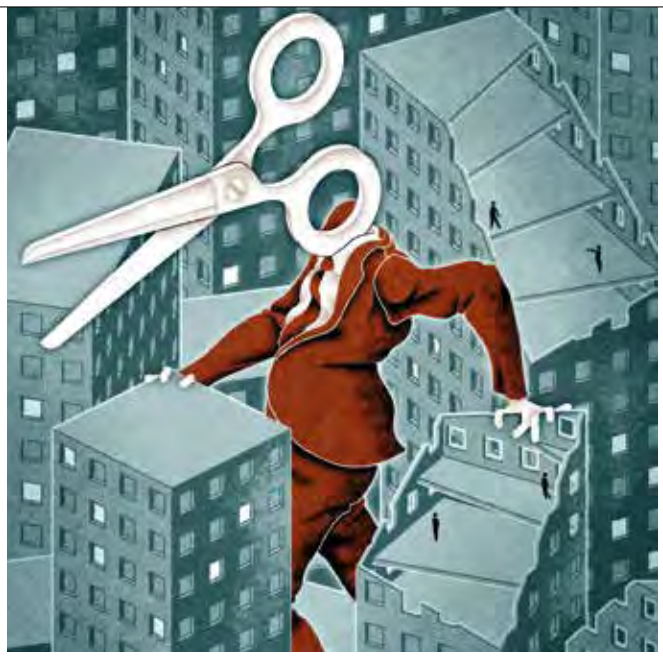
{ WELFARE SPENDING }

JEREMY WARNER

Cutting back on the size of the state makes for energetic political debates – and there is only so much that can be achieved in any case



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What is an appropriate size for government? This question is once again centre-stage in the British political debate after a spending review that aims to reduce government as a share of GDP to 36.4% in five years' time, from an expected 40% this year.

A similar argument is taking place throughout much of Europe. Is small, or at least smaller, government the way forward in the post-crisis world for economies struggling with mountainous public debt? Or does Europe's social market economic model demand high levels of spending and tax in the economy?

Figures compiled for the International Monetary Fund's latest *Fiscal Monitor* show big variations in size of government among advanced economies, ranging from less than 20% of GDP for Hong Kong and Singapore, through 31.4% for Switzerland, to approaching 60% for Denmark, Finland and France.

Government's share of the economy rocketed just about everywhere during the financial crisis, but as growth returned, it has since shrunk back down again – to an average of around 40% for advanced economies, which is roughly where the UK sits at present.

If the government in the UK achieved its aim of 36.4% by 2020, it would be a little bit lower than the prevailing average, but not significantly so. Even this relatively unambitious target is nonetheless proving extremely difficult to achieve. Under pressure from backbench MPs, the UK chancellor, George Osborne, has been forced to scrap some of his planned spending cuts, including reductions in income support and the police.

Ability to sustain a larger state without running up huge public debts depends crucially on the willingness of the economy to tolerate relatively high levels of taxation. Some countries, particularly the Nordics and France, seem culturally more at home with high tax burdens than others. In Britain, the ceiling seems to be around 40% of GDP. Much above that, and historically, tax raising tends to run into the law of diminishing returns. Already, the top 1% of earners in the UK contribute more than a third of income tax. Since many of these high earners are less likely to consume public services and are also relatively mobile, it might well prove counterproductive to attempt to tax them more.

If it is hard to tax more, it is proving even harder to cut by more, particularly when it comes to pensions and healthcare, accounting in Britain for more than half of total spending. Any politician who attempts to make significant cuts in these areas risks alienating the increasingly powerful 'grey vote'. The present UK government has ducked that challenge, automatically limiting its ambitions for a significantly smaller state.

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In countries that spend the least relative to size, healthcare and pensions are likely to be provided privately so that they are taken out of taxation altogether. Switzerland is known as a relatively low-tax jurisdiction, but this is largely because Switzerland's healthcare is privately paid for through compulsory social insurance. If these premiums were counted as income tax or national insurance, Switzerland's effective tax burden would look much more like the UK's, if not higher.

Protecting welfare spending loads more of the work in cutting the state back to size onto what used to be thought of as core government functions: policing, defence, local government and so on.

Advanced economy governments can certainly do more to modernise the way in which these public services are provided, but there is only so far you can go before the fabric of government begins to suffer. The bottom line is that, as long as welfare remains at the heart of the political consensus, efforts to cut the size of the state are likely to prove marginal at best.

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