

Jackson, Peter

Working Paper

Fiscal Containment and Local Government Finance in the U.K.

IUI Working Paper, No. 89

Provided in Cooperation with:

Research Institute of Industrial Economics (IFN), Stockholm

Suggested Citation: Jackson, Peter (1983) : Fiscal Containment and Local Government Finance in the U.K., IUI Working Paper, No. 89, The Research Institute of Industrial Economics (IUI), Stockholm

This Version is available at:

<https://hdl.handle.net/10419/95002>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.

Fiscal Containment and Local Government Finance in the U.K.

by Peter M. Jackson

CONTENTS

| | |
|--|-----|
| Introduction | 177 |
| The Gathering Storm 1970–1979 | 178 |
| The Theoretical Framework | 181 |
| Monetarism | 182 |
| Supply Side Arguments | 184 |
| The Growth of the Public Sector | 192 |
| Local Government Growth | 198 |
| Local Government Spending | 198 |
| Local Government Labour Market | 203 |
| Local Government Capital Market | 208 |
| Determinants of Expenditure | 209 |
| Education Expenditure | 211 |
| Government Revenues | 214 |
| The Fiscal Environment | 217 |
| Conclusions | 222 |
| Notes | 224 |
| References | 226 |

INTRODUCTION

This paper examines the development of the fiscal containment movement in the U.K. Throughout the 1970s there was a growing demand from several quarters for tighter controls over public spending, reductions in tax rates (especially on personal incomes) and for balanced public sector budgets. Such demands have of course existed during earlier periods but what sets the 1970s off from the 1950s and 1960s is the fiscal context within which the fiscal limitation movement has operated. First, public expenditure constraints are today much more severe than they were in earlier years and second, the underlying philosophy, upon which the policies of the fiscal limitation movement are predicated, has changed. The prescriptions and policy outcomes of the 1950s/60s were essentially based upon Keynesian teaching whereas the more recent philosophy is monetarist in genre.

Not only are there interesting differences between the fiscal limitation movements of different time periods but important differences exist between different economies within the same time period. This point is seen clearly by comparing the chapters in this volume. The fiscal limitation movement in the U.K. employs a set of macro-economic arguments to substantiate the case for reduced public sector budgets whereas the arguments used in the U.S. literature are predominantly micro-economic. The reasons for this difference in emphasis are explored towards the end of this chapter. Essentially the micro-economic approach has not been pursued in the U.K. because of the weak role that demand factors seem to play, the lack of suitable data to test micro-theories and the diffi-

culties of testing public sector bureaucratic supply models.

In this paper the general trends in U.K. public expenditure are set out both for central (i.e. federal) government and local government along with the trends in taxation, public sector borrowing and public employment. Since it is one particular interpretation of these trends which has heightened the demand for fiscal limitation, care is taken to set out the logical foundations of the fiscal containment argument and to subject it wherever possible to empirical verification. Before the theoretical and empirical elements of the analysis are examined it is instructive to set down the prevailing policies in the U.K. as they relate to public expenditure and taxation.

The Gathering Storm 1970-1979

The demand for fiscal containment comes from a number of different sources. There are those who distrust bureaucracy in general and the public sector bureaucracy in particular. They wish to return decision-making to the individual, to expand the scope of his choice and liberty through a reduction in public service provision and an enlargement of the domain of the market place. Others have become sceptical about the impact and the success of public spending programmes upon the alleviation of poverty and other social problems. Then there are those who are concerned about Parliament's ability to control public spending programmes. They demand Parliamentary and administrative reforms which will ensure that voters' preferences are sufficiently well articulated within the system, and furthermore that they prevail,

whilst the scope of bureaucratic influence and discretion over the supply of public services be constrained. The issue of efficiency is also an element in the argument for tighter budgetary control. If the constraints on public budgets were more severe then it is assumed that waste would be eliminated. Finally, there is the question of the impacts of public spending, taxation, and borrowing upon private sector decisions and inflation. If, as some believe, increases in these public sector magnitudes have adverse net effects upon social welfare then there is a case to be made for constraining them.

Stated in this way there exists a strong set of a priori arguments for public spending restraint coupled with balanced budgets. During the 1970s successive U.K. governments became increasingly persuaded by these arguments. Faced with a Sterling crisis, an inflation rate of 28% per annum and a loan from the IMF conditional upon public spending cuts being made, the Labour Government of 1976 began to roll back the public sector. James Callaghan, then Prime Minister, made his famous speech to the Labour Party conference in 1976 which indicated the first move towards fiscal containment:

"We used to think you could spend your way out of a recession, and increase employment by cutting taxes and boosting Government spending. I tell you in all candour that that option no longer exists, and that insofar as it ever did exist, it only worked by injecting a bigger dose of inflation into the economy, followed by a higher level of unemployment as the next step. Higher inflation followed by higher unemployment."

The process was completed in May 1979 with the election of a fiscal containment government. In

their first Public Expenditure White Paper of November 1979 (Cmnd 7746) the Conservative Government set out its broad economic strategy, which was;

"to bring down the rate of inflation and interest rates by curtailing the growth of the money supply and controlling Government borrowing; to restore incentives; and to plan for spending which is compatible both with the objectives for taxation and borrowing and with a realistic assessment for the prospects for economic growth."

The whole policy was predicated upon a straightforward belief that, "public spending is at the heart of Britain's present economic problem", because, "high government borrowing has fuelled inflation, complicated the task of controlling the money supply and thus denied the wealth creating sectors some of the external finance they need for expansion."¹

When the economic history of the 1970s comes to be written, it will record that a number of powerful pressure groups managed to win control over the intellectual framework within which economic policy-making in the U.K. is formulated. In the main these interest groups were found in the financial institutions of the City -- bankers, stock-brokers, and financial journalists. Their model of how the economy works is essentially monetarist in genre and was given support from the work of the "new classical" supply side economists and the mainstream monetarists. Just how this group managed to take over remains to be studied; a number of indicators point, however, to a plausible interpretation. The inflation of the 1970s, caused primarily by factors which lay outside the control of any government,² resulted in the breakdown of the

basic economic relationships which had characterised the U.K. economy in earlier years.³ This breakdown was interpreted by many as evidence that Neo-Keynesian economics was bankrupt and that policies based upon such thinking would fuel inflation and push the economy deeper into recession.

The fiscal containment movement seized the opportunity established by this combination of events to advocate a reduction in the relative size of the public sector.

THE THEORETICAL FRAMEWORK

The previous section outlined the basic philosophy which developed during the 1970s and which culminated in the election of a fiscal containment government in 1979. This philosophy reflected a particular model of the economy and it is to this we now turn. The questions which interest us are, (a) what a priori reasoning culminates in the policy prescriptions that public expenditure and taxation should be constrained; and (b) is there any evidence to substantiate such claims?

Until recently it was generally assumed that net fiscal multipliers were positive. This result was, however, challenged by Andersen and Jordan (1968) on empirical grounds. The thrust of their argument was that the long run net fiscal multipliers were at best zero and in some cases could be negative. Such observations clearly challenged the whole basis upon which expansionary fiscal policies had been predicated and gave rise to a series of works which addressed themselves to the question, "does fiscal policy matter"?⁴

The best way of tackling this issue is to consider the answers to the following question, "given that any increase in public expenditure has to be financed out of increases in taxation, public sector borrowing or increases in the money supply, what impact do these financing instruments have upon the level of economic activity and hence upon the net effects of a budget expansion"? The answer given by the traditional Keynesian is that there will be some expansion in income (output) brought about by the increase in public spending. Conceivably the expansion will generate sufficient resources (i.e. tax revenue or savings) to finance the budgetary expansion; but if not, other types of financing should be used. On the other hand, monetarists and supply side economists would argue that a tax financed budget expansion will be accompanied by disincentive effects in the labour and capital markets which will counter any expansion in real output brought about by the increase in public spending. Moreover, a bond financed budget deficit will, it is claimed, increase interest rates and "crowd out" private investment thereby constraining any expansion in real output. Thus, for these reasons governments should balance their budgets and reforms should be introduced to the fiscal constitution to limit the extent to which vote maximizing governments can raise taxes.⁵

We now turn to each of these arguments and explore them in greater detail.

Monetarism

Monetarists have for some time debated whether or not an increase in the nominal money supply re-

sults in an increase in the rate of inflation. This controversy remains unresolved (see Hahn, 1980a and b; and Kaldor, 1980). Despite its contentiousness the link between increases in the money supply and prices form one of the central tenets in both the U.K. fiscal containment movement and in official policy. The argument runs as follows. Assuming no change in taxation, increases in public spending are financed out of increased public borrowing or increases in the money supply. Either way, the temporary expansion of output raises the actual expected rate of inflation, and eventually promotes a wage-price explosion. Ultimately the wage-price explosion generates enough uncertainty and/or instability so that output and employment will fall. Thus, instead of expanding real output and employment a budget deficit will, in the medium term, cause a reduction in the level of economic activity through its impact upon inflation and expectations.

Whilst such an a priori account is plausible this is insufficient for its adoption as a reasonable description of the behaviour of the economy. It must be demonstrated that the account is empirically validated. This has not been done so far. A statistically significant link cannot be found between changes in the money supply or the public sector borrowing requirement and the inflation rate (see Kaldor, 1980). This is not too surprising given that it is only that part of the public sector's deficit which is monetized through the banking system which would impact on the money supply.⁶

Supply Side Arguments

Alongside the monetarist's argument there are what has come to be popularly known as "supply side" considerations. In brief, supply side economists examine the impacts of the public sector financial instruments (i.e. taxes and borrowing) upon market prices and hence upon resource allocation and long run real income determination. The elements of these issues can be gathered together under two headings (a) the disincentive effects of taxation and (b) the crowding out of private sector activity by the public sector.

(a) Disincentive effects of taxation: As far as the disincentive effects of taxation are concerned, the foundation of the arguments are very straightforward and are well documented in the standard public finance literature. An increase in the marginal rate of income taxation, for example, will change the relative prices of work and leisure. Whether or not the income or the substitution effect following that relative price change is the stronger will determine the existence, or otherwise, of a disincentive effect. A similar analysis is used to study the effects of other direct and indirect taxes upon consumption, savings and investment decisions.

Whilst the analysis is unambiguous the central issue from the perspective of policy making is an empirical one. Do disincentive effects exist in practice? To date the evidence comes down strongly in favour of the presence of a small but statistically significant incentive effect for the personal income tax in the U.K. (see, Atkinson and Stern, 1980; and Atkinson, 1980). This result is of importance to those policy makers whose philo-

sophy of fiscal containment is based upon the belief that disincentive effects do exist. The empirical evidence limits their case. However, it must be emphasised that our empirical knowledge about the effects of tax changes is extremely limited.⁷

(b) Crowding Out: The second strand to the supply side argument is summed up in the issue of "crowding out". Crowding out refers to the displacement of private sector activity by the public sector. It can take one of two forms, (a) real resource crowding out or (b) financial crowding out. Neo-Keynesians believe that real resource crowding out can only take place at full employment. In a zero-sum situation the public sector can only expand if there is a corresponding decline in private sector expenditures. Economists such as Bacon and Eltis (1976), however, have argued that the growth in the relative size of the public sector has absorbed real resources (particularly capital and labour) which has constrained the growth of the "productive" or "wealth creating" private sector of the economy. According to this view real resource crowding out will take place at less than full-employment. Moreover, if the underlying growth rate of the economy is to be increased, resources must be released from the public sector and returned to the private sector. This increase in growth, it is claimed, is necessary to finance any future growth in the public sector.

Interpretation of the financial crowding out arguments depends upon which theory of interest rate determination one subscribes to and how elastic private sector investment is to changes in interest rates. The popular view of financial crowding out can be stated in the following simple terms.

In order to finance its deficit the government has to offer bonds for sale to the general public at a price which will make them attractive. Price discounts on government bonds force up interest rates and the hike in interest rates will halt marginal private sector investment programmes. Thus, the expansionary effects of the public sector deficit will be constrained by the contractions caused by the fall in private investment. A bond financed public sector expansion, even at less than full employment, will have a small (perhaps even zero) impact on levels of real output and employment.

Whilst Neo-Keynesians have always recognised the existence of financial crowding out in some measure, the fiscal limitation movement argues that the financial crowding out effect is large. They insist that the increase in interest rates has been brought about by the need to finance a rapidly expanding public sector borrowing requirement and that the ensuing increase in interest rates has been responsible for the massive cut-back in private sector investment intentions. In other words, in this model interest rates are determined simply through the mechanisms of demand and supply in the money and capital market. Given that there is a limited supply of funds for investment if the public sector increases its demand then the price of these funds (interest rates) must increase. If the public sector is inelastic in its demand for finance but private sector demand is elastic, then the public sector will crowd out the private sector in the capital market with the result that the composition of final output will also change.

The policy prescriptions which follow from this view of the economy are that if the level of interest rates is to come down and thus private

investment expand, the public sector borrowing requirement must be reduced. This in turn requires a reduction in public expenditures, assuming that taxes are not to be increased.

There are, however, a number of controversial elements within this simple view of the economy which must be balanced up against an alternative perspective. First, in contrast to the above description of interest rate determination many believe that the current high level of short-term interest rates in the U.K. are due to the tight monetary policy which the government is pursuing. In addition the current high rates of inflation will be reflected in high nominal interest rates. Long term interest rates are determined by the way in which investors choose to hold their stock of wealth. This, in turn, depends upon uncertainty and the way in which individuals form their expectations. Thus, interest rates are not uniquely determined by the imbalances between the demand and supply of the stock of different financial assets as was claimed in the simple model. Instead, we need to add a number of other explanatory variables such as uncertainty, expectations of future interest rates and expectations of future rates of inflation. The rate of interest is the price paid for parting with liquidity whilst at the same time being a reward for saving. The more uncertain is the return on an asset the higher will be the rate of interest required before individuals will hold it in their portfolios. Long term assets will, therefore, have higher returns than short term assets because of the greater uncertainty associated with the long-run. The willingness to hold an asset depends crucially upon expectations.

It would, however, be a mistake to believe that dealings in financial markets are carried out directly by individuals. By far the major proportion of such transactions are carried out on behalf of individuals by the large financial institutions such as the pension funds and the insurance companies. Because so much of the wealth of a community is held indirectly by the financial institutions the community's liquidity preference is to a large measure determined by the preferences and expectations of these financial institutions. During periods of high and variable inflation, such as prevailed in the U.K. during the 1970s, the financial institutions have faced greater uncertainty. They have responded to this environment by keeping their options open through investing at the short-end of the market thereby keeping their balance sheets liquid. Political speeches demanding fiscal restraint coupled with the general monetarist climate have added to their uncertainty with the result that funds have been brought forward and held in government stock. It is not, therefore, just the price of government stock which has increased demand for it. Uncertainty has also played a vital role.

The second embellishment to the simple model of interest rate determination relates to the supply of funds for investment. Government can only run a deficit if there are surpluses elsewhere in the economy. During the 1970s the U.K. personal sector increased its savings rate⁸ from an annual average of 8.75% during the 1960s to 14% during the 1970s (see Coghlan and Jackson, 1979). This increase was in part due to inflation but uncertainty and increases in real disposable incomes also played a role. The rise in the savings rate would, of course, have been deflationary unless there were

compensating increases in investment (public or private). Private sector investment was, however, depressed because of the general recession and gloomy expectations. In the absence of the private sector expanding its investment, the additional funds created by the increase in personal sector savings were available to the public sector to finance its deficit without crowding out the private sector. Moreover, the expansion in public spending could be self financing in the medium-term due to the rise in real incomes, savings and tax revenues.

Thus, the observed high cost of capital is due to inflation and uncertainty. An increase in public sector borrowing does not, therefore, necessarily imply an increase in the real cost of capital. It might be a contributing factor amongst others. The problem is to identify how much of the increase in nominal interest rates is due to public sector borrowing. This empirical problem has not yet been solved.

Third, high interest rates also reflect a tight monetary policy. This point is frequently forgotten by monetarists. A tight monetary squeeze can cause crowding out. If the stock of money is held down relative to its demand this will force up short-term nominal interest rates. Under a system of floating exchange rates the exchange rate will rise. The increase in nominal interest rates will place a strain on industry cash flow especially for those sectors of industry which are faced with problems of stock appreciation, caused by the inflation, and which compete in export markets or which face an elastic demand for their final product and high money wage demands. The combined effect of these impact is to affect expectations adversely and to precipitate bankruptcies.

Emphasis upon controlling the money stock gives rise to a loss of control over interest rates which increases the uncertainty of future real and nominal rates. This uncertainty is exacerbated by high and variable rates of inflation. If interest rates are uncertain then so too are gilt edge security prices which means that their yield has to be much higher. Once again, it is uncertainty which forces up the cost of capital. In this case the high interest rates have been caused by the tight monetary policy.

Finally, the crowding out thesis assumes that private sector investment is highly interest elastic with interest rates being its principal determinant. What is the status of the evidence to substantiate such a claim? Recent evidence presented to the Wilson Committee⁹ demonstrated that the influence of financial factors on private sector investment is difficult to establish empirically. Whilst there are strong theoretical reasons to believe that financial factors do influence investment, much of the econometric research in this area has been inconclusive. The primary financial influence that would be expected to play a role is the cost of capital which depends upon a number of factors, including interest rates and expectations of inflation, and on how the funds are raised (whether by borrowing, retentions or new equity issues). Changes in the cost of capital can significantly affect the profitability of an investment but this, in turn, is also affected by tax rates and investment subsidies. Investment decisions, however, also depend upon non-financial factors such as the current level of capacity utilization and businessmen's expectations of the future growth of the volume of their sales.

Existing empirical evidence¹⁰ is inconclusive but it does suggest that the dominant influence on investment is the general macro-economic climate. That is, businessmen will invest when they think it will be profitable to do so. The econometric evidence suggests that expectations of the profitability of investment are related to changes in the level of output in the previous two years. It has proved difficult in these empirical studies to determine the importance of the influence of financial factors on investment. In practice the cost of capital is a difficult concept to measure. Results will, therefore, tend to be sensitive to the measure employed. In summing up their survey of investment studies the U.K. Treasury, in their evidence to the Wilson Committee, concluded that, "... we think that whilst the major influence on investment will generally be the expectation of output and sales growth financial factors can at times be important". The empirical evidence does not, therefore, exist to support one of the main pillars of the fiscal containment argument.

The essential lesson from this debate is that increased uncertainty has caused an increase in the long run cost of capital. Moreover, because of inflation, high and variable nominal interest rates, a high exchange rate and a world recession, the risks facing U.K. businessmen in the 1970/80s are much greater than those which they faced in earlier periods. Faced with this uncertainty lenders look for investments which are less vulnerable to inflation such as equities or property. Thus, bond prices must fall and interest rates must rise if individuals are to hold bonds. Inflation, however, also forces up the expected rate of return on equities. Unless profits keep up with inflation then dividends will not. The greater is

the variability of inflation the greater is the uncertainty of profits and dividends. Moreover, businessmen will not wish to issue fixed interest debt (e.g. debentures) during periods of high inflation since the future debt charges will be a burden. It is inflation and the uncertainty which it generates that forces up the cost of capital and depresses investment intentions.

In conclusion to this section, the fiscal containment movement in the U.K. is based upon the assumption that strong disincentive effects of taxation exist; that increases in the public sector borrowing requirement (PSBR) cause increases in the money supply and hence increase the rate of inflation and that private sector investment which is highly interest elastic is crowded out by public sector borrowing. Their policy prescriptions are that if inflation is to be reduced and economic growth increased then it is essential that taxes and public deficits be cut. This requires reductions in public spending. But there are alternative views of how the economy operates and there is very little empirical evidence to support the views of the fiscal containment movement.

THE GROWTH OF THE PUBLIC SECTOR

The public sector in the U.K. has grown both in absolute and relative terms over the period 1960-1979. In 1960 total public expenditure amounted to £8.9 billion. It had increased to £84.9 billion by 1979. Changes in the absolute size of public expenditure are meaningless unless set against changes in other variables such as prices, population or incomes. In Table 1 public expenditure is shown as a percentage of GDP (at market prices)

**Table 1 U.K. Public Spending as a Proportion
of GDP 1960-1979**
Market prices

| | 1960 | 1970 | 1975 | 1979 |
|---|------|------|------|------|
| 1. Total public spending | 35.0 | 41.0 | 49.5 | 44.8 |
| 2. Current expenditure on goods/services | 16.5 | 17.6 | 22.0 | 20.2 |
| 3. Capital expenditure on goods/services | 3.5 | 4.8 | 4.8 | 2.8 |
| 4. Current grants and subsidies | 8.4 | 10.6 | 13.7 | 14.4 |
| 5. Capital transfers | 0.3 | 1.6 | 1.1 | 1.0 |
| 6. Debt interest | 4.0 | 4.0 | 4.0 | 4.7 |
| 7. Net lending ^a | 2.0 | 2.4 | 3.6 | 1.7 |

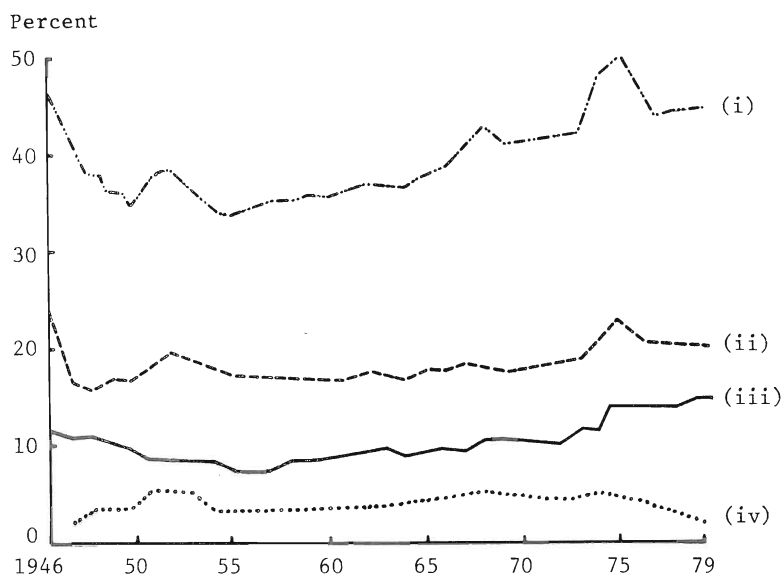
^a Net lending is included as an element of total public spending because it has to be financed through the exchequer's funds.

Source: National Income and Expenditure (HMSO); various years.

and in Figure 1 the growth in the relative size of public expenditure and its components is set out for the period 1946-1979.

Table 1 shows that the public sector's relative share of GDP has increased from 35% in 1960 to a peak of 49.5% in 1975. This does not, however, necessarily imply, as many commentators have suggested, that the public sector has absorbed an increasing share of the nation's resources, thereby crowding out or constraining private sector growth. In order to find out if this did happen it is necessary to break public expenditure down into its constituent parts. The resource element of public expenditure is shown in the national income accounts as expenditure on goods and services. Current account expenditure on goods and services represents the public sector's consumption of

Figure 1 U.K. Public Expenditures as % of GDP
Market prices



Notes: (i) Total public expenditure as % of GDP
(ii) Current expenditure on goods and services as % of GDP
(iii) Transfer expenditures as % of GDP
(iv) Capital expenditures as % of GDP

labour services and physical materials whereas capital account expenditure on goods and services refers to the public sector's consumption of capital goods. Taking the current and capital accounts together the public sector absorbed 19.8% of GDP in 1960. This increased to 23% in 1979.

The principal source of public sector growth in the U.K. has been in transfer payments. Since transfer payments are not part of GDP including them in the total of public expenditure tends to distort the ratio of public spending to GDP, since the limit to the ratio is no longer 100%. The in-

crease in transfer payments is shown in Table 1 and Figure 1. As a proportion of GDP transfers rose from 8.4% in 1960 to 14.4% in 1979. This growth is accounted for partly by long run demographic changes such as the number of pensioners within the population who are eligible for state pensions. But it has been the inflation of the 1970s along with rising levels of unemployment which has accounted for the recent rapid growth. Unemployment compensation payments increased in the 1970s as the real level of unemployment benefits rose and as the levels of unemployment increased. In 1960 326,000 persons (1.5% of the labour force) were unemployed. This had increased to 1,344,000 (6%) in 1979 and now stands at 2.5m in mid 1981. This larger number of unemployed received in 1979 unemployment benefits which were much higher in real and nominal terms compared to those paid in 1960. Thus the money value of these transfers as a percentage of GDP shot up.

Another factor which contributed to the growth of transfer payments was the policy decision of the 1975/76 budget to suppress inflation by subsidizing prices. Price subsidies were increased on commodities such as fuel, food, heating, transport and housing and local government property tax rates were heavily subsidized. Finally it can also be seen in Table 1 that the public sector's net lending to the private sector also rose during the mid 1970s. This illustrates the point that the public sector does, on occasions, borrow on behalf of the private sector. In this case it borrowed in order to support those industries, such as the U.K. motor industry, which were badly hit by the recession.

Public sector capital spending as a proportion of GDP has shown a decline since 1974 (see Figure 1). This reflects successive governments' use of capital spending to control public spending since it is politically more acceptable to delay planned capital programmes than to make public employees redundant or to control their wages and salaries.

From the above comments it is readily seen that ratios of public expenditure to GDP are ambiguous magnitudes which must be interpreted with care. Not only is it necessary to separate out public expenditure on resources from expenditures on transfer payments, it is also important to define the national income concept being used (i.e. is it net or gross and is it measured at market prices for factor cost?) and to distinguish between short run changes in the ratio and long run changes. In the short run the ratio might rise, not because public expenditure has deviated from trend, but because GDP falls. This is what happened in the mid 1970s in the U.K. Between 1973 and 1975 real GDP fell by 2.9%. The ratio of public expenditure to GDP, therefore, shot up and was interpreted at the time as an indication that public spending had exploded and was out of control. Between 1973 and 1975 general government final consumption (at constant 1975 prices) rose by 7.5% which was on trend. Moreover, transfer payments especially on unemployment compensation increased as the economy moved into recession. The combined effect of these movements was to show a rapid short run increase in the ratio of public expenditure to GDP, (see Figure 1).

There are other reasons why interpretation of the government expenditure ratio is problematic. These arise from differences in the price bases upon

which public expenditure and GDP are measured. In this context it is important to distinguish between relative price changes and absolute price changes. The former has been discussed at length by Baumol (1967) -- see also Jackson and Ulph (1973). Public expenditure represents government's purchase of inputs whilst GDP is a measure of expenditure on final output. This means that any productivity gains accruing to the public sector are automatically assumed to be zero in the national income accounts. Thus the relative prices of public inputs will rise faster than the prices of final output, because productivity gains are more fully accounted for in the private sector. If the public sector's share of final output remains constant it can be shown that its share in expenditure terms will rise (see Jackson, 1979).

When it comes to inflationary impacts on the public sector it can be shown that the inflation rate facing the public sector is higher than that for final output. This is because of the labour intensity of public services and because public sector input price rises cannot be set off against reduced profit margins.

Some of the price effects can be eliminated by revaluing public expenditure on goods and services and GDP at constant prices. This is shown in Table 2. The ratios in Table 2 give a clearer indication of the public sector's consumption of real resources.

It is readily seen from Table 2 that the public sector's share of the economy's real resources declined over the 1970s especially on capital account. This weakens claims that real resource crowding out took place.

Table 2 U.K. Public Sector Consumption of Real Resources. Percent

| | 1970 | 1975 | 1979 |
|---------------------|------|------|------|
| Current expenditure | 20.3 | 22.0 | 21.2 |
| Capital expenditure | 5.9 | 4.8 | 2.9 |
| Total | 26.2 | 26.8 | 24.1 |

Note: The figures show the ratios of public expenditure to GDP both deflated by appropriate indices with 1975=100.

Source: National Income and Expenditure; HMSO, 1980.

LOCAL GOVERNMENT GROWTH

Local Government Spending

Local government expenditure in the U.K. accounts for about one third of total public expenditure. This proportion is, however, variable. The increase in local government's share of total public spending from 27% to 33% between 1960 and 1970 reflects the decline in central government spending on defence, whereas the subsequent decline in local government's share from 33% to 29% between 1975 and 1979 is due in part to increased control over local capital spending programmes and also the increase in central government spending on transfers.

As a share of GDP, local government expenditure has shown a similar degree of variability (see Table 3). The qualifications about interpreting this ratio have already been discussed. In the case of local government spending it should be remembered that a smaller proportion of expenditure is on transfer payments. These transfer payments are primarily subsidies on housing and trans-

**Table 3 U.K. Local Public Expenditure Ratios
1960-1979**

All are shown as % of GDP at current market prices

| | 1960 | 1970 | 1975 | 1979 |
|---|------|------|------|------|
| Total local government spending | 9.3 | 13.4 | 16.1 | 12.9 |
| Local exhaustive public spending ^a | 7.8 | 10.6 | 11.8 | 10.0 |
| Local government capital spending | 2.6 | 3.7 | 3.7 | 2.0 |

^a Capital and current spending.

Source: as for Table 1.

port, grants to the personal sector in the form of scholarships and grants to universities, colleges etc. and rent rebates and allowances. Taking out these transfers we can see from Table 3 that local government exhaustive expenditures (i.e. on real resources) have been relatively stable during the 1970s as a share of GDP. It is seen once again that much of the increase in the relative share of local public spending was due to transfer payments.

Capital spending in the U.K. economy has, throughout the period 1960/80, remained relatively constant at 17% of GDP. In 1960 22% of total capital spending was carried out by the public sector (excluding the nationalised industries and public corporations). This had fallen to 15% by 1979. Within the total of public sector capital spending local government accounts for about 70% of it. In recent years there has been a slowing down in local government capital spending. This has, in

part, been due to the general control over public capital programmes but it has also been due to the completion of massive housebuilding, school building and road building programmes which were started during the 1960s.

The composition of local government current expenditure is set out in Table 4. The relative shares of the functional categories of current expenditure have displayed great stability since 1960. One element, however, which has increased considerably is grants to the personal sector. This has been due to the increase in rent rebates since 1974, which rose from £5m in 1974 to £197m in 1979. The increase in rent rebates reflects policies which have responded to the high inflation and increased levels of unemployment, especially in central city areas.

One statistic which is of interest and which will be developed later in this paper is the size of the surplus on current account. Whilst local governments in total have run a current account surplus it has not kept pace with inflation. In 1960 the surplus was 20% of current expenditure. This had fallen to 11% in 1970 and was 7% in 1979. Since the surplus on current account is an important source of finance or capital spending its reduction could imply that a larger proportion of capital expenditure has been financed from borrowing.

Local government capital expenditure is set out in Table 5. Over 90% of capital spending is allocated to fixed investment. The remainder represents capital grants to the personal sector (mainly for house purchase) and net lending to the private sector. There is a structural break in Table 5

Table 4 Composition of Local Government Current Spending (U.K.)

| | 1960 | | 1970 | | 1975 | | 1979 | |
|---------------------------------------|------|-----|------|-----|-------|-----|-------|-----|
| | £m | % | £m | % | £m | % | £m | % |
| Current expenditure on goods/services | 1357 | 79 | 3627 | 74 | 9776 | 75 | 15492 | 75 |
| Education | 655 | 38 | 1742 | 35 | 4809 | 37 | 7012 | 34 |
| Environment | 145 | 8 | 415 | 8 | 826 | 6 | 1457 | 7 |
| Police | 116 | 7 | 337 | 7 | 829 | 6 | 1593 | 8 |
| Roads/Lighting | 127 | 7 | 261 | 5 | 578 | 4 | 956 | 5 |
| Housing subsidies | 31 | 2 | 118 | 2 | 213 | 2 | 332 | 2 |
| Current grants to personal sector | 40 | 2 | 159 | 3 | 416 | 3 | 936 | 5 |
| Debt interest | 287 | 17 | 1037 | 21 | 2333 | 18 | 3451 | 17 |
| Total current spending | 1715 | 100 | 4941 | 100 | 12982 | 100 | 20573 | 100 |
| Balance: Current surplus | 245 | | 533 | | 1155 | | 1351 | |
| | 1960 | | 5474 | | 14137 | | 21924 | |

Source: as for Table 1.

Table 5 **Composition of Local Government Capital Spending (U.K.)**

| | 1960 | | 1970 | | 1975 | | 1979 | |
|--------------------------------------|------|-----|-------|-----|-------|-----|-------|-----|
| | £m | % | £m | % | £m | % | £m | % |
| <u>Capital Account</u> | | | | | | | | |
| Fixed Investment | 604 | 92 | 1819 | 96 | 3755 | 97 | 3641 | 93 |
| Housing | 255 | 39 | 735 | 39 | 2038 | 52 | 1747 | 45 |
| Education | 114 | 17 | 288 | 15 | 556 | 14 | 472 | 12 |
| Roads | 54 | 8 | 235 | 12 | 372 | 10 | 357 | 9 |
| Environment | 101 | 15 | 277 | 15 | 354 | 9 | 453 | 12 |
| Capital grants to personal sector | 13 | 2 | 30 | 2 | 75 | 2 | 134 | 4 |
| Total capital spending | 659 | 100 | 1886 | 100 | 3882 | 100 | 3871 | 100 |
| Balance: Financial surplus | | | -1263 | | -2525 | | -2194 | |

Source: as for Table 1.

which makes difficult the interpretation of the shares of capital spending by the various functional categories. In 1972/73 water, sewerage and sewage disposal services were transferred out of local government control. This accounts for the reduction in environmental capital spending and the apparent increase in the proportion spent on housing.

Local Government Labour Market

Local government services are typically labour intensive. To understand changes in current expenditure on goods and services it is, therefore, necessary to understand the behaviour of the labour markets faced by local governments. This is an under-researched area in the U.K. and work has only just started on it. A number of general remarks can, however, be made.

The degree of labour intensity of different local government services is shown in Table 6. Services

**Table 6 Ratio of Payroll Expenditure to Total
Current Expenditure. Percent**

| | 1970 | 1979 |
|--------------------------|------|------|
| Education | 85 | 94 |
| Housing | 1 | 5 |
| Environmental services | 48 | 76 |
| Law and order | 94 | 96 |
| Personal social services | 78 | 95 |

Note: Payroll expenditure includes employer's contribution to National Insurance and superannuation schemes.

have become relatively more labour intensive throughout the 1970s.

Employment by local government has increased both in absolute terms and as a share of total employment (see Table 7). This growth in employment has taken place mainly in the education, health and social services departments (see Table 8). Again care must be taken when interpreting these data. Much of the increase in local government employment has taken place amongst part-time employees, especially females. Table 9 shows the growth in female part-time employment in local government. Recent attempts to understand these trends suggest that the public sector offered white collar service type jobs which provided flexibility in hours and which were demanded by women re-entering the labour force (see Jackson, 1978 and Wilkinson and Jackson, 1981). Much of the growth in the public sector during the 1960s and early 1970s was accommodated by the availability of this type of labour.

Table 7 Employment by Sector, U.K.^a

| | <u>Private sector</u> | | <u>Public corporations</u> | | <u>Central government</u> | | <u>Local authorities</u> | |
|------|-----------------------|------|----------------------------|-----|---------------------------|-----|--------------------------|------|
| | No. | % | No. | % | No. | % | No. | % |
| 1961 | 18614 | 76.1 | 2200 | 9.0 | 1773 | 7.2 | 1870 | 7.6 |
| 1964 | 19012 | 76.2 | 2079 | 8.3 | 1771 | 7.1 | 2088 | 8.4 |
| 1967 | 18592 | 74.4 | 2164 | 8.7 | 1872 | 7.5 | 2364 | 9.5 |
| 1970 | 18264 | 73.8 | 2025 | 8.2 | 1905 | 7.7 | 2559 | 10.3 |
| 1973 | 18194 | 72.9 | 1890 | 7.6 | 1998 | 8.0 | 2890 | 11.6 |
| 1976 | 17448 | 70.5 | 1980 | 8.0 | 2315 | 9.3 | 3022 | 12.2 |
| 1978 | 17545 | 70.4 | 2061 | 8.3 | 2309 | 9.3 | 3013 | 12.1 |

^a Figures show the number of persons (in thousands) and the percentage of the employed labour force working in each sector; no allowance has been made for the effects of part-time working.

Source: Gazette Nov. 79, pp. 99-104.

Table 8 Local Authority: Employment by Major Departments. Great Britain

Thousands

| | Education Department | | Health & Social Services | Con-struction | Transport | Police | Others | Total |
|------|----------------------|------------------|--------------------------|---------------|-----------|--------|--------|-------|
| | Teachers | Ancillaries | | | | | | |
| 1952 | 318 | 139 | 116 | 70 | 103 | 72 | 630 | 1448 |
| 1955 | 349 | 149 | 136 | 70 | 96 | 74 | 641 | 1515 |
| 1958 | 381 | 171 | 152 | 93 | 96 | 80 | 653 | 1626 |
| 1961 | 427 | 339 ^a | 170 | 103 | 90 | 84 | 545 | 1755 |
| 1964 | 485 | 416 | 200 | 124 | 87 | 90 | 565 | 1964 |
| 1967 | 544 | 497 | 239 | 135 | 82 | 98 | 616 | 2212 |
| 1970 | 608 | 596 | 264 | 128 | 51 | 103 | 635 | 2386 |
| 1973 | 713 | 681 | 315 | 130 | 39 | 112 | 709 | 2699 |
| 1976 | 742 | 781 | 320 | 166 | 32 | 121 | 708 | 2870 |
| 1978 | 743 | 772 | 335 | 157 | 30 | 120 | 701 | 2858 |

^a Includes school meals staff from 1961 onwards.

Source: Gazette (various edns) and unpublished data from the DE.

Table 9 Local Authorities: Employment by Status and Sex. Great Britain. Thousands

| | Part-time employees | | Female employees | | Part-time female employees | | |
|------|---------------------|------------|------------------|------------|----------------------------|-------------------|--------------------|
| | No. | % of total | No. | % of total | No. | % of PT employees | % of all employees |
| 1952 | 255 | 18.6 | 604 | 43.9 | 211 | 82.6 | 15.3 |
| 1955 | 292 | 20.3 | 651 | 45.2 | 240 | 82.1 | 16.7 |
| 1958 | 339 | 22.0 | 714 | 46.2 | 279 | 82.2 | 18.1 |
| 1961 | 404 | 24.2 | 791 | 47.3 | 333 | 82.4 | 19.9 |
| 1964 | 508 | 27.1 | 908 | 48.5 | 419 | 82.5 | 22.4 |
| 1967 | 622 | 29.4 | 1070 | 50.7 | 520 | 83.6 | 24.6 |
| 1970 | 745 | 32.6 | 1231 | 53.9 | 629 | 84.4 | 27.5 |
| 1973 | 884 | 34.2 | 1446 | 55.9 | 748 | 84.6 | 28.9 |
| 1976 | 964 | 35.1 | 1605 | 58.4 | 859 | 89.2 | 31.3 |
| 1978 | 975 | 35.6 | 1622 | 59.3 | 884 | 90.7 | 32.3 |

Source: Gazette (various edns) and unpublished data from the DE.

What about wages and salaries in the public sector? Have these risen much faster than earnings elsewhere in the economy, thereby attracting labour into public services and expanding the relative size of the public sector? Again, it is only tentative evidence which can be offered. Comparing wages and salaries in the public sector with those in the private sector is rather a complex exercise in the U.K., since there is seldom a comparable private sector group. It is possible, however, to compare movements in the wages and salaries of particular groups of public sector workers with the changes in the average wage rate for the economy as a whole. These comparisons are set out in Table 10.

All groups of workers have done better than changes in the retail price index. Real incomes have, therefore, increased throughout the economy as a whole. Teachers, representing a strong professional group, have done better than the average as one would expect, whereas social workers appear to have lagged behind in the late 1960s, caught up in the early 1970s, but lost ground again recently. Police pay has been close to the average throughout. Each series does, however, show periods in which public sector pay lagged behind that in the private sector, a narrowing of differentials and

Table 10 Public Sector Salary Indices 1962-1977
Index 1962 = 100

| | Retail price | Private sector Wage rate | Teachers Wage | Social workers Wage | Police Wage |
|------|--------------|--------------------------|---------------|---------------------|-------------|
| 63 | 102.1 | 103.7 | 110.5 | 102.8 | 102.4 |
| 64 | 105.5 | 108.7 | - | 105.6 | 112.9 |
| 1965 | 110.6 | 113.4 | 128.1 | 109.8 | - |
| 66 | 114.9 | 118.6 | - | - | - |
| 67 | 117.8 | 123.2 | - | 120.3 | 123.4 |
| 68 | 123.3 | 131.3 | - | 125.1 | 129.8 |
| 69 | 129.9 | 138.3 | 150.9 | 130.1 | 134.9 |
| 1970 | 138.2 | 151.9 | 171.9 | 152.3 | 145.0 |
| 71 | 151.2 | 171.5 | 185.1 | 201.8 | 175.6 |
| 72 | 161.9 | 195.2 | 206.8 | 220.7 | 201.8 |
| 73 | 176.8 | 221.9 | 229.1 | 236.6 | 218.5 |
| 74 | 205.3 | 265.8 | 254.2 | 268.9 | 263.2 |
| 1975 | 255.2 | 344.2 | 395.3 | 364.6 | 387.1 |
| 76 | 297.3 | 410.6 | 450.0 | 408.2 | 408.1 |
| 77 | 344.3 | 437.4 | 473.2 | 428.6 | 447.6 |
| 78 | 372.5 | 499.0 | | | |
| 79 | 422.4 | 573.4 | | | |

Source: Compiled by the author.

then an adjustment. This is readily seen in the case of teachers. Their salaries lagged behind in the 1970s, especially in 1974. The Houghton Committee of that year recommended massive increases in teachers pay, which increases were implemented the following year.

The movements in public sector pay do not suggest that they led the private sector. However, large increases in wage rates in any single year will have significant impacts upon local government budgets. Almost all labour is unionised amongst local government groups. Whilst these unions are strong they have not until very recent years been militant. Moreover, they had to contend with a variety of incomes policies throughout different phases of the 1970s.

Local Government Capital Market

Local government capital spending is financed from three principal sources, (a) the surplus on current account (b) specific and general capital grants from central government and (c) borrowing. The proportions are shown in Table 11.

In general local authorities have managed to have a surplus on their current account each year. Although this surplus has not increased in proportion to current expenditure it has nevertheless financed an increasing share of capital expenditure. This is due to the decline in the volume in capital spending which has had to be financed. The greatest part of capital spending is, however, financed from local authority borrowing which contributes to the overall public sector borrowing requirement.

Table 11 Sources of Capital Finance
Percent

| | 1970 | 1975 | 1979 |
|----------------------------|-------|-------|-------|
| Surplus on current account | 25.0 | 30.0 | 35.0 |
| Capital grants | 8.0 | 5.0 | 8.0 |
| Borrowing | 67.0 | 65.0 | 57.0 |
| | 100.0 | 100.0 | 100.0 |

Only part of the local authorities' borrowing is raised on the open market, the remainder is obtained from loans received from central government. In 1979 local government borrowing from the open market was £1768 million or 14% of the total public sector borrowing requirement. There is no distinct pattern to local authority borrowing during the 1970s. All that can be said is that it has been much higher than in earlier periods and more variable.

Determinants of Expenditure

A number of factors have contributed to the growth in the absolute size of both real and nominal local government expenditures. These will include long term demographic factors such as increases in the school age population; real income changes, changes in the labour intensity of services and improvements in the relative (and money) wages of local public sector employees. A complete model of expenditure growth would need to incorporate these factors. For example, according to Wagner's Law the demand for public services is income elastic which implies that over time the absolute level of

real public expenditure will rise and moreover so too will the relative size of the public sector. An increase in real incomes, especially if the tax system is progressive, will generate the resources necessary to finance an expansion in public services. However, as Baumol (1967) has demonstrated the implied relative prices of public services will tend to increase over time. Thus, an expansion of real public services and public expenditures requires that the income elasticity of demand for these services be greater than the price elasticity (Jackson and Ulph, 1973).¹¹

Within this model of the determination of the public sector budget constraint there is a variety of alternative specifications of the decision-making process whereby public expenditures are determined through choices of public output levels. These include a social welfare function approach; a median voter approach; an incrementalist specification; or a bureaucratic approach. In practice the decision-making process includes elements of each. Budgets are history dependent in the sense that a large proportion of resources are locked into activities which have been determined by earlier decisions. Adjustments, therefore, take place at the margin (the increment) but these adjustments are cumulative which means that substantial changes to the content of programmes can be observed over time. When making adjustments at the margin there is an interplay between a number of agents in the decision-making process. These include politicians, pressure groups, and bureaucrats. The power of bureaucrats within the decision-making system and the degree of bureaucratic inertia is a function of the control system, (see Jackson, 1981) and the degree to which voters' demands are expressed and represented within the political system.

Whilst exogenous factors such as demographic changes and real income changes are likely influences upon public expenditures, we need to understand why decision-makers respond to these changes in the way they do. For example, an increase in pupil numbers could be accommodated by increasing class sizes. What is actually observed is the outcome of a series of decisions about what are desirable and feasible class sizes (and hence the demand for teachers and classrooms); the appropriate teaching technology (demand for other teaching inputs); and teachers' salaries. Responses to exogenous changes are, therefore, the outcome of a series of adjustments which can take into account political factors such as voter's response to the outcome of the decision. To the extent that voter's responses are weak, the discretionary powers of politicians and bureaucrats are enhanced. Whose interests are then served by local fiscal decisions becomes a complex issue in empirical political economy.

An understanding of the process of public expenditure determination is important to understanding the likely consequences of increased control over that expenditure. How do local politicians and bureaucrats respond to demands for expenditure restraint? Whose interests do they serve (implicitly or explicitly) when they respond? How much scope do they have to respond quickly in the short run? These questions are easy to ask but more difficult to answer. Some of them can be illustrated by an examination of education spending.

Education Expenditure

From Table 4 it can be seen that the bulk of local government's current expenditure is accounted for by education, debt interest and grants to the

personal sector (mainly for tertiary education). Debt interest is explained by the capital expenditure programme which is mainly on housing and education and by movements in interest rates. On average, therefore, much of the trend in local government spending is accounted for by education and housing policy decisions. As far as changes in education are concerned these have been dominated by (a) increases in the number of children of school age, (b) reductions in class sizes by improvements in the teacher/pupil ratio, (c) an increase in non-teaching staffs (see Table 8 above), and (d) an extension of education to younger age groups and to disadvantaged groups e.g. mentally handicapped. Changes in public sector school pupils are set out in Table 12.

Along with changes in pupil numbers the pupil/teacher ratio has also been changing. These are set out in Table 13.

It must also be remembered that the unit cost of secondary education is much higher than that in primary schools because of smaller sizes and because teachers are paid higher salaries in secondary schools. Unit costs in primary schools are about 50% of those in secondary schools.

The education system in the U.K. however, faces a falling school population up to about 2001. This follows reductions in fertility rates during the 1970s. Table 14 gives population projections of the under 16s.

Given these population changes the education sector in the U.K., in the absence of public expenditure cuts, would probably have absorbed a smaller proportion of the community's resources. On the

Table 12 School Pupil Numbers - U.K.

Thousands

| | 1961 | 1971 | 1979 |
|--------------------------------|------|------|------|
| Nursery schools ^a | 31 | 50 | 88 |
| Primary schools ^b | 4906 | 5161 | 5594 |
| Secondary schools ^c | 3165 | 3555 | 4646 |
| Special schools ^d | 77 | 103 | 151 |

^a Nursery school pupils under 5 years of age.

^b Primary school pupils aged 5-11 years.

^c Secondary school pupils aged 11+ years.

^d Special schools include; hospital schools and schools for the mentally and educationally sub-normal.

Table 13 Pupil Teacher Ratios - U.K.

| | 1961 | 1971 | 1979 |
|-------------------|------|------|------|
| Nursery schools | 22.7 | 26.6 | 22.2 |
| Primary schools | 28.9 | 27.1 | 24.2 |
| Secondary schools | 20.0 | 17.8 | 17.0 |
| Special schools | 12.5 | 10.7 | 9.3 |

Table 14 Population Projection: Under 16 years of age - U.K. Millions

| | 1971 | 1979 | 1981 | 1986 | 1991 | 1996 | 2001 |
|---------|------|------|------|------|------|------|------|
| Males | 7.1 | 6.7 | 6.4 | 6.2 | 6.4 | 6.9 | 7.0 |
| Females | 6.9 | 6.3 | 6.1 | 5.8 | 6.1 | 6.6 | 6.7 |

Source: Social Trends No.11 1981 (HMSO) Table 1.2.

other hand a decision might have been made to improve the volume of resources per pupil or to allocate the released resources to particular groups of pupils in greatest need. The adjustment to changing pupil numbers would, however, have been gradual. However, these school population projections have been used by those who wish to cut back on public spending as a justification for the cuts. The expectation by policy makers is that the cuts will be made immediately but the capacity of the system to respond to sudden adjustments without disruption is limited.

Government Revenues

In the previous sections trends in the public expenditures of both central and local governments have been examined. It will, however, be recalled that one of the principal elements in the fiscal containment argument refers to taxation. Trends in the level and composition of government revenues are shown in Table 15.

The problems of interpreting tax revenue ratios are similar to those for public expenditure. It can, however, be seen from Table 15 that throughout the post-war period there have been changes in the composition of the tax structure as between direct and indirect taxes. The most recent change is a move towards placing a greater emphasis upon indirect taxes.

Whilst this would be expected from a government that believes in the existence of the disincentive effects of direct taxes it is nevertheless counter to many of the arguments of the fiscal limitation movement because indirect taxes are more hidden

Table 15 U.K. Tax Revenues as a Proportion of GDP. Market prices. Percent

| | Taxes on ^a incomes | Taxes on ^b spending | National insurance and health service contributions | Local government rates |
|------|----------------------------------|-----------------------------------|---|------------------------------|
| 1946 | 17.3 | 15.7 | 1.7 | 2.7 |
| 1950 | 13.9 | 15.9 | 3.4 | 3.0 |
| 1955 | 12.1 | 13.8 | 3.1 | 2.5 |
| 1960 | 10.7 | 13.3 | 3.6 | 3.0 |
| 1965 | 11.3 | 14.0 | 5.3 | 3.4 |
| 1970 | 14.5 | 16.5 | 5.6 | 3.6 |
| 1975 | 16.0 | 13.5 | 7.3 | 3.8 |
| 1979 | 13.6 | 14.2 | 7.0 | 3.5 |

^a The personal income tax contributes 80% of the revenue from taxes on income; petroleum revenue tax = 0.8% and corporation tax 15%.

^b Includes local government rates plus excise duties and customs duties (46%); VAT (30%), Motor vehicle tax (6%).

Sources: National Income and Expenditure HMSO - various issues.

and less obvious to the taxpayer than are direct taxes.

The principal sources of local government revenue are (a) income from rates (i.e. the local property tax), (b) income from central government grants (i.e. specific and non-specific), (c) charges, and (d) borrowing. Changes in these sources of income are shown in Table 16.

The data contained in Table 16 illustrate the changes which have taken place in central/local government relations in the U.K. over the period. From 1966-79 central government grants-in-aid, especially the general Rate Support Grant (RSG)

Table 16 Local Government Revenues - U.K.
Percent

| | 1966 | 1970 | 1975 | 1979 |
|----------------------|-------|-------|-------|-------|
| Rates | 31.0 | 28.0 | 24.0 | 28.0 |
| Grants: | | | | |
| specific | 9.0 | 6.0 | 7.0 | 10.0 |
| general | 26.0 | 34.0 | 40.0 | 39.0 |
| Charges ^a | 13.0 | 14.0 | 12.0 | 13.0 |
| Borrowing | 21.0 | 18.0 | 17.0 | 10.0 |
| | 100.0 | 100.0 | 100.0 | 100.0 |

^a Mainly income from rents on public sector housing, plus income from trading services.

have been an increasing source of local government revenue. This has weakened any control relationship between the local electorate, which consumes local public services, and the local tax costs of providing these services, whilst at the same time forcing local government to be more accountable to central government.

The fiscal relations between central and local government in the U.K. are exceedingly difficult to interpret. Central government in its attempts to achieve the objectives of macro-economic control has used local government capital expenditure and the R.S.G. as policy instruments. However, local authorities do have access to the revenue from the rates to supplement cutbacks in grants, as seems to have happened between 1976 and 1980. Moreover, it is difficult to interpret precisely the degree to which local government is accountable to central government for its policies (see Layfield Enquiry into, Local Government Finance, Cmnd 6453, 1976). Central government departmental

circulars can give guidance regarding expenditure programmes but at the end of the day it is local government which implements a particular programme in terms of the set of activities and services distributed to the local electorate.

THE FISCAL ENVIRONMENT

So far each section has described trends in public expenditure and taxation and has provided some interpretive analysis. This contrasts sharply with the American approach to the analysis of public spending, which has paid much more attention to estimating demand elasticities for public services and grants-in-aid elasticities in the case of local governments. One reason for this difference lies in the differing fiscal environments which the two systems operate within.

In the U.K. public service output decisions are to a greater extent supply determined than demand determined especially at the level of local governments. This can be seen by considering how much of local government revenue is raised from local taxpayers. It was seen in Table 16 that just under one third of local government revenue was raised from local property taxes but within this source there are two groups of taxpayers. These are domestic ratepayers (i.e. those who pay property taxes on domestic properties) and non-domestic ratepayers (i.e. those who pay rates on industrial and commercial properties). In Table 17 the percentages of the total rate call (since the introduction of the domestic element of the Rate Support Grant, divided between domestic and non-domestic ratepayers) are shown.

Table 17 **Allocation of Rate Call**
Percent

| | Non-domestic ratepayers | Domestic ratepayers | Domestic element of RSG |
|---------|----------------------------|------------------------|----------------------------|
| 1966/67 | 52.2 | 47.8 | - |
| 1970/71 | 52.0 | 42.5 | 5.5 |
| 1978/79 | 40.5 | 47.9 | 11.6 |

Source: Compiled by the author.

It can be seen from Table 17 that non-domestic ratepayers have been paying a rapidly decreasing proportion of the local property tax. The domestic element of the central government's Rate Support Grant has increased. Thus, the subsidy element to domestic ratepayers from central government has increased. This reduces the impact of rate increases upon the consumers of local public services and is bound to have marked impact upon their decisions over demand for these services. In practice only 10% of total local government revenue was collected from domestic property taxpayers.

The weakness of demand within the system is compounded when it is further noted that only 40% of local voters pay the property tax since the property tax is only paid by the head of the household. There is no doubt that the demand model of U.K. local government expenditure determination is complex but to date it has not been examined systematically. Further complications exist when fiscal illusion is added to the picture (see Oates' paper in this volume). Local voters do pay national government taxes which finance local public services but whether or not local voters recognise this link is made more complex because of the amount of

income redistribution which takes place. It has, therefore, tended to be the middle and upper income groups (taxpayers) who have, through various pressure groups, complained about the burden of the total fiscal system.

This weakness of demand signals from taxpayers means that the system through which resources are allocated to public services is open to political and bureaucratic influences (see Niskanen, 1971, and Jackson, 1981). Theories of bureaucratic supply whilst developed at a theoretical level have very little empirical content in the context of the U.K. Evidence which does exist tends to suggest that, in the U.K., parliament's control over public expenditure allocations is weak whilst cabinet control over allocations at the margin is strong. This, however, begs the question of how cabinet decisions are implemented and how much control the legislature has over the executive in the implementation process. At the end of the day, whilst official policy can set the broad structure of the system of service delivery it is public employees who actually deliver the services and their interpretation of the system can be vital when it comes to questions of who benefits and the quality of the service.

This weakness of the influence of demand factors plays an important role when it comes to interpreting the fiscal limitation movement. There are many possible sources of criticism of the public sector as it affects behaviour elsewhere in the economy. These were reviewed in the early part of the paper. Even if none of these macro-criticisms are valid there still remains a case for the fiscal limitation movement on the grounds of economic efficiency. There are two senses in which the pub-

lic sector might be thought to be inefficient. First, the mix of public services might not be optimal. Second, the public sector could be producing the correct mix of outputs but at the wrong prices because of X-inefficiency.

Inefficiency on the demand side results in the public sector producing the wrong mix of services i.e. it produces the wrong level of outputs and the wrong quality of services. The outputs are wrong in the sense that they are not what the representative (median) voter demands. As Buchanan and Tullock (1962) have argued, this can arise when vote maximizing politicians try to buy off a number of different pressure groups. It can, however, also occur if voters' preferences are only weakly articulated within the system. Reforms to reduce allocative inefficiency must, therefore, be directed towards ensuring that "prices" play a more dominant role. This means that at the local level of government the tax costs of increases in public services must be recognised by the local voters. It is clear from the earlier discussion that this does not currently occur in the U.K. Improvements to the price system whilst being necessary are not sufficient to ensure improvements in allocative efficiency. There must be back up reforms to the parliamentary system of control of the bureaucracy to ensure that politicians and bureaucrats do respond to voters' preferences.

The second notion of inefficiency (X-inefficiency) refers to the amount of waste and fat that can exist in public budgets. In other words are the voters/taxpayers getting value for money? This requires improvements to be made to the system of control over public spending, particularly public wages. It also could require a consideration of

the information system which is used to make public expenditure decisions. If the information system is inadequate then it will become difficult to distinguish between improvements in the real level of service provision and expenditure increases which are nothing other than increases in the economic rents paid to bureaucrats.

Many would argue that the Public Expenditure Survey Committee (PESC) system of public expenditure planning and control, which was set up in the U.K. in 1961, was deficient insofar as it did not provide information of the kind necessary to make rational decisions in respect of public expenditure allocations. This system has been criticised elsewhere (see Jackson, 1980). For present purposes it is sufficient to note two major drawbacks with the PESC system. First, public expenditures were planned to grow, over the medium term, in line with the forecasted rate of growth in real GDP. Seldom were these GDP forecasts achieved. Actual GDP usually fell below forecasted. The result was that public expenditures as a proportion of GDP rose. Second, public expenditures were planned in real terms, i.e. at constant prices.

During periods of high inflation this practice of real resource planning in the public sector placed severe strains on the public sector's financing requirements. In other words the information provided to decision-makers when making decisions about the growth of public expenditure and its increase was not sufficient. These deficiencies were clearly identified during the 1970s when the growth in GDP was low and the rate of inflation high.

In 1976 the PESC system was supplemented by a set of cash limits which were intended as a short-run measure and which were supposed to focus the attention of decision-makers upon the ranking or priorities. The implementation of cash limits is taken up in Hepworth's paper in this volume.

CONCLUSIONS

Public expenditure in the U.K. has grown in both absolute and relative terms since 1950. Local government's share of public spending has increased. At all levels of government public expenditures on transfer payments have shown the most marked increase, especially post-1973 whereas capital spending has declined.

Despite the growth in public spending programmes there is no evidence to suggest that crowding out has occurred. The public sector's absorption of real resources has been steady and has shown a decline in recent years. One rationalisation of the situation is that the fears of those who saw the rapid growth of government were unfounded because of the difficulties involved in interpreting government expenditure ratios.

There is little empirical evidence to support the case of the U.K. fiscal limitation movement with its emphasis upon the macro-economic impact of public budgets. The evidence for disincentive effects of taxation and an interest elastic private sector investment function is very weak and in some cases contrary to expectations.

This does not, however, imply that there is not a strong case to be made out for improving control

over the public sector. The case to be made will differ from that usually made. Instead of emphasising the macro-economic aspects the fiscal limitation movement in the U.K. should turn its attention to the micro-economic issues of allocative efficiency and X-inefficiency. In this respect it is worthwhile recounting the words of Alfred Marshall.

"Government is the most precious of human possessions; and no care can be too great to be spent on enabling it to do its work in the best way: a chief condition to that end is that it should not be set to work for which it is not specifically qualified, under the conditions of time and place."

NOTES

- 1 See Cmnd 7746, The Government's Expenditure Plans 1980 - 81, HMSO. For an extended discussion of this background see Jackson (1981).
- 2 That is a quadrupling of the world price of oil, the failure of Russian harvests which forced up the price of food stuffs and a run on Sterling which forced up the dollar price of U.K. primary imports; see Dornbush and Fischer (1980).
- 3 For example the wage equation and the Phillips curve relationships of the Treasury model no longer performed adequately; see Blackaby, (1979).
- 4 See Blinder and Solow (1973, 1974) and for a useful summary of the debates see Cook and Jackson (1979).
- 5 These ideas are explored in greater detail in the public choice literature; see Buchanan, Burton and Wagner (1978).

6 The U.K. money supply growth is defined as:

| | £m 1979- 1980 |
|---|------------------|
| Public Sector Borrowing Requirement (PSBR) | 9,795 |
| <u>Less</u> Net acquisition of public sector debt by U.K. non-bank private sector | -9,110 |
| <u>Plus</u> Increase in Sterling bank lending to: | |
| (i) U.K. private sector | 9,336 |
| (ii) Overseas sector | <u>489</u> |
| <u>Equals</u> DCE (Domestic Credit Expansion) | 10,510 |
| <u>Less</u> Increase in external and foreign currency | -2,644 |
| <u>Less</u> Increase in bank's non-deposit liabilities | <u>-1,417</u> |
| <u>Equals</u> Increase in Sterling M3 | <u>6,449</u> |

- 7 For example, little is known about the impact of personal taxation upon savings decisions, household or company investment decisions or labour supply decisions of high income earners.
- 8 The personal sector's savings rate is expressed as the ratio of savings to personal disposable income.
- 9 Committee to Review the Functioning of Financial Institutions chaired by the Rt. Hon. Sir Harold Wilson. See Volume 1 of the Committee's Reports Evidence on the Financing of Industry and Trade, HMSO, 1977.
- 10 See Boatwright and Eaton (1972), Feldstein and Flemming (1971), Fleming, Price and Byers (1976), Brainard and Tobin (1968), Nadiri and Rosen (1969); and Fromm (1971).
- 11 See Gramlich, Hymans and Oates elsewhere in this volume.

REFERENCES

- Andersen, L.C., and Jordan, J.L. (1968). "Monetary and Fiscal Actions: A Test of Their Relative Importance in Economic Stabilisation", Federal Reserve Bank of St. Louis, November.
- Atkinson, A.B. (1980). "Horizontal Equity and The Distribution of the Tax Burden"; in H.J. Aaron and M.J. Boskin (eds.), The Economics of Taxation, Brookings Institution.
- Atkinson, A.B., and Stern, N.H. (1980). "Taxation and Incentives in the U.K.: A Comment", Lloyds Bank Review, April.
- Bacon, R.W., and Eltis, W.A. (1976). Britain's Economic Problems: Too Few Producers, MacMillan, London.
- Baumol, W.J. (1967). "The Macro-economics of Unbalanced Growth", American Economic Review.
- Blinder, A.S., and Solow, R.M. (1973). "Does Fiscal Policy Matter?", Journal of Public Economics, Vol.2, November.
- Boatwright, B.D., and Eaton, J.R. (1972). "The Estimation of Investment Functions for Manufacturing Industry in the U.K", Economica.
- Borcherding, T.E. (ed.) (1977). Budgets and Bureaucrats, Duke University Press.
- Brainard, W., and Tobin, J. (1968). "Pitfalls in Financial Model-Building", American Economic Review.
- Buchanan, J.M., Burton, J, and Wagner, G. (1978). The Consequences of Mr. Keynes, Hobart Paper 78, Institute of Economic Affairs, London.
- Buchanan, J.M., and Tullock, G. (1962). The Calculus of Consent, Michigan University Press, Ann Arbor.

- Coghlan, R.T., and Jackson, P.M. (1979). "The U.K. Personal Sector Savings Ratio: Past and Present and Future", Scottish Journal of Political Economy, November.
- Cook, S.T., and Jackson, P.M. (1979). Current Issues in Fiscal Policy, Martin Robertson, Oxford.
- Dornbusch, R., and Fischer, S. (1980). "Sterling and the External Balance"; in R. Caves, and L.B. Krause (eds), Britain's Economic Performance, Brookings Institution, Washington.
- Feldstein, M.S., and Flemming, J.S. (1971). "Tax Policy Corporate Saving and Investment Behaviour in Britain", Review of Economic Studies.
- Fleming, A., Price, R., and Byers, M. (1976). "The Cost of Capital, Finance and Investment", Bank of England Quarterly Bulletin, June.
- Fromm, G. (1971). Tax Incentives and Capital Spending, Brookings Institution, Washington.
- Hahn, F.H. (1980a). "Monetarism and Economic Theory", Economica, Vol.47, No. 185.
- Hahn, F.H. (1980b). "On Inflation." University of Cambridge Economic Theory Discussion Paper, No.36, August.
- Jackson, P.M. (1978). "The Growth of Public Sector Employment: The Case of the U.K."; in Fiscal Problems of Labour Supply, Institute for Fiscal Studies Conference Series No. 4, London.
- Jackson, P.M. (1979). "Comparative Public Sector Growth: A United Kingdom Perspective"; in M.W. Bucovetzky (ed.), Studies in Public Employment and Compensation in Canada.
- Jackson, P.M. (1979). The Planning and Control of Public Expenditure in the U.K. Open University Press.

- Jackson, P.M. (1980). "The Growth of the Relative Size of the Public Sector"; in D.A. Currie and W. Peters (eds), Contemporary Economic Analysis, Vol.2, Croom-Helm.
- Jackson, P.M. (1981a). The Political Economy of Bureaucracy, Philip Allen, Oxford.
- Jackson, P.M. (1981b). "New Economic Order"; in P.M. Jackson (ed.), The Government's Policy Initiatives, Royal Institute of Public Administration, London.
- Jackson, P.M., and Ulph, D.T. (1973). "The Relative Prices of Public Sector Goods", University of Sterling Discussion Paper.
- Kaldor, N. (1980). "Monetarism and U.K. Monetary Policy", Cambridge Journal of Economics, Vol.4.
- Nadiri, G., and Rosen, S. (1969). "Inter-related Factor Demand Functions", American Economic Review.
- Niskanen, W.A. (1971). Bureaucracy and Representative Government, Aldine, Chicago.
- Wilkinson, G.W., and Jackson, P.M. (1981). The Growth of Public Sector Employment in the U.K., PSERC Working Paper, University of Leicester, England.