CENTRE FOR POLICY STUDIES

THE CHANCELLOR'S RECORD

AN AUDIT OF THE LAST 10 YEARS

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CHAPTER ONE
INTRODUCTION AND SUMMARY

1.1 INTRODUCTION

The December 2006 Pre-Budget Report (PBR) will be the Chancellor's tenth, and, widely expected to be his last. This is, therefore, an opportune time to take an audit of some key aspects of the Chancellor's record over the last 10 years.

In addition to the customary economic forecasts and fiscal projections, the Chancellor is expected to discuss a series of heavyweight reports in this December's PBR. They include:

- Sir Rod Eddington's on transport, with its heavy emphasis on road-use charging.
- Kate Barker's on planning.
- Lord Leith's on the "long-term skills challenge". This report is expected to paint a bleak vision of our skills ability to meet the "China Challenge" (and indeed the India Challenge). The recommended remedy will doubtless require costly publicly-funded programmes.
- The Stern report on the economics of climate change which will doubtless be invoked to justify green taxes (see chapter 4 for more).
- Sir David Varney's on making HMRC more responsive to the needs of large businesses (see chapter 4 for further mention).

These reports, along with the latest paper on the preparations for the 2007 Comprehensive Spending Review,[1] are indicators of the Chancellor's 10-year

vision of the economy. The 2007 Comprehensive Spending Review will celebrate 10 years of power for New Labour and start the planning for another 10 years. One thing will be certain. The state will not get any smaller.

The 2007 Comprehensive Spending Review will celebrate 10 years of power for New Labour and start the planning for another 10 years. One thing will be certain. The state will not get any smaller.

1.2 THE ECONOMIC BACKGROUND: POOR PRODUCTIVITY GROWTH

Chapter 2 looks at the near-term economic prospects and overall performance of the economy over the last decade and concludes:

- The Treasury's Budget forecast of 2% to 2½% for GDP growth in 2006 looks plausible. If anything it on the modest side. The Treasury's 2007 forecast looks optimistic. (Section 2.2.)
- The economy has performed quite creditably since 1997. There have been no damaging "booms and busts" and GDP growth has averaged 2.8%. But the productivity performance has disappointed, with an annual average growth of less than 2%. (Section 2.3.)
- **Given that improved productivity performance is a key Treasury objective, then the deterioration in productivity growth is a policy failure.**
- GDP as an indicator of living standards is inadequate. GDP per capita makes allowance for a rising population. This measure has probably grown by less than 2½% since 1997. Households Real Personal Disposable Income (RPDI) has recently been depressed by higher taxes. (Section 2.3.)
- Large-scale immigration has undoubtedly bolstered GDP growth and, arguably, offset the weakening productivity performance. But the impact on GDP per capita could be neutral – at best. (Section 2.4.)
- There is evidence that the UK's competitiveness is slipping down the international league tables. (Section 2.5.)

1.3 PUBLIC SPENDING: WHAT WASTE!

Chapter 3 describes the developments in the burgeoning public sector over the past decade and concludes:

- After three years of famine (FY1997 to FY1999), the Chancellor turned on the spending taps. Between FY2000 and FY2007 public spending is expected to grow by an annual average of nearly 4½% (real terms) and, as a consequence, the share of public spending has risen sharply. This sharp rise has been against the tide of international trends. (Section 3.2.)

- As public spending has increased so has the number of people working for the public sector. Estimates of public sector pension liabilities (unfunded) have soared and are now estimated at £1 trillion. (Section 3.2.)
- The performance of public sector productivity has been dire and a factor dragging down whole economy productivity. Public sector prices discipline has also been poor and contributed to the waste of resources in the public services. Independent estimates suggest that public sector waste may now be as high as £85bn, about 15% of total government spending. Pouring money into the unreformed public services has been an expensive mistake. And one that was quite easy to foresee. (Section 3.3.)
- **Given New Labour's 1997 Manifesto claim that they would be "wise spenders, not big spenders", then the actual performance of the public sector with its endemic waste is a policy failure.**
- The Government's first "Efficiency Programme" (for the FY2005 to FY2007) incorporated the Gershon Review (for transferring £21bn of savings into front line services) and aimed to cut 84,000 civil service posts. The Public Accounts Committee and a quick inspection of the ONS's data suggest this Programme has been ineffective, despite the Treasury's claims to the contrary. (Section 3.4.)
- The Treasury does, however, seem more determined to gain savings for the period to be covered by the 2007 Comprehensive Spending Review (FY2008 to FY2010). The spending increases pencilled in for these years average less than 2% in real terms – these are tight plans after the years of profligacy. (Section 3.5.)

1.4 TAXES: MORE RISES TO COME

Chapter 4 looks at the increasing tax burden over the past decade and concludes:

- Reflecting the rapid rise of public spending, taxes have increased sharply since 1997. Moreover, Britain's tax increase has been the greatest of all major nations over this period. Indeed the international trend has been towards lower tax burdens. (Section 4.2.)
- **Given New Labour's 1997 Manifesto assertion that "the increase in taxes under the Conservatives is the most dramatic evidence of economic failure", then the Chancellor's increased taxes are a sign of policy failure.**
- "Stealth taxes" have accounted for much of the increase in the tax burden. In particular, several tax thresholds have not been fully raised in line with, for example, earnings, thereby dragging more people into paying tax and, moreover, paying tax at higher rates. This insidious – and dishonest – procedure is known as "fiscal drag". (Section 4.2.)
- The CBI has, justifiably, criticised the Government's record on taxes and the business sector. Business is paying more tax and having to deal

with an increasingly complex and uncertain tax regime. Many competitor countries are improving the business-friendliness of their tax regimes. Britain's tax competitiveness is deteriorating. (Section 4.3.)

- There is considerable evidence to show that the most dynamic economies have relatively small public sectors. The growth of Britain's public sector undermines economic dynamism. Tax rates need to be reduced. (Section 4.4.)
- The Chancellor claims that "tax (rate) cuts" mean "spending cuts" which, in turn, mean "worse public services". It is trebly fallacious. (Section 4.5.)
- The Chancellor is currently living beyond his means and taxes will have to rise again. The taxpayers will have to pay for the Chancellor's profligate ways. Green taxes, putatively intended to save the planet, are likely to be extended. (Section 4.6.)

1.5 PUBLIC FINANCES: IN THE RED

Chapter 5 analyses the fiscal balances behind this year's Pre-Budget Report and concludes:

- Even though the October 2006 public finances were reasonably satisfactory, there is, nevertheless, a "structural" annual borrowing requirement of around £30bn (around 2½% of GDP). (Sections 5.2.and 5.3.)
- **Given New Labour's 1997 Manifesto assertion that "the public finances remain weak" (they were heading for surplus), then the fact that the public finances are currently structurally weak, despite uninterrupted economic growth since 1993, is a policy failure.**
- The Chancellor has redefined his Golden Rule on several occasions. But, at least on one set of definitions, he should now meet his Golden Rule for the "current" economic cycle. He may also meet his Sustainable Investment Rule for the period up to FY2010, given the current definition of Public Sector Net Debt (PSND). (Section 5.4.)
- If the potential liabilities of the PFI, unfunded public sector pensions and Network Rail were added to the current coverage of PSND then the Sustainable Investment Rule would be shattered. (Section 5.5.)

REFERENCE

1. HM Treasury, *Long-term opportunities and challenges for the UK: analysis for the 2007 Comprehensive Spending Review*, November 2006.

> *"Productivity growth, alongside high and stable levels of employment, is central to long-term economic performance and rising living standards. Increasing the productivity of the economy is a key objective for the Treasury."*
>
> HM Treasury, *Enterprise and Productivity*, www.hm-treasury.gov.uk

CHAPTER TWO
THE ECONOMY: POOR PRODUCTIVITY GROWTH

2.1 INTRODUCTION

The economic section of the Pre-Budget Report is of key interest. The Chancellor's economic forecasts (as opposed to his forecasts on the public finances) have been fairly accurate in the past. The detailed figures are shown in table 1 of the annex. Given the data up to the third quarter of this year, the Chancellor's Budget forecast for GDP for 2006 looks, if anything, on the modest side.

Superficially the economy's performance since 1997 has looked satisfactory, but the productivity performance has been poor and there has been an over-reliance on the expansion of the labour force for growth – not least of all from immigration.

2.2 THE ECONOMIC FORECASTS

The main components of the Chancellor's 2006 Budget forecasts are set out in the table below.

THE CHANCELLOR'S BUDGET FORECASTS

	2005	2006	2007	2008
GDP at constant market prices (%)*	1¾	2-2½	2¾ – 3¼	2¾ – 3¼
Balance of payments (current account) (£bn)	-26¾	-32 ¾	-36 ½	-38 ¼
CPI (Q4) (%)*	2¼	2	2	2
Money GDP (£bn)	1211¼	1266 to 1269	1334 to 1345	1409 to 1428
Money GDP (%)*	4	4 ½ to 4 ¾	5 ½ to 6	5 ½ to 6 ¼

* Change year-on-year (%). The CPI forecast refers to the year-on-year change for the 4th quarter average.

Source: HM Treasury, *Budget 2006*, *A strong and strengthening economy: Investing in Britain's future*, TSO, March 2006.

The GDP growth forecast for 2006 undershoots the current Consensus forecast as shown in the following table. Growth for 2006 has tended to be stronger than widely expected at the time of the Budget. The Treasury's GDP forecast for 2007 is, however, on the optimistic side compared with Consensus, which does, however, look on the low side given the growth momentum. The Item Club (discussed below), for example, is forecasting 2.9% growth in 2007.

CONSENSUS FORECASTS FOR THE BRITISH ECONOMY

	2006	2007
GDP (%)*	2.6	2.4
CPI (%)*	2.3†	2.2
Balance of payments (current account) (£bn)	-31.6	-34.4
3 month interbank rate (%)	5.1 (end Jan. 2007)	4.9 (end Oct. 2007)

* Change year-on-year (%). The CPI forecast refers to the year-on-year change for Q4.

† October's CPI inflation rate was 2.4% (YOY).

Source: Consensus Economics, *Consensus Forecasts*, October 2006.

The Chancellor's economic forecasts and projections are relevant to the public finances. The GDP growth projections are based on the "cautious" view of the Treasury's "neutral" estimate of trend output growth, which is 2¾% to end 2006, slowing to 2½% thereafter due to demographic effects. The "cautious" annual trend growth assumption is ¼% lower than the neutral view – i.e. 2½% to end 2006 and 2¼% thereafter.

2.3 ECONOMIC PERFORMANCE SINCE 1997

The economy has performed quite creditably since 1997 and this has tended to divert attention form the poor productivity performance.

KEY ECONOMIC VARIABLES: 1997-2005

	GDP, market prices 2003=100	Whole economy productivity 2003=100	Total employment (000s)
1997	84.4	89.35	26,523
2005	105.2	103.45	28,741
2005/1997	1.25	1.16	1.08
Average annual change (%)	2.8	1.9	1.0

	Unemployed (000s)	Economically active (000s)	Economically inactive (000s)
1997	1,987	28,510	17,019
2005	1,458	30,199	17,611
2005/1997	0.73	1.06	1.035
Average annual change (%)	-3.9	0.7	0.4

Source: ONS, *Economic Trends Annual Supplement*, 2006. The employment data are from the Labour Force Survey (LFS).

The annual average growth rate of productivity of less than 2% is historically weak and all the more disappointing because the Chancellor has made a huge issue of raising productivity performance. Even in the much-criticised period of 1992 to 1997, the annual average growth in productivity was around 2.2%. The Chancellor's policies of improving productivity growth, therefore, have failed.

GDP growth has, however, been maintained by a robust increase in employment – partly through immigration, partly through higher activity rates of older workers and partly reflecting a drop in unemployment. Unemployment is, however, currently rising as workforce growth outstrips employment growth. According to the OECD, one of the reasons for the higher unemployment has been the large-scale immigration from eastern Europe. It is of note that over the period 1997 to 2005 the economically inactive, including the retired, have also increased.[1]

The growth of GDP is, of course, closely correlated with that of living standards. But when allowance is made for the rising tax take, total Households' Real Personal Disposable Income (RPDI) slipped back 0.2% in 2006 Q2 as higher income taxes and social security contributions took their toll.[2] Rising interest rates can only bite further into people's living standards.

If allowance is made for the rising population – and Britain's population has been growing at around 0.4% annually over the last 10 years – then the real disposable income per capita data would look even less attractive than total RPDI. GDP growth as a measure of economic success is, in itself, inadequate. At the very least GDP per capita must be considered. Given the growth in population, the average annual growth rate for GDPpc has probably less than 2½% over the last decade.

2.4 TREND OUTPUT GROWTH AND PRODUCTIVITY GROWTH

The Treasury's analysis of trend output growth, which is so crucial to their GDP and hence public finances forecasts, relies on the following components:

- Hourly productivity growth.
- Average hours worked, which are falling.
- The employment rate, i.e. the proportion of people in employment against all people in the relevant age group.
- And the changes in the population of working age, including immigration – the "demographics".

The Treasury's 2006 Budget Report estimates of these components are shown in the table below.

TREASURY: CONTRIBUTIONS TO TREND GROWTH AND ESTIMATED TREND GROWTH RATES (ANNUALLY, %)

	Contributions to trend growth (%)					Trend output growth (%)
	Trend output per hour worked (hourly productivity)		Trend average hours worked	Trend employment rate	Population of working age	
	Underlying	Actual				
1986Q2 to 1997H1	2.22	2.04	-0.11	0.36	0.24	2.55
1997H1 to 2001Q3	2.79	2.59	-0.44	0.42	0.58	3.15
2001Q4 to 2006Q4:						
2006 Budget	2.25	2.15	-0.2	0.2	0.6	2 ¾
2006Q4 onwards:						
2006 Budget	2.25	2.15	-0.2	0.2	0.4	2 ½

Source: HM Treasury, *Budget 2006*, *A strong and strengthening economy: Investing in Britain's future*, TSO, HC 968, March 2006.

The Treasury currently estimates that trend output growth is 2¾% a year (to the end of 2006), with trend output growth expected to slow to 2½% thereafter due to demographic effects. Two features are clear from these estimates:

- The slowing hourly productivity growth rates from an annual average of 2.59% (1997H1 to 2001Q3) to 2.15% from 2001Q4 onwards.
- The historically large annual increases in the working age population from 1997H1, reflecting unprecedented immigration flows, which are currently adding an annual ½% increase (approximately) to GDP. The decrease in the population contribution from 2006Q4 reflects the demographic effects of post-War baby-boom women reaching retirement age, which depresses the growth rate of the working-age population. If, however, immigration continues to be buoyant, especially following the accession of Bulgaria and Romania to the EU in January 2007, this deceleration may fail to materialise. And it should be noted that the immigration data are inadequate, which adds to the Treasury's difficulties in estimating trend output.

It should also be noted that there has also been an increase in people working beyond their normal retirement age (60 for women and 65 for men).

There are many possible reasons for the poor productivity performance including the drag on whole economy productivity because of the increasing public sector share of employment allied with a dire productivity performance of the public sector. This is discussed further in chapter 3 on the public sector.

The Bank of England speculated about the weak productivity growth earlier this year. The Bank wrote:[3]

> The extent of the slowing of the labour productivity growth is uncertain. But it seems likely that at least some of the slowing in productivity growth has been genuine. One possibility is that the greater use of migrant labour from the EU Accession countries has led to a fall in labour productivity growth. These migrant workers generally appear to occupy lower paid, lower productivity jobs. The recent energy price rises might also have lowered productivity growth. Higher energy prices will lower productivity growth temporarily if companies choose to scrap capital equipment that becomes unprofitable following a rise in energy prices. In addition, uncertainty over energy prices may lead firms to postpone investment decisions, which would also reduce temporarily the growth of the capital stock.

Concerning the impact of recent immigration flows and other labour force factors, and hence the economy's trend growth rate, the ITEM Club believes the Treasury's data are a tad too cautious.[4] The ITEM Club estimates that the trend GDP growth rate has recently been around 2¾% to 3%, rather than the Treasury's 2¾%. If it is right, then the economy clearly has had more headroom to grow than otherwise would be the case. The ITEM Club also takes the view that trend potential annual growth of 2¾% to 3% continues in 2007 and 2008.

The ITEM Club calculates that the labour supply grew on average by 0.7% per annum between 1997 and 2005 – directly adding 0.4 percentage points to potential growth. Had there been no inward migration, the labour supply may have only grown by 0.1% pa, adding less than 0.1 percentage points to growth. Immigration, therefore, added on average over 0.3% to growth over this period.

If ITEM is correct, the average GDP growth rate between 1997 and 2005 would have been only 2.5% if there had been no net immigration. Immigration has undoubtedly bolstered GDP and has, arguably, offset the deterioration in productivity performance. But the impact on GDPpc has been less favourable. Given ITEM's data on the contribution of migrant labour, the impact could be neutral at best.

2.5 FINAL CONSIDERATION: COMPETITIVENESS

When discussing the state of fitness of the British economy, overall competitiveness must be considered. Here the Chancellor's legacy is unimpressive. On both the main indices of international competitiveness, the UK has slipped in the league tables since the late 1990s. The World Economic Forum (WEF) calculated that Britain was the fourth most competitive economy in 1998; in 2006 it was the tenth. The International Institute of Management Development (IMD) put Britain at ninth in 1997 and 21st in 2006. In a world of increasing competition this slippage is discouraging.

REFERENCES

1. See Nicholas Boys Smith, *Reforming welfare*, Reform, November 2006, for a discussion of those economically inactive who are on welfare benefits.

2. ONS, *Quarterly National Accounts*, 2nd quarter 2006, 27 September 2006.

3. Bank of England, *Inflation Report*, February 2006.

4. Ernst and Young, *Economic Outlook for Business*, Autumn 2006, which summarises the latest UK quarterly forecast by the ITEM Club.

"The myth that the solution to every problem is increased spending has been comprehensively dispelled under the Conservatives… It is what money is actually spent on that counts more than how much money is spent."

"The national debt has doubled under John Major. The public finances remain weak. A new Labour government will give immediate high priority to seeing how public money can be better used. New Labour will be wise spenders, not big spenders."

"The Conservatives have wasted spending on the NHS. We will do better. We will raise spending on the NHS in real terms and put the money towards patient care. And a greater proportion of every pound spent will go on patient care not bureaucracy."

New Labour, because Britain deserves better, Labour party Manifesto, 1997.

CHAPTER THREE
PUBLIC SPENDING: WHAT WASTE

3.1 INTRODUCTION

After three years of prudence, from FY1997 to FY1999, the Chancellor has presided over a period of an unprecedented peacetime increase in public spending. The public sector has expanded significantly – not least of all public sector employment, which has been part of the Chancellor's expanding client state. There is evidence of waste and the performance of public sector productivity has been very disappointing.

The Chancellor has stated the spending plans for FY 2008 to FY2010 (the period of the next three-year Spending Review) will be tough. The challenge for the Chancellor's successor will be the implementation of these tough spending plans.

3.2 THE GROWTH OF PUBLIC SPENDING & THE PUBLIC SECTOR

Very roughly, the current Chancellor has initiated three phases of spending patterns – and implemented the first two. They are:

- Phase 1: FY1997 to FY1999, during which the Chancellor stuck to the tough Conservative spending plans. Famine.
- Phase 2: FY2000 to FY2007, during which the "Profligate Chancellor" turned on the spending taps – though it should be noted that spending growth in FY2005 to FY2007 showed some deceleration. Feast.
- Phase 3: FY2008 to FY2010, for which eye-wateringly tight data are pencilled in. Famine.

As can be seen from the table below, Total Managed Expenditure (TME) has increased from around £320bn in FY1997 to nearly £520bn in FY2005 and, despite some slightly bizarre claims that spending over the period FY2005 to FY2007 will be "tight", expenditure is planned to rise to £580bn by financial year 2007/08 –£260bn higher than a decade earlier. These data are at current prices and some allowance for inflation must be allowed for. But, even so, the increase in spending is startling. The cumulative increase in consumer prices over this period is expected to be comfortably less than 20% and the equivalent figure for the RPI is under 30%. Total public spending will have risen by over 80%.

Total Managed Expenditure has increased from around £320bn in FY1997 to nearly £520bn in FY2005.

It is instructive to note that there are around 25 million households in the UK. The Chancellor's generosity, albeit with other peoples' money, means that average spending per household in 2007/08 will be just over £10,000 higher than a decade earlier. Nearly half of this £10,000 will be on the two big "winners" over the decade, social security payments and health, with education another major beneficiary. Defence spending, however, is a big loser despite the high level of active deployment of British forces overseas over this period. The increase will have been derisory and, after allowing for inflation, defence spending will actually have fallen.[1]

The public sector's share of GDP, having fallen to 37.2% in FY1999, is calculated by the Treasury to reach 43.1% in FY2006 – a rise of nearly six percentage points in less than a decade.

The Treasury's pencilled in totals for FY2008 and FY2010 are also included in the table below – but will be discussed later in this chapter.

PART A: TOTAL MANAGED EXPENDITURE (TME)

	Total Managed Expenditure (TME) (£bn), current prices	Total Managed Expenditure (TME) (£bn), FY2004 prices	TME as % of GDP, market prices
Outturns			
FY1996	313.9	379.8	40.6
FY1997	320.9	377.1	38.9
FY1998	331.8	380.1	38.1
FY1999	343.3	385.7	37.2
FY2000	366.3	406.2	38.0
FY2001	389.6	421.5	38.7
FY2002	421.3	441.8	39.6
FY2003	457.6	467.6	40.8
FY2004	491.0	491.0	41.7
FY2005	523.2	512.4	42.7
Projections			
FY2006	552.3	528.1	43.1
FY2007	582.8	542.8	43.1

PART B: TOTAL MANAGED EXPENDITURE (CONTINUED)

	Total Managed Expenditure (TME) (£bn), current prices	Total Managed Expenditure (TME) (£bn), FY2004 prices
Famine:		
FY1997 to FY1999		
FY1999 over FY1996	1.09 (3 years)	1.015 (3 years)
Average annual growth rate (%)	2.9%	0.5%
Feast:		
FY2000 to FY2007		
FY2007 over FY1999	1.70 (8 years)	1.40 (8 years)
Average annual growth rate (%)	6.9%	4.3%
Famine*:		
FY2008 to FY2010		
FY2008	609 (4.5%)	
FY2009	638 (4.8%)	
FY2010	668 (4.7%)	
FY2010 over FY2007	1.1475 (3 years)	
Average annual growth rate (%)	4.7%	1.9%

Source: HM Treasury and ONS, *Public Expenditure Statistical Analyses 2006*.

- Current prices data from 2006 Budget report, table C4 and calculated as current expenditure + (gross investment – asset sales). The constant price data are compiled using the Treasury's assumption of inflation in the GDP deflator of 2¾% per annum for FY2008 to FY2010.

Canada, Germany, Italy and Spain have all cut back the size of the state in recent years. Germany's public sector share of GDP will be lower than the UK's in 2007.

As can be seen from the next table (based on OECD data), the UK's increase in General Government spending as a percentage of GDP far outstrips any other major OECD country between 1997 and 2007. Indeed, many countries have heeded the need to cut back the size of the state in recent years, cut back their state sectors and benefited accordingly. These countries include Canada, Germany, Italy and Spain. Germany's public sector share of GDP will be lower than the UK's in 2007. The UK is going against the tide. Other exceptions include the US and Japan – but note that their public shares are both around 36% to 37%.

GENERAL GOVERNMENT TOTAL OUTLAYS (% OF NOMINAL GDP): INTERNATIONAL COMPARISONS

	1997	2005	2007p	2007 minus 1997
Australia	36.0	34.9	35.3	-0.7
Canada	44.3	39.3	39.1	-5.2
France	53.7	54.4	53.9	0.2
Germany	48.3	46.8	45.1	-3.2
Italy	50.2	48.2	48.1	-2.1
Japan	36.0	36.9	36.5	0.5
Spain	41.0	38.2	38.3	-2.7
UK	**41.5**	**45.1**	**45.9**	**4.4**
US	35.4	36.6	36.7	1.3
Euro area	49.2	47.7	46.8	-2.4
OECD	40.6	40.7	40.5	-0.1

Source: OECD, *Economic Outlook*, June 2006. General Government is equivalent to Central Government and Local Government.

As public spending has expanded, so has public employment. The table below shows that, according to administrative data, there were over 5.8 million public sector employees in mid-2006, 685,000 more than in mid-1997. According to David B Smith,[2] the Labour Force Survey (LFS), at broadly the same date, said that 7.145 million people claimed to be working for the government. The discrepancy of over 1.25m people partly reflects the fact that people who work for Non Profit Institutions Serving Households (NPISH), such as universities, or people working for subcontractors, such as agency nurses, or those regarded as self-employed, such as GPs, are likely to regard themselves as being paid out of the public purse, even if that is not the way the data are defined in the national accounts.

But whatever the definition, public sector employment has risen rapidly over the last decade and has, moreover, increased as a share of total employment.

PUBLIC SECTOR EMPLOYMENT

	Administrative records (000s)				LFS (000s)	% of total employment	
Mid-years	Central gov.	Local gov.	Public corporations	Total public sector	Total public sector	Admin records	LFS
1997	2,107	2,728	339	5,174	6,046	19.5	22.7
2005	2,559	2,928	363	5,850	7,007	20.4	24.3
2006	2,557	2,948	345	5,859	7,145	20.3	24.8
Increase 1997-2006	450	220	6	685 (13%)	1,099 (18%)	0.8	2.1

Source: David B Smith, *Living with Leviathan*, IEA, 2006.

Reflecting the substantial increase in the number of public sector workers and the reluctance of the Government to tackle their pension privileges,[3] the bill for public sector pensions is soaring. Neil Record estimates that the public sector pension liabilities (unfunded) are about £1 trillion even though, he claims, the government estimates the liabilities at only half this level.[4] Given the Chancellor's tax raid on private sector pension schemes in his July 1997 budget, to the tune of around £5bn per annum, and the subsequent damage to private sector pensions, it can fairly be said that, in matters to do with pensions, there is indeed "public affluence and private penury".[5]

3.3 PUBLIC SECTOR PRODUCTIVITY AND WASTE

The expansion in public sector employment would hardly matter if the public sector proved to be as dynamic and efficient as the private sector it was displacing. The sad truth is that it is not. The public sector, untouched by the competitive pressures that keep the private sector on its toes and with a guaranteed income courtesy of the taxpayer, is, quite simply, underperforming. Anecdotal evidence apart, data published by the ONS in 2003[6] confirmed a picture of falling public sector productivity in the early 2000s, whereas private sector productivity grew, on average, by around 2% each year. The Chancellor's policies are leading to a situation in which the private sector is being "crowded out" by the underperforming public sector – much to the economy's detriment.

Since the pioneering 2003 ONS paper, there have been considerable attempts to improve the estimates of public sector productivity including the Atkinson review into public sector productivity[7] and the setting up of the UK Centre for the Measurement of Government Activity (within the ONS). Whilst the ONS's attempts to improve the calculation of public sector productivity are to be encouraged there is the increasing danger that the numbers will become distorted by the inclusion of highly subjective concepts of "quality" (for example, the number of passes at GCSE, when there is rampant grade inflation). Data with these "quality adjustments" are likely to be regarded with increasing suspicion. Moreover, insofar they increase Government output, they increase GDP which may or may not be defensible.

But whatever the measurement issues the official data on pubic sector productivity continue to look fairly dreadful. In the following table, compiled by David B Smith, the numbers for General Government output per employee show very sluggish growth and, coupled with the fact that the inflation rates for the costs of providing public services are much higher than for the household sector, confirm that the taxpaying public is getting a poor deal from the public sector. Smith concludes that, if public sector productivity and prices discipline had matched that in private sector, the same volume of government services could have been provided for some £63.5bn less in calendar year 2005. As he also points out, "this is over and above any waste that already existed in 1997". Poor productivity and bad price discipline amount to wasted resources.

GOVERNMENT OUTPUT PER EMPLOYEE COMPARED WITH OTHER SECTORS, AND COMPARISON OF GOVERNMENT AND HOUSEHOLD CONSUMPTION PRICE TRENDS, INDICES, 1997=100

Years	General Government output per employee	Non-oil GDP per employee	Manufacturing output per employee	General Government consumption deflator	Household consumption deflator
1997	100	100	100	100	100
2005	108.7	116.6	135.3	141.6	115.8
Average annual increase (%)*	1.05	1.9	3.85	4.4	1.85

Source: David B Smith, *Living with Leviathan*, IEA, 2006, using ONS data.
* Author's calculations

Turning to individual public services and starting with the NHS, the ONS published data in 2004 which suggested that since 1997 productivity had fallen by an annual average of between ¾% and 1.35%.[8] Other analysis confirmed that much of the extra cash going into the NHS had been absorbed by sharply higher employment costs reflecting the large increase in staff numbers, especially managerial staff, and rapid pay rises, even though there was little evidence that NHS staff, outside certain regional and specialty pockets, had been underpaid.[9] And more recent analysis by the ONS showed that, excluding "quality changes", NHS productivity is still falling.[10]

NHS productivity has fallen by annual average of between 0.75% and 1.35% between 1997 and 2004, while average prouctivity in education (excluding "quality changes") fell by around 1½% a year over the same period.

The ONS's findings on education are equally depressing. Excluding "quality changes", average productivity fell by around 1½% per annum between 1997 and 2004.[11] Concerning Social Security administration, productivity fell from 1998 to 2003, but improved between 2003 and 2005.[12]

These figures are a damning indictment of a Government that has poured money into an unreformed public sector since 2000. They may seem as dry as dust, but they tell a very sorry story. The taxpayer has had a very raw deal indeed. It is no mystery as to why so much money has been spent on the public services and there is so little to show for it. It has been wasted on a grotesque scale. The "model" of throwing vast sums at the unreformed public services has been tested to destruction. The hundred dollar question will be how the public services will cope when spending growth is curtailed during the period FY2008 to FY2010 – especially in the NHS.

There have been other approaches to the issue of waste and inefficiency. Apart from the Gershon Review (discussed below) other exercises include:

- The James Review of Tax Payer Value, which found some £35bn of potential savings.[13]
- The Taxpayers' Alliance has estimated that the Government wastes £82bn annually of hard-working taxpayers' money – from the billions wasted on IT systems failures to £2,500 paid by the MoD to retrain an aircraft worker as a nightclub pole dancer.[14]
- William Norton, former adviser to the James Review on government waste, calculated that government waste amounted to £85bn a year, equivalent to around 15% of total government spending.[15]
- Using data from an audit of all regulations by PriceWaterhouseCoopers in 2006, it has been estimated that seven key regulators (including the HSE, Food Standards Agency and the Financial Services Authority) are wasting £3.3bn a year by inefficiently regulating the economy. [16]
- Taking a different angle on inefficiency, the Construction Products Association (CPA) compiled a list of infrastructural projects and concluded that the backlog of repairs amounted to £3.9bn in the NHS and £8bn in the education sector, despite the huge sums allocated to these sectors. The road building programme was so badly delayed that it undermined the economy.[17]

3.4 THE GERSHON REVIEW & THE FIRST EFFICIENCY PROGRAMME

The Gershon Review was published with the 2004 Spending Review and was incorporated into the Government's first Efficiency Programme for the years FY2005 to FY2007. The Programme was designed to achieve efficiency gains across the public sector that would release £21.5bn a year by FY2007 for use in front line services. The Programme also aimed to reduce Civil Service posts by more than 70,000 and to reallocate a further 13,500 posts to front line services (nearly 84,000 in total). There were criticisms of the Gershon Review – principally that it was under-ambitious.

There have also been criticisms of the Government's Efficiency Programme – principally that it is not being achieved despite the Government's claim that it is. Earlier this year, for example, the Treasury claimed that the Programme was well on target and announced that "by the end of March 2006, departments and local authorities had already reported annual efficiency gains totalling £9.8bn" and "delivered over half of the 84,000 workforce reductions planned by 2007/08".[18] But the claim that the Civil Service cuts were on target did not seem to square with ONS data that showed a modest 3,000 drop in the number of civil servants between 2005 Q1 and 2006 Q1 (or 15,000 if the reclassification of the Magistrates' Courts Service is allowed for).

And in July 2006 the Public Accounts Committee released a report that cast considerable doubt over the robustness of the Treasury's calculations.[19] The PAC's report was sceptical to say the least and said "it is difficult to have confidence in what is being achieved when the Treasury and the Office of Government Commerce display a lack of openness about progress". (An earlier report from the National Audit Office, released in February 2006,

had expressed similar doubts.[20]) The PAC also expressed concern that any public spending cuts, rather than reflecting efficiency gains, could materially eat into resources available for public services, affecting the quality.

3.5 COMPREHENSIVE SPENDING REVIEW, 2007

But whatever the success or failure of the Efficiency Programme attached to the 2004 Spending Review, the Government does seem to be determined to push through efficiency reforms in the context of the next three-year Comprehensive Spending Review (CSR) for FY2008 to FY2010. The "CSR07", which will show the allocation of funding for these three years, will be announced in July 2007. As stated already the Chancellor has already pencilled in modest annual growth rates for public spending averaging just 1.9% in real terms. Even the Chancellor appears to be admitting that the public sector is so bloated that it needs a fiscal diet, and that the public sector is so wasteful that it is pulling down the nation's productivity.

The Treasury announced its latest savings review in July 2006, "entrenching the gains of the 2004 Spending Review".[21] As part of its preparations for the 2007 CSR, the government is implementing value for money programmes across all departments. All departments were required to make administrative (efficiency) savings of at least 2.5% (since increased to 3%) for the three-year period. A real terms pay freeze for 6 million public sector workers is also part of the plans.

The latest document released by the Treasury relating to its plans for the 2007 CSR examines the key long-term trends and challenges that will shape the next decade.[22] The trends and challenges surely point out the direction of a Labour Government led by Prime Minister Gordon Brown. They comprise:

- Demographic and socio-economic change, with rapid increases in the old age dependency ratio on the horizon and rising consumer expectations of public services.
- The intensification of cross-border economic competition, with new opportunities for growth, as the balance of international economic activity shifts towards emerging markets such as China and India.
- The rapid pace of innovation and technological diffusion, which will continue to transform the way people live and open up new ways of delivering public services.
- Continued global uncertainty with ongoing threats of international terrorism and conflict and the continued need to tackle global poverty.
- Increasing pressures on our natural resources and global climate, requiring action by governments, businesses and individuals to maintain prosperity and improve environmental care.

The Government will use the CSR as "a key milestone in making further progress against its established long-term goals of sustainable growth and employment; fairness and opportunity; a secure and fair world; and modern and efficient public services in the new context of the decade ahead."

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> *"The increase in taxes under the Conservatives is the most dramatic evidence of economic failure."*
>
> *New Labour, because Britain deserves better*, Labour Party Manifesto, 1997

CHAPTER FOUR
TAXES: MORE RISES TO COME

4.1 INTRODUCTION

The huge increases in public spending on the unreformed public services have required large rises in taxation on business, thus undermining their competitiveness; and on individuals, thus confiscating people's hard-earned money. Behind this confiscation is the idea that the state can spend people's money more effectively and efficiently than they can. But the opposite is the case. As demonstrated above, the poor productivity record and the evidence of huge waste in the public sector shows just how inefficient the public sector is.

The rises in taxes have, however, failed to keep up with the increased public spending and the public finances are "in the red". Even though the Government is planning a significant slowdown in public spending growth from FY2008, it is inevitable that taxes will rise further. Britain is simply ceasing to be a vigorously competitive economy, as is needed in the 21st century, and becoming more "European" economy with a bloated 20th century style public sector.

4.2 THE CHANCELLOR'S RECORD ON TAXES

Central Government cash receipts increased by nearly 50% between FY1997 and FY2005 from £290bn to £415bn (see table 5 in the annex for details) – while Local Authority taxes (principally Council Taxes) have effectively doubled. Unsurprisingly the share of net taxes and social security contributions as a percentage of GDP has risen since FY1996. It is, moreover, projected to rise further. Total public sector receipts as a percentage of GDP were 37% in FY1996, by FY2008 they are expected to be 41%.

PUBLIC SECTOR CURRENT RECEIPTS AS A PROPORTION (%) OF GDP AT MARKET PRICES

	Net taxes & social security contributions	Public sector current receipts
FY1996	34.8	37.0
FY1997	36.0	38.1
FY1998	36.4	38.6
FY1999	36.4	38.9
FY2000	37.2	39.6
FY2001	36.7	38.7
FY2002	35.3	37.3
FY2003	35.4	37.6
FY2004	36.2	38.3
FY2005 (part estimate)	37.5	39.7
FY2006 (projection)	38.0	40.3
FY2007 (projection)	38.5	40.9
FY2008 (projection)	38.7	41.0
FY2009 (projection)	38.7	41.0
FY2010 (projection)	38.7	41.0

Source: HM Treasury, *Budget Report 2006*, including tables C9 and C25.

Even though the basic rate of income tax has not been increased by the Government, there have been several ways by which they have sought to raise the tax burden on businesses and individuals. These include:

- Failing to raise starting and basic rate personal income tax thresholds (either/both the lower and upper limits) in line with earnings thus dragging more people into paying tax and, moreover, paying tax at higher rates. As the economy grows and people's incomes grow a higher proportion goes in tax – acting as a "fiscal drag" on private sector economic activity. Fiscal drag is the "king of all stealth taxes". There are currently 4 million top rate taxpayers compared with 2.1 million in 1997.[1]
- The burdens of Stamp Duty and Inheritance Tax have risen sharply under Labour as the thresholds have not been raised in line with the relevant asset (including house) price indices – another example of fiscal drag. Stamp Duty rates have also been increased.
- Another "stealth tax": aggressive moves against perfectly legal tax planning (avoidance) schemes, sometimes retrospectively.[2]
- Increases in National Insurance Contributions from April 2003 for employers, employees and the self-employed.
- Increased burden on the North Sea Oil Companies. The Supplementary charge to Corporation Tax (SCT) is currently 20%, making a total effective corporation tax rate of 50% for these companies.

The following table shows how the UK's tax/GDP trend is against the tide of lower tax burdens in other major economies. These countries appreciate the importance of adopting policies to improve their competitiveness. They

seem to realise that heavily taxed economies under-perform and destroy individual incentives. By 2007 the tax burden in the UK is expected to almost match Germany's. Britain clearly has had highest tax rise among the major EU nations – indeed all major nations – since 1997.

GENERAL GOVERNMENT TOTAL TAX AND NON-TAX RECEIPTS (% OF NOMINAL GDP)

	1997	2005	2007p	2007 minus 1997
Australia	35.6	36.4	35.8	0.2
Canada	44.5	41.0	40.9	-3.6
France	50.7	51.4	51.2	0.5
Germany	45.6	43.5	43.0	-2.6
Italy	47.6	44.0	43.6	-4.0
Japan	31.9	31.7	31.8	-0.1
Spain	38.2	39.3	39.3	0.9
UK	39.3	41.9	42.6	3.3
US	34.6	32.8	32.9	-1.7
Euro area	46.7	45.3	44.8	-1.9
OECD	38.9	38.0	37.9	-1.0

Source: OECD, *Economic Outlook*, June 2006

4.3 THE IMPACT ON BUSINESS

The CBI is becoming increasingly critical of the Government's attitude to business and tax. Firstly, it has estimated that the cumulative effect of post-1997 business tax rises will be around £80bn by 2010 and has claimed businesses have borne a disproportionate share of the increased tax burden.

Secondly, it complains about the increasing uncertainty and complexity of the tax system. Tolley's Yellow Tax Handbook on direct taxation had, apparently, 4,555 pages in financial year 1996/97 – a mere pamphlet by today's standards. The latest edition weighed in with 9,806 pages. And, thirdly, a recent CBI survey of FTSE350 companies and foreign-owned equivalents showed that 19% said they were considering relocating their HQ operations overseas and 5% said that they had moved their bases from Britain already because of Britain's increasingly unfriendly tax regime. Business is mobile. Firms in the survey generally found the tax regime far more burdensome than five years ago.

The Chancellor has attempted to pre-empt these criticisms with the Varney Review on making HMRC more responsive to the needs of large business. But whether business will be impressed by the Varney Review is, of course, an entirely different matter.

Crucially the UK is losing its corporate competitive advantage. The CBI's criticisms about the uncertainty and increasing complexity of the tax system are quite valid. And of equal importance, if not more importance, Britain's advantage as a low corporation tax country is being lost as other countries cut their taxes.[3] The UK's 30% standard rate of corporation tax, once highly

attractive, is increasingly uncompetitive internationally as other countries cut their rates. The UK is no longer a leader. It position is middling at best.

The latest KPMG Corporate Tax Rate Survey confirms this conclusion. KPMG has run an international analysis of corporate tax rates since 1993.[4] The average rate in 1993 was 38% – by 2006 it was 27.1%. Given all the evidence that lower tax rates can support economic growth (more below) a cut in Britain's rate is overdue.

4.4 THE IMPACT ON THE ECONOMY

There are many analyses of the relationship between the size of the state and the dynamic competitiveness of an economy.[5] And there is overwhelming evidence to show that the smaller the state's share of GDP, beyond a practical minimum guaranteeing internal and external security and the provision of opportunities enabling people to achieve their potential, the more dynamic is its economy. Many countries have heeded this in recent years, cut back their state sectors and benefited accordingly. Canada and Ireland, in particular, come to mind. But so have Finland and Sweden, by any standards archetypal Scandinavian "big state" economies. The UK, almost uniquely, has not.

Two of the latest contributions to the debate are a paper by David B Smith[6] (discussed in chapter 3) and the Tax Reform Commission's report.[7] The latter specifically deals with the taxation side and the report's conclusions are a useful summing up of what is now wrong with the British tax regime:

- The tax burden in the UK is high in both historic and international terms.
- The tax system is too complex, unfair and unstable.
- High taxes and tax complexity damage growth. The tax system is undermining UK competitiveness and precipitating economic decline
- Tax reform in other countries has worked extremely well

The CPS has argued on previous occasions that for the sake of the economy we cannot afford NOT to cut tax rates.[8] The need becomes more urgent with every passing Gordon Brown budget. But "tax 'n spend" fallacies cloud the debate, muddying the waters of debate for lower taxes.

4.5 TAX 'N' SPEND FALLACIES

If tax rate cuts are suggested to the Chancellor, his knee-jerk response is that they will lead to "tax cuts" (implying lower tax revenues) which will result in "public spending cuts" which will, in turn, lead to "worse public services". This dogmatic response is trebly fallacious. It is crude "spin".

The first fallacy is the implication that any tax rate cuts represent a total and permanent loss of revenue to the Government, without any offsetting increases. This is a static "lump of tax revenue fallacy". But, to take one example, lower personal taxes stimulate household incomes and personal consumption and hence increase indirect taxes. More interestingly, there are the "dynamic" effects which stimulate work. Lower business taxes

dynamically incentivise entrepreneurial activity, stimulate employment and GDP growth and thus increase tax revenues more generally. Similarly, lower income taxes incentivise people to work harder and, insofar as they earn more, can result in higher tax revenues.

Cautious estimates suggest that tax cuts of say £20bn to £30bn (2½% of GDP) could stimulate extra annual economic growth by 0.2% to 0.3%. This growth could, moreover, be used to provide resources for better public services. Indeed without economic growth and a well-functioning economy, there would be precious few resources for the public services.

The Irish experience has shown just how potent cuts in business tax rates can be in stimulating tax revenues. Corporate tax rates have fallen from 50% to 12.5%, whilst the yield from corporate taxes has risen from 1% of GDP to 4%. GDP has, of course, grown impressively over this period.

The second fallacy is that sharing economic growth between allowing people to keep more of their own hard-earned money by cutting tax rates ("tax cuts") and the public sector means "cuts in public spending". It simply does not, providing the economy is growing. And the Chancellor knows this. If, for example, public spending grows by 1% less than GDP per year from 2006/07, spending would be about £35bn higher (in real terms) by 2010/11 than in 2006/07.[9]

This represents a perfectly respectable increase in public spending which, along with appropriate reforms and prudent management, would surely deliver improvements in schooling and healthcare. But the appropriate reforms are essential.

And this leads to the third fallacy. This is that controlled public spending increases inevitably mean "worse services". It is now clear that the rapid and, arguably, unmanageable funding increases of recent years on the unreformed public services have been a recipe for wanton waste and falling productivity (as discussed in chapter 3). The key to good public services is proper management as well as reasonable funding. More money does not necessarily mean better services and, conversely, properly controlled spending does not inevitably mean worse services.

4.6 MORE TAX RISES TO COME: AND GREEN ONES AT THAT

But even though there is a strong economic case for cutting taxes, the odds have to be for further rises given the red ink in the public finances (see chapter 5).

The best bets, in the wake of the Stern Report,[10] are on "green" taxes. These are taxes on carbon emissions which are meant to save the planet from global warming. (But note that the current Climate Change Levy is not a tax on carbon emissions – it is an energy tax which applies to nuclear power.) Higher Vehicle Excise Duty for gas-guzzling 4x4s and higher taxes on air passenger transport are favoured tips.

Of course, green policies, whether taxes or trading schemes, for tackling climate change beg many questions about the science of climate change

which is, whatever Stern claims, very uncertain. But the risks of unrestricted carbon emissions are uncertain as well and, therefore, cost-effective restrictive policies are a sensible insurance policy. And they have the potential advantage of reducing the reliance on fossil fuels – which will increasingly have to be imported.

Yet, if economic tools are to be employed for restricting carbon emissions, taxes are surely preferable to international permit trading schemes that require all Governments to act consistently, objectively and fairly if they are to work. Permits for carbon emissions should be auctioned in an open and transparent market or, if allocated by Governments, allocated fairly between emitters. This has not been the case to date and is most unlikely to be the case in future.

Apart from the sheer impracticability of global trading schemes, taxes have other advantages. Firstly, the cost of carbon is known with taxes, and transparent, whereas prices can be very volatile and uncertain under trading schemes. Secondly, there is no need to set arbitrary baselines and targets as there is with trading schemes. Thirdly, the imposition of carbon taxes can be used to lower taxes elsewhere in the economy in order to maintain the overall competitiveness of business and/or people's real disposable income. Fourthly, current fuel taxes can be co-ordinated with other carbon taxes to provide a balanced package of carbon taxes. Finally, tax collection is administratively straightforward and can realistically cover all emitters – this is most emphatically not the case with trading schemes.

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"The national debt has doubled under John Major. The public finances remain weak. A new Labour government will give immediate high priority to seeing how public money can be better used. New Labour will be wise spenders, not big spenders."

"We will enforce the 'golden rule' of public spending – over the economic cycle, we will only borrow to invest and not fund current expenditure. We will ensure that – over the economic cycle – public debt as a proportion of national income is at a stable and prudent level."

New Labour, because Britain deserves better, Labour Party Manifesto, *1997*

CHAPTER FIVE
PUBLIC FINANCES: IN THE RED

5.1 INTRODUCTION

The forecasts for the public finances will undoubtedly be of interest to the economic and political commentators in the forthcoming Pre-Budget Report. In particular there will be a focus on:

- Any revisions to the Chancellor's forecasts for the current budget and Public Sector Net Borrowing. In the light of the good October data we expect little change.
- Discussion on the two fiscal rules. The Chancellor will claim that they are both met.

5.2 PUBLIC FINANCES: DATA FOR THE FIRST SEVEN MONTHS OF FY2006

The public finances for the first seven months of FY2006 showed that central government current receipts were much in line with the Budget forecast. Strong corporation tax receipts were a feature of the data. Even though the spending figures are ahead of Budget projections, this may just be a matter of timing. It does not, in itself, indicate that there will be large over spending for FY2006.

GROWTH IN PUBLIC SECTOR REVENUES AND SPENDING (%, YOY)

	October 2006 over October 2005	7 months to October 2006 over 7 months to October 2005	Budget forecast, FY2006/07 over FY2005/06
Central Government current receipts	7.5	6.5	6.4
Central Government current spending	5.8	7.1	4.6
Public sector net investment	28.9	55.5	28.4

Source: IFS, *Public finance bulletin*, November 2006.

5.3 PUBLIC FINANCES: PROSPECTS FOR FY2006 AND BEYOND

At the time of the Budget the Treasury forecast a Public Sector current deficit of £7bn for FY2006, somewhat lower than in FY2005, and Public Sector Net Borrowing (PSNB) of £35.8bn, marginally down on FY2005's figure. Given the good October data, there is no pressure on the Chancellor to change his forecasts from the Budget (the first time since the 2000 PBR) and we do not expect him to do so.

But we believe that the Treasury's forecasts are too optimistic and expect the current budget balance to show a deficit of around £11bn for F2006, compared with a Treasury figure of £7bn, and a net borrowing figure of around £38bn, higher than the Treasury's £35.8bn. This maintains the general pattern of over-optimism shown in the Treasury's forecasts of the public finances since the early 2000s. See annex, tables 2 and 3, for the details of the Treasury's poor forecasting record.

PUBLIC SECTOR FINANCES FOR FY2006 (£BN)

	Public Sector current budget balance	Public Sector Net Borrowing (PSNB)
FY 2005:		
2006 Budget	-11.5	37.1
Current outturn	-15.1	37.5
7 months: April to October 2005	-11.5	20.6
FY 2006:		
2006 Budget	-7.0	35.8
2006 PBR, likely HMT forecast*	-7.0	35.8
7 months: April to October 2006	-8.7	22.9
CPS estimate of outturn	-11.0	38.0

* both data are unchanged.

Sources: HM Treasury: *Budget 2006*, HC 968 and ONS, *Public Sector Finances, October 2006*, 20 November 2006.

Given that the economy has been growing since 1993 this relatively unhealthy state of the public finances should be regarded as irresponsible mismanagement. The public finances should be showing healthy surpluses.

Looking beyond FY2006, the Treasury's forecasts continue to look over-optimistic. The table below compares NIESR's latest forecasts with the 2006 Budget forecasts.

PUBLIC SECTOR FINANCES (£BN)

	FY04	FY05	FY06	FY07	FY08	FY09	FY10
PS Current Budget							
PBR 2005	-19.9	-10.6	-4	0	7	11	13
Budget 2006	-19.0	-11.4	-7	1	7	10	12
Current outturns	-19.3	-15.1					
NIESR	-18.9	-16.2	-14.4	-7.3	-3.9	-0.8	0.3
CPS expected outturn	Na	Na	-11				
PS Net Borrowing							
PBR 2005	38.8	37.0	34	31	26	23	22
Budget 2006	397.	37.1	36	30	25	24	23
Current outturns	39.2	37.5					
NIESR	38.0	39.1	39.1	34.2	34.8	34.2	31.2
CPS expected outturn	Na	Na	38				
PS net debt (as % of GDP)							
PBR 2005	34.7	36.5	37.4	37.9	38.2	38.2	38.2
Budget 2006	35.0	36.4	37.5	38.1	38.3	38.4	38.4
Current outturns	35.0	36.5					
NIESR	35.2	36.8	37.3	37.7	38.2	38.4	38.3

Note: The latest data on outturns are from the ONS's October press release on the public finances (20 November 2006).

Sources: HM Treasury: *Pre-Budget Report 2005* and *Budget Report 2006*; *National Institute Economic Review* (NIER) no. 198, NIESR, October 2006.

5.4 THE FISCAL RULES

The fiscal rules, which were put together in 1997, are:

- The golden rule: which states that, on average over the cycle, the government will borrow only to invest and not to fund current spending
- The sustainable investment rule: which states that public sector debt as a proportion of GDP will be held over the cycle at a stable and prudent level. The government believes that, other things being equal, it is desirable that public spending net debt should be below 40% of GDP over the cycle.

There were two features of the golden rule that have, notoriously, subsequently been altered which have undermined the credibility of the Chancellor's adherence to sound finances.

The first is that, when the Chancellor first announced his Golden Rule, it was assumed that the actual balances would be cumulated over the cycle, and that the net figure should be zero or positive for the Golden Rule to be met. However, in more recent announcements the emphasis has been on the balances as percentage shares of GDP. This has been criticised on the grounds that it gives greater weight to the earlier years of the cycle, when some of the surpluses were large, and smaller weight to the later years when some of the deficits were large.

The second relates to the actual specification of the cycle. There have been three different specifications of the cycle.

(A) From FY1999 to FY2005: the original specification.

(B) From FY1997 to FY2005: as altered in July 2005.

(C) From FY1997 to FY2008: as altered in the 2005 PBR.

There is little doubt that, for all the Treasury's justifications of the re-specifications, the changes were primarily made for reasons of political expediency rather than economic transparency.

Taking all these revisions into account there are, therefore, theoretically six combinations of the Golden Rule: three incorporating the actual balances and three incorporating the current balance as a % of GDP. The first table below, incorporating levels and using the, arguably optimistic, 2006 Budget projections, shows that the Golden Rule would have been missed on the first and second specifications of the cycle – but just hit on the third.

PUBLIC SECTOR CURRENT BUDGET BALANCES: LEVELS (£BN)

	Balances	Cumulative		
		(A) FY1999-FY2005	(B) FY1997-FY2005	(C) FY1997-FY2008
Actual:				
FY1997	-1.2	Na	-1.2	-1.2
FY1998	10.5	Na	9.3	9.3
FY1999	21.1	21.1	30.4	30.4
FY2000	23.7	44.8	54.1	54.1
FY2001	10.3	55.1	64.4	64.4
FY2002	-11.9	43.2	52.5	52.5
FY2003	-18.9	24.3	33.6	33.6
FY2004	-19.3	5.0	14.3	14.3
FY2005	-15.1	-10.1	-0.8	-0.8
Projections:				
FY2006	-7	Na	Na	-7.8
FY2007	1	Na	Na	-6.8
FY2008	7	Na	Na	+0.2
Golden Rule met?		Missed	Just missed	Just hit

Sources: Actual data: ONS, *Public sector finances*, First Release, October 2006, 20 November 2006. There have been data revisions since the Budget. Projections: HM Treasury, *Budget Report*, 2006.

Given the unhappy outcomes using the actual balances, it is unsurprising that the Treasury prefers using balances as percentages of GDP. The next table covers the relevant data and shows the Golden Rule would have been hit on all three specifications of the cycle. The Chancellor could well be advised to declare his latest re-specification invalid and declare that he has met his Golden Rule.

PUBLIC SECTOR CURRENT BUDGET BALANCES: AS % OF GDP

Year (year of cycle in brackets)	Balances	Cumulative (A) FY1999-FY2005	Cumulative (B) FY1997-FY2005	Cumulative (C) FY1997-FY2008
Actual:				
FY1997 (1)	-0.14	Na	-0.14	-0.14
FY1998 (2)	1.21	Na	1.07	1.07
FY1999 (3)	2.30	2.30	3.37	3.37
FY2000 (4)	2.46	4.76	5.83	5.83
FY2001 (5)	1.02	5.78	6.85	6.85
FY2002 (6)	-1.12	4.66	5.73	5.73
FY2003 (7)	-1.67	2.99	4.06	4.06
FY2004 (8)	-1.62	1.37	2.44	2.44
FY2005 (9)	-1.22	0.15	1.22	1.22
Projections:				
FY2006 (10)	-0.6	Na	Na	1.16
FY2007 (11)	0.1	Na	Na	1.17
FY2008 (12)	0.5	Na	Na	1.22
Golden Rule met?		Just hit	Hit	Hit

Sources: Actual data: ONS, *Public sector finances*, First Release, October 2006, 20 November 2006. The data have been revised since the Budget. Projections: HM Treasury, Budget Report 2006.

Turning to the Sustainable Investment Rule, that the Public Sector Net Debt should be less than 40% of GDP, the Treasury remains confident that it will be comfortably met over its full projection period, as the following table shows.

PUBLIC SECTOR NET DEBT (END OF PERIOD)

	Actual (£bn)	As a % of GDP
Actual:		
FY1997	352.9	41.6
FY1998	351.6	39.3
FY1999	345.4	36.6
FY2000	312.4	31.7
FY2001	317.1	30.6
FY2002	349.3	32.0
FY2003	384.7	33.2
FY2004	424.5	35.0
FY2005	462.7	36.5
Forecast:		
FY2006	493	37.5
FY2007	530	38.1
FY2008	560	38.3
FY2009	590	38.4
FY2010	619	38.4
Sustainable Investment Rule met?		Yes

Sources: Actual data: ONS, *Public sector finances*, First Release, October 2006, 20 November 2006. Projections: HM Treasury, Budget Report 2006.

5.5 PUBLIC SECTOR NET DEBT: COVERAGE ISSUES

There are, however, many criticisms of the Treasury's limited coverage of public sector liabilities for calculating the Public Sector Net Debt (PSND). This is especially so in the case of the Public Finance Initiative (PFI). As can be seen from the following table they, cumulatively, amount to very considerable potential liabilities indeed.

ESTIMATED PAYMENTS UNDER PFI CONTRACTS – MARCH 2006 (SIGNED DEALS), PROJECTIONS

Year	£bn	Year	£bn
FY2005	5.9	FY2018	4.9
FY2006	6.5	FY2019	4.9
FY2007	6.7	FY2020	5.0
FY2008	6.9	FY2021	4.6
FY2009	7.3	FY2022	4.6
FY2010	7.4	FY2023	4.5
FY2011	7.6	FY2024	4.5
FY2012	7.6	FY2025	4.4
FY2013	7.7	FY2026	4.1
FY2014	7.6	FY2027	3.8
FY2015	7.7	FY2028	3.4
FY2016	7.8	FY2029	3.1
FY2017	7.1	FY2030	2.7

Source: HM Treasury, *Budget Report*, 2006.

The ONS does now make some allowance for PFI liabilities – though a relatively modest figure.[1] The ONS estimates that the total liability under finance leases for certain capital assets was £4.95bn at the end of March 2006, and this has been added to the PSND. About 85% of this figure relates to PFI and PPP projects. But HM Treasury estimates that the total capital value of all PFI and PPP projects is over £64bn, of which £23bn relates to projects where the public sector is, or is expected to become, the economic owner. These considerably larger numbers are, however, currently omitted from the PSND data.

In addition to the PFI issue there are two other issues:

- The costs of Network Rail, estimated at around £20bn. Network Rail's liabilities, although guaranteed by government, were agreed to be off-balance sheet because of the, arguably, sham independence conferred on the organisation by the presence of a board.
- Public sector pensions liabilities are off-balance sheet. As discussed in chapter 2, these have been estimated to be around £1 trillion.[2]

Clearly, the issue of PSND coverage remains highly controversial. Brooks Newmark MP and Stephen Hammond MP have estimated that total public sector liabilities are around £1,340bn. This figure is equivalent to £53,000 for every household in the country and represents 103.5% of GDP, clearly in breach of the Sustainable Investment Rule. Their data are shown in the following table.

PUBLIC SECTOR LIABILITIES (£BN)

	£bn
PSND (as calculated by HM Treasury)	487
Public sector (including local government) pensions	810
PFI ("cautious" estimate)	25
Network Rail	18
The "real" figure for the PSND	**1,340**
	(103.5% of GDP)

Source: Brooks Newmark MP and Stephen Hammond MP, *Simply Red: the true state of the public finances*, Centre for Policy Studies, November 2006.

REFERENCES

1. ONS, "Improving estimates of public sector debt", press release, 20 September 2006.
2. Neil Record, *Sir Humphrey's legacy: facing up to the cost of public sector pensions*, IEA, 2006.

ANNEX
TABLES

TABLE 1: TREASURY GDP GROWTH FORECASTS FOR 2000 TO 2008: MID-POINTS FROM 2000

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Nov 97	(2½)								
Mar 98	(2½)								
Nov 98	(2½)	(3)							
Mar 99	(2½)	(3)							
Nov 99	(2¾)	(2½)	(2½)						
Mar 00	(3)	(2½)	(2½)						
Nov 00	3	(2½)	(2½)	(2½)					
Mar 01	3	(2½)	(2½)	(2½)					
Nov 01	3	2¼	(2¼)	(3)	(2½)				
Apr 02		2¼	(2¼)	(3¼)	(2¾)				
Nov 02		2	1½	(2¾)	(3¼)	(3)			
Apr 03			1¾	(2¼)	(3¼)	(3¼)			
Dec 03			1¾	2	(3¼)	(3¼)	(2¾)		
Mar 04				2¼	(3¼)	(3¼)	(2¾)		
Dec 04				2¼	3¼	(3¼)	(2¾)	(2½)	
Mar 05					3	(3¼)	(2¾)	(2½)	
Dec 05					3¼	1¾	(2¼)	(3)	(3)
Mar 06						1 ¾	(2 ¼)	(3)	(3)
Current outturn	3.8	2.4	2.1	2.7	3.3	1.8			

Sources: Successive Budget Statements & PBRs. The forecast data, in brackets, relate to the mid-point of the forecasts.

TABLE 2: TREASURY FORECASTS FOR THE PUBLIC SECTOR CURRENT BUDGET BALANCE (£BN), FROM FINANCIAL YEAR 2000/01

Date of forecast	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
Nov 98	3	8	10	11							
Mar 99	4	8	9	11							
Nov 99	11	13	13	12	11						
Mar 00	14	16	13	8	8						
Nov 00	16.6	16	14	8	8	8					
Mar 01	23.1	17	15	8	9	9					
Nov 01	25.1	10.3	3	4	7	8	9				
Apr 02	21.6	10.6	3	7	9	7	9				
Nov 02		7.7	-5.7	-5	3	5	8	10			
Apr 03		9.9	-11.7	-8	-1	2	6	9			
Dec 03			-11.8	-19.3	-8	-5	0	4	8		
Mar 04			-12.3	-21.3	-11	-5	0	4	9		
Dec 04				-21.1	-12.5	-7	1	4	9	12	
Mar 05				-20.4	-16.1	-6	1	4	9	12	
Dec 05					-19.9	-10.6	-4	0	7	11	13
Mar 06					-19.0	-11.4	-7	1	7	10	12
Current outturn	23.7	10.3	-11.9	-18.9	-19.3	-15.1					

Sources: Successive Budget Statements and PBRs.

TABLE 3: TREASURY FORECASTS FOR THE PUBLIC SECTOR NET BORROWING (£BN), FROM FINANCIAL YEAR 2000/01.

Date of forecast	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
Nov 98	5	2	2	1							
Mar 99	3	1	3	4							
Nov 99	-3	-3	1	4	6						
Mar 00	-6	-5	3	11	13						
Nov 00	-10.1	-6	1	10	12	13					
Mar 01	-16.4	-6	1	10	11	12					
Nov 01	-18.8	2.5	12	15	13	13	13				
Apr 02	-15.9	1.3	11	13	13	17	18				
Nov 02		1.2	20.1	24	19	19	19	20			
Apr 03		-0.4	24	27	24	23	22	22			
Dec 03			22.5	37.4	31	30	27	27	24		
Mar 04			22.9	37.5	33	31	27	27	23		
Dec 04				34.8	34.2	33	29	28	24	22	
Mar 05				35.4	34.4	32	29	27	24	22	
Dec 05					38.8	37.0	34	31	26	23	22
Mar 06					39.7	37.1	36	30	25	24	23
Current outturn	-19.9	0.9	24.9	34.1	39.2	37.5					

Sources: Successive Budget Statements and PBRs

TABLE 4: SPENDING REVIEWS: TME PLANS (£BN)

Year	Item	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07
1998	DEL	168.8	179.2	190.1	200.2						
	AME	164.8	172.4	179.9	189.5						
	TME	333.6	351.6	370.0	389.7						
2000	DEL		176.8	195.2	212.1	229.3	245.7				
	AME		163.9	176.4	180.8	186.2	193.9				
	TME		340.7	371.6	392.9	415.4	439.6				
2002	DEL					239.7	263.5	279.8	301.0		
	AME					178.7	191.2	201.7	210.4		
	TME					418.4	454.6	481.5	511.4		
2004	DEL							279.3	301.9	321.4	340.5
	AME							208.3	218.9	227.8	239.5
	TME							487.6	520.8	549.2	580.0

DEL = Departmental Expenditure Limit (net of depreciation).

AME = Annually Managed Expenditure.

TME = Total Managed Expenditure. TME=DEL+AME

Sources: Successive Spending Reviews. The underlined data show the new spending plans for each Spending Review. The summer 2007 Spending Review will specify the plans for FY2008 to FY2010.

TABLE 5: CENTRAL GOVERNMENT CASH RECEIPTS (CASH BASIS) (£BN)

Year	Total (includes interest and dividend receipts and “other receipts”)
FY1997	287.6
FY1998	305.4
FY1999	322.6
FY2000*	365.2
FY2001	347.8
FY2002	349.3
FY2003	363.7
FY2004	387.6
FY2005	415.5
FY2005 over FY1997	1.45 (8 years)
Average annual growth rate (%)	4.75%

* Receipts include cash receipts of £22.5bn, paid by the mobile phone companies.

Source: ONS, *Public sector finances: October 2006*, 20 November 2006.