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Taxation in Britain and Europe in the 1990s

The questions under consideration in this chapter are twofold: 'Will Britain be the lowest-taxed nation in Europe in the late 1990s?', and 'Is it in Britain's long-term interests to accept the European Commission's plans for the harmonisation of taxes and social policy?'

The size of the state sector in Britain was reduced significantly by the Thatcher government during the 1980s. According to figures published by the OECD, the ratio of general government expenditure to GDP in the UK went down from a peak of 47.5 per cent in 1981 to 41.3 per cent in 1988. It declined further in 1989, and increased in 1990 and 1991 largely because of the effect of the recession on social security benefits. The purpose of this chapter is partly to assess whether the sustained 1980s trend towards a smaller state sector can be maintained in the 1990s. But it is also, and perhaps more importantly, to compare public spending trends in Britain and in other industrial countries, particularly in Europe.

My conclusion may be provocative. It is that in the late 1990s Britain is likely to be the lowest-taxed nation in Europe, an advantage which is largely to be attributed to the tight control over expenditure maintained during the 1980s. The Thatcherite legacy will therefore influence Britain's international financial position for many years to come. Of course, that legacy could be squandered, with much still depending on political decisions yet to be taken.

The starting-point for our discussion is to compare the relative importance of public expenditure in the main industrial countries in the 1960s and 1970s. For most of these two decades the four large European countries had a similar ratio of general government expenditure to GDP or GNP. In 1960 the figure varied from 30.1 per cent in Italy to 34.6 per cent in France, with Germany and the UK in between with

32.0 per cent and 32.6 per cent respectively. Over the next twenty years two features were apparent: a rising ratio of government spending to GDP or GNP in all countries, and a tendency for France and Italy to have slightly lower ratios than Germany and the UK.

Even so, by 1979 the differences were marginal. By then the UK had the lowest government expenditure to GDP ratio of 42.6 per cent, while France, Italy and Germany were respectively at 45.0 per cent, 45.5 per cent and 47.7 per cent. The European countries had consistently higher state spending – in relation to national income – than other large industrial countries in the Group of Seven, notably the USA and Japan.

In the 1980s, however, a marked divergence appeared between the UK and the other large European countries, and indeed between the UK and the rest of Europe as a whole. This divergence has attracted surprisingly little comment, perhaps because the statistics are not always easy to interpret. As is well known, the ratio of government spending to GDP is highly cyclical. It rises during recessions partly because the cost of certain forms of public expenditure, such as social security, increases with higher unemployment, and partly because the recession itself reduces output. But it falls during booms, as these effects go into reverse. Any assessment of trends has to be qualified by this cyclical pattern.

Thus, in the early 1980s the ratio of government spending to GDP rose very sharply in the UK, from 42.6 per cent in 1979 to 47.5 per cent in 1981. Most of this change was due to the recession in those two years, which was an unusually severe one, rather than to a fundamental failure of control. Nevertheless, some observers drew the conclusion that the Thatcher government would prove unable to curb the various pressures for ever-higher public spending. Given the vehemence of its anti-spending rhetoric, this would have been an embarrassing outcome. One of the nicer ironies of those years is that such comments may have made it easier to push through reforms which did, in the end, appreciably alter long-term trends in public expenditure. The key changes occurred in two areas: first, fiscal policy and debt control, and, second, 'social policy' broadly understood.

The effects of budgetary action, both when deficits are being reduced and when they are being increased, are self-reinforcing. The reason is that a change in the deficit or surplus affects the level of debt and, hence, the amount of debt interest in future years. Virtue receives its reward not once, but many times over. Action to cut a budget deficit now (or to raise a budget surplus) implies slower growth (or a reduction) of

Figure 11.1 The state sector in Europe, the USA and Japan – government spending as a percentage of GDP

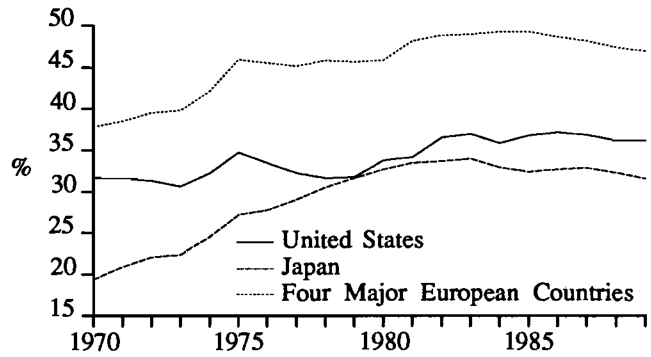
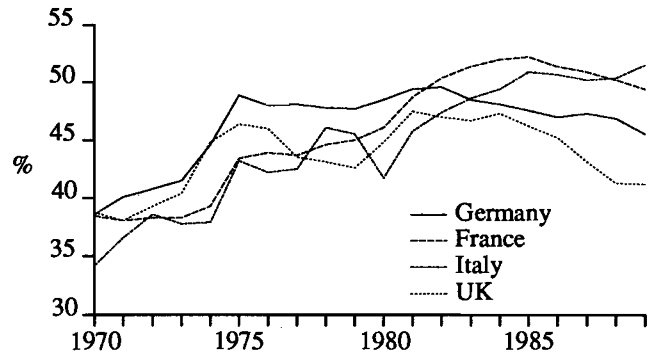


Figure 11.2 The state sector in the four large European countries – government spending as a percentage of GDP



public debt in the current year, which makes possible lower debt interest charges in all years to come.

This line of argument is very important to understanding Britain's success in the 1980s in keeping public debt, and therefore debt interest costs, on a downward path. In 1980 the government announced a medium-term financial strategy (MTFS) which envisaged a reduction in the ratio of the PSBR to GDP from 3.75 per cent (or £8.5 billion) in 1980/81 to 3 per cent in 1981/82, 2 per cent in 1982/83 and 1 per cent in 1983/84. However, the target for the first year, 1980/81, was exceeded by a wide margin, with an outturn of almost £13 billion. Although the overshoot was largely due to the unforeseen harshness of the recession, it prompted a vigorous response by the government. Taxes were raised by about £5 billion, roughly 2 per cent of GDP, in the 1981 Budget in order to return to the path set in the original MTFS.

. The result was that the underlying strength of Britain's public finances improved considerably. The PSBR/GDP ratio was held at about 3 per cent in the next four financial years, despite an economy operating with high unemployment and much unused capacity. Even better, as the economy returned to more normal levels of labour and capital utilisation in 1985 and 1986, the PSBR/GDP ratio dwindled to under 1 per cent and, finally, in 1987/88, the deficit was replaced by a surplus. There has subsequently been a return to significant deficit, mainly because of adverse cyclical effects. These effects should not persist in the long run.

The ratio of net public debt to GDP increased in the early years of the Thatcher government to 47.5 per cent in 1984, but then began to fall and, from 1988, declined rapidly. It is now about 30 per cent. If the average interest rate on the national debt is put at 10 per cent, the decline in the debt/GDP ratio since 1984 has saved the government the equivalent of 1.75 per cent of GDP in debt interest payments. The benefits from the 1981 Budget were even greater. It meant that over the following decade the avoidance of debt interest equivalent to approaching 25 per cent of GDP (i.e., 2 per cent of GDP multiplied by 10, plus some extra benefit because of the compounding-of-interest effect). By 1991 the saving of debt interest due to the 1981 Budget was therefore equivalent to about 2.5 per cent of GDP.

The effect of the economic setbacks of the early 1980s on social policy were also, paradoxically, to facilitate the task of expenditure control in the late 1980s. During the recession of 1980 and 1981, and for some time afterwards, most observers took a highly pessimistic view not only

of the short-run outlook, but also of long-term growth prospects. For example, in its December 1982 *Economic Review* the National Institute forecast that in the 1983-87 period the average growth rate would be a meagre 1.4 per cent a year. Because of these expectations there were doubts about the economy's ability to meet pension and social security commitments over the long term. The government shared the anxiety about the growing burden of social expenditure and introduced a number of reforms which reduced its future spending obligations.

The implied cutback in the state's role of course agreed with Mrs Thatcher's own political preferences. To a lesser extent, it conformed with the attitudes of the Conservative Party as a whole. But the various changes were readily acceptable to informed commentators – and, indeed, public opinion at large – only because of the mood of pessimism and 'crisis' in the early 1980s. Because people doubted the economy's long-term ability to pay for extra public services, they were prepared to tolerate significant retrenchment of the state sector.

The reduction in the government's commitments came in two forms. First, and crucially, it became a convention that pensions, benefits and so on should be indexed to prices, not to earnings. The logic of this practice was obvious, given the general assumption in the early 1980s that the economy would suffer high unemployment and meagre 1-1.5 per cent growth into the indefinite future. However, its effect in an economy enjoying 2.5-3 per cent per year real growth in earnings – which has, in fact, been the standard performance from 1982 onwards – has been to reduce substantially the ratio to GDP of spending on the various benefits.

Indeed, if the British economy continues to grow at 2 per cent a year for another generation, the indexation of benefits to prices rather than earnings will accomplish – by itself – a veritable social revolution. 2 per cent per year growth over twenty-five years will result in a rise in national output of 85 per cent. If demographic and other influences are neutral, the effect will be virtually to halve the cost of pensions and social security as a share of GDP.

It would require considerable work to give a precise estimate of the importance of this effect over the last decade alone. But a rough indication of the order of magnitude is easy enough. In 1981 the cost of social security was £31.1 billion (according to *Social Trends*), while nominal GDP at market prices was £254.1 billion. So the ratio of social security costs to GDP was 12.75 per cent. With real incomes growing since then by 2.75 per cent a year on average, indexation to prices

rather than earnings has reduced the cost of social security by 2.5-3 per cent of GDP. The ratio of social security costs to GDP has in fact fallen by about the indicated amount, being roughly 9.5 per cent in 1990/91. But this may have been partly coincidence. For example, the state-earnings related pension scheme, SERPS, was not abolished at a stroke, but only put on a course which might see it wither away over thirty or forty years. At present the cost of SERPS is still rising strongly.

Secondly, the government took various more specific measures to reduce government expenditure on pensions and social services. Perhaps the most significant were the phasing-out of SERPS and attempts to be more selective in paying benefits, notably to the unemployed. These measures were so numerous and varied that they are impossible to list in a short chapter. But their cumulative impact has undoubtedly been very great. It should also be noted that legislation to curb the power of the trade unions has helped, because it has lowered the natural rate of unemployment (i.e. the rate of unemployment associated with stable pay settlements). By reducing the sustainable level of unemployment, this has cut the public-expenditure cost of providing those out of work with a reasonable standard of living.

The combined effect of all the reforms is difficult to quantify. Much depends, in any case, on such things as the take-up of benefits and the extent to which people come to prefer private provision (of health care, insurance coverage for disablement and unemployment, etc.) over state provision. For example, there clearly has been a well-defined pattern in the last two years for private-pension provision to replace state provision, as people have opted out of SERPS and set up their own Personal Pension Plans. But initially this process has added to state expenditure, not reduced it, because of the incentives given to encourage the switch out of SERPS. Despite all the problems, it seems likely that in the medium to long term – over, say, another decade – the various changes will have lowered the share of state spending in GDP by at least 2 or 3 per cent and perhaps by over 5 per cent. (That assumes they have not been reversed by a different government.) There probably already has been some effect in this direction in the last few years.

Before we assess the outlook for the government spending to GDP ratio in coming years, one more aspect of the subject needs to be discussed. This is the influence of demography on trends in public expenditure. Demography is most relevant in three areas – education costs (which depend on the number of children and young people); the cost of state pensions (which obviously depends on the number of elderly);

and the cost of public health (which depends on the number of elderly and especially on the number of very old, i.e. over 80, whose requirements for medical attention are particularly intensive).

The key point here is that demographic trends are more or less neutral in the UK over the next twenty years. The number of elderly has been rising as a proportion of the total UK population almost continuously in the post-war period. In 1951, 5.5 million people were over 65 in a population of 50.3 million, giving a ratio of the elderly to the total of 10.9 per cent. In 1981 8.5 million were over 65 in a population of 56.4 million and the ratio of the elderly to the total was 15.1 per cent. This year there are expected to be 9.1 million over 65 in a population of 57.5 million, implying a ratio of 15.8 per cent. But that will be a peak for almost another twenty years. Official population projections are that in 2006 there will be 9.2 million elderly, constituting 15.4 per cent of a total population of 59.6 million. It is true that the ratio of old people to the total population will start rising again after 2010, but that does not present any immediate policy problem.

In qualification, it should be said that the numbers of both the very old and the young will be rising in the next fifteen years. There are projected to be 2.6 million very old people in 2006, compared with 2.2 million in 1991, while the number aged under 16 is expected to increase from 11.7 million in 1991 to 12.8 million in 2001 and 12.6 million in 2006. (The figures in this and the previous paragraph are taken from Table 1.2 in the 1991 edition of *Social Trends*.) But the extra burden of coping with these increases is modest relative to the existing costs of looking after the dependent old and young. Broadly speaking, the ratio of the working population to the total population will be stable over the next fifteen years and demography will have no adverse implications for public expenditure control.

With demography neutral in its effects, we can suggest how much the ratio of state spending to GDP will fall over the next decade if two current policies are maintained. These two policies are a balanced budget over the course of the business cycle and benefits remaining indexed to prices, not earnings. If the UK economy grew by 2.5 per cent a year and inflation was moderate, the effect of these two policies would be to reduce the share of government expenditure in GDP by about 3.5 per cent by the year 2000. With real growth of 2.5 per cent and 4 per cent inflation, the ratio of net public debt to GDP would fall from 30 per cent to 16 per cent over a decade if no new debt were issued, i.e. a balanced budget were achieved. Net debt interest would

therefore fall from its present level, about 2.5 per cent of GDP, to 1 per cent of GDP. With 2 per cent real growth, i.e. almost 30 per cent in a decade, social security costs as a share of GDP, 9 per cent in 1990/91, would fall to 7 per cent by 2000/01.

The overall outcome would depend also on other kinds of public expenditure. Perhaps the most important change in prospect is a reduction in the ratio of defence spending to GDP, because of the fading of the Soviet threat to the West. Defence spending in recent years has averaged 4 per cent of GDP. It seems quite plausible that this will be reduced by 2-3 per cent of GDP in coming years. Combining this gain and the effect of ongoing trends in debt interest and social security expenditure, it is not silly to claim that in the year 2000 the ratio of government spending to GDP could be 5 per cent lower than it is at present, which would make it closer to 35 per cent than 40 per cent. Of course, the exact number would depend on the state of the business cycle and other factors. This is very much a back-of-the-envelope calculation. But the arguments which lie behind it are powerful and easy to understand, and it seems unlikely that more detailed work would lead to a very different answer.

The central conclusions of our discussion are in fact confirmed in a more academically rigorous paper in the Autumn 1990 issue of the OECD's *Economic Studies*. The paper, 'The sustainability of fiscal policy: new answers to an old question' by Olivier Blanchard, Jean-Claude Chouraqui, Robert P. Hagemann and Nicola Sartor, assesses future fiscal trends in most of the OECD countries. It confirms that the UK will have no difficulty sustaining present fiscal policies in the foreseeable future and demonstrates that prospects for public expenditure are very different in the UK from elsewhere in the OECD, particularly in the rest of Europe.

The OECD paper examines two main subjects. The first is the medium-term (i.e. five-year) correction to fiscal policy required to stabilise the ratio of net public debt to GDP or GNP. This exercise ignores all influences on the fiscal situation except the dynamics of public debt (i.e. the effect of a deficit on the future level of debt and debt interest costs, and the interaction with economic growth). The second is also concerned with the correction to fiscal policy required to stabilise the net public debt ratio, but the time-horizon is extended to forty years, and the analysis incorporates the long-term threat to expenditure control from the ageing of the population as well.

In contrast to the early 1980s, there are now relatively few countries

which face medium-term fiscal difficulties. There are only two – Italy and Greece – where the problem is at all serious, although Norway, The Netherlands and Spain also need to make some adjustments. The paper estimates that, from a 1989 starting-point, Italy needed to cut the ratio of its budget deficit to GDP by 4.6 per cent and Greece by 11.1 per cent, if they wanted to stabilise their debt to GDP ratios in five years. However, its calculations also identify countries which could raise their deficit to GDP ratios without jeopardising medium-term fiscal sustainability.

It turns out that the UK could increase its deficit to GDP ratio more than any other OECD country in the next few years, without sliding into unsustainability. This is emphatically not a recommendation for so-called 'fiscal expansionism', just a comment on the underlying strength of Britain's public finances. Developments since 1989, notably various increases in public expenditure since Mrs. Thatcher's departure from office, may have undermined Britain's public finances somewhat.

But it is the long-term arithmetic which shows how impressive the UK's relative position has become. In 1990 the OECD paper estimates that non-interest government spending as a share of GNP was 33.2 per cent in the UK, somewhat higher than in the USA (31.4 per cent) and Japan (27.8 per cent), but markedly less than in the three other large European countries (40.9 per cent in Germany, 42.5 per cent in Italy and 46.8 per cent in France). Moreover, whereas the process of population ageing is more or less complete in the UK, at least until 2010, it has a long way to go in other OECD countries.

The paper therefore suggests, for the various countries, the multiples by which non-interest government spending as a share of GDP will have to increase by the year 2028 to compensate for

1. the prospective increase in pension spending taken alone; and
2. the prospective increase in spending on both pensions and health care.

The table below shows the implied ratios of non-interest spending to GDP or GNP in the Group of Seven and three smaller European countries. A striking feature is that the ratio is lower in the UK than in any other country. Indeed, it is not much more than half the level in Sweden.

Table 11.1 Non-interest government spending as a share of GDP

Table shows non-interest spending as a % of GDP, actual and predicted. Column 2 shows projections to 2028 allowing for higher pension spending only and column 3 allowing for both higher pension spending and the extra cost of health care.

	Actual 1990	Projected, 2028 (Pensions only)	Projected, 2028 (pensions and health)
USA	31.4	36.7	38.9
Japan	27.8	35.0	36.4
Germany	40.9	51.9	51.9
France	46.8	54.3	55.2
Italy	42.5	51.4	51.9
UK	33.2	35.2	35.9
Canada	33.3	38.6	41.6
Denmark	52.2	56.9	56.4
Netherlands	46.4	58.0	60.3
Sweden	54.0	61.0	62.1

Source: OECD *Economic Studies*

Even these numbers – dramatic though they are – may understate the UK's relatively favourable position, because they do not take account of a probable increase in the relative cost of health care with economic growth: the price of medical care, which is labour-intensive, rises faster than the price of other goods and services, as productivity and wages increase over time.

The OECD paper explores this aspect in a separate analysis, which widens yet further the gap between the UK and other industrial countries. As the paper remarks, when allowance is made for the tendency for health care to become more expensive, every OECD country faces a need for fiscal correction (i.e, higher taxes or spending cuts) in coming years, 'with the notable exception of the UK'.

The UK's exceptional position comes out vividly in a comparison with countries like Italy and The Netherlands, which have both a medium-term deficit problem and face significant long-term population ageing. The OECD paper shows that, assuming that the price of health care rises 2 per cent more than prices in general over the next forty years, Italy needs to raise taxes (or reduce spending) by 6.7 per cent of GDP, while The Netherlands needs to do so by 5.3 per cent, in order to stabilise the debt to GDP ratio. By contrast, the UK could cut taxes by 2.2 per cent of GDP. Since taxes are already lower in the UK than in

these two other countries, the implication is that the gap in the tax burden could widen to 15 per cent or so of GDP today and still leave the UK with public finances as sound as theirs. Indeed, by early in the next century a tax differential as large as this is possible between the UK and all the other large European countries.

The purpose of referring to the OECD paper has been to show that the relatively casual observations made earlier in this paper are supported by more careful academic analysis of comparative fiscal trends. In fact, one assumption of the OECD work is misleading, but the mistake does not flatter the UK's position so much as underestimate how good it is. The OECD authors' projections of pension spending have been obtained, they say, 'by making the assumption that the ratio of public pension expenditure to GNP changes in line with variations in the old-age dependency ratio'. Implicitly, the assumption is 'that the ratio of the average pension to the average gross wage remains unchanged over time'. But we have already seen that – because of the indexing of the basic state pension to prices, not earnings – the ratio of the average state pension to the average gross wage could fall sharply in the UK in coming years. This would magnify the gap in prospective tax burdens between the UK and other European countries.

The argument presented here has many implications. First of all, it shows that – contrary to some media comment – the Thatcher government transformed the UK's international position on perhaps the most basic yardstick of a country's political orientation, the ratios of tax and state spending to national income. So far the full benefits have not come through. The tax/GDP ratio is lower in Britain than other European countries, but the difference is not all that great, largely because Britain has a smaller budget deficit than most of its neighbours. But the moderate level of the underlying deficit here, and the possibility of a return to surplus in the mid-1990s, will yield dividends later. More fundamentally, other European countries will have to raises taxes during the 1990s because of population ageing, whereas Britain will not need to do so. Indeed, as the effect of other social policy arrangements unfolds, Britain may be able to lower taxes quite sharply.

Conclusions: tax competition, not harmonisation

The central conclusion of this chapter – that tax rates will be far lower here than in other European countries by the late 1990s – seems very robust. Quite large changes in assumptions – for example, about the

underlying rate of economic growth in Britain compared to elsewhere in Europe – would not affect the main point. But, of course, the whole subject is intensely political. Britain will undoubtedly have a tax advantage over the rest of Europe, but the size of that advantage will depend on a number of political decisions yet to be taken.

A debate has been brewing in the Conservative Party on these issues. In the 1991 Budget speech Mr Lamont reiterated the goal of an income tax rate of 20p in the pound, but he did nothing tangible about it. In any case his pledge was not consistent with the stable or rising expenditure to GDP ratios envisaged by the official Budget publication, the 1991/92 *Financial Statement and Budget Report* for the early 1990s. The Prime Minister has made no secret of his wish to improve the quality of public services and would presumably be prepared to pay for them by raising taxes. Mr Major's flexibility on spending and debt has also come through in his remarks in newspaper interviews that he has no 'ideological hang-ups' about budget deficits. It seems a fair generalisation that neither Mr Major nor Mr Lamont is as keen to curb the state sector in the early 1990s as Mrs Thatcher and Mr Lawson were in the 1980s.

The achievement of a significant tax advantage over the rest of Europe would be important in attracting inward investment from the USA and Japan, and in promoting a healthy economy compared with our European neighbours. However, this relative attractiveness would not be welcome to the EEC Commission in its present mode of thinking. Certain aspects of British policy might be characterised as 'social dumping', and fall foul of the Social Charter. They might also conflict with plans for tax harmonisation within the EEC, if such plans were pushed through by majority voting under a new Treaty. It would be in the interests not merely of Britain, but also of our European neighbours, if there were tax competition in Europe, not convergence towards a single European norm. Tax competition would tend to drive tax rates down and limit the size of the state sector.