Budgeting for Balance

How hard is this going to be?

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About the Author

Jonathan Dupont joined Policy Exchange in April 2014 as a Research Fellow in the Economics & Social Policy Unit. Prior to joining, he has worked as a parliamentary researcher, an independent economic researcher and an analyst for the There is Nothing British about the BNP campaign. He has co-written multiple books on public policy, and a paper on fiscal rules – Binding the Hands of Government – for the Institute of Economic Affairs. Jonathan read Philosophy, Politics and Economics at the University of Oxford.

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Executive Summary

- Together, a decade of loose public spending, fiscal stimulus and the aftermath of the financial crisis left Britain with the highest deficit in its postwar history at 10.2% of GDP. Even half a decade later, that deficit is only half closed, and remains high internationally.
- Given that much of the damage to the UK economy is expected to be permanent – we will never recover the growth we have lost – we had little choice but to embark on an equally historically large fiscal consolidation to bring the budget back into balance.
- In this paper, we look at the experience of fiscal consolidation so far, and how to approach the remainder of the task. Do we need to keep going until the deficit is literally zero, or can we get away with stopping when the deficit is back at its mid 2000 levels? Where have the savings come from so far, and what has been the impact on public services? How does the Government plan to find the rest of the savings, and how do we ensure that as many savings as possible come from increased efficiency?

Is balancing the budget a good idea?

- In the 2015 Summer Budget, the Chancellor unveiled a new fiscal rule to apply from the end of Parliament, that in normal times the Government should seek to run an absolute surplus. No fiscal rule is perfect, but all in all this rule achieves a reasonable balance of transparency, strictness, intergenerational fairness, flexibility and credibility. Avoiding a rule that requires calculating the hypothetical amount of spare capacity left in the economy creates a much simpler target, and given recent experience and future spending pressures it is not unreasonable to bear down on debt faster than in the Great Moderation years. Protecting investment and intergenerational fairness is best achieved through other measures, such as ring-fenced investment or intergenerational accounts.
- If anything, the rule is too flexible, providing little to no guidance on what is to happen outside of normal times, or if a Government fails to meet its target. In order to prevent slippage, one option would be to supplement the main rule with a secondary target for the level of debt as a percentage of GDP the Government would like to see by, for example, 2045. This would better approximate what we are trying to achieve in the long run with fiscal rules and sustainability, and offset some of the weaknesses of a deficit target on its own.

Where have the savings come from so far?

- So far, around half the fiscal consolidation has come from current departmental spending, with the rest being made up by roughly equal contributions from

tax increases, scale backs to investment and welfare savings. £21 billion was found from higher tax revenues, largely increases to VAT and national insurance, and another £17 billion from welfare, with the biggest savings coming from freezes or slower uprating. Departments have saved £8 billion from public sector pay restraint, and at least £25 billion from efficiency savings through reductions in the public sector workforce and pensions bill and better management of property, contracts and procurement.

- So far, despite the scale of the savings, quality and service levels appear to have been relatively unaffected – although the rate of improvement in health and education has slowed. Opinion surveys of the public suggest that the majority believe that that the quality of public services has stayed the same or improved. There is some concern however that such surveys fail to pick up the experience of vulnerable minorities, such as in social care.
- Future savings are likely to be much harder than the measures taken so far. Much of the increase to VAT or reduction in public investment was simply reversing the discretionary fiscal stimulus introduced after the crisis. Holding down increases in benefit payments or public sector pay largely just reversed its overshoot in the post crisis years when private earnings fell. Many of the easiest efficiency savings have now been made, while ever greater proportions of the public sector have been ring-fenced.
- The recent consolidation comes in the context of extremely rapid spending increases from 2000 to 2007 – and significantly faster than international peers. Even after ten years of consolidation, total public spending is set to be 36.3% of GDP, still larger than it was from 1998 to 2000. However, looking only at the aggregate disguises how the breakdown of public spending has changed. Much of the increase in the plentiful years went to health and education – which has not been reversed – while the choice to ring-fence health, education and aid for a decade is tripling the rate of cuts for unprotected departments. This is fundamentally reshaping the look of the state. Between 2010–11 and 2019–20 the share of current departmental spending is set to fall from a half to a third.

Where will future savings come from?

- The public sector is complicated. It contains 24 ministerial departments, 22 non ministerial departments, 361 agencies and public bodies, 72 high profile groups, 11 public corporations, and 3 devolved administrations. Simple changes are either politically unrealistic, or unlikely to save much money. Merging entire Government departments by itself, for example, is unlikely to save much money without a radical scaling back of what the new department does.
- The Government has already announced its intention to save a further £12 billion from welfare cuts, £5 billion from higher taxes, and £5 billion from further pay restraint. That leaves a further £15 billion to find from departmental savings – or around £30 billion from unprotected departments when you take into account ring-fences.
- The biggest source of these savings is likely to be further efficiency savings, although there is a risk that some of what gets described as efficiency is simply displacing costs to the private sector or just cutbacks to services. While there is

nothing wrong with cancelling low value projects or passing on costs to those who benefit, what we really mean by 'efficiency' is delivering more for less. How many such savings are realistic? Given previous experience and the still relatively untapped potential from pooling resources, digital transformation and devolution, it would be unwise to say that further significant savings are impossible – but equally we have to be careful that we do not cut too far. At present, there is no consistent or comprehensive measure of efficiency across Government, with little joined up thinking or transparency over what reductions in service Government expects will be necessary to meet its fiscal target.

How can we better manage the process of finding savings?

- Given the complexity of the state, and the difficulty in many cases of measuring let alone modelling public sector quality or efficiency, we will never figure out the perfect spending allocation from the centre, or from the one off, adversarial and overly political process of a Spending Review.
- Instead of thinking of the Spending Review as something that happens as a one off, revisited every four years, it would be better to think of it as a more iterative, ongoing and flexible process that takes place over the whole course of the Parliament. The Coaliton Government had a genuinely impressive record on improving efficiency, and providing more reassurance that the quality will continue to be protected will allow the Government to continue to be ambitious on further reform.
- In particular, we should seek to create a Spending Review that is more:
  - **Transparent.** Transparency over assumptions is as, or more, important than accuracy in forecasts – but Government out ever tells us what it plans to spend, not what it expects to get for the money. Without transparency, many will always simply assume that cuts mean public services are getting worse. There is no perfect way to judge realistic efficiency savings, but Governments should at least be more transparent over how they plan to find savings:
    - Alongside spending envelopes, the Government should encourage focus on outcomes over inputs through publishing regularly updated business plans, key metrics and efficiency assumptions, which should be publicly revisited and reviewed annually by Parliament and the relevant Select Committee.
    - The remit of What Work Centres should be expanded to improve the evidence base of policy, randomly revisiting old business cases to check how well original assumptions have held up.
    - To improve the transparency and comparability of political debate, the OBR should consult on a new standardised fiscal consolidation metric and work towards bottom up forecasts of departmental spending. This would avoid the confusion of the last election, where political parties and institutions were all releasing numbers on different bases making them hard to compare.
  - **Digital.** Despite the hype, digital technology has so far only contributed a small percentage of efficiency savings. It offers a still relatively untapped

opportunity to improve public sector productivity, reduce wasteful demand and increase feedback – but will only take off with full buy in from centre of Government:

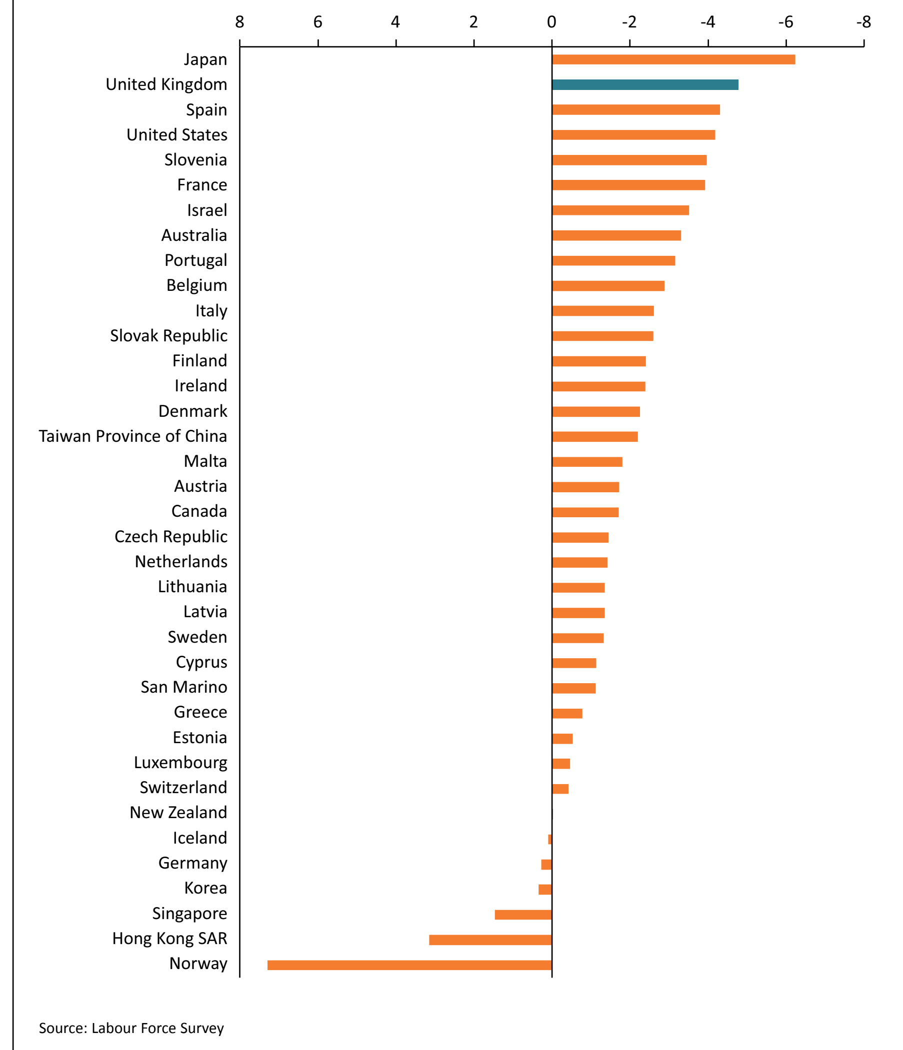
- The Government should commit fully to the adoption of Government as a Platform. However, GDS should develop GaaP as a platform on which others can build, rather than trying to construct all its components in-house. Just as Google does not build all the apps for the Android operating system, GaaP should allow government to benefit from the best innovation, experience, expertise, security and economies of scale of the private sector. Every single part of the public sector should have a standardised feedback page on Gov.uk, giving a rating for user satisfaction and allowing individuals to post public or private comments. At the same time, alongside these more informal ratings, each Department should commission monthly opinion polling of their core stakeholder groups.
- Local government should make much greater use of digital, with the creation of a Local Government Data Marketplace and a new Mayor's Office of Data Analytics for major cities.

- **Devolution.** Devolution offers the potential for significant further savings from pooling budgets, innovative reform and utilising local wisdom – but it will require more responsibility and engagement by local voters and councils to experiment with new approaches:
  - The Government should introduce a standardised annual tax statement for local government, including basic detail of that council's performance compared to regional and national averages. While many local authorities do as well or better than central government in the level of transparency they provide, it can still be difficult for disengaged voters to judge the performance of their council, and the trade-offs they are being asked to judge on between taxes and quality.
  - After greater transparency is in place, we should phase out the current system of Council Tax referendums. Just as devolved powers over business rates encourage better stewardship of local economies, control over council tax encourage more responsibility for local services. In the long run, we should seek to give councils full control over setting their rates and levels of council tax, with ten year independent reviews to adjust revenue grants. As an intermediate step, we should phase out the current referendum system, and in the short term significantly increase the national 'excessive' level up from 2%.

1
How Big is the Problem?

In 2014/15, seven years after the onset of the financial recession, Britain was still running a deficit of 4.9% of GDP, or £ 88 bn, or just over £3000 per family.[1] That is higher than in all but six years in the post war period before the financial crisis. The IMF estimates the UK's deficit to still be the second highest out of its 37 advanced economies, behind only Japan.

Figure 1.1: General government deficit in 2015 (% GDP, IMF, WEO April 2015)



Source: Labour Force Survey

1 Author calculation from Public Finances Databank, OBR, 1st October 2015

Table 1.1: How do we measure fiscal sustainability?

	Inter-temporal budget gap/intergenerational accounts	Whole of Government Accounts	Public Sector Net Debt	Public Sector Net Borrowing
What is it trying to measure?	Will future citizens have to pay higher taxes?	Comprehensive picture of government assets and liabilities based on private sector International Financial Reporting Standards.	The balance of government cash and liquid assets against borrowing.	The accrued difference between total government spending and income each year.
How comprehensive?	Very.	Moderate. Doesn't include expected policy costs or tax incomes.	Low. Doesn't include future policy costs, public sector pensions, contingent liabilities, or non-liquid assets such as property, plant or equipment.	Low. Doesn't include changes in expected policy costs, public sector pensions, contingent liabilities, or non-liquid assets such as property, plant or equipment.
What level of assumptions?	High. Requires assumptions over future growth, demographics, and evolution of policy costs.	Moderate. Requires long term assumptions over interest rates and public sector pensions.	Low to high. Current levels of debt can be measured directly, but projecting into future requires just as many implicit assumptions as more comprehensive measures.	Low to high. The current deficit can be measured directly, but projecting into future requires just as many implicit assumptions as more comprehensive measures.
Who produces?	OBR produces projections in its annual Fiscal Sustainability Report.	HM Treasury produces an annual estimate.	ONS produces current numbers, and OBR projects up to fifty years into future.	ONS produces current numbers, and OBR projects up to fifty years into future.
What can we learn from this measure?	Growth, demographics, and the evolution of public sector productivity will have the biggest impact on fiscal sustainability.	A better picture of long term fiscal sustainability, limiting temptation to move transactions "off balance sheet."	Expected future cost of debt interest – and easiest measure to compare historically and internationally.	Immediate feedback on whether fiscal sustainability is improving or not. Potential impact of fiscal choices on aggregate demand.

The deficit in isolation does not tell you everything you need to know about fiscal sustainability.

In the very long run, what we really care about is whether government spending and debt interest are going to grow faster than the economy as a whole, forcing future citizens to pay an ever higher burden in tax, slowing growth and risking the possibility of an outright default. The broadest measures of fiscal sustainability such as the new **Whole of Government Accounts** or to an even greater extent the **inter-temporal budget gap** attempt to give a comprehensive picture of the government's projected assets, liabilities, costs and income, and whether this is likely to be sustainable or not.

Such calculations are inherently uncertain, and inevitably more so the further into the future you try to project them, or after trying to take into account contingent risk. On the other side of the spectrum are measures that are less comprehensive but require fewer assumptions to estimate, especially if you only

look at their current state. The **public sector net debt**, for example, is the total of the state's financial liabilities, netted against liquid assets. (Although it does not include pension or future policy liabilities, such as increasing welfare costs.) In any one year, we can consider **public sector net borrowing**, the difference between annual government spending and taxation that gets added to the stock of debt.

Alongside the assumptions versus comprehensibility trade off, a second axis to consider is to what extent improving sustainability will require deliberate action by the government, and to what extent it will improve on its own as the economy recovers. One way to estimate this is by a top down calculation, estimating the sensitivity of the different elements of the public finances to the level of the spare capacity in the economy (the 'output gap'), and using this to estimate the structural deficit, or **cyclically adjusted net borrowing**. Other estimates, such as the **primary balance**, seek to exclude the cost of debt interest, focusing only on the spending and tax that is under direct government control. Alternatively, we can make a bottom up forecast, estimating the evolution of tax revenues and spending under current policy baselines, and look at how much policy change or **discretionary consolidation** the government will need to implement to achieve its deficit targets, reducing spending or increasing taxes. (Theoretically, under a balanced budget target discretionary consolidation and changes in the structural deficit should be equivalent to each other – but methodological limitations mean they can diverge in practice.)

All of these measures have their uses. Metrics like the inter-temporal budget gap give you the best picture of fiscal sustainability in the very long term, while public sector net debt gives you a measure that is most easily comparable internationally or historically. The level of discretionary consolidation gives you the best idea of how relatively challenging it will be to meet different fiscal targets, while the deficit is the simplest and easiest number to judge, especially in the short term. Over the course of the last Parliament:

- public sector net borrowing fell from £154 billion (10.2% of GDP) in 2009–10 to £90 billion in 2014–15 (4.9% of GDP)[2]
- public sector net debt increased from £960 billion in 2009-10 (60.2% of GDP) to £148.7 billion in 2014–15 (80.8% of GDP)[3]
- cyclically adjusted net borrowing decreased from £122 billion in 2009–10 (8.1% of GDP) to £76 billion in 2014–15 (4.1% of GDP)[4]
- discretionary fiscal consolidation, calculated against a baseline of unchanged policy from 2009–10 on, totalled £106 billion by 2014–15[5]
- net liabilities increased from £1,186 billion in 2010–11 (75% of GDP) to £1,852 billion in 2013–14 (111% of GDP)[6]
- the OBR's estimate of the inter-temporal budget gap decreased from 3% of GDP in 2011to 1.9% of GDP in 2015[7]

In the early parts of this report, looking at fiscal sustainability we will largely be focussing on the deficit and debt, while later when examining the direct impact on public services we will instead be considering discretionary fiscal consolidation.

2 Public finances databank, OBR, 1st October 2015

3 Public finances databank, OBR, 1st October 2015

4 Public finances databank, OBR, 1st October 2015

5 Budget 2015, HM Treasury, March 2015

6 Whole of Government Accounts 2013-14, HM Treasury, 2015

7 Fiscal sustainability report, OBR, July 2011; Fiscal sustainability report, OBR, July 2015

Where did the deficit come from?

At its highest in 2009–10 the deficit was £153.5 bn, or 10.2% of GDP,[8] caused by a combination of:

- **The existing deficit.** Even before the arrival of the recession in 2007–8, the UK was already running a deficit worth 2.7% of GDP, with the last time the UK saw a balanced budget being 2001.[9] The 2000 Spending Review announced significant increases in spending on health, education and tax credits, which was not revisited as the bursting of the dotcom bubble led to disappointing income and corporation tax receipts.
- **Deliberate fiscal stimulus.** As the scale of the recession became clear, the then Chancellor Alistair Darling announced several measures such as a temporary VAT cut and greater investment spending to try and stimulate demand in the economy. The IFS calculates discretionary fiscal stimulus worth 1.2% of GDP from the 2008 Pre Budget Report onwards.[10]
- **Deterioration in the wider economy.** Between the 2008 March Budget and autumn Pre Budget report, the forecast for tax revenue in 2009–10 fell from £608 bn to £536 bn, increasing the predicted deficit from a manageable £38 bn to a colossal £118 bn.[11] While some of the fall in tax revenue was temporary – a cyclical side effect of the business cycle that would reverse itself as unemployment fell back down and tax revenues increased – the greater part of it is expected to be permanent from structural damage to the economy. Much of the potential growth we lost from the recession we are unlikely ever to recover.

How much of the increase in the deficit was a short term cyclical effect, and how much was structural?

In many ways, this is a misleading question – or at best, one that needs further assumptions to answer. Ultimately, the real distinction is whether you assume as your neutral baseline that public spending stays flat in cash terms or as a percentage of the economy. If you look from the cash perspective, the main problem was the recession undermining the tax receipts needed to keep increasing the public sector at a steady percentage each year. By contrast, if you assume spending should be constant as a share of GDP, the problem was that the real economy as a whole turned out to be 11% smaller than we expected it be,[12] and yet public policy does not automatically update to cut the value of its commitments by an equivalent amount.

One way to see this is to compare the evolution of public spending and tax revenue looked at in terms of cash and as a proportion of GDP. If you compare the difference between the last pre-crisis forecasts of Budget 2008 and eventual outturn for cash, shortfalls in tax receipts make up 77% of the difference. By contrast, if you look at errors as a percentage of GDP, it is the surge in spending that is responsible for 62% of the error.[13]

More concretely, the implication of this was that while some policies – tax revenues, most notably – automatically adapt to the changing circumstances, others such as welfare payments or public sector pay require hard deliberate decisions from politicians over how much to adapt to new circumstances, and what to protect even as the rest of the economy shrank. For the most part, New Labour chose to put off these decisions, allowing welfare, public pay and spending

8 Public Finances Databank, OBR, 1st October 2015

9 Public Finances Databank, OBR, 1st October 2015

10 http://election2015.ifs.org.uk/public-finances

11 Historical official forecasts database, OBR, February 2015

12 Author calculation based on the growth trend from 1992 to 2007

13 Author calculations based on Crisis and consolidation in the public finances, Jon Riley & Robert Chote, OBR, September 2014

to shoot past the private economy in general – a not necessarily unreasonable decision, given the complexity of reopening a spending review and the virtue of maintaining the economic automatic stabilisers in the downturn. Nevertheless, at some point those decisions have to be faced.

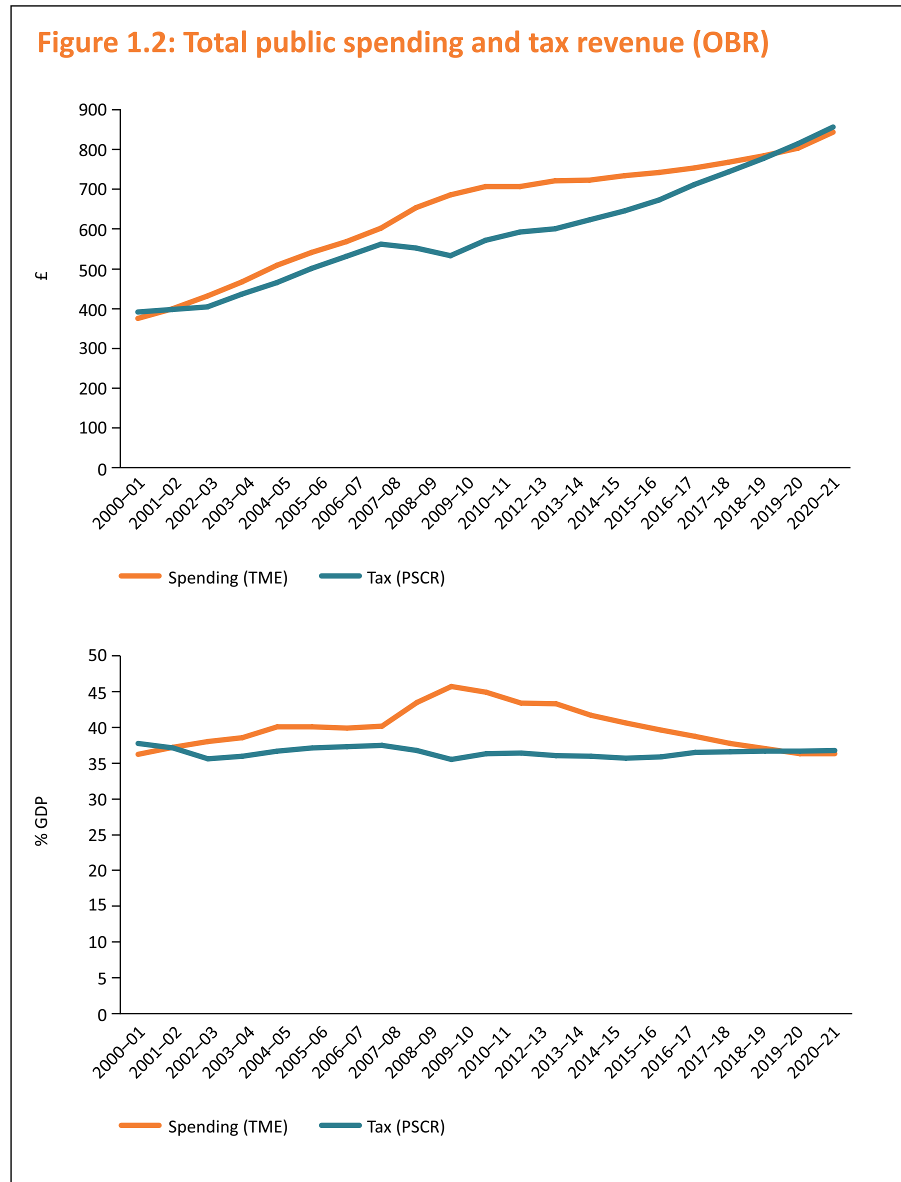


Figure 1.2: Total public spending and tax revenue (OBR)

How big is the consolidation?

However you look at it, the current fiscal consolidation is historically large. Measured as a percentage of GDP, the decade from 2009–10 is set to see the largest fall in the deficit since the post war demilitarisation. It is nearly twice as big as the fall in the deficit over the eighties, and a fifth larger than the fall in the nineties – albeit over a more extended time scale. Whereas previous consolidations saw public spending still grow in real terms, this one is to see a 3% shrink in total.[14] The only comparable episodes in the recent past have come in the aftermath of war, the heart of the Great Depression and the height of Thatcherism between 1983 and 1987.

14 Author calculations from Public Finances databank, OBR, September 2015

Table 1.2: Historic British fiscal consolidations (Bank of England, OBR)

Start	End	Average annual spending growth
1900	1906	-1%
1906	1910*	2%
1910*	1918	26%
1918	1922	-14%
1922	1923	-4%
1923	1924	1%
1924	1929	3%
1929	1931	4%
1931	1935	0%
1935	1945	13%
1945	1950	-6%
1950	1951	10%
1951	1955	1%
1955	1959	3%
1959	1964	5%
1964	1966	6%
1966	1970	3%
1970	1974*	6%
1974*	1979	1%
1979	1983	3%
1983	1987	0%
1987	1992	2%
1992	1997	1%
1997	2001	3%
2001	2005	5%
2005	2010	3%
2010	2015	-1%
2015	2019	0%

Turning from historical to international comparisons, the UK has already implemented one of the largest consolidations out of the major economies, and the further consolidation pencilled in for the next five years will see it climb further up the rankings. Only the most troubled economies from the Eurocrisis and Iceland are set to see more.

That the UK would have to undergo consolidation approaching this scale was largely inevitable, whoever the Government had been. As you would expect, there is a clear relationship between the size of the hole left in the public finances of different nations post crisis, and the subsequent levels of consolidation undertaken by their governments. Under the IMF's data, the UK is in total implementing

9.9% of GDP worth of consolidation by 2020, against an 8.5% hole in 2009. If it had followed the trend seen amongst other OECD economies exactly, the total consolidation would be around 11% smaller, or 8.8% of GDP in total. Conversely, the planned average rate of consolidation is actually moderately slower than the OECD trend – 0.9% of GDP a year, against an implied 1.2% of GDP.

Figure 1.3: Austerity until 2015 (fall in CAPB, % potential GDP, IMF)

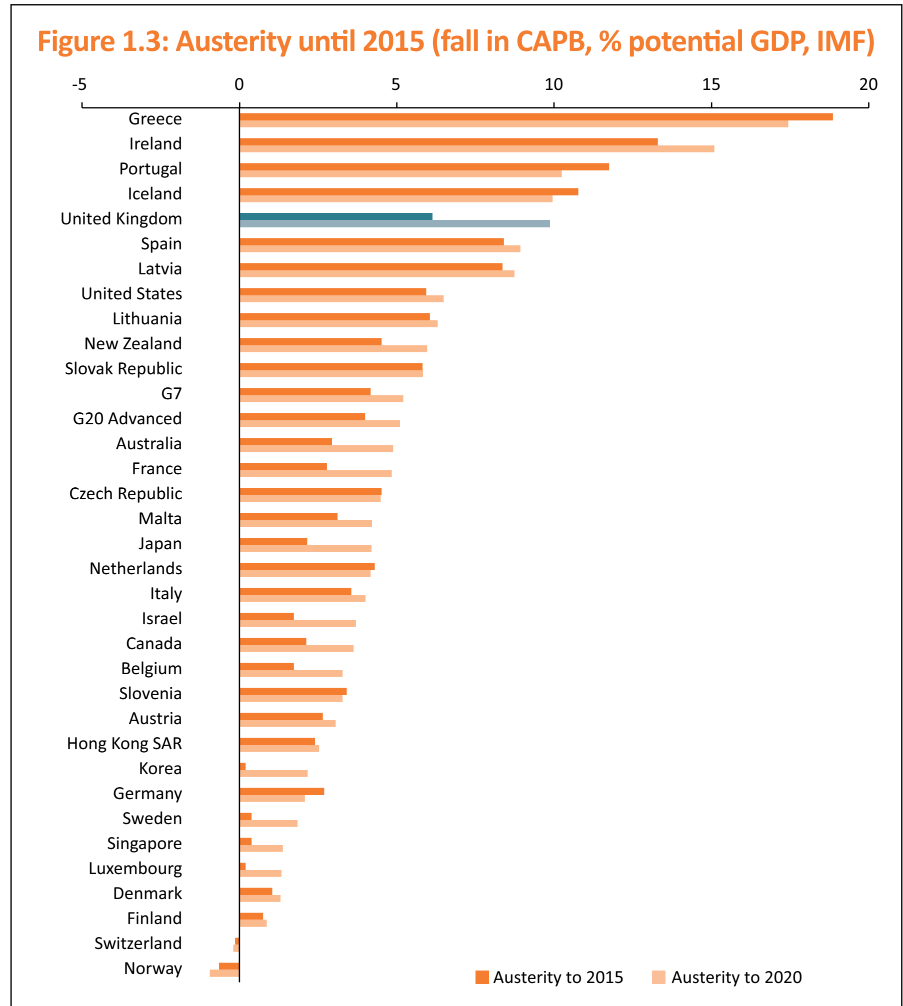
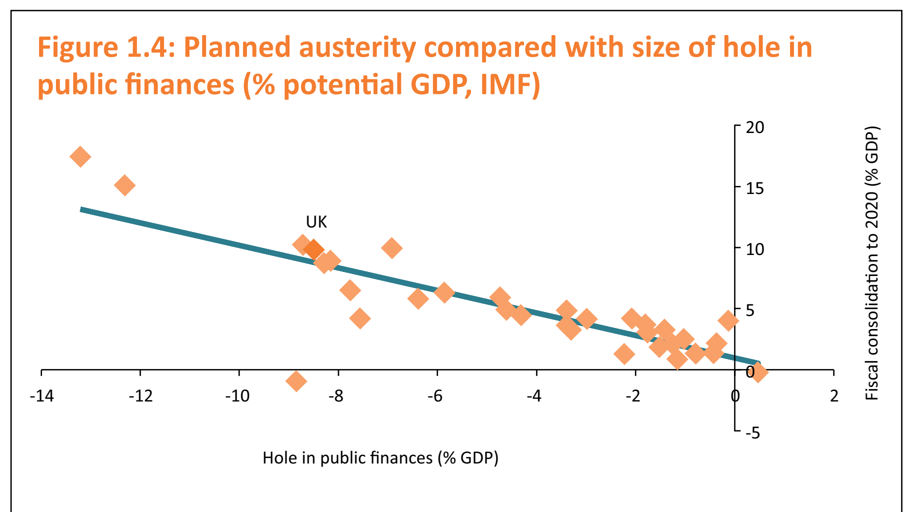


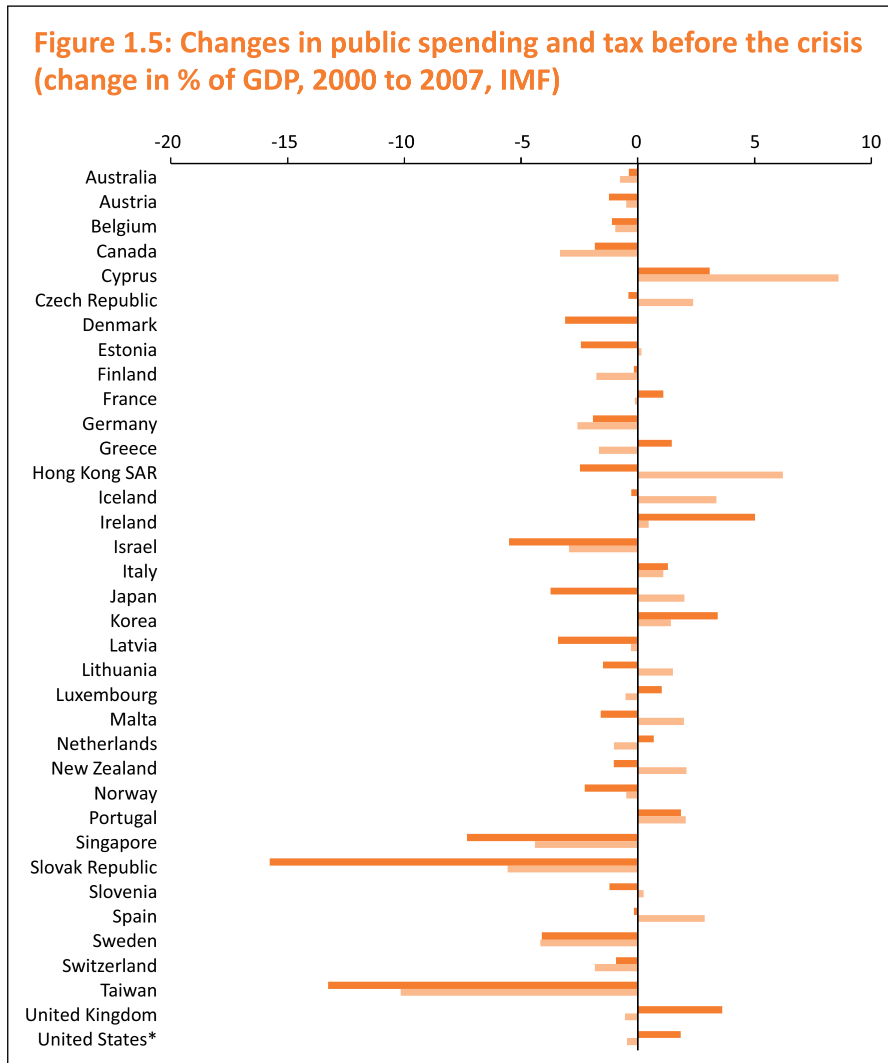
Figure 1.4: Planned austerity compared with size of hole in public finances (% potential GDP, IMF)



If the size of the hole in 2009 is largely responsible for the size of the consolidation, how did we get into this position in the first place?

Looking first at tax revenues from 2000 to 2007, the changes the UK saw were actually more modest than those experienced by most other advanced economies. While you might have expected taxes to rise over the period 2000 to 2007 to pay for higher spending, they moderately fell by 0.5%. By contrast, the UK had one of the largest expansions of spending as a proportion of the economy – and this was before the subsequent stimulus and shrinking of the economy during the recession years.

Figure 1.5: Changes in public spending and tax before the crisis (change in % of GDP, 2000 to 2007, IMF)



2
Is Balancing the Budget a Good Idea?

In the 2015 Summer Budget, George Osborne set out a new set of fiscal rules, his Treasury's third in three years:

- a target for a surplus on public sector net borrowing in 2019–20, and a supplementary target for public sector net debt to fall as a share of GDP in each year from 2015–16 to 2019–20
- a target, once a surplus is achieved in 2019–20, to run a surplus each subsequent year as long as the economy remains in normal times.

However, this rule is only to apply in normal economic times, which are to be defined as any time "the economy is not hit by a significant negative shock that reduces real GDP growth to less than 1% (on a rolling 4 quarter-on-4 quarter basis)." When this is not the case, the rule will be completely suspended, allowing "the automatic stabilisers to support the economy when they are needed." Instead, the Government must go the House of Commons with a new set of fiscal rules, the form of which is not prescribed except that they must ensure the budget balance eventually returns to surplus.

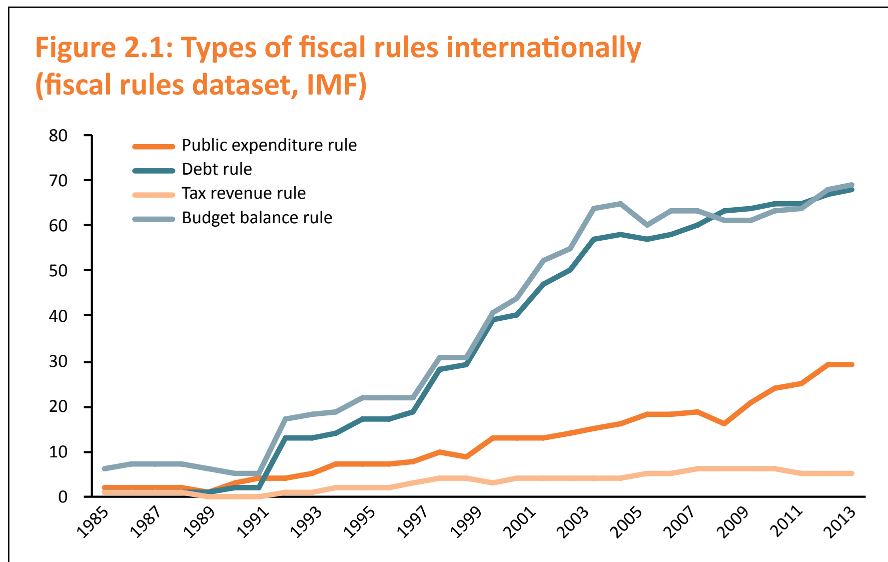
Internationally, fiscal rules grew rapidly in popularity over the 1990s, and in recent years, these rules have increasingly been backed up by the creation of Independent Fiscal Institutions such as the US' Congressional Budget Office or the UK's OBR to monitor adherence. Of the 89 countries in the IMF's 2014 Fiscal Rule database, the clear majority (78%) have some form of budget balance rule. The Chancellor's new rule is slightly unusual however, in that the majority of countries supplement this rule, with 81% of countries with a budget balance rule also making use of a debt rule. Around a third of these balanced budget rules make some adjustment for the business cycle, while 17% exclude some items such as public investment.[15]

Despite their popularity, there is little consensus in the literature as to what the optimal fiscal rule looks like – partly because the ideal inevitably depends on the circumstances of time or place, and is always seeking to adjudicate between multiple trade-offs. Should the rule prioritise maximum discretion to respond to the unforeseen, or should it lock in long term fiscal sustainability as much as possible? How much do we trust politicians to make the right decision, and how much do we have to tie their hands? Most studies find that stricter rules and tighter monitoring are associated with smaller deficits as you would expect, but

15 Fiscal Rules Dataset 1985 – 2014, IMF Fiscal Affairs Department, May 2015

there is less consensus on the degree to which greater discretion actually helps with macroeconomic stabilisation.[16]

Figure 2.1: Types of fiscal rules internationally (fiscal rules dataset, IMF)



While there is no perfect formula, we can get a sense of a rule's strengths and weaknesses by judging it against some intuitively desirable criteria:

- **Transparent.** Is it easy to objectively tell whether the rule is being met or not?
- **Strict.** Does it see debt fall at a reasonable pace?
- **Fair.** Does it create fairness between generations?
- **Flexible.** Does the rule leave enough flexibility to respond to recessions?
- **Credible.** Does the rule leave any loopholes, or potential for cheating?

How does George Osborne's new rule score against these goals?

Transparent

While most politicians are keen on 'balancing the budget', there is considerably more confusion over what this actually means:

- **Public sector net borrowing.** The simplest definition, following the classical definition, is whether in any one year the Government spends more than it brings in in tax revenue. This was the definition followed by Victorian Chancellors, ensuring the steady payoff of Napeolonic debt – between 1816 and 1913 the Government ran a deficit greater than 1% of GDP in just six years.[17]
- **Current budget deficit.** Others argue we look at the budget balance on a more balance sheet basis – taking into account investment and depreciation, and considering the net assets of the state. Given that this is very difficult to do in practice, most people use a simpler rule of thumb, arguing that we should allow borrowing for investment, while ensuring day to day spending doesn't exceed tax revenues.
- **Primary balance.** The primary balance looks at the gap between tax and spending, excluding payments for debt interest. As long as the primary balance

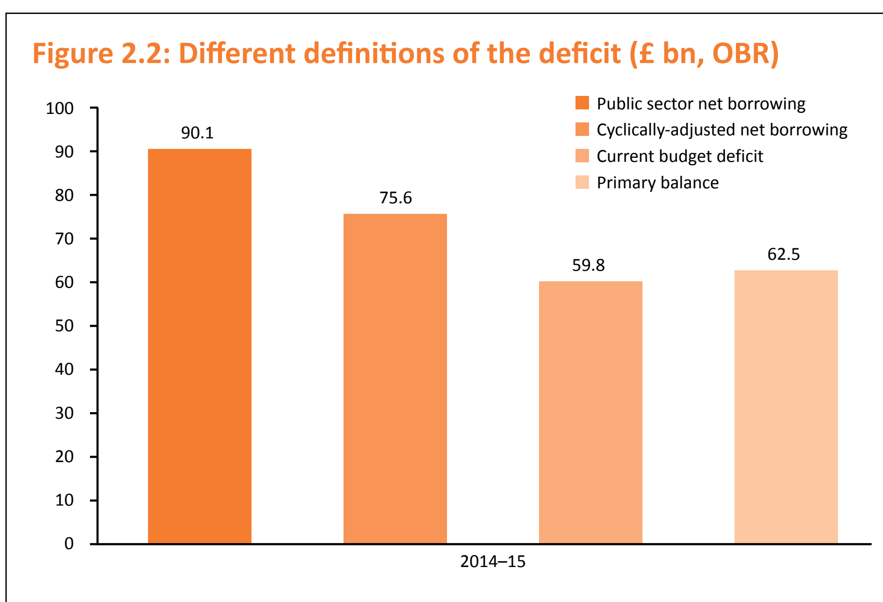
16 For a good recent summary, see Prudent Debt Targets and Fiscal Frameworks, Falilou Fall, Debbie Bloch, Jean-Marc Fournier and Peter Hoeller, OECD Economic Policy Paper, July 2015

17 Author calculation based on The UK recession in context — what do three centuries of data tell us?-Data Annex - Version 2.2, Bank of England, July 2015

is sustainably smaller than the growth rate as a proportion of GDP, debt should eventually shrink as a proportion of GDP too.

- **Cyclically-adjusted budget deficit.** During a recession, tax revenues naturally fall while spending on areas like welfare increases. As the economy recovers, these effects will naturally unwind – but trying to do this during the midst of the recession risks making demand worse. Furthermore, there is a good argument for seeking only gradual changes to tax rates, rather than constantly altering them every year to try and balance the in-year budget. Hence, there is a good argument for allowing the 'automatic stablisers' to act, only seeking to balance the 'structural' proportion of the budget that won't go away on their own.

Figure 2.2: Different definitions of the deficit (£ bn, OBR)



The Coalition Government's fiscal target combined two modifications to the simple deficit target, seeking to balance the structural current deficit. Internationally, the IMF often measures 'fiscal effort' through changes in the cyclically adjusted primary balance.

While applying structural adjustment and treating investment differently to day to day spending has theoretical appeal, in practice both adjustments rely on assumptions about the economy that are difficult if not impossible to prove. Nobody really knows the amount of spare capacity in the economy (the output gap) needed to apportion the budget into structural and cyclical components. Similarly, trying to really understand the balance sheet of the state and long term fiscal sustainability requires enormous assumptions about the future evolution of demographics, interest rates and so on.

Avoiding these assumptions creates a simple target that is far harder to game and more intuitively transparent to the public – one reason the Victorian target was so successful in the era of classical finance. Simplicity isn't everything, but it shouldn't be ignored either.

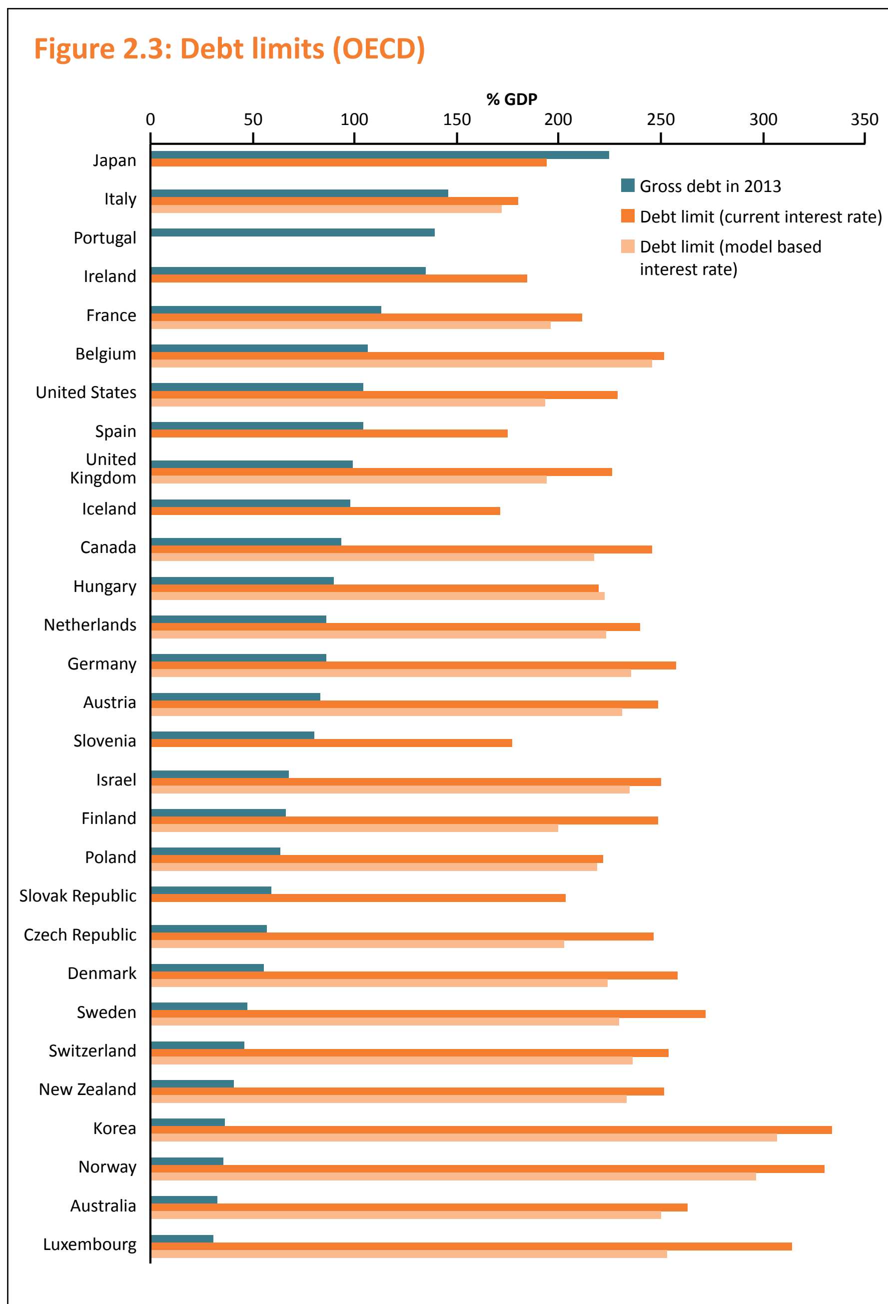
Verdict: The rule's simplicity makes it easy to understand, transparent to the public and avoids the need for technocratic judgement over the level of spare capacity in the economy.

Strictness

Ultimately, at least in terms of the public finances, it is not the deficit that itself matters per se but how the overall level of debt is expected to evolve in the future. One of the most fundamental questions lying behind any fiscal rule is what overall level of public debt should we aim for- and how fast should we seek to get there?

There are good arguments to be made that we do not necessarily want to do this as fast as possible. Suppose for simplicity that the current level of public spending is a given, and we face a trade-off between higher taxes and a higher deficit. High taxes distort the economy, and the higher we raise them the more distortionary they become. Therefore it is better to smooth taxes over time, raising them for a small amount over a long time rather than a large amount in a small time.[18] In other words, debt adjustment should be relatively slow.

Figure 2.3: Debt limits (OECD)



18 On the Detelmination of the Public Debt, Robert J. Barro, 1979

On the other hand, if the experience of the last decade has taught us anything, it is the potential for unforeseen emergencies to rapidly spike up debt. Since 2007, the UK's general government gross debt has increased by 48% of GDP, while the average for advanced economies is 26%.[19] The higher debt is before a crisis, the greater the risk that afterwards it will reach levels that are economically or politically unsustainable, setting off a vicious cycle of higher risk payments on interest rates, higher deficits and therefore still higher interest rates. At some point, the political system will reach its limit of austerity measures on spending or tax – Greece being the notable contemporary example – and default will be the only practical alternative to seeing debt spiralling out of control.

One way to think of this is to conceptualise the buffer between current levels of debt and a theoretical point of no return as a country's 'fiscal space.' Inevitably, there are considerable unknowns over where exactly this debt singularity starts to kick in, but we can get a rough idea from looking at the historical response of countries' primary balance to changes in debt. A reasonable rule of thumb for an OECD nation is that it is likely to kick in at around 200% of GDP.[20] Moody's estimated in May 2014 that the UK had 133 percentage points of GDP worth of fiscal space – enough to consider it 'safe', but with the lowest margin of the other safe countries. While the UK is very unlikely to reach the crisis point, it is not impossible to conceive of black swan events that could take us pretty close, like a rapid breakdown of the Euro or a major war.

"Public sector net debt is currently at 80% of GDP in the UK, around the level where worries about its impact on growth begin to kick in."

Beyond the risk of an outright debt crisis, debt also harms the economy at much lower levels. All else being equal, the higher taxes needed to pay the bill for debt or higher interest rates from higher debt discourage private investment and distort the economy. While causation likely runs both ways, a range of studies have found that higher debt hurts growth, with a nonlinear effect probably starting at around 80–100% of GDP. In addition, there is some evidence that higher levels of debt make fiscal policy less effective as worried households and businesses are more likely to offset fiscal stimulus with greater savings of their own.[21]

In the 1990s and early 2000s when Britain's debt was relatively low, it was not an unreasonable judgement to run a small budget deficit, allowing debt to drift gradually upwards. In hindsight, however, this was a mistake and Britain would have done better to match the performance of other advanced economies in stabilising or paying down debt, creating more fiscal space for the financial crisis and lessening the scale of fiscal consolidation.

Public sector net debt is currently at 80% of GDP in the UK, around the level where worries about its impact on growth begin to kick in. It is true that debt has been much higher in the past – but largely as the unavoidable result of wartime, and in the current environment of low and stable inflation, it is much less likely to disappear on its own. Given that we have not actually eliminated boom and bust, it is likely that the UK will continue to face shocks pushing up debt in the future, requiring the need for greater headroom. It is possible to maintain a small deficit and still shrink debt as a proportion of GDP as long as growth is positive – but recurrent recessions could easily see debt never falling. The OECD calculates that

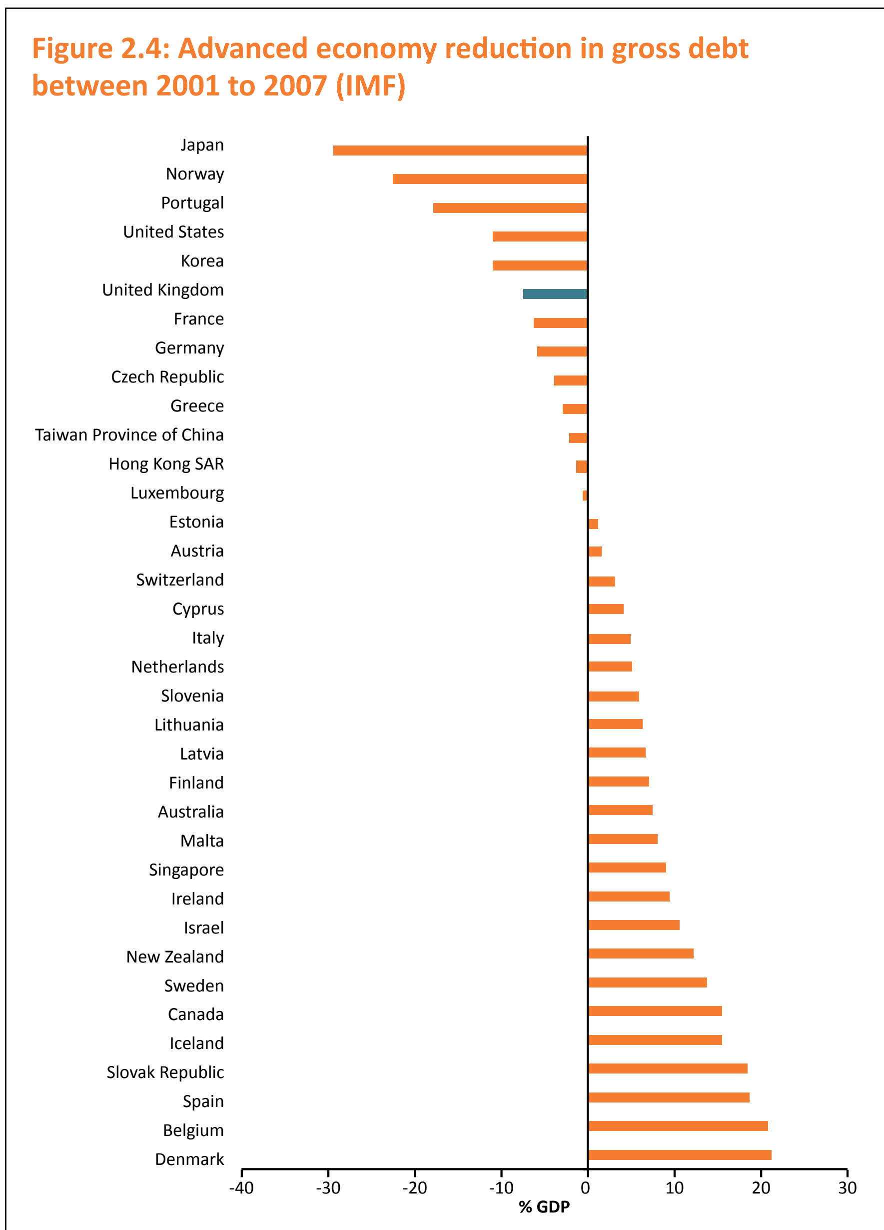
19 World Economic Outlook, IMF, April 2015

20 Prudent Debt Targets and Fiscal Frameworks, Falilou Fall, Debbie Bloch, Jean-Marc Fournier and Peter Hoeller, OECD, July 2015

21 Prudent Debt Targets and Fiscal Frameworks, Falilou Fall, Debbie Bloch, Jean-Marc Fournier and Peter Hoeller, OECD, July 2015

in order to achieve a 90% chance of staying within prudent debt levels, the UK needs to aim for a debt level of 64% of GDP by 2040.

Figure 2.4: Advanced economy reduction in gross debt between 2001 to 2007 (IMF)



If we accept the Government's rough definition of a recession from the new rule as any time annual growth falls below 1%, then over the very long term the UK has seen 58 recessions since 1700, or one every five years or so. On average, each recession left public debt 6% of GDP higher. In the modern era, recessions have been rarer at one every 15 years since the Second World War, but left debt 10% higher.

Whether this trend towards rarer but larger recessions will continue is hard to say. As a rough estimate, we considered a simple model in which the chance of a recession was normally distributed, on average taking place every ten years but

with 10% chance of being more frequent than 4 years and 10% chance of being less frequent than every fifteen years. Each recession increased debt by a normal distribution centred on 10% of GDP, with 10% chance of the impact being zero and 10% chance of the impact being 20% or more. In this approximate model, aiming for a current balanced budget (a 1.4% of GDP deficit) saw a relatively slow fall in debt, and a not insignificant chance that it wouldn't fall in the long term at all.

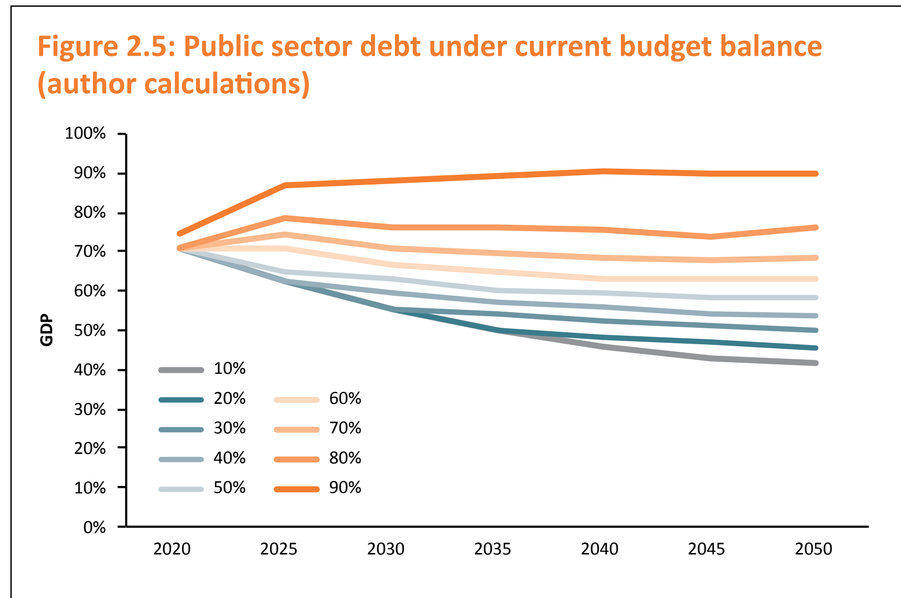


Figure 2.5: Public sector debt under current budget balance (author calculations)

By contrast, running an absolute balanced budget sees debt reliably fall in the vast majority of our scenarios.

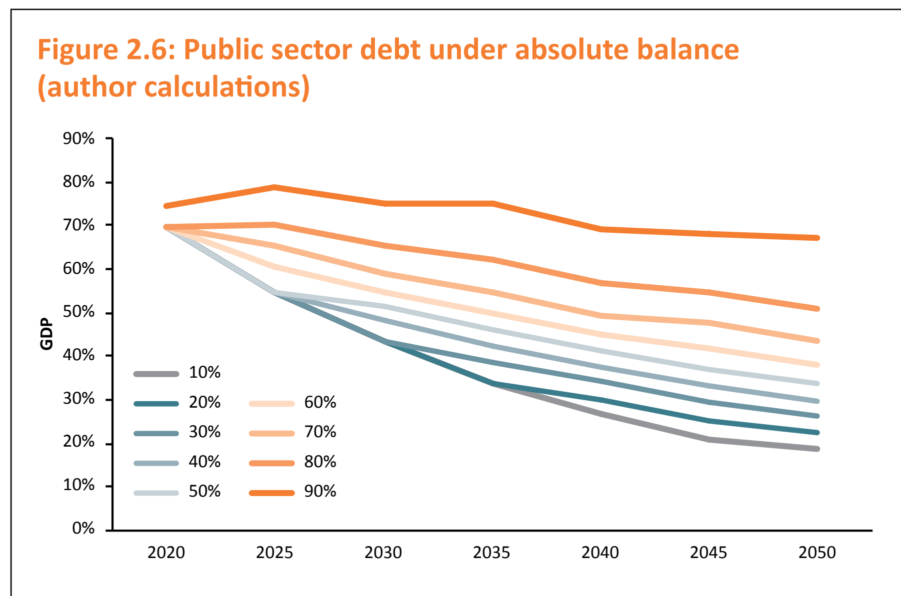


Figure 2.6: Public sector debt under absolute balance (author calculations)

Any decision over the right target deficit is ultimately a judgement over the balance of risk. Running a large surplus would be overkill, paying down debt faster than is likely needed. Britain has a centuries long track record of institutional stability and fiscal responsibility, its own independent monetary policy and is

unlikely to run into shocks on the scale of the financial crisis very often, implying it does maintain a buffer of some fiscal space. Equally, running a deficit above the economy's growth rate, allowing debt to spiral out of control, would be highly irresponsible – and given the signal it would send would likely quickly have disproportionate effects through higher risk premiums on interest rates.

In practice, the decision over the appropriate level of budget balance is generally between one or two good rules of thumb: seeking to balance overall tax with spending, or allowing a modest amount of borrowing for investment, but balancing the so-called current budget. The record of the early 2000s however, was that seeking to do the latter proved little headroom when forecasts ultimately proved over optimistic, leading debt to ultimately creep up – while Britain's base level of debt obviously now starts from a much higher position. Even before the financial crisis, projections of the deficit five years ahead of time were over optimistic on average by 2% of GDP between November 1998 and April 2003.[22] Seeking a faster reduction of debt with more headroom than a current balanced budget would allow is not unreasonable – and especially so to the extent that savings can be found from wasteful spending.

Verdict: The new rule is stricter than fiscal rules Britain has employed in recent past, but this is not unreasonable given current high levels of debt and to provide more room for error in case of over optimistic forecasts.

Fair

Many people believe it is counterproductive to ban borrowing to invest. Just as a family would take on a mortgage or a business issue bonds to fund investment, many argue that it makes little sense not to borrow for investments that could actually speed up future growth – and especially so at a time when interest rates are near zero. If investment is judged through the same fiscal framework as day to spending, there is always a temptation for Governments to cut back on less visible investment than politically sensitive, already pledged day to day spending. Rather than cancelling current projects, the Government can simply scale back new commitments. Since 2009–10, public sector net investment in the UK has fallen from 3.2% of GDP to less than half of that, or 1.5% of GDP.[23]

As many of the supporters of borrowing to invest are wont to argue in other contexts, however, using household analogies to analyse Government borrowing can be misleading. There are some situations – most notably war – when using debt to smooth out high short term costs makes sense. Unlike a person, however, Government doesn't enjoy life cycle effects, in which its income will usually peak in middle age.

Neither do low interest rates necessarily mean that now is a good time to invest, especially if we understand what has been causing the fall.[24] If low interest rates are the result of depressed 'animal spirits' and private appetite for risk, then there may be a case for government trying to take advantage of temporary lowering borrowing costs or to reprofile existing debts. On the other hand, if lower interest rates represent a rational market judgement of slower population or technological growth, those same trends will lower the expected value of public as much as private investments. Given that world interest rates have been in decline since the millennium and markets currently expect them to stay subdued for decade, it is hard to completely rule out a supply side 'secular stagnation'. Trying to outguess the market is difficult at the best of times.

22 Historical official forecasts database, OBR, February 2015

23 Public Finances Databank, OBR, October 2015

24 Low interest rates do not call for more investment, Scott Sumner, Econlog, April 8 2015

More importantly, unlike a business, Government investments are based not just on a cash return but a broader consideration of social value that is hard to monetise. Equally, while government interest rates are generally lower than those for the private sector, this does not necessarily imply that it is better for all financing to come from the state and gilts rather than the private sector. (As a reductio ad absurdum, just because Government interest rates are low, does not mean we should nationalise every industry that requires investment.) One reason government interest rates are so low is that the equity risk is transferred to the general taxpayer – even if a project turns out be unnecessary or goes over budget, the Government will still generally pay rather than declare bankruptcy – but this is just displacing cost rather than reducing it. In general, public borrowing makes the most sense for projects where the returns are likely to be non monetary or the equity risk is largely political. For those investments that can be monetised and the effect of political decisions such as prices controls separated out from operational efficiency[25] – a new toll road or runway, say – there is little reason not to offload them to the private sector, who can borrow off the government's balance sheet.

If you look at what government does more broadly, while it may get classified in an accounting sense as current spending, vast amounts of it are better thought as investment:

- Education and health build or protect human capital, increasing skills, productivity and ultimately earnings and tax revenues.
- The Foreign Office, military and international aid build hard and soft power abroad, protecting future security.
- Even in the welfare system, over half of the redistribution from the tax and benefit system is across stages of the lifecycle rather than between people.[26]

Even if government is not literally like a business, is it only fair that future generations should pay some of the costs for assets like schools and hospitals they enjoy?

The problem with this is the current balance is a very crude way of measuring intergenerational fairness. A much more comprehensive measure is the new Whole of Government Accounts, which aims to add together all the government's assets and liabilities. Between 2010-11, estimated total liabilities increased by £770 bn from £2.4 trillion to £3.2 trillion, while assets only went up £103 bn. Only £188 bn of this increase came from higher government borrowing – the bigger increase actually came from higher estimates of the cost of public sector pensions.[27]

A still broader look at fiscal sustainability would also take into account future promised welfare payments and likely public sector spending, netted against future tax revenues. As discussed above, one measure of this is the 'inter-temporal budget gap', the theoretical amount the deficit would have to be reduced over an infinite time span to ensure the present value of tax revenues covers the present value of spending and paying of debt. The OBR's latest estimate is that even taking current plan consolidation into account that this gap is equal to 1.9% of GDP,[28] the equivalent of £36 bn today. Alternately, if we are focussed as much on pure equity as solvency the intergenerational balance gap shows the amount taxes would need to be raised to ensure future generations were not worse off than today's. Such estimates are inevitably very sensitive to assumptions over

25 Through a Regulatory Asset Base model, for example.

26 Redistribution from a Lifetime Perspective, Peter Levell, Barry Roantree and Jonathan Shaw, IFS, 2015

27 Whole of Government Accounts 2013-14 key facts and figures, HM Treasury, 2015

28 Fiscal sustainability report, OBR, 2015

future growth and interest rates, but the broad lesson is that the real threat to intergenerational fairness is less inadequate investment and more unsustainable health spending or benefits for the elderly.

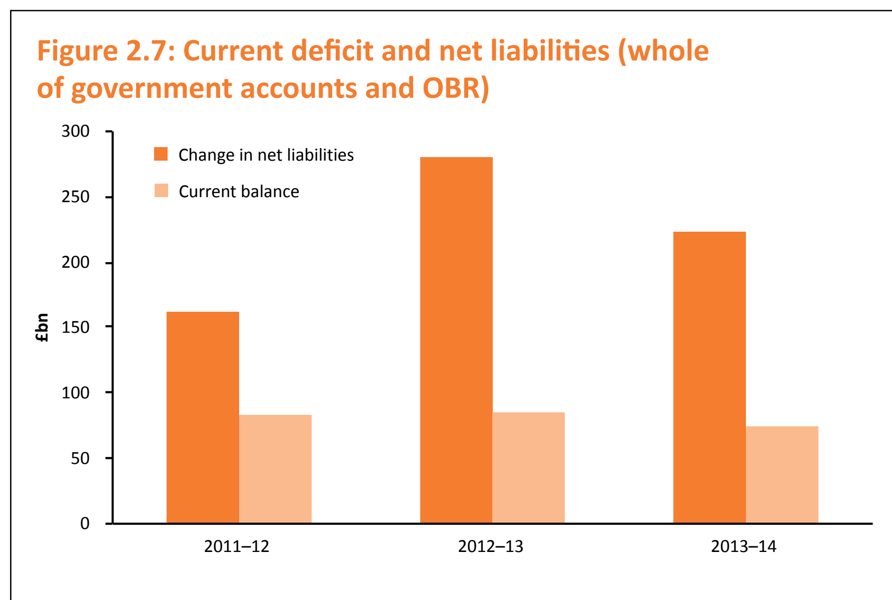


Figure 2.7: Current deficit and net liabilities (whole of government accounts and OBR)

Neither is a current budget target the most straightforward way to protect investment spending from short termist politicians. Promising to run a balanced current budget doesn't even necessarily guarantee higher investment spending – the government can use the additional leeway on current spending instead. Any form of ring-fencing has downsides, creating perverse incentives to re-categorise expenditure and to focus on the amount spent rather than outcomes. Nevertheless, as Jonathan Portes and Simon Wren-Lewis suggest, it would be much more straightforward to simply ring-fence public sector investment as a given proportion of GDP.[29] The Treasury's fiscal assumption already is for public sector gross investment to say constant as a share of GDP from 2018–19.

In short, while both intergenerational equity and preserving investment are important – targeting balance in the current budget is not necessarily the best way to achieve both.

Verdict: By itself, the rule does not do enough to ensure intergenerational fairness – but this is probably better protected by an instrument other than the government's primary fiscal target.

Flexible

Any fiscal rule is a trade-off between being strict enough to ensure credibility, and maintaining flexibility to respond to unforeseen events and the ups and downs of the economic cycle. At one extreme, some economists argue that all fiscal rules are inappropriate – instead we should use the deficit to manage demand in the economy. Look after unemployment, in Keynes' phrase, and the budget will look after itself.

However, in a normal economy, there are many reasons to believe that unemployment and demand are better looked after by an active monetary rather than fiscal policy. Monetary policy is simpler, faster to implement, easy to adjust,

29 Issues in the Design of Fiscal Policy Rules, Jonathan Portes and Simon Wren-Lewis, 2014

at less risk of politicisation, more powerful in an open economy with floating exchange rates and with no downside in terms of greater debt. It is not even clear that fiscal policy actually has any effect when monetary policy is working normally – if the central bank is already setting policy to achieve its inflation target, it will have to offset any further increase in demand from a higher deficit.[30] Equally, if we believe that the current target is failing to achieve the 'divine coincidence' of stabilising growth and inflation, a better alternative to active fiscal policy is simply to change the target. Targeting nominal growth, or even wages, would ensure the Bank of England took account of both inflation and demand in the economy in its decisions.

How can we judge if we're in a normal economy or not?

- **Growth.** The simplest sign that something is wrong with the economy is when growth sharply slows. The most familiar version of this is a recession, technically defined as two quarters in a row when the economy shrinks – although economies can still be struggling for long after the time positive growth returns. The new fiscal rule defines non normal times as any time growth is below 1% on a four quarter rolling basis.
- **Output gap.** The more nuanced metric is an output gap, which seeks to measure the amount of spare capacity existing in the economy from inadequate demand. While we can never measure this directly, we can use other indicators such as unemployment or business surveys to estimate its level.
- **Monetary policy ineffectiveness.** In the context of fiscal policy flexibility, what really matters is the capacity of monetary policy to manage demand, or at least to manage it better than fiscal policy. There is no unambiguous framework to judge when we may be in such a liquidity trap. Some point to interest rates being at the zero lower bound, making it impossible for the Monetary Policy Committee to lower them further – but even when interest rates are zero, the Bank of England still maintains many other tools including Quantitative Easing, forward guidance or in the extreme, a monetary 'helicopter drop'.

Fortunately, the first two definitions give very similar answers. For the most part, it is not hard to tell when we are in a sustained recession – growth dips, unemployment rises and estimates of the output gap goes up. The rule would still have allowed substantial freedom to respond to the four major recessions of the last thirty years.

Even outside a recession, growth forecasts are inevitably imperfect. On average, forecasts for a year or more out have an average error of around 1 percentage point.[31] In a scenario where growth remains above 1% – and so the surplus rule is still in force – small variations in growth are unlikely to have much impact on the cash output of spending,[32] but they could easily see tax revenues fall below forecast. In theory, it is better to allow the deficit to act as a short term 'shock absorber', rather than continually chase in year balance through tinkering with tax rates or reopening Spending Review settlements. In practice, the Treasury already alters tax rates at least once a year anyway. Leaving some leeway on the target – a surplus of half a percent of GDP or so – and planning for spending to rise slower than growth in the economy as a whole would leave enough of a buffer to absorb mildly disappointing tax revenues for a few years. In the post-war

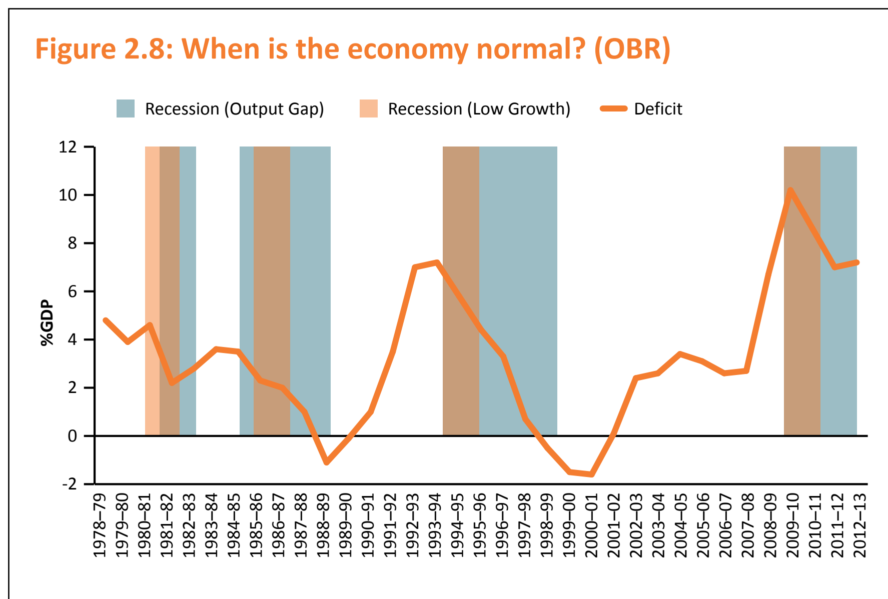
30 Why the Fiscal Multiplier is Roughly Zero, Scott Sumner, 2013

31 Forecast Evaluation Report, OBR, October 2015

32 One exception would be a external shock to inflation

period, there has only been one occasion where growth has been higher than 1%, but less than its long term average, for more than two years in a row. More severe shocks than this would either trigger the rule's exemption clause, or if prolonged reflect a long term structural reduction in the economy's capacity that the Government would have to adapt to in any case.

Figure 2.8: When is the economy normal? (OBR)



Verdict: The room leaves ample flexibility for the Government to respond to most scenarios – the one possible exception being an extended period of disappointing, but not dire growth.

Credible

If anything, the fiscal rule is too flexible – and flexibility has its own cost in reduced credibility.

The strength of the current design of the system is that it gives complete freedom for the automatic stabilisers to kick in during a recession, and does this without any of the imperfection of trying to calculate an output gap. The weakness is that this freedom is so broad as to give the Treasury far more discretion than is needed – running huge structural deficits even when monetary policy is completely unconstrained, and with little incentive to return to balance as soon as possible.

The rule gives a future Chancellor complete discretion to set new fiscal rules any time growth dips below 1%. If we make the not unreasonable assumptions that a Chancellor gives themself a comfortable path to return the budget to balance – five years, or a Parliament, say – and that recessions happen every eight years or so, the rule could easily spend more than half the time being redundant. In practice, a future Chancellor can abandon any set of fiscal rules – and based on past experience, likely would if they thought them unachievable – but it would still be better to set more guidance now of the likely strategy in response to a normal recession.

Furthermore, the current rule provides little incentive towards accurate forecasts or caution in setting future spending plans. Any shortfalls are effectively ignored. As Britain learned in both the early 2000s and early 2010s, deficit reduction often takes longer than initially planned, allowing debt to creep up

in the meantime. This is difficult to tackle with just one fiscal rule – but was addressed by both the New Labour and Coalition systems with supplementary rules, setting hard limits for debt.

Verdict: The rule is only likely to be in effect half the time, and provides little guidance on what to do outside 'normal times', creating the possibility of a slippage on debt.

Overall

No fiscal rule is perfect. Inevitably, all rules face unsolvable trade-offs.

The great strength of the new system is its simplicity. It is easy to understand, and should see debt steadily fall while still allowing maximum flexibility during a downturn. Given that fiscal rules are as often honoured in the breach as the observance, it allows a reasonable amount of headroom for over optimistic forecasts or spending reduction slipping by a year or two.

The downside is that it is much less good at controlling the deficit in less good times. In addition, the rule does little to ensure long term fiscal sustainability or protect investment from opportunistic raids.

Table 2.1: Judging the new fiscal rule

Factor	How to judge	Surplus rule
Transparent	Is it easy to objectively tell whether the rule is being met or not?	Yes. Hard to think of more straight forward rule.
Strictness	Does it see debt fall at a reasonable pace?	Yes. Implies that debt will continue to fall at reasonable pace under most scenarios.
Fairness	Does it create fairness between generations?	Maybe. Need to address generational equity and protect investment, but this is probably best done outside of the main fiscal rule.
Flexibility	Does the rule leave enough flexibility to respond to recessions?	Yes. The rule gives Chancellor complete flexibility for five years any time growth falls below 1%.
Credible	Does the rule leave any loopholes, or potential for cheating?	Maybe. No real implications if rule is not actually met. Little guidance given over how quickly budget has to return to balance. But OBR and transparency should help.

How can we maintain the strengths that come from the rule's simplicity, while reducing its weaknesses?

No one measure or rule is likely to achieve all the different things we mean by fiscal sustainability. Rather than seek out the one perfect metric or rule, it is better to choose a few key measures that can counterbalance the weakness of each other.

Recommendation: The Government should add a supplementary rule to prevent slippage on debt reduction. As with the current fiscal rules, the likelihood of meeting the rule would be judged by the OBR.

In the past, Policy Exchange has recommended the use of a debt brake mechanism as used in Switzerland, in which any missed targets are effectively caught up through more ambitious deficit targets in future years.

An alternate rule that would achieve much the same impact would be to set an explicit target for debt in the medium to long term – for example, for debt to fall back to 40% of GDP by 2040. This would force the Government to run greater surpluses if early forecasts proved over optimistic, and equally would actually allow a fiscal easing if growth surprises on the upside. A secondary benefit is that it would increase democratic transparency – rather than all parties committed to subtly differently defined balanced budgets and accusing the others of fiscal irresponsibility, they could instead give a hard target of how low they think debt needs to be and what assumptions they are making. If one party believes the other is being too lax and the other too cautious, it would be better for them to quantify their differing assumptions over the future frequency and severity of recessions.

The headline public sector debt statistic will however never be a fully comprehensive account of the state's liabilities. Focusing too much on public sector net borrowing increases the temptation for Government to artificially move future spending commitments off balance sheet, or make policy pledges without considering the long term costs. Some of the Government's most expensive current commitments are its long term guarantees for nuclear power or the triple lock commitment to pensioners. Neither are included in the conventional deficit.

Recommendation: As part of its fiscal sustainability report, the OBR should consider the implications of current Government policies for long term intergenerational fairness.

This could be based on a purely technocratic generational accounting approach, taking into account as much as possible all of the public sector's assets, liabilities and expected future costs from present policy baselines. **This would show our best estimate as whether taxes will have to go up in future to meet current spending commitments.** The OBR should specifically highlight any cases where policy choices benefit the public finances in the short term, but worsen fiscal sustainability in the long run.

As well as increasing transparency, this would also increase pressure for Government to in some cases choose more realistic long term assumptions – current Government assumptions imply that departmental spending and welfare will rapidly shrink as a proportion of the economy, which the OBR in effect ignores in its own long term forecasts, believing this to be unrealistic.

In the worst case, the OBR could at least publish two sets of forecasts based both on official assumptions, and what it believes to more likely. There is some precedent for this from the US, where the Congressional Budget Office publishes long term forecasts based both on current law and an 'Alternative Fiscal Scenario' based on policy changes it thinks are overridingly likely.

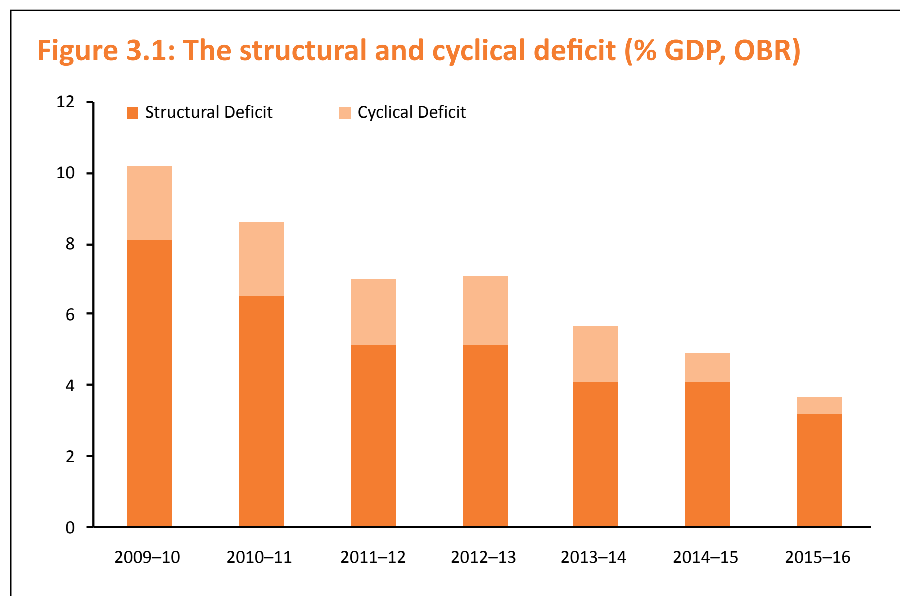
3

Fiscal Consolidation in the Last Parliament

In 2009–10, on the latest numbers, the UK's deficit stood at 10.2% of GDP.

As the economy recovered and tax receipts recovered, some of the deficit was always going to go away on its own. The OBR estimates that around 20%, or 2.1% of GDP of the original deficit was cyclical. In addition, around another 1.2% of GDP worth of Alistair Darling's stimulus[33] – largely the VAT cut and infrastructure spending – would come to a natural end.

Figure 3.1: The structural and cyclical deficit (% GDP, OBR)

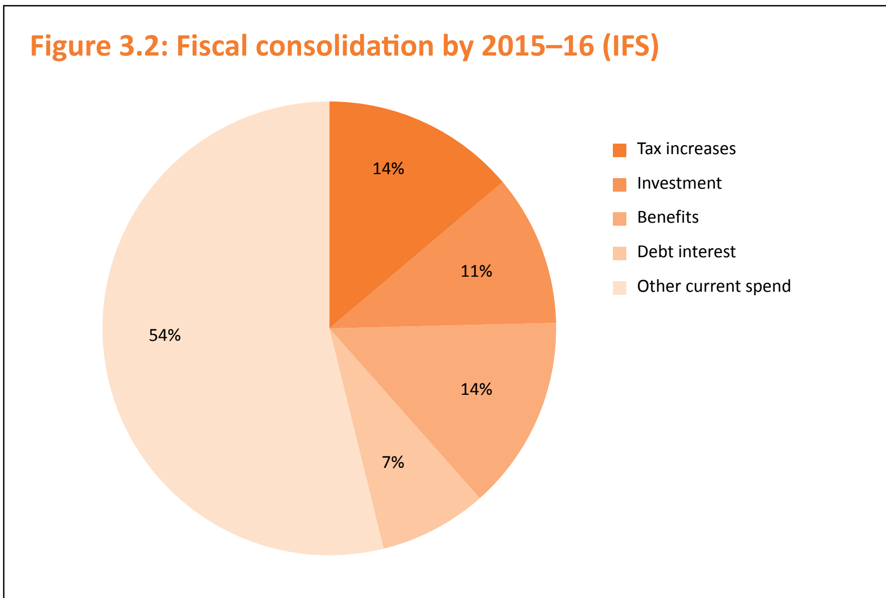


However, the vast majority of the budget deficit was going to require deliberate fiscal consolidation to correct for an economy now smaller than original assumptions.

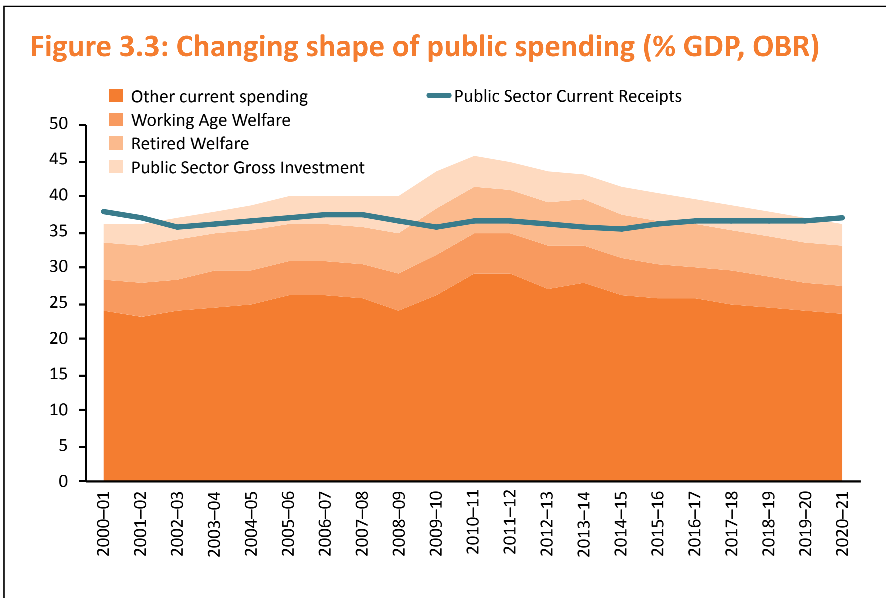
So far, around half this consolidation has come from cuts to departmental spending, with the rest being made up by roughly equal contributions from tax increases, scale backs to investment and welfare savings. In addition, running a lower deficit also means lower debt, implying more savings from lower debt interest payments.

In general, we are just over half way through the process of fiscal consolidation and closing the budget deficit. The budget is expected to finally be balanced in 2019–20.

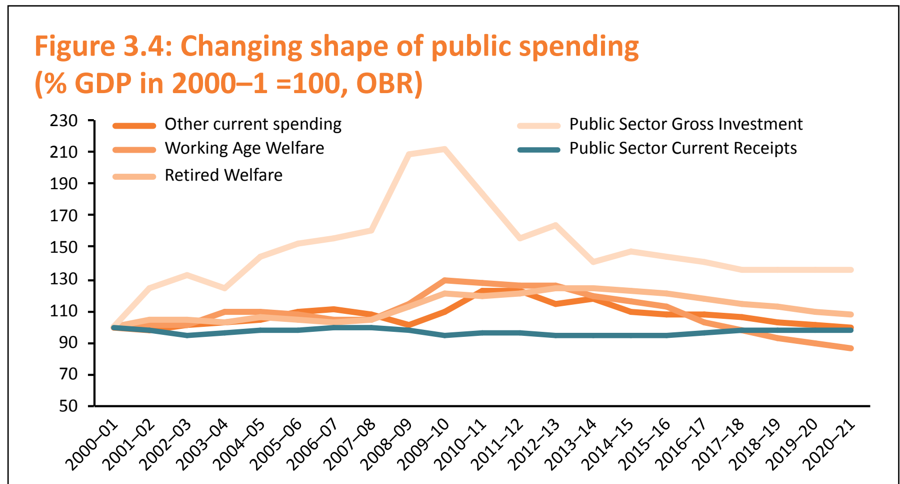
33 Public Finances, Election 2015 Briefing, IFS, 2015



If you compare this with the last time the budget was balanced in 2000–1, it is striking how little has changed. After falling slightly as a proportion of GDP during the crisis, tax revenues are expected to recover to 36.7% of GDP, almost identical to the 37% they were in 2001, while total spending will be 36.3% of GDP compared to 2001's 36.1%.



Even if you break this down further, the net changes to the balance of spending initially look small. After temporarily surging in the run up to and during the crisis, public sector net investment will end up at 1.4% of GDP, just above its 1.2% 2001 level, and equal to the average during the great moderation period of 1992 to 2007. Pensioner welfare will be barely any higher at 5.7% of GDP – although working age welfare will be down from 4.6% to 3.9% of GDP. Finally, all other current spending will be moderately larger, up from 23.1% to 23.5% of GDP.

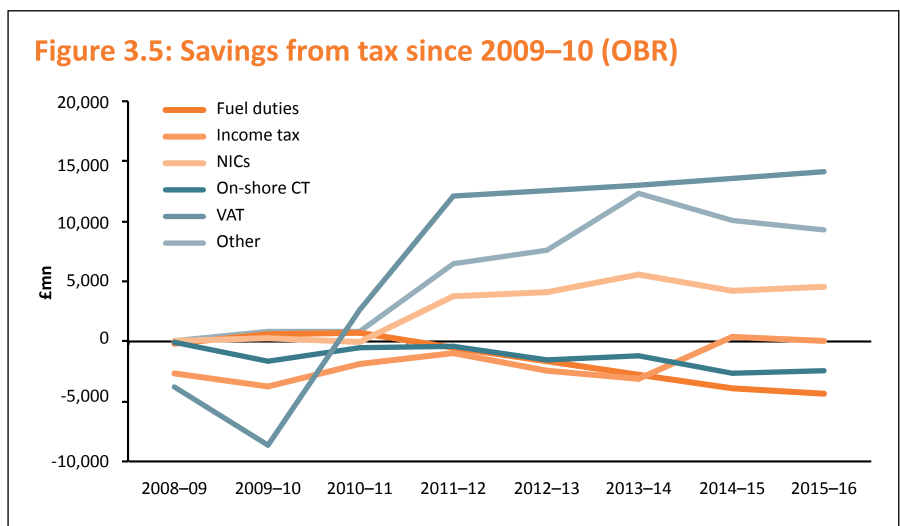


This return to the past, however, was far from automatic – on a more micro level, how were these savings found?

Tax

On net, tax changes have saved £21 bn since the beginning of the crisis at the end of 2009 – compared against around £120 bn from spending reductions. However, the net change is dwarfed by gross changes, as the Government changes the balance of taxation from one tax to another. Over the same time period, tax increases have generated £76 bn in higher revenue, but other giveaways have taken off another £55 bn. The majority of the net change was planned by Labour, whose plans implied an additional £16 bn in tax revenue, to which the Coalition added just another £5 bn.

By far the biggest change was the Osborne's first decision to raise the main rate of VAT not just back to 17.5% but up to 20%, bringing in £14 bn. However, much of this was used to scale back Labour's planned National Insurance increase and start the process of raising the income tax personal allowance. In addition, over the course of the Parliament the Government also had to find money to pay for repeated reductions in corporation tax, and even more costly at £4.4 bn, cancelling planned increases in fuel duty.

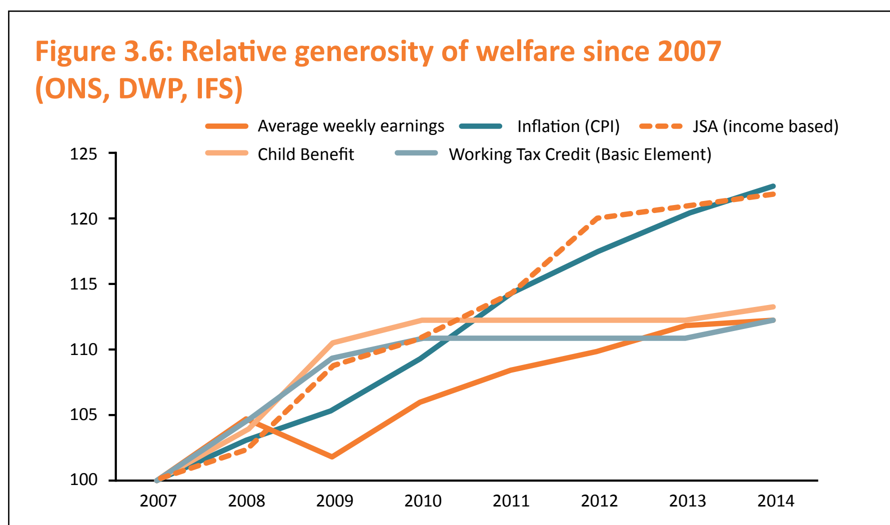


Welfare

In welfare, active decisions made by the Coalition Government were planned to save the taxpayer £21 bn compared to continuing previous policy, with the most significant changes coming from switching from RPI to CPI indexing, freezing or capping increases in working-age benefits, removing child benefit from higher rate tax payers and reforming disability related benefits. Despite these changes, total benefit expenditure has actually risen by £30 bn – largely driven by the increasing cost of an ageing benefit, although some benefits such as housing and disability benefit have also proven more expensive than initially expected. The IFS estimates that on net welfare changes have succeeding in actually saving £17 billion compared to continuing with previous policy.[34]

One argument for the Coalition's strategy was that while in the early years of the recession benefits continued to grow faster than inflation or earnings, the decision to limit uprating brought them back in line with changes to average earnings by the end of the parliament – although on the other hand, the years before the recession saw increases in welfare generosity significantly lag earnings. (As is inevitable in a system where benefits are tied to inflation rather than earnings.)

Figure 3.6: Relative generosity of welfare since 2007 (ONS, DWP, IFS)



Departmental spending

The majority of the overall savings have come from current departmental spending. In terms of magnitude, the largest savings have come from cutbacks to local government, although much of this is down to the localisation of council tax benefit in 2013–14.

Given the very different size of departments, the absolute scale of cuts can hide the relative impact of savings. As well as local government, unprotected departments like Transport, the Home Office, Foreign Office, Justice, Culture, Media and Sport, and Business, Innovation and Skills have all seen substantial savings. Excluding education, health and international development, the average real cut has been around a quarter. The total net saving from current departmental spending has been around £30 billion.

34 Benefit Spending and Reforms: The Coalition Government's Record, Andrew Hood and David Phillips, Institute for Fiscal Studies, January 2015

Figure 3.7: Savings by department since 2009–10 (£bn, PESA, author calculations)

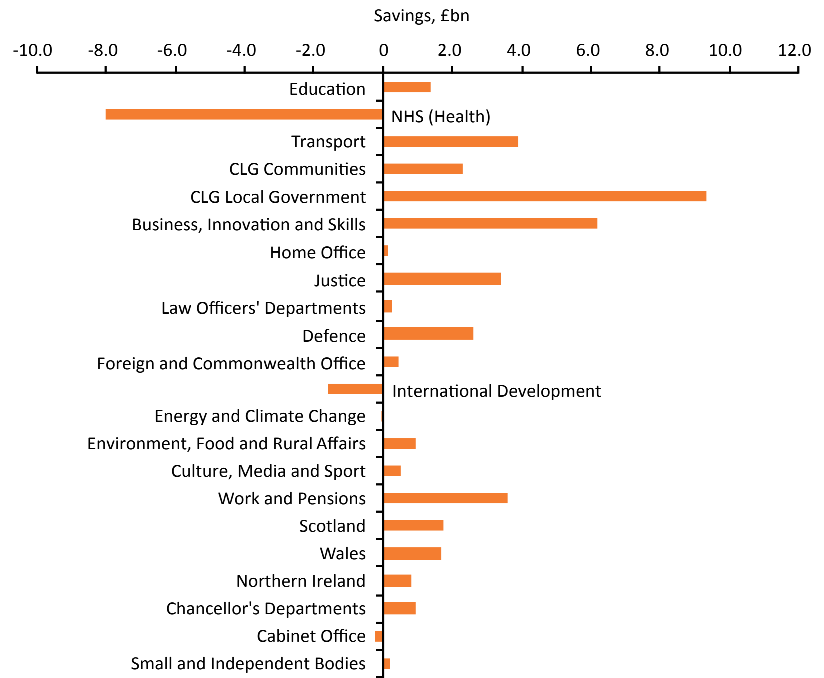
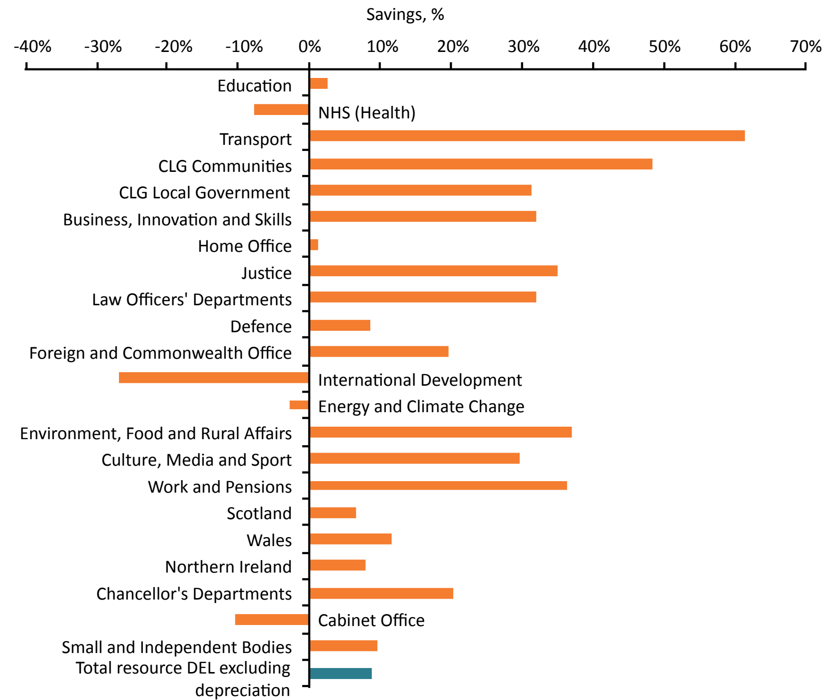


Figure 3.8: Savings by department since 2009–10 (%, PESA, author calculations)



How were these savings found?

One substantial source of savings has been pay restraint in the public sector. Like the decision to hold down welfare uprating, this policy had aspects of both structural and cyclical saving. Even ignoring pension benefits, average public sector pay is generally higher than private sector pay, although a large amount of this is down to having a higher skilled wokforce. However, between 2008 and 2010 public sector pay continued increasing while private sector pay suffered in the recession – opening up a 5% differential for similarly skilled workers. Pay restraint over the last Parliament reduced this differential back to 0%, and saved approximately £8 billion in total.[35]

Even more significant than pay restraint has been attempts to increase efficiency and reduce waste. As we will discuss later, defining efficiency is difficult, and there is no comprehensive measure of what savings have been found in Government.

However, we do have relatively good data for central government – around a fifth of total public spending. Each year the Cabinet Office's Efficiency and Reform Group has been compiling a list of savings achieved against a baseline of no policy change from 2009–10, with a rough target of an additional £5 billion in cumulative savings each year. Central Government has slightly underperformed against this, but still saved an impressive £18.7 bn over the first four years of the parliament – largely through reductions in the public sector workforce and pensions bill and better management of property, contracts and procurement. Despite receiving a lot of the hype and press attention, so far savings from greater use of technology or the well regarded Government Digital Service have been extremely modest. The consolidation of 23 websites into the new Gov.UK, for example, is estimated to have saved only £61 million in total.[36]

Table 3.1: Efficiency savings in 2014–15 (Cabinet Office)

Saving	£ bn
Advertising and marketing	0.3
Centralising procurement	1.8
Commercial relationships	2.2
Consultancy and contingent labour	1.6
Workforce reductions	2.8
Pensions reform	2.9
Property portfolio optimisation	0.6
GDS public services network savings	0.1
Operational savings total	*12.4*
Major projects	2.8
Construction	1.9
GDS controls and gds wider savings	0.4
GDS transformation	0.1
Asset sales	0.4
Commercial models	0.0
Fraud, error and debt benefits	0.7
Total	**18.7**

35 Summer Budget 2015, HM Treasury

36 Savings delivered in FY2014/15 in Government Departments – Technical Note

What has been the impact of the cuts?

The other alternative to pay restraint or efficiency savings is simply for Government to just do less – a reduction in scope. What has the impact of the cuts been on the front line of public services?

Unfortunately, it is not simple to gain a comprehensive understanding of the policy decisions made by Government, let alone to judge their impact. While the Treasury and OBR provide a comprehensive 'scorecard' of changes to tax or welfare, changes to departmental spending are generally only judged in the aggregate with Departments left to judge the details of their budget.

Looking at the most macro level presents a mixed picture. On the one hand, there has been no obvious breakdown in the basic functions of Government or clear deterioration on most metrics – but on the other hand some of the improvements seen in previous years seem to have slowed down.

- **Welfare.** Compared to initial fears, the labour market has rebounded relatively quickly with unemployment back close to pre-recession levels and youth unemployment substantially below the current EU average.[37] On the latest data, income inequality remains basically static, and slightly down on pre-recession levels.[38]
- **Education.** The average of the percentage of English Key Stage 2 pupils achieving Level 4 in reading trended up over the Parliament, while the percentage achieving Level 4 in Mathematics grew even faster.[39] The proportion pupils in state schools achieving the equivalent of 5+ GCSEs A*–C continued to improve through till 2011–12 and then stayed roughly constant in 2012–13, after which point methodology changes made it hard to make a consistent comparison.[40]
- **Health.** Age-standardised mortality rates remain below their 2009 and 2010 levels, albeit with relatively little improvement from 2011 onwards.[41] Overall patent experience scores from the National Patient Survey for 2014-15 are up slightly on 2011–12, but down on the year before.[42] On the other hand, waiting times have been creeping up, and 88% of acute trusts are now forecasting a deficit by the end of 2015/16.[43]
- **Crime.** Recorded crime stopped its decade long fall in 2013-14, and rose slightly in 2014-15.[44] However, the ONS note that this increase could be due to "the renewed focus on the quality of crime recording". The more reliable crime survey numbers show no such deterioration, with the fall in crime if anything accelerating from 2012 on.[45]

Such indicators are inevitably imperfect. Living standards, health, education and crime are influenced by many factors other than the amount spent on public services – not least the impact of a historic recession – and looking at only a smaller number of indicators can distort the overall picture. Many people worry that the impact of short term cuts will only show up with a delayed impact after many years.

A more nuanced view is likely to come from asking the users of government services. Unfortunately, outside health, we have relatively little data on public opinion, although the data we do have is relatively optimistic. A recent poll by Ipsos Mori found that while concern has slightly increased since 2012, overall 76% of people do not think they are being affected by the cuts very much or at all. While

37 Eurostat

38 Living Standards, Poverty and Inequality in the UK: 2015, Chris Belfield, Jonathan Cribb, Andrew Hood and Robert Joyce, Institute for Fiscal Studies, July 2015

39 National Curriculum Assessments at Key Stage 2, Department for Education, August 2015

40 Revised GCSE and equivalents results in England, 2013 to 2014, Department for Education, January 2015

41 Age-standardised mortality rates (ASMRs), 2001-2014, ONS, July 2015

42 Statistical bulletin: Overall patient experience scores 2014 Adult inpatient survey update, NHS England, May 2015

43 Quarterly Monitoring Report, The King's Fund, October 2015

44 Recorded Crime Statistics for England and Wales 2002/03 – 2014/15, Home Office, July 2015

45 Crime Survey for England and Wales, ONS

not insignificant numbers believe things have got worse, the bigger picture is that 55% believe the quality of public services has stayed the same or got better over the last five years with little difference between the public as a whole and users of services. The same rough trend holds true if you drill down to individual services like GP surgeries, hospitals, schools and colleges, local services or the police, although there are subtle differences. The public seem relatively worried about the police, road maintenance and universities, although it is possible that this is partly due to the long run pessimism over crime or, in the latter case, concern over tuition fees. Slightly more people feel that health services have got worse than got better, with this particularly true amongst users of care for the elderly.[46]

Figure 3.9: Outcomes of public services, 2007=100 (IFS, DfE, NHS England, Home Office)

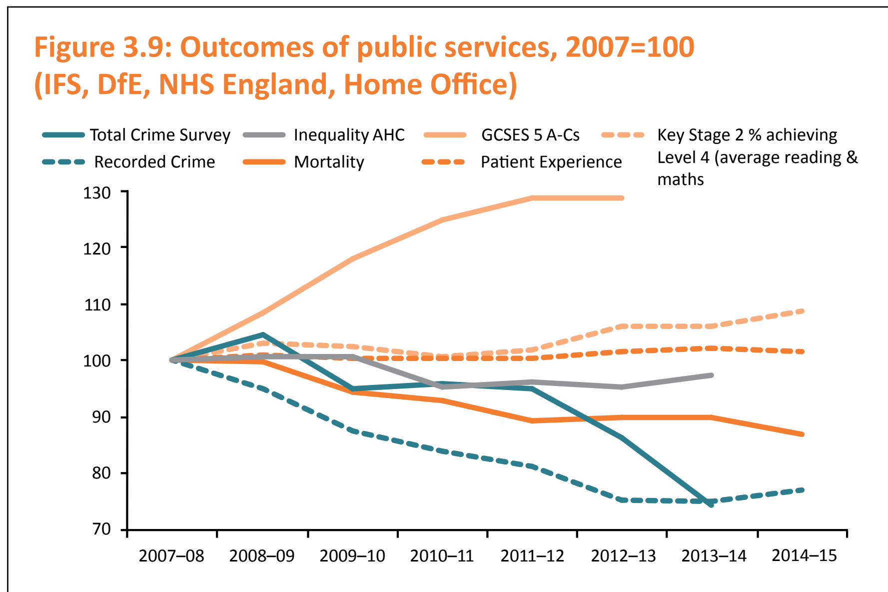
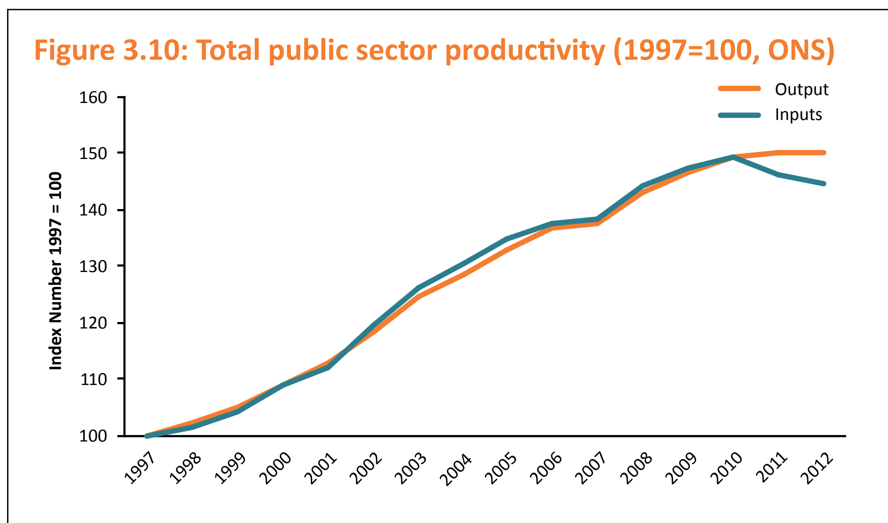


Figure 3.10: Total public sector productivity (1997=100, ONS)



A third source of information comes from the ONS' statistics on total public sector outputs, inputs and productivity. Unfortunately, the ONS numbers are only produced with a significant lag, and the latest data we have only goes up to 2012. Nevertheless, the data we do have suggests that cuts in the resources going into the public services did not lead to any declines in the outputs experienced by the public.

46 Coming to terms with austerity?, Ipsos MORI, 28 October 215

None of these sources of data are ideal on their own, but together they all seem to tell the same story: while there are inevitably individual losers, overall cuts to the funding of public services do not so far seem to have translated to worse quality. On the other hand, in some cases quality has stopped increasing at the rate seen in the 2000, while some sectors such as social care have been harder hit.

4

Finding Future Savings

Where are future savings going to come from?

In 2015–16, the OBR estimates that the overall deficit will be £69.5 billion. Around £9 billion of this is expected to go away on its own as the economy recovers from the recession. Even if pre-election policy was frozen in place, a further £34 billion is expected to go away on its own. That leaves a further theoretical £27 billion of discretionary consolidation to find by the end of the decade to balance the budget – except the Government has chosen to actually overachieve its target, running a surplus of £10 billion and taking the desired savings up to £37 billion.

Beyond this, the Government has already given significant detail on where it expects much of that £37 billion to come from:

Workforce – £5 billion

While the gap between public and private pay for comparable workers is now closed, public sector workers still enjoy substantially more generous pension entitlements. The Government argues that this justifies continuing overall pay restraint in the public sector for another four years, capping average pay increases to 1% with the expectation that this should save £5 billion by 2019–20.[47]

Given that the OBR currently expects overall earnings growth to average 3.9% between 2015–16 and 2019–20, there is an obvious risk that the cap creates difficulty in recruiting – despite the current freeze, the NHS pay body believes there to be little sign of "general recruitment and retention issues",[48] although the School Teachers' Review Body has highlighted greater emerging pressures.[49]

The likely best way to resolve the tension is to give individual departments more flexibility about how they allocate their funding. In the run up to the Spending Review, Policy Exchange has recently published a separate report on how to improve pay and performance in the civil service through devolving paybill control to departments, reducing the use of consultant and agency staff, reforming redundancy pay, reducing training budgets, and aligning overall workforce resources with department objectives.[50]

Welfare – £12 billion

As far back as January 2014, the Chancellor spoke of the need to find an additional £12 billion in welfare savings to prevent accelerating cuts in departmental spending, creating the much commented on rollercoaster profile of public spending in OBR forecasts. By the time of the election, this had been joined by an additional £5 billion from reduced tax evasion – together enough to reduce real cuts from 2015–16 to 2018–19 to 2.3% a year, the same as the average over the last Parliament.

47 Summer Budget 2015, HM Treasury, July 2015

48 NHS Pay Review Body, Twenty-Eighth Report, 2014

49 School Teachers' Review Body, Twenty-Fifth Report, 2015

50 Whitehall Rules! Improving pay and performance in the Civil Service, Damian Hind, Policy Exchange, 2015

In practice, the Summer Budget saw the Chancellor smooth out the profile for departmental saving largely through pushing back the target for balancing the budget an extra year to 2019–20, and borrowing an extra £16.7 billion over the first three years of the Parliament. This allowed the Government to break the manifesto target of £12 billion in the first two years of the Parliament – instead finding £7 billion on this time scale, and the full £12 billion only at the end of Parliament.

Figure 4.1: Implied department spending envelope (£2015–16 bn, OBR, author calculations)

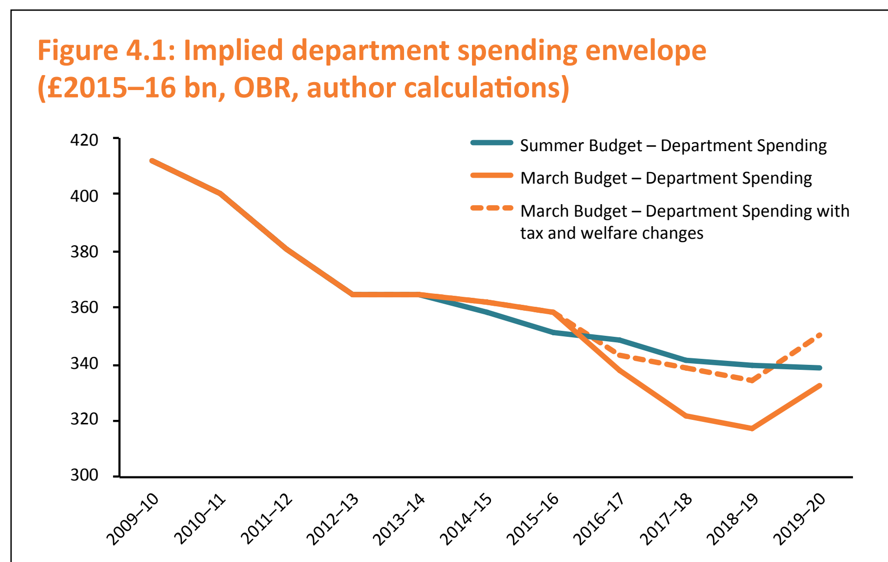


Table 4.1: Summer budget welfare savings (IFS, DfE, NHS England, Home Office)

Measure	Saving in 2019–20
Freeze working-age benefits, tax credits and Local Housing Allowances for 4 years from 2016–17	3.9
Reduce income thresholds in tax credits and work allowances in UC	3.3
Reduce social sector rents by 1% each year for 4 years from 2016–17	1.3
Limit child element to 2 children for new births in tax credits and new claims in UC	1.1
Remove family element in tax credits and UC, and the family premium in Housing Benefit, for new claims	.56
Align Work-Related Activity Group rate with JSA for new claims	.45
Benefit cap: reduce to £20,000, and £23,000 in London	.41
Increase tax credits taper rate to 48%	.35
Support for Mortgage Interest: change from welfare payment to loan; maintain capital limit at £200,000	.26
Pay to stay: higher income social housing tenants to pay market rents	.25
Reduce income rise disregard in tax credits	.18
End automatic entitlement for out-of-work 18–21 year olds	.04
Universal Credit parent conditionality from when youngest child turns 3	.035
Total	**12.1**

Despite the partial row back, the changes to the welfare system remain substantial. While the Government has said it is open to further "sensible welfare reforms" finding more money from welfare will be difficult. The Government's pension tax lock and commitment to protect wealthy pensioners benefits such as the Winter Fuel Payment preclude some of the easiest savings. According to the IFS, the planned changes will see the average working household on benefits or tax credit lose £750 a year – much more than the £200 they will gain (at best) from the National Living Wage.[51]

While these changes will save money in the short term, it is not sustainable for living standards or work incentives to just keep cutting the real value of benefits forever. The best way to create long lasting savings are through structural changes to the economy and welfare system: increasing the supply of housing to cut housing benefit, merging more benefits into Universal Credit and increasing the effectiveness of the Work Programme. Policy Exchange will be producing more work on creating a sustainable welfare system in the coming months.

Tax – £6 billion (at least)

The Conservative manifesto pledged to find an additional £5 billion from "tax evasion, and aggressive tax avoidance and tax planning", while increases in VAT, Income Tax or National Insurance were specifically ruled as "tax rises on working people would harm our economy, reduce living standards and cost jobs."

Like welfare's £12 billion, the Summer Budget saw the data for the achievement of this £5 billion pushed back to 2019–20. However, alongside evasion and avoidance the Government also included in its £5 billion total "addressing imbalances in the tax system" which as defined as places where "certain reliefs are disproportionately benefiting certain groups of individuals", which you might think as defining almost every tax. In practice, it is probably best to think of the Budget as containing £5.6 billion in tax cuts netted against £8.8 billion in other tax rises and £2.8 billion in reduced tax evasion and avoidance, improving the overall public finances by £5.8 billion.

While the Government's new tax lock law forbids increasing the main three rates, the Chancellor will still have to find substantial tax rises from elsewhere, if for no other reason than to pay for the rest of the Government's £7.5 billion commitment to raise the personal allowance to £12,500 and the higher rate threshold to £50,000 by 2020–1. In practice, after having cut fuel duty in 2011 and then freezing it ever since, it would seem strange to allow it to go up again with RPI from 2016 – freezing it for a second parliament could cost another £3 billion.

If we think about taxes more broadly, it seems likely that the Government will seek much more than a net £6 billion, as it seeks to shift the burden away from outright spending cuts to changes in the way current services are financed.[52] Universities could raise more money from higher student fees and alumni donations, the burden of public transport be shifted from taxpayer to ticket fares, business funding converted from grants to loans, new sector specific charges introduced on the apprenticeship levy model and cultural funding become more dependent on the National Lottery.

Departmental spending – £20 billion

Assuming the Government finds no additional money from tax or welfare, it will need to save £20 billion out of departmental budgets by 2019–20 – or £15

51 An assessment of the potential compensation provided by the new 'National Living Wage' for the personal tax and benefit measures announced for implementation in the current parliament, William Elming, Carl Emmerson, Paul Johnson, David Phillips, Institute for Fiscal Studies, 2015

52 Emran Mian provides a good summary of the options in a blog for the Social Market Foundation at Spending Review 2015: Refinancing the State?, September 18 2015, www.smf.co.uk/spending-review-2015-refinancing-the-state/

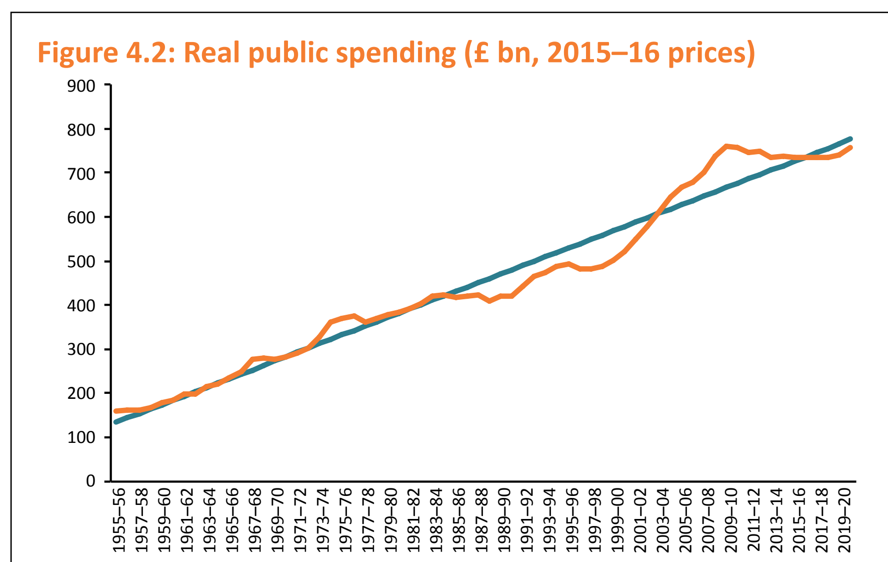
billion if you take account of the savings from pay restraint. This, however, is only an on net number, and doesn't take account of the many spending commitments the Government has already made, including most notably the five ring-fences:

- **Health:** an additional £8 billion in real terms for the NHS by 2020–21
- **Education:** per pupil current spending in schools protected in cash terms
- **Defence:** Ministry of Defence budget to go up by 0.5% a year in real terms, ensuring the UK meets the NATO target to spend 2% of GDP on defence
- **Aid:** Overseas Development Assistance to go up in line with GNP, ensuring the UK donates 0.7% of its economy
- **Investment:** While not an explicit commitment, the Government's current fiscal assumption is for Public Sector Gross Investment to be protected in real terms in 2016–17 and 2017–18, and then as a proportion of GDP from 2018–19 on.

Taking these ring-fences into account more than triples the savings needed from unprotected departments to a real terms cut of 18.8% between 2015-16 and 2019–20, or £24 billion in total. This comes on top of a 25% real terms cut the unprotected departments have already suffered since 2010–11.[53]

Overall, despite all the sound and fury of the Thatcher shrinking of the state, the New Labour investment in public services and the Coalition's consolidation, by the end of this decade we are basically on course to be back on the same trend of real public spending growth as seen in the thirty years from 1955 to 1985.

Figure 4.2: Real public spending (£ bn, 2015–16 prices)

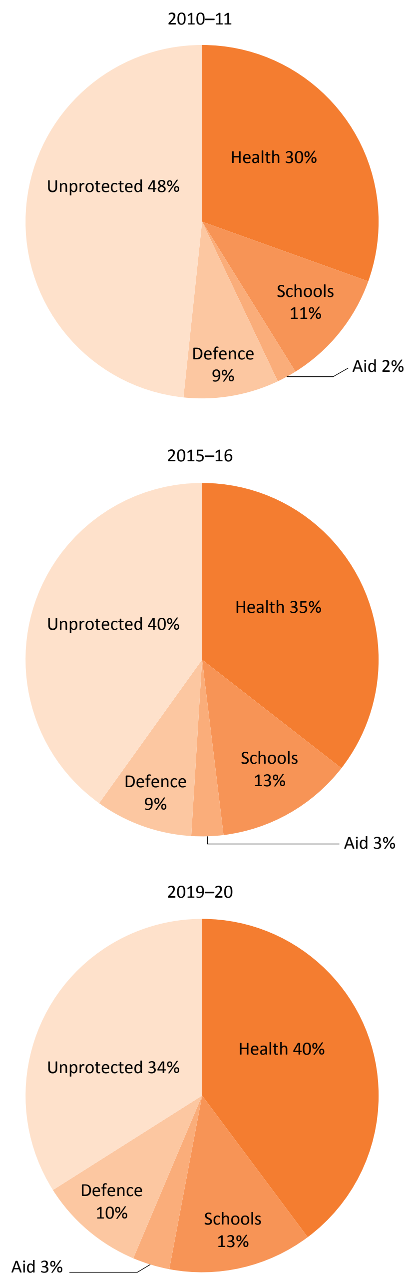


What has really changed is the shape of the spending within that overall envelope. The continued process of expanding and then protecting some areas of spend while cutting others back has led to a significant shift in the shape of the state – with unprotected departments share of current spending falling from around half in 2009–10 to a third by 2019–20.

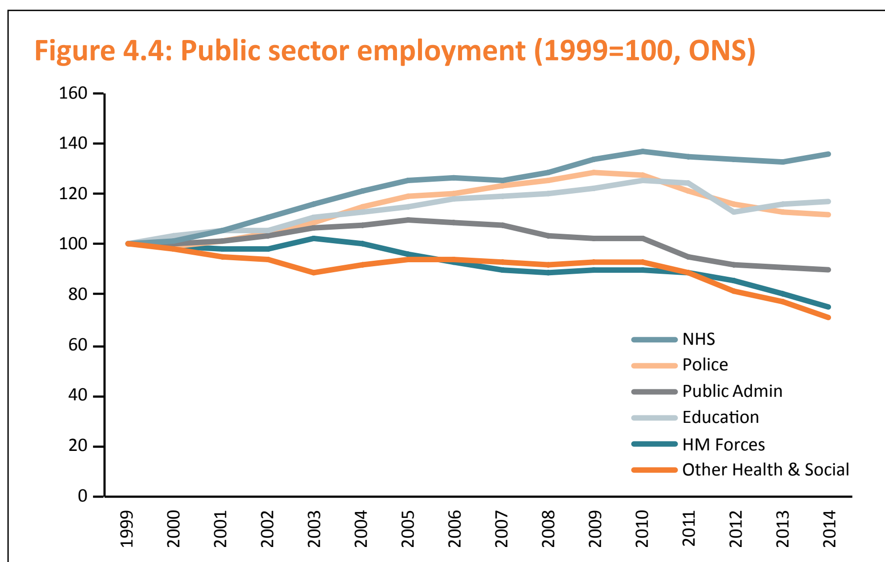
53 The Outlook for the 2015 Spending Review, Rowena Crawford, Carl Emmerson, Gemma Tetlow, Institute for Fiscal Studies, October 2015

Another way to see this shift is to look at the trends in public sector employment. 2000 to 2010 saw a significant increase in employment in the NHS and education – which was halted, but not reversed over the first half of the consolidation. By contrast, the number employed by the police or in the more generic category of public administration has fallen by 13% since 2009.

Figure 4.3: The changing shape of the state (RDEL exc depreciation, PESA, IFS)*



* Unprotected calculated as remainder of RDEL after subtracting protected departments. Doesn't take into account block grants to devolved administrations



Is it really plausible to take another 20% out of unprotected departments over the next four years?

Some have argued that rather than risk damage from further 'salami slicing' of public spending, further savings on the scale required are only plausible through a fundamental restructuring of what the state does.

One frequent suggestion is that we should consider the abolition or merging of whole government departments, such as Business, Innovation and Skills (BIS), Energy and Climate Change (DECC), International Development (DfID), or Culture, Media and Sport (DCMS). However, while there may be good operational reasons for reducing the number of departments and creating a simpler org chart, administrative restructuring is by itself unlikely to save much money without a corresponding radical scaling back of what the new department does:

- Central government administrations make up a relatively small proportion of public spending – 1.5% overall – while the current total admin budget for the four departments is just £ 1.1 bn.[54]
- Even assuming merging departments would completely eliminate their current admin budget, £1.1 bn is probably an over estimate of the potential additional savings given the government is already attempted to save money through sharing backend functions.
- Some rationalisations can save money, especially at the local or QUANGO level where institutional responsibilities overlap. Policy Exchange, for example, has recently suggested consolidating the thirty bodies currently responsible for delivering energy policy into three new bodies.[55] However, this is less true at the departmental level, where reorganisations can easily cost as well as save money. In the past, according to a report by the National Audit Office so-called Machinery of Government changes have tended to cost around £15 million on average, with "limited evidence of measurable benefits, or of reorganisation being the most effective way to deliver those benefits."[56]

54 Public Expenditure Statistical Analyses, HM Treasury, 2015

55 Governing Power: Improving the administration of the energy industry in Great Britain, Richard Howard, Policy Exchange, November 2015

56 Reorganising central government, National Audit Office, 2010

While the potential for administrative savings may be small, the total resource budget controlled by BIS, DECC and DCMS is significantly larger, or £15.6 bn excluding deprecation in 2015–16.[57] Even putting budgetary considerations aside, many believe that it would be a good thing for the Government to scale back on subsidies to elitist arts, inefficient energy supplies or attempts to control the market. However, whatever your ideological predisposition such activities only make up a relatively limited proportion of the three departments' budgets:

- The vast majority of BIS' budget goes on university funding, science and research, or skills, not market frameworks.
- The most controversial subsidies towards energy projects come out of household bills rather than direct taxation, with DECC's biggest costs by far coming from nuclear decommissioning.
- Eliminating all public subsidy for museums, art and heritage might save a billion or so, but would obviously be highly controversial – and break the Conservative manifesto pledge to keep "major national museums and galleries free to enter."

Other decisions would hypothetically save significant sums of money, but are politically unlikely or go against the Government's stated preferences. The Government is unlikely to cancel High Speed 2 – a £4 billion saving – or to renege on its £6 billion triple lock promise on the pledge.

Equally abandoning the ring-fences would make the savings much easier for the currently unprotected departments, but would risk significantly worse outcomes in health and education. Freezing the NHS budget in real terms would save £6 billion, or international development in cash terms just under £1 billion.

In reality, a more significant contribution to further savings is likely to come from further attempts to improve efficiency across the public sector:

- **Central government.** The Cabinet Office's Efficiency and Reform Group believes that central Government can find an additional £15 to £20 billion of savings by 2019–20 through measures such as moving more Government transactions fully to digital and increasing digital uptake, reducing the amount of office space from 10 to 8 squared metres per full time employee by 2018, and centralising a further £10 billion of procurement spend to the Crown Commercial Service by 2019–20.[58]
- **Local government.** In calculating its Future Funding Outlook, the Local Government Association assumes that councils will be able to continue make efficiencies at 1.5% per year tapering to 1% by 2020.[59]
- **NHS.** NHS England's Five Year Forward View – the source of the £8 billion funding gap – assumes 2 to 3% net efficiency gains a year till 2020, more than twice the historic 0.8% average.[60]

The level of achievable efficiency savings will clearly have a significant impact on the extent to which further cuts require scaling back of public services. If we assume unprotected departments can match the promised performance of

57 Public Expenditure Statistical Analyses, HM Treasury, 2015

58 Efficiency and Reform in the next Parliament, Cabinet Office, December 2014

59 Future funding outlook for councils 2019/20 – Interim 2015 update, Local Government Association, June 2015

60 The NHS Five Year Forward View, NHS England, October 2014

the NHS – not unreasonable, given that health has traditionally been one of the hardest areas to improve efficiency in – the 'funding gap' for unprotected departments roughly halves. Combined with the savings from pay restraint, this would significantly reduce the burden of the cuts.

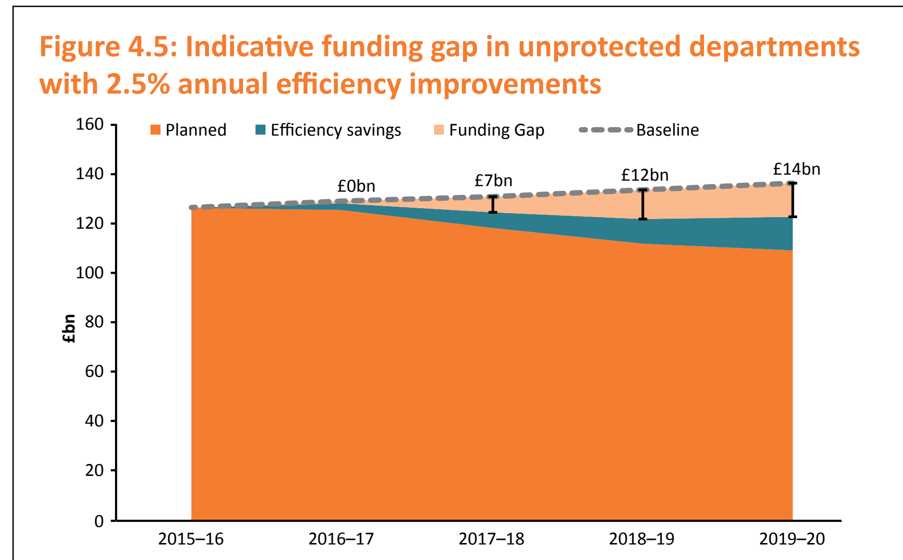


Figure 4.5: Indicative funding gap in unprotected departments with 2.5% annual efficiency improvements

But how do we know what an achievable rate of efficiency improvements is? How do we ensure that so-called efficiency savings really do deliver more-for-less, and not just a hidden reduction in quality? Equally, from the other side, how do we stop unambitious departments from lowballing the achievable level of savings, or being overly protective of bureaucratic empires?

To answer those questions, we need to turn our attention to the process of finding savings: the Spending Review.

5
The Spending Review… and Beyond

The Spending Review

The public sector is complicated. It contains 24 ministerial departments, 22 non ministerial departments, 361 agencies and public bodies, 72 high profile groups, 11 public corporations, and 3 devolved administrations.[61] Every one of those sub organisations is likely to have more than one objective, often conflicting, often hard to measure. Even if we could predict the broad strokes of the evolution of the economy – and all the evidence suggest that we cannot – it is hard to adjust those macro outcomes to the implications for every service or local area.

Given the complexity of the state, and the difficulty in many cases of measuring let alone modelling public sector quality or efficiency, we will never figure out the perfect spending allocation from the centre, or from the one off, adversarial and overly political process of a Spending Review.

The current system of Spending Reviews dates from 1998, which introduced a new system of public spending management through multiple year spending settlements, separate current and capital budgets, and new Public Service Agreements to increase transparency and accountability over outcomes. Under the current process, the Government sets an overall envelope for public spending, and then departments one by one negotiate behind closed doors their individual settlements, the headline results of which are announced at the Spending Review itself.

However, instead of thinking of the Spending Review as something that happens once, every four years, with the bottom line largely decided beforehand, it would be better to think of it as a more iterative, ongoing and flexible process that takes place over the whole course of the Parliament. Without sacrificing the greater certainty that comes from multiple year plans, we should seek a process that can learn and evolve over the course of a Parliament.

There is no perfect way to judge how much money different public services will require in future, and what the trade offs between cost and quality are likely to be. However, even so, there are many flaws in the current Spending Review process:

- **Top down, rather than bottom up.** The UK government is already over centralised, and the Spending Review is if anything even more so. The overall target for spending reductions is set at the beginning by the Treasury – far before the process of gathering evidence on plausible spending reductions has been made.

61 www.gov.uk/government/organisations

- **Too focused on inputs, not outputs.** Given the challenge of measuring productivity, government spending too often focuses solely on what resources have been added ("An extra £ x billion for this cause!") rather than how much good those resources are doing.
- **Little transparency.** Most of the decisions over future spending priorities takes place behind closed doors, with only the very highest level ambitions entering into the public debate – and often through numbers that are hard to interpret and liable to mislead.
- **Overly political.** One reason for the lack of transparency is that as in any other bureaucracy, decisions over spending priorities inevitably become political with every department fighting for the importance of its own cause and insisting future efficiency reductions to be impossible.

Some of these problems are unavoidable. Without the feedback from user choice that comes in a market, it is harder to judge exactly how much value public services are creating. Without the power of competition to experiment and incentivise better performance, there is always the danger that bureaucratic empires will go unchecked. Given that we will never be able to introduce a full market in many public services – and certainly, not in the short term – we will always have to be operating in the world of second best.

A Spending Review probably has to be a top down exercise to some degree, and given the number of trade-offs it has to make will always be centred on human judgement and negotiation.

While it will never be perfect, there are many things we could do to make the process better:

- **Transparency.** How can we increase the visibility to the public of the trade-offs and reassure the public that further savings don't simply mean public services getting worse?
- **Digital.** How can we use the power of technology to improve quality, efficiency and choice in the public services?
- **Devolution.** How can we take advantage of the current shift towards greater devolution to harness the power of local choice, knowledge and experimentation?

Transparency

Nobody knows what the growth rate will be in five years, the level of tax revenues the Government will bring in or the emergency expenses it will have to fund. Despite the widespread recognised difficulty if not impossibility of forecasting, however, most people believe the creation of the independent Office for Budget Responsibility has been a welcome innovation in UK policy. It is not that those employed by the OBR are that much more talented or rational than the old Treasury forecasters, but that formal independence has allowed the OBR to be much more open about its assumptions and judgements. The virtue of the OBR is transparency, not technical expertise.

We face similar problems in trying to judge future required levels of funding. While inputs remain under the Government's control, and many variables such as demographics are reasonably predictable in the medium term, the Government only has a limited idea upfront of how efficiently it can convert its inputs into outputs.

Many people are intuitively sceptical of the whole concept of improving government efficiency, believing it to be analogous to empty promises to achieve savings through cutting 'waste'. The Coalition overcame this scepticism by being as open and transparent as it could about its methods, and having its final calculations double checked by the institutionally independent National Audit Office. Without transparency, many will always simply assume that cuts mean public services are getting worse.

Box 5.1: Is it possible to measure public sector productivity?

In a market, it is a reasonable assumption that when consumers choose a more expensive product it is because they think it is of a higher quality, allowing you to get a measure of output separate from costs – but it is far from clear that the same logic applies to the public sector.

Even worse, in some areas of the public sector, it is not even clear theoretically what it would mean to be productive. How do you value the return from an extra aircraft carrier or maintaining an independent nuclear deterrent? What about policies on which reasonable people differ if this is a moral end or not – should we value creating additional 'punishment' in the prison, or solely its effectiveness at lowering crime? For decades, official statisticians found these problems too hard, and effectively gave up, assuming that public sector productivity was eternally constant at 1, with outputs in the national accounts set equal to inputs. But even if it is hard, ignoring productivity altogether is a recipe for wasteful spending, poor quality of cuts and bad prioritisation of resources. There is already a bad tendency in public discourse to mistake inputs for outputs, seeing spending however many billion as a proxy for how much we care about an issue, rather than recognising that many problems cannot simply be solved by throwing more money at them.

While there is no single method or one number that can measure the quality of public services, by taking into account a range of metrics we can get a reasonable picture in the round:

- **Country wide comparisons.** International league tables like the OECD's PISA tests for education or the Commonwealth Fund ranking of health care systems can give a big picture view of how resources are converting into outputs. Even after taking into account differences in living or wage costs, there is relatively little connection between amounts spent and relative performance. On a more one off basic, the recent McNulty report into value for money in the railways drove much of its analysis from a benchmarking exercise, comparing the cost of British rail to four other European countries.[62] However, while a good sense check, such comparisons are generally too broad brush to give much actionable advice, while any contrast is always tainted by differences like culture and geography that remain out of politicians' control.
- **Controlled policy counterfactuals.** At the other end of the scale, we sometimes have reasonable evidence of the impact of individual policies through the use of Randomised Control Trials, which can be converted into a monetary figure through the use of standardised figures such as Quality Adjusted Life Years in medicine.
- **Pure efficiency at producing outputs.** We can divide overall productivity intwo two stages: how efficient are we turning a set of inputs into a set of concrete

62 Realising the Potential of GB Rail, Report of the Rail Value for Money Study, Summary Report, May 2011

outputs, and then how effective are these outputs at creating the outcomes that we actually intended?[63] In many cases, the first step is significantly easier to measure than the second – it is much more straightforward to calculate how much it cost DVLA to print a licence or hold a test than the effectiveness of that test in enhancing road safety.

- **User feedback.** Surveys of consumer experience are sometimes dismissed as too soft or overly subjective, but ultimately the best judge of the quality of any given product or service is probably the user themselves. The private sector has extensive experience at developing surveys to measure seemingly softer values like customer satisfaction, and while online feedback measures like Amazon or TripAdvisor scores can be overly polarised, few believe that there is no connection at all between quality and a product's star rating.

The current ONS public sector productivity statistics uses a mixture of methods. In some areas such as police and defence where the outcome – security – is collectively consumed, the ONS has no choice but to use the old outputs=inputs, constant productivity assumption. In other areas, such as social care or prisons, the ONS judge efficiency through a direct measurement of outcomes such as care home places, prisoners or caseloads in a court. Finally, in health and education the ONS actually tries to make some judgement over effectiveness through quality adjustment based on variables like survival rates, waiting times, patient survey data and GCSE exam results.

Under the current system the OBR has no way of assessing whether forecasts for departmental forecasting are actually plausible or not, and what the likely implications for the output of public services is. While future tax revenues or welfare expenditure are estimated from bottom up forecasts of demographic change or growth, departmental spending is calculated as a remainder of whatever is left after these forecasts are deducted from the Government's assumption for total public spending. This can lead to drastic changes in forecast departmental expenditure, despite little shift in the outlook of economic fundamentals. The OBR's forecasts for the 2014 Autumn Statement, for example, showed current departmental spending falling from £316 billion in 2015–16 to £280 billion by 2019–20, with many believing that this level of savings impossible.[64] By the July 2015 Summer Budget, thanks to added welfare cuts and a slower path of deficit reduction, current departmental spending was instead set to rise to £320 billion.

In order to better judge the impact of future savings we need to know two things: what services the Government planning to stop altogether or at least fund from a different source, and at which rate can the public sector improve its efficiency or productivity.

Lots of numbers were thrown around in the run up to the election – but almost nobody knew what they meant, or what they implied for the public spending. Did the Conservatives target for £30 bn of further cuts represent only "saving £1 a year in every £100 that government spends"[65] or did it threaten to gut the welfare state, taking us back to Wigan Pier and the 1930s? Were both Labour and the Conservatives broadly committed to fiscal responsibility, balanced budgets and deficit reduction, or did voters face "an epic choice [between an]... eye-watering

63 Growing the productivity of Government Services, Patrick Dunleavy and Leandro Carrera, 2013

64 See, for example, Bloodletting analogies or Don't get Levels and Rates of Change confused, Giles Wilkes, Freethinking Economist, June 2014

65 The Conservative Party Manifesto 2015

shrinkage of the state… [and] deficit-reduction plans… so mild it is amazing how controversial they are within [Labour].”[66]

Equally, any future spending plans include an implied assumption about the future path of productivity, and it would be better to make this assumption explicit. Whether you believe the NHS will ever be able to sustainably improve its efficiency improvements above its long term average of 0.8%, for example, has big implications for how big you think the size of the state will be in the 2020s and whether taxes will need to go up. What doesn't get measured doesn't get managed.

“Equally, any future spending plans include an implied assumption about the future path of productivity, and it would be better to make this assumption explicit”

While measuring productivity is hard enough, what we really want Government to know is not past performance but future capacity for improvements. While the Government currently doesn't produce a forecast for future efficiency as it does spending and taxes, there is a reasonable level of precedent of this kind of calculation across the wider and quasi public sector:

- **Efficiency assumptions in funding projections.** As previously mentioned, the NHS's Five Year Forward View presented three scenarios for the next five years, demonstrating the impact of assumed 0.5%, 1.5% and 2–3% rates of productivity improvement. Similarly, the Local Government Association has produced its own funding outlook, based on continuing efficiency gains of 1–2% per year.
- **Targeted efficiency savings in central Government.** After co-ordinating £20 bn in efficiency savings over the last Parliament, the Cabinet Office's Efficiency and Reform Group has set out an ambition for a further £15–20 bn in new savings over the next five years. These savings are theoretically forecast – and ultimately measured – on a bottom up rather than top down approach. The cash released from each initiative is compared against a baseline of what the Government would have spent with no policy change, and the total aggregated to produce the final figure.
- **Assumed efficiencies for regulated industries.** While the state has often been reluctant to forecast its own productivity, it has been much less averse to deciding reasonable goals for price regulated industries. In general, under regulatory systems such as RPI-X, the regulator in principle allows prices to rise with inflation minus assumed reasonable efficiency gains – with companies allowed to keep any difference from outstanding performance as profit. No consistent method has been used to generate this efficiency assumption, with regulators largely using their own judgment of the best methodology. Ofgem, for example, based its assumption of 1.5% efficiency gains for electricity and gas transmission price controls on a business plan submission, the Civil Aviation Authority set a 1% assumption for Heathrow and Gatwick based on bottom up assessments of potential savings, while Ofwat based its assessment for the water sector by assuming the sector should be able to match the productivity performance of comparable industries.

66 Mightly different, Bagehot, The Economist, Jan 17 2015

More concretely, successive recent Governments have sought to improve performance management, striking the right balance between clarity over targets and avoiding perverse consequences. New Labour launched Public Service Agreements alongside the first Spending Review, incorporating 600 targets over 35 areas of Government – but over the next decade the number of targets was significantly reduced. Under the Coalition, Public Service Agreements were replaced with Business Plans that would focus on the actual actions to be taken rather than targeted outcomes – although the plans later came to include impact indicators as well, somewhat blurring the difference. By the end of the last Parliament, there were over 207 impact indicators across government, from the number of FDI projects attracted to the UK to emergency hospital re-admissions within 30 days. According to the Institute for Government, across the Government as a whole over half of the indicators showed improvement between 2010 and 2015, although that was by no means the case for every department.[67] The new Government has announced the creation of Single Departmental Plans to bring together "efficiency, spending round and activity plans."[68]

At the same time, the last Government built on the precedent of NICE in the NHS to launch seven independent What Works Centres to collate together evidence on effective policy in health and social care, education, crime reduction, early intervention, local economic growth, elderly quality of life and well-being. Alongside these seven centres, there are also two similar bodies for Wales and Scotland, a new Independent Commission of Aid Impact and, of course, the OBR itself. While none of these bodies can be a substitute for democratic judgment, by separating out some independent accountability they help to provide some checks and balances to the overall policy making ecosystem. In an ideal world, evidence shouldn't be political.

In reality, social science is often seriously flawed,[69] while many policy initiatives fail as much from badly implemented pilots or lack of iteration as from structural flaws. The overriding message of many of the What Works centres so far is that in much of what the public services do, we simply do not know what works. We don't want to create bureaucratic gatekeepers or make potential failure so embarrassing as to slow the process of experimentation.

Nevertheless, while literature reviews or simplistic targets shouldn't override judgment, it is equally a mistake to ignore data altogether. The share price, profit or consumer satisfaction aren't the only numbers that matter when deciding corporate strategy, but a private sector CEO is still likely to know them all off by heart. Given the emergence of big data on the technological side or ever greater diversity from devolution, we are likely to soon enter a golden age of data on public sector outcomes.

The Government is already collecting much of the right information, but much of it remains buried away on obscure parts of Gov.uk and data.gov.uk, or worse, kept internally to a department. Government business plans have not been substantially updated since 2013, and many of the impact indicators suffer from hard to access or incomplete data. At present, discussion of what we want our public services to do and how much we are prepared to spend is kept almost completely separate during political debate. While the possibility of missing a spending or deficit target is enough to drive weeks of speculation in the press, business plans and impact measurements seem to have little impact on parliamentary debate.

How can we increase the transparency of what the Government plans to achieve, and not just what it plans to spend?

67 Whitehall Monitor: Deep Impact, Institute for Government, 2015

68 Clarifying our priorities - Single Departmental Plans, John Manzoni, 29 July 2015, https://civilservice.blog.gov.uk/2015/07/29/clarifying-our-priorities-single-departmental-plans/

69 Is Economics Research Replicable? Sixty Published Papers from Thirteen Journals Say "Usually Not", Andrew C. Chang and Phillip Li, 2015

Policy recommendations

- **As part of future Spending Reviews, the Government should encourage greater focus on outcomes over incomes by setting explicit efficiency targets for each department, and regularly updating the new Single Departmental Plans and key metrics alongside spending totals.** The best laid plans will go awry, while as in the regulated industries no efficiency assumption will be perfect. Nevertheless, openly stating its assumptions will give a much better idea of the degree to which the Government plans to balance the budget through cuts and efficiency gains – and in many departments these forecasts can ultimately be compared to outturn data, which the ONS is already looking to significantly speed up the publication of.

  The new Single Departmental Plans should not be a one off exercise, but regularly updated documents giving the public much greater transparency of not just spending numbers but what the department plans to achieve and what it plans to cut. Secretaries of State should give an annual update to Parliament and the relevant Select Committee on progress against the plan, highlighting what assumptions have changed, what the trends are from impact measures and user feedback and how plans are evolving going forward.
- **The mandate of the What Work Centres should be expanded to improve the evidence base of policy.** What Work Centres need to move from being purely passive summarisers of existing literature to active generators of new evidence. Between them, What Work Centres and the OBR should randomly review a proportion of policies each year, assessing how well the assumptions lying behind their business case has held up. In addition, they should be given the power to ask a department or devolved authority for a public response if they believe the opportunity is being missed to properly measure the impact of a new policy through randomisation, a control or both. In the long run, we should aim for What Work Centres to review Impact Assessments before policy is approved, separating the creation and auditing of new policy.
- **The OBR should consult on a standardised fiscal consolidation metric, and producing bottom up forecasts of departmental spending alongside Budgets and Autumn Statements.** At present, the Treasury produces its own numbers through a relatively opaque methodology, which differs substantially from the approach taken by, say, the IFS in calculating consolidation, the approach used pre-election to estimate an additional '£25 billion' of cuts were needed[70] or the OBR in its own one off estimate of total consolidation.[71] Producing a standardised methodology would give a common currency for the fiscal plans of different parties to be judged against each other. If they wished, parties could then have their fiscal plans and final number audited by independent consultancies, as UKIP already did at the last election. This would give much of the benefit of currently popular proposals for the OBR to audit opposition manifestos, while avoiding the danger of overly politicising the OBR itself.

On an ongoing basis, the OBR should audit the efficiency assumptions produced by individual Departments, and use them to produce a bottom up forecast of future predicted levels of departmental spending and implied cuts. The

70 Figuring out Cameron's spending cuts, Chris Giles, Financial Times, October 15 2014

71 Crisis and consolidation in the public finances, Jon Riley & Robert Chote, September 2014

Government can still produce an assumption for overall spending (Total Managed Expenditure) levels, but the OBR should be able to flag up if these look likely to clash with its other assumptions on efficiency or tax revenues.

Digital

In the private sector, digital technology has transformed productivity. The automation of the assembly line has allowed manufacturing output to grow with an ever diminishing number of workers. Precise controls of logistics chains pioneered by Walmart, and then copied by British supermarkets like Tesco, revolutionised productivity in the retail sector, cutting the cost of the weekly shop for customers. Comparison websites like TripAdvisor have created a new era of transparency and consumer power. Near costless split A/B testing has created a culture of near constant experimentation and refinement for companies like Google, while the power of cloud services like Amazon S3 have made it easier than ever before to scale up a new company.

Like many entrenched bureaucracies, the public sector has by contrast struggled to stay up to date with the latest technology. In 1999, five years after the launch of Yahoo!, the 68,000 staff working for the Government's benefit agencies only had access to 8 PCs capable of getting online. 2001 saw a real push by the Department of Work and Pensions to get rid of paper – but it was telephones and call centres that they were racing to take advantage of, not the nascent web. As late as 2007, 95% of VAT returns were still made on paper.[72] From the UK's infamous NHS contract to the botched rollout of Obamacare, Government IT contracts are widely seen as a joke.

But that doesn't mean the public sector will never be able to take full advantage of tech, using it to radically lower costs, increase choice and improve quality. Previous General Purpose Technologies like the steam engine only reached their full impact many decades after their initial invention as business models and supply chains slowly adapted. Just as the internet is only now reshaping physical industries like urban transport or hospitality, the Government was always going to be a relative laggard. However, in the long run there is no reason to believe that the final impact of technology on the public sector will be any less transformative than in retail, publishing or the music industry.

Digital technology offers three central benefits to the public sector:

- **Automation.** While much of the recent hype has been on the 'rise of the robots', or cars that drive themselves, automation has had a big effect on routine administrative and cognitive work as it has physical. In the future, algorithms can take over the bulk of many roles, from administering benefits to marking maths exams, significantly lowering costs.
- **Prevention.** Reducing demand is potentially as important as increasing supply. Tech can make this much easier, from identifying crime hotspots or benefit fraud to drops in a child's grades or early diagnosis of health problems. Using digital nudges can make it easier to encourage good habits, from paying tax on time to cancelling GP appointments you cannot attend.[73]
- **Communication.** Instant feedback can improve consumer power in the public as well as the private sector, while telepresence and constant alarms make it easier for the truly vulnerable to get instant help.

72 Growing the Productivity of Government Services, Patrick Dunleavy and Leandro Carrera, 2013

73 http://policybytes.org.uk/people-who-liked-nudge-also-liked-digital-nudge-2/)

While widely admired internationally, the last Government's digital strategy is best seen as a proof of concept – a minimal viable product – laying the foundations, rather than the end product. The new Government Digital Service led the development on converting 20 exemplar transactions to digital by default, saving money and generally improving user experience at the same time. The proportion of Jobseeker's Allowance claims made online increased from just 9.5% in September 2010 to 86.1% by July 2015.[74] The Gov.uk Performance website offers instant access to the latest cost and user satisfaction data for hundreds of government services, while elsewhere the introduction of Real Time Information for PAYE and digital tax accounts should see the end of the annual tax return, and a potential revolution in the tax and welfare system.

The eventual goal of many is to create what is often termed 'Government as a Platform" (Gaap). To start with, this would involve breaking down the silos between different departments, services and datasets in Government. Rather than have every Department try to do everything itself through expensive, custom solutions, the focus would be on building common services that could be shared across Government: such as the new Gov.uk Verify system, allowing users to prove their identity and usable by many government services from applying for a driving licence to renewing tax credits. Even more significant, collaboration could increasingly take place not just internally within Government, but across and out to the private and third sectors as well, allowing anyone with a new idea to build off government infrastructure and open data. Just as Apple does not build every app for an iPhone, as Government develops Gaap it should seek to create a market and platform for public services, not control or try to build all of them itself. The interaction between Government and citizen needs to be redesigned to make sense from the user's perspective – joined up, custom, intuitive and instant – not just to meet the legacy of bureaucracies often decades or centuries old.

However, many barriers still exist in the way of achieving truly digital government. To start with, there is the pure scale of what still needs to be accomplished, digitising the rest of Government's over 700 transactions, and with a likely reduced budget and headcount for GDS. Fundamentally, the public sector is always going to struggle to attract the best star programmers to work in the sector rather than chase inevitably higher wages from a Google or the excitement of a start-up. Future transactions are likely to prove harder to deliver full channel shift to digital on, especially as the Governments runs into groups that are less comfortable on the web. 23% of UK adults still don't possess the basic digital skills to do things like use a search engine or send an email.[75] Given the shortage of common standards and open API, many datasets do not work well together, making it hard to get a fully joined up view of government. Harder than the technological problems, however, will be the cultural and institutional issues. No incumbent likes being disrupted, but to make real cashable savings will require co-operation across departments and basic redesign of how services work.

Policy recommendations

- The Government should commit fully to the adoption of Government as a Platform. **However, GDS should develop GaaP as a platform on which**

74 http://digitalleaders.co.uk/2015/09/an-evolved-role-for-gds-helping-to-deliver-the-post-bureaucratic-age/

75 www.go-on.co.uk/issue/

others can build, rather than trying to construct all its components in-house. Just as Google does not build all the apps for the Android operating system, GaaP should allow government to benefit from the best innovation, experience, expertise, security and economies of scale of the private sector. Creating a digital core to Government will create a cheaper, more flexible, innovative and empirical public sector – but will not happen without full buy-in from the centre of Government.

The principles behind GDS now need to be extended out to the rest of the civil service, with GDS itself focussed on defining and promoting standards rather than trying to do everything itself. Where possible Government data should move to open standards, with an aim of making this legally mandated by 2025. Where this is not practical or cost effective, the Government should explore the use of low-cost, software-based 'middleware' to convert between old and new standards.

- **Every single part of the public sector that is consumer facing should have a standardised feedback page on GOV.UK, giving a rating for user satisfaction and allowing individuals to send in private comments.** User satisfaction for a school or Job Centre should be as transparent to the public as the rating for a book on Amazon, hotel on TripAdvisor, or for that matter, GP surgeries through NHS Choices. The form should also be embeddable in external websites, and also incorporate data accessed from other sources, such as feedback from text messages. Individual organisations could also choose to make their feedback public, although this will not be appropriate in every case.

This process already exists for all centrally run government digital services. As part of the digital by default agenda, every service is obliged to collect data on four Key Performance Indicators: cost per transaction, completion rate, digital take-up and user satisfaction. The latter is measured by a standard GOV.UK feedback page, which feeds into service dashboards on the central Performance platform (www.gov.uk/performance):

GOV.UK

Home

Give feedback

Overall, how did you feel about the service you received today?

- Very satisfied
- Satisfied
- Neither satisfied or dissatisfied
- Dissatisfied
- Very dissatisfied

How could we improve this service?

(Limit is 1200 characters)

Please don't include any personal or financial information, for example your National Insurance or credit card numbers.

Send feedback

However, much of data on user satisfaction from the wider public sector either exists in inconsistent formats, or isn't collected at all. The data that does exist rarely filters out into the wider political discussion – it is not included in the Treasury's Budget or Spending Review documents, let alone influence OBR fiscal forecasts or political debate. The Performance Platform is a good start, but we need to go further to collect consistent data, and then make it more visible to end users and political stakeholders.

This data can be built on the precedent set by the introduction of the NHS Friends and Family Test in 2013, where every patient visiting AE or staying overnight is asked "How likely are you to recommend our <ward / A&E department> to friends and family if they needed similar care or treatment?" Such data is inevitably crude, not perfectly representative and often unfair to overworked providers. Nevertheless, it is not random either: early results suggest that the data has a strong correlation with scores from the more systematic NHS Inpatient Survey, and some correlation with mortality data.[76] Moreover, by being fast, frequent and giving open-ended user comments, it allows providers to learn rapidly about problems and course correct. Equally, despite initial fears by staff, in many cases feedback has also helped to identify what they are already doing well. 85% of NHS trusts report that the Friends and Family Test has been helpful in improving patient experience.[77]

"85% of NHS trusts report that the Friends and Family Test has been helpful in improving patient experience"

At the same time, alongside these more informal ratings, each Department should commission monthly opinion polling of their core stakeholder groups as a secondary source of information. It is inevitable that every policy change will produce some losers, while survey data can be affected by factors such as the overall economy or the season. Nevertheless, confidence in fiscal consolidation would be much improved if we had time series data on users of adult social care, and could see trends in overall satisfaction. Rapid falls should at least raise an amber light.

Data is only useful if it is used. The UK Government is a world leader on opening up its data, and in some cases, such as urban transport, this has already led to a range of innovative new products. In others, it is still not easy enough for users to get access to the kind of data that would enable reach choice. The Government should commission the equivalent of online comparison site operators for the public sector to ensure the rapid production of simple league tables. In addition, trends in user satisfaction data needs to be included in departments' annual updates to their Single Departmental Plan, increasing its political visibility.

- **Local government should make much greater use of digital, with the creation of a Local Government Data Marketplace and a new Mayor's Office of Data Analytics (MODA) for major cities.** Instead of seeking to replicate the GDS model for local authorities, the Government should establish a new platform in which suppliers and authorities can come together to request or

76 www.bmj.com/content/346/bmj.f2960/rr/655809

77 Review of the Friends and Family Test

bid on custom apps, algorithms or datasets. Solutions would be based on open standards, and designed to easily scale across the sector.

Major cities such as London or Manchester, however, should create their own Mayor's Office of Data Analytics, based on the model employed in New York to combine, analyse and interpret public datasets. In New York, MODA has helped better identify illegal conversions, identify builds in danger of greater fire risk and model the economic effect of streamlined regulation. For a city like London, its own version of MODA could help authorities better share services, identify empty or unsafe houses, fight fraud, or highlight the best place to start a new business.[78] All this could be done largely based on existing datasets – rather than wait for the development of a future 'smart city'.

Devolution

Just as it is impossible to micromanage every area of the front line from Whitehall, central government should devolve decisions whenever possible to the local area. Every local area is different with different needs, and a single ring-fenced national funding formula is unlikely to be efficient. Devolution allows for experimentation, and learning from difference. Inevitably, front line staff are more incentivised to innovate or cut costs the closer to the decision making they feel. Even voters are more likely to accept the merging of two hospitals if they believe it is a decision taken by local officials rather than imposed from on high.

Like other unprotected departments, local government has already seen around a quarter cut in real terms since 2010–11. (Central government funding has gone down by more than this – around 40% – but some of the gap has been made up from increased council tax income.) For the most part councils have sought to protect statutory services, seeking cuts instead from more discretionary services like planning and housing. So far, local government has done relatively well at finding much of these savings from greater efficiencies, with over 95% of English councils now sharing some services such as back office functions to deliver greater efficiencies of scale.[79] Many councils have actually increased their reserves. This process will grow significantly harder in the current Parliament, with the Local Government Association predicting a £9.5 billion funding gap by 2019–20, larger than the total amount that local government spends on what you might consider administration such as central services and capital financing.[80] The National Audit Office has complained that the Department for Communities and Local Government only has a limited understanding of the potential for local authorities to cut further without hurting service levels.[81]

One area that is particularly concerning is the impact of further spending reductions on social care. The extent of these cuts was limited in the last Parliament through a combination of efficiency savings, sharing resources from the NHS and redirecting money from other local government budgets. Nevertheless, research by Age UK found that day care places for social care still dropped by two thirds between 2010–11 and 2013–14, at home help by one third and getting meals on wheels by 64%.[82] Over the current Parliament, it is only likely to get harder to redirect funding from savings elsewhere, while the sector faces increased costs from an older population and the new National Living Wage, creating a £700 million funding gap for adult social care.[83] Social care is particularly concerning because many of its recipients are those who will struggle most to raise the alarm if quality does drop.

78 Big Data in the Big Apple, Eddie Copeland, Capital City Foundation, 2015

79 Under pressure – How councils are planning for future cuts, Local Government Association, 2014

80 Future funding outlook for councils 2019/20 Interim 2015 update, Local Government Association, 2015

81 Financial sustainability of local authorities 2014, National Audit Office, November 2014

82 Social care cuts 'major cause' of A&E problems, Nick Triggle, BBC News, 21 January 2015

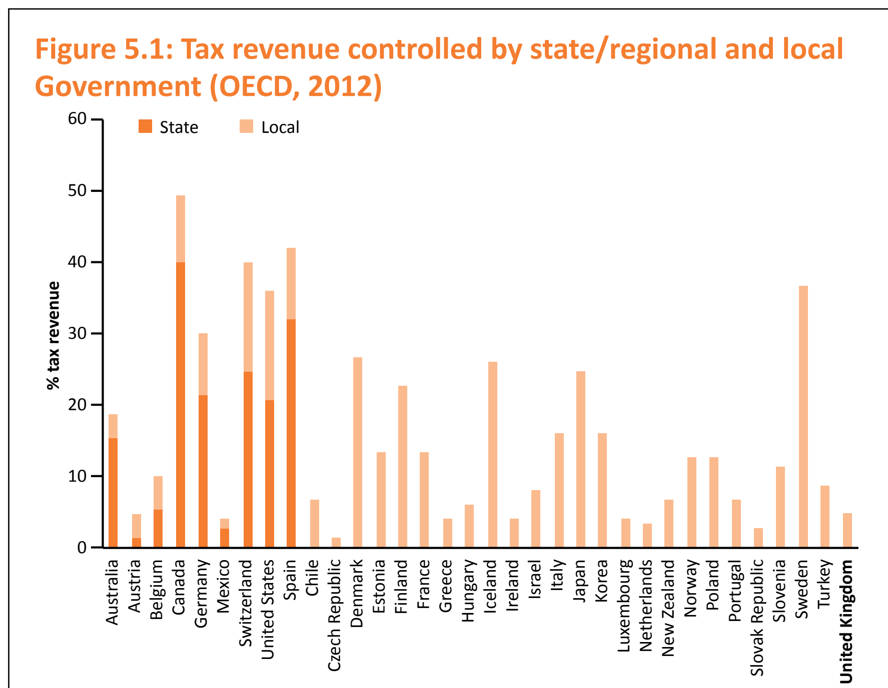
83 Adult social care, health and wellbeing: A Shared Commitment, Local Government Association, September 2015

While the challenge will grow harder, many local councils still have the potential to make significant savings through greater use of shared services and integration between joined up budgets. In the last Parliament, the Government piloted Whole Place Community Budgets in which the silos between different funding streams are broken down, and local public service providers work together with a single pooled budget to improve outcomes. One estimate suggests that scaling up the efficiencies planned for in the pilots could save anywhere from £4.2 to £9.7 billion a year.[84] Greater Manchester Combined Authority believes that by taking full control of its health and social care systems and creating multi-disciplinary neighbour teams to assist clients with more than one problem it can make a significant inroad into its £1.1 billion funding gap.[85]

But in order to unlock the greatest savings, we need to trust local authorities with greater responsibility. As many have noted, the UK has one of the most centralised tax systems out of the advanced economies, with just 4.9% of tax revenue controlled by subnational levels of government compared to an OECD average of 14%.[86] Devolved further powers and spending without symmetrical responsibility for tax risks creating a culture of dependency, and little incentive to make the best long term decisions.

While some fear that devolving powers to tax will simply lead to massive tax increases and reduce the pressure for reform, internationally fiscal decentralisation is associated with smaller and more efficient Government, with one study finding every percentage point increase in the share of local government also increases public sector efficiency by one point. The evidence on devolution's impact on growth is mixed, but there is some evidence that greater devolution of tax responsibility can boost long term growth – and particularly so for countries that are as centralised as Britain.[87] It is particularly notable how in the UK seven of the largest English cities outside London have actually seen growth below the national average, whereas in other European countries like France, Italy and Germany they have tended to be the strongest performers.[88]

Figure 5.1: Tax revenue controlled by state/regional and local Government (OECD, 2012)



84 Whole Place Community Budgets: A Review of the Potential for Aggregation, Ernst & Young, January 2013

85 A Plan for Growth and Reform in Greater Manchester, GMCA, March 2014

86 www.oecd.org/ctp/tax-policy/revenue-statistics-levels-of-government.htm

87 Taxpayers for Fiscal Decentralisation, Matthew Sinclair in A U-Turn on the Road to Serfdom, Institute of Economic Affairs, 2014

88 Decentralisation Decade, Ed Cox, Graeme Henderson and Luke Raikes, IPPR North, 2014

Policy recommendations

- **The Government should introduce a standardised annual tax statement for local government, including basic detail of that council's performance compared to regional and national averages.** Early on, the Coalition Government scrapped Labour's 'Comprehensive Area Assessments, believing them to be overly top down, bureaucratic and ineffective. At one point, the National Audit Office estimated the cost of monitoring local government to be as high as £2 billion a year. Nevertheless, the Government didn't abandon the principle of transparency, producing a range of new league tables over the Parliament from the performance of local areas in planning to premature death to adoption.

  While many local authorities do as well or better than central government in the level of transparency they provide, it can still be difficult for often disengaged voters to judge the performance of their council, and the trade-offs they are being asked to judge on between taxes and quality. The Government should build on the precedent of the new annual tax statement for national government, creating a template for local authorities that include basic metrics about the performance and user satisfaction of the area's schools, hospitals, facilities and care systems. Inevitably, such numbers will be on the surface be unfair, looking worse in areas that suffer from greater deprivation – but we should trust in voters to be grown up enough to make their own adjustments for this.
- **After greater transparency is in place, we should phase out the current system of Council Tax referendums.** Under the current system, local authorities must hold a binding referendum of the public if they seek to raise council tax by more than an 'excessive' amount in a year – currently set at 2%. In the long run, however, both this and the previous system of capping undermine accountability, and prevent the kind of local responsibility and feedback that devolution is supposed to encourage.

  The Government has already given councils devolved powers over business rates to encourage a better link between stewardship and performance of local economies. Granting greater discretion over council taxes is the logical parallel step for local services. In the long run, we should seek to give councils full control over setting their rates and levels of council tax, with ten year independent reviews to adjust revenue grants. As an intermediate step, we should phase out the current referendum system, and in the short term significantly increase the national 'excessive' level up from 2%. This should not be taken as a signal for all councils to immediately hike their bills – and those that did would be named and shamed in the next set of tax statements – but would provide some flex for those councils that were genuinely struggling to fund, for example, social care.

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