One More Time

Repairing the public finances

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June 2015

Social Market Foundation

ACKNOWLEDGEMENTS

This research and publication has been made possible by the generous support of PwC. I would particularly like to thank Charles Lloyd, Rosamund Gentry and Nick C Jones.

I would like to thank Emran Mian and Nigel Keohane for valuable comments and input throughout the project.

Supported by:

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ABOUT THE SERIES: SPENDING CHOICES AFTER 2015

The report is the sixth and final paper in our ***Spending choices after 2015*** series, which looks ahead to policy challenges facing the 2015 Spending Review. Previous papers include: *A Deficit of Growth* (November 2014) and *Deficit of Growth II* (January 2015), which highlight potential choices for savings and the huge uncertainties around, continued growth. *Investing for Growth* (February 2015) sets out priorities for growth-friendly spending, focusing on investment in skills and boosting productivity. *Commitment Issues* (March 2015) argues against protecting specific budgets ahead of the next Spending Review so that opportunities for efficiency and improvements are not missed. The fifth paper *Taxing Matters* (March 2015) argues that additional increases in tax thresholds will reduce the tax base further, reducing revenues and putting the UK in a poor position to deal with another downturn.

EXECUTIVE SUMMARY

Back in 2010, it was expected that the deficit would be cleared in time for the 2015 election. Instead, growth disappointed, and whilst progress was made, the job of repairing the public finances was left incomplete. Now, the current Government is planning further public spending cuts to eliminate borrowing by 2018-19. This paper sets out the scale of the challenge ahead and what this means for how Government should make the important tax and spending decisions needed to deliver on its commitments. Unless otherwise stated, all figures in this paper are in real terms, in 2015-16 prices.

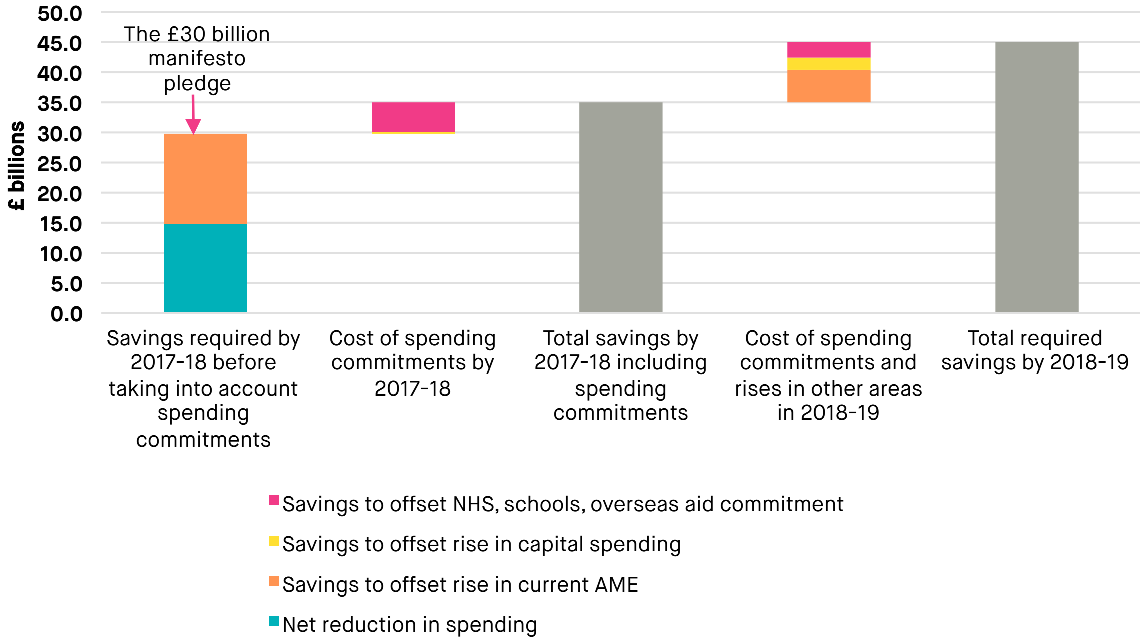
THE SPENDING CHALLENGE

The Government has set itself an ambitious target of eliminating borrowing by 2018-19. It plans to do this by reducing total Government spending by 1% a year in real terms for two years, followed by a freeze in 2018-19. The annual 1% a year cut forms the basis of a commitment in the Conservative Party manifesto to "save £1 a year in every £100 that government spends". It anticipates that delivering this will require a £30 billion consolidation by 2017-18.

This challenge is harder than it sounds. The manifesto does not set out exactly how the £30 billion is calculated. However, it does not appear to include commitments to spend more on schools, healthcare and international aid. The Government has also said it wants capital spending to increase; we assume this means that it will not want to reduce spending below March 2015 Budget levels. And whilst total Government spending is to be kept flat in real terms in 2018-19, there are areas of spending outside Government's direct control, such as debt interest payments, that are forecast to rise, requiring offsetting savings elsewhere.

Based on the Office for Budget Responsibility (OBR) March 2015 forecasts, we estimate that after taking these into account, the total savings in annual budgets that will need to be found come to around £45 billion by 2018-19. This is shown in chart 1 below.

Chart 1: From £30 billion to £45 billion



Source: SMF estimates based on OBR March 2015 forecasts and Conservative Party 2015 manifesto commitments.

Making £45 billion of savings will be difficult, especially if the easiest savings have already been made. Not all Government budgets are available for savings. As set out in Box 1, the combination of spending commitments and spending protections means that the spending challenge is not as simple as "saving £1 a year in every £100 that government spends." Instead, over the course of three years, saving £12 in every £100 may be closer to the real scale of the challenge. Making the required levels of cuts is also likely to be politically more difficult now than in 2010, as it becomes more difficult to make cuts without damaging service quality. This is particularly the case for unprotected departments such as policing, justice and business and employment support, which have already seen larger than average cuts since 2010.

Box 1: Not as easy as '£1 in £100'

The Conservative Party manifesto pledges to reduce total Government spending in 2016-17 and 2017-18. For these two years, Government will aim to save £1 a year in every £100, or around £2 in £100 in total. Spending will then be frozen in 2018-19. But this not as simple as it sounds.

Firstly, there are areas of spending that are projected to increase across all three years, 2016-17, 2017-18, 2018-19. These include spending areas that are outside Government's direct control, such as debt interest. They also include areas where Government has said it will increase spending, such as the NHS, international development and schools. We also assume that Government will not want to reduce capital spending beyond that set out in the March 2015 budget.

Overall this means that in the three years 2016-17 to 2018-19, an average of £1.30 a year will be added for every £100 onto Government spending, or a total of around £4 for every £100 across the entire period, before any savings are made. So for spending to actually fall by around £2 in every £100 by 2018-19, Government would need to find savings of around £6 in every £100.

Secondly, not all of the £100 is open for making savings. A number of areas are likely to be protected in some way, or will not be within Government's direct control. For example, education, health, international development, the state pension, debt interest and capital spending come to almost a half of total spending. This means that the level of saving required across the three years to 2018-19 could be closer to £12 in every £100 across budgets that are within the Chancellor's scope.

The single most significant risk to the deficit reduction programme is the uncertainty in economic forecasts. Growth in tax revenues, driven by a growing economy, is expected to play a substantial part in bringing the deficit and borrowing down. However, historical experience tells us that five years' worth of steady growth may be over-optimistic. More importantly, the OBR is expecting potential GDP growth to start to pick up towards its historical long-term average. Yet, given the UK's recent poor productivity performance, this is far from certain. If, over the next few years, the economy's growth potential continues at the rate estimated by the OBR for 2014-15, borrowing would fail to be eliminated by 2018-19, even if the Government implements the planned savings. Instead, borrowing would be running at around 1.8% of GDP. In this situation, it is likely that deficit reduction would have to be postponed.

WHAT THE DEFICIT REDUCTION PROGRAMME NEEDS TO ACHIEVE

Economic growth must be a top priority running through the Government's entire policy programme, including its tax and spending decisions. The Conservative Party manifesto sets out an ambition to become the most prosperous major economy in the world by the 2030s. But poor economic performance over the past five years has meant sluggish growth in living standards. Decisions that the Government takes to boost productivity will have repercussions well beyond 2020; but they are vital to the long-term sustainability of economic growth and public finances, especially in the context of an ageing population. Government needs to be able to map out and identify areas of growth-friendly activities within different budgets, and ensure that – where effective – these activities are prioritised.

Infrastructure and R&D are particularly important, as well as areas such as skills and business support. In fact, in some areas – infrastructure and R&D in particular – where we are lagging behind other major economies, there is a rationale to be spending more, rather than less. That is not to say that inefficient spending in these areas should be maintained; rather that effective programmes in these areas must be prioritised. Government should also maintain a growth-friendly tax system.

Fairness and distributional effects of spending decisions are likely to become of even more concern. YouGov polling suggests that the majority of the public already see the way cuts have been allocated as unfair. With large welfare cuts expected, Government will need to monitor the effect of policies on disadvantaged groups.

To deal with the challenge, it is important that all parts of the public finances should be scrutinised, including tax reliefs. Even within ring-fenced budgets, Government should look at how money can be better spent to improve outcomes. Most importantly, the Government should fully scrutinise tax expenditures – tax reliefs that are designed to deliver specific policy objectives and so act as an alternative to public spending. As reported by the National Audit Office (NAO), tax reliefs remain an under-scrutinised area of the public finances; the need to make substantial savings means that this cannot continue. **One option for doing this is to score tax expenditures against relevant departments' budgets, to give them an incentive to compare the effectiveness of this type of spending against other spending programmes.**

Finally, it is likely to only become harder to make pure efficiency gains without seeing a deterioration in the quality of public services. **This means that Government must look at where longer-term reforms are needed to maintain the quality of Government services whilst spending less.** Areas where there could be scope for further reform include commissioning, introducing competition and choice, localising decision-making, looking at areas where the private sector could do more, and shifting costs from taxpayers to users, potentially through charging.

MAKING BETTER DECISIONS

This leaves a set of difficult decisions that need to be made as part of the next Spending Review process. The process needs to improve value for money for the taxpayer, whilst making growth-friendly choices. There is a need to find savings early, but the need to undertake longer-term reforms is becoming more urgent as it becomes harder to make cuts without affecting the quality of public services. Designing effective reform will require time. Government will often need to consider departmental budgets in tandem, especially where there are related areas of spending, for example, employment and skills-related spending spans the Department for Education, Business, Innovation and Skills, and the Department for Work and Pensions. **To deal with these tensions, we recommend a two-phase approach to reviewing spending.**

The first "Efficiency Review" would be a fast review, seeking to find the first half of the savings required. These Efficiency Review savings should be identified at the latest by the 2015 Autumn Spending Review. Assuming that the £12 billion of welfare cuts set out in the Conservative Party manifesto will be fully identified, this will leave just under £11 billion of savings to be found elsewhere, for example from departmental savings, or better scrutiny of tax expenditures. Some departmental savings have already been found as part of the work leading up to the 2015 Summer Budget.

The second "Reforms Review" should consist of a longer programme, addressing the need for longer-term public service reform, taking into account challenges such as population ageing, which will pose an increasing cost to the economy and taxpayer. The programme should start with thematic reviews based around specific policy goals, allowing related budgets across different departments to be looked at in tandem. One option would be to centre these reviews around priorities set out in the Conservative manifesto. For example, a review on "Jobs for All", the second element of the manifesto plan, would look across the areas of skills, employment support and business growth, examining what is currently done across the Department for Work and Pensions, Business Innovation and Skills and the Department for Education, as well as local government and local enterprise partnerships.

Thematic reviews should be led and staffed by individuals with expertise in the relevant policy area, but who are able to take an objective, cross-departmental view. One option is to ask outgoing Permanent Secretaries from related departments to head up the work, potentially alongside a Minister from a non-related area and a non-executive departmental Board Member, to bring in wider commercial expertise. Each team could be complemented by a secondee from the Treasury, part of whose role would be to maintain a strong focus on the potential implications of decisions for economic growth. These reviews should inform final decisions on spending allocations, reporting by Budget 2016 at the latest.

Bringing in external scrutiny and ideas during this time will be vital. We recommend a re-run of the Spending Challenge, but this time with explicit incentives for entrepreneurs and small businesses to pitch in practical ideas for saving money. Government should also take the time to better understand public priorities on spending. The whole Review process should be scrutinised by a Spending Review Joint Committee with members drawn from the Commons and the Lords.

CHAPTER 1: FINISHING THE JOB

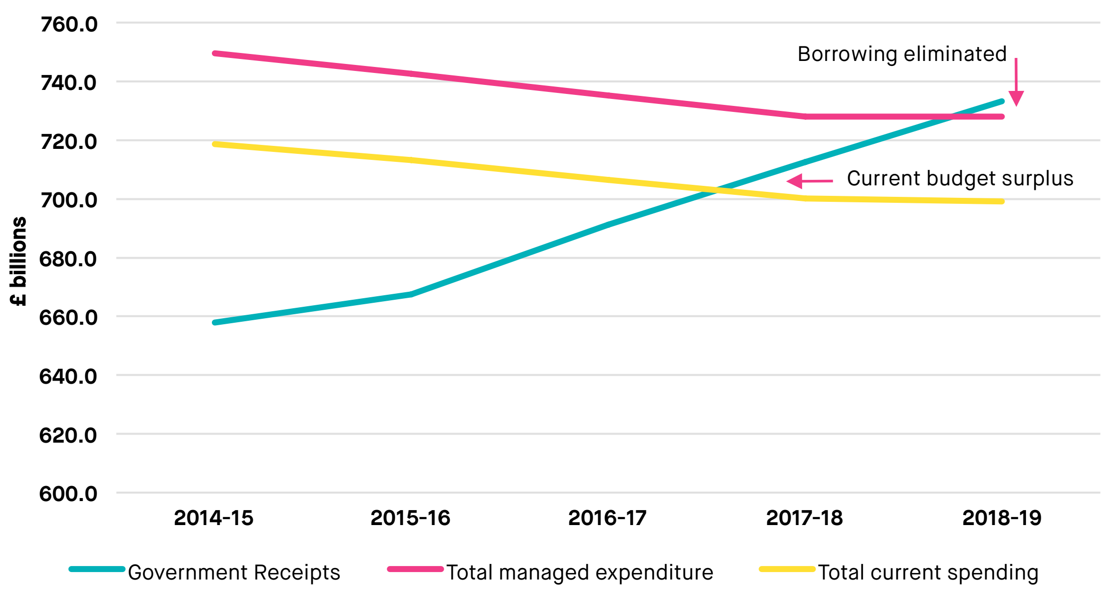
Back in 2010, the last Government's plan was to eliminate the deficit by 2015. But progress was slow, hindered by the sluggish return to economic growth. Now, in 2015, the Conservative Party manifesto sets out the current Government's plan to "finish the job" by 2018-19.[1] This paper starts by looking at the size of the challenge ahead, before going on to set out how Government should conduct the next Spending Review.

Unless stated otherwise, all figures in this paper are in real terms, in 2015-16 prices.

FINISHING THE JOB

Of all the parties going into the 2015 election, the Conservatives set themselves the most ambitious target. Borrowing is to be eliminated in its entirety by 2018-19, meaning that total Government receipts will exceed total Government spending, allowing national debt to be paid down. Along the way, there is an interim target, to balance the structural current budget by 2017-18. The structural current deficit is the difference between total Government receipts and current Government spending (that is, excluding investment spending), adjusted for the state of the economy.

Chart 2: Government receipts and spending 2014-15/2018-19 (2015-16 prices)



Note: Total current spending in this chart is total managed expenditure minus public sector net investment. In 2017-18 and 2018-19, the OBR estimates that the output gap will be zero and therefore the current budget will be equal to the structural current budget in those years.
Source: OBR March 2015 forecasts of Government receipts and Government investment; total managed expenditure estimate based on Conservative plans as set out in the 2015 manifesto.

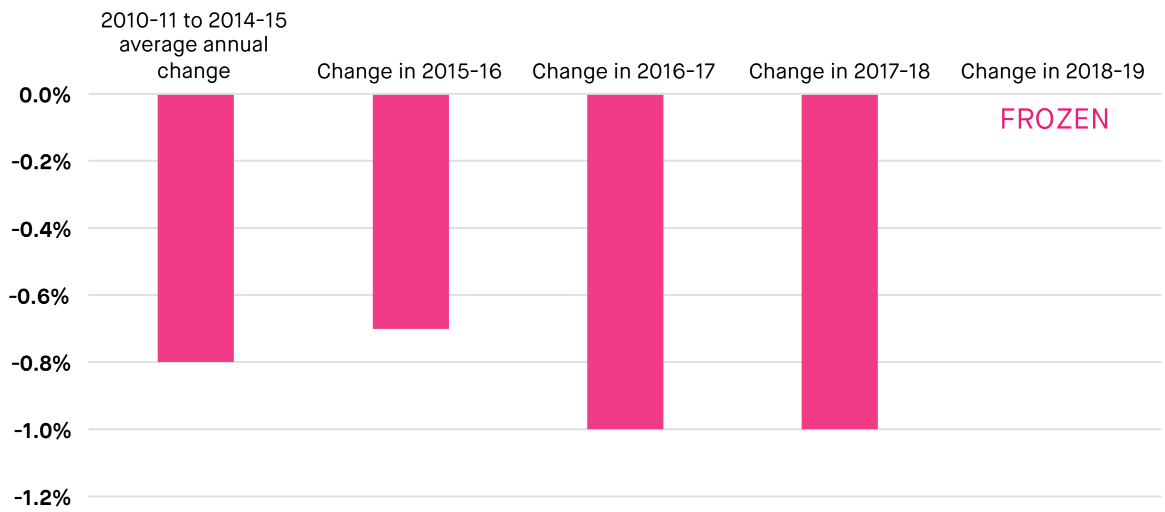
THREE MORE YEARS OF CONSOLIDATION

The last Government set out plans for spending cuts for the years 2010-11 to 2015-16.[2] The OBR's March 2015 Economic and Fiscal Outlook showed that this amounted to a real cut to total spending of around 4% since 2010.[3] However, this masks some significant changes in composition. Because some areas of spending, including pensions and debt interest have been rising, the real cut to departmental budgets, which fund public services, has so far amounted to 12%.[4]

The question now facing Government is how to achieve the rest of the savings required to hit the target of eliminating borrowing by 2018-19. This mainly covers the years 2016-17, 2017-18 and 2018-19. George Osborne has made an early start by identifying around £3 billion in departmental in-year savings for 2015-16 however, some of these savings are likely to be one-off rather than ongoing.[5]

The commitments made in the manifesto suggest that much of the savings are to come from cuts in public spending. Total Government spending is to be reduced by 1% a year in real terms for two years – 2016-17 and 2017-18 – the pledge to save “£1 a year for every £100 that government spends”.[6] This is faster than the pace of cuts during the 2010 Parliament, when the annual cut to total spending averaged 0.8% a year. Total spending is then to be kept flat in real terms in 2018-19. The real cut to total spending by 2018-19 compared to 2015-16 is just under £15 billion.

Chart 3: Annual real growth in total Government spending



Source: OBR Table 4.18; Conservative Party manifesto. Figures refer to total managed expenditure.

The expected growth in the economy means that over the same three year period – 2016-17 to 2018-19, Government revenues are expected to rise by around £20 billion a year, as the tax take increases due to higher levels of productivity and wage growth. This combination of spending falling and the tax take rising would allow borrowing to be eliminated by 2018-19, with a surplus of just over £5 billion. Assuming that the cuts to spending come from current, rather than capital spending, the interim 2017-18 current budget target would also be hit, with over £12 billion to spare.

REQUIRED: £45 BILLION OF SAVINGS

The net cut to total spending by 2018-19 is £15 billion. However, across the course of the Parliament, a number of areas of spending are set to rise. That means that savings elsewhere must be found to compensate, as shown in Chart 4. Firstly, the OBR’s most recent forecast rise in areas of spending that are outside the Government’s direct control comes to around £20 billion.[7] The largest component of this is debt interest which despite low interest rates is expected to rise by 39%.[8]

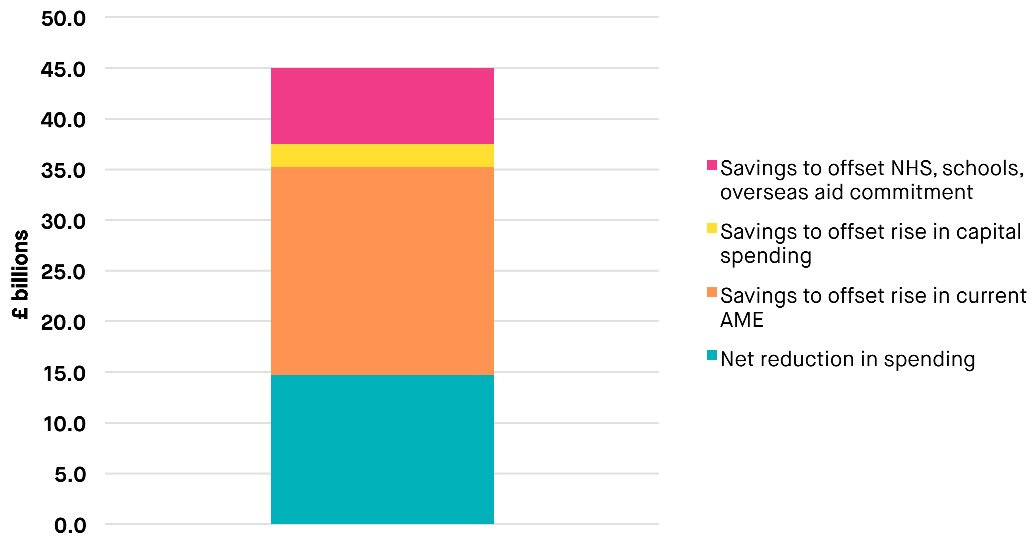
Secondly, the Conservative Party manifesto commits to increasing capital investment spending, and George Osborne has previously said that capital spending will grow in line with GDP.[9] If the path set out in the 2015 March Budget is followed through, this would mean that gross capital spending would rise by around £2 billion. This would need to be paid for by savings in current spending.

Thirdly, the Conservative Party manifesto sets out a number of spending commitments, including an additional £8 billion a year for the NHS by 2020; a real-terms increase in the schools budget; and a commitment to increasing international development in line with national income. Assuming that these spending rises are introduced gradually over the course of the Parliament, these spending commitments mean that off-setting savings of over £7 billion in current spending need to be found by 2018-19.[10]

In total then, the total savings required could come to around £45 billion between 2015-16 and 2018-19. Ahead of the Summer Budget, the Treasury announced that it had found in-year savings of £3 billion. Depending on the extent to which these are one-off savings or not, this could leave around £42 billion left to find.[11]

There are other areas where spending could rise that we have not taken into account here, which would increase the amount of off-setting savings that would need to be made. Although the Government has not committed to spending 2% of GDP on defence, it has been under considerable pressure to do so. It is also before taking into account other, smaller commitments that are starting to build up, such as the extension of free childcare.

Chart 4: The £45 billion savings programme



Source: SMF estimates based on OBR March 2015 forecasts and Conservative Party 2015 manifesto commitments

WHAT ABOUT THE CONSERVATIVE PARTY'S £30 BILLION TARGET?

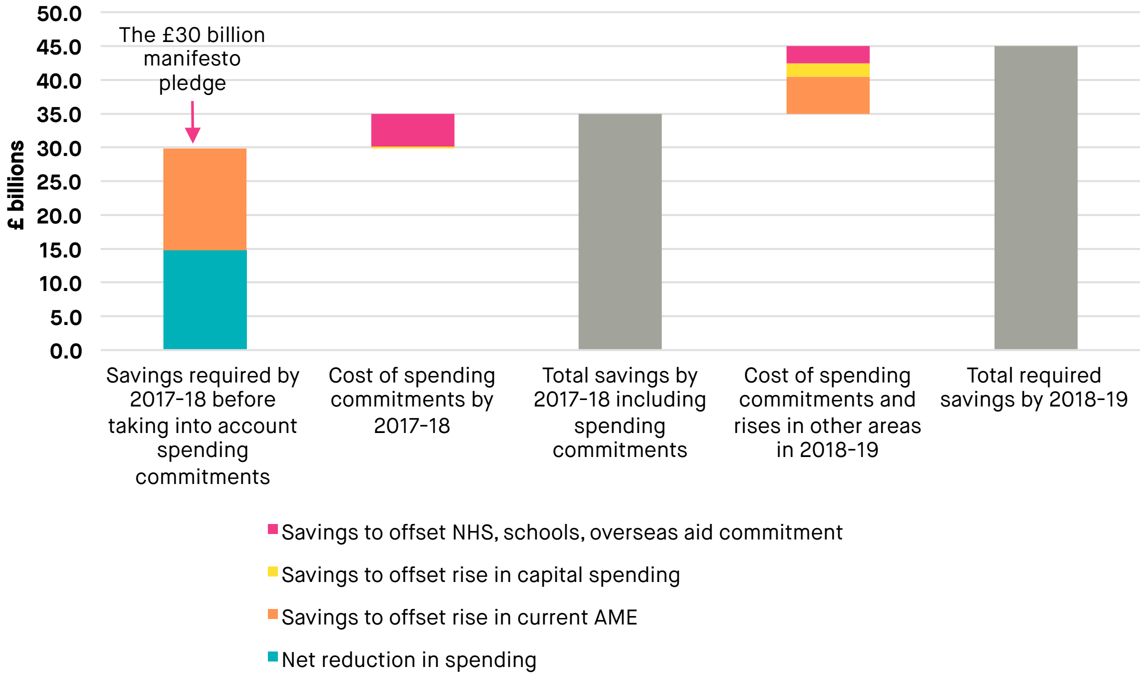
The Conservative Party manifesto sets out two phases of a fiscal consolidation programme. It says that £30 billion in savings is needed to meet its plan to reduce Government spending by 1% a year in real terms in 2016-17 and 2017-18. There are two reasons why this number differs from our £45 billion estimate.

Firstly, the £30 billion does not include savings that would need to be made in 2018-19. Although total Government spending would be kept flat in 2018-19, savings would still need to be found in this year to offset rises in areas of spending that are outside Government's direct control.[12]

Secondly, there are other spending pressures in the years 2016-17 and 2017-18 that require additional savings to be made. The manifesto does not set out exactly how the £30 billion is calculated. However, it does not appear to include the cost of spending commitments for the NHS, schools and international development. We also assume that the Government will not want to reduce gross capital spending beyond that set out in the March 2015 Budget, which would also require offsetting savings to be found elsewhere.

Chart 5 shows the difference between the £30 billion stated in the Conservative Party manifesto and our £45 billion estimate.

Chart 5: From the Conservatives' £30 billion to the SMF's £45 billion



Source: SMF estimates based on OBR March 2015 forecasts and Conservative Party 2015 manifesto commitments

In the election campaign, the Conservatives focused on what savings would be made by 2017-18. In particular, they set out plans for £12 billion in welfare cuts and £13 billion from departments. Whilst not counting towards total spending, the Conservative Party manifesto also set out plans to save £5 billion from reducing tax evasion and aggressive tax avoidance and planning; however, in any case, this is roughly offset by tax giveaways,[13] unless the Government was prepared to wait until 2020 and only make tax giveaways once the economy has seen several years of sustained growth.

This means that the £12 billion in welfare cuts and £13 billion in departmental cuts only comes to around 55% of the total savings that need to be made by 2018-19. Assuming that £12 billion is the limit that can be achieved from welfare savings, this would mean that around £33 billion would need to come from savings to departments' current budgets. This would come on top of savings of around a quarter that have already had to be made in many departments over the last five years. This could mean some difficult decisions in unprotected areas including policing, justice, and business and employment support.

Box 2: The IFS estimate of departmental spending cuts

In its pre-election briefing and post-election Observation, the Institute for Fiscal Studies (IFS) said that the Conservative plans imply cutting unprotected departments by £30 billion between 2015-16 and 2018-19. This is different to the £30 billion in the Conservative Party manifesto and our £45 billion estimate, as it is the saving required from departments alone, rather than the sum required from both departmental cuts and welfare cuts. It assumes that the planned £12 billion welfare savings are indeed achieved in full. It reflects both the NHS, schools and international development commitments; and the rise in spending that is outside Government's direct control. However, unlike our estimate, it does not make any assumption about the path of capital spending.

Source: IFS, Public spending: more cuts to come, June 2015

Further, decisions over how the £12 billion in welfare cuts are to be achieved are yet to be made. They potentially involve some difficult decisions. As we set out in *Commitment Issues* (2015), finding £12 billion becomes much harder once large areas of welfare spending are taken off the table. The manifesto sets out plans to freeze working age benefits for two years; however, this is expected to raise only £1 billion.[14] Other announced measures, such as reducing the household benefit cap to £23,000 a year, and removing the automatic entitlement to housing benefit for 18-21 year olds on Jobseekeers Allowance save only relatively small amounts.[15]

Box 3: Not as easy as '£1 in £100'

The Conservative Party manifesto pledges to reduce total Government spending in 2016-17 and 2017-18. For these two years, Government will aim to save £1 a year in every £100, or around £2 in £100 in total. Spending will then be frozen in 2018-19. But this not as simple as it sounds.

Firstly, there are areas of spending that are projected to increase across all three years, 2016-17, 2017-18, 2018-19. These include spending areas that are outside Government's direct control, such as debt interest. They also include areas where Government has said it will increase spending, such as the NHS, international development and schools. We also assume that Government will not want to reduce capital spending beyond that set out in the March 2015 budget.

Overall this means that in the three years 2016-17 to 2018-19, an average of £1.30 a year will be added for every £100 onto Government spending, or a total of around £4 for every £100 across the entire period, before any savings are made. So for spending to actually fall by around £2 in every £100 by 2018-19, Government would need to find savings of around £6 in every £100.

Secondly, not all of the £100 is open for making savings. A number of areas are likely to be protected in some way, or will not be within Government's direct control. For example, education, health, international development, the state pension, debt interest and capital spending come to almost a half of total spending. This means that the level of saving required across the three years to 2018-19 could be closer to £12 in every £100 across budgets that are within the Chancellor's scope.

It is not simply the scale of the challenge that causes difficulties. As pointed out by the Institute for Government, the conditions are different in 2015 compared to 2010. As it becomes harder to cut without damaging service quality, public perceptions and concerns are likely to change. Already, opinion polls suggest more people think that the way spending cuts are being implemented is unfair than fair.[16] Finding politically palatable ways of reducing spending is likely to be more difficult in the 2015 Parliament.

As we set out in Box 3, the combination of spending commitments and spending protections means that the spending challenge is not as simple as "saving £1 a year in every £100 that government spends." Instead, over the course of three years, saving £12 in every £100 may be closer to the real challenge.

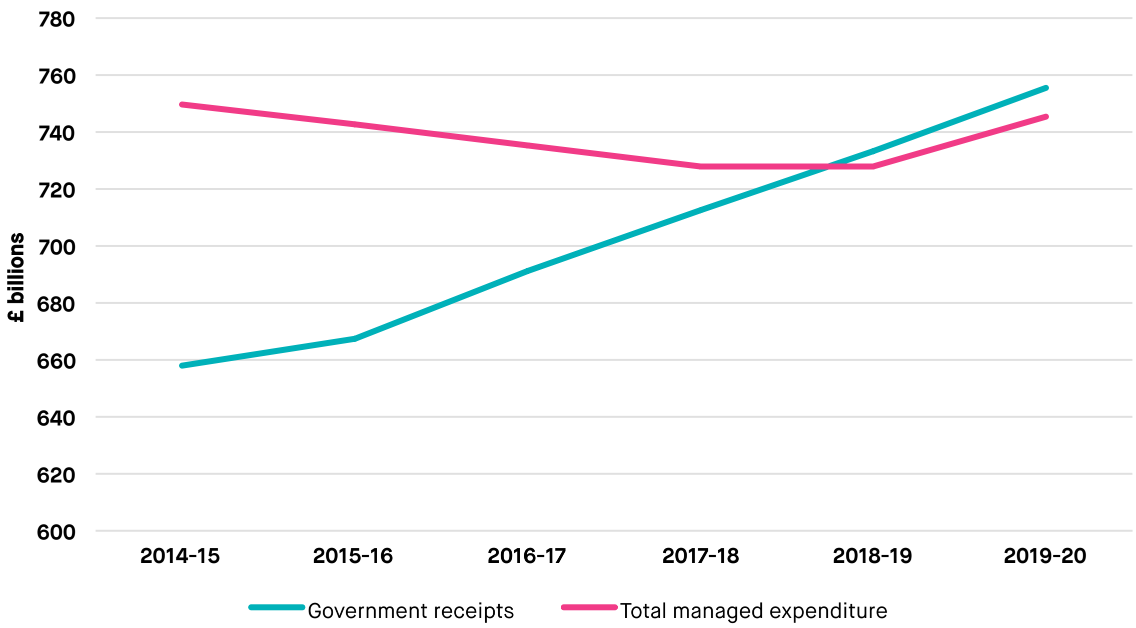
The £45 billion saving outlined in this paper is what is needed to meet the Government's target to reduce total spending by 1% a year for two years followed by a freeze. But even if Government wanted to rely more on tax rises to lower the deficit, it would be severely restricted in doing so. Proposed legislation will commit the Government to not raising rates of income tax, VAT and National Insurance which account for around 64% of tax revenue. In addition, the income tax threshold will be adjusted over time to ensure that those working 30 hours a week on the minimum wage will not pay income tax. This means that the burden must in large part fall on public spending.

COULD THE GOVERNMENT EASE UP ON PLANNED AUSTERITY?

There have been recommendations from some quarters that the pace and level of spending cuts be reconsidered. The OECD has recently pointed out that evening out the profile of fiscal consolidation would lower its impact on growth.[17] Separately, an IMF Staff Discussion Note suggested that the cost to the economy of policies needed to bring down public debt, such as higher taxes or lower productive public spending, are likely to exceed the potential benefits.[18]

The Government could choose to slow down on spending cuts. Total spending is set to rise in line with GDP in 2019-20, according to the Conservative Party manifesto. It is possible to do this without borrowing because tax receipts are forecast to continue to rise in that year, as shown in Chart 6. If the Government were to reset the target for eliminating borrowing to 2020, it could smooth the path of spending over the course of the Parliament, reducing the size of the total savings required. However, this would mean breaking the manifesto promise to reduce total spending by 1% a year for two years followed by a freeze.

Chart 6: Government receipts and spending (2015-16 prices)



Note: Total current spending in this chart is total managed expenditure minus public sector net investment.
Source: OBR March 2015 forecasts of Government receipts and Government investment; total managed expenditure estimate based on Conservative plans as set out in the 2015 manifesto.

IF WE DON'T GET GROWTH, THE PICTURE LOOKS WORSE

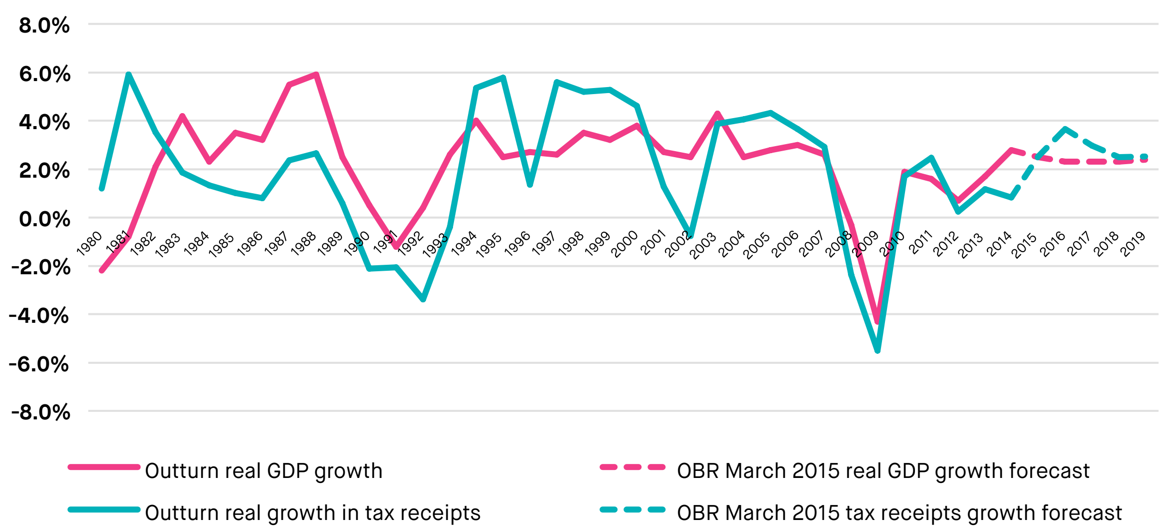
As shown in Chart 6, expected growth in tax revenues as the economy grows is, in fact, more important than spending cuts in achieving the target to eliminate borrowing. But tax revenues are highly dependent on the state of the economy.

In its most recent report, the OBR forecast annual real GDP growth of between 2.3% and 2.4% in the years to 2020. This is based on its view that productivity growth will slowly pick up to reach historical average rates. Its forecast is for steady growth. The steadiness of the forecast growth path is a reasonable assumption – by their very definition we cannot predict potential future shocks to come.

But we should bear in mind that in reality such a stable path is fairly unlikely, as shown in Chart 7. Risks to economic growth could include changes in oil prices, or performance in our main export markets, such as Europe. There are also political risks to economic growth, for example on immigration policy and membership of the EU.

The relationship between economic growth and tax revenues is not exact; the presence of different thresholds and rates within the tax system means that there is not a one-to-one relationship between the two, and sometimes tax revenues can lag behind GDP growth. A good example is in recent years when employment grew, but poor wage growth meant income tax revenues did not initially grow as quickly as might be expected. However, broadly, as shown in Chart 7, growth in tax revenues tends to follow ups and downs in economic growth, especially in recent years. It can also be fairly volatile – more so than economic growth itself. This volatility could blow deficit reduction plans off course, meaning that targets may not necessarily be achieved on time.

Chart 7: Economic growth and tax receipts



Source: OBR Databank; ONS Quarterly National Accounts

But there is a more fundamental uncertainty about the state of the UK economy's underlying health. The OBR was disappointed in its last report, saying that productivity growth was again below forecast, with a rise in hourly productivity of 0.2% in 2014. This compares to an annual average of over 2% during the decade leading up to the crisis. This is important because the economy's potential to grow in the future will constrain the amount the Government can hope to receive in tax receipts.

In the longer-term, lack of productivity growth would make it much harder to cope with the pressures of an ageing population. As set out in the OBR's Fiscal Sustainability Report, the costs associated with an ageing population, such as pensions and healthcare, mean that in the future, more fiscal consolidation will be required, beyond that envisaged in the current Parliament.[19]

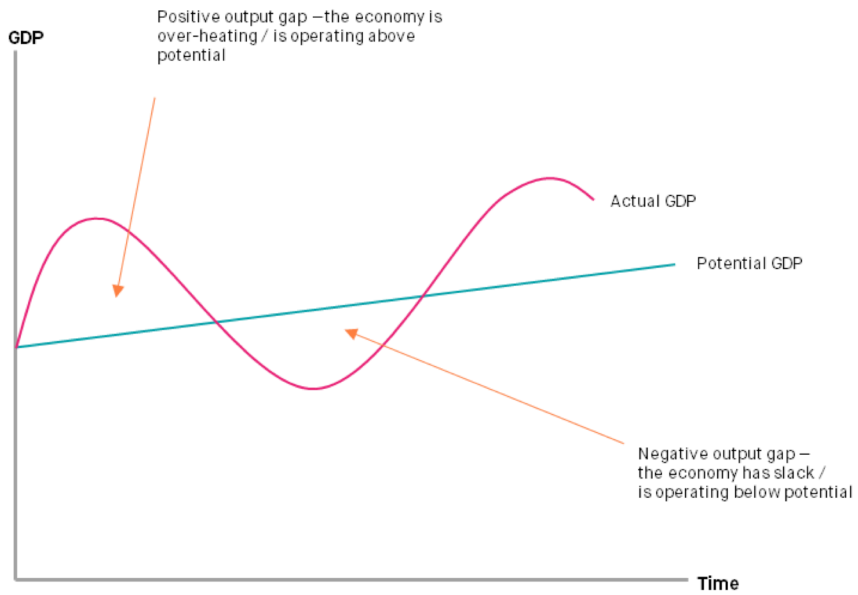
Essentially, we do not yet know what level of Government spending is sustainable in the medium to long term, because we do not know about the extent to which the poor economic performance over the last five years is indicative of a "new normal" post the financial crisis, or whether we can return to levels of growth we saw pre-crisis. Forecasts of the public finances hinge on this question.

The OBR's March 2015 forecast assumes that poor productivity performance in recent years is partly a cyclical phenomenon and therefore does not fully reflect the economy's potential to grow over the coming years. It assumes that potential GDP growth and productivity growth will rise over the next five years, albeit slowly. But as the OBR says, "since it is difficult to explain the abrupt fall and persistent weakness of productivity in recent years, it is also hard to judge when or if productivity growth will return to its historical average."

Box 4: GDP, potential GDP, and the finances

The diagram below shows a stylized illustration of the relationship between potential GDP and actual GDP. Growth in potential GDP is primarily driven by 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. Growth in potential GDP can be seen as representing the long-run sustainable growth rate of the economy.

While actual GDP growth will affect the public finances (particularly tax revenues), much of this may only be temporary, if the economy is operating above or below its potential. Hence, forecasters try to measure potential GDP to estimate the extent to which deficits are temporary or permanent. The part of the deficit that is estimated to be permanent is known as the "structural" or "cyclically-adjusted" deficit. The OBR March 2015 forecast assumes that the UK economy is operating at slightly below potential (with a gap of 0.4% in 2015-16) and that it will recover to its potential level in 2017-18.



Charts 7 and 8 look at what different assumptions about the potential growth of the economy could mean for the current budget deficit and borrowing. In these estimates, we assume that, as in the OBR forecast, the economy is operating at full potential from 2017-18 onwards.[20] The first, "best case scenario" looks at what would happen if the economy returned to the long-term rate of estimated potential GDP growth expected in the pre-crisis March 2008 Budget, of around 2.7%, from 2015-16 onwards. Under these very optimistic assumptions, the Government would meet its targets very easily, with money to spare.

But in the second, "worst case scenario", it is assumed that the economy's growth potential continues at the 2014-15 rate estimated by the OBR, rather than gently rising to its estimated historical average. As can be seen, if this happens, the current deficit would no longer be cleared by 2017-18 or 2018-19, even if the Government implements the full amount of savings currently planned. In 2018-19, the current budget would be in deficit, by around 0.4% of GDP. Borrowing would also fail to be eliminated, and would be running at 1.8% of GDP. In this situation, it is likely that the deadline for deficit reduction would need to be postponed.

These are approximations; in practice, the effect on the public finances will depend on a number of factors, including the extent to which growth is driven by employment, and the extent to which it is driven by productivity growth. It will also depend on possible short-term shocks to the economy. But the scenarios do demonstrate how susceptible the finances are to the performance of the economy. Even pushing through the planned savings may not be enough to repair the public finances.

Chart 8: The effect of potential growth assumptions on the current deficit (% of GDP)

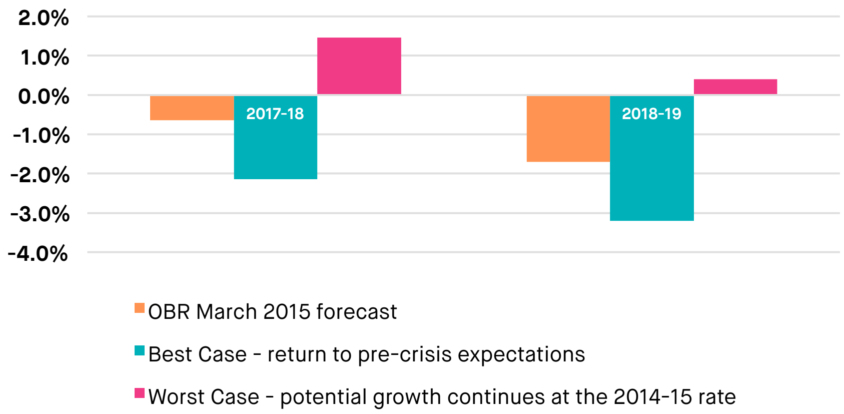
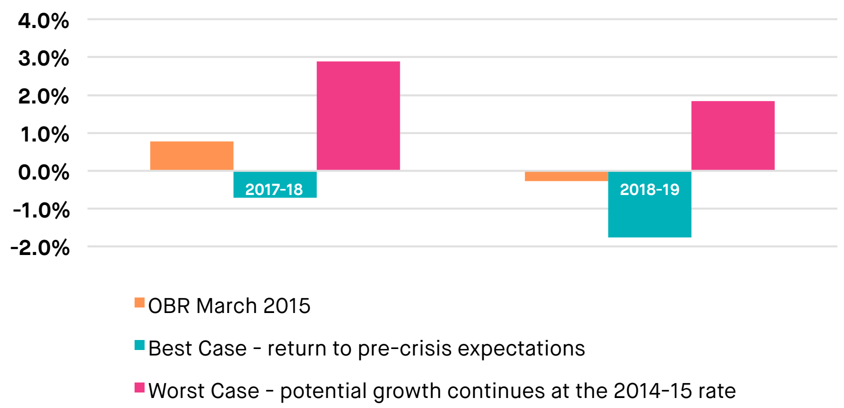


Chart 9: The effect of potential growth assumptions on borrowing (% of GDP)



Source: SMF estimates. Figures in Charts 8 and 9 update the OBR March 2015 forecast on the basis of Conservative spending plans. The OBR March 2015 figures are based on the OBR's March 2015 growth and potential growth forecasts.

The potential uncertainties ahead mean there is a strong rationale to press on with the consolidation programme early in the Parliament, whilst the economy is growing. But at the same time, we should not forget that the way in which savings are made could have an effect on the economy's potential to grow.

The rest of this paper looks at two questions:

- **What does the deficit reduction programme need to achieve?** What are the important factors that must underpin the Government's consolidation plan?

- **Making better decisions:** How should Government undertake its next Spending Review to ensure these objectives are met?

CHAPTER 2: WHAT DOES THE DEFICIT REDUCTION PROGRAMME NEED TO ACHIEVE?

ECONOMIC GROWTH IS A TOP PRIORITY

Economic growth will need to be a top priority for the current Government. Growth in GDP per capita since 2009 has averaged at around 1% a year, and has been especially slow compared to previous recoveries.[21] Wage growth was, until 2014, poor,[22] and as a result, median incomes among those under 60 are still below 2007-08 levels.[23]

The Conservative Party manifesto commits to pursuing an "ambition to become the most prosperous major economy in the world by the 2030s". It promises to increase infrastructure spending, help businesses to create more jobs and invest in science and technology. Boosting our long-term productivity is vital to allow sustained growth in living standards.

The full effects of Government efforts to improve the UK's productivity will most likely only be felt in the longer-term, well beyond the Government's deadline for its deficit reduction programme. But nevertheless, these effects are important to the long-term sustainability of the public finances, especially in the context of an ageing population.

Growth must therefore be a top priority running through the Government's entire policy programme. In the context of the deficit reduction programme specifically, this means that spending choices must be growth-friendly. Areas of spending that are likely to be particularly important are set out below. In some of these areas, there is, in fact, a case for more spending, rather than less.

- **Infrastructure:** Investment in infrastructure can boost business investment, jobs and growth. The effect is particularly pronounced when the existing capital stock is under pressure.[24] 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.[25] The UK spends less on infrastructure (as a proportion of GDP) compared to other comparable countries,[26] and lags behind several other advanced economies, including Germany, France, Japan and the US in terms of the quality of its infrastructure.[27]

- **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.[28] The UK currently suffers from low levels of both public and private sector R&D investment.[29]

- **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.[30] The UK performs well on international university rankings and the proportion of the population completing higher education.[31] But despite this, it faces significant skill gaps in several sectors, such as science and engineering, holding back their growth. In addition, a relatively high proportion of the workforce is stuck in low pay, low skilled jobs.[32] The UK's level of spending on education is close to the OECD average.[33] So unlike infrastructure and research and development, the case for more spending on education is less clear-cut, although the forecast rise in pupil numbers is likely to put pressure on budgets. Given the UK's skills gaps, a more important priority for Government is to focus on improvements in how our education and skills budgets are spent, and look at wider barriers to private sector investment in skills.[34]

- **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.[35] 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.[36] Government funding in this area is important; however, as we explore later, the need for intervention is likely to change over time.

There is a strong argument for prioritising growth-friendly Government activity. This is important for living standards, but also for the health of the public finances.[37] That is not to say that inefficient spending in these areas should be maintained. Government must look at the outcomes it is achieving and look for ways of improving value for money. But it should avoid cutting spending programmes that are likely to be effective in boosting UK productivity.

The Conservative Party manifesto commits to increasing investment in infrastructure in line with national income, protecting school funding and investing in research infrastructure. However, as we set out in *Investing for Growth* (2015), it is important that Government does not take a simplistic approach based on the way spending is currently categorised. Instead, **Government needs to be able to map out and identify areas of growth-friendly spending across Government budgets.** For instance, the adult skills budget lies separate to the educational and schools budget; research infrastructure, such as the building of new laboratories needs to be accompanied by budgets for running costs to allow these facilities to be used to their full potential.

Equally, **it is also important to maintain a growth-friendly tax system, both in terms of administrative efficiency and the costs to businesses of complying, and the structure and rates of the tax system itself.**[38] The evidence suggests that some taxes have a greater effect on growth than others. In particular, taxes on corporate income tend to have the largest negative effect on growth, followed by income taxes. Taxes on property are the least likely to reduce long-term GDP per capita, with consumption taxes somewhere in the middle.[39]

This evidence suggests that the Conservative Party manifesto is right to focus on giving businesses "the most competitive taxes of any major economy". However, at the same time, Government should not discount the possibility of raising taxes that have a lesser effect on growth, to help achieve the total savings required to hit its deficit reduction targets. It should also be alert to the fact that tax cuts that operate by reducing the number of individuals or businesses liable for tax, as opposed to reducing rates of tax, risk narrowing the tax base, potentially increasing its volatility over time.[40]

FAIRNESS AND DISTRIBUTIONAL EFFECTS

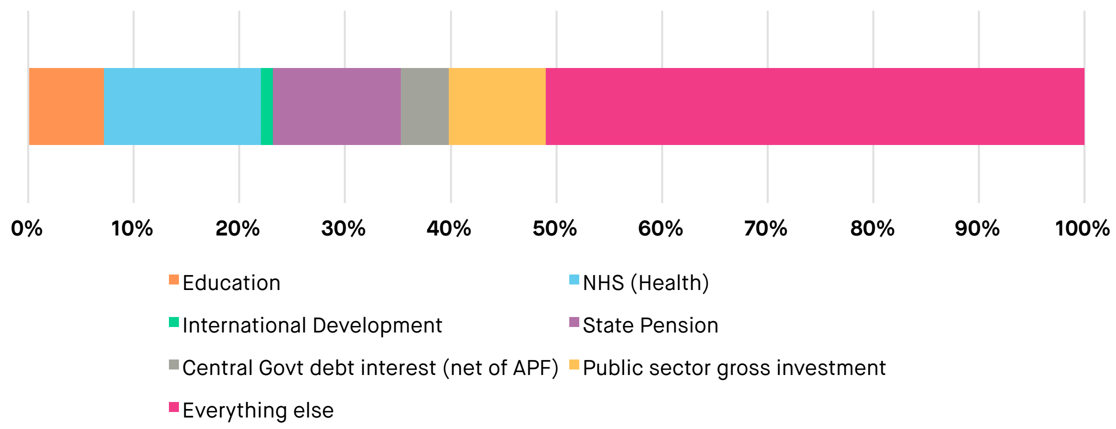
Some groups may be more severely affected than others by cuts in state spending, for example, on welfare payments. This is likely to be particularly the case for groups where poverty rates are high and/or those who have few other options for supporting themselves. In the interests of fairness, it may be preferable to protect such spending and make cuts elsewhere. Special attention might need to be paid where such groups do not have a strong political voice.

Coming on top of cuts in the last Parliament, it is likely to be even more important to pay attention to this in the coming years. There is also a more specific political difficulty. As set out earlier, the public is unconvinced that cuts have been spread fairly. A failure to properly take into account distributional consequences could begin to undermine public support for a continued consolidation programme.

SCRUTINISE ALL AREAS OF THE FINANCES

It is vital that all parts of the public finances are scrutinised for the potential to make savings. As set out earlier, there are a number of spending areas that are already being protected. Within departmental budgets, these include health, schools and international development. Within welfare spending, there is a commitment to protect pensions and benefits for pensioners. After taking into account debt interest payments, and assuming that Government will want to protect capital spending, that could leave around half of Government spending from which savings can be made.

Chart 10: Total managed expenditure (2015-16)



Source: OBR March 2015 & Budget 2015 forecasts

There are reasons to prioritise some types of Government activity over others. These include, for example, programmes and policies that promote growth, as explored above. Withdrawal of some programmes would have greater costs than others, for example where the benefits are particularly concentrated on disadvantaged groups. There are also reasons to think that the scope for savings will be lesser in some budgets than others, for example in healthcare, where costs are rising faster than inflation.[41]

However, ring-fences and promises of more spending in specific areas should not take the focus away from how best to achieve good value for the taxpayer. For example, the overseas aid target has been criticised because of the risk that the target to spend a specific amount of money becomes more important than the outcomes of improving lives in developing countries.[42]

Further, the inter-linkages between different types of budgets mean that in many cases it is not sensible to make decisions about some budgets without considering the effect on others. The clearest case is the commitment to increase spending on pensions and healthcare, which must be paid for from savings elsewhere; as an unprotected area, social care for older adults has had to take on part of this burden.[43] Thus support for older adults has increased in some areas, but been tightened in others; worse, a likely consequence of poor social care is increased costs for the NHS, for example due to more or longer stays in hospital.[44]

Government has already committed to protecting a number of budgets, and increasing spending on certain areas. However, it must ensure that beyond this, it allows itself as much flexibility as possible in how these budgets are spent. **Even within ring-fenced budgets, Government must focus on how budgets can be spent in a way that improves outcomes.** Reforms in the way that public services are delivered, as explored in more detail below, are an important part of this. Further, Government also needs to make sure that **where there are strong links between departments, relevant budgets are looked at in tandem.** Greater use of pooled budgets, including between ring-fenced and non-ring-fenced areas, may improve working between departments. Examples include across health and social care, and across employment and skills support.

IMPROVING TAXPAYER VALUE FOR MONEY: TAX RELIEFS

It is also important that Government considers *implicit* as well as explicit spending. There are a number of Government objectives that are achieved through the tax system through tax reliefs rather than through Government departmental budgets. Examples include encouraging saving (tax reliefs on ISAs and pensions), helping businesses (such as reliefs for small businesses and specific sectors) and financial help for families with children (zero rating on VAT for children's clothes). As has been argued elsewhere, these areas of implicit spending, or lost revenue, have not received the same scrutiny as areas of explicit Government spending.[45]

Not all tax reliefs are an instrument to achieve wider Government objectives; the purpose of some is to better define the intended scope of the tax, or to simplify the system. The NAO estimates that the cost of "tax expenditures" – specific tax reliefs that are designed to deliver policy objectives, and which often act as an alternative to direct public spending – amount to around £101 billion.[46] This is equivalent to the size of a large government department's budget. For context, the largest departmental budget – health, which includes all spending on the NHS – is only slightly larger, at around £113 billion.[47] **The next Spending Review process must include scrutiny of tax expenditures alongside explicit spending. One option for doing is to score tax expenditures against relevant departments' budgets, to give them an incentive to compare the effectiveness of this type of spending against other spending programmes.**

IMPROVING PUBLIC SERVICE DELIVERY

Given the scale of challenge, and the fact that departmental budgets have already taken substantial cuts, it will become harder to make pure efficiency gains without seeing a deterioration in the quality of Government services. **This will increase the imperative to look at how services are delivered, and where reform needs to be undertaken. The Spending Review process will need to allow time for these types of reforms to be developed.** And the timetable for savings may have to accommodate the fact that many worthwhile reforms are likely to take time to be implemented and deliver improvements. In some cases, they may mean a short-term increase in spending to cover upfront costs. Areas where there may be scope to look further at potential reform include:

- **Improving commissioning:** There has already been a substantial move towards commissioning services based on outcomes rather than specification of activities. Examples include employment support (Work Programme), reducing reoffending (Transforming Rehabilitation), and providing intensive support for families (Troubled Families Programme).

There are strong rationales for providers to be paid based on outcomes rather than specific activities, as this improves incentives for cost efficiency and innovation. There is likely to be scope to expand these principles to other areas, such as international development, where the scope for Payment by Results is starting to be considered,[48] and skills and training.

However, at the same time, Government needs to continue to improve the way it commissions. As SMF analysis has previously highlighted, getting payment by results contracts right can be difficult, requiring the ability to adequately measure and quantify the results by which providers are to be judged. It also requires careful calibration of levels of payments and payment structures to ensure that incentives work well, and to ensure there is competition in the market of providers.[49] It is also important that inter-linkages between different types of services are taken into account in commissioning. For example, commissioning health and social care services together is likely to be more effective in situations where patients require a combination of both services.[50]

- **Introducing competition and choice:** Since the 1990s and 2000s, competition and choice have been introduced in healthcare (for example hospitals competing for patients) and schools (academies and free schools). Evidence suggests that these can deliver benefits. For example, hospitals in areas where there is greater competition have seen greater improvements in mortality rates.[51]

  It is likely that there is greater scope for exploiting the potential benefits of competition, but ensuring that it works well requires a well-developed understanding of the incentives and behaviour of end-users and providers. For example, many parents do not consider academic results when choosing a school, limiting the ability of "parent power" to push schools to improve.[52] It has also been argued that the benefits of introducing competition are greater when different types of providers, such as mutuals, are able to compete.[53] It is therefore promising that the Conservative Party manifesto promises a "right to mutualise" for public sector workers. This also provides a potential route to improving contestability in public services.

- **Localism:** Under the 2010 Government, there was an increased focus on pushing decision-making down to the local level. Examples include City Deals, which give cities more autonomy in return for being held accountable for local growth. More recently, plans have been announced to devolve a range of responsibilities across skills, employment, and health and social care to areas that elect city-wide Mayors, starting with Greater Manchester.[54]

  There are a number of potential advantages to devolving decision-making. Local decision-makers may have better information about the local population and so may be able to make more effective use of scarce funding. Local commissioners can potentially pool and reallocate budgets according to need in a way that Central Government may find harder to do. It also provides potential opportunities for innovative models to be tested on a small scale.

  However, localising decision-making is not a panacea. Cross-country analysis shows that for it to improve the efficiency of public services, local government needs to have the capacity to make high-quality decisions and local accountability needs to be effective. Evidence also suggests that it is not enough to simply devolve spending; the positive effects on public services are maximised when revenue-raising powers are devolved at the same time.[55] But if the capabilities and accountability are not present for local government, incentives for improving value for money are likely to be blunted; and with autonomy already handed down, it may be difficult for Central Government to compensate by pushing through reforms. Effectively, localism, if it does not work, could be hard to reverse, and so carries some risk.

Finally, there is a balance to be struck in how much decentralisation is sensible. International evidence suggests that, for example, at least a third of budgets in healthcare need to be devolved for there to be improvements. At the same time, there are inevitably some areas where decision-making is most effective if it takes place at a centralised or regional, rather than local, level. These include decisions that span more than one geographic area (for example pan-regional infrastructure); spending where there are likely to be substantial economies of scale; and where regional distribution and equity is likely to be a concern. However, localisation is not the only way in which innovation can be encouraged. As set out above, commissioning arrangements such as payment by results can also work to incentivise providers to try different ways of improving public services.

- **Areas where the public sector could withdraw:** In many areas, Government support is needed to compensate for market failures, that is, valuable services that the private sector would not provide. However, the Government should monitor areas where it could reduce support and save money, without having a detrimental effect on end-users, particularly in areas where the private sector may be able to do more. One example is business support and lending. After the financial crisis, lending to both businesses and households saw a collapse.[56] A number of Government initiatives have helped improve access to credit, including Help to Buy, the Funding for lending Scheme and various schemes now operated by the new British Business Bank.

  Even before the crisis, there were structural gaps in funding, especially for smaller, growth businesses.[57] Government support is important here to make sure that lack of access to credit does not hold back businesses that have strong growth potential. But in other areas, as the economy recovers to sustainable levels of growth, it is likely that the private sector will be able to play a greater role in providing funding than it has in recent years, potentially allowing Government to pull back.[58]

- **Shifting costs:** Services do not necessarily have to be fully taxpayer-funded. Compared to other OECD countries, the UK raises less revenue from non-tax sources.[59] In some areas, Government should consider whether end-users and beneficiaries should bear more of the cost. This should be considered in areas where shifting the cost in this way is likely to have wider benefits, rather than in situations where the only effect would be to shift the costs. Simply shifting the costs may reduce the burden on taxpayers, but there would be little net benefit overall to society if individuals had to pay for the service in a different way.

  There are two potential reasons why in some cases there could be wider benefits from shifting costs. The first is that where end-users and beneficiaries directly face the cost of a service, this may change their incentives and behaviour in a positive way that improves outcomes. The second is that shifting costs onto users may be seen as fairer from a distributional perspective, particularly if the beneficiaries tend to be from higher income or wealthier groups.

  Before the election, it was reported that one of the options being considered for cuts in the welfare budget was to push more of the cost of the industrial injuries compensation scheme onto employers.[60] To the extent that this would sharpen incentives on employers to reduce the risk of injury at work, such a move could improve the quality of working conditions and reduce the likelihood of workplace accidents. This could therefore be an example where shifting costs away from Government could result in wider benefits.

Another example is in health and care costs. The Barker Commission on health and social care has argued that prescription charging should be revisited, as the current system of exemptions is inconsistent and arbitrary. The exemption for those over 60, for example, is inconsistent with the new state pension age, and with the fact that poverty rates have declined significantly among older age groups.[61] Other potential rationales for incorporating some level of user charging in healthcare is to encourage people to take preventative action.[62]

In summary:

- **Growth must be a top priority running through the Government's entire policy programme.**
    - Government needs to be able to map out and identify areas of growth-friendly spending across Government budgets. Activities that are growth-enhancing need to be prioritised as part of any Spending Review.
    - Government must also maintain a growth-friendly tax system.

- **Distribution and fairness of spending decisions will continue to be important, if not more so, in this Parliament compared to the last.**

- **All parts of the public finances should be scrutinised for the potential to make savings.**
    - Tax expenditures need to be considered alongside explicit spending.

- **Government has already committed to protecting a number of budgets, and increasing spending on certain areas. However, it must ensure that beyond this, it allows itself as much flexibility as possible in how these budgets are spent.**
    - Even within ring-fenced budgets, Government must focus on whether budgets can be spent in a way that improves outcomes.

- **The scale of the challenge ahead will increase the imperative to look at how services are delivered, and where reform needs to be undertaken. The Spending Review process will need to allow time for these types of reforms to be developed.**

CHAPTER 3: MAKING BETTER DECISIONS

As set out in the last section, there is a substantial challenge ahead. The next Spending Review process needs to improve value for money for the taxpayer, whilst making choices that are growth-friendly. Given the size of the savings that needs to be found, coming on top of five years of austerity, the Review will need to fully scrutinise all areas of spending. It will need to allow for reform that will improve public services, accepting that such reforms may not deliver the improvements in spending needed on a timetable that fits the deadline for the deficit reduction programme.

This raises challenges for the Spending Review process. The process needs to allow for sufficient time to analyse where further efficiency savings can be made, and where reforms are needed, in some cases looking across departmental budgets in tandem. The process also needs to get incentives right for those taking part in the Review. A key risk is that the Review pits one department against another, with different departments seeking to defend and protect their own spending programmes.

The Chancellor has announced that a Summer Budget will take place on 8 July and has announced some initial savings identified as part of the work leading up to this.[63] The Budget will also reflect tax and spending proposals set out in the Conservative Party manifesto. The first full Spending Review of the 2015 Government is expected to come in Autumn of this year.

This Chapter looks at how Government should conduct a Spending Review this time. There is no set template for Spending Reviews, and different Governments have chosen to conduct Reviews in different ways.

A SHORT HISTORY OF SPENDING REVIEWS

The concept of a multi-year Spending Review was introduced in 1998, under the last Labour Government. Previous to this, departmental spending budgets were published annually.[64] The rationale behind the multi-year Spending Review was to provide greater certainty to departments and provide incentives for better long-term planning and efficiency savings.[65]

Under Labour, the final Spending Review publication was usually the culmination of a series of policy and efficiency reviews, which looked at Government priorities and the scope for efficiency savings. Often reviews were conducted on cross-departmental issues. This meant that a full Spending Review programme would take some time, often lasting 1-2 years. The first Comprehensive Spending Review, in 1998, was published over a year after Labour came into power.

By contrast, under the Coalition Government, Spending Reviews have been a quicker process. The 2010 Spending Review was published in October 2010, only five months after the 2010 election, partly because of the need to allocate budgets for the early years of the Parliament. This meant there was less time for policy reviews to be conducted in advance – with the exception of the Strategic Defence Review which reported in October 2010. Instead, more of the policy development required for public service reform was postponed until after the review. This time, there is an argument to do more preparatory work ahead of setting multi-year spending allocations, particularly where substantial reforms will be needed to make savings or improve services.

Table 1: UK Government Spending Reviews 1998-2013

1998 Comprehensive Spending Review[66]	The Spending Review for the first time set out public service agreements – specific commitments that Ministers were accountable for delivering. Based on 30 "zero based reviews" of Departments' objectives, policies and spending plans, 6 of which were cross-departmental.
2000 Spending Review	Prior to the Spending Review publication, the Government conducted 15 cross-cutting reviews, building on the 2000 Wiring Up[67] report which recommended better cross-departmental working and pooled budgets. Reviews included deprived areas; under-fives; young people; welfare to work; criminal justice and care and support for older people.
2002 Spending Review	Prior to the Spending Review publication, the Government conducted seven cross-cutting reviews, covering science and research; small businesses; public sector employment; at-risk children; health inequalities; the role of the voluntary sector; and improving public space.
2004 Spending Review	The Spending Review built on a number of reviews, which were announced and completed during 2003 to 2004 • A review of public sector efficiency by Sir Peter Gershon, covering procurement, back-office and work practices • A number of cross-cutting reviews covering child poverty, science and innovation, and regional priorities. These reviews covered both short-term and longer-term priorities, for example, the science and innovation review covered the period 2004-2014.
2007 Comprehensive Spending Review	The CSR was the final publication of a larger programme of work, announced two years earlier in 2005. The programme included: • An assessment of long-term opportunities and challenges for the UK. • Cross-cutting policy reviews covering areas including children and young people; economic development and regeneration; housing growth; and mental health and employment outcomes. • An assessment of where there was potential to save money across Government
Spending Review 2010	Preceded in June 2010 by the "Spending Challenge" programme, which asked public sector workers and the public to contribute their ideas for saving money.[68] The Government also conducted a Strategic Defence Review and National Security Strategy. After the Spending Review, the Government published the Open Public Services White Paper in 2011, setting out its strategy for public service reform.
Spending Round 2013	Set out overall spending plans and budget allocations for departments in 2015-16 – the first year of the next Parliament – and updated plans for 2014-15.

WHAT SHOULD THE SPENDING REVIEW LOOK LIKE THIS TIME?

Undertaking the full consolidation required is likely to be more difficult this time than in 2010. It will require greater analysis of the potential for cross-departmental savings, and for further reform. This argues for a longer Spending Review process; as argued by others, including the Institute for Government, having a longer Spending Review process allows for greater rigour and collaboration.[69] However, at the same time, there is pressure to finish the consolidation programme early in the Parliament, as set out in Chapter 1. For this reason, we recommend a two-phase approach.

The Government should conduct a fast "Efficiency Review" that identifies around a half of the savings required. In tandem it should launch a longer-running "Reforms Review" that allows for the more in-depth analysis required to develop successful, wider reforms, and identify the remainder of the savings needed.

The Efficiency Review must look across all areas of Government spending, including tax expenditures. It should aim to find around half of the total savings required, to be implemented by 2017-18. As shown in Chapter 1, if the Government follows through on its spending plans, there would be around a £12 billion surplus on the current budget in 2017-18, more than is required to simply balance the current budget in that year. This allows the potential for some savings to be identified later than currently planned. However, it is likely to be helpful to go further than what is needed to simply balance the current budget. This is because longer-term reforms, which will be looked at in more detail in the Reforms Review, often require some upfront costs, even if they deliver savings over the longer-term. **Some of the savings found in the Efficiency Review should therefore be put aside in a fund that can be used to implement reforms identified in the Reforms Review.**

These Efficiency Review savings should be identified at the latest by the 2015 Autumn Spending Review. Assuming that the £12 billion of welfare cuts will be fully identified, this will leave just under £11 billion of savings to be found elsewhere, for example from departmental savings, or better scrutiny of tax expenditures. Some departmental savings have already been found as part of the work leading up to the 2015 Summer Budget.

The longer, Reforms Review will need to address the need for longer-term public service reform. It will need to start by looking at the outcomes Government is seeking to achieve, and then look at whether the way budgets are currently deployed across different departments and across national and local Government makes the most effective use of scarce resources. It should seek to find the remainder of the savings required by 2018-19, but should also take a longer-term perspective, considering the effects of future pressures such as demographic changes.[70] It should report by Budget 2016 at the latest.

As part of the Reforms Review, we recommend that Government returns to the model of undertaking a set of thematic reviews ahead of making final decisions on spending allocations. This will allow related areas of Government services and spending to be looked at in tandem. These reviews would be centred around Government's top priorities, rather than around specific departments. One option would be to centre these reviews around the priorities set out in the Conservative Party manifesto. The reviews would look at what needs to be done, and examine what is being done across different, related parts of Government. The thematic reviews should also look in detail at the scope for efficiency savings, comparing efficiency across different departments, as recommended by the Govern Up review.[71]

For example, a review on "Jobs for All", the second element of the manifesto plan, should look across the areas of skills, employment support and business growth, examining what is currently done across the Department for Work and Pensions, Business Innovation and Skills and the Department for Education, as well as local government and local enterprise partnerships. A review on "Dignity in Retirement", the sixth element in the manifesto plan, should look across the areas of retirement incomes, later life career opportunities, and long-term health conditions, examining programmes within the NHS budget, as well as in the Department for Work and Pensions and BIS in central Government; and across local authority social care. Alternatively, thematic reviews could centre around the manifesto's "plan for every stage of your life".

To undertake these reviews, Government needs to ensure they are headed up and staffed by individuals with the right expertise, but who are able to take an objective cross-departmental view. Good working knowledge and understanding of the relevant policy area is important; however, the reviews need to be headed up by individuals who do not have a strong vested interest in the final departmental budget allocation decisions. One option would be to ask Permanent Secretaries who are leaving departments but are yet to be allocated to a new department to head up reviews, potentially alongside a Minister from a non-related department, and a departmental non-executive Board Member, to bring in wider commercial expertise. Each team could be complemented by a secondee from the Treasury, part of whose role would be to maintain a strong focus on the potential implications of decisions for economic growth.

The final conclusions of the thematic reviews should feed into a final Reforms Review that makes budget allocations. We would expect that the thematic reviews would identify areas where spending may be best undertaken by other departments, or at different levels of Government, or should be shared across different parts of Government. Where this is the case, these budgets should be separately earmarked. Departments and local bodies should be given the opportunity to bid for these budgets, either separately, or together, building on the model used for Local Growth Funds and DfiD's Challenge Funds.

Box 5: The SMF's Efficiency and Reform Reviews

The Efficiency Review should:

- Set out spending totals for 2015-16 to 2017-18.
- Aim for around half of the savings required, to be implemented by 2017-18.
- Look for savings across the entirety of the Government budget, including implicit tax expenditures through tax reliefs.
- Plan for some of the savings to be used to fund reform plans identified as part of the Reforms Review.
- Avoid making cuts that are likely to be harmful to growth.
- Report on measures at Summer Budget 2015, or the Autumn Spending Review 2015 at the latest.

The Reforms Review should:

- Aim for the remainder of the savings needed to complete the consolidation programme, with a strong focus on long-term reforms.
- Consist of thematic reviews before final spending allocations are made.
- Avoid making cuts that are likely to be harmful to growth.
- Report on identified savings at Budget 2016. Savings to be implemented by 2018-19.

GETTING EXTERNAL SCRUTINY AND IDEAS

It is important that the Spending Review process is open to external ideas and scrutiny. In 2010, the Government ran a "Spending Challenge" website, inviting first public sector workers, then members of the public to submit suggestions for saving money.[72] An assessment by the Treasury Committee of the Spending Review process concluded that whilst it was worthwhile to undertake this type of consultation, it was not a substitute for "longer-term engagement with public sector employees and responsiveness to input from stakeholder groups".[73] Another challenge with welcoming suggestions is that Government needs to have the capacity and data analysis tools to adequately examine and assess the ideas it receives.

Nevertheless, we recommend that given the relatively small cost of maintaining and designing a website to gather ideas,[74] **a re-run of the Spending Challenge would be a helpful exercise**, and Government should, more broadly, seek to better understand public priorities on public spending.[75] However, to **encourage the submission of feasible and practical ideas, Government should specifically incentivise entrepreneurs and small businesses to submit proposals for small-scale savings** in how services are delivered. This would be in addition to the Spending Challenge. Winning bidders could be given the chance to deliver their proposal, in return for being paid a certain percentage of the total money saved. This would allow for greater innovation in cost reduction, and if successful, it may be possible to replicate small-scale savings across the wider public sector.

The 2010 Spending Review was scrutinised by the Treasury Committee in the House of Commons. If the Review is to consist of a longer programme of work, with interim outputs, it is likely to be useful to **set up a specific Spending Review Committee that operates for the length of the programme.** This could be set up as Joint Committee with members drawn from both the Commons and the Lords, to allow for a wide range of expertise to be drawn on. Such a Committee would be expected to report on the outputs of the thematic reviews and the final review setting out spending allocations.

In summary:

- **The Government should conduct a fast "Efficiency Review" that identifies around a half of the savings required. This review should report on savings by the Autumn Spending Review 2015 at the latest.**

- **In tandem it should launch a longer-running "Reforms Review" that allows for the more in-depth analysis required to develop successful, wider reforms, and identify the remainder of the savings. The Review should be completed by Budget 2016.**

- **The Government should re-run the Spending Challenge, this time with incentives for entrepreneurs and small businesses to submit money-saving ideas.**

- **A Spending Review Committee should be set up to scrutinise the Review process.**

ENDNOTES

[1] Conservative Party manifesto, 2015
[2] HM Treasury, Spending Round 2013, 2013
[3] OBR Economic and Fiscal Outlook, March 2015 Table 4.18
[4] OBR Economic and Fiscal Outlook, March 2015 Table 4.18
[5] HM Treasury "Chancellor announces £4½ billion of measures to bring down debt", 4 June 2015
[6] Conservative Party manifesto, 2015
[7] Specifically current Annually Managed Expenditure (AME)
[8] This is partly due to the reductions in debt interest due to the Asset Purchase Facility falling over time, and partly because until 2018-19, Government will still be borrowing every year, and so still adding to debt.
[9] HM Treasury, "Extracts from the Chancellor's lecture on economic policy", Royal Economic Society, January 2015
[10] Assuming the promised increases start from the first year of Government and then rises smoothly over the course of the Parliament, as opposed to simply introducing the full spending increase in the final year of the Parliament.
[11] HM Treasury "Chancellor announces £4½ billion of measures to bring down debt", 4 June 2015
[12] Specifically, current AME excluding welfare. As explained earlier, a large part of this is accounted for by debt interest payments.
[13] IFS, Post-election austerity: parties' plans compared, 2015
[14] IFS, Taxes and benefits: the parties' plans, 2015
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[16] See, for example, YouGov poll cited in Julian McCrae and Oliver Ilot, The Budget and Spending Review, June 2015
[17] OECD, Economic Outlook Volume 2015 Issue 1, June 2015
[18] Jonathan Ostrey, Atish Ghosh and Raphael Espinoza, When Should Public Debt Be Reduced? IMF Staff Discussion Note, June 2015
[19] OBR, Fiscal Sustainability Report, 2015
[20] Our estimates are based on the OBR's ready-reckoner tables, provided in its March 2015 Economic and Fiscal Outlook.
[21] OBR, Economic and Fiscal Outlook March 2015, chart 3.19
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[31] SMF, Growing Businesses, 2014; OECD, United Kingdom Country Note 2014
[32] SMF, Growing Businesses, 2014, SMF, Making Progress, 2014
[33] OECD, Education at a Glance, 2014
[34] For example, firm and market structures may result in under-investment in skills by firms. See, for example, Demos, Good Jobs: A Demos and PwC essay collection, 2014
[35] SMF, Good for Growth, 2013
[36] SMF, Growing Businesses, 2014
[37] In the last Parliament when economic growth was still weak, there was a strong case for spending on areas such as infrastructure to provide a boost to the economy. Now that the economy is growing again, the short-term gains are smaller, but the longer-term productivity gains are still important.
[38] PwC, Paying Taxes, 2015
[39] OECD, Tax and economic growth, Economics department working paper no.620, 2008
[40] SMF, Taxing Matters, 2015
[41] See SMF, Commitment Issues, 2015 for more details

[42] House of Lords Select Committee on Economic Affairs, The economic impact and effectiveness of development aid, 2012.
[43] SMF, Commitment Issues, 2015
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[45] See for example, Jill Rutter, "Opening the hidden ringfence: why the next public expenditure round needs to look at the Chancellor's big "spending" programme", March 2015 http://www.smf.co.uk/opening-the-hidden-ringfence-why-the-next-public-expenditure-round-needs-to-look-at-the-chancellors-big-spending-programme/
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[54] HM Treasury, Speech by the Chancellor on "Building a Northern Powerhouse", May 2015
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[58] The Government has recently set up UK Government Investments (UKGI) to sell public assets such as shares in Lloyds Banking Group and Eurostar and parts of the student loan book. It has also announced plans to sell the remainder of Royal Mail. The effect of doing this on the longer-term Government finances is not always clear-cut, as foregone future revenues need to be balanced against the sale value of the asset. More broadly, however, the effect of asset sales do not have a substantial ongoing effect on borrowing and deficit figures (aside from the effect they have in reducing debt interest payments). HM Treasury, "Government creates new company to deliver record asset sales programme", May 2015; HM Treasury "Chancellor announces £4½ billion of measures to bring down debt", 4 June 2015
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[63] HM Treasury "Chancellor announces £4½ billion of measures to bring down debt", 4 June 2015
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[67] Cabinet Office, Wiring it up, 2000
[68] Prime Minister's Office, "PM and Deputy PM letter to public sector workers", June 2010
[69] Institute for Government, Preparing for the next spending review, 2014
[70] See, for example, OBR, Fiscal Sustainability Report, 2015
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[72] HM Treasury, "Spending challenge FAQ", http://webarchive.nationalarchives.gov.uk/20130405170223/http://www.hm-treasury.gov.uk/spend_spendingchallenge_faq.htm
[73] House of Commons Treasury Committee, Spending Review 2010, 2010
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[75] Examples include Citizens' Juries type ideas. See for example PWC, Smaller government, bigger society, http://www.pwc.co.uk/government-public-sector/issues/a-citizens-view.jhtml