Pointmaker

FIVE FISCAL FALLACIES

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SUMMARY

- Today's debate over fiscal retrenchment is obscured by five fiscal fallacies.
- Fallacy #1 is that the UK's past fiscal profligacy is indefinitely affordable and sustainable. The reality is that it is neither, and continued profligacy would risk severely impairing economic performance and condemning millions of mortgage-paying homeowners to penury.
- Fallacy #2 is that the economy would perform more strongly if the state continued to spend beyond its means. The UK cannot borrow its way out of a debt problem.
- Fallacy #3 is that the planned spending cuts are 'massive'. The reality is that they merely unwind a small part of the earlier profligacy.
- Fallacy #4 is that there is a direct relationship between government expenditure and the quality of public services. Yet productivity in the public services (particularly in the NHS once the increase in prescriptions is stripped out) dropped sharply over the last decade. The quality of any public service need not automatically suffer because of reduced levels of spending.
- Fallacy #5 is that there is equivalency between £1 spent by the state and £1 left in the hands of individuals and businesses. Evidence suggests that excessive state spending impairs economic competitiveness.
- There is no such thing as a pain-free recession. When a recession occurs, government cannot eliminate the pain, but it can use fiscal and monetary policy to defer the pain to the future. This is what the Labour Government did between 2008 and 2010.
- The snag with deferral is that the pain, when it arrives (as it must), will be much worse than if it had not been put off. This is why the Coalition is right to avoid the soft option of continuing the unsustainable strategy of using ever-greater public borrowings to push economic pain into the future.
- The most important issue is increasing private sector growth. Therefore the burdens imposed on business by Labour's obsessions with complexity, moral absolutism and political correctness must be cut – and quickly.

1. INTRODUCTION

Later this month, the Chancellor will unveil his budget in particularly trying circumstances. Economic growth reversed in the final quarter of 2010, consumer confidence has turned sharply negative, and opposition to fiscal restraint has intensified as cuts in public spending, announced last year, begin to take effect.

It is imperative that, despite these short-term challenges, the Coalition sustains its resolute approach towards restoring fiscal sustainability after a decade of reckless escalation in public expenditures. Thus far, the Coalition has stood commendably firm on the need for fiscal rebalancing. Ultimately, the critical issue is getting growth going at the same time as spending responsibility is restored. This is a tough call, but not an impossible one.

The general public appears to be undecided on the need for spending restraint.[1] This uncertainty may be based in large part on a string of misunderstandings which are described here as the "five fiscal fallacies".

The aim of this report is to explain why each of these five misconceptions is untrue.

1. It is *not* true that continued high spending is any way affordable in the medium or longer term.

2. It is *not* true that the economic outcome would be better, *in anything other than the very short term*, if government continued spending at unsustainable levels.

3. The spending cuts outlined by the government are *not* massive when they are seen in the context of the massive real-terms[2] increases in public expenditures since 1999-2000.

4. There is *no* automatic linkage between the scale of government expenditures and the quality of public services, so reductions in spending need not automatically impair public service quality.

5. Finally, there is *not* a zero-sum game between money spent by the state and money retained by private individuals and businesses. The UK's worst competitive weaknesses arise from excessive regulation and interference.

Of the "five fiscal fallacies", three were addressed in an earlier CPS paper,[3] so the fourth and fifth fallacies are the main focus of this report.

2. THE CONTEXT – A TOXIC LEGACY

The context here is the profound fiscal and economic failure of the Labour Government between 1997 and 2008. The seemingly-satisfactory economic growth of that period was largely illusory, a borrowing binge was misrepresented as sustainable growth, and, worse still, government spending increased up to and beyond the capability seemingly created by the phantom boom.

While the recession which began in 2008 did indeed have a global catalyst, the severity of the exposure of the UK was essentially home-grown. Government's ability to manage the decline in demand had been undermined by a spending spree which created one of the worst fiscal deficits in the OECD.

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[1] According to the latest YouGov polls, 50% now think the cuts are too deep, compared to only 27% who think they are about right (6% would prefer even deeper cuts). See http://ukpollingreport.co.uk/, 22 February 2011.

[2] Adjustments to 'real-terms' are undertaken using the broad-basis GDP deflator.

[3] T Morgan, *A Shower, not a Hurricane: the modest nature of the proposed cuts*, Centre for Policy Studies, October 2010.

How could this have been allowed to happen? Essentially, regulatory reform was bungled. The tri-partite system, which shared the Bank of England's regulatory role with the Financial Services Authority and the Treasury, resulted in a disastrous weakening of oversight. The Bank's monetary policy remit was tied to a strictly retail definition of inflation (CPI[4]), which ignored even the concept of *asset* price inflation.

Gordon Brown and his advisers seem to have subscribed to a 'debt doesn't matter' philosophy. Mortgage and consumer debt 'doesn't matter' so long as property prices remain high and incomes remain secure. Corporate debt 'doesn't matter' so long as cash flow exceeds debt service costs. Drastic overstretch of bank balance sheets 'doesn't matter' so long as the viability of the banks is not tested by unexpected shocks. Escalating external debt 'doesn't matter' so long as the country can continue to find willing lenders. Government borrowing 'doesn't matter' so long as GDP remains robust.

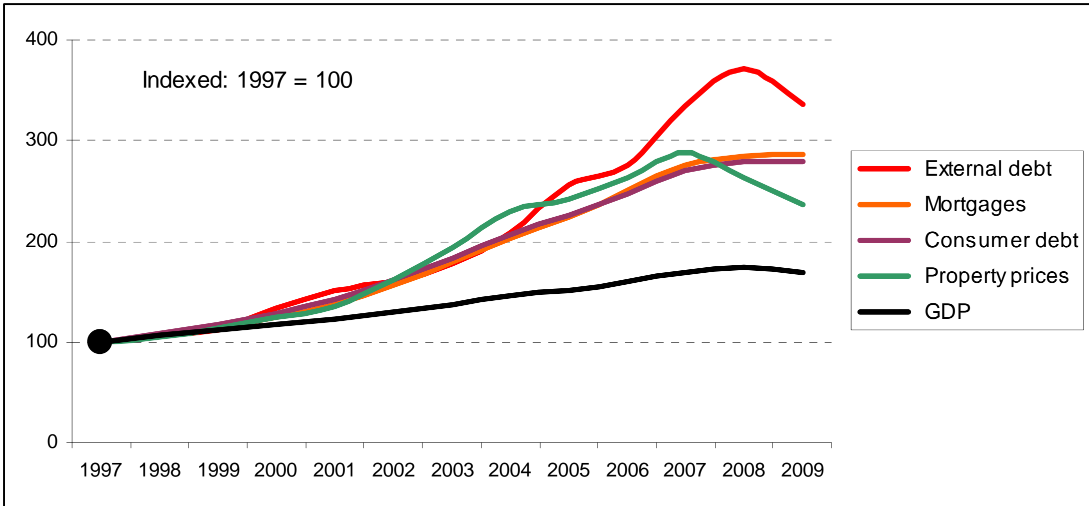
Each of these 'so long as' caveats was a hostage to fortune. Mr Brown seems to have had utter faith that nothing adverse would *ever* turn up, and that the economy could run indefinitely on a wave of escalating indebtedness.

Freed from the Bank's oversight, lenders threw caution to the winds. Long-established mortgage criteria, which had included a Loan to Value (LTV) limit of about 85% and a maximum loan-to-proved-income multiple of about 3.0x, were supplanted by LTVs as high as 125%, and by income multiples which, at the top end, were essentially unknowable, since many lenders no longer bothered to require proof of earnings.

The Bank, with its regulatory authority diluted and its monetary policy tied to retail price inflation alone, was powerless to intervene, and had to sit on the sidelines and watch the emergence of a massive debt-driven asset bubble. Between 2000 and 2007 – a period in which nominal GDP increased by 44% – property prices, outstanding mortgage amounts and unsecured consumer lending rose by 131%, 121% and 110% respectively (See Figure 1).

[4] The Consumer Price index, a measure of inflation.

FIGURE 1: OUT OF CONTROL – THE DEBT-FUELLED 'BOOM'*



Sources: HM Treasury, Bank of England, Office for National Statistics, Lloyds Banking Group

Meanwhile, and because both fiscal and monetary policies had discouraged saving, the escalation in mortgage, consumer and corporate debt sucked in huge borrowings from overseas. Between 1997 and 2008, gross external debt soared from £1.68 trillion to £6.25 trillion. In 2010, the UK had external debt of $144,000 for each man, woman and child in the country, a level drastically higher than in the US ($45,000), Italy ($38,000) or Spain ($47,000).[5] Even these debt figures, of course, exclude huge unfunded public sector pensions commitments.

The effect of the debt explosion was to create largely illusory growth. Consumers, reassured by inflated housing equity and bombarded by loan offers, opted in to the prevailing "debt doesn't matter" philosophy.

Inevitably, all of the 'so long as' caveats exploded simultaneously. Property prices did *not* remain high. Incomes did *not* remain secure. Corporate cash flow *did* fall. The banking system *was* subjected to external shocks.

Suddenly, debt *did* matter, very much indeed.

[5] CIA, *World Factbook,* 2011.

3. FALLACY #1: PROFLIGACY IS INDEFINITELY SUSTAINABLE

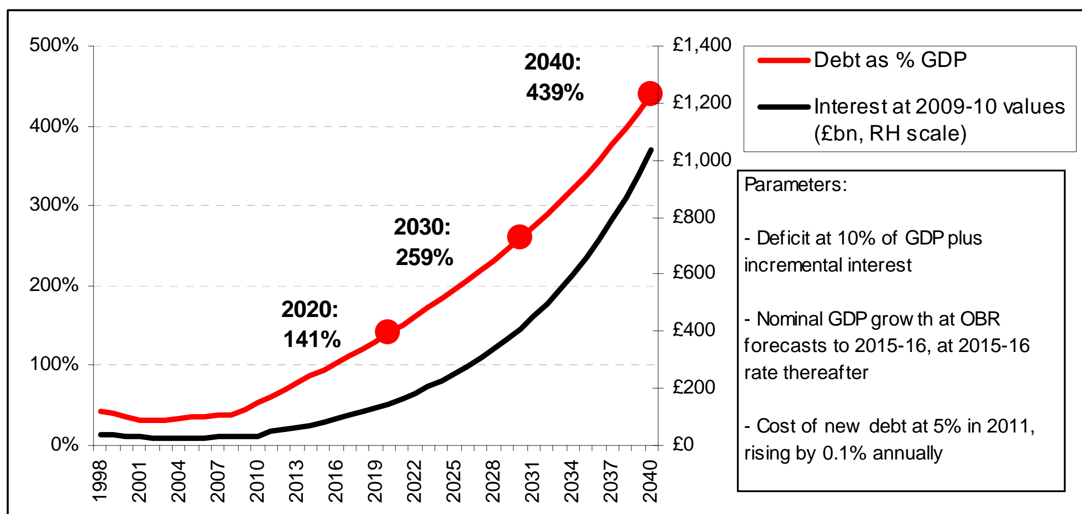
The first fallacy is that government could continue to run deficits at anywhere near the 2009-10 level (11% of GDP) *on an indefinite basis*. Anyone who believes this understands neither the debt markets nor the exponential function.

The exponential debt threat was addressed by the Bank for International Settlements (BIS) in a report[6] which warned that continuation of large deficits would quickly drive national debt to unsustainable levels. One reason for this is the exponential leverage created by escalating interest expense.

Figure 2 depicts the long-term trajectory for debt if the deficit remained at 10% of GDP. Both debt and real interest expense take off very quickly, and the situation rapidly becomes wholly unsustainable.

[6] BIS, *The future of public debt: prospects and implications*, March 2010.

FIGURE 2: EXPONENTIAL DEBT RISK



Sources: author calculation using BIS methodology

The BIS projections were even more frightening than this, showing national debt reaching about 300% of GDP by 2025 and well over 500% by 2040. Discussion about the timing of reaching such debt ratios is essentially academic, because debt at these levels could not be serviced anyway, interest rates would already have risen sharply, and the required annual debt increments would have become impossible to obtain.

4. FALLACY #2 – THERE IS AN ECONOMIC SOFT-OPTION

The second fallacy is that the economy would perform more strongly, *over the longer term*, if the state continued to spend far beyond its means.

This superficially-attractive counter-argument begins with the observation that deficit reduction impairs economic output because it takes spending out of the economy. That this is indeed true means that there is a seductive case for slackening the pace of deficit reduction.

But there are some serious objections to this superficially attractive idea. To understand why, we need to appreciate that, by definition, *there is no such thing as a pain-free recession*.

Obvious though this is, the public could have believed otherwise until recently. After the financial crisis, economic output declined by nearly 6%, yet many people actually felt better off, not worse. Far from falling, government spending had risen, from £583 billion in 2007-08 to £669 billion in 2009-10 and a likely £697 billion in 2010-11. Modest declines in real incomes had been far more than offset, for millions of households, by sharp falls in mortgage interest payments. The much-vaunted 'worst recession for 70 years' must, until recently, have seemed remarkably pain-free to a majority of British people.

The contradiction between a sharp economic downturn and apparent public comfort resulted from the huge fiscal and monetary stimulus. As well as slashing the base rate to an all-time-low of just 0.5%, the Labour Government, in the space of just two years, borrowed £250 billion and injected a further £200 billion through Quantitative Easing (QE), the contemporary euphemism for printing money. Add in the deficit likely to be incurred in 2010-11 and aggregate three-year stimulus totals £600 billion.

Such fiscal and monetary largesse is not remotely sustainable over anything other than the very short term. Moreover, the returns on this huge stimulus have been extremely poor, so advocates of continuing with big deficits need to explain the apparent disconnect between enormous stimulus spending on the one hand (£600 billion, or 40% of GDP, to date) and the very sluggish return to growth (in the range of 1% to 2% annually prior to the Government's fiscal tightening) on the other.

The explanation for the paucity of the growth return on this massive stimulus lies in the profoundly different nature of the current recession.

Prior to 2008, all of the recessions experienced since 1945 had been *destocking* events. Producers, either experiencing or anticipating lower demand for their goods and services, cut back inventories and capacity. The decline in demand becomes self-reinforcing, because capacity reductions undercut employment and hence spending power, whilst cuts in inventories and in purchasing force suppliers to cut their own capacity. Keynesians are right to argue that government intervention can be appropriate in a destocking recession.

The current recession, however, is different. It is a deleveraging event, *not* a destocking one. Businesses and individuals have looked over a debt abyss and have pulled back in fear. Their aim now is to reduce their leverage. Stimulus pumped in by government will be used to reduce debt, *not* to boost consumption. This is why stimulus has not, this time, worked according to the Keynesian calculus. It simply transfers debt from private balance sheets to that of the government.

The core problem with sustained high deficits is the interest rate risk. Since 2008, one of the main factors cushioning the economy has been the sharp fall in mortgage costs. If markets pushed interest rates upwards, the spending power of the UK's 11.4 million mortgage payers would fall sharply. Meanwhile, a rise in rates would impair mortgage affordability, pushing property prices downwards and trapping the same overstretched borrowers in negative equity.

There is of course *some* room for a debate over the pace of deficit reduction. The key issue is the sustained demonstration of resolve to the bond markets, in the absence of which the interest rate risk would become dangerous. Aiming to bring the deficit down slightly more slowly – to, say, the Maastricht limit of 3% of GDP over five years – might be taken as demonstrating sufficient resolve. In the long term, however, organic growth is strongly preferable to debt-driven public sector stimulus.

5. FALLACY #3 – CUTS ARE MASSIVE

Critics of the Coalition's expenditure plans attach terms such as "massive" to the scale of the spending restraint planned by the government. This is not the case.

In 1999-2000, government spending totalled £343 billion, which, had it simply moved in line with inflation,[7] have reached £438 billion by 2009-10. In fact, spending in that year was £669 billion, a real-terms increase of 53% over a ten year period in which GDP had increased by less than 17%. By 2014-15, and again expressed at 2009-10 values, aggregate spending will be a modest 3% below the 2009-10 figure, which cannot remotely be described as a "massive" cut. Moreover, spending will remain 48% higher than in 1999-2000 (see Figure 3).

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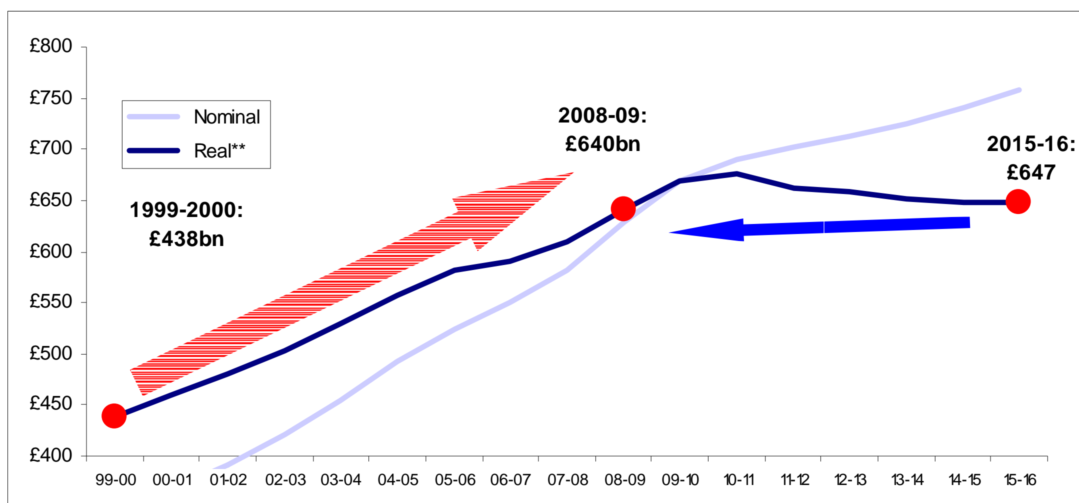
7 The broad-basis GDP deflator is used in this calculation.

FIGURE 3: THE MODEST SCALE OF THE PROPOSED CUTS



Sources: HM Treasury spending, GDP and GDP deflator statistics **At 2009-10 values

To be sure, there are three reasons why the cuts will feel a lot worse than this. First, and courtesy of the debt built up by the Labour Government, interest expense is poised to rise sharply, and, second, the Coalition has promised to protect real-terms spending on health and international development. These factors leverage the cut in unprotected departments to a real-terms 10%. Even here, however, expenditures will still remain 36% higher than in 1999-2000 (see Figure 4).

Lastly, departments have long become accustomed to year-on-year real-terms budget increases of about 4%, a factor which has encouraged a less-than-zealous approach to efficiency.

But no one should imagine that Coalition plans amount to a major reversal of past spending increases. By 2015-16, and expressed at 2009-10 values, spending (of £647 billion) will remain higher than in 2008-09 (£640 billion), let alone 1999-2000 (£438 billion). Between 1999-2000 and 2009-10, real-terms spending increased by £231 billion. In turning the spending clock back to 2008-09, the Coalition will be reducing real-terms expenditures by £22 billion, a small fraction of the previous escalation.

6. FALLACY #4 – EQUIVALENCY BETWEEN SPENDING AND SERVICES

When it is announced that there are to be material real-terms reductions in departmental expenditure, it is easy to think that this must feed through into a decline in the quantity and quality of the services that are delivered.

This natural assumption is seriously misplaced. The fourth fiscal fallacy is the belief that service quality is *always directly proportionate* to the amount spent by government. The reality is that there is no cast-iron relationship between government expenditures and the quality of public services. The quality of public services will not *automatically* suffer because of reduced levels of spending.

The absence of a direct spending-outcomes link can be demonstrated both logically and statistically.

FIGURE 4: DEPARTMENTAL SPENDING AT CONSTANT 2009-10 VALUES

£bn	1999-00	2009-10	2014-15	vs 09-10	vs 99-00
Health Care	£63	£120	£121	+1%	+92%
DfID	£5	£6	£10	+80%	+119%
Protected departments	£68	£125	£131	+5%	+93%
Pensions	£84	£117	£116	-1%	+38%
Welfare	£75	£109	£101	-7%	+34%
Education	£53	£86	£74	-13%	+39%
Defence	£36	£44	£48	+10%	+36%
Other	£90	£157	£121	-23%	+35%
Unprotected departments	£338	£513	£461	-10%	+36%
Spending before interest	£406	£638	£592	-7%	+46%
Interest expense	£32	£31	£55	+78%	+72%
Total Spending	£438	£669	£648	-3%	+48%
Real GDP	£1,207	£1,408	£1,583		

Sources: HM Treasury spending, GDP and GDP deflator statistics

Let's start with logic. If a Fire and Rescue Service, for example, hires two additional junior fire-fighters, it is reasonable to assume that the quality of the service will improve. But no such service improvement will ensue if the same budget is spent instead on employing a Diversity Officer. The same contrast arises if a GP practice decides to hire an additional administrator rather than an additional nurse.

Whilst some administration is of course necessary, a government which is expanding its expenditures should be able to capture economies of scale. The administrative staff required in a school with 20 teachers does not need to be doubled if the number of teachers is increased to 40. The back office which meets the needs of 10 doctors will not need to double in order to meet the needs of 20. The principle of economies of scale should mean that, *as expenditure increases, the front-line component of the workforce should expand much more rapidly than the back-office element*, so that the overall employment ratio should tilt in favour of the front line.

The importance of public sector productivity

This is not what happened from 1997 to 2010. To see why, we need to start by examining the relationship between public service output and the resources committed by government. In the private sector, measuring productivity is relatively straightforward, because the market sets a value on output. But measuring public service productivity is rendered much more difficult because of the general absence of market valuation measures for outputs such as health care, education and policing.

Historically, it was simply assumed that public service outputs were exactly the same as inputs, a situation which effectively embedded the fourth fiscal fallacy into the national accounts, and meant that policymakers and the public had no real way of knowing how much output they received for each £1 spent on public services.

Since 2005, however, the Office for National Statistics (ONS) has put commendable effort into measuring both the quantity and the quality of public service outputs. Such output measures are now available for health, education, adult social care, social security administration, children's social care, and public order and safety. Between them, these account for about two-thirds of General Government Final Consumption Expenditure (GGFCE).[8]

On an overall basis, the ONS has calculated that, between 1998 and 2007, outputs from public services increased by 33.6%, with gains varying between 52.5% in health care and 3.9% in SSA. Since inputs rose by 38.3% over the period, there was an overall decline in productivity of 3.4% between 1997 and 2007.[9]

Though very far from reaping the economies of scale which should have pushed public service productivity *upwards* over a period in which real spending increased by 52%,[10] this 3.4% decline, spread as it was over ten years, doesn't sound too bad. It implies that public service output has increased markedly, even though output has not quite kept pace with inputs. But how meaningful are these measures of output? To answer that, we need to take a detailed look at how health care productivity is measured.

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8 A measure of public spending which excludes transfer payments.

9 Since productivity = total output/total input, productivity growth for 1997-2007 can be calculated by dividing the output index value in 2007 (133.6) by the input index value for 2007 (138.3). This gives a productivity index value of 96.6, representing a 3.4% decline over the period.

10 Real-terms GGFCE, at 2009-10 values, was £309 billion in 2007 compared with £203 billion in 1998.

The bizarre world of measuring health care productivity

The output quantity measure for health care uses three categories of output:

- Hospital and Community Health Services (HCHS), comprising numbers of in-patient, day case and out-patient episodes. HCHS output increased by 43% between 1995 and 2008.
- Family Health Services (FHS), which comprise GP, nurse, dental and sight test services. FHS output increased by 25% between 1995 and 2008.
- GP prescribing of medicines. Prescribing increased by 201% over the 1995-2008 period.

These three categories of output are then weighted according to the sums spent on each. Thus weighted, overall output increased by 61.5% between 1995 and 2008. The further inclusion of various quality measures raises this output gain to 69.5% over a period in which inputs increased by 75%.

There are two obvious problems with this methodology. First, inputs – the aggregate of labour, goods and services – may have increased by 75% between 1995 and 2008, but real-terms health *spending* actually increased by 109%, from £51 billion in 1995-96 to £107 billion in 2007-08.[11] This tells us that the real cost of inputs has risen much more markedly than the volumetric measure of those inputs, which has significant implications where value-for-money is concerned.

Just as significantly, the number of prescriptions trebled between 1995 and 2008. Though prescribing is a relatively modest part of the overall weighting (accounting for 17.2% of expenditures in 2008), the huge scale of the increase in prescribing (201%) dwarfs much smaller output increases in the HCHS (43%) and FHS (25%) categories. Such was the pace of growth in prescribing that, since 1999-2000, government has spent more on prescriptions than on all Family Health Services combined.

Should the number of prescriptions be included as such a large measure of health care outputs? One could argue that a healthier population might even require fewer prescription medications, not more. The direct inclusion of prescriptions implies that doctors can improve both patient health and their own contributions to output simply by issuing more prescriptions, irrespective of the effectiveness of the medications prescribed.

In order to look at what role rising costs, and the questionable inclusion of prescriptions, have on health care productivity, two adjustments need to be made to the way in which health care output is measured:

- an index of real expenditures should be used instead of a volumetric input measure,
- prescriptions should be excluded from output calculations.

The results are set out in Figures 5 and 6 overleaf.

Figure 5 shows outputs both as measured by the ONS and on an ex-prescriptions basis ("Output excluding Rx"), and compares both with real-terms expenditures. On an ex-prescriptions basis, output increased by 43% over this period, a much smaller increase than the 69% recorded by the ONS. Real-terms expenditure rose by 109%, a far greater increment than output on either of the measures shown in the chart.

[11] Converted to 2009-10 values using the GDP deflator.

Another important point is that the divergence between spending and output only really began after 2001, the year in which the Labour Government, freed from a commitment not to exceed the public spending plans of the preceding (Conservative) administration, opened the spending taps. From then on, health care outputs seem to have fallen ever further adrift of the funds lavished on the service.

Figure 6 sets ONS and recalculated productivity indices against real-terms health spending. Over a period in which real spending doubled, productivity worsened by 3.3% on the ONS measure but by almost 34% when outputs are measured ex-prescriptions and are set against real spending rather than against volumetric resource use.

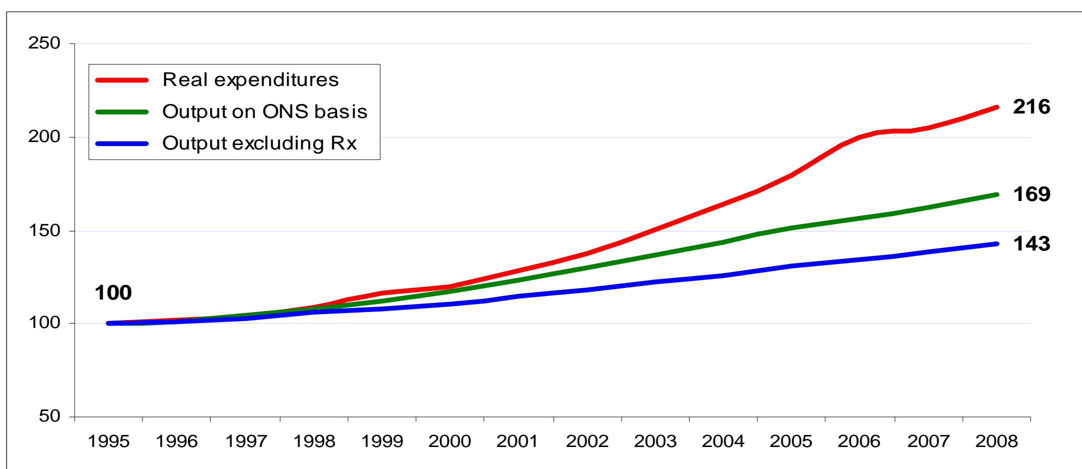
The implications of this calculation are far-reaching. If productivity had merely remained constant, and if the level of prescribing had not increased, the health care provided in 2008 could have been delivered at a real-terms cost that was much (34%) lower than the sum actually spent in that year (£102 billion).

The optimism of public sector productivity data

Health is by far the largest component of GGFCE (representing 31.5% of the total in 2007), but there are reasons to believe that the outputs of other spending categories are similarly exposed to the somewhat optimistic and simplistic methodologies used to measure health care outputs. The measurement of education output undertakes quality adjustment using published GCSE results even though many employers and others believe that these results have been affected by 'grade inflation'. Why not use, say, class sizes instead? The ONS itself concedes that output measurements in some sectors are even "less well focused" than those used in health and education, citing as an example the use of unweighted prisoner numbers in the measurement of prison service output. Wouldn't reoffending rates be a better measure?

The general point seems to be that real public service productivity may have eroded significantly over a period in which steady increases in expenditure ought to have driven productivity upwards by capturing economies of scale.

FIGURE 5: COMPARATIVE HEALTH CARE OUTPUTS AND EXPENDITURES, 1995-2008



Sources: ONS and author calculations, see text

Moreover, the private sector continued to increase its productivity throughout this period. In 2009, the Centre for Business and Economic Research compared the published 3.4% decline in public sector productivity between 1997 and 2007 with the 28% gain recorded in the private sector and concluded that taxation could have been lower by £58 billion had the public sector achieved private-sector levels of productivity improvement.[12]

The key point which emerges from this analysis is that there is no *automatic* equivalency between the resources committed by the state and the resulting quality of public services. Therefore, if the output of public services is not guaranteed to rise because more resources are committed, it follows that reductions in spending need not automatically degrade the quality of public services.

Tales of public sector waste

One set of reasons for the productivity deficit, identified by Sir Philip Green in his admirable Efficiency Review of government spending, is to be found in waste, in lax control and in inefficiency. A key finding was that government had failed to leverage either its scale or its credit rating as a purchaser of goods and services. The Review found faults in data correlation, in procurement practices and in budgeting, together with a lack of motivation to save money.

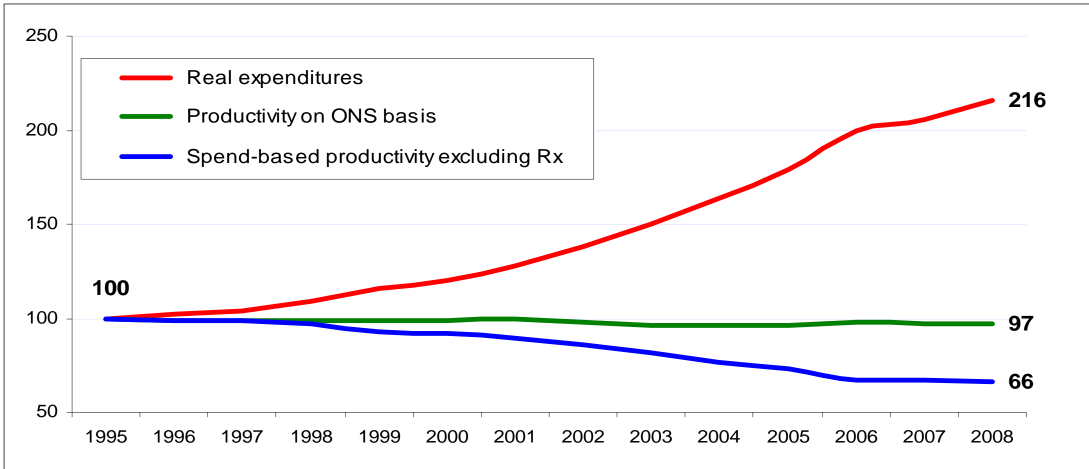
It is shocking, for example, that 71,000 public sector employees have *unmonitored* procurement cards on which they can each spend up to £1,000 per month, and that government typically "allows expenditure of up to £1,000 without monitoring or authorisation."[13]

Sir Philip was initially told that central government spent £2 billion annually on travel. This figure was then revised to £500 million, and revised again to the accurate-sounding £768 million, before he discovered that the actual sum was £551 million.

[12] As reported in the *Mail On Sunday*, 22 August 2009.

[13] Cabinet Office, *Efficiency Review by Sir Philip Green*, October 2010.

FIGURE 6: COMPARATIVE HEALTH CARE PRODUCTIVITY AND EXPENDITURES, 1995-2008



Sources: ONS and author calculations, see text

The impression which emerges is of a government machine which tolerates lax and wasteful practices, first because it doesn't have accurate data at its command and, second, because waste doesn't seem to matter very much.

A second reason for declining public sector profitability was the excessive bureaucracy built in to the Labour Government's target system. Each group of public sector targets requires one set of people to gather the necessary data and another set to receive and process the results. The target system inevitably skews public service outcomes towards arbitrarily-determined measures.[14]

The rapid proliferation of officials earning more than £100,000 annually throughout Britain's quangos, arms-length agencies and local authorities is another obvious sign of excessive and costly bureaucracy. The tax credit system also imposed huge bureaucratic burdens without achieving any improvement in equality.[15] Under Labour, the government consistently misused information technology, losing embarrassing personal records as well as wasting money on poorly-specified IT systems. Yet it still felt that an ID card system was a worthy cause on which to spend perhaps £18 billion[16]. When tax system miscalculations threatened 1.4 million people with additional demands, the initial response of HMRC – that it saw "no need to apologise" – seemed to typify the attitudes that had developed across the upper echelons of the public services under Labour.

The cumbersome tax credit system, the incompetent use of IT, the sprawl and arrogance of bureaucracy and the waste and inefficiency on the scale identified by Sir Philip Green are all shocking. But the main point, as it concerns the fourth fiscal fallacy, is that all of these failings involve *the spending of government funds in ways which do nothing whatever to promote the quality of public services.*

If we conclude that raising public expenditures by no means guarantees improvements in the quantity and quality of public services, then it surely follows that reductions in real-terms spending need not degrade services – always presupposing, of course, that the reductions are correctly targeted.

7. FALLACY #5 – PUBLIC-PRIVATE EQUIVALENCY

The fifth fallacy is that there is equivalency between £1 spent by the state and £1 left in the hands of individuals and businesses. The reality is that excessive government spending seriously impairs competitiveness. This can be considered in two ways.

First, there is not so much a gap as a chasm between productivity in the public and private sectors. Obviously, moving resources from a high- to a low-productivity sector necessarily impairs growth.

[14] Targets are, in any case, all too easily circumvented, as is illustrated by the anecdotal reports of hospitals employing "hello nurses" to greet each new arrival so that the patient has been "seen" within the required time, even if he or she then has to wait very much longer for actual medical attention.

[15] Between 1996-97 and 2008-09, the UK's Gini index (a measure of inequality) actually *increased*, from 33.3% to 35.7%. See Institute for Fiscal Studies, *Poverty, inequality and living standards spreadsheet.* The stated numbers are BHC (before housing costs), with inequality being considerably worse (40.3% in 2008-09) on an AHC basis.

[16] LSE cost estimate, reported BBC news website, 29 May 2005.

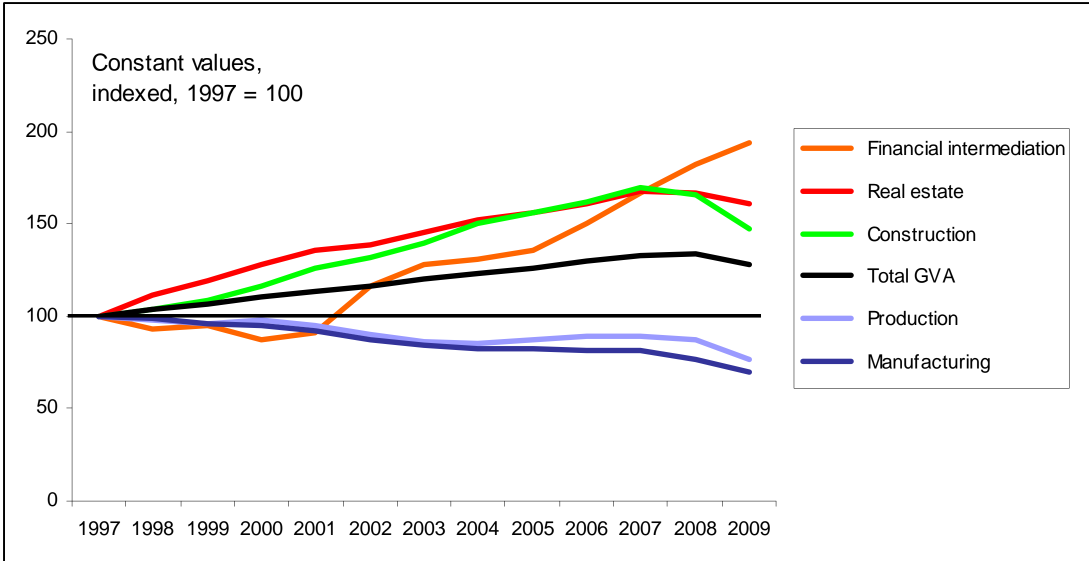
But that is precisely what Labour did when it increased public spending from 36% of GDP in 1999-2000 to 48% in 2009-10. Most of the 'growth' of that period was really a bubble, with escalating debt and soaring property prices creating booms in construction, financial intermediation, and real estate whilst manufacturing output declined (see Figure 7), and with rising personal debt driving consumption in a manner that was equally unsustainable.

Shifting resources from the high-productivity private sector into the lower-productivity public sector is emphatically *not* the way to create growth. Rather, government needs to improve not only productivity but competitiveness, and the most recent Global Competitiveness Report (GCR), produced by the World Economic Forum, highlights some striking weaknesses.

In the survey, the UK ranked twelfth within 139 countries assessed. The UK has a number of competitive strengths, particularly in technological preparedness, labour mobility and market size. But some of the weaknesses are extremely striking. The UK ranks 72nd (behind countries such as Ethiopia and Tajikistan) on the wastefulness of government spending, and 89th (behind Nigeria and Zimbabwe) on the "burden of government regulation". The survey ranks Britain an appalling 56th on the macroeconomic environment, reflecting 107th place on savings ratios, 108th on government debt and 117th on the deficit. Tax rates, tax regulations, inefficient government bureaucracy and policy instability are cited as four of the five most problematic factors for doing business, the fifth being access to financing.

The impression which emerges from the GCR is of a country with good technological and innovative characteristics which is hamstrung by a morass of bureaucracy, waste, over-regulation and interference. It is bad enough spending public money in ways that do not deliver an at-least-equivalent return in terms of services, but it is surely unforgiveable if public spending actually *undermines* economic competitiveness.

FIGURE 7: NOT SUSTAINABLY PRODUCTIVE – A BUBBLE ECONOMY



Source: ONS GVA series, adjusted using HM Treasury 2009-10 GDP deflator series, indexed to 1997 = 100

8. GETTING THERE

The conundrum faced by the Coalition is simple to state but exceptionally difficult to answer. On the one hand, the Coalition has rightly identified a need to reduce the deficit. On the other, fiscal tightening will undoubtedly impact growth in the short term (though failure to tackle the deficit could inflict *far greater* economic damage by forcing interest rates upwards).

Interest rate risk is the single greatest threat to the UK's economic well-being, so reducing the deficit is imperative. Aiming to reduce the deficit to the Maastricht 3% target might have been a slightly easier objective, but anything higher than 3% carries exponential debt risk.

By far the most important issue is getting private sector growth under way because, if this is accomplished, private sector expansion can offset (and, in due course, surpass) public sector contraction. The best way to do this would be to free businesses and consumers from the handicapping regulation that was created by Labour's predilections for complication and control-freakery. Much of the regulatory burden was created by an obsession with political-correctness agendas, with micro-managing and target-setting, and with spurious moral absolutism.

No one should be in any doubt that the economic pain from the recession *will* turn up, and that the only question about this is *when*. Putting it off through irresolution over the parlous state of the public finances would only serve to make the eventual pain very much worse.

A NOTE ON DATA AND GRAPHS

Detailed spreadsheets showing the background data and calulations for all statistics and graphs in this report can be found on the CPS website: http://www.cps.org.uk/cps_catalog/Statistics.xls

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ISBN 978-1-906996-29-1

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