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THE CONSERVATIVES' PROPOSALS

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The Conservatives' proposals

The Conservatives have made several proposals for tax and benefit reform, including benefit changes, reforms to savings taxation, a cut in fuel duty and a package of tax cuts for families. This Election Briefing Note analyses how these measures would affect household disposable incomes, how much they would cost and what the implications for the structure of the tax and benefit system might be. The Briefing Note closes with a look at the Conservatives' longer-term aspirations.

1. Tax cuts for families

The Conservatives plan to reduce income tax for families with children by:

- making personal allowances transferable for married couples with children aged under 11;
- increasing the children's tax credit for children under five;
- more generous tax treatment of widowed parent's allowance.

We consider each of these measures in turn and then look at the overall distributional effect of the package.

A transferable allowance for married couples

Under present legislation, the income tax personal allowance – a band of income someone can receive in a year without having to pay income tax – is a fixed amount for each individual, regardless of personal circumstances. This means that each partner in a couple of working age can earn up to £4,535 in the 2001–02 tax year without paying income tax. If the couple only has one earner (e.g. a wage-earning wife and a househusband), the partner not in paid work cannot transfer his or her allowance to the working partner. The Conservatives argue that this situation is inequitable because it means that a single-earner couple (e.g. with one partner earning £30,000 p.a.) often pays more tax overall than a two-earner couple with the same gross earnings (e.g. £15,000 p.a. each).

The Conservatives propose to make the personal allowance *transferable* for some families: in married couples where one partner's income is below the personal allowance level, the unused part of the allowance could be transferred to the other partner to reduce that partner's tax bill. To qualify for transferability, a couple would have to have a child aged under 11 and/or be in receipt of invalid care allowance in respect of a relative. The maximum value of the transferred allowance would be restricted to the basic rate of income tax (i.e. a maximum of 22% of £4,535 or £997.70 in the case where one partner has no taxable income and transfers his or her entire allowance to the other partner). In isolation, the cost of this reform to the exchequer is estimated at around £1bn.

Arguments for and against the transferable allowance proposal

As intimated above, the main argument for making personal allowances transferable is that the present system biases income tax treatment in favour of two-earner couples and against single-earner couples, because a two-earner couple can use two sets of personal allowances whereas a single-earner couple can only use one. The Conservative view is that this situation is unfair, and if net household income were the only relevant criterion for assessing fairness of the tax system, this argument would seem valid.¹ However, it is not clear that two-earner couples have an advantage in living standards over one-earner households that is proportional to their tax advantage. The (unpaid) labour of a non-working partner surely makes a positive contribution to the living standards of single-earner couples, whilst single-earner couples with children will probably incur much lower childcare costs than two-earner couples.

Additionally, the transferable allowance plan introduces an interaction between the marginal tax rates faced by first and second earners. Under the current system, husbands and wives face the same marginal income tax rate structure in most circumstances. However, under the Conservative proposal, in a couple with a non-working wife and a husband who earned enough to use up the whole of the wife's transferred allowance, if the wife were to enter work, her partner would effectively pay 22p extra tax for every £1 of income she earned up to the personal allowance limit. This means that labour market participation by a second earner would be discouraged under the Conservative proposal relative to the current situation. Given that many potential second earners will be married women seeking to re-enter the labour market after having children, the Conservative plan seems effectively to discourage this.

A more generous children's tax credit

The Conservatives are proposing an increase of £200 per year in the value of the children's tax credit (CTC) for parents with children under the age of five. In the March 2001 Budget, the Chancellor announced that the CTC would be increased by £520, or £10 per week, for couples with a baby under 12 months old. The Conservatives propose to increase the CTC by £3.85 per week, or £200 per year, for families with children aged between 12 months and five years. The estimated cost of this increase is just over £300m.

Labour's 'baby credit' and the Conservative under-five credit are examples of a move on both sides of the political spectrum towards increased support for young children in the tax-benefit system relative to older children. This is reinforced by recent increases in the Sure Start maternity grant for new mothers on means-tested benefits and by real-terms increases in the value of benefits for children under 11 in the working families' tax credit (WFTC) and income support. This favourable treatment for families with young children may seem surprising, given that most research on the relationship between

¹ Note, however, that the use of household income as the sole measure of well-being in a family is not uncontroversial. If, for example, husbands and wives did not share their income, then a family where a husband received 100% of a given amount of household income would have a very different distribution of welfare between husband and wife compared with a household where the husband and wife received the same total amount but 50% apiece.

household size and living standards indicates that older children are more expensive to families than younger children.² However, to the extent that childbirth and its immediate aftermath involve a high cost to mothers and to families, increases in state support for new mothers can be justified on equity grounds. Also, mothers with young children are more likely to be out of the labour market (or working part-time rather than full-time) than mothers with older children, and so the extra payments for young children could be viewed as some compensation for forgone earnings.

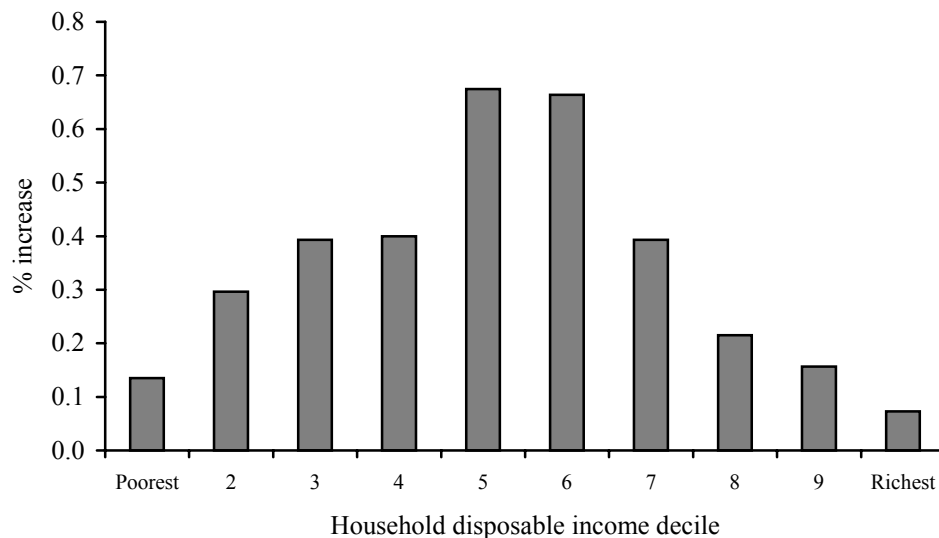
Changes to widowed parent’s allowance

In April 2001, widowed parent’s allowance replaced widowed mother’s allowance as a regular benefit for widow(er)s with dependent children. It is set at roughly the same level as the basic state pension plus any SERPS accrued by the deceased spouse, with an additional amount per dependent child. Currently, although the child additions are non-taxable, the main benefit is taxable. The Conservatives propose to make the entire allowance non-taxable. This reform would be expected to cost around £50m.

Distributional effects of the family tax package

Figure 1 shows the combined effects of the Conservative family tax package on the distribution of household disposable incomes, divided into deciles (10 equally sized portions), ranked from poorest to richest. The overall cost of the package is estimated at around £1.3bn.

Figure 1. The distributional effects of the family tax package



Source: IFS TAXBEN model, run on Family Expenditure Survey data for 1997–98.

² This is discussed in more detail in Chapter 3 of M. Brewer, M. Myck and H. Reed, *Financial Support for Families with Children: Options for the New Integrated Child Credit*, Commentary no. 82, IFS, London, 2000.

The graph shows that these reforms have the largest effect in percentage terms at the 5th and 6th deciles of the income distribution. Above and below these, the effects taper off. At the foot of the distribution, average gains are small, largely because the poorest families pay little or no income tax in general. At the top, average gains are lower partly because the maximum gains from the transferable allowance and CTC reforms – which are fixed cash amounts – are a lower percentage of annual income for the richest households than for those in the middle of the distribution. In the case of the transferable allowance reform, the top deciles contain a larger proportion of two-earner couples (who would not gain from the reform unless one partner's earnings are very low) than single-earner couples (who are more likely to gain from the change); single-earner couples are more likely to be located in the middle of the income distribution, where the largest percentage gains are. Also, families in the top deciles tend to have fewer children on average (especially younger children) and so are less likely to gain from transferable allowances and the CTC increase, which are limited to families with children aged under 11 and under five respectively. In cash terms, the family package is worth an average of £9.39 per week for single-earner families with children and £2.89 per week for two-earner families with children.

2. A tax cut for savers

The most expensive single element of the Conservatives' tax-cutting package is their plan to abolish income tax on savings interest and dividends for everyone except higher-rate taxpayers. The current system already provides for tax-free saving, notably through Individual Savings Accounts (ISAs). But these are subject to strict annual limits, and the return on any funds held in addition to these is liable to income tax.

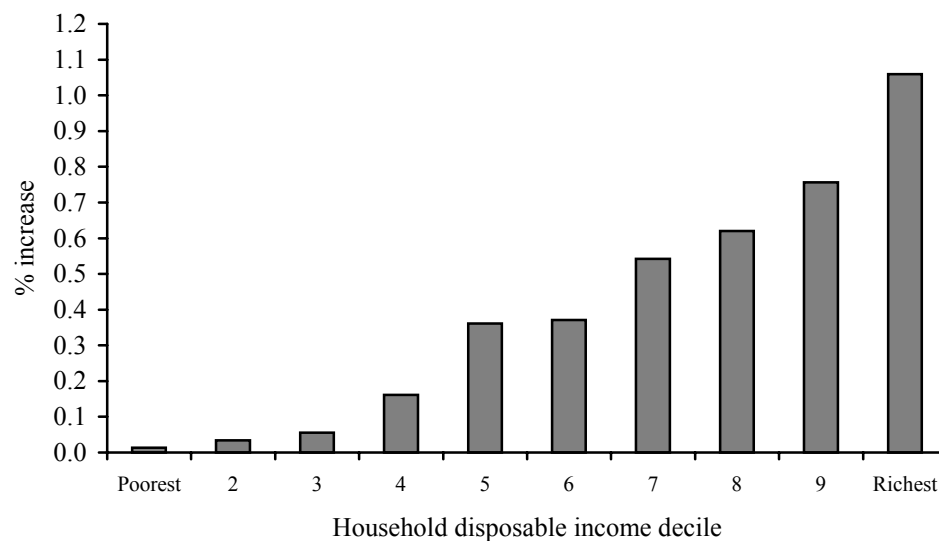
All taxpayers have 20% of bank or building society interest deducted at source. This is the final levy on basic-rate taxpayers, but starting-rate taxpayers can then claim half the deduction at source back, leaving their tax rate on interest at 10%, and higher-rate taxpayers face an additional tariff on their savings after completing their tax returns.

Under the Conservative proposal, no income tax would be deducted at source, and no tax would be paid at all by starting- or basic-rate taxpayers. Income from dividends would also be tax-free below the higher-rate threshold. For higher-rate taxpayers, any savings income held in excess of the higher-rate threshold, where savings income is viewed as the top tranche of income, would continue to be liable to 40% tax.

The Conservatives' estimate of the cost of the savings tax cut is around £3bn. Figure 2 presents IFS's estimate of the distributional effects of the reform. It shows that the poorest 30% of households gain very little from the reform – partly because they have little or no savings income on average, but also because their total income from all sources is less than the value of their personal allowance, so they pay no income tax. The average gain is 0.3% or greater for households in the top 60% of the income distribution. In the richest 10% of households, average gains are large – around 1.1% of disposable income. Thus the Conservative reform has a regressive distributional effect. A

few households would realise substantial gains; any individual with more than £29,400 of taxable savings income (the higher-rate limit) and no income from earnings would gain £5,880 a year, as all his or her savings income below the higher-rate limit would become non-taxable. However, the fact that higher-rate taxpayers would continue to pay tax on savings above the higher-rate threshold means that the reform is far less regressive than it would otherwise be. Someone whose earned income alone was greater than the higher-rate threshold would not gain anything from the reform, as savings income is taxed as the top ‘tranche’ of income.³

Figure 2. The distributional effects of changes to savings taxation



Source: IFS TAXBEN model, run on Family Expenditure Survey data for 1997–98.

Is the Conservative proposal a good idea? There are some reasons for thinking it is, on pure efficiency grounds. If investments are made out of earned income (which is mostly subject to tax), the objection to a tax on savings income is that it is double taxation of a sort, which distorts the choice between current consumption and saving for future consumption. The Conservative reform would go some way towards correcting this distortion.

There is also a more pragmatic argument in favour of the proposal. Given that every adult can save £3,000 in cash or £7,000 in stocks and shares each year in an ISA under current rules, if people took full advantage of this, then the vast

³ When analysing Figure 2, it should be borne in mind that the Family Expenditure Survey (FES) data significantly underestimate the level of savings holdings compared with National Accounts data (see, for example, Chapter 2 of J. Banks and P. Johnson (eds), *How Reliable Is the Family Expenditure Survey?*, IFS, London, 1998). Thus the overall gains from the savings tax cut will probably be greater than those shown here, although we have no way of knowing in which deciles the gains are under-measured in the FES. On the other hand, the FES data used here are from 1997–98, before ISAs were launched. This may cause a tendency to overestimate the gains from the policy, as, to the extent that households have shifted previously taxable savings into ISAs since 1999, they already pay no tax on savings income and so would not benefit further from the Conservative proposal.

majority of people would pay no tax on their savings income even under existing rules. However, in practice, this is not the case: a recent IFS report found that ‘in spite of the proliferation of new savings vehicles, the majority of people still hold the majority of their [financial] wealth in conventional forms such as interest-bearing accounts at the bank or building society’.⁴ There are several possible reasons for this: individuals might need to move savings in and out of accounts regularly, in which case ISAs are not suitable; or there might be ‘hassle costs’ involved in closing accounts with small sums in them and transferring into an ISA. However, the Conservative plan has the merit of extending the tax-free savings environment to many small savers who are currently missing out, for whatever reason; this equalises the savings tax regime for all basic-rate taxpayers. Also, individuals on the 10% marginal rate currently need to apply for a rebate to claim back the tax charged at 20% at source on their savings; this is an administrative complication that would be eliminated if savings tax on these people were abolished.

On the other hand, it can be argued that there are dangers in the Conservative proposal from the perspective of horizontal equity in the tax system. Under current inheritance tax rules, an individual receiving an inheritance bequest of up to £242,000 and no other income, and investing the bequest for an annual income lower than the higher-rate threshold, would pay no tax under Conservative plans; this would make his or her tax treatment substantially more lenient than another individual with the same gross income but from earnings rather than investments. Under the current system, such a tax-free investment income could only be built up piecemeal by using the ISA allowance of £7,000 per person per tax year. Another possible tax loophole is that individuals with control over the form that their remuneration takes (e.g. the self-employed) could choose to pay themselves in shares rather than earned income (for example); the dividend income from these shares would then be tax-free. However, this could only be done up to the basic-rate tax limit.

In short, the Conservatives have produced a radical proposal that will help many smaller savers as well as reducing distortions to savings behaviour induced by the tax system. However, the overall distributional impact is regressive, and the proposal may open up new tax loopholes.

3. Extra help for pensioners

The Conservatives have two proposals that help many pensioners. On the tax side, they propose increasing personal income tax allowances for pensioners by £2,000. This reform is estimated to cost around £800m and would benefit pensioners whose income is currently more than £6,230 per year (those with lower incomes already pay no income tax and so would not see further gains). Estimates from Family Resources Survey data for 1998–99 suggest that the reform would benefit around 35% of pensioners. Pensioners falling into this category are mainly concentrated in the middle of the overall household income distribution. The maximum gain to a pensioner from the reform is

⁴ J. Banks and S. Tanner, *Household Saving in the UK*, IFS, London, 1999.

£440 per year for a basic-rate taxpayer. Higher-rate taxpayers would not benefit because the extra personal allowance for pensioners compared with people of working age is tapered away for pensioners with £17,500 or more of income per annum.

At the same time, the Conservatives propose increasing the basic state pension by £1 per week for single pensioners aged 75 or over and by £2 per week for married couples aged 75 or over. These increases are over and above the increases that Labour plans for 2002 if re-elected. The cost of this reform is estimated to be around £100m. Analysis of the distributional effects shows that gains are concentrated in the bottom half of the income distribution, mainly because pensioners aged over 75 are a fairly poor group on average. However, the poorest pensioners are currently entitled to extra means-tested support through the minimum income guarantee (MIG); they are unlikely to gain, because MIG entitlement would be withdrawn pound-for-pound against any increase in pension income. However, the pension increase would help pensioners who did not realise they were entitled to the MIG or were not taking it up for some other reason.

The third plank of Conservative proposals is the ‘consolidated pension’ – a plan to offer pensioners the option of waiving their entitlement to free TV licences for the over-75s, the winter fuel payment and the Christmas bonus in exchange for a higher basic state pension of equivalent value. At first blush, it is not clear why pensioners who pay income tax or those on the MIG would opt for consolidation, as the winter fuel payment and implicit value of the TV licence are not counted as taxable income or as income for the MIG means test, whereas an equivalent increase in the basic pension would be; these groups would therefore lose out from opting for pension consolidation, other things being equal. However, pensioners in specific groups not entitled to one or more of the specific payments being replaced (e.g. pensioners in nursing homes, who do not receive the winter fuel allowance) would gain from consolidation.

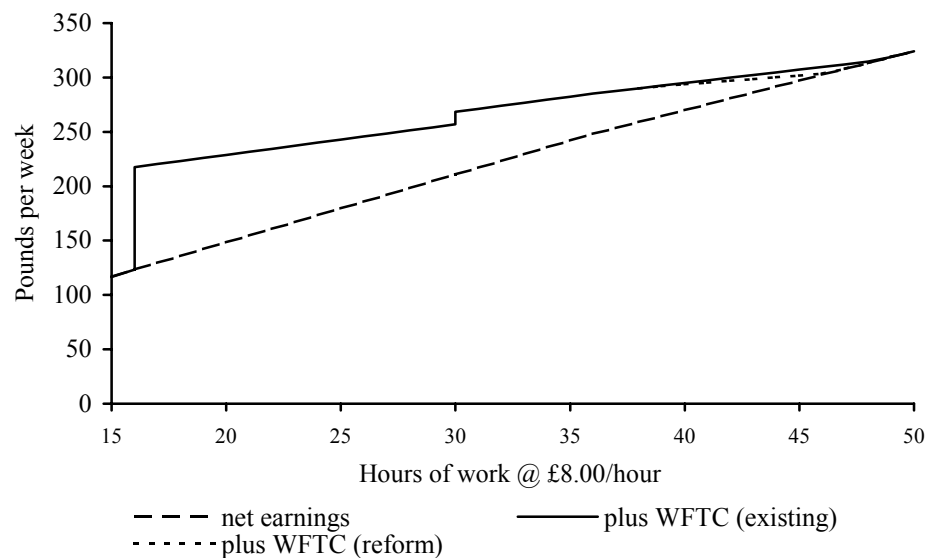
The Conservatives are considering changes to income tax coding and/or MIG rates for the affected groups to overcome the unattractiveness of opting for consolidation. However, these would significantly increase the administrative complexity of income tax and income support without making most pensioners any better off in real terms.

4. In-work benefit reform

The Conservatives plan to introduce a ‘kinked taper’ for the working families’ tax credit, which would reduce benefit entitlement for families whose entitlement is £30 or less under the current system. For these families, the WFTC withdrawal rate per pound of additional net income would rise from 55p to 70p. Figure 3 shows what the impact of this benefit cut would be on the budget constraint of a single parent with two children aged five and 11, working 16 or more hours per week with gross earnings of £8 per hour and no other income. The reform means that entitlement to WFTC disappears completely at gross earnings of around £375 per week, as opposed to £390 per week under the existing system, but its effect on the overall budget constraint

is minimal. The reform is designed to save money as well as limiting the spread of high marginal rates up the income distribution, which the higher generosity and shallower taper of WFTC compared with its predecessor, family credit, have entailed. The reform would certainly be a step in this direction; however, set against this must be the impact of higher marginal deduction rates for those moved onto the 70% taper. The reform would also introduce additional complexity into the WFTC assessment for only modest gains to the exchequer: the savings from this reform are estimated to be roughly £75m.

Figure 3. WFTC receipt by gross earnings under present system and with kinked taper

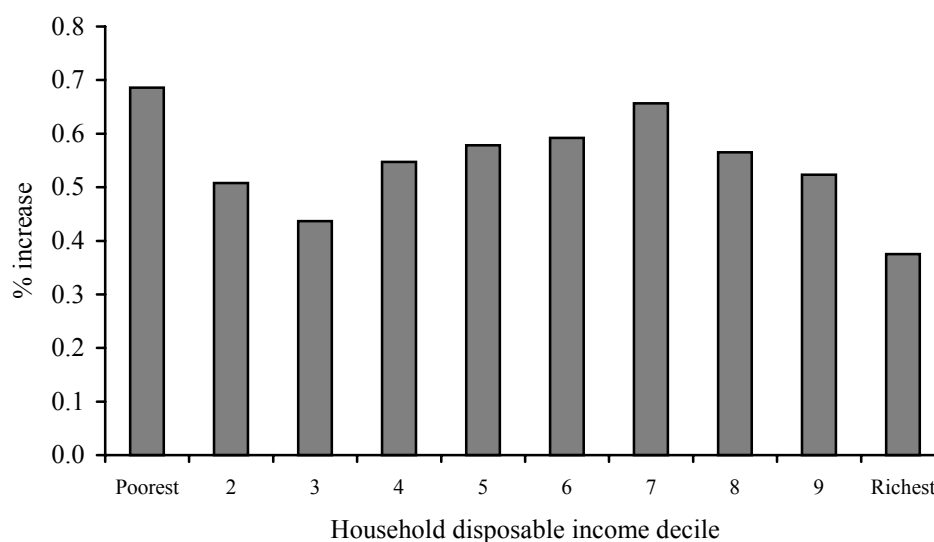


In addition, the Conservatives plan to make a further £200m of savings by scrapping the New Deal for Lone Parents (NDLP) and reducing the generosity of the Social Fund. As the NDLP is projected to cost around £100m in 2001–02, this implies that the Conservatives are planning to reduce the allocation of resources to the Social Fund by approximately £100m. The Social Fund currently provides loans for essential expenditure for families on income support or income-based jobseeker’s allowance, as well as funeral payments, cold weather payments, winter fuel payments for pensioners and for families on income support, and community care grants. Government figures indicate that, in 1999–2000, total expenditure on the Social Fund was around £1.4bn. As a proportion of this, £100m seems small. However, the *discretionary* elements of the fund (community care grants, budgeting loans and crisis loans) amounted to only around £550m. If the Conservatives’ £100m saving came exclusively from cuts in discretionary payments, this would substantially reduce the sum available to fund emergency payments to benefit claimants in difficult circumstances, making them worse off.

5. Cutting fuel duty

The Conservatives plan a 6p cut in duty on petrol and diesel. Figures from HM Treasury suggest that the cost of this reform will be in the region of £2.2bn.⁵ Figure 4 shows the impact on the distribution of household incomes.

Figure 4. The distributional impact of the Conservative fuel tax cut



Source: IFS TAXBEN model, run on Family Expenditure Survey data for 1997–98.

The fuel duty cut has a slightly uneven impact on the distribution of household income, with the bottom decile gaining by most on average – just under 0.7% – but with all deciles except the richest gaining at least 0.4%. Of course, people who do not own or use a car will gain nothing from the reform, and as the proportion of car-owning households is higher for richer households than for poorer households, the *number* of gainers will be larger higher up the income distribution. Whilst the fuel protests of September 2000 seem to indicate that a cut in fuel duty would be a very popular policy with some fuel consumers, it should be recognised that reductions in petrol prices will presumably mean that car use and vehicle mileage will be higher than they would have been had duty remained at current levels. This could contribute to an increase in congestion and make reductions in carbon dioxide emissions harder to achieve.⁶

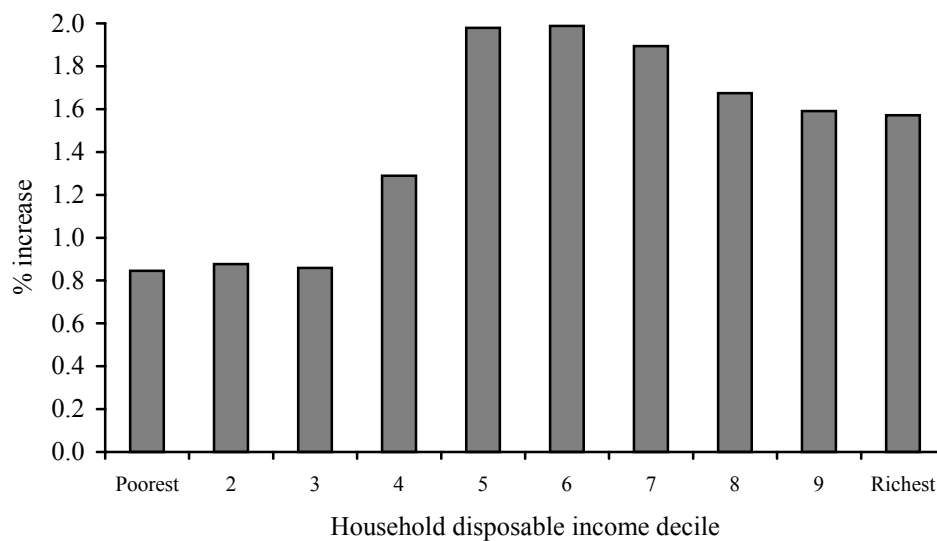
⁵ Source: HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, London, November 2000.

⁶For a detailed treatment of these issues, see L. Blow and I. Crawford, *The Distributional Impact of Taxes on Private Motoring*, Commentary no. 65, IFS, London, 1997.

6. The overall effects of the reforms

This section shows what the combined net effect of all the Conservative proposals examined so far would be. Figure 5 shows the net effect of the Conservative package on the distribution of incomes in percentage terms by decile. When looking at this graph, it should be borne in mind that the Family Expenditure Survey data probably underestimate the impact of a few of the Conservative reforms (particularly the savings rate cut). None the less, the general shape of the results would be unlikely to change even if the data were more accurate.

Figure 5. The effect of the Conservative package by income decile: percentage terms



Source: IFS TAXBEN model, run on Family Expenditure Survey data for 1997–98.

Figure 5 shows that the distributional impact of the overall Conservative package is not straightforward. The clearest result is that the poorest 30% of households gain less on average than richer households. This is because most of the money being given away takes the form of various income tax cuts and reliefs, none of which can benefit the many households at the bottom of the distribution who pay no income tax. By contrast, the households in the middle 20% of the income distribution are the biggest gainers of all in percentage terms. Many households in this group gain from one or more of the transferable allowance, increases in pensioner tax allowances, the CTC increase for young children and the savings tax reforms. At the top of the distribution, the effect of the savings tax cut dominates. The cut in fuel duty is the one policy that has average benefits across all deciles.

In Figure 6, an analysis of how much people gain in terms of cash per week presents the same information in less abstract terms. On this measure, the richest 10% are way out in front. This is because a given percentage gain shows up as a larger cash gain for a rich household than for a poor household.

The cash analysis shows that the richer the decile, the larger is the average gain.

In Table 1, we present the average gains by family type. Families are presented in three sub-groups: families with children, pensioners and other groups. The table shows that single-earner couples with children do best from the Conservative proposals on average. This result is mainly driven by the transferable allowance for married couples with children under 11 and the increases in the children's tax credit for children under five. Two-earner couples where one of the couple has low earnings also gain from the transferable allowance plan. Pensioners do well on average, due to the increases in their income tax allowances, the savings tax cuts and the increases

Figure 6. The effect of the Conservative package by income decile: cash per week

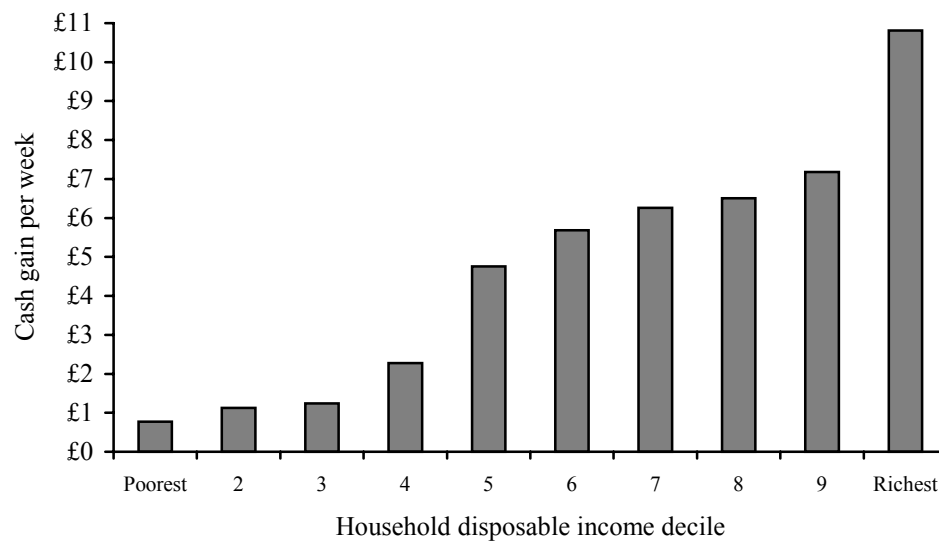


Table 1. Average weekly gains from combined Conservative proposals by family type

Family type	Average weekly gain
<i>Families with children</i>	
Single-parent family	£1.12
No-earner couple with children	£2.07
Single-earner couple with children	£11.97
Two-earner couple with children	£6.28
<i>Pensioners</i>	
Single pensioner	£4.32
Pensioner couple	£8.77
<i>Others</i>	
Single, not employed	£1.89
Single, employed	£2.45
No-earner couple without children	£6.23
Single-earner couple without children	£4.84
Two-earner couple without children	£4.24

in the state pension for the over-75s. Couples without children all do fairly well on average from the reforms, with increases of between £4.24 and £6.23 per week. These gains are larger than anything seen for these groups under Labour since 1997 (as shown in Election Briefing Note 5), and show that the Conservative reforms would be less targeted on families with children than the last four years of tax and benefit changes. The large average gain for no-earner couples without children is principally driven by the people in this group who have retired early with high levels of savings, and hence gain strongly from the abolition of savings tax for basic-rate taxpayers. The groups gaining least from the Conservative package are single non-pensioners of all types.

7. Additional Conservative tax proposals

A range of additional Conservative tax proposals go beyond the scope of the analysis undertaken in this Election Briefing Note, principally because paucity of data means we are not able to identify with precision the gainers and losers from them. The firm additional tax-cutting commitments comprise: further tax relief on approved share options; simplification and reduction of capital gains tax; repeal of the IR35 legislation; and reduced business rates in rural areas. The Conservatives are also committed to abolition of the climate change levy, funded by a 0.5% increase in employer National Insurance contributions.

8. Conservative long-term aspirations

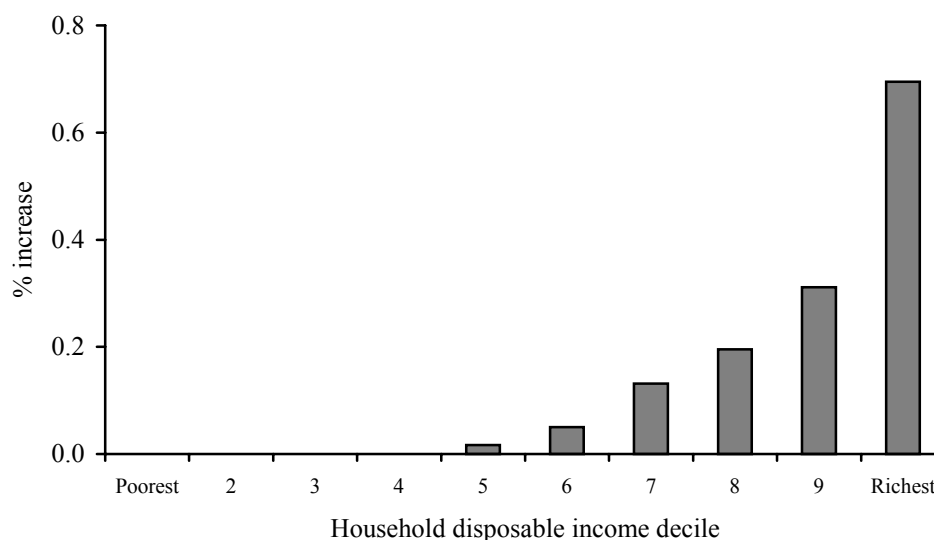
Raising the higher-rate threshold of income tax

Shadow Chancellor Michael Portillo has said that, over the course of a parliament, as and when funds allow, the Tories would like to raise the higher-rate threshold (HRT) of income tax by around £2,500. It is currently set at £29,400 of taxable income. The motivation behind this policy is that the number of higher-rate taxpayers has increased from around 2 million in 1996–97 (the last year of the Conservative administration) to more than 2.7 million in 2000–01. Given the current earnings distribution, a rise of £2,500 in the HRT would remove around 500,000 people from the 40% rate.

The distributional effects of this increase in the HRT are shown by income decile in Figure 7. The beneficiaries from the reform are individuals whose income is currently above the HRT. Not surprisingly, they are concentrated at the top of the income distribution. The maximum gain – to someone earning at least £2,500 more than the HRT – would be around £8.65 per week.

The number of higher-rate taxpayers tends to increase over time because tax thresholds are habitually indexed by price inflation from year to year whereas earnings normally grow by more than price inflation – a process known as ‘fiscal drag’. The Conservative proposal is designed to compensate for fiscal drag. However, if the reform were to be enacted later rather than sooner in a Conservative parliament, one would expect that fiscal drag that is likely to occur *after* 2001 would increase the number of higher-rate taxpayers still further – thus making it more expensive to restore the 1996–97 position fully.

Figure 7. Distributional effects of increasing the higher-rate threshold by £2,500



Tax breaks for private medical insurance

The Conservatives plan tax reductions and cuts in National Insurance contributions for individuals who take out private medical insurance (PMI). One argument for this reform is that it may reduce pressure on NHS resources by increasing the incentives for people to use alternative private sector care. However, as shown in a recent IFS study,⁷ the current distributional incidence of PMI is strongly skewed towards the top of the income distribution. Whilst this does not rule out the possibility that a tax break might encourage PMI further down the income distribution, it should be borne in mind that the Conservative proposal has a large dead-weight cost attached to it because the tax break subsidises PMI for individuals who *already* hold it as well as encouraging new take-up of PMI. In addition, it is likely that increased coverage of PMI would reduce the overall level of support for increased spending on the health service, as suggested by existing research into support for the NHS among people with private health insurance.⁸

9. Conclusions on Conservative tax and benefit proposals

So far, this Election Briefing Note has analysed the Conservatives' tax and benefit proposals. We have seen that their proposed tax cuts for families with

⁷ See Figure 5.5 in C. Emmerson, C. Frayne and A. Goodman, *Pressures in UK Healthcare: Challenges for the NHS*, Commentary no. 81, IFS, London, 2000.

⁸ T. Besley, J. Hall and I. Preston, *Private Health Insurance and the State of the NHS*, Commentary no. 52, IFS, London, 1996.

children help middle-income households most. Meanwhile, the abolition of basic-rate savings tax has a regressive distributional impact. The 6p cut in fuel duty has a fairly even distributional impact but helps car-owning households in the lowest 10% of the income distribution most. Combined with tax cuts for pensioners, the pension increases and modest cuts in the working families' tax credit, the overall effect of the Conservatives' plans is to help families in the middle and at the top of the income distribution more than the poorest 30%, largely because of the focus on reduced income tax. But families in all income deciles see average gains of at least 0.8% in their disposable incomes. The biggest average gainers by family type are single-earner couples with children.

The Conservatives estimate that the net cost of their tax cut package will be around £8bn. The remainder of this Briefing Note assesses their plans to cut spending by £8bn to pay for these tax reductions.

10. Can the Conservatives cut spending by £8bn?

The Conservatives plan to spend £8bn less than the current published government plans. This is a relatively minor proportion of government expenditure – a little less than 2%. But the Party is committed to match Labour funding in a number of fields – notably health, education, the police, defence and transport. This section asks whether the Tories have credible plans to save money in other areas of government spending.

Table 2 lists the proposed spending cuts relative to Labour's plans.

Reductions in state activity

There is no question that some of the cuts represent genuine reduction in the scope of state activity, and should therefore be expected to yield savings. For example, the list of Department of Trade and Industry activities earmarked for cuts would involve the government doing less and so spending less. The same is true of the proposed reduction in the regeneration budget; in this case, the Conservatives propose to substitute tax cuts of a similar magnitude to encourage the private sector to substitute for the regeneration activity from which the state would be withdrawing.

Likewise, some of the social security measures represent a straightforward reduction in the generosity of the benefit system through a tightening of conditionality. Forcing lone parents whose youngest child is 11 or older to get jobs, rather than rely on income support, is one example, while the 'Can Work, Must Work' guarantee (a dilution of the entitlement of unemployed people to reject job offers regarded as unsuitable) is another.

In some of these cases, dispute about the precise saving to be obtained may remain; for example, the cash saved by forcing lone parents of older children to seek work will depend on the availability of jobs. But still, in these cases, there is little doubt that the Conservatives are proposing to move public policy in a direction that should save some public money by reducing either state

activity or the generosity of state transfers. They therefore represent a genuine alternative to Labour on the appropriate balance between tax and public spending.

Table 2. Conservatives' proposed reductions in spending (£m)

	2003–04
Spending on bureaucracy	1,800
<i>Social security spending</i>	
Fraud package	1,000
Can Work, Must Work guarantee	330
Disability fundholding	100
Privatising industrial injuries benefit	160
Requiring lone parents with children aged 11 or over to seek work	500
Reform of housing benefit	425
Total social security	2,500
<i>Department of the Environment, Transport and the Regions (DETR)</i>	
Scrapping 'best value'	125
Not implementing the full roll-out of arm's length companies	100
Savings on housing PFI	200
Not creating regional assemblies	205
Interest from sale of QE2 Centre, Ordnance Survey and 2 Marsham St.	25
Streamlining GORs, abolishing RDAs, streamlining Planning Inspectorate	100
Regeneration	200
Total Department of the Environment, Transport and the Regions	1,000
<i>Department of Trade and Industry</i>	
E-commerce subsidies	20
State as venture capitalist	50
'Local competitiveness budget'	100
'Innovation budget'	40
Regional expenditure	25
Advertising export services	30
University Challenge and Reach Out Fund	20
Total Department of Trade and Industry	300
Replacing the New Deal with Britain Works	400
Creation of a community legal aid fund	500
Endowing universities	1,300
Endowing Britain's culture	200
GRAND TOTAL	7,955

Source: Conservative Party website, www.conservatives.com/issuestax3.cfm.

Savings that aim to avoid a reduction in state service provision

A very large proportion of the savings presented, however, would supposedly see government outlays fall without a reduction in the quality or quantity of public provision. The two most important examples are the proposed saving on government administration and the social security fraud package. Together, these two measures alone represent 35% of the total proposed savings. The difficulty here is that it seems likely that any government that could costlessly save in this way would do so, making it doubtful that these can be claimed as specifically Conservative savings.

The proposed saving on administration is set at £1.8bn because ‘Labour have allowed the cost of Government administration to rise by £1.8 billion in cash terms since the election’.⁹ This seems arbitrary – much of the cash increase since that year simply compensates for inflation, and the inflation rate over the last four years does not obviously relate to the optimal amount of real resources to spend on administering government. It also implies that the Conservatives believe that they can now run government with less real resources than they required when they were last in office.

If there were a determination to cut administration costs by this amount regardless of the consequences, then the risk arises that this would adversely affect either the efficiency or the delivery of public services. If, on the other hand, the cuts were conditional on there being no adverse side-effects, it might be impossible to deliver them on this scale. Opposition parties often find it attractive to suggest that savings can be made on ‘red tape’ – Labour in 1997 argued that such savings would fund its NHS waiting-list initiative. In government, achieving such savings proves less easy. From very early in its term, Labour found it necessary to divert additional resources to the NHS rather than simply to redirect cash from management to front-line services.

Savings on fraud are similarly easier to assert than to achieve. It might be possible to reduce fraudulent claims by an increase in the policing of the conditions of benefit claimants, but such an initiative might impose hassle and delays in payment on genuine benefit claimants who would, presumably, be required to spend more effort proving that they were entitled than is currently the case. If fraud could be cut without such adverse side-effects, it is unclear why any government would choose to put up with it.

Various other measures in the list also seek to secure lower spending without a reduction in service provision. For example, the proposal to administer legal aid through a community fund could certainly save money if the move involved a cut in legal aid funding. If it did not, it is less obvious it would succeed. Likewise, the claim that the housing budget could be cut without reducing the quality of the social-rented stock needs to be argued rather than asserted. It might also be seen as optimistic accounting to claim £205m from not setting up regional assemblies when there is, it seems, no provision for these in the current public finance plans. The assertion that a privatised New Deal programme would be £400m cheaper without being less effective is another example of a strong assertion backed by little evidence.

⁹ *Conservative Spending Plans: Saving Money, Improving Vital Services, Room for Tax Cuts*, The Conservative Party, London, 2001.

Endowing universities and Britain's culture

The final set of proposals concern the creation of endowment funds that would provide certain institutions with a stream of income that would substitute for government spending. The most important example is the creation of an endowment for universities from capital realised by the annual sale of the student loan book. On close inspection, the policy turns out to have two elements.

The first is the restructuring of student loans, which would, most significantly, involve interest being calculated at the market interest rate instead of the current subsidised interest rate. The Conservatives believe that this would raise £700m per year. This represents a genuine political choice to withdraw an element of state subsidy, seemingly making a legitimate part of the £8bn of cuts offered.

But the Conservatives plan to couple this with a pre-commitment to more generous tax treatment of graduates, from 2005–06, when they come to repay their loans. As the funds from the subsidy cut will already have been 'spent' on part of the initial £8bn of tax cuts the Conservatives plan to make, this future commitment implies a modest weakening of the public finances, as it means forgoing a certain amount of future income tax revenue. It is not obvious that the Conservatives have any special means to address this weakening that would not be available to alternative administrations.

The second element of the policy sees the revenue from the sale of the loan book invested in the private capital markets, rather than being used to pay off national debt, which it is implicitly assumed is what alternative governments would use the revenue to do. The income derived in this way would be given to universities, and government funding would be cut commensurately. But the Conservatives assert that they could, on the basis of historical experience, reasonably expect that the privately invested assets would yield a 2% excess return compared with what would effectively be achieved by a policy of reducing national debt, enabling them to cut university funding by more than they would have saved by reducing public debt.

As the loan book is sold annually, the Conservatives assume that, every year, by investing in stocks, they could effectively obtain a new stream of income worth 2% of the loan book in perpetuity. Because a new income stream is obtained annually in this manner, the Conservatives argue that they can claim the total present value of this future income stream as a saving in every year. If the overall merit of the scheme is granted, capitalising the stream of savings in this way would seem justifiable on economic grounds, even though it implies a higher level of borrowing. The annual sell-off means that, over time, the universities would see an ever-larger part of their income deriving from endowments rather than direct grants.

A number of objections might be made against the policy of endowing universities as opposed to continuing with traditional state subsidy. First, the 'excess return' supposedly earned by investing in equities as opposed to debt should in fact – if financial markets work efficiently – reflect the higher risk associated with these assets. If the government is averse to taking on risk, then the gains from investing in stocks come at a cost that must be faced.

Second, if the government decided that the state's taking on some risk in this way would be beneficial, there is no reason why the optimal extent of this risk-bearing should be equal to the scale of the loan sell-off. In theory, the national debt could be doubled and all of the money invested in stocks, yielding a massive exchequer benefit.

Finally, it seems unappealing that, when the state absorbs risk in this way, it should be borne exclusively by one element of the public sector – the universities. For if the government is taking on risk, it might be expected that it would be better that this risk were spread across spending activities, so that the fluctuation in income for any individual part of the public sector is reduced. Over time, if, as the Conservatives plan, universities are increasingly to be funded by endowment, then eventually a large proportion of their income would be subject to the volatility of stock markets. In these circumstances, given their need to budget to provide certain services every year, it might well be that they would prefer an investment in something such as government debt, which yields a lower average return but greater certainty of income.

11. Conclusions on Conservative spending proposals

Some of the Conservatives' proposed cuts involve the state withdrawing from certain activities – for example, supporting certain groups through social security and subsidising certain business activities. But these represent only a small portion of the total of £8bn. Where the claim is that the remaining cuts are without consequence for public provision, the best assumption is that alternative administrations would deliver the same; where there are such consequences, which other parties may shrink from, then an open debate about these would be welcome.

While in the short term the Conservatives could end up funding part of their £8bn tax cut through increased borrowing without particularly serious consequences for the public finances, in the longer term a desire to reduce taxes must, if it is to be achieved, be matched by a willingness to identify reductions in the scale of public services.