth century legislation; (ii) levelling up the single allowance to deal with the problem of the two-earner couple on a no-loser basis; and (iii) partially transferable allowances to ensure that single-earner couples do not lose.

However, it is probably fair to assume that if the Chancellor adopted this solution, he would be accused of producing a mouse of a reform. Moreover, to judge from the tenor of his original proposals for fully transferable allowances, he wants to be relatively generous to single-earner couples. The beauty of partially transferable allowances is that they can be presented as a statesmanlike variant on the original transferable allowance scheme which has been modified to take account of criticisms. More importantly, they provide a flexible and general framework within which he can be as generous as he wishes to single-earner couples by increasing the transferable proportion of the allowance. He may not do that this year because he has other priorities. But he will have opened a way forward for future years.



## 4.2 Capital Gains Tax

A tax-reforming Chancellor with a penchant for abolishing taxes might well be tempted by capital gains tax. Despite being reformed in 1982, and again in 1985, it remains an outstandingly unpopular element in the tax system. It is extremely difficult to operate, impossible for most people to understand, and raises relatively little revenue. But the Chancellor cannot just abolish it.

The main reason why not, as the Chancellor himself stated during the election campaign, is that a capital gains tax is needed to protect income tax. At present, there is a considerable advantage for taxpayers to channel their investment income through capital gains (taxed at 30% with a threshold of £6,600 per year and an indexation allowance) rather than as income (taxed in full at up to 60%). The result is that many smaller-scale investors pay no capital gains tax. Better-off individuals do pay some, and companies also have to pay tax – at corporate tax rates – on their capital gains. But if capital gains tax were abolished completely, the attractiveness of capital gains would be greatly increased. So although capital gains tax revenue is around £2.5bn a year at present, its abolition would certainly cost much more than this in terms of income tax revenue forgone, as individuals and companies sought to channel as much income as possible into newly tax-free gains.

One of the reasons for the unpopularity of capital gains tax is its complexity. It is heavy in compliance costs on the taxpayer, and the administrative costs of the tax have only been kept within bounds by raising the annual exemption so high that a substantial proportion of realised capital gains are excluded. Perhaps a more important reason for the hostility to capital gains tax is the perception that most of the capital gains realised since the introduction of the tax have not been real gains but have reflected no more than compensation for the effects of inflation on capital values.

The reforms made to the tax in 1982 and 1985 both tried to address this objection by introducing some indexation provisions into capital gains tax. But these reforms have two huge flaws. One is that the tax now passes all understanding in the labyrinthine complexity of its provisions. The other is that all the inflationary gains made prior to March 1982, when inflation was at its most rapid, are still taxed in full: relief is only given for inflation since that date. This means that holders of assets purchased in the mid-1970s can still be sitting on substantial tax liabilities on inflationary gains if they sell. There are two things a Chancellor with money to spend could do about this: extend indexation back to 1965 or eliminate all pre-1982 gains.

Extending indexation back to 1965 would win some applause from the taxpayer who benefits, and a commensurate groan from his accountant who has to calculate by how much. There are formidable practical difficulties involved in indexing retrospectively. Consider, for instance, share pools. Prior to 1982 (when indexation was first introduced) transactions in a given stock which took place at different times could be lumped together into a pool. This greatly simplified the basis of calculating the costs to be apportioned to part disposals of shareholdings and also for dealing with rights and scrip issues. But extending indexation would involve unravelling all such transactions by reference to their date, to assess the indexation allowances which should be given. This in many cases would be a mammoth task, even if the records since 1965 were still

available to enable the calculations to be done (which is highly unlikely). Moreover, shares are not the only problem. Where enhancement expenditure and part disposals have taken place on other assets, similar problems would arise. In short, an already complex tax would become still worse, and the revenue cost would be considerable.

A rather tidier alternative is simply to pretend that capital gains tax was introduced in March 1982 for the first time. This would require the valuation of all assets held at March 1982, and the tax would be confined in all cases to indexed gains since then. This course is in fact an extremely straightforward one to follow now, since under the 1982 indexation reform, market values of assets had to be established as at 31 March 1982 in any case. So the work has already been done, and the amputation of all unrealised pre-1982 gains would present minimal administrative problems, although its revenue cost might be quite high. Just how high is hard to tell, for the reform would encourage the "locked-in" to sell at last, which in turn would increase CGT revenue on the post-1982 element of any gain. This second alternative looks like an attractive proposition.

Both these alternatives deal with just one problem with capital gains tax, arising from the way the indexation provisions have evolved. But is there a case for a more general reform – not abolition, but a recasting and simplification of the capital gains tax?

Recent US experience provides an interesting pathfinder here. Since the 1986 Tax Reform Act, both short- and long-term gains have been taxed at income tax rates. There is no messing about with complex indexation provisions, nor is there a different lower tax rate on capital gains than on other sources of income. This bold reform follows the objective of securing revenue from a broader tax base with lower rates and fewer exemptions and reliefs. It greatly reduces the incentive to channel income into capital gains, and reduces the discrimination between the tax treatment of different kinds of asset.

However, it is difficult to see how these reforms could be replicated easily here. Even if there is a wholesale reduction in higher income tax rates, charging all capital gains at the taxpayer's marginal income tax rate would dramatically increase most individuals' capital gains tax bills, and bring into tax all those smaller gains which the present high annual exemptions are there to exclude. If at the same time the indexation provisions were removed, this would simplify the tax, but raise again the objection that it was unfairly based on inflationary gains.

If the US reform therefore seems a non-starter, what about other mechanisms? One way in which many countries tax capital gains, which avoids the complexities inherent in full-blown indexation, is to taper the capital gains tax charge by reference to the holding period of the asset, so that the longer the asset is held, the lower the effective tax rate charged when it is sold. But this too is no panacea. The relief given for inflation through such tapering is far too rough and ready, and it inevitably results in an aggravated "lock-in" effect, with taxpayers realising their capital losses just before the anniversary of purchase (so gaining relief at a higher rate), and holding on to capital gains until just after (so being taxed at a lower rate).

## Analysis of Tax Options

In short, it seems the Chancellor in fact has surprisingly little room for effective and worthwhile reforms to capital gains tax. There remains one final road he could follow. This would require abandoning the concept of taxing capital gains, but instead taxing net capital disposals. The effect of this would be to defer any tax charge until financial assets were sold to pay for consumption: no tax would arise on switching investments, and the individual could determine the extent of his tax liabilities on capital disposals by whether he saved or spent them. Under such a tax, suitably constructed, indexation provisions of the kind required for CGT are unnecessary, and the tax base would be much simpler and fairer.

## 4.3 Corporation Tax

### The 1984 reforms

Nigel Lawson's first Budget was notable for major changes to the structure of corporation tax, which earned him the reputation of a tax-reforming Chancellor. The beginning of his second Parliament as Chancellor may well be a time at which he returns to corporation tax to assess the effects of his earlier measures, and to consider whether further reforms are necessary. In this section we also follow this course, and suggest that there may be changes which could be viewed as building on the 1984 reforms.

The approach he took in 1984 was to expand the tax base at the same time as reducing the tax rate from 52% to 35% over a three year period. The expansion of the tax base was principally achieved by the gradual elimination of first year allowances for investment in plant and machinery and industrial buildings, and the immediate abolition of stock relief. In his first Budget speech, the Chancellor declared that he had "set out a new and improved framework of business taxation for the remainder of this Parliament and beyond".

There were two apparent aims of the 1984 reforms. The first was to reduce the overall tax burden on companies. This was a long-term aim, after a transition period in which it was claimed that the effect of the reforms on tax liabilities would be roughly neutral. The second aim was to reduce the impact of corporation tax on companies' decisions. It was claimed that the pre-1984 system had "encouraged low-yielding or even loss-making investment", and that consequently it was necessary to reduce allowances.

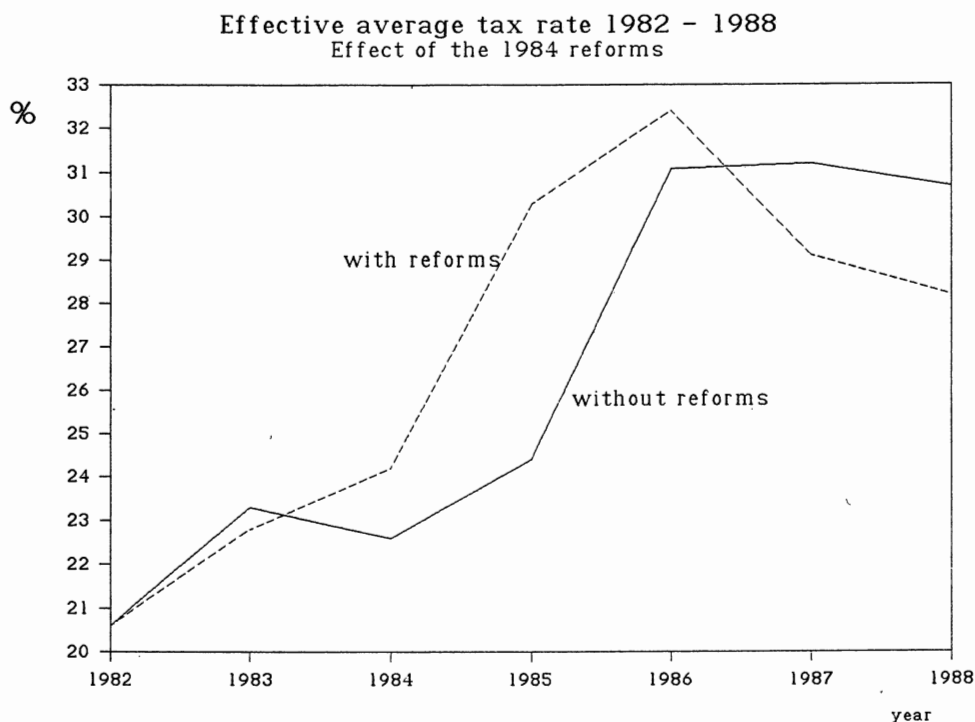
Recent research at IFS<sup>1</sup> has examined the degree to which the 1984 reforms were successful in meeting these objectives. We briefly outline the results of this research, which has used a detailed model of the corporation tax system and accounting data on a sample of 400 quoted companies. We then go on to discuss the current state of the tax system and possible reforms which might remove remaining weaknesses.

Figure 1 presents estimates of an "effective average tax rate" for our sample of companies over the period 1982 to 1988. The solid line represents average tax rates under the actual tax system, including the 1984 reforms. The broken line indicates what the tax rates would have been, had the reforms not taken place. One interesting point to note is the rapid rise in average tax rates over the period 1982 to 1986. This was due to a combination of factors. An underlying feature of this period is that company profits rose rapidly, in some years at rates of over 20%. This was an important reason for the explosion of corporation tax revenues, since many companies which did not pay tax in the early 1980s began to do so. They had not paid tax earlier because the generous allowances under the pre-1984 tax system were higher than their profits. However, as profits rose they once again began to exceed the accumulated tax losses of many firms. The rise in corporation tax was thus faster than the rise in profits as these firms moved back into tax.

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<sup>1</sup> Devereux (1987 and 1988).

Figure 1.



That this was an important effect is reflected in the fact that both of the lines in Figure 1 rise rapidly up to 1986. Thus, even without the reforms, there would still have been a surge in tax revenues and average tax rates. However, it is notable that average tax rates rose faster under the actual system than if the reforms had not taken place, because of the reduction in the total value of allowances and the consequent move into tax of previously tax-exhausted companies. It is clear that, over the transition period, the reduction in the statutory tax rate was not great enough to offset these effects, with the result that the overall corporation tax burden rose.

In the longer run, the position is less clear-cut. As capital allowances build up again, the multiplier effect moves into reverse, i.e. corporation tax liabilities will grow at a slower rate than profits. This is reflected in the falling line in Figure 1. However, the question as to whether, in the long run, the average tax rate will be higher under the reformed corporation tax system than under the pre-1984 system depends crucially on the rate of inflation. The new tax base is close to historic cost profit and in periods of inflation this will tend to overstate the true profit of the firm. Hence the average tax rate rises with inflation. By contrast, the pre-1984 tax base was insulated against the effects of inflation by first year allowances and stock relief. We estimate<sup>1</sup> that the "break-even" rate of inflation is around 7%. Above this level, the 1984 reforms would lead to a

<sup>1</sup> Devereux (1987), King and Wookey (1987).

## Green Budget 1988

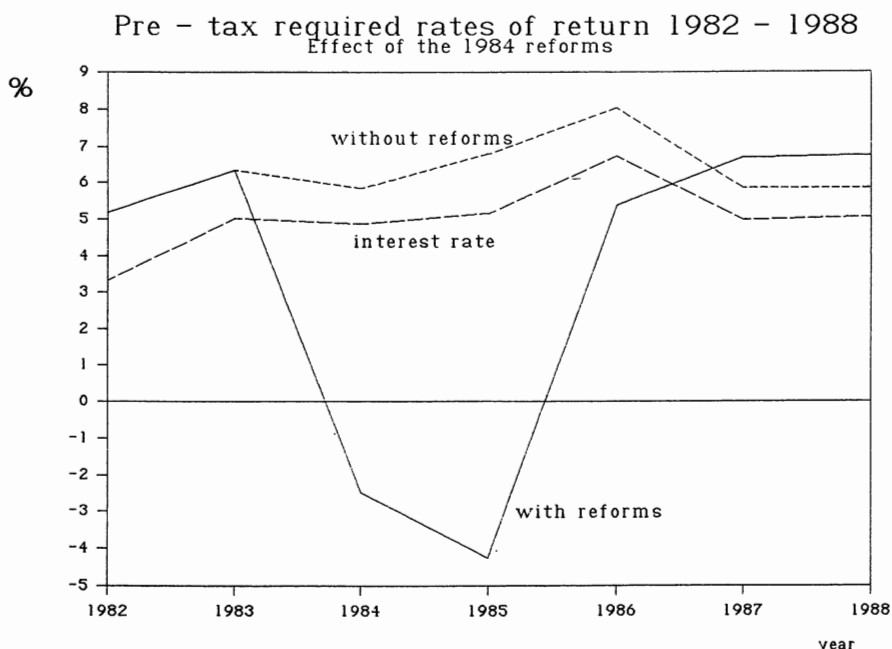
higher tax burden on companies. Below 7%, the reforms would lead to a lower tax burden. At current inflation rates, then, the reforms have been successful in reducing taxes. However, such a result is sensitive to increasing inflation.

The second aim of the 1984 reforms was to make the corporation tax system more "neutral" – that is, to make companies' decisions less dependent on tax considerations. In particular, it was asserted that the pre-1984 system encouraged low-yielding investment in capital assets, possibly at the expense of employment.

A useful way of assessing the effect of the reforms is to calculate the cost of capital. This is defined as the minimum pre-tax rate of return required by a company from direct investment. We can calculate the importance of the tax system by comparing this required pre-tax rate of return with the return that the company must offer to its suppliers of finance. The difference is a measure of the tax incentives or disincentives to investment. Under the pre-1984 system it was claimed that the return required from direct investment by companies was lower than that required by the suppliers of finance, thus encouraging "low-yielding" investment. A neutral system is one in which the market cost of capital is identical to the required pre-tax return. If the required pre-tax return is higher, the tax system discourages investment.

Figure 2 presents some estimates for the required pre-tax return, for the actual and pre-1984 systems. It also shows the real interest rate.

Figure 2.



Consider first the dotted line indicating the required pre-tax return if the reforms had not taken place. It is interesting to note that it is always higher than the real interest rate, indicating that, on average, the pre-1984 system resulted in a disincentive to invest. This result is contrary to the Government's claims made in 1984, and is a result of averaging over several types of

investment projects. The Government was correct to claim that for some investments (e.g. debt-financed investments in plant and machinery) the pre-1984 system yielded an effective subsidy to investment. However, for others (e.g. investment in commercial buildings and stocks) there was a disincentive to invest. The weighted average for the IFS sample of companies yields a small disincentive to invest. However, this result is sensitive to the weights used for averaging. Nevertheless, Figure 2 does cast some doubt on the claims that the pre-1984 system effectively subsidised investment.

The dashed line in Figure 2 shows the required pre-tax return for the reformed system. There are two important effects of the reforms. In the long run (after the transition period) the new system yields a higher cost of capital than the old system - the direction in which the Government was aiming. However, on the results shown, the effects of the reforms were simply to increase an already existing average disincentive to invest.

The effects of the transition period, however, were dramatic. The combination of falling allowances and the falling tax rate produced extremely high incentives to invest. Essentially, this is because the returns on investments were taxed at a lower rate than that against which allowances had been permitted. There is some evidence that this had a profound effect on investment in 1984 and 1985. This is shown in Table 15, where the large incentives to invest in these years were matched by an explosion in the rate of increase of investment to well over 20% in each year.

Table 15. Company Fixed Investment and Tax Incentives

Year	Gross fixed investment		Tax incentive
	£bn	% increase	%
1982	15.3	2.0	-1.8
1983	15.5	1.2	-1.1
1984	19.4	25.1	8.0
1985	24.5	26.8	9.7
1986	26.0	5.9	-1.3

Source:

Investment: Financial Statistics.

Tax incentive: Own estimates of difference between pre- and post-tax cost of capital.

Note: The "tax incentive" measure is defined as the post-tax cost of capital (the return required by suppliers of finance) minus the pre-tax cost of capital (the return needed by the company on its direct investment in order to repay the suppliers of finance and to pay taxes). Thus if a company requires a 5% post-tax return to repay its lenders, a tax incentive of 8% (as in 1984) indicates that the company needs to earn a pre-tax return on its investment of -3%.

### Weaknesses of present system

Where does this leave the current corporation tax system? There are at least three features which cause concern. The first is the sensitivity of average tax rates to the rate of inflation. As mentioned above, the Government's apparent aim of reducing the tax burden on business depends on a low rate of inflation being maintained. The two features of the current system which are most important here are the absence of indexation on capital allowances and the

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absence of stock relief, although these are offset to some extent by the deductibility of nominal interest payments. However, although there is a strong case for moving the corporation tax system from an historic cost profits base to a real profits base, it must be considered unlikely that the Chancellor would be sufficiently persuaded of this view to act on it in the forthcoming Budget.

The second weakness of the current system is that, on average, it acts as a disincentive to fixed investment by companies (and is more severe in this respect than the pre-1984 system would have been). Several measures would relieve this effect, for example introducing some allowance for commercial buildings, reintroducing stock relief or increasing allowances on other assets. Again, however, it must be concluded that the Chancellor is unlikely to take any of these measures.

A final weakness of the system is its remaining non-neutralities. In particular, there are still large differences in the treatment of different sources of finance used by companies. These stem from the generous treatment of interest payments compared with the less generous treatment of dividend payments. Essentially the difference arises because interest payments are deductible from the tax base, thereby gaining relief from tax at the rate of 35%, whereas dividends are taxed at the imputation rate, effectively gaining relief at the rate of 27% (both on the assumption of no tax exhaustion or unrelieved advance corporation tax). This effect is of course closely related to the taxation of investment income, since the advantage of debt finance may be shared between lender and borrower.

### Possible reforms

One possible solution to this problem, which would not require any fundamental change to the corporation tax system and which could be said to build on the 1984 reforms, is simply to increase the imputation rate to be the same as the corporation tax rate at 35% (strictly, it would need to be at the rate of 35/65 since the rate is applied to net dividends). Essentially, the returns to debt and equity finance would then receive tax relief at the same rate, i.e. 35%. The effect of this reform is shown in Table 16 for a hypothetical company which distributes all of its taxable profit in the form of dividends.

For this company, the effect of increasing the imputation rate is to reduce mainstream corporation tax (MCT) to zero. This compares with a level of 11 if the company were to pay the same level of net dividends under the current system. If there are no further changes to the income tax structure, the possibly surprising result of increasing the imputation rate is to increase the net income received by shareholders in all tax brackets (compared with the situation in which net dividends are unchanged). Since MCT is zero (in this example), the tax charge is simply income tax at the shareholder's tax rate. In fact, the net income of the shareholders is exactly equal to the case under the existing system in which the firm distributes a gross dividend of 108 (a net dividend of 73). This equality suggests that if such a reform were enacted, we would expect dividend payments to be reduced, although leaving shareholders exactly as well off. This would provide additional funds for reinvestment.



## Analysis of Tax Options

Table 16. Effect of Increasing the Imputation Rate to 35% or Reducing the Corporation Tax Rate to 25%

	Actual system	With higher imputation rate	with lower C.T Rate
	£	£	£
Taxable profit	100	100	100
Corporation tax	35	35	27
Net dividends	65	65	73
Advance CT	24	35	27
Mainstream CT	11	0	0
<b>Total tax paid by firm</b>	<b>35</b>	<b>35</b>	<b>27</b>
Receipts of shareholder:			
Dividend	65	65	73
Tax credit	24	35	27
<b>Total receipts of shareholder</b>	<b>89</b>	<b>100</b>	<b>100</b>
Income tax due from shareholder with tax rate of:			
0%	- 24	- 35	- 27
27%	0	- 8	0
60%	29	25	33
Net income of shareholder with tax rate of:			
0%	89	100	100
27%	65	73	73
60%	36	40	40

Alternatively, the Government might note the increase in net income for shareholders in the table. This would undoubtedly be tied into the observation that any shareholder with an income tax rate of less than 35% would be entitled to reclaim part of his tax credit from the Inland Revenue. Several responses to these outcomes are possible. One would be to add an 8% income tax surcharge on dividend income, thereby leaving basic rate taxpayers exactly as well off as they are under the existing system. To maintain neutrality, however, such a surcharge would need to be applied to both dividend and interest receipts. As such, it would effectively be an investment income surcharge. One justification for imposing such a surcharge is its close similarity to employees' National Insurance contributions which are not paid on investment income. However, it seems unlikely that the Chancellor wishes to preside over any increases in tax in this Budget.

An alternative possibility is, however, closely connected with the earlier comments concerning reductions in the corporation tax. Neutrality between debt and new equity finance for companies requires that the imputation rate be equal to the corporation tax rate. Neutrality between debt and retention finance requires further that the corporation tax rate be equal to the shareholders'

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income tax rate on interest income. (This is shown in the following box, which indicates the relationship between the required rate of return on direct investment and the return required by suppliers of finance.)

Effect of Taxation on Required Rate of Return of an Investment: Different Sources of Finance	
New Equity	$p = r \frac{(1 - m_I)(1 - s)}{(1 - m_D)(1 - \tau)}$
Retentions	$p = r \frac{(1 - m_I)}{(1 - \tau)}$
Debt	$p = r$
	<p>where:</p> <p>p = required pre-tax rate of return on fixed investment</p> <p>r = return required by supplier of finance (assumed to be the real interest rate)</p> <p>m<sub>I</sub> = marginal personal tax rate on interest income</p> <p>m<sub>D</sub> = marginal personal tax rate on dividend income</p> <p>s = imputation rate (expressed as a proportion of gross dividends)</p> <p>τ = corporation tax rate</p>
	<p>Note. It is assumed that capital allowances are exactly equal to true economic depreciation. Taxes on capital gains are ignored.</p>

It is clear that both types of neutrality could be achieved by setting all of these tax rates to be equal.<sup>1</sup> This is essentially what was suggested above in raising the imputation rate and the personal income tax rate to 35%. However, an easier way of achieving this equality is simply to reduce the corporation tax rate to the basic rate of income tax, 27%. This alternative is shown in the third column of Table 16. Again, mainstream corporation tax is extinguished if the company pays out its entire taxable profits in the form of dividends. Since the only effective tax is again personal income tax, shareholders are exactly as well off as with an increase in the imputation rate.

Such a reform would have three further effects which would appeal to the Chancellor. First, it would clearly reduce the burden of tax on companies (though this is already falling due to the build-up of capital allowances). Second, it would reduce the disincentives to invest discussed above. Third, it would improve companies' cash flow which, in turn, should help to increase investment. A possible drawback of this move is its cost. For example, a reduction in the tax rate from 35% to 27% could cost around £4bn.

It must therefore be acknowledged that this is unlikely to happen in a single step. However, judging from the Chancellor's previous reforms, he would be prepared to announce a progressive reduction over a number of years. In conclusion, then, major changes to the *structure* of corporation tax in the 1988 Budget are unlikely, but a reduction in the *rate* is a significant possibility.

<sup>1</sup> Note that, in principle, there would need to be a flat rate on all investment income. Even without this politically unacceptable change, however, significant moves towards neutrality could be made. Note, too, that we have ignored taxation of capital gains.

## 4.4 North Sea Taxation

Reforms to the taxation of North Sea oil and gas production formed part of the 1987 Budget. Those reforms were at least partly in response to the dramatic fall in the dollar world oil price in 1986 – and the even more dramatic fall in its sterling equivalent from late 1985 due to exchange rate movements. The price collapse had a considerable impact on the potential profitability of new projects in the North Sea at the same time as devastating company cash flows.

The reforms enacted last year were directed at these problems. First, rebates on advance petroleum revenue tax (APRT) were to be paid earlier, and second, the "field-by-field" basis of petroleum revenue tax (PRT) was breached by 10% of development costs on new fields becoming allowable against PRT on other fields.

However, the problems that existed in early 1987 have not been completely dissipated by these reforms. Two recent reports<sup>1</sup> have both highlighted the impact of the existing tax system on new development in the North Sea. One particular problem concerns incremental investment on existing mature fields. Given that such fields tend to be considerably larger than new fields, even relatively small increases in their capacity could significantly boost UK production of oil. However, the tax system acts as a considerable disincentive to undertake such incremental investment. This disincentive arises from several features in the tax system, mainly to do with licence royalties and corporation tax. PRT generally acts in such a way as to counteract the disincentive effects of these two taxes, and is fairly successful in doing so for new fields, partly as a result of the cross-field allowance introduced in the 1987 Budget. However, it does not currently counteract the effects of the other two taxes for incremental investment.

There are a number of paths open to the Chancellor to try to improve incentives for the continuing development of the North Sea. Probably the most likely reform is the introduction of an incremental investment allowance for PRT. This would be directly aimed at the problem discussed and would be a natural extension of the measure introduced last year for development expenditure on new fields. It would offset the disincentive effects of licence royalties and corporation tax. It is difficult to quantify its likely cost, because it is not known to what extent it might lead to additional development.

A complementary measure would be to abolish licence royalties. This would extend reforms made in the 1983 Budget, when licence royalties were abolished for new fields only. This would, of course, allow the Chancellor to claim the abolition of another tax. The total cost of these two measures would be around £200 million, although this might be slightly higher in 1988 because of timing effects.

One other feature of the North Sea tax system merits attention. That is the treatment of the huge costs of closing down production on new fields and removing all rigs and their machinery. So far, the tax system has not had to cope with this because no fields have yet been abandoned. However, in the

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<sup>1</sup> Select Committee on Energy (1987) and Bond, Devereux and Saunders (1987).

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next few years several of the earlier fields will reach the end of their economic lives. (Note, though, that the revenue consequences for 1988/89 of reforming the tax treatment of abandonment costs are likely to be zero.)

The current system regarding abandonment costs is a muddle. Some fields, generally the large and profitable ones, will receive very generous relief. Others, generally small and less profitable, will receive much less. The precise details of the system are too complicated to describe, but are outlined in a recent IFS Report (Bond, Devereux and Saunders (1987)). This report also proposes revisions to the existing system which would remove the anomalies that would otherwise appear in the near future.

## 4.5 Indirect Taxes

The European Commission has, during the last year, made proposals for the harmonisation of indirect taxes (VAT and excise duties) throughout the EEC. These proposals form part of the programme of action to "complete the internal market"; they are intended to allow the abolition of fiscal controls at the Community's internal frontiers. The Commission is recommending that this programme should include a substantial convergence of the rates of VAT and excise duties in member states.

### Value added tax

Member states would be required to operate a two-tier system for VAT, with a standard rate of between 14 and 20 per cent which would apply to most goods and services, and a reduced rate of 4 to 9 per cent for certain "basic goods and services". Most of the commodities which are zero-rated in the UK at present would come under the reduced rate band, except that children's clothes would be subject to VAT at the standard rate.

More substantial changes would be required in UK excise duty levels. The Commission envisages complete uniformity in duty levels throughout the Community. As a recent report by the House of Commons Select Committee on European Legislation has noted, this would require reductions in all the UK's duty rates on alcoholic drinks, which would range from about 40% in the case of spirits duty (a fall of £2.30 on an average bottle) to about 85% (down 70p per bottle) on table wine. The tax on cigarettes would have to be reduced by about 10% (12 pence per packet). The duty on petrol would be increased by about 25% (20p per gallon), with a fall of a roughly similar size in the duty on derv.

In view of the substantial departures from existing tax levels, and the implications for the tax revenues of some member states, the Commission's proposals are likely to encounter stiff resistance. They may well be modified considerably after discussion in the European Parliament and amongst member states. The proposals do not in any way force the Chancellor's hand in this present Budget - although they might provide him with added reasons to do things that he already wants to do.

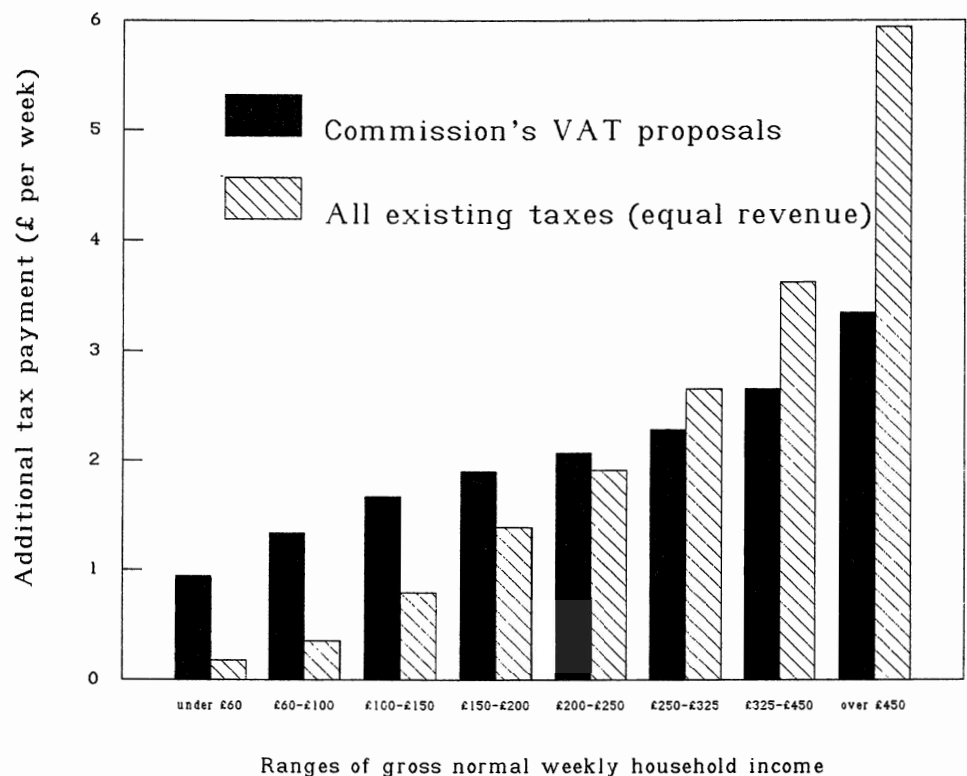
Much discussion has centred on the possibility of abolishing or reducing the scope of VAT zero-rating. Food, public transport, children's clothing, books and newspapers, new houses, fuel, water and power are all zero-rated for VAT in the UK. There is, however, a strong presumption on efficiency grounds in favour of applying a uniform VAT rate to all goods and services. Different rates of taxation for different commodities have the effect of artificially distorting consumers' choices between them. These distortions impose costs of taxation which are over and above the costs inevitably involved in raising revenue.

The case for retaining zero-rating has been the effect that its abolition would have on the living standards of poorer households. As Figure 3 shows, the burden of VAT on presently zero-rated items would be borne more heavily by poorer households than is the burden of the tax system overall. If the revenue

from imposing VAT on zero-rated items were merely used to finance a general reduction in all taxes, the net effect would be to worsen the living standards of poorer households relative to richer households.

Figure 3.

Distributional impact of the Commission's proposals for VAT.



However, it would be possible to use the revenues raised by ending VAT zero-rating in a way that would more than compensate poorer households for the extra tax they would have to pay. Since, as Figure 3 shows, the extra VAT that would be paid by poorer households is less, in cash terms, than the extra VAT that would be paid by richer households, a lump-sum redistribution of the revenues would leave poorer households better-off than at present. As Davis and Kay (1985) have shown, use of VAT revenues to finance an increase in tax allowances and social security levels would have much this effect. Explicit compensating measures of this form would more than compensate for the adverse distributional consequences of the ending of VAT zero-rating.

Ending all VAT zero-rating would contribute substantially to tax revenues; the Government's estimate is that the Commission proposals for VAT would bring in an extra £3bn in a full year. More likely are marginal additions to the VAT base, either in areas where Community pressure is strong (e.g. non-domestic energy, where ending VAT zero-rating would actually raise little revenue), or on commodities where the distributional justification for zero-rating is weaker

## Analysis of Tax Options

(e.g. newspapers and magazines). For reasons of administrative cost and complexity, the Chancellor is unlikely to want to introduce a lower-rate band for VAT at this stage, and any extension of the VAT base would be likely to be at the standard 15 per cent rate, rather than the lower rate of 4 per cent which the Community proposals would apply to most zero-rated goods and services.

### Excise duties

In last year's Budget, the Chancellor allowed the real level of most excise duties to fall, by failing to "revalorise" duties denominated in money terms in line with inflation. Leaving excise duties unchanged again this year would cost some £0.6 million compared with full revalorisation, and would have the merits of avoiding any boost to price inflation and of moving real duty levels on alcohol, tobacco and derv (though not on petrol) in the direction the Commission is proposing.

Table 17. Change in Real Value of Excise Duties (%)

Year	Spirits	Wine	Beer	Petrol	Cigarettes
1978	-7.7	-7.7	-7.7	-20.9	-7.7
1979	-11.7	-11.7	-11.7	8.3	-4.3
1980	-1.9	-3.5	2.7	4.7	-4.7
1981	2.4	4.4	23.8	23.3	16.4
1982	-2.1	3.3	4.4	3.6	5.1
1983	0.4	1.1	1.0	0.2	0.8
1984	-3.0	-23.6	6.0	0.3	9.0
1985	-4.0	2.0	1.5	-1.4	1.7
1986	-3.3	-3.3	-3.3	4.3	9.4
1987	-3.8	-3.8	-3.8	-3.8	-3.0

However, for reasons of health policy, the Chancellor is unlikely to permit the real level of duty on cigarettes to continue to decline, and public concern about the costs of alcohol abuse has also grown. Duties on alcoholic drink have in fact been held constant since 1985 and their real value has fallen by about 7%. The Chancellor could thus find health arguments for pushing alcohol taxation up again if he wished to do so, even though it would run counter to the European Commission's proposals on fiscal harmonisation. He may also invoke the health argument to justify yet another increase in tobacco duty. Finally he could use the opportunity provided by the weakness of the *sterling* oil price to repeat the trick he played in 1986, and raise petrol duties in order to put pressure on the oil companies to reduce their prices.

When the Chancellor comes to weigh up the arguments, he will find inflation and EEC considerations pointing to a cut in real duty rates, while revenue and health considerations may indicate a rise. On balance we expect these arguments to offset each other; our best guess is that duties are raised in line with the RPI, leaving them unchanged in real terms.

## 4.6 The Taxation of Savings

In recent years a number of major reforms have taken place in the area of savings taxation. Some forms of saving, such as contributions to life assurance schemes, have lost their favourable income tax status, whilst others, such as direct share ownership via the new Personal Equity Plans, have gained in privilege. There have been significant changes to the operation of capital gains tax, relating mainly to the provisions for indexation of gains, and the 1984 Budget saw the abolition of the investment income surcharge, another tax with a major impact on savings. Together these changes have significantly altered the pattern of savings taxation in the UK. In this section we consider the changes which the present Chancellor has made in this area in the light of the principles which underlie the taxation of savings, provide an assessment of the quantitative significance of the changes which have been made, and examine possibilities for reform.

### The principles of savings taxation

A fundamental idea in the taxation of savings is that of "neutrality". Essentially this is the principle that the tax treatment of different assets should produce minimal distortion to the savings decisions of individuals and corporations. A system which encourages investment in assets with a low pre-tax rate of return simply because of the relative tax advantages of doing so may be expected to produce an inefficient allocation of investment funds. A neutral tax system is not necessarily an ideal system, but does provide a useful bench-mark against which to assess tax-induced distortions in the savings market.

The present UK tax system is far from neutral between different forms of saving. In some cases the return to a given investment is defined as an income and so is liable to income tax, whereas in others the return is classed as a capital gain and so is taxed under the entirely different regime of capital gains tax. In some cases the investment is made out of pre-tax income and only the return is taxed, in others out of post-tax income with the return also being taxed, and in still others the investment is made out of post-tax income with the return going untaxed. Furthermore, factors such as the expected rate of inflation can, via the tax system, be important in determining the relative attractiveness of assets. All of these factors mean that the tax regime is an important consideration in the assessment of alternative investments.

This complex pattern of tax privileges and penalties has arisen from a series of *ad hoc* government measures, whose individual and combined effects have often been far from those which were originally intended. Here we examine the way in which government intervention affects the market for savings and look at the direction of recent policy.

### An analysis of recent policy

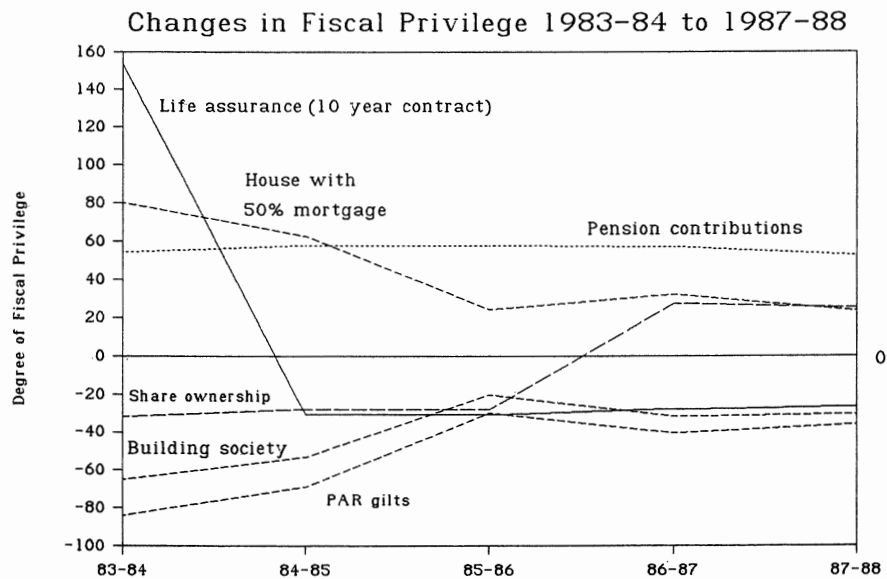
In order to quantify the non-neutrality of the present UK tax system and to chart the direction of recent policy, we use a measure of the tax status of a given asset known as the "degree of fiscal privilege" or "DFP" associated with



that asset. The precise derivation of this measure is described in Hills (1984), but essentially it seeks to capture in a single number the many factors which lead to differences in the tax treatment of different assets. When the DFP is positive the asset is tax-privileged; when the DFP is negative, holdings of the asset are penalised by the tax system. Increases in the DFP thus represent improvements in the attractiveness of a particular asset from a tax point of view. More precisely, when the DFP is +100% the tax privilege associated with the asset is as important as the real return to the asset itself as a determinant of the investment decision. A DFP of 0 represents the simple taxation of the real return to an asset at the investor's own marginal income tax rate.

Figure 4 shows how the DFP for a range of assets has changed over the past four years for a basic rate taxpayer at the prevailing inflation rates.

Figure 4.



In the diagram 1983-84 refers to the tax regime following the 1983 Budget, and so on. The April to April inflation rates were as follows: 1983-84 8.4%, 1984-85 6.9%, 1985-86 3.0%, 1986-87 4.2%, 1987-88 4%. The basic rate of income tax was 30% from 1983-84 to 1985-86, 29% for 1986-87, and 27% for 1987-88.

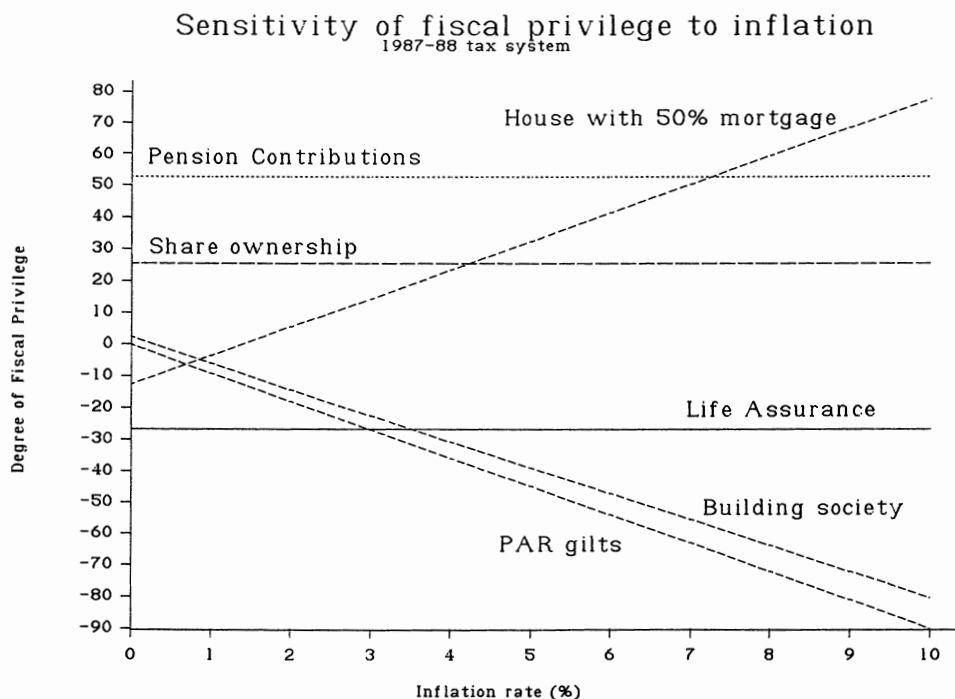
What is immediately striking about this diagram is the wide range of degrees of fiscal privilege associated with the different assets. These differences arise from a variety of factors, such as whether real or nominal gains are taxed, whether the return from the asset comes as income or as a capital gain, whether investment is made out of pre- or post-tax income, and so forth. It is precisely this pattern of rather arbitrary differences or non-neutralities which leads to distortions in the savings market and to pressure for a movement to a uniform treatment of savings either under an expenditure tax base - which essentially exempts from tax all forms of savings - or under an income tax base, whereby all forms of savings are liable to tax. However, as we look at the recent changes in more detail, we see that there is no sign that the Government has adopted such a coherent strategy.

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The sharp drop in the DFP of payments on life assurance contracts reflects changes made in the 1984 Budget. As a result of the Budget measures, premiums on new contracts could no longer be offset against income tax. This was a reform which represented a move towards an income base for the tax system. It was, however, followed two years later by a measure which moved away from the income base, namely the introduction of Personal Equity Plans (PEPs). The effects of this measure are shown in the sharp rise in the DFP of direct share ownership between 1985–86 and 1986–87. Under these Plans, individuals may invest up to £2,400 annually in shares, and any dividend income or capital gain accruing from the investment is exempt from tax. The introduction of PEPs coming just two years after the abolition of life assurance premium relief suggests the absence of any strategic plan for the taxation of savings.

The diagram does, however, show a reduction in the dispersion of fiscal privilege among these assets, and, to be fair to the Chancellor, the ending of life assurance premium relief has contributed to this improvement. The differences in fiscal privilege have also been reduced by the basic rate reductions contained in each of the last two Budgets, and also by the trend towards lower inflation. The way in which inflation affects the tax privileges or penalties associated with a particular asset is shown in Figure 5.

Figure 5.



Here we see that changes in the inflation rate have a significant effect on the pattern of fiscal privilege. In cases where it is nominal interest that is taxed or subsidised, the attractiveness of the asset concerned is sensitive to the prevailing inflation rate and, as Figure 5 suggests, the lower inflation rates of recent years have led to smaller differences between the fiscal privilege of different assets. It is worth noting, however, that an upsurge in inflation would again highlight

the structural differences in the taxation of these assets, and would increase distortions within the savings market. Overall, then, the pattern appears to be that the Government's wider aims of reducing inflation and of lowering direct tax rates have indirectly had the effect of reducing distortions in the savings market, but that there is no deliberate policy aimed at unifying the tax treatment of savings.

### Budget options

The reluctance to pursue such a radical policy was in fact signalled in the Chancellor's 1985 Budget speech. Rejecting an expenditure tax as "impractical and unrealistic", he went on to talk of pursuing a "middle way ... within the framework of our existing income based system".

This suggests that we might expect further isolated measures designed to encourage particular forms of saving, measures which are likely to complicate still further the existing rather arbitrary pattern of fiscal privilege. He has indeed promised that a Green Paper would be issued before any "thorough-going reform" of the tax treatment of personal savings, and so we should not expect dramatic changes in this area in the 1988 Budget. There are, however, a number of less radical options which might interest the Chancellor, and we consider these below. (Possible reforms to CGT which might have considerable impact on the savings market are discussed elsewhere in this Commentary.)

One possibility, which we have discussed above in the context of higher rates reform, would be to restrict the value of mortgage interest relief to the basic rate. Another option is an end to the present situation where cohabiting couples are eligible for tax relief on a combined £60,000 of mortgage whereas married couples are restricted to £30,000. Clearly the cheapest way of doing this would be to restrict the relief to one amount of £30,000 per property.

A second area in which the Chancellor may consider reform is the tax treatment of pension funds. At present, contributions into pension schemes are tax-deductible, income and capital gains accrued within the pension fund are tax-exempt, and at the end of the policy up to 25% of the final value may be received as a tax-free lump sum. The Chancellor himself acknowledged in 1985 that "there is a case for changing the tax treatment of pension funds", and his reference in the same speech to the "anomalous but much-loved" tax-free lump sum suggests that this element of the tax privileges of pension funds may be most vulnerable to reform.

A third possible area is the further encouragement of personal shareholding. Personal Equity Plans have not been a success; only around 3% of those individuals who hold shares appear to have taken them up, and these are mainly wealthy individuals with already large portfolios, taking advantage of the capital gains tax exemption. In the wake of the crash, the Chancellor may wish to bolster confidence and further encourage individual shareholders.

The chief distinction between PEPs, which have not attracted a great deal of interest, and the French *Loi Monory* and US Individual Retirement Accounts (IRA) which have, is that the tax relief on PEP's comes during and at the end of the holding period, whereas under *Loi Monory* and IRAs it is given at the point of contribution. If tax is then charged on withdrawal, the tax treatment is similar to that given in the UK to pension contributions. If it were decided to

## Green Budget 1988

model PEPs more closely on IRAs by giving tax relief on contributions, the system could be operated in a similar way to mortgage interest relief at source; individuals would contribute out of taxed income and the fund managers reclaim the tax direct from the Inland Revenue. If international experience is any sort of guide, the take-up of such a scheme would be much higher than that of the original PEP scheme, and such a reform might go some way to reinforce the new greater level of personal share ownership.

We see, then, that without a major change in policy we may expect little in the way of radical reform in this area. A number of isolated changes may well be made but any search for a strategy for the taxation of savings in the 1988 Budget is likely to be a frustrating experience.

# Appendix 1

## Forecasting Government Revenues

This appendix explains in detail how we arrived at our estimates for government revenues in 1987/88 and 1988/89. Of these two sets of figures, those for the coming fiscal year are of more interest because they in large part set the monetary limits within which any package of measures for the 1988 Budget must lie. However, we begin by examining the revenue picture for 1987/88, since this will form the base for our 1988/89 projections. While we obviously have more information on the fiscal year drawing to a close than for the one about to begin, we should stress that our forecasts for 1987/88 are still subject to a large error margin. Even the official Budget estimates of the PSBR for the current year – made when the year is eleven-twelfths complete – are subject to a £1bn error margin, as Table A1 illustrates. Our own estimates, based on less information and carried out two months earlier, are subject to a still wider margin.

Table A1. PSBR Forecast, Budget Estimate and Out – turn, 1979/80 to 1986/87

(£ billion)	Forecast <sup>a</sup>	Budget estimate <sup>b</sup>	Actual out – turn
1979/80	8.3	9.1	10.0
1980/81	8.5	13.5	12.7
1981/82	10.6	10.6	8.6
1982/83	9.5	7.5	8.9
1983/84	8.2	10.0	9.8
1984/85	7.2	10.5	10.2
1985/86	7.1	7.0	5.8
1986/87	4.1	4.1	3.4
Mean absolute error	1.9	0.9	

<sup>a</sup> Beginning of financial year.

<sup>b</sup> Eleven – twelfths through financial year.

**Methods** Table A2 shows the alternative methods by which we predict the various tax revenues for 1987/88. The starting – point for all components of revenue is the forecast given in the Financial Statement and Budget Report (FSBR or the "Red Book") published on Budget Day 1987 (column 1). Updated government estimates for the more important revenues appear in the November Autumn Statement (column 2). The third column is a mechanical forecast for full – year revenues derived from published monthly figures, allowing for expected seasonal variation using the following formula:

$$1987/88 \text{ forecast} = \frac{[\text{revenues Apr – Nov 1987}]}{[\text{revenues Apr – Nov 1986}]} \times 1986/87 \text{ total}$$

These receipts figures can be a useful monitor of revenue trends, though they are highly sensitive to one – off fluctuations in revenues (such as the large PRT repayments in September 1986) and should always be treated with caution.

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Table A2. Government Revenues in 1987/88

1987/88	1	2	3	4	5	6	8	9	10
£ million	FSBR	Autumn	Current	1986/87	Growth of	Budget	Result	IFS	
	Statement	Statement	receipts	out - turn	revenue	cost	model	IFS	FORECAST
<b>Income tax</b>	39900	40400	41062	38499	14.8	2170	41950		42000
<b>National Insurance</b>	28500	28900	29084	26683	8.7	130	28848		29000
<b>Corporation tax</b>									
non - North Sea	13600	14350						13300	14500
of which MCT				7200			9300	9300	10440
ACT				3500			4000	4000	4060
North Sea	1400							1200	1300
<b>Total</b>	15000		16660					14500	15800
of which MCT	10300		11366						
ACT	4700		5294						
<b>Capital taxes</b>									
CGT	1300		1050	1064					1300
CTT	1100		1092	988					1100
<b>Total</b>	3300								3300
<b>Expenditure taxes</b>									
VAT	23300	23800	22501	21377	10.3	- 180	23759	23485	23700
Petrol, derv, etc.	7800		7679	7507	7.0	240	7792	7697	7800
Tobacco	4800		5070	4769	4.2	105	4864	4824	4850
Alcohol	4300		4243	4195	9.9	105	4505	4379	4350
Betting	800		853	785	8.6		853		850
Car tax	1100		1036	962	10.3		1061		1050
VED	2600		2638	2575	11.5		2781		2700
TV licences	1030		1000	990	8.6		1075		1030
Stamp duties	2100		2422	1860	40.0		2604		2200
Rates	16900		16980	15545					16900
<b>North Sea revenues</b>									
Corporation tax	1400							1200	1300
PRT	1700							2100	2000
Oil royalties	800							700	900
<b>Total</b>	3900	4500						4000	4200
<b>Other</b>									
NS ACT set - off	- 800								- 800
Accruals adj.	0	- 200							- 200

Column 8 shows a further check on some revenues, based on a general elasticities approach. We start from assumptions (shown in Table A3) about the rate of growth of the relevant tax base (e.g. personal incomes for income tax, consumer spending for indirect taxes) and apply a tax elasticity to arrive at a forecast growth rate for tax revenues. We then apply this to the out - turn for the previous year and subtract the cost of Budget measures where applicable. This approach also forms the basis of our 1988/89 forecasts and is explained in greater detail below. A final alternative estimate for some revenue components is available from a specific IFS computer model, and is shown in column 9.

## Forecasting Government Revenues

The final column shows our actual forecast (reproduced in Table 6 on p.13) which is a judgemental average of the alternative forecasts. We discuss below the main differences from the government projections.

**Table A3. Key Assumptions**

		1987	1988
<b>Growth of personal incomes</b>			
wages per head	%	7.0	8.5
employment	%	1.7	2.0
wage bill	%	8.7	10.5
Growth of consumer prices	%	3.4	4.5
Growth of consumer spending	%	8.6	7.7
Oil price	\$/barrel	18	18
Exchange rate	\$/£	1.64	1.83
Growth of corporate profits	%	20	5
Effect of banks' bad debt provision on corporate tax	£m	-	-800

**Income tax** The Government upped its FSBR forecast by £½bn in the Autumn Statement which it attributed to faster-than-expected growth in earnings. Continued strong growth in wages and salaries, with little prospect of any slow-down before spring 1988, coupled with a more optimistic view about income tax elasticities than the Treasury admits to, leads us to expect a rather higher figure for income tax. This view is supported by the evidence of income tax in the first half of 1987/88.

**Expenditure taxes** Consumers' expenditure has grown a little faster than the 8% predicted at Budget time, due mostly to the continuing decline in the savings ratio to the unprecedentedly low level of 5% in 1987Q3. Any slow-down in spending due to the stock market crash appears to have been more than compensated for by the reduction in interest rates in October.

**VAT** VAT receipts, by far the largest component of expenditure taxes, were revised up by £500 million in the Autumn Statement. Our analysis of the composition of consumer spending in the first half of 1987/88 (see Table A4) indicates that the shift towards VATable commodities continues at much the same pace as it has over the previous four years. We attach relatively little weight to the latest receipts data, which have been compiled under a new accounting system and may be subject to revision.

**Table A4. Forecast Growth in Components of Consumers' Expenditure**

	Total cons exp %	Mainly VATable goods	Mainly non-VAT goods
1984/85	7.0	8.3	4.9
1985/86	9.1	10.0	7.3
1986/87	9.6	11.7	5.6
<b>forecast</b>			
1987/88	7.6	9.2	3.2

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- Excise duties** The FSBR forecasts for the main excise duties – petrol, tobacco and alcohol – are very much in line with the predictions from receipts and from the IFS model of consumer spending patterns. This is a sophisticated model of consumers' expenditure, disaggregated into ten commodity groups, estimated using Family Expenditure Survey data from 1970 to 1984. It can predict changes in the share of total expenditure of each of the categories resulting from changes in relative prices (so that, for example, we can estimate the effect on beer expenditure of a change in the price of cigarettes).
- Stamp duties** The 70% growth in stamp duties forecast in the FSBR seems conservative next to the almost 100% growth implied by the receipts to November, though this figure is highly dependent on the pattern of government share issues through the year. Moreover, the stock market crash has greatly depressed share prices and while this was offset by higher volume of spending in October and November, stamp duty from shares in the final part of 1987/88 is bound to be considerably lower. On the other hand, the rest of the sources of stamp duty, of which house purchases are the largest (see Table A8), have remained buoyant throughout 1987/88.



## Forecasting Government Revenues

### Government revenues in 1988/89

**Method** For 1988/89 our forecasting method is to start from our 1987/88 projection and apply a growth rate derived either from the relevant IFS tax model or using the elasticities approach discussed above. Table A5 shows the results.

**Table A5. Government Revenues in 1988/89**

1988/89	1	2	3	4
£ million	IFS 87/88 forecast	Growth rate	Budget costs	FORECAST
Income tax	42000	1.156	1000	47552
National Insurance	29000	1.098		31842
Corporation tax				
non – North Sea	14500			15115
of which MCT	10440	1.120	800	10893
ACT	4060	1.040		4222
North Sea	1300			1000
Total	15800			16115
of which MCT				
ACT				
Capital taxes				
CGT	1300			
CTT	1100		25	
Total	3300	1.121		3700
Expenditure taxes				
VAT	23700	1.092		25880
Petrol	7800	1.075		8385
Tobacco	4850	1.047		5078
Alcohol	4350	1.114		4846
Betting	850	1.077		915
Car tax	1050	1.092		1147
VED	2700	1.115		3011
TV licences	1030	1.077		1109
Stamp duties	2200	1.050		2310
Rates	16900			18300
North Sea revenues				
Corporation tax	1300			700
PRT	2000			2100
Oil royalties	900			700
Total	4200			3500
Other				
NS ACT set – off	– 800			– 600
Accruals adj.	– 200			0

**Income tax** Expected growth in income tax is basically determined by forecast growth in earnings and employment. But, as Table A6 shows, in recent years income tax revenue has grown significantly faster than incomes, i.e. the revenue elasticity is greater than unity. This is the result of an income tax system where the operation of personal tax allowances means that marginal tax rates will always

## Green Budget 1988

exceed average tax rates. However, the marginal rate faced by the vast majority of taxpayers has been falling, and is expected to fall again in this Budget, which will tend to reduce the revenue elasticity in future years. In 1988/89 we have applied a slightly lower elasticity to total earnings growth, to take account of the higher-than-usual contribution of extra employment. (We assume that new entrants to the labour force contribute extra income which is taxed at the average rate rather than the marginal rate.)

Table A6. The Elasticity of Income Tax Revenues

	Actual tax £m	FSBR est. of budget effect £m	Adjusted tax £m	Change in adj. tax %	Change in incomes %	Elasticity
1982/83	31730				8.8	
1983/84	33089	2000	35089	10.6	7.7	1.4
1984/85	35276	1820	37096	12.1	7.2	1.7
1985/86	38392	1590	39982	13.3	8.1	1.6
1986/87	42109	2075	44184	15.1	8.2	1.8
1987/88	46304	2970	49274	17.0	8.2	2.1

**Corporation tax** We derive estimates for on-shore MCT and ACT from the IFS computer tax model of the corporate tax system (described in Devereux (1986)). The model uses accounting data for a sample of around 400 large company groups and applies the actual rules of the corporation tax system to the accounting variables to estimate each company's tax liabilities.

**MCT** Mainstream corporation tax is forecast to grow substantially more slowly than it has in recent years. After the recession of 1980/81, MCT receipts rose rapidly for two principal reasons: strong growth in historic cost profits and the effects of the 1984 corporation tax reforms. Both of these caused an increase in the tax base which led in turn to a steep decline in the proportion of tax-exhausted companies. As a result, mainstream tax liabilities rose even faster than the underlying increase in profits. However, during 1988 it seems highly likely that these trends will reverse: the 1984 reforms will entail a build-up of capital allowances, and fewer companies will move out of tax exhaustion. This means that mainstream receipts will rise at a lower rate than profits. Furthermore, there is a growing consensus that 1988 will see a marked slow-down in the growth of company profits. Since this could have important revenue implications for later years, we take a closer look at the profits outlook in Appendix 3.

Table A7 shows the various model predictions for the growth of MCT in 1988/89 using different assumptions about the rate of growth of profits. One other recent development which will slightly reduce corporation tax receipts in 1988/89 is the decision to allow banks to write off £800 million of bad debts against their tax liabilities. We have assumed none of this £0.8bn is carried forward to fiscal year 1989/90.

## Forecasting Government Revenues

**Table A7. IFS Corporation Tax Model Forecasts**

	Profits assumption	MCT growth %	ACT growth %
1987/88	17.9	26.7	19.1
1988/89			
low	1.6	10.0	2.1
middle	8.6	13.8	2.1
high	15.2	17.3	2.1

**ACT** The IFS corporation tax model forecasts a sharp slow-down in the rate of growth of advance corporation tax receipts to around 4% in 1988/89, in line with the forecast slow-down in dividend growth.

**Expenditure tax** Consumers' expenditure is forecast to grow strongly again in 1988, though slightly less fast than in 1987 due mostly to an expected rise in the savings ratio from the extremely low current level. The composition, as well as the level, of consumer spending is very important to expenditure taxes, particularly VAT. We see little reason why the trend increase in share of total spending taken by VATable goods should slow and have consequently assumed a VAT elasticity of 1.2. As far as excise duties are concerned, we have assumed they are revalorised at the expected rate of inflation.

**Stamp duties** We have forecast a sharp slow-down in the rate of growth of stamp duties from over 50% in 1987/88 to around 5% in 1988/89. The two major components of stamp duties come from transactions in shares and in property. As Table A8 shows, stamp duty from stocks and shares has grown enormously since 1984/85, reflecting the booming stock market. Post-crash, our best guess is that stock prices will remain at about the same level through 1988 while the volume of trading will fall relative to 1987; which suggests (at best) zero growth in stamp duties from stocks and shares. As far as property is concerned, it seems likely that house prices will continue to rise in 1988, though probably not quite at recent rates. Some slow-down in the volume of purchases is expected.

**Table A8. Stamp Duties 1983/84 to 1986/87**

	Land/building		Stocks/shares		Other		Total
	£m	% of total	£m	% of total	£m	% of total	£m
1983/84	551.6	48.5	451.1	39.7	134.8	11.9	1137.5
1984/85	399.1	43.8	359.8	39.5	152.2	16.7	911.1
1985/86	506.7	41.2	519.2	42.2	204.8	16.6	1230.6
1986/87	750.5	40.3	890.5	47.9	219.1	11.8	1860.1

Source: Inland Revenue Statistics.

**North Sea revenues** In recent Budgets the prospects for North Sea oil revenues have been of crucial importance in determining the Government's financial position. However, since the collapse of the oil price in 1986 and with North Sea production past its peak and the Treasury coffers bulging with non-oil revenues, this is no longer the case: North Sea revenues are forecast to contribute only 2% of total

## Green Budget 1988

revenue in 1988/89. Nevertheless, it would be wrong to classify oil revenues as being of negligible importance to the Chancellor's calculations, especially as they remain so volatile. North Sea oil revenues depend on the oil price in sterling, which in turn depends on the dollar price determined in the international market and the sterling/dollar exchange rate. These two variables remain as difficult as ever to forecast. For 1988/89 we have assumed an average oil price of \$18 a barrel with the exchange rate remaining around its present level of about \$1.80 to the pound.

Table A9 shows the revenue predictions of the IFS North Sea tax model under alternative assumptions about the oil price and the exchange rate. Revenues increase with the dollar oil price but decrease as sterling strengthens against the dollar. We believe it unlikely that North Sea revenues will deviate by more than £1bn either side of our central forecast.

Table A9. North Sea Tax Revenues under Alternative Assumptions (£ million)

		Exchange rate (\$/£)		
		1.60	1.80	2.00
Oil price	14	2890	2520	2220
per barrel	18	3900	3390	2990
(\$)	22	4940	4300	3790

**Asset sales** Although classified in the government accounts as "negative spending", receipts from the government privatisation programme are equally seen as a source of revenue. They have become increasingly important over time: from below £500 million per annum before 1982/83, to over £2bn in 1984/85, £4bn in 1986/87 and a forecast £5bn for each fiscal year 1987/88 to 1990/91. Despite the shadow cast over the privatisation programme by the stock market crash, we believe the government will comfortably hit its MTFs target for receipts in both 1987/88 and 1988/89.

As Table A10 shows, in 1987/88 over £2bn came from the second instalment of earlier issues – British Gas and British Airways; another £2bn worth of new issues were launched before the October crash. On the other hand, the Government's sale of its stake in BP (£7.2bn to be staggered over three years and its biggest sale to date) was most definitely affected by the crash. The issue was massively undersubscribed by the public, but the Government chose to go ahead with the issue, obliging the underwriters to take up the slack. The subsequent Bank of England guarantee to buy back any partly-paid shares at 70p for a limited period could have then wiped out any revenue gain for the Government from the issue, but for heavy purchases by the Kuwaiti Investment Office keeping the price above 70p. In the event, less than 2% of the BP shares were returned to the Bank, at a cost of less than £20 million.

As far as privatisation receipts in 1988/89 are concerned, the adverse effect of the crash on prices and small investor confidence might have been expected to jeopardise the Government's £5bn target. But as Table A10 shows, £4.7bn of the £5bn target is guaranteed from second and third tranches of issues already launched. This leaves just £300 million to be raised from new issues: candidates

## Forecasting Government Revenues

include British Steel and electricity (there is also some remaining stock in British Telecom available). However, given the volatile state of the stock market and government fears of a repeat of the BP fiasco, against a background where almost all the target can be met from existing issues, it seems unlikely that there will be any major new privatisation issues in 1988/89. The prospects for asset sales in 1989/90 and after are much less certain.

Table A10. Receipts from Privatisation

£ million	1987/88 <sup>a</sup>	1988/89
Royal Ordnance	200	
Rolls - Royce:		
part 1	500	
part 2	600	
British Airways:	400	
British Gas:		
part 2	1700	
part 3		1700
BAA:		
part 1	600	
part 2		700
British Petroleum:		
part 1	900	
part 2		2300
BT (pref. shares)	200	
Other		300 <sup>b</sup>
<b>Total</b>	<b>5100</b>	<b>5000<sup>c</sup></b>

<sup>a</sup> 1987/88 figures net of costs.

<sup>b</sup> Required to meet target.

<sup>c</sup> Announced target.

## Appendix 2

### The Government's Spending Plans

The results of the summer's inter-departmental wranglings over government spending in the coming three years are sketched out in the Autumn Statement and published in detail in the January White Paper, *The Government's Expenditure Plans 1988-9 to 1990-1* (Cm 288). This document suggests that government expenditure is, broadly speaking, under control, with the 1987/88 total actually coming in under target. As far as prospects for 1988/89 are concerned, an overshoot and/or upward revision of the announced plans is possible. However, for the purposes of calculating the fiscal adjustment, we have assumed that the Government will meet its spending plans in 1988/89.

#### Out-turn for 1987/88

The Autumn Statement revised down the FSBR forecast for the 1987/88 planning total by £1bn to £147.6bn. The White Paper revised this number down by another £300 million. The main reason cited for both these revisions is higher-than-expected capital receipts of local authorities and New Towns - more council houses have been sold, and at higher prices, than forecast at the last Budget. These unexpected gains have more than offset the limited overshooting of various departmental planning totals. The final out-turns for both the planning total and general government expenditure are very sensitive to the March spending figures which are particularly difficult to forecast accurately due to, for example, end-of-year surges in local authority spending. But with £600 million still left in the contingency reserve, we believe the 1987/88 out-turn will not deviate far from the White Paper estimates.

#### Prospects for 1988-89

The 1988/89 planning total is set to rise by £9.5bn from 1987/88 levels to £156.8bn - an increase of 6.4% in nominal terms, or 2% after allowing for forecast general inflation. This planned increase in real terms is consistent with the Government's central policy aim of reducing public spending as a proportion of the national product, because GDP is forecast to grow faster in real terms than spending. Reductions in the burden of debt interest (forecast to remain constant in nominal terms over the next three years), in unemployment and subsidies to industry have also played a part.

There are two main reasons to be slightly cautious about the Government's ability to hit its 1988/89 spending plans. First, major components of spending remain as difficult as ever to forecast and control. Allocations to local authorities, social security and for the EEC have been revised up from the 1987 White Paper plans, which gives an indication of the continuing difficulty the Treasury faces in these areas. Social security expenditure, which accounts for over 30% of the planning total, is particularly sensitive to assumptions on unemployment, take-up rates and demography. Second, there is the question of whether sufficient allocation has been made for the growth in costs in other departments - particularly health, education and defence - which are

## The Government's Spending Plans

generally reckoned to outstrip general inflation significantly. Even if the planned savings through efficiency drives are realised, the Government is likely to face a choice between imposing volume cuts on these departments or making more money available.

When we add to these standard difficulties the growing political pressure to increase spending on the NHS, the Government's safety net against overshooting – the announced £3.5bn contingency reserve – could prove inadequate. We have nevertheless taken the Government at its word on spending in 1988/89.

# Appendix 3

## Company Profits

The profitability of the non-oil company sector has shown a substantial improvement since the end of the last recession. Since 1982, non-oil profits, as measured in the national accounts, have achieved large gains in both nominal and real terms, with nominal profits increasing by 21% p.a. between 1982 and 1987. Non-oil profits have benefited from a sustained growth in output and demand at home and overseas, at a time when cost pressures have been relatively subdued. Stronger demand has enabled margins to be widened and generally weak fuel and raw material prices have helped firms to maintain these wider margins. Total profits (including oil) have been less buoyant, averaging 15% a year over this period, but this reflects the sharp drop in North Sea oil company profits in 1986 and 1987 following the fall in the oil price. The figures for the most recent years have been distorted by the reclassification of privatised firms from public corporations to industrial and commercial companies. Even after adjusting for these, however, the growth of profits remains impressive. The question is whether it will persist.

### Outlook for profits in 1987/88 and 1988/89

In the first half of 1987/88, non-oil profits were 23% higher than in the same period of 1986/87. But this figure is significantly distorted by the privatisations of British Gas (from 3 December 1986), British Airways (from 6 February 1987) and the British Airports Authority (from 16 July 1987). After adjusting for these, we estimate that underlying non-oil profits growth in the first half of 1987/88 was up only 13.5% on a year earlier. This represents a slow-down in the underlying rate of non-oil profits growth, but even so it remains well above the growth of money GDP, which over the same period increased by 9.5%. It is important to consider whether profits growth can be maintained significantly in excess of money GDP or whether the slow-down will continue.

Recent econometric work<sup>1</sup> has estimated profits directly from their interaction with other macro-economic variables such as exchange rates, demand and wage costs. This is a departure from the two more usual methods employed to forecast profits, both of which have clear disadvantages. The first method is to aggregate the profits forecasts of equity market analysts. Following periods of strongly rising profits, forecasts derived in this way often prove too optimistic and seem to respond only with a lag to changes in reported profits growth. The second method frequently employed is to project national income in total and then to subtract from this total forecasts for other components of income (wages, income from self-employment, and so on). In this way, company profits are derived as a residual, but this has the unfortunate consequence that all forecasting errors on the national income total or its sub-components will end up affecting the profits forecast.

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<sup>1</sup> See "Focus on company profits" in the December 1987/January 1988 edition of Goldman Sachs's UK Economics Analyst.



## Company Profits

A number of factors have recently been working against the continuation of rapid growth in company profits. The most important of these is undoubtedly the squeeze on margins resulting from the 12% appreciation of sterling during the second half of 1987. The initial impact of stronger sterling may actually be to help profits as a result of lower prices for imported raw materials, the benefits of which are not all passed on directly to the consumer. Furthermore, over fairly short time horizons, companies nowadays appear more willing to hedge against adverse movements in exchange rates. Consequently, the adverse effects of sterling's appreciation on profits may not show through until some time in early 1988/89. In the long run, though, econometric work suggests that the effect of a sustained 10% appreciation of sterling is to reduce profits by 13% as margins are squeezed, particularly on export-related business.

The slow-down expected by many forecasters in the US economy in the first half of 1988/89 following the October 1987 stock market crash will lead to somewhat slower world trade growth and also to more subdued export growth. This suggests that UK exporters' profit margins will be squeezed further as they struggle to compete in an environment of lower demand abroad. Domestic demand growth in Britain is also likely to be a little lower in 1988/89 and unit wage costs are projected to increase more rapidly. Both of these factors would tend to reduce the rate of profits growth further. Table A11 gives Goldman Sachs's latest forecasts of the macro-economic variables that have been found to be significant in explaining the evolution of non-oil profits. It also sets out the estimated long-run effects on profits of a 1% change in each of these variables.

Table A11. Influences on Profits

	1986/87	1987/88	1988/89
\$/£ exchange rate	1.49	1.70	1.87
GDP deflator (% increase)	2.4	5.3	5.4
Real personal disposable income (% increase)	4.5	3.6	3.7
Whole economy unit wage costs (% increase)	4.9	4.8	5.3
<b>Long-run effects on non-oil profits of a:</b>			
1% appreciation in sterling		+1.3%	
1% increase in GDP deflator		+1.0%	
1% increase in real disposable income		+1.3%	
1% increase in unit wage costs		-0.6%	

Source: Goldman Sachs, UK Economics Analyst, December 1987/January 1988.

Taken together, these forecasts suggest that non-oil profit growth (after adjusting for the impact of privatisations) may be just a little lower in 1987/88 than in 1986/87, at around 15%. This is of most immediate importance for the Budget arithmetic as it is the level of company profits in 1987/88 that determines the corporation tax base in 1988/89. However, the forecasts point to a significant slow-down in 1988/89 to around 4.5% (compared with money GDP growth of 8%) as the strength of sterling finally takes its toll. If true, this

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would signal the end of the corporation tax bonanza enjoyed by the Chancellor in recent years, though it must be admitted that some other City forecasts are more optimistic than Goldman Sachs about profits growth in 1988/89.

Table A12. Profits Forecasts

	1985/86	1986/87	1987/88	1988/89
Gross Trading Profits:				
Total (%) <sup>a</sup>	+11.0	-3.4	-17.7	+6.1
Oil (%)	-17.9	-53.0	+34.2	+15.3
Non - oil (%) <sup>a</sup>	+30.0	+16.2	+15.1	+4.4
Non - oil (£bn) <sup>b</sup>	41.3	48.6	57.6	60.2

a Figures for 1985/86 are adjusted to exclude the impact of the privatisation of British Telecom. Figures for 1986/87 and 1987/88 are adjusted to exclude the impact of the privatisations of British Gas, British Airways and the British Airports Authority.

b Not adjusted for privatisations.

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