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Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

28 February 1984

Andrew Turnbull Esq
10 Downing Street

Dear Andrew,

As you know, we have since the 9 February Cabinet been pressing ahead with the preparation of a text of the proposed Green Paper on the prospects for public expenditure and taxation in the longer term, with a view to its publication on Budget day. The Chancellor has now asked me to send you the enclosed copy of the latest version of the text, as it has emerged from a series of meetings taken by him, and which he would like to discuss with the Prime Minister at their meeting tomorrow. You will see that it follows the form agreed by Cabinet - ie concentrating on aggregate public expenditure figures, and avoiding detailed figures for individual programmes. Nevertheless, some inter-departmental clearance clearly is required, and the process is now starting, with officials in spending Departments being shown in confidence the paragraphs dealing with their departmental programmes. The Chancellor will wish to discuss with the Prime Minister how best to handle clearance with Cabinet colleagues.

The enclosed text is still very much a working draft. The graphs are being re-done, and Michael Scholar is still working on the annexes. But the Chancellor would like to be sure at this stage that the Prime Minister is content with the way in which the text is coming out.

Yours ever,

J O KERR

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DRAFT GREEN PAPER

PUBLIC EXPENDITURE AND TAXATION INTO THE 1990's

Introduction

1. This Green Paper is the government's contribution to the current debate on public expenditure and taxation in the longer term.

2. Each year the government reviews and carries forward its public expenditure plans in the Public Expenditure Survey, and publishes the results in a White Paper. The latest in this series, The Government's Expenditure Plans 1984-85 to 1986-87, (Cmnd 9143), was published last month. As a decision-making process which produces detailed control totals for public spending, and later Supply Estimates for Parliamentary approval, the Public Expenditure Survey is inevitably concerned with the relatively near future - on current practice the next three years. But the government takes these decisions within a longer-term strategic framework: thus, in the latest account of the government's Medium Term Financial Strategy (MTFS) in Part 2 of the Financial Statement and Budget Report (FSBR), assumptions about public spending, borrowing and taxation are set out for the next five years. Beyond this, the government thinks it valuable from time to time to look to the more distant future, to form a view both of the likely pressures for public spending much further ahead and of the economic and fiscal prospect which will govern what public expenditure can be afforded.

a promise to repeat? update?

3. This Green Paper is concerned with the longer-term fiscal prospect, for the years up to 1993-94. It does not record decisions by the government either on public expenditure programmes or on taxation. It attempts, rather, to set out reasonable and defensible assumptions about how the economy as a whole might develop and to derive from them a framework within which to conduct the discussion of expenditure and taxation.

4. The government believes that the public debate on this issue is of the first importance. As this Green Paper will argue, the growth of public spending has, over the past twenty years, been the motive force which has driven ever upwards the burden of taxation, on individuals and companies alike. The government believes that it is necessary to reverse this process, to decide first what can be afforded, then to set expenditure plans for individual programmes consistently with that decision.

I Public Expenditure - past trends

5. Over the last twenty years public expenditure has risen both in real terms and as a proportion of total national output. Changes in definition and coverage over the years complicate the figures. But in broad terms, public expenditure* has risen in cash from around £10 billion in 1963-64 to some £126 billion in 1984-85. In real terms the rise has been from around £64 billion** in 1963-64 to getting on for double that figure, in 1984-85.

6. The real annual average rate of growth of public expenditure over this period was 3 per cent; GDP growth averaged 2 per cent a year. Thus over these twenty years real public spending has risen by 91 per cent, while real national income has risen by 49 per cent.

7. As a proportion of GDP, general government expenditure rose from around 36 per cent in 1963 to a peak of 48 per cent in 1975-76. After the cuts imposed after the crisis of 1976 the proportion declined to an estimated 42 per cent in 1977-78. But since then the proportion rose again up to 1982-83, since when it has fallen somewhat.***

8. Charts 1 and 2 illustrates these changes.

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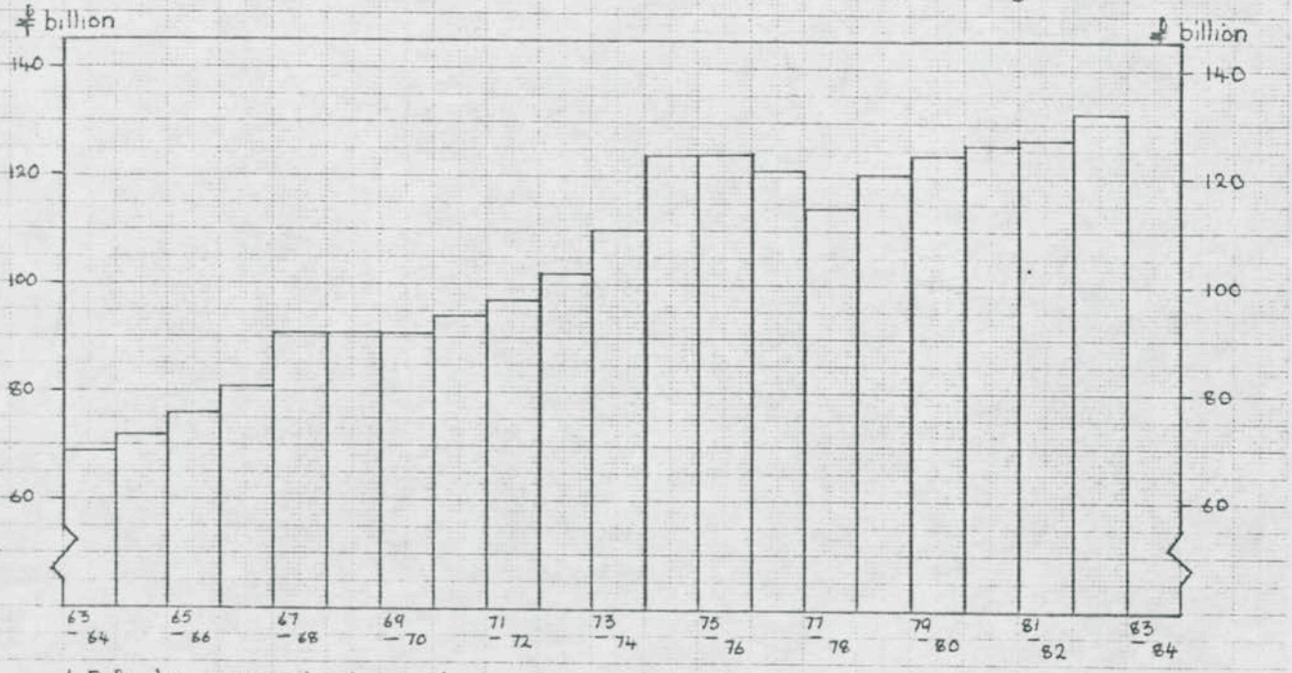
* on the general government expenditure definition. This and other definitions are explained in Annex 1.

** in 1983-84 cost terms. 'Cost terms', 'real terms', and other related concepts are explained in Annex 1.

*** Changes in definition mean that the published figures in the past have risen as high as 60 per cent in 1976 before the treatment of nationalised industries and certain other components of expenditure was changed.

Chart 1

Trends in general government expenditure[1] in real terms[2] over the past 20 years

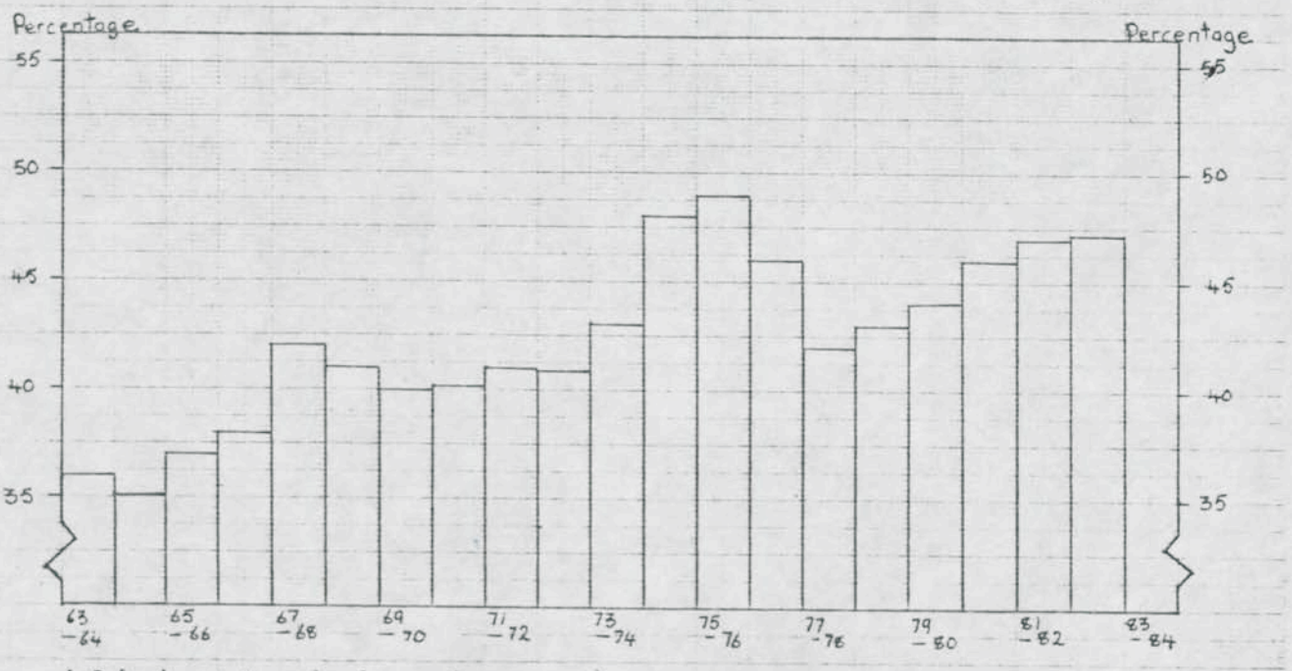


1 Defined as in the national accounts

2 Cash figures deflated using GDP deflator. base year 1982-83 = 100

Chart 2

Trends in general government expenditure[1] as a percentage of GDP over the past 20 years



1 Defined as in the national accounts

9. Public service manpower, too, grew rapidly over these years:

Table 1

Public Service Manpower, excluding the armed forces, since 1960

(thousands, numbers unemployed)

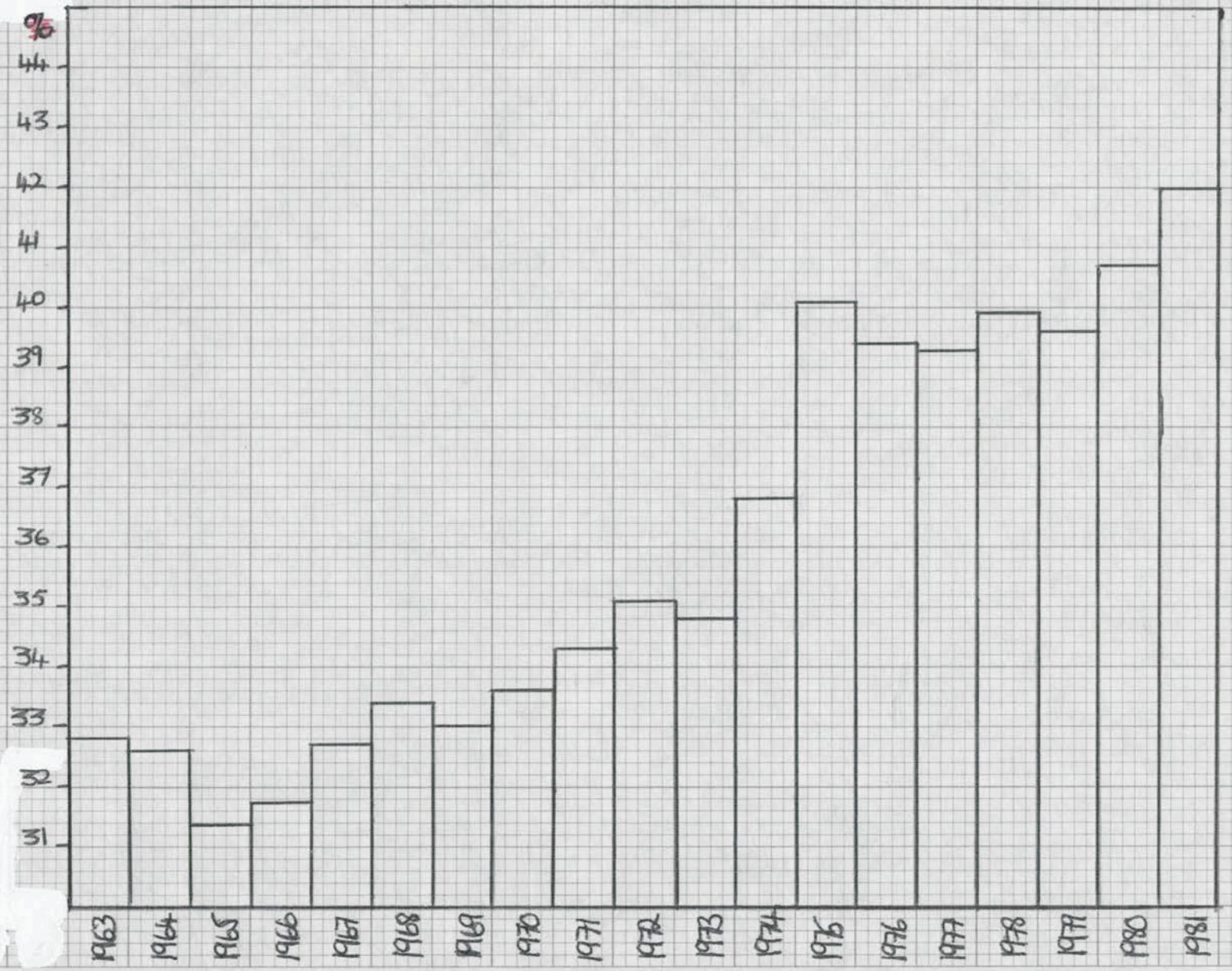
	1960	1965	1970	1975	1980	1985
Civil Service	640	655	702	708	700	[649]
National health service	543	[600]	648	869	952	[997]
Local Government	1,821	2,154	2,559	2,993	3,027	[2,931]
Total	3,006	[3,411]	3,911	4,569	4,681	[4,578]

10. Powerful forces were at work driving public expenditure upwards over this period. Rising expectations about the help which the government should give to the more disadvantaged sections of the community led, in Britain as in many other countries, to a steep rise in spending on the social programmes. Public spending was also increased for economic reasons, either as a general stimulus to demand, in the hope that this would encourage economic growth and employment, or to secure more specific economic objectives - for example in regional or industrial development. At the same time, there has all too often been over-optimism about the prospective growth in total national output, so that spending plans have been set at a level unsustainable for anything but the very short-term.

11. During the 1970's there was a major deterioration in the economic background. A series of shocks to the international trading and monetary system - in particular, the oil price increases of 1973 and 1979 - created conditions of deep recession and rapid inflation, which imposed severe strains on the budgetary position of countries world-wide. Higher inflation was itself a cause of higher public expenditure. Recession-induced expenditures climbed steeply, and at the same time rising expectations of public services continued unabated, notwithstanding the greatly increased difficulty of financing higher spending.

12. Chart 3 shows how rapid the growth of public spending has been in the seven major OECD countries:-

GENERAL GOVERNMENT EXPENDITURE AS A PERCENTAGE OF GDP (Averages for the Seven major OECD Countries)



Source: OECD Secretariat and National Accounts.

An analysis, by member country, of these totals, together with their GDP growth rates, is set out at Annex 2.

More recent trends

13. Since 1978-79 public expenditure has grown by just over 7 per cent in real terms. Tables 1A and 2 show how different expenditure programmes have changed over the past five years, both in cash and after allowing for inflation as measured by the GDP deflator.

Table 1A Total public expenditure by programme* £ million cash

	1978–79	1979–80	1980–81	1981–82	1982–83	1983–84
Defence	7,497	9,228	11,173	12,605	14,408	15,716
Overseas aid and other overseas services						
Overseas aid	727	798	904	978	984	1,063
Net payments to EC institutions	751	839	221	153	580	500
Other overseas services	367	439	496	554	600	731
Agriculture, fisheries, food and forestry	812	1,007	1,345	1,382	1,861	2,087
Trade and Industry	2,034	2,257	2,743	3,249	2,269	1,800
Energy	550	561	623	1,118	892	1,180
Employment	1,045	1,237	1,934	2,241	2,359	2,287
Arts and Libraries	340	404	478	524	616	624
Transport	2,672	3,278	4,000	4,277	4,395	4,560
Housing	3,571	4,520	4,461	3,128	2,640	2,760
Other environmental services	2,222	2,640	3,071	3,108	3,554	3,787
Law order and protective services	2,034	2,577	3,160	3,731	4,174	4,681
Education and Science	7,754	8,942	10,898	11,841	12,682	13,356
Health and personal social services	7,425	8,899	11,362	12,724	13,817	14,688
Social Security	16,437	19,417	23,429	28,567	32,445	35,324
Other public services	966	1,156	1,415	1,538	1,631	1,666
Common services	853	1,009	1,098	1,454	1,560	950
Scotland	3,713	4,547	5,359	5,830	6,242	6,767
Wales	1,489	1,769	2,112	2,218	2,386	2,587
Northern Ireland	2,132	2,446	2,899	3,215	3,500	3,799
Other planning total items						
Special sales of assets		-999	-356	79	-488	-1,200
Reserve						100
Local authority current expenditure not allocated to programmes (England)						
General allowance for shortfall						-300
Planning total	65,752	76,922	92,672	104,676	113,377	120,328
Memorandum item						
Debt interest (net)	2,204	3,429	4,491	5,741	5,946	7,000

* the programme figures in Tables 1 and 2 are presented consistently with those in the public expenditure White Paper Cmnd 9143. They therefore include nationalised industries borrowing which is separately identified in Chart 4 and provide separate figures for Scotland expenditure in and Wales which is allocated to functional programmes in chart 4.

Table 2 Public expenditure in cost terms by programme(1) £ million base year 1982–83

	1978–79	1979–80	1980–81	1981–82	1982–83	1983–84
Defence	12,183	12,835	13,092	13,442	14,408	14,968
Overseas aid and other overseas services						
Overseas aid	1,162	1,090	1,037	1,022	965	988
Net payments to EC institutions	1,220	1,167	259	163	580	476
Other overseas services	615	631	603	611	619	721
Agriculture, fisheries, food and forestry	1,320	1,400	1,576	1,473	1,861	1,987
Trade and Industry	3,305	3,139	3,214	3,463	2,269	1,714
Energy	893	780	730	1,191	892	1,124
Employment	1,698	1,721	2,266	2,389	2,359	2,178
Arts and Libraries	553	562	560	558	616	595
Transport	4,342	4,559	4,687	4,561	4,395	4,343
Housing	5,803	6,286	5,228	3,336	2,640	2,629
Other environmental services	3,611	3,672	3,598	3,314	3,554	3,607
Law order and protective services	3,306	3,585	3,703	3,979	4,174	4,459
Education and Science	12,602	12,438	12,769	12,627	12,682	12,720
Health and personal social services	12,067	12,377	13,313	13,568	13,817	13,988
Social Security	26,713	27,006	27,453	30,463	32,445	33,642
Other public services	1,570	1,608	1,658	1,640	1,631	1,587
Common services	1,386	1,403	1,286	1,550	1,560	905
Scotland	6,034	6,324	6,279	6,217	6,242	6,445
Wales	2,419	2,460	2,475	2,366	2,386	2,464
Northern Ireland	3,464	3,402	3,397	3,429	3,500	3,618
Other planning total items						
Special sales of assets		-1,389	-417	84	-488	-1,143
Reserve						95
Local authority current expenditure not allocated to programmes (England)						
General allowance for shortfall						-286
Planning total(2)	106,857	106,989	108,588	111,624	113,377	114,598

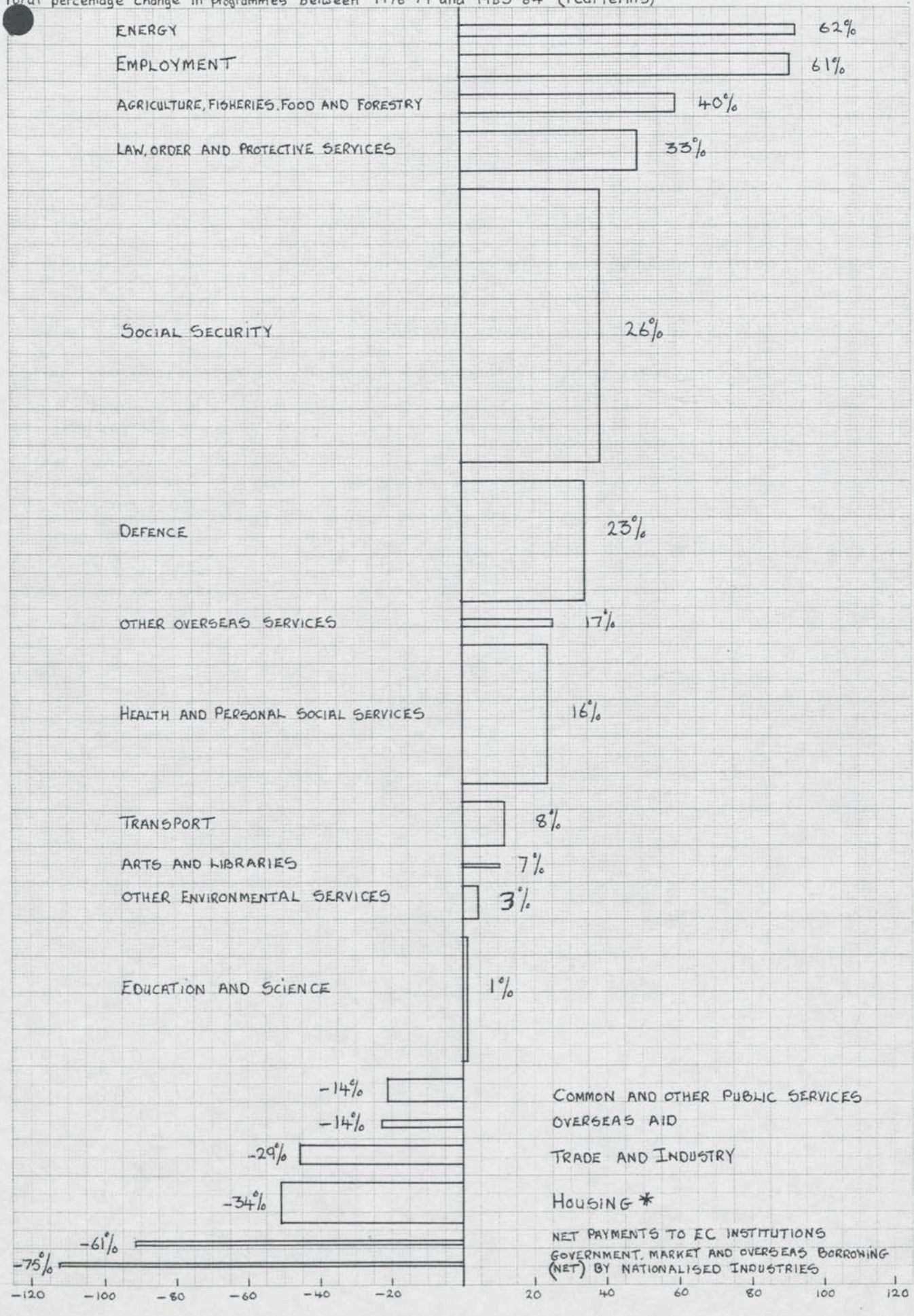
(1) Cash figures as in Table 1.3 adjusted for general inflation as measured by the GDP deflator at market prices. The GDP deflator is assumed to increase by some 5 per cent in 1983–84 and in 1984–85 as stated in the Autumn Statement 1983, paragraph 1.48.

(2) Totals do not always add because of rounding.

14. Chart 4 below illustrates these changes.

CHART 34

Total percentage change in programmes between 1978-79 and 1983-84 (real terms)



Notes

1. The width of each bar on the vertical axis is proportional to expenditure on the programme concerned in 1983-84
2. Expenditure in Scotland, Wales and Northern Ireland has been allocated to individual programmes.

* Housing figures are calculated before any deduction for council house sales.

15. The principal reasons for this increase in public expenditure are given below:-

(i) Provision for defence expenditure has increased by £8.2 billion over the last five years, 23 per cent in real terms. This is primarily a reflection of the Government's commitment to meet the NATO aim of real increases in defence expenditure of 3 per cent per annum in full up to 1985-86. In addition, all defence Falklands costs have been met out of monies additional to the 3 per cent annual rate of real growth.

(ii) Agriculture, fisheries, food and forestry expenditure has grown 40 per cent in real terms. This is mainly due to the high cost of market support under the Common Agricultural Policy which now accounts for more than half of this programme. Market support for products covered by the CAP involves public expenditure (mainly by the Intervention Board for Agricultural Produce) on purchases into intervention, export refunds and production and consumption subsidies. This expenditure has increased because CAP pricing policy has increased agricultural production in the UK. Most of this expenditure is prefunded or reimbursed from the Community budget: receipts from this source are taken into account in assessing our net contribution to EC institutions (recorded in programme 2.7).

(iii) Expenditure on the law and order programme has grown by 33 per cent in real terms since 1978-79 to reach £4.7 billion in 1983-84. More than half of this is on police, and has permitted an increase in the authorised establishment from 118,663 to 121,500, a greater increase in actual strength within these limits, and substantial increases in pay. The priority the Government attaches to law and order has also led to measures to relieve the pressures on the prison service, which accounts for 12 per cent of the programme. The number of prison staff has risen by 1,300, and the programme of prison building, refurbishment and maintenance has been expanded.

(iv) The health and personal social services programme has grown about 16 per cent in real terms since 1978-79, continuing a pattern of sustained growth over and above that attributable to demographic pressures, which has seen expenditure on the Natonal Health Service roughly triple in cost terms since the early 1950s. Expenditure on services mainly for elderly people (who now occupy 2 in every 5 occupied hospital beds) has increased rapidly, at over 3 per cent per year in real terms over the past eight years. There has been considerable expansion to meet rising expectations: more treatments, new treatments and higher levels of staffing. More patients have had hospital treatment: in 1982 there were nearly 8½ per cent more in-patient and day cases than in 1978. Spending on drugs was [12 per cent] higher in real terms in 1982-83 than in 1978-79. The average GP had some 7 per cent fewer patients on his list in 1982 than in 1978: this in itself should permit a higher standard of health care for the mentally ill in hospital; and the nursing staff/patient ratio has improved by 17 per cent since 1978-79. But pressures for additional expenditure continue to be intense, and there appears to have been little, if any, effect on the gap between services and expectations.

(v) Social security spending has grown 26 per cent in real terms over the period 1978-79 to 1983-84. In 1983-84 it is estimated at £35.3 billion, 29 per cent of the public expenditure planning total*. About half of the programme represents expenditure on the elderly; over the period the retirement pension and linked long-term benefits, such as supplementary pension, have more than kept pace with the rise in prices, and the number of pensioners has increased by around 650,000. There have also been significant increases in the numbers receiving disability benefits; for instance mobility allowance recipients rose from 95,000 in 1978-79 to 315,000 in 1983-84, and the numbers in receipt of attendance

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* This is defined in Annex 1.

allowance went up by over two thirds. The programme has also been affected by the recession, leading to significant increases in spending on unemployment benefit and supplementary benefits; in total, expenditure on the unemployed has increased in real terms since 1978-79 from £2.4 billion to £6.2 billion and now represents about 18 per cent of the social security programme, or 5 per cent of the public expenditure planning total.

(vi) Interest on government borrowing, although not in the planning total, also has to be paid for. Since 1978-79 the cumulative public sector borrowing requirement has totalled around £60 billion. As a result the stock of public sector debt held outside the public sector has risen by 57 per cent and gross debt interest (now running at about £15½ billion a year) has increased by 86 per cent. In the past, high inflation progressively reduced the burden of public debt. Now, to reduce this burden, government borrowing has to be reduced.

(vii) Local authorities

Responsibility for spending on many services lies with local authorities not central government. They account for about a quarter of public expenditure. While central government grants finance over half of local authorities' current expenditure, local authorities are free to determine both levels of spending and their own priorities. Despite continuing calls from the government for restraint, and changes to the grant system to make it act as a disincentive to high spending, local authority current spending has risen since 1978-79 by 9 per cent in real terms in England, and 15 per cent in Scotland. The consequence has been a heavy and rising rate burden, despite large cash increases in Exchequer grants.

16. The Government has contained the effect of these increases on total public expenditure by reducing expenditure on other programmes:

(i) the cost of central government administration has been sharply reduced. Since May 1979 the size of the Civil

Service has been reduced by 99,700 - from 732,300 in April 1979 to 632,600 in January 1984. It is now smaller than at any time since 1945. This reduction represents savings approaching £600 million a year.

(ii) net payments to the European Communities institutions have been reduced by budget refunds amounting to some £2,600 million in the three years to December 1983.

(iii) expenditure on trade and industry has fallen by 29 per cent in real terms over the last five years. Support for BL and the aviation industry has fallen sharply since 1981-82. The 1979 changes in regional policy contributed to declining regional development grant payments from 1982-83; and steel redundancy payments fell off from their 1981-82 peak. These falls were offset in part by large increases in spending on science and technology.

(iv) the public sector housing programme has been reduced by 34 per cent in real terms over the last five years, before taking account of the effect of public sector housing sales. Such sales count as negative public expenditure, so that the net reduction in the public sector programme is larger than this. New starts in the private sector are now at their highest level for ten years.

17. The overall picture is, thus, one of a considerable shift in the composition of public expenditure since 1978-79, reflecting in large measure the government's priorities and commitments. Four years ago, for example, the net public sector housing programme was almost twice the size of the law and order programme - yet by next year it will be no more than half its size; and the trade and industry programme fell from being about one quarter of the size of the health and education programmes in 1978-79 to being about one-eighth of those programmes by 1983-84.

18. These figures do not include what are sometimes called "tax expenditures", such as relief for mortgage interest and life assurance premium relief. These two amounted to a little under £1½ billion (cash) in 1978-79 and to about £3½ billion in 1983-84 - a real terms increase of about 50 per cent.*

II Taxation - past trends

19. The rise in public expenditure over the past twenty years has necessarily led to a corresponding rise in taxation. Taxes and rates, plus national insurance contributions, were some 29 per cent of GDP in 1963-64. They rose to over 37 per cent by the end of the 1960's. The proportion fluctuated during the 1970's. By 1978-79 non-North Sea taxes plus national insurance contributions and rates represented 34.7 per cent of non-North Sea GDP.

explain why comparison is confined to non North Sea taxes and GDP

20. Because of the upward pressures on public expenditure and the need to reduce an excessive and unsustainable level of borrowing, the non-North Sea burden has increased further since 1978-79 - from 34.7 per cent to 38.6 per cent in 1983-84. This increased burden was necessary despite the contribution made by the North Sea to total government revenue: North Sea taxes rose in cash terms from £½ billion in 1978-79 to £8½ billion in 1983-84. Chart 4A illustrates the total change in the tax burden throughout the period since 1963-64.

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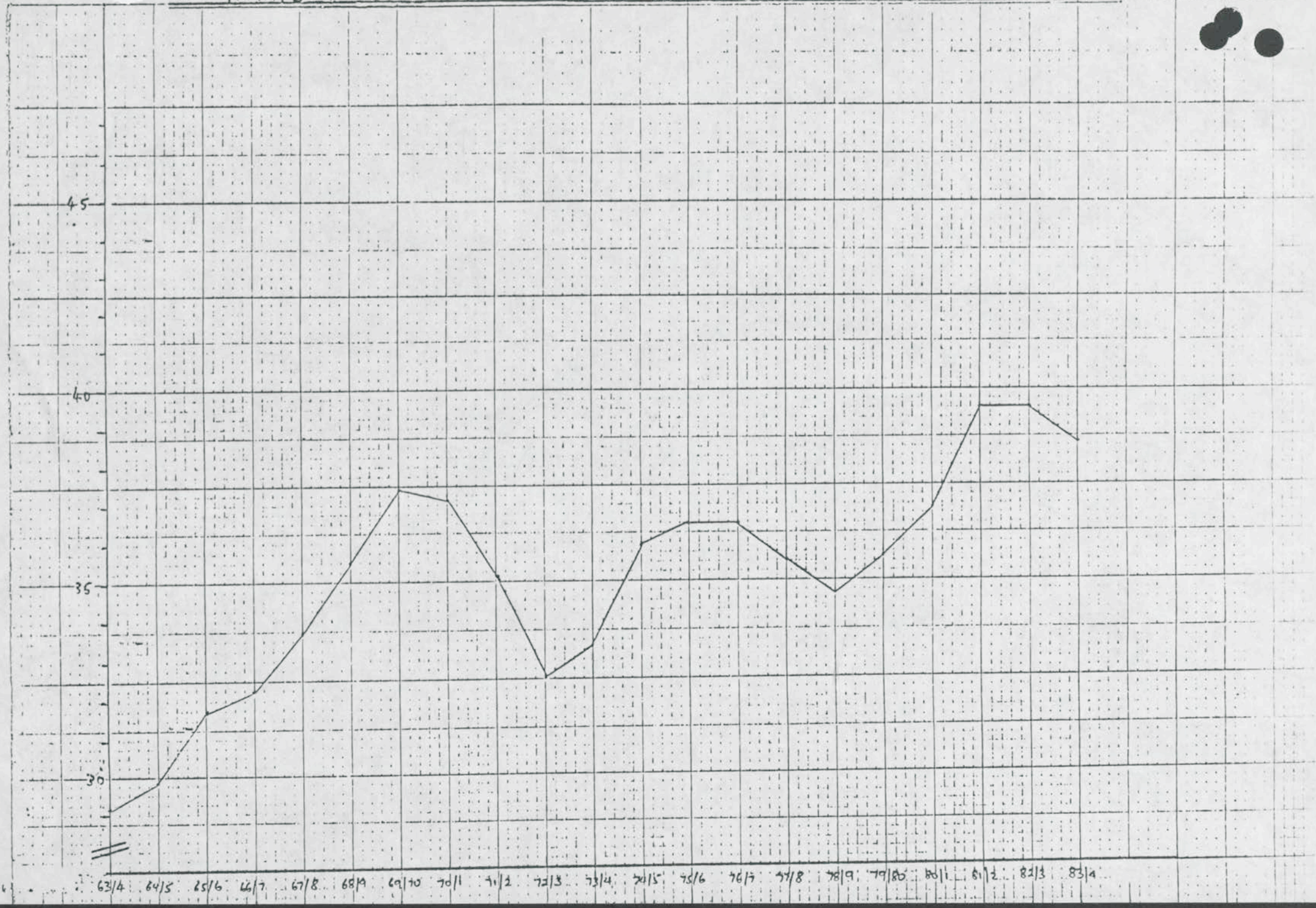
* Information on direct tax allowances and reliefs, and on the difficulties of quantifying their costs, is published in the annual Public Expenditure White Papers (most recently on pp 164-5 of Cmnd 9143-II)

CHART 4A

NON-NORTH SEA TAXES PLUS NIC'S AS % OF NON-NORTH SEA GDP



21. The shares of the different taxes in the total burden have also changed over this period. The following table shows this for the period since 1963-64.

Table 3

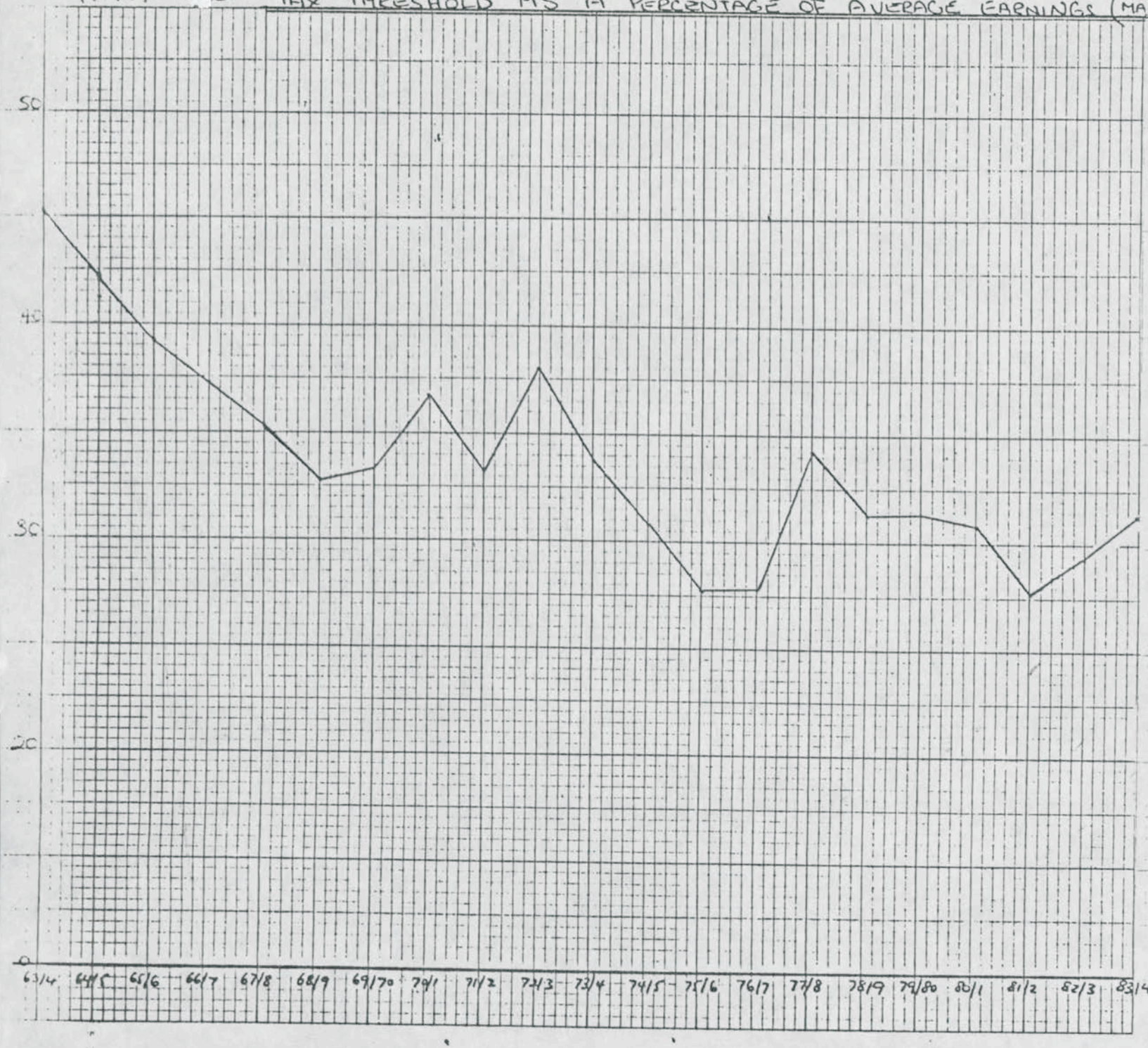
Tax and other payments in real terms
£ billion (1982-83 prices)

	1963-64	1978-79	1983-84	%Change 1963-4 to 1983-4	%Change 1978-79 to 1983-84
Income Tax	16.7	31.1	30.0	+80	-2
Corporation Tax					
Mainstream	4.3	3.7	3.2	-26	-14
ACT	-	2.2	1.7	-	-25
North Sea Taxes	-	0.9	8.7	-	+830
Capital taxes & stamp duty	2.4	2.3	2.6	+8	+17
Taxes on expenditure	18.5	25.6	32.2	+74	+29
NIS	-	3.4	1.5	-	-53
LA rates	6.4	9.4	11.6	+81	+23
Total Central Government taxes and rates	48.3	78.7	91.4	+90	+17
NICs - employees	4.4	6.7	9.9	+125	+52
NICs - employers	3.9	10.1	10.3	+164	+6
Total, taxes, rates & NICs	56.5	95.5	11.5	+97	+19
Memorandum items:					
Income Tax and employees' NICs	21.1	37.8	39.9	+90	+7
NIS and employers' NICs	3.9	13.3	12.1	+210	-9
Employees' and Employers' NICs	8.3	16.8	20.2	+140	+25

Over the period as a whole, the increasing tax burden has led to a substantial increase in income tax. There has however been a small fall since 1978-79, helped by the new revenue from North Sea taxes and the policy of shifting the burden from direct to indirect taxation. There has been a big increase in national insurance contributions, as the real value of benefits generally has been maintained or even increased while their volume has grown. Rates, reflecting higher expenditure by local authorities, have grown throughout the period. The yield of Corporation Tax has risen very little, because of declining company profitability.

22. One important result of these trends has been that many people on low incomes are now paying tax. The tax threshold for a married man fell from 45 per cent of average earnings in 1963-64 to 31 per cent in 1983-84. Chart 5 illustrates this change. The low starting-point for tax means not only that large numbers of low-paid people have been brought into tax for the first time, but also that the average rate of tax paid by those above the threshold, who may be on average earnings or less, has increased. A married man without children at average earnings paid about 13.1 per cent of his income in income tax in 1963-64. He pays over 20 per cent today. Chart 6 shows how this proportion has varied throughout the period.

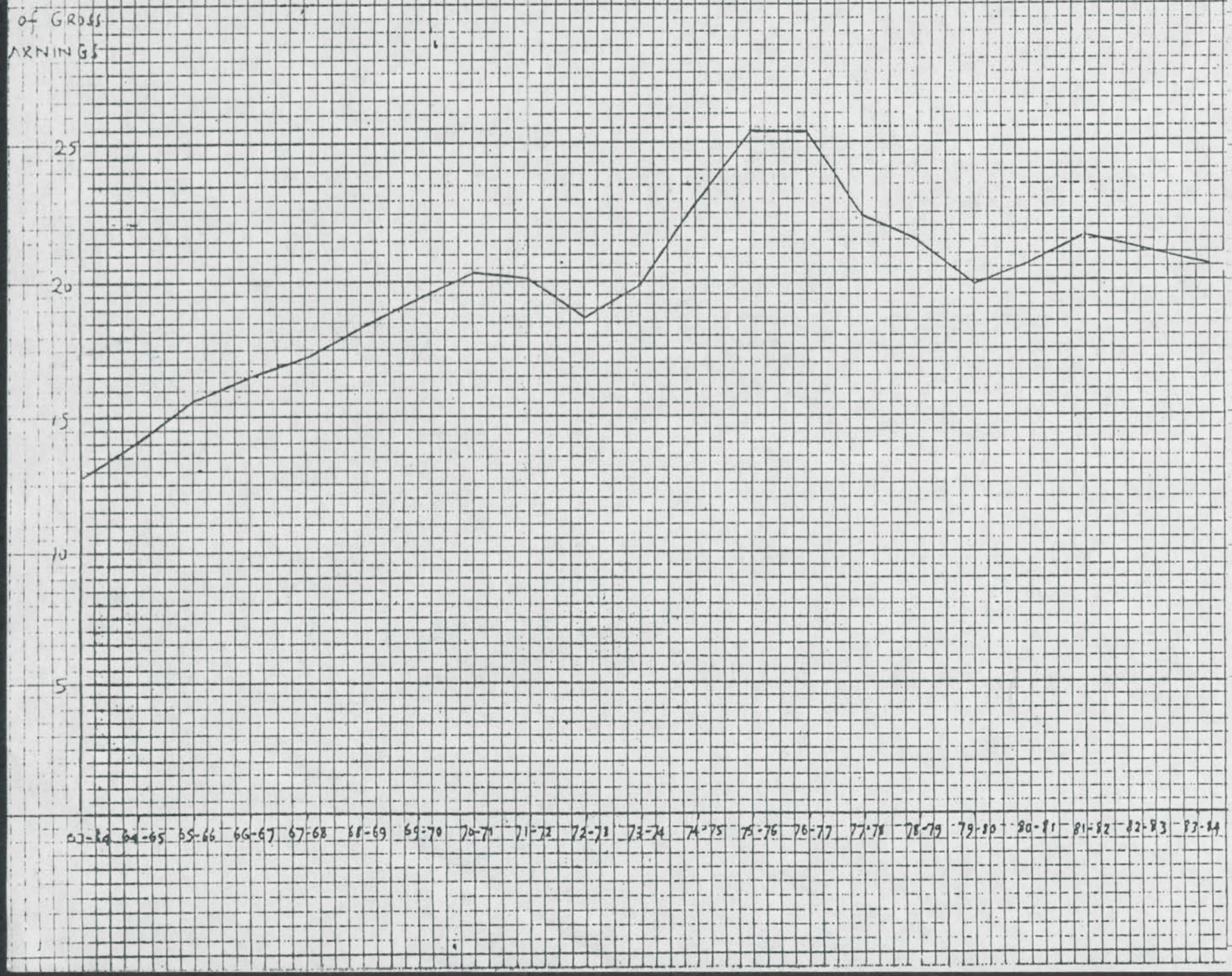
CHART 5 TAX THRESHOLD AS A PERCENTAGE OF AVERAGE EARNINGS (MARRIED MAN WITHOUT CHILDREN)



Show an estimate for 84-5 dotted line

CHART 6

INCOME TAX AS PERCENTAGE OF GROSS EARNINGS : MARRIED MAN (NO CHILDREN at average earnings)



show an estimate for 84/85

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23. The burden of tax on the lower paid has therefore risen substantially. At the same time, the level of social security benefits has, over the period as a whole, been raised broadly in line with earnings. The result has been that increasing numbers of people have come to be simultaneously subject to tax and entitled to means-tested benefits. If their income rises, they therefore suffer both an increase in tax and a withdrawal of benefits and the marginal rate of deduction for them, taking those two effects together, can be higher than the tax rate at the top of the income scale. This is the "poverty trap". Another effect of raising taxation on low incomes, while maintaining or increasing the value of benefits, has been to change the ratio between net pay in work and benefit income in unemployment. Income in unemployment can therefore become a high proportion of, and can even equal, net income in work: the "unemployment trap".

III Public expenditure - future prospects

(a) Medium term

24. The government's policies for public expenditure up to 1986-87 were set out in the Public Expenditure White Paper published on 16 February. Total public expenditure is planned to grow in cash in the three years 1984-85 to 1986-87 by 5 per cent, 4½ per cent and 3½ per cent respectively, from £126.4 billion to £136.7 billion. Given the likely prospect for inflation over that period, the government expects the level of public expenditure to remain broadly constant in real terms up to 1986-87. Further, the assumption in the government's Medium Term Financial Strategy, set out in Part 2 of the FSBR, is that total public expenditure will remain constant at its 1986-87 level in real terms for a further two years, up to 1988-89, although decisions have yet to be taken for these years.

(b) Longer term pressures

25. Beyond 1988-89, the prospects are necessarily a good deal less clear, both for public expenditure totals and for individual programmes. There will be some who will argue that it makes little sense to consider, still less to decide upon, public spending totals without a clear idea of the implications for individual programmes.

The government believes that such thinking has been largely responsible for the upward drift of public expenditure over many years. It is necessary to turn the argument round the other way, to decide first what can and should be afforded, then to set expenditure plans for individual programmes consistently with that decision. This Green Paper is primarily concerned with this major fiscal issue. It does not, accordingly, attempt to make detailed projections of individual expenditure programmes so far ahead in the future. But it is possible now to discern some of the pressures for still higher public spending.

26. It is in the nature of the public services that demands are literally limitless, because they are not restrained by the price mechanism which forces those making demands to balance them against costs. Where possible, the government is seeking to transfer the provision of services into the market sector. In other areas it may be possible to use charges as a more direct way of testing demand, even within the public sector. There may, too, be a case for hypothecating revenues to individual expenditure programmes, particularly in the social field, in order to bring home the costs of benefit improvements. But over a wide range of services the only means of limiting the burden on the economy is for the government to control the supply.

27. Over the next decade there are reasons to expect continuing pressures for more spending, and insistent demands for improvements. One is demography - especially, the effect of increasing numbers of the very elderly. Another is rising expectations, as incomes of the working population increase. In those services which depend on personal contact, there will be less scope for reducing costs by the use of new technology, so that the relative cost of providing these services will tend to increase over time. In other areas technological advance will yield substantial cost savings; but it can also open up new possibilities for improved levels of service, and therefore new demands.

28. The following paragraphs indicate the main pressures on individual expenditure programmes.

Social Security

29. Since there is no clear 'right' level for any particular social security benefit, there are constant demands both for real increases in the level of benefits and for extension of benefit coverage to those who do not at present qualify.

30. Because about half of present expenditure goes on the elderly, the numbers of those above pension age is the main demographic influence on the programme. Between now and 1995-6 the projection is for very little increase in this number - from about 9.9 million to 10.2 million. But, in the early years of the next century numbers will rise rapidly as the 'baby boom' of the 1950's and early 1960's comes to retirement age and by 2025-6 the latest projections suggest a total of 12.3 million.

31. Moreover, against this background the programme will also have to cope with the rapidly - growing pension entitlement under the 1975 Social Security Act. More people - particularly married women - will be entitled to a pension in their own right, and between now and 1993 steady growth in the number of pensioners is expected. By 1993 there will be 600,000 more pensioners than in 1983-84. On average each 100,000 pensioners represents about £160 million of the total provision for the basic state pension. More significantly, the earnings-related pension element of the 1975 State Earnings-Related Pension Scheme (SERPS) scheme is now beginning to increase expenditure, and the effect will be appreciable from the early 1990's. Unless there are changes to the 1975 scheme it will be reaching maturity from the turn of the century; anyone retiring after 1998 will be potentially entitled to a full earnings-related pension and this will have its full impact at the same time as demographic factors begin to exert their maximum pressure. There will be more pensioners; and they will, in general, be a lot better-off, even relative to those in work, than they are now.

32. Until then however, most pensioners will be reliant on the basic state retirement pension; and there will continue to be substantial dependence on supplementary pension. The government is committed to raising these benefits in line with inflation. But, as the recovery progresses, there is likely to be strong pressure for benefits to rise faster than this. Lastly, there is growing support for equalisation of

pension age as between men and women - although whether this would increase or reduce public expenditure would depend upon the age at which equalisation was set.

33. Such pressures are not confined to expenditure on the elderly. As noted in paragraph 15(v), expenditure on disability benefits has been growing rapidly. To meet the calls for a comprehensive disability benefit would cost about £3 billion a year. Increases in child benefit are often advocated not only to alleviate family poverty, but also to reduce the poverty and unemployment traps. But significant increases in this universal benefit are very expensive: each £1 on child benefit costs £500 million in a full year.

34. Nevertheless, as the economic recovery progresses and the number of those unemployed falls over the next decade, the recession-induced pressures on the social security programme will abate: for each 100,000 fewer unemployed there should be a fall in the cost of benefits to the unemployed of around £185 million.

Defence

35. It is difficult to be confident of a reduction in international tension or in external threats to UK interests. Pressures for increases in defence spending may also be fuelled by the growing sophistication of defence equipment. The government will seek to offset these factors by pursuing greater value for money within the defence programme, and a more equitable division of the common defence effort among the European Allies. But there will continue to be strong arguments for more expenditure on defence.

Demography

36. The demographic projections referred to in the following paragraphs are summarised in the table below:

Table 4

Demographic projections for the United Kingdom

millions

	1981	1984	1991	2001
Under 15	11.6	11.0	11.1	12.2
(as % total)	(20.1)	(19.5)	(19.5)	(21.0)
15 to pensionable age	34.5	35.1	35.3	35.5
(as % total)	(61.4)	(62.3)	(62.0)	(61.2)
Pensionable age	10.1	10.2	10.5	10.3
(as % total)	(18.0)	(18.1)	(18.4)	(17.7)
Total	56.2	56.3	56.9	58.0
of which over 75	3.2	3.5	3.9	4.2
(as % total)	(5.7)	(6.2)	(6.8)	(7.2)

Source: Office of Population, Censuses and Surveys (OPCS).

Health and Personal Social Service

37. As with social security, demographic changes constitute a major influence on this programme. Health care costs are dependent on age. The costs in the 0-4 age group are about twice as much per head as for those of working age; for the 65-75 age group about four times as much, and for the 75 and over age group about nine times as much. Until the early 1990's, and again from the early years of the next century, the proportion of the elderly and very elderly in the population is forecast to rise. In particular the numbers of those over 75 are forecast to rise from 3.5 million in 1984 to 3.9 million in 1991. If current levels of gross health expenditure per head of population in different age groups were to remain constant over time, spending would need to rise about 1 per cent a year between 1983-84 and 1993-94 simply to keep pace with demographic changes.

38. Medical advances may prove a major further pressure. Where these lead to simpler or non-hospital treatments, they may in fact reduce costs. But where they involve expensive equipment, expensive surgical techniques or new drugs they can lead to powerful demands for increased funds. Even where unit costs are relatively small (eg hip replacement surgery) widespread demand for such treatment may strain the resources available.

39. Changes in social attitudes and patterns of treatment may also pose problems for expenditure control in this programme. Increasingly, on both medical and social grounds, the aim is to keep

the elderly and the mentally ill and mentally handicapped in the community. Although treatment in hospital is expensive, keeping people in the community requires heavy investment in support services - the medical professions, social workers and domiciliary support. This affects both the family practitioner services and the local authority personal social services, both of which are highly labour-intensive.

40. Finally, evidence from other countries suggests that increased affluence will lead to pressures for a greater proportion of spending on health care. Here as elsewhere, demographic pressures and increasing demands are not the whole story. The scope for cost reductions flowing from new technology has already been mentioned. Beyond this the Health Service needs to achieve continuing efficiency improvements, from higher productivity and better management, following the example of private industry in recent years. As standards of living grow it would be reasonable to expect people to make a larger direct contribution to the costs of their medical treatments, through higher charges; and many have chosen to make provision for their health needs outside the State system, whilst continuing to contribute towards Health Service costs through their taxes. As living standards continue to rise, some further increase may be expected in the numbers who so choose. These developments will moderate the pressures for an increased contribution from the taxpayer, but such pressures will still continue.

Education

41. Demographic changes affecting education over the next decade are such that, if current levels of provision per pupil and per student were broadly maintained, education's share of GDP could be expected to decline significantly. The number of pupils in maintained schools is expected to fall from over 8.9 million in 1984 to a trough of some 8.05 million in 1991, rising thereafter to around 8.2 million by 1994. If the cost per pupil were maintained at existing levels every 100,000 fewer pupils would lead on average to savings of around £90 million a year - although there are diseconomies of scale which will erode such savings. The number of students in higher education is projected to fall from 580,000 in 1984 to around 465,000 in 1994. A number of factors, however, are likely to work in the opposite direction. There will be the usual pressures for increased expenditure

per pupil. Moreover the number of primary school children is forecast to rise steadily from 1986, with under fives projected to increase from 1988. As more married women take up paid employment the pressures for increased nursery provision seem likely to grow, although these pressures could be met by employers or by private individuals rather than the public authorities. Technological advance in industry may, too, result in extra demand for relatively expensive courses in science and technology within further and higher education - although there may be scope for involving employers in the financing of such courses.

Capital expenditure

42. Table 1.13 of the latest Public Expenditure White Paper shows that total public sector capital spending has remained broadly constant in real terms since 1978-79. The government believes that there is no self-evidently correct level of capital spending in aggregate, but that each capital project should be proceeded with when justified by a searching investment appraisal. Without a rigorous case-by-case assessment of this kind scarce resources will be wasted, as has all too often happened in the past. Nevertheless, in the longer term, with sustained economic growth and more demand (in the case of roads, for example, heavier traffic) there will be pressures to spend more on maintaining and improving the stock of capital assets in the public sector.

Public Service Pay and Pensions

43. Public service pay accounts for about one-third of public expenditure - some £38½ billion in 1983-84 - or about 13 per cent of GDP. Each extra 1 per cent on the pay bill adds around £1/3 billion to public expenditure, with particularly heavy effects on the law and order programme (of which 73 per cent is pay), education (62 per cent) health and personal social services (56 per cent) and defence (37 per cent). Increases in pay also lead to increases in public service pension costs. To the extent that real incomes in the private sector rise there are likely to be upward pressures on public service pay which would have direct implications for the level of service which could be provided within a constant level of public expenditure, unless offsetting improvements in efficiency can be made.

International Comparisons

44. Other countries face similar pressures on spending. In the United States a Report by a National Commission on Social Security Reform was published last year. The Commission estimated that the two main social security trust funds which provide Old Age and Survivors Insurance and Disability Insurance faced a shortfall of between $150-$200 billion between 1983-89 unless benefits were restrained and taxes increased. The Commission expected that the Health Insurance Fund would also run into financial problems at the end of the decade. In each case the difficulties were expected to grow in the first half of the next century.

45. The Japanese government has also recently produced a report on social expenditure looking ahead to the year 2000. The report, 'Japan in the Year 2000', found that:

(i) In the year 2000 16 per cent of the Japanese population was expected to be over 65, compared to 9 per cent at present.

(ii) Partly as a result, the proportion of the population at a productive age was expected to fall from 60 per cent today to 55 per cent by 2015.

46. [Paragraph on European experience - to follow.]

47. The OECD Secretariat's recent survey of the prospects for social expenditure concluded it was difficult to foresee increases in the scope or coverage of any of the main social programmes in the major OECD countries, despite the likely pressures to do so. Beyond 1990 the Secretariat expected the principal challenge facing social welfare systems might be to accommodate the demands of an ageing population which required both higher provision for pensions and heavy demands on the health system. The disappearance of the extended family meant that older people had come to rely more on the state. The Secretariat concluded that if these trends were not reversed the demands on public welfare programmes would be likely to increase.

V. Future prospects for the tax burden

48. As the economic recovery has gained pace from mid-1981 onwards, and with the benefit of the rapid fall in the rate of inflation, public spending has been held in successive Public Expenditure Surveys to the cash plans announced in the 1982 White Paper. It will be vital to maintain this firm control of public expenditure in the years ahead; without it there will be little prospect of alleviation of the excessive levels of taxation of recent years.

49. In the process of debating and determining public spending it is clearly right that decisions about the level of total spending should reflect in some degree the purposes and needs of particular programmes. But, as experience over many years and in many countries has shown, the reality of spending decisions has been that their effect has been to raise total expenditure to a level which bears no relation to what taxpayers will tolerate or to the consequences for incentives and growth. This process cannot be allowed to continue indefinitely.

50. The size of the tax burden over the next decade will depend upon a large number of factors. The two most important are the rate of economic growth and the level of public expenditure.

Economic growth

51. It is the government's policy to continue the sustained reduction in inflation of recent years so that, with appropriate micro-economic policies - the encouragement of enterprise, efficiency and flexibility - conditions are created for continuing economic growth and higher employment. The growth rate over the next decade will depend on how quickly costs and prices adjust to the Government's financial framework. More rapid adjustment, particularly in the labour market, will mean faster growth. The growth rate will also depend on how successfully public expenditure is controlled so that the burden of taxation can be reduced and incentives improved.

52. For the purposes of this Green Paper it has been assumed that the economy will grow on average 2¼ per cent a year for the five years until 1988-89. For this period, the projections are in line with

those of the Medium Term Financial Strategy, as set out in the Part 2 of the FSBR. Thereafter there are two factors pointing to some slow-down in the growth rate: in the North Sea sector output may by then be in gradual decline, exerting a contractionary influence, of perhaps ¼ per cent a year, to GDP; and the labour supply will hardly be increasing. Two alternative growth paths after 1988-89 are considered. In the first GDP grows by 2 per cent a year, equivalent to about 2½ per cent a year for the non-North Sea sector. This is about average for the period since 1951 and significantly better than in the last decade. In the second case GDP grows at 1½ per cent a year, equivalent to about 1¾ per cent for the non-North Sea economy.*

53. It is important to avoid over-optimistic growth assumptions since it is never difficult, if the economy grows faster than expected, either to increase public expenditure or to reduce taxes. It is very much more difficult, when the growth rate is disappointing, to cut expenditure; and damaging to raise taxes.

The North Sea

54. The path of North Sea tax revenues has an important bearing on the composition of the overall tax burden. The profile of production, the behaviour of real oil prices and the level of tax-deductible expenditure by oil companies are important in this context. Production is expected to be close to its peak level in 1984-85, and may fall steadily after that. In the years to 1988-89 the projections are at the centre of the ranges [announced in Parliament on 1 March.] Thereafter, production is assumed to fall by an average 5 million tonnes a year so that by 1993-94 it may be little more than half of its peak level. It is assumed here that after falling over the next two years or so in real terms, oil prices 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 cent a year. Inspite of this North Sea revenues fall in the projections from about 3 per cent of GDP in 1983-84 to about 1¾ per cent of GDP in 1993-94 as North Sea oil and gas production falls. The calculations are set out in Annex 4.

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* The background to the growth assumptions is set out in Annex 3.

Debt interest and public sector borrowing

55. Another important feature of the projections is the prospect for net debt interest payments. This reflects the course of public sector borrowing and interest rates. 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. With stable prices by the end of the period real interest rates will have come down to more normal levels, and net debt interest may have fallen from about 3 per cent of GDP in 1983-84 to about 2 per cent in 1993-94. The calculations are set out in Annex 5.

56. Falling inflation and interest rates require a further reduction in the PSBR as a percentage of GDP. If the PSBR did not fall, achievement of lower inflation would require unacceptably high real interest rates. Such a situation would be unlikely to be sustainable indefinitely.

57. In the period to 1988-89, the PSBR is assumed to follow the illustrative path set out in the MTFS. Thereafter it is assumed to fall further as a share of GDP, from 1¾ per cent in 1988-89 to 1 per cent in 1993-94. On this basis, the ratio of public sector debt to GDP should be broadly stable by the end of the period. There is inevitably some uncertainty about the precise PSBR path which would be consistent with the government's aims on inflation. But given the aim of stable prices, the scope for varying the PSBR as a share of GDP is relatively limited. If a higher path were followed, a good deal of the apparent scope for increased spending or lower taxes would be pre-empted in the event by higher debt interest payments.

58. The fall in the PSBR as a share of GDP after 1984-85 broadly matches the fall in net debt interest payments. Both reflect the fall in inflation in the projections, and the accompanying fall in nominal interest rates. Net of debt interest little or no underlying change in the PSBR is assumed. On this basis, the tax burden for the non-North Sea sector can be reduced to the extent that public expenditure falls more than North Sea tax revenues as a share of GDP.

Public expenditure and the tax burden

59. In assessing the effect on the tax burden of different assumptions about the growth of public expenditure this Green Paper concentrates on changes in non-North Sea taxes. Accordingly, and for consistency, changes in the level of non-North Sea taxes are expressed in the following paragraphs as a proportion of non-North Sea GDP. This treatment reflects the natural focus of public interest in these issues - which is on the level and burden of personal and corporate taxation in the non-North Sea sector.

60. If the public expenditure planning total is held flat in real terms up to 1988-89 as in the MTFS, the non-North Sea tax burden would be lower than in 1983-84 but still slightly above its level in 1978-79. The figures are shown in Table 5 below.

Table 5: The Burden of Taxation in the MTFS period

(per cent)

	1973-74	1978-79	1983-84	1988-89
Non-North Sea Tax*	33	34.7	38½	35½
Total Taxes**	33	34.1	39	36

* As a proportion of non-North Sea GDP (at market prices)

** As a proportion of GDP (at market prices)

61. Thereafter, the extent of the further reduction in the tax burden will depend on the growth of public expenditure. The government intends to continue to hold public expenditure firmly in check. But part III of this Green Paper describes the pressures which are likely to build up for more spending. Therefore, rather than carry forward a single projection beyond 1988-89, this Paper explores the implications of two alternative projections - that the public expenditure planning total either stays flat or grows by 1 per cent a year in real terms over the following five years. The figures in Table 6 illustrate what the burden of taxation in 1993-94 would be on the two different projections for GDP and on the two different assumptions about public expenditure growth after 1988-89.

Table 6: The Burden of Non-North Sea Taxation in 1993-94
(per cent of non-North Sea GDP at market prices)

GDP growth (per annum after 1988-89)	Public Expenditure Growth after 1988-89 (per annum)	
	Zero	1%
1½%	33	35
2%	32	34

62. If the public expenditure planning total is held flat, the burden of non-North Sea tax could be brought down to well below its 1978-79 level of 34.7 per cent by 1993-94. This further reduction in tax and improvement in incentives should lead to a better economic performance and thus make it more likely that the higher growth path is achieved. But, even so, the tax burden would be only about 1 per cent lower than it was in 1973-74 and still some way above the level of the early 1960's. With 1 per cent growth of public expenditure the picture would be worse: after a decade the tax burden would be little different from what it was in 1978-79. With 2 per cent growth of expenditure - ie still below the growth rate of the last twenty years - the burden of taxation would be 36-37 per cent, well above the 1978-79 level.

63. Such a reduction in the burden of taxation will allow a reversal of the trends of the last twenty years - the bringing into tax of the lower paid and the increase in the tax paid by those on average earnings - which have been described earlier in this paper. The proportion of income taken by income tax for those on average earnings is now 20 per cent. In the worst case shown in Table 6 this percentage would fall to 18 per cent. This reduction would, to those on present average earnings, be worth £3.50 a week. In the best case, it would fall to 13½ per cent (worth an extra £11 a week to those on present average earnings), still not quite down to the levels of the early 1960's. These calculations* are made on the extreme assumption that the benefits of tax reductions are concentrated exclusively on personal allowances.

*which allow for Budget changes, including those on company taxes

VII Conclusion

64. Public expenditure, in Britain as in other countries, has risen over many years, both in real terms and as a share of national income. It is difficult to escape the conclusion that there is an inbuilt tendency for spending to rise; and an inbuilt resistance to expenditure reductions. The inevitable consequence has been that the taxes required to pay for this spending - taxes on people and on the firms they work for, - have risen in step, unless, for a limited period, governments increased their borrowing. Such borrowing, however, has to be repaid, and might more properly be described as a tax on future generations.

65. These increases in taxation have, in the government's view, had a serious impact on Britain's economic performance over many years. Since lower growth has not led to lower demands for public services, the outcome, year after year, has been still higher taxation to finance ever higher public expenditure.

66. As public spending takes a larger and larger share of GDP, so the public sector steadily encroaches on the rest of the economy. This is a process which cannot go on indefinitely. Last month's Public Expenditure White Paper documented the government's determination to hold its spending at broadly its present level in real terms for the next three years; and the revised medium term financial strategy, presented in the Budget, projects this unchanged level of public spending forward for two more years. These plans, like those in the 1982 and 1983 White Papers, represent a major change in direction for this country.

67. This Green Paper shows how difficult it will be to stick to these intentions. There will be demands on all sides - in the fields of defence, social security, health and education, to name but a few - to improve public services, and there will also be arguments that additional spending is required in some cases simply to stand still and prevent these services from deteriorating. Some of this will, no doubt, be special pleading; but in some cases programmes will need to be increased, and the increases financed by reductions in programmes

of lower priority, or by further efficiency savings across programmes as a whole.

68. Without firm control over public spending, however, there can be no prospect of bringing the burden of tax back to tolerable levels. On the illustrative framework set out in this Paper the tax burden will be reduced to the levels of the early 1970's only if public expenditure is held at its present level in real terms right up to 1993-94.

69. If, on the other hand, we assume what by historical standards is a very modest rate of public expenditure growth - 1 per cent a year in real terms after 1988-89, compared with the average 3 per cent growth of the last twenty years - the tax burden would be scarcely back to its 1978-79 level even after ten years of growth at about 2 per cent a year: still less to its level in the 1960's and early 1970's.

70. In order to underline the inescapable connection - so often overlooked in public debate on these issues - between public spending and the taxes required to finance it, the projections in this Green Paper have concentrated upon quantifying the reduction in the tax burden which different combinations of circumstances might produce. But it would, of course, always be open to the government to decide, once the virtuous circle of lower taxes and higher growth had been established, to devote some of these resources to improved public services rather than reduced taxation. There should, however, be no general presumption that higher public spending is inevitable if provision in these areas is to be improved, given the scope for switching from public to private sectors, and for improved efficiency within the public sector.

71. All these projections are of course, subject to a wide range of uncertainty. But on one issue there can be no room for doubt: Parliament and the government must reach its judgement about what public expenditure in total can be afforded, then contain individual programmes within that total. If the public discussion of these important issues leads to a wider understanding of this fact - that finance must determine expenditure, not expenditure finance - the discussion will have served a useful purpose.

72. The government looks forward to a continuing debate on the fiscal prospects in the longer term. There will, no doubt, be much discussion of the validity and realism of the broad economic assumptions made in this Green Paper; of the conclusions to be drawn for individual programmes from the consideration of future pressures on public spending; and of whether the additional resources created by continuing economic growth should go to reducing the present unacceptably high level of taxation, or to further improvements in the public services, or to both in some degree. But the government hopes that the main theme of this Green Paper will remain at the centre of the debate: that to break away - as at some stage, on any view, we must - from the pattern of the past in which public spending and taxation took an ever-larger share of our national product, we must establish a clear view of what can be afforded; set our spending plans accordingly; then stick to those plans.

ANNEX 1

DEFINITIONS

Units for measuring public expenditure

1. Three units of measurement have been used in recent and past public expenditure White Papers. These are

(i) Cash: This is the amount of cash paid or received during the year. The Government's public expenditure plans are now made in cash terms.

(ii) Real (or cost) terms: This is equal to cash expenditure, excluding the effects of any rise in average GDP prices. (If cash expenditure were £100m in year A and £106m in year B, and the GDP price level had risen by 5 per cent between the two years, expenditure in year B would be about £101m in "year A cost terms".) Cost terms is a useful measure of expenditure for comparisons over time, and for medium and longer term public expenditure projections.

(iii) Input volume: This is the physical quantity of input.

2. None of these units measures the amount of service delivered by a programme. Growth in input volume over time is usually less than growth in the amount of service delivered, because of increases in the efficiency with which the inputs are used. Changes in cost terms expenditure may be more or less than changes in the amount of service delivered, depending upon both relative price changes and efficiency gains. The difference between growth in cost terms expenditure and growth in input volume, for a whole programme or part of a programme (eg pay), is usually called the relative price effect.

3. Sometimes the term level of service or level of provision is used to describe changes in the amount of service delivered adjusted for, especially, demography. Neither the amount of service delivered nor levels of service can usually be measured precisely.

4. It is important when describing the growth or contraction of public expenditure programmes to distinguish between changes in cash expenditure, real (or cost) terms expenditure, input volume and levels of service.

Glossary of other terms

Cash limits: Cash limits set a limit on the amount of cash the Government proposes to spend or authorise on certain services or blocks of services during one financial year. The nationalised industries' contribution to public expenditure is controlled by means of external financing limits, which are a form of cash limit for individual industries.

Cash plans: Planned cash expenditure for each programme over the next few years are published annually as a White Paper called The Government's Expenditure Plans.

Debt interest: "gross debt interest payments" by the public sector are as defined in the national income accounts. "Net debt interest" is broadly that part of gross debt interest that has to be financed from taxation or further government borrowing (see Cmnd 9143 for further details).

Estimates or Supply expenditure: Expenditure by central government which is financed by monies voted by Parliament in the annual Supply Estimates.

General government expenditure: General government expenditure is the principal measure of public expenditure (q.v.) in the national income accounts, published monthly in 'Financial Statistics'. Unlike the planning total, general government expenditure includes debt interest, non-trading capital consumption, stock appreciation and VAT paid by local authorities but refunded to them, and it excludes revenue from certain sales of assets. A fuller list of the differences is provided in Part 5 (paragraph 32) of the public expenditure White Paper Cmnd 9143.

Medium Term Financial Strategy: The statement of the government's objectives for monetary and fiscal policy for the medium term, published in the annual Financial Statement and Budget Report (FSBR).

Public Expenditure Planning Total The planning total includes all public expenditure programmes (including grants to and borrowing by public corporations), special sales of assets and the Reserve.

Public expenditure: There is no unique definition of public expenditure. Different definitions are required for different purposes and these change overtime. The difference between the public expenditure planning total (q.v.), the national acounts definition of general government expenditure (q.v.) and the definition used for measuring public expenditure as a percentage of GDP are described in Part 5 (paragraph 32 to 37) of the public expenditure White Paper Cmnd 9143.

Public Expenditure Survey: The government's annual review of expenditure plans covering the forthcoming three year period, published in The Government's Expenditure Plans.

PSBR (Public sector borrowing requirement): The PSBR is the difference between public sector cash receipts from and payments to the private sector and overseas. The PSBR is the sum of the central government, local authorities and public corporation borrowing Requirements less all lending transactions between the sub-sectors.

Public expenditure as a share of GDP: The relative size of public expenditure can also be measured by setting it against the gross domestic product (GDP). In doing so it must be remembered that not all public expenditure is part of GDP; the former includes transfer payments (for example social security benefits) whereas GDP does not. This measure of public expenditure is intended to indicate the proportion of nominal GDP to be financed through government taxation and borrowing.

[Taxation glossary to be added]

ANNEX 2

SOCIAL EXPENDITURE BY COUNTRY, 1960-1981

	Social expenditure as a percentage of GDP		*Annual growth rate of real GDP*		*Annual growth rate of real social expenditure*	
	1960	*1981[a]*	*1960-75*	*1975-81[a]*	*1960-75*	*1975-81[a]*
United States	10.9	21.0	3.4	3.2	7.7	2.9
Japan	8.0	17.5	8.6	5.1	9.7	8.9
Germany	20.5	31.5	3.8	3.0	6.7	1.9
Canada	12.1	21.7	5.1	3.3	9.5	2.9
France[b]	13.4	23.8	5.0	2.8	7.4	7.6
Italy	16.5	29.1	4.6	3.2	7.4	3.1
United Kingdom	13.9	24.9	2.6	1.0	5.6	3.3
Australia	10.2	18.6	5.2	2.4	8.6	2.4
Austria	17.9	27.9	4.5	2.9	6.0	4.6
Belgium	17.0	38.0	4.5	3.0	9.1	4.6
Denmark	10.2	29.0	3.7	2.2	9.3	4.4
Finland	13.2	n.a.	4.5	2.9	7.3	n.a.
Greece	8.7	12.8	6.8	3.5	7.8	2.3
Ireland	11.7	27.1	4.3	3.5	8.2	5.2
Norway	11.7	27.1	4.3	4.1	9.5	5.6
Netherlands	16.3	36.1	4.5	2.0	9.2	1.4
New Zealand	13.0	19.6	4.0	0.4	4.4	3.7
Sweden	14.5	33.5	4.0	1.0	8.4	4.0
Switzerland	7.7	14.9	3.4	1.8	6.9	2.5

Notes:
a) Or latest available year. *b) Excluding education expenditure.*
Source: OECD Secretariat and National Accounts.
n.a.: not available

GROWTH IN THE LONG TERM

This annex discusses the assumptions for GDP growth that underlie the projections of non-North Sea taxation for 1993-94. As explained in paragraph 34 two assumptions for GDP growth for the period 1988-89 to 1993-94 are made, of 2 per cent and $1\frac{1}{2}$ per cent, with corresponding figures of [$2\frac{1}{4}$] per cent and [$1\frac{3}{4}$] per cent for GDP less North Sea. The growth rate over the preceding five years, the period of the MTFS, is assumed to be $2\frac{1}{4}$ per cent a year.

2. Since 1951 there have been two distinct phases in output growth. From 1951 to 1973 the growth of GDP(1) averaged 2.9 per cent a year with little variation from cycle to cycle (Table A.1). Since 1973 growth in the UK, as in other industrialised countries, has been much slower: between 1973 and 1979 the average was 1.3 per cent and from 1979 to 1983 it was 0.3 per cent, although this is not strictly comparable because 1983 was not a cyclical peak.

3. The growth of North Sea production has contributed about [0.7] per cent a year since 1973, implying an average growth of GDP less North Sea output of [0.3] per cent over the period 1973 to 1983.

4. The slowdown in growth after 1973 was not accompanied by any slowdown in the rate of increase in the working population, which increased, as it had done in the period up to 1973, by about $\frac{1}{2}$ per cent a year on average (Table A.1). Numerically, most of the slowdown in output growth after 1973 is accounted for by a slower growth of output per employed person. This averaged 1 per cent over the 1973 to 1979 cycle, compared with about 2.4 per cent in the two decades to 1973. This measure may tend to understate the underlying growth of productivity since it takes no account of changes in hours worked or numbers of part-time workers.

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(1) Factor cost at 1980 prices, average estimate

5. Output growth in peace-time periods before the Second World War was generally higher than in the decade after 1973, but lower than in the two decades before 1973. The growth rate between most cyclical peaks from the 1850s to the Second World War was within the range $1\frac{1}{2}$ per cent to $2\frac{1}{2}$ per cent a year (Table A.2). Productivity growth was nearly always within the range $\frac{1}{2}$ per cent to $1\frac{1}{2}$ percent a year.

6. There are three main factors which are relevant to the trend rate of growth over the period 1988-89 to 1993-94:

i. North Sea production. This is assumed to decline by about [$3\frac{1}{2}$] per cent a year over the period 1988-89 to 1993-94 (see Annex 4), equivalent to a reduction in the GDP growth rate of about [$\frac{1}{4}$] per cent a year. The rate of decline is rather less rapid than that assumed forthe period from 1984-85 to 1988-89. North Sea production is an integral part of the economy with complex interactive effects between the onshore and North Sea sectors, notably through the exchange rate and current account. The decline of North Sea production will tend to stimulate the growth of the rest of the traded goods sector of the economy, just as the opposite occurred when North Sea production was building up. But it is unrealistic to expect onshore GDP growth to compensate fully for declining North Sea production in the short term. The underlying growth of onshore GDP is unlikely to be raised much above what it would otherwise have been.

ii. Labour supply. The contribution of the labour supply to the growth in productive potential is determined by demographic factors, projections of which are relatively firmly based, and by activity rates. The projections recently published by the Department of Employment(2) suggest an increase in the labour supply over the period 1988-89 to 1993-94 of [10,000] a year on average, slower than the increase projected from now until 1988-89 of about [120,000] a year. This suggests that the labour supply will not make a significant contribution to trend GDP growth from 1988 onwards.

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(2) See Department of Employment Gazette February 1984

iii. Productivity growth. The causes of the slowdown in measured productivity growth after 1973 are not fully understood. Some of them, however, may be reversible. In particular, there is no reason to believe that oil price shocks will recur with as much disruption as in the 1970s. The harmful effects on investment and growth of high and variable inflation have been reversed. There is evidence from the last two or three years that firms have been increasing efficiency and reversing the labour hoarding that had contributed to poor productivity in the 1970s. It is difficult to assess how much of this might be a once-for-all event caused by the pressures of the recession and how much represents a trend change in productivity growth. The absolute level of productivity in the UK remains well below that in competitor countries so there is plenty of scope for making productivity gains. There is also an increasing awareness of the need for efficient working practices. For these reasons it seems likely that productivity growth will improve substantially on that of the 1970s. But it may not regain the levels of the 1950s and 1960s especially if a reduction in umemployment is associated with a shift, within and between industries, towards more labour-intensive activities and processes.

7. The assumed growth rates of $1\frac{1}{2}$ per cent and 2 per cent a year between 1988-89 and 1993-94 thus lie within the range of $1\frac{1}{2}$ per cent to $2\frac{1}{2}$ per cent that prevailed before the Second World War. They are lower than the growth rate in the two decades before 1973, and higher than that since 1973. Various factors, including North Sea oil production, labour supply and the labour-intensity of some areas of production, suggest that the pre-1973 performance will not be matched. Others, such as the reduction in inflation, the rise in productivity growth and increasing cost-consciousness, point to a better performance than in the 1970s. It is not fruitful to attempt to predict what the actual outcome will be. But there are reasons for believing that the assumed growth rates are plausible in the light of past experience and the sparse knowledge that we have about future developments.

Table A.1

Growth of Output, Working Population and Productivity since 1951
(per cent per annum)

	GDP	Working Population	Output Per Employed Person
1951-1955	2.8	0.7	1.9
1955-1960	2.5	0.5	2.1
1960-1964	3.4	0.8	2.3
1964-1968	2.6	0.1	2.8
1968-1973	2.6	0.2	2.6
1973-1979	1.3[0.5][1]	0.6	1.0
1979-1983	0.3[ ][1]	0.1	1.9

[1]GDP less North Sea

Note: The growth rates are measured between years which are approximately comparable from a cyclical point of view except in the case of the last period: all years up to and including 1979 were cyclical peaks, but it is expected that 1983 will turn out to have been below the peak-to-peak trend.

Table A.2

Growth of Output and Productivity since 1856
(per cent per annum)

	GDP	Output per Employed Person
1856-1860	1.8	0.6
1860-1865	2.0	1.3
1865-1873	2.4	1.6
1873-1882	1.9	1.3
1882-1889	2.2	1.2
1889-1899	2.2	1.1
1899-1907	1.2	0.5
1907-1913	1.6	0.5
1924-1929	2.6	1.4
1929-1933	2.0	0.8
1951-1973	2.9	2.3
1973-1979	1.3	1.0

Note: The growth rates are measured between years which are approximately comparable from a cyclical point of view.

NORTH SEA OIL REVENUES TO 1993-94

This annex describes how the projections in this Green Paper of Government revenues from the North Sea over the period to 1993-94 were derived.

2. For the period to 1988-89 the projections of North Sea revenues are in line with those underlying the Medium Term Financial Strategy. Revenues in 1988-89 are projected to be about /£8½ billion/ in current prices, equivalent to about /£7½ billion/ in 1982-83 prices. Oil and natural gas liquids (NGL) production is assumed to be at about the centre of the new forecast ranges, announced by the Minister of State for Energy in Parliament on /7 March/; and it is assumed that real world oil prices, after falling by more than 10 per cent over the next two years, then remain constant at their end-1985 level. A fuller description of the MTFS projections of North Sea revenues is given in a Press Notice published on Budget day.

3. In assessing the level of oil production after 1988-89 we have projected forward production from fields currently in production or under development and have assumed that all the likely candidates for development among existing discoveries do in fact go ahead. To the extent that some of the latter do not do so, we assume that their place is taken either by other projects among existing discoveries or by future discoveries. This produces a profile in which the centre of the range of oil production continues to fall after 1988-89 though at a slower rate than in the previous three years. By 1993-94 we are assuming that oil production is a little over 65 million tonnes, representing the centre of a range of /40-95/ million tonnes. New fields among existing discoveries account for about a quarter of this total. In projecting gas production we have taken account of fields currently in production or under development. New developments are assumed to come forward at a rate sufficient to ensure that likely future demand is met.

4. By the end of the MTFS projections, the real sterling North Sea oil price is assumed still to be below current levels. For the purposes of the projections beyond 1988-89, we have assumed that the real oil price grows on average at about 2½ per cent a year,

reaching £150 a tonne (in 1982-83 prices) by 1993-94. This assumption is consistent with some rise over the same period in the real world oil price. A constant real gas price after 1988-89 is assumed for new gas developments.

5. The implication of these assumptions about production and prices is that the real value of oil and NGL production is assumed to fall at about 4½ per cent a year over the period 1988-89 to 1993-94. The projections of Government revenues from the North Sea were derived by taking the average tax rate on gross revenues from oil and gas production implicit in the MTFS projection of total royalty and tax receipts in 1988-89 and assuming it remained constant over the period after 1988-89. The 1988-89 figure is based on the results of the Inland Revenue field-by-field model of the North Sea. It could be argued that the average tax rate might rise after 1988-89, as some of the fields now or soon to come on stream exhaust their tax allowances and pay tax at the full rate. On the other hand, if the assumptions underlying these projections prove correct, existing discoveries yet to be developed will be contributing a significant proportion of production by the early 1990s. This would tend to depress the average tax rate.

6. As a result of these assumptions, total North Sea oil and gas revenues are projected to fall from about £7½ billion (at 1982-83 prices) at the end of the MTFS period to about £6 billion by 1993-94, or from 2¼ per cent of GDP to about 1¾ per cent.

7. The margin of error around these estimates is very large indeed. Even the projections of revenues to 1988-89 in the MTFS are highly uncertain. The uncertainties increase as one moves further into the future. They arise at each stage of estimation: production, prices and tax deductible expenditures. Production projections are particularly uncertain at this stage because it is too early to assess the extent to which the changes made to the North Sea fiscal regime in the 1983 Budget might give rise to higher production during the next ten years.

Annex 5

Debt Interest

This annex explains the evolution of net debt interest of the public sector. The definition of net debt interest used here is on a National Accounts basis and includes only debt interest flows between the public and private and overseas sectors: it therefore differs from the concept used in Public Expenditure White Papers.(1)

2. Debt interest flows are related to the stock of debt outstanding, the current and past rates of interest, and the characteristics, particularly the maturity structure, of the stock of debt outstanding.

3. Gross debt interest payments by the public sector, principally to holders of gilts and National Savings, reached a peak as a proportion of GDP in 1981-82, reflecting the high level of the PSBR, and increasing interest rates from about 1975 onwards. The bulk of government stock outstanding is of fixed interest securities. Because of this, total debt interest payments are slow to react to changes in interest rates. Over the next five years the stock of public sector debt is expected to decline as a proportion of GDP, because the ratio of the PSBR to GDP is low compared with the assumed growth of money GDP. The lower stock of debt outstanding, coupled with an assumed decline in both nominal and real interest rates as inflation is brought down further and pressure in financial markets eases, imply a further reduction in debt interest payments over the long-term period from 1988-89 to 1993-94, perhaps by an amount equivalent to up to 1 per cent of GDP.

4. Debt interest receipts by the public sector are flows on loans made by the public sector to the private and overseas sectors. [These include such items as public corporations' trade credit and loans by local authorities for house purchase as well as interest on the reserves.] The maturity structure of the debt instruments is on average shorter and a

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(1) See Cmnd 9143-II, Explanatory and Technical Notes for a definition of the PEWP definition of net debt interest.

higher proportion is accounted for by variable interest instruments than in the case of British Government Securities and National Savings. As a result interest receipts are relatively more sensitive to changes in interest rates, and are projected to fall proportionately more than interest payments over the next ten years. Nevertheless, net debt interest payments are projected to decline as a proportion of GDP, by about [0.7] per cent of GDP, because the initial stock of liabilities of the public sector are about [three] times initial assets.