Tax Options for 1990

The Green Budget

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Preface

One of the better features of the British law-making system is that when the government is contemplating new legislation in a controversial area, it often produces a so-called Green Paper, in which existing legislation is described, its short-comings reviewed, and options for change are set out and discussed.

Yet for one of the most important and controversial pieces of legislation produced each year – the Finance Act – the outlines are announced, as a *fait accompli*, in the Budget. There is no consultative document and the Budget-making process is shrouded in impenetrable secrecy.

This has always seemed an absurd way to proceed. The justification usually given is that consumers will act on any advance knowledge they may glean from the consultative process (e.g. stocking up on whisky if they expect an increase in the duty thereon) with deleterious consequences for revenue. Yet other countries find it possible to discuss tax changes before they are implemented and the Treasury Committee concluded in 1982[1] that "the advantages of more and earlier discussion of tax changes more than outweigh the administrative problems involved in their earlier formulation".

Despite this recommendation – made in response to the Armstrong Report[2] – nothing has changed. So in the absence of an official Green Paper on the Budget, the IFS has since 1982 published its own Green Budget. The IFS was founded in order to stimulate a more informed debate about the tax system, and a substantial part of our research output is devoted to devising and testing better ways of raising tax. Tax reform is an arcane and specialised subject, but at Budget time it attracts wide public interest. The Green Budget is an opportunity to remind people of the outstanding shortcomings of the tax system, and of the possible solutions to those problems.

However the purpose of the Green Budget is assessment, not advocacy. Although IFS researchers have strong views (the IFS itself of course has no corporate view) about the way the tax system ought to evolve, these are put forward on other occasions (for example a Tax Reform conference was held just before Christmas). In the Green Budget we analyse the political and economic constraints – particularly the state of the macroeconomy – which limit the Chancellor's scope for action, and assess the probability of change in the light of these.

Despite – or perhaps because of – this low-key approach, the Green Budget helps to set the agenda for tax change. In this spirit, the present Green Budget (Green in the sense of Green Paper) contains a special Green section (Green in the environmental sense), emphasising that tax can play a role (small at present, but likely to grow in future) in encouraging more environment-friendly behaviour. It also seeks to remind the Chancellor that he should finish the reform of National Insurance on which his predecessor embarked, that there are strong arguments for extending the tax privileges available under the PEP (Personal Equity Plans) scheme to other savings instruments, and that the corporation tax system is still far from perfect.

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1 "Budgetary Reform" Sixth Report of the Treasury and Civil Service Committee, House of Commons, 1982.

2 "Budgetary Reform in the UK", Report of the Committee chaired by Lord Armstrong of Sanderstead, Oxford University Press, 1980.

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1 Overview

Macroeconomic Considerations

The Budget is, as its name implies, an exercise in public sector housekeeping. It is also an opportunity for tax reform, and a way of steering the macroeconomy. The present government has liked to emphasise the first two aspects of Budget-making and play down the third. But the economy is currently at a dangerous corner, and Mr Major's key task is to reassure our international creditors that he can bring it back onto a path of steady, non-inflationary growth.

The Budget will be framed against a background of a still-huge – though clearly now falling – trade deficit, which has become progressively more difficult to finance. Despite a two point rise in already-high interest rates and a $13bn fall in the official foreign exchange reserves, sterling fell by 12 per cent last year. This is fuelling inflation fears and excessive wage settlements, particularly in the exporting industries which find it easier, as the exchange rate comes down, to yield to wage demands and pass on the resulting increase in costs.

Mr Major's predecessor liked to argue that the current account deficit did not matter, in the sense that it reflected private borrowing that could be easily financed (rather than public borrowing that reflected an inherently unhealthy economy). The "ease of finance" argument has worn rather thin with the rise in interest rates (which threatens recession) and the drop in the exchange rate (which threatens inflation). And even Mr Lawson recognised that the excess demand, of which the current account deficit was a symptom, mattered.

In principle a current account deficit can result from an overvalued exchange rate or from excess domestic demand. Our analysis suggests that the problem has been excess demand. The obvious policy conclusion is that the Budget should aim to curb demand, and this should, given the excellent export performance and prospects in a strong world economy, maintain the rapid improvement in the balance of payments now under way. There is no need for a lower exchange rate: on the contrary since inflation is a worry, and since a falling exchange rate boosts inflation, a stable exchange rate policy is clearly indicated.

This points to a continuing policy of high interest rates, which is also indicated by other considerations. The economy has been brought to its present pass by a long consumer upswing, terminating in an astonishing surge in borrowing linked to a booming house market. Easier access to credit resulted in spending growth in 1987-9 which was far in excess of anything predicted by the major forecasters. The housing market, and credit growth, have been reined back by high interest rates, which are thus helping to reduce demand as well as support the pound.

However an important underlying cause of the boom is financial liberalisation and competition in credit markets which has enabled younger consumers to spend against expected future income. The boom may be over, but many of the conditions which led to it are still in place. Financial markets are still free. Real incomes continue to grow at around 3 per cent per annum. The government's financial surplus underpins the promise of future progress towards a 20 per cent tax rate. So December's bounce-back in spending is a timely reminder that the cooling of demand, which has been achieved by raising interest rates, may not survive their reduction.

The boom has led to rising inflation, which is now clearly the most important problem that Mr Major has to address in his first Budget. A tight monetary policy will prevent a rebound in consumer spending which at this stage would be disastrous. But toughness must be tempered with caution, because 15 per cent interest rates have already substantially slowed the growth of both demand and output. The slowdown in demand has pushed up stock-output ratios. There is a risk that companies, many of whom went sharply into debt in the recent investment boom, may try to reduce their indebtedness by rapidly shedding stocks. The result, as in 1980, would be a sharp downturn.

As always the Chancellor has to steer a course between inflation and recession – but this year his margin for manoeuvre is smaller, and the consequences of error much greater, than at any time since 1980–1. There will not be room for *both* a cut in interest rates *and* a cut in personal taxes, this year. The fiscal/monetary mix should not be eased until inflation pressures have clearly peaked. Yet Mr Major may at some stage this year need to reduce interest rates in order to help distressed companies. And he would in any case give up much of his discretion over interest rate movements when the UK joins the Exchange Rate Mechanism of the European Monetary System (EMS). So fiscal policy should aim at reducing domestic demand in order to give the Chancellor scope for any reduction in interest rates that may prove necessary.

For if the balance of payments is to improve without either a large rise in private savings (unlikely) or a large reduction in private investment (undesirable) then public savings, and the Public Sector Debt Requirement (PSDR), cannot be allowed to melt away. And if consumer demand is to be restrained while easing the monetary squeeze on the company sector, the tax weapon will need to be directed at the personal sector. The ability to target tax changes in this way is one reason for using fiscal policy more actively than has been the government's recent custom.

However, Mr Major's task in setting a tight fiscal policy is not being made any easier by the apparent rapid disappearance of his large budget surplus. Less than £4bn of this year's debt repayment target of £14bn had been achieved by December, and though the main tax-paying season is still to come, City estimates of the PSDR for this year and next have been revised down sharply. If this decline in the PSDR is occurring mainly because of a slowdown in GDP growth, there is a case for simply allowing it to occur, since it reflects the operation of automatic stabilisers in the economy. But it is not clear that this has been the case in the present fiscal year, which could well see growth in non-oil GDP of 2.5–3 per cent – close to productive potential. Therefore there

has been no easing in the pressure of demand in the economy this year. The fact is that the PSDR has declined even though GDP growth has been roughly on trend. This would normally be seen as sign of fiscal easing, which has been inappropriate in view of the inflation threat which faces the economy. This fiscal easing should now be offset.

If a weak economy has *not* been the main reason for the drop in the PSDR, what has been the cause? A combination of specific and unrelated factors has arisen to cut the Budget surplus. Revenue this year has been hit by the shortfall of National Insurance contributions which will persist, but grow little worse, in 1990–1. It has been caused by an unexpectedly large take-up of personal pensions plans, which should be peaking; and by the 1989 Budget cuts in employees' contribution rates which are now fully reflected in the monthly PSDR figures. There are some signs that corporation taxes, which reflect profits in 1988–9, may turn out lower than forecast. But there is as yet no evidence that other revenues are coming in lower than expected this year, or of slower growth next. For although demand, which determines taxes on expenditure, will grow more slowly next year than expected last March, this is more than offset by higher wages and prices. Nor will the shortfall in privatisation receipts get any worse next year. And though there are worries that local authority spending may turn out considerably higher than expected, under the new financing arrangements this should simply imply a higher Community Charge, not a lower PSDR.

We forecast a PSDR for 1989–90 of £10bn, which would rise to £10½bn next year on unchanged policies (no change in tax rates and full indexation of allowances and revalorisation of specific duties). However, in order to reassure the financial markets of their determination to fight inflation we expect the government to adopt a fiscal stance which is recognisably "tough" on three different criteria: first there will be a small discretionary increase in the tax burden as a result of Budget changes, for the first time since 1981. Second, the PSDR, both in absolute terms and as a share of nominal Gross Domestic Product (GDP) (the government's favoured indicator of the fiscal stance) will be higher next year than this. And third, those same measures of fiscal stance will be tighter than in last year's plans, over the entire 5 year period covered by the Medium Term Financial Strategy. In this way the unanticipated shortfall in debt repayment last year will be made up by faster debt repayment from next year onwards. This is mainly achieved by admitting to higher revenues in all future years. But there is also a discretionary increase in taxes of £1bn in the 1990 Budget which will boost revenue from next year onwards.

Prospects for Tax Changes

Income tax Changes to income tax are often seen as setting the tone for a Budget, and this seems likely to be the case this year. Although we have now had a long line of tax-cutting Budgets, the main choice facing Mr Major this year seems to be whether or not to *increase* the real burden of income tax. The two most obvious routes would be an increase in the basic rate by 1p to 26p or a failure to increase allowances in line with inflation. Either would raise around £1.5 billion. Raising the tax rate would be a move away from the 20p target set in the 1988 Budget, but would be a very strong statement of the government's

intention to control excess consumer demand. Not increasing allowances would mean bringing more people into the tax net, and is a less progressive change than raising the rate, but on balance seems more likely. If, as we believe, the Budget will increase the tax burden, reinforcing the government claim that fiscal policy is the essential buttress to monetary policy, income tax will probably have to provide most of the increase.

MIR There have been some suggestions that the mortgage interest relief (MIR) ceiling of £30,000 might be increased in the Budget, as a way of helping homebuyers. The ceiling has been unchanged since 1983, and to increase it now would be a retrogressive step, which would increase consumer demand, delay any fall in interest rates, help only those with mortgages in excess of £30,000 and provide a stimulus to the housing market, which is something the government is keen to avoid. Avoiding such a change and thus helping interest rates down before the election is certainly economically and politically more attractive.

Independent taxation We already know about the changes to the taxation of married couples to be introduced in the 1990 Budget, since they were announced in 1988. For most couples there will be no change in total tax payments on earned income, with the main exception being two-earner couples who at present elect to be taxed separately, who will gain from the changes. Under the current system, any investment income of a couple is taxed as the husband's income, even if it comes from assets owned by the wife. From April 1990, wives will be able to set their investment income against their own allowance, thus reducing tax bills for couples where the wife does not work, or works but has a lower marginal income tax rate than the husband. The cost to the government of this change is hard to estimate, but is likely to be a minimum of £0.5 billion in 1990-1.

Company cars A further area within income tax which might provide some extra revenue in a tight Budget is the taxation of company cars. In 1988, Mr Lawson doubled company car scale charges, while commenting that prior to the change perhaps as little as one-quarter of the true value of a typical company car was covered by the scale charge. In the 1988 Budget speech we were also told that "the scale of undertaxation is so great that it cannot be put right in a single year". In 1989 the scale charges were increased by one-third, and a similar increase this year would raise £¼bn.

NICs The most dramatic change in the 1989 Budget was the reform to employees' National Insurance contributions (NICs) which removed discontinuities in the schedule for low paid employees, reducing disincentive problems. A similar reform to employers' NICs is desirable, but unlikely both because of its direct cost, and the danger of accommodating wage demands. The NI ceiling, beyond which no further employee contributions are due, continues to decline relative to earnings; some revenue could be raised, and a desirable reform begun, by increasing the ceiling, although this seems unlikely. A final problem with NICs is their exclusion of benefits in kind, which encourages their use. Company cars, mentioned above, are probably the greatest beneficiary, but the problem applies to all forms of non-cash payment.

Corporation tax The corporation tax system introduced in 1984 is very vulnerable to inflation, even at reasonably low levels. The rise in inflation in recent years has amplified distortions which exist at any non-zero rate of inflation. Radical reform to remove these problems would be welcome, but would require a major about-turn. One way of reducing the problems caused by inflation without abandoning the 1984 reforms would be to reintroduce stock relief, although even this seems unlikely. An alternative change, less disruptive to the system, and less effective as a response to its problems, would be simply to cut the rate at a cost of £400 million for each 1 per cent cut. However, concerns over wage inflation probably rule out any substantial concession to the corporate sector. One further dark horse is some action to restrict the amount of tax relief banks can claim on provisions against doubtful overseas debt. Any move here might be seen as retribution following the banks' pulling out of the student grant scheme.

Indirect taxes A "neutral" Budget would be one which increased all indirect duties in line with inflation. The main problem with such a Budget from the government's point of view is that it would add 0.5 per cent to the Retail Price Index (RPI) (and almost as much to the annual rate of inflation, since duties were not fully revalorised last year). We are likely in any case to see some increase in RPI inflation next April when the rates are replaced by the Community Charge and the Uniform Business Rate, and this is likely to increase the pressure on the Chancellor not to revalorise the specific duties, especially if wage claims are still accelerating. On the other hand, leaving *all* duties at their current levels would cut the real tax burden by some £1.4bn, and irritate health and environmental lobbies. Given the need to raise taxes and hold down the RPI we can expect some increases, perhaps to tobacco products, strong alcohol, and leaded petrol, while other duties are left at current levels.

Taxation and saving There has been much recent debate over the possibility of encouraging more saving by using the tax system. The Chancellor has indicated that he is unsympathetic to such changes, correctly pointing out that new tax incentives would reduce public sector saving by cutting revenue, and thus might not increase national saving at all. Nonetheless, the taxation of saving in the UK is a mess, and there is ample scope for reform. The most likely change would be a further extension of Personal Equity Plans (PEPs), following that last year. Both the range of assets allowed and the annual limit could be increased, extending the tax privilege available to a larger part of the savings market and bringing the treatment of ordinary interest-bearing saving more into line with that on housing and pensions, overwhelmingly the two major savings vehicles at present.

Environmental issues As policy begins to take more explicit note of environmental consequences of economic action, the role of the tax system in this area is likely to grow. Taxes can be used to raise the price of goods to reflect the environmental costs of pollution and to provide revenue to help clean up the environment. The government has already moved into this area with the tax differential in favour of unleaded petrol. Budget options include carbon taxes, imposing Value Added Tax (VAT) on fuel, fertiliser and effluent discharge taxes, further incentives to use unleaded fuel, incentives to introduce catalytic converters, and differentiation of Vehicle Excise Duty in favour of small cars.

Summary Forecasting the precise content of a Budget almost two months away is always difficult, and this year more so than ever because of the uncertain macroeconomic framework. At present, we expect to see a net increase in total tax of some £1bn. £1½bn might come from not increasing income tax allowances, ¼bn from company cars, with possible additional sources of revenue being benefits in kind and NICs, and environmental or health driven increases in indirect taxes. The gross increase in revenue might thus reach £2bn of which £½bn might go on holding down some indirect taxes, and thus the RPI, with a further ½bn revenue loss resulting from independent taxation, a net increase of £1bn.

2 The Economic Forecast

2.1 The World Economy

The major developed economies experienced strong growth again in 1989 which has taken the economic upswing into its eighth successive year. As so often in recent years, there was some tendency for forecasters to underestimate economic growth but the margin of error was fairly small. A year ago, the OECD Secretariat was forecasting growth of 3.25 per cent in 1989; it now estimates that the outturn will be 3.5 per cent. A similar underestimate was made by other international forecasters including the Treasury. The additional GDP growth contributed to a slightly faster rate of inflation in 1989 than expected a year ago. At that time the OECD expected an inflation rate of 4 per cent compared to an estimated outturn of 4.4 per cent.

Early in 1989, inflation picked up in most countries largely as a result of the impact of earlier increases in oil prices and the effect of indirect tax increases in Germany and Japan. Against this background of increasing inflation pressure, monetary policy in each of the major developed countries was tightened further, maintaining a trend that began during the first half of 1988. More recently there has been a greater differentiation in the conduct of monetary policy. Faced with signs of weakening economic activity in the US and a slight easing in inflation pressures, the Federal Reserve eased monetary policy gradually from last May. But in continental Europe and Japan demand continues to grow strongly and the underlying rate of inflation may not yet have peaked. So despite some recent moderation in the rate of economic expansion the trend has been towards higher short-term interest rates.

Consensus forecasts show the present economic expansion continuing in 1990, though at a slightly reduced pace as a result of the more restrictive stance of policy. The OECD Secretariat forecast that growth in the developed countries will slow to 3 per cent this year, which would be close to the Secretariat's estimate of the long-run rate of potential output growth in the OECD area. Accordingly, consumer price inflation is expected to stabilise at around 4.5 per cent. Progress in reducing the core rate of inflation is unlikely unless either the growth of demand slows by more than expected by international forecasters or supply side developments evolve more favourably.

Table 2.1. Forecasts for the World Economy

% change from previous year	1988	1989	1990	1991
OECD Real GNP				
HMT	4.5	3.5	2.8	–
OECD	4.4	3.6	2.9	2.9
Goldman Sachs	4.5	3.3	2.3	–
OECD Consumer Prices				
HMT	3.3	4.3	4.0	–
OECD	3.3	4.4	4.5	4.4
Goldman Sachs	3.3	4.4	4.1	–
UK Export Markets				
HMT	8.5	7.0	5.0	–
OECD	9.2	9.2	7.2	7.4

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

Sources:
HMT – Her Majesty's Treasury, "Autumn Statement", November 1989.
OECD – "Economic Outlook", December 1989.
Goldman Sachs – "UK Economics Analyst", February 1990.

One of the risks to these forecasts is the possibility that economic activity remains stronger than expected which could lead in turn to a further upturn in inflation. There has been a repeated underestimate of growth in the OECD area since 1987. It is possible that the potential growth rate has increased as a result of the structural reforms implemented in the major developed economies in recent years. In this case higher growth would pose no worries for inflation. But there is undoubtedly also a cyclical element in the growth. Business confidence has been boosted by the longevity of the economic expansion and this has contributed to a sharp revival in investment growth since 1987. While this will enhance the supply side performance of the developed economies, it also adds to demand pressures in the short run. The danger is that this will now lead to a strengthening in wage demands in the next year and give a further upward twist to inflation. If this occurs then economic policy may yet need to be tightened further in a number of countries which could lead to a sharper slowdown in activity eventually.

The risks to these consensus forecasts are not one-sided though. It is possible that output growth could slow by more than is generally expected, particularly given the uncertainty about the timing and effects of monetary tightening on economic activity. Economic growth in the United States has slowed to around a 1 per cent annual rate as export growth and capital investment have tailed off and there are signs that this weakness may be spreading to the consumer sector. This raises the probability of a full-scale downturn developing. However, with real incomes expected to grow at around 2.5 per cent this year and with world trade remaining buoyant, most forecasts suggest that US economic weakness will be fairly short-lived. There also remains the perennial risk that

progress in reducing global current account imbalances which slowed last year will come to an end in 1990, which could pose problems for financial markets. But given prospective domestic demand differentials between the US and other countries and the favourable level of US competitiveness, further slow progress towards reduced trade imbalances seems likely to be maintained.

Overall, while risks exist in the world economy, the present situation seems relatively favourable for the UK. The Chancellor can probably plan on the assumption that UK export markets will continue to expand at a fairly healthy rate in the next year or two. Indeed the OECD Secretariat forecasts that markets for UK manufactured goods will expand by almost 7.5 per cent a year in both 1990 and 1991.

2.2 The UK Economy

In 1989 the UK economy generally performed less well than the consensus of forecasters had expected. Although the sharp slowdown in output growth which has taken place was generally foreseen, this was expected to lead to an earlier improvement in the balance of payments than has actually occurred. In its Autumn Statement, the government raised its estimate for the 1989 current account deficit to £20bn from £11bn made a year earlier and the Budget forecast of £15bn. Other forecasters made similar upward revisions through the year. Partly as a result of this disappointing trade performance last year, interest rates have stayed high for longer than expected. At the beginning of last year the consensus was for bank base rates to have fallen to 11 per cent by the end of 1989 compared to the actual level of 15 per cent. This helps to account for the fact that the rate of retail price inflation (via the impact of mortgage rates) ended the year at 7.7 per cent compared to the consensus forecast of 5 per cent made at the beginning of last year. Retail prices, excluding mortgage interest costs, rose by a little over 6 per cent.

Most of the errors in forecasting were based on an over-optimistic view of the speed at which the economy would respond to the tightening of monetary policy. But there is little doubt that the economy has now slowed markedly. Despite this, the behaviour of inflation remains worrying. Excluding mortgage interest payments, the underlying rate of retail price inflation is running at just over 6 per cent and is yet to show a clear peak. With the stubbornly high balance of payments deficit continuing to put downwards pressure on sterling, at a time when pay deals have still not peaked, the Chancellor cannot yet contemplate easing the monetary squeeze, for fear that a premature easing in base rates could lead to a further disastrous rise in inflation.

Domestic Demand

Most forecasters are expecting the prevailing high level of interest rates to depress domestic demand growth further during 1990 with some forecasters expecting a decline in the absolute level of domestic demand. Consumer confidence is running at very depressed levels and it is generally expected that the combination of a weak housing market and high interest rates will induce the personal sector to save more this year. Furthermore, the gap between average earnings increases and price increases may narrow further, so the rate of growth in real personal disposable income will slow. These factors have already led to a marked slowdown in consumer spending growth in recent months and it seems likely that the level of consumer spending will continue to rise very slowly, if at all, from now on. The Treasury forecast is for growth of 1.25 per cent this year compared to an increase of 3.75 per cent in 1989; this forecast is only fractionally less than the consensus view of other forecasters. There is a widely held view that investment growth will also tail off sharply during 1990. This is consistent with recent surveys of investment intentions which indicate only a very slight increase in investment this year as firms pare back plans for capital spending in response to the weaker demand environment. The Treasury projects an increase in the level of investment of 1.75 per cent

this year which is about one percentage point higher than the consensus of forecasters. Perhaps the greatest area of uncertainty in economic forecasts relates to the behaviour of stockbuilding. According to official national accounts data, which admittedly are very unreliable, there has been a sharp increase in the level of stocks relative to output in the whole economy during recent quarters. To restore this relationship to normal, firms would need to run down stocks and most forecasts now assume that this will occur this year. The Treasury's forecast, for instance, which is reasonably close to the consensus, projects a £0.3bn decline in stocks this year after an estimated £5.4bn increase in 1989. This would be sufficient to knock 1.5 per cent off the growth of GDP in 1990. Taken together, these projections for consumption, investment and stockbuilding would lead to a stagnation in the level of domestic demand compared to an increase of 3.5–4 per cent last year.

Net Trade

Import volume rose by about 9.5 per cent last year compared with a rise of only 4.5 per cent in export volume. This contributed to a further widening in the current account deficit to over £20bn last year from £14.7bn in 1988 and the deterioration would have been much worse but for an improvement in the terms of trade of almost 5 per cent. Nevertheless, there have been some encouraging trends in recent sets of trade figures. Export deliveries, in particular, rose rapidly in the second half of 1989 as domestic capacity constraints eased. Import volume also slowed through the year in line with the weakening in domestic demand growth and the growth of non-oil export volume is now exceeding that of non-oil imports. Most forecasters expect that these trends will be maintained during 1990. Growth in UK export markets should remain strong this year and it is possible that UK firms could increase their market share as domestic capacity pressures ease further and as they take advantage of the boost to competitiveness that has followed last year's sharp decline in sterling. A recovery in oil exports should also underpin this firm trend. Import growth is projected by most forecasters to remain weak this year given the outlook for domestic demand. As a result, most forecasts show an improvement in net trade volumes during 1990. The Treasury forecast, which is again reasonably close to the consensus, indicates a 6.25 per cent increase in export volume this year compared with a 1.25 per cent gain in import volume. Although the terms of trade may deteriorate slightly, this should be consistent with some improvement in the current account deficit on most forecasts to around £15bn.

Table 2.2. Demand Prospects

Annual % change, volume	1988	1989	1990
Private Consumption			
HMT	6.8	3.8	1.3
LBS	6.9	3.7	1.6
NIESR	6.9	3.8	1.2
Goldman Sachs	6.9	4.4	1.3
Total Fixed Investment			
HMT	13.2	5.3	1.8
LBS	13.1	7.4	2.5
NIESR	13.1	4.9	1.0
Goldman Sachs	13.7	6.6	0.7
Exports of Goods & Services			
HMT	0.7	4.8	6.3
LBS	0.7	4.5	6.7
NIESR	0.7	5.1	8.2
Goldman Sachs	0.8	5.0	7.8
Imports of Goods & Services			
HMT	12.2	9.3	1.3
LBS	12.2	7.6	0.5
NIESR	12.2	9.7	0.6
Goldman Sachs	12.4	8.6	0.8
Real GDP			
HMT	4.3	2.0	1.3
LBS[a]	4.7	2.5	1.9
NIESR[a]	4.7	2.3	1.6
Goldman Sachs	4.4	2.5	1.0

[a] Output – based.
Sources:
HMT and Goldman Sachs – as Table 2.1.
LBS – "Economic Outlook", October 1989.
NIESR – "National Institute Economic Review", November 1989.

Output

The general picture this year, therefore, is likely to involve a major slowdown in the growth of domestic demand, offset to some extent by an improvement in net trade volumes. The net effect of these factors may be to cut the growth of non-oil GDP to under 1 per cent this year. (Growth in the whole economy may be at least 0.5 per cent higher than this reflecting the recovery in North Sea oil output from temporary supply disruptions last year.) If these consensus forecasts prove correct then the sharp decline in unemployment witnessed since mid-1986 may be brought to an end during the course of 1990 as firms shake out labour to help bring wage costs under firmer control. There is as yet no clear consensus about economic prospects for 1991, though several forecasters project a gradual recovery in the growth of GDP to around 2 per cent.

Table 2.3. Other Key Indicators

	1988Q4	1989Q4	1990Q4
Price Inflation (%)			
HMT	6.5	7.5	5.8
LBS	6.5	6.8	5.6
NIESR	6.5	7.2	5.1
Goldman Sachs	6.5	7.6	6.4
Unemployment (millions)			
LBS	2.1	1.7	1.7
NIESR	2.1	1.7	1.7
Goldman Sachs	2.1	1.7	1.6
	1988	1989	1990
Current Account (£bn)			
HMT	−14.5	−20.0	−15.0
LBS	−14.6	−19.0	−14.8
NIESR	−14.6	−21.1	−17.9
Goldman Sachs	−14.7	−20.3	−12.8

Sources:
As Table 2.2.

Inflation

Turning to inflation, the Treasury's Budget prediction last year was for an increase in 1989/90 of 5.5 per cent in the GDP deflator (which is not affected by mortgage rates and is a good measure of the underlying rate of inflation across the whole economy). This seems likely to be around 1.5 per cent below the eventual outturn and maintains the Treasury's trend of the previous year of seriously underestimating the extent of inflationary pressures in the economy. The Treasury was not alone in this however. At this stage last year only one of 22 major economic forecasters (Oxford Economic Forecasting) expected the rate of retail price inflation at the end of 1989 to be higher than the 6.5 per cent prevailing at the end of the previous year. Looking ahead, the consensus expectation is for the rate of retail price inflation to drop to around 5.5 per cent by the end of 1990. The Treasury is at the higher end of expectations with its forecast of 5.75 per cent. A further slight drop is shown in consensus projections for 1991 although this largely reflects the beneficial impact of declining mortgage rates on the headline inflation rate rather than any clear improvement in the underlying rate.

3 The Major Risks

3.1 The Recession Risk

As we noted in Section 2 above, most economic forecasters are projecting only very modest growth in non-oil real GDP this year. These forecasts appear to be broadly consistent with recent developments in the economy though data in the second half of last year – apart from December's provisional retail sales figures – indicate that activity was already weaker than is consistent with the consensus forecasts. Non-oil GDP increased by only 0.1 per cent between 1989Q2 and Q3, and what little data we have for the fourth quarter suggests that non-oil growth will remain very subdued. Manufacturing output has been virtually unchanged now for around six months, largely due to a decline in the production of consumer goods. This tallies with evidence from the retail sales figures, which shows the volume of sales unchanged between the second and fourth quarters of last year, despite the unexpectedly sharp pick-up in sales in December.

These figures indicate that a marked slowdown in activity has already occurred, and there must be a severe risk that real GDP growth in 1990 will fall short of the consensus projection of around 1–1.5 per cent. It is true that most downturns in UK activity in the post-war era have seen nothing more serious than a slowdown in growth, rather than an absolute decline in output. But in the downturns which started in 1974 and 1979, the absolute level of output *did* fall sharply. One reason for this appears to have been that global activity fell particularly sharply in both of these two downturns, so weak growth in exports exacerbated the problems of domestic demand. This seems most unlikely to happen during 1990–1. However, the other distinguishing characteristic of the 1974 and 1979 downswings concerned the financial status of the company sector, and its response to a worrying financial deficit. Essentially, companies became desperate to correct their financial deficit by cutting back investment, employment and – especially – inventory levels. There is a clear risk that the same could occur during the current downswing, in which case it would be likely to be much more savage than is shown in consensus forecasts.

Although profits growth has been extremely strong in the last few years, company sector outlays on items such as investment, tax, dividends and take-over activity have been rising even faster than profits. As a result, the borrowing requirement of the company sector has been running at around 14 per cent of GDP in recent quarters, which is equivalent to over £70bn at an annualised rate. This rate of borrowing is much greater than has been seen at the onset of previous UK recessions; even those in 1974–5 and 1979–81, the two episodes which were characterised by sharp company sector cutbacks in response to rising financial deficits, saw nothing similar in scale to the present amount of borrowing.

The main risk now probably relates to the behaviour of stocks. Stock levels in the economy at large over the past decade have been declining steadily from a level of around a third of annual output. Table 3.1 shows that stock levels declined by 3.6 per cent between the fourth quarter of 1974 and 1975, and by 4.6 per cent between the first quarter of 1980 and 1981. These savage declines in stock levels produced exceptionally weak periods for real GDP growth, even though there were also large declines in the real volume of imports (of 5.9 per cent and 17.2 per cent in the two periods respectively). In the Treasury forecast for 1990 the projected decline in stock levels is much smaller than occurred in either of these two previous downturns. Specifically, the Treasury is projecting a drop of only 0.3 per cent in stock levels between the second half of 1989 and the second half of this year; this allows real GDP to continue growing by 1.6 per cent between these two periods, with import volumes staying roughly flat.

Table 3.1. Stocks and Imports in Previous Periods of Destocking

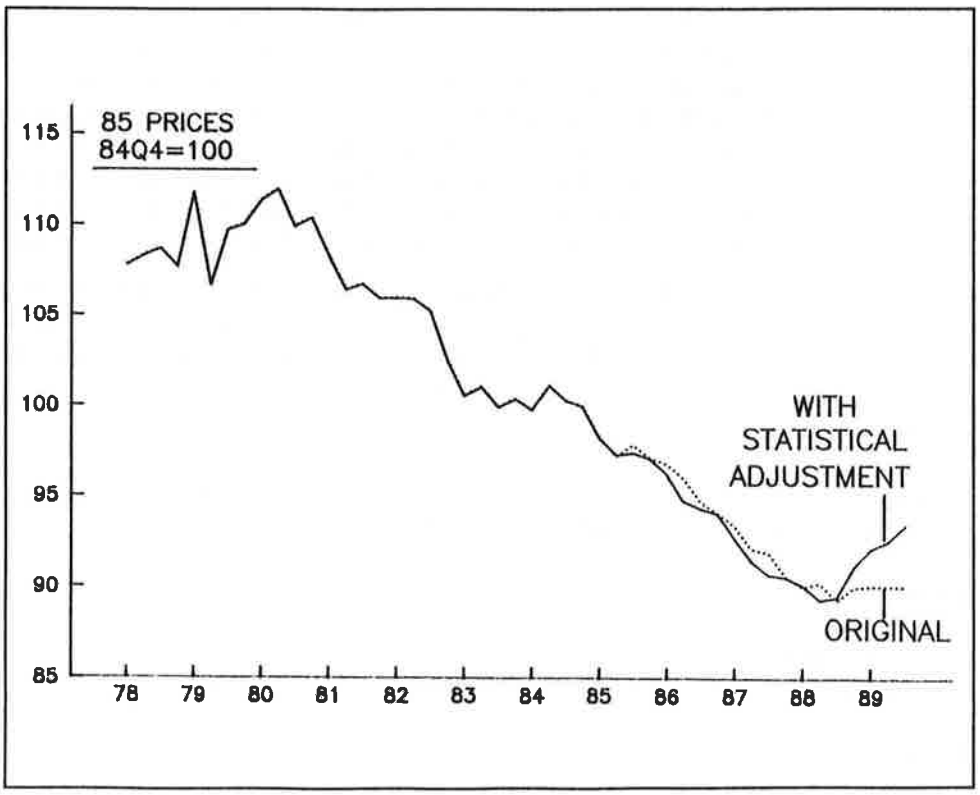
Per cent changes	GDP[b]	Stock levels[b]	Stock/output ratio	Imports of Goods and Services[b]
(i) 1974–76				
74Q4 to 75Q4	0.0	−3.6	−3.6	−5.9
75Q4 to 76Q4	4.5	1.7	−2.8	7.4
(ii) 1980–82				
80Q1 to 81Q1	−1.9	−4.6	−2.7	−17.2
81Q1 to 82Q1	0.6	−2.1	−2.7	13.1
(iii) 1989–90[a]				
89H2 to 90H2	1.6	−0.3	−1.9	0.1

[a] Treasury forecast.
[b] Volumes at 1985 prices.

One of the problems in judging whether this forecast will prove realistic concerns the unsatisfactory nature of stock data in the economy at present. The CSO is currently making large ad hoc statistical adjustments to the stock figures in an upwards direction. These leave room for considerable uncertainty about the true level of stocks in the economy, which in turn creates uncertainty about the present level of the stock/output ratio, and about the scope for a reduction in that ratio in the quarters ahead. Figure 3.1 shows that figures which *include* the statistical adjustment show a sharp counter-trend rise in the stock/output ratio over the past few quarters, while those figures which exclude the statistical adjustment show that the ratio has merely stabilised during 1989. If the former figures prove right, the extent of stock shedding which could occur in the next two years could be surprisingly large, and indeed much greater than is shown in the Treasury or any other forecast. For example, if firms decide to reduce the stock/output ratio to a level which would be consistent with its extrapolated 10-year downtrend – say by the end of 1991 – the level of stocks would need

to be reduced by around 10 per cent by then. This would be likely to lead to a much deeper recession in output than is currently expected, as well as to a vastly greater improvement in the balance of payments figures.

Figure 3.1. The Stock Output Ratio (whole economy)



In the present state of uncertainty, it is difficult to conclude anything other than that the downside risks to economic forecasts at present are unusually large, and this is one reason why the Chancellor needs to remain extremely cautious about the extent of any tightening in overall macro-policy at present, even though inflation pressures are still rising.

3.2 The Risk of a Rebound

The conventional wisdom has it that Mr Major now faces serious problems in managing the economy because of policy errors by his predecessor. The authorities have lost control of broad money growth and, with hindsight, policy errors can be detected, notably the relaxation which was initiated to offset the 1987 crash and continued in an ill-fated attempt to shadow the DM in 1988. But it would be quite wrong to pretend that low interest rates in 1987–8 were the main *cause* of the unprecedented surge in borrowing which led to an overheated economy. Nor is it possible to ascribe that surge to the 1988 tax cuts, though again, with hindsight, these now appear ill-judged from a macroeconomic viewpoint. The truth is that the surge in consumption in 1987 and 1988 – which coincided with a very rapid fall in unemployment – was apparently due to a fall in the savings rate which was not predicted by any of the major macro-models, as Table 3.2 shows.

Table 3.2. Real Consumer Spending Growth: Forecasts and Outturns

Annual % change	1987	1988
National Institute[a]	4.3	2.9
London Business School[a]	3.9	3.3
H M Treasury[b]	4	4
Goldman Sachs[a]	3.3	3.8
Outturn	5.4	6.9

[a] Forecast for year made in February of that year.
[b] Budget forecast published in March.

The key role played by the savings rate in the consumer boom of 1987–8 makes the present boom quite different from previous episodes of economic mismanagement. Table 3.3 decomposes the growth of spending into growth of incomes and change in the savings ratio. It shows that in the Barber boom of 1972–3 real incomes grew by 15 per cent and in the Healey boom of 1978 they grew by 13 per cent. These figures were clearly way beyond the capacity of the economy to supply. In the current episode real income growth in 1987 and 1988 was only 8½ per cent. The difference this time, and the reason for our present difficulties, is that whereas the Barber and Healey expansions were damped by a *rise* in the savings ratio, the Lawson expansion was, unprecedently, reinforced by a *fall*.

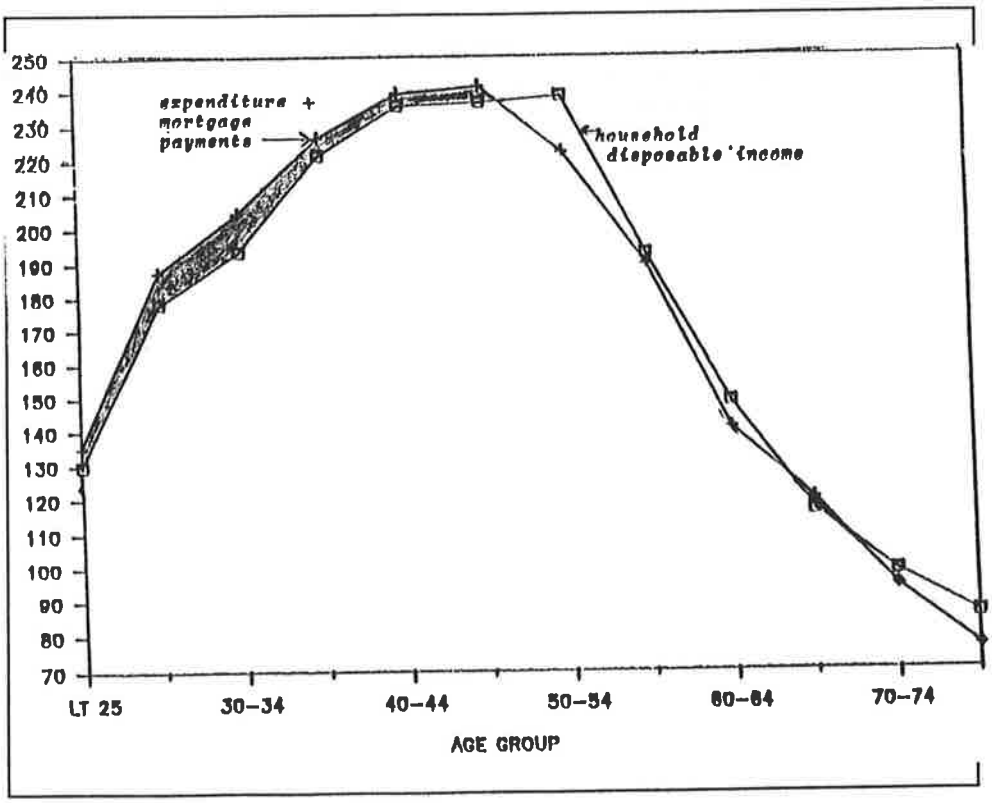
Table 3.3. Income, Saving and Spending in Three Cycles

	Changes in real incomes %	+	Change in saving ratio[a] %	=	Change in real spending %
The Lawson Boom					
1986	3.7		1.9		5.6
1987	3.6		1.8		5.4
1988	4.9		2.0		6.9
1989	3.3		0.4		3.7
The Barber Boom					
1972	8.4		−2.3		6.1
1973	6.4		−1.2		5.2
1974	−0.8		−0.7		−1.5
1975	0.5		−1.1		−0.6
1976	−0.1		+0.4		0.3
The Healey Boom					
1978	7.2		−1.7		5.5
1979	5.6		−1.4		4.2
1980	1.5		−1.5		−1.0
1981	−1.3		1.5		0.2
1982	−0.1		0.7		0.8

[a] Plus sign indicates more spending, fall in savings ratio.

The reasons for that unexpected fall are most probably connected with the liberalisation of financial markets that gathered pace in the late 1980s. There has always been a strong underlying demand for credit connected with the life cycle. Evidence from the Family Expenditure Survey suggests that income first rises and then falls across the life cycle and also that the young and old dissave while those in middle age do the bulk of the saving. However, Figure 3.2, based on cross-section data for a single year, suggests that in the past the scale of the dissaving was rather small in relation to the underlying variation in incomes. The liberalisation of financial markets, which has made it much easier to borrow against future income, may be changing that. The underlying demand for credit, to smooth spending across the life cycle, will almost certainly be greater in the 1990s than in the past. In other words, the major *underlying* cause of the 1987–8 boom is still in play.

Figure 3.2. Income and Spending by Age



Source: "Family Expenditure Survey".

The *immediate* cause of the boom was an explosion of borrowing secured on housing. The dominant role of mortgage finance in personal borrowing means that the housing market, which has played such an important role in the past cycle, will continue to do so. Rising house prices boost the growth of credit because would-be borrowers feel wealthier and lenders are reassured by the increased collateral. They also boost turnover and hence the number of *opportunities* to borrow. Conversely, when house prices are depressed, borrowing slows. The downturn in retail spending over the past year is intimately connected with the downturn in the housing market.

Easier access to credit means that spending has become increasingly divorced from *current* real incomes and influenced more by lifetime real incomes and by borrowing. In other words fluctuations in real incomes will matter less and credit conditions – including the state of the housing market – will matter more. Expectations of lifetime real incomes are probably changing little, being linked to current real incomes which continue to grow by a respectable 3 per cent or so, and on present policies will probably do so again next year. The necessary slow growth of spending thus depends crucially high interest rates. If they fall, spending could rebound.

Alternatively of course, the Chancellor could seek to moderate these expectations of rising incomes, by admitting that economic prospects for the next year or so are fairly dismal. He could even make it clear that the time is not ripe for further progress towards a 20 per cent tax rate. More effectively he could increase the burden of income tax for a year or two.

3.3 The Risk of Rising Inflation

The major worry, ever since the excess demand in the economy carried the balance of payments into deficit, has been that the ultimate consequences of this overheating would be inflation. In the early phases of a boom the economy suffers from demand-pull inflation – the strength of demand enables suppliers to widen margins and put up prices. That kind of inflationary pressure, which was in any case much attenuated by a ready supply of imports, is no longer a problem. In the Christmas shopping period this year retailers were obliged to mark down prices to shift the merchandise, and there is anecdotal evidence that unexpected buoyancy of December's retail spending figures reflected purchases in the post-Christmas sales to take advantage of lower prices – which helps explain the stability of retail price inflation in that month.

Margins are thus now under downward pressure. But there is as yet little sign that inflation is falling. We are simply witnessing a shift, normal at this stage in the cycle, from "demand-pull" to "cost-push" inflation. The problem is that wages, far from reacting to the downward pressure on margins, are still edging upwards. One reason for this is that the labour market remains tight – the weakness of demand and output has slowed but not yet reversed the long fall in unemployment as firms respond by labour-hoarding to widespread fears of a coming skills shortage. A second reason is that wage negotiations are typically influenced more by reports of historic price inflation and *last year's* profits (both high) rather than by forecasts of *next year's* (distinctly lower). A third reason frequently cited is that the chosen means of cooling the economy – high interest rates – is substantially raising the living costs of younger workers, who are understandably trying to recoup in the wage package what they have lost on their mortgage payments. By contrast those who *gain* from high interest rates are typically older workers or retired people who have little influence in the formulation of wage demands.

The claims from shopfloor workers burdened by high mortgage repayments are being met by employers who have a cushion of past profits to fall back on, who fear losing key workers, and (above all) who have been encouraged by a 12 per cent fall in the effective exchange rate to believe that they may be able to pass on the resulting cost increase in higher prices. Over the past two years wage inflation has edged upwards from 7 to 9½ per cent. Meanwhile output growth has slowed from 5 per cent in 1987 and 1988 to 2 per cent in 1989. As a result the growth of unit costs has accelerated from 3 per cent in 1987 to 8 per cent last year. With wages still accelerating and output growth set to slow further, there is little prospect of a fall in cost pressures this year.

There are many different ways of measuring inflation, as Table 3.4 shows. The most encouraging feature of the present situation is that the prices charged by producers for their goods as they leave the factory gate have grown over the past year at the 5 per cent rate which has obtained for most of the 1980s. Fluctuations in unit costs over the cycle are nothing new and were in 1985-6 absorbed within profit margins with little effect on output prices. The hope is that this will happen again, and that the underlying inflation rate will remain at 5 per cent at the wholesale level, 6 per cent in the shops.

"Headline" inflation, including the effect of mortgage interest payments, is however some 2 per cent higher than this, and the rate of increase of costs is not far behind. The great fear is that the headline rate continues to drive excessive wage claims so that the underlying rate rises towards the "headline" rate. The chances of this happening have been greatly increased by last year's fall in the exchange rate and will be strengthened by any further fall.

Table 3.4. Key Inflation Indicators 1987-9

Annual % change	1987	1988	1989
Producer prices	3.9	4.5	5.0
Retail price (excl. mortgage costs)	3.9	4.6	5.9
Retail prices (all items)	4.1	4.9	7.8
Unit labour costs	4.0	6.8	8.8[a]
Exchange rate index (% change to end December)	9.4	4.4	−11.9

[a] First three quarters.

A lower exchange rate boosts inflation directly by putting up the prices of imports (which now account for nearly a third of total spending). It also weakens the resistance to higher wage claims of the larger manufacturing firms, who sell a high proportion of their output abroad and can safely pass on increased labour costs if the exchange rate falls. Since these firms (e.g. Ford) pay an important role in setting a "going rate" for wages, there is a direct connection between a falling exchange rate and higher wage settlements.

4 Balance of Payments

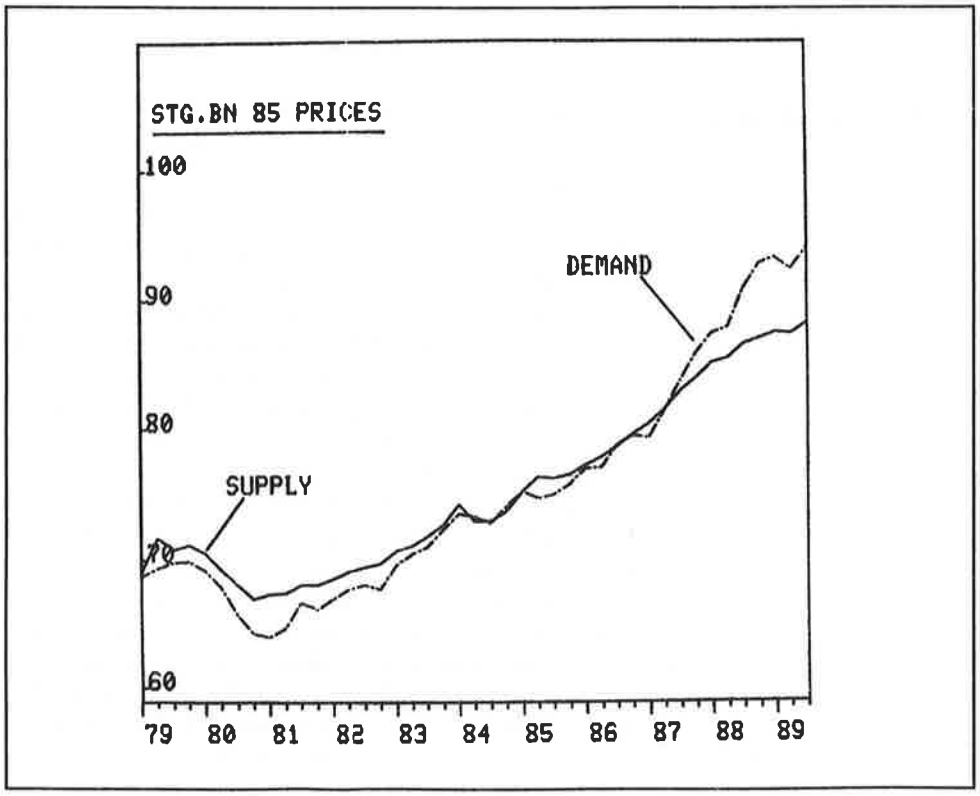
4.1 Explaining the Deficit

Last year, the UK recorded a deficit on current account equivalent to 4 per cent of GDP, roughly the same as the deficit in 1974, the previous post-war record. Mr Lawson suggested on many occasions that the deficit did not matter *per se*, but was only a problem in so far as it indicated that the UK economy was facing inflationary problems as well. Mr Major, on the other hand, has shown more concern about the deficit on the grounds that it might prove troublesome to finance, and he has stated that he would prefer to see it improving more rapidly than is implied by the Treasury's latest forecast, which shows a £15bn current account gap this year. A rapid but temporary improvement may happen when, as at present, demand is being met out of stocks rather than by imports. But the underlying import propensities remain large. So although UK export performance has improved in the 1980s, the trade deficit is likely to remain an important symptom, and early warning, of inflationary pressure. As such it might need to have a rather larger role in the setting of policy than it has in the recent past. In considering how it might affect fiscal policy, we shall look at three separate questions. First, how has the deficit arisen? Second, is it likely to be satisfactorily financed? Third, what would be the consequences of taking a policy decision to close it more rapidly than many forecasters currently consider likely?

A deficit on the current account of the balance of payments must by definition be accompanied by all of the following three separate accounting counterparts. First, aggregate demand in the economy must exceed aggregate supply. Second, total investment must exceed total savings. Third, total imports must exceed total exports (provided that "imports" and "exports" are defined to include invisible debits and credits on services, transfers, interest, profits and dividends). Although all three of these aggregates must always move in unison, it can be useful analytically to examine them separately. Indeed, this tells us quite a lot about whether the type of deficit which the UK is running is likely to be satisfactorily financed for very long.

Let us start by looking at what has happened to aggregate supply and demand. Figure 4.1 shows that, after several years in which supply (or output) kept pace with domestic demand, an acceleration in demand growth started to out-pace supply from around the middle of 1987 onwards. Although output growth did accelerate relative to its long term trend – real GDP increased by almost 4.5 per cent in 1988 – this was not sufficient to keep pace with demand, which rose by 8 per cent in that year. It is therefore clear that the deficit arose because of an acceleration in demand, rather than any slowing in supply.

Figure 4.1. Domestic Demand and Supply



Excess demand had most of its effect on import volumes, which rose by 12 per cent in 1988. However, there was also some depressing effect on exports as firms switched sales away from foreign markets in order to meet booming home demand. Exports volume grew by only 1 per cent in 1988. Therefore, excess demand *both* increased imports *and* reduced exports.

Apart from its effect on the trade account, the increase in demand, relative to supply, also resulted in the economy over-heating, as shown by the fact that inflation pressures started to rise. It is often implied in public debate that the existence of a current account deficit must necessarily imply that the economy is over-heating. In fact, it is *not* axiomatic that this is so. It is quite possible for demand to exceed supply, but for supply to be well below the potential of the economy. In such circumstances – which may for example arise when the exchange rate is over-valued – a current account deficit can perfectly well co-exist with *declining* inflation pressure. An over-heated economy is not simply one in which demand exceeds supply, but is one in which demand exceeds supply *potential*. And this is what happened in the UK in 1987–8.

The rapid increase in domestic demand was initially matched by domestic supply, but once capacity constraints were hit in an increasing number of industries from 1987 onwards, the economy became constrained by a shortage of supply. Demand continued to increase, so the current account worsened *and*

inflation pressures intensified. It is important to note that very little of the deterioration in trade can be attributed to any loss of competitiveness in the period from 1985–8. Most competitiveness measures indicate that UK relative costs and prices, measured in a common currency, worsened by only around 5 per cent over this period. This is sufficient to explain only a small fraction of the deterioration in the trade account. This is significant, since it suggests that a depreciation in sterling will not necessarily be needed to correct the trade imbalance. The initial problem was caused by excessive growth in domestic demand, and the solution can be found by reversing the situation.

Now let us look at where the demand came from. Table 4.1 shows that the growth rate of private consumption remained extremely strong at 5–7 per cent p.a. throughout the 1986–8 period, while the growth in investment increased from 2 per cent in 1986 to 9 per cent in 1987 and 13 per cent in 1988. Thus the initial growth in demand came primarily from the consumer; but once companies found that supply constraints were being hit, they responded by greatly expanding their capital spending.

Table 4.1. Demand, Savings and Investment

	1985	1986	1987	1988
Growth in Volume Terms (%)				
Consumers' Expenditure	3.7	5.6	5.4	6.9
Government Consumption	0.0	2.1	1.2	0.4
Fixed Investment	3.9	1.9	8.8	13.1
Change in Stocks[a]	−0.1	0.0	0.1	0.7
Savings and Investment (% of GDP)				
Private Savings[b]	17.8	16.6	17.0	15.3
Private Investment	14.3	14.4	16.4	19.1
Difference	3.5	2.2	0.6	−3.8
Public Savings	1.1	1.0	1.2	3.0
Public Investment	3.6	3.2	2.6	2.3
Difference	−2.5	−2.2	−1.4	0.7
Total Savings	18.9	17.6	18.2	18.3
Total Investment	17.9	17.6	19.0	21.4
Difference	+1.0	0.0	−0.8	−3.1
Current account[a]	1.0	0.0	−0.8	−3.1

[a] As % of GDP.
[b] Includes residual.

We saw earlier that the existence of a current account deficit implies by definition that total investment in the economy must exceed total saving. This is confirmed by the figures shown in the bottom half of Table 4.1, which split the behaviour of saving and investment into their public and private sector components. Taking the private sector first (i.e. the combined accounts of the personal and company sectors), savings dropped by 2.5 percentage points of GDP from 1985–8, while investment rose by 4.8 percentage points. Taken together, these two changes "explain" a deterioration of 7.3 percentage points in the current account balance. Fortunately, however, these private sector events were offset to some extent by opposite changes in the public sector. Public savings rose by 1.9 percentage points of GDP from 1985–8, while public investment fell by 1.3 percentage points. Thus the public sector contributed to a 3.2 percentage point improvement in the current account, and this eliminated almost half of the deterioration which was caused by private sector behaviour.

Put simply, the story of the last few years has been the following. Private consumption started to grow extremely rapidly in 1985 as private savings fell. This then led to an increase in private investment when capacity came under strain. The simultaneous decrease in private savings and increase in investment was virtually unprecedented; taken in isolation, it would have produced a much larger current account deficit than the one which actually emerged, and more over-heating. But the UK was saved from an even worse situation by the government's decision first to allow its budget deficit to be eliminated, and then to allow a large budget surplus to develop.

4.2 Financing the Deficit

By definition, a current account deficit must be financed by a capital account surplus. This does not mean, however, that a current deficit will always be financed without problems. Often, a combination of higher interest rates and/or a lower exchange rate will be needed to attract capital inflows to offset a current deficit. The latter would be particularly worrying in cases, like that of the UK at present, where the current account problem reflects an over-heated economy, since a depreciation in the exchange rate could unleash pent-up inflation pressures. But attempts to stabilise the exchange rate through repeated increases in interest rates can result, with the usual time lags, in an over-correction in the real economy. Getting policy right in such circumstances is therefore unusually difficult.

There are no easy rules or formulae to judge whether the UK can satisfactorily finance a current account deficit of anywhere near its current size. The past record of similar-sized economies which have attempted to run such large deficits for any length of time is far from encouraging: without exception, post-war experience in such cases shows that they end with either a substantial drop in the exchange rate, or a severe drop in domestic demand, or both. However, there are many examples of smaller economies – Denmark is perhaps the leading example – which have been able to run large current account deficits for many years without disastrous effects (though even Denmark has faced severe difficulties in recent years as the government has tried to return the current account towards balance; since 1986 the level of real domestic demand in Denmark has fallen by around 5 per cent). Deficits in these small economies make miniscule demands on world capital markets, so they may not be relevant to the UK case. But the freeing-up of restrictions on global capital flows in the last decade may make it easier for large economies to finance current account deficits than it was before. If capital flows were truly mobile across the globe, then large capital flows could be generated by small differentials in interest rates, and current account discrepancies might be relatively easily financed.

Even then, however, the financeability of a given deficit would depend on the characteristics of that deficit. A UK current account deficit implies that foreigners are increasing their financial claims on UK citizens (or that British citizens are reducing their claims on foreigners). In the long run, this is only sustainable if foreigners feel comfortable that the assets they are acquiring will produce an attractive rate of return. This in turn means that they must be satisfied with the creditworthiness of the projects they are financing, and with the prospects of eventually being able to repatriate their money without incurring large currency losses. This last requirement is linked to their confidence in the fiscal and monetary policies being pursued by the government.

The OECD[1] has recently listed some criteria that might be associated with "benign" rather than "malign" current account deficits. The former variety might be financed rather more easily than the latter. There are two main criteria on which to focus: the degree of government distortion involved, and the likely sustainability of the financial flows supporting the deficit.

The degree of government distortion involved works on two main levels. First, there is the question of whether the current account deficit is accompanied by a government deficit, or by a private sector deficit, in the domestic economy. Second, there is the question of whether there are distortions to free capital movements arising from differences in taxation, subsidies, protection or regulation. The smaller the degree of government involvement in any of these areas, the more likely it is that the capital flows which underpin current account gaps will result in a more efficient international allocation of capital. This is because they are likely to reflect genuine differences in savings propensities, and in the rates of return on investment, in different economies.

On these criteria, the UK current account deficit must be scored as "benign". As we have seen, the deficit is entirely a *private* sector deficit, with the government being in surplus; and there is no strong reason for believing that tax and other distortions are particularly important.

Since the deficit is therefore a private sector phenomenon, should the government worry about it? It should according to the OECD, because even private sector deficits may not prove *sustainable*. Sustainability is an elusive concept. One indicator of sustainability is the behaviour of the ratio of the outstanding stock of international debt to GNP (or, as a related concept, debt servicing costs to export earnings). On these indicators, the UK again appears to be running a benign deficit, since Britain's still owned net external assets worth £94bn at the end of 1988, apparently enough to pay for several more years of deficit before the UK becomes a *net* debtor (as the US has in recent years). It is worth noting though that the level of external assets may be overstated. According to the Bank of England,[2] the presence of a large balancing item in the balance of payments statistics could mean that the UK's net external assets may be £50bn or so lower than recorded.

However the situation is not quite so secure as this piece of arithmetic suggests. The fact is that even a current account deficit as large as £20bn is fairly small in relation to private capital flows. These can usefully be divided into direct investment, portfolio investment and banking flows. Of these flows the least volatile is direct investment, which responds, very broadly, to long term economic fundamentals – the existence of a natural resource to be developed, or large differences in labour costs. Apart for a brief period when the North Sea was being developed, the UK has long been a net exporter of capital on this account.

1 "Economic Outlook", December 1989.

2 "Bank of England Quarterly Bulletin", November 1989.

To finance the deficit (other than by depleting the official reserves) therefore the UK must generally attract inflows of *portfolio* capital, or be a net recipient of *banking flows*. All these private flows, which account for the great bulk of the capital account, are inherently volatile movements of short-term money, governed by interest rate differentials and by expected exchange rate movements. When the deficit began to widen alarmingly in 1988 it at first required a much larger short-term interest premium on sterling assets to attract the funds. This year, as the high level of UK interest rates has threatened recession and the authorities have been reluctant to implement further rises, it has required a 12 per cent fall in the exchange rate to finance the deficit.

A lower exchange rate reduces the expected future depreciation of sterling that foreign buyers build in when they contemplate the purchase of UK assets, and so boosts the prospective rate of return on such assets. But this way of securing capital inflows is a trick which cannot be played very often. A once-for-all depreciation, followed by a period of stability, makes UK assets more attractive. A series of falls which are extrapolated and built into future expectations make the deficit harder to finance. Memories of the vicious circle of high inflation, high interest rates and a depreciating currency which characterised the UK economy in the 1970s, are all too fresh.

This analysis suggests that the financing of the deficit is getting significantly more difficult each year. A sharp rise in interest rates was required in 1988. Last year a further 2 per cent rise in interest rates, plus a 12 per cent fall in sterling produced a substantial net capital inflow – but even so the authorities have had to spend around $13bn of the official foreign exchange reserves. This can hardly be considered "painless" financing. The rise in interest rates threatens recession. The fall in the exchange rate threatens inflation.

4.3 Consequences of Closing the Deficit

The arguments outlined above indicate that the current account deficit has arisen because of an excessive rise in domestic demand, especially consumer demand, and that this has simultaneously caused severe over-heating in the domestic economy. At present, there is therefore no real difference between the inflation problem and the current account problem; they are simply two sides of the same coin. In these circumstances, it is easy to agree that policy should be aimed at reducing the deficit, since this amounts to the same thing as saying that inflation pressures should be brought under control.

If, however, the deficit persists after inflation pressures have clearly abated, it may be somewhat more difficult to argue that policy should *still* be aimed at closing the deficit further, or eliminating it altogether. The existence of an on-going deficit without the continuation of inflation problems would imply (i) that aggregate demand exceeds domestic supply, but (ii) that supply is no longer above its long-run potential. (The former condition is required for a trade deficit to exist, while the second is required for inflation problems *not* to exist.) Under such conditions, the financing of the trade deficit may become rather easier, since the financial markets may have more confidence in the government's fiscal and monetary discipline. An easing in financing problems would be particularly likely if it were clear that consumption growth had abated by then, while investment growth remained strong. But even in these circumstances, the government could not be indifferent to the indefinite continuation of a large current account deficit, since this would always increase the risks of a loss in foreign exchange confidence, forcing sudden – and possibly inappropriate – policy adjustments.

Mr Major seems to have accepted these arguments to a much greater extent than Mr Lawson did. What does this imply for the fiscal/monetary stance and the economy more generally?

First, we need to consider the role of the exhange rate. Should the government set policy so that sterling is likely to depreciate further? This might appear attractive to many, since currency devaluation is often prescribed as the appropriate solution to trade problems. But we have argued that the UK's present trade difficulties have arisen because of excess demand, not because of an over-valued exchange rate. Any large and sustained depreciation in sterling from here would be likely to keep the inflation rate well above the government's targets, and may not even succeed in improving competitiveness for very long. Policy is therefore likely to be set with a view to keeping the exchange rate broadly stable as the current account improves.

This, of course, implies that overall demand policy will need to be held fairly tight in order to ensure that the required further slowdown in domestic demand growth does indeed take place. But it is unclear how far domestic demand will need to slow, or even decline, to correct the current account deficit over a reasonable time horizon. This is because the relationships between demand and trade are not clear-cut.

The optimistic view is the following. The current account deficit of around 4 per cent of GDP indicates that demand is 4 per cent above supply at present. Therefore if demand is reduced by 4 per cent while output remains unchanged, the current account deficit would disappear. This could theoretically be accomplished with 2 years of demand growth at 1 per cent p.a., with output growth remaining fairly high at 3 per cent p.a. There would be no recession, just a shift of resources away from domestic demand and towards export demand (or import substitution).

This optimistic view depends on the proposition that output growth in the economy is always supply-determined, so that output does not fall when demand growth is cut back. This may well be true over the long term, but over short periods it is almost certainly too optimistic. This is because it implicitly assumes that resources can be instantly switched between those sectors of the economy which produce traded and non-traded goods respectively. This point can be clarified by looking at the stylised example in Table 4.2. In situation I, the economy has a trade deficit of 4, with output (supply) of 100 and demand of 104. Since (by definition) none of the deficit can emerge from the non-traded goods sector, demand and output in that sector are equal at 50 each. Meanwhile, in the traded goods sector, demand is 54, output is 50 and the trade deficit is 4.

Table 4.2. Correcting the Deficit – A Stylised Presentation

	I Deficit situation	II Interim correction	III Final correction
Traded Good Sectors			
Output	50	50	52
Demand	54	52	52
Net Trade	−4	−2	0
Non-Traded Good Sectors			
Output	50	48	48
Demand	50	48	48
Whole Economy			
Output	100	98	100
Demand	104	100	100
Net Trade	−4	−2	0
Unemployed Resources	0	2	0

Now consider the effects of a policy which cuts demand in the economy by 4 (Situation II.) This applies equally to traded and non-traded goods sectors, so demand drops by 2 in each sector. In the non-traded goods sector, this automatically drags down output by 2 to 48. In the traded goods sector, the initial impact may be similar, but companies can fairly quickly replace the loss of domestic demand by increasing their export sales, so output remains at 50 and the net trade deficit drops to 2. For the economy as a whole, output drops by 2 in response to the decline of 4 in demand, and the trade deficit halves to 2.

This, however, is not the final solution. There are now unemployed labour and capital resources in the non-traded goods sector which previously produced output in that sector worth 2. In the long run, these resources can theoretically be switched into the traded goods sector, where they can produce output of 2, rather than remaining unemployed (Situation III.) With no further changes in domestic demand, this has the result of increasing output in the traded goods sector to 52, and wiping out the trade deficit. Comparing Situation III with Situation I, we find that demand in the whole economy has dropped by 4 and the trade deficit has improved by 4. Output is unchanged at 100. But in order to get to this happy end-point, the economy has had to pass through the tricky phase II in which output and demand have both dropped, and the trade deficit has hardly improved. And, in fact, this painful phase could have been even more painful if the government had decided to opt for an instantaneous correction of the entire trade deficit in Situation II. This would have required a cut in overall demand of 8, with output dropping by 4 in the non-traded goods sector, and therefore by the same amount in the whole economy.

The key issue is how fast resources (labour and capital) can be moved out of the non-traded goods sector into the traded goods sector. If this can be done quickly, then the trade deficit can be closed quickly, with relatively little drop in overall output and demand in the economy. On the other hand, if resources are slow to move, then a large and prolonged reduction in output and demand may be needed to correct the deficit. In the past, Britain's record on this has been mixed, but it certainly is not uniformly bleak, and it suggests that a very substantial improvement in the current account position is feasible in the next couple of years without a deep recession.

Table 4.3 shows what happened on the last three occasions in which the UK was faced with the need to cut a large current account deficit fairly rapidly. The two experiences from 1967–9 and 1974–6 are the most relevant, since they show improvements in the current account equivalent to about 2.5 per cent of GDP over two years – something which would be considered quite satisfactory at present. In the first of these instances, 1967–9, demand grew by 3.3 per cent over the 2 years, while output expanded by 5.5 per cent, i.e. roughly at its trend rate of growth. This was a highly satisfactory outcome, but it was assisted by the aftermath of the 1967 sterling devaluation. This led to a marked improvement in competitiveness, which assisted the switch from non-traded to traded goods sectors in the economy. The second experience, that from 1974–6, was less satisfactory. In those years, demand growth almost ground to a complete stand-still (0.5 per cent over 2 years), and this dragged output growth down to only 3 per cent cumulatively. The adjustment during that period was not helped by any improvement in competitiveness, which may be one reason why it was more painful than in 1967–9. (Indeed, in 1975, the first year of adjustment, output actually fell in real terms.)

Table 4.3. Output, Demand and Net Trade Balances

%	Output Growth (GDP)	Domestic Demand Growth	Change in Net Trade Volumes[a]
1964–6	4.5	3.3	1.2
1967–9	5.5	3.2	2.3
1974–6	3.0	0.5	2.5

[a] as per cent of GDP.

If the government is aiming for a sizeable adjustment in the current account position from 1989–91, without opting for a further large sterling depreciation, the experience of the next two years could be closer to that of 1974–6 than to 1967–9. This assumes that any supply-side improvements in the whole economy between the mid-1970s and now have been only second order; if this is wrong then the outlook would be rather brighter, since resources might shift into the traded goods sector more rapidly than in earlier years. But the experience of the economy throughout the whole of the 1980s suggests that it would be dangerous to make too much allowance for this. This suggests that an improvement in the trade balance worth 2.5–3 per cent of GDP could be achieved by holding domestic demand growth close to zero *both this year and next*, while output increases by (say) 1 per cent in 1990 and 2 per cent in 1991. (These GDP figures include oil; the non-oil growth rate would be closer to zero in the first year.)

An outcome such as this would be broadly in line with the Treasury forecast for 1990, which shows domestic demand growth of zero this year, output growth of just over 1 per cent, and an improvement in the current account equivalent to about 1.2 per cent of GDP. There is nothing in past experience which suggests that this is an unrealistic combination for 1990. Indeed, as we noted earlier, a burst of intense destocking could produce a temporarily larger improvement in the trade balance this year. However, we do not yet know whether the authorities will be willing to bite the bullet and aim for a *second* year of domestic demand growth of around zero. If they do prove willing to accept this, then the delayed shift of resources out of the non-traded goods sector into traded goods would be likely to boost the growth in real GDP to around 2 per cent, and the current account deficit might drop to under 1 per cent of GDP. But a further year of zero growth in domestic demand would imply very weak consumption in the pre-election period, and this could be too much for the government to bear. If so, demand might grow faster than zero next year, but the current account deficit would improve less, and the inflation risks would undoubtedly increase.

5 The Budget Strategy

5.1 Policy Aims

In each of the last two Green Budget publications, we argued that the government should err on the side of keeping its overall demand stance tight in the year ahead taking fiscal and monetary policy together. In early 1988, this recommendation was made despite the 1987 stock market crash which appeared to risk inflicting severe damage on the growth of domestic and global demand. But we felt that this risk was less worrying than the alternative risk that the economy was beginning to over-heat severely. We judged that it would be more damaging in the long run to allow the economy to over-heat than to allow a temporary recession in demand and output. On the mix between fiscal and monetary stringency, we recommended a tightening on the fiscal side, since at that time pressures on the exchange rate were strongly upwards. We judged that this was not helpful, given the emerging balance of payments problem, and were therefore reluctant to allow higher interest rates to incur too large a part of the burden of tightening the policy stance.

Last year, as in 1988, we argued that the risks of inflation were more severe, and would be more damaging in the long run, than the risks of recession. However, by that stage, interest rates were already at 13 per cent and there was no prospect of any early cut in rates. We judged that this degree of monetary stringency would eventually prove enough to produce the required slowdown in domestic demand, so that there was no need for any further tightening in the fiscal stance. Indeed, we thought that minor tax remissions would be appropriate.

With the benefit of hindsight, we now know that the strength of demand growth in the economy has been continuously stronger than expected, and the current account problem has been correspondingly worse. It would probably have been advisable to have run a tighter fiscal policy throughout 1987-9 than the one which was actually implemented (though this does *not* imply that there was an *easing* of the fiscal stance in those years – tax rates were actually cut by less than was required to offset the combined impact of public expenditure restraints and real fiscal drag). A tighter monetary stance would also have been advisable, at least in the early part of the 1987-9 period.

What about the future? There is now no doubt that high interest rates are biting on the economy. Non-oil GDP growth seems to have been very low in the second half of last year, and recent confidence indicators in the consumer and business sectors suggest that an absolute decline in activity might be quite close at hand. Yet these recessionary risks are balanced by the continuation of powerful inflationary pressures in the system, especially emanating from the high wage demands and the recent depreciation in sterling. A premature easing in the overall policy stance could yet result in a further significant rise in the

underlying inflation rate. Since the new Chancellor has repeatedly (and rightly) said that the prime objective of monetary policy should be to get inflation down, it seems clear that there is no room for any policy easing at present.

If the overall mix is to remain tight, what does this imply for the two separate wings of macro-policy – i.e. fiscal and monetary policy? At present, the government is choosing to place a great deal of weight on high interest rates as the means of depressing the growth of demand. This has the advantage that policy can be changed relatively quickly in response to developments in economic data; fiscal policy, by contrast, is less flexible. Furthermore, a tight monetary stance also helps to bolster the exchange rate, which is useful when market confidence is at a low ebb, and when a clear signal needs to be sent to pay bargainers, as at present.

But there are also disadvantages inherent in an over-reliance on interest rates as the main policy weapon. First, we need to consider the consequences of a decision to join the ERM. Once this has occurred, interest rate policy will need to be oriented mainly towards achieving exchange rate stability, and will not be available to respond to the near-term vagaries of domestic economic data, except in so far as these are reflected in foreign exchange pressures. This will automatically increase the need for a more active fiscal regime. In the early stages after sterling enters the Exchange Rate Mechanism (ERM), pressures on interest rates are almost certain to be downwards, almost regardless of events in the domestic economy. But, as in 1987 when Mr Lawson was shadowing the European Monetary System (EMS), such pressures might be entirely inappropriate. We explained in Section 3.2 that there is a definite risk of a major rebound in consumer activity when base rates start to come down. It is not possible to be confident that the long-term adjustment of consumer borrowing to the deregulation of financial markets has yet ended; the trend decline in the savings ratio, which seems to have been temporarily arrested in the last few quarters, could all too easily resume.

Against this background, it would seem sensible to err on the side of caution in the setting of fiscal policy, not just for this year but over the medium term. A continuing shortage of private saving would be a development which policy cannot ignore. The 1989 Green Budget publication argued that special tax incentives to encourage private savings would probably fail to increase the overall savings of the nation, since the depressing impact on public savings (as tax revenues fall) would more than offset any gains to private savings. So if there is any resumption of the downward trend in the personal savings ratio, this would need to be offset by a continuing high level of public saving. Otherwise, the current account deficit is unlikely to be narrowed, as we have argued is necessary.

This implies that the path for the budget surplus may need to be higher than previous versions of the Medium Term Financial Strategy (MTFS) have implied, especially if base rates are to come down for ERM or political reasons. Essentially, it seems difficult to see room for *both* tax cuts *and* interest rate cuts in the next couple of years. If the Chancellor wishes to engineer a substantial reduction in mortgage rates before the election, he would be well advised to tighten the fiscal framework now.

There is one further argument in favour of doing this. High interest rates hit both consumer spending and investment. But the main problem the UK has encountered during the 1980s has been one of excessive growth in consumer borrowing and spending. Obviously, to the extent that it is possible, it would be desirable to dampen consumer demand while protecting investment. An increase in personal taxes can be better directed to this objective than the maintenance of extremely high interest rates.

5.2 The Public Finances

There can be little doubt that the surge in inflation, following the abandonment of the broad monetary targets, has reduced the status and credibility of the Medium Term Financial Strategy. However the MTFS still has an important role as the accounting framework within which Budget decisions are taken. The arithmetic works as follows. At Budget time the spending plans are already fixed at the levels announced in the previous Autumn Statement. The borrowing target is also in principle laid down in the previous year's MTFS as are the revenue projections. But both are revised, often substantially, at Budget time. In the light of the latest revenue projections, the Chancellor makes a decision on the new borrowing target, (regarded as "the" measure of fiscal stance and an important signal to financial markets) and on the associated fiscal adjustment (the amount by which taxes must be raised or lowered to hit the target).

For the past three years the Chancellor has had to frame the Budget against a background of upwards-revised revenue projections for the year just ending. This year promises to be different, with revenue coming in close to the forecast made last March, as Table 5.1 shows:

Table 5.1. Revenue Projections for Current Financial Year

£bn	Beginning of year[a]	End of year[b]	Revision
1986–7	156	159	+3
1987–8	169	174	+5
1988–9	185	191	+6
1989–90	206	206[c]	0

[a] Forecast made in FSBR published at beginning of year shown.
[b] Forecast made in FSBR published at end of year shown.
[c] IFS estimates.

Since this year has seen a £5bn upward revision to the public spending plans, there is an initial presumption that the fiscal adjustment, which was estimated at only £1bn last March, must now be negative to the tune of £4bn. We have however had no official warning that tax increases will be necessary, for the very good reason, as we shall see below, that revenue for the year ahead is once again likely to come in well above target. This has become a predictable annual "surprise", which has further reduced the credibility of the MTFS.

Table 5.2 sets out the fiscal arthmetic. It shows the *general government* accounts: tax receipts, less the amount set aside for debt repayment, gives the amount *available* to spend. The difference between that figure and *planned* government spending gives the *required* change in tax. To get from the General Government Debt Repayment to the much more widely regarded Public Sector Debt Repayment, shown at the bottom of Table 5.2, we have to add in Public Corporations Debt Repayment, which we expect to fall next year.

Table 5.2 shows that the government's revenue projections for 1989–90 are proving fairly accurate in total, with higher income tax receipts offsetting the unexpectedly low National Insurance contributions. But with spending higher than originally forecast, debt repayment will be lower as the monthly figures suggest. For the coming year, a comparison of columns 3 and 4 shows how the upward revision of spending plans would, other things being equal, have converted a small positive fiscal adjustment in 1990–1 into a significant negative. But as column 5 shows that upward revision, which we believe will prove greater than admitted in the Autumn Statement, is now broadly offset by the near £8bn upward revision of revenue projections. On our calculations, if the Chancellor was content to stick to his previously announced borrowing target, he could still afford to cut taxes by £1bn. But since we expect him to announce a tighter borrowing target, for reasons explained below, he will have instead to *increase* taxes.

Table 5.2. Calculating the Fiscal Adjustment

£ billion	1989/90		1990/1		
	Budget projection	IFS estimate	Budget projection	Autumn Statement	IFS estimate
	1	2	3	4	5
General government receipts	206	205½	214	214	221½
less					
General government debt repayment	12	8	8	8	10½
equals					
Available to spend	194	197½	206	206	211
less					
Planned spending	194	197½	205	210	212
equals					
Fiscal adjustment (change in tax)	0	0	1	−4	−1
Memo Item:					
PSDR	14	10	10	10	11½

The revenue and expenditure forecasts on which this assessment is based are set out in detail in Table 5.4 and discussed more fully in the Appendix. In the last Budget, the government underestimated revenue for 1990–1 by a substantial amount but, as Table 5.3 shows, this is not unusual. The revenue forecasts for the next-year-but-one written into each successive version of the MTFS have proved consistently overcautious. The Treasury "discovered" an extra £8bn of revenue in 1987, an extra £11bn in 1988 and an extra £13bn last year.

Table 5.3. Revenue Projections for Coming Year

£bn	Made in Budget *a year before* start of year shown	Made in Budget *at* start of year shown	Tax give away in that Budget	Implied revenue projections	
				level	change
1986–7	159	156	1.0	157	−2
1987–8	164	169	2.9	172	8
1988–9	178	185	4.3	189	11
1989–90	195	206	2.1	208	13
1990–1	214			221½[a]	7½

[a] IFS estimate.

However, the assertion that the Treasury has underestimated revenue for the coming year requires a little more justification than usual, because the official forecasts have not, for once, underestimated revenue in the *current* year. Moreover, the PSDR has come in consistently below forecast this year, and City economists have been revising downwards their estimates of debt repayment for next year. The general view appears to be that just as an over-heated economy produced more revenue than expected in the period 1987–9, a rapidly cooling economy will produce less revenue than expected in 1990.

We believe this analysis is wrong. The PSDR is lower than expected mainly because of lower privatisation receipts and of a shortfall of National Insurance contributions following the unexpectedly large switch to personal pensions after the 1989 Budget changes. Both shortfalls will recur, but will not grow. We also now expect corporation tax receipts, although revised *upward* in the Autumn Statement, to come substantially *below* the FSBR forecast. Mr Major admitted to a shortfall in the Autumn Statement debate, and the money market tightness, which normally accompanies heavy corporate tax payments at this time of year, is less acute than usual. However the growth of revenue next year, which depends on the respectable profit growth already recorded for 1989–90, is not in question and will be helped by higher taxable profits from the banks (due to less generous write-off of banks' sovereign debt). Nor is there any reason to expect slower than previously expected growth next year of other revenues. Revenue depends mainly on *nominal* magnitudes, and if next year's real GDP growth is slower than expected, inflation is higher. In particular income, which determines income tax and National Insurance, is most unlikely to be lower in 1990–1 than was expected in the 1989 Budget.

In the last Budget the Treasury forecast a revenue increase between 1989–90 and 1990–1 of only 4 per cent. That seemed implausibly low at the time, even taking into account the full year effect of the reforms to the National Insurance system. It still seems low, notwithstanding the developing recessionary tendencies of the economy.

Table 5.4. Revenue and Expenditure Forecast

	1989/90			1990/91
	FSBR	IFS	% change	IFS
RECEIPTS				
Income tax	46.9	48.4	*11.7*	54.1
Corporation tax total[a]	22.4	21.5	*7.3*	23.1
On-shore Corporation tax[b]	22.1	21.2	*7.4*	22.8
of which Mainstream	15.3	14.2		
Advance	6.8	7.0		
North Sea Corporation Tax[c]	0.8	0.8		
Petroleum Revenue Tax	1.4	1.4	*0.0*	1.4
Capital Gains Tax	2.1	2.1	*7.0*	2.2
Inheritance Tax	1.1	1.1	*6.3*	1.2
Stamp duties	2.4	2.1	*4.0*	2.2
TOTAL Inland Revenue	76.3	76.6	*9.8*	84.1
Value Added Tax	30.0	30.3	*7.6*	32.6
Duties on petrol	8.8	8.7	*7.6*	9.4
tobacco	5.1	5.1	*5.5*	5.4
alcohol	4.7	4.7	*7.1*	5.0
betting	1.0	1.0	*7.1*	1.1
Car tax	1.4	1.6	*8.5*	1.7
Customs duties	1.8	1.8	*7.5*	1.9
Agricultural levies	0.1	0.1	*5.0*	0.1
TOTAL Customs & Excise	52.9	53.3	*7.3*	57.2
Vehicle Excise Duty	2.9	3.0	*1.2*	3.0
Oil royalties	0.6	0.6	*0.0*	0.6
Gas levy	0.4	0.4	*0.0*	0.4
Rates	20.6	20.8	*11.0*	23.1
Other taxes etc.	3.3	3.3	*0.0*	3.3
TOTAL taxes & royalties	156.9	157.9	*8.7*	171.9
National Insurance contributions	34.0	33.2	*3.9*	34.6
Interest & dividends	7.0	6.9	*1.4*	7.0
Gross surplus & rent etc.	8.5	7.7	*3.9*	8.0
General government receipts	206.4	205.7	*7.5*	221.4
EXPENDITURE				
Total departmental spending	168.7	173.4		
Privatisation	−5.0	−4.2		−5.0
Reserve	3.5	0.0		
Planning Total	167.2	169.2		
General government debt interest	17.1	17.8		
Other adjustments	10.1	10.3		
General government expenditure	194.3	197.3	*7.5*	212.0
BORROWING				
Public corporations market debt repayment etc.	1.7	1.9		1.0
General government debt repayment	12.1	8.4		9.4
PSDR before Budget changes	13.8	10.3		10.4
Tax increases				1
PSDR after Budget changes				11.4

[a] includes ACT (net of repayments), NS corporation tax after ACT set off and corporation tax on gains.
[b] includes ACT and corporation tax on gains.
[c] before ACT set off.

It should be stressed however that the fiscal projections this year are more than usually uncertain, reflecting uncertainty about the economy. If the economy moves into recession, employment falls, wage increases moderate, and consumer spending does not grow at all, then revenue could easily come in some £2–3bn lower than we expect. Table 5.5 shows the key assumptions in our forecast for 1990–1 and the sensitivity of the revenue projections to varying each of them by 1 per cent. It also shows how large is the margin of error surrounding the forecast of corporation tax receipts.

Table 5.5. Revenue Projections: Key Assumptions and Sensitivity to Change

	Assumption (annual % change except oil price)	Revenue effect of 1% change (£ billion)
Wages	9.5	1.1
Employment	0.0	0.7
Prices	6.0	0.35
Consumer Spending	1.0	0.5
Sterling oil price (£/barrel)	12.6	0.03
Memo item:		
Non-oil corporate tax average absolute error of past FSBR forecasts 1984–5 to 1988–9		0.7

One helpful way of looking at the government's financial position compared with what was expected in the last Budget is as follows. Inflation has turned out significantly higher than expected. That has led to an increase in public spending. But because spending is cash limited, departments have not been compensated in full for inflationary increases. Revenue on the other hand has risen more than proportionately with inflation, mainly because the buoyancy of income tax. The rise in wages will squeeze profits, but in 1990–1 this does not affect corporation tax revenues, which are based on the still-buoyant profits recorded in 1989–90. In sum, the unexpected rise in inflation has boosted revenue more than proportionately and spending slightly less than proportionately. The resulting improvement in the PSDR has broadly compensated the authorities for the loss of revenue from slower-than-expected real growth of consumer spending. But the level of the PSDR is down, this year and next, largely because of the permanent loss of revenue from corporation tax and National Insurance.

We normally rely heavily on the official estimates of public spending although we make our own independent estimates of revenue. We suspect that overspending may be contributing something to the PSDR shortfall and this is reflected in a fairly arbitrary increase in our public spending projections of £1bn this year, £2bn in 1990–1. Some of this will be carried out by local authorities, and paid for by a higher-than-forecast Community Charge. Our revenue projections take this into account.

1.3 The Budget Judgement

Fiscal Policy

The greater-than-forecast revenue for 1990–1 presents the Chancellor with a choice between cutting taxes or repaying debt at a faster rate. To see which is more likely it is useful to look at the history of such decisions summarised in Table 5.6. This suggests a very simple rule: the new borrowing requirement/debt repayment target for the *coming* financial year announced at Budget time is virtually identical to the outturn, estimated at that time, for the year just finishing. That rule has held for the past four Budgets.

Table 5.6. The PSBR in Current and Coming Year

£ billion	Forecast made at Budget time in:										
	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
For:											
Fin. yr. just ending	9.1	13.5	10.6	7.5	10.0	10.5	6.8	4.1	−3.1	−14	−12½[a]
Coming year	8.5	10.6	9.5	9.2	7.2	7.1	7.1	3.9	−3.2	−14	

[a] From Autumn Statement.

However, all of these Budgets have been occasions on which the outturn for the year just ending has been much *better* (i.e. lower borrowing or more debt repayment) than forecast. That will not be the case this year. And in earlier years (e.g. 1984 and 1985), when the outturn for the year just ending was worse than had been forecast in the previous Budget, the response was to announce a significantly more ambitious target for the coming year. There was a ratchet effect in operation. If borrowing was reduced faster than expected, the previously planned *rate* of improvement was maintained from the new base. If progress was slower than expected, absolute level of the old targets was re-asserted, implying a more rapid progress in the immediate future.

The MTFS currently envisages a fall in the rate of debt repayment in future years and a gradual return to a balanced budget. In this framework, a slower-than-expected rate of debt repayment could simply be welcomed as an unexpectedly rapid move back towards a balanced budget. In other words, the Chancellor could ignore the fact that the PSDR has come in below target in year 1 of last year's MTFS and leave the other years unchanged. The problem with this "easy" option (see Table 5.7) is that it would, if our revenue projections are correct, leave room for tax cuts of about £1bn, which would give all the wrong signals to consumers (who might start borrowing and spending again) and to the foreign exchanges (who might start selling sterling).

The second "hard" option, more in line with practice in 1984 and 1985, would be to assert that some of the debt repayment, missed in 1989–90, would be made up in 1990–1 and subsequent years. This would allow the government to

claim, credibly and consistently with past practice, that they were tightening fiscal policy, returning more slowly to a balanced budget. Even a PSDR target as high as £8bn for 1991–2 would probably leave scope for pre-election tax cuts.

Table 5.7. Two Options for the PSDR in the Medium Term

	£bn	1989/90	1990/1	1991/2	1992/3	1993/4
1989	Budget projection	14	10	6	3	n/a
1990	Budget projection:					
	"Easy" option	10	10	6	3	0
	"Hard" option	10	11½	8	4	1

If the Treasury's assessment of the economic situation is anything like our own, the Chancellor will rule out the "easy" option on macroeconomic grounds: any fiscal stimulus however small is inappropriate at the present time. Moreover the analysis in Table 5.8 of the ways in which the Chancellor chose to spend the tax windfalls in recent years reveals an overwhelming preference for reducing borrowing rather than cutting taxes. The fact that next year's extra revenue is a direct result of higher-than-expected inflation, and that so much of it has already been pre-empted by extra public spending, can only reinforce this tendency.

Table 5.8. How the Chancellor has Disposed of his Revenue Windfalls

£ billion	1985/6	1986/7	1987/8	1988/9	1989/90	1990/1
1 Tax windfall[a]	4¼	−2½	7½	11	13	7½
2 Change[b] in public spending	5½[f]	−1	4	3	1	7
3 Change[b] in PSDR	0	½	3	7	14	1½
4 Change[c] in fiscal adjustment	−1¼	−2	½	1	−2	−1
5 Previous estimate of fiscal adjustment[d]	2	3½	2	3	3	1
6 Tax cuts	3/4	1½	2½	4	2[e]	−1[e]

[a] Difference between Budget forecasts of revenue (before tax changes) for the coming financial year and the MTFS projection made in the previous Budget.

[b] "Changes" are differences between figures in current and year−earlier Budget statement. Positive sign indicates more public spending and more debt repayment (or less borrowing in earlier years).

[c] Line 4 = line 1 − line 2 − line 3. Extra scope for tax cuts is the revenue windfall less money earmarked for extra public spending and debt repayment.

[d] From previous year's Budget statement.

[e] Line 6 = line 4 + line 5. New scope for tax cuts is previously estimated scope plus tax windfall net of other claims. Discrepancies are due to a £1bn change in debt repayment of public corporations in 1989−90, reversed in the following year.

[f] Spending actually rose by £7½bn offset by £2bn of extra borrowing by public corporations.

This conclusion is reinforced by Table 5.9 which shows the PSDR as a share of nominal GDP. On this measure, which is the government's favoured indicator of its fiscal stance, the fiscal position has been loosened in the current financial year (both compared with the previous year and compared with earlier plans

for the current year). This is because debt repayment is now officially forecast to be less than expected at Budget time, while the forecast of nominal GDP has been revised upwards. Were Mr Major to stick to his predecessor's plan of a £10bn PSDR next year (the "easy" option), that would be a looser fiscal policy than previously planned (slower rate of debt repayment as a share of GDP) because of the the upwards revision to inflation. It would also be significantly looser than the outturn for the previous year.

Table 5.9. Measuring the Fiscal Stance

	1989/90			1990/1		
	PSDR £bn	Nominal GDP £bn	PSDR as % GDP	PSDR £bn	Nominal GDP £bn	PSDR as % GDP
Budget 1989	14	509	2.75	10	532	1.85
Green Budget 1990						
"Easy"	10.3	517	1.99	10	552[a]	1.81
"Hard"	10.3	517	1.99	11.4	552	2.06

[a] Forecast in Autumn Statement.

If by contrast the authorities go for the "hard" option and aim for a £12bn debt repayment in 1990–1, the ratio of the PSDR to nominal GDP will be higher than the probable outturn for the current financial year and significantly higher than last year's plan for 1990–1. The result will be an unequivocal message for the financial markets: a tax increase and a tighter fiscal stance.

Table 5.10 summarises the position. We believe that Mr Major will find an extra £8bn of revenue for the next financial year. After paying for the extra public spending this will leave him with £1bn, which added to last year's fiscal adjustment gives him £2bn to "spend". However, because of a smaller rate of debt repayment by public corporations, it will require tax increase of £1bn in order to achieve £2bn increase in the planned PSDR from £10bn to £12bn.

Table 5.10. Disposing of the Revenue Surplus (£bn)

Revenue overshoot	7½
less extra public spending	7
plus previous fiscal adjustment	1
equals new fiscal adjustment (scope for tax cuts/debt repayment)	1½
of which extra public sector debt repayment	1½
smaller contributions from public corporations	1
required tax change	−1[a]

[a] Minus sign indicates tax increase.

Finally, we would stress that these guesses about the Budget judgement are only as good as the rather fragile revenue and spending projections on which they are based. But if revenues turn out to be significantly lower than we expect, we would expect a larger increase in tax rates. If they turn out to be significantly

better, the government will not use the revenue to cut tax rates. It will instead announce an even more ambitious debt repayment programme, as Table 5.11 shows.

Table 5.11. Effect of Different Revenue Forecasts (£bn)

Pre-Budget revenue forecasts	Tax changes	Post-Budget revenue projections	Announced PSDR
220	3	223	12
222	1	223	12
224	0	224	13

Monetary Policy

As part of his Budget deliberations, Mr Major will have the opportunity to reconsider the role assigned to the exchange rate and to monetary aggregates in controlling inflation. Under Mr Lawson, monetary policy decisions became guided increasingly by the behaviour of the exchange rate; a policy which helped lead to his resignation after repeated disagreements over this policy with the Prime Minister's personal economic adviser, Sir Alan Walters. Since Mr Major took office as Chancellor, the government's attitude towards the exchange rate has seemingly become much more equivocal, as shown by the fact that the sterling exchange rate index dropped at one stage by more than 5 per cent without triggering any change in base rates.

The Chancellor has repeatedly affirmed the government's commitment to join the exchange rate mechanism of the EMS once the conditions laid down at last year's Madrid summit are satisfied. Ultimately, this means that sterling will again be pegged to the Deutschemark but this may not occur for perhaps another year. In the meantime, sterling will be allowed to float more freely than under Mr Lawson, and the Chancellor seems likely to seek alternative ways of bolstering the anti-inflation credibility of the Medium Term Financial Strategy.

It has been argued (for example in the Treasury and Civil Service Committee's Report on the 1989 Autumn Statement) that there should now be a greater emphasis on the growth of broad money when determining monetary policy. Broad money targets were finally abandoned in the 1987 Budget because of the unreliability of the relationship between broad money growth and the growth of money GDP. This decision coincided with the emergence of much greater inflationary pressures in the economy and some have linked the two events. However, given its past unhappy experience with the unreliability of M3 and M4 velocity of circulation, the Treasury is unlikely to be persuaded that it is desirable to set a target for the growth of a broad monetary aggregate such as M4. Indeed this was ruled out by Treasury officials giving evidence to the Select Committee late last year.

One possible alternative would be for the government to introduce a target for M2, a transactions measure of the money supply. Unlike M4, this measure of the money supply is not distorted by volatile movements in wholesale deposits which convey little information about inflation. Since the end of 1988, the annual growth of M2 has steadily decelerated from 17 per cent to around 10

per cent in response to the tightening of monetary policy, while M4 growth has continued to average around 17.5 per cent over this period. This relatively well-behaved performance of M2 in the last year may attract the attention of the authorities. The argument against having a M2 target has always been that data are only available from mid-1982 which perhaps is a too short time period to assess the reliability of this monetary aggregate as a guide to money GDP growth. However, on the available data, there does seem to be a reasonable relationship between M2 growth and subsequent movements in money GDP growth a year or so later. If the government does feel obliged to reintroduce a broad money target to enhance the credibility of the MTFS, then an M2 target would be the strongest candidate.

The possible introduction of a target for M2 growth seems likely to be the only significant change to the MTFS. There seems no reason to expect the government to abandon M0 as its principal targeted monetary aggregate. M0 has been targeted continuously since 1984 and has proved to be a fairly reliable coincident indicator of movements in money GDP. Certainly, the Treasury feels that it was a mistake to ignore the acceleration in M0 growth during 1988 and both Mr Major and the former Chancellor have stressed the need to get M0 back within its published target range. At the same time, monetary policy will continue to be guided by movements in the exchange rate. Mr Major may not place the same emphasis on the exchange rate as Mr Lawson did but he adheres to the view that movements in the exchange rate do independently affect the level of inflation.

6 Analysis of Tax Options

6.1 Income Tax

The 1989 Budget will be the twelfth consecutive Conservative Budget, and on the income tax side is likely to look very different from any Budget since the beginning of the last decade. The income tax changes since 1978 are illustrated in Table 6.1. If we count National Insurance contributions as an income tax, every Budget since 1982 has included a reduction in income tax as a major element in its package of tax changes. Not since 1981 have we seen an increase in the real burden of income tax; a consistent theme in Conservative statements about taxation in the last three election campaigns, and between them, has been that cutting income tax increases incentives to work and invest, and reduces distortions in the economy. The government view of the tax system has been as an instrument for improving the supply-side performance of the economy rather than as a tool for controlling the demand-side. This analysis, alongside the Medium Term Financial Strategy, would suggest that the very large public sector surplus should be used in reducing taxation. If all of the projected 1990-1 surplus were to be used in this way the basic rate of income tax could be cut from 25p to around 18p.

Table 6.1. Income Tax Changes since 1978

	Basic rate	Top rate on earned income %	Real level of allowances, 1978/89 = 100
1978/9	35	83	100
1979/80	30	60	102
1980/1	30	60	104
1981/2	30	60	93
1982/3	30	60	99
1983/4	30	60	108
1984/5	30	60	115
1985/6	30	60	119
1986/7	29	60	122
1987/8	26	60	122
1988/9	25	40	126
1989/90	25	40	126

Few things can be less likely than such a cut in the 1990 Budget. As the state of the macroeconomy has caused more and more concern, the government has made substantial efforts to restrict consumer demand using a very tight monetary policy on top of its already reasonably tight fiscal policy. In the 1990 Budget we can be fairly confident that the maintenance of this stance will rule out cuts in income tax. Indeed there may even be income tax increases.

Although no government, and especially not this one, likes to raise taxes, to do so would show how seriously the problem of inflation and excess demand was being taken.

Given that changes to income tax in 1990 seem likely to be viewed principally in terms of their impact on aggregate demand, rather than as part of a structural reform, final decisions can probably be left until very soon before the Budget. If by early March the strength of demand has dwindled enough as a result of the current tight monetary policy, income tax increases seem unlikely and unnecessary. If, on the other hand, there is new evidence that domestic demand has not slipped back, that the balance of payments has not improved, and that inflation is not improving, some increase in income tax in the Budget seems possible.

Freezing Allowances

If an increase were to be made the obvious options are either to increase the basic rate by 1 p to 26p or *not* to increase income tax allowances in line with inflation over the previous year. These two have fairly different effects on the distribution of income, although with inflation at around 8 per cent they raise similar amounts of revenue, around £1.5bn. Raising the tax rate imposes losses in proportion to income, whereas not increasing allowances in line with inflation imposes the same loss on all basic rate taxpayers. Raising the rate imposes much smaller losses on the poor, and larger losses on the better off than freezing allowances. Freezing allowances also requires explicit approval by the House of Commons as a result of the Finance Act 1981 (which superseded the so-called Rooker-Wise amendment and requires that allowances be increased in line with inflation). It would bring large numbers of low paid individuals into income tax when they receive their 1990 wage increase, not; an unattractive feature to a government which made much of the removal of individuals from the tax net by the increase in allowances in 1982-5.

However, when the state of the economy last led the Conservative government to raise income tax, in 1981, they chose to do so by freezing allowances – a discreet way of raising the real burden of taxation that imposes no immediate and highly visible cash losses on taxpayers. If income tax is to be increased in real terms in the Budget, failure to increase allowances in line with inflation must be the most likely route.

The MIR Ceiling

There has been some discussion recently of the possibility of raising the ceiling on mortgage interest relief (MIR) above its current level of £30,000, where it has stood since 1983. The argument put forward in favour of such a change is that it would be a way of easing the problems currently faced by homebuyers without reducing interest rates. A number of opposing arguments exist. First, it would seem to fly in the face of the government's aim of controlling consumer demand and would presumably delay any cut in interest rates. Second, it would help only those with mortgages in excess of £30,000, who would tend to be the better off. Third, it would lead to a reduction in the downward pressure on house prices, and might even stimulate some growth. Mr Major's predecessor burnt his fingers badly in 1988 with the pre-announced change to a maximum

relieved mortgage of £30,000 per property from £30,000 per tax unit, which so stoked up the housing market. Fourth, such a change would now be quite expensive, reducing the scope for any adjustments elsewhere in the tax system. Finally, the steady withering of this distortion as house prices have risen has been one of the most substantial achievements of this government in tax reform, albeit a passive one. To throw this away now would be foolish. An increase in the mortgage interest relief ceiling seems unlikely, and would certainly be unwelcome.

Fringe Benefits

The Convervative government since 1979 has made a good deal of progress in attacking the tax privilege associated with certain fringe benefits, and especially company cars. In his 1988 Budget speech Mr Lawson noted that independent studies suggested that "a typical company car may be taxed on only about a quarter of its true value". Since that statement scale charges have been doubled (in the 1988 Budget), and increased by a further third in the 1989 Budget. This would imply that company cars are currently taxed on two-thirds of their value. Were Mr Lawson to increase scale charges by 50 per cent in this Budget, he would raise some £0.5 billion, and the scale charges would have reached, and possibly exceeded, an appropriate value. Some increase in the scale charges seems likely, although probably not one of 50 per cent.

There has been much recent discussion of the income tax treatment of children. At present, employer provided childcare is taxed in the same way as any other benefit in kind, and childcare costs incurred by parents are not deductible from taxable income. The government seems unsympathetic to suggestions that childcare should be subsidised directly by the tax system, and it seems unlikely that there will be any changes here in the Budget.

Independent Taxation

We already know about the (probably) most important change to income tax next year; the introduction of the reform to the taxation of married couples announced in the 1988 Budget. At the moment a married man receives an income tax allowance roughly 1.6 times as large as a single person, all investment income of a married couple is treated as the husband's income, and if a wife has earnings of her own she can claim a wife's earned income allowance equal to the single person's allowance. The couple's income is added together, all allowances subtracted, and tax calculated. For around 5 per cent of couples, this method means that they pay income tax at the higher rate; they can opt to forego the extra 0.6 of the married man's allowance, and be taxed as individuals (although investment income is still all treated as the husband's). This way they pay less in higher rate income tax, and are thus better off despite losing the excess of the married man's allowance over the single allowance.

From April 1990 *all* married couples will be taxed separately. All individuals will have their own allowance, equal to the single person's allowance. This can be used to offset both earnings and investment income. Married couples will receive an extra allowance, the Married Couple's Allowance (MCA), equal to 0.6 times the single allowance. There will be two important effects. First,

couples who at present opt to be taxed separately and therefore lose the excess of the Married Man's Allowance over the single allowance will now receive the MCA and therefore will gain up to £625 p.a. Second, any investment income of a wife with no earnings, or earnings below the single allowance, should no longer be subject to tax.

This change will lead to a reduction in tax revenue, the size of which is very difficult to estimate. There are two principal problems in estimating the cost. First, we do not have current data on the level and distribution of asset holding by the tax-paying status of individuals within couples. Second, much of the potential loss of tax revenue would result from shifts of assets out of forms in which they are subject to composite rate income tax, and into forms which pay income gross. If we assume that there is no reallocation of wealth into different forms, the cost of the independent taxation of investment income seems likely to be between £0.5bn and £1bn. If assets were reallocated on a large scale, the cost could be far greater.

6.2 The Taxation of Savings

The Savings Shortage

Since we have had too much consumption in recent years, there have been many calls for an increase in saving, particularly personal savings, and many fingers pointed at the tax system as a way to achieve such an increase. We would argue that the common view that we should look for ways of using the tax system to encourage more personal saving may be mistaken, but that nonetheless there are many aspects of the taxation of saving which would benefit from reform.

There can be no doubt that the collapse in the personal saving ratio was one of the main causes of our current economic problems, and from that point of view at least, personal saving is too low. However, if our concern is about a shortage of saving in the economy as a whole, we should be more interested in national saving, which includes the saving of the corporate and public sectors. Mainly because of the growth in the public sector surplus, national saving has fallen far less dramatically than private saving.

Not only is it inappropriate to think of personal sector saving alone in this context; even if it were the case that saving was too low, it is not certain that introducing new tax incentives for saving would be the best way to increase it. Indeed, the most effective way of using the tax system to increase national saving might be to increase taxes and thus raise public sector saving, directly increasing national saving. This is precisely the route this government has taken in running unprecedently large public sector surpluses.

Effect of Tax Incentives

If new tax incentives for saving were introduced, there would be a danger that assets would simply be shifted from forms of saving which did not benefit from tax relief to those which now did, without any new saving by the personal sector. It is even possible that saving would fall, since a smaller amount of saving would be required to achieve a given level of future income under the new liberalised tax system. Add to this ambiguous effect on personal saving the unambiguous reduction in tax revenue and therefore fall in public sector saving, and it becomes clear that new tax incentives for private sector saving may not have the effect which at first seemed likely.

Although reform of the taxation of saving may not be a way to achieve an increase in the *level* of saving, it is still much needed. The tax system we have at present treats different forms of saving in radically different ways. Some forms of saving, such as that in an owner occupied house, or a private pension, are very favourably treated by the tax system. Others, such as saving in interest-bearing accounts, are heavily penalised by the tax system. The result is that the tax system, rather than underlying economic factors, plays a major role in determining the rate of return on different savings forms, and thus the allocation of savings. The main problem with the taxation of savings in the UK is the distortion of savings decisions which it creates, and it is this problem that the Chancellor should address.

Two Special Problems

Before moving on to discuss ways in which reform might be introduced, it is worth noting two specific problems which are more serious this year than has been the case for some time.

Inflation Many of the distortions to the saving market are aggravated by inflation. A clear example is the taxation of interest income. If the real interest rate is 5 per cent, the inflation rate zero, and the tax rate 25 per cent, total tax in a year would be 1.25 per cent and the real net return 3.75 (5 – 1.25). If nothing changes except that the inflation rate rises from zero to 10 per cent, so the nominal return rises to 15 per cent, total tax rises to 3.75 per cent (15 x .25), leaving a real net return of only 1.25 (15 – 3.75 – 10). This effect occurs because inflationary income, which does no more than hold constant the real value of investment, is taxed as though it were real income. As inflation has climbed since 1986, this problem has steadily worsened.

Composite rate tax Interest on accounts held by individuals at banks and building societies is paid net of basic rate income tax. That is to say, unless an investor is liable to higher rate income tax, no further tax is due on any interest received from these sources. To allow for the fact that some individuals holding money in banks and building societies are zero rate taxpayers, tax is deducted not at the basic rate but at the composite rate. The composite rate is an average of the marginal tax rates of account holders, and is thus below the basic rate, (in 1990–1 it will be 22 per cent). Zero rate taxpayers *cannot* reclaim composite rate tax.

Until April 1990, all investment income of married couples is treated for tax purposes as being the husband's income, so tax is due on the wife's investment income even if she has no other income. From April 1990 this will no longer be the case; all adults will have their own tax allowances to offset against both earned and investment incomes. One result of this will be a dramatic increase in the number of zero rate taxpayers subject to the composite rate. The tax efficient response for all zero rate taxpayers is to move their funds to a form which pays interest without first deducting composite rate tax (National Savings for example), but many will not. Given this, the composite rate should fall, benefiting investors with a tax liability as well as those without. But the composite rate is calculated in arrears, and so will not be reduced to reflect the impact of independent taxation until the 1991–2 tax year. Although there are enormous administrative advantages from the composite rate its manifest inequity will affect far more people under independent taxation than at present.

Potential Reforms

The ideal tax treatment of savings would avoid both the inequities and the inefficiencies associated with the current regime. To achieve such an ideal system we would have to tax all forms of saving in the same way. There are in principle two possible routes to such an outcome, which are known as the Comprehensive Income Tax (CIT) and the Expenditure Tax (ET).

A CIT taxes in full the real return to all savings, that is any return in excess of that required to compensate for inflation. No distinction would be made between income and capital gain, with capital gains subject to tax as they accrued under a pure CIT. The CIT can be thought of as implementing in full the indexation of the income tax for inflation and applying it to all assets. An expenditure tax relieves the return from saving from tax altogether. The act of saving would be tax deductible, the act of dissaving taxable. Such a scheme would operate within the framework of a direct tax, with net savings deducted from taxable income.

In principle, both the ET and the CIT achieve the goal of non-discrimination between different forms of saving which we outlined above; the CIT by imposing the income tax rate on the real return to saving, the ET by imposing no tax. Debate over which of these two routes is most desirable continues, but it is now widely accepted that any rapid move to either is impossible, and that progress can best be made by a series of small developments.

One might hope that some preferred direction could be inferred from recent government changes to the taxation of savings, but it is difficult to identify any clear strategy here, or even any belief that one might be required. Changes made to the capital gains tax in 1982, 1985 and 1988 have moved that tax considerably in the direction required for a CIT. The introduction of PEPs in 1986 and their extension last year, along with the liberalisation of personal pensions legislation, has moved in precisely the opposite direction, towards an ET. As we noted above, it may not really matter which way we go, *provided* the aim is uniformity. If there is no coherent strategy, we will amplify distortions rather than remove them.

If, as seems sensible, it is accepted that sweeping changes to the whole of the tax system as it affects saving are unlikely, we must look for ways in which gradual change, consistent with current government policy, could move towards a more sensible regime. The best hope, as outlined in the third report of the IFS Capital Taxes Group[1] is further extension of the Personal Equity Plan scheme. We refer to such a regime as an Extended Personal Equity Plan, or EXPEP.

The EXPEP builds on the fact that since the bulk of saving in the UK is already channelled into forms where the return to saving is not taxed, a sensible reform would be to extend this privilege to all saving. The existing PEP has already done so for new investment in equities, and since last year also for unit trusts. As PEPs grow, a steadily larger proportion of these assets held by individuals will be held in PEPs. The most important range of assets currently penalised by the tax system are interest-bearing deposits. Under an EXPEP scheme these would be treated just as investment in equities is now, with *no* tax being charged on interest income. There would be an annual limit on the amount which could be invested in the EXPEP, as at present. Certain types of

1 "Neutrality in the Taxation of Savings: an Extended Role for Personal Equity Plans", IFS Commentary No 17.

assets, such as unquoted companies, closely controlled companies, and unincorporated businesses might present avoidance problems, and so would initially be excluded.

An EXPEP would provide for many currently tax penalised assets a tax regime similar in effect to that available for owner occupied housing and retirement saving. By doing so, it would remove many distortions in the savings market, and the inequity inherent in the tax penalty on these assets most commonly held by the less well off. The annual cost would not be great, and while we would not expect any noticeable increase in national saving, the efficiency gains should appeal to a government wedded to supply-side improvements.

6.3 National Insurance Contributions

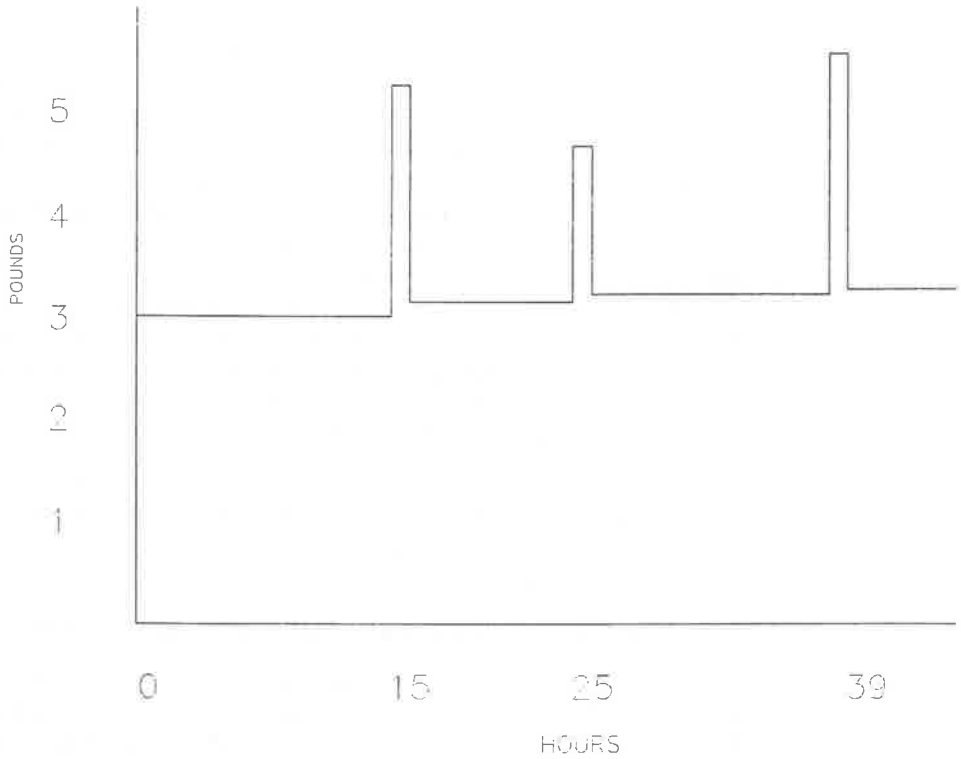
National Insurance contributions (NICs) may once have been a forgotten tax, but that is no longer the case. By 1988–9 NICs were raising three-quarters as much revenue as was raised by income tax, thus making them the second largest source of government revenue. The structure of NICs had already been subject to reform in 1985, but the government returned to the same problem in 1989 and took further action, removing some of the discontinuities in the employee's NIC schedule and with them some of the disincentive problems which had existed. When looking back on tax reform in the 1980s, the 1985 and 1989 NIC changes will seem significant landmarks. However, it is vital to notice that the 1985 reforms make much more sense as the first step in a reform process which was continued with the 1989 changes. Without the 1989 Budget, the introduction in 1985 of new discontinuities seemed of little worth; as a step towards the introduction of the 1989 system they seem quite coherent.

Similar sentiments can now be applied to the 1989 reform. The changes made are sensible, but still leave much to be done. We should recognise the achievement of the reforms already enacted, while emphasising the need for further progress. Three areas of difficulty remain.

The Structure of Employer NICs at Low Earnings

The 1989 reform removed the jumps in employees' NIC liability which had occurred at £75 p.w. and £115 p.w. and substantially reduced the jumps at the lower earnings limit (LEL) of £43 p.w. at which NIC liability begins. Despite arguing that these reforms removed "a serious work disincentive from the system", Mr Lawson argued that the jumps in liability for employers' contributions, which were unchanged, were "not a real problem". This seems wrong. Consider Figure 6.1, which shows the marginal cost to an employer of increasing by one hour the weekly hours of an employer earning £3.00 per hour. At 15, 25, and 39 hours per week the marginal cost rises sharply and then falls. These hours correspond to the thresholds of £43 p.w., £75 p.w. and £115 p.w. at which contribution rates jump for employers. Clearly, it makes little sense for employers to have staff working these hours; it might make more sense to incur the fixed costs of taking on an additional member of staff to work 14 hours at a gross wage plus employer's NI cost of £42 than to increase the hours of 14 employees from 14 to 15, at a cost of £73.50.

Figure 6.1. Marginal Cost of Extra Hour



If the 1989 reforms to employees' NI were desirable, and they were, similar changes to employers' NI are at least as much so. The main reason for not introducing such changes in this Budget must be the cost, of over £3bn, but they should form a key part of Mr Major's medium term plans for tax reform.

The NI Ceiling

The second problem is caused by the NIC ceiling. At earnings beyond £16,900 p.a. no further NICs are due from employees. For a married man, the 40 per cent income tax rate may well not become due until earnings are in excess of £30,000. Over a range of income from £17,000 to £30,000 the marginal direct tax rate is only 25 per cent, compared with 34 per cent (25 per cent income tax and 9 per cent NIC) below that income level. The marginal direct tax rate schedule produced by the current system is shown in Figure 6.2 If the higher rate income tax threshold continues to grow in real terms, and the basic state pension remains stable in real terms, we can expect the range of incomes over which tax rates fall to grow. This is because the NIC ceiling is tied by law to grow at the same rate as the basic state pension. Not only this, but if real earnings continue to rise at, say, 3 per cent per year, in seven or eight years the NIC ceiling will be below average earnings. Table 6.1 shows the decline in the ceiling relative to average full time male earnings in the 1980s.

Figure 6.2. Marginal Direct Tax Rates 1989/90

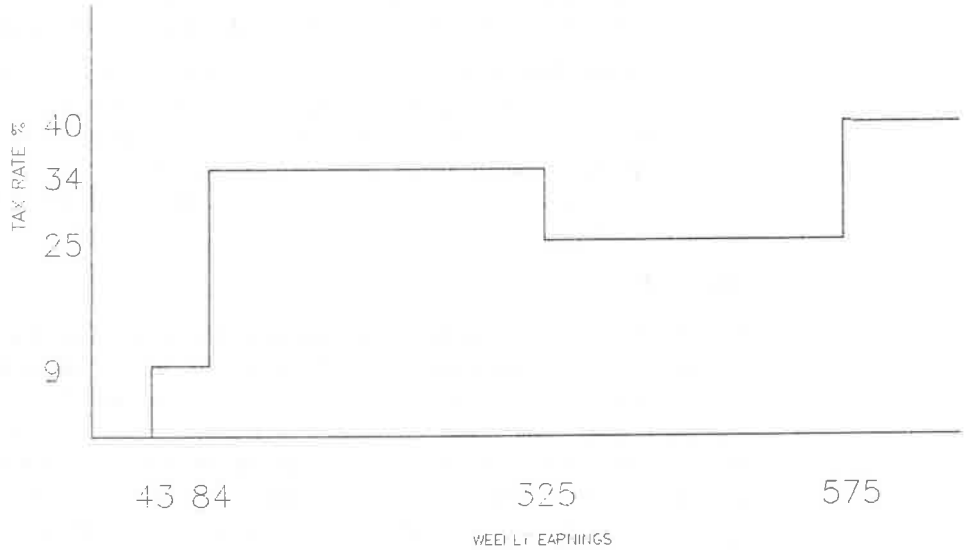


Table 6.2. Excess of Ceiling over Average Male Earnings

1981	45%
1982	45%
1983	43%
1984	40%
1985	38%
1986	37%
1987	32%
1988	24%
1989	21%

Simply abolishing the ceiling would present both administrative and distributional problems, and thus seems unlikely, although we should remember that in 1985 the government did abolish the ceiling for employers' contributions. The major administrative problem is connected with the State Earnings Related Pension Scheme (SERPS). SERPS entitlements are based on earnings between the LEL and the ceiling. If the ceiling were abolished, some way of preventing SERPS entitlements from accruing on all earnings would be required. The obvious solution would be a SERPS ceiling below which contributions conferred entitlement to a SERPS ceiling, and beyond which this was not the case. This was the solution adopted for employers' contributions when the ceiling was abolished for them in 1985.

The distributional problem with abolition is that some individuals would lose up to £1000 p.a., even if the higher rate of income tax were cut by 9 per cent. These individuals are those whose incomes at present substantially exceed the NIC ceiling, but are not high enough to pay the higher rate of income tax. The

best way around this problem would be to increase the NIC ceiling whenever tax cuts are made. It might be unrealistic to expect that the NIC ceiling would be raised by enough to offset all gains, but some progress could be made.

Reform of the NIC ceiling may seem politically unattractive at present, but it seems inevitable in the medium term. It is hard to imagine that a direct tax system which favoured the top half of the income distribution so much as the UK system seems likely to by 1995 will be acceptable. The longer the government continues to ignore this problem, the more difficult it will be to effect a solution.

The NIC Base

The third remaining problem, and the one which has thus far received least attention from the policymakers and the media, is the difference between the types of income subject to Schedule E income tax and those subject to NICs. The most important difference arises in the treatment of benefits in kind. Whereas Schedule E income tax is due on all benefits in kind, such benefits are specifically excluded from NICs. The consequences of this difference are substantial. Consider an employer who wishes to provide a basic rate taxpayer in the 9 per cent NIC band with an extra £100 of net income. The employee needs £151.52 of gross earnings, on which income tax of £37.78 and NICs of £13.64 are due. The employer has to pay £15.83 of NICs on the £151.52, giving the total ot £167.35. Alternatively, if the employee is to be provided with benefits in kind to a net value of £100, the cost to the employer is £133.33. The only charge on the income is the £33.33 of income tax on the gross benefit worth £133.33, since neither employer nor employee incur any liability for NICs. The incentive for provision of benefits in kind provided by the current system is obviously large. As noted earlier, the company car is probably the most significant such benefit, the exclusion of which from NICs has an annual cost to the Exchequer of something over £1bn.

There has thus far been one breach in the exclusion of benefits in kind; since May 1988 gilts, which were previously exempt, have been included. This change was welcome, both in its own right, and as a signal that the government did not rule out such moves. Further reform in this direction would be very desirable and have the welcome side effect of raising a little more tax revenue.

6.4 Corporation Tax

The last major reform of corporation tax, in 1984, was intended to provide a stable and enduring framework by setting up a rational system which would not unduly distort business decisions. Despite criticisms of the new structure, particularly regarding its failure to deal adequately with inflation, there have been no further important reforms. However, recent economic troubles, and grim forecasts for the near future, have combined to make a serious review of the system look more desirable, and perhaps more likely, than in previous years.

The present system has two important weaknesses; it discourages investment at any positive inflation rate, and it is unindexed, so that the effective tax rate rises with inflation, thus adding to the disincentives to invest. This problem has been obscured in the past five years of strong profitability, low inflation and booming investment. But inflation is now running at nearly 8 per cent, the growth of profits has dipped sharply, (many forecasts for 1990 are now negative) while investment has slowed dramatically and looks set to fall.

On the macroeconomic side, the government still has a large surplus, but is forced to keep an extremely tight fiscal stance in the coming Budget, to contain consumer spending. The Chancellor might be attracted by the idea of cutting taxes in an area with little effect on consumer demand, while being seen to aid business in both the long and short term. Any reform that effectively lowers corporate taxes raises the value of the stream of post-tax profits which underpins share prices, and is likely to raise share values, but the form which the tax cut takes can determine whether any additional cash is distributed immediately or reinvested in the business.

The departure of Mr Lawson, the architect of the 1984 reforms, is an obvious opportunity for change, but another structural alteration is most unlikely given the government's strong criticisms of the piecemeal tinkering that characterised the 1970s. While we have argued elsewhere[2] that a complete overhaul of the system should be seriously considered, it seems unlikely that this could be achieved at the next Budget. We therefore concentrate on three simple options open to the Treasury in March and use the IFS corporation tax model to estimate the costs and effects of each.

We focus on the *average* tax rate (the total tax burden on companies as a proportion of real profits) and on the post-tax *cost of capital* (the minimum required rate of return from an investment). The first affects investment by increasing or reducing the internal funds available to finance it, the second affects it by raising or lowering the hurdle that projects must clear to be profitable. We use our model to quantify these effetcs. The results are shown in Table 6.3.

2 "Corporation Tax and Inflation: A Growing Burden for Business", Bond, Devereux and Freeman (1989), IFS Commentary No 16.

Table 6.3. Estimated Effects of Corporation Tax Reforms on Industrial and Commercial Companies

	Fall in average tax rate (%)	Fall in average cost of capital (%)[a]	Cost (£bn)	Estimated investment[b] effect (£bn)	
	1991/2	1991/2	1991/2	1990/1	1991/2
Higher allowances[c]	1.4	0.2	1.4	0.1	0.5
30% rate	1.1	0.2	1.6	0.2	0.6
Stock relief	1.6	0.6	1.6	0.5	0.9

[a] averaged over sources of finance and type of investment.
[b] including investment in stocks.
[c] applied to new and existing assets. 40% plant and machinery, 8% industrial buildings.

As Table 6.3 shows, the effect on investment of all three options is initially small, driven only by the change in the cost of capital, because of the lag in corporation tax payments. As tax payments fall in 1991–2, the costs to the government rise, but average tax rates also fall allowing liquidity-constrained companies to increase investment further. We would expect this effect to be even larger in 1992–3. It should be noted that the demand effect is not limited to investment. A reduction in average tax rates also makes more cash available for distribution as dividends. We comment briefly on the rationale for each of these reforms.

Stock Relief

The reintroduction of stock relief is justified on the grounds that the taxation of purely inflationary gains on stocks is a major flaw in the system. This reform has the added attraction of reducing the incentive to companies to destock and the consequent risk of recession. From the microeconomic point of view stock relief alone is slightly less than ideal in that it does not solve all the problems of inflation. As a simple interim proposal however, it performs remarkably well. In political terms, such a move seems unlikely, since the introduction of stock relief is historically associated with periods of high inflation; the argument that an indexed tax system would undermine the credibility of the government's fight against inflation appears to carry considerable weight in official circles. Such fears seem exaggerated; anti-inflationary credibility is established in the conduct of macroeconomic policy, rather than in the design of the tax system, a principle recognised in the indexation of capital gains tax. Moreover, it is not clear that the most effective way to prevent inflation is to exaggerate its ill effects deliberately through the tax system.

Capital Allowances

Capital allowances would be the most straightforward way of directing tax cuts towards investment in the long run. However the reintroduction of first-year allowances would be a step in the opposite direction from the 1984 reforms, and is unlikely. Alternatively, the existing depreciation allowances could be raised with very similar effects; Table 6.3 illustrates the effect of applying higher depreciation allowances to new and existing assets. Raising the depreciation rate for new

investment *only* would have the advantage of lower exchequer costs, but the disadvantage of creating an arbitrary distinction between new and old investment. The effect on new investment via the fall in the cost of capital would be the same, but there would be no significant change in average tax rates, and therefore no further effect on investment via increased cash-flow.

The Tax Rate

The "headline" tax rate of 35 per cent could simply be reduced. This is the most obvious way to ease the burden without reneging on any past statements, but also the least effective. Reducing the rate alone does little to alter investment incentives, since capital allowances could then only be set off at the lower rate; the extra money is more likely to be distributed to shareholders, compared to the introduction of stock relief. Furthermore, it would do nothing to relieve the long-term problems inherent in the system. A cut of around 3.5 per cent would be necessary merely to compensate firms for the present level of inflation; so any real easing would involve a substantial lowering of the rate. Despite these drawbacks, the simplicity and political appeal of this option leave it as the slightly more likely choice if the Chancellor decides to reduce the corporation tax burden at all.

Surplus ACT

One possible candidate for reform is the treatment of unrelieved Advance Corporation Tax. A company pays ACT on the dividends it pays but can offset this against Mainstream Corporation Tax. In any one year it is possible that gross dividends exceed taxable profits; unless the ACT is set off against Mainstream tax paid in earlier years, it will remain "unrelieved". Since the abolition of many allowances in 1984 and after a period of high profits this is not generally a problem. However, companies making a large proportion of their profits abroad, but paying dividends in the UK, may face this situation every year, since they are unable to set off ACT paid against foreign tax liabilities. In this case however, it seems unlikely that the government would ever give full relief on the unrelieved ACT since this would essentially be giving a rebate on foreign tax paid. This problem should be seen as one of a number of difficulties in the tax treatment of profits earned abroad, which would best be solved in the context of a sensible harmonisation procedure.

Conclusion

The government looks set to ignore the structural flaws in the corporation tax system, although the economic situation has put reform in this area back onto the agenda. Indeed, it seems unlikely that there will be significant change at Budget time, and unfortunate that the most appropriate simple option, stock relief, will probably be ruled out.

6.5 Indirect Taxes

In determining the level of indirect taxes, the Chancellor faces the usual dilemma. On the one hand there are pressures to opt for low or even zero changes in taxation to minimise the Retail Price Index (RPI) effect of revalorisation, while on the other health and environmental lobbies will wish to see duties rise, in line with inflation at the very least. Somewhat in the background is pressure from the European Commission for generally lower tax rates in the interests of harmonisation, though there is now considerable flexibility in the post-Cockfield plans.

We consider the likely importance of each of these issues. We believe that the Chancellor will increase some duties, aware of the need for a higher overall tax burden, and secure in the knowledge that the next election is far away. But the final decision will be strongly influenced by pay settlements between now and Budget time.

European Tax Harmonisation

As a part of its plan for a single European market by 1992, the European Community has proposed changes in indirect taxation across member countries. First, it has proposed a new system of administration, to avoid the need to collect taxes at borders. Second, there are proposals to bring rates of tax into line, to avoid the incentives for agents to buy in one country while consuming (or selling) in another. The original report, by Lord Cockfield, was rejected by the UK government on many counts – in fact even the need for change was questioned.

The original set of EC proposals suggested drastic changes to the rates of UK Excise Duties. At today's rates of exchange, with today's duties, they imply a drop in the price of cigarettes by 12 pence per packet, 14p off a pint of beer, 73p off a bottle of wine, £2.48 off a bottle of spirits, 27p off a gallon of DERV, and 13p *on* the price of a gallon of four-star petrol. The health implications of such changes are worrying, especially for wine and spirits where price movements have large effects on consumption. Now there are some new, more flexible, suggestions on duty rates but there seems to be no likelihood of any wide-ranging reforms to VAT in this Budget and little sign that EC considerations will play an important role in Mr Major's thinking on Excise Duties.

Revalorisation of Excise Duties

Although a "neutral" Budget would include the uprating of Excise Duties in line with inflation in the year to the previous December, straight revalorisation is a rare event. The following table lists the real value of Excise Duties since 1977, (that is, the money value of the duty in March divided by the RPI in December of the previous year).

Table 6.4. Real Value of Excise Duties, 1985 = 100

Year	Petrol	Derv	VED	Spirits	Beer	Wine	Cigarettes
77	91.5	108.4	106.7	142.6	88.4	155.5	90.0
78	70.0	96.7	95.1	127.1	78.8	138.7	80.3
79	79.2	106.5	87.8	117.3	72.7	128.0	80.3
80	83.5	98.9	89.9	112.7	75.3	124.4	77.1
81	100.1	118.6	91.1	112.2	90.6	126.3	87.8
82	100.6	91.0	92.9	106.5	91.7	126.6	89.1
83	100.0	100.4	93.6	106.1	91.9	127.0	89.1
84	100.0	100.0	94.1	102.7	97.1	96.7	96.8
85	100.0	100.0	100.0	100.0	100.0	100.0	100.0
86	102.2	102.3	94.6	94.6	94.6	94.6	100.8
87	98.5	98.6	91.2	91.2	91.2	91.2	103.8
88	100.3	100.4	88.0	88.0	92.0	92.0	103.4
89	93.9	94.0	82.4	82.4	86.1	86.1	103.4

Table 6.5 shows the price effects of revalorisation on standard units of each good, assuming an inflation figure of 7.7 per cent. However, this table assumes that any increase in duties is passed on to consumers in full. Given that profitability in some of these industries is high, and that demand conditions are weak, it is possible that tax increases will be partly absorbed in the form of lower margins. This would mitigate the inflation impact of increases in excise duties.

Table 6.5. Effect on Prices of uprating Excise Duties in Line with Inflation

RPI	Petrol (gallon)	Derv (gallon)	Ved (£pa)	Beer (pint)	Wine (bottle)	Spirits (bottle)	Cigarettes (packet)
7.7%	8.3p	7.1p	£7.80	1.7p	6.4p	42.4p	8.7p

The principal reason the Chancellor may wish to avoid revalorisation is inflation. Mr Lawson decided last year that it would be better to leave the money values of most duties intact, rather than add 0.5 percentage points to the retail price index through revalorisation. This year, unfortunately for the Chancellor, there is likely to be an upward blip in inflation resulting from rates reform (see Section 6.6); Mr Major would therefore presumably wish to keep changes to the value of Excise Duties as low as is practical. However, the question is whether the various health, social and environmental lobbies can be resisted for another year.

The Chancellor could of course argue that since 1992 is not far away, now is the time to begin convergence to European levels of excise duties, which would imply reducing their real value (i.e. not revalorising). But this would be an abrupt change from the government's previous position which is outright rejection of the Commission's indirect tax harmonisation proposals. He is more likely to accept the health and revenue argument for raising at least some of the duties despite the inflation effect.

The Case for Duty Increases

As Table 6.4 shows, the value of many excise duties has signally failed to keep pace with inflation in recent years. For goods such as alcohol and tobacco, the consequent fall in the real price is likely to have had adverse health implications. In particular there has been concern that increasing numbers of young people are consuming high amounts of alcohol. The recently published 1986 General Household Survey drinking section found that 39 per cent of men aged 18–24, and 19 per cent of women in the same age-group, exceeded medically recommended "sensible" drinking levels (21 units of alcohol per week for men, 14 units for women). Such health concerns may be difficult to resist for a second year, although previous Conservative Chancellors have found such arguments easier to withstand for alcohol than for cigarettes.

In the case of road taxes, the concerns are increasingly environmental. These issues are tackled in more detail in Section 6.7. The duty on leaded petrol must be a prime candidate for an increase, on grounds of pollution. In addition, there are several possibilities for Vehicle Excise Duty. This duty has long ceased to be solely a means of financing road building and maintenance, its original purpose. Its value has been fixed at £100 per annum per car since 1985, since when its real value has fallen by nearly 20 per cent. One suggestion is that it should be abolished and replaced by higher petrol taxation, relating tax more closely to usage. However, because this duty is a valuable check on the ownership of MoT certificates, abolition would require some planning. An alternative approach might be to uprate the VED but offer "green" rebates e.g. for cars fitted with catalytic converters.

Whether or not the Chancellor opts for revalorising Excise Duties, either across the board or on particular items, there are a number of goods that may receive favourable treatment. The 1988 Budget, whilst leaving most duty rates unaltered, introduced new rates of tax for certain alcoholic drinks – low alcohol brands and "coolers" – while the 1989 Budget widened the tax advantage in favour of unleaded petrol from 5p to 14.2p (including VAT). Further widening of the tax incentive on unleaded petrol would have the benefit of backing up government statements on the environment. However, unleaded petrol now (Dec. 89) accounts for 28.7 per cent of all gallons purchased, so that the revenue costs of increasing the tax gap need careful consideration. Presumably, if alcohol duties are not increased in this Budget, action on lower alcohol drinks, and possibly on the new "premium" strength cans of beer and lager (which may contain as much alcohol as two pints of beer, in a single can), may be used to allay some health concerns.

For a Chancellor wishing to hold down inflation and not cut taxes, the setting of indirect tax rates in the 1990 Budget presents problems, aggravated by environmental and health concerns, and the prospect of 1992. Given this background, we expect to see increases in some rates, perhaps particularly on tobacco, strong drink and leaded petrol but no change in others. The real reductions will probably be defended on environmental and possibly even European grounds, although inflation is likely to have been the driving force.

6.6 Local Taxes

The Local Government Finance Act 1988 changes radically the local government financial arrangements in England and Wales. The main changes – being introduced in April 1990 – can be classified under three headings. Firstly, domestic rates previously paid by each household will be replaced by a flat rate poll tax called the "Community Charge". A second feature is the removal of local authority control over the setting of non-domestic rates, i.e. rates that fall on businesses etc. From April, the business rate – the rate poundage – will be uniform in England and Wales, and the rates paid by each business will be the product of the uniform business rate and the new rateable values of business properties, revalued in 1989. The final major element involves changes in the grant system; in the future local authorities will receive a fixed lump sum which is independent of actual levels of expenditure. Previously block grants varied with expenditure levels.

Legislation in Scotland introduced the Community Charge and the new grant system a year earlier in April 1989. Distinct from England and Wales, revaluations of business (and domestic) property took place in 1985. Further, variable business rate poundages have been retained and since April 1989 business rate bill increases have been constrained to increase in line with the Retail Price Index. The government has announced that it aims to achieve a common non-domestic rate poundage across Britain (England, Wales and Scotland) over the next five years.

The movement away from taxing households towards taxing individuals has meant that more people are eligible for local tax rebates. For those with incomes below Income Support thresholds, 80 per cent of the Community Charge will be covered by benefit. For every individual £1 earned in excess of the threshold, 15p in benefit will be lost compared with the 20p previously lost under the rate rebate system. The Community Charge benefit with its slightly more generous taper means that there will be an additional estimated expenditure on benefits in 1990–1 of approximately £400m.

The government recognises that the overall effect of the move from rates to Community Charge will affect considerably the personal finances of many households. To avoid any sharp increases in individuals' local tax bills, the government has introduced a "safety net" scheme to phase in the changes. Under the "safety net" arrangements, losing local authorities can raise only up to £25 per adult plus inflation above the 1989/90 expenditure level from Community Charge payers. The costs to the government of the safety net are met by limiting the negative adjustments of gaining authorities after allowing for inflation to a sum equivalent to a minimum of £75 per adult. In the financial year 1990–1 the safety net arrangements will be self financing.

In October 1989 at the Conservative Party Conference Mr David Hunt, Minister of State at the Department of Environment, introduced the "transitional relief scheme" whereby if local authorities spend at "sensible levels" i.e. current levels plus inflation, then "no ratepayer or ratepaying couple anywhere in the country

will be more than £3 a week worse off when the Community Charge is introduced". The transitional relief scheme will cost £300m, boosting expenditure on transitional grants to nearly £700m.

The effects on businesses of the changes in local government finance are very significant. Revaluations have had the greatest effect on business rate bills – 75 per cent of the change is a result of the revaluation. The combination of revaluation and the uniform rate poundage (34.8p in the pound in England, 36.8p in Wales) will lead to the incidence of rates changing significantly.

On average factories and warehouses gain and shops and offices lose whilst in regional terms the incidence of rates shifts from the North and Midlands to the South East, South West and East Anglia. The reform thus provides a new incentive to business to relocate from the South East to the North and Midlands. It has been the government's aim to keep the yield from the UBR in real terms at the same level as the revenue raised from the non-domestic sector in 1989-90. With so many losers (0.9m face higher rate bills out of 1.6m business properties revalued) the government has set a transition period of five years where losses are limited to a maximum of 15.5 per cent in the first year. Since gains in any one year will also be limited to a maximum of 20 per cent, the transitional scheme is self financing.

An important aspect of the interim arrangements is that the relief (attached to the business, not the property) is lost if the business moves. This means that a shop or office in the South East that is contemplating a move to new premises will now face a huge (up to sevenfold) increase in its rate bill if it moves, but can continue to enjoy transitional relief if it stays put. The implications for the commercial property market could be profound with a large incentive not to move within the South East and an equally large incentive to move within the North and Midlands.

The changes in local government finance this year will have a significant impact on prices. There appear to be three possible channels by which the reforms may influence the Retail Price Index. The first is that as a result of the introduction of the Community Charge, local tax incidence in 1990 will tend to shift away from households at the top of the income distribution and pensioners – both not covered by the RPI – towards households which are covered by the RPI. The higher local tax bill of "index households" implies an increase in the RPI of between 0.1 and 0.2 per cent.[3] More ambiguous is the affect of changes in business rates on the RPI. The total level of business rates will be unchanged and in the long run the reform will not be expected to affect prices. However, if in the short run there is an asymmetric response in terms of price adjustment – i.e. losers increase prices by the full amount of the UBR increase and gainers do not adjust prices – then taking into account the transitional arrangements there could be an effect on the RPI of up to 0.3 per cent. However the maximum figure is unlikely to be achieved in tight demand conditions, which means that the impact of higher rate payments will be

3 "Treatment of Community Charge in the Retail Price Index", Department of Employment Retail Price Index Advisory Committee. Cm644. HMSO, 1989.

absorbed by firms through lower profits or by their landlords through lower rents. Combining both the "index household effect" and business rate effect implies an impact on the RPI of between 0.1 and 0.5 per cent.

Finally, the Government has assumed that local authority spending will increase by around 4 per cent when determining its Community Charge levels. A number of commentators have argued that local authority inflation will be significantly higher, probably in the region of 7.5 per cent. Further, local authority expenditure may increase in real terms if local authorities push through new spending, believing on the basis of Scottish experience[4] that the blame for the resulting higher Community Charge can be put on the government. These considerations, plus the unwinding of creative accounting measures and avoidance problems suggest that the average Community Charge will be significantly greater than the official estimate of £278. The aggregate burden on Community Charge payers in England in 1990–1 is assumed by the government to be £7.55bn. This is 14 per cent less than the domestic rate burden in 1989–90 and would have an impact on the RPI of −0.6 per cent. Nevertheless most commentators expect total local authority expenditure to rise by about 10 per cent. If this was the case the average Community Charge bill would be close to £320 and the effect on the RPI would be about 0.6 per cent.

The overall impact on the RPI from the changes in local government finance could range between 0.7 per cent and 1.1 per cent. With tight market conditions expected in 1990 we expect the effect on the RPI to be towards the bottom end of this range. The increase in the RPI in April 1989 due to rates was 0.4 per cent. Therefore the net effect on inflation in April could be in the order of 0.3 per cent.

All the expenditures mentioned above have been accounted for in the Autumn Statement and the government's White Paper on public spending. There have been no recent changes affecting the revenue position and it seems that unless the government gives way to pressure on easing the transition of the effect of the new business rates it is unlikely that there will be any relevant announcements in the Budget.

4 "The Switch from Domestic Rates to the Community Charge in Scotland", Gordon Hughes, "Fiscal Studies", August 1989.

6.7 Environmental Taxes

Introduction

Budgets may increasingly come to have a "green" tinge because taxes might be a useful tool in the management of the environment, as well as a possibly significant source of new tax revenue. Other mechanisms for environmental protection such as tradeable permits to pollute, or straightforward regulation will sometimes be preferable, but taxes are an instrument particularly well-suited to controlling certain types of pollution.

Economic agents frequently damage the environment without paying for the harm they do. For example, when farmers use fertilisers they pay for the cost of producing the fertiliser, but they pay nothing for the clean water which they (indirectly) pollute when the nitrogen from the fertiliser leaches into the water system. Users of energy pay for the cost of energy production, but do not pay for the resulting effects of global warming because of the carbon dioxide given off by their burning of fossil fuels. Because producers and consumers pay less than the full costs of making goods involving polluting activity, the goods are too cheap, so more of them are produced and consumed than is economically efficient. Taxes can be used to raise the price of goods to reflect the environmental and economic costs of pollution – and provide revenue to help clean up the environment.

Taxes are better than regulation in controlling some sorts of pollution because they allow individuals to weigh up the costs and benefits of their behaviour on a case-by-case basis. For example, sometimes the benefits of increasing food production by using nitrogen on a particular field will be so large that a farmer will find it worthwhile to buy fertiliser, even though it is taxed and the price of the fertiliser therefore reflects the costs of removing the nitrogen from the water system. On another field, fertiliser use may not be worthwhile if its price reflects its environmental costs. Direct regulation might specify that a farmer is only allowed to use so much fertiliser per acre, in which case he would not be able to spread as much fertiliser on one field as he would like, even though he would be prepared to pay for the consequences of the pollution which he caused. On the other field, he would be allowed to use fertiliser even though the benefits from using it would be insufficient to pay for the environmental costs. As long as the tax level was set at a level which made the price of fertiliser reflect the environmental costs of using it, taxation would let *more* food be grown than direct regulation, with the *same* consequences for the environment.

Possible Environmental Taxes

There are many possible candidates for environmentally motivated taxation. Internationally there are taxes on fertilisers and pesticides (Norway and Sweden), non-returnable containers, bottles, etc. (Norway, Sweden and Finland), and non-biodegradeable plastic bags (Italy). In addition, most countries have taxes on mineral oils which, whatever their original motivation, have substantial environmental implications.

Introducing environmental taxes can have consequences for industrial competitiveness, the distribution of post-tax income, and, of course, the environment. These effects are discussed for a few possible environmental taxes below.

Carbon taxes

Carbon dioxide has been implicated as a major source of possible global warming. It is produced principally by the burning of fossil fuels. A carbon tax has been suggested as a possible way of making the price of burning these fuels reflect the costs of the greenhouse effect. Because some fuels give off more carbon dioxide than others per unit of energy generated, the tax rates should in principle be different on different types of fuel. In particular, coal would be more heavily taxed than oil which itself should be subject to a higher tax rate than gas. For example, one calculation by Scott Barrett of the London Business School based on the Department of Energy's estimates of the responsiveness of demand to increases in the price of energy suggests that to reduce the rate of carbon dioxide emissions by 20 per cent in the long term would require tax rates of 24 per cent on coal, 19 per cent on oil and 14 per cent on gas. Such a tax would raise about £3bn per annum. Renewable energy sources (tidal, wind, solar, hydroelectric) would not be subject to a carbon tax. Nuclear energy gives off no carbon dioxide but should be subject to a tax reflecting the costs and risks of nuclear waste.

If the UK introduced a carbon tax unilaterally, the increase in the price of energy would increase industrial costs. Energy intensive products produced in the UK would become uncompetitive in world markets. For example, in 1984 for every therm of energy used, the Iron and Steel industry produced output worth £2.48, whereas the Electrical Engineering industry produced £47. Obviously, the former would suffer much more from a carbon tax than would the latter. The UK would therefore shift into producing low-energy intensive products, and would import those products requiring a greater energy content from countries without a carbon tax. Hence although UK production of carbon dioxide would fall, that of the rest of the world would rise, which seems rather to defeat the object of the exercise.

Possible cuts in carbon dioxide production could be engineered at lower costs to business by using taxes and subsidies to change the "merit-order" of energy production. This would involve taxing coal, but subsidising cleaner fuels, so as to encourage use of energy sources which did less environmental harm.

VAT on fuel

A further option is to put VAT on domestic fuel. According to the IFS model of consumer behaviour (SPIT), this would reduce household consumption of energy by 5.5 per cent (if introduced at a rate of 15 per cent) without increasing business costs. Currently household fuel is zero-rated (unlike any other country in the EC), so is taxed less highly than most other goods, whereas because it involves environmental damage it should in theory be taxed more heavily. The major disadvantage with this policy is that the effect would fall much more heavily on poor households and the elderly than on rich households and the young, so much of the £1.7bn which would be raised would have to be spent on offsetting the adverse distributional effects – for example, by reducing direct taxes and increasing pensions and other social security benefits.

Fertilisers and waste discharge

Nitrates in water can harm the health of humans and also river animals, and fertilisers are often implicated as sources of much of the increase in UK nitrate levels. The EC is prosecuting the UK for exceeding its limit on the amount of nitrates which may be present in the water supply. The cost of complying with the EC directive is estimated at £200–300m. This suggests that farmers are using nitrates without regard to the environmental costs, because they do not have to pay for them. A fertiliser tax would make them use less fertiliser, and would raise revenue to help clean up the consequences of their use.

Conventional wisdom suggests that taxes on fertilisers would do little to reduce concentration of nitrates. It seems the increase in crop yields is so great that at administratively feasible tax levels (above some level, farmers would buy their fertiliser in another country in order to avoid the tax) it is still worthwhile for farmers to pay the tax. This does not invalidate the case for a nitrogen tax; this conventional wisdom might not be true in the long term, and in any case, if farmers get such big yield increases then they, (and food consumers, if the increase in the cost of farming is reflected in food prices) not water consumers, should pay for the costs of getting them, reflecting the widely held belief that "the polluter should pay" for environmental damage.

Direct discharges of trade effluent into rivers are responsible for at least some of the pollution of the UK's freshwaters. No charges are currently levied on these discharges in the UK, unlike in many other European countries. There are charges on trade discharges into the sewage system, but these are at such low levels that research has shown them to have little effect on company behaviour. The Dutch experience of charges suggests that they have to be at quite high levels before companies start responding by reducing the quantity of pollutants discharged – about £125m is raised each year in discharge charges in the Netherlands. The Germans have had success with lower tax rates, but making them dependent on how well the firm is performing in comparison to similar firms and giving subsidies to firms which perform better than their industry's norm.

Road Transport Taxes

Road transport is likely to be the focus of most attention on the environmental consequences of taxation, for several reasons. Firstly, there already are taxes on road transport, so the politically and administratively burdensome step of introducing new taxes is unnecessary. Instead, the rates of tax and the basis of assessment can be altered to nudge producers and consumers towards environmentally-friendly consumption. Secondly, road transport is a significant source of airborne pollutants – carbon dioxide, nitrogen oxides, hydrocarbons and (especially) carbon monoxide. Thirdly, official projections of road traffic show a substantial increase – a doubling by 2025 – which will make the environmental consequences of road transport a more urgent political priority. Finally, it is known that market incentives through the tax system work in the case of road transport – the tax differential in favour of lead-free petrol seems to have had a substantial impact, with some 30 per cent of petrol sales now being lead-free.

Taxes might be used to "green" road transport in three ways. They could be used to further promote the use of lead-free petrol; they could be used to encourage the fitting of catalytic converters, and they could be used to cut fuel use and hence generation of carbon dioxide.

Lead-free petrol A further increase in the leaded/unleaded rates of petrol duty seems a distinct possibility in the coming Budget. Currently the tax differential between leaded and unleaded petrol is 14.2p. Most new cars run on unleaded petrol, so as old cars are replaced with new ones (which happens to around ten per cent of cars each year), the UK car stock will inevitably become unleaded.

However, the move towards unleaded petrol has been so strong that an additional increase in the differential might be seen as superfluous. The Chancellor may instead repeat his predecessor's success in encouraging unleaded petrol by similarly encouraging the fitting of catalytic converters.

Catalytic converters Catalytic converters can remove a significant proportion of the pollutants produced by burning petrol – in particular, hydrocarbons, carbon monoxide and nitrogen oxides. The European Community is setting standards for pollution which will almost certainly require the fitting of catalytic converters to all new cars after 1992. However, old cars will continue to run without converters, because the cost of fitting them is large – £300–800.

A differential based on car tax (currently at 10 per cent on the value of new cars) would encourage purchasers of new cars to buy those with converters. For example, car tax could be 10 per cent minus £300 for new cars with a converter, and 10 per cent plus £300 for those without. Alternatively, a differentiated vehicle excise duty (VED) could be used, which could encourage the fitting of converters to old cars. However, the current level of VED may be so low (£100 per car per year) as to make any possible incentive rather too small to have much impact.

Petrol duty Fuel has to be burned for pollutants to be given off, so there is a clear relationship between cutting fuel consumption and green objectives. The simplest way of cutting fuel consumption is simply to raise the price of petrol. Currently the price of petrol is lower than its average real price over the past 25 years. Based on the December 1989 price, the duty rate on four-star petrol would have to rise by 55p per gallon to get the real price of petrol back to the level of January 1975. Even this price rise would not take petrol duty rates in the UK above those of Italy. Such a price rise would raise £3bn, according to the IFS model of consumption behaviour, and cut consumption of petrol by nearly 8 per cent.

Vehicle excise duty However, there are some problems with increasing duty on petrol which suggests that such a policy might be combined with a restructuring of VED. One problem is that cutting petrol use through petrol duty will result in an unpopular and arguably inflationary increase in retail prices. In contrast, if VED was differentiated according to vehicle engine size it is possible to design tax rates which would raise only as much revenue as at present, but which would give an incentive to buy smaller cars – for example, a VED rate of £60 for car engines under 1000cc rising to £240 for car engines above 3000cc.

Another problem with increasing petrol duty is its distributional impact. Most poor families do not have a car, so generally increasing petrol duty is progressive – it hits the rich more heavily as a proportion of their income than the poor. However, looking at car-owners alone, the tax is regressive – any increase in petrol duty will increase the tax paid by poor car-owners by more as a percentage of their income than the increase in the tax burden of rich car-owners. The distinction is important to the extent that increases in petrol duty have very different effects in rural areas than they do in cities.

In rural areas, public transport is generally not very extensive. It may well be that some households have little option but to have a car, in order to get to work, to the shops, etc. It is clear that such households are in a very different position from city dwellers, who are much more likely to have the option of using public transport. Raising petrol duty is progressive to the extent that some less well off households will use public transport in cities so will be unaffected by the increase in petrol prices, but regressive to the extent that the rural poor are constrained to using cars as their only means of transport, and increases in petrol duty have to be borne – substitution into other forms of transport is impossible. A differentiated VED might encourage smaller cars which do more miles per gallon, without penalising people who live in areas with a poor public transport system.

A further tax change which might promote fuel efficiency would be to change the structure of scale charges for company cars. Over half of the new cars sold in the UK are company cars, so the tax treatment of such cars has a significant impact on the UK car stock. The absence of National Insurance on the value of car use makes them a tax effective way of giving income to employees. Currently scale charges (the amount added to income for income tax purposes) are fixed for three engines sizes. The tax perk is therefore larger if the company car is towards the top end of each engine size category, rather than towards the lower limit. Hence the tax perk when giving a car with an engine of 1401cc is smaller than that for a car with a 2000cc engine. There are two ways of ending this incentive to have large company cars – end the tax perk on company cars, or at least make the scale charges more progressive by engine size.

Budget Options

Some of the environmental taxes discussed above are serious options in the longer term but are unlikely to be introduced in the forthcoming Budget:

Carbon taxes increase industrial costs and hence simply export carbon dioxide production to other countries, unless introduced simultaneously by countries making up a large proportion of the world economy. The lesser alternative of putting VAT on domestic fuel and increasing benefits might reduce environmental damage, but the Prime Minister has given an assurance that this will not happen (at least until after the next General Election).

Fertiliser Taxes and Effluent Discharge Charges both seem unlikely to do much to improve the environment by discouraging polluting activity unless introduced at relatively high (and therefore probably politically unacceptable) levels. However, they would raise revenue which could be used to clean up the

pollution which each industry creates. This should be attractive to governments, but in practice both the tax and charge are unlikely until the new regulatory regime following water privatisation has had time to settle down.

This does, however, leave road transport as a possible area for changes in the tax system motivated by environmental objectives.

1) An increase in the leaded/unleaded petrol differential seems possible, although as 30 per cent of all petrol sales are already unleaded (a proportion which is rising rapidly) and all new cars run on unleaded petrol, it seems unlikely to have much additional impact.

2) Tax incentives to introduce catalytic converters may be introduced – either using VED or car tax or both.

3) An increase in petrol duty would raise revenue as well as cutting emission of gases, but would put up the RPI, so different policy objectives conflict.

4) A VED differentiated by engine size might help reverse the trend to larger engine sizes and hence might increase miles per gallon.

5) A change in company car taxation, either to reduce the tax incentive in favour of company cars, or to make it more progressive by engine size, might help to increase the fuel efficiency of the car stock.

6.8 Technical Issues

The Chancellor has two particular topics to address in his first Budget: the taxation of foreign exchange gains and losses and of convertible and indexed securities. Both raise important issues which have been considered in consultative documents issued by the Inland Revenue in the last year.

Foreign Exchange Gains and Losses

As long ago as October 1976 the then Chancellor issued a consultative paper on the taxation of foreign exchange gains and losses. The debate has rumbled on ever since. The business taxation system in the UK is notable for its silence on the matter. While the problems of foreign exchange have become more acute since the collapse of the 1944 Bretton Woods agreement in the early 1970s, there is nothing new in the exposure of UK businesses to the change in relative values of different currencies. The importance to taxpayers of the topic has, however, increased enormously with time.

In the absence of specific provisions, the Inland Revenue and the Courts have been driven back to general principles to determine how to deal with currency fluctuations. General principles dictate that, for a trading company, the starting point in determining its taxable profits is its accounts prepared in accordance with generally accepted accounting principles. The results as shown by the accounts must then be adjusted for the rules contained in the Taxes Acts as interpreted by the Courts. The most important of these adjustment is to exclude any "capital" as opposed to "revenue" items.

Where a foreign currency gain or loss is not taken into account in the adjusted trading results, broadly the gain or loss may either be taxed or relieved under the capital gains regime or be treated as a "nothing": neither taxable nor allowable.

Since the early 1970s the proper accounting treatment for currency fluctuations has been the subject of considerable debate, particularly in the US. In the UK this has resulted in the adoption of SSAP 20. However, development of the accounting issues has not enabled the tax system to move forward in a way that solves its fundamental problems.

In *Pattison* v *Marine Midland Ltd* a bank operating a matched foreign currency book was held to be entitled to calculate its profits on a matched basis, so avoiding the creation of artificial taxable profits through its being required to convert its foreign currency assets into sterling while receiving no relief for the matching loss on its foreign currency liabilities. From that case a Revenue Statement of Practice has emerged, but the debate on that Statement merely illustrated that solutions to the fundamental problems could only come through legislation. Indeed, this has been emphasised by more recent judicial decisions on the topic, notably that in 1989 in *Beauchamp* v *F W Woolworth plc* (1989).

The consultative paper of March 1989 accordingly considers the scope for legislative change given the principal problems of the present system, namely –

i) the absence of relief for exchange losses on capital borrowings (the corollary of this being that gains on such borrowings are not taxed);

ii) the hedging of currency exposures may be ineffective because the hedging transaction is treated for tax purposes on a different basis from the underlying transactions: what is perfectly hedged before tax becomes imperfect on a post-tax basis; and

iii) changes in the sterling value of foreign currency denominated share capital are not taken into account for tax purposes.

While providing for consultation a detailed and useful examination of these problems, it was not the objective of the consultative paper to propose the particular solution that the government intended to adopt.

Currency fluctuations over the long term are strongly linked to the underlying rate of inflation of the countries concerned, which in turn will influence the interest rate for particular currency borrowings. Short term, however, exchange rates are far more volatile and are affected by a number of factors which cannot be predicted with any certainty. It is easy to conclude in general terms that relief should be available for currency losses which are partly an unavoidable business cost and partly the equivalent of an interest cost which would normally be deductible in calculating profits. Symmetry then demands that exchange profits are taxable.

The problem and the appropriate response to it are easy to state. A solution which is practical and fair to taxpayers, which is not open to manipulation or abuse and does not involve an unacceptable cost to the Exchequer is almost impossible to achieve.

Fundamental issues arise: when should a currency gain or loss be recognised – by valuing foreign currency liabilities in each period or only when the gain or loss is actually realised? And in a pool of changing liabilities when does realisation occur? To what extent should the tax treatment of foreign currency assets match the tax treatment of the liabilities that finance them, both in terms of the timing and in the way in which the system adjusts for inflation? What protection is appropriate for the Exchequer to prevent taxpayers from realising losses and deferring commercially matched gains, or realising them off-shore? Complex legislation would seem inevitable.

A business tax regime based on cash flow rather than profits, such as suggested by the Meade Committee in 1978, would remove the need for a special regime for foreign currency fluctuations. However the adoption of a cash flow corporation tax raises different problems and cannot be justified purely as a solution to this issue.

Radical solutions apart, there appears to be a broad measure of support from those responding to the consultative paper for allowing trading companies to deduct all exchange losses on a translations basis (with gains brought in as trading receipts) subject to an election to match particular foreign currency assets and liabilities. For investment companies, there is a greater divergence

between those who would deal with exchange gains and losses on a capital gains basis and those who would be given "income" treatment by allowing losses as management expenses and taxing gains as income receipts.

What seems clear is that, within the framework of the present system, there is no such thing as a perfect solution. Any proposal can be criticised. The present system, for all its imperfections, has the advantage of familiarity and the absence of complex legislation incorporating all manner of anti-avoidance devices. This should not be underrated.

There is, however, broad agreement that the attempt to find some solution should be pursued, with the government now putting forward detailed proposals for further consultations. What may eventually emerge is a minimalist approach, eliminating for example the worst aspects of the tax fragmentation of hedges.

Convertible Securities

If the taxation of foreign exchange primarily concerns the taxation of the investing company, the issues raised by the consultative paper on convertible and indexed securities concern the savings institution or individual.

The taxation of securities consists of a variety of different taxing provisions, built layer upon layer into an intricate web through which even the most skilled can have some difficulty in tracing a path.

A brief history shows that, in the beginning, interest and discounts were taxable, gains on sale or premiums on redemption were not. With the coming of capital gains tax ordinary debts were exempt for the original lender (because he was only likely to suffer a loss) but gains on sales of securities or premiums on their redemption were subject to capital gains tax (CGT). Gains on government securities held for more than a year were then exempted from CGT.

Thereafter the interest element realised on the sale or redemption of a corporate security issued at a deep discount became subject to income tax, following which government and most (but not all) quoted sterling corporate securities were exempted from CGT. At the same time the accrued interest element realised on a sale of a government and all corporate securities became subject to income tax.

In 1989 the exemption for sterling corporate securities was extended to the unquoted sector: the deep discount regime was applied to non-corporate securities and a new regime for "deep gain" securities introduced.

As a result there are ordinary debts and securities; sterling and foreign currency securities: qualifying and non-qualifying corporate bonds; convertible and non-convertible securities: securities issued at a deep discount and those not so issued; deep gain securities and non-deep gain securities, each of which may be subject to some different form of tax regime. And if the proposals put forward in the latest consultative paper are adopted we shall have qualifying and non-qualifying convertible securities and qualifying and non-qualifying indexed securities.

Ultimately, the saving grace is that the intricate web of provisions is designed to produce a coherent result whatever the nature of the instrument. The design is to tax the full nominal interest element of an investor's return without relief for inflation, to exempt gains attributable, for example, to interest rate movements while taxing gains and relieving inflation on any equity element in the security (as with a convertible).

The challenge that faces us is to see if there is not an easier way to achieve a rational regime for taxing securities, without the layer upon layer of technical complication and obscurity.

So long as relief is given to borrowers for the full nominal amount of the interest they pay there is little prospect of the lender being taxed on his real rather than his nominal return. If that is accepted, a system under which holders of securities were taxed on the difference between acquisition costs and disposal or redemption proceeds plus any interest actually received might sweep away much of the complexity. A *de minimis* provision (as under the present accrued income scheme) might exempt small investors and losses on securities might be offset only against gains on securities.

So long as an equity investor obtains relief for inflation, this solution will not be ideal for convertible securities as the gain or loss will to some extent reflect the performance of the shares into which the security can be converted. Any attempt to dissect the equity return from the ordinary security element is, however, bound to be complex. A straightforward answer may be to tax the convertible security as any other security on disposals up to conversion but, following conversion, to accord ordinary equity treatment, including indexation from the date of acquisition of the security.

The development of the tax provisions for securities contains important lessons that should be heeded before we embark on a similar path in relation, for example, to the taxation of foreign exchange gains and losses. Patching the system rather than applying a more fundamental review of the context in which the issue arises only leads to complexity and inconsistency. The patching process was described by the late Presiding Special Commissioner, H H Munroe QC, as "a suppurating source of complexity".[5] Let us hope that the Chancellor will find a better way forward.

5 "Intolerable inquisition? Reflections on the law of tax", H H Munroe QC, 1981, p32.

Appendix: Forecasting the PSDR

This appendix explains in detail how we arrive at our estimates for government revenues in 1989/90 and 1990/1. The precise figures are of rather less significance than in the early 1980s when they often determined the size of the Budget package. Nevertheless, the PSDR forecast for the coming fiscal year occupies a prominent place in the Medium Term Financial Strategy and is an important influence on the Budget package.

Fiscal year 1989/90

While we obviously have a considerable amount of information on the fiscal year drawing to a close, it should be stressed that the forecasts are still subject to a large error margin. Even the official Budget estimates of the PSDR for the current year – made when the year is eleven-twelfths complete – are subject to a £1bn error margin. Our own estimates, based on less information and carried out two months earlier, are subject to a still wider margin. On the expenditure side we are heavily reliant on government figures, about which, this year, we have rather more doubt than usual. On the revenue side we make our own independent estimates.

Table A1 illustrates the various methods by which we predict tax revenues for 1989/90. 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 1989 (column 1). Significant revisions to the more important sources of revenue appear in the November Autumn Statement (column 2). The third column is an estimate of total revenue derived from published monthly receipts figures, allowing for expected seasonal variation using the following formula:

$$1989/90 \text{ forecast} = \frac{[\text{revenues Apr} - \text{Oct } 1989]}{[\text{revenues Apr} - \text{Oct } 1988]} \times 1988/89 \text{ outturn}$$

These figures can be a useful monitor of revenue trends, but they are highly sensitive to one-off fluctuations and should thus be treated with caution; this point is discussed further below with regard to individual taxes.

Column 8 shows our own prediction, derived either from a detailed IFS model, or by using a fairly simple tax-elasticities approach which derives the growth of revenue from key assumptions about the tax base, (e.g. personal incomes for income tax, consumer spending for indirect taxes). This approach also forms the basis of the 1990/1 forecasts.

The final column shows our actual forecast (reproduced in Table 5.4 with one or two adjustments for accounting conventions) which is a judgemental average of the alternative predictions. We discuss the main points of interest below.

Table A1. Government Revenues in 1989/90, "Head of Tax" Basis

	1 FSBR	2 Autumn Statement	3 Current receipts	4 1988/89 outturn	5 Growth of revenue	7 Budget costs	8 1989/90 result	9 IFS Forecast
Income tax	46900	48400	48389	43433	17.8	2810	48367	48400
Corporation tax[a]	22400	22900	24061	18537			21805	21500
On-shore [b]	22100	22600	23761	18037	20.3		21505	21200
of which MCT	15300		17026	11834	15.3		13900	13700
ACT	6800		6735	6203	22.6		7605	7500
NS[c]	800	800	800	1300			800	800
PRT	1400	1125	1055	1371				1400
CGT	2100		2104	2323	0.0		2323	2100
IHT	1100		1196	1071	0.0		1071	1100
SD	2400		2135	2255				2100
Total Inland Revenue	76300	78050						76600
VAT	30000		30223	27319	9.6	−315	30258	30300
Petrol	8800		8819	8693	3.1	250	8712	8700
Tobacco	5100		5234	4988	1.2		5049	5100
Alcohol	4700		4484	4510	3.2		4653	4700
Betting	1000		969	913	9.0		995	1000
Car tax	1400		1588	1416	10.8		1569	1600
Customs duties	1800		1856	1670		−20	1690	1800
Ag levies	100		143	165	0.0		165	100
Total Customs & Excise	52900	53150						53300
VED	2900		2976	2811	3.7	−40	2956	2950
Oil royalties	600	600	332					600
Gas	400		403	407	0.0			400
Rates/comm. charge	20600		20996					20800
Other	3300							3300
NI Contributions	34000	32700	33292	32610	10.6	2980	33087	33200
Interest + divs	7000	6900						6900
Profits rent etc	8500	7700						7700
General Govt. Receipts	206400	206900						205750

[a] includes ACT (net of repayments). NS corporation tax after ACT set off and corporation tax on gains.
[b] includes ACT and corporation tax on gains.
[c] before ACT set off.

Table A2. Key Assumptions

Annual % changes	1989/90	1990/1
Wages per head	9.9	9.0
Employment	1.0	0.0
Wage bill	10.6	9.0
Consumer prices	5.7	6.0
Consumer spending (volumes)	3.1	1.0
Oil price ($)	18.0	19.0
Exchange rate ($/£)	1.6	1.5
	1988/9	1989/90
Corporate profits	18	8

Income tax Income tax receipts, considerably underestimated by the government in the last financial year, are highly sensitive to the rate of wage settlements and employment, both currently difficult to predict. The continuing high rate of wage growth is still being offset to some degree by the full-year costs of the 1988 Budget reforms, in particular the higher-rate cuts, since all tax at the higher rate on investment income and half the tax on self-employed income is not collected by the Inland Revenue until the following financial year. The government raised its own revenue estimate by £1.5bn in the Autumn Statement, attributing the change to higher-than-expected growth of money GDP (revised up 0.75 per cent to 8.5 per cent). Although this reflects a more realistic attitude to wage growth, our own assumptions on wages are probably a little higher. However, this is tempered by the costs of mortgage interest relief. Our own forecast is therefore almost identical.

National Insurance The FSBR prediction for National Insurance and other contributions was altered in the Autumn Statement for a number of reasons. Faster-than-expected growth in wage bills led to an upward revision of £0.4bn. This was offset to some extent by higher-than-expected take-up of personal pensions, which allows employees and employers to pay a lower rate of NI, reducing estimated receipts by an estimated £2bn. The reforms to employees' NI announced in the 1989 Budget and introduced in October 1989 have also depressed revenues, but this is clearly not yet reflected in the current receipts figures. The IFS forecast of £33.2bn for the current year reflects the view that wage bill growth will be slightly faster than the government's underlying assumptions.

Corporation tax We derive estimates for onshore MCT and ACT from the IFS computer model of the corporate tax system.[1] The model uses accounting data for a sample of around 700 large company groups and applies the actual rules of the corporation tax system to the accounting variables to estimate each company's tax liabilities.

The FSBR prediction indicates a rise of £4bn in total receipts, raised an additional £0.5bn in the Autumn Statement, despite a fall of £0.5bn in North Sea revenue, a total non-oil growth rate of at least 25 per cent. The continued strong growth of dividends makes the ACT projection look a little low although this should not seriously affect total receipts. As far as MCT is concerned, the current receipts prediction is rather above the FSBR forecast, although we should not attach too much weight to this, since the bulk of MCT revenue arrives in January (figures for which are not available until March). Given that MCT is driven by company profits with a lag of nine to twelve months, the rate of growth of total tax is largely determined by the growth of profits in 1988/9, now estimated at around 18 per cent. Mr Major admitted in the Autumn Statement debate that corporation tax receipts were likely to be below forecast levels, attributing this change to unexpectedly high investment and we have adopted a figure well below the Autumn Statement projection, which reflects the lower IFS model forecast and our assessment of CTCCG (see below).

Corporation tax on companies' chargeable gains (CTCCG) Tax due on companies' capital gains is collected by the Inland Revenue along with MCT and ACT, but for National Accounts purposes it is classified as part of capital taxes. Figures for CTCCG are not published in *Financial Statistics* or the FSBR but they can be derived. Revenue under this heading has grown rapidly in recent years – probably due in most part to increased merger activity – to the point where it is now a major source of revenue in its own right. Capital taxes in general are particularly difficult to forecast; we adopt a figure slightly below the government's reflecting our less optimistic estimates of total profit growth.

North Sea revenues In past Budgets the prospects for North Sea oil revenues have been a crucial factor in determining the government's financial position, and one that was highly sensitive to such unstable variables as the oil price and the exchange rate. However, since the collapse of the oil price in 1986, and with North Sea production past its peak, this is no longer the case: North Sea revenues are forecast to contribute around 1 per cent of total revenue in 1989/90, and output forecasts for future years remain low.

1 See "The IFS Model of the UK Corporation Tax" IFS Working Paper No 84, Michael Devereux, 1986.

Expenditure taxes Consumers' spending slowed significantly in 1989, but remains higher than expected at the beginning of the year. 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 highly detailed behavioural model of consumers' expenditure, disaggregated into ten commodity groups, estimated using Family Expenditure Survey data from 1970 to 1986. 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) and the level of real income.

The VAT prediction is based on estimates of the changing pattern of expenditure on VATable and non-VATable goods. In the last few years the rapid growth of consumer spending has been concentrated on discretionary items all of which bear VAT, much more than on zero-rated items such as food, fuel etc. VAT has thus grown faster than consumer spending, but we expect the gap to narrow as consumer spending slows.

Table A3. Forecast Growth in Components of Consumers' Expenditure

Per cent	Total (nominal) consumers' expenditure	Mainly VATable goods	Mainly non-VAT goods
1985/6	9.1	10.0	7.3
1986/7	9.6	11.7	5.6
1987/8	10.4	13.2	4.9
1988/9	10.6	12.9	6.0
1989/90 (est.)	9.0	9.6	7.6

Source: "Monthly Digest of Statistics".

Use of lead-free petrol has almost certainly grown faster than the government expected, on recent estimates accounting for some 30 per cent of total petrol consumption, a response that could cost the government up to £250m in revenue. We have accordingly raised the expected costs of the changes in the last Budget, but this will not seriously dent total revenues; it does however raise the expected costs of any future concessions.

Public expenditure The estimated outturn for the public expenditure planning total given in the Autumn Statement is £196.3bn, £2bn higher than the plans in the 1989 White Paper. The Treasury attributes this upward revision to:

(i) £0.8bn fewer privatisation proceeds;

(ii) Claims on the Reserve in excess of the estimated figure of £3.5bn including an additional £2.75bn of expenditure by local authorities, £0.6bn by central government, and a further 0.7bn required to fiance public corporations (attributed mainly to the restructuring cost of British Coal);

(iii) An additional £600m in gross debt interest. The higher- than-expected outturns for the PSDR have reduced debt interest payments by more than forecast in the past two years. This has now been more than offset by the continuing high interest rates, but continues to fall as a percentage of GDP.

Table A4. General Government Debt Interest

	General government gross debt interest	
	£ bn	% of GDP
1986/7	17.6	4.5
1987/8	17.5	4.25
1988/9	17.7	3.75
1989/90 (estimate)	17.8	3.5
1990/91[a] (projection)	16.0	3.0

Source: Autumn Statements 1988,1989.
[a] estimates based on government predictions of Central Government Debt Interest in the new planning total.

However, recent PSDR figures suggest that spending may well overshoot this higher target. Local authority spending in particular looks high, as suggested in Mr Major's Autumn Statement debate speech; it seems possible that Local Authorities are bringing forward capital spending into this fiscal year in order to escape the introduction of new restrictions. Our forecast therefore revises total expenditure up by an additional £1bn.

Fiscal Year 1990/1

Our predictions for 1990/1 are based on the models described above, relying heavily on a series of key assumptions (see Table A2). The present widespread disagreement over the level of the main economic indicators for this year makes our task more difficult than usual, and we therefore indicate in some detail the sensitivity of the figures to changes in the assumptions.

Income tax The growth of income tax is broadly determined by the growth in earnings and employment. As Table A5 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 in which the operation of personal tax allowances means that marginal tax rates will always exceed average tax rates. Our estimate of the revenue elasticity for 1990/1 which draws on a detailed investigation[1] of tax elasticities using (among other approaches) our FES-based model of the tax system is 1.7. We assume that new entrants to the labour force contribute extra income which is taxed at the average rate.

We also take account of the revenue effects of indexation (we assume that the Chancellor increases allowances strictly in line with inflation) and of tax cuts in previous Budgets.

Table A5. The Elasticity of Income Tax Revenues

	Actual receipts (£m)	Tax cuts (£m) total costs	Adjusted receipts[a] (£m)	% change[b]	% change in wages and salaries	Elasticity
1982/3	30361	1840	32201			
1983/4	31108	2000	33108	9.0	7.3	1.24
1984/5	32507	1820	34327	10.3	7.0	1.47
1985/6	35353	1590	36943	13.6	8.7	1.56
1986/7	38499	2075	40574	14.7	8.0	1.84
1987/8	41402	2970	44372	15.2	9.3	1.63
1988/9	43433	5125	48558	16.6	10.4	1.6
1989/90[c]	48500	2810	51310	18.1	10.6	1.7

[a] Actual receipts plus tax cuts.
[b] Adjusted receipts in year t as a % increase on actual receipts in year t − 1.
[c] All forecast values.
Sources: Financial Statistics, Economic Trends, FSBR.

1 "Measuring the Responsiveness of Income Tax Revenue to Income Growth: A Review and Some Uk Values", Paul Johnson and Peter Lambert, Fiscal Studies, Noveember 1989.

Table A6. Government Revenues in 1990/1

£ million	1 IFS 1989/90 forecast	2 Growth rate[a]	3 Budget costs	4 FORECAST
Income tax	48400	15.3	1750	54055
Corporation tax	21500			23068
On-shore Corporation tax	21200	7.4		22760
of which MCT	13700	7.7		14750
ACT	7500	6.8		8010
NS Corp tax	800			800
PRT	1400	0.0		1400
CGT	2100	7.0		2250
IHT	1100	6.3		1170
SD	2100	4.0		2180
Total Inland Revenue	**76600**			**84120**
VAT	30300	7.6		32589
Petrol	8700	7.6[b]	−575	9362
Tobacco	5100	5.5[b]	−260	5380
Alcohol	4700	7.1[b]	−285	5033
Betting	1000	7.1		1071
Car tax	1600	8.5		1736
Customs duties	1800	7.5		1935
Ag levies	100	0.0		105
Total Customs & Excise	**53300**			**57206**
VED	2950	1.2		2985
Oil royalties	600			600
Gas	400	0.0		410
Rates/comm. charge	20800	11.0		23088
Other	3300			3500
NI contributions	33200	9.0	1700	34488
Interest + divs	6900			7000
Profits, rent, etc.	7700			8000
General Govt Receipts	**205750**			**221400**

[a] Underlying, before subtracting Budget costs, except where shown.
[b] Including revalorisation.

Expenditure tax It is widely expected that 1990 will see a continuing fall in the growth of consumers' expenditure (perhaps even declining in real terms in some quarters). The composition, as well as the level, of consumer spending is very important to expenditure taxes, particularly VAT; we use an elasticity of 1.07 for 1990/1, but note that a serious fall in real spending hits spending on VATable goods even harder.

Excise duties are again sluggish reflecting low real spending growth; we have made the conventional assumption that they are all revalorised at the expected rate of inflation, despite the failure to carry this out fully at the last two Budgets.

Corporation tax We follow a consensus projection here, with profits slowing significantly during 1989, and remaining sluggish for at least the first half of 1990. The 1990/1 figure depends mainly on the 1989/90 rate of profit growth, so the growth of overall receipts is expected to slow down, and slow further in the following fiscal year.

North Sea revenues North Sea revenues remain very sensitive to both the exchange rate and the oil price. Table A7 shows the 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 A7. North Sea Tax Revenues under Alternative Assumptions (£ million) 1990/1

Oil price per barrel ($)	Exchange rate ($/£)		
	1.35	1.55	1.75
15	2464	2072	1848
19	3220	2800	2500
23	4088	3416	3136

Local Authority receipts The provisions of the Local Government Finance Act 1988 theoretically imply that rates of local authority spending above present government forecasts for 1990–1 would have to be met out of higher Community Charge receipts. We therefore use a fairly buoyant figure for local authority revenues, consistent with our own public spending projections and with evidence that local spending is growing relatively quickly even in the present fiscal year.

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 £500m p.a. before 1982/3 to around £7bn in 1988/9. Since 1987, the government has simply pencilled in an intention to realise £5bn in each of the following three fiscal years. The figure for 1989/90 was revised down by £0.75bn at the Autumn Statement, but there is no present reason to alter the 1990/1 figure.

Public expenditure Planned general government expenditure was raised by £5.5bn to 210.5bn compared to the 1989 Public Expenditure White Paper, a new estimated growth rate of around 7 per cent, or 2 per cent in real terms, compared to this fiscal year, with most of the additional spending going to the Department of Health and the Department of Social Security. The figures for the coming fiscal year are subject to a wider margin of error than those for the year just closing; local authorities own expenditure in particular remains difficult to predict.

Moreover, nominal spending plans are very sensitive to assumptions about inflation, particularly the level of public sector wage settlements, as the recent upward revision illustrates. We have raised the Autumn Statement figure by an additional £1½bn, reflecting a slightly higher estimate of spending growth than the government's and a higher expected outturn for 1989/90. However, some of this reflects expectations of overshoots in local authority spending in 1990/1, which are largely offset by rising Community Charge payments, minimising the effect on the PSDR. We have also revised downwards by £½bn the estimate of debt repayment by public corporations, who are particularly vulnerable to slower growth.