THE DEBATE ON PUBLIC EXPENDITURE

The latest sterling crisis has raised the prospect of further cuts in public expenditure. It is widely believed that expenditure cuts may be forced upon the Government as a condition of the IMF loan now being negotiated, and there is a considerable body of opinion in this country which would welcome such a condition being imposed. Controversy about the level of public expenditure in the UK, and its significance in the country's present economic difficulties, has been continuous during the life of the present administration. The purpose of this article* is to identify and comment upon the main arguments in this debate.

Criticism of the present level of public expenditure is based on a number of distinct, though not unconnected views of its economic and social significance. One such view, which is of a different character to the others considered in this article, has emphasised the overloading of government and the consequence of this overloading on, for example, expenditure control. Rising expectations of public services - often induced by competitive bidding between political parties - have led to a massive increase in the economic and administrative responsibilities of government and its supporting bureaucracy, to a degree that control of the level and direction of public sector expenditure cannot be exercised effectively. Since variations in public expenditure are an important element in general economic management (particularly in what is unhappily described as 'fine tuning'), inability to control public expenditure vitiates the principles of conventional demand management; to this extent, therefore, the thesis of overloaded government has a direct bearing on Britain's current economic problems, particularly with respect to anti-inflation policy.

While convincing, however, this analysis is primarily concerned with general and longer-term trends in the role of the public sector and the machinery of government, and is less relevant to the specific role and implications of the present level of public expenditure in the UK. Moreover, although a gradual and permanent retrenchment of public expenditure is one possible solution to the overloading problem, this kind of analysis is equally concerned with changes in the machinery of government administration and control which may be required to support an expanded role for the public sector. This school of thought, then, is broadly neutral in the present debate.

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* This is a shortened preliminary version of a paper on public expenditure in the UK by the author and Professor Guy Peters.

A more specific line of attack on public expenditure is that its steady - and, in the last three years, rapid - increase has diverted resources from the important areas of investment in manufacturing industry, and exports. This argument formed the major theme in a series of Sunday Times articles (and subsequently a book) by Bacon and Eltis*, and is frequently expressed in the pages of the financial press. Hints of this attitude are to be found at a more official level; the recent White Paper on Public Expenditure 1974-79 claimed that public expenditure had risen from 42% of GDP in 1960 to about 60% in 1975, and that while public expenditure rose by 20% in volume terms between 1972 and 1975, output in the economy rose by only 2% in the same period *(Cmd. 6383, p.1)*. Though it does not actually say so, there is a clear implication that this rise in public expenditure was at the expense of alternative uses of the resources available.

Clearly, if the volume of public expenditure grows at g% per annum for a decade, and other categories of expenditure grow at r% per annum, and g is greater than r, the ratio of public expenditure to GDP will be higher at the end of the decade than at the beginning. However, there is no direct evidence to suggest that if the rate of growth of public expenditure were reduced, the rate of growth of other expenditure would rise by an amount sufficient to absorb the available resources, other than the elegant but empirically doubtful prescriptions of neo-classical economics. Except possibly in 1973, it is difficult to think of any period in recent British economic history when, by bidding away resources, the public sector has curtailed the rate of growth of exports or investment. The low rate of post-war growth in British manufactured output and investment has been attributed to a variety of factors, including the economic policies of successive governments, but the resource claims of rising public expenditure have not been convincingly established as one of them. To be sure, a higher level of public expenditure, financed by taxation, has affected the distribution, and may have affected the level of private consumption expenditure, but the issue at stake is not the balance between private and public consumption, but the allocation of resources between consumption (whether private or public) and investment and exports. With the present level of unemployed resources, it is simply not creditible to assert that public expenditure prevents resources being diverted to the production of exports or capital goods.

It is of course possible to argue that a longer-term view of rising

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* *R. Bacon and W. Eltis, Britain's Economic Problem: Too Few Producers, MacMillan, 1976.*

public expenditure might support the 'resource-diverting thesis. This is not strictly germane to the present debate, but in any case there is also little statistical support for it. Excluding transfer payments, the ratio of public expenditure to GDP did not change very much during the 1960's, and the UK experience with respect to the public sector is similar to that of other industrialised countries (see below), most of whom enjoyed high rates of output and investment during this period.

One suspects that the argument about the alleged effects of public expenditure on resource allocation stems from a belief that public expenditure is "too high", though there is no conventional economic wisdom, or even rule of thumb, to suggest when such a level is reached. To lend some perspective to their view, however, a recent paper by Neild and Ward* demonstrates that, in comparison with eleven other European countries, the UK had in 1973 the lowest ratio of public expenditure to GNP, and more recent data, though not on a strictly comparable basis, do not suggest any significant change in this ranking. This and more detailed comparative data, show that the prevailing level of public expenditure cannot be advanced as a unique phenomenon which, either through its effects on the general level of taxation, or the pattern of resource allocation, explains the UK's particular economic difficulties. Moreover, the ratios of public expenditure to GNP or GDP which are usually quoted in support of the argument that expenditure is intolerably high include transfer payments (social benefits and various subsidies and grants), which do not represent a claim on real resources by the public sector (though of course they figure in the tax burden on individual taxpayers). Thus in 1975 public authorities' real expenditure on goods and services amounted to about 38% of GDP at factor cost *(Blue Book, 1976)*, as distinct from approximately 60% when current transfer payments are included. The former includes expenditure on defence, law and order, health, education, environmental services and infrastructure expenditure. Comparatively, real public expenditure in the UK is also low by European standards and, absolutely, it is not evident that outlay on these public services absorbs an unduly high proportion of total resources in a modern economy (modern, at least in its aspirations). Nor is there any convincing evidence that voters' preferences would demonstrate any significant shift in the relative shares of public and private consumption.

A more convincing reason for the present unease over the level of

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* *Robert Neild and Terry Ward, "The Budgetary Situation: An Appraisal", University of Cambridge, Department of Applied Economics, [illegible].*

public expenditure stems from the dramatic changes in the burden of taxation in the last three years. While public expenditure has risen in volume (particularly expenditure on social services and industrial and regional aid), aggregate output has remained static and, more recently (1975-76) has fallen. It is one thing to pay a higher relative tax bill out of a higher real income, and quite another to pay higher taxes out of a fixed or falling real income. This unpleasant experience has been exacerbated by the structure of UK taxation, and by inflation. In the current fiscal year, estimated receipt from personal income taxation and social insurance contributions account for over fifty per cent of public sector receipts, while VAT accounts for about 12% and corporation tax 7%. Taxation is therefore heavily dependent on direct taxation of personal incomes, and its effects are immediately and painfully obvious to the individual taxpayer. In addition, rapid inflation without compensating changes in tax allowances and tax bands has brought about a sudden and dramatic shift in marginal and effective rates of taxation for most taxpayers, as well as bringing into the taxable income range a large number of low income households. In 1976, for example, a married man with two children under eleven years of age, and with average male earnings, will pay almost 25% of his income in tax and social insurance, compared with 10% in 1966. For a man on three times average earnings, the corresponding figures are 38% and 23%. Those on two to three times average earnings or over have also seen their real incomes eroded as a consequence of the flat-rate limits on wages and salary increases contained in the social contract.

Whether or not these marked changes in the level and distribution of personal taxation are equitable, their conjunction with stationary or falling real output in the economy have proved painful, and their effect has found expression of criticism of the level of public expenditure. Though understandable, however, this criticism does not substantiate the claim that reductions in public expenditure are a necessary condition for economic recovery.

Though often couched in more sophisticated terms, the most important and substantive criticism of the trend and level of public expenditure since 1974 derives from conventional views on aggregate demand management, with on this occasion the added complication of the relation between the public sector deficit, the money supply and the rate of inflation. As the Fraser Institute's first Quarterly Economic Commentary pointed out *(I,I, July 1975)*:

"The reaction of the UK to external events [the oil crisis and its consequences] has been almost unique .... So far from deflating ...

the Government has actually continued to inflate the level of aggregate domestic demand. This has of course merely postponed the painful readjustment .... the longer effective action is postponed, the more likely it is that its timimg and content will be determined by considerations of foreign confidence."

A majorcomponent of this growth in aggregate demand was public sector expenditure which, as already pointed out, rose rapidly in volume terms through 1973-76. This policy might have proved feasible, if imprudent, had it been accompanied from the start by strict control over money wages, higher taxes to reduce the public sector deficit and a managed depreciation of sterling to close the deficit in the balance of payments. In practice, of course, each of these necessary adjustments has taken place, or is taking place - real wages are being cut, effective taxation has risen sharply, and sterling has depreciated. As we predicted, however, the adjustment has been more painful, longer delayed and more subject to external events than if effective action, including tighter control over public spending, had been exercised during 1974. Instead, money wages were allowed to increase at a rate which temporarily maintained real consumption expenditure, and the difference between output and expenditure was financed by overseas borrowing; similarly the Government failed to pursue a consistent policy towards the depreciation of sterling, resulting in periodic sterling crises and a substantial cost to the reserves.

It is tempting to conclude that a sharp cut in the level of public expenditure would compensate for these earlier vacillations in policy. A decisive cut in public spending would be the simplest and most direct means of attack on the two problems of the balance of payments (through the fall in aggregate demand), and inflation (though the causal mechanism here is less certain). However, those who advocate such a policy must be prepared to face its consequences for unemployment: cuts of around £1bn in public spending would certainly push the level of unemployment above 2 million during 1977. Even with the recovery expected in private investment, it is difficult to envisage an expansion in output sufficient to make much impact on this level of unemployment for at least two years.

The alternative being pursued by the authorities is to maintain the level of public expenditure and to throw the burden of adjustment on private consumption. Simultaneously, they have tried to soften the impact of lower output on employment by engineering a fall in real wages. The real trade-off in the social contract is not so much between money wages and inflation (important though this is) but between wages and employment. Meanwhile,as lower incomes help reduce the balance of payments deficit, and the rate of growth of public expenditure is cut back, it is hoped that current levels of unemployment will be reduced by expanding exports and investment expenditure.

In principle this is a feasible alternative strategy, though it is inevitably more difficult to implement than the traditional policy of reducing aggregate demand (and employment) by cutting both private and public spending. On existing policies, the balance of payments deficit is expected to be eliminated by 1978, and inflation is expected to fall by that year to a level comparable with other industrialised countries.

In practice there are serious doubts about the likely success of this policy, for two main reasons. First, it is considered unlikely that the authorities can restrain the growth of money incomes, following the end of the present phase of constraint, to the extent necessary to effect a further fall in real incomes. Secondly, it is argued that the magnitude of the public sector deficit is inconsistent with the level of aggregate demand required to eliminate the balance of payments deficit, even if money wages are kept down to their present rate of increase. Moreover, to the extent that the public sector deficit is financed by short-term borrowing from abroad, or from the bank sector it is asserted to be inflationary. Recent measures to restrict credit by raising the minimum lending rate, and calling in special deposits, are designed to counter these inflationary pressures by restricting the growth in the money supply, though at the risk of retarding the recovery in industrial output.

To those reared on the prescriptions of Keynesian economics, a public sector deficit during a period of recession is a logical feature of counter-cyclical demand management. Moreover, sizeable deficits have been experienced by other developed countries. However, based on the concept of the full employment budget (i.e. expected public sector receipts and expenditure at a full employment level of GNP), somewhere between one quarter and one third of the current UK deficit can be attributed to the decline in net tax receipts resulting from the difference between actual and full employment GDP. A further proportion of the deficit can be attributed to increased aid to industry, but at least half can be argued to represent an excess of expenditure over taxation which cannot be attributed to the recession, and must be either reduced, or balanced by a similar reduction in private consumption expenditure.

In reality the pressures to cut public spending, though founded on genuine doubts about the effectiveness of current policy, owe less to a careful evaluation of its logic than to a judgement, based on the dreary record of Britain's economic performance, about the longer-term possibilities for the UK economy and the political will of Government to carry out the necessary policies. On paper, the collateral offered by North Sea Oil should offer enough guarantee to facilitate foreign borrowing on a scale sufficient to make the necessary adjustments. However, there does seem to be belief that the UK has a unique facility for throwing away such an opportunity.

Notwithstanding the fact that the public sector deficit should not have been allowed to grow to its present level, it cannot be proved that the level of public expenditure, or even the public sector deficit, necessarily prevents the targets of reducing inflation and eliminating the balance of payments deficit being achieved. The necessary corollary, however, is that real incomes must continue to fall - involving a further year's strict control over money wages - and the growth in money supply must be tightly constrained. As additional support, price controls should be relaxed to allow prices and profit margins to rise, and subsidies to nationalised industries, on foodstuffs and on housing should be cut (which will also reduce public expenditure).

Whether this additional squeeze on real personal disposable income is desirable - as opposed to cuts in public expenditure and higher unemployment - or politically feasible, is a matter of opinion, rather than economic reasoning. In his next budget, the Chancellor will almost certainly face demands for adjustments in tax allowances and tax gradations to compensate for the effects of inflation on the burden of personal taxation. In terms of the current government strategy, a net reduction in taxation must be ruled out, but it would be feasible to affect reductions in personal taxation with an increase in VAT, which could provide some psychological relief to taxpayers at an important phase of incomes policy.