

Aronson
Jol

THIS DOCUMENT IS THE PROPERTY OF HER BRITANNIC MAJESTY'S GOVERNMENT

C(84) 6

COPY NO 32

February 1984

CABINET

PUBLIC EXPENDITURE AND TAXATION IN THE LONGER TERM

Memorandum by the Chancellor of the Exchequer

A public debate on the longer-term prospects for public expenditure has been under way for some time. Given our declared aim of reducing the burden of public spending and taxation, any increase in public understanding of the scale and nature of the problem is to be welcomed; and it will help if we can, by emphasising the fiscal rewards, widen support for reining back the growth in public expenditure. I believe that the time has now come for us to contribute to the debate. In any event, the Treasury and Civil Service Committee are about to call for a paper on the issue; and we shall have to comply. The right course is, I believe, to publish an early Green Paper, or some other form of discussion document.

2. But obviously this is not without difficulties:
1. Different expenditure programmes have enormously varying timescales - for example, the full burden of the State earnings-related pension scheme does not arise until well into the next century.
 2. There are major uncertainties - for example about the rate of growth of output. This can be handled by giving alternative projections, but the risk is that these will blur the message.
 3. Some key economic assumptions - for example the rates of decline in unemployment, and of growth of real earnings - may be misrepresented as forecasts or even objectives.

More significantly, the 1982 work on long-term public expenditure, which was leaked to the press, shows the difficulties of projecting individual Departmental programme totals, forecasts of which are at once misrepresented as Government commitments or Treasury aims.

3. To meet these problems I now propose a different approach, which would avoid the need to display any individual programme figures. As explained in C(84) 5, I shall need to publish a new Medium Term Financial Strategy (MTFS) with the Budget, and I believe that it should extend to 1988-89, thus including expenditure totals for two further years beyond

the 1986-87 horizon of this month's Public Expenditure White Paper. I propose the parallel publication of a Green Paper projecting overall public expenditure totals forward, on alternative assumptions, for a further 5 years to 1993-94, and showing what this would mean for the burden of taxation.

The Green Paper would start with two introductory sections:

1. A section on past public expenditure trends, showing the seemingly inexorable rise over the past 20 years, at an annual average rate of $1\frac{1}{2}$ per cent, taking the total to over 40 per cent of Gross National Product (GDP): and, in parallel, the growth in the burden of taxation, now up to 39 per cent of GDP compared with the 1978-79 level of 34 per cent. This section would also show how, notwithstanding the considerable contribution North Sea taxation has made to the public finances, the burden of non-North Sea taxation has grown since 1978-79, from 35 per cent to 39 per cent of non-North Sea GDP.
2. A section drawing attention to likely pressures for further spending increases over the next decade - eg demography (health and social services), technology (notably defence and health), and capital infrastructure.
5. The central part of the paper would recall our 1979 commitment to reduce public expenditure as a proportion of GDP, and the actual course of events, which saw a sharp rise in this proportion, to a peak of 44 per cent of GDP in 1981-82. It would explain the reasons, which are in no way disreputable, and owe much to the recession. But it would go on to show how the tax burden could be reduced and economic prospects improved if, with recovery well under way, these pressures were held in check, and the public expenditure totals held constant in real terms through to 1993-94.
6. The annex sets out some projections (which would require reworking before publication). The main case assumes 2 per cent GDP growth, and shows that with expenditure held constant in real terms throughout, the non-North Sea tax burden would still be above the 1978-79 level (which we denounced at the time as too high) by 1988-89, and around 32 per cent by 1993-94, ie just below the 1973-74 level (33 per cent), but still some way above the level of the early 1960s. This would produce a sharp improvement in incentives. If (somewhat unrealistically) other taxes were held constant as a proportion of GDP, the rate of income tax could be reduced to 25p and allowances raised substantially, bringing the married man's allowance to nearly 60 per cent of average male earnings as against 31 per cent now. In practice, of course, some of the revenue would certainly be used to reduce the burden on the corporate sector.
7. The main case shown in the published paper should, I suggest, assume expenditure held constant in real terms up to 1993-94. It could of course illustrate other cases - for example an annual growth in expenditure of 1 per cent after 1988-89. But if we do not leave ourselves room for substantial tax reductions, the rate of GDP growth would be unlikely to

CONFIDENTIAL

maintain the 2 per cent average: the average over the past decade was only 0.9 per cent. The annex takes 1½ per cent GDP growth as a lower variant, and shows that with 1 per cent growth in expenditure the prospect would hardly be alluring: the non-North Sea tax burden would stay above the 1978-79 level for almost all the 10-year period.

If Cabinet agrees to the principle of publishing a Green Paper at Budget time, I would welcome views on the appropriate spending assumption for the period after 1988-89, and would circulate a full text for clearance within the next fortnight.

N L

Treasury Chambers
3 February 1984

CONFIDENTIAL

ANNEX: PROJECTIONS OF PUBLIC FINANCES TO 1993-94

1. The projections discussed here illustrate various paths of public expenditure over the next decade, and their implications for the burden of taxation.
2. A key factor in the projections is the assumed rate of economic growth. This affects not only the amount of tax which is collected for given rates and allowances, but also the burden of taxation associated with given paths of public expenditure and borrowing. For the first five years of the projections, to 1988-89, GDP is assumed to grow by an average $2\frac{1}{4}\%$ per annum. Thereafter, there are two factors pointing to some slow down in the growth rate: the North Sea sector will by then be contributing minus $\frac{1}{2}\%$ per annum to total GDP growth; and the growth of the labour supply will be somewhat less than in the first half of the decade.
3. The growth rate after 1988-89 will depend in part on the success of policy in bringing down the share of public expenditure and the burden of taxation. Accordingly we consider two cases. In the first, total GDP grows by 2% per annum, equivalent to about $2\frac{1}{4}\%$ per annum for the non-North Sea sector. This is about the average for the post-war period, and significantly better than the last decade. In the second case total GDP grows at $1\frac{1}{2}\%$ annum, equivalent to about 2% for the non-North Sea sector. Higher growth is more likely, the greater the reduction in the tax burden.
4. The path of North Sea tax revenues has an important bearing on the burden of non-North Sea taxation. Apart from the profile of production, the behaviour of real oil prices is of key importance. It is assumed here that after falling over the next two years or so in real terms, they flatten off and then start to rise again as the balance of supply and demand becomes progressively tighter. From 1988-89 they may be rising by 2-3% per annum, but even so North Sea revenues fall from about 3% of GDP in 1984-85 to about $1\frac{1}{2}\%$ in 1993-94 as output falls.
5. Another important feature of the projections is the path of net debt interest payments. This reflects the paths of public sector borrowing and interest rates. On the latter, some fall in real interest rates from present high levels is to be expected, with the path depending on the course of the PSBR and world interest rates. Falling inflation also points to lower nominal rates. If stable prices are achieved by the end of the period and real interest rates have come down to more normal levels, then net debt interest may fall from about 3% of GDP in 1983-84 to a bit under $1\frac{1}{2}\%$ in 1993-94. This more than offsets the fall in North Sea taxes.

6. Falling inflation and interest rates require a reduction in the PSBR as a percentage of GDP. It is not possible at this stage to anticipate the path in the MTFs, but for the purposes of this exercise we assume that it falls gradually to 1% by the end of the period.

7. It follows from these assumptions that the non-North Sea tax burden can be lightened to the extent that the fall in public expenditure relative to GDP exceeds the required reduction in the PSBR. If we assume that GDP grows by 2½% a year on average to 1988-89, and that the public expenditure planning total is held flat up to 1988-89 in real terms, the non-North Sea tax burden would still in 1988-89 be above its level in 1978-79*. The figures are shown below.

The Burden of Taxation in the MTFs period

	<u>1978-79</u>	<u>1983-84</u>	<u>1988-89</u>
Non-North Sea Tax	34.7	38.6	35½
Total Taxes	34.1	38.8	36

8. By 1993-94, some further reduction in the tax burden should be possible if the growth of public expenditure is held in check. The main case assumes GDP growth at 2% per annum, and expenditure held constant in real terms up to 1993-94; but figures are also shown for 1½% GDP growth and 1% real growth in expenditure. The tax implications are summarised in the table below.

The Burden of Non-North Sea Taxation in 1993-94

<u>GDP growth (pa)</u>	<u>Public Expenditure Growth (pa)</u>	
	<u>zero</u>	<u>1%</u>
<u>1½%</u>	32½	34½
<u>2%</u>	31½	33½

*The burden of non-North Sea taxes is defined as non-North Sea tax revenues as a share of non-North Sea GDP. It falls more than the share of non-North Sea taxes in total GDP because of the declining contribution of North Sea output in total GDP. Recent data for the non-North Sea tax burden are as follows:

<u>1978-79</u>	<u>1979-80</u>	<u>1980-81</u>	<u>1981-82</u>	<u>1982-83</u>	<u>1983-84</u>
34.7	35.7	36.9	39.6	39.5	38.6

9. If the public expenditure planning total were to be held flat, the burden of non-North Sea tax could be brought down to well below its 1978-79 level of 34.7% by 1993-94. The higher growth assumption is more likely to be the appropriate one in this case. But even so, the tax burden would be only fractionally lower than it was in 1973-74, the end of the previous Conservative administration, and still some way above the level of the early 1960s.** With 1% growth of public expenditure the picture would be worse. After a decade, the tax burden would be only marginally lower than the 1978-79 figure, which was widely held to be excessively high.

** Figures for the (non-North Sea) tax burden in selected earlier years are:

<u>1964-65</u>	<u>1973-74</u>	<u>1978-79</u>
30%	33%	34.7%