Briefing note

Budget 2010

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REFORM

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Key points

The task facing the Chancellor in his Budget is a straight forward one:

> to eliminate the UK structural deficit of around £100 billion through spending cuts and tax rises.

> to secure economic growth and employment so that the cyclical part of the deficit is eliminated as well.

> to reform the UK public sector so that it achieves greater productivity even after the deficit is eliminated, allowing taxes to be reduced.

The best means to do that are:

> To cut spending on benefits and reduce labour costs in the civil service, health and education. Other EU countries are already making these changes.

> To eliminate the exemptions in VAT (with protection for the poorest households), cut National Insurance Contributions and abolish the 50p rate.

> To make the NHS and education accountable to their users.

How to cut spending – at home and abroad

In all countries, public spending is very largely composed of benefit payments and public services. Of public services, the great majority of the costs is labour.

The Chancellor needs to announce policies to reduce benefit payments by restricting eligibility and encouraging employment and wage growth. He needs to announce policies to reduce public sector labour costs through wage cuts, reductions in headcount and reforms to public sector pensions.

The other heavily indebted countries in the EU – Portugal, Ireland, Greece and Spain – show what the UK has to do. These countries have already announced their deficit reduction plans:

> Portugal is means-testing more benefits and cutting the costs of the public sector workforce by 1 per cent of GDP.

> Ireland is cutting the costs of the public sector workforce through reductions in both pay (an average 7 per cent cut for all public servants) and headcount and reforming public sector pensions.

> Greece is cutting the costs of the public sector workforce through reductions in both pay (a 10 per cent cut in total public sector pay), reductions in full time civil service headcount through natural wastage and cuts in short term contracts.

> Spain is cutting the costs of the public sector workforce by 2 per cent of GDP through a pay freeze and reductions in headcount through natural wastage and cuts in short term contracts.

> Despite not being a heavily indebted country, Germany is making similar savings. It is reducing all public sector budgets and increasing the retirement age.

Where to cut

Public spending in the UK is largely made up of health, benefits (pensions and other benefits) and education – which between them account for nearly 60 per cent of total government expenditure. Each of these areas should expect cuts in line with their shares of public spending.

Table 1: Share of government expenditure on key services
HM Treasury (2009), *Public Expenditure Statistical Analyses*.

	Cost, £ billion (2008-09)	% of all government spending
Non-pensioner benefits	127	20
NHS	110	18
Pensions	77	12
School education	47	8

Some cuts, such as the abolition of benefits for middle and higher income people, can start immediately. Others, such as the removal of inefficiencies in public services through reforms to their structure, will take years of effort to achieve.

The public sector employs 6.1 million people compared to 5.2 million in 1999. Previous *Reform* research has found that the costs of the workforce should fall by around 15 per cent, equivalent to approximately one million front line jobs.

How to raise taxes

The Chancellor must raise taxes given the hole in the public finances. His challenge is to do so in such a way that the damage to economic growth is minimised.

The current proposals to increase National Insurance Contributions and introduce a 50p rate will damage employment and growth. They will delay the reduction in the non-cyclical deficit.

The right way to raise extra revenue would be to eliminate the exemptions in VAT while protecting the poorest households.

When to cut?

The typical goal of economic policy is to increase consumption and output. But in some cases the risk to the integrity of the economy is more important. That is the current position of the UK.

The UK is in the danger zone – at risk of damage from a withdrawal of investor support – as long as its debt-to-GDP ratio is rising. The Treasury currently predicts the debt-to-GDP ratio to rise until 2015. It is likely to be years after that given the Treasury's over-optimistic growth forecasts.

The UK has run unbalanced public finances for years. In the last 35 years, the UK has been in surplus for only seven. For these reasons the reductions in UK public spending need to start now and to last for many years.

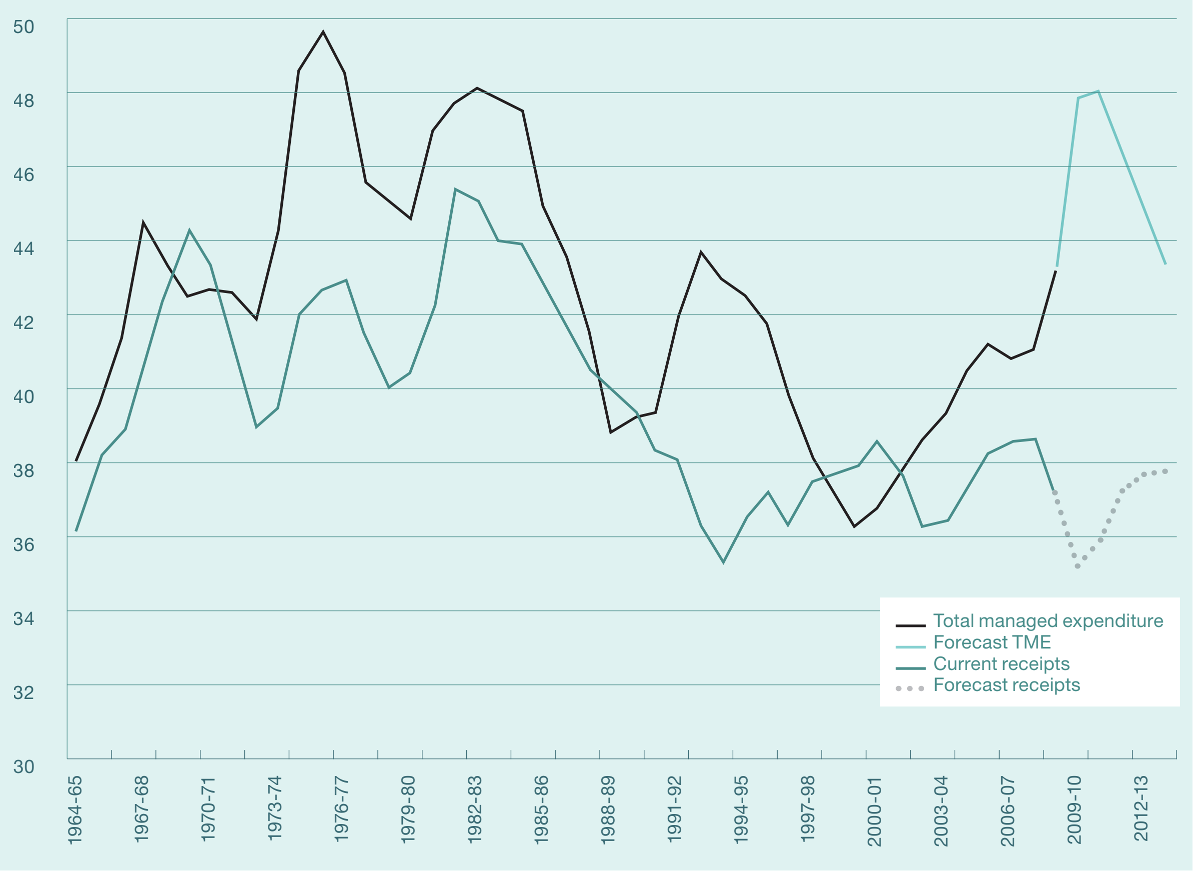
Fiscal aggregates

Taxes and spending

The link between taxation and public spending has broken. The public has come to believe that ever increasing welfare benefits and public services can be made available to them at little or no extra cost. In only eight of the forty-nine years from 1964-65 to 2013-14 will the government have received more than it has spent. While this problem is not new, since 2001-02 the gap has grown to large levels, reflecting the significant growth in spending since 1998-99.

Figure 1: Government spending and receipts as a percentage of GDP, 1964-65 to 2013-14

Source: HM Treasury (2009), *Public finances databank*, historic data.



Deficit reduction plans

Alistair Darling has pledged to halve public sector net borrowing over the four years to 2013-14, from £176 billion to £96 billion. The 2009 Pre-Budget Report showed that public spending is planned to be £58 billion lower by 2013-14. The rest of the £80 billion reduction in the deficit would come from tax increases of £22 billion.

The Conservative Party has said that the split between tax increases and public spending should be around 20:80. This would mean that a Conservative Government would raise taxes by around £16 billion and cut spending by about £64 billion by 2013-14.

The Liberal Democrats have argued that the bulk of the reduction must come on the spending side. Vince Cable has said that the Liberal Democrats have identified £10 billion more in spending cuts than the Government. On this estimate their tax to spending ratio for the fiscal tightening would be around 15:85.

Reform argues that the fiscal tightening should go further, proposing that borrowing be reduced to 4.5 per cent by 2013-14 and that the burden of adjustment should be borne by tax increases and expenditure reductions in the ratio of 12.5:87.5. This proposal would see £1 raised from tax increases for every £7 saved from cutting spending, following the Canadian rule of thumb from the 1990s.[1]

Table 2: Comparison of fiscal plans for the period 2010-11 to 2013-14
Sources: HM Treasury (2009), *Pre-Budget Report 2009: Securing the recovery; growth and opportunity; Reform* calculations.

	Government	Conservative	Liberal Democrat	*Reform*
Reduction in public sector net borrowing	6.5% (from 12.0% to 5.5%)	6.5% (from 12.0% to 5.5%)	6.5% (from 12.0% to 5.5%)	7.5% (from 12.0% to 4.5%)
Balance between tax rises/spending cuts	30:70	20:80	15:85	12.5:87.5
Increase in tax burden (per cent reduction)	£22.2billion (1.8%)	£16.0 billion (1.3%)	£12.2 billion (1.0 %)	£12.2 billion (0.9%)
Reduction in total managed expenditure (per cent reduction)	£57.8 billion (4.6%)	£64.3 billion (5.2%)	£67.8 billion (5.5%)	£85.7 billion (6.6%)

1 The Canadian Government's 1995 Budget included CA$7 in spending reductions for every CA$1 increase in tax revenue. The Minister of Finance at the time, Paul Martin, noted that the fact that the government cut back their own activities rather than putting the burden on taxpayers played a key role in generating support for the process of restoring the public finances.

International experience

Governments around the world have put in place fiscal consolidation plans. The key features of these plans for a number of European countries are shown below. They show that the major components of public spending in all countries are benefit payments and public services, with labour accounting for the great majority of public services costs.

Table 3: International fiscal consolidation plans

Sources: HM Treasury (2009), *Budget 2009: Building Britain's Future;* German Federal Ministry of Finance (2010), *German Stability Programme January 2010 Update;* Greek Ministry of Finance (2010), *Update of the Hellenic Stability and Growth Programme;* Irish Department of Finance (2009), *Ireland Stability Programme Update December 2009;* Irish Department of Finance (2009), Budget 2010; Government of Portugal (2010), *Speech by the Minister of State for Finance at the close of the final debate of the State Budget for 2010;* Portuguese Ministry of Finance and Public Administration (2010), *Portugal – Stability and Growth Programme 2010-2013,* memo, 8 March; Finance Ministry of France (2010), *Programme de stabilite de la France 2010-2013*; Spanish Ministry of Economy and Finance (2010), *Stability Programme Update: Spain, 2009-2013.*

	Fiscal tightening, per cent of GDP	Period	Revenue increases/ spending cuts balance	Detail
UK	6.5% (from 12.0% to 5.5%)	2010-11 to 2013-14	28:72	Tax rises of 1.8% of GDP (£22 billion) through increasing tax rates on income tax, social security contributions and duties. Spending cuts of 4.7% of GDP (£58 billion) including real terms freeze in government expenditure. Not yet backed by published departmental spending plans. Cuts include reduction in capital spending of £18 billion.
Ireland	8.8% (from 11.7% to 2.9%	2009 to 2014	33:67	Spending cut by €4 billion in Budget 2010, around 7 per cent of the annual government budget (equivalent to a £40 billion cut in the UK). Main cuts include reducing public sector workforce costs through a moratorium on recruitment and promotion and permanent overhaul of public sector workforce numbers, incentivised early retirement scheme, salary cuts averaging between 6% and 15% across the public sector, radical reform of public sector pensions for new entrants. Across the board detailed review of departmental spending resulting in 10% reduction in total spending between 2008 and 2010, covering most departments. Biggest cuts in social welfare (particularly JSA and child benefit), health (including a charge for prescriptions) and education. Measures to broaden tax base and reform the tax system, in particular introduction of water metering, a property tax and a carbon tax.

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Table 3: International fiscal consolidation plans, continued

	Fiscal tightening, per cent of GDP	Period	Revenue increases/ spending cuts balance	Detail
Germany	2.5% (from 5.5% to 3%)	2010 to 2013	0:100	Assumption consolidation will be met solely on the expenditure side. Spending will be cut from 48% of GDP in 2010 to 45% in 2013. "All areas of expenditure must make a contribution to consolidation." The bulk of cuts will come from reforms to the social security system and labour market reforms, including increase in the retirement age. Tax cuts amounting to over €24billion from 2010 on to reduce the burden on citizens and businesses, in particular cuts in social security contributions. Tax revenues will fall from 42.5% of GDP in 2010 to 42% of GDP in 2013.
Greece	10.7% (from 12.7% to 2.0%)	2009 to 2013	56:44	Expenditure cuts of 4.7% of GDP (equivalent to around £66 billion for the UK) achieved through controlling the public sector wage bill, reform of the social security system and departmental operating expenditure cuts. Control of public sector wage bill through: a real terms reduction of public sector pay, a reduction in headcount (mainly through a 5:1 rule of retirements and recruitment), 10% reduction in salary entitlements and a reduction of short-term contracts. Particular spending cuts in health, social security and defence. Tax rises of 6% of GDP focussed on reforms to reduce evasion and improve collection, elimination of exemptions and increase in duties.
Spain	8.4% (from 11.4% to 3.0%)	2009 to 2013	40:60	Tax increases of 3.4% of GDP and spending cuts of 4.8% of GDP. Reduction in Ministries' working spending, practical freeze on public sector pay, moderation of annual pension update, practical freeze in public sector hiring process, reduced investment in infrastructure. Increases in taxes on alcohol and tobacco, increase in normal VAT rate from 16% to 18% and the reduced rate from 7% to 8%, removal of annual income tax deduction of €400 per worker, increase in taxation of savings and reduction in corporate tax rate.

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Table 3: International fiscal consolidation plans, continued

	Fiscal tightening, per cent of GDP	Period	Revenue increases/ spending cuts balance	Detail
Portugal	6.5% (from 9.3% to 2.8%)	2009 to 2013	23:77	Spending cuts totalling 2.7% of GDP mainly through public sector wage restraint (equivalent to 1% of GDP) and "at least two out for one in" rule for public sector employment, reduction of social benefits (through greater means testing) and control of national health service costs. Tax rises of 0.8% of GDP including some broadening of social security contributions and income taxes, with rates mainly maintained at current levels except for a 3% increase in higher rate of income tax (from 42% to 45%).
France	5.2% (from 8.2% to 3%)	2010 to 2013	42:58	Spending cuts of 3% of GDP, including real terms freeze of public expenditure and control of public sector workforce costs through a "two out one in" rule for civil service recruitment. Tax revenues to rise by 2.3% of GDP, including tax on severance pay for voluntary retirement, a new tax levied on companies and a new carbon tax.

Taxation

The current tax base

Tax revenues

The Treasury estimates that tax receipts will pick up in 2010-11 as the economy starts to recover and continue to rise to reach historically high absolute levels – around 35 per cent of GDP – by 2012-13.

Table 4: Net taxes and national insurance contributions 2009-10 to 2013-14, estimates, real terms (2008-09 prices) and per cent of GDP
Source: HM Treasury (2009), *Public finances databank,* historic data.

	Cash, billions, 2008-09 prices	Per cent of GDP
2009-10	£458.4	33.2
2010-11	£478.3	33.9
2011-12	£509.2	34.9
2012-13	£531.3	35.3
2013-14	£550.1	35.3

Impact of the recession

The economic downturn has resulted in a fall in tax revenues. Total taxes were £21 billion less in 2008-09 than in 2007-08, equivalent to a fall of 2 per cent of GDP. Stamp duties have seen the biggest drop (largely due to the housing market decline), followed by inheritance tax receipts, although this is likely to be mainly due to the 2007 reform allowing couples to pool their exempt allowances. Corporation tax receipts are particularly volatile and have also seen a big drop in receipts of just under 10 per cent.

Table 5: The effect of the economic downturn on tax revenues
Source: HM Treasury (2010), *Public finances databank,* January.

	2007-08, billions (real prices)	2008-09, billions (real prices)	Change, billions	Change, per cent
Income tax	£155.5	£153.4	-£2.1	-1.4
Corporation tax	£47.5	£43.1	-£4.4	-9.3
Stamp duty	£14.4	£8.0	-£6.4	-44.6
Inheritance tax	£4.0	£2.9	-£1.1	-27.4
Capital gains tax	£5.4	£7.9	+£2.5	+45.5
VAT	£82.6	£78.4	-£4.2	-5.1

Balance between income and consumption taxes

The 1980s saw a shift from taxes on earnings towards taxes on consumption. Geoffrey Howe's 1979 Budget increased the VAT rate from 8 per cent on standard goods and 12.5 per cent on "luxury" items to a single rate of 15 per cent, while income taxes were substantially cut. Since about 1997 there has been a reversal of this trend. Today, the tax mix is much the same as it was at the end of the 1970s, with income taxes and national insurance accounting for the largest share – nearly half – of total taxes.

Table 6: UK tax mix 1978-79 to 2008-09
Source: HM Treasury (2009), *Public finances databank,* historic data; *Reform* calculations.

	1978-79	1988-89	1998-99	2008-09
Income tax and NICs	50%	43%	45%	48%
Indirect taxes	23%	27%	30%	26%
Corporation tax	7%	10%	9%	8%
Business rates and council tax	10%	11%	9%	9%
Stamp duty, capital gains tax and inheritance tax	2%	3%	3%	4%
Other	8%	5%	5%	5%
Total	100%	100%	100%	100%

The VAT base

HM Revenue & Customs estimates that at least £31 billion is lost annually from the various reduced and zero rated items, with the main ones being on food, the construction of new homes and gas and electricity. Britain is one of only four EU countries to apply a zero rate to food (with Ireland, Cyprus and Malta). It is one of only three to apply a zero or reduced rate to children's clothes (with Ireland and Luxemburg). The UK is alone in applying a zero rate on the construction of new homes (although six others apply reduced rates). Only nine member states have reduced rates for gas and electricity.

Table 7: Broadening the VAT base (estimated lost revenue 2008-09)

Source: HMRC (2009), *Estimated costs of the principal tax expenditure and structural reliefs, 2008-09.*

Zero-rated items	**£ million**
Food	11,450
Construction of new dwellings *	5,700
Domestic passenger transport	2,600
International passenger transport *	150
Books, newspapers and magazines	1,500
Children's clothing	1,200
Water and sewerage services	1,350
Drugs and supplies on prescription	1,450
Supplies to charities *	200
Ships and aircraft above a certain size	650
Vehicles and other supplies to disabled people	350
Reduced rate items	
Domestic fuel and power	3,950
Certain residential conversions and renovations	150
Energy-saving materials	50
Women's sanitary products	50
Estimated total	**30,800**

* These figures are particularly tentative and subject to a wide margin of error.

Competitiveness of corporation tax rate

Although higher than the OECD average, the UK's main rate of corporation tax is competitive compared to similar sized economies. Within the G7, Britain has the second lowest corporation tax rate, more than 10 percentage points lower than the American and Japanese main rates.

Table 8: Corporate income tax rates, G7 and OECD average
Source: Organisation for Economic Co-operation and Development (2009), *Tax Database: Table 11.1 Corporate Income Tax Rate, 1981 – 2009.*

	1990	2000	2009
Italy	46.40	37.00	27.50
United Kingdom	34.00	30.00	28.00
Germany	54.50	53.00	30.18
Canada	41.45	42.57	31.32
France	42.00	37.76	34.43
United States	38.65	39.34	39.10
Japan	50.00	40.90	39.50
OECD average	41.05	33.54	26.29

Reliance on financial services

A study by PricewaterhouseCoopers estimates that the financial services sector contributed £61.4 billion in tax receipts in the year to 31 March 2009, equivalent to over 12 per cent of total tax revenues. The recession has caused a drop in receipts from the sector of around 10 per cent (between the year to 31 March 2007 and the year to 31 March 2009). This estimated loss of £6.4 billion is equivalent to just over 1 per cent of total government receipts and is largely due to a significant drop in corporation taxes. However, HM Revenue & Customs data shows that corporate tax receipts from the sector were falling before the recession.

Table 9: Corporation tax receipts by industrial sector, millions
Source: HM Revenue & Customs (2009), *Table 11.1,* May 2009.

	2000-01	2004-05	2008-09
Manufacturing	£5,529	£4,646	£3,698
Distribution	£3,942	£4,475	£4,857
Other industrial and commercial	£9,769	£11,732	£16,275
Financial services	£11,301	£8,922	£7,584
North sea companies	£2,329	£3,831	£10,358
Total	**£32,870**	**£33,606**	**£44,772**

Tax policy proposals

Labour

The Government's plans in the 2009 Pre-Budget Report for raising tax revenues would see a significant proportion of the increase in taxes – around £11.1 billion in 2011-12 and £14.3 billion in 2012-13 – falling on labour. Announcements to date propose an increase in tax on income via the new 50p top rate and withdrawal of the personal allowance for incomes over £100,000, and on employment via a 1 per cent increase in National Insurance Contributions. Relief on pension contributions is also being restricted for those on incomes over £150,000.

Table 10: Key Labour Party tax proposals
Sources: HM Treasury (2008), *Pre-Budget Report 2009: Facing global challenges;* HM Treasury (2009), *Pre-Budget Report 2009: Securing the recovery.*

Proposal	Detail	Cost/revenue	*Reform* comment
50p top tax rate	50p tax rate on incomes above £150,000	Estimated would raise £2.4 billion a year (2012-13)	Adding to complexity and reinforcing perception of UK as hostile tax jurisdiction
Personal allowance clawback	Withdraw personal allowances on incomes over £100,000	Estimated would raise £1.5 billion a year (2012-13)	Adding to complexity and reinforcing perception of UK as hostile tax jurisdiction
Pension relief clawback	Restrict tax relief on pension contributions	Estimated would raise £3.1 billion a year (2012-13)	Adding to complexity and reinforcing perception of UK as hostile tax jurisdiction
Increase NICs	1% increase in employee and employer NICs	Estimated would raise £10 billion a year (2012-13)	Would damage job growth and employment
Raise primary NICs threshold	Raise primary NICs threshold to align with personal tax thresholds + £570	Estimated would cost £3.1 billion a year (2012-13)	Would fail to address much of the damage caused by the NICs rate increase
Freeze higher rate threshold		Estimated would raise £0.4 billion a year (2012-13)	Would be a tax by stealth and damage the integrity of the tax system
Increase in fuel duties		Estimated would raise £2.8 billion a year (2012-13)	Example of a corrective tax being used for revenue raising purposes

Liberal Democrats

Based on analysis of HMRC Survey of Personal Income (Public Use Tape) data, *Reform* estimates the proposal to increase the personal allowance to £10,000 would cost around £20 billion (without accounting for behavioural changes). Around 80 per cent of the benefit from this tax reduction would go to taxpayers with incomes above £10,000. The Liberal Democrats propose funding this change through distortionary measures on narrow bases.

Table 11: Liberal Democrat tax proposals
Sources: Liberal Democrats (2010), *Your Money Policy Briefing;* Liberal Democrats (2009), *Liberal Democrat Tax Plans;* Liberal Democrats (2009), *Creating a Banking Levy: A Fair Deal for the Taxpayer.*

Proposal	Detail	Funded	Cost/revenue	*Reform* comment
No tax paid on first £10,000 of income	Aim to take 4 million people out of income tax	Funded by the sum of the measures below	The Liberal Democrats estimate this to cost £16.5 billion	Expensive and poorly targeted approach to reliving the tax burdens of low income families
A “mansion tax”	A 1% levy on homes worth over £2 million		Estimated would raise £1.7 billion	Arbitrary and applying to a very narrow tax base – will affect only an estimated 70,000 to 80,000 households
Restrict tax relief on pension contributions to the basic rate for all individuals			Estimated would raise £4.6 billion	Adding further complexity to the environment for savers
Close gap between capital and income taxes	Align capital gains tax rates with income tax rates and reduce the annual exemption from £10,000 to £2,000		Estimated would raise £4.1 billion	Not immediate priority
Green taxes	Specific taxes on air travel have been proposed		Estimated would raise £2.6 billion	Green taxes should be based on environmental not revenue raising goals.
A 10% temporary tax on bank profits	Payable by all banks incorporated in the UK		Estimated would raise £2 billion annually	Inconsistent with competitiveness and reinforcing perception of UK as hostile tax jurisdiction for important sector

Conservatives

A key Conservative pledge is to cut the main rate of corporation tax from 28p to 25p and the small companies' rate from 21p to 20p. These tax cuts would be paid for by cutting certain reliefs available to companies. Businesses have warned that reducing headline rates by cutting allowances would not necessarily reduce their overall tax burden, and indeed would see the effective tax rate increase for some companies.[2] Conservative proposals for tax relief do not address the most damaging features of the tax system (and so should not be priorities) and are also inconsistent with the direction of travel of tax systems worldwide (including no longer recognising marriage).

Table 12: Conservative Party tax proposals
Sources: The Conservative Party (2010), *A new economic model: Eight benchmarks for Britain;* www.conservatives.com/Policy/Economy.

Proposal	Detail	Funded	Cost/revenue	*Reform* comment
Cut main corporation tax rate from 28p to 25p and cut small companies' rate from 21p to 20p		Paid for by reducing complex reliefs and allowances	Treasury ready reckoner: £1.2 billion and £22 million in 2010-11; £2.5 billion and £420 million 2011-12	Should not be a priority for the next Parliament
Raise inheritance tax threshold	Raise threshold from £325,000 to £1 million		Up to £3.1 billion annually	Should not be a priority for the next Parliament
Recognising marriage	End the couple penalty in the tax credit system and provide a transferrable tax allowance		Between £600 million and £3.2 billion, depending on the design	Inconsistent with modern tax systems and will not achieve its objective
"Freeze" council tax for two years	Councils that keep their council tax rises to 2.5 per cent or below would receive additional funding from central government to pay for a 2.5 per cent cut in council tax bills	Funded by reducing wasteful spending on advertising and consultancy in central government	Conservative estimate: £500 million in 2010-11 and £1 billion in 2011-12 Government estimate: £470 million more over the two years. 2010-11 council tax revenues: estimated at £25.8 billion	Adding to complexity and breaking the link between service delivery and taxes

Table continued overleaf >

2 For example, the last cut in the main corporation tax rate was paid for by scrapping Industrial Buildings' Allowances, with a significant impact on the manufacturing industry. Cutting capital allowances or R&D tax credits to pay for a rate cut would again mean an increased tax burden for the manufacturing sector.

Table 12: Conservative Party tax proposals, continued
Sources: The Conservative Party (2010), *A new economic model: Eight benchmarks for Britain;* www.conservatives.com/Policy/Economy.

Proposal	Detail	Funded	Cost/revenue	*Reform* comment
Abolish National Insurance Contributions on new jobs	Any new business started in the first two years of a Conservative Government will pay no Employer National Insurance on the first ten employees it hires during its first year	Paid for from the changes to the company tax regime	Just over £250 million a year	Short term gimmick that adds to complexity
Raise stamp duty threshold to £250,000 for first time buyers	Would take nine out of ten first-time buyers out of stamp duty	Funded by a flat-rate annual charge on non-domiciles (regardless of the length of time they have been in the UK)	Treasury estimate: cost of £200 million annually	Should not be a priority for the next Parliament
Increase the proportion of taxes collected from green taxation	Revenues would go into a families fund to reduce taxes on families		No detail	Green taxes should be based on environmental not revenue raising grounds

Reform

Scrapping all VAT exemptions while increasing benefits to compensate the poorest households would allow a reversal of the 50p rate and restriction of higher rate relief on pension contributions, as well as a 0.5 per cent cut in employee and employer National Insurance Contributions. Taken together, these measures would raise extra revenue of £8.3 billion in 2011-12 and £8.4 billion in 2012-13, compared to the Government's plans which would raise £11.1 billion in 2011-12 and £14.3 billion in 2012-13. These figures relate only to the major tax changes affecting income tax, National Insurance Contributions and VAT.

Table 13: *Reform* tax package – Income Tax, National Insurance Contributions and VAT, £ billions

	2011-12	**2012-13**
Income tax		
Scrap 50p rate on incomes over £150,000	-£2.5	-£2.4
Convert personal allowances into a tax free threshold (1)	£2.9	£2.9
Scrap gimmick reliefs and benefits	£1.1	£1.1
	Total £1.5	Total £1.6
National Insurance Contributions		
0.5%decrease employee and employer NICs	-£5.5	-£5.5
Raise primary NICs threshold to align with zero rate threshold (2)	-£2.7	-£2.7
	Total -£8.2	Total -£8.2
VAT		
Broaden VAT base with compensation for low income families	£15.0	£15.0
	Total £15.0	Total £15.0
Total increase	£8.3	£8.4

Note: (1) based on figures contained in PBR 2009; (2) based on figures contained in PBR 2008

Spending

This section examines public expenditure cuts that can and should be made to annually managed expenditure (transfer payments) and to departmental spending (departmental expenditure limits). The largest areas of public spending which have enjoyed the biggest increases in the last ten years will need to achieve the biggest reductions. These are welfare, health and education which between them account for nearly 60 per cent of total government spending.

Table 14: Government spending by function, 2009-2010 (projections)
HM Treasury (2010), *Public finances databank, February 2010.*

Function	Percentage of total government spending
Social protection*	28
Health	18
Education	13
Other**	11
Defence	6
Public order and safety	5
Debt interest	4
Housing and environment	4
Personal social services	4
Industry, agriculture, employment and training	3
Transport	3

* Includes refundable components of tax credits.
**Includes spending on central administration; culture, media and sport; international co-operation and development; public service pensions; plus spending yet to be allocated and some accounting adjustments.

It has been argued that cutting spending or raising taxes too soon could damage economic recovery (through further weakening private consumption). This should not, however, be used as an excuse for failing to develop a credible and detailed plan for addressing the deficit. A credible plan will need to recognise that the scope for (and economic effects of) making immediate cuts varies across areas of spending – with welfare spending (such as the Child Trust Fund) providing a fruitful area for early action. Failing to begin the process of restoring the public finances immediately will also mean that the costs of poor quality expenditure will continue to be incurred and there will be upward pressure on the costs of government borrowing (which in turn affect the costs of borrowing facing businesses and families).

Annually managed expenditure

The British Government spends more on welfare than anything else. In 2009, the bill for "social protection" was around £199 billion, almost double the level (in real terms) since 1991. Social protection represents 32.5 per cent of all government expenditure and is equivalent to 14.2 per cent of GDP.

Some welfare spending varies with economic conditions, with increasing unemployment leading to greater expenditure supporting people back to work, for example. However, since 2000 welfare payments have increased even when the economy was growing. This was due to the expansion of benefits to groups not in need, through Tax Credits, Childcare/Maternity Benefits and the Winter Fuel Allowance.

Table 15: Expenditure on social protection, real prices
Source: HM Treasury (2009), *Public Expenditure Statistical Analyses.*

Year	Expenditure, billions
1991	£108
1992	£120
1993	£132
1994	£139
1995	£145
1996	£145
1997	£147
1998	£145
1999	£143
2000	£150
2001	£154
2002	£162
2003	£165
2004	£172
2005	£177
2006	£181
2007	£182
2008	£188
2009	£199

Note: Spending on social protection (according to the UN definition as used by HM Treasury) includes expenditure on sickness and disability, old age, survivors, families and children, unemployment, housing, social exclusion, R & D social protection, and other social protection.

Benefit recipients

The main areas of expenditure on welfare are on families and elderly people. Only 12 per cent of welfare expenditure is spent on the major out of work benefits, while 42 per cent (£80 billion) is spent on the elderly and 21 per cent (£41 billion) is spent on working families. In 2008, 60 per cent of households were in receipt of at least one benefit; that figure rises to 93 per cent for households with children.

Table 16: Expenditure on key welfare programmes, 2009-10

Source: Department of Work and Pensions (2010), *Benefit Expenditure Tables;* HM Treasury (2009), *HMRC Supply Estimates 2009-10:* HM Revenue and Customs (2009), *HM Revenue and Customs 2008-09 Accounts;* Department for Transport (2008), *Annual Report 2008.*

	Expenditure, millions
Benefits for families with children:	
Child Tax Credit	£16,200
Child Benefit	£11,770
Child Trust Fund	£500
Statutory Maternity Pay	£1,783
Benefits for unemployed people and people on low incomes:	
Jobseekers Allowance	£4,950
Income Support	£8,208
Employment and Support Allowance	£1,761
Working Tax Credit	£7,500
Housing Benefit	£4,755
Council Tax Benefit	£19,512
Benefits for elderly people:	
Basic State Pension	£53,749
SERPS and SSP	£13,202
Pensions Credit (Savings and Guarantee)	£8,294
Winter Fuel Allowance	£2,731
Free TV license	£545
Free bus pass	£1,029
Benefits for sick and disabled people:	
Incapacity Benefit	£6,073
Disability Living Allowance	£11,437
Attendance Allowance	£5,125
Carer's Allowance	£1,506

Note: See Cawston *et al.* (2009), *The end of entitlement, Reform* for full explanatory notes.

Middle class welfare

A substantial proportion of welfare spending goes on middle and high earners, rather than those in need, through universal benefits and near-free higher education. *Reform's* 2009 report, *The end of entitlement*, found that the cost of middle class welfare amounts to around £31 billion per year. The most generous benefits to the middle classes include the Child Benefit, Child and Working Tax Credits, Retirement Pension and Winter Fuel Allowance and Statutory Maternity Pay. In the report *Reform* proposed a programme of £14 billion of savings that could be made in the welfare bill next year.

Table 17: *Reform* proposals for reductions in annually managed expenditure

Recommendation	**Savings, billions**
Means test Child Benefit	£7.0
Scrap unnecessary benefits for families: The Child Trust Fund Employer-supported Childcare Schemes Health in Pregnancy Grants The Healthy Start Scheme The Sure Start Maternity Grant	£1.3
Abolish universal pensioner gimmicks: The Winter Fuel Allowance Free TV licenses for the over 75s	£3.2
Start raising the qualification age for the state pension to 68 from 2010-11	£0.2
Scrap concessionary bus fares	£1.0
Charge student loan borrowers at the market rate	£1.2
Abolish the Educational Maintenance Allowance	£0.5
Total	**£14.4**

Departmental expenditure

Public and private sector productivity

Data from the Office for National Statistics shows that between 1997 and 2007 public sector productivity fell by 3.4 per cent, equivalent to an annual average fall of 0.3 per cent, while productivity in the private sector grew by an average of 2.3 per cent a year. During this time the unit cost of public service output grew by 13.7 per cent more than the unit costs for the whole economy. It is estimated that this declining productivity in the public sector could be costing taxpayers £58 billion a year.

Table 18: Annual growth in productivity in the UK
Sources: Phelps, M. (2009), *Total Public Service Output and Productivity,* UK Centre for the Measurement of Government Activity, Office for National Statistics; Office for National Statistics (2009), *Statistical Bulletin: Productivity Q2 2009;* Office for National Statistics (2009), *Output per worker: whole economy: percentage change per annum, seasonally adjusted,* UK, Time Series Data.

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Average annual growth
Public sector	0.2	-0.7	-0.9	0.4	-1.2	-1.4	-0.3	-0.6	0.6	0.6	-0.3
Private sector	3.4	2.6	3.3	1.7	1.2	2.1	2.8	1.6	2.2	2.4	2.3
Whole economy	2.7	2.2	2.7	1.4	1	1.9	1.8	1.3	2.1	1.9	1.9

Public sector headcount

The public sector accounts for around a fifth of total employment in the UK, with 6.1 million workers employed by the government. After dropping in the late 1980s and early 1990s, public sector employment has been rising every year since 1999. This trend has continued during the recession. In 2009 employment in the private sector decreased by 527,000 (2.2 per cent), while employment in the public sector increased by 46,000 (0.8 per cent). The biggest increase was in health, with NHS headcount rising by 4 per cent in 2009, or 62,000 new employees. Certain sectors have, however, already frozen workforce numbers or started reducing headcount in response to the constrained fiscal and economic position.

Table 19: UK public sector employment by industry, headcount, seasonally adjusted
Source: Office for National Statistics (2010), *Statistical Bulletin: Public sector employment Q4 2009.*

	1999	2004	2008	2009	Growth 1999-2009
NHS	1,212,000	1,475,000	1,510,000	1,621,000	34%
Education	1,151,000	1,337,000	1,393,000	1,418,000	23%
Police	227,000	264,000	289,000	297,000	31%
Civil service	503,000	568,000	522,000	532,000	6%
Local government	2,722,000	2,874,000	2,932,000	2,921,000	7%
Total public sector headcount	5,190,000	5,745,000	6,052,000	6,098,000	17%

Proportion of labour costs on the front line

The expanding public sector payroll means that in each of the major public services well over half of the costs of services are taken up by workforce costs. *Reform's* 2009 report, *The front line*, estimated that around a third of everything the government spends is on workforce costs.

Table 20: Public sector labour costs as a proportion of total costs

Sources: Healthcare and education: Phelps, M. (2009), *Changing Costs of Public Services,* UK Centre for the Measurement of Government Activity, Office for National Statistics; Police: UK Centre for the Measurement of Government Activity (2009), *Public Service Output, Input and Productivity: Measuring Police Inputs,* Office for National Statistics.

Service	1997	2002	2007	Average annual growth 98-07
Healthcare	51.6	53.0	53.6	5.6
Education	69.6	70.2	68.3	5.5
Police	-	74.6*	75.8	-

* This figure is for 2003.

Reform's spending proposals

Whitehall

While the recession is pushing private sector companies to make tough choices on personnel costs, many public sector workers have remained immune to the downturn. In the private sector measures including voluntary redundancies, foregone bonuses, pay cuts or freezes and even shorter hours with commensurate pay cuts have been introduced in efforts to reduce costs without making good workers redundant. Further, the average wage of a civil servant has risen by a third in real terms in the last ten years. Public sector pay should reflect the state of the Government's books and of departmental performance. In the immediate term, a number of measures could be implemented to reduce costs.

Table 21: Summary of Whitehall savings, *Reform*

Recommendation	Savings, millions
Freeze all civil service salaries	£169
Award no civil service bonuses	£25
Introduce a voluntary four day week with commensurate salary cut (based on 10% participation)	£200
Total savings	£394

Health

Health is the biggest departmental budget and the second biggest area of government spending after welfare. Real terms health spending has doubled since 1999, with the NHS accounting for 40 per cent of the increase in inputs across the whole public sector between 1997 and 2007. Wage inflation has absorbed much of the additional expenditure, with around £18.9 billion (43 per cent) of the £42.3 billion cash increase being absorbed in higher pay and prices.

Table 22: NHS departmental expenditure, 1999-2000 to 2010,11, real prices
Source: House of Commons Health Select Committee (2010), *Public Expenditure on Health and Personal Social Services.*

Year	Expenditure, billions
1999-2000	£50.0
2000-01	£53.9
2001-02	£58.9
2002-03	£62.6
2003-04	£72.7
2004-05	£76.1
2005-06	£82.0
2006-07	£84.6
2007-08	£91.2
2008-09	£94.5
2009-10	£101.6
2010-11	£103.2

Note: Expenditure figures from 2003-04 to 2010-11 are on Stage 2 Resource Budgeting Basis.

More than half of all health costs are now spent on staff, with labour costs in health care rising faster than those in the whole over economy over the last decade, particularly since 2003. The NHS has seen the biggest rise in staff numbers in the last decade of all public services, with headcount growing by nearly a third between 1999 and 2009. This increase in workforce has partly been driven by Government targets. Pay rises have also driven up the wage bill. Growth in pay in the NHS outstripped pay growth in the whole economy by around 15 per cent between 2002 and 2007. Higher paid members of staff – including registrars, consultants, GPs and managers – have seen pay increases that are least in line with productivity gains.

Table 23: NHS headcount, England
Source: The Information Centre for health and social care (2009), *NHS Staff 1998 – 2008 Overview.*

	1998	2008	Growth, headcount	Growth, percentage
Doctors	91,837	133,662	41,825	46%
Nurses	323,457	408,160	84,703	26%
Scientific, therapeutic & technical staff	99,656	142,558	42,902	43%
Ambulance staff	14,781	17,451	2,670	18%
Clinical support	289,363	355,010	65,647	23%
Infrastructure support	168,448	219,064	50,616	30%
Other GP practice staff	82,081	92,436	10,355	13%
Other	1,939	353	-1,586	-82%
Total	1,071,562	1,368,693	297,131	28%

Hospital activity is the most expensive element of the UK's health services. *Reform* research found that the NHS has, rightly, reduced the number of hospital beds in England by over a third over the last twenty years, from 270,000 to 160,000. These reductions have mainly been achieved in specialist care, while the acute sector has seen modest reductions since the early 1990s.

The closure of hospital services – including reductions in bed numbers – has in most cases been due to a redesign of service provision and enables the reduction of activities and control of costs. It is consistent with meeting the changing needs of healthcare. The key challenge for health services today is improving quality of life for survivors with long-term conditions and reducing disability.

Future reconfigurations should aim to reduce hospital services further, to help bring down costs and concentrate resources on the most critical services. This would enable the NHS to deliver higher quality care. The *Reform* report estimated that the NHS should seek to reduce bed numbers by a further 32,000 in the next Parliament. London, the North East and the North West have the highest density of hospital beds and could be expected to close at least a quarter of their beds.

Table 24: NHS Beds, by Strategic Health Authority
Source: Department of Health (2009), *Average daily number of available and occupied beds by sector, Strategic Health Authorities in England, 2008-09;* Department of Health (2006), *Strategic Health Authority Configurations.*

	Population (000s)	Total beds	Total beds per 1,000 people
England	50,093	159,386	3.18
North East	2,545	10,516	4.13
North West	6,827	23,707	3.47
London	7,429	25,681	3.46
South West	5,038	16,760	3.33
Yorkshire and the Humber	5,039	16,526	3.28
West Midlands	5,334	17,129	3.21
East Midlands	4,280	12,210	2.85
East of England	5,491	15,533	2.83
South East Coast	4,188	11,362	2.71
South Central	3,922	9,963	2.54

Education

The UK spends more on education than most other rich countries – around 20 per cent more than the OECD average as a proportion of GDP. Education is the third largest budget after health and welfare, with a total budget of £88 billion in 2009-10. Spending on schools (£47 billion) has increased as a proportion of GDP from 4.7 per cent in 1996-97 to 6.1 per cent in 2010-11.

Overall spending on all primary and secondary schools in the UK has seen an increase of 56 per cent in real terms in the decade to 2007-08. A simultaneous decrease in pupil numbers has meant that total funding per pupil (capital and revenue) increased by 98 per cent between 1997-98 and 2008-09.

Table 25: Expenditure on primary, secondary and non-tertiary post-secondary education, percentage of GDP
Source: OECD (2009), *Education at a Glance 2009.*

	1995	2000	2006
UK	3.6	3.5	4.3
Sweden	4.1	4.3	4.1
Belgium	-	4.1	4.1
France	3.8	3.6	4.0
USA	3.8	3.9	4.0
Canada	4.3	3.3	3.7
Norway	4.3	3.8	3.7
OECD average	3.7	3.5	3.6
Italy	3.5	3.2	3.5
Ireland	3.8	2.9	3.5
Germany	3.4	3.3	3.1
Japan	3.1	3.0	2.8

Staff costs make up the greatest proportion (over 68 per cent) of the education budget. Headcount has increased by nearly a quarter since 1999, while labour costs have seen a 5.5 per cent average yearly rise. The biggest rise has been in the number of teaching assistants – a growth of over 200 per cent in the ten years since 1999 – while the number of other support staff has doubled. The Treasury is in the process of reviewing the value for money of teaching assistants.

Table 26: Schools workforce, England
Source: DCSF (2009), *School Workforce in England;* DfES (2006), *School Workforce in England.*

	Number		**Cost (£ billion)**	
	1999	2009	1999	2009
Teachers	401,200	442,700	11.7	17.2
Teaching assistants	69,600	183,700	1.4*	1.7
Other support staff	79,100	162,200		2.0
Total	549,900	788,600	13.1	20.9

* Breakdown of cost between teaching assistants and other support staff not available for 1999.

Reducing spending on education will have to mean bigger class sizes. Research from the OECD and Ofsted and academic evidence from the Institute of Education suggests that teacher quality is far more important than class size in determining educational progress.

Summary of *Reform* recommendations

Table 27: Summary of *Reform* recommendations for Budget 2010

	Principles of reform	Recommendations
Deficit reduction	Reduce seven-eighths of the deficit through spending reductions and one-eighth through tax rises On the model of the Canadian government in the 1995 Budget	
Civil service	Make Whitehall accountable for value for money and performance Reduce costs of workforce	Give Ministers control over appointment of senior civil servants
Health	Be ready to cut the NHS budget along with other budgets Reduce costs of workforce Redesign services to shift care out of hospitals Increase choice and competition	Lower pay (through renegotiation or abolition of major contracts) and lower headcount (through natural wastage and some redundancies) Give patients choice of Primary Care Trust as well as hospital, to make commissioners of services accountable for performance and value for money
Welfare	Reduce costs of pensions Reduce costs of non-pension benefits	Increase retirement age immediately Tackle “middle class welfare” through increased use of means-testing (e.g. Child Benefit) or abolition of benefits (e.g. Winter Fuel Allowance)
Education	Reduce costs of workforce Reduce costs of infrastructure Reform of school funding to promote choice and competition	Reduce use of teaching assistants Reduce scope of Building Schools for the Future programme Introduce full choice of school with incentives for schools to reduce costs
Taxation	Raise indirect taxes and reduce direct taxes	Eliminate VAT exemptions, with protection for the poorest third of households Abolish the 50p rate of income tax Reduce National Insurance Contributions

Further reading

Bassett, D. *et al.* (2009), *Back to black, Reform.*

Bassett, D. *et al.* (2010), *Reality check: fixing the UK's tax system, Reform.*

Bosanquet, N. *et al*. (2007), *UK growth and opportunity: the need for a fundamental reassessment, Reform's submission to the 2007 Comprehensive Spending Review, Reform.*

Cawston, T. *et al.* (2009), *The end of entitlement, Reform.*

Haldenby, A. *et al.* (2009), *Fit for purpose, Reform.*

Haldenby, A. *et al.* (2009), *The front line, Reform.*