

CHAPTER

5

RETHINKING PUBLIC EXPENDITURE FROM A
SOCIAL DEMOCRATIC PERSPECTIVE

David Heald¹

Introduction

There are waves of public mood about public expenditure; it seems to be in fashion or strongly out of fashion. This contributes to alternating periods of plenty and famine in some countries, of which the United Kingdom provides a striking example. There is not only strong polarisation in periods of famine but also inadequate scrutiny during periods of plenty. Contemporary UK commentary, for example, exhibits conflicting narratives:

Labour's fiscal policy [1997–2010] amounted to little more than bribes to cultivate a client state of public sector employees and the feckless underclass. (Mowbray 2012)

Over a generation, social security has been rebranded as welfare, an undeserved gift rather than a right. (Clark 2012)

I think there's a very deliberate policy across all of the public sector to roll back the achievements that have been made in this country [United Kingdom] since the second world war – including the [National Health Service] – and that financial austerity is being used to pursue an agenda aimed at dismantling the state. (Gabriel Scally, quoted in Campbell 2012)

These quotations – quite mildly expressed compared to what can be found in the media and on the Web – contextualise this analysis of public expenditure from a social democratic perspective.

Social democracy presupposes a degree of confidence in the competence, legitimacy and accountability of state institutions. It requires a sense of common purpose and of belonging and inclusiveness, which together underpin

social solidarity. Yet social democracy is also about 'halfway houses', sometimes uneasy compromises between reliance on 'the market' and on 'the state', whose necessary periodic refurbishment can be problematic. The foundations of social democracy are therefore vulnerable to attack from multiple directions (as in the slogans 'shrink the state' or 'take public ownership of all the means of production'). It is difficult to write stirring rhetoric about the crafted or accidental compromises that social democratic policy stances sometimes involve. Faced with contemporary free-market radicalism, social democracy can appear deeply conservative in defence of inherited social settlements.

This chapter does not argue from first principles against attacks on public expenditure levels in OECD countries as wasteful and counterproductive (Schuknecht and Tanzi 2000). Rather, it covers ideology, public policy and technical issues of public expenditure definition and management. A degree of sympathy towards the use of public expenditure for economic, political and social objectives is assumed.

An approximation is that socialist parties have emphasised public ownership of the means of production whereas social democratic parties have emphasised high levels of public expenditure – with or without high public ownership of industry and infrastructure (Crouch 1981). As historically with public ownership, there are substantial country differences in the importance that political parties regarding themselves as social democratic attach to the size and scope of public expenditure. However, within a particular country at a particular date, such parties tend to prefer larger public expenditure/GDP ratios than do parties to their right.

Whereas privatisations have greatly reduced the size of public enterprise sectors, the debate on high public expenditure (often attacked as 'big government') is both continuing and more ambiguous. A social democratic position on public expenditure can be held by parties with other names or not held by parties with a social democratic label. Conservative and Christian Democratic governments have in the past expanded public services and the populist extreme right has a welfare tradition (as shown in the programme of the *Front National* in the 2012 French elections). Such breadth of political support for public expenditure suggests that there are complicated political, social, demographic and economic factors at work.

Public expenditure/GDP ratios might be taken as a preliminary indicator of big government. However, 'big' and 'strong' are not synonyms: indeed, public expenditure could be high in countries with weak governments unable to control interest group pressures to spend. The power of government to command and its relationship to society depends on many factors other than public expenditure ratios; Gamble (1988) drew attention to the link between the 'free economy and the strong state', the latter making the former possible.

Public expenditure is not the only instrument of public intervention, making valid cross-country comparisons more difficult than they would seem at first

sight. Political argument may revolve around whether the public expenditure/GDP ratio should be 20% or 30%, rather than 40% or 50%. However, two caveats are required. First, there is a profound distinction between proposals that substitute instruments (e.g. compulsory private healthcare insurance instead of public provision) and those under which government sheds responsibility on to individuals/households/families. Social democratic objectives might be achieved through the use of surrogates for public expenditure that do not require tax financing. Regulatory powers impose costs on private actors in relation to disability, historic buildings and health and safety. However, surrogates are often characterised by low transparency and unmonitored efficiency costs and equity impacts, especially when used to circumvent controls on recorded public expenditure (Heald 2012). Second, there is the issue of whether cash benefits are taxed, as this affects the interpretation of the public expenditure/GDP ratios (Adema et al. 2011). There are wide cross-country variations in the competence of public institutions, owing much to culture and traditions, and this may influence the choice of policy instruments.

Rethinking or rejustifying public expenditure, its objectives and mechanisms, is required from a social democratic perspective. Except where explicitly stated, this chapter focuses on ideas and policy priorities, not on party agendas and programmes. The next section discusses changes in the policy environment. Section three addresses the objectives of public expenditure through Musgrave's (1959) trilogy of allocation, distribution and stabilisation. Section four considers the neglect of tax policy-making, which has made public expenditure more difficult to finance and hence to defend. Section five responds to the identified challenges. Many of the examples used to illustrate particular points relate to the United Kingdom, reflecting the author's zone of confident knowledge. Albeit with different specificities, the issues discussed have general applicability.

Changes in the policy environment

From 1945 to circa 1973, most democratic political parties operated within the context of the Keynesian social democratic state (Heald 1983), albeit with some marked country variations. Subsequently the monetarist critique of macro-economic policy, which de-legitimised stabilisation policy, evolved into a more general free-market critique of big government, which has been labelled as 'neo-liberalism'.² In relation to public expenditure, neo-liberalism can imply a preference for small government or for making extensive use of market-like mechanisms to improve the efficiency of government. Under the 1997–2010 UK Labour Government, neo-liberal styles such as outsourcing and Public-Private Partnerships (PPP) were accompanied by large expansions in public expenditure.³

Although the 1970s can reasonably be portrayed as a period during which

governments lost control of public expenditure totals, the background to the 2010s is generally different. The private sector global financial crisis of 2008 translated into a public sector fiscal crisis, most obviously seen in relation to eurozone countries but also seen in the austerity programme of the 2010 Conservative-Liberal Democrat UK Coalition. The genuine requirement for medium-term fiscal retrenchment in response to GDP levels far below trend projections, and to the doubling of the net debt/GDP ratio, has been seized upon as a window of opportunity for a transformation of the role of the state, imposing policies that would otherwise have been politically inconceivable. This 'do not waste a crisis' tactic has significant implications for debate in a policy environment that differs drastically from 1945 to 1973.

First, social democratic compromises between the state and market were originally within national economies much less integrated into the global economy than is the case today. To varying extents, these compromises have been undermined by globalisation even where not unpicked by government policy. There can be two reactions within social democratic parties: one that accommodates change while offering generous protection; and one that resists economic change. Post reunification, Germany became contentiously labelled in the 1990s as the 'sick man of Europe'. Subsequently, the 1998–2005 SPD-Green Coalition of Chancellor Gerhard Schröder has been credited with labour market and pension reforms that were undertaken in a reasonably consensual way, without destroying the 'national bargain'. In contrast, Greece illustrates that resisting change is catastrophic in the medium term. Nevertheless, negotiating change while maintaining social consensus and trust in public authority is problematic for many countries.

Second, demography has changed dramatically in ways that threaten the social democratic consensus even in the absence of explicit policy attacks. Life expectancies far beyond previous expectations have significant expenditure consequences, as shown by the work of the European Council Economic Policy Committee's Working Group on Ageing Populations and Sustainability (see http://europa.eu/epc/working_groups/ageing_en.htm) (last accessed 22 February 2013)). The effects on healthcare and pension costs alone threaten fiscal sustainability (Fiscal Affairs Department 2011). Such issues are difficult for democratic politicians to deal with, as ageing groups have greater attachment to political processes through voice and electoral turnout. Equally fundamental, the heterogeneity of European populations has increased dramatically, resulting from migration from the Third World and from the operation of the EU internal labour market. These developments have created pressures in labour and housing markets, limiting wage growth and pushing up house prices and rents.

The earlier safety valve of upward social mobility is less available, reflecting the fact that social mobility in the 1945–73 period was mostly one way as a result of the expanding pool of managerial and professional jobs. In the second

decade of the twenty-first century, downward social mobility is more of a threat and affluent parents have both greater capability and greater inclination to protect their children. Examples include: housing moves into the catchment areas of prestigious state schools or claims to false addresses; gaming means tests; arbitrating nationality in response to differential university fees; tactical use of private facilities to speed up access to National Health Service treatment; and unpaid internships as a means of access to the professions. There can be less reliance either on self-restraint by economic and social actors, who have been encouraged to be more assertive and individualistic, or on social pressures against opportunistic behaviour. A culture of gaming rules and regulators complicates public governance at all levels. In these circumstances, achieving the social democratic value of equality of opportunity becomes more elusive.

Third, a factor weakening the social democratic position has been the ending of the widely held twentieth-century assumption that economic growth leads to less income inequality. Channelling some of the fruits of growth through the public budget into public services and the tax/benefit system was relatively painless for parties and governments; UK inequality reduced significantly between 1910 and 1979 (Dorling 2012). It was central to Anthony Crosland's formulation of social democracy (Crosland 1956). When the pre-tax/benefit distribution is widening, the tax/benefit system has to work ever harder to achieve any given post-tax/benefit distribution. A much-quoted statistic is that real US median earnings have been stagnant for twenty-five years while GDP has doubled (Plunkett 2011). Various explanations have been advanced: globalisation; technological change that puts premiums on certain skills; the weakening of trade union power; and unchallenged rent-seeking in key economic sectors.

A fourth change relates to the sheer scale of contemporary fiscal problems. Whereas episodes of fiscal stress occurred after 1945, the post-2008 circumstances do merit the term 'fiscal crisis' and analogies with the 1930s have become commonplace. Consequences have included budget reductions unprecedented in scale during universal suffrage. It is unclear how much fiscal austerity various countries can sustain without unpredictable social consequences and the destruction of political legitimacy. While the 1930s involved social distress and political traumas of an entirely different scale from those of the 2010s, the potential damage from contemporary economic, political and social dislocations should not be underestimated. Examples include: long-term output loss; failure to absorb younger generations into the labour market; heightened social and economic inequalities; civil disorder; and the growth of extreme political parties, some of which lack democratic commitment.

Objectives of public expenditure

Rethinking public expenditure from a social democratic perspective requires a fundamental examination of its objectives. Richard Musgrave's (1959) trilogy

of allocation, distribution and stabilisation remains a valuable framework. These elements cannot be treated separately in actual policy, as the objectives are interwoven and instruments aimed at one will have implications for the others. However, this decomposition brings valuable discipline to the analysis.

Policy positions on each are separable but, in practice, often overlap. Some hold that private markets are highly efficient at allocating resources; that the market-determined distribution of resources meets the fairness criterion; and that fiscal policy is destabilising or ineffective. Others hold that private markets are inefficient; that fairness requires extensive redistribution via the tax/benefit system; and that fiscal policy can be effective and stabilising. There are hybrid positions: for example, Samuel Brittan and Martin Wolf of the *Financial Times* are strongly Keynesian in arguing for deficit financing during the post-2008 global recession, yet strongly market-oriented in allocation and distribution, reflecting suspicion of big government. There are complications: big government usually leads to high automatic stabilisers, through the effects across the cycle of progressive taxation and the benefit system. Consequently, Keynesian deficit financing needs more discretionary countercyclical fiscal policy in a (relatively) small-government country such as the United States. While social democracy traditionally subscribes to the interventionist view in relation to the redistribution of income and wealth, it exhibits a range of positions on the allocative efficiency of markets and on the relative weight to be placed on monetary and fiscal instruments for the purpose of keeping the economy on a growth path close to full employment.

Allocation

The allocation problem in relation to public expenditure has two dimensions. First, there is the split between allocation through the market and non-market allocation through the state, principally through public expenditure. Further questions arise when the lines between public and private activities become less well defined: for example, does it matter for public policy that the US health sector accounts for 18% of GDP as distinct from the government-financed component being 8% of GDP? Much depends on the implications for access to healthcare and for cost control, and how healthcare financing impacts on other sectors. When policies are said to be 'unaffordable', there should be clarity about whether this claim refers to service configurations (e.g. en suite single rooms or dormitories in residential homes for the elderly) or whether it refers to who pays.

The second dimension refers to the composition of public expenditure: (a) between exhaustive public expenditure (when government is the decision-maker) and transfer payments (which add to the incomes of households operating in private markets); (b) by function, as between, for example, defence

and healthcare; (c) by economic category (e.g. pay); and (d) by geographical location.

At a conceptual level, an efficient allocation of public expenditure is when the net marginal benefit from each type of expenditure is equalised. Operationally, that is of limited help because important attributes, outputs and outcomes are not credibly quantifiable. The practice of public expenditure allocation is intensely political in both ideological and bureaucratic senses. For example, social democratic parties have traditionally stressed expenditure on welfare state services whereas parties to their right have given higher priority to defence and law and order. Even though social democracy points to higher total public expenditure, difficult trade-offs within those totals are inevitable. On functional composition, there can be big surprises in relation to earlier projections, such as new spending pressures on housing and pensions.

For allocation through public expenditure, at least three persistently tricky issues are raised: the determination of eligibility for services and benefits; the pursuit of productive efficiency; and the validation of Value for Money (VfM).

Determining eligibility

The broad choice is between universalism (services or benefits are attached to citizenship/residence) and targeting (access is conditioned on satisfying a means test that specifies income and/or wealth levels). There is an important distinction between *exclusion* (e.g. income limits on access to social housing) and *self-exclusion* (e.g. voluntary use of private facilities for health and education). Beyond an imprecise threshold in terms of participation in publicly provided services, exclusion and self-exclusion are likely to generate a drift from an inclusive form of welfare state to a residual model of welfare (Esping-Andersen 1996). There can be different configurations in education, health, housing, pensions and social care, but the effects interact.

In gross public expenditure terms, universalism is always more expensive as benefits and services go to the 'affluent' who could 'afford' to pay for themselves or not receive the benefit. Where the benefit is in cash (as with old-age pensions) the net expenditure cost depends on whether these are taxable in the hands of the recipient.

While always cheaper in gross public expenditure terms, means-tested benefits encounter severe implementation problems, including high administrative and compliance costs, low take-up rates and vulnerability to fraud. Multiple means tests lead to marginal rates of taxation/benefit withdrawal that damage labour market incentives and discourage saving, and, in some societies and circumstances, generate social stigma. Moreover, there may be less middle-class voice articulating demands for high-quality services and less support for the taxes required to pay for them. Public services can become tainted as 'only for the poor', sometimes unintentionally or deliberately inferior in quality to

private substitutes. Services not accessed by the bulk of the population are likely to lose taxpayer support (Flynn 1988).

Taxed UK old-age pensions contrast with hitherto untaxed child benefit. Arguments for the latter being untaxed have revolved around child benefit being paid to the mother (as the person most likely to have child-rearing responsibilities) and the existence of separate taxation of married couples and civil partners. The UK income tax system focuses on individuals whereas the benefit system focuses on households, making for some uncomfortable joins. However, from January 2013, an income tax charge will be imposed to the value of child benefit received if the adjusted net income of either partner exceeds £60,000 (with tapered withdrawal from £50,000). Alternatively, child benefit can be renounced. This is a landmark change, in relation to the gender-sensitive issue of separate taxation and to the recognition of child-rearing costs by the tax/benefit system. Small breaches may later expand.

Securing productive efficiency

There is a widely purveyed image of the 'bloated public sector', whether or not the characterisation is valid in a particular country or at particular times. This image of 'private good, public bad' may have little relationship to the actual quality of public sector performance. This is part of the denigration of the public sphere (Marquand 2004).

This context emphasises the importance of productive efficiency, yet also highlights several problems. First, there is ambiguity as to what is 'efficient'. If productive efficiency is conceptualised solely as least cost, there are certain actions denied to public organisations that may be used by some private organisations: those involving illegality include breaking immigration laws, disregarding health and safety laws, and evading taxes. There are uncertainties about the acceptability for public organisations to undertake certain legal actions: for example, in relation to the treatment of existing employees, offshoring activities to low-wage economies, shuffling costs on to other public bodies, and tax avoidance. Second, what may seem in the short term to be least cost may prove more expensive in the long term: for example, outsourcing hospital cleaning, or the neglect of physical infrastructure whether through inadequate maintenance or non-replacement of life-expired assets. Third, in an economy with macro-economic maladjustment or problems of regional structure, there may be public policy reasons why governments pay above local market wage rates in some locations.

The international spread of market-like techniques that are analysed under the label of 'New Public Management' (NPM) has shifted the emphasis on modes of governance within the public sector from hierarchy towards contract. Under this umbrella came techniques such as accruals accounting, agencification, purchaser-provider separation, quasi-markets, outsourcing, PPPs and privatisation. The jury is still out on the NPM package, in part because

it is a bundle of different tools. That makes evaluation particularly difficult; the evidence seems to be contradictory and often appears to conform to the *a priori* views of the evaluator.

From the perspective of social democracy, there are dangers in blanket condemnation of NPM prompted by overstated claims on its behalf or by the neo-liberal label attached to it. Public service production has always been a hybrid, for example, with private sector firms constructing fixed assets. Rubbishing what the public sector does, and how it currently does it, is more comfortable territory for those without commitment to social democratic objectives. Performance is both substantive and symbolic: it is possible for public sector performance on the ground to be improving whereas its image declines.

Validating Value for Money

Notwithstanding these complexities, continuous striving for productive efficiency through effective public management is vital for the sustainability of social democratic positions on public expenditure. Effectiveness must be assessed relative to policy objectives, a relationship that causes difficulties if policy objectives are poorly articulated and/or unstable. Value for Money requires that public expenditure programmes be effective in achieving policy objectives and do this in a cost-efficient way. Either by statute or by forbearance, public audit bodies do not comment on policy, only on the implementation of that policy. However, policy objectives are often not articulated clearly, especially in a form that leads to well-defined operational objectives. Governments conceal their objectives, including 'doing good by stealth', and policy objectives may change when governments change.

Two separate meanings of VfM become entwined. First is *cost effectiveness*, where the difficulties stem from ambiguities about outputs, outcomes and cost. Although the context is political, these questions are essentially technical. Second is *worthwhileness*, a little-used word that better captures the everyday understanding of 'value for money'. Whether spending public money is worthwhile is always value-laden and thus political in the broad sense.

Into this discussion comes the complicated concept of public waste. Whether something is waste can depend on how the policy objectives have been conceptualised and specified. What may look like waste might derive from disputed policy objectives, social or employment or territorial objectives that override cost minimisation, or redundant resources that have no social or policy justification. Differentiating these is likely to be controversial. A familiar tactic is to characterise as waste the spending on policies of which one disapproves: an excellent example is UK defence expenditure on the wars in Iraq and Afghanistan. What may look like efficiency improvements may derive from reductions in service quality, cost shifting to third parties, or genuine improvements in cost efficiency.

During the long period of UK public expenditure growth under the

1997–2010 Labour Government, what the expenditure was actually achieving received inadequate attention, as did questions of absorptive capacity. Paradoxically, it may require ‘hard times’ to raise the profile of systematic evaluation and to focus attention on choices at the margin between different expenditure types. Whatever the validity of the data, the Office for National Statistics’ productivity series for education and healthcare attracted much media coverage in the run-up to the 2010 General Election. Reported falls in public sector productivity, both absolute and relative to the private sector, ran strongly in sections of the media, but largely disappeared after the election. These data fitted the narrative of a bloated public sector and the waste of billions of additional expenditure in the 2000s, to be rectified by fiscal austerity.

Distribution

Welfare states shift massive amounts of money – interpersonally and geographically – and have huge resource implications intergenerationally: these often reflect complex and fragile distributional coalitions. Redistribution through the public budget, a tenet of social democracy, has become more problematic. Income dispersion is higher, whether measured at the individual or household level. Paradoxically, it is easier to build consent for redistributive policies and to implement them in relatively equal, homogeneous societies.

Sometimes it is argued, even within social democratic parties, that individuals and households should be left more exposed to market forces, which have now intensified through globalisation. However, this runs counter to Rodrik’s (1998) conclusion that public expenditure is higher in internationally open economies; governments cushion the effects, through risk pooling, and thereby can achieve greater economic flexibility.

Although there has to be enough economic inequality to motor a market economy that works through aspiration and incentives, this inequality must not destroy the social fabric that underpins its functioning (Hirsch 1977). The degree of pre-tax/benefit inequality is substantially outside policy control, though the distinctiveness of Scandinavia shows that tradition and culture may constrain inequality.

A popular sense that something is ‘unfair’ can have powerful political effects. However, attitudes about fairness can be opportunistic and/or confused, rather than consistent. Equity has interpersonal and territorial dimensions: removing unacceptable differences in living standards and public services for individuals/households within a country; and addressing inequalities between regions (a provision in the 1949 Basic Law of Germany). Social democracy presumes a normative commitment that supports both interpersonal and territorial redistribution. However, the domain over which that commitment applies has become more contested. More geographically mobile and socially differentiated populations make explicit redistribution more difficult to achieve and

undermine the stability of implicit intergenerational contracts (e.g. in relation to social security). This may reduce the sense of responsibility for others: with much greater knowledge about conditions elsewhere in the world, why should one care for geographically close neighbours if not for others with much worse suffering?

Moreover, there may be a 'revolt of the rich' at the individual/household level, taking the form of tax avoidance, threatened emigration or strengthened political opposition to financing public services and redistribution. There are powerful public finance arguments for making cash transfers when the objective is poverty reduction. This confronts claims that market-generated rewards are 'deserved' by the recipient and that government transfers are inferior. Such 'cash versus kind' questions are unlikely to have final answers, answers being contingent on circumstances. For example, the US Federal Government runs a massive food stamps programme whereas EU countries predominantly use cash benefits for poverty relief.

These tensions are mirrored at the level of the political collectivity. Within the eurozone, Northern Europe does not wish to transfer resources to Southern Europe. Prosperous regions within states such as Catalonia and Flanders wish to cut back transfers to the less prosperous, and those, like Scotland, which have tax revenues from natural resource rents such as oil may wish to prevent them going to the national budget.

Managing these dilemmas becomes particularly difficult when the market distribution of rewards disperses further and a non-negligible proportion of the population is unable, because of disabilities or lack of skills, or unwilling, because of cultural attitudes or a dysfunctional tax/benefit system, to generate sufficient resources in the marketplace for what their society considers an acceptable living standard. Public services do not operate in silos. What happens in housing, for example enforced moves because of housing benefit cuts, will have effects on population location and school achievement. Such circumstances have complicated effects: for example, child poverty will increase; educational and health indicators may deteriorate because of what is happening at the bottom of the income distribution; fecklessness will be attributed to those to whom it is certainly not applicable; and there will be a drag on economic productivity.

The residualisation of public services is a threat to social democracy. There may be tipping points in exit rates beyond which public sector services are reputationally devalued; rubbishing them as inferior then contributes to a political climate that stigmatises use, validates exit and supports expenditure cuts. Being inside the social networks developed through the use of private facilities may create competitive advantages in the labour market and in cultural and sporting achievement. Residualisation will lead to falls in electoral support for public spending on those services and to proposals that there should be tax deductibility of private fees. More extensive exit from public provision

threatens the approach to 'limiting the domain of inequality' that extracts certain goods and services from the market, allocating instead on some indicator of 'merit' or 'need'. Such specific egalitarianism (Musgrave 1959; Tobin 1970) sometimes emphasises the distribution of outcomes; in other cases the sole objective is that everyone has the opportunity to step on the ladder.

Intergenerational issues are rapidly acquiring greater salience: the expectation that each new generation would be better off than their parents has been dashed, not least because of reduced affordability of private house ownership and the decline of occupational pension schemes. These add to the effects of higher education fees and labour markets in which it is more difficult to gain a foothold. Inheritance has resumed an economic importance not generally possessed in the post-1945 period. In the background are concerns about long-term developments such as the economic impact of climate change. These developments contribute to pressures to unbundle the welfare state, for example in relation to young people, often without regard for direct and indirect ramifications for other parts of the welfare state.

Stabilisation

The 2008 financial crisis constituted a landmark in stabilisation policy, breaking a broad policy consensus established in the early 1990s that fiscal policy should be set with regard to the medium and long term, with monetary policy being used for short-term macro-economic management. The tools and instruments would be measurement of the output gap, fiscal rules and independent central banks. These were regarded as largely matters for non-political experts, with limited concern for the public accountability of those experts.

Several arguments coalesced against discretionary fiscal policy. First, there was the problem of lags: by the time additional public investment occurred the economic cycle had moved on, making the effect counterproductive. Moreover, economic cycles were not symmetrical and hence difficult to map in real time. Second, 'stop-and-start' changes damaged the efficiency and effectiveness of public expenditure programmes. Third, while governments might enthusiastically increase deficits during recessions, there was a singular lack of enthusiasm to run surpluses during booms – the pressures to spend or cut taxes were irresistible. These asymmetric reactions have contributed to secular increases in debt/GDP ratios. Fourth, there was an implicit ideological preference for monetary policy, seen as 'less interventionist' and less dependent on untrusted political processes. Social democratic parties mostly bought into this consensus because it seemed to solve the macro-economic problem while generating the taxation to finance public services.

Since 2008, discretionary fiscal policy has revived, though with conflicting purposes. Some have argued that governments should try to balance their economy rather than their short-term public finances. Others take the view that

market economies are automatically stabilising if left alone, or the view that all intervention makes things worse. A critical question has been whether the automatic stabilisers should be allowed to run their course, thereby increasing the fiscal deficit in the years when the economy has failed to recover. If not, the effect of the automatic stabilisers will be suppressed, either by weakening the underlying policies (e.g. reducing tax progressivity or benefit generosity) or by imposing expenditure reductions or tax increases of the same size as the automatic stabilisers. Near-zero interest rates have negated the interest rate tool of conventional monetary policy, leading to what has become known as 'Quantitative Easing'.⁴ Fiscal austerity is combined with lax monetary policy, with the latter partly intended to protect the real economy from the effects of the former.

In the context of this chapter, four observations are appropriate:

1. The ideological preference for monetary policy is misplaced, with there being a strong case for pragmatism on the basis of 'what works' in particular circumstances; indeed, the distinction between monetary and fiscal policy has been blurred by 'unconventional monetary policy' (Miles 2012).
2. The potential damage to coherent spending priorities and programmes that can be caused by fiscal fine-tuning, in either direction, should not be underestimated. Disruptive changes damage the actual and perceived efficiency of public institutions.
3. Intergenerational issues are pressing, a consideration which adds to the 'policy flexibility' case for containing and reducing debt/GDP levels and for monitoring both sides of the government balance sheet (Heald and Georgiou 2011).
4. The problem with fiscal rules is the incentives they create to find policy instruments that bypass those rules; this is likely to do damage to VfM and to breed cynicism that condones other rule-breaking. Setting budgets and taxes is central to political authority: removing or restricting this through the exercise of external authority has unpredictable and potentially far-reaching effects.

The neglect of taxation

On the assumption that social democracy does involve higher public expenditure than political positions to its right, higher-than-otherwise taxation is required. This is a difficult political message to convey, leading to exaggerated claims about future efficiency gains and to excessive reliance on the fruits of economic growth. The pressures on private consumption from widening pre-tax inequalities and the impact of the 2008 recession are hardening social attitudes (Park et al. 2012).

A depressing feature of the 1997–2010 Labour Government was its neglect

of the taxation system during fiscal plenty. A compulsive tendency to micro-manage, often for short-term media gains, was combined with failures not only to address structural issues but also to defend the purposes of taxation and to stress its relationship to political accountability (Bräutigam et al. 2008). There was no challenge to the remarkable levels of public ignorance about the operation of the UK tax system. Moreover, the ambitious but flawed implementation of tax credits suffered legitimacy problems because of a Treasury political style characterised by media spinning and a desire to do good, for example to reduce child poverty, but only by stealth.

The UK tax system is a prodigious machine for generating tax revenues: over the period 1965–6 to 2011–12 the ratio of public sector total receipts to GDP has never fallen below 35%. However, revenue generation is only one criterion. Most taxes impose efficiency costs on the economy: potential exceptions are externality-correcting taxes such as those designed to reduce environmental harm. These costs are analysed by economists in terms of ‘excess burden’ and the Marginal Cost of Public Funds (MCPF) (Dahlby 2008).⁵ The policy objective should be to raise the target revenue and to achieve redistributive goals, while minimising unintended impacts on the functioning of the market sector of the economy. There undoubtedly are ‘fiscal termites’ (Tanzi 2001), such as avoidance, technological change and globalisation, which threaten governments’ capacity to generate tax revenues at historic ratios to GDP. Nevertheless, the scale of the resulting problems needs to be kept in perspective, especially if the 2008 recession has genuinely stimulated coordinated international action through bilateral information exchange and OECD monitoring of tax havens, and stricter domestic enforcement.

The Mirrlees Review (2011) provided a road map for UK tax reform but timing issues have thus far limited its practical impact: it missed the period of fiscal plenty in the first decade of the century, and took too long from its commissioning in 2006. Its proposals for broadening the VAT base were marred by an unfounded belief in the credibility of offsetting tax/benefit measures and an inadequate recognition of the political problems of tax base broadening. The Review lacked clarity about whether differentiated VAT rates were simply distortions to the spending choices of consumers (*anomalies*) or whether, in part, they represented *policy encouragement* of particular patterns of expenditure such as books and newspapers. Public policy objectives might legitimately be progressed through either side of the government budget.

Increasing income inequality has made governments more dependent for taxation revenue on potentially mobile earners/consumers, thereby increasing revenue risk and adding to problems caused by capital mobility and tax havens. Inadequate attention has been paid to maintaining the legitimacy and integrity of taxation, for example by widespread failures to revalue the tax base for the residential property tax. This neglect of the taxation system (both

operationally and in active defence of the purposes of taxation) has left public expenditure exposed to populist and free-market attacks.

The crucial point is that the public expenditure levels typical of social democracies can only be mainly financed through the income, consumption and property taxes paid by the bulk of the population: proposals to finance them through taxes on the 'rich' are delusionary. The interaction of tax design with legitimacy is neatly illustrated by the controversy surrounding Mitt Romney's denigration as 'victims' the 47% (actually 46.4%) of the US adult population who do not pay federal income tax (Whipp 2012). This figure is heavily influenced by the fact that US old-age and veterans' pensions are not taxable.

From administrative and compliance cost perspectives, there are arguments for limiting income taxpayer numbers. From a legitimacy perspective, there are strong arguments for bringing citizens within the income tax net. Also, a wide income taxpayer base facilitates the operation of tax credits. In contrast, the Liberal Democrat (2010) UK General Election manifesto envisaged a personal allowance of £10,000 that would eliminate the income tax liability of 3.6 million taxpayers. This well-intentioned proposal, involving dangers for legitimacy, emphasises the importance of thinking about the taxation system as a whole and how that is portrayed.

The public expenditure challenge for social democracy

The distributional coalition supporting high public expenditure is a complex one. Instead of a reasonably clear left-right political spectrum, a more fragmented electorate runs along multiple spectra: for example, statist versus market liberal, social liberal versus social conservative, and internationalist versus nationalist. It has become more difficult to hold a pro-spending coalition together and it has become more difficult to negotiate with governments, for example about changes to retirement age and pensions. In particular, social groups expect that governments will come back for more concessions in a race to the bottom, and negotiators fear losing the confidence of their constituencies.

In these circumstances social democratic parties may lose votes (a) because these are taken by other social democratic parties (whatever their names), and/or (b) because economic and social developments lead to a decisive shift of political values to the right. A social democratic party may become seen as the party of welfare recipients, not as the party of workers.

De-unionisation of the private sector has pushed the centre of trade unionism into the public sector, leading to allegations that unions are merely defending vested interests in a way that is unfair to private sector employees who have lost entitlements. These tensions are accentuated by suspicions of there being (hidden) agendas about (a) de-unionising the public sector, via outsourcing,

competitive markets and the break-up of national bargaining, and (b) eventual service privatisation. While outsourcing might free political leaderships of certain difficult managerial tasks, there is ample evidence that outsourcing delivery does not necessarily divest responsibility, as evidenced by the security lapses in the run-up to the 2012 London Olympics. Notwithstanding advocacy of mutual or social or charitable enterprises as alternatives to direct public sector delivery, there are big questions as to what the eventual configuration of privatised suppliers would look like: UK buses, now dominated by an oligopoly, contrast markedly with the 1980s' projection of local and employee-owned firms. Procurement and regulation bring their own difficulties, as does direct production.

In this complex setting, social democratic thought needs clarity about the top-level issues. First, the optimal level of public expenditure for a particular country at a particular time depends critically upon 'big' decisions on the role of the state and on the choice of instruments. If healthcare is publicly financed, the aggregate level of public expenditure should be higher than if (a) the government compels private healthcare insurance, or (b) the government accepts no policy responsibility for healthcare. An excellent example of mismatching expenditure to policy commitments is UK defence expenditure in relation to foreign policy goals and commitments. The macro-economic imperative of restraining public expenditure commitments that are 'too high' relative to the present and future productive capacity of the economy and feasible tax revenue must be differentiated from the view that the expenditure is intrinsically undesirable.

Second, the 'how to tax' question is fundamental to the legitimacy and sustainability of 'high' levels of public expenditure. If public expenditure (after netting off charges to users) is relatively high, then aggregate taxation must be relatively high. Attention must focus on the efficiency costs of taxation and on the redistributive effectiveness of the tax/benefit system. Consent and compliance cannot be assumed. The rationale for a broad-based tax system, with the lowest tax rates consistent with targeted yield, has to be clearly articulated. Although parties in opposition will oppose government tax policy, those committed to high public expenditure should avoid populist positions on tax. Those wishing 'low' levels of public expenditure might see advantages in an inefficient tax structure and administration and in the erosion of governments' ability to raise revenue.

Third, there must be strong commitments to productive efficiency and to VfM. For this to hold, there has to be a recognition that these can cause difficulties with employees and beneficiaries, part of the distributional coalition supporting high public expenditure. Having established a clear view on the big picture, there should be pragmatism on 'what works'. Crucially, this means evidence-based policy, not the commissioning of policy-based evidence. There has been a damaging proliferation of advocacy masquerading as economic contribution/impact calculations, which, *inter alia*, neglect displacement effects

(see Kay 2010 for a witty critique). Techniques of economic analysis should be deployed in a manner that opens up debate (such as in the Dilnot Report (2011) on options for financing long-term care), not closes it down in a way that breeds public and practitioner cynicism.

Fourth, the distributional issues are complex. A sceptical eye should be cast on economic rents in privileged parts of the private sector, not least because these have contributed to the adverse distributional trends. Policies other than taxation and expenditure can have distributional impacts; consider the effects of interest rate policy on the incomes of retirees and those living off their fixed-income investments and the wider position of borrowers versus lenders.

Given the likely duration of public expenditure restraint, intergenerational issues will become more prominent. Universal benefits to the elderly, such as bus passes, winter fuel allowances, prescription charges exemption, and free personal care, are often criticised as wasteful because of the proportions going to the non-poor. However, the addition of new means tests aggravates the existing problem of ludicrously high marginal rates of tax/benefit withdrawal at certain points in the income distribution. Central governments will be tempted to push the pain 'downwards' via inadequately funded mandates to lower tiers of government, and 'outwards' by fall-back reliance on charities, bringing their own explicit or implicit means tests. Proposals for new charges, fees or tolls should always prompt the question as to whether these will be waived on income or other grounds. If so, these would accentuate existing problems. Where means tests are used, they require to be designed at a sufficiently centralised level so that coordination is possible and data are verifiable.

Looking at the redistributive effects and trends as a whole is emphatically important (Hills 2010). Paradoxically, while the cultural values underpinning concern about inequalities may be weakening, awareness of the economic costs attached to increasing inequalities may be growing (OECD 2011). These economic costs are sometimes subtle, particularly in programme interactions and second-round effects. The development of a detached underclass may: put pressure on the benefits system; damage the productive potential of the economy; and lead to higher expenditure and worse performance in education, healthcare and criminal justice. For example, there are remarkable inter-country differences in the proportion of males under thirty who are expensively imprisoned, serving as a reminder that cutting social expenditure can prove a false economy.

Fifth, from the perspective of 2012, the stabilisation issues look different as a result of the 2008 global financial crisis. The surge in debt levels since 2008 urges caution on debt levels in 'normal times'; there has to be sufficient fiscal room to allow for the full operation of the automatic stabilisers, however bad the recession. It is now less clear what would be a cautious debt/GDP ratio. The political difficulties associated with a policy of lowering debt levels are obvious: one government having taken the pain (foregone public services or

tax reductions), the following government might benefit politically by running debt levels back up.

Sixth, the achievement of substantive policy objectives in relation to public expenditure requires an open debate: securing fiscal transparency is imperative (Heald 2012). This might partly counteract the damaging obsession with 'scoring' (see Portes 2012) which elevates form over substance: for example, manoeuvring activities to just outside general government or just outside the public sector; using PPPs for reasons other than VfM; and pretending that government guarantees to privately undertaken public infrastructure are costless. Such devices add to country fiscal risks (by temporarily disguising the macro-economic position) and can result in inappropriate amounts and mixes of infrastructure. The default position should be suspicion of attempts to achieve desirable policy objectives by stealth, not least because this approach is unlikely to be sustainable.

In summary, the levels of public expenditure required to sustain the welfare state that is a central tenet of social democracy require a well-informed defence. Threats come from long-term factors such as globalisation and more complex social structures and from the current fiscal austerity which has been seized upon as an opportunity for far-reaching reforms by some governments. That defence requires not only the articulation of social democratic values in relation to the objectives of public expenditure but also open-minded yet hard-headed analysis of alternative public expenditure programmes within constrained totals.

Notes

1. The author wishes to thank the Royal Society of Edinburgh for his 2010–11 Scottish Government Support Research Fellowship on 'Improving the quality of public expenditure'. Sole responsibility for the contents of this chapter rests with the author.
2. 'Neo-liberal' is often a term of abuse, directed at particular policies and programmes by those who are hostile. In self-description, preference is given to labels such as 'free market', 'market liberal', 'liberal' or 'conservative', largely dependent on linguistic usage in their own communities.
3. From 1996–7 to 2007–8, the Treasury's measure of UK public expenditure (Total Managed Expenditure) grew in nominal terms by 85% and by 46% in real (i.e. GDP deflator-adjusted) terms. Over that period, the TME/GDP ratio increased from 39.5% to 40.7%, as GDP was growing strongly. The 2011–12 ratio was 46.6% (Treasury 2012, Table 4.1).
4. This involves the Central Bank creating electronic money in order to buy government securities in the market, thus forcing bond prices up and interest rates down. The expectation is that improved bank balance sheets will then result in more bank lending to the commercial private sector.

5. Excess burden is the loss of economic welfare caused by taxes beyond the realised tax revenue, which is a transfer to the government sector. This results from the way in which taxes create a wedge between prices faced by buyer and seller. The MCPF is therefore greater than 1, often thought to be in the range 1.2 to 1.3. A more efficient tax structure will lead to a lower MCPF than an inefficient one, thereby increasing the economically optimal size of public expenditure.