

# **Election Briefing 1997**

Lucy Chennells  
Andrew Dilnot  
Christopher Giles  
Alissa Goodman  
Amanda Gosling  
John Hall  
Paul Johnson  
Julian McCrae  
Jayne Taylor

*and*

Chantal Crevel-Robinson (word-processing)

Editors: Andrew Dilnot and Paul Johnson

The Institute for Fiscal Studies  
7 Ridgmount Street  
London WC1E 7AE

**Published by**

The Institute for Fiscal Studies  
7 Ridgmount Street  
London WC1E 7AE  
Tel: +44-171-636 3784  
Fax: +44-171-323 4780  
Email: mailbox@ifs.org.uk  
Internet: <http://www.ifs.org.uk>

© The Institute for Fiscal Studies, April 1997  
ISBN 1-873357-66-4

**Printed by**  
KKS Printing  
The Printworks  
12-20 Rosina Street  
London E9 6JE

# Executive Summary

## Taxation

Total general government receipts in the UK in 1997/98 will be around £300 billion, £7,500 for every adult in the UK. Between 1978/79 and 1997/98, the tax burden as a share of GDP has risen slightly, from 34.25 per cent to 36.25 per cent, while general government receipts have fallen from 38.75 per cent to 38 per cent. Compared with our European competitors, we are a strikingly low-tax country, although our tax burden still exceeds that of the US and Japan. Most OECD countries, including Japan and the US, have seen taxes grow more quickly since the late 1970s.

## Public finances

The UK's public finances have improved in recent years, with the PSBR likely to undershoot the forecast made at Budget time of £26.4 billion for 1996/97. Our expectation is that the out-turn will be just below £24 billion. On current plans, the PSBR will continue to decline, and would decline rapidly if growth were to accelerate, or earnings or price inflation to rise. The planned improvement is not enough to meet some of the rules now being imposed by the parties on themselves, and in particular seems unlikely to meet a strict interpretation of the 'golden rule'. Almost all of the planned improvement reflects a reduction in the planned share of public spending in GDP.

## Public spending

The plans for public spending that the Chancellor set out at the last Budget envisage lower spending growth over the next three years than has been witnessed at any time in the last three decades. Overall spending is set to rise in real terms by an average of 0.4 per cent per year, compared with an average of 1.9 per cent per year over the last 18 years. If, rather than growing at 0.4 per cent per year, spending were to grow at 1.9 per cent per year, spending in the last year of the next parliament would be some £24 billion higher. Labour are signed up to the government's spending plans for 1997/98 and 1998/99, although they promise additional spending financed by revenue from the windfall levy.

One area where spending plans are extremely tight is health. Although both major parties have committed to increase the real level of resources going into the NHS each year, the real spending plans beyond 1997/98 are effectively flat. Experience would suggest that extra resources will have to be channelled towards health next year and thereafter, but an unusually small reserve contained within the spending plans for future years means that there is considerably less flexibility to allow for this without breaking the overall spending limit. None of the major parties seems to have any satisfactory response to the very large gap likely to arise between spending plans and public expectations.

It is almost certain that over the next five years, either public spending, and therefore tax and/or borrowing, will be higher than planned, or substantial and radical reform of public sector provision will occur, either explicitly or by default.

## **Have governments made us better off?**

The major parties have been swapping statistics on tax and incomes for some time now. Not surprisingly, each chooses to answer a question that produces an answer they like. The Conservatives focus on net incomes, to draw attention to higher earnings and away from higher taxes, while Labour focus on taxes, to achieve the reverse. The reality is that net incomes have risen and that taxes have too. To the extent that governments are responsible for all changes in the economy, they can claim the credit for net earnings increases, and they clearly must take responsibility for tax changes. For the population as a whole, incomes have tended to rise over the whole period from 1978 to now. Incomes have also tended to become more unequal, with the 1983–87 and 1987–92 parliaments seeing the most rapid growth in both income and inequality. Summing all tax increases and decreases for personal and company taxes gives a figure of £11.5 billion p.a. for tax rises from 1992/93 to 1996/97. The net income of a married couple with two children and a single earner on average earnings has risen by £765 between 1991/92 and 1996/97.

## **Taxes and benefits 1992–97**

Looking more closely at the 1992–97 personal tax changes using the IFS tax and benefit model on a representative sample of the population, we find an average loss of £7 per week, or 2.6 per cent of post-tax income. In cash terms, the losses increase with income, from £2.80 for the poorest decile to £6.50 for the fifth decile and £14.10 for the richest decile. While the bottom decile lost on average, just over a quarter of households in the bottom decile gained over the period, principally from the reform of local tax benefits.

Analysing the changes by family types, we find pensioners suffering the smallest losses both in cash and percentage terms, while the largest losses were for working families. Pensioners were not hit by National Insurance contribution (NIC) increases, or much by the restriction of MIRAS, were partially protected from cuts in the married couple's allowance (MCA), and received some compensation for the VAT on fuel change in the form of higher state retirement pension and income support increases.

## Tax aspirations

The Conservative and Labour Parties both have long-term aspirations to change the income tax rate structure. The Conservative aim is to cut the basic rate of income tax from 23p to 20p, while the Labour aim is to achieve a starting rate of 10p rather than 20p. Obviously, those who are not income tax payers, including the great majority of those on low incomes, cannot gain directly from income tax cuts. This is especially true of basic-rate reductions, which do not even affect the lowest income tax payers, who are 20p rate payers. And even if income tax is the chosen means of helping those on low incomes, increasing tax-free allowances is more effective.

It is, of course, true, that changes in tax rates can affect behaviour. But the problem of high marginal tax rates in the 'poverty trap' is caused by the benefit system, not the tax system. The overall marginal rate for those facing the highest marginal rate of tax and benefit withdrawal, of 96.7 per cent, would only fall to 96.3 per cent with a 10 per cent income tax rate. It is the benefit system and the labour market more widely which need change if the poverty trap is to be addressed, not the income tax system, although raising allowances would be the most effective change if there must be some change. Labour's commitment to reduce benefit tapers can make sense with any of these income tax changes, or none.

Comparing a 10p starting rate and a 20p basic rate shows that the lowest eight deciles of the income distribution gain more on average from a 10p starting rate than from a 20p basic rate, while the top two deciles do best from a lower basic rate.

The least predicted major announcement in the manifestos was the proposal from the Conservatives for transferable income tax allowances for married people with children or caring for the disabled. Two million of the 30 million UK families would gain from this proposal by up to £17.90 per week.

The proposal contrasts with the reduction in the value of the married couple's allowance (MCA), and also rather reverses the spirit of the 1990 introduction of independent taxation. Roughly half of the money raised by reducing the value of the MCA would be given back, although to a subset of married couples. The policy would give no gains to single parents, cohabiting couples, couples without children or disabled dependants, or couples where both paid income tax.

The Liberal Democrats' tax proposals would give a £200 increase in the personal allowance, increase the basic rate of income tax to 24p, and impose a 50p rate over £100,000 p.a. There would be gains for those with incomes below £13,000 p.a., losses for those with higher incomes as a result of the higher basic rate, and large losses at incomes in excess of £100,000 (140,000 out of 26 million taxpayers).

We note that a future government might seek ways of raising revenue, either to fund reductions in other taxes or to increase spending. Many possibilities exist, and have not been ruled out by the parties. Restrictions in the value of income tax allowances are one obvious potential source, as is some further reduction in the rate of advance corporation tax.

## **Local/central relations**

Labour seem committed to abolition of local authority capping, although they would retain some power over 'excessive spending'. They would also allow phased release of capital receipts to finance housing investment, would consult on returning non-domestic rates to local control, and are committed to a Scottish Parliament, Welsh Assembly and Regional Chambers in England. To avoid problems on overall public spending control, it seems likely that Labour would phase the removal of capping controls.

## **Windfall levy**

Labour would impose a windfall levy if elected. Precisely which companies would be affected and how the tax would be assessed is still unclear. A truly one-off tax would largely be borne by shareholders, but to the extent that the windfall levy changed perceptions of the stability of both tax and regulatory regimes, the cost of capital might be affected. The more convincing the argument that the tax is a one-off, the less the effect on the cost of capital should be. The tax would be horizontally inequitable, since some of the shareholders who suffer may not have gained from low issue prices or subsequent lax regulation. The windfall levy idea is a worrying indicator of a trend towards seeking tax increases that can be presented easily, rather than that are economically most desirable.

## **The welfare state**

The debate on the future of the welfare state continues. With respect to social security, the problem with current policies is not that taxes will need to rise to pay for them, rather that given the low level state benefits will reach by the middle of the next century we need to find ways of achieving protection for those on low incomes alongside effective private provision. The political debate about the balance between public and private provision in social security, health and education is still undeveloped. Addressing these issues means facing the inescapable trade-off that either the role of private provision must grow, or public spending and taxes must rise, or we cannot have higher consumption. Since the level of consumption in these areas seems certain to continue to rise, as it has for at least the last century, this uncomfortable trade-off cannot be avoided.

## **Minimum wage**

A minimum wage at £3.00 per hour would affect 5 per cent of all workers, one of £4.00 per hour 19 per cent of all workers, one of £4.50 per hour 26 per cent of all workers. The direct impact of a minimum wage would benefit households in the top half of the income distribution more than those in the bottom half, since most gainers either have a working spouse or are younger people living with their parents. The effect of a minimum wage on numbers entitled to means-tested in-work benefits would be small, with a minimum wage of £4.00 per hour reducing expenditure on family credit by only 8 per cent.

# 1. Some background on the UK tax system

Total general government receipts in the UK in 1997/98 will be around £300 billion — £7,500 for every adult in the UK, around 38 per cent of gross domestic product (GDP). Table 1.1 shows the composition of the receipts in 1997/98 and 1978/79.

Income tax is our single largest tax, but now accounts for less than one-quarter of total receipts. Both value added tax and National Insurance contributions each raise around one-sixth of revenue. The capital taxes — capital gains tax and inheritance tax — make a very small contribution. The taxes that are typically thought of as being taxes on companies — corporation tax, business rates and the oil taxes — raise around 15 per cent of total receipts.

**Table 1.1 Government Revenue in 1997/98 and 1978/79**

	£bn 1997/98	% 1997/98	% 1978/79
Income Tax	71.8	24.0	29.0
National Insurance Contributions	49.1	16.4	15.6
Value Added Tax	50.7	16.9	7.8
Fuel Duties	19.6	6.5	3.8
Tobacco Duties	8.4	2.8	3.7
Alcohol Duties	6.1	2.0	3.5
Vehicle Excise Duties	4.5	1.5	1.7
Council Tax	10.6	3.5	9.2 <sup>a</sup>
Other Customs and Excise	6.4	2.1	2.6
Capital Gains Tax	1.1	0.4	0.6
Inheritance Tax	1.6	0.5	0.5
Stamp Duty	2.7	0.9	0.6
Corporation Tax	27.2	9.1	6.0
Business Rates	14.6	4.9	— <sup>a</sup>
Petroleum Revenue Tax	1.6	0.5	0.3
Oil Royalties	0.6	0.2	—
Other Taxes and Royalties	5.5	1.8	3.5
Total Taxes and National Insurance Contributions	282.1		
Other Receipts	17.2	5.7	11.7
<b>General Government Receipts</b>	<b>299.4</b>		

<sup>a</sup> Domestic and non-domestic rates combined contributed 9.2 per cent of the total in 1978/79.

Note: Components may not sum to totals due to rounding.

Source: *Financial Statement and Budget Report*, 1997/98 and 1979/80, HM Treasury.

The most substantial compositional changes since 1978/79 have been the large reduction in the share of income tax, offset by a growth in VAT and, to a lesser extent, in excise duties on fuel and in National Insurance contributions. Excise duties on alcoholic drink and tobacco have become less important.

**Table 1.2 Historical Series for Government Receipts**

	Total taxes and NICs as a percentage of money GDP	General government receipts as a percentage of money GDP
1965–66	31.75	35.25
1966–67	32.50	36.25
1967–68	34	38
1968–69	35.75	40.75
1969–70	37.50	41.75
1970–71	37	40.25
1971–72	35.25	39.75
1972–73	33	38
1973–74	33.75	38.50
1974–75	36.25	40.50
1975–76	36.75	40.25
1976–77	36.25	41
1977–78	35.25	39.75
1978–79	34.25	38.75
1979–80	35.50	38.75
1980–81	36.75	40.75
1981–82	39.75	43.75
1982–83	39.50	43.75
1983–84	39	42.75
1984–85	39.75	43.50
1985–86	38.75	42.25
1986–87	38.25	41.50
1987–88	38.25	41
1988–89	37.50	40.25
1989–90	37	40
1990–91	37	39.25
1991–92	36.25	38.25
1992–93	34.25	36.75
1993–94	33.75	36
1994–95	35	36.75
1995–96	35.75	38
1996–97	35.75	37.75
1997–98	36.25	38
1998–99	36.50	38
1999–00	37	38.50
2000–01	37.50	39
2001–02	38	39.25

Source: *Financial Statement and Budget Report*, 1997/98 and 1979/80, HM Treasury.



Table 1.2 shows how tax levels have changed over the last three decades. The first column is of total tax and National Insurance contributions, the second for general government receipts. The gap between these two series has narrowed, as 'other receipts', in particular the trading surpluses of now privatised industries, have declined.

Over the period 1978/79 to 1997/98, we see a clear, although quite small, increase in the tax level, from 34.25 per cent to 36.25 per cent. In only one year since 1978/79 has the tax level been lower than it was then as a share of GDP, 1993/94, before the very large tax rises that were needed to bring the public finances back into order. Looking at general government receipts, the picture is less clear. General government receipts are lower as a share of GDP now than in 1978/79, and have been continuously for the last six years. Current government forecasts show general government receipts exceeding their 1978/79 share by 2000/01.

If the next government sticks to present plans for taxation and public spending (see Chapter 2 on public finances and Chapter 3 on public spending), a fairly clear picture of the overall scale of government having peaked by the early to mid-1980s will be confirmed.

Table 1.3 compares tax as a share of GDP in a wide range of OECD countries, in 1978 and 1995. The most notable feature is what a low-tax country the UK now is within the OECD. No European OECD member state has a lower tax level, with the UK and Greece sharing the lowest figure of 37.6 per cent in 1995. Most of our continental competitors have very much higher tax levels, with only Greece, Ireland, Portugal and Spain having comparably low taxation.

**Table 1.3 Tax Shares in OECD Countries**

**General Government Receipts as a percentage of Nominal GDP**

	1978	1995
UK	37.0	37.6
Austria	46.2	46.7
Belgium	49.2	50.8
Denmark	50.4	59.3
Finland	43.9	52.8
France	42.5	48.9
Germany	44.8	46.0
Greece	26.5	37.6
Ireland	33.7	38.6
Italy	31.9	44.8
Netherlands	49.1	48.3
Portugal	29.2	38.2
Spain	27.0	38.1
Sweden	58.2	58.2
Canada	35.5	42.4
Japan	24.5	32.1
US	30.2	31.3

Source: OECD *Economic Outlook*, June 1995 and December 1996.

Note: OECD definitions vary slightly from those used domestically.

Outside Europe, Canada has a substantially higher tax level than the UK, while Japan and the US still have lower tax levels. In both Japan and the US, the number of elderly people is lower than in the UK, explaining part of the difference in public spending and therefore tax.

Between 1978 and 1995, only one OECD country — the Netherlands — reduced its tax level, from 49.1 per cent to 48.3 per cent. Sweden's tax level stayed constant at 58.2 per cent, while Austria's rose from 46.2 per cent to 46.7 per cent. The UK saw an increase on the OECD definition from 37.0 per cent to 37.6 per cent. All the other countries saw larger increases, and in many cases much larger increases, especially amongst the continental European economies. These large increases were the cost of retaining traditional comprehensive generous social-insurance-based welfare states.

The tax level in the UK rose during the first Conservative government from 1979/83, began to fall during the 1983/87 government, fell sharply in the 1987/92 government and has risen substantially since then. The tax level is now a little higher than in 1978/79. General government receipts have followed broadly the same pattern, but have been below the 1978/79 level for six years, reflecting lower 'other receipts'. Compared with most of our European neighbours, the UK is a low-tax country and has seen a much smaller increase in the tax level over the last two decades.

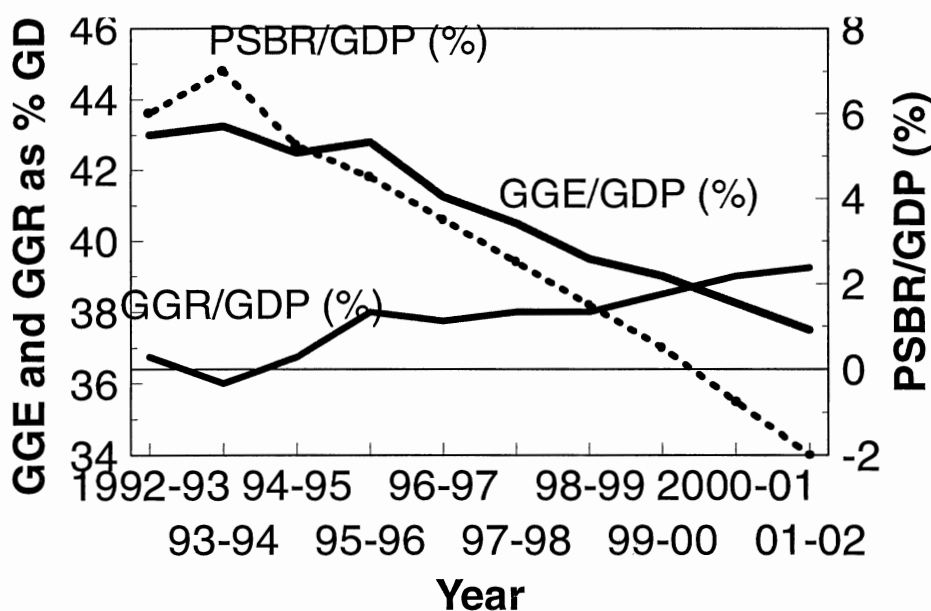
## 2. Public finances

The tax and spending policies of whichever party forms the government after the General Election will in large not be extensively shaped by the state of the public finances that it inherits. Over the past few years, the PSBR has declined from a peak of £45.4 billion in 1993–94 to a forecast in last November’s Budget of £26.4 billion in 1996/97. This improvement has resulted from both the recovery in the economy and a significant tightening of fiscal policy. In the early years of the parliament, we saw substantial tax rises announced in the two 1993 Budgets. More recently, very tight control of public spending has led to a further tightening of fiscal policy, which is planned to continue over the next few years. In this chapter, we assess the stance of fiscal policy that will be inherited by the next government against a number of ‘rules of thumb’ often used to give an indication of the appropriate level of public borrowing and we provide our own forecast of the likely path of the PSBR over the next few years.

According to the party manifestos, the major political parties have a broadly similar view as to how they will manage the public finances. The Conservatives have pledged that ‘Over the next parliament, we will achieve our goal for the government to spend less than 40% of national income’ and to ‘move towards a balanced budget over the medium term’. Labour’s manifesto suggests they will stick to the departmental spending plans laid out in the last Budget for the first two years of a new parliament. In addition, a future Labour government will ‘enforce the golden rule of public spending’ such that over the economic cycle, a Labour government would ‘only borrow to invest and not to fund current expenditure’. Labour also pledge to ‘ensure that — over the economic cycle — public debt as a proportion of national income is at a stable and prudent level’.

### The public finances over the medium term

Figure 2.1 : Public spending, taxation and the PSBR, as a percentage of GDP



Source: Financial Statement and Budget Report, 1997–98, HM Treasury, November 1996.

In last November's Budget, the Treasury forecast that the PSBR for 1996–97 was roughly 3.5 per cent of GDP, after nearly five years of continuous economic growth. Existing government plans, shown in Table 2.1, include a further tightening of fiscal policy over the next few years. Combined with economic growth, this is planned to reduce the PSBR to 2.5 per cent of GDP in 1997–98 and bring the public finances broadly into balance by the end of the decade. The fiscal tightening that is planned to occur during this period is to be achieved largely through public spending restraint, with planned real increases in the control total being significantly lower than growth in GDP. Figure 2.1 illustrates that the forecast reduction in the PSBR as a share of national income is planned to occur largely through public spending restraint.

*Table 2.1 : Treasury forecast of GGE, GGR and PSBR over the medium term (£ billion)*

	1996–97	1997–98	1998–99	1999–2000	2000–01
<b>General Government Receipts</b>	<b>280.9</b>	<b>299.4</b>	<b>315</b>	<b>333</b>	<b>352</b>
GGE(X)	307.4	314.7	322	331	339
<b>General Government Expenditure</b>	<b>308.5</b>	<b>319.0</b>	<b>327</b>	<b>336</b>	<b>345</b>
<b>PSBR</b>	<b>26.4</b>	<b>19.2</b>	<b>12</b>	<b>3</b>	<b>-8</b>
GGE(X)/GDP (%)	41.3 %	40 %	39 %	38.3 %	37.5 %
PSBR/GDP (%)	3.5 %	2.5 %	1.5 %	0.5 %	-0.75 %

Source: *Financial Statement and Budget Report, 1997–98*, HM Treasury.

On the basis of Treasury forecasts, the Conservative target of reducing public spending, as measured by GGE(X), to 40 per cent of GDP is likely to be achieved in 1997–98, irrespective of which party forms the next government. On the basis of these forecasts, the Conservative pledge to restore the public finances to balance over the medium term is also likely to be fulfilled in 2000–01, although this depends on no relaxation of fiscal policy, either in the form of tax cuts or in the form of additional increases in public spending.

Using information on tax receipts that has become available since last November's Budget, together with developments in the macroeconomy such as the continuing drop in the unemployment count, Table 2.2 gives an updated forecast of the government finances over the medium term. It seems likely that the PSBR in 1996–97 will undershoot the £26.4 billion forecast made by the Chancellor in his November 1996 Budget by some £2.5 billion. We forecast the PSBR to come in at around £23.9 billion for 1996–97.

Table 2.2 : The public finances over the medium term

Budget macro-forecasts updated with recently available information (£ billion)					
	1996–97	1997–98	1998–99	1999–2000	2000–01
<b>General Government Receipts</b>	<b>282.9</b>	<b>299.4</b>	<b>318</b>	<b>337</b>	<b>356</b>
GGE(X)	307.0	314.6	323	334	343
<b>General Government Expenditure</b>	<b>308.1</b>	<b>318.9</b>	<b>329</b>	<b>340</b>	<b>349</b>
<b>PSBR</b>	<b>23.9</b>	<b>19.1</b>	<b>11</b>	<b>2</b>	<b>-7</b>
GGE(X)/GDP (%)	41.2 %	40.0 %	39.2 %	39.3 %	38.6 %
PSBR/GDP (%)	3.2 %	2.4 %	1.3 %	0.3 %	-0.8 %

Source: IFS calculations.

## Will the next government have to tighten fiscal policy?

We can compare the present stance of fiscal policy with the policies advocated by Labour and the Conservatives in their manifestos and in recent policy statements. These are broadly consistent with a number of well-known ‘rules of thumb’ for determining the appropriate size of the structural deficit — the level of public borrowing that will occur when the economy is next working at normal capacity. These include

- **Debt sustainability.** This approach suggests that the government should avoid the future burden of interest payments on the national debt becoming unsustainable by stabilising the ratio of public debt to GDP. This would suggest a structural deficit of about 2.5 per cent of GDP.
- **The ‘golden rule’.** This suggests that the PSBR in 1997–98 should be no greater than the level of net public sector investment, which is planned to be £6.6 billion or approximately 1 per cent of GDP.<sup>1</sup> Even if there were to be some degree of undershooting of the PSBR this year and next, it is extremely unlikely that the out-turn could come close to being compatible with this target.
- **The proposed EMU Stability Pact.** Although the precise details of the proposed ‘Stability Pact’ are still to be worked out, it is likely that they would involve a maximum ratio of public borrowing to national income of 3 per cent, implying that the structural deficit should be considerably lower than this, and almost certainly no more than 1 per cent of GDP.

To estimate the size of the structural deficit in the UK public finances, we need to make some assumptions about the size of the ‘output gap’ — the difference between current output and output when the economy is next operating at normal working capacity. Whilst it is possible to infer that an output gap still exists if one assumes that the capacity of the economy has grown at a long-run rate of growth of 2.25 per cent since the economy was last at trend in 1990, evidence from the labour market suggests a rather different conclusion. Unemployment is below its five-year moving average and vacancy levels are running above their five-year moving average. Earnings growth has picked up recently and surveys are providing evidence of increased levels of capacity utilisation. This suggests that if an output gap still exists at all in the UK economy, it is likely to be eliminated during 1997–98, when we forecast the PSBR to be roughly 2.4 per cent of GDP.

A structural deficit of around 2.4 per cent of GDP is broadly consistent with the debt sustainability criterion but not with either the golden rule or any likely EMU Stability Pact. Present government plans for a further tightening of the stance of fiscal policy through expenditure restraint should reduce the structural deficit further over the next few years. But, the PSBR is unlikely to fall to the 1 per cent of GDP ‘golden rule’ target until 1998/99, one year later than we expect the output gap to close. A future government that pursued a policy based on debt sustainability would be likely to inherit public finances that required little immediate action, whilst one that focused on the ‘golden rule’ would probably need to tighten fiscal policy by at least 1 per cent of GDP, whether through tax increases or further spending restraint.

---

<sup>1</sup> The Labour Party’s proposals for the phased release of capital receipts held by local authorities for capital investment would have an identical impact on public spending and the PSBR as the equivalent rise in local authority borrowing. However, since all of the additional borrowing would be used for capital investment, this would have no impact on the structural deficit in terms of achieving the golden rule.

## Can the next government use a ‘growth dividend’?

Both of the major parties have argued that future growth in the economy will allow them to deliver their manifesto pledges on taxation and public spending. This implies that the rapidly declining PSBR that would result from a period of higher-than-forecast growth over the next year or so would be used as a justification for relaxing the stance of fiscal policy, whilst maintaining the downward trend of the PSBR.

Table 2.3 illustrates the impact on the public finances of using a more up-to-date set of macroeconomic forecasts supplied by Goldman Sachs. These envisage a slightly faster growth in consumer spending and profits in 1997/98, coupled with higher growth in earnings, than was forecast in last November’s Budget. For the rest of the period, we assume no further discretionary changes to tax policy and that the government achieves its spending targets for the control total in real terms.

Under this scenario, it is conceivable that we could observe a very rapid fall in public borrowing over the next couple of years, with the public finances returning to broad balance in 1998–99, with borrowing coming in some £10 billion lower than in last November’s Budget forecast.

Table 2.3 : The public finances over the medium term :

Goldman Sachs macro-forecast					
	1996–97	1997–98	1998–99	1999–2000	2000–01
<b>General Government Receipts</b>	<b>282.9</b>	<b>303.6</b>	<b>325.0</b>	<b>347.0</b>	<b>370.0</b>
GGE(X)	307.0	314.0	322.0	333.0	342.0
<b>General Government Expenditure</b>	<b>308.5</b>	<b>318.3</b>	<b>328.0</b>	<b>339.0</b>	<b>348.0</b>
<b>PSBR</b>	<b>23.9</b>	<b>14.3</b>	<b>2.0</b>	<b>-9.0</b>	<b>-22.0</b>
GGE(X)/GDP (%)	41.2 %	39.8 %	38.9 %	38.2 %	37.4 %
PSBR/GDP (%)	3.2 %	1.8 %	0.3 %	-1.0 %	-2.4 %

Source: Goldman Sachs forecast and IFS model.

However, in this scenario, a faster-than-forecast fall in the PSBR simply reflects a faster-than-forecast closure of the output gap and has no implications for the size of the structural deficit. As part of the growth of tax receipts would be the result of higher earnings growth in the private sector, the resultant pressures on the public sector pay bill would make the planned spending totals even harder to hit.

In response to such a rapid diminution in the level of the PSBR, it would be a rather sober Chancellor who would be able to resist the temptation to use this ‘growth dividend’ either to raise spending on front-line services or make headline-grabbing tax cuts. This would simply push output further above trend and, since faster growth simply means lower actual borrowing, not lower structural borrowing, might lead to an unwarranted relaxation of the fiscal stance.

The public finances have improved, but not by enough to meet the more stringent of the parties’ objectives. Almost all of the further improvement forecast reflects a reduction in public spending as a share of GDP. There is a possibility of a fairly rapid fall in the PSBR if growth accelerates. Such a reduction would largely *not* be reflected in a lower structural deficit.

# 3. Issues in public spending

## Introduction

This chapter examines the feasibility and implications of the public spending policies announced by the two major parties as they approach the election.

In the short term, Labour and the Conservatives have adopted similar policies towards public spending. The Conservatives' spending stance over the next three years is contained within the plans set out by the Chancellor in the Budget last November. Labour have committed to keep to the same overall public spending targets for the first two of these years — 1997–98 and 1998–99 — except for additional one-off spending to be financed out of revenue from the windfall levy on the privatised utilities.

The plans set out at the last Budget to which both parties have committed themselves envisage lower sustained real public spending growth than has been witnessed in decades, averaging less than one-half of one per cent real growth each year. If these plans are achieved, spending will drop to 40 per cent of GDP in the current financial year (1997–98), which is a specific Conservative manifesto pledge.

Given the tightness of the plans, there will be considerable pressure for them to be overshot, whichever party is in power. Health is one area where the pressure to allocate more resources in future years will be immense. Both parties have said in their manifestos that they will increase the real level of resources going into the NHS each year, but the spending plans as they stand only have real increases written into them for the first year of the planning horizon. Another example of where spending plans could come under strain is the funding of public sector pay settlements if average earnings growth in the economy starts to pick up.

In this chapter, we look at these issues concerning the immediate and longer-term prospects for public spending under the next government in some detail. Before we do this, we place these plans into the context of the path of public spending over the last century, and examine how the composition of public spending has changed over the last three decades. We also provide some international comparisons.

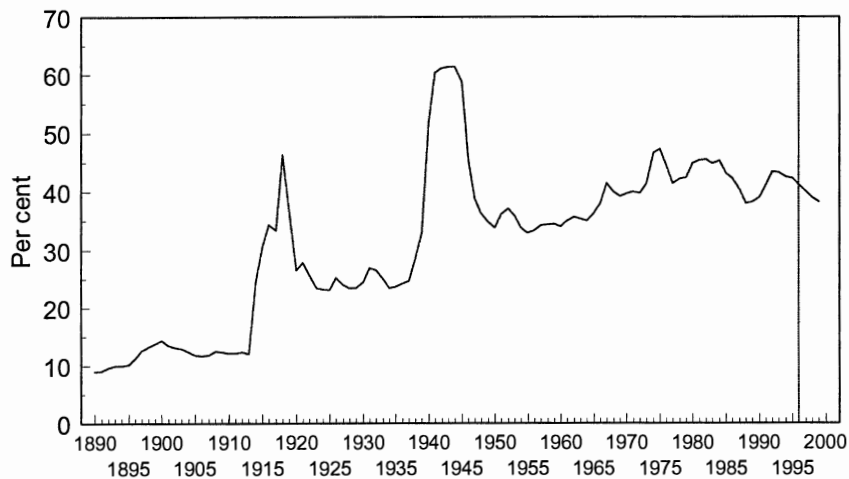
## The context

The size of government has grown rapidly over the last century, as its role in providing transfers, goods and services, and public investment has been expanded. This can be seen in Figure 3.1, which shows the share of government spending in GDP over the last hundred years. The graph reveals a clear upward trend in the share of public spending, from about 10 per cent of national income at the turn of the century to somewhere in the region of 40 per cent in recent years. Large peaks are evident over each of the two world wars; after each war, the share of public spending remained on a permanently higher path than its pre-war level. The path of public spending also shows cyclical movements around its upward trend.

Figure 3.2 focuses in on the changes in the share of public spending in GDP since 1970. These changes have been dominated by movements in the economic cycle. The peak in the share of public spending in GDP over this period (indeed, the peacetime peak over the whole century) was in 1975/76, when it reached over 47 per cent. This growth was curtailed by severe spending cuts imposed by the IMF in 1976/77. The share of spending in national income rose somewhat over the early part of the 1980s, dropped sharply over the mid-1980s, and rose back up again over the early part of the 1990s, in line with the economic cycle. The last few years of economic growth have seen the share of spending fall back once again, from about 43.5 per cent in 1992/93, to an estimated 41.25 per cent in 1996/97.

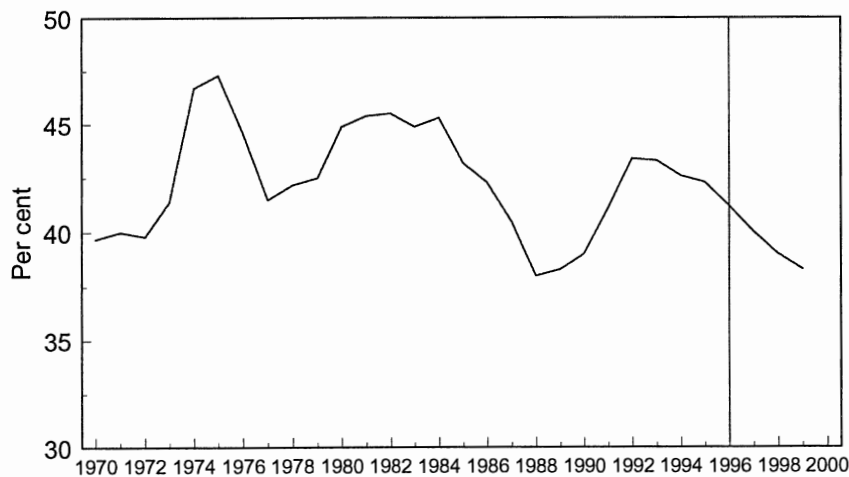
Although public spending has not yet fallen decisively as a share of GDP, it is apparent that the long-term upward movement has at least passed since the mid-1970s. Comparing similar points over the cycle, spending now takes up an estimated 41.25 per cent of GDP (in 1996/97), which is about 2 percentage points lower than its share of national income in 1985/86. It also takes up a slightly lower share (about one percentage point) than when the Conservatives took office in 1979.

**Figure 3.1 Public spending as a percentage of GDP since 1890**



Sources: *The Government's Expenditure Plans 1988–89 to 1990–91*, volume I; *Financial Statement and Budget Report*, 1997–98.

**Figure 3.2 Public spending as a percentage of GDP since 1970**

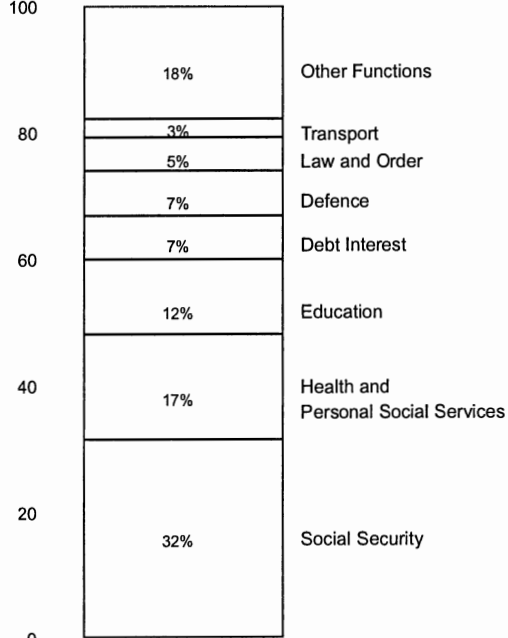


Source: *Financial Statement and Budget Report*, 1997–98.



Perhaps the clearest trend in public spending that has emerged over the last three decades has been the very marked compositional changes that have taken place. In particular, the share of public spending taken up by the three largest areas of government — namely, social security, health and education — has risen from under 40 per cent of the total spending bill in the early 1960s, to over 60 per cent today. Figure 3.3 shows the composition of public spending by function in 1996–97; the compositional shift over the last three decades is illustrated in Figure 3.4. Areas of spending that have been cut back include defence, which took up roughly 18 per cent of total government spending compared with 7 per cent today, and housing, which accounted for as much as 10 per cent of overall public spending in the mid-1970s compared with around 2 per cent today.<sup>2</sup>

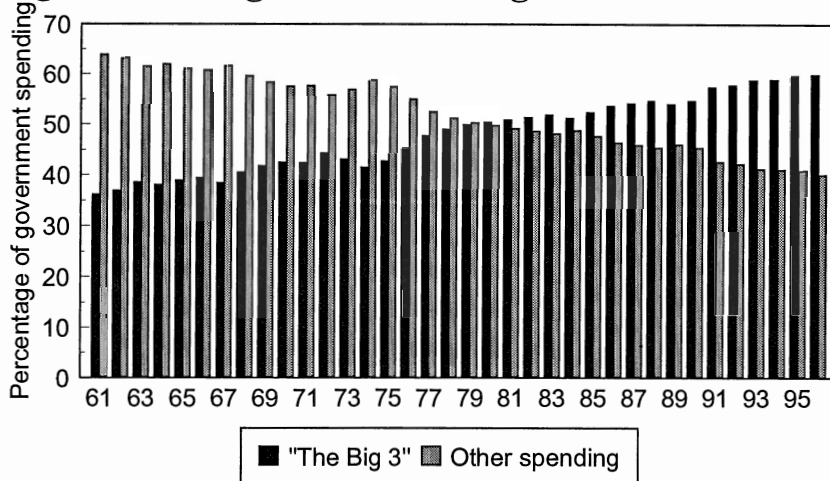
**Figure 3.3 The composition of public spending, by function, 1996–97**



Note: Estimated out-turn for 1996–97.  
 Source: *Public Expenditure Statistical Analyses*, 1997–98.

<sup>2</sup> Though much more money is now spent on housing benefit, which falls within the social security budget.

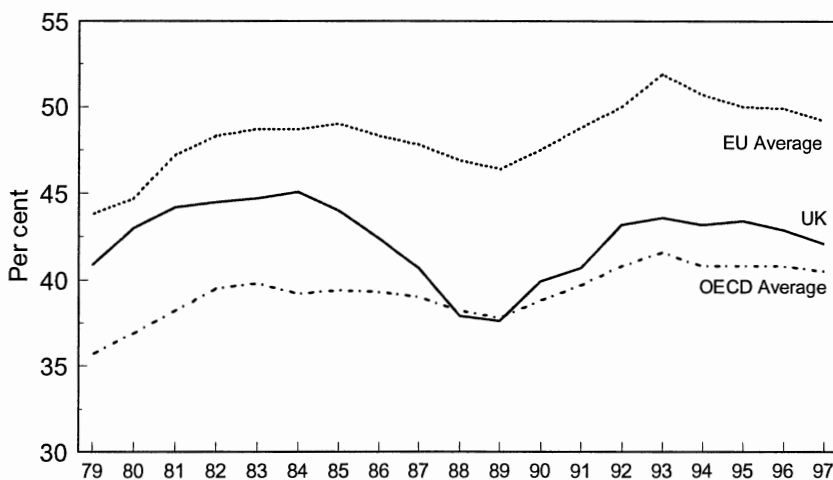
**Figure 3.4 The growth of 'the big 3'**



Sources: National Accounts Blue Books; Statistical Supplements to the FSBR.

Public spending in the UK is considerably lower as a share of GDP than the European average, but higher than the average for the OECD as a whole. This can be seen from Figure 3.5, which shows how general government outlays in the UK compare with the EU and OECD averages. In continental Europe, the general upward trend in the share of public spending in GDP continued over the 1980s and 1990s, whilst in the UK this underlying growth has slowed. This has meant that the gap between the EU average and the UK has widened considerably since the late 1970s. It has also meant that the size of government in the UK has come closer to that in the US, Japan and other countries with relatively small public sectors. This is reflected in the narrowing of the gap between the UK and the OECD average in Figure 3.4.

**Figure 3.5 International comparisons: general government outlays as a percentage of GDP, 1979–97**



Source: OECD.

## Labour and Conservative public spending plans in the short term

The public spending plans announced by Kenneth Clarke last November envisage lower sustained public spending growth than has been achieved in decades. Table 3.1 summarises the main plans. Over the next three years, the real value of overall public spending, as measured by GGE(X), is planned to grow by about one-half of one per cent in each year. The figures for planned growth in the control total (representing 85 per cent of overall spending) are very similar to this. As a share of GDP, public spending is due to fall to 40 per cent in the current financial year and to just over 38 per cent by the turn of the century.

The Shadow Chancellor has promised that a Labour government would keep within these targets this year and next (1997/98 and 1998/99), except for new spending to be financed from the proceeds of the windfall levy — which could be relatively large. The ‘welfare to work’ programme for which the windfall levy money has been earmarked has been costed at £3 billion overall, although some of this will go on tax rebates to employers rather than on additional spending. Labour also plan to release around £7.5 billion in accumulated capital spending receipts from the sale of council housing to local authorities to use for new investment, although it is as yet unclear how this will affect the spending totals. This is because the timing of the phased release is uncertain, and it may also be matched at least partly by borrowing reductions or offset by higher asset disposals. It is also possible that additional spending from the receipts could be taken outside the main spending totals altogether (see Chapter 11 on local government for a wider discussion). Aside from spending generated from these sources, Labour have said that ‘For the next two years Labour will work within the departmental ceiling for spending already announced’.

**Table 3.1 The government’s main public spending plans**

	1996/97	1997/98	1998/99	1999/00
<u>Control Total</u>				
£ billion	260.6	266.5	273.7	280.9
real % change	-0.3	0.2	0.7	0.6
<u>GGE(X)</u>				
£ billion	307.4	314.7	322.2	330.6
real % change	0.1	0.3	0.4	0.6
GGE(X)/GDP ratio	41.25	40	39	38.25

Note: Figures for 1996/97 are estimated out-turns; 1997/98 to 1999/2000 are plans.

Source: *Financial Statement and Budget Report*, 1997–98.

### How plausible are these spending plans?

These plans seem very ambitious indeed when viewed in the context of the spending increases that have taken place over the course of the last few decades. Rarely has public spending growth been so constrained for any significant number of years in a row. Although overall spending actually fell in real terms in a small number of years over the 1980s, these very tight spending years were generally surrounded by years of much laxer spending control immediately before and after them. Compared with the average spending growth over the various parliaments of the last thirty years, these plans also seem to be strikingly tight. Table 3.2 shows the average yearly percentage growth in real public spending over different

parliaments. In the last five years, the average real growth of public spending has been at about 2.3 per cent (although much of this growth took place in the first year of the parliament, when GGE(X) grew by 6 per cent in real terms). Over the last 18 years of Conservative governments as a whole, the average real growth in public spending has been about 2 per cent per year. The plan for real growth in spending over the next three years, at about one-half of one per cent each year, is much lower than either of these averages.

**Table 3.2 Public spending growth over different parliaments**

	average annual real % growth in GGE(X)
1963–64 to 1966–67	5.1
1966–67 to 1969–70	3.9
1969–70 to 1973–74	4.9
1973–74 to 1978–79	1.8
1978–79 to 1982–83	2.3
1982–83 to 1986–87	1.7
1986–87 to 1991–92	1.1
1991–92 to 1996–97	2.4
1978–79 to 1996–97	1.9
<i>plans 1996–97 to 1999–2000</i>	<i>0.4</i>

Source: *Financial Statement and Budget Report, 1997–98.*

If the trend over the next five years were to be equal only to the lowest in any parliament since 1963/64 (1.1 per cent p.a.), spending would end the next parliament some 4 per cent higher than planned, or around £11 billion p.a. If spending were simply to grow at the average of the last 18 years, the figure would be 8 per cent, or £24 billion p.a.

Of course, past history need not dictate what happens to public spending in the future, especially since some of the imposed constraint in spending growth to be achieved this year is due to some unusually large capital receipts. The control total in 1997–98 will be reduced by £1.7 billion because some assets sales (from the sale of MoD married quarters and the sale of the student loan book) are to be included as spending deductions from the control total.

More importantly, what happens to public spending in the short run, and over the longer term, depends on the pressures that exist within the three major spending areas — social security, education and health.

Social security is the largest single programme, accounting for about one-third of overall public spending each year. As we have argued before (see *Options for 1997: The Green Budget*, October 1996, IFS), and contrary to some popular belief, there is no immediate crisis in the social security budget, although the number of people dependent on social security remains a strong cause for concern. Many of the ‘problem areas’, where costs were seen to be spiralling out of control, have been dealt with in recent years — invalidity benefits, unemployment benefits and housing benefits have all been reformed in an effort to control costs in the last few years. Social security spending is set to continue to fall as a proportion of GDP as we approach the turn of the century.

Within education, there may be some considerable budgetary pressures; pupil numbers are rising, both because of birth rates and because of dramatically increased participation in post-compulsory education amongst the over-16s, inevitably putting strain on current funding levels. The funding of higher education, accounting for about one-fifth of the overall education budget, is likely to come under considerable scrutiny at the start of the next term of government, whichever party is in power. The Dearing Committee, commissioned by the present government to examine all aspects of higher education policy, is due to report its findings in June.

We now focus on the shorter-term prospects for the funding of health over the next few years, looking in some detail at the current health spending plans, assessing their feasibility and their implications for the NHS. We then go on to consider an area of spending that cuts across all departments — namely, public sector pay.

## **Health**

Both the main parties have now committed themselves to increasing the real level of funding to the NHS year on year. The spending plans for this year (1997/98) will be sufficient to honour this commitment. The plans for the years after the current one barely do so. Either they are infeasible, and will be broken, or they will mean a much lower injection of new resources into the health service than hitherto experienced. At a time when the public's demand for health care is inevitably rising (see discussion below of spending pressures over the longer term), this will have serious implications for how well the NHS will be able to continue in its role as a comprehensive universal provider of free health care.

The main health spending plans that were announced at the last Budget are set out in Table 3.3. They show health funding on two different definitions — to the Department of Health as a whole and to the NHS within that. The NHS totals are further broken down into current and capital spending.

Funding to the Department of Health is due to increase in real terms by 0.8 per cent this year, fall in real terms by 0.7 per cent the year after and increase by 0.1 per cent in 1999/2000. Interpreting these changes is complicated by the fact that some community care functions of the department are to be transferred to local government in 1998/99. Looking at the plans for the NHS, which are not affected by this functional change, we see that a 1.8 per cent real increase in funding is expected in 1997/98, followed by a zero real increase in 1998/99 and 1999/2000. Averaging out over the three years, this is equivalent to just a 0.6 per cent real annual increase.

Within the NHS, there will be a very marked shift away from capital spending. Government-financed capital expenditure in the NHS is planned to be cut by 22 per cent in real terms over the course of the next three years. Investment financed by the Private Finance Initiative, estimated to be £166 million in 1997/98, £307 million in 1998/99 and £422 million in 1999/2000, is planned to fill this gap, though if the teething problems with the signing of contracts between hospital trusts and private financiers are not ironed out, then PFI funds might not come in according to projection.

**Table 3.3 The government's main health spending plans**

	1996/97	1997/98	1998/99	1999/00
<u>Total Dept of Health</u>				
£ billion	33.97	34.94	35.38	36.12
real % change		0.8	-0.7	0.1
<u>NHS</u>				
£ billion	33.36	34.66	35.33	36.04
real % change		1.8	0.0	-0.0
per cent of GDP	4.5	4.4	4.3	4.2
<i>of which</i>				
<u>current NHS spending</u>				
£ billion	31.49	33.04	33.78	34.48
real % change		2.9	0.2	0.1
<u>capital NHS spending</u>				
£ billion	1.87	1.62	1.55	1.56
real % change		-15.1	-6.1	-1.4

Notes:

Figures for 1996/97 are estimated out-turns; 1997/98 to 1999/2000 are plans.

NHS and capital NHS spending totals are *not* inclusive of PFI-financed investment.

Source: Department of Health Press Release 96/359.

If these plans are met, they are likely to have serious implications for the NHS. Past history would suggest, however, that the targets may well be breached. The real growth in health spending planned over the next three years is well below average spending growth in health over any recent parliament, or indeed over any period of consecutive years. A detailed examination of previous plans made for health spending in each of the Budgets and Autumn Statements since 1982 shows that when plans are made for health spending, they are almost always overshot. On the other hand, any new government may find itself in a particularly tight corner this year in attempting to give more resources to health, without also overstepping its overall public spending targets. This is because the level of the reserve set aside for unforeseen spending needs within the current spending plans, from which additional funds may be allocated, is considerably lower than has often been allowed for. These issues are discussed in turn.

The projected growth in health spending over the next three years is far lower than the average growth in health spending since the Conservatives took office in 1979, or at any time over the last thirty-five years. This can be seen from Table 3.4, which shows the average annual real growth in NHS spending over various parliaments. The table also contains figures for the growth in overall public spending over the same periods for comparison.

Since 1978/79, the average real growth of health spending has been at about 3.1 per cent per year. This has been much the same over the last parliament, although the growth has been uneven, with much of it coming in one year, 1992/93. The fastest real growth in the NHS over the period for which we have reliable data came in the early 1970s. The period of lowest real growth was between 1982/83 and 1986/87, when growth averaged just 1.8 per cent in real terms.

**Table 3.4 Health spending: average percentage real growth per year over different parliaments and current plans for the next three years**

	NHS	GGE(X)
1963–64 to 1966–67	5.8	5.1
1966–67 to 1969–70	2.3	3.9
1969–70 to 1973–74	6.3	4.9
1973–74 to 1978–79	3.5	1.8
1978–79 to 1982–83	3.7	2.3
1982–83 to 1986–87	1.8	1.7
1986–87 to 1991–92	3.9	1.1
1991–92 to 1996–97	2.8	2.4
1978–79 to 1996–97	3.1	1.9
<i>plans 1996–97 to 1999–2000</i>	0.6	0.4

Source:

NHS spending growth: 1978–79 to 1995–96, Department of Health Departmental Reports; 1963–4 to 1977–78, National Accounts Blue Books. Note that the Blue Book figures used before 1978–79 are calculated on a slightly different basis from the later figures, but this makes no substantive difference to the trends over time. GGE(X) spending growth: *Financial Statement and Budget Report*, 1997–98.

**Table 3.5 Health spending: real growth per year, 1979–80 to 1996–97**

	Per cent
1979–80	2.3
1980–81	8.5
1981–82	2.4
1982–83	1.6
1983–84	1.0
1984–85	2.1
1985–86	0.1
1986–87	4.0
1987–88	4.3
1988–89	3.7
1989–90	0.7
1990–91	4.1
1991–92	7.0
1992–93	5.9
1993–94	0.6
1994–95	3.8
1995–96	2.1
1996–97	1.6

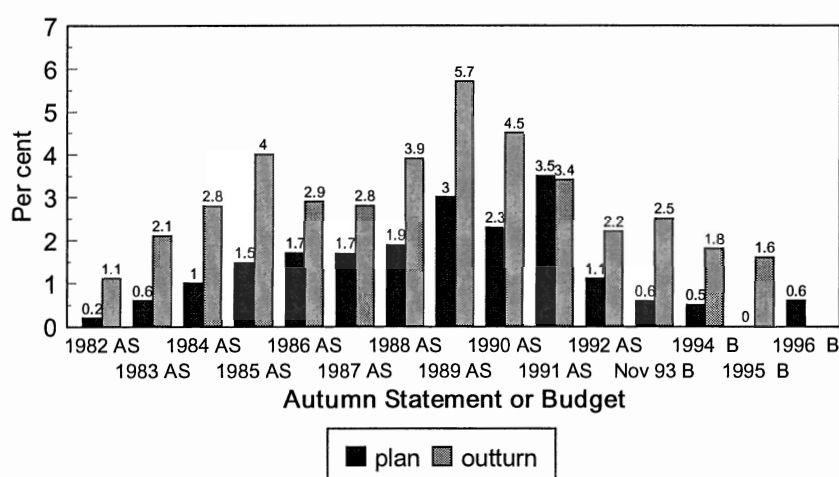
Source: 1979–80 to 1995–96, Department of Health Departmental Reports.

Looking at previous year-on-year spending changes, rather than averages taken over a period of years, also casts some doubt on the feasibility of the current health plans. Table 3.5 shows real spending growth in the NHS each year since 1979–80. Although very low real spending growth has been achieved in certain isolated years, these tend to be preceded and followed by years of relatively high spending growth. For example, government spending on the NHS

grew by just 0.6 per cent in real terms in 1993–94, but the years on either side of this saw unusually large spending rises.

Comparing previous health spending plans with actual health spending outcomes over the last fifteen years shows that, with just one exception, real health spending has outstripped plans made in each Budget or Autumn Statement since the public spending planning system moved to cash planning in 1982. This can be seen in Figure 3.6, which shows, for each Budget or Autumn Statement, the average yearly growth in health spending envisaged over the three year planning horizon. This is then compared with the actual spending out-turn over the three years. Notice that health plans in recent years have been particularly tight (since the 1992 Autumn Statement), but the growth in health spending thus far has not been in line with these plans.

**Figure 3.6 Health spending plans and out-turns: average percentage real growth per year over three planning years**



Notes:

Plans and out-turns expressed in terms of average real percentage growth per year over three-year planning horizon. For example, the years covered by the 1982 Autumn Statement were 1983–84, 1984–85 and 1985–86.

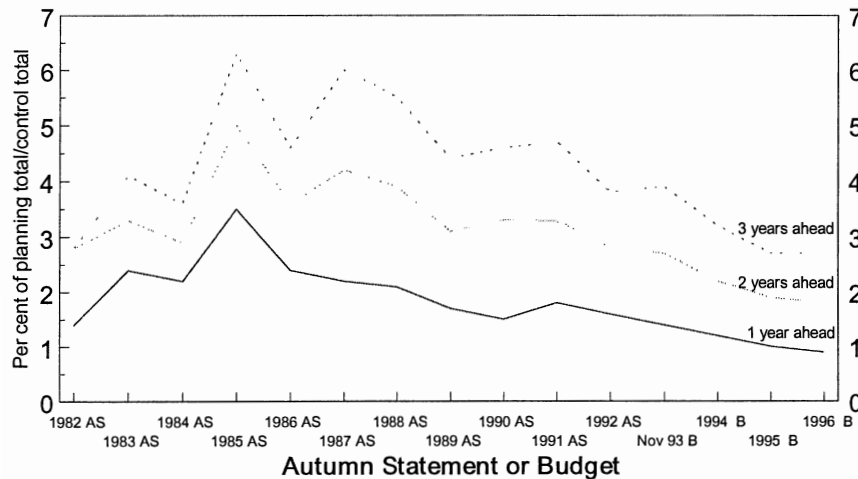
Out-turns relating to plans made in the 1994 and 1995 Budgets are out-turns *so far*.

Source: Department of Health Departmental Reports.

Unless other departments achieve substantial underspends, the only way in which the NHS can be given more funds without overall public spending plans being breached is if some of the contingency reserve is allocated to health. However, the next government may well be boxed into a particularly tight corner in this respect. Within the current plans for the control total, the Chancellor of the next government will have a reserve of £2.3 billion to allocate to departments in 1997/98, £5 billion in 1998/99 and £7.5 billion in 1999/2000. This is smaller than has been allowed for in previous years, particularly over the 1980s. The decline in the size of the reserve relative to the size of the control total (or planning total prior to 1992) is shown in Figure 3.7.



**Figure 3.7 Flexibility in spending plans: the size of the reserve relative to the control total or planning total (per cent)**

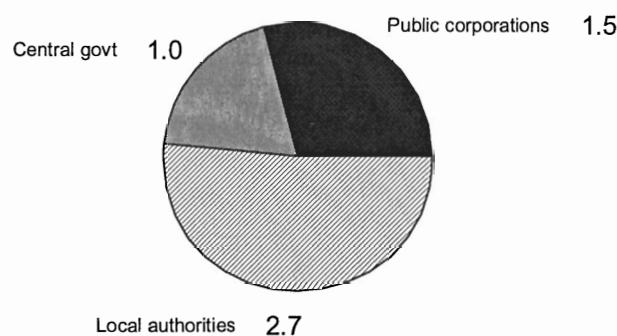


Source: FSBRs and Autumn Statements.

## Public sector pay

One major area of public spending that cuts across all departments is public sector pay. The public sector directly employs about five million people (one-fifth of the employed workforce), covering groups as diverse as the armed forces, the police, teachers, local government manual workers and the medical professions. Figure 3.8 shows where the 5.15 million public sector workers are employed. More than half of them work under the aegis of local authorities — mainly in education (1.2 million), social services (400,000) and the police (200,000). Public corporations, which encompass NHS trusts, are the next largest employment group in the public sector. Employment in NHS trusts accounts for about 1.1 million employees. The nationalised industries employ just 340,000 workers, compared with nearly 2 million at their height before the large-scale privatisations of the 1980s. Central government, covering much of the civil service (530,000), non-hospital NHS workers (90,000) and the armed forces (220,000), accounts for a further 1 million.

**Figure 3.8 The public sector as employer in the UK, 1996 (millions of employees)**



Total = 5.15 million  
(NHS trusts 1.1 m  
Local Authority education 1.2 m)

Source: *Economic Trends*.

The pay of its public servants costs the government about £100 billion each year, or roughly one-third of all public spending. Excluding spending on social security, this proportion is much higher; for example, wages account for as much as two-thirds of spending by hospitals and schools. What happens to pay and staffing in the public sector is clearly an important determinant of the overall public spending bill.

In recognition of its importance in overall public spending, since the 1992 Autumn Statement the government has set explicit targets for the public sector paybill. Since 1993, these targets have been in the form of a paybill freeze. Under the exact terms of this freeze, the paybill has been required to remain constant in nominal terms, and therefore to shrink in real terms as the general level of prices in the economy has risen. This means that no new cash has been available to departments to cover pay settlements in the public sector, and any pay deals in the public sector have had to be funded from savings elsewhere in departmental budgets or through the outsourcing of staff.

The imposition of controls on pay over a number of years has led some commentators to suggest that a bout of 'catch-up' pay deals in the public sector may be imminent, particularly if any new government were seen to be at all 'soft' on public sector unions. Some incoming governments in the past have witnessed rapid rises in the public sector paybill because of deferred and staged public pay settlements and other *de facto* incomes policies prior to elections.

If public pay settlements do spiral out of control, then it could prove hard for any government to keep within the overall public spending limits that have been set, since every extra percentage growth in the paybill adds about one-third of a percentage point to public spending overall. But up to now, as we have argued in the Green Budget (1996), pay growth in the public sector has not fallen significantly behind that in the private sector. Inasmuch as the paybill freeze has been effective — its size has actually grown somewhat in nominal terms since the freeze was introduced, from £93 billion in 1993 to £96 billion in 1995 (representing a cut of about 5 per cent in real terms) — this has not been achieved through keeping wage growth below that enjoyed by the private sector. The brunt of the freeze has in fact been borne through employment-shedding (particularly in the civil service) and contracting-out of services (mainly in local government and the health service).

This year's settlement from the pay review bodies, which covers 1.3 million public sector workers, including teachers, the medical professions, the armed forces and senior civil servants, and accounts for about one-third of the total paybill, averaged at just below 3.5 per cent. The pay increases are to be introduced in two stages, in April and December, and should cost roughly £750 million to implement. Whether this amount can be found from existing departmental budgets through shedding staff, contracting out services and general efficiency savings, is difficult to assess. It certainly should not prove more difficult to fund than last year, when awards of about 4 per cent were made.

Future public pay settlements may prove somewhat harder to pay for within existing spending limits, however. This is because last month's economy-wide average earnings growth figure, at 5 per cent, was higher than many had expected. If this earnings growth proves to be sustained, it may make the very tight public spending plans more difficult to achieve.

### **Public spending over the longer term — is the growth of government over?**

The Conservatives have made it plain that they want to see the size of government continue to shrink over the longer term. Their manifesto sets out that aim clearly, stating that under a Conservative government, public spending would 'grow by less than the economy as a whole over the economic cycle'. Labour have been less specific about their longer-term aims.

Is it possible that the growth of government can really be reversed over the long term? In general, a growing economy will tend to add to pressures on government spending, not to reduce them. These pressures stem from two main sources. The first source of upward pressure lies in the *demand* for publicly-provided goods and services. Many publicly-provided goods, particularly health and education, are 'superior goods', with an income elasticity of demand greater than one. As individuals and society as a whole grow richer, they will want to spend a higher proportion of their income on these goods; they expect more and better-quality services. If the public sector maintains its role in providing such goods, then the relative share of the public sector should increase, not fall.

A second source of upward pressure on the size of government lies in what happens to the *cost* of publicly-provided goods in a growing economy. Wages costs make up the bulk of total spending in labour-intensive areas of public provision, such as health and education. As living standards in general rise, then in order to maintain a quality and motivated work-force in the public sector, the wages of public sector workers must also rise. This means that labour-intensive areas of public spending will tend to grow at least in line with the growth of the economy. New technology can also be an upward source of pressure on spending in areas such as health. Although many treatments become cheaper to deliver with the aid of new technology, the advancement of medical research also makes a much wider, and sometimes very expensive, range of treatments available.

A further source of upward pressure on public spending over the coming decades will be social and demographic changes. An ageing population will increase demands for pension incomes and for health care; and any continued growth in numbers of lone parents and other no-earner households will tend to increase pressures on social spending.

The combination of these different factors will mean that whether public spending grows in the main areas of social provision or not, total spending on them will grow. If increased demands are to be accommodated through higher public spending, and paid for through the tax system, it is unrealistic to suppose that the size of government will shrink over time. The alternative is that there will be more private spending. In some areas, plans to increase the scope of private provision have already been put into place. For example, pension provision accounts for a major part of the current social security bill, and much future pension provision has already effectively been privatised (this is the subject of discussion in Chapter 13). In other areas, the mix between public and private spending has already started to shift. Private spending in health was about 10 per cent of public health spending in 1993–94, up from 5 per cent in 1978–79. In education, private spending is about 15 per cent of public spending, up from 8 per cent in 1978–79.<sup>3</sup> This change in the balance between public and private provision can only continue if the share of public spending in the overall economy is to continue to fall over the longer term.

## Conclusions

This chapter has examined the public spending plans announced by the two major parties in the run-up to the election, placing these plans in the context of the growth of government in this country over the last century and in an international context.

The plans for public spending that the Chancellor set out at the last Budget envisage lower spending growth over the next three years than has been witnessed in decades. Overall spending is set to rise in real terms by an average of 0.4 per cent per year, compared with an average of 1.9 per cent per year over the last 18 years. Labour are signed up to these plans for 1997–98 and 1998–99, although they promise additional spending financed by revenue from the windfall levy this year.

One particular example of where spending plans are extremely tight is health. Although both parties have made explicit promises to increase the real level of resources going into the NHS each year, the spending plans for health do not reflect this in any year besides the current one. Past history would suggest that extra resources will have to be channelled towards health next year and thereafter, but an unusually small reserve contained within the spending plans for future years means that there is considerably less flexibility to allow for this without breaching the overall spending limits.

Another example of where spending plans could come under strain is in funding public sector pay settlements. Although the settlement from the pay review bodies, covering 1.3 million public sector workers, should not prove more difficult to fund this year than last, there are signs that average earnings growth in the economy is starting to pick up. This could put some upward pressure on public pay settlements in the future.

In the longer term, the Conservatives have said that they want public spending to decline as a proportion of GDP. We have argued that the public's expectations for spending on the key areas of provision, especially pensions, education and health, can only rise as the economy

---

<sup>3</sup> See J. Hills (1995), 'Funding the welfare state', *Oxford Review of Economic Policy*, vol. 11, no. 3, Table 1, p. 31.

grows richer. Cutting back the size of government must imply serious choices about the public sector's role in the finance and provision of these key areas.

## 4. Has the government made us better off?

The main political parties have made apparently contradictory claims about the government's effect on the financial welfare of British citizens over the last parliament. Examples of the claims have appeared in their manifestos, in broadcasts, on posters and in press releases. They are sure to pop up again during the campaign.

- **Conservative:**  
*'Since 1979 [take home pay for a family on average earnings] has increased by £100 per week; this year alone it will increase by £7 per week'* CONSERVATIVE MANIFESTO, PAGE 8.  
*'The fact is that the average family will be £1,100 a year better off next year than at the time of the last General Election'* 'LABOUR RATTLED AND WRONG', CONSERVATIVE PRESS RELEASE, 27 NOVEMBER 1996
- **Labour:**  
*'Since 1992 the typical family has paid more than £2,000 in extra taxes- the biggest tax hike in peacetime history'* LABOUR MANIFESTO, PAGE 12.

Taken at face value, these claims would leave any voter confused and liable to disbelieve any figures relating to the levels of income or taxes over the last five years. How can they both be right? Simply, they are both correct answers to two different questions that were deliberately designed to give answers that suited the Parties' messages. Labour gives an answer to the specific question 'how much net extra tax in total would a typical family have paid by May 1997 compared with election day 1992?'. The Conservatives respond by giving an answer to the equally specific question 'how much will a married couple with two children on exactly average earnings be better off in 1997/98 compared with 1991/92?'

The parties have increasingly found it easier to campaign using these sorts of statistics because there is a great demand for a single all-encompassing number that explains the government's impact on our living standards. While it is certain that no single number can adequately explain the financial changes over five years in one household, let alone the nation, it is important to understand how the political parties have generated the numbers they use for campaigning and to question whether there might exist better ways of summarising the government's effect on living standards.

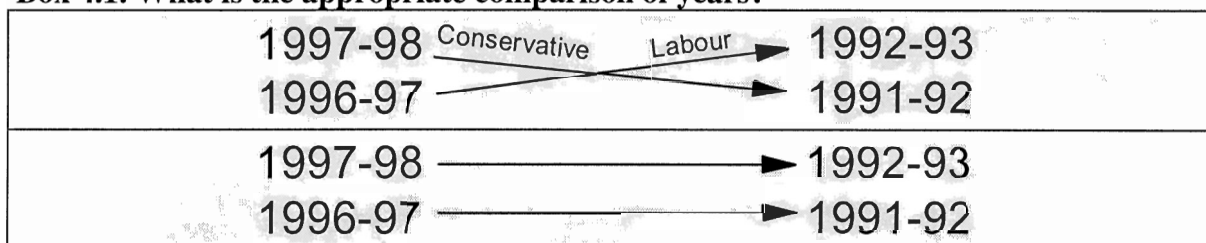
The two central claims of the parties both purport to show the effect of government policies on living standards over the last parliament. The substantive difference is that the Conservative claim relates to changes in net income levels whilst the Labour claim relates to changes in tax payments. There is no right and wrong here. If you believe that government is responsible for all changes in earnings and taxes, then a pure net income measure is correct. If, on the other hand, you believe that government only affects taxes and not earnings levels then a pure tax payments measure is correct. If you have a view in between these two extremes, then you would be interested in both bases of comparison. In what follows, we

analyse the parties' claims and seek more relevant measures of income levels and tax payments than those they might choose to present.<sup>4</sup>

## Income levels

The Conservatives' claim that a family on average earnings will be £1,100 a year better off than in 1991/92 is based on a projection of a long-running series of statistics produced in response to an annual parliamentary question from the opposition. The first thing to notice is the choice of years compared. The top bar of Box 4.1 stylistically shows the comparisons the major parties have an incentive to make, while the bottom bar shows the valid comparisons that can be made to judge the performance over the last parliament. The Conservatives like to compare 1997/98 with 1991/92 because there was high real average earnings growth in 1991/92 and the same is projected to be true in 1997/98. But it is clearly not appropriate to compare performance over a five-year parliament using six years of data. Of course, it would be in Labour's interests to compare the other diagonal in Box 1 because this choice of years avoids these two years of high earnings growth and tax reductions in 1997/98. This would be equally inappropriate. It is possible to make a good case either for comparing levels of net income in 1996/97 with 1991/92 or for comparing 1997-98 with 1992/93, as shown in the lower half of Box 4.1, and both give similar results.

### Box 4.1. What is the appropriate comparison of years?



If we compare financial year 1997/98 with 1992/93, the question posed is 'how much higher do we expect net income to be after this election than in the first year of the last parliament?'. This includes the direct tax changes of the 1996 Budget but excludes the effects of the 1992 Budget, which affected incomes in the first year of the parliament. A married couple with two children with one earner on average male earnings is shown to be £673 per year better off on this measure.

Comparing 1996/97 with 1991/92 answers the question 'how much better off were families towards the end of this parliament than at the end of the last parliament?'. This includes the effects of the 1992 Budget but not the direct tax changes of the 1996 Budget. The same married couple is £765 per year better off on this measure. The £100 extra under this measure is a result of higher real average earnings growth in 1991/92 than it is projected to be in 1997/98.

Though income and tax comparisons on either basis give similar results and both can be defended, for the rest of this chapter we will use the comparison of 1996-97 with 1991-92, for two reasons. First, this measure needs to use no forecasts of average earnings and prices

<sup>4</sup> In the whole of this chapter, we abstract from the effects of government spending on households' welfare, which is, after all, the purpose of taxation.

growth which, as will become clear, drive these results. Second, had Labour won the 1992 election, the 1992/93 tax system would have reflected their 1992 Shadow Budget and we would certainly have used 1991/92 as the base year to capture the effects of the first Labour government for 13 years. It is therefore consistent to view the tax changes from the 1992 Budget as part of this parliament. In addition, using 1991/92 as a base allows us to compare 18 years of Conservative governments consistently with the last year of the last Labour government in 1978/79.<sup>5</sup>

If the choice of base year can make comparing net income levels tricky, and enables different parties to put a very different interpretation on essentially the same series of figures, it is equally difficult to determine what is a good performance over one term of parliament. Average earnings generally grow faster than prices, so we would expect real net income to be higher at the end of one parliament than at the beginning. Perhaps the best basis using the Conservative's choice of measure is to compare the last government's performance with that of the previous three. The results are shown in Table 4.1. It shows that for both a single person and a married couple with two children on average earnings, the fourth term is only the third-best period in terms of real increases in net income. It is significantly worse than either the 1983–87 or the 1987–92 parliaments. It is significantly better than the first Thatcher term.

**Table 4.1. Income changes for families on average earnings over four Conservative governments (1997–98 prices)**

	1st Term 1978–79 to 1982–83	2nd Term 1982–83 to 1986–87	3rd Term 1986–87 to 1991–92	4th Term 1991–92 to 1996–97
<b>Married, two children</b>				
change in gross earnings	£815	£2,055	£2,252	£1,216
change in direct tax payments	£487	£285	£218	£451
<b>Change in net income</b>	<b>£328</b>	<b>£1,770</b>	<b>£2,035</b>	<b>£765</b>
<b>Single, no children</b>				
change in gross earnings	£815	£2,055	£2,252	£1,216
change in direct tax payments	£492	£481	–£52	£250
<b>Change in net income</b>	<b>£322</b>	<b>£1,573</b>	<b>£2,305</b>	<b>£966</b>

Source: IFS calculations based on answers to parliamentary questions (1989 to 1994).

A closer examination of Table 4.1 shows:

1. First and most importantly, the results are mainly driven by the real change in average earnings levels and not by tax or benefit changes. From the mid-1980s until the depth of the last recession, average real male full-time earnings grew quickly, particularly in the Lawson boom period straddling the 1987 election. Periods of slower real earnings growth inevitably show lower net earnings increases.

<sup>5</sup> It would be best to compare 1 May 1997 with 9 April 1992, but a lack of suitably consistent monthly average earnings figures prevents us from doing so.



2. Despite direct tax rate reductions in the mid- and late 1980s, real tax payments for families on average earnings tended to rise. This is a result of the progressivity of income tax and National Insurance contributions (NICs). As real earnings increase, the average tax rate rises, and for the families shown in Table 4.1, this effect more than offsets reductions in tax rates except for the single childless in the third term.
3. The choice of type of family can make a significant difference. As Table 4.1 shows, the choice between a married couple with two children and a single person on average earnings makes little difference in the first Conservative term. But in the second term, married couples did better than single people because all tax allowances (including the married man's allowance) were increased by more than inflation, as was child benefit, between 1982/83 and 1984/85. Conversely, in the last two terms, single people on average earnings had higher net income growth than married couples. This is a reflection of the non-uprating of child benefit between April 1988 and 1991 and the freezing and subsequent reduction in the value of the married couple's allowance since 1990.

The choice of family or person to compare is a deeper issue than whether to choose an 'average family' with two children or a 'typical' single person on average earnings. Neither of these is average or typical, and nobody earns the exact level of average earnings, certainly not every year. So the figures in Table 4.1 are often augmented as in Table 4.2 to show changes in income for families on multiples of average earnings. Not surprisingly, as the results are driven by changes in gross earnings, they show that those with twice average earnings have greater income gains than those on the average, who in turn have done better than those on half average earnings.

**Table 4.2. Changes in income and direct tax payments from 1991/92 to 1996/97 (1997/98 prices)**

Proportion of average earnings	Single, no children			Married, two children		
	50%	100%	200%	50%	100%	200%
Change in gross earnings	£608	£1,216	£2,432	£608	£1,216	£2,432
Change in direct tax	£43	£250	£1,034	£244	£451	£1,539
<b>Change in net income</b>	<b>£565</b>	<b>£966</b>	<b>£1,397</b>	<b>£364</b>	<b>£765</b>	<b>£893</b>

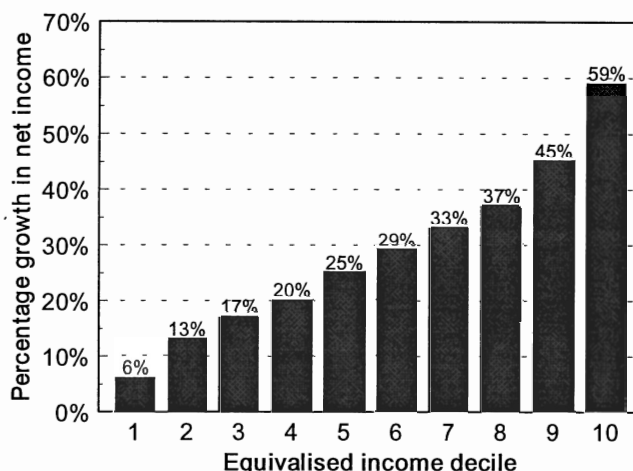
Source: IFS calculations based on answers to parliamentary questions (1989 to 1994).

But the real problem is that none of these families or examples is representative of the population as a whole. They all assume a household contains someone in employment, but only 56 per cent of individuals live in households with an employee present. It would be possible to keep expanding the number of example families, to show every conceivable sort of family type starting the period on every multiple of average earnings and finishing the period with any multiple of average earnings, but this would only encourage parties to pick the figures they found most attractive and try to persuade us that their choice of family was in some way more 'average' or 'typical' than the other party's.

When comparing net income levels over time, we need to know how all families have fared and the differences in experiences between different sorts of families or those on different levels of income. The Department of Social Security publishes a series like this every year, called Households Below Average Incomes, which is based on a large representative sample

of families' incomes and spending patterns. Unfortunately, the survey used does not track the same families from one year to the next, so it is impossible to know how individual families have fared, and the latest data used was 1994/95, but the series does show the income levels of different parts of the income distribution over time.

**Figure 4.1. Percentage growth in net income by income decile (1979 to 1993–95)**



Source: *Households Below Average Income 1979–1993/94*, DSS, 1996.

Figure 4.1 shows the percentage growth of real net income from 1979 to 1993/95<sup>6</sup> by net income range. The bar furthest to the right shows that the income level of the richest tenth (decile) of households is 59 per cent higher than the corresponding decile in 1979. At the other end, the bottom decile of households in terms of income levels is only 6 per cent better off than the equivalent group were in 1979. It shows that, over the course of the Conservative governments, there has been income growth at all levels of income but a massive divergence in growth of income between those with higher incomes and those with lower incomes.

The numbers behind Figure 4.1 can also be transformed into monetary values. Since 1979, the average increase in net annual income has been £4,185. As the graph shows, this varies with income levels, though. It is £11,858 for the top decile, £2,361 for the fifth decile and £268 for the bottom decile. So while it is clear that incomes, on average, have risen substantially, so the figures in Tables 4.1 and 4.2 are not wrong, they in some sense exaggerate income growth because they are based on average earnings, which have risen faster than the incomes of most households, particularly those that have incomes linked to benefit levels which have increased only by the rate of inflation.

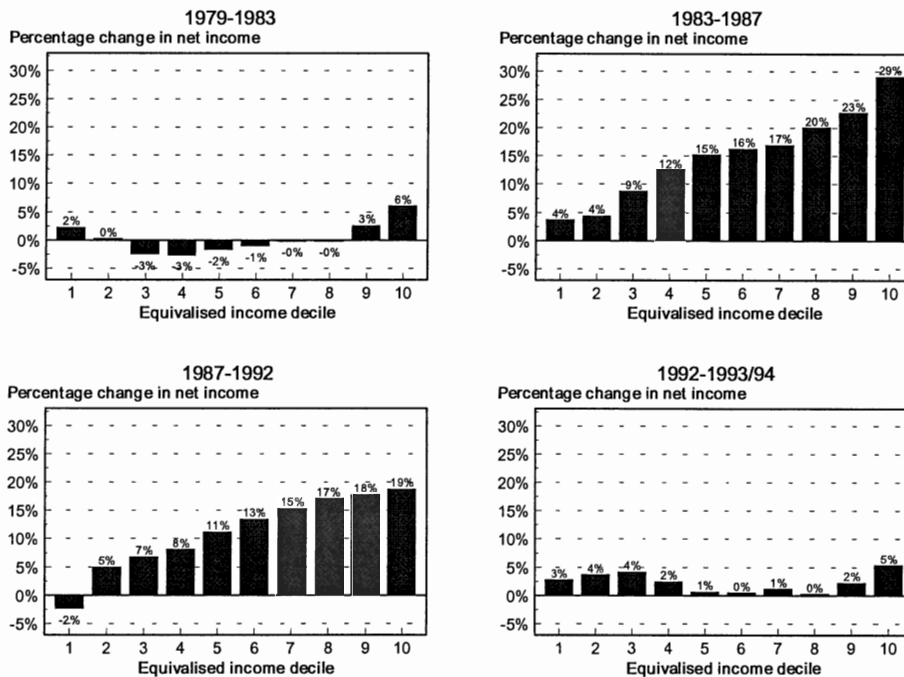
The DSS income growth numbers can also be split by parliamentary terms in order to compare the relative performance of each parliament. Figure 4.2 shows the income growth in each parliament since again split by income decile.<sup>7</sup> A similar picture to that of Table 4.1 emerges, showing that the largest gains in income and the periods of most unequal income growth occurred in the second and third terms of government. It is difficult to form firm

<sup>6</sup> 1993–95 includes Family Expenditure Survey data from financial years 1993–94 and 1994–95.

<sup>7</sup> Care must be taken in the interpretation of small changes in Figure 4.2, which are likely to be driven by sampling errors.

conclusions regarding income growth and distribution in the fourth term of office because the data are incomplete, although it seems that income and inequality growth will be slower than in the previous two terms.

**Figure 4.2. Percentage growth in net income by parliament**



Sources: *Households Below Average Income 1979–1993/94*, DSS, 1996; IFS calculations based on A. Goodman and S. Webb, *For Richer, For Poorer*, IFS, 1994.

## Tax payments

If there is argument about whether a government can claim credit for rises in levels of net income, there is less debate over whether governments are responsible for the levels of taxes. But this does not mean there are clear summary figures to evaluate the levels of or changes in tax payments. In fact, there seems to be even greater variety of methods used in calculating whether people pay more or less tax now. We will briefly explain some of the different bases for comparisons of tax levels over the last parliament.

Labour claims that the typical family has been hit by 22 tax increases, which total an extra £2,082 in tax paid since 1992. This figure is calculated by taking an example family, deeming it to be typical, and imposing the tax changes relevant to this family since 1992. But instead of calculating how much more or less tax this family pays per year now relative to 1992, Labour cumulates the tax changes from their date of implementation to the present day. They do this because most of the major tax increases occurred between April 1994 and April 1995, while the tax cuts occurred later and have less time to sum to a large number.

Are there better ways of calculating tax payments? First, Labour could simply use their 'typical' family but calculate tax payments on an annual basis. An example of this sort of analysis is given in Table 4.3. Though while the Labour Party number includes the effects of indirect tax changes, these are excluded from the figures in Table 4.3. The table uses the examples of the families on average earnings again and calculates their income tax and NIC

payments as a proportion of their gross earnings. It shows that direct taxes rose for both single people and married couples in the first Conservative term, mostly as a result of Geoffrey Howe's 1981 Budget. While direct taxes fell as a proportion of income for single people in most years since 1982/83, direct tax rates have fluctuated more for married couples due to offsetting reductions in income tax rates and reductions in the real value of child benefit and the married couple's allowance.

**Table 4.3. Direct tax changes for families on average incomes**

(1997–98 prices)	1997–98	1996–97	1991–92	1986–87	1982–83	1978–79
<b>Single, No Children (Av earnings)</b>						
Gross Income	£21,636	£21,316	£20,100	£17,847	£15,793	£14,978
Income Tax	£3,923	£4,022	£4,056	£4,089	£3,832	£3,748
NICs	£1,906	£1,870	£1,586	£1,606	£1,382	£973
Child Benefit	£0	£0	£0	£0	£0	£0
Net Income	£15,807	£15,423	£14,457	£12,153	£10,579	£10,257
<b>Income Tax &amp; NICs as % of earnings</b>	<b>26.9%</b>	<b>27.6%</b>	<b>28.1%</b>	<b>31.9%</b>	<b>33.0%</b>	<b>31.5%</b>
<b>Married, 2 Children (Av Earnings)</b>						
Gross Income	£21,636	£21,316	£20,100	£17,847	£15,793	£14,978
Income Tax	£3,648	£3,745	£3,551	£3,474	£3,322	£2,980
NICs	£1,906	£1,870	£1,586	£1,606	£1,382	£973
Child Benefit	£1,043	£1,052	£1,024	£1,185	£1,094	£830
Net Income	£17,124	£16,752	£15,987	£13,952	£12,183	£11,855
<b>Income Tax &amp; NICs – CB as % of earnings</b>	<b>20.9%</b>	<b>21.4%</b>	<b>20.5%</b>	<b>21.8%</b>	<b>22.9%</b>	<b>20.9%</b>

Source: IFS calculations based on answers to parliamentary questions (1989 to 1994).

Of course, the figures in Table 4.3 are only a measure of direct taxation, and it has been government policy since 1979 to shift the tax burden away from direct taxation. It would be possible to give these typical families an average basket of goods purchased and calculate indirect tax payments on this basis, but this would still suffer from all the same problems of using average families as the Conservative figures on income levels.

The best way of comparing tax payments, therefore, is to use a measure of the level of total taxation and attribute that level to households, as only individuals can ultimately pay tax. Over long periods, the best measure of this is simply the total tax burden — the ratio of total tax payments to GDP. But over shorter periods, such as one parliament, changes in the tax burden will often be affected by changes in the denominator (GDP) that have not filtered through to tax payments and the relationship between tax payments and GDP. An alternative and perhaps better measure over short periods is shown in Table 4.4, which sums the *intended* revenue effects of tax changes over this parliament.

**Table 4.4. Revenue effects of budgetary changes over this parliament**

<b>Tax changes from 1991–92 (£ million)</b>	<b>1992–93</b>	<b>1993–94</b>	<b>1994–95</b>	<b>1995–96</b>	<b>1996–97</b>	<b>Total</b>
March 1992 Budget	–£2,170	–£430				–£2,600
March 1993 Budget		£490	£6,235	£3,580		£10,305
November 1993 Budget			£1,675	£3,220	£1,180	£6,075
November 1994 Budget				–£1,255	–£120	–£1,375
November 1995 Budget					–£3,140	–£3,140
Measures taken between Budgets		£815	–£385	£505	–£120	£815
Excise duty adjustment					£570	£570
<b>Total</b>	<b>–£2,170</b>	<b>£875</b>	<b>£7,525</b>	<b>£6,050</b>	<b>–£1,630</b>	<b>£10,650</b>
<b>Total: 1997–98 prices (£ million)</b>	<b>–£2,563</b>	<b>£992</b>	<b>£8,291</b>	<b>£6,546</b>	<b>–£1,716</b>	<b>£11,551</b>
<b>Real tax increase per household (£)</b>	<b>–£117</b>	<b>£45</b>	<b>£377</b>	<b>£298</b>	<b>–£78</b>	<b>£525</b>

Source: FSBRs, March 1992 to November 1995.

For each Budget, we have added the value of any discretionary tax increases and deducted the value of tax reductions in the following tax year from the published FSBR figure. We also added additional effects in subsequent years and tax measures taken between Budgets.<sup>8</sup> Viewing the table horizontally, each row shows the net effect of each Budget, and viewing it vertically, each column shows the revenue effects of discretionary tax changes that occurred in that financial year. Finally, at the bottom of the table, we have uprated the figures using the GDP deflator to 1997/98 prices and divided by the number of households in the UK, to give a total discretionary tax increase this parliament of £525 per year per UK household.

But though this number includes all the discretionary tax changes, it does not show how these increases in tax payments have been distributed amongst UK families. For this, we need to estimate the effects of changes in the tax system on a representative sample of UK households. We show the results of this exercise in Chapter 5 and, using this method, generate a number for the overall change in taxes very similar to the £525.<sup>9</sup>

## Conclusion

We probably should not be too surprised that the major parties will seek, during this election, to show statistics that purport to show the government's effect on the electorate in vastly contrasting lights. The differences can be explained, in part, by the use of inappropriate choice of years to compare, the cumulating of changes over the parliament and the liberal use of typical families. We have also shown that even if you accept one or other party's basis of comparison, it is difficult to analyse what constitutes a 'good' or 'bad' performance.

<sup>8</sup> We had to make an adjustment for the petrol excise duty increases above inflation for 1996–97, which were announced in the March 1993 Budget but not included in the discretionary changes of subsequent FSBRs.

<sup>9</sup> The overall tax increase generated is £422 excluding changes in corporate sector taxation. A small part of this has been offset by social security changes affecting the household sector.

But the main difference between the claims of the parties is whether governments can claim credit for real changes in net incomes or whether they should be judged solely on the direct effects they have on our incomes through the tax system.

# 5. The effects of tax and benefit changes, 1992–97

We have looked at a number of ways of showing the effects of tax changes on a range of example families. In this chapter, we use the IFS tax and benefit model to consider the effect of tax and benefit changes since 1992 on a representative sample of the population. These simulations answer the question ‘how much worse or better off are people as of 6 April 1997 compared with a world in which at each Budget during the last parliament the Chancellor had stood up and said “I will make no changes except to take account of the effects of inflation” and then sat down again?’.

This means that the base for our comparisons is the April 1992 tax and benefit system, which came into force just before the last election, uprated to take account of inflation. This is compared with the system announced in the November 1996 Budget which came into effect on 6 April 1997. The results are calculated by the IFS tax and benefit model, TAXBEN, which models the changes for almost 7,000 households from the 1994/95 Family Expenditure Survey, a representative sample of the UK population. Using TAXBEN, we can see how the gains and losses since April 1992 have been distributed across the population.

## *The major changes considered in this analysis*

The major tax increases that directly affected households during this period were

- the increase of the main employee rate of National Insurance contributions (NICs) from 9% to 10%
- the restriction of the married couple’s allowance (MCA) to 15%
- the restriction of mortgage interest tax relief (MIRAS) to 15%
- the extension of VAT to fuel at 8%
- the introduction of insurance premium tax and its increase to 4%
- the increases in excise duties on tobacco and petrol in real terms
- the real increases in local tax revenues and the move from community charge to council tax

The major tax reductions that directly affected households during this period were

- the reduction of the basic rate of income tax from 25% to 23%
- the reduction of the rate of income tax on savings to 20% for basic-rate taxpayers
- the extension of the 20p income tax band in real terms to £4,100
- the reduction in excise duties on alcohol in real terms

The major benefit changes that affected households during this period were

- the compensation package for pensioners and those on low incomes associated with the introduction of VAT on fuel
- the move from community charge benefit to council tax benefit
- the introduction of a 30 hours premium and childcare disregard for family credit
- the reductions in one parent benefit and lone-parent additions to income support

- the introduction of the jobseekers' allowance in place of unemployment benefit and income support for the unemployed
- the introduction of incapacity benefit in place of invalidity benefit

## Distributional results

We begin by looking at how the gains and losses were distributed according to income level. This is done by dividing households into 10 groups of equal size by income adjusted to take account of the number of people in the household. These groups are known as deciles. The first decile contains the poorest 10 per cent of households while the tenth decile contains the richest 10 per cent. The net income levels that place households in different deciles are shown in Table 5.1.

Table 5.2 shows that the average loss over the period was £7 per week.<sup>10</sup> This represented a fall of 2.6 per cent in average post-tax incomes<sup>11</sup> for the whole population. We can look behind this average loss figure to see how it was distributed between households. In cash terms, the scale of the losses increased as income increased. For the poorest group, the average loss was £2.80 per week, rising to £6.50 for the fifth decile. The highest cash losses were among the richest households, with the richest decile losing £14.10 per week.

Looking at the distribution of losses as a percentage of post-tax income reveals a rather different picture. The decile that lost most relative to income was the bottom decile, where there was a 3.3 per cent fall in post-tax income. The other big losers were those in the fifth and sixth deciles, where post-tax income was reduced by 3.1 per cent and 3.0 per cent respectively. At the top of the income scale, the percentage losses were much lower, with the richest decile losing only 2.2 per cent, the second smallest loss for any income group.

What is driving these results? We begin by looking at what happened to the bottom deciles of the distribution. As most of those in the bottom three deciles do not have enough income to pay direct taxes, the major effects on these groups came through the changes to indirect taxes and benefits. The two changes with the largest impact on the bottom decile were the introduction of VAT on fuel and the increases in excise duty on tobacco, although the compensation package that accompanied VAT on fuel reduced the impact of this change. More than half of the loss in the bottom decile is accounted for by the increases in excise duties on tobacco. The relatively low level of income among households in the bottom decile means that small cash losses represent a larger percentage of their income compared with those further up the distribution.

While the bottom decile lost on average, we can once again look behind this average to examine the variation in how the loss was distributed between households in this decile. The final two columns in Table 5.2 show the proportion of each decile who gained or lost more than 1 per cent of their post-tax income. While about 10 per cent of households in the whole population gained by more than 1 per cent of their post-tax income, over a quarter of households in the bottom decile gained more than this amount. The main reason for these

---

<sup>10</sup> By average change, we mean the change summed over all households and divided by the number of households in the population.

<sup>11</sup> Post-tax income is defined as income including benefits less payments of direct and indirect tax.



gains was the switch from poll tax to council tax. Low-income households had to pay at least 20 per cent of their community charge bill, but under council tax the benefit system can cover the entire payment.

Losses in the second decile were markedly lower than those in the bottom decile. The main reason for this was that there were significantly more pensioners in the second decile than in the first decile and, as we shall see below, pensioners in general fared better than the rest of the population.

The results for those in the middle and higher deciles were largely driven by the changes to direct taxes. Many of the tax increases involved flat rate amounts across certain income ranges. For example, the restriction of the MCA to 15 per cent reduced the income of all married basic-rate taxpayers by £2.80<sup>12</sup> per week and of all higher-rate taxpayers by £8.80<sup>13</sup> per week. The increase in the rate of NICs hit all those with earnings above the upper earnings limit by the same amount, and the restriction of MIRAS also involved a largely flat rate increase in tax liability. These flat-rate changes constitute a lower loss in percentage terms for richer households. This accounts for the fact that while the richest deciles saw the highest cash losses, it is households in our middle deciles that saw the highest percentage losses.

Table 5.3 shows the impact of the changes broken down by family type. Pensioners saw the smallest average losses both in cash and percentage terms, while the largest average losses were for working couples. The low losses for pensioners were due to the fact that they were not affected by many of the tax increases seen during the parliament. As pensioners do not pay NICs and are unlikely to have mortgages, there was little impact from the increase in NIC rates or from the restrictions to MIRAS. In addition, pensioners tend to drive and smoke less than the rest of the population, reducing the impact of the increases in excise duties. The impact of VAT on fuel was also partly offset by increases in the state retirement pension and pensioners' income support premiums.

The losses for working couples were greater than those for single workers because the restriction of the MCA only affected couples and because couples tend to have higher incomes than single people. Two-earner couples with children lost most in cash terms, with an average loss of £13.70, followed by single-earner couples with children. In percentage terms, the ranking of these groups was reversed, reflecting the higher income levels of two-earner couples.

Single-earner couples lost, on average, 3.3 per cent of their post-tax income for those without children and 3.7 per cent for those with children. Again, the switch from community charge to council tax produced a substantial group of single unemployed and no-earner couples with children who gained over the period, with 17.2 per cent and 11.8 per cent respectively of each group gaining more than 1 per cent of their post-tax income.

---

<sup>12</sup> (£1,830 \* (0.23 – 0.15)) / 52.

<sup>13</sup> (£1,830 \* (0.40 – 0.15)) / 52.

## Future announced changes

The above results look at the changes that will have taken effect by April 1997. A series of further reforms are scheduled to take effect after that date. On benefits, the government is committed to removing lone-parent additions to benefit rates for new claimants after April 1998. The rate of these benefits in April 1997 was £4.95 for those on income support and £6.05 otherwise. Incapacity benefit, which replaced the non-taxable invalidity benefit, is taxable for new claimants. Under transitional arrangements, most current claimants do not pay tax on their benefits. The effects of these changes will feed through in coming years, affecting those on incapacity benefit with other sources of income outside the benefit system. For a basic-rate taxpayer receiving the basic long-term rate of £62.45 in 1997/98, the taxation of incapacity benefit will reduce post-tax income by £14.36 per week.

The major change to the tax system announced but not yet implemented is the phasing-out of tax relief for profit-related pay schemes. This is expected to increase income tax revenue by £1.7 billion in 1999/2000. While the impact of this change will vary widely between households, depending on whether they gain directly from such schemes, the average effect of this change would add about £1.40 to the average loss figure of £7.00 shown in Table 5.2. Finally, the government is currently committed to increasing excise duties on petrol by 5 per cent per year and duties on tobacco by 3 per cent per year in real terms.

**Table 5.1 Net income levels used to define deciles (£ per week)**

<i>Income decile</i>	<i>Single person</i>	<i>Couple with no children</i>	<i>Couple with two children</i>
Poorest	£74 and below	£121 and below	£183 and below
2nd	£75 – £88	£122 – £145	£184 – £218
3rd	£89 – £102	£146 – £167	£219 – £252
4th	£103 – £117	£168 – £192	£253 – £288
5th	£118 – £136	£193 – £223	£289 – £334
6th	£137 – £159	£224 – £261	£335 – £393
7th	£160 – £187	£262 – £307	£394 – £462
8th	£188 – £224	£308 – £368	£463 – £552
9th	£225 – £287	£369 – £471	£553 – £707
Richest	£288 and above	£472 and above	£708 and above

Source: Family Expenditure Survey, 1994/95.

**Table 5.2 The impact of tax and benefit changes 1992–97, by income decile**

<i>Income decile</i>	<i>Average gain/loss (£ per week)</i>	<i>Average gain/loss (% of post-tax income)</i>	<i>% gaining more than 1% of income</i>	<i>% losing more than 1% of income</i>
Poorest	-2.80	-3.3	26.7	49.9
2nd	-2.40	-2.0	16.5	52.6
3rd	-3.10	-2.3	15.2	53.8
4th	-4.40	-2.6	11.4	59.0
5th	-6.50	-3.1	6.3	71.8
6th	-7.80	-3.0	4.5	74.4
7th	-8.20	-2.7	3.7	77.6
8th	-10.20	-2.9	3.2	78.1
9th	-10.40	-2.5	3.8	77.0
Richest	-14.10	-2.2	3.4	78.7
<b>All</b>	<b>-7.00</b>	<b>-2.6</b>	<b>9.5</b>	<b>67.3</b>

Source: IFS tax and benefit model simulations.

**Table 5.3 The impact of tax and benefit changes 1992–97, by family type**

<i>Family type</i>	<i>Average gain/loss (£ per week)</i>	<i>Average gain/loss (% of post-tax income)</i>	<i>% gaining more than 1% of income</i>	<i>% losing more than 1% of income</i>
Single unemployed	-2.60	-2.2	17.2	53.4
Single employed	-7.40	-2.8	2.9	80.8
Single-parent family	-4.30	-2.4	6.7	65.7
NE couple, no children	-5.90	-2.9	10.5	68.5
NE couple with children	-4.00	-2.3	11.8	59.9
SE couple, no children	-10.40	-3.3	2.5	81.4
SE couple with children	-12.70	-3.7	8.9	83.2
TE couple, no children	-11.20	-2.7	1.7	82.8
TE couple with children	-13.70	-3.3	2.7	91.3
Single pensioner	-0.80	-0.6	22.6	35.2
Couple pensioner	-2.40	-1.1	14.7	46.0
<b>All</b>	<b>-7.00</b>	<b>-2.6</b>	<b>9.5</b>	<b>67.3</b>

Source: IFS tax and benefit model simulations.

Key : NE No-earner  
SE Single-earner  
TE Two-earner

## 6. Long-term aspirations

Both the Conservative and Labour manifestos contain long-term aspirations for the level of income tax rates. The Conservative Party restated its commitment to a basic rate of income tax of 20 per cent, which it aims to have introduced by the end of the next parliament. The Labour Party's manifesto confirmed its long-term objective of reducing the starting rate of income tax to 10p. Both these proposals will be costly to introduce. Moving immediately to a basic rate of 20 per cent would reduce revenue by almost £6 billion per year. If the current lower rate of tax were reduced from 20 per cent to 10 per cent, the cost would be even greater, at £9.5 billion per year; though, of course, introducing a 10 per cent rate on a smaller band of income, as would undoubtedly happen, would be cheaper.

### *The distributional effects of long-term tax proposals*

This is not the only difference between the two proposals. The main distinction relates to how the gains from these tax reductions would be distributed. Using the IFS tax and benefit model, we can compare the distributional impact of these two proposals. In order to compare like with like, we need to reduce the cost of lowering the lower rate of tax. This is done by narrowing the new 10 per cent band to £2,600, which leaves a 20 per cent band covering £1,500. Thus both reforms considered below have the same cost, in terms of lost revenue, to the exchequer.

The distributional results in terms of income levels are shown in Figure 6.1. These are again shown in terms of income deciles. In both cases, the gains from the change are limited for those in the poorest deciles, as few people in these deciles have income high enough to make them pay income tax. For the small group in the lowest decile who do gain, the gains from the reduction in the starting rate of income tax are greater than those from a 20 per cent basic rate. This pattern continues for the first eight deciles, with only the richest two deciles gaining more, on average, from the basic rate cut.

The reason for this distributional result is fairly clear. The introduction of a 10p rate reduces the tax bill of all current taxpayers, whereas the 20p basic rate only affects those with incomes high enough to be paying basic-rate tax. In addition, for basic-rate taxpayers, a reduction in the starting rate of tax reduces their tax liability by a fixed amount while gains from a reduction in the basic rate rise with income.

### *Why income tax rates?*

Why are both the main parties prepared to forgo such large amounts of revenue in order to reduce the rates of income tax? The main arguments put forward are to help lower-income people and to improve work incentives, but these are ill-founded.

First, it is an obvious point, but cutting income tax rates does not help the poorest groups because they do not pay income tax in the first place.

Second, cutting income tax rates is not even the best way of helping poorer people who actually do pay income tax. Increasing tax-free allowances is more help.

Figure 6.2 shows the impact of an increase in the personal allowance compared with the reduction in the starting rate of tax to 10p considered above. Again, the cost of both reforms is the same at £6 billion, which allows personal allowances to be increased by £1,250.<sup>14</sup>

As Figure 6.2 shows, the increase in allowances benefits those in the poorer deciles more than the reduction in the starting rate of tax.<sup>15</sup> This is because the gains from an extension of income tax allowances are more concentrated on those with lower income tax liabilities. For example, consider a single person earning £5,000 per year. Under the current tax system, they would pay £3.67 per week in income tax. This would be reduced to £1.84 per week if a 10p starting rate of income tax were introduced. However, under the extension of income tax allowances, this person would pay no income tax.

What about the effect of high tax rates on work incentives? The fact is that there is no evidence that a change in the basic rate from 23 per cent to 20 per cent would have any significant effect on work incentives.

However, should we not be concerned about very high marginal tax rates? The Labour Party manifesto contains the paragraph:

*Our long-term objective is a lower starting rate of income tax of ten pence in the pound. Reducing high marginal rates at the bottom end of the earnings scale — often 70 or 80 per cent — is not only fair but desirable to encourage employment.*

Such high marginal rates are indeed created at the bottom of the income distribution as a result of the combination of the withdrawal of means-tested benefits, such as family credit, and the payment of tax. But lowering the starting rate of income tax will not change this. Table 6.1 shows the effect of the introduction of a 10p starting rate on the level of marginal tax rates. For those not receiving in-work benefits, the reduction in the starting rate of tax from 20 per cent to 10 per cent does indeed reduce their effective marginal tax rate by 10 percentage points. However, those on the highest marginal tax rates would hardly notice the change, as increases in post-tax income lead to a reduction in benefit entitlement. The marginal tax rate drops by just 0.4 percentage points from 96.7 per cent to 96.3 per cent for those on the main means-tested benefits — family credit, housing benefit and council tax benefit. Even for those on only family credit, the change only reduces their marginal tax rate by 3 percentage points from 79 per cent to 76 per cent.

The point is that high marginal tax rates of over 70 per cent are caused primarily by the benefit system, not the tax system. Indeed, one could abolish the whole tax and National

---

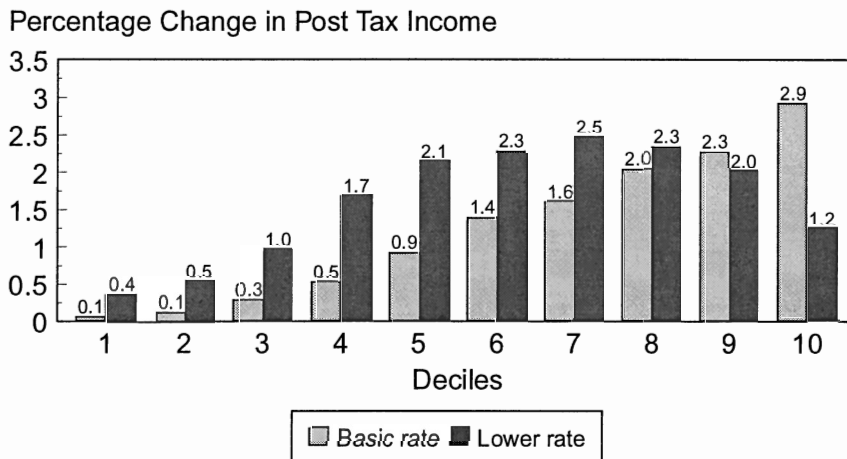
<sup>14</sup> To directly compare the two proposals, the points at which individuals begin to pay basic- and higher-rate tax are held constant at £8,145 and £30,145 of gross income respectively.

<sup>15</sup> Note that the numbers in Figure 6.2 are smaller than would be initially expected due to the interaction of the married couple's allowance and the 10 per cent starting rate. In particular, for those receiving the MCA, the 10 per cent starting rate has the same effect as an allowance increase and means that no one in receipt of this allowance would actually pay tax at a marginal rate of 10 per cent. If the MCA were adjusted to take account of the new starting rate, the differences between the two proposals would become greater. However, the Labour Party has not clarified the position of this allowance, so for the current comparison we have left the restriction of the MCA at 15 per cent.

Insurance system, and the marginal tax rate for those on family credit would still not fall below 70 per cent. Anyone who wishes to address these problems has to address their cause, which is the benefit system.

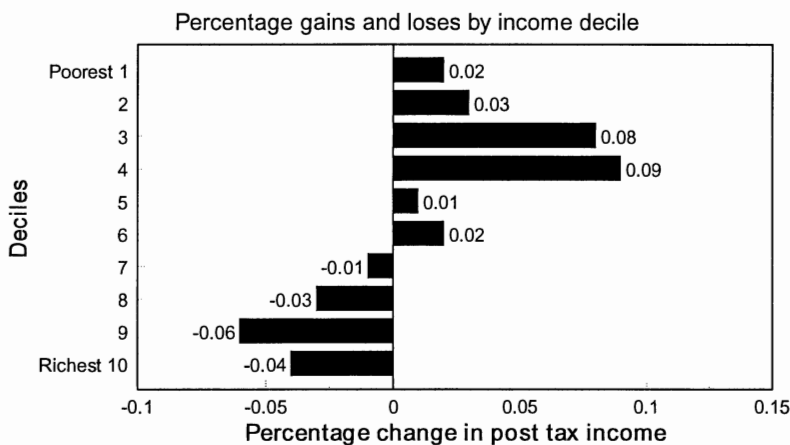
There remains one other reason for proposing cuts in income tax rates, and this relates to presentation. Popular debate about levels of taxation tends to concentrate on very simple measures — principally changes to rates of income tax — rather than considering the full complexities of the tax system. Given that none of the explanations looked at above appears to justify the priority given by the two main parties to cuts in income tax rates, the suspicion must remain that presentational considerations dominated these policy choices.

**Figure 6.1 Distribution of 10p starting rate versus 20p basic rate**



Source: IFS tax and benefit simulations.

**Figure 6.2 Gains and losses of extending allowances relative to 10p starting rate**



Source: IFS tax and benefit simulations.

**Table 6.1 Changes in marginal tax rates resulting from a 10% starting rate of tax**

	<i>Marginal Tax Rate</i>	
	<i>Current system</i>	<i>10% starting rate</i>
Paying income tax (IT) only	20.0	10.0
Paying National Insurance (NI) only	10.0	10.0
Paying IT and NI	30.0	20.0
Receiving family credit (FC) only	70.0	70.0
Receiving housing benefit (HB) only	65.0	65.0
Receiving council tax benefit (CTB) only	20.0	20.0
Paying IT and NI and receiving FC	79.0	76.0
Paying IT and NI and receiving HB	75.5	72.0
Paying IT and NI and receiving CTB	44.0	36.0
Paying IT and NI and receiving FC and HB	92.5	91.5
Paying IT and NI and receiving FC and HB and CTB	96.7	96.3

## 7. Introducing transferable allowances

The Conservative Party manifesto announced a major policy initiative on the taxation of couples. It proposed that married people should be allowed to transfer any unused part of their personal income tax allowance to their partner if that person was caring for a child or a disabled relative under the age of 65. There are two distinct aspects to this proposal. The first is ‘who gains from this change and how do these gains compare with the losses imposed by other changes to the taxation of couples?’. The second issue is whether such a change to the tax system is desirable.

### *Who gains from these proposals?*

The first column in Table 7.1 shows the gains from the implementation of the Conservative proposals for transferable allowances. The gain, averaged across all the families in the population, is 80p per week. However, this gain is concentrated on particular types of families. Only married couples with children or those caring for the disabled can gain from this reform.<sup>16</sup> Even within these categories, only two particular types of families can gain. These are those where just one partner is working or where both work but one partner does not earn enough to pay income tax. The result is that only 1 in 15 families — that is, 2 million out of a total of 30 million — would gain directly from these proposals.

The gains within these groups are therefore much larger than the average gain for the population. The average gain for married couples with children where just one partner works is £10.60 per week. For couples where both partners work, the average gain is less, at £2.30 per week. This is because many two-earner couples are already using all of their personal allowances, so there is none to be transferred to a partner.

The first column of Table 7.1 shows how these gains are distributed according to family income decile. It is clear that the largest gains from the reform are concentrated on the middle deciles, where most single-earner couples are found. The fifth decile gains most, with an average cash gain of £1.70 per week. It is also important to note that the poorest single earners would gain less than others from this proposal, as they will by receiving family credit and other means-tested benefits. Most of the gain they receive from reduced income tax payments would be offset by reductions in the amount of means-tested benefits that they receive.

It is useful to contrast the effects of this proposal with those of the erosion of the married couple’s allowance enacted over the past seven years. The second column of Table 7.1 and

---

<sup>16</sup> The modelled results do not apply to those caring for the disabled, as it is not clear what criteria would be used for eligibility.



Table 7.2 show the combined effect of the transferable allowance proposal and of the restrictions to the value of the MCA. The figures show which types of families have gained or lost as a result of these changes. While the introduction of transferable allowances would offset part of the losses caused by the restrictions to the MCA, the average loss for the population would still be 90p per week.

Again, the distribution of this loss varies across types of families. The only group that gains is couples with children where one partner works. This group will be, on average, £5.70 per week better off. The introduction of transferable allowances does not, however, reverse the losses suffered by other groups from the restrictions of the MCA. Single earners without children and two-earner couples lose on average between £3.20 and £4.30 per week. Couples over pension age lose less, as they were partially compensated for the reductions in value of the MCA. Single parents also lose from the changes, but the average loss for this group is low, as few single parents work. No-earner couples with investment income, such as the early retired, also lose from the changes.

In terms of income, while the fifth decile would gain most, on average, from the introduction of transferable allowances, this gain is not enough to offset the losses that this group have seen through the restrictions to the MCA since 1990. The only groups that would gain, on average, over the period are households in the second, third and fourth deciles.

### *Are transferable allowances desirable?*

The main justification given for transferable allowances is simple enough. At present, if only one member of a married couple works, the couple will benefit from one personal allowance of £4,045 (plus the MCA). The perceived unfairness in this is that if one member of a couple is earning £20,000, say, then he will pay tax on nearly £16,000 of that income, whereas if two members of a couple each earn £10,000, then each will benefit from a full personal allowance and their total taxable income will be just less than £12,000.<sup>17</sup> The idea behind a transferable allowance is that it will allow couples where one spouse is not working to benefit from two full allowances. This sounds attractive but is problematic for a number of reasons.

First, it is not actually clear that it is inequitable that single earners should pay more tax than two earner couples. There are ways in which single earner couples are better off. They benefit from more leisure time and the fact that one partner can stay at home to look after children, while two earner couples as well as having less free time are likely to have extra costs associated with childcare.

Second, the proposal to some extent removes the principle of independent taxation for married couples with children. The tax that each partner in the couple pays will depend directly on the income of the other. This implies that the Inland Revenue would need to know about both partners' incomes. Any changes to the circumstances of one partner during the year will mean an end of year tax adjustment for both partners, with the potential that one will receive a tax refund while the other receives a tax demand.

---

<sup>17</sup> For simplicity, we ignore the MCA as it makes no difference to this comparison.

Third, it means that the very first pound that a second earner receives will effectively be subject to tax. The position of second earners is shown in Figure 7.1. The solid line shows their current tax position, while the dotted line shows their position if transferable allowances were introduced. Currently second earners do not pay tax on the first £4,045 earned. Under the Conservative proposal the first pound they earn will effectively be taxed at 23%. This is because the second earner would take back £1 worth of their allowance from their partner, which leaves the partner with £1 more in taxable income on which tax must be paid. This will continue until the second earner earns over £4,045, when the transferable allowance will be exhausted, and they will start paying tax at the lower rate of 20%. The last time a large group of second earners, who are overwhelmingly women, paid tax on their first pound of earnings was in 1942, before the introduction of the Wife's Earned Income Allowance<sup>18</sup>.

Finally, this policy is aimed specifically at single earner married couples with children. It would not help single parents or cohabiting couples with children. For perhaps the first time in recent years, the tax system would be designed quite specifically to affect the way that people behave in their family relationships. It will form a big financial inducement for unmarried couples with children to get married and it will make it less worthwhile for mothers to go out to work. Whether we want a tax system that affects these decisions in such a way is largely a political and a social, rather than an economic, issue.

**Table 7.1 The impact of transferable tax allowances and restrictions to the MCA by family type**

<i>Family type</i>	<i>Transferable Allowances only</i> <i>Average gain/loss (£ per week)</i>	<i>Transferable Allowances and restrictions of MCA</i> <i>Average gain/loss (£ per week)</i>
Single unemployed	0	0
Single employed	0	0
Single parent family	0	-0.80
NE couple w/o kids	0	-2.30
NE couple with kids	0	-0.60
SE couple w/o kids	0	-4.30
SE couple with kids	10.60	5.70
TE couple w/o kids	0	-4.20
TE couple with kids	2.30	-3.20
Single pensioner	0	0
Couple pensioner	0	-1.30
<b>All</b>	<b>0.80</b>	<b>-0.90</b>

Source : Simulations on the IFS Tax and Benefit model

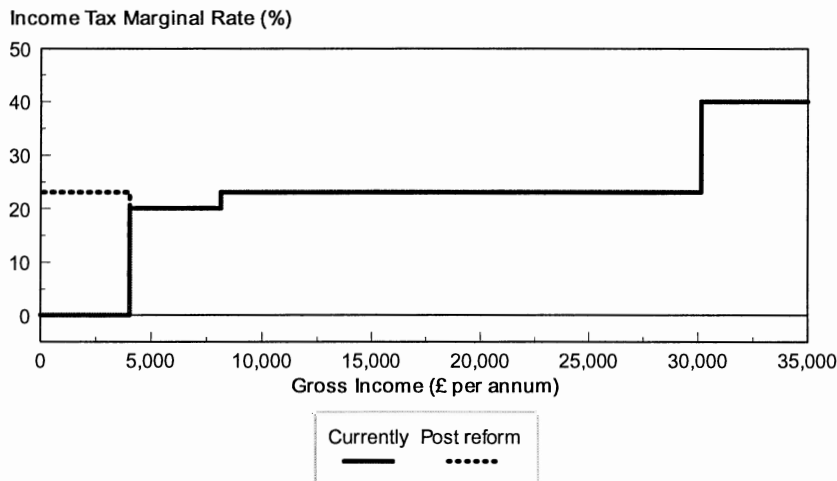
Key : NE No earners  
SE Single earner  
TE Two earners

<sup>18</sup> This allowance was abolished in 1990 with the introduction of independent taxation

**Table 7.2 The impact of transferable tax allowances and restrictions to the MCA by income level**

<i>Income Decile</i>	<i>Transferable Allowances only</i>	<i>Transferable Allowances and restrictions of MCA</i>
	<i>Average gain/loss (£ per week)</i>	<i>Average gain/loss (£ per week)</i>
Poorest	0.00	-0.10
2nd	0.40	0.10
3rd	0.80	0.30
4th	1.10	0.10
5th	1.70	-0.10
6th	1.50	-0.70
7th	1.00	-1.30
8th	0.80	-1.90
9th	0.50	-2.30
Richest	0.40	-3.60
<b>All</b>	<b>0.80</b>	<b>-0.90</b>

**Figure 7.1 The impact of transferable allowances on second earners**



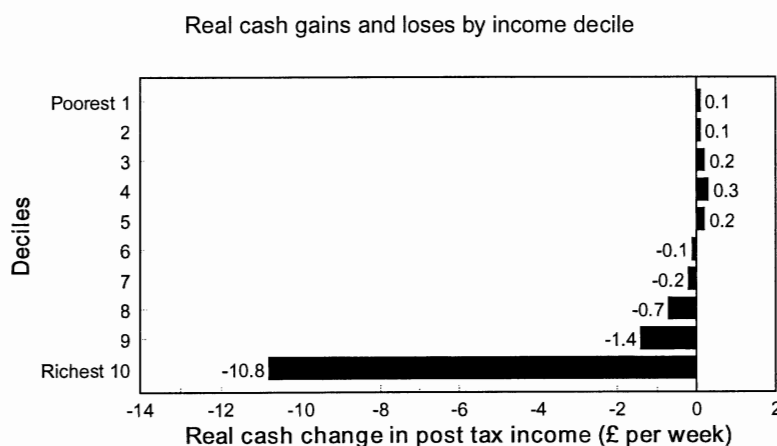
# 8. The Liberal Democrat Tax Proposals

In contrast to the other main parties, the Liberal Democrats have announced proposals to increase income tax. The package involves a 1 percentage point increase in the basic rate of income tax to 24%, a new income tax rate of 50% on taxable incomes above £100,000 per year and an increase of £200 in the personal allowance. This package would raise about £1.8bn in extra revenue. Overall, we estimate the average loss to households, defined as the total loss divided by the number of households in the UK, from these changes would be £1.30 per week.

However, as well as raising extra revenue, this change is designed to redistribute the burden of tax away from poorer groups and on to richer ones, in particular the very rich. The package produces both gainers and losers; income tax payers on incomes under £12,945 per year would typically gain from the changes, while those on incomes above this amount would typically lose.

Figure 8.1 shows the distribution of the gains and losses across households by income decile. The most striking thing about these results is the fact that most of the extra revenue is coming from the richest decile, where the average loss is £10.80 per week. This is due to the proposed 50% higher rate of tax. For anyone who currently pays higher rate tax, but has an income under £100,000 per year, the loss will be £2.70 per week. For those with taxable incomes above £100,000 per year, the losses from this change increase rapidly in cash terms. For example, someone earning £200,000 per year would pay an extra £187 per week, while someone on £300,000 would pay an extra £380 per week. However, there is only a small group of people in the range that would be suffering these large cash losses. Out of 26 million taxpayers, only 140,000 had incomes in excess of £100,000 per year in 1996/97.

**Figure 8.1 Distributional impact of Liberal Democrat income tax proposals**



At lower income levels, the pattern of losses is more moderate. Indeed, on average those in the bottom five deciles — that is, the poorest 50% of the population — gain from the proposals. The biggest average gainers are those in the fourth decile, who gain an average of 30p per week. These gains among lower income households are due to the impact of the increase in tax allowances, which will move half a million people out of tax altogether.

For those who have high enough incomes to be paying basic rate tax, the gains from the increase in tax allowances are offset by the increase in the basic rate. All basic rate taxpayers gain 88 pence per week from the change to allowances, but lose up to £4.23 from the increase in the basic rate. This accounts for the losses in the sixth through to the ninth deciles.

One final point needs to be made here. All these costings assume that there is no change in people's behaviour. But the scope for tax planning and tax avoidance is likely to rise with income, which suggests that the revenue generated from the introduction of the proposed 50% rate would be less than the direct impact reported here.

## 9. Other proposals

The Conservative manifesto pledges to “reduce the burden of capital gains tax and inheritance tax as it is prudent to do so”. We look here at some of the issues raised by this pledge, which in the case of capital gains tax are considerably more complex than they may at first seem. In addition, we look at the distributional effects of the Labour proposal to reduce the rate of VAT on fuel from 8% to 5%.

### Capital gains tax

In 1994/95, some 85,000 people were liable for capital gains tax (CGT), raising £0.8 billion for the exchequer.<sup>19</sup> CGT is levied on the real gains that arise from the disposal of assets. Only non-inflationary gains that have arisen since March 1982 are subject to CGT at the individual’s marginal income tax rate. The tax also has various exemptions and reliefs, of which the most used is the annual untaxed exemption of the first £6,500 capital gain.

While it is true that CGT seems out of place in a system moving ever closer to not taxing the return on savings, its residual role seems likely to persist. Although paid by very few, its complete removal would open up possibilities for tax avoidance that are best left closed. In particular, schemes that artificially transform income into capital gains would generate large benefits in a CGT-free world, as they did when the top rate of income tax was 98 per cent and the CGT rate 30 per cent. The combination of roll-over relief, retirement relief, indexation and the annual allowance provides substantial mitigation of tax liabilities already, and while further piecemeal reform to this already extraordinarily complex tax is possible, not least because of the weight of lobbying, the purely economic case for abolition seems weak.

### Inheritance tax

Inheritance tax (IHT), which is levied on the value of an individual’s estate at death or on assets transferred in the seven years before death, is forecast to raise £1.6 billion in 1997/98<sup>20</sup>. There are numerous exemptions and reliefs, the most important being the allowance of the first £215,000 of an estate, transfers of assets between spouses and gifts to charities. These reliefs mean that the vast majority of estates are not subject to IHT. For those who died in 1993/94, only 6.6 per cent of the estates notified for probate were subject to IHT,<sup>21</sup> and only 58 per cent of estates with a net value greater than the threshold were taxed. In 1993/94, only 17,363 estates were taxed.

---

<sup>19</sup>Inland Revenue Statistics 1996.

<sup>20</sup>Financial Statement and Budget Report, 1997-98

<sup>21</sup>The number of inheritance tax payments as a proportion of total deaths would be significantly lower, as the figure quoted excludes estates either so small or held in such a form as to make a report to the Capital Taxes Offices unnecessary. Source: *Inland Revenue Statistics 1996*.

Inheritance tax is the only major UK tax on wealth, and as such it could be seen as a useful tool of government redistributive policy, ensuring that wealth and unearned influence associated with that wealth is not concentrated amongst the same families across generations. But inheritance tax does *not* fulfil this role very effectively. The structures in IHT ensure that there is no tax incentive to spread wealth amongst recipients, and the ease of avoidance of the tax means that those paying are often simply the wealthy but badly advised.

## VAT on domestic fuel

The Labour Party manifesto pledges to reduce the rate of VAT on domestic fuel from its current level of 8% to 5%, the lowest level allowed under the EU's regulations against indirect tax competition. This move would cost about £400m in lost revenue.

The main reason for Labour's commitment to the reduction of VAT on fuel is a distributional one. Spending on domestic energy accounts for a considerable share of spending by poorer households and rises little with increasing income. In addition, elderly households tend to have fuel expenditures that are above the average. The initial introduction of VAT on fuel was accompanied by a compensation package that benefited both these groups. Despite this compensation, VAT on fuel remained a regressive measure, a fact that is behind Labour's commitment to reduce it to 5 per cent. The distributional impacts of this move are shown in Table 9.1, where the poorer deciles gain most as a percentage of their post-tax income.

**Table 9.1 Distributional impact of reducing the VAT rate on fuel to 5 per cent**

<i>Income decile</i>	<i>Average gain (£ per week)</i>	<i>Average gain (% of post-tax income)</i>
Poorest	0.37	0.46
2nd	0.39	0.32
3rd	0.37	0.27
4th	0.36	0.22
5th	0.39	0.20
6th	0.42	0.17
7th	0.40	0.14
8th	0.43	0.12
9th	0.45	0.11
Richest	0.47	0.07
<b>All</b>	<b>0.40</b>	<b>0.15</b>

Note: This shows first-round effects only; losses if benefits were indexed are not included.

Source : IFS Tax and Benefit model simulations

# 10. Revenue effects of possible tax changes

Given the problems that any government is likely to face in meeting the spending plans set out in the last Budget, it is quite possible that the next government will have to raise taxes, regardless of the platforms set out in its manifesto. Here we show the revenue effects of a number of possible tax changes that any new government might consider.

**Table 10.1 Revenue effects of possible tax changes**

<i>Tax change</i>	<i>Increase in tax revenue (£bn per year)</i>
<b>Income Tax Rates</b>	
Increase lower rate by 1p <sup>*</sup>	£1.0
Increase basic rate by 1p <sup>*</sup>	£1.9
Increase higher rate by 10p <sup>*</sup>	£5.0
Rate of 50% above £50,000 <sup>♦</sup>	£2.5
Rate of 50% above £100,000 <sup>♦</sup>	£1.0
<b>Income Tax Allowances</b>	
Abolition of Married Couple's Allowance <sup>♦</sup>	£3.2
Abolition of Mortgage Interest Tax Relief <sup>♦</sup>	£2.8
Restriction of personal allowance to 23% <sup>♦</sup>	£2.0
Restriction of personal allowance to 20% <sup>♦</sup>	£4.8
<b>National Insurance</b>	
Removal of upper earnings limit on Class 1 contributions <sup>♦</sup>	£3.5
Removal of upper earnings limit on Class 4 contributions <sup>♥</sup>	£0.5
<b>Indirect Tax</b>	
Increase in excise duties on tobacco by 3% <sup>♠</sup>	£0.2
Increase in excise duties on petrol by 5% <sup>♠</sup>	£0.9
<b>Corporation Tax</b>	
Reduction in lower and basic rate of tax on dividends and ACT rate to 15% <sup>♦</sup>	£2.0

Sources ♣ Treasury Tax Ready Reckoner

♦ IFS own calculations

♥Based on figures from Government Actuary's Department

♠ Financial Statement and Budget Report 1997/98

Notes: Costings assume no behavioural changes

All revenue figures are for full year effects



Table 10.1 gives the change in revenue that would be associated with various possible changes to the tax system. Most of the changes are self-explanatory. In the case of changes to the higher rates of income tax and the removal of the upper-earnings limit on National Insurance Contributions, the assumption of no behavioural effects means that these costings are the upper bounds on the amount of revenue that would be raised.

The costing for restricting the personal allowance to 23% assumes that it is implemented as a pure restricted allowance rather than as a tax credit (i.e. lower rate tax payers would not gain from this reform).

Note that the reduction in the basic and lower rates of tax on dividends accompanied by a reduction in the rate of Advance Corporation Tax (ACT) *increases* government revenue. When a company pays a dividend, it makes an ACT payment to the government. In return, the government issues two tax credits, one to the company and one to the shareholder. The company's tax credit is offset against its Mainstream Corporation Tax (MCT) liability. The shareholder's is offset against income tax. This means that if the ACT payment is reduced, so are both the credits. This has the effect of increasing government revenue from MCT and income tax by more than the reduction in revenue from ACT.

Finally, it is worth mentioning the possibility of restricting tax relief on pension contributions to the basic rate of 23%. It is extremely hard to estimate how much this might raise; however, using a combination of figures for employees derived from the IFS Tax and Benefit model, and the balance between employee and employer contributions recorded in *Inland Revenue Statistics* we would estimate a possible revenue increase of the order of £1.5–£2 billion for this policy. We should say though that the implementation of such a policy would be likely to lead to significant changes in saving behaviour that could reduce the revenue considerably.

# 11. Central / local relations

## Introduction

The Labour manifesto pledges the party to a significant decentralisation of power from Whitehall under a Labour government whilst the Conservatives promise a far less radical agenda which is broadly consistent with the centralising reforms of recent years. Labour's proposals differ from those of the Conservatives in four important respects - (1) the capping of local authority spending, (2) the release of the accumulated capital receipts to finance housing investment, (3) the introduction of a Scottish parliament, Welsh Assembly and Regional Chambers in England and (4) consultation on the return of non-domestic rates to local control. In addition, the Conservative Manifesto pledges the party to reduce the burden of non-domestic rates on small businesses.

## Capping

In 1996/97, the government's policy of capping the expenditure of local councils was a major influence on the local budgetary process with 77 % of authorities setting their budgets at the centrally determined cap. Aggregate local authority expenditure in England is a mere 0.3% below the level permitted by the capping system, representing less than £10 in Council Tax on a Band D property<sup>22</sup>.

In their manifesto, the Conservatives argue that they "*will, for so long as is necessary, retain the power to cap local authorities to protect taxpayers*". Labour argues, by contrast, that "*although crude and universal council tax capping should go*", they will "*retain reserve powers to control excessive council tax rises*", which implies at least a partial relaxation of the present capping arrangements.

### *Impact of capping on the public finances*

Under a more relaxed local finance system, a major constraint on local authority expenditure is high gearing ratios<sup>23</sup> which mean that, on average, a 1% increase in local spending above SSA leads to a 4.1% increase in local tax bills in England in 1997–98<sup>24</sup>. These gearing ratios vary considerably between authorities, ranging from a little over 2% in some shire districts to 9.3% for one Inner London borough.

Any increase in spending which did occur if capping were relaxed would count towards the control total. As a result, Labour's commitment to the relaxation of capping sits rather uneasily with the party's pledge to stick to already announced expenditure plans, unless

---

<sup>22</sup> Source : Finance and General Statistics (1996/97). CIPFA.

<sup>23</sup> The percentage increase in local tax bills for a 1 per cent increase in spending above the Standard Spending Assessment (SSA).

<sup>24</sup> Source : Department of the Environment web-site.

Local Authority Self-Financed Expenditure (LASFE) were to be taken outside the control total, as was the case during the Community Charge era.

Any council tax increases that resulted from the abolition of capping would have two additional impacts on the public finances. First, council tax benefit is expected to cost the government £2.1 bn in 1996/97<sup>25</sup>, some 19% of the estimated Council tax yield<sup>26</sup>. For every £1 increase in local spending, central government would pay an extra 19 pence in Council Tax benefit (CTB) for those already receiving CTB, and numbers entitled would rise. Second, increases in Council tax increase the measured Retail Price Index which is used for the annual uprating of benefits such as child benefit and the State pension. Thus, any rise in local taxes leads to increased central government social security spending generally.

Taking these factors into account, it is likely that a Labour government would phase any removal of capping controls, retain residual powers to prevent “excessive” increases in spending, and hold back any reforms which would enhance the local tax base and hence reduce gearing ratios until the local finance system had adjusted to a less restrictive local finance regime.

### **Release of capital receipts**

The Labour Party manifesto pledges that “*the phased release of capital receipts from council house sales will increase the stock of housing to rent*”. By 31st March 1996, English local authorities had accumulated £7.5 bn<sup>27</sup> of receipts from the sale of the council housing stock and other capital assets which the government has not allowed them to spend on investment.

Whilst potentially a politically attractive method of increasing investment in social housing, the release of accumulated reserves would score against public spending totals and the PSBR in exactly the same way as new borrowing. Compared to planned public sector capital expenditure of £18 bn<sup>28</sup> for 1997/98, releasing the whole stock of accumulated receipts in England would represent a 42% increase in capital spending in one year or 14% if spread over the current three year planning period.

#### ***How the “receipts mountain” arose.***

The 1980s Conservative policy of promoting home ownership by selling council houses to existing tenants at discount prices threatened to conflict with the policy of controlling local authority capital spending by placing large volumes of capital receipts in the hands of local councils. To retain firm control of local spending, the government introduced a series of provisions which required councils to “set aside” 75% of any receipts from the sale of council housing, and 50% of the receipts from the disposal of other assets. These could not

---

<sup>25</sup> Source : Public Expenditure Statistical Analysis 1996-97. HM. Treasury. March 1996.

<sup>26</sup> Source : Financial Statement and Budget Report (1996/97). HMSO.

<sup>27</sup> This figure is based on the sum of “provision for credit liabilities” across all local authorities in England. Figures supplied by the Department of the Environment.

<sup>28</sup> Financial Statement and Budget Report 1997-98. HM Treasury. November 1996. Table 5.4

be used for further capital spending but could be used either to repay debt directly or to make provision for future debt repayments.

Rather than use all of the “set-aside” receipts to repay debt, many local authorities amassed significant stocks of liquid assets. In part, this was in the hope that future governments would allow them to spend the accumulated receipts. Largely, however, this was a rational response to asset management given that interest rates during most of the last sixteen years have been substantially higher than the low fixed rates charged on much of the existing stock of local authority debt.

### ***Impact on the PSBR***

If the release of capital receipts represented a simple addition to existing spending plans, General Government Spending and the PSBR would each rise by £7.5bn, possibly spread over a number of years. However, the effect on the PSBR could be ameliorated in two ways. First, central government might reduce borrowing approvals to those authorities with large stocks of liquid assets. Since local authorities were issued credit approvals worth £3.2 bn in 1996/97<sup>29</sup>, reductions in borrowing could, in principle, fully neutralise the impact of a phased release of capital receipts. Second, the relaxation of the present capital finance system might encourage local councils to dispose of a greater level of assets; these asset disposals reduce public spending totals and the PSBR.

### ***Distributional issues***

Those councils with large volumes of the receipts may not be those with the largest concentration of needs. Whilst Outer London boroughs have an average of £231 of accumulated receipts per capita, Metropolitan districts, which have many similar characteristics, have only £108 per head. Within Inner London, whilst some authorities have no accumulated receipts at all, one authority has £366 per head.

As a result of this mis-match between spending power and spending need, a future government may be placed under pressure to redistribute spending power between authorities. Whilst it is unlikely that redistributing receipts between authorities would be politically feasible, the reallocation of borrowing credits to take account of existing receipts would have a similar effect in practice. In some cases, this might require the issue of negative borrowing approvals<sup>30</sup> (effectively forcing local authorities to repay debt) where councils have fairly large stocks of receipts and already have zero borrowing approvals.

### ***Policy priorities***

Whilst the release of accumulated capital receipts would require primary legislation, the Secretary of State has the power to relax the current set-aside provisions, as occurred during 1993. In 1994–95, this would have released an extra £1.7 bn<sup>31</sup> of capital receipts in England alone. One attraction of this approach might be that since local authorities would have a

---

<sup>29</sup> Source : Public Expenditure Statistical Analysis 1996-97. HM. Treasury. March 1996.

<sup>30</sup> This would require primary legislation, as would the release of accumulated capital receipts.

<sup>31</sup> Local Government Financial Statistics No.7 (1996). Department of the Environment.

greater incentive to dispose of assets, any increase in capital receipts which resulted might help to offset some of the impact of higher capital spending on the PSBR.

## Devolution

Whilst the Conservative Party is committed to retaining the present constitutional arrangements if it retains power at the next general election, the Labour Party has a substantial reform agenda involving introducing legislation for a Scottish parliament and a Welsh Assembly within its first year of government, with more limited plans for introducing a more accountable regional tier of government in England and a strategic authority for London at a later date. Each of these new bodies would require simple majority approval in a referendum but only the Scottish parliament would be given tax-raising powers, subject to referendum.

**Table 11.1 : Government spending, tax receipts and income per capita : Scotland and England (1993–94).**

Index, England=100

	<i>Per capita income</i>	<i>Per capita tax receipts</i>	<i>Per capita spending</i>	<i>Per capita health spending</i>	<i>Per capita education spending</i>	<i>Per capita social security spending</i>
Scotland	96.8	94.7	123	127	133	110
England	100	100	100	100	100	100

Source : Blow, Hall and Smith, *Financing Regional Government in the United Kingdom*, IFS commentary no. 54. (1996).

The Labour party's manifesto plan is that a future Scottish parliament would have the power to vary the Scottish basic rate of income tax by up to three pence in the pound up or down. With 2.1 million income tax-payers in Scotland, three pence on the basic rate of income tax in Scotland would raise just over £500 million<sup>32</sup> of revenue for a Scottish parliament which works out as £100 per capita or an average £214 per income tax payer<sup>33</sup>. In comparison, local authorities in the United Kingdom raised £166 per capita through the Council tax in 1995/96. A Scottish parliament's discretion over revenue raising would be limited to only 3.6% of the Scottish Office's budget for 1996/97<sup>34</sup>.

The basic rate of income tax in Scotland would be highly geared to the spending decisions of a Scottish parliament. A 1% increase in Spending would lead to an increase in the Scottish basic rate of income tax by just less than a penny in the pound, an increase of over 4% in the basic rate. This high "gearing ratio" means that the Scottish basic rate of income tax might be highly sensitive to any cut in the block grant provided by Whitehall, in a similar fashion to the influence of central government grant on local authority council tax rates.

<sup>32</sup> The methodology used to produce this figure is explained in "Options for 1997". IFS Green Budget. October 1996.

<sup>33</sup> Number of Scottish income tax payers. Source : Inland Revenue Statistics 1996. HMSO.

<sup>34</sup> Source : Financial Statement and Budget Report (1996/97). HMSO.

Table 11.1 shows that whilst income per head and identifiable<sup>35</sup> tax receipts per head in Scotland are only slightly lower than in England, identifiable per capita government spending is much higher in Scotland. For example, spending on education is 33% higher than in England and spending on health care is 27% higher. There is no reason, in principle, why the fiscal transfers which currently exist between Scotland and the rest of the United Kingdom should not continue to occur in the presence of devolved regional government. After all, the local government finance system is characterised by a very extensive system of equalisation of both needs and resources and large fiscal transfers exist in many federal states. On the other hand, a move to a more decentralised system of government is likely to increase the transparency of these implicit fiscal transfers. In the longer run, the size of these fiscal transfers could become a subject of substantial political debate.

## **Business rates**

Business rates are set to raise £14.2 bn in 1996/97, compared to £26.1 bn in Corporation tax and £9.9 billion in Council tax<sup>36</sup>. Since 1990, rate poundages have been determined by central government and have applied at an uniform rate, known as the Uniform Business Rate (UBR). This is applied to the “rateable value” of each property to determine tax bills. Labour proposes consultation on a return to locally varying business rates whilst the proposed Conservative reforms are aimed at reducing the burden of the tax on small business.

### ***The Labour Proposals***

The Labour manifesto argues that “there are sound democratic reasons why, in principle, the business rate should be set locally, not nationally”. However, the Labour party also pledges that the party “will not change the present system for determining the business rate without full consultation with business”. Given the traditional hostility of the business community to locally varying business rates, this falls far short of a specific pledge to return to a pre 1990 style system of locally varying non-domestic rates.

At present, council tax only pays for 23% of discretionary local spending<sup>37</sup>. This may damage local democracy for two reasons. First, if “he who pays the piper calls the tune”, central finance may lead to too great a level of uniformity in service provision. Second, this leads to high gearing ratios which, for an average authority, means that a 1 % increase in local spending above SSA leads to an increase in council tax bills of 4.1%. This makes local tax bills highly sensitive to central grant and makes comparisons of the performance of authorities which have different gearing ratios very difficult for voters. The return of non-domestic rates to local control would increase the local tax contribution to over 50% of local spending, and reduce average gearing ratios by more than a half. However, these arguments would apply to any addition to the local tax base, and apart from administrative simplicity, non-domestic rates have few merits as a local tax.

---

<sup>35</sup> The methodology used to derive these figure is explained fully in Blow, Hall and Smith “Financing Regional Government in the United Kingdom”. IFS Commentary No. 54.

<sup>36</sup> Source : Financial Statement and Budget Report 1997-98. HM. Treasury. November 1996. Council tax figure is net of Council Tax Benefit.

<sup>37</sup> Local authorities also spend considerable resources on administration of Council Tax Benefit, Housing Benefit and Mandatory Student Awards, which they carry out on behalf of central government.

Two particular disadvantages of locally varying business rates are often advanced. First, they damage local accountability by placing some of the burden of local spending on firms which do not have a vote - breaking the link between taxation and representation. In addition, the uneven distribution of the tax base necessitates complicated equalisation arrangements which blur the link between local spending decisions and household tax bills. Second, large variations in local tax rates may be bad for business by creating incentives for migration to low tax areas, generating a dead-weight loss for the economy as a whole. In practice, however, the empirical evidence on the effect of locally varying business property taxes on economic activity is rather mixed<sup>38</sup>.

A more modest reform which might be both consistent with Labour's aims and acceptable to the business community could be the introduction of US-style Business Improvement Districts (BIDs), in which areas of city centres would pay higher taxes for specific improvements to service provision, in much the same way as the managers of out of town shopping centres levy charges on occupants to provide common services.

### *The Conservative proposals*

The Conservatives plan to "reform business rates to reduce the cost that falls on small businesses". Whilst the manifesto gives no details of how this might be done, a number of issues arise :

- **Would relief help small firms or small properties ?** Whilst it would be relatively simple to target relief on small *properties*, defined in terms of rateable value<sup>39</sup>, targeting relief on small *firms* would lead to additional administrative costs since information on turnover is not presently available to local authorities.
- **Would small firms actually gain ?** Experience of partial derating for charities suggests that when a property is rated as a single building, it is not possible to identify the rates paid by individual tenants, and hence to give relief to those tenants who would qualify for it. Presumably small firms are particularly likely to be in multi-tenanted properties. In addition, if the type of premises occupied by small firms is distinctive, and not fully substitutable for the type of premises occupied by larger firms, landlords might be able to capture some of the relief for themselves by charging higher rents on such properties.

### **Concluding remarks**

The manifestos of the two major parties appear to differ substantially in their reform agendas for central/local relations. The Labour manifesto promises a significant degree of decentralisation of power from Whitehall with the possible introduction of a regional tier of government, and a relaxation of existing controls on local authorities. In comparison, the Conservative manifesto promises a far more modest reform agenda, and one which is very much in line with the reforms of the last four Conservative governments.

---

<sup>38</sup> See Denny, Hall and Smith, *Options for Business Rate Reform*, (1995) for a survey.

<sup>39</sup> Small properties already receive differential treatment under the transitional relief arrangements.

## 12. Labour's windfall levy

The Labour Party manifesto promises that, should Labour be elected, they would impose “a one-off windfall levy on the excess profits of the privatised utilities” (p. 19). However, apart from the fact that the levy will be imposed in the event of the Labour Party forming a government in 1997, and that the money raised will be used to finance a programme of schemes to help the young and long-term unemployed back into work, there are few details about the precise form this levy might take, exactly which companies might be affected by it, or how much money it would raise.

### **Who, how much and why?**

The Labour Party's shadow Chancellor, Gordon Brown, recently stated that all utilities privatised since 1979 and licensed by statute would be liable to the tax. This suggests that the tax is likely to include the regional electricity companies (RECs), the water and sewerage companies (WASCs), the electricity generators and the National Grid, as well as British Gas (BG), British Telecom (BT) and the British Airports Authority (BAA). More recently privatised companies, such as Railtrack and British Energy, might also be included, if the tax base runs up to the present.

No definite figures have been given for the amount of revenue that the tax will raise, although the programme of unemployment schemes is estimated to cost £3bn over the lifetime of the first Labour Parliament. The windfall levy is expected to meet these costs comfortably, and might raise significantly more.

The Labour Party has justified the tax with the arguments that the companies were sold off ‘too cheaply’ at the initial privatisation, that the regulatory regime has been ‘too lax’ over the period since privatisation; and that the companies have been able to exploit a degree of monopoly power. These last two points are closely related, since if the utilities had no monopoly power to exploit, the relative strength of the regulatory regime would be unimportant.

With the benefit of hindsight, shareholders in some of the utilities would clearly have been prepared to pay more for those companies, while shareholders in other utilities would not. Although the share prices of the water companies, the RECs, BAA and some of the generators have performed well in comparison with the stock market as a whole, shareholders in BT, British Gas and the Scottish electricity companies have not done so well.

### **Who will pay the tax?**

The question of who will ultimately pay the tax is difficult to answer. If the tax is truly one-off, and relates to profits which have been earned in the past, which companies cannot affect by their behaviour today, then prices and investment should not change. Hence, the burden of the tax would fall largely on the shareholders.

But which shareholders? Perhaps the most serious criticism of the windfall levy is that it is unlikely to tax all the owners of the firms who have actually received excess profits from the



privatisation of these companies, and does tax some owners who have not benefited. In the first day or two of trading of the utilities' shares, between 15 and 26% of the shares changed hands. Those who sold out immediately will not bear the burden of the tax. In addition, some of the utilities have been bought by other companies. Of the original 12 RECs, only Southern Electric has not either already had, or agreed upon, a change of ownership. The new owners would argue that they have not reaped the excess profits, but the price these companies actually had to pay for the utilities will have been lower than if the idea of the tax had never been adopted by Labour.

If there is a perception that the tax might be levied again or that the tax reflects a less stable regulatory regime than previously thought, this would lead to an increase in the cost of capital for the affected firms (i.e. the cost of financing their investments). If the cost of capital increased, this would be likely to feed through into higher prices set at the next regulatory review. An increase in the cost of capital might also reduce the amount of investment carried out by the firm, which would result in the tax being shared between customers, shareholders and employees, through lower cost reductions in the future, lower dividend payments and lower levels of employment. The Labour Party has, of course, emphasised that the tax would be one-off, so the cost of capital should not increase very much.

### **Implementing the tax**

What would the windfall tax be levied on? The Labour Party has not specified exactly what the base would be, but the method used to calculate 'excess profits', and the period of time those profits were earned over would have a significant effect on the payments of individual companies concerned.

Table 12.1 shows how the tax burden might be shared between the different utility sectors, according to three different types of tax base — one that uses total sales, one that uses a measure of excess shareholder returns based on share price and dividend information, and one that estimates excess profits based on company accounts information. These figures are not intended to predict how the burden of the windfall levy would be shared between different sectors, but to demonstrate how sensitive those shares would be to the actual measure of the tax base used.

A tax based on size as measured by sales would mean that a large part of the tax was paid by the group of 'other' companies (BT, BG and BAA), and a large part paid by the electricity companies, both RECs and generators, while the water companies would pay relatively little. Unlike the example based on turnover, the balance shifts away from the group of 'other' utilities, towards the electricity and water companies when excess shareholder returns are used. When an excess profits measure is used, the burden falls more heavily on the group of 'other' companies than was the case for excess shareholder returns. In particular, the water companies would pay a much smaller proportion of the tax, and BT would pay substantially more.

**Table 12.1: Estimated distribution of a windfall levy**

Sector	Total sales (1995)	Excess share- holder returns (1991–95)	Excess pre-tax profits (1993–95)
WASCs	11%	23%	9%
RECs	28%	34%	30%
Generators	18%	27%	27%
Others	43%	16%	34%

## Notes

1. The figures show the share of the total windfall levy liability paid by each sector under the alternative tax bases. Figures may not sum exactly to 100 due to rounding. The definition of the tax bases used are given in the text.

2. The WASC sector contains the 10 water and sewerage companies privatised in 1989. The REC sector contains the 12 regional electricity companies privatised in 1990. 'Others' includes British Gas, British Telecom and BAA. British Energy and Railtrack are excluded due to a lack of available accounting data.

3. Excess shareholder returns are taken from OXERA, 'The windfall tax', *Energy Utilities* (November 1996), and are based on a return index which accounts for both dividend income and capital gain, and assumes that these are re-invested in the company. The return from the FTSE-All Share index is subtracted, as an approximation of the normal return.

4. Excess pre-tax profits are based on company accounting data, as described in *Options for 1997: The Green Budget* (1996, IFS). A deduction is allowed for 'normal' profits estimated at 10 per cent of the net book value of total assets employed.

Which of these measures is the most suitable? Total sales in one year has the advantage of being easy to calculate, but does not necessarily bear a strong relationship to the company's excess profits, and is likely to be sensitive to the particular year chosen. Excess shareholder return has the advantage of appearing to be closely related to the rationales suggested for the tax, but the disadvantage of using share price as part of the calculation, since share prices are based on the expected *future* stream of income from the company, and so depend upon expected future profits growth. The aim of the windfall levy appears to be to extract a part of excess profits which have been earned in the *past*. Excess profits based on accounting data have the advantage of being related to the profits have been earned in the past by the company, for which the company is being taxed. The disadvantage of using accounting profit as the base is that it does not incorporate the idea that the companies were sold off too cheaply, and creates the problem of estimating what 'normal' profits might be.

Given that the rationales for the windfall levy argue that the initial share price was too low, and that the returns since privatisation have been too high, it seems likely that a measure would be adopted which takes account both of the initial value of the companies on flotation, and the excess returns since then. This suggests the excess shareholder return method might be used, perhaps over a fixed period of time immediately following privatisation. This tax base would tend to shift the burden of the tax towards the electricity and water sectors.

One final, and troubling, aspect of the tax is that it demonstrates the fact that political parties increasingly seek to conjure up new taxes on targets they believe will be palatable to the

electorate, in order to raise revenue, rather than being able to do so from the existing tax structure, which would be more coherent economically, and also more transparent.

## 13. Pensions and the welfare state

No part of the welfare state has been reformed so radically as has pension provision over the past 18 years. The present government has changed the method of uprating the basic state pension so that since 1980 it has risen in line with prices rather than according to the previous formula of the faster of prices and earnings. This is saving around £6 billion a year (net) and has resulted in the basic pension for a single person being around £20 a week less than it would otherwise have been.

Perhaps more radical have been the policies associated with the state earnings related pension SERPS. Its (future) value has been more than halved and around three quarters of the workforce are no longer members of SERPS because they have contracted out into occupational or personal pensions.

The Conservatives have suggested taking this type of policy one substantial step further. They have suggested that, for people newly entering the labour market, instead of building up entitlements to the basic pension as at present they should have a fund accumulating. The government would pay £9 per week into each person's fund, just as National Insurance rebates are paid into approved personal pensions. The funds would come from general tax revenues. In addition no further SERPS would be accumulated on an unfunded basis, instead 5% of salaries would have to be placed into a privately funded pension. This latter step is less radical than it sounds just because three quarters of workers are already contracted out of SERPS. The former step, by contrast, is a radical break.

In general changes of the type mooted are considered "unaffordable" because of the size of transition costs. They imply that one generation will have to pay for their own pensions and for the pensions of current pensioners, because current pensions are paid out of current receipts. The Conservatives' proposals, however, try to get around this in two ways. First they propose to phase in the changes so that nobody retiring before 2040 would receive the rebates. This keeps the costs low in the short run and allows some sharing of costs between generations. But it does not change the fact that there will be transition costs. Secondly, the Conservatives propose to make use of tax relief on pension contributions. The idea is that instead of providing tax relief for contributions, as now, contributions would be taxed but pensions in payment would be free of tax. This would effectively bring tax receipts forward to cover some of the cost of the double funding of pensions as it occurred.

This "solution" itself suffers from a number of problems. The first is just that it could be very complex to implement. Assigning employer contributions to occupational schemes to individuals is fraught with difficulties. Secondly, there is a question of trust - if the tax relief is not available up front what is going to hold a government 40 or more years down the road to providing it? Thirdly, it brings into doubt the reasons for making voluntary contributions to pensions. Why put money into a pension if the tax treatment of Personal Equity Plans, for example, is identical and the money is available at any time?

Finally, one has to ask what particular problem this proposed change is intended to address. There is no real funding problem for the basic pension. Indeed, as Table 13.1 shows,

National Insurance Contribution rates are projected to fall since increases in the tax base, resulting from higher earnings, will more than pay for the increased spending occasioned by increased numbers of pensioners. This is largely because the value of the basic pension will be so low as a proportion of average earnings by the middle years of the next century.

Table 13.1  
Estimated class 1 NI contribution rates under current policy

Financial year	Estimated class 1 NI rates (%)
1994/95	18.25
2000/01	17.7
2010/11	17.4
2020/21	16.8
2030/31	17.2
2040/41	15.8
2050/51	14.0

Source: Government Actuary's Department, 1995.

At approximately the same time that this pension proposal was announced the government also announced a scheme designed to promote the take-up of private insurance for the purposes of long term care. The idea is simple enough. At present people have to pay their costs of long term care so long as they have assets, *including* their house, in excess of £10,000. The government's proposal was that people buying insurance would be able to keep assets up to 1.5 times the value of the insurance bought. So someone buying an insurance policy paying out £50,000 to pay for care once their needs meet a certain level would, even after they had used up that £50,000, still be allowed to keep assets worth £75,000 *and* receive help from the state.

These proposed changes have one important thing in common with each other, and indeed with Labour Party proposals on pensions. The latter can effectively be summed up as continuing to allow the basic pension to wither by increasing it only in line with prices, improving the delivery of benefits to the poorest pensioners and encouraging the use of private provision through "stakeholder" pensions.

This is certainly a radical change to the proposals put forward by Labour at the 1992 general election. Then the party promised to raise the basic pension immediately - by £5 a week for single pensioners, and £8 for married couples - and to index it to earnings thereafter.

The point of all these policies is that they provide, in one way or another, a basic minimum level of provision through the state, and then encourage people who want to, or can afford to, to pay more. The minimum provided by the state - under either party's proposals - will be very low. To achieve a "reasonable" standard of living, or to protect their assets, people will have to invest more.

In this sense these policies provide an interesting comparison with the nursery voucher scheme proposed by the Conservatives as a step towards providing four-year-olds with nursery care. At a value of £1,000 these vouchers will be enough to pay for a very basic level of care, but those who want better will have to pay for it. The Labour Party's apparent support for direct provision of nursery places is closer to the traditional model of the welfare state.

One can begin to see how the new pattern of welfare provision might develop, in response to continued tight spending plans. In the NHS one could imagine a very basic level of provision being provided free with better facilities or more treatments available to those willing and able to pay. This is an issue specifically different from the reorganisation of health service provision that the Conservatives have overseen, though competing hospital trusts and GP fundholders would be in a position to play their part if such a policy change were to occur.

In other areas of social security we are already seeing a significant development in private permanent health insurance to supplement Incapacity Benefit - itself much less generous than the Invalidity Benefit of the 1980s, especially since the phasing out of earnings related additions. In addition the state will now only step in and pay mortgage interest costs after 39 weeks on Income Support - private insurance or one's own resources have to cover the interim.

# 14. The distributional effects of a national minimum wage

Both the two main opposition parties have pledged to introduce a minimum wage if they win the election. The essential argument for a minimum wage is set out in the Labour manifesto: “The minimum wage will remove the worst excesses of low pay (and be of particular benefit to women), while cutting some of the massive £4 billion benefits bill by which the taxpayer subsidises companies that pay very low wages” Labour party manifesto p 17

Rather than speculating on the possible effects of a minimum wage on employment we look here at what sort of people will be affected, whether those who gain are poor relative to those who do not and what might happen to benefit expenditure. As no party has committed itself to an exact level for a minimum wage we simulate the possible effects at various levels.

## How many people will be affected?

The more workers are affected by a minimum wage, the greater the potential costs in terms of unemployment and price rises. Table 14.1, which uses data from the 1995 Family Expenditure Surveys, shows that even a minimum wage of £3.00 per hour would affect over 5% of employees, most of whom would be women. A minimum wage of £4.50, would affect 26% of workers. Three things emerge from this table: first is the overall extent of low pay in the UK, second is the much higher prevalence of low pay among women than among men, and third is how much difference the exact level of a minimum wage would make to the number of workers covered.

**Table 14.1: Percentage of workers aged 19–59 affected by a minimum wage at various levels**

	£3.00	£3.50	£4.00	£4.50
Men	2.6%	5.3%	9.5%	14.1%
Women	8.2%	18.6%	29.0%	37.6%
All Workers	5.4%	12.1%	19.4%	26.1%

Sources: Family Expenditure Survey for calendar year 1995, converted into December 1996 prices

One possibility is that younger workers would be specifically removed from the coverage of a minimum wages This exclusion of younger workers might be automatic or contingent on the provision of on-the-job training. Table 14.2 shows the proportion of workers over 21 who would be affected by the same potential levels of minimum wage as in Table 14.1. The overall proportion of the “adult” workforce affected is smaller but the differences are not huge and are very small for women. Part of the reason why these differences are not bigger is just that many in the 19–21 age group are not in work. Nevertheless these results show quite clearly that a minimum wage even set at the relatively low levels of £3 or £3.50 an hour would not just affect the youngest workers.

**Table 14.2 Proportion of workers aged 22–59 affected by a minimum wage at various levels**

	£3.00	£3.50	£4.00	£4.50
Men	1.9%	4.0%	7.3%	11.5%
Women	7.6%	17.1%	26.9%	35.3%
All Workers	4.8%	10.7%	17.3%	23.6%

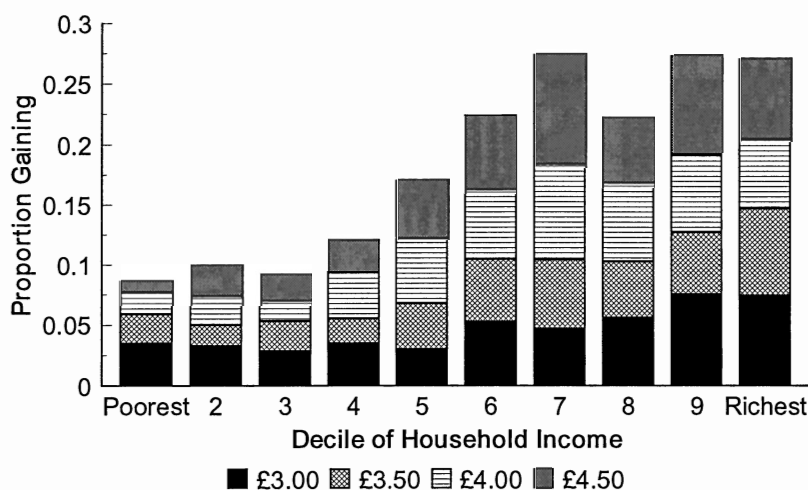
Source: Family Expenditure Surveys for calendar year 1995, converted into December 1996 prices

It is worth pointing out briefly that the initial level at which a minimum wage is set is not all that matters. How it changes over time is also crucial. If it increases in line with prices then the wages of low paid workers will not rise with increases in the overall standard of living. On the other hand, if a minimum wage is increased in line with average or median wages, it is likely to affect an increasing number of people over time.

### Would a minimum wage reduce income inequality?

Some of the growing pressure for a national minimum wage has come from the increase in the gap between rich and poor that has occurred since the late 1970s. But Figure 14.1 shows that most of those who would gain from a minimum wage of between £3.00 and £4.50 an hour are actually in the top half of the household income distribution. This is because most gainers either have a working spouse or are younger people still living with their parents. Naturally those who do not work will be unaffected. These facts are illustrated in Figure 14.2, which shows the proportion of various family types which would have increased incomes after the introduction of a minimum wage.

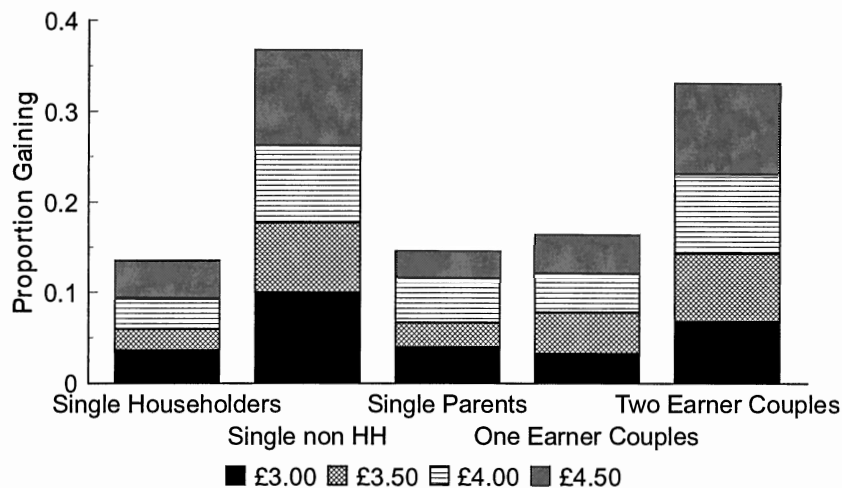
**Figure 14.1: Proportion of households with increased incomes after the introduction of a minimum wage**



Source: Family Expenditure Survey 1994/5



**Figure 14.2: Proportions of family types with increased income after the introduction of a minimum wage**

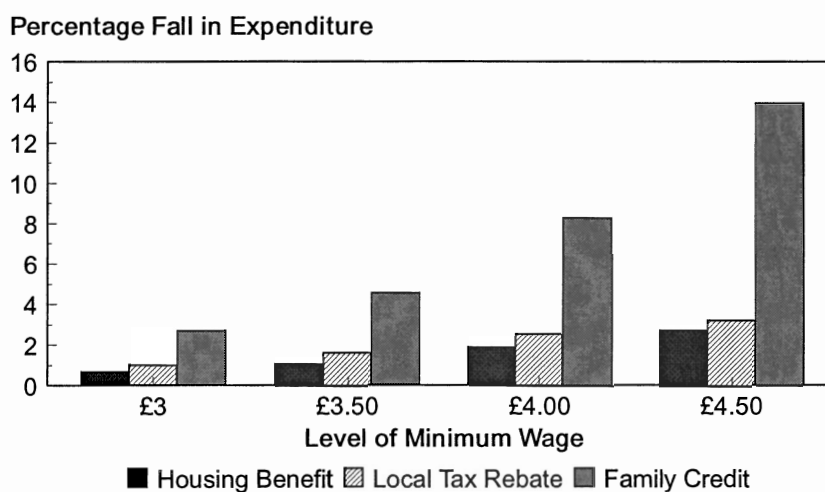


Source: Family Expenditure Survey 1994/5

### A minimum wage and in-work benefits

The Labour manifesto claims that a minimum wage would also cut the costs of in work social security benefits. These are not only a drain on the exchequer but can also serve to distort the workings of the labour market. A minimum wage set between £3.00 and £4.50 an hour is, however, not enough to float many people off benefits. Family Credit, for example, is designed to provide help for low paid families with children. Even with a minimum wage of £4.50 an hour only 5% of recipients would be floated off the benefit altogether.

**Figure 14.3: Percentage Fall in Expenditure on In-work Benefits for non-pensioners**



Source : Family Expenditure Surveys and TAXBEN

Figure 14.3 shows how expenditures on in-work benefits for non-pensioners would be likely to fall after the introduction of a minimum wage set at various levels. The largest falls are, not surprisingly on family credit. Still the bill would only fall by about 15% even

at £4.50 an hour. If more in-work benefits were extended to the childless (such as the proposed Earnings Top Up Scheme), one would expect the effects to be greater as more of the childless would be affected.