SMF Social Market Foundation

SPENDING CHOICES AFTER 2015

Part 3: Investing for Growth

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After years of sluggish growth, UK GDP grew by 2.6% in 2014, and by the end of 2014 was 3.4% higher than the pre-downturn peak.[1] Unemployment, at 5.8% in September-November 2014, was above pre-downturn levels of around 5.2%, but not by much. However, GDP per capita has taken longer to recover, and is still below 2008 levels.[2]

Poor productivity growth has constrained growth in wages, which have only recently overtaken inflation. Productivity is still below 2008 levels, although it has started to improve.[3] Whilst the recent economic data are promising, there are long-term and short-term economic challenges facing the next Government.

Even before the downturn, the rest of the G7's average productivity (per hour) was around 6% higher than that of the UK. By 2013, the gap had grown to 17%. There is room to improve on skills, investment and innovation. Tackling this is vital for living standards in the long-term, and for the long-term health of Government finances. Sustained economic growth will allow for a healthier tax base, making it easier to deal with the longer-term pressures on public spending, such as an ageing population.

Looking at the shorter-term horizon, sustained economic growth in the next Parliament will also be essential to the success of deficit reduction targets. As we show in *A Deficit of Growth*, the success of the three main parties' aims all depend on much higher growth than we have seen in the past seven years. Without this, even the substantial public spending cuts outlined in the 2014 Autumn Statement will not be enough to eliminate the current budget deficit by 2020, and certainly will not be enough to eliminate borrowing and pay down the national debt.[4]

The long and short term challenges mean that when the next Government comes to make its spending choices in its first Spending Review in 2015, economic growth must be a priority. Clearly, Government policy to boost economic growth is not simply measured by spending alone. But there are many areas of spending that are important for economic growth, and which would not necessarily be replaced by private sector spending if they were withdrawn.

This briefing note:

- Sets out what types of Government spending are good for growth, and where we are falling behind other comparable countries
- Sets out what the different parties have committed to
- Shows where growth-friendly spending is located, and argues that the way in which Government spending is currently categorised makes this a difficult task
- Concludes that the next Government will need to take a comprehensive and consistent approach to growth-friendly spending and sets out a number of recommendations.

WHAT SPENDING IS GOOD FOR GROWTH?

The main areas of growth-friendly spending are set out below. These areas span a range of departments. Some spending is categorised as capital investment, whereas some is categorised as current spending, and some is "implicit spending" in the form of tax reliefs and credits. Whilst all being "growth-friendly", the relative importance of spending in different areas will depend on where the UK's performance needs to improve, and how sensitive performance is to public sector funding. Spending in different areas will also have differing effects in the short and long-term – both in terms of living standards and the public finances.

- **Infrastructure**: Investment in infrastructure can boost business investment, jobs and growth. The effect is particularly pronounced when the existing capital stock is under pressure.[5] A recent study found that in advanced economies, a 1 percentage point of GDP increase in investment spending raises the level of output by about 0.4 percent in the same year and by 1.5 percent four years after the increase. The positive effect on GDP offsets the rise in public debt.[6] The UK lags behind several other advanced economies, including Germany, France, Japan and the US in terms of the quality of its infrastructure.[7]

- **Education and skills:** A skilled workforce increases productivity. Around a fifth of economic growth in the late 1990s and early 2000s was due to improvements in labour quality.[8] The UK performs well on international university rankings and the proportion of the population completing higher education.[9] But despite this, it faces significant skill gaps in several sectors, holding back their growth. In addition, a relatively high proportion of the workforce is stuck in low pay, low skilled jobs.[10]

- **Research and development**: Government grants and subsidies for research and development have been shown to increase private sector investment, in turn increasing productivity. The effects are particularly strong for smaller firms. Tax credits tend to be more effective in increasing private sector investment in the short-term, whereas grants tend to be more effective in increasing investment in the longer-term.[11] The UK currently suffers from low levels of both public and private sector R&D investment.[12]

- **Business support and access to finance**: New, growing firms, are important in bringing new innovations to market and increasing productivity, but can be stifled by lack of support such as access to finance.[13] Business lending fell after the financial crisis, but even before this, there were structural gaps in the market for financing for smaller businesses, with a particular gap for equity funding for small businesses with high growth potential.[14]

The cost of investment will of course depend on the Government's cost of borrowing. However, as shown in chart 1 below, the Government's cost of borrowing fell after the crisis and is still relatively low.

Chart 1: Monthly average yield on 10 year bonds (nominal %)

Source: Bank of England, series IUMAMNZC

WHAT HAVE THE PARTIES SAID ABOUT GROWTH-FRIENDLY SPENDING?

There is broad agreement across the Conservatives, Labour and the Liberal Democrats about the importance of capital spending for growth. Labour and the Liberal Democrats' main deficit reduction targets focus on current spending, excluding capital investment. This leaves substantial room to increase capital spending compared to the Conservatives, subject to both parties' aims to also start reducing debt as a proportion of GDP.

The Conservatives' target includes capital spending, however, they have indicated that spending cuts will not come from reduced capital investment, instead pledging to "grow capital investment at least in line with GDP".[15] Within capital investment, the parties have mostly emphasised infrastructure spending, for example, on transport and housing.[16] Less has been said about other types of growth-friendly spending, with the main exception of education.

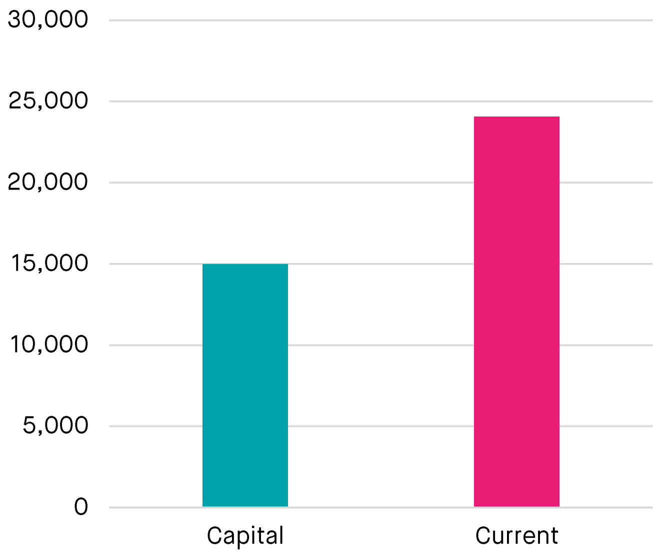
It will be important that the next Government comprehensively examines all areas of spending that are likely to be growth-friendly, taking a consistent view across these areas. Arguably, the way in which ring-fencing has worked in the 2010 Parliament, and the way in which spending is categorised into "capital" and "current" spending has not been helpful in identifying these areas and treating them in a consistent way. Below we set out some specific examples.

Much growth-friendly spending is current, not just capital spending

There is no single official categorisation of "growth-friendly spending". The closest is the "economic affairs" category used in the Treasury's Public Expenditure Statistics (PESA). "Economic affairs" is a broad category, including spending on enterprise and economic development; science and technology; employment programmes and sector-specific support. It does not include education.

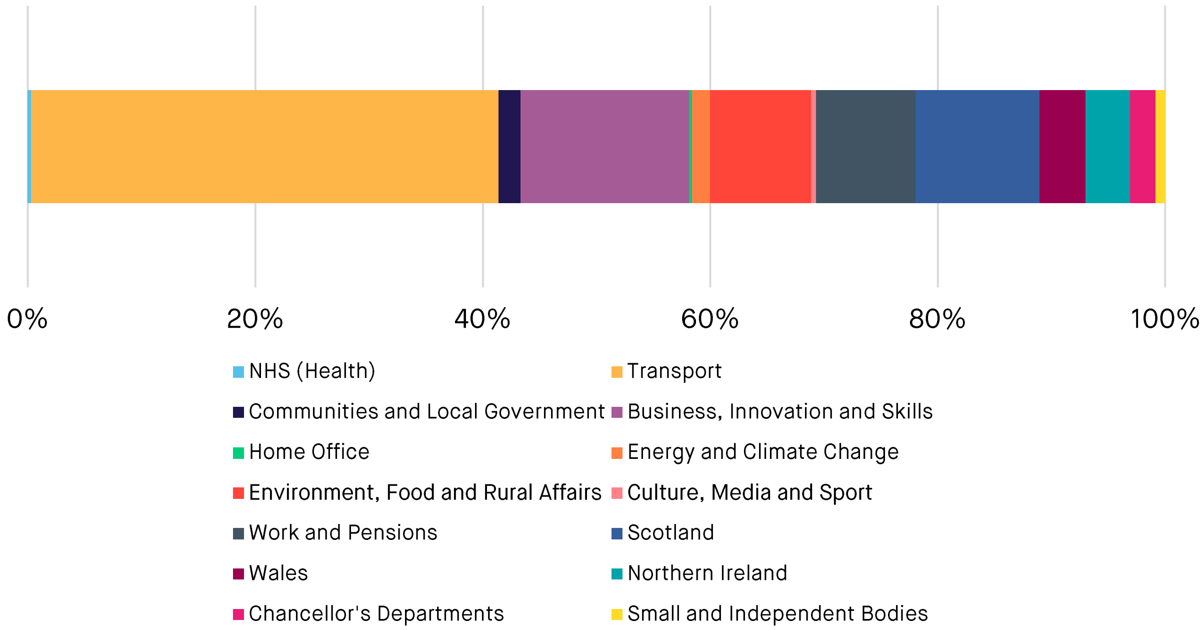
Despite the perception that growth-friendly spending is primarily capital investment, chart 2 shows that over 60% of spending on economic affairs is not capital spending. We can also see in chart 3 that spending on "economic affairs" is spread across a number of different departments. The most important are the Department for Transport (DfT), Department for Business, Innovation and Skills (BIS), Department for Environment, Food and Rural Affairs (DEFRA) and the Department for Work and Pensions (DWP).

Chart 2: Public spending on economic affairs, 2013-14 (£ millions)



Source: PESA

Chart 3: Public spending on economic affairs 2013-14, by departmental grouping

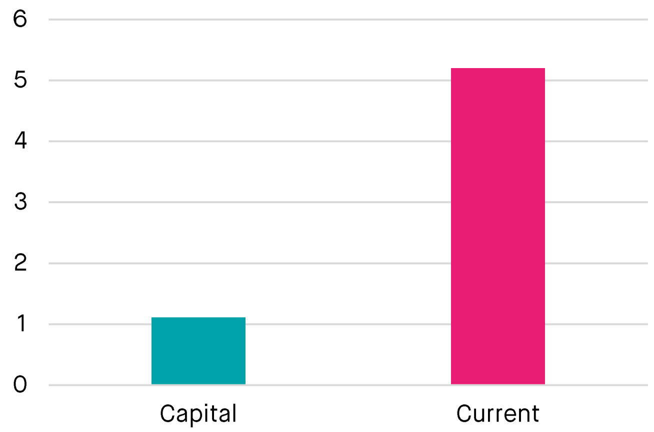


Source: PESA

Looking at a more specific example, BIS's science and research spending includes research funding for the Research Councils, the Higher Education Funding Council for England (HEFCE), the UK Space Agency (UKSA) and the United Kingdom Atomic Energy Authority (UKAEA). This spending has historically been split into current and capital spending; current spending accounts for the majority of the total.

The current Government has committed to increasing the capital part of the science and research budget by inflation in the next parliament, as shown in chart 4. However, no such commitments have been made for current spending (for example, staffing and running costs) needed to make the most of capital investment.

Chart 4: Science and research current spending plans 2015-16 (£ millions)

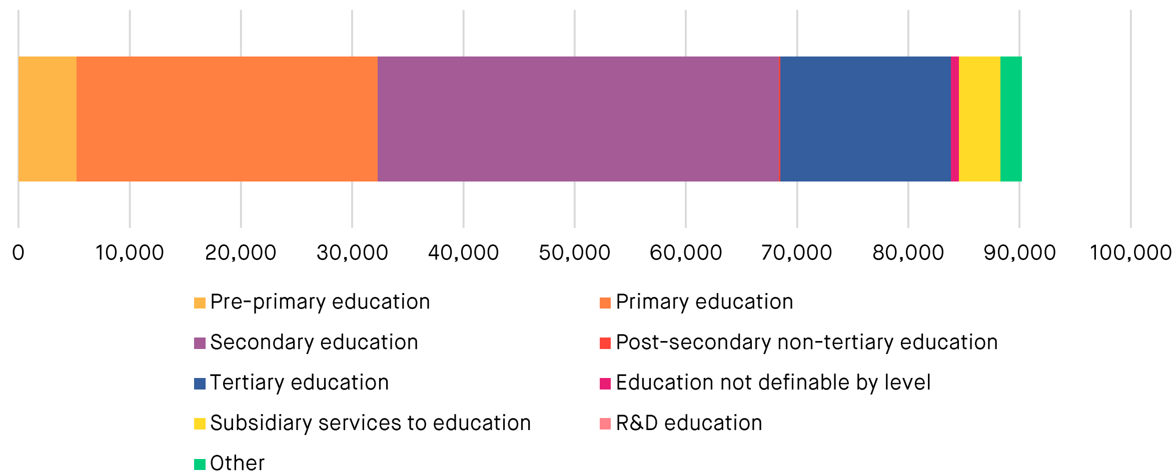


Source: BIS Annual Report and Accounts 2013-14, Capital and Resource DEL totals

The education budget is split across departments, with different areas treated differently

The debate on education spending in the next parliament has largely focused on the schools budget within the Department for Education (DfE). The schools budget (primary and secondary education) has been ring-fenced since 2010, and so protected from spending cuts so far. The Conservatives have said they would protect it in cash terms after 2015.

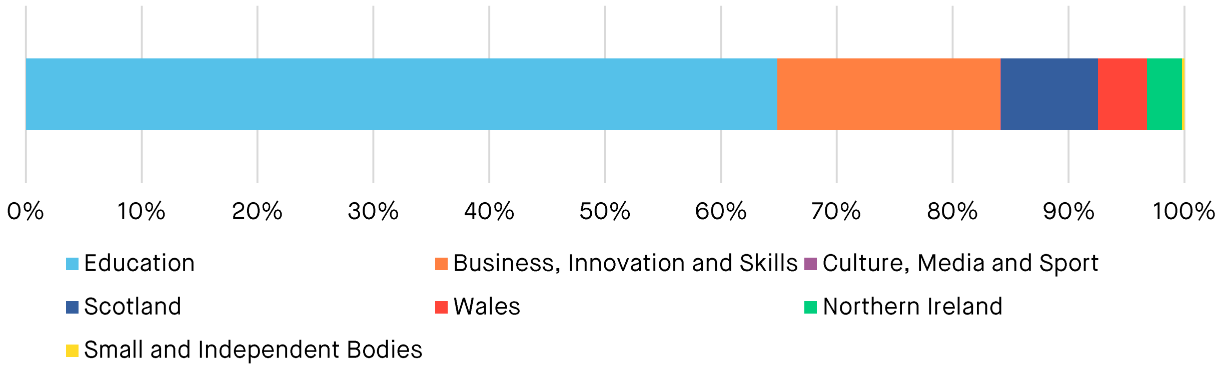
Chart 5: Public spending on education 2013-14 (£ millions)



Source: PESA

However whilst the schools budget constitutes the majority of education spending, there are also questions around the extent to which early years, further and higher education will be protected. BIS, the second largest holder of education-related budgets, was not protected from cuts in the last parliament.

Chart 6: Public spending on education 2013-14, by departmental grouping



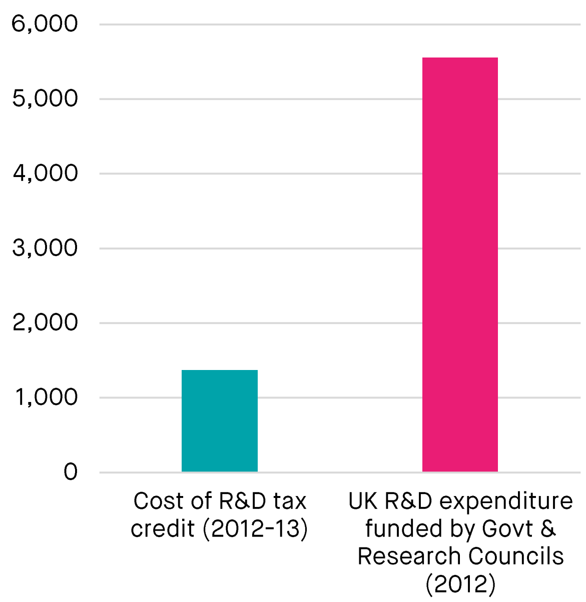
Source: PESA

Research and development spending happens through the tax system too

As set out earlier, research and development funding does not have to be through direct subsidies, but can also be implicit, through providing tax reliefs. This shows the importance of looking at both the tax system – as well as spending – through a lens of growth-friendly policies.

Chart 7 compares the cost of the R&D tax credit in 2012-13 against public-sector funded R&D in 2012. Implicit spending on R&D tax credits is relatively small compared to direct subsidies, but is still a substantial part of overall public R&D support. o Other tax-reliefs that could also be seen as growth-friendly include Entrepreneurs' Relief and income tax relief for investors in small, growing businesses (EIS/SEIS). The overall structure of the tax system itself also has consequences for the structure of the economy and growth.

Chart 7: Public spending on research and development (£ millions)



Source: ONS, UK Gross Domestic Expenditure on Research and Development, 2012; HMRC Research and Development Tax Credits Statistics 2014

WHAT SHOULD THE NEXT GOVERNMENT DO?

There is a strong case for more growth-friendly spending in the next five years. The UK has long-term productivity challenges that must be tackled; and in the shorter-term, sustained growth over the next five years will make the repairing the deficit much more achievable. At the same time, the UK Government is still enjoying low borrowing costs, making it a good time to invest.

Ensuring that the UK meets its long-term growth challenge will require the next Government to make sustainable economic growth a priority. This priority must be reflected in Government policy in general, but also in decisions on tax and spending. Specifically:

- The next Government will need to take a comprehensive view of spending – both within departmental budgets, and implicit spending within the tax system. It will need to be able to **map out and identify the most growth-friendly areas of spending**. The Conservatives, Labour and the Liberal Democrats have all highlighted capital investment as an area of spending that should be protected from cuts. This is a positive move, but risks being too simplistic.

- The next Government will need to **find better ways of prioritising different types of growth-friendly spending**, based on their likely benefits, so that spending is targeted in places where it can create the greatest benefits. Labour has proposed an Infrastructure Commission to help make better long-term decisions on where infrastructure investment should focus. This is a positive step, but the analysis in this paper shows that other types of growth-friendly spending need to be considered alongside infrastructure spending.

- Growth-friendly spending is important, but **Government also needs to ensure that growth-friendly programmes are delivered efficiently.** This places great importance on procurement and commissioning. For some types of projects, paying providers based on outcomes can help to ensure that the value of growth-friendly spending is maximised.

ABOUT THE BRIEFING

This paper forms part of a wider project the SMF is conducting in collaboration with PwC, which looks at the challenges and opportunities for the 2015 Spending Review and has included a series of roundtable discussion events.

ABOUT THE AUTHOR

Nida Broughton is Chief Economist at the SMF, where she leads research on growth, skills policy, entrepreneurship and analysis of public spending. Nida also has expertise in a range of public policy areas including education, housing and consumer markets.

Nida regularly appears in the media including Sky News, BBC Newsnight, BBC Radio 4 Today, BBC News and LBC, where she is known for providing rigorous and balanced economic and policy analysis. She has also written for titles including *City AM*, *New Statesman*, *Public Finance* and *The Independent*.

ENDNOTES

[1] ONS, Q4 2014 Primary Estimate of GDP

[2] ONS, Economic Review, January 2015

[3] ONS, Economic Review, January 2015

[4] SMF, *A Deficit of Growth*, 2014; SMF, *A Deficit of Growth II*, 2015.

[5] Ward Romp & Jakob de Hann, Public capital and economic growth: a critical survey, EIB papers, 2005; LSE Growth Commission, *Investing in Prosperity*, LSE, 2013.

[6] IMF, Is it time for an infrastructure push?, World Economic Outlook, October 2014.

[7] IMF, Is it time for an infrastructure push?, World Economic Outlook, October 2014.

[8] BIS, Supporting analysis for 'Skills for growth: the national growth strategy', 2010

[9] SMF, *Growing Businesses*, 2014; OECD, United Kingdom Country Note 2014

[10] SMF, *Growing Businesses*, 2014, SMF, *Making Progress*, 2014

[11] Bettina Becker, Public R&D policies and private R&D investment: a survey of the empirical evidence, Journal of Economic Surveys, 2014; Katharine Wakelin, Productivity growth and R&D expenditure in UK manufacturing firms, Centre for research on globalisation and labour markets Research Paper, 2000/20

[12] Tera Allas, Insights from international benchmarking of the UK science and innovation system, BIS, 2014

[13] SMF, *Good for Growth*, 2013

[14] SMF, *Growing Businesses*, 2014

[15] George Osborne speech to the Royal Economic Society, 2015

[16] See, for example, Danny Alexander speech to Liberal Democrat party conference, 2014; Ed Balls speech to Labour party conference, 2014; George Osborne speech to the Royal Economic Society, 2015