The Stock Market under Labour

For New Labour read Old

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SUMMARY

- The London stock market has behaved poorly under New Labour. From 1 May 1997 to 16 April 2004, the FTSE 100 Index has risen by just 2% and the All-Share Index has risen by 6%. Over the same period stock markets in comparable developed economies have shown an average increase of 46%.
- Economic growth in the UK in real terms has been 18% from 1 May 1997 to the end of 2003. The growth rate in GDP has compared well with comparable economies and has been slightly higher than the average for all countries in the OECD universe.
- Inflation (from 1 May 1997 to mid April 2004) was 18%. In real terms, the All-Share Index has therefore fallen by 10.4%.
- Investors in equities have not participated in this growth, nor had protection against inflation. Seven years of steady growth in the economy has led to a marginal increase of 6% in the earnings on which the All-Share Index is calculated and an actual fall of 0.3% in earnings on the FTSE 100. In contrast, earnings on the two main US indices have risen by an average of 35% over the same period and there has been strong earnings growth in many European stock markets.
- The position of dividends is worse. They have been devalued by the removal of tax credits for pension funds, charities and private investors in PEPs and ISAs. The underlying dividend

index on the All-Share Index today stands 10% lower than in 1997 and 11% lower on the FTSE 100.

- Company profits and earnings for shareholders have been harmed by new regulation and extra taxation. An estimate of the cost of these regulations and taxation drawn from various published estimates suggests that the annual burden to business is around £18 billion. This dwarfs the benefit of an estimated £3 billion saving from the much-vaunted cut in corporation tax from 33% to 30%.

- Labour enjoyed a golden inheritance in May 1997, but the competitive advantages it inherited have been significantly eroded by regulations imposed in roughly equal measure by the Government and by Europe. This is clearly evident by a sharp decline in the position of the UK in world competitiveness league tables and by sharply declining average returns on capital employed.

- The Government has presided over a pensions crisis. This has been exacerbated by two factors: removing from pension funds an annual £5 billion within weeks of coming to power; and a stock market which has performed significantly worse than in comparable countries.

- The stock market performed badly under the three previous Old Labour Governments (1945-51, 1964-70, 1974-79) because of economic mismanagement, antipathy to the private sector, a suspicion of profit, and antagonism towards shareholders and their dividends.

- The New Labour Government seems to be behaving in a similar manner. It has turned full circle with traditional 'tax and spend' policies on a dramatic scale, it has attacked profits with new regulations and taxes and it has devalued dividends for shareholders.

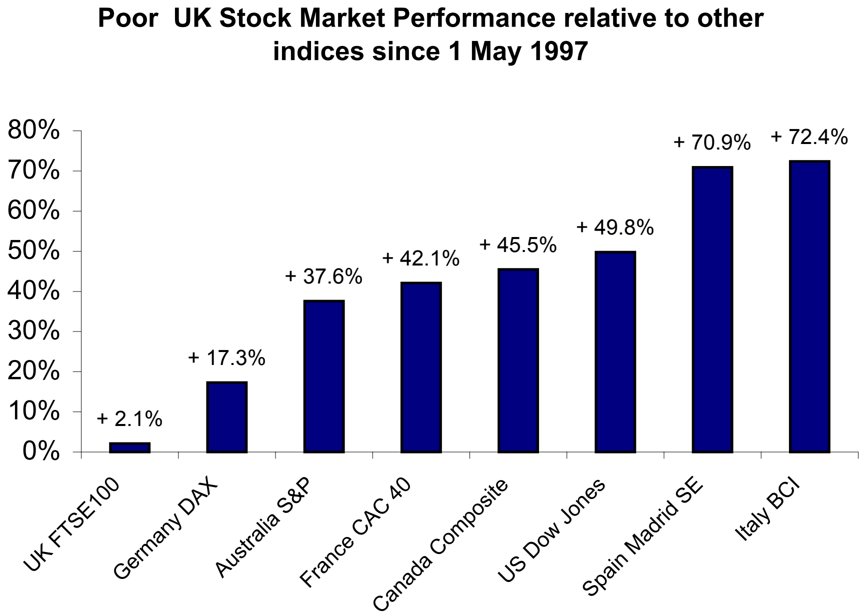
CHAPTER ONE

THE LONDON STOCK MARKET SINCE 1 MAY 1997

A FEATURE OF THE LONDON STOCK MARKET since the Labour Government came into power in 1997 has been the poor performance of equity shares, both in actual terms and by comparison with the performance of stock market indices in other developed economies. This contrasts strangely with the growth of the economy over the same period. Why has this happened?

Two important reasons why investors buy equity shares are to participate in the growth of the economy and to provide protection against inflation. In the UK over the last six and a half years, the economy has grown in real terms by 18%. Inflation has also been 18% based on the Consumer Price Index, but measured by the recently adopted Harmonised Index it would have been a more modest 10%. This economic growth has been impressive, but neither this growth nor its accompanying inflation have been reflected in stock market values. Since 1 May 1997, the FTSE 100 Index has risen by a mere 2.1% and the FT-Actuaries All-Share Index has risen by 5.7%.

Investors are therefore showing capital losses in real terms. It might be understandable if this poor performance had simply reflected trends in global equity markets where bull and bear markets often mirror one another, but the poor performance of UK markets stands in stark contrast to much better performing stock markets in other developed countries, with the particular exception of Japan. The chart overleaf below shows the performance of equity indices in major developed countries over the same period.



See Appendix 1 for details of calculations

Investors in seven major overseas markets have enjoyed an average rise of 46% since May 1997. (If Japan is included, the average rise for the eight countries would be 36%). These percentages compare with an increase of just 2.1% for UK investors.

This underperformance of the London stock market seems even more strange when comparisons are drawn with economic growth rates in those countries over the same period. Britain's economy has performed well. It has grown faster than France, Germany and Italy, although it has done less well than the US, Canada and Australia. The following table shows the percentage increase in real GDP from mid-1997 to 2003, together with the percentage change in stock market indices:

Comparison of Economic and Stock Market growth rates, mid 1997 to end 2003

	% increase in GDP*	% change in equity indices*
UK	18.3	2.1
Germany	8.9	17.3
Australia	25.4	37.6
France	16.4	42.1
Canada	27.4	45.5
US	21.7	49.8
Spain	23.9	70.9
Italy	10.7	72.4
Japan	7.0	– 38.3

* The increase in GDP is from mid 1997 to December 2003. The change in equity indices is from 1 May 1997 to 16 April 2004.

Sources: OECD, *Economic Outlook*, December 2003; and Appendix to this pamphlet.

Why therefore has the London stock market behaved so poorly? A contributory factor has been the strength of sterling and the weakness of the dollar: these have had a negative effect on overseas earnings. Another important factor is that Labour Governments have in the past brought with them an inherent political risk for stock markets – and that this is repeating itself. Shareholders have not participated in the growth of the economy since 1997. The underlying earnings of the 100 companies in the FTSE Index and of the 685 companies in the All-Share Index have shown barely marginal growth since 1997. The underlying dividends of both indices are today some 10% lower.

Low earnings and dividends on the All-Share Index

	1 May 1997	16 April 2004	% change
All-Share Index	2,138.89	2,259.90	5.7
PE Ratio	17.92	17.83	
Earnings Index	119.3	126.7	6.2
Dividend Yield	3.58	3.05	
Dividend Index	76.6	68.9	– 10.0

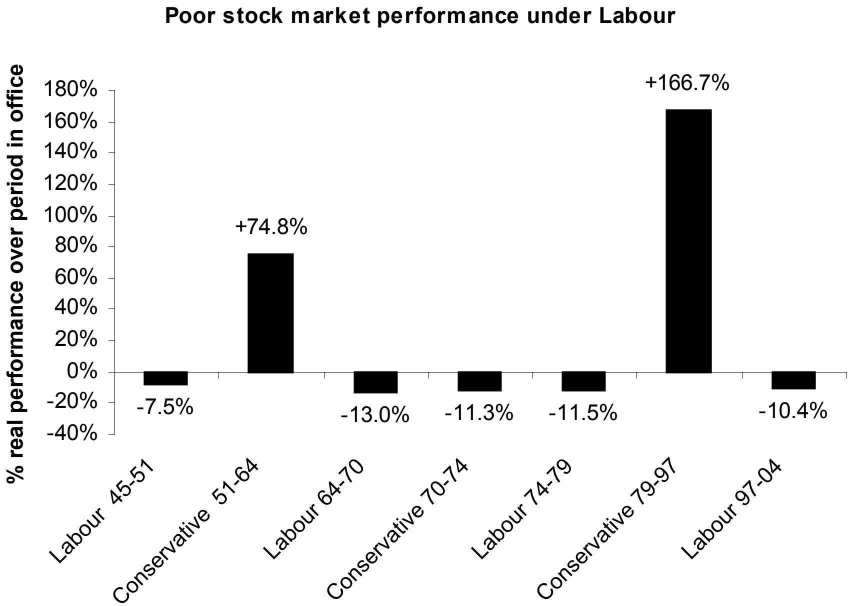
...and even worse on the FTSE-100

	1 May 1997	16 April 2004	% change
FTSE 100	4,445.0	4,537.3	2.1
PE Ratio	16.63	17.02	
Earnings Index	267.3	266.6	– 0.9
Dividend Yield	3.64	3.16	
Dividend Index	161.8	143.4	– 11.4

With stagnant company earnings and devalued dividends, it is hardly surprising that share prices in the UK have made little progress. This failure of shareholders to participate in the growth of the economy is in stark contrast to experience in other markets. In the US, earnings growth on the Dow Jones and S&P 500 indices has been around 35% since May 1997. The calculation of PE ratios of European stock market indices is less precise, but earnings growth of some 70% in France and 90% in Spain has been spectacular, and strong at around 30% in Italy.

One reason why shareholders have not benefited from economic growth is that New Labour has shown itself to have the same antipathy towards shareholders as the three previous post-war Labour Governments. Since the end of the war in 1945, there has been a remarkably close correlation between the colour of the governing party and the performance of stock markets – blue for bulls and red for bears. The following chart shows that, under the three Labour Governments (1945-1951, 1964-1970 and 1974-1979), the record was consistently poor. In comparison, under the two long periods of Conservative rule (1951-1964 and 1979-1997), the stock market was consistently strong (although under the Heath Government (1970-1974), the record was as bad as under Labour).

Could this poor performance be attributed in part to a suspicion of Labour politicians of the concept of profit? Of a failure to understand that profits are a vital source of wealth creation? Of a feeling that there may be something undeserving about shareholders receiving dividends?



See Appendix 2 for details of calculations

The three previous Labour Governments shared certain characteristics. These included high taxation, the imposition of controls, high levels of government spending and, above all, legislation reflecting an innate hostility to profits, dividends and shareholders. Stock markets are influenced by the consequences of political and economic decisions taken by governments and these characteristics combined to lessen the attraction of equity shares. The result was that over the three periods of office of post-war Labour Governments, stock market indices, after allowing for inflation, showed capital losses (in the case of the 1945-1951 and 1974-1979 Governments, these capital losses were much worse until investors were rescued by strongly rising markets anticipating the return of Conservative Governments in the general elections of 1951 and 1979).

A healthy stock market is important. There is a virtuous circle in a strong stock market. The stronger the economy, the higher the profits; the higher the profits, the higher the stock market; the higher the stock market, the greater the wealth. This wealth is widely shared. Government revenues climb higher. The savings held in pension funds, life assurance companies and unit trusts rise higher. The private shareholder builds an asset base that generates consumer confidence. Governments and companies enjoy a cheaper cost of capital.

The stock market matters. And it is primarily driven by the consequences of political and economic decisions taken by Governments.

CHAPTER TWO

THE GOLDEN INHERITANCE

THE PATTERN OF A poorly performing stock market under Labour Governments is being repeated under this Labour Government, but with an important difference. When the three previous post-war Labour Governments came into power in 1945, 1964 and 1974 they were immediately confronted with chronic economic problems. In contrast, Tony Blair and Gordon Brown have enjoyed the golden inheritance of a strong economy. Their good fortune was correctly forecast by the OECD. In its report on the UK economy in December 1996, it stated that: “The prospects for achieving sustained output growth and low inflation are the best in 30 years”.

It was a golden inheritance that would have accrued to whichever party won the 1997 election. The Conservative spending plans in place to eliminate government deficits were adopted by Labour. There was a need to raise interest rates in 1997, not because of structural weakness, but because of the boost to the economy of windfall gains of some £30 billion in 1996 from the mutualisation of building societies and life assurance companies. Buoyant revenues were always going to flow into the Chancellor’s coffers as the export and investment led recovery of the John Major years was succeeded by a tax-generating consumer boom. Economic growth, unemployment, inflation and interest rates all showed improving trends from 1992 onwards. There is no discernible change in the trend of these charts in 1997.

The election victory in 1997 had been welcomed in many parts of the City and the stock market had been particularly impressed with the serious intent of the Chancellor, Gordon Brown, to avoid the financial irresponsibility of previous Labour Governments. His decision to take the politics out of interest rates by handing over control to an independent Monetary Policy Committee, chaired by the Governor of the Bank of England, was much respected. With the following wind of a buoyant economy and a powerful global bull market, the honeymoon with New Labour lasted for two and a half years until the last day of the millennium, 31 December 1999. By this time the two principal indices, the FT-Actuaries All-Share and the FTSE 100, had risen by 51.6% and 55.9% respectively since Labour came to power.

Is New Labour really any different?

Despite its attempts to foster an image of financial rectitude, New Labour was, within weeks of winning the election in 1997, following some of the well-trodden footpaths of its predecessors. Gordon Brown imposed a £5 billion windfall tax on the privatised utilities and abolished tax credits for pension funds worth an annual £5 billion. David Blunkett signed the Social Chapter. And its second term has seen a return to policies of 'tax and spend' on a major scale.

At the same time, a hostility to business occasionally comes to the surface: the oil companies were criticised for making too much money, the national lottery was said to be too profitable, a 'rip-off' Britain campaign was mounted, the supermarkets were accused of exploiting their customers, bringing the private sector into the NHS was said to be immoral, Railtrack paying dividends was denounced as scandalous, the banks were too profitable – the list goes on.

Labour has introduced legislation and taken measures that have directly or indirectly harmed the interests of the shareholder. These measures mostly fall under two headings – taxation and regulation.

CHAPTER THREE

TAXATION AND REGULATION

Taxation

The overall burden of taxation, however measured, rose during each of Labour's periods of office. Historically, it has had few scruples about introducing taxation policies that discriminated against profits or dividends.

Since 1997, Labour has continued down the same path. Two tax measures were introduced immediately upon its election victory. The windfall tax was an old-fashioned Labour outcry against the profits of successful privatised utilities. Far more harmful was the decision to abolish the tax credit of 20% on dividends received by pension funds, which was announced with immediate effect by the Chancellor, Gordon Brown on 2 July 1997. Whereas the windfall tax was a one-off levy of £5 billion, the abolition of tax credits was to be an annual levy of £5.4 billion, of which approximately £4 billion related to pension funds. With the loss of revenue and the power of compound interest, the eventual cost to the pension funds will accumulate to a huge total: it has already probably reached about £30 billion.

Closely linked with the Chancellor's removal of this tax credit was his abolition a few months later in November 1997 of advanced corporation tax, itself the basis of the imputation tax system for corporate profits. This reform brought back an element of double taxation: corporation tax is charged on profits, and income tax charged on dividends paid out of taxed earnings. This had first been introduced by James Callaghan in 1966 but was repealed by Anthony Barber in 1973 with the imputation system, which removed the element of double taxation.

This abolition was an attack on the value of shareholder dividends. The dividend tax credit was immediately removed from pension funds. For charities and private investors in the Personal Equity Plans (PEPs) and their successor, the Individual Savings Accounts (ISAs), the recoverable tax credit has now been phased out. For standard taxpayers an advance tax payment of 20% has been replaced by a notional 11% allowance that low taxpayers are unable to recover. In simple terms, Gordon Brown reduced the value of dividends by 16%: this was reflected by an overnight reduction in the dividend yield on the FT-Actuaries All-Share Index from around 3.5% to 2.9%.

These measures carried with them damaging and confusing signals for savings. In addition to phasing out the dividend tax credits on ISAs, the amount allowed for investment, having been originally reduced from £9,000 to £7,000, will fall to £5,000. In a recent interview in February with the *Sunday Times*, Richard Wastcoat, managing director of Fidelity UK stated that "The Government is publicly committed to encouraging people to save, yet it has done more to damage the savings culture than to promote it".

One example of how the ordinary investing shareholder has been disregarded is the highly favourable capital gains tax concession introduced by Gordon Brown at a special rate of 10% to business investors. The implication is one of approval of founding shareholders – but disapproval of the more passive secondary shareholder, whose capital gains can quickly reach a marginal rate of 40%. In all probability, it is a measure that will lead to accounting manipulation with businesses being reconstructed and expenses kept artificially low.

Another example concerns an issue which the Chancellor has chosen to ignore. Labour Governments have twice in the past doubled the stamp duty on the purchase of shares from 1% to a penal 2%. By the time of the 1997 election the Conservatives had reduced this in stages to 0.5% with a commitment to remove it altogether, subject to the introduction of what proved to be an ill-fated settlement system. Gordon Brown regards the financial services industry to be sufficiently important to be included as one of his five economic tests for joining the euro, but he has declined to remove the competitive disadvantage to City practitioners of the 0.5% stamp duty. There is now no stamp duty on the purchase of shares in the major competing European stock markets. When asked by a Member of Parliament about this disadvantage last year in Treasury questions, the Financial Secretary to the Treasury, Ruth Kelly, replied, "Perhaps he could explain why during 18 years of Conservative Government, his party did absolutely nothing to reduce or remove stamp duty on shares". Her ill-informed reply showed that she was more interested in trying to make a cheap political point than in attending to a matter that is a Treasury responsibility.

In addition to these measures, or lack of them, Gordon Brown has immeasurably complicated the taxation regime with endless tinkering. He has imposed a range of taxes on business, some openly but many commonly referred to as stealth taxes. Their costs have to be borne by business in a market place which has become highly competitive because of increased global capacity and the transparency of the internet. Companies no longer have the pricing power which in the past enabled them easily to pass increased costs on to the customer. An estimate of the cost of additional taxation on business is summarised in a later chapter.

Regulation

Another feature of the three post-war Labour Governments was an instinct to impose controls on the economy. The most extreme form of control of the private sector was nationalisation, a bedrock policy of the Attlee Government, which also imposed strict controls on planning, the use of raw materials and the raising of capital. Nationalisation continued at a more modest level under Harold Wilson, although there was active campaigning for state interference within his party. The emphasis on controls during the 1964-1979 period expressed itself in a succession of prices and incomes policies. These policies embraced dividends and in one form or another dividends were subject to controls in 12 out of 14 years after their introduction in 1965.

Since 1997, this Government has avoided legislative controls on prices and incomes policies, but nationalisation has resurfaced in all but name with the decision to take Railtrack out of existence and replace it with the non-profit company, Network Rail, supposedly not owned by the government but in the last resort wholly dependent upon it for its financial needs. When Railtrack was put into administration, it was accompanied by hostility and contempt for the shareholders and the dividends they had received.

Under this Government, ‘control’ has been replaced by ‘regulation’ with arguably even more serious consequences for business and the private sector. Previous Labour Governments believed they had no alternative to controls as they struggled to deal with an economy with chronic problems and often in some form of financial crisis. The Labour Government inherited a structurally strong economy upon which they have imposed regulations, not out of necessity but out of choice.

This began with the signing of the Social Chapter immediately upon its return to power in 1997. This has opened the doors to waves of directives and regulations, some of which could have been voluntarily adopted rather than imposed. The problems of compliance with the Social Chapter have been costly and distracting and far different from the Prime Minister’s claim in the House of Commons in November 1997 that “The fact is that there are no measures in the Social Chapter that are going to cause problems for British business. It is just absolute nonsense.”

The naivety of that comment has since become apparent. The flow of more directives from Brussels is causing problems for

British business. There are several recent examples, including attempts to impose tough regulations over the employment of temporary and part-time labour. Another example has been the threat to the viability of our lightly-regulated market in the production and sale of vitamins.

However, it is not only from Europe that regulations have been flowing. The Government itself has introduced new regulatory measures, has imposed upon employers new tax-gathering responsibilities, has given trade unions new powers in tribunals and has made union recognition easier to obtain. It has presided over what is described as the "gold-plating" of European directives whereby our standards of compliance are set even higher than required and then enforced rigorously. It has presided over a culture in health and safety regulations that demands ever higher standards of compliance in a fruitless endeavour to eliminate the word "accident" from the vocabulary.

The outcome of the gathering pace of this culture of regulation and red tape is a relentlessly increasing cost. In large and medium-sized companies, this burden has been more easily carried by an expansion of the human resources, finance and administration departments. In smaller companies the burden is much greater because it has to be carried either in the form of extra consultancy costs or by distracting busy executives devoted wholly to making a business survive or grow. Employers' liability premiums have soared. These additional costs are non-productive and if profit margins are not to be squeezed, they have to be paid for out of higher prices.

The impact on business of tax and regulation since 1997

Although the total cost of regulation and taxation imposed on business since 1997 cannot be measured precisely, well-documented estimates have been made by three organisations: the British Chamber of Commerce (BCC), the Confederation of British Industries (CBI) and the Institute of Directors (IoD).

The BCC has for some time been calculating a Burdens Barometer to assess the cost of regulations imposed on business. Its latest analysis (published on 8 March 2004) lists 35 different measures introduced since 1998: their accumulated cost is estimated to be £30 billion; and the annual recurring cost is estimated to be £7 billion.

The biggest costs to business have been the Social Chapter and regulations related to employment. The most expensive single item has been the Working Time Directive which came into force in October 1998 and is now estimated to have an annual running cost of £2.3 billion. Other regulations concern parental leave, trade union recognition, works councils, tribunals, part-time workers and the collection costs of the working families tax credits, student loans and stakeholder pensions. Step by step the competitive flexibility of the labour market, one of the keys to economic success, is slowly being eroded.

The CBI has focused its calculations on the net cost of tax changes made since 1997 and has estimated both the annual and cumulative cost to business on a financial year basis. The net annual cost for the tax year 2003/04, after allowing for a credit of £3 billion from the cut in the rate of corporation tax, is estimated to be £6 billion. The cumulative cost since 1997 is estimated to be £39.6 billion. The two biggest items in the annual total are the abolition of tax credits on pension funds of £5.4 billion and the recent £3.9 billion for the increase in National Insurance.

The IoD focused its calculations on the additional employment costs arising from new regulations. These were set out by Ruth Lea in *Red tape in the workplace*. In particular she raised serious concerns about the direction that the Government and the European Union were taking us :

> This country has to make a choice between (1) free and lightly regulated labour markets, economic dynamism and strong job creation and (2) intrusive and heavily regulated labour

> markets, economic stagnation and weak job creation. There is, in reality, no Third Way. Heavy regulation destroys dynamism. Heavy regulation kills enterprise.

It repeats the estimated annual cost of the Working Time Directive at £2.3 billion and includes an estimate of the cost of the National Minimum Wage at £2.7 billion out of a total of extra employment costs of £5.9 billion. The National Minimum Wage was originally set at a modest hourly rate of £3.60 in 1999 and being less than feared, it allayed business concerns that it would trigger the high cost of maintaining pay differentials. However, with subsequent increases to its current level of £4.50 and to £4.85 proposed for October 2004, the National Minimum Wage is being increased at a faster rate than the growth in earnings. This inevitably puts gradually increasing pressures on the cost of maintaining differentials. The prospective increase in October 2004 will mean that the basic rate will have increased by 35% since its inception or by an annual rate of over 6%.

These estimates illustrate the scale of what has been happening. Adding together the estimate of taxation costs and the cost of regulation suggests an annual additional cost to business of around £18 billion, offset by the much vaunted concession of the reduction in corporation tax from 33% to 30%, estimated by the CBI to be worth £3 billion. The cut in corporation tax has been dwarfed by the extra cost of regulation and taxation.

The impact can be illustrated in rough and simplistic terms. Corporation Tax is currently charged at 30% of company profits. It raises for the Exchequer around £30 billion a year. It can therefore be assumed, therefore, that total profits are about £100 billion. The following table shows the impact of the new tax and regulatory costs.

Impact of tax and regulation on net profits

	Before	After
Pre-tax Profit (£bn)	118	100
Corporation Tax	33%	30%
Corporation Tax (£bn)	39	30
Net Profit (£bn)	79	70

This simplistic but indicative calculation shows that net profits have fallen by 11.4% as a direct result of Labour's tax and regulatory costs.

In addition to these approximate estimates, there is much anecdotal evidence from individual companies. At the Treasury's recent Advancing Enterprise conference Sir Terry Leahy, chief executive of Tesco, told the audience that more than 50% of his company's profits were now eaten up by taxes, including corporation tax and national insurance payments. He added that "Over time, high taxes will hinder the UK's ability to compete." At the other end of the scale, Reed Health, a recruitment company, recently illustrated how the Government's overall philosophy of regulation causes unwelcome intrusion into business. The company warned that the cost of regulation will dent profits, claiming that it now had to make 27 separate compliance checks on any healthcare worker it supplies.

The negative consequences for business of the taxation and regulation imposed upon it since 1997 can be illustrated in other alarmingly specific ways. In particular, there has been a sharp decline in Britain's standing in independent league tables of global economic comparisons.

CHAPTER FOUR

ECONOMIC LEAGUE TABLES

1. The World Economic Forum

The world competitiveness league table published by the Geneva-based World Economic Forum lists countries in order of their "capacity for medium-term economic growth" based on eight relevant aspects of their economies.

The ranking of the UK has been:

1998	1999	2000	2001	2002	2003
4	8	8	12	11	15

This survey indicates that the UK is steadily falling behind. In 1998, reflecting the prospects outlined by the OECD in December 1996, the UK stood in fourth place behind the US, Singapore and Hong Kong. Today we languish in fifteenth place, having been overtaken by Japan and Taiwan; Australia and New Zealand; the four countries of Scandinavia; and the Netherlands, Switzerland and Germany from continental Europe.

2. The Institute for Management Development

The Swiss-based Institute for Management Development publishes a world competitiveness scoreboard. As well as background criteria, they also incorporate data about actual performance. In 2003 they separated the previous list that incorporated countries of all sizes into two lists of countries with populations of above and below 20 million.

The following table shows the ranking of the UK under (a) the previous system and (b) the new system, which for the purpose of long-term comparisons has been recalculated for previous years. There is no figure available for 2003 under the former system.

	1997	1998	1999	2000	2001	2002	2003
a. All countries	9	13	19	16	19	16	n/a
b. Population 20m +	3	6	6	5	6	5	7

3. The Heritage Foundation

The Index of World Economic Freedom co-published by the US-based Heritage Foundation and the *Wall Street Journal* uses different background criteria to assess the economic freedom of structures in place in each country. The ranking of the UK has been as follows:

1998	1999	2000	2001	2002	2003	2004
3	4	8	7	9	9	7

There is a consistent pattern in these international surveys: an alarming decline in the competitive position of the UK since Labour came into power.

Another indicator of an alarming decline is the business 'Health Check'' which is published quarterly by Experian, the financial information consultants. Its research covers a universe of some 2,000 companies from the industrial and commercial sectors of the economy, but excluding the financial sectors. Annual trends in two of its particular ratios are shown in the following tables:

	Average % return on capital employed	Average % pre-tax margins
1997	12.50	7.51
1998	13.32	7.58
1999	14.18	8.09
2000	14.03	7.59
2001	12.48	7.14
2002	8.37	6.16
2003	5.76	4.24

The ratios peaked with the stock market in 1999. Since then, however, the Experian reports show that the average return on capital employed has fallen for 16 successive quarters. While the strength of sterling has been an important factor in these pressures on margins, they have also been exacerbated by regulation and taxation.

CHAPTER FIVE

THE STOCK MARKET AND FUTURE PROSPECTS

THE STOCK MARKET takes things as it finds them and is commonly accepted to be the best barometer available of current and prospective trends in the state of the economy. There is a mismatch between the Government's assessment of its management of the economy and the verdict of the stock market. The Government likes to sing the praises of its record and a typical quote would be a passage from Gordon Brown in his pre-Budget report of 10 December 2003:

> Today, I can report to the House that British inflation has been at its lowest for 30 years; interest rates are their lowest since 1955; this Christmas, there are more people in work than at any time in our history; and economic growth in this country is now strengthening. While America, Japan and half the euro area have suffered recessions, the British economy has - uniquely - grown uninterrupted, free of recession, in every single quarter in every single year since 1997. Now is the time for this stable and growing economy to seize the opportunities of the emerging world recovery.

It does not, of course, suit Gordon Brown to remind people of his economic inheritance in 1997. Nor does it suit him to admit that the economy has grown in every quarter since 1992. In another typical comment, Tony Blair recently claimed in answer to a Parliamentary Question on 25 February 2004 that :

> It is a tribute to the management of the economy under this Chancellor, and to this Government's record that we have seen in the past seven years dramatic reductions in unemployment, dramatic rises in employment and the best-run economy of any major industrialised country.

These are the headlines. But why hasn't the "unique" record and "the best run economy of any major industrialised country" prompted one of the best performing stock markets in the world?

The Government has presided over a pensions crisis that has driven many pension funds to close the doors to final salary schemes. Undoubtedly, the pension funds suffered badly from the ravages of the 2000-2003 bear market when the value of their assets fell sharply at the same time as their liabilities were perceived to be increasing because of greater longevity, but they were specifically harmed by the earlier decision of Gordon Brown in 1997 to abolish their annual tax credit of £4 billion, which has now accumulated to a total loss of some £30 billion. They have also suffered badly from the relatively much worse stock market performance in the UK.

It is sometimes claimed that the relative weakness of the UK stock market is due to a retreat from equities on the part of the pension funds and life assurance companies, as evidenced by the recent announcement by Standard Life that it had raised £7.5 billion from its equity portfolio. The weakness of this argument is that if it were true, the valuation of UK equities would have fallen and be either lower than it was, or lower than in comparable markets. Neither is the case. In fact, the PE ratios of the two indices are currently marginally higher than they were in 1997 and the dividend yields are marginally lower. Any negative effect of a reduced exposure to equities has been counter-balanced by an increase in the foreign ownership of UK equities.

It may be difficult to imagine but the FTSE 100 Index would, if its performance had matched comparable stock markets elsewhere, be standing at over 6,000. That would have resulted in PE ratios of 22 to 23, which would be difficult to justify.

Although economic growth has been sustained from year to year, share prices may now be lagging because of caution about the short-term and longer-term prospects for the economy. The drivers of current economic growth are government spending and consumer spending. The consumer boom continues unabated, driven by record levels of personal debt encouraged by low interest rates. Government spending continues at a higher rate than for the economy as a whole. Neither can continue indefinitely at these levels. The poor relation at the moment is business which lacks the confidence to invest: it is possible that it may come to be crowded out by government borrowing and it may struggle to compete with the recruitment advantages the public sector enjoys in terms of guaranteed pensions.

The short-term outlook

In the shorter term, there are serious risks in the economy. The build-up of personal debt and rising house prices are both heavily dependent upon the maintenance of low interest rates. The consumer boom has led to a chronically large balance of payments deficit. The 'tax and spend' policy has led to estimates of annual government deficits of £30 billion or more for each of the next six years and, by rising above 3% of GDP this year, Britain has come into line with the deficits of France and Germany. Financing these deficits may either force up the cost of borrowing or require significant further rises in taxation. If higher interest rates follow from the inflationary pressures of inefficient and excessive government spending, there is the danger of a downward spiral of slower consumer spending leading to declining government revenues.

Typical of concerns being expressed about the consequences of current government spending was the comment by Philip Bowman, chief executive of Allied Domecq, in a series of New Year interviews with business leaders in the *Financial Times* on 5 January 2004. He was reported as saying that "the country is rapidly losing its competitive edge because of increased government spending" and that "interventionist" government policies were adding "very significantly" to his company's cost base.

The long-term outlook

In the longer term, there are concerns that the management of the economy seems to be wobbling between the lightly regulated Anglo-Saxon model of capitalism successfully revived by Conservative Governments in the 1980s and 1990s, and the highly regulated social market model which prevails and struggles in the major economies of Europe. Is the Anglo-Saxon model safe in the hands of New Labour? Should shareholders be concerned that the UK, as the Government proposes, might sign up to a EU Constitution that includes objectives such as "The Union shall work for a Europe of sustainable development based on balanced economic growth, with a social market economy aiming at full employment and social progress"?

The Government claims to be leading the way in Europe to more flexible markets and less red tape. But its own record suggests the opposite. Regulation is pervading all walks of life. The tax and benefit systems have been complicated beyond the wit of most people. It is an interfering government. The economy is less efficient for it. The wealth-creating private sector is less profitable because of it. And the stock market is lower because of it.

APPENDIX 1

CALCULATION OF THE PERFORMANCE OF INTERNATIONAL STOCK MARKETS

	1 May 1997	16 April 2004	% change
UK FTSE 100 Index	4,445.0	4,537.3	2.1
UK All-Share Index	2,138.89	2,259.90	5.7
US Dow Jones	6,976.48	10,451.97	49.8
US S&P 500	939.77	1,134.57	20.7
France CAC 40	2,639.46	3,751.59	42.1
Germany DAX	3,438.07	4,033.98	17.3
Italy BCI	767.62	1,323.31	72.4
Spain Madrid SE	513.35	877.13	70.9
Australia S&P AllOrd	2,488.0	3,424.3	37.6
Canada Composite	5,976.6	8,695.35	45.5
Japan Nikkei 225	19,151.12	11,824.35	– 38.3

CALCULATION OF THE PERFORMANCE OF THE UK STOCK MARKET

Two indices are used to measure the movement in share prices – the Financial Times 30 Index (FT30) up to 1964 and the Financial Times Actuaries All-Share Index (ASI) thereafter. The Retail Price Index is used to measure inflation.

Dates	Index	Change (%)	Inflation (%)	Real Return (%)
1. Labour				
25 July 1945	118.4	(FT30)		
25 October 1951	138.3	16.8	26.3	– 7.5
15 October 1964	106.85	(ASI)		
18 June 1970	120.63	12.9	29.7	– 13.0
28 February 1974	149.27	(ASI)		
3 May 1979	280.28	87.8	112.3	– 11.5
1 May 1997	2,138.89	(ASI)		
16 April 2004	2,259.90	5.7	18.0	– 10.4
2. Conservative				
25 October 1951	138.3	(FT30)		
15 October 1964	364.9	163.8	50.9	74.8
18 June 1970	120.63	(ASI)		
28 February 1974	149.27	23.7	39.4	– 11.3
3 May 1979	280.28	(ASI)		
1 May 1997	2,138.89	663.1	186.1	166.7

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