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Housing activity to lead wider upturn

Mortgage credit indicators suggest stronger second half of 2001

Channels of influnce on the economy from mortgage credit

Mortgage credit is one of the most useful leading indicators to economic activity. Since much mortgage credit is extended by the banking system, its growth is associated with rises in both banks' assets and deposit liabilities. These deposits in turn constitute most of the money supply, and in the long run nominal national income and the money supply move together. More immediately, an upturn in mortgage credit is accompanied by greater turnover in the housing market (i.e., of existing homes) and, probably, by an increase in housing starts (i.e., in building new homes). Higher turnover in the housing market typically stimulates extra purchases of consumer durables, partly because the people selling their houses have the option to withdraw equity and so have extra purchasing power.

Advance indicators to mortgage credit are useful leading indicators

These comments - about the leading-indicator properties of mortgage credit - apply in virtually all modern industrial economies. (The fluctuations in mortgage credit were pronounced in the last boom-bust cycle.) But even better than mortgage credit itself are advance pointers to mortgage credit. What are they saying about the outlook for the UK after the recent interest rate cuts? In the UK mortgage approvals (after seasonal adjustment) totalled £12.3b. in March, compared with a monthly average in 2000 of £10.0b. In the first quarter (Q1) of 2001 they reached £35.4b., up from £33.0b. in Q4 2000 and £28.6b. a year earlier in Q1 2000. The March figure was an all-time record for one month and Q1 was an all-time record for one quarter. Of course, because the numbers rise with inflation, the number of loans (as distinct from the value) needs to be monitored to facilitate comparison with earlier cycles. In Q1 the number of loans approved for house purchase was 313,000, up from 295,000 in Q1 2000 and quarterly averages of 259,000 in 1999 and 296,000 in 2000. Note that the March and Q1 figures were before the Bank of England's interest rate cuts could have had much effect.

Second half of 2001 will see buoyant domestic demand

Mortgage lending and the state of the housing market are not the alpha and omega of macro-economic analysis. But they are very important in any macro-economic forecast. The message is clear enough, that the second half of 2001 ought to see rather buoyant domestic demand. This conclusion is reinforced by two considerations. First, money supply growth (on the M4 measure) is running at an almost double-digit annual rate. Secondly, the Government's has said that it plans large increases spending on health, education and public sector investment. (Of course, Labour may not be re-elected or, if re-elected, it may rein in the announced increases and break its promises. Neither outcome looks plausible at the moment.) So - despite the continuing travails in manufacturing and the global slowdown - the Bank of England was unwise to cut interest rates in early 2001.

Professor Tim Congdon 30th May 2001

Summary of paper on

"Rethinking the welfare state II"

Purpose of the paper

In a general election campaign which has (mostly) avoided radical discussion of the size of the state, both Mr. Blair and Mr. Hague have hinted that they would like greater private involvement in health and education. The paper suggests a method by which this might be reconciled with the equalisation which is the true objective of the welfare state.

Main points

* **Charging should be introduced in the so-called "public services", i.e., education and health, in order that the allocative advantages of the price mechanism can be harnessed. Citizens are to be handed statements of entitlement ("vouchers") to a certain value of education supply and health treatment, to enable them to pay for these services.**

* **The distribution of entitlement statements could be tilted towards the less well-off, as deliberate "piecemeal social engineering". The objective of equalisation might be better served by this approach than by the present free-at-the-point-of-delivery arrangements.**

* **If the government wants to reduce the size of the state and reduce taxation, it could freeze the value of the vouchers in real terms. Spending on education and health would continue to grow, but the extra spending would come from voluntary "topping-up".**

* **Over time the role of the state in education and health would contract, and might eventually be reduced to the redistributive task implied by the distribution of vouchers of different value to groups on different income scales.**

* **With social security spending growing in line with GDP, with miscellaneous public expenditure constrained to fall at the same rate (1.1% a year in real terms) as between 1982/3 and 1999/2000, and with the national debt assumed to be repaid, the stabilisation of spending on education and health in real terms reduces the ratio of government spending (and tax) to national output to 25% by the mid-2020s. The 25% limit proposed by Clark and Keynes in 1945 would be achieved. (See pp. 11 - 13.)**

This paper was written by Professor Tim Congdon, with help from Mr. Anthony Doeh in the preparation of the charts. It is the second part of a two-part paper on tax and the welfare state, and is based on talk given to the Politeia think-tank on 13th February.

Rethinking the welfare state II

How a combination of charging and entitlement distribution could transform the public services

Equalisation is the true purpose of the welfare state

The argument so far has been that the true purpose of the welfare state is to achieve greater equality of outcome and a substantial measure of equality of opportunity. The welfare state is understood here to include the state provision of education and health, as well as the various types of social insurance (pensions, unemployment benefits, social security benefits in general) which account for most of the British Government's (and other governments') transfer payment expenditure. As a matter of history, the state may be involved in education and health because of the government's supposed efficiency as a producer and a paternalistic view that it could make better choices for citizens than they could make for themselves. But, as a comment on the lessons of experience at the start of the 21st century, considerable doubts have to be expressed about these claims for the state. Neither the government's competence in the supply of education and health services nor the legitimacy of its paternalistic interventions in citizens' free choices can go unchallenged. The agenda for change can now be defined more precisely. The aim must be to arrange the supply of education and health in a way which recognises the welfare state's two deep-seated objectives of equality of outcome and equality of opportunity, but which takes advantage of the greater efficiency of private sector provision, and respects people's capacity to act according to their own interests.

The central proposal: charging to be intoduced, in conjunction with the distribution of entitlement statements which equalise outcomes and opportunities

The time has come for the central proposal. As education and health are not "public goods" in the technical sense, the problem of organisation is analogous to that in other resource-constrained contexts. With limited resources having to be allocated to competing ends, the price mechanism needs to be harnessed as an indicator of resource scarcity and a guide to allocative decisions. Charging must therefore be introduced in these two areas of the economy, just as it already applies to the great bulk of the goods and services that people enjoy. But – immediately – there appears to be a problem. The inequality of incomes and wealth which characterises modern Britain surely implies that a policy of charging would lead to great inequality in the levels of education and health provision. If that were the result, would it not be inconsistent with the two stated objectives of the welfare state, which – to repeat – are understood to be greater equality of outcome and approximate equality of opportunity? There would indeed be an inconsistency if charging were adopted in isolation. But here is perhaps the most vital and distinctive part of the proposal.

Entitlement statements might also be called "vouchers"

The government is to issue individual citizens with statements of entitlement to education and health services, and these statements ("vouchers") are to enable them to place orders with suppliers of these services (schools, doctors, hospitals). The statements of entitlement are to have a monetary value, but they can be discharged only by the "purchase" of education and health services. (They are entitlements to benefits in kind. Except in certain special circumstances, they cannot be cashed in.) When suppliers of the services have "sold" them to the citizens and been handed the statements of entitlement, these suppliers give the statements to the government and receive the monetary value. The resulting sums of money can be used – in education - to pay teachers' salaries, cover the cost of school textbooks and so on, and - in health – to pay doctors' and nurses' salaries, and to meet the all other expenditures required for patient care. (As will become clear later on pp. 9-10, in health the payments would be practice be largely intermediated via insurance companies.)

Distribution of vouchers can be biassed to favour the less well-off

Further, and crucially, all relevant citizens are to receive statements of entitlement of broadly equal monetary value, *unless the government wants to tilt the proposal for the purpose of "piecemeal social engineering" by, for example, increasing the value of the entitlement statements received by the less well-off.* The broad aim is – of course – to achieve exactly that equalisation which was earlier described as the true rationale of the welfare state. Indeed, the possibility of straightforward redistribution towards disadvantaged groups ("the socially excluded") - *by giving vouchers of higher value to those on low incomes* - is arguably greater with the voucher approach than in a system where education and health are supplied by administrative, non-market methods.

Value of vouchers to be covered by taxation

Of course, the total value of the entitlement distribution is to count as part of public expenditure. An essential feature of the proposal is that public expenditure as a whole is to be kept in balance with tax receipts. The inclusion of the monetary value of all the entitlement statements in total public expenditure is essential to prevent macro-economic abuse of the system, where an over-generous distribution of such statements leads to a budget deficit and undue pressure on national resources.

Suppliers become accountable to individual consumers - parents and patients - as in other market contexts

The intention would be that - in the early years and perhaps the early decades of the proposal - the entitlement statements pay for the greater part of the education and health services received by people, even though the underlying resource cost would be financed by taxation. Particular suppliers would be accountable to individual purchasers, as in the usual market context. But – in contrast with other market contexts – the state would be equalizing the value of different citizens' consumption of these services. The essential claim of this paper, the nub of the argument, is that a combination of charging and voucher distribution in the public services would enable the equalisation intended by the welfare state to be reconciled with, first, the efficiency of private sector provision and, secondly, a massive extension of the freedom to choose.

Proposal similar to that in Seldon's 1977 *Charge*, but with more forthright acceptance of equalisation as an objective

How does this proposal relate to previous ideas? It should be acknowledged straightaway that the voucher idea is not new. A large and diverse literature on alternative mechanisms for paying for public services already exists. The proposal being made here is closely affiliated, although not identical, to that made by Arthur Seldon of the Institute for Economic Affairs in his 1977 book, *Charge*. Seldon remarked on the extent to which the same people were both paying tax and receiving the benefit of so-called "public services", and emphasised the resulting destruction of incentives. He discussed at some length the redistributve effect of the state's existing activities (i.e., as they were in the mid-1970s). But he did not consider the possibility that vouchers might themselves be used for frankly redistributive purposes, by the payment of more valuable vouchers to the less well-off. This extension of the voucher idea may be right or wrong in some broader philosophical sense, but that is not the point. The political reality of the early 21st century is that Britain and other industrial societies are mass democracies. In such societies any proposal which appears to favour the top tenth or quarter of the population will get nowhere. It is simply a fact of life that the voucher proposal can make headway in the public debate only if it assimilates the rhetoric of the welfare state.

Should "topping-up" be prevented?

A counter-argument is that - even if the state were to boost the value of the vouchers received by the less well-off - a system of charging plus entitlement distribution could still lead to greater inequality than at present. Such are the inequalities in income and wealth distribution in the UK, and in other industrial societies, that no reasonable amount of redistribution via vouchers could offset the effect of differences in spending power. As long as people have the ability to "top up" the value of their entitlements statements, inequalities would result. Suppose, for example, that the value of the entitlement statements given to most parents for children in secondary education were £2,500 a year, but that low-income parents received an entitlement statement worth £3,250. What would happen if middle-class parents added another £1,000 or £2,000 a year to their education spending, so that they would be spending altogether £3,500 or £4,500 a year, whereas less well-off parents could not supplement the £3,250? Would not the result be increased inequality? And does not this possibility justify the prohibition of "topping-up"?

But topping-up would allow consumers to express their preferences

There is no single right answer to this question. It depends on one's point of view. One option for public policy would indeed be to ban topping-up. The result might be the desired equalisation in that part of the education system where payment were made exclusively by entitlement statements. But surely education policy has other ends. One objective, based on the simplest kind of welfare economics, is that parents be allowed to allocate as much of their incomes to their children's education as they wish. As a result, they would be happier than would otherwise be the case. Moreover, to the extent that society's total expenditure on education were greater, this would also be a result favoured by most people, whether directly involved in education or not. (It is nice to live in a well-educated country.)

In British education topping-up could, ultimately, make *all* education private, ending a fundamental social divide

But – in the case of British education – there is a further compelling reason not just for allowing parental supplements to the basic entitlement, but for approving them openly and warmly. One of the most fundamental divides in British society – perhaps the most fundamental divide – is between children who have been privately educated (in so-called "public schools") and those who have been educated in the state system. A key virtue of the current proposal is that, over time, it could end this divide. Suppose that the entitlement statements could be spent at any school, whether state-owned, privately-owned or with special charitable or religious status. Suppose also that topping-up were allowed without limit. Then it is clear that – from the standpoint of the consumers (the parents and the children) – the distinction between private education and the state system would have disappeared. There would be good and expensive schools, and there would be bad and cheap schools, and there might even be some schools which are both are good and cheap, and others which are bad and expensive, just as there are products and services of all prices and quality levels in the rest of the economy. But the fundamental divide in British society – the divide between the well-spoken, well-mannered, well-paid public-school-educated top 6% and the remaining 94% who belong to the underclass – would have gone.

In any case, the present state system of education is unequal

A further powerful argument can be directed against the egalitarian opponents of topping-up. They cannot deny that the education and health outcomes delivered at present, with virtual 100% state provision for most citizens, are profoundly unequal. These inequalities are not only between the small and privileged private sector and the large state systems (of education and health), but also within the state systems themselves. Vast differences in the quality of education and health services are found between regions of Britain, and even between different cities and towns in the same region, *although all the services are provided by the state.* The middle class pays for better-quality state provision, not directly but by purchasing houses in areas where the public services are particularly good. (An extension of the charging-plus-entitlement-distribution proposal might be a system of means-tested state scholarships for bright pupils from difficult backgrounds.)

Is privatisation of the capital assets in education and health necessary?

A different objection to the charging-plus-entitlement-distribution proposal comes from supporters of the free market system. They wonder whether the price mechanism can be harnessed as an allocative device without full-scale private ownership of the means of supply. They claim – in other words – that, if schools and hospitals remain in public ownership, supply will still not respond to price signals because the suppliers are not properly motivated.

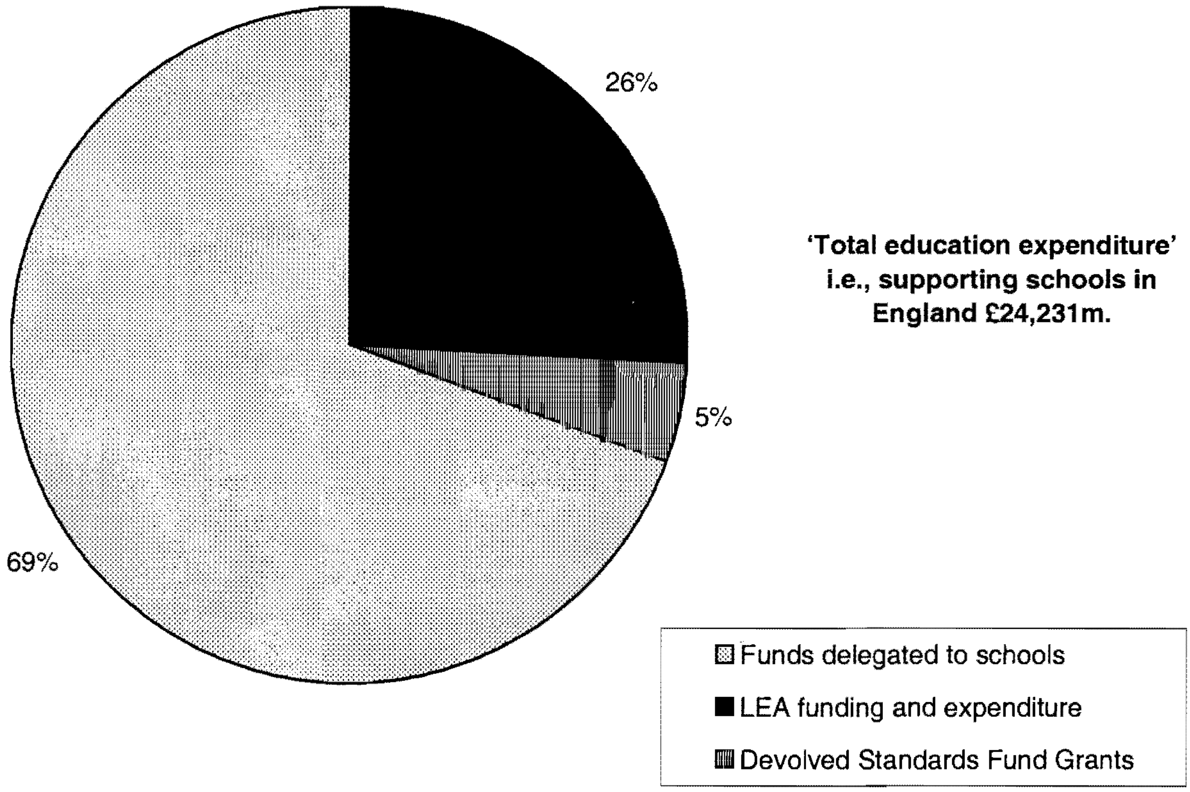
Arguably, prices are less effective as guides to resource allocation when assets owned by the state

Their view is that, for charging to work properly, it is essential that all capital assets be privately owned. Arrangements such as "the internal market" in the National Health Service are rejected as inadequate by these free-marketeers, because prices are judged to be ineffective stimuli to the reallocation of resources if the costs of over-supply fall on the state rather than loss-making private suppliers. (Note that it would be possible to continue with state ownership of the capital assets used in education and health, and yet for managers within these services to become subject to the "market forces". But – if they could not make profits or losses in a full commercial sense – the impact of these forces on decision-making would be diluted. The formation of hospital trusts in the National Health Service is an intermediate step, but it is not full-scale, profit-maximising private ownership.)

The cost of education bureaucracy

Over 25% of education expenditure soaked up by LEAs

Chart shows composition of 'total education expenditure' in fiscal year 2000-01. This measure refers only to public sector spending.



Source: *Unfair Funding* by the Centre for Policy Studies

In 1996 the Centre for Policy Studies published a study by Nick Deaton on *School Funding: Present Chaos and Future Clarity* and it has subsequently produced further work on LEA expenditure. The present Government has stated that it wants to curb "red tape" in education, but Deaton's latest pamphlet, *Unfair Funding*, says that between 1998/99 and 2000/01 LEAs' costs increased by 36% and rose as a share of total educational spending. In September 2000 the National Association of Headteachers described the present school funding system, with its large LEA role, as "a lottery" and "too complex". The CPS describes as a "scandal" the amount of money "taken from the education budget by inefficient and greedy Local Education Authorities". Higher LEA retentions may partly explain why increased government spending has been accompanied by worsening teacher shortages.

If assets are privatised, the state's job becomes to establish competition between suppliers

This objection may be valid. If so, in the education field the proposal needs to be accompanied by the sale of school buildings and teaching equipment to private agents. It is not clear whether the buyers would be large education supply companies, teachers' co-operatives, parent-teacher associations, religious charities, local mutual associations with an interest in education, or whatever. The market should be allowed to do its work. The task of the state should be to ensure intense competition and a wide range of alternative supply structures. (In the initial phase of privatising school assets, some bias towards organisations with teacher involvement might be politically astute, since it would give teachers a reason for supporting the radical upheaval implied by the move away from state ownership.)

Strong vested interests against change

In summary, a policy of charging plus entitlement distribution could take a variety of forms. Each might be complex in detail, but the overall result would be to extend choice and introduce private-sector efficiencies in supply, while meeting the welfare state's true objective of equalisation. Admittedly, it would be unrealistic to expect change from the existing structures to be rapid and comprehensive, partly because there are many vested interests which need to be overcome. The two areas – education and health – will be discussed in turn.

Heavy cost of Local Education Authorities

A fair conjecture is that the expansion of consumer choice and the introduction of competition is likely to be resisted more fiercely by bureaucratic interests in education than in health. The explanation is the remarkably high cost of managing the education system at present and the associated requirement for large numbers of administrators, mostly working for Local Education Authorities. In the 2000/01 financial year total education expenditure in England was £24,231m., but only £16,844m. was "delegated to schools". The balance was retained by the LEAs, partly to cater for children with special needs, but principally to pay for administration. Even allowing for children with special needs, administration absorbs about a quarter of the state education budget. (To put it another way, for every three pounds spent in schools on teachers' pay, books, equipment and so on, one pound is spent on LEA administration and is never seen by the schools.) The situation is similar, but not identical in Scotland, Wales and Northern Ireland.

Big differences in education spending per pupil at present

The proportion of their total funding retained by LEAs varies hugely. The London boroughs are at one extreme. In 2000/01 43.8% of Camden's education expenditure was kept by the LEA, 42.7% of Islington's, 41.3% of Lambeth's and 39.6% of Westminster's. By contrast, the LEAs of Havering, Suffolk, Wigan, Northamptonshire and Southend-on-Sea retained less than 21% of their total funding. One by-product of these marked differences in the cost of administering the system is huge inequality in the level of actual education spending per pupil. As it happens, the connection between education spend per pupil and educational outcomes is tenuous, and the absence of a clear connection raises fundamental questions about the efficiency of state education as a whole. At any rate, a case could be made that the whole structure mocks equality of opportunity or, indeed, any notion of equality whatsoever.

Voucher system would also require administration, but would it be very different from vehicle registration?

Of course, a voucher system would also involve administration. Parents would have to register with an official body and show the birth certificates of their children in order to qualify for the vouchers. When parents spent the vouchers (and perhaps "topped up" with some extra money of their own), the schools would need to keep records and ensure that the number of pupils matched the number of places. But the cost of administering the new voucher system could hardly be greater than the cost of the LEAs at present. Arguably, the task of voucher distribution and record-keeping would not be much more onerous than that of vehicle registration, and the cost to the state of vehicle registration is modest compared with that of LEA administration.

If less well-off were to receive more valuable vouchers, presentation of social security

As already discussed, the new system might include vouchers of (at least) two monetary values, a standard value which would apply to the great majority of parents and a higher value which applied to parents on lower incomes. Entitlement to the more valuable voucher would be established by the presentation of social security or other records, and ought to

records ought to be sufficient

involve no greater administrative hassle than the benefit system as such. This forthright differentiation in favour of the poor could prove a more powerful move towards equality of opportunity than anything so far done by the British state in educational policy. There might be some rough justice in the precise demarcation between those on low incomes who qualified for the high-value voucher and those on low-to-middling incomes who did not, but this roughness could hardly be any worse than under the existing system.

The National Health Service is the closest approach to a command-economy institution in a Western liberal democracy

What about health? A widely-held view is that, as state provision of health is the norm in the leading industrial countries, Britain's National Health Service is one among a number of essentially similar systems. This is not so. It is important to emphasise that the British system is unusual. A case could be made that the supply of health services under the NHS is the closest approach to the command economy found in a Western liberal democracy. Not only is it financed almost 100% by the state from tax revenues, but the absence of charging at the point of delivery muffles the signals to resource allocation that the price mechanism would provide in a market context. In most other industrial nations governments spend heavily on health, but health providers make some charge at the point of delivery. Even though the charge does not usually cover the full cost of treatment, the price mechanism is at work to guide resource allocation. In effect, Britain has a command economy in health supply which is at the opposite extreme from a free-market system. Most countries do not have a free-market system, but a hybrid arrangement in which state involvement and the private sector co-exist.

and the NHS, not the hybrid public-private systems found in other industrial countries, is the oddity

Indeed, one consequence of the absence of charging at the point of delivery – which, to repeat, is specially British – may be that health spending is lower, perhaps much lower, than it would be in a hybrid system. People would like to spend more, but they cannot do so, because the Government prevents them. In 1999 total healthcare expenditure was 7.0% of GDP in the UK compared with 9.5% in France, 10.5% in Germany and no less than 13.7% in the USA. But public healthcare expenditure in the USA was 6.1% of GDP, a fraction higher than in the UK where it was 5.9% of GDP. The big difference evidently was in private expenditure, which was much more important in the USA. The contrast with France and Germany was less extreme, but a gap remained. In France private health expenditure was 2.2% of GDP and in Germany 2.6% of GDP, in other words, double or more than double the UK ratio. One recent survey showed that public satisfaction with healthcare arrangements was much higher in France and Germany than in the UK.

In health the "voucher" would become a premium payment to a health insurer

For most people the operation of health vouchers would be different from the operation of education vouchers. The requirement for primary and secondary education is time-specific, arising when children are of a particular age, whereas the requirement for health care is inherently unpredictable. The demand for education vouchers relates to a particular school-year for a particular child, and is therefore easy to identify and specify. The notion of a "health voucher" is more elusive, because no one wants to be sick if it can be avoided. The voucher would therefore have to be a statement of entitlement to contribute to a health insurance scheme, not a statement of entitlement to a certain value of heath care. Every citizen would receive a voucher and would then choose between competing schemes. The insurance companies would go to the government and cash in the vouchers, using the proceeds to add to its investment funds. When scheme members needed medical treatment, the insurance companies would reimburse consultants and hospitals for the cost, as they do in the private sector at present. No great novelty is envisaged in terms of administrative structure, although the eventual outcome would be a vast expansion of the private medical sector.

Private-sector spending on health would move closer to European levels

"Topping-up" might or might not be allowed, depending on public opinion and the attitude of the government of the day. But – clearly – competition between existing private insurance schemes and newly-formed ones would be more straightforward if topping-up were allowed. It would be this ability to supplement the health insurance premiums financed by the state voucher with voluntary extra premiums which would make the British system closer to the French and German. Over time it would probably lead to a rise in the ratio of health spending relative to GDP. As with education, the government could try to compensate for the inequality which might arise from topping-up. It could tilt the system towards the less well-off, by offering vouchers of a higher value to people (or families) with incomes beneath a certain level.

Problem of distribution of health vouchers between different age groups

The transition from the present state-dominated system to the new system with competing private insurance companies and healthcare suppliers might be more problematic than in education. A major difficulty is to decide on the value of the health vouchers for particular age groups. At present the NHS is the agent of a massive redistribution from those of working age, mostly the young and middle aged, to the elderly. It would be ethically wrong, as well as politically unacceptable, to curtail the elderly's access to healthcare, simply because they have not had time to build up a contribution record. Moreover, the private sector would have to be given time to expand its facilities, as it could not replace the NHS overnight. One route would be to offer health vouchers to, say, people now under the age of forty and, year by year, to raise the age of entitlement. The elderly would of course have the same rights to NHS treatment as at present. Over 30 years virtually the entire working-age population would be covered.

Entitlement statements vs. tax relief

One point needs to be emphasised. An alternative method of expanding private medical provision would be for people to receive tax relief on health insurance premium payments. In one respect, this might appear superior to vouchers, because citizens have to take the initiative in arranging the type of medical insurance coverage most suitable for themselves. But tax-relief incentives have a serious drawback. This is that they are available only to taxpayers and are most valuable to people paying large amounts of tax. It follows that the expansion of private medicine by the tax-relief route is almost certain to widen inequalities in health provision. By contrast, one of the great virtues of the voucher method is that it is consistent with the equalisation which is taken to be the central purpose of the welfare state.

A system of charging and voucher distribution can secure as much equalisation as the present system - and perhaps even more

It is clear, then, that the introduction of charging in the two main public services (education and health) and the accompanying distribution of vouchers to citizens can secure as much equalisation of outcome and opportunity as the present arrangements. Indeed, by biassing the distribution of entitlements towards the less well-off, the proposal might lead to more equalisation than today. Charging could be implemented while the capital assets in education and health remained in state ownership. But it would probably be more worthwhile, in terms of improving the efficiency of resource use, if the capital assets were privatised. The eventual result – perhaps over two or three decades – would be a vast expansion of the private sector's activities. Supply would be matched more closely to demand and the same inputs would create more outputs. People would also have greater choice and more control over their own lives. Parents, not Local Education Authorities, would determine the kind of education their children had; patients would still have to be guided by doctors and specialists, but they would have more power to seek redress ("a second opinion") if they were unhappy with the attention they were receiving.

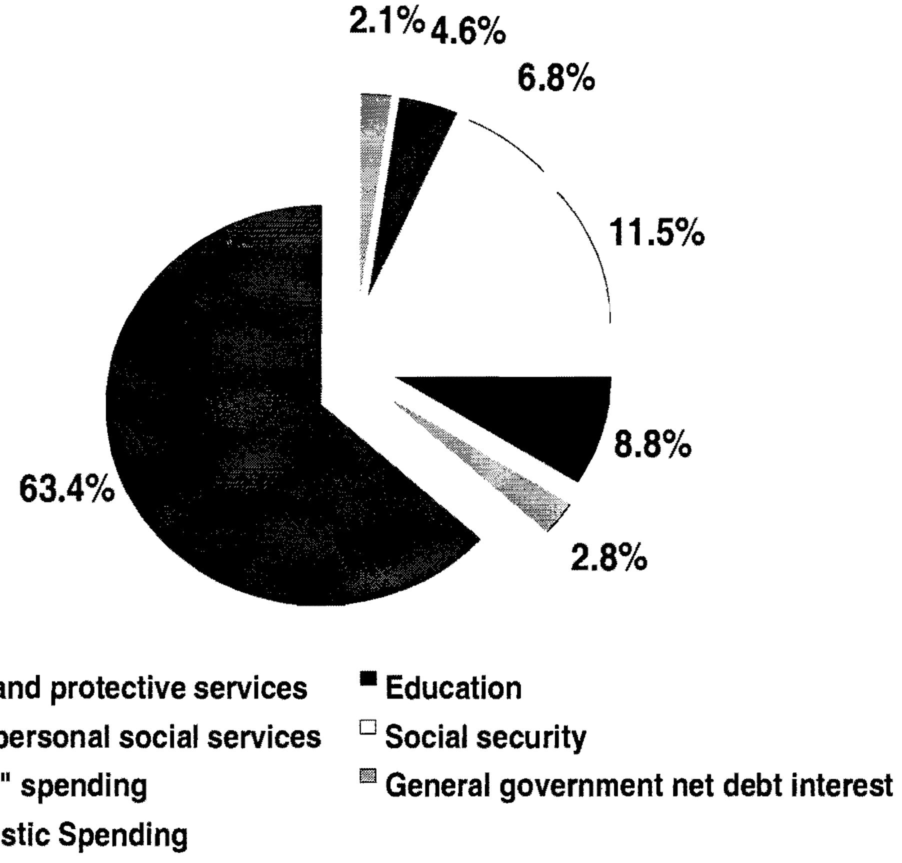
But how does this proposal link up with limiting the state to a quarter of GDP?

But how, exactly, would the new system lead to lower taxes? How would it take Britain back towards the 25% Clark/Keynes tax-to-GDP limit advocated in the first section of the paper? It was noted earlier that the combined monetary value of all the education or health vouchers distributed by the state would need to be covered by taxation to prevent undue pressure on the nation's resources. Implicitly, the total value of all the education and health vouchers would correspond to the state's total education and health expenditure at present. But how would that help in cutting taxes to a quarter of national income?

Public expenditure well over a third of GDP

The welfare state alone is a quarter of GDP

Chart shows ratio of different types of government expenditure, and other (i.e., non-government) spending to GDP in 1999/2000.



Spending on the welfare state consists of social security and, on some definitions, education and health. (Certain types of housing expenditure might also be included, but new building of council houses has fallen heavily since the mid-1970s.) Education and health together were about 11 1/2% of GDP in 1999 and may now approach 12%. Combined with social security, the welfare state costs almost a quarter of GDP. A frontal assault on this type of spending is politically difficult, perhaps because many voters are subject to what Sir Samuel Brittan has called "the Wencelas fallacy" (i.e., the belief that government spending is costless). But - in truth - any government has no resources of its own and must finance its expenditure by taxation. The British Government's spending on goods and services, including capital spending, is about half the total. Transfer payments account for the rest.

The value of vouchers to be frozen in real terms, but with no cuts in expenditure

The answer is that, when the state introduces the vouchers (and schools, general practices and hospitals start charging for their services), it should tell citizens that it intends to freeze the value of the vouchers in real terms. *There would be no cuts in expenditure. There would be no reneging on the promises currently contained in the democratic process.* But - over time - extra expenditure would have to be financed by parents, patients and citizens, as they saw fit. Evidently, an implicit assumption is that topping-up is not only allowed, but develops on a large scale. The extreme egalitarian case against topping-up is therefore rejected. The accountability of schools to parents, and of doctors to patients, would be strengthened by a move away from the current non-market arrangements to a system of charging and voucher distribution. But accountability would be greatly reinforced if large numbers of people, with higher post-tax incomes than before, were spending their own money. (Note that a system of charging plus voucher distribution could be adopted, with the value of the vouchers rising with the growth of output. But this approach would not lead to a decline in the ratio of tax to GDP. Of course, intermediate positions are feasible, with the value of the vouchers rising in real terms, but at a slower rate than national output.)

Freezing real value of vouchers would reduce expenditure/GDP ratio in a growing economy

In a society enjoying continuous economic growth, the effect of freezing the value of the health and education vouchers would be to reduce the ratio of government spending, and so of tax, to GDP. How feasible would be the objective of cutting the ratio of tax to GDP to a quarter? How long would it take for the Clark/Keynes target to be reached? Various assumptions can be made to answer these questions. The following discussion is intended to be illustrative; it does not purport to take the politics out of decision-making. Of course, in the real world the implementation of the different cases would be highly political and controversial.

Composition of British public expenditure in 1999/2000

The chart on p.10 shows the composition of British public expenditure in the 1999/2000 year, expressed as a proportion of GDP. The biggest item was social security, which amounted to 11.5% of GDP, while - within social security - the cost of state pensions was the largest single component. Health and education spending were 6.8% and 4.6% of GDP respectively. The only two other identified categories were "law, order and protective services" (2.1%) and "net debt interest" (2.8%). All other expenditure was consolidated in a miscellaneous group, which was 8.8% of GDP. The task of reducing public expenditure and tax to a quarter of national product now becomes an examination of alternative assumptions about the growth paths of these different types of expenditure, and the formation of a judgement about which set of assumptions is most realistic, both politically and administratively. Three sets of assumptions are considered.

Miscellaneous expenditures were reduced by 1.1% a year for almost 20 years, without a revolution

It is helpful at this stage to note that between 1982/3 and 1999/2000 all expenditures in the miscellaneous 8.8% group declined in real terms at a compound rate of 1.1% a year. The miscellaneous group includes transport, housing, other environmental services, defence, international development assistance, support for trade, industry, energy and employment, spending on agriculture, fisheries, food and forestry, spending on culture, media and sport, and "central administration and associated expenditure". The 1.1%-a-year real-terms reduction n all these items, taken together, may have on occasions been politically awkward, but it did not cause a revolution. So one assumption common to all three cases is that this 1.1%-a-year reduction continues indefinitely. Implicitly, Britain remains at peace in coming decades and another fall in the ratio of defence spending to GDP is acceptable, while the state withdraws further from housing provision, cuts back on industrial subsidies, curbs official aid to the arts and the Third World, and is careful about limiting the cost of Whitehall. Of course, the agenda requires responsibility and self-restraint by Britain's political leadership, but it is not impossible.

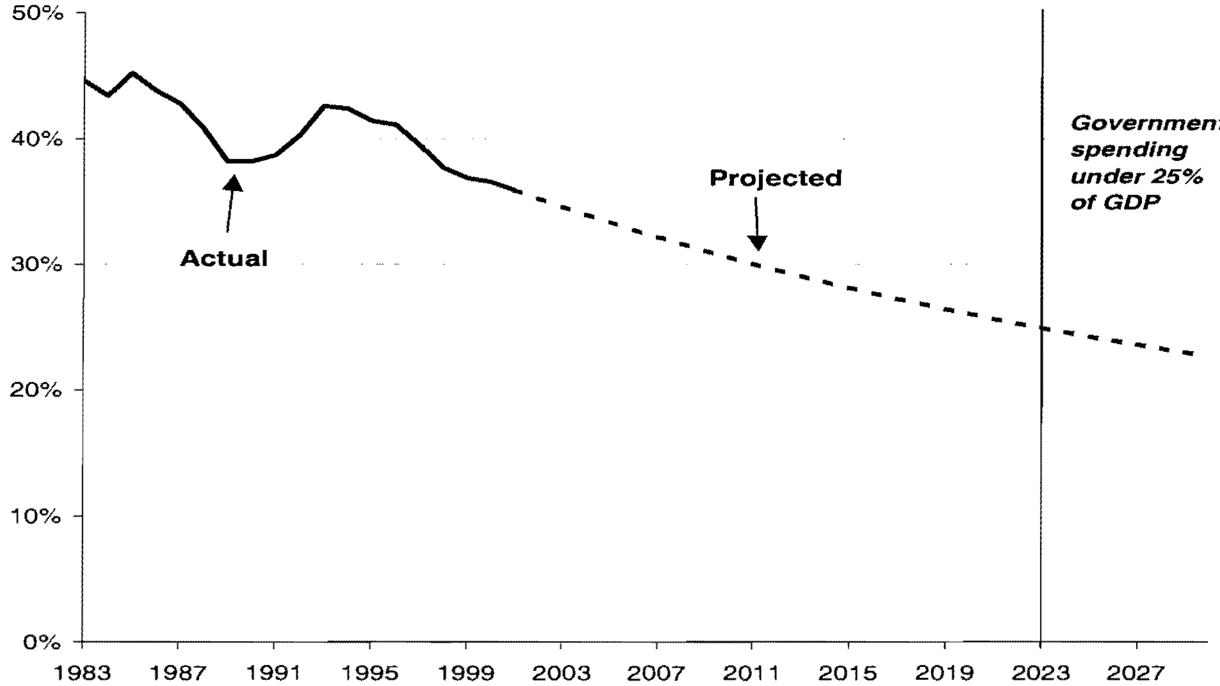
and this can continue

To repeat, a 1.1%-a-year fall was achieved over a period of almost 20 years, and the various cutbacks and economies did not cause a revolution.

A reasonable central case?

Stable health and education spend in real terms delivers 25% tax ratio

Chart shows U.K. Government spending as a percentage of GDP, past and projected. Case A projections based on the assumptions listed below.



***Case A assumptions*:**

Spending on law, order and protective services rises in line with GDP

Education spending remains constant in real terms

Health spending remains constant in real terms

Social security spending rises in line with GDP

"Other" spending declines by 1.1% a year in real terms, which is identical to its behaviour between 1982/83 and 1999/2000

Net debt interest falls by 0.1% of GDP a year and is nil by 2027

In this example public expenditure drops from almost 36% of GDP in 2000/01 to under 25% in 2002. At present taxes on personal income and employers' social security contributions are about 10% and 3 1/2% of GDP respectively. The restructuring of the welfar state proposed here would therefore be almost sufficient to eliminate both types of tax. Arguably, these tax reductions would stimulate higher trend economic growth, but the projection does not allow for such favourable further effects.

Two further assumptions common to projections of goverment spending

Two further assumptions are also common to all three cases. The first is that spending on law, order and protective services rises in line with GDP. This may seem ambitious given the continuing rise in crime and the associated need for more police, but again it is not unrealistic. The second is that net debt interest falls by 0.1% a year. Starting at 2.8% a year in 1999, it falls to nil by 2027. Given the post-war behaviour of the ratio of the national debt to GDP, this is not a particularly bold view. Just after the Second World War the national debt was over twice GDP, but at the end of 2000 the ratio of public sector net debt to GDP was down to 36.8%. According to the December 2000 issue of the OECD's *Economic Outlook*, the UK's ratio of net debt interest to GDP fell from 3.0% in 1995 to an estimated 2.1% in 2000. The OECD's definition appears to be different from the British Government's, but there is little doubt that the cost of debt servicing has fallen heavily in recent years. With sensible management of the public finances, it is not silly to envisage the possible repayment of the national debt over a generation.

Essence of proposal is that growth in spending comes from voluntary topping-up, so that ratio of public spending to GDP falls

Three assumptions vary in the different cases. The essence of the proposal in this paper is that the value of the entitlement statements ("vouchers") given to citizens should be held stable in real terms, so that growth in expenditure on education and health comes from people's own incomes and consists of voluntary topping-up of the vouchers. The proposal is deliberately gradualist, almost Fabian, in intention, to give people time to adjust their approach to both "consuming" and supplying education and health services. At any rate, the aim would be to stabilise education and health expenditure, while steady growth of GDP reduced the ratio of government spending to GDP. In all three exercises the growth rate of real GDP is assumed to be 2.2% a year, in line with past experience.

In first case, with social security rising with GDP, the Clark/Keynes target is met after a generation

In the first case (see p.12), education and health spending are assumed to be stable in real terms, and social security spending is assumed to rise in line with GDP. This assumption on social security seems the most neutral, but it can be discussed. Although the fixing of the basic state pension in real terms ought to prevent pension expenditure rising much more rapidly than GDP, much does of course depends on demographics. The rapid growth in incapacity benefit expenditure in the 1990s is another important and puzzling topic which deserves extended treatment. At any rate, with the stated assumptions, the ratio of government spending to GDP falls to under 25% by 2022. So the Clark/Keynes target is reached in a generation, according to plan. It is worth noting that total government spending keeps on growing in real terms, but always the rate of increase is less than that of GDP.

In second case, with health spending rising with GDP, the tax-to-GDP ratio would not quite reach 25% in the 2020s

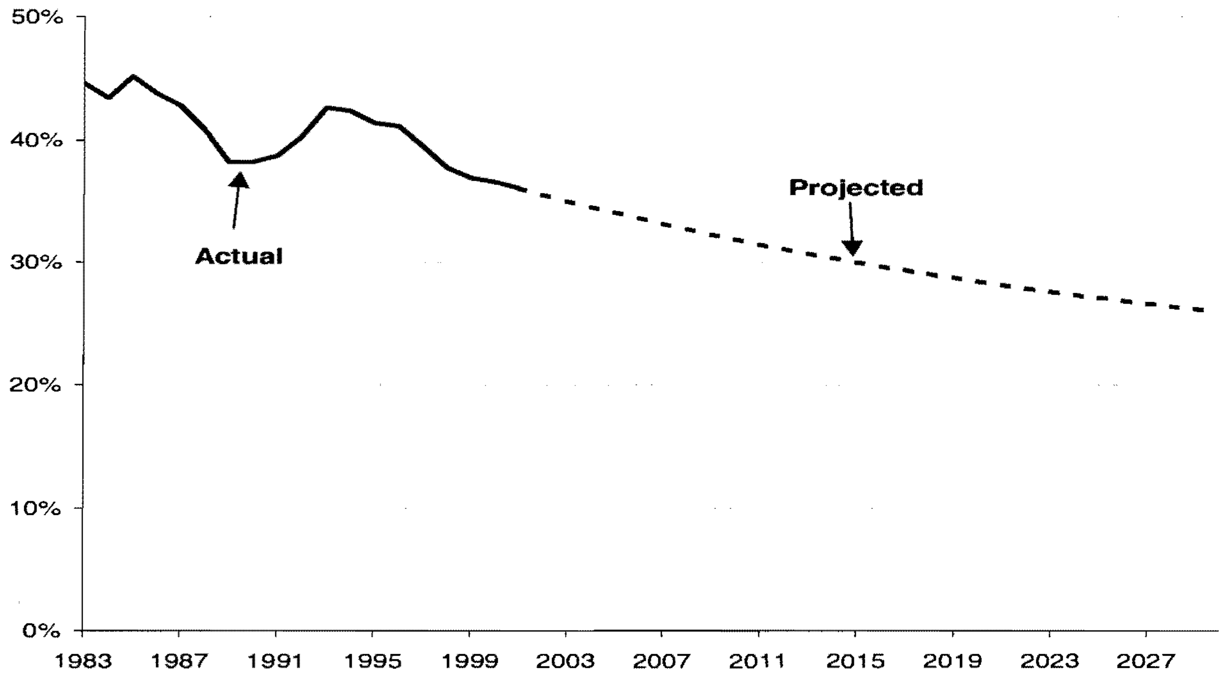
In third case, social security spending held constant in real terms

The first case is the central one, and the next two are intended to broaden the discussion. In the second case (see p.14), education spending is assumed to be constant in real terms, but health spending - as well as social security spending - is assumed to rise in line with GDP. This case ("the pessimistic case") recognises the strong political pressures on the Government to expand health spending, as well as the demographic imperatives. The number of old people - with their disproportionate requirement for health treatment - will be rising faster than the population as a whole over the next 25 years. The result is that government spending falls to under 30% of GDP by the 2020s, but does not quite reach 25% of GDP. In the third case ("the optimistic case", see p.15), education and health spending are assumed to be constant in real terms, as in the first case, and social security spending is also assumed to be constant in real terms. This assumption about social security might be rejected as "politically impossible", but could be defended on the grounds that the biggest single component (the state pension) is fixed in real terms and that the rest of the so-called "system" is a shambles, where big cost savings could be achieved by more rigorous administration and reduced eligibility. (Housing benefit and incapacity benefit are areas where the present Government, like its Conservative predecessor, is trying to control costs by these means.) In this third case government spending drops beneath 25% of GDP by 2015 and is under 20% of GDP by the late 2020s.

Case B: the pessimistic scenario

Growing state health spending jeopardises 25% target

Chart shows U.K. Government spending as a percentage of GDP, past and projected. Case B projections based on the assumptions listed below.



Case B assumptions:

Spending on law, order and protective services rises in line with GDP

Education spending remains constant in real terms

Health spending rises in line with GDP

Social security spending rises in line with GDP

"Other"spending declines by 1.1% a year in real terms, which is identical to its behaviour between 1982/83 and 1999/2000

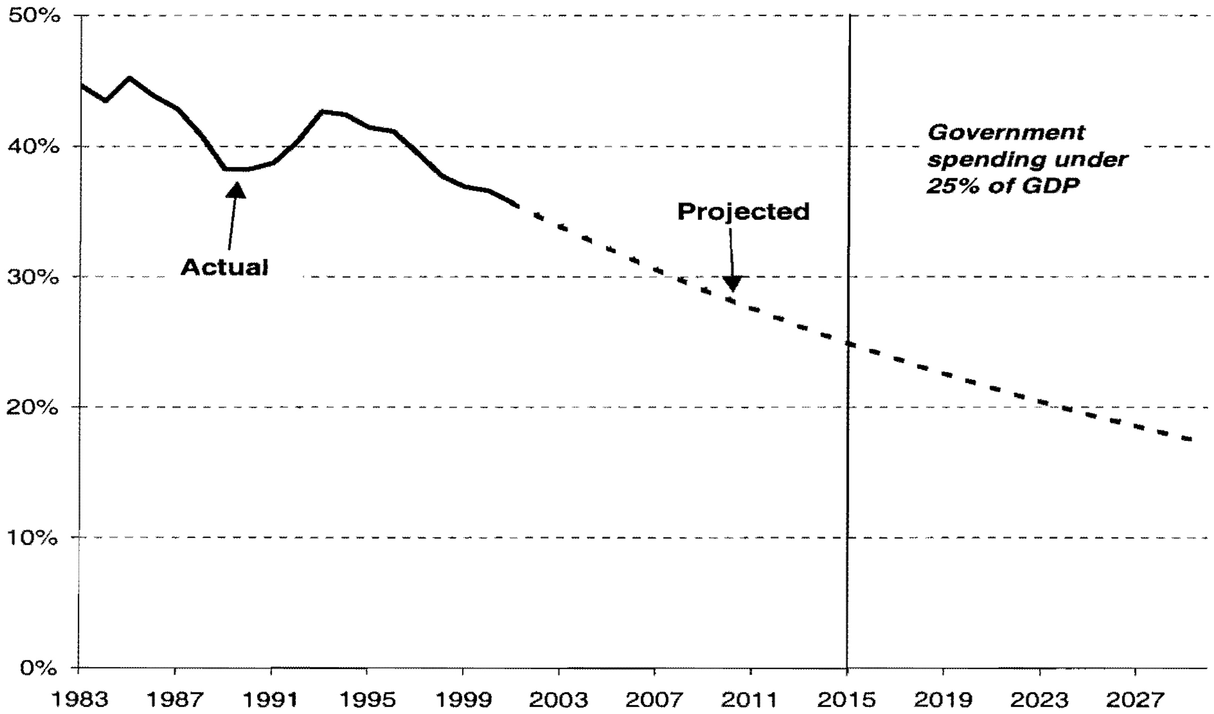
Net debt interest falls by 0.1% of GDP a year and is nil by 2027

Although less radical than Case A, the cut in taxation implied by Case B would still have major macroeconomic benefits. In 1998 taxes on goods and services (i.e., indirect taxes, mostly value added tax) were 10.2% of GDP, only slightly less than European Union average of 12.3%. If the relative burden of indirect tax remained the same, a sharp fall in other taxes in the UK would make it highly "tax-competitive" in the EU, probably inducing more companies to locate here.

Case C: the optimistic scenario

Stabilisation of real-terms social security spend transforms the economy

Chart shows U.K. Government spending as a percentage of GDP, past and projected. Case C projections based on the assumptions listed below.



Case C assumptions:

Spending on law, order and protective services rises in line with GDP

Education spending remains constant in real terms

Health spending remains constant in real terms

Social security spending remains constant in real terms

"Other" spending declines by 1.1% a year in real terms, which is identical to its behaviour between 1982/83 and 1999/2000

Net debt interest falls by 0.1% of GDP a year and is nil by 2027

As noted in the text, Case C may seem "politically impossible" because it depends on social security falling relative to GDP. But other countries have taken a hammer to social security spending, often with strong popular support arising from resentment of malingering and abuse of the benefit system. The drop in the ratio of public expenditure to GDP in Ireland since the mid-1980s has been sharper than that proposed for the UK in Case C, although its special demographic characteristics are partly responsible.

The 25% Clark/Keynes tax-to-GDP objective is attainable

Evidently, on the assumptions chosen, the Clark/Keynes objective would be attainable within about 25 years. The speed of the reduction in tax would of course depend on the expenditure path which emerged from the political process. The statistical exercises could be dismissed as fantasies. Sceptics might say that in a mass democracy the political process would simply not deliver the huge changes, in institutions and attitudes, implied by the analysis. In reply, it needs to be emphasised that the equalising objectives of the welfare state would be recognised and accepted throughout. *To repeat, by tilting the voucher distribution towards the less well-off the outcome might be greater equalisation than at present.*

State spending would be of *three* types (i.e., including spending on vouchers), not just two

More broadly, the aim would be to preserve the equalisation which is seen as the essence of the modern welfare state, while rejecting paternalist involvement in education and health provision, and injecting greater personal choice and market forces into these services. Increasingly these services would be seen as like other services, instead of being labelled the "public services". Indeed, state expenditure would consist of three categories - direct expenditure on goods and services, expenditure on transfer payments *and expenditure on vouchers*. It would not consist only of the two traditional two categories - direct expenditure and transfer payments. The expenditure on vouchers would be directed towards privately-supplied "public services". (The phrase "private 'public' services" appears in Seldon's *Charge*.)

Lack of radicalism in the general election debate,

The two major parties in the 2001 general election campaign have shied away from radical discussion of tax and expenditure. Apparently, they have been influenced by surveys from focus groups which show public hostility to "cuts" in services, and strong implied support for tax financing of government-supplied education and health. In the end big changes will probably come from a realisation that Britain is falling behind other countries which already have education and health systems with a greater private sector role. One interesting feature of the election campaign is that the expansion of the private sector's role may no longer be a particularly partisan area of political debate. Perhaps surprisingly, Mr. Blair seems to be receptive to the idea that private sector competition may spur better results in the public services. More expected was Mr. Hague's proposal for a "second supply-side revolution" in a speech to Politeia on 30th January. (The meaning of Mr. Hague's phrase was the privatisation of education and health provision, to follow the first supply-side revolution, understood as the privatisation of the transport and energy utilities under the last Conservative Government.)

but Ireland is already close to the 25% government-spending-to-GDP figure

In the long run tax competition between nations may be the most powerful reason that governments have to reduce the tax burden . In this context the remarkable position of Ireland needs to be mentioned. In the mid-1980s "general government total outlays" were over 50% of GDP in Ireland, compared with slightly more than 40% of GDP in the UK. But in 2000 such outlays were only 27.7% of GDP in Ireland and the OECD expects the ratio to fall towards 25% in the next two or three years. Taxes have not fallen correspondingly, but they are down to a third of GDP and further declines are to be expected. In the 1990s Ireland was able to attract substantial foreign investment, largely because of its low corporate tax rates. Perhaps it has been lucky, but Ireland now represents an awkward fiscal challenge to other European countries with government spending and taxes at over 40% of GDP.

The core objective of the welfare state can be met with much lower taxation

To conclude, the heart of the proposal in this paper is that charging should be introduced in education and health, in conjunction with the distribution of vouchers to all the relevant citizens. The value of the vouchers would be deliberately tilted to the benefit of the less well-off, in order to achieve the equalisation which is the true purpose of the welfare state. The value of the vouchers would also be frozen in real terms, so that - over the long run - payments for education and health would increasingly be paid by private individuals from post-tax incomes. Over a generation it would become realistic to reduce the size of the state, and the tax burden, to a quarter of GDP. That would - at some point in the 21st century - return the ratio of tax to national income to the limit that Clark and Keynes thought sensible in 1945.