Alternative Proposals on Tax and Social Security

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1 Introduction

Our aim in this commentary is to provide some assessment and analysis of the three main parties' tax and social security proposals. We look separately at the proposals for personal taxes and benefits, local taxation and company taxation. Also included is an examination of personal tax and benefit policy over the last 13 years, and an assessment of the likely path for public sector finances in the next Parliament.

In each section of the commentary we try to define precisely the basis of our analysis. When looking at the personal sector, for example, we explicitly ignore any impact changes in taxes or benefits might have on individual behaviour. The reason for doing this is that any estimates of behavioural change must be speculative. Nonetheless, we must remember that changes in taxes and benefits can affect behaviour: some, for example, would argue that the almost 50% increase in the top rate of direct tax from 40% to 59% proposed by the Labour Party will reduce enterprise and effort amongst the higher-paid. By contrast, when looking at proposals to change the corporation tax system so as to encourage investment, we do try to estimate the behavioural impact, since the sole objective of the proposal is to change behaviour. Uncertain as our estimates in this area must be, we must attempt such an analysis.

Wherever possible, we rely on detailed analysis of large and representative samples of the relevant population, whether it is the personal or business sector. The diversity of individual and business experience is very great, and it is simply impossible to assess the impact of complex proposals applied to diverse populations by calculating the impact on hypothetical individuals, families or businesses. A clear understanding of each party's proposals must be based on understanding their impact on all those affected. A 'typical' family with a working husband, a wife and two children, for instance, in fact represents only one family in 20 in Britain today, and they themselves differ widely in income, in type of housing tenure and in their consumption patterns. Likewise people on 'average' income are in fact by no means typical - almost two-thirds of all earners earn less than the average. Clearly, anything can be proved with a well-chosen 'average' person, as the experience of the last few weeks shows.

The debate over taxation policy is playing a significant role in the run-up to the general election, but there are dangers inherent in the type of attention being given to this area. Perhaps the single greatest concern is that there is little evidence of an awareness of the nature or impact of the tax system as a whole. Although income tax raises only one-quarter of total government revenue, it continues to attract a disproportionately large share of the attention of both politicians and the media. This overemphasis on income tax reflects another concern, which is the apparent lack of a clear set of medium-term goals for the tax system and a strategy for achieving them.

One of the clearest lessons of the 1980s is that tax reform, as opposed to simply tax reduction, tends to succeed only when there are a clear vision and some spare resources to ease the transition. All of the parties have clear ideas in some areas, but the extent to which these form a coherent whole is quite limited.

We must all hope that whichever party wins the election will put time and effort into developing a set of goals for the tax system as a whole, and a medium-term strategy for achieving them. Further debate about short-term gainers and losers in the personal sector, or the impact of temporary measures on the business sector, should give way to discussion of what we would like our tax system to look like at the turn of the century.

2 Taxes, Benefits and the Personal Sector

The Parties' Plans for 1992/93

What the Tables Show

The tables in this chapter show the effects on family incomes of the proposed regimes of the three main parties. We analyse the effect of changes in income tax, National Insurance and social security benefits on disposable incomes of families. All the parties propose to leave VAT unchanged and to increase excise duties by similar amounts in their first year of government so they have been omitted in the analysis of 1992/93.

For each party we have modelled the tax commitments for the first full year of a government under its control. This means that certain longer-term implications of the tax policies are not included. For example, it has been suggested that the Labour Party would create more 'losers' by withdrawing the 2% incentive to opt out of SERPS. Whilst this policy would be less generous than the Conservative proposals, it would have no direct effect for an individual until retirement so it is not included in this analysis. If this policy were included, a net present value of future increased state pension rights under Labour would also have to be taken into account. The figures would then bear little relation to a family's immediate disposable income under the different political parties.

The manifesto commitments are compared with an 'indexed base' which would be the tax and benefit regime for 1992/93 if there had been a neutral Budget. This is one where allowances, duties and benefits are uprated for inflation. The one exception is the pensioner rates of income support which were announced in October and included a rise greater than inflation. There is no difference between the parties regarding these rates so they have been included in the indexed base.

The tables have been calculated using the IFS Tax and Benefit Model, TAXBEN2, with 1990 Family Expenditure Survey (FES) data. A few points should be noted about this analysis to help with interpretation of the figures:

(i) The FES is an annual survey of roughly 7,000 households and includes all their income sources and expenditure decisions.

(ii) The FES is weighted to give a representative sample of current family types. All earnings and prices are then uprated to current levels by the appropriate indices.

(iii) A 'family' represents a single person or married couple, together with any dependent children. This means that a household containing a married couple, a school-age child, a grown-up son or daughter and a grandparent contains three family units.

(iv) The figures do not attempt to take account of any changes in behaviour that might result from changing the tax system. So, the incentive effects of the tax plans are not reflected in the tables.

In the following sections, the tables analyse the results for the Conservatives, Labour and the Liberal Democrats. We give a brief discussion of each party's tax and benefit policies and then present the effects of their proposals on family income by family type, gross income range and region. Finally, we show a graph of the gains and losses per week by decile under each party, to enable comparisons to be made between the parties.

Conservatives

The Conservative plans modelled are those announced in Norman Lamont's Budget on 10 March. The manifesto kept the Budget proposals intact and declared a number of medium-term aims relating to personal taxes. The Budget described below shows the areas in which the Budget was different from an indexed Budget. It also includes the elements (*) that have not been modelled, as they are the same as Labour's proposals, and those (#) that cannot be modelled or have no immediate impact on family living standards.

The Budget

Income tax
- New 20% lower rate band on the first £2,000 of taxable income.
- Married couple's allowance frozen at £1,720.
- Basic rate limit frozen at £23,700.

Benefits
- Increase of £2 and £3 per week in the single and couple pensioner rates of income support.

Taxes on spending
- Cigarette duty raised by 10%.*
- Leaded petrol duty raised by 7.5%.*
- Vehicle excise duty raised by 10%.*
- Car tax halved to 5%.*
- Betting duty cut from 8% to 7.75%.*

Savings
- Raise limit on investment and unit trust PEPs to £6,000.#
- Raise the inheritance tax threshold to £150,000 and exempt farmers and unincorporated businesses.#

The Medium Term

Income tax
- Reduce basic rate to 20% either by widening the lower rate band or by cutting the basic rate, if economic conditions allow.
- Allow the married couple's allowance to be transferable between husband and wife.
- Maintain mortgage interest tax relief.

Benefits
- Commitment to raise child benefit in line with prices.
- Provide a 1% incentive for holders of personal pensions aged over 30 from 1993.
- Introduce new disability benefits from April 1992.

Taxes on spending
- Non-manifesto commitment not to raise the VAT rate.

Savings
- Commitment to raise inheritance tax thresholds.
- Reform taxes on savings by 'building on the success of PEPs and TESSAs'.
- Reaffirm 1990 Budget commitment to abolish stamp duty on share transactions.
- Abolish Business Expansion Schemes.

Labour

The Labour plans modelled are those announced on 16 March in the Shadow Budget. This formed the core of the manifesto commitments on taxes and benefits, although some extra medium-term aims are spelt out in the manifesto. Where the Labour Shadow Budget proposed the same measures as Lamont's Budget, they have not been listed.

The Shadow Budget

Income tax

- Income tax personal allowance raised £180 above inflation.
- New higher rate of 50% charged on taxable income above £36,375.
- No lower rate band of income tax.
- Extend relief to all forms of employer-provided childcare.#

National Insurance

- Abolition of 2% 'entry fee' into the NI system charged on the first £54 per week of income, if income exceeds £54.
- Upper earnings limit of NICs abolished for NI purposes, so 9% charged on all income above £21,060.
- Abolition of 2% incentive to opt out of SERPS.#
- Employer NICs to be extended to all benefits in kind.#

Benefits

- Raise child benefit to £9.95 for every child.
- Raise the basic state pension by £5 per week for single pensioners and £8 per week for married couples.
- Corresponding increases to means-tested benefits for children and pensioners.

The Medium Term

Income tax

- Mortgage interest relief will remain at the present rate.
- Non-manifesto commitment not to raise top rate of tax higher than 50%.
- Allow the married couple's allowance to be transferable between husband and wife.

Benefits

- Restore link between state pensions and earnings (or prices if they rise faster than earnings).
- Reform disability benefits.
- SERPS based on 20 best years of earnings.
- Restore benefits to 16- and 17-year-olds 'as soon as possible'.

Taxes on spending

- Non-manifesto commitment not to raise VAT.

Savings

- Abolish Business Expansion Schemes.
- Postpone abolition of 0.5% stamp duty on share transactions for one year.

Liberal Democrats

The Liberal Democrats did not produce a detailed Budget and their manifesto was not detailed enough to model accurately. However, further details of their policies on taxes and benefits are available on request. The description of their policy and the tables reflect that detailed statement, not the manifesto.

Immediate Plans

Unified income tax and social security tax

- Combined standard tax rate of 35% (26% income tax and 9% social security tax (SST) with no ceiling).
- 9% SST for most taxpayers.
- Exceptions include men over 63, women over 60, those on sickness benefits, disability benefits and the unemployed.
- Allowance for both taxes to become a tax credit, worth £1,088 to all taxpayers. This is equivalent to an allowance of £3,110 p.a. restricted to the basic rate of tax. The figure of £3,110 represents the midway point between the personal allowance and the National Insurance lower earnings limit.
- Married couple's allowance to become a tax credit of £430.
- Combined rate of 42% at £33,000 of gross income and 50% at £50,000.
- Income tax and SST charged on earned and unearned income.
- Extensive, complicated and differentiated structure of allowances for investment income against SST and income tax.

Benefits

- Child benefit raised to £10.65 for first child and £8.80 for other children. Corresponding increases for means-tested benefits.
- State pension raised by £5 per week for single pensioners and £8 per week for couples.
- State pension raised for elderly pensioners by up to £18 per week for a couple over 80 years old.
- No corresponding increases for income support but full state pension paid to all men and single women regardless of their contribution record.
- Income support paid to 16- and 17-year-olds at lower rate.
- The under-25 income support rate increased to the full adult rate.
- Invalidity pension raised to £65.15 regardless of NI contributions, encompassing severe disablement allowance.
- Widow's pension raised to £59.15 and other widows' benefits raised proportionally.
- Increase invalid care allowance to £37.15.
- 100% maximum rebates for the Community Charge.

Taxes on spending

- No difference from the Conservative Budget.

Savings

- Capital gains tax threshold reduced to £2,000 and capital gains taxed as income under the income tax and SST.#

The Medium Term

Income tax and benefits

- Integrate tax and benefit system.
- Create a citizen's income of £12.80 a week to be paid to all people.
- New benefit for 'those in need' to replace income support, with additions for disabilities and specific childcare support.

Savings

- Move towards a system in which all savings have the same tax treatment.

Taxes on spending

- Increase duty on petrol.
- Graduate vehicle excise duty according to fuel efficiency.

The Distributional Consequences of Three Budgets

In this section we use the IFS Tax and Benefit Model to illustrate the distributional consequences of certain aspects of the Conservative Budget, the Labour Shadow Budget and the immediate plans of the Liberal Democrats. These are compared with an 'indexed' 1991/92 system. In doing this we show just the direct effects of proposed tax and benefit changes (not including changes to excise duties on which, in the short term at least, the parties have no differences). This, of course, ignores all other aspects of the parties' aspirations. In particular we can take no account of any benefits from the increased public spending proposed by Labour and the Liberal Democrats. Nor do we consider changes in behaviour, such as working more or less.

Table 2.1 shows how much would be raised or spent by the parties on these policies. These figures are also derived from the IFS model.

TABLE 2.1
Money Raised (-) / Spent (+) by Parties[a]

(£ million)	Conservative	Labour	Liberal Democrat
Means-tested benefits	+400	+40	+1,000
Pensions	-	+2,300	+4,400
Child benefit	-	+800	+700
Other benefits	-	+400	+1,100
Income tax and NI	+1,900	-3,700[b]	-6,200[b]
Total	+2,300	-260	+900

[a] Components do not necessarily sum to totals, due to rounding.
[b] These probably represent underestimates as the FES, on which the analysis is based, under-represents the very rich who would pay large amounts of extra tax under both Labour and the Liberal Democrats.

The Conservatives would spend £400 million on means-tested benefits and £1,900 million on cutting income taxes. Labour's Shadow Budget would be roughly revenue-neutral (over this range of policies) raising about £3,700 million from tax and NI but spending most of this on increased benefits, with around a quarter of a billion left. The Liberal Democrats, while raising significantly more extra tax revenue than Labour, would spend yet more on social security benefits, giving their plans a net cost of £900 million.

Some other types of policies which we do not model here would affect the overall totals, notably the cuts in car tax and increases in excise duties on which all parties appear to be in agreement. The opposition parties would raise money from other policies, e.g. Labour's proposal to end the 2% incentive for joining personal pension plans and the Liberal Democrats' proposals for raising capital gains tax.

Briefly, the figures can be explained with reference to the parties' policies outlined in the previous section. The extra spending on income-related benefits by the Conservatives reflects their proposed increases in income support rates for pensioners, while the reduced tax take stems from the introduction of the 20% tax band on taxable income of less than £2,000 per year.

The largest numbers in the Labour column are the £2,300 million extra being spent on pensions and the £3,700 million raised from tax and NI increases. Increased child benefit costs Labour a further £800 million and other benefits £400 million. This latter group of benefits are largely those statutorily linked to the level of the retirement pension, notably invalidity benefit and widow's pension.

The numbers under the Liberal Democrats are mostly larger than the Labour ones. They would spend £4,400 million more than now on the state pension, reflecting their policy both of increasing it more than Labour for pensioners over the age of 75 and still more for the over 80s, and of giving the full state pension to all over 65 *irrespective* of their contributions record. The large increase in expenditure on means-tested benefits is accounted for by allowing Community Charge rebates of up to 100% and by greatly increased generosity in the income support system to the under-25s. The large increase in tax revenue flows from the increase in the basic rate to 26% as well as the abolition of the NI ceiling and the imposition of a top joint rate of 50%.

Bear in mind that in what follows we are comparing budgets which do not spend the same amount of money on taxes and benefits. The Conservative budget will inevitably show bigger gains on average than that of the Liberal Democrats, which in turn will show larger average gains than Labour's. In this sense the comparison is 'unfair', for the latter two parties will be spending money on other things, the benefits of which we are unable to take account of.

The effects of the changes are given in Tables 2.2 to 2.10. We compare each set of proposals with the tax and benefit system as it was in 1991 adjusted for inflation. Tables 2.2, 2.3 and 2.4 show the effects of each party's policies by family type, while Tables 2.5 to 2.7 show effects by original income range, and Tables 2.8 to 2.10 effects by region.

All income changes are in pounds per week and are rounded to the nearest pound. The numbers in brackets in the '% gaining / losing' columns show the proportion whose incomes are changing by less than 1%. This gives some measure of the proportions of gainers/losers whose incomes are affected only a little by the changes. Note that income range is by range of *original* income, i.e. income before tax and benefits. No average gains/losses are given for the regions because the sample sizes involved for some make them unreliable.

The combined effect of the changes in the Conservative Budget is to cut taxes and increase benefits enough to increase incomes by an average of over £1 per family per week. The Liberal Democrat package results in an average gain of just under £1 per week. The Labour package, being almost revenue-neutral, leads to an average change of zero in people's incomes. The distribution of these small changes overall, however, differs considerably between the parties.

TABLE 2.2
Effects of the Conservative Budget, by Family Type

Family type	Average gain/loss (£ per week)	% gaining (less than 1% of income)		% losing (less than 1% of income)	
Single, not working	0	11	(3)	0	(0)
Single, employed	2	89	(32)	4	(4)
Single-parent family	0	25	(25)	1	(1)
Couple, not working, no children	1	29	(12)	2	(2)
Couple, not working, children	0	5	(3)	0	(0)
Couple, one working, no children	1	80	(70)	12	(12)
Couple, one working, children	1	74	(71)	16	(16)
Couple, two working, no children	2	87	(62)	4	(4)
Couple, two working, children	2	84	(72)	7	(7)
Single pensioner	2	93	(20)	1	(1)
Couple pensioner	2	77	(23)	1	(1)
Other	0	0	(0)	0	(0)
All	1	74	(38)	4	(4)

TABLE 2.3
Effects of the Labour 'Budget', by Family Type

Family type	Average gain/loss (£ per week)	% gaining (less than 1% of income)		% losing (less than 1% of income)	
Single, not working	1	21	(4)	0	(0)
Single, employed	0	86	(6)	9	(2)
Single-parent family	2	98	(48)	1	(1)
Couple, not working, no children	5	65	(8)	1	(0)
Couple, not working, children	3	99	(32)	1	(0)
Couple, one working, no children	-12	74	(48)	22	(5)
Couple, one working, children	-6	76	(26)	22	(4)
Couple, two working, no children	-6	76	(50)	21	(6)
Couple, two working, children	-3	76	(24)	23	(7)
Single pensioner	5	99	(2)	0	(0)
Couple pensioner	7	98	(7)	0	(0)
Other	0	1	(0)	0	(0)
All	0	80	(22)	9	(3)

TABLE 2.4
Effects of the Liberal Democrat 'Budget', by Family Type

Family type	Average gain/loss (£ per week)	% gaining (less than 1% of income)		% losing (less than 1% of income)	
Single, not working	6	90	(7)	1	(0)
Single, employed	-2	13	(3)	86	(46)
Single-parent family	4	89	(3)	10	(9)
Couple, not working, no children	15	94	(7)	6	(3)
Couple, not working, children	7	98	(5)	2	(1)
Couple, one working, no children	-5	28	(4)	72	(26)
Couple, one working, children	-5	37	(14)	60	(32)
Couple, two working, no children	-8	4	(1)	95	(42)
Couple, two working, children	-6	18	(13)	79	(46)
Single pensioner	6	97	(4)	3	(1)
Couple pensioner	11	94	(3)	6	(2)
Other	27	99	(2)	0	(0)
All	1	47	(5)	51	(26)

TABLE 2.5

Effects of the Conservative Budget, by Income Range

Income range (original income in £ per week)	Average gain/loss (£ per week)	% gaining (less than 1% of income)		% losing (less than 1% of income)	
Below 10	1	44	(4)	0	(0)
10 - 49	1	55	(24)	0	(0)
50 - 99	1	68	(23)	0	(0)
100 - 149	2	90	(17)	1	(1)
150 - 199	2	97	(29)	0	(0)
200 - 249	2	99	(42)	0	(0)
250 - 299	2	100	(71)	0	(0)
300 - 399	2	100	(79)	0	(0)
400 - 499	2	99	(82)	1	(1)
500 - 599	2	84	(84)	15	(15)
600 - 999	1	54	(54)	34	(34)
Above 999	-1	5	(5)	51	(51)
All	1	74	(38)	4	(4)

TABLE 2.6

Effects of the Labour 'Budget', by Income Range

Income range (original income in £ per week)	Average gain/loss (£ per week)	% gaining (less than 1% of income)		% losing (less than 1% of income)	
Below 10	3	64	(7)	0	(0)
10 - 49	4	82	(3)	0	(0)
50 - 99	3	93	(6)	0	(0)
100 - 149	3	98	(13)	0	(0)
150 - 199	3	99	(11)	0	(0)
200 - 249	3	100	(19)	0	(0)
250 - 299	3	100	(43)	0	(0)
300 - 399	3	100	(58)	0	(0)
400 - 499	2	81	(43)	17	(11)
500 - 599	-1	56	(47)	43	(10)
600 - 999	-10	33	(29)	63	(16)
Above 999	-106	1	(1)	99	(3)
All	0	80	(22)	9	(3)

TABLE 2.7

Effects of the Liberal Democrat 'Budget', by Income Range

Income range (original income in £ per week)	Average gain/loss (£ per week)	% gaining (less than 1% of income)		% losing (less than 1% of income)	
Below 10	8	97	(4)	0	(0)
10 - 49	9	97	(1)	1	(0)
50 - 99	5	74	(5)	24	(20)
100 - 149	3	42	(6)	57	(54)
150 - 199	2	33	(6)	65	(60)
200 - 249	1	27	(11)	72	(33)
250 - 299	0	20	(10)	77	(36)
300 - 399	-1	14	(10)	85	(49)
400 - 499	-3	5	(3)	93	(44)
500 - 599	-8	3	(1)	97	(24)
600 - 999	-13	2	(1)	97	(13)
Above 999	-61	2	(1)	98	(3)
All	1	47	(5)	51	(26)

TABLE 2.8
Effects of the Conservative Budget, by Region

Region	Average gain/loss (£ per week)	% gaining (less than 1% of income)		% losing (less than 1% of income)	
Northern	*	71	(33)	2	(2)
Yorkshire	*	76	(36)	2	(2)
North-West	*	74	(37)	3	(3)
East Midlands	*	78	(46)	2	(2)
West Midlands	*	74	(37)	2	(2)
East Anglia	*	81	(43)	3	(3)
Greater London	*	73	(42)	7	(7)
South-East	*	77	(42)	7	(7)
South-West	*	76	(40)	5	(5)
Wales	*	69	(32)	2	(2)
Scotland	*	70	(32)	3	(3)
Northern Ireland	*	69	(32)	2	(2)
All	1	74	(38)	4	(4)

TABLE 2.9
Effects of the Labour 'Budget', by Region

Region	Average gain/loss (£ per week)	% gaining (less than 1% of income)		% losing (less than 1% of income)	
Northern	*	82	(18)	6	(2)
Yorkshire	*	84	(20)	5	(2)
North-West	*	82	(22)	7	(3)
East Midlands	*	81	(24)	8	(2)
West Midlands	*	80	(20)	7	(3)
East Anglia	*	84	(28)	7	(2)
Greater London	*	71	(26)	18	(4)
South-East	*	78	(23)	14	(3)
South-West	*	80	(24)	10	(3)
Wales	*	82	(18)	5	(1)
Scotland	*	79	(19)	6	(2)
Northern Ireland	*	82	(15)	5	(1)
All	0	80	(22)	9	(3)

TABLE 2.10
Effects of the Liberal Democrat 'Budget', by Region

Region	Average gain/loss (£ per week)	% gaining (less than 1% of income)		% losing (less than 1% of income)	
Northern	*	56	(5)	33	(25)
Yorkshire	*	50	(7)	48	(31)
North-West	*	50	(4)	49	(26)
East Midlands	*	44	(6)	52	(27)
West Midlands	*	52	(5)	47	(26)
East Anglia	*	41	(5)	58	(31)
Greater London	*	42	(4)	56	(18)
South-East	*	40	(4)	59	(26)
South-West	*	46	(6)	53	(27)
Wales	*	56	(12)	41	(27)
Scotland	*	53	(5)	46	(25)
Northern Ireland	*	54	(4)	40	(26)
All	1	47	(5)	51	(26)

All the parties help pensioners more than other family types. The Liberal Democrats are most helpful to them, reflecting the large increase in the generosity of the state pension that they are proposing. Under their policies, married pensioners would be an average of £11 per week better off and single pensioners £6 per week. The equivalent numbers for Labour are £7 and £5, and for the Conservatives £2 and £2. The Liberal Democrats are considerably more generous to married pensioners than to single pensioners. This reflects the fact that more single pensioners receive income support and do not enjoy the full benefit of the increased pensions under the Liberal Democrat plans because of withdrawal. By contrast, Labour increase both pensions and income support rates for pensioners equally, while the Conservatives' smaller increases are in means-tested benefits only. These differences reflect considerable differences in emphasis between the parties regarding the roles of universal and income-related benefits.

A very large proportion of pensioners gain from the Conservatives, for many of those not poor enough to be helped by the increases in income-related benefits are rich enough to benefit from their 20% reduced rate band. A large majority of families in work also gain from this change, but most of them by small amounts, as shown by the relatively large size of the numbers in brackets compared with the total numbers gaining. Non-working families typically gain very little - only the taxpayers among them will have benefited from the Conservative Budget.

The pattern is very different under the Labour and particularly Liberal Democrat proposals. Under Labour the unemployed, especially those with children, do best. Most employees also gain, this time as a result of increased tax allowances and reduced National Insurance at the lower end as well as higher rates of child benefit. Once more many of the gains are relatively modest. The overall average impact is negative because some of the 20% or so of working couples who lose from the abolition of the NI ceiling and higher rate of income tax lose quite substantial sums. The Liberal Democrat table not only shows average losses among the working population but also shows the majority losing as a direct result of their commitment to a 1% rise in the basic rate of income tax. Around half of those losing lose only 1% of their income.

The tables showing distributional effects by income range show the most striking contrast between the parties. The Conservative table shows average gains of £1 or £2 per week over the whole income range, except for the very richest who lose through the failure to index the basic rate limit. By contrast, the average gains under Labour's proposals are around £3 per week at each level of income up to about £500 per week, with losses beginning after this and reaching substantial levels for people with incomes of more than £1,000 per week. Perhaps the most surprising aspect of the Labour table is the similarity of the gains over a very wide range of income. This partly reflects the fact that Labour is directing resources at universal rather than means-tested benefits, and partly that everybody in the middle income ranges is gaining a little from tax and NI reductions. A smaller proportion of the poorest are gaining, but those who are gaining are gaining a bit more.

The Liberal Democrats' package is more clearly aimed at those at the bottom of the income distribution. Their greatly increased generosity to pensioners partly explains this. Their abolition of the 20% rule for community charge benefit (CCB) helps all those on income support or CCB (except those in Wandsworth!). The increased generosity to the single under-25s on income support also helps those in the poorest groups. The result is that virtually all those in the two poorest income ranges gain, with gains averaging £8 and £9 per week against Labour's £3 and £4 and the Conservatives' £1 in these same income groups. The converse of this is that even at income levels between £100 and £150 per week, the majority of families are losing, and average losses start to bite at £300 per week. For the very richest, though, the losses from the Liberal Democrats are smaller than those from Labour.

Tables 2.8 to 2.10 show results by region. They do not include average gains/losses because some of the samples are too small to make such numbers either meaningful or reliable. However, changes in disposable income over a number of the regions in the tables can be given. Thus under Labour in the South (comprising London, the South-East and the South-West), annual total disposable income will fall by a total of around

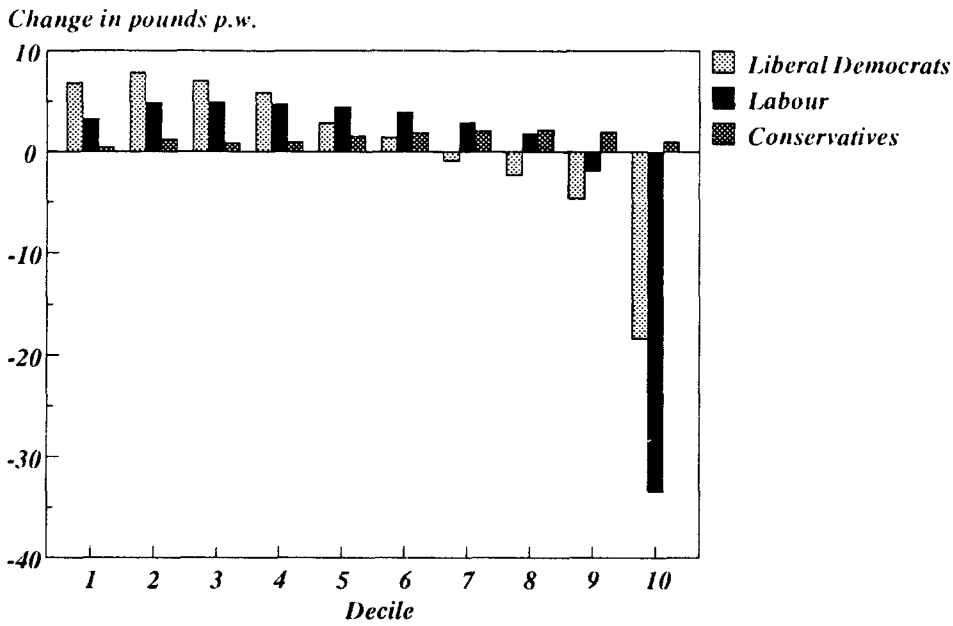
£1,500 million. In the Midlands and East Anglia, annual disposable income will rise by around £260 million, whilst in northern areas of England it will rise by £690 million. In the other countries of the UK, disposable income will rise by a total of some £290 million. This then represents a net transfer of resources from the South to the rest of the country of around £1.25 billion, with £250 million left over.

Since the other two parties' Budgets have a considerable net cost, there will be an average increase in income over the whole country. Even so, Liberal Democrat policies result in a net loss of income in the South of around £890 million. The Midlands and East Anglia will gain £430 million, the North £890 million and Scotland, Wales and Northern Ireland £500 million. The Conservative Budget involved a net give-away of over £2 billion to the personal sector and hence shows gains countrywide.

The proportions gaining and losing in each region reflect directly the relative affluence of the region. Under both Labour and the Liberal Democrats there are more losers in London and the South-East then elsewhere. The gainers are more heavily concentrated in the poorest areas - Wales, Scotland, Northern Ireland - under the Liberal Democrats. Even the Conservatives have most losers in London and the South-East.

Finally Figure 2.1 shows graphically the effects of the three parties' policies. For this purpose the population is divided into tenths, or deciles, with the poorest 10% of the population in decile 1, the next poorest tenth in decile 2 and so on up to the richest tenth in decile 10. The graph plots the average gains for each decile under each party's policies. This brings out the way in which the Conservative Budget affects most sections of the income distribution equally, how Labour would help all those in the lower three-quarters, with big losses in the very richest 10%, and how the Liberal Democrats would help the poorest more than the other two parties, impose losses at lower income levels than Labour but hit the richest rather less hard.

FIGURE 2.1
Average Gains and Losses by Decile



The Effects of Changes to the Tax and Benefit System 1979-92

We have shown what the effects of the parties' proposed Budgets will be. Here we use the IFS Tax and Benefit Model to look at what the effects of the actual policies carried out by the Conservative Government over the past 13 years have been. This helps put the proposed changes into perspective.

The number and size of changes to social security and taxation since the Conservatives first came to power in 1979 have been considerable. To outline them briefly, changes to income tax have included the reduction in the top rate of income tax on earned income from 83% to 40% and on unearned from 98% to 40%. The basic rate of income tax has fallen 8% from 33% to 25%. A reduced rate band was abolished in 1980 and reintroduced in this year's Budget. Independent taxation of husband and wife has replaced joint taxation. National Insurance contributions were increased, then reformed and reduced. VAT has risen from a standard 8% rate and a 12.5% rate on 'luxury goods' to a single 17.5% rate. (In this section we include the effects of changes to indirect taxes.) And, of course, domestic rates have been replaced by the Community Charge.

There have also been significant changes to social security benefits. In 1988 supplementary benefit was replaced by income support, and family income supplement by family credit. Housing benefit was reformed and substantially reduced. Some groups no longer qualify for particular benefits.

Using the IFS Tax and Benefit Model we are able to show how all these changes together have affected different types of people according to how much they earn and what sort of family they are a part of. The model can calculate the effects of the 1979 tax and benefit system, uprated to present day prices, on a representative sample of people, and compare these effects with those of the present system. This allows a meaningful assessment of the effects of government tax and benefit policy on people's incomes to be made.

All calculations are done on the basis of the population as it is at present. This means applying the 1979 system to a population which looks very different from that which existed in 1979. The incomes of those in work tend to be higher than was the case in 1979. Thus applying that same (1979) system to someone on average earnings in 1979 will have a significantly different effect from applying it to someone on average earnings in 1992. The average tax rate will appear higher in the latter case since tax allowances and thresholds will be relatively low compared with average earnings. Then comparing this with the present tax system the person will appear to have done relatively well over the period. Hence while it may be true that someone on average earnings in 1979 paid the same proportion of his or her income in tax as someone on average earnings now, if the 1979 system were introduced now, someone on average earnings would be paying considerably more tax.

Tables 2.11 and 2.12 show the average gains and losses from policy changes by family type and by income decile. They also show the percentages in each group gaining and losing. Family types are divided according to whether or not either husband or wife is working, number of children and age. The pensioner category includes all families where the head is over state pensionable age (65 for men, 60 for women). The 'not working' categories include all those under pensionable age who are not working including the unemployed, students and the sick and disabled. The income deciles split the population according to their position in the income distribution, once their incomes have been adjusted for family size. This process of 'equivalisation' allows direct comparisons to be made between different families - clearly a couple with two children needs more money than a single childless person. The poorest 10% of the population appear in decile 1, the richest 10% in decile 10.

TABLE 2.11
Distributional Effects of Tax and Benefit Changes 1979-92, by Family Type

Family type	Average gain/loss (£ per week)	% gaining	% losing
Single, not working	-2	31	58
Single, employed	15	84	12
Single-parent family	14	64	17
Couple, not working, no children	4	58	36
Couple, not working, children	2	70	22
Couple, one working, no children	15	69	27
Couple, one working, children	18	74	18
Couple, two working, no children	31	91	6
Couple, two working, with children	37	88	8
Single pensioner	6	78	15
Couple pensioner	12	72	20
Multiple family unit, no children	20	81	14
Multiple family unit, with children	20	75	19
All	18	77	17

TABLE 2.12
Distributional Effects of Tax and Benefit Changes 1979-92, by Income Decile

Decile	Average gain/loss (£ per week)	% gaining	% losing
1 (poorest)	-1	48	40
2	2	66	24
3	2	65	27
4	4	69	24
5	9	81	13
6	13	84	10
7	15	85	10
8	21	89	7
9	25	90	7
10 (richest)	87	92	6
All	18	77	17

Overall the tables reveal that tax and benefit changes have resulted in an average weekly increase of around £18 in disposable income. However, only the richest 30% have done this well or better, the overall average being pulled up by large gains among the richest 10% of around £87 per week. In the lower reaches of the income distribution the gains were much more modest, and in the lowest income decile there have actually been average losses of around £1 per week, although there are still more gainers than losers in the poorest decile.

When the gains and losses are analysed by family type, only one group is losing on average and that is the single non-working group. Non-working couples with and without children are also doing relatively badly with average gains of only £2 and £4 respectively. Those doing best are two-earner couples, this being a direct reflection of their higher incomes.

We now try to explain these changes. Clearly the most important reasons for the large gains among the richest have been the cuts in income tax rates, particularly in the higher rates of income tax. Some on the very highest incomes have gained several hundred pounds a week as a direct result of these cuts. Some of the gains here have been tempered very slightly by some recent changes, particularly the restriction of relief on mortgage interest payments to the basic rate. Others on moderate to high incomes have also gained from the basic rate cuts, which largely explain the gains of between £9 and £25 per week enjoyed by deciles 5 to 9. Of course, all those in these income groups will also have lost from the large VAT increases, while some will have gained from the switch from rates to the Community Charge. Nevertheless, the income tax cuts are easily the most important changes to have faced this group.

Lower down the income distribution, the patterns of gains and losses are more complex and require more explanation. On average we see losses only in the bottom decile, with small gains in the next couple of deciles. The complexity, however, is underlined by the significant proportions losing and gaining in this part of the distribution: 40% of the bottom decile are losing and 48% gaining, while a quarter of the second decile are losing and two-thirds gaining. This is reflected in the diverse experiences of those out of work who make up the majority of these deciles. While 58% of single non-workers are losing, only 36% of childless non-working couples and 22% of non-working couples with children are losing.

This indicates that poor single people without work have done worst from benefit reforms since 1979, and this is easily explained by reference to actual changes which have been made to the benefit system. Young single people were significant losers from the 1988 reforms, those under 25 receiving a reduced rate of income support. Students, also in this group, have lost out very considerably from changes in benefit rules which mean they can no longer claim either housing benefit or income support. All the poorer non-working groups have also lost out from the rule change which means they can no longer get 100% rebates on their local tax bills. And, of course, VAT increases have hit the poor, who have not been compensated by cuts in direct taxes because they do not pay them.

Of the three non-working categories, there have been fewest losers among those with children. This reflects the aims of the 1988 reforms which were specifically designed to direct more help towards poorer families with children, including poor working families, through the family credit system. Single parents have also done well from these reforms. For families with children just a little further up the income distribution, however, falls in the real value of child benefit have resulted in some losses.

The other groups which make up a major part of the bottom deciles are single and married pensioners. They have seen some gains on average, and only 15% of the former group and 20% of the latter have lost since 1979, while 78% of the former and 72% of the latter have gained. This pattern owes a considerable amount to increases in the income support rates for pensioners announced in this year's Budget and which we have included in the analysis even though they are not intended to come into effect until October. Among the pensioners who have still lost over the period, the majority have been affected by serious cuts in housing benefit, particularly new rules which reduce payments to anybody with savings of over £8,000 and altogether exclude from any receipt those with more than £16,000 in savings. Those pensioners who have gained significant amounts tend to have been relatively affluent and have thus gained from income tax cuts.

3 Local Taxation

The manifestos offered few surprises on local taxation. It is well known the Conservatives aim to remove the Community Charge by April 1993 and replace it with the Council Tax. Labour intend to introduce their 'fair rates' and give local authorities control over business rates. The Liberal Democrats would replace the Community Charge with a local income tax (LIT) and, like Labour, return business rates to local authorities.

Over the last two years the Government has reduced sharply the amount paid by local taxpayers towards local authority spending, with the aim of allowing a relatively painless introduction of the Council Tax. In the 1991 Budget the Chancellor, Norman Lamont, raised VAT by $2^1/_2\%$ in order to inject nearly £5 billion into local authority finances and so reduce Community Charge bills by £140. Local taxpayers are now contributing 20% (in net terms less than 15%) towards local authority spending. This proportion has been accepted by all the major parties as their starting-point for formulating their local tax alternatives.

Conservatives

If the Conservatives retain power in the election, they will complete their plan to introduce the Council Tax to replace the Community Charge in April 1993. The Council Tax is primarily a property tax based on capital values but with an additional element which partly relates payment to household size.

Under the Council Tax there will be a single bill for each household. It will reflect the value of the property though single-adult households will receive a 25% discount.

The Council Tax attempts to avoid the need for precise property valuation by assigning properties to a broad banding system of *eight* bands. The Government has fixed the relationship between the bands so that a household in the top band (band H in Table 3.1) pays no more than three times the payment of a household in the bottom band (band A).

TABLE 3.1
Council Tax

	Average bill for households with two or more adults[a]	Bill as a % of average property's	Property value (£, England 1991)	% of properties falling in band
Band A	£285	67%	Under 40,000	19
Band B	£332	78%	40-52,000	16
Band C	£380	89%	52-68,000	20
Band D	£427	100%	68-88,000	17
Band E	£523	122%	88-120,000	13
Band F	£618	144%	120-160,000	8
Band G	£713	167%	160-320,000	5
Band H	£854	200%	320,000 and over	2

[a] IFS estimates of Council Tax at Standard Spending.

At current levels the Council Tax will contribute 22% of local authority spending (15% after rebates). It follows that the gearing effect will be in the region of 6.1. That is to say that a 10% increase in local authority spending will increase Council Tax bills by close to 60%.

The Council Tax in band D would be £427 in 1992/93 if the local authority spends at the DoE Standard Spending Assessment (SSA). In general, Council Tax bills for 1992/93 in band D would fall within the £450-£480 range.

Concerns about the Council Tax include the following:

(i) There is a fear that although banding arrangements simplify the valuation of properties, they would also make decisions at the margin far more contentious. Moving down one band could save up to £140 when the system is in place.

(ii) Local authority accountants claim that without a local register - Ministers have refused to accept the need for registers - the single-person discount scheme will be almost impossible to administer effectively.

(iii) As the Council Tax is a highly regressive tax, there will still be a need for a substantial and expensive rebate system.

(iv) Many who have to administer the Council Tax are concerned that it is being pushed through too quickly. Local authority finance departments are currently still administering the running-down of domestic and non-domestic rates, the collection of the Community Charge, and now the introduction of the Council Tax.

Labour

If Labour win the election, they aim to replace the Community Charge with what they describe as 'fair rates'. Fair rates are very similar to the old domestic rates that existed before the Community Charge. In fact in the early years of a Labour government, local tax bills would be based on the pre-1990 rateable values, which were last assessed in 1973. In the longer run it will replace rateable values with a new method of assessment which will reflect a range of factors such as the re-build cost of properties, resale value etc. The Labour Party has recently detailed its local tax plans, giving illustrations of local tax bills for typical two-person households in each local authority for 1992/93. Labour make the following claims. In England a 'typical' family will be £168 a year better off on average than under the Community Charge, and £114 a year better off than under the Council Tax.

In order to substantiate these claims, the following assumptions were made:

(i) There will be administrative savings over the Council Tax in the order of £200 million. For this to be the case, the cost of administering fair rates would have to be on par - in real terms - with the costs of the old rating system. In the long run this will probably be the case but it is unlikely there will be substantial gains in administrative costs in the initial period of introduction.

(ii) Labour expect collection losses to be £390 million less under fair rates than under the Council Tax. This is because it is expected that non-payment will return to less than 2% of income - close to that achieved under the old rates - and that Council Tax non-payment will be 5.5% as a result of the difficulty involved in correctly identifying single-adult discounts.

(iii) Labour expect that under the Council Tax there will be a transitional relief package of close to £550 million which will be targeted on those who face big increases between their old rates bills and the new Council Tax bills. Given that fair rates bills will closely reflect old rates bills, it follows that transitional relief payment will be minimal. Labour intend to use the £550 million to increase the overall level of Revenue Support Grant (RSG).

(iv) Labour point out that the single-adult discounts under the Council Tax will cost £1 billion and that it is households with two or more adults that will have to foot the bill. By removing the single-adult discount there will be a substantial redistribution of the local tax burden away from households with two or more adults towards single-adult households. The costs to single-adult households in England could be an additional £160 on average.

Liberal Democrats

The Liberal Democrats would like to replace the Community Charge with a local income tax (LIT). They claim that it is the fairest system of local tax, given that, unlike the alternatives put forward by the Conservatives and Labour, local tax payments would rise more than proportionately with income - i.e. LIT is progressive.

The rate of local income tax will be determined by each local authority, and they will all inform the Inland Revenue. The Inland Revenue then sets a single 'local tax' rate above the average for each taxpayer. At the end of each financial year local taxpayers return a tax assessment which will allow them to claim a refund[1] on the amount withheld during the year.

The LIT will only be levied at the basic rate and not at the higher rate. For 1991/92 the Liberal Democrats claim that the addition to the basic rate of income tax would have been in the order of 3.3%.

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[1] With this form of withholding tax, the majority of taxpayers will claim refunds.

By bringing individuals into contact with the Inland Revenue on an annual basis, the Liberal Democrats overcome to a substantial degree the concern that there is currently insufficiently accurate information at the Inland Revenue on where individuals reside.

A fundamental concern about LIT is that the tax may be too progressive to use at the local level. Without a complicated grant equalisation system, there would be fears that the LIT would generate the 'flight to the suburbs' phenomenon, i.e. higher income earners would flee from high tax rate urban authorities which tend to have relatively higher spending on redistributive services such as social services.

A more general problem which awaits all parties - although largely ignored by them - is the large build-up of non-payment over the last three years. In some inner city authorities, local tax bills could be twice the amount they would have been if bills simply reflected local authority spending. There is a concern about whether local taxes are a credible means of collecting revenue from a large section of local taxpayers.

4 Long-Term Policy Towards Business

The choice between the visions of the Labour and Conservative Parties as embodied in their policies towards business is a choice between continental Europe, where most governments recognise a strong role for economic and social intervention, and the US, where the authorities are traditionally more *laissez-faire*.

It is a difference in philosophy wider than most commentators have perhaps realised. The Conservatives promise the continued application of the non-interventionist principles which we have witnessed over the last decade, principles which have made the UK an outlier in the European pattern of economic management (see, for example, Table 4.1). Underlying Labour's proposals is the abiding belief that government is well placed to improve upon the workings of the market.

TABLE 4.1
State Aid to Manufacturing as a Percentage of Gross Value Added in Manufacturing

	All manufacturing	Excluding steel and shipbuilding
Greece	15.5	16.4
Portugal	8.3	8.1
Italy	6.7	6.5
Ireland	6.1	6.2
Spain	5.3	3.7
Belgium	4.4	4.6
France	3.7	3.5
Netherlands	3.3	3.5
Germany	2.7	2.7
UK	2.7	2.5
Luxemburg	2.3	4.4
Denmark	2.0	1.6
EC-12 average	4.0	3.8

Source: Commission of the European Communities, *Second Survey of State Aids in the Manufacturing and Certain Other Sectors*, Luxemburg, Office for Official Publications of the European Community, 1990.

Conservatives

Nothing better illustrates the Conservatives' approach than the limited number of important specific policies in the party manifesto. The most significant proposals relate to new competition in railways and the privatisation of British Coal. There are some new measures for small firms, including a new Enterprise Service and a Consultancy Brokerage Service. Yet the most recently published Conservative spending plans actually project a shrinking Department of Trade and Industry, the budget falling from £1,118 million in 1990/91 to £850 million in 1992/93 in today's prices (see Table 4.2). The manifesto commitment to bring energy under DTI control may mask this process, but will not reverse it.

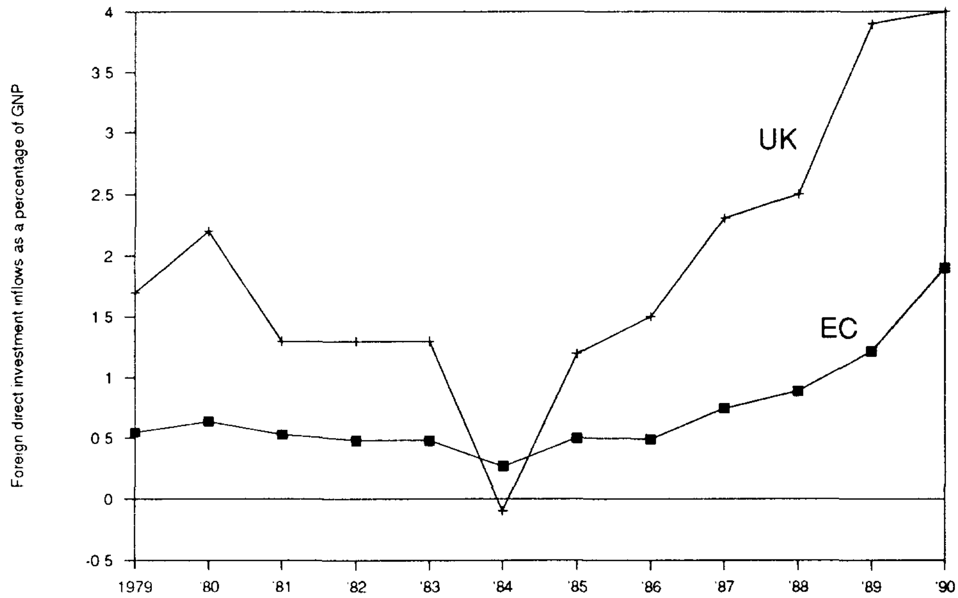
TABLE 4.2
DTI Expenditure and Budget Plans 1986-95

	1986/87	1987/88	1988/89	1989/90	1990/91	*1991/92*	*1992/93*	*1993/94*	*1994/95*
DTI expenditure in real terms (£ billion)	2.4	1.2	1.9	1.4	1.1	1.0	0.9	0.8	0.8
As a % of general government expenditure	1.1	0.5	0.9	0.6	0.5	0.4	0.4	0.3	0.3

Source: *The Government's Expenditure Plans 1992-3 to 1994-5.*

The Conservatives' manifesto - which is rather longer than Labour's - also mentions inward investment from abroad, a theme on which the party has placed a notable emphasis. This is not surprising, given that the rise in foreign direct investment in the UK has arguably been one of the successes of the decade (see Figure 4.1) - although the figures include take-over of UK firms by foreigners, in 1990 it was, for example, one-and-a-half times the size of gross manufacturing investment. The Conservatives promise to continue supporting foreign direct investment in the UK. They similarly state their backing for GATT and freer world trade, although it is unlikely that Labour would oppose any of these things.

FIGURE 4.1
Foreign Direct Investment Inflows 1979-90: a comparison of the EC and the UK



The striking difficulty for the Conservatives is to present their belief in not doing very much as an actual programme. It is the difficulty of grappling with this problem that probably accounts for the wealth of detail in the manifesto, proposing, for example, action to simplify trade mark registration and new controls on time-share contracts.

Labour

In marked contrast to the Conservatives, the Labour Party's 'Made in Britain' campaign promises government activism in a number of areas. The three manifesto pages on the supply side of the economy - liberally sprinkled with references to prevailing practices on the continent - promise the two major components of European-style intervention:

- new measures that will give money to industry (for example, increased first-year capital allowances, a 25% tax credit for additional R&D, a new investment scheme for small businesses, and a defence diversification agency to help defence suppliers redeploy themselves to civilian outputs);
- other measures that will impose burdens on industry (a statutory minimum wage of £3.40 per hour and minimum expenditure on training of 0.5% of payroll for nearly all businesses).

A detailed assessment of all of Labour's proposals is hard to make, since many are described in very general terms. For example, the proposed National Investment Bank is to operate on 'strictly commercial lines', investing in long-term infrastructure projects. It could have initial capital of anything between £50 million and £4 billion.

The most important policy that has been described in detail is the Manufacturing Investment Initiative. This involves a temporary 40% corporation tax allowance for additional investment in manufacturing plant and machinery. It would probably last for one year. At the moment, the first-year write-off is only 25%, so the Labour plan brings forward some of the tax allowances that are currently given in later years to the first year of investment.

The increase in manufacturing investment in plant and machinery stimulated by the extra allowance is likely to be around 6.5% (see S. Bond, K. Denny and M. Devereux, 'Investment and the role of tax incentives', in *Industrial Investment as a Policy Objective*, edited by Andrew Britton, NIESR Report Series no. 3, March 1992), bringing forward some £800 million of investment. Much of this will be investment that would have occurred anyway over the next few years, so, as Figure 4.2 shows, there is a slight fall in investment in later years. Overall, there is likely to be a very small increase in the productive capacity of the UK economy (by the year 2000, the capital stock will be about one-tenth of one per cent larger than otherwise, as Figure 4.3 shows), unless the scheme stimulates large general increases in aggregate demand. Of course, some of this accelerated investment will merely replace capital in good working order before the end of its life. It also carries the cost of destabilising the tax system. And in the absence of a firm commitment to end the scheme at a particular point in time, its effectiveness at accelerating investment may be reduced.

FIGURE 4.2
Percentage Change in Real Investment Relative to No Change

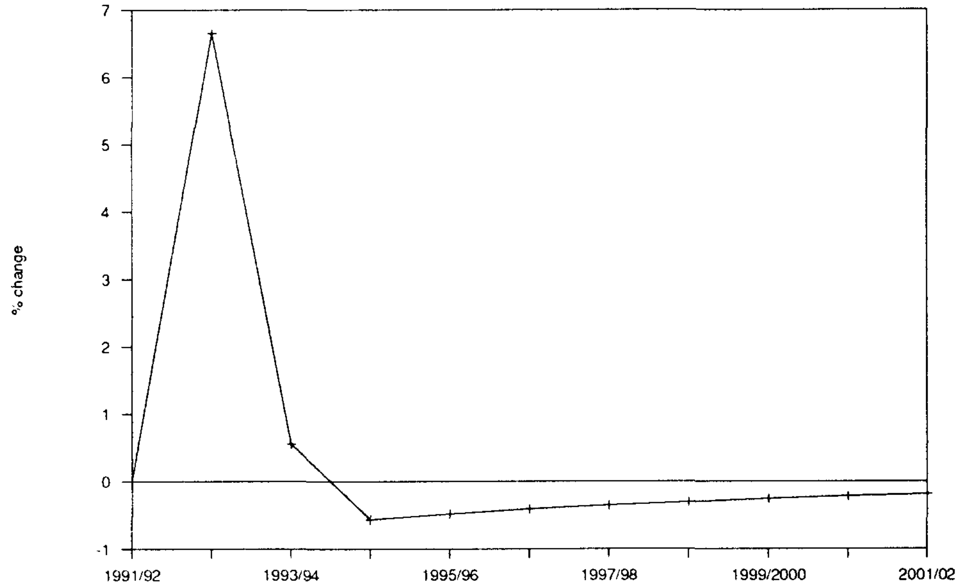
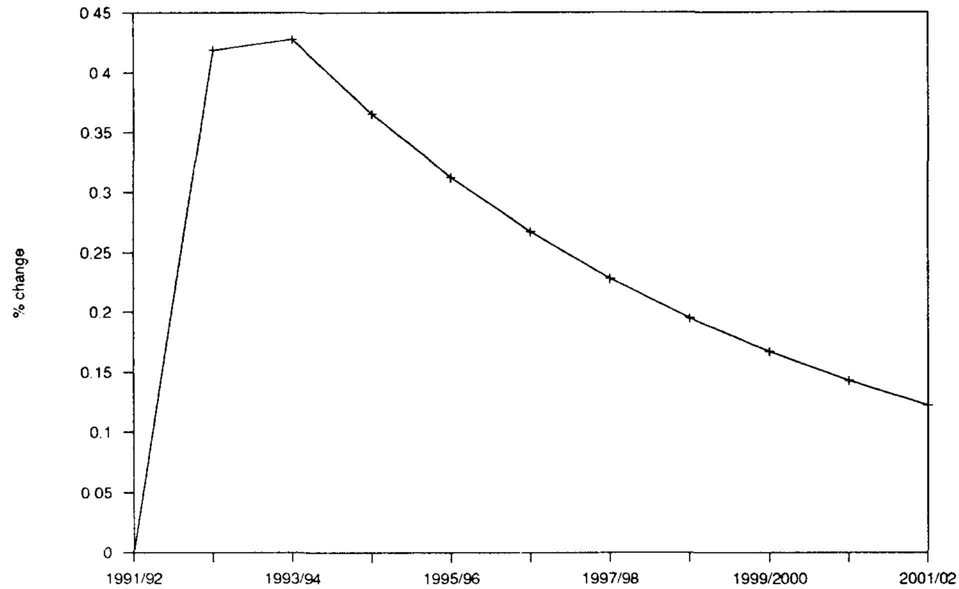


FIGURE 4.3
Percentage Change in Capital Stock Relative to No Change



By limiting the increase in allowances to additional investment, and only that in manufacturing, the costs can be contained. IFS estimates that the measure will cost £200 million in the second year of its operation (corporation tax is paid about one year in arrears, so the costs occur a year after the investment takes place). Much of this cost will be clawed back in later years as there will be less depreciation after the first year to be written off. This costing assumes that 'additional' investment can be tightly defined. If it cannot be, then the allowance will extend more widely and cost more. There must be some doubt as to the desirability or practicality of drawing boundaries around certain types of investment.

Other Labour measures seem to adhere more closely to the party's avowed objective 'not to replace the market, but to ensure that the market works properly'. The measures aim to affect the behaviour of private firms in areas where co-ordination is desirable but impossible without a co-ordinator. Labour's plans to expand the 'marriage bureau' operations of the development agencies can be defended in these terms, as can the proposals on R&D, training and the infrastructure.

Labour's Main Plans for Business

Investment

- Manufacturing Investment Initiative: enhanced first-year capital allowances for investment in technology and equipment.
- Growing Business Initiative: tax incentives for individuals to invest in new and growing manufacturing firms.
- National Investment Bank to fund public infrastructure projects.

The Work-Force

- Statutory minimum wage, set initially at £3.40 an hour.
- Legal obligation to spend 0.5% of payroll on training.

Innovation

- 25% additional tax credit for additional investment in R&D.

Regional Policy

- Regional Development Agencies for England to match those already existing in Scotland and Wales, with increased funding for the latter.

Specific Measures for Small and Medium-Sized Enterprises

- One-stop advice centres for all small firms.
- A minimum of 5% of government industrial R&D to go to firms of less than 500 employees (equivalent to £23 million on 1991 levels).

Liberal Democrats

It is hard to encapsulate the Liberal Democrats' policies for business in a simple phrase. Relative to the other two parties, their proposals involve slightly more immediate cash generosity but a greater willingness to impose burdens on companies when long-term objectives require it. For example, their plan to freeze the national non-domestic rate would boost company cash flow by considerably more than Norman Lamont's Budget changes to the transitional arrangements (which were supported by Labour). But at the same time, the Liberal Democrats would cut the Budget boost to the car industry by over a third, by making the car tax cut dependent on fuel efficiency. This is in line with the Liberal Democrats' ambitious environmental policies, which also include sharper limits on pollution through a tradable permit system. In this and other proposals, the party's application of the 'polluter pays' principle would increase costs for many firms.

The Liberal Democrats propose a series of changes to the tax system which are meant to have a direct effect on investment. They include reforms of the way that savings are taxed and the expansion of schemes which encourage innovation, especially in small and medium-sized enterprises. Other proposals directed at smaller firms are broadly similar to those of the Labour Party, although they include a few additional measures, demanding fair play when big firms deal with small ones. Once again, though, businesses would face additional costs as well as benefits. In line with the priority they have assigned to the nation's education, the Liberal Democrats propose a training levy on firms which is four times as big as Labour's, at the equivalent of 2% of payroll. In addition, firms would have to allow employees under 19 to spend a minimum of two days a week taking part in further education or recognised training courses.

Conclusion

Most of this discussion has focused on the longer-term attitudes, priorities and policies of the parties, yet it is their plans for reviving the economy in the short term, rather than their long-term visions of British industry, that have dominated debate.

Again, the Labour and Conservative recovery plans reflect their basic ideological instincts. The Conservatives injected some £715 million into the corporate sector in the Budget. This was on top of corporation tax cuts made last year, that are just coming on stream. There was an additional £635 million off car tax. This is the extent of Conservative recovery plans, since the recession does not receive any attention in the manifesto.

Labour stand by all of these measures and intend an extra 'emergency package' of £1.1 billion. Parts of this package - like the increased capital allowances for manufacturing investment - have been discussed above, and reflect the Labour emphasis on investment-led recovery. Other measures effectively increase spending without increasing taxes or the PSBR, involving, for example, the release of local authority funds for building and other projects.

Thus, the Conservatives illustrate in their approach to business their belief that the 'fundamentals' in the company sector are basically sound. Companies are short of cash, but the signals that will direct investment funds towards the appropriate projects as the economy recovers are not in need of any guidance from above. Labour, on the other hand, seems to believe not only that investment needs a bigger 'kick-start', but that it should be kicked in a certain direction of the government's choosing, namely the manufacturing sector.

Illustrative though this policy difference is, the sums involved - and thus the extent of any market manipulation - are relatively small. Indeed, probably the most striking feature of both the main parties' proposals for business is that in terms of their overall effect, the difference between the two is considerably smaller than the basic contrast in philosophies would lead one to expect.

5 The Public Finances to 1996/97 and the Impact of the Parties' Proposals

The state of the public finances over the lifetime of the next Parliament will exert a central influence on government's spending plans and the scope for tax reform.

Over the past few years, the public finances have deteriorated substantially; a £14 billion repayment of debt in 1988/89 has become a forecast £28 billion of borrowing in the coming year, 1992/93. This worsening position is both a result of some discretionary easing of fiscal stance on the revenue and on the spending side, and a reflection of the depth and duration of the recession.

Economic Assumptions

The main prerequisite for a projection of the public finances is a view of the likely path of the economy. Table 5.1 reproduces the working assumptions from the Budget 'Red Book' for growth and inflation over the next five financial years.

TABLE 5.1
Medium-Term Economic Working Assumptions

(% growth)	1992/93	1993/94	1994/95	1995/96	1996/97
Growth (real GDP)	2	$3\frac{1}{4}$	$3\frac{3}{4}$	$3\frac{1}{2}$	$3\frac{1}{4}$
Inflation (GDP deflator)	$4\frac{1}{2}$	$3\frac{1}{2}$	3	$2\frac{1}{2}$	2

Source: HM Treasury, *Financial Statement and Budget Report 1992-93*, Table 2.1, 1992.

Following a 2% fall in output in 1991/92, a modest recovery is forecast for 1992/93, with GDP up 2%. Growth is then assumed to gather momentum, with GDP increasing at over 3% per annum over the next few years. Although this is above the likely trend growth rate, the depth of the recession has ensured that the GDP *level* is well below trend.

Baseline Public Finances Forecast

Given the Government's spending plans, what does this economic scenario mean for the public finances? Table 5.2 shows the Government's projections of the PSBR and its key components for the next five years.

TABLE 5.2

The Public Finances in the Medium Term

(£ billion)	1992/93	1993/94	1994/95	1995/96	1996/97
Public spending planning total[a]	235	250$\frac{1}{2}$	263$\frac{1}{2}$	271	277
Local authorities' self-financed spending	9$\frac{1}{2}$	10	10	10	10$\frac{1}{2}$
Other spending	22	25	27	29	30
Privatisation proceeds	8	5$\frac{1}{2}$	5$\frac{1}{2}$	1	1
General government expenditure	258	280	295	309	317
Taxes	181	195	214	232	251
National Insurance	39	42	46	49	52
Other receipts	10	10	10	9	9
General government receipts	230	247	270	290	312
Fiscal adjustment	0	0	0	1	2
PSBR	28	32	25	19	6
PSBR (% of GDP)	4$\frac{1}{2}$	4$\frac{3}{4}$	3$\frac{1}{2}$	2$\frac{1}{2}$	$\frac{3}{4}$

Source: HM Treasury, *Financial Statement and Budget Report 1992-93*, Tables 2A.3, 2A.4, and 2A.5, 1992.

[a] Excluding privatisation proceeds.

On the spending side, the rate of increase in the planning total (excluding privatisation) is projected to slow from a real rate of 3% at the beginning of the period to less than $^1/_2$% by 1996/97. Local authorities' self-financed expenditure is presumed to grow at a slower rate, though other spending (which includes accounting adjustments and central government debt interest) is growing more rapidly. Repeated borrowing requirements are predicted to increase the ratio of net public sector debt to GDP from a trough of 27% to a peak of 35% in 1996/97. This will increase the burden of debt servicing. Finally, privatisation proceeds, which are counted as negative spending, decline to only £1 billion a year by 1995/96 from £8 billion in 1992/93.

Receipts pick up strongly in 1994/95, when the growth rate is projected to peak, though there is also the lagged impact of the strength of the recovery in 1993/94. The PSBR begins to decline in that year, though the reduction in borrowing is largest in 1996/97. Predictions of a falling PSBR have led the Government to pencil in a 'fiscal adjustment', or tax cuts, of £1 billion in each of 1995/96 and 1996/97. But on the Government's projections, there remains a borrowing requirement of £6 billion, or $^{3}/_{4}$% of GDP, by the end of the lifetime of the next Parliament.

The PSBR and the Economy

Developments in the public finances are driven by the future path of output. Because of the uncertainty surrounding predictions into the medium term, we have projected the outcome for the public finances on a more optimistic and a more pessimistic growth assumption. Note that we have assumed that the political affiliation of the next government will *not* have an impact on the rate of economic growth. Whilst this may seem unduly sceptical, it focuses attention on the underlying changes and the micro-economic issues.

The more optimistic scenario is that GDP growth is $^{3}/_{4}$% higher in each of the financial years 1993/94 to 1996/97, though remains at the 2% forecast in the Red Book for the coming year. The more pessimistic assumption is that GDP growth will turn out $^{3}/_{4}$% lower in each of these years. The impact on receipts has been modelled using the same techniques as the annual *Green Budget* exercise.[2]

Table 5.3 shows the impact of economic growth on the PSBR over the next five years. For 1992/93, we have retained the government forecast in each of the three scenarios. Looking forwards, the effect of a faster growth rate is at first small, but accumulates to a substantial difference.

In 1993/94, the optimistic scenario would result in the PSBR being held constant as a proportion of GDP. By 1996/97, a small debt repayment would be possible. On the pessimistic scenario, improvements in the public finances are very much smaller. The PSBR remains above 3% of GDP until 1995/96.

By the end of the period, the difference between the optimistic and pessimistic assumptions is some £16 billion. This underlines an important, albeit quite obvious, point: the out-turn for the public sector finances is highly sensitive to economic performance. One of the most marked features of the last few

[2] See Appendix 1 of *Tax Options for 1992: The Green Budget*, IFS Commentary no. 28, 1992, for details. Note that we have not adjusted spending for differences in growth rates.

TABLE 5.3
The PSBR and the Economy

		1992/93	1993/94	1994/95	1995/96	1996/97
	optimistic	28	30	20	12	-3
PSBR (£ billion)	baseline	28	32	25	19	6
	pessimistic	28	34	28	24	13
	optimistic	$4\frac{1}{2}$	$4\frac{1}{2}$	$2\frac{3}{4}$	$1\frac{1}{2}$	$-\frac{1}{4}$
PSBR (% GDP)	baseline	$4\frac{1}{2}$	$4\frac{3}{4}$	$3\frac{1}{2}$	$2\frac{1}{2}$	$\frac{3}{4}$
	pessimistic	$4\frac{1}{2}$	5	4	$3\frac{1}{4}$	$1\frac{3}{4}$

Source: Baseline projections from HM Treasury (1992), *Financial Statement and Budget Report 1992-93*, Table 2A.5. Optimistic and pessimistic figures, IFS projections.

years has been the speed at which the PSBR fell, became a substantial debt repayment, and then returned to a large PSBR. The public sector finances are highly cyclical; the government's scope for tax cuts, borrowing reductions or additional spending is highly dependent on the economy. Though the growth assumptions we have used probably lie at the extreme of what might happen, they are not absurd. The next government, whatever its political affiliation, will be reliant on economic growth for achieving its tax and spending goals.

The baseline projection shows the underlying position were the Conservatives to be re-elected; it is to the impact of a change in government that we now turn.

The PSBR under Labour

To assess the medium-term path of the public finances under Labour, we implement the specific commitments made in their manifesto. For 1992/93 and 1993/94, we have used the figures provided in the 'Shadow Budget'[3] and our own projections thereafter.

On the spending side, Labour has promised a one-off increase in the basic state pension and in child benefit. Subsequently, pensions would be uprated in line with the higher of earnings or prices, as opposed to the current procedure of price indexation. Forecast extra spending is given in the first line of

[3] Labour Party, *You're Better Off with Labour*, 1992.

Table 5.4. Privatisation proceeds would be lower under Labour, although some of the revenue from pre-election privatisation proceeds would still be received.[4] The Shadow Budget says that 'in a full year there will be £3.5 billion available for investment'. We have added £1.8 billion to 1992/93 spending, £3.5 billion to 1993/94 and a similar amount in future years to reflect extra health and education spending. Apart from these changes, we have assumed spending will follow the Government's predictions. Total extra spending compared with the baseline government forecast in Table 5.2 is given in the fourth row of the table, following the convention that privatisation proceeds are accounted for as negative spending.

TABLE 5.4

The Effect on the Public Finances of Short-Term Labour Commitments

(£ billion)	1992/93	1993/94	1994/95	1995/96	1996/97
Social security spending	+1.4	+3.3	+4.1	+4.9	+5.7
Other spending	+1.8	+3.5	+3.6	+3.7	+3.8
Privatisation proceeds	0	+4.6	+5.5	+1.0	+1.0
Total spending	+3.2	+11.4	+13.2	+9.6	+10.5
National Insurance revenues	+1.3	+2.8	+2.3	+2.6	+2.8
Income tax revenues	+1.9	+3.3	+3.5	+3.6	+3.7
Stamp duty	0	+0.8	0	0	0
Fiscal adjustment	0	0	0	+1.0	+2.0
Total revenues	+3.2	+6.9	+5.8	+7.2	+8.5
Effect on PSBR	0	+4.5	+7.4	+2.4	+2.0

Source: Figures for 1992/93 and 1993/94: derived from Labour Party, *You're Better Off with Labour*, 1992.
Figures for 1994/95 onwards: IFS projections.

On the revenue side, additional National Insurance contribution receipts come from the abolition of the contribution ceiling, from the extension of contributions on benefits in kind, and from bringing forward the abolition of the 2% incentive to 'contract

[4] We have assumed that Labour would receive £8 billion in 1992/93, £0.9 billion in 1993/94 and none thereafter. All but £2 billion of the 1992/93 receipts derive from pre-election privatisations. We have therefore implicitly assumed that Labour would continue with the privatisation of Northern Ireland electricity. Note that we have ignored the small revenue streams from debt repayment by former nationalised industries.

out' of SERPS one year to 1992/93.[5] The cost of abolishing the 2% National Insurance payment on earnings up to the lower earnings limit has also been included.[6] Extra revenue would also be raised from the income tax: from the new 50% higher rate and from not implementing the lower rate band included in the Government's plans, though this would be offset to an extent by higher personal allowances. Some extra receipts come from delaying the abolition of stamp duty on stocks and shares for a further year. Finally, we have assumed that Labour would use the fiscal adjustment pencilled in for 1995/96 and 1996/97 for purposes other than cutting taxes.

In the first year, Labour keeps within the Government's PSBR forecast, but in the second year, reduced privatisation proceeds require greater borrowing. In 1995/96 and 1996/97, borrowing would be £2-£3 billion higher.

The PSBR under the Liberal Democrats

The Liberal Democrats have provided costings of their proposals to 1996/97. The key elements are reproduced in Table 5.5. Extra social security spending is shown in the first row, again stemming mainly from one-off increases in pensions and child benefit, and from subsequently uprating the basic pension annually in line with earnings. The second row shows the cost of other spending measures, stemming mainly from additional public investment programmes. The Liberal Democrats have proposed that they would privatise the Government's remaining holdings in the electricity-generating companies and in British Telecom; we have assumed that they are able to match the proceeds built into the Government's forecasts.

Extra revenue from the income tax and National Insurance contributions arises from abolition of the upper earnings limit, a 1p increase in the basic rate and not implementing the lower rate band. Revenues from indirect taxes are increased mainly as

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[5] We have also assumed that Labour would not implement the 1% incentive for personal pension holders over 30 from 1993/94.

[6] Note that we have assumed that the current procedure of indexing the lower earnings limit (LEL) to prices is continued. This would only be the case if Labour revised the provision of the Social Security Act 1975 that the LEL should be set approximately equal to the basic state pension. If this legislation were not revised, the LEL would rise with the pension increases, costing some £0.5 billion in 1992/93 and more thereafter.

TABLE 5.5

The Effect on the Public Finances of Liberal Democrat Commitments

(£ billion)	1992/93	1993/94	1994/95	1995/96	1996/97
Social security spending	+4.3	+6.2	+6.5	+6.6	+6.9
Other spending	+7.1	+9.4	+10.0	+9.7	+11.0
Total spending	+11.4	+15.6	+16.5	+16.3	+17.9
Income tax/National Insurance	+8.4	+9.6	+10.4	+11.0	+11.7
Indirect taxes	+0.2	+1.5	+1.7	+1.1	+1.7
Other receipts	-0.3	-0.3	+0.3	+0.5	+0.6
Fiscal adjustment	0	0	0	+1.0	+2.0
Total receipts	+8.3	+10.8	+12.4	+13.6	+16.0
Effect on PSBR	+3.1	+4.8	+4.1	+2.7	+1.9

Source: Derived from Liberal Democrats, *The Liberal Democrat Manifesto Costings*, supplement to *Changing Britain for Good*, 1992.

Note: Excludes claimed savings from lower unemployment and proposed additions to the contingency reserve.

a result of the introduction of an energy tax, though offset to an extent by a phased 1% reduction in VAT. Other receipts reflect items such as a cut in national non-domestic rates on top of the reduction in the 1992 Budget, and revenues from road-pricing. Finally, the Liberal Democrats have committed themselves to using the fiscal adjustment to reduce borrowing. The resulting extra borrowing is shown in the final row.

The Public Finances and the Parties

Having discussed the Government's own forecasts and the impact of the manifesto commitments of the opposition parties, Table 5.6 draws together total spending, revenues and the PSBR for each of the main political parties.

The table shows the elements of the public finances on the baseline economic assumptions and assuming that no changes to tax and spending plans beyond those described above take place. It should not therefore be regarded as a forecast, but a description of what fiscal manoeuvre is available after short-term commitments have been met.

TABLE 5.6
Summary of the Parties and the Public Finances

(£ billion)	1992/93	1993/94	1994/95	1995/96	1996/97
Conservatives					
General government expenditure	258	280	295	309	317
General government receipts	230	247	270	290	312
PSBR	28	32	25	19	6
PSBR (excluding privatisation)	36	38	31	20	7
Labour					
General government expenditure	261	291	308	319	328
General government receipts	233	254	276	297	321
PSBR	28	37	32	21	8
PSBR (excluding privatisation)	36	38	32	21	8
Liberal Democrats					
General government expenditure	269	296	312	325	335
General government receipts	238	258	282	304	328
PSBR	31	37	29	22	8
PSBR (excluding privatisation)	39	43	35	23	9

Source: See Tables 5.2, 5.4 and 5.5.

Turning first to the Conservatives, the Red Book projections suggest that they will not achieve their target of a balanced budget in the lifetime of the next Parliament. Only if growth significantly exceeded the Government's assumptions, and if tax cuts or spending increases are modest and delayed until the 1995 Budget, could balance be achieved. Faced with a growing economy and a shrinking PSBR, it seems unlikely that a Conservative Chancellor would be able to forgo income tax cuts simply to accelerate the PSBR's decline. A relaxation in the pursuit of a balanced budget seems more likely.

Even assuming the Conservatives accept a lengthy delay in the return to budget balance, the first few years of another Conservative Parliament would not be tax-cutting ones. The Government has allowed for reductions in the 1995 and 1996 Budgets, but only very small ones. Achieving the 20p basic rate target by 1996/97 would mean borrowing of nearly 2% of GDP in that year on the baseline projections.

The path of the PSBR under Labour looks only a little different, though the absence of privatisation proceeds requires extra borrowing to fund the same level of spending. But whereas the Conservatives' ambition is to cut taxes, Labour's goal is to increase spending as and when economic growth allows. As for the Conservatives, in the first two years the scope for any spending beyond that announced looks severely limited. 1995/96 is the first financial year in which there is any significant 'growth dividend' for a Labour Chancellor to spend. But Labour is not committed to a zero PSBR as the Conservatives are. If Labour kept borrowing to 3% of GDP (the EMU limit), then annual public spending could exceed the Conservatives' plans by up to £15 billion, though only in the last years of a Labour Parliament. If growth is high, more scope would exist, but if growth were low, or Labour felt the need to reduce the PSBR below 3% of GDP during the high-growth years of the cycle, then substantial spending increases would be difficult.

Again, the Liberal Democrats' plans imply a similar profile for the PSBR, though with extra borrowing of £3 billion or more in the early years to fund a 'recovery programme'. The PSBR declines to a similar level to Labour's by 1996/97. But given the level of extra spending already entailed, a Liberal Democrat Chancellor would face a good deal less pressure than Labour to increase spending over and above that planned.

Irredeemable Promises?

Whoever wins the election, the public finances will limit a new government's room for manoeuvre, particularly in its first two years in office. Thereafter, the PSBR will begin to decline, but unless the economy performs far better than could reasonably be expected, the scope for the main parties to achieve their goals will be severely limited.

If the Conservatives won and were serious about achieving a balanced budget by 1996/97, they would have to forgo even the modest tax cuts already projected. It seems likely that the balanced budget rather than the tax cut target would go, allowing some scope for income tax reductions.

If Labour won, they would only be able to afford modest extra spending in the first two years beyond the child benefit and pensions rises. Thereafter, provided they maintained a relatively high level of borrowing, some spending increases would be possible, but not of a magnitude representing a significant proportion of total expenditure.

Again, the Liberal Democrats would need to add to borrowing, particularly in the early years, to achieve their goals.

Whoever wins the election, it is the performance of the economy that is of key importance in determining the scope for extra spending or tax cuts. But a 'growth dividend' of significant size will not appear until 1995/96, limiting the ability of whichever party (or indeed parties) form the next government to achieve its objectives.