EVIDENCE SUBMITTED TO THE REVIEW OF HM TREASURY COMMISSIONED BY JOHN MCDONNELL MP

from

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SUMMARY

The Kerslake Review was established by John McDonnell MP "to consider whether the current role, responsibilities and operating mandate of HM Treasury are appropriate for the task of promoting and managing sustainable growth in a fairer and more equal society, and to make recommendations". The evidence which I presented to the review (reproduced here) demonstrates that the analysis used by HM Treasury to describe the country's economic situation is not fit for purpose. As a consequence it is not possible for HM Treasury adequately to fulfil any of the objectives specified within the terms of reference given for the review. Further consideration shows that the way in which information about public finance and taxation is presented to the public does not realistically communicate the operation of government policy. This disadvantages democratic engagement in policy development. Constructive alternative analysis, measurable criteria and a platform for communication are suggested.

Introduction

It ought to be fundamental to a proper appraisal of the fitness for purpose of the Treasury that its established view of the country's economic situation should be subject to critical inspection. And when this is done it transpires that the established Treasury view is tragically misconceived. Not only are the national economic prospects being evaluated according to a set of false assumptions but the scope for government actions, both in terms of revenue and expenditure, is also being assessed according to inappropriate criteria. And discussion regarding the application of taxation, together with the distribution of its burdens and benefits, is given a distorted presentation which prevents households from recognising opportunities for constructive democratic engagement with public policy.

False Analysis

The evidence of false analysis is most easily recognised in relation to the exchange rate. There is no more fundamental foundation for the analysis of British economic policy than the universal political commitment to sterling as a sovereign currency. In consequence there is no more certain element in the economic outlook than the continuing existence of exchange rates.

For as long as sterling remains a sovereign currency the exchange rate will be a significant factor affecting the country's economic circumstances. But unfortunately both the Treasury (and hence the OBR) and the Bank of England (and hence the MPC) espouse the heartfelt belief that "devaluation makes our exports cheaper" (as Robert Chote puts it with technical precision, it causes "a change in the relative prices of domestic and foreign goods"). This erroneous preconception leads Treasury officials to suppose that any depreciation of sterling will expand sales volumes for British goods and services (because they're supposed to be cheaper following devaluation) thus boosting economic activity and employment. Such thinking is completely bogus.

Official expectations are directly contradicted by the evidence provided from the Office for National Statistics. The figures in Table 1 below amply illustrate this point.

Table 1: UK Trading Conditions Since 2004

	Exchange Rate US$/£	Exchange Rate €/£	Traded Goods Price Index for Exports	Traded Goods Price Index for Imports	Terms of Trade
2004	1.83	1.47	72.2	71.0	101.7
2005	1.82	1.46	74.8	74.0	101.1
2006	1.84	1.47	76.0	76.3	99.6
2007	2.00	1.46	75.6	76.2	99.2
2008	1.85	1.26	86.0	86.9	99.0
2009	1.57	1.12	86.9	87.8	99.0
2010	1.55	1.17	92.7	92.0	100.8
2011	1.60	1.15	100.0	100.0	100.0
2012	1.59	1.23	99.8	99.8	100.0
2013	1.56	1.18	100.9	100.4	100.5
2014	1.65	1.24	96.4	96.7	99.7
ẋ 2004-2007	1.87	1.47	74.7	74.4	100.4
ẋ 2009-2012	1.57	1.17	94.9	94.9	100.0

Consideration of the Evidence

The ONS figures indicate that the official expectations are completely refuted. The devaluation of sterling in the aftermath of the Great Financial Crisis was substantial: from $1.87 in the years before the crisis (2004-2007) to $1.57 in the years after it (2009-2012); from €1.47 in the years before the crisis (2004-2007) to €1.17 in the years after it (2009-2012). This devaluation raised the prices of goods imported and goods exported alike: there was no "change in the relative prices of domestic and foreign goods". The traded goods price index for exports went from 74.7 in the years before the crisis (2004-2007) to 94.9 in the years after it (2009-2012); the traded goods price index for imports went from 74.4 in the years before the crisis (2004-2007) to 94.9 in the years after it (2009-2012). In technical terminology: the terms of trade remained unchanged. And this ought to come as no surprise since you only need seven types of product to account for more than half of UK exports and you only need ***the same seven*** to account for more than half of the UK's imports as well. The categories are: Mechanical machinery; Electrical machinery; Cars; Medicinal & pharmaceutical products; Refined oil; Crude oil; and Other miscellaneous manufactures. So no wonder prices of imports and exports move together: their prices are those of the same types of products and come from the same world markets.

Evidence in Greater Detail

A more detailed consideration of the ONS data confirms that import and export prices within the same product categories habitually move together (being basically the same international price of course), showing that the UK is well integrated into global market determination of producer prices.

This evidence is presented in Table 2. The table contains data showing the price changes for exports and for imports that took place within the same categories of product in conjunction with the devaluation of sterling between 2007 and 2010. Also presented are the correlation coefficients which measure the degree of association between these export and import prices over a longer run of years (1998-2011).

Table 2: Selected Export Price and Import Price Changes 2007-2010 with Longer-Run Correlations (1998-2011); data from ONS

	Export Price	Import Price	Correlation coefficient
	2007-2010	2007-2010	1998-2011
	(% change)		(r)
Food: SITC 0:	20	30	0.99
Meat: SITC 01:	30	32	0.95
Dairy products & eggs: SITC 02:	33	21	0.78
Cereals and animal feeding stuffs: SITC 04+08:	14	27	0.99
Fruit & vegetables: SITC 05:	21	28	0.98
Beverages & tobacco: SITC 1:	21	20	0.97
Beverages: SITC 11:	22	24	0.96
Tobacco: SITC 12:	10	8	0.86
Crude Materials: SITC 2:	17	27	0.91
Textile fibres: SITC 26:	23	17	0.95
Metal ores: SITC 28:	9	28	0.82
Oils (animal & vegetable) and fats: SITC 4:	42	44	0.95
Chemicals: SITC 5:	25	26	0.99
Organic chemicals: SITC 51:	27	33	0.98
Inorganic chemicals: SITC 52:	40	48	0.98
Colouring materials: SITC 53:	19	34	0.91
Medicinal products: SITC 54:	21	6	0.66
Toilet preparations: SITC 55:	22	29	0.98
Plastics: SITC 57+58:	19	35	0.97
Material manufactures: SITC 6:	23	24	0.95
Material manufactures less erratics: SITC 6 less PS:	22	20	0.98
Wood & cork manufactures: SITC 63:	20	14	0.72
Textile fabrics: SITC 65:	21	22	0.92
Mineral manufactures less precious stones: SITC 66 less 6:	22	18	0.70
Iron & steel: SITC 67:	25	26	0.98
Non ferrous metals: SITC 68:	12	5	0.84
Misc metal manufactures: SITC 69:	24	30	0.91
Machinery & transport equipment: SITC 7:	18	17	0.93
Machinery: SITC 71-77:	21	19	0.88
Mechanical Machinery: SITC 71-74 less 716:	19	21	0.96
Electrical Machinery: SITC 716+75+76+77:	22	18	0.95
Road vehicles: SITC 78:	15	12	0.95
Transport equipment other than road vehicles: SITC 79:	21	17	0.64
Clothing and footwear: SITC 84+85:	19	11	0.94
Clothing: SITC 84:	19	9	0.93
Footwear: SITC 85:	19	14	0.93
Scientific & photographic: SITC 87+88:	15	14	0.98

The data shows price increases of similar magnitudes for both exports and imports within most categories of traded goods across the years of significant sterling devaluation associated with the Great Financial Crisis (2007-2010). The correlation coefficients make clear that the close association between export and import prices within the same categories of traded goods extends across a longer-run period of time.

The Impact of Devaluation

Because, contrary to official expectations, the price changes affecting tradable goods and services as a result of devaluation do not confer advantage on domestic producers the impact of devaluation is negative. Because such tradables account for two-thirds of household expenditure (see below) the effect of devaluation is to curtail purchases of these goods and services, both domestic and foreign alike. Because sterling devaluation has no impact on international prices there is no expansion of British sales abroad in volume terms. Of course the higher prices obtained for production of tradable goods and services in sterling terms will help to sustain profits in this sector of the economy and to protect employment numbers even though it may reduce average hours worked. So overall the impact of devaluation is to lower the standard of living for ordinary working people, by reduction in average working hours and increasing prices of tradable goods and services consumed. This matches the British experience following the Great Financial Crisis and associated significant devaluation of sterling.

Proper Economic Theory

In fact, the ONS data is entirely consistent with the proper economic theory. In a correct analysis, the crucial price-relativity affected by the exchange rate is that between tradables and non-tradables. Tradables being those things that are internationally portable (e.g. motor-vehicles; feed wheat; consultancy services etc.,). Non-tradables being those things irrevocably confined to our shores (e.g. residential property; domestic care services; the infrastructure of the public realm etc.,). The impact of sterling's devaluation has been to raise the sterling prices of tradables across the board (i.e. both the things we buy from overseas and the things we sell abroad) because their prices are set in international markets (and not in sterling terms); and these prices apply equally to 'imports' and 'exports' (being translated into sterling terms by the same exchange rate). Meanwhile the prices of non-tradables, which are confined to these shores and are therefore priced directly in sterling, remain unaffected by the devaluation of sterling. Hence the prices of tradables, which have increased because of the impact of sterling's devaluation, have risen relative to the prices of non-tradables whose prices have remained unaffected by that devaluation. **The pivotal role of the exchange rate is to alter the balance of activity in the UK economy between the tradables and the non-tradables sectors**.

Relative Significance

Because of its crucial significance, it is worth putting some dimensions on the tradables and non-tradables sectors in the context of the economy as a whole. Fortunately these different parts of the national economy can be readily identified from the accounts presented by the Office for National Statistics in the form of Supply & Use Tables. Results are shown in Table 3.

Table 3: Some 'tradables' and 'non-tradables' sectors identified from the 2010 Supply & Use Tables
(data from: SUTS 2010, ONS)

ECONOMIC SECTOR	£ million			Imports as % Supply	Exports as % Supply
	Supply	Imports	Exports		
SELECTED TRADABLES:					
Alcoholic beverages	40715	7270	5969	17.9	14.7
Coke and refined petroleum products	75126	18093	16754	24.1	22.3
Paints, varnishes and similar coatings, printing ink and mastics	6199	911	1256	14.7	20.3
Soap and detergents, cleaning and polishing preparations, perfumes and toilet preparations	21335	3964	3991	18.6	18.7
Industrial gases, inorganics and fertilizers (all inorganic chemicals)	12022	2687	3349	22.4	27.9
Petrochemicals	32838	13648	12354	41.6	37.6
Dyestuffs, agro-chemicals	3954	1115	1666	28.2	42.1
Rubber and plastic products	31586	9289	6221	29.4	19.7
Basic iron and steel	18326	5208	5107	28.4	27.9
Motor vehicles, trailers and semi-trailers	96656	35453	25750	36.7	26.6
Ships and boats	6311	2506	1734	39.7	27.5
SELECTED NON-TRADABLES:					
Sewerage services; sewage sludge	6443	0	0	0	0
Owner-Occupiers' Housing Services	101931	0	0	0	0
Veterinary services	3062	0	0	0	0
Residential care services	32109	0	0	0	0
Services furnished by membership organisations	11287	0	0	0	0

It's worth emphasising that when things are tradables they tend to be traded both ways: there are exports leaving the country and there are imports coming in at the same time. Take alcoholic beverages for example: of the £40715million total supply available in 2010, £7270million came from abroad (imports) and £5969million ended up overseas (exports). And although the UK is a 'net importer' of petrochemicals, it is still a substantial exporter (£12354million, 37.6% of supply). Whilst net trade in soap and detergents, cleaning and polishing preparations, perfumes and toilet preparations is negligible, there are substantial amounts both of imports (£3964million, 18.6% of supply) and of exports (£3991million, 18.7% of supply). Tradables aren't unambiguously either exports or imports; but they are definitely ***not*** non-tradables. Non-tradables can't be sold abroad and can't be bought from overseas; hence the zeroes in the table for imports and exports of residential care services, which is nevertheless a significant area of UK economic activity (total supply £32109million; similar in scale to petrochemicals £32838million; or rubber and plastic products £31586million).

National Accounts

A summary of national accounts considered on the basis of the distinction between the tradables and non-tradables sectors is given in Table 4.

Table 4: Inter-sectoral flows in the national accounts 2010 (data in £million)
(data from: SUTS 2010, ONS)

	Tradables	Nontradables	All Intermediate	Final Demand	Total Supply
Tradables	609877	357680	967557	1136446	2104003
Nontradables	129339	263331	392670	809509	1202179
Total	739216	621011	1360227	1945955	3306182

The UK's total gross output or supply in 2010 was £3306182million. Tradables accounted for 63.6% of this (£2104003million), non-tradables for 36.4% (£1202179million). Quite a lot of this overall economic activity involves sales within and between the productive sectors themselves. There is an interesting asymmetry about these inter-sectoral transactions. Transactions within the tradables sector itself (£609877million) represent 82.5% of the sector's total intermediate input purchases (£739216million) and 63.0% of its intermediate sales (£967557). The tradables sector purchases relatively little from the non-tradables sector (£129339, 17.5% of total intermediate input purchases by the tradables sector). By contrast the non-tradables sector has total intermediate input purchases of £621011million most of which (£357680million, 57.6%) comes from the tradables sector. This asymmetry of interdependence between the two sectors will be important when it comes to measurement of relative overall economic impact.

This 'intermediate' or 'business-to-business' (B2B) activity is important in itself of course, but, because it's recognised that the ultimate purpose of economic activity is to provide for people's consumption, it is 'final demand' (£1945955million; including purchases by or on behalf of households) that better represents the national standard of living. Tradables contribute the most to this (£1136446million, 58.4%), non-tradables deliver £809509million (41.6%).

Contributions to National Value Added

Before considering final demand in more detail, Table 5 gives a description of the way profits and pay are distributed within the economy.

Table 5: Pay and profit according to sector in 2010 (data in £million)
(data from: SUTS 2010, ONS)

	Tradables	Nontradables	Total
Compensation of Employees (Pay)	391742	404679	796421
Gross Operating Surplus and Mixed Income (Profit)	248020	242797	490817
Pay *plus* Profit	639762	647476	1287238

Together, pay (compensation of employees) and profit (gross operating surplus and mixed income) contribute £1287238million to the total 'value added' of the UK economy. Pay (£796421million) accounts for 61.9% of this contribution and profit 38.1% (£490817million). It is very interesting to note that the tradables and the non-tradables sectors contribute equally ('half-and-half') both to total pay and to total profit within the UK economy. This suggests that the two sectors should be considered as of equal importance when assessing the country's economic situation.

Final Demand

Tables 6, 7 and 8 offer an analysis of final demand for tradables and for non-tradables broken down to identify the contributions due to households, non-profit institutions serving households, central government, local government, gross fixed capital formation (investment) and exports.

Table 6: The composition of final demand in 2010 (data in £million)
(data from: SUTS 2010, ONS)

	Households	NPISH	Cen'gov	Loc'gov	GFCF	Exports	Total
Tradables	589941	1875	1498	8182	97477	437473	1136446
Nontradables	314018	35703	203640	121720	124016	10412	809509
Total	903959	37578	205138	129902	221493	447885	1945955

Table 7: The composition of final demand in 2010 (% within sectors)
(data from: SUTS 2010, ONS)

	Households	NPISH	Cen'gov	Loc'gov	GFCF	Exports	Total
Tradables	51.9	0.2	0.1	0.7	8.6	38.5	100.0
Nontradables	38.8	4.4	25.2	15.0	15.3	1.3	100.0
Total	46.5	1.9	10.5	6.7	11.4	23.0	100.0

Table 8: The composition of final demand in 2010 (% between sectors)
(data from: SUTS 2010, ONS)

	Households	NPISH	Cen'gov	Loc'gov	GFCF	Exports	Total
Tradables	65.3	5.0	0.7	6.3	44.0	97.7	58.4
Nontradables	34.7	95.0	99.3	93.7	56.0	2.3	41.6
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Final demand for tradables (£1136446) is dominated by sales to households (51.9%) and sales abroad (38.5%). Whereas final demand for non-tradables is balanced between households' purchases (38.8%) and purchases by central and local government (40.2%); education, health and social care are responsible for most of this government expenditure (being undertaken 'on behalf of' households).

Households' spending is split between tradables (65.3%) and non-tradables (34.7%); but government spending is almost entirely on non-tradables. The two sectors share spending on investment (GFCF): tradables (44%); non-tradables (56%).

The analysis above highlights the importance of public expenditure in relation to the non-tradables sector of the economy. Government is responsible for the lion's share of final demand for the non-tradables sector which itself accounts for half of pay and profits in the economy as a whole. Although the government spends almost nothing on tradables directly, the non-tradables sector makes significant purchases from the tradables sector as intermediate inputs, so government spending affects the tradables sector indirectly. By contrast, relatively little of any final demand for tradables is reflected in purchases of intermediate inputs from the non-tradables sector. This is the asymmetry referred to earlier. However, because demand for tradables inevitably includes demand for imports, there is more leakage abroad from tradables expenditure.

Overall Impact Measures

The overall, direct and indirect, impact on total gross output (or supply) due to a change of £1 in final demand for either the tradables or the non-tradables sector is measured by the relevant Leontieff 'impact multiplier'. Values for these impact multipliers calculated for selected years are presented in Table 9. It is interesting to note that the multiplier for the non-tradables sector is consistently greater than that for the tradables sector, and that the disparity has grown steadily wider over the years.

Table 9: Leontieff 'impact multipliers' for both sectors in various years
(data from: SUTS 2010, ONS; calculations by me)

	1997	2000	2007	2010
Tradables	1.64	1.63	1.62	1.57
Nontradables	1.82	1.85	1.86	1.88

Analytical Results

To sum up then: tradables and non-tradables are equally important in terms of the British economy's overall value added; sales abroad are a substantial portion of final demand for tradables; government spending makes a major contribution to demand for non-tradables; the knock-on effects of changing demand for non-tradables exceed those for tradables.

Because tradables and non-tradables each account for about half of national income (GDP) the scale of the problem posed when there is a change in their relative prices, caused by a change in the exchange rate, is significant. And because the government itself is responsible for large parts of the national infrastructure (which is non-tradable) and for purchases of educational and healthcare services on behalf of the population at large (services that are non-tradable) this analysis raises issues bearing directly on the economic responsibilities of government operation. Thus these observations are particularly pertinent for policy-makers of a social democratic persuasion. They provide a platform for a party with a purposive perspective on government. They might be the basis for "a New Economics, laying the economic foundations of a prosperous, fairer and sustainable society" (John McDonnell MP).

Evaluating the State of Public Finances

The analysis of Tables 6-8 has made clear the responsibility of government for the major part of final demand for non-tradables. So the government's financial situation must influence what scale of intervention is prudently permissible in terms of public expenditure.

Table 10 contains data reporting government finances, expressed in terms both of GDP and in terms of government revenue, for purposes of comparison. The UK is compared with the Eurozone and some of its constituent states as well as with the OECD as a whole and some other selected members, including especially the USA which has an important sovereign currency.

Public sector finances are usually assessed with reference to the twin measures of budget deficit and national debt. The standardised figures published by OECD are conventionally quoted in relation to the GDP of the country in question. However, the national income measured by GDP includes the private household and corporate sectors as well as the state; whereas the budget deficit and the

national debt are only attributed to the public sector; so it is actually more appropriate to assess public sector deficit and debts in relation to just the income of the public sector.

Table 10: Governments' Financial Situation 2010
(data from OECD; revised calculations by me)

	Deficit	**Grossdebt**	**Netdebt**	**GOV'T REVENUE**	**Deficit**	**Grossdebt**	**Netdebt**
	(as % GDP)				(as % Gov't Revenue)		
the UK	**-10.1**	**85.6**	**53.8**	**40.1**	**-25.2**	**213.5**	**134.2**
France	-7.1	95.5	57.3	**49.5**	-14.3	192.9	115.8
Germany	-4.2	86.3	49.8	**43.6**	-9.5	197.6	114.1
Netherlands	-5.0	71.6	34.4	**46.1**	-10.9	155.2	74.6
Italy	-4.3	126.7	99.5	**46.1**	-9.4	275.2	216.1
Spain	-9.7	67.7	40.2	**36.6**	-26.4	185.0	109.8
Greece	-10.8	153.0	117.2	**40.6**	-26.7	376.7	288.5
Eurozone	**-6.2**	**93.1**	**57.6**	**44.8**	**-13.9**	**207.7**	**128.6**
Australia	-4.7	23.5	1.8	**31.6**	-14.9	74.4	5.6
Canada	-5.4	83.0	29.7	**37.6**	-14.4	220.8	79.0
USA	**-11.4**	**97.8**	**74.3**	**31.3**	**-36.4**	**312.6**	**237.6**
Japan	-8.4	192.7	112.8	32.4	-25.8	594.4	347.8
OECD	**-7.7**	**98.7**	**59.7**	**36.3**	**-21.2**	**271.8**	**164.4**

Changing the basis of comparison from GDP to government revenue has interesting consequences. On the basis of GDP the UK's deficit (-10.1%) is bigger than the OECD (-7.7%) or the Eurozone as a whole (-6.2%); it's about the same as Spain (-9.7%) or Greece (-10.8%) and not far off the level of the USA (-11.8%). On the basis of government revenue however, the UK deficit (-25.2%) is much bigger than the Eurozone (-13.9%) and bigger than the OECD as a whole (-21.2%); it's about the same as Spain (-26.4%) or Greece (-26.7%) or Japan (-25.8%); but it's now shown to be substantially less than the deficit in the USA (-36.4%).

The comparison of debts is also interesting. The OECD reports two measures of national debt: gross and net. Although net debt recognises states can be owed money as well as owing it, the gross amount of debt is more relevant to market judgements of that debt's worth (as it represents shares in the income-stream of the government concerned).

Again the UK's relative position is altered by changing the basis of comparison from GDP to government revenue. In relation to GDP the UK's gross debt (85.6%) is somewhat lower than the Eurozone (93.1%) or the OECD as a whole (98.7%); lower than the USA (97.8%) and much lower than Italy (126.7%), Greece (153.0%) or Japan (192.7%). The same relativities hold for net debts assessed on this basis (i.e. vs GDP). In relation to government revenue the UK's gross debt (213.5%) is about the same as the Eurozone (207.7%), less than Italy (275.2%) or Greece (376.7%); lower than the

OECD as a whole (271.8%); and very much below levels in the USA (312.6%) and particularly Japan (594.4%). Net debt assessed on this basis (i.e. vs government revenue) exhibits the same relativities.

The UK Government's Financial Position

Looked at in relation to government revenue, the size of the UK's budget deficit justifies the concern with which it is being treated; and this concern would probably be more easily communicated and readily understood if expressed on this basis. Although I know it's *infra dig* to use the household budget as a paradigm for assessing state finances, it's an effective tool of communication.

Likewise, yet conversely, with government debt: a level of gross debt about double your annual income (like the UK's national debt expressed in this way) wouldn't be likely to frighten most people; especially anyone who's had a mortgage and who recognises the value of being able to live in a house, enjoying its benefits, whilst paying for it (analogous to the way we all inhabit the infrastructure of the public realm).

Of course judgements about the sustainable size of the public purse will necessarily be made in international markets and affect the price of the debtstocks which represent shares in the national state revenue-stream (just like commercial shares represent a chance to obtain dividends from businesses that are themselves basically revenue-streams e.g. Facebook). But it is pretty unlikely that government debt will be rejected and not seen as an essential part of any portfolio assembled by a pension fund or other financial institution (and UK government stock will be particularly desirable for those companies committed to making payments, to pensioners for example, in sterling).

The data in Table 11 illustrate recent trends in the financial position of the UK government compared with other countries of similar economic maturity. The twin benchmarks for assessing the financial situation of the government are the annual budget deficit and the debt owed by the state. The figures in the table show the levels of these two measures in terms of the government revenue stream.

Table 11: Government Financial Situation 2007-2012

	Deficit (as % government revenue)			Debt (as % government revenue)		
	2007	**2010**	**2012**	**2007**	**2010**	**2012**
the UK	**-6.8**	**-25.2**	**-15.6**	**115**	**214**	**248**
France	-5.5	-14.3	-8.7	146	193	203
Germany	0.5	-9.5	-0.4	150	198	195
Netherlands	0.4	-10.9	-8.2	113	155	177
Italy	-3.5	-9.4	-6.2	244	275	264
Spain	4.7	-26.4	-22.4	103	185	261
Greece	-16.6	-26.7	-15.8	283	377	416
Eurozone	**-1.5**	**-13.9**	**-7.2**	**159**	**208**	**218**
Australia	5.1	-14.9	-8.6	42	74	91
Canada	3.5	-14.4	-9.2	163	221	228
USA	**-8.6**	**-36.4**	**-26.8**	**196**	**313**	**346**
Japan	-6.2	-25.8	-29.5	482	594	639
OECD	**-3.4**	**-21.2**	**-14.9**	**196**	**272**	**293**

Source: OECD (with my own recalculations)

The most recent data indicate that the UK government's budget deficit (-15.6% of annual revenue) is not dissimilar to the average across the OECD as a whole (-14.9%). It is higher than the average across the Eurozone (-7.2%); much bigger than Germany's (-0.4%) and about the same as in Greece (-15.8%); and above the level in the Old Commonwealth. But it is considerably lower than in the USA (-26.8%) or Japan (-29.5%), both of which countries were impacted by the GGFC to the same extent as the UK in deficit terms.

As regards debt, the level of UK government debt (248% of annual revenue) is below the level across the OECD as a whole (293%) but higher than the average for the Eurozone (218%). It is quite a bit higher than the Netherlands (177%), but much less than Greece (416%). It is considerably below the level of the USA (346%) and, especially, Japan (639%).

As noted previously, these relativities matter because they are what ought to be taken into account by investors choosing between different countries (states and currencies) for the government debt element in their portfolios. From this perspective the UK seems not badly placed. The budget deficit is coming down and is only slightly above the OECD average; and the government debt, whilst rising, is still below the average in the OECD. Of course it's true that unless the budget deficit is eliminated the government debt will continue to increase. So the political priority attached to dealing with the deficit is understandable. Because a budget deficit exhibits a failure to match spending with revenue, resolving the situation so as to balance the budget could involve reductions in spending or increases in taxation or a bit of both.

Revisioning the Government's Financial Position

In order to appreciate the government's financial problem it is helpful to distinguish between three main aspects of government spending:

(i) collective consumption – the purchases of important everyday services that the government makes on behalf of the population as a whole, acting like the management of a purchasing co-operative and thus obtaining benefits of scale in buying these services (the biggest elements are education and healthcare);
(ii) infrastructure – the maintenance of the infrastructure within and around which economic activity is built and by which it is facilitated (this includes the 'hard' infrastructure such as transport facilities as well as the 'soft' infrastructure such as the legal system); and
(iii) public alms – payments made to people in recognition of their limited ability to earn sufficient to meet their needs (the biggest element of this being old age pensions).

In order to obtain the money to meet its spending commitments the government uses taxation. The main sources of tax revenue are:

(i) taxes on spending – general transactions taxes (such as VAT) or special sales taxes on particular products (such as excise duties and stamp duty);
(ii) personal or household levies – such as council tax or licence fees;
(iii) taxes associated with employment – levies on payments made to employees (national insurance contributions and income tax); and
(iv) taxes levied on corporate earnings

By convention HM Treasury eschews the notion of hypothecation (i.e. association of particular taxes with particular elements of expenditure). This is understandable as a sensible precaution against the offering of hostages to fortune. However, this prevents an otherwise very useful and potentially effective approach to communication.

Collective Consumption

Consider, for instance, the treatment of collective consumption as part of the government's responsibilities as outlined above. The notion of delivering 'benefits in kind' as the result of using the institutions of the state to act as purchasing agent on behalf of the population as a whole, on the principle of an all-embracing consumers' co-operative, owes much to the influence of Beatrice Webb. She had made a close study of working class co-operation and had identified the crucial distinction between producer and consumer co-operatives as the platform for a distinctively democratic British socialism based on people's universal interest as consumers rather than their sectarian interests as producers. And as a member of a Royal Commission concerned with welfare provision (the operation of the Poor Law) she had been struck by the insight that it was only by universal or collective provision that the interests of the poor could be successfully addressed (this subsequently provided the basis of the Beveridge design for a 'welfare state'). Her contribution to the instigation of collective consumption represents fulfilment of her "supreme ambition to present some clear and helpful idea of the forces we must liberate in order to bring about reformation", what she called "the faith, the enthusiasm of my life, the work I feel called upon to do" (Beatrice Webb, Diary September 30th 1889).

Beatrice Webb had specifically committed herself to the life of a social investigator: "Search after truth by the careful measurement of facts is the enthusiasm of my life" (Beatrice Webb, *Diary* August 17th 1889). As such she would surely base an appraisal of the system of collective consumption on the taxes that households pay directly when spending their take-home pay (e.g. transactions taxes such as VAT or Stamp Duty, licences for cars or televisions), compared with the

value delivered through purchases made by the government on their behalf (i.e. as collective consumption or 'benefits in kind' - mainly education and healthcare services).

Fortunately the Office for National Statistics gives us the figures we require to decide whether we think the state is doing an effective job in this regard. In the following tabulations (tables 12-14) I present the evidence in such a way as to allow a judgement about the effectiveness of the current system of government operation from a broadly Fabian social democratic perspective.

In each of these tables, the 'Low-money households' are the 30% of all households that have the least money available ('total household money') coming from original incomes ('take-home pay' for much the most part) plus state pensions and cash benefits (housing benefit, child benefit etc.,). I chose to use 30% because a recent study described 30% of households as 'the poor', and so did the Charles Booth study that Beatrice Webb helped conduct more than a century ago. For convenience and symmetry I have identified the 30% of households at the other (top) end of the total household money scale and then sub-divided them into 'Comfortable' and 'Secure' households (for technical reasons to do with potential statistical bias). This leaves the 'Middle-income households' as those squeezed into the middle between the upper 30% and lower 30% of households. It's interesting to note that 'original income' is the largest component of total household money across the board, even in the Low-money households.

The annual sums of money involved for the different groups of households are set out in Table 12.

Table 12: Households' Financial Circumstances

	Low-money households	**Middle-income households**	**Comfortable households**	**Secure households**	**ALL HOUSEHOLDS**
Number of households in the population ('000s)	**7929**	**10571**	**5286**	**2650**	**26436**
Percentage of households	*30%*	*40%*	*20%*	*10%*	*100%*
	£ per household per year				
Original incomes	4530	18562	40745	80093	24943
State pensions	3541	2914	1515	1055	2636
Benefits in cash	4036	4115	2188	2020	3497
Total household money	**12107**	**25591**	**44448**	**83168**	**31076**
Council taxes	952	1163	1379	1663	1192
Transaction taxes (VAT etc.,)	2798	5135	7632	10983	5518
Total household tax-payments	**3750**	**6298**	**9011**	**12646**	**6710**
Education	1146	2909	3393	3685	2555
National health service	3648	4127	4047	4185	3973
Total benefits in kind	**5008**	**7303**	**7696**	**8249**	**6787**

Source: ONS, 'The Effects of Taxes and Benefits on Household Income, 2011/12' (recalculations by me)

It is of crucial significance for the use of this analysis as a tool of democratic communication to notice that total household tax-payments (£6710 per household per year) account for 99% of the costs incurred delivering benefits in kind (£6787 per household per year). This means that the cost of collective consumption is covered by contributions collected from money directly spent by households. This quasi-hypothecation deserves to be considered for official adoption as an aid to transparency in political deliberation.

It is worth noting that even the Comfortable and the Secure households receive significant sums in terms of state pensions and cash benefits. It's also interesting to see that the value of total benefits in kind received by Comfortable households (£7696) and by Secure households (£8249) exceed the value of total benefits in kind received by Low-money households (£5008) and by Middle-income households (£7303). Nevertheless, the total value of benefits in kind received by Low-money households (£5008) is significantly greater than their total household tax-payments (£3750). The same is true for Middle-income households who receive benefits in kind (£7303) greater than their tax-payments (£6298). Taken together this means that for a substantial majority of households (70%) there are clear net financial benefits from the system of collective consumption.

An alternative presentation of the data is adopted in Table 13. The figures for receipts and payments within each group of households are expressed as percentages relative to the total household money.

Table 13: Receipts and Payments - Relativities in Terms of Total Household Money

	Low-money households	**Middle-income households**	**Comfortable households**	**Secure households**	**ALL HOUSEHOLDS**
Number of households in the population ('000s)	**7929**	**10571**	**5286**	**2650**	**26436**
Percentage of households	*30%*	*40%*	*20%*	*10%*	*100%*
	Relativities in terms of total household money (%)				
Original incomes	37.4	72.5	91.7	96.3	80.3
State pensions	29.2	11.4	3.4	1.3	8.5
Benefits in cash	33.3	16.1	4.9	2.4	11.3
Total household money	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Council taxes	7.9	4.5	3.1	2.0	3.8
Transaction taxes (VAT etc.,)	23.1	20.1	17.2	13.2	17.8
Total household tax-payments	**31.0**	**24.6**	**20.3**	**15.2**	**21.6**
Education	9.5	11.4	7.6	4.4	8.2
National health service	30.1	16.1	9.1	5.0	12.8
Total benefits in kind	**41.4**	**28.5**	**17.3**	**9.9**	**21.8**

Source: ONS, 'The Effects of Taxes and Benefits on Household Income, 2011/12' (recalculations by me)

The presentation in Table 13 brings out some interesting differences between the groups of households. As observed from Table 12, Comfortable and Secure households receive more benefits in kind, in absolute terms, than Low-money and Middle-income households; but the figures in Table 5 illustrate that the value of these benefits relative to the total household money available is very much less for Comfortable and Secure households (17.3% and 9.9% respectively) than it is for Low-money households (41.4%) and Middle-income households (28.5%). By the same token, the burden of household tax-payments is greater for Low-money households (31.0% of total household money) and for Middle-income households (28.5%) than it is for Comfortable Households (17.3%) and Secure households (9.9%). This doesn't alter the fact that most households (the Low-money and Middle-income groups) are net beneficiaries of the system.

Finally, recalibrating the data again, as presented in Table 14, illustrates the distribution of receipts and contributions across the household groups.

Table 14: Households' Shares in Receipts and Contributions

	Low-money households	**Middle-income households**	**Comfortable households**	**Secure households**	**ALL HOUSEHOLDS**
Number of households in the population ('000s)	**7929**	**10571**	**5286**	**2650**	**26436**
Percentage of households	*30%*	*40%*	*20%*	*10%*	*100%*
	Shares in overall receipts and contributions (%)				
Original incomes	5.4	29.8	32.7	32.1	**100.0**
State pensions	40.3	44.2	11.5	4.0	**100.0**
Benefits in cash	34.6	47.1	12.5	5.8	**100.0**
Total household money	**11.7**	**32.9**	**28.6**	**26.8**	**100.0**
Council taxes	24.0	39.0	23.1	14.0	**100.0**
Transaction taxes (VAT etc.,)	15.2	37.2	27.7	19.9	**100.0**
Total household tax-payments	**16.8**	**37.5**	**26.9**	**18.8**	**100.0**
Education	13.5	45.5	26.6	14.4	**100.0**
National health service	27.5	41.6	20.4	10.5	**100.0**
Total benefits in kind	**22.1**	**43.0**	**22.7**	**12.2**	**100.0**

Source: ONS, 'The Effects of Taxes and Benefits on Household Income, 2011/12' (recalculations by me)

The 10% of households classified as Secure account for 26.8% of overall total household money, 18.8% of overall total household tax-payments and 12.2% of overall total benefits in kind. The 20% of households classified as Comfortable account for 28.6% of overall total household money, 26.9% of overall total household tax-payments and 22.7% of overall total benefits in kind. The 40% of households classified as Middle-income account for 32.9% of overall total household money, 37.5% of overall total household tax-payments and 43.0% of overall total benefits in kind. The 30% of households classified as Low-money account for only 11.7% of overall total household money, 16.8% of overall total household tax-payments and 22.1% of overall total benefits in kind; these seemingly

low proportions are explained by the concentration of single-adult households in this group (singletons, especially pensioners and lone parents, having lower earning-potential than couples).

The System of Collective Consumption: Summary and Conclusion

From an overall social perspective one can observe that total tax-payments actually paid by households (i.e. not including income tax or national insurance which are mainly paid by employers via PAYE not directly by households) contribute 99% to the cost of providing the benefits in kind which result from collective consumption. And that for 70% of households (i.e. both Low-money and Middle-income households) the value of benefits in kind substantially exceeds the amounts paid in tax. Taken together these observations indicate that the system of collective purchase might be described as progressive in the nature of its operation.

"From each according to their ability, to each according to their need" was traditionally a description of a socialist system. Since schools are provided for those who need them for their children, and the health service is provided for those who need it for their care, whilst the size of the tax-payments seem to reflect households' ability to pay, perhaps the system of collective consumption reflects the consumer socialism that Beatrice Webb might have approved. Mind you it's very interesting to see that although the system takes most from the households with the most money (because they spend the most) these tax-payments represent a smaller share of their total money than the lower tax-payments made by the less-monied households represent in relation to *their* total available money.

Future Prospects for Collective Consumption

Thinking now about the financial prospects of the state in terms of its responsibility for collective consumption in the context of an ageing population (i.e. a larger number of older people with age-associated demands for health and social care services): this prospect is usually, and not unreasonably, expected to require increased expenditure even if there are unprecedented improvements in productivity throughout the system of health and social care. However, the treatment adopted above suggests that adjustment to existing transaction taxes would produce increased funding for care-provision in a relatively progressive manner without increasing the budget deficit. In fact, in tune with the report of the Dilnot Commission, the increase in the rate or level of tax would be quite modest (let's say raising VAT to 21.5%).

The Deficit: Public Alms and Infrastructure

Having demonstrated that the budgetary provision for collective consumption is already closely balanced (with expenditure on these benefits in kind being covered by households' payments of transactions taxes), it is clear that the budget deficit is, by and large, attributable to the other ingredients of public expenditure and taxation: on the expenditure side this means public alms and infrastructure; on the taxation side this means levies on employment (misleadingly labelled and conventionally described as 'income tax and national insurance').

It is deeply engrained within our culture that the government doesn't have any 'money of its own' but only the money that it takes from us (we the people, who shalln't be taxed without representation). But this is nonsense. In fact the government fulfils a valuable economic function for which fees are not only appropriate but actually essential (thus meaning that the government does indeed earn 'money of its own'). When we recognise that the public realm (the common space and the infrastructure that we share all the time we're going about our everyday economic activities) is a congested environment, then this leads us to acknowledge the valuable service of regulation

(controlling congestion) that only the monopolar authority of government can provide. Regulatory fees or charges (for the use of the infrastructure, including the 'soft' infrastructure of regulation itself), by raising the operating costs of economic activity, act to reduce congestion so thereby avoiding negative externalities and actually increasing national Value Added (GDP).

In fact one of the easiest ways to levy a tax that is proximately in proportion to the level of activity which an individual business represents is to require payment of a transaction-tax-equivalent on wages and salaries (i.e. employment). This is what income tax and national insurance contributions represent in practice. How the government spends the proceeds from this taxation of employment (and thereby congestion) is a decision for us to review as electors (so having, theoretically, an equal or democratic say in how the money's spent) – currently it's predominantly spent as public alms (mainly pensions).

PAYE and Rational Expectations

Having been trialled since the start of the Second World War, PAYE (Pay As You Earn) was formally instituted in 1944. These days over 85% of income tax is collected via PAYE. And National Insurance Contributions (themselves over one-fifth of HMRC receipts) are also collected by this method. So, altogether about half of all the government's revenue comes through PAYE. This means I think it's fair to say that most of us (who are not self-employed) do not pay income tax or national insurance personally. And although I know it's conventional to pretend that employers are making these payments on our behalf (we, the workers they employ) it's not the way we think about it really. In reality we all have what you might call 'rational expectations': we all make judgements about wages and salaries based on 'take-home pay'; we all take decisions about offers of work after making allowance for 'stoppages'. And certainly everybody recognises (in the light of numerous broadcast documentaries and News-items) that unemployed people evaluate offers of work in relation to post-tax earnings *vis-à-vis* out-of-work benefits.

Employment Taxes in International Context

This scheme of taxation, in which employment levies are paid to governments by employers notionally 'on behalf of' the workers they employ, operates across the economically developed world. Reviewing the way in which these levies are presented is quite interesting. The cost of making payments of income tax and social security contributions (national insurance) is expressed by the OECD as a 'tax wedge': the proportion of the total cost of employing workers that is accounted for by making such payments (i.e. both those that are being made notionally 'on behalf of' their workers - as 'income tax' or social insurance 'contributions' – and those made as explicit payments by employers *qua* employers).

Figures in table 15 below illustrate the size of this tax wedge in various comparable North-West European countries. You can see that it varies quite widely: ranging from 26.6% in Ireland to 55.8% in Belgium. The UK (31.48%) is towards the lower end of the range.

The table also shows the breakdown of these levies/taxes ('the wedge') into two categories:
(1) those explicitly made by employers by virtue simply of being employers; and
(2) those made by employers as deductions from workers' incomes (workers' incomes such as they would notionally be in the absence of tax and social insurance contributions).

This breakdown varies a lot between countries. For example, in the UK 31% of the payment is an explicit employer levy and 69% is represented as if paid by workers themselves (as income tax and national insurance); whereas in Denmark the whole payment is attributed to the workers; whilst in

France, Spain and Sweden more than half the payment is explicitly a charge on the employer. This differentiation offers governments scope to manipulate both the presentation of taxes and their economic application.

Table 15: Scale and Presentation of Employment Levies (Social Security and Income Tax)
(all figures are percentages)

	OECD 'Tax Wedge' (Employment Cost)	Explicit Employers' Share of Levies/Tax	Workers' Pay Share of Levies/Tax	Employment Levies as Transaction Tax	VAT Rate
Ireland	26.60	36.50	63.50	36.24	23
UK	**31.48**	**31.00**	**69.00**	**45.94**	**20**
Netherlands	36.94	22.71	77.29	58.58	21
Denmark	38.24	0.00	100.00	61.92	25
Spain	40.66	56.62	43.38	68.52	21
Sweden	42.93	55.70	44.30	75.22	25
Finland	43.12	43.07	56.93	75.81	24
France	48.92	58.57	41.43	95.77	20
Germany	49.22	32.83	67.17	96.93	19
Belgium	55.80	41.27	58.73	126.24	21

Source: OECD

The last two columns in the table illustrate what happens if the whole amount of employment cost ('the tax wedge') is expressed as a transactions tax (like VAT) explicitly levied on purchases of labour. These figures show that human resources are taxed more heavily than the general run of purchased inputs (taxed by VAT) in most of the countries considered here (though it's fair to say that some specific inputs, such as energy, attract special supplementary purchase/transaction taxes). This is appropriate because, as argued previously, the employment of workers is the best available indicator of the level of pressure on the country's infrastructure resulting from the operation of any particular business (i.e. the tax levied on payments to employees is a proxy for costing the use of the infrastructure as a business input; it stands in for an explicit rent - payable for the use of the infrastructure).

Implications for British Taxation

It should be apparent from the data in Table 15 that the implicit transactions tax cost of employing workers in the UK is very competitive (i.e. low) compared with that in other North-West European countries. This suggests that there could be scope for an increase in this tax-rate without the prospect of damaging the country's competitive position internationally. In fact an increase in the UK's implicit employment transactions tax rate (and with the increase wholly imposed on employers rather than workers), so that overall it was raised from 45.94% to nearer the Dutch level (58.58%), might be expected largely to eliminate the deficit.

Overall Conclusions Based on this Evidence

In the evidence presented above it has been demonstrated:

(i) That the economic analysis used by HM Treasury is defective and inappropriate given the unquestioned political commitment to sustain sterling as a sovereign currency, thus requiring the existence of exchange rates to translate internationally-determined prices into the UK domestic economic context. This means that HM Treasury cannot adequately fulfil the objectives specified for it in the terms of reference for the present review.

(ii) That official presentation of statistics relating to the state of the public finances is misleading and unhelpful.

(iii) That explanation of the British system of collective consumption (for non-tradables such as health-care and education services) in terms of a quasi-hypothecation of tax-revenues directly associated with household expenditure is sensible. This would have merit as a tool of communication fostering democratic engagement.

(iv) That reconfiguration of earnings-related taxation to abandon the misleading descriptors 'income tax' and 'national insurance' in favour of an explicit Employment Transactions Tax, levied directly through employers on the basis of payments made to workers, would be more appropriate and transparent indication of the role played by the state as provider of infrastructure (both 'hard' and 'soft' in nature). This would also facilitate determination of an appropriate rate of taxation on labour according to international conditions (most probably a higher rate than that implicitly in place at present and thus contributing to elimination of the current budget deficit).