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Opportunities in an Age of Austerity

Smart ways of dealing with the UK's fiscal deficit

Edited by Carey Oppenheim and Tony Dolphin

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Introduction

Tony Dolphin and Carey Oppenheim

Now that politicians are facing up to the reality of the fiscal situation, it is a good time to examine opportunities for progressive reform in the tough financial environment – the 'age of austerity' – that is likely to dominate in the public sector for much of the next decade. This report does just that: ippr commissioned experts from different fields each to look at one aspect of the problem or one area of public spending.

The problem and the debate

The UK's fiscal deficit (defined as public sector net borrowing) was £77 billion in the first half of the 2009–10 fiscal year and is on track for the Budget 2009 forecast of £175 billion (12.5 per cent of Gross Domestic Product) for the full year. Few think the deficit can be sustained at this level for very long – and the Government set out in the Budget a proposal, albeit lacking details, for reducing it to £97 billion (5.5 per cent of GDP) by 2013–14. This sparked a debate – mired in a fruitless political boxing match for much of the summer – over what should be done about the deficit. Initially, politicians on all sides seemed more intent on scoring political points than on addressing the crucial issues, such as how fast the deficit should be reduced, what the balance between spending cuts and tax increases should be and what principles should underpin spending reductions.

More recently, the quality of the debate has improved, though there is little agreement on anything other than that the deficit must eventually be reduced. There is no consensus, for example, on when the first measures to cut the deficit should be implemented. Labour and the Liberal Democrats warn that cutting the deficit too soon would endanger the economic recovery (before it has even started) – a view that attracts a lot of support, and not just among political parties of the centre-left. T*he Economist* magazine and the *Financial Times* commentator Martin Wolf have expressed similar views. Meanwhile, David Cameron and George Osborne for the Conservatives make the case for early and more substantial cuts in the deficit before the Government loses the confidence of global bond investors. Mervyn King, Governor of the Bank of England, is among those who have made the same case.

Less has been said about the balance between using tax increases and spending cuts to reduce the deficit. For now, politicians across the spectrum seem content to accept the tax measures proposed in the Budget and in last year's Pre-Budget Report, and instead to focus on the spending side of the equation. This has led to something of a bidding war as politicians across the political divide propose measures that would help to close the fiscal deficit. Vince Cable, Shadow Chancellor of the Liberal Democrats, was early into the fray, identifying nine areas of potential savings 'as a start to a radical programme of reform' (Cable 2009). These included a freeze on total public sector pay, scrapping several major IT projects and big cuts to the defence procurement budget. Gordon Brown uttered the word 'cuts' in a speech to the TUC in mid-September and promised measures to achieve the Budget target of more than halving the fiscal deficit (as a share of GDP) by 2013–14. And George Osborne, the Conservatives' Shadow Chancellor, used his speech to his party's annual conference to set out a series of measures designed to reduce the deficit, including an increase in the pension age, a freeze on public sector pay for those earning above £18,000 a year and restricting Child Trust Fund payments only to the poorest families (Osborne 2009).

Themes emerging from our experts' contributions

Each contributor was asked to look at one aspect of the problem or one area of public spending and to identify opportunities for contributions to reducing the deficit that would not damage progressive aims. The idea was to see if common themes would emerge that could help frame the deficit reduction process, rather than to come up with a 'top ten' list of

spending cuts, or to comprehensively examine every aspect of public spending in the search for savings. As a result, potential savings, such as cuts in the Government's IT programme, which others have identified and which will almost certainly be implemented whoever wins the next election, are not mentioned here.

A number of common themes did emerge.

1. Don't panic. There is a danger that the clamour for deficit reduction and public spending cuts will become uncontrollable. In the absence of evidence that public sector borrowing is currently crowding out private sector spending (and with monetary policy already at an extremely loose setting), cutting the deficit too soon and too quickly could prevent any economic recovery in the UK from taking hold. Peter Kellner and Phillip Blond both argue that government needs to balance the need for fiscal credibility in the medium term with support for the economy in the short term.

2. Plan for a long haul. Deficit reduction, whenever it commences, will be a long and painful process. John Hawksworth argues that the long-term costs of an ageing population in the UK necessitate additional fiscal tightening measures, over and above those needed to reverse the increase in the deficit in the last few years. Tony Dolphin runs through the arithmetic implicit in the 2009 Budget and calculates that – unless governments are prepared to increase taxes further than currently planned – departmental spending might have to be cut by almost 10 per cent in real terms between 2010–11 and 2013–14. Under a Conservative Government determined to reduce the deficit more rapidly, this figure could rise to nearer 20 per cent.

3. Don't rule out tax increases. The prospect of the effect on public services of swingeing cuts in spending might force governments to reconsider the need for further increases in taxes. Rick Muir suggests that all the main political parties will have to look afresh at tax measures. Paul Johnson argues that, if revenues are to be increased, it should be as part of a long-term vision for reform of the tax system, so as to increase its efficiency and the role of environmental taxes, and not done in an ad hoc manner.

4. Politics is going to get tougher. Public understanding of what is meant by public spending cuts – or tax increases – is cloudy to say the least. Deborah Mattinson and Rick Muir note that polling evidence suggests the public favour spending cuts over tax increases (though there are clear differences across party lines). This appears to be because they think spending can be reduced through efficiency savings that will not affect services. Given the choice between cuts in public services and tax increases, a recent poll suggests a small majority in favour of higher taxes. Peter Kellner highlights evidence from the Canadian Government's successful deficit reduction programme in the mid-1990s which shows that it is crucial to carry public opinion and have an informed public debate about the choices – and the implications of those choices.

5. To ring-fence is misguided. The public have a strong preference for certain services. Deborah Mattinson points out that polls consistently show more than four in five people still want to increase spending on the National Health Service. International aid, on the other hand, is seen as a prime candidate for spending cuts. This is an interesting juxtaposition for David Cameron as these are the two areas he has explicitly stated would be protected from cuts in real funding under a Conservative government. The Labour Party is also committed to continue to increase spending on health. However, while there might be a strong political case for ring-fencing certain areas of spending, this is unlikely to be the fairest, or the most effective, approach to take. Stephen Bundred argues, for example, that, while there might be a strong case for making schools a relative priority, large increases in real spending in recent years mean that they cannot be spared from cuts in any major programme of deficit reduction. And, of course, ring-fencing an area of spending as large as the NHS or schools budget adds significantly to the scale of cuts required elsewhere.

6. Nowhere will be off-limits. Government will have to make spending cuts and implement reform in areas that have previously been seen as off-limits. This is likely to lead to conflict with organisations that have strong public support. Rick Muir suggests that major reform of policing in the UK could both increase the effectiveness of the force and save money, but measures such as paying the police based on performance rather than length of service would prove controversial. General Lord Charles Guthrie and Andy Hull call for a major review of defence procurement, the immediate cancellation of several large-scale projects for the Royal Navy and a review of Britain's nuclear deterrent – not a series of proposals designed to find favour with the average Conservative backbencher but a Conservative Government determined to reduce the deficit would have to look at options like these.

Bridget Rosewell argues that public sector pay has outstripped private sector pay in recent years and could be held down, a policy that could lead government into conflict with its own civil service, which it would probably shrug off, but also with doctors, teachers and nurses, who will find more public support. Kayte Lawton and Kate Stanley point out that cutting welfare payments could involve measures such as taxing child benefit and winter fuel payments for the elderly. Creating losers from changes to the tax/benefit system (even if confined to those on higher incomes), among children and pensioners, is seldom good for the popularity of a government. But it is certainly an option worth exploring.

7. Innovate and improve. Every area of public spending will offer some opportunities, whether or not the funds they receive have increased rapidly in recent years. In the NHS, which has seen very large increases in spending, Liz Kendall argues that radical changes to services are required. She cites the example of emergency and urgent care, where bold reform could lead to significant improvements in patient care and savings of expenditure. Meanwhile, in further education, which has done less well for funds recently, Paul Lawrence suggests that substantial savings could be made simply by inefficient colleges following the lead of their more efficient counterparts. And David Begg argues that the need for extra revenues should lead government to look again at the more widespread use of road-user charging. This, he says, would restrict demand and help to ease what is the most congested transport system in Europe.

8. Learn from others. The Canadian experience of cutting public spending in the mid-1990s has been widely touted as a model for the UK government to follow, and Peter Kellner looks at its relevance. But there might also be lessons to learn closer to home. Tony Travers points out that local councils across Britain have already been active in controlling spending and seeking ways to increase revenues – and that they will continue to innovate in this area. Because different councils will take different approaches, there should be a wide range of experience to learn from. In addition, as Iain McLean points out, the devolution of powers to the Welsh Assembly and Scottish Parliament creates two extra bodies that Westminster can learn from, especially if they are given more autonomy over their revenues and spending.

9. Redistribution is still possible. Although it is much easier to redistribute income when the economy is strong and revenues are buoyant, it is still possible to redistribute when implementing cuts in public spending. Kayte Lawton and Kate Stanley propose a series of changes to child benefit and the child tax credit system, including taxing the former. This would reduce public spending but allow more money to be channelled to large families on low incomes – and so reduce child poverty significantly. Claire Callender and Donald E Heller suggest ending the blanket government subsidy on student loans and replacing it with more targeted subsidies, so that higher-earning graduates pay a higher rate of interest than their lower-earning counterparts.

10. Think long-term. One of the mistakes made by governments intent on deficit reduction in the past has been to forget about the long term and make cuts that were easy to implement in the short. This can lead to higher spending or lower revenues in later years.

Spending money on preventing problems developing, rather than on clearing them up later, makes financial sense as well as being obviously good for society. Polly Neate makes the case that targeting resources at programmes to help vulnerable children can lead to significant reductions in social problems later in life and Liz Kendall argues for a shift in focus in the NHS towards more prevention and early intervention. Similarly, government investment spending can increase the economy's productive potential and so help generate more revenues in the future. Phillip Blond (infrastructure spending across the board), David Begg (spending on the transport network) and Claire Callender and Donald E Heller (spending on human capital in higher education) all make the case for investment spending to be spared from cuts.

Reducing the deficit: tough all round but can be done in a smart way

What does this say about how government should approach the task of reducing the budget deficit?

It tells us that it will be a tough process – tough for the politicians that have to implement it, tough for those who lose their jobs or see their work conditions deteriorate as a result of cuts, tough for those who receive lower benefits or worse public services, tough for those who have to pay more for some public services, and tough for those who have to pay higher taxes.

But it also tells us that there are smart ways and not so clever ways of going about deficit reduction. Considering tax increases alongside spending cuts is smart; putting all the onus of deficit reduction on departmental spending is not so clever. Preserving spending on investment and preventative measures is smart; 'salami-slicing' spending is not so clever. Setting out the scale of the likely reduction in spending and services to get the public 'on side' is smart; implementing swingeing cuts in spending without a mandate is not so clever. Being open to making cuts across all areas of government is smart; ring-fencing certain areas not so clever. Tackling vested interests and implementing reform where it is long overdue are smart; avoiding conflict with popular groups not so clever. Learning from others is smart; thinking that you have some unique ability to tackle the problem not so clever. And being aware of who is bearing the pain and protecting those on lower incomes and the vulnerable are smart; while arbitrary spending cuts and tax increases are not so clever.

Tax increases to help close the deficit can easily be designed to be progressive. The concept of making a progressive cut in public spending is not such an easy one to grapple with. But the contributors to this volume have shown that it is possible for a smart government to reduce the fiscal deficit while holding to the principles that underpin progressive thinking. You will not agree with everything that each one writes – we don't – but we hope you agree that, together, these contributions help to advance the debate about how the deficit should be reduced. The challenge for politicians, in the run-up to the general election, is to lift the level of their debate to that found here.

Cable V (2009) *Tackling the fiscal crisis: A recovery plan for the UK*, September 2009, London: Reform

Osborne G (2009) 'We will lead the economy out of crisis', speech by George Osborne MP, Tuesday 6 October, available at www.conservatives.com/News/Speeches/2009/10/George_Osborne_We_will_lead_the_economy_out_of_crisis.aspx

1. The politics of austerity: tax and spending after the crash

Rick Muir

Britain is entering an age of austerity in which politics will look very different from how it did in the New Labour era. The last decade was a time of plenty: the economy grew rapidly on the back of a finance and property boom, while low interest rates fuelled an explosion in household consumption. A large number of people felt a lot richer as their homes leapt in value year upon year.

This prosperity generated abundant resources for the Labour government, which dramatically increased spending on public services. While the rich got very rich, the poor benefited too as a result of the Government's tax credits and extra spending. It was the longest period of continuous economic growth in modern British history. In economic terms, we really have never had it so good.

The prospects for the decade ahead could not be more different. In the aftermath of the collapse of the financial system, economists expect growth, once it resumes, to be much slower than in the last 10 years. Britain's economy will be burdened with paying back historically high levels of household and government debt while previous engines of growth, like the City, remain too weak to drive the economy forwards. Whereas in the last decade we sought to finance Scandinavian-style public services while demanding American levels of taxation, in the coming decade governments of any party will have to cut spending and raise taxes. We are entering austere and difficult times.

They will also be more interesting times. Politics is essentially the process for deciding who gets what, when and how. In the era of New Labour, these questions had a simple and, for Labour, an electorally satisfying answer: everybody got more. Every year the national pie got bigger and everybody got a larger piece, even if some people's pieces grew faster than others. In times of plenty, distributive conflict, whether between rich and poor or between the public and private sectors, is diluted. A quiet politics of consensus prevails.

The decade ahead will be noisier and more polarised politically as the parties battle over who should pay more and who should get less in a nation struggling to pay down its debts. The collapse of financial capitalism has already ruptured the centrist politics of the last decade. The Labour government has moved leftwards, jettisoning New Labour's commitment to free market orthodoxy. It has adopted Keynesian-style fiscal and monetary policies, nationalised high street banks, increased taxes on the rich and taken a much more interventionist position towards markets.

By contrast the Conservatives, while accepting the need for tighter regulation and reform in the City, have abandoned their previous commitment to match Labour's spending plans. As the extent of the public deficit has become clear, the Tories have returned to Mrs Thatcher's mantra of 'good housekeeping', arguing for speedy and deep cuts in public spending to get the deficit under control. At this year's Conservative party conference George Osborne turned previous political wisdom on its head by proposing a public sector pay freeze, raising the retirement age and cutting some benefits.

Recovery or debt?

The first issue of political contention is whether the main priority now is to reduce the public deficit or sustain the economic recovery. The Conservatives and right-leaning analysts argue that public spending should be cut now rather than waiting until 2011 as the Government plans (Taylor 2009). They point to the fact that Britain has a level of public debt unparalleled in peacetime, with the Government now borrowing one in every four pounds that it spends. Britain will emerge from this crisis in 2014 with more debt as a proportion of national income than most other developed countries (Chote *et al* 2009). They also point to comments from the Standard & Poor's ratings agency, threatening to review Britain's credit-worthiness. They

are concerned about a potential loss of confidence among bond traders and investors, which could raise the cost of government borrowing and lead to a slide in the value of sterling (Taylor 2009).

The Government and the Liberal Democrats take the view that this nightmare scenario is highly unlikely so long as the Treasury sets out credible plans for the medium to long term to get the deficit under control. The Government agrees that the level of debt will increase substantially, but argues that Britain went into the recession with a smaller share of debt to national income than France, Germany, Japan and the United States. The Lib Dem Shadow Chancellor Vince Cable points out that we have had much higher debt to GDP ratios in the past, albeit in wartime (Cable 2009). Many economists are concerned that a programme of spending cuts now would put a fragile economic recovery at risk. They point to the lessons of the United States after the Great Depression, which went for deficit reduction too quickly in 1937 and tipped the economy back into recession, and Japan in 1997, which repeated the US mistake of 60 years earlier. They point out that restoring growth is the best way to boost government revenues, reducing the need for spending cuts and tax rises in the longer run.

However, whatever its exact scale, all sides agree that Britain requires a fiscal squeeze at some point to put the public finances on a sustainable path. The argument then becomes what form that squeeze should take – and most importantly who should feel the pinch.

Tax rises or spending cuts?

Should the pain come through tax rises or spending cuts? The right argues that tax rises would hamper economic growth and points to evidence that cutting spending is the most successful path to fiscal consolidation (Taylor 2009). The Conservatives are committed to cutting a number of personal to cutting a number of personal and business taxes, including raising the threshold at which Inheritance Tax is paid and reducing Corporation Tax. For the Liberal Democrats, Vince Cable argues that most of the squeeze should come in the form of spending cuts, saying that 'direct taxes create disincentives to save, work and take risks while indirect taxes are generally regressive' (Cable 2009).

Indeed, despite earlier talk of 'Labour investment' versus 'Tory cuts', the Government itself anticipates that three quarters of the fiscal consolidation will be made up of cuts in real levels of spending. However, on tax it has already decided to introduce higher Income Tax for top earners and to increase National Insurance contributions. There were noises at this year's Labour conference of further tax rises to come. In support of the argument for higher taxes, some commentators have cast doubt on the view that higher tax economies suffer from lower growth. There is no simple correlation between the tax to GDP ratio and the level of economic growth, and indeed the high-tax Scandinavian economies have strong growth records (Dolphin 2009).

The public is split down the middle on this question: 36 per cent favour prioritising spending cuts and 38 per cent income tax increases. The public tend to divide along party lines on this question: Labour supporters favour tax rises, while Conservative voters favour spending cuts. Liberal Democrat voters are more evenly split, but lean towards tax rises (Page and Clark 2009).

Nevertheless it is clear that to put most of the burden of consolidation on tax rises would be politically unpalatable. The Institute for Fiscal Studies points out that to protect departmental budgets taxes would have to rise (and/or benefits be cut) by about £29 billion a year, or £930 per family, between 2010 and 2018 (Chote *et al* 2009). No party would be able to sustain such massive tax increases politically. Whatever the balance chosen between taxes and spending, any government will need to make spending cuts.

Where should the axe fall?

There are three broad approaches to reducing government spending, although any government is likely to adopt some mixture of all three. First, there is the traditional method, or what has become known as 'salami slicing'. Under this model each government department is given a

lower budget to live with, forcing ministers and managers lower down the food chain to find cuts. This method is tempting politically because decisions about what exactly should go can be devolved down to the local level, absolving ministers from some of the blame. It can also be done quickly, which is tempting for an incoming government which wants to get the pain over with while it can still blame its predecessor for the mess it inherited. However, this approach is rarely the most progressive one. It is the less visible and more vulnerable groups that tend to be targeted for reasons of political expediency: care for the very elderly in their homes, drug rehabilitation, mental health services, social work. Marginalised groups will make less noise than the middle class parents whose schools might otherwise suffer or the students whose university fees might otherwise increase. Salami slicing will also mean a reduction in the quality of frontline services across the board without asking questions about what the Government should be spending its money on.

The second approach is that of prioritisation: government could undertake an across the board review of all aspects of government expenditure and stop doing things that are less important or ineffective. This was the approach taken by the Chretien government in Canada when it successfully got the federal budget under control in the 1990s (see Peter Kellner's essay in this collection).

This can be a much more progressive approach because decisions can be made to protect those on the lowest incomes and with the most needs and make the cuts fall on those higher up the income scale. For example, both George Osborne and Vince Cable have proposed ending middle class entitlements to benefits and tax credits. The journalist Polly Toynbee recently argued that if cuts are to be made to the education budget, it would be more progressive to cut the university budget, from which middle class families largely benefit, rather than to cut pre-school and primary school budgets which are so important for children's life chances, particularly those from low income families (Toynbee 2009).

The third approach is to reform the way public services work. This is perhaps the least politically satisfactory in the short run. Structural changes inevitably involve confrontations with public sector staff. They also bring fiscal benefits much further down the track, very often beyond the lifetime of a single government. Reforms may also need to be front-loaded, needing more money to get them off the ground, which is hard to justify during a time of fiscal tightening. Nevertheless, if it is done right, reform to the way services work can secure the holy grail of improving services, while saving money at the same time.

Conclusion

British politics will look very different in the years ahead: more polarised ideologically and set against an imposing backdrop of fiscal austerity and, potentially, greater social conflict. British governments of any political hue will need to increase taxes and cut public spending. The political debate will be over how much fiscal consolidation is required, what the balance should be between higher taxes and spending cuts and what services should be cut and which social constituencies protected.

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2. The scale of the challenge

Tony Dolphin

There has to be a general election in the UK by June 2010. The government that is formed after that election will face an enormous challenge when it draws up plans to bring the fiscal deficit back down to a sustainable level.

After just six months of the 2009–10 fiscal year, the budget deficit (defined as public sector net borrowing) already totals £77 billion and it is on track to reach, or even exceed, the full-year total of £175 billion forecast in the April 2009 Budget. This will be the equivalent of 12.5 per cent of gross domestic product (GDP) and, by some margin, the largest deficit recorded in the UK since the Second World War.

Even for someone fully committed to the Keynesian notion of an active fiscal policy to support the economy when it is in recession, this is an eye-wateringly large deficit and it cannot be sustained at this level for very long without leading to an explosive increase in government debt. Even if the deficit is halved by 2013–14, debt will increase from 36.5 per cent of GDP in 2007–08 to over 75 per cent in 2013–14. Without efforts to reduce the deficit, debt could easily reach 100 per cent by the middle of the next decade. And higher levels of debt will be accompanied by higher interest payments, which will mean either higher taxes or cuts in other spending to fund them.

The next government will, therefore, face two tough fiscal decisions:

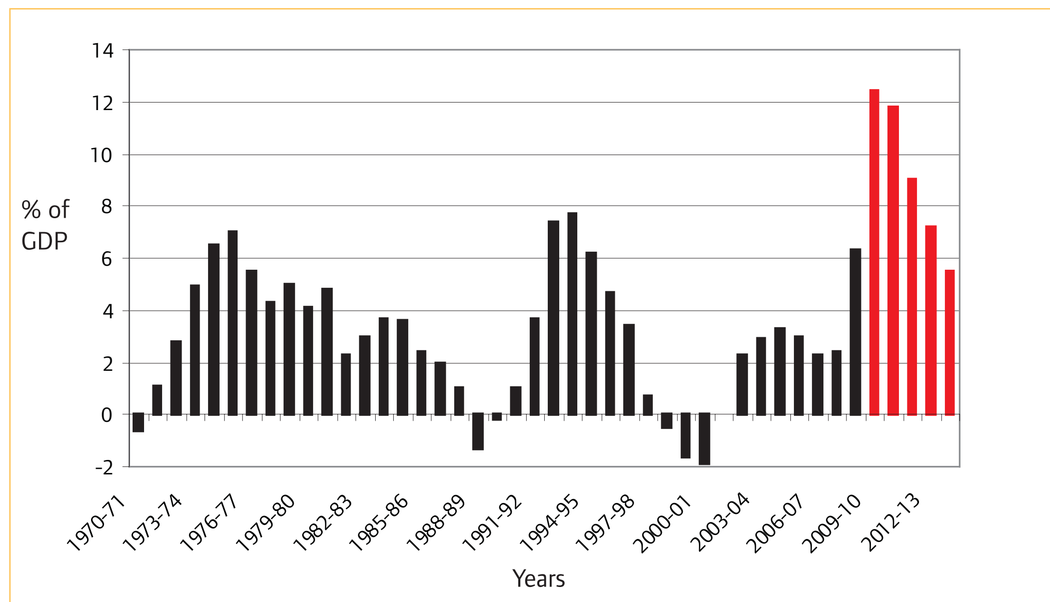
- How quickly to reduce the deficit
- What combination of tax increases and spending cuts to make to achieve the desired reduction.

How to quickly reduce the deficit

The current government's approach to the first decision can be characterised as 'secure the economic recovery first and then reduce the deficit'[1]; while the Conservative opposition favours 'cut the deficit now as the only way to generate an economic recovery'[2].

Figure 2.1. Public sector net borrowing (% GDP)

Source: HM Treasury, Budget 2009



1. See for example Alistair Darling's speech on 8 September (Darling 2009)

2. See David Cameron's speech on 8 September (Cameron 2009a)

The current government set out its plan for deficit reduction in the April 2009 Budget. Its medium-term projection sees the fiscal deficit being cut from £175 billion (12.5 per cent of GDP) in 2009–10 to £97 billion (5.5 per cent) in 2013–14[3]. However, it does not plan any significant reduction in 2010–11, for fear of derailing an economic recovery that would only be in its first year.

The Government's plan has been criticised by David Cameron and George Osborne, who have made it clear that a Conservative government would cut the deficit more quickly and more aggressively. In his response to the Budget, for example, David Cameron said, '… the Budget still does not do enough to get the public finances under control. In two words, it is completely inadequate' (Cameron 2009b). The Conservatives have yet to specify exactly what they regard as an 'adequate' deficit reduction plan but, given the language they have used to criticise the Government's plans, they would surely target lower deficits than those set out in the Budget in every year from 2010–11 to 2013–14. Rather than £97 billion (5.5 per cent of GDP) in 2013–14, they might aim for a deficit of around £50 billion, or 3 per cent of GDP (though this would imply a reduction in the deficit equivalent to 9.5 per cent of GDP in the space of just four years – something never achieved before in the UK).

The different approaches of the two main parties to the speed of deficit reduction reflect one of longest-standing debates in economics. The Labour approach is backed by economists who believe that fiscal policy should be used to support the economy because monetary policy is proving ineffective; the Conservative approach by economists who believe that higher deficits lead to higher interest rates, which 'crowd out' activity in the private sector. Winners of the Nobel Prize for Economics can be found in both camps and this is a debate that will continue long after the present crisis is over.

However, cutting the deficit more quickly than planned in the 2009 Budget does appear to be risky. The planned reduction over the four years between 2009–10 and 2013–14 is already equivalent to 7 per cent of GDP, identical to the reduction in the deficit between 1993–94 and 1997–98 (from 7.7 to 0.7 per cent of GDP). But this was achieved during a period of strong economic growth when consumer and investment booms were fuelled by rising household and corporate debt. Growth over the next few years is likely to be weaker, making deficit reduction that much harder. What is more, official interest rates are already at just 0.5 per cent and the Bank of England has embarked on the uncertain policy of 'quantitative easing'. The scope to provide a further monetary stimulus to the economy if it weakens as a result of a tighter fiscal policy is extremely limited. If the deficit is reduced too soon or too fast, economic growth could be highly anaemic over the next few years, and insufficient to bring about a reduction in unemployment.

Tax increases

The second decision facing the next government is the combination of tax increases and spending cuts that will be used to reduce the deficit. Here the gap between the two main parties is, perhaps surprisingly, smaller. Both seem to have opted for modest tax increases, with spending cuts taking most of the burden.

The current government has already announced a series of measures to increase revenues from tax and National Insurance contributions (NICs)[4]. These measures, and the economic recovery, are projected to lift tax revenues from 33.0 per cent of GDP in 2009–10 to 35.3 per cent in 2013–14, within 1 percentage point of their recent peak value, relative to GDP.

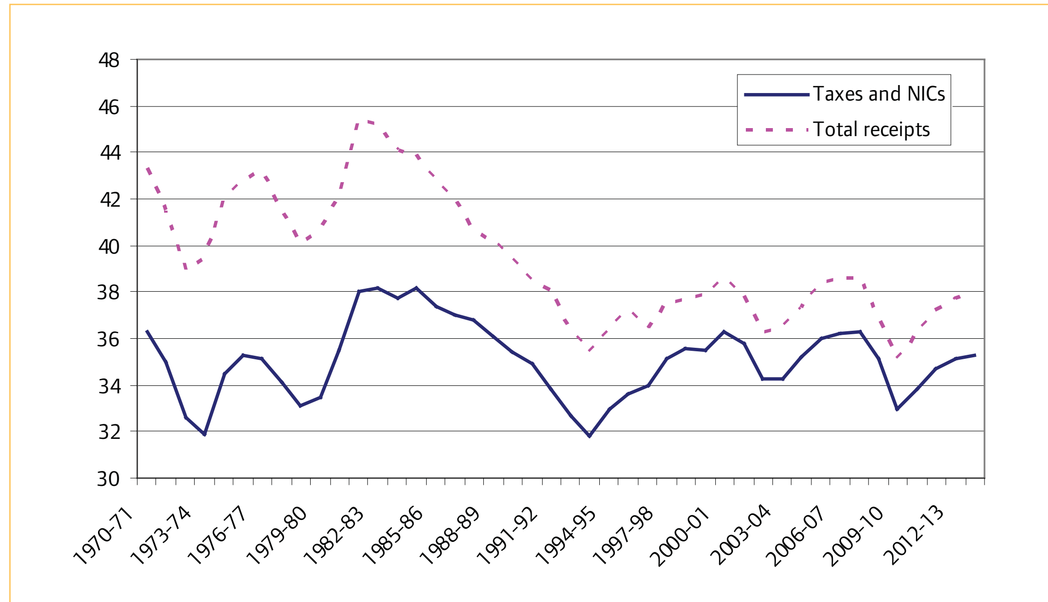
There is, however, scope for taxes to be increased further. In the early 1980s, when the Conservative government aggressively cut the fiscal deficit, it increased tax revenues to a record 38 per cent of GDP. It had the advantage of high inflation, which meant that one way

3. A further reduction is envisaged for later years to bring the cyclically-adjusted current budget into balance by 2017–18. See HM Treasury, Budget 2009 (p.19)

4. These include increases in employee and employer national insurance contributions from 2011–12 and an additional tax rate of 50 per cent on income above £150,000 from 2010–11.

Figure 2.2. Government receipts (% of GDP)

Source: HM Treasury, Budget 2009



it could increase taxes in a 'hidden' way was by freezing income tax allowances and allowing revenues to go up as large wage increases lifted people into the tax system and higher tax brackets (they repeated this trick in the 1990s). Extremely low inflation means this option is not available now. Tax increases will have to be more explicit.

The political parties will be reluctant to specify any particular increases ahead of the election, but there are several options that they could consider after it. A re-elected Labour government, for example, might attempt a major clampdown on tax avoidance, which the Tax Justice Network suggests costs £25 billion in lost corporate and personal tax revenues every year (Christensen 2009), while the Conservatives are reported to be considering an increase in the main rate of VAT to 20 per cent, which would raise an additional £12 billion in revenues (HM Treasury 2008). Both parties could increase 'green taxes. For example, the introduction of a carbon tax of £25 per tonne of CO_2 would raise revenues of £3.5 billion.

However, both an increase in VAT and a carbon tax would be regressive, hitting low-income families disproportionately hard. This would not be a just way to close the deficit. If taxes on individuals have to increase, the fairest approach would be to increase income tax rates (and the radical option to abolish the upper earnings limit on National Insurance contributions). But after three decades of cutting income tax rates, it seems none of the main political parties are prepared to make this case (though the planned introduction of a 50 per cent rate for those on very high incomes is likely to survive, whoever wins the next election). Hence, the political consensus is that public spending will have to be cut.

Spending cuts

The Budget forecasts total government spending (current and capital expenditure) of £671 billion in 2009–10, equivalent to 47.5 per cent of GDP, rising to 48.1 per cent of GDP in 2010–11, before coming down to 43.4 per cent of GDP by 2013–14. In real terms (that is, after allowing for inflation) total spending is projected to contract by 0.1 per cent a year between 2010–11 and 2013–14[5].

This is not unprecedented. There were comparable periods of little to no growth in public spending in the 1970s, the late 80s and in the late 90s. The difference is that in the late 80s and late 90s the economy was growing rapidly, so spending in areas such as out-of-work benefits was falling. The opposite will be true in the next few years, making spending restraint that much harder. The headline numbers mask the full scale of the challenge. First,

5. Real current spending increases by 0.7 per cent a year, while real capital spending contracts by 9.3 per cent a year.

Figure 2.3. Real growth in total managed expenditure (%)

Source: HM Treasury, Budget 2009 and author's calculations

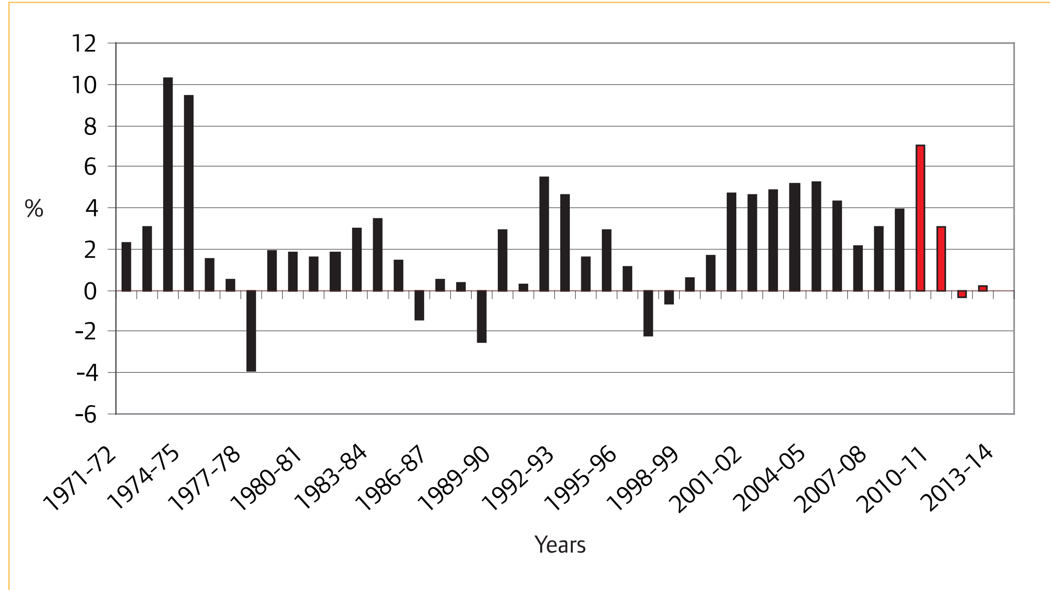
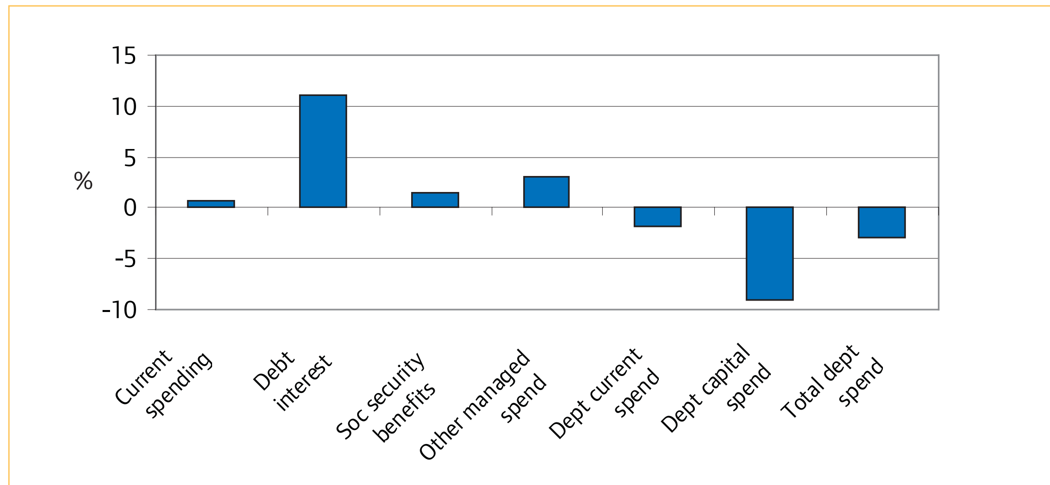


Figure 2.4. Annual change in real spending, 2010–11 to 2013–14 (%)

Source: HM Treasury, Budget 2009 and author's calculations



over the next few years debt interest payments will grow rapidly as a result of the rise in government debt caused by large fiscal deficits.[6] Second, there will be significant increases in spending on social security benefit payments (unless entitlements are changed).[7] As a result, there will be a significant squeeze on departmental spending. The Budget plans are consistent with a contraction in total departmental spending between 2010–11 and 2013–14 of 9 per cent in real terms. Current spending could fall by 6 per cent and capital spending by 25 per cent.

The Budget contains detailed spending plans only up to 2010–11, so the tough decisions about exactly how spending will be cut have yet to be made. However, senior figures in the Labour Government have suggested that health and children, schools and families, will be protected from real cuts in spending. This increases the scale of the cuts required by other departments.

Even if this protection only extends to current spending (the Government could argue that there is less need now to build schools and hospitals after the investment in recent years), the Budget projections suggest that spending by other departments will have to contract by 12 per cent in real terms between 2010–11 and 2013–14. This cannot be achieved by efficiency savings alone. A re-elected Labour Government would also have to consider major

6. The Budget projects a rise in net debt from £792 billion in 2009–10 to £1370 billion by 2013–14. Leaked HM Treasury figures suggest gross interest payments might increase from £27 billion in 2009–10 to £64 billion in 2013–14.

7. Leaked HM Treasury figures project an increase from £166 billion in 2009–10 to £193 billion in 2013–14.

cutbacks in some programmes, including defence, where the Trident upgrade and future naval procurement would appear to be vulnerable.

The problem facing a Conservative Government that wanted to target a lower fiscal deficit in 2013–14 would be even greater (assuming for now that it would not increase tax revenues above the Budget projection). It would have to make even deeper public spending cuts than those implied by the Budget projections.[8] If, for example, it wanted to target a fiscal deficit of £50 billion in 2013–14, and did not cut social security spending, it would have to cut real department spending by almost 20 per cent between 2010–11 and 2013–14. And if real current spending on health and international development – the two departments the Conservatives have said they will spare from real cuts – is maintained at its 2010–11 level, real spending by all other departments, including defence and schools, will have to be cut by 25 per cent on average.

This is not going to be achieved just by closing down quangos and tackling public sector pay and pensions; indeed it may be impossible to achieve at all. This suggests a Conservative Government would be forced to look at further tax increases (above those already proposed by the present government), increased user charges, cuts in social security benefits and tax credits, as well as substantial cuts in some government departments' budgets.

The scale of the fiscal challenge is so great that, whoever wins the next election, it will be time to look again at the role of the state: to ask where it is most effective and should be involved; to identify areas from which it might withdraw; and to debate which parts of society should bear the inevitable pain of deficit reduction. Tough decisions will be required which will shape the future of this country for the next decade. The electorate should be told before the next election how the major political parties will approach these decisions.

Cameron D (2009a) 'Cutting the Cost of Politics', speech by David Cameron, 8 September, available at www.conservatives.com/News/Speeches/2009/09/David_Cameron_Cutting_the_Cost_of_Politics.aspx?Cameron=true

Cameron D (2009b) Hansard, 22 April, Column 252, available at www.publications.parliament.uk/pa/cm200809/cmhansrd/cm090422/debtext/90422-0006.htm

Christensen J (2009) *Our taxes, our lives – Britain's failed tax consensus*, Tax Justice Network, available at www.taxjustice.net/cms/upload/pdf/Our_taxes_our_lives_14_JUL_2009.pdf

Darling A (2009) Speech by the Chancellor of the Exchequer, the Rt Hon Alistair Darling MP, at the Callaghan Lecture, Cardiff, 8 September, available at www.hm-treasury.gov.uk/press_79_09.htm

HM Treasury (2008) *Tax Ready Reckoner and Tax Reliefs*, London: HM Treasury, available at www.hm-treasury.gov.uk/d/pbr08_taxreadyreckoner_287.pdf

8. As a rule, for every extra 1 per cent of GDP the fiscal deficit is lower in 2013–14, an additional 2.25 per cent cut in total spending in 2013–14 is required, and an extra 4 per cent cut in departmental spending.

3. How can we meet the fiscal costs of an ageing population?

John Hawksworth

The recent public debate has focused on the medium-term challenge of getting UK public debt back under control[1], but there is also a longer-term challenge of meeting the potential costs to the taxpayer of an ageing population.

In parallel with the March 2008 Budget, the Treasury published its latest report on the long-term outlook for the public finances to 2057/58 (the next report is due later in 2009). The report highlighted that, based on a continuation of current and firmly announced future policies (for example, for state pensions), a significant increase is likely in age-related spending on health, long-term care and pensions as a share of national income (see Table 3.1).

The Treasury argued that this would be offset, in part, by a gradual decline in other spending (particularly price-indexed social security benefits other than pensions). Nonetheless, the Treasury projections still implied that total public spending, excluding debt interest payments, might rise from 40.5 per cent of GDP in 2007/08 to around 44.5 per cent of GDP in 2057/58. This increase of 4 percentage points of GDP in public spending would be equivalent to around £58 billion at 2009 GDP values.

Table 3.1: HM Treasury long-term public spending projections at March 2008, % of GDP

Years	2007/08	2017/18	2027/28	2037/38	2047/48	2057/58
Health*	7.4	7.9	8.6	9.2	9.6	9.9
Long-term care**	1.2	1.2	1.4	1.7	1.8	2.0
State pensions***	4.9	5.1	5.6	6.3	6.3	7.2
Education	5.0	5.6	5.8	5.6	5.5	5.6
Public service pensions	1.5	1.8	2.0	1.9	1.8	1.8
Total age-related spending	20.1	21.7	23.4	24.7	25.0	26.6
Other spending	20.4	19.1	18.9	18.6	18.1	18.0
Total spending (exc. debt interest)	40.5	40.8	42.3	43.3	43.1	44.5

*Gross NHS spending; **Excluding long-term care provided through the NHS; ***Defined as the sum of spending on the Basic State Pension, State Second Pension, Pension Credit, Winter Fuel Payments, Over-75 TV licences and Christmas Bonus

Source: HM Treasury 2008 (Table 4.1)

Pressures on spending

There are, of course, a great many uncertainties surrounding such long-term projections. However, these uncertainties are not a reason to dismiss the potential challenge of rising age-related spending as there are good reasons to believe that the estimates in Table 3.1 could, if anything, prove to be too low:

- As the Treasury's 2008 long-term public finance report acknowledges, it does not take into account non-demographic factors that could have a significant upward impact on health spending in the long term, such as rising obesity and the strong past trend for demand for health services to rise more than proportionately with incomes. Analysis by the Organisation for Economic Cooperation and Development (OECD), for example, suggests that these non-demographic factors could add significantly more to health spending over the period to 2050 than the pure effects of ageing (OECD 2006)[2].

1. See, for example, PwC Public Sector Research Centre (2009), which draws on the key findings from Hawksworth (2009).

2. That study projects increases in age-related public spending of around 7.2 per cent of GDP for the UK between 2005 and 2050 (including health, long-term care and pensions).

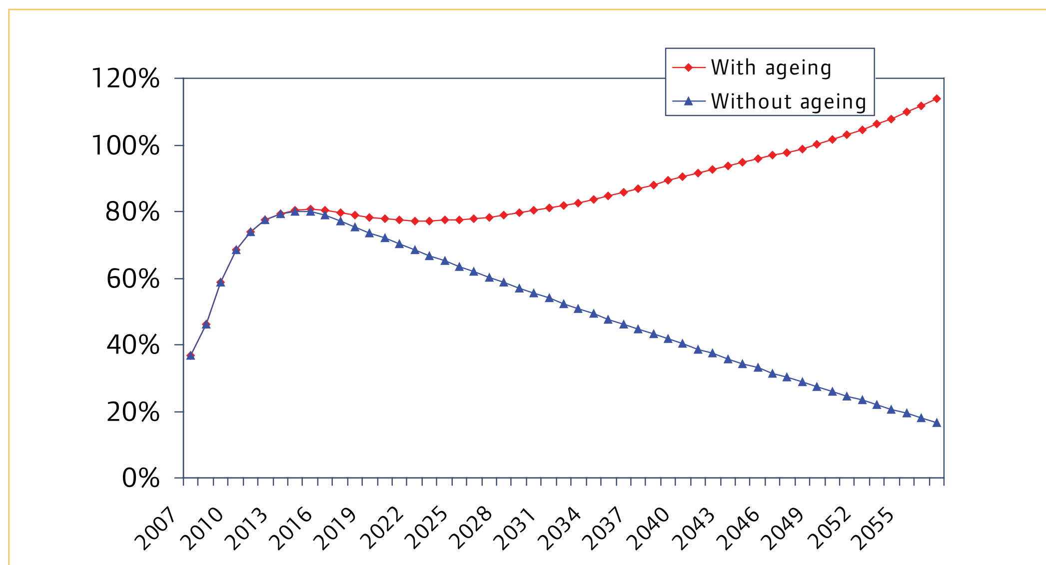
- Following the Pension Commission report in 2006, the UK government has put in place a long-term pension reform settlement that is intended to be lasting, including a gradual increase in state pension age to 68 by 2046, with further increases thereafter in line with rising life expectancy. The effects of this higher state pension age and related rises in participation rates by older workers are already factored into the Treasury projections, so going much beyond this will not be easy (although it may well prove necessary as an alternative to further large tax rises, as discussed below).
- As the median age of the voting population increases, the political pressure for additional age-related spending, over and above that implied by current policies, seems likely to increase in future decades.
- There are areas such as international aid, measures aimed at child poverty reduction, childcare, transport infrastructure development and social housing where the pressures are for rising spending as a share of GDP in order to meet long-term policy objectives.
- Ongoing government efforts to improve public sector productivity through initiatives such as the Operational Efficiency Programme and the Public Value Programme are important and need to be embedded in a strong public sector culture of continuous performance improvement backed by ministers and top civil servants. It is likely, however, that such efficiency improvements are implicitly already built into current government spending projections to a significant degree.

Even if the possible downward bias to Treasury spending projections in areas like health is discounted, however, the fact that the projections are uncertain only adds to the arguments for starting to make provision for these potential costs earlier rather than later. Indeed, making such provisions could be seen in part as offering an insurance policy against these uncertainties. If spending does not rise as far as projected, some of these insurance 'premiums' could be returned to future taxpayers or used to pay more generous pensions or to fund additional NHS spending. But if spending rises further than expected and no such insurance has been taken out, then very large tax increases might need to be imposed on future generations of workers, with potentially much more damaging economic consequences than if earlier provision had been made.

As illustrated by the upper line in Figure 3.1 below, which includes the fiscal costs of ageing but assumes no further policy action beyond current plans, delay in addressing the challenge of ageing could lead to an unsustainable upward spiral in UK public debt in the longer term.

Figure 3.1. Alternative scenarios for public sector net debt using Treasury projections with and without costs of ageing

Source: PwC projections using Treasury data



Need for fiscal tightening

To avoid such an outcome, a further significant fiscal tightening (through higher taxes or lower public spending than the Treasury projects) will be needed in the long run – over and above the measures needed to halt the rise in public debt between now and 2017/18. We have, therefore, developed a model that updates the Treasury's long-term projections from March 2008 to allow for subsequent events and the new medium-term Treasury fiscal projections up to 2017/18, as set out in the April 2009 Budget Red Book. This allows us to investigate different options for meeting alternative public debt reduction targets given these future costs of ageing (this model was also used to generate the debt scenarios shown in Figure 3.1).

As summarised in Table 3.2, our analysis suggests that, depending on the particular debt target and timescale adopted, an additional fiscal tightening by 2017/18 of the order of 1.7 to 3.0 per cent of GDP would be needed to cover the costs of ageing. This translates into around £25 to 43 billion per annum at 2009 GDP values or around £1,000 to £1,700 on average per household. This is over and above the cumulative discretionary fiscal tightening equivalent to 6.3 per cent of GDP already set out in the 2008 Pre-Budget Report and the 2009 Budget in order to return the current budget to balance by 2017/18, which is the Treasury's new medium-term operating rule.

Table 3.2: Estimated additional fiscal tightening needed by 2017/18 to meet alternative public sector net debt targets

Additional fiscal tightening needed	% of GDP	£ billion per annum at 2009 GDP values	£ per annum per household (at 2009 values)
Reduce debt to 50% GDP by 2047/48	1.7	25	1,000
Reduce debt to 40% GDP by 2047/48	2.0	29	1,150
Reduce debt to 40% GDP by 2030/31	3.0	43	1,700

Source: PwC analysis based on HM Treasury projections
Note: Final column based on Office for National Statistics estimate that there are around 25 million households in the UK. Cash figures are all expressed at 2009 GDP values. Final column is rounded to avoid spurious accuracy.

Table 3.2 assumes that the additional fiscal adjustment to cover the longer-term costs of ageing occurs no later than 2017/18. The longer this adjustment is postponed beyond this date, the larger it will need to be. The scale of the fiscal adjustment could be reduced if working lives and state pension ages were increased more rapidly than current government policy and Treasury projections assume[3], but whether the majority of voters would prefer working longer in return for paying somewhat lower taxes remains to be seen.

It is clear, therefore, that meeting the long-term costs of ageing in the UK will require a significant further fiscal squeeze in the medium to long run, as well as a reassessment of key aspects of policy on state pensions and extending working lives.

This inevitability reinforces the case for taking firm action to reduce the budget deficit to more manageable levels as soon as the recession is safely over, so as to get the public finances back in reasonable shape by the middle of the next decade prior to having to face up to the next fiscal challenge: that of an ageing population.

3. National Institute estimates (Barrell *et al* 2009) suggest that a one-year increase in working lives could reduce the budget deficit by around 1 per cent of GDP after 10 years, which if maintained would reduce public debt by around 20 per cent of GDP after 30 years.

Barrell R, Hurst I and Kirby S (2009) *How to Pay for the Crisis or Macroeconomic implications of pension reform* London: National Institute of Economic and Social Research, May, available at www.niesr.ac.uk/pdf/EWLfin.pdf

Hawksworth J (2009) *With public debt rising so high, how can we meet the fiscal costs of an ageing population?* London: PricewaterhouseCoopers LLP

HM Treasury (2008) *Long-term public finance report: an analysis of fiscal sustainability,* March, available at www.hm-treasury.gov.uk/bud_bud08_longterm.htm

Organisation for Economic Cooperation and Development (OECD) (2006) 'Projecting OECD Health and Long-term Care Expenditures: What are the Main Drivers?', *OECD Economics Department Working Papers*, No. 477, Paris: OECD

PwC Public Sector Research Centre (2009) *Dealing with debt: Reforming public services and narrowing the fiscal gap* London: PwC Public Sector Research Centre, available at www.pwc.co.uk/pdf/dealing_with_debt.pdf

4. Welfare spending – Time to reasess universal benefits?

Kayte Lawton and Kate Stanley

In the face of oncoming austerity, no public spending can simply continue without scrutiny. All spending must be subject to robust tests of providing public value, meeting a demonstrable need and contributing to progressive goals. This must include spending on welfare benefits. We cannot simply assume that, because welfare is an intrinsic part of the progressive vision of a society that supports those who are worst off, the current system should remain untouched. Welfare must also be subject to tests of public value.

Difficult political decisions will have to be made – and it does not get much tougher than making changes to benefits for the young and the old that will create losers – but government might have to go there. In this chapter we examine some of the options.

Universal benefits for children

The state provides income and services to support families in raising their children but here we focus on the big-ticket income transfer: Child Benefit.

Child Benefit is the sacred cow of the welfare system. It has very high take-up rates and passionate support across the political spectrum. It is also a very effective vehicle for reducing child poverty, simple to administer and easy to understand. But it does have limitations and the time has come time to look at all the options in harnessing the power of Child Benefit to reach the poorest children.

The primary reason for reforming Child Benefit is that, as a universal benefit, it is very poorly targeted and expensive to increase. In 2008/09 Child Benefit cost £11.3 billion, making it one of the most costly benefits for government.

The structure of Child Benefit also generates inequality between large and small families by paying a lower rate for second and subsequent children. From January 2009, the Child Benefit rate for the eldest or only child was £20 a week, compared with £13.20 for each additional child. Poverty is concentrated in larger families so this is a major challenge (Department for Work and Pensions 2009). In addressing this structural problem, by raising the rate of Child Benefit for second and subsequent children to the rate paid for first children and so lifting a significant number of children out of poverty, we would add significantly to the Child Benefit bill.

Many campaigners and supporters argue that any changes to Child Benefit (except rate increases) are undesirable because the benefit is an effective way of getting money to poor families and any meddling could be the first step on a slippery slope to eventual denigration. However, there is cross-party support for a universal Child Benefit as a principle and it is difficult to imagine any party wanting to pick this particular fight. It is perfectly possible to argue that reforming Child Benefit now, at this time of austerity, will in fact protect it for generations to come.

One very important argument made by supporters of the status quo is that universal benefits – of which Child Benefit is the most significant – are crucial in ensuring support for the welfare system as a whole, especially among the better off (White 2003). This is certainly a serious consideration. However, new polling data for ippr suggests that straightforward universalism might not be as necessary to achieving this collective spirit as is often argued. In a poll we commissioned in September 2009 of over 1,000 people in marginal electoral constituencies, 45 per cent of people said they would be more likely to vote for a party that pledged that future increases in Child Benefit would only go to lower income families. 20 per cent of those polled said they would be less likely to vote for such a party. The remaining one third either did not know or said it would not make any difference to their voting decision[1].

1. Polling conducted by Brand Democracy on behalf of ippr. Brand Democracy polled 1,042 adults between 16 and 18 September 2009.

So what are the options for reforms that would provide public value, meet needs and support progressive goals? In other words, how do we get greater bang for the taxpayer's buck? The priority must be to ensure that more money gets to lower income families especially when unemployment is rising, and with it the rate of child poverty.

One option would be to tax Child Benefit and use the additional revenue to increase the rate of Benefit paid to second and subsequent children. Taxation is preferable to means-testing as a way of redistributing resources because the effect on take-up would be minimised. Means-tested benefits tend to suffer from relatively low take-up rates.

However, the effect of taxing Child Benefit worth £20 a week would be reduce the net value of the benefit to £16 a week for basic rate taxpayers. Families with more than two children would benefit overall because they would receive a higher level of benefit for the second and subsequent children. But families with one or two children would lose out overall. We therefore propose raising the rate of Child Benefit paid for all children to £22 a week. This would mean that basic-rate taxpaying families with two children gain overall. Table 4.1 shows the net weekly value of Child Benefit if it were paid at a rate of £22 a week and taxed.

Table 4.1: The net value Child Benefit would have per week if it were increased to £22 and taxed

Gross annual income of highest earner in a family	Scenario – under:	Net value of Child Benefit per week			
		One child	Two children	Three children	Four children
Less than £6,475	current arrangements	£20	£33.20	£46.40	£59.60
	ippr proposals	£22	£44	£66	£88
£6,475 - £37,400	current arrangements	£20	£33.20	£46.40	£59.60
	ippr proposals	£17.60	£35.20	£52.80	£70.40
Over £37,400	current arrangements	£20	£33.20	£46.40	£59.60
	ippr proposals	£13.20	£26.40	£39.60	£52.80

Further resources could be made available if eligibility to Child Benefit were removed for children aged 16 or over in higher income families. This would ensure that low-income families continued to receive financial support for children over 16 in full-time education and training. In the long term, Child Benefit for over-16s in education or training could be combined with the Educational Maintenance Allowance to provide a streamlined system of financial support for young people from low-income families participating in post-16 education and training.

Elsewhere, we have argued that entitlement to Child Tax Credit (CTC) should be removed from families who are only eligible for the Family Element of CTC (Cooke and Lawton 2008). This is currently worth £10.48 a week and is paid to all families with children with a household income up to £50,000, meaning that nine out of 10 families are in receipt of CTC. Modelling by the Institute for Fiscal Studies has shown that tapering the family element of CTC to a rate of 39 per cent as soon as a family's income makes them no longer entitled to the child element of CTC would save about £1.35 billion (Brewer et al 2008). This change would affect about 2 million families and would mean that families with an income of about £27,500 or more would no longer be eligible for tax credits.

Using the ippr tax/benefit calculator we have modelled a package of reforms to Child Benefit which includes the following measures:

- Increasing the rate of Child Benefit paid to all children to £22 a week
- Taxing Child Benefit based on the income of the highest earner in a family
- Removing entitlement to Child Benefit from young people aged 16 or over where household income is over £25,000.

We estimate that this package would remove 350,000 children from poverty, making a significant contribution to the goal of eradicating child poverty. The net cost would be approximately £770 million. However, if we add in the savings generated by the changes to entitlement to CTC for higher income families, as set out above, overall savings of approximately £600 million could be achieved. These measures combined would redirect limited resources to where they are most needed and generate significant savings for the public purse.

An alternative option would be to use the revenue raised from taxing Child Benefit to increase the Child Element of CTCs, instead of increasing the rate of Child Benefit paid to additional children. However, there is a strong argument for increasing the level of Child Benefit paid to additional children on the grounds of fairness and also because it helps to tackle the concentration of child poverty in large families.

In the long term, a more comprehensive option would be to combine Child Benefit and the Child Tax Credit into a single progressive universal children's entitlement. This could involve a universal 'floor' (through Child Benefit) with a means test (through the CTC). Child Benefit would boost the Family Element of the CTC and raise the level of CTC across the board. This would have the advantage of creating a single entitlement within a strongly progressively universal framework. However, it would also pose some significant administrative challenges and costs. Integrating the two systems would also be a major challenge.

Universal benefits for older people

There are a range of universal benefits available to older people of which the Basic State Pension is by far the most significant. We look at this very briefly here and then turn, briefly also, to Winter Fuel Payments.

Pensions

The Government already has plans to gradually raise the state pension age to 68 for all by 2046. The Conservatives have proposed bringing forward this rise, increasing the state pension age for men to 66 by 2016. But they promise not to start increasing the state pension age for women until at least 2020, as per current government plans (Osborne 2009).

It seems sensible that current plans for raising the pension age should be brought forward and/or it should be increased by more than planned, given increases in healthy life expectancy (Brooks et al 2002). The savings such a policy would generate would not be realised for many years; however, this does not mean they are any less important to do now. Elsewhere in this volume, John Hawksworth has argued that demographic pressures mean spending restraint will have to extend well into the future; we agree that we need to consider policies today that will limit spending only after a long lead-in time.

Winter Fuel Payments

Everyone over the age of 60 is entitled to Winter Fuel Payments (WFPs), which are designed to boost the incomes of older people and also form one element of the Government's fuel poverty strategy. Payments range from £125 to £400 a year, depending on age, living arrangements and entitlement to other benefits, but everyone over 60 gets something – even if they are in work or on high incomes. WFPs cost the Government £2.7 billion in 2008/09.

As a fuel poverty[2] measure, WFPs are very poorly targeted with just 12 per cent of recipients thought to be fuel-poor. However, many would argue that WFPs are not in fact a measure to reduce fuel poverty specifically but are merely a way of increasing the incomes of pensioners using a non-means-tested mechanism. The universal entitlement to, and automatic payment

2. The Government defines fuel poverty as occurring when a household would have to spend more than 10 per cent of its income on all household fuel in order to maintain an adequate level of warmth in the home. This is defined as 21 degrees Celsius in the living room and 18 degrees Celsius in other occupied rooms (EFRA Select Committee 2009).

of, WFPs means that take-up is very high and they are received by those pensioners on very low incomes who fail to claim their entitlement to Pension Credit.

Although they may benefit some, it is clear that WFPs represent significant and poorly targeted expenditure, and are therefore in need of reform in the current context. The Environment, Food and Rural Affairs Select Committee (2009) has recommended taxing WFPs for basic-rate taxpayers and ending entitlement altogether for higher-rate taxpayers. These measures combined would save £250 million a year, about 10 per cent of current spending on WFPs, and should be seen as a first step towards reducing expenditure on this benefit.

Entitlement to the payments should be removed from people aged 60 to 64 as the state pension age for women rises to 65 in 2020. More broadly, a major, well-targeted programme of domestic energy efficiency improvements would be a more sustainable way of reducing fuel poverty (and tackling climate change) and may mean that the level and entitlement to WFP could be revisited in future.

Conclusion

In the challenging times ahead, progressives must be prepared to take on our own assumptions about the untouchable quality of certain welfare policies. We have only been able to very briefly sketch out a rationale for reform and some possibilities for how reforms might be designed. But we believe the case for change is strong, if not straightforward. A bold government could implement reforms that would improve the power of policies such as Child Benefit, the Basic State Pension and Winter Fuel Payments to contribute to tackling poverty and inequality, while also reducing their cost.

Brewer M, Browne J and Phillips D (2008) *Options for Tax Credit Reform* London: Institute for Fiscal Studies, available at www.barnardos.org.uk/barnados_options_for_tax_credit_reform_2.pdf

Brooks R, Regan S and Robinson P (2002) *A New Contract for Retirement* London: ippr

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5. The NHS – Can better care deliver better value?

Liz Kendall

As the debate rages about when and where the Government spending axe should fall, other public services must look on the National Health Service with envy. Labour and the Conservatives both declare they are the real Party of the NHS. To prove the point, each commits to continued real term increases in NHS funding, albeit at a much slower rate than recent years.

Yet to think that the NHS is somehow safe from the public spending squeeze would be wrong. The ageing population, the increase in chronic and 'lifestyle' conditions like heart disease and obesity, rising fertility rates (particularly among older women) and the likely negative effects of the recession, especially for the nation's mental health, will drive major increases in demand for healthcare in the foreseeable future.

It does not stop there. Health prices tend to rise faster than those in the wider economy. New drugs and health technologies account for an annual average 0.5 per cent increase in the NHS budget. NHS Trusts will also need to fund the 0.5 per cent increase in employer National Insurance contributions for 1.3 million staff from 2011/12 on top of the £420 million of inflationary pressures built into the NHS pay system. A squeeze on social services budgets will further increase pressure, since less support to keep older people healthy and living independently is likely to lead to more serious health problems developing, fuelling even greater demand for the NHS.

Principles for reform

These pressures mean the NHS needs to make at least £20 billion of savings over the three years from 2011, just to stand still (Appleby *et al* 2009). Politicians need to be honest about the scale of this challenge. They also need a clear set of principles to guide decisions about how the problem will be addressed.

The first principle must be to maintain the founding commitment of the NHS: that healthcare should be free at the point of use, according to patients' needs, not their ability to pay. International comparisons consistently show the NHS is one of the fairest, most cost-efficient health systems in the world.

The second principle should be to protect, and wherever possible seek to improve, services for those in greatest need. Despite its overall fairness, the 'inverse care law' – where patients with the greatest health needs also have the worse access to services – still bedevils the NHS and must be tackled in the years ahead.

Third, the NHS should shift its focus towards prevention and early intervention in order to avoid building up problems for the future. The Wanless Report (2004) rightly argues that this is one of the keys to containing healthcare costs in the long term.

Fourth, the NHS should seek to give patients greater say and greater control over their care. Evidence from initiatives such as personal budgets and the Expert Patient Programme shows this can improve patients' outcomes and reduce service use and the overall costs of care.

Finally, reforms should involve and engage patients, the public and staff. This will lead to better decisions about NHS services, and more support for change. This can only be achieved locally: a service as large and complex as the NHS cannot be micro-managed in Westminster and Whitehall.

Learning from past experience is vital (NHS Confederation 2009). A strategy based on letting waiting lists grow will not significantly reduce costs; it will only produce a one-off saving and there will also be significant additional costs involved in managing long waiting lists. Long

waiting lists also undermine support for the founding principles of the NHS and build up problems for the future because patients' health worsens as their treatment is delayed. In addition, better-off patients can jump the queue by paying to go private, leaving the poorest and most disadvantaged patients to suffer.

Restructuring the NHS – removing regional health authorities or merging Primary Care Trusts – may seem like a tempting option. But previous re-organisations have produced smaller savings and benefits than originally predicted. The costs – and opportunity costs – also tend to be greater. Anyone who has worked in the NHS knows that restructuring tends to distract people from the real business of reforming care.

Some commentators have called for co-payments to be introduced, for example charging people to visit their GP. They argue that prescription charges and payments for dentistry have been accepted without undermining the founding principles of the NHS and that the poorest could be protected by excluding them from paying.

Even if those on low incomes are excluded, evidence from other countries suggests modest co-payments can be expensive to administer and have little or no long-term impact on rates of service use. Charges that are set high enough to affect behaviour either result in patients accessing services when their health has worsened (thereby increasing treatment costs) or avoiding primary health care altogether, turning to more expensive emergency services instead.

Less but more effective inspection and regulation, further 'back office' savings, and more intensive use of NHS buildings and equipment (which are still too often restricted to a nine-to-five working week) can help.

One-off pay freezes will also make a contribution, but are far from the panacea politicians seem to suggest. Better results could be achieved by considering pay and pensions as a total reward package for staff. However, this must be addressed across the public sector, which will take time.

More radical changes to NHS services are now urgently required. Frontline services should be protected, but they cannot be set in aspic. The good news is that there is a growing body of evidence that suggests a relentless focus on improving the quality of healthcare can also transform its efficiency. Achieving this means some services will need to be specialised in regional centres. However, the bigger challenge is shifting more services out of hospitals and into the community, towards prevention and early intervention.

Improving emergency care

One example where major improvements and savings could be made is in urgent and emergency care. Despite considerable improvements in the last 10 years, patients still find accessing these services complex and confusing, particularly out of hours. They often don't know which number to call – 999, NHS Direct or the GP – or which services are available in their area, other than their local Accident & Emergency.

At the same time, demand for urgent and emergency services is increasing. For example, the number of 999 calls is growing by an average of 6.5 per cent (or 300,000 more patients) a year. Spending on ambulance services accounts for around 1.5 per cent of the NHS budget, but the decisions taken by ambulance staff can lead to around 20 per cent of total healthcare costs. The number of journeys to hospital is coming down, but taking patients to A&E is still too often the only option.

Demand for ambulance services is greater, and rising faster, in deprived areas. Four patient groups account for three quarters of the increase in demand since 2000/01: those who have suffered falls (one in ten calls to 999 is for an older person who has fallen), breathing problems, chest pains and people who are unconscious or have passed out (often related to alcohol). Many of these patients could be better cared for in the community or at home, or

prevented from requiring help in the first place through better management of their conditions.

Incremental improvements in individual services will not deliver the scale of change required. Instead, we need a bold vision for changes across the whole system of emergency and urgent care (Ambulance Service Network 2009). The goal should be to create a simple, seamless point of access to the system with a new three-digit number for urgent care – 111 – to sit alongside 999. Better access must be combined with a range of high quality emergency and urgent care services available around the clock.

We finally have the tools to make this happen. NHS Pathways is a new telephone assessment system that can triage 999, NHS Direct and GP out-of-hours calls consistently and appropriately. It is owned by the NHS and backed by the Royal Colleges and British Medical Association, who are leading its clinical development.

Once assessed, patients should get the most appropriate care for their needs. A major problem in the past has been the lack of information about local urgent and emergency care services including GPs, minor injury and walk-in centres, community nurses, falls teams, pharmacies, mental health and social services, as well as Emergency Departments and ambulance services.

The NHS now has the technology to create a 'real time' directory of local services, showing what is available, where and when. Crucially, this technology matches patients' needs with the skills of staff in each service. This not only means patients will get the best available care but that commissioners will be able to identify gaps in service provision. Preventative healthcare that empower patients with long-term illnesses like heart disease and diabetes to better manage their condition will be a key priority here.

None of this will be easy. Improving service quality and delivering savings of the scale required cannot be done without significantly and permanently shifting care out of hospitals. There will also be big changes for staff, who will need to work at different times, in different ways and in different places to meet patients' needs.

But with leadership and focus, and by working with clinicians and the public, the NHS can deliver better care for patients and better value for money for taxpayers. It should seize this opportunity with relish.

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6. Children – Spending on prevention services

Polly Neate

Whatever we spend on services for our children and young people, we must spend it more wisely. Right now we are paying a high price for failing our most vulnerable children, and there is an acute risk that short-term, recession-driven decision-making will make this worse.

To understand why, we must see what we spend now on children's services as an investment in the future of our society. We have to take both a long-term and short-term view: long-term because the full benefits for communities and society as a whole may not be felt until today's children reach adulthood; short-term because, as parents are all too aware, childhood vanishes quickly and the opportunity to genuinely transform an individual life then dramatically reduces.

Both intuitively and through experience, we know this. The UK government has set ambitious child poverty targets and overseen unprecedented levels of investment in children's services. However, this investment has not been matched by the improvement in outcomes required to turn around the social problems that concern us all. Returns on investment have been relatively low.

Those who work directly with children and young people also know that intervening early before problems become entrenched and severe – particularly for the most vulnerable children growing up in chaotic, complex and marginalised families – is better for children, better for communities, and better for the economy at every level than spending on picking up the pieces.

Yet despite knowing this, we still generate new and costly initiatives to pick up the pieces, and at times of financial pressure we have a record of cutting back even further on preventive early intervention services. When we talk of cuts, it appears less risky politically to cut back on prevention because the effects are delayed. In terms of headlines, it may well be less risky. But we cannot allow the current recession to shift spending even further from where it can be most effective.

We must think in terms of investment rather than spending. And this is not merely a semantic distinction.

The return on investment

In our recent research report *Backing the Future*, Action for Children and the New Economics Foundation proved that a 10-year investment of £191 billion in targeted interventions, such as working with families to keep children out of the care system, or improving parenting skills, will deliver a net return of £269 billion (Aked *et al* 2009). This support for the most vulnerable should be accompanied by an investment of £428 billion in universal childcare and paid parental leave, which will deliver a net return of £606 billion over 20 years and eventually render many of the targeted interventions unnecessary.

These numbers are huge but they must be compared with the £4 trillion cost over 20 years of continuing with the current paradigm under which we continue to pay the costs of what are preventable social problems. And this figure is conservative: we used only the lowest estimates when counting the costs of preventable crises in health (such as teenage pregnancy, substance misuse, mental health problems and obesity), criminal behaviour including violent crime and the rising problems of young people not in education, employment or training and family breakdown.

Furthermore, these are merely the financial returns to the Treasury. Analysing the social return on investment of individual-targeted early intervention services provided by Action for Children has shown that for every £1 invested annually, between £7.60 and £9.20 of social value is generated for individuals, families, communities and other local services.

Despite this evidence, it is of course challenging to recommend extra investment at a time when both headlines and behind-the-scenes conversations are all about cuts: how to safeguard each competing pot of money that is part of the public spending whole. It is particularly challenging given that the savings to be achieved may end up benefiting a different department, either in Whitehall or the town hall, from the one that pays for the investment. But we know that this silo mentality drives inefficiency. This knowledge is what lies behind the launch of the Total Place pilots[1], for example, which take a holistic view across a geographic area of spending and assess where it can most effectively be targeted in order to achieve maximum sustainable benefit.

To support the idea of investing large sums in preventative measures, it may be necessary to find new ways of encouraging investment in the future, because such a shift will be fundamental and require considerable cultural change. Action for Children and the New Economics Foundation have proposed a system of 10-year bonds in order to fund the upfront investment needed to shift to a preventative funding model – upfront because you cannot stop picking up the pieces until preventative early intervention has had a chance to work. The evidence in *Backing the Future* proves that such an investment would be secure. And there is potential to make it work on a local as well as national scale, engaging communities in taking the principles of Total Place one step further.

A shift in objectives

The cultural shift in thinking about how we spend our limited resources must be matched by a shift in the objectives we set for services for children.

The data analysis and economic modelling undertaken for *Backing the Future* were accompanied by detailed service-level case studies, assessments of the social return on investment in services, two citizens' jury events – one involving young people and one involving parents – and reference to a panel of young people and one of experts.

The research into services demonstrated that you cannot deliver well-being to children and families in the way you deliver commodities. For vulnerable children and their families, the path to well-being is one they must tread themselves, with support. Positive outcomes are co-produced by those who need support and those who give it. For families already battling a complex range of problems from ill health to substance misuse to poor school attendance, a financial crisis might be the final straw but recovery will not be achieved by a fiscal response alone. It is about working alongside families for as long as it takes, making apparently simple changes that build confidence and that last. So as well as investing in early intervention, we need to understand what works – and what does not.

The *Backing the Future* study found that those services that generated a significant annual social return on investment had clear common features. They worked intensively and flexibly, spending time on the causes rather than the symptoms of problems. They focused on the wider family as well as the individuals within it who appeared to be causing the most difficulty. And they positioned themselves positively, making themselves accessible and non-stigmatising, engaging families who could then link to more targeted, specialist services as required.

Close analysis of successful services reveals six critical pathways to achieving well-being for children:

1. Link up and link in: build consistent, stable and trusting relationships with children and support them to link with each other and the community.

2. Think family: the well-being of children and that of their families is inextricably linked.

1. Total Place is a government initiative that looks at how a 'whole area' approach to public services can lead to better services at less cost. There are 13 pilot areas participating in the scheme with the aim of redesigning the way public services are planned and delivered.

3. Promote the positive: recognising and rewarding the things that children and young people are good at helps them build inner resources – resilience and self esteem.

4. Encourage action: children and young people are not passive recipients of services but need to see themselves as active citizens with rights and responsibilities.

5. Factor in fun: services will not be accessible to children unless they remember what childhood is about.

6. Recognise children's wider world: peer relationships, experiences of fairness, freedom, choice and other services.

Following these pathways, services have supported children and families to transform their lives. They also recouped the initial investment used to fund them within two to three years. And the state received demonstrable financial returns through increased tax revenue, decreased benefits payments, reduced costs of crime and anti-social behaviour, reduced health costs for children, and savings to the care system and other long-term child care options.

Transforming the legacy

If we continue with our current paradigm, the recession will exacerbate the problems we already have, shattering lives and forcing ever more difficult decisions on how to prioritise where we pick up the pieces first. This is why this time of austerity is a time of opportunity – if we choose to grasp it.

If we fail to make a paradigm shift for cultural reasons – it is just too difficult to look beyond individual government departments, election cycles and headlines calling for more money to be thrown at the symptoms of neglect – it will be to our shame. That sense of shame is felt already by many in the children's services sector because we know from several well-publicised studies just how poor the well-being of our children and young people is compared to those in other developed countries. In fact we lag behind on almost every measure of well-being, but lead the pack when it comes to preventable social problems.

The belief that a child is lucky to live in the UK, with its relative wealth and proud history of public services, has been fundamentally challenged in recent years, despite the increased spending on child care. If we grasp the opportunity offered by the present need to rethink our spending, we can transform the legacy that the current generation of policymakers and service providers will leave behind.

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7. Schools – Off-limits for cuts or not?

Steve Bundred

Governments do not always behave in power as they said they would when they were in opposition. But when Tony Blair told the Labour Party Conference in October 1996, 'Ask me my three main priorities for government and I tell you: education, education and education' this was not just rhetoric. Since the election of New Labour in 1997, only health can claim to have proved a higher priority for government – both in spending terms and in the attention devoted to system reform – though when Blair talked about 'education, education, education' it is now clear that what he really meant was 'schools, schools, schools'.

While university vice-chancellors and heads of further education colleges may continue to gripe about alleged under-funding, school head teachers can credibly make no such claims. Ministers are justifiably proud of the priority they have afforded to schools' spending since 1997, because they have honoured the pledges they made and they have the figures to prove it.

Owing to the commitment to match the outgoing government's spending plans in the first two years of office, it was not until 1999/2000 that schools' spending under Blair and Brown started to take off. When the Conservatives left office, overall revenue expenditure in primary and secondary schools totalled £13.9 billion. But by 2007/08, it had increased by 56 per cent in real terms, to £28.9 billion. These figures relate to local authority maintained schools only. When government-funded academies and city technology colleges are included, the increase is even greater. And because pupil numbers fell over the same period, in terms of funding per pupil the growth in spending equates to a 65 per cent increase in real terms.

The Government has been similarly generous with its capital funding allocations. The *Building Schools for the Future* programme, launched in February 2004, is the largest and most ambitious scheme of its kind anywhere in the world. It was allocated £9.3 billion over the three years 2008/09 to 2010/11 in the last Comprehensive Spending Review and the aim is to see every one of the 3,500 state secondary schools in England rebuilt or remodelled over the lifetime of the programme.

Has the extra money been well spent?

Some of it undoubtedly has. Educational attainment has risen. Legitimate reservations may be expressed in respect of this claim arising, for example, from concerns about examination standards or from a closer look at inequalities in attainment levels. But the fact remains that the 67 per cent of 16 year olds who achieved the equivalent of five or more A* to C grades in GCSE examinations in 2009 comfortably exceeded the Government's target of 60 per cent.

So, as with the health service, the issue is not whether the performance of schools has improved during the Blair and Brown years, but whether the level of improvement has been commensurate with the scale of the additional funding that has helped to make the improvement possible.

This question is especially pertinent to a future in which public finances are being squeezed for all other services. Because if the same improvement could have been achieved with less money, it follows that it must be possible to reduce funding without damaging the attainment prospects for future students. And depending on the scale of any such reduction, attainment levels could continue to improve. In other words, if schools have not been managing their finances well in the recent past, whatever party is elected after the next general election it could continue to give priority to education while realistically expecting head teachers and education authorities to deliver more for less.

Incentives to deliver

In the Audit Commission's report *Valuable Lessons: Improving economy and efficiency in schools*, published in July 2009, we looked at how well schools are delivering value for money from the extra resources they have been given. And we found that the incentives to be economical and efficient are weak.

To begin with, the accountability framework for schools does not emphasise the need to provide value for money. School governing bodies often fail to provide the constructive challenge on financial management that is part of the support they are expected to provide to head teachers and their staff. And although Ofsted (the Office for Standards in Education, Children's Services and Skills) assesses value for money under the leadership and management component of its school inspections, it acknowledges that its judgements have in the past tended to focus more on overall effectiveness than on economy or efficiency. Ofsted plans to give a higher priority to value for money in the future.

In addition, although efficiency savings targets are commonplace throughout the public sector they were only incorporated into schools' funding settlements in 2008/09. Not all schools are aware of the assumed efficiency gain, which has resulted in the growth in school spending this year being less that it would otherwise have been. And there is no requirement for schools to report to anyone on whether greater efficiency is actually being achieved. They are required to undertake a self-evaluation against the Department for Children, Schools and Families' (DSCF) Financial Management Standard in Schools (FMSiS) and compliance with this standard is now mandatory. But the FMSiS focuses on processes rather than the achievement of economy and efficiency. As one head teacher we spoke to put it: 'it's easy to have good documentation for bad decision making'.

The *Valuable Lessons* report was based on substantial data analysis, a literature review and a series of case study visits and interviews. We visited 23 schools in seven council areas and conducted interviews with 60 individuals in schools and 24 officers in councils. We found that because money has been plentiful in recent years, and because the accountability framework within which schools operate does not provide strong incentives for them to ensure that it is well spent, head teachers and school governors often have little knowledge of how their unit costs compare with those of similar sized schools elsewhere.

DCSF encourages schools, through the FMSiS, to benchmark their costs. It provides a national benchmarking website which enables them to do so but only around half of all schools visited this site in the year to July 2008. We also found that there are some weaknesses in the financial information made available to schools by DCSF and by local councils and that in their management of key resources, such as the deployment of staff, schools do not always give full consideration to possible alternative approaches, or understand what the financial implications of these alternatives might be.

Decisions about the deployment of staff are critical to ensuring both value for money and better performance in schools and there have been major changes in recent years in the way in which staff resources are used. Since 1997, teacher numbers in England have grown by 32,000, but there are also 100,000 more teaching assistants and 70,000 more support staff. Over the same period pupil numbers fell by 80,000. No doubt the intention behind these changes has been to drive improved performance by reducing pupil/teacher ratios and freeing up teacher time currently spent on non-teaching tasks. But few school governing bodies have genuinely probed the value for money of these decisions.

In these circumstances, it would be astonishing if savings in schools could not be achieved without damage to the education they provide. And the Commission's report pointed to a number of areas in which this would be possible, based on the experience of those who have so far been active in prioritising value for money in the way in which they manage.

For example, we found that between 1999/2000 and 2007/08 expenditure by schools on goods and services increased from £4.0 billion to £6.8 billion, but there were significant

variations in the costs incurred on individual elements of this, when comparing schools of similar sizes in similar areas. For the items we reviewed, more than 80 per cent of primary and secondary schools were in the upper quartile of per pupil expenditure, relative to their statistical neighbours, for at least one item.

Better run schools are already showing what can be done. One primary school we looked at saved over £133,000, representing just over 2 per cent of its revenue budget, by moving from a council's traded caretaking service to in-house provision. And in aggregate, we estimated on the basis of some conservative assumptions that savings of more than £400 million are possible from improved procurement of goods and services.

Even this figure is small in comparison with the potential saving from the funding that schools have chosen not to spend, but to hold onto instead. School balances increased from £680 million in 1999/2000 to more than £1.76 billion in 2007/08. In real terms this represents an increase of 79 per cent for primary schools and 197 per cent in secondary schools – far more than the real increase in overall funding for schools over the same period. In 2007/08 alone, balances in secondary schools increased in real terms by 22 per cent and in primary schools by 7 per cent.

DCSF guidance suggests that a primary school should hold no more than 8 per cent of its annual income in reserve and a secondary school no more than 5 per cent. But nearly 40 per cent of schools have balances that exceed these suggested maximum levels. Our report made the point that hoarding cash intended for education is poor value for money. And we concluded that more than £500 million of the reserves currently being held by schools should be released.

While schools are sitting on large financial reserves that they apparently do not need it will be difficult to persuade managers of other, more cash-strapped, services that spending cuts are necessary. There are therefore good political reasons, as well as a strong fiscal case, for arguing that schools should not be off-limits when decisions have to be made about where the cuts should occur.

This is not to suggest that the priority attached to education spending over the last decade should be reversed. It argues merely that, for any favoured service, protection from spending cuts must be relative and not absolute.

Governments are entitled to have spending priorities. Indeed it is essential that they do. The priority that has been afforded to education during the Blair and Brown years has delivered real benefits. And in the future, ensuring good education for our young people will continue to be vital to our economic prosperity and general well being.

But the two services that have experienced the biggest increases in funding since 1997, health and education, have in consequence been under the least pressure to deliver value for money. It defies credulity, therefore, to suggest that greater efficiencies cannot be found from these services, or that they are to be found only in back office functions. The work of the Audit Commission has already identified the extent to which savings in schools are possible without damage to education services.

So in an age of austerity, spending in schools must take its place alongside other services as a candidate for reduction. And this is no doubt why even the Schools Secretary, Ed Balls, announced in September 2009 that school budgets might be cut by £2 billion after 2011.

Audit Commission (2009) *Valuable Lessons: Improving economy and efficiency in schools* London: Audit Commission, available at: www.audit-commission.gov.uk/nationalstudies/localgov/Pages/valuablelessons.aspx#downloads

8. Further education – Making smart cuts and improving efficiency

Paul Lawrence

Political leaders have identified the inevitability of cuts in public spending while simultaneously giving assurances of protection for frontline workers in education and health. This chapter argues that in further education (FE) there is considerable scope for cuts alongside improvement in service, with the cuts in some circumstances acting as a catalyst for better practice.

Cuts in funding are measurable by their very nature. Cuts in service, it has been suggested by some college principals, are by no means as measurable, or inevitable. Below I identify three broad areas where 'smart cuts' could be made without fundamental damage to the sector: attitude and behavioural change; efficiency gains; and reorganisations and partnerships.

Potential efficiency gains

There is a strong feeling within the FE sector that there are some efficiency gains there for the taking. During the week commencing 7 September 2009, 20 FE principals were contacted by KPMG for their views on the levels of future funding in the sector. Their unanimous view was that the 'inevitable cuts' would not be confined to quangos or Non-Departmental Public Bodies (NDPBs) (although up to 71 such bodies have a direct link to aspects of FE). The principals had positioned their colleges for cuts of between 5 and 15 per cent in real terms.

If cuts are smart they will be designed to protect most but not all frontline deliverers. The sector's current pay cost benchmark averages 63 per cent (measured as pay cost as a percentage of college income) but would be lower if some colleges did not have such high ratios – up to 75 per cent for some general further education (GFE) colleges. This needs to be addressed.

Implementing cuts requires a series of reorganisations if efficiencies are to be achieved. There is a growing opinion across the sector as a whole that there are too many colleges, a view shared by many principals (and all 20 referred to above). Fewer colleges would lead to increased efficiencies, raised quality and positive benefits for learners.

Mergers are now considered individually on their own merits. 'The merger as last resort' philosophy described in *Models for Success* (DIUS 2008) is no longer the message. If colleges want to merge now there needs to be a strong business basis to the case – plans for future growth, more full-cost courses, and greater employer engagement.

If merger is not a viable business option to save and improve a college, failing colleges should be allowed to close. This might sound like a harsh suggestion but consider the reality of 'failing' colleges: high unit costs, low performance, poor equipment, poor Ofsted reports and an overall lack of attractiveness to learners. Analysis of individual learner records shows that full-time learners in FE will travel large distances from their home for provision that is better quality than is on offer at their local college. In more than five areas outside London there is evidence of almost 50 per cent migration by full-time 16- to 19-year-old FE learners.

Colleges are important to the local area for learning and training purposes but also for social and community reasons. One way to encourage this is by giving groups of efficient local colleges their own 'sub-branding', where possible using partnerships with other providers, including the third sector. This results in a common strategic message, lower unit cost and a greater focus on area-wide needs.

There are other ways to achieve efficiency gains. One is through formal collaboration, contractually bound with formally agreed milestones and timescales. This is much discussed but there are very few actual examples. There is a big opportunity for successful colleges and

other strong providers to aid the rest of the sector and improve performance. Why is this not happening? It is not for lack of willingness on behalf of those colleges. Some of the barriers and other disincentives need to be more openly identified, challenged and remedied.

The FE sector is structurally diverse in terms of the types of colleges it contains. In addition to sixth form colleges (SFCs) and general further education colleges (GFEs), there are specialist colleges – for example in art and design, music, and for students with learning difficulties and disabilities. Sixth form colleges are predominantly A-level providers, while GFEs try to cover between 13 and 15 sector subject areas. The smaller GFE colleges often contend with low learner numbers per group in the 16 to 19 age range, high unit costs and insufficient funds to invest in employer engagement. There is space for a further, less ambitious kind of college, with a vocational emphasis on four or five key subject areas relating to local employer needs. These employers could be approached for support to provide equipment and even small-scale capital help. Some Regional Development Agencies are already actively considering this option. The M4 corridor is one obvious geographical focus.

A new approach to human resources (HR) would also benefit the sector, so that each college's staffing is relevant for what it or its college group wants to deliver. Staffing structures also need to reflect the different segments of what FE colleges deliver in terms of type of contract and pay by recognising the different margins that each segment generates as well as the differing delivery styles needed. Expertise from the private sector to make HR structures more modern and realistic has already been positively demonstrated at a number of colleges (for example, Cornwall College). Attitude change in this area, on the part of some governors and some senior leaders, is needed before change is put into action on a large scale.

Reforming funding

There is an option to make changes to the funding methodology, too. Apart from making cuts to the levels of funding per qualification, it would make sense to offer opportunities for the very best providers (in efficiency terms) to bid again in-year for more places – at a lower unit cost. This would encourage formal partnerships between more and less efficient colleges and reduce costs by driving down failure and non-completion rates as well as incentivising quality improvements. More radically, consideration could be given to funding only those providers with a Good or Outstanding in their last Ofsted inspection – high quality correlates strongly with high retention and successful outcomes. To concentrate resources in this manner would reduce waste and allow the funding freed up to be invested in targeted provision for young people not in education, employment or training ('NEETs') and other hard-to-access groups.

It may also be time to consider competitive funding: awarding batches of funding based on a college's ability to deliver value for money. Tesco sells its bread at a much lower price than the corner shop because it sells much more and generates higher demand. The 'price' of a National Vocational Qualification (NVQ) is the same whatever the scale or quality of the provider (or its efficiency level).

Reorganisation of back-office delivery functions is frequently discussed but problems of scale, time, ego, fear, traditional thinking, the current reality that 'it simply doesn't have to be done yet', as well as the absence of models that are really easy to copy means that pull-through is limited. The scale of cuts that the sector will face will increase the urgency to manage change well. The best will be done by those who have accepted what is happening and are making a planned, proactive strategy now.

There are plenty of other reorganisations and changes that will enable smart cuts and raise efficiencies, especially after changes are made to administration in the sector.

The final consideration is precisely how to ensure the changes are made. What the FE sector really needs is a clearly defined interventionist framework, underpinned by greater clarity on core values. Some key principles should include: learners deserve high quality opportunities and wide choice; mediocrity and under-performance should not be tolerated; recovery should happen quickly or not at all. Having such a small collection of important principles would help clarify for the successor bodies to the Learning and Skills Council precisely what underpins the FE sector and what the targets are. This would ensure that change happened earlier, that inefficiencies were rooted out and poor practice would not be allowed to continue.

In the case of financial poor performance, it would make sense to completely abolish all exceptional support funding for FE colleges that comes from the public sector purse. Instead, a college in need would receive exceptional support in management and leadership from a Grade 1 college as a part of a formal collaboration for a 12 month minimum period (there would be a fee for the providing college, but less than the cost of exceptional support). Private sector intervention could also be considered to provide a formal managed turnaround service, though barriers (such as VAT charges) would have to be removed. Colleges would recover by improving their practice, supported by commercial loans if necessary. We cannot afford for failing colleges and their consequent lack of investment to risk meeting learners' needs and improving the country's skills base. If such suitable recovery could not be achieved in six months then a more radical solution would have to be implemented.

There is scope to make the most efficiency gains from the most inefficient providers. The key is actually making things happen and this is the role that the new Government and its agents must take on after next year's General Election, whatever the outcome.

Conclusion

Smart cuts in further education, potentially of £1 billion, could be achieved relatively quickly alongside improved efficiency. The best colleges have already decided that efficiency gains of up to 15 per cent will be needed and have positioned themselves accordingly. The opportunities are even greater in the less successful colleges but will only be achieved by a tougher, more interventionist approach. It has been too easy for some colleges to be inefficient for too long, damaging opportunities for their learners.

Informed intervention should be the way forward, guided by the expertise offered by the 157 Group of college principals, the Association of Colleges and other college groups, and some private provider organisations, consulting directly with government. It is possible to make cuts and efficiency gains without damaging FE provision. Elements of the sector must now be forced – because persuasion has not worked – to modernise, as the best deliverers have already. The alternative is closure.

Department for Innovation, Universities and Skills (2008) *Further Education Colleges – Models for Success* London: DIUS

9. Higher education – Can we afford not to invest in human capital?

Claire Callender and Donald E Heller

Government expenditure on higher education has risen steadily in England since Labour came to power in 1997. The economic benefits for our globalised knowledge economy of investing in higher education are well known. Higher education is central to providing the flexible skills required for tomorrow's workforce and will be integral to our economic recovery. However, the current fiscal and political realities make cuts in public spending on higher education very likely. Will this necessarily mean a reduction in investment in human capital?

The fiscal constraints are already being felt. To curtail public spending on higher education, the Government limited the number of new undergraduate students entering universities in the current academic year. This squeeze on university places undermines the Government's desire to expand and widen participation – hallmarks of their higher education policies. An estimated 132,000 eligible students are without a university place (UCAS 2009). Those most affected are students with lower A-level results and 'non-traditional' students, who are the primary focus of the Government's widening participation strategies.

The initial trigger for this cap on student places was the spiralling costs of student financial support. In 2005/06, before the system was reformed, financial support absorbed 35 per cent of total annual public expenditure on higher education, at a cost of £3.5 billion. By 2010/11, this is projected to increase to 52 per cent at a cost of £9.8 billion (DIUS 2008).[1] Such a financial commitment is not sustainable.

The policy objectives and challenges are twofold:

1. How to reduce public spending on higher education without undermining the quality of provision, while safeguarding and widening participation levels.

2. How to preserve higher education revenues without increasing public expenditure.

This chapter concentrates on student financial support for full-time undergraduates studying at universities in England, and specifically on student loans. It makes no proposals for changes to the current system of Government-funded student maintenance grants or institutional bursaries.[2]

The 2004 Higher Education Act, which came into force in 2006/07, allowed English higher education institutions to charge up to £3,000 (£3,225 in 2009/10) per annum for their full-time undergraduate courses. All full-time undergraduates, irrespective of their family's income, now pay tuition fees. They can take out a Government-funded student loan to cover their fees, which they repay after graduation. And they can get a loan for their living costs, a provision which pre-dates the 2004 Act.[3]

Concerns about the effect of the 2004 reforms on widening participation prompted a new package of financial support for low-income students. First, Government-funded means-tested maintenance grants were re-introduced having been abolished in 1998. Second, higher education institutions charging tuition fees above £2,906 are obliged to give bursaries of at least £319 to students receiving full grants.

1. Government figures show that by 2010/11, the cost of providing student loans for tuition and living costs will be over £1.5 billion per annum while the cost of grants will be another £1.2 billion. The capital costs of providing cash for issuing student loans, net of anticipated receipts from the repayments of student loans, will be a further £5.7 billion per annum (DIUS 2008).

2. These are discussed elsewhere; see Callender and Heller (2009)

3. A quarter of the maximum maintenance loan is means-tested. The amount students can borrow for their living costs (but not for tuition fees) varies depending on their family income, whether they receive a Government maintenance grant, where they live while studying, where in England they study, and their year of study. Loans for living costs are paid in cash directly to the student while the value of the tuition loan is transferred directly to the institution.

By 2007/08, variable tuition fees had generated an additional £878 million for the higher education sector (Office for Fair Access 2009). The new system of student financial support is more progressive and has resulted in 'a significant increase in transfers from graduates and taxpayers, directed towards both the funding of universities and student support' (Dearden *et al* 2007: 30).

But, as described, these reforms have led to substantial increases in public expenditure for several reasons. More students than anticipated – 69 per cent – now receive a Government maintenance grant. Furthermore, student loans for both tuition and maintenance are very expensive because between 80 and 85 per cent of undergraduates take them out, and they are heavily subsidised by the Government. The interest on student loans for both tuition and maintenance is equal to inflation, so in effect is a zero real rate of interest. This is lower than the rate at which the Government borrows. In addition, repayments are based on a graduate's ability to pay. Low-paid graduates either pay nothing or have low repayments while high-earning graduates repay their loans at a faster rate. Any outstanding student loan debt is written off after 25 years. The longer a student takes to pay off her loan, the greater the Government subsidy. Consequently, maintenance loans cost the Government around £21 for every £100 a student borrows while tuition fee loans cost it £33 for every £100 borrowed (Dearden *et al* 2007).[4]

The interest rate subsidies, however, are regressive because they particularly benefit students from higher-income families (Barr 2004). Moreover, because loans are so costly, their availability is limited and they do not meet all students' living costs. And money spent on student loans diverts funding from universities and other higher education activities, including measures to enhance quality and to improve access.

If, as many expect, the current cap on tuition fees is raised following the forthcoming Government review of student funding, and student loans cover any increase in full, as they must, then the costs of tuition fee loans to the Government will escalate. Tuition loan subsidies will become more regressive as more students from wealthier families will attend universities charging the highest tuition fees, and so will benefit disproportionately – 25 per cent of the richest students get top A-level grades compared with 3 per cent of the poorest (Chowdry 2008).

Principles that underpin reform

There are several core principles that underpin our proposed reforms. Some were developed originally in the 1997 Dearing Report (National Committee of Inquiry into Higher Education [NCIHE] 1997).

- Student support should be 'equitable and encourage broadly based participation' (NCIHE 1997, para 20.2) and help widen participation. Economic principles of equity dictate that people of similar means should contribute the same amount to the cost of their education, while people with greater ability to pay should contribute more than those with less ability (Musgrave and Musgrave 1980). Students should be provided with enough Government financial support to ensure that they can enrol in higher education and complete a degree. Similarly, student loan repayments should be related to a graduate's ability to pay, as is currently the case
- The costs of higher education should be shared among those who benefit from it, namely society through the taxpayer, students and graduates, and their families (Johnstone 2006). This notion is now broadly accepted and underpins current funding. More controversial is the balance of contributions between these beneficiaries. Our proposals, like earlier reforms, would increase graduates' contributions and shift more of the costs of going to university on to them.

4. This subsidy includes defaults on repayment but does not include the cost of graduate repayment 'holidays' on loans announced in 2007.

- Higher education should be free at the point of use for all students. The payment of tuition fees should be deferred until students have graduated, as is currently the case. No student or parent should be expected to pay tuition fees upfront as this is a potential financial barrier to participation and is inequitable as only wealthier families can afford to pay upfront or can access credit easily to pay for fees.
- Student financial support provisions, where possible, should be universal rather than means-tested because universal benefits are easier to understand, have higher take-up rates, and are not so stigmatising. While our proposals largely adhere to this principle in terms of access to loans, they also incorporate the requirement that 'those with the means to do so to make a fair contribution to the costs of higher education' (NCIHE 1997, para 20.2).
- The system must be 'easy to understand, administratively efficient and cost-effective' (NCIHE 1997, para 20.2).

Proposed reforms

Our initial proposals address the first policy objective – how to reduce public spending on higher education without undermining the quality of provision, while at the same time maintaining and widening participation levels.

We suggest ending the blanket Government subsidy on student loans for both maintenance and tuition fees for all students and replacing them with more targeted subsidies. This could be achieved in different ways. One option would be changing the implicit interest rate on loan repayments for higher earning graduates but not for lower earning graduates. Graduates with lower earnings would still benefit from loans that carried a zero real rate of interest. Graduates with higher earnings would have loans with an interest rate pegged to the Government's real cost of borrowing. Another 1 per cent could be added to cover some of the subsidy to low-income graduates and the costs of losses arising from the protective features built into income-contingent loans (for example, debt forgiveness after 25 years), as well as administrative costs. So the taxpayer would subsidise low-earning graduates as is the case now, but no longer subsidise those who benefit from higher incomes.

The advantages of such a strategy to the Government are considerable. First, this system would be more progressive and equitable. Those with greater ability to pay would contribute more to the costs of their education. Second, it would reduce the student support bill. Third, the savings could be used to expand the student loan scheme to other student groups such as part-time students who currently receive only minimal government-funded student support, and so help widen participation (Fazackerley *et al* 2009). Finally, the increased costs of borrowing may deter wealthier students, who anticipate higher earnings and who do not need a loan, from taking one out.

Such a system of universal access would be relatively easy to understand, administratively efficient, and cost-effective while higher education would remain free at the point of use.

An alternative, cheaper but far less progressive option, would be to end the loan subsidy for all students, not just higher earning graduates. The interest rate on student loan repayments would be linked to the Government's cost of borrowing for all students.

Turning to the second policy objective – how to preserve institutions' revenues without increasing public expenditure on higher education – the most obvious source of additional funding is tuition fees. A rise in the cap on tuition fees is a likely outcome from the Commission on student support arrangements and variable fees, which is being launched later this year. If higher education is to remain free at the point of use, the payment of these higher tuition fees would need to be deferred and repaid on graduation. To safeguard equity, affordability and widening participation, any fees increase would have to be covered in full by the existing provision of income-contingent student loans.

One obstacle to raising the tuition fee cap, apart from the very real political fall-out from such a development, are the costs to the Government of providing larger loans to cover higher tuition. These costs would be lower if the interest rates on student loans were changed in line with our proposals. Significantly, too, the smallest subsidies would go to students from the wealthiest families who will make up the majority attending the universities that will charge the highest fees. These students will get the highest paid jobs (Naylor *et al* 2002).

What are the likely consequences of higher student loan interest rates for the best paid graduates who tend to come from the wealthiest families? First, both their student loan repayment burden and their higher education costs would increase, but there is little evidence that potentially higher repayments or costs would deter affluent students from participating in higher education, unlike their poorer peers (Callender and Jackson 2006, Heller 2008). Second, it may take them longer to repay their loans, but much of this would be offset by their higher than average wages on graduation. Third, students when taking out their loan would not know what interest rate they would be paying once they graduated. When deciding whether to take out a loan, they would have to make a range of assumptions about their future earnings. However, under the current system, because the interest rates vary in line with inflation, the actual rates paid are similarly unpredictable.

For many, our proposals will be considered unpalatable and politically difficult to implement. However, fundamental changes to the current system of student finance are required if we want an equitable and fair system that can meet the needs of higher education in the twenty-first century – if we want to cut public spending on higher education, while doing everything to preserve investment in human capital.

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10. Policing in new times

Rick Muir

The police are unusual in having survived the last 30 years of public service reforms largely unscathed. Whereas schools and the health service have been in a state of almost permanent revolution since the 1980s, the way the police service is organised, managed and incentivised has not significantly changed over this period. Of course, policing today is very different from in the past: standards are higher, training has improved, the role is more demanding and technological advances have revolutionised important aspects of police work. But the basic structure of the police service established following the 1962 Royal Commission remains intact and the police have successfully fought off attempts by both Labour and Conservative governments to change it.

Change is now unavoidable. After a real terms increase in funding of 21 per cent between 1997 and 2007, the police service now faces the challenge of coping with a significant cut in resources. This will not be easy given that the service is likely to face rising demands, particularly if the recession pushes the crime rate upwards. The police will have to do more with less and the only way to do that is to reform the way they work.

This chapter argues that the police service should embrace the current crisis as an opportunity for change. Rather than simply slashing the number of frontline officers, the service should find ways of doing things differently. If the Government has the patience and courage to see through a serious programme of police reform, it could both improve the service at the frontline and save money.

Police performance

Although spending on the police has risen dramatically in recent years, police performance has not improved commensurate with that increase. From the overall crime figures, police performance looks very strong. Crime as measured by the British Crime Survey has fallen by 45 per cent since 1995 and fear of crime has fallen significantly over the same period (Walker *et al* 2009). However, most of that fall was due to Britain's buoyant economy over that period, rather than to the impact of policing (Solomon *et al* 2007, Pearce 2007).

Because the overall crime rate is affected by many different factors, we need to look at other indicators to assess the success or otherwise of police work.

Crime detection rates show little improvement: 28 per cent of recorded crimes were 'cleared up' in 2008/09 – which is little different from the 29 per cent detection rate in 1998/99 (Gash 2008, Walker *et al* 2009). Although changes in reporting standards in 2002 mean that in fact the 2008/09 detection rate is likely to be significantly better than that in 1998/99, much of the increase in detections since 2002 has been made up of cautions for minor offences and the imposition of new 'penalty notices for disorder'. The number of detected offences leading to a court summons, in other words those one would expect to cover the most serious types of offences, has actually fallen over the same period.[1]

Detection rates also vary enormously from force to force, suggesting that police performance is patchy across the country. For example, in 2008/09 the sanction detection rate for violence against the person was 67 per cent in Cumbria, but just 34 per cent in Staffordshire and Leicestershire. In the same year, the sanction detection rate for robbery ranged from an impressive 66 per cent in Cumbria to just 16 per cent in Greater Manchester (Walker *et al* 2009).

1. Detected crimes are those that have been 'cleared up' by the police. Detections can be subdivided into two categories: sanction detections (where the offender receives some formal sanction) and non-sanction detections (where no further action is taken). The detection rate is the number of detections recorded in a given year as a percentage of the total number of crimes recorded in the same period.

Detections per officer have actually decreased in the years since 2003. Whereas in 2003/04 each officer was detecting 10.2 offences a year, this has now fallen to 9.4 offences per officer.[2]

Public satisfaction with the police has fallen. The proportion of the public saying that the police do a 'good or excellent job' fell from 64 per cent in 1996 to 53 per cent per cent in 2008/09 (Allen *et al* 2006, Walker *et al* 2009). There has, however, been a slight increase in satisfaction in the last three years, which corresponds with the introduction of the Government's neighbourhood policing programme (Walker *et al* 2009).

So, despite headline falls in crime levels, police performance has not improved significantly over the last decade, and on some measures it has got worse. This is despite record increases in public spending on the police service with the highest ever number of police officers now in place (Solomon *et al* 2007). The UK now spends 2.5 per cent of its GDP on its criminal justice system – the highest of any other country in the Organisation for Economic Cooperation and Development (OECD), including the United States – and two thirds of that spending is on the police service (Solomon *et al* 2007).

These figures suggest taxpayers are not currently getting the best possible value for their investment. Over the next few years resources are likely to be squeezed, meaning that further improvement can only come from radical reform to the way the police service works.

The police workforce

Most of the money dedicated to the police is spent on its people and it is in this area that reform could bring about some of the most significant improvements.

The composition of the police workforce should be diversified, aligning individual skills to different tasks much more closely than at present.

The general role of constable should be broken down and officers should be allowed to focus on areas that most match their skills and that they find most rewarding. Alongside greater specialisation of roles, more civilians should be employed to carry out administrative and customer service tasks which warranted constables currently perform at high cost. Workforce modernisation pilots have shown that better use of civilian staff can save significant amounts of police time, enabling officers to focus on the frontline. In the long run, this should mean that we need fewer officers overall, delivering savings over time, while also protecting the number of officers out on the beat.

The service should attract more graduates and others who have learned specialist skills outside the service. To do this the single point of entry should be abandoned and pay restructured to enable recruitment from outside the service at higher levels of pay.

Police teams are currently far too small. Tom Gash estimates that very significant savings could be made over time if the police were to move to teams of eight officers per manager, thus cutting out excessive layers of middle management (Gash 2008).

Finally, and most controversially, police pay should be reformed. The current system is based on length of service and rewards longevity in post rather than performance. If pay were more closely aligned to performance and the difficulty of different roles, this would reward and incentivise officers who are performing well. Taken together these reforms to the police workforce would enhance productivity and provide a better service at lower cost.

2. Police officer numbers from Mulchandani and Sigurrdson (2009). Overall number of detections taken from Kershaw at al (2008), Mitchell and Babb (2007), Nicholas *et al* (2005), Walker *et al* (2006) and Walker *et al* (2009).

Organisational change

The structure of the police service is inefficient. There is far too much central interference by the Home Office in terms of setting priorities for and monitoring the performance of local police forces. The move to a single public confidence target is a step in the right direction but there are still plans for considerable amounts of national inspection. Money could be saved in the Home Office and Her Majesty's Inspectorate of Constabulary by putting local authorities in charge of setting priorities for their local police and monitoring their performance. People should hold their local councils to account for delivery and Whitehall should get out of the way.

There is too much overlap and duplication in policing. Each of the 43 police forces does its own procurement of IT, equipment and uniform when it would be much more cost effective to procure these items collaboratively. Significant savings should be found through the pooling of back office functions like IT, human resources and finance. Information systems and processes should be converged to prevent losses of information and the inefficient use of separate systems.

None of these problems is ever adequately addressed because there is a lack of leadership and coordination in the police service. While local police priorities and operational decisions should be left for local authorities and chief constables to decide, there should be a single National Police Agency at the centre with some limited powers to ensure that forces are getting the best value for public money. This agency could as a last resort instruct forces to collaborate or procure equipment jointly if they were not doing so of their own accord. It would also ensure that cross-regional crime was being adequately tackled through coordinating national and regional policing efforts.

This National Policing Agency would be formed by merging the existing National Policing Improvement Agency (NPIA) with the operational components of the Association of Chief Police Officers (ACPO). Such a rationalisation of existing national police agencies should deliver administrative savings of its own in the long run.

Conclusion

The police service has not undergone the kind of reforms that have been undertaken in other parts of the public services. Politically, it is very difficult to reform the police service because the public tends to sympathise with and trust the police much more than they do elected politicians. Reform is also institutionally difficult to carry out because the police service is so fragmented and local accountability tends to be very weak. The way forward is to empower local government to set the priorities for their local force, while also rationalising existing national policing institutions into a single agency at the centre that would have the ability to deliver reforms to the workforce and ensure value for money. These reforms will encounter resistance within the service, but they offer a way of saving money by reducing costs over time rather than by slashing frontline services in the short run.

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11. Defence – A reality check

General Lord Charles Guthrie and Andy Hull

In most of the years between 1997 and 2007 the defence budget enjoyed an increase in real terms. This nonetheless failed to reflect the UK's increased defence commitments and there is now a black hole of some £9 billion per annum in the £36 billion annual defence budget.

Spending is not under control. Large defence procurement projects when mismanaged almost always overrun in terms of both cost and time, meaning that in the end we can afford less of the equipment we decided we needed when the order was first placed. The current top 20 major Ministry of Defence (MoD) procurement programmes have a cumulative delay of 483 months. A recent MoD-commissioned independent review confirmed that the department's procurement system was overheated because too many types of equipment were being ordered for too large a range of tasks at too high a specification in excess of any likely budget to pay for them.

We have to stop spending money we do not have and start dealing with realities. Some fundamental choices have to be made. This year Italy has downsized its defence spending by about 7 per cent. Spain has done so by 4 per cent. The United States is scrapping high-cost programmes like the F-22 fighter aircraft and the European Theatre Defence Missile Shield. In the present economic circumstances, spending cuts are unavoidable, and defence cannot be exempt.

Whichever party is in power after the general election should as a matter of urgency perform a wide-ranging strategic review of security, including but not limited to defence. This strategic review must assess the changed global security environment in which we now operate. It must identify possible and probable threats and hazards, both globally and specifically with regard to the UK, and the appropriate responses in the light of that assessment, prioritising among them in the context of a worldwide recession. Trade-offs will need to be made, and certain risks entertained: 100 per cent security is a false prospectus. The strategy must not be cost-driven, but nor can costs simply be ignored. Precious resources will have to be used more effectively and savings will have to be made.

Any strategic review of security at this juncture is likely to build up a picture of a global security landscape, radically reshaped since the last strategic defence review in 1998.

We live in a world now where conflict between states, while it cannot be ruled out, is less common than conflict *within* states. Weak and failed states are more dangerous than strong ones, and nuclear proliferation is a growing danger. The potency of non-state actors like Al Qaeda is greatly enhanced, as 9/11 tragically demonstrated. Security is now arguably as much about mitigating and adapting to climate change as it is about defeating enemies, as demonstrated by the inclusion of climate change in the current US Department of Defense Quadrennial Defense Review. Resource scarcity – energy, food, water – threatens to destabilise places and peoples around the globe. Pandemics, such as swine flu, can spread at a hitherto unimaginable speed.

Cyber-security is now serious business. Pirates plunder on lawless seas. There has been a marked shift from conventional to irregular warfare, asymmetric conflict and counter-insurgency. Urbanisation results in 'war among the people'. And, as our expeditions in Iraq and Afghanistan have both shown, fighting wars may to some extent be easy, but building the peace is hard.

In security terms, it is time to move from one era to another. The risk profile in 2010 is much altered from that of a decade ago. We must rebalance our capabilities accordingly.

We should retain some flexibility in our military capabilities, but continued attempts at UK full-spectrum capability, acting like a mini-US, are not affordable now, never mind

sustainable in the longer term. In the foreseeable future it is highly likely that we will be operating as part of alliances. This means we can make cuts in areas where we duplicate or add little to our allies and specialise in areas where we add more. We must examine burden-sharing in more detail, without ignoring the risks inherent in relying on others to provide aspects of our defence.

We need to take this seriously in Europe, where duplication and redundancy are rife. The military-industrial complexes of Europe need to be shaken up to rein in spiralling costs and reduce production and procurement delays. The way to strengthen NATO is to strengthen its European pillar by deepening structured defence cooperation and integration across the continent. The UK cannot go it alone. Europe needs to be made to work in security terms, however impossible a political task that might sometimes seem. The US, rightly, will expect and demand nothing less.

What does this mean for defence spending?

In concrete terms, this will have to mean, above all, not developing new weapons to fight old wars. The two new 65,000-tonne aircraft carriers, the planes to fly off them, and the destroyers to protect them must be firmly in the frame for cuts. The super-carriers are currently costing £5 billion (already £1 billion more than originally predicted). The F-35 Joint Strike Fighters which fly off them cost up to £10 billion, depending on how many we buy (70 per cent more than predicted in 2001). Six Type-45 destroyers are set to cost £6 billion.

We question the order the UK has placed for 232 Typhoon Eurofighter aircraft, at a cost of £21 billion, but contractual obligations and penalties mean the Government cannot back out now. And yet, at the height of the 1991 Gulf War, the largest number of UK fighters on a single sortie was twelve. Mass air formations are a thing of the past, and our primary ally, the US, has no shortage of planes.

In terms of personnel, politicians have begun to query the ratio that at present allows for 86,000 civilians in the MoD to direct our 175,000 servicemen and women. In particular, there are doubts as to the need for 23,000 staff working in Defence Equipment and Support. Serious thought must also be given to the number of headquarters we maintain outside the MoD.

Reaching an appropriate configuration for today's defence may mean a recognition that the armed forces are not necessarily of equal importance and some may suffer more than others in terms of cuts. It will then be vital that petty inter-service rivalry is not allowed to interfere with our enactment of national security strategy.

But the money saved by some of the cuts suggested above is unlikely to be available to reduce the fiscal deficit. First, the black hole in the defence budget needs to be filled. And then there are areas of the defence budget where sound security strategy will mean increased expenditure.

Command and control assets and intelligence, surveillance and reconnaissance kit will be needed, including sensors, radar, satellite imaging technology and unmanned aerial vehicles. Our robotics may need to be enhanced. We will need to invest more in both defensive and offensive cyber capability. The Army's ranks, currently 99,000, need to swell by 15,000: boots on the ground matter in most of the likely scenarios. These soldiers need proper kit to do their job: not just helmets and body armour, although they are important, but more counter-improvised explosive device (IED) equipment, helicopters, and heavy-lift aircraft. Future operations may put a premium on Special Forces, both at home and abroad. The Navy needs fast patrol boats to effect interdictions at sea. We need to bolster our capacity to handle civil contingencies within the UK. And we argue strongly for the creation of a civilian/military stabilisation and reconstruction force, for the critical task of rebuilding countries ravaged by war.

Question marks over the nuclear deterrent

The UK's nuclear deterrent must be part of any strategic review of security, and we welcome the recent creation of a new Top-Level Group to consider it. We must approach this vexed question in the context of a world in which Barack Obama has just won the Nobel Peace Prize in large part for convincing world leaders to state their collective long-term determination to get to a world free of nuclear weapons.

Obama is working towards bilateral reductions in nuclear arsenals with Russia. Gordon Brown has announced the UK's potential willingness to place all or part of our nuclear arsenal at the disposal of multilateral nuclear disarmament negotiations, if that becomes useful, to help the world 'get to zero'. Meanwhile, the Government has cut the UK's stockpile of warheads from 200 to 160 and is thought to be considering cutting it further to 120. In keeping with the recommendation of ippr's recent Commission on National Security in the 21st Century, it has been strongly suggested that the key decision on the initial £2 billion of work on Trident renewal may be postponed until after the Non Proliferation Treaty Review Conference next year. The Prime Minister has also stated at the UN General Assembly that the Government is willing to consider reducing the UK's fleet of Vanguard class submarines (which carry the Trident missiles) from four to three (saving £3 billion). These are all moves we endorse.

Many argue that nuclear weapons are for fighting an enemy that no longer exists. Here, the contentions are that: a nuclear deterrent will be of very little use in tackling most of today's and tomorrow's most likely threats; the only nation actually to have dropped atomic bombs, immolating tens of thousands of innocent civilians, was not an aggressive dictatorship, but a liberal democracy; the ability to obliterate is no sound basis for national prestige, or a seat at the UN Security Council; the costs are prohibitive; and public opinion, polls suggest, remains in favour of the retention of some form of nuclear weapon, but one delivered more cheaply, accepting any concomitant decrease in capability. We have some sympathy with these views.

However, if our democratically elected representatives decide – and there must be a Commons vote – that the UK will keep a nuclear deterrent for reasons of strategic uncertainty and continuity, then the question becomes one of how best to deliver that deterrent. The current system has three components: the Trident missiles (operational life until 2042), the warheads on them, and the Vanguard class submarines which carry them (operational life extended to 2024). Together, they provide a strategic, operationally independent, credible nuclear deterrent that is continuously at sea. The UK has already approved design and concept work for a new fleet of replacement submarines, but the decision to go ahead at a cost of £11–14 billion does not need to be made – and should not be – until at least 2014.

Some options are more attractive then others. Delivery systems based on surface vessels, aircraft or land are, we are told, impractical. Further extending the operational life of the Vanguard submarines might be possible. Equipping – as is technically possible – modified new Astute class hunter-killer submarines (we have so far ordered three, out of a possible seven, at a cost of £4 billion) with nuclear warheads for launch on Tomahawk cruise missiles would likely be around £10 billion cheaper, but problematic. These submarines are capable of circumnavigating the globe without surfacing or refuelling but cruise missiles would have reduced range and power, and, unlike the Trident intercontinental ballistic missiles (ICBMs), would be sub-sonic and so easier to shoot down, at least given current technologies. It may yet prove possible to modify the existing Astute design to carry ICBMs, which could assuage this concern.

In the end, though, with all eyes on the public finances, there is no getting around the fact that Trident – built by BAE Systems in Barrow-in-Furness and docked at HM Naval Base Clyde at Faslane – is hugely expensive. At a procurement and development cost of £20–30 billion, depending on whose figures you believe, renewal of the Trident system like-for-like comes at an astronomical cost. The country's best brains are needed to think up practical ways to deliver our deterrent more cheaply.

All the prices cited in this chapter are for procurement and development only – not lifetime costs – and are accurate only as far as secrecy and uncertainty concerning actual costs permits. Yet some of these big-ticket items, not least Trident, have very significant lifetime costs. The think tank Reform has recently argued that a renewed Trident system would cost £70 billion over a lifetime of 25 years, and Greenpeace put the cost even higher at almost £100 billion, factoring in expenditure on associated activity at the Atomic Weapons Establishment at Aldermaston. A fuller debate on Trident than is possible here would also need to consider possible decommissioning costs, and the industrial ramifications – in terms of Cumbrian and Scottish jobs – of terminating the programme.

What we are good at

Whatever the decisions made in Westminster and Whitehall on defence spending in the years to come, cold war relics and museum arms have no place in a modern British military. Defence planners cannot remain in denial about the harsh realities of the downturn. Business as usual is not an option. We must concentrate on what we need and what we are good at. If we try to be good at everything, we will end up good for nothing.

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12. Transport – How do we identify the priorities?

David Begg

The chill winds of the economic depression are about to hit the transport sector. Up to now it has been private companies in the sector that have borne the brunt of the cuts in expenditure. For example, public transport operators have been driving down their cost base in a desperate attempt to preserve profit margins in the face of slower passenger growth. So far, transport in the public sector has been relatively immune. But that will change after the general election, when the overriding policy objective will be to get to grips with the country's burgeoning fiscal deficit.

Historically, transport has always been more exposed to public expenditure cuts than other sectors and this time will be no different. It is much easier to scrap a road scheme, reduce spending on road maintenance or delay a railway project than it is to close a school or a hospital.

When John Prescott, as Secretary of State for the Environment, Transport and the Regions, launched his 10-year plan in 1999, he promised to secure higher levels of transport spending. This has been achieved! Over the last 10 years public spending on transport has tripled and, while this is less than the five-fold increase in health spending over this period, it compares favourably with most other spending departments.

This has resulted in the UK closing the gap on other European countries in transport spending per capita. The highlights are a raft of new road and rail projects (the biggest being the Channel Tunnel Rail Link), a good start on rebuilding London's Underground and a very generous free travel scheme for pensioners.

Outlook for the next decade

The boom times are over and we had better prepare for a decade of austerity. The Treasury's own forecast is that total investment spending will fall by a half from £44 billion this year to £22 billion in 2013. Whatever the percentage cut in public expenditure, history tells us that transport will be cut at twice the average rate. The Department for Transport (DfT) spends just over £12 billion per annum: £5 billion goes on rail – £3.5 billion to Network Rail and £1.5 billion to Train Operating Companies to run the rail franchises; £4.5 billion to the Highways Agency and the rest is made up of direct grants to local authorities and support for the bus industry.

With around 40 per cent of the DfT's budget going on rail, you would think that it would be exposed to cuts. However, too much is already contractually committed and there are few easy pickings. The Office of the Rail Regulator will continue to put the efficiency squeeze on Network Rail but this will yield a maximum of £1 billion per annum in savings by the middle of the next decade and most of the franchise commitments DfT has with the Train Operating Companies have some way to run.

The political pressure that has been mounting on the level of rail fares will make it very difficult for any future government to ask passengers to pay more to reduce the burden on the taxpayer. This means that rail expenditure is relatively fixed compared with the budgets for the Highways Agency and Local Government. Any expenditure in these areas that is not committed and firmly nailed down is vulnerable in a decade that will witness a purge on public expenditure on an unprecedented scale – even eclipsing the cuts imposed by the Thatcher Government in the early 1980s.

The implications for the transport sector are immense. Can we afford the national free travel scheme for the elderly? Expenditure on this is growing wildly as the number eligible spirals upwards. With the unemployment rate likely to shoot up towards 10 per cent there will be

pressure on the transport sector to contribute towards plans to get people back to work and reducing transport costs will be high on the agenda. Reducing the number of jobless people should take precedence over the national free travel scheme. While this is right from a policy perspective, as always it is the politics of this which is likely to be a show-stopper.

The bus industry receives a £130 million per annum grant to help offset the fuel duty it pays. This will be high up the list for the chop. Bus operators will argue that this will push up fares and why should they pay fuel duty when rail and aviation do not. But their pleas will fall on deaf ears. The DfT is coming under increasing pressure to scrap this payment under state aid rules and to subsidise fuel duty payments runs contrary to the Government's objective of cutting carbon emissions.

The Highways Agencies budget looks very exposed. Postponing or cancelling extra road capacity will save money; it will have less impact on congestion levels during an economic downturn with declining and/or slow growth in traffic volumes and will meet with minimum public resistance.

Why does our roads system have very different governance arrangements from all the other utilities? Gas, water, electricity, telecommunications have all been privatised with an independent regulator to protect the consumer. Network Rail and Welsh Water are not-for-profit companies at arms' length from the Government. For the answer look no further than politics and finance.

Every now and then a policy paper is published which makes politicians sit up and take notice and gathers supportive momentum at Whitehall. The recent paper by the RAC Foundation – calling for the Highways Agency to be turned into a corporate body as part of a wide-ranging reform of Britain's road system – is a case in point (Smith 2009).

With the prospect of a new Government being formed within the next year, this is a fertile period for new policy ideas. The main political parties will keep a healthy distance from the RAC proposal for fear of being accused of wanting to privatise the roads. This is only one possible outcome for the Highways Agency proposed in the paper, along with a host of hybrid governance possibilities from BBC-type public interest corporations to not-for-profit trusts. But the media will immediately jump to the more sensational headline of privatised roads, road pricing and Dick Turpin money collectors trousering cash from the poor old motorist.

So we should not expect much political backing for the proposal, or for it to feature in any party manifesto for the next election. It will, however, be top of the 'to do' list for the next Government's Secretary of State for Transport because if the Government is looking for up to 20 per cent cuts in public expenditure, for transport this will translate into cuts of at least 30 per cent. This is inevitable if there is to be an element of protection from the cuts for the two big elephants in the room: education and health. We face the prospect of the roads programme being dismantled and road maintenance slashed. Little wonder the RAC Foundation is agitated. They look enviously at Network Rail and the level of funding that is committed, and raise the legitimate grievance that roads are the poor relation in comparison.

The prognosis for road users under the status quo is poor. Less investment in infrastructure, cuts in maintenance – and, when the economy picks up, traffic levels will return to their upward trend, creating more congestion. For a poorer service, road users can expect to pay more as motoring taxes rise to shore up the public finances and the impacts of carbon trading on the price of fuel. Moreover, they have no regulator to ensure that money is being spent efficiently on the road network and no consumer watchdog to look after their interests.

In the 1980s the Thatcher government faced similar challenges for the then publicly-owned utilities: gas, electricity and British Telecom. They were inefficiently run and the consumer was given a raw deal. Privatisation proved to be one of the most successful policies of that

decade despite facing stiff opposition at the time (I plead guilty). Privatising the motorway network has support within the Conservative opposition but the shadow cabinet view it as a political own goal and they certainly do not want to turn it into an election issue.

The reason roads have been left behind by the privatisation bandwagon is that they do not generate a revenue stream. The RAC argues that vehicle excise duty and fuel duty qualify, but the last thing a cash-strapped Treasury is going to agree to is siphoning off major revenue streams to fund road infrastructure.

Road pricing will come back on the agenda – and it will be driven by financial expediency.

Opportunity for change

The dire economic clouds may produce a silver lining as far as transport policy is concerned. Financial expediency could give a boost to the road pricing agenda. There were over 30 local authorities prepared to implement congestion charging in the late 1990s. The substantial growth in local authority funding for transport over the last decade has dampened the appetite to tap into new revenue sources.

Historically, the British transport disease has been to curtail expenditure on capacity (road, rail and airports) – usually because of Treasury constraints, but often for environmental/ political reasons – while failing to restrict demand. The result is we have the most congested transport system in Europe.

What a perfect opportunity to break away from our past mistakes by charging for congestion and pollution, constraining demand for travel when the upturn comes and at the same time raising much needed revenue. This would be much better for the economy and the environment than putting the emphasis on taxing income, wealth creation and employment. Let us hope a future government focuses more on taxing economic bads than economic goods.

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13. Local government – tough decisions ahead

Tony Travers

Local government was not particularly favoured during the recent years of public sector expansion. Compared with the NHS, schools or international development, councils have been seen as too distant, too diffuse and too difficult to offer ministers the opportunity to spend public money in such a way as to claim direct credit for the results. Moreover, local government is funded by the ever-unpopular Council Tax, which means aggressive capping has been used to limit councillors' freedom.

The table below makes this point clearly, showing the increase in current expenditure within sectors and services over the period 2004–05 to 2008–09.

Table 13.1. Increase in current expenditure, 2004–05 to 2008–09

	2004–05 (£bn)	2008–09 (£bn)	Change (%)
Education (schools)	33.2	41.5	+25.0
NHS	78.9	104.8	+32.8
International services	5.4	6.8	+25.9
All local government	58.6	70.6	+20.5
All central government	330.2	408.8	+23.8

Sources: DCLG 2008, HM Treasury 2009
Notes: 'Education' is all services funded within local government, though this is overwhelmingly schools. Since 2006–07, schools funding has been through the centrally-determined Dedicated Schools Grant. 'All local government' excludes education. 'All central government' includes NHS and international services.

Current spending by local government increased by just over 20 per cent in cash terms between 2004–05 and 2008–09, which was ahead of the rate of inflation in this period. However, schools' spending rose by 25 per cent and the NHS by almost 33 per cent. This is hardly surprising as successive governments, informed by public opinion, have given their greatest priority to health and education spending while showing little desire to maintain local authority expenditure (Ipsos MORI 2009, Question 7).

Because the Government has capped Council Tax in England, local authorities have not been able to raise it by more than 3 to 4 per cent annually in recent years. Although councils are the only institution apart from Parliament that has access to tax revenue, their capacity to use this power freely is very limited. Local government can, in effect, spend an amount generated by the total of its central support (grants and national non-domestic rate), income from charges and its capped Council Tax yield. The relatively low percentage spending increase shown Table 13.1 is indicative of central government's desire to hold local authority current spending down relative to other sectors.

Politicians in both the major parties have spoken of a desire to maintain health and international development (and sometimes schools) spending in real terms (see for example Guardian 2009). Evidence suggests that these services are likely to receive greatest priority from whichever government is in power after the 2010 general election. Local government no longer has direct responsibility for schools' funding, and none at all for the NHS or international development. The 'age of austerity' that lies ahead is, therefore, likely to see pressure on council spending increased by more than the average.

Likely areas for cuts

Many authorities now privately expect real-terms reductions in their spending of between 10 and 15 per cent over the next five to seven years. Some even envisage cuts of up to 20 per

cent. Whitehall support is likely to be frozen, while Council Tax, if it is allowed to rise at all, will do so by less than 3 per cent per year. Yet within local government budgets lie the police, fire and emergency services, social care for children and for the elderly, environmental services and libraries. Demographics will not help, particularly as numbers of the very old will rise sharply in the coming years. The public are generally enthusiastic for spending on law and order, so cutting the police may prove difficult. Whitehall will, as it always does, make demands for higher spending. Any council that has attempted to close libraries will attest to the horrors involved.

Local government leaders will face the awkward question of what to cut and whether to stop providing some services altogether. Westminster-based Labour, Conservative and Liberal Democrat politicians have united behind the idea of public sector pay freezes, 'efficiency savings', a 'cull' of quangos and asset sales. Indeed, at the Labour Party Conference this year, Cabinet ministers made commitments to increased spending to be paid for by 'local government efficiencies' – as if they were new money. But it would be delusional to imagine such steps will come close to delivering the scale of reductions likely to be required.

It is against this background that some (mostly Conservative) councils have begun to look at radical ways of reducing the cost of providing services. Generally, such initiatives have involved 'outsourcing' much of the council's administration (Illman 2009). Other proposals have included joint provision of services[1] or the so-called 'Easy Council' model, based on the logic of cheap airlines (Moore 2009). The Government published its Operational Efficiency Programme report during the spring of 2009, which made a number of proposals for money-saving, including asset sales, improved procurement and the so-called 'Total Place' initiative (HM Treasury 2009b).

Local government will have to consider a wide range of ways of making itself more efficient and/or lowering its costs. But such efforts will not be sufficient to avoid the need for reductions in spending on frontline services. National politicians have been desperate to avoid discussing 'cuts' and have had to resort to a variety of rhetorical devices and evasions to minimise any implication that the public should be confronted with the reality of what lies ahead. Council leaders and officials now face the challenge of how to approach a long period of reduced local expenditure against this background of denial.

Options

It is inevitable that local government will need to increase the use of charges wherever possible. For some authorities, income from fees and charges already exceeds their Council Tax yield. Authorities will find little alternative but to push up charges for parking, licensing, planning, leisure facilities, social services, fines and, indeed, any potential source of income. The Local Government Association should press the Government for maximum freedom to test the market. The less well-off can always be shielded from the full impact of fees and charges by the use of discounts and exemptions.

A second option will be to pursue the option of 'outsourcing' back-office activities. Many councils already do this, so it is less dramatic an option than it would have been in the past. Labour and Liberal Democrat authorities have generally been as willing as Conservatives to use contractors and consultants to deliver services. But in future the scale of contracting-out is likely to be radically increased. Whatever the ideological objections some councillors may have to 'privatisation', there may be little choice if the alternative is cutting the number of social workers or street-sweepers.

Third, many councils will consider cutting back on 'non-statutory' activities. This sounds easier in theory than it would be to deliver in practice. Throughout the Thatcher years, when

1. See, for example, joint agreement between Gosport and Eastleigh councils to provide joint audit services, www.eastleigh.gov.uk/meetings/Published/C00000432/M00003896/AI00022000/$GBCandEBCPartnershipAgreement20092012v9.docA.ps.pdf 1

a 'cuts' narrative was popular with the Government as well as their political opponents, it proved almost impossible to stop delivering state services. A number were privatised or had charges imposed, but none was actually closed down or stopped. Thus public service pensions, libraries, leisure facilities, subsidised bus services and grants to voluntary organisations all survived the 1980s. It is hard to imagine that councils will find the wholesale removal of provision any easier today than in earlier decades.

Fourth, following London Borough of Barnet's foray into the 'Easy Council' model, it is almost inevitable a number of councils will find ways of charging for services provided at levels above a basic standard. Depending on how such an option is presented, it can appear divisive or a sensible way of raising more revenue. Some people would see the possibility of councils charging extra for service levels above the norm as creating two-tier provision. Others would view the same idea as building on, say, the model adopted within the railways or at the UK government's Passport Agency where people can pay above the odds for a better quality or quicker service. Many authorities already offer options within social services or library provision, though generally not as a way of cross-subsidising the rest of their services.

A fifth option would be for authorities to join together with other councils and possibly other public service providers to achieve efficiencies by pooling budgets and services. This is the logic of the Government's Total Place initiative. In principle, this is an idea that could produce big savings for all public services. However, there are obstacles. Local councils often find it difficult to work together formally to deliver major services. More awkwardly, Whitehall departments have long been unwilling to allow their local bodies to pool budgets. Thus, while joint provision and partnerships offer significant potential benefits, there would have to be radical changes in approach for this to happen on any kind of scale.

Sixth, the Government might be persuaded to allow councils to take control of some of the social security benefits, particularly housing benefit, paid to people living within their area. A number of authorities, including Essex and London Borough of Newham, have from time to time made proposals to make more constructive use of some social security resources so as to make longer-term changes to their areas. Although radical, ideas of this kind could potentially deliver significant longer-term savings.

Finally, councils may decide it would be easier to make across-the-board, 'salami-slice' cuts to many or all of their services. Although such an approach is hardly brave, it might have the merit of simplicity, comprehensibility and a kind of fairness. A public sector pay freeze, suggested by all the major political parties, is akin to a salami-slice. Flat-rate cuts would be inclusive and the public would understand what was going on. It would not, of course, allow for much sensitive planning or logical change.

Councils face the future knowing reductions to their spending are inevitable. The Government is most unlikely to shield many (or any) council services from cuts. As a result, it is likely local authorities will use some or all of the approaches outlined above. By 2015, local government is likely to be spending many billions of pounds a year less than at present. Staff numbers will be 10 to 15 per cent lower. Many services will be delivered by external contractors. 2010 will be the start of a radical process of change within local government. Planning and common sense could make this a process with beneficial outcomes. The public will surely expect such a result, even if national politicians are too fearful to explain what is going on.

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14. Public sector pay – time to share the private sector's pain?

Bridget Rosewell

Some might think that the private sector deserves its pain and that the comeuppance of bankers and other fat cats is long overdue. The public sector, it is argued, has never indulged in the same unseemly practices as the private sector and therefore remains more responsibly rewarded.

However, the gulf between public and private sector pay is much greater than is commonly realised. Even before taking into account the enormously more favourable pension entitlements of public sector workers, under Gordon Brown – first as Chancellor of the Exchequer and then as Prime Minister – most of them have come to earn considerably more than their immediate comparators in the private sector.

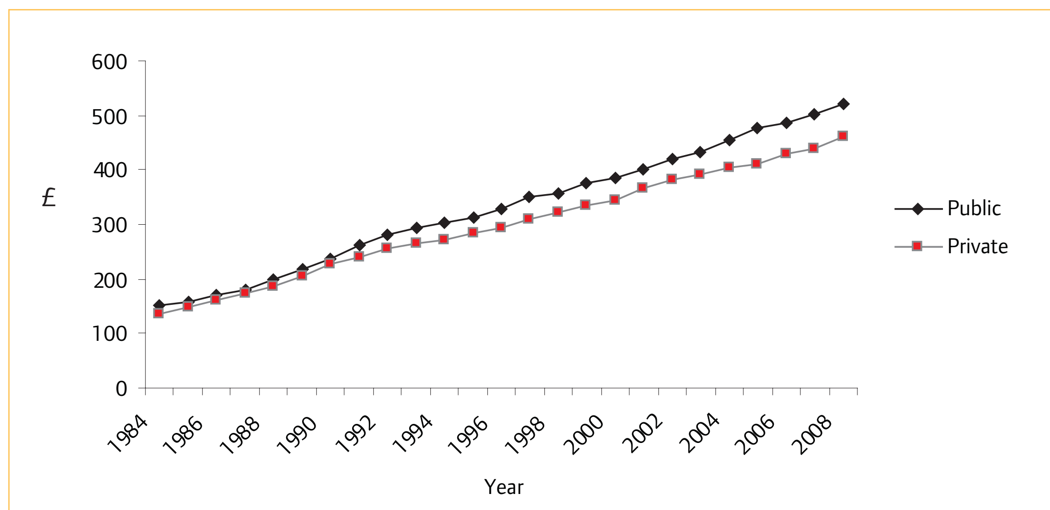
Trends in pay

If we examine the average earnings of public and private sector workers, as compiled in the Annual Survey of Hours and Earnings, it shows that the difference between the public and private sectors is minor. Over the last 10 years the average pay of adults in the public sector (in full-time work and whose pay was not affected by absence) varied from 4 per cent higher to 4 per cent lower than that of those in the private sector. For the 10 years as a whole, the public sector was 0.6 per cent worse off. Hardly earth shattering and you might say that over time, reward is fairly evenly distributed: but actually it is not.

To understand this, we must turn to the statistics not on average earnings but on median earnings. Sometimes the average and the median can be the same. The woman of average height is likely also to be of median height, with half the female population shorter than she is and half taller. However, earnings are not distributed in this way. There are a lot of women who do not earn very much – perhaps they are on £10,000 a year – but there are a few who earn more than £100,000. Adding in these high salaries pushes up the average, but it has very little impact on the median – the salary of the halfway person. If we are interested in what incomes most people get, we should be much more interested in the halfway mark than in the average. If we only look at the average, then the figures will be skewed by the small proportions of very high earners.

Although in terms of averages the public and private sector are very similar, the median public sector worker in 2008 was paid 14 per cent more than the median private sector worker. The minor differences between the averages is thus only the result of the fact that the typical public sector worker earns more than his or her counterpart in the private sector

Figure 14.1. Median weekly earnings, £ (all)



but this is offset by the fact that in the private sector at the top end there are a few workers paid big money.

For most people it is more lucrative to be paid by the taxpayer. This means that although there are many low paid people in the public sector, there are just as many in the private sector. Moreover, this differential has been increasing.

Figure 14.1 above shows the earnings of the median person in both the private and public sectors. It is clear that a negligible difference in pay in the mid 1980s slowly escalated throughout the subsequent period and especially since the turn of the Millennium. This has happened for a number of reasons.

The last ten years have seen a huge expansion of spending and employment which has given the public sector a sense that its activities are worth more and must be paid more. Pay review bodies have bowed to the demands of staff for more pay to reflect the increasing demand for their services. Such bodies also create a self-referential circle where each review feeds off the one before to justify further increases. This process is often criticised when it applies to, say, members of boards of public companies. It has received much less attention in the wider public sector.

The median public sector employee would have to suffer a cut in wages of 15 per cent to be at the same level as the median person in the private sector distribution.

Would this be fair? Not if the pay differential is justified for one of two reasons. One is if the terms and conditions of employment are more attractive in the private sector and this compensates them for lower earnings. The other is if the higher earnings in the public sector reflect higher skills, more output and better value for money for the taxpayers whose incomes are used to pay for them.

In the case of terms and conditions, it is not the case that they are better in the private sector. Public sector employees still have access to defined benefit pensions, which are available to fewer and fewer private sector workers. In addition, holiday and other entitlements are rarely less generous in the public sector. This does not enable us to defend higher wages. Nor does value for money.

Trends in productivity

Recent estimates of public sector productivity show that since 1997 productivity has actually fallen (Phelps 2009). The calculations suggest that public sector outputs grew by 2.9 per cent per year between 1997 and 2007, the same rate as total output in the whole economy. However, inputs grew by an annual rate of 3.3 per cent, implying a reduction of 0.3 per cent per year in productivity. So even if public sector workers are more highly skilled, these skills are not producing extra output. Skills are being rewarded for what they might represent, not what they actually produce.

Two thirds of public sector activity has direct measures of output, such as numbers of children educated, and about half (in health and education) also has adjustments for quality. Only social security administration showed an increase in productivity between 1997 and 2007 and since this sector contributes only 2 per cent to total government output this is insufficient to counteract the fall in education, health, adult social care, children's social care, and public order and safety.[1]

Of course, these estimates are incomplete and inadequate. There are examples where, for example, keeping cases out of court might be effective in improving public safety but would reduce output. On the other hand, this can also be said of several aspects of private sector output, even though market measures are more readily available. Current estimates of productivity show that, on average, productivity in the economy as a whole increases by

1. The police and defence have no direct output measures along with an 'other' sector.

around 1.5 per cent per year. To turn the reduction of productivity in the public sector into an increase of this scale would require a massive mis-measurement of outputs, which seems quite implausible.

It is hard to avoid the conclusion that relative earnings in the public sector have risen, while terms and conditions have shown a relative improvement and productivity has fallen. This implies that the taxpayer is having to work harder and harder to support the activities of the public sector.

To compensate for the loss of productivity over the last 10 years for which we have data, earnings should fall by a further 3 per cent to bring them more in line with the private sector. This of course makes no allowance for any differences in levels in 1997, for which I have no evidence. Even so, it is the changes that are being compared. The relative cost of the public sector has risen – by 17 per cent – due both to the increase in wages and the loss of productivity.

These estimates are across the whole of the public services. It may well be the case that these aggregate figures conceal regional and sectoral distinctions which paint a different picture. For example, in London differentials look less positive than in the rest of the country. A report for the Greater London Authority in 2003 argued that high job vacancy rates reflected the effect of national pay scales which failed to show the realities of the London labour market and costs of living (NERA 2003).

Equally, there may be parts of public service that do deliver value for money compared to the average. However, the existing statistics do not identify that there are many. In the final analysis, public services face a willingness-to-pay test which ought to be as strenuous as in markets where consumers can vote with their feet. Indeed, given the state's compulsive powers, this test ought to be even more stringent. Public service workers have no inbuilt right to be paid better and on better terms than those in the private sector. Incentives for more people to find opportunities in the private sector could well increase growth and value-added in wealth-creating sectors. Such value-added is the source of greater taxes and revenues overall for the economy and in turn can generate better and more effective public services of whatever form.

Conclusion

The last 10 years have seen great expansion of the public services. These investments have certainly created additional output but have not been value for money. The fate of the median private sector worker, paid less and taxed more than his or her public sector counterpart, creates quite the wrong set of incentives in the economy for growth and innovation. Taxpayers' money has been unduly used to increase the private consumption of those employed in the provision of public services rather than provide the services themselves.

The answer, however unpalatable, must be to shift this incentive structure. This must take several forms. The differences in terms and conditions must be addressed and the pension system must, at a minimum, be reformed for new entrants. Then there ought to be a pay freeze across the board, and pay cuts above the median level of, say, 10 per cent. With falling prices and falling mortgage costs, this will cause little hardship and is in any case the experience at present of many in the private sector. Such a proposal will still leave the median public sector worker better off than his or her private sector counterpart.

NERA (2003) *The London Labour Market, Case for London, Technical Report 4*, London: GLA Economics, available at www.london.gov.uk/mayor/economic_unit/case_for_london/labour_market_report_main.pdf

Phelps M (2009) 'Total public service output and productivity', *Economic and Labour Market Review,* Vol 3, No 8, August

15. Let's ask the public

Deborah Mattinson

Among the Westminster Villagers – politicians, journalists and policy wonks – there is a broad consensus that public spending must be controlled and borrowing reduced.

Much of the recent debate starts from the assumption that this, objectively, is the right analysis, and that it is an analysis that voters share. In fact, little published polling actually asks whether the public agree with the central argument, instead tending to preface questions with information that confirms rather than questions the consensus view. For example, Yougov asks: 'It is widely accepted that any Government will have to take tough decisions over the next few years to reduce borrowing…which of these options do you prefer?'

So, do the public actually buy into the view of the policy elite that a different approach to spending is required? It seems there is not straightforward acceptance of this view. While there is widespread public knowledge that spending has increased, the sheer scale of the increases has never cut through, and people struggle to understand the significance of the millions and billions bandied around by politicians and commentators. This has always been the case and focus group discussions over the years have revealed voters' lack of knowledge about the relative costs of different projects. For example, in the late 1990s irate voters demanding an end to spending on the Millennium Dome believed that the saved funds alone could solve all the problems of the NHS.

There are fundamental inconsistencies at the heart of the public's attitudes. Debt is universally agreed to be a bad thing – people apply learning from their own domestic finances and focus group anecdotes abound of friends and neighbours caught in a spiral of debt. Support is, therefore, strong for a long-term plan leading to debt reduction. There is also now an assumption that cuts are on the cards. In mid September, Populus found 84 per cent described 'significant cuts' as 'inevitable', regardless of the outcome of the next general election.

Yet, there is also support for a strategy of 'fiscal stimulation'. Despite the difficult vocabulary often used by politicians and commentators and the, initially counterintuitive, nature of the proposition, investment and 'growing your way out of a recession' wins voter credibility. In fact, there is considerable anxiety about cutting too soon. Yougov in September found 70 per cent agreed that 'public spending will be cut in due course, but if it is done too soon, Britain's economy will be damaged and unemployment would rise still further'.

It is vital to set the public's views of the options that politicians lay before them in this context. While people know there is a problem, they lack any real sense of its scale or implications. They are broadly aware of the debates about borrowing and debt, and cuts versus investment but do not hold a settled view of one solution.

In other words, the case for the Westminster Village consensus is yet to be made. The presumption of voters' agreement is a potentially dangerous underpinning if tough choices are to be made.

What solution does the public favour?

If asked to come up with their own solutions, and without having access to the information that has formed the policy elite's views, most voters will opt unequivocally for eliminating waste. The rationale for this is their assumption that governments waste tax-payers' money. There has not yet been a government that has escaped this criticism.

In June 2009, Yougov found 77 per cent agreeing that 'it is in principle possible to cut public spending by £10 in every £100 without reducing the quality of public services or the level of

welfare benefits'. MORI found that 63 per cent agreed that 'there are many public services that are a waste of money and can be cut', and 77 per cent disagreed that 'public services are already run efficiently, and the only way to cut spending is to cut services provided to the public'.

Yet qualitative research, digging beneath these figures, shows that the public's view of what constitutes waste is not clear. It suggests that people, often encouraged by politicians themselves, latch on to 'waste' – an uncontroversial negative – as a way of achieving imperceptible cuts. Further probing reveals that the same voter may be unwilling to live with the real consequences of the cuts that they propose.

When posed as a choice between alternative strategies, the public offer an unhelpful and inconclusive three-way split. Even when the question is prefaced with the usual stern restatement of the Westminster Village consensus – 'government borrowing is now at record levels and will need to be reduced in future' – 36 per cent favour 'government spending should be reduced even if it means spending on key public services should be cut', while 38 per cent agree 'spending on public services should be maintained even if it means increasing the income tax I pay'. There remains widespread uncertainty around the issue, with 27 per cent saying they 'don't know' which of the two statements comes closest to their views (MORI, September 2009).

However, when a more straightforward choice is presented between tax increases on the one hand and spending cuts on the other, the public dial turns sharply in the direction of cuts. In September 2009 Yougov asked, 'Should cutting the budget deficit be mainly through raising taxes or cutting public spending?' Faced with a question that does not mention the potential impact of spending cuts on public services, only 21 per cent of the population supports tax increases while 60 per cent back spending cuts. It is clear that the precise phrasing of a question around this complicated issue has a powerful effect on the results of opinion polling: it seems that mentioning 'spending cuts' without talking about 'services' leads to greater support for reducing expenditure.

If cuts are to be made, where should they fall?

One thing is clear from the surveys and focus groups: the NHS is a sacred cow in voters' eyes and contemplating health cuts is a risky exercise for any politician. Just 6 per cent picked health from a list of candidates for cuts supplied by Yougov. When asked, unprompted, to name the areas people feel should be protected from cuts – even if it means tax rises and/or cuts elsewhere Populus has health topping the list by 15 points. MORI found that 77 per cent believe that 'some services should be protected' despite the consequence of cuts elsewhere or rising taxes, and that 82 per cent of that group had the NHS in mind (schools and care for the elderly come second and third).

This dogged commitment to spending is true even when the question is prefaced with the Westminster consensus about the 'deficit in public finances', as Comres has shown: support ran at 82 and 84 per cent for not just maintaining spending in health and education but increasing it in a September poll.

A recent MORI study found that overseas aid was the preferred area for cuts at 56 per cent, with benefit payments second at 44 per cent, while defence was the favourite in a Yougov poll (which did not offer overseas aid as an option). Populus invited voters to select their own candidates for cuts and had MPs' pay and perks as the clear winner followed by local authorities, defence, then civil servants/government administration.

Within these findings, there are demographic and party differences. Older voters are less likely to favour cuts to defence, as are Conservative voters, while Liberal Democrat voters are much more likely. There is, incidentally, a specific opportunity with defence: ICM found that 54 per cent agreed that, against a backdrop of Trident reaching the end of its operational life, 'Britain should no longer have a nuclear deterrent'. Yougov posed a different choice,

stating that replacing Trident 'is likely to cost around £20 billion' and offering alternative ways of spending the money. 30 per cent opted to 'replace Trident as planned' but 65 per cent preferred alternative spending plans including raising nurses pay (33 per cent) and building affordable new homes (23 per cent). Conservative voters were more likely to support the 'Trident as planned' option but still, on the whole, preferred the money to be reallocated.

The issue of welfare benefits is more nuanced. Many C1/C2 swing voters have long felt aggrieved that government is not fair to them. They see themselves as the 'squeezed middle': not wealthy enough to be insulated from the economic downturn, but not poor enough to be on the receiving end of handouts. They identify a group of 'deserving' poor: the elderly, those who have a long track-record of work and are recently unemployed, and the young. When Yougov offered a range of choices for alternative ways to spend the £1.1 billion used to help young people find work, 67 per cent opted to leave that budget as it was. These voters also identify 'undeserving' poor: people who they believe have not made a contribution, either because they are new to Britain or because they are long-term receivers of benefit payments. The 'undeserving' are harshly judged and consequently top of the list when benefit cuts are chosen.

Let's ask the public

So a review of the available data for guidance on public opinion turns up few certainties. We can see that the public does not yet fully buy into the Westminster Village consensus. This, of course, does not exclude that possibility in the future. However, as things stand, the detail behind the debate has not extended beyond Westminster. Meanwhile many voters, without the facts that they need to make an informed view, seem to base their opinions on long-standing beliefs: 'governments waste money', 'the NHS is a great institution', 'foreigners are work-shy' and so on.

It is the problem with opinion polls. James Fishkin, the founder of deliberative polling methods, whereby people are given balanced evidence before being questioned, observed that 'ordinary opinion polls can only tell you what people think, given how little they know'.

It is also the problem with an increasingly dysfunctional relationship between voters and Westminster, where each has developed such a low regard for the other that proper debate has become almost impossible.

If Westminster is serious about knowing what the public thinks then it must stop asking questions designed to reinforce the status quo and start to really listen. It must clearly communicate the facts behind the issues and seek to engage the voter in a grown-up, frank and open dialogue. Only this kind of no-holds-barred exchange of facts and views can lead to a genuine consensus about the way forward.

Of course, the alternative is to carry on as we are, presuming that we all agree about what needs to be done then debating the detail selectively. It is Westminster talking to itself, and it means that politicians and policymakers setting out their future stalls with an eye on the voters of Harlow, Slough and Redditch will continue to miss the mark.

16. Opportunities for new taxes

Paul Johnson

This volume focuses mainly on how the Government's fiscal deficit can be cut through reductions in spending. There is, of course, another route to closing the fiscal gap – tax rises. While spending cuts surely ought to bear the brunt of the work, tax rises will have to do their share – and that share may be quite substantial.

Raising really quite substantial sums can be achieved in numerous ways. It does not require major economic surgery, though it could provide the opportunity for radical and worthwhile changes to the tax system.

We can distinguish three broad routes to increasing the tax take:

1) Incremental changes to the current system. These could be more or less attractive, but large increases in the tax take are certainly possible without significant reform or new taxes

2) Raising more revenue as part of a long-term vision of reform, which may include, for example, improving the efficiency of the tax system, increasing the role of environmental taxes or increasing progressivity

3) New taxes, or substantial changes to current taxes, driven by immediate needs but without a long-term vision.

The incremental route is possible, though there is much to be gained from taking the reformist route, especially following a long period of increasing complexity and lack of apparent direction in policymaking. Unfortunately the current government appears set on taking the last, most damaging, route.

Incremental changes

It is important to be clear that Route 1 is perfectly plausible. Relatively large sums of money can be raised – in more or less rational and desirable ways – through incremental changes to the current system.

For example, a 1-penny increase in the basic rate of personal income tax would raise around £5 billion annually by 2011–12. And we should quite definitely not rule out an increase of this kind. The 20p in the pound basic rate is the result of a downward trajectory over the last 30 years. There would likely be no great economic cost to raising it to 21 or 22p – which is, in any case, where it appeared to have settled before the fun and games that accompanied the abolition of the 10p lower rate of tax. It is bizarre that such a possibility seems effectively barred as part of political debate.

Increases in national insurance contributions, on the other hand, seem much more popular with politicians. Again, big sums are potentially available. A 1p increase in the main employee rate would raise over £4 billion a year and a similar increase in the employer rate would rake in more than £5 billion. While the basic rate of Income Tax has been declining for 30 years, these less politically troublesome – but less economically sensible and less progressive – National Insurance rates have been gradually ratcheted up.

A similar amount, about £5 billion, could also be raised by 2011–12 by not indexing any Income Tax allowances and limits. This would almost certainly be politically easier – nobody would appear to lose out in cash terms, even if there would be real effects. But its effect is much more regressive than a simple increase in tax rates. In fact, perhaps rather surprisingly given its pretension to progressiveness, the current government has already made very substantial use of fiscal drag, through a failure to index allowances and limits in line with earnings. The number of people paying Income Tax rose from 25.7 million in 1996–97 to 31.6 million in 2007–08 and the number paying it at the higher rate rose from 2.1 million to 3.7 million over the same period.

Raising the main rate of Value Added Tax by a penny would also raise about £5 billion a year. Increasing duties on petrol and diesel, a route which was used extensively in the 1990s to help close the fiscal deficit that existed at that point, raises around £1 billion for every 2p increase.

The point of these illustrations is not to suggest that any or all of these policies would be the right ones. Indeed most would be distinctly undesirable. Rather it is to show the power of the current system to raise substantial additional revenues.

Reform

While it is clear that real reform is not necessary to raise revenue, there is, nevertheless, a very strong case for a long-term programme of reform aimed not just at increasing tax revenue but also at creating a more rational and more effective tax system. For at least the last decade, the tax system has suffered badly from the lack of any long-term vision or direction. This is perhaps best illustrated by the number of simple policy about-turns in recent years. The most egregious examples include the introduction then abolition of the 10p starting rate of Income Tax, the introduction then abolition of taper relief for Capital Gains tax and the introduction then abolition of a zero rate of Corporation Tax for small companies. In each case the original policy was ill conceived and the about-turn was welcome from an economic point of view but highly damaging politically. It is crucial that the next government takes a view of where it wants the tax system to head.

Among the directions for reform that are worth considering, three have the potential both to raise revenue and to improve the tax system in one dimension or another.

First, rather than raising the current VAT rate, VAT could be extended to cover the wide range of goods and services that are currently exempt, with a suitable compensation scheme for low-income households alongside. A compensation scheme can be readily designed to compensate such households on average. The problem is always that there will be low-earners who lose out – those who spend unusually large amounts on goods on which VAT is not charged. This makes the transition difficult. But to fail to make changes for this reason results in the status quo never changing.

Moving to a wider VAT base would significantly simplify the current system and it would get rid of the distortions that favour one kind of consumption over another. The argument against is that the poor spend a larger proportion of their income on currently VAT-free goods such as food. But exempting such spending from VAT is not an effective policy for redistribution. In cash terms the rich gain more from it. The Income Tax and social security system – which are designed to do the heavy lifting in terms of redistribution – can be changed to compensate the poor, on average, for the VAT change.

Second, there is some scope for increasing environmental taxes – though not perhaps to the extent that some have claimed. Three substantial changes are possible.

- The imposition of VAT at the full rate on energy consumption (essentially part of the first suggestion above). It is bizarre that we currently effectively subsidise energy consumption by charging VAT on it at just 5 per cent.
- A carbon tax, particularly on those parts of energy production (importantly, gas use) that are not part of the current European Union Emissions Trading Scheme.
- Widespread introduction of road-user charging. This is not just desirable – in that it would have substantial economic benefits – but is urgent and will become increasingly so because as cars become more efficient the tax on petrol will yield less money and will relate less directly to the main externality that driving actually creates – congestion.

Third, thought needs to be given to the taxation not just of income, but also of housing. Council Tax is currently regressive in relation to house value – the less valuable the house,

the higher the Council Tax as a proportion of value. It is also capped such that owners of £10 million homes pay no more than those who own £1 million homes. Both equity and efficiency demand that it relate more closely to house value (and that the next government finally manages to institute a revaluation of properties so that relative value in 1991 is no longer the tax base used). In addition, owner-occupied housing is still significantly more lightly taxed overall than rented housing and a case can be made for going at least some way to eliminating this anomaly.

There are other reforms, for example to Inheritance Tax and Capital Gains Tax, which could raise revenue and improve the equity and efficiency of the system. At present any gift made more than seven years before death is entirely free of Inheritance Tax. Capital Gains Tax is charged at a rate lower than tax on income from savings. CGT liability is also forgiven entirely at death. Various assets such as agricultural land are exempt from Inheritance Tax. All of these features are both distorting and inequitable.

Other desirable reforms – to the taxation of savings and profits for example – might cost money. The crucial thing for a new government is to consider the reform of the system as a whole.

It goes without saying that none of these routes to higher tax take would be universally popular, or politically easy, but if there was ever an opportunity to make such reforms, the current fiscal climate surely provides it.

Dead ends

So we could make incremental changes to the current system. Much better, we could institute real reforms and improve the system's efficiency (and, through adjusting the direct tax and social security system, its equity) while raising revenue. Thus far, though, the current government appears to have taken the worst of all routes – imposing substantial new complexity without any clear long-run goal.

The most headline grabbing change announced by this government as part of its effort to raise tax revenue has been the imposition of a higher rate of tax at 50p in the pound on incomes over £150,000. Reasonable people can disagree over whether this is a good idea, and indeed over whether it will actually raise any money. Certainly it will not raise much. But alongside this have come one truly bizarre change and one massive complication of the current system.

The bizarre change is the introduction of a 60 per cent marginal rate of Income Tax on incomes between £100,000 and about £112,000 – such that the marginal Income Tax schedule goes: 20 per cent, 40 per cent, 60 per cent, 40 per cent and 50 per cent as incomes rise. This was sold as a tapering-away of the personal allowance for higher earners, but what it is is simply the imposition of a 60 per cent marginal rate over a range of income.

The massive complication is the limiting, to 20 per cent, of the value of tax relief on pension contributions for those earning over £150,000 (actually there is a taper towards 20 per cent that starts for those at £150,000). One of the many extraordinary features of this change is that it directly contradicts the huge amount of work that led to a significant simplification of the taxation of pensions just a few years ago. (It is, therefore, yet another example of the current government's lack of an overall tax strategy.) It also creates a series of inequities – between those with different sorts of pension schemes and between those with different shaped earnings profiles – and incentives to reduce apparent earnings.

Conclusion

There is an urgent need for the next government to adopt a coherent tax strategy. If it does so, it can raise additional revenues while not imposing substantial additional costs on the economy and while improving the overall functioning of the system. This is one of the big wins that the current fiscal crisis actually makes available. It will take some political courage to take advantage of this opportunity, but the prize is worth the cost.

17. Is this the future and does it work? Lessons from Canada

Peter Kellner

Modern democracies are not good at cutting public spending. Their politicians are afraid to axe cherished services and opinion polls feed those fears. The result is that governments tiptoe round the edges: hunting for efficiency savings, curbing 'red tape', closing quangos, increasing the role of the private sector, nibbling at the least popular budgets – such as prisons and defence… and doing all of this haphazardly. When crises demand urgent short-term cuts, the favoured method is to postpone capital spending projects, for who will really mind if a new road or hospital is delayed by a year or two, provided that frontline services do not disappear in the meantime?

There are plenty of examples from Britain and other countries of how to cut public spending in such piecemeal ways. The Thatcher and Blair/Brown years were full of them. But what about undertaking a thorough, one-off, big-bang, reduction in what the state spends? Probably the clearest lessons come from Canada, which set out in 1994 to cut central government spending's share of gross domestic product by one-fifth, in order to bring terrible federal finances under control. In subsequent years the budget deficit disappeared and the economy flourished. It is no wonder that in recent months some British journalists have written articles whose message for both Labour and Conservative leaders can be simply summarised as 'Copy Canada'.

If only it were that easy. Certainly there is plenty to learn from the Canadian experience. But there are also big differences in the underlying nature of the two countries and between their economic circumstances then and ours today.

What happened in Canada?

Between the mid-1970s and the mid-90s successive Canadian governments lived well beyond their means. Public spending climbed from under 40 per cent of GDP to more than 50 per cent, but tax revenues did not keep pace. As a result, federal debt climbed from less than 20 per cent of GDP to more than 70 per cent. The government deficit averaged 6 per cent of GDP, and at times touched 9 per cent. Real interest rates soared. One third of all government spending was used to pay interest on the massive debts. Italy apart, Canada entered the mid 1990s with the weakest public finances of any major economy. The core reason was not wilful profligacy, but the mounting cost of implementing a raft of social reforms passed in the late 60s and early 70s, such as better state pensions, health care and unemployment insurance.

In October 1993, the Liberal Party returned to power with a sweeping victory, ousting the Conservatives whose contingent in the 295-seat Parliament collapsed from 155 to just two. Barring some political catastrophe, the Liberals could look forward to a decade or more in power. This confidence gave them the political room to take radical action to cure the government's finances, and so redeem their election pledge to reduce the deficit sharply and eventually eliminate it.

As so often happens, the consequences of that bold pledge had not been fully worked out before the election. But, for once, an incoming government did not fudge the issue. It repeated its promise to halve the government deficit to 3 per cent of GDP by 1996–97. After some conventional nibbling at the spending figures in 1994 (cutting the defence and unemployment insurance budgets), Jean Chretien, the Prime Minister, and Paul Martin, the new Finance Minister, embarked on a huge exercise, known as the Programme Review, to find big savings. For once that tired term 'root-and-branch' applies.

One of the most important initial decisions was to set rolling, two-year spending targets, combined with six-monthly progress checks. Previously, Canada (like most countries) had

published one-year plans and long-term aspirations. The trouble with these is that one year is too soon to reap the benefits of big changes, while the long-term is a land beyond the fiscal rainbow, which sharp-elbowed ministers protecting their departmental budgets can safely ignore.

Two years turned out to be not too soon, not too distant, but just right. It gave enough time for new policies to start working, but not enough time for ministers to dump responsibility for failure on their successors. This is certainly one lesson that could be applied to Britain especially if, as happened in Canada, ministers come to realise that their career prospects depend on how intelligently they offer to cut their spending, not how fiercely they protect their budgets.

The second, and larger, decision was to reject uniform, across-the-board cuts. As Mr Martin said in a speech in 1995, such a strategy 'is fraught with moral hazard since a policy of uniform cuts destroys the incentive for individual departments to become as lean and efficient as possible – that is, in the next round of cuts, the keener would risk hitting bone while their lax counterparts still have fat to slice' (cited in Martin 1996).

Instead, Mr Chretien appointed a special committee of ministers to go through each department's budget, line by line, and decide where money could be saved by doing the task more cheaply or more efficiently – or even abandoning the task altogether. It turned into an intense, six-month inquiry into the functions, as well as cost, of a government at the turn of the Millennium.

Although the decision-making process was ultimately conducted behind closed doors, it was undertaken within a context of wide public debate. At the start of the process, Mr Martin announced his overall objectives and published a range of background papers. The Finance Committee of the Canadian Parliament held a series of public meetings. Journalists, think tanks, pressure groups and individuals waded in. Few could dispute Mr Martin's verdict at the time that: 'the consultation contributed importantly to creating reasonable expectations as to the magnitude and the general nature of the budget actions that were needed. This is surely of great importance in building public understanding and support for any ambitious programme of fiscal consolidation' (Martin 1996).

That said, the final decisions were inevitably centralised. For the period of the Programme Review, Canada's future was ultimately determined neither by open debate nor by the aggregate effect of departmental planning, but by the Prime Minister, Finance Minister and a handful of officials in the Department of Finance and Privy Council Office. There was probably no alternative. Another lesson from Canada is that anyone in Britain who yearns for more decentralised government may have to defer their dream if they are serious about cutting public spending.

There was one respect, though, in which power was dispersed from the centre. Before the Programme Review, Canada's Federal Government attached strings to its large grants to the country's provinces: so much for education, so much for social protection and so on. Afterwards this was converted into a single block grant, for provinces to spend as they pleased. As the provinces, together, were responsible for almost one quarter of all spending on transfers and public services, this involved a large measure of financial devolution.

Provinces were not spared pain: their total income from the federal government fell by much the same extent, proportionally, as spending on federal services. But they had much the same freedom, and responsibility, as the central government in Ottawa. One of the effects was to engage far more people, both formally and informally, in the process of spending cuts. This further reinforced its public acceptability.

That particular reform would terrify civil servants in Whitehall. Such financial devolution would run counter to the trend in recent decades of centralising spending decisions and leaving city, county and district councils as delivery agencies rather than true arbiters of local

spending priorities. But then our councils bear little resemblance to Canada's provincial governments, whose powers are more akin to those of Scotland's government. In England, the differences with Canada are more apparent than the similarities.

Impact of the Programme Review

When the dust had settled the following impacts could be observed:

1. The overall targets were reached. Within three years, overall public spending fell from around 50 per cent of GDP to around 40 per cent. The public finances improved rapidly. Within five years federal net debt had fallen from more than 70 per cent of GDP to under 50 per cent; within ten years the figure had halved to 34 per cent.

2. Real public spending fell by 10 per cent in three years. With the economy growing, again by 10 per cent, over the same period, it was possible to reach the target of spending as a proportion of GDP.

3. The cuts were targeted. In percentage terms, the biggest reductions were in subsidies (to industry, transport and housing), overseas aid, the environment, welfare support and education. Health was largely protected, as was law and order. Just one department was allowed to spend more (Indian and Northern Affairs).

4. Many of the savings were achieved through privatisation and the transfer of government functions to freestanding agencies. Minor, but symbolically important, savings were achieved through slimming central government bureaucracy and reducing the number of civil servants.

5. Politically, the process worked: the Liberals won the next three general elections.

Lessons for the UK

Fifteen years on, Canada has changed less than might have been imagined back in 1994. The boundary between government and private responsibility has not shifted greatly. The health, education and welfare systems have survived largely intact. Indeed, health spending is now higher than ever, both in cash terms and as a proportion of GDP. Yet some changes are real. On the plus side, Canada did achieve substantial efficiency gains and cut spending in a relatively open and publicly acceptable manner. On the minus side, the pain has been visible, notably in education (with larger class sizes, especially in universities) and welfare: the Organisation for Economic Cooperation and Development (OECD) finds that the gap between rich and poor has widened significantly, and by more than in most advanced economies, since the mid-90s.

So what lessons are there for the UK? Procedurally, quite a lot. Any equivalent exercise here would do well to copy Canada's methods for persuading cabinet ministers to buy into the process, setting two-year targets, and involving the public in the debate. However, four qualifications should be noted.

First, Canada's federal structure is different from Britain's; we have fewer opportunities to spread the process among decision-makers locally and regionally – unless, that is, we intend to end Whitehall's ability to determine education policy and set welfare benefits across the country.

Second, as part of its process, Canada caught up with things that had already started to happen in Britain: privatisation and handing responsibilities to agencies. In these respects, we have less fat to shave from our system today than they had in 1994.

Third, neither Labour nor the Conservatives could copy Canada's strategy without violating commitments both parties share: reducing poverty, maintaining the quality of frontline services such as education, funding defence adequately and increasing overseas aid.

Fourth, and largest, part of the rationale for Canada's Programme Review was that its public-sector debt imposed not just a financial cost but an economic one. Excessive public spending

crowded out private enterprise. This happened via interest rates. Real interest rates in the early 90s were alarmingly high. For many private businesses, the costs of borrowing were prohibitive. As the Programme Review was implemented, rates halved. The private sector could borrow more cheaply. It was able to take up the slack in demand caused by public spending reductions. Growth continued. The impact on the jobs market was slower but Canada ended up with the lowest unemployment levels for 30 years.

Britain is not in the position Canada was in the mid-90s. Public borrowing is certainly very high but our interest rates are very low, as is inflation. In financial and employment terms, there is no evidence that public sector spending is crowding out private spending. This presents any British government dedicated to reducing government debt with a dilemma. If it does not act, the debt will grow even larger; but if it acts too soon and too sharply, its actions will hold back our fragile recovery by reducing the overall level of demand in the economy without stimulating private sector growth. Canada provides an essential guide to how to cut public spending; but the very different economic circumstances in which it acted mean that we should be careful about when, and how fast, we plan to reduce government debt in the first place.

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18. The case for a slimmed down state

Phillip Blond

The trouble with much of the current debate about the public finances, the indebted state and private sector revival is that it remains captured by an earlier economic model. Those on the left argue for the productive 'demand maintaining' role of public spending while those on the right point out the essentially unproductive nature of public expenditure. For the left, high levels of public sector debt and expenditure are, in the present situation, justifiable as the real danger lies in the complete collapse of the labour market and a huge rise in unemployment that could force us from a V-shaped recovery into an L-shaped recession. The right also fears a collapse in the private sector but they worry about the state crowding out private sector recovery with higher public debt leading to increased interest repayments and higher taxes on the private sector.

In one sense, both rationales are correct. The right is correct that the public sector can break the private sector. An increasing public debt is unsustainable as it needs higher taxes to finance it and those taxes levied on private businesses choke off private sector recovery which again diminishes the extent of the Treasury's tax receipts. So the deficit increases still further, requiring further tax increases and starting the cycle all over again. In such a manner, an unreformed state gradually strangles the private sector that alone can provide the tax receipts and revenue growth required for economic recovery. Moreover, increasing the tax take itself depresses the growth rate of the economy as a whole with the standard GDP loss per tax dollar raised variously calculated at between 30 and 50 per cent.[1]

Similarly, the left can argue, and it does, that the issue is one of maintaining demand while the economy is frighteningly fragile. Knock out public expenditure too early in the economic cycle, they contend, and all the demand in the economy collapses. You then have a huge jump in unemployment, which destroys both domestic consumption and investor confidence and plunges the economy into an even deeper slump.

Private sector growth

As can be seen from the above, the key factor required for economic recovery is private sector growth. Both left and right are cogent in arguing for it but they have on the face of it diametrically opposed views on how to achieve it.

What the right often miss is that one key to providing private sector growth is the public funding of infrastructure. If the state can provide the structural means to aid competitiveness – transport, broadband capacity, education and the consequent development of high-end skills – then public expenditure can, and indeed does, aid private sector growth. But objectively – this is where Labour has so evidently failed – British infrastructure is in a terrible state. Even though we are the sixth richest country in the world, we are rated 34th, behind Namibia and Spain, in terms of our infrastructure (Bosanquet *et al* 2009).

Insufficient investment in communications, utilities and transport is a key reason for low British productivity – indeed, Britain spends less on this area as a proportion of GDP than any other country in the Organisation for Economic Cooperation and Development (ibid). Our rail networks are decades behind those on the Continent in terms of cost per mile for the user and easy inter-city access (travelling horizontally across the nation rather than vertically via London is a form of suffering one would not willingly wish on another). Our transport networks are light years behind what has been achieved in parts of Asia and mainland Europe. Our education is producing the fiction of ever greater internal success,

1. See, for example, Harrison (2006: 165) or the following quoted from Smith (2006): 'the US Congressional Budget Office (CBO) has reported that the "typical estimates of the economic cost of a dollar of tax revenue range from 20 cents to 60 cents over and above the revenue raised"'.

while externally in the real export-creating skills of languages, technical ability and industrial innovation we are falling ever further behind.

One might argue that we have improved much of the income of those dependent on the state for their wages (the GP contract springs to mind, as do the NHS consultants who boosted their pay by more than 25 per cent for working fewer hours) but we have not generated enough national assets to make the growth in public expenditure a driver of private sector growth and success.

In short, we have spent too much, too ineffectively on the wrong things. Moreover, we seem to have got less for more. Public sector productivity has declined by 3.4 per cent in the ten years since 1997 whereas the private sector over the same period has seen a rise of 27.9 per cent. This productivity gap has produced a net loss to the public purse, if we had tracked the private sector gain, of some £58 billion (Centre for Economics and Business Research Ltd 2009). Any defence of the productive role of public expenditure has to address these issues and explain why we have failed to marshal the benefits of public expenditure for overall economic competitiveness.

In headline terms, public spending rose from of 36.3 per cent of GDP in 1999/2000, to 47.5 per cent in 2009/10, although the jump in this ratio in recent years is not so much due to a massive increase in public expenditure over the last three as it is to a collapse in the level of GDP. Nonetheless, the ongoing structural budget deficit is real – it comes from relying on the revenues generated from a bubble in the asset prices and making that a norm which forms the governing baseline for all future state expenditure. Far more cogent would have been to assume, as Giles Wilkes has pointed out, a 2.5 per cent long-term growth figure for the economy rather than the 3 per cent the Treasury appears to have used (Wilkes 2009). Given that the majority of the ongoing deficit (some 25 per cent) is caused by a collapse in revenues that began when the housing market stalled in summer 2007, the criticism of the Labour Party is less that there has been an unplanned surge in expenditure than that they believed their own propaganda. They suggested that a new economic paradigm with permanently low interest rates had been achieved and that the time of boom and bust was over, so growth figures and revenue streams from the good years could be safely incorporated into expenditure and debt ratios for the next.

But deficits are still real and a false assumption on ongoing growth has left public expenditure worryingly exposed. Public spending is now approaching 50 per cent of GDP and the annual budget deficit for 2009–10 is likely to exceed the £175 billion forecast in the April 2009 budget. The ongoing debt flow will hugely increase the stock of public debt and overall public debt could, if trends continue and nothing changes, hit nearly 100 per cent of GDP by 2015.

If the benign interest rate environment changes as other countries begin to move out of recession, British debt might look increasingly unattractive and would require a higher yield to sell. Thus, our debt position would become increasingly expensive to maintain and worsen the deficit still further.

We are not, however, in the 1980s. Even if core inflation in the UK is much higher than in competitor countries, few seriously think that we are facing a global inflationary problem. Thus the old rightwing agenda of price control is not applicable in current circumstances (or if it is, the real risk is deflation, not inflation). As such, even on these terms stimulating demand should be in a monetarist lexicon as the right thing to do. The real fiscal decision lies in playing off unemployment against deficit reduction. Cut too early and too soon and you risk kicking out the last prop holding up the British economy; you produce a recession that increases the deficit still further. On the other hand, do nothing and the deficit continues to rise and with it the cost and time of repayment and the risk of higher debt servicing charges.

Timing is everything

It remains true that we must go fiscally tight to reduce expenditure and monetarily loose to encourage private sector growth but the issue is when? At the moment we are loose fiscally and monetarily – and this is to maintain the economy as a whole. The indications that we are emerging from recession and so can safely and aggressively reduce public expenditure are just not there. In the third quarter of 2009 British GDP showed a further contraction of 0.4 per cent – leading to the longest recession on record of six quarters of continuous negative growth. Other countries seem to be emerging from the downturn but the UK appears still to be contracting.

The key is to produce private sector growth that generates the tax revenue to close the funding gap, while raising public sector productivity so that we can do more with less. By so doing it is hoped that the two lines on the deficit graph – revenues and expenditure – will start to converge rather than diverge. The British have historically lagged in various productivity measures compared with the US, France and Germany. The key difference seems to be lack of capital investment in plant and machinery. However, that might be because the UK is now a predominantly service-based economy that requires less capital investment. If so, then innovation in service delivery and in the service sector would deliver real productivity growth.

It is here that the idea of a slimmed down state and real increases in growth can start to gain some real traction. For example, if we can paraphrase the earlier economic model as one founded on an extreme individualism that requires the state to police the outcome, then the structural links between economically damaging self-interest and state bureaucracy become clear. In short, an anarchic market that has abandoned trust and eschewed ethos requires a state bureaucracy to police it and enforce contacts and compliance. The costs of this audit state are enormous. Target-setting distorts outcomes, budget-driven compliance substitutes false for true measures and thus erodes service, driving up failure rates and producing failure demand (the rise in demand on a service because of a failure to correctly address the problem in the first place – the need to see ten different people to get a benefit form filled in correctly or several different doctors to have an illness correctly diagnosed).

For example, as Paul Lewis has pointed out in respect of the introduction of quasi-markets in the NHS, during the 1980s the NHS employed around 1,000 senior managers and overall administrative costs accounted for around 5 per cent of the total budget. By 1995, the NHS employed 26,000 senior managers and administrative costs had more than doubled relative to the total NHS budget, absorbing about 12 per cent of the total budget (Lewis, forthcoming). In which case, any net gain in efficiency is absorbed by higher transaction costs, and there seems no real reason to assume that traditional contracting out is really any different from this.

Creating a civil economy

In place of the state increasing the costs of transactions through audit and compliance between two parties that are fundamentally suspicious of each other, we could instead begin to create a civil economy. A civil society requires both state and market to be subordinated to a more effective growth-engendering economy. That economy serves society; it both demands and creates trust. Trust so conceived minimises and reduces the cost of compliance. If the cost of transactions falls, then the regulatory burden on business is reduced and if trust becomes normative, more cross-party ventures are possible and so more business is engendered.

The state on this account is the agent of enforcement for an economy of individual suspicion. The rightwing case for a slimmed-down state is not, then, what one initially suspects – it is not about the old contest between privatised individuals and a collectivised state. Properly conceived, it represents the first sign of a new mutualism and a different sort

of capitalism. With less state you can have more society and with more society you can have more economy. We should abandon the logic that has led us to both state and market failure. With our economy in crisis we need instead what both these pseudo-alternatives have suppressed: the economy of civil society.

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19. Letting Scotland and Wales go it alone

Iain McLean

It is not, strictly, unthinkable that Scotland could 'go it alone'. The long-term policy of the Scottish National Party, which since 2007 has formed a minority government in Scotland, is sovereign independence within the European Union. In Wales, the nationalist party, Plaid Cymru, is in a governing coalition with Labour, but no credible proposals for full independence have been made.

If the people of Scotland or Wales opted for independence that would be their choice and I do not think people outside those countries should obstruct it. Obviously, any independence negotiations would have to cover the share of UK national debt that the independent countries would take on. They would also cover the apportionment between Scotland (or Wales) and the rest of the UK of:

- The UK Continental Shelf, and the resulting flow of oil and gas revenue
- The assets and liabilities of nationalised banks, especially RBS and the former HBOS
- Defence assets.

Opportunities and impacts

What opportunities in austerity would spring from either country going it alone? The public expenditure per head saved in the rest of the UK from the ending of block grant under the 'Barnett formula', and entitlement programmes such as social protection and public sector pensions, would be trivial, even though these blocks loom large in Scottish and Welsh public spending. Scotland and Wales contain only about 13 per cent of the UK population. What is large to them is small to the rest of the UK.

The real opportunity would be for an independent Scotland or Wales to take a different approach to taxing and spending, in the light of the substantial debt servicing costs and share of bank bailouts that they would have to service. Their tax effort is too low under the present regime. Faced with a hard constraint they would have to be inventive. There could be lessons for the rest of the UK.

Something approximating to 'National accounts' are produced for Scotland (Scottish Government 2009) but not for Wales. The Scottish Government publication *Government Expenditure and Revenue for Scotland* (GERS) shows that in most years Scotland, were it to be an independent state, would have a structural deficit at present tax and expenditure levels even assuming that North Sea Oil revenue was almost all apportioned to Scotland as the nationalist Scottish Government would like. For instance, GERS 2007–08 shows Scottish tax receipts, with almost all North Sea receipts apportioned to Scotland, amounting to £52.5 billion, and public expenditure in Scotland amounting to £53.3 billion (GERS 2007–2008, Tables 4.1 and 6.1). The latter figure is derived by apportioning current UK expenditure on non-devolved matters (defence, debt interest, international services) pro rata to population.

If 'national accounts' for Wales were produced, they would show an independent Wales to be in severe structural deficit. Wales, unlike Scotland, is a poor part of the UK. It has below-average tax receipts per head and above-average social protection per head.

The impact on the rest of the UK of Scottish independence would be broadly neutral in the short run, because, very roughly, the tax forgone from the North Sea would be balanced by the rest of the UK's taxpayers not having to finance the higher public spending per head in Scotland. In the longer run, as North Sea revenue faltered, the rest of the UK would do relatively better out of the deal and Scotland relatively worse: but that would be the Scots' problem. The impact on the rest of the UK of Welsh independence would be mildly positive because Wales is a small part of the UK. Its fiscal impact on Wales would be catastrophic.

What about fiscal autonomy short of independence? This has been proposed by the Scottish Government in its National Conversation (Scottish Government 2007) and by the Calman Commission on the future of devolution in Scotland (Commission on Scottish Devolution 2009). It is being considered by the (Holtham) Independent Commission on Funding and Finance for Wales, which has issued an interim report (Independent Commission on Funding and Finance for Wales 2009). Everybody in the debate, including an ad hoc House of Lords Select Committee on the Barnett Formula (2009), believes that the present 'Barnett' arrangements are indefensible. The options on the table are: reformed grant system; assigned taxation; or devolved taxation[1]. A mixed system, combining elements of two or all of these, is also possible.

Most commentators believe that the model for a reformed grant system would be the Commonwealth Grants Commission of Australia, whose Chair gave evidence to Calman. A reformed grant system would probably cut grant to Scotland, where public spending is high relative to GDP, and increase grant to Wales, where it is low. But as with Scottish or Welsh independence, this would make little net difference to the amount available to spend per head in the rest of the UK at a given level of taxation. It might, though, have knock-on consequences as regions of the rest of the UK queried their public-spending-to-GDP ratio – public expenditure per head in London, the richest region of the UK, is remarkably high.

Because Scots policymakers can rationally anticipate that they will do badly from a switch to an Australian regime, they will oppose it; policymakers in Wales will likely support it. But otherwise a move to a needs-based grant regime would have little effect on the rest of the UK. It might make the Scottish government a little more fiscally responsible as it had to count the pennies more carefully.

So the most interesting territory is tax assignment or devolution, especially tax devolution. There are already devolved taxes in Scotland and Wales. They have control over the rates and base of Council Tax and business rates. Scotland (but not Wales) has the power to vary the standard rate of Income Tax by up to 3p in the pound. This power (the 'Scottish Variable Rate') has never been used.

The most suitable taxes to devolve are taxes on things that cannot move. Taxes on land and property are the most suitable for devolution and Corporation Tax is the worst, closely followed by VAT. Devolution of Corporation Tax would lead to pretend incorporations in the lowest-tax regime. Devolution of VAT would lead to megastores in either Carlisle or Gretna and to online traders shifting massively and unstably to whichever regime had the lowest VAT rate (it would also, probably, be outlawed by the EU).[2] Although unexploited North Sea oil does not move, it is an unsuitable tax base for devolution because the yield is volatile and unpredictable.

Following this logic, pointed out by its Independent Expert Group on finance[3], Calman recommended the devolution of a substantial proportion of Income Tax to Scotland, together with a number of relatively small taxes on things and people that cannot pretend to be somewhere that they are not (landfill tax, aggregates levy, air passenger duty, and stamp duty land tax). The main taxes on land and property – Council Tax and business rates – are already devolved. Following the publication of the Calman Report, the Holtham Commission has called for evidence on whether tax powers should be devolved to Wales, with a consultation deadline of 31 October 2009.

1. Taxes are assigned if the proceeds from a certain territory are handed over to that territory's government for it to spend as it sees fit but with the subnational government having no power to change the tax rate or the tax base. They are devolved if the rate and/or the base, as well as the proceeds, are for the subnational government to determine.

2. This is not an argument against the assignment of VAT revenue to the place it is raised. That would have a modest incentive effect, encouraging the subnational government to grow its trading economy in order to improve its VAT receipts.

3. See the four volumes of evidence from the Independent Expert Group to Calman at www.commissiononscottishdevolution.org.uk/papers.php.

More than this: Calman came up with a cunning plan. The worst aspect of the present arrangements is that the governments of Wales and Scotland have (spending) power without (tax) responsibility – the prerogative of the harlot throughout the ages, as Stanley Baldwin might have said. In order to force the Scottish Parliament to set an Income Tax rate, Calman proposes that the level of standard-rate UK Income Tax chargeable in Scotland be reduced from 20p to 10p in the pound. The Scottish Parliament would then have to set a Scottish rate – perhaps 10p, in which case Scotland's funding stays the same; perhaps 9p, in which case it taxes less and must spend less; perhaps 11p, in which case it can spend more but must tax more. In any case, the marginal decision on taxing and spending then rests where it belongs – with the elected representatives of the Scottish people.

The power to tax implies the power to borrow. Since tax yields would be less predictable than the present 'Barnett' grant, the Scottish and Welsh governments would have to have the power to borrow, both to smooth the cycle of tax receipts and to finance capital formation. This could again bring a dose of fiscal realism. As in Canada and many other countries, the market could rate Scottish and Welsh government debt and the cost of capital would vary with the credibility of the related future income stream. This might cure the Scottish government and people of the belief that the new Forth Bridge and the Borders railway are manna from heaven.

Making Scotland (or anywhere else) fiscally responsible also aligns incentives properly, unlike now. The Scottish government would have a direct incentive to make its economy grow, because then it can spend more and/or reduce the tax rate. This could have really dramatic results for the taxes that nobody is talking about, namely land and property taxes. Council Tax is a bad tax; so is stamp duty on house purchases; and business rates are little better.

Council Tax is seriously regressive – the poor pay proportionately more than the rich. It bears almost no relationship to current property values. It allows homeowners to profit from windfall gains due to public investment, such as a new hospital or the Edinburgh trams (well, one day…). It gives people in bigger houses than they need no incentive to trade down. Stamp duty is levied on an absurd, corruption-inviting 'slab' system where, above a threshold, the whole value of a transaction is taxable at the new rate. Expensive curtains, anyone? There has also been a hugely distorting exemption of residential property from Capital Gains Tax since Conservative Chancellor Selwyn Lloyd abolished 'Schedule A' of Income Tax in 1961.

At present, NIMBYs have an incentive to block every planning application that would grow an area's tax base. NIMBYs have votes; the beneficiaries of development, such as future social housing tenants or future employees of an industrial development, do not. There are serious biases against economic growth in the planning and property tax system.

These are some of the multiple reasons why everybody who thinks about it seriously favours an *ad valorem* land tax. There is no real difficulty in establishing the size of the tax base (that is, the capital value of the land underneath houses and businesses) since there are many transactions that are recorded on a national database (the Land Registry)[4]. The problem is political. Any suggestion to change a tax regime provokes screams from the losers and silence from the winners. This happened when council tax valuations were updated in Wales in 2003. Politicians have not had the courage to move to a defensible system of land and property taxation. If public spending on things they like to show constituents at election time came to depend on it, they might find the courage to move.

Spatial economists think that the UK land-use planning system is the biggest barrier to economic growth in the country[5]. A government with the courage to tackle it could make

4. I don't take sides in a 100-year old controversy as to whether the tax base should be simply land ('Site Value Rating') or land plus the property on it. They would have similar results and offer similar incentives to government and taxpayers.

5. See chapters by Nicholas Crafts and Stephen Nickell in Uberoi *et al* 2009.

huge gains in tax yield and economic efficiency at the same time. Scotland and Wales have the chance to lead – but the rest of the UK could follow. Scrap Council Tax and stamp duty, relocalise business rates, impose an *ad valorem* land tax on houses. And if that does not sound sexy, in the centenary year of Lloyd George's People's Budget, remember the old Liberal marching song:

Sound the call for freedom boys, and sound it far and wide,
March along to victory, for God is on our side,
While the voice of nature thunders o'er the rising tide:

"God gave the land to the people."

Chorus:

The land, the land,
'Twas God who made the land,
The land, the land,
The ground on which we stand,
Why should we be beggars
With a ballot in our hand?

God gave the land to the people.

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