briefing notes

LONG-TERM TRENDS IN BRITISH TAXATION AND SPENDING

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1. The Scale of the Public Sector

In 2000, government spending in the UK was a little less than £360 billion and government revenues a little more than £370 billion. Numbers like these are so large as to be hard to interpret, but they equate to between £14,000 and £15,000 for each UK household – an amount equivalent to the post-tax income a childless couple would need to be in the middle of the income distribution.[1]

Looking back over the period since 1939, we have seen substantial growth in the size of government. There has been an increase by a factor of about 5.5 compared with 1938 in the real level of government spending. But while changes in the real level of spending provide some indication of the developments we have seen, they conflate the growth of the whole economy and the change in the role of government within that economy. Since 1938, the real level of GDP has grown by a factor of somewhat less than 5. We therefore focus in most of the rest of this section on the share of the economy absorbed by government activity.

Figure 1.1 shows the level of government revenues and spending since 1900, so as to set our discussion of the period from 1939 in the context of the whole of the twentieth century.

Perhaps the most striking feature of Figure 1.1 is the role of wars. The twentieth century begins with relatively high spending reflecting the costs of the Boer War. The First and Second World Wars both lead to very large increases in public spending and rather smaller increases in tax. The Korean War (1950–53) may just have a discernible effect, but neither the Falklands (1982) nor the Gulf (1991) conflict seems to have had an impact on spending that is visible in Figure 1.1.

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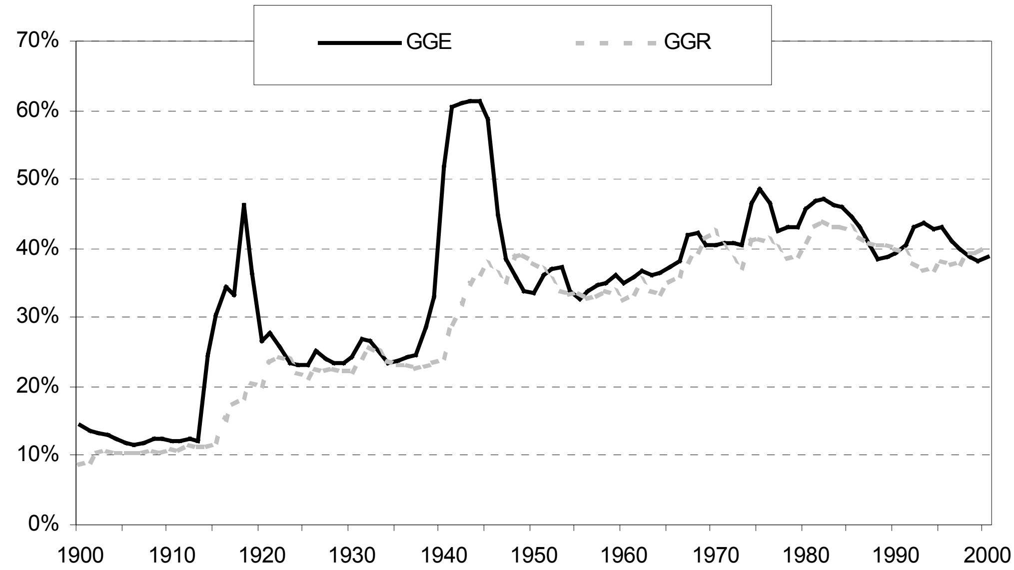
[1] A. Goodman, *Inequality and Living Standards in Great Britain: Some Facts*, IFS Briefing Note no. 19, 2001, www.ifs.org.uk/inequality/bn19.pdf. The similarity of median income and government spending per household helps give a rough feel for the scale of the latter. But, for several reasons, it implies little about the relative magnitudes of private and public spending – for one thing, because some items (such as social security benefits) count in both.

Figure 1.1. Government spending and revenues as a percentage of GDP since 1900



GGE = general government expenditure; GGR = general government revenue.
Notes: For years after UK accession to the European Community, both revenue and expenditure totals have been adjusted to include European income and spending. Numbers on the European System of Accounts 95 basis are available only back to the 1940s, before which time they are measured differently. All series change in 1948, so there is only one major discontinuity in the graph.
Source: Authors' calculations, based on data from C. H. Feinstein, *Statistical Tables of National Income, Expenditure and Output of the UK, 1855–1965*, Macmillan, Basingstoke, 1976, until 1947 and from the Office for National Statistics from 1948 onwards.

More important than the short-run effect of the major wars on spending was the more enduring effect on the size of government. After both the First and Second World Wars, public spending fell back when hostilities ceased, but to levels much higher than those that had preceded the war. This failure of government to return to its pre-war role has been called the 'ratchet' or 'displacement' effect.[2]

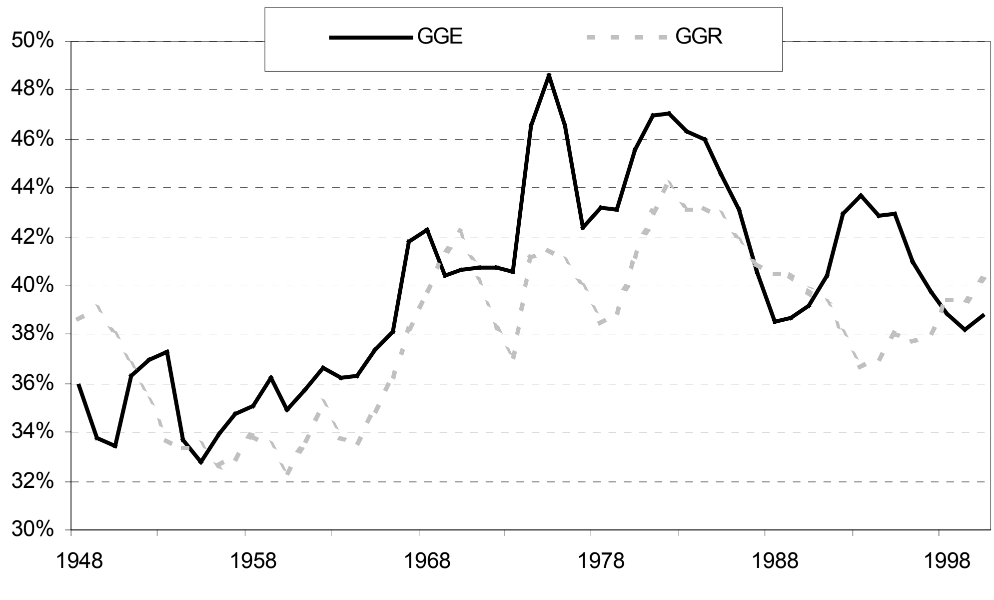
Discussion of the size of state activity typically focuses on public spending. A natural model of the activity of government is to think of politicians (or voters) starting with a set of desired objectives for state activity, and then raising tax to finance these. But if we look at the tax as a share of GDP series in Figure 1.1, another possibility also seems plausible. Whereas the spending share falls at the end of both World Wars, albeit not completely, the tax share barely does. Perhaps, then, electoral pressures check the ability of politicians to raise taxes as much as they would like in peacetime, but wars ease this constraint. If so,

[2] The second term dates from A. Peacock and J. Wiseman, *The Growth of Public Expenditure in the UK*, Princeton University Press, Princeton, 1961.

then the role of wars in allowing governments scope for higher levels of non-military spending once war is over may be important.

The wars dominate Figure 1.1 to an extent that dwarfs any trends in post-war tax and spending. Figure 1.2 therefore focuses on the path of taxation and public spending for the period 1948 onwards. In the early post-war years, overall spending continued to decline for a period, although it was boosted temporarily by the Korean War in the early 1950s. From the mid-1950s until the mid-1970s, there seems to be a trend to higher spending, although there is considerable volatility. From the mid-1970s until the end of the century, the pattern is reversed, with an apparent tendency for public spending to decline as a share of GDP, although again with some periods of growth. The two marked periods of growth in the last quarter of the century – in the early 1980s and the late 1980s / early 1990s – both coincided with downturns in the economy, which led both to shrinking GDP and to higher cyclical government spending as unemployment rose steeply. The first decline, from the peak of the mid-1970s, reflected substantial reductions in the real level of public spending, while the long declines from the early 1980s and mid-1990s combined spending restraint with economic growth.

Figure 1.2. Government spending and revenues as a percentage of GDP since 1948



GGE = general government expenditure; GGR = general government revenue.
Note: For years after UK accession to the European Community, both revenue and expenditure totals have been adjusted to include European income and spending.
Source: Authors' calculations based on data from the Office for National Statistics.

The path of revenue fluctuates less than that of spending, and far from falling smoothly after the war, it actually rose as a share of GDP in 1948 and 1949.[3] The tax share showed no clear and systematic sign of increasing until the mid-1960s, but did then rise substantially to 1970. The second half of the 1960s is striking as the most (or, perhaps, the *only*) significant and sustained increase in the tax burden seen over the twentieth century that did not reflect war or pre-war military build-up: between 1964 and 1970, general government revenue increased from 33.6 per cent of GDP to 42.1 per cent, an increase of 8.5 percentage points.

Over the following 15 years, to the mid-1980s, the tax share fluctuated without any obvious trend up or down. The fluctuations were driven in part by the performance of the economy and in part by discretionary policy. Figure 1.2 shows that in the last decade and a half of the twentieth century, tax as a share of GDP declined, although far from smoothly – a sustained decline until 1993 was followed by a tendency for the tax burden to rise. The election of a Labour government in 1997 was followed by a small increase in the tax share, raising questions about whether a return to growing government might be seen, but it is as yet too early to judge this.

Across the developed world, the evolution of the UK's tax burden is relatively distinctive. In the early post-war years, the UK was a relatively high-tax country, and the large increases in the UK's tax burden that took place over the 1960s ensured that it remained so into the 1970s. But in most other industrial countries, the state continued to grow at least into the 1980s and often beyond; by contrast, the absence of a trend in the UK's tax burden since the mid-1970s now leaves it as a relatively low-tax country, when compared with the G7 and EU averages. (See OECD, *Revenue Statistics, 1965–1999*, Paris, 2000, for more details.)

2. The Tax System

As we have already noted, the Second World War led to a substantial increase in taxation. Government revenue absorbed 23.4 per cent of GDP in 1939, while by 1945 it had reached 37.6 per cent, compared with the 9.0 per cent of 1900 and 40.2 per cent in 2000.

The need for more revenue during the war led to increases in tax rates, increases in the coverage of existing taxes and the introduction of wholly new taxes. Perhaps the most dramatic change was to income tax. Prior to the war, income tax had never been a 'mass' tax. It was first introduced in 1799, and

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[3] In Figure 1.1, definitions of the series change in 1948. But even when measured consistently on the old basis, the series tells a similar story – for example, general government revenue as a percentage of GDP in 1949 remained as high as it had been in the last full year of the war, 1944.

was permanently in place from 1842, but there were still fewer than 4 million taxpayers in 1938. By the end of the war, the number of taxpaying families had increased to over 12 million, an increase which was sustained into the following decades, as shown in Table 2.1. Indeed, over the post-war decades, the number of taxpaying individuals tended to continue growing, so that by 1998–99 there were some 26.9 million. The other major sources of new revenue during the Second World War were an excess profits tax, increased excise duties and capital levies.

Table 2.1. Number of income taxpayers by year

Financial year	*Number of taxpaying families (thousands)*	*Number of taxpayers (thousands)*
1938–39	3,800	N/A
1948–49	14,500	N/A
1958–59	17,700	N/A
1968–69	20,700	N/A
1978–79	21,400	25,900
1988–89	21,500	25,000
1998–99	N/A	26,900

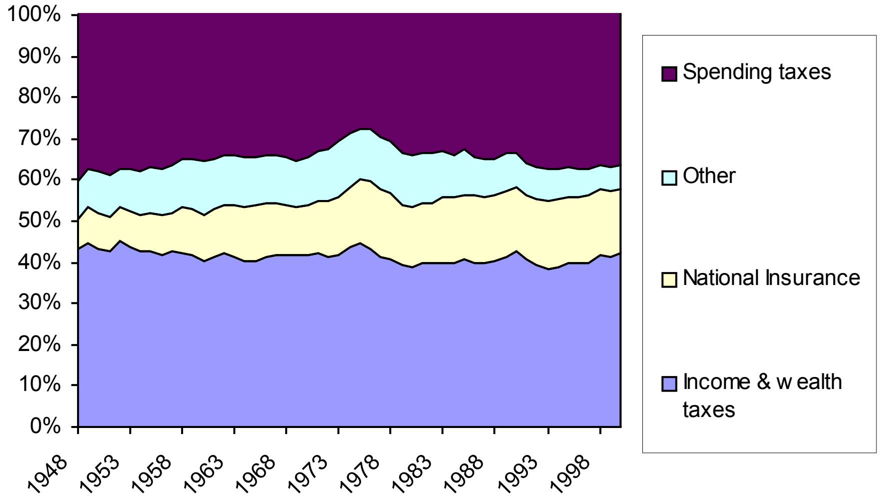
N/A = not available.
Notes: Joint taxation of a couple was in place before 1990, and before this date the Inland Revenue regarded couples where both adults paid tax as a single unit. Thus the number of taxpaying individuals had no administrative significance for the early years, and so was not collected; for later years, the same is true of the number of taxpaying families, and so this is unavailable after 1990. Taxpaying families and individuals are defined throughout as those with income sufficient to pay income tax after using up all reliefs and allowances due.
Source: Inland Revenue Statistics (1987, 1992 and 2001 editions).

As Figure 1.2 showed, during the post-war period, the overall level of tax first fell, then remained broadly stable until the mid-1960s, after which it rose to 1970, was broadly stable for a decade and a half, then declined somewhat after the mid-1980s. Figure 2.1 charts the relative importance of different types of tax in providing this evolving total of government income since 1948.

Looking at Figure 2.1 overall, the stability in the relative importance of the different types of government income is perhaps more striking than the changes over time. But some interesting trends are evident. The relative importance of taxes on income and wealth tended to decline a little over most of the post-1948 period, from 44.8 per cent of general government revenue (GGR) in 1949 to 38.9 per cent in 1980. Since this time, there has been a slight recovery in their relative importance, so that by 2000 they stood at 42.3 per cent of GGR. By contrast, the role of National Insurance contributions, which should probably be thought of as more like a tax on income than anything else, increased in importance fairly smoothly between the 1940s (they represented 8.8 per cent of government revenue in 1949) and the mid-1980s (16.4 per cent in 1986), since when their share has stabilised. Taken together, these trends mean that broadly-defined 'direct' taxes (National Insurance and income and wealth taxes combined) have increased modestly in importance over the whole period, from having accounted for about 50–52 per cent of revenue in the 1950s to reaching 58 per cent in 2000.

The stability of the share of taxes on spending as shown in Figure 2.1 masks shifts in the balance between excise duties on individual commodities and general sales taxes. Aside from National Insurance contributions, VAT is the only major source of revenue to have become much more important over the period. By contrast, for much of the period, product-specific excise duties failed to keep pace with inflation.

Figure 2.1. Breakdown of general government revenue by source since 1948[a]



[a] A discontinuity in the 'income and wealth taxes' series arises in 1991, when restrictions to mortgage tax relief meant it ceased to count as negative tax (becoming instead a spending item), inflating income receipts by 1–2 per cent of GGR in the early 1990s relative to the 1980s. In the later 1990s, mortgage tax relief was phased out, and ultimately abolished, so comparisons between years before 1991 and those in the last few years shown are little affected: by 2000 the distortion is only 0.1 per cent of GGR.
Notes: For years after UK accession to the European Community, both GGR and its components have been adjusted to include European income. 'Income and wealth taxes' includes local taxes directly paid by households, taxes on corporate incomes and capital taxes. 'Spending taxes' includes intermediate taxes on production, such as non-domestic rates.
Source: Authors' calculations based on data from the Office for National Statistics.

Indeed, the effect of inflation on the composition of the tax take is clearly visible in the first half of the 1970s, an era before indexation of the tax system for inflation was automatic. In these years, therefore, price increases reduced the state's real take from excise duties, while increasing its take from income tax by eroding the real value of allowances. The share of spending taxes fell from 32.7 per cent of GGR in 1972 to 27.6 per cent in 1975, while the shares of income tax and National Insurance rose. After the mid-1970s, inflation rates tended downwards, and it came to be expected that Budgets would adjust the tax system for inflation, so trends in the price level become a less important determinant of the balance of revenues.

One important type of revenue not singled out in Figure 2.1 is local taxes. In the early twentieth century, these accounted for up to a third of total revenues, but their importance declined as the taxes required to pay for both World Wars were raised at the national level (A. Dilnot and C. Emmerson, 'The economic environment', in A. H. Halsey with J. Webb, *Twentieth Century British Social Trends*, Macmillan, Basingstoke, 2000). By the late 1940s, local taxes (chiefly a property tax called 'rates', which had both business and household components) accounted for only around 7 per cent of GGR. The role of local taxes then recovered, so that they represented almost 10 per cent of GGR in the mid-1960s, and as late as 1989 they remained at this level. Since then, however, local taxes have again become much less significant, representing only between 3 and 4 per cent of revenues in the last decade of the twentieth century. This is because the council tax, like its predecessor the community charge (popularly known as the poll tax), raises less revenue than did domestic rates (which were abolished in 1990), and also because in 1991 non-domestic rates became a central government tax, the revenue from which is redistributed to local authorities.

In contrast to the current UK position, in federal countries such as the USA and Germany, around a third of government revenues can be collected through local- and state-government taxes. Even amongst unitary states, the UK state has come to fund an unusually low proportion of its activities through local taxes. (See OECD, *Revenue Statistics, 1965–1999*, Paris, 2000.)

Another type of tax not shown separately in Figure 2.1 is capital levies (classed on the graph as an income and wealth tax), which by 2000 overwhelmingly consisted of inheritance tax but in earlier years included various other tariffs. These were raised sharply during the Second World War, and still constituted about 5 per cent of the government's income in the late 1940s. Over the following 30 years, the relative importance of capital taxes fell steadily, and by the 1980s and 1990s they had stabilised at just half a per cent of GGR.

Although personal income tax is now, and has for the whole period been, responsible for only around a quarter of total tax revenue, it has been the focus of the bulk of popular and political attention for much of the period. In 1973, the system was overhauled, integrating the surtax on high incomes, which dated back to 1911, into the main income tax and simplifying the operation of the rate structure. (Prior to the reform, for example, the basic rate of tax was 38.75 per cent but with earned income relief of two-ninths, making a tax rate of 30.14 per cent; in 1973, the basic rate was set at 30 per cent.) But during the 1973 reform, the very top rate of income tax on earnings was left at 75 per cent. In 1974, the top rate on earnings was actually increased, to 83 per cent.

Throughout these years, the highest feasible rate on investment income was higher still.[4] These very high tax rates became the focus for discontent over the possible disincentive effects of taxation, even though they affected very few individuals and the theoretical impact on labour supply was ambiguous.[5]

The top rate on earnings was cut to 60 per cent in 1979 and then 40 per cent in 1988, while the basic rate also fell, from 35 per cent in 1977 to 22 per cent in 2000. Partly to offset the costs of these reductions, a range of allowances, such as mortgage tax relief, life assurance premium relief and the married couple's allowance, have been removed. In addition, the number of higher-rate taxpayers increased in the last two decades of the twentieth century, as the thresholds between bands were generally indexed only in line with prices (which tend to go up more slowly than incomes). Together these changes help to explain why, in spite of the cuts in 'headline' tax rates, the relative importance of income and capital taxes in the total was maintained over the 1980s (as we saw in Figure 2.1).

National Insurance contributions began the period as lump-sum taxes earning the right to lump-sum benefits. An element of graduation was introduced into the tax in 1961, and the tax became more closely earnings-related in 1975 but retained a ceiling beyond which no further charge was made. In 1985, the ceiling was removed for the half of contributions paid by employers, and the subsequent 15 years saw three further substantial and progressive structural reforms completing a transformation from poll tax to near-replica of income tax which has turned a large and regressive part of the tax system into a large and broadly progressive part of it.

A separate corporate income tax was introduced in the UK in 1965 (companies previously having been taxed under general income tax legislation) and has been subjected to major reform in 1973, 1984 and 1997–98. Perhaps the most striking feature of the current regime is that it continues to raise significant revenue, despite concerns that globalisation would lead to a 'race to the bottom' as countries competed with one another to attract businesses by offering lower and lower tax rates. The failure of this to occur (corporation tax still raised 10 per cent of revenue at the end of the 1990s[6]) suggests that there

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[4] This was because of the existence of the investment income surcharge, an additional income tax charge on unearned income. As this had a maximum rate of 15 per cent, in the second half of the 1970s it combined with the 83 per cent top main income tax rate to give a top feasible marginal rate of 98 per cent on unearned income. Very few individuals were actually charged at this marginal rate. The investment income surcharge was abolished in 1984.

[5] At the end of the 1970s, only around three-quarters of a million people paid higher-rate tax (compared with around 2.75 million in 2000), and of these only a very small proportion had incomes sufficient to pay the very highest marginal rates.

[6] Figure for 1999 from OECD, *Revenue Statistics, 1965–1999*, Paris, 2000.

may be country-specific opportunities that companies can exploit and which governments can therefore tax.

The post-war history of indirect taxes saw a decline in the significance of excise duties for much of the period, with a late increase in the last two decades as taxes on tobacco and fuel oils were raised with health and environmental objectives in mind. But even these increases were halted in the face of concerns about cross-border smuggling of tobacco products and political unrest about the price of petrol. Until 1973, purchase tax was the principal other form of indirect taxation. It was introduced during the Second World War as a tax on the wholesale value of a fairly wide range of goods, excluding services, food and goods already subject to excise duties. There were up to seven different rates at any one time and the structure changed frequently. VAT was introduced in 1973 as part of the UK's entry to the European Economic Community. Some goods are exempt or zero-rated, and there have been one or, on occasion, two rates applied to other goods.

Although the last quarter of a century has often been characterised by a stated desire to simplify the tax system, the outcome has been mixed. In some fields, such as National Insurance contributions, clear progress has been made. In others, such as the tax treatment of saving, or indirect taxes generally, progress in some areas has been offset by added complexity in others.

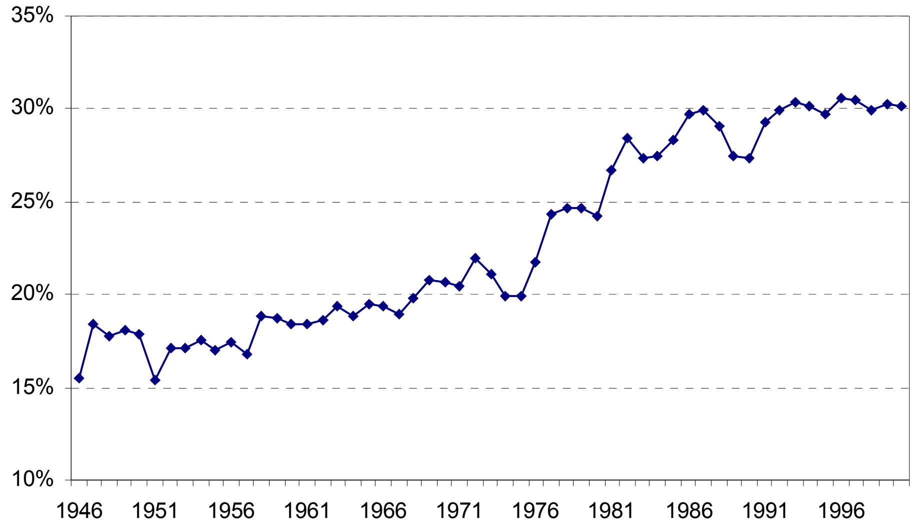
3. The Composition of Public Spending

Section 1 showed that the importance of overall government spending in national income tended to increase during the first half of the post-war era and has tended to decrease since then. But this overall story masks considerable variation across different areas of spending, and this is the issue to which we now turn. In particular, expenditure on the main pillars of the Welfare State is seen to have grown in relative importance, reflecting changing demographic and economic conditions as well as increasing public expectations, at the expense of spending elsewhere.

The most substantial growth in spending share is seen in social security. Social security spending merely involves the government redistributing money between people, rather than deciding what it should ultimately be spent on. As such, one might expect that the former would have very different economic effects from the latter and (perhaps) that it could more easily receive public approval. In fact, however, the steepest rise in social security spending coincided with the cessation of growth in state spending in the economy overall.

At the beginning of the post-war period, only 15 per cent of total public spending went on social security, as can be seen in Figure 3.1. A buoyant economy helped ensure that this share grew fairly slowly to 20 per cent in 1975, despite significant increases in benefit levels and considerable growth in the numbers entitled to retirement benefits.[7] From the mid-1970s on, though, spending grew much more rapidly, approaching 30 per cent in 1986 and reflecting huge increases in the numbers dependent on benefits – both because of a huge increase in unemployment (and non-employment more generally) and because of changes in the demographic structure, such as the increasing numbers of low-income lone parents. Since the mid-1980s, in spite of cyclical fluctuation, the overall share has remained fairly stable.

Figure 3.1. Government spending on benefits as a percentage of general government expenditure since 1946



Notes: For years after UK accession to the European Community, GGE has been adjusted to include grants from Europe. The *Blue Book* counts some mortgage tax relief (MIRAS) as social assistance spending after 1979 and all of it in this way from 1991. To avoid discontinuities, this spending has been netted out.
Source: Authors' calculations based on data from the Office for National Statistics.

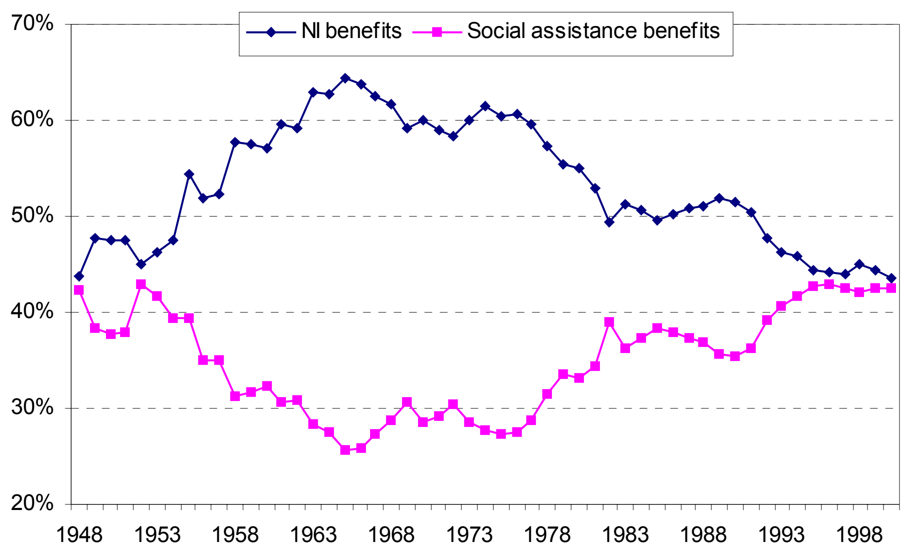
In part, the relative stability of social security spending since the early 1980s reflects rather tight control of benefit rates, which have mostly fallen relative to earnings since 1979. But the move away from contributory benefits to those tested on incomes has also played a part. Figure 3.2 shows the changing relative importance of the two main types of benefit since 1948. The first class – 'National Insurance' benefits – are conditional on the claimant having made contributions out of earnings in the past, but entitlement is not reduced if claimants have independent income or wealth. They are paid when the claimant stops working – for example, the state pension in the case of retirement. The second class – 'social assistance' benefits – have no link to past contributions

[7] Between 1951 and 1971, the number of adults aged over 65 grew by 2 million, to 7.4 million (calculation based on census data reported in Office for National Statistics, *Annual Abstract of Statistics 2000*, London, 2000, p. 28).

and are made dependent on ‘need’, which, depending on the benefit, is assessed by income, family size or health.

Figure 3.2 shows that in the first two decades after the Second World War, the relative importance of National Insurance benefits increased, from 42.2 per cent of the total in 1948 to 65.6 per cent of the total in 1965. This reflected real-terms increases in the rates of these benefits, as well as an increase in the proportion of the population entitled to them. Over these years, the proportion of benefit spending represented by social assistance fell commensurately. In the 15 years after 1965, these trends were slightly reversed, initially because of the introduction of new benefits that were not conditional on contributions and so counted as ‘social assistance’, notably a raft of new benefits for disabled people in the late 1960s and early 1970s and, from the late 1970s onwards, the universal child benefit.

Figure 3.2. Cost of selected types of benefit as a percentage of total benefit spending since 1948

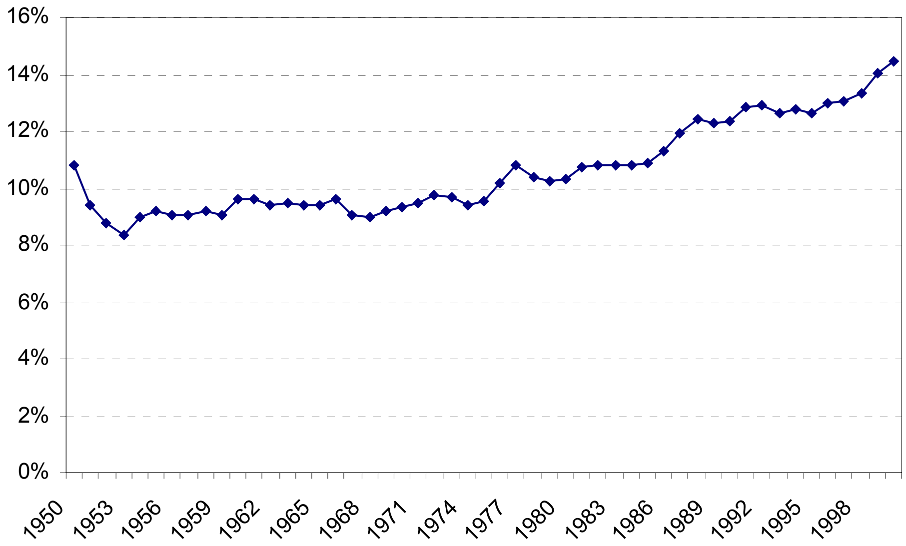


NI = National Insurance.
Notes: For years after UK accession to the European Community, GGE has been adjusted to include grants from Europe. The *Blue Book* counts some mortgage tax relief (MIRAS) as social assistance spending after 1979 and all of it in this way from 1991. To avoid discontinuities, this spending has been netted out.
Source: Authors’ calculations based on data from the Office for National Statistics.

After 1979, these trends continued, but for new reasons. In particular, National Insurance benefits were made less generous, through tighter time limits, the abolition or reduction of earnings-related top-ups and the freezing of real-term rates. So the proportion of benefit spending they accounted for fell from 55.4 per cent of the total in 1979 to 43.5 per cent in 2000. To a degree, social assistance spending increased automatically as a result, as means-tested benefit entitlement was required to ‘top up’ the incomes of an increasing proportion of those in receipt of National Insurance benefits. But the overall effect of the shift away from the 'contributory' principle was to reduce benefit expenditure, as increasingly widespread means-testing targeted money away from all but the poorest.

Two other areas of spending – health and education – have seen their share of the total rise over the post-war period, although their growth paths have been very different. In health, we see relative stability in the spending share until the mid-1970s, since when the spending share has risen by nearly a half (Figure 3.3). Demographic pressures may explain some of this pattern, as the number of the very oldest pensioners, who are particularly heavy users of healthcare, went up most rapidly in the last quarter of the century.[8] But given that pensioners more generally (a far larger group) also use the health service disproportionately, and given that their numbers increased more rapidly in the first few post-war years than in the last two decades of the century, it seems unlikely that demographics can offer anything like a complete explanation. Rather, it seems that some combination of rising relative costs in healthcare provision and rising public expectations must have been important.

Figure 3.3. Health spending as a percentage of general government expenditure since 1950

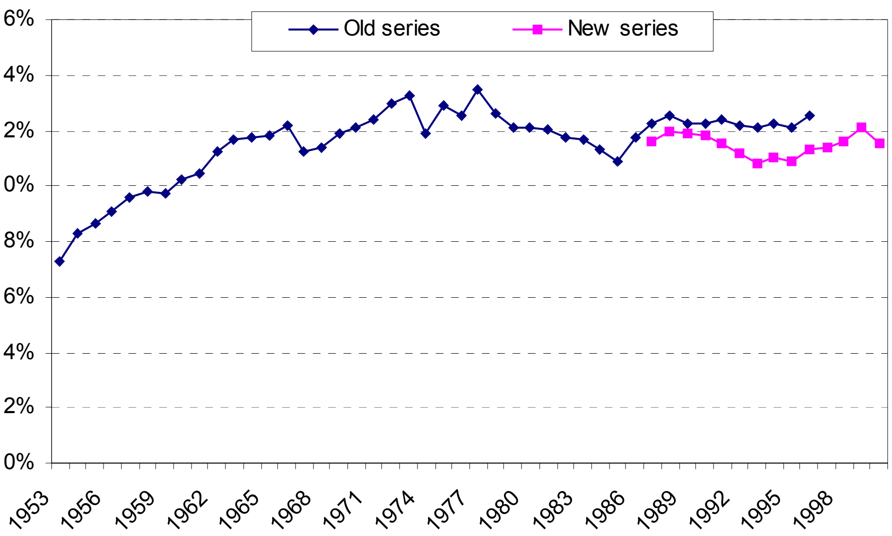


Note: For years after UK accession to the European Community, GGE has been adjusted to include grants from Europe.
Source: NHS spending figures from Department of Health, *The Government's Expenditure Plans*, various years; GGE from Office for National Statistics.

[8] Between 1951 and 1971, the number of people aged over 85 grew by just 260,000 to 480,000; but in the shorter period 1981 to 1998, the increase was twice as large – 520,000 – taking the total to just over 1.1 million (calculations based on census data reported in Office for National Statistics, *Annual Abstract of Statistics 2000*, London, 2000, p. 28).

In education, the pattern of increase is reversed, with a fairly steady rise until the mid-1970s followed by a quarter of a century of broad stability (Figure 3.4). The trend in education mirrors the demographics of post-war Britain, and may be partly explained by them. In the years up until the mid-1970s, the 'baby boom' combined with increases in the school-leaving age to increase the school-aged population. Between the mid-1970s and the end of the 1980s, though, the total number of pupils declined in more years than it increased, which might have been expected to reduce the pressure on the education budget. Again, however, demographics are unlikely to provide a complete explanation, as throughout the 1990s the school-age population grew but there was little sign of a recovery in education's spending share.

Figure 3.4. Education spending as a percentage of general government expenditure since 1953

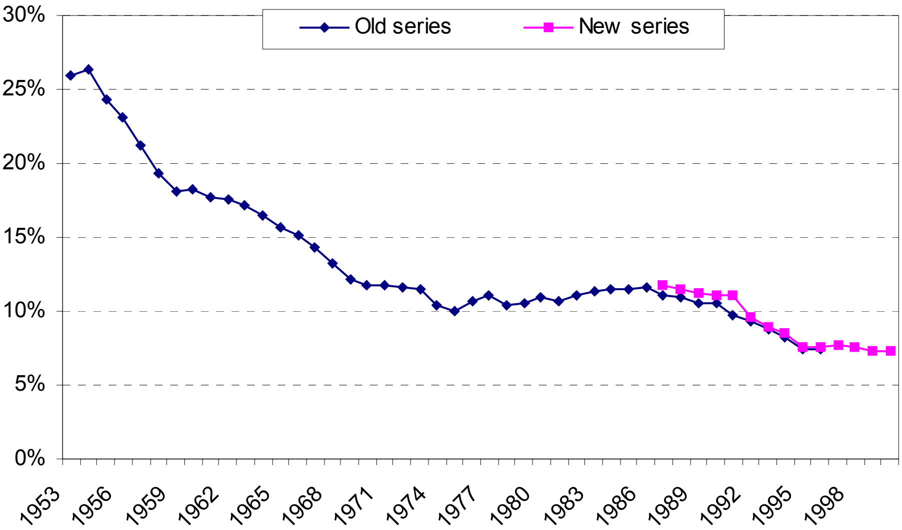


Note: For years after UK accession to the European Community, GGE has been adjusted to include grants from Europe.
Source: Blue Book (various years) for old education series; new education series and GGE from Office for National Statistics.

Overall, then, since the 1950s, the proportion of government spending consumed by the three main pillars of the Welfare State have tended to increase – social security by just under 15 percentage points of the total, health by around 5 percentage points and education by around 4 percentage points. Corresponding to these increases in shares are reductions elsewhere.

Defence is the single field of government activity that has seen the most dramatic decline. Figure 3.5 shows defence spending as a share of total spending in the years since the end of the Korean War. In 1953 and 1954, defence spending constituted over a quarter of government outlays, but it then fell very steeply throughout the remainder of the 1950s and 1960s. In these years, National Service was phased out and imperial commitments were scaled back with decolonisation and the ultimate decision to withdraw from all bases East of Suez (in 1968). By 1975, defence spending had reached just 10 per cent of the total. At this point, the decline was checked, and the defence share actually inched up for a period as Britain entered into a new NATO commitment to increase defence spending until the mid-1980s. But the thawing and then the end of the Cold War heralded a new decline – the defence share fell from around 12 per cent to about 7 per cent between 1986 and the end of the century.

Figure 3.5. Defence spending as a percentage of general government expenditure since 1953

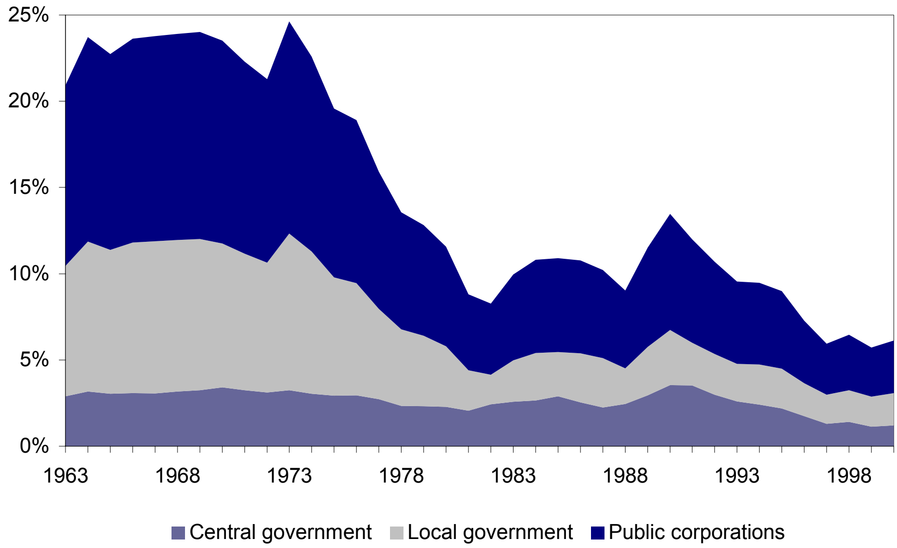


Note: For years after UK accession to the European Community, GGE has been adjusted to include grants from Europe.
Source: Blue Book (various years) for old defence series; new defence series and GGE from Office for National Statistics.

The overall decline in the defence share since the 1950s thus approaches 20 percentage points, a decline so large that it could be thought of as offsetting the great bulk of the increase in the share for social security, health and education. The particularly rapid decline in defence spending between 1954 and 1964 (during which around half the total decline occurred) helps to explain how it was that over these years welfare provision was expanded and demographic pressures were apparently met without difficulty, even while, as we saw in Figure 1.2, the tax burden was relatively stable: reduced defence commitments were freeing resources for the government to spend on the Welfare State.

In later decades, another area of government activity to be squeezed was spending on capital projects. The investment done by central and local government fluctuated at around 10–12 per cent of general government expenditure (GGE) between 1956 and 1976. As Figure 3.6 shows for the years since 1963, if investment by the nationalised industries is taken into account, the scale of public investment until 1976 is approximately twice as large. After the mid-1970s, the relative importance of public investment declined very sharply indeed. It fell to represent less than 10 per cent of GGE by the early 1980s, since when, in spite of fluctuations, it has declined further, so that it represented just 6 per cent of GGE by 2000.

Figure 3.6. Different types of state investment as a percentage of general government expenditure since 1963



Note: Public corporation investment is not counted as a component of GGE in the *Blue Book*.
Source: Blue Book, various years.

The decline breaks into three phases. First, between 1976 and 1982, as the graph shows, the decline is principally explained by the fall in local government investment. Housing explains most of this – council housing investment had fluctuated around 5.5 per cent of GGE in the two decades after 1956, but collapsed almost to zero between 1976 and 1982, and it has never significantly exceeded 1 per cent since then. House building is one activity that the state withdrew from almost completely – the number of council houses completed in 1998 was less than 1 per cent of the 1976 level. Education investment, another responsibility of local authorities, also fell especially sharply between the late 1970s and early 1980s and has never significantly recovered.

The second phase of the decline in public investment as a share of GDP, which lasted for most of the 1980s, was caused by a fall in public corporation investment. (Public corporation investment looks stable on Figure 3.6 because it is given as a proportion of GGE, which was declining as a share of GDP over most of this period.) This fall largely reflected privatisation, and so the majority of this investment has been substituted for by private sector activity rather than discontinued – for example, when British Telecom was privatised in 1984, a significant amount of public sector investment was simply reclassified as being private.

After a modest recovery in the years 1987–92, public investment started falling again. The investment cuts in this third phase of decline were general across public services, and Figure 3.6 shows that central government investment fell most sharply. Although the current Labour government has announced plans to increase public investment, they do not seem likely to be sufficient to reverse the decline seen since the 1970s.[9]

The final type of government spending with dwindling relative significance is debt interest payments. In 1955, interest paid out by the state to the private sector and the rest of the world was equal to 14.3 per cent of GGE, but it had fallen to just 9.4 per cent of GGE in 1975, since when, in spite of fluctuations, it has tended to fall further, to just 7.2 per cent by 2000.[10] But the extent to which indebtedness constrains the government's ability to engage in other types of spending will depend on the underlying strength of its financial position rather than on the cash flow of interest payments it is making. We consider how the former can be assessed in IFS Briefing Note no. 26.[11]

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[9] For a detailed discussion of these issues, see T. Clark, M. Elsby and S. Love, *Twenty-Five Years of Falling Investment? Trends in Capital Spending on Public Services*, IFS Briefing Note no. 20, 2001, www.ifs.org.uk/public/bn20.pdf.

[10] Source: Office for National Statistics. For years after UK accession to the European Community, GGE has been adjusted to include European spending.

[11] T. Clark and A. Dilnot, *Measuring UK Fiscal Stance since the Second World War*, IFS Briefing Note no. 26, 2002, www.ifs.org.uk/public/bn26.pdf.