THE PRICE OF THE PROFLIGATE CHANCELLOR

HIGHER TAXES TO COME

Ruth Lea

THE AUTHOR

Ruth Lea is Director of the Centre for Policy Studies. She is on the University of London Council and is a Governor of the London School of Economics. She has served on the Council of the Royal Economic Society, the National Consumer Council, the Nurses' Pay Review Body, the ONS Statistics Advisory Committee, the ESRC Research Priorities Board and the Retail Prices Advisory Committee. She is the author of many papers including *Education and training: a business blueprint for reform*, *Healthcare in the UK: the need for reform*, *CAP: a catalogue of failure*, *The Work-Life balance...and all that* and *Red tape in workplace*. She was Head of the Policy Unit at the Institute of Directors (IoD) between 1995 and 2003. Prior to the IoD, she was the Economics Editor at ITN, was Chief Economist at Mitsubishi Bank and Chief UK Economist at Lehman Brothers. She also spent 16 years in the Civil Service in the Treasury, the Department of Trade and Industry and the Central Statistical Office.

The aim of the Centre for Policy Studies is to develop and promote policies that provide freedom and encouragement for individuals to pursue the aspirations they have for themselves and their families, within the security and obligations of a stable and law-abiding nation. The views expressed in our publications are, however, the sole responsibility of the authors. Contributions are chosen for their value in informing public debate and should not be taken as representing a corporate view of the CPS or of its Directors. The CPS values its independence and does not carry on activities with the intention of affecting public support for any registered political party or for candidates at election, or to influence voters in a referendum.

ISBN No: 1 903 219 67 1

Centre for Policy Studies
57 Tufton Street, London SW1P 3QL
Tel: 020 7222 4488 Fax: 020 7222 4388
e-mail: mail@cps.org.uk

website: www.cps.org.uk

Printed by The Centre for Policy Studies, 57 Tufton Street, London SW1

CONTENTS

.

CHAPTER ONE
SUMMARY

1.1 INTRODUCTION

On 17 March 2004, the Chancellor of the Exchequer is due to present his eighth budget. His first was in July 1997.

This paper analyses the Chancellor's record as custodian of the nation's finances. It concludes that there have been two Chancellors. In his first two years, he adopted the previous Conservative administration's rather strict plans and even in 1999 public spending was under control. The public finances flourished. This was the high summer of the Prudent Chancellor.

But from 2000 onwards, the Prudent Chancellor was replaced by the Chancellor "with a purpose". Since 2000:

- the growth of public spending has been extraordinarily rapid;
- the tax burden continued to increase sizeably;
- financial caution has been abandoned and there is now a sizeable "black hole" in the public finances;
- the unreformed public services have failed to deliver efficiently and effectively.

The Profligate Chancellor has replaced the Prudent Chancellor.

1.2 THE PUBLIC SECTOR: A GROWTH INDUSTRY

Chapter 2 analyses the main developments in public spending and public employment. Its main conclusions are:

- total public sector spending growth was squeezed in FY 1997 (financial year 1997-98) and FY 1998. It grew modestly in FY1999. But in FY2000 spending increased rapidly and has done since;
- in FY1997 total spending was £322 billion. In FY2005, it is planned to be £519 billion (42% of GDP at market prices). Total Managed Expenditure (TME) is, therefore, planned to increase by nearly £200 billion in eight years. This easily outstrips GDP growth over the period. As a consequence, public spending is set to take an increased share of the nation's output. (Section 2.1.);
- the estimates of public spending as a share of GDP are, arguably, significantly underestimated. If, for example, GDP at "basic prices" (excluding taxes net of subsidies on products) is taken as the divisor instead of GDP at market prices, then the public sector's share of GDP could be some five percentage points higher. (See Annex to Chapter 2.);
- high public spending "crowds out" the private sector. Spending as a proportion of GDP should be cut back by ensuring public spending grows slower than GDP. (Section 2.3.);
- as public spending has soared, public sector employment has increased significantly. Moreover, there is rising concern that many of the new public sector jobs are "non productive". For example, the number of NHS managerial and administrative staff, who now out-number beds, has grown quicker than the number of nurses. (Sections 2.4 and 2.5.);
- there is much disquiet about public sector productivity and the efficient and effective delivery of public services. According to experimental work by the ONS, productivity has actually been falling since 1998. (Section 2.6.).

1.3 TAXATION: AN INCREASING BURDEN

Chapter 3 looks at the increasing tax burden and its main conclusions are:

- central government tax receipts were nearly £350 billion in FY2002, nearly £90 billion higher than they were just six years earlier. This amounts to an increase of £1,500 for every man, woman and child in the country. This is a tax increase on a grand scale. (Section 3. 2);
- more and more people are trapped into paying tax. Moreover, the Chancellor's profligate spending of taxpayers' money on the public services arguably hurts the poorest the most: the bottom quintile (by gross income including cash benefits) pays the most taxes as a proportion of income. (Section 3.3.).

1.4 THE BORROWING CHANCELLOR

The conclusions of chapter 4, on the public finances, are:

- the public finances are now deteriorating rapidly, despite a higher tax-take. Borrowing is expected to be around £37 billion in FY2003 (about 3½% of GDP). (Section 4.1.);
- the Chancellor missed the Maastricht excessive deficit rule for calendar 2003. (Sections 4.1);
- the Chancellor's forecasts for borrowing are optimistic. He expects the public finances to improve for FY2004 and beyond and remains confident that he will meet his golden rule for the current economic cycle (FY1999 to FY2005). (Sections 4.2 and 4.3.);
- many commentators – including the OECD, the IMF, ITEM, the IFS and NIESR – are not so optimistic. They have all indicated that there is, at the very minimum, a risk that the golden rule will be breached, unless there are further tax hikes and/or public spending is reined in. (Section 4.4.).

CHAPTER TWO
THE PUBLIC SECTOR: A GROWTH INDUSTRY

> So lightly as it comth, so wol we spende.
>
> Geoffrey Chaucer, *Canterbury Tales: The Pardoner's Tale*

2.1 INTRODUCTION

There is little doubt that Gordon Brown started out as a prudent Chancellor, not least of all because he adopted the, arguably, hair shirt spending plans for the first two years of the new Labour Government from the previous Conservative administration. But as this chapter shows, prudence has been replaced by profligacy. The Chancellor's mantra "Prudent for a Purpose", insofar as it means anything at all, can be interpreted as being "prudent" in the first term, lulling people into a false sense of security so that they would trust him with the public purse, so that the "purpose" of pumping sizeable extra taxpayers' funding into the unreformed public services could be "afforded" in the second. The money does indeed seem to "come lightly" to the Chancellor. And how he spends it.

2.2 PUBLIC SECTOR SPENDING: THE CHANCELLOR'S RECORD

Table 1 shows public sector spending – or to use the Treasury's term "Total Managed Expenditure (TME)."[1] It includes data in both current prices and constant FY 2002 (financial year 2002-03) prices.

---

[1] See Annex 1 for more details on terminology.

Public spending was, if anything, squeezed in FY1997 and FY1998 and growth remained modest in FY1999. Such was the control over public spending that TME as a proportion of GDP fell back quite sharply. This was indeed the time of the prudent Chancellor.

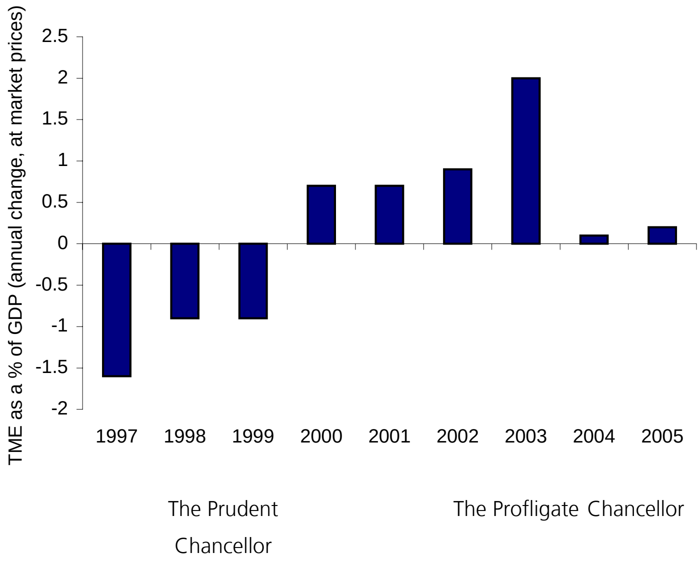
Since then, public expenditure growth has easily outstripped GDP growth in both constant and, especially, current prices. (The latter feature indicates that public sector inflation has tended to outstrip whole economy inflation.) TME as a proportion of GDP began climbing in FY2000 and is set to hit 42% in FY2005.[2] Public spending is set to take an ever-greater share of the nation's output, thus crowding out the private sector.

TABLE 1: GROWING TOTAL MANAGED EXPENDITURE (TME)

	TME FY2002 prices		TME Current prices		TME as % of GDP at market prices	
Outturns	**£bn**	**% growth**	**£bn**	**% growth**	**£bn**	**% growth**
FY1996	365.2		Na		40.8	
FY1997	364.2	– 0.3	322.1		39.2	– 1.6
FY1998	364.9	0.2	331.0	2.8	38.3	– 0.9
FY1999	368.8	1.1	341.5	3.2	37.4	– 0.9
FY2000	388.9	5.4	363.5	6.4	38.1	0.7
FY2001	403.3	3.7	391.8	7.8	38.8	0.7
FY2002	419.1	3.9	419.1	7.0	39.7	0.9
Projections						
FY2003	Na		460.2	9.8	41.7	2.0
FY2004	Na		487.3	5.9	41.8	0.1
FY2005	Na		519.1	6.5	42.0	0.2

Sources: HM Treasury, *Pre-Budget Reports*, 1998-2003.

CHART 1: THE TWO CHANCELLORS



---

[2] These data are all for financial years. Calendar year data show a similar pattern. Data for calendar years are shown in Annex 2, Table 2.

These data of spending to GDP at market prices arguably underestimate the share that the public sector takes of the national income. See the Annex to this Chapter for a technical discussion of this issue.

Spending on health has grown quickly – especially after the April 2002 budget. It is, moreover, projected to show further fast increases.

TABLE 2: GROWING HEALTH SPENDING (current prices)

	Resource (current) budget			Capital budget	
	Total Health		Of which: NHS	Health	Of which: NHS
Outturns	**£bn**	**% annual increase**	**£bn**	**£bn**	**£bn**
FY1996	33.4		32.8	0.4	0.2
FY1997	35.1	5.1	34.5	0.2	0.2
FY1998	37.5	6.8	36.8	– 0.1	– 0.2
FY1999	40.0	6.7	39.4	0.9	0.9
FY2000	43.6	9.0	42.8	1.3	1.3
FY2001	48.7	11.7	47.4	1.8	1.7
FY2002	55.9	14.8	54.2	2.0	1.9
Plans					
FY2003	63.1	12.9	61.4	2.7	2.6
FY2004	68.5	8.6	66.5	3.5	3.4
FY2005	74.7	9.1	72.7	4.4	4.4

Sources: HM Treasury, *Pre-Budget Reports*, 1998-2003.

A useful breakdown is the distinction between the departments' programme spending as shown under "Departmental Expenditure Limits" (DELs), which are the three year limits for departmental spending, and the Annually Managed Expenditure (AME). The latter includes social security benefit spending, public service pension payments and central government debt interest and is treated separately by the Treasury as it is dependent on economic factors strictly beyond the Treasury's control.

As debt interest payments were lower, so could spending in other departments increase… The Prudent Chancellor was already developing the spending habit.

In 1998, the Comprehensive Spending Review[3] showed that DEL expenditure was little over 50% of total spending. But by the July 2002 CSR,[4] DEL spending was nearer 60%. This reflected in part the Chancellor's use of his "windfall savings" to reduce AME spending: as debt interest payments were lower, so could spending in other departments increase. The resources going into departments have, therefore, grown quicker than the total spending figures. The Prudent Chancellor was arguably already developing a bad spending habit.

---

3 HM Treasury, *Comprehensive Spending Review*, 1998.

4 HM Treasury, *2002 Spending Review*, 2002.

Table 3 illustrates this discrepancy in growth between DEL spending and AME spending. Between FY1998 and FY2005, DEL spending rose by 78% while AME spending increased by a modest 28%. TME rose by 53%.

TABLE 3: DEL AND AME COMPARED

	DEL £bn	AME £bn	TME £bn
FY1998 (outturn)	168.8	164.8	333.6
FY2005 (plan)	301.0	210.4	511.4
% increase 1997-2005	+78%	+28%	+53%

Sources: HM Treasury, *Comprehensive Spending Reviews*, 1998 & 2003. See Annex 2, Table 3 for full data.
DEL: Departmental Expenditure Limit.
AME: Annually Managed Expenditure.
TME: Total Managed Expenditure.

2.3 REDUCING PUBLIC SPENDING AS A % OF GDP

The rapid increases in public spending seen since FY2000 should be viewed with alarm. There is strong economic evidence that high levels of public spending "crowd out" private sector activity and undermine growth.[5] And there is little convincing evidence so far that the Chancellor's higher spending has delivered appreciably better services that are efficiently and effectively delivered. There is, therefore, an overwhelming case for cutting back the share of GDP taken up by the public sector.

Norman Blackwell[6] has recommended that the Government should aim to reduce the ratio of public spending to GDP from its forecast level of 42% for FY2005 (see Table 1) back to the 40% recorded for FY2002. This would be achieved by allowing GDP to grow quicker than TME.

This policy has been adopted by Shadow Chancellor Oliver Letwin MP in his statement on Conservative Party public spending plans for FY2005 to FY2011.[7] The basic figures are shown in the Table below. They show that, if public spending was limited to 40% of GDP in FY2011, total spending would be £663 billion, £144 billion greater than in FY2005 but £35 billion lower than if the spending to GDP ratio of 42% were to be maintained.

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

FY2011 TME-GDP ratio, assumption	FY2005 TME (£bn)*	FY2011 TME (£bn)	TME increase FY2005 – FY 2011 (£bn)	TME % increase FY2005 – FY2011
42%	519	698	+ 179	+ 34%
40%	519	663	+ 144	+ 28%

* Assumes that, in FY 2005, TME as a proportion of GDP will be 42%.
Source: Conservative Party website.

---

5 See, for example, David B Smith, *Public Rags or Private Riches: High Public Spending Makes Us Poor*, Politeia, 2001.

6 Norman Blackwell, *Freedom and responsibility: a manifesto for a smaller state, a bolder nation*, Centre for Policy Studies, 2003.

7 Data available from the Conservative party website: www.conservatives.com.

2.4 PUBLIC SECTOR EMPLOYMENT

One obvious consequences of the rapid increase in the share of GDP going into public spending is the impact on employment. The latest official figures for public sector employment relate to 2002.

TABLE 5: GROWING PUBLIC SECTOR EMPLOYMENT

	Total private sector (000s)*		Total public sector (000s)†		Total (000s)		Public sector as % of total
	Level	Annual Change	Level	Annual Change	Level	Annual Change	
1997	19,532	654	4,954	– 115	24,486	539	20.2
1998	19,934	402	4,944	– 10	24,878	392	19.9
1999	20,214	280	5,094	150	25,308	430	20.1
2000	20,696	482	5,094	0	25,790	482	19.7
2001	20,853	157	5,212	118	26,065	275	20.0
2002	20,722	– 131	5,298	86	26,020	– 45	20.4

* Excluding the self-employed and government-sponsored trainees.
† Including HM Forces.
Data are mid-year headcount.
Source: Ole Black and Ian Richardson, "Jobs in the public sector: June 2002," *Labour Market Trends*, September 2003.

Reflecting the squeeze on public spending in FY1997 and FY1998, the number of public sector employees actually fell in 1997 and 1998 – but since then there has been significant public sector growth. It is instructive to note that the private sector actually lost jobs in 2002.

The data for private and public sector employment for 2003 will not be available until summer 2004, but there are already data for 2003 for jobs in "public administration, education and health" (a good proxy for the public sector). And they have boomed in recent quarters.

TABLE 6: WORKFORCE JOBS BY INDUSTRY (HEADCOUNT)

	Sept. 2002	Sept. 2003	Change	
	000s	000s	000s	%
Total	29,517	29,779	262	0.9
Agriculture & fishing	412	434	22	5.3
Energy & water	214	213	– 1	– 0.4
Manufacturing	3,837	3,734	– 103	– 2.7
Construction	1,878	1,984	105	5.6
Distribution, hotels & restaurants	6,883	6,894	11	0.2
Transport & communications	1,804	1,780	– 25	– 1.4
Finance & business services	5,666	5,765	99	1.7
Public admin., education & health	7,026	7,179	153	2.2
Other services	1,797	1,798	0	0

Source: ONS, *Labour market statistics*, ONS, 11 February 2004. Data are seasonally adjusted.

Over the year to September 2003, the clear winners were the public services (with many of the "new" jobs being taken up by women), construction (bolstered by PFI/PPP projects) and finance and business services. Manufacturing continued to haemorrhage jobs. It is reasonable to conclude that the public sector share of total employment increased further in 2003.

2.5 PUBLIC SECTOR EMPLOYMENT: "NON-PRODUCTIVE" JOBS

But why be concerned about the increased number of public sector jobs? One reason is that it is increasingly clear that many of the new public sector jobs appear to be "non-productive". While an increase in the number of teachers, doctors and nurses may be welcome, few of the new jobs seem to be in these "productive" categories.

In the NHS, for example, the numbers of senior managers, managers and clerical and administrative staff have increased significantly since 1996. And they have increased substantially quicker than nursing staff, as Table 7 shows.

TABLE 7: MORE ADMINISTRATORS RECRUITED THAN NURSES

	1996	2001	Change	
			Number	% change
Managers et al*				
Whole time equivalents (WTEs)	152,880	176,600	23,720	15.5%
Headcount	181,620	211,650	30,030	16.5%
Nurses et al†				
Whole time equivalents (WTEs)	248,070	266,170	18,100	7.3%
Headcount	301,250	330,540	29,290	9.7%

Data are for England and are as of 30 September each year.

* The number of senior managers, managers & clerical and administrative staff.

† The number of qualified nursing, midwifery and health visiting staff.

Source: DoH website, data on the NHS HCHS (Hospital and Community Health Services).

In addition the claim that there are now more NHS managers (along with clerical and administrative staff) than beds appears to be true as the next Table shows.

There are now more administrators than beds in the NHS… and more "non-teachers" (in terms of WTEs) than teachers

TABLE 8: MORE ADMINISTRATORS THAN BEDS

	1996	2001	Change	
			Number	% change
Total managers & administrators	181,620	211,650	30,030	16.5%
Total average number of beds†	212,680	199,670	– 13,010	– 6.1%
Ratio of managers to beds	0.85	1.06	0.21	

Sources

* From Table 7.

† Commons Hansard, 17 Dec 2002, Column 793W.

A similar story is unfolding in education. The expansion of "non-teachers" seems to be easily exceeding that of "teachers", as the next Table demonstrates. As a consequence, the ratio of non-teachers to teachers is increasing.

TABLE 9: MORE NON-TEACHERS THAN TEACHERS

	2000	2003	Change	
			Number	% change
Teachers				
Full-time	348,804	372,588	23,784	6.8%
Part-time	137,157	143,159	6,002	4.4%
Total headcount	485,961	515,747	29,786	6.2%
Whole time equivalents (WTE)*	417,383	444,168	26,785	6.4%
Non-teachers				
Full-time	142,678	179,870	37,192	26.1%
Part-time	533,230	583,331	50,101	9.4%
Total headcount	675,908	763,404	87,496	12.9%
Whole time equivalents (WTE)*	409,293	471,637	62,344	15.2%
Ratio of non-teachers to teachers				
Full-time	0.41	0.48	0.07	
Part-time	3.89	4.07	0.18	
Total headcount	1.39	1.48	0.09	
Whole time equivalents (WTE)*	0.98	1.06	0.08	

Data are for England & Wales, as of June each year.

* Assumes 2 Part-time staff equal one Full-time member of staff.

Source: Local Government Employment Survey, 2003.

No discussion about the public sector is complete without a mention of the flourishing market in silly public sector jobs, complete with handsome salaries and generous pensions.[8] Many such jobs are advertised in *The Guardian's* weekly public sector supplement. Last year the Adam Smith Institute (ASI) surveyed these "Guardian jobs" and concluded that their annual cost is around £1 billion (salary alone and excluding perks and pensions).[9] The ASI identified "Five-A-Day Co-ordinators" (to promote five pieces of fruit or vegetables a day), "Walking Officers" (to promote walking) and "Real Nappy Officers" (to promote "real" nappies).

2.6 PUBLIC SECTOR OUTPUT AND PRODUCTIVITY

Have the Chancellor's extra billions for the public services delivered better services? Official productivity data suggests that the extra funding has not delivered the extra services efficiently and effectively.

The measurement of public sector output and productivity is, of course, crucial to any understanding of what may be happening in the public sector. But until 1998, the ONS measured government non-market output at

---

8 A report by the BBC "Public sector wins pension jackpot" (3 December 2002), concluded that the "average" public sector pay and benefits package had outstripped, for the first time, that of the private sector. This had (partly) arisen because of the mass closure of private sector final salary pension schemes. This report is available from the BBC's website: www.bbc.co.uk/news.

9 Adam Smith Institute, *Five-A-Day officers "Silliest public job in Britain"*, 2003.

constant prices by equating output to the sum of all deflated inputs.[10] This was clearly unsatisfactory and the ONS is to be congratulated on compiling new measures of output and gradually introducing them into the national accounts. The new-style measures now cover about 70% of the public sector and the areas covered include health and education.[11]

Last year the ONS released a path-breaking paper on government output and productivity",[12] which included "a first experimental estimate of overall government productivity" for the period from 1995 to 2001. On the basis of this estimate, productivity rose between 1996 and 1998 but fell in 1999, 2000 and 2001 (interestingly enough when government spending boomed), as shown in the Table below.

TABLE 10: FALLING PUBLIC SECTOR PRODUCTIVITY

	£bn (volume data, 1995 prices)							Change
All functions	**1995 base**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**1995-2001**
Volume of government output	141.0	142.7	142.8	145.0	149.4	152.5	156.4	
Annual change		1%	0%	2%	3%	2%	3%	11%
Volume of government input	141.0	142.4	141.4	142.8	149.4	153.9	160.3	
Annual change		1%	– 1%	1%	5%	3%	4%	14%
Annual productivity change		0%	1%	1%	– 2%	– 1%	– 2%	

Source: Alwyn Pritchard, "Understanding government output and productivity", *Economic Trends*, ONS, July 2003.

The ONS paper concluded that "between 1995 and 2001, government output went up by 11% while the volume of its inputs rose by 14%. Over this period, output growth has therefore fallen behind the increase in inputs, implying, on the new experimental measure, a fall in productivity. This suggests that resources are being used less efficiently." To be fair the paper did go on to say "however, there are other possible explanations. For example, the spending may have been on things which improve outcomes but do not contribute to output as measured for national accounts and the output measures may have failed to reflect all the quality improvements made in the outputs."

But caveats apart, this ONS paper did make important observations about public sector productivity, which echo other concerns. One such concern relates to the "soaring" public sector wages bill, which "eats up" much of the

---

10 Timi Ashaye: "Recent developments in the measurement of general government output", *Economic Trends*, ONS, 2001.

11 In December 2003, a National Statistics review of government output measurement was announced, under Sir Tony Atkinson (hence the "Atkinson review"). The review team was asked to report by July 2004 and prepare a final report by Jan 2005.

12 Alwyn Pritchard: "Understanding government output and productivity", *Economic Trends*, ONS, July 2003.

extra funding. The undoubted rise in the wages bill reflects both increased employment and the fact that earnings inflation in the public sector has tended to outstrip that in the private. According to the ONS, earnings inflation for the public sector was running at 5% to 5 ½% for much of 2003, compared with 3% for the private sector. As employee "compensation" accounts for nearly 50% of costs in public administration and around 46% for education and health compared with only 35% for the whole economy, rising earnings and headcount are especially important for these sectors. (See Table 4 in Annex 2 for details.)

2.7 TREASURY PUBLICATIONS: INFLATION

As the public sector has grown, so has the size of the Treasury's publications that are released at the time of the Budget, the Pre-Budget Report (PBR) and (every two years) the Spending Review. Tables 1A to 1C in Annex 2 shows the details. Briefly, the Treasury report in July 1997 was 128 pages long and cost £16.80. In April 2003 it was 294 pages long, with ever-more grandiose language, and cost £45. Similar inflation has occurred to the PBR.

ANNEX TO CHAPTER TWO
SOME MEASUREMENT ISSUES

Like many statistics, public spending data are full of measurement problems. In particular, the way in which spending, and the crucial spending to GDP ratios, over time are calculated is controversial. This section analyses briefly some of the most important measurement issues. They are of the greatest significance, not least because the measures of spending and spending to GDP ratios favoured by government tend to be biased on the downside. In other words, alternative measures of spending and spending to GDP ratios, which are arguably more valid measures, show the state's share of GDP growing even more rapidly than the Government's favoured measures.

GDP AT MARKET PRICES OR FACTOR COST?

The first issue, and arguably the most important, relates to the chosen price basis of GDP. As David B Smith has pointed out,[13] for most of the early post-war period it was accepted that the correct measure of GDP was the "factor cost" measure that excluded indirect taxes and subsidies. (See annex 1 for definitions for the price bases of GDP.) Smith lists three reasons for taking "factor cost" data:

- GDP at factor cost is a more accurate measure of the national output available to support public consumption;

---

13 David B Smith, op. cit.

- public spending pays almost no indirect tax and so a more accurate measure of the level of the spending burden can be achieved if factor cost GDP is used as the divisor;
- the alternative market price measure of GDP, which is gross of indirect taxes, would rise if there were a switch from direct to indirect taxation, even if nothing else had changed.

Unfortunately the "factor cost" data have largely been superseded by data at "basic prices". But the "basic prices" price basis is a similar concept to factor cost – but one that deducts fewer indirect taxes. Data at basic prices deduct taxes on products (eg VAT and duties) less subsidies on products. (Again see annex 1 for details.)

As the following table shows, the taxes on products (net of subsidies) amounted to nearly 11.3 % of GDP at market prices in the year 2002. If TME is taken as a % of GDP at market prices the ratio is 39.3%; if TME is taken as a % of GDP at basic prices (see below) the ratio is 44.3%.

ANNEX TABLE 1: GDP AND TME DATA (YEAR 2002)

	GDP (£bn)	TME* (£bn)	TME-GDP ratio
GDP at market prices	1,043.9	409.8	39.3%
Subtract Taxes on products **plus** subsidies on products	-118.4	Na	Na
GDP (Gross Value Added, GVA) at basic prices	925.584	409.8	44.3%

* TME at market prices – but little difference between TME at basic prices and TME at market prices.

Source: ONS, *United Kingdom National Accounts: the Blue Book 2003*, 2003.

Another aspect of the GDP at market prices versus GDP at basic prices debate is significant. In 2003, GDP at market prices by 2.3% but GVA (an equivalent national accounts concept) at basic prices grew by only 1.9%.

ANNEX TABLE 2: GDP AND GVA

	Chained volume measures 2002					
	GDP at market prices		Less basic price adjustment		GVA at basic prices	
	£ bn	% Growth p.a.	£ bn	% Growth p.a.	£ bn	% Growth p.a.
2000	951.3		112.1		839.2	
2001	971.6	2.1	116.6	4.0	854.9	1.9
2002	987.9	1.7	121.7	4.4	866.3	1.3
2003	1,011.1	2.3	128.2	5.3	882.9	1.9

Source: ONS, *UK output, income and expenditure, 4th quarter 2003*, February 2004.

PUBLIC SPENDING IS PART OF GDP

The second problem arises because public spending is part of GDP – so as public spending rises, so does GDP and this dampens the consequent increase in the spending-GDP ratio. Arguably a more relevant measure of the tax and spending burdens is their ratio to the non-state funded element of GDP. After all the state cannot fund itself and relies on the private sector to generate wealth and taxes. The state generates no funds of its own.

"Public money" is money forcibly taken from people by the state; it is taxpayers' money. Very crudely if public spending is, say, 40% of GDP then the ratio of public spending to non-public spending would be 40% ÷ 60% or 67%.

Consider the following example. Taking general government final consumption (GGFC) (over half total public spending) and calculating GGFC to (GDP minus GGFC) ratios gives a quite alarming picture. The ratio rises significantly more quickly than the straight GGFC-GDP ratio. And given the current rapid increases in public spending in forthcoming years (which will be partly fuelling economic growth), this phenomenon will worsen.

This is all the more important because GGFC is the general government's direct contribution to GDP and, as is shown in section 2.6, its productivity performance is under-performing that of the private sector. As GGFC increases its share of GDP, the overall productivity performance of the economy will, therefore, be undermined.

ANNEX TABLE 3: GGFC BY CALENDAR YEAR, CURRENT MARKET PRICES

	GGFC	GDP	GGFC-GDP ratio		GDP – GGFC	GGFC-(GDP minus GGFC) ratio	
	£bn	£bn	%	% change	£bn		% change
1996	146.2	763.3	19.2		617.1	23.7	
1997	148.2	810.9	18.3	– 0.9	662.7	22.4	– 0.7
1998	154.0	859.4	17.9	– 0.4	705.4	21.8	– 0.6
1999	166.3	903.9	18.4	0.5	737.6	22.5	0.7
2000	177.8	951.3	18.7	0.3	773.5	23.0	0.5
2001	191.2	994.0	19.2	0.5	802.8	23.8	0.8
2002	209.5	1,042.9	20.1	0.9	833.4	25.1	1.3
2003	231.9	1,100.5	21.1	1.0	868.6	26.7	1.6

Sources: ONS, *UK National Accounts (Blue Book 2003*, 2003; ONS press release on GDP for 2003 (February 2004) and author's calculations.

THE PUBLIC SECTOR'S CHANGING COVERAGE

The third concern is the changing coverage of the public sector. An obvious example for the UK is the treatment of the privatised nationalised industries. Before privatisation they were in the public sector, after privatisation they were not.[14] Sometimes analysts attempt to overcome the problems of definitions of the public sector, by using general government data (data for central and local government, excluding the public corporations). But there are problems with inconsistencies here as well. For example, NHS trusts are currently classified as public corporations, but from June 2004 they will be reclassified as part of central government and, hence, general government. (The NHS trusts were classified as public

[14] Note the contentious treatment of the "renationalised" Network Rail's borrowing. It is currently scored as private sector borrowing and will therefore not count towards government debt.

corporations during the switch to ESA95 in 1998. See annex 1 for more on the European System of Accounts (ESA).)

TAX CREDITS: NEGATIVE TAX OR SPENDING?

The fourth concern is the treatment of the Chancellor's revised tax credits. The "new" tax credits (the Working Tax Credit and the Child Tax Credit, introduced in April 2003) count as either negative tax (eg a deduction from income tax) for amounts within the tax liability of the recipient or as a benefit (current expenditure) for amounts that exceed the recipient's tax liability. This treatment applies to both the Treasury's calculations of net taxes and social security contributions (with knock-on effects for spending) and the ONS's national accounts.

But the "old" tax credits (the Working Families' Tax Credit and the Disabled Person's Tax Credit, worth about £6 billion in FY2002) were all treated as negative taxation for the purposes of calculating net taxes and social security contributions, whilst they were treated entirely as benefits in the national accounts.

DON'T FORGET THE PFI

Finally, when looking at projections far beyond the current spending review period, the Private Finance Initiative's (PFI's) liabilities should not be forgotten. It is too easy to regard PFI as the costless option. Yet there are significant costs in the pipeline.

ANNEX TABLE 4: ESTIMATED PFI PAYMENTS

Year	£bn	Year	£bn	Year	£bn
FY2003	5.4	FY2012	5.1	FY2021	3.2
FY2004	5.7	FY2013	5.0	FY2022	3.1
FY2005	5.8	FY2014	4.9	FY2023	3.1
FY2006	6.0	FY2015	4.8	FY2024	3.1
FY2007	6.0	FY2016	4.8	FY2025	3.0
FY2008	5.8	FY2017	4.1	FY2026	1.6
FY2009	5.8	FY2018	3.6	FY2027	1.3
FY2010	5.6	FY2019	3.4	FY2028	1.2
FY2011	5.3	FY2020	3.6		

Data are for projections for signed deals, April 2003.

Source: HM Treasury, *Budget 2003*, 2003.

CHAPTER THREE
TAX: AN INCREASING BURDEN

> There is no art which one government sooner learns of another than that of draining money from the pockets of people.
>
> Adam Smith, *Wealth of Nations*

> The Chancellor of the Exchequer is a man whose duties make him more or less a taxing machine. He is entrusted with a certain amount of misery which it is his duty to distribute as fairly as he can.
>
> Robert Lowe, Viscount Sherbrooke (1811-92, Liberal politician)

3.1 INTRODUCTION

Mirroring the large increases in public spending, there have been large increases in taxation. There is little doubt the current Chancellor is a strong advocate of "tax 'n' spend" policies. Moreover, he seems to believe that taxing people of their rightly earned income is "fair" (the Chancellor's "fairer society" can be seen as enforced income distribution) as they can "afford" it. To forcibly tax people on their hard earned incomes, on the promise of some redistributive utopia, is, apparently, "fair and just".

But this interpretation should be challenged. People's incomes from employment, for example, are directly related to their current work effort. And even though they can arguably "afford" to pay more tax, it is not clear why it is regarded as fair and moral that they should. In fact just the opposite can apply. If people work hard, there is a strong moral cased for allowing them to keep most of their hard-earned earnings and not siphoning it off into public sector projects – many of which are of dubious worth and are delivered inefficiently.

But not only has the Chancellor taxed people more heavily, he has made the tax system increasingly complicated. There is an urgent need for tax simplification. Maurice Saatchi and Peter Warburton have made three proposals in this respect:[15]

- to clear up the muddle at the heart of our current tax system, the absurd overlap between taxes and benefits;
- to simplify the system by exchanging the existing web of allowances, reliefs, credits, tax breaks and indexations for lower tax rates;
- to merge selected government departments. This, they calculated, would result in a 20-30% saving in administrative costs, all of which could be used to boost investment in health and education.

This Chapter shows how the tax burden has been rising in recent years and how it is expected to continue rising. It does not go into the tax system in detail – for example, how rates have changed or how Labour's stealth taxes taxes have been introduced.[16]

3.2 LABOUR'S TAX RECORD

In his 1997 Budget report the Chancellor stated that one of his aims was "keeping the overall burden of taxation as low as possible". And in its 1997 Manifesto, the Labour party said "save and invest, not tax and spend… New Labour is not about high taxes for ordinary families… Our long-term objective is a lower starting rate of tax. This goal will benefit the many, not the few… New Labour will establish a new trust on tax with the British people. The promises we make we will keep."

It is hard to reconcile these statements with what has actually happened.[17]

Starting with central government tax receipts, they have risen rapidly since FY 1996, as Table 11 demonstrates. These data omit local authority taxes and the rises in Council Tax.

The Table shows that between FY1996 and FY2002, total central government cash revenue increased by one third, at a time when retail prices rose by about only one tenth. Total receipts in FY2002, at nearly £350 billion, were nearly £90 billion higher than they were just six years earlier. This amounts to an increase of £1,500 for every man, woman and child in the country. This is a tax increase on a grand scale.

---

15 Maurice Saatchi and Peter Warburton, *The War of Independence*, CPS, 1999. The authors developed their ideas in *The Bad Samaritan*, CPS, 2000.

16 See *45 Stealth taxes under New Labour*, CPS. 2001.

17 See Keith Marsden, *Gordon Brown and British competitiveness*, CPS, 2003 for a comparison of the Chancellor's pledges and the outturns.

TABLE 11: GROWING CENTRAL GOVERNMENT CASH RECEIPTS (CASH BASIS)

	Inland Revenue			Customs & Excise			
	Total £bn	Income tax	Corp. tax	Total	VAT	Social security contributions	Total*
FY1996	104.0	70.2	27.8	82.4	46.6	45.1	261.4
FY1997	117.6	78.3	30.4	89.8	50.6	49.3	287.1
FY1998	128.2	88.5	30.0	94.0	52.3	53.2	304.6
FY1999	139.4	96.0	34.3	97.3	56.4	54.6	320.2
FY2000	149.1	108.4	32.4	102.2	58.5	58.5	364.9†
FY2001	149.1	111.0	32.0	104.9	61.0	61.0	347.1
FY2002	145.9	111.1	29.3	108.7	63.5	62.6	348.4
Growth							
1996-02	40.3%	58.3%	5.4%	31.9%	36.3%	38.8%	33.3%

Sources: ONS, *Public sector finances: January 2004*, 2004.

* The total also includes interest and dividend receipts and "other receipts".

† Includes cash receipts of £22.5 billion, paid by the mobile phone companies.

From 1996 to 2002, government revenue increased by a third… the equivalent of £1,500 for every man, woman and child in the country.

Table 12 shows the basic data for taxes as a % of GDP. As with public spending, there are measurement problems.[18] In particular, it should be noted:

- the treatment of tax credits as negative income tax in the Treasury's analysis of public sector statistics;
- GDP at market prices gives lower tax-GDP ratios than GDP at basic prices (or better still at factor cost) that, arguably, is a better measure;
- arguably, taxes should be taken as a ratio of non state-funded GDP.

18 See Annex to Chapter 2 for details.

TABLE 12: GROWING CURRENT RECEIPTS

	Net taxes & social security contributions	Public sector current receipts
	% of GDP at market prices	
FY1996	34.8	37.2
FY1997	36.0	38.4
FY1998	36.5	38.7
FY1999	36.5	39.0
FY2000	37.3	39.7
FY2001	36.7	38.8
FY2002 (outturn)	35.6	37.6
FY2003 (estimate)	35.9	38.1
FY2004 (projection)	36.7	38.9
FY2005 (projection)	37.3	39.5
FY2006 (projection)	37.7	39.9
FY2007 (projection)	38.0	40.2
FY2008 (projection)	38.2	40.4

Sources: HM Treasury, *Pre-Budget Report*, 2003.

The tax-GDP ratio rose significantly between FY1996 (when it was 34.8%) and FY2000 (when it was 37.3%). It slipped back in FY2001 and FY2002, but has probably risen in FY2003 (largely as a result of the NICs rate increase that came into effect in April 2003) and is on a trajectory to increase every year until the end of the Treasury's projected period (FY2008). According to the Treasury,[19] the increase in the ratio from FY2004 onwards is largely driven by the factors including fiscal drag (see annex 1 for a discussion of fiscal drag) and the recovery of financial company profits.

As a consequence of the rapid rise in taxes, the "average Brit" spends more of his/her working year paying his/her taxes.[20] And, moreover, it has been calculated that average after tax "take home" pay actually fell following the increase in NIC rates in April 2003.[21]

3.3 WHO PAYS?

The Chancellor's demands for taxes trap ever more people into paying taxes. 25.7 million people were paying tax to the Inland Revenue in FY1996 but by FY2003, this had increased to 30.7 million.[22] While part of the explanation is the increase in employment (see Chapter 2 for data), this is not the whole explanation.

---

19 HM Treasury, *Pre-Budget Report 2003*, 2003.

20 The Adam Smith Institute has calculated that "Tax Freedom Day", the day the average taxpayer starts working for himself/herself as opposed to the government, is slipping. In 2002 Tax Freedom Day was 1 June and in 2003 it was 2 June. But in 2004 it will be 7 June and in 2005 it will be 9 June.

21 Allister Heath, "Take-home pay falls as higher tax takes toll", *The Business*, 15 February 2004.

22 David Hughes: "Record 31 million are sucked into Labour's tax trap", *Daily Mail*, 27 August 2003, using Inland Revenue data.

Another reason is the low level of personal allowances. People start paying income tax "far too early".[23] In FY2002 the personal allowance for income tax purposes was just £4,615 a year or £89 a week. It was "frozen" by the Chancellor for FY2003. This decision, arguably, hit the worst paid the most. A personal allowance of £89 a week means that if a person works for 20 hours at the current minimum wage of £4.50 an hour, then he or she starts paying income tax and NICs.

The poorest pay 42% of their gross income in tax – more than anyone else.

Taking indirect and direct taxes together, the lowest income groups (which include many pensioners) pay a disproportionate amount of tax. Table 13 shows that the bottom quintile pays 42% of its gross income (income plus cash benefits) in taxes, whilst all other quintiles pay substantially less.

TABLE 13: POOR HOUSEHOLDS PAY MORE TAX

	Quintile groups of all households					All
	Bottom	**2nd**	**3rd**	**4th**	**Top**	**households**
	% of gross income paid in tax					
Direct taxes						
Income tax	3.2	6.9	10.3	13.5	18.4	13.8
Employees' NICs	1.2	2.4	4.0	4.8	3.9	3.8
Local taxes	7.3	4.8	3.8	2.9	1.8	3.0
All direct taxes	11.6	14.1	18.1	21.3	24.0	20.6
Indirect taxes						
VAT	11.5	7.5	7.0	6.3	4.7	6.1
Duty on alcohol	1.6	1.0	1.0	0.9	0.6	0.9
Duty on tobacco	3.1	1.8	1.6	0.9	0.3	1.0
Duty on fuel & vehicle excise duty	3.4	2.4	2.4	2.1	1.3	1.9
Other indirect taxes	10.9	7.1	5.8	5.0	3.6	5.1
All indirect taxes	30.4	19.8	17.8	15.2	10.5	15.0
All taxes	**42.1**	**34.0**	**35.9**	**36.5**	**34.6**	**35.6**

Source: Caroline Lakin: "The effects of taxes & benefits on household income, 2001-2002", ONS, 2003.

[23] Maurice Saatchi and Peter Warburton discuss this iniquitous situation in their pamphlet *Poor people! Stop paying tax!*, CPS, 2001.

CHAPTER 4
THE BORROWING CHANCELLOR

> Neither a borrower, nor a lender be;
> For loan oft loses both itself and friend,
> And borrowing dulls the edge of husbandry.
>
> William Shakespeare, *Hamlet*

> Annual income twenty pounds, annual expenditure nineteen nineteen six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery.
>
> Charles Dickens, *David Copperfield*

4.1 INTRODUCTION

In 1997, the Chancellor inherited a situation in which the Public Sector Borrowing Requirement (PSBR) was improving (after the disastrous experience of the early-mid 1990s). In November 1996 the then Conservative Chancellor expected a PSBR of £26.4 billion for FY1996 (it eventually came in at under £23 billion) and his projections showed a return to negative borrowing (a positive "Public Sector Debt Repayment") in FY2000. These projections did not look especially unreasonable.

The continuing tight public spending for FY1997 to FY1999, together with increased taxes – such as the removal of the tax credit on dividends – and good economic growth contributed to a rapid return to financial health. Negative borrowing was recorded for FY1998 to FY2000. These were the "golden years" of the prudent Chancellor.

Since 2000, spending has increased rapidly, resulting in quickly deteriorating finances. This was despite higher taxes, not least the increase in NICs in April 2003. Thus borrowing was roughly in balance in FY2001 but has rapidly shot up since then: the Public Sector Net Borrowing (PSNB) for FY2002 was £22.5 billion and it is widely expected to be around £37 billion for FY2003.

4.2 CURRENT DEVELOPMENTS

Much to many people's surprise, recent GDP growth has been roughly in line with the Treasury's forecasts. Yet revenues have been disappointing. And this has damaged the borrowing figures. As Table 14 demonstrates, even though VAT receipts have been buoyant (reflecting the strong retail sales) and NICs contributions are higher (reflecting the higher rates since April 2003), other categories of revenue have been weak.

TABLE 14: WEAKENING GOVERNMENT REVENUES

	FY2002 £bn	FY2003 £bn	Change (FY2003 minus FY2002) £bn
Current receipts			
Taxes on production (including VAT)	118.6	125.9	7.3
Taxes on income & wealth	119.0	120.9	1.8
Other taxes	5.2	5.3	0.1
Compulsory social contributions	50.4	58.9	8.5
Interest & dividends	6.8	6.3	– 0.5
Other receipts	5.5	5.1	– 0.4
Total current receipts	305.6	322.4	16.7
Current expenditure			
Interest	17.9	19.2	1.3
Net social benefits	96.7	102.9	6.2
Other current expenditure	195.9	214.9	19.0
Total current expenditure	310.6	337.0	26.5
Depreciation	– 3.8	– 3.8	0
Current budget	– 8.7	– 18.5	– 9.7
Investment	12.8	17.0	4.2
Depreciation	3.8	3.8	0
Net investment	9.0	13.2	4.2
Net borrowing	**17.7**	**31.7**	**13.9**

These relate to central government finances, April to January, not seasonally adjusted.

Source: ONS, *Public Sector Finances*: *January 2004*, February 2004.

Moreover, the Chancellor missed one of the Maastricht "targets" for calendar year 2003. The Maastricht "targets" are that:

- the general government deficit should not exceed 3% of GDP;
- general government debt should not exceed 60% of GDP.

As Table 15 shows, he met the debt target easily, but just missed the deficit target.

The public balances: some definitions and some recent history

The world of public sector statistics and terminology is arcane, but three basic concepts are important (they are discussed in more detail in annex 1):

- The *surplus on the current budget* (current surplus) is the balance of total current receipts minus total current expenditure, net of depreciation;
- *Net Borrowing* (NB) is net investment minus the current surplus. The Public Sector Net Borrowing (PSNB) relates to the whole of the public sector;
- The *Net Cash Requirement* (NCR) is net borrowing plus the balance of "financial transactions determining the net cash requirement" including items such as net lending to the private sector and the rest of the world. The NCR for the public sector (as opposed to, for example, central government) is the Public Sector Net Cash Requirement (PSNCR), previously known as the Public Sector Borrowing Requirement (PSBR).

TABLE 15: MISSING A MAASTRICHT TARGET

	2000 calendar year	2001 calendar year	2002 calendar year	2003 calendar year
General government deficit				
Net borrowing (£bn)	– 14.2	– 8.0	15.2	33.9
As a % of GDP	– 1.5	– 0.8	1.5	3.1
General government debt				
Debt at nominal value (£bn)	400.4	386.4	401.3	438.4
As a % of GDP	42.1	38.9	38.5	39.8

Source: ONS, *Government deficit and debt under the Maastricht Treaty*, February 2004.

4.3 PROJECTIONS WITH A PINCH OF SALT

As already stated the FY2003 data are likely to be worse than in FY2002. However, the Chancellor, in his December 2003 Pre-Budget Report, still expected improvements in the balances between FY2004 and FY2008. But these projections should be taken with a pinch of salt. As Tables 5A and 5B in Annex 2 show, the Chancellor has had to revise down his projections for the current budget surplus, and revise up his projections for borrowing, in every budget and pre-budget statement since March 2001.

For every budget since March 2001, the Chancellor has had to revise downwards his projections for the budget surplus; and revise upwards his projections for borrowing.

Tables 16A and 16B clearly show that, since the March 2002 budget, the Treasury has had to revise the balances consistently and sizeably in a negative direction.

TABLE 16A: BAD FORECASTS ON BUDGET SURPLUS

	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008
	Public Sector Current Budget Surplus, £bn						
Budget 2002	3	7	9	7	9	Na	Na
PBR 2002	– 5.7	– 5	3	5	8	10	Na
Budget 2003	– 11.7	– 8.4	– 1	2	6	9	Na
PBR 2003	– 11.8	– 19.3	– 8.3	– 4.7	0	4	8
PBR 2003 minus Budget 2002	**– 14.8**	**– 26.3**	**– 17.3**	**– 11.7**	**– 9**	**Na**	**Na**

TABLE 16B: BAD FORECASTS FOR BORROWING

	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008
	Public Sector Net Borrowing, £bn						
Budget 2002	11	13	13	17	18	Na	Na
PBR 2002	20	24	19	19	19	20	Na
Budget 2003	24	27	24	23	22	22	Na
PBR 2003	22.5	37.4	31	30	27	27	24
PBR 2003 minus Budget 2002	11.5	24.4	18	13	9	Na	Na

Sources: HM Treasury, *Financial Statement and Budget Reports* for 2002 and 2003 and *Pre-Budget Reports* for 2002 and 2003.

4.4 THE CHANCELLOR'S FISCAL RULES

The Chancellor's fiscal rules 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. So to accord with the rule, the average surplus on the current account over the cycle should be positive (or, at least zero). HM Treasury's judgement is that the current economic cycle began in FY1999 and will end with FY2005;
- **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 sector net debt should be below 40% of GDP over the cycle.

The Chancellor is well within his sustainable investment rule. And, so far, the Treasury has projected data showing that he will meet his golden rule for the FY1999 to FY2005 cycle – though it looks increasingly likely it will be broken. In the 2003 Pre-Budget Report, he claimed, on the basis of figures shown in Table 17, that he would meet the golden rule for the cycle FY1999 to FY2005 with a cumulative current budget surplus of £14 billion. This has since been revised to £16 billion.

TABLE 17: MEETING THE FISCAL RULES

	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08
Golden rule										
Surplus on current budget (% of GDP)	2.1	2.1	0.9	– 1.1*	– 1.7	– 0.7	– 0.4	0	0.3	0.6
Sustainable investment rule										
Public sector net debt (% of GDP)	36.2	31.2	30.2	30.9*	32.8	33.8	34.6	35.1	35.4	35.5

* Since revised by the ONS to –1.2% and 30.8% respectively.

Sources: ONS: *Public Sector Finances, 2004*, 2004; HM Treasury, *Pre-Budget Report, 2003.*

4.5 WILL THE GOLDEN RULE BE BROKEN?

As already indicated, there are increasing expectations that the golden rule will be broken, unless either:

- there are more tax increases; and/or,
- public spending plans are reined back.

There is, in other words, widespread scepticism that the improvements to the public finances as projected in the 2003 PBR will be achieved. Many respected commentators are on the record saying that the golden rule is looking fragile, at best, and dead in the water, at worst:

- the OECD has warned the Chancellor to either raise taxes or cut spending in order to avoid breaking his fiscal rules;[24]
- The IMF has stated that "in our view, in the absence of actions…the risk of breaking the golden rule in the current cycle is not trivial";[25]
- ITEM has said that "it is increasingly likely that the government will show a deficit over this economic cycle. ITEM's forecast suggests that the "golden rule" will be breached in FY2005 or FY 2006";[26]
- The IFS has said that "given the size and direction of recent forecasting errors, even on the Treasury's own figures it is touch-and-go whether the golden rule can be met over the current cycle without reducing existing spending plans or raising more revenue";[27]
- NIESR has said that "the letter of the golden rule is close to being broken".[28]

It is, moreover, instructive to note just how far adrift two of the most respected British forecasters, the IFS and NIESR, are away from the Treasury's forecasts of the public sector finances. Their forecasts are shown in Tables 18A and 18B. NIESR's projections are especially worrying. But the IFS forecast should not be regarded with any complacency.

---

24 A Fifield, "OECD prudence warning for Brown", *Financial Times*, 27 November 2003.

25 Quoted in the IoD's Budget Representations, March 2004.

26 Quoted in the ITEM Club's *Economic Update*, December 2003, Ernst and Young.

27 Robert Chote et al (editors), *The IFS Green Budget: January 2004*, IFS, January 2004.

28 NIESR, *National Institute Economic Review*, January 2004.

TABLE 18A: PUBLIC SECTOR CURRENT BUDGET SURPLUS (£BN)

	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008
PBR 2003	– 11.8	– 19.3	– 8.3	– 4.7	0	4	Na
IFS (Jan 2004)	Na	– 18.7	– 12.0	– 12.7	– 11	– 7	Na
NIESR (Jan 2004)	– 10.6	– 19.1	– 17.0	– 18.2	– 15.7	– 13.3	– 10.6

TABLE 18B: PUBLIC SECTOR NET BORROWING (£BN)

	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008
PBR 2003	22.5	37.4	31.0	29.9	27	27	Na
IFS (Jan 2004)	Na	36.7	34.7	37.9	38	38	Na
NIESR (Jan 2004)	20.9	36.8	38.6	42.3	42.4	42.2	41.5

Sources: Robert Chote et al (editors), *The IFS Green Budget: January 2004*, IFS, January 2004; NIESR, *National Institute Economic Review*, January 2004).

ANNEX 1
GLOSSARY OF KEY TERMS

Annually Managed Expenditure (AME): see Total Managed Expenditure (TME).

Basic prices: see prices.

Comprehensive Spending Review (CSR): see Treasury statements.

Control total (public expenditure): see Total Managed Expenditure.

Current balance (surplus or deficit on current budget): see public finances accounts.

Departmental Expenditure Limits (DEL): see Total Managed Expenditure (TME).

European System of Accounts (ESA): or, more fully, the European System of National and Regional Accounts. An integrated system of economic accounts which is the European version of the System of National Accounts (SNA), which is the internationally agreed standard system for macroeconomic accounts. The current UK national accounts are based on the European System of Accounts, the 1995 version – known as ESA95. ESA95 was based on SNA93.

Factor cost: see prices.

Financial Statement and Budget Review (FSBR): see Treasury statements.

Fiscal drag: the effect of inflation upon effective tax rates or, sometimes, the effect of growth in nominal GDP on tax revenues. Under progressive income tax systems, increases in earnings may push people into higher tax brackets. In a tax system that is not indexed for taxation, this has the result that simply increasing earnings to keep pace with inflation will generate higher tax revenues. With the decline of inflation rates across the west since the 1980s, the term fiscal drag has loosely been used to refer to the fact that, even in an indexed system, if earnings grow more quickly than prices, then the government again ends up with extra revenues without having to raise tax rates in explicit policy changes. It acts as a restraining effect of progressive taxation on income expansion. Fiscal drag can also serve to automatically constrain the effect of the pressure of inflation in the economy. It appears to have declined in the UK in the last decade, as the progressivity of the tax system has fallen. (The reverse situation can arise if earnings fell.) "Fiscal boost" is sometimes used to describe the situation where inflation can lead to a proportional decrease in the tax take of certain "volume" taxes, eg petrol duties.

Fiscal rules: these 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.

General government: see public sector.

Golden rule: see fiscal rules.

Maastricht "excessive deficits and debt": these were determined by a protocol to the Maastricht Treaty and are:

- the general government deficit should not exceed 3% of GDP;
- general government debt should not exceed 60% of GDP.

The increase in general government gross consolidated debt at nominal value (for Maastricht purposes) = general government net borrowing (GGNB) + the net acquisition of financial assets – swaps + consolidating transactions in Maastricht debt instruments – "other accounts payable" + other adjustments.

Market prices: see prices.

Pre-Budget Report (PBR): see Treasury statements.

Prices: there are several methods of measuring prices in the national accounts. The key ones are:

- **Basic prices:** these prices are the ONS's preferred method of valuing gross value added (GVA) and output. They reflect the amount received by the producer for a unit of goods or services minus any taxes payable plus any subsidy receivable on that unit as a consequence of production or sale (ie the cost of production including subsidies). As a result the only taxes included in the basic price are taxes on the production process – such as business rates and any vehicle excise duty paid by businesses – which are not specifically levied on the production of a unit of output. Basic prices exclude any transport charges invoiced separately by the producer.
- **Producers' prices:** these equal basic prices plus those taxes paid (other than VAT or similar deductible taxes invoiced for the output sold) per unit of output less an subsidies received per unit of output.
- **Purchasers' prices or market prices:** essentially these are the prices paid by the purchaser & include transport costs, trade margins & taxes (unless the taxes are deductible by the purchaser), ie: Purchasers' price equals producers' price plus any non-deductible VAT or similar tax payable by the purchaser plus transport prices paid separately by the purchaser & not included in the producers' price.
- **Prices at factor cost:** in the former system of national accounts these were the basis of valuation; they excluded the effects of taxes on expenditure and subsidies.

The relationship between the types of prices are shown in the Table below:

ESA95 code	
	GDP, at market prices
D.211	**Less** value added taxes (VAT) on products
D.212, D.214	**Less** other taxes on products (eg alcohol duty)
D.31	**Plus** subsidies on products
	Equals Gross value added, at basic prices
D.29	**Less** taxes on production other than taxes on products (eg business rates, vehicle excise duty paid by businesses & operating licences)
	= Gross value added, at factor cost

Private Finance Initiative (PFI): an arrangement whereby the private sector provides an asset-based public service under contract to a public body. This could involve the designing, financing, building and operating of assets providing the public services. The PFI was launched in 1992. A Public Private Partnership (PPP) is a risk-sharing relationship based upon a shared aspiration between the public sector and one of more partners from the private and/or voluntary sectors to deliver a publicly agreed outcome and/or public service.

Producers' prices: see prices.

Public expenditure: see Total Managed Expenditure.

Public finances – accounts: the key terms and relationships are shown in the Table below on public sector transactions by sub-sector and economic category:

1 Total current receipts	Taxes on income & wealth + taxes on production (including VAT) + other current taxes + taxes on capital + compulsory social security contributions + gross operating surplus + interest & dividends from private sector & RoW (rest of world) + interest & dividends (net) from public sector + rent & other current transfers
2 Total current expenditure	Current expenditure on goods & services + subsidies + net social benefits + net current grants abroad + current grants (net) within general government + other current grants + interest & dividends paid to the private sector & RoW
3 = 1-2 Saving, gross plus capital taxes	
4 Less depreciation (conventionally shown as negative in the accounts)	
5 = 3+4 Surplus on the current budget (current balance)*	
6 Total net investment	Gross fixed capital formation (GFCF) less depreciation + increase in inventories & valuables + capital grants (net) within public sector + capital grants to private sector + capital grants from private sector
7 = 6-5 Net borrowing (NB)†	
8 Financial transactions determining the net cash requirement (NCR)	Net lending to private sector & RoW + net acquisition of company securities + accounts receivable/payable + adjustment for interest on gilts + other financial transactions
9 = 7+8 Net cash requirement (NCR) ‡	

* The surplus on the current budget can also be defined as: current resources minus current uses (= net saving) plus receipts of capital taxes.

† Public Sector Net Borrowing (PSNB) is the net borrowing for the total public sector. It is the balance between income and expenditure in the consolidated current and capital accounts and is measured on an accruals basis.

‡ The Public Sector Net Cash Requirement (PSNCR) is the net cash requirement for the total public sector. It is measured on a receipts basis. The PSNCR can also be defined as public sector cash receipts minus public sector cash outlays. It was previously known as the Public Sector Borrowing Requirement (PSBR).

Public Private Partnerships (PPPs): see Private Finance Initiative.

Public sector: this comprises:

- general government (central government and local government);
- public corporations.

Public Sector Borrowing Requirement (PSBR): see public finances accounts.

Public Sector Net Borrowing (PSNB): see public finances accounts.

Public Sector Net Cash Requirement (PSNCR): see public finances accounts.

Public sector net debt: comprises central government sterling & foreign currency gross debt + local government gross debt + public corporations gross debt – public sector liquid assets.

Public Spending Agreements (PSAs): set out the departments' plans to deliver results in return for the investment being made. They were introduced after the 1998 Comprehensive Spending Review.

Purchasers' prices: see prices.

Relative Price Effect (RPI): the adverse effect which causes the cost of government services to rise more rapidly than prices generated in the private sector.

Spending Review (SR): see Treasury statements.

Sustainable investment rule: see fiscal rules.

Tax rates, average and marginal: the average tax rate is total tax payments expressed as a proportion of income. The marginal rate is the proportion of an extra unit of income that is taken in tax. Marginal rates are higher than average tax rates in progressive tax systems.

Third generation of mobile phone companies: cash receipts of £22.5 billion were paid to government by the mobile phone companies (for allowing the use of spectrum by third generation mobile phone companies) during the 2nd and 3rd quarters of 2000. The cash receipts are treated in the public sector finances as pre-payments of rent at the rate of £1bn over the life of the licences.

Total Managed Expenditure (TME): total public sector spending, comprising public sector current expenditure and public sector gross investment (but net of sales of fixed assets). TME replaced the previous system of classifying public spending into the annual "control total" plus cyclical social security plus debt interest in 1998. It can also be divided into:

- **Departmental Expenditure Limits (DEL**): three year limits for department's programme spending; and
- **Annually Managed Expenditure (AME):** spending that is not easily subject to firm multi-year limits. AME includes social security benefit spending, public service pension payments and central government debt interest.

Treasury statements: the key statements made by the Chancellor of the Exchequer are:

- **The Budget statement:** usually made in spring, which is the financial statement of the government's planned revenues and spending for the forthcoming fiscal year and includes an economic assessment. The Financial Statement and Budget Review (FSBR) (the old "Red Book") accompanies the budget statement. The FSBR has also included the "Economic and Fiscal Strategy Report" (EFSR) since March 1999.
- **The Pre-Budget Report:** this is given by the Chancellor in November and December and includes revisions to the budget's forecasts for the economy and the public finances.
- **The Spending Review:** this is made in July every two years and gives the government's spending plans for three financial years. The 1998 Spending Review was known as the Comprehensive Spending Review.

ANNEX 2
EXTRA TABLES

ANNEX 2 TABLE 1A: INFLATION IN BUDGET REPORTS

Date	Title	Reference number	Pages	Price
November 1996	Financial Statement and Budget Review 1997-98 (in plain red cover)	HC 90	160	£17.90
July 1997	Equipping Britain for our long-term future	HC 85	128	£16.80
March 1998	New ambitions for Britain	HC 620	168	£22.00
March 1999	Building a stronger economic future or Britain	HC 298	190	£28.00
March 2000	Prudent for a purpose: working for a stronger and fairer Britain	HC 346	228	£35.00
March 2001	Investing for the long term: building opportunity and prosperity for all	HC 279	226	£40.00
April 2002	The strength to make long-term decisions: investing in an enterprising, fairer Britain	HC 592	250	£45.00
April 2003	Building a Britain of economic justice	HC 500	294	£45.00

ANNEX 2 TABLE 1B: INFLATION IN PRE BUDGET REPORTS

Date	Title	Reference number	Pages	Price
November 1997	Securing Britain's long-term future	Cm 3804	112	£20.00
November 1998	Steering a stable course for lasting prosperity	Cm 4076	134	£25.00
November 1999	Stability and steady growth or Britain	Cm 4479	172	£32.50
November 2000	Building long-term prosperity for all	Cm 4917	206	£40.00
November 2001	Building a stronger, fairer Britain in an uncertain world	Cm 5318	206	£45.00
November 2002	Steering a steady course: delivering stability, enterprise and fairness in an uncertain world	Cm 5664	226	£45.00
December 2003	The strength to take the long-term decisions for Britain: seizing the opportunities of the global recovery	Cm 6042	266	£45.00

ANNEX 2 TABLE 1C: INFLATION IN SPENDING REVIEW REPORTS

Date	Title	Reference number	Pages	Price
July 1998	Modern public services for Britain: investing in reform (1999-2002)	Cm 4011	118	£18.00
July 2000	Prudent for a purpose: building opportunity & security for all (2001-2004)	Cm 4807	166	£32.00
July 2002	Opportunity & security for all: investing in an enterprising, fairer Britain (2003-2006)	Cm 5570	192	£22.75
July 2002	Public Service Agreements (2003-2006)	Cm 5571	50	£11.25

ANNEX 2 TABLE 2A: PUBLIC SECTOR EXPENDITURE DATA BY CALENDAR YEAR

	Total Managed Expenditure		TME in real terms (chained volume measures,		TME as % of GDP
	£m, current prices	Annual change	(£m)	Annual change	
1996	313,347		343,726		41.1
1997	321,573	2.6%	342,920	– 0.2%	39.7
1998	330,802	2.9%	343,240	0.1%	38.5
1999	340,722	3.0%	345,551	0.7%	37.7
2000	360,262	5.7%	360,237	4.25%	37.9
2001	383,641	6.5%	374,929	4.1%	38.6
2002	409,830	6.8%	387,989	3.5%	39.3

Source: ONS, *UK National Accounts (Blue Book) 2003*, 2003.

ANNEX 2 TABLE 3B: GENERAL GOV. FINAL CONSUMPTION BY CALENDAR YEAR

	Current market prices			Chained volume measures reference year 2000		
	GG final consumption £m	GDP £m	GGFC/GDP ratio %	GG final consumption £m	GDP £m	GGFC/GDP ratio %
1996	146,189	763,290	19.2	167,287	837,158	20.0
1997	148,176	810,944	18.3	166,972	864,710	19.3
1998	153,959	859,436	17.9	169,226	891,684	19.0
1999	166,337	903,865	18.4	174,472	916,639	19.0
2000	177,794	951,265	18.7	177,794	951,265	18.7
2001	191,195	994,037	19.2	180,875	971,565	18.6
2002	209,491	1,042,908	20.1	185,799	987,932	18.8
2003	231,875	1,100,462	21.1	189,626	1,011,103	18.8

Sources: ONS, *UK National Accounts (Blue Book) 2003*, 2003 and ONS press release on GDP for 2003 (February 2004).

ANNEX 2 TABLE 3: SPENDING REVIEWS: TME PLANS (£BN)

Date	Component	FY'98	FY'99	FY'00	FY'01	FY'02	FY'03	FY'04	FY'05
July 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				
July 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		
July 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

DEL = Departmental Expenditure Limit.
AME = Annually Managed Expenditure.
TME = Total Managed Expenditure.
The underlined data show the new spending plans for each Spending Review.
Sources: HM Treasury, *Comprehensive Spending Reviews*, 1998, 2000 & 2003.

ANNEX 2 TABLE 4: OUTPUT BY INDUSTRY, 2001, £BN

	Intermediate consumption	Taxes (net)*	Compensation of employees	Costs at purchasers' prices†	Compensation as a % of costs	Gross operating surplus	GVA at basic prices‡	Total output at basic prices•	Compensation as a % total output
Agriculture & fishing	11.2	-0.4	3.2	14.4	22.2%	5.9	8.6	19.8	16.2%
Mining & quarrying	9.3	0.2	3.0	12.3	24.4%	20.8	24.0	33.4	9.0%
Manufacturing	259.1	2.7	110.5	369.6	30.0%	38.3	151.6	410.6	26.9%
Energy & water	32.7	1.4	4.7	37.4	12.6%	10.2	16.2	48.9	9.6%
Construction	75.1	0.6	25.9	101.0	25.6%	23.8	50.2	125.4	20.7%
Wholesale & retail trade	137.6	7.7	88.6	226.2	39.2%	43.2	139.5	277.1	32.0%
Transport & communications	81.7	1.3	48.3	130.0	37.2%	23.0	72.5	154.3	31.3%
Financial intermediation	195.7	2.3	118.4	314.1	37.7%	136.7	257.4	453.1	26.1%
Public administration & defence	39.9	0	38.7	78.6	49.2%	7.1	45.8	85.6	45.2%
Education & health	111.3	0.1	94.8	206.1	46.0%	15.2	110.1	221.4	42.8%
Other services	40.5	0.9	27.9	68.4	40.8%	16.4	45.1	85.6	32.6%
Total**	1,034.3	16.8	546.1	1,580.4	34.6%	300.1	880.9	1,915.2	28.5%

* Taxes less subsidies on products.
† Costs at purchasers' prices = intermediate consumption + compensation of employees.
‡ GVA = compensation of employees – taxes less subsidies on production other than those on products + operating surplus/mixed income, gross.
• Total output at basic prices = GVA at basic prices + intermediate consumption at purchasers' prices.
** Including adjustment for financial services.
Source: National Statistics: UK National Accounts (Blue Book 2003, TSO 2003).

ANNEX 2 TABLE 5A: PUBLIC SECTOR SURPLUS ON THE CURRENT BUDGET, FY96-FY08, £BN*

Date	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08
Nov 96	-20.9	-13.8											
Jul 97	-21.2	-5.5	4.4										
Jul 97†	-21.2	-8.0	2.7										
Nov 97	-19.1	-3.7	4.0										
Mar 98	-20.2	1.2	5.5										
After reclassification following switch to ESA95: approximate effect to reduce surplus by £3 1/2bn for FY97													
Date	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08
Nov 98		-1.8	7.3	0	2	7	10	11					
Mar 99		-2.6	6.2	1	3	7	9	11					
Nov 99			9.5	8.5	10	12	13	12	11				
Mar 00			9.8	16.5	13	14	13	8	8				
Nov 00				18.8	15.7	15	13	8	8	8			
Mar 01				18.7	22.3	16	14	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

* Outturns are underlined; other data are either estimates, forecasts or projections.

† Excluding the windfall tax and associated spending (WTAS) – all other data include the WTAS where appropriate.

Sources: HM Treasury, B*udget Reports*, November 1996 to April 2003 and *Pre-Budget Reports*, November 1997 to December 2003.

ANNEX 2 TABLE 5B: PUBLIC SECTOR BORROWING, FY96-FY08, (£BN)*

Date	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08
Nov 96	26.4	19.2	12.2	3	-8	-18							
Jul 97	22.7	10.9	4.0										
Jul 97†	22.7	13.3	5.4										
Nov 97	22.6	9.5	4.5										
Mar 98	22.7	2.6	2.3										
After redefinition: approximate effect to reduce borrowing by £2bn for FY97													
Date	**FY96**	**FY97**	**FY98**	**FY99**	**FY00**	**FY01**	**FY02**	**FY03**	**FY04**	**FY05**	**FY06**	**FY07**	**FY08**
Nov 98		5.7	-2.9	6	6	3	2	1					
Mar 99		6.6	-2.8	4	5	2	3	4					
Nov 99			-4.5	-2.1	-1	-1	1	4	6				
Mar 00			-4.9	-11.0	-5	-3	3	11	13				
Nov 00				-15.6	-8.7	-5	2	10	12	13			
Mar 01				-15.2	-15.0	-5	2	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	24.0	27	24	23	22	22	
Dec 03							22.5	37.4	31	30	27	27	24

* Public Sector Borrowing Requirement (PSBR) before November 1998. Public Sector Net Borrowing (PSNB) from November 1998. Outturns are underlined; other data are either estimates, forecasts or projections.

† Excluding the windfall tax and associated spending (WTAS) – all other data include the WTAS where appropriate

Sources: HM Treasury, B*udget Reports*, November 1996 to April 2003 and *Pre-Budget Reports*, November 1997 to December 2003.