POLICY CHALLENGE

PUBLIC SPENDING

A twenty-year plan for reform

Patrick Minford & Paul Ashton

CENTRE FOR POLICY STUDIES

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1995

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1
The present situation

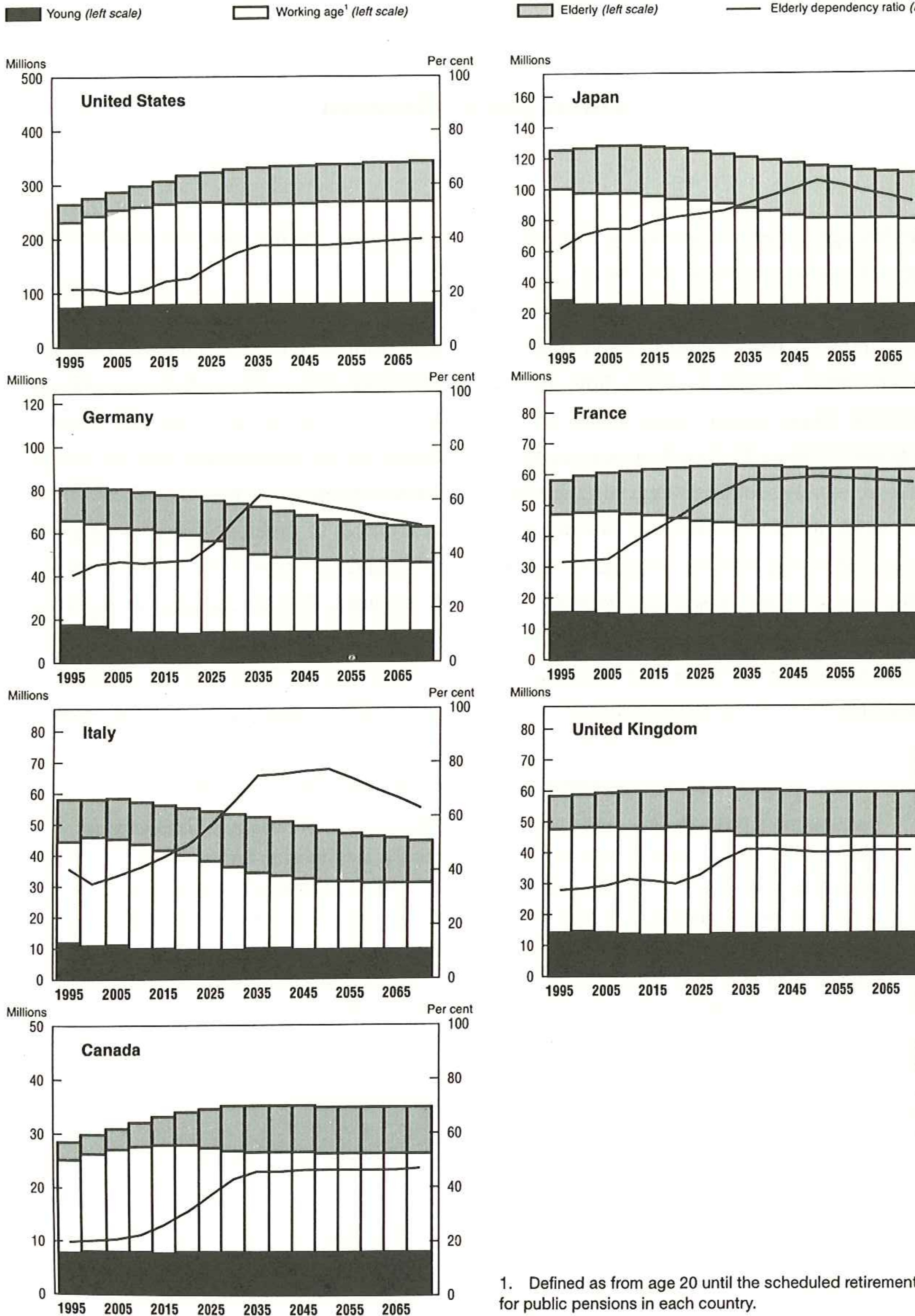
Public spending must be reduced if the economy is to prosper; and the economy must prosper greatly so that taxes can also be cut.

Huge demands on Britain's public finances will be made by an ageing population and a declining tax base. Figures 1a and 1b are reproduced from the OECD's *Economic Outlook* (June 1995). Figure 1a shows how the elderly:workforce ratio will rise from around the current 28 per cent to about 40 per cent by the year 2035. The OECD's own calculations shown in Figure 1b, based on current pension contributions and commitment policies, are in fact relatively soothing, suggesting that Britain — alone among the richest OECD countries — does not face a 'pensions time bomb'. This is a matter of opinion. There are already inexorable pressures for more spending on the elderly and past experience of the demands for welfare, partly associated with ageing, is not reassuring. It is all too easy to envisage worthy objectives on which to spend public money — and to forget the invisible cost, through taxation, to pay for them. Yet it is a cardinal point of economics that it is more efficient to keep tax rates low, and so stimulate activity across the whole economy, wherever opportunities

The reason tax rates should be kept low and equalised ('or neutral')

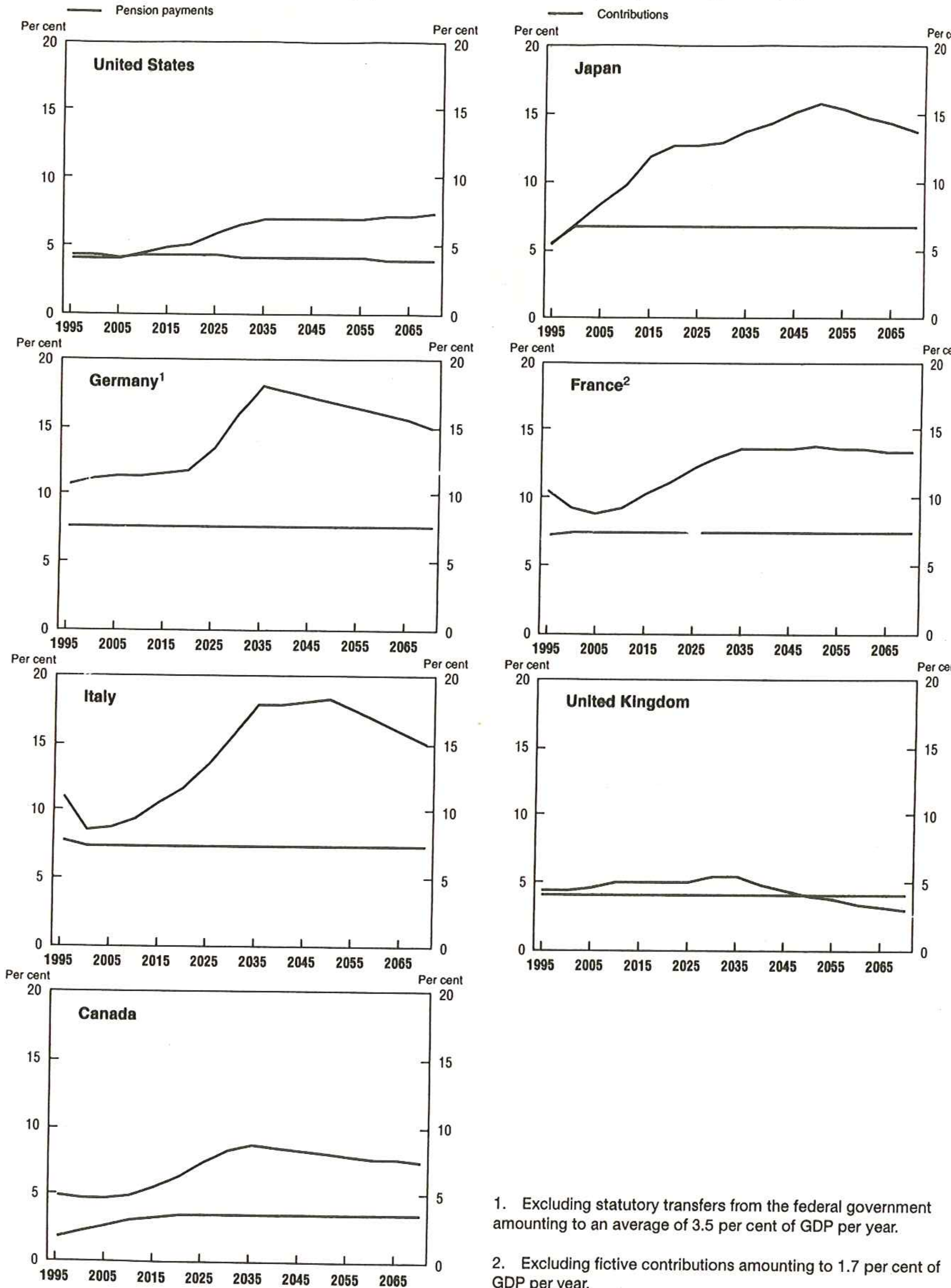
Suppose that £100m must be raised in taxation and the products of two equal-size industries, cars and electronics, are sold in world markets at world prices immune from the influence of these industries. Tax at 10 per cent could be levied on each; alternatively, one product (say, cars) could receive preferential treatment, and a 20 per cent tax levied on the other (electronics). In the first case, both industries will be equally affected: the damage will be spread. In the second, electronics will suffer disproportionately, cars not at all. The situation is illustrated in Figure 2. The damage is shown by the hatched area which measures the amount of lost output, multiplied by the gap between its world market value (price) and its cost to producers (price at which it would have been supplied). In effect, this gap is the lost profit to the British economy. The damage is much greater when tax rates are unequal.

Figure 1a: Population projections and elderly dependency ratios, 1995-2070



1. Defined as from age 20 until the scheduled retirement
for public pensions in each country.

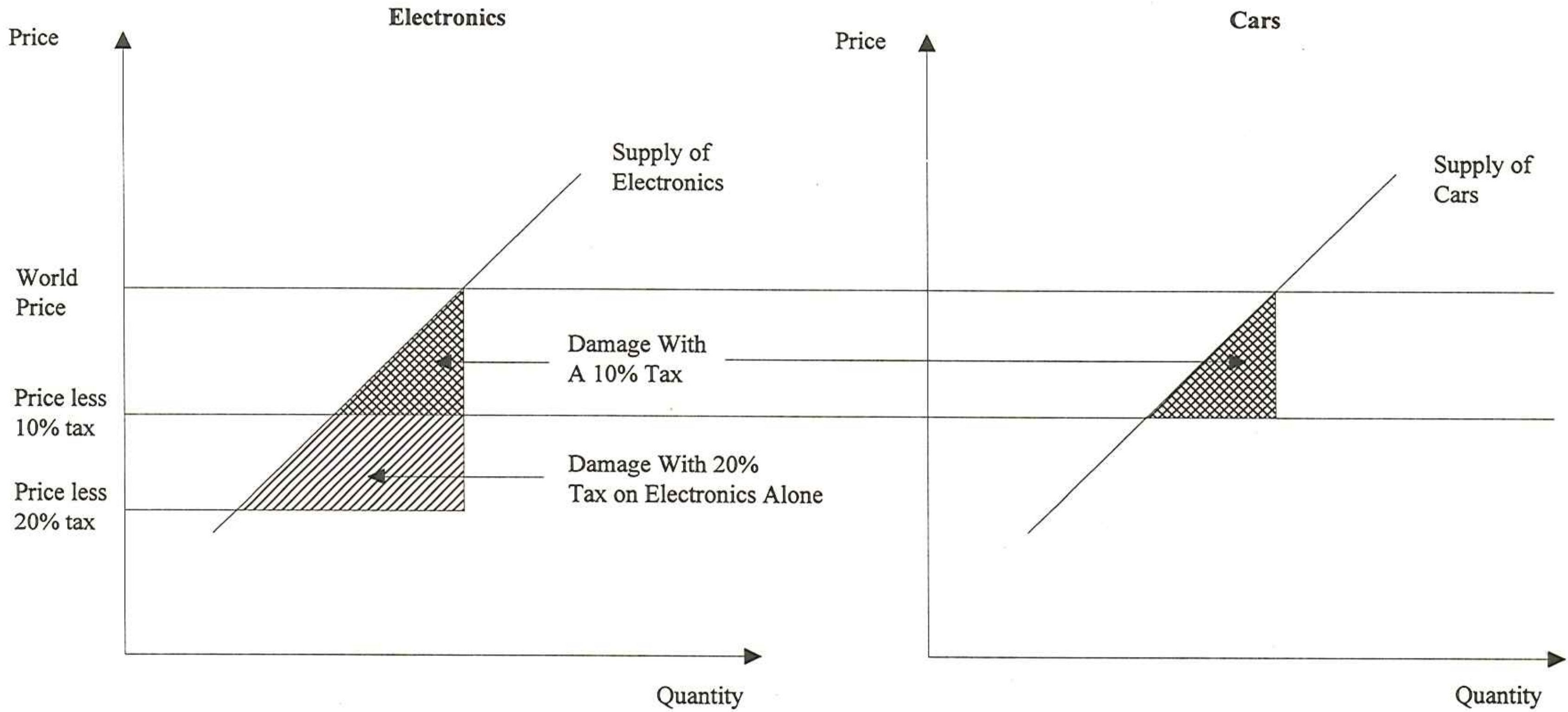
Figure 1b: Pension payments and contributions (as a percentage of GDP)



1. Excluding statutory transfers from the federal government amounting to an average of 3.5 per cent of GDP per year.

2. Excluding fictive contributions amounting to 1.7 per cent of GDP per year.

Figure 2



When taxes are levied heavily on one industry, the damage - shown by the hatched area - is much greater when tax rates are equal

are greatest, than it is to raise them to subsidise particular elements — which are valued less and cost more than the rest.

An old fallacy is that ministers can have a successful drive on 'waste'. Ministers are always looking for savings in public spending. There is plenty of waste in the public sector — but that waste is a product of the existing pattern of incentives. It cannot be tackled effectively by ministerial campaigns: edicts, official reprimands, and so forth. Waste can only be altered by structural change involving the entire operational framework (for example, by privatisation or 'Next Step' agencies) and establishing arm's length relationships that genuinely change the incentives of those involved: that is, pay or promotion must depend on carrying out tasks in a different way.

The problem with cutting public spending today is that many of the easier actions have already been taken. These include privatisation and Next Step agencies; there is also the continuing programme of 're-inventing' government, essentially by more decentralisation and contracting-out. Yet, despite the effectiveness of this huge programme in restraining spending, more than 40 per cent of GDP is still spent in the public sector. The reason is clear: there has been an enormous rise in welfare spending of every kind. During 1993-94, social security spending was £87 billion; the health service cost around £36 billion; education cost nearly £34 billion. Altogether, these three sectors take 25 per cent of GDP; in 1979 they took 19.5 per cent.

This does not mean there is no scope left for economy elsewhere. There is. One need only think of the behaviour of the associations representing the prison officers, the police, and the Inland Revenue's officials. These are some of the toughest unions left in the country and they are all in the public sector. The delay in tax computerisation, for example, or the sabotaging of novel ways of dealing with criminals (such as electronic tagging), can be traced directly to these unions. The Government is trying flanking tactics of decentralisation and contracting-out, and obtaining some satisfactory results. But these are not enough. Outright confrontation with those employed in providing these essential public sector services is particularly difficult; economies can be made — perhaps £1.5 billion over five years — but they take time and are not large.

It is primarily welfare which must be scrutinised to deliver substantial economies on the scale the privatisation programme of the 1980s seems to have delivered.

Welfare programmes, in the main, do one of three things:

- support the unemployed — by spending on 'job creation' and 're-training'

- support those who are in work or who cannot work (eg, pensioners, the disabled) and who remain poor despite income from work or savings

- provide free or subsidised services to anyone who wants to take them up; in this way, large numbers of people who could afford to buy such services (the 'middle classes') obtain them at little or no (direct) cost. They will, of course, pay for them through higher taxes.

To set out these three functions is to reveal at once how politically sensitive they all are. The unemployed and the poor are the most vulnerable of any society and no government would wish to cut them off from basic help. The safety net principle commands consensus across all parties here; the dispute is centred only on amounts. It is almost impossible to imagine any UK government cutting benefits by about a quarter, in real terms, as recently happened in New Zealand.

As for the middle classes, the late Lord Joseph tried to tackle them over student grants in the early '80s — and received very little reward for his efforts. These are the floating voters for whose support each party vies when a general election looms.

Few real economies in public spending can be expected in the immediate future — although Peter Lilley, in his subtle and well-thought-out way, has accomplished more in this field than most of his colleagues. His patient, gradualist approach is already reducing expenditure; over the longer term, his social security reforms will save very appreciable sums. There is an extraordinary contrast between the UK's prospective pensions problem and that of other G7 countries. Fig. 1b, also taken from the OECD's June 1995 *Economic Outlook*, shows how the UK's projected pensions balance is under control, whereas other G7 countries face escalating net commitments. This partly reflects Government reforms to SERPS in 1988; the 1995 Pensions Bill finishes the job, ensuring that pensions commitments are very largely restricted to a basic minimum, with private pension provision filling the gap. Other problems have also been addressed — by introducing the new jobseeker's allowance; reforming

invalidity benefit; tightening the rules governing housing benefit; setting up the Child Support Agency. In short, a phased programme has been devised which will target welfare benefits better and limit disincentives. The lesson of these reforms is that once the welfare issue is properly understood, its problems can be solved by cumulative gradual action which receives popular consent.

But this can only be a beginning. There is a need to consider the possibilities for reducing public spending by further long term reform in order to enable a step change to a low-tax dynamic economy. This debate is especially timely, given the success of Newt Gingrich's 'Contract with America' which set out the radical reform programme that helped to secure the huge Republican win in both Houses of Congress. The following chapters contain key elements for planned public spending cuts.

2

Avoid deflation and expand the economy

Today, because of the slack in the economy, it can safely be allowed to expand. Not only is there considerable under-utilisation of available plant and buildings in the service, retail, housing and construction industries — where a slump continues — but there is a great mass of unemployed or 'resting' people who are willing to work and who can be hired once recovery is steady. Their number has been calculated at about 1.5m; unemployment could be reduced to under 1m without any consequential risk of wage inflation.

When the temporary effect of raw material price rises during the past year is removed, the inflation rate is about 1.5 per cent. Inflation next year, based on rises in wages and productivity, could well be 1 per cent or less. As an American economist once said of low US inflation in the early 1980s, the 'pen trembles' to write down such low numbers. But they are beginning to look probable.

The biggest threat is not inflation, but deflation. However plenty of people think that inflation is still the major threat and therefore argue for caution in monetary and fiscal policy — ie, deflation. But the situation was the same in the 1930s; then prices actually began to fall. The same could happen now. Already, a number of prices have been falling for some time — including house prices and prices of goods in High Street shops, where 'sale' announcements now seem permanent fixtures.

Today's deflation arises from much the same causes as in the 1930s. First, there are immense technological changes: in the '30s it was the mass production techniques pioneered by Henry Ford; today it is computerisation. Second there is the rapid growth among emerging producer economies: in the '30s it was competition within the advanced industrialised countries; today it is competition from the low wage 'emerging' countries. The result is falling wages for unskilled workers — and a consequent fall in consumer spending. There is a third feature: a tight monetary policy that fails to respond to a rapidly changing environment. In the '30s, the US Central Bank stood pat when banks were collapsing all over America; today, many Western central banks are unwilling to print the extra currency for which the

emerging countries have such a growing appetite.

Japan is an example of a country already in the grip of an icy deflation. Prices have been falling and the Government has discovered how hard it is for monetary policy to offset this, because interest rates cannot be driven below zero. Yet the real cost of borrowing, when interest rates are zero and product prices are falling by 5 per cent or so, is of course 5 per cent. Recovery is near impossible when the real costs of borrowing are at such high levels.

That example should serve as a warning to the Chancellor of the Exchequer. He must act very soon to ensure that deflation in this country does not materialise and that the current slowing down of the economy does not turn into another recession. It is to the Chancellor's credit that he prevented interest rates from rising this summer, even though both his own Treasury officials and the Governor of the Bank of England urged an increase. The Chancellor must be encouraged to go further — and cut interest rates.

The recovery is being artificially held back by over-tight policies. Interest rates are too high for the job of controlling inflation and tax rates are too high for the job of balancing the Government's books.

The recovery must be allowed to proceed. Interest rates must fall soon, and with them also tax rates. A proper recovery would permit tax revenues to rise, and spending on benefits to fall naturally. It is estimated that £20 billion can become available for tax cuts without any changes in spending policy.

According to its present plans, the Government will have a small surplus in 1999/2000 and this should rise steadily thereafter. But the Government should be budgeting for a deficit of £17 billion — about 2 per cent of GDP — the amount needed in the growing economy to keep a steady ratio of public debt to GDP; hence there is scope for £20 billion tax cuts or more in the long term.

Details of these figures and the associated arguments are to be found in the latest *Quarterly Economic Bulletin* of Liverpool University's Macroeconomics Group. The argument is clear cut. As the Chancellor said at Blackpool, tax rates should be set 'for keeps': they should form a stable framework which will ensure that businesses can make decisions with minimum uncertainty and without artificial incentives to speed up or defer production and investment plans from their appropriate timing. It follows that tax rates should be set according to what can be afforded. This means setting them so that in the long term the ratio of public debt to

national income is constant or 'sustainable'. A PSBR of about 2 per cent of GDP in an economy growing normally would imply such constancy: hence the arithmetic above. Cutting tax rates by some £20 billion over three years or so would allow the PSBR to settle at around this level (or below — in which case further tax cuts would become possible).

3

An initial tax package

It is important that when a radical spending reform programme goes ahead the economy is strong and people are confident. At present, insecurity and the 'feel-bad' factor are undermining confidence in the economy and therefore discouraging any serious changes to it. The policies just set out involve the responsible easing of fiscal and monetary policy; they should produce growth of 4 per cent for several years, and get unemployment down to 1m by 1998.

In monetary policy there is scope for interest rates to be reduced at once, with a steady diminution thereafter. This is now widely recognised in the wake of recent weak figures for growth and unemployment. Interest rates in Germany are now down to 4 per cent and likely to fall further. Even in the USA, where unemployment is at a 30-year low, they are below 6 per cent. Those of the UK now look quite anomalous.

In fiscal policy, there is scope for the standard rate of income tax to fall by 5p — to 20p — at a cost of £8 billion. The top rate of tax could also be abolished, at a cost of £6 billion. (These costs do not take account of any savings from the increased activity to be expected from the higher incentives this low-tax economy would create.)

The time-scale of these cuts could be three years, as argued above.

Tax-cutting recognises that the middle-classes are the key voters to be wooed over to spending reforms. In the same vein, inheritance tax could be abolished at a cost of £1.4 billion. Finishing the task, implicitly begun by previous Chancellors who made certain classes of savings tax-exempt, all savings income could be freed of tax. Capital Gains Tax should also be abolished (thus maintaining crucial savings incentives, as the country moves into the era of high age-dependency). This would cost another £1 billion but it is feasible to expect most of this sum to be recovered by taxing pension lump sums.

4

Where to cut public spending

It is against the background of newly-invigorated growth described in previous sections that radical savings in public expenditure can go ahead. The most obviously redundant will be the whole raft of programmes concerned, either directly or indirectly, with job-creation. Government programmes are not tested by market need and have notoriously poor results. It is now accepted that training is best done by employers, or by people choosing and paying for their own courses, apprenticeship or other general training schemes. Employers must take on the responsibility of training their employees. The government's training schemes cost £2 billion a year. Government should withdraw from this activity.

Regional and inner city grants can then be cut back. They would only be made available to areas with unemployment rates 3 per cent above the national average, and then only for carefully argued cases. Thanks to the more flexible housing and labour market, unemployment is now evenly spread. Another £1.5 billion can be saved here.

A high proportion of the budgets of the Departments of Trade and Industry, Employment and Environment, as well as of the Welsh, Scottish and Northern Irish offices, are justified on the grounds of job-creation. This criterion should not be accepted as a justification for any public spending project.

Overall, the budget cuts in all these areas could yield £4.5 billion. If the amounts for greater efficiency, mentioned in Chapter 1, are included, the total sum of £6 billion could be expected from these general cuts.

5

Transforming enterprise

With the benefit of lower taxation, the average household will be able to pay for its own health and education needs. There are three advantages in this. First, those who pay, control — and have the power to get value for their money. When the state is the intermediate buyer, it is less sensitive to individual and household requirements, so the pattern of spending is less effective.

Second, the amount of resources devoted to health care and education would no longer be held back by arbitrary Treasury decisions. There is an inevitable, and often malign, effect of state buying because of the divorce between the buyer (the department of state) and the financier (the Treasury representing the taxpayer): total spending is therefore not properly sensitive to household needs.

Third, and most importantly, the marginal tax rate on the household would come down, so increasing incentives to work and take entrepreneurial risks. This will happen even if there is no efficiency gain from the last two reasons: *before* the household paid through a higher (marginal) rate of tax; *now* the household will pay 'up front' — say, through a school fees or health insurance policy — and the tax rate is lower. Household living standards are, of course, no higher since the fees have now to be paid; but, crucially, *incentives are transformed*: if, for example, the standard rate of income tax came down from 20p to 10p, then 90 per cent of every extra pound earned would be retained. This is the stuff of which dynamic economies like Hong Kong are made.

How would people pay their own way? In education it is straightforward. Everyone must be educated. And everyone must pay, either out of income, or savings, or borrowings.

As far as higher education is concerned, loans would replace grants; no short-run cash savings for the Government are assumed but, in the long run, as repayments come in, there will of course be savings here too.

In health care it is more complicated. Everyone must insure in a minimum cover policy. This would cover normal medical problems, going to the doctor, having a baby, the normal

school fees and medical insurance could be partly dealt with by a rise in Child Benefit (o equivalently a schools 'voucher') and partly by loans. Anyone on benefit would be entitle to a loan (at a 3 per cent real interest rate) from the Agency to discharge these costs — th loan being repaid over the long term once benefit is no longer needed. To sharpen incentive to take work, 10 per cent of unemployment benefit (in excess of insurance entitlement would become a loan. The new system would ensure that nobody on low earnings would b worse off than now over their lifetime; that has been, and will continue to be, a constraint o the parameters of the new system.

There must, of course, be a reasonable transition period allowed for implementation o these vital reforms. Older generations who have planned on the basis of the present system will retain their rights — much as occurred when rent control was abolished.

7

Strategic reform over twenty years

It would be unreasonable to expect vast public spending economies to result immediately from all these reforms. Over time they would build up to £70 billion in total. That could take 20 years or more. But on the basis that a quarter of these savings should come through in the next five years, the standard rate could come down by another 10p. Income tax rate in this country would then be reduced to 10p. In the longer term, it would also be possible to reduce indirect taxes by another £27 billion, enough to reduce the cost of living by 8 per cent, and to decrease marginal tax rates (inclusive of indirect taxes) to one of the lowest in the civilised world. The saving in indexed benefits that this fall in living costs would bring (as well as the reflux of revenue due to higher labour supply and reduced tax avoidance) would allow additional Child Benefit, or a school voucher, of £20 a week.

In the appendix details are shown of the full expenditure savings and tax cuts once the programme has been completed (Table 1). Calculations are also shown for a very poor household dogged by repeated misfortune in order to judge whether the programme satisfies the 'no losers' principle (Tables 2 and 3). The principle is to ensure, that over the household members' lifetime, they are no worse off. Finally calculations are shown for an average household (Table 4) who are plainly considerably better off, as well as enjoying much better incentives.

8
Conclusions

The programme outlined here is fairly radical. It could not possibly be embarked upon, a
least in its entirety, before a general election. Indeed, to implement all its provisions coul
well take two Parliaments. But it is by no means a project doomed to 'political impossibility'
Across the political spectrum there is now a demand for rationality to be introduced into th
Welfare State. People have realised that welfare costs threaten to get out of control, a dange
that the OECD's projections for other G7 countries all too clearly illustrate.

During 1994/95, some of the changes to the benefit system outlined above have bee
embarked upon, in piecemeal fashion: notably, tighter monitoring and a greater degree o
lifetime responsibility (so that those with resources from earlier or later episodes should a
least co-finance current episodes of poverty). The Labour Party has recognised that change
should be made: Tony Blair has called for a 'tough-but-caring' approach to benefits; Fran
Field has called for the reintroduction of the insurance principle into welfare; although th
details are unclear, the principles are consistent with what is set out here. The progressiv
withdrawal of the state from provision would, of course, require people to take mor
responsibility for their own insurance provisions than at present.

Above all, what the arithmetic in this paper shows is that there is a possibility of using th
present scope for fiscal easing to bring in changes that would leave the safety net intact i
real terms over people's lifetimes. Hence proposals of this sort can meet the crucial politica
test in a democracy: that they do not generate 'losers'. If this test can be met, then th
prospect of the massive gains in efficiency and dynamism that could be produced by cuttin
tax rates so sharply is irresistible.

Appendix: Details of the programme in steady state

Table 1 shows the steady state balance of tax and expenditure cuts. The transitional path has not been assessed: this complex task would however balance the state's books in the same way, allowing tax cuts to go forward in line with the growing expenditure cuts. These in turn would recognise the older generation's rights.

Table 2 shows how, again in steady state, a very low income family would be affected by the programme over their lifetime if they worked as continuously as permitted by child care. The top half of the table shows weekly changes in taxes and expenditures. The bottom half converts these weekly changes into effects on lifetime savings by the age of 65: a real interest rate of 3 per cent is assumed for accumulation (the resulting accumulation factors are shown in the penultimate row). Overall it can be seen that the household is better off by nearly £60,000.

However, Table 3 shows how the effect of the programme changes must be modified (for loss of the gain from tax cuts, as well as the loan element in unemployment benefit) if the household's main earner is unemployed for five years (one year each in the age bands) and ill for five years in the last age band of working life. This Table is based on assessments of typical 1980s experience by Professor Le Grand of Bristol University in a programme for Granada Television. Unfortunately, knowledge of lifetime patterns is limited by a lack of 'cohort statistics' where a certain group is followed throughout a long period. It is on the pessimistic side both in the context of this programme — with its substantial boost to the economy and to incentives — and also because the unemployment rate we are now able to reach is well below the 1980s average, even if this programme did not go ahead.

Tables 2 and 3 taken together indicate that this poor household — for all its unemployment and illness — would be about £12,000 better off over the parents' lifetime. The programme

was calculated in order to achieve no losers among the poor over their lifetime. This deliberately pessimistic example shows that it meets the objective.

Table 4 shows the effect of the programme on a household where both man and woman have jobs at, or slightly above, average earnings but the woman works part-time in later life. The household gains substantially from the programme because the tax cuts outweigh the extra schools/health expenditures. This basically reflects the fact that much of the tax cut is not related to the schools/health switch but to general economies as well as to the fiscal 'dividend' from current excessive caution.

Table 1: Fiscal costs of programme in steady state

	£ billion per year
Size of present surplus above permissible PSBR (1.5% of GDP)	20
General cuts in programme	6
Saving in NHS costs	28
Saving in Education costs*	14
Total available for tax cuts	**68**
Income tax rate cut to 10p	-39
less recovery of revenue due to additional labour supply and reduced tax avoidance	+6
Abolition of inheritance and Capital Gains tax, income from savings tax exempt	-2
Indirect tax cuts [8% fall in RPI]	-27
less reduction in indexed benefit payments	+6
Rise in child benefits by £20 per week	-12
Total	**-68**

* Excludes higher education where continued cash outflow projected in loan form.

Table 2: Illustrative effect on low earning family with 2 children over life time (£'s)*

Couples Aged	17-22	23-28	29-34	35-39	40-64	65-79
weekly joint income	336	240	240	324	324	99=
Income Tax (at 10p)	21	19	19	19	19	-
saving in indirect tax	22	20	20	24	21	8
extra child benefit	-	40	40	40	-	-
Health insurance+	-19	-38	-38	-38	-19	-19
School fees++	-	-	-63	-92	-	-
Total Effect In Net Income (p.w)	**24**	**41**	**-22**	**-47**	**21**	**-11**
No of years	6	6	6	5	25	15
Total gain or cost (-) in this period of life	7458	12792	-6864	-12220	27300	-8580
Factor of accumulation	3.8	3.26	2.65	2.22	1.47	0.80
Acc. effect in value of savings by age 65 (3% real int rate)	28454	70156	51966	24838	64969	58105==

Notes

*Assumed earnings man £4 per hour 17-22, man £5 per hour 23-65; (48 hours week man when working); woman £3 per hour (48 hours hours weekly from 36 onwards)

= Income Support topped up

+Health insurance : £500 p.a. per person

++ School fees:£1650 p.a. per child primary, £2400 p.a. per child secondary

== Value of lifetime effects at age 65

Table 3: Effect for illustrative low-earning family of man's unemployment for five years in each work period and 5 years of sickness in last work period* (£'s)

Aged	17-22	23-28	29-34	35-39	40-64
loss of 10% of income support for 5 years unemployment	-120	-247	-247	-247	-120
loss of income tax and indirect tax for 5 years sickness and 5 years unemployment	-2236	-2028	-2028	-2236	-12480
Accumulation factor	3.8	3.26	2.65	2.22	1.47
Accumulated effect on retirement savings by age 65	-8952	-16368	-22396	-27908	-46430

* Table shows necessary adjustments to Table 2 through assumed unemployment and sickness, because

- No saving in income tax, saving in indirect tax offset by fall in indexed benefit;
- loan of 10% Income Support (comes in after 6 months)

Table 4: Illustrative effect on medium income household (£'s; based on average earnings male £316.40, female £263.70)

Couples aged:	17-22	23-28	29-34	35-39	40-64
Weekly Figures					
Male	293	366	366	366	366
Female	211	-	-	140*	140*
Total wage income	504	366	366	506	506
Inc.Tax savings	47	39	39	47	47
Indirect Tax	34	29	29	39	34
Extra Child benefit	-	40	40	40	-
Health Insurance	-19	-38	-38	-38	-19
School fees	-	-	-63	-92	--
Total Effect on Weekly Net Income	**62**	**70**	**7**	**-4**	**62**
No. of years	6	6	6	5	25
Total gain (cost, -) in this period of life	19344	21840	2184	-1040	80600
Factor of Accumulation	3.8	3.26	2.65	2.22	1.47
Accumulated effect in value of savings by age 65 (3% real interest rate)	73507	144705	150492	148184	266666

* £140 = 28 hours x £5; part-time working from age 35 for female.)
+Based on 8% of net income (after tax and NIC, plus child benefit).

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