The cuts are the wrong answer

John Grieve Smith

The cuts in public expenditure proposed in the Comprehensive Spending Review are the wrong answer to the problem of the budget deficit, for two reasons. The first is that they are deflationary when we have not yet fully recovered from the recession. The second is that they will harm vital public services. The government, along with a good many others, is making a panicky reaction to the possibility of loss of confidence in financial markets. But it is unlikely that seasoned actors in the financial markets are going to have doubts about the UK government's ability to meet its interest or repayment liabilities.

The cuts will not only reduce public sector jobs by over half a million, but will then have a multiplier effect on private sector jobs as sacked workers spend less on consumption. A better way to reduce the deficit would be a progressive increase in taxation. An increase in taxation like the proposed rise in VAT will mean a corresponding reduction in the quantity of goods and services bought by the less well off: but those who are better off are likely to show a much smaller reduction by digging into their savings. Progressive tax increases which fall more heavily on those higher up the income scale are the way to reduce the deficit with the minimum effect on consumption. Possible candidates are income tax increases for those at the top of the income scale, and increase in inheritance tax. The proposed bank levy also seems a good bet.

Company taxation is a tricky field, but contrary to the government's present intentions, a modest increase would not necessarily be deflationary. But it would be best done on an EU basis, and might well be welcome to other countries facing a similar problem. This would, however, involve the Treasury supporting, rather than opposing, harmonisation of corporate taxation in the EU.

The severity of the cuts

Public discussion of the cuts is confused by the use of the phrase "real increases" in expenditure. To the economist a "real increase" is the increase in expenditure in money terms less GDP inflation. A serious omission from the Spending Review document is a statement as to what the Treasury are assuming about the rate of increase of wages and salaries per head, GDP productivity and hence GDP inflation. Without this information, it is not possible to fully appreciate the

significance of the proposed public expenditure figures. But they look as if they will lead to some serious cuts in the quality of services.

Expenditure on schools is said to be safeguarded, because it will increase by 0.1 per cent a year in “real terms”. In fact this implies serious cuts in numbers or restraint in pay. Some schools are already not replacing teachers who leave, in order to reduce numbers by natural wastage. The NHS is under similar pressure.

Clearly part of the government’s motivation is to achieve a “smaller state”. The implications of such an approach have to be viewed in the light of the general trend for countries to devote a higher proportion of national output to education and health, as they get richer. This reflects two factors. The first is that that the scope for improving productivity, if any, is very limited in these fields, so that the cost of providing a given level of service in these fields shows a relative rise. The other is that as the standard of living goes up people expect higher standards of health care and education. The choice is how far this should be provided by the state, and how far by the private sector. A call for a smaller state is not about bureaucracy, but more reliance on private schools and health provision.

John Grieve Smith is a Fellow of Robinson College, Cambridge