Allister Heath
David B. Smith

At a Price!
The True Cost of Public Spending

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THE AUTHORS

ALLISTER HEATH is Associate Editor of *The Spectator* magazine and Deputy Editor of *The Business* newspaper. He is the author of *Flat Tax: Towards a British Model,* TaxPayers' Alliance and the Stockholm Network (2006). He has been a regular contributor to *The Scotsman* and *Scotland on Sunday.* He was educated as an economist at the London School of Economics and at Oxford University.

DAVID B. SMITH has been Chief Economist at Williams de Broe Plc, since 1982. He is a member of the Shadow Monetary Policy Committee of the Institute for Economic Affairs and is currently a Visiting Professor in Business and Economic Forecasting at the University of Derby. His recent papers include *When is Britain's Tax Freedom Day?* (2002) and for Politeia he has written *Public Rags or Private Riches? High Public Spending Makes Us Poor* (2001).

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Foreword

The message of Gordon Brown's tenth Budget was unambiguous: high public spending is not to be curbed. Spending on social policy, thought popular with voters, will be raised for education and, like the health service, attract extra funds. The picture to emerge from the Budget does not, however, tell the whole story, and a different set of questions is needed for the Chancellor and the country. Is the overall strategy right for the UK? Will higher levels of public spending improve education or healthcare? How will Britain's economy be affected – its growth, competitiveness and employment?

Politeia's recent work by Vito Tanzi and Ludger Schuknecht* suggests the truth may be of a different order to that implied by protagonists of high spending. Public spending over c. 35 per cent of GDP does not necessarily bring better social or public services. Where the higher spending industrialized countries have cut tax and spending, the story is the same. The evidence now is that favoured social policy goals need not be damaged by spending cuts; and while the UK has been raising tax and spending, a number of other countries has, over the past two decades, successfully cut them by an average of 7 per cent. Already there is a small group of advanced economies now spending around 35 per cent of GDP per annum.

The UK Government, by contrast, is, as this study shows, set to spend c. 45 per cent of GDP next year. The authors, Allister Heath and David B. Smith, suggest a picture both more complex and more problematic than the current orthodoxy, where the dramatic growth in the UK's public sector may have far-reaching and damaging consequences for this country.

In Part I Allister Heath considers the growing numbers of people on the Government's payroll, suggesting higher percentage growth in the public sector than in the private sector (for the year ending autumn 2005). The increase, which appears to be far greater than the official figures reveal, will bring the UK's public spending to c. 45 per cent of GDP, at a time when her continental neighbours are cutting it, and the overall Eurozone spending figure is falling. With high spending and the taxes needed to finance it, come a number of consequences including compliance and administrative costs, 'deadweight costs' and lower economic lower growth.

David B. Smith shows in Part II that public spending is even higher than the official Treasury estimates reveal – and it is rising. The dangers to Britain's economy are immense. Effort, risk taking and investment are discouraged. The calculations suggest that deadweight losses will be high – and could equal 20-60 per cent of the revenues raised. The increase in the public spending burden has been accompanied by a reduction in the growth rate – and the evidence is that it leads to low economic growth and growth foregone. As the UK reaches public spending of 45.7 per cent of GDP, she will have to compete with countries which have far lower levels – English-speaking countries like Australia (35.5 per cent), the US (36.6 per cent), Ireland at 35.2 per cent and even Germany which, the estimates suggest, will be lower next year at 45 per cent than the UK.

The message is clear. Higher public spending is not needed for better social or public services. There is little to gain from pitching the level above 35 per cent of GDP and much, economically, to lose.

Sheila Lawlor,
Director,
Politeia

**Reforming Public Spending: Great Gain, Little Pain*, by Ludger Schuknecht and Vito Tanzi. Dr Ludger Schuknecht is the Principal Economist, Fiscal Department, European Central Bank and Professor Vito Tanzi served as Director of the Fiscal Affairs Department of the International Monetary Fund,1981-2000.

A Lower Tax Future? The Economic Role of the State in the 21st Century, by Vito Tanzi.

I

Gain or Loss? The UK's Growing Public Sector

Allister Heath

A Tale of Two Economies

During the mid-1980s, when Britain was undergoing painful but necessary economic surgery, it seemed that Ireland would remain the sick man of Europe, stuck in a failing big government, high tax rut. Instead, the Irish decided to follow Britain's lead, and eventually went much further down the reformist path than even Margaret Thatcher had dared.

In little more than fifteen years, Ireland has gone from being a failing economy to Celtic tiger; it has given the emerging Asian economies a run for their money and emerged as one of Western Europe's very few success stories, creating jobs and prosperity for its people. It is therefore deeply ironic that, at a time when other countries, led by Ireland but now also including many Eastern European countries such as Estonia and Slovakia, have successfully embraced the sorts of free-market reforms the UK pioneered two decades ago, the British Government has now changed course and opted instead for the failed high-tax model long favoured by countries such as France, Germany and Italy.

Since becoming Chancellor of the Exchequer in 1997, Gordon Brown has presided over an astonishingly fast and sustained expansion in government spending and intervention. In stark contrast, Ireland has continued to cut taxes. In 2006, the OECD is forecasting that Britain's public sector will grow to 45.4 per cent of GDP, against 35.2 per cent of GDP in Ireland.[1]

Ireland's flagship policy has been to slash its corporate tax to just 12.5 per cent, helping it to attract huge amounts of foreign investment; Brown's claim to fame is to have been the Chancellor who took Britain's tax burden above Germany's for the first time in living memory. This year, in 2006, on the OECD's definition, the UK Government's tax and non-tax receipts will reach 42.4 per cent of GDP, higher than Germany's 42.1 per cent.

1 Regularly updated figures can be downloaded from http://www.oecd.org/dataoecd/5/51/2483816.xls

The UK: Spending, tax, red tape and the consequences

Next year, in 2007, public spending in Britain is expected to overtake Germany's, at 45.7 per cent of GDP against 45 per cent of GDP, according the OECD. The figures have grown dramatically since 2000, when they were just 37.5 per cent of GDP. These OECD figures are significantly higher than numbers produced by the Chancellor, Gordon Brown.

The burden of red tape has also exploded under the present Government, even though it was already very high under the Conservatives. The British Chambers of Commerce calculates that the cumulative cost to businesses of some of the major regulations introduced since 1998 has now reached £50.3bn[2]. This figure, which uses the Government's own regulatory impact assessments, is obviously an underestimate of the real cost of red tape to the economy as a whole.

One of the Better Regulation Task Force's most interesting findings – based on American and Dutch estimates applied to Great Britain, because we do not have a proper assessment in this country – was that the total cost of red tape in Britain is about 10 per cent of GDP, or close to £120bn a year.[3]

It is possible to use these figures as the basis for the calculation of a rudimentary total intervention index assessing the total impact of spending, taxes and red tape on the economy. 45 per cent of GDP worth of public spending, plus another 10 per cent, makes a total intervention index of 55 per cent – suggesting a country far down the road to traditional European social democratic statism. But the truth is that even such figures underestimate the real extent of the problem: the standard measure of GDP used includes indirect taxes and subsidies. Stripping those out to get pure value-added, which makes much more sense, public spending climbs to above 50 per cent of the value of the British economy and the overall total intervention index easily reaches over 60 per cent of Britain's value added, an astonishingly high figure.

It is possible to refine this measure further, with even more devastating conclusions. Each extra pound raised ends up costing the economy much more than one pound – and not just because of compliance costs and administrative costs, which ought to be included in the Better Regulation Task Force figures. In addition to the direct burden of tax, economists also calculate what they call a "deadweight cost" of taxation, a somewhat nebulous concept but one that is crucial to understanding basic microeconomics. Also sometimes called an excess burden, a deadweight loss occurs when individuals change their behaviour in response to higher taxes, reducing

2 http://www.chamberonline.co.uk/YQk2k8VoarMi4g.html

3 The 10% figures is to be found at http://www.brtf.gov.uk/reports/lessismoreentry.asp

economic welfare as measured by the consumer and producer surplus. One recent discussion suggested that the deadweight cost for the UK would be at least £138bn in 2005-06 – and that was one of the conservative estimates cited by the author, in a review of the international literature on deadweight costs and applies the estimates to the UK[4]. Updating the total intervention index to include the deadweight cost would take it up to between 65 per cent and 70 per cent of the economy, depending on whether the usual measure of GDP is employed or the more accurate gross value added figures.

The tax and regulation burden has a huge additional price: the opportunity cost to the economy of the reduced economic growth and output it entails. I have analysed much of the literature showing how high taxes and spending, and especially high marginal tax rates, hit the economy in my recent book, *Flat Tax: Towards a British Model*, which makes the case for a dynamic approach to tax cuts and argues for the introduction of a flat tax in the UK.[5] While there are no good model-based studies or econometric estimates of how much growth has been cut as a result of the increased spending, a 0.5 point a year reduction in gross domestic product would be a perfectly plausible guess.

The results of Gordon Brown's irresponsible tax, spending and regulatory activities and the European Union's contribution to the tide of red tape, have been remarkable yet entirely predictable. Britain's underperformance compared to its closest neighbour is especially stark: having been lower throughout history, real incomes in Ireland are now 20 per cent higher than in the UK, and are growing twice as quickly.

Productivity, the fundamental driver of economic performance, has grown over three times as quickly in Ireland as in Britain over the last decade.

The creeping re-socialisation of Britain has been the most important economic and social story of the past eight years, a disastrous but little-understood development which stands in stark contrast to the false pro-enterprise narrative implied by 11 Downing Street and repeated by too many commentators.

4 http://www.iea.org.uk/files/upld-publication307pdf?.pdf, see page 155.

5 Allister Heath, *Flat Tax: Towards a British Model*, TaxPayers' Alliance and Stockholm Network, February 2006, http://www.taxpayersalliance.com/issues/flat_tax_paper.php

A Growing Public Sector: On the Payroll, not 'Employed'

Working for the Government, paid for by the taxpayer

Perhaps the most remarkable cultural revolution of the Brown years has been the huge growth in the number of people who depend for their jobs, incomes and lifestyles on Government jobs or largesse. Needless to say, these people have a strong vested interest in preventing any Irish-style economic counter-revolution from ever taking place in the UK; as a class, they want ever higher taxes and public spending.

Gordon Brown's dramatic increase in the recruitment and payment of public sector workers means that they are now paid more than those in the private sector – even before the market value of their pensions is included. Far more people are also now dependent on Government contracts, and increased regulations mean that large numbers of people are also indirectly employed by the state, doing jobs that would not exist without taxes or red tape. Finally, there has been a huge increase in the number of people dependent on Government subsidies.

It is more difficult than usually realised to know how many people work for the Government – though the availability of information has improved marginally over the past year, thanks in part to a long campaign by some free-market economists and by my own newspaper, *The Business.* The two main measures now available are the Government's favourite, the new quarterly Public Sector Employment series launched recently by the Office for National Statistics[6]; the second is derived from the Labour Force Survey and is also conducted by the ONS. It is much less well-known but more interesting. A third measure is sometimes used; it is also derived from the Labour Force Survey but is misleading because it is based on the Education, Health and Public Administration Statistics sub-section of the workforce statistics and actually includes employees of private schools and private healthcare.[7] Because of its serious flaw, this third measure should never be used and will not detain us any longer; but it is worth examining the first two in some detail.

How large is the public sector workforce? The Office of National Statistics, The Labour Force Survey and the left out millions

The ONS's new quarterly Public Sector Employment series is based on asking all public sector organisations how many employees they have on their books. The public sector comprises central government, local government and public corporations as

6 See http://www.statistics.gov.uk/STATBASE/Product.asp?vlnk=13615

7 These figures can be found in Table 5(2) of the monthly ONS Labour Markets Statistics press release, available from http://www.statistics.gov.uk/StatBase/Product.asp?vlnk=1944

defined for the UK National Accounts; the ONS's aim is to produce a measure of the public sector workforce which follows the National Accounts' definition of the public sector.

However, as we shall see, this significantly undercounts the real total who work directly or indirectly for the Government.

The share of the public sector workforce is then derived from the difference between Labour Force Survey employment estimates for the whole economy and the ONS's quarterly Public Sector Employment series collected from public sector organisations. The current estimate, on that measure, is that 20.2 per cent of the population work in the public sector.[8]

On this new – and now official – measure of public sector employment, which is based on counting employees who work for public sector bodies, total public sector employment was 5.826 million in the third quarter of 2005, an increase of 72,000 since the third quarter of 2004. The tale told by the ONS quarterly Public Sector Employment series is fascinating, if incomplete. From 1991 to 1998, public sector employment fell every year, with an overall reduction of 816,000 over that period. From 1998 public sector employment rose every year to stand at 5,826,000 in September 2005. This was 663,000 higher than in June 1998, but still below the levels of 1991 and 1992, the ONS says on its website.

The ONS breaks down its quarterly Public Sector Employment figures. It finds that central government employment soared by 42,000 in the twelve months to the third quarter of 2005, against a rise of 32,000 in local government and a decline of 2,000 in public corporations. The largest increases in the twelve months to the third quarter of 2005 were in health and social work and education, up by 45,000 and 25,000 respectively. Employment in the private sector increased by 249,000 (up 1.1 per cent) in the twelve months to the third quarter of 2005 compared with the rise of 72,000 (up 1.3 per cent) in the public sector.

Crucially, the number of employees in the Civil Service in Great Britain was down only 3,000 to stand at 567,000, and this of course does not mean anybody actually lost their job – despite the claim that the Chancellor would abolish 80,000 or so posts in his Gershon-inspired efficiency drive. This should not come as a surprise: the Chancellor has talked about cutting posts, not jobs, in all of his speeches or publications referring to his supposed cost-cutting drive. The main policy appears to be moving people to different posts deemed to be in front-line services, while chopping other posts – but

8 http://www.statistics.gov.uk/pdfdir/pse0106.pdf

sacking almost nobody and allowing the total state sector employment figures to go on soaring.

Workers included in the ONS quarterly Public Sector Employment series are defined very carefully by the ONS[9]. It says that the figures should count the number of employees with an employment contract who are being paid by the organisation. It should also include overseas workers in the Armed Forces, Diplomatic Service and the British Council but exclude locally engaged staff.

It is quite clear that the measure misses out many people whose livelihoods depend on the state, whose salaries – part or full time – are paid by the taxpayer. The ONS goes on to stipulate in its terms of reference for the quarterly Public Sector Employment series that the self-employed, contract workers and agency temporary workers should be excluded; but that casual or fixed-term employees should be included. Remarkably, GPs are excluded as they are technically classified as self-employed. Employees of Network Rail, supposedly a private company, but now since 2002, a company limited by guarantee and dependent on the government, are also excluded – as are the employees of companies involved in private finance initiative work for the Government. Employees of universities are also excluded.

"Workers who only work part of the year (e.g. those on casual or annualised hours contracts) should be counted at the time they are being paid for – if they are not working but are still being paid they should be included. If they are not working and not being paid at the reference point they should be excluded from the statistics", the ONS also adds. Finally, employees on secondment or loan should be included only if most, or all, of their wages are being paid, so some will slip through the net.

The ONS explains that when deciding upon which route to follow to produce its new quarterly Public Sector Employment figures, it considered four options: whether the measure should include the number of people working on public sector work (including contractors, agency staff); the number of people working on public sector work being funded by the public purse (such as GPs or self-employed consultants); the number of people with an employment contract within the public sector (including those on unpaid leave, such as sick leave or career break); and finally the number of people with an employment contract and being paid by a public sector organisation. Needless to say, the first two options, which make the most sense if one were trying

9 The explanations in this paper summarise and follow closely those contained in Stephen Hicks, Craig Lindsay, Donna Livesey, Nick Barford & Richard Williams, *Public Sector Employment*, March 2005, Office for National Statistics, http://www.statistics.gov.uk/cci/article.asp?ID=1095; as well as the discussion in Stephen Hicks, Annette Walling, Daniel Heap & Donna Livesey, *Public Sector Employment Trends 2005*, Office for National Statistics, http://www.statistics.gov.uk/cci/article.asp?id=1293, an annual publication

to assess the importance of the state on the UK jobs market, were dismissed as inconsistent with national accounting principles and difficult to measure in practice. One excuse cited by the ONS is that public sector organisations are less likely to have accurate estimates of the number of agency workers and consultants working for them as they are paid by invoice – so no human resource payroll records are created.

An alternative and superior source to the administrative and survey data from public sector organisations is the Labour Force Survey (LFS) which is also conducted by the ONS but which follows international guidelines and is the source of the internationally comparable measure known as the 'International Labour Organisation' (ILO) unemployment. It estimates that by autumn 2005 7,054,755 people worked in the public sector, equivalent to some 24.5 per cent of the total, up from 6,045,691 or 22.7 per cent in summer 1997.[10] Although this too may actually turn out to be an underestimate, it is a significantly higher proportion than the quarterly Public Sector Employment figures of 5,826,000. One amazing feature of the data is that they show that 33.9 per cent of women now work for the Government, against 16.3 per cent of men. The figures also show that 28.2 per cent of employees (excluding the self-employed) work for the public sector.[11] These data also reveal that a very large proportion of the growth in employment in recent years has come from the public sector – over 2.162m. extra jobs were created between summer 1997 and August 2005, of which 1,009,064m. or 46.7 per cent have come from the public sector.

Unlike the quarterly Public Sector Employment data, the LFS measure is based on a poll of individuals rather than information collected from public sector employers. As a result, the LFS measure includes many of the categories controversially excluded from the other measure – in effect, anybody who believes they work for the public sector and are willing to say so will be included, unlike in the other measure where it is the Government and the ONS that decide.

The LFS is a survey carried out continuously by the ONS across the UK, which samples around 60,000 households and is used extensively by economists in government, academia and business. It provides the main measure of the number of people in employment as a whole. However, it is not the ONS's preferred measure of the total number of employees in the public sector – even though it contains a little known series of questions which ask people whether or not they work in the private or public sector.

10 The latest statistics, updated every quarter, can be found at: http://www.statistics.gov.uk/STATBASE/Expodata/Spreadsheets/D7922.xls

11 The latest statistics, updated every quarter, can be found at: http://www.statistics.gov.uk/STATBASE/Expodata/Spreadsheets/D7923.xls

The LFS asks respondents whether they work for a private firm or business or a limited company, or some other kind of organisation. According to the ONS, if they answer that it was some other kind of organisation they are then asked what type of non-private organisation it is. Answers are subsequently classified by the interviewer as one of the following: a public limited company; a nationalised industry or state corporation; central government or the civil service; local government or council (including police, fire services and local authority controlled schools/colleges); a university or other grant-funded establishment (including 'opted-out' schools); a health authority or NHS trust; a charity, voluntary organisation or trust; the armed forces; or some other kind of organisation.

If respondents state that they work for a public limited company, or charity, voluntary organisation or trust, they are classified as a private sector worker – respondents falling into the rest of the categories are classified as public sector workers. Crucially, the ONS adds that respondents who report that they are self-employed (which of course will include many consultants to the state sector) or an unpaid family worker are classified as being part of the private sector. People on Government employment and training schemes are classified as part of the public or private sectors in the same way as other workers. The only exception is those on college-based schemes who are considered neither public nor private sector workers.

The reason the ONS does not like this survey for the purpose of measuring public sector jobs (though they love it for total jobs) is because the definition of public sector used by the LFS is different from the official one used in the national accounts. According to the ONS, the LFS overestimates the number of people in the public sector because respondents can report themselves working in the public sector when really they are in the private sector according to national accounts definitions. This, of course, is a very legalistic answer; my contention in this paper is that the LFS's results actually give a broader and better picture than the quarterly Public Sector Employment estimates largely because it is not so strict at sticking with the overly restrictive national accounts definitions.

An example of what the ONS does not like is that employees of public-funded bodies' such as universities, often classify themselves as being in the public sector when asked as part of the LFS survey. Universities are, in fact, officially part of the private sector in the national accounts as they are not technically controlled by government, even though many would immediately go bankrupt if all government funding were to cease. Under the LFS, however, they are classified as part of the public sector. Employees working for agencies and contractors can also classify themselves as working in the public sector in the LFS though their employer is technically part of the private sector.

Other examples are GPs (both doctors and dentists) and GP practice staff. In the LFS they are separated according to whether the practice is mainly NHS or private, which makes sense but breaches the flawed national accounts rules which says they are self-employed and therefore always part of the private sector.

What is most stunning about the ONS's justifications is that is that it is fully aware of the controversy. It is worth reproducing one lengthy quote in full:

> "However, it was acknowledged that in some instances different definitions are needed to meet differing user requirements. For example, when calculating the productivity of public sector services a slightly wider definition of the public sector related employment may be needed. For instance when measuring the productivity of the health service in the UK, GPs and their staff conceptually should be included, but under the System of National Accounts are excluded because they are self-employed and therefore classified to the private sector."

The ONS also admitted that there may be a need to keep tabs on the number of agency and self-employed workers for some purposes, such as the public sector and government accounts.

Worryingly, the ONS is trying to adjust the LFS figures to make them more compatible with its favourite measure. The work remains at the analysis stage but involves shifting university workers, agency workers and some others to the private sector. The result has been to half the gap between the two measures.

The left out millions: who are they?

Ultimately, however, it is clear that neither series provides a fully satisfactory estimate of the real number of people whose jobs depend on the Government either directly or indirectly. Many people whose jobs would not exist were it not for Government financing, regulations or spending are not counted in either the official quarterly public sector employment measure of the LFS measure.

For example, there are thousands of inspectors and others whose jobs are mandated by Government but are paid for by the private sector and performed by private companies. Much of the construction industry also depends on Government contracts, as of course do all the PFI projects. Even the defence industry depends on the state.

Figures from the Management Consultancies Association, which represents about two-thirds of the industry, show that its members earned £1.9billion from Government contracts in 2004-05, up from £1.28billion the previous year and £605m. in 2002-03 – a rise of nearly 50 per cent. That is out of a £6.6bn total for members of the Association. If these figures are extrapolated across the whole industry, it would mean spending on management consultancies has soared from £1.9 billion to £2.85 billion.[12]

Another area which is increasingly dependent on the Government is the charities sector. At the end of September 2005, there were 167,387 "main" charities on the Charity Commission's Register. At the end of the 3rd quarter, the total annual income of these charities was £37.408bn.[13] The best available data have been produced by the Charities Aid Foundation. It finds that the top 500 charities received £9.1 billion in the financial year 2003-4 – and that Government grants accounted for £1.405bn and lottery income another £252m.[14] This is a total of £1.657bn, or 18.2 per cent of their income.

So far, all of these figures have examined the number of people working for the state. But far more people depend on the Government for all or most of their income than those who work for it. According to the Family Resources Survey, 2003-04, 69 per cent of households are on some kind of benefits, including 22 per cent on income-related benefit and 15 per cent on tax credits (these latter two categories overlap).[15] And according to the Households below Average Incomes, 2003-04, 54 per cent of the income of the people in lower quintile comes from benefits and tax credits.[16]

The growth of Gordon Brown's client-state has been phenomenal. Fraser Nelson, my colleague at *The Spectator* and *The Business*, has added up the number of people dependent on the state from a variety of official sources. The first killer figure, which he obtained by email from the Department for Works and Pensions in March 2006, is that by August 2005 an astonishing 5.3m. people were claiming out-of-work benefits of some kind. While the total breakdown of this figure was not made public by the DWP, recent official figures find around 816,000 people on jobseekers' allowance; 2.630m. on incapacity benefit/special disability allowance; an extra 116,000 on the disability component of income support; 761,000 people on income support for lone parents; 161,000 people on various other forms of income support; and almost 1m. others.

12 Jill Sherman, Tony Halpin and Tom Baldwin, 'Labour's army of consultants adds 1p to income tax', *The Times*, September 26, 2005; 'The taxpayer should not foot rising bills for management consultants'; Leading Article, 26 September 2005, *The Times;* Graeme Wilson, 'Army of Labour consultants puts 1p on income tax', 27 September 2005, *Daily Mail;* Matt Keating, 'Is the hired help just a rip-off', 22 October 2005, *The Guardian*

13 http://www.charity-commission.gov.uk/registeredcharities/ccfacts305.asp

14 http://www.cafonline.org/research/factsandfigures.cfm

15 Family Resources Survey, 2003-04, Table 3.10, p 63

16 Households below Average Incomes, 2003-04, Table 2.2, p 15, http://www.dwp.gov.uk/asd/hbai/hbai2004/pdf_files/chapters/chapter_2_hbai05.pdf

In addition to this are the approximately 7m. public sector workers on the LFS definition, as explained above. Around 11.5m. pensioners are claiming a state pension, which takes the total to 23.8m. or about 54 per cent of the electorate. Approximately 31 per cent of people claiming a state pension derive the majority of their income from sources other than government benefits; adjusting the figures to take account of this reveals that roughly 20.248m. people, close to 46 per cent of the electorate, rely on the state for all or more than half their income, according to Nelson's research – and this is even before including all of those on tax credits, farmers who rely on hand-outs from the Common Agricultural Policy, Network Rail employees and other groups partly or wholly dependent on government.

Gain and Loss

The bulk of Gordon Brown's public sector bonanza has gone not into better services, but into higher salaries and more staff. Public sector workers are now better paid than their counterparts in the private sector, have better pensions and work fewer hours. They have much reason to be grateful to the Labour Government – and they repay the Government by voting for it. Many of Labour's safe seats are as socialised as the Soviet states in Eastern Europe used to be. Of the 200 seats where the public sector workforce is highest, just 20 per cent are held by the Conservatives, against 70 per cent by Labour, considerably more than its overall 55 per cent share of the seats in Westminster.[17] By contrast, in the 200 seats where the private sector is most important, exactly half are Conservative. In Manchester Blackley, 67 per cent of the electorate are Government employees or welfare clients. The figures are 67.5 per cent in Liverpool Walton and a staggering 71 per cent in Cynon Valley. In Rhondda, 17 per cent of the electorate are on incapacity benefit – but just 2.8 per cent on unemployment benefit. One of the great stories about British society is the huge regional variation between London and the South of the country, which remains largely capitalist, and the socialised North, Scotland, Wales and Northern Ireland.

The contrast with countries such as Ireland or Australia that have restrained the size of their government and cut taxes over the past decade is shocking. Larger and larger parts of Britain have become dependent on wealth being generated in parts of Britain which are not yet socialised; as a result, they have become staunch supporters of Brown's ever-expanding state. Britain is thus suffering from a vicious feedback loop:

17 Fraser Nelson, 'The triumph of big government', *The Spectator,* 25 February 2006; Leader comment, 'Buying British votes', *The Business*, 26/27 February 2006.

the more tax and spending goes up and the more the number of those dependent on the Government goes up, the harder it will ever be for any reformer to reverse course and the faster the British economy and society will decline. This will make it even easier for Brown to expand the public sector further, and so on. Slowly but surely, Britain is becoming trapped in a social democratic dependency culture; we cannot be very far away and may have already reached the critical tipping point when reversing course becomes all but impossible, such is the power of the vested interests in favour of bigger government.

For the sake of those ordinary, working people, families and children who will suffer the most from Brown's re-socialisation of the British economy, let us hope they change their mind before it is too late. The stark truth is that in today's globalised, ultra-competitive world, unless a major political party in Britain finds the courage to halt and then reverse the rise of the social-democratic state, the UK will be condemned to slow decline.

II

How Size Matters: The Economic Consequences of the Growing State

David B. Smith

A Bigger State

One of the most important issues in contemporary political economy is the effect of public spending, and the taxes and borrowing required to finance it, on a country's economic performance, including the growth of national output. Not only is the state the largest single player in contemporary economies, but many governments try to control, via regulation, what they do not take in taxes. The wider consequences of such intense government involvement in so many Western economies are serious, not least because of the threat posed to personal property rights and liberty.

Today the level of public spending is historically high in almost all Western democracies, but there are also striking differences between nations, and between the regions of any given country. When expressed as a share of the officially preferred market-price measure of Gross Domestic Product (GDP) – a concept which almost certainly overstates national output because it is measured gross of such indirect taxes as Value Added Tax and Excise Duties – general government outlays in the Organisation for Economic Co-operation and Development (OECD) area ranged from not quite 31 per cent in Korea to 57¼ per cent in Sweden last year. However, the ratio is far lower – at around one fifth – in many of the South East Asian 'tiger' economies, with which Britain now must compete. The equivalent OECD measure for Britain was not quite 45 per cent last year though there are wide disparities across the country.[18]

The role of the size of government as a possible explanation of the marked differences in economic performance internationally and regionally has been unduly neglected in Britain's public debate, which appears to be unaware of the substantial and long-

18 The nearest equivalent domestic figures show that the government-spending ratio ranged from 291/4 per cent in South-Eastern England, to 57 per cent in Wales and not quite 64 per cent in Northern Ireland during financial 2003-04 (Table 7).

established international literature on the effects of public spending on economic performance. [19]

Attempts to quantify the share of national output absorbed by the state are bedevilled by serious conceptual and statistical difficulties (Smith (2002 I and II)). However, the broad historic trends are clear enough to suggest that the rise in the share of national income taken by government represented one of the most striking developments of the twentieth century. This can be seen from the statistics for a wide range of industrialised nations in Table 1 (overleaf), which draws on the statistics supplied by Tanzi and Schuknecht (2000), and updates them using figures from the Annex to the December 2005 OECD *Economic Outlook.*

Unfortunately, there are inconsistencies between Tanzi and Schuknecht's data for the overlap year of 1990 and the OECD figures for the same period. These seem to have resulted partly from the introduction of new methods of compiling the national accounts for many of the countries concerned after the publication of their *Public Spending in the Twentieth Century* in 2000 (see the footnote to Table 1 for further details). As they stand, the two sets of figures show a quadrupling in the government spending ratio for the 'typical' Western economy from an unweighted average of just under 12½ per cent in 1913, to 44¾ per cent in 2005, if government spending is defined widely to include transfer payments, such as welfare benefits and debt interest, and the GDP concept employed is the market-price measure.

The latest (2005) figures for the OECD area as a whole reveal a government spending burden of 40.9 per cent in 2005, compared with 42.1 per cent a decade earlier, and a figure for the Euro-zone of 47.9 per cent, compared with 50.5 per cent in 1995.

19 Some of this literature was discussed in the author's earlier Politeia pamphlet (Smith 2001). Unfortunately, much of it is of a highly statistical nature and it would not be appropriate to attempt a detailed literature review here. However, a rather longer paper, which examines these issues in more detail, can be obtained from the author by E-mail (david.smith@wdebroe.com). In addition, Allister Heath's recent discussion of flat rate taxation (Heath (2006) also looks at the international literature dealing with the consequences of a high tax burden.

Table 1:
Ratios of Public Expenditure, including Transfers, to Money GDP at Market Prices (%)

	1870	1913	1920	1937	1960	1980	1990	2005
Australia	18.3	16.5	19.3	14.8	21.2	34.1	36.2	35.7
Austria	10.5	17.0	14.7	20.6	35.7	48.1	51.5	49.5
Belgium	-	13.8	-	21.8	30.3	58.6	51.9	49.1
Canada	-	-	16.7	25.0	28.6	38.8	48.8	39.5
France	12.6	17.0	27.6	29.0	34.6	46.1	49.3	53.9
Germany	10.0	14.8	25.0	34.1	32.4	47.9	44.5	46.8
Italy	13.7	17.1	30.1	31.1	30.1	42.1	54.4	49.2
Ireland	-	-	-	-	28.0	48.9	42.9	35.8
Japan	8.8	8.3	14.8	25.4	17.5	32.0	31.8	37.4
Netherlands	9.1	9.0	13.5	19.0	33.7	55.2	52.5	47.7
New Zealand	-	-	24.6	25.3	26.9	38.1	53.3	37.6
Norway	5.9	9.3	16.0	11.8	29.9	43.8	54.0	46.1
Spain	-	8.3	9.3	18.4	18.8	32.2	42.5	38.5
Sweden	5.7	10.4	10.9	16.5	31.0	60.1	61.9	57.2
Switzerland	16.5	14.0	17.0	24.1	17.2	32.8	30.0	36.9
United Kingdom	9.4	12.7	26.2	30.0	32.2	43.0	42.2	44.9
United States	7.3	7.5	12.1	19.4	27.0	31.4	37.1	36.6
Unweighted Average of Countries With No Missing Observations*	10.7	12.4	19.3	23.2	27.9	42.6	44.9	44.8

*Excludes Austria, Belgium, Canada, Ireland, New Zealand and Spain. The mean break in 1990, as defined above, is a trivial +0.05 percentage points. This means that the averages quoted in the main text are not noticeably affected by these definitional breaks.

Sources: Tanzi & Schuknecht (2000); IMF, including May 2000 *World Economic Outlook* (see especially IMF Table 5.4 page 172); and *OECD Economic Outlook* (December 2005, Annex Table 25). Unfortunately, there are some substantial discrepancies between the Tanzi and Schuknecht (T&S) and OECD data for the overlap year of 1990, and the figures should be regarded as illustrative only. The known breaks in 1990, defined as 'OECD - T&S' are: Australia +1.3, Austria +12.9, Belgium -2.4, Canada +2.8, France -0.5, Germany -0.6, Italy +1.0, Ireland +1.7, Japan +0.5, Netherlands -1.8, New Zealand +12.0, Norway -0.9, Sweden +2.8, Switzerland -3.5, UK +2.3 and US +4.3. These changes appear to have resulted from the adoption of ESA95 national accounting principles after the T&S data were compiled, and might also reflect the problems T&S faced in picking up the expenditure of lower tiers of government in federal systems, among other factors.

The problem of measurement

In Britain alone, the share of general government spending in the alternative factor-cost measure of GDP – which is a more accurate measure of national output, because it is defined net of the distorting effects of indirect taxes and subsidies, than the market-price measure used for international comparisons – increased from under one tenth in the late nineteenth century, to between one quarter and well under one third in the inter-war period and to just over one third in the late 1950s. A rapid rise in the spending share followed during the second half of the 1960s and the 1970s, and this was, in turn, followed by a noticeable drop through the 1980s, a levelling out in the 1990s, and a resumed increase more recently (see Table 2).

The official way of calculating Britain's national accounts changed after 1998, making it impossible to carry on the early part of the table with any consistency beyond the mid-1990s. However, a set of figures on the current definition is available from 1946 to 2004 in the UK Office for National Statistics (ONS) publication *Economic Trends: Annual Supplement* (table 5.4) and can be updated to 2005 Q3 using the March 2006 edition of ONS *Economic Trends* (table 6.4). These statistics have been used to fill in the figures from 1950 onwards. The fact that figures for 1950 are given on both the old and new bases gives some impression of the scale of the definitional breaks involved. In particular, the new figures appear to be running some ¾ per cent higher in 1950, where total spending is concerned, than their predecessors. This is only a small discrepancy when compared with the subsequent growth in the share of public expenditure. The official figures given in the March *Budget Report* can be manipulated to reveal that the ratio of general government expenditure to factor-cost GDP is intended to rise from 47 per cent in the fiscal year 2004-05, to 48½ per cent in 2005-06, and 49 per cent in 2006-07, before holding at 49 per cent in 2007-08. These ratios can be compared with the Labour low point of 42¾ per cent recorded in 1999-2000 and the 44¾ per cent recorded in 1997-98, when the Government was still sticking to its Conservative predecessor's expenditure plans. Using the officially preferred market-price measure of GDP instead shows that HM Treasury expects its measure of the spending burden to rise from 41¼ per cent in 2004-05 to 42½ per cent in 2005-06, and around 42¾ per cent in 2006-07 and 2007-08. The HM Treasury projections have been challenged, however, because they depend on a faster pace of economic growth than is predicted in independent consensus forecasts, and also far better Government cost control in the future than in the recent past.

What size should the public sector be?

Economists are trained to believe that many problems can be regarded as how to maximise social welfare while subject to constraints. This applies to the issue of the optimal size of the state as much as it does to more obvious topics in microeconomic theory. No serious economist disputes that certain commitments are fundamental such as external defence, maintaining law and order at home, protecting human and property rights and public health, and providing primary and secondary education (though there may be some debate about publicly funding the later stages of education). All of these will generate high economic as well as social returns. However, the historical record – and the experience of today's successful economies, including the 'tiger' economies – suggest that this can be achieved when the state is spending no more than a fifth or so of national output, or less than one half of the present OECD average.

It should also be non-controversial, in terms of basic economics, that the marginal benefits of additional government spending diminish once it grows beyond a certain point, while the marginal opportunity cost in terms of lost efficiency, foregone growth and higher unemployment start to increase more rapidly. Quantifying the social welfare maximising point – at which the falling marginal benefit curve from additional government spending crosses the rising opportunity cost of the need to pay for it – is one of the most important tasks in political economy. However, it is only recently that economists have been able to attach even a rough order of magnitude to where this point occurs in practice. Fortunately, considerable progress has been made with respect to this issue in the past half dozen years. In particular, the research carried out by Tanzi and Schuknecht (2000) and Tanzi (2004) for a wide range of countries, looking at data back to the late nineteenth century, suggests that state spending need be no higher than 30-35 per cent of market-price GDP in order to achieve most of the important social and political objectives which justify government intervention.

Considerable support for this view is provided by the relatively good economic performance of such low spenders as the US, Australia and the Republic of Ireland in creating growth and jobs (and their high rankings in 'happiness' surveys) compared with the high-spending Euro-zone, and the fact that if London, the South-East and Eastern England are treated as one unit, its combined government expenditure would amount to almost exactly 32 per cent of market-price GDP, while the equivalent ratio in South-Eastern England alone is 29¼ per cent. However, the corresponding tax burdens in these UK regions are far higher than such figures would imply on their own because of the significant outward transfers to poorer parts of the country including the old Labour heartlands in places such as Scotland, Wales and the North East. Some of these transfers are clearly justifiable. However, the large differences between living costs in the different parts of the UK mean that a system which

**Table 2:
Ratios of Main Categories of UK Public Expenditure to Money GDP at Factor Cost at Ten-Year Intervals (%)**

Pre-ESA 95 Definitions	General Govt. Final Exp.	Grants to Persons	Subsidies	Debt Interest	General Govt. Invest.	Total General Govt.
1870	5.2	0.0	0.0	3.5	0.6	9.3
1880	5.6	0.0	0.0	3.1	1.2	9.9
1890	6.2	0.0	0.0	2.4	0.7	9.3
1900	10.0	0.3	0.0	1.8	1.9	14.0
1910	8.8	0.4	0.0	1.9	1.2	12.3
1920	8.7	2.7	2.2	6.1	1.8	21.5
1930	10.5	5.3	0.6	8.4	3.0	27.8
1938	15.1	5.3	0.8	5.7	3.8	30.7
1950	18.9	6.3	4.2	4.8	4.7	38.9
Wartime Peaks						
1917	39.0	0.9	0.5	4.3	0.1	44.8
1944	56.1	5.4	2.8	5.0	1.0	70.4
ESA95 Figures						
1950	19.5	5.7	4.1	5.4	4.8	39.6
1960	18.9	6.4	2.1	5.1	3.9	36.7
1970	21.2	8.9	2.0	5.1	5.4	42.9
1980	25.2	11.8	2.5	5.9	3.0	48.5
1990	23.4	12.2	1.0	4.2	3.0	43.8
2000	23.8	13.7	0.6	3.2	1.5	42.7
2004	27.3	13.6	0.7	2.3	2.0	45.9
2005	28.0	3.2	0.7	2.4	2.1	46.3

Sources: Feinstein (1972), *ONS National Income Blue Book* (various dates); *ONS Economic Trends: Annual Supplement*, 2005 Edition; and WdB estimates.

Note: The table omits 'Net Current Grants Abroad', which is why the total exceeds the items shown. 'Other Current Grants' have been consolidated with 'General Government Final Expenditure' in the ESA95 figures. The figures for 1900 and 1950 are distorted by the Boer War and the Korean War, respectively, while those for 2005 are partly forecast.

concentrates on generating equality in cash terms has become noticeably unfair in real ones (Table 8).

If it is assumed that 35 per cent of market-price GDP represents the tipping point beyond which further increases in government spending cease to add to social welfare, then Germany is currently spending 11¾ per cent of GDP more than would seem to be optimal, the Netherlands has overshot by 12¾ per cent, Italy by 14¼ per cent, and France by nearly 19 per cent, while Sweden is spending $22^1/_4$ per cent more of market-price GDP than would appear to be consistent with maximising the welfare of its people. At the other extreme, the Australians and Irish are only spending some $^3/_4$ of 1 per cent of GDP beyond the upper limit, and expenditure in the US and Switzerland is only some $1^1/_2$-2 per cent above it, despite America's unusually large expenditure on defence by international standards.

Britain was reasonably close to this 35 per cent optimum from the mid-1950s until the big spending Wilson administration of 1964-70, and again in 2000, when general government outlays represented $37^1/_2$ per cent of GDP on OECD definitions. However, Britain's public spending burden was almost 10 per cent beyond it last year and is likely to be $10^3/_4$ per cent above it by 2007, when the OECD expects Britain's government spending burden to reach $45^3/_4$ per cent of market-price GDP, compared with 45 per cent projected for Germany and not quite 47 per cent for the Euro-zone as a whole. The extent to which government spending in Europe has now run well ahead of its estimated optimum suggests that a proper cost benefit analysis of today's welfare states would concentrate on two issues. The first is what have been the gains to society as a whole, as distinct from politicians and vested interest groups, from pushing public spending so far beyond its apparent optimal level in many European countries. The second issue is how much collateral damage has resulted.

The Impact of Big Government

Difficulties of measurement

Measuring the share of national output absorbed by the state is surprisingly problematic, because of uncertainties about the appropriate definitions of both the denominator and the numerator. This means that one should beware of the danger of pseudo-precision. On balance, it looks as if the current official presentation, which uses the market-price measure of GDP, significantly understates the true resource costs of the public sector in Britain, possibly by some 6 percentage points of national output (Table 3). The use of market-price GDP also affects international comparisons, because it tends to understate the underlying tax and spending burdens in countries that rely heavily on indirect taxes and hence the advantage that the US has over value added tax-heavy Europe, for example.

Paying the price in tax and borrowing

The 'Government's budget constraint' – which is derived from the rules of double entry book-keeping – means that public spending can only be financed through taxation, long-term borrowing or borrowing from the central bank, which then has to 'print money'. Few people believe the old-fashioned Keynesian argument that budget deficits are stimulatory these days, and it is interesting that the present Chancellor has never tried to justify budget deficits in this way. The reasons that budget deficits are no longer considered to be stimulatory nowadays include: a) Ricardian equivalence theory which suggests that people anticipate the future higher taxes that inevitably result from budget deficits and so rein back their consumption spending immediately; b) the evidence from simulations on macroeconomic models and international panel-data studies; and c) the fiscal stabilisation literature produced by bodies such as the International Monetary Fund (IMF), the European Commission, and the European Central Bank (ECB). (See, for example, Giudice, Turrini and in Veld, J (2003) or Snowden (2004) and the references cited therein.)

Table 3:
Alternative Measures of the Shares of Government Spending and Taxes in UK National Output in Fiscal Year, 2004-05

	Value (£bn)	Share of GGE in GDP (%)	Share of Total TNIC GDP % in GDP (%)	Share of Non-Oil TNIC in GDP (%)
General Government Expenditure (GGE)	484.0			
Total Taxes & National Insurance Contributions	427.6			
Non-Oil Taxes & NICs*	422.5			
GDP at Current Market Prices	1,177.2	41.1	36.3	35.9
GDP at Basic Prices	1,045.2	46.3	40.9	40.4
GDP at Factor Cost	1,028.5	47.1	41.6	41.1
Non-Oil GDP at Current Market Prices	1,147.8	42.2	37.3	36.8
Non-Oil GDP at Basic Prices	1,015.8	47.6	42.1	41.6
Non-Oil GDP at Factor Cost	999.1	48.4	42.8	42.3

*Includes taxes paid directly to European Union. These totalled £4.1bn in 2004-05.

Sources include ONS *Financial Statistics* and ONS *Quarterly National Accounts First Release,* 22 December 2005, and WdB calculations. The market-price spending ratio differs from the one given by the OECD shown in Table 1 because of timing effects (the OECD estimate for calendar 2004 was 43.9 per cent), but it is not clear why they differ otherwise, although the OECD does re-work its figures onto a standard international basis.

High deadweight cost/losses

Taxes expropriate property rights, and have adverse supply-side effects, because they penalise wealth creation and leave British producers uncompetitive in world markets. All taxes discourage effort, risk-taking and investment in physical, financial and human capital, and induce slower growth and prevent the jobs market from clearing. Taxes also generate 'deadweight' losses of real economic welfare, which the US Congressional Budget Office (CBO) calculates could equal 20-60 per cent of the revenues raised (see: Lightfoot (2005)), proportions that would indicate deadweight losses of somewhere between £89½bn and £268bn (or 8½ per cent to 25 per cent of factor cost GDP) in 2005-06, if applied to UK non-oil tax receipts. However, simulations on macroeconomic forecasting models – including the author's own – suggest that there are significant differences between the effects of the various taxes. Model simulations also suggest that it is by no means clear whether increasing UK taxes from their present high levels will lead to a smaller budget deficit, once allowance has been made for the adverse 'second-round' effects of increased rates of taxation on the private sector tax base and welfare payments. This is a spectre at the current feast of public spending that the entire UK political class is ignoring.

Lower growth, greater poverty

Studies have confirmed that high public spending leads to reduced growth and, eventually, to a much poorer population than would otherwise have been the case. Table 4 (above) brings the calculations in Smith (2001) up to date and shows illustrative and approximate calculations of the effects of increased government spending on economic growth, employing statistical estimates of the impact of public consumption on the growth performance of nations provided in Barro (1997). Professor Barro estimated that, other things being equal, each 1 percentage point rise in the share of government spending in GDP was associated with a 0.14 per cent retardation in the growth of real GDP per head. This may not sound much, but it is consistent with work done by the author in the mid-1970s, and implies that the rise in Britain's public spending burden between 1997 and this year may have shaved half a percentage point off Britain's long-term rate of economic growth. The increase since the 2000 low point could have cost just over 1 per cent off the growth rate, although all such estimates need to be treated with considerable caution.

Table 4:
Estimated Effects on Economic Growth of Increase in Public Spending Since 1960

	Change in Public Spending Burden 1960–2005 (%)	Estimated Impact Impact on Annual Economic Growth (%)	How Much Higher Output would have been in 2005 with 1960 Spending Levels (%)
Australia	13.2	-1.8	123
Austria	0.9	-0.1	5
Belgium	21.2	-3.0	278
Canada	8.1	-1.1	64
France	19.8	-2.8	246
Germany	15.0	-2.1	155
Italy	18.1	-2.5	204
Ireland, Republic of	6.1	-0.9	50
Japan	19.4	-2.7	232
Netherlands	15.6	-2.2	166
New Zealand	-1.3	+0.2	-9
Norway	17.1	-2.4	191
Spain	19.2	-2.7	232
Sweden	23.4	-3.3	331
Switzerland	23.2	-3.2	313
United Kingdom	10.4	-1.5	95
United States	5.3	-0.7	37
Unweighted Average	13.8	-1.9	160

Source: Williams de Broë calculations, OECD and IMF, as quoted in footnote to Table 1. The change in the public spending burden (first column) has been 'break corrected' to allow for discrepancies in overlap years. However, the figures should be regarded as no more than highly approximate. A particular concern is that the figures for 1960 and 2005 may have been be distorted by business cycle effects, and it would have been better to do the calculation with five or ten year averaged data if such had been available.

Growth forgone

The figures in Table 4 may appear at first glance to be on the large side. However, the figures for likely growth shown in the final column reflect both a large increase in the size of the typical public sector over the past 45 years and the effects of compound interest over such a long period rather than a powerful negative effect from the spending burden on growth. The results are also consistent with the crowding out long observed in macroeconomic forecasting models, and the dramatic slowdowns observed between the growth rates achieved by many countries in the 1960s and early 1970s and those observed in the past five years. Examples are German growth which slipped from a yearly average of 4.5 per cent in the decade to 1972 to 0.7 per cent in 2001 to 2005, France which slowed from 5.8 per cent to 1.6 per cent, Italy from 4.8 per cent to 0.7 per cent, Japan from 10.1 per cent to 1.3 per cent, Canada from 5.5 per cent to 2.6 per cent, the Netherlands from 5.6 per cent to 0.8 per cent, Belgium from 4.8 per cent to 1.5 per cent and Sweden from 3.7 per cent to 2.1 per cent. These figures contrast with the relatively modest growth decelerations observed in the more parsimonious US (4.4 per cent in 1961-72 to 2.6 per cent in 2001-5) and Australia (5.4 per cent to 3.1 per cent), while the Republic of Ireland achieved an acceleration in its average annual growth rate from 4 per cent in the decade up to 1972 to 5.3 per cent over the past five years.

UK's consistent problem: slow growth and big government

Britain set up a welfare state rather early in the post-war period by international standards, and also possessed a worryingly low growth rate, which stimulated countless misconceived interventionist initiatives from both Conservative and Labour Governments from the early 1960s onwards. However, the subsequent stabilisation of the British tax and spending burdens, at a time when other countries were raising theirs, meant that UK growth only slowed from a yearly average of 2.9 per cent in the decade ending in 1972 to 2.3 per cent between 2001 and 2005. The scale of the growth decelerations observed in many industrialised nations over the past three to four decades has huge implications for the living standards of the citizens of the nations concerned.

Government spending and growth

There might have been statistical problems (to do with simultaneity) in some of the earlier cross-section studies, which could have biased the estimated effects of government spending on growth. However, subsequent research suggests that the bias has been towards under- rather than over- estimation. For example, researchers from the OECD (2003) carried out a 'panel data' study several years after Barro's book was published using data for 21 OECD countries. This OECD study found that spending had a coefficient of plus 0.19, but taxes had a negative coefficient of 0.44, when spending and taxes were included separately. This implies that tax-financed expenditures have an overall negative impact on growth of 0.25 percentage point, or roughly twice Barro's estimate. Such research suggests that the figures in Table 4 may, if anything, be substantial underestimates. This possibility may be supported by the size of the international growth decelerations that have been observed in practice. One might also suspect that the marginal effects of rising tax and spending burdens are not linear, but become progressively more severe beyond a certain point, which is why the famous 'Laffer' curve is the shape that it is.

Table 5: Alternative Estimates of People Employed in the Public Sector

Years	Central Govt.	Local Auths	Total General	Public Corp.	Total Public	Labour Force Survey Est. of Total Public	% of Total Employment: Admin Measure	% of Total Employment: LFS Measure	Proportion of Employees in Trade Unions (%): Public Sector	Proportion of Employees in Trade Unions (%): Private Sector
1995	2,158	2,759	4,917	454	5,371	6,126	20.7	23.6	60.7	19.9
1996	2,121	2,734	4,855	417	5,272	6,232	20.1	23.8	60.6	19.4
1997	2,081	2,728	4,810	368	5,178	6,046	19.4	22.7	60.8	19.0
1998	2,086	2,710	4,796	370	5,166	6,037	19.2	22.4	60.4	18.4
1999	2,094	2,741	4,834	374	5,209	6,166	19.1	22.6	59.9	18.3
2000	2,132	2,776	4,908	383	5,290	6,282	19.1	22.7	60.6	17.9
2001	2,208	2,777	4,985	396	5,381	6,372	19.3	22.9	59.9	17.7
2002	2,297	2,794	5,091	397	5,488	6,500	19.6	23.2	60.1	17.3
2003	2,407	2,837	5,244	394	5,638	6,616	19.9	23.4	59.4	17.1
2004	2,478	2,889	5,367	384	5,751	6,896	20.2	24.2	59.3	16.3
2005	2,533	2,929	5,462	383	5,846	7,007	20.3	24.3	n/a	n/a

Source: Hicks et al (2005), Tables 3.1, 4.1 & 4.9.

Internal transfers: the economic and political impact

One growth-retarding step taken by the present British Government has been to increase the transfer of resources from the high- to the low-productivity areas of the economy. This process has had two dimensions. The first is the shift from the more productive private sector into public provision (Tables 5 and 6). The other is the transfer of resources from the high productivity regions of Britain to the less productive ones. The latter is a serious 'real' injustice to the expensive and productive areas, in the same way as Portugal's tax bands would be if imposed on Germany. Table 8 attempts to compensate for this by adjusting the fiscal 2005–6 starting point for income tax and the higher rate threshold for the regional differences in nominal Gross Value Added (GVA) per employee, and the Inheritance Tax Threshold (IHT) to reflect regional differences in house prices (see: Smith (2005) for further details). There is clearly a risk that the distribution of the UK's tax burden across the regions has become so arbitrary in real terms that it will result in the emergence of an English secessionist party. The rise of the Northern League in Italy, the emergence of a reinvigorated Catalan independence movement in Spain, the velvet divorce between the Czech and Slovak republics, and the secessionist noises that occasionally emerge from the Western Provinces of Canada over the scale of fiscal transfers to Quebec, all demonstrate what happens when less productive areas of a state push the demands that they make on their neighbours beyond a certain point.

Where Does New Labour Stand?

How does the New Labour economic project fit into the typology of economic systems? At one extreme, there is the pure free-market capitalism of the sort that came close to prevailing in Britain in the nineteenth century, when the state absorbed less than a tenth of national output. This can be regarded as a system in which the owners of human, physical and financial capital can do what they like with their resources, and are free to allocate the returns from their enterprise and endeavours as they see fit. Pure socialism, on the other hand, is a system in which all means of production are expropriated and controlled by the state, and the government decides how the resulting output is allocated. However, and in practice, most of the former Eastern European states, including the former USSR, still had underground or uncontrolled sectors of somewhere between a quarter and a third of national output in the 1970s, and it is unclear whether pure socialism has ever been implemented in reality. An old-fashioned mixed economy, such as Britain's in the 1950s, is one in which the ownership of capital and the production process are left to market forces, but a proportion of the ensuing output is creamed off, preferably by non-distorting taxes, to support wider social goals. The share of British government spending in market-price national output was reasonably close to Tanzi and Schuknecht's 30-35 per cent optimum in the late 1950s (the same appears to have been true of many other countries at the time, see Table 1) despite Britain's massive expenditure on defence by contemporary standards.

Table 6:
Government Output Per Employee Compared With Other Sectors, and Comparison of Government and Household Consumption Price Trends

	General Govt. Output Per Employee		Non-Oil GDP Per Employee		Manufacturing Output Per Employee		General Govt. Consumption Deflator		Household Consumption Deflator	
Years	1997 = 100	Ann % Chg.	1997 = 100	Ann % Chg.	1997 = 100	Ann % Chg.	1997 = 100	Ann % Chg.	1997 = 100	Ann % Chg.
1995	96.4	2.4	96.8	1.4	99.7	-1.0	94.9	2.2	94.6	3.3
1996	99.2	3.0	98.6	1.9	99.0	-0.7	98.2	3.4	97.6	3.1
1997	100.0	0.7	100.0	1.5	100.0	1.1	100.0	1.8	100.0	2.5
1998	100.8	0.8	102.5	2.5	100.5	0.4	102.7	2.7	102.7	2.7
1999	102.6	1.9	104.5	1.9	104.6	4.2	106.7	3.8	104.3	1.6
2000	104.8	2.2	107.5	2.8	110.2	5.4	110.6	3.7	105.6	1.3
2001	104.9	0.1	108.8	1.2	113.3	2.8	116.1	4.9	107.9	2.1
2002	107.1	2.1	110.2	1.3	116.0	2.3	122.7	5.7	109.4	1.5
2003	108.7	1.5	112.1	1.6	122.5	5.6	129.0	5.1	111.5	1.9
2004	109.5	0.7	114.6	2.4	130.7	6.8	133.3	3.3	112.8	1.2
2005	110.1	0.5	116.0	1.2	134.5	2.8	139.0	4.3	115.1	2.0

Source: ONS national accounts and employment data, WdB calculations.

New Labour's so-called 'third way' seems to correspond to none of the above. Instead, it appears to be a system under which the private sector maintains a nominal legal control over its capital and labour, but the returns on these factors of production are so heavily influenced by tax and regulation that the public sector ends up effectively controlling them. This dubious form of mixed economy, which is widespread across Continental Europe but philosophically distinct from the British mixed economy of the 1950s, appeals to the political and bureaucratic classes in many countries because it forces all sectors of society to keep on good terms with the state and its functionaries if they are to remain in business.

'Third way' economies also seem capable of generating good growth in their early years, when GDP is being boosted by its public spending component, although this can mask a far worse performance on the part of the non-socialised component of national output, if this is stripped out from the overall GDP figures. However, 'third way' regulations and controls create inefficiencies, which lead to more regulations and controls, until everything seizes up to the point at which deregulation becomes essential if the system is to survive. Britain's disappointing 1¾ per cent rate of economic growth last year, which was noticeably less that most official and independent forecasters had anticipated at the start of the year, and rising joblessness, may indicate that the supply side of the British economy is already buckling under the strain of its increasing tax and regulatory burdens.

Table 7:
General Government Expenditure in 2003-04 by Country / England / Scotland / Wales and Region

	Identified Public Spending 2003–04 (£m)	Scaled Public Spending 2003–04 (£m)	Est. GDP at Basic Prices in 2003–04 (£m)	Ratio to GDP at Factor Cost (%)	Ratio to GDP at Basic Prices (%)	Ratio to GDP at Market Prices (%)	Prop'n. Empl'ed in Pubic Sector* (%)
North-East	17,261	21,209	33,792	63.9	62.8	55.7	23.7
North-West	44,172	54,274	102,000	54.1	53.2	47.2	21.5
Yorks & Humber	29,954	36,805	74,443	50.3	49.4	43.8	20.3
East Midlands	23,208	28,516	64,450	45.0	44.2	39.2	17.9
West Midlands	31,032	38,129	80,815	48.0	47.2	41.9	19.5
South-West	27,696	34,030	78,552	44.0	43.3	38.4	20.4
East	28,137	34,572	99,620	35.3	34.7	30.8	18.6
London	52,944	65,053	162,030	40.8	40.1	35.6	19.0
South-East	41,728	51,271	155,440	33.6	33.0	29.3	17.6
England	296,131	363,858	851,142	43.4	42.7	37.9	19.5
Scotland	37,152	45,649	81,427	57.1	56.1	49.8	23.8
Wales	20,277	24,914	38,769	65.4	64.3	57.0	23.3
Northern Ireland	13,527	16,621	23,076	73.2	72.0	63.9	29.8
UK	367,086	451,041	994,414	46.2	45.4	40.2	20.3

*Average of four quarters to 2005 Q2. The original Labour Force Survey figures have been scaled down by the ONS (see: Hicks et al (2005) for details).

Sources: HM Treasury, ONS and WdB estimates (see: Smith (2005) for further details).

Milton Friedman once remarked that he supported liberal-market capitalism because it was the best guarantor of personal liberty, and not personal liberty as the best guarantor of free-market capitalism. The fact that New Labour has imposed its interventionist policies on Britain through stealth – and hence without a proper democratic mandate – should not conceal the facts that its micro-management is a potential threat to personal freedom (Major (2003)) and that a cost-benefit analysis of the effectiveness of New Labour's stewardship would produce a pretty damning balance sheet as far as the results were concerned. Thus, it is possible to calculate from the figures given in Table 6 that the cost of providing general government final consumption in 2005 would have been $21\frac{1}{2}$ per cent lower if the productivity performance of the government sector had moved in line with that of the non-oil economy as a whole, and government costs had moved with the household consumption deflator. The difference represents some £$49\frac{3}{4}$bn, over and above any waste that already existed in 1997.

A serious policy debate is needed between the ‘growth maximisers’, who want eventually to constrain the share of public spending in national output until it is on a par with such successful high-growth economies as the US, Ireland and Australia, and the ‘redistributionists’ across the political parties, who would rather achieve equality of misery in a poor, static and heavily-controlled society. Anyone who believes that advocating smaller government is not realistic should consider not just the Irish economic miracle but also recent ECB research into the effects of government spending, carried out by Schuknecht and Tanzi (2005 – I and II). Their research examined the experience of 22 industrialised countries over the past two decades. It demonstrates that, contrary to common belief, several countries apart from the Republic of Ireland were able to reduce the ratio of government spending to GDP by remarkable amounts, with Belgium, Canada, Finland, the Netherlands and New Zealand all managing cutbacks of between 10 and nearly 15 percentage points from their peak spending ratios, with another four countries reducing by 5-10 percentage points: and that these ambitious retrenchers do not seem to have suffered as a result of their large reductions, either in a macroeconomic sense, or in terms of lower social well-being. On the contrary, ambitious expenditure reforms appeared to coincide with improvements in fiscal, economic and human development and institutional indicators, even if it took time for these benefits to accrue. The authors also found that the unfavourable effects of fiscal parsimony on income distribution were small and were mitigated in absolute terms by faster growth.

Table 8:
Public Expenditure Per Capita and Tax Thresholds Adjusted for Relative Regional Incomes and House Prices

	Public Spending Per Capita 2003–04 (£)	Price-Deflated Public Spending (£)	Personal Allowance for Income Tax (£)	Starting Point for 40% Income Tax (£)	IHT Threshold Corrected for House Prices (£)	Regional House Prices in December 2005	Gross Value Added Per Filled Job (UK=100)
North-East	6,797	7,428	4,528	29,970	201,257	135,968	92.5
North-West	6,491	6,630	4,543	30,067	221,972	149,963	92.8
Yorks & Humber	5,980	6,321	4,567	30,229	218,559	147,657	93.3
East Midlands	5,458	5,569	4,733	31,331	236,141	159,535	96.7
West Midlands	5,833	5,916	4,601	30,456	244,582	165,238	94.0
South-West	5,540	5,518	4,592	30,391	296,121	200,057	93.8
East	5,151	5,105	4,719	31,234	301,170	203,468	96.4
London	7,166	6,660	5,933	39,269	397,454	268,517	121.2
South-East	5,164	4,858	5,140	34,020	344,024	232,420	105.0
England	5,940	n/a	4,944	32,724	287,997	194,569	101.0
Scotland	7,346	7,676	4,773	31,590	188,945	127,650	97.5
Wales	6,901	7,365	4,450	29,452	219,764	148,471	90.9
Northern Ireland	7,945	8,302	4,386	29,030	202,951	137,112	89.6
UK	6,164	6,164	4,895	32,400	275,000	185,788	100.0

Source: Office for National Statistics, Office of the Deputy Prime Minister and WdB estimates. See: Smith (2005) for further details.

Another issue all market liberals ought to think about is improving the linkages between representation and taxation. The only partial solutions which spring to mind are: a) to make the maximum possible use of flat-rate proportionate taxes; b) to reinstate the Beveridge insurance principle (see: Lawlor (1998)); c) to contemplate a more federal approach to setting tax rates, possibly modelled on that of the Swiss cantons; and d) to try and reverse the growth in pernicious means-tested benefits.

Short or longer term gain?

The real public spending debate is not about economics, but over the extent to which instant gratification is preferred to deferred benefits – in the form of the increased living standards, improved life chances, and lower unemployment – which would result from a more parsimonious approach in the immediate future. Political or policy decisions tend to be made on a more short-term basis than those made by individuals, whose concerns stretch into their future (and often that of future generations too).

One consequence of the larger state is therefore the imposition of an excessively high rate of time discount on society at large.

Means-tested welfare benefits, in particular, transfer resources from people who can defer gratification – such as savers, those who study, investors and the ambitious – and place them in the hands of people who are, on average, more likely to blow everything in the search for instant gratification. To an economist, such penalisation of 'virtue' and subsidisation of 'vice' (or, in the case of legal aid, criminality) should decrease the supply of the former and increase the supply of the latter, provided that the long-run elasticity of supply is anything greater than the special case of zero, which people seem to implicitly assume when setting up welfare programmes. There is a tendency in British economic debate to assume that supply elasticities are small. However, US supply-side economists now appear to believe that the elasticity of labour supply with respect to the post-tax real wage is around 3, in that a 1 per cent rise in the real return from effort induces a 3 per cent rise in the total hours worked in the economy as more people participate in the labour force and work longer hours (see: Prescott (2004)). This effect is sufficient on its own to explain why working hours have collapsed across much of high-tax Europe over the past few decades but not in the lower-taxed US.

It is not clear whether this sort of value can be carried across to the wider debate over welfare dependency (Bartholomew (2004)), although US economists are now doing interesting statistical studies in this area. However, some economists might suspect that the elasticity of supply of welfare claimants was closer to infinity than to zero provided that: the incentives to claim were strong enough; the bureaucratic hurdles placed in the path of potential claimants could be easily overcome, perhaps by misrepresentation; and social attitudes were given sufficient time to adjust so that potential claimants no longer felt as embarrassed about living off the backs of other people's work efforts, as an older generation of the honest poor clearly did four or five decades ago.

Conclusion

This paper has examined the growth of government over the past century and how far it exceeded the optimal point at which social welfare is maximised. Until recently such a task has not been easy because there was little firm evidence on where the optimal point lay. The evidence now is that the optimal size of general government expenditure is somewhere around 30-35 per cent of GDP (market price measure).

Across Europe however, the public spending burden is almost everywhere far higher than this optimum would suggest with the exception of the Republic of Ireland, which also has one of the strongest economic performances. The view that 35 per cent or so represents the desirable upper limit on the size of state spending is also borne out by the relative performance of the low-spending US and Australia, compared to the Euro-zone as a whole.

The costs of pushing government spending beyond this optimal point are serious. The loss of personal liberty and the property rights that go with an interventionist state are two major costs. There is also the risk that big states, which are insufficiently constrained by the democratic process, tend to be inefficient and ultimately corrupt with impropriety amongst the politicians or officials. The economic costs of a large – or too large – state are higher. They include slower growth, high structural unemployment, and the static inefficiency in the use of scarce resources.

The adverse effects can be quantified in a number of ways – ranging from simulations on macroeconomic forecasting models, to cross-section and panel-data studies of the effects on economic performance of public spending. The evidence from panel-data studies is that the adverse effect of a 1 percentage point increase in the government spending burden beyond its socially optimal point is quite small, at around 0.1 to 0.2 percentage points off the sustainable rate of economic growth. However, these effects are more serious if the government spending burden overshoots by 10 to 20 or more percentage points (as we see in Europe) and one allows for the effects of compound interest over a generation or so. It is likely that these effects are non-linear, and become progressively more severe as the government spending burden expands, although there is little published research on this issue.

Under Gordon Brown's stewardship, the British economy embarked on what may prove to be a dangerous experiment: what will the consequences of increasing government involvement in the economy be to a small, open and trade dependent economy, with a currency which has, historically, suffered speculative attacks? This is taking place when continental European countries have realised that big spending policies are unsustainable. Such countries are already trying to limit the absorption of resources by the state. The latest forecasts from the OECD show the share of general government outlays in the Euro-zone as a whole falling from a 1997 figure of 49.3 per cent to 46.9 per cent next year, while in the UK an equivalent increase is expected from 41.5 per cent to 45.7 per cent, an amount that might be expected to slow the sustainable rate of economic growth by around $1/2$–$3/4$ per cent per annum. The OECD expects that America's spending burden will be only 36.6 per cent next year, compared with 35.4 per cent in 1997, while Australia's will be 35.5 per cent and Ireland's 35.2 per cent, and even Germany's will be only 45 per cent, which is 3.3 percentage points less than in 1997.

There are further grounds for concern. The UK has avoided a serious recession in recent years largely because of the successful conduct of monetary policy. This means that the cyclically adjusted fiscal situation in Britain is weaker than appears from the crude figures. The OECD estimates that the cyclically-adjusted government deficit will be 3 per cent of UK GDP next year, for example, compared with 1.6 per cent in Germany, 2.4 per cent in France, and 2 per cent in the Euro-zone as a whole. The underlying deficit is expected to be even worse in the US next year, at 3.9 per cent, but the trend in the US is improving, while low-spending Australia is expected to show a structural surplus of 1.2 per cent of national output in 2007. Such comparisons suggest that, if the British economy does enter a business cycle downturn in the next few years, its fiscal deficit could balloon at a frightening pace, just as happened under Labour in the mid-1970s, again in the early 1980s under the Conservatives, and also during membership of the Exchange Rate Mechanism in the early 1990s. More generally, the long-term consequences of the present British Government's policies are likely to be a permanent deterioration in the nation's economic performance, similar to that which followed the introduction of the then President Mitterand's highly interventionist policies in France in the early 1980s, or the huge increase in government spending under Chancellor Kohl, which followed German economic and monetary union in the early 1990s.

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