

# PLAN C 12

## **TIME FOR A PLAN C?**

SLOW GROWTH  
AND FISCAL  
CHOICES

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# Time for a Plan C?

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In October 2010 the Chancellor, George Osborne, presented what we might want to think of as ‘Plan A’; the government’s Spending Review, which fixed budgets for each government department up to 2014/15.<sup>1</sup>

The review announced an £81 billion cut in public spending in the remaining years of this parliament, with average departmental cuts of 19%.

Since the start of the spending review period there have been numerous calls for a ‘Plan B’. This included a letter published in October 2011 and signed by 100 economists, which argued:

“It is now clear that plan A isn’t working... We urge the government to adopt emergency and commonsense measures for a Plan B that can quickly save jobs and create new ones. A recovery plan could include reversing cuts to protect jobs in the public sector, directing quantitative easing to a green new deal to create thousands of new jobs, increasing benefits to put money into the pockets of those on lower and middle incomes and thus increase aggregate demand.”<sup>2</sup>

Since then in its annual green budget, the IFS Green Budget warned that however painful cuts had been to date, they amount to less than a tenth of what is planned by the 2016/17 fiscal year and that 88% of the cuts to benefits and 94% of the cuts to current public spending are still to come.<sup>3</sup>

Most recently data from the Office for National Statistics (ONS) showed the economy shrank by 0.2% in the first quarter of 2012 putting the UK into recession.

With increasing commodity prices, an ageing population, and an on-going crisis across the Eurozone affecting exports many now believe the UK should not expect to return to an economy growing consistently at faster than 2% a year for the foreseeable future.

The Plan C challenge is for policy makers, opinions formers and ordinary citizens to examine how we would cope, and even thrive, with long term slow growth. How can we adapt to a period of low growth very different from the era of high growth that we have recently experienced? Is there any way in which we can plug this gap? What can we do differently and are there are new things we should be doing?

## Time for a Plan C?

It is not difficult to list the problems arising from slow growth ranging from high unemployment to falling living standards and declining public service entitlements. Slow growth will mean more hard choices about public service and welfare entitlements. Faced with further retrenchment, will it be possible through public service reform to protect the most vulnerable and universal service standards and if so how?

Does slow growth require a more profound shift in policy, expectations and culture?

Might it even be possible for some things about our economy, society and culture to improve despite (or even because of) slow growth? This paper forms part of the RSA collection – Time for Plan C? – which will explore the implications of, and responses to, slow growth from the perspective of a highly respected and influential set of thinkers.

- **Paul Johnson**, Director of the Institute for Fiscal Studies on what will slow growth mean for fiscal policy.
- **Gavin Kelly**, Director of the Resolution Foundation on the implications of slow growth for living standards.
- Journalist **Deborah Orr** on the values that will get us through a sustained period of low growth.
- Economist **Vicky Pryce** on the implications of slow growth for the overall shape of the economy and particularly regional economies.
- **Nick Seddon**, Deputy Director of Reform on the implication of slow growth for public service reform.
- **Julian Thompson**, Director of Enterprise at the RSA on how we need to change the way we see the relationship between human capital and economic recovery.

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# Slow growth and fiscal choices

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debt will be more than  
**75%**  
of national income  
in 2016

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Estimates of the permanent damage done to the UK's public finances by the great recession of 2008/09 are being revised ever upwards as estimates of sustainable economic output are revised downwards. The scale of the fiscal consolidation, now planned to run from 2010 right through to 2017, is enormous – well over £100 billion or 7% of national income – and unprecedented at any time since the second world war.

Worryingly for politicians of all stripes there may well be many more tough decisions to come. Even taking into account projections that involve strong economic growth of 2.7% in 2014 and 3% in each of 2015 and 2016, the next general election is likely to be fought against the backdrop of a continuing deficit.

There are significant risks on the downside here. And the years after 2016 will not look comfortable in any case. Public sector net debt will be above 75% of national income; nearly twice the level supposedly considered the maximum acceptable by Gordon Brown when he was Chancellor of the Exchequer. Add in to the equation demographic trends and it seems clear that substantial additional tax rises or spending cuts will be required to keep fiscal balance.

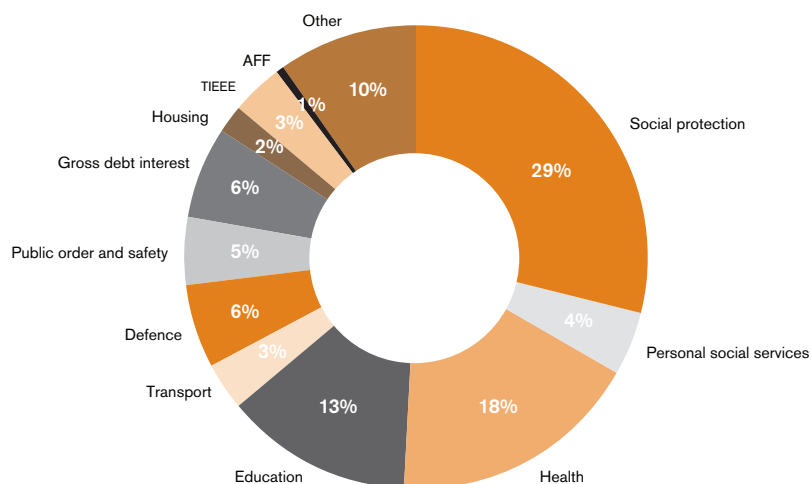
The scale of the challenges that all this implies, requires really serious thinking about the size and role of the state, the level and composition of public spending, and the most efficient and effective way of reforming the tax system.

As ever, a good place to start is to ensure that we understand why we are where we are. This paper briefly outlines how the work of the state has been changing over time. With this in mind, we then consider some possible options for tax and spending reform, which might be consistent with an increasingly limited budget.

## How spending has changed

The chart below (Figure 1) shows how we currently spend our money. Nearly 30% of all government spending, or £200 billion a year, currently goes on social protection: state pensions, welfare benefits and tax credits. A further 18% is spent on the health service. Add the 4% that currently goes on social care and more than half of total government spending is readily accounted for. Education weighs in at 13% of the total. The remaining third or so is split between defence, transport, public order and safety, debt interest and other activities. The scale of the big three – social security, health and education – is worth remembering.

**Figure 1. Composition of total public spending in 2010/11**



Notes: TIEEE is spending on trade, industry, energy, employment and the environment. AFF is spending on agriculture, fisheries and forestry. Other includes spending on public and common services, international services, recreation, culture and religion, EU transactions and accounting adjustments.

Source: Table 4.2 of HM Treasury, *Public Expenditure Statistical Analyses 2011*, Cm. 8104, July 2011, [http://www.hm-treasury.gov.uk/pespub\\_pes11.htm](http://www.hm-treasury.gov.uk/pespub_pes11.htm)

Go back 30 years or so and the state looked rather different. By the end of the 1970s social security, social care and health accounted for just a third of total spending, not half as it does now. Meanwhile, spending on defence, housing and support for industry, energy and trade were relatively much bigger than they are today. So big choices have been made: in the last 30 years, the state has become much more of a welfare state. Interestingly, while spending on health has almost doubled as a proportion of total spending – from 10% to 18% – spending on education has remained fairly constant at 12% of the total.

It would be harsh to say that this change has been entirely unplanned. The political parties and, it seems, the electorate, have made no secret of the priority that they give to health spending. Indeed there is considerable consistency in the shape of the choices made by the current government and the last. Health spending is being protected more than any other element of public service spending over the period from 2010, just as it secured the largest scale of increases during the years of public spending boom. Schools' spending is also being relatively protected following a decade of increases. However, it would be generous to suggest that the scale of change in priorities has been planned.

The scale of the challenge ahead is evident in the long-term forecasts of the Office for Budget Responsibility. Spending on health and pensions will rise by 5% of GDP (£80 billion or so in today's terms) purely in arithmetic response to demographic change. If we allow it to do that, and do not increase the totality of public spending, by the middle of the 21st century health, social care and pensions will account for a full half of all government spending. In fact it would be a triumph if health spending could be reined in only to grow faster than national income in respect of the ageing population. History suggests that increasing demand and costly new technology will drive up spending considerably more than that.

*The scale of the challenge ahead is evident in the long-term forecasts of the Office for Budget Responsibility*

To pay for this we no longer have a huge defence budget to raid. In terms of what we spend on supporting the economy, there is no longer low hanging fruit to grab. The public house building budget has all but gone. If this increase in health and pension spending is to be paid for from lower spending elsewhere, we will have to find new budgets to raid.

At the same time, tax revenues are unlikely to be hugely buoyant. Indeed the reverse can be expected. We will lose road fuel duties as cars become more efficient. North sea oil taxes are likely to diminish. And one day corporation tax revenues will surely succumb to the pressures of tax competition, if not from abroad then from within the UK. Indeed, the government is already consulting on a lower rate in Northern Ireland and the Scottish government is lobbying hard for its own lower rate.

All this means we need to think hard about what our priorities are and how we can change the way we spend and tax.

### Spending choices

There are two key ways of thinking about how to reduce public spending. The first looks at replacing public money with private money: getting beneficiaries to pay more. The second looks for straightforward opportunities to reduce provision.

Apart from higher education we have made remarkably little progress in getting people paying for public services. In the health service charges for prescriptions and dental work have a very long history but little else has changed. Schooling remains wholly free. These kinds of areas, health and education, are the most obvious places to look as they are publically provided private goods – where spending renders benefits to identifiable individuals – as opposed to publically provided public goods such as defence, policing and environmental services.

But is there scope for change? Well, it is worth noting that, even by comparison with our continental European neighbours, UK citizens are unusually dependent on public money for health care provision. The constant refrain that we do not want a health system like that in the US is not helpful in this debate. There are well functioning systems that draw in more private money. Systems of co-payment for primary care, and top-up health insurance for particular types of intervention, must be at least worthy of consideration.

The shocking state of public debate on health in this country seems to prevent us from looking seriously at this option. Meanwhile, the situation with respect to long-term care provision sits rather at the polar opposite; where individuals with pretty much any assets are expected to pay for their own care until those assets run out. It is genuinely very odd that we should think this acceptable and yet think *any* private co-funding of health care to be unacceptable.

In his report on long-term care published last year Andrew Dilnot put forward a proposal that would in fact *increase* public spending on this element of the welfare state.<sup>4</sup> His proposition was that those who require such care should, through savings or insurance, pay for the first £35,000 or so of the costs. For the minority whose costs turned out a lot higher the state would pick up the rest of the tab rather than, as at present, the individual being responsible until their assets are almost entirely run down. The private sector struggles to provide open ended insurance for

something as potentially extensive as long-term care but can cope with limited insurance of this kind. Could this principle be extended to other elements of health provision? Would it be possible and reasonable to expect individuals be asked to save or insure for the first £X of the costs of various elective procedures or of total hospital costs up to, or after, a certain age? Because most of us will need such spending the case is different to long-term care. But this should not prevent us asking whether the principles underlying the Dilnot report open up some new areas for principled debate and research that have for too long been neglected.

The most radical reforms to the structure of public spending have been made in the area of higher education. The consistent direction of travel – taken by each main party when in government, whilst opposing and repudiating the same policy in opposition – has been to move from taxpayer funding to payment by the beneficiary. This has been possible because higher education confers a clear earnings advantage; it is in large part a personal investment to which there is a return. Even as public spending on higher education falls during this current period of austerity, total spending is largely protected because of the planned increase in private contributions. The problem is that it is hard to think of other substantial areas of spending with features similar enough for this principle to be widely extended.

As we have seen spending on social security is much bigger than spending on either health or education. It is hard to see a significant retrenchment in public spending which does not involve some pain for the social security budget. One should think of that budget in two parts: that spent on pensioners, and that spent on those of working age.

The most striking aspect of current policy is that almost the only substantial element of public spending to be largely protected from cuts has been spending on benefits for pensioners. Pensioner incomes, relative to those of the rest of the population, are higher than they have ever been. Indeed, one of this government's first announcements in this area was that pensions would be enhanced through a so called 'triple-lock' ensuring that they rise each year by the minimum of earnings growth, the CPI and 2.5%. And the range of accumulated benefits paid to all pensioners – winter fuel allowances, free TV licences and free bus travel – remain sacrosanct, however poorly targeted they may be.

The loss of much private pension provision, and the need to protect incentives to save, does mean that reverting to simple inflation indexation of state pensions may look unattractive. But looking at the various other benefits received by pensioners, and moving the state pension age up faster than the planned increase to 68 by 2046, must be worthy of consideration.

### **Tax choices**

Raising large additional amounts of tax revenue requires the use of the big taxes: income tax, national insurance and VAT. Between them they account for two thirds of all tax revenue. An additional one penny on the basic rate of income tax raises £4.5 billion a year. This is more than the whole of Inheritance Tax, more than the whole of Capital Gains Tax, more than three times what the climate change levy brings in. That is not to say that there are not other desirable reforms to the tax system that could raise money.

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# £4.5bn

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But in order to raise serious amounts of money we need to alter taxes on income or consumption. And after all, relative to many other ways of increasing tax, it is not clear that putting, say, three pence on the basic rate of tax would be especially damaging or unfair. It would only take us back to where we were in 1999 after 20 years of rate cuts, but could raise a handy sum in a way which is more transparent, fairer and probably more economically efficient than raising national insurance contributions (the favoured tool of all governments looking to hide an increase in taxes on income and call it something else). Not a radical change then, but putting more than 30 years of cuts in the basic rate of income tax into slight reverse should certainly be among the first policies for a tax raising chancellor to consider.

The other mainstay of significant tax increases has of course been to increase the main rate of VAT. It rose from 15% to 17.5% in 1991 to pay for the undoing of the poll tax, and then rose again to 20% in 2011 to help pay down the deficit. But more radical change is needed. We have a narrower tax base for VAT than almost any other European country. The more we raise the main rate whilst leaving large swathes of spending – on food, books, housing – completely untaxed or, in the case of domestic fuel taxed at just 5%, the greater the economic distortions and inefficiencies we create. We also create inequities. The better off consume more of these untaxed goods and therefore, in cash terms, gain the most from the lack of tax. The current regime also favours those who happen to prefer spending their money on designer clothes for their children over those buying educational toys, it favours those who prefer books to music, and those who keep warm by turning up the heating over those who keep warm by putting on an extra jumper.

Naturally extending VAT would create large numbers of losers among the less well off. It has been demonstrated on numerous occasions that these groups can be compensated on average by increasing benefits and reducing other taxes. But some – those who spend unusually large amounts on food, books or energy – would be left worse off. It is always easier to stick to the status quo and favour this group at the expense of everyone else. But the case for overcoming this tyranny of the status quo is very strong.

Another area where change has proved extraordinarily hard, but where it is becoming increasingly urgent, is in motor taxation. Because the biggest cost created by driving is the congestion created for other motorists, and because that varies hugely according to when and where people drive, it has always been the case that some form of congestion charging would be a more efficient way of charging for motoring than fuel taxes. But this economic case for congestion charging is swiftly becoming matched by fiscal necessity. Year after year cars are becoming more efficient and the revenue from fuel taxation is beginning to fall off. Looking forward, real progress on our climate change targets will require the car fleet to move away from reliance on petrol altogether. That would involve the eventual loss of more than £30 billion a year in tax revenues. Introducing congestion charging when there is still a quid pro quo to offer in terms of lower fuel taxes is surely now a strategic priority from a fiscal point of view.



*Council tax is assessed based on a property valuation which is now 20 years out of date*

Other areas of the tax system in need of reform which also offer the opportunity for additional revenue raising, seem to be just as politically sensitive as extending the VAT base and introducing congestion charging. One is the reform of council tax. Council tax is assessed based on a property valuation which is now 20 years out of date. That is absurd. It is also designed to be deliberately regressive such that occupiers of high value properties pay tax at a much lower rate, as a proportion of the value of the property, than those in the lowest value properties. The case for, at least gradually, putting that right by increasing the rate on higher value properties is a strong one.

Of course, our tax system still contains obvious gaps and avoidance opportunities for those who know how to use them. Capital gains tax is an unsatisfactory tax in many ways: too harsh in not taking account of inflationary or 'normal' returns; too generous in being charged at a lower rate than income tax – and thus offering an obvious route to tax avoidance – in offering significant allowances and in being forgiven at death. It remains in need of significant reform. Inheritance tax remains half-hearted, fails to get at the truly wealthy, and retains extraordinary allowances for business and agricultural assets which again result in obvious tax planning and reduce revenues. Different rates of tax on the employed, the self-employed and small companies also continue to create unnecessary complexity and loss of tax revenue.

Finally, just as they have appeared untouchable when it comes to spending cuts, pensioners retain a series of tax advantages. Much the most substantial is the complete exemption from National Insurance Contributions (NICs) of their private pension income. For employer contributions to pension schemes are made free of NICs. No NICs are charged when the pension is taken. This is a very big tax advantage indeed. One, presumably unintended, consequence of the fixation of successive governments on reducing income tax rates, whilst increasing NI rates, has been to increase this relative advantage. There could be a case for any future increases in NI rates – which will occur only because income tax is seen as politically untouchable – to be accompanied by an equivalent tax surcharge on private pension income.

### **The way forward**

The current set of spending cuts comes after a decade of spending increases on a scale not seen in a generation. There are many reasons to fear that, even after the current deficit is sorted out, there will be continuing challenges for the fiscal arithmetic. We need to be ready to meet those challenges.

That means taking a much clearer view on what it is that the state should be doing and what role individuals have. It means being clear about the degree of redistribution we want through public spending, welfare and taxation. Also, it means having a far better and more strategic debate about what we want from the tax system.

We might decide as a society that we are content to see taxes and spending rise as a share of national income. In that case there are ways of raising taxes that are more efficient and more equitable than others. If we go down that route we need to make the right choices and not be driven just by the politically easy and expedient. The economic costs of doing so are large.

We might decide that we do not want the share of the state in national income to rise. That will require further hard decisions on spending priorities. In this case we need to be clear that if we follow the example of the past three decades and protect spending on health, pensions and welfare, then the shape of the state will become overwhelmingly dominated by these programmes at the expense of everything else. We need to decide collectively whether that is the route we want to take.

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# Endnotes

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- 1 Government, Spending Review 2010.
- 2 “100 leading economists tell George Osborne: we must turn to Plan B”. *Guardian*, 29 October 2011.
- 3 *The IFS Green Budget*, IFS February 2012.
- 4 Commission on Funding of Care and Support op cit.

The RSA: an enlightenment organisation committed to finding innovative practical solutions to today's social challenges. Through its ideas, research and 27,000-strong Fellowship it seeks to understand and enhance human capability so we can close the gap between today's reality and people's hopes for a better world.



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