A Deficit of Growth

Spending choices after 2015

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SMF Social Market Foundation

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EXECUTIVE SUMMARY

The current Government came into power in 2010 with the aim of fixing the public finances. It was expected that this would be completed by 2014-15. But this has not proved to be the case. It was not long into the Government's first term when it became clear that the spending cuts set out would not be sufficient to meet the target of eliminating the structural deficit. Since then, more and more cuts have been pencilled in.

The result is that by the end of 2015-16, day-to-day departmental spending will have fallen by over 12% in real terms compared to 2010. On the current Government's plans, last set out in March, this number will grow to 23.5% by 2018-19. And because health, education and international development have been largely protected, other departments have had to take much larger cuts to their budgets.

Why has the deficit reduction programme been so unsuccessful that deadlines have had to be repeatedly postponed? In large part, the answer is the state of the economy. In the early years of the Government's term, growth was sluggish, holding down tax receipts and increasing welfare payments. Now, the economy has started to recover, and is in fact doing better than expected back in March. But instead of showing an improvement as expected, public sector borrowing is looking worse, currently at 6% higher than this time last year. Whilst the economy has started to grow, GDP per capita is still below its pre-crisis peak. Productivity growth has been poor, and wages have yet to increase, with the result that higher income tax receipts have yet to materialise.

This is deeply worrying, because it suggests that much more borrowing is likely to be structural than previously thought, and will persist over time through into the next parliament, even as the economy continues to recover. The SMF has taken the OBR's March 2014 forecast and updated it with the latest estimates of borrowing and the state of the economy. Our calculations under this SMF core estimate suggest that borrowing by 2018-19 could be around £15 billion higher than currently forecast.

This means that even with the deep cuts to public spending planned in the next Parliament, a Conservative Government would most likely miss its stated target to deliver a surplus in 2018-19. The only way to hit the target would be to rely on surprise over-heating of the economy that temporarily reduces borrowing, or to pencil in further cuts. This would take the total cuts required to around £52 billion after 2015-16. The other two main parties have set themselves different targets, focusing on non-capital spending. The Liberal Democrats would also need to pencil in further cuts to meet their target. Labour would still be able to meet its aims by sticking to the current Government's spending plans, but with a much smaller margin for error.

In fact, as the SMF's calculations show, the underlying state of the economy is pivotal in determining success or failure in repairing the public finances. If the UK economy could repeat the sustainable growth era of the early 2000s, there would be no need for fiscal consolidation in the next parliament at all. But if we see a repeat of the last few years, it will become all but impossible to meet any of the parties' current targets for public

spending. The additional cuts that would be required to meet the targets on time look inconceivable in a historical context.

So what might the next Parliament hold for public spending? All parties will most likely need to make further savings to meet their targets. The current Government plans suggest that the pace of cuts faced by Government departments is set to become faster. To meet the Conservatives' plans under the SMF core estimate, the pace will have to be faster still – amounting to an average annual cut of 6.2% to current departmental spending in the years after 2015-16. If the NHS, education and international development continue to be protected, the average annual cut faced by other departments would need to be around double this size. Coming on top of spending cuts so far, this is likely to be very difficult to achieve.

Even if the pace of average annual cuts to day-to-day departmental spending in the next parliament is kept to the rate we have seen so far – around 2.6% a year, producing a total of £23 billion in savings over the period 2015-16 to 2017-18, difficult choices will still have to be made. It would potentially leave some departments with day-to-day budgets of around half what they were in 2010, especially if areas such as the NHS, education and international development continue to be protected. And with fewer cuts to departmental spending, more savings would have to be found elsewhere. For example, under the SMF core estimate, the Conservatives would need to find around an extra £30 billion in savings, on top of the £23 billion from departmental spending, to meet their targets. The most likely outcome is that the deadline to repair the public finances would be postponed yet again.

It is clear that the single most important factor to success or failure in repairing the public finances is sustainable growth, which in turn drives sustainable tax revenues. This means that the next Government must have an ambitious plan for long-term growth, and such a plan must be an integral part of its public spending strategy. Spending that boosts the economy's underlying productivity will need to be prioritised – they are likely to include infrastructure, skills, education and research spending. A sensible strategy may also include some tax cuts – as long as these cuts can be expected to sustainably increase economic growth.

The effectiveness of public spending in delivering outcomes will be vitally important. Payment by results and decentralisation both have the potential to deliver greater value for taxpayer money; but only if they are done well. At the same time, it needs to be recognised that there will be long term consequences of spending decisions that reach far beyond the different parties' short-term targets. Many pressures on spending, such as an ageing population, will grow stronger in the coming years. Reform designed to deal with long-term challenges and improve outcomes in the long-term may require upfront investment, for example, in new technology.

Allocating the cuts in the next Spending Review is likely to be even harder than in 2010. It is unclear whether public support for cuts will be sustained over the coming years. And the process of the Spending Review itself may need to change. The usual combination of short-term fiscal targets and rigid departmental and accounting

boundaries may well suppress the much needed debate on how best to create sustainable growth whilst leaving the public finances in better shape for the long-term. Between now and the election, the SMF will be exploring how these trade-offs can be made in next Government's first Spending Review in 2015.

SECTION 1: THE SCALE OF THE SAVINGS CHALLENGE

Introduction (or how we got here)

When the current Coalition Government came into power in 2010, public sector net borrowing stood at £157 billion, or 11% of GDP in 2009-10. Public sector net debt stood at £829 billion, or 56% of GDP.[1] These figures exclude the effects of temporary financial interventions.

As a result, the Government set out a plan to reduce debt and borrowing. It set out two aims. Its first, core, "fiscal mandate" was to eliminate the structural deficit within a five year period – at the time, by the end of 2014-15. The structural deficit referred to the structural element of the current budget – broadly, the gap between day-to-day non-investment spending on welfare and public services and tax revenues that persists once the economy has recovered. Its second, supplementary target, was to have public sector net debt falling as a proportion of GDP between 2014-15 and 2015-16.[2]

As the Government's term wore on, the deadlines for achieving these targets receded further into the future. The core fiscal mandate was always for Government spending and receipts to be consistent with the plan to eliminate the structural deficit at the end of a rolling five year period. So the mandate itself never had a fixed deadline. Still, at the time, in June 2010, it was expected that by now, in 2014-15, the Government would have eliminated the structural deficit and would in fact be running a small structural surplus, to the tune of 0.3% of GDP.[3]

Instead, the last OBR forecast suggested that the Government will still be well in deficit territory by the end of 2014-15, with a structural deficit of 2.2% of GDP.[4] Meanwhile, as early as 2012, the Government acknowledged that it was on course to miss its supplementary debt target.[5]

The difficulty in achieving these targets has meant that additional spending cuts have had to be pencilled in. In 2010, it was expected that going into the next election the Government would have completed its plan to repair the public finances. Instead, we are only halfway through the programme. As we show in this report, there is substantial further tightening to come in the next parliament.

This paper looks at the challenge to finish fixing the public finances in the next parliament. In particular:

- The remainder of Section 1 sets out what we know so far about different political parties' fiscal targets in the next parliament, focusing specifically on the choices beyond 2015-16; and explains why fixing the finances has posed, and will continue to pose a huge challenge.

[1] OBR, Public Sector Finances databank
[2] OBR Economic and Fiscal Outlook (March 2014)
[3] OBR, June 2010 Budget forecast (2010)
[4] OBR Economic and Fiscal Outlook (March 2014)
[5] HM Treasury, Autumn Statement (2012)

- Section 2 shows how dramatically each party's fiscal target depends on the state of the economy. We update the OBR's March 2014 forecast with the latest estimates of GDP and borrowing to show that since then, the outlook has worsened, raising the prospect of further cuts. These could be avoided if the economy performs better than expected, but could balloon if the economy under-performs.

- Section 3 looks at the choices faced by the next Government, and where additional savings could come from, focusing specifically on the first spending review that the next Government will need to conduct, covering the years beyond 2015-16.

Throughout this report, our figures are in real terms, 2014-15 prices, unless stated otherwise.

What is set to happen in the next parliament?

Spending for the year immediately after the election (2015-16) was set in a Spending Round conducted by the Government in 2013. Labour has committed to abiding by the total spending set out in this review. In this first year of the next parliament, the fiscal consolidation started in 2010 will continue.

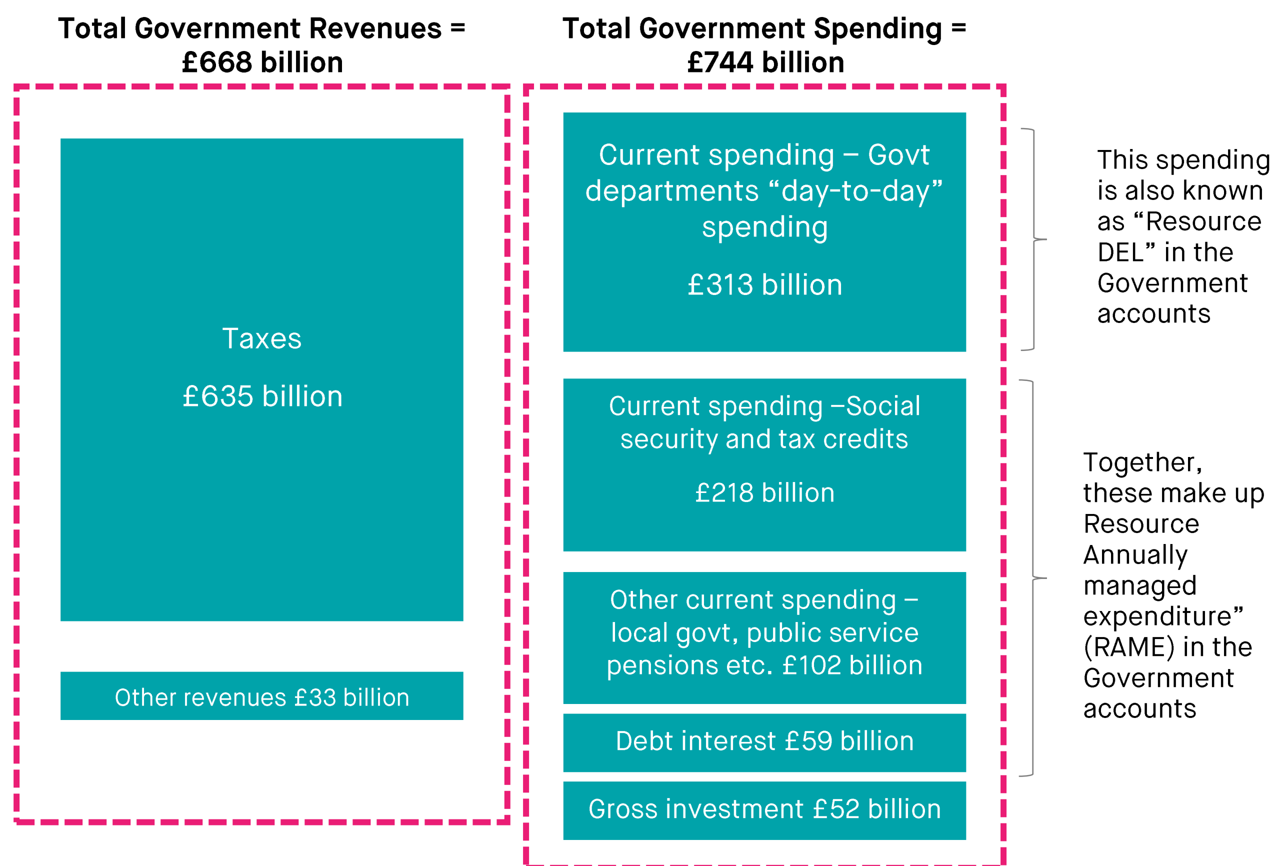
The main contribution to this ongoing consolidation will come from current, or "day-to-day" departmental spending, which will fall by around 3.2% in that year.[6] In total, by the end of 2015-16, current departmental spending will have fallen by over 12% since 2010. Because education, health and international development have broadly been protected, the burden has mainly fallen on other departments.

But beyond 2015-16, the focus of this paper, we know less about how spending may evolve. Under the current Government's plans, total departmental spending would fall by around 13% from 2015-16 to 2018-19.[7] This would be a faster pace of cuts than that seen so far, resulting in a situation where in total, by the end of 2018-19, day-to-day departmental spending will have fallen by almost 24% since 2010.[8]

The main components of the public finances

The boxes below illustrate the main components of the public finances, as they will stand in 2015-16, the first year of the next Government.

[6] OBR Economic and Fiscal Outlook (March 2014), Table 4.15 and supplementary fiscal Table 2.14
[7] OBR PSCE in RDEL measure (broadly same as RDEL minus depreciation); OBR Economic and Fiscal Outlook (March 2014), Table 4.15 and supplementary fiscal Table 2.14
[8] OBR PSCE in RDEL measure (broadly same as RDEL minus depreciation); OBR Economic and Fiscal Outlook (March 2014), Table 4.15



Note: Figures are in 2015-16 prices. Government revenues exclude APF transfers. Local Government spending includes some welfare-related spending.
Source: OBR, Economic and Fiscal Outlook (March 2014)

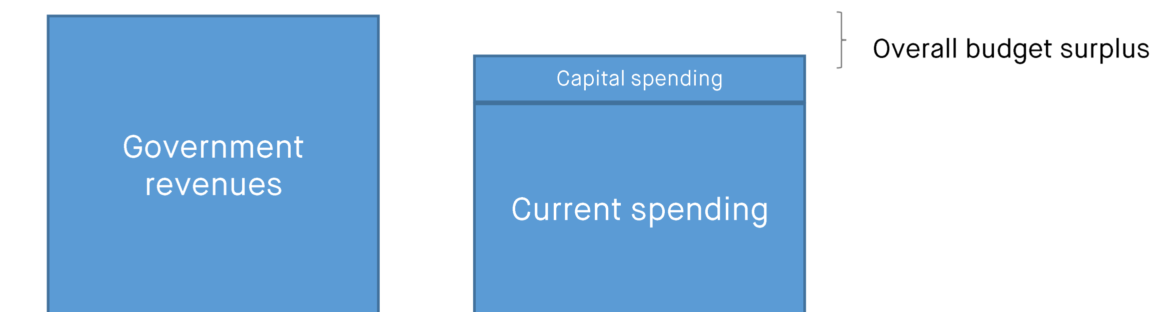
Public sector net borrowing, or the **overall deficit/surplus**, is the difference between total Government revenues and total Government spending. The **current budget surplus or deficit** is the difference between total Government revenues and total current spending (i.e. it excludes gross investment such as spending on infrastructure).

As well as these "headline" numbers, the OBR also produces **cyclically-adjusted** figures. Cyclically-adjusted measures strip out the effect of the short-run economic cycle. For example, in a downturn, headline borrowing will tend to rise as revenues from taxes fall and spending on social security increases. Cyclically-adjusted measures show the state of the public finances when the economy is operating at capacity – neither operating with slack, nor over-heating. The role of the economy and the economic cycle is explored in more detail in Section 2.

The three main parties have provided some indications as to whether they would stick to these plans if they form part of the next Government, but as yet, no specifics as to the exact fiscal target that would be pursued, or where any consolidation would come from. What might happen in the next Government's first Spending Review is therefore not yet clear.

Conservatives

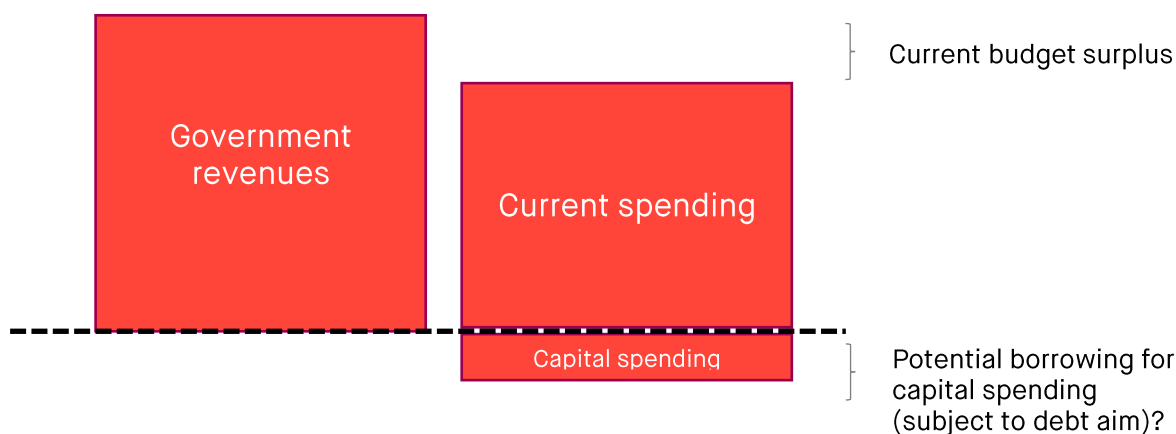
George Osborne has said the Conservatives would aim to run an overall surplus, on both capital and current spending, and David Cameron has set out an aim to "balance the books by 2018".[9] In this analysis we therefore assume that the target fiscal year is 2018-19, the final year included in the OBR's most recent forecast.



Labour

Ed Balls has said that a Labour Government would "get the current budget into surplus and the national debt falling as soon as possible in the next parliament."[10] As yet no explicit deadline has been given for the target to get the current budget into surplus, so in this analysis we measure the target against 2018-19, the final year included in the OBR's most recent forecast. We do not analyse the effect of the debt target in detail, except to say that this implies that Labour would most likely aim to generate a sufficiently large surplus to allow them to begin paying debt down.

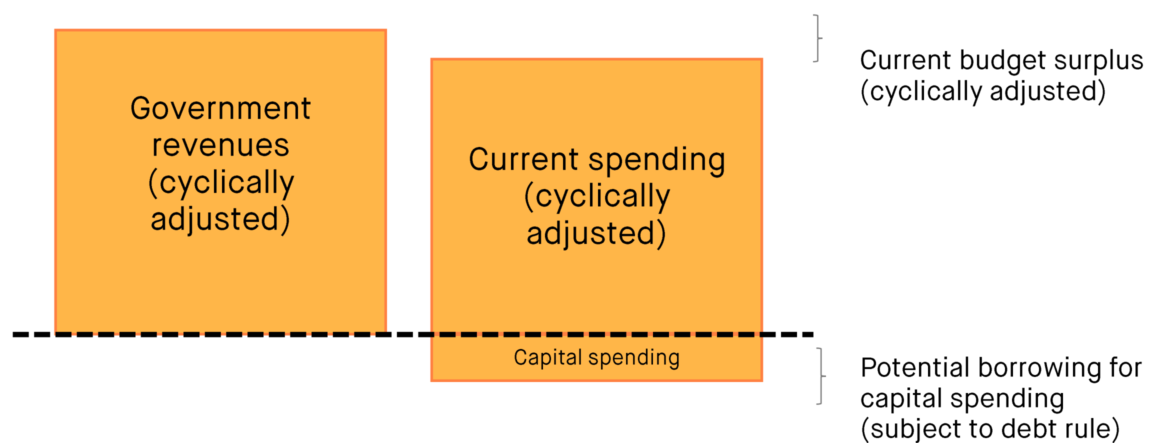
In his speech to the Labour party conference, Ed Balls also said that in the Labour manifesto "there will be no proposals for any new spending paid for by additional borrowing". However, it is not clear from this whether Labour will be, like the Conservatives, explicitly targeting an overall surplus. It is also not entirely clear what baseline "additional borrowing" refers to. In this analysis, we therefore assume that Labour will be targeting a surplus on the current budget only.



[9] George Osborne, speech to Conservative party conference (2014); David Cameron, speech to Conservative party conference (2014).
[10] Ed Balls, speech to Labour party conference (2014).

Liberal Democrats
The Liberal Democrats have said that they will aim to run a cyclically-adjusted balanced current budget by 2017-18.[11]

Beyond this, in his speech to party conference, Danny Alexander looked ahead to the period beyond the 2015 Spending Review, setting out a commitment to get debt as a proportion of GDP "down to sustainable levels" by the mid-2020. We do not analyse this commitment in detail, as it extends beyond the period of the next parliament,[12] except to say that this implies that the Liberal Democrats would most likely seek to go slightly beyond a cyclically adjusted balanced budget to a small cyclically adjusted surplus, which would allow them to start paying the debt down.

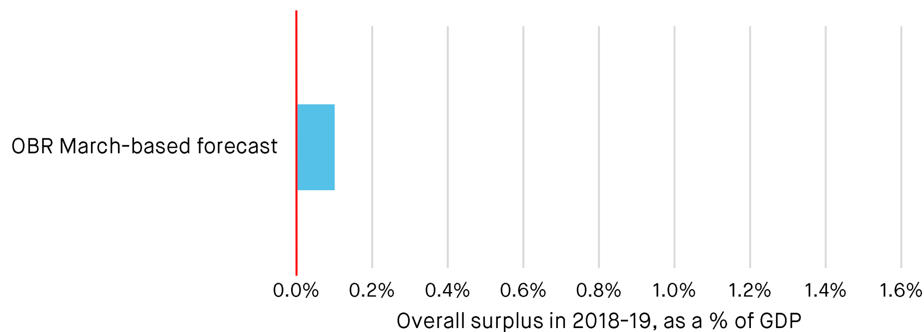


[11] Nick Clegg, "Opportunity for everyone" speech (June 2014)
[12] Danny Alexander, speech to Liberal Democrat party conference (2014)

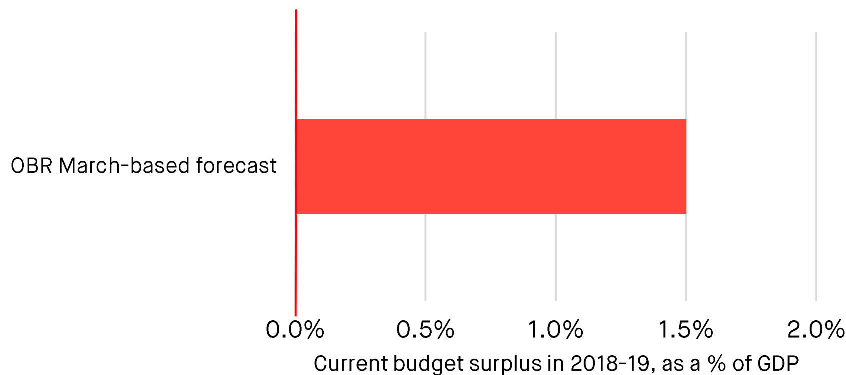
How do the parties' plans differ from the OBR's last forecast?

The charts below show how the different political parties' targets compare against the OBR's latest forecasts from March 2014. The targets are all achievable, if spending does indeed evolve as forecast by the OBR in March. As we show in Section 2, however, this is highly dependent on the state of the economy, and the latest forecasts show less room for error than previously.

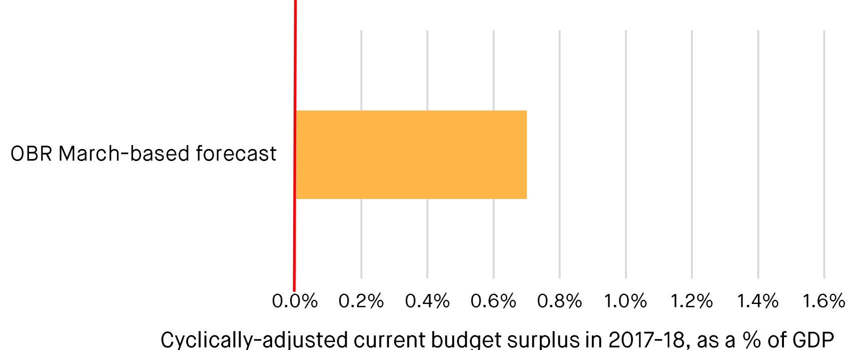
Conservatives: run overall surplus and eliminate borrowing by 2018-19
ON COURSE



Labour: run current budget surplus by 2018-19
ON COURSE



Lib Dems: run cyclically-adjusted current budget surplus by 2017-18
ON COURSE



Cyclically-adjusted current budget surplus in 2017-18, as a % of GDP

The Conservative plans provide for the least room to increase spending beyond what is currently planned, as they are aiming for an overall surplus after taking both capital and current spending into account. By making cuts of around £38 billion to departmental spending after 2015-16, on the current OBR forecast, they are set to run a small surplus in 2018-19. As departmental capital spending is set to slightly increase during this period, the cut pencilled in for current departmental spending is around £40 billion.

By contrast, the Labour and the Liberal Democrat targets focus on current spending. They could therefore use borrowing to fund capital investment. This would mean, for example, that Labour could increase current spending by up to 1.5% of GDP or around £28 billion, beyond what is current planned by the final year of the next parliament and still hit its target. This would reduce the cut in current departmental spending after 2015-16 from around £40 billion to around £12 billion.

The Liberal Democrats could increase spending by up to 0.7% of GDP or around £13 billion beyond what is currently planned by 2017-18 and still hit their target. This would mean that they could make cuts of around £19 billion to current spending by 2017-18 and still meet their target. If they were prepared to push back the deadline to after 2017-18, they would have room to loosen fiscal policy further.

On the last OBR forecast, the Labour and Liberal Democrats plans could therefore mean much less austerity in the next parliament than currently planned. Both, however, would most likely want to err on the side of caution, so as to allow some surplus to allow debt to be paid down, and potentially for contingency.

But the upcoming OBR forecast may look less rosy

However, much has changed since the last OBR forecast in March. The next OBR Economic and Fiscal Outlook will be published on 3rd December, the date of the Chancellor's Autumn Statement.

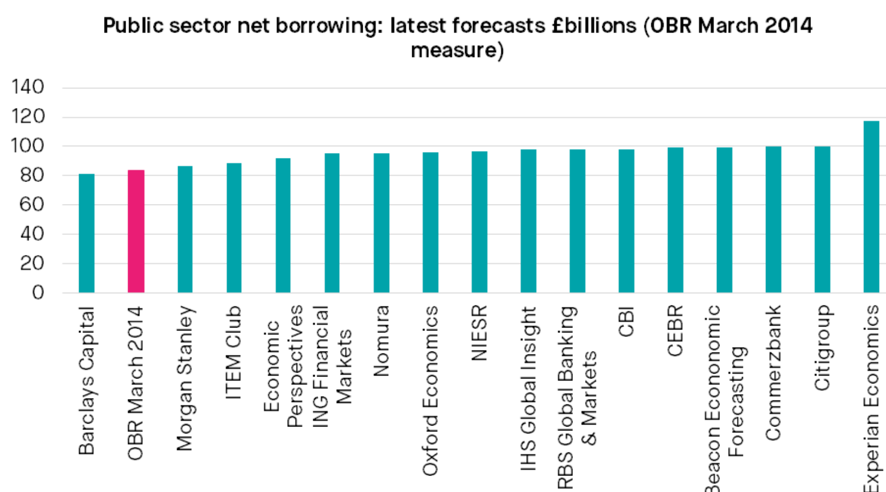
Whilst the economy has continued to recover, public borrowing has not fallen as expected. The OBR expected borrowing for 2014-15 to be £87 billion, a 12% fall on the previous year.[13] The latest figures show borrowing tracking at 6% *higher* than this time last year.[14] If this continues, borrowing in 2014-15 could be £17 billion higher than forecast. The shortfall is largely due to poor tax receipts.

To some extent, the borrowing figures may recover in the coming months. There are some timing effects, for example, self-employment receipts are likely to boost revenues in January. However, overall, the OBR has said that weak earnings growth, lower than expected property transactions and lower oil and gas revenues mean that the total tax

[13] OBR Economic and Fiscal Outlook (March 2014), Annex B. Note this was a provisional figure based on the OBR's expectation as to the results of the ESA2010 revisions. This number is reported here as all ONS figures are now based on ESA2010.
[14] ONS Public Sector Finances October Release (2014)

receipts forecast for 2014-15 is unlikely to be met.[15] Given the scale of the gap now, it is likely that overall borrowing will turn out to be higher than forecast for 2014-15.

Most independent forecasters are also expecting borrowing for 2014-15 to be higher than the OBR expected in March.



Source: HM Treasury, Forecasts for the UK economy, November 2014. Chart shows forecasters' latest estimates as of November 2014. Here, PSNB is shown based on the OBR's measure as used in its March 2014 forecast.

Usually, as the economy grows, borrowing would be expected to fall. It would be expected that less would need to be spent on benefits for those in unemployment or on low incomes; and more would be received in tax revenues. But this has not happened. The average (median) of forecasts in the last three months puts borrowing at around £12 billion higher than the OBR forecast; and forecasts made more recently, in the last month, put borrowing at around £13.5 billion higher than the OBR forecast. If this indicates a greater level of structural spending than previously thought, then less borrowing will disappear as the economy recovers, meaning higher borrowing in the next parliament than forecast back in March.

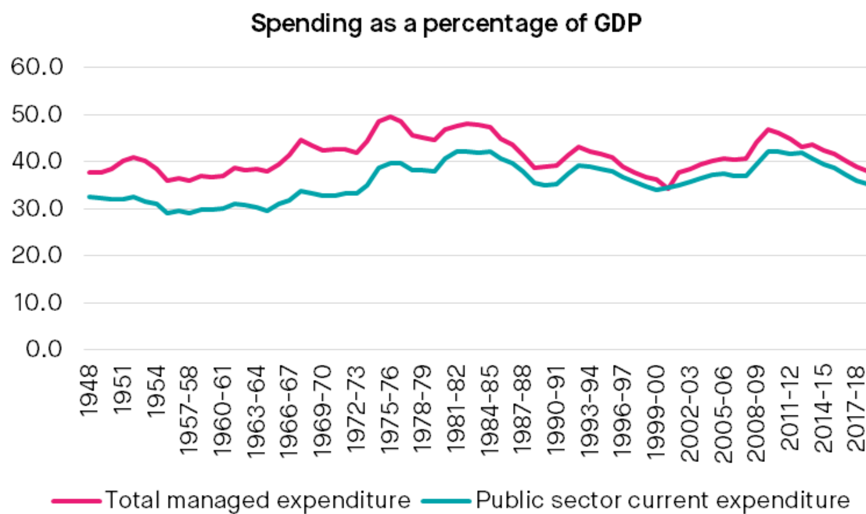
This would mean that public sector borrowing would not be eliminated by 2018-19, if there are no offsetting tax rises or spending cuts. This would make it much harder to achieve the Conservatives' target of an overall surplus in the next parliament, and would most likely substantially reduce the margin of error for Labour and the Liberal Democrats.

So the latest trends do not bode well for the parties' targets after the next election, with the potential for even more cuts to be pencilled in. In fact, as we explore in Section 2, the state of the public finances is hugely dependent on the state of the economy. The OBR's forecasts of GDP and the output gap will affect its judgement over how much of the extra £12 billion – and indeed how much of the deficit in its entirety - is structural and therefore how much is likely to remain when the economy is expected to finally fully recover in the middle of the next parliament.

[15] OBR, Commentary on the public sector finances release October 2014 (2014)

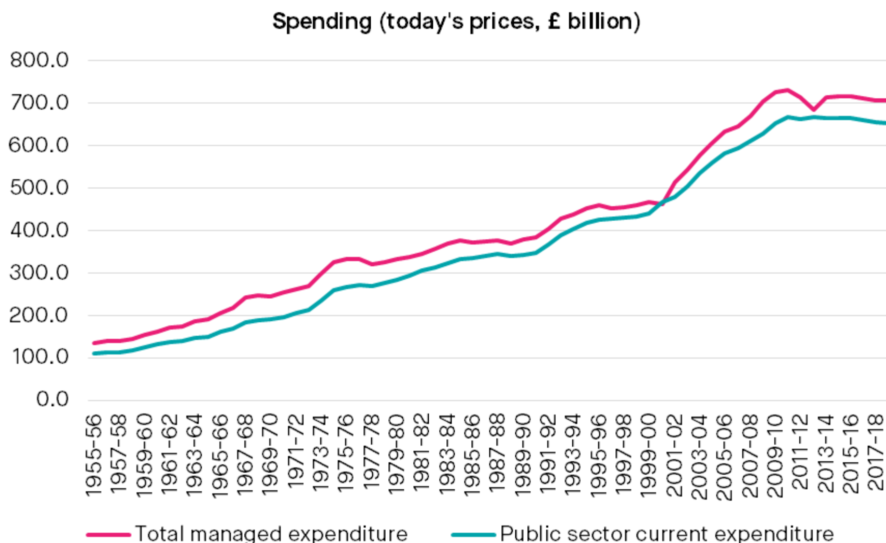
Putting the challenge in context

As set out earlier, on current plans, there is substantial further austerity to come beyond 2015-16. On these plans, the next Government will have to find £38 billion of savings in its first Spending Review, in 2015, covering the years 2015-16 to the end of the next parliament. This will come on top of substantial tightening in the 2010 parliament. There have been examples in past decades when spending has fallen as a proportion of GDP as shown the chart below, but this has usually happened at times when the economy has been growing. That is, it was not so much that spending was cut, but that income was growing at a sufficiently high rate so as to outpace any growth in spending.



Source: OBR Databank

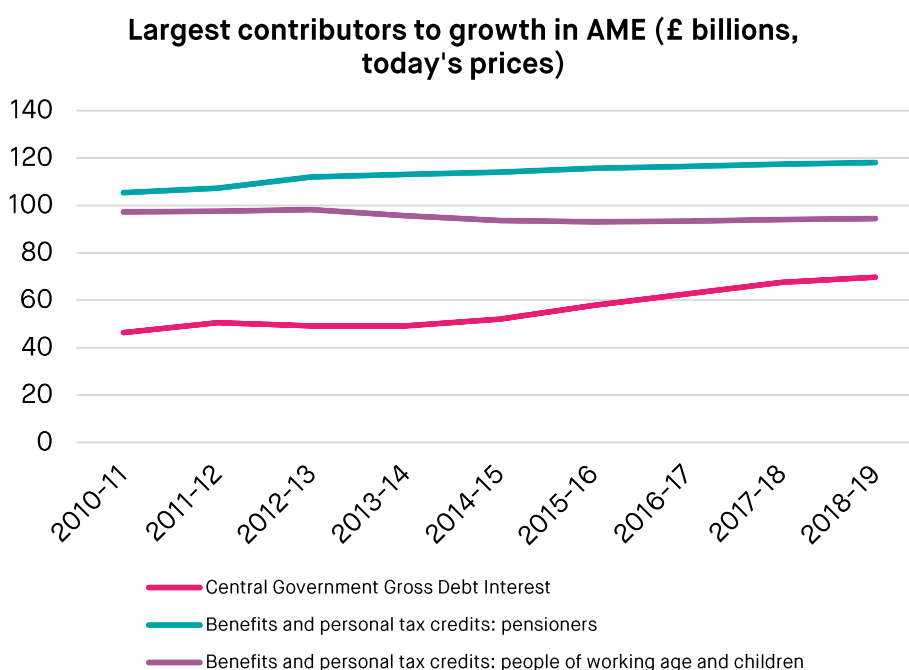
The post-2010 period is remarkable in halting the trend in rising spending in absolute (real terms) as shown in the chart below. Historically, spending has usually tended to increase as the economy has grown. In terms of billions of the pounds, the trajectory in public spending is a sharp change in trend from the last 60 years. Spending has never even stayed stagnant before, let alone dropped.



Source: OBR Databank

But even this does not tell the full story. Public sector current expenditure is made up of both departmental spending (for example, health, education, defence, justice) and what is known as annually managed expenditure (AME), which includes social security benefits, tax credits, public sector pensions, debt interest and a number of other items.

AME spending has been rising and is expected to rise further. In the period 2015-16 to 2018-19, it is expected to rise by around £29 billion or 8% in real terms. The rise is AME is largely due to rises in spending in areas that are difficult to directly control. These include interest on Government debt and rises in social security spending, in particular spending on pensioners, which in turn is driven in part by demographic factors. Growth in welfare payments to pensioners was especially important in the 2010 parliament, and was not offset by falls in welfare spending on those of working age and children. Growth in debt interest payments will be of growing importance in the next parliament. The consequence is that departmental spending has to be cut just to keep total spending the same in real terms.



OBR Economic and Fiscal Outlook (March 2014), 2013, 2012; DWP benefit forecast tables

The cuts required in the 2015 Spending Review imply a faster pace of cuts to departmental spending than during the current parliament, unless cuts are made to welfare, or taxes rise. The average annual cut to current departmental spending for the years 2010-11 to 2015-16 is 2.6%. The average annual cut to current departmental spending after 2015-16 implied by the current spending plans involves an average annual cut of over 4%.[16]

[16] OBR Economic and Fiscal Outlook (March 2014), Table 4.15

SECTION 2: THE GROWTH CHALLENGE

Section 1 set out the huge challenge ahead for public spending in the next Spending Review in 2015. The debate about how to fix the UK's public finances has predominantly focused on spending cuts, and to a lesser extent, tax rises. But as shown in this section, the performance of the economy is the single most important determinant of whether targets are likely to be met. Poor performance of the economy is a primary reason why further cuts have had to be repeatedly pencilled in since the initial spending review in 2010.[17]

How does the economy affect the public finances?

The size of the economy determines the amount Government can expect to raise in tax receipts and the amount it can expect to spend on social security. For example, when wages rise, Government gains in income tax payments and reduced spending on tax credits.

When looking at how the state of the public finances is likely to change in the future, a key consideration is the extent to which current GDP growth is likely to be structural, and therefore sustained over the longer period, or cyclical, in which case it is likely to change in the shorter term.

The OBR estimates GDP and potential GDP – the latter is a measure of the maximum level of output that is sustainable in the medium to long-term. If an economy is operating at potential, it is operating at full capacity, with no further room to grow sustainably, in the absence of any long-term productivity improvements that could increase an economy's potential itself. The difference between actual GDP and potential GDP is known as the output gap.

If the output gap is large, this would suggest that the economy is far away from full capacity; and can be expected to return to its sustainable level in the short-term. This would indicate that there is a large cyclical element to the public finances. If the output gap is negative, as is currently estimated by most forecasters, this would imply that the economy has room to grow in the short-term and so the finances are likely to improve as the economy recovers.

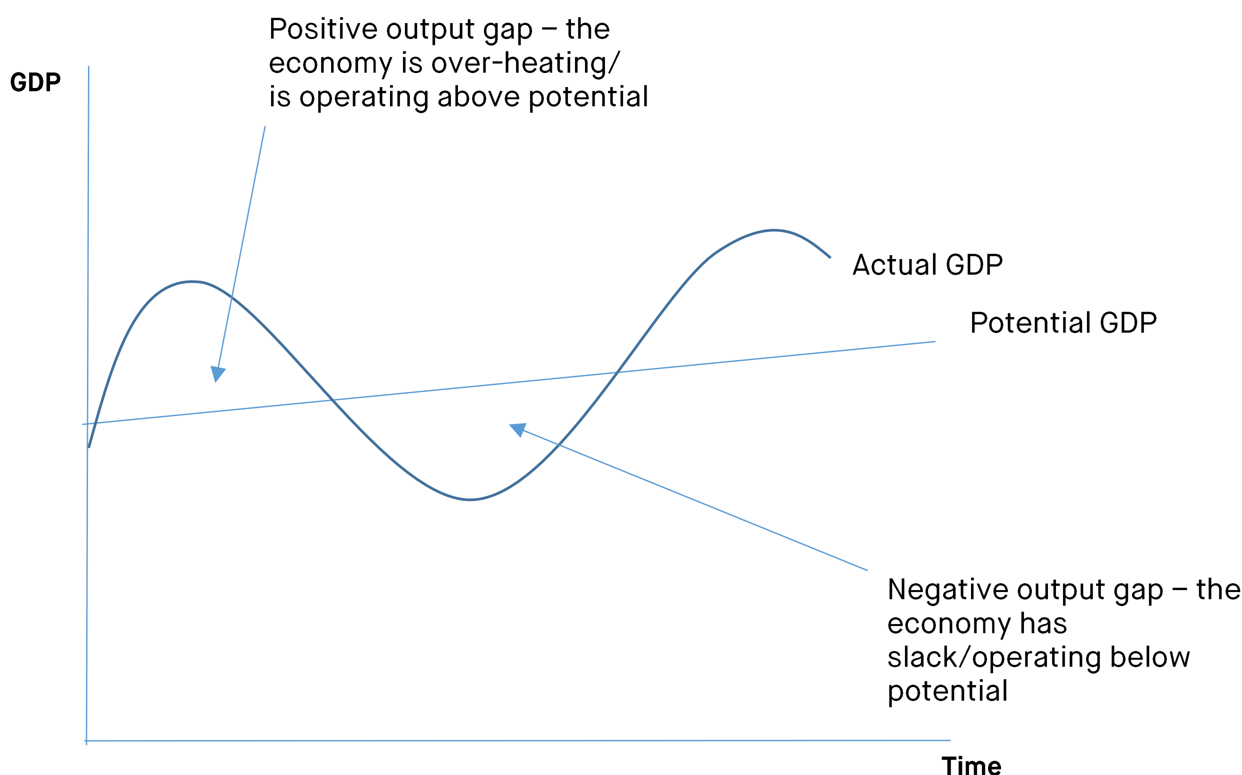
The question is, what is the underlying state of the economy, and how large is the output gap? As set out in this section, GDP is higher than expected in 2014-15. But there is a question as to whether this simply reflects a faster recovery, or whether it reflects an improvement in the underlying state of the economy.

GDP and Potential GDP

The diagram below shows a stylised illustration of the relationship between potential GDP, actual GDP and the output gap. Growth in potential GDP is primarily driven by

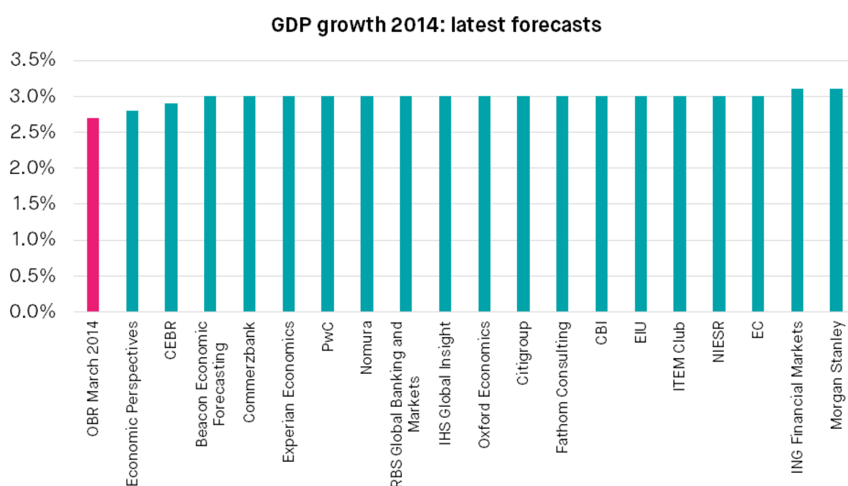
[17] IFS, "Cutting the deficit: four years down, five to go?" (April 2014)

underlying productivity improvements, that expand the amount of output that an economy can sustainably produce. In any given year, actual GDP could be higher or lower than potential GDP – the difference is known as the output gap.



The changing forecast for the economy

On the surface of it, the economy has been performing better than expected. The OBR expected GDP growth in 2014 to be 2.7%. This is looking well on course to be met, and possibly exceeded, with GDP in the third quarter of 2014 3% higher than the same quarter a year ago.[18] The latest median of independent forecasts suggests growth for 2014 as a whole will be around 3%.

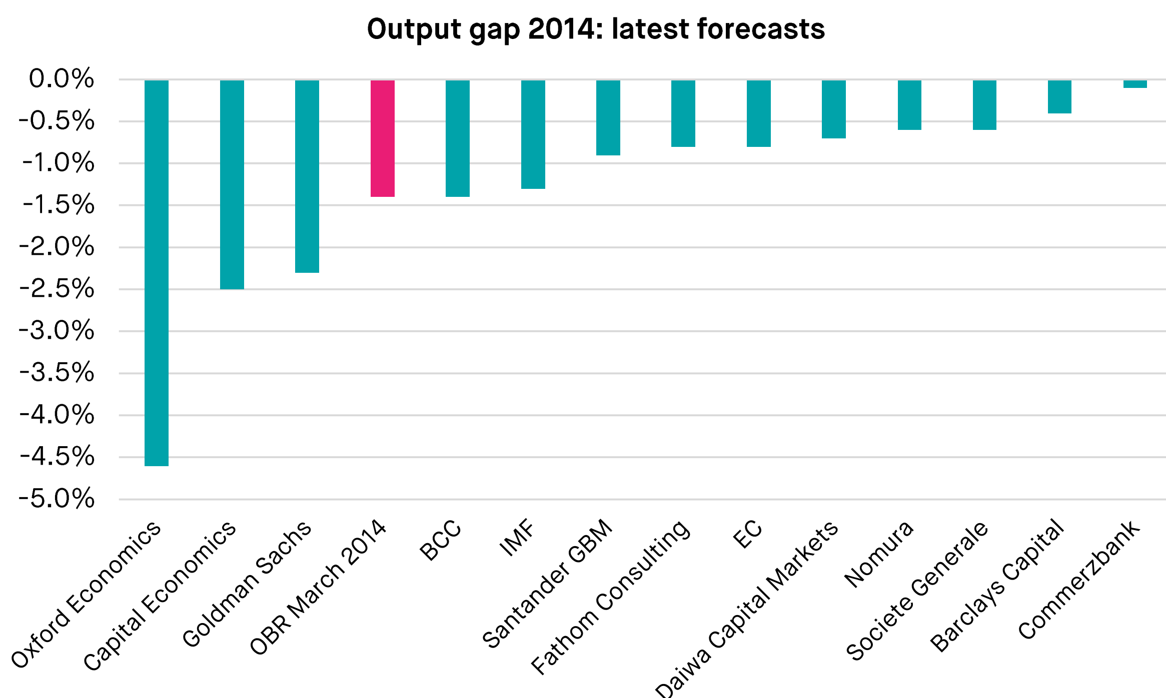


Source: HM Treasury, Forecasts for the UK economy, November 2014. Chart shows forecasters' latest estimates as of November 2014

[18] ONS, Gross Domestic Product Preliminary Estimate, Q3 2014 (2014)

Does this represent a faster recovery or a better underlying state of the economy than we previously thought? If it represents a faster recovery, then we would expect growth to slow down as the economy reaches capacity. If it represents a better underlying state of the economy, this would suggest that the economy's potential or capacity has increased, and that higher levels of growth than previously thought might be sustainable over a longer period.

There is always considerable uncertainty as to the gap between an economy's potential and actual GDP – the output gap. As shown in the chart below, despite being consistently more optimistic on growth compared to the OBR's March forecast, forecasters are much less consistent on the size of the output gap.



Source: HM Treasury, Forecasts for the UK economy, November 2014. Chart shows forecasters' latest estimates, made over the three month period September-November 2014.

Overall, however, the median of independent forecasts point to a narrowing of the output gap, to 0.8%, down from the OBR's March forecast of 1.4%. This would suggest that – on average – forecasters are ascribing the majority of the higher than expected GDP growth to a faster recovery rather than an improvement in the economy's underlying health.

The narrowing of the output gap is consistent with some trends in the labour market, in particular, falling unemployment and growth in hours worked.[19] It is, however, less consistent with the lack of growth in wages, which would be expected to rise if the economy was recovering more quickly.

[19] ONS, UK Labour Market, November 2014 (2014)

The economy and the finances

Understanding the size of the output gap helps to estimate the likely state of the public finances when the economy has fully recovered. For example, back in March, the OBR estimated an output gap for the UK in 2014-15 of -1.3%. This means that the economy was operating at this level below capacity. This in turn meant that it expected that around two-thirds of the current deficit was structural – that is the other third would disappear as the economy recovered. Combined with cuts pencilled in for the years ahead, this meant that the deficit by 2018-19, when the economy was expected to have fully recovered, would have turned into a surplus of over £30 billion on the current budget. After taking into account investment spending, there would be a small surplus on overall spending of £1.1 billion.[20]

The OBR's estimate of the output gap is crucial as is determines how much of the Government's deficit is structural, and how much will disappear as the economy recovers. This year, GDP is looking better than expected; but as set out in Section 1, borrowing is actually looking worse. The lack of progress in the state of the public finances, alongside growth in GDP, suggests that more spending is structural than previously thought.

In Section 1, we set out how close each party was to achieving its targets, based on the OBR's most recent forecasts from March 2014, which show how the state of the public finances are set to evolve between now and 2018-19. As we demonstrated there, on these forecasts, the Liberal Democrats are set to meet their target on time by 2017-18, and Labour and Conservatives will also meet their targets on time by 2018-19.

In the set of three scenarios below, we show how the underlying state of the economy is a pivotal determinant of how the state of the public finances will evolve in the next parliament. Our first scenario – the "SMF core forecast" - simply updates the OBR's March forecast with more recent estimates of borrowing and the output gap. Our subsequent two scenarios – "Back to the 2000s" and "Stuck in the 2010 rut" illustrate how better or worse economic performance than expected could change the path of the public finances.

In the absence of exact details on how much each party would seek to reduce or increase spending, we look at how close each party would come to hitting its target if it followed the spending plans set out by the current Government in the last OBR forecast. This allows us to show how much each party could loosen by and still hit its target (or conversely how much it would need to consolidate by to hit its target) in each scenario. As described earlier, these targets differ. The Conservative target takes into account both current and capital spending; Labour's target focuses on current spending; and the Liberal Democrats' target focuses on cyclically-adjusted current spending.

[20] OBR Economic and Fiscal Outlook (March 2014). Note 1.1bn is headline; 4.8 is underlying; 4.9 is ESA10 adjusted. Figures in 2018-19 prices

We specifically focus on the structural element of the public finances. This means that our main consideration is the underlying growth in potential GDP – or the capacity of the economy – which is reflected in the output gap. This has a direct impact on the likely level of the cyclically-adjusted, or structural current budget surplus in the next parliament. The headline deficit or surplus could differ from this, if the economy is over-heating or performing under capacity (i.e. has some slack). Differences in inflation rates and the composition of growth could also have an effect.

For simplicity, we assume that from now until 2018-19, the economy continues to fully recover to capacity level, and then remains growing at a steady level in line with potential GDP, neither over-heating nor performing under capacity. Over-heating or performing under capacity would not affect the Liberal Democrats' target. It would, however, affect the Conservatives' and Labour's targets. In both cases, over-heating would make it easier to hit the targets, and under-performance compared to capacity, for example, due to temporary shocks, would make it harder to hit the targets.

These are indicative estimates based on ready-reckoners as provided by the OBR.[21] More details on the methodology are included in the Annex.

[21] Specifically, we adopt the OBR ready-reckoner assumptions that a higher level of potential GDP in 2018-19 is reflected in a larger output gap today. We also assume that the structural element of the deficit or surplus persists over time as a percentage of GDP.

The SMF core estimate

For the SMF core estimate we take the OBR calculations for how the state of the public finances will evolve in the next parliament, and update them with the latest forecasts of public sector net borrowing, GDP growth and the output gap. According to these latest forecasts, whilst GDP growth is currently higher than expected, much of this is due to a faster recovery than expected, with little improvement in the underlying health of the economy.

Recent GDP growth is at least partly related to demographic factors. In contrast, on a GDP per capita basis, weak productivity growth means that the economy is not expected to reach its pre-crisis peak until early 2017.[22] The result is that wage growth has been poor. In fact, wage growth has fallen every year since 2008.[23] Some projections suggest that real wages will not fully recover until 2018.[24]

The lack of wage growth has meant that income tax receipts have been depressed. As set out in Section 1, forecasts put public sector net borrowing for 2014-15 at around 14%, or around £12 billion higher than forecast by the OBR earlier this year. This may well be a best-case estimate, which assumes that the latest position is likely to improve as more tax receipts come in over the next few months.

At the same time, independent forecasts made over the same period suggest that the output gap in 2014 is smaller by around 0.6 percentage points compared to the last OBR forecast, as the economy has continued to recover.

This means an increase in the size of the structural deficit, which, if it persists, will reduce the expected current budget surplus in 2018-19, and replace the expected overall surplus with a deficit.

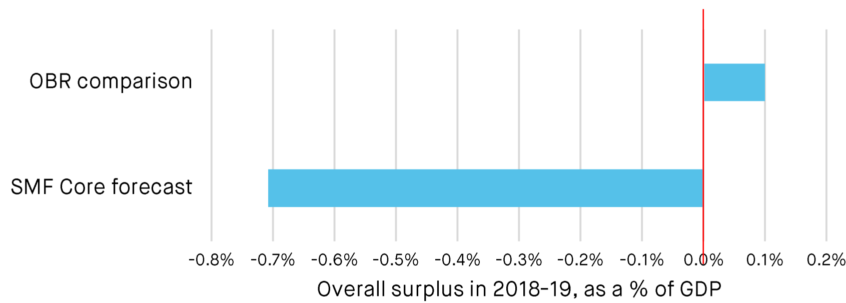
As the charts below show, this would mean that on current spending and tax plans, the Conservatives would no longer be able to run an overall surplus in 2018-19. They would only be able to run a surplus by making further cuts, raising taxes, or relying on the possibility of an over-heating economy that would temporarily make the headline figures look positive by bringing in extra tax receipts. Assuming relying on over-heating is not an option, the Conservatives would need to tighten spending by an additional 0.7% of GDP, or over £13 billion if they still wanted to run a surplus in 2018-19. This would be on top of the existing amounts set out in Section 1, bringing the total amount required in the next Government's first spending review to well over £50 billion.

The Liberal Democrat target would also be missed, but by smaller margin – 0.3% of GDP or just under £5 billion. Whereas under the previous OBR forecast, their target would have allowed some loosening compared to the current Government's plans, under the SMF core estimate, they would need to tighten faster than is planned by the current Government.

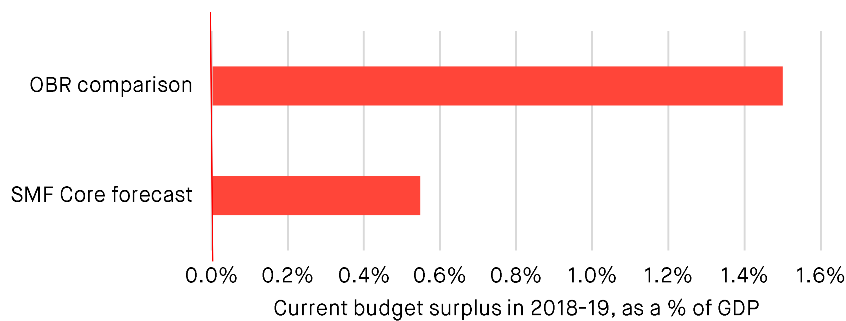
[22] OBR, Economic and Fiscal Outlook (March 2014)
[23] ONS, Annual Survey of Hours and Earnings, 2014 Provisional Results (November 2014)
[24] John Hawksworth and Nick C Jones, "Good jobs, higher living standards?" in Demos Quarterly (Autumn 2014)

The Labour target would continue to be hit, and would leave some room for additional spending or tax cuts compared to current plans, amounting to around 0.5% of GDP or around £10 billion. They would therefore still be able to reduce the current Government's consolidation plan, although not by as much as before, particularly if they wanted to pay debt down. They would need to make total cuts to current spending of around £30 billion instead of £40 billion if they wanted to run a current budget surplus in 2018-19.

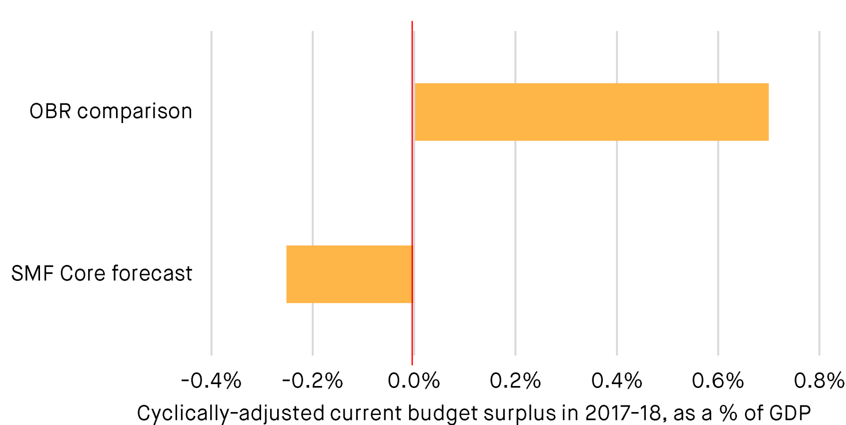
Conservatives: run overall surplus and eliminate borrowing by 2018-19
TARGET MISSED



Labour target: run current budget surplus by 2018-19
ON COURSE



Lib Dem target: run cyclically-adjusted current budget surplus by 2017-18
TARGET MISSED

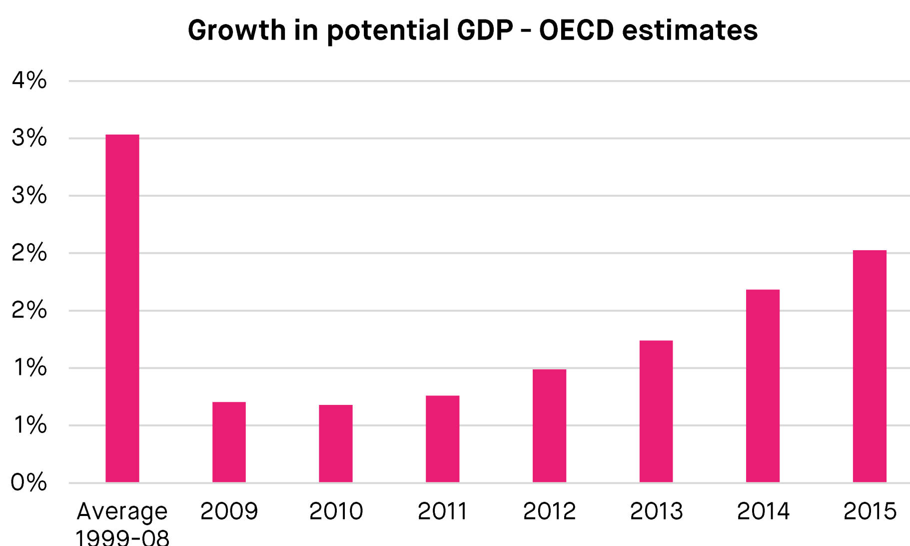


“Back to the 2000s” scenario

What if the UK could do better, and relive the sustainable growth trend of the early 2000s? In this scenario, we use the same latest forecasts of public sector net borrowing and GDP growth as in the SMF core estimate. But we assume that in the next parliament, the UK can regain the momentum it saw in the 1999-2008 period.

During this period, the UK saw average GDP growth of around 2.7% a year. And whilst it is now almost certain that the economy was over-heating around the 2006-2007 period, in the earlier years, potential GDP is estimated to have been expanding at a sufficient rate to allow sustained economic growth.

As shown in the chart below, the OECD estimates that during the decade prior to the crisis, the UK’s potential GDP – its underlying capacity – grew at 3% a year, as underlying productivity increased. Since 2008, growth has been much lower as productivity growth has stagnated. In its last forecast, the OBR assumed that potential GDP would start to rise again, to around 2.1% by 2018.



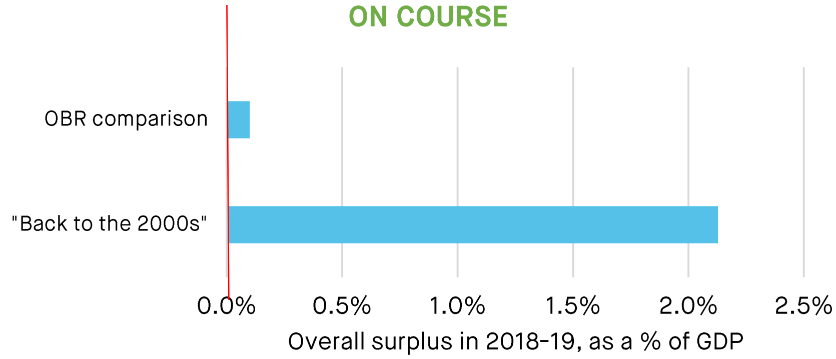
Source: OECD, Economic Outlook database, Annex 20

This scenario assumes that in 2015-16 onwards, potential GDP returns to growing at a rate of 3% a year, rather than the lower rate forecast by the OBR. This means that by 2018-19, potential GDP would be over 3% larger than forecast by the OBR. We assume that the economy would recover to this new, higher level of potential GDP.

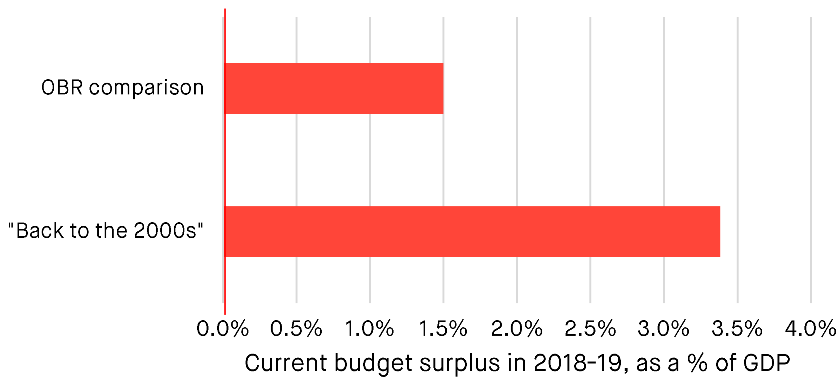
Higher growth would improve the state of the finances, by bringing in more tax receipts and allowing less spending on welfare, as incomes and profits rise. As the charts below show, this would leave all three parties well on track to meeting their targets. In fact, all parties could substantially *increase* spending relative to the current Government’s plans and still meet their targets. For example, even the Conservatives could increase spending by just over 2% of GDP compared to current Government plans –around £40 billion - and still meet their target with the same room for error as expected in the last

OBR forecast. Effectively, this would wipe out the need for any fiscal consolidation in the next parliament at all.

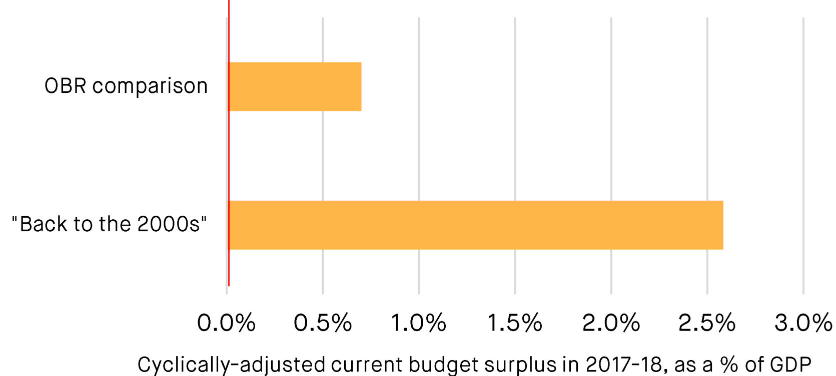
Conservatives: run overall surplus and eliminate borrowing by 2018-19
ON COURSE



Labour: run current budget surplus by 2018-19
ON COURSE



Lib Dem target: run cyclically-adjusted current budget surplus by 2017-18
ON COURSE



"Stuck in the 2010 rut" scenario

In this scenario, we use the same latest forecasts of public sector net borrowing and GDP growth as in the SMF core estimate. But we assume that in the next parliament, the UK fails to regain momentum and sees potential GDP grow at the same rate as in the 2010 parliament, a period when growth largely stagnated.

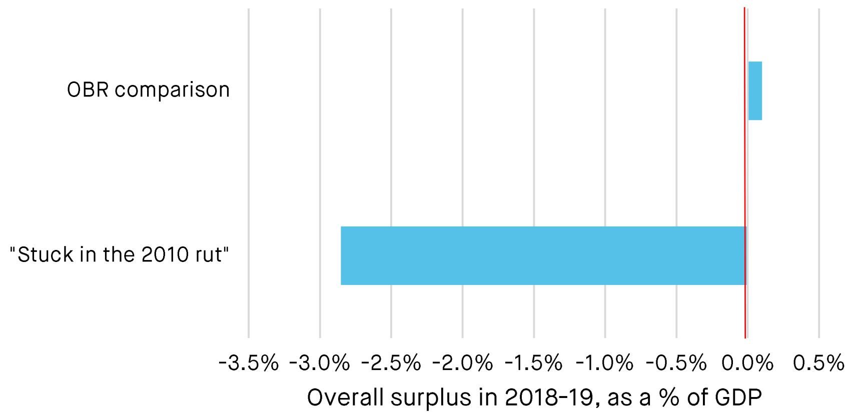
This means that instead of potential GDP growing at a rate of around 2.1 - 2.2% a year in the next parliament as assumed by the OBR, potential GDP grows at the rate estimated in the 2010 parliament – an average of 1.4% a year.

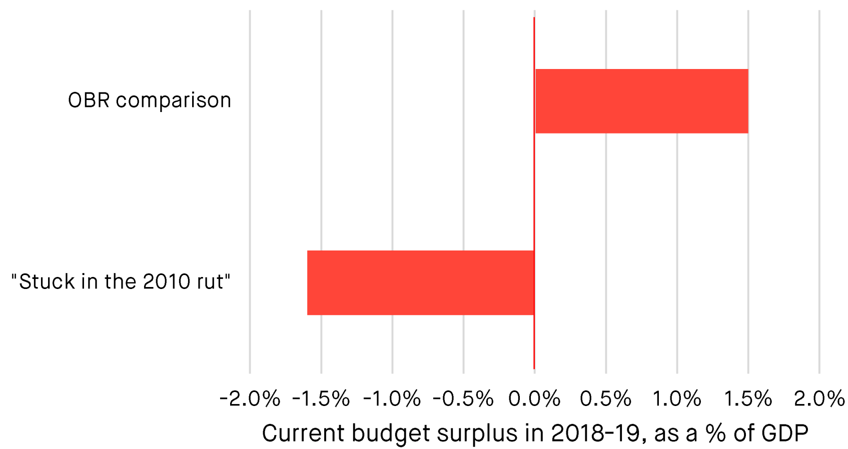
Lower growth will lower tax receipts and increase spending. As the charts below show, in this scenario, all parties would miss their targets by a substantial margin. Borrowing would not be eliminated by the next parliament and the current budget would still be in deficit. This would apply to both the headline and cyclically adjusted figures.

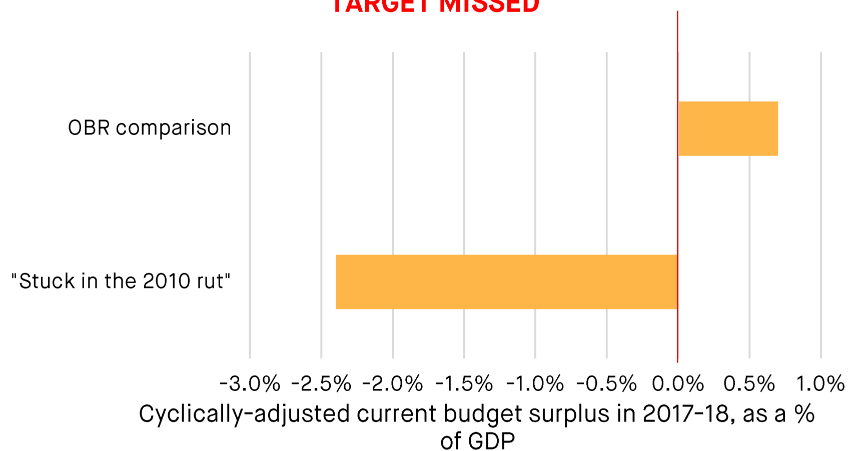
The Conservatives would need to make further spending cuts or tax rises of around 2.9% of GDP, or around £52 billion, *on top* of the spending cuts already set out in Section 1, if they still wanted to achieve an overall surplus by 2018-19. This would amount to an inconceivable £90 billion consolidation in the 2015 Spending Review.

Labour would need to tighten by at least an additional 1.6% of GDP or an additional £30 billion on top of cuts planned by the current Government if they wanted to achieve a current budget surplus in 2018-19 and more if they wanted to start paying the debt down. The Liberal Democrats would need to tighten by around 2.4% of GDP or an additional £45 billion by 2017-18, on top of cuts planned by the current Government if they wanted to achieve a cyclically-adjusted current budget surplus in that year.

It is hard to see how consolidation of this magnitude could happen. For example, achieving £92 billion in savings would be equivalent to taking around a quarter off departmental spending in the absence of further cuts to welfare or tax rises, and would come on top of cuts already made in the 2010 to 2016 period. The most likely outcome would be a further postponing of the deadline to repair the public finances.


Conservatives: run overall surplus and eliminate borrowing by 2018-19
TARGET MISSED
OBR comparison
"Stuck in the 2010 rut"
-3.5% -3.0% -2.5% -2.0% -1.5% -1.0% -0.5% 0.0% 0.5%
Overall surplus in 2018-19, as a % of GDP


Labour: run current budget surplus by 2018-19
TARGET MISSED
OBR comparison
"Stuck in the 2010 rut"
-2.0% -1.5% -1.0% -0.5% 0.0% 0.5% 1.0% 1.5% 2.0%
Current budget surplus in 2018-19, as a % of GDP


Lib Dems: run cyclically-adjusted current budget surplus by 2017-18
TARGET MISSED
OBR comparison
"Stuck in the 2010 rut"
-3.0% -2.5% -2.0% -1.5% -1.0% -0.5% 0.0% 0.5% 1.0%
Cyclically-adjusted current budget surplus in 2017-18, as a % of GDP

The purpose of the two scenarios set out above is to show how pivotal the role of the economy is in repairing the public finances. Any sensible plan to fix the public finances must include a plan for growth. If the economy cannot deliver sustained growth, then the cuts required could balloon, and the deadline for repairing the public finances will have to be postponed beyond 2020. Conversely, if the economy out-performs expectations in its ability to deliver higher levels of sustainable growth, then little fiscal consolidation beyond 2015 will be needed at all.

In the next section, we look at how spending might be distributed in the 2015 Spending Review, the first Spending Review of the next Government, covering the years 2015-16 and beyond.

SECTION 3: CHOICES IN 2015

What we know about the choices so far

Current economic forecasts suggest that all parties will be looking for savings in the first spending review of the next Government in 2015, although the magnitude of those savings differs substantially.

So far there has been little detail from the parties on how consolidation will be achieved. What we do know so far, mainly from speeches at the 2014 party conferences, is set out below. We then show what choices are likely to be faced by the new Government in 2015, under the SMF core estimate.

Conservatives

Any consolidation under the Conservatives is likely to come mostly from spending cuts, with George Osborne saying in 2014 that "the option of taxing your way out of a deficit no longer exists, if it ever did". [25]

In fact, a number of proposed tax cuts were set out in David Cameron's 2014 conference speech, including raising the tax-free personal allowance from £10,500 to £12,500 and raising the threshold for the 40p income tax rate. The Conservatives have said they expect this to cost £7.2 billion a year, of which the cost of increasing the personal allowance would come to £5.6 billion.[26]

At the same time, David Cameron committed to maintaining the most competitive corporate taxes in the G20. We do not know whether the income tax cuts would come after or before the Government has achieved its surplus target. At worst, they add to the already large spending cuts needed. At best, they signal an unwillingness to use tax rises to hit the deficit targets, placing most of the burden on spending.

George Osborne also said that a Conservative Government would cut "Whitehall spending by at least the same rate for the first two years of the next Parliament as we have done through this Parliament," and that this would save at least £13 billion.[27] He specifically highlighted restraint on public sector pay as one option to make savings. However, some areas will be protected: David Cameron committed to protecting the NHS budget, and the Conservatives have also previously expressed a commitment to maintaining capital spending as GDP grows.[28]

Welfare, excluding disability and pensioner benefits, has been highlighted as an option for savings, or at least reform. Specific areas highlighted in recent speeches include replacing Job Seekers Allowance, reforming housing benefits and reducing the benefits cap to £23,000. However, at least some of these proposed savings from these reforms

[25] George Osborne, speech to Conservative party conference (2014)
[26] IPPR, Tax plans from party conference (October 2014)
[27] George Osborne, speech to Conservative party conference (2014)
[28] George Osborne, speech to Conservative party conference (2013)

have already been earmarked to fund apprenticeships, and so will not be used to reduce the deficit.

Labour

It is likely that a Labour Government would rely on tax rises as well as spending cuts. Some tax rises were set out in Ed Balls's and Ed Miliband's speeches to party conference. They included a number of savings, although many have already been earmarked for increasing spending elsewhere. A "mansion tax" for houses worth of £2 million and a tax on tobacco companies is planned to support NHS spending. Ed Balls also set out plans for a bank bonus tax and increasing the bank levy, which were specifically earmarked to fund a Compulsory Jobs Guarantee Scheme and an expansion of free childcare. In addition, a plan to increase the top-rate of income tax, back to 50p was set out.

Ed Balls also set out potential savings, predominantly to welfare rather than departmental spending. They included continuing to raise the retirement age; capping child benefit rises at 1% for the first two years; and stopping payment of the winter fuel allowance to the richest 5% of pensioners. He also referred to capping "structural" social security spending. Assuming this is defined in the same way as the current Government's welfare cap, this will already have been factored into current Government spending plans. Other savings included cutting ministerial pay and cutting spending on free schools in areas where there are sufficient school places.[29] Housing is expected to be prioritised within the capital budget.[30]

Liberal Democrats

In his speech to conference, Danny Alexander set out a "fairness rule" that requires the best-off to contribute the most to help pay down the deficit.[31] This suggests that the Liberal Democrats would expect to focus more on tax rises compared to the Conservatives. According to the conference speeches, this would include new council tax bands for the highest value properties.

On departmental spending, the Liberal Democrats plan to continue to prioritise health, education and infrastructure, with speeches including:

- A commitment to going further than protecting the NHS Budget in real terms, by increasing spending by £1bn every year. This is expected to be paid for by taking away "three different tax breaks which benefit the highest earners".
- Likely protection of education spending, with Nick Clegg referring to "protecting funding from cradle to college".
- A commitment to require a balanced budget, but allow for additional investment in productive economic infrastructure – roads, railways, broadband, housing – as long as the overall debt is falling as a share of the economy.

[29] Ed Balls, speech to Labour party conference (2014).
[30] Ed Miliband, speech to Labour party conference (2014).
[31] Danny Alexander, speech to Liberal Democrat party conference (2014)

As with the Conservatives, the Liberal Democrats have also said they would raise the tax-free personal allowance from £10,500 to £12,500.[32]

In summary, whilst we know about the parties' broad fiscal targets and priorities for spending cuts, we know very little of the detail. Many of the savings suggested so far are set to allow more spending elsewhere, rather than to reduce the deficit. And some announcements involve more spending rather than less. In the rest of this section, we look at how cuts could be split across departments, before turning to welfare and taxes.

Cutting departmental spending

Under the spending plans set out in the Budget in March 2014, departmental spending was set to be cut by around 10% from 2015-16 to 2018-19, or around £38 billion. However, during this period, capital spending is planned to slightly increase – and indeed, none of the three major parties have signalled that they would choose to cut capital spending. In fact, the Labour and Liberal Democrat targets specifically focus on current spending only. Meanwhile, the Conservatives have previously said they would increase capital spending in line with GDP.[33] In this analysis, we therefore focus on cuts pencilled in for current departmental spending after 2015-16. Current departmental spending is set to fall by around 13%, or £40 billion under the Government's current plans.

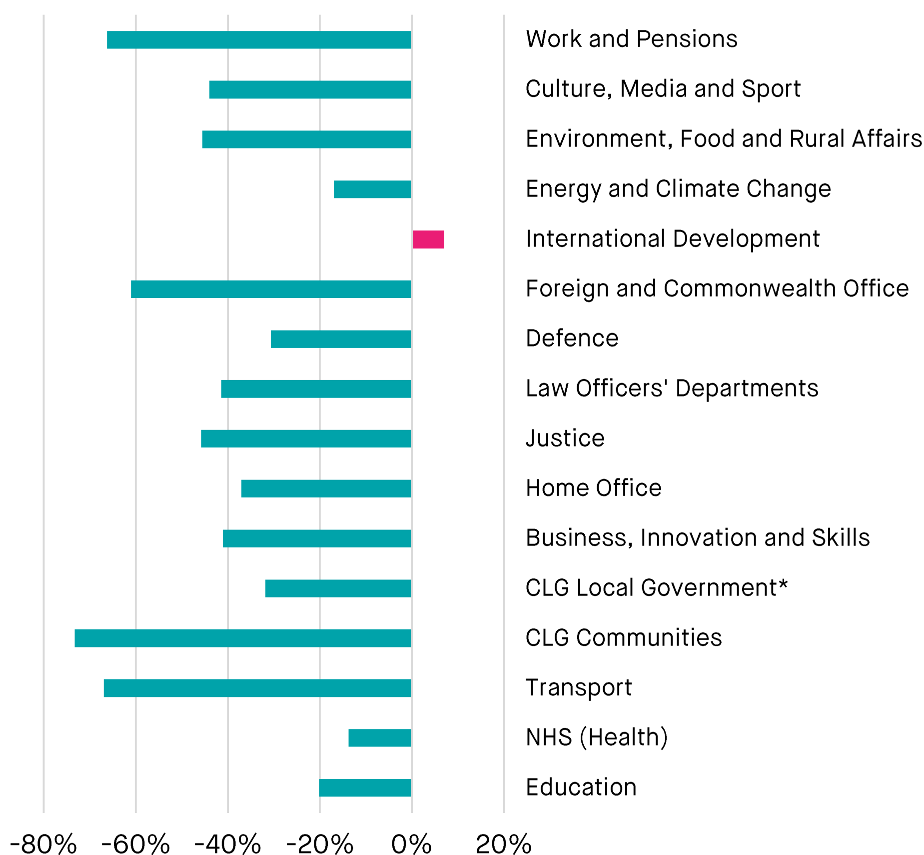
In reality, the size of the cut targeted might be much more or much less. As shown in Sections 1 and 2, the amount the next Government will need to look for in the 2015 Spending Review will depend firstly on the state of the economy, and secondly on the measure of the deficit it is choosing to target. And each of the three major parties has set out a different target. Under the SMF core estimate, the cut currently planned would not be sufficient to hit the Conservatives' target of an overall surplus in 2018-19. Instead a cut to current departmental spending – assuming capital spending is maintained as planned - of around £54 billion would be required.[34] This is equivalent to a cut of over 17% in just the years after 2015-16 unless savings are found from welfare or taxes.

Even the March forecast entailed a large cut - around a 4.5% average annual cut. Meeting the Conservatives' target under the SMF core estimate would increase this average annual cut to 6.2%, equivalent to around 17% over the period 2015-16 to 2018-19. It is hard to see how this would be achievable. Current departmental spending will have already seen substantial cuts by 2015-16 – around 12% on average.[35] Some departments will have been cut by far more than this, as the NHS, education and international development have been protected from cuts. As these areas of spending accounted for around half of total departmental spending in 2010, other departments had to take double the average cut. The chart below shows what a further cut of 17% to every department would do, coming on top of cuts since 2010. As can be seen, nearly all

[32] Nick Clegg, speech to Liberal Democrat party conference (2014)
[33] George Osborne, speech to Conservative party conference (2013)
[34] As calculated in Section 2, the overall cut needed to meet the Conservative target is £52 billion. However, as capital spending is expected to slightly grow in real terms, keeping capital spending as planned would mean current spending would need to be cut by £54 billion.
[35] OBR Economic and Fiscal Outlook (March 2014), Table 4.15

departments, apart from ones that have been protected thus far and Energy and Climate Change, would see their current spending cut by a minimum of 30% by 2018-19.

Splitting out £54 billion equally: total real terms cut since 2010 (Resource DEL excl. depreciation)



*For CLG Local Government, we show Resource DEL and Resource AME combined. This is because of substantial switches between DEL and AME to reflect changes to local government policy on business rates and council tax retention.
Based on PESA 2014 and SMF calculations

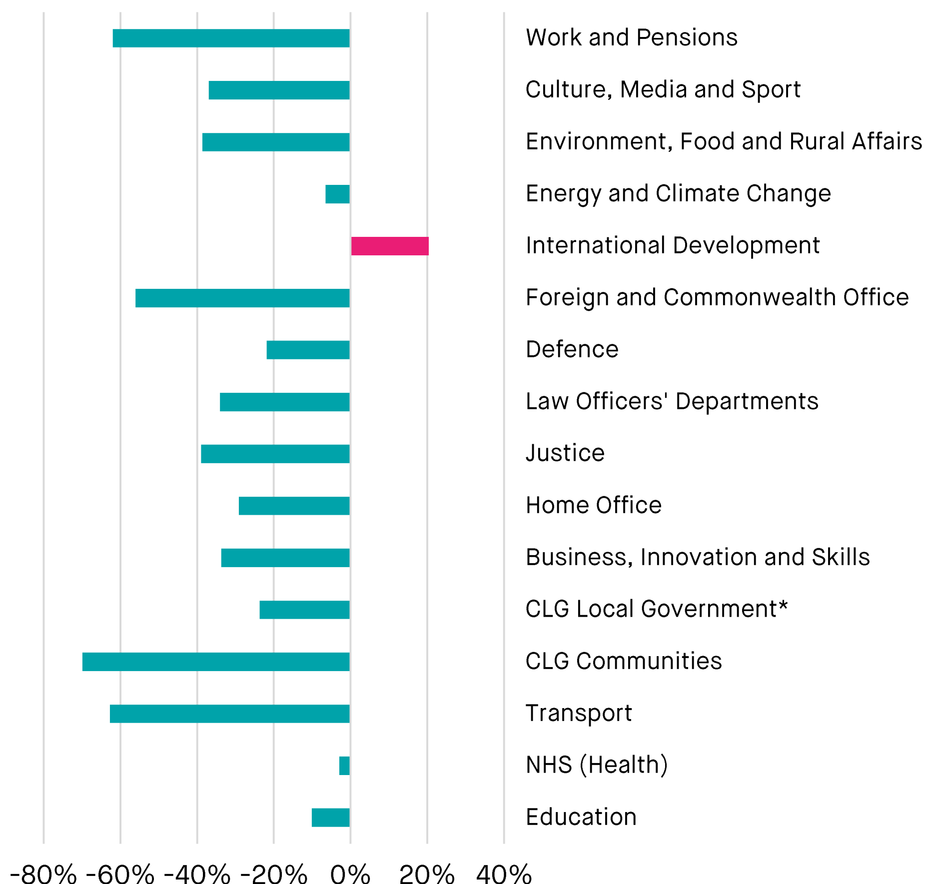
The plans currently set out involve *increasing* the pace of cuts compared to the 2010-11 to 2015-16 period. But the difficulty of finding cuts in departmental spending is likely to only increase. Indeed, coming on top of the fact that the easiest cuts have already been made, it may be unrealistic to think that spending can be cut at an even greater rate than in the 2010 parliament.

Going slow

The most likely scenario is that the pace of cuts in the 2010 parliament represents the more realistic (but still difficult) path of spending cuts. If this happens, the cut from current departmental spending after 2015-16 would amount to £23 billion, or around 7.6% by 2018-19. This would still entail difficult decisions, coming on top of the cuts

made in the previous 5 years. It would mean that the total cut in current departmental spending would amount to around 19.5% over the entire period 2010 to 2019.

As shown in the chart below, if the cut after 2015-16 was spread equally, with each department taking a 7.6% cut, this would leave many departments substantially smaller compared to 2010. Some of the worst hit departments would be Work & Pensions (over 60% cut), Foreign and Commonwealth Office (56% cut) and CLG Communities (around a 70% cut). The Department for Transport would also see a substantial cut to current spending, however, this department is unique in that most of its budget is capital spending rather than current spending, and it has benefited from a rising capital budget settlement during the period in question.



*For CLG Local Government, we show Resource DEL and Resource AME combined. This is because of substantial switches between DEL and AME to reflect changes to local government policy on business rates and council tax retention.
Based on PESA 2014 and SMF calculations

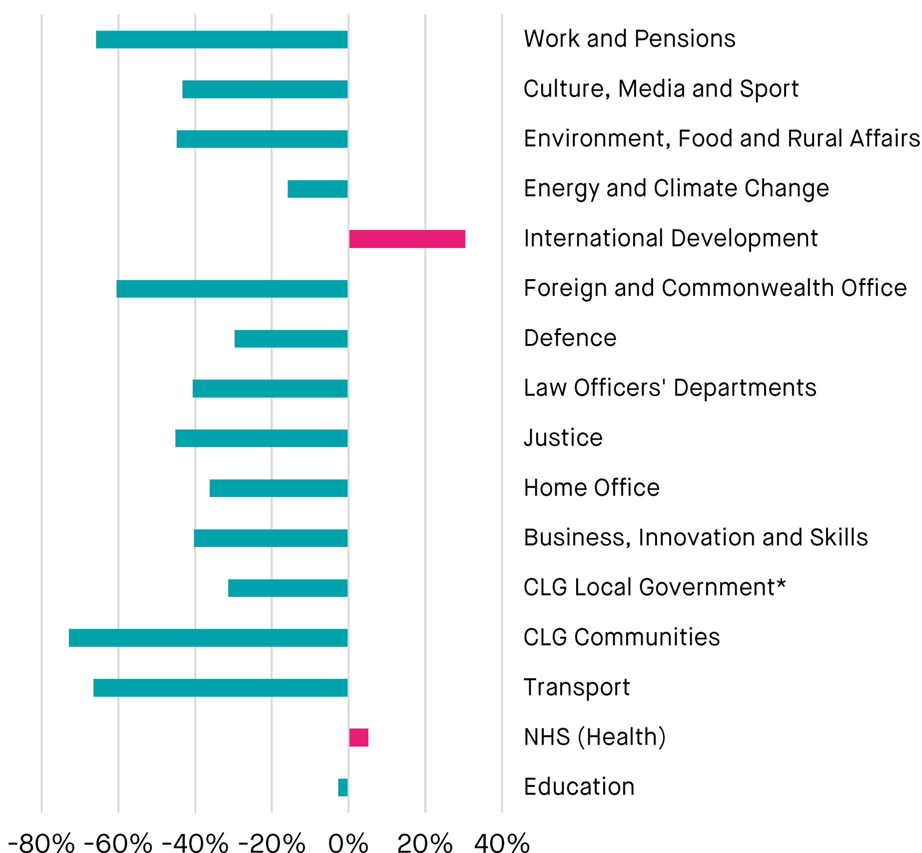
But sharing out the pain equally is unlikely to be feasible. Since 2010, spending on the NHS, education and international development has been broadly protected. In particular, it would be very difficult to impose a real-terms cut on the NHS. Even keeping the budget flat in real terms is difficult for the NHS. Historically spending on health has had

to be increased faster than GDP growth to keep up with growing demand and rising costs due to an ageing population and the expectation that the NHS should be able to adopt new emerging technologies.

This means that although the NHS has been protected from a real terms cut since 2010, it has still had to make substantial efficiency savings to continue to meet the needs and expectations of its users. The funding gap has been estimated at over £30 billion.[36] Closing this gap requires around a 3% efficiency gain a year.[37] In this context, imposing a 7.6% real terms cut on the NHS is unlikely to be feasible.

If the NHS, education and international development continued to be protected in the next parliament, other departments would have to take a much larger average cut after 2015-16, of around 17%. This would, for example, leave Work & Pensions with a current budget around a third of the size it was in 2010. The Communities budget would have been cut by over 70%.

Splitting out £23 billion across non-protected departments: total cut since 2010 (Resource DEL exc depreciation)



*For CLG Local Government, we show Resource DEL and Resource AME combined. This is because of substantial switches between DEL and AME to reflect changes to local government policy on business rates and council tax retention.
Based on PESA 2014 and SMF calculations

[36] SMF, Spending Review 2013 briefing (2013); NHS England, The NHS belongs to the people (2013)
[37] NHS England, Five Year Forward View (2014)

Where will the rest of the money come from?

As can be seen, even taking cuts at a slower pace compared to that pencilled in is likely to be extraordinarily difficult. And fewer cuts to departmental spending will mean that more savings will have to be found elsewhere.

Labour would need to find an extra £6 billion from welfare or tax rises if it wanted to take spending cuts at this slower pace and still meet its target under the SMF core estimate. If it wanted to start paying the debt down, it would need to find even more elsewhere. The Liberal Democrats would have to find a further £20 billion if they still wanted to meet their 2017-18 target.

The Conservatives would face the most difficulty. They already had little margin for error under the OBR's last forecast, and are set to miss their target under the SMF core estimate. This means that if they took cuts at the slower pace, they would be short by around £30 billion if they still wanted to meet their target of an expected surplus by 2018-19. This would need to be found from elsewhere, such as welfare or tax rises. Of these two, welfare is the most likely candidate: the Conservatives have already signalled they will not raise tax, and indeed have announced around £7 billion of tax *cuts* that will need to be funded.

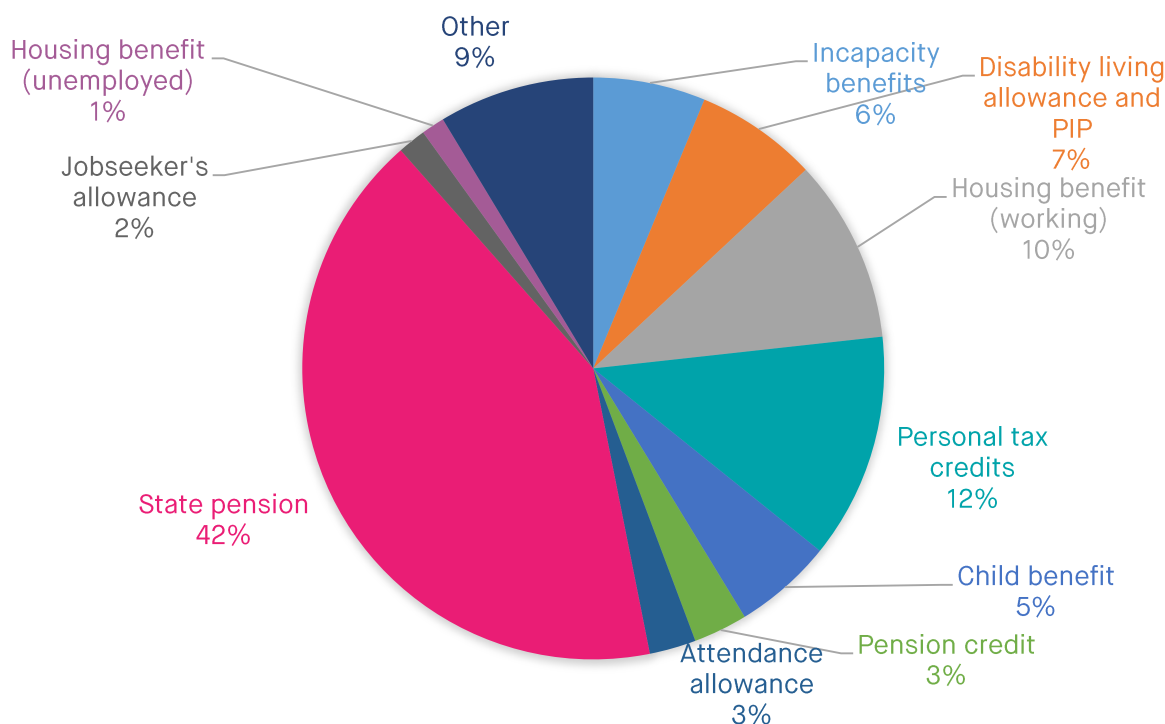
The rest of this section looks at the options for making savings across welfare and tax.

Welfare cuts?

Given the difficulty in making all the savings required from spending cuts, it is likely that welfare will see further cuts.

The Conservatives have already said that welfare cuts will be an option. The current Government has set out a welfare cap covering around a half of welfare spending, which excludes state pensions and unemployment benefits. This may indicate that welfare spending within the cap is more likely to be considered for cuts. The cap excludes the state pension and unemployment-related benefits, but includes most other benefits, such as housing benefit for those in work, tax credits, child benefit, incapacity benefit and disability living allowance. If the Conservatives wanted to cut £30 billion from welfare, only from elements in the welfare cap, this would amount to cutting these benefits by around a quarter on average.

Welfare spending, 2015-16



OBR, Economic and Fiscal Outlook (March 2014)

The table below sets out examples of cuts that could be made and the approximate amounts they would save. As can be seen, much more radical cuts, beyond those already being thought about, would be needed to allow the Conservatives to go more slowly on departmental spending.

Abolishing winter fuel payments for richest 5% of pensioners	*£0.09 billion*
Reducing the benefits cap to £23,000	*£0.14 billion*
Capping child benefit bill rise at 1% for 2 years	*£0.2 billion*
Cut Jobseekers Allowance bill by 10%	*£0.3 billion*
Cut incapacity benefit bill by 10%	*£1.3 billion*
Abolishing winter fuel payments	*£1.9 billion*
Cut housing benefit bill by 10%	*£2.5 billion*
Two year working age benefit freeze	*£3 billion*

Note: 2014-15 prices, amount saved in 2018-19. Indicative estimates.
Sources: OBR Economic and Fiscal Outlook (March 2014); George Osborne speech to party conference 2014

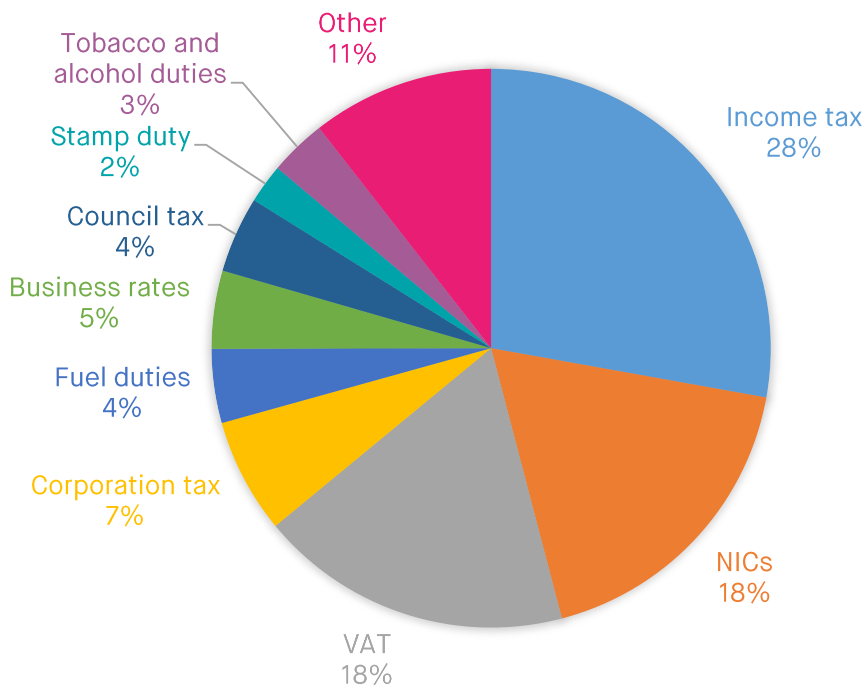
Tax rises?

The Conservatives have signalled that they do not plan to raise taxes in the next parliament. At the very least, a rise on income tax would be unlikely given commitments to reduce income tax instead. They have also said they will maintain competitive corporation tax rates. This could leave open the door to rises in other taxes, although recent speeches suggest this is unlikely.

Labour and the Liberal Democrats, however, might choose to raise taxes to ease the burden on departmental spending. Given that they will be targeting smaller spending cuts than the Conservatives, tax rises for them have the potential to make achieving the required departmental savings much easier.

The largest elements of taxation revenues come from income tax, VAT and National Insurance Contributions (NICs).

Tax revenues, 2015-16



Source: OBR, Economic and Fiscal Outlook (March 2014)

The table below sets out examples of tax rises that could be made and the approximate amounts they would save. Given the difficulty in making even small cuts in welfare, it is likely that tax rises will have to bear some of the burden.

Increase alcohol and tobacco duties by 1%	*£0.1 billion*
Mansion tax on properties worth over £2 million	*Approx. £1.2 billion*
Increase Class 1 employee National Insurance Contribution by 1 percentage point	*£4 billion*
Increase basic rate of income tax from 20p to 21p	*£4.5 billion*
Increase Class 1 employer National Insurance Contribution by 1 percentage point	*£5 billion*
Increase VAT standard rate from 20% to 21%	*£5.5 billion*
Having higher rate tax relief on pension contributions	*£7 billion*

Note: 2014-15 prices, amount saved in 2018-19. Indicative estimates.
Sources: estimates based on HMRC ready-reckoners; Labour party website, "Labour's mansion tax"; Pensions Policy Institute, Pension Facts (2011).

As can be seen, taking cuts after 2015-16 at a slower pace, to match the pace of cuts seen so far would impose the need for large cuts from welfare or tax rises, especially for the Conservatives, who are aiming for the hardest to achieve target of all three parties. It is very hard how to see how cuts of this magnitude could be made in the absence of very radical change to the shape of the state.

The most likely outcome is for spending targets to be yet again postponed.

CONCLUSION: THE NEED FOR GROWTH AND REFORM

The next Government, of whichever colour, will most likely be faced with making large spending cuts in its first Spending Review to meet its target for the public finances. We have been here before; the cumulative cuts to current departmental spending in the 2010-11 to 2015-16 period amounted to over 12%. But it is likely that the easiest cuts have now already been made. And as more borrowing now looks likely to be structural than previously estimated, the challenge may be even larger than it looked earlier this year in March. Given the difficulty in making further cuts, it is likely that the next Government will need to consider tax rises as well as savings in welfare and departmental spending.

However, the new Government must not lose sight of the substantial difference that a healthy, growing economy can make to the public finances. Recapturing the sustained growth of the early 2000s could eliminate the need for any spending cuts in the next parliament at all. In reality, it will of course take time to mend our economy; productivity growth has been poor in recent years.

But the vital need for sustainable growth means that Government must take a growth-friendly approach to fiscal consolidation in the next Parliament. The commitment by parties to maintaining investment spending is a positive sign. Studies show that if done well, and correctly targeted, Government spending on infrastructure can raise GDP with no overall rise in public sector debt.[38] But there are also areas of day-to-day spending that are important for growth, and which will also need to be prioritised. These are likely to include areas such as skills, education and science spending. And whilst tax cuts will make it much harder to achieve fiscal targets in the short-term, there may be a case for them if they increase productivity and growth.

In addition, it is more important than ever to ensure that spending intended to boost growth, and indeed spending more generally, actually delivers the outcomes that Government is aiming for. This means a strong focus on ensuring that spending is well targeted, in areas where it can deliver best value for money. Given the amount that needs to be saved, it is likely that Government will have to substantially change how and what it delivers.

This could mean a need for greater focus on ensuring that those delivering public services or publically-funded projects are incentivised to deliver value for money for the taxpayer, for example, through payment-by-results. Examples of this include the Work Programme; an NAO study found that the programme was performing similarly to other job-assistance programmes in past, however there have been difficulties in encouraging providers to help those who need it most, and in correctly designing incentive payments.[39]

Another approach to improving outcomes is greater decentralisation - allowing local areas to make choices about what is needed most in their areas. The UK is among the

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[38] IMF, Now is a good time to invest in infrastructure (2014)
[39] NAO, The Work Programme (2014)

most centralised of developed countries. [40] This arguably reduces the ability of, and incentive for, local government to take steps to increase growth in their areas. All parties are now planning for more decentralisation in the coming years. But at the same time, they will need to be wary of the fact that there are likely to be limits to how much spending can be effectively decentralised, without removing the central government's ability to take on more strategic, pan-regional decisions.

And whilst the fiscal targets are relatively short-term, the longer-term consequences of the next Government spending decisions are likely to be of greater importance. The full effects of spending designed to boost the UK's longer-term productivity are, almost by their very definition, unlikely to be seen immediately. In addition, there are many spending pressures, such as the effect of an ageing population that are likely to become only more important as time goes on.[41] Reform that is designed to cope with these longer-term pressures and improve outcomes in the future may well increase costs today. Integration of health and social care, for example, whilst expected to deliver better outcomes more efficiently, is likely to require some upfront investment.[42] Similarly, new technology could improve the way public services are delivered in the future, but could increase costs in the short-term.

Allocating the cuts in the 2015 Spending Review is likely to be even harder than in 2010. And there are questions as to whether the usual Spending Review process will be able to effectively deal with the challenges ahead. For example, short-term fiscal targets, as currently set out by the three main parties, may shift focus away from the longer-term spending pressures to come, and the need for sustainable economic growth. Rigid departmental and accounting boundaries may obscure the relative importance of different elements of public spending in achieving the twin aims of repairing both the economy and the public finances for the long-term.

In the coming months, the SMF will explore in more depth the potential decisions faced by the next Government in its first Spending Review, and how it can seek to deliver on meeting fiscal targets, boosting growth and ensuring the public services remain fit-for-purpose. Meeting these are likely to involve difficult trade-offs across different areas of spending and taxation.

[40] Lord Heseltine, No stone unturned: in pursuit of growth (2013)
[41] OBR, Fiscal sustainability report (2014)
[42] The King's Fund website, Care co-ordination through integrated health and social care, accessed November 2014

ANNEX: METHODOLOGY

In Section 2, we construct three scenarios – the SMF core estimate; Back to the 2000s; and Stuck in the 2010 rut. The purpose of these scenarios is to demonstrate how assumptions about how the economy will evolve over the next few years have a significant effect on future deficit and borrowing.

In all three scenarios, we use the median of independent forecasters' estimates of public sector net borrowing for 2014-15, to update the forecast made by the OBR in March 2014. We use estimates made in the last three months, that is, September-November 2014, as published in HM Treasury, *Forecasts for the UK economy,* November 2014.

We use this new forecast of borrowing to update the 2014-15 forecast of the deficit on current spending, assuming that net investment remains unchanged. We then calculate how much of this deficit is structural by using the OBR's method which is as follows. This method is outlined in OBR, *Working Paper No.3: Cyclically adjusting the public finances*, June 2012.

Structural deficit as % of GDP = Actual deficit as % of GDP – 0.5*(output gap in current year) – 0.2*(output gap in previous year).

This allows us to estimate how much larger the structural deficit is compared to the OBR's March forecast. We assume that this extra amount of structural deficit persists over time as a percentage of GDP. This assumption is consistent with the OBR's cyclical adjustment ready-reckoner published as Table 5.5 of the OBR's March 2014 Economic and Fiscal Outlook.

This allows us to calculate the cyclically-adjusted current budget deficit in 2017-18, which is the Liberal Democrats' target. We calculate the current budget deficit and the overall deficit for 2018-19 under the assumption that in 2018-19, the economy is operating at trend growth, neither over-heating, nor operating with slack. This forms the basis of the SMF core estimate.

For our "Back to the 2000s" scenario, we take the OBR's estimates of potential GDP growth over the period 2008-09 to 2014-15. We then project forwards assuming that potential GDP grows at 3% a year until 2018-19. We make the simplifying assumption, consistent with the OBR's cyclical adjustment ready-reckoner, that a higher level of potential in 2018-19 is reflected in the starting output gap.

For our "Stuck in the 2010 rut" scenario, we take the OBR's estimates of potential GDP growth over the period 2008-09 to 2014-15. We then project forwards assuming that potential GDP grows at 1.4% a year until 2018-19. As with the second scenario, we make the simplifying assumption, consistent with the OBR's cyclical adjustment ready-reckoner, that a lower level of potential in 2018-19 is reflected in the starting output gap.