The author

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From 1966 to 1968, he was Treasury Finance Officer for the Kenya Government. After lecturing at Glasgow University in economics he worked as a first Secretary in the Diplomatic Service in the Foreign and Commonwealth Office (1974-76). He was then appointed Deputy Director of the Overseas Development Institute, which included a period working for the then Secretary of State for Trade and Industry, John Smith MP, as a Special Advisor. From 1983 to 1990, Vince worked as Special Advisor on Economic Affairs for the Commonwealth Secretary General, Sir Sonny Ramphal.

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- Protectionism and Industrial Decline, 1983
- The New Giants: China and India, (Chatham House) 1994
- The World's New Fissures; The Politics of Identity (Demos) 1995
- Globalisation and Global Governance, (Chatham House) 1999
- Multiple Identities, (Demos) 2005
- Public Services: Reform with a Purpose, (Centre for Reform) 2005
- The Storm: The World Economic Crisis and What it Means, (Atlantic) 2009

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Tackling the fiscal crisis: A recovery plan for the UK

Vince Cable MP

September 2009

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Executive Summary

The central issue emerging now in the UK – and the one which will dominate politics for the next few years – is the size of the UK government budget borrowing and deficits, and government debt. The stark reality is that much of the deficit does not represent either automatic stabilisers or a deliberate fiscal stimulus; it is "structural" in character and will not be reversed on recovery.

There has been an extraordinary growth in the share of public spending over the last decade: a rise of over 10 per cent of GDP. With the benefit of hindsight it is clear that much of this expansion was based on taxes from the financial services sector and the inflationary housing bubble which was a temporary windfall rather than a secure, permanent source of revenue. However, although some of us warned of the unstable "bubble" character of economic growth, the scale of the structural imbalance was underestimated by everyone, including the independent commentators.

The apocalyptic cries of "national bankruptcy" are unhelpful scare-mongering; but the problem is a serious one and a fiscal tightening to the tune of around 8 per cent of GDP over 5 years may well be needed. The current Government's plans for a correction of 6.4 per cent of GDP over 8 years are optimistic. They underestimate the size of the structural deficit, assuming a brisk economic growth rate of over 3 per cent per annum after 2011-12. They place too much reliance on cuts in capital spending; due to halve from 2010-11 to 2013-14 while current spending will face real cuts of only 2.3 per cent per year. And they fail to address how the tightening will be made from 2014-15 to 2018-19. The risk of declining market confidence and market concerns over inflation leading to an increase in borrowing costs, means a plausible plan to eliminate the structural deficit is critical.

The emphasis for fiscal consolidation must fall on controlling public spending, not higher taxes: to commit to additional tax revenue raising from the outset undermines any commitment to setting priorities in spending. This process will be painful and difficult. It will involve real cuts in many areas and will mean that the big budgets – health, welfare, defence and education – must be tackled. There should be no "ring fenced" areas of spending. Existing spending has to be justified, not simply assumed to be necessary and trimmed at the edges.

The traditional method of "salami slicing" with across-the- board cuts to all services without any priorities being set, causes considerable damage to valued services. Instead, a systematic process of selecting high and low priorities for public spending is needed. Radically decentralising decision making to local government through transferring revenue raising powers would help achieve better value for money. Engaging democratically elected politicians in the choices would inject democratic accountability. The debate should not become distracted by a focus on "efficiency" savings. No doubt public administrators can be made more conscious of costs and efficient management, but it is not credible to believe that greater "efficiency" is a panacea, not least because it has been invariably promised and not delivered in the past.

Nine specific areas of potential savings are identified as a start to a radical programme of reform. The main proposals are:

> 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.

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> 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.

Fiscal policy is political. Politicians must not shy away from explaining in detail how they will tackle the problem of deficits and debt. The proposals outlined in this paper do not constitute an exclusive or exhaustive list. Major, specific areas of potential savings are identified though the examples are illustrative and represent only a first, rough, attempt. Undoubtedly more are required to meet the exacting fiscal disciplines that will be required.

1
After the storm

We have just passed through a major economic storm. I do not propose to revisit history here. The debate is shifting from crisis management to dealing with its aftermath and the project of reconstruction. It is possible that we haven't yet seen the worst but a reasonable working assumption is that the issue for the future is now one of the timing, strength and durability of recovery as well as the legacy of damage.

The focus of debate has changed since the credit crunch first started in August 2007. Much of the attention has centred on the banking sector and the best way of countering the effects of a banking collapse and buttressing the sector against future shocks. There has also been a major debate around how to head off recession, deflation or even depression, as in the interwar period, and the relative contributions of monetary and fiscal policy.

At the time of writing, it seems very likely that the sharp drop in British GDP predicted in 2009-2010 of 3.5 to 4 per cent would be realised, but that a catastrophic collapse has been averted. Given the economic firepower directed at the crisis – almost zero interest rates, credit created through quantitative easing, devaluation, the UK and wider international fiscal response and the rescue of banks – it would be amazing if there hadn't been some stabilisation. We do not yet know the timing and trajectory of recovery, but we no longer face Armageddon.

The central issue emerging now in the UK, and one which will dominate politics in the next few years is the size of the UK government budget borrowing and deficits, and government debt. These problems are, in large measure, a legacy of the financial crisis: the direct costs of rescuing the banks and the indirect costs in the form of greatly depleted government revenue. There has also been a "fiscal stimulus", though it has been far less important (relative to monetary policy) than the Government or its critics claim. However, some would argue that a structural imbalance between current public spending and revenue – that is, deficits which are not produced by cyclical factors – and an unsustainable growth of public spending were occurring well before the financial crisis.

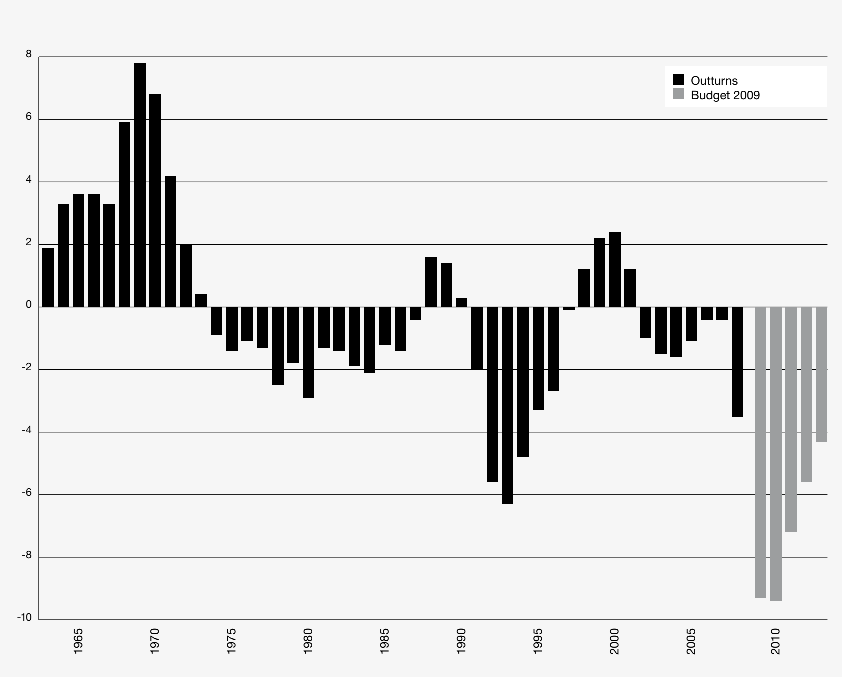
With the benefit of hindsight it is clear that the growth in public spending was based on taxes from the financial services sector and the inflationary housing bubble which was a temporary windfall rather than a secure, permanent, source of revenue. Although some of us warned of the unstable "bubble" character of economic growth, the scale of the structural imbalance was underestimated by everyone including the independent commentators. The Institute for Fiscal Studies and National Institute of Economic and Social Research were among the first to argue that there was a structural deficit; but their estimate for several years was only around £5 to £10 billion – up to 1 per cent of GDP. After the financial crisis, the deficit is now a gaping one – anywhere between 5 and 10 per cent of GDP and probably nearer the latter.

It is clear that there was a growing budget deficit which needed to be addressed, but that it is the banking crisis, and its consequences, which explain its scale and acute nature. In addressing the deficit there is a difficult issue of timing. If action is taken too soon and too abruptly there is a risk of deepening and prolonging the recession. If it is taken too late the problem of managing government borrowing and debt become progressively more serious. But, without doubt, serious fiscal tightening will be required and the purpose of this pamphlet is to suggest how that should be done.

But first, the numbers. The Treasury estimated in the 2009-10 Budget that public sector net borrowing could reach 13 per cent of GDP this financial year and monthly borrowing figures since the Budget suggest that borrowing could be even higher. These figures compare with 8 per cent of GDP in 1992-93 and 1993-94 in the last major recession and 7 per cent in 1975-76 when the International Monetary Fund was required to support the economy with a major loan and adjustment programme.

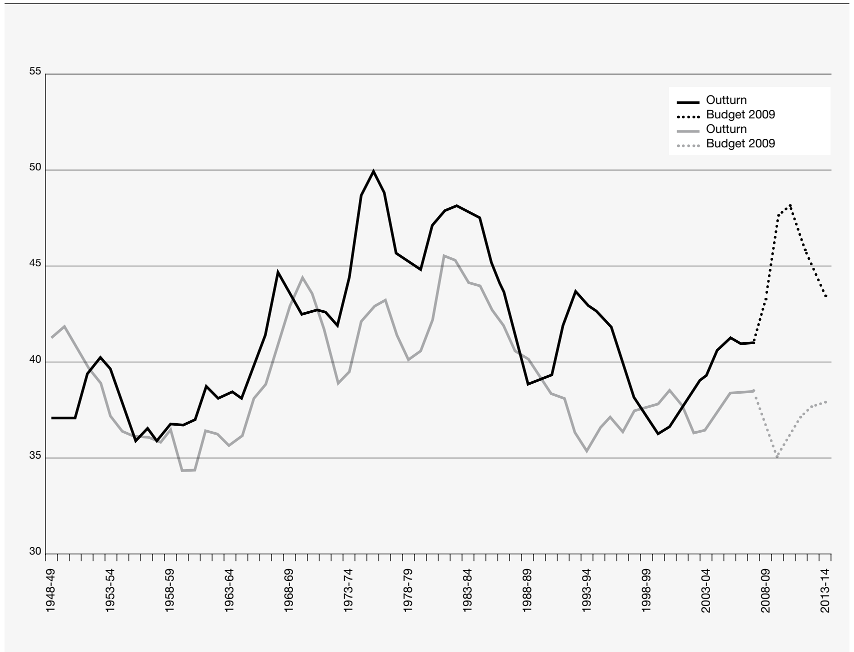
Since public sector net borrowing includes borrowing for capital investment and the impact of one-off asset transactions, an alternative measure is the deficit on the current budget, estimated at around 10 per cent of GDP (as against 6 per cent of GDP at the trough of the last recession). The Government's own projections, which incorporate some fairly optimistic growth assumptions and severe restraint in public spending, are that the net borrowing requirement will reduce over the next few years but by 2013-14 will still be over 5 per cent of GDP and the current budget deficit around 4 per cent of GDP.

Figure 1: Current account of government budget, per cent of GDP
Source: HM Treasury (2009), *Budget 2009: Building Britain's Future*



Underlying these big deficits is a tale of falling government revenue receipts and rising spending. Total government receipts are expected to be around 35 per cent of GDP this financial year, and could be lower than at any time since Harold Macmillan was Prime Minister. There are reports of a collapse in government revenue from corporation and income tax from the financial services sector in particular, and from transaction taxes, notably stamp duty linked to financial dealing and housing. Government revenues are bound to fall in recession since there is less activity, less consumption and lower incomes. But much of the loss of revenue is attributable to deeper problems.

Figure 2: Share of public spending and taxation in GDP
Source: Institute for Fiscal Studies (2009), *Budget 2009 briefing and analysis; public finances*



Note: public spending is total managed expenditure and taxation is current receipts.

At the same time, government spending as a share of GDP has risen to 48 per cent, partly reflecting the increased demands on public spending in a period of recession. But there has been an extraordinary growth in the share of public spending over a decade – by over 10 per cent of GDP. This is quite an increase, especially in a briskly growing economy.

2

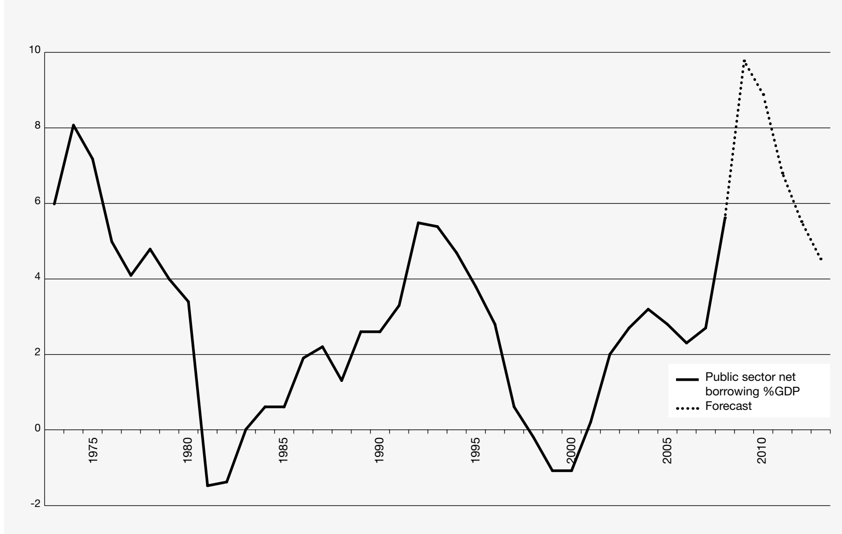
The scale of the fiscal crisis

A structural or cyclical deficit?

From a policy point of view, we need to know how much of the borrowing and deficit is "structural"; that is, will not correct itself with economic recovery. The concept of a "structural" deficit is not quite as secure as it sounds. It is now clear (or clearer) that spending plans and revenue assumptions made several years ago were based on an optimistic view of the sustainability of the boom in both financial services and in the housing market. That is why government and independent forecasters now assess the "structural" deficit, retrospectively, as being much bigger than when they assessed the numbers before the recent crisis.

The Government's own figures, let alone those of independent commentators, suggest that the deficits now being accumulated are "structural" rather than cyclical. Adjusted for the cycle, the Government estimates the net borrowing requirement to be 10 per cent of GDP rather than almost 13 per cent and the public sector current deficit to be around 6 per cent of GDP rather than almost 10 per cent. The cyclically adjusted current deficit is only eliminated in 2017-2018 on the Government's figures which, as we have noted, are optimistic.

Figure 3: Cyclically adjusted public sector net borrowing, per cent of GDP
Source: HM Treasury (2009), *Public finances databank*



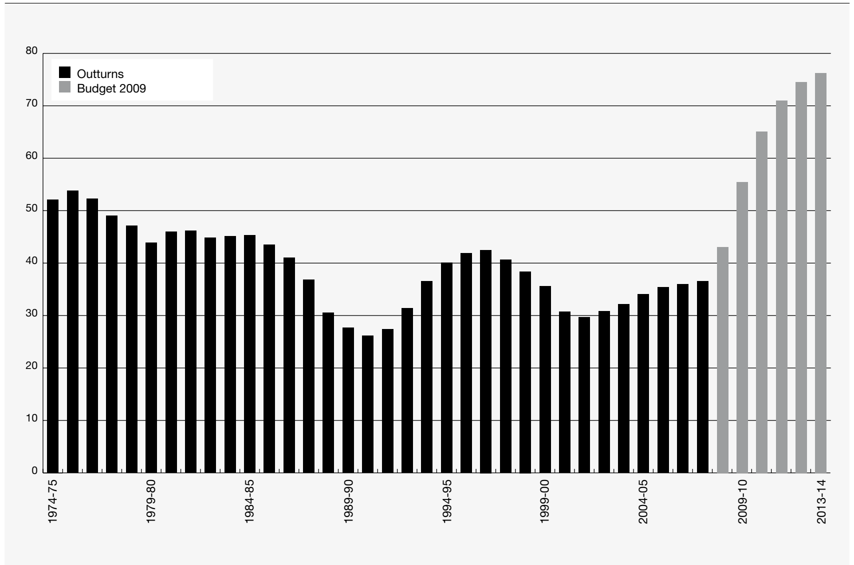
These estimates of the "structural" element in the deficit are educated judgments and it would be misleading to work on any assumption other than a wide range of 5 to 10 per cent of GDP. When we try to understand the Government's estimate of around 6 per cent of GDP (actually 6.3 per cent of GDP), this seems to be the figure which excludes the temporary discretionary deficit attributable to the VAT cut and advancing capital spending, and an element of acceptable structural deficit to finance public investment, approximately 2 per cent of GDP.

Whichever convention we adopt no one now seriously believes that the budget deficit will correct itself when (or if) the economy recovers. A large fiscal correction is needed. A reasonable assumption is that a correction of around 8 per cent of GDP is required (the 10 per cent borrowing requirement excluding the cycle or deducting 2 per cent for public investment).

There is another way of looking at the problem, in terms of public debt rather than deficits: the stock rather than the flow; the level of water in the bath rather than the flow through the taps. In popular debate it is the level of public debt rather than deficit which tends to be to the fore and this may reflect some semantic confusion. There is also an obvious connection between the two, but the public debt measure raises additional issues notably the ethics of transferring obligations from one generation to the next and the long term financial sustainability of debt. The adoption by the UK and the EU of public debt, as well as deficit, objectives under the Maastricht rules underlines the necessity to look at both.

Until the financial crisis struck, the Government was just about within its declared target of 40 per cent of GDP net public sector debt though it was straining at the limit even if we ignore some government liabilities – on PFI projects and public sector pensions – which were, arguably, understated. On the Government's own figures in the 2009 Budget the public sector net debt in relation to GDP will virtually double to 76 per cent by 2013-14 (explained by four years of large scale, albeit diminishing, borrowing).

Figure 4: Public sector net debt, per cent of GDP
Source: HM Treasury (2009), *Budget 2009: Building Britain's Future*



Official public debt figures are not however particularly helpful since they produce some melodramatic numbers once we take into account nationalised and semi-nationalised banks. The Office for National Statistics counts bank liabilities but not assets against government net debt which necessarily produces enormous numbers for, for example, the RBS which is (or was) the world's largest bank in balance sheet terms with liabilities (and assets) one and a half times UK GDP. The idea that the semi-nationalisation of RBS has increased public debt from 80 per cent to 230 per cent of GDP makes debt measures largely meaningless from a policy standpoint. I shall concentrate, therefore on the deficit rather than the debt.

Although the scale of the fiscal problem, and the necessary correction, are very large, such corrections have been made before in modern times. The current position is not entirely unprecedented. A structural net borrowing requirement was reduced from 8 per cent of GDP to a surplus of 2 per cent of GDP over a seven year period from 1975 through a contribution of austerity measures introduced by Denis Healey in the wake of the IMF loan and then the fiscal squeeze of the Howe budgets in the early Thatcher years. This adjustment was far from painless and included the "Winter of Discontent". A comparable if somewhat smaller adjustment took place between 1993-4 and 2000-01 as the Conservative Government's fiscal response to "Black Wednesday" was followed by Gordon Brown's adoption of Conservative spending targets.

The broad aggregates sketched out above suggest that although the causes of the current fiscal problem are very different from those in the recent past – neither involved a banking collapse – we are now heading for a similar period of fiscal consolidation. But this doesn't tell us how urgent the correction is and the time period within which it has to be attempted; and the breakdown between tax and expenditure measures, as well as the composition of each.

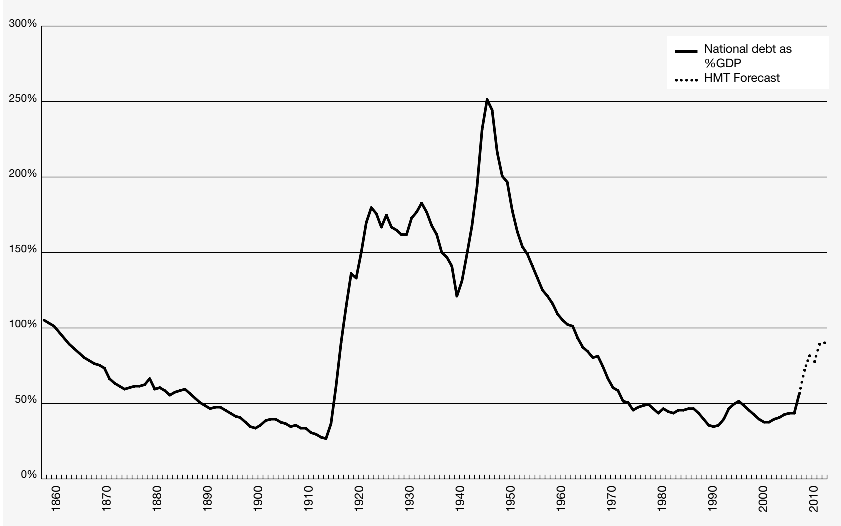
How urgent is the fiscal problem?

There are two broad approaches to the current fiscal crisis which reflect both party political differences and differences of economic philosophy; one is fairly relaxed and plays down the seriousness of the problem; the other is more apocalyptic and shades into hyperbolic language about "national bankruptcy". As is often the case, Britain's dialectic approach to debate and political allegiance obscures the fact that the truth is somewhere in the middle.

The former view is essentially that, while the scale of the budget deficit and public borrowing constitute a problem, they are a reflection of a global, shared problem; that there is a strong "Keynesian-type" argument for maintaining deficit financing and fiscal stimulus until there is clear evidence or reasonable expectations of recovery; and that while fiscal virtue is to be applauded it isn't needed yet: what has been called the Augustinian principle, after that Saint's advice on deferred sexual gratification. This represents the broad approach to policy of all major Western governments, notably the USA and including our own.

Although arguments have become highly politicised in the UK there is a perfectly respectable argument for the above approach. First, while the level of public debt (in relation to GDP) is expected to rise rapidly it will still be at modest levels compared with most of the last two centuries. Wars (the Napoleonic, the Great War and the Second World War) sent debt to GDP ratios well above 100 per cent.

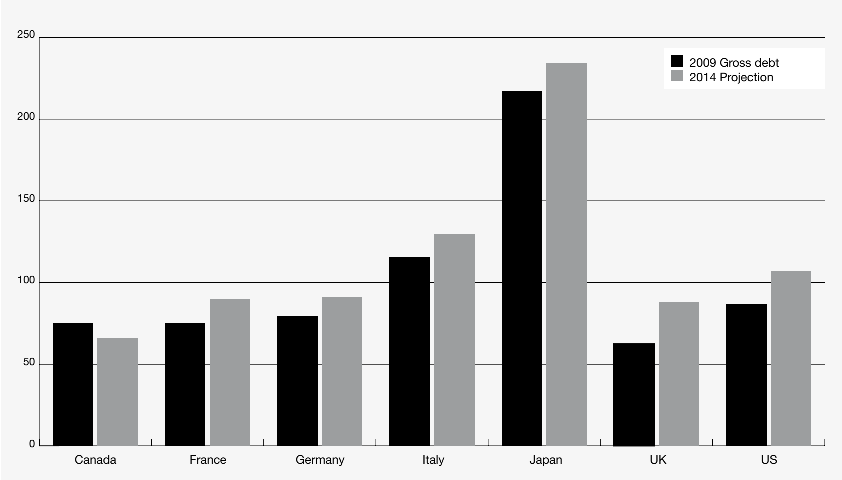
Figure 5: Historic national debt, per cent of GDP
Source: HM Treasury (2009), *Public finances databank*



Note: Also known as historical series of gross nominal liabilities of the national loans fund.

Arguably, a collapse of the banking system is comparable. Britain has survived massive indebtedness in the past and has been able gradually to bring down the debt in peacetime. Second, Britain entered the crisis with less public debt than most other developed countries.

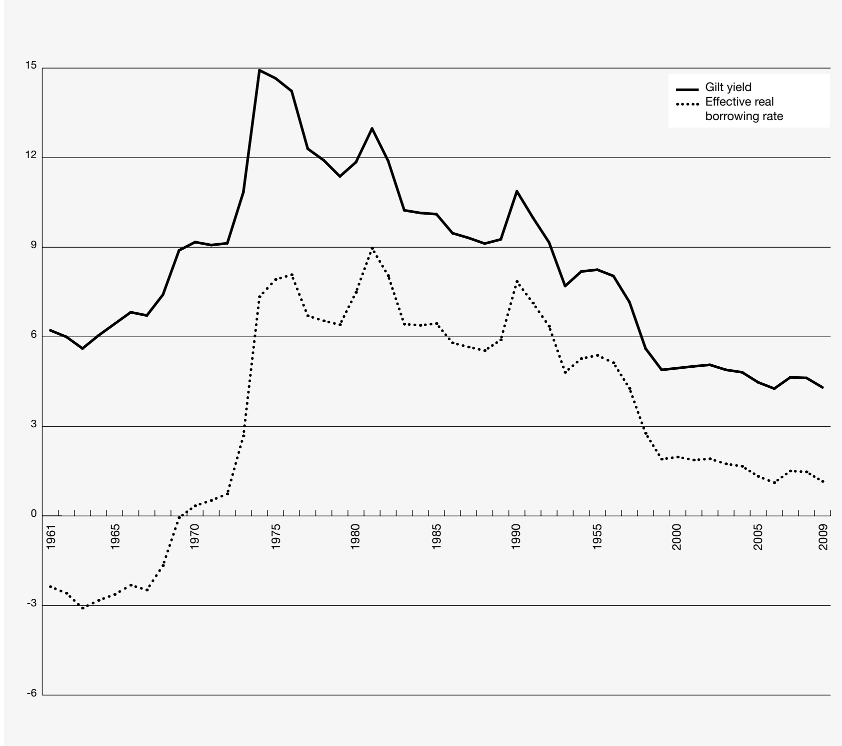
Figure 6: Comparison of national public debt, per cent of GDP
Source: International Monetary Fund (2009), *IMF Staff Position Note: Fiscal Implications of the Global Economic and Financial Crisis; and World Economic Outlook database,* April 2009.



By next year when the debt to GDP ratio will be around 70 per cent – double the previous level and the highest since 1969 – the UK public debt will still be below the EU and OECD average and that of the USA. The claim that Britain has a comfortable public debt position is somewhat undermined by dodgy accounting and also by the very precipitate – relative – deterioration. But it is broadly true that the Government has some room for manoeuvre, which it is using to the full.

A third point, and an important one, comparing this crisis and earlier recessions, is that the cost of borrowing – of servicing debt – has been historically low. The cost of borrowing has been less than 2 per cent (yields on index linked government bonds) for the last decade. By contrast, the real cost of borrowing rarely fell below 4 per cent from the mid-1970s to the mid-1990s. The future interest burden from the same level of debt was therefore so much greater in that period than now. Since the Conservatives were in power for much of that time it is easy to understand this aversion to public debt, though they appear not to have noticed what has changed. If interest rates remain low then a given level of debt is less of a problem than when interest rates are higher and a given budget deficit is less of a problem also since the deficit after interest payments (the primary deficit) is smaller than when interest rates are high.

Figure 7: The cost of government borrowing, per cent, 1961-2008
Source: Debt Management Office (2009), *Average Daily Yields for 2½% Consolidated Stock and author's calculations*

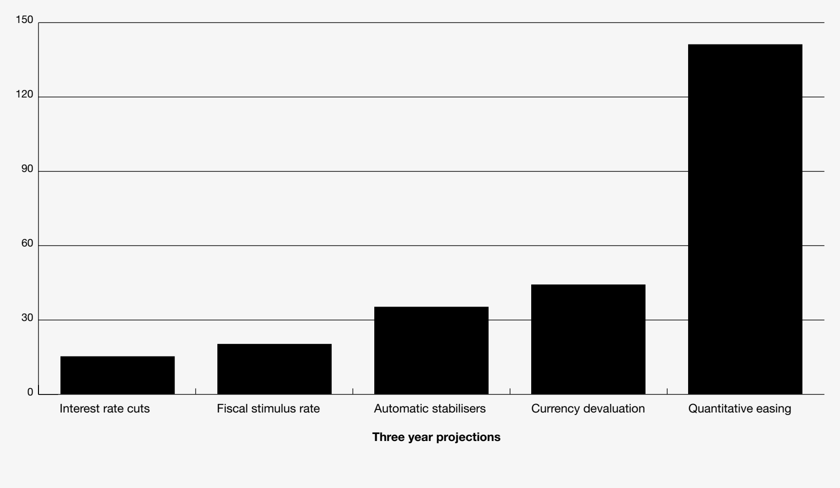


The final point is the "Keynesian" argument that deficit financing is a necessary response to the threat of price deflation and a slump in output and employment. Some of the conditions which led to Keynes' original analysis are undoubtedly present. Monetary policy has been actively and aggressively used but may not be adequate to sustain demand at a level consistent with something like full employment. Interest rates have been cut to near zero. Money supply has been expanded by means of quantitative easing but, so far, appears to have been largely hoarded as liquidity by banks: the "liquidity trap" as Keynes described it. Expressed differently, in monetarist language, the expansion of money has been offset by a declining velocity of circulation. "Pushing on a piece of string" is a simpler way of putting it.

The Keynesian remedy is the use of a deliberate fiscal stimulus to supplement monetary stimulus. Such a stimulus raises output and employment (together with government tax yields) and thereby "pays for itself" in economic terms. In fact, despite the strong advocacy, defence and criticism of "Keynesian" measures the UK has used very little discretionary stimulus and monetary policy has been much more important. The much hyped and debated VAT cut, together with the acceleration of capital projects amounted to just over 1 per cent of GDP and is to be reversed in 2010-11. Nonetheless it is also broadly Keynesian in approach to have allowed automatic stabilisers to operate which reflect a fall in revenue and increased spending outlays in recession – with the reverse in periods of recovery. There is broad cross-party support for the use of stabilisers in this way.

Figure 8: Stimulating the economy, £ billion

Sources: Interest rate cut, fiscal stimulus and currency devaluation from Institute for Fiscal Studies (2009), *Green Budget 2009: The UK Economic Outlook*, presentation by Morgan Stanley; automatic stabilisers from International Monetary Fund (2009), *IMF Country Report No. 09/212: Staff Report for the 2009 Article IV Consultation;* quantitative easing from Bank of England (2009), *Quantitative Easing Asset Purchases as at 3 September 2009.*



The central issue on fiscal policy is that much of the budget deficit does not represent either automatic stabilisers or a deliberate fiscal stimulus, but is "structural" in character and will not be reversed on recovery. This has been described as "toxic Keynesianism". But we should perhaps not get too hung up on terminology or the origins of the fiscal deficit. From a broadly Keynesian perspective – which is the author's – it would be damaging to seek to curb the deficit in recession conditions (since it would be likely to deepen recession). But the structural nature of the deficit means that there will have to be a major correction once it becomes clear that the economy is no longer in a downward spiral. The data emerging in recent weeks suggests that we may be approaching that point.

The deficit sceptics

There is a contrary view: the anti-Keynesian argument that a fiscal stimulus will not work to stimulate demand. The most topical and relevant to the current debate is the "German" view (attributed to the German Chancellor and Finance Minister). This is, essentially, that consumers and business investors will not spend or invest more in response to tax cuts or government spending increases since they know that tax increases will follow and will moderate their behaviour accordingly, by saving more (the so called Ricardian equivalence). While there is some evidence to suggest that the German aversion to higher taxes played some role in encouraging high savings rates in the recession which followed reunification, there is no suggestion that this is a factor of any significance in the UK at present (though households appear to be saving more for other reasons including worries about personal over indebtedness).

A related argument is that government borrowing "crowds out" private investment. The superficial evidence to support this view is that banks are currently happy to lend to the government but not to private businesses (or individuals). This does not however imply causality. Banks are looking for ultra-safe, liquid investments which most of the private sector does not provide (without government support). There are technical remedies to this problem: penalising banks which deposit money with the Bank of England. "Crowding out" could become a problem but it isn't at present. Indeed the Organisation for Economic Co-operation and Development judges the UK to have more spare capacity than any other major developed economy.

Even if these concerns are not particularly relevant at present, one problem with classic Keynesian remedies is that they assume a closed economy or a high degree of international coordination of fiscal policy. In practice, demand leaks into imports, particularly for an open economy like the UK. Also international capital markets limit the scope for deficit financing. There could be a sudden loss of confidence that national public debt can be serviced without recourse to inflation (or, conceivably but improbably, default). Worse than expected government borrowing and debt figures could trigger a significant downgrade of government debt and an offloading of government securities with a reluctance to buy more. "Cliff edge" problems of this kind are more likely to occur with fixed exchange rates as occurred in 1992 when there is exchange rate as well as credit risk. David Cameron has recently speculated that a similar crisis could recur. But there is no sign at present of any reluctance by markets to lend to the UK government despite some technical hiccups in bond auctions and a modest deterioration in credit status.

A more plausible result of anxiety about UK sovereign debt is a gradual increase in the cost of borrowing. So far that hasn't happened. As noted above the cost of government borrowing is low. The current real yield on index linked gilts is 1-1½ per cent, far below the 4 per cent which was common in the 1970s and 1980s. This suggests that there is still an appetite for UK government paper at historically low borrowing rates. It could be said in response that the government is currently buying large volumes of government bonds as part of quantitative easing and this is helping to push down the yields. Once quantitative easing ends, it is not clear what conditions will be like for borrowing.

Future confidence and the cost of borrowing will be determined by changing market judgements as to the sustainability of UK government debt servicing. What will disturb them is that having accepted a public (net) debt constraint of 40 per cent of GDP for the last decade as a reasonable test of sustainability, the Government is now anticipating double that level, or, quite possibly, much worse. But we have already noted that there is a similar deterioration taking place for other economies. The level of government debt has moreover often been above 100 per cent in the last two centuries and it has returned to more moderate levels without provoking a crisis.

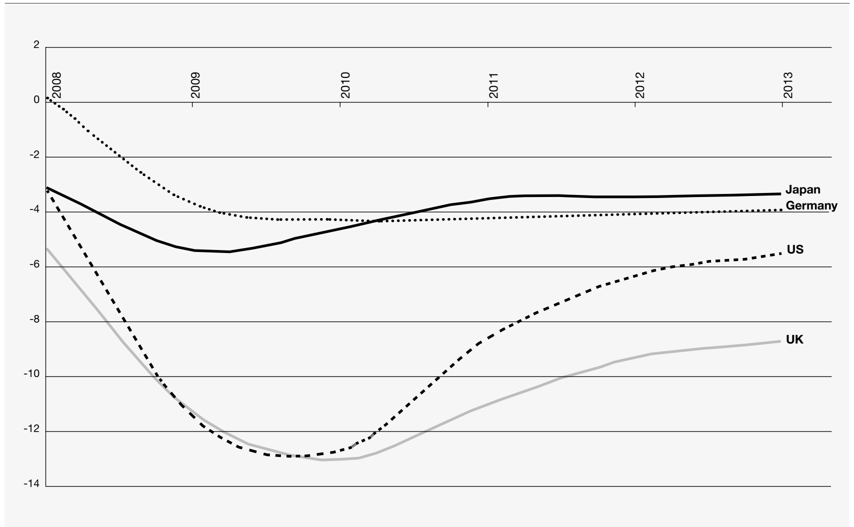
So does the debt level matter? Those who worry about debt argue that debt can become explosive – in other words it grow exponentially leading in due course to default and/or rapid inflation to write off the real burden of nominal debt. The so-called debt trap depends on a mathematical relationship between the stock of debt, the cost of borrowing and the economic growth rate. In crude terms, if the cost of borrowing exceeds the country's economic growth rate, the amount of debt and debt service will grow even in the absence of fresh borrowing. Moreover, there is an element of circularity in the process. If market confidence is lost, the cost of borrowing rises making debt sustainability even more difficult.

Could Britain find itself in this position? The main anxiety is that Britain will revert to higher levels of inflation to reduce the real value (and cost) of government debt, resulting in a search for higher yields on new government debt as a means of inflation-proofing. There are, however, two defence mechanisms. One is for the government to borrow predominately in index linked gilts to protect borrowers against inflation risk. The second protection is for government to make it absolutely clear that it will not undermine the independence of the Bank of England and will honour the current inflation target of 2 per cent. It is difficult to see the political conditions in which any government would publicly instruct the Bank of England to pursue higher inflation than 2 per cent per year.

Comfort also comes from the fact that developed countries like Japan and Italy operate at far higher levels of government debt than Britain has or is likely to have. Neither is in good shape economically but neither has defaulted on debt and neither has resorted to inflation to "burn off" debt. (Italy has no independent monetary policy so is not in a position to in any event).

This comfort blanket is not as warm as it appears. Japan, unusually, finances its government debt from domestic savings at very low interest rates. Patriotism or lack of imagination (or lack of opportunity) locks in Japanese savers in a way that it is highly unusual in the Western world, particularly the UK. It is conceivable, though unlikely, that British savers could be persuaded to entrust their money to the British government for very low returns but it would require a major cultural shift to achieve it. The Italian position again is different in a sense that markets assume that Economic and Monetary Union partners would not allow it to default on its debt and that Germany in particular would intervene to assist with a major package of support, acting as lender of last resort. This assumption may or may not be true but it does not apply to the UK which is outside EMU. There is also, because of EMU, not the same exchange rate risk factored into bond yields as there is with the UK. But the key point is that these countries like France and Germany have relatively small budget deficits at present compared with the UK and the USA. The USA deficit is expected to narrow sharply with recovery leaving the UK uniquely exposed.

Figure 9: Comparison of budget deficits, per cent of GDP
Source: The Economist (2009), *Economist Intelligence Unit: CountryData*



The conclusion is this: first, a substantial fiscal adjustment is required, more than existing Government proposals; second, the government is right to argue that any consolidation should be measured rather than sudden, since the latter could abort recovery; but, third, Britain is exposed to the risk of declining market confidence and market concerns over inflation leading to an increase in borrowing costs; and, therefore, fourth, it is necessary for any government to have a plausible plan to eliminate the structural element in the fiscal deficit.

The policy mix

The future of fiscal policy cannot be divorced from what happens in relation to monetary policy. Figure 10 sets out the options.

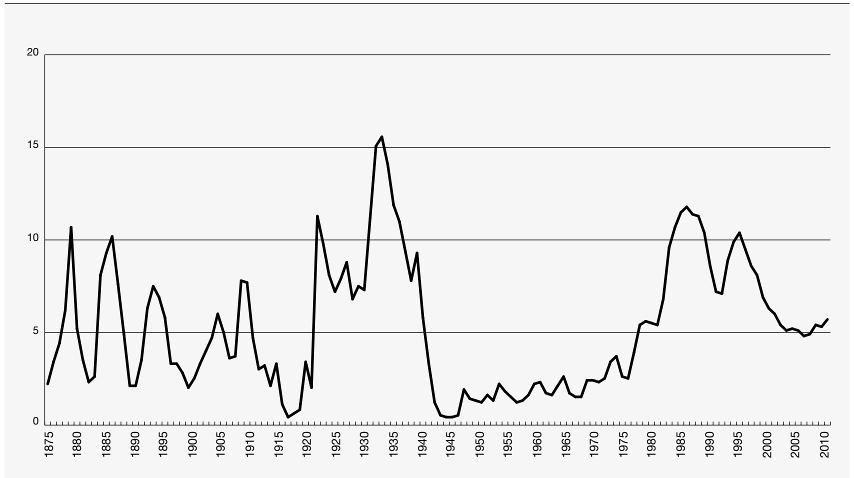
Figure 10: Macro economic policy options

Slump, Deflation (BUST)	**Weak recovery, Low inflation risk**
A	B
Low interest rates and quantitative easing Expansionary fiscal policy	Easy monetary policy as in A Fiscal tightening
Stagflation	**Inflationary recovery (BOOM)**
C	D
Higher interest rates Fiscal stimulus	Higher interest rates Fiscal tightening

Where the dominant fear is slump and deflation there is a case for using both monetary and fiscal policy aggressively (A). This is broadly where the UK and other Western countries have been in the last year though, in the UK, worries about the scale of deficit financing help to explain the emphasis on monetary policy: low interest rates and quantitative easing (and devaluation). The opposite position is inflationary boom (D) where both interest rates and fiscal policy are used to rein in demand. The main policy criticism over the period leading up to the current crisis is that this is where the policy should have been but wasn't: the Central Bank failed to tighten monetary policy (because it disregarded asset inflation) and the Government failed to impose budget discipline.

We are now entering even trickier waters where there is a hesitant and uncertain recovery. But premature or excessive fiscal tightening risks a return to slump and deflationary conditions. Unemployment is still rising to levels comparable to those in past recessions except for the 1930s. If inflation risks are seen to be low, governments should move towards fiscal tightening (B) with a loose monetary policy.

Figure 11: Unemployment rate 1875 – 2010, per cent
Source: Deane, R.F. (1988), *British Historical Statistics;* Office for National Statistics (2009), *Time series data: Unemployment rate UK All Aged 16 and over Seasonally Adjusted*



2
Tackling the fiscal crisis
The scale of the fiscal crisis

An even more difficult scenario for the UK would be "stagflation" since the Bank of England would be required under its mandate to act against inflation; but the weak fiscal position does not allow for offsetting fiscal policy. Policy makers would be trapped, obliged to look at ways of adjusting the composition of tax and spending to achieve better outcomes through microeconomic interventions. We do not at present know where the UK economy is heading. A plausible assumption is that we are still in (A) and heading to (B) requiring a continuation of easy money and fiscal tightening. The insistence of the Governor of the Bank of England that deflation is a bigger danger at present than inflation reinforces that judgment.

The base case: The Government's plans

We discussed earlier the figures relating to the scale of the structural deficit which has to be dealt with through fiscal consolidation: a reasonable assumption is that 8 per cent of GDP may be of the order required. The Government has announced plans to deal with some of this: roughly 6 per cent of GDP. The Government's plans for dealing with its definition of the structural deficit are tax increases announced in the Budget, such as increased fuel duty and the 50 per cent rate which will take effect in the 2010-11 period (about 0.7 per cent of GDP) and unspecified curbs on spending in the 2011-14 period (by 2.4 per cent of GDP). A further fiscal tightening (of 3.2 per cent of GDP) would not occur until the period 2014-15 to 2017-18 and the Government does not specify how this should occur. The implication of this proposed tightening is that, excluding interest payouts, statutory obligations to pay social security and commitments such as public sector pensions, current departmental spending overall would face real cuts of 2.3 per cent per year. Capital spending is due to halve from 2010-11 to 2013-14.

Reviewing the Government base case assumptions in the light of the broad analysis above, the following comments can be made:

- It is right to address the process of fiscal tightening gradually and cumulatively.
- The Government estimate of the structural deficit is at the lower end of the range of possibilities and a brisk economic growth rate is assumed after 2011-12. Many, including the author, would argue that such growth – over 3 per cent per annum – is highly optimistic given the likely impediments to strong recovery: namely the reluctance of consumers to borrow to spend in the wake of overextended household balance sheets, the continued difficulties for companies in raising capital to expand, the Government's own fiscal retrenchment and weakness in major export markets. A period of slow growth, continuing large structural deficits and rising government debt is very plausible.
- There is excessive reliance on cuts in capital spending. 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.
- The means employed in the major fiscal tightening required for 2014-15 to 2018-19 are not addressed at all.

The clear implication is that the fiscal adjustment – through taxation and/or public spending, particularly current spending – has been underestimated and will have to be bigger than this Government has budgeted for.

Spending or taxation?

Fiscal consolidation could come from curbs on spending or increased taxation. In practice there will almost certainly be elements of both and no Chancellor would sensibly rule out tax increases. But the emphasis certainly should be on public spending. The current Government, while pretending to be the stout defender of public services against the opposition, is itself proposing that over three quarters of fiscal consolidation in the period 2010-11 to 2013-14 should be in the form of cuts in public spending.

That emphasis is right. That is not because public spending is inherently undesirable. Unlike ideological opponents of state spending I am comfortable with a more Scandinavian approach to public services and taxation. But these societies have fundamentally different, much more decentralised, structures which provide greater accountability and efficiency. Until our public sector and democratic system can be reformed to provide comparable quality of service and responsiveness it is not right, or feasible, to seek higher rates of taxation.

In the UK public spending has been allowed to grow very rapidly on the back of what was a windfall in tax revenue. Tax revenue depended to an unhealthy degree on a "bubble" economy in financial and housing markets. Much of that revenue has now been lost and, though it may return in part and at some stage, it would be foolish to base future spending commitments upon it. A related point is that the rapid increase in spending has often been inefficiently spent without adequate democratic accountability and with declining productivity, to the extent that we can meaningfully define and measure it in public services. The Office for National Statistics estimates that public sector productivity declined by 3.4 per cent from 1997 to 2007 while private sector productivity rose by 27.9 per cent. The sudden deluge of funding (in relation to comparable OECD countries) has been likened by *Reform* to a "flash flood" and there is a strong argument for focussing on how resources can be better spent rather than validating current spending levels with higher taxes.

In addition, direct taxes create disincentives to save, work and take risks while indirect taxes are generally regressive. Moreover, the overall tax system is widely perceived to be unfair with low income groups paying disproportionately and the very wealthy treating tax as a, largely voluntary, nuisance. So the emphasis should be on spending control; though the magnitude of the fiscal adjustment required is such that taxation cannot be ruled out. Indeed, the Government revealed through carelessly redacted documents that it envisaged not merely a reversal of its VAT cut but an increase to 20 per cent. The Conservatives have hinted that they would do the same. Such a measure would raise around £13 billion. "Green taxes" are the other mechanism available which raise revenue while promoting sustainable growth. The basic principles were cogently set out by the OECD recently: "corporate taxes are the most harmful for growth, followed by personal income taxes, then consumption taxes with recurrent taxes on immovable property having the least impact." But to commit to additional tax revenue raising from the outset undermines any commitment to setting priorities in spending.

3

Principles for managing public spending

There is now a consensus amongst major parties that considerable spending restraint will be required for the foreseeable future. The traditional way in which this is done is by fixing restrictive expenditure totals for government departments and letting ministers and officials (and, increasingly, agency heads) decide how to deliver the cuts. The result is what is called "salami slicing". Ministers defend their core departments and pet projects, there is some slicing off of most services and the main casualties are programmes which fall between departments (like climate change and social exclusion) and unfashionable activities (like mental health).

We have had a sterile debate between Labour and the Conservatives on the impact of the alleged "10 per cent cuts" if certain sectors (health, international development) are protected from any real cuts under the Government's own planning assumptions. This broad brush approach and the high level of generality takes existing commitments as given rather than asking what the government should do and not do.

Before discussing specifics, a first step is to set out some broad principles for looking at public sector spending. If there is to be a decade of austerity it is essential for the programme to be anchored in structures which can survive the ups and downs of fashion and political popularity. One of the main dangers at present is that a new government comes in with an insecure political mandate – with minority support in the electorate, let alone the country – and rushes into a round of quick but brutal cuts in order to get the pain over quickly. This would leave the structure of government intact while ensuring that it is less well resourced. It would also have maximum negative impact on the economy when the recovery is weak.

Principle 1: Zero based budgeting

One basic principle behind a different approach is zero based budgeting. What this means in practice is that everything should be on the table. There should be no ring fenced areas of spending. All government departments and programmes have to justify their expenditure.

The best, recent, model is the **Programme Review** approach adopted by the Canadian Liberals in the 1990s when the Chrétien Government provided a model for how a progressive, left of centre administration embarked on radical fiscal retrenchment. The starting point was a specific choice as to what the state should do, and stop doing. Government spending programmes and agencies had to be justified, not operate on the basis that they existed because they existed (with a bit shaved off), but whether they were absolutely necessary. This approach is most evidently useful where commitments have mushroomed in the absence of a strategic review of affordable objectives, as has occurred with defence procurement. It is also a necessary discipline for all agencies. It is usually possible to justify the existence of agencies on the basis that they do some good some of the time. RDAs are a case in point. The question should be posed instead: if they didn't exist would we need to invent them? (Probably not in this case). On this approach the outcome is that government stops doing a range of activities which are not absolutely essential or which the market will provide. But the same approach dictates that there may be some new or bigger roles for government in some areas.

Principle 2: Democratic accountability

One of the biggest institutional weaknesses in government economic management is the lack of parliamentary involvement in the scrutiny of government spending, before the event (as opposed to limited and selective retrospective audit through the National Audit Office). Line by line approval of spending commitments (and cuts) would concentrate the minds of legislators in a way which is missing in the current opaque processes of Whitehall. Parliamentary Select Committees, particularly if given enhanced powers to vet appointments to the boards of government agencies, could act as an effective vehicle for exposing waste and incompetence and abuse of power in the less transparent corners of government. The Conservatives are saying that, if they win the election, they will decide their priorities afterwards on the basis of round-the-table debate amongst ministers behind closed doors and under fiscal rules set by a quango. Excluding the public and their parliamentary representatives will ensure that there is minimum "buy in" to any agreed package. It would be a seriously retrograde step.

Principle 3: Localism

The issues of accountability apply also at a lower level. There should be radical decentralisation. Governments will frequently impose spending cuts on local government by cutting support grants and letting local politicians take the rap for service cuts. But this is not decentralisation: that involves transferring more revenue raising powers to local government, specifically business rates. It also involves giving local councillors more, and genuine, responsibility for local spending and the stewardship of public funds by removing capping and the huge central government bureaucracy overseeing local government. Britain must reverse over-centralisation and move to a model closer to that in most parts of Europe and North America.

There is evidence that local councils can achieve better value for money. Unlike central government, which can freely borrow or monetise its deficits, local government is forced to make difficult choices from the start. There is much more incentive to seek higher efficiency. Localism is good economics as well as good politics. An essential prerequisite for effective public spending discipline is that decision making is devolved to local government, not just in existing fields of responsibility but in new areas such as health commissioning too.

Principle 4: Transparency

Democratic accountability can only work effectively if voters and their representatives know what is going on and where money is spent. MPs have discovered, painfully, themselves that exposure to detailed scrutiny of expenses is a remarkably effective discipline in making servants of the public treat public money more carefully. They should demand the same level of scrutiny and control of spending by the civil service and quangos. The Mayor of London is publishing all Greater London Authority expenditure over £1,000 on its website. There is no reason why comparable transparency should not apply throughout government (and local government).

A key nut to crack is the secrecy around “commercial confidentiality”. It is impossible, for example, for Parliament to exercise any effective scrutiny over computer contracts or defence contracts because of commercial confidentiality exemptions to Freedom of Information. This will have to change, drastically. There may be genuine reasons for concealing particular items which relate directly to competitor advantage but the onus of proof, which should be demanding, should be on the contractor who wishes to enjoy protection.

Principle 5: Public sector reform

A further essential element is a commitment to achieve more efficiency in the way money is spent. There is a danger however of "reform" and "efficiency" becoming meaningless mantras to which all parties subscribe and which mean quite different things to different people. The essential point is the acceptance, only tenuously supported by this Government, that what matters is the outcome of public spending (and public satisfaction), not the amount spent. Beyond that general proposition there is, however, a great deal of disagreement – over the role of markets for example, or over target setting. There is much dissatisfaction that the rapid growth of public spending has not produced a commensurate improvement in health outcomes or patient satisfaction. But the Government's mechanisms for trying to ensure better outcomes – a proliferation of targets – has in turn produced many distortions and inefficiencies.

Some pitfalls

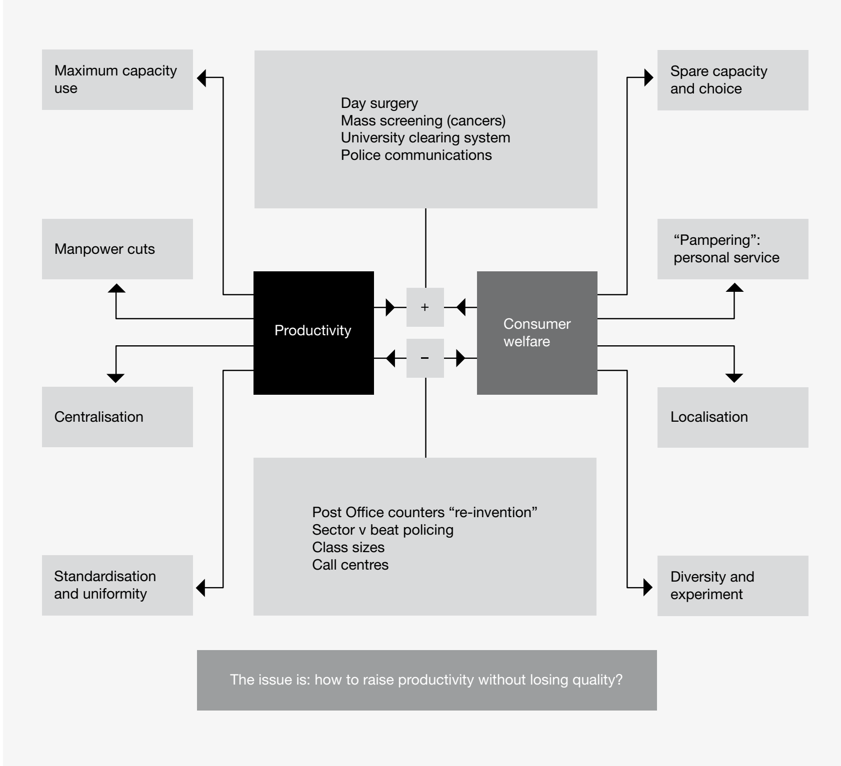
In spelling out some overarching principles I recognise that there are some potentially major difficulties.

First, there is the potential misuse of "efficiency". Without doubt there are major areas of potential improvement: government procurement is one. Sir Peter Gershon's reforms to procurement through the Office of Government Commerce were designed to liberate some of these gains, through greater professionalism in the public service, using specialist procurement skills and a degree of centralisation amongst fragmented purchasers. Some of this has happened.

But there are grounds for scepticism. Since time immemorial, governments have promised to deliver better "value for money", "greater efficiency" and "waste reduction", as of course they should. This Government has repeatedly promised to make "efficiency savings" and is currently promising to save £30 billion per annum (following £20 billion per year in the period after 2007) through such measures which, conveniently, aspire to save money without reducing or withdrawing services. The National Audit Office has been highly sceptical of the claims and its analysis of the £20 billion per annum efficiency gains claimed by the Government in recent years (mainly through computerisation and better procurement and headcount reductions), suggests that evidence can be found for only a quarter of these claimed improvements.

One of the dangers of such phoney efficiency is that what is passed off as higher labour productivity is often a disguised cut in the quality of service delivery. For example, it should be possible to increase "efficiency" – in conventional productivity terms – by, for example, increasing class sizes in schools and colleges, ending foot patrols by the police or increasing the case load of social workers. It may be that there is some scope for more efficient working without affecting service – by, for example, reducing police patrols from double to single manning or by hospitals having better logistics for moving patients or supplies around large buildings – but such genuine "efficiency" should not be confused with hidden cuts in service.

Figure 12: Public sector productivity versus consumer welfare
Source: Cable, V. (2005), *Public Services: Reform with a Purpose*, Centre for Reform



The public sector is also replete with what economists call the "agency problem". Just as private sector managers are likely to pursue the interests of managers rather than shareholders, public sector managers are likely to pursue their own interests ahead of taxpayers or service users – be it in the form of salary, perks, facilities or empire building. Of course there are many individuals motivated by a sense of public service but we should not assume that that is their only objective. The creation of vast numbers of quangos and quangocrats may or may not have achieved the aim of reducing capricious political interference in public administration; but it has certainly created a mass of vested interests. Quangos, in particular, can often devote considerable resources to publicity and commissioned studies in order to justify their continued existence. Unless priorities are clearly defined, senior managers may simply seek to offload "cuts" onto less powerful parts of the bureaucracy or onto junior staff or public service users.

The "agency problem" isn't confined to senior managers and quangocrats but also to some of the mechanisms designed to improve efficiency. It has become fashionable to support secondments from or to the private sector but secondees may well have an overriding interest in securing orders for current or future employers. The author of one influential book on government spending – *Plundering the Public Sector* by David Craig – claims that consultants cost governments an estimated £20 billion each year. Some, no doubt, contribute expertise and new ideas, but they also have an interest in repeat business and government dependency. Efficiency enhancing government IT systems in particular have become a scandalous source of cost overruns and waste.

4

Where should the cuts be?

Even if mechanisms are in place to exercise choices more sensibly and sensitively there has to be an overall framework. For the life of the next Parliament (until 2014-15), the Government's assumption of no overall growth in real spending seems plausible as a starting point. Because major elements in spending involve automatic increases (pensions and other benefits) this clearly implies cuts. The issue is where?

The period after 2014-15 will be punctuated by a further election at which choices can be debated in the light of the facts, then known. It seems highly likely that the fiscal pressures will continue unabated and the Government assumes a further fiscal tightening of 3.2 per cent of GDP in the period 2014-15 to 2017-18. I have argued above that this is almost certainly an underestimate of what is required. While this point reinforces the importance of a framework for looking at long term spending priorities, it makes little sense at this stage to spell out precise quantitative targets. A further consideration is that the demographic effects of an aging population will slowly begin to have a significant effect on budgets for personal health care and pensions. It is possible to offset these costs if, for example, the population of current retirement age were to work longer. But the effect is to bring even more pressure on long term government spending commitments.

Within the framework spelt out above it is possible to set out more specifically how different priorities could be established in what will be a highly constrained fiscal environment. Without prioritisation, there will be indiscriminate and inefficient cuts in valued public services. A different approach could involve some of the following:

Public sector pay

Public sector pay accounts for £158 billion (2008-09), roughly 11 per cent of GDP and 22 per cent of government spending. It is impossible to duck the fact that public sector pay will be severely constrained in any attempt to stabilise the budget. There may well be many individuals who can make a pressing case for more, particularly those on low pay, but in aggregate terms pay discipline is unavoidable. It is also right. In a recession the public sector has provided secure employment and – on average – rising salary and wage levels while the private sector has been shrinking and wages have been cut in many industries.

The Government's working assumption is that, in the period of the next Parliament, public sector pay will rise by 1.5 per cent per annum. There is a strong argument for trying to keep overall pay constraint in nominal terms, saving £2.4 billion a year. A zero growth assumption is not the same as a pay freeze since some groups would get more or less depending on decentralised bargaining and independent pay reviews. The argument for concentrating the fiscal adjustment on pay is that whereas there are undoubtedly some areas of public service where genuine productivity gains can be achieved, for the most part there is a straight trade-off between pay and the availability of resources to improve or maintain the quality of service. A tough indicative target of zero growth would make it clear that the priority is to maintain service delivery despite cuts in finance.

How is it possible to set a tough overall framework for pay while providing enough flexibility for recruitment and to accommodate pressures from low paid staff some of whom are on or around minimum wage levels? In the case of the civil service specifically there should be a salary freeze for several years as well as an end to bonuses, saving £200 million a year in total. One radical approach would be to set a specific target of cutting overall spending commitments on staff earning over, say, £100,000 by 25 per cent in any organisation or department. It would be for senior management to decide whether to absorb the cut in reduced numbers or pay cuts or reduced benefits including pensions. Given the complexity of many pay packages it would be wrong for government to be over prescriptive. But such an approach, setting an example from the top, would make it easier to persuade more junior staff to accept restraint. It would be easier to monitor such measures if all public sector high pay and allowances (including non executive and executive directors of quangos) were to be publicly declared as is already the case for company directors in public companies.

Transfer payments

Social security payouts of various kinds account for £180 billion (planned in 2010-11), or 12.5 per cent of GDP. There is undoubtedly a case for looking afresh at a range of entitlements. But the issues are not straightforward. Targeting of benefits – as has already occurred with the gradual shift from a universal pension – creates higher marginal tax rates with disincentives to save (in the case of pensions) or to work. There are take up problems with means tested benefits: serious amongst the elderly, less so amongst working families.

The simplest reform could be to taper the family element in tax credit which the Institute for Fiscal Studies estimates could raise £1.35 billion. This should occur. A more radical reform would be to target child benefit by assimilating it into tax credit. David Davis MP and others have advocated this approach. It is certainly incongruous to many people that the very rich receive child benefit. The IFS estimates that £5 billion or more could be saved by no longer making child benefit universal. The implication, however, of the tapering of child tax credit and the loss of universal child benefit, would be a loss of income for some middle income families. Such a reform would be easier to make if income tax were cut for standard rate payers. I favour making this reform in principle, but more work needs to be done on how to manage offsetting tax cuts.

Issues around pensions are even more difficult because of take up problems and savings disincentives associated with pension credit. Indeed there is a strong argument for raising the basic state pension to reduce dependence on pension credit. If this is to happen, savings could nonetheless be made. First, abolishing mandatory retirement and age discrimination associated with it has wider economic benefits, but would also have short term fiscal benefit from delaying pension payouts. Second, especially with an improved state pension, there is a strong argument for bringing forward higher qualifying ages currently planned to commence in 2024.

Although it is not a transfer payment in the normal sense, Liberal Democrats have cast doubt for a long time on the overall merits of the "baby bond scheme": the Child Trust Fund. It is no doubt desirable to engender a savings culture amongst the young and a long term approach to saving. But there is little evidence that it generates additional savings especially amongst target low income groups. In an ideal world, with no government funding constraints, such a scheme would be attractive; but in the constrained world which we inhabit there is a strong argument for using the funds – roughly £500 million a year – elsewhere, for example, to reduce class sizes in infant schools, as a way of enhancing the life chances of the young. Existing Child Trust Fund investments would of course be protected.

Reforming public sector pensions

The cost of employing three million people in government (and another three million in local government) is not confined to wages and salaries. There are long term pension liabilities which can extend decades beyond retirement. The annual cost of public sector pensions in excess of the employer contributions was £2.3 billion in 2007-08 and this figure is forecast by the Treasury to double to £4.6 billion by 2010-11. Some public sector pensions are actuarially fully funded, notably in local government, but overall it is estimated that there is an annual £28 billion subsidy to unfunded schemes, equivalent to the law and order budget. That sum is the amount that would need to be paid in additional contributions if the schemes were actuarially fully funded. In the private sector, the inability of companies to maintain such contributions has led to almost all defined benefit schemes being closed to new entrants who are offered defined contribution schemes instead.

There has to be review, leading to radical reforms, in the way public sector pensions are operated. It could be argued that since the subsidy is notional rather than actual (the reality is a large unfunded liability) there is no compulsion to reform. But given the underlying anxiety about the size of public debt it is important for government to demonstrate one major liability is being managed properly. There is also an issue of equity between the public and private sector. It is no longer true, in general, that public sector pensions are a compensation for relatively poor pay. And for highly paid civil servants the value of an index linked pension at 40 to 50 per cent of final salary is an extremely valuable, and costly, perk. The MPs' scheme, for example, involves a taxpayer contribution of 26.8 per cent of salary and, even then, has a £50 million hole.

The reform of public sector pensions has to be carefully designed, as the state pension reforms have been post-Turner. There is no question of cutting the pensions payable to existing pensioners and accrued entitlements. But it is reasonable to expect higher employee contributions or a move to later retirement ages. Public sector pension reform affects outlays only gradually and in the long term but increased contributions for under-funded schemes could happen in the short term.

Cutting back databases and IT systems

One of the major failures of government in recent years has been its inability to manage complex, information-based systems properly leading to large cost overruns. When established they have posed serious risks of data insecurity and leakage. And there are serious civil liberties concerns over, for example, the identity card scheme should it become compulsory. Decisions have to be made on the merits of individual projects but there are several candidates for the axe:

- Both main opposition parties are already committed to scrapping the ID Card Scheme. The most recent estimates of costs is around £5 billion over 10 years (including £300 million for foreign nationals in the UK), but some estimates have ranged up to £20 billion, particularly if the cost of other government departments, beyond the Home Office, using the database is factored in. Much of this cost would be accounted for by user charges though the Government has said that charges could be waived if the scheme was compulsory and would fall on the taxpayer.
- Contactpoint is another database which should be scrapped; a database of all 11 million under 18s. Designed to improve child protection, there are serious fears that the data system will be intrusive, insecure and open to abuse. Costs are placed at £200 million over the next 5 years but are potentially much higher.
- The NHS IT Scheme is the biggest government IT project (and is claimed to be the biggest in the world). The first phase of the project is operating for the "choose and book" scheme, said to be enhancing public choice. Substantial economies could however be made: very conservatively £250 million in the next five years but since the overall scheme has been costed at £18 to 20 billion this must be a very modest estimate of what is possible.

- A "super database" to track all emails, texts, internet and other communications data has been discussed in government but is less advanced in planning than the above. Very provisionally, overall costs are placed at £6 billion. This should also be scrapped.
- There is a generic issue as to whether IT contracts should be pursued through established major suppliers on their standard quality systems or on an open source basis. The established suppliers will argue that there is no such thing as "free" software and that savings from open sourcing are false economies. The opposite view is equally passionately held – and has become the basis for public procurement in Germany. Liberal Democrats argued for going down the latter route in 2004-5 and believe that annual savings of around £500 million could comfortably be made in this way.

Curbing "industrial policy" and state capitalism

One of the earliest policies which Liberal Democrats advanced for a contraction of state activity was in the field of industry policy and best captured in the slogan "abolish the DTI". Since then, the Department of Trade and Industry has gone; the 180 schemes of different kinds have been drastically pruned and the recession has produced a renewed demand for government intervention of various kinds, now refined by Lord Mandelson into a more sophisticated approach to industrial policy.

There are some areas of business support for which there is a compelling case even in a financially stringent environment and within a liberal approach to economic policy. The private sector is unlikely to fund more than a small part of "blue skies" scientific research or work on common standards. Overwhelmingly the most important role of government at present, not being performed very well, is requiring state owned banks to make credit available on reasonable terms to sound companies which cannot access liquidity in the wake of the "credit crunch". But there are more questionable activities which could and should be cut:

- Regional Development Agencies no doubt perform some useful tasks in support of business activity and they will argue that they "create jobs", though whether this is the best way to create employment is doubtful. RDA's appear to be more valued in traditionally depressed areas like the North East and serve far less obvious a purpose in the South East or East of England or London. The nine RDAs spent £2.3 billion in 2007-08 (excluding Scotland, Wales and Northern Ireland). Some funds could be reallocated to local authorities but there should still be scope for large savings.
- The Export Credits Guarantee Department provides an indirect subsidy to arms exports in particular of £100 to £200 million a year which is difficult to justify on wider policy grounds.
- Much of the funding of training has been shown to duplicate what business provides or is happy to provide. An estimated 85 to 90 per cent of the £925 million annual Train to Gain budget is of this kind, and another £65 million or so is spent on Skills Councils. Again, a deep recession with substantial unemployment is not a good time to pass the costs of training to businesses but this is an area of long term saving. Even a halving of the budget could save £500 million per annum.
- The funding of agriculture is largely a matter for the EU under the Common Agricultural Policy. And it is broadly welcome that, instead of artificially high support prices and import barriers encouraging overproduction there is now a more transparent system of subsidies. Moreover some of these subsidies, particularly in marginal farming areas as with hill farming, perform an environmentally valuable function. However there is no justification for single farm payouts to large commercial farmers whose output, particularly arable, is also profitable. Of the £3 billion a year in single farm payments a high proportion goes to the biggest and most profitable farmers (a third to one per cent of recipients) and it would be sensible to introduce a clawback mechanism to retrieve this "deadweight" cost.

Cutting the costs of centralisation

I have already argued that devolved decision making to local government is likely to be more efficient as well as more democratically accountable. In addition there are major savings from eliminating the structures established to exercise central control over expenditure. Large savings could be made in the Department of Communities and Local Government alone but there are large numbers of health and education quangos (plus others in the Department for Culture Media and Sport and the Department for Environment, Food and Rural Affairs) which perform tasks better carried out locally or not at all:

> Scrapping central inspection by the Audit Commission and the compliance costs associated with inspection regimes, as well as unnecessary, intrusive bodies like the Standards Board, could save £1 billion a year.

> The government offices of the regions spend over £2 billion a year and while they administer some valuable programmes like the Supporting People Programme (housing services for vulnerable people) there is much duplication of the work of local councils and of overlapping programmes in the field of local enterprise and social deprivation. It is difficult to believe that substantial savings could not be made by eliminating this tier of administration without affecting services.

> The health service is weighed down by centralised targets and over-administration. Scrapping the Strategic Health Authorities (SHAs) would save £200 million a year. There are specialised health planning roles – for rare diseases for example – which cannot be carried out by Primary Care Trusts and would have to be done centrally. But the SHAs add an extra tier without adding value.

> Education is awash with quangos (22 for the Department of Children, Schools and Families and the former Department of Innovation, Universities and Skills which is now rolled into the new Department for Business Innovation and Skills) and centrally imposed inspection and central mechanisms. My education colleagues have identified potential savings of around £600 million a year from the scrapping of national strategies and reducing assessments; and a further comparable amount from scrapping some quangos (QCA, OFQUAL, NAA, LSC), drastically reducing others (OFSTED, BECTA) and eliminating a dozen small targeted central programmes. These and other savings could be used in part for funding schools via local education authorities to reduce class sizes or support less advantaged pupils.

Controlling defence procurement

Armed forces chiefs frequently deplore the lack of funding for front-line troops and there is a wealth of evidence that troops are inadequately protected and armed in combat zones and are receiving insufficient support for their housing, health and disabilities. The forces frequently complain of being overstretched for the tasks they are asked to perform. But at the same time there is staggering waste in the procurement process with billions spent on weapons systems which arrive late, over budget and are of minimal operational value. There is little doubt that major savings could be made in the defence budget by cancelling or scaling down weapons systems, though there is then a political question as to how far savings should be deployed elsewhere.

Two issues have to be disentangled. The first is the policy issue of what the armed forces are required to do and whether that can be afforded. The second is whether procurement is cost effective. As to the first, in a war for survival there is no room for refined analysis. Governments spend, and if necessary borrow, whatever is necessary to keep their forces equipped to fight. Our current position is different. Defence spending and military commitments overseas, as in Afghanistan, are largely optional. An essential step then, is to have an urgent periodic strategic review to try to define defence priorities which have to be funded. Decisions like the acquisition of a second new aircraft carrier are dependent on how committed Britain is to a worldwide interventionist role. The process is somewhat circular however since finance dictates what is possible. It is a reasonable underlying assumption that the share of defence spending in GDP (now 2.7 per cent) is unlikely to rise.

The second issue is whether it is possible to acquire military equipment (and services) more cheaply and better. There is often a big disparity between the cost of procurement in the UK and overseas. This additional cost is not, in fact, defence spending but a subsidy to the defence equipment industry though it appears a defence cost. My focus is on the second issue rather than the first, though there is some overlap. The main items for savings are:

- One of the biggest procurement scandals in modern times relates to the Eurofighter/Typhoon, originally envisaged to perform a role in the Cold War confrontation with the USSR. The costs are hidden behind commercial confidentiality but have been estimated at around £20 billion. It is now argued that it is no longer possible to make very large savings since decisions have been irrevocably made or subject to penal cancellation costs, as with the £3 billion Tranche 3. There is however a potential additional £5 billion to be spent (or saved), spread over six years, on an upgrade and modernisation programme.
- A close second in disastrous procurement is the A400M transport aircraft where abandonment has been recommended by all parties, potentially saving large sums since there are as yet no major cancellation costs and easily available cheaper US alternatives (the C-17). The total programme is costed at £22 billion.
- There has been severe criticism of the Nimrod MRA4, for which alternatives are available.
- The proposed Defence Training Review contract is estimated to cost £13 billion over 25 years and is believed to be a highly expensive option.
- My defence colleagues have argued for scrapping the £7 billion Future Rapid Effect System (FRES) order and replacing it with armoured vehicles bought "off the shelf", with a net saving of £3 billion.
- The biggest strategic decision relates to a successor to the Trident submarine. My Liberal Democrat colleagues have argued that the planned government replacement should be scrapped, leaving open the possibility of a much more modest deterrent. The capital costs saved would be £20 billion spread over a period between 2012 and 2027 and there would be an estimated £50 billion running costs over 25 years.

- There is also undoubtedly scope for considerable manpower savings. The British armed forces have one of the highest ratios of non-operational to operational staff amongst NATO countries. Senior officers are deployed in office functions because of the absence of commands and there is administrative duplication between services. The procurement executive is also massively overstaffed because of protectionist procurement policies and it has been estimated by industry sources that £1 to £2 billion could be saved by outsourcing the function.

Better value from the NHS

Public spending on health has enjoyed exceptional rates of growth. There is evidence that much of this spending has failed to improve services, but has been absorbed in administrative costs and higher salaries. Yet it is the one area of public spending where there is most extreme political sensitivity to any suggestion that more (or even the same) could be done with less. Up to a point this sensitivity is understandable. With an aging population there will be growing demand for health care and social services, other things being equal. There are areas of health care – like mental health – which are currently under-funded on most criteria. There is strong public demand for new cancer drugs or Alzheimer drugs which are financially rationed. It is easy to see how a sharp reversion to financial austerity could produce highly unpopular cuts.

Yet it is also widely acknowledged within the NHS that there has been large scale misdirection of resources and it is the counsel of despair to argue that there would be no improvement in future. The first priority must be to try to protect services by reducing the administrative overheads which have grown around the target setting culture. Removing Strategic Health Authorities would be a help as well as cutting the administrative burden placed on hospitals and GP surgeries.

In order to make the NHS work more efficiently in this more constrained environment, several elements need to be in place. First purchasing – commissioning – must be democratically accountable by, as far as possible, aligning the NHS with local government (or devolved government as already occurs in Scotland, Wales and Northern Ireland). Such alignment is necessary to ensure that priorities are set – albeit indirectly – by the public rather than the NHS bureaucracy or professional interest groups. There is however a corollary to local preferences and choice: that it is no longer possible to insist on uniform levels of provision to avoid "post code lotteries".

Second, there is still much scope for "supply side reform" since there is much empirical and anecdotal evidence that some hospitals, in particular, operate very inefficiently despite the plethora of targets they are required to pursue. One proposal is to pay hospitals and other "providers" like treatment centres for treatment – the tariff – based on better run hospitals rather than the average. Some differentials can be explained for good solid reasons – such as small units to service isolated communities – but there would be more clarity about which bits of the NHS deliver best value for money. It is estimated that tariff reform could save £2 billion a year once the system is operating effectively.

Third, there is the issue of demand management. The principle of "free at the point of use" is fundamental though it has been eroded at the margin, as with dentistry. Charges for prescriptions act as a price for using primary care and it would be invidious to extend it via, for example, charges for visits to GPs since the same large groups exempted will still be exempted and there would be an extra penalty for non exempt users whose conditions require repeat visits (diabetics for example or those with long term and degenerative illnesses).

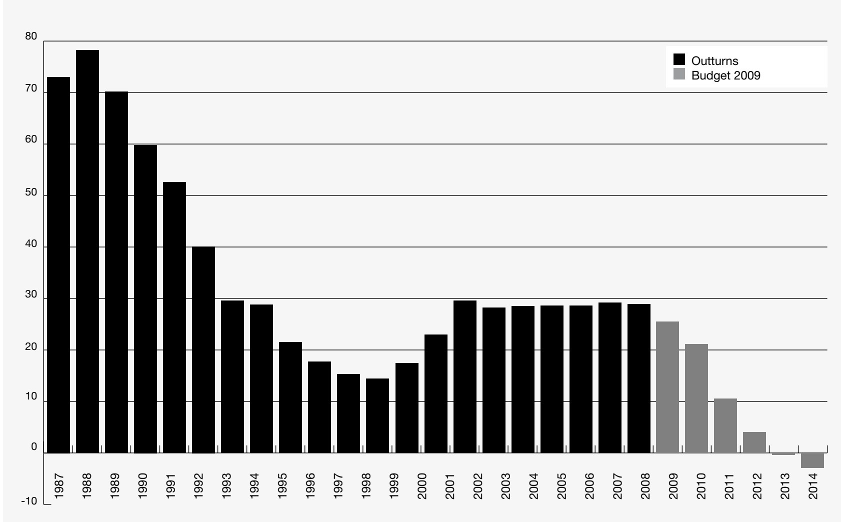
4 Tackling the fiscal crisis
Where should the cuts be?

Asset sales

Privatisation, and asset sales more generally, waere a major feature of the last Conservative Government though the overall fiscal impact was probably a subsidiary factor to wider policy and ideological considerations. Nonetheless Conservative governments raised around £60 billion by selling off swathes of British industry. The Labour Government maintained a commitment to further asset sales. Experience has been mixed: Qinetiq was sold almost certainly far too cheaply, with the officials and ministers concerned outwitted by clever and self-interested negotiators. But substantial sums were raised from the sale of Westinghouse (£5.4 billion) in 2006 and £2.3 billion from selling a stake in British Energy (used to offset decommissioning costs.) The Government announced further asset sales of £30 billion in 2006-7 for the next three years, mainly land. It transpires however, that around £10 billion of actual sales were by local councils and much of the cost involved transfers between government departments.

A point has now been reached at which the public sector has little or no net worth, or at least as conventionally measured. The family silver has largely been sold. Moreover, depressed equity and land markets make this a bad time to sell.

Figure 13: Government net worth, per cent of GDP
Source: HM Treasury (2009), *Budget 2009: Building Britain's Future*



Nonetheless there are potentially enormous opportunities from realising the value of often dormant public sector assets and there are private investors, such as infrastructure funds and real estate developers, with large sums to invest. It is possible to see the outline, at least, of realising substantial value for the taxpayer though there is a trade off to be made between maximising value, which may involve holding on to assets – as with bank shareholdings – for a considerable period and realising cash quickly to reduce budget deficits and government debt. The former should take precedence and since public sector financing problems are likely to remain for a long time there is no great urgency in rushing in to deals which deliver poor returns for taxpayers' assets. But where asset sales realise substantial value for the taxpayer they must be pursued. And since they are "one off" receipts they are ideally suited to paying off debt rather than plugging current deficits.

There are several routes to explore:

> There are still several conventional privatisations to be attempted. The Government's failure to secure a successful part-privatisation of the Royal Mail is unlikely to be a permanent outcome. My colleagues and I first advocated share sales five years ago and there remains scope for a properly designed package which involves partial worker share ownership and guarantees that cash realised from a successful trade sale or share floatation would be capitalised into a fund to support the post office network. There is no good reason why several other small government enterprises should not be sold in the right conditions – like the Royal Mint – though the sums involved are small.

> There are in addition government agencies like the Highways Agency which is valued by the government asset register at £80 billion (mostly in land value). While a conventional privatisation would not be feasible – there is no income stream at present – there is value which could be realised with imaginatively structured deals. A sensible way forward would be to link asset sale with the introduction of road user pricing but that poses major technical and other practical challenges including the separation of different kinds of roads. This is one for the long term.

> A much bigger and more urgent issue concerns the commercial banks. The acquisition of shares in RBS and the Lloyds Group cost the government £37 billion and it is an objective of policy to recoup this investment with a profit for the taxpayer. The timing of any sale is complicated by multiple government objectives: to realise maximum value for the taxpayer in the eventual sale; to require semi-nationalised banks to lend to sound UK businesses as a means of countering recession; active management of "bad" assets to secure value; and to achieve a different banking structure, through sell offs and reorganisation, in the interests of future competition and minimising future taxpayer exposure to banks currently "too big to fail". Experience of the countries which have had to nationalise banks – Sweden, Israel, Korea, the USA (with Continental Illinois) – is that it may take a decade to achieve a satisfactory, profitable, sale.

There is a similar set of considerations with the fully nationalised banks – Northern Rock and the residue (the "bad banks") of Bradford & Bingley and Dunfermline. The government has paid nothing for the shares but has absorbed substantial losses from the bad loans of these banks which it must aim to retrieve on sale.

There are several ways in which the sales could be achieved. In particular there are financial techniques – such as exchangeable bonds – which might enable the state to realise an early sale while capturing future uplift in share values.

> The taxpayer can also realise substantial value for intangibles such as spectrum, landing rights and emissions trading. One of the most successful privatisations in modern times (though different language was used) was the Labour Government's sale of spectrum for 3G telecoms licences. The auction was designed to maximise taxpayer value (the sale raised around £25 billion) and appears to have been successful in that aim, without inhibiting innovation by the telecoms operators.

That model can be employed more widely. Airport landing rights at major airports are a classic case of a valuable, scarce resource handed out freely to commercial operators rather than used to realise value for society at large. In the UK the grandfathering of landing rights acts as a large subsidy to BA and a barrier to entry to its competitors like Virgin and British Midland. Ten years ago I put forward a suggestion backed by Virgin and British Midland for the auctioning of landing slots at Heathrow and it was estimated then that the slots were worth around £1 billion per annum. The scarcity, and therefore the value, must have increased since. The main impediment is an EU ruling against auctioning (under pressure from the leading airlines) and the UK government should give priority to reversing the policy.

A potentially massive revenue source is the value of emission permits under cap and trade as now operated in the EU's CO_2 scheme. Hitherto, permit entitlements have been grandfathered and my party and I have been advocating that the scarcity value (£1 to £2 billion a year) should be required (by the energy regulator) to be set aside for social tariffs. As of 2013, permits will be sold, in part, and the proceeds will accrue directly to governments under the EU scheme. Current values are around £1 billion but they will rise steeply as coverage expands from electricity generators to other CO_2 emitters and as the emission limits tighten. The ensuing carbon price, including the permit charge, also sets the framework for more environmentally balanced investment in energy, industry and transport.

> The other area of major unrealised asset value lies in the public sector property portfolio, roughly estimated to be worth £370 billion book value (£130 billion in central government and its agencies) – though valuations are before the recent slump in the market. The Government has been endeavouring to realise economic value from its property assets by, for example, using defence land for housing developments. There are however proposals from the private sector to manage these assets more actively, helping the state to derive an income stream or capital value, using Real Estate Investment Trusts (REITS), for example.

5

New public spending in a world of cuts

One of the merits of a radical, zero based approach to public sector priority setting is that not merely does it identify large areas of spending which can be cut (or asset sales) in the interests of fiscal stability but it potentially creates opportunities for funding other activities which are more relevant and a better use of public funds. There are three main areas I would identify.

Spending transformation

First, there is spending transformation: where cuts are, at least in part, used for what are perceived as higher priority activities. Such an approach also achieves more political "buy in" for potentially controversial cuts. Several examples will suffice. First the proposed Titan prison complexes costing £1.35 billion and wider prison building costing £600 million (excluding land and running costs of £400 to £500 million a year) are questionable value for money and some of the savings could be diverted to other – arguably more appropriate – investment in, say, secure mental health facilities, drug rehabilitation and prison education. The programme of motorway widening and major roads – up to £1 billion over the next few years – could be diverted into rail projects for environmental reasons. Similarly some defence cuts should be reallocated to frontline military spending; savings from ID cards into frontline policing; savings from the "Baby Bond" scheme into school education and hospital efficiency savings into mental health or personal care.

Youth unemployment

There is urgent need for a major programme in one area: unemployment amongst young people (under 25s). Large numbers are out of work with much higher unemployment rates than in older workers and the experience of past recessions suggests that if we fail to deal with youth unemployment we consign a generation to the scrap heap. The Government has suggested a job (or training) guarantee on Scandinavian lines providing 6 months of work or training for all young people out of work for over a year. Professor Layard has suggested mechanisms based on the experience of Community Employment Schemes in the 1980s, with benefit tied to participation, and working closely with local charities and community groups to identify a bank of "real" jobs, incorporating environmental projects such as home insulation and caring work. The probation service already operates similar but smaller schemes with local authorities for young offenders. The cost of an employment guarantee scheme is estimated by Professor Layard at around £3,300 for a six month placement once taxes and benefits saved are taken into account.

Infrastructure

Proposed cuts in public capital investment make it difficult to envisage how large infrastructure investments can be undertaken. Among the big, environmentally important projects under consideration are the Severn Barrage (up to £15 billion investment required) and a variety of intercity high speed rail projects (perhaps costing £20 to £30 billion). Without expressing any views on the desirability of these or other projects – which could also include upgrading the London Underground, the endlessly delayed CrossRail, new water and sewerage systems, broadband rollout and renewable energy projects of various kinds – there is a large pent up demand for infrastructure investment which economist Dieter Helm estimates at around £500 billion.

These are unlikely to be entirely privately financed given the political and other risks involved. One mechanism could be an infrastructure bank along the lines of the European Investment Bank (which lends around □50 billon a year) or the proposed US National Infrastructure Bank being launched by the Obama administration, committed to spending $60 billion over 10 years. There are large, private infrastructure funds looking for investment opportunities and secure, long term returns which could provide equity capital; the public might well respond to bond issues floated to finance imaginative infrastructure projects and the banks clearly have a role in providing debt finance. But some degree of government sponsorship and support – perhaps underwriting capital increases – could be necessary as it is for multilateral development banks at present.

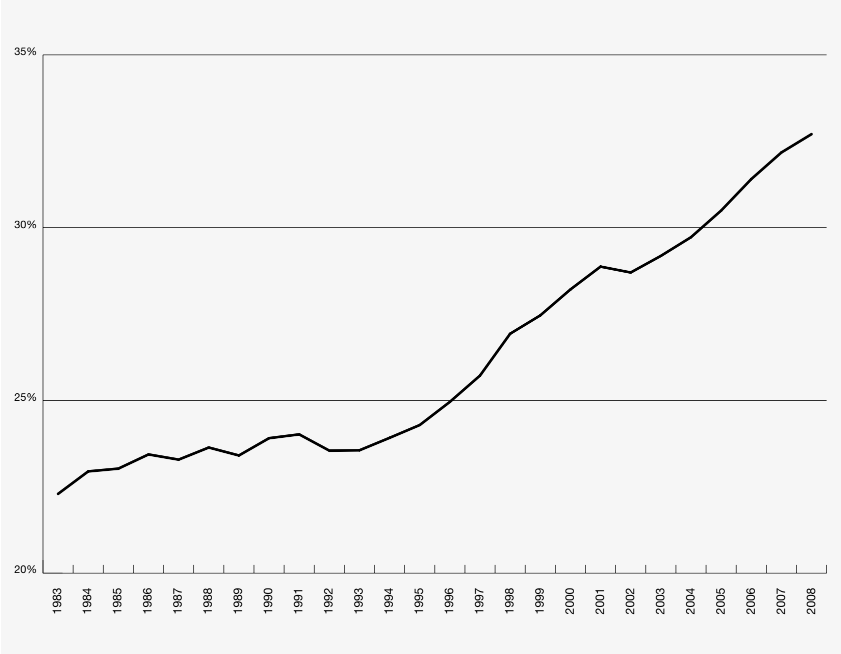
Such a commitment to long term investment, particularly involving environmental improvement, is as essential in the long term as fiscal consolidation and retrenchment. Without fiscal consolidation it will not be possible to remedy the current gross imbalance in the economy. Without infrastructure investment there will not be a functioning, modern, sustainable, "green" economy for the next generation to work with.

Conclusions

For much of the next decade, the dominant issues in economic and social policy will mostly arise from the massive budget deficit bequeathed by the "credit crunch" and this Government's economic policies. The consequences will be painful and difficult and will involve a period of austerity in public spending including real cuts in many areas.

There are essentially three, overlapping stages in economic recovery. The first involves using a temporary fiscal deficit alongside expansive monetary policy to stave off slump. There are also specific, growing, problems like rising unemployment, especially among young people, which call for active, albeit temporary, government measures to absorb the unemployed in productive activities. The second involves rectifying the large structural deficit which has arisen in the UK budget mainly because of the expansion of public spending on the basis of revenue growth from the financial services sector and the housing market which were unstable and impermanent. The range of estimates is wide, but the Government's estimate of a 6.5 per cent of GDP correction over an eight year period is optimistic. A fiscal contraction of around 8 per cent of GDP may be required over a shorter period – perhaps five years – to persuade the UK's creditors that the government is serious. Third, but not least, the emphasis on retrenchment should not detract from the long term structural adjustment required in the economy; away from an overdependence for activity and tax revenue on financial services and on demand for consumer borrowing on the back of house inflation.

Figure 14: Finance and business, per cent of GVA
Source: Office for National Statistics (2009), *Time series data: Gross Domestic Product by Gross Value Added*



But the emphasis in this paper is on fiscal consolidation which I have argued will fall predominantly on public spending. Indeed the Government's own proposals for the 2013-14 period assume that almost 80 per cent of the adjustment falls on spending.

This process can be carried out traditionally through "salami slicing" and cause considerable damage to valued services. Or there can be a more systematic process of selecting high and low priorities for public spending; radically decentralising decision making to local government; and engaging democratically elected politicians in the choices. No doubt public administrators can be made more conscious of costs and efficient management but it is not credible to believe that greater "efficiency" is a panacea, not least because it has been invariably promised and not delivered in the past. But much more is required than a cultural change in the Whitehall machine. In the past public spending decisions have been made too opaquely and remotely, in Whitehall. The adoption of fiscal rules has added spurious precision to the process. Proposals to invest considerable power in a quango with oversight of public spending threatens to make the problem worse, removing decision making even further from democratic processes. Fiscal policy is political and the politicians must explain in detail how they will tackle the problem of deficits and debt.

This paper sets out broad principles to guide this process. A key assumption is that there are no "ring fenced" areas of spending: that existing spending has to be justified, not simply assumed to be necessary and trimmed at the edges. Major, specific areas of potential savings are identified, though the examples are illustrative and represent only a first, rough, attempt. Undoubtedly more are required to meet the exacting fiscal disciplines that will be required.