A taxpayers' guide to the party political responses to the fiscal crisis

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About the author

Matthew Sinclair is the Research Director at the TaxPayers' Alliance. Since joining the TPA in May 2007, he has produced major reports on government capital procurement, environmental policy, NHS performance, the dynamic effects of corporate tax cuts, the economic and social burden of crime and the effects of aid policy, among others. He frequently represents the TaxPayers' Alliance on the television and radio, particularly on economic matters.

Executive Summary

1. Ahead of the Pre-Budget Report 2009, political attention is focussed on Britain's unprecedented fiscal crisis:

- **The second highest deficit in the EU**, and debt set to double in three years from 44 per cent in 2007 to 80 per cent in 2010.
- **The second highest structural deficit in the G20 advanced countries**, at 7.8 per cent of GDP.

Each major political party has made a series of policy proposals to address the crisis. This report is not an accounting exercise that attempts to cover every party policy and the likely fiscal impact, but an assessment of the main policies that have been announced or are associated with each party. It looks at the pluses and minuses of each of those proposals, providing the most comprehensive guide available to the current state of the debate over what is likely to be the most pressing issue in British politics through to the next election and beyond.

The Government – the Labour Party – have introduced or pledged:

2.1 To increase taxation on high earners. Measures such as the 50p rate are unlikely to increase revenue.

2.2 Multiple increases in Fuel Duty. Motorists are already overtaxed.

2.3 An Operational Efficiencies Programme. Many of the savings under the Gershon Review, which this programme succeeds, were dubious.

2.4 Cuts in capital budgets. These are probably necessary but could have serious economic effects and will be difficult with high demand for infrastructure spending.

2.5 Pay freezes or low rises for senior public sector staff. This is welcome but the Government proposal will save significantly less than Conservative and Liberal Democrat pay freeze proposals.

2.6 Analysts have suggested that the Government may increase national insurance contributions by 1 per cent for employers and employees. That could increase unemployment, which is already at extremely high levels.

The Official Opposition – the Conservative Party – have pledged:

3.1 A one-year pay freeze for public sector workers earning more than £18,000. This is almost certainly necessary and fair given the substantial and rising pay gap between the public and private sectors.

3.2 To abolish the National Child Trust Fund for higher income families. The fund should be abolished altogether.

3.3 Abolish tax credits for families earning more than £50,000. Cutting middle class welfare is necessary but should be a prelude to longer term reform of the welfare system.

3.4 Cut the "cost of politics". It is particularly important that Parliament and the government take a lead in cutting costs, when they expect the rest of the public sector to do likewise.

3.5 Bringing forward rises in the state pension age. The Conservatives' plans are extremely cautious given the rise in life expectancy, and the consequent increase in the number of retirees for each person of working age at any given state pension age.

3.6 One-third cut in "Whitehall bureaucracy". Cuts in non-front line spending are needed, and the TaxPayers' Alliance has made a number of proposals in this area.

3.7 £50,000 cap on public sector pensions. This is clearly massively inadequate with the cost of gold plated public sector pensions. Contribution rates need to be increased to reduce the cost to taxpayers.

3.8 Analysts have suggested they may increase VAT from 17.5 per cent to 20 per cent or more and remove or weaken exemptions. Such an increase would be regressive and increase poverty and benefit dependency. Increasing the rate charged on domestic fuel and power would hit poor and elderly people who are most vulnerable to rising electricity prices.

3.9 It has also been suggested that they may introduce a levy on profits of the bailed out banks. This measure seems a sensible way of recouping some of the cost of the bailouts, but it is important the measure is restricted to the bailed out banks.

The Liberal Democrats have a wide range of policies, but particularly:

4.1. Abolishing Regional Development Agencies and large parts of departmental business spending. TPA reports have recommended that these organisations be cut or abolished.

4.2 Introduce a 'mansion tax' on high value properties. This scheme has already run into trouble and will be an inefficient means to raise a relatively small amount of revenue.

4.3 Abolish Trident. This measure would save significant amounts but necessarily involves a range of strategic concerns that may be more significant than the cost.

The **United Kingdom Independence Party's** signature policy is withdrawal from the European Union:

5.1 Leave the European Union. As with Trident, the cost to the Exchequer should be a small part of the decision over Britain's relationship with the EU. There are a range of other concerns from the cost of regulation to a lack of democratic accountability.

The other two national parties with elected representatives at a national level are the **British National Party** and the **Green Party**. Neither appears, in the key policy documents available on their websites, to have even acknowledged the existence of the fiscal crisis, let alone proposed significant policies to address it.

The overall impression, having looked at all the key reports and policy documents, is that none of the parties have yet come close to proposing policies that would adequately address the fiscal crisis, though they are likely to provide more details of their proposed strategy before the election. A credible strategy should contain the following four components:

6.1 Short term fiscal tightening of around £50 billion in spending cuts, along the lines identified by the TPA and Institute of Directors.

6.2 Adopt fiscal rules with embedded expenditure targets. Research by the OECD suggests that expenditure-based rules are associated with success in fiscal consolidation, and that other rules are not.

6.3 Structural reforms to the public services to improve productivity and get the best results with limited resources. The Centre for Economics and Business Research has argued that the public sector's failure to meet private sector levels of productivity growth now costs the taxpayer £58.4 billion a year.

6.4 Pro-growth policies, such as cuts in corporate tax and the repeal of burdensome regulation. Increased growth will make it considerably easier to restore the public finances to health.

Tax rises will either hit people on low or middle incomes or fail to raise revenue as firms and those on high incomes avoid high taxes or move to lower tax jurisdictions. Massive structural deficits have been created by huge rises in spending; spending cuts are needed to restore the public finances to health.

Foreword

No one should underestimate the scale of the fiscal crisis. The £175 billion we are borrowing this year isn't just a temporary problem that will melt away as the economy recovers, concrete action will be needed to reduce the structural deficit in the public finances. At the TaxPayers' Alliance, we have taken this problem seriously and I am proud that we have been at the forefront of the public debate, proposing serious measures to cut tens of billions in borrowing.

But, with an issue this important, we can't afford for everyone to work in their silos, only considering their own favoured set of proposals. There needs to be a serious public debate about different potential policies to address the fiscal crisis. That's why we have written this report ahead of the Pre-Budget Report to explore the potential of various proposals that the parties have offered and some of the consequences.

Before we wrote our report with the Institute of Directors in September of this year, on how to save £50 billion in spending, there was a serious dearth of credible, specific policy. Thankfully, the debate has moved on and politicians are now offering us specific proposals.

We understand that it isn't possible for the parties to outline complete fiscal plans ahead of the election, that there are constraints on what they can say and know about what is needed. But, parties that hope to deliver fiscal restraint in office need to propose spending cuts or tax rises on a scale that will be credible before the election, otherwise they won't have the mandate they need from the electorate that will make it possible to overcome powerful roadblocks like the Unions. That means they need to give us a more thorough outline of a fiscal consolidation worth tens of billions.

At the same time, they need to be proposing the right measures. It is vital that fiscal restraint doesn't impose an unsustainable burden on families or undermine the economic success that will be essential to improving the nation's finances.

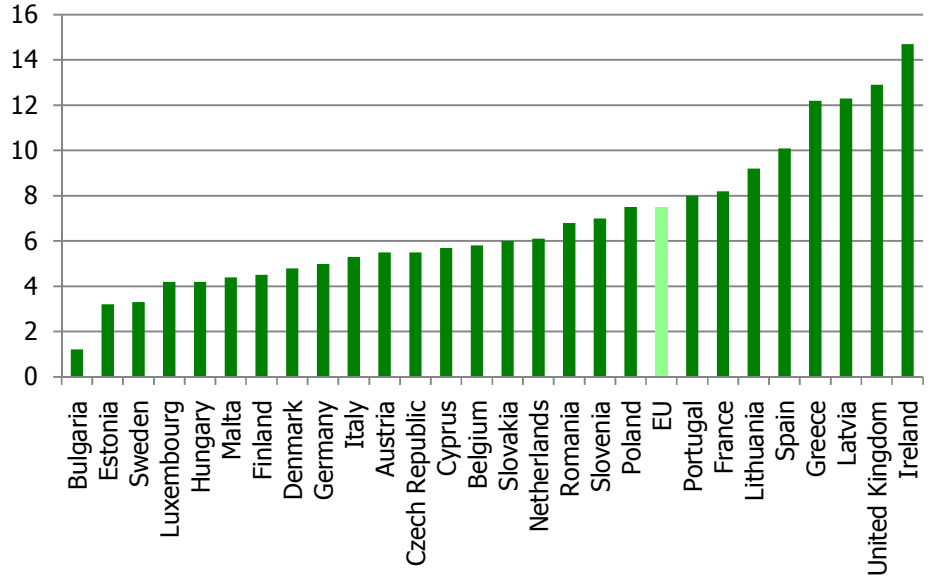
With all that in mind, I hope you enjoy reading our report, which will hopefully bring clarity to a debate where it is easy to get lost in a mass of announcements and re-announcements. The TPA will continue to play its part at the heart of the debate, looking out for the interests of ordinary taxpayers and giving them the information they need to decide how to vote at the forthcoming general election.

Matthew Elliott
TPA Chief Executive

1. Introduction

Britain faces an unprecedented fiscal crisis. The European Commission estimates that Britain's gross general government debt will have doubled in just three years, from 44 per cent in 2007 to 80 per cent in 2010.[1] Our deficit is the second highest in the EU as a share of GDP, and far above the EU average.

Figure 1.1: Net general government borrowing, per cent of GDP, 2010[2]

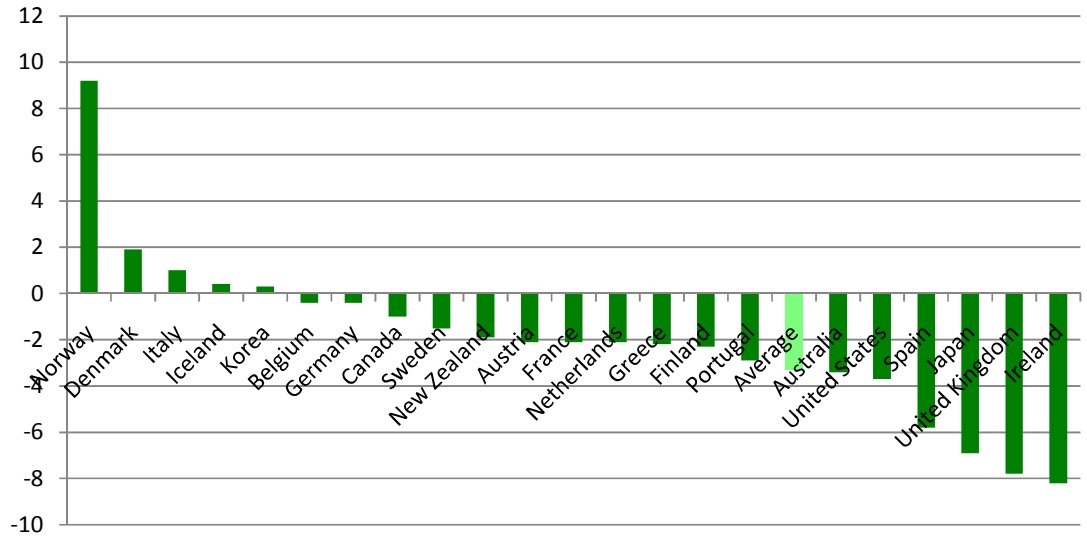


Government borrowing is not just a temporary result of the recession; the IMF estimates that Britain has the second highest structural deficit in the G20 advanced countries at 7.8 per cent of GDP. By contrast Italy has a structural surplus of 1.0 per cent of GDP.

[1] European Commission Economic and Financial Affairs Directorate General *'European Economic Forecast, Autumn 2009'*, October 2009, Table 42: Gross debt, general government, http://ec.europa.eu/economy_finance/publications/publication16055_en.pdf

[2] Ibid., Table 37: Net lending (+) or net borrowing (-), general government

Figure 1.2: Structural primary balance, per cent of GDP, 2010[3]



In both the percentage of our GDP that we are borrowing, and the huge share of that borrowing that is thought to be structural, Britain is second only to Ireland. The OECD's Economic Outlook survey suggests that in 2011 Britain will have the highest deficit in the OECD.[4] In Ireland, with a population around a tenth that of the United Kingdom, a government cost cutting panel recently recommended that 17,000 public sector jobs had to be cut.[5] Ministers are taking a ten per cent pay cut and urging other high paid public sector workers to take a similar cut, though many appear to be refusing and the cut will apparently not affect the ministers' or officials' pensions.[6]

In some ways, the level of borrowing expected in the next few years is comparable to the level in the world wars. TaxPayers' Alliance research has shown that, adjusted for RPI inflation, even the Treasury's estimate of likely borrowing is twice the amount borrowed in the First World War.[7] As well as studying the structural deficits of developed countries, the IMF also produced estimates of what it would take to put countries on a path to sustainable, target levels of debt. That standard is for each country to stabilise debt as a percentage of GDP at their level at the end of 2011 or 60 per cent, whichever is lower. In order to meet that standard, which would still leave Britain's debt much higher than it has been as recently as 2001, we would need to improve our primary balance by 12.8 per cent of GDP, well over £150 billion.

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[3] IMF Fiscal Affairs Department *'The State of Public Finances Cross-Country Fiscal Monitor: November 2009'*, 3 November 2009, Table 7: Debt and Primary Balances, http://www.imf.org/external/pubs/ft/spn/2009/spn0925.pdf. The primary balance is net lending or borrowing excluding interest expenditure.
[4] OECD *'Economic Outlook No. 86'*, November 2009, Summary of projections
[5] McDonald, H. 'Ireland told to cut €5bn from public spending', *Guardian*, 16 July 2009
[6] Smyth, S. 'Pensions not affected by ministers' 10pc 'pay cut', *Irish Independent*, 15 October 2008
[7] Available online here: http://www.taxpayersalliance.com/research/2008/11/new-research-browns-borrowing-will-be-double-the-debt-needed-to-win-world-war-one.html

The TaxPayers' Alliance has played an active role in the debate over how to reduce borrowing and restore the public finances to health. In particular, the TPA recently released the report *How to save £50 billion: Reducing spending for sustainable public finances* with the Institute of Directors, which set out a number of measures that could be taken to cut spending by £50 billion. The full list of measures is provided in Table 1.1, more detail can be found in the original report.[8]

Table 1.1: The full list of suggested savings and emergency possibilities

Item	Item description	Annual saving, £m	
	Tackling areas of spending that are not performing		**£5,477**
1	Abolish the Bus Service Operators' Grant	£451	
2	Abolish Sure Start	£1,456	
3	Abolish Building Schools for the Future	£2,300	
4	Abolish the Education Maintenance Allowance	£530	
5	Halt further orders and upgrades for the Eurofighter	£740	
	Curbing over-extended government		**£1,595**
6	Halve the government advertising and publicity budget	£270	
7	Abolish Contact Point, the children's database	£44	
8	Abolish the NHS National Programme for IT (NPfIT)	£1,181	
9	Abolish identity cards	£55	
10	Abandon plans to extend the compulsory school leaving age to 18	£45	
	Cutting out the middle-man		**£6,928**
11	Halve public sector spending on consultants	£1,100	
12	Reduce non-frontline staff in health and schools by 10 per cent	£921	
13	Reduce the size of the civil service by 10 per cent	£1,233	
14	Scale down 'Local Education Authorities' (LEAs) in England	£599	
15	Slim down the Department for Communities and Local Government (DCLG)	£1,317	
16	Rationalise the framework of regional government and business support	£940	
17	Begin a thorough rationalisation of taxpayer funded quangos and public bodies, including total abolitions, funding reallocations and budget cuts	£818	
	Tackling specific budgets		**£6,491**
18	Cut 25 per cent from the budget of the Department for Culture, Media and Sport (DCMS)	£725	
19	One year freeze of the resource and capital budgets of the Department for International Development	£862	
20	One year freeze of the Home Office resource and capital budgets	£360	
21	One year freeze of the grants from the Department for Communities and Local Government to local and regional governments	£687	
22	Cut 10 per cent from the budgets of non-ministerial departments, except for UK Trade and Investment and the UK Statistics Authority	£1,700	

[8] Available at: http://www.taxpayersalliance.com/50bil.pdf

Item	Item description	Annual saving, £m	
23	One year freeze of the grants given to Scotland, Northern Ireland and Wales (current spending only)	£1,400	
24	Simplify and rationalise the skills system and the plethora of skills programmes	£757	
	Tackling above-inflation indexing		**£1,441**
25	One year freeze of the Basic State Pension and the Minimum Income Guarantee	£1,441	
	Restraining public sector pay and perks		**£8,711**
26	One year pay freeze across the public sector, excluding members of the armed forces serving in conflict zones	£6,203	
27	Increase employee contributions to all unfunded public sector pension schemes by a third	£2,508	
	Cutting middle-class welfare		**£11,999**
28	Abolish Child Benefit and the Child Trust Fund, and increase the Child Element of the Child Tax Credit to address child poverty concerns	£8,447	
29	Taper away the Family Element of the Child Tax Credit at 39 per cent immediately upon exhaustion of the Child Element of the Child Tax Credit	£1,350	
30	Target spending on free bus passes for the elderly and disabled on those who genuinely need it	£438	
31	Abolish free TV licences	£564	
32	Abolish interest subsidy to student loans	£1,200	
	Total annual saving from 2010-11 onwards		**£42,642**
	Further emergency possibilities after 2010		**£7,421**
33	A further one year pay freeze across the public sector, excluding members of the armed forces serving in conflict zones	£6,203	
34	Reduce gross annual pay by 5 per cent for the richest 10 per cent in the public sector	£1,218	
	Total potential annual saving from 2011-12 onwards		**£50,063**

As with any list of cuts on this scale, this list did prove controversial and there was an active debate following the release of our report.

This report extends the TPA's contribution to the debate over how to improve the health of the public finances by examining some of the other proposals that political parties have endorsed or are thought likely to implement if they form the next government. It does not present an accounting exercise examining every financial detail of each party's plans. It also does not look at pledges to increase spending or cut taxes that might increase borrowing, that subject may be covered in future TaxPayers' Alliance research.

2. The Labour Party

The Government have introduced, or have pledged to introduce, the following tax rises:

2.1 Increase taxation on high earners.

2.2 Multiple increases in Fuel Duty.

And, the following spending cuts:

2.3 Operational Efficiencies Programme.

2.4 Pay freezes or low rises for senior public sector staff.

2.5 Cut in capital budgets.

2.6 Cuts in some major defence projects.

Analysts have suggested that the party is also likely to introduce further tax rises, highlighting the possibility of:

2.7 Increase in National Insurance Contributions by 1 per cent for employers and employees.

2.1 Increase taxation on high earners

There are a number of measures that the Government are introducing to increase tax rates for high earners:

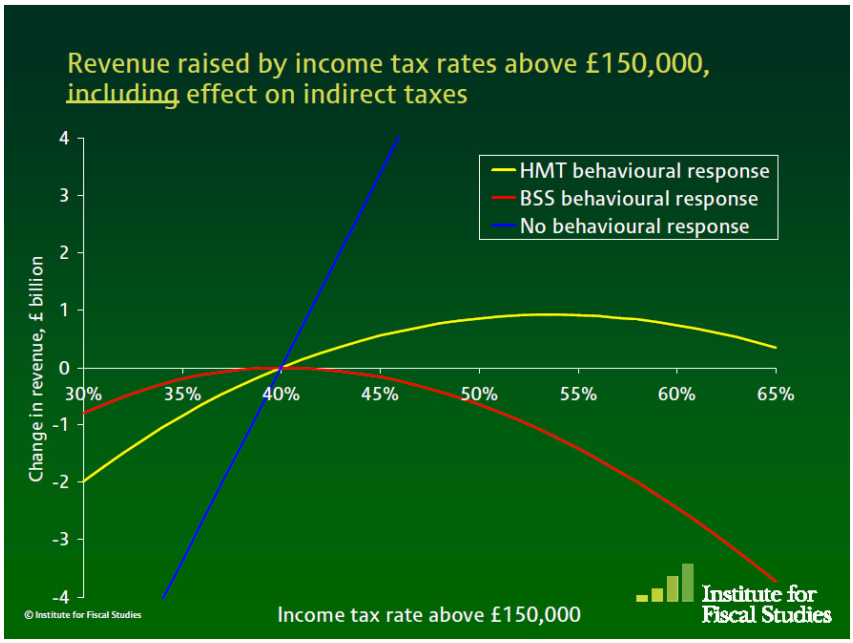
- 50p tax rate on income above £150,000.
- Restrict the personal allowance for those with incomes over £100,000.
- Restrict tax relief on pensions for those with incomes over £150,000.

These measures are designed to increase revenue while making the tax system more progressive, on the basis that "it is fair that those who have gained the most should contribute more."[9] However, the Institute for Fiscal Studies (IFS) has argued that the behavioural effects of the 50p rate are likely to be greater than the Treasury has allowed for. That means that – depending on the effect on indirect tax revenues – the introduction of the new 50p rate may well reduce total revenue.[10]

[9] HM Treasury *Budget 2009 Speech*, 22 April 2009
[10] Adam, S. *'Budget 2009 – Direct taxes and benefits'*, Institute for Fiscal Studies, 23 April 2009, http://www.ifs.org.uk/budgets/budget2009/tax_benefit.pdf

Figure 2.1 shows the effect of different tax rates on revenue from high earners on the basis of no behavioural response, the Treasury's estimate and an IFS (titled BSS in Figure 2.1) estimate of the likely behavioural response.

Figure 2.1: IFS estimates of the revenue effects of income tax rates with behavioural responses



However, Fraser Nelson, Editor at the Spectator, has pointed out that IFS estimate of the likely behavioural effect of the 50p rate is based upon evidence from the last significant changes in top marginal rates in the 1980s, and that mobility for high earners is likely to have increased since then meaning that the behavioural response and revenue loss from the 50p rate may well larger.[11] That would imply a reduction in revenue if this tax is introduced that is much higher than the IFS expect. The Centre for Economics and Business Research has suggested that the 50p rate will lose the Government £800 million a year, mean 140,000 lost jobs over time and lead to 25,000 high earners leaving the country.[12]

The effects of restricting high earners' use of the personal allowance and pension relief are likely to be more complex. Restricting use of pension relief will make avoidance harder and therefore may reduce the behavioural response but, when combined with the other changes pushing up taxes on high earners, it seems possible that the main change would be increased emigration as the avoidance strategy of last resort.

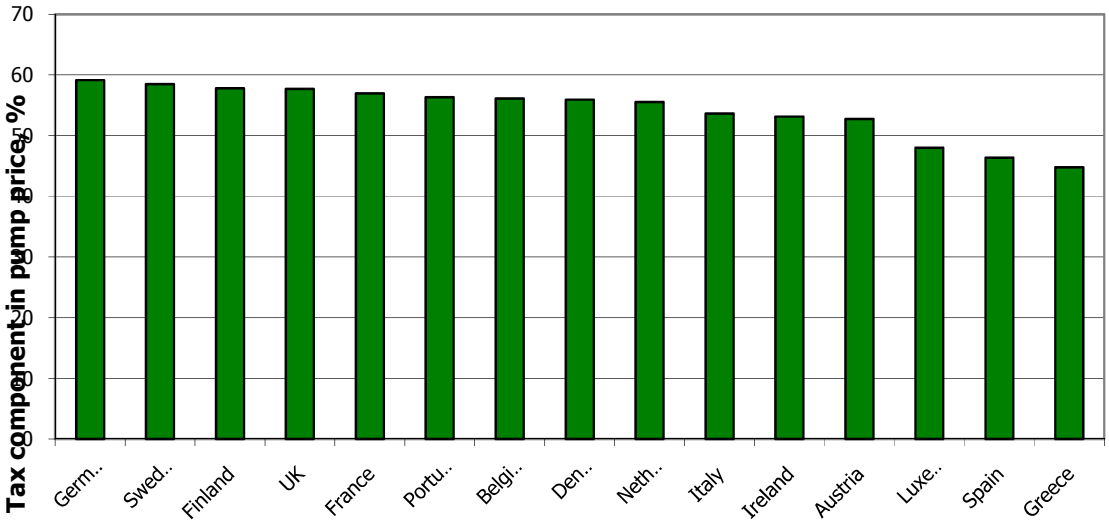
[11] Nelson, F. 'Why we need a proper debate about the 50p tax rate', *Spectator Coffee House*, 30 April 2009
[12] McWilliams, D. *'Government will lose £800 million from tax hikes on the rich'*, Centre for Economics and Business Research, 22 April 2009

2.2 Multiple increases in Fuel Duty

In the 2009 Budget, the Government set out plans to increase Fuel Duty by 2p per litre in September 2009 – from 54.19 pence per litre to 56.19 pence per litre – and then by another 1p per litre each year from 2010 to 2013.

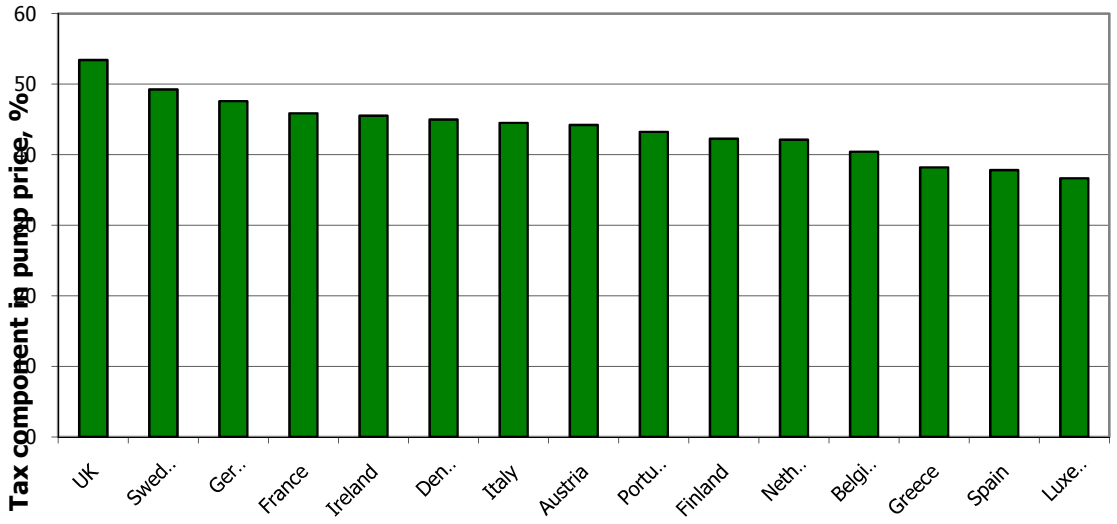
This is despite the fact that Government estimates show that Britain already has one of the highest rates of taxation on motor fuel in the EU. Figures 2.2 and 2.3 show that Britain has the level third-highest tax component for petrol and the highest tax component for diesel in the EU:[13]

Figure 2.2: Tax component of pump price, petrol



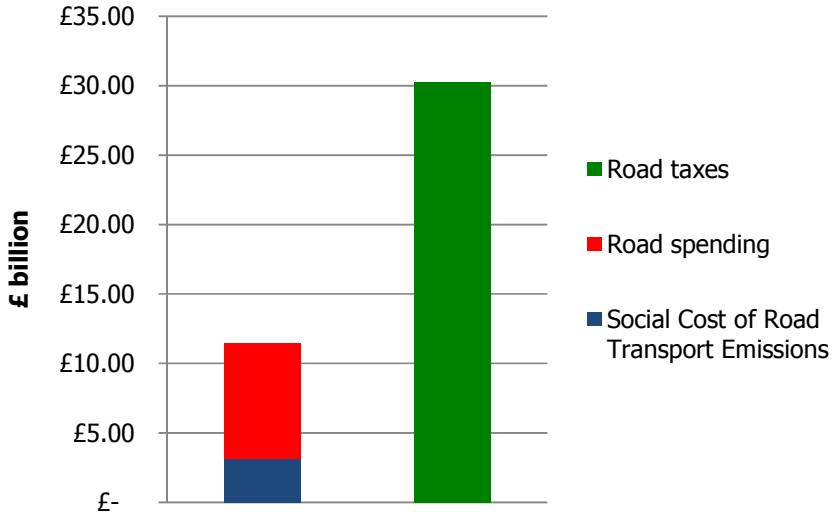
[13] BERR *'Energy trends and prices'*, Tables 5.1.1 and 5.2.1, June 2008

Figure 2.3: Tax component of pump price, diesel



At the same time, research by the TaxPayers' Alliance, in partnership with the Drivers' Alliance, shows that road taxation is well in excess of the social cost of road transport emissions (based on the DEFRA "shadow price):[14]

Figure 2.4: Road transport taxes, spending and social cost



The same research also showed that far more is spent on the railways for the amount of passenger and freight traffic moved:

[14] Available online from: http://www.taxpayersalliance.com/transportspending.pdf

Figure 2.5: Spending per 1,000 passenger kilometres

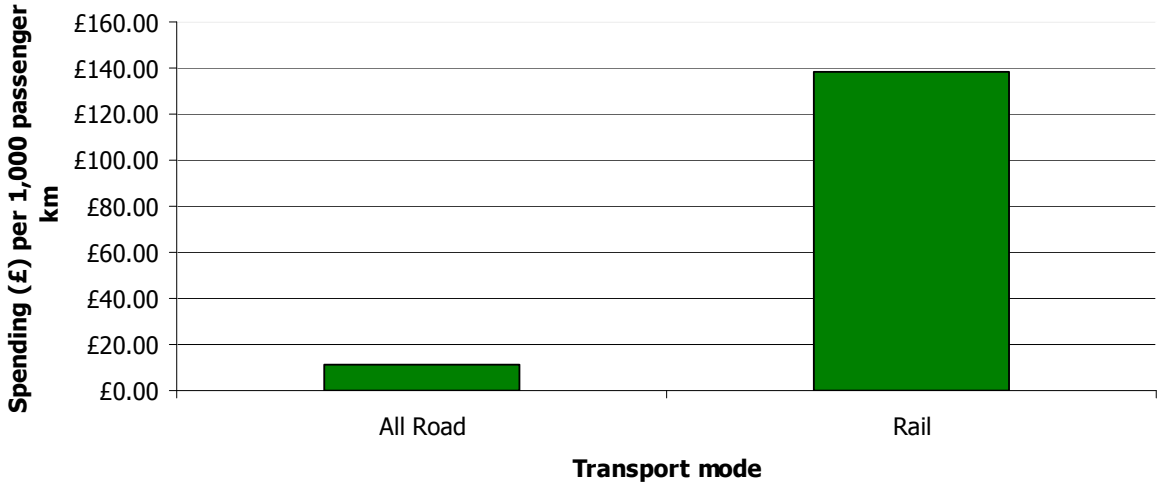
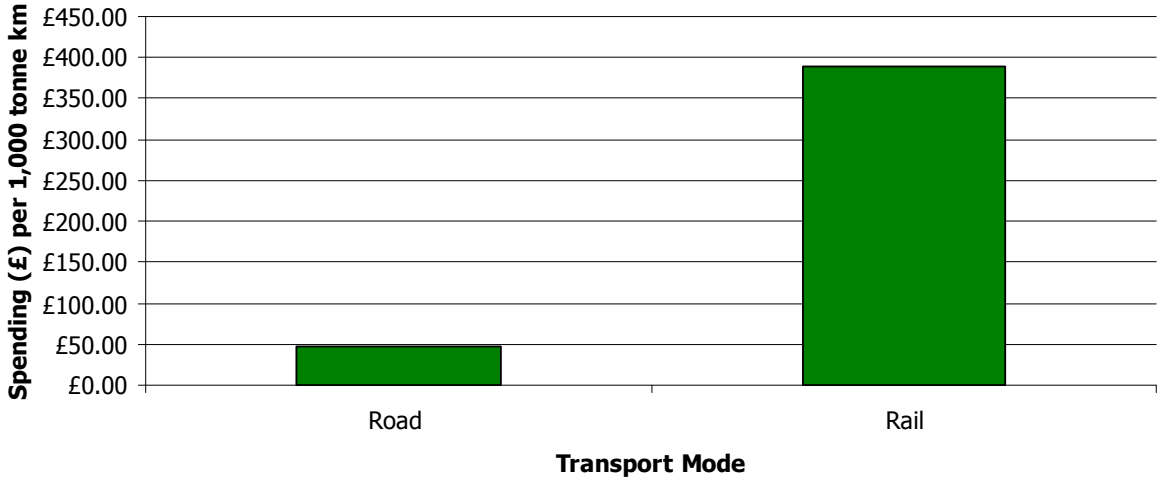


Figure 2.6: Spending per 1,000 tonne kilometres



With motorists already taxed at a far higher rate than the cost of maintaining the road network or the greenhouse gas emissions from road transport can justify, further increasing taxes on motorists will make the tax system less fair and more distorting. Driving is a necessity for many people who need to get to work or access services outside city centres.

2.3 Operational Efficiencies Programme

The Operational Efficiencies Programme is the successor to Gershon Review, which the Treasury argue delivered over £26.5 billion in savings. The Operational Efficiencies programme aims to save another £35 billion by focussing on five key areas:

- Back office operations and IT
- Collaborative procurement
- Asset management and sales
- Property
- Local incentives and empowerment

Unfortunately, the results of earlier top-down efficiency drives have been disappointing. According to the National Audit Office, up to three quarters of the efficiencies identified in the Government's Gershon Review were never realised.[15]

There is huge scope for increasing public sector productivity. Office for National Statistics data suggests that public service productivity fell by 3.4 per cent between 1997 and 2007.[16] The Centre for Economics and Business Research has argued that the public sector's failure to meet private sector levels of productivity growth now costs the taxpayer £58.4 billion a year.[17] That can only be achieved over time by seriously reforming how public services are delivered, though. It is not an alternative to cuts in spending to address the immediate fiscal crisis.

2.4 Cut in capital budgets

In his paper on potential cuts in public spending for the centre right think tank Reform, Vince Cable argued that the Government's fiscal strategy is overly reliant on cuts in capital spending, which is due to halve from 2010-11 to 2013-14.

> *"Not all government capital spending is productive by any means. But the implication is that investment will be sacrificed to meet current spending commitments, that infrastructure will be allowed to deteriorate and that the construction sector will carry a disproportionate share of adjustment."*

A report in Fiscal Studies found that a 1 percentage point increase in the share of government consumption in GDP reduces the equilibrium GDP growth rate by 0.216 percentage points, but the same increase in government investment raises the growth rate by 0.167 percentage points.[18] That would suggest that the Government's focus on

[15] National Audit Office '*The Efficiency Programme: A Second Review of Progress*', February 2007. The report concluded that only 26 per cent of the reported efficiency savings "fairly represent efficiencies made".
[16] Office for National Statistics *'Total public service output and productivity'*, Economic & Labour Market Review, Vol.3 No.8, August 2009
[17] McWilliams, D. '*The UK's public sector productivity shortfall is costing taxpayers £58.4 billion a year – in other words, not far short of half our income tax is paying for public sector inefficiency'*, 23 August 2009
[18] Mo, 'Government Expenditure and Economic Growth: the supply and demand sides', Fiscal Studies 28 (4), 2007

cutting capital expenditure will mean lower growth over time, though some studies have produced different results.[19]

There is likely to be high demand for new infrastructure investment, including improving transport infrastructure and replacing electricity generating plants being decommissioned as they come to the end of their useful life or have to be scrapped under European Union regulations. Policy Exchange research suggests that the amount of infrastructure investment needed to meet existing policy commitments is likely to be over £400 billion by 2020.[20]

Table 2.1: Policy Exchange estimates of likely minimum level of infrastructure investment required in Britain by 2020

Sector	Requirement	Cost (£ billion)
Energy	Replacement requirement	42
Energy	Investment in the networks	65
Energy	Renewables	136
Energy	Energy efficiency	21
Transport	Rail networks and high speed lines	69
Transport	London transport	32
Transport	Roads	9
Transport	Air transport	10
Communications	Nationwide roll-out of Very High Speed DSL	5
Water	Water and sewerage networks	37
Water	Flood and coastal defences	8
Total		**434**

The extremely high level of investment in renewable energy that the Policy Exchange report includes as a minimum is driven by targets that are unlikely to be met.[21] At the same time, spending just £9 billion on the road network up to 2020 would mean massive cuts from existing levels. Also, much of this spending will come from private investment, driven by market demand or government regulations.

However, it is clear that there will be substantial demands for public sector infrastructure investment, including roads, rails, flood and coastal defences and quite possibly large shares of spending on energy efficiency and very high speed DSL roll-out. There is also an ongoing need to spend on facilities and capital equipment in policy areas like health,

[19] Ghosh, S. & Gregoriou, A. *'On the Composition of Government Spending, Optimal Fiscal Policy, and Endogenous Growth: Theory and Evidence'*, June 2006
[20] Helm. D., Wardlaw, J. & Caldecott, B. 'Delivering a 21st Century Infrastructure for Britain', Policy Exchange, 1 September 2009.
[21] Renewable Energy Foundation *'Note on Pöyry Energy (Oxford) Ltd, Implications of the UK Meeting its 2020 Renewable Energy Target, a report to WWF-UK and Greenpeace UK (August 2008)'*, 7 November 2008

education, science and defence. It may not be possible to deliver a programme of cuts overly dependent on cuts in capital spending.

2.5 Pay freezes or low rises for senior public sector staff

In October 2009, the Government recommended a pay freeze for 40,000 senior public sector staff in 2010/11. They recommend that a further 700,000 middle-ranking staff should get low rises, between zero and one per cent. This is different to the pay freezes recommended by the other parties as it alters the Government's stance in approaching the pay review bodies, rather than imposing a particular pay settlement.

There are two key advantages to the Government's approach:

- Pay settlements can differentiate more between different organisations with different needs.
- Wage restraint is likely to be easier to enforce if the deal is sanctioned by a pay review body.

There are some disadvantages, though:

- There are serious concerns that many pay review bodies are unrepresentative and that their independence means they are not accountable to taxpayers.
- Pay bodies are designed to decide on the basis of the needs and circumstances of a particular sector or employer. They are poorly equipped to reflect an urgent national policy imperative such as the current fiscal crisis.

At the same time as considering these arguments over the method by which the Government is introducing wage restraint, it is also important to consider how ambitious they are being. Putting in place a near-freeze on less than 750,000 workers out of the around 6 million strong public sector workforce will yield a far smaller saving than the Conservatives' freeze for all staff earning more than £18,000 (4 million workers) or the Liberal Democrats' overall freeze.

2.6 Increase in National Insurance Contributions by 1 per cent for employers and employees

Research for the accountancy BDO Stoy Hayward has suggested that the Government may well introduce a 1 per cent increase in national insurance rates for employers and employees.[22]

An increase in employees' national insurance would effectively operate as an increase in income tax. By contrast, an increase in employers' national insurance would effectively operate as a tax on employment. As it would increase the cost of taking on workers such a measure would reduce the demand for labour. That would mean workers would either need to accept lower wages than without the new tax or face greater chances of unemployment.

As of November 2009, nearly 2.5 million Britons are unemployed, or 7.8 per cent of the workforce. Young people, who are likely to be the worst affected by any rise in national insurance as they tend to be lower paid and therefore more easily pushed into unemployment, are facing even higher unemployment rates. Nearly a fifth of those aged 18-24 are unemployed.[23] Even before the crisis, OECD research showed that the proportion of the UK 16-25 population who are not in employment, education or training was 13 per cent, up from 11.6 per cent in 1997. That does not reflect an international pattern as the linear average of the 16-25 not in employment, education or training rate across the OECD has fallen from 12.4 to 12 per cent.[24]

[22] BDO Stoy Hayward *'Time to break the silence? Assessing the tax options available to help rebuild the UK Government's fiscal policy'*, pg. 5, http://breakingthesilence.bdo.uk.com/includes/downloads/BDOBreaktheSilence.pdf
[23] ONS *'Labour Market Statistics – November 2009'*, 11 November 2009, http://www.statistics.gov.uk/pdfdir/lmsuk1109.pdf
[24] OECD *'Disadvantaged youth in Britain need better skills and effective job-search help'*, July 2008

3. The Conservative Party

The Conservatives have not pledged to reverse any of the Government's tax rises, and they have not yet pledged any additional tax rises. They have pledged the following spending cuts, which we believe will come in addition to any cuts under the Government's spending plans:

3.1 One-year pay freeze for public sector workers earning more than £18,000.

3.2 Abolish national child trust fund for higher income families.

3.3 Abolish tax credits for families earning more than £50,000.

3.4 Cut the "cost of politics".

3.5 Bring forward rises in the state pension age.

3.6 One-third cut in "Whitehall bureaucracy".

3.7 £50,000 cap on public sector pensions.

Analysts have also suggested that the party is likely to introduce some tax rises not in the Government's current plans, highlighting the possibility of:

3.8 Increase VAT from 17.5 per cent to 20 per cent and remove or weaken exemptions.

3.9 Introduce a levy on profits of the bailed out banks.

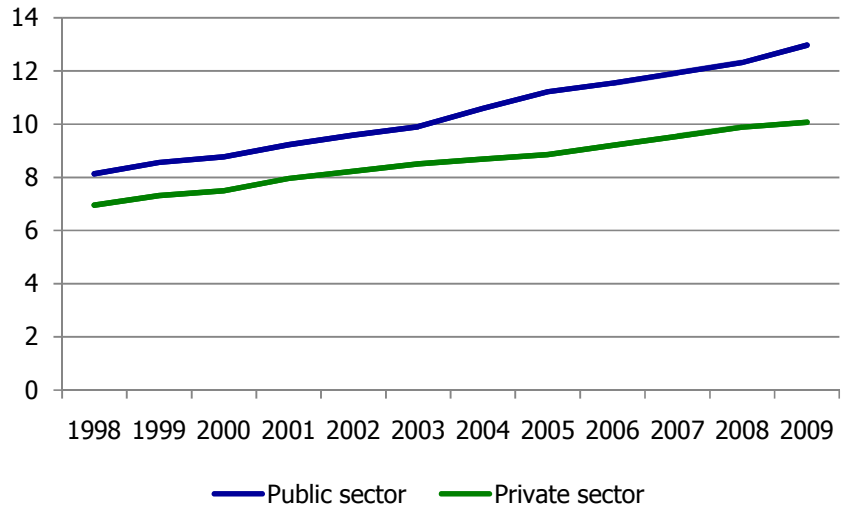
3.1 One-year pay freeze for public sector workers earning more than £18,000

The Conservatives have pledged to freeze pay for public sector workers earning more than £18,000. The measure will affect around four million workers. The TPA's research with the Institute of Directors on how to cut public spending by £50 billion suggested that a one year pay freeze for all public sector staff would save around £6 billion, so it is reasonable to assume that this measure will save at least £4 billion by freezing the pay of two thirds of the public sector.

Given that the gap between public and private sector remuneration is significant and has grown since 1998, and the scale of the crisis in the public finances, there is a good case that a freeze is fair and necessary. Figure 3.1 shows public and private sector gross hourly pay since 1998:[25]

[25] Office for National Statistics, *Annual Survey of Hours and Earnings*

Figure 3.1: Median gross hourly pay, £



In order to make this policy credible and effective it will be necessary to do a number of things:

- Ensure that the freeze is enforced in those areas where the government does not have direct control, particularly in the quangos that employ a large number of highly paid staff.
- Organisations and pay review bodies may well see spurious reasons why their area is remarkable and should not be subject to a freeze. They may need to be overruled.
- Overcome the union resistance to any freeze. Mark Serwotka, head of the Public and Commercial Services union, has said that there is a "very strong likelihood" of strikes if the pay freeze goes ahead.

The Liberal Democrats are also proposing a pay freeze. Their proposal is to freeze the average level of public sector pay but allow increases in some areas if others face pay cuts.

3.2 Abolish national child trust fund for higher income families

Under the present arrangements for the National Child Trust Fund, households with incomes of £16,040 or more receive £250 to put in trust when a child is born, and families with incomes under £16,040 receive £500. That money can be withdrawn from the fund once the child reaches the age of 18. The Conservative plan is to abolish the lower payments, and therefore only make trust fund payments to low income families.

The problems with the scheme are obvious. Even the lowest paid family is likely to pay far more than £250-£500 in tax over 18 years. It would be far better to cut taxes, or future taxes in the form of government borrowing, and let those families keep the money in the first place. There is no particular need for families to have a lump sum available when they reach 18, there are already measures in place to support students going to university; arguably family income is more important during a child's formative early years. The TaxPayers' Alliance report with the Institute of Directors argued that the National Child Trust Fund should be abolished in its entirety. Lower income families could be helped by keeping down indirect taxes and cutting income tax on the low paid. In lieu of that, the Conservative plan is a reasonable way forward.

3.3 Abolish tax credits for families earning more than £50,000

The Conservatives have pledged to abolish tax credits for those earning more than £50,000. It is not clear exactly how that will be achieved at this stage.

The TPA's research with the Institute of Directors on how to cut public spending by £50 billion recommended tapering away the Family Element of the Child Tax Credit at 39 per cent immediately upon exhaustion of the Child Element of the Child Tax credit. Calculations by the Institute for Fiscal Studies suggest that such a measure could save more than £1.3 billion. The report also recommended abolishing Child Benefit and compensating the poorest families by increasing the Child Element of the Child Tax Credit, which could save more than £8.4 billion.

This is an important area in which significant savings can be made. There are two main issues that have to be kept in mind:

- The take-up of means tested benefits is often lower which may mean that some families miss out.
- Marginal deduction rates, the amount that people lose in higher taxes or reduced benefits with each extra pound they earn, will rise which may hurt incentives.

That means cuts in middle class benefits are no substitute for benefit reform, one plan to simplify the system has been outlined by David Martin for the Centre for Policy Studies.[26] However, they are an immediate way of reducing the cost by a substantial amount. At the moment, middle class families are essentially paying higher taxes now and in the future, through borrowing, and then getting some of the money back in benefits. This process is wasteful and benefits for those who don't really need them are clearly an area where costs should be cut with the scale of the present fiscal crisis.

[26] Martin, D. *'Benefit simplification'*, Centre for Policy Studies, 3 August 2009

3.4 Cut the "cost of politics"

In September 2009, the Conservatives set out a series of proposals to cut the cost of Parliament and the Cabinet:

- Abolish the £10,000 Communications Allowance available to MPs.
- Cutting subsidies to food and drink in Parliament, saving "up to £5.5 million."
- Cut the budget for official government cars by a third.
- Cut all ministerial salaries by five per cent and then institute a pay freeze for the next Parliament.
- Scrap Regional Assemblies, saving £18 million, and the Standards Board for England, saving another £9.5 million.
- Stop public sector bodies hiring PR consultants, saving £10 million a year.
- Cut the number of MPs by 10 per cent, saving £15.5 million, and demand a ten per cent cut in costs from the Parliamentary authorities.

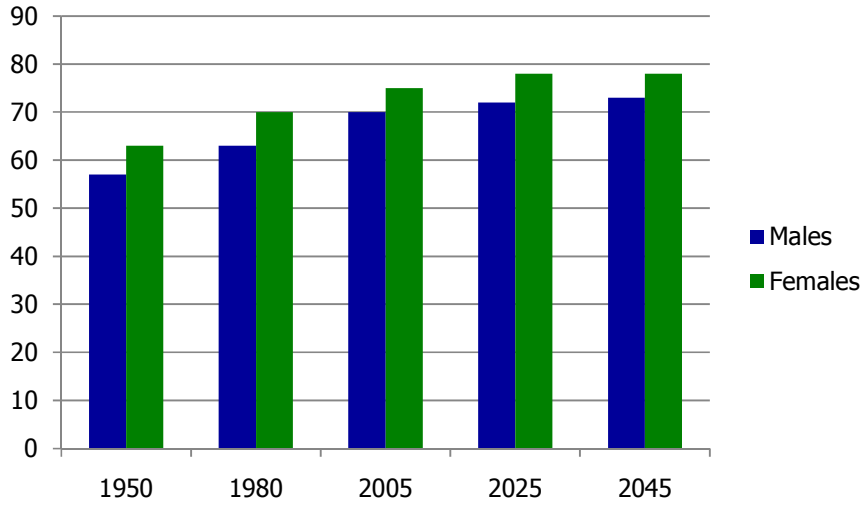
In total, the Conservatives expect these measures to save £120 million. The amount saved is less important though, than the role of Parliament in providing a clear lead for cuts across the public sector. Several of these measures are also important in terms of democratic principle, as well. The TaxPayers' Alliance report *Taxpayer Funded Lobbying and Political Campaigning* highlighted the problems with public sector lobbying, in particular.

In some areas, the Conservatives need to go further. For example, the regional tier of government should be cut back further, with organisations like the Regional Development Agencies, which spend significantly more than the Regional Assemblies, cut or abolished. The Conservative local government team have suggested that the Regional Development Agencies would be abolished under a Conservative government, but our understanding is that minor changes to their organisation and structures of accountability are more likely.

3.5 Bring forward rises in the state pension age

The Pensions Policy Institute has argued that a fair standard for the state pension age could be one that 75 per cent would reach. They argue that this would not be unreasonable as an average of previous expectations. By that standard, the pension age should already be over 70.

Figure 3.2: State Pension Age set so that 75 per cent of 25 year olds would reach it[27]



In that context, Conservative plans to raise the state pension age for men to 66 from 2016 and, for women, to 65 by 2020 seem far from ambitious, though they are a significant acceleration from the current Government plans. It will be extremely difficult to maintain healthy public finances in the medium term if the bad start that current borrowing is giving the country is combined with a continued and significant rise in the number of retired people that each person of working age is expected to support.

3.6 Cut the cost of Whitehall by a third

The Conservatives expect to save £3 billion a year through two key measures:

- Cutting "centralising" bureaucracy. This would mean cuts in a range of quangos from the Learning and Skills Council to the Qualification and Curriculum Authority that the Conservatives describe as "setting *policy*, distributing *funding* and *regulating* services and businesses". They expect savings of £2 billion a year in this area.
- Cutting "back office" bureaucracy. This would include finance, human resources, property management and IT functions and is expected to save £1 billion a year.

This level of cuts away from the front line seems achievable and desirable. Some of the activity going on at these bodies is important, though many of them have grown rapidly in recent years, but they are also a key source of interference in local services which often reduces efficiency. For example, Local Government Association research suggests that reducing central government interference in local authorities could save £4.5 billion while protecting local services.[28]

[27] Pensions Policy Institute *'Raising state pension age: are we ready?'*, Chart 5, http://www.pensionspolicyinstitute.org.uk/uploadeddocuments/PPI_SPA_Report_Sept_02.pdf
[28] Local Government Association *'Bonfire of bureaucracy could save taxpayers £4.5 billion'*, 20 November 2009

3.7 £50,000 cap on public sector pensions

There is clearly a significant problem with the liabilities and costs attached to public sector pensions. Research for Policy Exchange has shown that the liability for unfunded public sector pensions is now £1.1 trillion and costs £45.2 billion to service.[29]

In that light, capping some of the highest cost pensions is welcome but distinctly inadequate. The TPA's research with the Institute of Directors suggests that the most effective way of reducing the cost of public sector pensions in the short term is to increase the contributions rate by a third, which would take a typical public sector worker from 6 to 8 per cent. Public sector pensions would still be extremely generous compared to those in the private sector. A typical public sector pension is currently worth more than 40 per cent of salary whereas a typical private sector defined contribution scheme pays just 7 per cent of salary. The reform that the TPA and Institute of Directors recommended would save more than £2.5 billion.

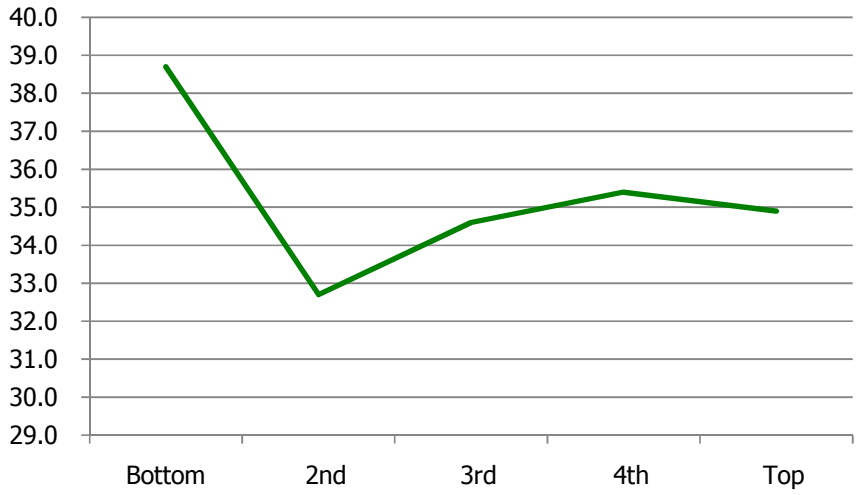
3.8 Increase VAT from 17.5 per cent to 20 per cent and remove or weaken exemptions

In the New Year, the temporary cut in VAT will expire and the rate rise back to 17.5 per cent. There have been suggestions that the next Government will increase the rate further under any party, but the policy is particularly associated with the Conservatives. Research for the accountancy BDO Stoy Hayward has suggested that the Conservatives are likely to increase VAT to 20 per cent. They also expect that the Conservatives may abolish exemptions on books and magazines and increase the rate of VAT on domestic fuel and power from 5 per cent to 9 per cent.[30] It has also been reported in the media that the Conservatives are at least studying the idea of increasing VAT to 20 per cent.[31]

- The Office for National Statistics report Effects of taxes and benefits on household income makes it clear that the poor already pay a larger share of their income in tax than the rich. The poorest fifth of households pay 38.7 per cent of their gross income, whereas the richest fifth pay 34.9 per cent. [32]

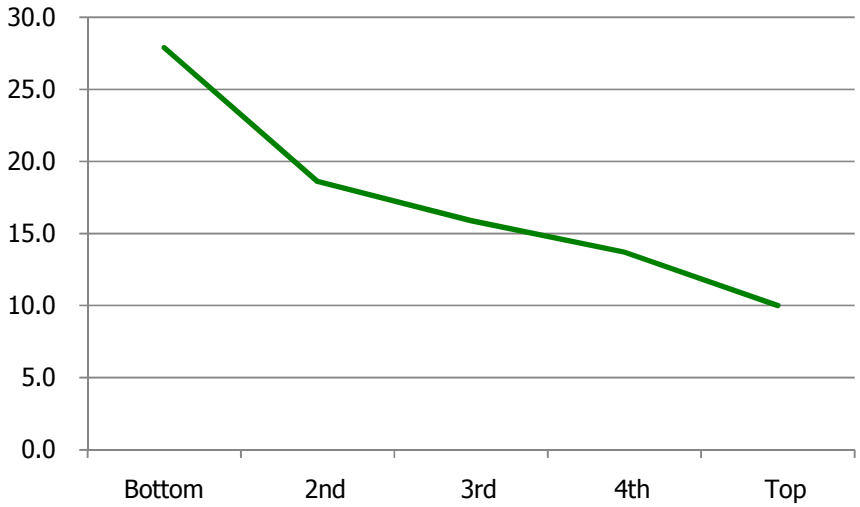
[29] Record, N., Mackenzie Smith, J. & Kay, L. *'Public Sector Pensions: The UK's Second National Debt'*, Policy Exchange, 11 June 2009
[30] BDO Stoy Hayward *'Time to break the silence? Assessing the tax options available to help rebuild the UK Government's fiscal policy'*, pg. 5, http://breakingthesilence.bdo.uk.com/includes/downloads/BDOBreaktheSilence.pdf
[31] Hennessy, P. & Jamieson, A. 'Tories study plans for 20pc VAT', *Daily Telegraph*, 8 August 2009
[32] Office for National Statistics *'Effects of taxes and benefits on household income 2007/08'*, 29 July 2009

Figure 3.3: All taxes as a share of gross income, by income decile



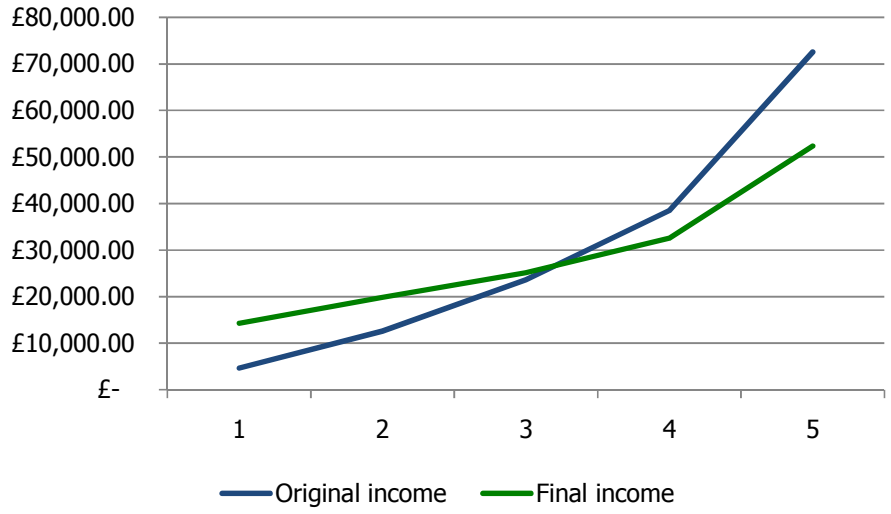
- The most regressive taxes are indirect taxes. The poorest fifth pay 27.9 per cent of their gross income in indirect taxes whereas the richest fifth pay 10.0 per cent. This biggest indirect tax is VAT but the 'sin taxes', such as duties on cigarettes and alcohol, and Fuel Duty are also significant and regressive.

Figure 3.4: Indirect taxes as a share of gross income, by income decile



- The cumulative effect of taxes and benefits on the income distribution is progressive. The poor have a higher final income, after taxes and benefits, while the rich have a lower final income. That means that high tax rates are forcing the poor into greater dependence on benefits though, which is likely to have a number of negative effects including high marginal withdrawal rates which hurt the incentive for low income workers to increase their incomes.

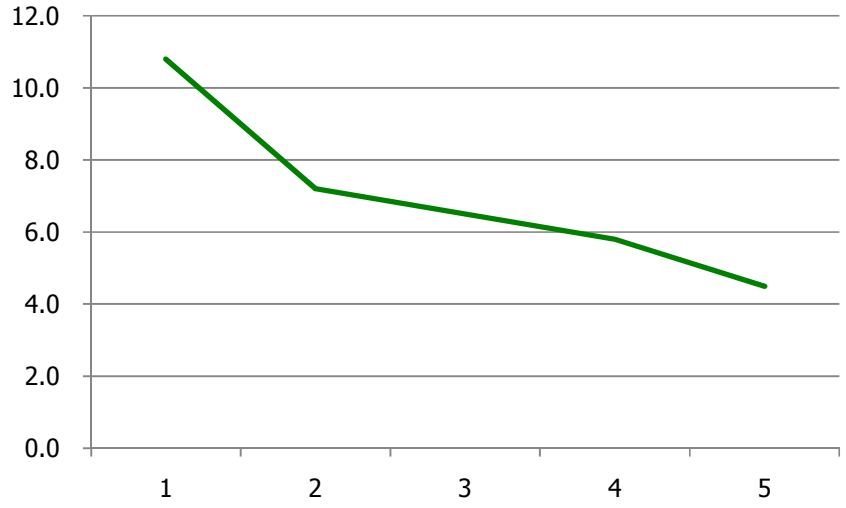
Figure 3.5: Incomes before and after taxes and benefits, by income decile



Increasing VAT to 20 per cent would raise significant revenue, up to £10 billion a year. But, it would make the tax system more regressive, which would have a number of negative consequences:

- VAT is heavily regressive. Office for National Statistics data shows that VAT takes 10.8 per cent of the gross income of the lowest income quintile of the population, while it takes 4.5 per cent of the highest income quintile.

Figure 3.6: VAT as a percentage of gross income, by income quintile



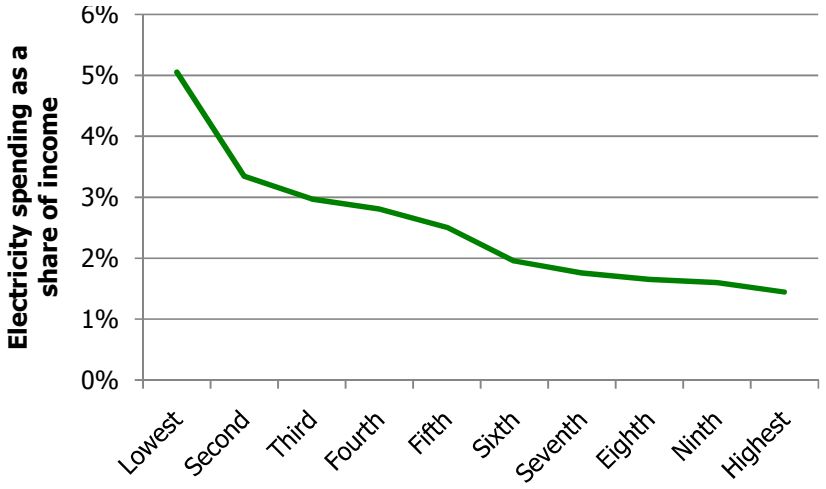
- Increasing tax on the poorest would increase poverty and benefit dependency. That may reduce the revenue gain from increasing VAT and endanger efforts to tackle long term social problems. It would also be hard to reconcile with Conservative Leader David Cameron's statement that the "poorest in our society should not pay an unfair

price for mistakes made by some of the richest"[33] and that a Conservative Government would "make sure the system always considers the effect of any policy response on the position of the poorest in society".[34]

Increasing the rate of VAT charged on domestic fuel and power would also be extremely troubling:

- Figure 3.7 shows that lower incomes tend to be associated with spending a higher proportion of income on electricity.

Figure 3.7: Electricity spending as a share of total income, by income decile[35]



- Climate change policy is already significantly increasing domestic fuel and power bills. Government estimates put the cost of climate change policies at 14 per cent of household electricity bills and 3 per cent of domestic gas bills.[36] That burden is expected to rise significantly and create an "affordability crisis" even without further increases in taxation.[37]

Increasing VAT, either the general rate or the rate on domestic fuel and power, would be a serious mistake.

[33] Cameron, D. *'Fiscal responsibility with a social conscience'*, 19 March 2009
[34] Cameron, D. *'Making progressive conservatism a reality'*, 22 January 2009
[35] Office for National Statistics, *Annual Survey of Hours and Earnings 2008* and *Family Spending 2008*
[36] BERR *'UK Renewable Energy Strategy – Consultation'*, Paragraph 10.5.3, June 2008
[37] Citigroup Global Markets *'Pan European Utilities'*, 22 October 2009

3.9 Introduce a levy on profits of the bailed out banks

James Forsyth, Political Editor at the Spectator, has reported that the Conservatives are planning a levy on the profits of the bailed out banks:[38]

> *"There will also likely be some form of additional tax on banks, something The Spectator called for last week. I understand that once change being floated is what would be, in effect, a windfall tax on financial institutions. It would be billed as an accountancy rule: any bank that has received state aid cannot write off old losses against tax. Osborne's office is rightly concerned that banks will try to put their international losses through their London office, with a view to paying no British tax for years or more."*

This is a broadly sensible idea. But, it is critical that it only apply to bailed out banks. That will reduce the possibility that a levy would drive businesses to move abroad and help to reduce moral hazard. Competitive pressure from non-bailed out banks should ensure that the cost of the measure is not passed on to consumers. The other challenge is that any levy would need to be set at a level where it did not endanger banks increasing their capital levels, which is necessary so they can rebuild their lending capacity.[39]

[38] Forsyth, J. *'David Cameron is planning a government of GOATS and Dragons'*, 28 November 2009
[39] IMF *'Global Financial Stability Report: Navigating the Financial Challenges Ahead'*, October 2009, pp. 40-41

4. The Liberal Democrat Party

The Liberal Democrat Deputy Leader and Shadow Chancellor, Vince Cable, has set out a series of proposals in a report for the centre right think tank Reform:[40]

- Zero growth overall for public sector pay (saving £2.4 billion a year), a 25 per cent reduction in the total pay bill of staff earning over £100,000 and a salary freeze and end of bonuses for the civil service (saving £200 million a year).
- Tapering the family element of the tax credit – saving £1.35 billion.
- A radical review of public sector pensions with the view to moving to higher employee contributions and later retirement ages. There is currently a £28 billion subsidy to unfunded schemes.
- Scrapping several major IT systems including the ID card scheme (£5 billion over 10 years), Contactpoint (£200 million over 5 years), the NHS IT scheme (£250 million over the next 5 years) and the proposed "super database" (£6 billion).
- Curbing "industrial policy", including scrapping Regional Development Agencies (£2.3 billion annually) and EGCD subsidies (£100 million annually) and reducing (by at least half) the Train to Gain and Skills Councils budgets (£990 million together a year).
- Reforming the National Health Service, by reducing the centralisation and over-administration – starting by scrapping Strategic Health Authorities (£200 million a year) – by strengthening commissioning and with "supply side reform" – in particular tariff reform could save around £2 billion a year.
- Curbing the centralisation in education, by cutting national strategies and scrapping quangos – saving around £600 million a year.
- Reducing the amount of waste in the defence procurement process, including scrapping the Eurofighter and Tranche 3 (£5 billion over 6 years), the A400M (total cost £22 billion), Nimrod MRA4, the Defence Training Review contract (£13 billion over 25 years) and the Trident submarine successor (£70 billion over 25 years).
- Examining possible future public sector asset sales, including some aspects of the Highways Agency (land value of £80 billion) and intangibles such as spectrum, landing rights and emissions trading.

These recommendations are not all party policy but may give a sense of the spending cuts that the Liberal Democrats are most amenable to. The Liberal Democrats have a wide range of policies. But there are a number that constitute particularly important contributions to the debate:

[40] Cable, V. *'Tackling the fiscal crisis: A recovery plan for the UK'*, Reform, September 2009

4.1 Abolishing Regional Development Agencies and large parts of departmental business spending.

4.2 Introduce a 'mansion tax' on high value properties.

4.3 Abolish Trident.

4.1 Abolishing Regional Development Agencies and large parts of departmental business spending

The TaxPayers' Alliance has recommended abolishing the Regional Development Agencies (RDAs) and radically reforming the business department in two reports: *The case for abolishing regional development agencies* and *An affordable voice for business: Reforming the Department for Business, Enterprise and Regulatory Reform*. The picture is complicated by the creation of the new Business, Innovation and Skills (BIS) department, but it would still be reasonable to expect that savings of around £3 billion could be achieved.

- The government has failed to create a better environment for business, and most of the business support activity taking place within the department is wasteful.
- The RDAs have failed to reduce regional inequality and have presided over falls in regional employment and competitiveness.

The approach of taking businesses' money in taxes – or future taxes through borrowing – then giving it back to them in grants, after significant amounts are lost supporting an expensive bureaucracy, is misguided and should not be continued.

4.2 Introduce a 'mansion tax' on high value properties

The Liberal Democrats' proposed 'mansion tax' on the value of properties worth £1 million or more would have meant around 250,000 people paying an average of £4,000 a year, 0.5 per cent on value above the £1 million threshold. Since the policy was announced, it has been amended to a tax of one per cent of value above a £2 million threshold.

The problem with this policy is similar to that with council tax, which the Liberal Democrats have long argued for replacing: people with high value properties do not necessarily have high incomes. Many elderly people, having paid off their mortgage, live in houses they have paid for over a lifetime on a relatively low pension income. For that reason, the Liberal Democrats initially announced a rebate for those poor enough to qualify for housing benefit. That is unlikely to adequately deal with the problem, though, even if it still applies after the threshold was increased. Paul Smith, chief executive of

the Haart estate agency group, told the Guardian that "If a home is worth £1.5m, the 0.5% tax would apply to £500,000 of it, meaning the owner will have to pay £2,500 a year. The extra tax on a £4m property would be £15,000 a year. This level of taxation is absurd and will only lead to disagreements about values."[41] The level of taxation has now increased, though it will apply to even fewer homes.

That kind of complication, in a new tax that would produce quite a small amount of revenue, suggests that the 'mansion tax' is not an efficient tax. It is entirely possible that it won't cover the cost of the policy it is designed to fund – a very worthwhile increase in the personal allowance – and the package may therefore increase rather than reduce deficits.

4.3 Abolish Trident

The Liberal Democrats have proposed that Trident should be abolished. The Government's estimate of the cost of replacing the scheme is £15-20 billion. This is based on the cost of the existing system when it was procured, with some allowance for cost inflation. Greenpeace argue that this misses key costs – in particular, replacing or extending the life of the missiles – and that based on international experience the cost is likely to have doubled to around £30 billion.[42]

Under either estimate, replacing the scheme is clearly going to cost a substantial amount. It needs to be borne in mind though, that it is not an annual cost but will be incurred over a number of years. It is therefore less significant, compared to the other items discussed in this report and the TPA's earlier work with the Institute of Directors than the headline figure might suggest.

The reason the TPA has not taken a position on Trident is that the decision needs to be taken with strategic concerns in mind. There are a series of moral concerns and beliefs about the strategic environment that need to inform a decision over Trident:

- Does an independent nuclear deterrent improve our security?
- Is maintaining a nuclear deterrent morally acceptable?
- Is maintaining a nuclear deterrent necessary to play our part in security alliances?
- Is maintaining a nuclear deterrent helpful to our standing in the world?

These questions are outside the expertise of the TPA but it is difficult to have a meaningful debate over Trident without addressing them.

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[41] Sparrow, A. 'Cable accused of planning 'unworkable' mansion tax', *The Guardian*, 21 September 2009
[42] Greenpeace *'In the firing line: an investigation into the hidden cost of the supercarrier project and replacing trident'*, September 2009

5. Minor parties: the BNP, Greens, UKIP

This report is focussed on the debate over how to control the United Kingdom's national debt, therefore, those parties catering to particular geographical areas such as the Scottish National Party, Plaid Cymru, the Democratic Unionist Party, Sinn Fein and the English Democratic Party have not been included. The minor parties that have elected representatives in the Westminster and European parliaments are the United Kingdom Independence Party, the Green Party and the BNP.

At the time of writing, neither the BNP nor the Green Party appears, in the key policy documents available on their websites, to have even acknowledged the existence of the fiscal crisis.[43]

Like the Liberal Democrats, the United Kingdom Independence Party does have other policies, but their signature policy is to leave the European Union.

5.1 Leave the European Union

Like the debate over Trident, the decision over Britain's membership of the EU is necessarily tied into much wider issues. For example, whether membership enhances or diminishes Britain's wider international influence and the degree to which democratic accountability is sacrificed. The TPA has carried out extensive research in this area, looking at the cost of schemes like the Common Agricultural Policy and Common Fisheries Policy. Recently, the TPA released the book *Ten Years On: Britain Without the European Union* by Dr. Lee Rotherham.

Britain's net contributions are around £6 billion. That would be saved if Britain moved to the kind of relationship Switzerland, for example, enjoys with the EU. Significant amounts of that may be reinstituted at a national level though, and larger savings may be in reduced costs to families and businesses as the regulatory burden could be cut and policies like the Common Agricultural Policy and Common Fisheries Policy abolished. EU policy is extremely important – and the brevity with which this report covers the subject should not be taken as an indication of the importance of the issue – but not, primarily, as a means to ease the fiscal crisis.

[43] Their website pages on the 'Economy' and EU election manifestos.

6. Conclusions

The parties' responses to the fiscal crisis are clearly critical to their credibility. The scale of Britain's structural deficit – at £100 billion or more which is not just a temporary result of the recession – means that fiscal tightening will be necessary. The public are well aware that action is needed, and expect politicians to prove that they are able to deal with such a serious issue, that they are in politics for more than expense claims and photo opportunities.

This report has highlighted many of the problems with responding to the fiscal crisis with tax rises. Potential tax rises tend to fall into two categories:

- Tax increases that hurt the economy and raise little or no revenue. Increased taxes on the 'rich' or capital fall into this category. They are at best a distraction and, at worst, actually counterproductive as the behavioural response means that revenue falls when the rate increases.
- Tax increases that hurt people on low or middle incomes. An increase in VAT, in particular, would clearly make the tax system more regressive and would likely increase poverty and benefit dependency.

The basic problem is that the current fiscal crisis isn't following a decade of tax cuts, but tax rises. That means there is not much room to tax companies or high earners more without driving them to move to lower tax jurisdictions. At the same time, and particularly following the recession, increases in the tax burden on poor and middle income families will cause serious hardship.

Britain's structural deficits are driven by massive increases in spending, of around £30 billion a year, that were premised on spending the proceeds of a temporary boom as if they came from a permanent improvement in the country's economic fortunes. High spending is the problem and spending cuts are the solution. However, no party has come close to proposing even the £50 billion of fiscal tightening – through cuts or tax rises – that the TPA and the Institute of Directors identified, let alone the £100 billion or more that is needed. It is likely that new policies will continue to be announced in the coming months and that all the parties will go to the election with more complete fiscal strategies.

However, it is probably no accident that the parties have so far proposed only around a tenth of the £100 billion fiscal tightening necessary and it is unlikely that the British politics will be able to deliver a rapid tightening on that scale. However, a clear and credible strategy is needed. In our view, it should have the following four components:

6.1 Short term fiscal tightening of around £50 billion in spending cuts

There is a clear need for immediate cuts to improve the state of the public finances. Many areas of public spending can be identified as either failing or non-priority. That was the approach taken by the TPA report with the Institute of Directors that identified £50 billion of potential spending cuts.

There may be a case that the fiscal situation is so dire that spending cuts alone cannot produce the fiscal tightening needed. For a response to our proposals along those lines to be credible though, it would need to propose a total fiscal tightening greater than the one we identified, or one of equal size that produces fewer harms. Yet, none of the political parties have yet proposed anything like the £50 billion in fiscal tightening contained in our report, even when combining tax rises and spending cuts.

6.2 Adopt fiscal rules with embedded expenditure targets

The Conservatives have argued that fiscal rules are inherently ineffective:[44]

> *"The failure of the fiscal rules in Britain is consistent with the emerging conclusions of the academic literature on the shortcomings of rules in general. Both on paper and in reality, simple rules have been found to be either too loose to be effective, or so inflexible that governments break them, undermining their credibility. While it might be theoretically possible to design a rule that was right in all situations, it would be so complex that it would be impossible to operate in practice."*

However, research does suggest that simple fiscal rules can be effective, but that they have to include an expenditure target, which the Government's fiscal rules have not. Research by the OECD suggests that expenditure-based rules are associated with success in fiscal consolidation, and that other rules are not:[45]

> *"Historical observation is consistent with the regression results in suggesting that in general budget-balance rules that are not combined with expenditure rules are less effective. A striking example of this is the United States experience: neither the Gramm-Rudman-Hollings (GRH) Act of 1985 nor its revised version in 1987 succeeded in significantly reducing the fiscal deficit. A further example is the Stability and Growth Pact (SGP), which has not so far led to sustainable positions being attained, notably in large EU countries. On the other hand, when the United States turned to an expenditure-based rule, the Budget Enforcement Act (1990-2002), a surplus was achieved and maintained for a time. Some EU countries (e.g.*

[44] Conservatives *'Reconstruction: Plan for a strong economy'*, September 2009
[45] OECD *'Economic Outlook: Preliminary Edition', IV. Fiscal Consolidation: Lessons from past experience'*, http://www.oecd.org/dataoecd/21/33/38628499.pdf

Netherlands, Spain, Sweden, Finland and Czech Republic) supplemented the SGP by national rules (in most cases including some expenditure ceilings) and also enjoyed success. There were, however, some failures. For instance, after France introduced multi-year objectives for real government expenditure in 1998, its structural fiscal position deteriorated continuously until 2003, at which time it came under the European excessive deficit procedure."

In light of that evidence, and in order to give greater credibility to efforts to improve the state of the public finances, an expenditure target should be introduced.

6.3 Structural reforms to the public services

Structural reforms to the public services are needed to improve productivity and get the best results with limited resources. As we argued above, there is huge scope for increasing public sector productivity, which fell by 3.4 per cent between 1997 and 2007.[46] The Centre for Economics and Business Research has suggested that the public sector's failure to meet private sector levels of productivity growth now costs the taxpayer £58.4 billion a year.[47] Increasing the rate of public sector productivity growth will make it easier to meet a given expenditure target.

6.4 Pro-growth policies

Increased growth will make it considerably easier to restore the public finances to health. The optimistic predictions for growth in the Budget are one reason why its fiscal projections may understate the seriousness of the situation. There are a range of policies that may increase growth over time:

- Lower spending
- Cuts in specific taxes, for example corporate tax
- Repealing burdensome regulation

In a report for the TPA, the Centre for Economics and Business Research found that even a broad range of tax rises, which would increase revenue initially, would lose the Exchequer money within seven years.[48] TaxPayers' Alliance research suggests that lower

[46] Office for National Statistics 'Total public service output and productivity', *Economic & Labour Market Review*, Vol.3 No.8, August 2009
[47] McWilliams, D. '*The UK's public sector productivity shortfall is costing taxpayers £58.4 billion a year – in other words, not far short of half our income tax is paying for public sector inefficiency',* 23 August 2009
[48] McWilliams, D., Snook, R. & Ohanissian, A. *'Can tax increases solve the United Kingdom's public finance crisis: A report for The TaxPayers' Alliance'*, CEBR, July 2009

corporate tax rates are associated with higher corporate tax revenue growth.[49] Both these papers show the extent to which policies that increase growth can dramatically increase revenue over time, sometimes enough to outweigh a reduction in revenue with a tax cut quite quickly.

6.5 Conclusion

It is possible for politicians to respond credibly to the dire state of Britain's public finances. That will require a change in the attitude that politicians can prove their commitment to quality public services by promising to increase spending. In reality, such promises end in the situation we are facing now, with a wasteful feast leading to an uncomfortable famine.

A key lesson identified by Jens Henriksson, Executive Director for the Nordic-Baltic Countries on the IMF Board, from Sweden's successful fiscal consolidation is that any government looking to address big deficits needs to be honest with its citizens and with financial markets.[50] Part of that has to be that British parties outline a clear and credible programme before and after the election. Suggesting that fiscal tightening can be achieved through painless gimmicks, hit everyone but the median voter or even isn't necessary in the first place is not convincing or helpful.

Cutting spending now, and controlling it in the future, can restore the public finances to health and provide lower taxes and a more stable economy in the years to come. Unfortunately, the parties are a long way from delivering credible plans to deliver the greater prudence they have all claimed to represent.

[49] Elliott, M., Sinclair, M. & Taylor, C. *'How cutting corporation tax would boost revenue'*, Conservative Way Forward, September 2008
[50] Henriksson, J. *'Ten lessons about budget consolidation'*, Bruegel Essay and Lecture Series, 2007