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Re-Booting Government

How to deal with the deficit without cutting vital services

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Executive Summary

Reducing deficits and debt is essential. Debt imposes a large interest-payments tax on citizens, limits the options open to governments, and it weakens political leaders both at home and abroad.

Options: Some governments see inflation as a way to manage down their debts. But inflation is a fraud, particularly on savers and pensioners, and is no longer seen as a legitimate policy. Rapid economic growth could quickly reverse the financial situation, but higher taxes do not encourage growth. The experience of other countries suggests that most of the budget consolidation must come through expenditure cuts. However, spending cuts are politically difficult. And while crisis-driven freezes and across-the-board cuts may be necessary in the short term, they can undermine morale and sometimes risk cutting into both good programmes and bad. In the long run, more structural approaches are needed.

Short-term savings: Yet, even in the short term, savings can be made through structural cuts: eliminating programmes that underperform, cutting benefits and other expenditures that are poorly targeted, and opening up spending to public scrutiny by posting all expenditures online in simple form.

Medium-term measures: Medium-term savings can be made by privatizing state assets such as the Royal Mail. The recent, explosive growth of quangos also provides scope for spending cuts, particularly in those bodies that lack clear purpose, underperform, or get in the way of other public and private bodies. In addition, medium-term and long-term savings can be achieved by devolving funding from Whitehall to local governments, and indeed beyond that to service providers, where value for money can be much more closely monitored. And we need a UK equivalent of the US Grace Commission, to bring private-

sector expertise onto the problem of monitoring and controlling public expenditure.

Re-thinking government for the longer term: Getting the public finances into long-term shape, however, requires a complete re-think about what the government does and how it does it. The approach should be to weigh priorities and programmes against each other. By working out which public services are valued and essential, and which bring the public only marginal benefit, we will be able to clear a large volume of low-value initiatives – and perhaps spend more on the most valued services, even as the total cost of government is reduced. This is rebooting government.

Lessons from abroad: Canada provides some valuable lessons, as does Sweden, both of which turned large deficits into surpluses within a short time. There has to be a single, public service reform minister, in charge of making these structural changes, and failure has to be a career-breaker. The lead minister has to be a *reform* and not a *finance* minister, so that all ministers can buy in to the approach rather than regarding it as a financial assault on their empires. The efforts of each minister in evaluating their departments and eliminating marginal programmes must be closely monitored. The programme needs to be a coherent whole, rather than a series of ad hoc measures and backtracks that satisfy nobody.

Rules for responsibility: Lastly, there needs to be a set of budget rules for the future, monitored independently, which sets limits on spending, deficits, debt, borrowing and taxation.

The need to deal with deficits

The coalition government partners have agreed that Britain's public sector deficit must be substantially reduced within five years. This is a wise policy. The national debt is now

the highest in peacetime history. Many economists expect it to be as large as the nation's income within five years. Without action, the Bank for International Settlements estimates it will be five times that within thirty years.

Meanwhile, government borrowing – which adds to the debt total each year – is forecast to reach 14% of national income next year, another peacetime record, and as high as that of beleaguered Greece. The structural part of this borrowing – the part caused by chronic government overspending rather than exceptional expenditures such as the bank bailouts – is expected to reach 10% of national income. It is right that these worrying figures should be addressed.

Options for deficit reduction

There are four obvious ways of bringing down annual deficits.

Economic growth: Some people argue that a period of rapid economic growth and rising will rapidly eclipse this borrowing, and return the deficit to more normal levels. However, smaller deficits still mean an increasing, rather than diminishing, national debt; it would take very rapid growth indeed to start paying off the total of our borrowing. And the continuing troubles of our main trading partners, Europe and the United States, suggest that our trade and thus our fortunes are unlikely to turn up any time soon.

Raising taxation: Other commentators argue that, in order to ensure a smooth recovery, public spending must be protected, and that the only realistic way to close the deficit is to raise taxation. However, a number of international economic studies suggest very strongly that rises in taxation choke off economic growth, particularly in highly taxed countries like the UK today. Indeed, a 2001 study by the OECD found that raising taxes by 1% of GDP would reduce economic growth by about 0.6%.¹ Meanwhile there is evidence that the new 50% rate of income tax is causing Britain's mobile, entrepreneurial talent to relocate abroad – as it did in the 'brain drain' of the high-tax 1970s – which again threatens economic recovery and a growth-led antidote to the debt. In this respect, imposing higher rates of taxes on work and enterprise, like Income Tax and Capital Gains Tax, are much more damaging than widening the incidence of consumption taxes like Value Added Tax; but neither actually encourages growth.

Inflation: In the past, governments have whittled down their debts through inflation – paying back their debts in

devalued currency. Apart from the moral objections to this sort of fraud, it will make people less willing to lend when the government needs to borrow. More obligations are now indexed for precisely that reason, which makes inflation less useful as a budget tool anyway. But there is a deeper problem: the false boom of rapidly rising prices confuses investors and leads to resources being diverted into the wrong places, such as speculative housing bubbles, rather than into solid, long-term businesses. In other words, inflation is economically destructive.

Reducing expenditure: The other way of reducing the deficit is to reduce public spending. Again, some critics argue that this inevitably means job losses, since quests to cut 'waste' in the public sector rarely succeed; and that greater public expenditure would generate more jobs. This is not true. It is like trying to revive a patient by taking blood from one arm and injecting it into the other. While public spending may create public jobs, they come at the expense of private jobs, since the spending has to be paid for either by higher taxation (which makes consumers cut back, raises business costs, and so forces some firms out of business), or by public borrowing (which absorbs the investment funds needed by businesses, and is dangerously high already). And it is private, not public, jobs that will create long-term growth.

The art of balancing budgets

Studies by academic economists and international bodies such as the European Commission, the International Monetary Fund, the and the Organization for Economic Cooperation and Development agree that the best way to bring public budgets into balance, and so provide a stable foundation for long-term growth, is through spending restraint, supported by believable budget rules, rather than through higher taxes.

However, just as the art of taxation (to quote Louis XIV's finance minister, Jean-Baptiste Colbert) consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing, the art of cutting public expenditure is precisely the same. Savings must be maximized, but with the minimum of political fall-out. In the face of a crisis, voters might well be prepared to accept temporary cuts in all budgets. For longer-term solutions to work, however, governments need to ensure that the essential services that people most value are still delivered – even if they might be delivered in other ways or by other people, and even if more marginal parts of government activity are cut out.

Short term solutions

Dealing with the deficit therefore requires some lateral thinking, and a mixture of short-term and long-term approaches. In the short term, say up to three years, a number of crisis measures are possible, though not always agreeable.

Pay freezes: One such measure would be a two-year freeze on public sector pay. This is probably as much as can be endured before the loss of morale starts to seriously hit essential services. It would, however, bring sizeable savings of about £6bn per year. There may have to be tweaks – such as maintaining pay rises for the lowest-paid or for the armed forces – but equally some of the top salaries could actually be reduced. Since people in the private sector have suffered pay cuts of roughly 10% in recent years, many would regard this public-sector restraint as only fair.

Recruitment: A freeze on recruitment – or at least, not automatically replacing employees who leave or retire – is perhaps a better way of managing staff costs and forcing new approaches and efficiencies on those who remain. This approach is common in the private sector and has allowed major savings in some council budgets too.

Underperforming initiatives: There are a number of government programmes, often introduced to gain political headlines, which are underperforming. These are plainly marginal to the core purpose of government and are candidates for cuts. They include programmes such as the Education Maintenance Allowance and Sure Start. The Institute of Directors has calculated that another £5.5bn could be saved in such ways.² There are also savings of perhaps £1.5bn to be made from unpopular programmes that could be abandoned, such as the child database and the national identity database.

Middle-class benefits: There are very substantial savings to be made, perhaps up to £12bn, from cutting the state benefits that go to the middle classes. Some families earning £46,000 a year nevertheless qualify for Tax Credits: most people would think this money better spent on helping families earning £6,000 a year instead. Free bus travel and TV licences for pensioners are also poorly targeted, when many pensioners are quite well off: again, it might be better to target the money on the poorest.

Government grants: In the short term, cuts can be made in government advertising, civil-servants' expenses, grants to outside groups such as trade unions, arts organizations

and voluntary bodies. Many of these grants are politically motivated and bring only marginal benefit to the general public; and in any event, it is probably better for such groups to be funded by voluntary public contributions rather than by involuntary tax contributions decided by politicians rather than the public.

Posting spending online: Publishing all items of government and local government expenditure online will be a short-term measure with profound long-term results. Many departments complain that the information, such as civil-service salaries, is already published on their websites; but of course this information can be difficult to find, inconsistent, and incomplete. With the exception of some defence and security spending, all government spending items should be made public, in a format that allows the public, newspapers, academics and others to process the data. The longer-term effect of this is to bring far greater focus on value for money in public services. If contractors, for example, can see what schools or clinics are actually paying for supplies and buildings, they will be able to propose a large variety of more cost-effective alternatives.

Medium-term approaches

Privatization: In the medium term, depending on the recovery of world markets, there are one-off savings of around £16bn to be made from the privatization of bodies such as the Royal Mail, the Tote, and the utilities in Scotland, as outlined in a recent Adam Smith Institute report by City analyst Nigel Hawkins.³ A further £32bn could be raised from the sale of the government stakes in the Royal Bank of Scotland and the Lloyds Banking Group, as well as the 'good bank' part of Northern Rock.

Quangos: Also in the medium term, it should be possible to close a number of quangos, including the Regional Development Agencies, whose contribution to public life is exceeded by their cost. Among these would be many in agriculture, education and healthcare, where they proliferate and crowd out private entrepreneurship. Business leaders complain that the various skills quangos actually get in the way of skill development, rather than promote it. Cutting such costs means lower taxes for businesses and the public, and therefore a greater chance of speedy economic recovery. And there should at least be a national debate on whether agencies like the Equalities Commission and the Carbon Trust have largely made their point and are contributing much to their core purpose any longer.

There should be a zero-base, 'sunset' rule for quangos: they should be given clear objectives over a five-year term, and their life should not be renewed unless they can justify both success and good value in delivering those objectives.

Devolving funding: Budget processes in the private sector, which faces a daily pressure to reduce costs and raise productivity because of competition, are generally much more devolved than in government. Public services too could improve value for money by being prepared to devolve budgeting more extensively. There are already plans to shift some parts of public spending from Whitehall to local authorities; and Canada managed to make efficiencies by devolving spending to its provinces too. Likewise, there are plans to devolve much more of the education budget down to schools and academies themselves, devolving funds even further, out of local-authority hands and into the hands of those actually running schools. There is no reason why this principle should not be taken into other public services, such as benefits provision and the National Health Service, which it is now commonly agreed is far too big to manage from the centre, and which no private company would try to.

A UK Grace Commission: There is no need for politicians and officials to try to identify all the savings options themselves, however. The private and independent sectors can be recruited to the search. An example is the US President's Private Sector Survey on Cost Controls – known as the Grace Commission – established in 1982 by Ronald Reagan. Importantly, it was staffed and funded entirely by the private and charitable sectors. Its personnel were seconded, and any expenses paid, by private-sector employees, so that no public funds were used. This guaranteed the Commission's independence from political manipulation, and allowed it free rein to propose cost-control techniques that worked well or were common in the private sector.

Over thirty task forces looked at around 98% of public expenditure. The Commission accepted the broad thrust of public policy, but its focus was on getting value for money in how those key objectives were delivered. It proposed short-term and long-term changes in the way government worked, and led to practical improvements in service delivery and value for money. It is an exercise that could be easily repeated in the UK, widening the range of budgeting options that government has to draw on.

Longer-term approaches

Re-booting government: An effective long-term approach to defeating the deficit and getting public spending under control means re-thinking the purpose of government itself. As different administrations come and go, they tend to add new programmes, often to serve their own political objectives, and soon the public budget becomes cluttered with costly initiatives that conflict, compete, or underperform. Often, when an administration moves on, its initiatives (and their funding) remain, but having lost their champions, they lose their sense of purpose and their effectiveness. Government becomes rather like a computer that is overloaded and slowed down by unwanted files and applications; the sensible thing is to save what is essential to save, and then reboot it. We need to reboot government.

Re-thinking public administration: How many government departments, for example, do we really need? Having too many creates real problems, particularly in view of the well-known tendency of public bodies to create new work for themselves. But there is a cost to democracy as well. With roughly 120 ministers and officers on the government's payroll, the House of Commons has become dominated by the executive, instead of being the people's champion against state power.

Questions have already been asked about the Business department, which many business people say gets in their way, and which produces scores of small support schemes that do little good (apart from capturing a day's headlines) and come at high bureaucratic and financial cost. Britain has also managed without a Culture, Media and Sport department for most of its long history; important though these things are, it is not clear that they have to be managed by politicians and civil servants.

The right size for a Cabinet is probably about the size of a football team – around half of what it is today. That would improve the collegiate working of government, and it would make ministers more recognizable, and therefore more accountable, to the public. Apart from the Prime Minister, how many do we need? I would say a Finance Secretary, a Foreign Secretary, a Justice Secretary, a Defence Secretary, an Interior Secretary, an Infrastructure Secretary, Health, Education, and Welfare Secretaries and a Local Affairs Secretary. Add a temporary Secretary for Public Service Reform and that seems about the right size for an executive Cabinet.

Canadian therapy: Traditional quests for ‘cuts’ are difficult because they create antagonism and disunity between spending and Treasury ministers. At best, departments spend up to the centrally imposed limits, rather than looking critically at what they deliver and how they deliver it.

When Canada in the late 1980s and early 1990s attempted to reduce a ballooning public deficit through cuts and pay freezes, morale among public service providers slumped, and the country was hit by strikes. Since the services that people valued were cut just as severely as those that nobody would have missed, citizens’ trust in the government and public sector was destroyed. As for ‘efficiency’ programmes to ‘cut waste’ – well, the Canadian experience is that they help, but do not actually achieve major cuts in costs.

The incoming Liberal government of 1993 faced a public debt and deficit of much the same proportions that the UK has today. Yet they managed to reduce the deficit to zero in just five years – with budget surpluses nearly every year since – almost exclusively by cutting spending. Between 1993 and 1997, spending fell by 9% of GDP, while taxes hardly rose at all.

The Canadians’ first move was to appoint a minister with the specific responsibility for public service renewal, so that there was a single, senior person with the authority to drive through the change process and make sure every other minister collaborated. Apart from pay freezes and central targets, nothing was off limits: every part of the public service, even healthcare and foreign aid, would be put under scrutiny.

The technique was to conduct a complete review of all areas of government activity. Ministers were each charged with defining what their department was there to achieve. What was its core purpose? Did it really need civil servants to achieve that purpose, or could it be delivered better by private providers, voluntary groups or by the public themselves? With one high-ranking reform minister in charge, there could be no stonewalling or hiding from such tough decisions. And with a *reform* rather than a *finance* minister in charge, everyone accepted that this was not just an exercise in penny-pinching but a complete re-think of how government engaged with citizens.

Cabinet retreats, at which ministers’ progress would be scored and new targets set, kept up the pressure. Everyone knew that for the approach to succeed, all ministers had to speak with one voice, and there was no room for departmental game-playing. Over the years, a co-

ordinating panel of ministers built up expertise that could be deployed on the reformation of one department after another.

The process recognised that some public service functions remained vital, while others could be completely redesigned or even eliminated. The end result was small cuts (or even increases) in some departments, but large savings in others whose role was redefined – massive cuts in transport and farm subsidies, for example, but rises in benefits for the elderly.

Within three years, Canada’s budget deficits were eliminated and the debt started to come down. Within five years, the size of the civil service had fallen by nearly a quarter (23%) –with no strikes or civil unrest. Before long, with the economy returning to health, the government budget could actually start growing again.

Signing the pledge: The Republic of Georgia might seem distant and different from either the UK or Canada, but it too managed to revive a debt-ridden and failing economy very rapidly. Between 2004 and 2008, Georgia’s GDP per head nearly tripled, with year-on-year economic growth of 7.8%. It grew even through the credit crunch. Much of that was down to the shrewd policies of the head of the Central Bank (and subsequently Prime Minister) Vladimir ‘Lado’ Gurgensidze, who drew up formal rules to restrain government spending, borrowing, and debt.

So successful were these rules that the current President, Mikheil Saakashvili, now proposes to incorporate them into the constitution. The measures would cap government expenditure at 30% of GDP and the budget deficit at 3% of GDP. The national debt will be capped at 60% of GDP. The proposals also specifically outlaw the sort of off-balance-sheet accounting by which five-sixths of the UK’s public debt does not show in the government’s books.

Another key part of the measures is that the spending and borrowing limits must be met over fixed 3–5 year periods – so that politicians cannot fudge the figures by stretching the meaning of the words ‘economic cycle’ as happened in the UK.

In a recent report, *Why Britain Needs An Economic Responsibility Act*, the Adam Smith Institute has built on these lessons to propose six targets – which, once achieved, become rules – for budgetary management. These include capping spending at one-third of GDP, the deficit at 3% and the debt at 40%. Off-balance-sheet

obligations would have to be stated, limited, and provided for. Borrowing would be allowed only for investment, and what counted as ‘investment’ would be scrutinized by independent economists, rather than left up to politicians to decide. And there would be limits, including referenda, on tax rises.

The quick-start guide to rebooting government

Sweden’s budget turnaround

Sweden is another country that turned around its economy with encouraging speed. Sweden suffered three years of negative growth in the early 1990s; by 1994 the deficit reached 11% of GDP and the national debt was forecast to reach 128% of GDP within six years. In fact, the deficit was transformed into a surplus, and the debt peaked at only 53%.

Certainly, strong cuts were required, not just in the civil service but in Sweden’s famous welfare state. Beyond those details, however, Sweden provides more general lessons about why and how to rebalance government budgets, as the former Finance Secretary Jens Henriksson has written.⁴ Combining these with some of the Canadian experiences gives us the following reform programme.

Debt is weakness: We need to assert firmly that strong public finances are essential everywhere. Debt constrains what governments can do, taxes citizens dearly through interest payments, and weakens ministers both on the international stage and with the public at home. So focusing on budget consolidation is key.

Single reform minister: Second, there must be a single minister responsible for seeing through the budget consolidation, and failure should be a career-breaker. That minister should be a *reform* minister, not a *finance* minister, to ensure that other ministers buy into the re-think rather than seeing it as just a ‘cuts’ exercise.

Clear goals: Third, the public must be given clear goals for the exercise: only when ministers are agreed and united will the public accept the need for change, and will the message of budget reform percolate right down through the government system.

Coherent package: Fourth, the plan has to be a coherent package. Ad hoc measures will not work, because everyone will regard themselves as valid exceptions: the message has to be that we are all in this effort together, and cuts in one place cannot be softened by giving in to those who demand spending elsewhere.

Honesty: The package must be honest, too: telling people that it will not hurt will simply infuriate them when it does. Citizens are more likely to respect and follow the politicians who tell them the bitter realities, and explain why they are necessary.

Structural reform: Lastly, reform has to be structural. As the Canadian experience shows, a bacon-slicer approach to public spending is not enough in the long run. The key lesson is to focus on what it is that the government really has to do, and do that better, while eliminating those programmes that have only a marginal effect on society and the economy. This enables government to reduce its cost, while at the same time providing better services and engaging more effectively with the public.

Endnotes

- 1 Bassanini & Scarpetta, *The Driving Forces of Economic Growth: Panel Data Evidence for the OECD Countries*, OECD Economic Studies, No. 33, 2001.
- 2 *How to Save £50bn*, Institute of Directors, 2010.
- 3 Nigel Hawkins, *Privatization – Reviving the Momentum*, Adam Smith Institute, 2008.
- 4 Jens Henriksson, ‘Sweden: Ten lessons about budget consolidation’ in Matthew Sinclair (ed), *How to Cut Public Spending*, Biteback Publishing, 2010.