Cutting public spending by £167bn
A modest but necessary aim

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The socialist ratchet all over again

All three major parties are entering the election campaign with similar plans for cutting the deficit. The timing and magnitude of proposed deficit cuts are slightly different but all the plans involve raising taxes significantly. This comes after a period during which the main discretionary areas of public spending have increased dramatically – both in real terms and relative to national income. Tax rates have also increased very rapidly.

It seems that, once again, we have reached the position described by the late Sir Keith Joseph of a 'socialist ratchet'. The greatest ambitions of the Conservatives are to reduce the growth of the state or, at best, reclaim a proportion of the advances in government encroachment that have been made by Gordon Brown in the last 12 years.

This is deeply worrying. A Labour government was elected in 1997 that has increased the role of the state in economic life dramatically. It may then be followed by a Conservative government whose greatest ambition appears to be to reclaim some of that ground.

The dismal fiscal position

Nevertheless, the challenge of reducing the proportion of government spending in national income to below the levels that existed in 1997 is huge. We can understand the magnitude of that challenge with some simple budget arithmetic using the government's own forecasts[2] which are themselves optimistic.

GDP and inflation

- Nominal GDP is expected to be £1,406bn in 2009/10 and £1,824bn in 2014/15.
- Inflation is projected to be a compound rate of 2.1% [this is RPI inflation; the GDP deflator is slightly different].
- This rate of inflation implies real GDP (at 2009/10 prices) of £1,644 bn in 2014/15 and hence real GDP growth of 3.2% per annum over five years.

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[2] Government forecasts obtained from HM Treasury (2010).

Tax revenues

- Current tax revenues (and other receipts) are expected to be £507.5bn in 2009/10 and £699bn in 2014/15.
- If tax revenue were to grow in line with inflation, tax receipts would grow to £563bn in 2014/15.
- If tax revenues were to grow in line with GDP they would grow to £659bn by 2014/15.
- The actual projected level of tax revenues therefore implies a 1.2% growth in tax receipts over and above inflation *and* GDP growth every year. In other words, the government is trying to ensure that, in the next few years, tax revenue catches up with the huge increases in structural spending of the last few years.

Government spending

- Government spending is expected to be £654.6bn in 2009/10 and £748bn in 2014/15.
- If government spending were to remain constant in real terms, it would rise to £726bn in 2014/15 in cash terms.
- If government spending were to grow in line with GDP, public spending would rise to £850bn in cash terms by 2014/15.
- As such, the government is planning real increases in government spending which, by 2014/15, will equal £22bn in cash terms (or about £20bn expressed in today's money). Government spending will be £102bn less than the level that would have prevailed had it increased in line with GDP.
- Overall, therefore, the government is proposing a 'standstill' projection of government spending (in real terms), but a huge increase in taxes is expected.

Regarding these calculations, three things should be noted:

1. The calculations are approximate and, in particular, the years for calculating spending and inflation may not be consistent.
2. The measure of GDP here is 'market price GDP' – this significantly raises GDP artificially and therefore lowers the proportion of GDP represented by taxes and spending.
3. The Treasury has extremely optimistic growth forecasts.

Freezing the tax take and creating a new tax system

There have been huge increases in both the tax and government spending burden in recent years. A free-market government should not just seek to reverse these but cut government spending and taxation further still. Let us assume that the aim of a free-market government was to keep the tax burden constant in real terms and also eliminate the deficit – a modest aim. Tax would then fall as a percentage of national income and this would allow a real-terms rise in tax allowances and falls in tax rates. For the first time in many years, tax allowances could be increased in line with earnings (or better) and not just in line with prices.

The urgency of taking action in the UK is not simply indicated by the size of the tax burden but also by other problems within the British tax system. We have an appallingly complex tax system which is surrounded by a great deal of legal uncertainty. We also have a tax system that penalises the poor when they start to earn relatively small amounts of income. As the pressure group Care has shown, families in the UK also have amongst the highest tax burdens in the OECD (see Draper and Beighton, 2010).

If the tax burden were to remain constant in real terms, it would rise to £563bn (see above) by 2014/15. Spending would have to fall by £185bn by 2014/15 (£167 bn in today's money) to balance the budget. This would lead to a real terms cut of 26% of current spending (4.7% per annum) to be delivered over five years and I would suggest this as the minimum necessary.

Not surprisingly, this figure for spending cuts is roughly equal to the total of the current budget deficit. In essence, tax receipts would remain constant in real terms thus falling to more respectable levels as a proportion of national income; the whole of the deficit would be removed by cutting spending. Neither increases in tax rates nor increases in tax revenue caused by real economic growth would be used to finance cutting the budget deficit. Taxes as a proportion of GDP would then fall from 36% to 31% - not far off the level achieved during the mid-1960s – and government spending would also be at 31% of national income.[3]

This target is achievable and is only a little below the proportion of GDP represented by government spending in countries such as Australia and Ireland in 2005. As Smith (2006) shows, it is perfectly possible to have a fairly extensive state with this level of government spending. Indeed, it would be a more extensive state than the author would like – we are, for the purposes of this paper, recognising the politically possible.

This level of public spending would enable us to have a coherent tax system again. One reason our tax system is so complicated is because high tax rates encourage both avoidance and evasion. Many taxes exist that cause substantial economic damage (such as stamp duty and capital gains tax) because taxes on income cannot realistically be lifted higher. With public spending at 30% of national income, the tax base could consist simply of the minimum VAT rate of 15% allowed by EU law applied uniformly across all goods and services. There could then be an additional local sales tax averaging (say) 5% to finance those aspects of spending dealt with at

[3] Again, it should be noted that this is based on the government's approach to measuring these things. If the better measure of factor cost GDP is used, the underlying level of government spending and taxation would be higher than 31% as a proportion of national income.

local level. In addition, a flat-rate income tax of about 15% would be necessary – this would be applied to all income, including corporate profits. All other taxes would be abolished, though some user-charges might be maintained.

Cutting public spending

As it happens, the Conservatives, if elected, will find it deeply painful to try to implement the modest cuts in spending they have proposed. History and economic theory suggest that small spending cuts will be delivered in a way that produces the maximum political pain. Cuts are administered by incumbent bureaucrats. Bureaucrats can implement spending cuts in a way that minimises the harm to themselves whilst maximising the publicity impact. Important services are cut first; cutting waste is an afterthought. We are familiar with this not just from *Yes Minister* – which was, in fact, based on sound economic theory well understood by at least one of the authors of the programme – but from our experience of spending cuts in the Thatcher era. Any government that wishes to cut spending may as well 'think big' and use a completely different approach to cutting government spending.

Instead of starting at current spending levels and trying to negotiate spending reductions from current levels, we should clear the decks. Government has become so dysfunctional in every area that we should start from scratch. Over a five-year period all government functions should be subject to a new kind of Beveridge report that radically looks afresh at everything that is done, if it should be done and how it should be done. These reports should be undertaken by people intellectually sympathetic to minimising the role of government and maximising the space for the private sector and the 'big society' in solving economic and social problems. The people appointed should have analytical minds – like Beveridge's – so that they produce new approaches to public policy that achieve limited objectives efficiently.

In implementing the reforms it would be known in advance that there would be an overall cap on expenditure of 30% of national income and proposals for reform would only be accepted if they could be enduring – that is if they did not entrench vested interests that gradually expanded the role of government.

In education, for example, the aims might be to require parents to ensure that their children were educated and for the state to provide finance to parents ring-fenced for that purpose. A straightforward Act of Parliament could lay out what was defined as education and local authorities could simply be responsible for taking cases to court where they did not believe that the ring-fenced funding was being spent by parents in the way defined in the Act. The poor would be helped, competition would raise standards, parental choice would be paramount and any reasonable economic or social objective of government intervention in the education system could be achieved.

Yet armies of bureaucrats at central and local government level would simply have no function and would have to go. Total spending would be way below current levels: perhaps only 50% of current levels, though parents could spend more if they wished out of their much higher post-tax income. Theory and evidence both suggest that standards would be better than in state-directed education systems – especially for the poor. This is not a recipe for perfection. The problem is that the pursuit of perfection and an intolerance of risk and diversity have led to a situation where educational provision for the poor – the very people the state system was designed to help – is particularly bad. It is also possible that additional state funding would have to be given in respect of pupils with special needs and so on, but the key would be that such funding would be directed through parents. Indeed, such provision could be one of the functions of government at local level. The leading academic in the field of further education has suggested that nearly half of government expenditure in that sector is entirely wasted (see Wolf, 2009) – something that would be avoided, she argues, if spending was channelled through learners. This bodes well for those who believe that much greater spending reductions can be achieved in the rest of the education system if current structures are abolished.

Similar approaches need to be taken across each government function including policing, health, pensions and welfare. In the welfare field, many benefits would be removed altogether. For example, child benefit could be abolished and, if necessary, replaced by child tax allowances; there is no justification whatsoever for free television licences, a winter fuel allowance and free transport for the elderly. With regard to other out-of-work benefits, there must be time limits put on them and conditions applied, so that not working is not an option whilst receiving benefits. An exception to the work requirement would be where an individual was experiencing a short period of unemployment and, for this reason, it is important to separate out (as Beveridge always intended) insurance-style benefits (see below) from safety net provision for the very poor. This approach would both dramatically reduce fraud and increase work incentives. Furthermore, the whole way in which housing benefit is provided must be reformed so that the tenant always pays a proportion of the rent.

With regard to welfare benefits, the state may wish to provide certain insurances and levy a hypothecated national insurance tax for those. However, the tax must be voluntary with people being able to opt out of state financed health provision, a minimum level of state pension, industrial accident, unemployment and incapacity cover on an actuarially neutral basis if they have made their own private arrangements. Such private arrangements should be encouraged and the state would have to compete with them on a fair actuarial basis with a reference to the Office of Fair Trading being possible if (as currently is the case with the contracted-out rebates for state pensions) the government abused its power to keep out the private competition. In some areas, such as pensions, transition arrangements may be necessary.

We see how easy it is to meet government objectives much more efficiently and with much lower government spending if we consider the energy sector. Here the government spends significant amounts of money encouraging the use of non-carbon fuels. At the same time it implicitly subsidises domestic, carbon-intensive fuel use by charging VAT on energy consumption at a rate 12.5% below the standard rate. Transport subsidies – and the absence of VAT on public transport - also encourage the use of an economic activity that is naturally carbon intensive. Different policies both increase taxes and public spending and also pull in precisely the opposite directions. State spending on this function could be removed and a non-discriminatory rate of VAT imposed.

Conclusion

It is not the purpose of this paper to be the review that is desperately required, though some hints are given above as to the direction of reform. Every department must be razed to the ground. A Conservative government that really believes in a free economy should have a spending target of 30% of national income by the end of the Parliament, financed by a flat tax. More ambitious targets can be proposed for future parliaments. Minds must then be concentrated on how the target will be achieved by 2015. All reasonable economic aims of government can be achieved with the government taking nearly one third of national income. With a much more coherent tax system and lower levels of taxes, individuals will be better equipped to provide for themselves or supplement government provision in a way which suits their diverse individual needs.

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