



# Newsletter

July 2009

*The **Social Market Foundation** is an independent public policy think-tank, developing and advancing innovative solutions across a broad range of economic and social policy. We publish original research, hold seminars and debates in Westminster and beyond, and run a diverse programme of events at the three main party conferences. Since its foundation in 1989, the work of the SMF has been principally devoted to promoting the social market philosophy, which seeks to marry markets and social justice. It neither sees the market as a necessary evil nor as an end in itself but as a means to improve people's lives. It is underpinned by adherence to two key principles: first, a positive preference for market mechanisms, while recognising that a truly pro-market approach is often not a free-market one; and second, a belief that a sustainable market economy rests on social and political foundations that are widely regarded as fair. Our work aims to elucidate these ideas and to explain why the social market is a fruitful source of solutions to public policy problems.*

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## Welcome to the Summer edition of the SMF newsletter

The social market approach that underpins the work of the SMF holds the view that, in many cases, the market economy does not contain the conditions for its own survival. Unfettered free-markets can bring about their own collapse; a truly pro-market position is not a free-market one.

This month has shown just how relevant the intellectual concerns of the SMF are to contemporary policymaking. The historic publication of the "Regulating financial markets" White Paper reflects the now widespread consensus that the state must play a far greater role in guiding and regulating the financial sector. While the details are still to be finalised on how policymakers will deploy dynamic regulation to second-guess the economic cycle and root out systemic risk, the social market approach is now observable right across the political and intellectual spectrums. As governments around the world discard the failed ideologies that led to the financial crisis, it would be no exaggeration to say: "we are all social marketeers now."

## In this edition

This SMF newsletter includes articles on a variety of topics:

- Latest News – page 2
- Note from the Director – page 4
- Forthcoming publications:
  - Vicious Cycles – page 6
  - Well-being – page 8
  - From Feast to Famine – page 11
  - Party Conference events taster – page 13
  - Fiscal Reform – page 14

## Latest news

### Research

This month the Social Market Foundation will be publishing three major reports.

***Vicious Cycles: Sustained employment and welfare reform for the next decade*** is the follow-up to the 2008 SMF report *The Flexible New Deal: Making it work*. This report looks at how to tackle the problem of 'revolving door' employment. The authors argue that contracting-out employment services provides the solution to tackling rising unemployment and reducing public expenditure – the two defining challenges of the coming decade.

[http://www.smf.co.uk/vicious\\_cycles.html](http://www.smf.co.uk/vicious_cycles.html)

***From Feast to Famine: Reforming the NHS for an era of austerity*** is the culmination of the SMF's two-year long health project, examining how the NHS should be shaped to respond to the challenges of the coming years. The report looks at how to cut costs and streamline services in the face of the impending public spending squeeze. The authors make the case for limited charging for GP visits to constrain the inexorable growth in demand for healthcare, which threatens to overwhelm the NHS in the coming years of austerity.

[http://www.smf.co.uk/from\\_feast\\_to\\_famine.html](http://www.smf.co.uk/from_feast_to_famine.html)

***Well-being: How to lead the good life and what government should do about it*** asks why we are no happier than we once were, and whether increasing the level of well-being should be the aim of government. This new collection brings together celebrated academics and commentators – including Richard Reeves, Liam Halligan, Kevin Hickson, Will Hutton and Marina Bianchi – to look for answers in the work of earlier thinkers, with Richard Layard concluding with his own take on the utilitarian argument.

<http://www.smf.co.uk/well-being.html>

### Events

This year the Social Market Foundation will be hosting, as always, a huge range of fringe events at all three of the autumn party conferences. Topics range from the use of technology in healthcare to the future of home ownership, with speakers such as **Lord Adonis, Michael Gove MP** and **Don Foster MP**. Detailed on page 13 are our keynote events where **Vince Cable MP, Lord Mandelson, Oliver Letwin MP** and **Theresa May MP** will be discussing the future of the British economy. The full programme is now available on our website at [www.smf.co.uk/conf-2009.html](http://www.smf.co.uk/conf-2009.html). For more information, please contact Laura Tomlinson on 0207 227 4407 or [ltomlinson@smf.co.uk](mailto:ltomlinson@smf.co.uk).

We are also currently planning our programme of events for the post-conference season and will shortly produce our 2009/2010 themes document. Please contact [whoyles@smf.co.uk](mailto:whoyles@smf.co.uk) to ensure you receive it upon publication or to discuss ways in which you might wish to partner with us over the next year.

**The SMF is now on Twitter.** Please go to [http://twitter.com/SMF\\_Events](http://twitter.com/SMF_Events) for regular updates on our 2009 party conference programme.

### Westminster boardroom

The conference room at the Social Market Foundation is available to hire for meetings and seminars. It is an ideal venue for those seeking a location near the heart of government, as we are situated within a short walking distance of underground stations at Westminster, St James' Park and Victoria and just minutes from the Houses of Parliament and Whitehall.

*For more information about how to book our boardroom and hire rates please contact SMF on 020 7222 7060 or see our website [www.smf.co.uk/room-hire](http://www.smf.co.uk/room-hire)*

## Note from the Director

### **The banking white paper fails to address the causes of last year's financial collapse and should focus more on rules and less on regulator discretion**

*Ian Mulheirn*  
*Director*



What caused the crash of late 2008? It would be comforting to think that those designing the new framework of financial regulation would do so informed by a full appreciation of the answer. But in the debate over regulation – to which the Treasury's white paper this week is a major contribution – important lessons of the crisis are being overlooked. Macroeconomic causes aside, there were two main drivers of the financial and ensuing economic meltdown: inadequate regulatory rules and common-or-garden human nature.

After waking from the collective boom-time reverie, policymakers are in danger of missing the behavioural point. The macro-prudential agenda appears to be focusing more on the discretion of sagacious regulators than on promoting a better rules-based system. As the Treasury's paper this week put it: 'Constraining the inherent pro-cyclicality of financial markets will require an element of discretion.' Yet an overreliance on the proposed Council for Financial Stability will make the failures of the past more likely to recur.

The accurate, but partial, conclusion of the post-mortem on the origins of the crisis was that the regulatory rules governing finance were ineffective. Financial innovation meant that new products and institutions were beyond the reach of the existing rules.

Meanwhile, an 'underlap' of responsibility between the Bank of England and the Financial Services Authority meant that nobody raised the alarm about dangerous levels of debt across the financial sector. This has led many observers to suggest that, since the rules failed, more regulator discretion is needed to allow those who referee the system to adapt to this fast-changing environment. A nice idea – in theory.

**“There were two main drivers of the financial and ensuing economic meltdown: inadequate regulatory rules and common-or-garden human nature”**

The important question of how to ensure that banks are holding enough capital to cushion themselves against losses is a good test case for how this might work. There is widespread consensus on the need to force banks to raise their capital reserves in good times to protect them from collapse in the bad times – so-called 'dynamic provisioning'. The difficulty is how to do it, and the Treasury's white paper largely left that argument for another day.

Those who emphasise past regulatory failure advocate some kind of independent panel, similar to the Bank's Monetary Policy Committee, to monitor systemic risk and tell banks to increase their capital buffers when things start to overheat. This would presumably be a power that would sit with the proposed council. But working out the difference between a sustainable and an unsustainable growth in lending, without the benefit of hindsight, is a near impossible task. And, in the confusion, regulators are exposed to capture by the soothing siren calls of the City.

Boom mania and collective delusion were major ingredients of the subsequent bust, and very few stood aloof from it. In 2006, for example, the International Monetary Fund went out of its way to explain how banks were less vulnerable than ever to credit or economic shocks. In the same vein, others, in extolling the efficiency of markets, convinced themselves that risk was spread to those most able to bear it rather than those least able to understand it. So a reliance on groups of 'experts' to judge when things are getting risky suggests a naivety about the behaviour of human beings that would be touching if it wasn't so potentially catastrophic.

A rules-based approach to capital requirements therefore merits a much closer look. Some will argue that rules themselves can be watered down once people get complacent in the good times. But at least such an institutional constraint requires transparent public debate to change it. And that is a better safeguard against spurious and seductive arguments, made behind closed doors, in a system that relies purely on the judgement of a few experts.

The regulatory system that emerges from the financial debacle of the past two years must recognise the weaknesses of the human beings who run it. The business cycle will always be with us. But until we finally grasp our own susceptibility to the stories we tell, and design institutions that can save us from ourselves, we can expect financial and other bubbles to continue to grow and burst with devastating results.

*This article was originally produced for Public Finance in July 2009*

## Forthcoming Publications

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### Vicious Cycles: Sustained employment and welfare reform for the next decade

**Beth Foley and Rena Menne**

Despite the success of welfare-to-work policies to date, 40% of those leaving benefits will re-claim within six months of starting work. Although large numbers are caught up in this cycle of 'revolving door' employment, little is currently done to address the issue. This is largely due to the fact that it is hidden within the current employment service system. In the case of any two new Jobseeker's Allowance (JSA) claimants, one may be unemployed for the first time and the other facing the third, fourth or even fifth spell within a couple of years, yet both will be offered identical support. Recognising that these two people have fundamentally different needs is crucial to achieving sustained employment. Tackling unemployment and delivering taxpayer value-for-money from public services will dominate the policy agenda of the next decade. Both of these objectives can be achieved, but a bolder approach to welfare reform will be necessary.

The current employment service system contains many inefficiencies and inconsistencies. Services are administered by a number of providers, operating under overlapping contracts and facing very different sets of incentives. While providers and policymakers rightly recognise that resources should be rationed according to those who need most support, centrally-imposed arrangements are neither consistent nor effective. Jobseekers possessing personal characteristics seen to reduce their employment chances – such as disability or a work-limiting health problem – are identified early on, and moved onto specialist programmes.

But, for the vast majority of jobseekers, the length of an individual JSA claim will be the only factor used to determine the support they receive. Most will have to wait for 12 months before they become eligible for specialised support. There is a rationale for this waiting period; 80% of JSA claimants will find a job of their own accord within six months, and offering them specialist support will create unnecessary costs. Yet, while this argument is valid, it only presents half the picture. While a twelve month waiting period does lower deadweight costs, it also increases the need for other kinds of expenditure, such as benefit costs. Jobseekers trapped in a cycle of revolving door employment become increasingly hard to help; they become disengaged from the labour market and suffer the 'scarring' effects associated with long and repeated spells of unemployment. All of this is costly to the Exchequer, as well as to individuals and their families. Policy must therefore work harder to offer help quickly to those who need it.

### **Better support with less money?**

The current recession poses two further challenges for welfare reform over the next decade. The employment service system is faced with soaring unemployment while, at the same, public spending is set to come under substantial pressure. Any alterations to the current model must therefore go some way to creating a system that is more successful, efficient and cost-effective. The question is: what would such a system look like?

First, a much more effective means of categorisation and resource allocation is required. To identify those trapped in revolving door unemployment early on, jobseekers should be classified according to the *proportion of time* over the last two years they have spent unemployed. A 'labour market attachment indicator' would allow for early identification and intervention to break the cycle of revolving door employment.

Second, the payment-by-results approach should form the basis of the new system. Under the current system, Jobcentre Plus has no incentives to ensure that it supports its clients into sustained employment. The payment-by-results framework in place for private providers has demonstrated that a focus on the outcome of sustained employment can dramatically improve retention rates. This approach should now be extended and incentives aligned so all providers are operating in a mixed market. Multiple-client contracts should encompass all jobseekers, with providers paid on the basis of sustainable outcomes.

A payment-by-results approach brings other benefits. The analysis of a wide range of interventions shows that there is no single intervention which has proven successful for all jobseekers, because individual needs vary so greatly. Trying to determine appropriate support from the centre is therefore unlikely to achieve effective or efficient outcomes. In contrast to a centrally determined strategy, a simplified, more flexible approach is needed. Responsibility for resource allocation should be devolved to frontline advisers, who are generally in the best position to identify an individual jobseeker's needs. If providers were to be paid according to an escalator payment schedule – under which payments increase with the numbers of jobseekers helped into work – deadweight costs, associated with unnecessary expenditure on those who would have found work anyway, would be minimised. This approach would also give providers the flexibility necessary to tailor cost-effective support for each individual.

Under this new, unified model for employment services, people would not be judged on crude or arbitrary criteria, but could receive support appropriate to their individual needs right from the start of their claim. Employment services would be better at identifying harder-to-help clients, faster in helping people back into work, more focused on sustainable employment and more cost-effective. Breaking the cycle has never been more important: this is the way to do it.

*For more information about the SMF's work in this area please go to [www.smf.co.uk/vicious\\_cycles.html](http://www.smf.co.uk/vicious_cycles.html)*

*This project has been made possible by the kind support of Remploy.*

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## Well-being: How to lead the good life and what government should do about it

**Dr Simon Griffiths**

In 961, reflecting on a long and seemingly successful life, Abdul Rahman III, Caliph of Cordoba, wrote:

“I have now reigned above fifty years in victory or peace; beloved by my subjects, dreaded by my enemies, and respected by my allies. Riches and honours, power and pleasure, have waited on my call, nor does any earthly blessing appear to have been wanting to my felicity. In this situation, I have diligently numbered the days of pure and genuine happiness which have fallen to my lot: they amount to fourteen.<sup>1</sup>”

Two weeks of happiness in a lifetime of abundance is pretty scant. More than 1,000 years later the Caliph’s gloomy reflections are more relevant than ever before, and are mirrored in two related questions that run through a new edited collection from the SMF.

First, why are we no happier now than we once were (or to use the language of the social scientists, why is ‘subjective well-being’ no higher)? Even in recession, most of us in the West are far wealthier than at any time in previous decades. Between 1957 and 2006, the UK’s GDP per person almost trebled in real terms. Roughly speaking, orthodox economics equates a rise in the level of purchasing power with an increase in the well-being of a society. Yet, during the same period, the proportion of people in the UK who said that they were “very happy” fell from 52% to 36%.<sup>2</sup> Other surveys present a slightly less pessimistic picture of well-being trends, but in almost all cases they show that we are no happier now than we were a generation or so ago.<sup>3</sup> This has become known as the “paradox of progress”.<sup>4</sup>

Some commentators have even argued that there is a direct link between the pursuit of wealth and unhappiness. The quest for ever-greater GDP by governments or for ever-greater affluence by individuals has been compared to a sickness – often dubbed “affluenza”. And there are those who would argue that the affluenza of bankers, taking ever higher risks, is at least in part responsible for our current woes. These arguments are specific examples of an

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<sup>1</sup> Edward Gibbon, *Decline and Fall of the Roman Empire* (Electric Book Company, 2001), Volume V, 401.

<sup>2</sup> Mark Easton, “Britain’s happiness in decline”, BBC Online, Tuesday, 2 May 2006, [http://news.bbc.co.uk/1/hi/programmes/happiness\\_formula/4771908.stm](http://news.bbc.co.uk/1/hi/programmes/happiness_formula/4771908.stm)

<sup>3</sup> The evidence is compiled in the online annex to Layard’s *Happiness*, available at <http://cep.lse.ac.uk/layard/annex.pdf>

<sup>4</sup> Richard A. Easterlin, “Does Economic Growth Improve the Human Lot?” in Paul A. David and Melvin W. Reder, eds., *Nations and Households in Economic Growth: Essays in Honor of Moses Abramovitz*, (New York: Academic Press, Inc., 1974)

older and wider critique of consumerism that runs through RH Tawney's *The Sickness of an Acquisitive Society* and Thorstein Veblen's critique of "conspicuous consumption".<sup>5</sup>

Second, the authors in this new SMF collection ask, should increasing levels of subjective well-being be the main aim of government? A survey for the BBC found that a massive 81% of people thought that government's prime objective should be happiness not wealth.<sup>6</sup> This has long been the argument of utilitarians, from their "founding father", Jeremy Bentham, at the turn of the nineteenth century, to Richard Layard - the author who has done most to popularise the doctrine's contemporary revival. These authors argue that happiness is the only thing that is "self-evidently good". As Layard writes: "If we are asked why happiness matters, we can give no further, external reason. It just obviously does matter".<sup>7</sup> All other goods - freedom, equality or health, for example - are important if, and only if, they are "instrumental" to happiness. This idea is rarely taken as seriously as it is in the small Himalayan kingdom of Bhutan, which since 1972 has assessed policies according to GNH (Gross National Happiness) rather than GDP (Gross Domestic Product).<sup>8</sup>

The view that happiness is the "greatest good" - and hence, that the happiness of the people should be the main aim government - has long been challenged. To the philosopher Isaiah Berlin, utilitarianism was part of the "Ionian fallacy" - the tendency to privilege one value above all others.<sup>9</sup> Nowhere is this fallacy better satirised than in Aldous Huxley's dystopian novel, *Brave New World*:

"But I don't want comfort" [said John the Savage] "I want God, I want poetry, I want real danger, I want freedom, I want goodness, I want sin."

"In fact", said Mustapha Mond [World Controller for Western Europe] "you're claiming the right to be unhappy" . . .

"Not to mention . . . the right to be tortured by unspeakable pains of every kind."

There was a long silence.

"I claim them all," said the savage at last.<sup>10</sup>

It may be that the world is "incorrigibly plural" and that the focus on happiness does not reflect the many possible good things in life that are valuable: freedom, justice, community and so on.

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<sup>5</sup> RH Tawney, *The Sickness of an Acquisitive Society*, (London: Fabian Society, 1920); Thorstein Veblen, *The Theory of the Leisure Class* (originally 1899), <http://www.gutenberg.org/etext/833>

<sup>6</sup> Easton, "Britain's happiness in decline"

<sup>7</sup> Richard Layard, *Happiness: Lessons from a New Science* (London: Penguin, 2005), 113

<sup>8</sup> Andrew C. Revkin, 'A New Measure of Well-Being From a Happy Little Kingdom', *The New York Times*, October 4, 2005, <http://www.gpiatlantic.org/conference/media/nyt1004.pdf>

<sup>9</sup> See, for example, Isaiah Berlin, "Does Political Theory Still Exist", in *The Proper Study of Mankind*, ed. Henry Hardy and Roger Hausheer (London: Pimlico, 1998), 78.

<sup>10</sup> Aldous Huxley, *Brave New World* (London: Chatto and Windus, 1932), 237

There are other questions and concerns with government's role in promoting happiness – many of them staples of undergraduate political philosophy courses: Can the happiness of the few be sacrificed for the much greater happiness of many? What obligation is owed to future generations or to the planet? Is raising average levels of happiness more important than ending specific cases of unhappiness? Can one category – happiness – cover all our feelings of pleasure, bliss, joy, awe or contentment? Is the same true for all the shades of unhappiness? Layard deals with many of these classical challenges to utilitarianism in his contribution to this book.

The authors in this new SMF collection go in search of the modern theoretical source of the debate by examining the contribution of earlier modern "Greats": J.S. Mill, Keynes, Crosland, Galbraith and Scitovsky. In an Afterword, Richard Layard brings this book up to date with a contemporary argument for a utilitarian approach to public policy. With one exception, all of the writers in this book and their subjects worked largely in Britain or the US, which goes some way to supporting Nietzsche's jibe about the grounded empiricism of Anglophone philosophy: "Mankind does not strive for happiness; only the Englishman does that."<sup>11</sup>

For Layard, happiness is an idea whose "time has come". The government's recent decision to launch "happiness lessons" seems to support Layard's claim, as does David Cameron's claim that "it's time we focused not just on GDP, but on GWB - general well-being".<sup>12</sup> As we struggle out of recession, the authors in this collection examine the values that should guide our way.

*Simon Griffiths is Senior Research Fellow at the Social Market Foundation and Lecturer in Politics at Goldsmiths, University of London. This is a revised version of the preface to *Well-being: How to lead the good life and what government should do about it*, co-edited by Simon Griffiths and Richard Reeves, published by SMF this week, and will be available at <http://www.smf.co.uk/well-being.html>*

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<sup>11</sup> Friedrich Nietzsche (trans. R.J. Hollingdale), *Twilight of the idols and The Anti-Christ* (London and New York: Penguin Books) 1990

<sup>12</sup> BBC Online, "Make People Happier, Says Cameron", 22 May 2006, [http://news.bbc.co.uk/1/hi/uk\\_politics/5003314.stm](http://news.bbc.co.uk/1/hi/uk_politics/5003314.stm)

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## From Feast to Famine: Reforming the NHS for an era of austerity

**David Furness and Barney Gough**

“Your proposition may be good, but let’s have one thing understood – whatever it is, I’m against it!”

Health policymakers can no longer afford to adhere to Groucho Marx’s aphorism if the core values of the health service are to survive the next ten years. Britain is in the midst of a severe economic recession which has ripped the deepest peacetime hole in the public finances in this country’s history. A huge and sustained public spending squeeze is inevitable and, despite the political rhetoric, it will hit the NHS hard over the coming decade. With demographic changes set to stretch health services as never before, the odds on the NHS seeing its 70<sup>th</sup> birthday in rude health are lengthening. If we want to maintain an equitable and high quality health service, it is time to challenge a long-held political taboo and consider the case for user charges in the health service.

Health policymakers are facing a big problem, even if the politicians don’t want to talk about it. With a huge spending squeeze on its way, how can we maintain a high quality health service over the next decade? There are only three possible answers to this question: raise more money, use existing resources better, or somehow slow the inexorable growth in healthcare demand.

The first option is clearly off the table. Extra money for healthcare is not going to appear. There is little public appetite for further tax rises, and any new tax revenue, or savings elsewhere, will be devoted to reducing the enormous fiscal deficit that threatens the UK’s creditworthiness.

So can the existing budget instead be spent more effectively? The answer is yes, up to a point. This should be a central priority for the NHS, and there is substantial scope for efficiency savings. This week’s report from the Social Market Foundation will set out how the health service can save money by becoming more efficient, more responsive and more locally accountable. But such economies will not be sufficient to meet this gargantuan challenge.

In addition, we must now start a debate about who gets what from the NHS. With the spending tap closed, rationing of healthcare services in some form is unavoidable. This fact must be confronted strategically, or rationing by the backdoor threatens to undermine that most important NHS value, fairness. If deliberate decisions on how to limit demand for NHS services are not taken, we will inevitably see a return to the days of limiting patients’ demand by waiting list, crumbling infrastructure and a poor quality service.

Ultimately these approaches to limiting demand hit the poor and the sick the hardest. Avoiding this outcome must be the top priority. Over time the insidious effects of a return to 'stealth' rationing would destroy the NHS. The rich would opt to pay for private treatment rather than NHS care, leaving public provision as little more than a second-class service for the poor, who cannot afford to pay their way out.

But how can healthcare be rationed fairly? To achieve this we need a mechanism to encourage people to ration themselves. Limited charges for those who can afford to pay must be a key part of the demand management toolkit. A charge of £20 should be introduced for better-off people to visit the GP. This would dovetail with strategies to encourage people to look after their own health, or to access care initially in cheaper settings such as local pharmacies. Such a charge, capped at around £100 per annum, would not raise revenue for the NHS, nor would that be its aim. But it should be sufficient to encourage people to think more carefully about how to manage their health needs cost-effectively. Evidence suggests that charges do not lead to worse health outcomes for those asked to pay. Except among the poor.

It is therefore essential that those who cannot afford to pay are not put off from going to see their GP because of the charge. Exemptions to charges should be linked to receipt of other state benefits, particularly tax credits, as happens across many other government services. This would also allow a rebalancing of the burden of prescription charges, where currently rich retirees are exempt, while the working poor are made to pay. It cannot be fair that Fred Goodwin's prescriptions are paid for by taxpayers, while those on the minimum wage must pay for their own basic drugs? The tax credit system offers a simple mechanism to ensure that charging is fair.

Constraining demand will help to mitigate the impact of the spending squeeze, but an open and honest debate is needed about how to do it. Notional charging offers the tantalising prospect of limiting unnecessary expenditure on health without adversely affecting health outcomes. While it may be unpalatable, a limited and well-designed charging structure is part of the progressive solution that will safeguard the NHS for everyone. But this will require those of Groucho Marx's persuasion to recognise that 'free at the point of use', is not the same as 'fair'.

*This article was originally produced in the Sunday Times on 12 July 2009*

*This report was launched in July 2009 and is available on our website at [www.smf.co.uk/fromfeasttofamime](http://www.smf.co.uk/fromfeasttofamime)*

*This project has been made possible by the kind support of BUPA, Pfizer, Standard Life Healthcare and NHS Connecting for Health.*

## Forthcoming Events

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SMF Keynote in conjunction with Centre Forum  
Liberal Democrat Party Conference

### **Britain's Economic Future: Where now for the state and the market?**

Date: Tuesday 22<sup>nd</sup> September 2009, 18.30 – 19.30  
Venue: Dorchester 2, Marriott Highcliff Hotel, Bournemouth

Chair: Ian Mulheirn, SMF

Speakers: Vince Cable MP  
Will Hutton (tbc)  
Giles Wilkes, Centre Forum

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SMF Keynote in conjunction with Progress  
Labour Party Conference

### **Britain's Economic Future: Where now for the state and the market?**

Date: Wednesday 30<sup>th</sup> September 2009, 12.45-13.45  
Venue: West Pier Suite, Umi Hotel, Brighton

Chair: Evan Davis (tbc)

Speakers: Lord Peter Mandelson, Secretary of State for Business, Innovation and Skills  
Ian Mulheirn, SMF

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### SMF Keynote Conservative Party Conference **Finding the Path to Economic Recovery**

Date: Monday 5<sup>th</sup> October 2009, 19.00-20.00  
Venue: Stanley/Livingstone Room, Radisson Edwardian Hotel, Manchester

Chair: Ian Mulheirn, SMF

Speakers: Rt Hon Oliver Letwin MP  
Rt Hon Theresa May MP  
Brendan Barber, TUC

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## Could Do Better?

### Options for reform after the UK's fiscal crisis

**James Lloyd**



Borrowing from US political rhetoric, “never waste a crisis” seems to be a phrase policymakers have taken to repeating during the current economic malaise. Although political debate on the topic remains suspended for the time being, the UK’s fiscal situation is potentially one such crisis that merits reflection on options for reform to fiscal policymaking.

As widely acknowledged, the 2009 Budget revealed the UK to be facing its largest fiscal deficit since the Second World War. Economic historians will argue for decades about how the UK arrived in this predicament. Whether it has resulted entirely from the ‘exogenous shock’ of the credit crunch and ensuing recession, or reflects a choice to run up a deficit in what were very clearly ‘sunny times’ prior to 2007, the situation now confronted suggests, at the very least, that the way fiscal policy is made in the UK deserves review.

Like most countries, fiscal policymaking in the UK is highly discretionary and highly centralised: all the components of fiscal policymaking reside inside HM Treasury. Despite the ‘golden’ and ‘sustainable investment’ rules that comprise the ‘fiscal framework’, these are really just statements of intent by the Government, lacking any coercive power or formal external evaluation. Contrast this with the German government’s recently adopted legislation to impose a legal ceiling on the public deficit of 0.35% of GDP from 2016: a genuine ‘fiscal rule’ despite the potential get-outs that future German governments may be able to use to sidestep the law.

So are there alternative arrangements that the UK could adopt for making fiscal policy? In fact, there are plenty of options, and they are far more substantial than a simple refinement of the ‘fiscal framework’. Given the current public spending crisis, it is worth dusting off some of the ideas that have long animated researchers on the topic.

Various elements of fiscal policymaking could be hived off to an independent fiscal authority at arm’s length from the government. In particular, an independent body could carry out official fiscal projections for policymaking, as is currently the case in Belgium and the Netherlands. Certainly, transferring official projections out of the Treasury would put an end to the endless sniping at perceived bias that accompanies current HMT fiscal forecasts. The quality of political debate might also be improved if an independent fiscal authority was obliged to carry out alternative projections for opposition parties.

But why stop there? An independent fiscal authority could be given formal oversight powers for whether the government was meeting its fiscal rules. It’s unclear what sort of powers

could go with such a responsibility beyond formally slapping the wrists of politicians. And as the current crisis has shown, rigorously keeping to fiscal rules is not always the best idea, and can risk exacerbating a downturn if public spending cuts are enforced. Nevertheless, the option of beefing up oversight of the fiscal framework is there.

However, what has long fascinated academic observers of fiscal policy is whether decision-making would be improved if an independent fiscal authority were responsible for setting policy, perhaps after the government of the day had dictated a broad set of principles to follow. The parallel in the UK is obviously the Bank of England's power to set monetary policy.

The idea of an independent statutory body making fiscal policy may seem outlandish, and it is certainly difficult to see it as anything except anti-democratic. But consider the political pain that will be exacted over the coming decade as balance is brought back to the public finances. Would it not be so much easier for the politicians if there were an austere fiscal authority to bear the brunt of public anger for all the nasty public spending cuts now on the horizon?

For the time being, it remains speculation whether the next government, with a fresh political mandate, may choose to have an 'MPC-moment', handing some element of fiscal policymaking to an external body, just as the new Labour government famously granted control of interest rates to the Bank of England in 1997. If it demonstrated a commitment to bring public spending back under control, this would certainly win favour with the bond markets and potentially help to lower borrowing costs for the UK. Indeed, if things get really bad, a future government may be forced to roll out one of the options outlined above just to convince bond investors that a route-map back to sounder public finances in the UK will be followed.

*This article draws upon a forthcoming SMF report on fiscal policymaking to be published during summer 2009. For more information please contact [jlloyd@smf.co.uk](mailto:jlloyd@smf.co.uk)*

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