

The Spending Plan



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The Spending Plan

March 2015

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Foreword

In February 2004 the TPA published its first *Bumper Book of Government Waste*, which identified £50 billion of wasteful spending by politicians. Back then, the TPA was a group of volunteers, so our research was limited by our spare time. Government data on spending was much more secretive then too.

We were concerned by our findings. We knew that the spending commitments being made by the Government at the time – and later supported by all parties – were leading the UK down a dangerous path. We could also see that it was cynically aimed at buying votes in the short term, willfully ignoring the longer term negative consequences.

And we were proved right. The egregious spending built up since then has left the UK government (and hence future taxpayers) with a yawning and unsustainable deficit of around £90 billion (5 per cent of GDP) of which a massive £77 billion is deemed to be structural, ie, it won't go away without deliberate spending cuts, even in good economic times.

In 2012 we published *The Single Income Tax*, the result of our 2020 Tax Commission with the Institute of Directors. This set out the benefits of reducing the tax burden to a more reasonable 33 per cent of GDP. Together therefore, eliminating the unsustainable deficit and cutting taxes to a more reasonable level require that spending comes down from 40.5 per cent to 35.2 per cent, or lower.

This is a problem that has to be fixed but politicians are reluctant to tell us exactly how they will do it. We need more honesty. So in this report we are setting out a detailed and robust plan to reduce spending. And if they disagree with our proposals, then the question is clear: what would you do instead?

Getting spending under control is about much more than dealing with a tough fiscal climate. Reducing public spending should be part of a big picture strategy: it would mean lower taxes for families across Britain, less debt for future generations, and faster economic growth generating prosperity for all. That is the pitch we want politicians to make.

It is important to remember that the spending levels envisaged here will rank us alongside Switzerland, Australia and New Zealand – advanced, civilised economies from which we can learn a lot. Such a vision will still involve taxpayer-funded education and healthcare for all, robust defence and justice systems and massive welfare transfers to those in most need. But it will have eliminated the wasteful and unnecessary programmes and departments that we cannot afford and should do without. And it will leave far more of people's earnings in their own hands to spend, save or invest as they prefer.

It's incredible to see how far the TaxPayers' Alliance has come in such a short space of time. From those early meetings in coffee shops, we are now producing in-depth and thorough reports like *The Spending Plan*, hopefully influencing the public policy debate. As a complement to *The Single Income Tax*, we now have a complete plan for fiscal policy. We will use it as the platform from which we will fight to protect taxpayers.

Matthew Elliott and I would like to congratulate Jonathan Isaby and the team at the TPA for all their hard work on the Spending Plan, in particular John O'Connell for overseeing the research and Rory Meakin and Alex Wild for their dedication to this project. We would also like to thank all the supporters of the TPA over the past eleven years who have enabled us to thoroughly research government fiscal policy and produce this comprehensive Spending Plan for the UK.



Andrew Allum

Chairman & co-founder, TaxPayers' Alliance
March 2015

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Executive summary and menu of savings

Executive summary and menu of savings

The Office for Budget Responsibility has forecast that public spending as a share of GDP will be 35.2 per cent by 2019–20, down from 40.5 per cent in 2014–15. That trend is welcome, both for the public finances in general and taxpayers who have to fund the spending. The question then is: what do policy-makers do to reach that goal? Increasing taxes would be highly damaging to the fragile recovery as the literature shows that high taxes and spending have important and damaging consequences for growth. Relying on revenues rather than spending reductions ignores the big increase in public expenditure since 2001. The coalition government made reducing borrowing the defining mission of their time in office, and the deficit is forecast to be eradicated by 2018–19.

The best way to eliminate the deficit is to reduce spending. Politicians and civil servants should always look to eradicate waste from their budgets, and the savings achieved by cutting out frivolous or unnecessary spending can be significant. But to achieve big and long-term savings a government must cut out entire programmes or substantially reform areas such as public sector pay and pensions. Welfare must be reformed too and this has popular support; 59 per cent of benefit claimants themselves now think benefits are too high and discourage work.

The Spending Plan sets out practical proposals that will help any government meet the OBR's forecast. But more than that, the report explores why an economy with a relatively low spending to GDP ratio will not only grow faster and provide a better standard of living – increasingly so with time – but also will be fairer and more ethical. Detailed sections on tax credits and fiscal churn show how the government takes money from taxpayers only to hand it back out to top up low post-tax wages. The report also explores the ethical justification for lower spending and looks at countries with higher spending levels like Norway and Sweden. An analysis of political history shows that lower government spending is popular in the longer term, supported by a look at international examples of successful spending reduction programmes.

That evidence tells us when fiscal consolidation happens largely on the spending side it is more successful. For instance, Canadian governments of the 1990s reduced the budget deficit from 9.1 per cent of GDP to zero in five years, and have proceeded to run surpluses in almost every year since. This was achieved almost exclusively through reductions in public expenditure – between 1992 and 1997, spending fell by 9 percentage points of GDP, while taxes barely rose.

This report is also a complement to *The Single Income Tax*, the final report of the 2020 Tax Commission. It advocated a programme of tax reform that would drastically simplify taxes and reduce the burden for individuals and businesses. *The Spending Plan* offers a programme of reductions to bring spending as a share of GDP down to a level to allow for the comprehensive tax reform package recommended by the commission.

With a reduction in spending followed by serious tax reform, the UK would be in a far more stable and sustainable fiscal position. A low tax, low spend economy would create better incentives to work, save and invest. It is also much fairer to leave more money in the pockets of those who earned it. We estimate that if spending had have been kept to our recommended level of 31.7 per cent of GDP since 1965, average household income would have been £59,000 instead of £32,000 in 2012–13, almost £27,000 higher.

With a reduction in a spending followed by serious tax reform, the UK would be in a far more stable and sustainable fiscal position

This should be the defining vision for our economy in an internationally competitive world, with an increasingly mobile workforce.

Implementing this vision is no easy task. But it is not impossible, either. Australia, New Zealand and Switzerland will all be spending around a third of GDP in 2017. Political will is needed to ensure we remain competitive in the future.

The OBR has already said that spending as a share of GDP will come down. *The Spending Plan* offers a guide to how this can be achieved. But if policy-makers, commentators and other critics are not convinced by our programme, then they must answer the question: what would they cut instead?

Menu of savings

Some of the fiscal implications of the suggested policy measures overlap with each other, so assessing the scale of a combination simply by adding them together would provide a misleading forecast. However, we have selected two programmes to show how a government could reach two separate targets and estimated the savings that each offers after the effects of overlapping expenditure have been accounted for.

The first programme of 24 policy measures shows what action the government could take to meet the overall spending levels set out in Autumn Statement 2014, where total managed expenditure rises from £737 billion in 2014–15 to £780 billion in 2019–20 (and falls as a share of GDP from 40.5 per cent to 35.2 per cent). Spending not covered by policy measures in both programmes are assumed to rise in line with inflation except for central government debt interest payments, where the Office for Budget Responsibility's forecasts are available and have been used.

The second programme of 41 policy measures shows how the government could bring spending down further still, to meet the level recommended by the TaxPayers' Alliance and Institute of Directors' 2020 Tax Commission, enabling the government to implement the Commission's tax policy proposal outlined in its final report, The Single Income Tax. This second programme ends a year later in 2020–21, when it suggests that TME should have fallen slightly in cash terms, from £737 billion in 2014–15 to £732 billion.

Programme one: meeting coalition spending forecasts

Three government departments – BIS, DECC and DCMS – should all be abolished along with many of their agencies, but those necessary functions they contain should be transferred to other departments, such as higher education to the Department for Education. The government should minimise fiscal churn by scrapping benefits such as bus passes, winter fuel payments and child benefit for those who don't need them. It should carry out the Conservatives' plan to freeze benefits for two years while ditching the unfair 'triple lock' guarantee for state pension claimants.

Scotland's grant should be cut to reflect its prosperity relative to Wales and grants to local authorities should be cut with some tax powers transferred to them, encouraging innovation and efficiency. Planning regulations such as building height restrictions and the green belt which have driven up housing costs should be relaxed to allow more house-building, which would bring down the cost of housing benefit. The coalition government has cut subsidies to trade unions but they should be abolished entirely.

Pay for public sector staff should be managed more efficiently to help bring down the premium over pay in the private sector so taxpayers don't pay over the odds for the work done on their account. National pay bargaining should be scrapped and grants to departments and bodies trimmed to reflect where the cost of living is lower.

Overly generous annual leave should end and the Treasury should impose an excess sickness rate penalty on departments and bodies with high absence rates to provide an incentive to improve management.

The table below lists the measures costed in this programme to reduce spending to the coalition's plan of 35.2 per cent of GDP by 2019–20. We estimate that this programme, while increasing unaffected spending areas in line with inflation, would lead to spending reaching £771 billion in 2019–20, or 34.8 per cent of GDP.

Programme one measures, savings relative to projected spending, £ million

Measure	2015–16	2016–17	2017–18	2018–19	2019–20
Abolish BIS and reassign necessary functions	274	4,112	4,203	4,286	4,371
Abolish child benefit and increase the child element of the child tax credit to address child poverty concerns	0	2,858	2,915	2,980	3,058
Abolish DECC and reassign necessary functions	0	0	338	344	351
Abolish free TV licences	644	655	701	759	835
Abolish the Christmas bonus	154	153	152	150	148
Abolish the Department for Culture, Media and Sport	0	2,743	2,743	2,743	2,743
Abolish the pensions 'triple lock' and link state pension to CPI	0	1,200	2,700	4,800	6,800
Cut annual leave entitlements where overly generous	1,448	1,383	1,420	1,408	1,401
Cut Scotland's grant to match its relative prosperity compared to Wales	4,300	4,260	4,248	4,312	4,385
Establish an excess sickness rate penalty to bring public sector rates into line with the private sector	849	810	788	782	778
Flatten housing benefit rates across expensive areas to cut 10% off bills	0	2,529	2,579	2,638	2,680
Freeze benefits for two years then uprate with CPI	0	722	1,839	1,906	1,962
Means test winter fuel payments	1,479	1,474	1,459	1,446	1,443
Reduce the welfare cap to £20,000	735	735	748	763	778
Relax planning restrictions that inflate housing costs to cut housing benefit bills	0	885	1,805	2,770	3,752
Repeal the Equality Act 2010	0	46	47	48	49
Replace grants to local authorities with devolved taxes to encourage better local spending	804	1,713	2,652	3,710	4,885
Scrap national pay bargaining	0	1,510	2,938	4,372	5,800
Scrap trade unions' subsidies of facility time, grants and office space	105	103	102	100	99
Scrap the childcare subsidy programme named "tax-free childcare"	300	700	800	900	900
Scrap the remaining contributory benefits	0	1,631	1,663	1,638	1,634
Cut the number, scope and budgets of quangos and public bodies	0	367	373	381	389
Stop paying over the odds to borrow money	331	370	527	598	688
Target free bus passes for the elderly on those who genuinely need them	530	548	567	565	560
Sum total of measures	11,953	31,507	38,307	44,399	50,489
Programme total after overlap adjustments	11,904	30,934	37,453	43,413	49,370

Programme one measures, forecast fiscal aggregates, £ billion

	2014–15	2015–16	2016–17	2017–18	2018–19	2019–20
Total managed expenditure	737.1	739.3	730.0	747.3	759.6	771.3
Government spending not covered by <i>Spending Plan</i> measures	162.1	164.0	166.0	169.0	172.4	175.8
Debt interest payments	35.9	40.4	47.3	54.0	57.5	60.1
Government spending within <i>Spending Plan</i> measures	539.1	534.9	516.7	524.3	529.8	535.4
Rest of the economy	1085	1149	1226	1291	1364	1444
GDP	1822	1888	1956	2038	2124	2215

Programme two: savings to deliver the 2020 Tax Commission's *Single Income Tax*

Programme two provides a plan to bring public spending down to the level that was anticipated in the 2020 Tax Commission's final report, *The Single Income Tax*. It recommended a share of national income of 33 per cent of GDP, which would allow much simpler, fairer and lower taxes. However, accounting standards released since then have changed the way both GDP and taxes are calculated, and this means that to achieve the same low rates and simple tax system the level of spending would now be calculated at 31.7 per cent of GDP. Little in reality has changed, except that the same level of GDP is now calculated higher than it was before, meaning that both current and forecast tax and spending levels show up as between 1 and 2 percentage points lower than they used to.

In addition to the savings included in programme one, to meet the objective of bringing spending down to a level ready to implement The Single Income Tax, the government should scrap HS2 and operating subsidies for Transport for London and train operating companies (while leaving capital expenditure given to Network Rail, TfL and Crossrail as planned). TfL and train operating companies should have more room to review their expenditure and vary their prices to make up the revenue so passengers pay more of the cost of their travel instead of taxpayers. Foreign aid for international development should be scrapped along with the department, leaving only a responsibility for humanitarian disaster relief, which should be transferred to the Foreign Office and the Ministry of Defence. Modest charges should be introduced in the NHS for GP appointments, overnight hospital stays and missed appointments. Prescription charges should rise to £10 and exemptions should be withdrawn from everyone except those on low incomes.

Elsewhere in the NHS, GP contracts should be renegotiated to cut excessive pay for GPs, auditing should be tightened to remove 'ghost patients' and the management of NHS estates should be improved to match the most efficient 25 per cent of trusts. Tighter management controls should be set up to cut the use of expensive branded medicines where cheaper generics are available.

The pupil premium should be returned to its 2011 level and universal free school meals scrapped. The school leaving age should return to 16 with the 16–19 bursary scheme ditched and student loans should be made more affordable to taxpayers with higher interest rates and repayments, and lower thresholds. The state pension age should rise faster, to 67 instead of 66 by 2020. The state pension and pension credit should be frozen in 2016–17, increasing with inflation thereafter. Finally, the UK gets a very bad deal from the EU's common agricultural policy (and common fisheries

policy), so the government should withdraw our share of EU funding for the CAP and CFP and administer farming and fisheries programmes itself.

The table below lists the measures costed in this programme to reduce spending to make possible the comprehensive tax reform plan in the 2020 Tax Commission's *Single Income Tax* of 31.7 per cent of GDP by 2020–21. We estimate that this programme along with increasing unaffected spending areas in line with inflation would lead to spending reaching £736 billion in 2020–21. This would mean that the spending ratio would fall to 31.7 per cent of GDP during the latter half of the year. The whole-year average figure would be 31.9 per cent of GDP.

Programme two measures, savings relative to projected spending, £ million

Measure	2015–16	2016–17	2017–18	2018–19	2019–20	2020–21
Abolish BIS and reassign necessary functions	274	4,112	4,203	4,286	4,371	4,459
Abolish DECC and reassign necessary functions	0	0	338	344	351	358
Abolish DfID, scrap development aid and transfer humanitarian responsibilities to the FCO and MoD	0	6,844	13,284	13,921	14,598	15,276
Abolish the Department for Culture, Media and Sport	0	2,743	2,743	2,743	2,743	2,743
Abolish child benefit and increase the child element of the child tax credit to address child poverty concerns	0	2,858	2,915	2,980	3,058	3,138
Abolish free TV licences	644	655	701	759	835	919
Abolish the Christmas bonus	154	153	152	150	148	147
Cut child tax credits to their 2003–04 level in real terms	0	5,254	5,458	5,629	5,765	5,905
Freeze benefits for two years then uprate with CPI	0	722	1,839	1,906	1,962	2,018
Means test winter fuel payments	1,479	1,474	1,459	1,446	1,443	1,440
Reduce the welfare cap to £20,000	735	735	748	763	778	794
Scrap the childcare subsidy programme named “tax-free childcare”	300	700	800	900	900	900
Scrap the remaining contributory benefits	0	1,631	1,663	1,638	1,634	1,630
Target free bus passes for the elderly on those who genuinely need them	530	548	567	565	560	553
Flatten housing benefit rates across expensive areas to cut 10 per cent off bills	0	2,529	2,579	2,638	2,680	2,720
Relax planning restrictions that inflate housing costs to cut housing benefit bills	0	885	1,805	2,770	3,752	4,764
Amend repayment terms on student loans to make them more affordable	2,692	2,692	2,692	2,692	2,692	2,692
Return the compulsory school leaving age to 16 and scrap 16–19 bursary scheme	1,113	1,126	1,146	1,169	1,192	1,216
Return the pupil premium to 2011 levels	1,846	1,868	1,900	1,938	1,955	1,973
Scrap universal free school meals for pupils in reception to year 2	377	769	789	810	832	855
Increase the extent of charges in the NHS	0	8,997	8,322	8,690	9,077	9,359
Raise the efficiency of NHS estates to match the top 25 per cent	660	1,335	2,039	2,773	3,536	3,606

Measure	2015–16	2016–17	2017–18	2018–19	2019–20	2020–21
Reform patient list auditing to cut NHS 'ghost patients'	0	132	135	139	143	147
Renegotiate contracts to cut excessive pay for GPs	0	527	1,072	1,094	1,115	1,137
Stop prescribing branded medicines where generics are suitable	158	166	176	187	199	211
Repeal the Equality Act 2010	0	46	47	48	49	50
Replace grants to local authorities with devolved taxes to encourage better local spending	804	1,713	2,652	3,710	4,885	6,198
Shrink grants to Scotland, Northern Ireland and Wales in line with England and cut Scotland's grant to match its relative prosperity compared to Wales	5,291	5,143	5,429	6,981	8,684	10,408
Cut the number, scope and budgets of quangos and public bodies	0	367	373	381	389	396
Withdraw UK funding for EU agriculture and fisheries and spend it directly	0	2,791	2,791	2,791	2,791	2,791
Cut annual leave entitlements where overly generous	1,448	1,383	1,420	1,408	1,401	1,395
Establish an excess sickness rate penalty to bring public sector rates into line with the private sector	849	810	788	782	778	774
Scrap national pay bargaining	0	1,510	2,938	4,372	5,800	5,771
Freeze the basic state pension and minimum income guarantee in 2016–17, then uprate with CPI	0	2,400	3,900	6,000	8,000	10,000
Raise state pension age to 67 by 2021	0	0	108	1,034	2,227	2,380
Scrap trade unions' subsidies of facility time, grants and office space	105	103	102	100	99	97
Stop paying over the odds to borrow money	331	370	527	598	688	795
Abolish rail operator subsidies and increase premiums by 33 per cent by deregulating fares	0	721	1,006	1,038	1,434	1,434
Abolish the bus service operators' grant	0	279	284	290	296	302
Scrap HS2	490	1,886	1,693	3,300	4,000	4,498
Scrap operating subsidies to TfL	0	179	365	557	756	769
Sum total of measures	20,280	69,156	83,949	96,320	108,597	117,018
Programme total after overlap adjustments	20,226	68,573	83,073	95,253	107,285	115,549

Programme two measures, forecast fiscal aggregates, £ billion

	2014–15	2015–16	2016–17	2017–18	2018–19	2019–20	2020–21
Total managed expenditure	737.1	733.4	698.0	708.2	717.1	724.5	736.0
Government spending not covered by <i>Spending Plan</i> measures	89.7	90.8	91.9	93.5	95.4	97.3	99.2
Debt interest payments	35.9	40.4	47.3	54.0	57.5	60.1	62.7
Government spending within <i>Spending Plan</i> measures	611.5	602.2	558.9	560.7	564.2	567.1	574.0
Rest of the economy	1085	1155	1258	1330	1407	1491	1574
GDP	1822	1888	1956	2038	2124	2215	2310

Prologue

While we believe this plan robustly and comprehensively demonstrates how to bring spending down to the meet the forecast of 35.2 per cent of GDP or the 2020 Tax Commission target of 31.7 per cent of GDP, readers should bear in mind four important aspects.

There is more waste than that identified in the policy measures

We have good reason to believe that spending on many areas such as defence procurement and aspects of employment terms and conditions is wasteful, and which better policies could reduce or eliminate. Due to factors such as contractual complexity or a lack of adequate official data, we were unable to ascertain sufficiently robust estimates of baseline costs and the savings that might arise from such policy measures.

Deeper public policy reform is needed, too

Fundamental reform in areas such as pensions, healthcare and education should be explored with a view to minimising fiscal churn and removing constraints on markets that stop providers (and potential providers) from delivering better, cheaper services. That such reform was beyond the scope of this plan – which seeks to propose the most concrete, deliverable measures that we can be sure would deliver benefits by 2020 – does not mean that it should not be pursued.

Saving estimates, implementation dates and current policy

Savings estimates are usually based on forecasts which are themselves based on current policy. Implementation dates are based on assumptions of the soonest practical implementation date possible. With a small number of exceptions where timing is crucial, the date a policy is implemented would not substantially affect the potential saving in 2020. For further details, please see the notes, sources and methodology section.

Any government should implement programme two measures

Even if the next government does not wish to bring down spending by enough to allow for a comprehensive redesign of the tax system as proposed by the 2020 Tax Commission, it should adopt the measures in programme two nonetheless. For example, HS2 is a bad project that should be scrapped immediately. If the money saved wasn't simply left to allow overall spending to fall so that taxes or the deficit could be cut, it would nonetheless be better spent on other projects.

Chapter one

*Fiscal churn
should be
minimised*

1. Fiscal churn should be minimised

Fiscal churn happens when money is taken away from individuals and then given back to them in benefits. It can be seen as distinct from fiscal redistribution, where money is taken from one group of individuals and distributed to a different group. While the problems that arise from redistribution are well known, fiscal churn is perhaps particularly problematic because although the churned money must be raised through taxation (with all the economically destructive incentives that entails) it leaves the recipient no better off than if the government were to have simply left it in his pocket in the first place. In fact, he is worse off because he has to fund the administration of the churn.

So governments should take steps to minimise and eliminate fiscal churn wherever possible, not just to save on administration costs and avoid the need to levy heavier taxes to fund it, but also to restore the self-reliance and independence which having to claim money from authority saps.

1.1. Work for the Dole

Over the past 50 years, welfare spending has grown relentlessly and now consumes 30 per cent of all government spending. Of this, 45 per cent goes on benefits for working age people.

The latest available figures, from 2013, show 4.6 million working age people are currently not working and reliant on benefits – a number that has remained stubbornly high even when the economy has grown (it has been over 4 million for decades). Typically, each claimant receives several benefits, and in many cases the value of these benefits taken together adds up to £15,000 to £25,000 per year – about the same as a low-skilled worker earns and often more than the minimum wage. It is no wonder that benefit dependency is widespread when there is so little incentive to get into low-paid work. This costs money we can ill afford and is deeply socially corrosive. One in eight children now grows up in a household where no one works.

Some argue that the jobs simply aren't there, particularly with the difficult economic situation. However, the data shows that 4.5 million new jobs have been created since 1997,¹ and that employment today stands at a higher level than at any time in UK history. As 3.5 million jobs were created since 2000, out-of-work welfare claimant rolls stayed about the same. UK welfare claimants were not moving into work as jobs were created. Two-thirds of the jobs created were taken by immigrants prepared to work hard rather than rely on benefits. Many of the UK population on out-of-work benefits evidently weren't interested in the new jobs.

The current government is trying to remedy the situation, and their policies are moving in the right direction. Since 2013, benefits have only gone up by 1 per cent a year – compared to 2.9 per cent growth in wages and salaries last year and a forecast of 3.5 per cent this year – thereby tipping the balance back a little in favour of working. However, it will take some time to outweigh the regrettable 5.2 per cent blanket benefit increase put through in 2012, when wages and salaries grew by just 2.4 per cent.

The universal credit is designed to make sure that work always pays slightly better than being on benefits, particularly for those on lower incomes, and recent Department for Work and Pensions evidence suggests that it is having a positive

1. ONS, *Labour Market Statistics*, February 2015

Work for the Dole would remove the option of receiving an income similar to many people's full time wages (at taxpayers' expense) while giving nothing back to society in return

effect. This is a welcome improvement on the previous system, but evidence from the US suggests that this will have a limited effect – because some people are still happy to live on benefits even if by working they could have a slightly higher income. The work programme, good in concept, has not yet delivered results that are clearly better than had there been no intervention (although this may be due to selection bias in the sample of jobseekers referred). And the mandatory work programme, again good in concept, is very limited in scope and it has not delivered clear results thus far. The government's policy initiatives are all sensible moves in the right direction. But they need to be strengthened to stand a better chance of delivering radically improved outcomes.

The TaxPayers' Alliance launched its Work for the Dole campaign in September 2013 with a detailed report authored by entrepreneur Chris Philp.² Three weeks later at the Conservatives' party conference, the work and pensions secretary, Iain Duncan Smith, announced that the government would implement most of the campaign's recommendations. The government's policy is called help to work and began in April 2014.

Work for the Dole would remove the option of receiving an income similar to many people's full time wages (at taxpayers' expense) while giving nothing back to society in return.

Work for the Dole would require, after a certain time, anyone claiming the universal credit to undertake compulsory activity or (if claiming incapacity benefit or employment and support allowance) activity that they are physically able to do. This would include training or work activity. Anyone over the state pension age would be excluded and pension provision would not be affected.

The required activity would have the following features:

- It would be for 30 hours per week for anyone not working
- For anyone working, it would top up their working time to 30 hours per week
- The 30 hour benchmark may be adjusted downwards for people with childcare or similar obligations. For some people there would be no requirement at all (such as people caring for a child under four or caring for someone with a severe disability)
- The programme would continue indefinitely, until either (i) the person is working more than 30 hours per week (or their benchmark if lower) or (ii) until they stop claiming benefits entirely

The required activity would consist of one of the following:

- Community work, such as clearing parks or cleaning graffiti (provided that such work would not ordinarily be performed on a paid-for basis)
- Work for a registered charity
- Participation in a recognised training programme
- Work experience, or participation in a work-based training programme or apprenticeship-type scheme. If these are with commercial organisations, then there must be genuine skills development – it cannot simply be free labour for the commercial company
- Physical attendance at a job search centre where meaningful job search and preparation activities would be undertaken

2. Philp, C., *Work for the dole: A proposal to fix welfare dependency*, TaxPayers' Alliance, 2013. All references in this report, and polling data, can found here: <http://lowtax.es/1Dzs176>

Work search activity should continue alongside the mandatory activity, which is why the mandatory activity period is set at 30 hours and not 40 hours per week.

Referrals onto the scheme would automatically occur (on a non-discretionary basis) at the following times:

- For those with a history of more than five years of national insurance contributions, after two years of claiming the universal credit
- For those with a history of two to five years of national insurance contributions, after one year of claiming the universal credit
- For those with a history of less than two years of national insurance contributions, after three months of claiming the universal credit

This has the effect of giving more latitude to people who have paid in to the system previously and strengthens the contributory concept in out-of-work benefits.

Sanctions (ie suspension of benefits payments) for non-compliance with requirements set by Jobcentre Plus advisers are currently time limited, only applied to jobseeker's allowance and ESA (except for those who have been transferred to universal credit) and are applied at the discretion of those advisers. They are used only used sporadically and so are not currently especially effective.

Anyone not compliant with Work for the Dole activity requirements would automatically have *all* their universal credit payments suspended as long as the person is not Working for the Dole. If a change to EU law or opt-out is required for full implementation, the government should seek this as part of a renegotiation of the UK's relationship with the EU.

Although the complete suspension of universal credit benefit payments may seem an extreme sanction, the evidence from the US suggests that this is required to make the scheme fully effective.

These proposals are designed to deliver the following policy outcomes:

- The tax-paying public are entitled to see some kind of community service in return for the benefits that they pay for after a certain time.
- Work for the Dole would eliminate some fraud and tackle the perception of fraud.
- Work for the Dole under the universal credit umbrella would remove the option of claiming benefits other than JSA and ESA (such as housing benefit and the child tax credit) while in fact not seeking work, which is currently possible.
- Work for the Dole would provide a powerful incentive to seek a proper job (by making it less tolerable to subsist on benefits in the long term) while at the same time helping participants get into the habit of working.
- The work experience, apprenticeship or training activities that will form part of the package can enhance claimants' skills and the credentials of the participant.

Establishing Work for the Dole will cost money initially. It is estimated that 575,000 people would be eligible for referral onto the programme on day one. The cost of initially administering the programme is estimated at £1.05 billion in the first year. Based on the kind of changes in behaviour that this kind of system has produced in other countries, the programme should rapidly lead to a gross saving of £3.51 billion per year on an ongoing basis and a net saving of £2.46 billion in the

first year. Based on the results of similar programmes around the world, 345,000 will come off benefits over time.

These proposals will reduce the cost of welfare and increase the number of people in work. This is good for taxpayers, good for the economy and ultimately good for the people who move back into work. The best route out of poverty lies in working, not relying on benefits, and these proposals will result in more people working.

It is expected that the deterrent effect of the programme and the fact that people would adjust their behaviour means that quite quickly the scale of the programme would reduce, and the size of the net saving compared to not introducing the scheme would increase.

The evidence from around the world is compelling: Work for the Dole (or Workfare) programmes are successful in terms of reducing welfare dependency:

- USA temporary assistance for needy families program: 1996–2000 saw a 60 per cent reduction in welfare caseloads
- USA – New York City work experience program: 1995–2000 saw welfare caseloads decline by 50 per cent as Mayor Giuliani implemented tougher welfare conditions and a workfare programme
- USA – Wisconsin works: 1990–2000 saw an 80 per cent reduction in welfare caseloads
- Canada – Ontario works: 1998–2004 saw caseloads decline by 54 per cent
- UK – project work pilot: 1996–97 saw a 46 per cent reduction in welfare claims

Attitudes towards welfare dependency have hugely hardened over the last ten years: 57 per cent of the public now believe that benefits are too high and discourage work

Public opinion is ahead of the politicians on this issue. Attitudes towards welfare dependency have hugely hardened over the last ten years. 57 per cent of the public now believe that benefits are too high and discourage work, up from around 30 per cent in the 1990s. Even 59 per cent of benefit claimants themselves now think benefits are too high and discourage work. There is 70 per cent support for the £26,000 per year benefit cap, 77 per cent support for means testing child benefit and 75 per cent support for stopping benefits for people who refuse work. Only 28 per cent feel that the government is being too harsh and 47 per cent felt that the government should do more to force people into work. There is 75 per cent net agreement for the proposition that those who can should do full-time community service for their benefits.

Fixing welfare dependency is a fiscal imperative. It is also a social imperative because endemic worklessness amongst millions of citizens stresses the fabric of society and denies them the chance to improve their lot. Public opinion is behind stronger action.

Policy-makers should monitor the effectiveness of the government's Help to Work policy and review it against the detail of the TaxPayers' Alliance Work for the Dole, particularly with respect to the extent of sanctions.

1.2. Pension reform

Spending on pensions has risen inexorably with an ageing population. Adjusted for inflation, spending on the state pension and pension credit has doubled since 1996 and is approaching £100 billion a year. When it was introduced in 1908, the state pension age was 70 and average life expectancies were much lower. Even when lowered to 65 in 1925, most people could not expect to live long enough to claim a

pension. By contrast, life expectancy is now high and rising rapidly. Not only are we living longer, but thanks to better diets, healthcare and technology, people are much more likely to be able to work at a given age.

The scale of spending commitments for pensioners means that no government serious about getting a grip on spending can afford to ignore pension reform. Therefore pensions should be reformed with a view to reducing the burden on taxpayers by raising the state pension age faster and cutting back on unaffordable promises of increases.

Policy 1: freeze the basic state pension and minimum income guarantee in 2016–17, then uprate with CPI

Spending on the state pension and pension credit has become unaffordable. The “triple lock” promise – that pensions will always rise by whichever is higher out of inflation, earnings growth or 2.5 per cent – made by the Conservatives before the 2010 election was irresponsibly profligate. It is doubly so to keep it now as spending is forecast to rise from £93 billion to £108 billion in 2019–20. Instead, the next government should ditch the policy and freeze pensions in 2016–17. Thereafter, they should increase them in line with inflation. This would save £10 billion by 2020–21, part of our programme to bring spending down to 31.7 per cent of GDP.

As part of our list of savings to meet the current government’s aim of reducing spending to 35.2 per cent of GDP by 2019–20, we also assessed a less prudent policy. This would scrap the triple lock and increase pensions by inflation but not freeze them in 2016–17. We estimate that this would save around £6.8 billion.

Policy 2: raise the state pension age faster, to 67 by 2020

The government has recognised that the ageing population is leading to an affordability crisis for the state pension. The Pensions Act 2011 accelerated the increase in the state pension age and the effects on the exchequer will begin to be felt in 2016. By 2020, it will have risen to 66 for both men and women. The Pensions Act 2014 increased the age to 67, although this will not happen until 2028. While these reforms are a step in the right direction, they are inadequate.

Using estimates of monthly age cohorts by birth relating to people who will reach the state pension age under current rules up to 2020–21, we modelled how many new pension claims there would be each financial year. We then ran the same model assuming that the state pension age would be rising to 67 instead of 66. We multiplied the difference by Department for Work and Pensions forecasts of average state pension and pension credit payments to calculate an estimate of the difference. We found that this would save around £2.2 billion in 2019–20.

Fundamentally, it is difficult to defend why taxpayers should be told to fund decades-long retirements for healthy and fit people in their 60s at all, except for the fact that people have been promised state pension-funded retirements and made their plans accordingly, meaning there is an element of unfairness about removing that entitlement. Counteracting this, however, is the unfairness of telling taxpayers to pay for it, as an ever larger proportion of the population is aged over 65 and the average length of retirement gets longer.

The state pension age should be increased to 67 by 2020. It is beyond the scope of *The Spending Plan* to make recommendations for spending that will not have effect until after 2020–21. Nonetheless, policy-makers should not stop at 67, and they should not wait until 2026 before taking further action. The sooner such changes are announced, the more able those affected will be to adjust their plans if they would prefer to do so.

Policy 3: target free bus passes for the elderly on those who genuinely need them

In England, local authorities are currently given grants to provide concessionary, off-peak bus travel to eligible disabled people and eligible older people (those above the women's state pension age).

Some authorities such as in London provide further concessions with those over the age of 60 granted free peak time travel on buses, trams, Underground, Overground and DLR.

Concessionary fares are the responsibility of the devolved governments of Scotland, Northern Ireland and Wales.

The requirement for local authorities to provide concessionary bus fares for older people should be abolished and the formula grant from the Department for Communities and Local Government reduced accordingly.

The grant would still be paid to local authorities to provide concessionary bus travel for claimants of disability living allowance, the personal independence payment and the attendance allowance (5 million people).

The cost of providing statutory concessionary fares to eligible older and disabled people was £1.087 billion in 2014–15, an increase of 1 per cent on the cost in 2013–14. After allowing for claimants of the above benefits, more than £500 million would be saved in each of the next six years.

Policy 4: abolish free TV licences

Currently, those over 75 are eligible for free TV licences which ordinarily cost £145.50. This policy will cost £644 million in 2015–16, rising to £918 million in 2020–21.

If the BBC wishes to continue exempting over 75s from the licence fee, it could be financed from their budget but no increase in the licence fee should be approved.

Policy 5: means test winter fuel payments

The winter fuel payment is a tax-free annual payment to eligible pensioners. It is a cash payment that recipients can spend on whatever they please.

All recipients of pension credit (guarantee credit) would continue to receive the payment in full. In 2015–16 this would mean the poorest 17 per cent of pensioners receive the full payment. The payments range from £100–£300 per annum so £200 has been used to calculate savings.

Pensioners with weekly income above the guarantee credit (£148.35 in 2014–15) will have the payment withdrawn so that only pensioners in the bottom third of the income distribution will receive winter fuel payments. The estimated spending on those who earn more than the guarantee credit level was calculated by subtracting the pension credit caseload from the bottom third of pensioners and multiplying the result by an assumed £100 each.

Policy 6: reduce the welfare cap to £20,000

Analysis of the coalition government's £26,000 benefit cap led to increased employment levels in affected households. To continue this progress the government should go further and reduce the benefit cap to £20,000.

A limit of £20,000 is still significantly above the national minimum wage which is around £13,000 for an adult over 21 working full time. It is significantly closer to national average post-tax pay, whereas the £26,000 cap is equivalent to a pre-tax income of around £35,000. The government was right to argue that being on benefits

should not pay more than average wages. That's why they should reduce the cap to the level of post-tax income for someone in work.

Policy 7: abolish child benefit and increase the child element of the child tax credit

There have been efforts to ensure that better-off families stop receiving child benefit. George Osborne announced at the 2010 Conservative party conference that child benefit would tapered away from individuals earning over £50,000 and withdrawn at £60,000. But there were problems with that policy which quickly came to light, not least that households with two earners who were on each on, say, £50,000 would keep the benefit in full. The Institute for Fiscal Studies showed how inefficient the proposals were in a 2012 report:³

170,000 families could increase their net income if an individual in that family managed to lower their pre-tax income; a further 200,000 families could find themselves with a lower net income if their pre-tax income were to rise slightly. It would mean removing Child Benefit from some couples whose joint earnings were £43,000 but not removing it from other couples whose joint earnings were £84,000.

A more sensible option would be to integrate child benefit into the Child Tax Credit:⁴

Combining child benefit with tax credits (or, from October 2013, with universal credit) would allow a more sensible withdrawal against the combined income of a couple, rather than against that of the higher-income individual. Consequently, it would lead smaller losses amongst one-earner couples and lone parents than the government's proposal.

Once administration costs are taken into account, this measure would save more than £3 billion a year by 2020–21, assuming a consistent rate of increase in costs.

Policy 8: scrap the childcare subsidy programme named “tax-free childcare”

Under this scheme, the government will pay 20 per cent of the cost of childcare up to a maximum of £10,000, leaving parents to pay the remaining 80 per cent. With no more justification beyond the fact that 20 per cent happens to be the same number as the basic rate of income tax, the government branded it as “tax-free childcare”. The benefit parents receive is the same irrespective of whether their marginal tax rates is 20 per cent, 40 per cent or 45 per cent. In fact, the money is paid even if the parents are not even taxpayers. But the deceitful name is not why the subsidy should be scrapped.

This scheme does nothing to tackle the root causes of the high costs of childcare (see section 2.1.5 for further discussion), which are largely down to government policies in the first place. Things like heavy regulation of qualifications and stringent staff-to-children ratios have made childcare extremely expensive. But while it does nothing about the costs of regulation beyond transferring some of them from parents to taxpayers, it will cost an estimated £900 million by 2018–19.⁵ Over lifetimes, there

3. Brewer, M., & Joyce, R., *Withdrawing Child Benefit from better-off families: are there better options?*, Institute for Fiscal Studies, 2012

4. Ibid.

5. Office for Budget Responsibility, *December 2014 Economic and Fiscal Outlook: Fiscal Supplementary Tables, 2014*, table 2.16

is a large overlap between parents and taxpayers as groups of people, highlighting the wasteful and unnecessary “fiscal churn” that schemes such as this represent.

Policy 9: cut child tax credits to their 2003–04 level in real terms

The Institute for Fiscal Studies calculated that reversing the discretionary increases in the child element of the child tax credit since 2003–04 would save around £5.1 billion in 2015–16.⁶ We assumed that the fraction of forecast total tax credit expenditure in 2019–20 would be the same as next year to estimate that this would equate to a saving of around £5.8 billion in 2019–20.

That increase since 2003–04 was and remains unaffordable. The government should reverse it.

Policy 10: flatten housing benefit rates across expensive areas to cut 10 per cent off bills

Flattening housing benefit rates by reducing the number of ‘broad rental market areas’ (BRMAs) could significantly reduce housing benefit expenditure, particularly in London and the South East. There are over 150 BRMAs in England alone, and areas of high rent have disproportionately large numbers of housing benefit claimants. By determining rates over a wider rental market area, there would be lower benefit expenditure and less pressure in high-cost areas within regions.

Housing benefit rates should be flattened across the UK in order to reduce expenditure by 10 per cent. People who have to pay for their own housing frequently have to broaden their geographical sights to find somewhere in their price range so it is not unreasonable for benefit claimants to be asked to do the same. Many of those who work in London are forced by high prices to look outside the city and commute. Housing benefit claimants should not be immune from this reality of life.

It was not possible to reliably estimate the effects of savings from defined measure so we recommend that the Department for Work and Pensions investigates the data they have to estimate what level of broaden could achieve a saving of at least 10 per cent of the housing benefit bill.

Policy 11: scrap contributory benefits

Contributory benefits are paid dependent on national insurance contributions. While a significant sum is spent on them, most of the expenditure would be replaced by equivalent benefits where eligibility is assessed on income. The Institute for Fiscal Studies estimates that scrapping contributory eligibility for jobseeker’s allowance and employment and support allowance would save around £600 million in 2015–16. Adding the forecast expenditure on maternity allowance and bereavement benefits brings the total to around £1.6 billion.

These benefits are paid to people who do not need them. It makes little sense to tax people and then hand those same people back benefits in the form of insurance against events that they could otherwise afford to insure themselves against if they wanted to. It would also make abolition of national insurance simpler.

Flattening housing benefit rates by reducing the number of ‘broad rental market areas’ (BRMAs) could significantly reduce housing benefit expenditure

6. Johnson, P., et al, *Green Budget 2015*, Institute for Fiscal Studies, 2015

Chapter two

*Government
should only
regulate where
necessary*

2. Government should only regulate where necessary

As people go about their jobs and lives, they are subject to government regulations at almost every turn, especially in business. The myriad forms and checks that people must go through to satisfy government cost billions of pounds every year and stop more productive activities from occurring. Burdensome regulation is often welcomed by big businesses as it locks out new, disruptive competition from smaller operators less able to absorb the costs of compliance.

Most regulations have an upside but having an upside isn't enough. The clear, visible upside must outweigh the often hidden, often dispersed downsides, too. Excessive regulation hinders public sector productivity too. Police officers having to fill out pages of forms when reporting straightforward crimes, for instance, or health and safety legislation that demands excessive checks for basic tasks. This mountain of bureaucracy is added to by Brussels. When the government imposes new regulations, it quite often has to set up a new quango to enforce them, which costs even more money. Some regulation is necessary but when it causes affordability concerns in markets such as housing, food and childcare or is a problem in the wider economy then we should ask if it's too much and how it might be cut back.

2.1. Kristian Niemietz: government should reduce the demand for welfare

The parliament of 2010–15 was dominated by the cost of living debate. Stagnant wages were not keeping up with inflation and political parties and interest groups were proposing different ways to tackle the issue. But those advocating more government intervention – through regulations and higher taxes – failed to see that it was exactly those actions that were the main causes of high living costs. In *Redefining the Poverty Debate – a landmark report for the Institute of Economic Affairs* – Dr Kristian Niemietz outlined ways to genuinely tackle poverty by eliminating government interventions in areas such as planning, energy markets and childcare. Reform in these areas not only saves taxpayers' money, but reduces the cost of living for millions of people.

2.1.1. The “iron triangle” of social policy and its discontent

The social policy literature often describes the trade-offs faced in welfare policy design in terms of an “iron triangle”. The triangle's corners represent policy aims that are desirable, but which are also in conflict with one another. These aims are:

- Ensuring adequate financial protection against poverty.
- Maintaining strong incentives for benefit recipients to enter or re-enter the workforce, progress in it, and build up savings. This refers to incentives to take up employment or self-employment, to increase working hours, to acquire skills, save and invest.
- Keeping public spending on welfare under control, so that tax can be kept low.

When evaluating this welfare system through the iron triangle lens, it performs poorly on all three dimensions

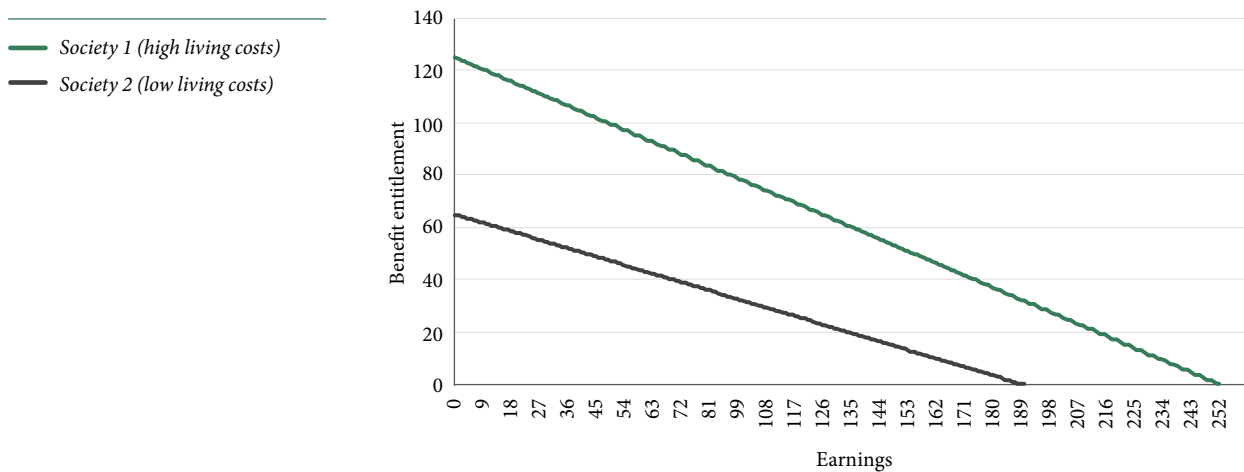
The concept of the iron triangle is intuitively appealing but an analysis of welfare policies through this lens can be shallow and incomplete. It focuses too much attention on how a welfare system's parameters are specified, overlooking the fact that welfare systems can outperform others on *all three* dimensions because their performance is affected by a lot of things that take place outside of the triangles. The shortcomings of the concept can be illustrated by imagining a hypothetical society in which the median income is £250, and where a low-skilled worker can earn £150 when working full-time and year-round. It is assumed that people need £130 to avoid poverty (more on the definition later). There is an income replacement benefit of £125. Those who have no income of their own receive the full rate, while for those who have some earned income, each pound earned reduces benefit entitlement by 50 pence.

When evaluating this welfare system through the iron triangle lens, it performs poorly on all three dimensions. The benefit level is set slightly below the poverty threshold, so this welfare system does not provide full protection against poverty. Yet it does not provide strong work incentives either. Through benefit withdrawal, recipients are effectively taxed at a marginal rate of 50 per cent, a very high rate under any realistic assumptions about the elasticity of labour supply. Last but not least, the system is not especially cost-effective either. It is only when earnings reach £250 that benefits are fully withdrawn, which means that in this society, half of the population are in receipt of benefits.

Within the iron triangle framework, there is not much that could be done to improve this system. Raising benefits is not an attractive option when work incentives are already weak, and public spending is already high. Cutting benefits is not an attractive option when benefit levels are already insufficient to protect recipients against poverty. Lowering the withdrawal rate is not an attractive option when a large share of the population is already in receipt of benefits. Raising the taper rate is not an attractive option when low-earners are already unduly penalised for increasing their earnings. This system is unattractive regardless of which corners of the triangle one prioritises – but this is not due to faulty design. The basic problem in this hypothetical society is not that the welfare system's parameters are poorly chosen. The basic problem is that external constraints *allow* no “good” choices. The poverty level is simply too close to the income level that the low-skilled could earn through their own efforts. Under such circumstances, a benefit level anywhere near the poverty level will inevitably produce a situation in which the low-skilled will not be much better off working than not working. And the problems only just begin here. If the benefit level is high relative to earnings levels, a high withdrawal rate will also be required, because otherwise, benefit entitlement will sprawl absurdly high up the income distribution. High withdrawal rates reduce the payoff from increasing earnings, discouraging people from, for example, moving from part-time to full-time employment.

Now consider a society which is identical except insofar as (for whatever reason) a sum of just £65 is sufficient to avoid poverty. In that society, the task of designing a welfare system which performs well on all three criteria of the iron triangle is infinitely easier. The benefit rate could be set at the poverty threshold, making the system fully poverty-proof. The withdrawal rate could be low, providing much stronger incentives to progress in work. At a withdrawal rate of, for example, 35 per cent, somebody earning three quarters of the median income would no longer be entitled to any benefits, so despite the flatter withdrawal, the number of benefit recipients would be lower than in the first society.

Figure 2.1: benefits and benefit withdrawal in two hypothetical societies



The welfare system of the latter society is clearly superior to that of the former, and it is superior in every respect. It is better at poverty prevention, better at preserving work incentives, and better at saving taxpayers' money. This is already true in a static perspective, and over time, the performance of the two systems would only diverge further. In the second society, a greater proportion of the workless would take up jobs, and a greater proportion of those in minor and/or sporadic employment would move on to full-time, year-round employment. So the second society will simply not need high levels of welfare spending in order to prevent poverty. It can therefore afford tax cuts for those on low and middle incomes, leading yet again to higher living standards for the low-paid and stronger work incentives. The second society has not broken out of the iron triangle; it still faces, in principle, the same trade-offs as the first society. But it has created conditions under which these constraints are manageable, and under which, over time, advancements on all three fronts are possible. The first society is trapped in the iron triangle, the second one has created something more akin to a virtuous circle.

This chapter will argue that the UK's welfare system is currently a lot like the system of the first hypothetical economy described above. It performs poorly on all three criteria of the iron triangle – high fiscal costs, poor work incentives, and insufficient protection against poverty – and that this situation could not be substantially remedied through parametric reforms. But this chapter will also argue that with sufficient political will, the UK could easily emulate the conditions of the second hypothetical economy. The virtuous circle described above could take effect in the UK as well. The UK has everything it takes to create a situation in which high living standards, strong work incentives, high work levels and low taxes for low-to-middle income earners mutually reinforce each other.

2.1.2. Market distortions drive up welfare spending

The above examples referred to an unspecified "poverty level", as if there were an obvious threshold level separating the poor from the non-poor. In reality, there is nothing obvious about measuring poverty and setting poverty lines. On the contrary, it been a subject of academic controversy for more than a century. But large-scale surveys show a high degree of agreement about which goods and services constitute "necessities" in modern Britain and there are good reasons for building a poverty

measure on this basis.⁷ Poverty could be measured by assembling a consumer basket containing all those goods and services that the majority of the population consider necessities, and collecting their market prices. The poverty line would simply be the total cost of that consumer basket, and it would be dominated by the cost of items like housing, childcare, food and energy. The starting point of a cost-effective anti-poverty policy would be to study systematic variation in the cost of those items across comparable countries as well as within countries across time, and where substantial systematic variation exists, to identify its drivers.

In the above examples, the first society could be thought of as representing an economy in which the markets for basic essentials have been severely distorted. Basic essentials are expensive, not because they are inherently scarce, but because misguided policies have curtailed their supply. This makes high welfare spending necessary, even though “high”, in this context, does not translate to high levels of material comfort for the recipients. High welfare payments do not lead to comfortable living standards, they merely reflect the high cost of basic essentials. But there is a fundamental asymmetry at work: rising costs of basic essentials lead to higher benefit levels, but they do not lead to higher wages at the lower end of the wage distribution. Wages are determined by productivity at the margin, not living expenses. Rising rents and energy bills do not make an employee’s labour more attractive to an employer. Under conditions of distorted markets for essentials, the difference in living standards between the low-paid and the workless will therefore shrink. This will make low-paid work relatively less attractive. To some extent, this trend can be alleviated by expanding in-work benefits and/or making wage replacement benefits “portable” into employment. But this will inevitably involve a very high fiscal cost, while also leading to a range of undesirable knock-on effects, such as subjecting a much larger share of the population to means-testing – with all the problems this entails.

What this society should do is to follow the lead of the second society and remove the supply-side distortions in the markets for essentials. This will decrease welfare spending – not by penalising the workless, but by cutting the cost of attaining a decent minimum living standard. Benefit levels can then be adjusted downwards without decreasing their purchasing power.

This hypothetical society is a lot like the UK today. In the UK, the markets for various basic essentials are severely distorted. The most extreme case is the housing market, but substantial distortions also exist in the energy sector, childcare and agriculture. These distortions have led to an unfavourable combination of unnecessarily high basic living costs, high welfare spending, weak work incentives, high rates of economic inactivity among disadvantaged groups, and, last but by no means least, unnecessarily diminished living standards among the low-paid. Removing these distortions would unleash the virtuous circle described above. Easily affordable rents, low food and energy bills and reasonably priced childcare would greatly diminish the need for public expenditure on out-of-work benefits and in-work benefits alike, by enabling far more people to afford all of these items without government assistance.

As a desirable side-effect, rising living standards of the low-paid would make low-skilled work vastly more attractive relative to not working. Far fewer people would require in-work benefits to supplement their wages. The consequent removal of some of the taper would in turn make progressing in the labour market become a lot more attractive. More workless people would enter low-paid work, more part-time workers would move into full-time work, more unskilled workers would

7. Niemietz, K., *An analysis of the welfare cuts in the Comprehensive Spending Review and the Budget 2010*, Economic Affairs, 31, 1, Institute of Economic Affairs, 2011, pp. 80–85

acquire skills to move into more demanding positions, etc. Enormous savings in benefit spending could be achieved, which could be used to cut income tax and national insurance, thus reinforcing the beneficial effects just described. This is what a supply-side reform agenda, based on removing distortions from the markets for essentials, could achieve.

Unfortunately, there is almost always somebody who benefits from market distortions, no matter how wasteful and inefficient their overall effects. Distortions can create economic rents. We know from public choice economics that lucrative rent-seeking becomes worthwhile when those rents are concentrated and tangible, while the costs of the policy are more abstract (requiring knowledge about a hypothetical counterfactual) and dispersed. Compared to those who bear the cost of the policy, the beneficiaries will be better organised, more knowledgeable about the relevant policy area, more active and more vocal in defending their privileges. This means that even if there is a clear economic and social case for removing those distortions, political incentives can work in favour of retaining them. On top of those standard public choice explanations, there is an additional reason for the continued existence of distortions which inflate the cost of essentials in the UK: the distortions in the markets for essentials are defended by groups which enjoy the sympathy of large sections of the media. Hence, a strong economic case for reform does not necessarily translate into a strong political case.

2.1.3. An assessment of the British welfare state

It has been claimed that the British welfare state fares poorly on all three criteria of the iron triangle. This section will substantiate this claim.

High spending

Social policy textbooks still evolve around the distinction between a supposed Anglo-Saxon model of capitalism, with minimalistic welfare provision, and a Nordic model of social democracy, with extensive welfare provision. But in reality, the UK has long become indistinguishable from the Nordic countries in terms of net public social expenditure. Spending on family benefits, such as child tax credit, child benefit and childcare subsidies even slightly exceed Nordic levels.

Table 2.1: public social expenditure in the UK and the Nordic countries, 2009 (per cent of GDP)

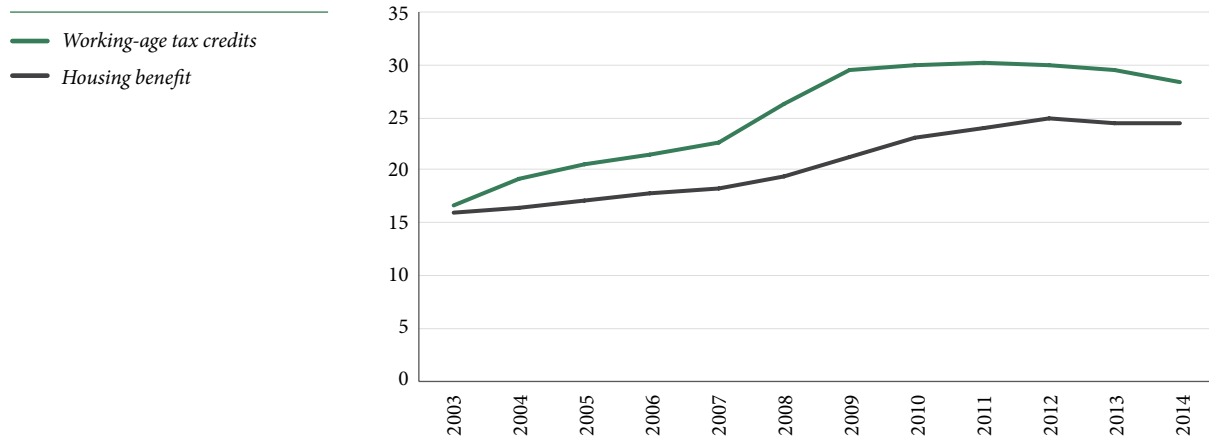
	Total net social expenditure (public and publicly mandated) (%)	Expenditure on family benefits (%)
Denmark	23.80	3.90
Finland	23.90	3.30
Norway	19.10	3.30
Sweden	24.30	3.80
UK	22.80	4.20

Source: OECD (2012) and OECD (2012a)

While this situation has been building up for quite a while, major additional increases have occurred over the past decade, largely driven by housing benefit, working tax credit and child tax credit. Taken together, and expressed in constant 2014–15 prices, expenditure on these items has jumped from £29 billion in 2003–04

to an estimated £53 billion in 2014–15. The Great Recession clearly accounts for a part of that, but upward trends were already visible in boom times.

Figure 2.2: expenditure on housing benefit and tax credits, 2003–14 (£ billion per year)



Source: based on data from DWP⁸

The mechanism behind this has been described above for a hypothetical society, and the graph shows that it actually occurs in the real world. Until very recently, housing benefit rates have been pegged to local rent levels, so the increase in spending on housing benefit is an automatic consequence of the increase in rent levels. Higher basic living costs have pushed up benefit levels, but not wages, which, on its own, would have decreased the living standards of the low-paid and reduced the pay-off from entering work. In order to counteract this development, in-work benefits had to rise as well.

Poor work incentives

There are two standard measures of work incentives. The “replacement rate”, the ratio of out-of-work income to in-work income, measures the incentive to work at all. The “effective marginal tax rate”, the rate at which a small increase in gross earnings translates into an increase disposable income, measures the incentive to progress in the labour market.

For people who are not currently in work, the salary they could potentially earn is not observable, but it can be modelled on the basis of observable characteristics. Adam and Browne⁹ have done this for various population subgroups in the UK. There is, of course, a lot of variation across all subgroups, depending on the specific circumstances of each household. But the authors show that among couple households with nobody in work, as well as for single parents, median replacement rates are around 70 per cent. This means that a large share of the population is not, or would not be, massively better off in work than out of work. These figures provide some contrast to the “scroungerphobia” cultivated by parts of the tabloid media. Given the strong financial disincentives against work, the remarkable result is not that some people do not take up work when they probably could. The remarkable

8. DWP, *Outturn and forecasts: budget 2014, benefit expenditure and caseload tables, 2014*

9. Adam, S., & Browne, J., *Redistributing, work incentives and thirty years of UK tax and benefit reform*, Institute for Fiscal Studies, IFS working paper 10/24, 2010p

result is that so many people in low-paid jobs *do* work, even when it makes little financial sense for them to do so. This suggests that a culture of work and self-reliance may still be much more widespread than commonly believed. If financial incentives were the sole determinant of employment levels, the welfare system would have collapsed a long time ago.

A major reason for the high replacement rates is housing benefit. The table below shows local housing benefit rates for a two-bedroom flat as a percentage of the gross salary of somebody working 40 hours a week on the minimum wage.¹⁰ It shows that in many medium-sized cities in the south of England, that ratio is around 60 per cent, rising to around 80 per cent as one approaches London. In most of London itself, the ratio is above 100 per cent, and well above that in Inner London.

Table 2.2: housing benefit rate for a two-bedroom flat as a percentage of a gross full-time salary on the minimum wage, 2014

Area	Housing benefit rate for a two-bedroom flat as a percentage of a gross full-time salary on the minimum wage (%)
Liverpool	41
Manchester	46
Cambridge	55
Bristol	58
Southend on Sea	59
Canterbury	59
Reading	74
Oxford	76
Slough	76
Brighton	76
Woking	85
Enfield	97
Greenwich	101
Inner London	119

Source: based on data from LHA Direct¹¹

Among the low-paid and those with weak labour market attachment, effective marginal tax rates (EMTRs) in excess of 70 per cent – well above the marginal rates faced by middle and high income earners – have also become the norm. The British labour market thus resembles a ladder on which the lowest rungs are furthest apart¹² and this is not the result of a poor choice of parameters. Rather, it is the

¹⁰. This ratio is not the same as the replacement rate discussed above. The replacement ratio is based on disposable income, not gross salary, and for the low-paid, the former can easily exceed the latter. For example, a minimum wage worker in a high-rent city can be entitled to housing benefit payments in excess of their tax payments, albeit not the full rate. What the table shows, approximately, is the ratio of market rents to the market incomes of the low-skilled. The higher that ratio is, the harder it is to achieve low replacement rates.

¹¹. LHA Direct, *LHA rates and LHA bedroom calculator*, www.direct.gov.uk/en/Diol1/DoltOnline/DG_196239#changes0, accessed January 2015

¹². Niemietz, K., *Redefining the Poverty Debate*, Institute of Economic Affairs 2012, pp. 80–85

Universal credit demonstrates that as long as the inflated cost of basic essentials is not addressed, there is only so much that can be achieved through parametric reform

same mechanism that has been described above, except that this time it is not for a hypothetical society: Rising costs of essentials have triggered an expansion of entitlement to in-work benefits, which has subjected an increasing number of households to means-testing. 5.7 million households are now in receipt of tax credits,¹³ and 5.1 million households are in receipt of housing benefit.^{14, 15} The withdrawal of one of these payments, combined with income tax and national insurance, leads to EMTRs above 70 per cent.

The introduction of the universal credit will eliminate the most absurd aspects of the current system. But the typical EMTR faced by a universal credit recipient will still be 76 per cent. While a huge improvement over the current system in various ways, universal credit also demonstrates that as long as the inflated cost of basic essentials is not addressed, there is only so much that can be achieved through parametric reform. Lowering the benefit withdrawal rate within the given price structure would simply be prohibitively expensive.

Insufficient protection

The UK has one of the largest welfare states in the world, but as mentioned, largesse must not be confused with generosity. A large share of British welfare spending is simply a response to exceptionally high basic living costs. The share of the population receiving housing benefit, for example, is about twice as high as in the Nordic countries.¹⁶ Housing benefit is not “more generous” than its Nordic equivalents; it does not offer a higher degree of housing security. It simply has to cover many more people because many more people have been priced out of the housing market, and on a per-capita basis, it simply costs more to provide a given level of housing security in the UK than it does in the Nordic countries.

Broadly speaking, the electorates of the Nordic countries have made a deliberate political choice to offer some of the world’s most generous levels of welfare protection and to pay for it through very high taxes. The British electorate has made no such choice. Here, welfare spending has followed the cost of basic essentials, which, in turn, have been pushed up by product market distortions. The UK has accidentally ended up with a welfare state of Scandinavian proportions; it is probably the only country in the world that combines ‘Anglo-Saxon’ attitudes to welfare¹⁷ with Nordic levels of welfare spending. The British have become ‘reluctant Nordics’, involuntary members of the league of large welfare state nations.

But in the UK, Nordic welfare spending does not lead to Nordic outcomes. Levels of material deprivation, a consumption-based poverty indicator, remain fairly high.¹⁸

The following subsections will analyse the distortions in the markets for housing, childcare, food and energy, as well as outline how they can be removed.

2.1.4. Housing

British house prices are among the highest that can be found anywhere in the world. This is the result of a prolonged period of sustained house price inflation.

13. HMRC & ONS, *Child and working tax credit statistics*, December 2013

14. DWP, *Outrun and forecasts: budget 2014, benefit expenditure and caseload tables*, 2014

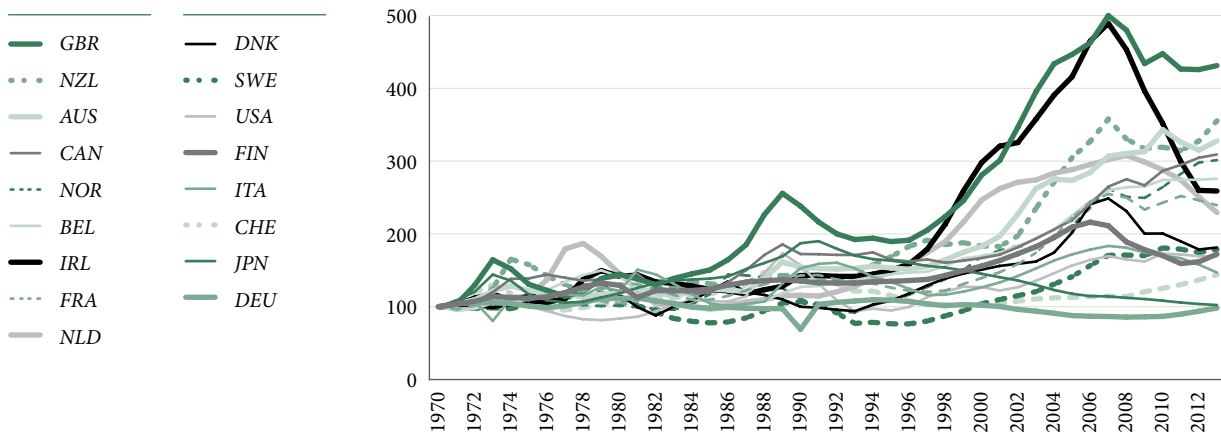
15. These groups overlap, of course, but the extent of the overlap is not explicitly recorded.

16. OECD, *Agriculture and fisheries, agriculture policy indicators, producer and consumer support estimates*, 2012

17. Niemietz, K., *Redefining the Poverty Debate*, Institute of Economic Affairs 2012, pp. 184–193

18. Stávková, J., Birčiaková, N., & Turčínková, J., *Material deprivation in selected EU countries according to EU SILC income statistics*, Mandel University, MENDELU working papers in Business and Economics 12/2012, 2012

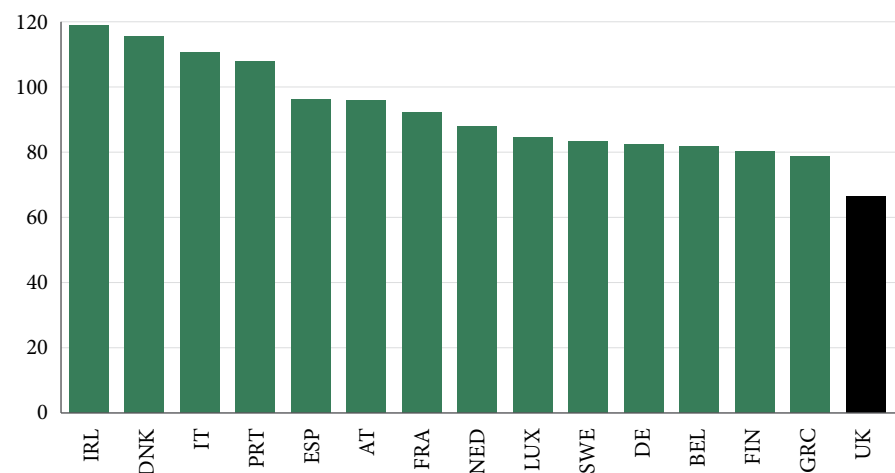
Figure 2.3: house prices in real terms, OECD countries, 1970–13 (1970 = 100)



Source: based on data from OECD¹⁹

This is a supply side problem. During the past three and a half decades the number of housing units completed (per 10,000 inhabitants) in the UK has steadily declined, and has long been exceptionally low by international standards.²⁰ As a result, the existing housing stock, approximated here by average residential floor space per household, is now hopelessly inadequate.

Figure 2.4: average residential floor space (in m²) per household, 2008



Source: author's calculation, based on data from Entranze/Enerdata²¹ and OECD²²

Its spatial distribution is also outdated, still reflecting the economic geography of the past. During this period, the centres of economic activity have shifted southwards, a shift to which the housing sector has not been able to respond. There are too few homes, and many of them are not where people want to live.

19. OECD, *OECD Housing price database*, www.oecd.org/eco/outlook/focusonhouseprice.html, accessed January 2015

20. Eurostat, *Housing statistics in the European Union 2010*, http://abonneren.rijksoverheid.nl/media/dirs/436/data/housing_statistics_in_the_european_union_2010.pdf, accessed January 2015

21. Entranze/Enerdata, *Average floor area per capita dataset*, 2014

22. OECD, *Doing better for families*, 2011

More and more people have found themselves unable to shoulder their housing costs without financial assistance from the state

The impact on affordability has been dramatic. The standard measure of affordability is the “median multiple”, which is the ratio of the median house price to the annual median income, both collected at the local level. Historically, median multiples in the UK and other English-speaking countries have clustered between values of 2 and 3. This meant that a family in the middle of the local income distribution required between two and three years’ worth of salaries to afford a house in the middle of the local price distribution. Today, there is not a single region left in England where that ratio is less than 4. Median multiples of around 5 have become the norm in most of the country and values above 6 have become the norm in southern England. In Greater London and other “hotspots”, median multiples exceed 7. With differences in timing, rents have moved in the same upward direction.²³

House prices and rents in all UK regions have increased at a much faster rate than incomes, which means that more and more people have found themselves unable to shoulder their housing costs without financial assistance from the state. 45 per cent of all households in the rental sector now receive housing benefit, with an average amount of £357 per month.^{24, 25} And the ripple effects of high property prices affect almost all product markets. The cost of retail space, office rents and other commercial property is contained in the final consumer price of all goods and services. Clearly, any attempt to bring the cost of living under control must start with property prices.

The determinants of house prices are a well-researched topic in economics. The standard method in empirical studies on this subject is to express house prices as a function of a number of potential determinants, including some index constructed to measure the restrictiveness of land use planning policies.

The impact of planning restrictions is an empirical question, not a question that can be answered *a priori*. One could imagine theoretical situations in which restrictive planning policies have little impact on housing costs. The reason is that planning restrictions do not indiscriminately hinder all development. They are usually selective, strongly protective of undeveloped land, but much less so of land that has been previously developed. So one could imagine a situation in which the main effect of a planning system is to redirect development from relatively strongly to relatively weakly protected or unprotected areas, not to significantly curb development overall. The system would then prevent development on the fringes of towns and villages, but it would still leave the alternatives of, for example, redeveloping abandoned industrial sites, regenerating decaying neighbourhoods, bringing empty homes back into use, etc. As long as there are enough opportunities for “intensive” as opposed to “extensive” development, and as long as the unprotected sites are close-enough substitutes for the protected sites, there need not be a strong impact on the overall volume of development. A planning system would then have a strong impact on *where* houses are being built, but only a weak impact on *how many* are being built.

But while such an outcome is theoretically imaginable, we do not actually observe it anywhere. The empirical literature is remarkably conclusive: house prices can fluctuate for all kinds of reasons, but in the long term, the decisive factor is the severity of restrictions on development. Planning restrictions really do reduce housing development, rather than just redirecting it.

23. House Price Indicators, *The Economist*, 2014

24. DCLG & ONS, *English housing survey: households. Annual report on English households 2011–12, 2013*

25. This is a weighted average covering private rental, council housing and registered social landlords.

Already in 1990, Brueckner²⁶ summarised the verdict of the research in the following terms: *“There is now a large empirical literature documenting the effects of growth controls on housing and land markets. The evidence to date conclusively establishes that growth controls raise housing prices in communities where they are imposed”*.²⁷ Since then, these findings have been strengthened and reinforced.

Pollakowski and Wachter²⁸ have modelled the determinants of house prices in Montgomery County, Washington D.C., and found: *“The results of our study confirm results found elsewhere: land-use regulations raise housing and developed land prices within a locality”*.²⁹

Malpezzi’s³⁰ cross-sectional study, which covers over fifty US metropolitan housing markets, finds: *“Our results suggest that regulation raises housing rents and values”*.³¹

Dawkins and Nelson³² provide a more cautious literature review, emphasising remaining uncertainties, but on balance, they also conclude: *“The most important policy implication to be gleaned from this review is that local planners play a significant role in determining the severity of housing price inflation attributable to urban containment policies”*.³³

Anthony³⁴ estimates the effect of Florida’s “Growth Management Act”, a set of planning restrictions and regulations, and concludes: *“Using data from the entire state over a 16-year period, with two measures of affordability and after controlling for alternate hypotheses, this research finds that Florida’s GMA has had a statistically significant and negative effect on housing affordability in the state.”*

Glaeser and Gyourko³⁵ model house prices in 45 US metropolitan markets, with a particular emphasis on the importance of planning restrictiveness relative to physical scarcity of suitable land. They find: *“The bulk of the evidence marshalled in this paper suggests that zoning, and other land-use controls, are more responsible for high prices where we see them. [...] Measures of zoning strictness are highly correlated with high prices. [...] [Our evidence] seems to suggest that this form of government regulation is responsible for high housing costs where they exist”*.³⁶

Chi-man Hui and Sze-mun Ho³⁷ study housing costs in Hong Kong, and find: *“The analysis demonstrates that most of the planning variables affect housing prices statistically”*.³⁸

Glaeser et al,³⁹ using a broad data pool of US metropolitan areas, find that *“new construction has plummeted and housing prices have soared in a small, but increasing*

26. Brueckner, J., *Growth controls and land values in an open city*, Land Economics 66, 3, 1990, p. 237–720

27. Ibid. p. 327

28. Pollakowski, H., & Wachter, S., *The effects of land-use constraints on housing prices*, Land Economics, 66, 33, 1990, pp. 315–234

29. Ibid. p. 323

30. Malpezzi, S., *Housing prices, externalities, and regulation in US metropolitan areas*, Journal of Housing Research, 7, 2, 1996, pp. 209–241

31. Ibid. p. 236

32. Dawkins, C., & Nelson, A., *Urban containment policies and housing price: an international comparison with implications for future research*, Land Use Policy, 19, 2012, pp. 1–12

33. Ibid. p. 11

34. Anthony, J., *The effects of Florida’s Growth Management Act on housing affordability*, Journal of the American Planning Association, 69, 3, 2003, pp. 282–295

35. Glaeser, E., Gyourko, J., & Saks, R., *The impact of building restrictions on housing affordability*, FRNBY Economic Policy Review, Federal Reserve Bank of New York, 2003, pp. 21–39

36. Ibid. p. 35

37. Chi-man Hui, E., & Sze-mun Ho, V., *Does the planning system affect housing prices? Theory and with evidence from Hong Kong*, Habitat International, 27, 3, 2003, pp. 339–359

38. Ibid. p. 357

39. Glaeser, E., Gyourko, J., & Saks, R., *Why have house prices gone up?*, NBER working paper series, no. 11129, National Bureau of Economic Research, 2005

number of places. These changes do not appear to be the result of a declining availability of land, but rather are the result of a changing regulatory regime that has made large-scale development increasingly difficult in expensive regions of the country”.⁴⁰

Saks⁴¹ looks at several metropolitan markets in the US, and shows: “Raising the degree of housing supply regulation by one standard deviation results in 17 per cent less residential construction and twice as large growth in housing prices”.⁴²

Glaeser et al⁴³ concentrate on housing costs in Manhattan, where they find that regulatory constraints are a more important determinant than scarcity of space, high demand or market power in the building industry: “one-half or more of the value of a condominium can be thought of as arising from some type of regulatory constraint preventing the construction of new housing”.⁴⁴

The OECD, in another literature review, also points out that “there is an emerging consensus that local land-use regulation has become a binding constraint on the supply of new housing units in some countries”. They caution, however, that “there is much less of a consensus on the magnitude of the impact”.⁴⁵

In a study of British housing markets, Hilber and Vermeulen⁴⁶ find “a substantial impact of regulatory supply constraints [...] The baseline estimate yields a reduction [in house prices] of 35 per cent [if the planning system were completely relaxed]. [...] House prices would be roughly 25 per cent lower in the South East, had it the restrictiveness level of the North East, which is arguably still highly restrictive in an international context”.⁴⁷ As the authors acknowledge, it is highly likely that their study substantially underestimates the impact of planning restrictions. Firstly, the authors use an index which cannot measure the planning system’s restrictiveness in absolute terms; it can only express it relative to the study’s base year of 1974. Their figures measure the impact of *increments* in the planning system’s restrictiveness since 1974, not its total impact, which is clearly greater. The systematic upward trend in land prices began around 1960, and by 1974, land prices had already more than doubled. Before 1960, they were essentially trendless.⁴⁸ Secondly, the study cannot account for spillover effects. Development restrictions in, for example, London may well raise house prices elsewhere as well, but this effect would not be picked up in the study. Thirdly, the study is also generous in its definition of “natural obstacles”. This is sensible because it means that the study errs on the side of caution, but inevitably, it means that some of the variation in house prices which should have been attributed to the planning system will have been misattributed to natural obstacles instead.

To summarise, the literature shows, as conclusively as econometric literature can realistically be expected to get, that land use constraints prevent development and push up house prices. This still leaves one question unanswered: why is the above-described theoretical scenario of a non-binding planning system, a planning system that only redirects development rather than stifling it, not observed anywhere? Where is the theoretical mistake in this reasoning? The literature does not explicitly

40. Ibid. p. 20

41. Saks, R., *Job creation and housing construction: constraints on metropolitan area employment group*, working paper: Finance and Economics Discussion Series (FEDS), Federal Reserve Board, 2005

42. Ibid. p. 20

43. Glaeser, E., Gyourko, J., & Saks, R., *Why is Manhattan so expensive? Regulation and the rise in housing prices*, Journal of Law and Economics, 48, 2, 2005, pp. 331–369

44. Ibid. p. 376

45. Andrews, D., Caldera Sánchez, A., & Johansson, Å., *Housing markets and structural policies in OECD countries*, OECD Economics Department working papers, no. 836, 2011, p. 30

46. Hilber, C., & Vermeulen, W., *The impact of restricting housing supply on house prices and affordability*, final report, DCLG, 2014

47. Ibid. p. 21

48. Barker, K., *Barker review of land use planning. Final report recommendations*, HM Treasury, p. 47

address this question, but three plausible reasons, complementary rather than mutually exclusive, could offer explanation.

1. Even in the absence of restrictive planning laws, local policy-makers will have an incentive to prioritise derelict land and abandoned homes when releasing land for development, because such sites can have a negative impact on the surrounding areas. Other things being equal, such land will also be cheaper than undeveloped land, because the anticipated cost of redevelopment will be factored into its price. Thus, incentives to “recycle” previously used land before tapping into new land do not have to be created by a restrictive planning system. They already exist anyway. They are a feature which is common to both liberal and restrictive planning regimes, which is why they do not show up in the econometric models.
2. As already mentioned, the “land recycling” scenario rests on two assumptions: firstly, there have to be enough brownfield sites and under-used urban neighbourhoods to accommodate the development that the planning system has prevented elsewhere. Secondly, those unprotected areas have to be close substitutes for the protected areas. If the models detect a strong impact of planning regulations on house prices, the most plausible interpretation is that these assumptions rarely hold, or at least not for extended periods. There may simply not be enough land suitable for redevelopment in the right places for long, and not every plot of land is a close substitute for every other plot of land.

So-called “nimby” organisations have successfully entrenched the myth that development on the edge of existing settlements is wholly unnecessary

This point is specifically relevant in the UK context. So-called “nimby” (an acronym of “not in my back yard”) organisations which typically oppose housing developments, like the Campaign to Protect Rural England (CPRE), have successfully entrenched the myth that development on the edge of existing settlements is wholly unnecessary because, allegedly, there is an almost limitless reservoir of brownfield land lying idle. At the heart of this myth lies a simple aggregation fallacy: the whole of the UK is treated as one single housing market, and every plot of land is treated as a perfect substitute for every other plot of land. The existence of brownfield sites in the north of England is then used as a “proof” that development in the south is “unnecessary”. Sir Simon Jenkins, one of the UK’s most prominent advocates of nimbyism, argues:

These mill towns of the north, which I still think many of them are very attractive places, [...] are the sane places for people to live. [...] Travel down the Don Valley in South Yorkshire. You just travel for mile upon mile of unused, brownfield, infrastructures land. Everything is there.⁴⁹

Jenkins wants to fossilise a settlement pattern of the past, built around the economic geography of the past. In this mindset, it is irrelevant where the people currently alive want to live and where the jobs in today’s economy are being created. Instead of building houses where people want to live, people should move to where the brownfield sites happen to be.

There is, of course, nothing wrong with brownfield redevelopment. Indeed it has much to recommend it such as the improvement of

⁴⁹ Jenkins, S., We are creating Detroits in the North while we are eating up the countryside, *The Telegraph*, 28 March 2014

unsatisfactory, decaying urban environments and in some cases the potential to preserve and put back into use aesthetically attractive features of the historic buildings. But if the housing cost crisis is to be solved, this is a side issue. According to the DCLG,⁵⁰ there is only enough developable brownfield land for just over 1.5 million homes. That should be seen as an upper limit, because it assumes away all competing potential uses for that land. And much of this land would be too expensive to make suitable for residential development because it is contaminated with levels of pollution that exceed minimum safety standards. Those brownfield site opportunities which loom so large in the campaign materials of anti-development protesters are simply not there.

3. Planning constraints that are initially harmless may develop more of a “bite” over time, while attitudes to development could also harden over time, and those attitudes could be endogenous rather than exogenous. Privileges that have been around for long enough often come to be seen as “rights”, and this entitlement mentality is apparent in the campaign materials of British nimby organisations. Organised beneficiaries of planning restrictions clearly do believe that they have a “right” to block development and disregard the housing needs of other people, and the planning system may itself have contributed to fostering that mentality. Treating attitudes as endogenous has important policy implications.

One could theoretically imagine a planning regime that prevents outwards development through a green belt initially, as long as genuine alternatives remain available within the urban area, and which then progressively loosens protection as these opportunities are used up. But this is an unrealistic prospect because by the time for loosening restrictions has arrived, an entrenched nimby lobby will already have been created.

The evolution of housing policy in the UK seems to fit this description quite well. At the time when the Town and Country Planning Act 1947 was passed, planning constraints were a lot less damaging than they are today, and they may even have delivered net benefits. At that time, the conditions for the above-described scenario of a planning system that merely redirects development, as opposed to blocking it, were probably broadly met. Throughout the 1950s, land prices remained stable, and around 60 new homes were built each year per 10,000 inhabitants. This suggests that back then there really were enough viable alternatives to greenfield development within the existing urban areas. During the 1960s, land prices rose, but the annual number of housing completions nonetheless increased to around 70 per 10,000 inhabitants. From the end of the 1960s onwards however, construction activity declined steeply when measured on a population-adjusted basis. The “low-hanging fruit” had been picked; the easy options for redevelopment of previously developed land had been used up. This would have been the time to begin a gradual relaxation of the planning system. No such relaxation occurred, of course.

It was only in the mid-2000s, after a decade of escalating house prices, that the then government developed a serious interest in planning reform. But by then, nimby opposition had already grown into a formidable political force which had convinced itself of its self-serving rhetoric. When the Barker Review pointed to the connection between planning restrictions and the house price escalation, and

50. DCLG *Land use: proportion of new dwellings on previously developed land, England 1989 to 2011*, 2013

recommended a modest relaxation of the planning system in order to increase building activities, the nimby lobby responded by denying the obvious. CPRE⁵¹ claimed that building more houses would:

*make very little difference to house prices – which depend far more on demand-side rather than supply-side factors. [...] At the time of publishing this report, house prices were stable or falling. Homes were expected to become more affordable for first time buyers as earnings rise. But the Barker Review argued that there has been a long-term undersupply of new homes for sale. We disagree. [...] [T]here is not a long-term undersupply of market homes. But if government now believes there is, and changes policy accordingly, the result is likely to be an oversupply.*⁵²

Follow-up reports repeated the message that there are no problems in the British housing market, that housing affordability was not an issue, and that that the real problem to worry about was overdevelopment.^{53, 54}

More recently, CPRE has had a subtle change of rhetoric. The organisation now claims that they had always recognised the need for more housing (although previous publications explicitly said the precise opposite). Outright denial of the problem is now less common, while the already-mentioned brownfield site myth now takes centre-stage.

But this is merely a cosmetic change. The severity of the housing crisis has done nothing to mellow the resistance of nimby organisations against development; if anything, those groups have become more defensive and more hysterical. Places where development is envisaged are now routinely described as “under threat” or “under siege”. Places are not simply “changed” by development, they are “desecrated”, “ruined”, “destroyed” or “disfigured”.

The problem is that in the UK, opponents of development have started believing their own excuses and their own scaremongering.

It is not just groups such as CPRE focusing on greenfield sites which operate to reduce the supply of housing. In addition, neighbourhood amenity groups and historical and architectural interest groups all operate to prevent potential developments from receiving planning permission. Tall buildings are opposed in urban areas even when such buildings are scarcely taller than their neighbours. Local development plans and frameworks in most local authorities contain policies which tightly restrict building heights. For example, the local plan of Wandsworth Borough Council in Inner London contains a map which stipulates that for most of the borough anything over four storeys is “likely to be inappropriate”.⁵⁵ Other authorities are less prescriptive, relying instead on phrases such as that of Bristol City Council’s local plan, which states that the “height, scale and massing of development should be appropriate to the immediate context, site constraints, character of adjoining streets and spaces, the setting, public function and/or importance of the proposed development and the location within the townscape”.⁵⁶ In other words, nothing taller or bulkier than the existing buildings on the adjoining streets, except in exceptional

51. CPRE, *Building on Barker. How we can continue to improve housing for everyone without damaging the environment and sprawling over the countryside*, 2005

52. Ibid. pp. 3–5

53. CPRE, *Policy-based evidence making. The Policy Exchange’s war against planning*, 2006

54. CPRE, *Deconstructing Barker. A one dimensional understanding of a multidimensional issue: a critique of the Barker Review of planning*, Levett-Therivel, 2007

55. Wandsworth Borough Council, *Local plan*, <http://lowtax.es/1EU2JOk>, accessed February 2014

56. Bristol City Council, *The Bristol local plan*, <http://lowtax.es/1BGaOc8>, accessed February 2014

circumstances. Local residents' associations across the country closely monitor development proposals to ensure that these policies remain in place and are enforced, to minimise the new development in their area and therefore avoid additional traffic on roads in their area and to minimise shadows from developments falling over their existing members' properties.

Heritage groups similarly rely on policies which resist the loss of historic buildings and neighbourhood characters, which often extends beyond merely maintaining historic buildings but also resisting "in-fill" and "backland" development which can be said to diminish the historic character of a conservation area or the setting of a listed building.

Those groups are often unwilling to engage with the facts about the realistic options to develop new housing supply and promote an analysis where the UK is full of easily developable brownfield sites and unused properties, and where building on greenfield sites is wholly unnecessary. It is not an exaggeration to say that this idea is a fantasy. The hope that they will eventually become more accepting of development as the negative impact of excessive house prices becomes more apparent is unfounded. So far, the opposite has happened. The self-portrayal of nimby organisations should not be taken at face value: those groups can only be realistically judged by what they actually do on the ground, not by what they claim to be doing. Of course, there is no organisation in the UK which describes itself as opposed to all development *per se*. Nimby organisations always claim that they are only opposed to "unnecessary development", "inappropriate development", "haphazard development" "uncontrolled development", "development at any cost" etc. But it is, of course, impossible to "prove" that a particular place "needs", or "is suitable", for development. It is always possible to find reasons for dismissing a development project as "unnecessary" or "inappropriate". Progress in housing policy will have to be achieved against those groups, not with them.

The following four steps would solve the housing crisis in the UK:

Protecting land from development should be done in a selective manner, not in the form of a blanket ban

1. Green belts should be relaxed. This could be achieved either through abolishing the concept entirely and replacing it with a policy of protecting selected areas of undeveloped land which is of a high aesthetic and environmental quality. Alternatively, existing green belts could be broken up into "green wedges". Protecting land from development should be done in a selective manner, not in the form of a blanket ban. It should be done on the basis of a plot's environmental, recreational and amenity value, not its location alone. There are good reasons for, for example, keeping woodland and meadowland free from development. But for undistinguished farmland, mere proximity to London, Oxford, Cambridge, Bristol or Bath should no longer be a reason for an automatic presumption against development.

With lots of development around green wedges, there would be "less countryside" in total, but a vastly greater number of people would be able to enjoy that countryside without having to travel for miles. Green belts protect enormous expanses of land for a small share of the population – those who live in or near them. Green wedges, in contrast, would protect large (as opposed to enormous) expanses of open land which would be accessible for a much larger share of the population.

Alternatively, the planning consultant Barney Stringer of Quod planning consultancy has estimated that there are around 20,000 hectares

*Local authorities
should be able to
raise their own tax
revenue and devise
their own tax systems*

of undeveloped green belt land within 800 metres of a station. Professor Paul Cheshire of the London School of Economics calculated that at current density norms of 50 houses per hectare, this equates to space for almost a million homes. Despite potentially offering space for so many new homes, this measure would involve just 4 per cent of the London green belt. In a report published by the Adam Smith Institute, Tom Papworth noted that this number would be much higher if the distance from the station was amended from a 10-minute walk to a 10-minute bicycle ride.⁵⁷

2. Height restrictions in urban areas should be greatly relaxed. For example, as long as a framework of central guidance remains, it should require planning authorities to balance expanding demand for housing in an area against maintaining existing development patterns so that a building of no more than one or two storeys taller than the prevailing height would no longer automatically be considered inappropriate. Roads would start to see buildings being replaced with slightly taller buildings allowing a gradual and organic change in the character of an area driven by demand while still protecting people from the prospect of neighbours building tower blocks in quiet, suburban neighbourhoods. This would make more small scale development feasible in large swathes of London and other cities. Meanwhile, restrictions on tall buildings in city centres and other locations where they could be viable should be further relaxed.
3. Local autonomy, especially fiscal autonomy, should be greatly strengthened. Local authorities should be able to raise their own tax revenue and devise their own tax systems. If most tax revenue accrued to the local rather than the national level, permitting development would become a means for local authorities to broaden their tax base and increase their revenue. The current, highly centralised tax system destroys the link between local public finances and the local tax base. By pooling almost all revenue, it forces local authorities that allow development to share the proceeds with authorities that obstruct it. In a localised tax system, pro-development local authorities could keep all the additional revenue generated by permitting development.⁵⁸

This effect would be exacerbated by the fact that under conditions of tax competition between authorities, the weight of taxation would have to shift towards factors that are less mobile, the most obvious candidate being land. Local authorities would probably begin to experiment with various forms of land value taxation. Since land with planning permission is worth a multiple of land without it, granting planning permission would become a straightforward way of broadening the land value tax base.

This does not entail a *carte blanche* for developers. In a competitive tax system, local authorities would become more like service providers, trying to attract customers/residents by offering an attractive package of local amenities and public services. Affordable housing would have to be part of that package, but so would green spaces, scenic views, and the visual attractiveness of the townscape more generally. Poorly planned, low-quality development in inappropriate places would undermine the attractiveness of that package, which would also jeopardise the local tax base. Compared to the current system, intelligent town planning would become more, not

57. Papworth, T., *The green noose*, Adam Smith Institute, 2015

58. Niemietz, K., *Redefining the Poverty Debate*, Institute of Economic Affairs 2012, pp. 89–90

less important. The policy focus would shift from “what can we do to stop this development?” to “how can we achieve the kind of development that makes this town more attractive, in the most suitable places?”

4. Housing-related expenditure should be devolved to the local level.

Housing benefit and social housing subsidies should be paid from locally raised taxes. In places which fail to provide a sufficient supply of housing, taxes would have to be higher than elsewhere, because more people would require financial assistance with housing costs. Conversely, making housing affordable by allowing high levels of development would become an easy way for local authorities to cut expenditure. This point should not be underestimated. The annual cost of housing benefit amounts to over £900 per household.⁵⁹ Places which adopt sensible planning policies could bring that cost down to almost zero, and could cut their local tax bills accordingly. In places where housing policy continues to be dictated by nimbys, residents would ask themselves whether the preservation of every field on the edge of town really justifies a substantially higher tax bill.

Those policies would bring house prices back down again to median multiples below three, that is, to levels at which median income earners need less than three annual salaries to afford an average-priced house. Expenditure on housing benefit could easily be pushed back to the levels recorded in the late 1980s and early 1990s, when they were about a third of current levels in real terms (based on data from DWP⁶⁰).

But these measures have to be preceded by a change in attitudes to housing policy, which is probably best illustrated by the following episode:

In 2013, Sir Simon Jenkins, chairman of the National Trust, was commenting on the housing problems of younger people from rural areas, who were unable to find accommodation in proximity to their families. Jenkins argued that unmet housing need in such areas was not a reason to build houses: “Are you going to say that people who have lived in the Windrush Valley [in the Cotswolds] for 100 years have a right to go on living there? No, I’m afraid they don’t. Sorry.”⁶¹ His remarks provoked a backlash of angry comments in papers like the *Daily Mail*. The anger was surprising, because Jenkins had said nothing new. He had merely restated his well-known position against housing development which he had stated countless times before.⁶² So what explained the backlash?

Jenkins had violated an unspoken rule of British the housing debate: He had spelt out the implications of his anti-development position. The unspoken rule is that one must never admit that high house prices are driven by a refusal to permit sufficient levels of housing development. It is this “doublethink” which allows people to be outraged about high house prices, while also being outraged about a proposed housing development nearby. It allows politicians to profess themselves outraged about the “scandal” of rising house prices in their constituency, while also having their picture taken with a local “protect our green belt” or “no to over-development” campaign. If housing policy is to make any progress, this is the attitude that has to change.

59. Housing benefit costs £24.6bn per year, and there are 26.4 million households in the UK, resulting in an average of £931.

60. DWP, *Outrun and forecasts: budget 2014, benefit expenditure and caseload tables*, 2014

61. Barrow, B., You’ve no right to a house near your parents: National Trust chief warning to children of rural families, *Daily Mail*, 13 March 2013

62. Jenkins, S., *Don’t Concrete over Britain*, Prospect, Issue 207, June 2013

2.1.5. Childcare

The UK records some of the world's highest levels of public expenditure on childcare subsidies. On this count, the UK has overtaken some of those countries where comprehensive provision of childcare services has traditionally been an integral part of the welfare model, such as Norway, Finland, France, Belgium and the Netherlands. The difference in public spending is not explained by differences in usage patterns: British parents do not make greater use of childcare services than parents elsewhere in western Europe.⁶³ It is driven by differences in unit costs.

High unit costs are also the reason why, despite those high levels of public spending, the affordability of childcare remains a serious issue. In contrast to other high-spending countries, where public subsidies cover most of the cost of childcare, British parents are also faced with substantial user charges.⁶⁴

There is a complex array of instruments to support families with childcare costs. The childcare element of the working tax credit refunds 70 per cent of childcare costs, subject to a cap. Under the early years programme, three and four year olds are entitled to 15 hours of free nursery schooling per week. Sure Start children's centres sometimes offer childcare at subsidised rates, and employers receive tax rebates if they co-finance their employees' childcare expenses. In total, childcare subsidies account for 1.1 per cent of GDP.

But the total fiscal cost of high childcare prices is vastly greater. For those who no longer qualify for substantial amounts of childcare subsidies, high childcare costs are a deterrent to labour market entry. Those who do qualify are subject to means-testing, which can spread far up the income distribution. They may not be deterred from *entering* the labour market, but means-testing reduces the incentive to progress in it. Among recipients of the childcare element of working tax credit, the average payment is over £3,000 per year.⁶⁵ Since this sum is withdrawn at a rate of 41 per cent with gross earnings, it elevates the threshold income at which entitlement to WTC expires by about £7,500 per year, compared to a similar household not using childcare services.

Until the late 1990s, childcare services used to be provided in a relatively informal setting. Since then, it has been turned into increasingly standardised and normalised profession. The government now sets detailed requirements about staff qualifications, staff-to-children ratios, conditions of the premises, safety measures, activities etc. The motivation was an understandable one. Children from different socio-economic backgrounds arrive at school with vastly different levels of preparation. Harmonising the childcare environment, and changing it from a "supervised playground" to a form of pre-school education, was seen as a means to even out those gaps. But the creation of a heavily regulated childcare sector has created compliance costs, costs related to inspection and enforcement, and costs related to registration and preparation.

The combination of cash subsidies with subsidies in kind has also driven up costs further. WTC contains a demand-side subsidy, the childcare element, which is a transfer payment earmarked for childcare expenses. This transfer is probably justifiable if the objective is to boost demand among low-income families. However, through the creation of Sure Start centres, Tony Blair's Labour government also built a parallel structure of childcare provision on top of the existing one. This entailed

For those who no longer qualify for substantial amounts of childcare subsidies, high childcare costs are a deterrent to labour market entry

63. OECD, *Doing better for families*, 2011

64. Ibid.

65. HMRC & ONS, *Child and working tax credits statistics*, December 2013

a replication of fixed costs that could have been avoided by simply building on the infrastructure that was already there.

Childcare should be deregulated – but it is important to note that the alternative to statutory regulation is not “no regulation”. Rather, there is a conflicting relationship between statutory and private forms of regulation.⁶⁶ In markets where consumers demand quality signals about a product that they cannot easily judge for themselves, suppliers are enticed to look for signalling devices. In the case of childcare, it could fall on child-minding agencies to devise standards that their members must meet, and rules they must follow.⁶⁷ If the case for government intervention is seen in informational asymmetries, it would be more logical to argue for very specific interventions addressing these asymmetries directly, rather than general government regulation. For example, childcare providers could then be legally required to disclose selected pieces of information, which could also be collected and publicised by the government. What the government should not be involved with is the day-to-day business of provision. It should not regulate inputs, such as staff-to-children ratios. Needless to say, this approach is easily compatible with a tough stance on fraud and abuse.

The funding streams also need to be merged and greatly simplified. Among the current set of instruments, the most sensible one is the childcare element of WTC. It is work-contingent and relatively well targeted, it allows freedom of provider choice, and through its co-payment of 30 per cent, it retains incentives to seek value for money. A single payment along these lines should replace all others, providing a limited subject subsidy in an environment in which most parents find childcare affordable on an unsubsidised basis.

Among those continental European countries where enrolment in childcare services is about the same as in the UK, most record only half the British level of public expenditure on childcare, or less. Sensible childcare reform could quite easily knock half a percentage point of GDP off public spending.

2.1.6. Food

Economists notoriously disagree on almost everything. Yet one of the few areas in which a broad consensus exists across completely different schools of economic thought is free trade. In a survey among members of the American Economic Association, 83 per cent agreed with the statement “*The US should eliminate remaining tariffs and other barriers to trade*”, while only 10 per cent disagreed.⁶⁸ It is easy to see why: trade liberalisation demonstrably brings a boon to consumers. The phasing out of EU textile quotas between 1995 and 2009, for example, has been a great success, especially for low-income consumers.⁶⁹ It has also shown that public choice obstacles can be overcome, and that liberalisation is possible even in traditionally highly protected sectors. The same success story could be repeated in agriculture, if that sector were opened to world trade in the same way as the textile industry. Yet agriculture remains a bastion of protectionism and distorting subsidies.

⁶⁶. Arthur and Booth (2010) discuss this relationship with regard to financial markets, but identifying general principles than can apply to any market.

⁶⁷. See Truss (2012, pp. 5–6) on the role of childminding agencies in the Netherlands, albeit within a wider framework of government regulation.

⁶⁸. Whaples, R., *The policy views of American Economic Association members: the results of a new survey*, Econ Journal Watch, 6, 3, 2009, pp. 337–348

⁶⁹. Francois, J., Manchin, M., Norburg, H., & Spinanger, D., *Impacts of textiles and clothing sector liberalisation on prices*, Final report prepared for the Directorate-General for Trade, Commission of the European Union, 2007

The stubborn persistency of agricultural protection sometimes irritates economists, because the case for free trade in agriculture is no less clear-cut than in other sectors:

Most economists are quick to point out [that] the costs of protecting the agricultural sector in the developed countries clearly outweighs the benefits to these societies as a whole.

Agricultural exceptionalism in the developed world is therefore an inefficient curiosity for economists.⁷⁰ Indeed, much of the more recent empirical literature has not been about *whether* agricultural protection causes a net welfare loss, but about the relative contribution of trade barriers and domestic interventions to it.^{71, 72} The finding that removal of agricultural protection would cause a net welfare gain, even in a static perspective, is only reconfirmed in passing.

The OECD compiles summary estimates of net effects of agricultural policy on producers, taxpayers, and consumers separately.^{73, 74, 75} The net transfer from consumers to producers is captured by the ratio of domestic prices to world market prices, recorded at the border. Prices are collected at the farm gate level, in order to control for variations unrelated to agricultural policy. The value of these coefficients fluctuates a lot, but in the 2001–10 period, European food prices have, on average, been 16 per cent above world market levels.⁷⁶ This is a purely static perspective. Presumably, the main benefit of agricultural liberalisation would be the creation of a more efficient international division of labour, and productivity improvements brought about by increased competitive pressure.

This assessment is borne out by international experience. The most frequently cited example of agricultural liberalisation is New Zealand, where the sector was rapidly liberalised while state support was withdrawn. Between 1983 and 1989, agricultural subsidies were cut from 3.8 per cent of GDP to 0.4 per cent. The total value of producer support, which also includes the value of protectionism, fell from 33 per cent of farm revenues to 5 per cent.⁷⁷ Subsequently, the sector underwent a difficult period of restructuring and readjustment, consisting of technological and organisational changes, and a better alignment of agricultural activities with the country's comparative advantages. The ascent of New Zealand's successful horticulture and wine industries has been linked to the removal of state support.⁷⁸

In the end, the sector managed to achieve strong productivity growth, both relative to its own past record and to the overall economy.^{79, 80} Today, New Zealand still has one

70. Thies, C., & Porche, S., *The political economy of agricultural protection*, The Journal of Politics, 69, 1, 2007, pp. 116–127

71. Anderson, K., Martin, W. & Valanzuela, E., *The relative importance of global agricultural subsidies and market access*, World Trade Review, 5, 3, 2006, pp. 357–376

72. Hoekman, B., Ng, F., & Olarreaga, M., *Agricultural tariffs or subsidies: which are more important for developing economies?*, World Bank Economic Review, 18, 2, 2004, pp. 175–204

73. OECD, *OECD's producer support estimate and related indicators of agricultural support*, 2010

74. OECD, *Agricultural policies in OECD countries at a glance*, 2010

75. OECD, *StatExtracts, Agriculture and fisheries, agricultural policy indicators, producer and consumer support estimates*, 2014

76. Ibid.

77. Sandrey, R., & Scobie, G., *Changing international competitiveness and trade: recent experiences in New Zealand agriculture*, American Journal of Agriculture Economics, 76, 5, 1994, pp. 1041–1046

78. Evans, L & Grimes, A., *Economic reforms in new Zealand 1984–95: the pursuit of efficiency*, Journal of Economic Literature, 34, 4, 1996, pp. 1856–1902

79. Kalaitzandonakes, N., *Price protection and productivity growth*, American Journal of Agricultural Economics, 76, 4, 1994, pp. 722–732

80. Sandrey, R., & Scobie, G., op. cit.

Agricultural reform would probably require a renegotiation of the UK's relationship with the EU

of the largest agricultural sectors in the developed world, even though the mark-up of farm-gate food prices over world market prices has dropped to less than 1 per cent.

Australia provides another showcase for a largely self-supporting agricultural sector, which thrives with a very low level of protection and subsidies. Direct measures of market price support have almost completely disappeared. Over the past decade, farm-gate prices in Australia have been virtually identical to world market prices. As in the case of New Zealand, the agricultural sector remains one of the largest in the developed world.

Agricultural reform in the UK is, of course, complicated by the fact that this policy area is centralised at the EU level. Reform would probably require a renegotiation of the UK's relationship with the EU, towards a status closer to that of Switzerland, which is not part of the customs union and can therefore determine its own trade policy. Switzerland, of course, uses these powers to the opposite end, pursuing an agricultural policy which is even more protectionist than the common agricultural policy (CAP). If the UK acquired a similar level of sovereignty, it should use it for the benefit of British consumers, not interest groups. It should abolish the CAP entirely, and replace it with unilateral free trade in agriculture. Negotiating access for British farmers to foreign markets would be a helpful addition.

Liberalisation should be comprehensive on the domestic front as well – it should mean much more than an abolition of the CAP. The Luddite rejection of GM food is another example of how low-earners are forced to pay the price for the costly obsessions of the “chattering classes”. Adopting a permissive approach to GM food, as in the US, could unleash productivity improvements in agriculture.⁸¹

After a fall in food prices, rates of income replacement benefits could be adjusted accordingly, to keep their purchasing power constant. Wages at the lower end of the income spectrum would not, of course, adjust downwards, so low-earners' purchasing power would rise. The result would be a combination of fiscal savings, higher living standards for the low-paid, and stronger work incentives. The latter would increase labour market entries, allowing, in due course, a second round of fiscal savings, part of which could be recycled into tax cuts for low to middle-income earners.

2.1.7. Energy

For as long as it was a nationalised monopoly, the British energy sector got roped into the political power games of its time. In order to pacify the unions linked to the coal industry, successive governments pressed the Central Electricity Generating Board to favour domestically produced coal over more cost-effective energy sources.⁸² It was a classic example of a forced redistribution from consumers to a well-organised producer group. Post-privatisation, energy suppliers rebalanced their energy portfolios by substituting natural gas for domestic coal. During the brief era of energy liberalisation (the late 1990s and the early 2000s), energy prices fell in real terms. Since the mid-2000s, they have been on the rise again.⁸³ Fuel poverty, which had been tumbling until then, jolted up again.⁸⁴

To a large extent, fluctuations in energy prices are driven by wholesale prices. These are largely global prices, over which British policy-makers have little control.⁸⁵

81. Rickard, S., *Liberating farming from the CAP*, IEA discussion paper no. 37, Institute of Economic Affairs, 2012, pp. 12–15

82. Robinson, S., *The return of centralised energy planning*, Economic Affairs, 33, 3, Institute of Economic Affairs, 2013, pp. 312–326

83. ONS, *Consumer price indices, time series*, 2012

84. DECC, *Annual report on fuel poverty statistics*, 2013

85. Bourne, R., *Low pay and the cost of living: a supply side approach*, IEA Briefing Paper, Institute of Economic Affairs, 2014, pp. 55–57

And yet, a noticeable share of energy prices is explained by the various schemes that force energy retailers to include minimum shares of energy from renewable sources in their portfolios. Those schemes represent a subsidy to the renewable energy sector, except that unlike most conventional subsidies, it is not paid out of general taxation. It is paid through energy bills, and its cost merges with energy prices. Together with related “green” measures, they represent 4 per cent of the retail gas price and 12 per cent of the retail electricity price (based on data from DECC⁸⁶).⁸⁷ Additional increases are already scheduled.

The total cost of renewable energy subsidies to consumers is a lot greater. These figures show only the costs that private consumers pay through their household energy bills. But renewable energy subsidies also raise the cost of production in energy-intensive sectors,⁸⁸ which, in various ways, will also be passed on to consumers. All of this creates political pressure to raise benefit levels, whilst diminishing the living standards of low-earners.

Renewable energy subsidies are not justifiable on environmental grounds. As critics have pointed out right from the start, total CO₂ emissions of all participating industries *are already capped* at the European level, through the emissions trading scheme (EU-ETS). On their own, both the subsidisation of renewables and the ETS are potential instruments to cut carbon emissions – but they cannot be meaningfully combined. When the total amount of CO₂ emissions is already capped, selectively reducing emissions in any one particular sector can only shift them to some other sector, with no impact on the total. All it does is replace the carbon abatement strategy which households and firms would otherwise have chosen with one that they would not have chosen. The ETS forces companies (and indirectly, private households) to cut their carbon emissions. One possible way of doing that would be to shift from conventional to renewable energy. If this shift does not occur, the only logical explanation is that the same volume of carbon reduction can be achieved at a lower cost. Subsidising renewable energy therefore means substituting costly carbon abatement strategies for less costly ones.

Empirical outcomes from Germany, where renewable energy programmes have been around for longer and are pursued on a larger scale, show precisely that. The replacement of gas-fired and coal-fired energy generation with renewable energy saves carbon, but at a cost per abated unit of carbon that is vastly greater than the cost of carbon abatement efforts in other sectors.⁸⁹

Subsidising renewable energy has nothing to do with lowering carbon emissions. It is simply a form of industrial policy, a policy of picking winners. Renewable energy subsidies should be scrapped entirely, and the EU’s renewable energy targets ignored. That would lead to lower energy prices, and benefit levels could then be adjusted downwards accordingly. It would lead to fiscal savings and stronger work incentives.

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86. DECC, *Annual report on fuel poverty statistics*, 2013

87. These figures do not include the cost of the EU’s emissions trading scheme (EU-ETS), the only one among the ‘green’ measures that is actually justifiable on environmental grounds. They do not include the cost of the so-called Warm Home Discount either.

88. ICF International, *An international comparison of energy and climate change policies impacting energy intensive industries in selected countries*, Final report to BIS, 2012

89. Frondel, M., *Economic impacts from the promotion of renewable energies: the German experience*, Institute of Energy Research, 2009

Policy 12: reform planning rules to reduce housing benefit bills

The town planning system is dysfunctional and is imposing substantial costs onto property markets (see section 2.1.4). In turn, this is causing problems for businesses, whose operations are distorted by excessive commercial property costs leading to lower productivity and growth. But just as substantially, it is responsible for the substantial proportion of the housing affordability crisis. Green belt policies constricting London and other cities are warping their development and preventing the market from responding to demand from England's rising population. The effect on prices and rents of this restriction might not be so powerful if developers could respond to rising demand by building taller buildings. But this, too, is largely prohibited.

Planning policies make tall buildings impossible in most locations and even effectively prohibit buildings just one or two floors higher than their neighbours in almost all locations, due to concerns about issues like oversight and disrupting the existing pattern of development or being out of keeping with neighbours. In some places, demand for space frustrated by restrictions on building "out" or "up" has turned to "down" into basements or "in" through filling in gaps between buildings and on large gardens back gardens between homes. Inevitably, these too have been prohibited (in the case of "garden grabbing" by the Mayor of London) or are being (in the case of basement excavations by some central London councils).

All this has predictable and disastrous effects on prices. And that in turn means on the housing benefit bill. We have estimated that a substantial relaxation of height restrictions and the green belt, if implemented in 2015–16, would save taxpayers £3.8 billion by 2019–20. We calculated this by applying Hilber and Vermeulen's 35 per cent estimate of the house price fall that would occur after the complete removal of additional planning restrictiveness since 1974 to the housing benefit.⁹⁰ This would mean a fully-realised saving of £9.4 billion but we assumed that it would take 10 years for the effects to manifest into a new equilibrium. For this reason, we assumed only 40 per cent of the saving would be available after four years.

The government should, at the least, adopt Professor Paul Cheshire's suggestion to declassify from the green belt any land within 800 metres of a station.⁹¹ It should also amend national policy to prevent councils from refusing permission for buildings on account of their height if the proposed building is no more than two storeys taller than the neighbours, with the exception of conservation areas and areas of outstanding natural beauty.

Policy 13: abolish DECC and reassign necessary functions

The Department for Energy and Climate Change could be scrapped with several of its functions moving into other departments.

The Nuclear Decommissioning Authority should move into the Department for Environment, Food and Rural Affairs as along with the expense of decommissioning Sellafield, which accounts for a large proportion of DECC expenditure. Likewise, the Office for Nuclear Development and Carbon Budget Programme should also move with them. The Global Threat Reduction and nuclear security programmes, meanwhile, could move into the Home Office.

But some functions should be abolished. The Official Development Assistance is a form of aid and should go. However, the expenditure for this is already accounted for in the proposal to scrap development aid and therefore is excluded from our

⁹⁰. Hilber, C., & Vermeulen, W., *The impact of restricting housing supply on house prices and affordability, final report*, DCLG, 2014

⁹¹. Cheshire, P., *Where should we build on the Greenbelt?*, London School of Economics and Political Science British politics and policy blog, 14 July 2014

savings calculations for abolishing DECC. The fuel poverty programme should also be scrapped. As the government spends less, there could be cuts in fuel duties which would reduce fuel poverty. The green deal should be scrapped as it is not the purpose of the government to lend to individuals for home improvements. The innovation programme is unnecessary. Private finance sources should be left to carry out its functions without taxpayers being told to fund or underwrite them. The renewable heat incentive would be removed as it subsidises uneconomical energy sources. Funding for the energy and markets reform programme should be scrapped, as its stated aim is to ensure supply and affordability. The carbon capture and storage programme which works with the private sector to develop capture technologies should be funded privately, too. The community energy savings programme has been closed but still has costs over £2 million. The “heat and other programmes” expenditure should also be scrapped.

These measures would save over £320 million rising to over £380 million in 2020–21.

2.2. Health and safety

Well intended as much of health and safety legislation is, the impositions can have a very detrimental financial effect. Health and safety legislation should be rolled back for the vast majority of businesses in the UK where the risks are relatively few. Examples of the difficulties facing businesses can be found in almost any of the Health and Safety Executive’s (HSE) guidance publications. For example the publication *Whole-body vibration: The Control of Vibration at Work Regulations (2005)* is 56 pages long, has 27 references, 3 appendices and 3 “further reading” recommendations.⁹² Guidance of this sort is deeply unhelpful.

A Policy Exchange report found that micro businesses spend 7.2 hours per month on compliance, almost a whole working day.⁹³ The total cumulative cost of health and safety is estimated to be almost £4 billion and has spawned a new health and safety consultancy industry. Analysts in 2010 valued this sector at between £700 million and £1 billion, demonstrating the direct costs of health and safety compliance. Moreover, a basic health and safety qualification can be acquired in just ten days from the Royal Society for the Prevention of Accidents (ROSPA). Policy Exchange also notes that there is also a large incentive for such consultants to overemphasise the level of mitigation that is required, further hindering the business. Such is the level of health and safety concern that an Institute of Directors survey found that sixty per cent of businesses consider health and safety to be a key priority.⁹⁴

The levels of health and safety legislation have risen sharply. Policy Exchange notes that in the years 1984 to 2010, there were 125 such statutory instruments enacted. Despite popular assertions, the rate of enactment is not increasing, but it would not be unfair to assume that the rate should decrease as risks are eliminated. It is also telling that government health and safety posters (which are required in every workplace) have ten demands of employers and only four of employees. The burden of responsibility is placed squarely on the employer and not on the mental faculties of the employee. There is also a direct £13.20 cost to the employer for the purchase of the poster. Compliance costs are immediate, petty and tiresome for businesses.

⁹² Health and Safety Executive, *Whole-body vibration: the control of vibration at work regulations*, 2005

⁹³ Taylor, C., *Health and Safety: Reducing the Burden*, Policy Exchange, 2010

⁹⁴ *Ibid.*, p. 10

With the withdrawal of health and safety legislation, businesses would be freer to pursue innovative business models

The effect of health and safety is not limited to business costs, for it also creates a risk-averse culture which can have significant effects on individuals. The Policy Exchange paper reports that 50 per cent of the Scout Association's volunteers are concerned about being sued and asked to leave the organisation. Indeed over 5 per cent have considered giving up their volunteering work due to fears of litigation and seventy per cent feel that litigation deters potential volunteers.⁹⁵

Levels of work-related fatal injuries are falling, and have roughly halved to 133 between the years 1994–95 and 2013–14.⁹⁶ Work-related deaths are thankfully rare, and they largely occur in a minority of industries such as agriculture, mining and quarrying, utilities, manufacturing and construction. Combined, these sectors account for 83 of the 133 work-related fatal injuries last year. Despite services accounting for 79 per cent of UK GVA in 2014,⁹⁷ they only had 35 work-related fatal injuries.⁹⁸ There is a great discrepancy in the risk factors across different industries.

Health and Safety legislation should be rolled back, particularly in the services sector. There is a great deal of parliamentary time taken up enacting laws which burden businesses and create a more fearful workforce. The £4 billion that such legislation has cost thus far cannot be reclaimed, but future costs can be reduced. Clearly there are sectors that have greater degrees of risk, and it is important that safety is not ignored in them. But in a great majority of workplaces, health and safety legislation is an expensive box to tick rather than a genuinely purposeful exercise.

The argument that this would damage a growing health and safety industry is valid but can be mitigated. The emergence of this new sector based on new business opportunities demonstrates the high levels of agility and innovation in private enterprise. With the withdrawal of health and safety legislation, businesses would be freer to pursue innovative business models.

The agency that is responsible for advising organisations on their legal obligations is the Health and Safety Executive (HSE). The HSE should be disbanded and its remit undertaken by the Department for Work and Pensions. The £151.9 million that the HSE spends annually is directly funded by the Department for Work and Pensions and there are undoubtedly efficiencies to be made through operational synergies. With 3,081 staff there is a very large workforce and the chief executive had a pro rata salary of £170,000–£175,000 in 2013–14.⁹⁹ The number of inspections by the HSE is falling, with businesses inspected on average once every fourteen and a half years.¹⁰⁰ Oversight by the HSE in this way is not an effective or suitable way of spending taxpayers' money.

2.3. Equalities and human rights

The Government Equalities Office (GEO) is responsible for implementing and upholding the government's equality strategy. A ministerial department (albeit a small one), the GEO has been at the centre of repeated controversy over both its objectives (as expressed in legislation such as the Equality Act 2010) and the activities of its principal agent, the Equality and Human Rights Commission (EHRC).

95. Ibid., p. 7

96. Health and Safety Executive, *Statistics on fatal injuries in the workplace in Great Britain 2014*, <http://lowtax.es/1A8EkES>, accessed 11 December 2014

97. World Bank, <http://lowtax.es/1FxdGZw>, accessed 11 December 2014

98. Health and Safety Executive, *Statistics on fatal injuries in the workplace in Great Britain 2014*, <http://lowtax.es/1A8EkES>, accessed 11 December 2014

99. Health and Safety Executive, *Annual report and accounts*, 2013–14

100. Ibid.

Formally established as a single body in 2007, the EHRC was formed of three pre-existing quangos: the Commission for Racial Equality, Equal Opportunities Commission and Disability Rights Commission). The merger was intended to improve relations between the organisations, binding them together in the pursuit of common objectives. But the tripartite structure of EHRC (retaining the three distinct strands within it) has done little to resolve the fierce battling for resources between interest groups. Indeed the unedifying scramble over this lucrative source of taxpayers' cash has overshadowed the EHRC's first years, with public disagreements between commissioners leading to resignations.

Ben Summerskill – then chief executive of Stonewall, a gay rights group – suggested that the cumbersome EHRC was just too big to be run effectively by one person.¹⁰¹ Kay Hampton, another commissioner to resign, was more direct in her criticism of the then chief executive (Sir Trevor Philips), describing his leadership as “driven by self-interest”.¹⁰²

Criticism of the EHRC has come from all quarters, including the government's own watchdogs. In July 2009 the National Audit Office (NAO) described the organisation as having “no business strategy, no agreed organisational design, and no clear understanding of what the commission would do”. The NAO also noted that the EHRC had re-employed, without authorisation, senior staff from predecessor bodies who had been previously made redundant. This went directly against the “efficiency” objective behind merging the three bodies, and ended up costing the taxpayer almost £1 million in consultancy costs.¹⁰³

The EHRC is a quango that perhaps best exemplifies an organisation created solely to appease powerful interests. But it appears to be failing even in this narrow – and unnecessary – objective. Indeed, the think-tank Civitas called for the abolition of the EHRC in 2011 because it “contributes very little to meaningful equality in Britain.”¹⁰⁴ They also argue that the Equality Act 2010 which created the EHRC had £200 million budgeted to offset increased initial business costs and many of the supposed benefits were “ideological rather than financial”.

Former EHRC chief executive, Trevor Philips, described the danger of undermining true human rights issues with frivolous cases as “nonsense on stilts”.¹⁰⁵ Yet the EHRC has regularly (with taxpayers' cash) supported court cases such as these. Most recently they mistakenly conflated politeness with the law over the issue of wheelchairs on buses¹⁰⁶ and supported Roma travellers on planning law disputes where it was unclear why the problem related to their remit rather than a more generalised concern with the effects of the planning system.¹⁰⁷ And best known are legal actions against Christian guesthouse owners over allegations of homophobic discrimination which have received wide-ranging media coverage.

The GEO's targets are arbitrary and unreasonable, and the department threatens to undermine the important gains made by women and minority groups over recent decades. The insistence that central government (or worse still, the GEO and EHRC)

¹⁰¹ Summerskill, B., Why I quit the new human rights and equality watchdog, *The Times*, 27 July 2009

¹⁰² Bennett, R., Trevor Phillips urged to stand down after further resignations at EHRC, *The Times*, 25 July 2009

¹⁰³ National Audit Office, *Comptroller and Auditor General's report on the qualification of the quality and Human Rights Commission's accounts*, 2009

¹⁰⁴ Williams, N., *Assessing the Damage*, Civitas, 2011

¹⁰⁵ Phillips, T., Human rights should help us protect the vulnerable, *Sunday Times*, 11 December 2011

¹⁰⁶ Williams, A., Anger as judges put wheelchairs on buses on a par with baby buggies and say disabled passengers have no legal priority, *Daily Mail*, 8 December 2014

¹⁰⁷ Romani Gypsy mother hopes to win High Court right to live in caravan on land she owns in Cudham, *Sevenoaks Chronicle*, 30 November 2014

know what is best for every employer in the country is misguided and obstructive. Abolishing this expensive mini-department and its agent would yield a total saving of £50 million and relieve many small businesses of overburdening and costly regulation.

Policy 14: repeal the Equality Act 2010

According to its impact analysis, the Equality Act 2010 has an estimated annual cost to both the public and private sectors of up to £70 million. This law should be repealed as it places burdens on small businesses to familiarise themselves with the law and to ensure that they act in compliance with it causing a loss in productivity. This is also the case in the public sector where the annual cost is estimated to be between £7 million and £41 million.

The impact assessment made for the Act suggests that each of the 25,612 public bodies would be expected to have a personnel manager under whose remit the implementation of the Act falls. The average wage for such a person is expected to be £25.13 and assuming a 38 hour working week the total remuneration for one person at each of these bodies in one year would be close to £1.3 billion. Given this, it seems to be an underestimation that the act would only cost the public sector £7 million per year, equivalent to slightly over 0.5 per cent of these employees time. Thus we have taken the highest estimate for costs.

The costs (if grown in line with CPI inflation) would be £49 million in 2020–21. As already stated this is likely to be a gross understatement, and does not include the costs to the private sector.

Policy 15: return the compulsory school leaving age to 16 and scrap 16–19 bursary scheme

Education policy aimed at 16–19 year olds must change. For some time we have pushed children into A-Levels and towards university when it has not been suitable for all of them. A target of 50 per cent of school-leavers attending university has been scrapped, which is welcome as it was misguided; it demonstrated that we didn't take manual qualifications and apprenticeships seriously enough and it stopped some students from entering the workplace when that may have been the better option. Scrapping the education maintenance allowance was the right thing to do in the long term and we should also abolish the 16–19 bursary scheme. Returning the compulsory school leaving age to 16 would allow some students who would prefer to pursue employment, work experience or another form of qualification to pursue their goals.

2.4. Quangos, departments and governance

Dealing with the sprawling army of quangos goes to the heart of reassessing government functions. Too often organisations are set up as a knee-jerk reaction to a policy crisis, without any real consideration about whether a new organisation is needed, or if it will simply duplicate functions already carried out elsewhere. They are almost always permanent too, finding ways to stay open even if the original objective has been met.

While all quangos are notionally accountable to a parliament or assembly, the excessive cost involved in monitoring such bodies means that, in practice, accountability is minimal. Quangos are often used by ministers to avoid taking responsibility for failures in public service delivery. The Qualifications and Curriculum Authority (QCA) for instance, provided a useful buffer for departmental ministers during the SATs fiasco of 2008.

Quangos are often used by ministers to avoid taking responsibility for failures in public service delivery

Quango boards are also seen to serve as another form of patronage with many people serving as non-executive members of a quango board holding several seats, or moving from one organisation to another. As parliament still has no formal powers in the appointment process to quangos, the suspicion is that the jobs remain the gift of ministers. That makes them even less accountable to taxpayers.

Executives should have to appear annually before their respective select committee to make the case for their budget and functions for the coming year, and non-executive appointments need far greater scrutiny.

With so many quangos in operation, duplication of responsibilities is inevitable. Overlapping jurisdictions not only blur lines of accountability and authority, they also lead to a considerable waste of resources. A proper rationalisation of the quango state – not merely a headline-grabbing ‘bonfire’ – must take place to reflect a reassessment of the functions of government.

Policy 16: cut the number, scope and budgets of quangos and public bodies

The coalition government’s promised bonfire of quangos did not reduce the number or scope of quangos as much as was hoped or as much as was necessary. There are still too many unaccountable and expensively-managed quangos. There needs to be a serious and systematic rationalisation of both the functions and continued existence of each public body.

Currently, there are over 400 such organisations and the government should disband some and move some others into a ministerial department to make efficiency savings. This would create savings by removing unnecessary functions and by increasing efficiency through reducing duplication of back-office operations.

The measures listed below should save almost £400 million annually by 2019–20. This is not an exhaustive list. (See policies 13, 14, 27 and 29 for further examples of bodies covered by *The Spending Plan* but which are accounted for separately.) The government should instigate another review of public bodies, this time with tougher criteria. But is indicative of what could be achieved, bringing further savings.

Individual measures:

- The Commonwealth Scholarship Commission in the UK should be abolished because it should not be a function of government to decide on behalf of taxpayers how much of their money should be taken from them to spend on providing foreign students with free or subsidised education in the UK. This can be achieved by private institutions and voluntary donations.
- The Health and Safety Executive should be abolished as it places undue burdens and costs on businesses which do not have the flexibility to accommodate new rules.
- The Office for Civil Society should be abolished as its functions, namely to encourage “social action and [to build] social capital” can be achieved by the private and voluntary sectors.
- The Sports Ground Safety Authority should be abolished as the vast majority of sports grounds already have suitable safety measures and new planning applications have to comply with existing safety standards.
- Employer based award committees within the National Health Service clinical excellence awards scheme should be abolished. These awards were held by over 50 per cent of the consultant population in 2012, and are applied for by the individual concerned.

Chapter three

*Government
should not pay
over the odds*

3. Government should not pay over the odds

Government organisations are notoriously bad at getting good value. Examples can be found in anything from purchasing high-end military kit to basic office supplies. But governments also pay over the odds in other ways – they offer high-interest bonds to selected demographic groups, provide unnecessarily generous repayment options for graduates paying back loans or increase benefits faster than wages for those in work. Politicians are keen to be seen as generous but there's no such thing as generosity when you're paying with someone else's money.

Policy 17: cut the pupil premium to its 2011 level

The pupil premium announced in 2011 consisted of a £625 million allocation for children who were registered as eligible for free school meals and had been looked after for 6 months or longer. This was extended in 2012 to all those eligible for free school meals at any point in the previous six years, meaning that a pupil whose parents with a significantly improved financial situation still qualify. The cost of the scheme has since extended to over £2.5 billion for a variety of disadvantages. The pupil premium should be awarded to schools dealing with currently disadvantaged pupils rather than those who have perhaps been qualified as disadvantaged in the past. This is particularly important at a time when evidence of significantly increased pupil attainment as a result of the fund remains in doubt. It takes years for changes in the education system to be demonstrated in results and attainment, so policy-makers should exercise caution when using taxpayers' money to expand relatively new schemes. Returning to 2011 levels would ensure those schools with the most disadvantaged pupils are still given additional help.

Policy 18: replace grants to local authorities with devolved taxes to encourage better local spending

The UK has one of the most centralised tax systems in the developed world. In 2013–14, only 25 per cent of taxpayer funding for local authorities came from council tax with the balance coming from central government grants.

To limit the extent to which central government collects taxes from individual areas and churns it through its bureaucracy only to return it to the areas from which it came, the 2020 Tax Commission proposed that at least 50 per cent of all tax funded-expenditure by local authorities should be raised from local taxation.

Reducing central government grants as a percentage of local authority revenue expenditure by 4 percentage points each year from 2015–16 would make local authorities responsible for raising 50.7 per cent of their revenues by 2020–21.

There is an abundance of empirical evidence showing that public sector efficiency increases with fiscal decentralisation. An econometric study from the German CESifo Group looked at 21 OECD economies between 1970 and 2000 and concluded that:¹⁰⁸

Our main finding is that government efficiency increases with the degree of fiscal decentralisation. This result appears to be robust to a number of different specifications and fiscal decentralisation measures.

¹⁰⁸ Adam, A., Delis, M. D., & Kammas, P., *Fiscal decentralization and public sector efficiency: evidence from OECD countries*, CESifo working paper 2364, 2008

A 10 percentage point increase in local and regional governments' share of total national tax revenue improves public sector efficiency by around 10 per cent

The authors find that a 10 percentage point increase in local and regional governments' share of total national tax revenue improves public sector efficiency by around 10 per cent.

The proposal would increase local government's share of current receipts from 3.7 per cent to 7.5 per cent – a 3.8 percentage point increase. This in turn should lead to savings from greater efficiency worth £4.9 billion in 2019–20 which should be subtracted from the government's grants to local authorities.

Policy 19: amend repayment terms on student loans to make them more affordable

There is a good case for taxpayers to be asked to underwrite a loans system for students in higher education to promote participation, a more educated population and a more skilled workforce. However, this case becomes less strong when the case is for a particularly generous system that, in effect, tells all taxpayers, including uneducated ones on low incomes, to pay more tax so that educated graduates can enjoy a generously subsidised repayment regime.

The cost of subsidised interest on student loans is forecast by the Office for Budget Responsibility (OBR) to be £4.9 billion next year. The Institute for Fiscal Studies (IFS) calculated the impact of amending the terms of the new loans system on the net present value of the whole lifetime of the loans for a cohort of 300,000 students. We used these estimates to calculate the potential savings by implementing similar measures on existing loans. In total, we estimated that all three measures would save around £2.7 billion, once we adjusted for the differences between the proposals the IFS assessed and the ones we have recommended, and further adjusted them to account for overlaps.

The estimates for the three individual measures are:

- Raise repayment rates from 9 per cent to 15 per cent. We estimated that this would save around £1.4 billion a year.
- Cut the repayment threshold from around £18,000 to £15,000. We estimated that this would save around £700 million a year.
- Raise the interest rate from CPI to CPI plus 3 per cent. We estimated that this would save around £1.3 billion a year.

Policy 20: freeze benefits for two years then uprate with CPI

Benefits are usually uprated with inflation measured by the consumer prices index in the preceding September. However in 2013–14, 2014–15 and 2015–16, the uprating of most working age benefits, excluding disability benefits, has been limited to 1 per cent.

However earnings growth in these years has been weak and lower than the change in CPI.

For 2015–16, the CPI in September 2014 increased by 1.2 per cent whilst average weekly earnings increased by just 0.6 per cent. Even by limiting the uprating to 1 per cent, working age benefits are still set to increase by more than they would have had they been uprated in line with earnings.

This both disincentives work and is unfair on those in work and not claiming benefits.

Working age benefits and tax credits should be frozen in 2016–17 and 2017–18 and then uprated by CPI, the increase in which is forecast to be lower than that in average earnings over the forecast period.

Some of the products sold by NS&I are needlessly increasing borrowing costs and undermining commercial banks and other financial services providers

Policy 21: stop paying over the odds to borrow money

National Savings and Investments (NS&I), the state-owned savings bank and investment organisation, has traditionally been a cheap way for the UK government to finance its borrowing requirement. Given that that NS&I is 100 per cent backed by the government, their deposits and savings products are considered safer than those of commercial banks so interest rates are usually low. It has often been cheaper for the government to borrow through NS&I than the gilt market.

However NS&I has increasingly been used by the government as an electioneering tool. This is best illustrated by the recent sale of £7.5 billion worth of “65+ guaranteed growth bonds”, more widely known as “pensioner bonds”. The one and three year pensioner bonds pay an annual interest rate of 2.8 per cent and 4 per cent respectively.

By comparison, on 11th February 2015, the Debt Management Office held an auction in which it was able to sell £1.75 billion of conventional 3.5 per cent Treasury gilts with a maturity date of 22 January 2045.¹⁰⁹ They were able to sell the gilts for as much as £124.52 with bids exceeding the allotment 1.58 times over. Because the DMO was able to sell the gilts for more than their par value, the yield to maturity at average accepted price was significantly lower than the coupon rate – just 2.358 per cent.¹¹⁰

Simply put, the government was able to borrow more cheaply for 30 years on the gilt market than it chose to from pensioners for one year.

Some of the products sold by NS&I are needlessly increasing borrowing costs and undermining commercial banks and other financial services providers.

Savers have a wide range of investment products like ISAs and savings accounts. So given that government can able to borrow cheaply on the gilt market, the Treasury should stop accepting new deposits and selling bonds through NS&I.

Interest should continue to be paid on existing investments and all bonds with maturities should be honoured.

Policy 22: withdraw funding from the CAP and continue subsidies directly for British farmers

The common agricultural policy (CAP) pushes up the price of food for consumers. (See section 2.1.6. for further discussion of the CAP and food prices.) It also shuts out large swathes of the developing world from free trade, meaning we subsidise farmers in Europe while keeping farmers outside of Europe poor. This costs taxpayers twice, as the EU gives out a significant amount of money in aid to subsistence farmers to try and compensate for the protectionist policy. In a research paper for the TaxPayers’ Alliance in 2009, Lee Rotherham found that the CAP cost the UK £10.3 billion, or £398 per household.¹¹¹ British farmers get a raw deal from the CAP too, with more farmland than some recipient countries but fewer grants. Pulling out of the CAP, spending the money agriculture already receives and cutting our fee to the EU in proportion to its spending on the CAP would save around £2.8 billion a year.

^{109.} UK Debt Management Office, *Result of the sale by auction of £1,750 million of 3.5% Treasury Gilt 2045*, press notice, 11 February 2015

^{110.} *Auction of British Government stock*, UK Debt Management Office press notice, 3 February 2015

^{111.} Rotherham, L., *How the Common Agricultural Policy costs families nearly £400 a year*, TaxPayers’ Alliance, 2009

Chapter four

*Government
should carry out
functions where it
is more effective*

4. Government should carry out functions where it is more effective

There are many things that the government will never be as good at the market at providing. That is why the large-scale denationalisation of public utilities and companies in the 1980s was so successful and will not be reversed; at least not any time soon. On the other hand, there are some things that most people are happy for the government to provide, such as an army and police force, courts of law and guaranteeing healthcare, education and meeting the basic needs of those unable to provide for themselves. Government has its limitations and should focus its efforts on providing good value by doing a smaller number of things very well.

4.1. Healthcare reform

In lieu of more significant reform to mimic a European insurance-based model that delivers better healthcare than the NHS, we have to find ways to save money

All too often politicians measure their performance on how much money they can spend rather than what taxpayers get in return. This is perhaps most acute in healthcare spending. Any reasonable arguments about structural reforms to deliver better outcomes are shouted down and sensible debate is stymied – the answer always seems to be more money for the NHS, regardless of the question. A number of reports – for instance, from the Academy of Medical Royal Colleges – demonstrate how money can be saved relatively easily but that doesn't dampen the call for more cash. Other reports show that international competitors outperform the NHS, yet there is still no level-headed discussion about how we can deliver better outcomes.

The funding model for the NHS cannot last in its current form. In lieu of more significant reform to mimic a European insurance-based model that delivers better healthcare than the NHS, we have to find ways to save money. It is also important that patients appreciate that healthcare is not “free” – we pay a lot of money for it. And we deserve better results.

Policy 23: stop prescribing branded medicines where cheaper generics are suitable

Doctors and prescribing nurses too often write prescriptions for drugs that are cheap and available to buy off the shelf in pharmacists and supermarkets, such as paracetamol. However, there is a significant cost to taxpayers every time that a prescription is written and administered. Given that the majority of prescriptions written are free for the user – but paid for by taxpayers – there is very little concern about the cost of providing drugs like paracetamol via traditional prescriptions. What can make this process even more expensive is when patients are prescribed branded medicines when there are cheaper generic alternatives available, which are just as effective. In evidence to the Commons Health Committee, the British Generic Manufacturers Association estimated it to be £140 million.¹¹²

It is worth noting that the opposite can also sometimes be true – generic drugs can sometimes be more expensive than branded alternatives. Much more has to be done to provide the most effective drug, both in how it will help the patient and how it will cut costs. The NHS should implement systems to ensure that prescribers have

¹¹². Health Committee, <http://lowtax.es/1vl66xA>, accessed 19 February 2015

to actively choose a more expensive alternative and that the practice, not the NHS, pays the premium when there is no medical reason for it.

4.2. Transport reform

A modern and functioning transport infrastructure is crucial for economic growth. That means the right projects must be targeted at the right areas, with a level-headed analysis of what would deliver the best results. It also means finding the best way to pay for projects, whether with taxpayers' money or private funding. But there are significant annual costs in maintaining infrastructure and long term investment requirements too. The question is who should pay for those requirements: passengers, taxpayers, or both?

The Department for Transport will spend around £15 billion in 2015–16. Nonetheless, there are significant problems with the UK's transport infrastructure. Road, rail and air usage are all near or at capacity in many parts of the country, particularly in London and the South East. This mismatch of supply and demand causes congestion and overcrowding which can have a substantial impact on journey times and fuel consumption. As well as leading to lower productivity and efficiency levels, this also reduces the value of the transport network by making its use more stressful for drivers and passengers. Furthermore, the nearer systems are to capacity, the less resilient they become as there is less spare capacity to deal with problems as they arise.

Many of these problems are attributed to policy decisions. Firstly, planning and regulatory restrictions prohibit operators from responding to demand for services by creating new supply. Secondly, price controls prohibit suppliers from using prices as fully as they otherwise might, which can shift incentives for transport operators from expanding supply to using infrastructure more intensely, perhaps more so than is optimal. If prices cannot be increased, private sector operators have less incentive to finance new infrastructure. Similarly, business cases for potential projects in the public sector are less compelling than they would otherwise be.

Practical examples of these effects can be found at Heathrow airport which reports that it runs at 98 per cent of capacity as well as many major roads, commuter rail and metro lines in cities across the UK.

Reform of the transport network should focus on removing constraints on increased supply and regulations which prevent operators from managing demand. The cost to taxpayers should be reduced with the burden transferred to passengers. But where possible, reductions should be focused on current spending, not capital. Furthermore, the government should address the structural problems in transport markets, particularly those in rail. The McNulty Study found that efficiency was 20–25 per cent lower in GB rail than the median European level and that a 30 per cent efficiency improvement could be possible by 2018–19.¹¹³ This would equate to savings of between £740 million and £1.05 billion.

The study found that ownership and regulatory structures were misaligned, among other problems. It is in areas such as this where improvements in costs must be sought to minimise the impact on passengers of reducing subsidies.

113. Sir Roy McNulty, *Realising the Potential of GB Rail*, 2011

Policy 24: abolish rail operator subsidies and increase premiums by 33 per cent by deregulating fares

The Department for Transport's rail operating subsidies ranged from £355 million for Northern Rail to the premium South West Trains paid of £312 million in 2013–14. Measured per passenger mile, it ranges from 25.8p for Northern Rail to a premium from First Capital Connect of 8.5p. We propose that for operators where a subsidy is paid that the subsidy is eliminated. We also propose that where a premium is collected that this is increased by at least 33 per cent.

If a railway cannot cover its operating costs, taxpayers should not be told that they must part-pay for passengers' journeys instead. To make up the difference, the train operating companies should be given more freedom to increase fares and change their fare structures to take advantage of yield management techniques and to let prices reflect the fact that rail capacity is much more scarce at peak times than it is off-peak. Additional revenue from higher fares could improve benefit:cost ratios for transport projects in some areas where it exceeds the cut in subsidy or the increase in the franchise premium.

These proposals do not apply to the network grant made to Network Rail.

Policy 25: scrap operating subsidies to TfL

Transport for London plans indicate that it is expecting operating grants to fall from £874 million to £704 million in 2015–16 before rising steadily to £756 million in 2019–20. Meanwhile, it expects its fares income to rise steadily from £4.3 billion in 2014–15 to £6.3 billion in 2019–20.¹¹⁴ With buses and trains packed full of commuters, taxpayers should not be expected to fund the operating costs for its networks. If it can't break even when its services are straining at capacity, which many are, then that tells the observer something about how well-matched or otherwise supply and demand are.

Gradually, spread over four years starting in 2016–17, the Department for Transport should eliminate operating grants to TfL. It should be expected to find the difference through efficiency-saving cost reductions if possible and if not through fare increasing or service cuts. By 2019–20 this would save over £750 million.

Policy 26: abolish the bus service operators' grant

The bus service operators' grant (BSOG) – previously known as the fuel duty rebate – refunds bus operators for the bulk of their fuel duty costs. The subsidy was intended to keep bus services commercially viable, but evaluations of the programme consistently recommend bringing it to a close.

In its response to a public consultation on the issue of local bus services, the Local Government Association concluded that:¹¹⁵

BSOG is not well focused on the achievement of public policy objectives... it does not encourage efficient use of fuel or cleaner, greener vehicles, nor is it related to tackling congestion, driving up patronage, improved performance, better quality services or improved accessibility.

Oxera, an economic consultancy, reflected that abolition of BSOG was central to improving the value of taxpayer support for bus services. The Government's own Commission for Integrated Transport has lobbied hard for reform of the subsidy.

BSOG should be scrapped, and efforts concentrated on reducing the cost of fuel for all road users

¹¹⁴ TfL, *TfL Business Plan*, 2014

¹¹⁵ LGA, *Local bus service support – options for reform*, Local Government Association response to the consultation, 2008

Although fuel is a considerable cost for bus operators, other taxpayer subsidies to the industry already address many of the public's concerns about bus services (particularly the continued provision of rural routes). BSOG should be scrapped, and efforts concentrated on reducing the cost of fuel for all road users.

4.3. International aid reform

Policy 27: abolish DfID, scrap development aid and transfer humanitarian responsibilities to the FCO and MoD

Hernando de Soto wrote in his 2000 book *The Mystery of Capital* that if America met the obligation to spend 0.7 per cent of national income on overseas aid, it would take 150 years to exceed what the world's poorest had in savings.¹¹⁶ Global remittances – money transferred home by workers overseas – are set to hit \$516 billion in 2016, according to the World Bank.¹¹⁷

The developing world is growing at an astonishing rate. The removal of trade barriers and an embrace of free markets means that countries in Africa, Asia and South America are growing very rapidly. The Pew Research Center, based in the United States, undertook an international survey in which almost 50,000 people were questioned in 44 advanced, emerging and developing countries. The results were that a clear majority of the world wants more freedom to trade and grow.¹¹⁸

But the money given out by the Department for International Development generally doesn't deliver more freedom. A study by the TaxPayers' Alliance found that foreign aid spending has no bearing on the freedom of ordinary people, the press or business in developing countries.¹¹⁹

The focus should be on ensuring that trade barriers are removed rather than self-importantly believing increasing our aid budgets is the answer, no matter how well-intentioned. As a rich nation, we can – and do – play a significant role in assisting in disaster zones, including medical disasters. But when many emerging economies are forecast to overtake traditional European powerhouses in the course of this century, we should make sure any money we send overseas is targeted in the right areas rather than misspent on development projects that do not deliver.

The burgeoning aid industry too often confuses inputs with outcomes. For example, a report from the Independent Commission for Aid Impact (ICAI) found that a £1 billion education programme in east Africa, funded by DfID, did not greatly improve the educational outcomes of the children there. That is simply not good enough.

Another ICAI report found that projects funded by UK aid are pushing both poor and rich alike “towards corrupt practices.” The chief commissioner of the ICAI in full said in the report:

We saw very little evidence that the work DfID is doing to combat corruption is successfully addressing the impact of corruption as experienced by the poor. Indeed, there is little indication that DfID has sought to address the forms of corruption that most directly affect the poor.

¹¹⁶. De Soto, H., *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*, Basic Books, 2000

¹¹⁷. The World Bank, *Migration and Development Brief*, 22, 2014

¹¹⁸. Pew Research Centre, 9 October 2014, www.pewglobal.org/2014/10/09/emerging-and-developing-economies-much-more-optimistic-than-rich-countries-about-the-future/, accessed 20 February 2015

¹¹⁹. TaxPayers' Alliance, *Does international aid increase freedom in recipient countries?*, 2014

While departmental budgets are facing necessary restraint in the UK, the DfID budget is set to be locked to the same arbitrary, unsustainable and ideological target of 0.7 per cent as mentioned above. In 2019–20, 0.7 per cent of forecast national income will equate to £15.5 billion. Abolishing that spending while allocating £1 billion for humanitarian efforts would save taxpayers £14.5 billion.

In order to get real and drastic tax reform, substantial savings must be made. Scrapping DfID and moving responsibility for disaster relief into other departments would refocus our spending priorities and ensure that British taxpayers' money is not wasted on vanity projects, lost to fraud or corruption, or spent on other schemes which simply do not deliver results for the very people they are designed to help.

4.4. Business promotion

The best way for the government to promote business in the UK is to have low, stable and predictable taxes, strong property rights and good regulations. The disastrous regional development agencies sought to boost economic activity in the regions but were rightly scrapped. But the local enterprise partnerships that have replaced them are only marginally better. The government is too eager to involve itself where it is not needed. Instead of distributing grants, loans or any other type of corporate welfare, governments should look at cutting taxes which inflate costs and reduce demand for products and services.

Policy 28: abolish BIS and reassign necessary functions

The secretary of state for business, innovation and skills, Vince Cable, was right when he said the department should be scrapped, before he took office in 2010. A number of functions should remain, however, and be moved into other departments. The Turing Institute, the Crick Institute and other research-intensive operations should be moved into an expanded Department for Education and Skills, along with the funding councils for higher and further education. The Better Regulation Executive should be kept and moved into the Cabinet Office.

Some of the more useful business support services could be tendered out to organisations such as the Institute of Directors or the British Chambers of Commerce, which are closer to on-the-ground businesses than a remote Whitehall department. We have estimated that these remaining programmes, to be run through a skeleton staff moved into the Cabinet Office to monitor the tendering process, would require around 20 per cent of their existing spending.

A number of non-departmental public bodies would not be missed. InnovateUK, formerly the Technology Strategy Board, and the Green Investment Bank, are unnecessary and are only useful for funding projects which private sector investors consider to be poor value or too risky. Similarly, instead of giving money to the Regional Growth Fund to distribute to well-connected businesses, taxes should be cut. A government that followed this plan in full would be able to implement the recommendations of *The Single Income Tax*, including abolishing corporation tax and both employees' and employers' national insurance.

Britain's patchwork of business groups, from the CBI to the Institute of Directors and the British Chambers of Commerce, have developed local, regional and national networks to represent their members to decision-makers. The Local Enterprise Partnerships replicate these groups, not just squeezing out the business groups but

We estimate savings of around £4.5 billion annually could be made from abolishing BIS

often dominating local politics in a way that they were never intended to. The Local Growth Fund should also be scrapped.

We estimate savings of around £4.5 billion annually could be made from abolishing BIS.

Policy 29: abolish DCMS and transfer Royal Parks and heritage functions to other departments

According to a report by The New Culture Forum, more public installations and sculptures were opened in the 1990s and 2000s than in the entire preceding century.¹²⁰ But the state cannot fairly decide which arts projects are worthy of funding, and which are not. Philip Davies, the MP for Shipley, found out that the Arts Council was on track to spend £347 million on opera during the 2010–15 Parliament but only £1.8 million on brass bands.¹²¹ Other reports suggest that until recently, 50 per cent of Arts Council funding was spent in London.¹²² That gives the impression that arts funding is just as liable to be captured by more powerful vested interests as any other form of subsidy. Local and more niche art projects do not get the same support as something like opera, which could fund itself through private donations and ticket sales as it has done throughout its history.

There is, of course, historical precedence for high quality arts being provided by the private sector and by people who pay for tickets. The Arts Council was established by Royal Charter in 1946: are we really to argue that a thriving and vibrant arts scene did not exist in the UK before this time?

Technology should play a major role in how artists seek to fund their activities. Crowd sourcing websites are increasingly used to obtain the cash to pursue an artistic project, and bureaucrats at quangos or in departments shouldn't crowd out such innovations.

Some items of DCMS spending, such as free entry to museums, are arguably harder to justify scrapping. But quite often, many of the people visiting such venues would have done so anyway without subsidy. If museums or galleries want to encourage groups of schoolchildren to go for free, or extend opportunities for visitors who might not otherwise be able to go, then they should re-introduce charges and do that out of their budgets. We have estimated that £2.7 billion could be saved by abolishing the department while retaining an allocation of £30 million for heritage bodies.

Policy 30: scrap universal free school meals

The plan to provide free school meals for all infant school pupils in reception, year 1 and year 2, and disadvantaged pupils in sixth form colleges, was beset by problems from the very start – not least when it was pointed out that many schools did not have the appropriate catering facilities to deliver the policy. The Office for Budget Responsibility has forecast spending at £620 million in 2014–15, and £755 million in 2015–16. After adjusting for inflation and forecasts for the growth in the number of primary school pupils, we estimate spending will have risen to around £830 million by 2019–20.

It is nonsense to provide the children of rich parents with “free” school meals, especially – as with all universal benefits – it requires subsidy from those on the low incomes through tax. Children of parents on income support, income-based

¹²⁰. Toronyi-Lalic, I., *What's That Thing? A Report on Public Art*, The New Culture Forum, 2012

¹²¹. HC Deb, 4 March 2014, c777W

¹²². Booth, P., *Should the state support the arts?*, Institute of Economic Affairs, 13 February 2015, <http://www.iea.org.uk/blog/should-the-state-support-the-arts>, accessed 20 February 2015

jobseeker's allowance, income-related employment and support allowance, the guaranteed element of pension credit, child tax credit or universal credit are already eligible for the meals. If a stigma exists around those children on free school meals at certain schools, it should be beholden upon teachers to think innovatively to reduce it – perhaps through a token system – and to address bullying directly. It is also unclear why that stigma is not supposed to be important in year 3, when free school meals are again means-tested.

Chapter five

*Government
should not tolerate
a lax attitude to
spending*

5. Government should not tolerate a lax attitude to spending

It is difficult for central government to ensure that local councils, the NHS, quangos and devolved administrations spend money wisely. And by extension they also find it difficult to sanction any organisation that does spend money unwisely. This means that some organisations spend money well, and some badly, and a lax approach to public spending can range from splurging on vanity projects to poor HR practice and allowing excessive sickness rates. In order to repair the public finances, public sector organisations across the board must be far more rigorous in their approach to spending and ensure that staff who misspend are held accountable.

5.1. Sickness rates

Despite the gap narrowing over the last 20 years, public sector workers remain more likely to take sickness leave than private sector workers. This has been the case every year since 1994 – the earliest year for which data is available.

There are a number of reasons why sickness leave may be higher in the public sector. The ONS lists the following factors:

- Differences in the types of jobs between the two sectors with some jobs having higher likelihoods of sickness than others.
- Individuals within the private sector are more likely to not be paid for a spell of sickness than individuals within the public sector.
- Women have more sickness absence than men and the public sector employs a higher proportion of female workers.

However, even after performing regression analyses accounting for many such factors, the ONS still finds that public sector workers are much more likely to be off work through sickness.¹²³

Policy 31: establish an excess sickness rate penalty to bring public sector sickness absence rates into line with the private sector

The ONS report, *Sickness Absence in the Labour Market*, shows that 2.9 per cent of working hours were lost to sickness in the public sector in 2013, compared to 1.8 per cent in the private sector. When broken down further, public sector health organisations lost 3.4 per cent of working hours, central government 3 per cent and local government 2.7 per cent. There are several underlying factors – those working in healthcare are more likely to be exposed to illnesses, for instance.

But when these figures are adjusted for workplace size, hours worked, age and region of the UK, sickness in the public sector is 24 per cent higher than the private sector. And the gap remains stubbornly high. Public sector productivity has picked up since 2010 as the overall headcount has decreased, but tackling excessive sickness rates compared to the rest of the economy would boost it further still. This would deliver better value for money.

¹²³ ONS, *Sickness in the Labour Market*, 2014

There should be greater accountability in public sector organisations, with more stringent reporting requirements, doctor's notes where applicable and tougher sanctions for those found to have been dishonest about a sickness absence. A penalty should also be introduced for public sector organisations that break average rates without reasonable explanation.

5.2. Compensation – pay and pensions

Public sector pensions and conditions were traditionally more generous in the public sector to compensate for lower wages. But this is no longer the case. Despite the recent restraint in public sector pay, statistics consistently demonstrate the existence of a pay premium for public sector workers. This premium grew significantly between 1997 and 2007. Indeed in 2014 the IFS found that:¹²⁴

As measured by pay only, the public sector differential was at 7.1 per cent in 1997 and at 2.3 per cent in 2007. Including workplace pensions, the differential rose from 17.9 per cent in 1997 to 20.2 per cent in 2007. Between 2007 and 2012, as cuts to public service pensions came in, the public sector differential including pensions fell to 16.8 per cent, compared to an increase in the differential to 4.6 per cent for pay only.

Even after accounting for factors like qualifications, the Office for National Statistics has consistently demonstrated that a pay premium exists in the public sector.¹²⁵ Even though this fell in the latest available estimate, much of the fall can be attributed to methodological alterations such as changes to corrections for worker characteristics and switching from mean to median.

Taxpayers shouldn't be expected to pay for higher wages and better conditions in the public sector than people might otherwise expect to receive in the private sector.

Policy 32: cut annual leave entitlements where overly generous

A 2013 survey of almost 200,000 employees of 208 organisations and 391 employee groups found that the median holiday entitlement for public sector workers is 27 days compared with 25 days for manufacturing companies and public sector services organisations.¹²⁶

Despite some restraint in public sector pay in recent years, public sector employees still enjoy a significant pay premium over their private sector counterparts, especially when defined benefit pension schemes are included.¹²⁷

Given the higher pay and greater job security in the public sector, there seems little justification for more generous holiday arrangements.

Average annual leave entitlements should be brought into line with those in the private sector by capping annual leave at 25 days, plus the 8 Bank Holidays.

Doing this would mean a saving of around 0.9 per cent of the public sector pay bill which HM Treasury currently puts at £164.4 billion.¹²⁸

¹²⁴. Institute for Fiscal Studies, *Workplace pensions and remuneration in the public and private sectors in the UK*, 2014

¹²⁵. ONS, *Public and Private Sector Earnings March 2014*, 2014

¹²⁶. Carty, M., *HR data round-up May 2013: Public sector still leads on annual leave*, XpertHR, 16 May 2013

¹²⁷. Institute for Fiscal Studies, *Workplace pensions and remuneration in the public and private sectors in the UK*, October 2014

¹²⁸. HM Treasury, *Public Expenditure Statistical Analyses 2014*, table 5.3

Policy 33: scrap national pay bargaining

Moving towards greater regional differentiation of public sector pay would save money in two key ways:

- In low-cost regions, staff wouldn't have to be paid excessive salaries. Public sector staff in London are paid a small premium but given the much lower living costs, many staff outside London are often significantly better off than those doing the same job in London.
- In high-cost regions, organisations wouldn't have to hire expensive agency staff unnecessarily. In the NHS in particular they are often used because in richer areas with higher costs of living, trusts struggle to recruit the staff they need while offering national pay rates. So they hire agency staff where pay isn't restricted. But that can have other adverse effects beyond the additional expense of hiring agency staff instead of permanent employees.

Introducing local or individual pay bargaining would also have two important beneficial side effects:

- It would reduce the crowding out of the private sector in poorer regions.
- It would improve standards and even save lives in richer areas of the country. With the cost of living much higher in the South East but pay for healthcare staff, for example, not sufficiently different to that in regions where the cost of living is lower, standards are compromised. A study for the London School of Economics found that centralised pay bargaining was having a significant effect on heart attack death rates. For a 10 per cent rise in wages outside the health service (a 10 per cent richer area), the heart attack death rate went up by between 4 and 8 per cent.¹²⁹

In 2012, Policy Exchange estimated the saving available at £6.3 billion.¹³⁰ After adjusting for the Office for Budget Responsibility's forecast for decline in the public sector pay bill, we estimate that this saving would fall to around £5.8 billion by 2020.

Big public sector unions are extremely attached to centralised pay bargaining for obvious monopsonistic reasons. It also gives national trade union leaders prestige and importance. But tackling this problem has to be part of a package of reform to make public sector pay and pensions more affordable for taxpayers.

5.3. Small items of waste

The Forestry Commission spent £70 on a bunny suit. £2,340 was the cost of six pictures of herbs bought by the Heart of England NHS Trust. A whisky tasting event for international golfers, paid for by Angus Council, cost £3,860. To undertake a proper fiscal consolidation, tackling these items of waste alone won't do the job. But what spending like this does show is a mindset held by many politicians and bureaucrats. If little care is shown with small amounts of money, what does that tell us about how an organisation handles big procurement deals? Furthermore, frivolous spending,

¹²⁹ Hall, E., Propper, C., & Van Reenen, J., *Can Pay Regulation Kill? Panel Data Evidence on the Effect of Labor Markets on Hospital Performance*, Centre for Economic Performance discussion paper no. 843, 2008

¹³⁰ Holmes, E., & Oakley, M., *Local Pay, Local Growth Reforming pay setting in the public sector*, Policy Exchange, 2012

such as the £70 mentioned above, shows a disregard for the person who worked hard all month and had that money deducted from their pay packet in taxes. A more careful approach with smaller amounts of money is vital to encourage a better culture.

5.4. Union funding

Unions are given millions of pounds of taxpayers' money every year through grants such as the Union Learning Fund and the Union Modernisation Fund. But they fight necessary reductions to public spending and block important public service reform. Increasingly, trade unions are becoming exclusively public sector organisations, which makes their demands all the more unreasonable and unrealistic.

As well as direct payments, they are also subsidised in other ways: through facility time and when public sector payroll departments take dues from pay packets on their behalf. Facility time means that the full-time equivalent of thousands of public sector workers work for unions instead of teaching children, looking after patients or delivering services. Unions should pay for this themselves, or at the very least we should look to cut these subsidies back to private sector levels.

Policy 34: scrap trade unions' subsidies of facility time, grants and office space

Trade unions should be voluntary bodies of members and they should look to their members for financial support, not taxpayers. Unions are subsidised through direct funding and through paid staff time within public sector bodies.

TaxPayers' Alliance research has revealed that the cost of this has been over £100 million per year in recent years. The level of subsidy is now declining and the measures to limit the worst excesses are welcome but further action is necessary. Taxpayers should not be asked to fund any union activity and union members would enjoy more responsible unions if they had to rely on them and them alone for their finances.

Eliminating grants and facility time would save over £90 million a year in these costs. Further uncoded savings could be available from the reclamation of office space and equipment that is currently used by union officials, but we have not been able to estimate the extent of this.

Eliminating grants and facility time would save over £90 million a year

5.5. Politics (spin, political officers, communications)

The government has to communicate with the people it represents. It should make clear what services are available to people, how to access them and report on the health of the country's finances. The last few decades have seen the emergence of a growing class of "spin-doctors" and their remit goes beyond the basic requirements of government communication. For instance, TaxPayers' Alliance research found that there were 826 public relations or communications staff at NHS trusts in 2013.¹³¹ That is far too many for a service that has the sole purpose of treating patients. When budgets are reduced, spending on communications should be reduced too.

131. Wild, A., *Unnecessary jobs in the NHS*, TaxPayers' Alliance, 2014

Policy 35: shrink grants to Scotland, Northern Ireland and Wales in line with England and cut Scotland's grant to match its relative prosperity compared to Wales

The Barnett formula ensures that public spending per head is higher in Northern Ireland, Scotland Wales than it is in England. It is outdated and unfair, with Lord Barnett himself saying the policy is flawed.¹³² The reality is that the Barnett formula cannot possibly survive. It is little more than a crude back-of-the-envelope rule for splitting annual increases in public spending, drawn up back in 1978 a short-term expedient. It was never designed to last for thirty years and to bear the public scrutiny and resentment it now engenders. Further detail on this can be found in a paper for the TaxPayers' Alliance authored by Mike Denham.¹³³

In the meantime, more must be done to restore fairness to the distribution of public sector spending. In 2012–13, public spending per head in Scotland was £10,152, while in England it was £8,529. That means somebody living in the North East region of England received £1,623 less in public spending than another person over the border in Scotland.

Our first proposal, as part of the menu of savings to achieve the OBR's forecast of spending to GDP, recommends that Scotland's grant should be cut to reflect its prosperity relative to Wales, which compared to England is three times poorer than Scotland. For more substantial savings, Scotland's grant should be cut to reflect its prosperity relative to Wales with further reductions to grants for both Wales and Northern Ireland, as well as Scotland, in line with total managed expenditure.

Policy 36: increase the extent of charges in the NHS

The current model for funding the NHS is unsustainable in the long-term. As countries become better off, they spend more on healthcare as people live longer and technology improves. As outlined later, the NHS itself must undergo substantial reform to make it affordable in the long-term, but more immediately we must look at ways of paying for the growing costs of healthcare outside of general taxation. The think tank Reform proposed a comprehensive set of proposals to introduce charges for certain NHS services, such as prescriptions and GP appointments, from which those on low incomes could be exempt.¹³⁴ In France, for instance, GP appointments are charged for and then those on benefits can claim back the costs later. Introducing a price mechanism, even if the money is refunded, will help people to realise that healthcare is expensive and that nothing is "free".

Reform estimated in 2013 that their proposals could save around £3 billion a year. We estimate that the savings would be around £9 billion by 2020, due to a combination of larger budgets, tighter eligibility criteria for exemptions and higher charges.

- £10 prescription charge. By abolishing all exemptions from prescription charges except for low income groups (we estimated that 30 per cent of prescriptions would remain exempt) and applying a £20 charge, by 2019–20 the NHS could save £5.4 billion a year.
- £20 flat-rate GP consultation charge. We doubled Reform's 2013 estimate

¹³² Swinford, S., My funding formula for Scotland is a terrible mistake Lord Barnett admits, *Daily Telegraph*, 16 September 2014

¹³³ Denham, M., *Unequal Shares: The definitive guide to the Barnett Formula*, TaxPayers' Alliance, 2008

¹³⁴ Cawston, T., & Corrie, C., *The cost of our health: the role of charging in healthcare*, Reform, 2013

of a £1.2 billion saving with a £10 charge and increased it in line with inflation to estimate a saving of £2.7 billion by 2019–20.

- £20 daily “hotel” charge for overnight hospital stays. We estimated that the NHS could save £442 million by 2019–20.
- £25 fine for missed outpatient hospital appointments. We estimated that the NHS could save £465 million by 2019–20 comprised of £200 million in fine revenue and £265 million in fewer wasted appointments.

Policy 37: raise the efficiency of NHS estates to match the top 25 per cent

The amount of unused floor space on the entire NHS estate is equivalent to that used by nearly 14 trusts, according to the building consultancy EC Harris.¹³⁵ They calculate that the NHS could save £3 billion a year by making better use of its vast estates and facilities, matching the efficiency of the top 25 per cent of trusts. Savings that big would offer significant relief to trusts struggling with the increasing cost of delivering healthcare, and must surely factor as a key strand of meeting the £20 billion efficiency savings highlighted by the Nicholson challenge. NHS management must, as a matter of urgency, start to make better use of their existing property to save money and boost productivity. Staff within NHS trusts should be involved in this process, as they will no doubt have the best idea of what works and what doesn't.

We have estimated that £3.6 billion could be saved by 2019–20 after adjusting for growth in the overall budget.

Policy 38: reform patient list auditing to cut NHS “ghost patients”

In response to a written question from Valerie Vaz MP in 2013, health minister Norman Lamb revealed that in 2012 there were more than 55.7 million general practitioner registered patients in England, 104.2 per cent of the population.¹³⁶

GP surgeries receive an annual payment for each patient registered with them, so clearly some are getting more funding than they should be.

There are a number of reasonable explanations for why patients may remain on registers for a period of time after they otherwise should. They may change surgery, emigrate or die without the surgery being made aware. But a system which allows more than 2.2 million more people to be registered than there are in the country is clearly deeply flawed and in need of reform.

It would be unreasonable to expect the number of registered patients to exactly match the population at any given point in time, but introducing a system which brings the number of “ghost patients” down to 101 per cent of the population is both achievable and desirable.

Policy 39: renegotiate contracts to cut excessive pay for GPs

Reforming GP contracts by implementing a review of the quality outcomes framework, minimum practice income guarantee, the senior factor payments and the dispensing doctors' fees could help bring the cost of GPs down to a more affordable level.

The OECD's *Health at a Glance 2013* report revealed that UK general practitioners are paid 3.4 times the average wage, while those in Belgium are paid just 2.3 times average earnings.¹³⁷ By bringing English GP pay into line with Belgium's, whose healthcare system is highly regarded, over £1 billion could be saved.

¹³⁵. EC Harris, *NHS Estate Efficiency Review A potential saving of at least £1.5 billion*, 2014

¹³⁶. Response to a written question from Valerie Vaz MP by Norman Lamb MP, 13 September 2013

¹³⁷. OECD, *Health at a Glance 2013*, 2013

It is anticipated that any review could not achieve the full saving in the first year but would be achieved through gradual reform until 2020–21.

Policy 40: scrap HS2

HS2 should be scrapped. It was based on a bad business case that has continued to unravel since it was first presented. For instance, the costs and benefits of the project were calculated on the basis of zero productivity on trains – in other words, it assumed that passengers don't do any work on their commute. This is clearly untrue and puts the assumptions on shaky ground. Furthermore, the initial business case assumed average passenger income of around £70,000.¹³⁸ If this materialises, then the project is quite openly a high speed rail line for well-off passengers paid for by less well-off taxpayers.

The stated case for HS2 has also morphed over time, as politicians found their arguments wanting. The project was initially about quicker journey times. Then it became about capacity, which again was debunked.¹³⁹

The case then moved on to argue that HS2 would rebalance the economy between North and South, and help drive regeneration in the North. But the precedent for such claims is unfavourable. The Institute of Economic Affairs examined what has happened since high-speed services were introduced in east Kent as part of HS1, and the region has actually performed worse in terms of employment than the rest of the South East and the rest of Britain.¹⁴⁰

The case is now being made that HS2 will free up capacity for freight. But this will not happen to any significant degree until 2026 at the earliest. Not only that, HS2 could damage freight capacity on key parts of the rail network. On the southern section of the West Coast Main Line, for instance, it is possible that freight trains will continue to operate on the 'slow lines', together with semi-fast and stopping passenger trains. That would not free up any useful additional freight capacity.

The stated costs – above those calculated in this report – could also escalate significantly. The Treasury has said that the government will spend £4 billion on HS2 in 2019–20 and £4.5 billion in 2020–21.¹⁴¹ These are the figures we used to calculate savings. But another Institute of Economic Affairs report found that councils, transport bodies and local business groups are lobbying central government to fund other projects along the route. Along with other new costs not accounted for in the business plan, the total cost could reach £80 billion.¹⁴²

There are far more worthwhile transport projects. Easing congestion around commuter towns and increasing capacity on existing lines would be cheaper and preferable. Furthermore, the benefit per pound spent is usually better on road projects than rail. New technologies will make HS2 redundant by the time the first train is due to leave Euston, too, not least the development of driverless cars.

HS2 is a bad project and it is unaffordable. It should be scrapped now for a significant saving.

¹³⁸ Stokes, C., *High Speed Rail*, TaxPayers' Alliance, 2011

¹³⁹ Stokes, C., *HS2 Capacity Analysis*, TaxPayers' Alliance, 2011

¹⁴⁰ Wellings, R., *Failure To Transform: High-Speed Rail And The Regeneration Myth*, Institute of Economic Affairs, 2014

¹⁴¹ HM Treasury, *Investing in Britain's future*, 2013

¹⁴² Wellings, R., *The High Speed Gravy Train: Special Interests, Transport Policy and Government Spending*, Institute of Economic Affairs, 2013

Policy 41: abolish the Christmas bonus

The Christmas bonus was introduced in 1972 and is given to claimants of certain benefits in the run up to Christmas. At present it is a one-off, tax-free payment of £10. Christmas can be a costly period for many people but the government should instead look at its own interventions and the impact they have on the cost of living. High taxes on consumer products, for instance, often make up a significant proportion of the cost. Over 70 per cent of the cost of petrol for those wishing to drive to see relatives in the festive period is tax. Taxes on drinks to see in the new year range from 50 to 70 per cent.

The administration costs of benefits like this are too high and as part of a broader reform, payments like this should be abolished to save money and simplify the system. The overall bill is around £150 million a year, so scrapping it will deliver a significant saving.

Chapter six

*Public spending
in Britain is
too high and is
unacceptably
wasteful*

6. Public spending in Britain is too high and is unacceptably wasteful

6.1. David B. Smith: market economies grow faster

There is a long history of macroeconomic studies which have found that economies where public spending is a lower share of national income tend to see stronger economic growth. That includes the early cross-section studies (section 6.1.1); modern panel data studies (section 6.1.2); and the results of econometric modelling (section 6.1.3).

Government spending can theoretically reduce prosperity by discouraging working and investment and the critical theoretical question is whether or not it affects just the level or the level and growth of income. That is the difference between the results from the neo-classical and post-neo-classical endogenous growth theory models of the economy (section 6.1.4).

6.1.1. Early cross-section studies showed that economies with larger market sectors grew faster

The relatively strong performance of most western economies in the 1950s and 1960s – and the fact that public spending ratios had fallen with cuts in defence spending after the second world war and the early 1950s Korean war – meant that many people had become too relaxed about the economic harm done by high spending and taxes by the early 1960s.

Growing problems resulting from the excessive expansion of government spending were already apparent by the late 1960s, however. Britain, for example, had to devalue sterling in 1967 and seek an International Monetary Fund (IMF) bailout in 1969. In the US, the combination of President Johnson's great society welfare programmes and the costs of fighting the Vietnam war were also leading to rising inflation and undermining the US dollar's role as a reserve currency. Things got much worse in the first half of the 1970s, when it was becoming increasingly apparent that the Keynesian intellectual apparatus was breaking down. In particular, inflation expectations had become un-tethered, the sustainable growth rate had slowed markedly, and structural joblessness was rising. This situation encouraged a small number of economists to switch their attention from the then conventional Keynesian approach to look at the long-term determinants of economic growth, as distinct from the factors that predominated at business cycle frequencies.

One example is an early paper by Smith that related the average growth rate of a sample of developed countries over the decade to 1972 to two measures of the share of government spending in national output – one including transfer payments, one excluding it – and the fall in the percentage of the labour force in agriculture.¹⁴³

The current relevance is that many of the subsequent studies summarised in table 3.4 have produced similar results, suggesting that the underlying effects are robust. Among the findings from the early studies that have repeatedly cropped up in the literature are the following:

¹⁴³ Smith, D. B., *Public Consumption and Economic Performance*, National Westminster Bank Quarterly Review, November 1975. The share of employment in agriculture was included because countries such as Japan, Spain, Italy and France were growing rapidly at the time by taking underemployed people out of peasant agriculture and moving them into manufacturing. The same applies to countries such as China today.

An increase in the ratio of public spending to national income crowds out private-sector capital formation almost on a one-for-one basis

- There is a statistically significant negative impact of government spending on growth.
- Direct public provision of goods and services is more damaging to economic growth than welfare payments. The government is a poor supplier of goods and services compared to the private sector.
- Growth reflects many factors other than the ratio of public spending to national income. It is important to avoid naive mono-causal explanations.¹⁴⁴
- An increase in the ratio of public spending to national income crowds out private-sector capital formation almost on a one-for-one basis. This is why economies with high spending ratios become under-capitalised and find it difficult to compete internationally and to offer well-paid jobs.
- Inflation is not determined by the spending ratio, as long as central banks do their job properly. This includes recognising when there has been a supply withdrawal and not cutting interest rates when growth slows for supply-side reasons. The Bank of England and US Federal Reserve both appear to have made this mistake in the 21st century, as they also did in earlier periods, exacerbating the risk of stagflation. Bank of England research carried out in 2001 estimated that the UK monetary policy errors that resulted from overestimating the output gap contributed 3.0 to 7.1 percentage points to UK inflation in the 1970s and 0.7 to 5.5 percentage points in the 1980s.¹⁴⁵
- It was predicted in 1975 that the sluggish growth, which was then regarded as a specifically British disease, would infect other countries as their spending ratios rose towards the higher British level. This has proved correct.

6.1.2. Modern panel data studies show that economies with larger market sectors grow faster

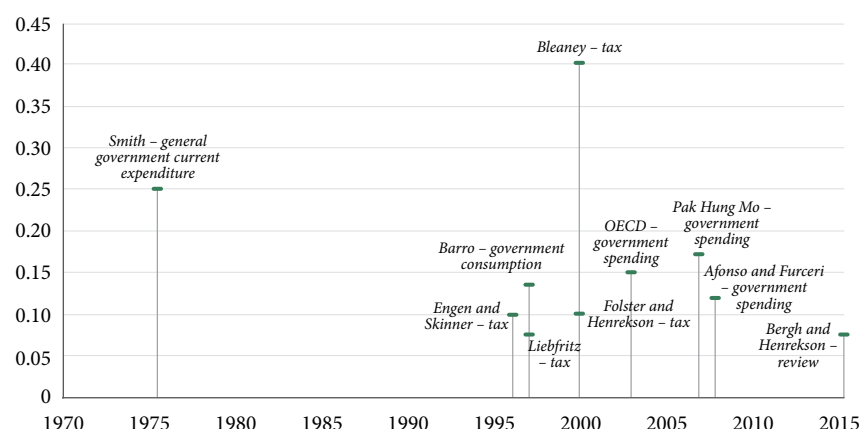
Such pioneering studies were hampered because of the limited data available. There were also econometric problems, including issues of the direction of causation and small sample sizes. The next big advances were: the introduction of panel-data studies, which combined time series and cross-section data; the introduction of more sophisticated econometric methods, and the development of large datasets incorporating over 100 countries. The findings of a representative set of these studies between 1975 and 2011 are summarised in figure 6.1 and, in more detail, table 6.1.¹⁴⁶

¹⁴⁴. A 2005 literature review by Durlauf, S. N., Johnson, P. A. & Temple, J. R. Growth Econometrics in Handbook of Economic Growth vol. 1, listed no less than 145 economic variables that had been examined at some point in the growth literature.

¹⁴⁵. Nelson, E., & Nikoloy, K., *UK Inflation in the 1970s and 1980s: the Role of Output Gap Mismeasurement*, Bank of England, working paper no. 148, December 2001

¹⁴⁶. The references between 1989 and 2002 (inclusive) in this table were largely taken from Table 1 in the article “Public Spending, Taxation and Economic Growth” by Patrick Minford and Jiang Wang in “Sharper Axes, Lower Taxes: Big Steps to a Smaller State” edited by Philip Booth, Institute of Economic Affairs, 2011. More recent studies are: *The Sources of Economic Growth in OECD Countries*, OECD, 2003; Mo, P H., *Government Expenditure and Economic Growth: The Supply and Demand Sides*, Fiscal Studies vol. 28 no. 4, 2007; Afonso, A., & Furceri, D., *Government Size, Composition, Volatility and Economic Growth*, ECB working paper series, no. 849, January 2008; Johansson, A., Heady, C., Arnold, J., Brys, B., & Vartia, L., *Taxation and Economic Growth*, OECD Economics Department working paper no. 620, July 2008; Furceri, D., & Sousa, R.M., *Does Government Spending Crowd Out Private Consumption and Investment?*, World Economics, vol. 12, no. 4, October – December 2011; Afonso, A., & Jalles, J.T., *Economic Performance and Government Size*, ECB working paper no. 1399, November 2011.

Figure 6.1: timeline of studies showing the effect on growth of a 1 per cent decrease in tax or spending as a share of national income



By and large, the more sophisticated studies confirmed the results of earlier cross section studies, with strong evidence that increased public consumption crowded out private investment. In addition, quantitatively similar coefficients for the negative effects of government consumption on economic growth were often discovered. Numerous studies have shown that an extra 1 percentage point increase in the share of government consumption in GDP appears to be associated with a fall of somewhere between 0.1 percentage points and 0.4 percentage points in the growth rate of real GDP per head, with a strong clustering around 0.1 to 0.2 percentage points.

Table 6.1: summary of studies of the negative impact of tax and spend policies on economic growth

Author	Data coverage	Main explanatory variables	Comment	Levels or growth effect
Smith (1975)	19 industrialised countries, using annual average data 1961–1972.	Two measures of general government consumption excluding and with transfers, change in share of workforce in agriculture, investment ratio.	1 per cent point on general government current expenditure reduced growth of GDP per head by 0.25 per cent, one per cent point on wide government consumption measure, including transfers, reduced growth by 0.10 per cent. one per cent point on narrow government current expenditure reduced investment ratio by 0.94 per cent. This was a pioneering early study. Its level of statistical sophistication would not be considered up to modern standards.	Growth
Koester & Kormendi (1989)	63 countries for which at least five years of continuous data exist for the 1970s.	Marginal tax rates, average tax rate, mean growth in labour force and population.	1 per cent point decrease in marginal tax rate would increase per capita income by more than 0.7 per cent in an average industrial country.	Level
Barro (1991)	98 countries in the period 1960–1985.	Human capital, government consumption, political instability indicator, price distortion.	1 per cent point increase in tax-to-GDP ratio lowers output per worker by 0.12 per cent.	Level

Author	Data coverage	Main explanatory variables	Comment	Levels or growth effect
Hansson & Henrekson (1994)	Industry level data for 14 OECD countries.	Government transfers, consumption, total outlays, education expenditure, government investment.	Government transfers, consumption and total outlays have a negative impact on growth while government investment is not significant.	Growth
Cashin (1995)	23 OECD countries over 1971–88 period.	Ratio of public investment to GDP, ratio of current taxes to GDP, ratio of transfers to GDP.	1 per cent point increase in tax/GDP ratio lowers output per worker by two per cent.	Level
Engen & Skinner (1996)	US Modelling together with a sample of OECD countries.	Marginal tax rates, human capital, investment.	2.5 per cent point in tax/GDP ratio reduces growth by 0.2 per cent to 0.3 per cent.	Growth
Barro (1997)	Sample of nearly 100 countries.	Government consumption ratio, educational attainment, life expectancy, fertility rates, inflation, measures of rule of law and democracy.	1 per cent point on government consumption reduces growth by 0.136 per cent.	Growth
Liebfritz et al. (1997)	OECD countries over 1965–95 period.	Tax/GDP ratio, physical and human capital formation, labour supply.	1 per cent point increase in tax/GDP ratio reduces growth by 0.05 per cent to 0.1 per cent.	Growth
Bleaney et al. (2000)	17 OECD countries over 1970–94 period.	Distortionary tax, productive expenditure, net lending, labour force growth, investment ratio.	1 per cent point increase in distortionary tax/GDP ratio reduces growth by 0.4 per cent.	Growth
Folster & Henrekson (2000)	Sample of rich OECD/non-OECD countries over the 1970–95 period.	Tax/GDP ratio, Government spending/GDP ratio, investment/GDP ratio, labour force growth, human capital growth.	1 per cent point increase in tax/GDP ratio reduces growth by 0.1 per cent.	Growth
Bassanini & Scarpetta (2001)	21 OECD countries over the 1971–98 period.	Indicators of government size & financing, physical capital, human capital, population growth.	1 per cent point on tax/GDP ratio reduces output per head by 0.3 per cent to 0.6 per cent.	Levels
Alesina et al. (2002)	18 OECD countries over the 1960–96 period.	Primary spending, transfers, taxes on business, indirect taxes, government wage consumption. All as shares of GDP.	1 per cent increase in government spending/GDP ratio lowers investment GDP ratio by 0.74 per cent after five years.	Levels effect but reduced investment would imply lower growth in post neo-classical models
OECD (2003)	21 developed countries over the period 1971–98.	Lagged real GDP, stocks of physical and human capital, population growth, rate and volatility of inflation, indicators of government size, trade variable.	Detailed 248 page study of influences on economic growth. A one per cent point rise in government spending ratio considered in isolation cuts growth of GDP per head by 0.15 per cent. Including spending and taxes separately gives coefficient of plus 0.19 per cent on spending ratio but minus 0.44 per cent for tax ratio, implying minus 0.25 per cent growth effect for tax-financed spending.	Growth and Levels
Pak Hung Mo (2007)	Data set for large sample of countries running from 1970–1985 broken up into five year sub periods.	Paper uses a new approach to estimate how government spending affects GDP growth via total factor productivity, investment and aggregate demand.	1 per cent point rise in government consumption/GDP ratio reduced growth by 0.216 per cent and one per cent point rise in transfer payments cut growth by 0.172 per cent. However, a one per cent point rise in government investment boosted growth by 0.167 per cent. Hence, author's recommendation to switch government spending from current and transfers to investment.	Growth

Author	Data coverage	Main explanatory variables	Comment	Levels or growth effect
Afonso & Furceri (2008)	EU 15 countries and residual OECD over the period 1970–2004, data broken up into five year periods.	Government expenditure and taxes are broken down into several components. Other variables include initial output, population growth, investment ratio, human capital and openness.	1 per cent point rise in government spending/GDP ratio cut OECD growth by 0.12 per cent, EU growth by 0.13 per cent. one per cent point increase in tax/GDP ratio cuts growth by 0.12 per cent in both cases. Larger effects can be found for individual expenditure and tax components. Indirect taxes and social contributions appear most damaging and worse than income tax. Subsidies and government current expenditure have worst negative effects on growth on the spending side.	Growth
Johansson et al (2008)	21 OECD countries over the period 1970–2005.	Tax/GDP ratio, physical capital, human capital, population growth, tax structure variables.	1 per cent point rise in tax/GDP ratio is associated with a fall of 0.14 per cent to 0.27 per cent in level of real GDP. Tax structure also a significant factor, with income taxes most damaging and taxes on immovable property least damaging.	Levels
Furceri & Sousa (2011)	145 countries over the period 1960–2007.	Examines effects of government spending on private consumption and investment, separate results for OECD, non-OECD and Total provided. Also allows for effects of business cycle.	1 per cent point rise in government spending/GDP ratio reduces private consumption by 1.9 per cent and private investment by 1.9 per cent overall. For OECD countries, one per cent point on government spending/GDP ratio cuts consumption by three per cent and investment by eight per cent. Equivalent negative figures for non-OECD are 1.8 per cent and 1.5 per cent, respectively.	Levels
Afonso & Jalles (2011)	108 countries over the period 1970 to 2008.	Also considers the effects of institutional quality, and effects of fiscal rules in an EU context. Government size is a an amalgam of different measures, not a simple spending ratio.	There is a significant negative effect of size of government on growth, institutional quality has a positive impact, government consumption is detrimental to growth irrespective of the country sample considered.	Growth
Bergh & Henrekson (2015)	Review of literature. Government size and growth	Tax/GDP ratio, government spending/GDP ratio.	A review of studies finds that an increase of government size by 10 percentage points is associated with a 0.5 to 1 percentage point lower growth rate.	Growth

As table 6.1 confirms, most recent research has tended to be consistent with this rule of thumb. Pak Hung Mo,¹⁴⁷ for example, found that a 1 percentage point rise in the share of government consumption in GDP reduced growth by 0.216 percentage points and that a 1 percentage point increase in transfer payments had a negative effect of 0.172 percentage points while European Central Bank (ECB) economists Afonso and Furceri discovered that a 1 percentage point hike in the government spending ratio decreased growth by 0.12 percentage points in the OECD area and by 0.13 percentage points in the EU.¹⁴⁸

¹⁴⁷. Mo, P. H., *Government Expenditure and Economic Growth: The Supply and Demand Sides*, Fiscal Studies vol. 28, no. 4, 2007, pp. 497–522

¹⁴⁸. Afonso, A., & Furceri, D., *Government Size, Composition, Volatility and Economic Growth*, European Central Bank, working paper no. 849, January 2008

Applied to the average household income of £32,108 in 2012–13, this would have meant an average income of £58,956 – almost £27,000 more per household

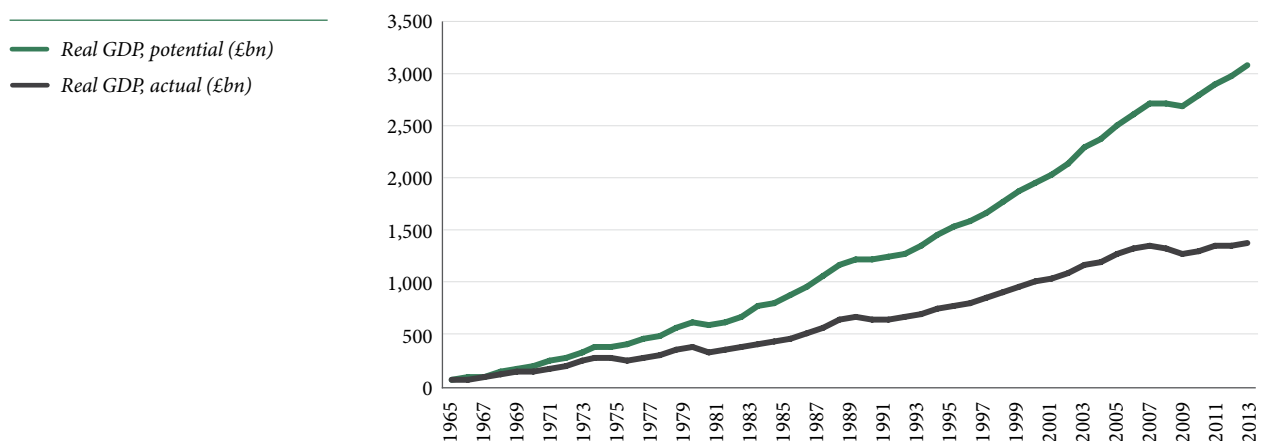
In addition, the ECB authors found that the volatility of taxes had an adverse impact on output, over and above the reduction in growth that arose from the size of the tax burden. This should not be a surprise since capricious and unpredictable changes to the tax regime greatly add to the uncertainties of doing business and discourage investment in socially worthwhile high-risk/high-return projects, such as advanced technological innovation or energy exploration in the North Sea. There is an obvious analogy here with optimal financial portfolio investment theory which suggests that individual investors should seek to maximise the mean return on a portfolio of assets minus roughly two-thirds of the standard deviation. In contrast, society in general should seek to maximise mean returns because it can better absorb risk, in the same way that very large airlines often self-insure. In practice, one is unlikely to know the true parameters of the probability distributions concerned so there is uncertainty as well as risk.

The effect found in panel data studies is large and suggests that higher spending may have a severe impact on long-run prosperity. Using the Afonso and Furceri estimate that a 1 per cent rise in general government consumption is associated with a 0.13 per cent reduction in expected growth. Figure 6.2 shows the path of growth with the actual levels of spending in those years and the growth that might have been expected with the 31.7 per cent share we recommend.

In 2014 the British economy was three times the size it was in 1965. If the spending ratio had been 31.7 per cent then the economy might have grown to more than five times the size it was in 1965 over the same period. That means final British national income would have been more than 80 per cent higher. Applied to the average household income of £32,108 in 2012–13, this would have meant an average income of £58,956 – almost £27,000 more per household.

There are limitations with panel data studies. The first is that GDP is defined to include government spending. This will bias the results if the main concern is the health of the private sector, which also constitutes the tax base since the government cannot tax itself. If an extra £100 billion of government spending crowded out exactly £100 billion of private sector activity, there would be no apparent negative (or positive) relationship between an increased private sector share in GDP and either the level of GDP or its growth rate.¹⁴⁹ However, the ratio of tax receipts to GDP would fall in line with the decline in the private sector tax base and the budget deficit would swell under these circumstances.

Figure 6.2: compound real growth, 1965–2014, actual and with 2020 Tax Commission spending ratio



¹⁴⁹ The same applies to the macroeconomic model simulations discussed in the next section, where the quoted multipliers always refer to the change in GDP resulting from a change in government spending.

A second caveat is that the direction of causation is not always clear, in part because the government budget constraint introduces problems of simultaneity between spending, taxes, and borrowing which can make interpretation of the results tricky. This has led to attempts in some of the more recent US studies to identify the purely-exogenous component of government spending, using either military expenditures or politically-determined congressional earmark spending increases. A third caveat is the issue of data quality and consistency across a large sample of countries. Putting together data sets for many nations means that variables may not be measured consistently or with comparable accuracy. Such measurement errors are likely to cause both the size and statistical significance of the estimated effects to be understated. Given these problems, it is remarkable that so many investigations have come up with such similar results over the past three and a half decades. It suggests that the underlying effect is robust.

6.1.3. Econometric modelling shows that economies with larger market sectors grow faster

The use of econometrics goes back to just before the second world war. However, the subject did not take off until the late 1960s when advances in computer technology made the estimation and simulation of forecasting models a practical proposition. There was a heated crowding-out debate in the late 1970s and early 1980s as to whether higher government spending was good or bad for the economy and which were the least damaging tax and borrowing options to finance it.

Modelling has fallen out of favour in recent years because it is now believed that the parameters of forecasting models shift whenever there is a change in the policy regime¹⁵⁰ and because such research generates too few publishable articles to appeal to most academics. This is bad news because model simulations still provide one of the best guides to the second-round effects of tax and spending changes on the wider economy and are certainly nearer the truth than the largely static calculations that underlie so much of the public debate. The Macroeconomic Modelling Bureau at the University of Warwick made this clear in 1993.¹⁵¹

In order to analyse the impact of the various fiscal policy instruments it is essential to consider both direct and indirect effects. For example, the direct effects of tax changes on government finances can be quantified through an assessment of the size of the tax base to which the tax change is to be applied, and such calculations may measure the short-run impact on government revenue quite well. However, over a period beyond the first few months following the tax change, the indirect effects through the operation of the economy as a whole come to dominate. Simulations of models of the macro-economy are the only method of quantifying the size and time profile of these indirect effects.

One of the great benefits of the Warwick bureau studies, which were carried out between 1989 and the bureau's closure in 1999, was that they performed comparative policy simulations of a range of tax and spending measures using nearly all the leading macroeconomic forecasting models of the day. This included the models then used by the Bank of England and HM Treasury as well as those of the London Business School, National Institute of Economic and Social Research (NIESR),

¹⁵⁰. This is the famous 'Lucas critique': Lucas, R., *Econometric Policy Evaluation; a Critique*, Carnegie-Rochester Conference Series on Public Policy 1, 1976, pp. 19–46

¹⁵¹. The source for this quotation is Church, K.B., Mitchell P.R., Smith P.N., & Wallis K.F. *Comparative Properties of Models of the UK Economy*, National Institute Economic Review, August 1993. The Warwick bureau existed from 1983 to 1999 and ran comparative simulations on all the leading academic and official models of the period. Comparable research is still being carried out by the ECB and in the US but it seems to have largely died out in Britain.

Oxford Economic Forecasting and Liverpool University (now the Liverpool/Cardiff model). In the August 1991 NIESR Review, for example, the Warwick team simulated the effects of reducing the rates of VAT, income tax, and employers' national insurance contributions, as well as of increasing the level of general government expenditure. The advantages of such work were that: it was possible to assess the impact of different taxes on a wide range of economic variables in a way that was not unduly dependent on the quirks of any particular model; it indicated how the impact of tax changes often depended on other aspects of the models concerned – for example, the nature of the wage and exchange-rate equations; and it revealed oddities in the models involved, which could then be corrected.

An updated version of such evidence would clearly have been invaluable recently, and could have highlighted the important adverse consequences of the decision to increase the standard VAT rate and employers' national insurance contributions. Unfortunately, the UK policy debate has tended to become over-reliant on the static calculations employed by bodies whose expertise lies in the microeconomic details of the tax structure rather than the wider second-round macroeconomic consequences. Such static calculations can misjudge the direction, as well as the magnitude, of the long-run effects of tax changes on public borrowing and other economic variables.

An important step towards more accurate and comprehensive fiscal analysis of tax policy decisions was taken by HM Treasury in 2013, however. In addition to the usual analysis provided at an autumn statement, that year's documents included results from the Treasury's computable general equilibrium model which estimates some of the dynamic effects of cuts in the rate of corporation tax. Unfortunately, perhaps the model's most significant flaw is that it does not capture the effect on the rate of economic growth, only the level. But the results were impressive, nonetheless. The announced cut in the rate from 28 per cent to 20 per cent was found to increase GDP by between 0.6 and 0.8 per cent, equivalent to an increase in average wages of around £500 per household in 2013–14 prices.

One of the few recent UK attempts to undertake a dynamic analysis using a properly specified macroeconomic forecasting model was published by the NIESR shortly after the general election in 2010, shown in table 3.5.¹⁵² The table shows the effect on the level of real GDP of fiscal tightening measures equivalent to 1 percentage point of GDP. The government spending cut simulation, for example, suggests that it reduces real GDP by 0.37 percentage points in the first year after its implementation, and 0.14 percentage points in the second year, but that GDP was 0.23 percentage points higher by the third year. The inclusion of government spending in the definition of GDP means that a 1 percentage point cut in the public spending ratio boosted the residual private sector component of national output by the equivalent of 0.63 per cent of total GDP in year one, 0.86 per cent in year two, and 1.23 per cent in year three. This is pretty strong evidence in favour of the crowding-in effects of government spending reductions from what was once regarded as the main UK bastion of Keynesian economics. The NIESR research further suggests that the first-year effects of a VAT hike are more damaging than raising the same revenues from an increase in income tax, although both effects are close to zero in the second and third years of the simulation.

¹⁵² Barrell, R., *What are the effects on growth of increases in taxes and cuts in spending?*, NIESR press release, 18 June 2010.

Table 6.2: impacts on growth of 1 per cent of GDP budget improvement from fiscal measures

	Government spending cut	Income tax increase	Government pay cuts	Increased VAT	Pension and benefits reductions
Year 1	-0.37	-0.11	-0.05	-0.16	-0.10
Year 2	-0.14	0.00	0.00	0.02	0.00
Year 3	0.23	-0.01	0.03	0.05	-0.01

Simulations of the effects of different tax and expenditure assumptions using the Beacon Economic Forecasting macroeconomic model have also been presented in research for the TaxPayers' Alliance.¹⁵³ The paper argued that the process of deficit reduction and economic recovery would be best served through a mixture of reduced public spending and tax cuts. A similar study was produced for the 2011 Institute of Economic Affairs publication *Sharper Axes, Lower Taxes: Big Steps to a Smaller State*.¹⁵⁴

The main findings of that study were:

- The best buy amongst the counter-factual tax and spending options considered would have been one in which the VAT and national insurance increases implemented in 2011 had not taken place but public spending had been cut by a further £20 billion instead.
- The increase in VAT to 20 per cent was an error that had boosted joblessness by some quarter of a million, cut national output by 1.2 per cent and increased the public sector net borrowing requirement by 0.1 to 0.2 percentage points of GDP.
- Cuts in public consumption reduced headline GDP but had no immediate adverse effect on private activity while leaving real private domestic expenditure higher in the long run – a result that tallies with the NIESR research described above.
- The official UK borrowing projections were unlikely to be achieved, even if some modest reduction in the PSNB/GDP ratio remained possible in the longer term. That prediction has since been confirmed in the 2011 autumn statement.

However, there are serious impediments to any attempt to incorporate the effects of taxes into time series-based macroeconomic forecasting models. One problem is the complexity and fluidity of the tax system itself. This makes it hard to incorporate tax measures into economic relationships which may include quarterly observations back to the early 1960s. In theory, if the tax structure were fixed, and all that changed was the rate of tax, provided this changed fairly frequently, it would not be too difficult to incorporate taxes into a time-series modelling framework. Unfortunately, none of these conditions hold in practice, especially when stealth taxes are being employed to hide increases in the tax burden.

In the Beacon Economic Forecasting model the logarithmic ratio of non-oil tax receipts to non-oil GDP is explained statistically using the logarithm of a weighted

¹⁵³ Smith, D. B., & Sinclair, M., *The economic effects of a rapid fiscal adjustment*, TaxPayers' Alliance, 21 June 2010

¹⁵⁴ Booth, P., (ed) *Sharper Axes, Lower Taxes: Big Steps to a Smaller State*, Institute of Economic Affairs, 2011

average of the various UK tax rates, the logarithm of one minus the ratio of government spending to GDP, and a time trend. This statistical equation embodies noticeable fiscal drag, reflecting the progressive nature of the tax system, so that a 1 per cent rise in the weighted tax rate generates a 1.63 per cent rise in receipts, while there is also a positive time trend of 1.24 percentage points of national output per annum.¹⁵⁵ However, the tax receipts equation also has the property that revenues fall as the share of government spending (defined to exclude debt interest) in national output increases. This implies that only the private sector generates tax revenues, a consideration that has become increasingly important as it has shrunk over the years. The Treasury has consistently overestimated tax receipts when government spending has risen because it does not properly allow for this effect. This mistake works the opposite way round when the private sector is growing rapidly.

At a more detailed level, different taxes have different effects in the Beacon Economic Forecasting model, with a VAT increase being more immediately inflationary than a rise in income tax, for example. However, the practical difficulty of measuring the effective rates of tax concerned mean that there are effectively only two main categories of tax incorporated in the model, indirect and direct (including national insurance contributions). Increases in both sets of taxes have serious adverse effects on a wide range of private activities, including household consumption, private investment, net trade, employment and the exchange rates. In some cases, supply-side theory implies that it is the relative tax burden in Britain compared to overseas that is the more relevant. The export, import and exchange rate relationships are examples of where this hollowing out effect applies. The main difference between the consequences of the two main tax types is that the higher inflation brought about by increased indirect taxes has initially more powerful second-round effects because it triggers increases in interest rates and reduces household consumption.

It is also important to note that, even in a model such as the Beacon Economic Forecasting one that incorporates some of the strongest adverse feedbacks from high taxes to the wider economy of any UK forecasting model, those adverse effects are probably understated because of the difficulty of measuring the ex ante tax burden over time. The damage done by a tax rate that is high but unaltered throughout the estimation period cannot be picked up by conventional time-series methods, for example. Instead, its adverse effects will be allocated to other variables including the constant terms in the statistical relationships concerned. This is why the evidence from panel data studies provides an essential supplement to the results derived from macroeconomic modelling.

6.1.4. Neo-classical macroeconomics suggests countries with larger market sectors will have a higher level of income; post-neo-classical endogenous growth theory suggests countries with larger market sectors will have a higher level and growth rate of income

There is some debate in the literature as to whether taxes and spending affect the level or growth of real GDP. That problem exists on two levels.

The first is that the change in the size of the state within a given period may not be closely associated with its level at the start of the period, making it difficult to disentangle the two effects. At its peak in 1993, for example, spending in Sweden was 71.7 per cent of national income, but it has subsequently been cut by 19.8 percentage points to 51.8 per cent of national income in 2011. Does Sweden's current reasonable economic

¹⁵⁵. The error correction equation concerned was estimated using quarterly data from 1978 Q2 to 2011 Q3, had an R-bar-squared of 93.39 per cent and a standard error of 2.76 per cent. However, much of the explanatory power resulted from the inclusion of seasonal dummy variables designed to pick up the marked seasonal fluctuations in tax receipts.

performance, therefore, indicate that the size of the public sector does not matter or that large spending cuts create such strong results that they can offset the adverse effects of a high starting level?¹⁵⁶ Leach has examined the reasons for the relative success of the Nordic economies in recent years. He concludes that “the success of Scandinavia is a triumph of government downsizing, and smart deregulation. Nordic countries are therefore a showcase of “neo-liberalism”, and not a counterexample.”¹⁵⁷

The second issue concerns the growth model considered appropriate. In a so-called neo-classical model one would expect the path of the logarithm of aggregate supply to move from one growth line to a lower parallel one when non-productive government spending and taxes rose, but the slope of the line to remain unaltered. This means that the growth rate would fall in the transition period but would then return to its previous rate. In a post-neo-classical endogenous growth model, in contrast, the slope of the growth line would be flatter after the spending or tax burden rose, as well as there being a downwards shift. This means that both the growth and the level of output would be permanently reduced.

Figure 6.3: effects in neo-classical model

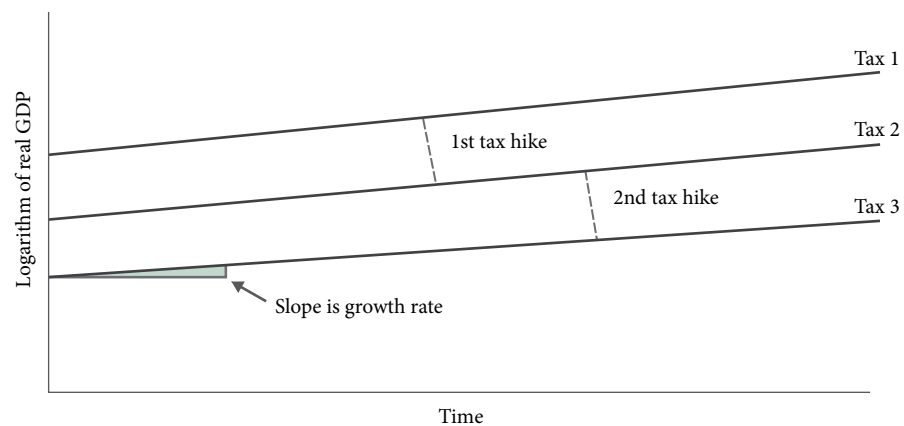
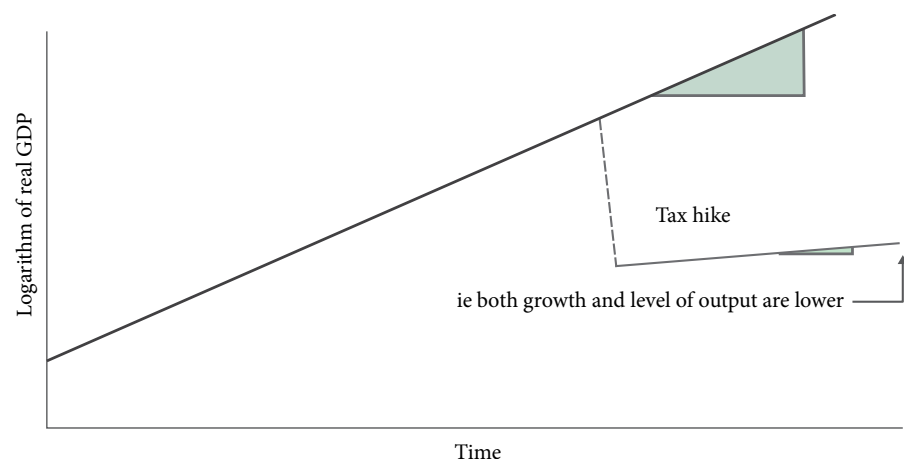


Figure 6.4: effects in post-neo-classical endogenous growth model



¹⁵⁶. This issue is addressed in the statistical analysis reported by Bates, W. *How Much Does Size of Government Matter for Economic Growth?* consultancy report prepared for New Zealand 2025 Taskforce, 27 September 2010. In practice, modern econometric techniques can readily distinguish between growth and levels effects so this is not a problem in a serious analysis.

¹⁵⁷. Leach, G., *Economic Lessons from Scandinavia*, Legatum Institute, 26 October 2011

There is general agreement that an increased public consumption burden drives down the ratio of private capital formation to national output

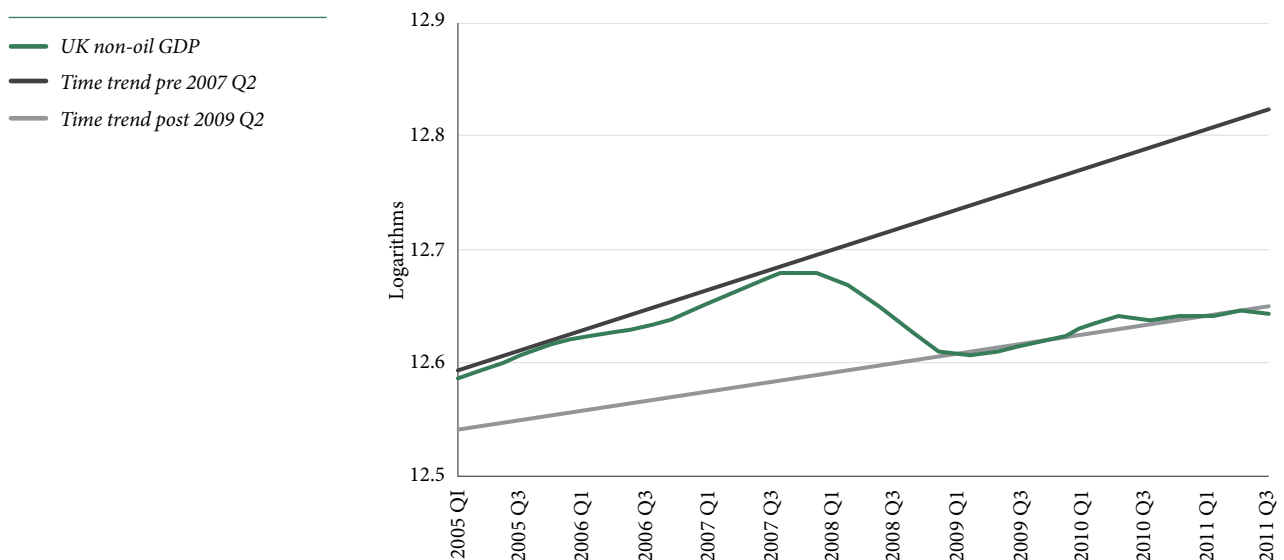
There is general agreement – and much empirical evidence – that an increased public consumption burden drives down the ratio of private capital formation to national output. The disagreement is entirely to do with whether technical progress proceeds exogenously – as the neo-classical school believes – or whether it has to be embodied in new capital equipment – in which case, no investment means zero technical progress – as the post neo-classical endogenous growth school believes.

Different taxes may also have different effects on the level and growth of income; many of those effects are discussed in more detail by Heath.¹⁵⁸

That the UK may have suffered from a post neo-classical supply withdrawal in recent years can be seen from figure 6.2. This shows the logarithm of UK real non-oil GDP from 1995 Q1 to 2011 Q4, which is the longest back run currently available, and two time trends; one fitted from 1995 Q1 to 2007 Q2, and the other from 2009 Q2 to 2011 Q4. The similarities with the diagram showing the effect of a tax hike in a post-neoclassical-endogenous growth model are apparent, even if the small number of observations for the two periods means that the results need to be treated with caution.

The statistical results¹⁵⁹ indicate that real non-oil GDP was 16.6 per cent below its pre-2007 Q2 trend in the fourth quarter of 2011 but it was then only 0.7 per cent below the post-2009 Q2 trend. The slope of the pre-2007 Q2 trend was equivalent to a growth rate of 3.5 per cent each year while the post-2009 Q2 trend was 1.6 per cent each year, representing a growth deceleration of 1.9 percentage points. Such differences explain why it is hard to measure the output gap in practice and why supply shocks can be quantitatively important. This remains the case even if it is accepted that the post-2009 Q2 trend is not yet well defined and that some of the recent weakness of GDP results from a demand shortfall as well as a supply contraction.

Figure 6.5: logarithm of UK real non-oil GDP 2005 Q1 to 2011 Q4 with fitted time trends



A good theory should be capable of explaining both microeconomic and macroeconomic phenomena. Indeed, one of the objections to Keynesianism in its early

¹⁵⁸. Heath, et al, *The Single Income Tax*, The TaxPayers' Alliance and the Institute of Directors, 4.1.2., 2012

¹⁵⁹. This work was carried out prior to the revisions of data in September 2014 in accordance with the Eurostat's European System of Accounts ESA2010. The nature of the revisions are such that readers should view them with significant caution.

days was that it was not properly rooted in the older microeconomic approach. The development of “representative-agent” models from the early 1980s onwards was an attempt to remedy this defect. However, the simplifying assumptions required to make these models work – especially those concerning the ways in which economic agents formed their expectations – meant that this approach failed to give any advance warning of the 2008 financial crash. The shortcomings in the conventional theoretical macroeconomic model meant that financial bubbles and crashes were considered to be so illogical by central bankers that they could not happen, leaving the monetary authorities in Britain and the US badly unprepared when they did occur.¹⁶⁰

The dynamic general stochastic equilibrium forecasting models that followed on from this approach – and were widely employed by central banks – assumed that output quickly reverted to its underlying trend following any disturbance.¹⁶¹ However, no serious attempt was made to explain this trend in terms of the post-tax returns to supplying labour, new capital formation or engaging in entrepreneurship.

The increase in the British and US spending ratios in the 2000s could be expected to lead to a noticeable slowdown in the sustainable growth rate of those economies. In the case of the UK, for example, the 8.4 percentage point rise in the government spending ratio between 1996–2000 and 2006–10, a comparison that smoothes out the recent recession, might be expected to slow growth by 1.25 percentage points, for example from 2.75 per cent to 1.5 per cent (section 6.1.7). Since the values of equities and property represent the net present values of future income streams deflated by the risk-free return on long-term bonds, such a slowdown would be expected to reduce the values of shares and property by some 45 per cent, other things being equal. This implies that the global financial crash was part of the transmission mechanism through which increased public spending in the US and elsewhere crowded out private activity and caused a supply withdrawal.

The global financial crisis may have partly been a consequence of the increased scale of government diminishing aggregate supply. Perverse tax incentives, such as the more favourable treatment of corporate debt than equity, may also have contributed to the crisis.

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6.2. Howard Flight: tax credits

It is particularly irritating that the Treasury red book figures and those from the Department for Work and Pensions on welfare spending differ and include different, particular items. In addition, some of the regional expenditure for Scotland, Wales and Northern Ireland amounting to £49 billion for 2014–15 and local authority spending, amounting to £35 billion, comprise an element of welfare expenditure. Making the best of the data available, total national welfare spending for 2014–15 will be between £230 billion and £240 billion. Budget 2014, meanwhile, estimates spending on “social protection” at £222 billion in 2014–15. With projected NHS

¹⁶⁰ Smith D. B., *Cracks in the Foundations? A Review of the Role and Functions of the Bank of England after Ten Years of Operational Independence*, Economic Research Council, research paper no. 23, May 2007

¹⁶¹ The issue of how to incorporate the supply side properly has recently been addressed in Vetlov, I., Hledik, T., Jonsson, M., Kucsera, H., & Pisani, M. Potential Output in DSGE Models, European Central Bank working paper, no. 1351, June 2011. Most current forecasting models do not incorporate such insights.

expenditure for 2014–15 of £108 billion, these two areas of expenditure account for approaching 50 per cent of current expenditure of £732 billion. Spending in these two areas has, moreover, grown the fastest, well in excess of inflation and fiscal revenues. Two self-evident points present themselves. Firstly, as the German chancellor, Angela Merkel, has pointed out in a European context, this is unsustainable. Secondly, expenditure in these areas will have to be, at the least, tightly constrained if not reduced in order to sort out the public finances.

Within total welfare expenditure, £87 billion is accounted for by state pensions. (Note there is a further £10 billion bill for “pay as you go” public sector pensions not included in the welfare spending total). A further £29 billion is accounted for by tax credits and housing benefit, which now amounts to £25 billion. Other material items include £13 billion disability allowance, £6 billion attendance allowance, £4 billion jobseeker’s allowance, £2.4 billion statutory maternity pay, £2 billion winter fuel payments and £2.3 billion child benefit. I estimate the element of welfare expenditure within expenditure on the regions and local government expenditure at around £10 billion. Since their introduction by the Labour government in 2003–04, expenditure on tax credits has, approximately, doubled.

Budget 2014 introduced a commitment to cap welfare spending for the years 2015 to 2019. This cap was set at £119.5 billion in 2015–16 rising to £126.7 billion in 2018–19. The cap does not, however, include jobseeker’s allowance and its passported housing benefit; universal credit payments to claimants subject to full conditionality and on zero income; both basic and additional state pension expenditure; government transfers, such as television licences for the over 75s; and benefits classified under departmental expenditure limits, such as maternity grants and payments for specialist vehicles.

Iain Duncan Smith is to be congratulated for getting to grips with the nightmare territory of welfare spending and tax credits. The universal credit provisions increase tapering and reduce “cliff edge” disincentives for those entering work and they look to be bearing fruit already. Since 2010, 1.5 million new jobs have been created, of which approximately one-third – 620,000 – have increased the numbers of self-employed to 4.5 million. Interestingly, 70 per cent of the increase in the number of self-employed since 2008 is represented by individuals aged over 50. The new universal credit includes jobseeker’s allowance, employment and support allowance, income support, working tax credit, child tax credit and housing benefit. The maximum universal credit payable to households with children will be £26,000 tax free, equivalent to an annual taxable income of £35,000. Given that this is substantially above the level of average earnings it looks too high and subsequent governments may well look to reduce this.

The debate which has, however, been ducked involves the economic arguments for and against paying in-work, cash benefits. The political and moral case is to boost the incomes of the lower paid to achieve a reasonable, “western” standard of living and to boost employment. However, there is a downside to the move away from cliff edges and towards more proportionate withdrawal of benefits from those on low incomes. Tax credit tapers reduce the incentive for employees to negotiate higher wages because a substantial fraction of the negotiated gain from an employer would be “lost” in tax credit payments withdrawn through the taper. This has the effect of lowering the equilibrium wage rate which, in turn, requires minimum wage legislation to put a floor on the extent to which employers can hold down pay. This is important because in cases where the employee would have been employed without the tax credit, some of the value of the tax credit would accrue to the employer in the form of a lower wage rate than otherwise would have been the case. So, in

these cases, tax credits have the effect of subsidising wage costs, at least in part. It is worth noting that this applies to the universal credit and would be true of a negative income tax, too.

Any payment to people that is withdrawn proportionately when their original incomes rise will weaken their incentive to increase their original incomes. When this proportion is 100 per cent, in other words when they lose £1 of benefit for each £1 of extra original income, this will entirely eliminate the immediate financial incentive for people to increase their incomes. Other incentives will still exist, such as the desire to earn your own money rather than rely on the state. And some might try to raise their earnings anyway with a view to increasing them still further in future when the earnings pass the taper and they get to keep at least some of the extra money earned from that subsequent earnings increase. But these incentives are much less direct and powerful than that of keeping the money in the first place.

It is also true that this effect is reduced the further away the taper gets from 100 per cent. The lower the taper, the more money you keep and therefore the greater the incentive to increase your earnings.

In addition, this effect also influences employers' decisions over whether to hire labour or invest in labour-saving technology. As discussed, tax credits transfer some of the marginal cost of labour from employers to taxpayers. The effect of this is to make labour more attractive and, consequently, to reduce the attractiveness of labour-saving technology. While the upside of this has been stronger employment figures, the downside has been weaker productivity. Productivity growth can ultimately only happen when companies produce more output with the same resources, or the same output with fewer resources. The principle means of achieving this is through labour-saving technology. Weak productivity and weak wage growth are highly likely to be the consequences of the tax credit system, just as the weak productivity growth during the Speenhamland system was in large part caused by the same flawed policy then.

So as the cost of tax credits has doubled over a decade, it is no wonder that the chancellor of the exchequer wants to increase the minimum wage to reduce the exchequer costs of subsidising employment. Yet if the minimum wage is pitched too high it will price some people out of work. It is not certain that employers would still view all of those currently employed on wages on or just above the current minimum wage level as profit-making expenses should the minimum wage level rise, once the risks associated with employing staff have been taken into account.

The recent prior attempt to introduce what amounted to employment subsidies was the negative income tax proposals of the Heath government, in 1974. This was overtaken by the "three-day week" spring general election. Interestingly, however, the Labour party leadership was strongly opposed to the proposals at the time. They pointed to the arguments which led, eventually, to the ending of the early 19th century arrangements to subsidise employment, known as the Speenhamland system. This extended the Elizabethan poor law provisions to the payment of in-work benefits/subsidies. This was financed, locally, under the poor law rates. The ballooning costs led to some towns going bust, as the poor law levies escalated. Particular criticisms were that paying employment subsidies suppressed natural market pay rates and encouraged over-manning in long-standing, non-growth sectors – at the time, agriculture. This, in turn, depressed productivity growth. As well as depressing equilibrium wage rates, subsidising employment also discourages people from improving their skills because the taper means that the skills make little difference to their overall take-home pay. When the Speenhamland system was abolished in 1834 there was a substantial movement of labour out of agriculture into the new iron,

*Tax credits transfer
some of the marginal
cost of labour
from employers to
taxpayers*

coal and steel industries of the day, leading to the Industrial Revolution take-off over the following 20 years. This was accompanied by large increases in real pay. When Gordon Brown introduced tax credits I opposed them on much the same arguments, quoting the points made by the Labour leadership back in 1974.

While tax credits undoubtedly had a role in preserving jobs during the difficult economic period following the financial crisis in 2008–09, it is observable that they have also had similar effects to those of the Speenhamland system. The cost ballooned, doubling over approximately a decade, wage increases have been suppressed and UK productivity growth has been negative and poor over the last decade as a whole. Low productivity is the fundamental reason for recent poor performance of real wages and is one of the reasons people cannot keep up with the rising cost of living.¹⁶² If real wages are to rise, we need a bigger movement of people into the new, higher growth, high-tech sectors; and individuals need to see, readily, that if they improve their skills, their take home pay will increase.

There is also a practical, administrative issue with regard to tax credits. They were introduced in 2003–04 on, effectively, a self-assessment basis which, inevitably, was found subsequently to have led to substantial over-payments. This has been tightened up since, but what is really needed is, in effect, a negative income tax return to discourage and detect over-claiming. Yet, here, the system is too complicated for many to be able to cope with this.

The new universal credit regime has the advantage of centralising and, in this context, simplifying, welfare payments, including tax credits, but is also likely to continue, if not worsen, the “Speenhamland” negative effects. There is, potentially, an even stronger incentive to employers to hold down wages and a continuing, negative impact on productivity growth. The majority of claimants for universal credit will be in work.

There is also one particular territory which I believe has become an unfair “nightmare”. Gordon Brown introduced child tax credits as an additional and separate benefit to the existing, historic, child benefit. George Osborne subsequently limited qualification for child benefit, discriminating against non-working mothers by not tying receipt quantum eligibility to family incomes. Child benefit was introduced as a universal benefit by the Wilson government to replace child tax allowances, which benefitted the better off paying higher rates of tax. Subsequently, the argument has been employed that having children is a voluntary decision and, therefore, should not enjoy special fiscal treatment. I view the latter as a nonsense, in that if nobody had any children the country and indeed the economy would die out in due course. Raising children has become increasingly expensive and, as it is in the national economic interest so to do, is deserving of fiscal support. It seems unnecessary to have two different sorts of child support. The logical remedy might be to roll both into a single benefit or credit, with a minimum universal benefit, which increases on what amounts to a family, means-tested basis.

Universal credit will also include housing benefit. This was introduced by the Thatcher government, essentially as an alternative to the provision of subsidised council housing. Notwithstanding, both local councils and housing associations continue to provide subsidised housing but which also qualifies, where relevant, for housing benefit. The objection to housing benefit is that it has been landlords who have been the main beneficiary, as a result of being able to charge higher rents than they could otherwise achieve. In this sense, it is the reverse side of the coin to working

¹⁶². Reforms aimed at reducing costs in housing, childcare, food and energy markets are discussed in section 2.1.

tax credits which have held down wages to the benefit of employers. Housing benefit has served to raise rental incomes for landlords. It has also given rise to a significant source of abuse, particularly, in large inner city areas. The new arrangements also pose the practical problem in that, where to date housing benefit has been paid directly to the landlord – including frequently housing associations – the funds will instead be credited to the relevant individuals' bank account, leaving open the possibility of some not paying their rent and spending the money on other things. Like tax credits, housing benefit costs have also risen sharply to a current total of £25 billion. The case for reform in housing markets is overwhelming.¹⁶³

What reforms might, therefore, be sensibly made which would be politically possible and acceptable? Any reform would need to both reduce what are otherwise likely to be ever increasing and unaffordable costs and also to reduce the distortive and negative effects on the labour market and market rates of pay. Without tackling the harmful impact wage subsidies have on firms' investment decisions and therefore productivity, productivity and thus wage growth will continue to be subdued. I believe both main parties are politically committed to the new universal credit arrangements at least for the next generation. I anticipate that the amounts of individual tax credits and the maximum universal credit payment will be reduced or frozen. If we are to continue to provide welfare for people in work which depends on how much they earn, then on balance a negative income tax is probably a better way to do it than the tax credits or the universal credit, especially if it can reduce the taper while minimising the cost to taxpayers. But I see universal credit moving in the direction of the German welfare system, which is based on assessments by welfare officers of how much support subsidy a family or individual needs. Housing benefit might be controlled by introducing maximum payments, determined, as appropriate, on a regional basis. I would argue for the working tax credit element to be phased out of universal credit and replaced with a negative income tax. Child benefit and child tax credits should be merged into a single, universal child benefit, increasing on a family income, means-tested basis.

Lord Flight is a successful fund manager, a financial services regulator and a director of Metrobank. He was the member of parliament for Arundel and South Downs from 1997 to 2005 and became shadow chief secretary to the treasury and a member of the shadow cabinet.

6.3. Crowding out private sector

6.3.1. In some regions spending is particularly high and crowding out the private sector

Research by the Centre for Economics and Business Research shows dramatic disparities in the extent that spending is higher or lower as a share of income in different regions.¹⁶⁴

¹⁶³. Reforms to the housing market are discussed in section 3.1.4

¹⁶⁴. Centre for Economics and Business Research, *One pound in five earned in London subsidises the rest of the UK – Northern Ireland, Wales and North East receive more than a fifth of their income as subsidies from outside the region*, 13 February 2012

Table 6.3: government spending and deficits in UK regions, percentage of GDP at market prices, 2010–11

Region/country	Total receipts	Expenditure	Deficit	Deficit compared with UK
North East	29.7	61.9	-32.2	-22.2
North West	37.5	55.9	-18.4	-8.5
Yorkshire & the Humber	35.0	53.7	-18.7	-8.8
East Midlands	34.1	49.0	-14.9	-4.9
West Midlands	35.4	53.8	-18.4	-8.4
East	36.7	45.1	-8.4	1.5
London	45.2	34.9	10.3	20.3
South East	41.1	40.3	0.7	10.7
South West	35.7	47.4	-11.7	-1.7
Scotland	43.0	53.0	-10.0	0.0
Wales	30.3	66.3	-35.9	-26.0
Northern Ireland	27.7	67.0	-39.3	-29.4
UK	37.9	47.9	-10.0	0.0

Those substantial disparities are the result of pronounced differences in earnings and productivity. Unfortunately they may be exacerbated and entrenched by high spending and high taxes.

Before regional spending data became available, it was possible to believe that the main problem was not that public spending was harmful but that it had to be paid for and that all practical funding methods had adverse consequences which increasingly outweighed the gains. The underperformance of certain areas, despite decades of massive transfers from outside, suggests that high levels of government spending may themselves be responsible for the problems of the poorer regions, even when the public spending is funded by transfers from elsewhere. How can large amounts of “free” money be damaging?

Receipt of transfers can be harmful because they encourage people to look towards political activism and state dependency, rather than their own efforts in the marketplace. It leads to a misallocation of entrepreneurial talent of the kind envisaged by Baumol.¹⁶⁵

Transfers will also affect the labour market. In particular, policies such as a minimum wage, out-of-work benefits and non-wage labour costs are often understood on the basis of their effect on the national economy. But if there is a series of distinct regional labour markets, with imperfect mobility between them, the impact of additions to labour costs will vary from place to place with the adverse impact being greatest in the low cost and low productivity regions and least in the high cost and high productivity areas. More jobs will be destroyed – or never created – in low productivity areas, such as the North East, than in London and the South East.

This point is illustrated in the third column of Table 3.8. That column scales the 2011 minimum wage of £6.08 per hour (now £6.50 per hour) for the differences in median gross weekly earnings in the various regions of the UK. The table suggests that the minimum wage should range from £5.39 in Northern Ireland and £5.40 in the North-East, to £6.68 in South-East England, and £7.40 in London, if it were

¹⁶⁵ Baumol, W. J., *Entrepreneurship: Productive, Unproductive, and Destructive*, The Journal of Political Economy, 98, 5, October 1990

to reflect regional differences in median earnings. The fact that it does not do so explains why the minimum wage is likely to price more people out of employment in the North East than in London, for example. The percentage of the working age population with no qualifications was 8.4 per cent in the South East but 21.4 per cent in Northern Ireland in mid-2009.

Table 6.4: median weekly earnings, productivity and minimum wage and tax thresholds corrected for regional differences

	Labour productivity (basic-price GDP per head in 2010)	Median gross weekly earnings in April 2010 (£)	Adult minimum wage scaled to reflect differences in median earnings (£)	Scaled personal allowance for income tax in 2012–13 (£)	Inheritance tax threshold corrected for house prices in December 2011 (£000)	Percentage of working age population with no qualifications in 2009 Q2	Population of working age claiming a key social security benefit in February 2010 (%)
North East	74.3	479	6.01	9,249	183	10.7	17.9
North West	85.2	483	6.05	9,315	208	11.0	16.6
Yorkshire & the Humber	81.4	479	6.01	9,249	211	10.4	15.1
East Midlands	82.6	477	5.99	9,212	226	10.3	13.1
West Midlands	83.0	479	6.01	9,249	236	13.6	15.1
South West	90.5	485	6.09	9,363	297	6.6	11.6
East	93.6	506	6.35	9,764	338	8.4	11.0
London	171.9	661	8.29	12,751	610	7.8	12.0
South East	110.5	541	6.79	10,452	402	6.5	9.8
England	103.0	524	6.57	10,108	339	9.1	13.1
Scotland	94.0	519	6.52	10,027	237	10.3	15.5
Wales	72.2	473	5.94	9,139	204	10.6	17.4
Northern Ireland	76.7	457	5.74	8,826	170	17.2	-
UK	100	518	6.50	10,000	325	9.5	11.0

Welfare benefits in Northern Ireland, Wales, Scotland and northern England – even when financed through taxes collected in London and the South East – can diminish employment in the recipient regions due to their micro-economic effects. That was the situation in the former East Germany, where West German employment costs were imposed on an economy where output per head was only around one-third of that in the former West. Similar problems have been observed in Poland by Zientara, where benefit levels set at a national level have almost no observable harmful effects in Warsaw but have been associated with a serious structural unemployment in the old centres of heavy industries.¹⁶⁶ And it is a well-understood problem for the Italian Mezzogiorno.

One response to the regional anomalies in the labour market associated with the present system would be to introduce regional differentials in welfare benefits

¹⁶⁶ Zientara, P., *Regionalism and Free-Market Reform: The case of Poland*, Economic Affairs, Institute of Economic Affairs, vol. 27, no. 2, June 2007

and the minimum wage, to reflect the divergent productivity and living costs of the regions concerned.

Another response, widely practised in nations with a federal structure, is to make welfare benefits a responsibility of devolved arms of government, such as states, provinces or cantons. The local administration of welfare allows benefits to be set appropriately to local conditions, and reduces the problems caused by setting one benefit level across a heterogeneous area. Public sector pay also needs to better reflect conditions in different regions.

At budget 2012 the government announced it had “provided evidence to the pay review bodies on the economic case for reforming public sector pay to better reflect local labour markets”.

It has been known for some time that a relatively high tax burden at the level of individual states is associated with a poor economic performance in federal systems. However, recent years have seen the appearance of US studies which suggest that high government spending levels are damaging, even when they have been funded from outside. Such studies typically apply a neo-classical growth model to look at the effect of externally determined transfers from the US federal government to individual states. One feature of such models is that exogenous transfers tend to lead to increased consumption but a withdrawal of labour hours, as citizens of the state can now afford to take more leisure, and also reduced private sector capital formation because of crowding-out effects and increased shareholder payouts.

Cohen, Coval and Malloy used the fact that the politically powerful chairmen of congressional committees could use their powers to “earmark” extra federal spending for their constituencies to study the issue.¹⁶⁷ Since these expenditures were politically determined, they could then be treated as exogenous with respect to their effects on activity and employment within the recipient states concerned, which were examined using a sample of 16,734 firms over the period 1967 to 2008. The Harvard Business School authors concluded:

The central finding of this paper is that positive shocks to the seniority of a state’s congressional delegation cause large and persistent increases in government allocated funding to the states, and significant retrenchment on the part of corporations headquartered in the state. This retrenchment appears to be a response to the large and persistent increase in federal funding that the state receives following the shock. Following the appointment of a senator to the chair of a powerful committee, we estimate that his state experiences, on average, a 40 per cent to 50 per cent increase in its share of congressional earmark spending, a 9 per cent to 10 per cent increase in its share of total state-level government transfers, and a 24 per cent increase in its share of government contracts. At the same time, firms residing in the state cut their capital expenditures by 8 per cent to 15 per cent, reduce their research and development spending by 7 per cent to 12 per cent, and increase payout by 4 per cent to 13 per cent. Employment and sales growth are also impacted, as corporations scale back employment growth by 3 per cent to 15 per cent, and sales growth falls by up to 15 per cent.

This finding is of interest because of the details it provides on the “crowding-out” transmission mechanism involved when funds are allocated primarily for political

¹⁶⁷ Cohen, L., Coval, J.D. & Malloy, C., *Do Powerful Politicians Cause Corporate Downsizing?*, National Bureau of Economic Research, March 2010

purposes, irrespective of whether that occurs in the US or Britain. Overall there is good evidence that receiving substantial fiscal transfers is depressing the economies of Britain's struggling regions.

6.3.2. Public sector debt is a large and growing burden on taxpayers and the economy

UK official debt is substantial but the real national debt is much higher

The official national debt is only part of the public sector's total liabilities. Research for the TaxPayers' Alliance estimated that total liabilities are much higher and have risen dramatically. The findings are shown in table 6.5.¹⁶⁸

While the estimates are now dated, TPA research released in 2014 has shown that unfunded public sector pension liabilities have grown from £1.3 trillion in 2009–10 to £1.7 trillion in 2012–13.¹⁶⁹ And meanwhile public sector net debt has grown from £884 billion in December 2009 to £1.5 trillion in December 2015.

The intergenerational accounting measure of the off-balance sheet commitments of the state calculated by Hagist et al. suggests that the UK was already in the weakest situation of any industrialised country in 2004, well before the international financial crisis struck, as shown in table 6.6.

Table 6.5: official and real public sector liabilities, 2000–01 to 2009–10

£ billion	2000–01	2005–06	2006–07	2007–08	2008–09	2009–10
Official national debt (PSND)	311	462	498	622	742	890
Plus						
Unfunded public sector pensions	434	907	931	1,104	1,119	1,283
Unfunded state pensions	1,411	2,028	2,199	2,370	2,542	2,717
RBS/Lloyds debt	0	0	0	0	3,439	2,585
PFI (capital only)	10	24	28	35	35	38
Network Rail debt	0	18	18	20	22	23
Nuclear decommissioning	14	31	37	44	45	45
Other	109	148	133	81	171	292
Real national debt	2,289	3,617	3,844	4,276	8,114	7,873
Real national debt (% of GDP)	231	285	286	302	566	560

Table 6.6: fiscal gaps as a share of GDP in 2004 (%)

Country	Explicit debt	Implicit debt	Total
Spain	45.4	35.4	80.8
Switzerland	55.2	64.8	120.1
Austria	62.8	179.9	242.7
Norway	40.6	250.8	291.3
Germany	62.5	252.6	315.1

¹⁶⁸. Denham, M., *The Real National Debt: A Decade of Reckless Growth*, TaxPayers' Alliance, 19 October 2010

¹⁶⁹. Meakin, R., *The £1.7 trillion invisible debt mountain: public sector pensions liabilities*, TaxPayers' Alliance, 2014.

Country	Explicit debt	Implicit debt	Total
France	60.4	254.9	315.3
USA	57.1	350.8	407.9
UK	37.2	510.0	547.2

There is an independent negative crowding out effect through the budget deficit.

High and rising debt tends to mean lower economic growth

The seriousness of the debt issue across the developed world, and its potentially catastrophic consequences for monetary union, has caused the European Central Bank (ECB) to carry out several major studies of the subject. The conclusions are likely to apply to many other similar industrialised economies, including the UK.

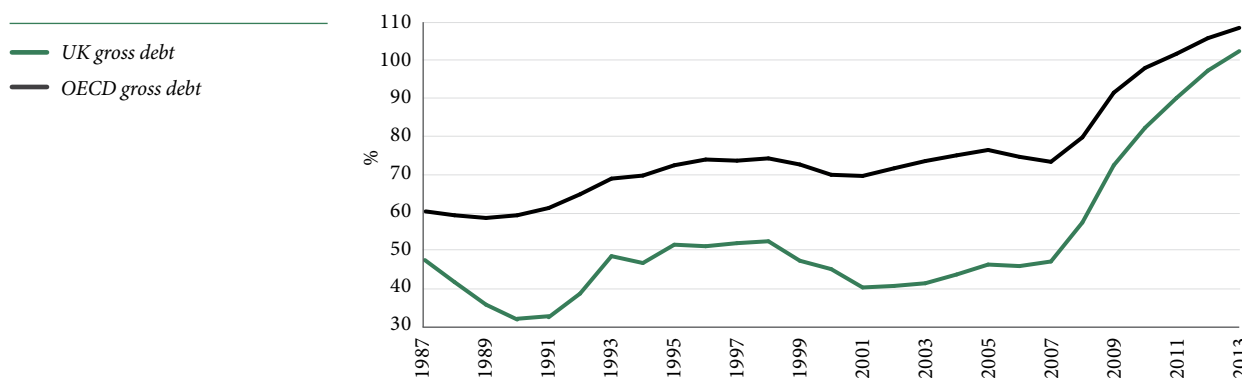
A recent study by Checherita and Rother investigated the relationship between the government debt to GDP ratio and the growth rate of GDP per head for a sample of twelve eurozone countries for the four decades from 1970 onwards.¹⁷⁰ The basic empirical growth model related the growth rate of real GDP per head to the initial level of income per head, the ratio of investment/saving to GDP, population growth and the level of gross government debt as a share of national income.

The relevant coefficients were estimated using a sophisticated panel-data approach, which allowed the effect of the debt to GDP ratio to take on an inverted U shape – ie positive initially and then switching to negative beyond a certain point.

The ECB researchers found several channels through which the level, or the change, in the government debt ratio adversely affected real growth including through: private saving; public investment; total factor productivity; and long-term interest rates. A robust conclusion was that public debt was harmful for economic growth above a threshold of some 90 per cent to 100 per cent of GDP but crowding out effects through the budget deficit (the change in the debt stock) had an independent negative effect below this threshold.

While that study's use of gross rather than net debt may not be ideal, it is significant that the aggregate OECD gross government debt to GDP ratio rose from 73.3 per cent in 2007 to 105.7 per cent in 2011, with figures of 90 per cent in the UK, 95.6 per cent in the eurozone, 97.6 per cent in the US and 219.1 per cent in Japan being recorded for last year. This implies that further increases in public debt and budget deficits will have a negative effect on growth in all the leading economic areas.

Figure 6.6: ratios of general government gross financial liabilities to nominal GDP at market prices 1987 to 2011 with OECD forecasts for 2012 and 2013



¹⁷⁰ Checherita C. & Rother, P., *The Impact of High and Growing Government Debt on Economic Growth: an Empirical Investigation for the Euro Area*, working paper no. 1237, August 2010

Keynesian demand management is unlikely to be effective: the Keynesian multiplier is not likely to be high enough in Britain for fiscal demand management to be effective

The main justification for the big increase in deficit-financed public spending, which followed the 2008 global financial crash in countries such as the US and the UK, was that this would help maintain economic activity in the wider economy. The fiscal multiplier is usually defined as the absolute change in real GDP caused by a one-unit increase in the volume of government expenditure. For example, if a \$1 billion increase in US government consumption caused a \$1.6 billion increase in US GDP, then the multiplier is 1.6 (this figure has been used by Obama administration officials to justify the increased US federal government spending of recent years). Multipliers may differ across time horizons, and they may change sign as crowding out effects accumulate. This means that it is normal to distinguish between the impact multiplier, which reflects the effect in the current period (often one year); the cumulative multiplier, which measures the cumulative change from the time of the impulse to government expenditure to the reported time horizon; and the long-run multiplier, defined as the cumulative multiplier over all time periods.

Government expenditure is a component of GDP, so that any value of the multiplier less than unity implies a contraction in the private sector of the economy. It is only if the multiplier takes a value greater than unity that extra government spending provides any stimulus to private GDP. In the early days of Keynesian economics, it was occasionally argued that the multiplier took on extremely high values such as 5 or 10. However, empirical research from the early 1970s onwards suggested that the multiplier was at most 1.5 to 2 and that it could be unity or less. There was also some agreement that deficit financed spending would only be expansionary if monetary policy was accommodating. Otherwise, the likelihood was that extra public spending would crowd out an equivalent or greater volume of private activity. Much of the research into the multiplier has also assumed (usually implicitly) that aggregate supply and the structural rate of unemployment were unaffected by increased government expenditure, so that it was only demand side crowding out that was relevant.

The big increase in deficit-financed public expenditure in recent years, and the apparent destabilisation of the public finances that has resulted, has led to new research into the value of the multiplier and what determines it. Ilzetzi, Mendoza and Vegh employed a quarterly data set for 20 high income and 24 developing countries to investigate the effect of government expenditure shocks in a working paper at the IMF.¹⁷¹ The main findings were that the output effect of an increase in government consumption was larger in industrial than in developing countries; the fiscal multiplier was zero in countries operating under flexible exchange rates, such as the UK; fiscal multipliers were lower in open economies than in closed ones; and fiscal multipliers in relatively high debt countries where public debt was over 60 per cent of GDP were zero.

The IMF found that the fiscal multiplier was generally very small on impact and less than unity in the long run and that it was also negative under certain circumstances, all of which implies that private expenditure is reduced not boosted by increased government spending. There was also no sign that higher public investment was stimulatory where developed countries were concerned, although it may

171. Ilzetzi, E., Mendoza, E. G. & Vegh, C. A. *How Big (Small?) are Fiscal Multipliers*, IMF working paper WP/11/52, March 2011

be in developing countries as their infrastructure is in greater need of improvement. The authors concluded that:

Our results suggest that seeking the holy grail of fiscal stimulus could be counterproductive, with little benefit in terms of output and potential long-run costs due to larger stocks of public debt. Moreover, fiscal stimuli are likely to become even weaker, and potentially yield even negative multipliers, in the near future because of the high debt ratios observed in countries, particularly in the industrialised world.

A broadly contemporaneous paper from Cwik and Wieland, researchers at the European Central Bank,¹⁷² used five different macroeconomic models with Keynesian features, such as wage and price rigidities, to investigate whether the spending packages announced by euro area governments for 2009 and 2010 were likely to boost GDP by more than the one-to-one needed to avoid damage to private activity. They concluded that new Keynesian models do not support the old-fashioned textbook Keynesian multiplier effect and that European governments' increased spending plans would result in a reduction in private sector spending for consumption and investment purposes. One reason was the forward-looking behaviour of households and firms who anticipated higher tax burdens and interest rates in the future and therefore reduced their consumption and investment (see later in this section). They also argued that new Keynesian dynamic stochastic general equilibrium models provided a strong case for government spending cuts. Announced with sufficient lead time, anticipated future cuts induced a significant short run stimulus and sustained crowding in of private spending.

Other studies have come to different conclusions. Guajardo, Leigh and Pescatori found that fiscal consolidation leads to weaker private domestic demand in another IMF working paper.¹⁷³ The IMF authors attempted to identify the truly autonomous element of fiscal consolidation using Budget speeches and IMF documents and claimed that estimates based on conventional measures of fiscal policy appeared to be biased towards overstating the expansionary effects of fiscal consolidation. Adams and Ganges found that the multipliers for government expenditure on real GDP were around one to two in the case of the US.¹⁷⁴ This relatively high value may reflect the fact that the US is a more closed economy than most European ones, as well as the different properties of the specific forecasting model employed. Those results have been challenged by an ingenious recent paper by Barro and Redlick, which examined the multiplier effects of US military spending over the years from 1912 to 2006, and incorporated a measure of the average marginal rate of income tax. They found that the multiplier was significantly greater than zero but less than one.¹⁷⁵ Estimated multiplier values of around 0.6 to 0.7 at the median unemployment rate were a typical result. This confirmed that there was a considerable crowding out of private expenditure when military expenditure rose and possibly other exogenous government spending components as well.

172. Cwik, T. & Wieland, V., *Keynesian Government Spending Multipliers in the Euro Area*, ECB working paper series 1267, November 2010

173. Guajardo, J., Leigh, D. & Pescatori, A. *Expansionary Austerity: New International Evidence*, IMF working paper WP/11/158, July 2011

174. Adams, F. G. & Ganges, B., *Why Hasn't the US Economic Stimulus been More Effective: the Debate on Tax and Expenditure Multipliers*, *World Economics*, 11, 4, October–December 2010

175. Barro, R.J. & Redlick, C.J., *Macroeconomic Effects from Government Purchases and Taxes*, Harvard discussion paper, October 2009. The authors chose to work with military expenditure because it can be considered as exogenous to the wider economy.

It is not difficult to test the claim that high spending levels are positively related to high levels of private sector employment

An important conclusion from the various international studies is that the UK may possess an unusually low – or even negative – fiscal multiplier because of its openness, floating exchange rate and high debt stock.

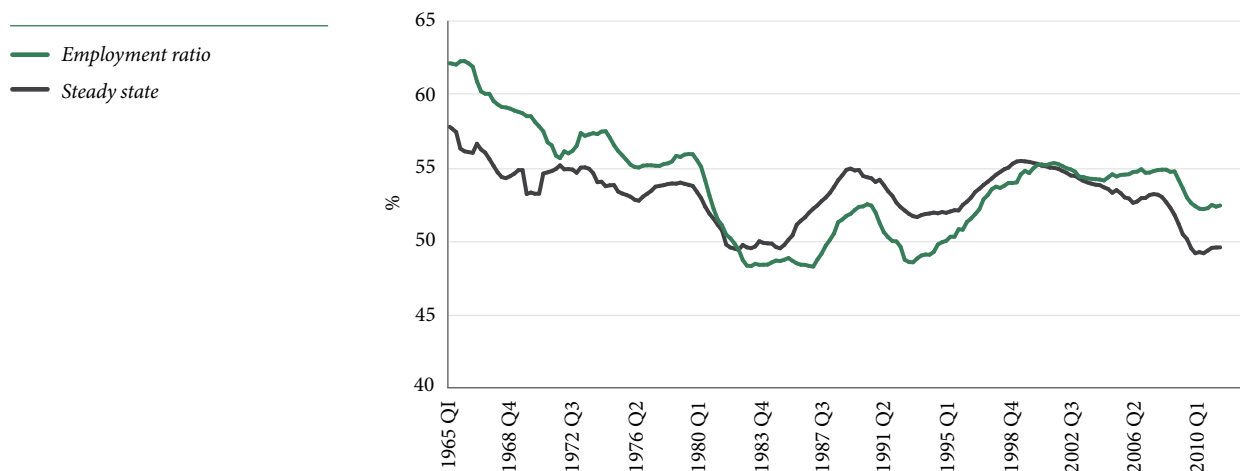
Perhaps the most basic claim of Keynesian economics is that high levels of government spending can create private sector jobs, through the expansionary second-round effects of the fiscal multiplier. But the research discussed so far tends to imply that extra government spending crowds out private expenditure, irrespective of whether it is financed by taxation or by borrowing.

However, it is not difficult to test the claim that high spending levels are positively related to high levels of private sector employment though. Since the public spending ratio is a bounded variable, in the sense that it can never exceed 100 per cent, the fairest statistical comparison is with the ratio of private sector employment to the population of working age, since this is a similarly bounded variable. Using a normal general to specific modelling strategy, the long-run steady state relationship that emerged was:

$$EMPRAT\% = 77.0754 - 0.5182 * SPENDRAT\%$$

Where: *EMPRAT%* = ratio of private-sector employment to the population of working age expressed as a percentage, and *SPENDRAT%* = ratio of General Government Expenditure to non-oil GDP measured at basic prices, also expressed as a percentage.

Figure 6.7: ratio of UK private sector employment to population of working age and “fitted” using long run steady state from a statistical relationship with the share of general government expenditure to non-oil money GDP at basic prices, 1965



The error correction relationship involved had an R-bar-squared of 48.87 per cent where the quarterly changes in the employment ratio were concerned and the standard error was 0.23 percentage points. There was also a satisfactory Durbin Watson statistic of 2.04, suggesting that there were few systematic elements in the residuals that had not been accounted for.

The interpretation is that 77.1 per cent of the population of working age would be employed in the private sector if there was zero government spending¹⁷⁶ – this should not be taken literally, because zero is completely outside the range of the spending ratio data (the mean government spending ratio over the estimation period from 1964 Q4 to 2011 Q3 was 46.1 per cent with a range of 37 per cent to 53.9 per cent) – and that each 1 percentage point rise in the spending ratio was associated with a 0.52 percentage point drop in the private-employment ratio. There was a two quarter “dead start” before changes in the spending ratio adversely affected the private-employment ratio so the direction of causation involved seems to be reasonably unambiguous. Figure 6.8 provides a comparison of the private employment ratio with the long run steady state of this estimated relationship.

The fact that government spending can be used to increase public sector payrolls means that it remains possible that extra government jobs could more than compensate for the employment lost in the private sector as a result of an increased spending ratio. However, this leaves a financing problem because net tax receipts are generated by private sector employment while public sector costs are driven by the government wage bill.

With public sector wages now significantly higher than those in the private sector it seems unlikely that increasing government spending leads to higher employment in the economy as a whole. The Office for National Statistics has estimated that even after accounting for “differences in the types of job and characteristics of employees [...] as far as possible”, public sector pay is 7.8 per cent higher than private sector pay.¹⁷⁷

The Institute for Fiscal Studies has come to a similar estimate and found that average hourly wages were 8.3 per cent higher after adjusting for public sector workers having “greater experience and more education”. The difference is particularly stark in those northern regions where living costs are noticeably lower than they are in London and the South East. The Institute for Fiscal Studies reported that there was “no evidence of a public sector pay premium in the South East of England, while in Wales the estimated premium is 18.0 per cent for men and 18.5 per cent for women.”¹⁷⁸

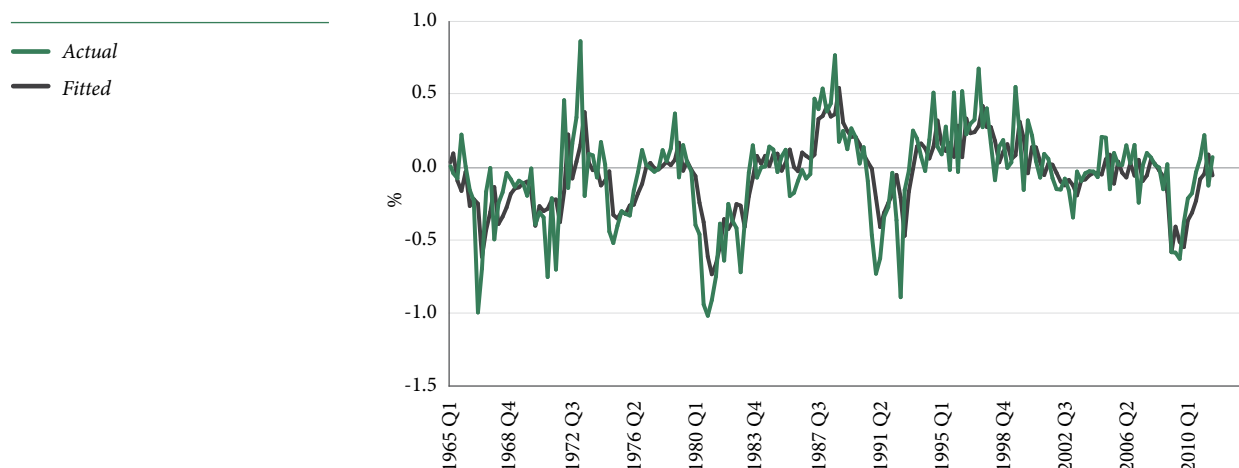
The relationship considered here is far simpler than those typically incorporated in econometric models, which operate at a higher level of detail. In the Beacon Economic Forecasting model, for example, total employment is broken down into manufacturing jobs, other private employment and government employment, while the self-employed, armed forces personnel and those on work-training programmes are also separately distinguished. The evidence here represents no more than a simple statistical challenge to Keynesian claims that higher government spending boosts private sector growth and employment.

176. Stay-at-home parents, students and the incapacitated all help explain why one would not expect a 100 per cent private employment to working age population ratio even in a theoretical state with zero government.

177. Damant, A. & Jenkins, J., *Estimating differences in public and private sector pay*, Office for National Statistics, July 2011

178. Emmerson, C. & Jin, W., *Public sector pensions and pay*, Institute for Fiscal Studies Green Budget 2012, February 2012

Figure 6.8: plot of actual and fitted values for quarterly changes in the private sector employment ratio, 1965 Q1 to 2011 Q3



There is evidence that the public respond to higher deficits by saving more to pay for the future taxes expected as a result, which undermines the efficacy of fiscal demand management

Ricardian equivalence is the concept that, because people see that higher taxes or lower spending will be needed in the future to pay for current budget deficits, they save more than they would have done otherwise straight away. This then negates the effects of the intended Keynesian fiscal stimulus. The concept has been controversial since it was first introduced by Barro.¹⁷⁹ While a number of economists have been highly critical, and quite extreme behavioural assumptions would need to hold for it to apply exactly, many studies have found that it holds to a sufficient extent that it undermines the effectiveness of fiscal stimulus. Seater has summed up the evidence:¹⁸⁰

Needless to say, so revolutionary a theory has not gone unchallenged, and its revival has led to extensive research, both theoretical and empirical, into the effects of government debt on the economy. The fruit of that effort is the subject of this essay. Although the aggregate effects of public debt and deficits have not yet been fully determined, two overall conclusions are now clear.

The first appears uncontroversial: it seems almost impossible that Ricardian equivalence holds exactly. The theoretical foundations for any effects of debt on the economy depend on subtle concepts such as the intensity of intergenerational altruism, the possibility of strategic behaviour by individuals in their family relations, the nature and extent of liquidity constraints, and the effects of various kinds of uncertainty on the household maximisation decision. Careful examination of those factors suggests that exact Ricardian equivalence is implausible.

The second conclusion is far more controversial: despite its nearly certain invalidity as a literal description of the role of public debt in the economy, Ricardian equivalence holds as a close approximation. Although there is much empirical evidence appearing to reject Ricardian equivalence, a dispassionate reading of the literature leads to the stated conclusion. Testing theories of government debt's effects is not trivial. Estimation is sensitive to the treatment of specification, simultaneity, and data stationarity, as well as simple measurement of the quantities involved, so

¹⁷⁹ Barro, R. J., *Are Government Bonds Net Wealth?*, *Journal of Political Economy*, 82, 6, December 1974

¹⁸⁰ Seater, J. J., *Ricardian Equivalence*, *Journal of Economic Literature*, 31, 1, March 1993

that careful attention to interesting issues of econometric methodology is essential. Much of the published evidence on Ricardian equivalence, both favourable and unfavourable, fails to attend to those issues and is sufficiently flawed to be uninformative. When attention is restricted to the more methodologically sound studies, it is difficult to find statistically significant effects of debt, suggesting that Ricardian equivalence holds approximately.

Real PDE is the volume of private domestic expenditure (real PDE), which is defined as non-welfare-financed household consumption, private investment and stock building. This was equivalent to some 67.1 per cent of the basic-price measure of UK GDP¹⁸¹ in 2011.¹⁸² It is the main domestic variable that is operated on by monetary policy, although net exports are weakly influenced by the real exchange rate, which reflects the relative stringency of UK monetary policy compared to overseas. In theory, the government's fiscal decisions should be taken with a view to moderating the volatility of PDE, if one accepts the original Keynesian demand management view that the task of fiscal policy is to counterbalance an inherent instability in the private sector.

Table 6.7: private and government sector components of expenditure measure of UK money GDP at basic prices in 2008

	Value (£bn)	Basic price GDP (%)	Volume change 2008 to 2011 (%)
Privately-financed household consumption	713.4	55.6	-7.1
Welfare-financed household consumption	164.6	12.8	12.4
Non-profit institutions	35.8	2.8	-2.4
Government consumption	315.6	24.6	1.5
Government investment	32.9	2.6	5.0
Private & 'other' investment	208.4	16.2	-14.4
Stock building & valuation changes	2.3	0.2	–
Exports	422.9	32.9	1.7
Equals: total final expenditure	1,895.9	147.7	-2.3
Less: imports	462.0	-36.0	-3.5
Less: basic price adjustment	150.0	-11.7	0.4
Equals: GDP at basic prices	1,283.8	100.0	-2.0

Table 6.7 is an attempt to make the distinction between real PDE and other parts of the economy clearer.¹⁸³ It does so by breaking up the GDP identity to distinguish

¹⁸¹. Both the factor cost adjustment and the similar basic-price adjustment take out indirect taxes and add back subsidies, to correct for the fact that both are included in the main expenditure items. The main difference between the two is that the factor cost adjustment takes out all indirect taxes the basic price adjustment takes out most indirect taxes. If the GDP components were individually expressed at factor cost and/or basic prices the main effects would be to reduce the shares of household consumption and PDE. The other GDP components are only lightly affected by taxes and subsidies.

¹⁸². Or 55.2 per cent if the basic price adjustment is taken off PDE.

¹⁸³. Office for National Statistics data. Non-profit institutions serving households are a hybrid of private charities and government-funded institutions such as universities. Some 80 per cent is probably funded by government, but there is no official breakdown available.

between its general government and private sector sub-components. The second column shows the shares of each component in basic price GDP, while the third column shows the volume change between 2008 and 2011. The table brings out the very different experiences since 2008 in privately-financed household consumption, which contracted by 7.1 per cent in the three years to 2011, and welfare-financed consumption, which increased by 12.4 per cent. A similar contrast between government and private sectors can be observed in the case of investment, with government capital formation rising by 5 per cent but private investment falling by 14.4 per cent.

These divergent experiences explain why aggregating government spending and private expenditure can lead to a serious underestimation of the extent to which the private sector reacts to a tax shock, for example. This can be seen from figure 6.9. The chart confirms that real PDE is noticeably more volatile than overall GDP, reflecting the way in which imports act to offset fluctuations in domestic consumer demand as well as counter-cyclical movements in government spending.

Figure 6.9: annual per cent changes in UK Real GDP at basic prices and real private domestic expenditure 1965 Q1 to 2011 Q4

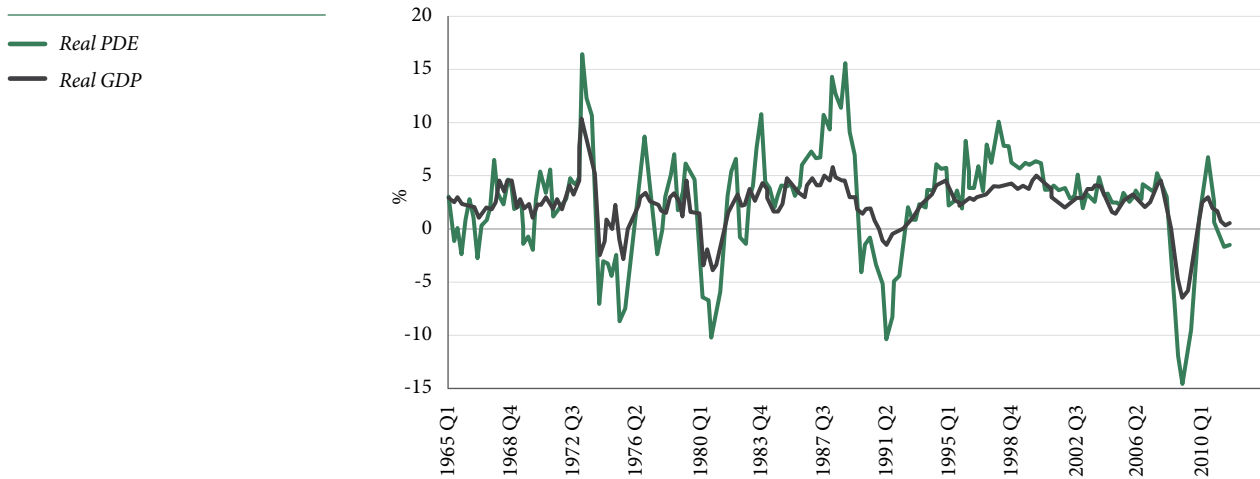
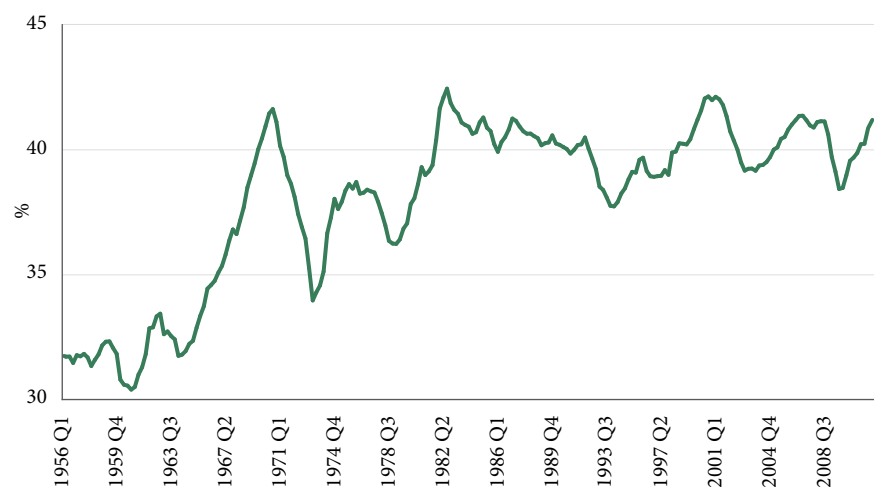


Figure 6.10: ratio of smoothed UK non-oil tax receipts to non-oil money GDP at basic prices 1956 Q1 to 2011 Q4



In order to evaluate whether there was a significant difference between the effects of the budget deficit and the tax burden, a standard general-to-specific modelling

strategy was employed in which the logarithm of real PDE was initially related to: its own past levels, the change in the logarithm of the price-deflated M4ex broad money stock; the real three-month inter-bank rate; the non-oil tax burden and general government net borrowing, both expressed as smoothed ratios to non-oil GDP;¹⁸⁴ a time trend; a “post-crash” dummy variable covering 2008 Q2 to 2011 Q3; and a separate dummy for 2008 Q4 when Lehman Bros. failed. A standard nesting-down procedure was then employed until a final error-correction model in mixed changes and levels was achieved. The final long-run steady state in levels over the period 1964 Q2 to 2011 Q3 was:

$$\log RPDE = 11.5257 - 0.0155 * RRIB - TAXRAT - BRGRAT + 3.06\% \text{ per annum} - 17.35\% \text{ post-2008 Q2.}$$

Where: *RPDE* = real private domestic expenditure, *RRIB* = real three-month inter-bank rate, *TAXRAT* = ratio of non-oil taxes to non-oil GDP, and *BRGRAT* = ratio of general government net borrowing to non-oil GDP

In theory, broad money should not affect the level of real PDE in equilibrium, which is why real M4ex is only present as a short-term growth effect. The economic interpretation of the full error-correction model is that real PDE normally grows by 3.06 per cent per annum.¹⁸⁵ However, private activity falls by 1 per cent for each 1 percentage point rise in the burdens of taxation and government borrowing, while a 100 basis points rise in the real rate of interest cuts activity by 1.55 per cent. In the short term, a rise of 1 percentage point in the borrowing ratio cut real PDE by 0.53 percentage points, but there was a dead start of two quarters before the tax burden kicked in with a negative coefficient of 0.88. This result suggests that budget deficits do not stimulate private activity, even in the short run, but crowd it out right from the start. An increase in the real rate of interest also has a discernible negative effect on the growth of real PDE, while an increase of 1 per cent in real M4ex boosts PDE growth by 0.48 per cent with a one quarter delay.

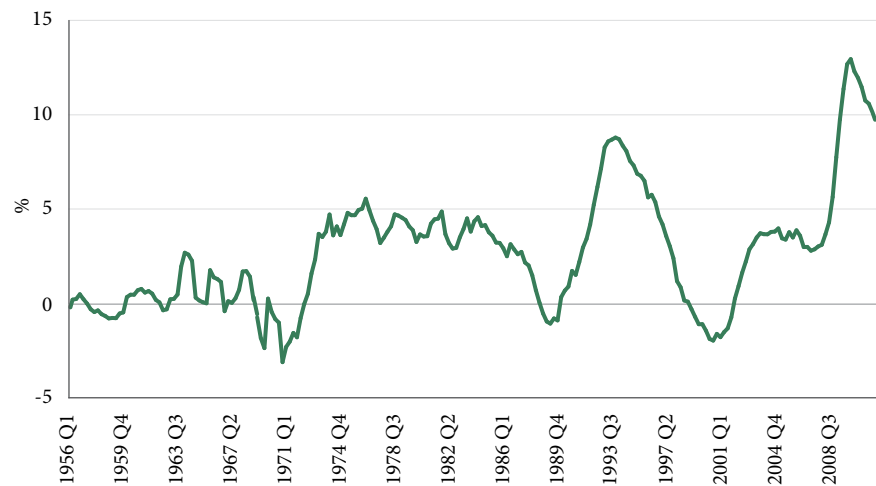
The likelihood that the long-term coefficients on the borrowing and tax ratios are not significantly different from each other is consistent with the view that government spending crowds out private activity, irrespective of how it is financed. However, the statistical relationship for real PDE explained a relatively modest 21.9 per cent of the quarterly changes in real PDE between 1964 Q2 and 2011 Q3 and had a standard error of 2.0 per cent. In addition, the dummy variable for the period 2008 Q2 to 2011 Q3 appeared with a powerful coefficient of minus 17.35 per cent. This clearly picked up the disruption that followed the worsening of the global financial crash during the course of 2008. However, it probably also reflects problems with the

¹⁸⁴. Neither series is seasonally adjusted by the Office for National Statistics, despite the existence of very large seasonal swings which badly distort the data. A trailing four quarter moving average was correspondingly employed for estimation purposes. This is how the data is presented in figures 6.9 to 6.11. This smoothing process meant that there is an implicit two quarter lag built in. The interest rate and M4ex terms also appeared with a one quarter lag before they took effect. Such lags helped to reduce the simultaneity problem and mean that the direction of causation was more clearly identified.

¹⁸⁵. This specification is equivalent to a neo-classical growth model rather than a post neo-classical endogenous growth one because output always returns to the same growth trend, once the spending ratio has settled at a particular level. It is not being claimed that this represents a satisfactory growth model. It is just being hoped that the equation is good enough for the purpose at hand, which is to test the similarity of the spending and borrowing effects. Adding measures of exogenous world activity, and possibly the real exchange rate, would probably improve the fit if attempted in future research. Removing the volatile stock building component, which also picks up statistical errors generated elsewhere in the national accounts, from PDE results in noticeably closer statistical fits.

new 2008 base-year national accounts introduced by the Office for National Statistics (ONS) in 2011.¹⁸⁶

Figure 6.11: ratio of smoothed UK general government borrowing to non-oil money GDP at basic prices 1956 Q1 to 2011 Q4



The similarity between the tax and borrowing effects in the long run suggested that it made statistical sense to replace the pair with the general government spending ratio, since this represented a better specification. The resulting statistical relationship represented only a minor deterioration on the earlier equation, had an R-bar-squared of 20.0 per cent and had a standard error of 2.03 per cent. The long-run steady state of this relationship was:

$$\log RPDE = 11.5617 - 0.0160 * RRIB - SPENDRAT + 2.91\% \text{ per annum} - 11.68\% \text{ post-2008 Q2.}$$

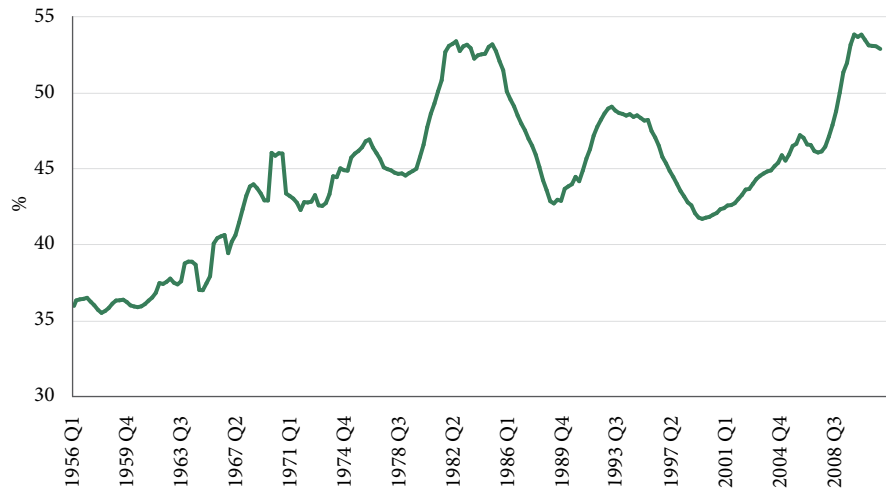
Where: *SPENDRAT* = ratio of general government expenditure to non-oil GDP

The short-term coefficient on the smoothed government spending ratio was minus 0.35, confirming that there was no stimulus to the private sector from increased government spending even in the short run, but instead a reasonably powerful crowding-out effect. Furthermore, the post-2008 Q2 dummy variable was noticeably less significant in this specification and could be dropped entirely if the long-run coefficient on the spending variable was unconstrained, when it became minus 1.66 (the difference from minus unity also had a reasonably significant “t” statistic of 1.92).

¹⁸⁶ The same relationships were estimated using the previous 2006 base-year national accounts data and an estimation period that ended in 2010 Q4. These produced broadly similar long-term results. However, there was no need for a sustained post 2008 Q2 dummy variable, just three negative single quarter ones for 2008 Q4 and 2009 Q1 and Q2. The short-run negative impact effects of borrowing and taxes were not significantly different from each other using this data set and the coefficient on spending alone was insignificantly different from minus unity. Adding three more quarters to such a long data set would not normally be expected to noticeably alter the results, so the explanation must lie in the changes made by the UK Office for National Statistics (ONS). The ONS arguably botched the introduction of the new ‘ESA 2010’ national accounts, which were delivered months behind schedule and are still only available in partial form where historic back runs are concerned. It is not unreasonable to be deeply suspicious of the accuracy of the current ONS statistics, as a consequence.

That result suggests that the growth in the share of national income spent by the state after 2000 has contributed to the severity of the recession that followed the financial crisis, and the weakness of the recovery. And, at the same time, the planned reduction in public spending may be more likely to prove inadequate – if the intention is to encourage private activity – rather than excessive.

Figure 6.12: ratio of smoothed UK general government expenditure to non-oil money GDP at basic prices 1956 Q1 to 2011 Q4



6.4. Ethical limits of government spending

6.4.1. High and redistributive taxes cannot be used to promote happiness

Happiness economics is founded around the finding in surveys that happiness does not increase in developed economies with average income, but does increase for individuals with their relative income. For example, Lord Layard has argued that:¹⁸⁷

Survey evidence suggests that there has been no increase in happiness since the 1950s, despite vast increases in income.

Proponents of happiness economics claim that this means too much emphasis is placed on aggregate economic growth and that more attention should be paid to how policy can deliver increased happiness. Among other things, they argue this justifies higher taxes:¹⁸⁸

None of this would matter if income fell like manna from trees. But income is earned by the sacrifice of time with your family and friends. If much of the extra income (say 60 pence in the pound) brings no overall increase in happiness, we should reduce the incentive to acquire it. It would therefore be efficient to have a marginal tax rate of say 60 pence in the pound – corresponding to the 60 pence worth of pollution caused by the extra pound that is earned.

This is the first dramatic policy implication of adopting a happiness-based approach to public policy, and should form an important part of a social

¹⁸⁷. Layard, R. *Towards A Happier Society*, New Statesman, 24 February 2003

¹⁸⁸. Ibid.

There are a number of problems with basing policy on findings from happiness surveys

democratic agenda that is based on the new social science. Up to now we have apologised for taxation. The standard economic analysis says that taxation reduces work effort, which is true. But it also says that this is inefficient, which our previous analysis shows is false. Indeed taxation is one of the most important institutions we have for preserving a sensible balance between work and leisure. We should be proud of it and stand up for it.

Politicians making decisions can and will already take into account objectives other than economic growth, as voters take a range of factors into account when they cast their vote. But there are a number of problems with basing policy on findings from happiness surveys: weaknesses in the evidence underlying happiness economics; strong assumptions about the policy implications; and the question of whether happiness – understood this way – is really the right objective for government policy.

The same surveys show that happiness does not correlate with other likely variables either, including income inequality, public spending, crime rates, longevity, and even clinical depression.¹⁸⁹ So either a broad range of social policies, successful in achieving their immediate objectives, do not improve our happiness either, or the measures themselves aren't reliable.

Many happiness surveys use a three point scale – asking whether respondents are “not happy”, “fairly happy”, or “very happy” or something similar.¹⁹⁰ That measure is not continuous, since moving between categories requires a substantial change in opinion and therefore often only very substantial changes in public happiness produce a difference that is statistically significant. Similarly, an individual on the margin of two categories might experience only a very small difference, but enough of one to shift him from one category to another.

There is also an upper limit to how happy someone can register themselves, whereas there is no equivalent upper limit on other variables such as how someone's income can grow. And the surveys are a highly relative measure, not an absolute one. Even those surveys which use more graduated scales – which therefore offer more precise data – are subject to those problems.

Ormerod reports that more “subtle recent work is in fact suggesting that there is a clear and positive connection between life satisfaction and income, and that there appears to be no cut-off point for this”, citing work by Kahneman and Deaton.¹⁹¹

The results produced by indices of different countries which use happiness surveys to assess their economic performance produce very implausible results. For example, the New Economics Foundation has produced three editions of the happy planet index by combining a measure of happiness with a measure of resource intensity. They say that countries which score well “show that achieving, long, happy lives without over-stretching the planet's resources is possible.” But Saudi Arabia (13th), Mexico (23rd), Burma (39th) and Haiti (42nd) were way ahead of Sweden (53rd), the United Kingdom (74th) and the United States (114th) in the 2009 index.¹⁹² Again that does not inspire confidence in the underlying measure of wellbeing. The 2012 version produced similarly remarkable results. Australia (76th),

^{189.} Johns, H. & Ormerod, P., *Happiness, Economics and Public Policy*, Institute of Economic Affairs, 2007, <http://lowtax.es/HUWU4p>

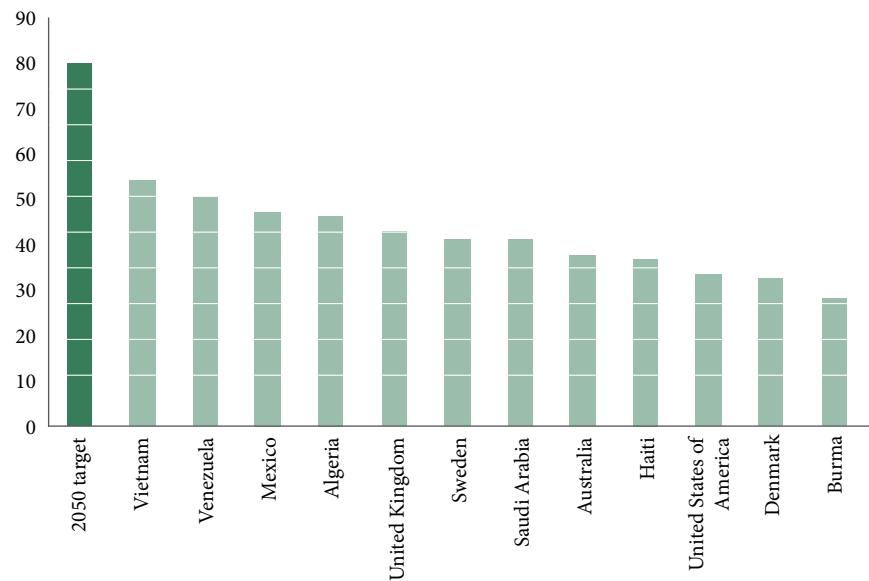
^{190.} Ibid.

^{191.} Ormerod, P., *The Folly of Wellbeing in Public Policy in Booth, P. (ed) ... and the Pursuit of Happiness: Wellbeing and the Role of Government*, Institute of Economic Affairs, January 2012

^{192.} Abdallah, S., Thompson, S., Michaelson, J., Marks, N. & Steuer, N. *The Happy Planet Index 2.0: Why good lives don't have to cost the Earth*, June 2009, HPI results table

the United States (105th) and Denmark (bottom, at 111th) all came markedly lower than Vietnam (2nd), Venezuela (9th) and Algeria (26th).

Figure 6.13: happy planet index score, selected countries



It is reasonable to argue that promoting economic growth should not be the sole focus of policy. But in reality it never has been, and politicians will hopefully respond to voters who have a range of priorities. Johns and Ormerod wrote in a study for the Institute of Economic Affairs (IEA) that the “much more securely grounded” longitudinal panel data on happiness finds that “stable family life, being married, good health, having religious faith, feelings of living in a cohesive community where people can be trusted, and good governance contribute to happiness.” That would lead to a set of policy proposals very different to those recommended by Lord Layard, which might prioritise the family and social cohesion.¹⁹³

With the difficulties measuring happiness, radical shifts in policy on the basis of the surveys would clearly be a mistake. It would be impossible to properly understand what works or assess the results. Dubious schemes could be supported with significant amounts of money, which it will be easy to justify taking on the grounds that money does not make people happy.

Of course, happiness is not just a matter of what you are paid. But money is the raw material that allows us to make all sorts of choices, including those that make us happy. If someone wants a home to build a stable family life then a higher income will make that easier. Others might be happier with the experience of a foreign holiday, or if they are able to support religious or other charitable causes. Higher government spending precludes the lower taxes which allow people to use their own money to pursue their own happiness.

Calls for politicians to embrace an ever wider duty to promote our wellbeing are vulnerable to the critique contained in Aldous Huxley’s *Brave New World*. It might be possible for people to be extremely satisfied with their condition if they are inculcated with low expectations and treated with recreational drugs (like the fictional soma in the book). Other choices might produce a life that is less superficially happy but in some sense more meaningful. With a narrower set of objectives – such as building a stable, prosperous and liberal society – politicians do not neglect our

¹⁹³. Johns, H. & Ormerod, P., *Happiness, Economics and Public Policy*, Institute of Economic Affairs, 2007

broader wellbeing. They simply leave the question of what constitutes a good life to the individual rather than impose their own interpretations of what that might be.

6.4.2. It is legitimate to spend a limited amount to support essential services

It is relatively easy to justify spending to provide national defence, a police force and criminal and civil justice systems. It is true that we could live in isolation, or live with foreign invasion or with crime, or resolve disputes by force. But life in those circumstances would be a great deal more miserable than life under a system in which crime is controlled (although sadly not eliminated), and disputes can reliably be resolved peacefully.

This obvious argument for providing these things is a utilitarian one. Most of us are better off in a law-governed society than in a lawless one. Our lot is also greatly improved by living in a society where property rights can be sustained and where contracts can confidently be made, in the knowledge that they can be enforced. Such conditions allow businesses and trade to develop, to a far greater extent than would be possible without those guarantees. They also give consumers confidence when agreeing to buy from suppliers. Not only does it become reasonably safe to pay deposits in advance of work being completed or large goods being made to order, it also enables consumers to obtain compensation if they have legitimate cause for complaint.

It is, however, worth noting that other ethical arguments point in the same direction. The deontologist will readily agree that respect for property, the keeping of promises, and observance of the law are generally sound maxims. As Kant would note, they are maxims that one can obey easily and which should be universal. Given that not everyone can be relied upon to observe them voluntarily, but practically everyone would want everyone else to observe them, there is a good case for having a system of laws to ensure enforcement. The virtue ethicist will be keen that people should have the opportunity to use their talents to the full. Most of us can only do so in a peaceful society, and in a society in which property is respected and agreements are kept.¹⁹⁴

While these arguments show that it is perfectly legitimate for government to spend at least some of our money in order to achieve the objectives, it does not follow that everything in this general area should be provided by or even financed through government, or that there should be no efforts to limit the burden of providing these services on taxpayers. One might, for example, expect those who got involved in civil disputes to bear the full costs of resolving those disputes, or expect convicted criminals to pay as much as possible of the costs of the police and criminal justice system. Similarly, courts often expect claimants to demonstrate that alternative means of dispute resolution have been exhausted before hearing a claim. Moreover, much “policing” work is carried out privately by private security guards in places such as shops, warehouses and universities.

6.4.3. It is legitimate to spend a limited amount to support other services, but less so as the marginal benefits diminish as spending rises

Roads and other infrastructure, schools, hospitals and a social security system are all things that modern states provide. There is a utilitarian case for the provision of all of these things, at some level, to the extent that they are not provided privately. They can greatly enhance welfare. And the enhancement to welfare that is produced by an initial slice of provision, such as primary education and the prompt treatment of

¹⁹⁴ This point does not apply to everyone. Creative artists sometime do their best work under adverse conditions, including civil strife or even war, but most of us are not like that, and the gain from the elimination of strife far outweighs any loss of works of art that might have been created.

medical conditions that are easily treatable and best treated early, would be very likely to be enough to justify the coercion that is involved in taxation. As one moved on to more and more generous provision, the benefits per extra pound spent would be likely to fall, and the rising burden of taxation would make the coercion involved more and more objectionable, ultimately to the point where further taxation could not be justified. Thus a utilitarian approach to the consideration of specific items of spending would be entirely consistent with the notion of a welfare-maximising overall level of spending, set at somewhat below the most generous possible level of spending.

A virtue ethicist could make a similar argument for state provision of services that allow people to use their talents to the full. Again, the return from provision would be high enough to justify taxation and spending to make basic provision, but the case for further taxation and spending would get progressively harder to make as one moved on to more generous provision.

One specific type of provision for which utilitarians in particular might argue is the provision of goods which are available to all, in the sense that there is no practical way of excluding people, whether or not they meet some condition such as payment, and which are such that one person's enjoyment of the good does not diminish other people's enjoyment of it. The classic example is national defence. Such goods are likely to be under-provided in a purely market system, because providers could not enforce payment for them and would therefore make inadequate returns. There is therefore a case for spending in order to provide such goods at the level that will maximise overall welfare, rather than at the level that the market would naturally provide.

6.4.4. It is legitimate to spend a limited amount to support those in need, but not with an overly generous welfare system that creates dependence

Even in a rich country, some people would, without external help, live in unacceptably poor conditions. Government spending programmes are one way to provide that help. They may be the only way to ensure that help is reliably provided to all who need it, because charitable donations, while important, may be routed to specific classes of beneficiary whom the donors consider to be the deserving poor. But how strong are the arguments that we should ensure that help is provided to all who need it?

The utilitarian argument for helping the poor is clear. The utilitarian objective is to increase overall utility. The utility of the poor can be increased by improving their lot. The cost of generating an extra unit of utility among the poor is such that if one takes that amount from the rich, they lose less than one unit of utility. Therefore, the utilitarian would say, this is a perfectly good reason to support government spending on relevant programmes. It does not, however, follow that an arbitrarily high level of spending should be incurred for this purpose. As tax burdens rise, other losses are imposed, and there comes a point where total utility is not increased by further transfers to the poor. Most obviously, economic growth may be lost, and large-scale provision will require transfers from people on moderate incomes, not just people on high incomes.

Deontologists can recognise a duty to care for the poor. Kant certainly did.¹⁹⁵ His thoughts on that duty were, however, about the duties of individuals, not about a taxpayer-funded welfare state. He did also consider taxpayer-funded welfare, but his argument for it is obscure and not wholly convincing.¹⁹⁶

195. Kant, I., *Groundwork of the Metaphysics of Morals*, p. 423; *Metaphysics of Morals*, pp. 452–454

196. Ibid., pp. 325–326. A study of the limitations of the scope to build on Kant's argument is given in Penner, J. The State Duty to Support the Poor in Kant's Doctrine of Right, *British Journal of Politics and International Relations*, 12, 1, February 2010, pp. 88–110.

Virtue ethicists can point out that it is virtuous to care for those less fortunate than oneself, and can therefore accept that provision for the poor is a good reason for government spending. But like utilitarians, virtue ethicists would set limits to the extent to which this should be done, and would do so on the basis of the same ethical system that they saw as justifying some transfers. Excessive transfers would limit the opportunities to live a full life of those who paid. They would also encourage dependence and discourage work among both the recipients and taxpayers.

Suppose that we accept such arguments, and decide that the poor should be helped through taxation. We then have to consider the role of charity, as an alternative means of help. We need to look at the positions of the individual contributors, the individual recipients and the population as a whole.

Let us start with the individual contributors. A utilitarian is likely not to care whether the poor are helped through equally efficient charity or through government spending programmes, except to the extent that there are second-round effects, such as adverse economic consequences of high taxes. What matters is that the poor are helped. A deontologist may positively favour charity over taxation. Kant argued that the truly moral action had to be motivated by a sense of duty, not by consideration of the consequences for oneself or for others.¹⁹⁷ It is possible to pay taxes out of a sense of duty, and to make charitable donations because it makes one feel good (a desirable consequence for oneself). But it is more likely that tax will be paid out of fear of being penalised for non-payment, and that a charitable donation will be made out of a sense that it is the right thing to do. (This is not to deny that charitable donations can be made for many other reasons, including the feeling of pleasure from making them or the admiration that known generous donors may attract.) Finally, a virtue ethicist might well prefer to see voluntary charitable donations. The ground for this preference would not be the same. It would be that it is more virtuous to give voluntarily than to hand over money because of the threat of penalties.

The first priority of individual recipients is likely to be to get help. To that extent, the source of the help may not matter. But recipients may quite legitimately care about how they are helped. They may feel ashamed at receiving charity. To the extent that this is so, it would be better if they received statutory benefits, to which they were legally entitled. It would be better both on utilitarian grounds, because removing any sense of shame would improve their quality of life, and from the point of view of virtue ethics, because there is virtue in accommodating people's sensitivities.

Great reliance on charitable contributions might also have adverse effects at the level of society as a whole. Charitable contributions depend on individual choice, and one might have concerns about a society in which some contributed a lot, while others on comparable incomes contributed little or nothing, even though the large contributors were happy to make their contributions. The distribution of benefit might be very uneven, with those who were generally seen as the undeserving poor receiving very little provision. And such a lack of provision might have serious consequences for the rest of society. For example, if ex-prisoners lack the support to pay for essentials and to find work, they may re-offend, imposing costs both on the victims of crime and on society as a whole, through the cost of the police, court and prison systems.

This argument may have merit to the extent that donors are less receptive to causes which deal with this problem than those who allocate spending on government programmes. On the other hand, there is a case for making some distinction between the deserving and the undeserving. Any who are really undeserving, the deliberate architects of their own misfortune, have no moral claim on the rest of us. Knowledge

Great reliance on charitable contributions might also have adverse effects at the level of society as a whole

¹⁹⁷ Kant, I., *Groundwork of the Metaphysics of Morals*, p. 390

that those who are seen to have squandered their income rather than saved money to provide for things like long-term care may get short shrift, should create incentives to provide for oneself, and not to assume that others will provide. Utilitarians would approve because such incentives would lead to the better management of resources, with an eye to one's future needs as well as one's current wants. Virtue ethicists would approve because the incentives would encourage the virtue of independence.

Finally, none of the ethical theories gives us any precise idea of where to draw the boundary between needs and wants. Furthermore, none of them guides us as to whether to be greatly exercised about relative poverty (such as income of less than half median income), or whether we should only address absolute poverty (such as a lack of housing or of food). Such questions can be regarded as empirical ones, which we can best answer by surveying attitudes.

We can conclude that while it is legitimate to use government spending and tax to alleviate poverty, there is considerable scope for argument about the extent to which this should be done. And there are clear ethical arguments against an over-generous welfare system. Beyond a certain point, it becomes a burden that reduces both the welfare of those who pay for it, and the virtue of those who come to depend on it.

6.4.5. It is legitimate to spend a limited amount to promote opportunity

It is good to live a fulfilled life. Some people happen to have all the resources they need for that anyway, but most of us need education, healthcare and a reasonable income, many are brought up in families without adequate income to pay the full cost of education, and many do not have the income to pay the full cost of healthcare. A system of taxation and government spending can provide all of these things, effectively by taking part of the cost of the supply of goods and services to poorer people, and transferring that part of the cost to richer people – although taxpayer-funded provision is by no means guaranteed to ensure a high standard of provision, or a uniform standard across the country. A system of taxation and spending achieves redistribution by making the same opportunities for education and healthcare available to all, but charging some people more than others. It also ensures that these services will be available to all, and requires all to pay the price appropriate to their income, regardless of people's own spending preferences or their actual use of the services in question.

A utilitarian could accept this objective. A sense of fulfilment, and the possession of the practical ability to lead the life of one's choice, are both sources of utility. Not only are healthcare and education valuable in themselves, and for the opportunities that they create, but the utilitarian has a special reason to value education: it enables us to form our preferences under better conditions than would otherwise be the case. An educated person is aware of more options than an uneducated one, and can weigh up their advantages and disadvantages more effectively. A utilitarian would, however, set limits to the use of tax revenues in this way. A substantial tax burden would both damage economic growth and limit the opportunities of those who had to pay, including those on moderate incomes because there simply are not enough people on high incomes to pay a substantial total burden. Furthermore, what is to be paid for out of taxes is generally determined by elected governments, not by each of us individually. That lack of individual choice would limit the extent to which fulfilled lives were achieved, because an important aspect of fulfilment is self-determination, rather than following a plan that has been laid down by others.

You have to use your opportunities yourself

Daniel and Tom both start a degree course in physics in the same year. Daniel works long hours, has a very limited social life, and spends his vacations gaining work experience. As a result, he gets a good degree. He is taken on by a law firm specialising in patents, where he has a successful career, becoming a partner in his thirties. Tom spends a lot of time on sport, travelling during his holidays, and gets only a mediocre degree. He has difficulty finding work, but eventually finds an office job in which he does not use his knowledge of physics at all.

Can Tom argue that Daniel should be taxed heavily, so as to provide generous public housing, subsidies for public transport and the like, that would reduce Tom's need to spend his own limited income on necessities? It would seem not. Tom faced the same choices as Daniel. He chose different options, and he must live with the consequences.

This does not mean that provision should not be made for those who would be in real poverty without public spending. But it is hard to see why those who can earn a reasonable living for themselves should be subsidised by those who made choices that led them to be better off.

A virtue ethicist could also support the objective. It is a virtue to make the best use of one's talents, and having the resources to develop and apply those talents is therefore conducive to virtue. A virtue ethicist would, however, want to set limits to the extent of taxpayer-funded provision. Not only is it a virtue to develop and to apply one's talents, it is also a virtue to achieve things under one's own steam, or with the voluntary co-operation of others. An achievement that substantially reflects the mandated contributions of others is less of an achievement.

We may also note that a whole new line of thought on the topic of justice, the capabilities approach, takes opportunity to be of primary importance. What matters is the freedom to do the things for which one has the intrinsic capacity. Thus we are intrinsically capable of thought, and emotional relationships, and control over our environment. We ought therefore to be given the external equipment to engage in such activities, equipment such as education and personal freedom, so that we can engage in them to the extent that we choose.¹⁹⁸

Only a deontologist need have nothing much to say, either positive or negative, about this objective. It would be possible to argue for duties that would imply that the objective should be pursued, but that would take us beyond the normal scope of deontological argument.

It does therefore appear to be legitimate to use spending and taxation to promote opportunity, but only within fairly strict limits.

Equality of opportunity is an objective that is quite different from equality of outcome. The idea of equality of opportunity is that nobody should be excluded from advancement, or from particular positions, by factors outside his or her control. But if someone chooses options that impede his or her advancement, that is down to him or her, and not something for which the rest of us should be expected to compensate. Equality of opportunity can therefore easily be combined with inequality of outcome.

198. Good starting-points for an exploration of the capabilities approach are Nussbaum, M. C., *Women and Human Development: The Capabilities Approach*, 2000; Sen, A. *The Idea of Justice*, 2010

We should also note that perfect equality of opportunity is an impossible goal: we could only hope to move in that direction, not to get all the way

Equality of opportunity is not something that might be promoted by government spending and taxation alone, of course. There are other policies that could be far more important. But spending does have some potential roles. The first role is to promote opportunity, in particular by ensuring the availability of education, regardless of financial means, so that anyone with the necessary natural abilities and inclination to hard work can do well, and has a reasonable chance of entering the profession of his or her choice. This can be subsumed within the objective of promoting opportunity. There is no need to consider it separately under the heading of equality of opportunity. Indeed, the mere promotion of opportunity through education is likely to have the side-effect of increasing equality of opportunity. This is because help to all brings bigger benefits to the disadvantaged than to the advantaged: the same investment can be expected to make a bigger difference to those who start from a lower base. And if opportunities increase for all, as when economic growth permits greater provision for education, both taxpayer funded and privately funded, that should surely be welcomed, even if the new distribution of opportunities is less equal than the old one.

We should, however, note that if opportunities to enter the most demanding professions are indeed to be made available to all, quite high spending is likely to be required. That must lead us to stop and consider just how much ethical and political justification there is for pursuing the conferral of opportunity to the greatest possible extent. We should also note that perfect equality of opportunity is an impossible goal: we could only hope to move in that direction, not to get all the way. And we may reasonably hesitate to offer taxpayer subsidies for services that primarily benefit the individual rather than society, and that are, unlike healthcare, not necessary for a reasonable life.¹⁹⁹

The second role is to ensure that opportunity is indeed equal. Taxation could be used to pay for generous spending on education and training, in order to compensate people for not having the advantages that other people enjoy through having been born into families where culture and ambition are the norm. Taxation could also be used to fund payments of cash to people at certain points in their lives, which they could then spend on training, or on setting up their own businesses.

Even if equality of outcome is to be dismissed as a legitimate objective of taxation it does not follow that this aim of equality of opportunity is to be dismissed. The crucial difference is this: equality of outcome includes at least a reasonable degree of equality of personal income and wealth (it may not require perfect equality of income and wealth: some may be adequately compensated in outcomes for getting less money by, for example, greater job satisfaction or more leisure time). But the total amount of income, and the total amount of wealth, are not fixed. It is possible to make the poor richer, without making the rich poorer. It makes sense to take this option, given that there are no strong arguments for equality of outcome in itself.

Opportunity in itself can be addressed in the same way. It is possible to use the fruits of technological progress and of economic growth to provide better education for some, without worsening provision for others. But if the “equality” aspect of equality of opportunity is to be significant, it must relate to competitions which some cannot win without others losing.

There are two reasons for wanting an opportunity to compete with others on equal terms, and one is of rather narrower application than the other. The reason of

¹⁹⁹. The obvious example is education, where individual returns to tertiary education are markedly greater than the social returns. For a survey and discussion, see European Commission, *Efficiency and effectiveness of public expenditure on tertiary education in the EU*, European Economy Occasional Papers 70, 2010, pp. 24–28

comparatively narrow application is that one may wish to exercise one's talents in a particular way, in areas where there are far more people who wish to do so than places for them. The reason of wider application is that one may wish to be higher up the pecking order than others.

The former reason is of limited application because there is no inevitability about the number of positions in many walks of life. Economic growth can bring new businesses and new opportunities. The number of taxpayer-funded opportunities in areas of work that are normally taxpayer-funded, such as education, medicine and academic research, is of course limited, but economic growth can bring forth new privately-funded positions in such fields, and where there is a natural limit, that can reflect some desirable fact. For example, it is a good thing if the general level of health is such that few doctors are needed. The latter reason can be of wide application because whenever there is a scale of status, some will be high up it and some will be low down it.

Given that there is a reason of wide application, we must consider the ethical and political arguments for ensuring equality of opportunity in the sense of being fairly placed in competition, and whether those arguments are strong enough to justify the substantial taxation and spending that achievement of such equality may entail. (High taxation and spending may not be the only way to achieve equality of opportunity. The use of tests for access to positions that do not favour those who have had advantages earlier in life may be an alternative.)

Ethical theory, unaided by political theory, has little to say here. Utilitarians want to see good, competent people in influential positions. Where they come from matters little. There are two main utilitarian arguments for equality of opportunity. One is the fact that without it, resentment may build up among those who feel excluded from opportunities, and that resentment will itself be a source of loss of utility. The other is the fact that if people are excluded from competition for posts by force of circumstance, the most talented people may easily be overlooked, so that important jobs are not done as well as they could be done. The virtue ethicist will be keen that people should use their talents, but if only a certain proportion of the population can occupy influential positions, it is inevitable that only a certain number of people will be able to exercise talents that are specific to that kind of position. The deontologist is unlikely to have much to say, because his primary concern is with how individuals should act, rather than with how society as a whole should be organised. He would, however, be likely to say that anyone who selected people for positions should consider candidates on their merits, and should not be biased.

Stronger views on equality of opportunity come from political thought. In particular, John Rawls argued that one of the principles we would choose, if we were designing a society without knowing who we would be within it, would be the principle that social and economic inequalities were to be arranged so that they were "attached to offices and positions open to all under conditions of fair equality of opportunity".²⁰⁰ His view that we would agree to such a principle is perfectly plausible, although we can of course challenge the view that imagining what we would want, if we were in a position of ignorance as to who we would be, is the right way to settle such questions. But we should consider how far such a principle could plausibly go.

Rawls' formulation is quite general. His concern is with both social and economic inequalities. It could cover not only competition for well-paid jobs, but also competition for jobs with good working conditions. And it could cover both jobs in the public sector and jobs in the private sector. This is where the debate is to be had.

200. Rawls, J., *A Theory of Justice*, revised edition, 1999, p. 266. All references are to this edition.

If we agree that there is something in principle desirable about fair competition, over what range is it important to ensure it through state intervention?

One can make a strong case in respect of appointments to taxpayer-funded positions. There are three main reasons for this. First, if we are required to pay for positions, we should be in a position to compete for them. Second, we should get the best people doing the jobs for which we have to pay, and the absence of market pressures to hire the best people means that some other regulatory mechanism is needed. Third, if the friends of those in political power could have privileged access to plum positions, corruption would be rife. The case is distinctly weaker for jobs in the private sector, where we are not required to pay, there are market pressures and, while corruption exists, it is primarily a cost for those who have chosen to be shareholders, employees or customers of the enterprises concerned.

Then we must ask how much should be done. Anti-discrimination laws and strict rules on the public advertisement of jobs in the public sector should go a long way towards achieving the goal, and they already exist in the UK. Measures that impose higher direct costs, such as the provision of extra education for those who have been disadvantaged by their upbringing, might be considered, but such measures would benefit applicants for jobs in the private sector just as much as they would benefit applicants for jobs in the public sector. If we consider the full equalisation of opportunity in the private sector to have limited value, then the expenditure involved would, on average, produce less of an improvement per pound spent than it would have if the value attached to equal opportunity in the competition for public sector jobs applied universally. The conclusion to draw is that while there is merit in increasing opportunity through education, the case that may be made for higher spending on education based specifically on equality of opportunity is quite weak. That may serve as a conclusion for this section as a whole. The promotion of opportunity is worthwhile, although resources are limited and we cannot go as far as we might like in that direction. But putting the case for spending on education and the like in terms of equality of opportunity, rather than simply in terms of opportunity, does not greatly strengthen the case for spending.

6.5. Limited set of legitimate objectives for government

There is a limited set of legitimate objectives for government

There is a certain limited set of objectives for government, and limits on the extent to which they can be pursued and enhance social welfare. Those limits are considered in this section.

Research suggests that extra spending ceases to contribute to increasing welfare beyond 35 per cent of national income. That should be seen as the maximum justifiable level of public spending (section 6.4.1).

Some claim that the findings of happiness economics provide a scientific template for an ambitious new role for government: promoting happiness. However the early empirical findings that were the basis of that claim seem to be weaker than they initially appeared and happiness economics has not changed the proper role of government (section 6.4.2).

We have looked at the legitimacy of using taxes to support action in a number of broad areas: essential services (section 6.4.2); other services (section 6.4.3); supporting those in need (section 6.4.4); and promoting opportunity (section 6.4.5).

The maximum justifiable level of public spending is 35 per cent of national income

The French economist Paul Leroy-Beaulieu wrote in 1888 that tax revenue of five to 6 per cent of GDP could be considered “moderate”; revenue of eight to 10 per cent of GDP would be “normal”; and revenue beyond 12 per cent of GDP would be “exorbitant”, and would undermine economic growth in a country.²⁰¹ There is a modern literature on the optimal size of government that tries to understand both the size of government that maximises welfare in the short term and that maximises economic growth to improve prosperity over the longer term.

Different taxes and different types of public spending have different consequences for welfare and economic growth. As a result there is no single optimal share of public spending in national income. If taxes and spending were more efficient, that could justify a higher share of national income, whereas particularly inefficient taxes and spending could mean that it was optimal to tax and spend less. As a general rule, however, this definition explains the optimal level of public spending as a share of national income:²⁰²

The social welfare maximising point can be defined as the share of national output at which the discounted net present value of the diminishing marginal social utility derived from extra government spending equals the rising opportunity cost in terms of the net present value of the foregone economic output, and also personal liberty, of the need to pay for it.

The fact that this definition is couched in net present value terms means that it can cope with issues such as inter-generational equity or environmentalist concerns about the long-term future of the planet provided the appropriate rate of societal time discount is employed, a real rate of around 2.5 per cent to 3.5 per cent.

Tanzi and Schucknecht produced an estimate based on the United Nations human development index to see at what point in increasing public spending as a share of national income no further increases in social welfare became discernible. Their results suggest that, even if you accept the current set of objectives the state is expected to achieve, general government does not need to spend more than 35 per cent of national income.²⁰³

Davies produced a similar study and found a smaller optimal size of government. He used panel data for 154 countries and found the optimal size of government to maximise the human development index was 30 per cent (measured as consumption and investment spending combined). That was made up of consumption spending at 17 per cent of national income and investment spending of 13 per cent of national income.

There are limitations to that kind of study though. Tanzi notes that:²⁰⁴

Some of the countries with the highest HDI scores and with high levels of public spending, such as Norway, Canada, Sweden, Belgium, the Netherlands, and Finland, have in recent years significantly reduced their public spending while retaining their high HDI index [...] Thus, there is life after public

201. Cited in Tanzi, V., *The Economic role of the state in the 21st century*, Cato Institute, 2005

202. Smith, D. B., *Living with Leviathan: Public Spending, Taxes and Economic Performance*, Institute of Economic Affairs, 2006

203. In their initial research Tanzi and Schuknecht used a figure of 30 per cent but more recent papers, many of which have been published by the London think tank Politeia, have quoted a 30 per cent to 35 per cent range. Professor Tanzi has updated this work in part 4 of Tanzi, V., *Government versus Markets: the Changing Economic Role of the State*, 2011.

204. Tanzi, V., *The Economic role of the state in the 21st century*, Cato Institute, 2005, p. 622

spending reduction. These countries have shown that public spending can be significantly reduced without causing the large fall in public welfare that many expect. A scatter diagram [...] shows that there is no identifiable relationship between levels of public spending and HDI. This is confirmed by the absence of any correlation between the two variables.

The human development index was not designed for this purpose and may not properly capture differences in living standards between countries, particularly among relatively well-off countries like the UK.

For example, beyond a certain level the contribution of health spending to life expectancy diminishes rapidly. Additional spending is no longer focused on conditions that can kill people earlier in life, where it will make a substantial difference to life expectancy, but instead on end-of-life care for the elderly. That may mean countries where healthcare is rationed less, and provided more in response to demand from consumers who spend a lot on treatment that improves their quality of life (or marginally extends it at the end) but makes little difference to aggregate life expectancy, appear to have inefficient healthcare sectors. Life expectancy will also be seriously affected by lifestyle decisions that will contaminate any assessment of the role of public spending. In the same way, the education index looks at the adult literacy rate and the amount of time spent in school. In developed countries those are probably more a measure of social dysfunction and inputs than public sector output and its effects on aggregate welfare. Those studies may also measure the short-term results of higher spending but not the long-term cost in terms of diminished economic growth. While some of the costs of higher spending may be reflected in the index, such as a reduced ability to buy private healthcare or education or an immediate reduction in incomes from reduced labour supply, the dynamic economic harms over time may not be. For a more complete understanding of the optimal size of government, we also need to consider the effects on economic growth (section 6.1). There have been a large number of studies looking at the optimal size of government to maximise economic growth, some of them summarised in table 6.8.

Table 6.8: studies of the growth-maximising size of government

Author	Title (year)	Country	Optimal size of government	Notes
Branson, J. & Lovell, C.	A growth maximising tax structure for New Zealand (2001)	New Zealand	22.5%	Annual growth rates in New Zealand since 1945 have varied from 18 per cent to -8 per cent. Meanwhile the tax burden has grown from 23 per cent to 35 per cent. At the optimal rate, real growth would have increased by 17 per cent.
Chao, J. & Grubel, H.	Optimal Levels of Spending and Taxation in Canada (1998)	Canada	34% (government spending)	In 1996, public spending in Canada was 48 per cent of GDP. Reducing spending to the optimal level would have meant growth levels of 3.7 per cent, rather than 3 per cent.
Chobanov, D. & Mladenova, A.	What is the optimum size of Government? (2009)	Sample of OECD countries	25%	The authors also examined the relationship between the optimal size of consumption and the general government consumption on final goods and services for a set of 81 countries. In that case, they estimated that the optimal size of government consumption is 10.4 per cent of GDP.

Author	Title (year)	Country	Optimal size of government	Notes
Facchini, F. & Melki, M.	Optimal government size and economic growth in France (1871–2008): An explanation by the state and market failures (2011)	France between 1871–2008	30% (government spending)	This extensive study found that the optimal level was reached in 1940. In the period 1999–2009, it was around 53 per cent. The authors note that other studies on France have indicated an optimal size of around 40 per cent, but they dismiss these as having analysed too short a time period.
Forte, F. & Magazzino, C.	Optimal size of government and economic growth in EU-27 (2010)	EU–27 countries	37% (government spending)	This paper combines the models set out by Barro, Armey, Rahn and Scully to use a BARS curve. The peak of the BARS curve – where economic growth is maximised – is at 37 per cent in this model. The actual level was 47 per cent, hindering economic growth.
Herath, S.	The size of government and economic growth: an empirical study of Sri Lanka (2010)	Sri Lanka	27% (government spending)	This paper uses Armey's quadratic curve and finds that it applies to developing economies, as well as developed economies.
Karras, G.	On the optimal Government size in Europe: theory and empirical evidence (1997)	European countries	16 % average (+/-3%) (government spending)	The study also found that evidence that the marginal productivity of government services is negatively related to government size. In other words, the public sector is more productive when small.
Karras, G.	The optimal Government size: further international evidence on the productivity of Government services (1996)	Various	23% average (government spending)	The average of 23 per cent ranges from 14–33 per cent. In Africa, the rate is 20 per cent; in North America, 16 per cent; in South America, 33 per cent; in Asia, 25 per cent; and in Europe, 18 per cent.
Keho, Y.	Estimating the growth-maximising tax rate for Cote d'Ivoire: Evidence and implications (2010)	Ivory Coast	21.1% to 22.3% (revenue/GDP)	In this case, the author finds that the current tax revenue/GDP ratio is actually too low in the Ivory Coast, and that revenues should be increased to the optimal rate.
Mutascu, M. & Milos, M.	Optimal size of Government spending: The case of European Union member states (2009)	EU–15	30% (government spending)	This could have led to a maximum rate of GDP growth of 3.96 per cent a year on average for the EU15 countries, which is higher than the average 2 to 3 per cent achieved. The average level of expenditure was 46 per cent, so to get to the optimal level this would have had to be reduced by 16 per cent.
Mutascu, M. & Milos, M.	Optimal size of Government spending: The case of European Union member states (2009)	EU–12	27% (government spending)	This optimal rate could have led to growth of 7.7 per cent, with a reduction in spending of just over 13 per cent.
Rahmayanti, R. & Horn, T.	Expenditure efficiency and the optimal size of Government in developing countries (2011)	Developing countries	15% (government spending)	The sample consists of 63 countries, but a score could not be determined for 16 of them, as the model required a sufficient efficiency score.
Schoeman, N. & van Heerden, Y.	Finding the optimum level of taxes in South Africa: a balanced budget approach (2009)	South Africa	18.5% (revenue/GDP)	The author finds that the optimal rate of taxation in South Africa is actually much lower than it has been in reality for two decades.
Scully, G.	What is the optimal size of Government in the United States? (1994)	United States	21.5% to 22.9% (revenue/GDP)	Taxes as a share of GDP have not been in this range since 1949. Growth calculations based on the model suggest that American families would have had twice as much real income.

Author	Title (year)	Country	Optimal size of government	Notes
Scully, G.	Optimal taxation, economic growth and income inequality in the United States (2008)	United States	19.3% (revenue/GDP)	At the mean tax rate, a growth rate of 3.4 per cent was expected. However, shifting down to the optimal level increased the growth rate to nearly 7 per cent.
Turan, T.	Optimal Size of Government in Turkey (2014)	Turkey	15.4%–17% (1970–2012) and 8.8%–9.1% (1950–2012)	Optimal size of government for Turkey varies from 8.8 to 9.1 per cent of GDP for 1950–2012 and 15.4 to 17 per cent for 1970–2012, depending on the specification. The optimal size of the central government expenditures excluding the interest payments is 14.4 per cent of GDP for 1980–2012.

There are limitations with those studies as well, however. Kahn argues that:²⁰⁵

On the measurement front, [research should go] beyond the size of the government budget to include such factors as regulations, price controls, and trade restrictions. Regarding methodology, it has argued for approaches that take into account “simultaneity” (the problem of disentangling cause and effect) and the multidimensional nature of the problem, and which look for lasting effects on the level, rather than the growth rate, of economic activity. Surveying the literature, and looking directly at broader measures of government size, while the evidence does not allow us to determine what the optimal size of government is, it does clearly indicate that, for the most part, the governments we observe are too large – at least from the point of view of maximising GDP per capita.

For the purposes of this review, the right conclusion is that there appears to be a maximum justifiable level of spending at 35 per cent of national income but that lower levels of spending are likely to substantially improve economic growth and prosperity over time. Those short and long-term priorities could be balanced with a 33 per cent of national income target, which was also the mean level chosen by respondents to polling by ComRes in 2011.²⁰⁶

²⁰⁵ Kahn, J. A., *Can We Determine the Optimal Size of Government?* Cato Institute, 14 September 2011

²⁰⁶ ComRes, *Taxation*, 2–4 July, 2010

Chapter seven

*Government
spends your
money less
effectively than
you do*

7. Government spends your money less effectively than you do

7.1. Eamonn Butler: the morality of tax

Spending requires tax and while it may be a necessary evil – it remains an evil

Everyone knows the moral arguments for government spending. It gives us large public projects such as roads and bridges; essential functions such as defence and the justice system; and produces a more equal society by redistributing income from the rich to the poor.

We hear the moral arguments against government spending much more rarely. Yet these unspoken arguments are surprisingly numerous, and surprisingly strong. Spending requires tax and while it may be a necessary evil – it remains an evil.

7.1.1. Through tax, government spending is coercive

First, taxation relies on the use of force. Most of us would willingly make some voluntary contribution towards things like policing and poverty relief. But taxes at today's levels can be extracted from us only by the threat that non-payers will be fined or imprisoned. The belief that our taxes might do some good is only a small part of the reason why we pay up. The main reason we pay our taxes is the threat of judicial force.

Plainly, coercion is an evil. We could perhaps justify the use of force against people if it forestalls some even greater evil – arresting an intended terrorist, for example. That is simply choosing the lesser of two evils. But it is much harder to justify the evil of force against some people in order to produce good for others – using compulsory purchase orders, say, to facilitate a new airport development. That is because we cannot compare how different people feel about these things: we cannot get into their minds and strike any balance between the grief of those who lose their family homes against the pleasure of air travellers.

So if we propose to use force – including taxation – against people in the name of creating some wider benefit, we need to ensure that our case is really strong. Coercion is a serious business: it imposes an awesome responsibility on the authorities to ensure that the money raised through it is spent wisely and effectively. Bureaucracy and waste are not just a loss to the economy – they are a moral outrage.

But the only thing that seems to have been produced by decades of government waste and efficiency campaigns is targetitis and more bureaucracy. Most people believe that they could spend their money far better than the government does, and that waste and bureaucracy are in the very nature of public spending. If so, forcing people to pay for them through taxation is quite immoral.

7.1.2. Tax eclipses personal morality

Not only is taxation a form of confiscation under threat of force. It is confiscation by people who believe their values and priorities are superior to those whom they force to pay up.

The idea that Whitehall – or a majority in parliament – knows best is not just contemptibly patronising; it is also a breathtaking moral claim. Even if they do reflect majority opinion, who is to say that their values and ethics are superior to someone else's?

Taxation forces people to pay for things they disagree with, and indeed for things that they may oppose morally, at the deepest personal level. People may have fundamental moral objections to abortion, foreign wars, mixed-sex schools, even bank bailouts – yet they are still forced to finance these things through taxation. Their values may be just as profound as those of people in authority, their feelings as keen, their views just as rigorously constructed. Yet we force them to live with the dismal thought that purposes they consider highly immoral are being funded with their money, and that things they regard as evil – perhaps as plain murder – are being done in their name. This should give ministers and officials in spending departments the utmost discomfort, though there is scant evidence that it does.

7.1.3. Spending raises the state over individuals

The fact that taxation limits people's control of their own resources means that it necessarily reduces their freedom. They are not at liberty to use their own earnings, capital and savings as they believe is right for themselves and their families, and as they think is ethically appropriate. This in turn means that an important part of their moral being is extinguished. People can only be considered moral – or immoral – if they actually have control over their own actions, and are free to make moral choices. A person whose choices are usurped by another is not a whole human being, but a mere cypher. Taxation and therefore government spending eats into people's moral integrity and makes them, in part, mere agents of the state.

But institutions like the state do not have values. Only *individuals* have values. Only individuals choose, act, and hold ethical beliefs. They may well combine on collective projects such as mutual defence or welfare or the creation of large infrastructure projects. But the collectivity, the society or the state is not some super-human being with values and beliefs of its own, to which those of individuals can be legitimately sacrificed: it is simply an integrated arrangement of individuals. Individuals remain the ultimate ethical units. And since no person has any more or less moral worth than another, individuals must be treated as ends, not as means to someone else's ends.

This is why the argument that some people must be forced to pay money for the benefit of others is extremely fraught. The state has no prior moral right to people's property. If it did, there would be no logical stopping point; no level of state expropriation which any of us had any right to resist.

7.1.4. Spending undermines personal responsibility

By relieving people of control over their own resources, public spending also – malignly – relieves them of personal responsibility. They may wish, for example, to take care of elderly relatives, or to provide educative activities for their children, or to give themselves training that might enhance their employment prospects. By eating into their income, savings and capital, taxation reduces their ability to do these things – all of them things that would bring benefits to the community as a whole, and not just to the specific family. Although most of us want to see individuals, families and local groups taking more responsibility for their own lives and welfare, high taxes make it more difficult for them to do so.

Indeed, spending may leave people convinced that they have no outstanding social obligations at all. When our taxes are collected, we are told that they will pay for vital public services such as education, welfare and policing. And since most people greatly underestimate the cost of public services, they may well look at their tax bill and conclude that these services must be in ample supply. That in turn may

make them believe that their social obligations have been completely discharged – that they have paid handsomely for others to do the job.

They may well feel, then, that it is up to the teachers to make sure that their children are literate, numerate and well behaved, and that they need take no responsibility in this. They may believe that the welfare state, comprehensive as it is, clears them of any moral duty to help others who might need their help. They may walk on by when they see children being neglected or crime and vandalism being committed, believing that these are the responsibility of the police and social services that their taxes pay for.

7.1.5. Spending crowds out private contributions

People who pay high taxes are also less likely to make financial contributions for the general benefit. In the first place, tax leaves them with less money to devote to charitable giving. Schools, hospitals, libraries, galleries, orchestras, care homes and other welfare charities have all benefited from the bequests of people who understand their importance to society and humanity; but high rates of lifetime or inheritance taxes inevitably leave people with less to give.

And again, when people have the impression that the state will provide through its spending programmes, they see less reason to contribute their own support to good causes. When people see public libraries closing, their first thought is to demand that public expenditure priorities should be changed – rather than to dip into their own pockets. Why support medical research, for example, when the government already directs countless grants and subsidies to this very function?

A classic example was the Royal National Lifeboat Institution, which was created independently in 1824, but fell on hard times thirty years later. So in 1854 it accepted £2,000 in government grants. But for every pound the government put in, the RNLI lost thirty shillings (£1.50) in voluntary donations. People could not see why they should support a state-funded institution. So in 1869 the RNLI cut loose again, and has flourished ever since.

7.1.6. Societies with larger governments are less generous

The 1960s US vice-president Hubert H Humphrey was once voted “the most generous man in America”. It was not for giving away his own money, but for his keenness to give away other people’s through tax and public spending measures. Yet higher public spending is no measure of a country’s generosity, morality or philanthropy. Indeed, charitable giving that comes voluntarily, through the goodwill and public spirit of private donors, is far more laudable, and far more superior morally, than support that is extracted from people by force.

America gives almost twice as large a proportion of its earnings (1.67 per cent of GDP) to charity as does the UK (0.73 per cent of GDP). It means the Average American gives \$15 a week to charity, the average Briton only the equivalent of \$5 a week.²⁰⁷ At least in part, that must be due to the fact that the US leaves people the space to make their own decisions about what to support. The US government absorbs only 27 per cent of America’s income each year, while the UK government takes 39 per cent. In addition, the US actively encourages charitable giving, allowing its citizens to deduct all their philanthropic gifts from their taxable income.

This is one reason why low-tax America has long had a deep and generous tradition of private giving. The Scottish-born Andrew Carnegie, who sold his steel

²⁰⁷. Calculations from GDP figures and Charities Aid Foundation, *International Comparisons of Charitable Giving*, November 2006

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company in 1901 for \$480 million, used most of that money to fund scientific research and to establish schools, libraries and colleges, particularly in the US, Canada and the UK. Another American immigrant, the Hungarian-born financier George Soros, is reckoned to have given over \$7 billion to philanthropic causes so far, including anti-poverty initiatives in Africa, delivering internet infrastructure into Russian universities, and promoting democracy in Eastern Europe. Bill and Melinda Gates intend to give away their entire software fortune on causes such as education, healthcare and the eradication of malaria. The US actor Paul Newman gave over the whole profit from his popular supermarket sauces, amounting to more than \$300 million, to charitable causes.

So it seems that it is not only governments that can spend money on good causes. Indeed, private individuals, voluntary societies and independent charities seem to promote such projects with far greater enthusiasm, imagination and effect. Unfortunately, however, at least some of their vigour is sapped by the burden of higher taxes.

7.1.7. The self-interest of the authorities

It is not as if the money raised through taxation is spent in accordance with the views and wishes of those it comes from – or even as if it is spent honestly and objectively in the public interest.

We get very little say in where our tax money goes. Elections are infrequent, perhaps no more than every four or five years. When elections do come, we are not voting on individual spending programmes but on a whole package of measures that cloud include issues as diverse as immigration, schools, healthcare, welfare, unemployment and prisons. On such infrequent and confused evidence, the politicians who decide where our money is to be spent cannot have any clear idea of what the public's priorities really are, and of the depth of feeling that different people have about those priorities.

But then our legislators and officials have priorities of their own. People do not suddenly become angels when they are elected into office or start working for a government agency. They have their own interests, ambitions and objectives that inevitably colour the decisions they make. Officials may well try to ensure that public money is spent effectively and dispassionately; but they may equally have an eye on protecting their own budgets. Parliamentarians may well claim, and believe, that they are in politics to make things better for everyone; yet they may also incline to take greater care in steering public resources to their own voters and supporters. The real world of government is very distant from the textbook ideal in which representatives and officials weigh up the issues dispassionately, decide them impartially and apply them objectively in the public interest.

7.1.8. Spending promotes interest-group politics

Some politicians make no bones about being in politics to promote the interests of their own supporters; but in fact everyone involved in the process of deciding how taxpayers' money is spent inevitably brings to it some smaller or larger measure of their own self-interest. The more money that flows through that decision-making process, the more power is given to politicians and officials to indulge those personal interests.

A great deal of what passes for income redistribution, for example, is actually a form of vote buying, with grants and subsidies being steered to particular groups that are favoured by the ruling party. Interest groups take full advantage of this, lobbying for special legislative favours for their cause or their industry, often in return for party funding or other inducements. Such favours can be extremely lucrative,

perhaps involving tax concessions, subsidies or regulations that make life harder for competitors; so it is not surprising that lobbying is such a big industry. But the higher that tax rates are, the bigger are the potential rewards from getting special tax treatment, and the larger the lobbying industry grows. High taxes, as they say, feed big government rather than hungry children.

As the US humourist H L Mencken put it, “elections are advance auctions for stolen goods”. Interest groups of all sorts are out for the favours that the politicians of a large state are able to grant them. The only group that seems to be under-represented in this carve-up of taxpayer funds is, unfortunately, taxpayers themselves.

7.1.9. Inefficiency of government spending

There is an argument that people can spend their own money better than others can, and that taxpayers too can spend their money more effectively than can politicians and officials. Given that taxes are collected by coercion, this should worry us, since it implies that, to some extent, people are being coerced for no good purpose.

To illustrate the argument, consider four kinds of spending. First is when I spend my own money on buying things for my own use. In this case, I will of course be very concerned to get a good price, but also to get good quality. Second is when I spend my money on buying something for someone else – a present for my aunt, say. Here, I am very concerned about the price, but not so concerned that I get good quality. Third is when I spend someone else’s money on myself – as with an expense-account lunch. Here I am keen to get good quality, but hardly concerned about the price at all. Fourth is when I spend someone else’s money on someone else. And this is the public sector.

There is, certainly, an argument that charities and voluntary groups are probably more efficient in spending other people’s money on services such as healthcare, education and welfare than are governments. That is why various governments, while continuing to fund these services, have given over some or all of their provision to private and voluntary organisations.

One important reason for the difference may be that a private body is better able to treat people as individuals, and to tailor support innovatively around their needs, than is a civil servant who inevitably has to follow a book of rules laid down by some distant central legislator. A charity might conclude, for example, that an unemployed person would be better served by a course in interview technique or self-assertiveness training than by a lifetime of cash benefits. A charity might pay for immediate private treatment of a back problem, rather than let the condition deteriorate until the person is unable to work again. In the state sector, such novel approaches do not come easily and the funding would often have to be coaxed out of someone else’s budget.

7.1.10. Spending promotes scepticism of government

An interesting point about presents is that the people who receive them tend to underestimate their costs. A very informal newspaper survey of Christmas presents some years ago put the difference at around 14 per cent.

In a similar fashion, surveys suggest that people significantly underestimate the cost of public services. Yet they see the full cost they are paying through taxes plainly enough. There is, also, a wide feeling that public services are poorly targeted and that the public bureaucracy is wasteful and inefficient. These perceived deficiencies may prompt many people to conclude that they are getting poor value from the money they pay in taxes.

The higher that public spending goes, therefore, the more likely people are to regard the taxes required to pay for it as unjust confiscation rather than a payment for services. They come to consider themselves more as victims that are being exploited by those in power, rather than as willing collaborators in the provision of essential public functions. On occasion, such alienation has led to taxpayer revolts – such as the UK fuel duty protests of 2000 and California’s 1978 Proposition 13 measure to limit property taxes, which prompted more general taxpayer protests throughout the United States. And there is evidence that, when personal taxes rise beyond a level of roughly one-third of income, a silent tax protest starts, with people more likely to avoid or evade tax, or to move their money or themselves to lower-taxed jurisdictions.

Likewise, as the range of functions performed by the government grows ever wider on the back of increased taxation and spending, individual taxpayers each see the government doing more and more things that they regard as marginal, pointless or even downright undesirable. This again makes them feel like exploited victims of the political class rather than willing contributors.

7.1.11. Higher spending is morally corrosive

Indeed, as the state takes on increasingly wide and diverse roles, managing it all becomes increasingly difficult for the authorities. The opportunities for making mistakes grow in number, the scale of the potential shortcomings becomes larger, and gaps, inconsistencies and injustices open up. An overstretched state begins to lose authority – which may be corrosive at a moral level too, with citizens becoming increasingly cynical of law and authority.

Moreover, the higher that taxes are, the less willing are people to pay them, and the more widespread will avoidance and evasion become. The standard official response to that, of course, is to tighten the rules and increase the penalties of non-compliance – in other words, to *increase coercion*. But this simply breeds even greater resentment, and sets us on a downward ethical spiral. The American comic Will Rogers once joked that income tax had made more liars out of his countrymen than had golf. In the UK today, even professional suppliers will ask whether you would prefer to settle in cash rather than see VAT added to your bill. When ordinary people come to believe that taxes are unjustly high, it makes criminals of us all.

As the nineteenth century French politician and author, Frédéric Bastiat, pointed out, almost everyone supports the provision of basic services such as defence and the administration of justice. But when people believe that government is plundering, they will inevitably try to avoid or evade the taxes it imposes on them.

7.1.12. Ethical corrosion in government

The unwillingness of taxpayers to allow themselves to be exploited also prompts politicians to be underhand about how they raise taxes. There is a strong moral argument that the amount of tax we pay should be transparent and obvious – precisely so that we can have an honest debate about whether we are getting good value from the money that is taken from people by force. But that transparency does not suit governments who want to spend more money than the public would willingly pay. And so we have seen the rise of “stealth” taxes, in which the full burden of the tax is deliberately concealed.

Rather than raise the “headline” rates of tax, for example, payment thresholds may be adjusted, or simply not raised in line with inflation, in order to bring more people into the higher rate brackets. Reliefs and exemptions may be phased out. Taxes may be imposed on things such as pension contracts, where the increased burden may not become obvious for many years. Duties may be imposed on consumption items, such

as fuel, insurance or air travel, where the tax becomes subsumed as part of the price such that its amount is not obvious to the consumers who are paying it. There is a case for calling such stealth taxes dishonest and morally unacceptable.

Envy taxes are a particularly immoral set of impositions. Envy taxes against particular groups – people with high incomes, say, or who choose to spend more of their money on large houses, expensive cars or other extravagances – are, in their origin and by their nature, socially divisive. Nor is it moral, in particular, to impose very high rates of tax on higher earners, when those taxes raise little revenue, increase the incidence of avoidance and evasion, and drive high-fliers and entrepreneurs to seek refuge in other countries rather than create business and employment opportunities for their fellow citizens at home.

There is another way in which government spending is morally corrosive. The larger that the government budget grows, the more opportunities that arise for politicians and officials to grant favours to interest groups, supporters and friends. Those opportunities in turn extend the possibility – perhaps the likelihood – of political and bureaucratic corruption, with such favours being granted in return for cash or personal benefits.

7.1.13. The government gravy train

In addition, the higher that spending grows, the more people there are who have an interest in keeping it that way. In Scotland, for example, over 50 per cent of GDP, the country's income, derives from public spending. In the North East of England, it is more than 60 per cent. In Wales, more than 60 per cent of GDP comes from the state (section 6.3.1). It is no wonder that the (generally more hostile to public spending) Conservatives are hardly represented in these areas. But, whatever the fortunes of particular parties, the figures do suggest that people who live in places that are highly dependent on government spending, or who themselves depend on it, are more likely to vote for more of it, rather than to make some dispassionate judgement about what is beneficial for the nation as a whole.

Indeed, the bigger the government pie, the keener are most of us to get a slice, rather than think about the general prosperity of the nation. The more money that the government is spending, the more of us think that some part of it should come to us, and the more likely we are to lobby for precisely that. This is particularly true when we feel that a large part of the government's spending is being wasted on other people.

7.1.14. War between social groups

It is not just envy taxes that engender competition and resentment between different social groups that, ideally, we should like to see living in harmony and cooperation. All public spending is to some extent divisive.

In the market place, different people can choose different products. Car buyers, for example, can choose any colour they want, in countless shades. One person's choice does not preclude another's. Things are quite different in politics and government, however. Elections and votes in the legislature decide what everyone will have – from the size of the defence force through to the quality of road repairs.

People may have different views on what their tax money should be spent on; but in the political arena there is only one winner. Rather than accommodating diversity in peaceful coexistence, political decisions pitch different people and groups and opinions against each other. The higher the taxes they pay, the more determined will people be that *their* choices should prevail, and the more bitter becomes the political debate. Such factional rivalry undermines the idea and substance of a moral society.

Perhaps the greatest moral scandal in taxation is that the poor pay most of it

7.1.15. Perverse incentives

Tax constitutes an extra price that is imposed on things such as income, capital and saving. So through tax, spending has the perverse effect of discouraging people from earning, from saving up and from accumulating the capital goods that will raise productivity and generate wealth for the whole community. Indeed, taxes on these things have the economically and morally debilitating effect of promoting idleness and indebtedness – which may explain some of our present predicament.

There is a strong moral argument that people who create things should enjoy the fruits of their creativity. It is, after all, their labour and ingenuity that has produced those fruits. And one can argue that people have a right to use their natural talents freely and without others impeding them, as taxation surely does. For purely selfish reasons too, we should want people to be creative and to use their talents, since it is through such creativity and effort that the productivity of humankind increases. But tax (and therefore spending) stifles that creativity.

Perhaps the greatest moral scandal in taxation is that the poor pay most of it. For a start there are, quite simply, more of them. Around two-thirds of the population live on earnings that are below the national average, and most of them pay tax on their earnings and savings, plus all of their expenditures that are subject to VAT and excise duties. By far the bulk of our tax revenue, in other words, comes from those who are least well off.

Not only that, but some of the poorest people also quite commonly face by far the highest rates of tax. In many countries, including the UK, welfare benefits are phased out as people's income rises, while income tax and payroll or social taxes start to cut in. The result is that many people are discouraged from moving off social benefits and into a job, since they would lose most or all of the extra income that having a job would bring in. The disincentive effect of benefits being phased out may be hard to do anything about; but the additional disincentive of the taxes that are applied on low earnings are by no means inevitable and as such must surely be morally indefensible. In addition, such perverse incentives encourage a moral malaise among those whose lives they corrupt – a culture of dependency that swamps the natural urge to self-improvement.

Inheritance tax has some of the same effects, discouraging saving and capital accumulation. It is also at odds with human nature – and thus with our basic ethical programming – since the drive to provide for one's friends and family, and in particular one's children, is a strong human instinct. The tax hits families at the very worst time of their lives, namely after bereavement. It encourages people to rearrange their affairs to avoid it, with the unfortunate result that their assets are likely to produce less than they otherwise would, making them and their families worse off.

7.1.16. Spending reduces human prosperity

Precisely because of the perverse effects on creativity and productivity, countries with high-spending governments grow more slowly than those with low-spending ones. They export less and create fewer jobs. All of these things are misfortunes for the millions of individuals whose prosperity is directly diminished. But not only that; they also harm anyone who depends on government and charitable support, because a less wealthy public has less to spend on such causes.

Tax havens are often criticised for facilitating money-laundering and crime; but there is a moral case for low-tax jurisdictions too. In the first place, the finance that they attract may be the only viable livelihood in places that are otherwise largely barren: choking off that finance may cause real hardship. And low-tax jurisdictions have another beneficial effect: their existence reduces the ability of governments in other

countries to impose unjustly onerous taxes on their own populations, with all of the economic and moral downside this implies.

7.1.17. Is taxation theft?

Is taxation theft? Some people say so, but the term is loaded and therefore perhaps best avoided in a discussion of the morality of taxation. Unlike theft, taxation at least has the justification that it is usually imposed only by the decision of a majority, after public debate, and for public rather than private purposes.

Nevertheless, if two strong people took money from a third by force and spent it on themselves, we would certainly call it theft, even if they tormented their victim by first holding a vote on the matter. If 51 per cent take money by force from the other 49 per cent and spend it as they think fit, is there really such a big difference?

But such name-calling is hardly necessary. It is evident that high taxes are not moral, or generous, or the hallmark of a humane society. On the contrary, they are coercive, they undermine personal morality and responsibility, they diminish prosperity and crowd out charity, they are divisive and inefficient, they reward power and discourage creativity and they turn both people and governments into cheats. The moral case against them and against the high levels of spending from which they arise, in other words, is quite strong enough.

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7.2. Nima Sanandaji: comparison of Sweden and Norway

Previously seen as a bastion of social democracy, Sweden has implemented policies which have brought its economy closer towards other Western European states. This chapter briefly describes the significant reduction of taxes and expenditure that underlie this shift. Particular focus is given to reforms of sick and disability benefits. This change has been a key part of Swedish workfare policies and illustrates the possibility to reform central aspects of welfare systems. This contrasts markedly with Norway. The two countries have comparable economies, with similar social systems and have undergone a period of global recession. Whilst Sweden has focused on workfare reforms, Norway has continued on a traditional social democratic route. This can explain why the share depending on public benefits has fallen significantly in Sweden but remained relatively high in Norway. It can also explain why both Norway's new centre-right government and Denmark's Social Democrats are aiming to strengthen the incentives to work.

7.2.1. Shifting to workfare

For a long time, high levels of taxation have been a drag on the otherwise vigorous Swedish economy.²⁰⁸ The country can serve as a good example of the detrimental effects of burdensome taxes.^{209, 210} However, the Swedish experience also illustrates

208. Bergh, A., & Henrekson, M., *Government size and implications for economic growth*, AEI Press, 2010

209. A study published by the European Central Bank found that income tax rates in Sweden are revenue-maximising. For capital taxes, rates in Sweden were found to be even higher than the revenue-maximising rate. This means that capital taxes are damaging the economy so much that a cut in the rates would increase revenues.

210. Trabandt, M., & Uhlig H., *How far are we from the slippery slope? The Laffer curve revisited*, European Central Bank working paper series, no. 1174, 2010

how taxes can be lowered within the frame of European welfare models. As late as 2005, taxes captured 49 per cent of Swedish economic output. Only Denmark, where the corresponding figure was 51 per cent, had a higher tax burden in the OECD. No other country came close. Seven years later the level of taxation in Sweden had fallen to 44 per cent, below that of not only Denmark but also France, Belgium and Italy.²¹¹

The changes are noteworthy from a taxpayer's perspective. According to the Swedish Taxpayers' Association the typical employee was in 2005 burdened by 60 per cent average taxes, when including both direct and indirect taxation.²¹² In 2012 the level had been reduced to 54 per cent.²¹³ While the rates remain high, the fall is nonetheless impressive. Those interested in how high tax levels in modern welfare states can be moderated can learn much from the Swedish centre-right government that governed Sweden between 2006 and 2014. Although defeated at the 2014 election, its re-election in 2010 was an unusual feat for the centre-right in Sweden, which for much of its modern history has been seen as a Social Democratic one-party state.

Table 7.1: tax burdens in OECD countries, highest 10

2005	%	2012	%
1. Denmark	50.8	1. Denmark	48.0
2. Sweden	48.9	2. France	45.3
3. Belgium	44.5	3. Belgium	45.3
4. France	44.1	4. Italy	44.4
5. Finland	43.9	5. Sweden	44.3
6. Norway	43.2	6. Finland	44.1
7. Austria	42.1	7. Austria	43.2
8. Iceland	40.7	8. Norway	42.2
9. Italy	40.6	9. Hungary	38.9
10. Slovenia	38.6	10. Luxembourg	37.8

Source: OECD Stat Extract²¹⁴

The Swedish government carried out a broad reform agenda. Workfare policies introduced included liberalising temporary employment contracts, reducing the generosity of benefits and an earned income tax credit aimed particularly at those with lower incomes. Overall, the reforms seem to have been successful. Sweden has performed impressively during a time of global recession, prompting the *Washington Post* to label the nation as the “rock star of the recovery”. The magazine has praised Swedish fiscal conservatism.²¹⁵ Anders Borg, the politician responsible for much of the policy shift, was ranked by the *Financial Times* as finance minister of the year.²¹⁶

211. OECD, accessed 1 January 2014

212. Swedish Taxpayers' Association (Skattebetalarnas Förening), *Fakta för skattebetalare*, 2006

213. Swedish Taxpayers' Association (Skattebetalarnas Förening), *Fakta för skattebetalare*, 2013

214. OECD, op. cit.

215. Five economic lessons from Sweden, the rock star of the recovery, *Washington Post*, 24 June 2011

216. Moderate with a tonsorial twist, *Financial Times*, 2011

7.2.2. Changes in state spending

It is important to note that tax cuts in Sweden have occurred at a national level. Local taxes which provide the main funding for welfare services such as health, schooling and care for the elderly have remained relatively unchanged. Between 2005 and 2011, the average municipality in Sweden in fact increased spending per capita, adjusted for inflation, by 9 per cent.²¹⁷ Thus, the reductions in taxes occurred at the same time when funding for key welfare services increased. To some degree, the reductions in taxes were self-financing, by prompting increased economic activity.²¹⁸ The reduced taxes were also financed through spending cuts.

Government expenditure in Swedish Kronor per head on different budget areas is shown in table 7.2 below. Total spending in Sweden fell from 80,125kr to 75,672kr over this period, or by almost 6 per cent. Interestingly spending rose in most areas, including: administration, international aid, migration, healthcare and social care, aid to family and children, culture, environment and energy, communications and state aid to municipalities. In a few areas however it was substantially reduced. This includes defence, aid to the elderly and social planning.

Table 7.2. real per capita state spending in Sweden (in 2005 Kronor)

Kronors, adjusted for inflation	2005	2012
Administration	6,389	7,004
Defence	4,868	4,241
International aid	2,460	2,817
Migration	531	770
Healthcare and social care	4,250	5,476
Sick and disability aid	14,042	8,849
Aid to the elderly	5,097	3,857
Aid to family and children	6,529	7,051
Integration and equality	708	630
Labour market policies	7,343	6,217
Education and student aid	7,018	6,988
Culture	991	1,149
Social planning etc.	344	92
Regional growth	363	318
Environment and energy	595	704
Communications	3,502	3,999
Support to enterprise, farming etc.	2,316	2,078
State aid to municipalities	6,336	7,943
Interest on state debt etc.	3,609	2,555
Fee to EU	2,833	2,934
Total	80,125	75,672

Source: The Swedish National Financial Management Authority²¹⁹ for data on spending during 2005 and 2012 respectively, population data for per capita adjustment from Statistics Sweden.²²⁰

²¹⁷. Sanandaji, N., *Kvartalstänkande i välfärden – om bristande prioritering av äldreomsorgen*, Timbro, 2013

²¹⁸. Flood, L., *En skattepolitik för både innan – och utanförskapet*, SNS – Centre for Business and Policy Studies, 2010

²¹⁹. The Swedish National Financial Management Authority (Ekonomistyrningsverket), *Tidsserier, statens budget m.m. 2012*, ESV, 38, 2013

²²⁰. Statistics Sweden (SCB), *Sveriges framtida befolkning, 2060*, 2012

The greatest change occurred in the budget area of sick and disability aid, where spending fell by 5,193kr from 14,042kr to 8,849kr per person. This cut alone explains the overall trend of falling spending by 4,453kr (or 3,399kr if you disregard the lower interest payments on state debt). Had sick and disability spending remained unchanged, all else being equal, total state spending would have increased. How, then, was this saving possible to introduce, and what does it really represent?

7.2.3. Background to reforms

Generous sick and disability benefits can be seen as a cornerstone of the traditional welfare model. Therefore they are thought to be difficult to change, even when the benefits of reform are evident. Indeed, many countries still struggle to implement mechanisms that can reduce over-utilisation. It is telling that Sweden, with strong support for welfare state institutions, has succeeded in introducing change. The first key step was a realisation among both experts and the wider public that the previous system was simply neither economically or socially viable.

In 2005, analyst Jan Edling wrote a report which discussed the high hidden unemployment in Sweden. Edling explained that since the beginning of the 1990s, approximately one fifth of the Swedish population of working age had been supported by unemployment, sick leave or early retirement benefits. Additionally, he noted that sick leave and early retirement were often utilised to hide the true unemployment level.^{221, 222} Edling's analysis is not unique in reaching these conclusions.^{223, 224} What is interesting is that Edling wrote the analysis for LO, the Swedish Trade Union Confederation, which has very close ties to the Swedish Social Democratic party. The analysis challenged Swedish welfare policies in general, and the ruling Social Democratic government in particular. Perhaps not surprisingly, LO initially decided not to publish it. This upset Edling to the point that he left his job, and made the analysis publicly available.

Following a serious economic downturn in 1991, 7 per cent of the working age population in Sweden were in receipt of early retirement benefits.²²⁵ The economy recovered relatively quickly but the combination of high taxes, rigid labour market regulation and generous public benefits seems to have stifled job growth. The high actual unemployment was to a large degree hidden through a continuous influx into early retirement. As shown by the Swedish National Institute of Economic Research the higher rates of early retirement and sick leave did not have medical causes. The Swedish population continued to have good health thanks to active lifestyles and relatively high quality medical care. It has also been shown that changes in norms led to a situation where it became more acceptable among the population to over-utilise the benefit systems.²²⁶ In the election year of 2006, at a time of economic expansion, early retirees composed over 11 per cent of the entire working age population.²²⁷

221. Edling, J., *Alla behövs: blott arbetsmarknadspolitik skapar inga nya jobb*, The Swedish Trade Union Confederation (LO), 2005

222. Edling, J., *Agenda för Sverige*, Ekerlids, 2005

223. Confederation of Swedish Enterprise (Svenskt Näringsliv), *Färre sjukskrivningar och fler arbetade timmar*, 2009

224. Herin, J., Jakobsson, U., & Rydeman, A., *Ge de arbetslösa en chans – 150 000 nya jobb genom halverade arbetsgivaravgifter*, Den Nya Valfärden – The New Welfare Foundation, 2006

225. The Swedish Social Insurance Agency (Försäkringskassan), *Strategier för begränsning av sjukfrånvaro och förtidspensionering: erfarenheter från Danmark, Finland, Island, Norge och Sverige 1990–2007*. Stockholm (Socialförsäkringsrapport, 5), 2008

226. National Institute of Economic Research (Konjunkturinstitutet), *Den svenska sjukfrånvaron*, Konjunkturläget, June 2003

227. The Swedish Social Insurance Agency, 2008, op. cit.

The Swedish Social Insurance Agency has itself noted that until 1 July 2008, there was no formal limit on how long sick leave pay would be handed out in Sweden. This relates to the fact that Sweden had longer sick-leave periods even compared to the other Nordic welfare states. Thus a lack of a “gate keeping mechanism” in part explained the uncontrolled influx of early retirees as well as long sick leave periods.²²⁸

Experts, researchers and top ranking politicians on both side of the political spectrum were aware of the problems. But the obvious solutions, the introduction of gate keeping mechanisms and somewhat less generous benefits, were not easy to implement. Already previous Social Democratic governments had attempted to change the system in this direction, with some success in terms of outcome. However, a persistent belief was that the sick and disability system constituted such a core element in the welfare system that major reforms could simply not be introduced.

Why, then, has change been possible in Sweden? One answer is that the perverse effects of the system were evident for large segments of the general population. Many noted that people in their surroundings were over-utilising the system. Another is that the system was socially irresponsible, as it trapped individuals in state dependency which could translate to life-long social and economic poverty. Acceptance of welfare reform grew in part due to the realisation that economic and social ills were being exacerbated by the very welfare programmes that were supposed to alleviate such problems.

7.2.4. An overly generous system corroded social norms

The Swedish welfare state was created in a society based on strong norms relating to work and responsibility. But, over time, attitudes adapted to generous welfare.²²⁹ A significant portion of the Swedish population came to consider it acceptable to claim sickness benefits without being what would previously have been regarded as sick. A survey from 2001, for example, showed that 41 per cent of Swedish employees believed that it was acceptable for those who were not sick, but felt stress at work to claim sickness benefit. Additionally, 44 per cent believed it was for those who were dissatisfied with their working environment acceptable to claim sickness benefits. An even higher rate of 48 per cent said it was acceptable for those who had problems in their family to do so.²³⁰

One illustration is sick-leave related to sporting events rather than actual sickness, a practice most common among men. During the Winter Olympics in 1988, absence due to sickness increased by almost 7 per cent among men in comparison to women (used as a control group). When the World Championship in cross-country skiing was televised in 1987 the increase was 16 per cent.^{231, 232} With time the tendency to call in sick to work seems to have grown. During the 2002 Fifa World Cup, sickness absence among men increased by an astonishing 41 per cent. Some of the increase might be due to the different nature of the events. But the stark difference in the rates during the two events also indicates a change in people's attitude to

228. Ibid.

229. Sanandaji, N., *The surprising ingredients of Swedish success – free markets and social cohesion*, Institute of Economic Affairs, 2013

230. Modig, A., & Broberg, K., *Är det OK att sjukskriva sig om man inte är sjuk?*, memo T22785, TEMO, Stockholm, 2002

231. When calculating these figures, women's rate of sickness leave is used as a reference. If women also to some degree reported sick to watch sports, the male increase is underestimated

232. Skogman Thoursie P., *Reporting Sick: Are Sporting Events Contagious?*, Journal of Applied Econometrics, 19, 2004, pp. 809–823

what is morally acceptable. Over time more people were willing to over-utilise sick leave to watch sport.²³³

This erosion of norms of unacceptability supports Swedish scholar Assar Lindbeck's theory on self-destructive welfare state dynamics, in which the welfare system wears down norms relating to work and responsibility.^{234, 235} A recent paper gives strong support for this notion. It shows that younger generations rely on sick insurance more often compared to older generations in Sweden. The author concludes: "Amongst the younger generation twenty percentage points more take a sick leave day compared to those born 20 years before, after differences in age, education, income and family circumstances have been adjusted for. The younger generation's higher demand for sick leave pay can be seen as a measure of how rapid the welfare state affects norms relating to public handouts."²³⁶

The changes in norms and behaviour are, on a daily basis, evident for the general population in Sweden. With time, it became clear to many that overly generous systems were a drag on the country's economy and a considerable cost for taxpayers. Moreover, they also constituted a break from the general social contract on which the Swedish welfare state was founded: that those able to work should do so rather than live off others. This can explain why the major centre-right party in Sweden, the Moderates, could win two consecutive elections on the basis of being the "New Labour party".

Early retirement for people healthy enough to work can also be attributed to direct government action. Regional offices of the Swedish Social Insurance Agency paid bonuses to administrators who moved people from sick leave to early retirement.²³⁷ The effect of this was that the public sector openly encouraged the process which hid true unemployment levels. The cost was deeper economic and social exclusion of people who were healthy enough to one day come back to work. This practice likely increased support for changing the previous system.

7.2.5. Reforms have stimulated employment

After changes in sick and disability insurance were introduced in Sweden, they were initially met with harsh criticism. One explanation is that a large share of the nation's population relied on these systems for support. Even those who were healthy enough to switch from benefits to work had grown used to dependency.

Also, central bureaucracies are far from optimal when it comes to judging the need for aid. Some people who had serious illnesses, and limited working capacity, were told that their support would be taken away if they didn't seek and accept employment. These examples made big headlines in the Swedish media. With time however, the harsh criticism turned to acceptance. Today even the Social Democrats have rejected calls to reverse the reforms.

According to an analysis by the Confederation of Swedish Enterprise, the reforms can explain a reduction in sick leave between 2006 and 2009 which corresponds to

233. Persson, M., *Korta sjukskrivningar under fotbolls – VM 2002 – en empirisk studio*, mimeo, Department of Economics, Uppsala University, 2005

234. Lindbeck, A., *Hazardous Welfare-State Dynamics*, American Economic Review, Papers and Proceedings, 85, 2, 1995, pp. 9–15

235. Lindbeck, A., *Prospects for the Welfare State*, Seminar paper no. 755, Institute for International Economic Studies, Stockholm University, 2008

236. Ljunge, M., *Yngre generationers högre sjukskrivningstal – ett mått på hur snabbt välfärdsstaten förändrar normer*, Ekonomisk Debatt, 5, 2013, pp. 56–61

237. Nerikes Allehanda, *Förtidspension gav 500 kronor i bonus*, 2005

some 41,000 additional full-time employees.²³⁸ In a small country such as Sweden this is a significant boost to employment, amounting to roughly 1 per cent of the workforce. Even more impressive is that this increase has occurred during a time dominated by global recession. Importantly, the reforms have to a large degree focused on reducing the influx of future dependents into the system. There are thus likely long-term benefits that will be realised over time.

7.2.6. Sweden vs. Norway

In contrast to Norway, Sweden's workfare policies constitute an almost natural experiment. Two very comparable economies, with similar social systems, underwent a period of global recession. Whilst Sweden focused on workfare reforms such as changes in sick and disability benefits, oil-rich Norway continued on a traditional social democratic course. The result was that a significant difference arose in dependency rate between the two countries.

In 2006 20 per cent of the working age population in Sweden were supported by one form of public support or another.²³⁹ In Norway the share depending on public benefits, according to the Norwegian paper *Aftenposten*, was also 20 per cent in 2006.²⁴⁰ Both figures are given as full-year equivalents, which means that two individuals who were each on sickleave for six months would count as one full-year equivalent. In 2012, despite the onset of a deep global economic crisis soon after 2006, the share of those supported by public benefits had fallen to 14 per cent in Sweden.²⁴¹ In Norway, by contrast, the rate had also fallen, but only by a single percentage point.²⁴²

Clearly, the overall effect of the workfare policies (ie, the combined effect of reduced taxes on work, introduction of a gate keeping mechanism in sick and disability payment and less generous transfer systems) was quite significant. Another way to compare Sweden and Norway is to look at the practice of giving early retirement to young individuals, hiding them from the unemployment statistics. This practice can be criticised for creating life-long dependency for individuals who are healthy enough to establish themselves in the labour market. A recent study showed that 2 per cent of young people aged between 16 and 29 in Sweden are in early retirement, twice the figure of the early 1990s. In Norway, 5 per cent of Norwegians aged between 18 and 29 are in early retirement.²⁴³

Differences can also be seen in work ethics between Norwegian and Swedish youth. In a survey three out of four Norwegian employers stated that Swedish young people working in Norway have better a work ethic than their Norwegian counterparts. Out of those questioned, 28 per cent believed that Swedes aged between 16 and 24 have high work capacity. Merely 2 per cent held the same opinion for young Norwegians. Stein André Haugerund is president of the recruitment company which carried out the survey, Proffice. He explains that part of the explanation lies in the

238. Confederation of Swedish Enterprise (Svenskt Näringsliv) *Utanförskap och arbetslöshet – en exkluderande arbetsmarknad!*, 2006

239. Statistics Sweden (SCB), *Antal personer försörjda med sociala ersättningar och bidrag 2012, 2013*

240. Under deg som statsminister har antallet som står utenfor arbeidslivet økt, *Aftenpost*, 19 August 2013

241. Statistics Sweden, 2013, op. cit.

242. *Aftenposten*, August 2013, op. cit.

243. Bernitz, B. K., Grees, N., Randers, M. J., Gerner, U., & Bergendorff, S., *Young adults in disability benefits in 7 countries*, *Scandinavian Journal of Public Health*, 41, 12, 2013, pp. 3–26

generous and unreformed welfare state in Norway, which has created a situation where incentives for hard work are limited.^{244, 245, 246}

7.2.7. Conclusion

Workfare policies introduced in Sweden have not only made it possible to reduce the tax burden, they have also allowed for an increase in funding to services whilst reducing dependency on public transfers. The tax burden on the average employee fell from 60 to 54 per cent between 2005 and 2012, and from 49 to 44 per cent as share of GDP. During the same time, the share of the adult population supported by public handouts was reduced from 20 to 14 per cent.

The contrast with Norway is stark. The Norwegians have continued to rely on generous welfare policies with limited incentives to work. The result is that one fifth of the adult population in Norway still relies on various forms of public support rather than working for a living. Also, a strong difference has emerged in the work ethic between the young of the two countries. This difference substantiates the thesis that welfare systems can undermine norms related to individual responsibility.

Before 2006, strong centre-right governments had been a rare exception in Swedish politics, at least since the start of the Social Democratic era in 1936. The ability of the centre-right to win two elections in a row has ended the sense of a Social Democratic “one party state” which has long dominated the country’s political landscape. The centre right have lost power in the 2014 election. However, the Social Democrats and the Swedish Environmental party both accepted most of the tax cuts introduced by the centre-right government. They have also toned down their criticism of less generous transfer payments and the gate-keeping mechanism in sick and disability transfers. Only the previously communist Left party still robustly criticises these measures.

The successful Swedish experience with workfare seems to have encouraged change in neighbouring Denmark, even amongst the ruling Social Democrats. Bjarne Corydon, the country’s Social Democrat finance minister, recently made international headlines by discussing the need to reduce the generosity of transfer systems in the country.²⁴⁷ Even Norway, which thanks to its oil wealth can afford very generous welfare, seems poised to move in the same direction, following the election of a reform-oriented centre-right government. These developments are a reminder that significant changes to public spending and taxes are possible. Over time they can also gain popular support, even within high welfare nations where many depend on transfers rather than work.

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One fifth of the adult population in Norway still relies on various forms of public support

²⁴⁴. Svensk arbetsmoral utklassar normmännens, *Dagens Möjligheter*, 14 November 2012

²⁴⁵. Together with the fact that Norwegian wages, thanks to oil-wealth, are higher than those in Sweden, this can explain why the number of young Swedes employed in Norway has increased from 1,300 individuals in 1990 to fully 28,000 in 2010. Swedish youth had come to make up almost one fifth of the Norwegian capital Oslo’s youth population.

²⁴⁶. Innvandring gir knallhard konkurranse om ungdomsjobbene, *Aftenpost*, 7 October 2013

²⁴⁷. Corydon: Konkurrencestat er ny velfærdsstat, *Politiken*, 23 August 2013

Chapter eight

*Government
spending should
be cut to under a
third of national
income*

8. Government spending should be cut to under a third of national income

To implement the tax reforms proposed by the 2020 Tax Commission, which would deliver stronger growth and eliminate nearly all loopholes and exemptions, we need to reduce spending to around a third of national income. That is not much further than is currently projected by the Office for Budget Responsibility. Taking spending down to these levels will not lead to mass destitution. The governments of Australia, New Zealand and Switzerland spend roughly that proportion and, while there are differences between the economies, spending a third of national income doesn't mean ruin. In fact, it would mean exactly the opposite: higher incomes, faster economic growth and lower prices. Indeed, the IMF projects that South Korea and Singapore will spend around 20 per cent of GDP by 2017²⁴⁸ and they are high-growth economies benefitting from trade and commerce.

8.1. Tom Packer: lower government spending is popular in the longer term

Spending control has often been politically beneficial to those governments that have embraced it

The experience of the last century shows that far from being political suicide, as is sometimes claimed, spending control has often been politically beneficial to those governments that have embraced it.

This section will discuss the “Geddes Axe” (still a record for peacetime cuts), the anti-waste fervour that helped provoke it and the 1931 election. Then we look at the substantial success made in reducing expenditure as a share of GDP in the early 1950s in very difficult circumstances, and the electoral rewards that followed before turning to the IMF-influenced Callaghan retrenchment of the late 1970s and the reasons why Labour was unsuccessful in the 1979 election.

Next we consider the complex history of Britain's 1980s retrenchment and the fiscal restraint of the late 1990s, showing both why it failed to save the Conservative party, and how it helped New Labour attain unprecedented popularity before it frittered it away. We look at how New Labour won a reputation for fiscal responsibility and how real and perceived divisions on spending between the two parties both diminished sharply.

Finally, international evidence on the impact of large-scale expenditure reductions is examined, demonstrating that the effect of large spending cuts is politically positive – but tax rises do seem to damage governments' chances of re-election.

8.1.1. The Anti-Waste League brings about the “Geddes Axe”: 1921–24

The so called “Geddes Axe” was the spending restraint that largely followed the recommendations made by the committee on national expenditure chaired by Sir Eric Geddes, which was in turn a response to a political phenomenon, the “Anti-Waste

248. International Monetary Fund, *World Economic Outlook Database*, October 2012

League". The Axe brought about the only time in recent British history when spending has fallen not just as a share of GDP but in absolute terms.²⁴⁹

The Anti-Waste League is almost forgotten today, but was second in importance only to the rise of the Labour party in British politics during the 1918–22 parliament. It was, in essence, a reaction to the high level of government spending and taxation post first world war. The government of the time was a coalition between the Conservatives (which had a small absolute majority) and a large number of "Coalition Liberals" who had won election with Conservative backing. Their leader, Lloyd George, was prime minister and in many ways provided the policy leadership which had brought about a large expansion of peacetime expenditure and the retention of much wartime taxation (which was a massive increase from pre-1914 levels). This included doubling pensions, expanding the number of people entitled to unemployment benefit and raising the number of peacetime employees of the government. Account had to be taken of the burden of war debt, so taxation was high by historical standards. Spending was double what it had been six years earlier and the number of income tax payers was three times as high.²⁵⁰ Largely thanks to the first world war, debt had risen about ten-fold.²⁵¹

Even so the level of government spending had fallen since 1918 essentially because of the reduction in military expenditure. As after the second world war, peacetime spending after the first world war increased even as military spending decreased by a greater amount. One might have expected the fact that expenditure was falling to reduce anti-spending sentiment among the general public.

Crucially the coalition that dominated the country included the Conservatives (then as now the party most hostile to peacetime expenditure) and the opposition was chiefly Labour (then as now the most sympathetic to high public spending of the major parties). In other words the opposition could be expected to push for higher expenditure, not lower, particularly on peacetime activities. In the event, rather opportunistic efforts to exploit such sentiments by Labour and "non coalition" Liberals came to very little.²⁵² At the same time Labour (which at that point had never dominated a government) was widely regarded as dangerously and radically socialist – it had only recently adopted its notorious clause IV which was considered to reflect a belief in a fully socialist, government-owned economy. Many Conservatives, who had been implacably anti-Liberal before the war, believed Lloyd George and the Liberals were necessary to prevent "socialism". The Russian Revolution had occurred shortly before and outside the Labour party there was widespread (mostly unjustified) fears the Labour party was attracted to "Bolshevism".²⁵³

The circumstances might not have seemed ripe for any political pressure to cut the size of government, despite the large increase in spending and the existence of many civil society non-governmental organisations that objected to such policies, such as the Income Taxpayers' Society. Moreover the coalition had taken some steps to prevent further growth in the size of government, making it clear in December

249. Lilico, A., Holmes, E. & Sameen H., *Controlling spending and government deficits: Lessons From history and International Experience*, Policy Exchange, 2009

250. McDonald, A., *The Geddes Committee and the formulation of public expenditure policy, 1921–1922*, *Historical Journal* 32.2, 1989

251. Burrows, G. & Cobbin P., Controlling government expenditure by external review: The 1921–2 "Geddes Axe", *Accounting History* 14.3, 2009, p. 218

252. McDonald, A., *The Geddes Committee and the formulation of public expenditure policy, 1921–1922*, *Historical Journal* 32.2, 1989, p. 647

253. Cowling, M., *The Impact of Labour 1920–1924 The Beginning of Modern British Politics*, 1971

1920 that there would be no more new programmes.²⁵⁴ It appeared the coalition could take the anti-spending vote for granted.

However, strong anti-spending sentiment saw the rise of a new political force, the Anti-Waste League. Though it ran candidates for election, the League was not strictly speaking a party. It gained a great deal of press attention and support particularly from the *Daily Mirror* and the *Daily Mail*, then the largest selling newspapers in the country owned by the Harmsworth brothers and having about half the readers of metropolitan newspapers.²⁵⁵ By 1921 they ran candidates for election, often with the support of dissenting members of the major parties, particularly Conservatives. These candidates were to achieve remarkable electoral performances and shake the coalition.

With hindsight the coming storm can be seen in the result of a by-election shortly beforehand, when a Liberal taking an anti “extravagance” line had nearly replaced the (Conservative) speaker of the house as member for Penrith and Cockermouth during May 1921.²⁵⁶ Generally, however, the government (particularly the Conservatives) had done quite well in by-elections for a government of that period with losses only being to Labour. A key result was in July. Westminster St George’s was a very safe inner-city Conservative seat and the deceased Conservative had gained 90 per cent of the vote at the 1918 general election. In the by-election, the Anti-Waste candidate (who had some backing in the Conservative party and had been a member) won 57 per cent of the vote, defeating the Conservative nominee.

Nine days later there was a vote in another safe Conservative seat, which was nonetheless demographically very different: East Hertfordshire – deep in the rural borders. This time the Anti-Waste candidate defeated the coalition Conservative 68 per cent to 32 per cent. Ten days later on 28 July there was a by-election in another very safe Conservative seat, Westminster Abbey (demographically and politically very similar to nearby St George’s). This time the Conservatives were ready for the challenge, took a strong “anti-waste” line and held on 43.6 per cent to 34.9 per cent with a zealously anti-government spending Liberal, Arnold Lupton, getting 21.5 per cent.

The threat was taken very seriously by the Conservative party and by Lloyd George who, though a principled believer in government spending, was also a politician who prioritised political survival. After St George’s, he told the then Conservative party leader Sir Austen Chamberlain that the results of the by-elections accurately reflected the public will. He added that the worst thing for the coalition would be being “caught between Labour in the North and Anti-Waste in the South”.²⁵⁷

Lloyd George then established the committee on national expenditure chaired by the former cabinet minister, Sir Eric Geddes. There were some internal battles over the exact powers of the committee and the extent to which it could make “policy”, or make policy recommendations, which were seen as a matter for the cabinet. In practice it was able to make very sweeping recommendations. There were three key attributes of the committee members. All were self-made men and all were highly successful (mostly in business). They included Lord Inchape, a successful businessman and a president of the Income Taxpayers’ Society, and Sir Joseph Maclay, a former cabinet minister well known as one of the most zealous members of the

254. McDonald, A., *The Geddes Committee and the formulation of public expenditure policy, 1921–1922*, *Historical Journal* 32.2, 1989, p. 648

255. *Ibid.*, p. 645

256. *The Times*, 16 May 1921, p. 10

257. McDonald, A., *The Geddes Committee and the formulation of public expenditure policy, 1921–1922*, *Historical Journal* 32.2, 1989, p. 650

government for cutting spending. The minister who liaised with the committee was Hilton Young, who had written the *System of National Finance* in 1915, the standard work on government accounting, which also argued strongly for minimal governmental expenditure.²⁵⁸

The Committee recommended sweeping expenditure reductions. It also made a highly innovative use of benchmarking where it sought to compare the efficiency of government departments with their nearest equivalents in the private sector. They recommended cuts of £87 million to be achieved by efficiency savings and by widespread cuts in defence spending and social programmes (including the privatisation of early council houses with a 50 per cent discount) and by reducing the size of government bureaucracy. The cabinet reduced the cuts to £53 million (for example by refusing to raise the school starting age to six and opposing the abolition of the Forestry Commission).

The outcome, however, still represented a massive fall in expenditure. Expenditure on both social programmes and defence fell in absolute terms over the following years – an event unique in British history in the 20th century. Government current spending fell by 23 per cent. Total spending fell from £1.6 billion in 1921 to a trough of £1.1 billion in 1923; this was a period of falling prices but even so the fall in real terms was some 10 per cent, despite a rising population.²⁵⁹

A striking feature of the government's response was the contrast between its approach to the technical aspects (for example its use of benchmarking or recommendation to end the public pay settlement) which were not replicated nor its proposed change in government structures; and its main provisions for cuts, which were largely accepted. This underlines the political nature of the response. The provision of income tax cuts in the 1922 budget over Treasury objections (they had preferred to cut business tax) was also a response to the same political pressures.²⁶⁰

This political response was effective. Even the Anti-Waste League's earlier by-election defeats were probably the result of a clear U-turn by the coalition. On 8 September 1921, after the Geddes Committee had convened, another Conservative seat, the suburban Lewisham West, became vacant. Again the Conservative held on narrowly beating the Anti-Waste candidate 38.9 per cent to 35.4 per cent. The winning Conservative candidate in Lewisham West, Philip Dawson, had been endorsed by the Middle Class Union.²⁶¹ Subsequently the Anti-Waste League rapidly disintegrated, partly due to personal rivalries²⁶² but more fundamentally because its agenda had been incorporated into the policies of the mainstream parties, particularly the Conservatives. Through an aggressive government programme of tax and spending cuts the threat had been eliminated.

Indeed every seat the Conservatives had lost to the Anti-Waste League was Conservative again from 1922. Anti-Waste insurgents became normal Conservative MPs.

The destruction of this threat meant that the Conservative party retained its narrow majority after 1922 after breaking with Lloyd George, though their number of seats fell from 382 to 344. The Conservative share of the vote only fell from 38.4 per cent to 38.2 per cent though they ran slightly more candidates in 1922 than

258. Burrows, G. and Cobbin, P., *Controlling government expenditure by external review: The 1921–2 "Geddes Axe"*, *Accounting History* 14.3, 2009, pp. 199–220

259. Lilico, A., Holmes, E. & Sameen, H., *Controlling spending and government deficits: Lessons From history and International Experience*, Policy Exchange, 2009

260. McDonald, A., *The Geddes Committee and the formulation of public expenditure policy, 1921–1922*, *Historical Journal* 32.2, 1989, p. 671

261. *The Times*, 13 September 1921

262. Cowling, M., *The Impact of Labour 1920–1924: The Beginning of Modern British Politics*, 1971, p. 67

1918.²⁶³ The bottom line was that the party that had most clearly responded to the Anti-Waste League, the Conservatives, was the most successful.

8.1.2. The 1931 election and the “cuts” landslide

The 1931 general election was probably the closest to one fought mainly on “spending cuts” ever seen in the UK. A minority Labour government had been kept in power by the Liberal party since 1929. In the wake of the Great Depression, weak tax receipts and mass unemployment had driven a big rise in the deficit. The prime minister, Ramsay MacDonald, wished to cut spending but was overruled by a majority of his Cabinet. He then formed a “national” government with the Conservatives and Liberals. Theoretically this was in order to stay on the gold standard system of fixed exchange rates but in the event the new national government rapidly left it. They then ran an election campaign as the “national” government before the cuts had been implemented.

By contrast, though they promised to balance the budget, Labour also promised to repeal the cuts that the Conservative-dominated government had introduced – particularly the 10 per cent reduction in unemployment benefit. The government had also introduced an increase in income tax but that was implemented with consensus across the parties.

The Labour manifesto declared:²⁶⁴

The Labour party protests against the reduction in the rates of unemployment benefit. ... It pledges itself to reverse immediately the harsh policy of the present Government. ... It will restore, as rapidly as the claims of the unemployed and other depressed sections of the community permit, the remuneration of teachers and other public servants.

The fundamental divisions were reflected in election addresses by government supporters with strong appeals to economy. However, the leading historian of the 1931 election states Labour election addresses “unanimously denied the need for economy, and attacked the specific measures involved, especially the reduction in unemployment benefit”; the “great majority” also attacked the pay cuts for public employees.²⁶⁵

The results were devastating for Labour. The Conservatives, despite not running in a substantial number of seats, gained an overall majority of the vote for the only time in the 20th century with 51.1 per cent of the vote²⁶⁶ and “national” candidates got over 60 per cent of the vote to 31 per cent for Labour. Labour were reduced to 52 seats (from 515 candidates), National Labour had 13 and the (non-governmental) Liberals 4. Of the Conservatives’ 518 candidates an incredible 470 were elected.²⁶⁷ All but one of the Labour cabinet members who stood as Labour lost and only two of its junior ministers won re-election as Labour candidates. One of these, Clement Attlee, was to become Labour deputy leader by default, thus setting himself up for his future Labour leadership. It remains a unique result in the history of British two-party politics.

²⁶³. Tetteh, E., *UK Election Statistics 1918–2007*, House of Commons Library research paper 08/12, 01 February 2008

²⁶⁴. *Labour’s call to action: the nation’s opportunity*, Labour party manifesto, 1931

²⁶⁵. Thorpe, A., *The British General Election of 1931*, 1991

²⁶⁶. Ibid.

²⁶⁷. Tetteh, E., *UK Election Statistics 1918–2007*, House of Commons Library research paper 08/12, 01 February 2008

Some have attempted to downplay the implications of this overwhelming electoral defeat for Labour. One argument was that there had simply been a rallying behind the Conservatives of the anti-socialist or anti-Labour vote (the Labour vote did not fall significantly in those seats which they contested).²⁶⁸ But in the 49 seats where there was only a Labour and Conservative candidate in both the 1929 and 1931 elections, the Tory vote increased on average by 42.9 per cent and Labour's fell by 24.2 per cent. This represented a swing of 14.5 per cent, barely behind the 15.5 per cent the Conservatives obtained in seats where a Liberal candidate had dropped out between 1929 and 1931 and ahead of the 13.5 per cent they received in seats where the Liberals ran in both elections.²⁶⁹ In truth the Labour vote seems to have held up relatively well because the Liberals ran less than a quarter as many candidates as two years before. Many of these previously Liberal voters turned to the Conservatives but also a substantial number switched to Labour (particularly in middle class and rural seats with a weak Labour party, which had by 1929 not fully supplanted the Liberals as the second party).²⁷⁰ This obscured a massive swing away from Labour.

The election was not simply about spending cuts. The national government ran on a call for a "free hand" to introduce "empire free trade" (ie turn the British Empire from a free trade zone to a trading block), though without actually endorsing it. Every previous election fought on that issue had gone badly for the Conservatives. Labour's attempts to exploit free trade sentiment were undermined when it was shown that several members of the cabinet had backed similar proposals. Labour sought to mobilise dislike of bankers by calling for the nationalisation of the "credit system". It also sought to harness resentment against capitalists by calling for price controls and the nationalisation of several industries. It cannot have helped Labour both that they had presided over the collapse of the British economy and that their former leader and the former Labour chancellor were both denouncing Labour as irresponsible and extreme. On the other hand, by being part of the national government, the Conservatives had been forced to take some of the blame for its problems. Furthermore, it was a Conservative dominated national government which took Britain off the previously totemic gold standard.²⁷¹ But fundamentally, spending cuts had both caused the national government to be formed and formed the core of Labour's opposition to it.

Unsurprisingly in the wake of such a landslide the spending cuts were implemented. Total public spending fell from £1.2 billion in 1931 to £1.1 billion in 1934. Even after accounting for the negative inflation rates at the time, that represents a 6 per cent cut. Measured as a share of GDP, it fell from 27.2 per cent to 23.5 per cent.

The 1935 election did not reverse the result of 1931. While a relatively "normal" election it saw another strong Conservative victory with 429 seats. This was partly the product of prosperity. In contrast to the 1920s, the British economy had one of the best performances in the world by this point. While America's Great Depression shrank their economy by as much as 30 per cent, Britain's contracted by "only" 5–6 per cent and it subsequently grew by around 4 per cent per year in the mid-1930s.²⁷²

The events of 1931 remain the most clear cut case where a government introduced tough cuts and the opposition clearly pledged to repeal them. It also

268. Close, D. H., *The Realignment of the British Electorate in 1931*, History 67, no. 221, 1982, pp. 393–404

269. Thorpe, A., *The British General Election of 1931*, 1991

270. Close, D. H., *The Realignment of the British Electorate in 1931*, History 67, no. 221, 1982, pp. 393–404

271. Thorpe, A., *The British General Election of 1931*, 1991

272. Lilico, A., Holmes, E. & Sameen, H., *Controlling spending and government deficits: Lessons From history and International Experience*, Policy Exchange, 2009

represents the biggest victory for one governing party over another in modern electoral history. That victory was for the low-spending side.

The Conservative government of 1951–55: shrinking the state quietly

Under this government, spending fell from 41.1 per cent of factor cost GDP in 1951 to 36.4 per cent in 1955, the lowest share in British history since the second world war. This is striking given the supposed consensus of the period. It casts doubt on that notion of consensus, which has increasingly come under attack from historians who believe the 1950s were in fact a period of strong differences between those who believed in free markets and those who favoured a controlled economy.²⁷³

This was not a government that was in a strong position when it came to power. Its parliamentary majority was only 17 and the Conservatives had actually won fewer votes than Labour in 1951. The reduction in spending owed something to the end of the Korean war and also to economic growth driven by key supply side changes, notably the end (overcoming intense Labour opposition) of rationing and price controls. However, Rab Butler, the chancellor, had to deal with a new problem: the pressure placed on public finances by the NHS. Aspects of charging in the NHS which Labour had considered as emergency measures (such as charging for prescriptions) were rendered permanent. The most important exception to this pattern, increased subsidies for home building, was deliberately designed to be temporary.²⁷⁴

In 1955 Labour ran in part on opposition to some of these changes and a desire to raise welfare expenditure. This included inflation indexing of benefits and the elimination of the newly introduced charges for NHS services “including those on teeth, spectacles and prescriptions”.²⁷⁵ Thus while the differences were not as sharp as in 1931, it was an election that turned in large part on ratifying spending restraint.

The result was a clear though not overwhelming Conservative victory. Their share of the vote rose from a high 48 per cent to a very high 49.6 per cent while Labour’s fell slightly from 48.8 to 46.4 per cent. This in turn led to the Conservatives increasing their number of seats from 321 to 345. The government which had produced the lowest share of spending post-war, had received the highest share of the post-war vote.²⁷⁶

The government which had produced the lowest share of spending post-war, had received the highest share of the post-war vote

8.1.3. Callaghan and the “IMF cuts”

The Labour government famously reduced spending in the late 1970s when it agreed to cuts as a condition of receiving help from the IMF. Spending fell by 4 per cent of GDP. This was particularly impressive given that it did not happen in a period of high economic growth. Indeed, from 1977 to 1978 total managed expenditure fell by 4 per cent. This policy was highly controversial within both the Labour party and the cabinet, with many calling for an “alternative economic strategy”. Of course, the subsequent 1979 election saw probably the most famous defeat of a Labour government. In the previous 1974 election Labour had a lead over the Conservatives of 3.6 per cent of the vote, while in 1979 they were to trail by 7 per cent. Does this represent an example of spending restraint backfiring politically? There are reasons to think otherwise.

273. See for example Kelly, S., *Ministers matter: Gaitskell and Butler at odds over Convertibility*, *Contemporary British History*, 14:4, 1950–52 (2000), pp. 27–53 and Scott, K., *The Myth of Mr Bustkell*, 2002

274. Whiteside, N., *Creating the welfare state in Britain, 1945–1960*, *Journal of Social Policy*, 25, 1996, pp. 83–104. See also Scott, K., *The Myth of Mr Bustkell*, 2002

275. *Forward With Labour: Labour’s Policy for the Consideration of the Nation*, Labour party manifesto 1955

276. Tetteh, E., *UK Election Statistics 1918–2007*, House of Commons Library research paper 08/12, 01 February 2008

The first is that the outcome also represented a repudiation of several years of fiscal irresponsibility. Spending had increased sharply both in real terms and as a percentage of GDP since 1972, a policy started by the famous Heath “U-turn” but very much continued under Wilson’s government. Though retrenchment had happened, perhaps voters regarded it as merely the inevitable consequence of earlier extravagance.

Secondly, the choice in 1979 was very different from that of the 1930s or 1950s. The Conservatives took a stronger anti-spending line and indeed in their manifesto the Conservatives referred to “our plans for cutting government spending and borrowing” though they did say “it is not our intention” to cut healthcare spending.²⁷⁷

Thirdly and most famously, the Callaghan government had huge economic problems. Though they managed to bring down inflation (thanks in large part to their spending restraint) it remained high and notoriously they experienced a wave of public sector strikes in 1978, the infamous “winter of discontent”.

Fourthly, the Callaghan government did not actually perform that badly electorally in 1979 but mostly stayed at the same level as in 1974. Labour’s share of the vote did fall but only modestly, from 39.3 per cent to 36.9 per cent. The party has since only exceeded that figure in two elections, the landslide victories of 1997 and 2001. The real problem for Labour in 1979 was the big increase in the Conservative vote which rose from 35.7 per cent to 43.9 per cent²⁷⁸ on a manifesto which emphasised tax cuts and, more quietly, spending restraint. This still stands as the largest increase in the Conservative share of the vote since the second world war.

The causes of this surge can be seen by examining the issues that were named by those who switched to the Tories. Among previous voters the biggest issue was strikes, among young people taxes.²⁷⁹ It was not a repudiation of Callaghan’s spending policies. 1979 was less a defeat for Jim Callaghan than a triumph for Margaret Thatcher’s brand of aggressive free market populism.

8.1.4. Thatcher’s ministry: success and struggle

The Thatcher government’s fiscal adjustments were somewhat complicated. The first two years actually saw spending rise as a share of GDP, due mainly to one of the worst recessions in UK history. However it was also the result of various policy choices, particularly the desire to match Labour’s last commitment on pay increases (post the Callaghan government’s contracts) for the subsequent year – an understandable move politically but one that had sharp implications for the fiscal balance. This was particularly problematic given the Thatcher government’s desire to get the deficit under control. In 1981 it was widely assumed that a U-turn on fiscal policy like Heath’s in 1972 was inevitable.

However, chancellor Geoffrey Howe introduced the largest one-year fiscal contraction in British peace time history, consisting of a large tax increase and sharp spending cuts. By 1984 the Lawson boom had begun. But spending was kept carefully under control and new spending programmes were conspicuous by their absence. The result was that while from 1979 to 1984 the Thatcher government had kept spending roughly constant as a share of GDP, from 1984 to 1990 it fell from over 48 per cent to around 39 per cent.²⁸⁰

277. 1979 Conservative party Manifesto, Conservative party

278. Tetteh, E., *UK Election Statistics 1918–2007 House of Commons Library Research Paper* 08/12, 01 February 2008

279. Penniman, H.R., (ed), *Britain at the Polls 1979; Crewe I, Why the Conservatives Won, 1981*, pp. 274–286

280. Lilico, A., Holmes, E. & Sameen, H., *Controlling spending and government deficits: Lessons From history and International Experience*, Policy Exchange, 2009

On the basis of these sharp choices, the public clearly chose the option of spending less

This was an era of unusually sharp divisions between the parties on government spending. Labour did not simply complain about Conservative spending restraint and cuts but offered a clear alternative. In 1983 Labour went so far as to argue for increasing spending in general to serve human welfare and also to “expand the economy, by providing a strong and measured increase in spending”. They also called for increases on numerous specific items including a jobs programme, a 4 per cent annual increase in social services spending and more on renewable energy.²⁸¹ While the 1983 Conservative manifesto did contain a pledge to “maintain” healthcare spending, it also included many attacks on “overspending” and a pledge to “maintain firm control of public spending and borrowing”.²⁸² The choice was unmistakable.

The 1987 Labour manifesto was more cautious but also consisted both of attacks on Conservative “cuts” and calls for new spending, including phasing out charges for pharmaceuticals. Labour said they would pay for this through cancelling tax cuts for the richest 5 per cent and a new wealth tax. Again the contrast was unmistakable.²⁸³

The public did not miss the obvious differences and unlike the earlier period, polling data exists to measure it. In 1987 the British Electoral Survey asked a cross sample of the electorate where on a scale of 1 to 11 they thought the parties stood on preference for spending on health and education versus reducing taxes. On that scale of 1 to 11, the average score given to the Conservatives was 4.13 points closer to cutting taxes (and therefore further away from increasing spending on health and education) than the score they gave to Labour. When asked how much the parties wished to equalise incomes the gap was wider still at 5.48 points. The electorate, in other words, had a clear idea of the gulf that separated the parties.²⁸⁴

In the light of the sharp differences on these issues, as well as others such as nationalisation and defence, it is no wonder that polling for the British Electoral Survey found that over 80 per cent of the British public saw a “great difference” between the two parties in 1983 and 1987 compared with 40 per cent in the early 1970s and 50 per cent in 1979.²⁸⁵

On the basis of these sharp choices, the public clearly chose the option of spending less. Thatcher’s governments combined frequently poor poll ratings with extremely strong performances in general elections. In 1983 the Conservatives won 42.4 per cent of the vote and 397 of the 650 seats (an increase of 58 from 1979) and a lead over Labour of 14.8 per cent of the vote. In 1987 the Conservatives got “only” 42.2 per cent of the vote, 375 seats and a lead over labour of 11.4 per cent of the vote. This represents the two largest consecutive majorities for any party between the 1930s and the 2000s.²⁸⁶

On the other hand, there is some evidence that this was a period of growing support for higher public spending. In 1987, according to the British Social Attitudes Survey, the proportion of the British population responding that more should be spent on health, education and welfare as well as the taxes to pay for it went up from 32 per cent to 46 per cent. By 1990 the level was around 50 per cent, where it stayed for the next decade or so.²⁸⁷ It has been suggested plausibly that this was a backlash

281. 1983 Labour Party Manifesto, Labour party

282. *Forward: the Challenge of Our Time*, Conservative party manifesto, 1983

283. *Britain will win with Labour*, Labour party manifesto, 1987

284. Adams, J., Green, J. & Milazzo, C., *Has the British public depolarized along with political elites? An American perspective on British public opinion*, *Comparative Political Studies* 45.4, 2012, pp. 507–530

285. Adams, J., Green, J. & Milazzo, C., *Mass Responses to Elite Depolarization An American Perspective on British Public Opinion*, *Comparative Political Studies* 45, no. 4, 2012

286. Tetteh, E., *UK Election Statistics 1918–2007*, House of Commons Library research paper 08/12, 01 February 2008

287. Park, A. et al., *British Social Attitudes: Exploring Labour’s Legacy*, 2012

against Thatcher's fiscal restraint. However, the figures barely shifted after the big increases of the early 1990s.

When assessing poll results on policy issues, the wording of questions is crucial. A PoliticsHome poll in 2008 (on behalf of the TaxPayers' Alliance) with different questions got a very different response. After being reminded that the money the government spends on public services and other things comes mainly from taxation, 67 per cent believed the government "spends too much and therefore taxes too much".²⁸⁸ The British Social Attitudes Survey questions mention the most popular forms of government spending and ignore the least popular.

It is also worth considering the possibility that the public might think of tax and spending in terms of absolute tax revenue and spending levels rather than in accordance with such concepts as proportion of GDP. In other words they might actually answer the question posed. On this basis spending and tax revenues were rising and do so almost every year. Ultimately the 1983 and 1987 elections provide the best test of public opinion of spending. That was an overwhelming victory for the small government side.

However, the British Social Attitudes Survey provides a continuous measurement of public opinion using the same question. So even if the headline figures should be treated warily, it is still noteworthy that they found that public opinion in 1987 was significantly more hostile to a hard line on spending than it is today. And yet a government that was rapidly shrinking the state's share of the economy won an easy victory over its opponent that sought (in 1987 somewhat quietly) to increase it. This provides a very hopeful model for those seeking to reduce government spending; and a very powerful, historical warning for those seeking to expand it.

8.1.5. Major, Blair and fiscal adjustment

After having held power for 18 years, in 1997 the Conservatives had their most catastrophic election result since the 19th century. They lost a quarter of their votes and over half their seats. Their share of the vote fell from 41.9 per cent to 30.7 per cent and their seats from 336 to 165. The Conservatives have not since matched the 1992 result in terms of seats or votes.²⁸⁹ It is an especially striking result given that virtually all economic indices were very healthy by the date of the election.²⁹⁰

There are a number of possible explanations for this electoral catastrophe. The aggregated problems of having been in power for 18 years, the enormous popularity of New Labour post 1994 (including its caution in offering any hostages to fortune) and the collapse of Conservative economic credibility after the pound left the exchange rate mechanism offer credible explanations.²⁹¹

One important question is whether the 1997 election results reflect on the efforts made by the Major government and in the first years of the Blair government to achieve fiscal adjustment, in part by controlling spending. In other words, had the spending cuts come home to roost?

If the fiscal adjustment did hurt the Conservatives it could be seen as a delayed result of 1992, when the Conservatives had sharply increased spending in the run up to the election, raising it by 10 per cent over two years. This helped to create a record

²⁸⁸. PoliticsHome survey for TaxPayers' Alliance, October 2008

²⁸⁹. Tetteh, E., *UK Election Statistics 1918–2007*, House of Commons Library research paper 08/12, 01 February 2008

²⁹⁰. Lilico, A., Holmes, E. & Sameen, H., *Controlling spending and government deficits: Lessons From history and International Experience*, Policy Exchange, 2009

²⁹¹. Blair and the ERM are emphasized in Sanders, D., *Conservative incompetence, Labour responsibility and the feelgood factor: why the economy failed to save the Conservatives in 1997*, *Electoral Studies* 18.2, 1999, pp. 251–270

deficit at 7.7 per cent of GDP in 1993–94. Attempts to repair this damage then could be seen as laying waste to Conservative chances in 1997.

That may well be part of the story but fiscal tightening at the beginning of the Parliament was due to tax increases not spending restraint. In broad terms the Major ministry implemented restraint in two doses. The tax increases took effect earlier and ended up being a very important part of the fiscal consolidation. They were mostly introduced in the 1993 Budget. Initially, this was not matched by impressive spending restraint which grew by 2 per cent a year, partly due to the pressures of a weak economy until 1995. This meant that debt peaked at around 50 per cent of GDP in 1995–96.

Spending was restrained more significantly from 1995 to 1999, however. This of course included the first two years of the New Labour government where managed expenditure (though not total expenditure) actually fell. This occurred with and helped cause a boom, which together with the spending restraint saw the creation of a surplus by 1998–99.²⁹²

By 1995 the Major government was already overwhelmingly unpopular; in fact its performance in the polls was even weaker than the 1997 result. Throughout 1995, Mori poll ratings for the Conservatives ranged from 26 per cent to 32 per cent. By contrast, ratings for Labour ranged from 47 per cent to 53 per cent.²⁹³ That is, they predicted an even bigger victory than Labour actually achieved. Local election results tend to bear this out; the 1995 local elections saw the worst results for the Conservative party in any election ever, losing over 2,000 councillors.²⁹⁴ So if anything, the period of spending restraint from 1995 led to an improvement in the government's electoral situation.

Even more significant is what happened when fiscal restraint was continued for the first few years of the New Labour government. During this period the Labour party was exceptionally popular, more popular than any other party of recent decades. ICM polling found Labour enjoyed poll ratings during this period of 40-something per cent, after the initial 60-something per cent ratings it first won. But when Labour first relaxed, and then abandoned, the restrictions on spending and fiscal restraint in the subsequent years its popularity fell, too. By 2003 it was nearly always under 40 per cent in the polls.²⁹⁵ If anything the post-retrenchment era was an era of falling popularity.

Even more fundamental was the lack of choice over public spending that contrasted radically with the 1980s. Far from challenging the Conservatives on their spending plans, Labour pledged to match them for the first two years (and subsequently did so). On spending, the 1997 Labour manifesto is a very Thatcherite document. It declared that the “myth that the solution to every problem is increased spending has been comprehensively dispelled under the Conservatives. Spending has risen. But more spending has brought neither greater fairness nor less poverty”.²⁹⁶

When Labour reversed course they were not by and large challenged by the Conservatives. In 2001 they made the rather technocratic promise to reduce spending as a share of GDP, but also pledged to match Labour's plans for massive

292. Lilico, A., Holmes, E. & Sameen, H., *Controlling spending and government deficits: Lessons From history and International Experience*, Policy Exchange, 2009

293. Guardian/ICM polls, 1984, downloaded from <http://lowtax.es/17hkZGc> on 30 March 2014

294. Clements, R., *The local elections of 4 May 1995*, House of Commons Library research paper 95/59, 10 May 1995

295. Guardian/ICM polls, 1984, downloaded from <http://lowtax.es/17hkZGc> on 30 March 2014

296. *New Labour: because Britain deserves better*, Labour party manifesto, 1997

new spending on the NHS.²⁹⁷ By 2005, the Conservatives were pledging to increase spending by 4 per cent a year and to “spend the same as Labour would on the NHS, schools, transport and international development and more than Labour on police, defence and pensions”.²⁹⁸ The Blair years were very much the opposite of the 1980s. It was an era not of confrontation but of consensus on spending.

Polling confirms that this was also the view of the public. The British Election Survey (see the discussion of the Thatcher years above) measured how the public perceived the two parties’ attitudes to increased expenditure on health and education compared to reducing taxation and expenditure. It did this by asking people to place each party on a scale from 1 to 11, with higher spending and taxes at one end and lower spending and taxes at the other. The gap between perceptions of the parties actually widened in 1992 from 4.13 to 4.23. But it subsequently narrowed rapidly to 3.35 in 1997 and 2.04 in 2001. On the question about whether the parties believe government should promote income equality, the pattern was different but in the same direction. The difference between the perceptions of Labour and the Conservatives fell from 5.48 in 1987 to 4.82 in 1992 to 4.72 in 1997 but then more sharply to 2.82 in 2001.

Much of this change reflects a change in the perception of Labour. On the question on social services expenditure their score rose (ie, they were seen as less keen on spending) from 3.03 in 1987 to 4.17 in 2001 though there was actually a slight (and possibly electorally fatal) move leftwards in 1992.

Conversely, the Conservative party score fell. That is, they were seen as having moved in a pro-tax/pro-spending direction. This was barely the case in 1992 (only a fall from 7.16 to 7.06) but by 1997 their rating had fallen to 6.94 and then to 6.21 in 2001. In other words the Conservative party that lost elections by a landslide unseen since before the reign of Queen Victoria was seen by the public as more moderate on spending than the one that had won a landslide in 1987. The Conservatives also moderated in public eyes on the question of government equalising outcomes. Their perceived score fell from 8.43 in 1987 to 7.47 in 2001.²⁹⁹

The same narrowing of differences can be seen more broadly in the British Election Survey question on whether the public saw a ‘great difference’ between the parties. By 1992 the percentage of respondents who agreed fell to 1979 levels at around 50 per cent. More strikingly it then continued to fall to record lows. It collapsed to around 35 per cent in 1997 and by 2001 had further sunk to around 30 per cent.³⁰⁰

The evidence is fairly strong that in the late 1990s being in favour of lower spending was electorally beneficial. However, what is most striking is the lack of electoral choice which may explain the fall in turnout from 77.7 per cent in 1992 to 61.4 per cent by 2005. First Labour moved to the right on spending and then the Conservatives followed Labour to the left. The public saw increasingly little fiscal difference in this period between the two main parties. This helped underlay the collapse of the previously dominant Conservatives.

297. *It's time for common sense*, Conservative party manifesto, 2001

298. *Are you thinking what we're thinking? It's Time for Action*, Conservative party manifesto, 2005

299. Adams, J., Green, J. & Milazzo, C., *Mass Responses to Elite Depolarization An American Perspective on British Public Opinion*, *Comparative Political Studies* 45, no. 4, 2012, pp. 507–530

300. *Ibid.*

8.1.6. International evidence and examples

Does the international evidence on spending bear out the same picture of commitments to retrenchment of expenditure being rewarded? The obvious way to test this is to look at the results in developed nations as a whole.

The compatibility of strong fiscal adjustments with electoral success is examined in a recent study led by Alberto Alesina.³⁰¹ This looked at the nineteen members of the OECD which have been members since its foundation in 1975. That is, affluent and long-standing democracies like the UK.³⁰²

Alesina's study found that countries which experienced large fiscal adjustments were not more likely to have changes of government shortly thereafter. Importantly, it also suggested that fiscal adjustments were more likely to be electorally harmless if spending cuts rather than tax increases were the main way in which this was achieved.

For the ten largest fiscal consolidations, 37 per cent of those that undertook them were not re-elected. Over the period as a whole, governments in these countries were defeated 40 per cent of the time. In other words, there was essentially no difference between the re-election of those governments undergoing massive fiscal consolidations and those that did not.

But when fiscal consolidations used tax rises, the impact was much more electorally damaging. Governments were defeated in only 20 per cent of elections in the countries where expenditure adjustment accounted for the largest share of fiscal consolidation. This contrasts with those fiscal consolidations which relied more on tax hikes. In these cases, governments lost 56 per cent of the time – considerably more than the norm. In other words, governments which have tightened fiscal policy primarily by cutting spending have been more likely to win re-election. And those which have tightened primarily by raising taxes have been more likely to be voted out.

A more sophisticated regression analysis examining the link between fiscal consolidation and election outcomes for all nineteen countries found the same lack of correlation between them. This was true even for 'large' fiscal consolidations (more than 1.5 per cent of GDP). However, it did find that ones associated with attempts to increase revenue had a negative effect. In other words, tax rises were associated with worse electoral outcomes, but this was not the case for spending cuts.

This was not simply due to the economic benefits of retrenchment. Even after adjustments were made for economic growth, inflation and unemployment, the same electoral robustness could be seen. Economic growth and low inflation boosted the chances of incumbent governments. Levels of unemployment had only a small independent effect on electoral chances, separate from economic growth.

A study of this nature raises several questions. One is how long is the correct lag period to examine the electoral effects of fiscal tightening? Alesina's recent study used a two-year lag but he also re-ran the calculations using the next election and found that it made no difference, even if it was more than two years.³⁰³

Another is how reproducible the results are. Brender and Drazen used a larger sample size which includes developing economies and new democracies as well as OECD countries from 1960–2003 and again found that deficits reduce electoral performance. They find this is one of the few ways in which economic voting is

301. Alesina, A., Carloni, D. & Lecce, G., *The Electoral Consequences of Large Fiscal Adjustments*, National Bureau of Economic Research working paper 17655, 2011

302. The countries in question are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Netherlands, Norway, Portugal, Spain, Sweden the UK and the US.

303. Alesina, A., Carloni, D. & Lecce, G., *The Electoral Consequences of Large Fiscal Adjustments*, National Bureau of Economic Research working paper 17655, 2011

So if spending cuts are so electorally harmless, why are they so rare? This is a question scholars have both neglected and struggled to answer

similar across countries, in both developed and developing economies.³⁰⁴ A decade earlier Alesina had led a different team which found a similar effect to that of the 2011 survey.³⁰⁵

The results raise another question: does the lack of a negative correlation arise because only governments that are already in a strong political position dare to cut spending, given the threat of political discontent from those who receive the spending which is being cut? Alesina's recent 2011 study tried to make some adjustment for this by comparing governments without one-party parliamentary majorities to those with them. This made no difference to whether fiscal consolidation was undertaken and/or the chances of success.³⁰⁶

A similar analysis was made by a group of economists on behalf of the European Commission who used regression analysis on reform in OECD countries. They found that it tended to be more electorally successful in states with a larger state sector (like the UK after the 2010 general election). They also found that overall retrenchment tended to increase the chances of re-election. This was only true, however, where there were less heavily regulated financial services markets. They convincingly argue that this is because well-functioning and lightly-regulated financial markets allow the gains made by reforms to come into effect quicker, in time for the subsequent election.³⁰⁷ This, of course, is worrying for the current efforts at fiscal consolidation in the eurozone. It also underlines the lesson that fiscal consolidation works best with other reforms to strengthen long-term economic growth.

So if spending cuts are so electorally harmless, why are they so rare? This is a question scholars have both neglected and struggled to answer.

One suggestion is the opposition of organised interests which influence governments, frustrating or delaying reform to avoid their particular ox being gored.³⁰⁸ Another might be that the opponents of cuts are more directly obvious to politicians than the widely dispersed voters who worry about taxes, debt and the size of government. A third might be that right-of-centre elites may be reluctant to believe they can win votes by increasing the gap between them and left-of-centre parties on spending issues. Another and perhaps the simplest is ideological: that politicians on the whole support high spending more than the general public.

There are also a number of foreign examples of politically successful retrenchment which have some implications for the United Kingdom. Two of particular interest are those of Sweden from 1993 to 2006 and the “debt brake” passed into law by the Swiss people in 2001.

8.1.7. Sweden and Social Democratic cuts

Sweden in particular (and to a lesser extent Scandinavia in general) is famous for its dominance by social democratic governments and a generous welfare state.

However, since the early 1990s there have been large cuts in spending, larger than in other western democracies. From 1993 to 2008 Scandinavia has seen a shrinkage

304. Brender, A. & Drazen, A., *How Do Budget Deficits and Economic Growth Affect Reelection Prospects? Evidence from a Large Cross-Section of Countries*, National Bureau of Economic Research working paper 11862, 2008

305. Alesina, A.F., Perotti, R., Tavares, J., Obstfeld, M. & Eichengreen, B., *The political economy of fiscal adjustments*, Brookings Papers on Economic Activity, 1998, pp. 197–266

306. Alesina, A., Carloni, D. & Lecce, G., *The Electoral Consequences of Large Fiscal Adjustments*, National Bureau of Economic Research working paper 17655, 2011

307. Buti, M., Turrani, A., Noord, P. & Biroli P.A., Carloni, D., Lecce, G., “Defying the ‘Juncker Curse’: Can reformist governments be re-elected? *Empirica Spriner*, vol. 36 (1) pp. 65–100 February 2009

308. Alesina, A., Carloni, D. & Lecce, G., *The Electoral Consequences of Large Fiscal Adjustments*, National Bureau of Economic Research working paper 17655, 2011

in the size of a welfare state built up in peacetime unmatched on the planet. Of the four Scandinavian countries, the smallest shrinkage in the size of the state was in Denmark – where its share of GDP fell by 10 per cent. In Sweden the share of GDP spent by state fell from 71.7 per cent in 1993 to 51 per cent in 2007.³⁰⁹

What is particularly striking about the Swedish retrenchment is that it happened mainly under left-of-centre social democratic governments. This is despite the fact that demographically and in terms of party loyalty, Sweden is among the most polarised in the world (including along class lines with the well-off voting overwhelmingly for right-wing parties).³¹⁰

The beginning of this period saw a right-wing coalition government in power. A serious recession struck (involving bank failures), which led to a deficit crisis. Key to subsequent events was a bipartisan agreement which the Social Democrats had signed in opposition. They agreed measures to restore long-term fiscal health both by raising taxes but also by other measures such as reforming pensions (including reducing them relative to real earnings), deregulating labour markets, and reducing welfare. In 1998 they also adopted binding fiscal rules.³¹¹

The Swedish Social Democrats were shocked by an unexpected defeat in the 1991 election. In a sense they made similar moves to Labour in the 1990s, with the important differences that they had been the historical governing party and that they were willing to introduce reductions in spending and a new fiscal consensus rather than simply accept them. At the same time their veteran role as the creators and expanders of the Swedish welfare state gave them credibility in doing so.³¹²

In short, the Swedish centre-left struck on a strategy to allow them to preserve their political hegemony. By accepting conservative free market reforms and combining that with their traditional role as the guarantor of the welfare state, they managed to avoid being dragged down as the originators of a failed economic model. As a result they remained the dominant force in coalition governments from 1994 to 2006. Due to the extremely proportional nature of the Swedish election system they never won a majority but remained the dominant player governing with parties to their left and right.

Though highly electorally successful, this should not be seen as simply cynical. The example shows what one might call a paradox of social democracy. A very large welfare state can cause intolerable damage to the economy which in turn means both that the economy can no longer sustain the stresses placed on it and that political support for it eventually evaporates. By the early 1990s Scandinavian economies were in this situation. By restraining spending so that it fell as a share of GDP, Social Democrats were in the long run able to provide a larger welfare state than if there had been no welfare reform. However the limits of this were shown in 2006 when they lost power because of the relatively high level of unemployment which was at least partly the product of a refusal to introduce labour market reforms that were opposed by the unions.

Nonetheless, Sweden in the 1990s and 2000s illustrates how, through embracing a smaller state, social democrats can win elections.

309. Leach, G. *Economic lessons from Scandinavia*, Legatum Institute, 2011

310. Granberg, D., *A Contextual Effect in Political Perception and Self-Placement on an Ideology Scale: Comparative Analyses of Sweden and the U.S.*, *Scandinavian Political Studies* 10, 1987, pp. 39–60, and Svallfors, S., *Class, Attitudes and the Welfare State: Sweden in Comparative Perspective*, *Social Policy & Administration* 38, 2004, pp. 119–138

311. Leach, G., *Economic lessons from Scandinavia*, Legatum Institute, 2011

312. Anderson, K., *The Politics of Retrenchment in a Social Democratic Welfare State Reform of Swedish Pensions and Unemployment Insurance*, *Comparative Political Studies*, 34 no. 9, 2001, pp. 1063–1091

8.1.8. Switzerland and the ‘debt brake’

The previous examples have all consisted of examples where politicians have introduced spending restraint, but in Switzerland this restraint was passed by a referendum of the electorate. Switzerland famously has a well-developed system of referendums at federal and cantonal level. When Switzerland passed its federal debt brake in 2003, several cantons already had one.

Two points should be made about the debt brake. Firstly because major taxes are fixed by other referendums it acts overwhelmingly as a spending cap. Secondly the Swiss constitution since 1959 had in theory decreed that long-term government debt should be paid down and deficits avoided. However, it lacked enforcement mechanisms and by the 1990s rising debt was the norm.

The debt brake represented a solution pushed by the most free market and anti-spending of Switzerland’s four major parties, the Swiss People’s Party, and was disliked by the Social Democrats. It passed with 85 per cent of the vote and has not been reversed. Essentially it creates a projection of the long-run structural deficit chiefly on the basis of past fiscal years. If there is a continuous deficit over several years (or much less likely a theoretical surplus), the accumulated “deficit” triggers an automatic restriction on spending. No form of expenditure is exempted so politicians and officials cannot claim that “investment” would pay for itself. The fact that debt can build up over several years despite the rule allows Keynesian demand management to be operated if the government chooses.³¹³ More importantly it means there is less of a temptation to throw out all the controls to defend spending in one given year.

The Swiss federal debt as a share of GDP has fallen from 28.3 per cent to 20.3 per cent in the decade since 2002. Some critics have argued that this would have happened anyway due to an impressive boom, but the Swiss performance is unmatched among similar and neighbouring countries, including those such as France which in theory has constitutional measures to prevent high debt.

It is also noteworthy that in the 1980s a similar boom did not lead to large surpluses and a structural deficit that appeared shortly after the introduction of the debt brake was rapidly eliminated. Moreover, fiscal policy has been much more consistent (that is the more the economy grows the larger the surpluses) than it was before the brake was introduced.³¹⁴

However, there are two key potential problems with the debt brake. One is that there is the danger it will lead to bad priorities in expenditure, particularly given the extent to which Switzerland’s long-term fiscal problems, like those in most of the western world, are driven by popular entitlement expenditure. The second is that, as written, a majority of both houses of the Swiss parliament can overturn it during an ‘emergency’ which is for them to define. In practice the latter has not been a problem in the Swiss system, probably because deference to the result of referendums is strongly held in Swiss political culture and because the Swiss Peoples’ Party, often the largest party, is strongly committed to it.³¹⁵

Obviously the Swiss political system is very different from the UK. However, a clear and reasonably “cheat-proof” rule along similar lines could be very popular and hard for politicians to undermine. In particular if it was passed by a referendum, it would be very hard to repeal without another one. British membership of the EU

313. Bodmer, F., *The Swiss Debt Brake: How it works and what can go wrong*, Swiss Journal of Economics and Statistics 142 no. 3, 2006, pp. 307–330

314. Beljean, T. & Geier, A., *The Swiss debt brake—has it been a success?*, Gerzensee, 2012, pp. 1–2

315. Bodmer, F., *The Swiss Debt Brake: How it works and what can go wrong*, Swiss Journal of Economics and Statistics 142 no. 3, 2006, pp. 307–330

is an important precedent for how hard it is to reverse a referendum without another one, even in a parliamentary democracy like the UK. The power of referendums as a force for keeping spending under control has already been seen at local level in the UK. Since 2013 a local authority which intends to increase council tax by 2 per cent or more must hold a referendum. Before the law was introduced increases above that level were commonplace. Very few councils have since proposed a rise which would trigger a referendum. However, the increased use of charges by some councils also suggests any such a cap has to be carefully designed.

8.1.9. Conclusion

So what conclusions can be drawn from the record of attempts to reduce public expenditure?

Firstly, the British historical experience suggests that far from being electoral suicide, spending cuts have tended to be electorally beneficial, particularly when the choice was clear. Where there has been a chasm between the two main parties on spending 'cuts', the lower-spending side has won.

Labour victories, particularly since Thatcher, have occurred when the partisan differences on public expenditure between Labour and the Conservatives have been small, both objectively and in the eyes of the public. Far from the Conservative defeats of 1997 and 2001 being the product of a move towards fiscal radicalism, the Conservatives moved to the centre on expenditure both objectively and in the eyes of the public as shown by the British Election Survey's trends from 1987.

International evidence broadly supports this assessment. Governments which tighten fiscal policy are not more likely to lose elections. Cross-national regressions suggest that 'austerity' is a highly misleading term and there is evidence that tax increases are much more dangerous than spending reductions. This effect is independent of the economic benefits provided by lower spending, though that clearly helps.

There are a number of possible explanations as to why politicians seem excessively wary of the political dangers of spending cuts. These include the power of organised interests groups, political ideology and the possibility that politicians – those who spend taxpayers' money – are keener on government spending than those who pay for it.

Mainstream right-wing parties should not become complacent that they 'own' fiscal responsibility as an issue. The huge problems the Anti-Waste League posed for the Tories after the first world war is an object lesson in the consequences of such complacency. So is the effectiveness with which Labour attacked Tory excessive expenditure in the late 1990s.

The flip side of this is the opportunity presented to left-of-centre parties by embracing spending restraint. Sweden, of all countries, has shown that a commitment to steady reductions in the size of the state can play a key role in building rather than undermining support for them. And the golden age of support for the Labour party in Britain in recent decades came when it took its toughest line on spending.

When one further considers the degree to which a stronger economy helps governing parties and that economies with smaller governments grow faster (at least in the context of the size of western governments), the electoral case for politicians across the political spectrum to embrace lower spending is very strong indeed.

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8.2. Nima Sanandaji: international examples of politically successful spending cuts

Increasing public spending can be a tempting solution to social ills, not least for left-of-centre governments. But increases in spending and taxation can have significant effects on growth and employment, particularly in countries where state expenditure already accounts for much of the economy. This chapter describes how even the French socialist government and the social democratic leadership in Denmark have moved towards the idea that smaller, rather than larger, government can be beneficial. In part this is explained by the realisation that higher public spending does not necessarily lead to better outcomes for welfare systems.

During the spring of 2014 Manuel Valls was appointed as the new prime minister of France. Merely two weeks later he announced extensive cuts in public spending, including a state pension freeze and a trimmed budget for healthcare and social benefits.³¹⁶ The plan was in line with commitments made earlier during the year by fellow Socialist party member President François Hollande. Mr Hollande, famous for introducing a 75 per cent tax rate for high-income individuals, surprised many by promising to reduce public spending. Perhaps most interesting is that he expressed his ambition to use the savings not only for lowering the public debt but also to cut taxes. “In 2014, this year, we will save €15 billion”, Hollande promised in a speech. “In 2015 to 2017 we will unlock €50 billion more. This has never been done before.”³¹⁷

Hollande is correct in that such a move would be unique for the country. French policies in general, and those of the Socialist party in particular, are geared towards high levels of public expenditure and burdensome taxes. General government expenditure grew from an already high level of 53 per cent of GDP in 2008 to 57 per cent in 2012. How then can the promise of lower spending be explained? One answer is that the general public is keen for change. It is no coincidence that Manuel Valls, a centrist within the Socialist party, was appointed to the role as prime minister shortly after the Socialists suffered defeats in local elections. Another explanation is that even among the French Socialist government, experts are aware of the economic ills that can result from extensive levels of taxation and public expenditure.

In the short term increasing expenditure can be a tempting choice, even when the funds are not spent in the best way. One reason is that politicians can buy the support of voters and interest groups that benefit directly from spending. Another is that public spending can stimulate the economy in the short term. In addition, government spending can, in moderate amounts and when invested in public goods such as security, basic research and transport infrastructure, promote development. But it can also be harmful for economic performance through a range of different mechanisms, particularly when it reaches high levels. Even in the short term, higher spending can impair growth and employment by crowding out private sector activity.³¹⁸ Particularly in countries such as France, where public expenditure is already high, there are ample gains in trimming rather than expanding government.

316. France24, *France's new PM targets welfare in drive to cut spending*, 16 April 2014

317. Russia Today, *Hollande pledges €50bn public spending cut in 2015–17*, 14 January 2014

318. See for example Tanzi, V. & Zee, H.H., *Fiscal Policy and Long-Run Growth*, International Monetary Fund staff papers, vol. 44, no. 2., 1997; Taylor, J. *An Empirical Analysis of the Revival of Fiscal Activism in the 2000s*, SIEPR Discussion Paper 10–031, 2011; and Cohen, L., Coval, J. & Malloy, C., *Do Powerful Politicians Cause Corporate Downsizing?*, Harvard Business School and National Bureau of Economic Research working paper, 2011. Bergh and Henrekson conclude based on a research review that an increase in government size by 10 per centage points is associated with 0.5 to 1 per cent lower annual growth rate in Bergh, A. & Henrekson, M., *Government Size and Implications for Economic Growth*, American Enterprise Institute, 2010

Table 8.1: total expenditure of general government, percentage of GDP

	2002	2012
South Korea	23.6	30.2 *
Australia	34.6	32.3
Switzerland	36.9	34.1
Slovakia	45.1	37.8
Estonia	35.8	39.5
United States	36.0	40.0
Canada	39.6	40.6
Japan	38.3	42.0
Poland	44.3	42.2
Ireland	33.5	42.6
Norway	47.1	43.3
Luxembourg	41.5	44.3
Czech Republic	45.6	44.5
Germany	47.9	44.7
Portugal	43.1	47.4
Iceland	44.3	47.4
Spain	38.9	47.8
United Kingdom	40.9	47.9
Slovenia	46.2	48.1
Hungary	51.5	48.7
Netherlands	46.2	50.4
Italy	47.1	50.6
Austria	50.7	51.7
Sweden	55.6	52.0
Belgium	49.8	55.0
France	52.9	56.6
Finland	49.0	56.7
Denmark	54.6	59.4

Source: OECD “Stat Extracts” database. Data collected 19 April 2014

In 2013 Angel Gurría, secretary-general of the OECD, said: “The French economy has tremendous assets and considerable potential, but excessive regulation and high levels of taxation are gradually eroding its competitiveness.”³¹⁹ François Hollande campaigned boldly on defending government spending, spending more on social benefits and raising the taxes on the wealthy. As previously noted, however, since becoming president in 2012, even he has accepted that a reduction in the size of the state is needed to promote private sector job creation.³²⁰

³¹⁹ France must cut out ‘inefficient’ public spending, says OECD, *Public Finance International*, 19 March 2013

³²⁰ Dorfman, J., Hollande Converts, Proposes Austerity and Lower Taxes To Boost Growth in France, *Forbes*, 18 January 2014

The experience in Denmark relates to that of France. Recently Denmark has stood out as holding the highest level of taxation in the OECD. The country also has the highest share of government spending in the OECD. Interestingly, this share increased from 54 to 58 per cent of GDP between 2001 and 2011, when the country was under centre-right leadership – mainly as a response to the global crises. In 2011 power shifted to a centre-left government led by the Social Democrats. Somewhat surprisingly, this prompted a move towards economic liberalisation.

Helle Thorning-Schmidt, Denmark's prime minister since 2011, has cut welfare entitlement as well as other areas of public spending. It is clear that this policy shift is motivated by a realisation that the Danish system needs to be changed. Bjarne Corydon, the country's Social Democrat finance minister, has invested his political capital in promoting reduced generosity in the country's welfare system. Corydon explained: "I believe in the competition-state law as the modern welfare state. If we are to ensure support for the welfare state, we must focus on the quality of public services rather than transfer payments."³²¹

The Danish government seems to have gone so far in criticising government spending that they have lost public support. It is understandable that the French left-of-centre government would move towards the ideas of moderately smaller government in order to improve their chances of re-election. But why would the Danish Social Democrats do so, even if it meant going against the wishes of the general public? To answer this question, we can look back at Nordic history.

In a research article with the telling name "Why Are They Doing It? Social Democracy and Market-Oriented Welfare State Reforms", Michael Klitgaard asks why Social Democratic parties have been "leading political forces when universal welfare states are reformed in accordance with market-oriented principles". Klitgaard concludes that Social Democratic party elites perceive policy problems as threats to the legitimacy of the universal welfare state, and thus act to introduce market mechanisms to strengthen the welfare systems.³²²

Another study, based on the development in Denmark, notes that the country's Social Democratic party introduced new policies on taxation, unemployment insurance and early retirement that stood in conflict both with the party's historical attitudes and with voter preferences. This, according to Christian Larsen and Jørgen Andersen, "provides one of the clearest examples of the independent causal effects of economic ideas". The Danish Social Democrats have simply previously been convinced that market-friendly policy options were the better choice for the country, even if they were not popular in the short term.³²³ The same explanation seems to hold today.

France and Denmark are, of course, not unique. Fiona Ross concludes that in many countries, "the left and centre have turned to market-liberal policy solutions", and that the left in countries such as Australia and New Zealand, "initiated, rather than simply perpetuated, market-liberal policies". According to the author, part of this transformation can be explained "in terms of the credibility gap plaguing leftist parties since the 1970s era of economic chaos, heavy taxes and spending, and strong, disruptive unions". Ross also reports that measures to restructure public services,

321. Corydon: Konkurrencestat er ny velfærdsstat, *Politiken*, 23 August 2013

322. Klitgaard, M., *Why Are They Doing It? Social Democracy and Market-Oriented Welfare State Reforms*, *West European Politics*, 2007, pp. 172–194

323. Larsen, C.A. & Andersen, J., *How New Economic Ideas Changed the Danish Welfare State: The Case of Neoliberal Ideas and Highly Organized Social Democratic Interests*, *Governance*, 2009, pp. 239–261

which probably would have been unpopular had they been introduced by British Conservatives, attracted popular support when presented by New Labour.³²⁴

As I recently showed in the book *Renaissance for Reforms*, co-authored with Professor Stefan Fölster and published jointly by Timbro and the Institute of Economic Affairs, increasing economic freedom can be a winning recipe for left-of-centre governments. Since the mid-1990s the left-of-centre OECD governments which have increased economic freedom have been considerably more likely to win re-election than those which have reduced it.³²⁵ Can we expect this relationship to hold also in the near future? Will left-of-centre governments push for reduced spending?

In recent years, the European left has broadly become more radical, not more moderate. French economist Thomas Piketty's book, *Capital in the Twenty-First Century*, argues that inequality is rising and should be met with confiscatory taxes on the rich. It is no coincidence that it has gained tremendous support since its translation into English in April 2014. At the same time, policy is not only driven by ideology but also by an understanding of the economic realities of the world. And those realities suggest that relatively few social gains lie in increasing already large public sectors. Increasing the scope of the public sector can on the other hand have detrimental implications on growth, employment and welfare dependency.

Shortly after François Hollande spoke about the need to slim government expenditure, Professor Jean Pisani-Ferry wrote an article that illuminates the more pragmatic way of thinking that influences left-of-centre governments. Pisani-Ferry is a French economist at the Hertie School of Governance in Berlin. He also serves as the French government's commissioner-general for policy planning. In the article he asked a simple question: "Why do some governments spend more than others?"³²⁶

Pisani-Ferry notes that European governments have "reached the point at which taxes can scarcely be increased further" and "cannot both repay their debts and keep welfare spending at current levels". However, public expenditure is not always equal to greater social investments in reducing poverty and inequality. He continues to write that "French public bodies spend 12 percentage points of GDP more than those in Germany, with no significant difference in outcomes in terms of health, education, or poverty. This suggests that some countries are more efficient at social welfare than others."³²⁷

Pisani-Ferry's contention is well worth exploring for governments on both the right and the left. Germany has a mature welfare state, with strong social ambitions. A general government expenditure slightly below 45 per cent of GDP is evidently enough to support extensive welfare systems. Arguably also Canada with 41 per cent government expenditure and Australia with a 32 per cent level have admirable social systems and outcomes. How much is it really necessary to spend to achieve a given quality of a functioning welfare system, given that some countries achieve similar results with substantially different costs? Should it not be possible to reduce the scope of government in the United Kingdom without reducing basic welfare services? The experience in Denmark and France suggest that even socialist and social democratic politicians can warm to the idea that more government spending does not always entail better welfare.

324. Larsen, C.A. & Andersen, J. *How New Economic Ideas Changed the Danish Welfare State: The Case of Neoliberal Ideas and Highly Organized Social Democratic Interests*, Governance, 2009, pp. 239–261

325. Fölster, S. & Sanandaji, N., *Renaissance for Reforms*, Timbro and Institute of Economic Affairs, 2014

326. *Cut the Spending, Spare the Poor*, Project Syndicate, 30 January 2014

327. Ibid.

Notes, sources and methodology

General notes on savings estimates

All estimates of savings have been calculated against a baseline of estimated figures for a 'do nothing' policy. That is, what would happen to the expenditure without any policy changes. Where possible, these estimates have been sourced from Office for Budget Responsibility estimates. Departmental budgets have been taken from the Treasury's Public Expenditure Statistical Analyses where possible and have been assumed to grow with CPI inflation. The Department for Work and Pensions *Benefit expenditure and caseload tables December 2014* were used to estimate measures relating to welfare and pensions estimates.

The remit of *The Spending Plan* is two-fold. First, to demonstrate how a new government following the May 2015 general election could reach the Office for Budget Responsibility's forecast of total managed expenditure falling to 35.2 per cent of GDP by 2019–20. Secondly, to demonstrate how a government could meet the 2020 Tax Commission's objective by bringing total managed expenditure down to 31.7 per cent of GDP by 2020–21.

For most of the policy measures we have proposed, the exact timing of their implementation would make little difference to the estimates in either 2019–20 or 2020–21. Consequently, the implementation date and the estimates for the years until 2019–20, especially the overall impact on total managed expenditure, should not be viewed overly prescriptively. The implementation dates chosen are best assumptions for what would be the soonest reasonably practical, which is why most measures begin in 2016–17.

Priority measures due to time sensitivity

1. Raising the state pension age (policy 2) should be decided and announced as soon as possible to allow people time to adjust their retirement plans.
2. Relaxing planning restrictions on the green belt and building heights (policy 12) should be implemented as soon as possible because housing markets will take time to adjust to a new framework for supply.
3. The ending of operating subsidies for train operating companies (policy 24) should be announced immediately to maximise the extent to which it can be worked into the franchising schedule and minimise the extent to which existing franchises may need to be renegotiated.
4. The ending of operating grants for TfL (policy 25) should be announced immediately so that it can be phased in over four years, giving TfL the time to review their operations and plan ahead.
5. Devolving tax-raising powers to local authorities and cutting grants (policy 35) should be announced and implemented as soon as reasonably possible to allow time for increased competition and responsibility to drive up efficiency and push down costs.
6. HS2 should be scrapped immediately (policy 41). Time wasted on delaying this measure will mean millions of pounds in consultancy fees and, soon, construction costs for a wholly unnecessary project, irrespective of whether the money saved is reallocated to other projects or returned to taxpayers in lower taxes.

Fiscal aggregates

OBR forecast aggregates (£bn)	2014–15	2015–16	2016–17	2017–18	2018–19	2019–20	2020–21
GDP	1,822.0	1,888.0	1,956.0	2,038.0	2,124.0	2,215.0	2,310.2
OBR total managed expenditure	737.1	746.2	746.7	751.3	765.3	779.9	794.8
OBR total managed expenditure (% of GDP)	40.5	39.5	38.2	36.9	36.0	35.2	34.4
TPA programme two proposals to meet the 2020 Tax Commission target (£bn)							
Proposed total managed expenditure	737.1	733.3	698.0	708.2	717.1	724.5	736.0
Proposed total managed expenditure (% of GDP)	40.5	38.8	35.7	34.8	33.8	32.7	31.9
Government spending not covered by <i>Spending Plan</i> measures	89.7	90.8	91.9	93.5	95.4	97.3	99.2
Debt interest payments	35.9	40.4	47.3	54.0	57.5	60.1	62.7
Government spending within <i>Spending Plan</i> measures	611.5	602.2	558.9	560.7	564.2	567.1	574.0
Rest of the economy	1,084.9	1,154.7	1,258.0	1,329.8	1,406.9	1,490.5	1,574.3
TPA programme one proposals to meet the OBR forecast (£bn)							
Proposed total managed expenditure	737.1	739.3	730.0	747.3	759.6	771.3	–
Proposed total managed expenditure (% of GDP)	40.5	39.2	37.3	36.7	35.8	34.8	–
Government spending not covered by <i>Spending Plan</i> measures	162.1	164.0	166.0	169.0	172.4	175.8	–
Debt interest payments	35.9	40.4	47.3	54.0	57.5	60.1	–
Government spending within <i>Spending Plan</i> measures	539.1	534.9	516.7	524.3	529.8	535.4	–
Rest of the economy	1,084.9	1,148.7	1,226.0	1,290.7	1,364.4	1,443.7	–

Policy measures table (baseline, proposed and saving)

	2014–15	2015–16	2016–17	2017–18	2018–19	2019–20	2020–21
Policy 1: freeze the basic state pension and minimum income guarantee in 2016–17, then uprate with CPI (programme two)							
Baseline	93,100	96,000	98,200	101,000	104,400	107,700	111,000
Proposed	93,100	96,000	95,800	97,100	98,400	99,700	101,000
Saving	0	0	2,400	3,900	6,000	8,000	10,000
Policy 1: uprate the basic state pension and minimum income guarantee with CPI from 2016–17 (programme one)							
Baseline	93,100	96,000	98,200	101,000	104,400	107,700	–
Proposed	93,100	96,000	97,000	98,300	99,600	100,900	–
Saving	0	0	1,200	2,700	4,800	6,800	–
Policy 2: raise the state pension age faster, to 67 by 2020 (programme two)							
Baseline	93,100	96,000	98,200	101,000	104,400	107,700	111,000
Proposed	93,100	96,000	98,200	100,892	103,366	105,473	108,620
Saving	0	0	0	108	1,034	2,227	2,380

	2014–15	2015–16	2016–17	2017–18	2018–19	2019–20	2020–21
Policy 3: target free bus passes for the elderly on those who genuinely need them (both programmes)							
Baseline	1,087	1,098	1,109	1,120	1,131	1,143	1,154
Proposed	1,087	568	561	553	566	583	601
Saving	0	530	548	567	565	560	553
Policy 4: abolish free TV licences (both programmes)							
Baseline	644	644	655	701	759	835	919
Proposed	644	0	0	0	0	0	0
Saving	0	644	655	701	759	835	919
Policy 5: means test winter fuel payments (both programmes)							
Baseline	2,127	2,100	2,081	2,047	2,016	2,001	1,986
Proposed	2,127	621	607	588	570	558	546
Saving	0	1,479	1,474	1,459	1,446	1,443	1,440
Policy 6: reduce the welfare cap to £20,000 (both programmes)							
Baseline	735	735	735	748	763	778	794
Proposed	735	0	0	0	0	0	0
Saving	0	735	735	748	763	778	794
Policy 7: abolish child benefit and increase the child element of the child tax credit (both programmes)							
Baseline	11,603	11,710	11,829	12,066	12,335	12,662	12,990
Proposed	11,603	11,710	8,971	9,151	9,355	9,604	9,852
Saving	0	0	2,858	2,915	2,980	3,058	3,138
Policy 8: scrap the childcare subsidy programme named “tax-free childcare” (both programmes)							
Baseline	0	300	700	800	900	900	900
Proposed	0	0	0	0	0	0	0
Saving	0	300	700	800	900	900	900
Policy 9: cut child tax credits to their 2003–04 level in real terms (programme two)							
Baseline	5,134	5,100	5,254	5,458	5,629	5,765	5,905
Proposed	5,134	5,100	0	0	0	0	0
Saving	0	0	5,254	5,458	5,629	5,765	5,905
Policy 10: flatten housing benefit rates across expensive areas to cut 10 per cent off bills (both programmes)							
Baseline	24,515	24,941	25,296	25,788	26,381	26,801	27,202
Proposed	24,515	24,941	22,767	23,209	23,743	24,121	24,482
Saving	0	0	2,529	2,579	2,638	2,680	2,720
Policy 11: scrap contributory benefits (both programmes)							
Baseline	5,473	6,031	6,600	6,778	6,736	6,791	6,846
Proposed	5,473	6,031	4,969	5,115	5,098	5,157	5,216
Saving	0	0	1,631	1,663	1,638	1,634	1,630
Policy 12: reform planning rules to reduce housing benefit bills (both programmes)							
Baseline	24,515	24,941	25,296	25,788	26,381	26,801	27,221
Proposed	24,515	24,941	24,411	23,983	23,611	23,049	22,457
Saving	0	0	885	1,805	2,770	3,752	4,764

	2014–15	2015–16	2016–17	2017–18	2018–19	2019–20	2020–21
Policy 13: abolish DECC and reassign necessary functions (both programmes)							
Baseline	321	330	334	338	344	351	358
Proposed	321	330	334	0	0	0	0
Saving	0	0	0	338	344	351	358
Policy 14: repeal the Equality Act 2010 (both programmes)							
Baseline	45	46	46	47	48	49	50
Proposed	45	46	0	0	0	0	0
Saving	0	0	46	47	48	49	50
Policy 15: return the compulsory school leaving age to 16 and scrap 16–19 bursary scheme (programme two)							
Baseline	1,107	1,113	1,126	1,146	1,169	1,192	1,216
Proposed	1,107	0	0	0	0	0	0
Saving	0	1,113	1,126	1,146	1,169	1,192	1,216
Policy 16: cut the number, scope and budgets of quangos and public bodies (both programmes)							
Baseline	358	363	367	373	381	389	396
Proposed	358	363	0	0	0	0	0
Saving	0	0	367	373	381	389	396
Policy 17: cut the pupil premium to its 2011 level (programme two)							
Baseline	2,500	2,545	2,576	2,619	2,672	2,704	2,736
Proposed	2,500	699	707	719	734	748	763
Saving	0	1,846	1,868	1,900	1,938	1,955	1,973
Policy 18: replace grants to local authorities with devolved taxes to encourage better local spending (both programmes)							
Baseline	98,753	102,499	107,928	112,653	117,638	122,791	128,170
Proposed	98,753	101,695	106,215	110,001	113,928	117,906	121,972
Saving	0	804	1,713	2,652	3,710	4,885	6,198
Policy 19: amend repayment terms on student loans to make them more affordable (programme two)							
Baseline	3,500	4,900	4,900	4,900	4,900	4,900	4,900
Proposed	3,500	2,208	2,208	2,208	2,208	2,208	2,208
Saving	0	2,692	2,692	2,692	2,692	2,692	2,692
Policy 20: freeze benefits for two years then uprate with CPI (both programmes)							
Baseline	60,100	59,400	60,900	62,700	65,000	66,900	68,819
Proposed	60,100	59,400	60,178	60,861	63,094	64,938	66,800
Saving	0	0	722	1,839	1,906	1,962	2,018
Policy 21: stop paying over the odds to borrow money (both programmes)							
Baseline	2,665	2,494	2,491	2,395	2,416	2,457	2,513
Proposed	2,359	2,163	2,121	1,868	1,818	1,769	1,718
Saving	0	331	370	527	598	688	795
Policy 22: withdraw funding from the CAP and continue subsidies directly for British farmers (programme two)							
Baseline	6,139	6,139	6,139	6,139	6,139	6,139	6,139
Proposed	6,139	6,139	3,348	3,348	3,348	3,348	3,348
Saving	0	0	2,791	2,791	2,791	2,791	2,791

	2014–15	2015–16	2016–17	2017–18	2018–19	2019–20	2020–21
Policy 23: stop prescribing branded medicines where cheaper generics are suitable (programme two)							
Baseline	8,569	9,028	9,567	10,139	10,766	11,432	12,139
Proposed	8,419	8,870	9,401	9,963	10,579	11,233	11,928
Saving	0	158	166	176	187	199	211
Policy 24: abolish rail operator subsidies and increase premiums by 33 per cent by deregulating fares (programme two)							
Baseline	2,615	2,932	3,065	3,154	3,173	3,208	3,243
Proposed	2,615	2,932	2,344	2,148	2,135	1,774	1,809
Saving	0	0	721	1,006	1,038	1,434	1,434
Policy 25: scrap operating subsidies to TfL (programme two)							
Baseline	3,479	2,522	1,762	1,796	1,859	1,771	1,801
Proposed	3,479	2,522	1,583	1,431	1,302	1,015	1,032
Saving	0	0	179	365	557	756	769
Policy 26: abolish the bus service operators' grant (programme two)							
Baseline	268	276	279	284	290	296	302
Proposed	268	276	0	0	0	0	0
Saving	0	0	279	284	290	296	302
Policy 27: abolish DfID, scrap development aid and transfer humanitarian responsibilities to the FCO and MoD (programme two)							
Baseline	10,300	11,239	13,687	14,284	14,921	15,598	16,276
Proposed	10,300	11,239	6,844	1,000	1,000	1,000	1,000
Saving	0	0	6,844	13,284	13,921	14,598	15,276
Policy 28: abolish BIS and reassign necessary functions (both programmes)							
Baseline	17,273	18,072	18,289	18,618	18,990	19,370	19,758
Proposed	17,273	17,798	14,177	14,415	14,704	14,999	15,299
Saving	0	274	4,112	4,203	4,286	4,371	4,459
Policy 29: abolish DCMS and transfer royal parks and heritage functions to other departments (both programmes)							
Baseline	7,429	6,637	6,637	6,637	6,637	6,637	6,637
Proposed	7,429	6,637	3,894	3,894	3,894	3,894	3,894
Saving	0	0	2,743	2,743	2,743	2,743	2,743
Policy 30: scrap universal free school meals (programme two)							
Baseline	620	755	769	789	810	832	855
Proposed	620	378	0	0	0	0	0
Saving	0	377	769	789	810	832	855
Policy 31: establish an excess sickness rate penalty to bring public sector sickness absence rates into line with the private sector (both programmes)							
Baseline	4,809	4,814	4,597	4,473	4,438	4,415	4,393
Proposed	4,809	3,965	3,787	3,685	3,656	3,637	3,619
Saving	0	849	810	788	782	778	774
Policy 32: cut annual leave entitlements where overly generous (both programmes)							
Baseline	164,861	165,026	157,600	161,855	160,560	159,757	158,959
Proposed	164,861	163,578	156,217	160,435	159,152	158,356	157,564
Saving	0	1,448	1,383	1,420	1,408	1,401	1,395

	2014–15	2015–16	2016–17	2017–18	2018–19	2019–20	2020–21
Policy 33: scrap national pay bargaining (both programmes)							
Baseline	6,317	6,324	6,039	5,876	5,829	5,800	5,771
Proposed	6,317	6,324	4,529	2,938	1,457	0	0
Saving	0	0	1,510	2,938	4,372	5,800	5,771
Policy 34: scrap trade unions' subsidies of facility time, grants and office space (both programmes)							
Baseline	106	105	103	102	100	99	97
Proposed	106	0	0	0	0	0	0
Saving	0	105	103	102	100	99	97
Policy 35: cut Scotland's grant to match its relative prosperity compared to Wales (programme one)							
Baseline	69,991	70,970	70,326	70,115	71,171	72,378	–
Proposed	69,991	66,670	66,066	65,867	66,859	67,993	–
Saving	0	4,300	4,260	4,248	4,312	4,385	–
Policy 35: shrink grants to Scotland, Northern Ireland and Wales in line with England and cut Scotland's grant to match its relative prosperity compared to Wales (programme two)							
Baseline	69,991	70,970	70,326	70,115	71,171	72,378	73,605
Proposed	69,991	65,679	65,183	64,686	64,190	63,694	63,197
Saving	0	5,291	5,143	5,429	6,981	8,684	10,408
Policy 36: increase the extent of charges in the NHS (programme two)							
Baseline	11,725	12,201	12,775	13,381	14,048	14,753	15,498
Proposed	11,725	12,201	3,778	5,059	5,358	5,676	6,140
Saving	0	0	8,997	8,322	8,690	9,077	9,359
Policy 37: raise the efficiency of NHS estates to match the top 25 per cent (programme two)							
Baseline	8,837	8,797	8,902	9,063	9,244	9,429	9,617
Proposed	8,837	8,137	7,567	7,024	6,471	5,893	6,011
Saving	0	660	1,335	2,039	2,773	3,536	3,606
Policy 38: reform patient list auditing to cut NHS "ghost patients" (programme two)							
Baseline	4,162	4,227	4,310	4,421	4,544	4,670	4,800
Proposed	4,162	4,227	4,178	4,286	4,405	4,527	4,653
Saving	0	0	132	135	139	143	147
Policy 39: renegotiate contracts to cut excessive pay for GPs (programme two)							
Baseline	3,178	3,216	3,255	3,313	3,380	3,447	3,516
Proposed	3,178	3,216	2,728	2,241	2,286	2,332	2,379
Saving	0	0	527	1,072	1,094	1,115	1,137
Policy 40: scrap HS2 (programme two)							
Baseline	420	980	1,886	1,693	3,300	4,000	4,498
Proposed	420	490	0	0	0	0	0
Saving	0	490	1,886	1,693	3,300	4,000	4,498
Policy 41: abolish the Christmas bonus (both programmes)							
Baseline	154	154	153	152	150	148	147
Proposed	154	0	0	0	0	0	0
Saving	0	154	153	152	150	148	147

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