



RESEARCH NOTE 27

BUDGET 2008 REPORT

Key points

- The discussion around Alistair Darling's first Budget is likely to be dominated by immediate worries, such as non-dom taxation, capital gains tax, rising budget deficits, Northern Rock, and the impact of the credit crunch on economic growth. These are all vital issues. But it's important not to forget the negative longer-term effects of fiscal policy in recent years.
- Public spending has quite simply surged since 2000. On the OECD numbers, it has increased from 37.5 per cent of GDP in 2000 to 45 per cent last year – an increase unprecedented during a peacetime period of steady economic growth. In 2000, Britain's public spending as a share of national income was below the OECD average. It is now 4.5 percentage points higher.
- In several key areas of public spending there is little evidence that increased funding has translated into better results:
 - In healthcare, there is no discernable effect on mortality amenable to healthcare from the big increases in spending after 1999.
 - The education budget has risen substantially but the UK has fallen down rankings of international education performance.
 - Recorded crime has risen, detection rates have fallen, and re-conviction rates have increased.
- It is becoming increasingly clear that controlling spending and cutting taxes will bring significant economic benefits over the medium to long term. This can be seen in a number of ways:
 - There are a number of academic studies which suggest that economies with a smaller share of GDP consumed by government will grow faster. The effect on growth is large enough that spending increases since 2000 might already be costing us around £12 billion a year in lost GDP.
 - The Treasury has consistently overestimated tax revenues as tax rises failed to generate as much revenue as expected under a static analysis. Recent tax rises have had significant negative dynamic effects.



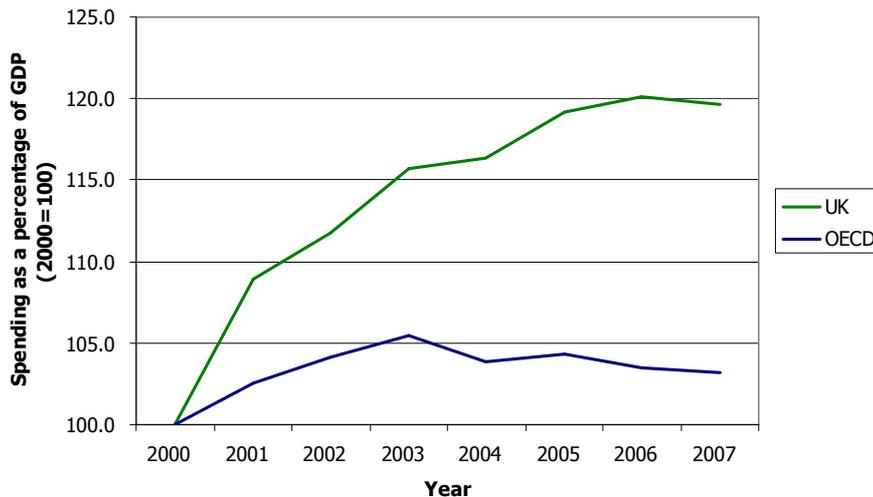
- A dynamic model produced for the TaxPayers' Alliance has shown that pre-announced, phased cuts in corporation tax could lead to major increases in economic growth and, over time, tax revenue.

- Reducing the size of the state will need a number of policies designed to curb the growth in public spending. One of those would be to reduce the size of the Civil Service in a painless (and, compared to the Gershon process, more effective) way. Almost a quarter of the Civil Service will retire in the next ten years. If none of these positions were rehired taxpayers could eventually save £3.3 billion a year in salary, employer NI and pension costs.

1 The failure of increased spending on public services to deliver results

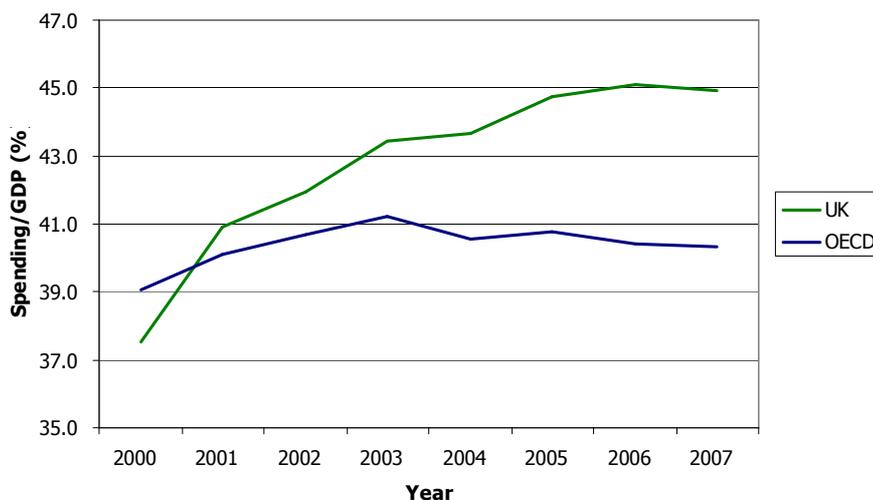
Spending has increased substantially since 2000. Government spending in Britain has grown far faster than the OECD average.¹

Chart 1.1 Government spending as a percentage of GDP, growth in OECD average and UK



This has resulted in government spending as a proportion of GDP in Britain rising to well above the OECD average.²

Chart 1.2 Government spending as a percentage of GDP, OECD average and UK



¹ OECD, "Economic Outlook 81", Annex Table 25, May 2007

² *Ibid.*



What value are taxpayers getting for this massive increase in the amount spent on public services?

Health

Spending on healthcare has risen substantially since 1999 with real terms public spending on healthcare of £57.3 billion in 1999-00 and £92.8 billion in 2006-07.³

The TaxPayers' Alliance study *Wasting Lives: A statistical analysis of NHS performance in a European context since 1981* found that poor NHS performance was resulting in 17,000 deaths per year. Mortality amenable to healthcare was 26.9 per cent higher in the UK than in comparable European countries - http://tpa.typepad.com/home/files/wasting_lives.pdf.

The study also found that Gordon Brown's additional spending since 1999, despite significantly outpacing spending growth in comparable European countries, has made no discernable difference to the pattern of improving mortality amenable to healthcare.

Education

Spending on education has risen substantially since 1999 with real terms public spending on education of £47 billion in 1999-00 and £69.8 billion in 2006-07.⁴

During that time the UK has fallen down international rankings of educational performance. British educational performance ranked far higher in the 2000 edition⁵ of the respected OECD PISA international comparison of educational standards than it did in the 2006 survey.⁶ In scientific literacy Britain fell from 4th to 14th; in mathematical literacy from 8th to 24th and in reading literacy from 7th to 17th.

Law and Order

Spending on law and order has risen substantially since 1999 with real terms public spending on public safety of £20.9 billion in 1998-99 and £29.8 billion in 2006-07.⁷

³ Both figures in 2005-06 prices, HM Treasury, "Public Expenditure Statistical Analysis 2007", HMSO: April 2007, pg. 51

⁴ Both figures in 2005-06 prices, HM Treasury, "Public Expenditure Statistical Analysis 2007", HMSO: April 2007, pg. 51

⁵ Office for National Statistics, "International Student Assessment: Results for England 2000", December 2001

⁶ OECD, "The Programme for International Student Assessment (PISA)", December 2007

⁷ Both figures in 2005-06 prices, HM Treasury, "Public Expenditure Statistical Analysis 2007", HMSO: April 2007, pg. 51



Despite this recorded crime rose by 6 per cent over that period.⁸ Detection rates fell from 29 per cent to 26 per cent. Two-year prison reconviction rates rose from 58 per cent in 1995 to 65 per cent in 2004 (the most recent data available).⁹

This failure to secure value for money suggests that public service reform will yield better results than crude increases in resources. Spending should be restrained in order to prevent further waste.

⁸ Home Office, *"Recorded Crime Statistics 1898 to 2001/02"*; Home Office, *"Recorded Crime Statistics 2002/03 to 2006/07"*

⁹ Home Office, *"Reconvictions of prisoners discharged from prison in 1996"*, Tables 9.1 and 9.6 (includes 1995 data); Home Office, *"Re-offending of adults: results from the 2004 cohort"*, March 2007, Table A5 (for the two-year reconviction rate, the 2004 cohort is the most recent for which data is available).

2 The dynamic benefits of low taxation

2.1 Countries with small Governments grow more quickly

A series of institutions and academics have produced estimates of the effect of growth in the size of the state on economic growth. Growth in the size of the British state since 2000 will already have had significant effects on annual GDP.



The European Central Bank (2008) – Based in Frankfurt and responsible for monetary policy covering the 15 member countries of the Eurozone, the European Central Bank also maintains a research programme which releases regular working papers. Their estimate¹⁰ that each 1 per cent growth in government consumption as a share of GDP leads to a 0.13 per cent fall in GDP growth was produced by António Afonso, from the ECB's UECE – Research Unit on Complexity and Economics, and Davide Furceri, from the University of Palermo and the University of Illinois at Chicago.

If the result obtained by the researchers at the European Central bank holds for Britain since the start of a major growth in Government consumption as a percentage of GDP since 2000 then it will already be costing us £13.7 billion in lost GDP each year.



Robert J. Barro (1997) – Rated by IDEAS/RePEc as the most influential economist in the world.¹¹ Robert Barro is currently Paul M. Warburg Professor of Economics at Harvard University and has produced numerous widely cited studies on a diverse range of subjects and has a particular reputation for his work on economic growth. His estimate¹² that each 1 per cent growth in government consumption as a proportion of GDP leads to a 0.136 fall in economic growth is contained in a 1997 book *The Determinants of Economic Growth: A Cross-Country Empirical Study*.

¹⁰ Afonso, A. & Furceri, D. 'Government size, composition, volatility and economic growth', European Central Bank: Working Paper no. 849, January 2008

¹¹ IDEAS/RePEc, 'Economist Rankings at IDEAS', January 2008, <http://ideas.repec.org/top/top.person.all.html>

¹² Barro, R. J. 'Determinants of Economic Growth: A Cross-Country Empirical Study', MIT Press, 1997

If the result obtained by the Barro holds for Britain since the start of a major growth in Government consumption as a percentage of GDP since 2000 then it will already be costing us £14.4 billion in lost GDP each year.



Folster & Henrekson (2001) – Researchers at the Swedish Research Institute of Trade and the Stockholm School of Economics estimated¹³ the effect of the size of government on economic growth using an econometric panel study on a sample of rich countries over the period 1970-95. They found that as econometric problems were addressed the relationship between small government and high economic growth became more robust and found that each 1 per cent growth in government consumption as a proportion of GDP leads to a 0.07-0.08 per cent fall in economic growth.

If the result obtained by the researchers at the Stockholm School of Economics holds for Britain since the start of a major growth in Government consumption as a percentage of GDP since 2000 then it will already be costing us £7.9 billion in lost GDP each year.

An average of the three estimates suggest that our GDP per annum is £12 billion lower than it would have been if government's share of the economy had not increased. This is pure deadweight loss and does not include other effects on growth of government decisions such as increased regulation.

Table 2.1.1 Estimates of loss of annual GDP due to dynamic costs from post-1999 spending growth

Organisation	Implied loss to annual GDP from post-1999 spending growth
European Central Bank	£13.7 billion
Barro	£14.3 billion
Stockholm School of Economics	£7.9 billion
Average	£12 billion

¹³ Fölster, S. & Henrekson, M. 'Growth effects of Government Expenditure and Taxation in Rich Countries', Stockholm School of Economics: Working Paper no. 503, Research Institute of Industrial Economics, June 2000

Table 2.1.2 European Central bank estimate of loss of annual GDP due to dynamic costs from post-1999 spending growth

	2000	2001	2002	2003	2004	2005	2006	2007	2008	
Government expenditure % of GDP	37.5	40.9	42.0	43.4	43.7	44.7	45.1	44.9	45.1	
Percentage increase		3.4	1.1	1.5	0.3	1.0	0.4	-0.2	0.1	
Effect on growth		0.44%	0.14%	0.19%	0.03%	0.14%	0.05%	-0.02%	0.02%	
Cumulative		0.44%	0.58%	0.77%	0.80%	0.93%	0.98%	0.96%	0.98%	Money GDP, 07-08, £bn
GDP per annum cost, £ billion		6.1	8.1	10.7	11.2	13.1	13.8	13.5	13.7	1,404

Table 2.1.3 Barro estimate of loss of annual GDP due to dynamic costs from post-1999 spending growth

	2000	2001	2002	2003	2004	2005	2006	2007	2008	
Government expenditure % of GDP	37.5	40.9	42.0	43.4	43.7	44.7	45.1	44.9	45.1	
Percentage increase		3.4	1.1	1.5	0.3	1.0	0.4	-0.2	0.1	
Effect on growth		0.46%	0.15%	0.20%	0.03%	0.14%	0.05%	-0.02%	0.02%	
Cumulative		0.46%	0.60%	0.80%	0.84%	0.98%	1.03%	1.01%	1.02%	Money GDP, 07-08, £bn
GDP per annum cost, £ billion		6.4	8.5	11.2	11.7	13.7	14.4	14.1	14.4	1,404

Table 2.1.4 Stockholm School of Economics estimate of loss of annual GDP due to dynamic costs from post-1999 spending growth

	2000	2001	2002	2003	2004	2005	2006	2007	2008	
Government expenditure % of GDP	37.5	40.9	42.0	43.4	43.7	44.7	45.1	44.9	45.1	
Percentage increase		3.4	1.1	1.5	0.3	1.0	0.4	-0.2	0.1	
Effect on growth		0.25%	0.08%	0.11%	0.02%	0.08%	0.03%	-0.01%	0.01%	
Cumulative		0.25%	0.33%	0.44%	0.46%	0.54%	0.57%	0.55%	0.56%	Money GDP, 07-08, £bn
GDP per annum cost, £ billion		3.5	4.7	6.2	6.5	7.6	8.0	7.8	7.9	1,404

2.2 Increasing spending creates nasty fiscal surprises

From 2000 government spending began to rise significantly as a proportion of the economy. Since then the Government's predictions of spending have been somewhat optimistic and their estimates for taxation extremely optimistic:

2001-02

£million	Forecast, 2001 Budget	Outturn, 2003 Budget	Error
Current receipts	398,400	389,900	8,500 overestimate
Spending	393,700	389,600	4,100 overestimate

2002-03

£million	Forecast, 2002 Budget	Outturn, 2004 Budget	Error
Current receipts	407,200	396,200	11,000 overestimate
Spending	418,400	419,100	700 underestimate

2003-04

£million	Forecast, 2003 Budget	Outturn, 2005 Budget	Error
Current receipts	428,300	418,900	9,400 overestimate
Spending	455,700	454,300	1,400 underestimate

2004-05

£million	Forecast, 2004 Budget	Outturn, 2006 Budget	Error
Current receipts	454,700	451,300	3,400 overestimate
Spending	487,600	491,000	3,400 underestimate

2005-06

£million	Forecast, 2005 Budget	Outturn, 2007 Budget	Error
Current receipts	486,700	485,700	1,000 overestimate
Spending	518,600	523,400	4,800 underestimate

Over this period, current receipts outturns were net £33.3 billion lower than expected in each Budget immediately preceding the financial year. Net spending outturns were £3.4 billion higher than expected in each Budget immediately preceding the financial year. The fiscal position turned out worse than expected as higher government spending led to slower growth than would otherwise have been the case, while the Treasury simply didn't raise as much tax revenue as they thought from higher taxes.



2.3 Cutting corporation tax

The TaxPayers' Alliance commissioned the Centre for Economics and Business Research to model the impact of pre-announced, phased cuts of 2 per cent each year in corporation tax until the Irish level of 12.5 per cent was reached –

http://tpa.typepad.com/research/files/dynamic_model_of_uk_economy_budget_2007_irish_ct_rate_simulation_results.pdf

They estimated that, by 2021, relative to the baseline forecast:

- GDP would be 8.7 per cent higher;
- Total fixed investment would be 60.9 per cent higher;
- Total employment would be 8.7 per cent higher while manufacturing employment would be 10.1 per cent higher;
- Disposable income would be 9 per cent higher largely due to a 13.5 per cent boost to wages and salaries;
- Consumer spending would be boosted by 2.3 per cent;
- The savings ratio would be 13.1 per cent higher.

Although this plan would cost £3.8 billion initially, by 2021 revenue would be £28.7 billion higher than the base case, largely due to higher income tax and VAT receipts. Within eight years revenue would be higher than without corporation tax cuts.

3 How to help alleviate the problem: reducing the size of the Civil Service

There has been justified concern over recent decades that the huge size of the Civil Service is a symptom of the excessive size of government. Indeed, in recent decades governments of both parties have pledged to increase the efficiency of the Civil Service.¹⁴

Efforts to achieve this however, have been forestalled by fears that reducing the size of the Civil Service must entail large scale forced redundancies, involving expensive redundancy payments, considerable hardship for the Civil Servants let go and considerable political pain for a government facing strikes. However a breakdown of Civil Servant numbers by age suggests this need not be the case:

- Almost a **quarter** of the Civil Service, 131,800 Civil Servants, will retire within the next ten years.¹⁵
- If none of these positions were rehired that could mean a saving of **£2.6 billion** in salaries alone. It would also substantially reduce future bills for Civil Service pensions and other costs.¹⁶
- As the Government would no longer need to pay employer's pension contributions (£510 million) or employer's national insurance contributions (£180 million), the final potential saving could be **£3.3 billion** per year – **£130 per household**.¹⁷

This implies that substantial savings can be made through reducing the numbers in the Civil Service without needing to make compulsory redundancies.

In France President Nicolas Sarkozy has pledged to replace only half of retiring civil servants. Although the implementation of this pledge has been delayed, it is still planned to be put into effect by the end of his

¹⁴ Labour Government: the 2004 Gershon Review promised to reduce the size of the Civil Service by 70,000; Conservative Government: Margaret Thatcher's 1982 *Efficiency and Effectiveness in the Civil Service* began a process of widespread Civil Service reform.

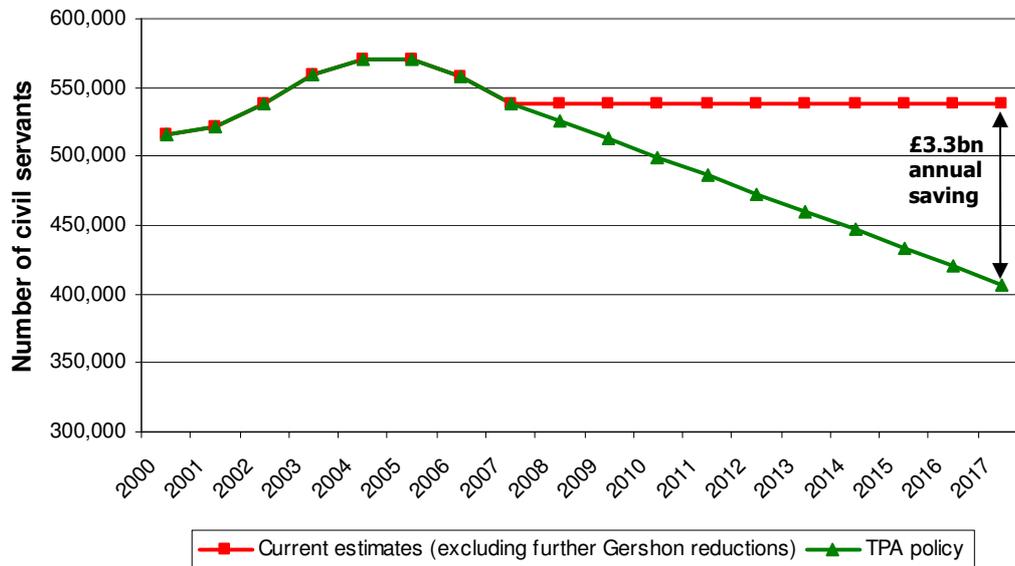
¹⁵ The number of Civil Servants retiring in the next 10 years is the number aged '50 & Over' from Civil Service Statistics 2006, Table G. It is compared to the total number of Civil Servants in 2007, from Table 1, Public Sector Employment Q3 2007, Office for National Statistics.

¹⁶ The saving in salaries assumes that the average Civil Service job discontinued would otherwise be paid the median full-time equivalent Civil Service salary of £20,010: Civil Service Statistics 2006, Table C.

¹⁷ The pension saving is based upon a 19.4 per cent employer contribution that was the average in 2006-07, giving £3,880 per employee or £510 million in total: Cabinet Office, Civil Superannuation, Resource Accounts 2006-07, page 8. The employers' national insurance contributions saving is based upon multiplying pay above £5,000 by 9.1 per cent (employer's NIC rate based on contracted-out final salary pension scheme) to get £1,365 per employee. This is equivalent to £180 million per annum.

term.¹⁸ In the United States former presidential candidate and New York Mayor Rudy Giuliani made a pledge that, were he elected president, he would not rehire half of the government staff due to retire in the coming years.¹⁹

Chart 3.1: Civil Service employment



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¹⁸ Samuel, H. "Sarkozy backs down over civil service job cuts", *Daily Telegraph*, August 2007, <http://www.telegraph.co.uk/news/main.jhtml?xml=/news/2007/08/01/wsarkozy101.xml>

¹⁹ MacGillis, A. "Giuliani, Sarkozy and the Civil Service", *The Trail - washingtonpost.com*, November 2007, http://blog.washingtonpost.com/the-trail/2007/11/07/giuliani_and_sarkozy.html