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Social Market Foundation

AXING & TAXING

How to cut the deficit

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FIRST PUBLISHED BY
The Social Market Foundation, June 2010

11 Tufton Street, London SW1P 3QB

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ACKNOWLEDGEMENTS

The authors would like to thank James Lloyd, Rena Menne and Richard Kelly for their input to this report. We would also like to thank other supporters of the SMF for their comments and suggestions throughout.

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EXECUTIVE SUMMARY

The UK's debt crisis is mounting. This year's borrowing is likely to be bigger even than last year's record £156bn deficit. With bond markets getting jittery about sovereign debt, the coalition has one shot at cutting the unprecedented deficit. The Government's emergency budget and spending review in the coming months must not shrink from the challenge. If it fails to take decisive measures, the cost of borrowing will balloon, and ultimately much more draconian cuts and taxes will be required. It's time to act.

The new Office for Budget Responsibility (OBR) has estimated that the structural gap between what the Government raises in tax and what it spends is around 8% of GDP for 2010-11, revised slightly upwards from 7.3% at the March budget. This corresponds to a total structural deficit of around £110bn. During the election campaign, each of the main parties committed to closing the filling the element of the structural deficit that resulted from the recession – a figure which the Treasury estimated to be around £69bn. The IFS calculates that the OBR's analysis has revised up that permanent impact of the recession on the public finances to some £74bn.[1] This paper, an updated version of the one we published on 11th June, includes the extra spending and tax measures that will be required to make up the £74bn needed in the light of the OBR's analysis.

There have recently been many warm words from politicians about sharing the pain of cuts. But the harsh reality is that some will be hit much harder than others. The debate about exactly how the pain will be distributed should start now.

In its pre-election plans, the Conservative party stated its intention to fill the fiscal hole with a mixture of 80% spending cuts and 20% tax rises, implying more than £55bn of spending cuts to come. But cuts on this scale have the potential to cause serious industrial or even civil unrest, particularly since the coalition has also indicated that it intends to ring-fence huge areas of public spending (including healthcare, child benefit payments). Instead, controlling the deficit must be a matter of pragmatism: the markets must be confident that the ultimate plan will be acceptable to the public. This paper proposes a credible package that splits the burden roughly 60:40 between spending cuts and tax rises. Even going this far will involve many painful spending cuts, and the unaffordable ring-fencing of the NHS budget in particular must be dropped if cuts elsewhere are to be bearable.

This report argues that the programme of cuts and tax rises to come should be based on four firmly social market principles:

[1] Institute for Fiscal Studies, Press release , 14 June, 2010.

- Public spending that supports **opportunity and economic growth should be protected**. In practical terms this means maintaining investment in the UK's education system, skills base and physical infrastructure – the drivers of social mobility and economic growth.
- The poorest and most **vulnerable should be protected** as far as possible. Tough decisions about benefit spending are unavoidable, in particular for the middle classes. Progressive universalism is no longer affordable if cuts are to be remotely progressive, as the Government has claimed they will be.
- Where taxes must rise, the Government should take the opportunity to **simplify the tax regime**. A less distortionary tax system is desirable, even if it cannot offer a lighter tax burden.
- Bold and radical **market-based public service reforms** to achieve the necessary savings should be enacted, in preference to 'salami slicing'. These should include a new role for the private sector in offender management and new user charges in healthcare.

The SMF spending review proposes the following spending cuts, among others.

- **A 10% pay cut and five year freeze for GPs and Consultants**, whose pay has exploded in recent years, saving £1.3bn.
- The introduction of **£20 user charges for GP visits** to manage demand on the overstretched NHS, saving some £1.1bn in GP time alone.
- Introducing **payment by results in offender management** saving the Ministry of Justice around £1bn.
- **Halving the ISA allowances**, saving around £500m per year by 2014-15.
- **Ending the self-assessment of Disability Living Allowance** and making eligibility the same as for other disability benefits, saving £3bn per year.
- Introducing **age-related tax credits and increasing the taper rate of the Child Tax Credit** so that high earners get nothing, saving 3.5bn.
- **Cutting Child Benefit for the better-off**, saving £5.3bn.
- **Ending the wasteful Train to gain programme,** saving some £700m per year.

Proposed measures to simplify the tax system as well as raising revenue include the following.

- **Freezing the personal allowance for retirees** to bring it closer into line with that for working age people, netting £1bn by 2015-16.
- Ending the expensive and regressive **VAT exemption on books and newspapers**, bringing in £1.6bn.
- Raising **CGT to 40%** for non-business assets, applying indexation relief to ensure that only real gains are taxed, bringing in around £2bn.
- A **levy on short term wholesale bank liabilities** of the sort that contributed to the financial crises, raising £2.7bn.

But alongside the tax and spending measures, this paper proposes an option to boost UK productivity levels by removing huge road congestion costs faced by British businesses.

- **Reducing congestion** through the introduction of road charges by giving away shares in the road network to every citizen. This is estimated to boost tax revenues by around £5bn per year.

The task ahead is daunting. But principled decisions taken now will lead to a bright future rather than national decline precipitated by cuts and taxes in all the wrong places.

Spending cuts

Department	Measure	Saving
Ministry of Justice	Outcome-based commissioning for sub-12 month prisoners	£1bn
Department of Health	GP charging to manage demand	£1.1bn
Department of Health	10% pay cut and five-year freeze for GPs and consultants	£1.3bn by 2016
Department of Health	Abolish Strategic Health Authorities	£1bn
HM Treasury	3 year public sector pay freeze	£7.8bn
Department for Work and Pensions	Housing Benefit reform. Widen Broad Market Rental Areas and lower reference rent proportion	£700m
HM Treasury	Raise all public sector pension contributions by 1%	£1.5bn
HM Revenue and Customs	Increase tax credits1st taper rate by 6ppts	£1.9bn
	Introduce age-related Child Tax Credit	£1.5bn by 2016
	Cut Child Benefit for those not on tax credits	£5.3bn
	Taper the family element of tax credits will other tax credits	£0.9bn
Devolved administrations	Freeze grant to Scotland, raise grant to Wales, to bring spending per capita into line with England	£3.5bn
Department for Work and Pensions	Cut Winter Fuel Payments to better-off pensioners, giving the higher rate to pensioners on pension credit. Reform free TV licenses in the same way.	£1.7bn
Department for Work and Pensions	End self-assessment and assess Disability Living Allowance claims in the same way as Employment and Support Allowance. Re-assess all existing working	£3bn

	age claimants.	
Department for Transport	End free bus passes for the over-60s	£1bn
HM revenue and Customs	Halve ISA limits. Reduce stocks ISA limit to £5,000 per year and cash ISA limit to £2,500	£0.5bn
Business, Innovation and Skills	Axe the Train to Gain programme, recycling part of the savings into more effective skills provision	£0.7bn
Business, Innovation and Skills	Raise student loan interest rate to government cost of borrowing for higher-paid graduates	£0.4bn
Ministry of Defence	Reduce frictional procurement costs	£0.8bn
Other recently announced cuts	Child Trust Fund and other efficiencies	£6.2bn
Total		**£41.8bn**

Tax rises

Tax	Measure	Revenue
VAT	Up 1.5 pence	£7.5bn
VAT	Remove books, magazines zero-rate	£1.6bn
CGT	Raise CGT to 40% for non-business assets but add indexation relief	£2bn
Income tax	Freeze higher PA for older people	£1bn
Bank liabilities levy	Levy on short term wholesale bank liabilities	£2.7bn
Taxes already in place	Measures already in train – excl. £6bn NICS change	£13bn
Total		**£27.8bn**

Promoting growth

Productivity	Measure	Tax revenue
Transport infrastructure	Congestion charging plus voucher mutualisation, removing two-thirds of the UK's £20bn congestion costs	£5bn
Total		**£5bn**

INTRODUCTION: THE SIZE OF THE PROBLEM

Despite the recent welcome news that borrowing for 2009-10 was in fact £156bn, some £22bn less than was feared a few months ago, the UK's fiscal situation remains the worst peacetime deficit in this country's history. While much of that deficit will shrink as the economy recovers, the March Budget implied that the Treasury believes the recession caused a £69bn permanent hole in the public finances. On 14 June, the Office for Budget Responsibility revised that estimate upwards, to some £74bn.[2]

The policy decisions required to close the bulk of the structural deficit over the next six years are the focus of this paper. With an emergency budget planned for 22 June and a spending review to set departmental spending due in the autumn, the next few months will see the new coalition government setting out its plans for spending cuts and tax increases. While it would be wise to undertake the fiscal consolidation over a number of years, it will be necessary for the new government to set out a comprehensive plan for how the job will be done in short order. Developments in Europe have demonstrated just how investors can take flight from sovereign debt where the credibility of the government is weak. For the UK government to win credibility with investors, it must take the political pain now, and hold both the country and the coalition together thereafter.

This will not be easy, but there are many different ways to approach the problem, some of which are more viable than others. This paper illustrates a package of cuts and tax rises that we believe is needed.

At the time of the election, some £19bn of tax increases were already planned by the outgoing government. The new coalition has made clear its intention to reverse £6bn of National Insurance increases planned by the government, hence we can say with certainty that £13bn of the £74bn hole will be filled on current plans. The starting point for this paper is to outline a package of measures to make up the balance of £61bn annually by 2015-16. Some spending plans were outlined by the new administration in the run-up to the election, such as a one-year public sector pay freeze. But, for simplicity, this paper includes only the £6.2bn of spending reduction plans announced by the Chancellor and Chief Secretary on 24 May.

TAX INCREASES OR SPENDING CUTS?

In their pre-election spending plans all three main parties set out the proportions in which tax rises and spending cuts would contribute to filling the hole. Labour plans argued for one-third tax rises and

[2] Ibid.

two-thirds spending cuts; the Conservatives proposed one-fifth tax rises and four-fifths spending cuts; and the Liberal Democrats proposed three-tenths tax and seven-tenths spending.

However, none of these plans looks credible. Whatever the ultimate form of the repair work to the public finances, the over-riding necessity is not that it conforms to any one ideological stance about the level of taxation, but that it is sufficiently politically viable to command the confidence of investors in government debt. Clearly £74bn of tax rises would be politically untenable, as would completing the entire job through spending cuts alone. That plans for deficit reduction convince the bond markets responsible for pricing Britain's debt should be the foremost consideration in deciding the balance of tax rises and spending cuts.

Past precedent suggests that it is very likely that tax rises will have to share the burden with spending cuts more evenly than politicians will currently admit. In the fiscal consolidation undertaken in the early 1990s, the Government in fact allowed tax rises to do more of the work in plugging the gap.[3]

For these reasons, it seems unlikely and indeed unwise for the Conservatives to implement their pre-election tax and spend plans, or the Liberal Democrats theirs. Taxation will have to rise substantially. In the light of the disquiet likely to be caused by the kind of spending cuts that must now be considered, this paper argues that tax increases should make up around 37% of the structural deficit. Spending cuts then comprise around 56% of the gap, with productivity-boosting measures enhancing economic growth and doing the remaining 7% of the work by boosting tax revenue.

PRINCIPLES FOR WHAT TO CUT – A SOCIAL MARKET APPROACH

What are the principles under which these decisions should be taken? The Government should aim to take measures that are seen to be fair and socially just, but that do not hobble wealth creators and the market as we look to return to strong and sustainable economic growth. There is only weak evidence on how the level of taxation in an economy affects growth, providing little guidance for policymakers. However, economic growth models suggest that how tax revenues are used is important in stimulating growth: spending cuts therefore offer a chance to deploy public spending in ways which maximise opportunity and economic growth.

What does a social market approach mean in practice?

3 Institute for Fiscal Studies, *Filling the Hole: How Do the Three Main Parties Plan to Repair the Public Finances* (London: IFS, 2010).

This paper proposes that cuts and tax rises should conform to four broad social market guidelines: Investing in the future, protecting the most vulnerable, simplifying the tax regime and introducing market-based reforms in public services.

- Public spending that supports **opportunity and economic growth should be protected**. In practical terms this means maintaining investment in the UK's education system, skills base and physical infrastructure – the drivers of social mobility and economic growth. The SMF spending review protects from cuts education and skills training (except where there is clear evidence of ineffective spending), as well as necessary infrastructure investment such as improvement of our roads and transport systems.
- The poorest and most **vulnerable should be protected** as far as possible. Tough decisions about benefit spending are unavoidable, in particular for the middle classes. Progressive universalism is no longer affordable if cuts are to be remotely progressive. For this reason, the SMF plan argues for Winter Fuel Payments and Child Benefit to be reformed to take them away from better-off recipients.
- Where taxes must rise, the Government should take the opportunity to **simplify the tax regime**. There are many exemptions and special rules in the tax system that have questionable economic justification and are in many cases regressive. These should go. A less distortionary tax system is desirable, even if it cannot offer a lighter tax burden.
- Bold and radical **market-based public service reforms** to achieve the necessary savings should be enacted, in preference to 'salami slicing'. These should include a new role for the private sector in offender management and new user charges in healthcare.

The task ahead is daunting. But principled decisions taken now will lead to a bright future not national decline precipitated by cuts and taxes in all the wrong places.

PART ONE: SPENDING CUTS

Department	HMRC
Measure	Child Benefit and Tax Credits targeting
Annual saving	£9.6bn

Payments to families cannot go untouched

Tax credits and Child benefit payments to families represent some £35bn of Government spending each year. This large amount of government spending cannot go untouched in the cuts to come. The priority in reforming the system must be to protect the very poorest families from the worst cuts, and improve work incentives among those parents most able to move into employment. Additionally the focus should be on encouraging people to move into work before worrying about progressing within it. There is often a tension between these two goals and when money is tight, policymakers are forced to choose between them.

Protecting the poorest but ending universal entitlements

- Eligibility for the family element of tax credits should be removed from all families in the upper half of the income distribution. Tapering the family element of the Child Tax Credits (CTC) with the rest of CTC would save £0.9bn per year. Over 1.6 million families in the upper half of the income distribution would lose up to £545 per year from this change.[4]
- Secondly, Child Benefit entitlement should be means tested and tapered away as part of the tax credits system. Again, this would remove the support from most families in the top half of the income distribution, saving around £5.3bn per year.

Boosting work incentives

Currently, the child element of CTC is worth the same amount of money for children of all ages, with the exception of an additional payment made when a child is under one. However, in order to strengthen work incentives, the CTC child element should be lowered for older children.

- CTC for children over five should be frozen for five years. CTC for younger children would continue to rise in line with prices. This would have the effect of encouraging parents to seek work once their child is at school –parents with school age children are roughly twice as responsive to changes in financial work incentives as parents of younger children - while protecting the financial

4 Child and Working Tax Credit Statistics, HMRC (April 2010).

support available to families with the youngest children. This measure would save around £1½bn per year by 2015-16.[5]

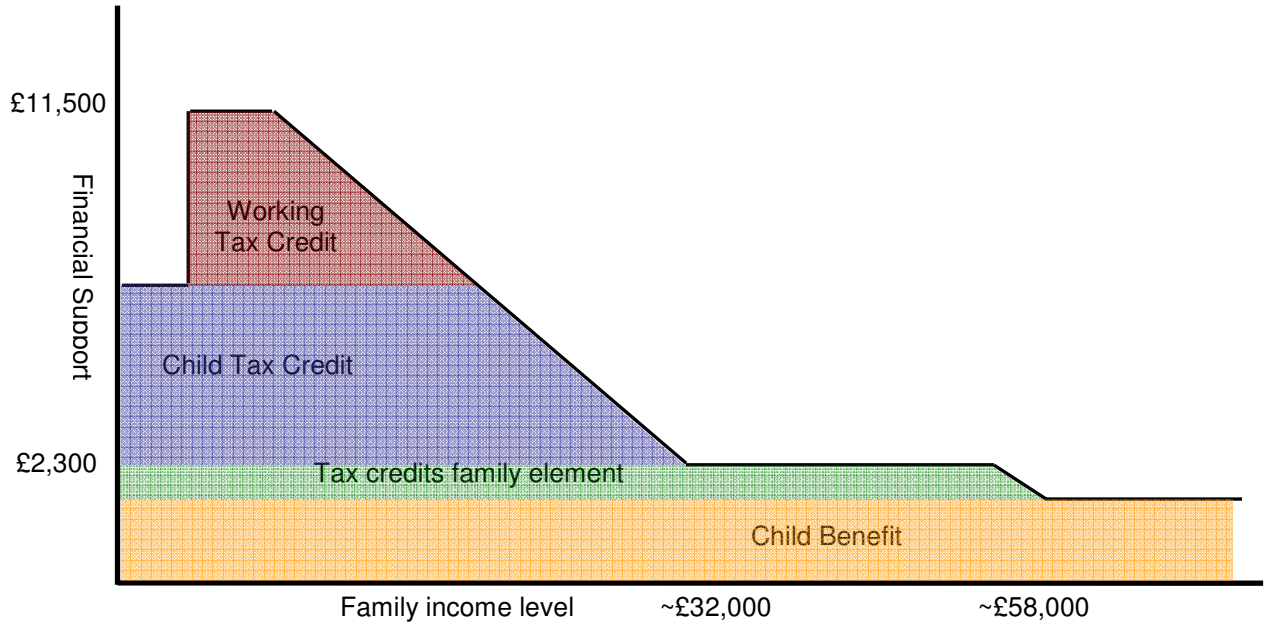
Prioritising incentives to work over incentives to progress

It is necessary to reconsider the trade-off between incentives to move into work and incentives to progress once there. The former must take priority over the coming years, allowing the government to save money by withdrawing tax credits more quickly as income rises.

- Increasing the taper rate of tax credits from 39% to 45% the government would save around £1.9bn per year.[6]

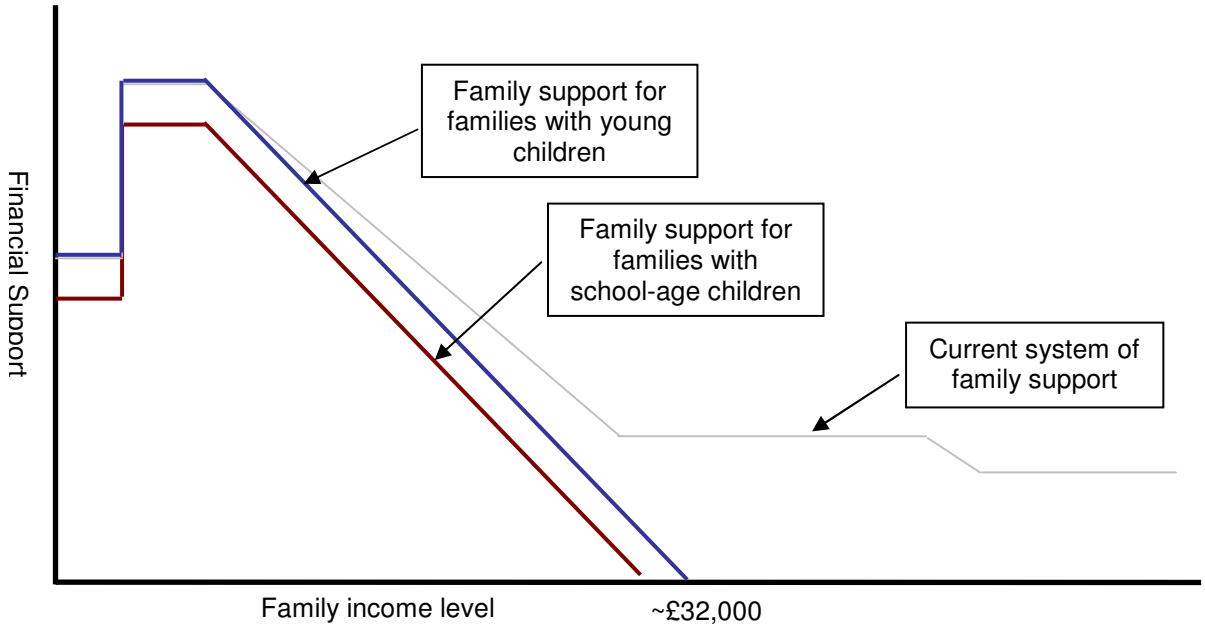
The diagrams below show how the existing financial support for a family with two children is structured as the family income level rises. The second chart shows how these proposals would change the available support – taking the most from those families higher up the income scale, and none from the poorest families with young children.

Current family support system



5 Ibid.
6 HM Treasury, *Building Britain's Long-Term Future: Fairness and Prosperity for Families* (London: HMSO, 2007).

Proposed new structure



Department	Ministry of Justice
Measure	Outcome-based commissioning to reduce re-offending[7]
Saving	£1bn per year by 2015

The costs of crime are driven by high re-offending rates

Crime costs the UK some £72bn each year, with almost a third of that sum falling to the taxpayer. And failure to crack re-offending among prisoners serving short-term sentences is a key driver of these costs. Offenders with prison terms of under a year comprise the large majority of those handed sentences each year, and almost three quarters of them are back behind bars within two years of release. Each time they return to prison, the cost to the criminal justice system is around £60,000 per person. Among this group 58% have ten or more previous convictions. And criminal justice system and incarceration costs for this group are around £3½bn each year.

Move to a model of payment by results to reduce recidivism

The SMF's recent publication *Prison Break: tackling recidivism, reducing costs* proposed moving to a model of payment by results for private and third sector organizations. Two key changes would be necessary to make the new system work:

- Split the short- and long-term prison populations to enable more accountable rehabilitation of persistent offenders on short-term sentences.
- Contract out end-to-end offender management for all sub-12-monthoffenders to regional providers paid by results to reduce recidivism.

SMF analysis suggests that by bringing bear the best rehabilitation techniques, contractors paid by their success could reduce recidivism rates by some 20 percentage points, saving the exchequer around £1bn per year.

7 For all analysis in this section see I. Mulheirn, B. Gough and V. Menne, *Prison Break: Tackling Recidivism, Reducing Costs* (London: Social Market Foundation, 2010).

Department	HM Treasury
Measure	Three-year public sector pay freeze
Annual saving	£7.8bn by 2014-15

Long pay freeze doesn't mean no pay rises for public sector workers

The public sector payroll accounted for £174bn of public spending in 2008 – just short of one third of all public expenditure. There is a perception that public sector workers are better paid than their counterparts in the private sector. But wage increases have broadly been in line with those of the private sector since 1997. IFS analysis – mainly using data from before the recession - suggests that, after controlling for the education and experience of employees, public sector workers do enjoy a small pay premium (2% for men and 7% for women) in terms of hourly wages.[8] They also receive more generous pension rights and arguably more secure employment.

With average earnings growth in the private sector in the three months to March 2010 was running at 1.2% on a year earlier, compared to 4.0% in the public sector, it seems clear that this pay differential has widened still further.[9] It is therefore not only fair but inevitable that public sector pay should make a substantial contribution to deficit reduction.

Since reductions in public sector pay also lead to a reduction in the income tax take and national insurance contributions of those workers, a £1 cut does not create a £1 fall in the budget deficit, but rather a fall of around 73p. For this reason freezing the public sector pay level for three years could be expected to save £7.8bn per year by 2014-15.

Importantly, the freezing of the overall pay envelope need not imply that individual civil servants' pay remains static for three years. The progression and seniority elements of pay would be unaffected since the retirement of older workers frees up resources for others. Marginal reductions in headcount over the period should be manageable through natural wastage freeing up resources to increase the pay of what will have to be more productive public sector employees. For these reasons there is little reason why low-paid public sector workers in particular should not continue to see pay growth over the period.

8 Institute for Fiscal Studies, *IFS Green Budget*, by R. Chote, C. Emmerson and J. Shaw (London: IFS, 2010).
9 Office for National Statistics, Average Weekly Earnings, http://www.statistics.gov.uk/cci/nugget.asp?id=10.

Department	HM Treasury
Measure	Public sector pension contributions up 1%
Annual saving	£1.5bn

Public sector pension contributions must rise

Public sector pensions are the envy of all private sector workers, with analysts calculating that public sector employees have accumulated more than twice the level of pension benefits in their generous final salary pension schemes than have private sector employees.[10] The value of the public sector pensions liability has been estimated by the CBI to be some £1tr.[11] This situation is no longer sustainable.

It is time that public sector employees were asked to contribute more towards the funding of this growing liability. All public sector employees should therefore be asked to increase their contributions by 1% of their gross wage. Based on a public sector payroll of £174bn per year, this would bring in around £1.5bn. While it would not solve the problem of unfunded liabilities, raising contributions would make the disparity with private sector benefits slightly less unfair.

[10] J. Kirkup, "Public sector staff 'should lose final salary pensions'", The Daily Telegraph, September 4, 2010
[11] CBI, *Getting a Grip*, (London, CBI 2010)

Department	Department for Work and Pensions
Measure	Housing Benefit caps reduced
Annual saving	£700m

Reference rents for the Local Housing Allowance should be tightened

Housing Benefit for claimants in private rented accommodation comes in the form of the Local Housing Allowance. The allowance is set with reference to the median rental value of appropriately sized houses within Broad Market Rental Areas, of which there are typically three in each borough.

1.4 million families claiming Housing Benefits live in private rented accommodation, with the average award in the region of £110 per week.[12] This compares to an average HB award of around £85 per week for those families in social housing. The total cost of HB for families in the private rented sector is therefore around £8bn per year.

However, the LHA is both expensive - leading to press stories about thousands of families claiming in excess of £26,000 per year in Housing Benefit[13] - and bad for its recipients. It is unclear why workless families should be entitled to median levels of rent, when low-income working families are confined to cheaper accommodation. And once in median cost housing, workless families with low skills face a benefit trap. Moving into low-paid employment will offer little improvement in take-home pay once the claimant's relatively high LHA award has been withdrawn.

The LHA should therefore be tightened in two ways.

- First, the Broad Market Rental Areas should be widened, to encompass entire boroughs and therefore more affordable housing.
- Second, the reference rent should be taken as the 40th percentile of comparable private rents in the area. This would make the move into work much more worthwhile for claimants.

If these measures were to cut the average award by £10 per week, the exchequer would save around £700m per year.

[12] http://research.dwp.gov.uk/asd/hbctb.asp.
[13] http://www.dailymail.co.uk/news/article-1282969/Housing-benefit-families-pocket-26-000-plus-excessive-claims-continue-rise.html?ito=feeds-newsxml.

Department	Department for Work and Pensions
Measure	Reform the winter fuel payment and TV licenses for the over 75s
Annual saving	£1.7bn

Government should think again about reforming the winter fuel giveaway

The annual winter fuel payment is made to pensioners to help them afford to heat their homes. The basic payment currently has two rates: £300 for those over 80 and £200 for those over 60. The March budget allocated another £100 to the older group and £50 to the younger group for this winter only. The core cost of the policy is around £2.1bn for 2010-11 with the additional giveaway costing a further £600m.[14][15] Some nine million pensioners benefit from the money.

The coalition government has ruled out cutting the winter fuel allowance, but this is a mistake. While protecting the elderly from the cost of rising energy prices is admirable in principle, it is no longer defensible for the money to go to well-off pensioners, who are by far the wealthiest age group in society. Nor is it clear why older pensioners should receive more money, rather than poorer younger pensioners. For these reasons, eligibility for the higher-level payment should be based on receipt of pension credit. With 3.35 million pensioners and pensioner couples receiving pension credit in 2010, this change would safeguard the poorest and most vulnerable pensioners at a cost of around £900m per year. The overall package would therefore save around £1.3bn per year.

Free TV licenses must go, with the poorest compensated

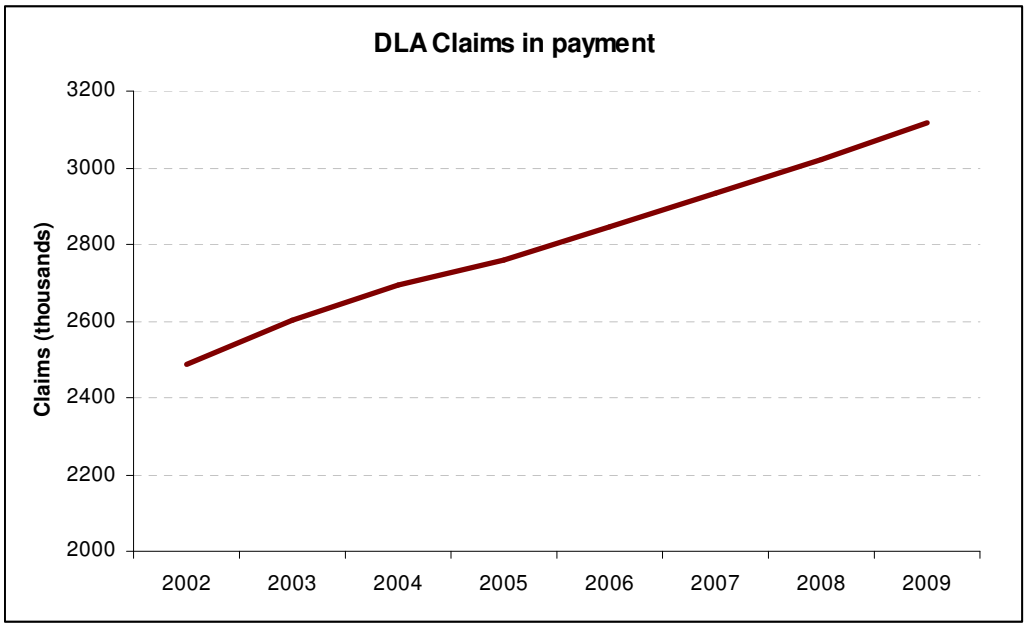
Free TV licenses for pensioners over 75 cost the taxpayer around £600m per year.[16] These are no longer affordable as a universal benefit and should be abolished, with the value to less well-off pensioners recycled through the Pension Credit. With some 35% of over 75s claiming Pension Credit, the saving to government would be around £400m per year.

14 Department for Work and Pensions, benefit expenditure tables, http://research.dwp.gov.uk/asd/asd4/medium_term.asp.
15 HM Treasury, *Securing the Recovery* (London: HMSO, 2010).
16 Department for Work and Pensions, http://research.dwp.gov.uk/asd/asd4/medium_term.asp0.

Department	Department for Work and Pensions
Measure	Assessing Disability Living Allowance eligibility more rigorously
Annual saving	£3bn

Applying consistent eligibility rules for disability benefits

Disability Living Allowance (DLA) is a universal benefit paid to people who are physically or mentally ill, and who have restricted mobility or need someone to help look after them. This is an important element of the support available to disabled people, take-up of which has been growing rapidly since its introduction in 1992, with the caseload increasing by 50% in the past decade. At the end of last year over 3.1 million people were claiming an average of £70.51 per week. DLA now costs around £11.4bn per year and rising.[17]



However, the rules for claiming the benefit are much more lax than those that apply to the other major disability benefit, the Employment and Support Allowance (ESA). Most claims for DLA are self-assessed and do not entail a medical assessment, and around half of claims are approved.[18] Moreover

17 DWP tabulation tool.
18 DWP, Disability Living Allowance Quarterly Statistics, February 2005.

70% of the stock of claimants have indefinite DLA awards,[19] which explains why some 87% of claims have been in payment for over two years.[20]

By contrast, claims for the ESA – the out-of-work benefit for people who are sick or disabled – are subject to a medical assessment, and around 68% of claimants see their claims refused.[21] While these benefits serve different purposes, their client group is very similar, with around 74% of working age DLA recipients also receiving Incapacity Benefit.[22] If it is reasonable to medically assess claims for out-of-work disability benefits, it is hard to justify why the same should not be true of DLA. Therefore, in order to ensure that the people who really need DLA receive their money, it will be necessary to tighten up the eligibility criteria for DLA to bring it into line with that of ESA.

New claimants of DLA should be assessed in the same way as ESA claimants, rather than through a self-assessment form. This might be expected to reduce the rate of successful claims from around 50% to the ESA level of 32%, slowing the rate of growth in claimant numbers. In addition, the existing caseload of 2.9 million claimants under pension age should, as with ESA, be reassessed to ensure that support is going to those who need it most. Applying the ESA eligibility rates to existing claimants would reduce the number entitled to around 1.9 million, potentially saving around £3bn per year.

19 Department for Work and Pensions, *DLA Claimants - A New Assessment: The Characteristics and Aspirations of the Incapacity Benefit Claimants Who Receive Disability Living Allowance*, by C. Beatty, S. Fothtergill and D. Platts-Fowler (London: HMSO, 2009).
20 DWP tabulation tool.
21 Department for Work and Pensions, *Employment and Support Allowance: Work Capability Assessments Official Statistics* (London: HMSO, 2010).)
22 Department for Work and Pensions, *DLA Claimants - A New Assessment: The Characteristics and Aspirations of the Incapacity Benefit Claimants Who Receive Disability Living Allowance*.

Department	Department for Transport
Measure	Abolish concessionary travel subsidy
Annual saving	£1bn

Free transport for the over 60s must go

Since 2008, the exchequer has funded free bus travel for those over the women's pension age. This perk is now estimated to cost around £1bn per year.[23] As spending that was signed off at the height of the boom, it is no longer affordable and the policy should now be scrapped.

23 Department for Transport, http://www.dft.gov.uk/consultations/closed/specialgrantfunding/consultationqa.pdf.

Department	Department of Health
Measure	Charging for primary care appointments
Annual saving	£1.1bn

The NHS has a bad track record in efficiency savings and demand management

The NHS has a poor track record in efficiency. Despite record increases in funding ONS analysis reveals that productivity in the NHS has actually fallen by 3% since 2001. This presents a stiff challenge to a service that will need to find efficiency savings of more than £20bn, according to the new Health Secretary Andrew Lansley MP.

Part of the reason for inefficiency in the NHS is that patients receive unnecessary care, or care delivered in expensive and inappropriate settings. Powerful local hospitals can distort clinical priorities and make it difficult for commissioners to reconfigure services and treatment paths to avoid unnecessary admissions. An Audit Commission report found that "PCTs made little or no inroad in 2008-09 to transferring care from hospital or in dampening demand"[24].

Demand management should be a matter for patients

The best way to prevent unnecessary care is to incentivise patients only to go to the doctor when they really need to. But this should not undermine the principle that care is not determined by one's ability to pay.

- NHS charges should be overhauled and means tested so that poor people do not pay anything at all. But wealthier people (those not receiving tax credits or benefits) should pay a £20 charge to visit the GP. This would not be intended to raise revenue but to manage demand for health services.

How much can be saved?

In 2004 Germany introduced a €10 charge for the first visit to a doctor in each quarter. Like the SMF system it includes a series of exemptions so that people who cannot afford to pay receive free treatment. This resulted in an 8% drop in doctor visits. It is reasonable to assume that the SMF's more extensive system of charges would have a more significant impact. It is not unreasonable to expect a 15% reduction in the number of appointments. The overall saving to the NHS could be up to £1.1bn

20 Audit Commission, *More for Less,* (London: Audit Commission, 2009)..

per year from the reduced appointment numbers alone. Larger savings could potentially be made with the knock on reduction in referrals from primary to secondary care.

Department	Department of Health
Measure	Pay cut and freeze for GPs and Consultants
Annual saving	£1.3bn

Cut pay levels, not services

Doctors, both GPs and Consultants, have benefited disproportionately from tax funded increases in NHS spending. The average GP partner enjoys excellent hours and conditions of work and now earns over 106,000[25]. This compares with average pay of £44,000 in 1997.[26] The average Consultant earns £121,000. Over three years of their new contract consultant pay increased by 25% but their average number of hours declined.[27] Both groups are in the top 1% of earners.

Doctors play a crucial role in the NHS but their renumeration is unjustifiably high. Given the impact of the cuts on all other parts of society, the pay of GPs and Consultants is now unacceptable and must be addressed.

The Prime Minister has already announced a 5% cut and five year pay freeze for government ministers. With GP and Consultant average salaries well in excess of those of junior ministers, it is time for doctors to take a significant pay cut and pay freeze. Cutting salaries by 10% would save some £600m per year, while freezing salaries for a further five years would save an additional £750m per year by 2015-16 relative to what would have happened were they to rise in line with RPI at 2.5%.

21 NHS Information Centre, *GP Earnings and Expenses Enquiry 2007/08* (London; the Health and Social Care Information Centre, 2010).
26 http://www.prospectmagazine.co.uk/how-britain-has-changed-since-1997/

27 King's Fund http://www.kingsfund.org.uk/topics/workforce_and_professionalism/

Department	Department of Health
Measure	Abolition of Strategic Health Authorities
Annual Saving	£1bn

Strategic Health Authorities (SHAs) are an unnecessary layer of bureaucracy

While there is merit in the argument that public services are undermined by continual reorganization, there is no reason to accept the status quo if it does not deliver good value for money. In the NHS, Strategic Health Authorities do not add sufficient value to the delivery of health services.

The role of SHAs is ill-defined. While nominally determining the strategic direction of services in 10 regions the reality is that their main task has become the performance management of commissioning. Additionally they also contribute to the training budget for NHS staff. This is an important task but not one that should cost the £5.1bn annual budget afforded to SHAs.[28].

With the move toward GP commissioning SHAs will no longer have a role in performance managing the commissioning process. Instead, as the SMF has argued,[29] there should be a single commissioning regulator building on the competencies in the World Class Commissioning programme. This would allow a significant saving of up to £1bn from the current SHA budget, with the money allocated for training (currently £4.1bn) reinvested elsewhere.

28 Department of Health, *Department of Health: Departmental Report 2009* (London: HMSO, 2009), 226.
29 D. Furness and B. Gough, *From feast to famine: reforming the NHS for an age of austerity,* (London: SMF, 2009).

Department	HMRC
Measure	Halve ISA allowances
Annual saving	£500m by 2013-14

High ISA allowances are a tax-break for the well-off

ISAs are an important part of encouraging a saving culture in the UK. However, at their currently levels - £10,200 per year for stocks and £5,100 for cash – they are primarily a tax break for the well-off.

In 2007-08, at lower savings limits, around 6 million of the 10 million cash ISA holders filled up their allowance, while for stocks around 900,000 of the 2.4 million users saved the maximum level. Given the distribution of savings within ISAs in 2007-08, it is reasonable to expect that the vast majority of those who in 2007-08 used their full allowance will continue to do so under the new higher rates.[30]

At a time when a range of harsh measures are being taken elsewhere in tax and benefit system, ISAs should not be exempt. Halving cash and stocks ISA limits would save a minimal amount in stamp duty on share purchases – around £20m per year – but the exchequer savings from halving cash ISAs are likely to be much greater, at about £150m.[31] Assuming that cash ISAs are held for an average of three years, the exchequer savings from halving allowances would build to around £500m per year by 2013-14.

30 ISA statistics http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/topics_savings_isas.htm.
31 Assumes savings interest rates in 2013-14 of 4% and that one-in-five saver are higher rate taxpayers.

Department	Business, Innovation & Skills
Measure	Abolition of Train to Gain and reinvestment in effective skills programmes
Annual saving	£700m

Train to Gain doesn't work

Train to Gain offers employers the chance to recoup spending on training for their workers. The aim of the programme is to tackle the long tail of low skills in the UK workforce, which is a substantial drag on UK productivity. However there have been problems both in the delivery of the programme (such as ineffective brokerage systems[32]), and overall value for money, and the policy is failing to tackle the problems it seeks to address.

Deadweight costs are too high

By paying employers for employee training, the Train to Gain programme was always at risk of incurring deadweight costs to government. That is, companies that would already have funded training for their own employees are, under the Train to Gain scheme, able to get government to pay. This increases costs to the taxpayer without increasing the stock of skills in the workforce.

The National Audit Office has concluded that the programme never offered good value for money. Half the employers surveyed admitted that they would have provided the same training without government assistance through Train to Gain.[33] This implies that around 50% of the £1.47bn budget for the programme can be said to represent a deadweight cost. Train to Gain should therefore be abolished with half of the budget reinvested in more effective forms of skills promotion, and the other half saved.

32 Ofsted, *The Impact of Train to Gain on Skills in Employment* (London: HMSO, 2008).
33 National Audit Office, *Train to Gain: Developing the Skills of the Workforce* (London: HMSO, 2009).

Department	Business Innovation and Skills
Measure	Raise student loan interest rate for higher-paid graduates
Annual saving	£400m

The country cannot afford to subsidise the best-paid graduates

In the last academic year, the Student Loans Company issued £6.2bn in loans to students.[34] The interest paid on these loans is heavily subsidised, as it should be to ensure that financial constraints are not a barrier to higher education for students from less well-off backgrounds. The cost to the taxpayer of last year's loans works out at around £1.4bn, due to the fact that outstanding loans are written off after 25 years for those who have not yet fully repaid, and because of the fact that interest rates charged to students are lower than the government's cost of borrowing.[35]

The bulk of subsidy, some £800m per year, relates to the subsidised loan rates, with the Government charging students zero real interest. Given the dangers of putting off students from poorer backgrounds with the prospect of a substantial and growing debt burden on leaving university, it would be a mistake to raise the interest rate on student loans across the board. However, it is reasonable that relatively well-paid graduates face the full cost on the Government's borrowing on their behalf. Graduates earning £25,000 per year or more should pay interest on their student loan at the Government's cost of borrowing, currently around 2.2%.[36]

In 2007-08 the median graduate starting salary was £20,000.[37] With earnings growth and individual progression, it is therefore reasonable to assume that around half of all loans would no longer be subsidised (apart from the 25 year debt forgiveness rule). This would save the exchequer some £400m per year.

34 Student Loans Company, Statistical First Release, (SLC, Glasgow, 2009).
35 Institute for Fiscal Studies, *Future arrangements for funding higher education,* L. Dearden, A. Goodman, G. Kaplan and G. Wyness (IFS, London, 2010).
36 Ibid.
37 Higher Education Statistics Agency, http://www.hesa.ac.uk/dox/fsr137/fsr137_table_5.pdf.

Department	Devolved administrations
Measure	Reform funding structure (the Barnett Formula)
Annual saving	£3.5bn

Fairness for the devolved administrations

It has long been noted that under the Barnett Formula, Scotland is able to fund health spending that is 20% higher per head than the NHS in England. Some of this difference reflects need in different parts of the UK. But much of it is simply a consequence of the political challenge of reopening the debate on funding for the devolved authorities.

Reopening the Barnett Formula is likely to be hugely controversial. However, an estimate made by David Bell suggests that a needs-based allocation formula would reduce Scottish funding by up to £4bn, though Wales would receive more than current levels. In the coming decade of austerity it cannot be right that poorer people in one part of the union pay for better services in other parts.[38] Nor is it fair that Wales should receive the least funding.

A review of the Barnett Formula will be difficult, but has the potential to contribute to closing the structural deficit and making the Union fairer in the process. That reform should be undertaken now.

38 D. Bell, *Devolution in a Downturn,* IPPR (London, 2010)

Department	Ministry of Defence
Measure	Improved efficiency in defence acquisition
Annual saving	£800m

Strategic defence issues should be the subject of proper debate

The cancellation of a replacement for the UK's Trident nuclear weapons has been widely discussed as a way of bringing down the deficit. But defence policy should not fall within the parameters of political discussions about tax increases and spending cuts to close the financial gap. It is imperative that decisions about future defence requirements are made on the basis of an informed decision about the right equipment necessary to keep our troops and our country safe. It is therefore necessary for the government to undertake a much-needed Strategic Defence Review before decisions can be made about cuts in defence spending. Security must come before financial considerations.

Procurement can be improved

While defence should never be a political football it is clear that savings at the MoD can nevertheless contribute to a wider spending review to bring down the deficit. In particular defence procurement must be radically improved by adopting best practice in commissioning. Current practices are described as "over ordering and under costing" by an MoD commissioned report. This must change.

Bernard Gray's Review of Acquisition argued that the "frictional costs" of systematic delays in procurement are £900m-£2.2bn per year.[39] Improving skills in commissioning can help to make savings in this area without compromising Britain's defences. Achieving a 50% reduction in frictional costs associated with defence procurement would save around £800m per year.

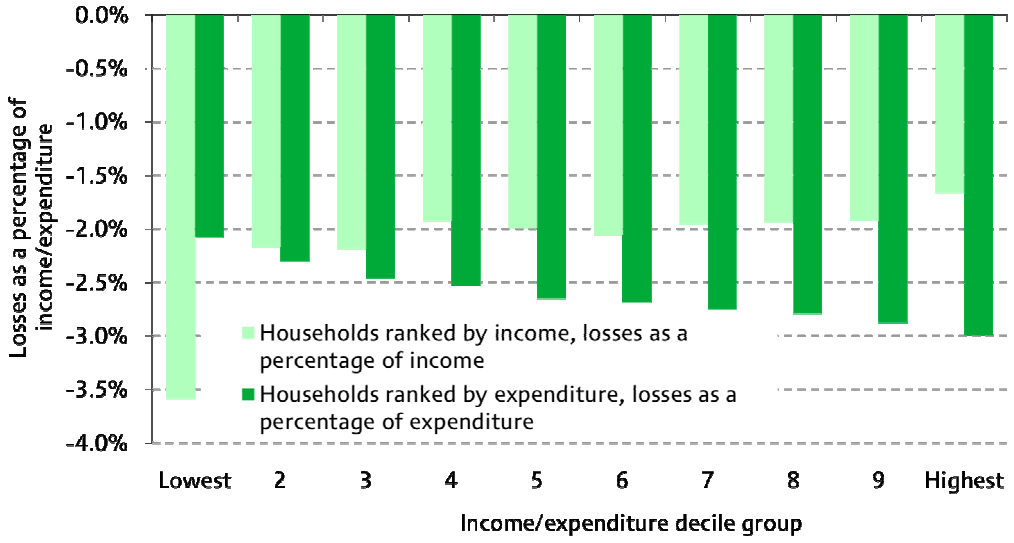
39 Ministry of Defence, *Review of Acquisition for the Secretary of State for Defence*, by B. Gray (London: HMSO, 2009).

PART TWO: REVENUE RAISERS[40]

Department	HMRC
Measure	VAT up 1.5 p to 18.5%
Annual revenue	£7.5bn

VAT rises are politically viable and are not regressive

Big tax rises are also necessary, and VAT is the most politically viable option. A common objection to VAT is that it is a regressive tax because people with low incomes tend to pay disproportionately more tax than richer counterparts. However, this is often because people on transitory low incomes tend to borrow to spend, in anticipation of higher future earnings. Students are one example of this. While they may appear poor on a snapshot basis, they may well be spending and therefore paying VAT in fair proportion to their future expected earnings. When this effect is taken into account, VAT is a progressive tax in that the better-off pay a higher proportion of their income than do the poor. Analysis by the IFS shows how a VAT rise hits the better-off proportionately harder when households are ranked by expenditure.[41]



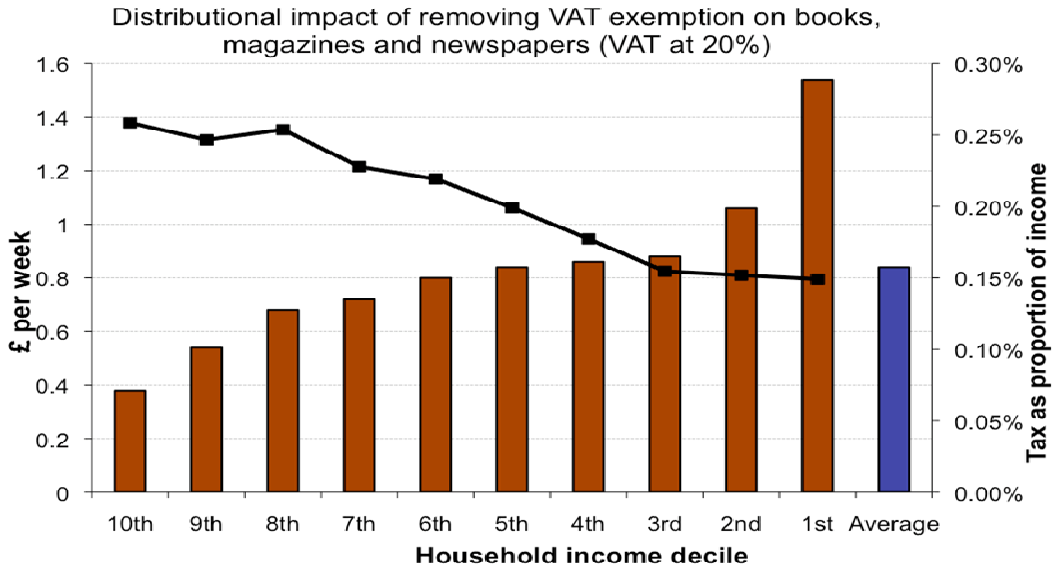
Even with the other tax rises and spending cuts proposed in this paper, it will be necessary to increase VAT by 1.5 pence, to 19%, bringing in an additional £7.5bn per year

40 Unless otherwise stated, evidence in this section is derived from HM Treasury and HM Revenue and Customs, *Tax Ready Reckoner and Tax Reliefs* (London: HMSO, 2009).
41 Institute for Fiscal Studies, *IFS Green Budget*, by R. Chote, C. Emmerson and J. Shaw (London: IFS, 2010).

Department	HMRC
Measure	Abolish VAT exemption on Magazines, books and newspapers
Annual revenue	£1.6bn

Simplify VAT by removing books and newspapers exemption

Many of the exemptions from VAT, notably those on children's clothes and food, justify the added complexity by ensuring that the tax is progressive (see above). One notable exception to this rule is the VAT exemption on books, newspapers and magazines. This exemption is currently worth £1.5bn per year, the large majority of which goes to families in the top half of the income distribution (see chart).[42] As a proportion of income, the tax relief is slightly more progressive, but not so much so as to justify the continued existence of this mainly middle-class tax break. Removing the exemption and imposing VAT at the new higher rate of 18.5% would generate around £1.6bn per year.



42 Office for National Statistics, *Family Spending: A report on the 2008 living costs and food survey*, (2009); Department for Work and Pensions, Households Below Average Income, (DWP, 2010)

Department	HMRC
Measure	Freeze income tax personal allowances for pensioners for five years
Annual Revenue	£1bn

Close the personal allowance gap between pensioners and working age people

Over recent years, pensioners have benefited from a wide range of tax and spend measures. Some of these are now unaffordable, particularly the substantially higher income tax personal allowances available to those over 65. For those aged 65 to 74 the personal allowance currently stands at £9,490 per year compared to a working age personal allowance of £6,475. For over 75s, the allowance is higher still.

With working age taxpayers carrying the bulk of the burden in repaying the deficit, it is no longer affordable to have pensioner personal allowances so much higher than those available to younger people. Freezing the age-related personal allowances for five years would erode their value by around £1,200, saving £1bn per year by 2015-16.

Department	HMRC
Measure	Capital Gains Tax increase
Annual Revenue	£2bn

Real capital gains should be taxed as income

The coalition agreement stated that Capital Gains Tax rates should rise from the current flat rate of 18% to close to the to rates of income tax, for non-business assets. This is vital to shore up the income tax base, preventing people from avoiding income tax by reclassifying income as capital gains. It is also clearly fair. It cannot be a priority to tax the labour income of rich and poor people alike in order to fund lower tax rates on windfall gains in wealth that accrue from rising land prices. Not least because land price rises tend not to be the result of the efforts of the owner but of other people's labour.

Nor is it convincing to suggest that people who are speculating on property to fund their retirement should be exempt from their own poor decisions – decisions which themselves helped to inflate an unsustainable housing bubble. However, the re-introduction of a CGT rate of 40% should be accompanied by inflation relief to ensure that holders of assets are not unfairly penalised by having the tax applied to nominal gains.

The revenue implications of a raised headline CGT rate, with inflation relief and exemptions for entrepreneurs are very difficult to estimate, and much of the beneficial effect may come through higher income tax revenues. Raising the existing 18% rate to 40% would bring in over £2bn per year, although this would be reduced by the application of indexation relief. On the other hand, the effect on the income tax base would operate to increase overall tax revenues. It is therefore reasonable to assume that the revenue from such a change would be in the order of £2bn per year.

This will not be popular among the wealthy upper middle classes, but this group has by definition gained the most from ballooning asset prices over the past 15 years, through no effort of their own. It that argument cannot be won then cuts will fail to be progressive or fair.

Department	HMRC
Measure	Bank liabilities levy
Annual revenue	2.7bn

A levy must be based on sound principles, not just popular anger

In the wake of the financial crisis there is a popular desire to tax banks and bankers more, but the justification for such a move are varied. The idea of imposing a tax of some form onto the banking system in the UK is popular and something that the new coalition is committed to implementing. But the nature of any such levy is important. It must be based in sound economic principles to help prevent the recurrence of the financial crisis. It should not be seen as a mechanism to build up a war chest to pay for the next crisis.

On this line of thinking taxing transactions with some form of Tobin Tax should be ruled out. It is, if anything, likely to increase volatility of financial markets by discouraging investors from hedging risk; and in the face of long term international imbalances, a tiny charge on transactions will have no effect. Similarly, the idea of an ongoing banker's bonus tax should be dropped. If bankers' bonuses are seen as undeserved, this must be justified by the identification of a market failure, which should then be corrected at source.

Taxing short-term liabilities will raise money and encourage less risky behaviour

One of the primary causes of the financial crisis was the tendency of banks and other financial institutions to rely excessively on very short-term borrowing to fund longer-term investments. Reliant on such volatile lending, and implicitly guaranteed by the taxpayer, banks like Northern Rock, RBS and HBOS were in effect imposing an externality on the British taxpayer. Taxing short-term liabilities is therefore an economically efficient way to tackle the problems in banking sector. Reuters Breakingviews has calculated that the revenue from such a levy would be in the order of £2.7bn per year.[43]

43 G. Hay and H. Dixon, "Thinking It Through," *Reuters Breakingviews*, March 24, 2010.

PART THREE: PROMOTING ECONOMIC GROWTH

Department	Department for Transport
Measure	Congestion charging combined with mutualisation of the strategic road network
Annual revenue	£5bn by 2020

Congestion is a major cost to the economy[44]

Congestion imposes major economic, environmental and personal costs. This is in large part due to inefficient use of the road network. Unlike train passengers, motorists have no clear financial incentive to use the road network during less congested periods or on less congested routes. Congestion has been estimated to cost the British economy around £20bn per year, and the Eddington transport review made it clear that annual costs could rise to a further £25bn.

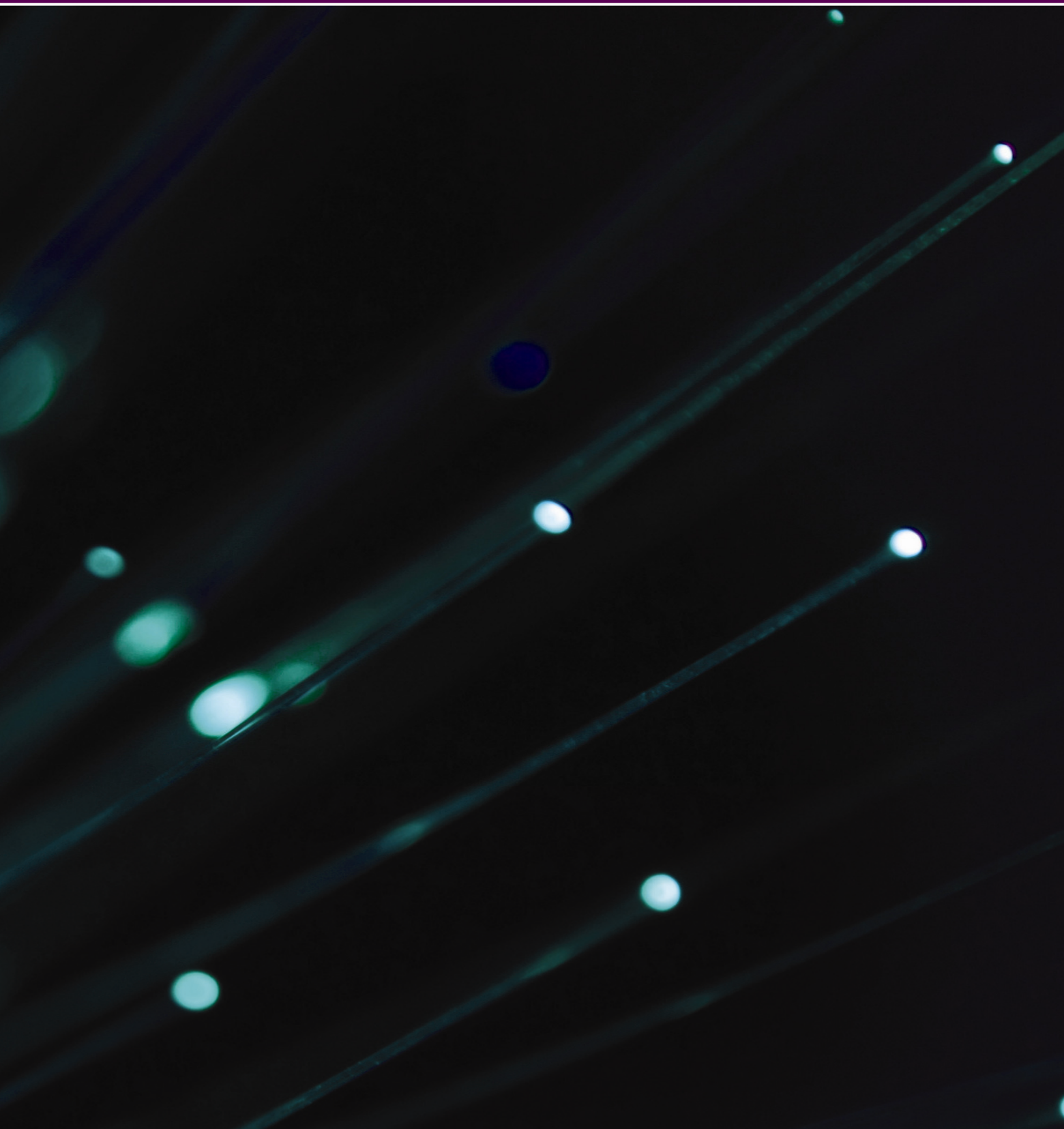
Congestion charging is the solution

Congestion charging is the best way to encourage more efficient use of the roads but has been avoided by governments who see it as politically toxic. Voters are wary of what they see as another tax on drivers. Therefore revenues from charging should be directed back to citizens rather than to government, as argued in the recent SMF report *Roads to Recovery: reducing congestion through shared ownership*.

- Every citizen should be given an equal share in the road network that can be traded on the stock market;
- Road pricing should be introduced with the profits going to shareholders – the citizens of the UK;

By deploying the kind of satellite tracking charging system that is currently being implemented in Holland, we can expect efficient road pricing to alleviate a large portion of congestion, and with it costs to the economy. Assuming that two-thirds of the problem was removed and based on a tax-to-GDP ratio of 40%, road pricing can be expected to deliver £5bn in higher tax revenues to the exchequer.

44 For analysis on this measure see I. Mulheirn and D. Furness, *Roads to Recovery: Reducing Congestion Through Shared Ownership* (London: Social Market Foundation, 2010).



The UK's debt crisis is mounting. This year's borrowing is likely to be bigger even than last year's record £156bn deficit. With bond markets getting jittery about sovereign debt, the coalition has one shot at cutting the unprecedented deficit. The Government's emergency budget and spending review in the coming months must not shrink from the challenge. If it fails to take decisive measures, the cost of borrowing will balloon, and ultimately much more draconian cuts and taxes will be required. It's time to act.

The impact of the recession on the gap between what the Government raises in tax and what it spends is around £74bn according to Office for Budget Responsibility estimates. This paper spells out the full range of measures necessary to fix the deficit over the next six years, by cutting public spending and raising taxes in a way that exemplifies social market priorities.

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