

The BOW GROUP

Principle Author



Donna Edmunds

Donna Edmunds has four years experience as a political advisor in both Brussels and Westminster to Conservative representatives.

She has recently been appointed as the Bow Group's Head of Media.

Chairman's Statement

In order for significant and sustainable growth to occur in the UK economy before 2015, as well as cutting the deficit and lowering taxes, the Government need to focus on keeping the cost of living down, opening up access to the housing market to first time buyers, keeping lending costs low, and encouraging new industries such as shale gas extraction and 4G to flourish in the UK marketplace.

Ben Harris-Quinney

Media Enquiries

Donna Edmunds
Head of Media
comms@bowgroup.org
T +44 (0) 7876 333 696

Ben Harris-Quinney
Chairman
chairman@bowgroup.org
T +44 (0) 07875 570 898

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Press Briefing

BUDGET 2013

Introduction

“Economic policy is not just about pounds, shillings and pence. It is the compass from which all other policy areas find their direction.”

Dr Liam Fox, speech at the Institute of Economic Affairs, 11th March 2013

The conservative movement is in turmoil. Many faithful Conservatives feel that their party has lost touch with its core values, splitting the party and the vote. For George Osborne, the 2013 budget represents his last chance to put conservative fiscal policy into practice and have the effects felt before the next election. In other words, it is his last chance to demonstrate to the electorate that a conservative budget can bring prosperity to the nation.

But what are the core values that underline a conservative fiscal policy? The Conservative MP Dr Liam Fox, talking at the Institute of Economic Affairs ahead of the 2013 budget, said “I want to talk about an economic narrative underpinning our policy approach that would send the clearest message that the Conservative’s core values of hard work, building for a better future and celebrating success are still at the centre of everything we try to do.”

So a conservative fiscal policy would have supply side measures at its heart. A conservative budget would set low personal taxes to reward hard work; an end to quantitative easing and artificially depressed interest rates, to incentivise saving at all levels of society; and low corporate taxes, to beget success from success.

Conservatism also stands for responsibility, including a responsible approach to cutting budgets and balancing the books, so the budget must also include a more stringent approach to cost cutting. This needn’t only take the form of budget slashing. Welfare is one of the biggest bills on the government’s books, yet tax-cutting measures to incentivise work would have the fortuitous additional effect of reducing welfare payments. Evidence from around the world demonstrates that in order to enact a cultural shift from welfare dependency to self-sufficiency, the welfare state must be less profligate, but crucially measures to curb welfare generosity must be paired with supply side reform, giving people a route to self-sufficiency. The Chancellor must therefore give more priority to supply side reforms as a route to shrinking the welfare bill.

In the 2012 Autumn Statement, the treasury rebuked the last Labour government for a financial crisis caused in part

by unsustainable levels of debt. Yet the signs are that there will be few measures designed to reduce the national debt, with the treasury preferring to 'reinvest' the vast majority of the savings it has made from budget cuts in the form of stimulus measures. This is pure Keynesian economics, and should play no part in a Conservative-led government's budget. In order to offer the electorate real choice at the next election, the Chancellor must abandon his Keynesian approach to growing our economy (as favoured by Labour) in favour of a genuine move to free market solutions.

Incentivising work

"If Atlas carries the world on his shoulders, we need a good, strong Atlas and not too heavy a world. Our job in Government is to provide the right framework in which enterprise can flourish and we are doing it. But, of course, it rests with the people themselves to pick up the challenge and it is in the people that we Conservatives place our trust."

Margaret Thatcher, Conservative Party Conference Speech, 14th October 1983

Under Cameron's leadership, the Conservative party has attempted to shed its 'nasty party' label through the implementation of liberal social policy. Yet it will be judged at the next election on its economic progress first and foremost. Consequently, if the party wants to regain the trust – and the votes – of the electorate, it must strive to be a 'nice' party fiscally.

Through welfare reform, the Conservative-led government has sought primarily to use the stick to encourage people back into work. Little mention has been made of the moral aspect to work or the benefits that it can offer a person. Too little use is being made of carrots.

This is a mistake, not least because enticing people into work through lower taxes is electorally popular – Sweden's Conservative government has just been re-elected for the first time on the back of fiscal policies that (amongst other measures), gave low waged earners an 8% tax cut, a level at which the government was able to boast that they were putting an extra month's salary into people's pockets. The reform paid for itself in reduced welfare spending, and is thought to be irreversible thanks to its popularity. That the British government has already had to make the economic argument for lowering the 50p rate of tax only serves to make it all the more sensible to do the same at the lower levels too, thus putting an end, for the Conservatives, to accusations of being a party only for the rich.

However, rather than viewing tax cuts as a stimulus, the Chancellor appears to view them as a treat to be enjoyed when times are good; consequently, the treasury is busy dampening any expectations of a tax-cutting budget this month. This is backward thinking.

The economist Arthur Laffer has ably demonstrated in his work that government stimulus spending is a myth, for the simple reason that governments must take from one person to give to another. As a result, the gain from any stimulus spending is offset by the loss of taking that money out of the economy elsewhere. Conservatives believe in allowing the public to keep as much of their own money as possible as much because it makes economic sense as for reasons of moral rectitude. Yet this Conservative chancellor has gone in the opposite direction, introducing 299 tax rises during his tenure against 109 tax cuts, according to the Taxpayers' Alliance. Many of these directly affect the quality of quotidian life, others do so indirectly through depressing the economy.

With the cost of living rising, tax cuts that affect living costs would again be popular at the ballot box, and would have the added advantage of providing real stimulus to our flat-lining economy. These should be paired with changes to the welfare system to best combine incentives to getting people off welfare.

Many loyal Conservatives are somewhat alarmed to find themselves in line with current Labour policy, but support a reduction in VAT rates. The current 20% rate depresses demand. Switzerland and Liechtenstein, two of Europe's most financially successful countries, have VAT rates of 8%. Britain should enact the same immediately, sending people back into the shops.

The Chancellor has made much of freezing petrol duty over the last two and a half years, but the cost of petrol is still at an historical high, impacting heavily upon household budgets and people's ability to get to work. Rather than simply freezing the duty, the Chancellor should actively cut it sending out a strong message that he is listening to hard working families and is on their side. Currently the combined cost of fuel duty and VAT amounts to 60% of the price of fuel, the highest in Europe. Simply reducing VAT as suggested above would bring this rate below 50%, but actively cutting fuel duty itself, even by a few percentage points, would send a further message that the Chancellor is on the side of British people and industry. Whether through VAT reduction or fuel duty reduction, it is crucial that the tax on fuel not exceed the cost of the fuel itself.

Vehicle excise duty should also be set at a flat rate, ending the penalisation of those who cannot afford newer, 'greener' cars.

Finally, the Chancellor has in the past indicated support for a move away from the current obsession with renewable energy sources. His tax breaks for shale gas extraction detailed in the 2012 Autumn Statement were a move in the right direction, but so far have done little in the immediate term for householders struggling to keep up with energy costs. Politically there is little he can do on energy – that would require parliament revisiting the 2008 Climate Change Act. But in his capacity as Chancellor, he could cut the VAT and green energy tariffs currently adding £91.50 to a typical dual fuel bill in 2012 – up from £56.50 in 2010. Hardworking families would like to see green energy tariffs and the subsidies that they fund scrapped completely.

Incentivising investment

'It is a paradoxical truth that tax rates are too high today and tax revenues are too low and the soundest way to raise the revenues in the long run is to cut the rates now. The purpose of cutting taxes now is not to incur a budget deficit, but to achieve the more prosperous, expanding economy which can bring a budget surplus.'

John F. Kennedy, Address at the Economic Club of New York, 14th December 1962

As noted previously, Osborne has so far failed to make the link between lower taxes and growing an economy. Yet without making use of this essential tool in his kit, he is severely hampering the ability of British businesses to drive forward a recovery from the 2008 recession.

In June 2010, Osborne raised the rate of Capital Gains Tax from 18% to 28%. The result, according to the Adam Smith Institute, was a 64% reduction in the amount of tax paid, costing HMRC nearly £5 billion. Much more sensible and conservative in nature would have been a three year Capital Gains Tax exemption window to encourage businesses to offload any assets currently languishing on the books, with a return to the 18% rate thereafter.

This should be accompanied by an immediate reduction of Corporation Tax to 11%, undercutting Ireland's 12.5%. Estonia has taken the unusual step of levying Corporation Tax only on monies paid out to shareholders. Profits reinvested within the company are zero rated, encouraging companies to grow. Many small

business owners unable to secure finance to expand their companies, but the Treasury's response so far has been to offer government backed loans and grants, stepping in where banks fear to lend. This is simply an product of the left wing belief that government is the answer. Conservative administrations the world over have amply demonstrated that when governments allow businesses to keep more of their money, it is used in expanding businesses and growing the economy. Yes, Osborne has announced a reduction in corporation tax to a more-competitive 21%, but it will only come into force in 2014. Why the wait when there are good businesses out there now struggling under the double burden of taxation and red tape?

These and other tax rate reduction measures would drive up the deficit in the short term as tax receipts fell, but with businesses freer and incentivised to expand, the resultant economic growth would make up the shortfall in bucket-loads. With less than 1,000 days until the next election, the resultant surge in the economy might be the ticket that this Conservative party needs to make an impact at the polls.

There is, of course, more to supporting the business community than simply offering lower tax rates (although lower taxes are always welcome). Red tape continues to stifle entrepreneurship, and the labour market is badly in need of reform.

Research by the Centre for Social Justice has shown that a single parent in receipt of benefits who takes a part time job paying £400 a month will keep just £84 of those earnings after loss of tax credit and benefits are taken into account. That represents an effective tax rate of 79%, higher even than the French dare venture. Little wonder, then, that of the 510,000 jobs created during the last three years, most have gone to immigrant workers. Current rhetoric regarding strivers and shirkers may make good headlines, but does nothing to encourage people into the job market. This has a very real human cost in loss of opportunity, loss of self-respect, and loss of community cohesion. It is the moral duty of conservatively minded people to promote the benefits of the employer and employee relationship to both parties.

A solution could be found in Germany where they have introduced 'mini-jobs', part time contracts whereby a worker can earn up to £400 a month tax free in exchange for giving up certain labour rights such as unfair dismissal. Workers are allowed as many of these contracts as they can juggle, so long as none of them are with the same employer. This clearly benefits those

taking the jobs, but it also benefits the employer as he now has a more flexible, dynamic labour market, allowing his company in turn to be more flexible and better serve its customers' needs.

A similar model should be introduced immediately in Britain.

Reducing spending

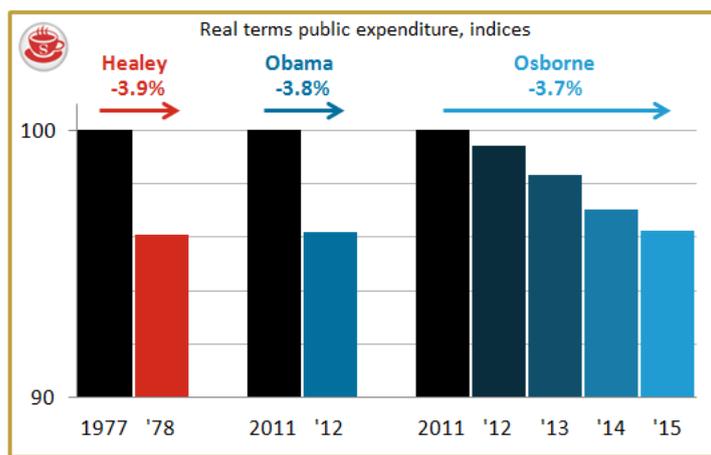
"We will not be able to build a sustainable recovery with long-term growth, unless we fix this fundamental problem of excessive government spending and borrowing that undermines our whole economy."

David Cameron,

speech in Keighley, West Yorkshire, 7th March 2013

As Cameron is fond of saying, you can't borrow your way out of a debt crisis. Yet of the £6.6 billion saved from government budgets last year, £5.5 billion was used not to reduce the deficit (let alone pay down debt), but as an 'investment package' of infrastructure building and subsidies. The action simply doesn't match the rhetoric.

When in opposition, Osborne and his Conservative colleagues heavily criticised Brown for being too timid in his plans to cut the deficit by 33.3% by 2013. Yet Osborne himself has only managed a 25% deficit reduction. Spending went up by over 60% during the Labour years, yet Osborne has cut less over three years than Dennis Healey managed in one:



Source: OBR, "Economic and Fiscal Outlook March 2011" and OMB, "US Budget FY 2012"

This administration has suffered all of the political fallout for austerity, without actually enacting any austerity within the system. As Conservatives, the Prime Minister and Chancellor shouldn't just be talking about cutting budgets because it's politically beneficial, paying lip service to the idea whilst pretending to be

taking tough measures. As Conservatives, they should be *doing it* because it's the right thing for Britain.

Beyond the strictures of the Treasury, Conservative administrations are upholding the conservative principle of financial responsibility. Windsor and Maidenhead borough council has seen a real terms decrease in council tax rates of 11.6% since 2010/11, yet has managed to deliver a pay increase to the bottom 40% of staff, a new library and sensory room, £4.85m spent on improving schools in 2013/14, £950,000 for adult social care and over a £1m on highways.

How? By stripping out waste rather than simply salami slicing budgets. They have tackled wage inflation by removing themselves from the national pay scheme; tackled the cost of equipment and supplies by shopping around; tackled uplifted service provider contracts by renegotiating the contracts every year; tackled spending on demand led services by challenging their officers to prove existing demand; and tackled grant funding costs by scrutinising the effectiveness of the grants.

As council leader Cllr David Burbage has said: "Our work to make savings through better ways of working and eliminating unnecessary administrative costs - instead of direct cuts - means we can further invest in front-line services and make them even better for our residents. ... The bottom line is - there should be no hiding place for wasted money in the Royal Borough."

If Osborne is determined to stick to his Plan A and ignore supply side reforms, root and branch reform of government spending is essential to get the country's finances back on track. The current administration must abandon plans to set a uniform rate of savings across all departments. Rather, the effectiveness of each department and spending line must be carefully scrutinised. There are strong conservative arguments to make in favour of prioritising defence spending over the department for energy and climate change, for example.

It is imperative for the country that spending cuts are given more urgency. A 3.7% budget cut over three years must surely be described as lacklustre by all but the most ardent statist. Osborne should aim to reduce the budget by at least 3% in 2013/14 alone.

A Note on "Fairness"

"The income effects in an economy always sum to zero. Literally, they always sum to zero. The government cannot give to anybody anything that the government

does not first take from someone else.”

- Arthur Laffer, 'Return to Prosperity', 2010.

In recent times it has become fashionable to talk about fairness in progressive terms. 'Fairness' has taken on a new definition whereby the more wealth an individual has, the more it can be legitimately confiscated by the state.

Since the 2012 Autumn Statement, this administration has made much of the raise in personal allowance as a mechanism to introduce more of this sort of fairness into the tax system. But the figures involved are small: basic rate taxpayers will be just £290 better off in 2013/14, most of which will be lost in reduced benefit payments by those at the lower end. It is also being offset at the higher end as earners are forced into the higher tax band through inflation.

This month marks the 25th anniversary of Nigel Lawson's radical tax cutting budget, in which the top rate of tax was cut to 40%. Unpopular with the left at the time, they have continued to uphold a static income narrative in which higher tax rates mean more income for the treasury.

The evidence from that 1988 tax cut does not bear this theory out. In 2008/9, the top 1% contributed 23% of the total income tax liability. By comparison, in 1986/7, the top 1% contributed 14% of the total income tax liability; in 1981/2 it was 11%. Thanks to this measure alone, Lawson ought to be hailed as the most redistributive Chancellor we have yet seen.

Conservatives should be bold in their advocacy of supply side economics. We should not be ashamed to make a case when the facts are on our side. For that reason, in the name of fairness, we must advocate moving towards a flat rate of income tax.

A flat rate of tax is fair because everyone's output is

	1976-77	1978-79	1981-82	1986-87	1999-00	2008-09
Top 1%	11	11	11	14	21.3	23.0
Top 5%	25	24	25	29	39.8	42.3
Top 10%	35	35	35	39	50.3	53.1
Next 40%	45	47	46	42	n/a	n/a
Lower 50%	20	18	19	16	11.6	11.5

taxed on an equal basis. As a society we like to consider that the work effort of a nurse is equal in value to that of a successful footballer. If that is so, it is only fair that each individual keep the same proportion of the proceeds of that work.

It is also fair because under a flat rate of tax, wealthier citizens provide a greater proportion of the income tax take. Government in turn benefits through taking a smaller portion of a much bigger pie.

In addition to his 40p rate, Lawson's 1988 budget included a few tax simplification measures. Simplification of the tax code means fewer loopholes for the rich to exploit, creating a more level playing field for taxpayers. Osborne would be wise to follow his predecessor's example and simplify the tax code wherever possible.

Finally, little has been made in the media of the regressive effects of quantitative easing. So far the Bank of England has added £375 billion to the economy through quantitative easing measures, keeping credit rates artificially low and boosting the prices of assets such as houses and fine wine. Whilst this is good news for wealthy citizens who own such items, it is less welcome for those whose incomes are squeezed by inflation. The Bank of England itself estimates that the richest two million households are better off by £127,000 a year, and average households by £9,000 a year. Meanwhile, the poorest two million households are worse off by £310 a year.

Thatcher knew that conservatism is about aspiration, it is about giving everyone, no matter what their background may be, the opportunity to work hard to better their lot in life. Her administration gave hope and a sense of achievement to millions of hard working British, and it was duly rewarded with continuing trust at the ballot box.

If Osborne wishes to be remembered in the same way, he would do well to listen to the clamouring backbenchers in his party and enact bold, positive reforms to immediately open Britain up for business. Allow people to work harder, allow them to keep more of their money. Allow businesses to reinvest profits to foster further success. As a conservative, he must champion supply side reforms because they are a moral necessity as much as a financial one.

About The Bow Group

The Bow Group is a leading think tank based in London. It is the oldest in the UK and celebrates its 60th Anniversary this year. Since its foundation, the Bow Group has been a significant source of policy ideas, and many of its papers have had a direct influence on Government policy and the life of the nation. Many of the Bow Group's alumni currently sit in Parliament, including 5 former officers who were elected at the 2010 General Election.

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Summary of policy suggestions

Incentivising work:

An 8% tax cut for the lowest paid in society, along the Swedish tax credit model.

Cost of living tax cuts, including an immediate cut in VAT rates to 8%.

Cuts in fuel duty so that tax is no more than 50% of the cost of fuel.

A flat rate of vehicle excise duty to reduce penalisation of the poorest car owners.

Scrapping of green energy tariffs and the subsidies they fund.

Incentivising investment

Capital Gains Tax to be zero rated for three years to encourage sales of assets

Corporation Tax to drop to a much more competitive 11%. Alternately, Corporation Tax to be zero rated for all company profits reinvested in the company.

Introduction of German style 'mini jobs', with earnings of up to £400 for each job zero rated. Workers to be allowed to take on as many mini jobs as they like from different employers.

Reducing spending

Budget cuts to be made according to the effectiveness of the funding stream, rather than simply enacting uniform cuts across all departments.

A firm commitment by Osborne to reduce overall spending by 3% in 2013/14.

Fairness

A flat rate of taxation to be introduced.

Simplification of the tax code to reduce avoidance through loopholes.

An immediate end to quantitative easing

Recommended Reading

Arthur Laffer PhD & Stephen Moore, *Return to Prosperity*, Simon and Schuster Inc, 2010.

Jude Wanniski, *The Way The World Works*, Gateway Editions, 20th anniversary edition, 1998

Friedrich von Hayek, *The Road to Serfdom*, (1944), Routledge Classics, 2nd Edition 2001.