Whatever happened to the Laffer curve?*

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* ver. 1.0. This paper derives from a larger project reported in full in Middleton (1996b) and developed in Middleton (1997). Full details of the public finance dataset can be found in appendix I of the former (which includes data to 1979), with the full 1900-93 dataset reported in the latter.

POSTSCRIPT:
Middleton (1997) was not subsequently published as the ICBH did not in the event proceed with that conference volume, but the manuscript is available as a pdf.
1. Introduction

1.1 ‘[I]n this world nothing is certain but death and taxes.’ True to its status as the ‘dismal science’ economics has yet to provide a solution to the former condition, but at least in the mid-1970s the discipline was able to offer some solace and even salvation on the latter in the form of the Laffer curve, or more correctly the Dupuit curve since, as with much else in economics, there was nothing new in the theoretical proposition that, given certain conditions (the so-called ‘prohibitive range’), a reduction in tax rates would yield an increase in total revenue. The origins of this episode are somewhat shrouded in mystery but seem to have involved a Californian professor of business economics, an aide to President Ford, a Washington restaurant and a cocktail napkin upon which was drawn a diagram (here represented as Figure 1) which has become immortalised as the Laffer curve. There is now a pretty solid literature on this topic, both empirical and theoretical, not to mention almost wholly critical. However, it is not my intention to review this here in what is offered as some very tentative first thoughts at the beginning of a broader project on postwar taxation policy. Rather, my particular interests are threefold.

1.2 The first relates to my long-standing concern with how economic ideas get translated into policy, and in particular to the eternal struggle between ideas and vested interests which Keynes used as a rhetorical device in that oft-quoted final paragraph of the *General Theory* (Keynes 1936, p. 383), whereby ‘Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back.’ Thus it is of some interest why, when marginal rates on personal income were considerably lower in the US than in Britain (maximum values of 70 per cent and 98 per cent respectively in 1979), and thus less likely to be in the prohibitive range, that opinion in the former was much more receptive to the Laffer curve than in the latter where, as Geoffrey Howe (1994, pp. 128-9) relates in his memoirs, ‘My Treasury team and I had never succumbed - never seriously anyway - to the mistaken interpretation of Lafferism, which have led some US policymakers so far astray.’ It is hoped that a study of the rise and fall of the Laffer curve will cast light on how differences between America and Britain in the structures for policy formulation - the policy community and policy style - condition the manner in which ideas can be incorporated into economic policy. It is already well-established that fad and fashion play a much stronger

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1 Like all good quotes this is usually taken out of context, and when viewed in the round Dr Franklin was actually warning more of the dangers of complacency than of the inevitability of misery. The full quotation, contained in a letter to M. Le Roy (1789), was as follows: ‘Our Constitution is in actual operation; everything appears to promise that it will last; but in this world nothing is certain but death and taxes.’

2 As will become clear, there are many possible variants of the Laffer ‘curve’ and thus of the underlying model: the broad elements were published in Laffer (1981) and Canto *et al.* (1983), and the earliest identifiable work is a working paper (Canto *et al.* 1978) which does not appear to have ever been published. See also Parsons (1989, pp. 158-9) on why there was so few formal academic publications by Laffer, and the savage critique of Laffer by Mirowski (1982).

3 Arsène-Jules-Emile Juvenal Dupuit (1804-66), a French engineer and economic theorist (pioneering cost-benefit analysis) had argued (1844, p. 104) that ‘If a tax is gradually increased from zero up to the point where it becomes prohibitive, its yield is at first nil, then increases by small stages until it reaches a maximum, after which it gradually declines until it becomes zero again. It follows that when the state requires to raise a given sum by means of taxation, there are always two rates of tax which will fulfil the requirement, one above and one below that which would yield the maximum.’ See Ekelund (1987) for a short study. This precursor of the Laffer curve is identified in Atkinson and Stern (1980, p. 43), though there is an earlier translation of the Dupuit paper than the one they cite; see also Brown and Jackson (1990, pp. 451-2).

4 Wanniski (1978, p. 3; 1983, p. 97) and Stein (1984, ch. 7); for insider views by two academics (respectively, an Assistant Treasury Secretary for Economic Policy, 1981-2; and a member of Congressman Jack Kemp’s staff), see also Roberts (1984, pp. 27-30) and Bartlett (1985).

role amongst professional economists in America than in Europe,\textsuperscript{6} but the Laffer curve episode also illustrates more broadly what qualities an idea has to have in order to gain political appeal.

Figure 1 \textit{Laffer curve}

1.3 Secondly, the Laffer curve episode is of interest from the standpoint of a comparative history of the reaction against big government. In America, Britain and many other OECD states the case for tax reform was an integral part of that reaction, but why was it only in America that there was a ‘tax revolt’? This leads directly to my third concern: the relationship between economic performance and public finance systems, and more particularly the question whether the reforms of personal taxation undertaken in Britain and the US as a consequence of the Thatcher/Reagan victories of 1979-80 actually achieved their stated objectives: that of a renaissance of their respective economies.

1.4 This paper is organised as follows: §2 considers the verity of the claims made by the opponents of big government in the context of Britain’s public finance system, reporting some long-run datasets collected as part of my recent research into Britain’s relative economic decline and public sector growth. §3 then looks at the origins of the Laffer curve as an idea and its translation into the American and British policy debate. §4 is concerned with the evidence for a Laffer curve in Britain, while §5 draws some preliminary conclusions.

2. Britain’s economic problem: too large a public sector?

2.1 During the 1970s there developed amongst the burgeoning New Right a critique of Britain’s public finance system which, as part of a wider assault upon big government, incorporated the following stylised elements:

- ‘Public expenditure is at the heart of Britain’s present economic difficulties’, such that unless its onward march could be halted the ‘economy would be threatened with endemic inflation and economic decline’ (HMSO 1979, paras 1, 3).
- There had been an excessive growth of the non-market sector which had crowded-out

\textsuperscript{6} Frey and Eichenberger (1993, p. 185) and Baumol (1995, p. 188).
market-sector investment (the Bacon and Eltis 1976 thesis).  

- ‘Britain has become saddled with the most eccentric and most penal tax structure of any developed country’ (Conservative Party 1976, p. 40).
- In a yet stronger form, responsibility for Britain’s economic decline has been lain at the door of excessive taxation. Thus, for example, for Wanniski (1978, p. 15), ‘The British empire was built on the lower end of the “Laffer curve” and dismantled on the upper end.’
- ‘Labour and higher taxes go together like strawberries and cream’, a more recent utterance but a hardy perennial.  
- Keynesian demand management had imparted an excess bias to government growth and resulted in an unsustainable rise in the debt/GDP ratio, a staple of the public choice school (for example, Buchanan et al 1987).

2.2 In investigating these claims our starting point is necessarily that economists have never been able to identify a clear relationship between public finance systems and economic performance. There have been many attempts to do so, and in particular to set supply-side limits to economies beyond which lies degeneration into inflation and/or stagnant output, as for example in Clark’s (1945) proposition that the maximum sustainable tax ratio in a capitalist economy is 25 per cent (a conclusion with which Keynes concurred), or, more recently, Friedman’s warning that an expenditure ratio beyond 60 per cent was the line ‘we dare not cross’. Figure 2 portrays a typical aggregate approach to this issue by charting the growth of the expenditure ratio against the GDP growth rate for 1950-93 for the principal OECD countries. This yields a correlation coefficient of -0.27 which, while of the right sign for those of the Leviathan public choice school, indicates more what is lacking from such an approach than what it captures. In particular, there is too much noise here from catch-up and convergence, while the empirical work on public finance systems and economic growth is typically bedevilled by problems of multicollinearity as fiscal variables tend to be highly correlated with the level of income as well as with each other (Easterly and Rebelo 1993, p. 419). Moreover, what is distinctive here about the British case is the low growth of both its public sector and real GDP.

2.3 Against this background we now examine some long-run public finance series for what they reveal about the British case: whether there was something distinctive about Britain’s situation which, on objective assessment, offers succour to the New Right cause. It is central to what follows that the significant growth of the public sector in Britain predates the Second World War, and that the subsequent period is best characterised as the consolidation, not the advent, of big government. The issue of timing is of major significance. Until very recently, those who tended to implicate government as the root of cause of economic failure concentrated on postwar economic policies and the growth of the public sector, while those who looked further back tended to identify forces more deeply rooted in Britain’s social and political structure (Warwick 1985). Accordingly, by viewing government growth as a longer-run process it is possible to adopt a more balanced perspective on relative economic decline,

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7 The second (1978) edition of this work has recently been reissued (Bacon and Eltis 1996) with the main text unrevised but with a foreword by Prof. Lord Skidelsky and a new introductory essay, ‘Bacon and Eltis after 20 years’, which uses the Swedish case to reiterate their main themes.
9 See Shoup (1981) for a survey.
10 Clark (1977, p. 23) reproduces a letter received from Keynes (dated 9 March 1945, but not included in the collected writings), that ‘as a practical proposition I should be strongly disposed to agree ... [that] 25 per cent taxation is about the limit of what is easily borne ...’ A year later, in some reflections on the 1946 budget, Keynes described the 25 per cent limit as ‘pseudo-scientific; but with some sound empirical basis’ (Keynes 1946, p. 414).
one which escapes from the economist’s simple dichotomy of government versus market failure. In the following we concentrate upon issues of timing, cross-country comparisons and the role of partisanship in public sector growth.

Figure 2 OECD-16: ratio of 1993 to 1950 general government expenditure as % of GDP and annual average growth rate of real GDP, 1950-93

2.4 The transformation in the economic significance of government is clearly evident from Figure 3 which charts the long-run course of the expenditure ratio and the overall composition of total public expenditure (TPE) as between goods and services (PACE), gross capital formation (GCF) and transfer payments (items 3-6 of Table 1). Over the period as a whole the expenditure ratio rose by just over three and a half times, though it should be noted that the public sector’s direct claim upon resources (items 1-2 of Table 1) increased by far less: from 11.1 per cent to 26.3 per cent of GDP. It was thus transfer payments which fuelled the growth of public expenditure, especially current grants to the personal sector which rose from 0.5 per cent to 15.1 per cent of GDP. It is clear also, given the major peaks associated with the two world wars and the minor peaks of the Boer (1899-1902) and Korean (1951-2) Wars, that war has played an important part in this process. However, since the expenditure ratio continued its upward course after both world wars Peacock and Wiseman’s (1967) thesis of the ‘displacement effect’ is not a sufficient explanation for long-run public expenditure growth. Table 1 shows a transformation in the functional classification of TPE over the course of the century. Before the First World War defence was the largest budget item, with social expenditures second in rank and growing. Thereafter, social expenditures become the dominant budgetary item, experiencing sharp upward shifts during both trans-war periods and during peacetime with the interwar period, the 1960s and the period since 1979 being particularly significant.


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11 TPE is here defined according to the CSO’s pre-1977 conventions, ones which differ slightly from those employed since 1979 where the emphasis has been more on financial control than on resource use. It is introduced here to permit long-run comparisons, but where required estimates using current definitions of TPE are employed later.
## Table 1 TPE as % of GDP at current market prices, by economic category and functional classification, selected years, 1900-93

<table>
<thead>
<tr>
<th>Year</th>
<th>A. Economic category:</th>
</tr>
</thead>
</table>
| 1900 | 1. Current goods and services | 9.3  
|      | 2. Gross capital formation | 1.8  
|      | 3. Current grants to personal sector | 0.5  
|      | 4. Subsidies | 0.0  
|      | 5. Current grants paid abroad | 0.1  
|      | 6. Debt interest | 1.6  
|      | **Total** | **12.9**  
| 1903 | 1. Current goods and services | 8.5  
|      | 2. Gross capital formation | 1.9  
|      | 3. Current grants to personal sector | 0.4  
|      | 4. Subsidies | 0.0  
|      | 5. Current grants paid abroad | 0.2  
|      | 6. Debt interest | 2.0  
|      | **Total** | **10.9**  
| 1907 | 1. Current goods and services | 38.4  
|      | 2. Gross capital formation | 3.1  
|      | 3. Current grants to personal sector | 0.9  
|      | 4. Subsidies | 0.1  
|      | 5. Current grants paid abroad | 0.2  
|      | 6. Debt interest | 1.9  
|      | **Total** | **43.9**  

**Notes:** (a) Full details of the calculation of these series are given in Middleton (1996b, app. I); (b) The distribution by economic classification is more accurate than that by function for the years to 1948; thereafter they use identical sources.

**Source:** Middleton (1997, table 7.1).

## Table 2 Public sector receipts as % of GDP at current market prices, selected years, 1900-93

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<td>1900</td>
<td>1.0</td>
<td>6.6</td>
<td>1.0</td>
<td>0.0</td>
<td>0.4</td>
<td>0.7</td>
<td>0.0</td>
<td>9.7</td>
</tr>
<tr>
<td>1903</td>
<td>1.9</td>
<td>7.3</td>
<td>0.9</td>
<td>0.0</td>
<td>0.6</td>
<td>0.9</td>
<td>0.0</td>
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<tr>
<td>1907</td>
<td>1.5</td>
<td>7.2</td>
<td>1.1</td>
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<td>1.0</td>
<td>0.0</td>
<td>11.2</td>
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</tbody>
</table>

**Source:** Middleton (1997, table 7.2).
2.5 Figure 4 charts the receipts ratio since 1900 with Table 2 providing a breakdown by category. The upward trend which prevailed through to the mid-1980s resulted from increased rates on existing taxes and a widening of the tax base. Of these developments, the most important concerned the income tax which ‘changed out of all recognition’ as a consequence of the First World War (Sabine 1966, p. 154). If the proportion of the population subject to taxes on income be accepted as a proxy for state growth then Britain’s public finance system was quite underdeveloped on the eve of the First World War when there were about one million income tax payers. As Cronin (1991, p. 8) states, payment of income tax was ‘virtually a badge of class status’, whereas by the early 1980s there were 25 million taxpayers (Dilnot et al. 1985,
The rise to prominence of the income tax and the development of national insurance determined the shift in the tax mix over the course of the century. Taxes on expenditure provided nearly 77 per cent of total tax revenue in 1900 but thereafter were gradually eroded down to a low point of 36.7 per cent in 1975, before recovering up to 46.8 per cent by 1993 as part of a stated policy, pursued by Conservative governments since 1979, of reversing the trend towards increased reliance on direct taxation. Figures 5A-C provide long-run estimates of the effective rates of tax on expenditure, personal and corporate income, all of which have been transformed over the course of the century, though since 1979 the taxation of profits has returned to levels little higher than those prevailing between the wars.

Figure 5 Effective rates of tax: personal and corporate income (%), 1900-93
Notes:
(a) Expenditure on housing is excluded from the tax base because it was liable to domestic rates. There are no long-run data on the indirect allocation to consumption of taxes on industrial inputs and these have therefore not been excluded.
(b) Taxes on income paid by the personal sector includes addition to reserves and national insurance contributions, while the tax base includes current grants from public authorities.
(c) UK corporate and overseas taxes are on an payments basis, with corporate income, the tax base, net of interest payments.

2.6 If we take as given that the two world wars had a displacement effect on taxable capacity the long-run data for the expenditure and receipts ratios suggests that it is also possible to identify two significant periods for the permanent growth of the public sector and one very short phase of temporary growth. In respect of the former category, we identify the period between the wars and the decade after 1958, while in the case of the latter it was the years 1973-5 when it was widely considered that public expenditure was growing out of control. In terms of permanent growth it was social expenditures which led the way, with - in respective order - mass unemployment and political competition being the decisive factors. The latter deserves further comment as there is general agreement that, for the postwar period, there was no simple relationship between partisanship and public expenditure growth; rather there had been a steady acceleration under all governments until Labour was forced into severe retrenchment between 1976-7. The beginnings of this process may be dated as 1957-8. Until that point Conservative governments had been able to contain pressures for increased public expenditure through the benefits of the peace dividend made available by the ending of the Korean War. As Figure 6 shows, real TPE growth begins in 1958, the year in which the Chancellor of the Exchequer and his Treasury team resigned after failing to secure Cabinet backing for a substantial deceleration in the rate of growth of welfare expenditure (Lowe 1989). Figure 6 also includes an extrapolation of the 1958-64 growth of real TPE forward to 1979, at which point it would have been some 16 per cent above the actual figure (or 8.3 per cent above the figure that might have been expected if the last Labour government had maintained the growth rate of TPE experienced between 1974-6).

2.7 This leads directly to the next observation, that all incoming Labour governments had formed ambitious public expenditure plans whilst in opposition but within two years of taking office

12 Judge (1982, p. 29); see also Castles (1982) and Hogwood (1992, pp. 40-4).
were forced into subsequent cutbacks.\textsuperscript{13} The coincidence of rising real TPE (and the expenditure ratio) before the elections of 1955, 1959, 1964, 1966 and 1974 (but not 1970) are consistent with some sort of political business cycle, though this has proved very difficult to specify in practice.\textsuperscript{14} Public expenditure thus appears to have been a central ingredient of the postwar political contest, with the process beginning in the 1950s under the Conservatives. However, as Klein (1976, p. 418) observed, ‘the British evidence suggests that the competition between the parties is in terms of their rival claims to effectiveness in managing the economy as a whole, not in terms of increasing the benefits of public expenditure.’ Some ideological and electoral impact on the short-term course of public expenditure was clearly evident, but against this should be placed the clear finding from electoral studies that changes in political allegiance were more performance-related than issue-related, with, as Samuel Brittan (1975, p. 135) notes, ‘Voters simplify[ing] the problems of choice by shifting attention from policies to consequences’ with ‘beliefs about the latter ... formed by “simple inferences from who is or was in power.”’

\textbf{2.8} Some long-run, cross-country data on the expenditure and receipts ratios are given in Tables 3-5. Unfortunately, there is insufficient data from which to compile tax ratios before 1950 but it is clear that in terms of the expenditure ratio Britain’s public sector was not unduly large relative to its principal European competitor, Germany, on the eve of either the First or the Second World Wars (Middleton 1992, app. table 3). It should be noted that the public sector grew in all ACCs between the wars, but that for Britain the period of significant growth came in the 1920s, whereas other G-7 economies experience their critical phases of growth in the 1930s. The explanation is most likely the differential experiences of unemployment as between Britain and other OECD states, with the 1920s being relatively worse than the 1930s in the case of the former, and the British downturn beginning in 1929 being far less severe than was the case with most ACCs (Middleton 1996b, p. 93).

\textsuperscript{14} See Middleton (1996b, pp. 482-3, 576-7).
Table 3  **G-7** and Netherlands: total government expenditure as % of GDP at current prices, selected years, 1880-1950

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Table 4  OECD: general government expenditure as % of GDP at current prices, selected years, 1950-90

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Notes: (a) Because of the different source used for the 1950 and 1960-90 estimates, the 1950 and 1960 figures are not strictly comparable. The average difference amounts to less than half a percentage point of GDP and there are no significant differences for either the EC or G-7 groups; (b) Closest available date to 1990.

### Table 5 OECD: government current receipts as % of GDP at current prices, selected years, 1950-90

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**Notes:**

(a) Because of the different sources used for the 1950 and 1960-90 estimates, the 1950 and 1960 figures are not strictly comparable.

(b) The 1950 US estimate (12.8), recorded in Peters (1991, table 2.2) is assumed to be an error and 22.8 has been substituted.

(c) Closest available date to 1990.

**Source:** Middleton (1997, table 7.5).

### 2.9 In terms of public sector size the interwar period can be characterized as exhibiting a process of catch-up and convergence, with a lower coefficient of variation for the expenditure ratios in 1938 in relation to both 1929 and 1913. Fortunately, the data are much fuller and of better quality for the postwar period. Table 4 shows the overall position for Britain in relation to the EC-9, G-7 and OECD states using the SNA definition. Whilst Britain’s expenditure ratio was consistently above that for the G-7 and OECD, it remained around the EC-9 average, so that ‘If increases in the public expenditure/GDP ratio count as evidence of sin, there are many sinners’ (Heald 1983, p. 32; Hadjimatheou 1987). Indeed, by 1979, when the expenditure ratio stood at 42.9 per cent and exceeded both the G-7 (40.7 per cent) and OECD (42.5 per cent) averages, it was well below the average for EC-9 states (48.8 per cent). Britain’s public sector, by this measure, was thus not out of step with suitable comparators.
2.10 Furthermore, Britain’s relative position had changed markedly over the preceding thirty years. In 1950 Britain had one of the largest public sectors in Europe (32.1 per cent of GDP as against the EC-9 average of 27.5 per cent), so that over the intervening years it had the slowest rate of growth of the public sector by this measure of the EC countries. The data in Table 4 suggests an approximate inverse relationship between the expenditure ratio in 1950 and the rate of growth of this ratio to the mid- to late-1970s. Clearly there was a process of catch-up and convergence in the 1950s as the coefficient of variation is reduced for the G-7 and EC-9 though not for the OECD grouping (Middleton 1996b, p. 94). Thereafter, the experience of individual countries is more diverse (Lane and Ersson 1990, table 6.5), with the British case being distinctive in that there was a very marked reduction in the expenditure ratio between 1975-9 after an equally marked rise in the years 1973-5, the initial years of the OPEC I price shock.

2.11 Trends in the receipts ratio broadly mirror those in the expenditure ratio. Thus, from a tax burden considerably above the average for all comparators at the beginning of the postwar period Britain’s public finance system had been transformed to one below the EC-9 and OECD averages by 1979. We will note in the next section that there are good grounds for arguing that the weight of personal taxation was high by international standards in 1979 but at this point we can conclude that the aggregate tax burden was still very much lower than that born by many other much more successful economies.

2.12 Some additional indicators of the long-run growth of the public sector are given in Figures 7-9 and Table 6. Looking first at public sector employment (Figure 7) we observe a near fivefold rise in its share of the total working population between 1900 and 1979, a development which was accompanied by a marked shift from the production of non-market services (defence and general government) to an almost equal balance between non-market services and market and non-market production of goods (the nationalized industries). By this indicator, the process of public sector growth was well-established before the First World War, though evident mainly at the local level. Thereafter, and through to the late 1970s, employment growth was more equally shared between central and local government, while, of course, the period immediately after the Second World War saw a substantial nationalization programme which brought new productive activities (such as coal and railways) into the public sector for the first time and transferred functions previously exercised by public corporations and/or local government. In contrast to the course of the expenditure and receipts ratios, the period after 1979 does mark a very significant turning-point for public sector employment. By 1992 this had fallen below even the 1950 figure, a consequence of sustained de-nationalization and a slight reduction in central government employment, though many of the activities of government were transferred to agencies which were private sector only in name and not funding: a blurring of the boundaries between the public and private sectors which very likely will have important unintended long-term effects.

2.13 The respective shares of the private and public sectors in gross domestic fixed capital formation (GDFCF) comprise another suitable indicator of the growth of government (Figure 8), though here we observe that the phase of government growth which had begun with the First World War was exhausted by the early 1950s with the completion of the Attlee governments’ nationalization programme. Thereafter, the private sector share rose, in part because high levels of capital formation were integral to the rapid - by historical standards - growth of the British economy through to OPEC I, but also because from the late 1960s onwards successive governments squeezed public sector investment programmes, an unsurprising result given the natural bias towards the short-term and the stronger political constituencies associated with current expenditure programmes. Thus Mullard (1987, pp. 48-
50) has demonstrated that between 1951-67 movements in current and capital expenditure were positively correlated, whereas this relationship was reversed from 1968 onwards so that the continued growth of current expenditure were partially accommodated by relative cuts in capital programmes.

Figure 7 Public sector employment by category as % of total working population, selected years, 1891-1992

Sources: Middleton (1997, figure 7.6).

Figure 8 GDFCF by sector as % of total GDFCF, 1890-1993(a)

Note:
(a) It is not possible to decompose public sector investment during the Second World War.
Once initiated, the downward course of public investment in GDP was then intensified by growing financial stringency. As a consequence by 1979 Britain was spending only 0.5 per cent of GDP on roads and railways, the lowest of the EC-9**, with the result that Britain’s road network compared unfavourably with its European competitors. Widespread backlogs of replacement investment and maintenance had been identified for the late 1970s, particularly in sectors which were later to be privatized or subjected to new forms of administration (water and sewerage, housing, education and hospitals). Such has been the contraction in public investment that by 1992 the share of the private sector in GDFCF now approximated to that prevailing in 1913.

2.15 It has been suggested that as the crisis in economic policy developed during the 1970s there resulted a more macroeconomic approach towards public expenditure, one in which current and capital programmes were aggregated with less regard for their differential impacts upon economic activity than for their total effects upon the PSBR. As the size of the PSBR became more and more the focus for adverse comment, and the critique of big government gathered force, public expenditure becoming an anathema with a consequent erosion of the distinctive rationale for capital programmes (Mullard 1987, pp. 197-8). Since the current account of the public sector was in surplus throughout the whole of the postwar period until 1992 (see Figure 9), so that any PSBR derived from state capital formation, a different system of budgetary accounting and a greater understanding of the public finances might have resulted in a less extreme reaction against state activity and public expenditure after 1979. Soon after the war, John Hicks (1948) had indeed identified the problem that the traditional system of budgetary accounting did not easily accommodate the much increased level of state trading, and would provide misleading signals through the budget balance, and while the budget accounts were eventually brought closer to national income accounting conventions, difficulties remained to haunt both the investment programmes of the nationalized industries and government budgetary polices.

Sources: As figures 3-4.
Table 6 Distribution of marketed output (as percentages of marketed output), selected years, 1900-91

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Notes:
(a) No estimates for personal sector rent, interest and dividends are available before 1920. Estimates have been made from the total values for rent, gross trading profits and debt interest, with the distribution of these to the personal sector being assumed to be the same as in 1920.
(b) No estimates for income from employment in general government are available before 1920 and thus employment shares (from the 1901 and 1911 census) have been used, assuming that the general government share in total income is proportionate to its employment share.
(c) Feinstein (1972) does not provide estimates of market sector capital consumption; these have been taken as proportionate to the ratio of private to public sector GDP for.
(d) No estimate for income from employment in general government is available for 1948; assumed to be same proportion of total personal income as in 1951.

Source: Middleton (1997, table 7.6); derived from Bacon and Eltis (1976, p. 250).
2.16 On this theme one further point should be made here which is pertinent to both the actual course of Britain’s public sector and the implicit counterfactual: that far from Britain having too large a public sector, the opposite might have been the case. There is evidence for the postwar OECD states that public non-military capital formation is positively correlated with private sector total factor productivity (TFP) growth, and the suggestion has been made that the productivity slowdown after OPEC I followed in part from the lower rates of public investment exhibited after 1973 (Aschauer 1989). Given the fiscal stress experienced by all OECD states at this time, and the political biases working to cut capital more than current expenditure programmes (de Haan et al. 1996), it may well be that fiscal policies intensified the productivity slowdown, especially in Britain between 1976-7 when the Labour government made deep cuts in investment programmes. Recent econometric research for Britain suggests that had public infrastructure investment in the 1980s been maintained at the same proportion of GDP as was the case between 1966-79 then labour productivity growth in Britain would have risen from 4 to 4.5 per cent per annum (Lynde and Richmond 1993). Thus, in this case a larger public sector might have reaped dividends for overall economic growth.

2.17 The relationship between outstanding national debt and national productive capacity detailed in Figure 10 also illustrate the growth of the public sector and the different demands placed upon it, principally by war. The burden of the national debt has also exercised an important, but variable, influence upon twentieth-century British public policy by shaping perceptions of the economically acceptable boundaries of the public sector (Middleton 1996a, pp. 119-22). The downward trend in the debt burden established after the ending of the Napoleonic Wars was brought to an abrupt end by the First World War which saw a fivefold rise in the ratio of debt to GDP, followed by a further slight rise to the eve of the Second World War, a negative inflation tax. The Second World War then resulted in a further rise, but proportionately much less than in the earlier conflict. Finally, the postwar period was characterized by a declining ratio, the effects of the inflation tax more than compensating for the growth of deficit-financing under the new regime of Keynesian economic management. One effect of the new policy regime was to cast the national debt in a new light, since debt expansion was a necessary by-product of the commitment to full employment and the debt would pose no serious subsequent problems since public and private debt could be conceived quite differently, namely through the doctrine of ‘we owe it to ourselves’ (Musgrave 1985, p. 51). With the demise of the Keynesian system in the 1970s, which in part followed from the very marked deterioration in Britain’s public finances, especially between 1973-5, the issue of the sustainability of the national debt reappeared once more with a renewed emphasis on the effects of the debt burden on the supply of capital and labour, and thus crowding-out; issues which had exercised public policy before the Second World War.

2.18 A long run view of the balance, and composition, of the public sector budget is given in Figure 9. The sharp deterioration in the combined balance during the two world wars is a concomitant of the behaviour of the national debt. However, it should also be observed that, during the years before Keynesian deficit-financing was permissible, public sector deficits were more the rule than the exception: of the thirty peacetime years between 1900-38, the combined balance was in deficit on eighteen occasions, with the current account in deficit in seven of these years. Clearly, pre-Keynesian budgetary orthodoxy was more an aspiration than a reality, though the desire for fiscal balance dominated policy (Middleton 1985, chs 5-6). After the Second World War, the public sector was in deficit for all but seven years, but the current account was always in surplus, even during the years of fiscal stress of the 1974-9 Wilson-Callaghan administration. Thus, under the Keynesian policy regime, but not the

\[\text{Wright (1977); Thain and Wright (1990; 1995).}\]
previous period of budgetary orthodoxy, current receipts always covered current expenditure and deficits reflected public sector fixed capital formation. The more recent deterioration in the public finances, with current receipts falling short of current expenditure from 1992/3, which was occasioned by the erosion of the tax base in the mid-late 1980s and the effect of automatic stabilizers with the business cycle depression of 1989-92, is thus a clear a clear break with postwar trends, as has been observed by a number of commentators.

Figure 10 Ratio of outstanding national debt to GDP, financial years, 1900/1-91/2

Source: Middleton (1997, figure 7.9).

2.19 Finally, given the central role played by Bacon and Eltis in the attack on big government we report in Table 6 some long-run estimates of the share of marketed output absorbed by the government sector. Since its inception the Bacon and Eltis thesis has attracted much critical comment, both conceptual and empirical, but it is clear from Table 6 that, in general to 1979, the growth of non-marketed output was at the expense of market-sector consumption rather than market-sector investment. Since then, and rather paradoxically given the objective of rolling back the frontiers of the state, government-financed consumption has continued to rise, a consequence largely of mass unemployment. In rejecting the thesis that in the long-run the growth of the public sector was at the expense of private sector investment we also make appeal to the very long period over which the investment ratio in Britain has been significantly below that of comparators (Maddison 1991, table 2.3). This suggests that there were other structural forces in operation, and given the long-run relative decline of the British economy, it is essential not to conflate excess burden and deficiencies in economic performance. This will become clearer as we turn to look in more detail at the postwar period, but first we should note the relative price effect (RPE) and how this distorts the growth of TPE.

2.20 A long-term perspective on the RPE is provided by Figure 11 which shows the upward trend in the price of government goods and services relative to the general price level. It is important to distinguish between the various channels through which the RPE operates. For national income accountants the RPE is a consequence of the relative price of public sector inputs rising faster than the relative price of private sector final outputs, a phenomenon in turn due to the convention that no productivity benefits are imputed to the activities of
general government. In other words, the RPE is a measurement problem: it tells us nothing of substance about the relative efficiency of market-sector versus non-market-sector activities. However, the RPE can also be invoked to make stronger statements about non-market efficiency. Thus, for example, in the Baumol (1967) model the relative price of non-market services rises because they are more labour-intensive and technologically less progressive than those in the market sector (for example, some 60 per cent of NHS expenditure is labour costs) (Cullis and Jones 1987, p. 85), while Peacock and Wiseman (1979) and many others have gone further to argue that non-market sector inefficiency stems from institutional barriers made possible by the absence of competitive disciplines, i.e. X-inefficiency.

Figure 11 Relative price of government final consumption expenditure (1979=100), 1890-1993(a)

Note:
(a) Defined as general government final consumption expenditure price deflator divided by GDP (market prices) deflator.

2.21 The consequence of the RPE is that, as Parry (1986, p. 164) concluded in his survey of postwar British public expenditure, ‘Public sector relative growth largely disappears when the measure is in constant prices.’ His data, which uses a slightly different definition of TPE than that employed earlier, is reproduced in Figure 12. We have already seen that when the British public sector is measured by the conventional indicators, the expenditure and tax ratios and public employment share, there is a pattern of an initially high starting point, as immediate postwar changes consolidated developments of the interwar period in the provision of public, semi-public and merit goods, followed by low and uneven growth. In current prices the expenditure ratio increased by just short of 20 percentage points over the period 1937-79, a rise of three-quarters, but with the greater part of this being concentrated over the trans-war period 1937-51, so that there was only a rise of 8.4 percentage points of GDP since 1951. Moreover, when measured in constant prices, even this growth largely disappears. Thus Parry’s estimate of the expenditure ratio at current prices grows from 37.1 to 44.9 per cent between 1951-79, but only from 44.1 to 46.2 per cent at constant 1975 prices. Our long-run series for the tax ratio also shows how slight has been the increase in the state’s absorption of resources: a rise of 17.6 percentage points of GDP over 1937-79, of which only 4.3 percentage points occurred since 1951.
2.22 The RPE has added significance because all public finance systems are subject to its operation, being particularly evident in public health and education in all G-7 countries. However, it is extremely difficult to say whether it was stronger in Britain, although Klein and Scrivens (1985, table 2) estimate the RPE for these two programmes to be less evident between 1960-75 in Britain than in Germany and Japan. Our concern here is not to deny that public sector outputs in Britain were subject to technical and productive inefficiencies, but rather to highlight the lack of cross-country evidence that such characteristics were stronger in Britain than in other ACCs and can therefore be linked directly to broader economic failure.\textsuperscript{16} It is, therefore, no exaggeration to conclude that the attack on big government launched by agencies such as the IEA rested on very flimsy empirical foundations and a insularity all too typical of public policy debate in Britain.\textsuperscript{17}

3. The Laffer curve: from idea to policy

3.1 In reviewing the literature on the rise and fall of the Laffer curve Alan Peacock (1989, p. 25) observed that ‘The history of fiscal doctrine is strewn with statements concerning the critical point at which taxes will become “dangerous” to the economy’ and that, with so many antecedents, there was no theoretical novelty in the Laffer curve. What there was, however, was a very particular sort of appeal, especially in America.

3.2 Just as the reaction against Keynesianism and big government predated the first Thatcher administration, the appeal of supply-side ideas predated Laffer and Reagan,\textsuperscript{18} with the Nixon administration (1968-74) marking the beginning of the transition to more conservative economics (Stein 1984, ch. 5; see also Stein 1996, p. 228). Initial fiscal conditions were,
however, rather different. As Figure 13 shows in America the 1970s began with a deficit and this was being brought under control before OPEC I hit, whereas in Britain there was a substantial rise in the PSBR associated with the tax cutting strategy of the Heath government and then the Barber boom (differential movements in the tax and expenditure ratios for Britain and the US are shown in Figures 14 and 15 respectively). With the end of the ‘golden age’, the slowdown in growth, the rise in unemployment and inflation, the pressure on the public finances initially intensified, but in America the budget was brought back into surplus by the late 1970s (i.e. before Reagan’s election) whereas in Britain there was far less of an improvement. The fiscal inheritances of the Thatcher and Reagan administrations were, therefore, very different (as indeed were the performances of their real economies, see Figure 16).

Figure 13  **US and UK: general government financial balance as % of nominal GDP, 1970-95**

![Graph showing US and UK general government financial balance as % of nominal GDP, 1970-95](image)

*Sources: Chouraqui (1988, table 1.2) and OECD (1995b, annex table 30).*

Figure 14  **US and UK: general government current receipts as % of nominal GDP, 1970-95**

![Graph showing US and UK general government current receipts as % of nominal GDP, 1970-95](image)

*Sources: OECD (1982, table 6.5; 1995b, annex table 29).*
3.3 Nonetheless, in opposition both viewed the economic problem in a broadly similar manner, with the rise to prominence of three interconnected macroeconomic objectives (with associated policy trade-offs):

1. The reduction of inflation, which whether by monetary or fiscal means would entail higher unemployment which would itself, through the automatic stabilizers, weaken the public finances.
2. The balancing of the budget which would, given a realistic assessment of the potential for immediate cuts in public expenditure, delay the scope for tax cuts in the short-term.
3. The reduction of total public expenditure, which, given the commitment to higher defence expenditure, would require a reduction in fiscal benefits (both positive and negative expenditures) for the middle-classes, the targeted median voter.

3.4 In these circumstances, Stein (1984, p. 236) characterises three possible forms of response:

1. *Carterism* - pursuing each element in the approach so tentatively and flexibly that no harm would be done to anyone, but no significant good either.
2. *Thatcherism* - recognizing the costs of the objectives being pursued and being
willing to pay them.

3. Reaganism - denying that the objectives being pursued had any costs.

3.5 Enter the Laffer curve, transmitted from that Washington cocktail napkin to the ‘Republican Congressional bloodstream’ through the agency of Jude Wanniski, a leader writer on the Wall Street Journal (Stein 1984, p. 246). Thus in the US, as in Britain, where Samuel Brittan at the Financial Times and Peter Jay at The Times were - along with the IEA - the leading figures in educating political opinion against the Keynesian consensus, it was financial journalists who exercised the key role in propagating new economic ideas. With the collapse of the Bretton Woods system, the resulting shift in exchange rate regime and the onset of substantial public sector borrowing, there occurred in Britain (and America) a ‘quantum jump in the financial markets’ influence between the 1960s and 1970s’ (Keegan and Pennant-Rea 1979, p. 132). Contemporaneously, there developed a greater role for opinion in the foreign exchange and money markets, and with the traditional preoccupation of the newspapers and television with conflict, drama and novelty the stage was set for the economic policy debate to be opened up to much greater scrutiny. The near monopoly of elite debate behind largely closed Whitehall/Washington doors was over. As Andrew Graham, who was an economic advisor to the first Harold Wilson government, has put it:

One of the things I would say that has changed dramatically over the last 25 or 30 years is that at the time, in the late 1960s, although politicians would have been reading the press, the economic [sic] commentators were not taken anything like as seriously. Of course, politicians were watching the press for headlines that could cause trouble in the House of Commons or whatever, but I did not have the impression of the press and television running the agenda of debate in the way they do now.

3.6 Against this background, what was the particular appeal of the Laffer curve in America. First and foremost, for a Republican Party that had been taught some painful electoral lessons about voter preferences between fiscal prudence and the economics of Santa Claus, the Laffer curve offered the ‘economics of joy’: the means to reduce tax rates whilst simultaneously reducing the budget deficit (which, as we saw in Figure 13, was already coming back into balance), and protecting public expenditure programmes. As two notable academic observers of the first Reagan presidency put it:

It seemed to allow the Reagan candidacy to escape the dismal prospect offered both by traditional Republican economics and by monetarism, a prospect of austerity and distributional conflict in the name of long-term solvency. Tax-induced ‘growthmanship’ meant that there could be economic success without pain, as monetary policy held back inflation and faster growth in the private sector relieved of high taxes benefited everyone. As far as treating an ailing economy was concerned, supply-side theory was the equivalent of laughing gas when compared to the monetarists’ and orthodox conservatives’ devotion to chemotherapy. It is not difficult to convince people that the world would be a better place if taxes were cut.

3.7 This gives some clue to the necessary ingredients for an economic idea to have popular

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21 Seldon and Graham (1996, p. 159); see also Graham (1990) for his assessment of postwar macroeconomic policy effectiveness.
22 Nixon’s landslide victory in 1972, after abandoning traditional Republican economics, is usually contrasted with Goldwater’s defeat in 1964, who had campaigned on a ticket of austerity; Nixon’s near defeat in 1968, when only the disarray of the Democratic Party could counteract the unpopularity of conservative economics; and Ford’s defeat in 1976, again on a ticket of fiscal conservatism, to an unknown candidate from Georgia (Stein 1984, pp. 236-7).
23 Heclo and Penner (1983, p. 27).
salience. Thus, and our second factor, the ‘economics of joy’ cut across traditional left-right political divisions. Economic growth has long been the prophylactic for an interrelated complex of economic and social concerns, most notably as the means of escape from the distributional conflict between capital and labour (Arndt 1978): the politician’s philosopher stone, that of ‘policy without pain’ (Heclo 1981, p. 397). Thirdly, as Parsons (1989, p. 158) notes:

As a ‘scientific’ theory [the Laffer curve] did not really begin to evolve until after it had won its way to the White House. [It] was taken up because it offered a slice of social philosophy which even Mr Reagan could apparently understand: its success in the media bore witness to how it could be sold politically. At one level it offered an ill-defined vision, at another a metaphor for conservative rhetoric which complemented the political arguments being advanced for tax cuts and budgets.

3.8 Thus successful economic ideas might be likened to a multi-layered cake, appealing to different constituencies who, having variable perceptions of a policy problem, are stimulated by new ideas in very different ways. And, of course, since McCloskey (1983) we have been constantly reminded that that economics is but one form of rhetoric;\(^24\) that the telling of the story - and of its competitors - is of importance. Furthermore, if the economic mind is driven at least in part by psychology as well as by the neo-classical construct of rational economic person, whereby ethics and morality ‘turn economic transactions into social encounters’(Lewis \textit{et al.} 1995, p. 193), we can see why the Laffer curve might have a very particular appeal. At its core lay a conception of human behaviour, with the income-leisure choice and the incentives/disincentives provided by taxation, guaranteed to connect to the prejudices of many voters, especially as we know from survey evidence that voting preference more than any other factor determines attitudes towards taxation (Lewis 1982, ch. 4), though we also know that there is considerable ignorance about the rates of tax actually incurred.\(^25\) As Lewis (1982, p. 39) puts it:

Go into almost any English country pub, order some drinks, settle by the bar and then work the subject of tax into the conversation. Ask the locals what they think of income tax, rates or VAT. Any betting man would back his predictions of the gist of what would be said.

3.9 To these propitious conditions one should then add a change in context, whereby, in effect, the market for economic ideas became much more contestable in the late 1970s. The perception of national economic failure, a perception strongest in Britain and America than elsewhere within the OECD, engendered a crisis in professional, academic economics which, because of the evolution of their economic policy regime, was easily identifiable as resulting from one particular policy paradigm: Keynesianism. Economists were humbled, and with it formal economics. A policy vacuum resulted, one quickly filled by a higher profile for what David Henderson (1986, p. 3) calls DIYE, do-it-yourself economics. Thus in a passage which consciously mimics the closing paragraph of Keynes’s \textit{General Theory}, Henderson contends:

\begin{quote}
contrary to what Keynes assumed, these have not necessarily been the ideas of economists. Over wide areas of policy the judgements of politicians and their officials, as also of public opinion in general, have been and still are guided to a large extent by beliefs and perceptions about the working of the economic system, and about national interests and the welfare of the community, which owe little or nothing to the economics profession. In so far as the world is ruled by economic ideas, these are often the intuitive ideas of lay people, rather than the more elaborate systems of thought which occupy the minds of trained economists.
\end{quote}

\(^{24}\) See Mäki 1995) for a recent literature review of the debate initiated by McCloskey and others.

\(^{25}\) See (Brown 1968) for a study of misconceptions over the UK income tax, and a report of a survey of workers (N=179) and managers (N=53) in which no one correctly estimated their marginal tax rate, with the latter being slightly less fiscally challenged.
3.10 With the collapse of external authority for academic economics there arose the possibility of internal reform within the economics profession to regain its former position. Yet, looked at very broadly, it is arguable that this has not happened on either side of the Atlantic; indeed, a number of dissenting economists have argued that as a consequence academic economics is in crisis, not least because it has vacated the high policy ground to financial journalists, market gurus and other practitioners of DIYE (for example, Ormerod 1994 and Krugman 1996). In the US, and notwithstanding the enormous growth of what Stein (1986) calls the ‘Washington economics industry’, professional leadership in economics continues to lie with the practitioners of high theory, and with the academic rewards accruing to those who pursue originality and theoretical rigor rather than those who proffer policy advice and seek political influence (Brown and Eichenberger 1993). In such circumstances, part of the appeal of the Laffer curve to politicians was twofold: that it derived from someone on the fringes of academic economics - a largely unknown professor of business economics - and that the academic community reacted so negatively to Laffer and his construct. This is mirrored in Britain with the delight in which the behaviour of the British economy after 1981 appeared to confound the doom-laden message of the ill-fated 364 economists.26 As in the parallel contest between monetarist and Keynesian ideas, where it was Friedman who triumphed over Tobin in the political arena, notwithstanding the contrary verdict drawn by academic economists about this contest (Parsons 1989, pp. 150-1), in the debate over supply-side ideas Laffer and Wanniski followed Stigler’s (1955, p. 5) injunction to its logical extreme: ‘wares must be shouted - the human mind is not a divining rod that quivers over the truth.’ Observing that only a limited number of economists might be counted in the ‘supreme class’ (Smith and Marshall), and therefore that their claims would be recognised without the usual exaggerations, the Laffer curve clearly fell into the category of requiring ‘repetition, inflated claims and disproportionate emphasis’.

3.11 Laffer and Wanniski seemed to have deliberately targeted the Washington community and snubbed the usual academic protocols. This was not just because the target, the burgeoning New Right, were clearly anti-intellectual in the sense of anti-academic, anti East Coast liberal intellectualism (Parsons 1989, p. 149). Some further insights into what makes a good economic idea then follow:

- A snappy title, preferably pseudo-science and involving a person, as in the Phillips curve. The Laffer curve incorporates a person and a simple diagram, so simple that it could be drawn on the back of a cocktail napkin. As Gordon Brown has learnt to his cost, neo-classical endogenous growth theory does not have quite the same ring to it, and who would be brave enough to draw it? On this reasoning the Bacon and Eltis thesis might well be the British equivalent of the Laffer curve.
- The prospect of speedy results. It was perhaps this, more than any other factor, which has upset the economics establishment, even those sympathetic to supply-side ideas (for example, Feldstein 1986).
- Its capacity to guide policy in the future, whilst making sense of what went wrong in the past. In particular, where there was a history of policy reversals, a good idea would make sense of these and provide a solution, as for example in the revival of planning in Britain as a response to ‘Stop-Go’.
- Some modicum of academic respectability in terms of a progressive research agenda, provided in this case with continuing work by mathematical economists/public finance specialists into the theory of optimal taxation.
- The ability to widen the policy space. Thus a good idea should open up existing questions in new ways, and allow governments to practice was hitherto unthinkable. For

example, if reducing tax rates really does increase revenue, might not lower wages and cuts to welfare benefits increase employment?

- Finally, the Laffer curve appeared at the end of a long cycle in economics and politics, the quest for laws and fixed points. This was part of the dominant belief that economic systems were deterministic rather than open-ended, evolutionary and thoroughly unpredictable. In this sense the Laffer curve might be likened to the Phillips curve, which for long guided policy (Seldon and Graham 1996, pp. 154-5), though of course we all know what fate befell the Phillips curve.

4. **Laffer at work in Britain**

4.1 Turning our attention now to the British case, how and why did the Laffer curve make the journey across the Atlantic and with what results? Given the role of think-tanks in educating the British New Right about the reaction against big government taking place in the US, it would be expected that the IEA would have been an important conduit for the Laffer curve. Yet Cockett’s *Thinking the unthinkable* (1994) makes no mention of this construct. It might have been expected to have made an appearance in a 1977 volume of IEA readings on *The state of taxation*, but the earliest references I can find is in the report of a discussion (involving such luminaries as Minford, Beenstock, Rees-Mogg et al.) on a chapter by Eltis (1980, pp. 70-2) in a volume on *Is monetarism enough?* where Eltis (in IEA 1980a, p. 85) refers to ‘Laffer’s well-known diagram’.27

Figure 17 Beenstock’s (1979) Laffer curve

4.2 Looking elsewhere, Beenstock’s (1979) paper in the *Lloyds Bank Review* for October 1979 seems to be the first entirely devoted to the construct.28 There he estimated that maximum revenues occurred at an aggregate average tax rate of 60 per cent, a figure deriving from a simple regression (reproduced in Table 7) for the period 1946-77 which was then fitted to produce a Laffer curve for 1977 (reproduced as Figure 17). With this technique of aggregation, one which Beenstock recognised conflated the separate disincentive effects of

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27 The first formal treatment of the Laffer curve in an IEA publication seems to be Feige and McGee (1982) and McGee and Feige (1982), though IEA (1980a, p. 85) does reproduce a stylised diagram of total tax revenues against the rate of taxation.

28 This provoked a number of critical comments: Atkinson and Stern (1980), Hutton and Lambert. (1980) and Grinyer, *et al*. (1980); see also Beenstock’s (1980a; b) responses, and his further comments on Eltis’s (1980) paper in IEA (1980a, pp. 82-4).
corporation tax on capital and income tax on labour, an actual average tax rate of 40 per cent was estimated, one which was clearly below the 60 per cent peak of his Laffer curve. Nonetheless, he estimated that at current tax rates the marginal cost of £1 of revenue in terms of disincentive effects was approximately £3 of GDP. From this followed the conclusion that Howe’s June 1979 budget, which cut the top marginal rate from 83 to 60 per cent (but did not abolish the investment income surcharge of 15 per cent), was ‘unlikely to involve a sacrifice of tax revenue’ (Beenstock 1979, p. 13). Howe had said as much in his budget speech; indeed his speech merits a little comment.

Table 7 Beenstock’s (1979) regression output

<table>
<thead>
<tr>
<th>REV (= -32546 + 2081.4T + 18.0tT - 21.581T^2)</th>
<th>(13523)</th>
<th>(751.4)</th>
<th>(1.25)</th>
<th>(10.57)</th>
</tr>
</thead>
<tbody>
<tr>
<td>R^2</td>
<td>0.996</td>
<td>DW</td>
<td>1.65</td>
<td>SE £519 millions</td>
</tr>
</tbody>
</table>

where:

REV = central government receipts from taxes on income and expenditure plus national insurance contributions plus local authority receipts from rates (all at 1975 prices, £ millions)

T = Tax revenue as % of GDP
t = time trend

Source: Beenstock (1979, p. 11).

4.3 In offering a ‘New Beginning’, consciously defined as reversing economic decline, supply-side issues held centre stage in the budget speech:

We need to strengthen incentives, by allowing people to keep more of what they earn, so that hard work, talent and ability are properly rewarded.

... Excessive rates of income tax bear a heavy responsibility for the lack-lustre performance of the British economy.

... It is universally recognised, or almost universally recognised, that the present top rate of 83 per cent. on earned income is an absurdity. The rate of 98 per cent. on investment income is even worse. Such rates bring in very little revenue. But they kill incentives and are patently unjust.

[Hansard 1979, cols 240, 258]

4.4 What was conspicuously absent from Howe’s budget speech was the argument that these cuts in top marginal rates would more than pay for themselves in terms of additional revenue generated by any or all of the following possible effects:

- the Laffer curve, i.e. work incentives/labour supply effects.
- falls in avoidance and evasion (the Gutmann effect).
- reduction in net emigration.
- switching of remuneration from perks to salary and/or from capital gains to income.

4.5 The sole evidence - that is beyond DIYE - presented to justify these cuts were that Britain’s top marginal rates vastly exceeded the European average, with specific reference being made to the case of France (60 per cent), Germany (56 per cent) and the US (50 per cent) (see Table 8). Given the momentous nature of what was proposed - see Figure 18 for long-term trends in key marginal rates - and the cries of outrage it produced, it would have been
expected that Howe would have provided more of a justification. Whilst we should not expect the sort of appeal to evidence and academic literature that academics would demand, it is surprising that no mention was made of the Laffer curve given its intrinsic appeal and usefulness at this juncture. Whilst, as we have already noted, Howe (1994, p. 128) later recorded that he never succumbed to the full American version of Lafferism, he was ‘ready to agree with this insight, at least when it was applied to the grotesquely high, almost confiscatory, rate of taxation - from 83 to 98 per cent on every pound above £25,000 a year’ and that ‘We scarcely needed Laffer to persuade us that these rates could and should be cut substantially, at the very least without loss of revenue.’

Figure 18 Income tax rates, 1887/8-1995/6

Sources: Inland Revenue, various.

Table 8 OECD: tax schedules and maximum income tax rate, 1975 and 1989

<table>
<thead>
<tr>
<th></th>
<th>Number of brackets</th>
<th>Maximum rate</th>
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</thead>
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<tr>
<td>Australia</td>
<td>7</td>
<td>4</td>
</tr>
<tr>
<td>Belgium(a)</td>
<td>11</td>
<td>7</td>
</tr>
<tr>
<td>Canada(a)</td>
<td>13</td>
<td>3</td>
</tr>
<tr>
<td>France</td>
<td>13</td>
<td>13</td>
</tr>
<tr>
<td>Germany</td>
<td>Very large(b)</td>
<td></td>
</tr>
<tr>
<td>Ireland</td>
<td>6</td>
<td>3</td>
</tr>
<tr>
<td>Italy</td>
<td>32</td>
<td>7</td>
</tr>
<tr>
<td>Japan(a)</td>
<td>19</td>
<td>5</td>
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<tr>
<td>Netherlands(c)</td>
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<td>UK</td>
<td>10</td>
<td>2</td>
</tr>
<tr>
<td>US</td>
<td>25</td>
<td>3</td>
</tr>
</tbody>
</table>

Notes:
(a) Local income taxes payable in addition.
(b) Has polynomial formula tax schedule.
Source: Kay and King (1990, table 15.1).

4.6 It is certainly the case that by the time Lawson came to give his penultimate budget the Laffer
curve effect had become fully embodied in Conservative thought:

It is now nine years since my predecessor, in his first Budget in 1979, reduced the top rate of income tax from the absurd 83 per cent. that prevailed under Labour to 60 per cent. where it has remained ever since. At that time, this was broadly in line with the European average for the top rate of tax. It is now one of the highest....

The reason for the worldwide trend towards lower top rates of tax is clear. Excessive rates of income tax destroy enterprise, encourage avoidance and drive talent to more hospitable shores overseas. As a result, so far from raising additional revenue, over time they actually raise less.

By contrast, a reduction in the top rates of income tax can over time result in a higher, not a lower, yield to the Exchequer. Despite the substantial reduction in the top rate of tax in 1979, and the subsequent abolition of the investment income surcharge in 1984, the top 5 per cent. of taxpayers today contribute as much a third as much again in real terms as they did in 1978-79, Labour’s last year.

[Hansard 1988, col. 1012]

4.7 The 1988 budget constitutes the high watermark of Conservative fiscal achievements, allowing Lawson to do for personal taxation what he had attempted for corporation tax in the 1984 budget, that is radical reform (Lawson 1992, p. 814). The 25 per cent standard rate, long a Conservative ambition, was finally attained, and a new target of 20 per cent established. But most of all, and unprecedented given eighty years of progression in the income tax hitherto (Figure 18), there was now to be one single higher rate: 40 per cent (with capital gains tax assimilated to income tax rates). No wonder the House of Commons was rather lively that day, with Hansard (1988, col. 1012) recording that: ‘Grave disorder having arisen in the House, MR. DEPUTY SPEAKER, pursuant to Standing Order No. 45 ..., suspended the sitting for 10 minutes.’

4.8 Did some sort of conversion in thinking about the Laffer curve take place between 1979 and 1988, or are these merely differences in expression and, in particular, a reflection of the very different styles of the two Chancellors, the former a sheep in wolf’s clothing and the latter a wolf with no sartorial pretences. In the intervening years, the Laffer curve - and Laffer himself 29 - had certainly come in for a hard time from British academics. Hemming and Kay (1980) gave it a very rough ride in one of the early issues of Fiscal Studies, while Chuck Brown’s Direct Taxation and Short-run Labour Supply project at Stirling, which was funded directly by the Treasury, was entirely unable to provide the sort of evidence of disincentive effects that the Treasury’s political masters sought (Brown et al.’s 1982; 1985). Only Minford proved unshaken in his convictions about this issue, as with much else of the Thatcherite project. 30

4.9 The Laffer curve presumes that the positive substitution effect, whereby lower marginal tax rates increase the financial return from working an additional hour (thereby boosting labour supply because the opportunity cost of leisure has risen), is more powerful than the negative income effect, that is where a tax cut by increasing disposable income may lead workers to choose to consume greater leisure. Not surprisingly the 1988 tax cuts have been subject to very detailed scrutiny, especially by those attached to the IFS. Attention was directed to one Laffer’s central propositions: that if tax rates were reduced when in the prohibitive zone, not only would total revenue rise but the proportion of total personal taxation paid by high income groups would also increase.

4.10 In 1978/9 the top 1 per cent of taxpayers constituted 11 per cent of tax liabilities, rising to 15 per cent by 1990/1; the top 5 per cent’s share rising from 25 to 32 per cent over these years

30 On the former, see Ashton and Minford (1987); Minford (1988) and Minford and Ashton (1991); on the latter, see his collection of papers (Minford 1991).
(HMSO 1992, table 2.3). In an early assessment of this phenomenon Dilnot and Kell (1988, p. 91) did find an unexplained shift in the proportion of income tax which was paid by the highest income groups ‘which is consistent with, though not proof of, moderate behavioural changes in response to the reductions in higher rates of income tax in the 1979 Budget.’ Subsequent work, however, has lessened even this small possibility (Brown 1988). In particular, Brown and Sandford’s (1991) study of 300 accountants, a group deliberately chosen as statistically unrepresentative and as likely to overestimate the supply side effects of tax changes,31 could find no evidence of the 1988 budget leading to harder working or longer hours. Indeed, demand side factors continued to condition behaviour. There was, however, evidence that the reduction in marginal rates would lessen avoidance/evasion.

4.11 The empirical work on the very limited disincentive effects at the top end of Britain’s tax system, as against the well-documented problems at the bottom end (where marginal rates of the tax/benefit system can typically exceed 100 per cent), has been confirmed in the years since the 1988 budget.32 Moreover, the example of other OECD countries has also proved instructive, in particular the massive budgetary difficulties of the US after the major tax reforms in 1981 and 1986: a fate, we will argue later, shared to a lesser extent by Britain’s public finance system.

5. Conclusions

5.1 It appears then, both as a construct in political economy and as a demonstrable economic relationship, the Laffer curve in Britain is conspicuous more by its absence than by its presence. Admittedly, reference to the curve is routine in academic analyses of the effects of Conservative supply-side reforms since 1979,33 but it remains a curiosity that Conservative politicians did not make more frequent reference to this construct.34 This is particularly the case when the reform of personal taxation, and in particular reductions in the top marginal rates, in Britain, as elsewhere, necessarily entailed returning to a higher level of economic inequality,35 though this central tenet of New Right thought was, obviously, not given prominence.36 The Laffer curve provided the perfect means to obscure this issue behind a piece of pseudo-science; it would have been possible to argue that, in practice, tax cuts for the rich would not exacerbate existing inequalities because the rich would actually contribute a higher proportion of total income tax paid; and, of course, it all fitted with the anti-intellectualism of the times that we have identified.

31 The locus classicus, Break (1957), adopted a similar approach. The sample were more likely than the general population to be high income earners, better informed about the tax system and with considerable freedom to adjust their behaviour in response to changing incentives.
32 On taxation and labour supply, see Blundell (1992; 1995); on taxation and savings, Broadway and Wildasin (1994).
33 For example, Brown and Jackson (1990, pp. 451-6), Healey and Levacic (1992; ch. 5) and Robins (1993). The influence of Laffer may, however, have been more diffuse. Young (1991, p. 407), in his biography of Thatcher, includes Laffer as one of two Americans (the other being Friedman) who were part of the ‘chosen elite’, those who were as much her teachers as her agents, behind whom ‘loomed the contentious but revered figure of Hayek’. But Thatcher (1993) makes no mention of Laffer in her memoirs (and only three mentions of the beloved Hayek), while Lawson (1992) is equally silent as is Walters (1986).
34 Moreover, in 1978/9 only 19,200 tax payers had the 98 per cent marginal rate, equivalent to 0.09 per cent of the total number of income tax payers (calculated from HMSO 1981, tables 16, 19). No doubt more vocal and politically influential than the average tax payer, in terms of numbers they were dwarfed by those low income groups facing marginal rates which actually exceeded 100 per cent because of the interaction of the tax and benefit systems. In 1979/80 there were an estimated 80,000 families in the ‘poverty trap’ (Pond 1982, p. 55).
35 See, however, Kenworthy’s (1995) demonstration of the falsity of the presumed efficiency-equity trade-off.
5.2 Yet such arguments were not used in Britain, and indeed there developed nothing like the tax revolt that was experienced in the US. A number of reasons suggest themselves why, after so many similarities in the reactions against big government, British and American experience diverged in this instance. First, and somewhat paradoxical given that by OECD standards the tax take is so small, in America there was much more reliance on the progressive income tax to raise revenue than in any other OECD state, with their structures being much more progressive than in either Britain or Sweden (Steinmo 1993, p. 36). Secondly, in the US the tax revolt began at the local/state level, with Proposition 13 in California in 1978 being enormously significant for the subsequent Congressional debate. This initially concerned property taxes and the widespread perception of unfairness (Peters 1991, pp. 41, 67, 171). In Britain the debate developed rather differently. There was widespread dissatisfaction with the system of local rates, much of this also concerning fairness in the sense of horizontal and vertical equity, but somehow the link never got made with national tax issues in the same way. In any case, the Conservatives got cornered into the poll tax debacle (Butler et al. 1994).

5.3 Thirdly, if the survey evidence be accepted that attitudes and behavioural responses to taxation are at least in part conditioned by prior beliefs about government, its size and its legitimacy (Lewis et al. 1995, p. 239), we should expect substantial differences in practice between Britain and the US. Indeed, it is arguable that in Britain there is a deep-seated ambivalence about the desirability of tax cuts; that the Thatcherite revolution is far from complete. Thus British social attitudes display no weakening - indeed, the very contrary - of the public attachment to core welfare services (Taylor-Gooby 1995), although, as elsewhere in Europe, there has been something of a retreat from support for more specific interventions to redress market failure through government intervention (Döring, 1994).

5.4 Finally, reform of personal taxation - both that attained and that desired by the political right - needs to be viewed in the context of the state of the public finances in Britain, the US and other OECD states, and especially within the EU where the Maastricht convergence criteria have highlighted long-running fiscal imbalances. The massive deterioration in Britain’s budgetary position after 1989 (see Figure 13), the biggest movement in the PSBR in peacetime this century, compelled substantial tax rises on expenditure and income, this following on from a decade in which the average tax take had risen anyway (the receipts ratio in Figure 14 shows as much). It is estimated that of the £31 billion in tax cuts implemented between 1979-92, the top percentile received 93 times as much per capita as the lowest 50 per cent of income earners (Glyn and Miliband 1994, p. 1). It is a commonplace that the years since 1979 have witnessed the most pronounced and most sustained widening of inequalities in income and wealth this century, though there were many contributory factors in addition to the changes in the tax system we have documented (Goodman and Webb 1994). Inequality also increased in the US, although the process predates trends in Britain by a decade or so (Atkinson 1996, p. 23). For US public finances, Stein (1996, p. 266) records:

The year 1981 was the year of the Big Budget Bang. The combination of a large tax cut and a large increase in the defense program ballooned the deficit up to levels never seen before. Fiscal policy in all the years since ... was dominated by the efforts to deal with the consequence of that event.

5.5 There have been numerous attempts to cap the deficit in the US, starting with the Gramm-Rudman-Hollings law of 1985 which required a balanced budget by 1991 (OECD 1995a, p. 59), when the deficit topped $200 billion (2.5 per cent of GNP). Even when adjusted for the effects of automatic stabilisation (the high employment budget deficit) the position was unparalleled in peacetime, but in the US - as in Britain - having ‘cut’ personal taxes there seems no going back. Bush’s ‘watch my lips, no new taxes’ in the US and the antics of Conservative central office during the 1992 election campaign all provide salutary lessons. It
may well be that, as a number of public finance economists have observed (for example, Kay and King 1990, ch. 15), recent years have been the death throes of the income tax in the western world, but it is also the case that the New Right tactic has failed. Not only didn’t tax reform impart the promised supply-side boost - economic performance has been lacklustre in the US and UK by OECD standards - nor did it contain the onward march of public expenditure. The game failed; tax reform did set revenue limits but politicians responded by permitting substantial public deficits rather than risk the unpopularity associated with deep cuts in public expenditure programmes. It might all have been so different if there had been a Laffer curve!
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