

**Annual London Lecture at the Invitation of
The Mayor and the Leader of the Council
of
The Royal Borough of Kensington and Chelsea
at
The Town Hall
Irwin Stelzer*
13th March 2006**

This is a daunting assignment, for several reasons. First, although I live in Britain most of the time, and Her Majesty has graciously granted me indefinite leave to remain, and although I lived for many years in The Royal Borough before decamping for Westminster, I am an American. That automatically means that I am associated with large deficits, hurricane Katrina, the war in Iraq, lack of compassion for the disadvantaged, and a host of other things that are not at the top of popularity polls here in Britain, a situation not helped by the fact that I am more or less a neoconservative and, to compound what is seen by so many in Britain as a felony, I voted for George W. Bush -- twice.

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Second, I am no expert on local government, and as the Mayor has pointed out in a book being launched this evening – one I commend to you not only for the information it contains but because it is, actually a good read -- “Local government in England is complicated because of the relationship between central Government and local government....Local authority finance in England is complex, technical and opaque.”¹

Third, economists are not accustomed to giving learned opinions on, and advice to an entity that is held responsible for the performance of public services even though its finances come largely from central government, operates under rules that are largely imposed on it by central government,² performs functions that are often mandated by central government – and that has any good it does claimed by central government, with the cock-ups blamed on local government. This model is not the usual one to which incentives, cost controls, and the other tools of economic analysis can readily be applied.

So, Mr. Mayor, you and your colleagues are running a business in which you cannot control your revenues, you

¹“Local Government in London: Its origins, evolution and functions,” published by Councillor Warwick Lightfoot, February 2006, pp.4 and 96.

² A leader in The Times pointed out, “Whitehall is fond of heaping extra responsibilities on to local authorities while being less than helpful in meeting the price of such expenditure. February 20, 2006.

cannot control your expenses, you cannot control the nature of your products, and you cannot control large portions of your work force. And you have to operate this “business” in the most densely populated local authority area in the UK, which certainly magnifies such problems as refuse collection, and speaks for the need of financial arrangements that give due weight to unique local circumstances, rather than attempt to produce nation-wide uniformity of service by eliminating the economically sensible but much derided “postcode lottery”. Or, as you put it more gently but with equal force in a newly published discussion of the role of local government, “...[N]ational government sets the policy framework for services that are delivered through local authorities.”³ This setting of the policy framework affects all aspects of local government. For example, “Like other services, libraries are set more and more targets by central Government, some of which can be at odds with local priorities.”⁴

So Philip Stephens may have had it right when he described the system of local taxation as one:

...that at once strangles councils and seeks to heap on them the opprobrium for ever higher bills; the draining of what little civic

³ Lightfoot, op.cit., p.62.

⁴ Ibid., p.77.

pride and local self-reliance survived the 1980s; and local services micromanaged from Whitehall in the spurious hope of uniformity.⁵

That is a strange situation for an economist to confront.

But I have been asked by Councillor Lightfoot to share a few thoughts with you from the perspective of an economist, and since it is my custom to bow to higher authority, I will do so – on the assumption that you will correct any errors during the question period, and allow me, and my wife who is here to suffer through still another of my speeches, to join you for dinner even if what I have to say does not please all of you.

In your invitation letter you called my attention to a statement made by Tony Crosland some thirty years ago, “The party in local government spending is over”. The American version was delivered more recently by Bill Clinton, at the time President of the United States. He told a joint session of congress ten years ago, “The era of big government is over.”

Both Tony Crosland and Bill Clinton were formidable politicians. Both got many things right when they peered into the future. But the era of big government -- heavy expenditure on social services by governments at all levels,

⁵ Financial Times, February 28, 2006.

and in all countries – is hardly over, to use Clinton’s formulation; or, the party goes on, to use Crosland’s. Perhaps Simon Heffer had it right when he wrote, “Centrally as well as locally, Britain is on a spending spree.”⁶ Big government is here to stay, and the party, with its inevitable hangover, goes on.

Indeed, since Crosland made his pronouncement the welfare state has expanded rapidly in most countries. Here in Britain we have of late seen a spectacular increase in the level of expenditure on the health and other services, both in absolute terms and relative to the size of the economy. Spending on the NHS has risen at an annual rate of around 7% in real terms, and total spending by the government now consumes about 42% of GDP, up from 37% only a few years ago. Despite that massive increase in spending, the demand for more and more services continues to outstrip supply. And will continue to do so unless policymakers can decide on how to limit that demand. One Member of Parliament told me at dinner last week that demand for social services will grow inexorably, and cited an example: a constituent of his, a millionaire, angrily asked him, “How are you going to take care of my old mother?” Instead of suggesting that the

⁶ Simon Heffer, “Cameron and Co must get to grips with spendthrift councils,” [The Daily Telegraph](#), February 21, 2006.

burden might more properly be borne by her son than by the state, this MP feels he has an obligation to take on that burden – using someone else’s money, of course.

In part the continued expansion of government is the result of demographic changes: an ageing population requires more medical care and more special housing. In part it is due to technology: we are now capable of using massively expensive technology to improve both the length and quality of life. In part it is due to rising expectations, and the tendency of policymakers to view poverty in relative rather than in absolute terms.

But in large part the growth of government, and the increase in the burdens placed on local government, is the result – intended and unintended – of policy decisions made by governments, and therefore within the control of governments.

Perhaps the most crucial error of those who have presided over the growth of the state has been to assume that the expansion of the role of the state would have no consequences for the extent of private-sector philanthropy. Our millionaire in search of state provision for his mother is only one example of the way in which individuals will transfer to government obligations they had previously assumed

were theirs to discharge. The historian Gertrude Himmelfarb has set forth in great detail the web (no pun intended on the Webbs) of private philanthropic organisations and activities that characterised Victorian Britain,⁷ and political scientist Charles Murray has described just how extensive civic participation once was in pre-welfare-state-America: “Broad networks, engaging people from the top to the bottom of society, spontaneously formed by ordinary citizens, provided sophisticated and effective social insurance and social services of every sort.”⁸

Those networks have shriveled in the face of expanding tax-funded bureaucracies. As Murray put it to me, pleas for philanthropic contributions of time and money can now be met by, “I gave at the office,” meaning that the tax man had already cometh, I have done my share, so I need not join or support voluntary organisations. That shift from private organisations to government bureaucracies, from voluntary giving to compulsory extraction, “ultimately degrades society as a whole,” concludes Murray.⁹

I mention this not with any hope of touching off a wave of regret at past policies, and triggering a mass movement in

⁷ Gertrude Himmelfarb, The De-Moralization of Society: From Victorian Virtues to Modern Values. London: The Institute of Economic Affairs, 1995, espec. Pp.143-169.

⁸ Charles Murray, In Our Hands: A Plan to Replace the Welfare State. Washington, D.C: AEI Press: Washington, D.C., 2006, pp.116-117.

⁹ *Ibid.*, p. 122.

favour of a roll-back of the state – although Charles Murray has set forth a “how-to” guide in his new book, “In Our Hands: A Plan to Replace the Welfare State”. After all, a leading Conservative politician/thinker made it clear some fifteen years ago that Britain has abandoned any notion of distinguishing between the deserving and undeserving poor, one traditional way of limiting the reach of the state and emphasising individual responsibility:

“Regardless of whether people in need have been reckless and feckless or unlucky and unfortunate there comes a point where the exact explanation of how they became destitute ceases to matter. They have a claim on us simply by virtue of being compatriots.”¹⁰

Even in America, where we have a conservative president, the central government continues to expand into areas once reserved for state and local governments, education being the prime example. And here in Britain, the Conservative Party, in the past one that at least retained some suspicion of the wisdom of the onward march of the state, has now pledged to devote half of any increase in national income to a further expansion of the welfare state.

¹⁰ David Willetts, Modern Conservatism. London: Penguin Books, 1992, p.141. Elsewhere in his book (p.147), Willetts lays out his “anxieties” that an expanding welfare state will cause private “mediating structures” to wither, and erode values such as prudence.

Rather than hoping to trigger a major policy reversal, I mention the atrophying of civil society that is a consequence of an expansion of the role of government in the hope that it will be a factor considered when government decides to take on still more functions once handled by the private sector. If you decide to extend what are already “cradle-to-grave” welfare benefits, to use Churchill’s description¹¹ – baby bonds at birth, means-tested pensions in old age – it should be in the full knowledge of the effect of such a policy on private-sector philanthropy, community activity and private savings.

The second policy error that is now bedeviling you is the increased use of means testing. It is certainly true that means testing has a ring of equity about it. Indeed, when the Beveridge Report was first circulated in government offices in 1942, before its release, Sir Kingsley Wood, then Chancellor of the Exchequer, minuted Winston Churchill:

“The weekly progress of the millionaire to the post office for his old age pension would have an element of farce but for the fact that it is to be provided in large measure by the general taxpayer.”¹²

¹¹ In March of 1943, in a broadcast entitled “After the War”, Churchill promised “national compulsory insurance for all classes for all purposes from the cradle to the grave.” Among the benefits: “There can be no finer investment for any community than putting milk into babies.” Cited in Timmins, *op.cit.*, p.48.

¹² Cited in Nicholas Timmins, *The Five Giants: A biography of the Welfare State*. London: HarperCollins, 1995, p.45.

It is also true that means testing is a handy tool for keeping down expenditure, at least in the short run. But in the longer term it clearly discourages savings, and makes fools of those who forego current gratification in order to avoid future pain. Again, I am not recommending that all means testing be eliminated: that would put a crimp in the plans of those who see the continued payment of child benefit to high-earning parents as a necessary bribe to be paid to maintain middle class support for the welfare state! But the effect of means testing, especially when used to reward those who have led profligate lives and penalise those who were more prudent, certainly could benefit from reconsideration.

The third policy error relates to the financing of local services. For reasons too numerous to recite here, there has been a worldwide increase in asset values – primarily homes and shares – that has exceeded the increase in the incomes of many of those holding those assets. A house in Beijing is no ready substitute for a house in the Royal Borough, but a worker in Beijing is. So house prices are free to rise, while wages are not. As a result, many people find themselves living in homes that have risen in value faster than their

incomes. According to data provided by the Office of Deputy Prime Minister, council tax rose by about 114% between 1994-1995 and 2005-2006, more than three times the rate of inflation and almost double the increase in average earnings.¹³ A further increase, at twice the inflation rate, is scheduled for 2006-2007.¹⁴ Put slightly differently, since 1996-1997, the year before Labour came to power, the average council tax bill will have risen from £525 to £1,053.¹⁵ When the higher values of their homes – the average house price in Kensington and Chelsea was £715,000 in 2004, the highest in Britain¹⁶ -- are translated into higher taxes on those assets, and the problem is compounded by increases in the rates of tax, many people find their incomes inadequate to meet the new tax burden.

In response, councils have developed what are called “a range of discounts and exemptions that are related to personal circumstances.”¹⁷ So people living alone are entitled to a 25% reduction¹⁸ -- I don't know enough about the details of local finance to know whether this means the Royal Borough grants such a reduction to the very rich

¹³ Office of the Deputy Prime Minister, “Key Facts and Trends: Local Government Finance in England”, p.13.

¹⁴ The Times, February 20, 2006.

¹⁵ Reported in The Times, February 20, 2006.

¹⁶ Oxford Economic Forecasting, “London's Place in the UK Economy, 2005-06,” November 2005, p.40

¹⁷ Lightfoot, op.cit., p.99.

¹⁸ Ibid.

bachelors and bachelorettes who must live in this Borough, since it boasts average household incomes more than 40% higher than in the rest of England.¹⁹

Elderly folk whose incomes have not kept pace with the market value of their homes could, of course, sell their homes, and use the capital gains to finance their golden years. Or they could extract the equity from those homes in a variety of ways, making that extracted equity available for spending or investment in income-producing assets.

But that's an economist talking. I once made what I thought was a perfectly sensible policy proposal that was capable of withstanding all sorts of hostile economic analysis, only to have it dismissed by my old friend, Woodrow Wyatt, as "against human nature". It is probably "against human nature" to insist on a policy that tells a person getting on in years that he or she must sell his house because the tax structure makes that necessary. A house, after all, is different from other assets – first, because it is both an investment good and a consumption good;²⁰ second, and more important for our purposes, one presumably becomes more attached to one's home than to shares or other financial assets.

¹⁹ Ibid, p.54.

²⁰ See Suzanne Stewart and Ike Brannon, "A Collapsing Housing Bubble?", Regulation, Spring 2006, p.6.

The logical alternative to finance locally-provided services is some form of local income tax. Or perhaps some economically crude but nevertheless sensible system can be devised, in which council taxes are moderated in the case of what we might call the deserving low earners, and income taxes used to make up the lost revenue. Better that than the current maze of local discounts, TV license fee relief, fuel cost relief, and the Chancellor's other goodie-of-the-month handouts to the elderly.

But the best alternative of all would be to begin to shrink the role of government in the lives of people – we now have vacations for children who behave badly, and chits with which to buy sports equipment for children who behave well. We have the state determining when parents may take their children out of school for holidays, and some local councils teaching parents how to teach their children how to cross the road. And we will soon have “super-nannies” to teach families how to get along – all provided by the state. The Guardian jobs section would be a source of hilarity were it not so ominous in its implications for the future prosperity of Britain. It is little wonder that the Chancellor now claims more than 42% of all the income produced in Great Britain,

and that council tax has more than doubled since 1994-1995.

Another serious policy error is to refuse to allow some portion of the cost of provision of various services to be borne directly by the user. The NHS is a case in point. “Free at the point of use” has become a slogan so engrained in the policy manifestoes of all parties that it is, I suppose, a waste of time to question it. But spare me a few minutes as I play Don Quixote. Given the ageing of the population, and the increasingly costly technology that is needed by any modern health service, the demand for more and better – more costly -- health care is bound to increase. I would like you to consider that it will be impossible for the state – for reasons I will discuss in a moment – to provide sufficient funds to meet that accelerating demand.

That means it will somehow have to ration the service. There are two ways government can do that. It can ask users of the service to pay some small part of the cost they impose on the system at the time they use it so that they will have an incentive to restrain the demands they place on the NHS and, indeed, other social services. Or it can ask patients to queue for the service.

I am told by politicians I respect that the British people prefer queuing to the price system as a means of rationing health care. I have no way of knowing whether these estimable gentlemen, many of them in a position to jump the queues without even having to go through the embarrassing process of asking for such preference, are projecting the views of the World War II generation onto the younger generation. So I won't venture an opinion especially since I come from a country in which impatience with queuing, and a preference for a system based on a combination of charges for those who can pay, and free care for those who cannot, seems to work tolerably well – witness the fact that when British and European patients (I assume Sean Connery, who hastened to America when threatened with a possibly dangerous ailment, rather than to Scotland, falls into one or the other category) are in a position to vote with their feet, the American health care system is the one to which many of them gravitate.

All I intend to do this evening is to suggest that in the modern world it is the lady or the tiger, queuing or charging. Steady increases in the funds devoted to the health care system – indeed to the social services in general – are not an option for Britain, for several reasons.

First, the state already claims 42% of GDP, as I have already pointed out. Now, there is no magic number that an economist can cite that, if exceeded, dooms a country to penury. But a look across the Channel suggests that when a government takes for itself half of the income a country is capable of producing, stagnation and persistent double-digit unemployment will be its fate. That is because the taxes required to sustain government at that level will inevitably have the following consequences: businesses will direct investment to more hospitable countries; individual risk-takers will find it imprudent to innovate when the bulk of any loss will be theirs, but the largest portion of any gain will go to the taxman; workers will decide that working those few extra hours is less attractive, since the state will claim a large portion of the payment for that labour.²¹

Therein lies the road to penury, as Britain will have to compete with a highly motivated work force in countries in which every increment in income translates into higher living standards, in which low taxes are seen as an instrument of economic development, and in which skills are being so rapidly upgraded that competence now extends far beyond

²¹ “High tax rates ... make paid work less attractive,” and deter investment and job creation. See, for example, Richard Teather, The Benefits of Tax Competition. London: The Institute of Economic Affairs, 2005, p.26-27

the t-shirt, trainers, bra and panties industries to which Europe's policymakers are devoting so much attention.

Having laid out my reasons for worrying about the sustainability, much less the expansion, of the range of social services offered by central and local government, let me turn to the good news.

The first bit of good news is that it might just be possible to obtain more services per pound spent. You already have experience with outsourcing and other means of drawing on the private sector, and I would expect that as you become increasingly skilled at negotiation and working as a partner with private sector firms, perhaps along the lines suggested by Bob White in one of a series of interesting papers published by The Smith Institute,²² you will develop means of increasing the efficiency with which local services are produced. More value for money, to use the English vernacular.

I am not familiar with the details of your outsourcing activities. But I am familiar with the effect competition can have on consumer welfare. Unless you are hampered by rules that limit your ability to choose among competing bidders, or by an inability to acquire the skills necessary to

²² Bob White, "Measures to make the public sector a better partner," in *Public Sector Procurement and the Public Interest*, Denise Chevin (ed.), The Smith Institute, 2005, pp.61-68.

move skillfully in a world of multiple competing suppliers, competition should force all potential suppliers to improve the efficiency with which they render services, and pass those efficiencies on to you and the ratepayers.

A second reason for cheer is that you have in recent years been granted new freedoms and powers – the freedom to improve the economic, social, and environmental wellbeing of the area, and the powers to charge for discretionary services and to trade through a profit-making company.²³ I would hope that these powers can be used to limit the demands on local government, rather than to increase its reach, and to develop user charges that relieve the burden on those who make less use of the services you provide than do others.

A third reason for some optimism is that politics is alive again in Great Britain. Nothing is as dangerous as a one-party monopoly of power, a situation that has prevailed for almost a decade here in Britain. Whatever else one thinks of the new leadership of the Tory Party – and views range from adoration (92nd sexiest man in Britain) to scorn (a lightweight with no substance) – one must concede that it has made politics interesting again, and broken New Labour's

²³ Lightfoot, *op.cit.*, pp.49-50.

monopoly of the public's attention. If the recent politics of personality is followed by a real debate of the sorts of issues we have been discussing this evening – that will require the Tories to find and explain policy differences with New Labour, which would, in Heffer's words, require them to lift "the new dispensation in which public spending ... became a good in itself" – the result can only be in the public interest.

The fourth reason to be optimistic about the future is laid out in a relatively recent publication, "The Competitive Position of London as a Global Financial Centre".²⁴ That study concluded, "London is clearly rated as the best city in Europe in which to locate a business, whether financial or otherwise."²⁵ But London competes not only with other cities of Europe, and given the high-tax, regulatory nightmare that many continental cities have become, being the leader of that rather weak bunch of contenders, even by an increasing margin,²⁶ is not assurance of success in a globalised world. More important is that London is level-pegging with New York – they "are virtually level as global financial centres", according to the report prepared for the Corporation of

²⁴ Prepared for the Corporation of London by Z/Yen Limited and published in November 2005.

²⁵ Ibid., p. 17.

²⁶ London has increased its lead over Paris and Frankfurt since the last survey was completed in 2003. Ibid., p.49.

London²⁷ -- and, if we are to believe David Smith in The Sunday Times (and I most certainly do), “London has always played second fiddle to New York among the world’s financial powerhouses. Now there is a real chance that the City could overtake Manhattan and claim the global crown.”²⁸

Now, this native New Yorker is not prepared to go quite that far, but I must say that I have noticed the extent to which the pace of life in London has increased, the quality of available accommodation and amenities here in the Royal Borough and elsewhere in London has been upgraded, the antipathy to high pay (although still lurking in the background in some circles) has diminished, and emphasis on merit, although still anathema to some politicians, has increased. All, good signs.

Less visible from this vantage point, but equally important, the success of London provides the government with tax revenues with which to meet the needs of communities throughout the country. High earners pay rather large income tax bills; capital gains tax receipts are rising steadily; the spending of Londoners generates VAT revenues – and not only as a result of the extravagant spending that makes for lurid stories in the press. One has to

²⁷ Ibid.

²⁸ The Sunday Times, March 12, 2006.

hope that the Chancellor will resist the temptation to kill the golden goose, either by continuing to raise taxes, or by ending the favourable tax regime that has made London so attractive to the world's investment bankers, ship owners, and other wealth-generators.

But I do not want to over-emphasise the importance of tax policy as a factor in business location decisions. High-tax jurisdictions with superb transport and other public services can be more attractive to businesses, and to the highly educated employees on which they increasingly rely, than low-tax jurisdictions with poor transport, rotten schools and polluted air. Worst of all, of course, are high-tax jurisdictions with public services so inefficient that the high level of expenditure does not produce an attractive level of services. This is especially important for local governments to remember, for they – you -- are on the front line: they deliver many of the services that in aggregate constitute the quality of life that is an important factor in location decisions of an increasingly mobile international elite, from protecting trees to maintaining libraries, to keeping the streets clean and, with great effort, gum-free.

Finally, and most important, the future is largely in your own hands. Yes, the globe may be warming, but we know

what to do about that if we believe it, and have the political will. Yes, there is a danger that Islamic fanatics might mount a terror attack in London, but we have the tools with which to minimise that risk and its consequences. Yes, the population is ageing, but that is a good thing, a testimonial to the increasing quality of medical care. And yes, the demands on local and other levels of government are increasing, but we know how to ration those demands and how best to finance the required services. All that is required is good sense and political will.

On that cheery note, and if I have not made too many errors, my wife and I would like to avail ourselves of your hospitality.

Many thanks for your attention.

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