

# **Tax Options for 1991**

## **The Green Budget**

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# 1 Overview

## Macro-Economic Considerations

**A war Budget** The run-up to the 1991 Budget is dominated by the Gulf War, which has added a huge new element of uncertainty into the already uncertain state of government finances. It is also dominated by a severe loss of business confidence in the face of a sudden and accelerating fall in demand and output. Conventional economic analysis tells us that there is little connection between the two events. The cost of the war is so far too small to have much effect on government finances. The threat of rising oil prices appears to have receded, and in any case, according to OECD and IMF calculations, a 50% higher oil price adds only a percentage point or so to world inflation in 1991, knocking a similar amount off real output - unwelcome but hardly a major disaster.

Yet it is clear that the Gulf conflict, because of its potential effect on oil supplies, has been an excuse to postpone many decisions, including decisions to purchase. It has probably helped to tip an already vulnerable economy into recession. And though the central forecasts are for an average recession, a disaster on the scale of 1980 or worse is widely feared. An early end to the war, or even confirmation that the fighting is now unlikely to result in any further serious disruption of oil supplies, could allay those fears and unleash some pent-up demand. Business plans predicated on an oil price of \$20 or less look very different from those based on a \$50+ price.

However, this enticing prospect contrasts starkly with the present reality. A sharp rise in unemployment, a sharp fall in output, and a sharp slow-down in bank lending have all recently confirmed what the CBI survey has been telling us for many months: the downturn in economic activity which started in the summer is still accelerating towards severe recession. The forecasters are hard-pressed to keep up with the spate of gloomy news, and the consensus has been revised down every month since September.

This is the background against which the 1991 Budget, the first from the Major-Lamont team, will be prepared. The Budget will be an occasion to take stock of the cost of the war, about which much more will be known in March. The Budget judgement will clearly be affected by those costs, which could easily amount to £3-4bn if the war continues right through the next financial year. Equally, it is still possible that the war will be over by April. The "costs" of equipment already lost may be quite high, but these weapons came out of stocks which do not have to be replaced, or not all at once. It is still possible that the first-year costs of a programme of replacement could be met out of the contingency reserve and by contributions from other western powers. So a war that ended by April would have a fairly small effect on the government's finances in 1991-92.

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This Green Budget is based on that assumption. This means that the risks to the public finances are all in the direction of higher spending. We believe that the right way to cope with any extra spending, compared with our assessment, is by raising borrowing, which is the time-honoured method of paying for wars. Given the depressed state of the economy, the inflationary pressure generated by additional debt-financed defence spending will be small, and in an election year the government will prefer to raise its PSBR targets rather than increase taxes.

**ERM and the election** Although billed in advance as a holding operation rather than an occasion for major tax changes, the Budget will be of interest to economic professionals because it is the first Budget under the new regime in which the ERM bands, rather than monetary targets, are the corner-stone of monetary policy. And since it could be the last Budget before the next election, and is certainly the last opportunity to do anything about an increasingly threatening recession, it is also of considerable political interest.

Every Budget is a juggling act, in which the Chancellor's natural ambition to leave his mark on the tax system must be balanced against the imperatives of the macro-economic situation, and the state of the public finances. This year, clearly, the scope for structural change to the tax system is extremely limited. Tax changes are usually unpopular and with the election so close, reform can only be contemplated if it could be sugared with tax cuts, which now seems most unlikely. Too much extra cash has already been committed to increased public spending, including poll tax sweeteners, and more may yet be pre-empted by the war.

This Budget will accordingly be judged mainly by how it deals with a deepening recession, at a time when inflation problems are still severe, in the new policy framework provided by ERM membership. Attention will also be focused on the deterioration in the state of the public finances that began before the war, and on the government's contingency plans for dealing with the additional costs of the war.

**The economic background** For the last four years Budgets have been framed against a background of strong (becoming excess) demand. Inflation has been a growing worry to which the government has responded, since May 1988, by progressively tightening its monetary stance. The inflation worry is still with us, but in all other respects the background to this Budget could hardly be more different. In the first half of the year a demand rebound and accelerating inflation were still a real possibility. But since the summer the pace of the slow-down has accelerated markedly and all the indicators are now pointing one way. The CBI surveys show a collapse in business confidence as severe as in 1980, though starting from a higher base.

Business attitudes reflect a real and sharp deterioration in business conditions. A rising exchange rate has made it harder generally to sell abroad, especially for US-oriented exporters who suffered both from a falling dollar and a collapse of US demand. And the slow-down in real disposable income (with the poll tax providing the *coup de grâce*) has made it hard to sell at home. So firms started to see the long sales



slow-down turn into an outright decline. Yet costs were still rising and the threat to profits was exacerbated first by the Gulf War, which threatened a sharp rise in fuel costs, and then by entry into the ERM which locked sterling to the continental currencies at a level many felt to be too high.

The resulting collapse in confidence follows a long period of rising profits and high animal spirits. In the boom years investment, financed to an unusual extent by borrowing rather than retained profits or new share issues, soared to unprecedented heights. Industry's legacy is a bill for debt interest, swollen by high base rates, which has helped to create, on official figures, a corporate borrowing requirement of some £30bn or 5% of GDP. Much of the borrowing is from banks which are becoming less willing to roll over credit lines, in order to rid their balance sheets of bad or doubtful loans. This "credit crunch", though still largely a US phenomenon, is also now increasing the pressure on UK companies to cut back their spending.

There is thus now a serious risk that a consumer-led growth recession becomes a producer-led slump. As evidence accumulates that this process is under way, the government, which faces an election within 18 months, will come under increasing pressure to ease its monetary stance. But it cannot easily do so because of the ERM constraint, and anyway present monetary conditions, though undeniably tight, have not yet produced a convincing fall in inflation. As always at this phase in the cycle, the slow-down in output has yet to be matched by a fall in wage settlements, so the growth rate of unit costs is still high.

**The ERM strategy** The government has clearly decided that its best hope of securing a change in wage behaviour is to stick to a strong sterling strategy, thus maintaining the pressure on companies to negotiate tougher wage settlements. In fact the pound, though stronger than it has been, is not currently overvalued against the German mark and the other European currencies (either on the conventional purchasing power parity measure, or compared with the average over the past decade). It may of course become so if present inflation differentials persist. It is certainly overvalued against a weak dollar, but there is little the government can do about that.

The main problem the government now faces is that of persuading both the foreign exchange market and the labour market that it is serious in its commitment to the ERM. When it has persuaded the foreign exchanges that there will be no devaluation, present interest rates will look excessive. When it has persuaded the labour market, present wage settlements will look excessive. A reduction in both is the perfect recipe for a resumption of growth without a resumption of inflation.

Unfortunately the only way of signalling, with deeds rather than words, that the ERM commitment is binding is to hold up interest rates. The consequence may be a deeper-than-necessary recession, and no time for recovery ahead of the election. One way of avoiding this out-turn would be to combine a tight monetary policy with some easing of fiscal policy at Budget time.

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**Fiscal policy in the ERM** The problem with this approach is that the present government has, for the past 12 Budgets, rigorously eschewed fiscal fine-tuning. Under the Medium-Term Financial Strategy fiscal policy was deliberately set on automatic pilot. The aim was to balance the budget in the medium term. In recent years, when the government has been confronted with a major and unexpected boom, it has been prepared to allow some automatic tightening of fiscal policy, but it has never admitted the case for discretionary action. The Treasury maintains that the forecasting uncertainties are too great, so that once-a-year changes in fiscal stance are as likely to be destabilising as stabilising. In the past they have also added that any "steering" that needs to be done can be achieved by changing interest rates.

However, in the ERM the scope for changing interest rates in response to domestic demand conditions has now been greatly reduced. So, with recession looming and interest rates locked at a high level, the pragmatic arguments for some discretionary fiscal action appear to be strong. We therefore believe that this, the first Budget in the ERM, could be an occasion for a re-examination of the Medium-Term Financial Strategy, and a restatement of the philosophical and strategic arguments for and against such action.

In a quasi-fixed exchange rate regime, where interest rates are assigned to hitting the exchange rate target, the theoretical case for a more active fiscal policy has always been recognised. Fiscal expansion now would, by offsetting the recessionary impact of high interest rates, make it politically easier for the government to keep rates high and thus *easier* to hit the *exchange rate target*. This is quite different from the situation in the early days of the MTFs, under which fiscal expansion added to total borrowing and hence, *ceteris paribus*, made it *harder* to hit the *broad money targets*.

**Implications for the MTFs** On balance, however, we believe that these arguments, though intellectually respectable and very beguiling in the present conjuncture, will not convince the authorities that a major change to the MTFs is appropriate. They can argue that, since they have been taking account of the exchange rate in their policy deliberations for some years, joining the ERM with wide bands hardly requires them to behave any differently. They can point to the great uncertainties engendered by the Gulf War. A fiscal boost might seriously disturb the financial markets already worried about the potential cost of the war. It could even prove an unnecessary stimulus if an early truce subsequently gave the economy a much greater boost.

Inside or outside the ERM the arguments for a balanced budget over the entire economic cycle remain in place. In the short term a balanced budget inspires confidence in financial markets. In the medium term it means that the burden of debt interest payments, which pushes tax rates higher than they would otherwise be for a given level of public spending, is slowly but surely reduced.

**The public finances** So a discretionary fiscal boost is most unlikely. But the authorities may - for the first time - be prepared to admit that there is a strong case for allowing the so-called automatic fiscal stabilisers to work. We expect the forecast PSDR of £7bn this year to shrink to only £1bn, a change that has more to do with public spending overshooting than with a recession-induced revenue shortfall. Contrary to what many people believe, the recession has so far caused a relatively small contraction of the tax base - non-collection of poll tax may have had a greater effect - which has been swollen by the effect of higher-than-expected inflation.

Next year, on fiscal forecasts which take full account of the recession, we still expect revenue to be some £2bn higher than the (typically cautious) Treasury forecasts made last year. Again this is because higher inflation outweighs the effect of a recession. It is often forgotten, for example, that a fall in output which is concentrated in investment and stocks has a relatively small effect on the indirect tax base, and income tax will not come in below expectations unless there is a fall in the wage bill which would, from an inflation perspective, be entirely welcome.

**A £4bn PSBR in 1991-92** Nevertheless, given the upward revisions to next year's public spending already announced in the Autumn Statement, and taking account of the past tendency for yet more extra spending to be discovered between the Autumn Statement and the following Budget, we now expect public spending in 1991-92 to be £10bn higher than projected last year. Taken together with £1bn of tax cuts forgone, these revenue and spending projections imply a £7bn revision to the public finances, from a forecast debt repayment of £3bn to a borrowing requirement of £4bn.

**A neutral Budget** On past form we would expect the government to respond to this worsening financial situation with a modest tightening of fiscal policy. However, on this occasion we expect Mr Lamont to announce a PSBR of £4bn, and no net changes in taxation. If he does, it will be the first time that this government has presided over a significant planned increase in borrowing from one year to the next. Moreover, the extra borrowing would be undertaken to finance a planned increase in public spending. This is probably as big a discretionary fiscal boost as Mr Lamont, whose top priority is to reduce inflation, will be prepared to admit at Budget time. But with pressures for higher public spending intensifying in the election run-up, the eventual PSBR in 1991-92 could be higher than £4bn - and would certainly be so in the event of a prolonged war.

### Prospects for Tax Changes

**Income tax** Changes to income tax are often seen as setting the tone for a Budget's tax changes, and this seems likely to be true this year. On balance, we think the chances of significant net cuts in income tax are slim, but there may well be shifts in the burden between groups. Increases in personal tax allowances at least in line with inflation seem likely; the only Conservative Budget of the last 12 years which failed to do this was that of 1981. The Chancellor may wish to increase allowances by more than this, which would be expensive but could be funded by tax increases elsewhere. One prime candidate for raising money would be to freeze the higher rate

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income tax threshold. This happened in last year's Budget, and may well happen again in 1991; it does not impose any cash losses, and strengthens the government's "caring" image if it is used to pay for allowance increases which particularly help those on low incomes.

**Company cars** A further possible source of extra revenue would be another increase in the level of income taxation on company cars. Mr Lawson doubled company car scale charges in 1988, and there have been further real increases since then, but the scale charges may still be below the appropriate true level. An increase of 15% in the scales would raise around £150m. An alternative, or additional, change would be to increase the extent to which the scale charge is a function of engine capacity, thereby encouraging use of smaller cars.

**MIR** As usual, the run-up to the Budget has been the cue for calls for an increase in the Mortgage Interest Relief ceiling from the £30,000 at which it has stood since 1983. To increase the ceiling now would have an undesirable effect on the tax system, and the Treasury is strongly opposed to it, not least because of its cost. One way of alleviating any such cost would be to restrict MIR to the basic rate of tax, raising £500m which would be enough to pay for raising the ceiling to £35,000. Any change here would be a surprise, however, especially since its strongest advocate has departed Downing Street.

**Reduced rate band** A common mistake is to believe that the introduction of a reduced rate band for income tax such as existed from 1978 to 1980 is a good way of helping the poor. The poor will *always* gain more from an equal-cost increase in the allowance, since to gain in full from the reduced rate requires taxable income in excess of the band. So despite the RRB's superficial attractions to a government intent on creating a more "caring" image, it would be an empty gesture and we do not expect it to happen.

**NICs** Despite positive steps in the 1985 and 1989 Budgets, there are still anomalies in the NI contribution structure; three stand out. First, the employees' NI ceiling: the abolition of the ceiling for employers was the most important change in 1985, and balance requires the abolition of the employees' ceiling. It also requires a change in the structure of employers' contributions for the low-paid, to match that made in 1989 to employees' contributions. Third, the inclusion of benefits in kind from the NI base would remove a major distortion from the system and could raise as much as £1bn. Given that the desire for a neutral tax system is likely to take second place to the need for revenue this year, bringing "perks" into the NI framework seems more likely than reducing employers' contributions on the lower-paid. Abolishing the NI ceiling would raise revenue but would make an important group of marginal Conservative voters worse off. By contrast the government could tackle perks without making employees worse off immediately, if it subjected them to employers' NI but not employees' NI.

- Saving** With the economy moving rapidly into recession the case for using the tax system to boost saving is much less strong than last year. Major new initiatives or dramatic reform seem equally unlikely, but some tinkering with TESSAs and PEPs may occur, both to tidy up problems and to encourage the (probably false) impression that the government has a strategy for this part of the tax system.
- Environment** The White Paper on the environment was not very positive on a role for taxation in environmental policy, except in so far as vehicle taxation was concerned. While we do not expect to see any new taxes announced with explicit environmental objectives, further changes to pre-existing taxes seem possible. The most likely changes are in petrol taxation, with further increases in the leaded/unleaded differential, perhaps enhanced by a shift from VED to petrol tax. Changes to company car taxation are also a possibility, as outlined above.
- Indirect taxes** Increasing indirect taxes in line with inflation would add 0.6% to the retail price index (RPI), unwelcome at a time when the government is trying to cut inflation. But failing to impose such increases would cost around £2bn, and enrage health and environmental lobbies. As last year, we expect to see increases broadly in line with inflation, although with some redistribution between taxes possible.
- Corporation tax** The corporation tax system we have had since 1984 is very vulnerable to inflation, which is currently increasing the average rate of tax on companies at a time when their cash flow is being weakened by the squeeze on profit margins. The case for indexation (e.g. stock relief) is stronger than ever, but still seems unlikely to carry the day. And although companies would be helped by reduction in corporation tax, the companies most in need of help are probably not paying much corporation tax anyway. The best way of helping companies in trouble would be a reduction in interest rates, and the government no doubt feels that there is a danger of any corporation tax cuts being passed on in higher wage settlements which would delay the moment when interest rates can be safely cut. Corporation tax reform must almost certainly wait at least until after a General Election.

## 2 The Economic Forecast

### 2.1 The World Economy

The major developed economies experienced a year of growth close to trend last year, taking the global economic upswing into its ninth successive year. However, the average figure masks the emergence of a notable divergence in economic performance between different countries, as the year progressed. Economic activity has remained buoyant in Japan and West Germany; in the latter case growth has been boosted by unification with East Germany. Elsewhere, rates of economic activity have been clearly slowing, even before the depressing effects of higher oil prices have had time to take effect. Recent economic data suggest that the US, Canada and Australia have entered a mild recession. Meanwhile in Europe there have been signs of output weakness developing in many non-German economies. Moreover, a major problem for these economies is that the Bundesbank is unlikely to ease monetary policy at any time soon and will quite possibly tighten again, thereby putting a floor under ERM countries' interest rates.

Despite emerging differences in cyclical economic performance among different countries, aggregate growth in the OECD area was forecast relatively accurately last year. A year ago, the OECD Secretariat was forecasting growth of 2.9% in 1990; it now estimates that the out-turn will be 2.8%. With growth expected to be close to trend, consumer price inflation was forecast by the OECD to stabilise at around 4.5%. In the event, higher oil prices resulted in an overshoot relative to this forecast; the OECD now projects this out-turn to be 4.8% but this implies a slightly better-than-expected underlying performance.

Consensus economic forecasts show the rate of economic growth slowing further in 1991. Higher oil prices imposed on an already weakening global economic environment account for much of the projected slow-down. The oil shock has probably not yet worked through fully to output growth in the industrial countries. Higher oil prices tend to act like a tax on factor inputs and lead to a reduction in aggregate supply, thereby depressing output and employment. By the spring to summer of this year, the impact will probably be visible.

**Table 2.1. Forecasts for the World Economy**

| % change from previous year | 1989 | 1990 | 1991 | 1992 |
|-----------------------------|------|------|------|------|
| <b>OECD real GNP</b>        |      |      |      |      |
| HMT                         | 3.3  | 2.5  | 2.1  | -    |
| OECD                        | 3.4  | 2.8  | 2.0  | 2.5  |
| Goldman Sachs               | 3.2  | 2.2  | 1.2  | -    |
| <b>OECD consumer prices</b> |      |      |      |      |
| HMT                         | 4.5  | 5.0  | 5.0  | -    |
| OECD                        | 4.4  | 4.8  | 5.6  | 4.6  |
| Goldman Sachs               | 4.4  | 5.0  | 4.9  | -    |
| <b>UK export markets</b>    |      |      |      |      |
| HMT                         | 7.5  | 4.3  | 3.9  | -    |
| OECD                        | 8.9  | 6.7  | 6.7  | 7.5  |

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

Sources: HMT - HM Treasury, "Autumn Statement", November 1990.  
 OECD - "Economic Outlook", December 1990.  
 Goldman Sachs - "UK Economics Analyst", February 1991.

However, consensus projections, which are based on an assumed average oil price this year of \$25 to \$30 per barrel, suggest that the oil shock will do far less damage to the world economy than the shocks of 1973-74 and 1979. There are four main reasons for this. First, the oil price increase is substantially smaller this time round. In 1990 prices the cost of oil has risen by only \$9 per barrel compared with a \$22 increase in 1973-74 and \$25 in 1978-80. Second, the use of oil in OECD economies has fallen significantly since the first oil shock: consumption of oil per unit of output has fallen by around 40% since 1973. Third, the underlying inflation performance in most OECD economies on which the oil price shock is being imposed is better than in either 1973 or 1979. Furthermore, improvements in labour market performance have strengthened the capacity of OECD economies to adjust to a relative price shock without adding to inflation. Finally, governments have been able to draw lessons from the past two oil shocks and consequently seem less likely to accommodate the short-term rise in inflation which otherwise might become embedded in a wage/price spiral. Simulation results by the OECD Secretariat and the IMF suggest that each \$5 per barrel increase in oil prices would boost consumer price inflation by around 0.5% this year and cut output growth by 0.3-0.4%. These results are broadly built into consensus projections which indicate that a 50% increase in oil prices to around \$27 per barrel may boost inflation by around 1% on average this year and cut output growth by 0.5-1%.

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The OECD Secretariat forecasts that growth in the developed countries will slow to 2% this year based on the assumption that oil prices average \$27 per barrel. Within the total, the weakest economic performance is expected in the UK and North America where growth is projected at under 1%. Balancing this to some degree is the expectation that growth will proceed at 3% or above in Japan and Germany.

Inflation is expected to rise further in the wake of the oil price shock but could then begin to ease during the course of the year. For the group of major developed economies as a whole, the OECD Secretariat expects inflation to average 5.6% this year, easing to 4.6% in 1992. The US is likely to remain a relatively high-inflation economy, but robust unit labour cost growth in several economies will probably prevent a major fall in global inflation even if, as most forecasters expect, oil prices fall back towards \$20 per barrel by the end of the year.

There is a general presumption that the effects of the Gulf crisis can be absorbed relatively smoothly over the next year. But apart from the risks to economic activity emanating from the uncertainties surrounding the Gulf conflict, most of the other risks facing the world economy seem to be on the downside for activity. In general, forecasters have assumed that private sector confidence is maintained, but it is apparent from business and consumer surveys that confidence has become much more fragile in recent months. If this weakens further, spending could be hit, with firms paring back investment plans and individuals cutting back consumption. Risks are also apparent in the financial system. Rising bad debts and inadequate levels of capital threaten the banking system, leading to some signs of a credit crunch and to fears that this may become more widespread. This is particularly the case in the US and Japan.

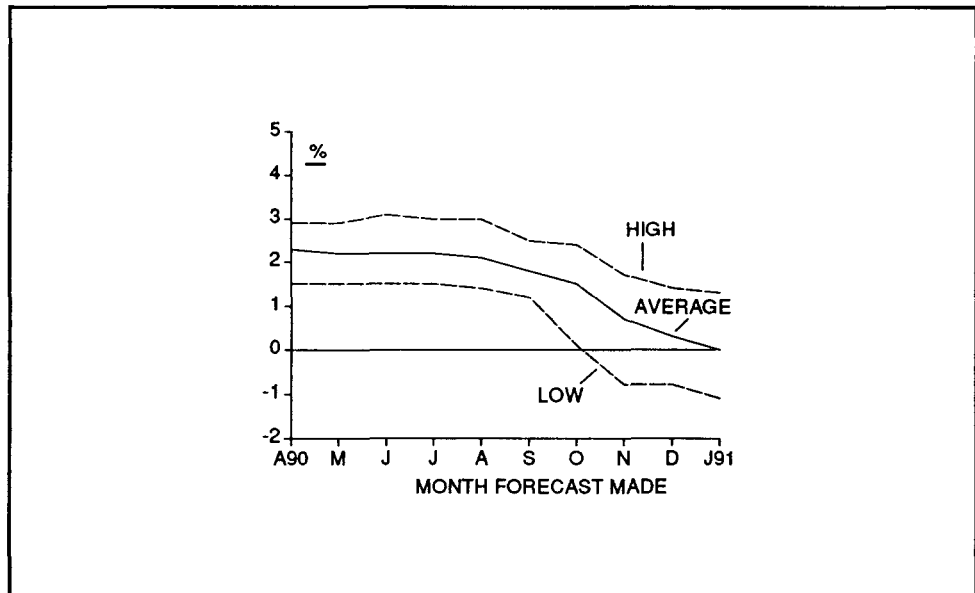
Overall, the world economic environment seems less propitious for growth than at any time for almost a decade. The hope is that the oil price shock, if it is not reversed, can be absorbed relatively easily, thereby paving the way for a better economic performance in 1992. The fear is that high oil prices could contribute to a damaging collapse in private sector confidence and in financial market stability which would exacerbate the present weakening economic climate. Either way, the Chancellor cannot plan on the assumption that the world economy will provide much of a support to activity in the UK in the next year.



## 2.2 The UK Economy

At this time last year the consensus view was that output growth would slow to about 1.5% in 1990, with a continuous slow-down taking place through the year. In the event it appears that real GDP in calendar 1990 will turn out to be around 1% higher than it was in 1989. While this is well within the acceptable margins of error on most economic forecasts, the pattern of growth through the year was very different from what was generally expected. The first half of 1990 was much more buoyant than anticipated, with real GDP growth of around 2% compared with the first half of 1989, and this was followed by a much weaker second half. Recent economic data show that a strong downward momentum in economic activity still exists. This has been reflected in the sharp downward revision to consensus forecasts for growth in 1991, particularly in recent weeks as Chart 2.1 shows. Our usual selection of mainstream, model-based forecasts, which were prepared before these data became available, have been overtaken by events. New forecasts currently in preparation will almost certainly show a less optimistic picture.

**Chart 2.1. Consensus GDP Forecasts for 1991**



According to the GDP components, the greater-than-expected strength in economic activity during the first half of 1990 occurred because of export buoyancy and because consumers continued to defy the impact of high interest rates. They were able to do this largely because real disposable income continued to grow strongly up to mid-year. However, everything changed in the third quarter. The reduction in the growth of exports which occurred as UK export markets slowed, together with the impact of slackening real disposable income growth on consumers' spending, combined to produce the sudden set-back in economic activity that was

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observed around the middle of 1990. What seems to have happened is this: tight monetary policy, world-wide and in the UK, had been slowing spending for some time. But in mid-1990 negative growth was registered for the first time and the effect on business confidence was dramatic.

### **Domestic Demand**

Most forecasters are expecting the prevailing high level of interest rates and weakened business and consumer confidence to depress domestic demand further during 1991, with many forecasters expecting an absolute decline in the level of domestic demand. Both the corporate and personal sectors are struggling under the burden of debt built up during the period of financial market liberalisation and world-wide easy money in the mid-1980s; interest payments have risen sharply to unprecedented peaks relative to incomes. The severity of any further cut-backs in private spending is likely to depend on the ability of the private sector to manage its debt burden. This will depend in turn on a combination of the confidence of the private sector, the availability of finance from the banking sector, and the speed at which monetary policy is eased. It is difficult to forecast with any certainty how deep the recession may be as the interplay of these factors runs its course, and there is a wide variation among economic forecasts.

Within the components of domestic demand, consumer spending growth is generally expected to decelerate further, reflecting a weaker trend in the growth of real personal disposable income. The Treasury's forecast of 0.5% growth this year compares with the consensus view of other forecasters for growth around 1% which is broadly in line with the consensus view of real disposable income growth.

There is a widely held view that the level of investment will continue to fall through 1991. This is consistent with recent surveys of investment intentions which indicate a decline in investment this year in response to the weak economic environment and as companies seek to improve their financial position. The Treasury projects a 1.75% drop in the level of investment this year compared with a drop of almost 4% expected by the consensus of forecasters. A downgrading to the Treasury's investment forecast may well be the main change introduced between the Autumn Statement and Budget projections.

Company spending on stockbuilding also seems likely to be cut back sharply. Survey evidence suggests that companies are becoming increasingly eager to cut stock levels, though not yet to the extent reached in 1980. The present survey readings, were they now to stabilise, would suggest that the decline in the level of stocks may cut GDP by just under 1% in the next 12 months.

**Table 2.2. Demand Prospects**

| Annual % change, volume                | 1989 | 1990 | 1991 |
|--|------|------|------|
| <b>Private consumption</b>             |      |      |      |
| HMT                                    | 3.8  | 2.5  | 0.5  |
| LBS                                    | 3.9  | 2.6  | 2.4  |
| NIESR                                  | 3.9  | 2.2  | 2.0  |
| Goldman Sachs                          | 3.9  | 1.7  | 1.0  |
| Consensus                              | 3.9  | 2.2  | 1.2  |
| <b>Total fixed investment</b>          |      |      |      |
| HMT                                    | 4.8  | -1.5 | -1.8 |
| LBS                                    | 4.8  | -0.9 | -1.3 |
| NIESR                                  | 4.8  | -1.1 | -1.9 |
| Goldman Sachs                          | 4.2  | -1.6 | -6.3 |
| Consensus                              | 4.8  | -1.8 | -3.7 |
| <b>Exports of goods &amp; services</b> |      |      |      |
| HMT                                    | 4.3  | 4.5  | 2.5  |
| LBS                                    | 4.3  | 5.1  | 3.0  |
| NIESR                                  | 4.3  | 5.3  | 6.3  |
| Goldman Sachs                          | 4.4  | 4.7  | 1.5  |
| Consensus                              | 4.3  | 5.3  | 2.7  |
| <b>Imports of goods &amp; services</b> |      |      |      |
| HMT                                    | 7.0  | 2.5  | 1.3  |
| LBS                                    | 7.0  | 2.6  | 1.8  |
| NIESR                                  | 7.0  | 2.9  | 5.9  |
| Goldman Sachs                          | 7.0  | 2.9  | -0.1 |
| Consensus                              | 7.0  | 2.5  | 1.4  |
| <b>Real GDP</b>                        |      |      |      |
| HMT                                    | 2.0  | 1.0  | 0.5  |
| LBS <sup>a</sup>                       | 2.5  | 1.5  | 1.4  |
| NIESR <sup>a</sup>                     | 2.5  | 1.3  | 0.8  |
| Goldman Sachs                          | 1.9  | 1.0  | -1.2 |
| Consensus                              | 2.1  | 1.2  | 0.3  |

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

Sources: HMT and Goldman Sachs - as Table 2.1.  
 LBS - "Economic Outlook", October 1990.  
 NIESR - "National Institute Economic Review", November 1990.  
 Consensus - "Forecasts for the UK Economy", HM Treasury, December 1990.

## Net Trade

The strength of sterling against the US dollar, taken together with a slow-down in the growth of UK export markets, has led to much less buoyancy in visible exports in recent months. Most economic forecasters expect this trend to be maintained during 1991 given the expected

## Green Budget 1991

weakening in world economic activity. The Treasury's forecast, which is broadly in line with the consensus, projects a 2.5% increase in export volume this year following a rise of around 4.5% in 1990. However, the sluggish performance of the domestic economy, and the onset of de-stocking, are likely to lead to an even more subdued performance from import volume. On past occasions whenever the level of stocks has declined significantly this has been accompanied by a drop in the absolute level of import volume. The Treasury's forecast, which is again reasonably close to the consensus, indicates a 1.3% growth in import volume this year after rising by an estimated 2.5% in 1990.

These relative trends in trade volumes have been the main reason for the improvement in the current account deficit in recent months. Most forecasters expect this improving trend in the current account to be maintained during 1991 as a result of the weakness of domestic economic activity. Typically, they show the deficit improving to around £11bn this year compared with an estimated deficit of £15.5bn last year. But with UK competitiveness deteriorating, and with GDP growth cycles in Britain and Europe moving into a different phase, a number of forecasts suggest that the improvement in the current account may not be sustained, so that a renewed worsening is likely next year.

### **Output**

The general picture this year, therefore, is likely to involve a decline in the level of domestic demand which may be partially offset by a modest improvement in net trade. The net effect of these factors according to the consensus of forecasters is to leave the level of output broadly unchanged between 1990 and 1991. It is worth noting, however, that the consensus forecast for activity has been falling like a stone in recent weeks and it may well have further to fall. There is no sign yet that activity is anywhere close to touching bottom and output may be on a declining path until the middle of this year. GDP may resume a gentle upward path in the second half of the year as by then the pace of de-stocking should be starting to slacken and consumer spending should be recovering as price inflation drops. The extent of any pick-up in final demand may be modest, though, since fixed investment could continue dropping well into next year. Unemployment is expected to rise steadily with most forecasts suggesting that the level will exceed two million during the course of the year. Recent figures suggest that this may be substantially on the optimistic side. There is as yet no clear consensus about economic prospects for 1992, though several forecasters project a gradual recovery in the growth of GDP to just over 2%.

### **Inflation**

It is fair to say that most forecasters have been excessively optimistic in the last two years about the trend in inflation. In part this stems from an over-optimistic view of the speed at which the economy would respond to the tightness of monetary policy. The underlying rate of inflation has been rising as the growth slow-down has boosted unit costs. This has made it

hard to cut interest rates, so the mortgage-related element of the RPI has also remained higher for longer than expected. The Treasury's Budget prediction was that inflation in the fourth quarter of 1990 would be 7.25% compared with the actual out-turn of 10%. Looking ahead, the consensus expectation is for the rate of retail price inflation to drop to around 5.5% by the end of 1991, which is in line with the Treasury's projection. A further slight drop is shown in consensus projections for 1992 towards 4.5%. This time these forecasts seem quite reasonable. Past cyclical experience in the UK suggests that the inflation improvement, when it begins in earnest, will be prolonged - precisely because the lags involved in this process are long. The severity of the downturn projected by most forecasters should help to bring wage inflation down from the middle of the year while the cyclical improvement in productivity that is likely will help eventually to contain unit wage costs. If past experience is repeated, price inflation could drop from a peak of 10.9% to a low point of 4-5% in 1992 or 1993. This is true of both the headline RPI figure and of core inflation.

**Table 2.3. Other Key Indicators**

|                              | 1989Q4 | 1990Q4 | 1991Q4 |
|------------------------------|--------|--------|--------|
| <b>Price inflation (%)</b>   |        |        |        |
| HMT                          | 7.6    | 10.3   | 5.5    |
| LBS                          | 7.6    | 10.0   | 5.6    |
| NIESR                        | 7.6    | 10.3   | 4.9    |
| Goldman Sachs                | 7.6    | 10.0   | 5.0    |
| Consensus                    | 7.6    | 10.2   | 5.2    |
|                              | 1989Q4 | 1990Q4 | 1991Q4 |
| <b>Unemployment (m)</b>      |        |        |        |
| LBS                          | 1.65   | 1.71   | 1.87   |
| NIESR                        | 1.65   | 1.77   | 2.10   |
| Goldman Sachs                | 1.65   | 1.77   | 2.54   |
| Consensus                    | 1.65   | 1.75   | 2.08   |
|                              | 1989   | 1990   | 1991   |
| <b>Current account (£bn)</b> |        |        |        |
| HMT                          | -19.0  | -13.5  | -11.0  |
| LBS                          | -19.1  | -17.0  | -16.6  |
| NIESR                        | -19.1  | -16.7  | -14.0  |
| Goldman Sachs                | -19.6  | -15.7  | -9.7   |
| Consensus                    | -19.6  | -16.0  | -11.7  |

Sources: As Table 2.2.

# 3 Major Risks

## 3.1 Corporate Spending

### Introduction

As we have seen, published forecasts encompass a wide range of views at present. This is usually a good indication of uncertainty, and is often a sign that the economy is approaching a turning-point. After two-and-a-half years of high interest rates the economy should be nearing its trough. Relatively small differences of view on the precise timing of the upturn can in these circumstances lead to fairly substantial differences in forecasts of annual growth rates.

But this is *not* the cause of the present dispersion of views. Far from reflecting a disagreement about the timing and extent of an incipient *upturn*, the forecasts differ in the extent to which they have taken on board the magnitude of the current *downturn*. In general we find, if we look at the current crop, that the more recently a forecast was published, the more gloomy it is. After two years of gradual slow-down, punctuated by fears of a bounce-back that was premature (because inflation had not yet even begun to fall) the economy appears to have gone into free fall. The downturn has its origins in consumer demand. But the serious worry now is that the shortage of orders from consumers has provoked a crisis of confidence among *producers*, which threatens to turn a downturn into a slump.

### The State of Company Finances

The underlying reason for focusing on producers is the fragile state of the corporate sector's finances. This is far from being a new story. It was, oddly, at the very moment of transition from the long 1981-87 upswing to the 1987-88 boom that the company sector moved into financial deficit. Table 3.1 shows the main elements in the accounts of UK industrial and commercial companies for the second quarter of 1987, when this deficit first appeared, and the third quarter of 1990, the most recent for which we have data. The growth of profits over that period has been negligible, though total current income has been buoyed up by rents and non-trading income as well as income from abroad. Even so, income has not been able to keep pace with the huge rise in prior claims on it, notably interest payments (because of the rise in rates) and taxes (which reflect the earlier fast growth of profits). Dividend growth has also, notoriously, far outstripped the growth of profits, and appears to be regarded by many companies, or their institutional shareholders, as a prior claim.

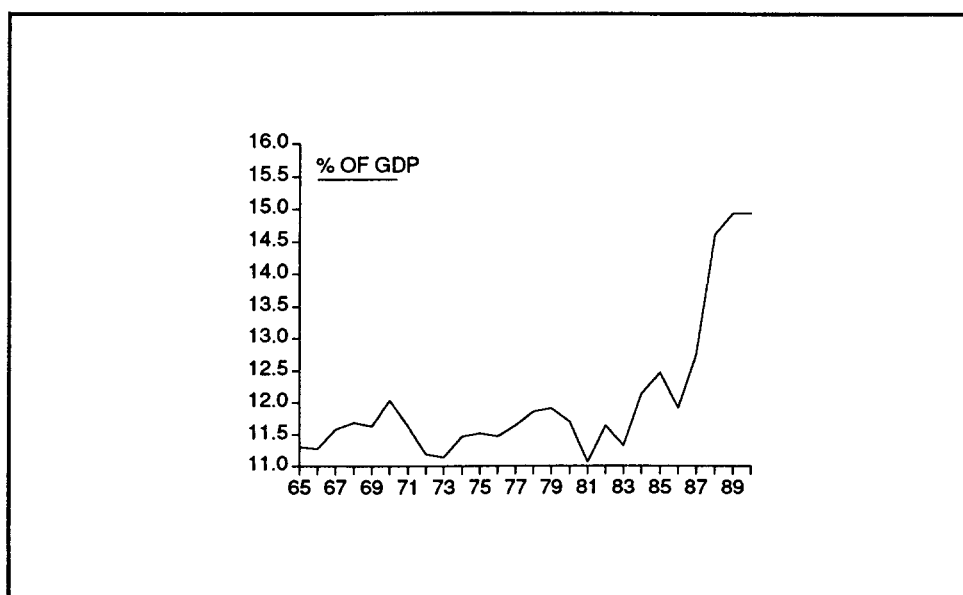
**Table 3.1. The Financial Position of Industrial and Commercial Companies**

| £ billion                               | 1987Q2 | 1990Q3 | Change |
|---|--------|--------|--------|
| 1. Current receipts                     | 20.2   | 26.1   | 5.9    |
| Profits                                 | 15.5   | 16.7   | 1.2    |
| Other                                   | 4.7    | 9.4    | 4.7    |
| 2. Current allocation of income         | 10.6   | 20.4   | 9.8    |
| Taxes, dividends and other              | 7.7    | 12.7   | 5.0    |
| Interest                                | 2.9    | 7.7    | 4.8    |
| 3. Current surplus (=1-2)               | 9.6    | 5.6    | -4.0   |
| 4. Available for capital spending       | 8.5    | 4.0    | -4.5   |
| 5. Actual capital spending <sup>a</sup> | 8.6    | 11.8   | +3.2   |
| 6. Balance to be financed (=4-5)        | -0.1   | -7.8   | -7.7   |

<sup>a</sup> Current surplus less profits due abroad, stock appreciation and capital transfers.

Source: CSO, Appropriation Account of Industrial and Commercial Companies.

Companies have thus seen their quarterly current surplus shrink by £4bn (i.e. an annual rate of nearly £20bn) over the period. But over that same period there has been a boom in business investment, which has reached a peak which is unprecedented over the post-war period (see Chart 3.1). Quarterly capital spending has increased by over £3bn, resulting in an increase in the quarterly deficit of nearly £8bn. What were the causes of this extraordinary turn-round?

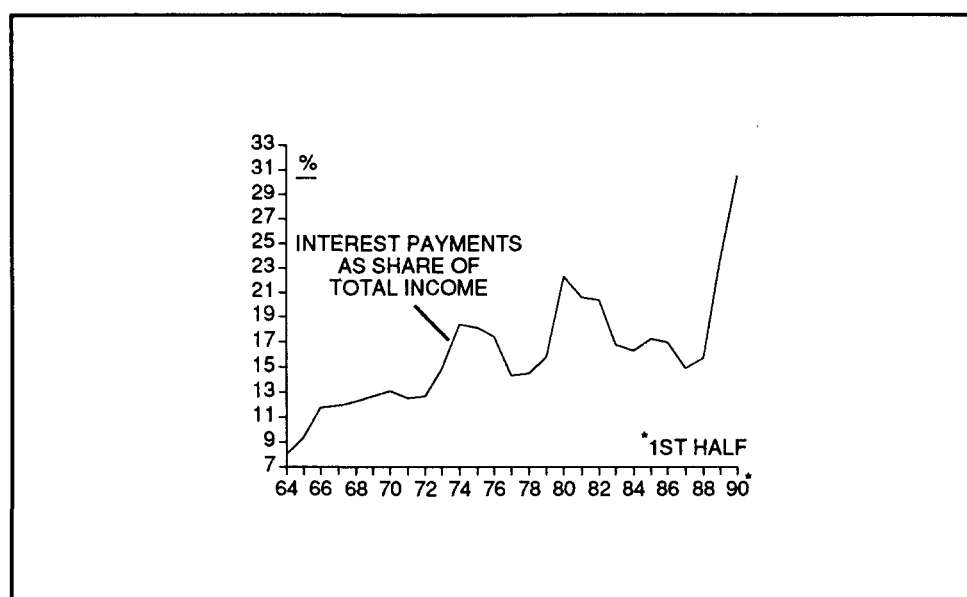
**Chart 3.1. Business Investment**

### The Financial Deficit and the State of Confidence

Its origins lie in the 1986 fall in oil prices, and the associated fall in the exchange rate, which gave a massive boost to business confidence and led companies to take on labour at an accelerating rate. The 1987 election result, which promised at least another four years of pro-business government, provided a further fillip. The immediate effect of the extra employment was to erode profit margins, at just the moment when businesses were confidently undertaking new investment on a massive scale.

Shrinking profit margins have encouraged an increase in the proportion of new investment financed by debt, which has risen in recent years from less than a quarter to nearly a half. In a stable economic environment, entrepreneurs welcomed the increase in gearing which promised higher returns on capital at the (acceptable) cost of an increase in risk. And because interest payments can be offset against the corporate tax bill, whereas dividend payments cannot, debt-financed expansion promised higher post-tax returns than alternative methods of finance. The resulting rise in debt levels, compounded by the sharp rise in interest rates, has left companies with an unprecedented burden of debt payments relative to income, as Chart 3.2 shows.

Chart 3.2. Companies' Income Gearing



At the start of the year, though the debt burden was high, companies could reassure themselves with the thought that it would fall as incomes rose and interest rates came down. But as the year unfolded, growth prospects worsened steadily at home and abroad, and it became clear that ERM entry, far from providing an opportunity for an early cut in interest rates, committed the government to a longer period of high interest rates in order



to establish credibility. Companies also had to face up to opinion poll evidence suggesting that a change of government might be imminent as well as to a war threat and a sharp spike in the oil price. Add to that list of woes the prospect that banks, whose own balance sheets are under pressure, may be less willing than in the past to extend the credit lines on which companies are more than ever dependent, and it is hardly surprising that the rate of decline of business confidence is threatening to become the sharpest ever recorded.

### **The Squeeze and the Likely Response**

The conclusion of the above analysis is that companies allowed themselves to move into deficit when economic prospects were good and they felt confident. It seems highly likely that now prospects are bad, and they feel less confident, they will take every measure they can to reduce the deficit. This analysis has been questioned, on the grounds that it is hard to find, among the larger companies, evidence of a deterioration in their financial position which matches that shown by the national accounts - which are in any case notorious for their inaccuracy in this area. We are not reassured by this, for a number of reasons. First, the national account deficit is still large even if it is adjusted to take maximum account of possible measurement errors, as represented by the balancing item. Second, there is independent evidence, from the CBI survey of company liquidity, of a deterioration in the financial position of companies. Third, even if this deterioration is concentrated on, if not confined to, smaller companies, the consequences could still be serious. It may after all be smaller companies that have the most difficulty in getting banks to extend the credit needed to tide them over the recession.

The risk remains that cut-backs by companies, large or small, attempting to improve their financial position, are now driving the economy into recession, the depth of which depends on where the cuts fall and how deep they are. Essentially, there are three ways in which the companies can bolster their finances. First, they can try to *improve profitability*, principally by controlling wage costs. Second, they can try to *reduce current expenditure* on interest, taxes and dividends. Third, they can reduce *capital spending*. In this section we examine the scope for action in each of these three areas.

#### *Improve Profitability*

With the government's anti-inflation squeeze constraining companies' ability to raise prices, attempts to improve profitability must focus in the first instance on reducing costs. Since the single biggest variable cost facing a firm is its wage bill, this means that companies have to rein back wage cost increases. This can be achieved in one of two ways: either workers must accept lower wage increases, or companies will have to shed labour.

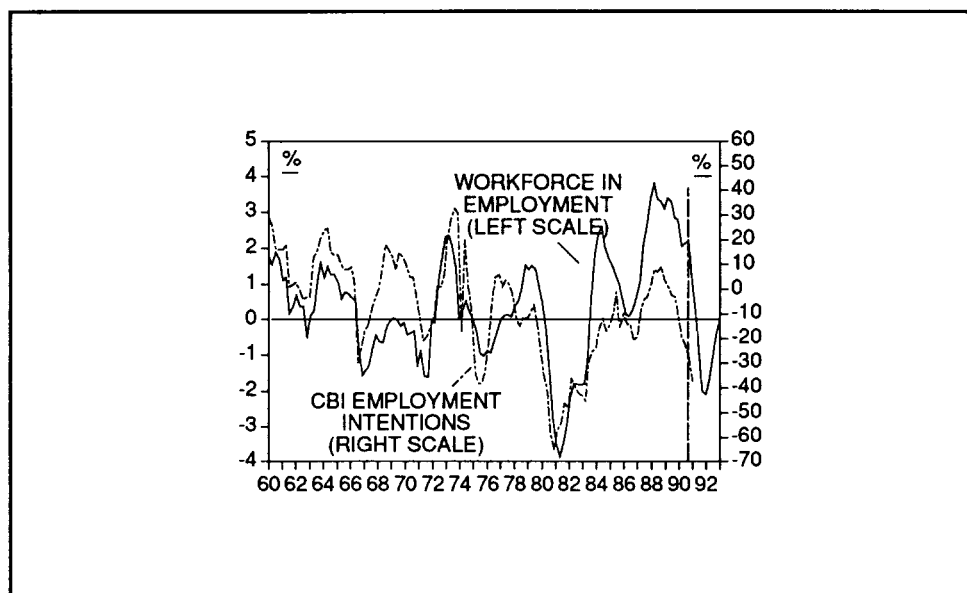
## Green Budget 1991

Ideally, from the point of view of output and employment, the company sector would respond to the squeeze by awarding lower wage increases. Provided the government maintains the growth of money GDP at an adequate rate, which is the essential aim of the Medium-Term Financial Strategy (MTFS), this should deliver the most favourable split between output and inflation. However, there is usually considerable resistance from the labour market to lower wage increases until there is clear evidence that price inflation is coming down. Indeed the headline rate of inflation has already fallen by more than 1 percentage point from its peak rate of 10.9% in October 1990 and yet the level of basic pay settlements continues to creep upwards. During the second half of 1990 the majority of settlements were clustered in a 9-10% range. But the first indications from pay deals in early 1991 suggest an increasing number of settlements above 10%. On a more encouraging note, there is some evidence of a number of deals below the prevailing rate of inflation in parts of the engineering, textile, retail and distribution industries, all of which have been badly affected by the downturn. Despite these few signs of increased realism in the labour market, it would be premature to say that pay deals across the whole economy are peaking. Indeed on past experience it would be optimistic to expect much of an improvement until the new pay round this autumn. By then, the headline rate of inflation should be clearly lower as some of the factors which boosted the headline rate last year drop out of the annual comparison. Furthermore, the unemployment rate will have been rising for around 18 months leading to an easing in labour market pressures.

As companies come to grips with the depth of the recession, therefore, employment is likely to start dropping fast in order that companies gain greater control over the increase in wage costs. There is already clear evidence that unemployment is rising sharply. Since the trough in unemployment in March 1990, the level has risen by 237,000 and there has been a notable acceleration in the rate of job losses in recent months. This is likely to gather momentum in the first half of the year as firms react to the sharp squeeze on profit margins. As Chart 3.3 shows, the CBI survey of manufacturing industry suggests that shake-out of labour which has already started will intensify and, past experience suggests, will subsequently spread to the rest of the economy.

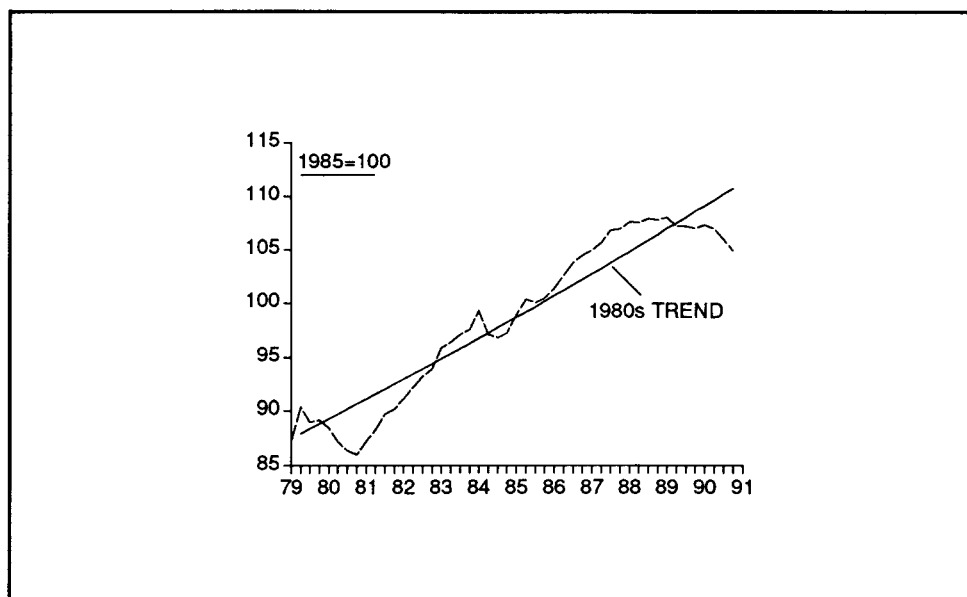
To gauge how far unemployment may rise, we have tried to calculate how much labour was shaken in during the boom period which may subsequently be shaken out again during the recession phase. One way of assessing this is to estimate how far productivity has fallen below trend at the current time. This would provide some indication of how far employment must fall to restore productivity to its underlying trend. From peak to peak in the last economic cycle (from the first half of 1979 to the first half of 1988), productivity growth averaged 2% per annum. If we assume that the underlying growth of productivity has continued at this rate, then it seems possible that by the end of last year the actual level of productivity was around 5% below trend (see Chart 3.4).

**Chart 3.3. Employment Expectations<sup>a</sup> and Changes in Employment**



<sup>a</sup> CBI survey balances.

**Chart 3.4. Whole Economy Productivity: Actual and Trend**



The implication of Chart 3.4 is that if the economy were to grow from now on at its trend rate of growth, there could be scope for around 5% of the work-force in employment, or 1.5 million people, to be thrown out of jobs over this year. Not all of these people would appear on the unemployment register since many of these may be part-time workers who are not eligible

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for benefit, but on usual relationships the unemployment total might rise by between three-quarters to one million over the next two years to over 2.5 million.

Such an easing in the labour market may finally bring pay deals under control, and a significant decline in deals in the 1991-92 pay round seems likely. In the mean time, unemployment may rise much more sharply than is built into consensus projections as companies strive to reduce the squeeze on margins.

### *Reduce Current Expenditure*

The scope for companies to improve their finances by reducing spending on interest, taxes and dividends is quite limited. In the short term, payments of interest and taxes are largely beyond the control of companies. Although some companies will obviously benefit from lower interest rates, the effect on the finances of the whole company sector is actually quite small. Companies seem now to be borrowing to finance interest payments, leading to a rising level of corporate debt. Thus even if the level of interest rates remained unchanged this year, interest payments and the financial deficit would still rise. If we assume that companies are rolling up interest payments on to their outstanding borrowing, then interest rates would actually need to average about 13% this year - almost two percentage points lower than in 1990 - to leave the level of interest payments broadly unchanged between the two years. Each additional one point cut in rates would reduce the financial deficit by around £2-2.5bn. Lower corporation tax payments are in prospect this year but this would largely reflect a reduction in profits and would therefore not benefit the company sector's financial position to any great extent.

Companies have more discretion to curb dividend payments but they face considerable pressure from shareholders not to exercise this discretion. Besides, a reduction in dividend payments would make only a modest contribution to improving company finances. A 10% reduction in dividend payments, for example, would only reduce the company sector's financial deficit, which in 1990 is likely to have been around £30bn, by about £2bn.

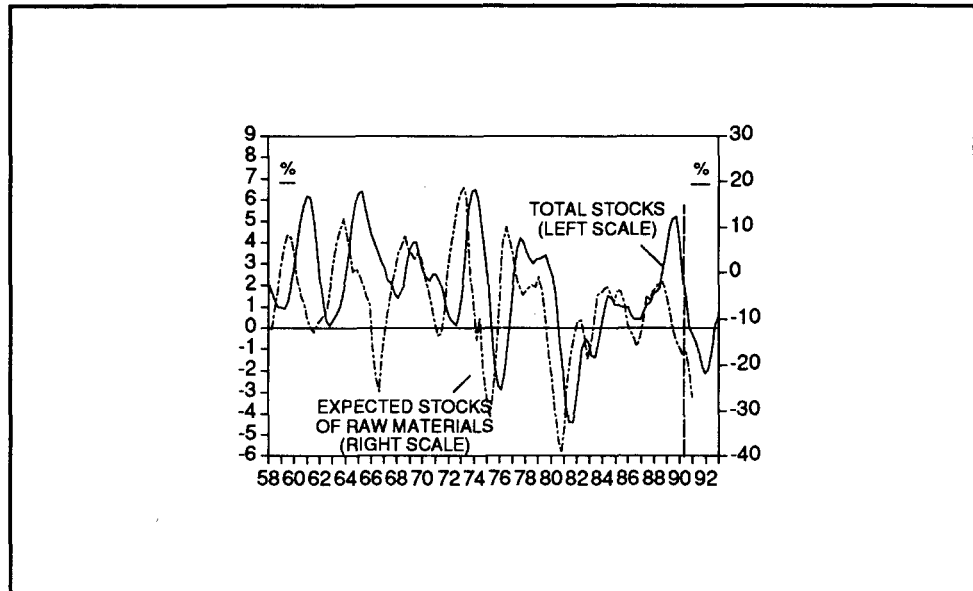
### *Reduce Capital Spending*

The other option open to companies is to reduce spending on stocks and investment. There is probably less scope for companies to cut stocks than in previous recessions given modern inventory control techniques. Nevertheless, the ratio of stocks to output has risen slightly in the last two years compared with the fairly sharp down trend that was evident during the 1980s. If companies were to seek to restore the stock/output ratio to this long-term down trend, this would imply a substantial shedding of stocks, which would cut GDP by just over 1%.

Recent CBI surveys have indicated that companies are now increasingly eager to reduce their inventory holdings, though not yet to the extent reached in 1980. On past relationships between survey data and subsequent changes in the level of stocks in the economy (see Chart 3.5), the present survey readings, were they now to stabilise, would suggest that

the decline in the level of stocks may cut GDP by a little under 1% in the next 12 months. This would reduce the financial deficit by around £4bn. In 1980, the swing in stocks cut GDP by 2.4%.

**Chart 3.5. Stock Expectations<sup>a</sup> and Changes in Stocks**



<sup>a</sup> CBI survey balances.

Fixed investment is now falling across the whole economy: between the second and third quarters of 1990 investment fell by 3.8% leaving the absolute level 2.7% lower than a year ago. According to the December 1990 CSO Investment Intentions Survey, which has a very good track record, companies in manufacturing are planning to cut investment by 7% in real terms this year after an estimated fall of 3% in 1990. Investment intentions in the CBI survey have not yet dropped as far as they did in most post-war recessions, and if this were maintained, it would be encouraging for the future of the economy. However, investment intentions tend to lag behind other activity indicators, and it seems probable that a further big drop will occur in intentions over the next few surveys. Given that the share of business investment in GDP is close to historically high levels, the subsequent drop in investment could be substantial.

The response of companies to their financial problems is further complicated by a deterioration in the availability of bank credit. It is very difficult to quantify the extent to which the "credit crunch" in the banking system is having any effect, but there are clearly some individual instances in which companies that need bank credit in order to survive have been denied it and gone bankrupt. According to the CBI, small companies, in particular, are finding it extremely difficult to obtain further bank credit.

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Most forecasters are not making much, if any, allowance for the impact of this on economic activity and thus it represents another source of downside risk relative to consensus forecasts.

### Conclusion

The unprecedented size of the company sector's financial deficit makes it very difficult to determine the speed and the scale of the adjustment of company spending. Nevertheless, there seems to be substantial scope for companies to cut back sharply spending on employment, stocks and fixed investment over the next couple of years.

The key to this adjustment is likely to depend to a large extent on what has happened to profits. During the last two recessions, the real level of non-oil profits collapsed by around one-third. With profits already low and the world facing recession, companies had little option but to slash their capital spending. Since stock/output ratios were extremely high at the start of these two periods, the economy moved smartly into an inventory-led recession which lasted for two years.

**Table 3.2. CBI Industrial Trends Survey - Historical Results**

| Percentage balance                   | October<br>1990 | January<br>1980 | July<br>1980 |
|--------------------------------------|-----------------|-----------------|--------------|
| Business optimism                    | -47             | -45             | -70          |
| Export optimism                      | -25             | -30             | -57          |
| Investment in buildings              | -26             | -30             | -47          |
| Investment in plant & machinery      | -15             | -18             | -43          |
| Firms working below capacity (%)     | 54              | 63              | 76           |
| Expected employment                  | -37             | -35             | -58          |
| Expected volume of new orders        | -22             | -24             | -47          |
| Expected volume of output            | -17             | -11             | -41          |
| Expected stocks of raw materials     | -27             | -24             | -41          |
| Expected stocks of work in progress  | -27             | -16             | -39          |
| Expected stocks of finished goods    | -21             | -12             | -30          |
| Adequacy of stocks of finished goods | 18              | 15              | 36           |
| Expected unit costs                  | 46              | 76              | 72           |
| Expected domestic prices             | 23              | 65              | 56           |
| Orders limit output                  | 80              | 82              | 91           |
| Skilled labour limits output         | 10              | 13              | 5            |

If profits fall sharply this time, there remains a chilling possibility that the economy could tumble into a deep recession. On past occasions, survey evidence has been an invaluable guide to the extent to which companies are cutting back spending on investment, stocks and employment. In this regard, it is worth noting, as Table 3.2 shows, that the October 1990 CBI survey is uncannily similar to that which was taken in January 1980, just as activity was falling off a cliff. If business confidence worsens further in the coming months, then company spending could still drop sharply

## Major Risks

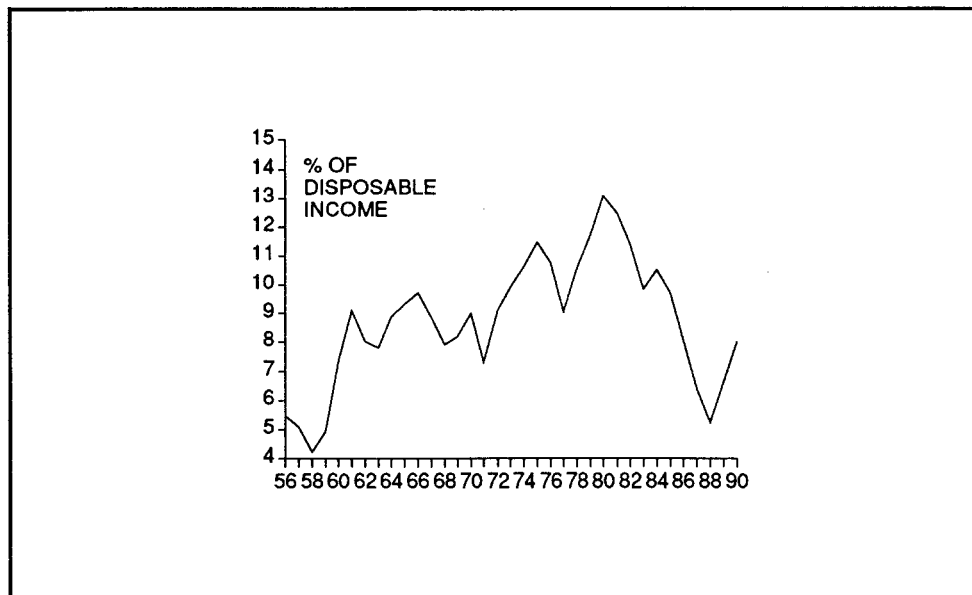
enough to produce a recession which rivals that of 1980 in severity. Whether or not this can be avoided will be crucially dependent on the speed with which the labour market adjusts. This will provide the true test of the supply-side improvement in the 1980s.

### 3.2 The Personal Sector Response

One of the most serious forecasting errors made by economists in recent years was to underestimate considerably the extent to which people would be prepared to run down savings to help finance the consumer boom of the late 1980s. From a peak of 15.2% at the end of 1979, the personal saving ratio fell steadily during most of the 1980s, reaching a trough of 4.5% in the third quarter of 1988.

Since then the behaviour of the personal sector has changed noticeably. Although real disposable income has continued to grow strongly, with growth averaging 5% a year in the last two years, consumer spending growth has averaged just 2.5% a year over this period. Thus the consumer recession has so far been caused almost entirely by a steady rise in savings; in the third quarter of 1990 the personal saving ratio rose to 8.8%, the highest level since the end of 1985.

Chart 3.6. The Personal Sector Saving Ratio



There are a number of explanations advanced for the decline in the saving ratio during the 1980s. Unfortunately, none of the consumer spending equations embodied in the mainstream macro-economic models can account entirely for the sharpness of the fall and for that matter the extent of the subsequent rise. Previously stable econometric relationships have long since broken down. The inability of these models to explain the past raises severe doubts about their ability to predict the future. Given the very depressed level of consumer confidence recorded in survey evidence, one of the risks to all economic forecasts is that the downturn could be intensified by a continuing rise in the saving ratio at a time when real disposable income growth will be slowing sharply.



The most widely accepted theoretical explanation of savings behaviour (although this is rarely incorporated in large-scale econometric models) postulates that individuals try to smooth their consumption over time by borrowing (running down their savings) when their income is low and by repaying borrowing (increasing savings) when their income is high. Clearly, this assumes that individuals have completely free access to credit. If in fact their access to credit is restricted then people will be forced to consume out of their current income.

Such a theory provides a potential explanation for the behaviour of savings in recent years. During the 1980s, there was widespread financial liberalisation across the major developed countries but this was particularly the case in the UK. A number of developments meant that it progressively became easier for individuals to increase borrowing. These included: (i) the abolition of HP controls; (ii) the opening-up of competition in the mortgage market and the subsequent ending of mortgage rationing; (iii) the abolition of the "mortgage lending guidance" in January 1987. Essentially this required banks and building societies to provide mortgages solely for the purpose of house purchase; its abolition made it much easier for individuals to remortgage their properties and in the process withdraw a substantial amount of equity which was then available for consumption.

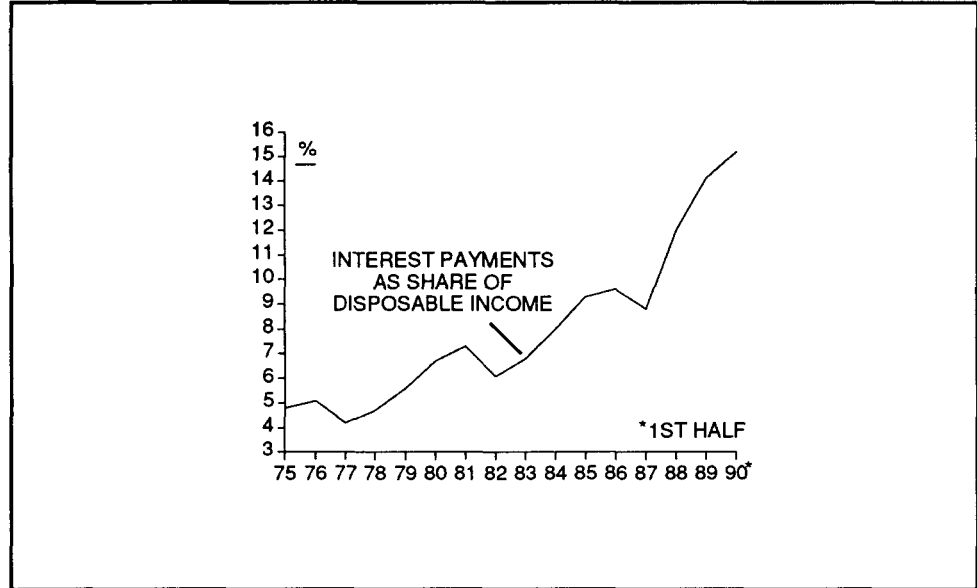
If people are suddenly released from their borrowing constraints, then you would expect to see a period of dissaving in which people jump onto a higher consumption path now at the expense of lower future consumption. A number of factors could have been in place to exacerbate this trend. First, there was a prolonged period of growth in real incomes during the 1980s which helped to bolster consumer confidence. Second, there was a rapid increase in personal sector wealth associated especially with booming house prices. Suddenly people felt a lot wealthier and for the first time it became relatively easy for them to unlock this wealth. Third, low and stable rates of inflation during the mid-1980s may have reduced the precautionary motive to save. Finally, demographic factors may have been important. During the 1980s there was a sharp fall in the proportion of the population aged 45-64. As this group has the highest saving ratio, this demographic change may partly explain the fall in the aggregate saving ratio.

But what about the position now? Like companies, individuals have borrowed heavily in recent years and they are now having to face up to the consequences. Real interest rates are at close to record levels and consumer confidence is close to record lows. Despite attempts to boost savings in the past two years, gross interest payments are at a record level as a share of disposable income, as shown in Chart 3.7. Over this period asset prices, especially house prices, have stagnated or fallen. Thus the vast number of people who entered the housing market for the first time near the peak of the housing boom in mid-1988 face the prospect that their mortgage debt is greater than the value of their property. This could place

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a dampener on housing market activity and consumption for some time. On top of this, real disposable income is now slowing markedly for the first time.

**Chart 3.7. Households' Gross Interest Burden**



While it is impossible to tell for certain whether the personal sector regards its debt/income ratio as being too high, it seems quite possible from recent savings behaviour that individuals will seek over time to reduce borrowing to more comfortable levels. Over the next year or so, the underlying rise in the saving ratio may be dampened by a desire to prevent consumption growth from weakening too much in the face of weaker real disposable income growth. But as individuals seek to repair their balance sheets, this could be an important factor in dampening any subsequent recovery in spending.

### 3.3 The Gulf War

This Green Budget is being prepared as the first shots in the Gulf War are fired. It is hard to know how to deal with the uncertain consequences of that war. It may all be over by the time the Chancellor delivers his Budget, in which case the consequences for public spending will be negligible. Alternatively it may by then be developing into the most important conflict in which this country has been engaged for many years, with costs of engagement of the order of £10m per day, £3.5bn in a full year. Our public spending projections are all based on the assumption of a fairly rapid end to the war. If that proves wrong, a major reappraisal will be needed.

Clearly, however, the war has ramifications far beyond the public spending field. If it turns out that the 1991 world recession is a deep one, future historians will link that fact to the conflict in the Gulf. But the truth is that we do not know, and will never know, how much the war has affected the global economy. What the economic forecasters have done, since the news broke, is make estimates of the probable change in the oil price, and run that through their models of the world economy. On the whole the results of these exercises are quite reassuring, for the reasons explained in Section 2.1. Oil is not as important as it was, and on the basis of a 50% increase in oil prices (compared with a no-war scenario), the world economy may experience an extra 1% or so of inflation and lose 0.5-1% of output.

However, these estimates, based on an analysis of past oil price shocks, cannot take into account the possible interactions between the Gulf crisis and the banking crisis. A decade of steady growth has led to a massive increase in levels of corporate indebtedness. When there has not been an economic downturn for a long time, there is a tendency to believe that there will never be another. In these circumstances the temptation to boost the growth of profits by gearing up is very strong. A decade of de-regulation has made it easier for lenders to satisfy the demand for this additional gearing.

The decade has also failed to produce a permanent solution to the rumbling problem of Third World debt and has introduced some new problems of First World debt, notably in the oil and property sectors. Much of this non-performing debt is an asset of the banking system, whose balance sheets have thus been seriously weakened. The markets have recognised this in the course of the decade by revising down the average credit rating of US money centre banks from triple A to A3. Many banks are now seriously worried about the quality of their loan portfolio and looking to cut back on doubtful lending.

The consequences of introducing an oil price shock into this environment are quite literally incalculable. It is very easy to tell plausible horror stories. The airline industry is one highly indebted sector where profit margins have been eroded by competition following de-regulation. It is also a sector which is particularly vulnerable to war for two reasons: its

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costs, of which fuel accounts for a huge proportion, are dramatically swollen by a rise in the oil price; and its revenues shrink because the fear of terrorism reduces air travel. So a prolonged war, which led to a prolonged rise in the oil price, could produce some spectacular airline bankruptcies, some large enough to drag down bankers too.

In these circumstances, it is easy to imagine that the financial institutions would become extremely risk-averse. At the margin there would be more businesses that would fail because bankers chose not to roll over credit lines. There would be less risk capital available for new investment projects. It is this sort of behaviour that people have in mind when they talk about recession turning into depression.

The fact that these risks are already widely discussed makes it unlikely that the 1990s will see a depression on the scale of the 1930s. The policy measures needed to prevent it are well understood. Nevertheless there has been an extraordinarily sharp fall in business confidence around the world since the Gulf crisis erupted. This does suggest that there are forces at work in the present situation that are less than adequately captured in the econometric models that predict such modest consequences of the oil price shock.

The purpose of this chapter of the Green Budget is to draw attention to the major uncertainties that the Chancellor must face in framing his Budget. This year it looks as though all the risks are on the downside, but that would be a misleading impression. When the crisis first broke, many experts predicted that if it led to a shooting war, the oil price would go to \$50 per barrel or beyond. Yet on the first day of hostilities the price of Brent crude stood at \$20 per barrel. This suggests that oil traders now believe that (with the Saudi oil wells protected by massive Allied forces) the war itself will cause no serious disruption of supply.

These developments imply that in the event of an early peace the oil price could fall sharply. The resumption of supply from Kuwait and/or Iraq will cause a major oil glut in the present depressed state of the world economy. The last (barely remembered) world downturn, in 1986, triggered off a massive fall in the oil price from over \$25 per barrel to (briefly) below \$10, before recovering to the \$15-20 trading range that we experienced until the latest crisis. This negative oil price shock, which carried the real oil price back to the level seen before the Shah fell in the late 1970s, was a fundamental cause of the world boom that began in 1987.

A sustained fall in the oil price, which might happen even without an early end to the war, would clearly have a profoundly beneficial effect on the economic outlook. It would improve the cash flow of many hard-pressed companies and thereby relieve the pressure on the banks which are having to prop them up. It would give the monetary authorities a good reason to cut interest rates, bringing further relief to industry and its financiers. It could, within a year, bring about another world boom comparable to the upswing of 1987-90.

## Major Risks

The economic forecasts shown in Section 2.1 are thus the centre of a particularly wide range of possible outcomes. The newspapers have in recent months been dominated by bad economic news, and perhaps for this reason most economic agents are currently preoccupied with the possibility that the economic background to the forthcoming Budget could be very much worse than the consensus forecast. That is certainly a real possibility. But we should not forget that it could also be very much better.

# 4 The Impact of the ERM

## 4.1 Exchange Rate Policy

### Introduction

When the government announced sterling's full membership of the ERM on 5 October 1990, it clearly viewed the decision as a major landmark in British economic history. For the first time since sterling's unfortunate flirtation with the European "snake" in 1972, the government took on an explicit commitment to keep the currency within pre-announced bands. This move back towards a fixed exchange rate regime significantly changes the rules of the policy game. Monetary policy changes because interest rates are now used to hit an exchange rate target rather than a monetary target. And the approach to fiscal policy has to be reconsidered because the low public sector borrowing requirement, which directly helps the achievement of a monetary target, does not so clearly help to hit an exchange rate target. So the fact of ERM membership should, in theory at least, have a profound effect on the coming Budget, the first to be framed under the new ground rules. For that reason we are devoting a chapter of this Green Budget to the ERM. In this section we consider the role of the ERM in the government's counter-inflationary strategy, and in particular (in view of the chorus of complaint about an "overvalued" exchange rate) whether we have joined the ERM at the right rate. In the remaining sections we go on to consider the role of monetary and fiscal policy in the new framework.

### Did We Choose the Right Entry Rate?

Sterling entered the ERM at a rate (DM/£2.95) which was close to the pound's market rate just prior to entry, and was also close to the average DM/£ rate which had been seen in the markets over the previous two years. At the time of the government's announcement, there seemed to be a fairly broad national consensus in favour of joining the system at the then prevailing exchange rate. For example, the opposition Labour Party explicitly called for membership only a week before it actually happened. Despite this apparent consensus, there are already loud calls for sterling to leave the ERM, or for the government to devalue the pound. As the economy has fallen into a deep recession, the discipline of the system appears to have prevented an early reduction in base rates, and this has already led to a good deal of frustration both among politicians and among economists.

In particular, some domestic monetarists are pointing to the experience of 1981-85, when UK inflation fell sharply despite the fact that the exchange rate also fell by a large amount over that period. They draw two conclusions from this. First, they say that a large improvement in inflation is perfectly compatible with a devaluation in sterling, provided that

domestic economic conditions are satisfactory. Second, they claim that the recovery in activity from 1981 onwards was partly due to the reduction in the exchange rate, and they argue that if the exchange rate now remains fixed, there will be no pronounced recovery in output in the years ahead. They therefore conclude that the pound should be devalued.

These arguments about the 1981-85 period may appear beguiling. From early 1981 to early 1985, sterling's effective exchange rate dropped by 27%, yet inflation simultaneously fell from 12.6% to 5.4%. Meanwhile, output recovered from the deep 1980-81 recession, and expanded at an annual average rate of 2.7% over the same period. These facts do not seem consistent with the belief that the exchange rate needs to be held constant in order to control inflation, which is the basic reason for joining the ERM.

However, this is not necessarily a conclusion which can safely be drawn. The impact of the exchange rate on inflation operates with quite long lags, especially via its indirect impact on wage bargaining conditions. It is quite possible that the drop in inflation from 1981 onwards was partly a lagged response to the rise in the exchange rate from 1977 to 1981; similarly, the rise in inflation after 1986 may have been partly a lagged response to the decline in the exchange rate from 1981 to 1985. Second, the adverse impact of the depreciation in sterling after 1981 on import prices was cushioned by the fact that world oil prices, commodity prices and manufactured goods prices were all declining in foreign currency terms at that time. Hence, sterling-denominated import prices rose by an average of only 9.8% per annum from 1981 to 1985, despite the very large drop in the exchange rate. Third, the recession of 1980-81 was exceptionally deep, by far the deepest since 1930. Although the current recession is also quite deep, it does not at present seem likely to rival that of 1980, so the disinflationary impetus currently being injected into the economy from domestic sources is not as great as it was then. It follows that there is less scope for allowing sterling to depreciate without causing inflation to rise.

In any case, the domestic monetarists who are asking for a devaluation of sterling appear to have overlooked the fact that the government joined the ERM precisely because the system seems to have delivered, during the 1980s, a more durable improvement in inflation for countries such as France and Italy than was achieved in the UK by domestic monetarism. Although domestic monetarism worked from 1981 to 1985, its successes did not prove durable, while those of the ERM did. In order to understand this, it may be useful to illustrate how the ERM discipline is supposed to work.

### **The ERM Discipline and How It Works**

The degree of counter-inflation discipline which will be exerted on the UK by sterling's membership of the ERM will depend on several factors. Most obviously, it will depend on the frequency and size of any realignments in the parity grid. If sterling is frequently devalued against other European currencies, then the ERM will exert little or no discipline over UK inflation, since the exchange rate will simply depreciate as and when UK inflation exceeds the European average. To some extent, this was how the

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system operated in the early 1980s, when realignments were frequent - though, even then, realignments typically reflected only part of any deviation in inflation rates between countries.

However, there has been no general realignment in the ERM since January 1987, and Bundesbank President Pöhl recently commented that realignments were no longer "a realistic alternative", adding that "we have to recognise that we have gone much further into monetary union than most people are aware of". If this is the case, then it will not be possible for the UK to ease its way into ERM discipline in the same way as France and Italy did in the early 1980s. Unless the rules of the game change in an unpredictable way, realignments look like being very infrequent, if indeed they happen at all.

If this is the case, then in the long term the prices of UK traded goods (manufactured and international traded services) will need to rise at broadly the same rate as that observed in other EC countries. Any persistent tendency for UK traded goods prices to rise faster than this will lead to a continuing loss of market share for UK companies, to a domestic recession, and eventually to a reduction in inflation back to the European norm.

This, essentially is how the discipline works, and it has necessary implications for the growth of wages in the traded goods sector, which is primarily the manufacturing sector. For example, if EC manufactured goods prices increase by 4% a year, then those in the UK will need to do the same. Over lengthy time periods, this probably means that UK unit labour costs in manufacturing will also need to rise by around 4% per annum. If labour productivity in manufacturing grows by around 3.5% per annum (somewhere between the low rate attained in the 1970s and the high rate attained in the 1980s) then there is scope for wages per head to rise by around 7.5% a year. Provided this occurs, there would be no reason for ERM membership to be associated with higher unemployment in the manufacturing sector than would otherwise have been the case.

What does this mean for UK inflation in general? It probably means that it would be somewhat higher than the 4% a year increases in prices in the manufactured (or traded goods) sector. This is because there might well be a tendency for wages in the sheltered sector of the economy to take their lead from the rate of increase in wages in the traded goods sector, and thus to rise by around 7.5% a year. (In the long run, there is remarkably little change in relative wages between sectors in the UK economy.) However, productivity in the services sector habitually rises less rapidly than in manufacturing, and may increase on trend by only about 1.5% a year. This means that unit labour costs (and prices) in the sheltered sector might rise by about 6% per annum, compared with 4% in the traded goods sector. If this is the case, then the recorded rate of price inflation in the whole UK economy would be in the region of 5-5.5% a year in the steady state.



## The Impact of the ERM

Paradoxically, this could mean that the higher the rate of increase in productivity in the manufactured sector, the higher will be the steady-state rate of inflation in the economy as a whole. High productivity growth in manufacturing offers scope for high nominal wage increases in that sector without pricing UK companies out of European markets, assuming a fixed exchange rate. If these more rapid increases in nominal wages in manufacturing then have knock-on effects in the service sector (which maintains its previously low productivity growth rate), then price pressures in the sheltered sector, and thus in the economy as a whole, will actually increase. This somewhat unpleasant result - that the higher the rate of manufacturing productivity growth, the higher the rate of overall inflation - was in fact a feature of the Japanese economy in the 1950s and 1960s, when the yen was largely fixed under the Bretton Woods system.

In the case of Britain in the 1990s, the adjustment to the ERM discipline can be accomplished painlessly or painfully, depending largely on the wage response. If wage increases magically adjust down to the 7.5% per annum which is consistent with a steady exchange rate (and if sterling has joined the system at the right rate - see below), then there is no reason for unemployment to rise as the adjustment to the ERM takes place. However, in the more likely case that the downward adjustment in wages from the present double-digit rates of increase will not happen automatically, there may well need to be some increase in unemployment to persuade workers to accept the necessary reduction in wage increases.

As this rise in unemployment occurs (and indeed it is probably already happening), there will inevitably be political pressures on the government to reverse the process of adjustment to ERM membership. These political pressures will be much the same as those which apply when any kind of counter-inflation strategy is introduced, whether it is one which relies on ERM membership, domestic monetarism or any other method. The case in favour of the ERM (compared with a regime of monetary targets) is that deviations from the counter-inflation strategy are more obvious and the political price of such deviations is accordingly much higher.

The reason for this is that inappropriate policy easing in the ERM case involves a publicly humiliating devaluation of the currency, which is something which governments have historically found very unpalatable. If devaluations are sufficiently unpalatable from a political point of view, then the ERM discipline will work, since governments will prefer to stick with the counter-inflation strategy rather than deviate from it. In the case of a domestic monetary strategy, it may be easier simply to diverge from announced monetary targets without overt political penalty.

It is for this essentially political reason that the ERM discipline in France and Italy seems to have delivered a durable improvement in inflation in the 1980s, whereas in Britain the improvement brought about by monetary targets proved more transitory.

### **The PPP Bench-Mark**

The speed at which these theoretical disciplining effects work in practice is likely to be profoundly affected by the entry rate that is chosen for sterling at the outset. Too high a rate will be hard to maintain in the markets, leading to the need for a very prolonged period of tight domestic monetary conditions and rising unemployment; too low a rate will fail to exert the required downward pressure on the inflation rate.

So much is obvious, but what is meant by "too high" and "too low" in these cases? Those who oppose the ERM would argue that economists are incapable of giving any precise meanings to these terms, so there is always a chance that the government will choose to defend the wrong exchange rate. They would prefer instead to leave the market to determine the "right" rate.

However, having decided to join the system, we need to find some way of choosing the right entry rate. Most theoretical models of the economy require the exchange rate to be anchored at purchasing power parity (PPP) in the very long term. At PPP, identical goods will sell at identical prices (expressed in a common currency) throughout the world, allowing of course for transportation costs. Hence, a British motor car selling in Germany will, if PPP holds, sell at approximately the same price (in DM terms) as an equivalent German car (N.B. this means equivalent in all respects, including quality and reliability).

Although economists have recently suggested other definitions of "equilibrium" or "sustainable" exchange rates (usually making some attempt to allow for equilibrium in the asset markets as well as the goods markets), most of these alternatives hold only in the short or medium term. In the long term, it is hard to see how the economy can attain a full equilibrium unless prices are equal for identical goods, which means that PPP will hold. (Other things might need to hold as well, but that is a different matter.) Certainly it would seem odd for the UK government to have joined the ERM at a rate which was significantly different from its estimate of PPP.

The problem, however, comes in measuring PPP. It might seem simple to produce inflation-adjusted exchange rate measurements (i.e. real exchange rate measurements), which is all that is required to derive PPP estimates. However, in practice things are not especially straightforward, since the available data series are far from perfect. In the first place, we need series for traded goods, so consumer price indices (which include goods and services in the sheltered part of the economy) are inappropriate. In the second place, not only do we need to know how real exchange rates have changed over time, but we also need some sort of bench-mark to give us the appropriate level at any given point in time.

In order to solve the first problem, it is usual to use price indices for manufactured export prices, or producer prices, rather than consumer prices. (Labour costs in manufacturing are also frequently used.) This is not wholly satisfactory, but it is the best we can do.

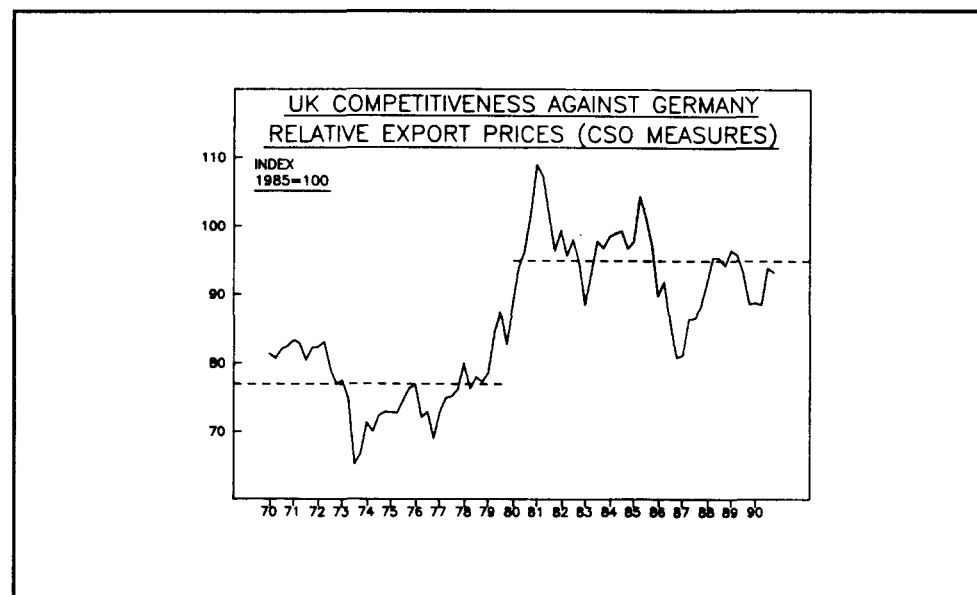
## The Impact of the ERM

The second problem is more difficult, since absolute bench-marks of selling prices are hard to find. One such bench-mark is provided by the OECD, which periodically provides indices of the actual selling prices of an identical basket of traded goods produced in various economies. This can be used to calculate an approximate bench-mark for PPP, and this has been done at Goldman Sachs. An alternative way of obtaining a bench-mark is to observe the actual movements of indices of the real exchange rate over time, and to say that PPP is represented by some average of these movements. This approach, which is based on the prior belief that PPP will hold in the long term, seems to have been followed by the Treasury when sterling's entry rate was selected.

In fact, both of these methods suggest that sterling's entry rate was quite close to PPP against the EC currencies. On the Goldman Sachs method, PPP against Germany is about DM/£3.20, which would suggest that the UK joined at an undervalued rate. This, however, is partially offset by an overvaluation of sterling against some other EC currencies, leaving sterling's overall entry rate within 5% of its PPP level against the ECU. Given the margins of error on these calculations, this is a trivial difference.

On the second method of attaining a bench-mark (i.e. using recent averages of real exchange rate movements), sterling's ERM entry rate also seems close to PPP. Chart 4.1 shows the recent behaviour of sterling's real exchange rate against the DM, using CSO data on relative export prices in a common currency. As the graph shows, the entry rate is close to the average real exchange rate over the last decade, though it is higher than the average for the 1970s; the advent of North Sea oil could well explain the rise in the real value of sterling during the 1980s.

**Chart 4.1. UK Competitiveness against Germany<sup>a</sup>**



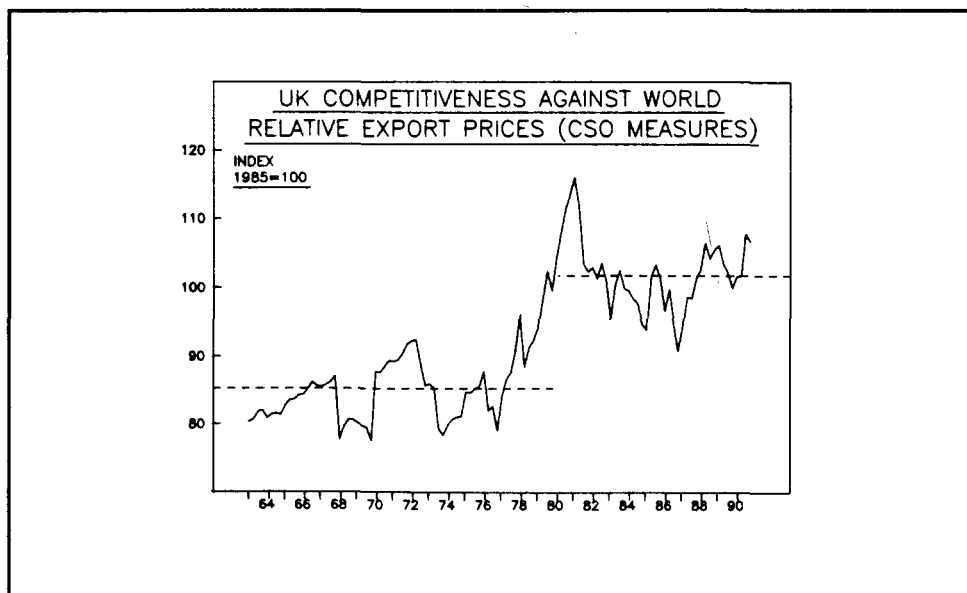
<sup>a</sup> Based on relative export prices in a common currency.

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On all these grounds, it therefore appears that the government has chosen an entry rate which is reasonably close to PPP against the major European currencies. This is also suggested by the performance of UK exports in the last year. In 1990 as a whole, manufactured exports have increased by about 8.5%, as compared with estimated growth in UK markets of about 7%. This rise in market share certainly does not suggest a chronically overvalued currency.

However, the situation is slightly different in the case of sterling's real exchange rate against all other currencies, not just the DM (see Chart 4.2). In this case, the real rate is around 7% higher than it has been on average for the 1980s, which seems to offer more substance to those who claim that the exchange rate is overvalued. But this primarily reflects the recent drop in the dollar, which has taken the US currency to an unprecedented degree of undervaluation against most other currencies, not just sterling.

**Chart 4.2. UK Competitiveness against All Trading Partners<sup>a</sup>**



<sup>a</sup> Based on relative export prices in a common currency.

It is not clear that this should have been taken into account when assessing the correct entry rate for sterling when joining the ERM. After all, the dollar's exchange rate is not being fixed; it is free to adjust against the bloc of ERM currencies, just as before. If the main problem arises from the valuation of the dollar, and if this can still be subsequently corrected by the market, this should surely have no effect on the appropriate rate at which to fix sterling against the EC currencies.

## The Impact of the ERM

Overall, then, it appears that the government has chosen a sensible entry rate, which is close to PPP against the EC currencies. If a much lower entry rate had been chosen - for example a rate well below PPP for "balance-of-payments" reasons - then the implication is that the selling prices of UK goods would have been lower than the average EC price for the same goods. This would have meant that UK companies could have continued to increase their prices faster than the EC average for quite a while before being priced out of export markets. Hence there would have been no immediate reason for them to control the rate of inflation in costs and prices, and the impact of the ERM discipline would have been postponed and diluted. Furthermore, the continuation of relatively high UK inflation would have eroded the initial competitiveness advantage bestowed by a low exchange rate, and would therefore have eliminated the "balance-of-payments advantages" of a low entry rate.

The crucial point is that a low nominal exchange rate on entry to the system does not guarantee that the real exchange rate can be kept low for very long after entry. UK inflation may simply have stayed higher for longer, leaving the real exchange rate no better off at the end of the day.

In electoral terms, it may have been sensible for the government to have diluted the initial discipline of the system in this way, perhaps alleviating the recession and delaying the improvement in inflation. In economic terms, however, such a course would have had few advantages.

## 4.2 The Role of Monetary Policy in the ERM

In the early months of sterling's ERM membership, it has often appeared that interest rates have been held at high levels simply in order to hold the exchange rate, while domestic considerations have appeared to point to the desirability of lower rates. That, at any rate, has been the conclusion that many people have drawn.

There is no doubt that, in fixed exchange rate systems, conflicts can arise between the needs of domestic economic management and the needs of exchange rate management. Under totally fixed exchange rates, monetary policy needs to be aimed entirely at achieving currency stability, and cannot therefore be targeted simultaneously at the domestic economy. Since the ERM is not a totally fixed exchange rate system - it does not cover all currencies, and at present permits quite wide fluctuations around the central rate - the contrast in practice is not quite that stark, but it nevertheless can arise.

Whether it is likely to arise frequently, or for prolonged periods, is a different matter. Let us, for example, examine what might happen if domestic demand in the UK starts to grow too rapidly, threatening a subsequent rise in the inflation rate. From a domestic viewpoint, the government would probably like to increase interest rates. But under such circumstances, it is quite possible that the pound will be at the top of the parity grid, preventing any increase in UK interest rates. This, in fact, is exactly what happened in 1987-88 when Chancellor Lawson followed his "shadow ERM" policy. In that period, there were large speculative inflows into sterling, and the government decided to hold interest rates low to keep the pound under DM3.00. This occurred despite fairly obvious evidence at the time of an overheating economy.

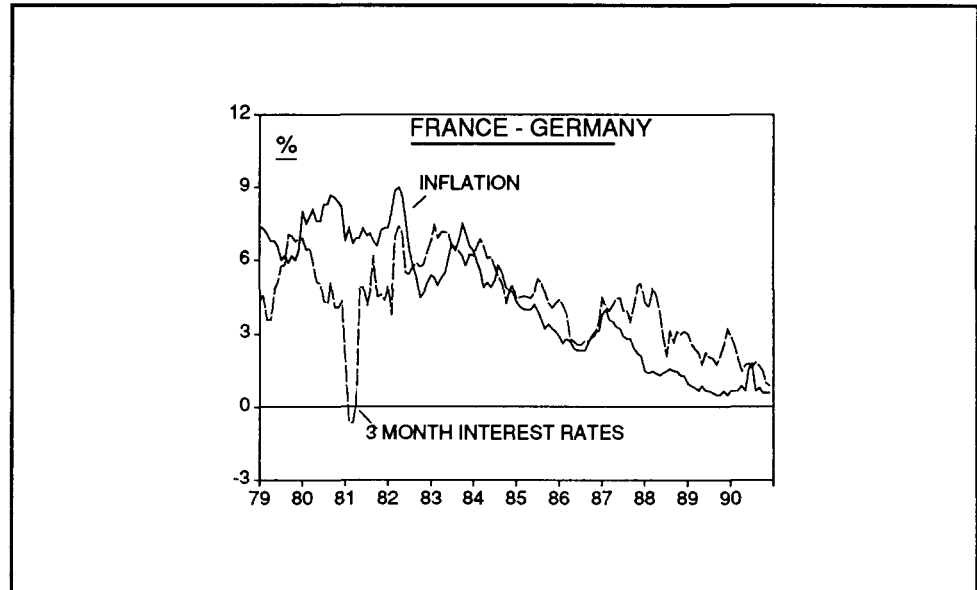
The government's dilemma at that time could have been removed if it had been willing to run a tighter fiscal policy. All it was willing to do was to allow the partial application of the economy's automatic stabilisers - the budget balance improved as a result of strong economic growth, but there were simultaneous discretionary reductions in tax rates. Even if the fiscal stabilisers had been allowed to work in full, this may not have been sufficient to arrest the growth in demand; tax increases or expenditure cuts may have been necessary to do this. This is an illustration of one of the most familiar results in economic theory - that fiscal policy should be more active in fixed exchange rate systems than in flexible rate systems.

However, the events of 1987-88 may have been the exception rather than the rule. The Treasury's Chief Economic Adviser, Sir Terence Burns, has argued that the occasions on which the needs of domestic management and exchange rate management will conflict will be fairly rare. He says that the foreign exchange markets are likely to take a broadly similar view to the government on the prospects for a rise in inflation. If inflation prospects are worsening, they will therefore require the rise in interest rates which the government anyway wants to see. Furthermore, the government can obviously influence the markets if it wishes them to reach this conclusion.

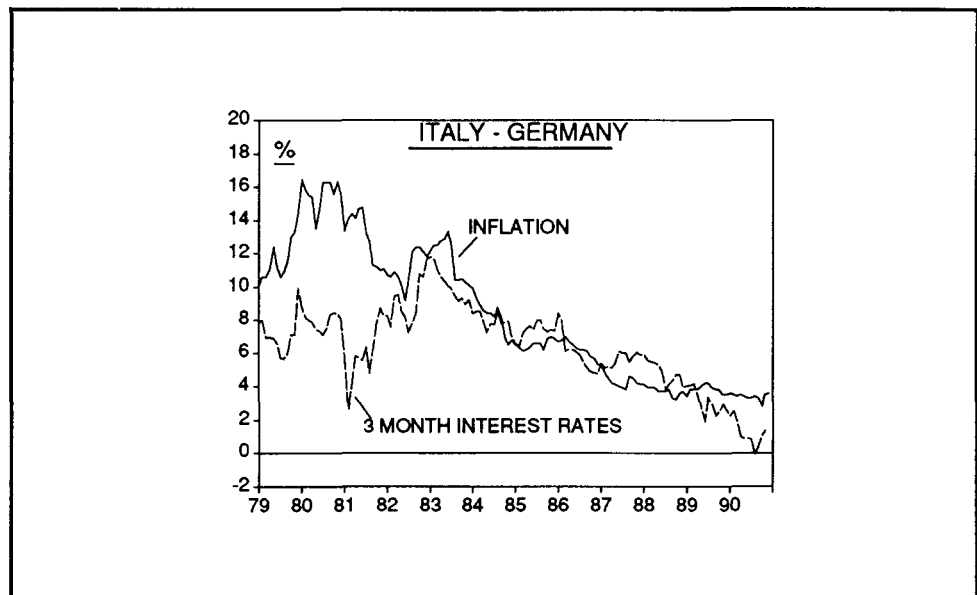
## The Impact of the ERM

This being the case, periods of serious conflict between the government's desires on interest rates, and what can be achieved given the ERM constraints on sterling, are not likely to be terribly prolonged.

**Chart 4.3. Inflation and Interest Differences: France-Germany**



**Chart 4.4. Inflation and Interest Differences: Italy-Germany**



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Some evidence in favour of this is provided in Charts 4.3 and 4.4, which show the behaviour of inflation and short-term interest rate differentials in the ERM in the last decade. Since realignments in the system became less frequent in 1983, the interest rate gaps between France, Italy and Germany have generally been broadly reflective of the inflation gaps between the same countries. Declining inflation differentials have created conditions in which France and Italy have been able to reduce interest rates without this undermining the exchange rate. Therefore interest rate changes in these countries have been closely connected with inflation conditions, which is probably what their governments would have wanted to see, inside or outside the ERM.

Why has this happened? According to foreign exchange theory, the interest differential between any two countries will be equal to the expected change in the exchange rate, plus or minus a risk premium. This risk premium will be affected by the risk of default on the financial instruments concerned, and the volatility of returns on these instruments. In the ERM, there has been a tendency for exchange rate changes at realignments to reflect the changes in relative prices which have occurred between countries since the previous realignment. Over time, the markets have built this experience into their expectations. Therefore the expected exchange rate change in the system has been closely connected to the inflation gap between countries at any given point in time. This, in turn, means that the interest rate gap has closely reflected the inflation gap. The implication of this is that when a country's inflation rate goes up, the foreign exchange markets will expect a greater depreciation of the economy, and will require a higher interest rate - which is exactly what is required for domestic policy purposes. Similarly, when inflation falls the markets will build in a lower expected depreciation and require a lower interest rate.

This may seem comforting, but the argument has a fatal flaw: remember that the only way in which interest rates can reflect domestic inflation conditions is if the markets *expect* these inflation gaps to be reflected in future exchange rate changes. But this conflicts with the basic intention of joining the ERM in the first place, which is to impose discipline by *not* devaluing when inflation is threatened. The paradox is this: once the markets become fully convinced that the UK government is committed to an exchange rate target, there will be *no* expected appreciation or depreciation. So UK interest rates must be identical to those prevailing in other ERM countries (give or take a small risk premium).

Now imagine the consequences of a rise in the expected rate of return in the UK. Capital would flow in from abroad. In a floating rate regime this drives up the exchange rate, reducing the expected rate of return to foreigners and choking off the capital inflows. In present circumstances the authorities would have to lower interest rates to keep sterling in its prescribed range. Alternatively, in a mature fixed rate system, the interest rate would not move and the authorities would simply supply unlimited quantities of pounds to the foreign buyers. Conversely, if expected returns



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fall, the consequence, in a fixed rate regime, is either that interest rates have to rise to protect the pound from capital outflows, or that the outflows are allowed to occur and the money supply shrinks.

Since it is true, almost by definition, that the expected rate of return in a country rises in a boom and falls in a recession, the argument outlined above shows that in a fixed rate system, the response of monetary policy is perverse. Interest rates fall and/or the money supply is allowed to rise in booms and the opposite occurs in recessions. So in a fixed exchange rate system in which mobile international capital moves to faster-growing countries because they offer a higher rate of return, there is a *systematic* risk of conflict between domestic and external objectives for monetary policy. The dilemma the government faced in 1988, when it needed to raise interest rates but could not because of the shadow-DM policy, and the dilemma it faces now, when a cut in interest rates is indicated by domestic recessionary conditions but ruled out (for a time at least) by sterling's relative weakness, are an inherent consequence of the return towards a fixed exchange rate regime. If the monetary policy dilemma is always resolved in favour of the exchange rate commitment, the consequence could be a less stable growth path for the economy. Is there, in these circumstances, an enhanced role for fiscal policy to undertake some of the stabilisation that monetary policy can no longer achieve?

## 4.3 Fiscal Policy in the ERM

### Rethinking the MTFS

The above analysis of monetary policy suggests that ERM entry is likely to prove something of a watershed for the Medium-Term Financial Strategy (MTFS). The Strategy was originally invented to give a clear signal that the era of fiscal fine-tuning was over. The government would no longer use discretionary changes in taxation or public expenditure to stabilise the output cycle. Fiscal policy was subordinated to monetary policy and the key objective, over the life of the government, was to move back towards a balanced budget. By reducing government borrowing, the authorities hoped to make their self-imposed monetary targets easier to achieve.

The main thrust of the original MTFS was thus towards monetary targets, now abandoned. The main architect of the Strategy, as Financial Secretary and Chancellor, was Mr Lawson, now departed. And the Strategy enjoyed strong Prime Ministerial support from Mrs Thatcher, now deposed. With a new Prime Minister, a new Chancellor, and a new counter-inflationary policy based on adherence to the ERM, the 1991 Budget is an opportune moment for a radical rethink of the MTFS, and of the role of fiscal policy.

In the 1980s, the Treasury, which used to believe that steering the economy by fiscal policy changes was one of its main roles, became profoundly disillusioned about the effectiveness of such fine-tuning. Its opposition to the use of an active fiscal policy was based on the view that the lags with which it operates are too long, and that too little is known about the future course of the economy to make discretionary fiscal changes at yearly intervals a sensible way of running the economy.

The experience of last year's Budget can only have reinforced this scepticism. On the evidence of the first half of the year, in which the economy proved surprisingly strong, fiscal restraint seemed in order. But given the nosedive the economy took in the second half of the year, such a policy might seem, with hindsight, less appropriate, though it might have enabled the authorities to ease monetary policy, which was the real source of the recession. The uncertainties we currently face - will a prolonged war push up oil prices and make recession more likely, or will a swift resolution cause prices to plunge and contribute to a spontaneous recovery? - make the chances of error in the 1991 Budget even greater. If the chances of getting such judgements right is low, it is better to leave well alone.

This argument applies only to discretionary changes. Automatic fiscal changes, in which boom conditions produce extra tax revenue while recessions generate shortfalls, are another matter, because these changes in the fiscal stance do not depend on forecasts. They are a response to the actual state of the economy, and such stabilisers may work silently to cool a boom or head off a recession before it is even recognised.

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Nevertheless the built-in stabilisers were not *designed* to give the economy a self-steering mechanism. The fact that income tax rises more than proportionately in a boom is a function of our desire for a progressive tax system. The fact that government spending rises in a slump reflects our desire to help the unemployed. So although the tax and spending system undoubtedly does act to offset shocks to the economy, there is no presumption that it does so to an optimal degree. Under the old policy rules there was accordingly scope for discretionary changes in interest rates to offset such shocks. And in the new world in which there is a serious risk, as discussed above, that interest rates will not be able to play that role, the authorities will have at least to re-examine the arguments for a more active fiscal policy.

For under the framework of broad money targets, as set out in the original version of the Medium-Term Financial Strategy, fiscal policy was seen as playing no role in stabilising output. Its job was to make it easier to achieve the monetary targets. Broad money growth depended on bank lending to public and private sector borrowers. The less the public sector borrowed, the less the need for high interest rates to rein back borrowing by the private sector. So a tight fiscal policy made it easier to hit the monetary targets. And for a given set of targets, a tight fiscal policy implied a lower interest rate.

This was essentially the strategy under Chancellor Howe. Under Chancellor Lawson, the policy developed. First, there was a greater emphasis on stability in the exchange rate, even though the UK was not formally a member of the ERM. Second, broad money targets were abandoned in 1985, and were replaced by a target for M0. Since growth in a narrow money aggregate such as M0 is not so closely related to bank lending as growth in broad money, there was less emphasis on reducing the budget deficit as a means of creating room for private borrowing.

Furthermore, by the early years of the Lawson Chancellorship, an excessive amount of public borrowing was no longer a problem. By now, the Treasury was operating on the basis that the budget deficit should be approximately zero over the medium term, implying that the PSBR excluding asset sales would be around 1% of GDP. This, according to the Treasury, would have led to the "sustainability" of fiscal policy, in the sense that the outstanding level of public debt would remain constant in the long term, relative to GDP.

Of course, things did not work out that way. The surge in private borrowing from 1985 to 1988 led to exceptionally rapid rates of growth in domestic demand, and the Treasury's tax coffers began to overflow with increasing revenue. Although Chancellor Lawson offset this process to some extent by making discretionary reductions in direct taxation, the size of the budget surplus for a time surprised both the Treasury and the markets. In these years, the Treasury in practice began to allow the automatic fiscal stabilisers in the system to operate to a large degree (see

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Chapter 5). No longer was the medium-term path for the budget deficit preordained; instead, it tended to shift markedly from year to year as the impact of the economic cycle took hold.

Thus, in the past several years, there has been considerable use of the automatic fiscal stabilisers, though the Treasury has not always been eager to admit as much. Nevertheless, even while the government's budget balance has been extremely volatile from one year to the next, the Treasury has maintained a long-term commitment to its "sustainability" rule, which continued to suggest an eventual return to broad budget balance.

During this period, policy was usually set with at least one eye on achieving exchange rate stability, and M0 growth was used as an indicator of the behaviour of domestic demand, rather than as a policy target in the strict monetarist sense. The Treasury's official line appears to be that this broad approach to fiscal strategy does not need to be very much changed now that the UK is in the ERM. Certainly, with 6% fluctuation bands either side of the central rate in the parity grid, Britain has not yet accepted the discipline of a fixed exchange rate target, and the actual fluctuations in the DM/£ rate over the last couple of years have been only slightly greater than those that are now permitted in the wide ERM band. So the need for a change in fiscal strategy is not so obvious.

In addition, the Treasury's view seems to be that ERM membership does not eliminate the need for a strict fiscal policy on average over the economic cycle. It appears still committed to the "sustainability" rule of broad budget balance over the long term. Furthermore, it seems to take the view that a tight fiscal stance, other things being equal, will tend to bolster financial confidence in the UK, and create scope for lower interest rates without undermining sterling. It therefore seems likely that any new version of the MTFS in the Budget will be a very close cousin of the MTFS of recent years. The Treasury may even explicitly reject the proposition that ERM membership makes a change in the MTFS inevitable.

However, there are certainly problems with this Treasury orthodoxy. If the ERM has made no difference to the degree of exchange rate variability, what has been the point of joining it? Surely, in the years ahead, the exchange rate will become increasingly fixed if the ERM discipline works, especially after sterling adopts narrower fluctuation bands. Whatever the Treasury may say, there are good reasons for believing that the conduct of fiscal policy should not be the same under fixed as under flexible exchange rates. Although the *long-term* aim of a *sustainable* fiscal policy (i.e. one which does not lead to an increasing burden of debt) may be the same, the appropriate *short-term* response to cyclical swings may be quite different.

### Long-Term Sustainability

The government's budget deficit must be financed by either the issuance of bonds or an increase in the monetary base. This remains true either inside or outside the ERM. However, what ERM entry might do is alter the scope for financing a budget deficit by increasing the monetary base, rather than by issuing bonds. In countries such as Italy and Spain, governments have in the past typically financed their deficits by using a large degree of monetary creation rather than bond issuance. This has obviously created the potential for a good deal of inflation, which is one reason why inflation in those countries has tended to be greater than that in Germany. Under a fixed exchange rate system, inflation in countries like Italy and Spain will have to come down to the German level, which means that the scope for monetary creation as a means of financing budget deficits will be much less.

In the case of the UK, however, the budget deficit is not typically financed to any large extent by a rise in the monetary base. Furthermore, the monetary base is extremely small (currently only about 3% of GDP), so any loss of ability to print money in order to finance the budget deficit after ERM entry does not make much difference to the government's overall budget constraint. We can therefore effectively ignore it in any discussion of the long-term sustainability of the fiscal stance in the ERM.

A sustainable fiscal policy is usually defined as one which holds constant the ratio of government debt to national income. This constraint means that the level of debt should grow in line with nominal GNP. (The relevant algebra, which is greatly simplified by ignoring seigniorage, is set out in the box.) Inside the ERM, assuming the sustainable real growth rate remains at 3% while inflation comes down to around 5% as discussed above, this means that the national debt (worth at the end of last financial year some £150bn) could grow at around 8% per annum, which would imply an increase in debt of £12bn. The actual PSBR target implied by this analysis is less because of asset sales which, like borrowing, worsen the government's future finances. The true purpose of the long-run sustainability rules is to ensure that the government's net income from capital does not decline over time, and from this perspective asset sales affect the position adversely just as new borrowing does. Taking account of asset sales and other complications (see box) we calculate that the sustainability rule could, on certain plausible assumptions, yield a target PSBR of £8bn.

This is a rather bigger number than the markets, conditioned by a few years of surplus, are used to. A target based on a constant ratio of national debt to income also implies that the burden of interest payments on that debt will remain constant. An alternative is to aim at the elimination of the national debt and associated interest payments. The benefit from such a strategy is that, at a given level of public spending, this would permit a reduction of tax rates. The elimination of the current near-£17bn of debt interest payments would translate into tax cuts equivalent to nearly 9p off the basic rate of tax.

### Debt Sustainability

Assume a constant debt to nominal GNP ratio  $b$ :

$$D = b.Y.$$

Then it is easily shown that the rate of growth of debt must be equal to the rate of growth of nominal GNP:

$$\frac{\Delta D}{D} = \frac{\Delta Y}{Y}.$$

But the change in debt  $\Delta D$  is the PSBR. So we can write:

$$\frac{PSBR}{D} \cdot Y = g$$

where  $g$  is growth of nominal GNP. This gives

$$\frac{PSBR}{Y} = g \cdot \frac{D}{Y} = g \cdot b \quad (1)$$

This result implies that to maintain the current debt/GNP ratio of 25%, and assuming a future growth rate of nominal GNP of 8%, the PSBR/GNP ratio must be set at  $.25 \times .8 \times 100 = 2\%$ , which implies a cash target of around £12bn.

But the PSBR can be divided into debt interest,  $rD$ , and the rest, PSBR\*. So we can write:

$$\frac{PSBR^* + rD}{Y} = g \cdot \frac{D}{Y}$$

i.e. 
$$\frac{PSBR^*}{Y} = (g - r) \frac{D}{Y} \quad (2)$$

If the growth rate of nominal GNP is equal to the nominal interest rate (as in some growth models), so  $PSBR^*/Y = 0$ , equation (2) implies that by balancing the budget *excluding debt interest payments*, the debt/GNP ratio would be held constant. Borrowing would then be needed just to cover interest, implying a target of £16.5bn on the Autumn Statement forecast of interest payments.

However, if nominal interest rates are typically some 2% higher than the nominal growth rate, equation (2) would imply a target surplus for the PSBR/GNP ratio excluding interest payments of 0.5% (to hold the debt/GNP ratio at 25%). This would reduce the permitted borrowing by £3bn to £13.5bn. To the extent that some £5.5bn of this is financed by privatisation receipts, the actual borrowing target is reduced to £8bn.

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To make the arithmetic simple, assume that the rate of interest is 10%, and that the government announces a 10-year programme of debt repayment. Then a PSDR of 1% of GDP would over 10 years reduce the debt burden from its present level of around 25% of nominal GDP to around 15%, pulling the debt interest burden down from 2.5% to 1.5% of GDP. In addition the debt burden would be falling as a consequence of the rise in nominal GDP each year - this process would halve the debt burden over 10 years (assuming nominal growth at 8%). Erosion and repayment of the debt burden would together reduce the value of debt interest from 2.5% to less than 0.5% of GDP. In the new steady state, with the same level of public spending (as a share of GDP) as at present, income tax rates could be some 6p lower.

There is nothing very surprising about this result. Any organisation that sets aside savings (or pays off borrowing) for 10 years will benefit from the accumulated interest income (or interest saved). When it is the finances of the nation that are at stake, and the benefit takes the form of lower tax rates, there may be an extra growth dividend from the incentive effects of lower tax rates. The government clearly believes this although both the theoretical and empirical evidence for the proposition is ambiguous.

In the present climate, as we shall see, a PSDR of even 1% of GDP will be difficult to achieve. But if the government maintained a balanced budget, the national debt, and the interest thereon, would fall as a share of GDP over the period by around 8% per annum (the growth of nominal GDP), halving the burden of debt and making room for more modest cuts in tax.

The main purpose of this kind of reasoning is to bring out the obvious fact that there is a trade-off between resources available to the government (for tax cuts or extra spending) in the present year, and the resources that will be available in future years. There may, as we shall see, be good short-term reasons for adopting an easier fiscal stance in a given year. But the price of doing so is always to make the choices confronting the government harder in future years. This trade-off is essentially the same inside the ERM as outside it, and from this point of view, ERM entry does not require much of a change to fiscal policy to ensure long-run sustainability.

### Shorter-Term Considerations

If the government were to adopt a balanced budget policy along the lines outlined above, it would continue a reduction in the debt/GDP ratio which has already brought it to a point close to a 200-year low for this country and significantly lower than the debt ratios in most other OECD economies. For example, the equivalent figures are 43% for Germany, 47% for France, 54% for the US, 69% for Canada and 98% for Italy. In these circumstances we can ask whether, given the strength of the recessionary forces now threatening the economy, there may be short-term arguments for relaxing the fiscal discipline a little in the coming Budget.

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It has become very clear in the last five years that private borrowing propensities in the UK economy can undergo sharp changes, and in a fixed exchange rate system these cannot necessarily be fully offset by changes in domestic interest rates. This creates the possibility that there could be large swings in domestic demand growth over medium-term periods, unless the budget deficit is allowed to move in the opposite direction. At the very least, this means allowing the automatic fiscal stabilisers to work as private borrowing behaviour moves above or below its long-term trend levels.

These fiscal stabilisers can be quite large, possibly larger than is shown by simulations on standard macro-economic models. This is because the timing of payments between the private sector and the public sector (both in the form of taxes, and other transactions between the two sectors) can be altered by the private sector in order to conserve cash when this is made necessary by cyclical conditions. For example, at present, the company sector may be taking steps to offload its financial deficit onto the public sector, both by minimising immediate tax liabilities and by delaying payments to public sector bodies. The tendency for the budget deficit to respond automatically to cyclical variations in GDP has often in the past caught forecasters by surprise, not least those in the Treasury. Now that corporation tax - a volatile element of the government's accounts - is a very important source of revenue, this tendency may be increased.

In response to all these points, the Treasury seems to have accepted that the fiscal stabilisers should henceforward be allowed to work in full (which is very different from the approach incorporated in the original MTFs). However, there may be much less willingness to take a further step and introduce discretionary changes to tax and expenditure policy in an effort to offset cyclical variations in GDP. Since there is nothing necessarily optimal about the size of the automatic stabilisers which happen to be built into the fiscal system, it can be argued that this reluctance to adopt discretionary measures is a mistake. In essence, it can be said that prior to ERM entry there was a large element of discretion in interest rate changes, which is no longer available to the government. Given that this is the case, perhaps there should be some additional element of discretion in fiscal policy changes.

The Treasury's case against this appears to be based on several points. First, as we have seen, it reminds us that the past record of fiscal fine-tuning has not been particularly impressive. Because budgets are a long way apart, there is often a tendency to react too much and too late to changes in the economic cycle. Second, it is more likely that taxes would be reduced, or expenditure increased, in a recession than that the opposite would occur in a boom. If a bias of this sort develops, then over the long term the budget deficit would tend to creep upwards. Third, it can be argued (though this is not an argument that any Chancellor is likely to use) that a more variable growth rate is no bad thing: deep recessions may cause changes in behaviour that make the economy more productive in the succeeding upswing. And fourth, even in the ERM there is likely to be some link between the size of the fiscal deficit and the opportunity for



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interest rate cuts. In order to maximise the scope for interest rate reductions in the year ahead, the Chancellor might decide to minimise any discretionary tax or expenditure action in the Budget.

In fact, however, the link between UK interest rates and domestic fiscal policy in the ERM may not be very great. There is now a fully integrated capital market throughout the EC countries, which means that the UK government has access to a very large pool of European savings. In such an environment, the interest rate impact of the budget deficit of any individual country is likely to be spread throughout the Community. Theory tells us that, if investors regard the bonds issued by different governments as perfect substitutes for each other, then the UK budget deficit will have no special effect on UK interest rates. The impact will be evenly spread throughout the capital markets of the EC.

We have not quite reached that stage yet, since investors do not regard foreign government bonds as perfect substitutes for UK gilts. Therefore the gilt issue can still have a larger effect on UK interest rates than on other EC rates. However, empirical estimates suggest that the effects on domestic interest rates of changes in the government bond issue have in the past been small, and this is likely to become increasingly true if the ERM is stable. Any linkage between the PSBR and British interest rates, which is already weak, might then disappear altogether.

The upshot of all this is that the Treasury seems ready to accept that the fiscal stabilisers should be allowed to work in full, but seems unlikely to go further than that and actually change tax rates for the purposes of fiscal fine-tuning. Whether this approach will survive a progressive hardening of the ERM commitment in the years ahead remains to be seen.

# 5 The Budget Strategy

## The Return of the Budget Judgement

There was a period in the early 1980s when Budgets were regularly castigated for being "boring". The reason was that an important element of surprise - the "Budget judgement" - had been eliminated by the adoption of the Medium-Term Financial Strategy. In earlier days the Chancellor decided at Budget time both how much he could afford to "give away" and how he would spend the money. Under the MTFS the scope for tax cuts was known in advance - it was set out as a "fiscal adjustment" in the previous year's "Red Book".

This period of calm - when the government's fiscal forecasts for the next-year-but-one were generally still looking accurate a year later - lasted until 1986. Stable growth and low inflation meant that the economy as a whole, not just the fiscal position, was relatively easy to forecast. Since then we have had three years in which the government's finances were, by a substantial margin, much better than expected and, it now appears, two years in which they have turned out worse.

The government's fiscal position is obviously sensitive to cyclical swings in the economy. Booms generate extra income and spending and hence extra tax revenue, and may also lead to lower spending on unemployment and related benefits. Slumps do the opposite. But it is too facile to say that government finances were better than expected between 1987-88 and 1989-90 because of the boom, and have since become worse because of the recession. The fact that inflation has been higher than expected, for example, should have *improved* the fiscal position because income tax, National Insurance and VAT, the main revenue sources, are automatically boosted by inflation while spending, which is cash limited, is not.

Clearly the revenue surpluses of 1987-88 and 1988-89 had much to do with the consumer boom whose scale was hugely underestimated by the official forecasters (and everybody else). But the revenue shortfall in 1989-90 was *not* a consequence of an unexpectedly severe downturn. It was due, more than any other single factor, to a shortfall in corporation tax. And the move into deficit in the current year has more to do with spending overshoot than revenue shortfall.

There is a particular problem with corporation tax, which has become a major source of revenue, rising from less than £5bn in 1979-80 to over £20bn currently. This tax depends on profits which are hard to measure and harder still to forecast, and the timing of tax payments is also uncertain. With an increasing amount of revenue coming from this unpredictable source, the Budget-time fiscal forecasts for the next-year-but-one are surrounded by a margin of error which swamps the so-called "fiscal adjustment" (only £1bn this year).

The previous year's MTFS is thus no longer a reliable guide either to the future fiscal stance (as measured by the PSDR or PSBR) or to future tax changes. Instead the Chancellor must decide, from year to year and on the basis of the latest information, at what level to set the PSBR/PSDR targets and how much he should change taxes in the current year. The "Budget judgement" is back.

### Lessons from Past Budgets

Each Budget is conditioned by the new information that has become available in the course of the year, which means that the MTFS guidelines are regularly adjusted. But this does not mean that past guidelines are without influence. And there are lessons to be learned by looking at the way in which the new information changes the Budget targets.

**Table 5.1. Change in Fiscal Position for the Year Ahead**

| £bn     | 1<br><i>Ex-ante</i><br>change in<br>PSDR | 2<br>Announced<br>change <sup>a</sup> in<br>PSDR | 3<br>Extra<br>revenue<br>required <sup>a</sup><br>(2-1=5-4) | 4<br>Previously planned<br>tax changes <sup>b</sup> | 5<br>Tax changes<br>announced<br>in Budget |
|---------|--|--|---|---|--|
| 1990-91 | -4.5                                     | -3   | 1.5   | -1  | 0.5  |
| 1989-90 | 13                                       | 14   | 1   | -3  | -2   |
| 1988-89 | 8  | 7  | -1  | -3  | -4   |
| 1987-88 | 3.5                                      | 3  | -0.5  | -2  | -2.5                                       |
| 1986-87 | -2                                       | 0.5  | 2.5   | -3.5  | -1   |
| 1985-86 | 0  | 0  | 0   | -2  | -2   |
| 1984-85 | 1  | 1.5  | 0.5   | -0.5  | -  |

<sup>a</sup> Changes announced at Budget time compared with previous year's MTFS.

<sup>b</sup> Fiscal adjustment in previous year's MTFS.

Table 5.1 shows the history of past Budgets. It is calculated by comparing the Budget-time forecast for the year ahead with the forecast published in the previous year's Red Book. The first column shows the change in the fiscal position - how much the PSDR would change if no further action were taken. The second column is (jointly with the last) a decision variable: the Chancellor can announce changes in the PSDR greater or smaller than that shown in column 1 by raising or lowering taxes. The third, which is the difference between the two preceding columns, shows the revenue change required to achieve the announced target. Since the revenue projections published in the previous year always include a provision for tax cuts, the change starts from that base. Thus in 1990-91 an extra £1.5bn was required to limit the announced deterioration in the

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PSDR to £3bn. This was achieved by Budget changes (shown in the last column) which raised revenue of £0.5bn compared with the forecast tax cuts of £1bn.

There are two simple lessons to be learned from Table 5.1. First, most of the forecast *ex-ante* change in the fiscal position (column 1) carries over into the *announced* change in the PSDR. In other words, when the government thinks it cannot hit its PSDR target for the coming year it changes the target rather than changing taxes. This is the sense in which the firm fiscal framework envisaged in the early days of the MTFS has been destroyed by the uncertainty of the fiscal forecasts.

On the other hand, and this is the second lesson, when the fiscal position has proved worse than expected, the discretionary changes in tax have been such as to *raise* revenue and limit the deterioration in the announced PSDR. That happened in 1986-87 when the shortfall in oil revenues following the fall in oil prices led Mr Lawson to reduce tax by only £1bn of the £3.5bn fiscal adjustment. It happened again last year when Mr Major responded to a £4.5bn deterioration in the fiscal surplus by increasing tax by £0.5bn, compared with the £1bn of tax cuts foreshadowed in the MTFS (although the fiscal tightening was less than it looked last year because the tax increases coincided with the introduction of independent taxation - announced in the 1988 Budget - which first reduced tax revenues in 1990-91).

This analysis suggests that although a certain cynicism about the influence of past plans on present decisions is in order, it would be wrong to assume that the state of the government finances has *no* influence on the Budget judgement. Before the MTFS was invented, the key influence was the state of the real economy. The rule, broadly speaking, was to cut taxes if forecast growth was below potential growth, raise them if it was above. The resulting fiscal surplus or deficit was held to be quite irrelevant to the Budget judgement.

In the early days of the MTFS, this kind of fiscal fine-tuning was formally abandoned. It was the state of the real economy that was held to be irrelevant to the Budget judgement, and the rule was that taxes should be cut only if this was consistent with achieving the targets for the PSBR, which were set on a declining path. The 1981 Budget, when taxes were increased in the depths of a recession because the PSBR had turned out worse than expected, marked the full flowering of this doctrine. Some would claim that the 1988 Budget, in which taxes were cut at the height of a boom, was an equally egregious example of pro-cyclical fiscal policy, but in fact it is much less clear-cut. The tax cuts were only slightly greater than previously planned, and no serious attempt was made to spend the unanticipated revenues either in that year or the next.

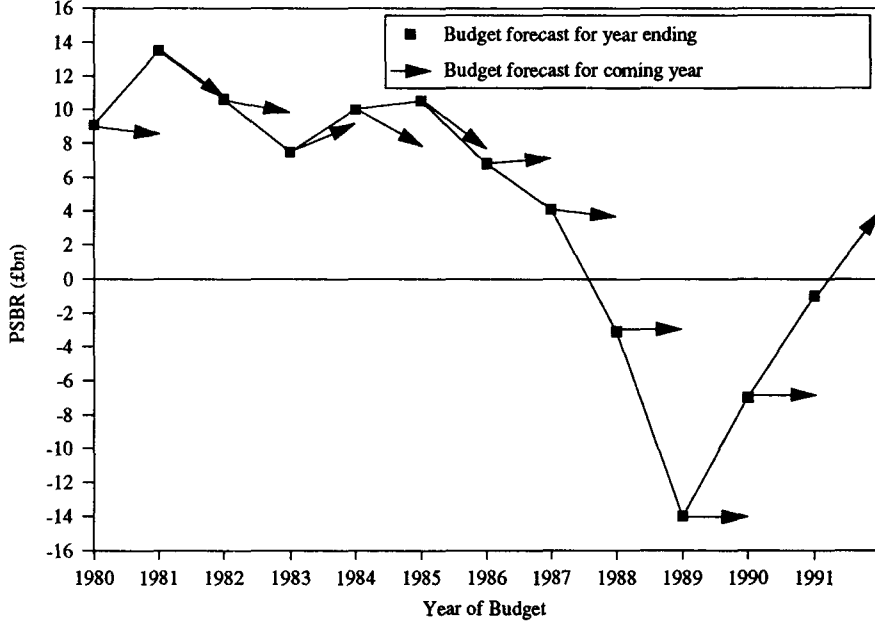
Table 5.2. Within-Year Changes in Official Estimates of Government Finances

|                | 1982-83 |       |       | 1983-84 |     |       | 1984-85 |       |       | 1985-86 |     |      | 1986-87 |       |      | 1987-88 |     |      | 1988-89 |     |      | 1989-90 |     |      | 1990-91 |     |     |
|----------------|---------|-------|-------|---------|-----|-------|---------|-------|-------|---------|-----|------|---------|-------|------|---------|-----|------|---------|-----|------|---------|-----|------|---------|-----|-----|
|                | FSBR    | AS    | FSBR  | FSBR    | AS  | FSBR  | FSBR    | AS    | FSBR  | FSBR    | AS  | FSBR | FSBR    | AS    | FSBR | FSBR    | AS  | FSBR | FSBR    | AS  | FSBR | FSBR    | AS  | FSBR | FSBR    | AS  | IFS |
| Expenditure    | 131.5   | 130.5 | 130   | 137.5   | 139 | 139   | 146     | 148.5 | 149.5 | 159.5   | 158 | 158  | 163     | 164.5 | 165  | 174     | 173 | 172  | 183     | 181 | 179  | 194     | 196 | 198  | 213     | 216 | 217 |
| Receipts       | 121.5   | 120.5 | 121.5 | 128.5   | 128 | 128.5 | 138.5   | 140   | 140   | 150     | 149 | 150  | 156     | 156.5 | 159  | 169     | 171 | 174  | 185     | 189 | 191  | 206     | 207 | 203  | 219     | 219 | 218 |
| PCDR           | 0.5     | 1     | 1     | 1       | 1   | 0.5   | 0.5     | 0     | -1    | 2.5     | 1   | 1    | 0       | 1     | 2    | 1       | 1   | 1    | 1       | 2   | 2    | 2       | 2   | 2    | 2       | 2   | 2   |
| PSBR           | 9.5     | 9     | 7.5   | 8       | 10  | 10    | 7       | 8.5   | 10.5  | 7       | 8   | 7    | 7       | 7     | 4    | 4       | 1   | -3   | -3      | -10 | -14  | -14     | -13 | -7   | -7      | -3  | -1  |
| Change in PSBR |         |       |       | -2      |     | +2    |         |       | +3.5  |         |     | 0    |         |       | -3   |         |     | -7   |         |     | -11  |         |     | +7   |         |     | +6  |
| of which       |         |       |       |         |     |       |         |       |       |         |     |      |         |       |      |         |     |      |         |     |      |         |     |      |         |     |     |
| Expenditure    |         |       |       | -1.5    |     | +1.5  |         |       | +3.5  |         |     | -1.5 |         | +2    |      |         |     | -2   |         |     | -4   |         |     | +4   |         |     | +4  |
| Receipts       |         |       |       | 0       |     | 0     |         |       | -1.5  |         |     | 0    |         | -3    |      |         |     | -5   |         |     | -6   |         |     | +3   |         |     | +1  |
| PCBR           |         |       |       | -0.5    |     | +0.5  |         |       | +1.5  |         |     | +1.5 |         | -2    |      |         |     | 0    |         |     | -1   |         |     | 0    |         |     | +1  |

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**Note to Table:**  
 The forecasts shown are those given in the FSBR at the beginning of the fiscal year, the Autumn Statement in the November of the fiscal year and the FSBR at the end of the year. Changes in the PSBR are given between the FSBR at the beginning and end of the year. The contribution of expenditure, receipts and public corporations are given as their effect on the PSBR.

Chart 5.1. The PSBR for the Current and Coming Year



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In fact the most striking characteristic of fiscal policy since the 1986 Budget has been the tendency to announce, for the coming year, a PSBR/PSDR target identical to the estimated out-turn for the year just ending, as Table 5.2 shows. Discretionary tax changes have been limited to offsetting some of the "real fiscal drag" (the tendency for tax revenue to rise as a share of GDP in a growing economy). The result has been that the huge change between forecast and out-turn in 1987-88 and 1988-89 now looks like a classic automatic tightening of fiscal policy in a boom, and the change in 1989-90 and 1990-91 looks like a similar automatic loosening of fiscal policy in a recession. Discretionary fiscal fine-tuning is out, but the automatic fiscal stabilisers are allowed full play.

Before we leave this analysis of the past, there are two further lessons to be drawn out. The lower panel of Table 5.2 splits the errors in the PSDR forecast into errors in the tax, errors in spending and errors in public corporations' borrowing. Only once (last year) has revenue been lower than expected, whereas public spending has come in both above and below target. There is a detectable tendency for the overspends to occur in the vicinity of an election (though that was not true of 1982-83).

### **The Public Finances in 1990-91**

The fact that the monthly PSBR figures have shown a deficit all year, now amounting to £6.3bn for the PSBR excluding privatisation receipts, has led most forecasters to expect the public finances to go back into deficit in 1990-91. The PSBR always improves in the January tax-gathering season, but the improvement could be less than usual this month. The squeeze on corporate finances could make companies delay their tax payments, and the 1987 Budget changes, which standardised the period between the end of a company's tax year and the due date for tax, may also reduce the concentration of tax payments in January. Simple extrapolation of the monthly PSBR figures, based on past experience of the seasonal pattern, suggests that the authorities will barely achieve a balanced budget this year, a disappointing out-turn compared with the £7bn surplus projected at Budget time.

However, as Table A1 in Appendix 1 shows, there is nothing in the current receipts figures to date to suggest that government *revenues* are coming in below target. Nor do our model-based tax forecasts, which take full account of the deterioration in the economic outlook, suggest that there will be a significant undershoot. For although output may be lower this year than officially forecast at Budget time, the shortfall will be concentrated on company spending - investment and stocks - which is not part of the tax base. The main determinants of tax receipts are the national wage bill and consumer spending at current prices, neither of which is likely to be significantly lower than expected. (The price-volume mix may be less favourable but this does not affect the tax take.)

The one area in which we do see a likely shortfall is the Community Charge, where non-payment could be running at over 10% rather than the generally assumed 5% of revenues. We treat this as an explicit adjustment which reduces the PSDR by £0.6bn.

The main reason for the below-target PSDR is thus an overshoot in public spending, much of it by local authorities. Some £3bn of this has already been admitted in the Autumn Statement. Past experience (see Table 5.2) suggests that in years when extra spending is recognised at Autumn Statement time, further spending is discovered in the following Budget. This pattern is likely to be repeated this year. The monthly figures for "net departmental outlays", even when adjusted to take account of the changes in accounting structure following the introduction of the Community Charge, point to a further overshoot, of just over £1bn.

The economic conditions which have played such havoc with the finances of private companies have also affected public corporations - many of which have large fixed costs and are particularly badly hit by a downturn in revenue. Instead of £1bn of debt repayment we now expect public corporations to be in balance. Together with the other changes this leaves a PSDR of only £1bn in 1990-91 as Table 5.3 shows.

**Table 5.3. PSDR Projections for 1990-91 compared with FSBR**

|                                    | Effect on PSDR<br>(£bn) |
|------------------------------------|-------------------------|
| Revenue shortfall                  |                         |
| Community Charge                   | -0.6                    |
| Other                              | -0.3                    |
| Extra spending                     | -4.1                    |
| Public corporations debt repayment | -1.0                    |
| <b>Total change in PSDR</b>        | <b>-6.0</b>             |

### The Public Finances in 1991-92

Our projections for 1991-92, starting from this lower base, show tax revenues some £2bn higher than in the Red Book forecast. This may seem surprising given that the recession next year will certainly be deeper than was anticipated last March, but the explanation is quite simple: the Treasury has for the past four years substantially underestimated revenue for the next-year-but-one in the MTFs forecasts published at Budget time, as Table 5.4 shows.

The forecast revenue growth of 4.5% between 1990-91 and 1991-92 always looked surprisingly low compared with forecast nominal GDP growth of 6.8%. It now looks as though nominal GDP will grow by 6.9%, and our revenue forecast is much more closely in line with this, at 6.1%.

## Green Budget 1991

**Table 5.4. How Revenue Projections have been Revised Upwards**

| £bn     | Projection made a year before start of year shown | Updated projection made in following Budget | Extra revenue discovered at Budget time |
|---------|---|---|---|
| 1987-88 | 164   | 172   | 8                                       |
| 1988-89 | 178   | 189   | 11                                      |
| 1989-90 | 195   | 208   | 13                                      |
| 1990-91 | 214   | 218.5                                       | 4.5                                     |
| 1991-92 | 229   | 231 <sup>a</sup>                            | 2 <sup>a</sup>                          |

<sup>a</sup> IFS estimates.

On the spending side we continue to assume that the overshoot admitted in the Autumn Statement is not the end of the story. However, we believe the overspending will be less than assumed by many City commentators. Compared with earlier overspending episodes (1974-75, 1980-81) there is much less upward pressure on public sector wages. In 1974-75 these were boosted by an ill-fated experiment in wage indexation. In 1980-81 the government was committed to honouring the Clegg awards, which were designed to restore public sector pay relativities that had been severely squeezed by the incomes policy of the late-1970s.

**Table 5.5. The Government's Finances**

|                                    | 1990-91   |                  |              | 1991-92          |                  |              |
|------------------------------------|-----------|------------------|--------------|------------------|------------------|--------------|
|                                    | FSBR 1990 | Autumn Statement | Green Budget | FSBR 1990        | Autumn Statement | Green Budget |
| General government receipts        | 218.5     | 218.7            | 217.8        | 228 <sup>a</sup> |                  | 231          |
| General government expenditure     | 212.7     | 215.7            | 216.8        | 225              | 234              | 235          |
| General government debt repayment  | 5.8       | 3.0              | 1.0          | 3                |                  | -4           |
| Public corporations debt repayment | 1.0       | 0.0              | 0.0          | 0                |                  | 0            |
| PSDR                               | 6.8       | 3.0              | 1.0          | 3                |                  | -4           |
| Money GDP                          | 548       |                  | 566          | 585              | 604              | 605          |
| PSDR as % of GDP                   | 1.25      | 0.5              | 0.2          | 0.5              |                  | -0.7         |

<sup>a</sup> Includes built-in tax cuts of £1bn.



**Table 5.6. The Public Finances**

|   | 1990-91      | 1991-92      |
|---|--------------|--------------|
| Income tax                                | 56.0         | 62.2         |
| Corporation tax                           | 20.8         | 18.3         |
| Petroleum revenue tax                     | 1.1          | 1.2          |
| Capital gains tax                         | 1.8          | 1.9          |
| Inheritance tax                           | 1.3          | 1.4          |
| Stamp duties                              | 1.7          | 1.7          |
| <b>Total Inland Revenue</b>               | <b>82.7</b>  | <b>86.7</b>  |
| VAT                                       | 30.7         | 32.3         |
| Petrol                                    | 9.7          | 10.6         |
| Tobacco                                   | 5.4          | 5.9          |
| Alcohol                                   | 5.0          | 5.4          |
| Betting and gaming                        | 1.0          | 1.0          |
| Car tax                                   | 1.5          | 1.6          |
| Customs duties                            | 1.8          | 1.8          |
| Agricultural levies                       | 0.1          | 0.1          |
| <b>Total Customs and Excise</b>           | <b>55.2</b>  | <b>58.8</b>  |
| Vehicle excise duties                     | 3.0          | 3.0          |
| Oil royalties                             | 0.7          | 0.7          |
| Rates                                     | 12.2         | 13.4         |
| Other taxes and royalties                 | 4.4          | 4.7          |
| <b>Total taxes and royalties</b>          | <b>158.2</b> | <b>167.4</b> |
| National Insurance contributions          | 36.2         | 39.2         |
| Community Charge                          | 11.7         | 12.3         |
| Interest and dividends                    | 6.4          | 6.4          |
| Other receipts                            | 5.8          | 5.8          |
| Adjustment <sup>a</sup>                   | -0.6         |              |
| <b>General government receipts</b>        | <b>217.8</b> | <b>231.0</b> |
| Central government own expenditure        | 141.9        | 153.1        |
| Central government support for LAs        | 42.7         | 48.8         |
| Public corporations                       | 2.1          | 2.3          |
| Privatisation                             | -5.3         | -5.5         |
| Reserve                                   | 0.3          | 3.5          |
| <b>New planning total</b>                 | <b>181.7</b> | <b>202.2</b> |
| Local authority self-financed             | 13.9         | 12.8         |
| Central government debt interest          | 17.8         | 16.5         |
| Accounting adjustments                    | 3.4          | 3.5          |
| <b>General government expenditure</b>     | <b>216.8</b> | <b>235.0</b> |
| <b>General government debt repayment</b>  | <b>1.0</b>   | <b>-4.0</b>  |
| <b>Public corporations debt repayment</b> | <b>0.0</b>   | <b>0.0</b>   |
| <b>Public sector debt repayment</b>       | <b>1.0</b>   | <b>-4.0</b>  |

<sup>a</sup> The adjustment accounts for unexpected non-payment of the Community Charge.

## Green Budget 1991

In 1980-81 there was also a sharp and unexpected rise in unemployment. Although this is happening again at present, it is not yet on the same scale and its effect on the public finances will be attenuated by the fact that many of those who lose their jobs will be part-time women whose entitlements will be far less than those of the full-time males who were worst affected last time around.

On the other hand the government is still in severe difficulties with the Community Charge and the next election is not far away. For these reasons we expect the authorities to admit to at least another £1bn of public spending compared with the Autumn Statement projection. We expect no improvement next year in the finances of public corporations, which have deteriorated in the recession this year.

Table 5.5 summarises the prospects for 1991-92. The revenue and expenditure forecasts on which this assessment is based are set out in detail in Table 5.6 and discussed more fully in Appendix 1.

Because the prospects for the economy are more than usually uncertain, we have estimated what would happen to income tax if employment or wage settlements fell more rapidly than expected; to taxes on expenditure if the amount of consumer spending or consumer prices fell more rapidly than expected; and to corporation tax and oil revenues if profits or the oil price turned out below expectations. The sensitivity of tax accruals from these main sources of revenue to changes in economic assumptions are shown in Table 5.7. A full explanation of the table can be found in Appendix 1.

**Table 5.7. Revenue Projections: Key Assumptions and Sensitivity to Change**

|                               | Assumption<br>(annual % change<br>except oil price) | Revenue effect of<br>1% change<br>(£bn) |
|-------------------------------|---|---|
| Wages                         | 9.0   | 1.3                                     |
| Employment                    | -1.5  | 0.8                                     |
| Prices                        | 5.5   | 0.2                                     |
| Consumer spending             | 0.5   | 0.5                                     |
| Sterling oil price (£/barrel) | 15.8  | 0.03                                    |
| Corporate profits             | -13.0   | 0.2                                     |

It should also be borne in mind that the differences between tax accruals and tax *payments* vary systematically over the economic cycle - in recessions taxpayers tend to alleviate their cash flow problems by late or partial payment of their tax bills, while in booms more of them pay taxes in full and on time. This is one reason why the scale of the public sector surplus in the 1987-88 boom (or of the movement into deficit this year) was not fully anticipated by the official forecasters. These forecasting errors suggest that Table 5.7 may somewhat understate the effect of a deeper-than-expected recession on tax revenues.

### The Budget Stance in 1991

Mr Major, when interviewed as Chancellor in October by *The Independent*, said he did not want a PSBR. But by the New Year, when the full scale of the recession was becoming apparent, the new Chancellor, Mr Lamont, said in his interview for the *Financial Times*:

My objective is to balance the Budget over the medium term, not in every single year. If damaging and de-stabilising tax changes are to be avoided, this could mean moving into modest deficit when output is below trend.

Our fiscal forecast for the present Budget points to a move from a (greatly reduced) surplus of £1bn in the current fiscal year to a £4bn deficit next year. However, if the recession proves worse than we have assumed (and at present the downside risks appear considerable), or the Gulf War goes on for longer, or pre-election spending proves hard to control, the out-turn could be a much larger deficit.

In the past, when confronted with an *ex-ante* deterioration in the fiscal position, this government has attempted to retrieve the situation by raising taxes - notably in the famous 1981 Budget framed, as the 1991 Budget will be, against a recessionary backdrop. However, there are two good reasons for expecting a different response this time around: first, the 1981 Budget came much earlier in the electoral cycle; and second, there is a different exchange rate regime. A tight Budget now could prejudice the chances of an economic recovery ahead of the election, while offering none of the offsetting benefits that were enjoyed in 1981.

Under a floating exchange rate regime, with the nominal framework provided by monetary targets, a tight fiscal policy made it easier to cut interest rates. When this happened in 1981 the resulting fall in the exchange rate was welcomed as providing an overdue improvement in competitiveness. The hard-pressed corporate sector thus benefited, in due course, both from lower interest rates and from a more competitive exchange rate. But now we are in the ERM the scope for any fall in the exchange rate is much reduced. And (as argued in Chapter 4) when the authorities are targeting the exchange rate rather than monetary growth, it is far from clear that a tighter fiscal policy makes it possible to reduce interest rates. So a tight Budget simply promises more short-term misery without any offsetting longer-term relief.

For these reasons we expect that Mr Lamont will, on this occasion, accept that a move from surplus to deficit is inevitable. We have already noted that in recent Budgets the built-in fiscal stabilisers have been allowed to work in full. This has not in the past meant accepting a move into deficit. This year it does, partly because the growth of revenue is attenuated by the recession, and partly because of the overshoot in public spending.

## Green Budget 1991

One of Mr Lamont's options is to make a virtue out of necessity, and claim that this extra public spending is a sensible, pragmatic response to the recessionary conditions which now prevail. This would be a major break with the past, though one which is consistent with the Conservatives' attempts, following the changes at the top of the government, to present a more "caring" image. But there is a risk that this loosening in fiscal stance that has been forced upon Mr Lamont will be interpreted by the foreign exchange markets as a loss of nerve. They might suppose that a looser fiscal policy today heralds a looser monetary policy tomorrow and sell sterling on the expectation of interest rate cuts.

We therefore think it unlikely that Mr Lamont, who like all Conservative Chancellors is looking for opportunities to cut taxes, will do so on any scale this year. A change in the fiscal stance for 1991-92 from a previously planned PSDR of £3bn to a PSBR of £4bn is quite enough fiscal loosening, and the Budget package announced in March is unlikely to add to the deficit that has been created by a combination of recession and overspending. It may nevertheless be possible for Mr Lamont to announce some small tax cuts, paid for by hidden tax increases, within the context of a neutral Budget, and it is to this that we now turn.

# 6 Analysis of Tax Options

## 6.1 Income Tax

1991 will see the thirteenth consecutive Conservative Budget, but one which is very unlikely to include significant cuts in the burden of income tax, which were the hallmark of budgets from 1982 to 1988. Table 6.1 summarises the principal changes made to income tax rates and allowances since 1978.

**Table 6.1. Income Tax Changes since 1978**

|         | Basic rate (%) | Top rate on earned income (%) | Real level of allowances (1978-79=100) |
|---------|----------------|-------------------------------|--|
| 1978-79 | 33             | 83                            | 100                                    |
| 1979-80 | 30             | 60                            | 102                                    |
| 1980-81 | 30             | 60                            | 104                                    |
| 1981-82 | 30             | 60                            | 93                                     |
| 1982-83 | 30             | 60                            | 99                                     |
| 1983-84 | 30             | 60                            | 108                                    |
| 1984-85 | 30             | 60                            | 115                                    |
| 1985-86 | 30             | 60                            | 119                                    |
| 1986-87 | 29             | 60                            | 122                                    |
| 1987-88 | 27             | 60                            | 122                                    |
| 1988-89 | 25             | 40                            | 126                                    |
| 1989-90 | 25             | 40                            | 126                                    |
| 1990-91 | 25             | 40                            | 126                                    |

Two patterns are very clear. First, this government cuts rates of income tax.<sup>1</sup> Second, the real value of allowances has only been reduced in exceptional circumstances; the only occasion on which allowances have not been increased at least in line with inflation was 1981, when freezing allowances was a major part of a tax-increasing Budget. During the run-up to last year's Budget there was much discussion of the possibility of freezing allowances. In the 1990 Green Budget we argued that if an income tax increase were to occur, freezing allowances was the most likely route. This still seems correct, but the government is even less likely to consider an increase in income tax necessary this year, given the state of consumer sentiment, so any across-the-board increase in income tax seems unlikely.

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<sup>1</sup> Although they did abolish the 25% reduced rate band in the 1980 Budget.

## Green Budget 1991

The minimum change in income tax which we expect is therefore indexation of the tax-free allowances in line with inflation, which would take the personal allowance from £3,005 to £3,285 and the married couples allowance from £1,720 to £1,880.<sup>1</sup> (change these when December RPI is available). It may be the case that the Chancellor wants to reinforce the new government's claim that it is more "caring" by making some further change to income tax that would particularly help those on low incomes, although if he does this we expect him to attempt to raise money through tax increases elsewhere to fund the change. The most likely such tax change is an increase in the value of tax-free allowances in excess of that required to offset inflation. This was the chosen form of tax cuts from 1982 to 1985 inclusive, and is certainly a more progressive way of cutting tax than reducing the tax rate. Increases in allowances produce the same increase in net income for all basic rate taxpayers, while a reduction in the rate produces gains proportional to taxable income. Raising allowances is rather expensive; even an additional 2.5% costs over £0.5 billion. This seems the likely size of additional increase, conferring an additional annual gain of only £20 on basic rate taxpayers.

### Reduced Rate Band

One of the most common fallacies about taxation is that introducing a reduced rate band (RRB) such as existed from 1978 to 1980 is a good way of helping the poor. It cannot be written too frequently that if the objective is to increase the incomes of the least well off, the administratively simpler option of increasing tax allowances is more effective than the reduced rate band.

Consider a choice between an increase in the allowance of £100 per annum and a revenue-neutral reduced rate of 20% on the first £550 per annum of taxable income. Table 6.2 shows the gains at different levels of (pre-reform) taxable income.

**Table 6.2. Gains (in £) from Higher Allowances compared with Reduced Rate Band**

| Income level      | 50    | 100 | 200 | 300 | 400 | 500 | 600   |
|-------------------|-------|-----|-----|-----|-----|-----|-------|
| Higher allowance  | 12.50 | 25  | 25  | 25  | 25  | 25  | 25    |
| Reduced rate band | 2.50  | 5   | 10  | 15  | 20  | 25  | 27.50 |

For anybody with enough taxable income to take advantage of the increased allowance, the gain is £25, while the full gain of £27.50 from the RRB is only achieved by those with taxable incomes in excess of the RRB. Thus for all those with incomes below the RRB, the allowance rise is best; for all

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<sup>1</sup> The relevant figure for indexation is the annual change in the RPI to December.

those above it, the RRB is best. It is a sad commentary on political life that although this argument was well known in 1978, the public relations attraction of having a lower starting rate was enough to carry the day.

Some of those who advocate an RRB appear to overlook the fact that under the present system the average rate of tax on those with incomes just above the tax threshold is still close to zero, and rises smoothly towards 25% as income rises. The fact that *average* tax rates rise with income means that our tax system is progressive even though the *marginal* rate of tax can be the same for someone on £5,000 as for someone on £15,000.

Helping the poor is not the only argument put forward for an RRB; the other common argument is that 25% is too high a starting rate of tax, which aggravates incentive problems. The suggestion that a 25% rate causes serious incentive problems is difficult to take seriously, but there *are* genuine worries about high marginal tax rates paid by the poor. However, these have little to do with the level of the standard rate of tax. They result from the interaction of income tax and the means-tested benefit system, which can create overall marginal tax rates of up to 96%. Unfortunately individuals facing such withdrawal rates gain almost nothing from reduction in income tax rates, because any reduction in their tax bills will be offset by reduced benefit entitlement. A reduction of 5% in an individual's income tax rate leads to a reduction in the overall withdrawal rate from 96% to 95.7% if that individual is entitled to family credit, housing benefit and community charge benefit. High marginal tax rates on the poor are the result of the social security system, not the tax system.

In addition to these arguments of principle, a new practical argument is now relevant. With the abolition of composite rate tax on interest income, it is now necessary to charge the correct amount of tax on all interest receipts. Complications caused by higher rate taxpayers are not too great, since these typically fill out annual tax returns anyway. With the current two-rate tax system it is therefore acceptable to withhold tax at the basic rate from all except those who certify themselves not to be taxpayers, and recoup the excess tax from higher rate taxpayers via their annual returns as at present. With an RRB, say of 20%, and without the composite rate system, the task of the Inland Revenue becomes horrendous. Millions of pensioners would probably find themselves in the RRB, as might many part-time workers. Should tax be withheld at 20% from all interest payments, it would be necessary to recoup the extra 5% tax from all basic rate taxpayers with interest income, an almost impossible task given that at present very few such individuals fill in tax returns. Should tax be withheld at 25% from all interest payments, it would be necessary to repay tax to all taxpayers in the RRB. The task of attempting to identify such individuals without resort to far more widespread use of tax returns seems unmanageable.

### **Raising the Money**

If Mr Lamont does choose to cut income tax by more than is required to account for inflation, he seems likely to fund those extra cuts by tax increases elsewhere, rather than by further government borrowing. The two most likely targets are the ones that were used last year: freezing the higher rate income tax threshold and further increasing the taxation of company cars. Not increasing the higher rate threshold in line with inflation would raise around £350m in 1991-92. Although this would have the somewhat ironic effect for this government of increasing still further the already record number of higher rate taxpayers, it reduces the number of individuals with earnings above the National Insurance (NI) ceiling but not paying the higher rates of income tax. Freezing the higher rate threshold to pay for raising allowances by more than inflation is clearly a progressive change, which would strengthen the government's "caring" image.

To raise the additional £150m needed to reach the £500m to fund a 2.5% real increase in allowances would require only a 15% increase in the real value of the company car scale charges. While these scales may by now be close to the appropriate values, the continued exclusion of such fringe benefits from the NI base makes a further increase in income tax liabilities quite reasonable.

### **Mortgage Interest Relief**

The Mortgage Interest Relief (MIR) ceiling has stood at £30,000 since 1983. If it had been increased since then in line with general inflation it would now stand at around £45,000, and if it had been increased in line with house price inflation it would stand at around £65,000. As interest rates rose, home-owners with mortgages have seen an increase in the level of the MIR ceiling as one possible way of alleviating their suffering. Such a change is unlikely, and would be unwelcome in terms of its long-term effects both on the housing market and on the tax system, for a number of reasons. First, one of the government's implicit objectives in following a high interest rate policy was to bring stability back to the housing market, which might be endangered by any increase in the MIR ceiling. Second, reductions in interest rates seem a more obvious way of dealing with the problems imposed by high interest rates than raising the MIR ceiling; increasing the ceiling might even delay interest rate cuts, and as such would be unwelcome. Third, any increase in the MIR ceiling would help only those with mortgages in excess of £30,000. Fourth, any such change would be expensive: an increase to £35,000 would cost £450m, to £40,000, £800m. Finally, the steady withering of this distortion as house prices have risen has been one of the most substantial achievements of this government in tax reform, albeit a passive one. To throw this away now would be foolish, and would hint at desperation. An increase in the MIR ceiling seems unlikely for all these reasons.



Another major change to the MIR system which has been discussed for many years is the restriction of MIR to the basic rate of tax. This change would raise around £500m, but seems unlikely to happen except in a Budget that contains substantial tax cuts elsewhere to offset the impact on higher rate taxpayers with mortgages of £30,000 or over, who could lose almost £700 per annum if such a change were made. One way of softening the blow would be to use the revenue raised to increase the higher rate income tax threshold, but even with this offset the change seems unlikely in 1991.

### **Fringe Benefits**

The last twelve years have seen considerable progress achieved in moving towards a tax system which neither encourages nor discourages the use of payment in kind rather than money. The most dramatic change has been in the taxation of company cars: scale charges have been almost quadrupled in real terms. It may be that a little more will be done on this front in the 1991 Budget, although the scale charges, which are an estimate of the value of the benefit to the taxpayer of having a company car at his disposal, are probably now quite realistic. Much the most significant remaining problem is the exclusion of all benefits in kind from the NI base. Were NI to be imposed on benefits in kind, some £1bn could be raised, and the economic inefficiencies which result from the tax incentive to such payments removed. Such a reform may be too much to hope for in this Budget; like restricting MIR to the basic rate, it would be far easier in the context of a tax-cutting Budget.

### **Childcare**

The 1990 Budget announced that subsidised workplace nurseries would no longer be treated as a benefit in kind for tax purposes. This seemed an ill-considered, knee-jerk reaction to some effective campaigning in the run-up to the Budget. Very few workplace nurseries existed, and it is unlikely that such provision is the best or the cheapest method of using public funds to make it easier for the mothers of young children to work. A wide range of alternatives exist, from increasing spending on state nursery provision to childcare vouchers. Mr Lamont, who seems to care more about fiscal neutrality than his predecessor, is unlikely to use the tax system to provide a further hidden and *ad hoc* subsidy to childcare, especially at a time when the young mothers encouraged back into the labour force would simply swell the number of those looking for jobs.

### **Savings**

The argument that the tax system could or should be used to encourage savings was never a very good one, although politically powerful. Now that the personal saving ratio is rising, and consumption has slumped, calls for new savings incentives are less frequent. But this is to ignore the real problem with the taxation of savings, which is not that savings as a whole are discouraged, but that the choice of the form in which to save is distorted by the tax system. Most saving goes into assets that are highly

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tax-privileged, on which the effective tax rate on the return to saving is negative, with owner-occupied housing and private pensions being the most obvious examples.

Recent years have seen the introduction of schemes such as PEPs and TESSAs which allow tax-free returns on equities and interest-bearing accounts respectively. These schemes should not really be seen as conferring privilege, but as giving more nearly equal status with assets such as housing and pensions. In an ideal world, the tax system would treat all forms of savings in the same way. Given that the great bulk of assets are already excused tax on the income they generate, further extension of this regime seems the right way forward to a more neutral system. A move towards removing the excess privilege of housing in the form of MIR and of pensions in the form of the tax-free lump sum, while simultaneously extending tax-free returns to all currently taxed assets, need not have a net revenue cost; indeed, such a reform could increase aggregate revenue since the cost of MIR is some £7.6bn and that of the tax-free lump sum £1bn, compared with current tax revenue from taxing the return to saving of some £5bn.

No substantial change is likely before an election, although we may well see some tinkering with PEPs or TESSAs. The most likely changes to TESSAs are increases in the maximum amount that can be contributed, a reduction in the minimum holding period, or some change which allows continuing tax relief at the end of the five-year life of a TESSA. The revenue implications of any or all of these are slight.

## 6.2 National Insurance Contributions

National Insurance contributions (NICs) may once have been a forgotten tax, but that is no longer the case. By 1988-89 NICs were raising three-quarters as much revenue as was raised by income tax, thus making them the second largest source of government revenue. The structure of NICs had already been subject to reform in 1985, but the government returned to the same problem in 1989 and took further action, removing some of the discontinuities in the employees' NIC schedule and with them some of the disincentive problems which had existed. Looking back on tax reform in the 1980s, the 1985 and 1989 NIC changes seem significant landmarks. However, it is vital to notice that the 1985 reforms make much more sense as the first step in a reform process which was continued with the 1989 changes. Without the 1989 Budget, the introduction in 1985 of new discontinuities seemed of little worth; as a step towards the introduction of the 1989 system they seem quite coherent.

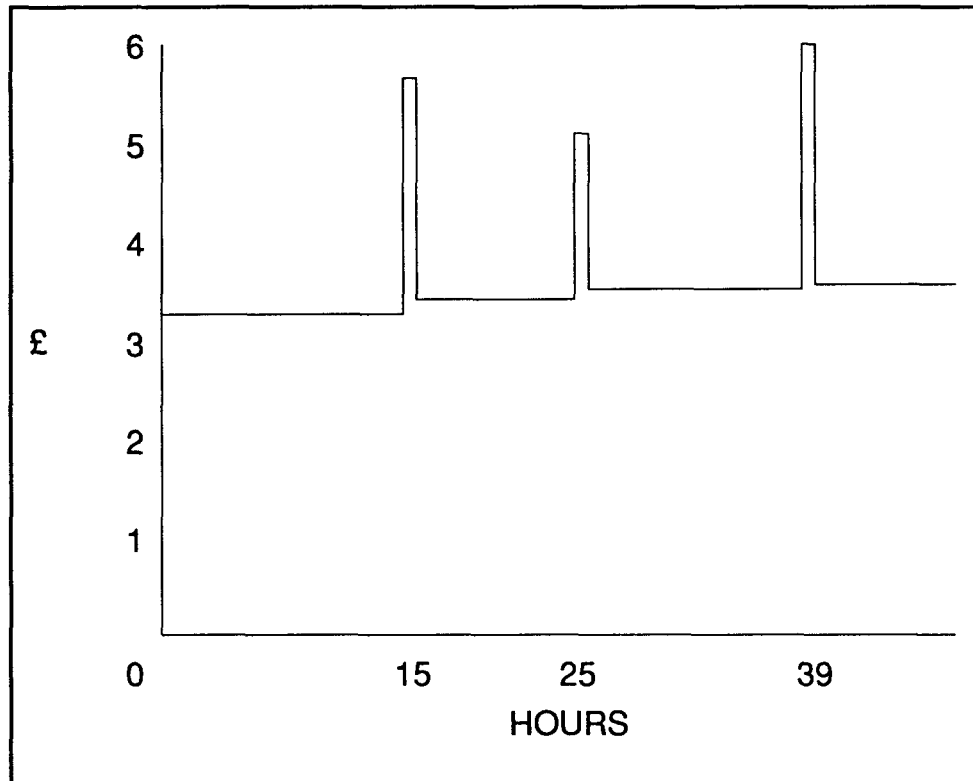
Similar sentiments can now be applied to the 1989 reform. The changes made were sensible, but still leave much to be done. We should recognise the achievement of the reforms already enacted, while emphasising the need for further progress. Three areas of difficulty remain.

### **The Structure of Employers' NICs at Low Earnings**

The 1989 reform removed the jumps in employees' NIC liability which had occurred at £75 p.w. and £115 p.w., and substantially reduced the jumps at the lower earnings limit (LEL) of £43 p.w. at which NIC liability began. Despite arguing that these reforms removed "a serious work disincentive from the system", Mr Lawson argued that the jumps in liability for employers' contributions, which were unchanged, were "not a real problem". This seems wrong. Consider Chart 6.1, which shows the marginal cost to an employer of increasing by one hour the weekly hours of an employee earning £3.25 per hour. At 15, 25, and 39 hours p.w. the marginal cost rises sharply and then falls. These hours correspond to the thresholds of £46 p.w., £80 p.w. and £125 p.w. at which contribution rates jump for employers. Clearly, it makes little sense for employers to have staff working these hours; it might make more sense to incur the fixed costs of taking on an additional member of staff to work 14 hours at a gross wage plus employer's NI cost of £45.50 than to increase the hours of 14 employees from 14 to 15, at a cost of £79.66.

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

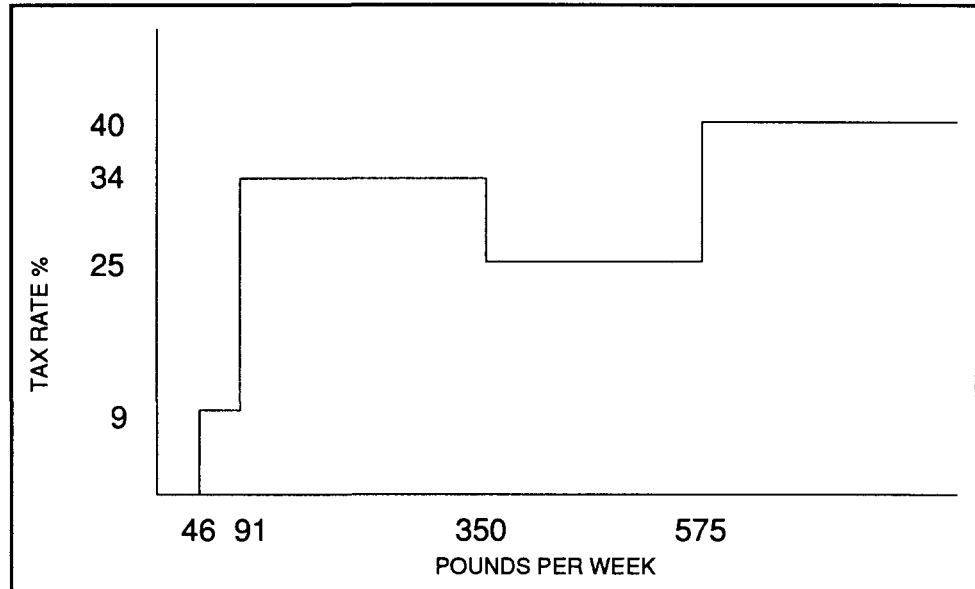
**Chart 6.1. Marginal Cost of Extra Hour**



**The NI Ceiling**

The second problem is caused by the NIC ceiling. At earnings beyond £18,200 per annum no further NICs are due from employees. For a married man, the 40% income tax rate may well not become due until earnings are in excess of £30,000. Over a range of income from £18,200 to £30,000 the marginal direct tax rate is only 25%, compared with 34% (25% income tax and 9% NIC) below that income level. The marginal direct tax rate schedule produced by the current system is shown in Chart 6.2. The lower bound of this notorious "dip" in the marginal rate schedule - the NI ceiling - is tied by law to grow only in line with pensions which in the 1980s have been reflatd in line with prices. The upper bound - the higher income tax threshold - is also generally expected to rise in line with prices. Since earnings grow faster than prices, the implication is that average earnings are growing inexorably towards the ceiling, so the "dip" is affecting increasing numbers (since the income distribution is at its densest around the mean). If real earnings continue to rise at, say, 3% per year, in seven or eight years the NIC ceiling will be below average earnings. Table 6.3 shows the ratio of average full-time male earnings to the ceiling in the 1980s.

**Chart 6.2. Marginal Direct Tax Rates 1990-91**



**Table 6.3. Average Male Earnings as Percentage of NI Ceiling**

|      |    |
|------|----|
| 1981 | 69 |
| 1982 | 69 |
| 1983 | 70 |
| 1984 | 72 |
| 1985 | 73 |
| 1986 | 73 |
| 1987 | 76 |
| 1988 | 81 |
| 1989 | 83 |
| 1990 | 84 |

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

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The distributional problem with abolition is that some individuals would lose up to £1,000 per annum, even if the higher rate of income tax were cut by 9%. These individuals are those whose incomes at present substantially exceed the NIC ceiling, but are not high enough to pay the higher rate of income tax. The best way around this problem would be to increase the NIC ceiling whenever tax cuts are made. It might be unrealistic to expect that the NIC ceiling would be raised by enough to offset all gains, but some progress could be made.

Reform of the NIC ceiling may seem politically unattractive at present, but it seems inevitable in the medium term. It is hard to imagine that a direct tax system which systematically, and to an increasing extent, favoured the top half of the income distribution would be acceptable indefinitely. The longer the government continues to ignore this problem, the more pressing becomes the need for a solution.

### **The NIC Base**

The third remaining problem, and the one which has thus far received least attention from the policy-makers and the media, is the difference between the types of income subject to Schedule E income tax and those subject to NICs. The most important difference arises in the treatment of benefits in kind. Whereas Schedule E income tax is due on all benefits in kind, such benefits are specifically excluded from NICs. The consequences of this difference are substantial. Consider an employer who wishes to provide a basic rate taxpayer in the 9% NIC band with an extra £100 of net income. The employee needs £151.52 of gross earnings, on which income tax of £37.88 and NICs of £13.64 are due. The employer has to pay £15.76 of NICs on the £151.52, giving a total of £167.28. Alternatively, if the employee is to be provided with benefits in kind to a net value of £100, the cost to the employer is £133.33. The only charge on the income is the £33.33 of income tax on the gross benefit worth £133.33, since neither employer nor employee incurs any liability for NICs. The incentive for provision of benefits in kind provided by the current system is obviously large. As noted earlier, the company car is probably the most significant such benefit, the exclusion of which from NICs has an annual cost to the Exchequer of something around £0.75bn.

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

Although major change in this field in the 1991 Budget seems unlikely, some extension of the NIC base would help to raise money for tax cuts elsewhere, while signalling the government's opposition to tax privilege for this form of payment.

## 6.3 Corporation Tax

The past year has been particularly tough for British companies. Continuing high interest rates have combined with sluggish demand to produce a serious liquidity crisis. Profits have fallen substantially in real terms over the past two years and are expected to be static at best over the coming year. Although the need to keep a tight fiscal stance and the fall in the government surplus make tax cuts less likely in general than in previous years, a cut in the tax burden on business may be one of the more attractive options open to the new Chancellor. Even if no tax cuts are to be made, there are good arguments for a review of the structure of the system within a revenue-neutral framework.

While an early cut in interest rates would be the simplest way to give substantial aid to the company sector, the government's hands may be tied on this matter. In this case, cutting corporate taxes could help to reduce concerns over immediate liquidity and the effects on future investment caused by the current crisis.

The Chancellor might also be attracted by an opportunity to channel tax cuts into an area with little effect on consumer demand, while being seen to aid business in both the long and short term. However, it must be borne in mind that even corporation tax cuts can *affect* personal income and spending. If the extra money simply feeds through to shareholders in the form of higher dividends or weakens the resolve of companies to resist high pay demands, this could undermine the government's anti-inflation policy.

On the micro-economic side, the weaknesses of the current system are becoming increasingly apparent. The last major reform of corporation tax, in 1984, was intended to provide a stable and enduring framework, by setting up a rational system which would not unduly affect business decisions. The present system has two important flaws: it discourages investment at any positive inflation rate, and it is unindexed, raising the effective tax rate as inflation rises, thus adding to the disincentives to invest. This problem was obscured in the mid-1980s, a period of strong profit growth, high investment, and low inflation. But now, with inflation running at around 10%, and profits and investment both plummeting, a serious overhaul of the system should be considered.

Since the state of the economy, the timing of the next election, and the desire to keep faith with the 1984 reforms make dramatic change unlikely, we concentrate on three simple options open to the Treasury: increase capital allowances, cut the rate of corporation tax, or give tax relief on stock appreciation.

Table 6.4 gives estimates of the effect of each of these options, derived from the IFS model of corporation tax. We focus on the change in tax payments and the post-tax cost of capital (the minimum required rate of return from an investment). We then comment briefly on the rationale for each of the options.

**Table 6.4. Estimated Effects of Corporation Tax Reforms**

|                                | Cost (£bn) |         | Fall in average cost of capital <sup>a</sup> (%) | Estimated investment effect <sup>b</sup> (£bn) |
|--------------------------------|------------|---------|--|--|
|                                | 1991-92    | 1992-93 | 1991-92  | 1991-92  |
| Higher allowances <sup>c</sup> | -          | 2.7     | 0.4  | 0.3  |
| 30% rate                       | 1.7        | 2.4     | 0.5  | 0.6  |
| Stock relief                   | 2.0        | 1.6     | 0.7  | 0.9  |

<sup>a</sup> Averaged over source of finance and type of investment.

<sup>b</sup> Including investment in stocks.

<sup>c</sup> Applied to new and existing assets for accounting years 1991-92 onwards, 40% for plant and machinery, 8% for industrial buildings.

For illustrative purposes, we assume that the 30% rate and stock relief are applied retroactively, with effect from April 1990, but that the higher allowances are effective only from April 1991. Changes applicable from 1991-92 onwards will have a negligible effect on revenue in 1991-92 because of the lag in corporation tax payments. All of the options could be made applicable from the coming year onwards, reducing the immediate revenue cost, but obviously also reducing the immediate benefit to companies.

### **Stock Relief**

On economic grounds the best proposal is the reintroduction of stock relief. Under the current system, companies are effectively charged tax on wholly inflationary rises in the value of their stocks. At current inflation levels this substantially raises the incentive to de-stock, and severely penalises those companies that hold high stock levels in the nature of their business. Although introducing stock relief does not deal with all the problems of inflation, it performs remarkably well as a simple interim proposal, and directs relief at those companies that are most unfairly treated at present.

This option may seem unattractive in political terms because the introduction of stock relief is historically associated with periods of high inflation; the argument that indexing the tax system would undermine the credibility of the government's fight against inflation appears to carry considerable weight in official circles. Such fears seem exaggerated; anti-inflationary credibility is established in the conduct of macro-economic policy, rather than in the design of the tax system, a principle recognised in the indexation of capital gains tax. Furthermore, it is not clear that the most effective way to reduce inflation is to retain a tax system which exaggerates its ill-effects.



### Capital Allowances

Capital allowances could be raised, as the most straightforward way of making sure that the companies that invest the most also benefit most from the change. Table 6.4 illustrates the effect of applying higher depreciation rates to both new and existing investments. If the change were restricted to new investments only, it would cost a great deal less and target the relief on companies that continue to invest through the recession. But it would create an arbitrary distinction between new and old investment which would make the reformed system difficult to administer.

### The Tax Rate

The "headline" tax rate of 35% could simply be reduced. This is the most straightforward way to ease the burden without renegeing on any past statements, but also the least effective: the worst-hit companies are already making losses and therefore derive no immediate benefit from lower tax rates, and the extra money goes to all companies regardless of their level of investment. Furthermore, reducing the rate alone does less to alter investment incentives than capital allowances, since capital allowances could then only be set off at the lower rate. Finally, cutting the rate would do nothing to relieve the long-term problems inherent in the system. A cut of around 5% would be necessary merely to compensate firms for the present level of inflation; so any real easing would have to involve a very substantial lowering of the rate.

An alternative way to cut the effective tax rate is to raise the small companies' limits, as at the last Budget, thereby being seen to aid business without substantial cost. This year the government faces the embarrassing prospect of having to raise the limits substantially simply to keep up with inflation. Although this again seems a possibility, it is not particularly desirable on economic grounds: it may actually raise the disincentive to invest by increasing the marginal tax rate,<sup>1</sup> it does nothing to alleviate the weakness of the system to inflation, and it becomes complex to operate as rather large companies are counted as "small" for tax purposes.

### Surplus ACT

One possible candidate for reform is the treatment of unrelieved advance corporation tax (ACT). A company pays ACT on the dividends it pays but can offset the tax against its mainstream corporation tax (MCT) liability. In any one year it is possible that gross dividends exceed taxable profits; unless the ACT is set off against tax paid in previous years, it will remain unrelieved. Since the abolition of many allowances in 1984, and after a period of high profitability, this is unlikely to be a serious problem for most companies. However, companies making a large proportion of profits abroad but paying dividends in the UK may simply build up "surplus ACT", without the prospect of offsetting it against future MCT liabilities.

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<sup>1</sup> Companies between the lower and upper limits for small companies relief face a marginal tax rate of 37.5% because relief is gradually withdrawn as profits rise.

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In this case it seems unlikely that the government would wish to give full relief on the unrelieved ACT since this would essentially be giving a rebate for foreign tax paid. This problem is one of a number of difficulties associated with the tax treatment of profits earned abroad, which would be best solved in the context of international tax treaties, or as part of a sensible European harmonisation procedure.

Although the prospects, and the need, for substantial reform are the strongest they have been for some years, it seems unlikely that there will be significant change at Budget time. There are some arguments for cuts in the overall burden of corporate tax, but these may well be overruled by the necessity of keeping a tight fiscal stance. The political demands for action may induce the Chancellor to announce some minor changes, such as an increase in the small companies threshold (as happened in the last Budget).

## 6.4 Local Taxation

The Environment Secretary, Michael Heseltine, announced at the end of last year that he was setting up the widest-ranging review of local government finance since the Layfield Committee report in 1976. Mr Heseltine invited opposition parties to contribute to the review and informed them that "No options are ruled in and no options are ruled out". He suggested that any reforms or replacement of the poll tax would take at least two years.

Meanwhile local authorities are left in a situation where many are struggling to raise revenue from what has come to be regarded as a discredited tax. Non-payment has been worryingly high in many authorities and could get worse if taxpayers expect the tax to be abolished. The reforms announced on 17 January were designed to improve the position pending the results of the review. Transitional relief is renamed the "Community Charge reduction scheme", and is extended in both coverage and generosity. More than 18m people will benefit, compared with the 11m under the old system, and benefits will be larger as the new scheme relates relief to actual rather than notional poll tax bills. In addition to the £950m available for this relief, £150m will be spent on benefits for those in sheltered and church housing.

Any further changes seem very likely to await the results of Mr Heseltine's review. The most likely time for an announcement of changes for 1992-93 is the summer, close to the annual Revenue Support Grant settlement.

## 6.5 Environmental Taxes

There are two ways in which the Budget can affect environmental policy. New taxes could be introduced with the explicit justification being on environmental grounds. In addition, existing taxes, first introduced for other reasons, could be adapted in some way in order to be more environment-friendly. As yet, the UK has no taxes which fall into the first category, and the success of the incentive in favour of unleaded petrol makes it likely that any green measures in the 1991 Budget will be adaptations of the current system, rather than new taxes.

The reasons for considering taxes as environmental policy instruments are now well known. Much industrial production results in pollution as well as providing useful output. The same is true of direct consumption of goods such as petrol. Firms can charge for the goods, but are not usually charged for the pollution. This means that firms in maximising profits may produce more of both goods and pollution than is the social optimum - in other words, people would be prepared to sacrifice some goods for a cleaner environment. Taxes on pollution would encourage firms to take account of the social costs of pollution as well as the private benefits of production. To put it more prosaically, green taxes will reduce the pollution directly by encouraging "dirty" firms to clean themselves up; or, if this is impossible, reducing the demand for polluting products.

Although the economic arguments for green taxes are widely accepted, the UK has yet to embrace fully environmental taxes. The duty on mineral oils acts as one, but was introduced long ago for reasons unrelated to global warming. Possibly the only genuine green fiscal measure in the UK of any importance is the reduction in this duty on unleaded petrol, which has been successful in stimulating the growth of this market. For some time it has been possible to explain the lack of further fiscal changes as being due to the preparation of the Environment White Paper, which was flagged as being a comprehensive statement of the government's priorities in environmental controls. This was published in September 1990, and did not announce any new fiscal measures (this in any case being the preserve of the Treasury). The Summary of the White Paper made it clear that whilst the government itself is convinced that "...[regulation] can be expensive to operate and may not deliver the most cost effective solutions" and hence is committed to "look at ways of using the market further to encourage producers and consumers to act in ways which benefit the environment", it believes serious practical problems rule out some widely canvassed taxes, and by implication the introduction of any new environmental tax in this Budget is very unlikely. Any changes which are made will be of the second type referred to above - changes in the *existing* tax system to promote environmental objectives.

### Carbon Taxes

In 1990, some sort of consensus was reached among scientists that global warming is taking place. As a result, 1991 may well see attempts to get international agreement to act to reduce greenhouse gas emissions. Yet given the huge disparity between emissions by different countries at present, the equally substantial difference in the costs of global warming to different countries, and the potentially large costs of reducing consumption of fossil fuels, there would seem to be no hope of any internationally binding agreement on greenhouse emissions. The European Community has suggested that any ending of the Gulf crisis gives a window of opportunity to impose an additional levy on crude oil, but such a proposal would unreasonably discriminate against oil as opposed to other fossil fuels, and little enthusiasm has been shown for the proposal.

Hence any measures taken by the UK to reduce global warming will be self-imposed. A commitment has been given that carbon dioxide emissions in 2005 will not be above their 1990 level. A carbon tax based on the amount of greenhouse gases given off when fossil fuels are consumed would be one way in which the target could be met. Appropriate tax rates might be between 15% and 40% of the current price of gas, oil and coal. Carbon taxes already exist in some Scandinavian countries, and are under serious consideration elsewhere within the EC. Yet the Environment White Paper was quite explicit that no such taxes would be introduced in the UK:

Long term measures affecting the relative price of energy can only sensibly be taken when competitor countries are prepared to take similar action. Unilateral action by the UK would do little to influence global warming. It would have a damaging impact on activity and employment in energy-intensive sectors, relative to our competitors, to little purpose. In the immediate future the reduction of inflation is of overriding importance. Given this, and our best assessment of how long it will take to achieve an international consensus, tax or other measures directly raising the relative price of energy outside the transport sector will not be introduced in the next few years.

*Paragraph 5.26 of the Environment White Paper, Cm 1200*

Although of direct relevance only to the energy sector, this paragraph reveals much about the attitude of the government to green taxes in general. First, the reference to the importance of reducing inflation suggests that any large-scale tax change which increased retail prices is extremely unlikely in this Budget. Traditional macro-economic problems continue to be the main focus of government attention. The second point of note is that transport is specifically excluded from the case against environmental taxes, which leaves the Chancellor with an extensive menu of options for green measures if he so desires; hence road transport is covered in greater detail below. Third, and most importantly, the government sees no point in introducing a tax if the rest of the world does not.

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This last point is worth expanding. A unilateral carbon tax would make production of energy-intensive goods in the UK uncompetitive, so production would shift to countries without such a tax, with the net effect being little or no impact on the volume of carbon dioxide emissions. This same argument could be applied to any pollution which is global in scale; use of taxes to tackle acid rain is probably ruled out on such a basis.

Nevertheless, this does not rule out the use of fiscal instruments to limit emission of greenhouse gases from the UK. Taxes on producers may be impractical, but domestic energy (gas and electricity) is taxed at a lower rate in the UK than other goods and services, whereas the environmental damage suggests that they should be taxed at a higher rate. The UK is the only country in the EC not to tax domestic energy. As producers could reclaim any VAT they pay on energy, they would be unaffected by this change. Extending VAT to cover domestic energy at the standard rate of 15% instead of the current 0% would cut domestic energy consumption by over 5%, and raise around £1.7bn in tax revenue.

There is one fundamental disadvantage with this as a proposal, but it is a problem which could, with some imagination, be overcome. Unfortunately, a series of short-term political and economic considerations guarantee that the attempt will not be made in the coming Budget. The major difficulty is the distributional impact. The poorest 10% of households would be around £1 per week worse off, whereas the top 10% of households would be £2 worse off, yet the richest 10% of households are around 16 times richer than the poorest before tax. In other words, spending on domestic energy varies very little according to the wealth of the household. Nevertheless, the fact that the rich do spend more on energy than the poor means that it is in principle possible to redistribute the revenues to protect them. Another important and less tractable problem is the collision of the environmental objective (requiring high energy prices) with the social policy objective of keeping old people warm (requiring low energy prices). Nevertheless, it is possible to think of solutions even to this difficulty.

There are at least three short-term reasons why VAT on fuel will not be introduced in this Budget. Most important is the effect on inflation (the RPI would be increased by around three-quarters of a percentage point). Second, the previous Prime Minister committed the government to keeping zero-rating on domestic energy, at least until after the next election. And third, the tax would affect the profitability of the recently privatised electricity supply industry.

Given that the "stick" approach of introducing a carbon tax or putting VAT on energy must be ruled out of contention as serious Budget options, the "carrot" of tax incentives could be used to encourage energy efficiency. Some possibilities (VAT zero-rating on energy conservation measures, for example) are probably ruled out by EC directives, but a range of alternatives remain, such as income tax relief on such expenditures. Some countries (Luxemburg, Japan) have accelerated

depreciation allowances for companies investing in energy-saving or environment-friendly equipment, although this seems a rather ill-targeted and easily abusable approach to the problem.

### Taxes on Road Transport

Road transport is responsible for a wide range of air pollution - carbon dioxide, carbon monoxide, nitrogen oxides, and ozone - as well as noise pollution and congestion costs. The predicted doubling of road traffic over the next 30 years has made the environmental costs of road traffic of more obvious political importance than some other sorts of pollution. Although motor vehicles are already heavily taxed, road transport remains by far the most likely focus of any green gestures by the Chancellor.

There are several taxes on motoring which can be roughly divided into taxes on *owning* a car (vehicle excise duty and car tax) and taxes on *using* it (petrol duty). Of most importance in revenue terms is the tax on mineral oils. The simplest and probably the most environmentally effective change the Chancellor could make would be to raise the tax on petrol. This would discourage car use where alternatives such as public transport, walking, cycling or not travelling at all were available, and would also encourage those buying new cars to put a greater premium on fuel economy. If raising petrol prices were announced to be a long-term strategy, it would also give companies an incentive to develop more fuel-efficient cars. Large amounts of revenue would be raised (a 10p increase raises over £200m). As cars are predominantly owned by richer households, the tax change would be mildly progressive. In 1986 the poorest 10% of households had on average 0.09 cars per household and spent 50p per week on petrol, whereas the richest 10% had an average 1.79 cars per household and spent over £16 per week. Finally, the European Commission's proposals for the harmonisation of indirect taxes would involve an increase in UK petrol prices. Without necessarily accepting the need for harmonisation, nor the Commission's competence in this area, such a change might be presented as part of the less confrontational approach towards Europe.

There are several problems with this approach, as seen from the government's standpoint. The inflationary consequences would be one factor (see the section on indirect taxes). Another is that the price elasticity of demand for petrol in the short term is low. The IFS Simulation Program for Indirect Taxes suggests that an increase in duty of over 50p per gallon would only reduce consumption by 8% in the short term. This is because people are locked into existing transport systems, and do not often have alternatives available. In the longer term the effect would be much larger, but in the short term the political fall-out might seem high compared with the environmental benefit. Even the distributional consequences of the tax are not devoid of political controversy - in some areas of the country, the sparse provision of public transport means that relatively low-income households must have cars, so suffer from the tax change. Finally, although petrol prices are by no means high compared with their average over the last 25 years, they are significantly above their average over the

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last five years and may rise further in any event as a consequence of the Gulf War. Consequently, although an increase above the rate of inflation cannot be ruled out, it seems somewhat unlikely.

Regardless of any change in petrol duty, there may be changes in both the leaded/unleaded and the petrol/diesel differentials. Unleaded petrol now accounts for 37% of sales in the UK - an example of the power of fiscal incentives. The differential is now 3.4p per litre (15.5p per gallon), and has been increased in every Budget since it was first introduced in 1987. A further increase may occur, although it is becoming increasingly difficult to understand the justification. Those who can easily convert their existing cars to unleaded petrol have probably already done so. Those who have not are unlikely to be persuaded to pay the costs of conversion by a small additional fiscal advantage. As (virtually) all new cars can run on unleaded petrol, and around 10% of the car stock is scrapped each year, use of unleaded petrol is hardly in need of further fiscal encouragement. Indeed, any increased differential might be environmentally damaging if it resulted in premature scrapping or was achieved by reducing the real price of unleaded petrol rather than increasing the price of leaded. Despite this, a further increase in the differential seems likely in 1991, probably achieved by an increase in excess of inflation for leaded petrol.

A coherent case for having a lower rate of tax on diesel (DERV) than petrol is rarely made. There seems to be little reason in principle why a particular form of mineral oil should be favoured over another. Possibly the best argument is that road haulage companies - whose lorries tend to run on diesel - must compete with EC companies which face lower rates of tax. If this is the reason for the lower duty then the case for harmonisation of diesel taxes across Europe seems a strong one. However, whereas such harmonisation would involve an *increase* in UK petrol duty (so would be green), diesel duty would have to be reduced. The increased differential would result in diesel-powered engines becoming attractive to motorists. Diesel engines can be environment-friendly - Germany had tax incentives in favour of such engines because of this until relatively recently - but this depends on the "tuning" of the engine. The Department of Transport has already announced that MOTs for cars will have a test based on carbon monoxide levels in exhaust fumes but has yet to make any announcement about diesel engines. If the tax on diesel is reduced, it is likely to be accompanied by some such regulation.

The second major tax on cars in the UK is vehicle excise duty (VED), an annual tax of £100 per car per year. In last year's Budget, John Major froze the tax at this level and increased the petrol duty, giving a tax package which left the *average* tax on motorists constant, but increased the *marginal* cost of car travel, so discouraging car use. This argument could well be used once again this year. Indeed, because VED is in the RPI, such a package would be both revenue-neutral and RPI-neutral, as well as discouraging pollution. In principle, there is no reason why VED could not be abolished in favour of higher duties. If VED is retained, it might be differentiated, so as to be at a higher level on large-engined cars - which accounted for much of the growth in car ownership in the 1980s. Although



the relationship between engine size and environmental damage is not a simple one, encouraging more fuel-efficient smaller cars is likely to be environmentally beneficial, and doing so through the VED system at least has the advantage that the burden does not fall more heavily on those in rural areas than city dwellers who can switch to public transport. An alternative use for VED or for the car tax levied on the sale of new cars is to give a tax reduction for cars with catalytic converters. However, such converters will be compulsory on all new cars by the end of 1992, so incentives are probably unnecessary.

The final area of road transport taxation which might be adapted in the Budget is the taxation of company cars. Even after a sequence of increases in the scale charges on company cars, it is still the case that it is cheaper for an employer to give an employee remuneration in the form of a car than in money. As such, it encourages more motoring than is economically or environmentally desirable. The root cause of the problem, as discussed above, is that the National Insurance system does not cover "perks"; failing fundamental reform of that tax, the second-best alternative is a further increase in scale charges to reduce the overall attraction of such cars. In addition, the current company car tax system is only crudely differentiated by engine size, there being only three categories of car. Hence it is more tax-efficient to give cars towards the higher limit of a category than towards the bottom end; so large cars are needlessly encouraged. As company cars account for around half of all new cars in the UK, company car tax is a major determinant of the nature of the UK car stock. Greater progressivity of scale charges by engine size is a Budget possibility.

### **Other Possibilities**

Apart from changes in the taxation of road transport and energy, there are an enormous range of environmental problems which might in principle be tackled using taxes. Examples of taxes which have already been introduced in other countries include a levy of 4p on plastic bags in Italy (reportedly leading to a 40% reduction in their use), charges on drinks containers throughout Scandinavia in an attempt to encourage recycling, levies on nitrates and phosphates which leach from fertilisers into the water system (also common in Scandinavia), and charges on direct discharges of waste water into rivers, canals and lakes (a feature of several EC countries).

Although the fact that all these taxes exist in some countries would seem to suggest that they are administratively feasible, it nevertheless would be surprising were any included in the Budget. A charge encouraging recycling would have little effect unless the recycling infrastructure were in place; taxes on the various forms of water pollution are unlikely to be introduced so soon after the introduction of a new regulatory tax system; and more generally, the White Paper might have been expected to show a little more enthusiasm for the concept of green taxes were Whitehall and Westminster seriously contemplating their introduction this side of the General Election.

### **Budget Options**

As noted earlier, it seems probable that the Budget will propose further increases in scale charges on company cars, and will continue the policy of last year in freezing VED whilst at the same time increasing petrol duty above the rate of inflation, the overall effect being to keep the average tax rate constant and to have no net impact on inflation. A further increase in the leaded/unleaded differential is likely, but there might be a freeze in the duty on diesel, given the changes in the MOT already announced for cars and probably imminent for other vehicles. Some form of tax incentive for energy conservation might be introduced, and it is possible that VED might be restructured so as to promote either small cars or clean engines. However, no new tax on any environmentally damaging production or consumption would appear to be likely.

## 6.6 Indirect Taxes

The most important question here is whether or not to maintain the real value of excise duties by increasing them in line with inflation over the last year. Although not increasing excise duties is attractive because it avoids increasing prices and thus the RPI, the revenue forgone would be some £2bn in 1991-92, making revalorisation seem likely. A similar inflation/revenue trade-off existed last year, with perhaps an even greater problem than with inflation, since it was still rising, but most excise duties were increased in 1990, by 7.7% to compensate for inflation. As can be seen from Table 6.5, the real level of all excise duties is now below the 1985 level, while spirits and wine are also below their 1980 levels, with petrol, beer and particularly tobacco above their 1980 levels. Health and environmental lobbies will add their weight to calls for at least inflation increases in duties this year.

**Table 6.5. Real Values of Excise Duties**

| 1985=100 | Beer  | Wine  | Spirits | Tobacco | Petrol<br>(4 Star) |
|----------|-------|-------|---------|---------|--------------------|
| 1990     | 86.2  | 86.1  | 84.2    | 99.7    | 95.6               |
| 1989     | 86.0  | 86.1  | 82.4    | 98.0    | 93.9               |
| 1988     | 91.9  | 92.0  | 88.0    | 103.4   | 100.3              |
| 1987     | 91.2  | 91.2  | 91.2    | 103.8   | 98.5               |
| 1986     | 94.6  | 94.6  | 94.6    | 106.8   | 102.2              |
| 1985     | 100.0 | 100.0 | 100.0   | 100.0   | 100.0              |
| 1984     | 97.1  | 96.7  | 102.7   | 96.8    | 100.0              |
| 1983     | 91.9  | 127.0 | 106.1   | 89.1    | 100.0              |
| 1982     | 91.7  | 126.6 | 106.5   | 89.1    | 100.6              |
| 1981     | 90.6  | 126.3 | 112.2   | 87.8    | 100.1              |
| 1980     | 75.3  | 124.4 | 112.7   | 77.1    | 83.5               |

Complete revalorisation at 9.3% would add around 0.6% to the RPI. The effects of revalorisation on typical prices are shown in Table 6.6.

**Table 6.6. Price Effects of Revalorisation**

|                   | Beer<br>(pint) | Wine<br>(70cl.<br>bottle) | Spirits<br>(75cl.<br>bottle) | Tobacco<br>(packet of<br>20) | Petrol<br>(litre of<br>4 Star) |
|-------------------|----------------|---------------------------|------------------------------|------------------------------|--------------------------------|
| <b>Before:</b>    |                |                           |                              |                              |                                |
| Price             | 104.0          | 257.0                     | 904.0                        | 182.0                        | 44.3                           |
| VAT               | 13.6           | 33.5                      | 117.9                        | 23.7                         | 5.8                            |
| Duty              | 20.4           | 77.2                      | 520.5                        | 69.8                         | 22.5                           |
| <i>Ad valorem</i> |                |                           |                              | 38.2                         |                                |
| <b>After:</b>     |                |                           |                              |                              |                                |
| Price             | 106.1          | 265.3                     | 959.7                        | 191.9                        | 46.7                           |
| VAT               | 13.9           | 34.6                      | 125.2                        | 25.0                         | 6.1                            |
| Duty              | 22.3           | 84.4                      | 568.9                        | 76.3                         | 24.6                           |
| <i>Ad valorem</i> |                |                           |                              | 40.3                         |                                |
| Price (% change)  | 2.0            | 3.2                       | 6.2                          | 5.4                          | 5.4                            |

Note: An *ad valorem* component is set on tobacco only. The price increase implicit in the "before" price is given by the Autumn Statement.

### European Tax Harmonisation

The European Commission's main aim is to abolish the fiscal frontiers that impede free trade between the member states of Europe by January 1993. Varying levels of indirect taxes within the Community are undesirable with respect to this aim for two reasons. First, frontier borders add an extra cost to industry and consumers by delaying the transport of goods across borders. Second, member countries can use indirect taxes as a tool for protection of domestic industry. There is evidence of this behaviour in wine-producing countries such as Germany, Greece, Portugal, Italy and Spain which do not charge any duty on wine.

The government may be considering action on the Commission's plans for tax harmonisation this year, ahead of the 1993 deadline. Although the Commission has not finalised its policy on indirect taxes, the latest proposal outlines a policy of minimum limits and targeting based on current averages of the duties in each country. In its 1989 proposal (COM(89) 525-7), the Commission has reformed its policy from a mandatory tax rate to a targeted rate with a minimum. This target is based on an average of all the existing rates in the Community. By January 1993, the proposal is that all member states should set a rate at or above the minimum and any movements after this should be in the direction of the targeted rates. The minima and targets for the duties are outlined in Table 6.7.

**Table 6.7. Excise Duties in 1990**

| Reported in £ at<br>January 1991<br>rates of exchange | Spirits<br>per hl of<br>alcohol | Wine<br>per hl<br>under<br>12% | Beer<br>per hl of<br>12 plato | Tobacco<br>per 1,000<br>cigarettes | Leaded<br>petrol per<br>1,000<br>litres | Unleaded<br>differential |
|---|---------------------------------|--------------------------------|-------------------------------|------------------------------------|---|--------------------------|
| UK  | 1,735.00                        | 110.28                         | 27.00                         | 34.91                              | 224.80                                  | 34.00                    |
| EEC target  | 987.36                          | 13.21                          | 12.68                         | 15.18                              | n.a.                                    | n.a.                     |
| Minimum   | 789.90                          | 6.60                           | 6.34                          | 10.59                              | 238.00                                  | 35.31                    |

**Excise Duties as a Percentage of Typical Price**

|            | Spirits | Wine | Beer | Tobacco | Petrol |
|------------|---------|------|------|---------|--------|
| UK         | 57.6    | 30.0 | 19.6 | 60.9    | 50.8   |
| EEC target | 31.9    | 4.0  | 9.2  | 26.5    | n.a.   |
| Minimum    | 25.5    | 1.8  | 4.6  | 18.5    | 53.8   |

The Commission proposal sets only a minimum level for petrol duty that all countries must be above by January 1993. As well as this, the minimum differential between leaded and unleaded petrol is set at £35.31 per 1,000 litres. The current UK differential is £34. The *ad valorem* component of the duty on tobacco faces the constraint that the combination of excise duty, VAT, and the *ad valorem* tax must be above 45% of the retail sale price and targeted at 54%.

In the case of petrol duty, an increase in the differential between leaded and unleaded petrol and an increase in the leaded duty would be necessary to comply with the proposal. Both objectives could be achieved with an increase in the leaded duty.

It seems likely that most excise duties will be increased in line with inflation, with a probable additional increase in the duty on leaded petrol, partly offset by a freezing in VED. This latter change is consistent with the government's environmental policy. Any change in VAT seems unlikely.

## 6.7 The Shape of Tax Legislation to Come

Whatever else can be foretold of 1991, this year's Finance Bill is the present government's last opportunity for making major technical change to the UK's tax system before the General Election. The desire to "cut and run", if prospects for an early election look good, ensure, however, that in 1991 the prospects for major reform are slight. Not that the Finance Bill need be a slim production: no Chancellor (least of all a new one) likes to be seen to be doing nothing. Nevertheless, to "cut and run" requires a concentration on highly technical "tinkering" that can be dropped with the minimum of fuss or passed on the nod. 1991 is, accordingly, a good year for reflection on what the final years of the current millennium should hold for the tax system.

Since 1979, Parliament has enacted over 3,500 pages of tax legislation. Not surprisingly, a contender for the prize for the fastest-growing sector of the economy in the 1980s must be the tax professions. Accompanying this growth in the legislation and in the number concerned with it has been the complaint that the tax system becomes more complex by the minute.

If then the priority for the 1990s were to be both improvement and simplification, we need to recognise where the existing system is complex and why that is so. A moment's reflection suggests four topics that may have a significant influence on the matter: the taxation of savings, the computation of business profits, the administration of the tax system, and Europe.

The current complexity of the tax system is largely attributable to the way in which we tax savings and business profits. The reasons for this are easy to see by the simple comparison of those matters with the taxation of earnings and with value added tax. Both employment income and supplies attracting VAT involve the movement of money which represents what is being taxed. The areas of complexity for both PAYE and VAT arise at the point at which they cease to be based on such movements, benefits in kind being a prime example.

The tax system is simple where the tax base is an easily identifiable cash movement. It becomes complicated when, as in the case of business profits or capital gains, there is no cash transaction that represents the tax base. Instead tax is levied on some underlying movement that can be difficult to compute. For example, while cash transactions may be the basis upon which a business earns its profits, taxing those profits involves a process of annual estimation, designed to identify the profit that has accrued rather than the gross cash receipts.

The greater simplicity of taxing cash transactions is recognised by taxing capital gains on a realisations rather than an accrual basis. However, what is then taxed is not the cash movement but the gain which may have accrued over time. At the heart of the distortions that arise where

## Analysis of Tax Options

something is taxed other than the cash that moves is inflation. Adjusting for the impact of inflation on both business profits and capital gains is a source of significant complexity.

Not that this is the sole source of complexity in the tax system: the multiplicity of tax rates is another factor. Most of VAT works as easily as it does because it applies a single tax rate to what is taxed. The areas of complexity of VAT also arise where this is not the case: where a mixture of standard-rate, zero-rate or exempt supplies are involved.

PAYE demonstrates that a multi-rate system can still work on a cash transaction basis. However, this is because what is taxed is derived and paid from one source. As soon as the taxable subject matter is derived and paid from a variety of sources, such as current investment income, this is no longer possible. The relative simplicity of taxing current investment income, such as dividends and interest (as opposed to capital gains), stems from the application of a single rate of tax - the basic rate - to the cash movement of the majority of that income.

The impact of multiple rates of tax on the complexity of the system is best demonstrated by the taxation of intermediaries. Where under a multi-rate system taxpayers pool their resources in an intermediary, the tax system is confronted with a problem:

- (i) if it taxes the intermediary as income or gains arise, it must in some way allow for the fact that different investors may be liable to different rates of tax on their share of the income or gains; but
- (ii) if to solve this problem the tax system defers taxing the investors until they receive their share of the profits, they benefit because they pay tax later than if they had invested direct.

If proof is needed of these difficulties, the fluctuations in unit trust taxation and in the taxation of settlements (to which the inter-generational problems of death taxes must be added) should provide sufficient evidence.

Intermediaries apart, the ability of the system to cope with a multi-rate system outside of PAYE is in large measure a matter of administration. The overriding feature of current administration is that it relies on business rather than individual taxpayers. A recent OECD study shows that in the UK only some 17% of the population received a tax return, as compared with 46, 50 and 95% in Germany, France and the US respectively.

Superficially, therefore, for the great majority represented largely by PAYE employees, the tax system is simple. But the 17% covers largely those with income subject to assessment, notably investment income. The implication is clear: the taxation of investment income at multiple rates is likely to necessitate the issue of tax returns on a much wider basis than is currently the case.

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If net gains and profits, deferral, inflation, intermediated savings (in a business or savings institution) and multiple rates of tax represent what is complex in the system, the way forward for those who espouse simplicity should be clear. It is no accident that the easier aspects of taxing savings are represented by pensions, Personal Equity Plans and Tax-Exempt Special Savings Accounts which share with PAYE and VAT the characteristics either or both of cash flow or of a single rate (in these cases zero) taxation.

It is relatively easy to suggest areas of the tax system that the present and future governments should address in the 1990s: the taxation of foreign exchange gains and losses; the use of offshore settlements; the taxation of securities; the methods of assessment and collection under the Scholastic system of income and corporation tax. Undoubtedly there is scope for a further 3,500 pages of legislation on these and other topics, to the greater gain of the tax professions.

A simple tax system need not be a good tax system, and a good tax system need not be simple. There are obvious trade-offs between, for example, simplicity and equity. However, it would be reassuring to feel that the 1990s could see us break free of the endless cycle of technical tinkering and change by recognising the fundamental causes of complexity and concentrating on the basic elements of simplicity.

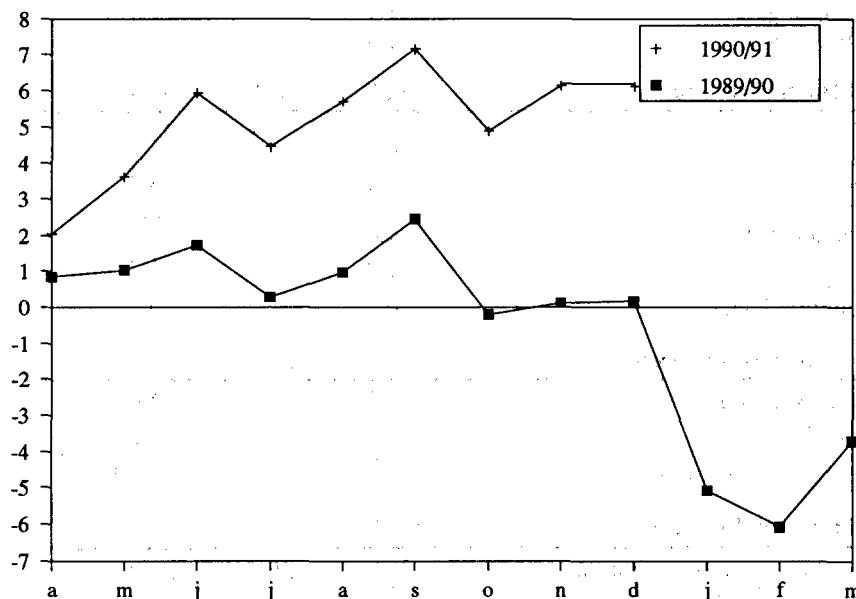
To what extent we shall be free agents in this must depend upon the development of the European Community and the single market. This will without doubt have a considerable influence on the direction and form of the UK's tax system in the 1990s. The elements of simplicity and complexity are not, however, unique to the UK. They are the universal lesson of any tax system.



# Appendix 1: Forecasting the PSDR

This Appendix details the methodology used to estimate government revenues for 1990-91 and 1991-92. This year has seen a deterioration in the state of the public finances compared with last year, as shown in Chart A.1.

CHART A.1 The Public Sector Borrowing Requirement



Note: Excluding privatisation proceeds, £bn, cumulative.

The government acknowledged this worsening situation in the November Autumn Statement, which reduced the forecast of the PSDR for the current year from the £7bn predicted in last year's Budget to £3bn. The out-turn for the current year will, as ever, be an important influence on the Budget package.

## Fiscal Year 1990-91

We have a considerable amount of information regarding the current fiscal year, but forecasts are still subject to a significant margin of error. The Treasury predictions for the current year published on Budget day, with eleven months of information, are subject to an error of £1bn; the estimates presented here, prepared two months earlier, are subject to a still wider margin.

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TABLE A.1 The Public Finances 1990-91

|   | FSBR         | Autumn Statement | Current receipts | Modelled      | IFS forecast |
|---|--------------|------------------|------------------|---------------|--------------|
| Income tax                                | 55.0         | 55.3             | 56.3             | 55.7          | 56.0         |
| Corporation tax                           | 20.7         | 21.0             | 23.3             | 20.8          | 20.8         |
| On-shore                                  | 19.7         | 20.0             |                  |               |              |
| North Sea                                 | 1.0          | 1.0              |                  |               |              |
| Petroleum revenue tax                     | 1.1          |                  | 1.1              | 1.1           | 1.1          |
| Capital gains tax                         | 2.1          |                  | 1.6              | 2.1 FSBR      | 1.8          |
| Inheritance tax                           | 1.2          |                  | 1.4              | 1.2 FSBR      | 1.3          |
| Stamp duties                              | 1.9          |                  | 1.7              | 2.2           | 1.7          |
| <b>Total Inland Revenue</b>               | <b>82.0</b>  | <b>82.8</b>      | <b>85.4</b>      | <b>83.3</b>   | <b>82.7</b>  |
| VAT                                       | 32.1         | 31.8             | 31.0             | 32.1          | 30.7         |
| Petrol                                    | 9.7          |                  | 9.8              | 9.8           | 9.7          |
| Tobacco                                   | 5.4          |                  | 5.7              | 5.4           | 5.4          |
| Alcohol                                   | 4.9          |                  | 5.0              | 5.0           | 5.0          |
| Betting and gaming                        | 1.0          |                  | 1.0              | 1.1           | 1.0          |
| Car tax                                   | 1.5          |                  | 1.5              | 1.6           | 1.5          |
| Customs duties                            | 1.9          |                  | 1.7              | 1.9 FSBR      | 1.8          |
| Agricultural levies                       | 0.1          |                  | 0.1              | 0.1 FSBR      | 0.1          |
| <b>Total Customs and Excise</b>           | <b>56.6</b>  | <b>56.1</b>      | <b>55.8</b>      | <b>57.0</b>   | <b>55.2</b>  |
| Vehicle excise duties                     | 3.0          |                  | 2.9              | 3.0           | 3.0          |
| Oil royalties                             | 0.7          |                  | 0.7              | 0.7 FSBR      | 0.7          |
| Rates                                     | 12.2         |                  | 12.2 FSBR        | 12.2 FSBR     | 12.2         |
| Other taxes and royalties                 | 4.4          |                  | 4.4 FSBR         | 4.4 FSBR      | 4.4          |
| <b>Total taxes and royalties</b>          | <b>158.9</b> | <b>158.9</b>     | <b>161.4</b>     | <b>160.5</b>  | <b>158.2</b> |
| National Insurance contributions          | 35.9         | 36.0             | 35.0             | 36.9          | 36.2         |
| Community Charge                          | 11.2         | 11.7             | 11.7 AS          | 11.7 AS       | 11.7         |
| Interest and dividends                    | 6.4          | 6.3              | 6.3 AS           | 6.3 AS        | 6.4          |
| Other receipts                            | 6.1          | 5.8              | 5.8 AS           | 5.8 AS        | 5.8          |
| Adjustment <sup>a</sup>                   |              |                  |                  |               | -0.6         |
| <b>General government receipts</b>        | <b>218.5</b> | <b>218.7</b>     | <b>220.2</b>     | <b>221.2</b>  | <b>217.8</b> |
| Central government own expenditure        | 137.8        | 140.9            | 140.9 AS         | 140.9 AS      | 141.9        |
| Central government support for LAs        | 41.8         | 42.7             | 42.7 AS          | 42.7 AS       | 42.7         |
| Public corporations                       | 1.4          | 2.1              | 2.1 AS           | 2.1 AS        | 2.1          |
| Privatisation                             | -5.0         | -5.3             | -5.3 AS          | -5.3 AS       | -5.3         |
| Reserve                                   | 3.0          | 0.3              | 0.3 AS           | 0.3 AS        | 0.3          |
| <b>New planning total</b>                 | <b>179.0</b> | <b>180.7</b>     | <b>180.7</b>     | <b>180.7</b>  | <b>181.7</b> |
| Local authority self-financed             | 13.3         | 13.9             | 13.9 AS          | 13.9 AS       | 13.9         |
| Central government debt interest          | 17.0         | 17.8             | 17.8 AS          | 17.8 AS       | 17.8         |
| Accounting adjustments                    | 3.4          | 3.4              | 3.4 AS           | 3.4 AS        | 3.4          |
| <b>General government expenditure</b>     | <b>212.7</b> | <b>215.7</b>     | <b>215.8</b>     | <b>215.8</b>  | <b>216.8</b> |
| <b>General government debt repayment</b>  | <b>5.8</b>   | <b>3.0</b>       | <b>4.4</b>       | <b>5.5</b>    | <b>1.0</b>   |
| <b>Public corporations debt repayment</b> | <b>1.0</b>   | <b>0.0</b>       | <b>0.0 AS</b>    | <b>0.0 AS</b> | <b>0.0</b>   |
| <b>Public sector debt repayment</b>       | <b>6.8</b>   | <b>3.0</b>       | <b>4.4</b>       | <b>5.5</b>    | <b>1.0</b>   |

<sup>a</sup> The adjustment accounts for unexpected non-payment of the Community Charge.

Table A.1 shows a selection of forecasts for the public finances for the current year. Government predictions from the Financial Statement and Budget Report or **FSBR** (April 1990) and the Chancellor's **Autumn Statement** (November 1990) are reproduced in the first two columns.

The third column uses the information already available (mainly data to October, though we have taken account of later information when available) to predict the out-turn for the public finances for the whole year. This **current receipts** method allows for expected seasonal fluctuation in revenues, though is reliant on the pattern of receipts over the year remaining the same between years. Monthly figures for expenditure are not available on the accounting basis used here, and for some revenues the seasonal pattern is extremely erratic. Estimates from the Autumn Statement and the FSBR (indicated by AS and FSBR) are therefore used for expenditure and some revenues.

**Model** estimates are shown in the fourth column of Table A.1. These are derived from estimates of the change in the tax base (personal incomes for income tax, consumers' expenditure for VAT) coupled with information from IFS models as to the elasticity of revenues with respect to the base.

The **forecast** shown in the final column is a judgemental average of these predictions.

### Current Receipts Forecasts

The current receipts method allows for expected seasonal variation in tax revenue accruals using the following formula:

$$1990-91 \text{ forecast} = \frac{\text{April-October 1990 out-turn}}{\text{April-October 1989 out-turn}} \times 1989-90 \text{ out-turn}$$

The accuracy of this method is therefore reliant on the seasonal pattern of revenues remaining the same, and so the estimates are sensitive to one-off fluctuations.

An additional problem is that some taxes are collected in "lumps" and so the proportion of revenues received by October is relatively low. Table A.2 shows the proportion of total 1989-90 revenues that had been received by last October. Around half the annual total had been collected for the majority of taxes in the first seven months.

**TABLE A.2 Percentage of Revenues Received in First Seven Months of 1989-90**

| Source                           | Percentage received |
|----------------------------------|---------------------|
| <b>Inland Revenue</b>            |                     |
| Income tax                       | 54.7                |
| Corporation tax                  | 49.2                |
| Petroleum revenue tax            | 53.7                |
| Capital gains tax                | 22.8                |
| Inheritance tax                  | 56.5                |
| Stamp duties                     | 61.6                |
| <b>Customs and Excise</b>        |                     |
| VAT                              | 56.7                |
| Petrol                           | 58.6                |
| Tobacco                          | 58.8                |
| Alcohol                          | 55.3                |
| Betting and gaming               | 57.0                |
| Car tax                          | 58.4                |
| Customs duties                   | 60.5                |
| Agricultural levies              | 64.3                |
| <b>Other taxes and royalties</b> |                     |
| Vehicle excise duties            | 59.9                |
| Oil royalties                    | 45.2                |
| Rates                            | 54.3                |
| National Insurance contributions | 54.6                |
| Interest and dividends           | 57.2                |

Capital gains tax is mainly collected at the year end, so only a fifth of total annual revenues had been collected by last October.

This used to be a problem with corporation tax, which was nearly all collected in January. Though the January "lump" remains large, a more significant problem with corporation tax is the phased implementation of a change to the timing of payments. This has altered the seasonal pattern of receipts<sup>1</sup> by moving payments forward, and created an October "lump" in receipts. The phasing of this change tends to upwardly bias the corporation

<sup>1</sup> Corporation tax is generally payable nine months from the end of a firm's accounting period, but companies assessable for tax prior to the fiscal year 1965-66 usually paid tax in January, unless they changed their financial year. This system was changed by the 1987 Finance Act, which reduced the interval between year end and payment of tax to nine months for all companies. Since the majority of companies have a year end in December, this has tended to shift the timing of receipts forward from January of one year to the previous October.

tax current receipts estimate, though since the scale of the impact of this change is difficult to assess, it is impossible to correct the current receipts forecast.

### Modelled Forecasts

The modelled forecasts are based on a prediction of the change in the revenue base for a particular tax. The relevant bases are listed in Table A.3.

**TABLE A.3 Tax Bases and Elasticities for Model Forecasts**

| Tax                | Base                           | Elasticity |
|--------------------|--------------------------------|------------|
| Income tax         | Nominal wage bill              | 1.7        |
| VAT                | Nominal consumers' expenditure | 1.0        |
| Car tax            | Nominal consumers' expenditure | 1.2        |
| National Insurance | Nominal wage bill              | 1.1        |
| Petrol             | Real consumers' expenditure    | 1.4        |
| Tobacco            | Real consumers' expenditure    | 0.3        |
| Beer               | Real consumers' expenditure    | 0.8        |
| Wines              | Real consumers' expenditure    | 1.5        |
| Spirits            | Real consumers' expenditure    | 0.9        |
| Alcohol            | Real consumers' expenditure    | 1.0        |

**TABLE A.4 Macro-Economic Assumptions for Model Forecasts**

| Percentage growth<br>except where indicated | 1990-91 | 1991-92 |
|---|---------|---------|
| Wages                                       | 10.0    | 9.0     |
| Employment                                  | 0.5     | -1.5    |
| Consumer prices                             | 6.5     | 5.5     |
| Consumers' expenditure                      | 1.5     | 0.5     |
| Oil price (\$)                              | 29.5    | 30.0    |
| Exchange rate (£/\$)                        | 1.8     | 1.9     |
| Corporate profits (previous year)           | -3.0    | -13.0   |
| Retail prices                               | 10.0    | 7.0     |

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The relationship between tax revenues and the change in the tax base is computed from detailed IFS models.<sup>1</sup> This generates a set of elasticities which are also shown in Table A.3.

Forecasts of these revenue bases for the different taxes are derived from the macro-economic working assumptions in Table A.4.

**TABLE A.5 Derivation of Model Forecasts**

|                           | 1989-90 | Growth | Budget costs | 1990-91 |
|---------------------------|---------|--------|--------------|---------|
| <b>Inland Revenue</b>     |         |        |              |         |
| Income tax                | 48.7    | 17.8   | -1.8         | 55.7    |
| Corporation tax           | 21.4    | -3.0   |              | 20.8    |
| Petroleum revenue tax     | 1.1     | 0      |              | 1.1     |
| Stamp duties              | 2.1     |        | 0.1          | 2.2     |
| <b>Customs and Excise</b> |         |        |              |         |
| VAT                       | 29.7    | 8.0    | 0.0          | 32.1    |
| Petrol                    | 8.8     | 2.1    | 0.8          | 9.8     |
| Tobacco                   | 5.0     | 0.5    | 0.3          | 5.4     |
| Alcohol                   | 4.6     | 1.5    | 0.3          | 5.0     |
| Betting and gaming        | 1.0     | 8.0    | 0.0          | 1.1     |
| Car tax                   | 1.5     | 9.6    |              | 1.6     |
| <b>Other taxes</b>        |         |        |              |         |
| Vehicle excise duties     | 2.9     | 1.8    | 0.0          | 3.0     |
| National Insurance        | 33.1    | 11.5   |              | 36.9    |

Table A.5 shows the calculations lying behind the modelled forecasts. The predictions for the growth in the revenue bases shown in Table A.3 are derived from the working assumptions in Table A.4. Combined with the elasticities from Table A.3, a forecast revenue growth rate is generated

<sup>1</sup>The income tax forecast is based on the results of Johnson, P. and Lambert, P. (1989), "Measuring the responsiveness of income tax revenue to income growth: a review and some UK values", *Fiscal Studies*, November. Corporation tax estimates use the IFS model described in Devereux, M. P. (1986), "The IFS model of the UK corporation tax", IFS Working Paper 84. Indirect taxes are forecast using the SPIT model discussed in Baker, P., McKay, S. and Symons, E. (1990), "The simulation of indirect tax reforms: the IFS Simulation Program for Indirect Taxation", IFS Working Paper W90/11.

(Table A.5, second column). However, this assumes that the tax system remains the same. We take account of the effect of the 1990 Budget package on revenues for 1990-91 (Table A.5, third column) using government predictions of "Budget costs" which are published in the FSBR. The resulting forecasts for individual revenues are given in the fourth column.

**Sensitivity** The modelled forecasts are naturally sensitive to the underlying economic assumptions about conditions in the whole of the current fiscal year. Table A.6 shows the impact on revenues of altering the assumptions.

**TABLE A.6 Revenue Effect of 1% Change in Assumptions for 1990-91 Forecast**

| Variable               | Revenue change<br>(£bn) |
|------------------------|-------------------------|
| Wages                  | 1.2                     |
| Employment             | 0.7                     |
| Consumer prices        | 0.2                     |
| Consumers' expenditure | 0.5                     |
| Oil price (£)          | 0.03                    |
| Corporate profits      | 0.2                     |

### PSDR Forecast for Fiscal 1990-91

The receipts forecasts for the current fiscal year (Table A.1, last column) are a judgemental average of the estimates provided from these different sources. Our forecast of a small PSDR of some £1bn arises from £1bn of over-expenditure, and a £1bn shortfall in receipts compared with the Autumn Statement estimate.

**Income tax** Income tax receipts have over the last few years been consistently underestimated by the Treasury. In 1989-90, for example, the FSBR prediction at the beginning of the year was almost £2bn lower than the out-turn. The Autumn Statement made a small upward revision in the forecast for the current year, though current receipts suggest that because of faster-than-expected growth in wage settlements this remains an underestimate. Our forecast of £56bn lies between the current receipts and model projections, and is £0.7bn above the Autumn Statement.

The Budget costs figure in the model estimates reflects the increase in allowances in the 1990 Budget and the introduction of independent taxation of husband and wife. The impact of the latter is particularly difficult to gauge, since it depends on the extent to which husbands transfer assets to non-working wives, who may then offset the income against their own personal allowance. This leads to greater uncertainty than usual in making forecasts.

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**Corporation tax** The Autumn Statement also included an increase in the forecast of corporation tax revenues of around £0.3bn. The current receipts estimate of over £23bn is an unreliable guide, due to the problem mentioned above of mainstream corporation tax (MCT) receipts being concentrated in January and the phased change in the timing of payments. However, the modelled estimate, reflecting the decline in corporate profits that started around 18 months ago, lies nearer the lower FSBR prediction. This figure provides our forecast of £20.8bn.

**Indirect taxes** The growth in consumers' expenditure has slowed significantly in the current year, and the Autumn Statement made a downward revision of £0.5bn in Customs and Excise receipts. Our forecast reduces this figure by a further £1bn.

**TABLE A.7 Growth in Components of Consumers' Expenditure and VAT Receipts**

| Per cent | Total consumers' expenditure | Mainly VATable goods | Mainly non-VATable goods | VAT receipts |
|----------|------------------------------|----------------------|--------------------------|--------------|
| 1986-87  | 11.2                         | 14.2                 | 3.3                      | 10.9         |
| 1987-88  | 9.8                          | 11.6                 | 4.5                      | 12.0         |
| 1988-89  | 13.1                         | 15.8                 | 4.8                      | 13.8         |
| 1989-90  | 14.0                         | 16.0                 | 6.9                      | 7.9          |
| 1990-91  | 8.9                          | 9.1                  | 7.9                      | 4.9          |

Notes: All figures show percentage changes in nominal values. The figure for 1990-91 is based on the first half of the year.

Sources: *Monthly Digest of Statistics, Financial Statistics, National Accounts Blue Book.*

The modelled forecasts use the IFS model of consumers' expenditure, estimated using Family Expenditure Survey data for 1970 to 1986. This model shows the extent to which expenditure on different categories of goods increases as consumers' expenditure increases. The elasticities shown in Table A.3 suggest that the expenditure on wine and petrol increases faster than total expenditure, and that on beer, spirits and tobacco more slowly. Spending on VATable goods is assumed to increase at the same rate as consumers' expenditure as a whole. In recent years, expenditure on VATable goods (and VAT receipts) have tended to increase faster than total spending (Table A.7), though this situation appears to have changed in 1989-90 and 1990-91 for VAT receipts. The growth of VAT revenues has slowed, and expenditure on VATables converged towards the general growth rate.

The model estimates of VAT receipts must therefore be treated with some caution, as it may well be the case that expenditure has now switched towards non-VATable goods. This view is reinforced by the evidence of a significant decline in the sales of durable goods. The forecast for VAT is



therefore over £1bn lower than that in the Autumn Statement at £30.7bn, in line with recent evidence from current receipts. The forecasts for other expenditure taxes are around those implied by the Autumn Statement, which revised the FSBR forecast down by around £0.2bn.

**National Insurance** The Autumn Statement increased the prediction for National Insurance contributions only slightly. The forecast of £36.2bn reflects the slightly higher assumption regarding growth in wages than that underlying the government's estimates.

**Local authorities** The FSBR predictions for Community Charge receipts of £11.2bn were based on an estimated average charge of £350. The Autumn Statement revised revenues upwards to £11.7bn to account for the out-turn of the average charge being £368. However, the "small allowance for non-collection"<sup>1</sup> is unlikely to be adequate. The latest forecast of non-payment is around 10%, compared with the 5% generally assumed by local authorities. Unexpected non-payment of £0.6bn is shown as an adjustment.<sup>2</sup>

**Public expenditure** Evidence as to the rate of growth of spending so far this year is difficult to assess, due to changes in accounting conventions following the reform of local government finance. However, an estimate can be arrived at by applying the current receipts methodology that we use for revenues to expenditure (Table A.8). The growth rate of net departmental outlays based on data for the first nine months of the year is applied to the planning total. Adjustments are made for the reform of local government finance by deducting an estimate of the revenue raised from national non-domestic rates. The FSBR and Autumn Statement estimates are shown for comparison.

Unadjusted net departmental outlays are running around 20% ahead of last year. Removing the distortion arising from local government reform reduces the growth rate to 12%, still ahead of the Autumn Statement estimate of 11%.

This suggests that there is likely to be some over-spending in the current year (beyond the £1.7bn announced in the Autumn Statement). Our forecast assumes overshooting of the Autumn Statement target by £1bn.

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<sup>1</sup> FSBR, 1990, Paragraph 6.26. The allowance made for non-collection is "as authorities themselves have [made] in setting the charges".

<sup>2</sup> Five per cent additional non-payment (above the figure assumed by the Autumn Statement) would produce a shortfall of £0.6bn at the mean Community Charge. This is in line with the local authority accounts, which show a £0.4bn accruals adjustment (the difference between accrual of entitlement to revenue and its actual collection) for the first half of the year.

TABLE A.8 What Do We Know about Expenditure?

|                   | Net departmental outlays |         |          | Planning total |         |          |
|-------------------|--------------------------|---------|----------|----------------|---------|----------|
|                   | 1989-90                  | 1990-91 | Increase | 1989-90        | 1990-91 | Increase |
| Unadjusted        | 155.8                    | 187.4   | 20.3%    | 162.4          | 195.4   | 20.3%    |
| Adjusted for NNDR | 155.8                    | 175.2   | 12.4%    | 162.4          | 182.5   | 12.4%    |
| FSBR              |                          |         |          | 162.4          | 179.0   | 10.2%    |
| Autumn Statement  |                          |         |          | 162.4          | 180.7   | 11.2%    |

Note: Data relate to the year to December.

Sources: Central Statistical Office PSBR Press Release, *Financial Statistics*, FSBR, Autumn Statement.

### Spending on the Gulf War

Mr Lamont has recently highlighted the need to take account of the impact of costs of war in the Gulf on public spending. The Ministry of Defence has issued figures showing a cost of £3.6m per day prior to hostilities, and calculates the cost of ammunition and equipment loss in the first four days of war at £100m. Whilst a protracted war may have public spending implications for 1991-92, there is unlikely to be a significant effect in the current year. Costs prior to war are overstated since they are gross costs; the net cost in terms of fuel, ammunition and logistical operations is likely to be substantially less. Equipment lost in action may not be replaced: with over 200 Tornados and having recently cancelled the eighth batch under the "Options for Change" review, much of the £100m "cost" quoted at the time of writing need not be incurred. Whilst some claim on the contingency reserve in the current year seems likely, the Ministry of Defence has taken offsetting action by cutting back expenditure in other areas and by enforcing a moratorium on payments to contractors. A final offset is assistance from other countries. Saudi Arabia has agreed to meet up to half the cost of war, and has provided help in the form of fuel and logistical support. In addition, Kuwait could be expected to contribute, and there is some prospect of financial aid from Germany and Japan, though this will mainly go to the US.

It would be rash to speculate on the costs of a longer war, though public spending may have to rise above previous targets, and this expense is likely to be (sensibly) met by additional borrowing. However, the Gulf does not seem to have any medium-term spending implications: there is unlikely to be long-run posting of UK troops in the Middle East, and the

diminished threat in the European theatre following the dissolution of the Warsaw Pact will maintain the long-run downward trend in military expenditure.<sup>1</sup>

## PSDR Forecast for Fiscal 1991-92

The forecast for 1991-92, given in Table A.9, shows a "modest" deficit of some £4bn.

Receipts for 1991-92 are again estimated using a variety of IFS models, generating projected increases on the forecast out-turn for the current year. Table A.4 shows the macro-economic working assumptions, and the revenue elasticities used are shown in Table A.3.

- Income tax** Revenues are projected to continue growing strongly as wages increase, though the growth rate is reduced somewhat by the assumption of a fall in employment. The Budget costs of £0.9bn primarily reflect the indexation of allowances and the abolition of the composite rate tax on savings announced in the 1990 Budget.
- Corporation tax** The fall in corporate profits in the current year will start feeding through to revenues, resulting in a decline in receipts of some £2.5bn.
- Indirect taxes** VAT receipts are forecast to continue growing, albeit more slowly, a result of continued inflation tempered by depressed consumer spending. If the fall in spending is more serious, then VAT receipts are likely to be hit much harder.
- Revalorisation of excise duties is assumed, bringing in around £2bn. Again, the estimates are sensitive to assumptions about the level and composition of consumers' expenditure.
- National Insurance** The fall in employment will also affect the growth of National Insurance contributions, though this will be offset by increases in wages, and revenues are projected to rise to £39bn.
- Local government** Both rates (reflecting the transitional arrangements for the introduction of national non-domestic rates) and the Community Charge (reflecting continued growth in local authority expenditure) are forecast to increase faster than inflation for 1991-92. The "Community Charge reduction scheme" announced on 17 January reduces revenues by £1.1bn, and this is shown as a Budget cost. This also affects the expenditure side - £1.1bn is transferred from local authority self-financed expenditure to central government support for local authorities.
- Any further changes to local government finance are unlikely to be introduced before 1992-93.

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<sup>1</sup> See Ridge, M. and Smith, R. (1991), "Military spending dynamics in a changing strategic environment", *Fiscal Studies*, February, forthcoming.

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TABLE A.9 The Public Finances 1991-92

|   | 1990-91      | Growth | Budget costs | 1991-92      |
|---|--------------|--------|--------------|--------------|
| Income tax                                | 56.0         | 12.8   | -0.9         | 62.2         |
| Corporation tax                           | 20.8         | -13.0  | 0.2          | 18.3         |
| Petroleum revenue tax                     | 1.1          | 7.0    |              | 1.2          |
| Capital gains tax                         | 1.8          | 7.0    |              | 1.9          |
| Inheritance tax                           | 1.3          | 7.0    |              | 1.4          |
| Stamp duties                              | 1.7          | 7.0    | -0.1         | 1.7          |
| <b>Total Inland Revenue</b>               | <b>82.7</b>  |        |              | <b>86.7</b>  |
| VAT                                       | 30.7         | 6.0    | -0.2         | 32.3         |
| Petrol                                    | 9.7          | 7.7    | 0.2          | 10.6         |
| Tobacco                                   | 5.4          | 7.2    | 0.1          | 5.9          |
| Alcohol                                   | 5.0          | 7.5    | 0.0          | 5.4          |
| Betting and gaming                        | 1.0          | 6.0    | 0.0          | 1.0          |
| Car tax                                   | 1.5          | 7.2    |              | 1.6          |
| Customs duties                            | 1.8          | 0.0    |              | 1.8          |
| Agricultural levies                       | 0.1          | 7.0    |              | 0.1          |
| <b>Total Customs and Excise</b>           | <b>55.2</b>  |        |              | <b>58.8</b>  |
| Vehicle excise duties                     | 3.0          | 0.6    | 0.0          | 3.0          |
| Oil royalties                             | 0.7          | 7.0    |              | 0.7          |
| Rates                                     | 12.2         | 10.0   |              | 13.4         |
| Other taxes and royalties                 | 4.4          | 7.0    |              | 4.7          |
| <b>Total taxes and royalties</b>          | <b>158.2</b> |        |              | <b>167.4</b> |
| National Insurance contributions          | 36.2         | 8.3    |              | 39.2         |
| Community Charge                          | 11.7         | 14.5   | -1.1         | 12.3         |
| Interest and dividends                    | 6.4          | 0.0    |              | 6.4          |
| Other receipts                            | 5.8          | 0.0    |              | 5.8          |
| <b>General government receipts</b>        | <b>217.8</b> |        |              | <b>231.0</b> |
| Central government own expenditure        | 141.9        |        |              | 153.1        |
| Central government support for LAs        | 42.7         |        |              | 48.8         |
| Public corporations                       | 2.1          |        |              | 2.3          |
| Privatisation                             | -5.3         |        |              | -5.5         |
| Reserve                                   | 0.3          |        |              | 3.5          |
| <b>New planning total</b>                 | <b>181.2</b> |        |              | <b>202.2</b> |
| Local authority self-financed             | 13.9         |        |              | 12.8         |
| Central government debt interest          | 17.8         |        |              | 16.5         |
| Accounting adjustments                    | 3.4          |        |              | 3.5          |
| <b>General government expenditure</b>     | <b>216.8</b> |        |              | <b>235.0</b> |
| <b>General government debt repayment</b>  | <b>1.0</b>   |        |              | <b>-4.0</b>  |
| <b>Public corporations debt repayment</b> | <b>0.0</b>   |        |              | <b>0.0</b>   |
| <b>Public sector debt repayment</b>       | <b>1.0</b>   |        |              | <b>-4.0</b>  |

**Public expenditure** The forecast for the PSDR is reliant on Government estimates for public expenditure. Spending appears to be under substantial pressure at the moment, particularly from Departments such as Health and Education, from war in the Gulf and from rising unemployment.

The forecasts include a £1bn increase in central government's own expenditure beyond the target set in the 1990 Autumn Statement.

**Tax changes** If the government chooses to add to pre-announced reforms of the tax system in the current Budget this will affect the PSDR forecast. Table A.11 (Appendix 2, below) shows the sensitivity of receipts to various changes in the parameters of the tax system.

The forecasts presented in Table A.9 assume an "indexed" Budget: that excise duties are revalorised and income tax allowances and thresholds increased in line with inflation.

**Economic conditions** There remains a good deal of uncertainty over economic conditions in the coming fiscal year, and the revenue forecast is very sensitive to these assumptions. Table A.10 shows the sensitivity of the 1991-92 forecasts to changes in the economic working assumptions.

**TABLE A.10 Revenue Effect of 1% Change in Assumptions for 1991-92 Forecast**

| Variable               | Revenue change<br>(£bn) |
|------------------------|-------------------------|
| Wages                  | 1.3                     |
| Employment             | 0.8                     |
| Consumer prices        | 0.2                     |
| Consumers' expenditure | 0.5                     |
| Oil price (£)          | 0.03                    |
| Corporate profits      | 0.2                     |

The public sector is likely to remain in surplus for the current year, with a modest debt repayment of £1bn. Next year, this is likely to become a borrowing requirement of around £4bn.

# Appendix 2: Tax Ready Reckoner

TABLE A.11 Direct Effects of Illustrative Changes in Taxation

|   | Cost/Yield<br>(£m) |
|---|--------------------|
| <b>Income tax</b>                                 |                    |
| Change basic rate by 1p                           | 1,950              |
| Change higher rate by 1p                          | 190                |
| Index personal allowance                          | 1,975              |
| Index higher rate threshold                       | 375                |
| Abolish Mortgage Interest Relief                  | 7,000              |
| Restrict Mortgage Interest Relief to basic rate   | 500                |
| Raise Mortgage Interest Relief ceiling to £35,000 | 450                |
| <b>Corporation tax</b>                            |                    |
| Change full rate by 1%                            | 370                |
| Change smaller companies' rate by 1%              | 35                 |
| <b>Capital taxes</b>                              |                    |
| Index inheritance tax threshold                   | 50                 |
| Index capital gains exempt amounts                | *                  |
| <b>Indirect taxes</b>                             |                    |
| Revalorise excise duties                          | 1,880              |
| Change VAT rate by 1%                             | 1,700              |

Notes: The revenue effect is computed for 1991-92 at full-year cost.  
Indexation arrangements assume inflation of 9.3%.  
Negligible changes are indicated by \*.

Source: Autumn Statement, 1990, Section 4.