2030 VISION

The final report of the Fabian Commission on Future Spending Choices

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The final report of the Fabian Commission on Future Spending Choices

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FOREWORD

John McFall

When the global financial crisis came, as Chairman of the House of Commons Treasury committee, I witnessed the power of public spending to mitigate economic calamity. In the decade I led the committee's work, I also saw the difference spending makes when sustained over time in improving public services and lifting families out of poverty.

The Fabian Commission on Future Spending Choices was established in the belief that public spending is a force for good. The remit of the commission was to examine the difficult public expenditure decisions facing a 2015 government and in all our work we have been guided by the need to harness the power of government spending more effectively and to restore public faith in the transforming role it has to play in creating a stronger society.

Not all public money is well spent and this report makes the case for improving decision making and accountability processes to see it spent better. At present the structures surrounding public spending encourage a short termism which is out of step with the needs of the country. Opaque procedures mean that profoundly democratic choices are closed to the public.

Policymakers should take a conscious, long-term view of the path of spending over many years to deliver a prosperous, sustainable and equitable economy and society.

We have grappled with difficult choices regarding how to reduce the deficit during the next parliament, which few governments would ever wish to confront. But we have shown that balanced, long-term choices can be made. As a former headteacher I take particular pride in one of our central recommendations, that spending on building skills and capability for the future should not be sacrificed to short-term pressures.

The recommendations contained in this report are not aimed at any one political party and we urge whichever party or parties take office in 2015 to embrace them. The challenges the commission explored are very great, but so too is the price of inertia. Carefully-weighed, long-term decisions can restore public faith in the power of politics.

As a commission we have tackled complicated and controversial issues and sought to build consensus drawing on our different perspectives. I would like to thank all of the commissioners who have made an invaluable contribution to this report as well as the witnesses who gave us evidence, members of our advisory network and the staff of the Fabian Society.

EXECUTIVE SUMMARY

This is the final report of the Fabian Society Commission on Future Spending Choices. The commission was established in autumn 2012 to explore the public spending choices facing government over the next two decades, including in the next parliament. It asks how these decisions can be made in a way that maximises prosperity, sustainability and social justice.

Political leaders must set out their future vision for the country and shape the spending decisions of today to achieve these ambitions. This requires a departure from the short termism which currently dominates public spending and new mechanisms to embed the long-term perspective at all levels of decision making.

Over the short term we propose an approach to reducing the deficit that returns the public finances to a sustainable position in a timely manner without neglecting the economic and social investment which will lay the foundations of national success in the future. We assess a number of scenarios for public spending from 2016 onwards and conclude that the next government can afford to spend more, but must spend in line with long-term objectives.

The report looks in some detail at spending pressures over the next two decades and how government might respond. We conclude that spending as a share of national income will probably need to rise a little over this period to

avoid harm to the economy or key public services; as will tax revenues if we are also to gradually reduce the national debt.

The report also makes recommendations about how to improve the process, planning, and effectiveness of public spending. A responsible programme for both reducing the deficit and taking a long-term perspective must be underpinned by organisational and institutional reforms for democratising and enhancing the quality of public spending.

Chapter 1: The story so far

Chapter 1 looks at some of the reasons why public spending is important. It sets out the long-term evolution of government expenditure from 1900 to the present, focusing on important structural shifts in spending including the consequences of the financial crisis of 2008.

- We argue that public spending is essential for the wellbeing of society: for growth, jobs and prosperity; economic and social stability; smoothing costs over the life cycle; insuring against risks; redistributing resources, power and opportunity; maintaining security; providing public goods the market cannot; and meeting international commitments.

- Today, public spending makes up 45 per cent of the UK's national income. Social security, the NHS and education account for over half this total. Expenditure grew to around the present percentage of GDP between the 1910s and 1940s, from a low of 15 per cent in the Edwardian era. In the last 60 years rising national prosperity has been the most important driver of increasing expenditure, with spending varying decade-by-decade but averaging at a little over 40 per cent of GDP.

- In the post-war period, social spending – on areas such as health, education and social security – has expanded as a proportion of national income; and this has been offset by declining spending on capital investment, defence, debt interest and other areas like industrial support. In the century ahead there will be less headroom to increase social spending as a share of national income since the other elements cannot be squeezed that much more.

- The 1997 Labour government sought to establish economic credibility by adopting the previous Conservative government's spending plans for the first two years: expenditure fell to 35 per cent of national income (in 2000/01) as the economy boomed. From that point spending was increased to around 41 percent of GDP, a figure more in line with historic and international averages. Recent studies have shown that the extra money delivered greatly improved outcomes and reasonable value for money, even if the results could have been better still. The main beneficiaries were people using healthcare and education, as well as low income children and pensioners. Over this period, public support for spending (and especially for social security) declined, which may make it harder to make the case for future spending.

- After the global financial crisis, spending increased to 47 per cent of national income and a large deficit opened up. This was mainly caused by sharp falls in economic output and government revenues. The coalition government is seeking to reduce the deficit and has held spending broadly flat in real terms during this parliament. This has entailed a huge shift between budgets, with higher debt interest and labour market-related social security leading to deep cuts elsewhere.

Under current forecasts, total spending, as a share of national income, will return to the same level in 2017 as it was under Labour in 2007; but there will have been a significant shift away from future-oriented expenditure, towards interest payments and pensions.

Chapter 2: Better spending reviews

We argue that spending decisions should be made in a more open and long-term manner, and outline a significant package of proposals to reform the conduct of spending reviews (chapter 2) and improve the quality of spending choices more broadly (chapter 3). Taken together these recommendations imply a radical shift in the way spending decisions are made, in order to build public confidence that their money will be well used.

- A regular cycle of multi-year spending reviews should be restored. In the context of five year fixed-term parliaments we argue for a spending review which sets detailed departmental budgets for three years, and suggest the possibility of setting indicative budgets for a further two. Capital investment plans and the broad outline of tax and spending should be set for five years.

- Spending reviews should be broader ranging and more participative, which implies a multi-stage process. They should begin with the publication of a set of principles to act as tests to guide individual decisions; and a long-term expenditure statement (to show the link between ministers' immediate plans and their views on the evolution of spending over decades). If time permits we would also like to see the publication of a 'draft' spending review for consultation. Sufficient time is also needed for a participative process, where budget holders develop options, using citizen and stakeholder participation as well as more formal consultation.

- This multi-stage process would greatly increase the opportunities for parliamentary oversight, but we also argue parliament needs more scrutiny capacity. We propose the creation of a specific budgetary committee for the House of Commons; and recommend that the Office for Budget Responsibility becomes an agent of parliament with a broader remit.

- The final spending review announcement should include coordinated, detailed plans on departmental spending and capital investment; and also set out the broad direction for social security, tax, and non-fiscal policy with major implications for tax or spend. Subsequent budgets would then be used to set out plans for detailed implementation, especially regarding social security and tax reforms.

Chapter 3: Better spending choices across government

Chapter 3 looks at how the public sector can become more focused on outcomes, deliver improved performance and manage money better. We note that this requires adequate public sector leadership and oversight capabilities, which could be endangered by further cuts to spending.

- An Office for Public Performance should be created as a powerful independent cross-government body, tasked with championing excellence, driving productivity improvement and encouraging innovation. In doing this it will help improve the use of public spending and help build trust in public services.

- Spending decisions should not just be about allocating resources, but also what is to be achieved with the money. Setting and monitoring goals regarding

performance should be a key part of financial decisions and wider public service governance, learning from the best of international practice in measuring and improving performance.

- We want to see more public money diverted to early intervention: all spending decisions should include a '10-Year Test' which considers long-term impacts, including the effects on society and other public agencies; local government should coordinate and scrutinise all local public service spending decisions to champion joined-up early action; and in the absence of sufficient progress, ministers should consider mandating budget holders to 'switch' a proportion of their annual spending from existing activities to early interventions, beginning in the second half of the next parliament.

- Other proposals to promote long termism include a requirement to announce the 'year 10' costs of all decisions; better accounting practice to take account of the assets and liabilities created by budgeting decisions; and an approach to defining national debt that removes any artificial hindrance to commercially-sound borrowing by public bodies, while also maintaining tough fiscal discipline.

- Flexibility and innovation in local level decision making has the potential to overcome budgetary 'silos'. We support more spending power for city regions and clusters of local authorities; a clear and consistent message from government that local agencies have permission to innovate and experiment within national frameworks; and local government leadership in coordinating all local budgets.

Chapter 4: Tests and trade-offs

Chapter 4 sets out eight 'tests' for spending choices and examines three major trade-offs that have informed our thinking.

- The eight principles against which spending choices should be tested are:
  1. Work backwards from the outcomes you wish to achieve and how these can be realised in partnership with others
  2. Invest in early intervention
  3. Demand productivity improvements, innovation and citizen participation
  4. Promote broad-based growth, employment and prosperity
  5. Distribute resources and insure risks over the life-cycle
  6. Reduce inequality, poverty and unequal opportunities
  7. Take a long-term, global perspective
  8. Act where the market cannot

- **Trade-off 1: how to balance between the future and the present?** We argue that governments must be committed to sustainable levels of debt relative to GDP and should have the long-term objective of returning public debt towards its pre-2008 levels over the coming decades. We also examine the balance between 'future' and 'present' oriented spending. The latter (eg pensions and healthcare) is very important, but should not squeeze out the former (eg education and capital investment). We would ideally like future-oriented spending to rise as a share of national income, since it is in the process of sinking below levels seen in recent decades. For this reason policymakers may need to consider policies to restrain the pace of growth in pension and healthcare

spending, so long as this does not undermine good quality, universal provision. Even then, higher levels of future-oriented spending may not be possible unless overall levels of public expenditure rise.

- **Trade-off 2: restrain spending or increase taxation relative to national income?** Over the next decade and beyond there will need to be tight restraint on public spending. However, we believe that policymakers should be open to the possibility of expenditure rising as a share of national income, since there are significant upward pressures on spending; even good progress on public sector performance and productivity is unlikely to offset them all. In the long term, freezing spending as a share of national income will only be achieved by reducing the generosity of entitlements or abandoning universal provision in pensions and public services, which we do not think is desirable. This conclusion, alongside our commitment to reducing national debt over time, leads us to believe that some increase in tax revenue, as a share of national income, is likely to be necessary over the next two decades.

- **Trade-off 3: how much to prioritise addressing inequality?** The scale of government action to address inequality is linked to both overall levels of spending and also to the composition of that spending. We believe resources for public services should be allocated according to evidence-based assessments of needs, at geographic or household level. We are concerned that social security policies will increase poverty and inequality over time and we would like to see reforms to entitlements and to the wider economy which enable low income groups to keep up with everyone else. In the next parliament ministers may need to consider reducing social security entitlements further but the acceptable room for manoeu-

vre is limited, as we do not support measures that will reduce living standards for low income households nor make deep inroads into universal provision.

Chapter 5: Long-term pressures and priorities

Chapter 5 examines the long-term pressures on public spending over the next 20 years and policy options for restraining upward increases in spending. We present three possible scenarios for the path of public spending in the early 2030s, calculated by the Fabian Society drawing on data from Office for Budget Responsibility (OBR) projections.

- Upward pressures on spending mean that over the next 20 years spending is likely to need to rise in areas like pensions and healthcare. However, decision makers will need to make trade-offs and should not assume that they will be able to meet these rising pressures in full. The main pressures come from the public's rising living standards and expectations; demographic change and public service costs. Rising morbidity and inequality are also potential pressures.

- The main policy options for restraining spending increases are to reduce the generosity of entitlements (eg by failing to raise health or pension spending in line with rising prosperity) or to restructure eligibility to reduce the extent of universalism. We believe such moves would be undesirable. The best solution to restrain rising spending is to increase performance, productivity and value for money in the public sector. This should be a top priority for future governments; however alone it is unlikely to fully offset rising spending pressures.

- We examine the possible profile of spending in the early 2030s, by considering a set of 'high spend' and 'low

spend' options calculated by the Fabian Society. They cover: health and social care; pensions; working-age social security; and 'future-oriented' spending eg education and capital investment. Only by implementing all the 'low spend' options will future governments be able to avoid spending and taxation rising as a share of national income (under this scenario spending would be 39 per cent of national income and tax 38 per cent). If all the 'high' options were implemented spending would rise to 44 per cent of national income, implying taxes of 43 per cent (assuming future governments were committed to reducing public debt). This tax ratio is not uncommon among OECD nations but has not been seen in the UK since the mid-1980s and would be a very big change.

- We also consider a 'mid way' scenario which would see spending reach 42 per cent of national income by the early 2030s. Of the three scenarios, this is our preferred path for spending over the next 20 years, however it will not avoid the need for difficult trade-offs. We consider a combination of policies which would increase spending on education and investment; take some steps to prevent inequality from rising; and fund most but not all the growing health and pensions spending pressures. Under this scenario revenues would need to rise to around 41 per cent of GDP. This would require the government to increase tax by around 2 to 3 per cent of GDP in the decade or so after 2020; if implemented gradually over time this could be achieved primarily through 'fiscal drag' on personal taxes.

Chapter 6: Reducing the deficit after 2015 – three scenarios

There are 'constrained alternatives' for spending in the next parliament and the performance of the economy will determine the range of spending options that can be contemplated. Chapter

6 presents three spending scenarios calculated by the Fabian Society for the years from 2016/17 until the public finances are stable: (1) retaining the coalition's current plans; (2) increasing real spending by 1 per cent a year; or (3) increasing real spending by 2 per cent a year. In each case we assume a new government would make negligible changes to 2015/16 spending plans, as the financial year would already by underway.

- **Scenario 1:** Implementing spending plans based on the coalition's current expenditure plans for 2016/17 and 2017/18 would have very serious implications for the beneficiaries of public spending, implying sweeping cuts to important public services and to social security. Even if social security entitlements were cut by £10bn (which would have very undesirable consequences) average spending on 'unprotected' departments might still fall by up to 15 per cent over two years. In this context it would be very difficult to start reshaping expenditure in line with the long-term priorities we have identified. In November the OBR is likely to revise upwards its projections for future growth and government revenue. In our view a future government should use this money to spend more than this scenario rather than cut taxes or reduce the deficit faster.

- **Scenario 2:** The Fabian Society calculates that a 1 per cent increase in real spending would leave a future government spending £20bn more than the coalition currently plans to. We hope this will become affordable as a result of economic growth exceeding current forecasts, but it could also be funded by raising some taxes or moderately slowing the pace of deficit reduction, while still reducing the deficit in the next parliament. Under this scenario there would be very difficult choices, but large-scale cuts could be avoided. We consider one combination of options which would

stop the drift away from future-oriented spending: a rise in capital investment; a modest reduction in social security entitlements; 'flat' real spending for the health, social care, education and economic budgets; and a 3.5 per cent annual cut for all other departments.

- **Scenario 3:** Increasing spending by 2 per cent a year will be difficult to achieve while still closing the deficit, unless economic growth is considerably higher than today's forecasts. Increasing spending by this level would make it easier to balance competing priorities. However the Fabian Society calculates that even under this scenario it would not be possible to shift significant resources towards future-oriented activities; and avoid social security cuts; and raise public service spending in line with rising pressures.

- Our preference is that spending should rise by no less than our second scenario. It may be possible to fund this through better than forecast growth and revenues, but should the circumstances require it, we would prefer to see moderate tax rises than further overall cuts to spending. We do not support broad-based tax rises when general living standards are still declining but tax increases targeting higher income groups could make a significant contribution to paying for scenario 2. One option would be to examine reform of pension tax relief, where there are potentially large savings that would affect only those on higher incomes.

Chapter 7: Social security

Chapter 7 examines a number of options for spending on social security in the short term and longer run. After exploring the prospects for reducing demand for benefits, we consider options for reducing entitlements, as well as areas where extra money might be needed.

- Both the design and overall generosity of social security are key ingredients in securing rising living standards for low and middle income households. Governments of all parties have made strenuous efforts to reform social security to improve incentives to work and save; but they have engaged less with the overall generosity of working-age social security. Ideally we hope economic reforms will help tackle inequality, but if market inequalities remain at present levels then current social security policies will be neither fair nor sustainable over the long term. This is because most non-pension benefits are indexed to prices, which means that living standards for working-age social security recipients will fall progressively relative to typical incomes. While deficit reduction continues, revising this policy is not affordable, but a change in long-term approach should be considered afterwards.

- We are very supportive of efforts to reduce market inequalities through economic reform, but we found that measures which could take effect quickly would not substantially reduce demand for social security spending. A significant rise in the minimum wage might save £500 million and similar savings might arise from improving work incentives for those who choose to have second earners in families with children.

- We have reviewed a wide range of possible reductions to social security entitlements for the short term. We are not making specific recommendations but have identified around £5bn of cuts which we think could be contemplated if a reduction in social security entitlements does became necessary. These include means-testing winter fuel payments and free TV licences; extending recent disability benefit reforms to older

people; and treating certain disability benefits as taxable income. It would only be possible to make larger cuts, of say £10bn or £15bn, by reducing the incomes of low income households or by ending universalism across almost all benefits except for the state pension. We want to avoid either of these paths.

- There will be very little scope for a new government to increase any social security entitlements in 2016/17 and 2017/18. However, we think consideration should be given to reversing a handful of the present government's reforms as soon as possible. Other possible priorities are to reform universal credit to improve incentives for parents to work; and to introduce a modest 'premium' for contribution-based jobseeker's allowance to recognise past contribution.

- As part of our illustration of the implications of a 1 per cent rise in spending, we suggested in chapter 6 that a £5bn reduction in social security entitlements might be needed by 2017/18. This change could be achieved by saving around £6bn from reducing entitlements and £1bn from reducing demand through economic reforms. Generating £7bn of savings would leave £1bn to reverse a limited number of recent cuts and a further £1bn for a very modest number of new entitlements.

Chapter 8: Investment and departmental spending

Chapter 8 explores some of the choices for departmental spending and capital investment after the next election. It looks in greater detail at how to strike a balance between 'future' and 'present' oriented spending, often taking as a starting point the possible budget settlement we outlined in chapter 6, to illustrate the trade-offs required if overall spending were to increase by 1 per cent per year.

- Implementing the plans implied by existing coalition expenditure forecasts would lead to further major cuts in departmental spending. It might be necessary to make cuts to NHS and schools spending; and continued real reductions to public sector pay would be inevitable. Under our alternative scenarios (outlined in chapter 6) it would be possible to achieve broadly flat departmental spending instead. In this case some budgets would still fall to pay for rises elsewhere but decision makers could weigh up options based on long-term priorities.

- Increasing overall capital spending should be a priority, if affordable, although the public sector balance sheet can also be used more imaginatively to leverage private investment (eg public guarantees for private borrowing). Our illustrations in chapter 6, which considered how to shift to more future-oriented spending, included provision for raising investment by £5bn (scenario 2) and £9bn (scenario 3). The priorities for investment are economic development, housing and public service infrastructure.

- We want to see education and economic spending prioritised. However given the constraints implied by scenario 2 this might mean these areas received only flat real settlements for as long as deficit reduction continued. In the short term this would make it very difficult to introduce new programmes which many have advocated, for example: increased childcare; adult skills programmes; support for innovation; or jobs guarantees. Any major spending commitments of this sort will probably need to be paid for within existing budgets.

- We recommend that adult social care and healthcare should receive the same funding changes, as the two

systems are inter-twined. In our judgement two more years of flat real funding may be required for these sectors, even if overall public spending rises moderately. Continued 'flat' spending will create huge pressures, even with improved performance and further pay restraint, but significant real spending increases in these areas would make it impossible to also prioritise future-oriented spending. Local government will not be able to continue with its current mix of services if it faces further deep cuts and under our alternative scenarios, local 'spending power' would fall only very modestly in 2016/17 and 2017/18.

- Continually improving performance and productivity will be essential for coping with tight budgets and for responding to long-term spending pressures. Pay restraint, though necessary in the short run, is not a long-term answer to containing public sector costs. Over time public sector pay should rise in line with average earnings, to maintain the quality of the workforce, however while deficit reduction continues it will probably be necessary for average pay to rise by no more than inflation.

- Finally we look at the spending implications of the UK's international commitments. We conclude that spending constraints until 2017/18 will mean that a new defence and security review will be needed in 2015 and it is likely to lead to further reductions in future military capabilities. Turning to the long term, future governments could reduce defence spending as a share of national income to European norms. Over time this could reduce annual defence spending by 0.7 per cent of GDP. However there might well be downsides to this approach, with respect to the UK's global influence, and as a commission we have not taken a

view on whether this move would be desirable. On international development we recommend that the current benchmark for spending is maintained in the short term, but we propose a review to assess whether it will remain appropriate into the 2020s. We also review EU spending and conclude that any immediate savings from leaving the EU would probably be outweighed by reduced growth and lower tax revenues over time.

INTRODUCTION

This is the final report of the Fabian Society Commission on Future Spending Choices, which the Society established to consider the public spending options for a government coming to power in 2015, looking over the long and short term. The Commission has spent a year hearing a wide range of expert evidence, carrying out its own research and debating the options ahead. The report sets out the consensus view of the commissioners. We began by hearing evidence on the fundamental role of public spending in creating a strong society and economy and the evolving profile of expenditure over the last 100 years. However most of our work has looked to the future.

The backdrop is the very grave fiscal challenge the UK continues to face in the aftermath of the global financial crisis of 2008. Nobody doubts that the government elected in 2015 will face a huge task in managing the public finances, with a budget deficit and high public debt. In the coming years, the debt and deficit must both fall and that will significantly limit the options for future spending choices. There are no easy answers and uncomfortable decisions will have to be made.

Nevertheless, as a commission, we are fundamentally optimistic about the future. It is wrong to say 'there is no alternative' to the present government's plans. We believe another way is possible, one that is no less committed

to fiscal responsibility, but that considers the long term alongside the immediate, in a belief that public spending today can create assets for the future. There will be further tough years of spending restraint but sometime in the next parliament the path for the deficit and public debt will become sustainable. It will be possible to respond to some of the rising pressures for more expenditure. And our work shows that if politicians make careful, long-term decisions about the future shape of public spending, they can deliver more for the British people even within tight constraints.

The Fabian Commission on Future Spending Choices was established, in part, to investigate how to improve the quality of public spending decisions in the next parliament and beyond. Our work has been guided by the strong belief that, although choices will be constrained, with a long-term, evidence-based perspective, policymakers can steer the future shape of government rather than simply react to external pressures. Our recommendations are aimed at whichever party or parties form the next government in 2015. Planning the future path of public spending for the long term and improving the process for making decisions are national causes around which all politicians should unite.

Taking a long view

Difficult spending decisions in the early years of the next parliament do not have to be poor decisions. Instead, we believe it will be possible to make choices with an eye to long-term prosperity and sustainability even with very tight public finances. Public spending decisions should be informed by explicit priorities and principles, using processes that embed a long-term and strategic perspective. In our commission, we've 'worked backwards' from the early 2030s and we believe future governments should do the same. This can be achieved by publishing a long-

term expenditure statement before every spending review, setting out the direction of travel for the next 20 years.

At a level of detail, budget holders across the public sector can replicate this approach by assessing the impacts of their decisions over a 10 year timescale. We call for a much more long-term perspective within all public services. This means considering the long-term consequences of all decisions and shifting resources to 'early action', not least through local government leadership; and, if there is little progress, we propose that government mandates the 'top-slicing' of existing budgets to pay for early intervention.

Looking to the future means delivering sound public finances that do not pass on rising debt to future generations. But it also means carefully shaping the composition of public spending to ensure that expenditure which will benefit the future is not squeezed out by competing priorities. In our view, it should as well mean taking spending decisions in a way that will not lead to inequality rising over time. For these reasons we caution against allowing important spending on healthcare and pensions to squeeze out expenditure on education and capital investment, or on working-age social security.

The future trajectory of social security is uncertain, since it should depend on whether governments can successfully tackle inequalities in the market. But we are clear that 'future-oriented' spending, such as education, preventative health and capital spending, should be a higher priority for government and, when affordable, spending in these areas should rise as a share of national income. This is one of our central conclusions as a commission.

There are alternatives

We believe there are a variety of viable paths for public spending; within constrained limits, alternative plans

can be just as (or more) effective in securing sound public finances. There is a need for an informed public debate about future spending options: when economic uncertainty prevails flexibility should be part of the armoury of policy.

We have looked at two sets of scenarios for public spending: three for the next 20 years and three for the two years after the next election. All of them are consistent with sound public finances and declining debt over the long term.

On current plans and projections, spending in 2017/18 is expected to account for 40 to 41 per cent of GDP, but over the next two decades there will be upward pressures on expenditure, caused by changing needs, cost pressures and rising public demand for the benefits public services bring. Neither the government nor other political parties have publicly stated how they would like spending to respond. The long-term options for the early 2030s are:

- *Spending falling slightly to 39 per cent of national income.* In this scenario it would be very difficult to increase future-oriented spending as a share of national income in line with our recommendation. Governments would also need to reduce the extent of healthcare and social security provision, relative to national income. Tax would not need to rise as a share of GDP but the level of public provision would decline.

- *Spending reaching 42 per cent of national income.* In this scenario it would be easier to increase future-oriented spending and make modest improvements to social security in order to tackle inequality. Spending on healthcare could rise as a share of national income, but to fully cover the pressures of rising costs major performance and productivity improvements would be required. Taxation would have to rise as a share of

national income in the medium term but the pace of change could be very gradual.

- *Spending reaching 44 per cent of national income.* This could allow for an increase in future-oriented spending; and for raising the generosity of healthcare and social security in line with rising prosperity, even after rising costs. This would require higher tax increases than the second scenario and would take taxation as a share of national income back to levels last seen in the mid-1980s. This would be a significant shift which might not secure long-term public support.

We believe public spending should distribute resources over our lives (eg healthcare, pensions); build capability for the future (eg education, capital investment) and tackle inequalities created by the market (eg working-age social security). It will not be possible to achieve all these aims if the first of these long-term scenarios is pursued so we conclude that, over the long-term, some increase in taxation as a share of national income is likely to be necessary. For this reason we prefer the second scenario to the first. Others may disagree with this judgement but they need to recognise that this will lead to government provision falling behind public expectations.

Turning to the shorter term, we assume that the plans set out already for 2015/16 will be retained by any new government, possibly with minor variations, since the financial year will already be underway.

For 2016/17 and 2017/18, the first two full years of the next parliament, the scenarios we considered are:

- *Spending cuts in line with the government's present plans:* This scenario will arise if the current timetable for deficit reduction is maintained, taxes remain unchanged and current OBR growth forecasts (March 2013) are

broadly correct. Under these plans there would be significant cuts to public services and/or social security after 2015/16. It might be necessary to cut health and schools spending and would certainly be very hard to begin rebalancing spending towards more future-oriented activity.

- *A 1 per cent real annual increase in spending:* this would imply £20bn more spending in 2017/18, relative to the government's current plans (in today's prices). It would reduce the need for most cuts but would still entail challenging constraints on spending. This scenario could be afforded by a combination of one or more of: higher than forecast growth (the next official growth forecasts are expected to be more optimistic than those published in March); some targeted tax increases on higher income groups, for example reform of pension tax relief; and a slight slowing in the pace of deficit reduction.

- *A 2 per cent real increase in spending:* this would imply £34bn more spending relative to the government's plans for 2017/18 (in today's prices). It would avoid more of the pain of cuts, but even under this scenario it would be difficult to both match the rising pressures for health spending and make a shift to more future-oriented activity. This option would only be affordable if the economy grows by significantly more than current forecasts and/or the public is prepared to accept quite large tax rises.

We think the third scenario is unlikely to be achievable, unless the economy performs much better than expected. However, if possible, we would like to see spending rise at least in line with our second scenario. We illustrate the sort of spending settlement that would be possible with a

1 per cent overall increase in expenditure and show how this could prevent future-oriented spending being further squeezed. In our example for 2016/17 and 2017/18 there would be: a rise in capital investment; a modest reduction in social security entitlements; 'flat' budgets for the health, social care, education and economic budgets; and a 3.5 per cent annual cut for all other departments.

A settlement of this sort would be extremely challenging, given the wide range of competing priorities. An increase in capital investment on the scale we think might be possible would only meet a small part of the demand for new homes, economic development and public service infrastructure; in the absence of unexpectedly good labour market performance, reductions to social security entitlements would be required; the health and social care sector would need to make major improvements to performance and productivity; and desirable future-oriented priorities such as early years provision, apprenticeships, funding for innovation and a jobs guarantee would only be possible in this period if they could be funded by 'switches' from within existing budgets.

Trust and 'tough choices'

Our work has shown that even if spending in the first two years of the next parliament is higher than current plans, 'tough choices' will be required. We illustrate this with one possible combination of social security entitlements: means-testing the winter fuel payment, ending the 'triple lock' on the state pension, extending recent disability benefit reforms to older people and taxing certain disability benefits. These would all be controversial decisions which we are putting on the table rather than actively recommending, but we believe politicians will earn trust and credibility if they square with the public about the difficult trade-offs which will need to be made.

The next government will also need to restore trust that the public's money will be spent well, especially if it is to present the case for spending and taxing more than implied by the coalition's present plans. Our recommendations include a significant package of reforms to improve the scrutiny and openness of spending choices and drive better value in the use of public money. The cornerstone is a proposal for an Office for Public Performance to restore faith in the quality of public spending, replicating the role the Office for Budget Responsibility (OBR) now plays regarding the quantity of public spending. 'Targets' has become a dirty word in recent times but without strong and consistent focus on performance from central government, it will be impossible to achieve the sustained improvements in public services which are needed to meet rising spending pressures and restore public trust.

1 | THE STORY SO FAR

Chapter 1 looks at some of the reasons why public spending is important. It sets out the long-term evolution of government expenditure from 1900 to the present, focusing on important structural shifts in spending including the consequences of the financial crisis of 2008.

- *We argue that public spending is essential for the wellbeing of society: for growth, jobs and prosperity; economic and social stability; smoothing costs over the life cycle; insuring against risks; redistributing resources, power and opportunity; maintaining security; providing public goods the market cannot; and meeting international commitments.*

- *Today, public spending makes up 45 per cent of the UK's national income. Social security, the NHS and education account for over half this total. Expenditure grew to around the present percentage of GDP between the 1910s and 1940s, from a low of 15 per cent in the Edwardian era. In the last 60 years rising national prosperity has been the most important driver of increasing expenditure, with spending varying decade-by-decade but averaging at a little over 40 per cent of GDP.*

- *In the post-war period, social spending – on areas such as health, education and social security – has expanded as a*

proportion of national income; and this has been offset by declining spending on capital investment, defence, debt interest and other areas like industrial support. In the century ahead there will be less headroom to increase social spending as a share of national income since the other elements cannot be squeezed that much more.

- *The 1997 Labour government sought to establish economic credibility by adopting the previous Conservative government's spending plans for the first two years: expenditure fell to 35 per cent of national income (in 2000/01) as the economy boomed. From that point spending was increased to around 41 percent of GDP, a figure more in line with historic and international averages. Recent studies have shown that the extra money delivered greatly improved outcomes and reasonable value for money, even if the results could have been better still. The main beneficiaries were people using healthcare and education, as well as low income children and pensioners. Over this period, public support for spending (and especially for social security) declined, which may make it harder to make the case for future spending.*

- *After the global financial crisis, spending increased to 47 per cent of national income and a large deficit opened up. This was mainly caused by sharp falls in economic output and government revenues. The coalition government is seeking to reduce the deficit and has held spending broadly flat in real terms during this parliament. This has entailed a huge shift between budgets, with higher debt interest and labour market-related social security leading to deep cuts elsewhere. Under current forecasts, total spending, as a share of national income, will return to the same level in 2017 as it was under Labour in 2007; but there will have been a significant shift away from future-oriented expenditure, towards interest payments and pensions.*

Public spending today

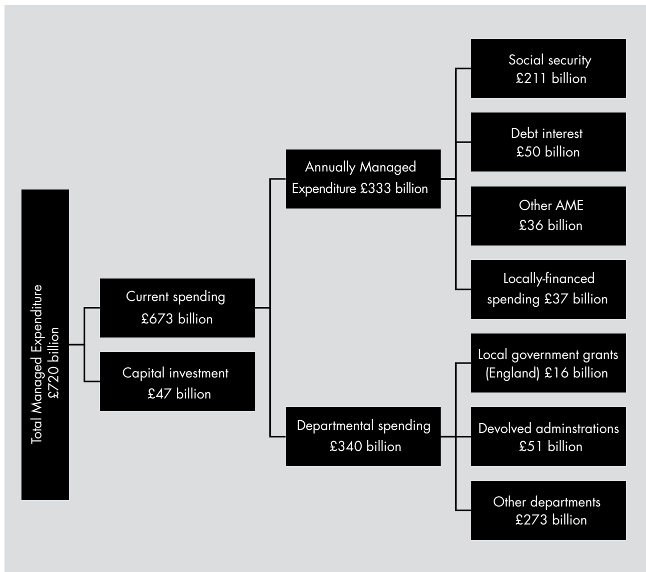
In 2013/14 public spending in the UK is expected to be £720bn or 45 per cent of national income. This overall level of spending ('total managed expenditure') includes three main components: capital investment, which is expected to create assets that bring enduring benefits over many years (£47bn); and two forms of day-to-day 'current' expenditure, departmental spending, which is fixed by ministers through spending reviews (£340bn) and 'annually managed expenditure' (AME) which cannot be fixed precisely in advance (£333bn). The distinction between 'capital' and 'current' spending arises from accounting rules and can be misleading, because a great deal of current spending is clearly intended as an investment for the future. In this report we refer to 'future-oriented' spending to describe both capital investment and current expenditure that is expected to create future knowledge, skills and capabilities (eg the schools budget).

AME includes social security, debt interest and locally financed spending. In recent years AME spending has been rising as a share of overall public spending and this is one reason why the coalition and the Labour party have each proposed a 'cap' on future social security spending. Since ministers cannot set annual budgets for AME they have to control expenditure in this area in other ways, for example by changing social security entitlements.

The national governments of Scotland, Wales and Northern Ireland spend £51bn and have very wide discretion with respect to how they use their large block-grants. This report considers spending by the UK government only and does not make recommendations on priorities for the devolved administrations, although they face similar challenges and trade-offs as the government in Westminster. Across the UK, local government also has a great deal of money at its disposal (£53bn plus grants

from devolved governments). In England its autonomy is tightly constrained by a wide range of statutory duties and national regulations. A very large and growing proportion of English council budgets are spent on statutory social care for children and adults (54 per cent in 2010/11).[1]

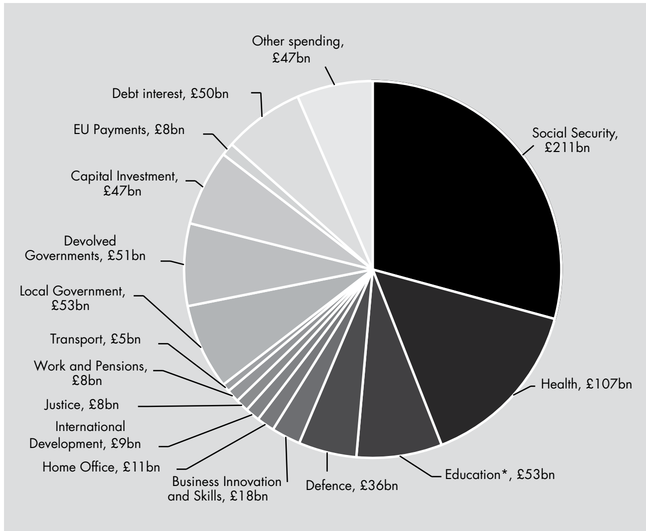
Figure 1: The main components of public spending in 2013/14



Source: Public Expenditure Statistical Analyses, HM Treasury, 2013

Departmental budgets pay for the public services and functions which are not the responsibilities of the devolved administrations. The two largest department budgets, health and education, are devoted to England only. However some of the smaller departments carry out activities reserved to Westminster across the whole UK or Great Britain. Defence, EU and international development budgets reflect the UK's current international commitments.

Figure 2: Main areas of UK public spending in 2013/14



Source: Public Expenditure Statistical Analyses, HM Treasury, 2013 Notes: (1) * UK government departments with functions devolved to national governments. (2) Local government excludes grants from devolved governments.

The single largest area of public spending is social security (including tax credits which will shortly become part of 'universal credit'). This accounts for more than one pound in every four. The majority of this, 54 per cent, is spent on older people and a significant minority goes to working households, leaving only around a quarter to go to households without work.[2] Social security stretches across the UK unlike many of the public services.

What is public spending for?

For over 100 years, people have been saying 'taxes are the price we pay for of a civilised society'.[3] Public spending provides for us all the things in life we can better secure

collectively than alone: shared goods we enjoy together, like parks and highways; vital services few of us could afford to buy privately, especially education and health-care; activities that look to the future, from investment in science and innovation to a strong pension system. Public spending pays for maternity services and for palliative care; for rescuing banks and building railways; for reception classes and PhDs; for emptying the bins and neurosurgery; for flood defences and green R&D; for local playgrounds and the Olympics; for safe streets and secure borders; for childcare and pensions; and to alleviate poverty here and around the world.

Government expenditure reflects our obligations to each other especially in its capacity to redistribute in an unequal society through tax, social security and public services. But it also embodies obligations to our future selves – to pay taxes so we will be provided for when bad luck or old age mean we need support – and obligations to future generations, creating resources, ideas and institutions that will benefit our grandchildren. Public money is critical to social and economic stability and advancement in our market-based economy. It means there's a healthy and skilled workforce; early-stage research and innovation that leads to commercial exploitation; new housing and transport links; stable, broadly-distributed economic consumption; and a national guarantor ready to step-in when crisis looms. By contrast, there is little empirical support for the argument that economic growth is inhibited by high state spending (relative to the range seen within OECD nations) as long as tax systems are well designed.[4]

We do not believe that the total quantity of public spending should be seen as totemic, either for the left or the right. Rather, the starting point should be to consider what we wish public spending to achieve and how this can be brought about most affordably. We do not want 'big

government' but 'big solutions', provided in the most efficient and effective way to secure good value for money. The size of overall spending as a share of national income should be determined by focusing 'bottom-up' on the value spending can bring in different areas, in the context of democratic choices, public preferences and economic affordability. Equally, we do not believe that public spending need be synonymous with public delivery. In our work we have not considered who should deliver public services at all. Even if public spending is to rise over time, this does not mean the size of the public sector will necessarily expand.

BOX 1: Eight arguments for public spending

1. Growth, jobs and prosperity

Public spending on areas like education, research, public health, transport and housing increases long-term prosperity and wellbeing. Expenditure on both human and physical capital is essential for productivity and living standards to rise over decades. This spending is an investment that pays back over time (often directly through increased future tax revenues) even though much is classified as 'current' spending by accounting rules. Many economists also argue that well-targeted spending during recession and stagnation can increase medium-term growth.

2. Economic and social stability

The business cycle generates economic instability which puts the prosperity, wellbeing and social fabric of societies at risk. Public spending is always an important and stable source of economic demand but it has a particularly key role during economic crises. Spending rises during downturns as more people become entitled to social security (and when the economy is growing fast it should rise less quickly than GDP to dampen economic activity).

During the financial crisis discretionary public spending played an important role in minimising harm (ie nationalising banks facing collapse; emergency stimulus spending).

3. Smoothing costs over the life cycle

We all experience fluctuations in our incomes and needs at different stages of our lives and public spending has a critical function in aligning our resources and outgoings over time. People are taxed throughout their lives in broad proportion to their ability to pay and receive support from government when their income is low or their costs are high, for example when bringing-up children, in retirement or when facing healthcare costs. This lifecycle distribution (from 'us to us') is the most popular dimension of public spending. It shows the value of 'universalism' in the welfare state, since only people with very high incomes are able to make plans during their working life to meet future pension and healthcare costs. It is 'collectivist' in that a single individual cannot expect to pay in and take out exactly the same amount over their lives. This is not true 'funded' insurance, since a government with secure public finances can finance future promises on a 'pay as you go' basis.

4. Guarantees against risk

Public spending also provides insurance-style guarantees to protect citizens against the effects of personal misfortune or wider economic forces. This form of support is a safety-net for everyone, but tends to benefit low-income groups: poorer households are more likely to face risks like unemployment or disability; most support is now means tested; and over time entitlements have lost value relative to earnings so offer very limited protection for mid and high earners. For all these reasons support for this sort of spending is low and declining, with recipients often stigmatised, even though this sort of welfare provision accounts for a small proportion of public spending (see Appendix 1). However policymakers are interested in widening the scope of this sort

of spending: the coalition government is extending protection for social care costs to higher income groups; and the Labour party is exploring the possibility of more generous, contributory unemployment insurance.

5. Redistribution and equality of opportunity

Redistribution through taxation and public spending serves the interests of fairness and long-term prosperity. It is often taken to mean the 'static' transfer of resources, through cash or services, but it also includes the redistribution of power and opportunity to ensure everyone has the capabilities they need to flourish in today's society. Redistribution is a feature of many different types of public spending and a number of the functions of spending set out here can be organised in a more or less redistributive way, at the level of both households and geographic communities. The extent to which redistribution is required is partly cyclical, with calls on public support rising when unemployment is high and wages low; but it is also driven by long-term structural issues, such as the proportion of people in low-paid work or the affordability of housing. The UK's 'market' inequalities (ie prior to redistribution) are amongst the highest in the OECD and remain much higher than in the 1970s. However the extent to which the UK redistributes through tax and benefits is pretty typical compared to other advanced economies and our public services are considerably more redistributive than average.[5]

6. Security

Public order and defence were the original functions of government and they still are an important dimension of public spending. Governments also need to grapple with new risks of all kinds, from terrorism and pandemic disease to cyber security and resilience. Over decades defence spending has shrunk as a share of national income, although the UK continues to devote more to defence than many comparable nations. Spending on

public order and safety is now almost as high as defence spending, following rising spending on policing, border security and the intelligence services in recent years.

7. Public goods

From an economic perspective public intervention is necessary for the provision and preservation of 'public goods' such as parks, clean air and a stable climate, which people value but the market could not deliver on its own. In addition many people (but not all) would argue that some activities have a special 'public' or 'civic' character and are best carried out beyond the market.

8. International commitments

Public spending allows the UK to maintain its commitments to poorer nations through international development spending and some elements of EU and defence expenditure. Well-targeted spending also reflects enlightened self-interest as it is likely to boost future trade and limit security threats.

The 100 year view

Over the last 100 years social spending on areas like health, education and social security has gradually expanded as a share of national income, as the 'welfare state' has grown to maturity. In the century ahead there will be far less headroom to increase this spending as a percentage of GDP, since there are few other areas of public spending to cut substantially and less room to grow public spending as a share of national income than in the past. The amount governments will have to spend is likely to depend (to a greater extent than previously) on the long-term success of the economy rather than changes in the way the economic pie is cut.

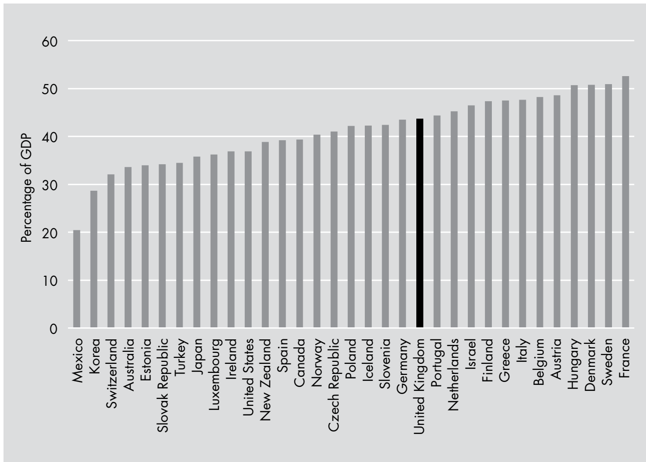
Overall levels of spending

During the 20th century, the creation and expansion of the welfare state was achieved first by growing overall public spending and then by switching expenditure away from areas like defence and capital investment. Similar growth occurred in all advanced economies, reflecting changing needs, public preferences and the costs of service delivery. In nations with 'small states' the same areas of economic activity grew, but in the private sector, as in the case of healthcare in the United States.

Before the financial crisis, UK public spending as a share of national income was unremarkable when compared to other advanced economies, at just a little above the OECD average (the UK's expenditure was the same as Germany's and well below that seen in successful Nordic economies). This comparison indicates that the UK had some scope to further increase spending as a share of GDP on a permanent basis, but this had limits before we would have become an outlier with respect to international comparators.

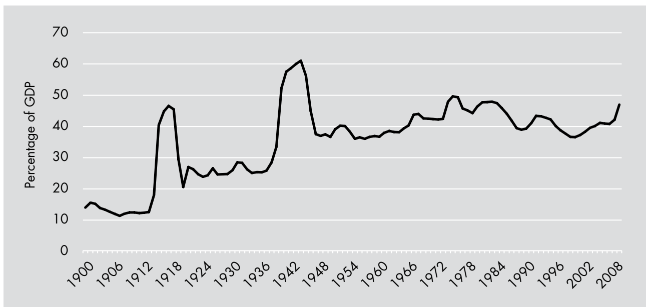
Figure 4 shows how overall spending increased from under 15 per cent of national income in the 1900s to around 25 per cent between the first and second world wars and has averaged a little over 40 per cent of GDP since the late 1940s. During this time overall spending has fluctuated between 35 and 50 per cent of national income, with peaks arising due to economic contraction rather than planned choices or sharp real increases in spending. After these peaks, governments have needed to rein in spending significantly, since shrinking economies lead to shrinking revenues and fiscal deficits. This has usually meant a period of near flat spending, rather than an actual decline in real expenditure. In the past, stable spending has been sufficient to reduce expenditure as proportion of national income quite quickly, in cases where the economy recovered rapidly from recession.

Figure 3: Public spending in OECD countries before the effects of the global financial crisis (2007)



Source: National Accounts at a Glance, 2013, OECD. Note: data is for 'general government expenditure' a slightly different measure from 'total managed expenditure' used by the UK Treasury.

Figure 4: UK public spending from 1900 to 2010



Source: Hills S, Thomas R, Dimsdale N, 'The UK recession in context – what do three centuries of data tell us?' in *Quarterly Bulletin*, Bank of England, 2010 Q4. Fabian Society calculations using data series for Total Managed Expenditure and nominal GDP.

Changes in recent decades have not all been cyclical. For 25 years until 2000 there was a downward trend in spending, driven by both economic and political factors. The immediate cause of this decline was rapid economic growth in the late 1980s and then the late 1990s, which was not matched by similar spending rises. But by the mid-1990s the threadbare condition of public services was of wide public concern and was one of the reasons for the election of the New Labour government in 1997.

In the first two years of government Labour largely stuck to the spending plans of the previous government, partly to prove it could be trusted. As the economy was booming this led spending to fall to a post-war low of 35 per cent of GDP in 2000. The party then made an unusually specific and open choice to change direction, and reversed the decline in spending over the following years. By 2007 UK public spending had risen to around 41 per cent of GDP, slightly less than the average of the previous 50 years.

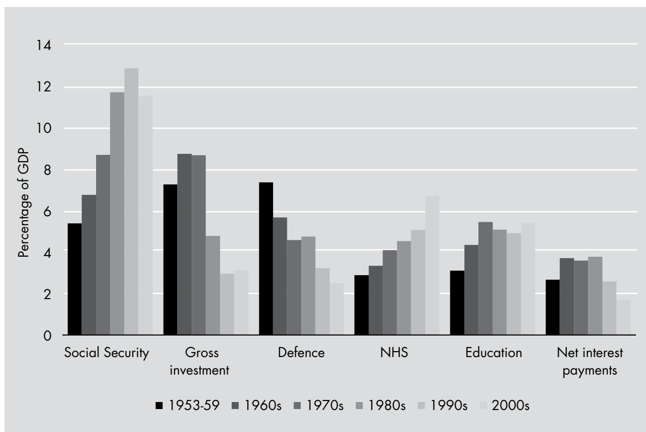
The composition of spending

Figure 5 shows the shift in the composition of public spending over the last 60 years. In the post-war period, spending on health, education and social security has been the rising priority. Education spending increased from 3 per cent to over 5 per cent of GDP between the 1950s and 1970s, peaking at this point and then returning to this level in the 2000s. Health spending grew steadily from around 3 per cent of GDP in the 1950s to 5 per cent in the 1990s, reflecting technological change and rising expectations; it then jumped rapidly in the 2000s following Labour's decision to match international levels of health spending.

Social security increased steadily from the 1950s but really jumped in the 1980s. Spending peaked in the 1990s and then fell back in the 2000s, to stabilise at around 11 per

cent of GDP. This rise has been driven by a combination of demographic change and widening economic inequalities. Older people have accounted for half or more of social security spending since the 1960s, except for a brief period during the 1990s recession. In the mid-2000s, before the financial crisis, pension spending was continuing to rise but working-age social security had fallen from its 1990s peak and stabilised at around 5 per cent of GDP.[6]

Figure 5: Shifting components of public spending since the 1950s



Source: IFS compilation from a variety of data sources

These increases in 'social' spending were offset by decreases in other areas of spending. Defence spending has been reduced by successive governments and debt interest fell considerably between the 1980s and 2000s. In addition, investment spending has fallen over time from an average of 9 per cent of GDP in the 1960s and 1970s to around 3 per cent in the last two decades. This huge reduction in investment since 1980 is in part explained by the privatisation of state-owned industries but it nevertheless marks a major shift. Since the early 1980s falling

spending on defence, capital and debt interest was more than sufficient to fund rising spending on social security and healthcare and was the main reason for the overall decrease in public spending as a share of GDP. It will not be easy to repeat this long-term shift in spending since non-social spending comprises a reduced share of public spending.

1997-2007

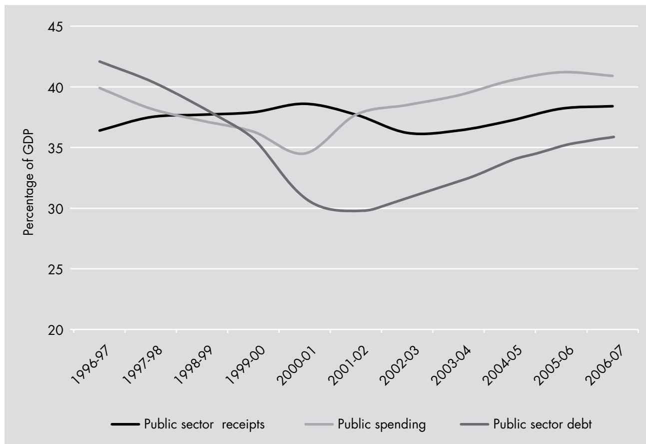
Spending by the last Labour government was broadly comparable to previous decades and recent academic analysis by the LSE has shown that the extra money that became available mainly delivered results.[7] Not all the money was well spent, but overall the evidence demonstrates the power of public expenditure to improve social outcomes and living standards.

With a strong economy, spending restraint and the one-off effects of the auction of 3G telecom licences Labour initially achieved a budget surplus of 4.1 per cent of GDP by 2000-2001. This was the conclusion of a very large fiscal contraction, worth 11 per cent of GDP, which had begun in 1993 and was achieved by freezing not cutting public spending, at a time of rapid growth.

However, after years of constrained spending the UK's public services were under great strain and poverty levels remained as high as in the early 1990s. So Labour rejected the option of permanently shrinking the size of the state and instead embarked on a period of above-trend 'catch-up' spending increases: between 2000 and 2005 the government made real terms public spending increases averaging 4.8 per cent a year.[8] Alongside these rising inputs, the government implemented reforms to the management of public services, for example the introduction of performance frameworks to monitor and supervise the quality of service outcomes.

By 2007 spending was just below the post-war average, so not excessive in itself; however revenues did not rise as quickly as anticipated, which meant Labour was running a moderate structural deficit just before the financial crisis.

Figure 6: Public expenditure, receipts and debt as a share of GDP 1996/97 to 2006/07



What did Labour achieve?

The largest beneficiary of the extra money was the NHS, while education spending also grew. The work of the LSE, among others, has shown that the extra money led to significant improvements in health and education outcomes.[9] Social security spending dipped slightly as a percentage of national income, as the economy recovered from the 1990s recession: there was a steady decline in the numbers claiming out-of-work benefits and Labour chose to recycle much of these savings into more generous entitlements for older people and families with children. This led to significant reductions in relative poverty among children and pensioners.

BOX 2: LSE analysis of Labour social policy 1997-2010

In June 2013 the LSE published a comprehensive analysis of Labour's social policy. The summary of the report concludes:

'in a more favourable climate than the current one, Labour spent a lot and achieved a lot. However there was a long way still to go in relation to its original ambitious vision.

- *Labour set out an ambitious agenda to raise outcomes overall, narrow socio-economic gaps and modernise public services.*
- *Public spending went up by 60 per cent and from 39.5 to 47.4 per cent of GDP. This was a large rise but the UK started from a low point. Until the crisis hit after 2008, spending levels were unexceptional by historic UK and international standards.*
- *The extra spending went mainly on services. Health and education both increased as a proportion of all public spending. There were new hospitals, schools, equipment and ICT, 48,000 extra FTE equivalent teachers, 3500 new children's centres, more doctors and nurses, and many new programmes aimed at neighbourhood renewal*
- *Nearly all the extra cash Labour spent on benefits went on children and pensioners. Benefits for working age people unrelated to having children fell as a proportion of GDP.*
- *Access and quality in public services improved. Waiting times for health services fell. Pupil-teacher ratios improved. Young children had greater access to early years' education. Poor neighbourhoods had better facilities and less crime and vacant housing.*
- *Outcomes improved and gaps closed on virtually all the socioeconomic indicators Labour targeted, such as poverty for children and pensioners and school attainment.*

However gaps remained large. In health some indicators improved although efforts to tackle health inequalities had mixed results.

- *On some key things Labour did not explicitly target, there was no progress. Poverty for working age people without children rose. There was no real change in levels of income inequality. Wage inequalities grew and disparities in regional economic performance persisted.'*

Source: Ruth Lupton et al, *Labour's Social Policy Record: policy spending and outcomes, 1997-2010* (2013)

At the time many commentators worried that the improved outcomes Labour was delivering were not proportionate to the pace at which spending was rising. Many feared that too much money was being eaten up by increasing costs, for example rising public sector pay (pay did indeed rise faster than average earnings for a while, to catch-up with years of relative decline). However, although more could undoubtedly have been done, the latest ONS data demonstrates that between 1997 and 2010 most of the extra money did translate into extra 'outputs' (measured as rising volume and quality of activity).

Looking across the public services, around two thirds of annual real spending increases (averaging at 4.4 per cent per year) translated into measured increase in outputs (3 per cent per year). The difference is accounted for by unit costs rising faster than economy-wide inflation (plus the possibility of additional unmeasured activity). This was partly driven by rising pay, but other costs (such as drugs and medical technologies) increased more, at least in the health service. Notably, NHS performance improvements were much better than for public services in general, despite the service being the recipient of the most new

investment. Almost all the extra real spending (averaging 5.7 per cent per year) translated into rising output (5.4 per cent per year). This happened because productivity gains almost cancelled out above-inflation increases in unit costs.[10]

Figure 7: Annual percentage increases in public service spending, outputs, inputs and productivity* 1997 to 2010

	Real Spending (1)	Outputs (2)	Inputs (2)	Productivity (2)
Public services	4.4	3	3	0
Healthcare	5.7	5.4	4.9	0.5
Education	3.9	2.7	2.3	0.3

Sources: (1) Chote R et al, Public spending under Labour, IFS, 2010 (2) Public service productivity estimates: total public services, ONS, 2013. Note: IFS data is for financial years, ONS data for calendar years. Different definitions of 'public services' are used so the first row provides an indicative comparison only.

*Productivity is a measure of the volume of outputs (eg services) produced by the volume of inputs (eg hours worked, supplies). It should not be confused with output produced per unit of expenditure, since the price of inputs is likely to rise over time. In all cases during this period output per unit of real spending declined as a result of rising unit costs (ie productivity improvements which led to inputs being converted into outputs were insufficient to cancel out the rising real cost of inputs).

Although this picture is better than is often assumed, there is no room for complacency. Productivity improvements in most public services are similar to those found in the hospitality, recreation and retail sectors but well behind those in many other areas of the private sector.[11] We believe Labour could have done more to champion performance improvements and that this must be a top priority for any future government.

BOX 3: Labour's record on health

Health spending more than doubled during Labour's last period in government and, as a proportion of GDP, health rose from 5.3 per cent in 1997-08 to 8.4 per cent in 2008-10.[12] From 2001 Labour embarked on a process of what has been called 'catching up and keeping up', guided by the UK's underperformance against international benchmarks.[13] As part of this agenda the NHS also underwent radical organisational change which mainly built on the market reforms of the previous administration.[14] More freedom and autonomy was given to public bodies and reforms were put in place which sought to extend patient choice. A number of new agencies were established to improve quality and cost effectiveness, notably the National Institute for Clinical Excellence (NICE), which provides guidance on the effectiveness of treatment and practice and is recognised as a global leader.

Recent reviews suggest that Labour's spending took the NHS towards being a high-performing health system.[15] Waiting times reduced dramatically and while some inequalities continued to exist there were improvements in access to services.[16] These changes were reflected in patient experience and by 2010 the proportion of patients who were satisfied with the NHS was above 70 per cent.[17] As we have seen, NHS productivity improved during the period, even during the years of very rapid spending increases.[18] A substantial increase in resources, combined with the impact of NHS reform and improvements to services beyond healthcare led to improved health outcomes in the UK.[19] The target to reduce overall mortality from circulatory disease was met and the cancer mortality rate fell by 22 per cent, satisfying Labour's target for this disease among people under 75.[20] [21] Although the UK still lags other countries in life expectancy, rapid increases were recorded over this period.[22] Nevertheless, a number of Labour's objectives for health outcomes went unmet. Health inequalities between high and low

income groups grew wider, as the health of high income groups improved fastest. This critical issue was the subject of the Marmot review in the government's closing years.[23]

Labour's impact on education was positive, but not quite as compelling as for health (see Box 3). Real education spending increased by 5.1 per cent between 2000 and 2010.[24] As a share of GDP, spending rose from 4.5 per cent in 1997/98 to 5 per cent in 2007/08.[25] Labour's most well-known objective was to expand the number of young people participating in higher education and by 2010, 46 per cent of young people were participating in higher education by the age of 30.[26] At ages 11 and 16, inequalities in attainment between social groups narrowed and overall attainment at each key stage improved considerably.[27] There is a continuing debate over how far these improvements in educational attainment indicate real improvements in pupils' capabilities and knowledge during this period. While international data shows educational attainment in the UK declining from 2000, others have argued the data is inconclusive.[28]

Social security

Labour's other major priority between 1997 and 2010 was to reduce poverty, specifically for families with children and for older people. The party did not meet its target of halving relative child poverty but it still made significant progress, especially in the context of high and static market inequalities. The child poverty rate fell from 33 per cent in 1997/98 to 27 per cent in 2010/11, lifting around 600,000 children out of poverty. Pensioner poverty fell from 29 per cent to 14 per cent.[29] Simulations shows that Labour's tax and benefit decisions were a significant driver in

reductions in poverty and that child poverty would have worsened were it not for the party's reforms.[30] By contrast, the overall level of income inequality remained broadly unchanged, having increased rapidly in the 1980s. This can be explained by rapidly rising incomes among the top 1 to 2 per cent of the income distribution and social security policies for non-pensioner adults without children, who were at greater risk of poverty in 2010 than 1997.[31]

The Labour government's poverty strategy emphasised the importance of employment as a route out of poverty for people in working life.[32] Labour introduced new welfare-to-work programmes coupled with the minimum wage and social security reforms to 'make work pay'.[33] Unemployment fell and the policies were particularly successful in supporting lone parents into work; and in its final years, the government finally began to make inroads into the number of people out of work on incapacity benefits. As for pensioner poverty, there was considerable emphasis on increasing saving and reforming the state pension system to recognise broader contributions.

Nevertheless, cash transfers were an important part of Labour's efforts to reduce poverty and inequality, and financial support was directed at families with young children, both in and out of work, and to pensioners. Other working age benefits and tax credits increased at a much more modest rate, with the generosity of out-of-work entitlements such as jobseeker's allowance declining because benefits were linked to prices rather than earnings. Until the economic crisis social security spending increases matched underlying economic growth, and spending on social security as a share of GDP was the same in 1997 and 2007.[34]

Public attitudes

During these years there was a significant shift in attitudes to public spending, much of it in favour of less generous

provision. Support for spending on older people, education and the health service remained high, with public confidence in the NHS increasing dramatically. However there was a decline in the number supporting increased taxes and spending and a particular hardening of views with regard to social security. Some shifting attitudes had a grounding in changing facts; after all public spending did rise, which might explain why fewer people would support further increases. However other changes in opinion were less obviously connected to such changes (see Appendix 2 for an analysis). For example, support for spending on unemployed people declined alongside unemployment, but this did not initially reverse after the financial crisis, although the most recent data for 2012 suggests some softening of attitudes to unemployed people.[35]

The shift in attitudes to social security spending has been driven by changing opinion regarding 'dependency', the view that government support is too generous and discourages people from taking responsibility for themselves. The public's views on this issue changed even though Labour's social security reforms created a system that is far less likely to give rise to dependency: work incentives were improved; the conditions placed on people without jobs were tightened; and the generosity of benefits declined, except for parents with children. However, whatever the reality, public confidence with respect to social security and the fairness of entitlements is now significantly lower than in the mid-1990s. Although similar changes are observed internationally, British people are more concerned about the costs of welfare provision and the problem of dependency than people in most other EU nations.[36] This poses a dilemma for policymakers seeking to reduce inequality and support standards of living. In designing future policy, public opinion is now a significant constraint and providing reassurance needs to be an explicit goal of policy alongside achieving social and economic objectives.

2007-2017
Crisis

The global financial crisis was the defining economic event of a lifetime. The crisis caused a very deep recession which has been followed by a long period of near stagnant growth, with the UK still some years away from returning to its previous GDP peak. Although the causes were almost entirely unrelated to the volume of public spending, there have been huge consequences for expenditure. In the immediate crisis the government chose to partly nationalise two major banks to save the British banking system and economy from collapse. This demonstrated the ultimate power of the exchequer to intervene at times of national emergency: only government had the ability to spend and borrow on the scale required, in the time required.

Public spending more broadly played an essential part in ameliorating the crisis by sustaining demand and investment as each collapsed in the private sector. After 2007, spending as a share of national income jumped rapidly as the economy contracted, rising from 41 per cent to 47 per cent of GDP by 2009/10.[37] Figure 8 shows that, in real terms, spending increased far less dramatically, by an average 3 per cent per year in Labour's last three years.[38] In the 2007 spending review, Labour had set out plans for relatively modest spending growth for 2008/09 to 2010/11; this planned spending was maintained but became a much larger proportion of GDP as the economy contracted. Additionally the crisis meant that the 'automatic stabiliser' of rising social security pushed spending up; and the government also opted for discretionary spending increases, especially to capital investment, as a short-term stimulus measure.

Alongside these moderate spending increases, there was a collapse in government revenues and a large fiscal deficit opened up. Before the crisis, government borrowing in 2008/09 was projected to be £23bn, approximately

1.3 per cent of national income.[39] By 2009/10 public sector net borrowing had reached a post-war peak of £159bn and although annual borrowing declined slightly in the coalition government's first two years in office, the OBR forecasts that in 2011/12, 2012/13 and 2013/14 the deficit will be stuck at around £120bn.[40] In four years significantly more will have been borrowed than in the previous 13 years.

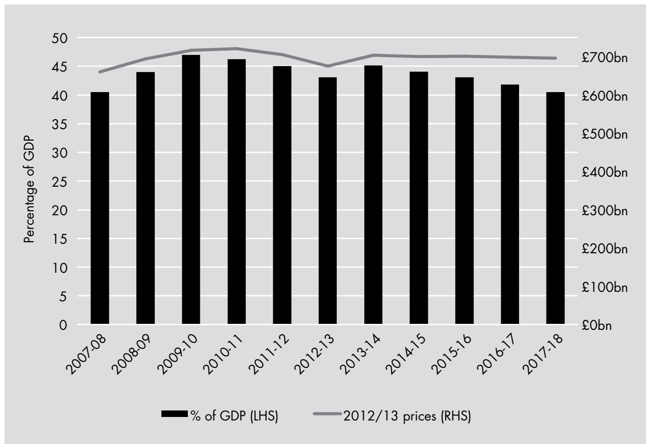
Austerity

By 2010, the collapse in revenues had created a large deficit, which the coalition government set out to close in a single parliamentary term, with cuts to the deficit and overall spending planned for each year. However, the UK's growth has remained very weak and the prolonged stagnation meant these plans had to be revised. Public spending was originally expected to fall by 1 per cent per year between 2010/11 and 2015/16 but this figure was revised to an average annual reduction of 0.4 per cent from 2010/11 to 2017/18.[41] So the austerity programme has been a period of near standstill rather than significant real decline in spending. However unlike in previous recessions, flat spending has not led to a rapid reduction in the deficit because economic growth has been so disappointing.

Beneath the near flat spending total a huge shift between budgets is taking place: it is mainly the composition not the size of public spending that is changing. Spending on debt interest and on labour market related social security has risen. Planned cuts to capital investment and 'unprotected' departments are being implemented as well as significant reductions in social security entitlements; this is causing suffering for many people who rely on public spending. Meanwhile spending on pensioners has risen as planned, and spending on the NHS, schools and international development has been broadly flat. As a result the

government is spending a smaller share of public expenditure on future-oriented spending, like skills, economic programmes and capital investment. This builds on trends from previous decades and could store up problems for the future.

Figure 8: Total managed expenditure between 2007/08 and 2017/18 as a percentage of GDP and in real terms



Source: Public Expenditure Statistical Analyses, 2013, HM Treasury; Economic and Fiscal Outlook, March 2013, OBR. Data for 2012/13 includes one-off transactions and does not reflect trends in spending.

It is sometimes said that Labour spent too much when in office. However, under the government's revised spending plans, it is aiming to return spending as a share of GDP to pretty much the level seen in the mid-2000s (see Figure 8). It is sobering that after a decade of economic crisis, stabilisation and austerity, the public finances will be back almost exactly where they started.

BOX 4: The impact of austerity

All three main parties promised an austerity programme at the time of the 2010 general election. However, compared to Alistair Darling's proposals, the version of austerity adopted by the coalition was both faster and more skewed towards spending cuts rather than tax rises. This choice has had significant consequences for the economy, incomes and public services.

Incomes: Tax and benefit changes between 2010/11 and 2015/16 are expected to reduce middle incomes by more than 2 per cent and the incomes of the poorest by 5 per cent. This comes on top of the effects of falling real earnings and low levels of employment. The top half of the income distribution have been less affected, apart from the top income decile who have experienced tax rises.[42] The overall impact of the tax-benefit changes is expected to be a jump in inequality on a scale last seen in the 1980s.[43]

Public services: Government departments face average cumulative cuts of 10 per cent between 2010/11 and 2014/15. Healthcare, schools and international development have been protected, leading to large reductions elsewhere. Major cuts include: communities (44 per cent), culture (35 per cent), justice (28 per cent) and home office (24 per cent). Public sector employment is expected to fall by one million between 2010/11 and 2017/18.[44] It is too early to make an overall assessment of how outcomes are changing but the volume of frontline provision is falling in many areas.

Local government: English local authorities will lose around 35 per cent of their central government grants between 2010/11 and 2015/16.[45] Poorer areas are more reliant on these grants because they have higher needs and can raise less from council

tax. For example, between 2013/14 and 2014/15 typical budgets will fall by 2.3 per cent in shire areas, 4.6 per cent in major metropolitan areas outside London and by 5.2 per cent in inner London boroughs.[46] So far cuts have had the most impact on planning, housing, cultural services and back-office activities, with authorities minimising cuts to social care and environment services. Many councils now speculate that on present trends by the end of the decade they will only have money to fulfil their statutory social care and refuse collection duties.

The government has set out its overall spending plans until 2017/18 but it has not announced the composition of spending for after the election year of 2015/16. The final chapter in this decade of crisis and austerity will be written after the next election and a future government will have choices: both on how much it decides to spend and how it will be allocated. The rest of the report considers how it should make those choices.

2 | BETTER SPENDING REVIEWS

We argue that spending decisions should be made in a more open and long-term manner, and outline a significant package of proposals to reform the conduct of spending reviews (chapter 2) and improve the quality of spending choices more broadly (chapter 3). Taken together these recommendations imply a radical shift in the way spending decisions are made, in order to build public confidence that their money will be well used.

- *A regular cycle of multi-year spending reviews should be restored. In the context of five year fixed-term parliaments we argue for a spending review which sets detailed departmental budgets for three years, and suggest the possibility of setting indicative budgets for a further two. Capital investment plans and the broad outline of tax and spending should be set for five years.*

- *Spending reviews should be broader ranging and more participative, which implies a multi-stage process. They should begin with the publication of a set of principles to act as tests to guide individual decisions; and a long-term expenditure statement (to show the link between ministers' immediate plans and their views on the evolution of spending over decades). If time permits we would also like to see the publication of a 'draft' spending review for consultation. Sufficient time is also needed for a participative process, where budget*

holders develop options, using citizen and stakeholder participation as well as more formal consultation.

- *This multi-stage process would greatly increase the opportunities for parliamentary oversight, but we also argue parliament needs more scrutiny capacity. We propose the creation of a specific budgetary committee for the House of Commons; and recommend that the Office for Budget Responsibility becomes an agent of parliament with a broader remit.*

- *The final spending review announcement should include coordinated, detailed plans on departmental spending and capital investment; and also set out the broad direction for social security, tax, and non-fiscal policy with major implications for tax or spend. Subsequent budgets would then be used to set out plans for detailed implementation, especially regarding social security and tax reform*s.

In chapter 1 we reviewed the ways in which public spending has changed recently and over the long term. Alongside these shifts there have been significant revisions to the process for allocating and managing expenditure over time. The most significant recent changes were the introduction of multi-year spending reviews in 1998 and the launch of an independent agency, the Office for Budget Responsibility, to oversee economic and fiscal forecasts in 2010. Another major innovation by Labour was to link spending decisions to the setting and monitoring of objectives for what public money was expected to achieve, through the use of public service agreements (PSAs). This approach has been largely abandoned by the coalition government.

The commission welcomes the innovation that has taken place over the last 20 years, but we think another major set of reforms is now needed. Spending decisions need to be

made in a more open and long-term manner and this entails a very different way of doing spending reviews and managing the public finances. It is not inevitable that difficult decisions about public spending should be poor decisions, and in the next two chapters we outline a significant package of recommendations aimed to make them better. Our proposals would embed an approach which enshrines the long-term perspective; democratises the spending process by opening it up to greater external scrutiny and participation; promotes experimentation and innovation by devolving responsibilities; and seeks to make investment in 'early intervention' a practical reality. To cap this, we propose the creation of a new institution to secure improvement in the quality and cost effectiveness of spending.

Taken together this package implies a radical shift in the way spending decisions are made. Many of our proposals are overdue in their own right, but we think they are also needed to build public trust in the government's ability to spend money well. This means not just achieving value for money, but establishing institutions to publicly demonstrate that each pound of public money is well used. This is particularly important if the next government decides to spend more than the coalition government's existing plans. It will need to demonstrate that any deviation really will deliver results.

In this chapter we look at the process for making and scrutinising major expenditure decisions through multi-year spending reviews, which are critical moments to take stock and set strategy. However, spending reviews should be integrated into better day-to-day management of performance and finances across the public sector. They should be part of a cycle of good governance and financial management, where the budgeting process is driven by what services can achieve for citizens. This is the topic of chapter 3, which considers how to achieve better results from the way money is spent across the public sector.

When should spending reviews happen?

The spending review process is the government's opportunity to take an overall view of the balance of spending, outline how it intends to allocate expenditure over a number of years, make technical allocations of budgets and agree what funding will deliver. We think it is essential that the long-term perspective is upheld in this process, and as an immediate priority we recommend that government restores a regular cycle of spending reviews to promote certainty for budget holders.

During Labour's period in office, spending reviews set out plans for three years ahead. At the time this was a major innovation and has been watched and imitated around the world. When the coalition came to power it continued this basic approach and held a four year spending review. However, since then, the Fixed-Term Parliament Act 2011 and the reality of multi-party government has required the coalition government to abandon multi-year budgeting. The result has been the one-year 'spending round' delivered by the chancellor in June 2013, which set spending priorities and allocated resources for the year 2015/16. In 2015 an incoming government is likely to make only small changes to allocations for this financial year, which will already be underway.

A new cycle of spending reviews is needed for the year 2016/17 onwards which is compatible with the fixed-term parliamentary cycle and sets out long-term certainty. One possibility would be to conduct a five-year spending review covering the period 2016/17 through to 2020/21. However, we do not think a definitive five year settlement is the best route, because fiscal uncertainty is very high. Nor should another four year cycle be considered (unless parliament decided to shift to four year fixed terms). This is because it would either leave a one year 'overhang' which would need to be plugged by another single-year

spending round; or would result in reviews being out of sync with the parliamentary timetable.

We therefore recommend that the next government carries out an initial 2015 spending review on a three year basis. At the same time consideration and modelling should be carried out to set a regular future cycle. The review would set out definitive plans for three years (2016/17 to 2018/19) giving budget holders the ability to plan with a degree of confidence. A rolling capital investment budget for a five year period should also be published, so major investments could be planned over the long term. Ministers might also consider setting indicative current spending totals for the following two years to give budget holders the ability to start long-term planning (however, there is a risk that these totals could be of only limited benefit if budget holders came to expect significant future revisions, in light of changing circumstances and priorities).

The key stages of a spending review

We believe spending reviews should be broader ranging in their remit and more transparent and participative in their conduct. This implies an open, multi-staged process, rather than the current internal government approach, which leads up to a single moment of parliamentary theatre.

We recommend that a future government should take the following steps:

- Begin by publishing principles to guide the process and act as a set of 'tests' to make individual decisions within the context of the current performance of the economy

- Publish a long-term expenditure statement, setting out a 'direction of travel' for spending over future decades, against which immediate decisions can be scrutinised

- Leave sufficient time for budget holders to develop options, on the basis of (1) the published 'tests'; and (2) citizen and stakeholder participation.

- Greatly increase the opportunities for parliamentary and external scrutiny. This could include the possibility of government publishing 'draft' plans for consultation (if the timetable for the process makes this possible).

- Near the conclusion of the process, make 'big picture' policy decisions side-by-side on: (1) departmental spending; (2) capital investment; (3) social security; (4) taxation; and (5) non-fiscal policy with major implications for tax or spend.

- Set spending totals, with clarity on what the spending will achieve and how progress will be assessed.

- Use subsequent budgets for the detailed implementation of the broad strategy announced in the spending review, especially regarding social security and tax reforms.

This approach would require ministers to avoid taking major long-term decisions in the first month or so of a new administration. They might well wish to conduct an interim budget to adjust plans for the financial year already underway reflecting their priorities. But the overall spending envelope and key decisions on tax and social security should be set near the end of the process, alongside decisions on departmental allocations, taking account of the input and scrutiny received throughout the process.

'Tests' to inform priorities and trade-offs

In a time of fiscal restraint it is more important than ever for public spending to work effectively towards the government's

desired outcomes. For this reason we want to see decisions made on the basis of a set of 'tests', which would give coherence to the process of weighing up competing priorities, ensuring that decisions are complementary and measuring future performance. There are precedents for this approach. In the lead up to the 2010 spending review, the government published *The Spending Review Framework,* which sought to explain how the government intended to make decisions.[47] The recent spending round gives an indication of priorities and in recent months the Labour party has also set out its thinking on principles to guide a 2015 spending review. We would wish this to become a formal part of any review in order to open the debate early in the process.

These tests will provide the roadmap for a more open and participative process. Individual budget holders will be able to use them to develop proposals 'bottom-up', with dialogue and participation from citizens and stakeholders. And parliament and other outside agencies will be able to apply them to the scrutiny of the process.

Ministers will rightly want to determine their own tests and indeed the process for debating and communicating such principles should be an important precursor to the spending process. This is not something that should be attempted in a hurry so we recommend that political parties give the development of spending tests careful thought prior to a general election. An external commission can't short-cut this process, but in chapter 4 we recommend eight tests for consideration by political parties.

A long-term expenditure statement

Returning to a medium-term cycle of spending reviews is only a step towards more long-term thinking on public spending. We believe that as part of the spending process, ministers should be expected to consider the direction of spending over the course of decades.

A long-term expenditure statement specifying the destination for spending would provide a reference point to show how a department's budget and objectives contributed to long-term strategy. It could also be a driver for collaboration if it encouraged ministers to consider the interaction between their budgets over the long term, such as instances where one department's cost cutting measures create liabilities for another in the future.

The statement could be published as part of a spending review consultation some months before the final announcement and would be a major set-piece event, which would deliberately shine a light on the long-term choices facing government. Ministers would then invite parliamentary debate and responses from the public and experts, in order to pull the momentum of policymaking towards a long-term perspective. In the immediate context of 2015 the statement would have particular value, because it would help ministers strike a balance between debating short-term deficit reduction measures and the long-term trajectory of public spending thereafter. In our view these two timeframes need to be considered side-by-side, not sequentially.

The long-term statement would build on and complement the OBR's existing fiscal sustainability report. The major difference would be that the government would need to set out its long-term policy judgements, which would inform future spending projections. At present, the OBR assumes 'unchanged policy' in an attempt to model the implications of economic and demographic factors. However, its judgement about what 'unchanged policy' amounts to is implicitly political and contestable, with different ways of interpreting 'default' policy having wildly different implications for the public finances. A government statement would bring dilemmas regarding future policy to the fore, by setting out how ministers would like to see spending evolve and the major policy changes that would be required to achieve this. All the modelling, and the judgements regarding economic

and demographic variables, would still be in the hands of the OBR to give the projections independence and rigour. But the long-term direction of spending is amendable to political steer so politicians should be responsible for stating their aspirations for policy.

Participative decision making

The publication and use of 'tests' is one way of making spending decisions in a more participative fashion. More generally, we want to see many more opportunities for involvement by major budget-holders across the public sector; and by citizens, including frontline workers. To make this possible the decision-making process should include opportunities for consultation using both traditional methods and new technologies. This implies a reasonable duration for the whole process, with ministers avoiding definitive top-level decisions at an early stage.

The practice of recent governments has been to set upper and lower limits for spending in different areas quite early in the decision-making process, often with political considerations front of mind. This reduces the government's capacity to make considered judgements on the overall balance of spending. For example, in 2010 the government announced 'ring-fences' for the NHS and international development in the coalition agreement before the full impact of the spending challenges facing other areas could be assessed. We do not dismiss the value of announcing upper and lower limits on spending, but they should primarily be a tool for communicating priorities. If announcements come too early, opportunities for participation are undermined and competing demands across government cannot be assessed in a neutral and evidence-based manner. We also support the principle of such limits being attached to issues rather than budgets, to avoid artificial constraints which may influence decisions

for purely procedural reasons (eg the allocation between health and social care; or the choice between childcare services and cash subsidies).

Ideally decision makers should begin by looking at relatively small blocs of spending (eg individual entitlements or public service programmes). They should consider the rationale for the spending using the principles set by the government, in partnership with all the relevant stakeholders; look at evidence of effectiveness, with reference to clear and consistent criteria; and make an assessment of what could be achieved with more or less money. This is sometimes called a 'zero-based' approach and needs to be part of a culture of continuing financial management, not just the spending review process itself. The formal methodology of zero-based budgeting has been in use for 35 years and is seen by some as cumbersome and outdated.[48] But the same insights should be reaffirmed in new ways: budget processes should start from small components and first principles; include more opportunities for participation; and become part of a culture of ongoing financial and performance improvement.

Coordinating tax, spending and non-fiscal policy

Budget holders should have a greater role in developing options for ministers, reflecting key trade-offs within their spheres of responsibility. But ultimately it is for ministers and the government at large to make the key judgements and trade-offs regarding the overall composition of spending, taking account of all the consequences. Looking wider still, the government should resist taking decisions on spending in isolation from other strategic decisions, regarding tax and non-fiscal policy.

Often different policy levers are alternative means of achieving the same ends and necessarily interact with each other. For example, efforts to reduce income inequality and poverty depend on public services, taxation and social

security reforms, and often one will be an alternative for another. It is critical that the spending review process works with the grain of this interaction on a collective, cross-government basis. Within the Treasury there is a good deal of coordination across these decision points, but we think the government should aim for a single public process that encompasses the design of taxation; the setting of the spending 'envelope'; the design of social security entitlements; and the allocation of 'discretionary' spending. This would imply that the spending review should become part of a set of periodic, scheduled reviews of all areas of taxation and spending, with the final announcement covering broad strategy across all these fields. It will always be necessary to review tax on an annual basis and budgets should be used to flesh out the detail of broad strategies, but there is also a good case for a more fundamental review of the tax system that might take place once in a parliament.

With severe constraints on public spending, government should also look to alternatives to spending or tax rises. Major policy interventions which might have a discernable impact on public spending or tax revenues should therefore be considered as part of the spending review process. Two examples bring this point to life:

- Inequality is tackled by tax, social security and public service delivery. But there is currently a great deal of interest in the prospects for reducing market inequalities, to reduce the need for redistribution by the tax and benefit system (so-called 'predistribution'). For example, a significant increase in the minimum wage might bring similar benefits as changes to tax or social security.

- Helping people save or insure themselves with private products helps to spread resources and manage risks without extra public spending. This approach is at the heart of the recent pension reforms which automatically

> enrol workers into private pensions. With little prospect of spending on new entitlements, similar principles could be applied in other areas from unemployment insurance to paying for care.

Publication of draft plans

We think ministers should consider publishing draft spending plans, although we are realistic that this might not be possible given the limited time available to set plans for 2016/17 in the period after the next election. A draft plan could set out worked-up proposals for spending in the next few years, both in totality and at the level of major budgets, taking account of the multi-decade direction presented in the long term expenditure statement.

This would be another significant break from the past. Traditionally budgets and spending reviews are highly secretive and when decisions are announced they are already cast in stone. Scrutiny by parliament is minimal, considering how important these decisions are.[49] For example, the Treasury select committee conducted an inquiry published little over one month after the 2010 spending review announcement.

The draft spending plan would give parliament, policy experts and the media the chance to comment on relative priorities, review the evidence and rationale informing decisions and highlight unforeseen consequences. This more deliberative approach would also serve ministers' interests, since it would create the space for them to change their minds without it creating humiliating climb-downs.

Enhanced parliamentary scrutiny

We also recommend institutional reforms to give parliament more involvement and oversight in the spending process. The new approach to consultation we outline here would

work best alongside increased parliamentary and institutional oversight of the spending process. As a first step parliament should establish a budgetary committee with a mandate to work on public spending and fiscal questions.

The remit of the committee would need to distinguish it from the existing Treasury and public accounts committees. However, these are two of the most important and over-stretched committees in parliament. We are confident there is room for a dedicated committee to oversee fiscal and budgeting decisions. Indeed the fact that its absence goes unremarked shows the extent to which UK parliamentarians and policymakers are normalised to secrecy and unchallenged executive authority.

As part of a new culture of scrutiny and openness, the government should also seek to reduce the complexity of the information on spending reported to parliament and the public; and provide better guidance on how data should be used and interpreted. The present government's decision to set up the OBR and be more transparent with data has been an important development, but more progress is needed. Even experienced parliamentarians find it very difficult to draw a clear picture from the many different sources of data about the public finances. Clear and accessible retrospective information, as well as independent forecasts, are needed to support better scrutiny during the decision-making process.

The Office for Budget Responsibility (OBR)

We recommend that the OBR is re-established as an independent body reporting to and advising parliament and its select committees in order to support parliamentary scrutiny and enable policymakers to consider plausible alternatives to existing government policies. The office should be tasked with responding to requests for information from parliament and undertaking studies which it considers

will advance public understanding of spending and fiscal choices. As part of this work it could evaluate the costs of policies in election manifestos by the main political parties.

The body would have a role similar to the US Congressional Budget Office (CBO), an independent body providing long-term analysis and conducting studies at its own direction. Its main remit would be to inform and serve parliament, but it would be strictly politically neutral and independent, in the same way as the National Audit Office (NAO). The specific detail of the OBR's enhanced role might take shape through evolution over time and we recommend a regular review of its work. Figure 9 sets out some of the possibilities.

We suggest that the OBR should make several interventions during the spending review process: first it should publish 'options analysis' reports (covering both the immediate spending period and long-term options); and only later in the process provide an independent costing of the government's final decisions.

Figure 9: Possible further responsibilities for the OBR

Current role of the OBR	Possible further responsibilities
Economic and fiscal forecasts, based on existing government plans	Scenarios for economic and fiscal forecasts, based on proposed alternative fiscal and spending policies
	Sensitivity analysis of fiscal data based on alternative economic projections
Assessing progress towards the Government's fiscal targets	Advice on the appropriate design of fiscal targets to meet broad policy aims, such as long-term debt reduction
Long-term sustainability of the public finances	Scenarios for long-term sustainability, based on proposed alternative fiscal and spending policies
Scrutinise Treasury's costing of budget measures	Scrutinise costs of a wider range of departmental policies not just those announced in the budget
	Independent assessment of costs of alternative policies proposed in parliament and by opposition parties
	Totally independent costing of policies (ie not just signing-off government assumptions)

3 | BETTER SPENDING CHOICES ACROSS GOVERNMENT

Chapter 3 looks at how the public sector can become more focused on outcomes, deliver improved performance and manage money better. We note that this requires adequate public sector leadership and oversight capabilities, which could be endangered by further cuts to spending.

- *An Office for Public Performance should be created as a powerful independent cross-government body, tasked with championing excellence, driving productivity improvement and encouraging innovation. In doing this it will help improve the use of public spending and help build trust in public services.*

- *Spending decisions should not just be about allocating resources, but also what is to be achieved with the money. Setting and monitoring goals regarding performance should be a key part of financial decisions and wider public service governance, learning from the best of international practice in measuring and improving performance.*

- *We want to see more public money diverted to early intervention: all spending decisions should include a '10-Year Test' which considers long-term impacts, including the effects on society and other public agencies; local government should coordinate and scrutinise all local public service*

spending decisions to champion joined-up early action; and in the absence of sufficient progress, ministers should consider mandating budget holders to 'switch' a proportion of their annual spending from existing activities to early interventions, beginning in the second half of the next parliament.

- *Other proposals to promote long termism include a requirement to announce the 'year 10' costs of all decisions; better accounting practice to take account of the assets and liabilities created by budgeting decisions; and an approach to defining national debt that removes any artificial hindrance to commercially-sound borrowing by public bodies, while also maintaining tough fiscal discipline.*

- *Flexibility and innovation in local level decision making has the potential to overcome budgetary 'silos'. We support more spending power for city regions and clusters of local authorities; a clear and consistent message from government that local agencies have permission to innovate and experiment within national frameworks; and local government leadership in coordinating all local budgets.*

The spending review process is a critical moment in the political cycle, but good use of public money depends just as much on continuous year-round choices. In this chapter we look at how the public sector can become more focused on outcomes, deliver improved performance and manage money better. At the heart of many of these challenges is the need to give public services a more long-term focus (something made even harder by current financial pressures). It is not just spending review announcements but all spending choices which need to embrace a decade-long perspective.

Before beginning it is worth noting however, that none of the reforms we propose in this chapter will be possible

if the public sector's leadership and oversight capacity shrinks beyond a sustainable level. Sooner or later reductions in the capability of public management (within the civil service and beyond) will prevent innovation, efficiency and wise spending decisions. Similarly if external regulators, inspectors and auditors do not have sufficient resources, the costs to the public sector are likely to far outweigh any immediate savings. We do not have evidence to say whether further cuts to management and oversight functions are yet unsustainable, but it is an important risk for decision makers to consider as they plan future spending allocations.

Driving performance and better outcomes

In our work we repeatedly heard how public services need to be far better at: focusing on the outcomes they achieve for citizens; driving performance and productivity improvements; and adopting innovations which lead to better results through major transformations. The most consistent message was that public services still need to do much more to adopt an ethos of 'early intervention' and long termism. We also took evidence on the need for performance and financial management to be stronger; and on how greater citizen participation and control can in many instances lead to better outcomes without spending more money, while also establishing more reciprocal relationships based on rights and responsibilities.

Driving performance, productivity and value for money includes three core elements:

1. *A performance framework with clarity regarding the outcomes the government wishes to achieve:* the government must be clear what it expects to be achieved from public spending; and the measures it will use to know it has succeeded. There must be appropriate incentives,

clarity of roles and responsibilities and capacity building. It must have a framework in place, which not only links its budget to its priorities; but also has suitable mechanisms of accountability, monitoring of progress and approaches to mediate when progress is not sufficient for citizens.

2. *Understanding costs and improving productivity:* It is critical that the costs of goods and services are known and that there is an active programme, including benchmarking, that leads to better results for less in each public service sector. This will involve building new approaches and better understanding of productivity. Examples include the introduction of day surgery and shifting government transactions from face-to-face to online. Of course in some areas it is undesirable to reduce staffing levels but in others new technologies and redesigned services can lead to better outcomes with fewer inputs.

3. *Delivering outcomes from a citizens' perspective*: this can be thought of as 'doing things differently' to achieve better outcomes, as opposed to doing 'more for less'. Most public service outcomes are co-produced with citizens and are often enhanced though the alignment of departmental programmes and departmental collaboration. This means eliminating duplication arising from 'silos' and aligning services involving multiple agenices, by working directly with citizens or communities. Examples include community safety, children in need and preventative services.

A robust focus on these challenges is essential both during and between spending reviews. In chapter 4 we discuss how the need to focus on outcomes, intervene early and demand performance improvements should be key 'tests' for making and evaluating spending decisions.

Performance and financial management

Public spending decisions should not just be about allocating resources, they must be about what the money will bring about too. Evidence from the OECD shows that the use of performance information in budgeting is associated with a greater clarity regarding how government aims are to be achieved, enhanced transparency and greater efficiency.[50] We therefore want to see spending decision-making incorporate considerations of performance to a much greater extent. The last Labour government made significant headway in making better use of performance information, through setting and monitoring outcomes. This approach has been largely abandoned, just as countries around the world were emulating the UK's approach.[51] We recognise that New Labour became overly-focused on achieving change by chasing progress against top-down performance targets. However, the basic idea of expecting budget holders to account for the results they achieve with the money they have remains valid. We want the UK to again be a leader in the use of performance information in the budgeting process, even if this happens in a less centralised context, where power and responsibility is more widely distributed. This should not mean developing thousands of detailed performance measures and a huge accompanying bureaucracy. But it is essential that governments set specific and measurable objectives for what they want public money to bring about. Whenever possible the aim should be to judge performance in terms of what is achieved for people's lives, not just the level of activity delivered.

Similarly, there is a good case for integrating spending decisions much more closely with ongoing financial management within government. The Institute of Chartered Accountants in England and Wales (ICAEW) have proposed that the Treasury should have stronger overall responsibility for controlling government finances after

allocations have been made, with active ongoing management of expenditure effectiveness, rather than just a 'budgetary' focus on overspends and underspends. It also recommends better balance sheet management across government to use cash and assets well. The institute recommends that this work should be led by a cross-government chief finance officer reporting to cabinet.[52]

An Office for Public Performance

By 2015 much of the institutional machinery the previous government used to improve public sector performance will no longer exist. The current approach to department 'business plans' is not sufficient to enable the cabinet, though the Treasury and Cabinet Office, to effectively scrutinise performance and support improvement. Additionally the Audit Commission, which drove significant improvements within local government, health and housing, will have closed. The National Audit Office (NAO) continues to do commendable work but its role is scrutiny and only a small part of its value for money activity comments on progress against standards and objectives. We therefore recommend the creation of a new 'Office for Public Performance'.

We believe that this new strategic office would fill an important gap, established perhaps as a non ministerial department or non departmental public body reporting to the prime minister. There are already sector specific bodies with responsibility for defining standards and monitoring performance. The best, like NICE, have established global reputations but other regulators are weak and underresourced. The NAO does excellent work on behalf of parliament but it is limited by resources and its remit is retrospective and at times it can take too cautious an approach to evaluation. We think there is a case for a forward looking and contemporaneous body, with a more direct link to ministers to advise how their objectives can be achieved.

The office would be an agency reporting to government, along the lines of existing regulators, with a governance structure which creates space for independent-minded, evidence based analysis and recommendations. It would be a powerful strategic body tasked with championing excellence, driving productivity improvement and supporting innovation. It would also be tasked with identifying the reasons for poor and coasting performance and so help to deliver better outcomes and value for money. In line with the approach to spending articulated in this report, the office would help ensure that as much attention is focused on what spending decisions are intended to achieve as what they cost, informing a better public conversation about spending. Obviously creating a new agency would come with a price of its own, however we are confident that it would pay for itself many times over through driving improved value for money across the public sector.

Figure 10: Possible functions for an Office for Public Performance

Supporting continuous productivity improvements	• Become a global expert on evidence-based approaches to benchmark and improve performance and drive value for money in the public sector. • Be a centre of knowledge on prevention and early intervention, alongside experts such as the early intervention foundation
Coordinating and spreading excellence between sector-specific bodies	• Act as a hub for coordinating approaches and driving good practice among public agencies responsible for setting standards, monitoring outcomes and driving performance improvement.
Monitor performance and evaluate the effectiveness of policy	• Assist government in measuring priority objectives and indicators and assuring action where performance is off track

Making ‘early action’ happen

‘Early action’ or ‘early intervention’ are catch-all terms to describe preventative policy interventions and services which aim to ameliorate the causes of social needs rather

than address their symptoms. The NAO has identified individual cases of public bodies using spending reductions as an opportunity to shift spending away from managing costly, acute needs.[53] But early intervention does not appear to have become an organising principle for making spending reductions. Indeed in some cases progress has been backwards, for example in the number of people receiving support from adult social care.[54] We think a stronger focus on early intervention should be central to a strategic reorganisation of public spending which can serve future social needs.

In this area, policymakers in England could learn from practice in Scotland and Wales since 2008. The Scottish government has ring-fenced significant sums for prevention. The Christie Commission into public service delivery in Scotland recommended that 'the adoption of preventative approaches...will contribute significantly to making the best use of money and other assets'. The Welsh government's future generations bill will impose a duty on public bodies to promote social, economic and environmental sustainability which incorporates early action and prevention.

We received detailed evidence on the cultural, institutional and organisational barriers to greater levels of preventative public spending. We have three recommendations to overcome these obstacles.

First, we think that the social and economic impact of policy choices over time need to feature much more prominently in budgeting decisions. As a commission we fully endorse the Early Action Taskforce's proposal for a '10-year test' as one way of achieving this. A 10-year test would require budget holders at all levels to consider the economic and social impact of decisions over the next decade. This would require budget holders to publicly examine when their decisions: (1) lead to higher costs in the future; (2) build up future liabilities; (3) generate higher costs in other parts of the public sector; (4) produce social benefits that will arise after the budget period; (5) damage

society and the environment over time. To be as effective as possible the ten-year test should evolve into a public 'event' which would enhance accountability; and prevent short-term political calculations blocking decisions that will reduce future demand for services.

Second, we believe that the local authority is the best placed local agency to drive and coordinate much of the shift to early intervention as they are close to the communities they serve. Later in this chapter we propose an enhanced role for councils in coordinating the spending decisions of all local public agencies. Driving the shift to early intervention is one of the main reasons we support this approach.

Our third proposal arises from the possibility that neither of these other two measures will be enough to drive significant shift in resources towards long-term spending. In this case, the next government may want to be more prescriptive and require budget holders to switch a proportion of their annual spending from existing activities to early interventions. Such an approach would be difficult to police, particularly at the boundary between early and reactive spending. But over the life of a parliament top-slicing small amounts of money across public sector budgets would generate a significant pool of resources dedicated to early action and would focus minds in financially constrained times. In the early months of the next parliament, ministers should establish a process and timetable for evaluating whether sufficient change is taking place, with a view to introducing 'top-slicing' in the second half of the parliament if needed.

Other ways to promote long-termism

'Year 10' costs

We have three other proposals to extend financial planning into the long term. First we want to see spending decisions across the public sector informed to a greater extent by an

assessment of the long-term costs. Impact assessments are intended to give decision makers a good understanding of the likely long-term costs and consequences of proposed policies, but it is unclear how far they affect decision making.[55] For example, the Department of Health recently announced its new social care reforms would cost an extra £1bn by the end of the next parliament. However, the official impact assessment revealed the costs would rise to £2.3bn by 2025 and this important information did not feature in the public debate.

To achieve a better understanding of the costs attached to policies, spending decisions should be published with 'headline' 'year one' and 'year 10' net costs for the budget holder and the public sector more widely. This would act as a high profile supplement to government impact assessments by generating more publicity and accountability.

Accounting practice

A shift toward open, transparent and long-term decision making in public spending decision should be reflected in government accounting practices. The UK is a global leader in public financial transparency. It has made significant progress in implementing accruals accounting and now publishes 'whole of government accounts' on this basis.[56] Accruals based accounting recognises a transaction once a decision with financial implications has been taken. By illustrating the assets and liabilities on the government balance sheet it provides a more complete picture of financial health.

Sophisticated accounting practices of this kind can empower government to make more informed spending decisions. But at present, accruals accounting is mainly used retrospectively for financial reporting, rather than the more useful purposes of balance sheet management. We recommend making greater use of accrual accounting in

setting budgets, which would encourage a long-term perspective in three ways:

1. Spending which creates an asset would be treated differently from that which does not (eg public borrowing to pay for public housing stock does not affect the overall balance sheet if the new liability is matched by a new asset).
2. The full costs of future liabilities would be more transparent (eg private finance initiative (PFI) projects are accounted for at the outset, enabling policymakers to make a transparent 'whole life' appraisal of different funding options).
3. Plausible risks of future government spending would be recognised as 'contingent liabilities'. This enables the government to issue loans or guarantees against its assets, while also showing these are not risk-free (eg the coalition's property market interventions).

Recognition of public debt

In addition to a more sensible use of accruals accounting, the government and ONS should review how some borrowing by public institutions is classified for the purpose of the national debt. To build a long-termist approach to financial management, we want to see national debt defined in a way that does not stymie prudent self-financed investments, for which the Treasury is extremely unlikely to ever need to assume liability.

First, the UK uses a broader definition of debt than most economies, and a shift toward using the headline measure of 'general government' rather than 'public sector' debt would bring the UK into line with many other EU countries as well as standard measures used by the European Commission, International Monetary Fund and rating agencies.

Second, the UK could benchmark itself against other nations with strong credit ratings regarding different approaches to the recognition of debt. The aim would be to adopt any sensible practices used elsewhere to prevent the artificial hindrance of commercially-sound borrowing in the public sector. For example, the commission heard that in Germany state-owned regional banks and house-building programmes are largely excluded from headline national debt.

However, any reform would need to be tightly supervised by independent agencies to provide reassurance that it would not undermine overall fiscal discipline. The OBR as well as the ONS would need to sign-off implementation to avoid any sleight-of-hand during transitions; and tough independent supervision of local government and public corporations would be needed to ensure that their borrowing is affordable.

Local government

The commission heard evidence of the dangers presented by institutional and budgetary 'silos' for wise public spending. Rigid central spending allocations can inhibit preventative interventions across service boundaries; make it harder to join-up services around their users; reduce incentives to collaboration; and create duplication and increased overheads. Many commentators propose that greater local decision making is part of the answer. The purpose of this commission is not to weigh up the case for and against localism. However, we support a number of reforms which could lead to more responsive and accountable spending, within the broad framework of England's existing settlement between national and local government.

Greater power should not come without responsibilities, however. We want to see local government embrace our key recommendations on a shift to long-termism and

performance improvement. For example councils, just like central government, should be expected to undertake a 'ten year test' and publish the 'year ten' costs of their decisions.

Clusters and city-regions

We want to see a bigger role for city regions and other local authority clusters, such as the Greater Manchester combined authority and the Greater London Authority. Many activities can be carried out more efficiently at levels above individual local authorities to increase productivity and concentrate specialist expertise (eg procurement and back-office functions). Large geographic areas are also strategically more appropriate for many functions, including economic development, transport, employment and skills, which were the subject of the Heseltine review's recommendations on sub-national spending.

At present ministers are encouraging local cooperation between local authorities without taking a strong view on how this should develop. A more hands-on approach may be needed in future, particularly as there are competing sub-regional approaches (eg city deals; combined authorities; local enterprise partnerships) with little clarity regarding the end-point of current experiments. In particular, a future government may need to consider structural reforms, if today's piecemeal initiatives prove insufficient.

Giving 'permission'

We want to see a climate of experimentation and diversity in the way services are delivered, within existing national frameworks regarding outcomes and entitlements. We heard evidence that national standards place fewer restrictions on local agencies than is often assumed. The barrier to innovation is often simply one of mind-set, capacity

and a sense of permission. Central government should say loudly that public bodies need to innovate and experiment within existing national financial and accountability structures. Ministers must also avoid the temptation to intervene in an ad hoc or retrospective manner with respect to issues which are not of national importance and should be left to local decision makers and their citizens (eg the frequency of refuse collections).

In exchange government should seek reassurance regarding the basis on which local autonomy will be exercised, with respect to: involving and responding to local residents; using evidence to design and evaluate services; a long-term outlook; and strong financial and performance controls. In other words, ministers should find ways for many of our recommendations for central government to cascade down to the local level.

Local government leadership

Local government should have a greater role in decision making and scrutiny with respect to all public money spent locally, even if there are no immediate plans to hand other agencies' budgets over to councils. This approach is being tested with the creation of health and wellbeing boards which give councils oversight of NHS spending and a limited role in joining up provision across agencies. The Labour party is consulting on a more radical model which would give local government the responsibility for commissioning NHS services, albeit with a still ring-fenced budget and clear requirements regarding the outcomes to deliver. The same approach could be applied in areas such as skills and employment, with central government allocating a fixed budget for a function but councils having control or influence over how it is spent.

Greater council involvement in all local level spending decisions should facilitate a more flexible approach, with

a blurring of the lines between agencies' budgets, joint decision-making and joint commissioning. We are open minded about the institutional arrangements required to make this happen (eg pooling budgets; lead commissioners acting on behalf of others; full-scale mergers of services). What matters is achieving a change in culture, so that joint decision making reaches deep into core activities, rather than just applying to a few marginal projects.

4 | TESTS AND TRADE-OFFS

Chapter 4 sets out eight 'tests' for spending choices and examines three major trade-offs that have informed our thinking.

- *The eight principles against which spending choices should be tested are:*
  1. *Work backwards from the outcomes you wish to achieve and how these can be realised in partnership with others*
  2. *Invest in early intervention*
  3. *Demand productivity improvements, innovation and citizen participation*
  4. *Promote broad-based growth, employment and prosperity*
  5. *Distribute resources and insure risks over the life-cycle*
  6. *Reduce inequality, poverty and unequal opportunities*
  7. *Take a long-term, global perspective*
  8. *Act where the market cannot*

- ***Trade-off 1: how to balance between the future and the present****? We argue that governments must be committed to sustainable levels of debt relative to GDP and should have the long-term objective of returning public debt towards its pre-2008 levels over the coming decades. We also examine the balance between 'future' and 'present' oriented spending. The latter (eg pensions and healthcare) is very important, but should not squeeze out the former*

(eg education and capital investment). We would ideally like future-oriented spending to rise as a share of national income, since it is in the process of sinking below levels seen in recent decades. For this reason policymakers may need to consider policies to restrain the pace of growth in pension and healthcare spending, so long as this does not undermine good quality, universal provision. Even then, higher levels of future-oriented spending may not be possible unless overall levels of public expenditure rise.

- ***Trade-off 2: restrain spending or increase taxation relative to national income?*** *Over the next decade and beyond there will need to be tight restraint on public spending. However, we believe that policymakers should be open to the possibility of expenditure rising as a share of national income, since there are significant upward pressures on spending; even good progress on public sector performance and productivity is unlikely to offset them all. In the long term, freezing spending as a share of national income will only be achieved by reducing the generosity of entitlements or abandoning universal provision in pensions and public services, which we do not think is desirable. This conclusion, alongside our commitment to reducing national debt over time, leads us to believe that some increase in tax revenue, as a share of national income, is likely to be necessary over the next two decades.*

- ***Trade-off 3: how much to prioritise addressing inequality?*** *The scale of government action to address inequality is linked to both overall levels of spending and also to the composition of that spending. We believe resources for public services should be allocated according to evidence-based assessments of needs, at geographic or household level. We are concerned that social security policies will increase poverty and inequality over time and we would like to see reforms to entitlements and to the wider economy which enable low*

income groups to keep up with everyone else. In the next parliament ministers may need to consider reducing social security entitlements further but the acceptable room for manoeuvre is limited, as we do not support measures that will reduce living standards for low income households nor make deep inroads into universal provision.

The rest of this report looks at the spending choices facing future governments, both over the long term (the next 20 years) and during the 2015 parliament. In this chapter we review the most important trade-offs for decision makers. There will be very difficult decisions over both these time periods and we think that only by proceeding with a clear idea of priorities can government hope to take these decisions in a way that is fair and builds the foundations of future prosperity.

Tests for spending decisions

In chapter 2 we recommended that ministers adopt a set of principles or tests to help them make decisions in a consistent and open fashion. Here we present a set of tests that we have used to guide our own thinking and which we recommend to decision makers in government

We think that adopting principles along these lines will help to: expose competing priorities and assumptions; provide clarity and coordination for dispersed decision makers; and enable external participation and scrutiny which engages with the government on its own terms. In other words, spending 'tests' should be a tool for clear thinking, coordinated and consistent upwards input, and open dialogue.

Our first three priorities are concerned with the way money is spent as well as the allocation between areas. They are therefore relevant far beyond the narrow confines of a spending review and are critical to ensuring that

BOX 5: Eight 'tests' for public spending decisions

1. **Work backwards from the outcomes you wish for and ask how these can be realised in partnership with others:** We think spending decisions should be made in the context of governments' long-term ambitions for the outcomes of public spending. To ensure that it is pursuing the most effective and affordable course governments should ask how outcomes can be achieved in partnership with citizens, companies and civil society rather than alone. For example, can helping people to save or insure themselves with private products achieve comparable outcomes to public spending; or would regulation of companies' behaviour lead to less hidden subsidy from government?

2. **Invest in early intervention:** A greater level of resources should be invested 'upstream' to prevent the causes of problems occurring rather managing acute demand. Allocating more money to effective early action can deliver better outcomes for services users and provide better value for money.

3. **Demand productivity improvements, innovation and citizen participation:** Achieving productivity, or getting more from each pound of spending, needs to be at the heart of good public spending decisions. This will mean designing spending processes so they emphasise performance and productivity improvements that need to go hand in hand with spending. Decision makers should demand evidence of how agencies will push innovation and work with citizens and other institutions to achieve better results.

4. **Distribute resources and guarantee against risks across the life cycle:** Individuals encounter unknown risks at different stages of the life course such as illness or unemployment, and public spending is an essential system to guarantee against these risks. Public spending also 'smoothes' lifetime

consumption by redistributing resources at times of need that are planned for, such as child rearing and retirement.

5. **Promote broad-based growth, employment and prosperity:** Spending that promotes employment, rising earnings and innovation should always be a key priority. Over the long term public spending decisions need to also ensure broad based distribution of prosperity and spatially-balanced employment.

6. **Reduce inequality, poverty and unequal opportunities:** A key test of public spending decisions should be whether they reduce or exacerbate poverty and inequalities. This applies to broad socio-economic inequalities as well as disadvantage linked to dimensions such as age, gender, race and disability.

7. **Take a long-term, global perspective:** A long-term and global perspective should inform all decision making. A long-term, cross-border perspective is particularly important for considering the continuing case for spending in areas such as as security, international commitments and investments to reduce carbon emissions and preserve the natural environment.

8. **Act where the market cannot:** There are areas of shared national life where the market cannot deliver. This includes what economists call 'public goods' which we can all enjoy together and from which no one can be excluded (security, public spaces) as well as services whose character and social benefit may derive from being free or delivered on a non-profit basis (the BBC, children's playgrounds).

government can meet the public's rising expectations with limited resources. Organising public spending according to these principles will contribute to the next government's capacity to reengineer how it works to meet people's needs and aspirations and do more with limited resources.

The question of how to balance our fourth, fifth and sixth principles is a critical judgement for long and short term policy. At present governments are implicitly prioritising the fourth over the fifth and sixth. But we think there is a strong case for a more even balance between the three. In particular we believe that supporting balanced growth in earnings, employment and economic output should be given more consideration in budget decisions, large and small.

In many cases the application of these tests should take place at a very granular level. They should act as the framework for participative, bottom-up dialogue and appraisal. However they also throw up some fundamental questions which need to be resolved to answer questions about the overall direction and priorities for public spending. In the rest of this chapter we consider three key trade-offs thrown up by these tests.

Trade-off 1: prioritise the future or the present?

Fiscal sustainability

In thinking about the public finances today, we should be mindful of the needs of future generations. We believe it is right to borrow to mitigate the effects of economic crises and to create assets for the future but that, in general, a high and rising level of public debt is undesirable. In particular, if policymakers were to maintain debt at today's levels on a permanent basis, while there might be few consequences in normal times, the UK would not have room for manoeuvre should another major fiscal crisis occur. As a commission we are committed to sustainable national debt and support the goal of returning public debt towards pre-crisis levels over decades. New fiscal rules should be developed to create a transparent means of monitoring progress towards that goal.

The OBR's fiscal sustainability report considers the action required for debt to return to 40 per cent of GDP

by the early 2050s or early 2060s. This analysis shows that to reduce public debt, policymakers will need to maintain a significant gap between non-interest revenues and non-interest expenditure (called the 'primary surplus'). On the basis of current policies and projections, the OBR calculates that this gap will be 2.1 per cent of GDP in 2020/21 and it suggests it should be 1.3 per cent in the early 2030s.[57] A different benchmark for future debt levels would change the precise level of these fiscal requirements (for example the OBR also considers what would be required to achieve public debt of 60 per cent of GDP). However, economic and demographic variables, which are uncertain, have a far greater influence on the amount of fiscal 'tightening' likely to be required: what matters is that governments are committed to making progress in the right direction not the precise long-term target they aim for.

Meeting conditions regarding sustainable debt (over each economic cycle) should be a long-term priority, which should not be set aside by the short-term temptation to cut taxes or spend more. From the perspective of paying off debt, it does not matter whether stable finances are secured by restricting spending or increasing taxes. Both high and low spending alternatives are compatible with fiscal responsibility. However, the prognosis for public debt would become a great deal easier if higher rates of trend growth could be achieved and, in part, this depends on growth-oriented spending choices: we believe that decisions about future levels and composition of spending should be taken with growth in mind.

Future or present oriented spending?

Responsibility towards the future is not just a question of debt, but also of the balance of expenditure. There is a difficult trade-off to make between present-oriented and future-oriented spending. At a detailed level, within many

policy areas, there is an import balance between 'early action' and meeting needs as they present themselves; in chapter 3 we argue for reforms to achieve a more preventative approach. However, there are also major choices in the broad allocation of resources across spending areas.

Spending on 'the present' includes pensions and healthcare, which are skewed towards older age groups. We strongly support spending in these areas as part of a strong welfare state which smoothes resources over people's lives, mainly on a universal, collectivist basis. Expenditure in these areas is also very popular and provides a stable source of economic demand. However, with rising pressures in these fields, there is a risk that future-oriented spending will be squeezed out. This spending includes expenditure on children and young people, skills, innovation and long-term infrastructure and can be expected to increase future wellbeing and economic output. In addition, further government spending may also be needed in order to decarbonise the economy, to complement tax and regulatory policy.

The trade-off between present and future oriented spending will pose immediate dilemmas for a 2015 government, which will inherit plans to spend considerably less of our national income on education and capital spending than was the case before the crisis. In 2007/08 education spending stood at 5.4 per cent of national income and the OBR projects it will sink to 4.5 per cent by the end of this decade (education spending will not have been lower since the early 1960s). Similarly, gross capital investment in 2017/18 is projected to be 2.8 per cent of GDP, which is below the average for the 1990s and 2000s and far beneath levels seen from the 1950s to 1980s.[58] Sticking to this low level of public investment will have a significant long-term effect, unless the money can be substituted by increased private investment (some of which could be promoted and channelled using public guarantees or new public institutions).

We believe that, over time, governments should seek to increase future-oriented spending as a share of national income from its current low levels. This should ideally be the aim for a 2015 government, although it will face heavy constraints in achieving this; in practice preventing further decline might be a realistic first objective. In the short term a future government might choose to treat spending on capital, skills and economic programmes no less favourably than the NHS. Over the long term, in order to increase future-oriented spending, it may be necessary to identify ways to rein in rising costs of healthcare and old-age social security at the margins, while maintaining good quality, universal provision. But future governments may also need to accept that more future-oriented spending will not be possible unless overall expenditure rises as a proportion of GDP.

Trade-off 2: restrain spending or increase tax relative to GDP?

The overall level of spending and taxation is the sum of hundreds of spending and revenue streams. From a 'bottom up' perspective, it is important to debate the desirability of different levels of spending and taxation in each of these areas. But we also need to look 'top down' to ensure that the future direction of spending and taxation policies are fiscally and politically sustainable.

Spending

Levels of spending are political choices but there are also practical constraints. In chapter 5 we chart the upward pressures on public spending which mean that the 'default' is for public provision to cost more over time, not just in real terms but as a proportion of GDP. These pressures include demographic change and increased public demand for

services as a consequence of growing prosperity. Rising costs in the public sector also create upward pressure on spending, although that can be partly countered by robust efforts to improve performance, productivity and value for money. This all means that over the long term, if public spending is to remain roughly stable as a share of GDP, there will need to be a reduction in the generosity or coverage of entitlements, relative to national income.

In some cases outcomes would simply be worse as a result. For example people with low incomes would be poorer and less able to secure good healthcare. But in other cases there would be a rise in private sector provision, either in a gradual, unplanned fashion as users of services made individual choices that public provision was inadequate; or as the result of policy decisions, for example to cease providing an entitlement on a universal basis. In this case all the same upward pressures would continue to exist, they would just effect private sector consumption rather than public spending. People would have to pay one way or another, through higher taxes or higher personal charges. In some cases the idea of most people topping up public provision with their own arrangements is well established and unproblematic: it is desirable for people to save for a pension or insure themselves against loss of income beyond what the state is able to offer. But with respect to public services, growing private involvement would not only be less equitable it would probably be less efficient, as the United States' experience of healthcare demonstrates.

If possible we wish to avoid moves in this direction and so we are open to the possibility of moderate increases in expenditure as a share of national income over the long term (see chapter 5). This will not avoid the need for tight controls on spending and tough action on public sector performance. However, it will only be possible to contemplate spending rising by more than GDP once deficit reduction is complete. In the meantime, the choice facing

policymakers is the pace at which spending lags behind economic growth. In chapter 6 we review the options and recommend less spending restraint than envisaged by the current government's plans.

Taxation

While there are clear upward pressures on public spending, the prognosis for taxation is more balanced. In the short term, with no changes to tax policies, an economic recovery should lead to a cyclical increase in revenues, although it is hard to predict how growth will feed through into tax-generating activity. Over the long term there are downward and upward pressures on revenue which roughly balance out. Over time revenues can be expected to rise as a share of national income due to 'fiscal drag' (the practice of linking tax thresholds to inflation not earnings). However, the OBR also highlights a number of areas where existing revenue streams may decline (eg oil and gas revenues, transport taxes, environmental taxes, tobacco duties, corporation tax).[59]

Future governments will need to decide whether tax changes should be broadly fiscally neutral or whether it is possible and desirable to gradually increase the overall tax share. This would be necessary if governments wish to both increase spending to reflect rising pressures and achieve sustainable public debt. There are likely to be significant political and practical constraints to a move in this direction, after 25 years of fairly stable levels of tax as a share of national income. However, a comparison with other advanced economies shows that the UK raises less revenue than many of its peers.

We believe that a moderate rise in taxation may well be the better option, when compared to the consequences for spending and outcomes of the alternative. This is a long term choice although some decisions on the tax share are

likely to be needed in the first half of the next parliament, as we discuss in chapter 6.

Trade-off 3: how much to prioritise addressing inequality?

Governments can equalise life chances and standards of living in three ways: by levelling-up opportunities through investment in the capabilities of individuals and communities; by shaping the working of the market economy so rewards are distributed more evenly; and by redistributing through social security, public services and taxation to equalise wellbeing in spite of market inequalities. The first and third of these strategies (which often overlap) entail significant public spending. Although options other than spending (eg market reforms or making taxation more progressive) have an important role to play, the evidence we have heard has convinced us that adequate levels of public spending, distributed in a way that takes account of social needs, remain an essential means of achieving a more equal society.

The scale of government action to address inequality is linked to both overall levels of spending and also to the composition of that spending. Our recommendation that resources should be refocused towards 'early action' and, more generally, towards 'future-oriented' budgets has the potential, if the money is spent well, to reduce inequalities in life chances. However despite this it is likely that future governments, with limited resources, will find it difficult to avoid policies with some negative implications for inequality.

The allocation of resources

Public spending, as well as having universal aspects, should benefit people from low income groups more

than anyone else: not only do poorer families typically receive more public support, but any specific level of resource is expected to make a greater difference to their lives, compared to those of people who start with more. However, for decades policymakers have discussed the 'inverse care law', the insight that those who need the most support often experience the lowest standards. This is partly explained by the 'sharp elbows' of higher income groups, but it can also be put down to the allocation of public money, which does not fully reflect the higher need for services linked to social disadvantage. Both the Labour and coalition governments have attempted to counter this phenomenon: for example Labour established children's centres and academy schools in low income neighbourhoods first; while the present government has introduced a 'pupil premium' in schools and a new university funding system which each target funding to children from low income families.

However the coalition has also reduced the account taken of deprivation in its geographic allocation of resources for both health and local government (Labour in government had increased both).[60] This stores up problems for the future and a 2015 government should seek to reverse these changes, where it makes sense and within existing spending totals. Future reforms to needs-based allocations should seek to establish wide agreement on the nature of varying needs and costs, to avoid this topic becoming excessively politicised. Demographics, population scarcity and social disadvantage all need to be weighted, alongside geographic variations in the costs of service delivery.

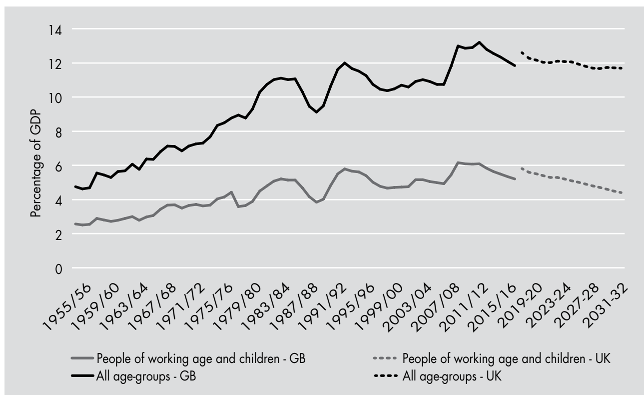
There is also the issue of spending allocations between the nations of the United Kingdom, which is based on historic spending patterns not social need. Our remit has been Westminster public spending and we have not considered allocation between nations. We note that in 2009 a House

of Lords select committee called for the replacement of the Barnett Formula with a needs-based allocation system.[61]

Social security

The coalition government has made significant reductions to social security, which can be expected to increase levels of poverty - although pensioners have been exempted. However, there are also long-term problems with social security that are less widely recognised: the underlying design of legislation will drive up poverty and inequality over time unless action is taken. This is because the law increases non-pension benefits in line with prices, which normally rise by less than average earnings. We do not believe that an assumption of rising poverty should be designed into long-term social security policies.

Figure 11: Social security spending as a percentage of GDP, including projections based on current legislation



Source: Benefit expenditure and caseload tables 2013, DWP, 2013; Fiscal Sustainability Report 2013, OBR, 2013. Notes: DWP projections until 2017/18; subsequent projections are Fabian Society calculations, extrapolating from OBR data (OBR projections are based on earnings indexation, but the office publishes the variance implied by current policies for the year 2032/33 only).

Many people assume that spending on social security is on an upward trajectory. However Figure 11 shows that on the basis of current policies, social security will decline as a share of national income (notwithstanding the upward pressures on pensioner entitlements). By contrast, the Department for Work and Pensions forecasts that linking benefits to earnings not prices (which would lead to stable levels of inequality in the absence of other changes) implies social security spending rising slightly in the years after the austerity cuts are complete. This illustrates the trade-off between the government's fiscal position and the extent to which policies mitigate inequality.

It will only be possible to combine spending a smaller proportion of GDP on social security with stable or falling levels of inequality by reducing demand for social security. In the short term we hope this might be achieved if better than expected economic growth leads to savings from labour market related social security. In the longer term structural economic reforms would be needed. For example, higher levels of pay, increased employment and more affordable housing could all reduce spending as a share of GDP (any increases in public spending in achieving these reforms should be more than offset by reduced social security and higher taxes). In each case to reduce inequality the savings arising from the reforms could be recycled into paying for more generous entitlements while maintaining the forecast level of spending.

However in chapter 7 we show that none of these structural reforms would generate significant savings in the short term. This means that in the early years of the next parliament adopting a more generous approach will be very hard. On current projections real social security spending will still be rising and very difficult short term decisions may be needed. In our view there is very little room for manoeuvre with respect to further reductions in entitlements, since we would be concerned to see

any measures introduced which would further reduce the living standards of people with low incomes; we also want to see the universal principle retained as an important component of social security. In chapter 7 we set out a limited range of reductions we think could be contemplated.

BOX 6: What about international commitments?

It is often suggested that with constrained public finances the UK should row back from its existing international commitments. Many people argue for a considerable reduction in UK defence spending, including an end to nuclear weapons. Others argue against the current prioritisation of international development expenditure in a time of spending restraint. The Conservative party has also launched a debate on the UK's continued membership of the European Union and one of the issues that will be discussed is the scale of financial savings withdrawal from the EU might bring. In 20 years' time it is possible to imagine the UK might have a very different global posture: spending less on international development, less on defence and no longer a member of the European Union. This would generate savings but they would take many years to accrue and would not be on a huge scale:

- *International development:* £6bn per year would be saved if international development spending was in line with the average for advanced economies.[62] We do not think the UK should change its approach to international development in the short term, but we propose that the next government should carry out a full review of the aid target, preferably on a multi-lateral basis, to assess whether it will remain appropriate into the 2020s.

- *Defence:* £11bn per year would be saved if defence spending was in line with the EU average. This change would however take some time to achieve.[63] The money might be used to reduce the pace of overall expenditure growth or transferred to other priorities. But there could well be downsides to this approach, with respect to the UK's global contribution and influence. As a commission we have not taken a view on whether this move would be desirable.
- *European Union:* In theory, an estimated £4bn per year might be saved if the UK withdrew from the EU (£1.4bn of which is international development spending).[64] However this saving would be easily wiped-out by lower tax receipts if exit led to weakened economic performance, and lower levels of employment, as is highly plausible. We are very sceptical about the economic and fiscal case for withdrawing from the EU.

Together these savings could over time amount to more than £20bn per year or 3 per cent of public expenditure. This is not an inconsequential sum, but we do not believe it is such a large figure that future strategy should be shaped with the public finances as the main consideration, given the implications these choices have for the UK's security, prosperity and global influence. Making recommendations on the costs, benefits and risks of major policy change in these three areas is beyond our remit as a commission. In the rest of this report, for the purposes of considering the financial affordability of other spending priorities, we have assumed current policies remain broadly unchanged. We assume that the defence budget will neither be singled out for cuts over other departments nor subject to specific protection. This would lead to defence spending being lower than current MOD planning assumptions.[65]

See chapter 8 for a fuller analysis

5 | LONG TERM PRESSURES AND PRIORITIES

Chapter 5 examines the long-term pressures on public spending over the next 20 years and policy options for restraining upward increases in spending. We present three possible scenarios for the path of public spending in the early 2030s, calculated by the Fabian Society drawing on data from OBR projections.

- *Upward pressures on spending mean that over the next 20 years spending is likely to need to rise in areas like pensions and healthcare. However, decision makers will need to make trade-offs and should not assume that they will be able to meet these rising pressures in full. The main pressures come from the public's rising living standards and expectations; demographic change and public service costs. Rising morbidity and inequality are also potential pressures.*

- *The main policy options for restraining spending increases are to reduce the generosity of entitlements (eg by failing to raise health or pension spending in line with rising prosperity) or to restructure eligibility to reduce the extent of universalism. We believe such moves would be undesirable. The best solution to restrain rising spending is to increase performance, productivity and value for money in the public sector. This should be a top priority for future governments; however alone it is unlikely to fully offset rising spending pressures.*

- *We examine the possible profile of spending in the early 2030s, by considering a set of 'high spend' and 'low spend' options calculated by the Fabian Society. They cover: health and social care; pensions; working-age social security; and future-oriented spending (eg education and capital investment). Only by implementing all the 'low spend' options will future governments be able to avoid spending and taxation rising as a share of national income (under this scenario spending would be 39 per cent of national income and tax 38 per cent). If all the 'high' options were implemented spending would rise to 44 per cent of national income, implying taxes of 43 per cent (assuming future governments were committed to reducing public debt). This tax ratio is not uncommon among OECD nations but has not been seen in the UK since the mid-1980s and would be a very big change.*

- *We also consider a 'mid way' scenario which would see spending reach 42 per cent of national income by the early 2030s. Of the three scenarios, this is our preferred path for spending over the next 20 years, however it will not avoid the need for difficult trade-offs. We consider a combination of policies which would increase spending on education and investment; take some steps to prevent inequality from rising; and fund most but not all the growing health and pensions spending pressures. Under this scenario revenues would need to rise to around 41 per cent of GDP. This would require the government to increase tax by around 2 to 3 per cent of GDP in the decade or so after 2020; if implemented gradually over time this could be achieved primarily through 'fiscal drag' on personal taxes.*

In keeping with our own recommendations, the commission has first considered the long-term direction for spending, before turning to priorities for an incoming government in 2015. Taking a long-term perspective is particularly important now because it will help policymakers to simultaneously

consider two time horizons: austerity for the next few years; and 'return to trend' thereafter. Decisions for both periods will combine to set the direction for the next 20 years: how spending is constrained for around five years; and where moderate increases are allocated after that point.

When people talk about long-term public spending sometimes there is an air of gloomy inevitability, that 'demographics is destiny' and there are just two paths ahead: for spending and national debt to rise inexorably; or for the gradual dismantling of the welfare state. We reject this pessimistic determinism: it is simply incorrect. The profile of future spending can and will be shaped by successive generations of political leaders: decent public entitlements can be sustained into the future without burdening unborn generations; and quite small changes, if maintained over decades, can make a big difference.

Future elected governments will decide for themselves how much to spend and what their priorities are. But they will make these decisions in the context of upward pressures, particularly with respect to what we have called 'present-oriented' expenditure: spending on areas like healthcare and pensions that provide protection against risks, on a collectivist, normally universal basis. The largest pressure is rising prosperity, which drives: higher pension payments (so that older people share in improving living standards); and increased public appetite for services (since with more money people want more education and healthcare, just as they want more commercial goods and services). Rising prosperity alone explains why spending can be expected to rise in line with GDP growth not just inflation. This is then supplemented by the effects of the ageing of the population and the likelihood of public service costs rising faster than inflation, which each create upward pressures of similar magnitude. All three factors come together when thinking about future healthcare costs, with the OBR suggesting that between 2020 and the early 2030s demographic change

might add 0.7 per cent of GDP to NHS costs and rising public service costs a further 1.3 per cent, a total of 2 per cent in just a decade. Both these factors are, however, open to significant uncertainty.

BOX 7: Upward pressures on future spending

Public expectations: As economies grow more prosperous, people typically want to consume more of services such as health and education. For example many more people wish to go to university than 50 years ago and people expect to be able to access the latest medical technologies. Indeed the main driver of health service spending is prosperity and innovation: rising affluence, new technology and changing expectations.[66] The OBR takes account of this effect by assuming spending on all public services will rise in line with GDP growth. Even this could be an underestimate: healthcare and education may be what economists call 'superior goods': things people wish to consume more of, relative to their income, as they become richer.

Demographics: The ageing of the population means demand for spending will rise in coming decades, with increasing pressure for expenditure on pensions, health and social care. While the direction of travel is clear, there is considerable doubt regarding the future population profile with uncertainty regarding life-expectancy, fertility rates and levels of migration. Over a 20 year timeframe this uncertainty has fairly limited consequences (implying that the upward spending pressure from demographics could range from between 1.2 and 2.4 per cent of GDP). By 2062/63 the projected dispersion arising from different demographic scenarios is much greater, with a range from 1.4 to 9 per cent of GDP.

Public service costs: Most public services are labour intensive so many of their costs increase in line with rising earnings which

typically rise faster than prices. Over the long term, public sector pay increases will need to broadly track those in the private sector in order to maintain workforce quality. Unless these rising costs are offset by increased productivity the price of public service outputs will therefore increase over time. Much can be done to improve the effectiveness of public services, especially through the adoption of new technology, but there are also limits, since we do not wish teachers, midwives or care workers to serve more and more people indefinitely. This is not a characteristic of the public sector but of many non-traded services: education, health and social care productivity is similar to that found in hospitality, recreation and retail.[67] The OBR currently projects that cost pressures could increase healthcare spending by 1.3 per cent of GDP between 2018/19 and 2032/33.

Morbidity: At present life expectancy is rising more quickly than healthy life expectancy, leaving people spending more years of life with illness and disability than in previous generations.[68] This leads to upward pressure on health spending and disability-related social security. The OBR incorporates this factor into its main spending projection by making the (pessimistic) assumption that use of healthcare will remain constant within each age group despite rising life expectancy. More optimistic assumptions about morbidity reduce the OBR's projections for upward spending pressures.

Inequality: Inequality is an important determinant of morbidity but it also has other effects. Over the last 35 years market inequalities have risen significantly in the UK. This has led to greater eligibility for social security due to high numbers of workless households and more people in low paid work.[69] British governments of all complexions allowed spending to rise in response and this pattern has been reflected across the OECD. If market inequalities rise further there will be greater pressures for public spending.

Downward pressures on spending: Not all social and demographic effects lead to upward pressures; some naturally reduce demand for spending. For example, as life expectancy rises, people can be expected to work for longer, pay more tax and receive their state pension later; and immigration increases the number of workers relative to the rest of the population. Both lead to increased tax revenues, shifts in demand for public spending and an increased supply of public service workers. They can also be promoted through policy interventions although public opinion creates significant constraints to both rapid increases to the pension age and high levels of immigration. Immigration and longer working lives can also have significant social consequences whatever their economic and fiscal benefits.

Policy options for restraining spending increases

Spending rises can be restrained through policy choices and the way in which public services are delivered. The first option is to reduce the generosity of entitlements: social security payments and public service outputs can both be allowed to grow by less than future increases in the nation's prosperity. Since the NHS operates on the basis of nationally controlled budgets, policymakers have the ability to vary the pace of spending growth in line with financial constraints. While rising demand, rising costs and population ageing combine to create large upward pressures, elected politicians can aim to withstand them in part (in effect choosing not to raise healthcare outputs in line with rising affluence). However, this brings considerable social and political risks.

Policymakers have been more effective at controlling social security costs: in chapter 4 we described how existing legislation means that non-pension social security spending can be expected to shrink over time relative to

GDP (because annual uprating is in line with inflation which usually rises by less than earnings or GDP). The downward pressure of current benefit indexation policies may be welcome from a fiscal perspective, but it implies rising economic inequality and starkly different treatment for different age groups. Current indexation policies have such a strong downward pull that they will more than cancel out the effect of demographics over the next 20 years.

An alternative to simply restraining the growth of entitlements is to restructure eligibility for public provision. In particular, policymakers could shift away from universalism, by restricting social security and public service entitlements to low income groups. Today the largest areas of public spending (healthcare, pensions and schools) are delivered on a universal basis and the government's decision to shift the composition of spending towards health and pensions means universal provision is growing as a proportion of expenditure, even though minsters have cut some important universal benefits. Shifting to a means-tested approach might save money but undermines the role of the state in distributing across the lifecycle and providing guarantees against risks. Critically it also diminishes public consent for spending. International studies show that more tightly means-tested systems are typically cheaper but they are not more progressive, since targeted welfare states have less generous entitlements and a less redistributive overall tax and entitlement system.[70]

There would be particular disadvantages in ending the universal principal in both pensions and healthcare. Means-testing of pension provision erodes incentives to save and most middle income households cannot save sufficient amounts through private pensions to expect a decent pension without public support. Meanwhile, introducing a co-payment or insurance based system to healthcare could make the system more expensive to operate and would be

likely to increase inequalities in access and quality of care. Many people would end up paying more for their healthcare overall, albeit with a higher share funded privately and a lower share funded collectively through taxation. There may be a case for marginal reforms to slightly shift the balance between universalism and means-testing in some areas of social security, but as a commission we do not believe the case has been made for any major encroachments on universalism with respect to pensions or public services.

The final route to restraining rising spending is to increasing performance, productivity and value for money in the public sector. This should be a top priority for future governments both to deliver more within tight constraints and to build public trust that any extra money will be well spent. Policymakers will need to permanently embrace innovation and efficiency, rather than see savings as part of a period of short-term pain. From the evidence we have reviewed, it is harder to predict the future path of improvements to performance and productivity. In chapter 1 we saw that Labour almost succeeded in increasing healthcare outputs in line with rising spending, so cancelling out the effects of increasing unit costs. Health outcomes also improved very significantly, though it is harder to establish a direct relationship to the extra spending. More recently – and under acute pressure - local authorities have been very effective at reducing costs with less detriment to public services than might have been expected. However on balance, our view is that performance and productivity improvements are necessary and achievable but will not be sufficient to mitigate all upward spending pressures.

Spending in the early 2030s

We have examined the consequences of combining a range of plausible 'low spend' and 'high spend' policy choices for different areas of public expenditure. These are highly

stylised scenarios based on the OBR's spending projections and using its main demographic and economic assumptions in all cases, in order to show the effects of different policy choices only. All the options assume that the coalition's current spending plans have been implemented in full; and all assume spending will rise to pay for an ageing society, so under any of these scenarios spending on pensions and the NHS will rise as a share of GDP.

Figure 12: Spending as a share of national income in 2032/33, under selected 'high' and 'low' scenarios (based on OBR projections)

	'Low spend' options	'High spend' options
Incomes - older people	**9 per cent of GDP** State pension linked to earnings not 'triple lock'; most other benefits linked to prices	**9.5 per cent of GDP** State pensions linked to 'triple lock'; other benefits linked to earnings
Incomes – children and working-age	**4.4 per cent of GDP** Benefits uprated in line with prices	**5.8 per cent of GDP** Benefits uprated in line with earnings
Health and social care	**9.4 per cent** Increase health and care spending in line with GDP, plus an adjustment for demographic change. Health outputs would not rise in line with prosperity unless there were very high performance improvements.	**10.9 per cent of GDP** Increase health spending to take account of rising prosperity, increasing costs and demographic change (ie in line with historic trends); also raise social care spending to meet unmet need.
Education	**4.5 per cent of GDP** Increase education spending in line with GDP	**5.5 per cent of GDP** Add 1 per cent of GDP to education spending to return spending to levels seen in the mid-2000s
Other non-interest spending	**8.4 per cent of GDP** Increase spending in line with GDP	**8.9 per cent of GDP** Add 0.5 per cent of GDP to spending. This could be used to return investment spending to levels seen in the mid-2000s

Source: Fiscal Sustainability Report 2013, OBR, 2013; Humphries, R, Paying for social care: Beyond Dilnot, King's Fund, 2013. Note: All estimates derived from Fiscal Sustainability Report projections and commentary, except for the increment for social care reform, taken from King's Fund projections.

Appendix 3 shows that if all the 'low spend' policy choices were selected, we find that spending in the early 2030s could be as low as 39 per cent of GDP; if all the 'high spend' choices were selected it could rise to 44 per cent. Both these outcomes are well within the range of spending in advanced OECD economies today (and all these nations face comparable upward pressures in the future). However, it is still a wide spread, which demonstrates the significance of long-term policy choices. This is particularly true because our assumptions were not intended to be extreme outliers: for example, in the 'high spend' case, the assumptions about rising healthcare costs are not unduly pessimistic; and the 'low spend' case did not involve ending the link between pensions and earnings. The variations in results therefore shows that future policy choices have much greater implications for the long-term public finances than demographic or economic uncertainties: demographics is not destiny.

Choosing all the 'low spend' options would see expenditure as a share of national income fall slightly through the 2020s and could be achieved by: restricting health spending rises; retaining social security policies which lock-in rising inequality; and keeping low levels of future-oriented spending post-austerity. This would have very serious consequences for public service outcomes, inequality and future economic prosperity. The 'high spend' options would arise if health and social care increased in line with rising costs and demand; social security was indexed to rising earnings; and resources for education and investment were increased to levels seen in the mid-2000s. This would imply a structural increase in spending of over 4 per cent of GDP over 10 to 15 years.

Either option is compatible with fiscal sustainability (ie our proposed commitment to reducing debt over the long-term) as long as, in each case, tax revenues are only slightly lower than projected spending. The 'low' scenario

implies tax revenues of 38 per cent of national income; and the 'high' scenario 43 per cent. (It sounds counter-intuitive to say that spending can sustainably exceed tax revenues, but under normal economic conditions governments can spend more than they raise and still reduce debt, as a share of rising national income.)[71]

In practice, future policymakers might select a combination of policy options that gave rise to spending and taxation anywhere within this range. For example in Box 8 we consider a 'mid-way' scenario which would take spending to 41 per cent of GDP (also see Appendix 3). But only by choosing all the 'low spend' options could they both freeze the tax take and reduce debt over the long term: revenue is around 38 per cent of GDP today so any other permutation of policies would require an increase in tax as a share of national income. This shows why there is such a difficult trade-off between future taxation and spending policies, as discussed in chapter 4. Most of the options one might wish to consider involve increasing revenue as a share of national income.

On an annual basis, the tax increases that would be required to fund the 'high' scenario would be quite small when compared to recent fiscal changes; but when implemented each year they would gradually take revenues as a share of national income towards levels last seen in the UK in the 1980s (although still common in many EU member states). A sustained shift of this sort would require democratic support, which is for now at odds with the public mood. Our 'mid-way' scenario, with more modest tax increases, would be more likely to secure consent, especially as it could be funded gradually and without the need for changes in tax policy, through 'fiscal drag'.

An alternative to incremental tax rises would be to raise some of the revenues through a one-off tax increase during the next parliament. In the next chapter we consider this option as part of a package to avoid some spending cuts

after 2015. An increase in taxes early in the next parliament would significantly reduce the need for annual revenue increases thereafter.

BOX 8: Long-term spending: a 'mid-way' example

Over the next 20 years it is perhaps unlikely to expect a large increase in tax revenue, from 38 per cent of GDP to 43 per cent. A 'mid-way' scenario is more plausible, especially because it could be funded by gradual changes with no change in tax policy: by the early 2030s 'fiscal drag' on income tax and national insurance could raise revenues to 41 per cent of GDP, assuming that the proceeds were not needed to make up for other declining revenue streams (see chapter 4). The illustrative 'mid-way' permutation we've examined would take spending to around 42 per cent of GDP by the early 2030s (based on current OBR projections and ignoring the effect of the economic cycle). In order to be on track to reduce debt over decades, revenues would need to be around 41 per cent (this would achieve the 'primary surplus' described in chapter 4).

Within this spending total we've illustrated a combination of policies which is consistent with our views on the best long-term balance between spending priorities: expenditure on future-oriented spending would increase; working-age social security spending would fall as a share of GDP but rise by enough to permit benefits to be uprated by more than inflation; and most but not all the rising spending pressures for health and pensioner incomes would be funded.

The 'mid-way' scenario could comprise the following elements:

- *'Future-oriented' spending could rise by 1.5 per cent of GDP:* spending on education and investment could rise as a share of national income to levels seen in the mid-2000s.

- *'Present-oriented' spending:* most but not all the upward pressures on pension and healthcare pressures could be funded. Health and social care spending could rise by 1.6 per cent of GDP, roughly half-way between the 'high spend' and 'low spend' scenarios; spending on pensioner incomes would rise by 0.4 per cent of GDP.
- *Tackling inequality:* spending on working-age social security could fall by 0.6 per cent of national income. This could allow for the system to be more generous than what is implied by price indexation policies, but would not fund the uprating of all benefits in line with earnings. This level of expenditure might be compatible with stable levels of inequality if combined with significant market reforms and would mean overall social security spending (including pensions) would be broadly flat as a share of GDP.

This package envisages some restraint to future growth in age-related spending, but only at the margins. With respect to pensions, we do not want to unravel the core of recent reforms which will ensure older people's incomes rise in line with overall living standards and give everyone a platform for saving. Nor do we think that the 'low' variant for healthcare spending is plausible. This would see NHS spending rising by little more than GDP which is probably politically unrealistic given the upward pressures the health service faces.

See Appendix 3 for more detail

6 | REDUCING THE DEFICIT AFTER 2015: THREE SCENARIOS

There are 'constrained alternatives' for spending in the next parliament and the performance of the economy will determine the range of spending options that can be contemplated. Chapter 6 presents three spending scenarios calculated by the Fabian Society for the years from 2016/17 until the public finances are stable: (1) retaining the coalition's current plans; (2) increasing real spending by 1 per cent a year; or (3) increasing real spending by 2 per cent a year. In each case we assume a new government would make negligible changes to 2015/16 spending plans, as the financial year would already by underway.

- ***Scenario 1:*** *Implementing spending plans based on the coalition's current expenditure plans for 2016/17 and 2017/18 would have very serious implications for the beneficiaries of public spending, implying sweeping cuts to important public services and to social security. Even if social security entitlements were cut by £10bn (which would have very undesirable consequences) average spending on 'unprotected' departments might still fall by up to 15 per cent over two years. In this context it would be very difficult to start reshaping expenditure in line with the long-term priorities we have identified. In November the OBR is likely to revise upwards its projections for future growth and government revenue. In our*

view a future government should use this money to spend more than this scenario rather than cut taxes or reduce the deficit faster.

- ***Scenario 2:*** *The Fabian Society calculates that a 1 per cent increase in real spending would leave a future government spending £20bn more than the coalition currently plans to. We hope this will become affordable as a result of economic growth exceeding current forecasts, but it could also be funded by raising some taxes or moderately slowing the pace of deficit reduction, while still reducing the deficit in the next parliament. Under this scenario there would be very difficult choices, but large-scale cuts could be avoided. We consider one combination of options which would stop the drift away from future-oriented spending: a rise in capital investment; a modest reduction in social security entitlements; 'flat' real spending for the health, social care, education and economic budgets; and a 3.5 per cent annual cut for all other departments.*

- ***Scenario 3:*** *Increasing spending by 2 per cent a year will be difficult to achieve while still closing the deficit, unless economic growth is considerably higher than today's forecasts. Increasing spending by this level would make it easier to balance competing priorities. However the Fabian Society calculates that even under this scenario it would not be possible to shift significant resources towards future-oriented activities; and avoid social security cuts; and raise public service spending in line with rising pressures.*

- *Our preference is that spending should rise by no less than our second scenario. It may be possible to fund this through better than forecast growth and revenues, but should the circumstances require it, we would prefer to see moderate tax rises than further overall cuts to spend-*

ing. We do not support broad-based tax rises when general living standards are still declining but tax increases targeting higher income groups could make a significant contribution to paying for scenario 2. One option would be to examine reform of pension tax relief, where there are potentially large savings that would affect only those on higher incomes.

In the last chapter we saw how, over the long term, governments will be required to cut public spending as a proportion of GDP if they wish to both reduce public debt over decades and maintain tax revenues at a constant level of national income. In this chapter we take a similar look at the implications for continuing with the government's current short-term plans to reduce spending, as well as reviewing two alternatives (see also Appendix 3).

At the time of the new election, the 2015/16 financial year will be underway and any new government is likely to make only minor adjustments to spending during the year. However, determining the level of spending for the following two to three years of the next parliament will be one of the most urgent issues to confront an incoming chancellor. A new government will need to consider its options over two timescales: the remaining years of deficit reduction and the period after when it will be possible to increase spending.

At present the deficit reduction phase is expected to last two years after 2015/16, on the basis of current OBR forecasts and government plans. We've reviewed three options for spending during this time. Once the deficit has been reduced it will be possible to return spending to 'trend'. However, there is also a choice to make on what that means, based on the view one takes on the most desirable path of spending to the 2030s.

The three scenarios we consider for deficit reduction after 2015 are (1) the government's present plans (a real

cut to total spending of 0.4 per cent per year in 2016/17 and 2017/18); (2) an annual real increase of 1 per cent per year in each of those years; and (3) an annual real increase of 2 per cent. These scenarios could lead to overall spending lying within a range of £712bn to £746bn by 2017/18 in today's prices. This range of possibilities exists because there is both economic uncertainty (more revenue could become available to pay for spending) and genuine but constrained choices for policymakers even if all are committed to closing the deficit in the next parliament.

This wide range leads us to believe that it would be unwise for political parties to commit to specific spending plans for after 2015/16 until much nearer the time. Indeed there is a reasonable chance that the stated plans of the present government will change considerably if the economic outlook continues to improve. Current spending plans are based on economic projections published in March 2013 and since then there has been positive news on the economy.

Figure 13: Three scenarios for total managed expenditure in 2017/18

Annual change in real public spending in the two years after 2015 election	Plannned	+1%	+2%
Total public spending in 2017/18	£712bn	£732bn	£746bn
Deviation from the coalition's current plans for 2017/18	–	+£20bn	+£34bn
Spending as a share of GDP in 2017/18 (OBR March 2013 economic projections)	40.5%	41.6%	42.4%

Notes: 2013/14 prices. Fabian Society calculations using Economic and Fiscal Outlook, March 2013, OBR, 2013 (also see Appendix 3)

As a commission our preference is for the next government to spend more from 2016/17 onwards than the coalition currently plans to, if the economic circumstances make it possible. We hope this could be paid for largely by extra revenues from economic growth, but if it cannot

we believe policymakers should be open to tax rises or slightly extending the duration of deficit reduction.

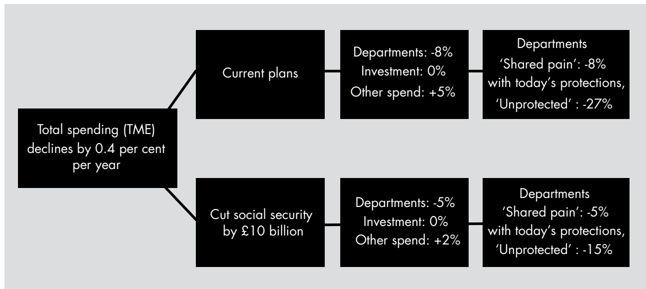
Scenario 1: The coalition's current plans

The coalition's published plans for 2016/17 and 2017/18 envisage interest payments continuing to rise rapidly, social security increasing by around 2 per cent over two years and capital investment being flat in real terms (meaning it will fall as a percentage of national income). This implies very significant cuts to current departmental spending, averaging 8 per cent over two years. These cuts could be spread evenly across all government departments. This would imply real cuts to health and schools budgets, major defence cuts and abandoning the 0.7 per cent threshold for international development spending.

Alternatively a future government could chose to protect these major budgets and impose greater cuts for all other areas. To illustrate this we have looked at the impact of protecting five budgets on a similar basis to the 2013 spending round: health (zero per cent cut); education (1 per cent cut); international development (rising in line with GDP); defence (2 per cent cut); security services (zero per cent). These areas account for over 60 per cent of all departmental spending so the impact of protecting them would be very high, with other government departments facing real cuts averaging 27 per cent of spending over two years (if defence and security were excluded from protection the average cut would be around 20 per cent). This would come on top of cuts to department budgets of between 24 and 60 per cent over the preceding five years.[72] These figures are so high because all the effects of (quite modest) overall cuts are concentrated in under a fifth of public spending. We are not in a position to assess the impact of these cuts in detail but in many areas they would call into question the viability of public services on their

current basis. A further 27 per cent real cut would imply some department budgets shrinking to between half and one fifth of their 2010 levels.

Figure 14: Analysis of the government's present spending plans



A likely alternative would be for a future government to reduce departmental cuts by making further reductions to social security spending. The government could cut £10bn from social security, as was mooted by the chancellor, George Osborne, at the 2012 Conservative party conference. In chapter 7 we show this would have very undesirable consequences which we find hard to contemplate. Such a cut could reduce real reductions to department spending from 8 per cent to 5 per cent. If the 2013 spending round protections continued this would leave 'unprotected' departments facing cuts of 15 per cent over two years (or 13 per cent if defence and security were unprotected). Even these would be very hard for departments to contemplate.

Adopting these plans would have very serious impacts on the beneficiaries of public spending, with sweeping cuts to important public services or to social security. Their implementation would also be incompatible with working towards the sort of long-term objectives we described

in chapter 4. With the constraints they impose ministers would not be able to raise health spending in line with rising pressures; they would have to further reduce the share of national income spent on education and investment; and working-age social security would become even less generous.

Although these are the current official spending plans they may not be feasible and they are not the only way to reduce the deficit, even on this government's timetable. The 2013 budget explicitly stated that published plans are an 'assumption' that did not reflect firm future policy should the current government remain in office after 2015: 'Fiscal consolidation for 2016-17 and 2017-18 is expressed as a reduction in TME [total managed expenditure]. It would, of course, be possible to do more of this further consolidation through tax instead.'[73] The Institute for Fiscal Studies believes a tax rise after 2015 'looks more likely than not' both on grounds of the impacts of further spending cuts and the behaviour of past governments after elections.[74]

There is also the possibility that the government will be able to spend more than planned without taxing or borrowing more, given the emerging signs of economic growth. In November the OBR is likely to revise upwards its projections for future growth and government revenue, for the first time since it was created. In our view a future government should use this money to increase spending rather than cut taxes or repay debt earlier than planned.

Scenario 2: Increasing spending by 1 per cent a year

As an alternative we considered a 1 per cent increase in public spending in 2016/17 and 2017/18. By 2017/18 this would leave a future government spending £20bn more than the coalition's existing plans. On current projections for GDP and government revenues this level of spending

would significantly reduce the deficit, shrinking spending as a share of national income from 43.1 per cent to 41.6 per cent in two years. This could be an underestimate if the change had a positive effect on growth (which would be the case if the IMF's current views on the 'multiplier effect' of public spending during a recovery is correct).[75] These spending plans are therefore consistent with a fiscally credible approach to deficit reduction

This money could be used to increase investment or social security spending; or to reduce cuts to department budgets. In practice, the latter would probably take highest priority, given the pressures on department budgets. Spending an extra £20bn on departments would have an important impact, reducing considerably the spending cuts needed after the next election. It would mean that over two years current departmental spending would fall by under 2 per cent in real terms, a sum which could be absorbed by conventional efficiency savings. The outlook would be even more positive for departments if the spending on social security was also below current plans. For example, spending £5bn less than planned on social security could result in a flat settlement for departmental spending. Alternatively, social security savings could be used for capital investment.

Before the financial crisis, to impose two years of real freezes on department budgets would have been considered extremely challenging. But after seven years of substantial cuts, a 'flat' real settlement would make a huge difference to public services. In particular it would eliminate the need for the huge discrepancies between 'protected' and 'unprotected' government departments we see today. In practice, ministers would still want to make differential allocations according to their priorities, but these would have smaller implications.

Under this spending scenario there would still be difficult trade-offs but it would be possible to imagine a future

government begin to set priorities in line with the long-term objectives we recommend. For example, a 1 per cent rise in overall spending is consistent with the following illustrative combination of spending choices:

- **Social security:** spending £5bn less than currently forecast. In chapter 7 we consider how this could be achieved without undermining universality or hitting low income groups disproportionately.
- **'Future-oriented' spending:** a £5bn increase in capital investment and 'flat' real spending for three key economic budgets: education; business, innovation and skills; and work and pensions.
- **Health and social care:** 'flat' real spending for the NHS and for the proportion of local government grants paying for social care. This would still be very challenging for health and care providers.
- **Other department spending:** a cut of around 3.5 per cent per year.

An incoming government will need to take a view on whether it is desirable to deviate from existing plans by £20bn, taking account of political and economic circumstances. On balance we believe a move in this direction is appropriate, as long as the economic conditions make it possible. The money could be generated by one or more of three sources: economic growth; slower deficit reduction; or higher taxes.

1. Stronger economic growth would be the ideal route. We estimate that extra revenue on this scale might be generated if annual growth is 0.5 per cent more than the OBR currently forecasts in each of the next five years.

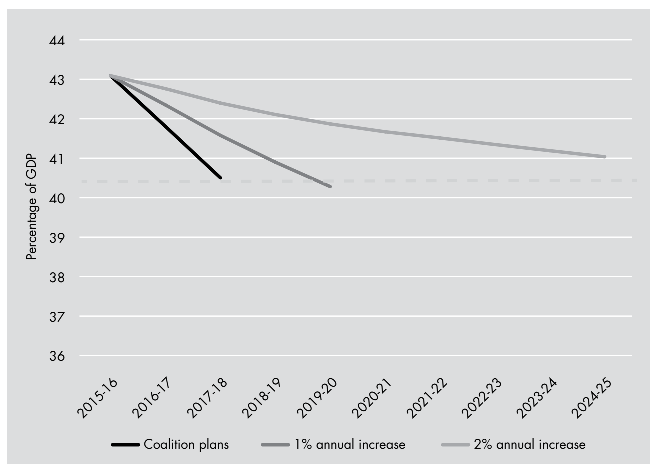
This is optimistic but not implausible, since recoveries can be surprisingly rapid once they are underway. The OBR's expected upward revisions in November may not be sufficient to fully fund a £20bn deviation in planned spending but are likely to signal a positive change nonetheless.

2. If the economy does not exceed expectations, the money could instead be found by borrowing a little more in the short term and taking one or two years extra to reduce the deficit. This is analogous to the 2010 election, when George Osborne and Alistair Darling each set out different timetables for deficit reduction. Figure 15 shows that spending would fall to the same level, relative to national income, as a result of sticking to the coalition's plans for two years or maintaining a 1 per cent rise for three to four years.

3. The final option would be to increase taxation as a share of national income. Raising taxes by £20bn would be a significant move (by comparison George Osborne raised £8bn in taxes in his June 2010 budget). It was beyond the commission's remit to look in detail at tax, however the evidence we have heard suggests there are plausible tax increases that could raise money of this magnitude without affecting low and middle earning households (see Figure 17). However there is also a political and economic judgement to be made.

Perhaps the most likely route to achieving spending growth on this scale would be a combination of two or three of these scenarios. For example, if the current signs of economic recovery continue it could well be possible to implement a 1 per cent annual spending rise with £5bn to £10bn of tax increases or by very slightly delaying the pace of deficit reduction.

Figure 15: Spending as a share of GDP under three spending scenarios, assuming no change to OBR GDP projections



Source: Fabian Society calculations, using data from Economic and Fiscal Outlook, March 2013, OBR, 2013

Scenario 3: increasing spending by 2 per cent a year

We also considered an increase in spending of 2 per cent a year for the duration of the deficit reduction period, which would entail a deviation from the present government's spending plans of £34bn by 2017/18. We conclude that this would not be a viable option unless the economy begins to grow faster than current forecasts or the public are prepared to accept very significant tax rises. This is because under this scenario, spending as a share of GDP would only fall very modestly on current growth forecasts (see Figure 15); so major tax rises would be essential to reduce the deficit during the next parliament.

On the other hand this scenario would become affordable if there was rapid growth. We estimate that the extra revenues to fund this option might be generated if growth

was one per cent higher than current forecasts over this year and the next four. A combination of higher than expected growth, tax rises and a slight slowing of the pace of deficit reduction are the most plausible route to this option becoming affordable. However as things stand we believe this scenario is less likely than the other two.

Even though this scenario entails spending considerably more than is currently planned, an increase to real spending of 2 per cent a year would still be below the long-term trend; it would not be sufficient to respond to all the upward pressures for spending, especially after years of restraint. It would however make it possible to pursue a number of our priorities for reshaping public spending without such difficult trade-offs as we confronted in scenario 2. For example, it would be consistent with the following settlement:

- **Social security:** no reduction in planned spending. Since spending would be expected to fall as a result of the recovering labour market this might make it possible to recycle spending into new or existing entitlements.

- **Future-oriented spending:** a £9bn increase in capital investment; and 0.5 per cent real annual increase to the main economic budgets (education; business, innovation and skills; work and pensions).

- **Health and social care:** 0.5 per cent real annual increase for the NHS and for the proportion of local government grants paying for social care.

- **Other department spending:** a 1 per cent real cut to other departments.

Even this level of increase would pose real difficulties for many public services. In particular increasing spending

on healthcare by less than 1 per cent would create a formidable challenge for the NHS.

All three scenarios assume a fixed level of spending, so in each case, if the economy and labour market were to perform better than forecast, there would be the possibility of reducing some of the pressures on public services by allocating savings from social security to departmental spending. This would be most likely to happen in the case of scenario 3 (since we think it is only likely to be affordable in context of high growth): instead of recycling money within social security some money could be used to increase department spending.

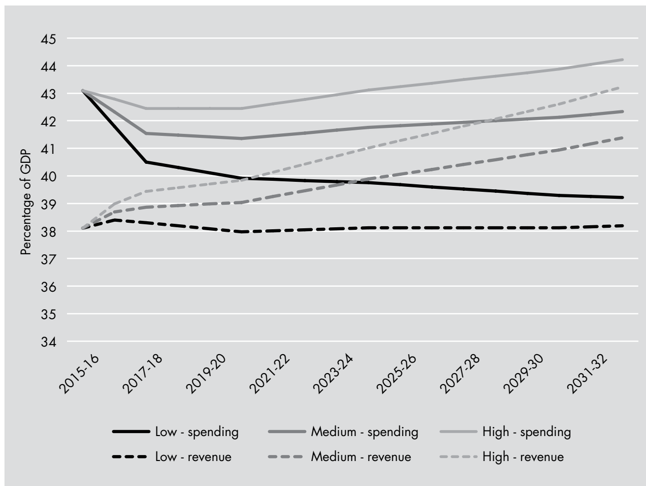
Return to trend

Figure 16 sets out three possible pathways for expenditure which show our short-term scenarios for spending until 2017/18, followed by a gradual change to achieve the possible levels of spending in the 2030s described in chapter 5. This chart is based on current OBR projections and after 2020 ignores changes caused by the economic cycle (which in practice leads to large annual fluctuations in spending and tax revenue). There is no necessary connection between the view you take on immediate and long-term spending options and this graph simply illustrates one set of possibilities. It should be noted, however, that proponents of higher spending in the long term who also opted for the coalition's short-term plans would create a potentially undesirable 'stop-start' spending profile: immediate cuts followed by higher 'catch-up' spending.

The 'low' spending path implies 'trend' increases in public spending of 2.3 per cent each year over the following 15 years, just below the assumed rate of GDP growth. The 'medium' path implies spending rising by 2.7 per cent and the 'high' path by 2.8 per cent. This illustrates how quite modest annual differences lead to significant shifts when

repeated year after year. Both the medium and high options imply quite stable levels of spending from 2015 until the early 2030s. However, within these totals the composition of spending would still need to change over time and there would be difficult decisions, with restraint required in many areas to accommodate upward pressures elsewhere.

Figure 16: Illustration of the possible path of spending and taxation as a share of national income over the next 20 years under three scenarios



Source: Fabian Society calculations, using OBR data. Scenarios: 'Low' = current government plans for spending and public spending at around 39 per cent of GDP in 2032/33; 'Medium' = a one per cent real increase in spending in 2016/17 and 2017/18 and public spending at around 42 per cent of GDP in 2032/33; 'High' = a two per cent real increase in spending in 2016/17 and 2017/18 and public spending at around 44 per cent of GDP in 2032/33. Notes: all these scenarios are based on existing OBR economic projections, so assume alternative tax and revenue choices have no impact on economic growth and that the higher spending scenarios are funded by tax or borrowing not higher growth. Until 2020 the effects of continued economic recovery are factored in, after that point the economic cycle is ignored. This illustration assumes moderate tax rises from 2016/17 onwards for the two higher scenarios to show how the short and long term pathway might link.

Tax choices

As a commission, we believe that a 2015 government should consider the case for tax to contribute a little more to fiscal consolidation than has been the case during the current parliament. Although tax changes do not avoid the need for difficult spending decisions, our second and third scenarios show how tax increases could contribute to policymakers having a more sensible range of spending options (although scenario 3 is only likely in the context of high growth as well). Tax increases would also lead to a better balance in the relative contributions of tax rises and spending cuts in closing the deficit. The government currently plans to close the deficit through 85 per cent spending cuts and 15 per cent tax rises.[76] This compares to the coalition's 2010 budget, where spending reductions accounted for 77 per cent of the planned consolidation and to Labour's plans in early 2010 where the figure was 70 per cent.[77] The UK is an outlier with respect to the emphasis it is placing on spending restraint: across developed countries only 60 per cent of deficit reduction was achieved through spending cuts from 2009 to 2013.[78]

Ruling out an increase in the tax take in the next parliament could also artificially restrict policymakers from adopting otherwise sensible measures. At the level of detailed policy decisions, there should be 'neutrality' between tax and spending decisions where they are alternatives, which is not possible if there is an arbitrary ceiling on new taxes. From one point of view, a policy should not be preferred because it is a spending cut not a tax rise, or vice versa. While this is an ideal that is frequently at odds with the reality of politics the first consideration should be a policy's expected outcomes, including their distributional effects. This is particularly important when tax and spending options are alternative means of achieving the same ends (for example the choice of reforming income tax

thresholds or tax credits to support family incomes) or are complementary elements in a policy package (eg tackling housing affordability by both taxing property and building homes). Additionally, policymakers should carefully explain how any new spending commitments will be paid for. Often it will be preferable to pay for new entitlements through tax rises than through spending cuts elsewhere, something both main parties seem to accept. For example the chancellor is using inheritance tax and national insurance contributions to pay for new entitlements to social care, while the Labour party is proposing a tax on bank bonuses to pay for its proposed job programmes.[79]

Figure 17: Examples of proposals for taxing high income/wealth households

Proposal	Cost
Harmonise pension tax relief (so relief is at basic rate of income tax)	£13 to 16 billion [PPI]
Cap the tax-free lump sum for pensions at £36,000	£2 billion [PPI]
Double council tax for homes in bands G and H	£2 billion [IFS]
Mansion tax on properties worth >£2 million	£1.7-2 billion [IFS]
1p rise in National Insurance Contributions for high-earners	£0.8 billion [IFS]
Abolish inheritance tax exemption for business and agricultural assets	£0.7 billion [IFS]

Source: IFS Green Budget 2013; Pensions Policy Institute, Tax Relief for Pension Saving in the UK, 2013. Note the PPI estimates do not model changes in behaviour regarding the taxable income of people with high incomes so may be an overestimate.

Making a modest shift from spending restraint to tax rises would alter the distributional effects of deficit reduction. The IMF has found that fiscal consolidation through spending cuts widens inequality, but this is not the case with tax rises.[80] Significant broad-based tax rises are not desirable at a time when the economy is fragile and real earnings are well below their peak in the mid-2000s.[81] However there are a number of plausible proposals for raising significant sums from higher income groups.

These have the potential to raise new revenue with relatively little pain, at least compared to the consequences of making equivalent cuts to public spending. Sizeable savings could be made for instance by reducing the tax foregone on highly regressive pension tax reliefs. Figure 17 show that tax rises for higher income groups could make a significant contribution to paying for scenario 2 (ie £20bn more spending than currently planned) even if economic forecasts are not revised upwards. They could also make a contribution to achieving scenario 3 (£34bn more spending) but this level of spending could probably not be achieved only by increasing taxes on high income groups, in the absence of strong economy growth.

Thought also needs to be given to the long-term direction of taxation. Figure 16 illustrates the possible tax implications of our three stylised spending pathways for the next two decades, again working on the assumption that policymakers are committed to reducing public debt over the long term. The chart shows that an incoming government will need to consider tax policy over two timeframes: both the immediate options for reducing the deficit; and the long-term direction for revenues. For any given level of spending in the 2030s there is a trade-off between the level of one-off tax increases introduced in the next parliament and requirements for extra revenue thereafter. Over the medium term there is a case for comprehensive reforms to taxation to make the system more equitable, efficient and buoyant, drawing on some of the principles proposed by the Institute for Fiscal Studies' Mirrlees Commission, among other sources.[82] It is, however, beyond the remit of this commission to consider these issues. Such reforms could take place on a revenue neutral basis or they could be designed around an assumption of gradually rising revenue as a proportion of national income. This choice should depend on the view policymakers take of desirable spending levels into the 2030s.

7 | SOCIAL SECURITY

Chapter 7 examines a number of options for spending on social security in the short term and longer run. After exploring the prospects for reducing demand for benefits, we consider options for reducing entitlements, as well as areas where extra money might be needed.

- *Both the design and overall generosity of social security are key ingredients in securing rising living standards for low and middle income households. Governments of all parties have made strenuous efforts to reform social security to improve incentives to work and save; but they have engaged less with the overall generosity of working-age social security. Ideally we hope economic reforms will help tackle inequality, but if market inequalities remain at present levels then current social security policies will be neither fair nor sustainable over the long term. This is because most non-pension benefits are indexed to prices, which means that living standards for working-age social security recipients will fall progressively relative to typical incomes. While deficit reduction continues, revising this policy is not affordable, but a change in long-term approach should be considered afterwards.*

- *We are very supportive of efforts to reduce market inequalities through economic reform, but we found that measures*

which could take effect quickly would not substantially reduce demand for social security spending. A significant rise in the minimum wage might save £500 million and similar savings might arise from improving work incentives for those who choose to have second earners in families with children.

- *We have reviewed a wide range of possible reductions to social security entitlements for the short term. We are not making specific recommendations but have identified around £5bn of cuts which we think could be contemplated if a reduction in social security entitlements does became necessary. These include means-testing winter fuel payments and free TV licences; extending recent disability benefit reforms to older people; and treating certain disability benefits as taxable income. It would only be possible to make larger cuts, of say £10bn or £15bn, by reducing the incomes of low income households or by ending universalism across almost all benefits except for the state pension. We want to avoid either of these paths.*

- *There will be very little scope for a new government to increase any social security entitlements in 2016/17 and 2017/18. However, we think consideration should be given to reversing a handful of the present government's reforms as soon as possible. Other possible priorities are to reform universal credit to improve incentives for parents to work; and to introduce a modest 'premium' for contribution-based jobseeker's allowance to recognise past contribution.*

- *As part of our illustration of the implications of a 1 per cent rise in spending, we suggested in chapter 6 that a £5bn reduction in social security entitlements might be needed by 2017/18. This change could be achieved by saving around £6bn from reducing entitlements and*

£1bn from reducing demand through economic reforms. Generating £7bn of savings would leave £1bn to reverse a limited number of recent cuts and a further £1bn for a very modest number of new entitlements.

In the last chapter we presented three scenarios for public spending. We illustrated the second of these scenarios, a 1 per cent increase in overall expenditure, with a package of allocations which included a £5bn net reduction in social security spending. This illustrates the difficult trade-offs that the next government will need to make, even if it has a little more money to allocate. In this chapter we consider the choices it could confront with respect to social security, including whether and how entitlements could be reduced, should this prove necessary.

After the 2015 election, reducing the numbers of people on working-age benefits and keeping social security costs under control will be a high priority. Under current projections social security is forecast to rise by £4bn in real terms between 2015/16 and 2017/18 (although this is a fall as a percentage of GDP). The main upward pressures come from the increasing number of older people and indexation policies for pension entitlements. These will be offset by the continued increase in women's state pension age and projections for falling numbers of working-age social security recipients as the economy slowly recovers.

The official projections assume there will be a relatively modest fall in the numbers receiving benefits in the early years of the next parliament. Looking at housing benefit (which includes people both in and out of work) the DWP assumes that in 2017/18 there will be 750,000 more recipients than before the financial crisis, a reduction of only 100,000 from 2015/16. The number of working households who are forecast to be reliant on the benefit will remain especially high.

Figure 18: DWP projections for changing number of housing benefit recipients (thousands)

Claimants in 2017/18 compared to…	2008/09	2015/16
Lone parents	-245	-14
Older people	-127	-52
Sick or disabled	109	-5
Unemployed	268	-100
Others (mainly working households)	745	66
Total	750	-105

Source: Benefit expenditure and caseload tables 2013, DWP, 2013

Of course, if GDP and employment forecasts are revised upwards, then these projections for social security caseloads will be reduced and spending would fall. In these circumstances it might be possible to reallocate £5bn without having to make significant changes to social security entitlements. However in this chapter we have taken a cautious view and worked on the basis that savings of this order may need to be generated through policy changes alone.

BOX 9: Capping social security

The government and the Labour party have both announced their support for a cap on social security. The chancellor has said his cap will exclude the state pension and jobseeker's allowance (plus the entitlements passported with it). The government's announcement of the cap said it would be a binding constraint save for small forecast fluctuations and would be set in nominal terms from 2015/16 onwards. In any given year the cap will apply between two and five years ahead.

We have no indication of the level at which the cap will be set (or indeed whether it will be over or under the DWP's current projections for social security spending). If set below reasonable projections of future spending it will simply become a device for signalling post-election cuts to social security spending (at a time the coalition government is unable to agree detailed policy changes). On the other hand if the cap set a little above planned spending it could be a more neutral tool that would ensure government reviewed the medium-term environment and put plans in place to avoid unexpected deterioration.

Our view is that such a cap can be made to work, but only if it is set at the conclusion of bottom-up process not as an *a priori* constraint. Ministers should set an overall cap with a clear view on the possible scenarios for future spending. This would mean considering all the non-cyclical pressures on social security spending, both those already factored into spending projections (eg demographic change) and contingencies that are not (eg soaring rents driving up housing benefit costs).

Our support comes with a number of caveats. Firstly, we are wary of capping costs by localising social security budgets, since local government is less able to respond to unexpected developments than national government. Secondly, we do not support the current government's plan to set a cap in nominal rather than real terms since this exposes low income families to the risk of inflation. Thirdly, we oppose a cap being set at a low level, when it would simply become a device to reduce spending rather than a mechanism to respond to unexpected developments.

The long view

The decisions future governments make regarding social security have huge implications for the long-term direction of the national finances, and for the wellbeing of low and middle income groups. The design of social security

has an impact on the overall level of employment and the previous and present governments have both made great efforts to design an efficient system that incentivises work and saving. However, government has been less strategic in its focus on the overall generosity of the system, which will help determine whether economic inequality rises or falls in future decades.

In chapter 4 we saw that social security indexation policies have been designed in such a way that, over time, inequality can be expected to increase and spending as a share of GDP to fall. It is questionable whether this is equitable or socially sustainable. When Labour was in office there were significant one-off increases to individual entitlements for working-age households (especially tax credits for children) but otherwise benefits were uprated in line with inflation and so lost value relative to living standards. The exception was the state pension and pension credit which were linked to earnings as part of a long-term strategy for future pensioner incomes. The coalition has further increased the generosity of pensioner up-ratings by introducing the 'triple lock' which means the state pension rises by the higher of inflation, earnings or 2.5 per cent. Other benefits have been indexed to the consumer prices index, which is usually lower than the measures of inflation which were previously in use.

We believe thoughtful debate is now needed regarding the prospect of maintaining a system that will potentially increase inequality over time and lock-in a permanent distinction in the treatment of different age-groups. In particular, policymakers should consider the implications for poverty and inequality of indexing working-age benefits to prices on a permanent basis. However, we also recognise that uprating all entitlements in line with earnings would be expensive and would not necessarily command public support especially in the short term. A more generous system is only likely to be acceptable if the number of people receiving support falls as a result of changes to the economy.

Reducing demand for social security

Ideally we would like to see fundamental economic reforms which reduce the demand for social security in four ways: (1) reducing the number of households without work; (2) raising employment prospects for those who choose to be second earners in families with children; (3) cutting the share of the workforce facing low pay; (4) improving the affordability of housing. There is growing debate regarding the prospects for addressing inequality by changing the distribution of rewards in the market economy (so-called 'predistribution'). Some progress can be made in the short term through government regulation and spending decisions, for example in the setting of the minimum wage or improving financial incentives for parents to move into work. However, real progress will require deep change within the operation of the market, for example by increasing the power of long-term shareholders, employees and consumers.

None of this is easy, but if change could be achieved over the next 20 years it would be possible to prevent inequality widening (and ideally begin to see it fall), without social security rising as a share of national income. Narrower market inequalities would reduce the strain on government redistribution; and if fewer people required support it would be possible to make entitlements per household more generous. In an ideal world, spending would be no higher than currently forecast but savings from the reduced demand would be recycled into raising individual entitlements in line with earnings. More probably, raising individual entitlements with earnings would require somewhat more expenditure than currently forecast. For example in chapter 5 our illustration of a 'mid-way' spending scenario, assumed that social security spending would be roughly flat as a share of GDP rather than decline as current policies imply.

Some reforms would take many years to deliver visible results, but immediate changes that might lead to social

security savings within a single parliament include: raising the minimum wage; improving support and incentives for those choosing to have a second earner in a family; and introducing guaranteed, subsidised jobs for the young and long-term unemployed. The first of these reforms would have a positive net effect for the exchequer, as might the second, while the third might only recoup some of its own costs:

1. ***Raise the minimum wage:*** The minimum wage has fallen behind inflation and now has the same real value as in 2004.[83] In principle raising the minimum wage to a living wage could save £1.1bn in social security, as part of £2.2bn overall savings for the exchequer.[84] However, such a move would also lead to fewer jobs as employment costs would increase. One fairly pessimistic projection suggests that introducing a mandatory living wage could reduce employment by up to 170,000 jobs potentially offsetting most or all of the savings to the social security budget (at least in the short term while the economy adjusted).[85] More modest or staged increases in the minimum wage would have less effect on social security spending but would also be unlikely to have negative employment effects. Savings of £500 million to social security from a significant increase to the minimum wage might be plausible.
2. ***Helping second earners to work:*** The Resolution Foundation's Commission on Living Standards proposed a series of measures to make work pay for second earners, including increasing the generosity of aspects of universal credit and extending entitlements to under-5s childcare (at a cost of £2.1bn). The commission did not assess the savings to social security that would arise from the expected increase in women's employment and hours of work. These could be considerable. The Mirrlees Report on tax reform modelled the effects of a revenue-neutral package of social security and tax reforms to

incentivise work among second earners in particular and found a dramatic increase in employment.[86] IPPR calculates that over four years the exchequer would gain between £5,000 and £20,000 for each parent returning to work, as a result of increased tax revenues cancelling out the costs of a publicly-funded childcare place (they did not calculate savings to social security).

3. ***Job guarantee schemes:*** The official evaluation of the last government's future jobs fund for young unemployed people estimated that a programme which cost £1.4bn (in a full year) recouped close to half its budget through higher tax revenues and lower benefit spending over two years. Spending on the latter would fall by £300 million in a full year; some of this is a direct consequence of substituting a benefit payment for subsidised employment, however part of the saving is a result of reduced likelihood of receiving benefits after the end of the job guarantee period.[87] This indicates that while job guarantee schemes for the young and long-term unemployed will not pay for themselves over the short term, they do appear to be good value: not only is it more constructive to subsidise a job than to pay people benefits, but the exchequer will recover half their costs spent over time. There is therefore a sound case for increasing the DWP's programme budget to pay for these sorts of schemes if there is confidence in the planned programmes.
4. ***Further welfare-to-work reforms to reduce long-term worklessness*****:** Providing better support for households where no one is working is also a priority and there may be scope to further reduce the number of lone parents and sick and disabled people who are out of work, building on the progress made over the last 15 years. The present government has embarked on a considerable reform programme including universal credit, the work capability assessment and work programme. The success of these reforms is not clear and

future changes should build on experience and evaluation of all the reforms currently being made.

We are enthusiastic about the potential of these reforms as ways to improve outcomes for citizens and improve the value for money of public spending. In the short term however they are not likely to free-up large amounts of social security spending. We have not modelled the likely impacts of these reforms, but a review of existing evidence suggests that short-term savings in the region of £1bn are plausible.

If these important economic reforms do not come about over time we believe the current declining path of social security spending will not be able to continue indefinitely. The OBR makes the same assumption and has developed projections on the basis of a change in policy in the future so that benefits are uprated with earnings not prices. It may not be possible to afford the indexation of all benefits to earnings, but some of the long-term savings arising from indexing benefits to prices could be ploughed-back into working-age social security. Once the deficit has been reduced, this might be used to fund a combination of more generous uprating or an expanded set of entitlements.

Making savings through reduced entitlements

As a commission we are reluctant to consider the withdrawal of further social security entitlements after so many cuts have already been made in recent years. However, we recognise that a future government may have little choice in the matter. We have therefore evaluated a range of possible future options, with a focus on the implications for inequality and the long-term future of the UK social security system, including the preservation of the universal principle.

The full results of this assessment are set out in Appendix 4. This is an indicative scorecard evaluating some of the arguments for and against possible cuts, relative to

each other; it does not imply a recommendation for a particular course of action. In summary:

- ***Changes which should not be considered:*** an immediate increase to the state pension age; fully means-testing disability benefits; reducing children's tax credits to levels seen in the early 2000s; restricting child benefits to two children; scrapping housing benefit for people aged under 25; means-testing universal credit more aggressively; extending the duration of the 1 per cent uprating of most working-age benefits; stopping child benefit when a child reaches 16; ending contributory benefits during working life; scrapping carers allowance.

- ***Changes which would be difficult, but could be considered:*** means-testing child benefit for families in the top quarter of the income distribution (or the top half of the distribution); applying personal independence payment eligibility criteria to people aged over pension age; means-testing winter fuel payment and the free TV licence; means-testing disability benefits to exclude the top quarter of the income distribution; ending bereavement and industrial injury benefits; freezing child benefit in cash terms.

- ***'Least bad options':*** taxing certain disability benefits; replacing the 'triple lock' on the state pension with earnings indexation; removing the winter fuel payment and free TV licence from upper-rate tax payers.

Overall our assessment is that social security savings of up to £5bn might be relatively achievable for an incoming government, but saving much more would be very hard without impacting on low-income households or unravelling key universal entitlements. Even our options for saving £5bn would be controversial as they focus mainly from measures affecting

higher income older people, who have been relatively unaffected by the effects of austerity so far. To save more without significantly reducing the incomes of poor households would imply a major encroachment on the universal principle: saving £10bn might mean shifting from universalism to 'progressive universalism' across almost all working-age entitlements; and saving £15bn would require a shift to even tighter means-testing. While we recognise that a future government will face very difficult choices, our preference is to avoid this path and retain universal entitlements if necessary by increasing taxation of higher income households instead.

Figure 19: Social security measures that might be required to reduce social security entitlements by around £5bn, £10bn and £15bn

	Illustrative Saving	To save approx £5bn	To save approx £10bn	To save approx £15bn
End 'triple lock' on state pension	£0 to 0.4bn	✗	✗	✗
Tax certain disability benefits (mainly affects mid and high income older people)	£1bn	✗	✗	✗
Extend Personal Independence Payment test to people over 65	£2bn	✗	✗	✗
Means-test winter fuel payment and free TV licence	£1.5 to 2bn	✗	✗	✗
Withdraw Child Benefit from richest 25%	£3bn		✗	✗
Withdraw disability benefits from richest 25%	£2bn (est)		✗	✗
End bereavement and industrial injury benefits	£1bn			✗
End contributory working-age benefits (JSA and ESA)	£0.5bn			✗
Absorb Child Benefit into universal credit	£1.5bn			✗
Absorb disability benefits into universal credit/pension credit	£2bn (est)			✗

Notes: see Appendix 4 for details and sources of each costing. Possible savings from changes to child benefit and disability benefits are cumulative.

Increasing social security entitlements

Although we favour a more supportive social security system in the long term, increasing entitlements while deficit reduction continues would be very hard. For example, it will be difficult to adopt an indexation policy that does not result in working-age benefits losing value relative to earnings each year for the time being. Since a future government may well need to cut social security entitlements, the case for any new spending will need to be considered with great caution. In particular, no future government will be in a position to reverse the large majority of the social security savings in the last few years. For example, the decision to remove child benefit from high income families is a major encroachment into the universal principle but would be very difficult to overturn in the short term, even if one wanted to, since it would cost around £2bn.

However, there are a handful of measures which are causing particular hardship and might be early candidates for a change in policy. We have selected three illustrative examples. The 'bedroom tax' for social tenants has been highlighted by many commentators. Although the Treasury estimates the saving from the policy to be £500 million it may be that most of these costs are being shunted onto local authorities, who are struggling to cope with effects of the dislocation the measure is causing. Two other reforms, which will cause hardship and might be candidates for early changes, are the 'localisation' of council tax subsidies and the indexation of local housing allowance to inflation rather than rising rents. Both are flawed policies and could be reversed for under £1bn: local council tax subsidies undermine national certainty regarding being better off in work, which the new universal credit is intended to create; raising housing support by less than rising rents makes housing progressively less affordable.

A future government should also give immediate priority to enhancing entitlements which are likely to increase employment and therefore might pay for themselves (in whole or part). Such reforms which on paper involve more spending should reduce demand and lead to flat or reduced overall expenditure. The top priority is to incentivise the second earner in the family to move into work or work longer hours, since the universal credit system currently being introduced gives almost no incentive for second earners needing childcare to work for more than a few hours a week.[88] Proposals include an earnings disregard for the second earner in a family and extending eligibility for the coalition's new childcare subsidy to all working families (rather than only those with two earners paying income tax). Together these options might cost £1bn.

Many commentators and politicians have also voiced their support for strengthening the contributory principle so that a wider range of people feel that working-age social security is relevant to them. Many options for extending contributory social security are unaffordable in the current fiscal climate. For example reversing the coalition's decision to introduce a one-year time limit on contributory employment and support allowance would probably cost £2bn; and earnings-related unemployment insurance would cost at least £1bn and probably more.[89] Indeed even in the long term new entitlements of this sort would need to be carefully balanced against enhancing the support available for low income households.

However one option we think should be considered would be to introduce a £30 premium for contributory jobseeker's allowance. This would recognise the difference between JSA earned by contribution and that based on need at an initial cost of £220 million, which might be considered affordable.[90]

Saving £5bn in social security

There are no easy choices when it comes to social security. However we believe some reductions to projected spending may be needed to allow expenditure on higher priorities within departmental spending and capital investment. In chapter 6 we suggested that £5bn net reduction to planned 2017/18 social security spending could form part of a balanced spending package.

Ideally, we hope that this could be paid for in whole or part by spending being lower than expected, if the labour market outperforms forecasts. But for these purposes we discount that possibility and show how a future government might be able to construct a package of modest savings through policy changes alone, using an illustrative example:

- **+£1 billion:** Spending to reverse recent reforms with the most harmful consequences

- **+£1 billion:** Spending to make work pay for second earners

- **-£ 1 billion:** Savings from reduced demand for social security, arising from a higher minimum wage and higher earnings for second earners in families. This figure is a plausible 'guestimate' not a modelled saving

- **-£6 billion:** Cuts to entitlements, which would mainly target higher income groups. Any reforms would protect poorer families and safeguard the universal principle

8 | INVESTMENT AND DEPARTMENTAL SPENDING

Chapter 8 explores some of the choices for departmental spending and capital investment after the next election. It looks in greater detail at how to strike a balance between 'future' and 'present' oriented spending, often taking as a starting point the possible budget settlement we outlined in chapter 6, to illustrate the trade-offs required if overall spending were to increase by 1 per cent per year.

- *Implementing the plans implied by existing coalition expenditure forecasts would lead to further major cuts in departmental spending. It might be necessary to make cuts to NHS and schools spending; and continued real reductions to public sector pay would be inevitable. Under our alternative scenarios (outlined in chapter 6) it would be possible to achieve broadly flat departmental spending instead. In this case some budgets would still fall to pay for rises elsewhere but decision makers could weigh up options based on long-term priorities.*

- *Increasing overall capital spending should be a priority, if affordable, although the public sector balance sheet can also be used more imaginatively to leverage private investment (eg public guarantees for private borrowing). Our illustrations in chapter 6, which considered how to shift to more*

future-oriented spending, included provision for raising investment by £5bn (scenario 2) and £9bn (scenario 3). The priorities for investment are economic development, housing and public service infrastructure.

- *We want to see education and economic spending prioritised. However given the constraints implied by scenario 2 this might mean these areas received only flat real settlements for as long as deficit reduction continued. In the short term this would make it very difficult to introduce new programmes which many have advocated, for example: increased childcare; adult skills programmes; support for innovation; or jobs guarantees. Any major spending commitments of this sort will probably need to be paid for within existing budgets.*

- *We recommend that adult social care and healthcare should receive the same funding changes, as the two systems are inter-twined. In our judgement two more years of flat real funding may be required for these sectors, even if overall public spending rises moderately. Continued 'flat' spending will create huge pressures, even with improved performance and further pay restraint, but significant real spending increases in these areas would make it impossible to also prioritise future-oriented spending. Local government will not be able to continue with its current mix of services if it faces further deep cuts and under our alternative scenarios, local 'spending power' would fall only very modestly in 2016/17 and 2017/18.*

- *Continually improving performance and productivity will be essential for coping with tight budgets and for responding to long-term spending pressures. Pay restraint, though necessary in the short run, is not a long-term answer to containing public sector costs. Over time public sector pay should rise in line with average earnings, to maintain the*

quality of the workforce, however while deficit reduction continues it will probably be necessary for average pay to rise by no more than inflation.

- *Finally we look at the spending implications of the UK's international commitments. We conclude that spending constraints until 2017/18 will mean that a new defence and security review will be needed in 2015 and it is likely to lead to further reductions in future military capabilities. Turning to the long term, future governments could reduce defence spending as a share of national income to European norms. Over time this could reduce annual defence spending by 0.7 per cent of GDP. However there might well be downsides to this approach, with respect to the UK's global influence, and as a commission we have not taken a view on whether this move would be desirable. On international development we recommend that the current benchmark for spending is maintained in the short term, but we propose a review to assess whether it will remain appropriate into the 2020s. We also review EU spending and conclude that any immediate savings from leaving the EU would probably be outweighed by reduced growth and lower tax revenues over time.*

In this final chapter we turn to some of the detailed choices facing departmental current and investment spending. In particular we look at how our commitment to prioritising 'future-oriented' spending should be brought to life in the next parliament. The starting point is the set of three possible scenarios for spending after the next election, outlined in chapter 6.

Total departmental spending

Our three scenarios imply a range of possibilities for departmental spending and public investment with very

different consequences. If current coalition plans are implemented (scenario 1) there will be further deep cuts to departmental spending and a real freeze on investment spending. This would be likely to have very serious implications for the beneficiaries of services, especially as most public bodies will have implemented the least painful savings, such as reducing management and back-office costs: the longer cuts continue the more they will affect service users in direct and harmful ways. If a future government were in a position where it had to implement cuts on this scale, there would be a number of implications.

First, it would probably mean having to reduce real spending on the NHS and schools. We cannot see how these huge budgets can be totally protected, given the consequences this would bring for all other areas. Such a shift would of course place great strain on schools and especially the NHS. But continuing with these 'protected' budgets would further accelerate the shift in the balance of overall spending away from future-orientated activities towards health and pensions. Second, tight public sector pay restraint would be inevitable. This would see most public sector workers facing up to seven years of below inflation pay awards, at a time when private sector earnings might be finally starting to recover. Cutting public sector pay is not a 'free lunch' for the government: sooner or later pay cuts will affect the quality of service. Third it would give an incoming government very little flexibility to introduce new spending measures, by 'switching' between spending areas (for example by moving money from acute services to early intervention). Any savings identified would be far more likely to disappear into the general pool of cuts.

BOX 10: Switch spending and earmarked taxes

In this time of spending restraint, when political parties and commentators propose new spending they usually feel obliged to say how this would be paid for, either by reducing spending elsewhere or by raising taxes. Examples include:

- **Social care reforms:** paid for by inheritance tax and national insurance contributions (coalition government policy)
- **Jobs guarantees:** paid for by a bankers' bonus tax (Labour party)
- **Housebuilding:** paid for by localising housing benefit into a single housing pot (IPPR)
- **Childcare:** paid for by freezing child benefit (IPPR)

This is an important tool for political communication and is helpful when looking at marginal changes to policy, especially between spending reviews. However, our focus has been on the totality of spending, which sets the context for individual switches. The overall spending envelope dictates the viability of any of these proposals because steeply falling spending levels make it more likely that any tax rises or spending cuts will be used to fund deficit reduction rather than being recycled into new expenditure.

We've resisted the temptation to make recommendations on particular spending switches outside of the overall spending and revenue totals in order to maintain transparency and avoid the prospect of 'spending the same money twice'.

In one of the main permutations we've looked at, to fund a broadly flat departmental spending settlement, taxes could rise (the deviation from the coalition's plans is £20bn but we hope tax rises would not be required to plug all this gap) and social security spending fall compared to current plans (by £5bn). This money would therefore be unavailable to fund switches over and

above this settlement. For this reason we've assumed that important spending priorities would need to be funded from within department totals, rather than looking at the possibility of even greater changes to taxation and social security.

However, if overall real spending were to grow by around 1 per cent per year (scenario 2) then it might be possible to increase capital investment and achieve an almost flat settlement for departmental spending. We have seen that this option would entail a £20bn deviation from the coalition's plans, which might need to be funded by tax rises in whole or part. For this reason it is essential that a future government works to convince the public that its priorities for using the extra money are important for the nation and that the extra money will deliver good value. This means that a 2015 administration must be principles-led and transparent in its allocation of resources and relentless in its focus on performance, productivity and value for money. In particular, after five years of cuts which will almost certainly result in one-off productivity improvements, the government needs to convince people that the public sector's ability to spend money well will not diminish if the 'tap' of public money is opened a little.

Broadly flat departmental spending would still create significant pressures, with some budgets likely to fall in real terms to pay for rises elsewhere. However, it would mean a future government would no longer need to designate 'protected' and 'unprotected' budgets, with huge discrepancies between their funding. In this context it will be much easier to talk about trade-offs between relative priorities and focus on how to make a smooth transition from short-term savings to achieving a longer-term trajectory for spending in different areas. In all likelihood there would still need to be pay restraint, with most public

workers still likely to receive pay awards of little better than inflation. However the easier climate would hopefully create more scope for flexibility and negotiation, albeit within tightly constrained overall payroll budgets.

Capital investment

With the UK's prolonged economic stagnation, many commentators have called for a temporary stimulus involving capital spending. We are sympathetic to calls for short-term, debt-funded investment spending right now, providing the money can be spent quickly and on economically useful activities. However, the economy appears to be finally starting to recover and the case for one-off temporary investment package may well recede.

Our focus has been on a different issue however: the question of whether the UK's ongoing level of public investment should be higher. On current plans, government investment will comprise less than 3 per cent of GDP after the 2015 election, lower than in the mid-2000s let alone in the more distant past. In 2015 public sector gross investment will be £49bn (2.9 per cent of GDP) and the coalition is planning to keep this level unchanged in the following two years.[91] By comparison, investment averaged 3.2 per cent between 2005/06 to 2007/08 and 6 per cent from 1972 to 1992.[92]

Government does not necessarily need to return to the very high investment levels seen in past decades, which were linked at least in part to greater public ownership of industry. But we believe that the public sector needs to play a big role in increasing economy-wide levels of investment. We hope that improving business conditions will lead to higher private investment. But the government should also explore two options. First it should use its balance sheet to support commercial investment (providing this is done in a transparent fashion with clarity regarding potential

liabilities). The current government has made steps in this direction in its housing measures, but there is a lot more that can be achieved, for example by capitalising a business investment bank on a significant scale in order to leverage in private assets. Second, we believe there is a good case for strong, sustained public investment. In chapter five we looked at options for public spending which included spending between £5bn and £9bn more on investment than the coalition's current plans (although in place of this spending commitment we would prefer new ways to leverage private investment with public guarantees). Spending an extra £9bn would increase public investment by 0.5 per cent of GDP, which is the sort of change we have examined in considering long-term scenarios for the early 2030s. We are thinking about a permanent increase in spending, continuing towards the 2030s, not a single stimulus. So while this increase might initially be funded through borrowing in its first year, in the long-run its affordability would depend on wider trade-offs on the overall level of tax and spending and an appraisal of the economic benefits such investment might bring, including the prospect of higher tax revenues in the future.

There are many strong candidates for future investment spending, which suggests that adding say an extra £5bn to the £49bn the present government plans to spend annually would bring real economic benefit. There are three main areas where there is a clear case for additional capital investment: economic development; house-building; and public service infrastructure. Only some of the possible projects we outline here under each category could be afforded, even with public investment at this new higher level, so choices from this list would have to be made. This would still be the case even if capital spending were to increase by £9bn (0.5 per cent of GDP). This demonstrates the value of also seeking to leverage new private finance:

1. **Economic development:** There is now significant agreement among economists and policymakers that the UK needs to spend more on economic infrastructure over the next decade or so. Some of this investment, such as in the energy sector, is motivated by resilience and sustainability, but organisations like NESTA also point to the huge implications for economic growth of, for example, superfast broadband.[93] All the political parties support the principle of public investment banks (the government has launched a green investment bank and is proposing a business bank). However there is disagreement regarding the size of their capital base and the extent to which they should be able to use their balance sheets to borrow money for lending. The Treasury's published 'pipeline' of infrastructure projects amounts to £320bn of investment by 2020. This includes much of the investment required to make the transition to a low carbon economy. A great deal of this pipeline can be funded privately, especially if the government is more imaginative in the use of its balance sheet to help capitalise financial institutions and create guarantees against risks. But the Treasury envisages £40bn of purely public capital projects and a further £60bn of public/private projects. This implies public investment of perhaps £7bn to £10bn each year. This is an area where public spending is likely to 'crowd-in' private investment, particularly as the UK has a huge corporate sector surplus with many companies hoarding money for want of good investment opportunities. However in areas like green investment it will be important to have contingency plans in case sufficient private funding is unavailable.
2. **Housing**: The UK faces an acute housing shortage and there is cross-party agreement on the need to increase housing supply. Shelter suggests that 250,000 new homes are needed each year for the foreseeable future, while current policies will result in (at best) 150,000 new homes

being built annually.[94] The charity calculates that 50,000 new affordable homes can be delivered each year for £3bn of government investment, so building one million affordable homes over the life of a parliament would cost up to £12bn each year. This would be an important and bold ambition for a 2015 government, although significant non-financial barriers to a rapid expansion in house-building would also need to be overcome.

3. **Public services:** During this parliament capital budgets for most public services have been cut by significantly more than current budgets (the exception is the NHS). This has perhaps been an understandable short-term response in order to safeguard day-to-day service delivery. But it will store up long-term problems unless very large sums of capital spending have been used poorly in the recent past. There will also be specific and pressing calls for public service capital spending in the next parliament. For example, the number of children in English schools will grow by 710,000 between 2015 and 2020, which we estimate will require £11bn of capital spending to create the required school places.[95]

Figure 20: Decline in capital and current budgets for the main public service departments, 2010/11 to 2015/16

	Capital	Current
NHS (Health)	3%	4%
Environment, Food and Rural Affairs	-25%	-33%
Northern Ireland	-27%	-7%
Scotland	-33%	-7%
Wales	-33%	-8%
Justice	-40%	-31%
Education	-41%	-3%
Work and Pensions	-46%	-37%
Home Office	-52%	-28%

Source: Public Services Statistical Analyses, HM Treasury, 2013

Education, innovation and jobs

Prioritising future-oriented spending is about more than capital investment. It also means targeting expenditure on areas that are likely to maximise growth and spread opportunity, such as education, innovation and job creation. Spending of this sort falls across several departments, but the main focus is the Department of Education (early years, schools) the Department for Business, Innovation and Skills (universities, adult skills, science, business innovation) and the employment programme budget of the Department for Work and Pensions.

BOX 11: New early years, skills and economic programmes: unaffordable priorities?

Early in the next parliament, while austerity continues, it may be difficult to introduce any new educational or economic spending programmes. However, there are a number of important potential priorities which should be investigated further, even if they only become affordable in the second half of the parliament. Within education-related budgets we believe the priority should be early years provision and adult skills. Within the economic budgets there is a balance to strike between prioritising job creation and support for innovation:

- **Innovation, research and enterprise:** There is strong evidence that public spending needs to play a major part in driving innovation in the economy, including the development and commercialisation of new technologies and business practice.[96] The case was brought together by NESTA in the 2012 report *Plan I* which proposed a one-off package of £2.5bn of current spending (as well as £1.5bn of capital) to support science, innovation and enterprise.

- **Early years and childcare:** An expansion of free or heavily subsidised childcare for pre-school children would have a significant impact on employment of parents, especially mothers. The Resolution Foundation has proposed extending the national entitlement of 15 hours per week to 25 hours per week, including holiday periods, at an estimated cost of £2.1bn.[97] This ignored the expected benefits for taxes and benefits of increased earnings and higher employment.
- **Jobs guarantees:** The Labour party has proposed a jobs guarantee programme for long-term unemployed people, which proposes offering work and training to those aged under 25 unemployed for more than one year, and a job for people aged over 25 unemployed for more than two years. It calculates the combined cost of the scheme at £1.6bn. However, the evaluation of a similar scheme, the future jobs fund, found that about half this cost was recouped, mainly through higher taxes.[98]
- **Further education, apprenticeships and adult skills:** There is now strong evidence of the positive economic impact of well-targeted further education, especially employer-led workplace training. Apprenticeships appear to deliver the most long-term benefits.[99] Public funding is also important to leverage in employer funding and promote positive views on the value of upskilling among individuals and employers.

In the early years of the next parliament, while deficit reduction continues, we recognise that it will not be possible to significantly increase spending for these three departments. However we believe they should be protected on the same basis as the NHS to avoid any further shift in the composition of spending away from future-facing activities. In chapter 6 we set out one possible spending settlement for 2016/17 and 2017/18 which included a

real term freeze for the three departments. This would be affordable if overall real spending were to rise by one per cent a year (scenario 2).

After difficult years of cuts a freeze may seem welcome, but it means it will be very difficult to introduce any major new entitlements or spending programmes, which many policymakers and politicians would like to see adopted. The reality is that any new taxes or savings identified elsewhere, will first need to be used to avoid cuts to existing programmes, which would otherwise be likely. All new spending across these areas would probably need to be funded from switch spending from within these departments' existing budgets. This could be possible through efficiency savings and reductions to less well-performing programmes, including a number of DWP employment initiatives. However, any significant savings might require ministers to top-slice the schools, universities and science budgets, for the sake of spending expected to achieve faster or larger returns. We do not think any large-scale move in this direction would be acceptable to decision makers.

Health and local government

Over the current parliament, the funding of health and local government have been chalk and cheese. The NHS has received considerable protection while councils have faced deep cuts, notwithstanding efforts to protect adult social care. Looking to the future this makes little sense, because spending by health and local government is deeply intertwined, with the NHS often picking up the costs if good quality council provision is not available, across housing, social care and public health in particular. The top-level decisions a future government takes on the level of council spending will have a massive impact on the public sector's ability to shift towards 'early action' since councils are often the agency responsible for early intervention, when

the 'costs of failure' fall on other services like the NHS or criminal justice system. In chapter 3 we suggest that councils should do more to coordinate local spending, with more joint commissioning and pooling budgets. But none of this is an alternative to adequate funding for local government.

Of course it is an oddity of the UK that national politicians have so much control over the spending power of local authorities. Local government has fewer revenue raising powers than subnational public bodies in almost any other advanced economy, which means they are dependent on central government revenue, especially in areas with high needs and weak local economies.[100] The commission has not considered the future of local government finance and taxation, although we recognise the current system is far from perfect. We would like to see a fundamental review of tax in the UK which considers how to fund councils better. However, for the time being our focus is on the existing system.

Our conclusion on short-term funding is that adult social care should be funded on the same basis as health, since they are so intertwined. So, in chapter 6's illustrative 'scenario 2' spending settlement, the proportion of council grants linked to social care would be frozen alongside the health budget. This would also leave open the option of greater integration between adult social care and health, something which all the main political parties are actively exploring. Turning to councils' other responsibilities, we do not believe it will be possible to cut local authority spending power on the scale seen in recent years. This is one of the main reasons we hope it will be possible to deliver a 1 per cent increase in public spending. In the illustration we considered, this would entail an annual decrease to councils' grants of no more than 3.5 per cent. Since councils also have locally-raised revenue which tends to rise or remain stable this grant cut might translate into a decline in council budgets of 1 to 2 per cent a year.

As the deficit reduction programme comes to an end, there is a strong case for increasing spending on social care. The current government has promised to implement a version of the Dilnot Commission's proposals to reform the funding of adult social care and this is now included in the coalition's spending plans. The Labour party is considering whether to accept these new arrangements or go further, with a more generous system of funding. Providing a full or partial contribution to the costs of a wide range of care needs could cost an extra £2bn or more.[101] Arguably, higher priority should be given to addressing the high levels of unmet need that exist today. Providing support to a slightly wider group of disabled people with 'moderate' needs would for example cost an extra £2.7bn by 2020.[102] This might be considered more important than supporting the care costs of mid and high income households. In chapter 5 we included extra spending for social care along these lines as part of our 'high' option for future health and care spending. We recommend that decisions are taken on future social care policy early in the next parliament so any new system can be implemented once public spending growth returns to trend.

Turning to the NHS, there will continue to be strong upward pressures. We can see little prospect of meeting these pressures via extra funding while the process of deficit reduction continues. Since healthcare accounts for such a large proportion of public spending even a very modest rise in spending would quickly eat up any extra resources that became available. In our example of how spending might be allocated with a 1 per cent rise in overall expenditure we suggested that NHS spending should continue to be frozen in real terms. A future government could take a different view and prioritise healthcare over future-oriented expenditure and working-age social security. However, this would further tip the balance of spending in favour of pensions and the

NHS. To take an extreme example, with this overall level of spending, NHS spending rises could return to their trend rate of 4 per cent a year only if social security entitlements were reduced by £10bn, investment was frozen and every other departmental budget was cut by 1.5 per cent per year.

The Nuffield Trust has considered the implications for the NHS of flat spending after 2015/16. It suggests that much of the gap between rising spending pressures and flat spending could be met by realising savings from productivity gains, improving the management of chronic conditions and increasing pay by inflation only. These savings would make it possible to increase NHS spending by just 1 per cent a year, still leaving a hole if there was no increase at all. If further efficiencies could not be found the level of service would decline. There are therefore significant risks in not increasing NHS spending immediately after the next election. However, for two years, we believe these are outweighed by other pressing calls on public spending. After that point health spending will need to rise by more than GDP for the next decade, unless there are very impressive performance and productivity improvements.

Productivity and pay

Improving performance in public services is a challenge faced across the world. One OECD review from before the financial crisis found that the most important factors for improved performance were high employee satisfaction; achieving economies of scale; and decentralising control (the latter two may of course come into conflict).[103] The present government is likely to achieve improvements to public sector performance as a consequence of spending reductions, since most organisations facing cuts are typically able to find significant savings before the outcomes

they produce diminish significantly. This appears to be the case with respect to local government at present.[104]

When or if spending cuts stop, it is vital that performance improvements are not allowed to slacken off. In order to demonstrate value for money to the public and respond to continuing pressure for spending, striving to increase performance needs to be a ‘permanent revolution’. For an incoming national government, the most obvious opportunity is to create new institutions and processes that link the measurement of performance with national budgeting decisions and support for innovation and improvement within organisations. As we argue in chapter 3, this is a significant hole in the coalition’s approach to public services. While cuts and organisational restructures create short-term pressures for reform, there has been a huge dilution of the institutional links between national government and local public services focused on goals and informed by evidence.

Value for money is of course intimately linked to the largest component of public service spending: pay. The pay bill for local and central government represented half of total departmental spending in 2010/11 but it is falling significantly. OBR projections suggest that the pay bill will fall by 19 per cent in real terms between 2010/11 and 2017/18. A total of one million jobs will be lost by 2014/15.[105] Significant performance improvements are required to prevent the loss of public sector workers leading to reduced quality and quantity of services.

Meanwhile salaries are also being reduced through average pay settlements of between zero and 1 per cent in cash terms between 2011 and 2015, with the OBR projecting that average public sector pay will fall by 4 per cent in real terms. This has widespread consequences for the family incomes of public sector employees and has contributed to falling real wages across the economy. There is considerable controversy as to whether pay is higher in the

public or private sectors, driven by difficulties in establishing comparable jobs. There is however general agreement that senior roles in the private sector are better paid, as are junior roles in the public sector. In the early 2000s Labour intentionally increased public salaries, which had been falling behind for many years. In many cases this was combined with workforce reforms, such as the NHS Agenda for Change package. At the start of the economic crisis private sector pay stalled while public pay did not adjust immediately. Since 2011 real pay in both sectors has been declining, but by slightly more in the public sector.[106]

The government coming to power in 2015 will face a dilemma on pay. Private sector earnings are likely to start to pick up as the economy recovers: by 2015 they are forecast to be rising by 4.5 per cent compared to 1 per cent in the public sector.[107] Choosing to cap public sector pay in the following years would place a further squeeze on employees' finances but would also create recruitment and retention problems. Sooner or later public sector pay will therefore need to start rising in line with average earnings, and this should be the long-term assumption when thinking about future spending choices.

The point where this becomes possible will be dictated by overall levels of departmental spending. But even if there is some relaxation in spending restraint, ministers are unlikely to want all the extra money to go in higher pay awards in the absence of improving services. This leads us to conclude that some sort of pay restraint will be needed for as long as deficit reduction continues. In the case of the NHS, there will be huge problems for as long as spending rises by less than GDP growth, unless pay is pegged to inflation only. We suspect that in most public services the story will be similar: even if it is possible to achieve broadly flat real-terms settlements for departments (rather than further cuts) raising average salary by more than inflation would probably be at the expense of the quantity of service

delivery. But this is a difficult balance which cannot be sustained forever because employees need fair remuneration in order to sustain and build the quality of services.

Although we regretfully conclude that pay restraint is needed, our preference is to avoid blanket pay 'caps', which give no flexibility for individual government departments and budget holders to consider their own needs and negotiate with employee representatives. Given the tight overall spending limits each public service will face, some devolution of responsibilities for pay negotiation is still likely to be compatible with overall pay restraint.

International commitments

During the course of our work we took valuable evidence on the spending implications of the UK's international and security commitments. Here we set out findings on the potential costs of different policy options with some limited commentary. However it was not our role to carry out a review of the UK's strategic international commitments.

Our overall conclusion is that strategic decisions with major implications for the UK's security, prosperity and global influence should be taken with a long-term perspective, including implications for long-term expenditure. They should not be made on short term cost grounds.

This does not mean these budgets should be excluded from a robust approach to value for money. For example we assume that defence spending will neither be singled out for cuts over other departments nor subject to specific protection. This would lead to defence spending being lower than current MoD planning assumptions.

Defence

Since 2010, the coalition government has made significant reductions to defence spending. The effect of these cuts has

been to return annual spending as a proportion to national income to the levels seen in the mid-2000s, at around 2.4 per cent of GDP.[108] Current defence strategy implies that spending will start to grow roughly in line with rising GDP after 2015. The government's plans for defence equipment assume spending in this area will rise by 3.8 per cent per year until 2021 with further similar growth likely until 2025. This assumption may be plausible once the deficit is closed but it is not for the early years of the 2015 parliament, when most spending areas will face spending settlements well below GDP growth. This suggests that the armed forces will need to revise their current plans and a 2015 government will need to consider reductions to new equipment or current capabilities.

Current long-term planning assumptions are based on the UK maintaining stronger conventional forces than most European countries and an independent nuclear deterrent. Over the next 20 years future governments could decide to take another path and gradually reduce defence spending towards international norms. For example, reducing spending to the EU average of 1.7 per cent of GDP would reduce the defence budget by 0.7 per cent of GDP (equivalent of £11bn per year, based on prices and GDP today). This saving could be used to reduce overall expenditure or transferred to other priorities. However, this would be a major strategic shift for the UK which might have implications for the UK's global contribution and influence and would not necessarily attract public support. As a commission we have not taken a view on whether such a move is desirable.

The most widely discussed option for savings is to reduce the scale of the nuclear deterrent. The government's recent Trident Alternatives Review concluded that a like-for-like replacement for Trident was the cheapest option for a replacement nuclear deterrent, given the cost and duration of developing new systems (although savings of around £ 0.5bn per year could be made between 2025

and 2035 if the UK opted for three submarines rather than four). If a future government chose not to replace Trident, it would save £1bn per year in 2020 rising to £2bn later in the decade.[109] In future decades, ongoing expenditure would also be lower, once the existing Trident fleet and nuclear weapons facilities were fully decommissioned. Every area of spending should be subject to careful evaluation and challenge, but it is worth noting that these potential savings are small when compared to the totality of public spending.

Reducing defence spending to EU norms could make a contribution to meeting rising spending pressures elsewhere. However the potential saving would not be sufficient to pay for anything like all the upward pressures on domestic spending. We support continued debate on these issues, but this should be driven more by considerations of national security and the UK's global influence, rather than short-term spending pressures.

International development

In 1970 the United Nations agreed that developed nations should aim to spend 0.7 per cent of national income on public sector development assistance. This objective has been accepted by every UK government since 1974 and in 2004 the Labour administration set out plans to reach the target by 2013 which were accepted by all parties at the 2010 election. The coalition has stood by this commitment despite other spending pressures and the Department of International Development (DfID) has been one of the only government budgets to see a real increase in spending since 2010. As a result this year the UK has become one of only six (north European) nations to have achieved the target. The UK is by far the largest of the group and the second largest donor nation, spending approaching half as much as the United States.

Critics have suggested that the 0.7 per cent target should be abandoned for a number of reasons: (1) it is unaffordable for the UK during austerity; (2) other nations are not making comparable efforts to achieve the threshold; (3) the target focuses on what is spent not what is achieved; (4) rapid increases in spending raise the risks of ineffective spending; (5) high levels of aid have negative consequences for governance and the development of tax systems in developing countries; (6) trade, investment and migrants' remittances are far more significant for development than aid; (7) the 0.7 per cent threshold is derived from academic studies in the 1950s and has no contemporary rationale.[110] Were these calls to be adopted it would be possible to imagine the UK gradually reducing its commitment over time to 0.35 per cent, roughly the same as Germany's spending today. This would save the equivalent of £6bn per year (based on today's prices and GDP).

However, there are good reasons for rejecting this course. DfID has an excellent global reputation and there is no shortage of important objectives relating to health, education and poverty alleviation in some of the world's poorest communities. Achieving the 0.7 per cent target also sends an important message out to international partners amongst both developed and developing nations. In 2015/16 the DfID budget will only amount to £8bn, out of total public spending of around £720bn. In the following two years if DfID's budget was decreased in line with other departments rather than rising in line with GDP there could be savings of around £1bn at most. This is not an insignificant amount, but as with defence commitments, we do not believe this is a sufficiently large sum to make a rapid, cost-based decision, given the implications for the UK's global position. In the short term we recommend that the government aims to ensure relevant spending across all departments is included in the count of Official Development Assistance. For the long term we propose that the

next government carries out a full review of the aid target, preferably on a multi-lateral basis, to assess whether it will remain appropriate into the 2020s.

European Union contributions

The Conservative party has promised a referendum on the UK's membership of the European Union should it return to government after 2015. There are a great many factors in assessing the advantages and disadvantages of continued EU membership and one consideration is whether the UK receives value for money from its financial contributions to the EU. In 2012, the UK contribution to EU institutions was around £13bn and EU spending in the UK amounted to around £5bn, making our net contribution around £8bn.[111] This discrepancy arises because large parts of the EU budget finances economic development in poorer member states and agricultural subsidies (the UK has a relatively small agricultural sector). UK governments have long argued for reform of the EU budget so that less money is spent on agriculture and more on economic development; this might not increase UK receipts significantly but it would be likely to increase trade. The EU's budget for 2014 to 2020 is currently in the process of being finalised. The UK was among several member states which successfully argued for a modest budget cut but there will be little change to its overall composition. A 2015 government will therefore have few immediate opportunities to re-open EU budget discussions.

On the other hand, were the UK to withdraw some short-term savings could, in theory, materialise. The UK would still need to pay contributions if it wished to remain a member of the single market and participate in other EU programmes on an opt-in basis. For example, Norway will this year make a contribution of €550 million to EU institutions. Since our economy is over eight times larger than

Norway's the UK contribution might be £4bn. On top of this a like-for-like domestic replacement for EU spending in the UK would cost £5bn. So realistically the UK might save in the region of £4bn from withdrawing from the EU (ie the ending of the UK's current gross contribution, less the replacement spending required). However exit this could have very significant consequences for economic growth, tax revenues and the UK's global influence. We are highly sceptical about the economic and fiscal case for withdrawing from the EU.

APPENDIX 1: THE FABIAN COMMISSION ON FUTURE SPENDING CHOICES

Commissioners

Chair: Lord McFall of Alcluith
Lord McFall was chair of the House of Commons Treasury Committee, a position which he held between 2001 and 2010. He currently serves on the House of Lords Economic Affairs Committee.

Dan Corry
Dan Corry was senior adviser to the prime minister on the economy from 2007 to 2010 and head of the Number 10 Policy Unit (2007-8). He has been chair of the Council of Economic Advisers in the Treasury.

Andrew Harrop
Andrew Harrop has been general secretary of the Fabian Society since September 2011. He has written extensively on public services including the Fabian publications *The Coalition and Universalism* and *For the Public Good*.

Carey Oppenheim (commissioner until May 2013)
Carey Oppenheim is a freelance policy and management consultant. Her previous roles include co-director of IPPR and special adviser to Tony Blair in the Number 10 Policy

Unit, specialising in policy on employment, social security, childcare, poverty and equalities.

Ray Shostak
Ray Shostak CBE, was head of the Prime Minister's Delivery Unit and Director General, Performance from 2007-2011. He was a member of the Board of HM Treasury and had policy responsibility for the government's performance framework.

Anna Smee
Anna Smee is the director of ventures at The Young Foundation. Prior to this, Anna was managing director of Hundred Consulting, working with private equity and venture capital firms.

David Walker
David Walker is part-time director of getstats, the Royal Statistical Society's campaign for statistical literacy and a contributing editor at Guardian Public Leaders Network. He is chair of the Economic and Social Research Council's methods and infrastructure committee.

Researcher: Robert Tinker

The remit of the Commission was to examine public spending choices for the UK government for the period after 2015 by considering how the UK can reduce the fiscal deficit in a way that maximises prosperity, security, sustainability and social justice.

After developing a range of possible scenarios for the public spending envelope, the inquiry aimed to produce evidence, analysis and recommendations on the following issues:

- **The case for future spending**: The purpose of public spending, the values and criteria which should be adopted, future pressures on public spending.

- **Future spending and the economy**: Economic reforms which might reduce demand for public spending, options for spending which maximise jobs, earnings and sustainable growth.
- **Future social security spending**: Social security design principles and choices, including possible cuts or spending increases.
- **Future public service spending**: Public service design principles and choices, including possible cuts or spending increases; public sector pay; sector-specific issues on major areas of spending, including preventative interventions and the configuration of provision.
- **Proposals or options for restraining individual budgets**: That are compatible with possible scenarios for overall public spending.

The Commission conducted its work through eight evidence hearings, by seeking submissions and by Commissioning background evidence papers. The Commission has been supported by an advisory network (for a full list of members see www.fabians.org.uk). The remit of the inquiry was the UK government so excluded decisions devolved to Wales, Scotland and Northern Ireland.

Witnesses to the hearings:

- James Browne (Institute for Fiscal Studies)
- Kate Bell (formerly, Child Poverty Action Group)
- Malcolm Chalmers (Royal United Services Institute)
- Anita Charlesworth (The Nuffield Trust)
- Patrick Diamond (Policy Network)
- Anna Dixon (formerly, The King's Fund)
- Paul Gregg (University of Bath)
- Christian Guy (Centre for Social Justice)
- Margaret Hodge MP (Chair, Public Accounts Committee)
- Donald Hirsch (University of Loughborough)

- Paul Johnson (Institute for Fiscal Studies)
- Ian Kearns (European Leadership Network)
- Gavin Kelly (Resolution Foundation)
- Kayte Lawton (IPPR)
- David Hall-Matthews (Publish What You Fund)
- Ian Mulheirn (formerly, Social Market Foundation)
- Simon Parker (New Local Government Network)
- Jonathan Portes (National Institute of Economic and Social Research)
- David Robinson (Community Links)
- Nicola Smith (TUC)
- Sonia Sodha (formerly, Dartington Social Research Unit)
- Professor Peter Taylor-Gooby (University of Kent)
- John Tizard (independent consultant and adviser)
- Stian Westlake (NESTA)

What we learnt

Hearing 1 – 'What is public spending for?'
Rises in public spending over the past 150 years have followed a stepped pattern whereby an external shock results in a new higher spending level around which expenditure then fluctuates. In general public spending does not go down for long even after attempts to significantly retrench. If the current deficit programme is successful it will mark a break from the past.

Hearing 2 – 'Scenarios and pressures for public spending'
The decision to ring fence major spending areas such as health and pensions is reshaping British public spending, with 'un-protected' department spending losing out. Assuming current protections remain during the next Spending Round by the time of the next general election current spending by non-protected departments will have fallen by a cumulative total of more than 30 per cent since 2010-11.

Over the next 20 years the costs of demographic trends such as population ageing are moderate and not uniform across spending areas. Rising demand for health care as a consequence of the ageing of the population will be quite modest. Revenue will rise faster than expenditure, assuming governments continue their current policies, including their approach to the indexation of tax thresholds and working-age benefits.

Over the next 50 years Britain faces a choice as to whether it wishes to pay for gradual increases in the cost of pensions and healthcare. Over many decades other areas of public spending could be squeezed unless taxes rise as a share of the economy. But the scale of action required is modest.

Hearing 3 – 'Predistribution: can economic reform reduce demand for public spending?'

The UK's is hampered by a version of capitalism where ordinary workers do not fully share in the proceeds of economic growth, with an unusually large low-wage sector. To alter patterns of inequality and disadvantage the UK needs investment spending (eg skills); market reforms ('predistribution'); and traditional redistributive transfers.

'Predistribution' interventions with respect to the cost of living, low pay and employment participation are important. But over the medium term they will only have modest impacts on levels of inequality. Some policies could realise small cash savings but the real potential of economic reforms is in relieving upward pressure on future budgets.

'Predistribution' approaches are less efficient at directing resources to those who most need support than targeted public spending. As a consequence significantly larger resources need to be marshalled to achieve comparable ends. Significant distributional intervention within markets may in some cases have negative economic consequences (eg rent controls).

Hearing 4 – 'How can public spending promote growth, jobs and earnings?'

Since 2003 tax credits have been the key source of income growth for low and middle earners. Coordinated policy action on affordable child care, skills, and low pay could together boost market incomes for low and middle earners. But there is continuing uncertainty about how to better channel GDP growth into the hands of low to middle income households.

Infrastructure and innovation are both vital to economic growth and heavily reliant on public investment. The priorities are not always obvious: for a third of the cost of High Speed 2 the government could ensure that the whole of the UK has super-fast broadband and this would probably have a larger economic impact

Hearing 5 – 'Tough choices: social security'

Social security under the previous Labour government was generally to the benefit of older people and families with children. The rising generosity was combined with a falling number of people claiming out of work benefits, particularly among lone parents. The proportion of total GDP spent on social security remained fairly constant, with significant increases in the amount spent on families with children and pensions offset by the fall in spending on out of work benefits.

Over half of social security spending is on pensioner entitlements which the government has protected. But universal benefits such as winder fuel payments and TV licences amount to only 2.5 per cent of pensioner social security spending and the administrative costs of means testing this benefit would be significant.

Further cuts to social security would all be controversial. Options include: extending the duration of below-inflation uprating; restricting universal pensioner entitlements; taxing more entitlements including disability benefits; restricting housing benefit for young adults.

Hearing 6 – 'Tough choices: public services'

Ageing is only a modest driver of rising health spending. The labour intensive nature of services, appetite for the NHS to 'do more' and significant technological advances are much larger factors.

A number of proposals for 'switch' spending have been proposed (pooling housing benefit and house-building budgets; replacing pensioner entitlements with capital spending). There are also policy options which might pay for themselves (in whole or part) such as investment in childcare that boosts female employment.

There is a deficit in local accountability and democracy regarding spending. Less than 25 per cent of expenditure spent locally is directly influenced by elected local politicians. Remove schools, and the figure drops to below 10 per cent.

Hearing 7 – 'Public services: productivity, innovation and waste'

Public services are people intensive and their productivity gains therefore lag those for the whole economy. In healthcare productivity has been basically flat, with increased quality of outputs matched by increased inputs.

The key to improving NHS productivity and achieving better outcomes is to change models of care by delivering more services outside hospitals and focus more on prevention. But over the first two years of austerity, primary care saw real cuts and mental health spending increased very little.

Early action and prevention spending should be protected from short term raids from other budgets, rather like capital budgets. However there are barriers that stop early action spending producing 'cashable' savings, some of which can be overcome with institutional reforms within public services.

Hearing 8 – 'International and security commitments'
International development spending could be better used, and there are arguments in favour of a greater emphasis on supporting governments and capacity building. There is the potential for some savings to be realised by merging functions of DfID and the Foreign Office.

Under this government defence has received real terms cuts of between 15-20 per cent. This means that relative to other non-ring fenced areas of spending it has enjoyed a better settlement. Future cuts in defence will be felt in terms of reduced personnel. If government does not wish to spend more on defence in the future, it needs to find ways of reducing ambition or doing a greater amount with its allies.

APPENDIX 2: PUBLIC ATTITUDES TO SPENDING 1997-2010

Findings from the British Social Attitudes Survey, with commentary on policy changes during the period:

Percentage of public who agree with following statements:	**Policy change**	**1997**	**2007**	**2010**
Tax and spend				
Reduce taxes and spend less	*Spending increased from 38% of GDP in 1997 to 41% in 2007*	3	7	9
Increase taxes and spend more		62	41	31
Government should redistribute income	*Redistribution remained broadly stable*	39*	32	36
Unemployment				
Unemployment benefits are too low and cause hardship	*Unemployment benefits lost value relative to earnings though benefits for children in non-working families increased significantly*	46	26	23
Unemployment benefits are too high and discourage work		28	54	54
Most unemployed people could find a job if they wanted one	*Availability of jobs was high in 2000s but unemployment increased with recession*	54*	67	54
Would like to see more government spending on… unemployed people	*Unemployment benefits lost value and number of recipients declined until the recession*	22*	15~	15#
Social security				
Government should spend more on welfare benefits	*Spending as a share of GDP broadly stable during Labour's period in office*	43*	32	29

If benefits were less generous people would stand on their own two feet	*Benefits for adults became less generous, but those for children and pensioners increased*	33>	52	55
Many benefit recipients don't deserve help	*Conditions for receiving benefits were tightened*	32*	36	35
Would like to see more government spending on… disabled people	*Benefited from investment in NHS but disability benefits and social care were low priorities*	74*	63~	53#
Would like to see more government spending on… parents who work on very low incomes	*Benefited greatly from tax credits and expansion of free early years education*	70*	69~	58#
Would like to see more government spending on… single parents	*Benefited from tax credits and early years, but numbers out of work on benefits fell*	35*	38~	29#
Would like to see more government spending on… retired people	*Generous support through Pension Credit reduced poverty. State pension linked to earnings in final year of Labour government.*	73*	73~	57#
Would like to see more government spending on… people who care for those who are sick or disabled	*Little improvements in services or benefits*	84*	85~	75#
The NHS				
Satisfied with the NHS	*Volume and quality of healthcare improved*	34	51	70
Healthcare standards have got worse over last 5 years		49<	27~	16
Oppose the NHS being made available only to those with lower incomes	*Universal principle maintained*	72~	74^	77

Data for the comparison years is not available for all questions. Alternative years are as follows:

*1998 ~ 2008 # 2009 >1996 < 1995 ^2006

People's first or second priority for extra government spending:

	1997	2007	2010
Health	78	74	71
Education	70	60	64
Housing	11	15	13
Police and prisons	10	15	11
Help for industry	8	4	10
Defence	3	7	8
Public transport	6	11	7
Roads	3	6	7
Social security benefits	9	5	5
Overseas aid	1	1	2

APPENDIX 3: SCENARIOS FOR PUBLIC SPENDING

Three scenarios for 2016/17 and 2017/18

Scenario 1: Coalition plans – March 2013

	Spending (13/14 prices) £ billion			Percentage change (13/14 prices)			Variation from coalition plans (13/14 prices) £ billion		Percentage of GDP	
	15-16	16-17	17-18	16-17	17-18	Both years	16-17	17-18	16-17	17-18
Department spending - current	£303	£291	£278	-4%	-4%	-8%			17%	16%
Annually managed expenditure - current	£366	£375	£385	2%	3%	5%			22%	22%
Total public sector gross investment	£49	£49	£48	0%	0%	0%			3%	3%
Total managed expenditure	£717	£715	£712	0%	0%	-1%			42%	41%

Scenario 2: 1 per cent annual increase in total managed expenditure: Illustration adds £5bn to gross investment; adds £20bn to department spending; cuts £5bn from AME

	Spending (13/14 prices) £ billion			Percentage change (13/14 prices)			Variation from coalition plans (13/14 prices) £ billion		Percentage of GDP	
	15-16	16-17	17-18	16-17	17-18	Both years	16-17	17-18	16-17	17-18
Department spending - current	£303	£301	£298	-1%	-1%	-2%	£10	£20	18%	17%
Annually managed expenditure - current	£366	£373	£380	2%	2%	4%	-£3	-£5	22%	22%
Total public sector gross investment	£49	£51	£53	5%	5%	10%	£3	£5	3%	3%
Total managed expenditure	£717	£725	£732	1%	1%	2%	£10	£20	42%	42%

Scenario 3: 2 per cent annual increase in total managed expenditure: Illustration adds £9bn to investment; adds £25bn to department spending

	Spending (13/14 prices) £ billion			Percentage change (13/14 prices)			Variation from coalition plans (13/14 prices) £ billion		Percentage of GDP	
	15-16	16-17	17-18	16-17	17-18	Both years	16-17	17-18	16-17	17-18
Department spending - current	£303	£304	£304	0%	0%	0%	£13	£25	18%	17%
Annually managed expenditure - current	£366	£375	£385	2%	3%	5%	£0	£0	22%	22%
Total public sector gross investment	£49	£53	£57	9%	8%	18%	£4	£9	3%	3%
Total managed expenditure	£717	£732	£746	2%	2%	4%	£17	£34	43%	42%

Scenario 1 variant: Current plans for total managed expenditure: Illustration adds £10bn to departmental spending; cuts £10bn from AME

	Spending (13/14 prices) £ billion			Percentage change (13/14 prices)			Variation from coalition plans (13/14 prices) £ billion		Percentage of GDP	
	15-16	16-17	17-18	16-17	17-18	Both years	16-17	17-18	16-17	17-18
Department spending - current	£303	£296	£288	-2%	-3%	-5%	£5	£10	17%	16%
Annually managed expenditure - current	£366	£370	£375	1%	1%	2%	-£5	-£10	22%	21%
Total public sector gross investment	£49	£49	£48	0%	0%	0%	£0	£0	3%	3%
Total managed expenditure	£717	£715	£712	0%	0%	-1%	£0	£0	42%	41%

Three scenarios for spending and revenues in 2032/33

	Percentage of GDP		
	Low variant	High variant	Mid-way
Health	7.6	8.9	8.2
Long-term care	1.8	2	1.9
Education	4.5	5.5	5.5
Pensions	6.5	6.6	6.5
Pensioner benefits	0.7	1	0.7
Public service pensions	1.9	1.9	1.9
Other social benefits	4.4	5.8	5.1
Other spending	8.4	8.9	8.9
Total non-interest spending	35.8	40.6	38.7
Total Managed Expenditure	38.8	43.6	41.7
Required primary balance	1.3	1.3	1.3
Required non-interest revenue	37.1	41.9	40.0
Required total receipts	37.9	42.8	40.9

Notes: All results are Fabian Society calculations, using OBR data (Fiscal Sustainability Report, 2013)

Description of Variants:
- Health - Low: OBR central case; High: OBR variant accounting for rising unit costs
- Social care - Low: OBR central case; High: 0.2% added to reflect possible reforms
- Education - Low: OBR central case; High: 1% added as a policy choice
- Pensions - Low: 0.1% reduction for replacing 'triple lock' with earnings indexation; High: OBR central case ('triple lock')
- Pensioner benefits - Low: price indexation; High: OBR central case (earnings indexation)
- Other benefits - Low: price indexation; High: OBR central case (earnings indexation)
- Other spending - Low: OBR central case; High: 0.5% added as a policy choice

APPENDIX 4: EVALUATION OF SOCIAL SECURITY REFORMS

This appendix sets out detailed commentary on the case for/against proposed reforms to social security entitlements early in the next parliament.

Possible reductions to social security entitlements

Proposal	**Comment**	**Annual saving (source in brackets)**
NOT RECOMMENDED FOR CONSIDERATION		
Increase state pension age to 66 by 2017/18	It would be unfair to people approaching retirement to move their state pension age at very short notice. The policy would only save money over three years as state pension age will reach 66 in autumn 2020.	Around £5bn [FS]
Means test universal disability benefits (personal independent payment, disability living allowance, attendance allowance) by absorbing them into universal credit and pension credit (or attendance allowance only)	Large numbers with mid and high incomes receive disability benefits, but they are designed to recognise the extra costs of disability people face (ie a similar case as for child benefit to reflect the extra costs of bringing up children). These measures could be applied to new claimants only, but the savings would take many years to materialise. Proposals to only apply these reforms to attendance allowance claimants would treat different age groups unequally.	Up to £6bn [IFS] (£2.5bn for AA only [KF])
Reduce child element of tax credits/ universal credit to 2003/04 level (in real terms)	This policy would reverse the significant efforts to increase family incomes and reduce child poverty made in recent years. At a time when market incomes are not growing this would also have a significant impact on child wellbeing and equality of opportunity.	£3.8bn [IFS]

Restrict child tax credit to two children (or for non-working households only)	This would reduce financial support for large families, which are already much more likely to face both poverty and deprivation.	£2.4bn (£1.4bn) [IFS]
Scrap housing benefit for under-25s (or just under-25s without children)	Many young people need to live apart from their parents for a wide variety of legitimate reasons (eg estrangement, space limitations, moving to find work etc). Only providing rent subsidies to parents would increase financial incentives for young adults to have children, which might be considered undesirable.	£1.8bn (around £900 million) [IFS]
Means-test universal credit more aggressively (withdraw 70p not 65p for every £1 earned)	This would reduce financial support for low paid working households and worsen financial incentives for moving into work and increasing hours or pay.	£1.3bn [IFS]
Extend 1 per cent uprating of benefits to 2017/18 (for those benefits currently affected)	Reducing the real incomes of low income families for five consecutive years will significantly reduce wellbeing and increase poverty and income inequality	£1.2bn [IFS]
Stop child benefit at age 16	With the school leaving age rising to 18 and young people no longer receiving education maintenance allowance, most parents continue to face significant costs when their children are 17 and 18.	£720 million [IFS]
Restrict child benefit to two children (or for non-working households only)	This would reduce financial support for large families, which are already much more likely to face both poverty and deprivation.	Around £700 million (£200 million) [IFS]
End contributory employment and support allowance and job seeker's allowance	This proposal would end the principle of contributory, universal benefits during working life, in return for a small financial saving. Many commentators are arguing for an extension of these sorts of benefits, rather than their final eradication.	£500 million [IFS]
Scrap carers' allowance and absorb it into universal credit	Carers' allowance is only available for people not working and recognises a valuable social contribution.	£100-200 million [IFS]
DIFFICULT BUT COULD BE CONSIDERED		
Means-test child benefit by making it an additional component of universal credit	This would extend the new child benefit means test beyond higher rate tax payers to many middle income families. The new means test is highly flawed, as it is based on individual not household incomes. But this proposal would leave almost half the income distribution without financial support for bringing up children (eg entitlement would only be available for a family with two children with incomes up to £33,000). This would increase financial pressures on mid-income groups who are seeing falling real incomes and would further undermine the universal principle	£4.5bn [IFS]

Means-test child benefit for families with incomes over £50,000	Now the principle of means-testing child benefit has been established, excluding a slightly larger group of high-income households might be considered acceptable. Although this would further undermine the universal principle it would also create a fairer means-test based on household income. This reform would exclude almost a quarter of the income distribution, rather as tax credits did when originally conceived. Absorbing child benefit into universal credit might help establish the new entitlement as a mainstream, majoritarian form of support.	£3bn [IFS]
Apply new personal Independence payment eligibility test to people aged over pension age receiving disability living allowance and attendance allowance	The new Personal Independence Payment has a more stringent test of eligibility than Disability Living Allowance which it replaces. However the previous test continues for recipients of DLA and Attendance Allowance over pension age. There is no reason in principle not to treat disabled people of different ages alike. Without trials it is hard to predict how many older people would lose eligibility and therefore the scale of the saving. It might be considered undesirable to reassess existing claimants aged over 65 in which case the majority of the savings would take some years to materialise.	£2bn [IFS]
Means-test winter fuel payment and free TV licence for over 65s by making them available to pension credit claimants only	This would withdraw valued support for many older people with moderate incomes and also from the third of low income pensioners who do not claim their entitlement to pension credit (although this reform might have the effect of increasing take-up). Winter fuel payment and the free TV licence are recent creations so means-testing them might not be considered an attack on the wider principle of a universal pension system.	£1.5 to 2bn [IFS]
Means-test disability benefits (personal independence payment, disability living allowance, attendance allowance) to exclude the top quarter of the income distribution	This would be analogous to the proposal to withdraw child benefit from parents with incomes higher than £50,000. It has the same disadvantages regarding the end of the universal principle. For a single person this might mean excluding anyone with incomes over roughly £25,000. This proposal could have significant operational difficulties, especially for older people who are often reluctant to claim means-tested benefits. It might also be judged less desirable to withdraw support from disabled people than families with children.	Unknown (low £ billions)
End bereavement and industrial injury benefits	Benefits for widowhood no longer reflect women's working lives. Support for industrial injuries could be absorbed into PIP and ESA.	Unknown (less than £1.5bn) [IFS]
Freeze child benefit in cash terms	Proposed as a way of switching money to finance increased childcare (reducing the costs of parenting for many). This would take money away from most parents with school-age children who tend not to be so reliant on childcare.	Estimated £500 million over 2 years [IPPR]

'LEAST BAD' OPTIONS		
Tax disability benefits (personal independence pay-ment, attendance allowance, disability living allowance)	Significant levels of disability benefits are paid to people with mid and high incomes, especially older people. One straightforward way of moderately reducing support for this group would be to classify disability benefits as taxable income, just like the state pension. This might be appropriate since these are universal benefits intended for a wide range of people including those with high earnings, pensions or savings. Following the coalition's reforms to income tax thresholds, this measure would have no impact on individuals with taxable income below approximately £10,000 and fairly small effects for those with incomes a little over this threshold	£970 million [IFS]
Replace the 'triple lock' on the basic state pension with earnings indexation	If the 'triple lock' is retained on a permanent basis it could mean that pensioners would see their incomes grow faster than equivalent working-age households in perpetuity. This seems hard to justify unless the aim of policy is to help older people become more affluent relative to other groups, rather than to keep up with rising overall living standards. With pensioner poverty now lower than poverty for the overall population this is unlikely to be a priority.	£0 to 400 million (by 2017/18) [FS]
Remove winter fuel payment from upper-rate tax payers	This modest measure would place the winter fuel payment on the same footing as Child Benefit. However implementation could be complicated, as has been the case with the child benefit reforms.	£100 million [LP]

Coalition social security reforms a future government might wish to reverse

Proposal	Comment	Cost
EXPENSIVE		
Restore child benefit for higher rate tax payers	This proposal would be regressive (unless accompanied by progressive tax increases) however it would restore the main example of universal social security available to working-age households.	£1.9bn [HMT]
Reverse the one year time limit for most people receiving contributory employment and support allowance	This reform removed the majority of contributory social security spending that still existed. However restoring it would reduce work incentives and might not be the best way to bring contributory entitlements back into the welfare system.	At least £2bn [HMT]
POTENTIALLY AFFORDABLE		
Scrap 'bedroom tax' for social housing	Reversing this ineffective and unpopular measure would by symbolically attractive. However by 2015 it might serve little purpose if most of those affected had already made alternative arrangements.	Up to £500 million [HMT]
Re-index local housing allowance to rent inflation	There will be growing hardship if financial support for rent is indexed to CPI inflation on a permanent basis, when rents are expected to rise faster.	£350 million (after two years) [FS]
Re-nationalise council tax benefit	Localised systems of council tax rebates undermine the aim of universal credit to create a single means-testing system with a guarantee that work will pay. Clear examples of hardship under the new scheme.	Around £500 million [HMT]

Proposals for new social security spending

Proposal	Comment	Cost
EXPENSIVE		
Index most benefits and tax credits to earnings (excluding state pension, pension credit, housing benefit)	This would prevent the long-term deterioration in low incomes, relative to average earnings making. Earnings indexation has been a highly successful element in efforts to reduce pensioner poverty. However the costs are high and a future government might wish to postpone the policy until after the deficit was reduced to a sustainable level. It would also be unacceptable to introduce this measure during a period of public sector pay restraint.	£3.6bn over 2 years [FS]

Introduce earnings related unemployment insurance	This would be a significant extension of contributory social security, along the lines of continental systems. However it would be very expensive and would divert any available resources away from low income households. Its main proponents, the IPPR, suggest it could instead be a loan scheme, since the costs are so high.	At least £1 billion [TUC]
POTENTIALLY AFFORDABLE		
£30 increase to contributory job seeker's allowance	This is the cheapest of a number of proposals to strengthen the contributory principle. It would recognise contribution by paying a higher rate of benefit to people eligible for contributory JSA (ie in the first six months of unemployment for people with an adequate national insurance record). On its own implementing this measure would be regressive (as is the case with all universal entitlements)	At least £220 million [TUC]
LIKELY TO GENERATE SAVINGS ELSWHERE		
Improve childcare support in universal credit by extending Budget 2013 childcare subsidy to universal credit recipients who do not pay income tax	The coalition has pledged to cover 85 per cent of the costs of childcare for people on universal credit who pay income tax. However this excludes large numbers of low paid workers, who will continue to receive 70 per cent support, which means second earners and low parents with childcare costs have no incentive to increase their hours beyond around 10 hours work a week.	Unknown [£200 million pledged to implement government proposals, but unfunded so far]
Increase generosity of universal credit for second earners by giving them their own earnings disregard	This measure would enhance incentives for second earners to return to work, targeting all families not just those with childcare costs.	£700 million [RF]

Sources for costings:

- FS = Fabian Society (own calculations for this project)
- IFS = Institute for Fiscal Studies (Green Budget 2013)
- KF = King's Fund (Securing Good Care for More People, 2010)
- IPPR = Institute for Public Policy Research (Nick Pearce, 'Labour must drop its child poverty target and find another way', Guardian Comment is Free, 13th May 2013)
- LP = Labour Party (speech by Ed Balls MP, 3rd June 2013)
- TUC = Trades Union Congress (Making a contribution: social security for the future, 2012)
- RF = Resolution Foundation (Gaining from Growth, 2012)
- HMT = HM Treasury (published costings at time of policy announcement)

GLOSSARY

Accruals accounting: a system of accounting which recognises a transaction once a decision with financial implications has been taken, unlike accounting based on cash transactions.

Annually managed expenditure (AME): part of total managed expenditure (TME). Government is said to have less control and certainty over this part of spending and is planned on an annual rather than multi-year basis. It includes debt interest, social security and locally raised revenue.

Automatic stabiliser: a function of some public expenditure and tax revenue that fluctuate automatically according to the economic cycle. This feature of public spending and tax brings stability to the economy at times of recession by sustaining consumer demand.

Autumn statement: An annual government economic update to parliament that takes place in November or December.

Barnett Formula: a formula used by the Treasury to allocate resources to Scotland, Wales and Northern Ireland.

Capital spending: Government spending that adds to the public sector's fixed assets and brings enduring benefits over many years, such as economic development, housing and public service infrastructure.

Congressional Budget Office (CBO): An agency providing fiscal analysis and data to support the work of the US Congress.

Current spending: day to day spending by government departments, such as pay, services and social security.

Cyclical and structural deficit: the 'cyclical' element of the budget deficit is that part which will recover with economic growth, whereas the 'structural' deficit is that which remains even after the economy returns to growth, and can be thought of as the 'permanent damage' caused by the recession.

Debt interest: the payments governments make to service public debt.

Departmental expenditure limits (DEL): part of total managed expenditure. DELs are limits on what departments have to spend and are set at spending reviews. With the exception of 2013, which set limits for the period 2015-16, since 1998 spending reviews have covered a two to three year period.

Fiscal consolidation: a reduction in the structural deficit over a set period of time.

Fiscal drag: the process whereby growth in earnings pushes employees into higher tax bands, allowing governments to raise tax revenue without adjusting tax rates.

'Future-oriented' spending: in the report we use this term to describe both capital investment and current expenditure that is expected to create future knowledge, skills and capabilities, such as education.

Gross Domestic Product (GDP): Total economic output of the national economy, as measured by the value of goods and services produced in the country.

Office for Budget Responsibility (OBR): an independent fiscal watchdog established in 2010 to monitor the government's fiscal performance.

Pensions 'triple lock': a policy which guarantees that the state pension in the UK rises by the higher of inflation, earnings or 2.5 per cent.

Predistribution: the idea that government can tackle inequality by intervening in the economy to boost

employment, increase low and middle earnings or reduce housing costs. It is prior to the state's traditional redistributive interventions through taxation, social security and public services.

Private finance initiative (PFI): a partnership model of delivering large scale infrastructure projects with private capital, introduced by the 1992 Conservative government and continued by the last Labour government. PFI has subsequently been criticised for representing poor value for money to the taxpayer.

Primary surplus: the surplus of government expenditure over revenues, before taking account of debt repayments.

Productivity: the relationship between economic inputs and outputs. It is a measure of the volume of outputs (eg services) produced by the volume of inputs (eg hours worked, supplies).

Protected and unprotected departments: as part of the government's plan for reducing the deficit it has protected or 'ring fenced' a number of departments such as health and overseas development from spending cuts. The effects is that other 'unprotected' departments face greater average cuts as reductions are not shared equally across government.

Public sector net borrowing (PSNB): a measure of the public sector fiscal deficit, or the size of the gap between public sector expenditure and revenues. In 2011-12, 2012-13 and 2013-14 the OBR forecasts underlying deficits of approximately £120bn.

Public sector net debt (PSND): a measure of total debt held by the government.

Public service agreements (PSA): A series of performance targets for different areas of government, first introduced at the 1998 comprehensive spending review.

Spending review: The spending review is the government process whereby public money is allocated between departments, usually over a multi-year period.

Total managed expenditure (TME): Public spending by central and local government, and public corporations.

Universal credit: a new social security entitlement due to be introduced by the Coalition government which aims to simplify and rationalise a range of social security benefits by providing one payment to recipients.

Zero-based budgeting: a method for distributing resources between departments which in theory justifies each allocation from scratch.

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- How can the activity be provided at lower cost?
- How can the activity be provided more effectively?
- Can the activity be provided by a non-state provider or by citizens, wholly or in partnership?
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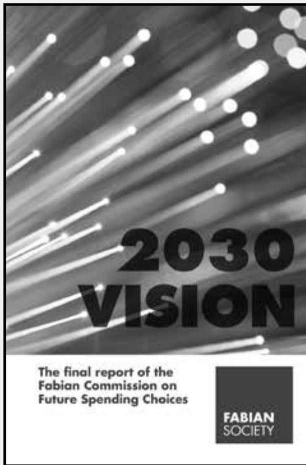

Discussion Guide: 2030 Vision

How to use this Discussion Guide

The guide can be used in various ways by Fabian Local Societies, local political party meetings and trade union branches, student societies, NGOs and other groups.

- You might hold a discussion among local members or invite a guest speaker – for example, an MP, academic or local practitioner to lead a group discussion.
- Some different key themes are suggested. You might choose to spend 15–20 minutes on each area, or decide to focus the whole discussion on one of the issues for a more detailed discussion.

A discussion could address some or all of the following questions:

1. With less opportunity for large increases in expenditure, governments need to spend money public money in different ways. One way in which governments can do this is to spend more on preventative programmes and solutions based on early intervention. What are the arguments in favour of shifting the balance of spending in this way, and what changes might be made in government so that this can happen?

2. This report sets out three scenarios for public spending after 2015, two of which involve spending more in the next parliament than the current government plans to. The report also suggests how increases in spending could be paid for. Should the government plan to spend more over the course of the next parliament, and if so where should the increase come from?

3. To many observers, public faith in the role of public spending and the ability of government to spend wisely is at an all time low. What can government do to restore this faith in the role public spending has in a good society?

Please let us know what you think

Whatever view you take of the issues, we would very much like to hear about your discussion. Please send us a summary of your debate (perhaps 300 words) to debate@fabians.org.uk.

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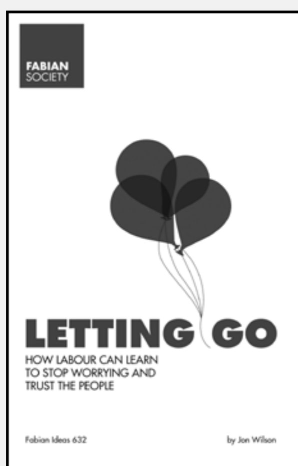

Letting Go

How Labour can learn to stop worrying and trust the people

If you get people in a room together, if people have the freedom to meet, talk and argue, they'll make better decisions about the things which affect their lives than anyone else.

In 'Letting Go: How Labour can learn to stop worrying and trust the people' Jon Wilson argues that Labour needs to become a movement rooted in people's experience, not be the party of the central manager. Above all, it needs to trust people again. The politician's vocation should be to create institutions where those conversations happen, not determine what they decide.

This doesn't mean Labour should abandon its faith in the state. Indeed, that faith needs to be renewed, because our public institutions embody Labour's sense of the purpose of politics: to protect and care, and provide a basis for us to lead good lives together. But the argument in favour of the public sector should be an argument for local control and popular ownership.

Together

A vision of whole person care for a 21st century health and care service

Whole person care – integrating physical, social and mental care in a preventative and person-centred system – is potentially Labour's big idea to go into the 2015 election with. The concept has already gained wide support among health professionals, policy experts, campaigners, practitioners and political advocates, who have united to welcome the approach. However, big questions remain around how to turn it from an interesting idea into a credible programme for government.

To inform the development of the whole person care agenda, Andy Burnham MP, the shadow health secretary, brings together a range of independent experts to explore the policy implications of integrated health and social care. Their essays do not represent Labour party policy, but outline the key areas that will need to be addressed in order to develop a coherent and effective 'whole person' approach to health and social care.

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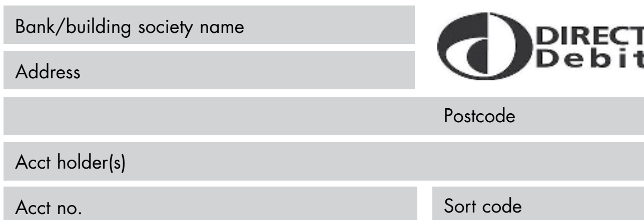

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2030 VISION: THE FINAL REPORT OF THE FABIAN COMMISSION ON FUTURE SPENDING CHOICES

This is the final report of the Fabian Society Commission on Future Spending Choices, which was established to explore the public spending choices facing government over the next two decades, including in the next parliament. It asks how these decisions can be made in a way that maximises prosperity, sustainability and social justice.

Political leaders must set out their future vision for the country and shape the spending decisions of today to achieve these ambitions. This requires a departure from the short termism which currently dominates public spending and new mechanisms to embed the long-term perspective at all levels of decision making.

Over the short term, the Commission proposes an approach to reducing the deficit that returns the public finances to a sustainable position in a timely manner without neglecting the economic and social investment which will lay the foundations of national success in the future. *2030 Vision* assesses a number of scenarios for public spending from 2016 onwards and concludes that the next government can afford to spend more, but must spend in line with long-term objectives.

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Commissioners:
Lord McFall of Alcluith (Chair), Dan Corry, Andrew Harrop, Ray Shostak, Anna Smee, David Walker, Carey Oppenheim (until May 2013)