Newsletter

June 2010

*The **Social Market Foundation** is an independent public policy think-tank, developing and advancing innovative solutions across a broad range of economic and social policy. We publish original research, hold seminars and debates in Westminster and beyond, and run a diverse programme of events at the three main party conferences.*

Since its foundation in 1989, the work of the SMF has been principally devoted to promoting the social market philosophy, which seeks to marry markets and social justice. It neither sees the market as a necessary evil nor as an end in itself but as a means to improve people's lives. It is underpinned by adherence to two key principles: first, a positive preference for market mechanisms, while recognising that a truly pro-market approach is often not a free-market one; and second, a belief that a sustainable market economy rests on social and political foundations that are widely regarded as fair. Our work aims to elucidate these ideas and to explain why the social market is a fruitful source of solutions to public policy problems.

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Welcome to this edition of the SMF newsletter

This week the new Office for Budget Responsibility (OBR) issued its first Pre-Budget forecast. While tax receipts look better than the last administration predicted, the structural deficit looks about £8bn worse. Coming on top of the £69bn of cuts and tax rises we were already expecting, this will make the pain of tax rises and spending cuts still worse. But the question is where the axe will fall. SMF's latest report Axing and Taxing: how to cut the deficit, launched last week, outlines what a social market approach to cutting the deficit would mean.

Meanwhile, after the emergency budget, SMF will welcome Sir Alan Budd to give one of his first public talks on the operation of the new OBR: can its independence survive once governments are no longer able to blame the fiscal mess on their predecessors? Evan Davis will respond.

Also in this issue, we look forward to the party conference season, for which preparations are underway. As usual, SMF will be hosting a wide range of discussion on topics from the future of pensions provision to how the new government can re-balance the economy. And this year, all the buzz is about the Liberal Democrats' get-together in Liverpool. See inside for details.

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Director's Note – a Big Hole to Fill

Ian Mulheirn, Director, SMF

The UK's debt crisis is mounting. This year's borrowing is likely to be bigger even than last year's record £156bn deficit. With bond markets getting jittery about sovereign debt, the coalition has one shot at cutting the unprecedented deficit. The Government's emergency budget next week, and spending review in the autumn, must not shrink from the challenge. If it fails to take decisive measures, the cost of borrowing will balloon, and ultimately much more draconian cuts and taxes will be required. It's time to act – but how?

"The unaffordable ring-fencing of the NHS budget must be dropped if cuts elsewhere are to be bearable"

The structural gap between what the Government raises in tax and what it spends was estimated at around £69bn according to Treasury estimates from the last Budget. The New Office of Budget Responsibility has revised that gap up by about £8bn. There have recently been many warm words from politicians about sharing the pain of cuts. But the harsh reality is that some will be hit much harder than others. We now need to debate the specifics.

In its pre-election plans, the Conservative party stated its intention to fill the fiscal hole with a mixture of 80% spending cuts and 20% tax rises, implying more than £60bn of spending cuts to come. But cuts on this scale have the potential to cause serious industrial or even civil unrest, particularly since the coalition has also indicated that it intends to ring-fence huge areas of public spending (including healthcare, child benefit payments). Instead, controlling the deficit must be a matter of pragmatism: investors must be confident that the ultimate plan will be broadly acceptable to the public if they are to retain confidence in UK government debt.

In a new report published last week, the SMF proposed a credible package that splits the burden roughly 60:40 between spending cuts and tax rises. Even going this far will involve many painful spending cuts, and the unaffordable ring-fencing of the NHS budget in particular must be dropped if cuts elsewhere are to be bearable.

This report argues that the programme of cuts and tax rises to come should be based on four firmly social market principles:

- Public spending that supports **opportunity and economic growth should be protected**. In practical terms this means maintaining investment in the UK's education system, skills base and physical infrastructure – the drivers of social mobility and economic growth.

"Progressive universalism is no longer affordable if cuts are to be remotely progressive"

- The poorest and **most vulnerable should be protected as far as possible**. Tough decisions about benefit spending are unavoidable, in particular for the middle classes. Progressive universalism is no longer affordable if cuts are to be remotely progressive, as the Government has claimed they will be.
- Where taxes must rise, the Government should take the opportunity to **simplify the tax regime**. A less distortionary tax system is desirable, even if it cannot offer a lighter tax burden.
- Bold and radical **market-based public service reforms** to achieve the necessary savings should be enacted, in preference to 'salami slicing'. These should include a new role for the private sector in offender management and new user charges in healthcare.

Adherence to these principles in the cuts and taxes to come offers the possibility that the UK can bounce back from this recession stronger than before. But if the government sidesteps difficult decisions about child benefit, NHS charging, Capital Gains Tax and congestion charging, we will instead have to pay a price far into the future in terms of poorer education and crumbling infrastructure.

Party conferences 2010

SMF's cross party reach and political independence means we are ideally placed to host conference fringe debates with senior politicians and decision makers from across the political spectrum.

"Help us explore the most pressing political issues the country faces"

In the context of dramatic political change, and with many daunting policy challenges ahead, the 2010 party conference season promises to be one of the most interesting and significant for years. With the political and policy landscape in flux, there has rarely been a more important time for open debate and discussion about the policy challenges ahead and the right way to tackling them.

As the 2010 season approaches, the Social Market Foundation is looking for sponsorship partners to help us to explore the most pressing political issues the country faces. For over 10 years, the SMF, in partnership with our sponsors, has been a leading contributor of insightful debate and discussion on the party conference fringe. As the leading cross-party think-tank, we are able to draw audiences and high-profile speakers to our events at each of the three main party conferences.

Our conference themes document details some of the key areas of debate that we are keen to pursue. It is not exhaustive, however, and we are interested to explore with potential sponsors areas of mutual interest not covered in the document.

To discuss ways you can work with SMF, please contact Rachel Baker, Conference Manager on 020 7227 4404 or RBaker@smf.co.uk

Contact
Rbaker@smf.co.uk
or
0207 227 4404

Home Secretary Theresa May MP speaking at an SMF event at Conservative conference 2009

Forthcoming events

To book a place at any of these events please email

events@smf.co.uk or telephone 020 7222 7060

Email

events@smf.co.uk

Emergency Budget 2010 - breakfast discussion

Date: 8:15-9:30am Wednesday 23 March
Venue: SMF, 11 Tufton St, London, SW1P 3QB
Speakers: Jesse Norman MP
Lord John McFall
Dan Roberts, Head of Business, The Guardian & The Observer
Chair: Ian Mulheirn, Director, SMF

Refugee Children and the Market in Legal Services

Date: 4:00-5:30pm Thursday 1 July
Venue: SMF, 11 Tufton St, London, SW1P 3QB
Speakers: Judith Dennis, Refugee Council
Rachiel de Chaviez, Hammersmith and Fulham Law Centre
Chair: David Furness, SMF

This event is part of an ongoing project with Hammersmith and Fulham Law Centre.

Demand management in the NHS - what works?

Date: 8:30-10:00am Wednesday 7 July
Venue: SMF, 11 Tufton St, London, SW1P 3QB
Speakers: Nigel Edwards, Acting Chief Executive, NHS Confederation
Michael Schofield, ACCA & Brighton and Hove PCT
Chair: David Furness, SMF

This event is kindly supported by:

Forecasting the future: what will be the impact of the Office for Budget Responsibility?

Date: 4:30-6:00pm Thursday 15 July
Venue: SMF, 11 Tufton St, London, SW1P 3QB
Speakers: Sir Alan Budd, Chairman, Office for Budget Responsibility
Evan Davis, BBC

Chair: **Ian Mulheirn, SMF**

The Coalition Government is beginning to deliver on its promises to shake up the financial sector, unveiling sweeping reform to the regulatory structure and launching a root-and-branch review of the banking sector. To set these events in context, this abridged extract from a forthcoming essay for the SMF by John Kay looks at the financial services industry through the lens of the age-old problem of rent-seeking.

Extract from "The market economy twenty years after the fall of the Berlin Wall"

John Kay

The ability of a political/economic system to resist rent seeking depends on the degree of economic decentralisation. Individuals will try to get their hands on the rents which concentrations of power attract whether they are found in the public sector, in private businesses, or in groups of private business. The wider the extent of the opportunities this created, the greater the tendency for individuals to gain wealth and influence for themselves by attaching themselves to power rather than exploiting their own individual talents and by developing distinctive capabilities in their own economic activities.

"The past decades have confused a pro-business stance with a pro-market stance"

There is a strong tendency for private concentration of economic power to be self-reinforcing. This problem was widely recognised in America's 'gilded age' at the end of the nineteenth century. The well-founded fear was that the new mega-rich – the Rockefellers, the Carnegies, the Vanderbilts – would use their wealth to enhance their political influence and hence enhance their economic power still further, subverting both the market economy and the democratic process. These concerns were the origin of anti-trust legislation, a point today often forgotten. The process that concerned Americans then is the problem we see in Russia – and elsewhere in the world – today.

The ability of a market economy to channel the desire for acquisition into channels that create wealth rather than extract it, depends on measures both to prevent the concentration of economic power and to limit the terms of access to such concentration. These are constraints on the economic power of the state: constraints on the concentration of economic power in large businesses: constant vigilance at the boundaries between the state and business: and a mixture of external supervision and internal restraint which prevents individuals who pull levers of economic power from using these levers to direct renting to themselves.

Because the last decades have confused a pro-business stance with a pro-market stance, we have emphasised some of these conditions at the expense of others. Western – and especially Anglo-Saxon societies - have constrained the economic role of the state. These measures have reduced the scope of one focus of rent-seeking, that by organised groups of public employees. A substantial element of such rent-seeking remains in areas that remain inescapably within the public sector.

But the larger issue is the concentration of power of large business, or groups of large businesses, and the use of the leverage that power gives to strengthen established positions and enhance that economic and political power still further. The topical – and most important example is the financial services industry.

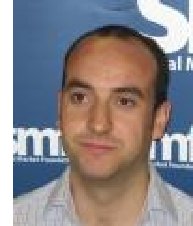
The problems of that industry are too familiar to require much elaboration. The governments of the world have pumped unbelievably large amounts of money into the system. Directly through recapitalisation and purchase or underwriting of so-called toxic assets: more substantially if indirectly through wide-ranging implicit and explicit guarantees of liabilities. Even if these explicit guarantees expire, a 'too big to fail' doctrine has been established which means that implicit guarantees persist indefinitely. The criteria needed to qualify for these guarantees are, essentially, that the firm is large, well established, and unsuccessful commercially. It is difficult to think of a policy more directly contradictory to the dynamic of the market economy.

"The financial services industry… has become the most powerful political force in Britain and the United"

Behind that lies the central fact of modern political life – that the financial services industry, and particularly its investment banking arm, has become the most powerful political force in Britain and the United States. The reasons are clear enough: the rents available in the financial sector have attracted much of the ablest talent in the two countries and created a generation of financiers who are both smart and wealthy.

The full version of this essay will be published by the SMF during the summer.

What next for social care funding reform?



James Lloyd, Senior Research Fellow, SMF

In the run-up to the general election campaign, the vexed issue of reforming the funding of older people's long-term care finally achieved the attention campaigners had long claimed it deserved. However the almighty row that broke out between the Conservatives and Labour merely highlighted what many stakeholders, policy analysts and campaigners had perhaps forgotten during the Green and White Paper consultations: with the need for everyone to contribute more, debate on reform is likely to be politically inflammatory.

"Many commentators are questions why those worth hundreds of thousands of pounds in retirement are given extra hand-outs"

With the general election now passed, a new government in place and fiscal consolidation underway, the long-term care funding debate that preceded the election already feels as if it was part of another era. Discussion of social care funding now is more likely to feature speculation as to which aspects of current expenditure on care are likely to be protected as the axe comes down on public services.

However, the issue has not gone away. The demographic changes that are pushing the current system further into crisis will exacerbate with each year that passes. This is why so many stakeholders were relieved by the announcement from the Coalition Government that they would set up an independent commission to review the topic, with a view to legislation following within one year. For the time being at least, the issue has not been shoved into the long-grass.

So what next for the debate on how to fund older people's long-term care? Several points are worth highlighting.

First, against the implementation of severe public spending cuts, those pushing for a Beveridge moment on social care funding are likely to be somewhat quieter. As the agenda rolled forward in the last few years, many dared to hope for a universal, transformative reform. But, as public employees are sacked in large numbers, more sober, incremental reforms are likely to come into the spotlight as pragmatism takes hold.

Second, fiscal consolidation has opened up a wider debate on so-called 'middle-class' welfare and universal payments to pensioners, such as free bus passes and winter fuel payments. Discussion on how to fund long-term care for older people is likely to be drawn into this debate. For the first time, many commentators are questioning why those worth many hundreds of thousands of pounds in retirement are given extra hand-outs notionally to

spend on things like fuel. Whatever its practical difficulties and implications for pension saving, means-testing is likely to underpin all discussion on how older people's social care is funded.

Third, any serious long-term care funding reform will require a transition to a national system of entitlement and assessment. As a pre-condition for funding reform, such a measure would on its own represent a huge change, requiring as it does the unpicking of local government financing. To even consider this reform at a time when public spending and public services are being squeezed on all sides appears a daunting task. Can the negotiations with local government required actually take place while the messy business of cuts is implemented?

"The new commissioners are unlikely to reinvent the wheel or devise an ingenious new solution"

Fourth, it remains to be seen whether the creation of the new independent commission on long-term care funding really represents an opportunity. Such independent reviews can be highly effective or quickly forgotten. A lot will depend on the personalities involved and how they respond to the remit they have been given. Although experts on long-term care funding can identify many missing bits of analysis and modelling that need to be done, the core options for funding older people's long-term care have already been identified and extensively debated. As such, the new commissioners are unlikely to reinvent the wheel or devise an ingenious new solution. The value they can add will be in providing more insightful evaluations of the different options, and assembling stakeholder and political consensus around a single pathway forward. This is a lot to be addressed within the space of 12 months.

All of these observations suggest that even more than before, it will be vital for policymakers to have in mind a clear end-point for reform, but to pursue step-by-step, multi-level policies encompassing short, medium and long-term measures. Whatever the difficulties now confronting reform, doing nothing is still not an option.

Cut traffic – give us all a share in the roads

Ian Mulheirn & David Furness

There are only three things that can fill the £167 billion black hole in the public finances: tax rises, spending cuts and economic growth. But while politicians trade misinformation about how the tax and spending pain will be distributed after May 6, what is missing is a more positive debate about how we can enhance productivity to stimulate economic growth.

"…pricing could be used to encourage people to travel off-peak and avoid the collective insanity of the rush-hour"

Essential to that challenge is finding a solution to the UK's overloaded road network. Our roads are the circulatory system carrying the oxygen of commerce around the economy, but the arteries are furred up. The solution, road-user charging, has long been seen as politically dangerous territory. But a new report from the Social Market Foundation outlines a way to make it a vote winner by giving away shares in our roads.

The cost of congestion is huge and set to grow by an extra £22 billion by 2015. Set against this immense burden on British business, last week's argument about the Conservatives' plans to cut some £3 billion from employers' National Insurance bills looks like small beer.

The environmental impact of congestion is also significant. Cars and lorries stuck in stop-start traffic belch out about twice as much CO2 as those on free-flowing roads. The misery of spending a bank holiday weekend staring at the number plate of the stationary car in front is an experience familiar to us all.

What is the solution? Building more roads is one option, but it's fanciful to think there will be the money or the political will to embark on a road-building spree. Even finding the cash to fill in potholes seems to be proving difficult.

Rail enthusiasts argue that the answer is to get people out of their cars and onto public transport — a nice idea but, with more than 90% of passenger journeys undertaken on our roads, one that can never make more than a marginal difference. So we can't have more roads and there are no viable alternatives to the car. The answer is clear: we must find a better way to use our existing roads. The key is user charging: variable pricing could be used to encourage people to travel off-peak and avoid the collective insanity of the rush-hour.

Just imagine how crowded the trains would be without off-peak ticketing, yet this common sense principle doesn't apply on most of our roads, despite evidence that it works. In London the congestion charge significantly improved the traffic flow (although its effects were soon undermined by more bus lanes and roadworks). Studies from elsewhere in the world confirm the effectiveness of road pricing in reducing congestion.

Yet public opposition to road pricing is overwhelming. Since plans for a Manchester congestion charge were decisively defeated in a referendum in 2008, politicians have seen the idea as politically toxic. But it need not be.

Voters are rightly wary of road pricing proposals because they believe they are just another ruse by venal politicians to part drivers from their cash, or to sell off the networks built with their tax money to pay for the state's debt crisis. Separating the good idea of road-user charging from voters' fears that they will be made to pay more is the political problem that must be solved.

"Every citizen in the country would be issued with an equal tradable share in the trunk road and motorway network for nothing"

The only way to convince the British public that road pricing is in their interests is to ensure that they benefit directly from the proceeds. Crucially, they must also retain ownership of what are, after all, their roads. In short, the Treasury must commit to keeping its hands off the money.

The answer is to mutualise the strategic road network. Rather than the sell-off of public utilities of the 1980s, every citizen in the country would be issued with an equal tradable share in the trunk road and motorway network for nothing. Road tax would be scrapped and drivers charged according to how much, where and when they use the main roads.

More than 100 billion vehicle miles are travelled on our strategic road network each year. At 10p per mile — similar to charges in continental Europe — and after covering the exchequer cost of scrapping the £5.2 billion road tax, normal price earnings ratios imply that each citizen's share would be worth about £1,500 on the open market. Individuals could choose to retain their share and benefit from the profits, or sell it and take the money.

The average driver would be significantly better off under the scheme, paying less in tolls than they currently do in tax. Heavy road users would pay more, but would save on the huge time and fuel costs of congestion. And foreign hauliers, who currently use UK roads for nothing, would have to pay their fair share.

As the parties unveil their manifesto pledges this week, we need to see less of the shady numbers on tax and spend and more bold policies that will foster growth for everyone's benefit. There are few challenges more pressing than our congestion crisis. It's time for our politicians to take the lead.

This article first appeared in the think tank column of the Sunday Times before the general election.

Publication highlights

Axing and Taxing: how to cut the deficit

By Ian Mulheirn and David Furness

The structural gap between what the Government raises in tax and what it spends is around £74bn according to current Treasury estimates, and could yet be bigger. This paper spells out the full range of measures necessary to fix the deficit over the next six years, by cutting public spending and raising taxes in a way that exemplifies social market priorities.

Better but Cheaper: reforming the Child Trust Fund

By Dr Rajiv Prabhakar, James Lloyd and Ian Mulheirn

This publication presents a range of options for the future of children's savings. It presents new analysis of the successes and failures of the Child Trust Fund regime to provide new ideas for the future.

Early Access to Pension Saving

By James Lloyd

Discussion of enabling early access to pension saving has been a feature of UK pension policy debate for some years. However, this discussion has come into sharper focus in light of the global financial crisis, and its potential impact on the attitude of UK households to locking away saving for many years. This report examines the evidence that current pension rules, associated with the UK 'annuities deal', deter pension saving. The report also explores in detail the practical considerations and problems that would be confronted by the multiple 'early access' models of pension saving that have been proposed.

Roads to Recovery: reducing congestion through shared ownership

By Ian Mulheirn and David Furness

Congestion imposes huge economic and environmental costs. The solution is road user charging but the political challenge is steep. To overcome the political objections to charging this report recommends a 'voucher mutualisation' of the Strategic Roads Network. This solution offers a politically acceptable transfer of ownership from public to private hands, giving every citizen in the UK a tradable share in their network for free. This shift will facilitate the introduction of road user charging and would be accompanied by the abolition of Vehicle Excise Duty. Any profits from operating the roads would then go to the shareholders: British citizens.