

# **SPENDING WISELY**

Principles for a good  
spending review

The first report of the Fabian Commission on Future  
Spending Choices

**FABIAN  
SOCIETY**

## ABOUT THE FABIAN SOCIETY

The Fabian Society is Britain's oldest political think tank. Since 1884 the society has played a central role in developing political ideas and public policy on the left. It aims to promote greater equality of power and opportunity; the value of collective public action; a vibrant, tolerant and accountable democracy; citizenship, liberty and human rights; sustainable development; and multilateral international cooperation.

Through a wide range of publications and events the society influences political and public thinking, but also provides a space for broad and open-minded debate, drawing on an unrivalled external network and its own expert research and analysis. Its programme offers a unique breadth, encompassing national conferences and expert seminars; periodicals, books, reports and digital communications; and commissioned and in-house research and comment.

The Society is alone among think tanks in being a democratically-constituted membership organisation, with almost 7,000 members. Over time our membership has included many of the key thinkers on the British left and every Labour Prime Minister. Today we count over 200 parliamentarians in our number. The voluntary society includes 70 local societies, the Fabian Women's Network and the Young Fabians, which is itself the leading organisation on the left for young people to debate and influence political ideas.

The society was one of the original founders of the Labour Party and is constitutionally affiliated to the party. We are however editorially, organisationally and financially independent and work with a wide range of partners from all political persuasions and none.

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## About the Fabian Commission on Future Spending Choices

The Fabian Commission on Future Spending Choices is a year-long inquiry established to examine public spending choices for the UK Government for the period 2015-2020. It is considering how the UK can reduce its fiscal deficit in a way that maximises prosperity, security, sustainability and social justice. The remit of the inquiry is the UK Government so excludes decisions devolved to Wales, Scotland and Northern Ireland. The commission has conducted its work through eight evidence hearings, by seeking submissions and by commissioning background evidence papers. This work has been supported by an expert advisory network.

The Commission is considering: the purpose of public spending and the values and criteria which should be adopted for determining spending allocations; pressures and priorities for public spending, including issues of long-term sustainability; likely scenarios for overall expenditure between 2015 and 2020; economic reforms which might reduce demand for public spending; how public spending can best support growth, jobs and earnings; and how the public sector can manage with less money. This first report considers the context and process for spending choices after 2015.

## Acknowledgements

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## The Commissioners

**Lord McFall of Alcluith** (chair) is a Labour peer and was Chairman of the House of Commons Treasury Committee, a position which he held between 2001 and 2010. He currently serves on the House of Lords Economic Affairs Committee.

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## **Emerging conclusions:** The process of spending choices

This report examines how improved institutional arrangements could lead to wiser spending choices. At this stage in our work we have identified a number of proposals which merit serious consideration and debate. We are exploring the following options:

### **Accountability**

- Publication of major government spending plans in draft for consultation
- A new Budgetary Committee of the House of Commons
- The Office for Budgetary Responsibility (OBR) to report to parliament with an expanded remit
- A new Office for Public Performance to advise on the quality and outcomes of public spending
- A citizen's tax statement to show how public money is spent

### **Spending Reviews**

- A return to a regular cycle of spending reviews, which will need to align with the new electoral cycle.
- A long-term expenditure statement at the start of each parliament setting out the government's view on the direction of travel for 10 or 20 years
- Using budget 'caps' and 'ringfences' mainly to communicate decisions and priorities at the end of the spending process, so as not to override participative, bottom-up decision-making.
- New fiscal rules which commit future governments to a significant reduction in debt over time

### **Better public spending**

- All spending decisions published with accompanying 'year one' and 'year ten' costs
- A '10 year test' for assessing the wider costs and benefits of all decisions across the public sector
- The possibility of future governments mandating budget holders to 'switch' a proportion of their budget from existing activities to early interventions
- The use of accrual accounting to genuinely inform budget choices
- More flexibility for councils and public corporations to borrow by not including some of this debt within national debt (subject to tight policing to preserve fiscal discipline)
- More spending power for city regions and clusters of local authorities, with the possibility of structural reforms at this tier in the future
- Greater local government involvement in how all money is spent locally
- Preserving the capacity of public management so that the public sector is able to make and evaluate wise spending choices

# OVERVIEW

This is the first report of the Fabian Commission on Future Spending Choices which was established to consider the public spending options for a government coming to power in 2015. The report is published to coincide with the 2013 spending round. It looks beyond current short-term debates to ask whether we are having the right sort of conversation about public spending; and what new principles, processes and structures can improve spending decisions.

The backdrop for our work is the very grave fiscal challenge the UK continues to face. The government has a high budget deficit and a high level of public debt, as a consequence of the financial crisis and the great recession. In the coming years debt and deficit must both fall and that will significantly limit the options for future spending choices. There are no easy answers and uncomfortable choices will have to be made.

## A different sort of conversation

We think a different sort of public conversation about spending is needed. In this report we set out the ways in which we want the conversation to change. In the next stage of our work we will consider how such a change might be achieved, including how to better engage with the public.

### Constrained alternatives

Until the public finances are in good order people should talk about 'constrained alternatives' rather than 'no alternative'. On current projections a government that wishes to close the deficit during the next parliament could commit to a narrow range of spending choices for 2016/17 and 2017/18. These range from a real cut of one per cent per year to a real increase of one per cent a year. The former (ie rapid deficit reduction and large reductions to departmental budgets) is not necessarily better for the long-term health of the economy and the public finances.

Any choice in this range will place severe constraints on public spending. The coalition's current plan is to cut overall spending after 2015 slightly, which will mean reducing department budgets at a faster rate than during the current parliament. However, a future government can choose a more hopeful and optimistic alternative that is likely to be more supportive of growth. If it chose to increase total spending by one per cent a year and other factors remained unchanged then departmental spending cuts would be far less significant than currently envisaged, although the consequence would be

tax increases or a longer period of deficit replacement. Spending in 2017/18 would be around £20 bn higher than currently envisaged. There would still be difficult trade-offs to make within overall spending totals, but ministers would have more scope to rebalance spending with a strategic, long-term perspective. In our next report we will consider the spending choices facing a future government under these two alternate scenarios.

The performance of the economy will have a far greater impact on the deficit than alternative choices regarding overall spending. The gap between GDP growth and spending growth is the main factor determining how quickly the deficit closes, so when GDP is rising at a reasonable rate there is a wider range of spending options. For this reason we recognise the case for time-limited investment and capital spending while the economy is still weak, as long as this does not create permanent expenditure commitments. However, this report does not consider the size or design of short-term stimulus measures, and these are not included in our scenarios for the spending envelope.

### Talking about debt

The national debt should be thought of as a ‘mortgage’ not a ‘credit card’: while we must not ignore the size of the deficit or public debt, it is the affordability of repayments and the direction of debt over decades that matters most; the value of ‘peak’ debt is only one factor to take into account. Future fiscal rules should commit government to a significant reduction in debt over the medium term. If sustainable long-term growth is restored there is room for cautious optimism as previous governments have been successful in reducing public debt fairly quickly.

### How much should we spend?

On current plans and assumptions, at the end of the austerity period (ie 2017/18) UK public spending is expected to comprise around 41 per cent of GDP. This is the level public spending stood at in 2007, before the crisis began. So, due to the contraction of the economy in recent years and relatively modest economic forecasts, spending as a share of GDP will not be low by historic standards when austerity comes to an end. This confirms that a future government in 2015 may have only limited room to spend more than is currently planned by the coalition.

At some point in the next parliament the austerity programme will come to an end. From that point onwards governments should plan on the basis of expenditure rising roughly in line with trend GDP growth, unless ministers wish to change the size of the state relative to economic output. If they do, they should say so and lead a public conversation on the trade-offs, since recent research suggests the British public is broadly content with the balance of spending and taxation.

### How should we spend?

We need more public conversation about how money is spent today. The starting point should be to re-state the value of public spending. Government expenditure is essential for: economic growth, investment and stability; dis-

tribution and sharing risks over people's lifetimes; reducing inequality and spreading opportunity; and maintaining security.

Many people would feel reassured if they knew more about how their money is spent. For example people over-estimate how much is spent on unpopular social security entitlements. Current public concern about working-age social security is at odds with the downward path of future spending in this area. On the other hand the public supports high spending on many large areas of expenditure facing future upward pressures, not least the NHS and state pensions. We therefore support moves to introduce citizens' tax statements.

Upward pressures on spending are significant but misunderstood. Demographic effects are less important than popularly imagined and will add one per cent of GDP to spending between 2017 and the early 2030s. Non-demographic upward pressures are less predictable but likely to be larger in scale, as past experience suggests that changing social needs, rising expectations and public service cost pressures will push up spending.

### A debate about priorities

These upward spending pressures in important and popular areas of 'social insurance' could crowd out future 'investment' spending on education or economic infrastructure. We therefore need a debate about the long-term balance between 'social insurance' and 'investment' spending; and about whether people will tolerate more taxation to make the trade-offs between the two areas easier.

Fortunately these debates are a little less difficult than they first appear because significant sums of unallocated money will gradually become available as a result of 'fiscal drag'. Retaining current indexation policies for social security and personal taxation until the early 2030s would free up the equivalent of £70bn by today's standards. Although observers question whether these indexation policies are sustainable, they have been in place for many decades. Indexation rules could be changed in the future but there are other alternatives regarding how the money is used: the money could be returned to tax payers in other ways; used to meet rising pressures for 'social insurance' and 'investment' spending; or it might need to be spent on social security to prevent widening income inequality. The point is, there are choices.

In our next report we will say more about the possible path for long-term spending. But we believe that asking the right questions is just as important as giving the right answers. It is time for explicit discussions about the spending choices facing the UK over the next few decades.

## Principles and process

We support a long-termist, principles-led approach to future spending choices which can be brought to life by a range of reforms.

### A clear direction of travel

Elected political leaders rightly wish to respond to people's immediate needs and aspirations, so processes and structures are needed to avoid the

long-term perspective being overlooked. We would like to see a return to a regular cycle of spending reviews, which will need to align with the new electoral cycle. In advance of a spending review ministers should begin the process by publishing a 'long-term expenditure statement' setting out their intended direction of travel for the next 10 or 20 years. This will prevent governments taking incremental decisions without giving thought to their long-term implications. This statement should also set out ministers' views on the main long-term challenges facing the country (requiring action over several parliaments) and how these relate to future spending priorities. Examples include climate change, pensions and public health.

### Spending principles

Future governments should announce clear principles that will guide their spending choices. At this stage in our work, we propose the following eight principles:

- Work backwards from the outcomes you wish for and ask how these can be achieved in partnership with others
- Invest in prevention and early intervention
- Demand productivity improvements, innovation and citizen participation
- Promote broad-based growth, employment and prosperity
- Distribute resources and insure risk across the life-cycle
- Reduce inequality, poverty and unequal opportunities
- Take a long-term, global perspective
- Conserve the 'public character' of activities at risk of being undermined by market forces

### Consider spending, tax and non-fiscal choices side-by-side

Decisions on spending, tax and other related policy decisions are often presented separately and at different times. But spending and taxation are frequently alternative policy choices, for example in improving the living standards of low-income households. And with severe fiscal constraints government should look to non-fiscal policy levers first, such as auto-enrolment in pensions. As part of this agenda ministers should encourage 'pre-distribution' interventions, although these are unlikely to realise major financial benefits for government in the short term.

### Embedding long-term decision making

All spending decisions should be accompanied by 10-year assessments, with 'year one' and 'year 10' costs published prominently. The wider costs and benefits of policies, for society and for other parts of the public sector, should

also be considered by adopting a '10 year test' as proposed by the early action taskforce. In future it may be necessary to go further by mandating budget holders to 'switch' a certain proportion of their annual spending from existing activities to early interventions.

Long-termism should also be further embedded into government accounting, building on important changes made by the previous government. Accrual accounting should be used more to inform future decisions not just to present past accounts, so that: spending which creates an asset receives due attention; the full costs of future liabilities are transparent; and plausible risks of future liabilities are recognised. Ministers and the Office of National Statistics should consider whether some forms of self-financed borrowing should be excluded from the normal measure of national debt, to give local authorities and public corporations greater ability to operate without undue hindrance. This would however need to be well policed and regulated so that it does not undermine overall fiscal discipline.

### Localism, blurred lines and experimentation

Rigid central allocations of local budgets may inhibit preventative interventions, make it harder to join-up services around users and lead to duplication. Analysis of the case for localism is beyond the remit of this commission, but we believe that local money can be spent better than today:

- City regions and clusters of local authorities should have a greater role, both to achieve efficiencies and because they are the right tier for many strategic economic functions. A future government may need to consider structural reforms, as today's piecemeal initiatives could prove insufficient.
- Local government should have more influence over all money spent locally, even if each agency retains its own budget. This will facilitate a blurring of lines between budgets and joint decision making.
- Central government should push for a culture of experiment and innovation, even within existing national financial and accountability frameworks.

### Transparency, performance and new institutions

Better spending choices require a more open and consultative process. We recommend that future governments set out 'draft' plans in advance of major spending decisions. They should also seek to reduce the unnecessary complexity of the information on spending reported to parliament and the public. We would like to see debate on structural reforms to give parliament much more involvement and oversight in the spending process. First, we think there may be a good case for creating a Budgetary Committee separate from the Treasury Select Committee, which has a huge remit and lacks sufficient resources. Second, the Office for Budgetary Responsibility (OBR) could be re-established with an expanded remit, reporting to and advising parliament, along the lines of the US Congressional Budget Office. Third we want to explore the creation of a new institution dedicated to improving the quality

of public spending: an Office for Public Performance. This powerful arms-length body, which might report to ministers or parliament, would police the quality of public spending and help build public trust and understanding. Working alongside the National Audit Office it would be a centre of excellence and champion to shift to outcomes-focused spending decisions; support continuous productivity improvements; drive out inefficiency and poor practice; and promote effective prevention and early intervention.

### A more participative approach to decision making

Decisions should be taken in a more participative fashion, with greater opportunities for involvement by frontline workers and citizens. The decision making process should be flexible and iterative. Ministers should therefore avoid making definitive top-level decisions early in the process. 'Caps', 'ring-fences' and other limits should ideally be decided at the end of the process, as a tool for communicating priorities and implementing decisions: if they are set too early they can distort spending choices and reduce opportunities for participation. We prefer an approach where individual entitlements and programmes are reviewed from first principles, in partnership with all the relevant stakeholders, looking at effectiveness and asking what could be achieved with less money. This is sometimes called a 'zero-based' approach although, as a methodology, 'zero-based budgeting' has significant limitations. However, decisions can't always be made from 'a blank piece of paper' and we believe that proponents of radical rebalancing of spending can risk ignoring the downsides of many proposals to 'switch' spending.

### The capacity of government

We need strong government to serve the economy and society. Only government can respond to emergencies like the financial crisis or can plan over decades, as with pension reform or de-carbonising the economy. But there is another sense in which we need strong government: the public sector needs to have the capacity to govern and spend well. In this year's spending round and in 2015 ministers should consider whether government at every tier has sufficient capability to make sound spending decisions which maximise cost savings and social benefits for the long term. Sooner or later depleted management and oversight capabilities will start to impede wise spending choices.

# 1 INTRODUCTION

The Fabian Society Commission on Future Spending Choices is an inquiry on the public spending choices facing the next UK government, in the period 2015 to 2020. Its remit is to consider how the government can reduce the fiscal deficit and secure long-term financial sustainability in a way that maximises prosperity, security, sustainability and social justice. The commission's focus is the UK government so excludes decisions devolved to Wales, Scotland and Northern Ireland. Since November 2012 we have reviewed a wide range of evidence, through eight evidence hearings; a call for evidence; and background working papers. This first report is published to coincide with the 2013 spending round and makes recommendations on how we think spending decisions can be made more wisely. Our final report in September will consider the content of the decisions facing the government coming to office in 2015.

The backdrop for our work is the very grave fiscal challenge the UK continues to face. The government has a high budget deficit and high level of public debt, as a consequence of the financial crisis and great recession. In the coming years both must fall and that will severely limit the options for future spending choices. There are no easy answers and uncomfortable choices will have to be made.

The last few months have been a busy time for the politics of public spending. This report is published just after the government published its departmental spending plans for 2015/16, the year of the next election. The coalition has previously announced how much it intends to spend in total for that year and for the following two. In the last month the Labour party has also announced its approach to fiscal policy, declaring that if it wins the next election it will only adjust the government's 2015/16 resource spending plans with limited and fully-costed variations. Labour has not signed-up to the coalition's spending plans for 2016 and 2017 but it has promised to keep a tight lid on spending, first by saying it will not be able to reverse most coalition cuts and second by instructing the shadow cabinet to prepare for falling departmental spending. Finally, all three main parties have agreed to the principle of an upper limit on social security spending to take some of the pressure of austerity off departmental budgets.

This report stands back from the immediate debate about spending totals and budget allocations and asks two questions. First, are we having the right sort of conversation about public spending? And, second, do we have the right principles, processes and structures for making spending decisions?

Although the Fabian Society is affiliated to the Labour party this inquiry has been conducted on a non-party basis and we encourage politicians from all sides to consider our findings and recommendations on how to spend more wisely.

# 2

## A DIFFERENT SORT OF CONVERSATION

We think a different sort of public conversation about spending is needed. In this report we set out the ways in which we want the conversation to change. In the next stage of our work we will consider how such a change might be achieved, including how to engage better with the public.

### Constrained alternatives

Britain will continue to face major public spending pressures for several years to come. But we believe the language in which these pressures are described can and should change. Instead of the polarising mantra ‘there is no alternative’ we think people should think in terms of ‘constrained alternatives’. Better public spending decisions will be made if ministers explain that they have options but also why these are severely limited by economic constraints. Until the public finances are on a firm footing the deficit must be reduced each year, but there are credible alternatives in how this is achieved regarding the split between spending cuts and tax rises; and in the number of years taken to reduce borrowing.

Indeed the last few years have demonstrated that the choices ministers make between ‘constrained alternatives’ (between the ‘Darling’ and ‘Osborne’ plans, for example) have far less bearing on the public finances than the underlying performance of the economy. The public conversation on spending should therefore begin with economic growth. In times of rapid economic growth large imbalances in the public finances can be corrected very quickly as revenues rise and spending falls back relative to the expanding size of the economy. This has been the story after ‘normal’ recessions, most recently in the 1990s when a budget deficit of seven per cent of GDP was eliminated through five years of roughly flat public spending.<sup>1</sup>

The evidence we have taken suggests that similar GDP growth in the next few years is conceivable but unlikely.<sup>2</sup> But the critical point is that, whatever GDP growth turns out to be, public spending must rise by considerably less in order for the deficit to narrow.<sup>3</sup> It is this gap between growth in spending and growth in GDP that matters, not whether real spending is rising a little or falling a little.

Assuming the economy does not start to grow rapidly, a government that wishes to close the deficit during the next parliament could commit to a narrow range of spending choices for 2016/17 and 2017/18. These range from a real cut of one per cent per year to a real increase of one per cent a year.<sup>4</sup> On current projections the former scenario might in principle close the deficit by

2016/17, but only if cuts did not have adverse impact on economic growth at this fragile time for the economy. Under the latter option the public finances would be restored to good health by around 2019/20, or earlier if the extra spending boosted growth or tax rises were introduced alongside this revised spending profile. The coalition's current plans lie somewhere between these two points and envisage real reductions in spending of a fraction of a per cent each year. This translates into larger departmental spending reductions each year than in the current parliament.

Spending profiles within this range could form the basis of a credible plan for closing the deficit. By contrast plans for annual real spending increases of two per cent could not: at least without major tax increases or unexpectedly high growth. This is what we mean by 'constrained alternatives'. It is possible for a future government to choose a different path but within constrained parameters.

The choice between these two scenarios is somewhat analogous to the choice confronting the electorate before the 2010 election, between the 'Osborne' and 'Darling' plans for deficit reduction. As events have shown a plan for more rapid deficit reduction involving further real cuts is not necessarily better for the long-term health of the economy and the public finances. It could be advantageous to adopt a more gradual pace of reduction, with more money targeted towards government activities that supports supply-side economic capacity.

We also prefer the language of 'constrained alternatives' because there is a climate of false precision when it comes to the public finances, given today's high levels of economic uncertainty. Politicians on all sides try to portray the plans of their rivals as extreme and irresponsible when their proposed alternatives would make far less difference to the UK's fiscal position than different scenarios for the performance of the economy. Independent analysts such as the OBR and Institute for Fiscal Studies (IFS) could also do more to support debate on 'constrained alternatives' by assessing the consequences of alternative spending profiles. Their current analysis is highly informative, but usually focuses on the plans of the government of the day not the credible range of alternatives which political parties might consider. This may increase the ability of the incumbent administration to set the terms for debate.

The greatest potential constraint on public spending in the next parliament would be prolonged economic stagnation. If the economy continues to underperform, further spending reductions (beyond the coalition's current plans) may become unavoidable whatever the political convictions of the next government. For this reason we recognise the case for time-limited investment spending while the economy is still weak, as long as this does not create permanent spending commitments. Such short-term spending to boost economic output might reduce the need for permanent reductions to expenditure in the future. However, this report does not consider the size and targeting of short-term stimulus measures as we assume they would come to an end before the end of the next parliament. We have also ignored the possibility of time-limited stimulus in setting out spending scenarios for after 2015.

On the other hand if the economy performs roughly in line with today's expectations we believe the next government will have choices, including the option of deviating from the coalition's current plans while maintaining fiscal credibility. In place of the coalition's current plan to cut overall spending after 2015 a future government could offer a more hopeful and optimistic alternative with a very slight increase in real total spending (annu-

ally managed expenditure (AME)). In the absence of unexpectedly strong economic growth this would be possible if the government was prepared to raise taxes or reduce the deficit more slowly.

Promising a slight rise in spending could have important implications for the options facing the next administration. On the coalition's current plans for small overall cuts to AME, current departmental spending (departmental expenditure limits (DEL)) is predicted to fall by around eight per cent over 2016/17 and 2017/18.<sup>5</sup> This is because most other areas of government spending are fairly fixed so all the effects of budget reductions are channelled into these areas. By contrast an overall real increase in AME of one per cent in the same two years would result in spending in 2017/18 being around £20 billion higher than under current plans. This extra money could result in current departmental spending hardly falling (less than one per cent per year). This opens up more flexibility for an incoming government regarding spending options. There would still be difficult trade-offs to make within overall spending, but ministers would have more scope to rebalance spending taking a strategic, long-term perspective.

In our next report we will return to these two spending scenarios and consider what each might mean for the allocation of public spending between priority areas.

## Talking about debt

One reason why it has been hard for the 'constrained alternatives' narrative to gain traction is because of popular misunderstanding regarding national debt. Debt has been portrayed as a 'credit card' which should be paid off just as fast as possible, rather than as a 'mortgage'. Public debt should be seen through a long-term prism: while we must not ignore the size of the deficit or public debt, it is the affordability of repayments and the direction of debt over decades that matters most; the value of 'peak' debt is only one factor to take into account. And just as with a mortgage, public debt can be a path to prosperity rather than just an unfortunate necessity. Debt is a virtue when it is used to invest in future wealth creation or acts as a shock absorber in times of crisis when the alternative would be greater human misery.

Public debt in the UK is also relatively low, compared to the standards of British history and contemporary international norms.<sup>6</sup> Historically British debt has been associated with war and the cost of repayment has been significant; but past debt has always been paid off and the country has never come close to insolvency. We are not complacent about debt but a slightly slower pace of deficit reduction or a one-off stimulus which adds to the total stock of debt would not be destabilising, as long as the next government has a long-term, credible and transparent plan for reducing debt in future years. Many commentators have argued that modest increases to debt-funded spending in the next few years would support growth, including over the long-term if it was well targeted towards increasing the UK's economic capacity.

Thinking about the long-term path of debt cuts through some highly technical debates regarding fiscal rules. While no set of rules will ever be free from criticism, the aim of any sensible rule should be to demonstrate that public debt will remain under control over the medium and long term. In Labour's period in office this was taken to mean keeping debt stable; the current government decided to be judged on the timing of 'peak' debt; and we believe

that the benchmark for the next government should be the credibility of its plans to substantially reduce debt over time. This might take the form of a specific medium-term debt target, along the broad lines of proposals by the IPPR, or a more qualitative approach, with an independent and authoritative appraisal of the sustainability of government plans, as proposed by Jonathan Portes of NIESR.

Detailed work on fiscal rules is beyond our remit, but in our work we have assumed that a future government will be committed to achieving sound public finances in the next parliament and gradual reduction of debt for the decades that follow.

## How much should we spend?

The attention paid to the deficit and public debt in recent years has been understandable. But it has obscured the equally important question of how much the government should spend as a share of our national wealth. We believe this should be a subject of more open political discussion. Before the financial crisis public spending comprised 41 per cent of economic output, a figure marginally below the British average for the last 50 years and middling when compared to other OECD nations.<sup>7</sup> Public spending then peaked at 48 per cent of GDP a level last seen in the recession of the early 1980s. It is now declining but there has been no public debate regarding how much it should decline by. In other words, once the public finances are in good health does the UK wish to be a medium, high or low spending nation, relative to international and historical norms?

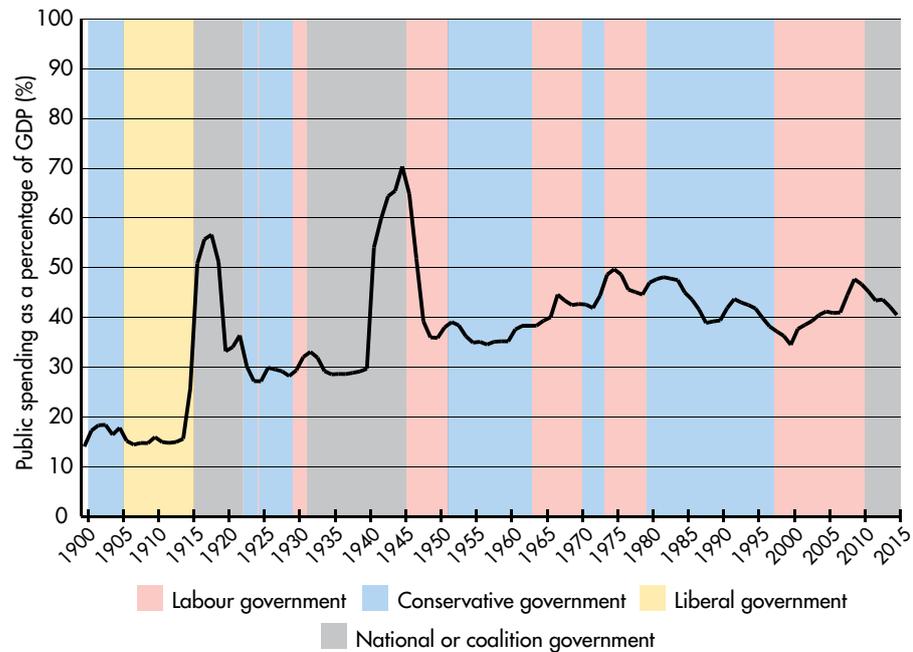
The coalition government's original intention was to 'overshoot' Britain's historical average for public expenditure by closing the deficit almost entirely through spending reductions rather than tax rises. This approach was justified in terms of efficacy rather than ideological commitments to a smaller state. However as a result of flat growth and the economy being smaller than expected this aspiration will not be achieved: by the time the deficit is closed spending as a share of the economy is now forecast to fall back to roughly the level at which it stood in 2007. It is sobering that after a decade of economic crisis, stabilisation and austerity the public finances will be back exactly where they started, at least according to current projections: as a share of GDP public spending, tax receipts and the deficit will all be pretty much identical in 2007/08 and 2017/18.<sup>8</sup>

How much governments choose to spend is a matter of democratic choice but historic and international comparisons are relevant. With spending in 2017 set to be similar to the New Labour peak there will be at most limited scope for a future government to raise expenditure relative to the size of the economy, particularly since the British public remains resistant to tax rises commensurate to the public services they say they wish to see. This reinforces our message of 'constrained choices': there will only be tightly restricted scope to raise spending after 2015.

Historically, over most of the last century, public spending increased at times of crisis but never quite fell back to previous levels after they were over: spending rose as a result of events rather than plans. Then for 25 years until 2000 there was a downward trend on spending. Although linked to neoliberal politics, the immediate cause of this decline was rapid economic growth in the late 1980s and then the late 1990s, which was not matched by

similar spending rises. In government Labour allowed spending to fall to a post-war low of 35 per cent of GDP in 2000 by continuing with the spending plans of the previous administration. It then made an unusually specific and open choice to change direction, and reversed this decline in the following years. By 2007 it was spending slightly less than the average of the previous 50 years, before spending jumped as a share of GDP as a consequence of the economic crash.

Figure 1: Public Spending as a share of GDP, 1900-2015



So it appears that periods of sustained growth, rather than economic crisis and recovery, are the times when there are the most opportunities to make planned changes in the size of the state. Labour’s ‘stop-start’ record after 1997 shows governments have choices during periods of growth and these can have a significant impact relatively quickly. It may seem far too early to be thinking about ‘after austerity’ but it is important to recognise that once the public finances are in good shape the default should be for spending to rise in line with trend GDP, unless politicians wish to embark on a structural change to public spending as a share of GDP. There was little debate along these lines during the New Labour years and we believe this is one reason why there has been so much subsequent disagreement about Labour’s record on public spending.

While many political partisans on both left and right worry about the size of the state, talking in these terms makes little sense to the public. What people want to know is: whether they will receive good quality services and provision; that money is spent effectively; and that resources are fairly distributed in line with their common-sense notions of need and desert. However in 2012 Fabian Society research discovered little public appetite for the state to do less. There was broad support for existing public provision and the current balance between spending and taxation. The British Social Attitudes Survey reports similar results.<sup>9</sup>

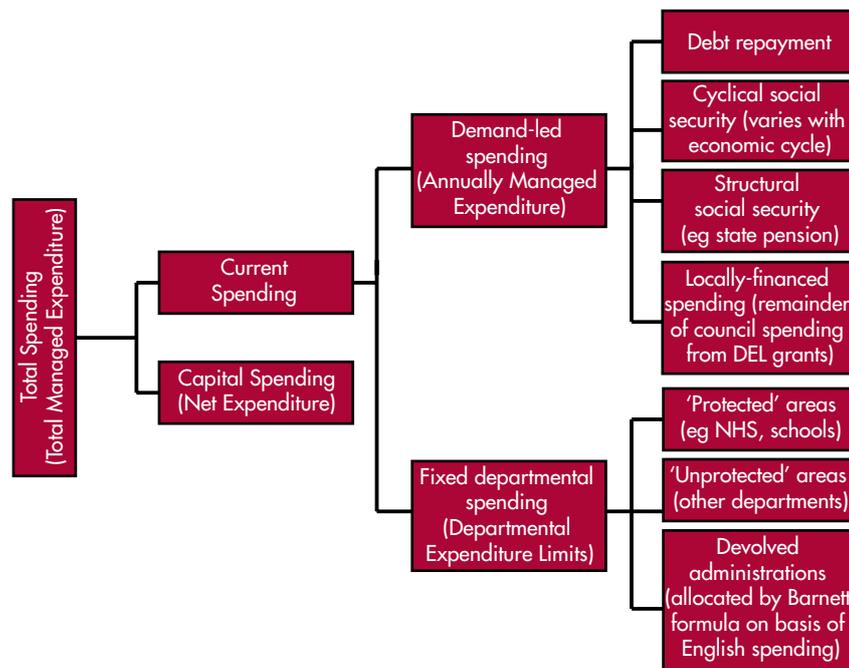
Future pressures point to spending remaining flat or rising slightly over

time, as we shall explore. But we think it is important to have an open conversation about these matters. If political leaders wish to change the long-term pattern of spending as a share of GDP, they should say so.

### How should we spend?

Drilling down beneath overall spending totals the conversation on public spending must be bewildering to most people. As Figure 2 demonstrates, making sense of public spending is a tricky business. During our hearings we took evidence on the balance between key 'blocks' of spending. We heard arguments that there should be a shift towards capital spending to invest in future supply-side economic capacity. We also heard concerns that demand-led spending (AME) is now greater than departmental spending over which the Treasury has annual control; and that so many areas of departmental spending are 'protected' by ringfences. As a consequence of high AME spending, when the government wishes to control spending the impacts on departmental spending are greatly amplified; and when large areas of this departmental spending are 'protected' the effects on the other departments are amplified still further.

Figure 2: Types of public spending



Within AME, social security is the largest area of spending. Some of this varies cyclically as a consequence of the economy and will decline automatically as the economy recovers and unemployment falls (eg social security spending increased by £15bn in the two years after 2007/08).<sup>10</sup> However most social security is not cyclical (eg pensions; tax credits for low paid working families; disability benefits). The government and the Labour party are now both proposing that some of this structural spending should be capped over the medium term.

You need to know all this to get a grip of the changing shape of public

spending during this parliament, so it is little wonder that understanding is low. The government originally intended to decrease total spending, but what has actually happened has been ‘shifts’ not ‘cuts’. Planned spending reductions for unprotected departments have been implemented (a 20 per cent fall in real current spending from 2011/12 to 2015/16). But the poor performance of the economy has meant that cyclical social security has remained very high and debt interest has increased. Meanwhile spending on pensioners has risen as planned, and spending on the NHS, schools and international development has been flat. The total effect is that spending is projected to be identical in real terms in 2015/16 as it was in 2011/12.<sup>11</sup>

Unpicking this sort of complex story is always going to be difficult, but public understanding could be improved if we talked more about how we spend money today and the likely future pressures on spending.

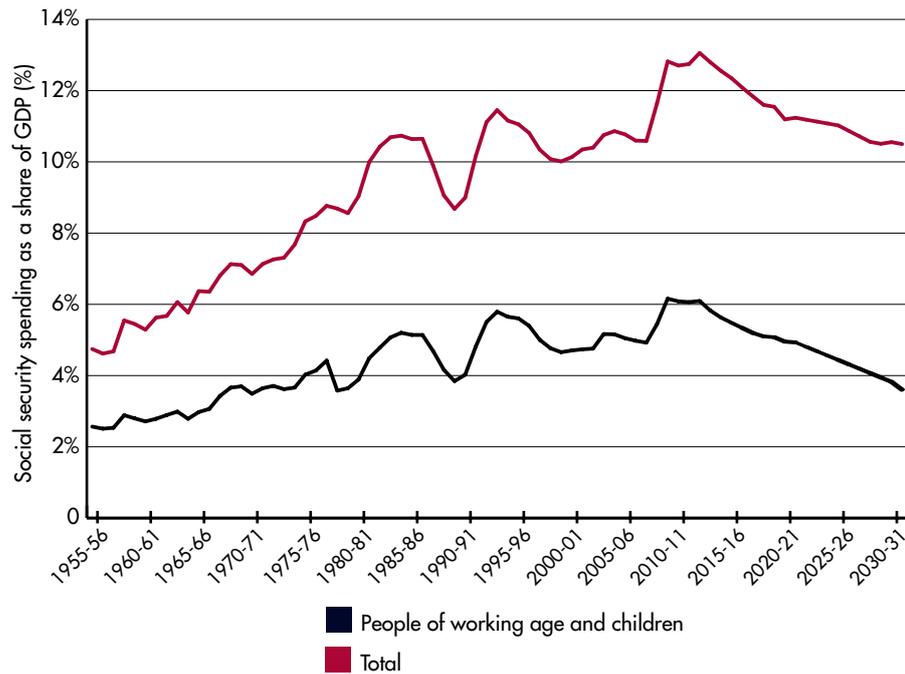
The starting point should be to re-state the value of public spending. Government expenditure is essential for providing the conditions for a flourishing society and for a productive, fair and efficient economy. In our hearings the following examples of ‘the case’ for spending were proposed:

Figure 3: ‘the case’ for spending

Security	Addressing market failures and externalities
Economic investment	Providing shared ‘public’ goods
Economic stability	International solidarity
Distribution of resources and sharing of risks over our lifetimes	Reducing inequality and spreading opportunities

Many people would feel reassured if they knew more about how their money is spent. For example contemporary concerns regarding working-age social security expenditure are out of sync with reality: the UK actually spends relatively little in this area compared to its other spending commitments; in recent times spending as a share of economic output has been flat, except for the effects of the economic crisis; and with current policies spending will fall for the foreseeable future.

Figure 4: Social security spending as a share of GDP (working age and total)

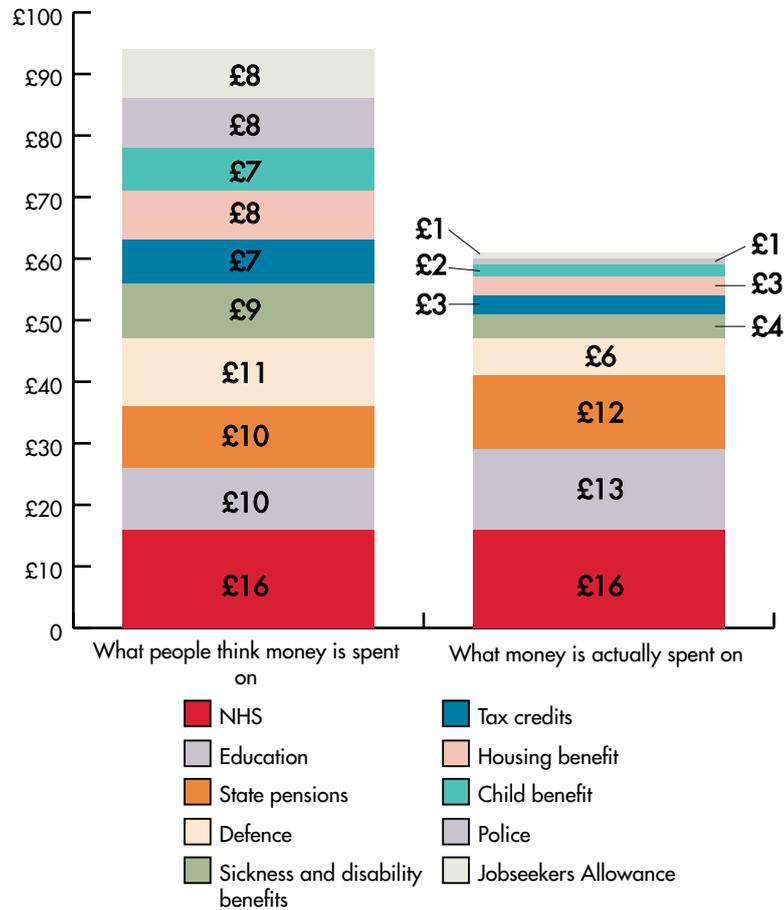


Source: 1955/56 to 2017/18, GB benefits and tax credits, DWP; 2018/19 to 2031-32, 'UK spending projections', Fiscal Sustainability Report, OBR 2012 (adjusted for current indexation policies)

Recent Fabian Society research (see figure 5) showed that people overestimate how much the government spends on most of the main working-age entitlements including job seeker's allowance (JSA), tax credits and housing benefit.<sup>12</sup> This is unsurprising given the high public concern about benefit spending and it suggests that greater awareness of how their money is spent might help provide some reassurance.<sup>13</sup> By contrast people's estimates of the amount spent on larger and more popular areas of spending are surprisingly accurate. In particular, the public correctly guessed that the NHS, state pensions and education are the largest areas of public spending and these are among the most popular too.

We therefore believe that politicians will reap rewards by taking more time to explain how public money is used today. This could increase the legitimacy of public spending and taxation and also help frame debates about the options and constraints for future spending choices. For this reason we endorse the recommendation of the 2001 Fabian Society Commission on Taxation and Citizenship for the publication of citizens' tax statement setting out how the public's money is spent.<sup>14</sup>

Figure 5: Thinking about all of the many things that government spends its money on, how much out of every £100 of government money do you think is spent on the following things?



Source: Fabian Review, Summer 2013

Some commentators describe the public’s strong commitment to many large and established areas of spending as an unwelcome constraint on political choices.<sup>15</sup> We prefer to see it as positive sign of consent for the long-term future of the welfare state. Importantly, there is strikingly strong public support for those areas of spending facing the greatest upward pressures, namely the NHS and state pensions.

These upward pressures are significant but often misunderstood. Demographic effects are important but less so than is popularly imagined. Assuming no change in policies, the ageing of the population is expected to add one per cent of GDP to spending on age-related provision between 2017/18 and the early 2030s.<sup>16</sup> This is undoubtedly a challenge for the public finances, but it would still leave spending on these areas below their 2010 levels as a share of GDP (because the annual effects of demographic change are an order of magnitude smaller than the impact of austerity). Meanwhile there is little evidence that population ageing will diminish public revenues or overall economic performance.

Non-demographic upward pressures on spending are less predictable but they are likely to be larger in scale. Over the last 100 years changing social

needs, rising public expectations and politicians' attempts to respond have resulted in rising social spending, decade after decade. It would be a major rupture if this process were to come to an end. In the 20 years prior to the financial crisis, across governments of both complexions, spending on health, education and social security increased by five per cent of GDP and most of this was unrelated to demographics.<sup>17</sup> Within public services, cost pressures are particularly acute since rising earnings over time mean that more money needs to be spent to deliver the same level of service, let alone improve provision. The OBR projects that these cost pressures could increase NHS spending by 1.6 per cent of GDP by the early 2030s, over and above the effects of ageing or rising public expectations.<sup>18</sup>

We want to see an open public conversation on spending pressures over the coming decades. If past trends continue it is easy to imagine public expectations, demographics and public service cost pressures combining to lead to rapid spending increases in areas like health and pensions. These are important and popular examples of what we call 'social insurance' spending: expenditure that distributes money across our lifetimes and insures us all against likely risks, on a collectivist, normally universal basis. But such rises could crowd out equally important spending that will boost future economic potential; what we call 'investment' spending, on education or economic infrastructure, for example. In recent decades most of the expansion of this sort of insurance spending was offset by falling spending on defence and debt interest. Today it is less obvious where equivalent reductions might lie in future, without affecting investment spending.

### A debate about priorities

So we need to discuss where the nation's relative priorities lie. What balance should be struck between social insurance and investment spending? And would it be sensible to increase taxation to make the trade-offs less fraught, assuming the public were prepared to tolerate such a move? To put the question crudely, should the UK government become mainly a social insurance state? For example, under one scenario for 2031, health, social care and pensions expenditure could comprise 51 per cent of all non-interest spending, up from 42 per cent in 2010.<sup>19</sup>

This would have implications for investment spending like education. The OBR currently projects that education spending will fall to 4.5 per cent of GDP by 2017/18 and remain around that level indefinitely, in the absence of policy changes. This is the level seen in the late 1980s and late 1990s and a full percentage point less than Labour was spending in the mid-2000s.<sup>20</sup> We question whether this is desirable for a high-skills knowledge economy.

Overall, however, we are not pessimistic because these trade-offs are less difficult than they first appear. The reason is that during the next few decades significant sums of unallocated money will gradually become available, assuming no change in policy. Projections on this basis show that public spending as a share of GDP will be flat in the years after 2017 while tax revenues will rise, opening up a large hypothetical surplus.<sup>21</sup> This gap is explained by government indexation policies for both taxes and social security: spending is projected to be flat because the inflation-based indexation of many social security entitlements cancels out the upward pressures of demographics; meanwhile tax revenues will rise even when tax rates are held con-

stant as a consequence of ‘fiscal drag’ where tax thresholds only increase in line with inflation also.

Retaining these indexation policies until the early 2030s would make available the equivalent of £70bn by today’s standards (4.6 per cent of GDP).<sup>22</sup> Of course, there won’t be some huge surplus come the 2030s; the money will be used between now and then. For example, some observers question whether these indexation policies are sustainable, although they have been in place for many decades. Indexation rules could be changed in the future but there are other alternatives regarding how the money is used. The point is that there are choices. Some or all of the proceeds of ‘fiscal drag’ could be returned to taxpayers if it was agreed that the overall tax burden should not increase over time. But some of the money freed-up from both tax and social security could also be used to increase spending on both investment and social insurance expenditure. Additionally, more money might need to be devoted to working-age social security, since current policies will lead to widening income inequality unless this can be prevented by major structural changes to the economy.

The conversation on future spending choices that we want to see is exemplified by figure 6, which sets out some plausible combinations of policy choices, drawing on OBR projections. The options are crudely positioned on a left-right political axis. These are not the only possibilities (restraining pension spending or running a structural deficit aren’t included, for example) and the chart deliberately strips out all the ambiguities and halfway houses that always characterise real politics. But the range of future choices is clear enough.

Figure 6: Seven plausible combinations for of spending and revenue options for to the early 2030s

	Policy options	1	2	3	4	5	6	7
<b>Revenue options</b>	No revenue increase (give back ‘fiscal drag’)					✓	✓	✓
	Use ‘fiscal drag’ from personal taxation for spending		✓	✓	✓			
	Raise revenue to level seen between 1965-1985	✓						
<b>Spending options</b>	Raise NHS spending in line with historic trends	✓	✓		✓		✓	
	Spending on education and investment at mid-2000s level, as a share of GDP	✓		✓	✓			✓
	Prevent widening inequalities through social security (assuming little change in market inequalities)	✓	✓	✓		✓		

In our next report we will say more about the possible path for long-term spending. But we believe that asking the right questions is just as important as giving the right answers. It is time for explicit discussions about the spending choices facing the UK over the next few decades.

# 3 PRINCIPLES AND PROCESS

**W**e support a long-termist, principles-led approach to future spending choices. To an extent this can be brought to life through changes to working practices and mindset, but we think significant institutional reforms would also be advantageous.

## A clear direction of travel

Elected political leaders rightly wish to respond to people's immediate needs and aspirations, so we think more process and structures are needed to avoid the long-term perspective being overlooked.

Taking a long view is the first step to making wise public spending decisions. In recent decades chancellors have shifted from setting plans for three or four years rather than one (this year's spending round is an exception resulting from coalition politics and the introduction of fixed-term parliaments). To build on this we have two recommendations.

First, we recommend a regular cycle of spending reviews is restored. The coalition began its life with a four-year spending review, which did not cover the whole five year fixed-term parliament. The result has been the current Spending Round, a limited and incremental process in the middle of a parliament. We think there is a need to return to a clearly planned cycle which enables government to set priorities and use them to make allocations. In addition there should be a programme of activity between spending reviews that involves better use of information to inform decisions and improve the relationship between budgeting and business processes. A new spending review cycle will need to align to the new electoral cycle.

Second, we recommend that in advance of each spending review ministers should publish a long-term expenditure statement setting out their intended direction of travel for the next 10 or 20 years. This can provide the backdrop for spending decisions to show where they fit within long-term trends. It would also force the government to speak openly about the competing long-term pressures and its vision for the shifting balance of spending over time. This statement should also set out ministers' views on the main long-term challenges facing the country (ie those requiring action over several parliaments) and how these relate to future spending priorities. Examples include climate change, pensions and public health.

A long-term statement could be published alongside each spending announcement or in the months that preceded it. The latter option would provide an opportunity for public dialogue, consultation and education. This might be a long-termist equivalent to the 2010 'spending challenge', which used technology to seek ideas for immediate savings. The objective in this

instance would be to involve people in debates about trade-offs and relative priorities over the medium and long term.

The projections and assumptions informing a long-term statement should be entrusted to the OBR, to give it independence and rigour. The process would be particularly important when power changed hands, as political parties' long-term spending choices could be highly revealing of their politics.

We hope that this approach will prevent governments taking incremental decisions without giving thought to their long-term implications. Instead the aim would be to begin each parliament with long-term direction and work backwards to short-term decisions regarding which budgets should rise or fall. This matters because small variations make a big difference over time; for example if the government decided every year to raise spending on education by one per cent more than trend GDP growth, after 10 years the nation would be spending an extra half a per cent of GDP (£8bn in today's terms).<sup>23</sup>

Taking a long-term perspective is particularly important now because it will help policy makers simultaneously consider two time horizons: austerity for the next few years; and 'return to trend' thereafter. Decisions for both periods will combine to set the direction for the next 20 years: how spending is constrained for around five years; and where moderate increases are allocated after that point.

## Spending Principles

Alongside a statement of the long-term direction of travel we would like to see future governments publish a set of clear principles guiding their spending choices. The Labour party has recently stepped tentatively into this space by suggesting four principles that will inform its future expenditure decisions.

At this stage in our work, we recommend the following eight spending principles:

1. Work backwards from the outcomes you wish for and ask how these can be achieved in partnership with others
2. Invest in prevention and early intervention
3. Demand productivity improvements, innovation and citizen participation
4. Promote broad-based growth, employment and prosperity
5. Distribute resources and insure risk across the life-cycle
6. Reduce inequality, poverty and unequal opportunities
7. Take a long-term, global perspective
8. Conserve the 'public character' of activities at risk of being undermined by market forces

Our first three priorities are concerned with the way money is spent as well as the overall allocation between areas. The principles relating to 'outcomes', 'prevention' and 'productivity' are critical to ensuring that government can meet the public's rising expectations with limited resources. During our work we heard time and again of the importance of:

- A focus on outcomes rather than outputs and finding ways in which government could work with citizens and other institutions to achieve better results with less public money.
- A really significant shift to prevention and early intervention which would mean diverting resources away from existing activities rather than doing more on the margins.
- A continual drive for productivity improvements and innovation, including improvements driven by citizen participation and better use of technology.

How to strike a balance between the first fourth, fifth and sixth principles is one of the most important dilemmas regarding the long-term direction of public spending. At present governments are implicitly prioritising the first over the second and third. We think there is a strong case for a more even balance between the three. In particular we believe that supporting balanced growth in earnings, employment and economic output should be given more consideration in budget decisions, large and small.

The seventh principle means taking the long-term perspective we have already advocated and also setting the UK in a global context. A long-term and global perspective should inform all decision making but is also important for considering the continuing case for specific areas of spending such as security, international commitments and investment to reduce carbon emissions. We spend around five per cent of GDP on international and security commitments. At this stage of our work we have not identified significant opportunities to reduce this share (our final report will look at options for security and international spending in more detail). Meanwhile de-carbonising the economy is a small call on public spending at present, but there is the possibility that greater public financing of green infrastructure could be required in the next decade.

The final 'public character' principle is perhaps the most ambiguous and politically contested: it reflects the widespread intuition that some dimensions of national life cannot simply be left in the hands of markets; whether that is support for the arts, public spaces or the delivery of core public services like health and education.

Our long-termist, principles-led approach to future spending choices can be brought to life by reforms in a range of fields outlined in the rest of this chapter.

### Consider spending, tax and non-fiscal choices side-by-side

We believe that spending, tax and non-fiscal choices should ideally be made side-by-side. This is because these policy levers are often alternatives to achieving the same ends and will always interact with each other. Today we have a sequential process of policy announcements where tax and the

overall spending envelope is set first, followed by social security, followed by departmental allocations. Within the Treasury there is a good deal of coordination across these decision points, but we think the government should aim for a single public process that encompasses the design of taxation; spending totals; the design of entitlements; and the allocation of 'discretionary' spending.

For example, efforts to reduce income inequality and poverty depend on both taxation and social security reforms and often one will be an alternative for another. It can be argued that efforts to improve living standards for low-income households focused too much on social security under the previous Labour government; and focus too much on tax reform under the current government. A more integrated approach would consider both side-by-side.

With severe constraints on public spending, government should also look to alternatives to spending or tax rises. For example, helping people save or insure themselves with private products helps to spread resources and manage risks without raising public spending. This approach is at the heart of the recent pension reforms which automatically enrol workers into private pensions. With little prospect of spending on new entitlements, similar principles should be applied in other areas from unemployment insurance to paying for care.

As part of our work, we took detailed evidence on the concept of 'predistribution': the idea that public spending to tackle inequality can be avoided by intervening in the economy to boost employment (for example by improving childcare provision), increase low and middle earnings or reduce housing costs. We strongly endorse this approach in principle. However, the evidence we heard suggested that even quite bold policy interventions would realise limited savings in the short term. 'Predistribution' and the rebalancing of the British economy has more promise for restraining future upward pressures on spending. But the magnitude of change needed to reduce inequality without major public spending is significant. It might mean, for example, reducing the numbers without work to levels last seen in the 1970s; cutting the share of workers in low paid jobs to levels in other European countries; and bursting the housing bubble in the face of powerful vested interests.

Housing policy is perhaps the best illustration of the case for integrated policy making. Rising property prices are both reducing living standards and increasing government spending on housing benefit. But tackling the housing bubble can be best achieved through a combined package of capital investment in housing; reform of property taxation; and non-financial measures such as financial and planning regulation.

## Embedding long-termism into decision making

As well as calling for governments to set out their long-term direction of travel, we want to see reforms to the process of decision making which embed a long-termist outlook.

First, decision making should be informed by a 10-year assessment of both the costs and benefits of every policy, which should then form a prominent part of public debate. This is already meant to happen within government as part of the 'impact assessment' process but from the outside it is unclear how much this really affects decisions. For example the Department of Health recently announced that its version of the Dilnot social care reforms would

cost an extra £1bn by the end of the next parliament. However the official impact assessment revealed the costs would rise to £2.3bn by 2025; important information that did not feature in the public debate. We recommend that all spending decisions should be published with 'headline' 'year one' and 'year 10' net costs for the budget-holder, as a high profile supplement to impact assessments.

Second, we would like to see the same approach taken with respect to the wider benefits and costs of policies, encompassing social and economic impacts and their effects on other areas of public spending. For example the early action taskforce found evidence of recent spending reductions on preventative interventions that will increase overall demand for public spending over time.<sup>24</sup> These decisions might occasionally be unavoidable but they should only be taken with full consideration of the consequences. We therefore endorse the early action taskforce's call for a '10-year test' to inform all budget decisions at every level of government. This would require budget holders to consider whether their decisions:

- Lead to higher costs in the future.
- Build up future liabilities.
- Generate higher costs in other parts of the public sector.
- Produce social benefits that will arise after the budget period.
- Damage society and the environment over time.

To drive a significant shift in resources towards prevention and early intervention it may be necessary to go further. A future government could adopt a more directive approach, with budget holders required to 'switch' a certain proportion of their annual spending from existing activities to early interventions. This would focus minds, especially in tough financial times; but it would be prescriptive and difficult to police, rather like the efficiency savings imposed on public bodies by both the previous and current government.

We also heard evidence that long-termism is hamstrung by traditional government accounting, which focuses very heavily on annual spending and revenue. One possibility is for the government to make better use of accrual accounting, which considers the timing of underlying economic activity rather than when cash transfers take place. Unlike traditional public sector accounting the accrual approach recognises the assets and liabilities associated with past activities or commitments. This accounting system is now used across the public sector and the government has recently started to publish 'whole of government accounts' on this basis. However it is mainly used to prepare accounts retrospectively rather than to inform future budgeting. Making greater use of accrual accounting could encourage a long-termist perspective in three ways:

1. Spending which creates an asset would be treated differently from that which does not (eg public borrowing to pay for public housing stock does not affect the overall balance sheet if the new liability is matched by a new asset).
2. The full costs of future liabilities would be more transparent (eg private

finance initiative (PFI) projects are accounted for at the outset, enabling policy makers to make a transparent ‘whole life’ appraisal of different funding options).

3. Plausible risks of future government spending would be recognised as ‘contingent liabilities’. This enables the government to issue loans or guarantees against its assets, while also showing these are not risk-free (eg the coalition’s property market interventions).

Another option for accounting reform would be for the government and Office of National Statistics to review how some borrowing by public institutions is classified for the purpose of the national debt. This can be justified if these bodies make self-financing investments for which the Treasury is unlikely to ever need to assume liability. The UK uses a broader definition of debt than most economies. Shifting to using the headline measure of ‘general government’ rather than ‘public sector’ debt would bring the UK into line with many other EU countries and with standard measures used by the European Commission, IMF and rating agencies. The UK could also benchmark itself against other nations and aim to adopt any practices which prevent artificial hindrance of commercially sound borrowing. For example we heard that in Germany state-owned regional banks and public house-building programmes are largely excluded from headline national debt.

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

### Localism, blurred lines and experimentation

Throughout our hearings the commission has heard evidence of the dangers that institutional and budgetary ‘silos’ present for wise public spending. Rigid central spending allocations can inhibit preventative interventions across service boundaries, make it harder to join-up services around their users and lead to duplication and increased overheads. Many commentators propose greater local decision-making as the answer.

There are also arguments against localism, however. First one can question the extent to which localisation really delivers improved efficiency and outcomes. Second there are rival arguments in favour of centralisation that compete with arguments for localism, namely: national political accountability; the desirability of geographically consistent entitlements and outcomes; the ability to respond to long-term strategic challenges at national level.

The purpose of this commission is not to weigh up the case for and against localism. However, we support a number of reforms to the way local money is spent.

First, we want to see a bigger role for city regions and other local authority clusters. The Greater Manchester combined authority and the Greater London Authority are two examples. Many activities can be carried out more efficiently at levels above individual local authorities to increase productivity and concentrate specialist expertise (eg procurement and back-office functions). Large geographic areas are also strategically more appropriate for

many functions, including economic development, transport, employment and skills, which were the subject of the Heseltine review's recommendations on sub-national spending.<sup>25</sup> At present ministers are encouraging local cooperation between local authorities without taking a strong view on how this should develop. A more hands-on approach may be needed in future, particularly as there are competing sub-regional approaches (eg city deals; combined authorities; local enterprise partnerships) with little clarity regarding the end-point of current experiments. In particular, a future government may need to consider structural reforms, if today's piecemeal initiatives prove insufficient.

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

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

Third, we support a climate of experimentation and diversity in the way services are delivered, within existing national expectations regarding outcomes and entitlements. We heard evidence that national standards place fewer restrictions on local agencies than is often assumed. The barrier to innovation is often simply one of mindset, capacity and a sense of 'permission'. Central government should say loudly that public bodies need to innovate and experiment within existing national financial and accountability frameworks. But they should also promote clear expectations regarding the process by which this happens, for example with respect to: involving and responding to local residents; using evidence to design and evaluate services; a long-term outlook; and strong financial and performance controls. In other words, ministers should seek reassurance that many of the recommendations we propose for central government would cascade down to the local level.

### Transparency, performance and new institutions

We think better spending choices require a more open and consultative process. At present budgets and spending reviews are highly secretive and when decisions are announced they are already cast in stone. Scrutiny by parliament is minimal, considering how important these decisions are. For example the Treasury Select Committee held a one-month inquiry on the 2010

spending review.

We recommend that in future governments set out ‘draft’ plans in advance of major spending decisions. This would give parliament, policy experts and the media the chance to comment on relative priorities, review the evidence and rationale informing decisions and highlight unforeseen consequences. This more deliberative approach would also serve ministers’ interests, since it would create the space for them to change their minds without it feeling like a humiliating climb-downs.

They should also seek to reduce the unnecessary complexity of the information on spending reported to parliament and the public. Even experienced parliamentarians find it very difficult to draw a clear picture from the many different sources of data and ways of reporting. This is a case where less is more.

We would also like to see debate on structural reforms to give parliament much more involvement and oversight in the spending process. A new approach to consultation would work best alongside increased parliamentary and institutional oversight of the spending process.

The Treasury Select Committee has a huge remit and limited expert capacity, unlike the Public Accounts Committee, which is serviced by the National Audit Office (NAO). We think there could be a good case for creating a separate Budgetary Committee to lead on public spending and fiscal questions.

Consideration should also be given to re-establishing the OBR as an independent body reporting to and advising parliament. We think its remit could be expanded, so that it is more like the US Congressional Budget Office. This enhanced role could take shape through evolution over time at the direction of parliament and its committees.

Figure 7: Possible further responsibilities for the OBR

Current remit of the OBR	Possible further responsibilities
Economic and fiscal forecasts, based on existing government plans	Scenarios for economic and fiscal forecasts, based on proposed alternative fiscal and spending policies
	Sensitivity analysis of fiscal data based on alternative economic projections (not just budget announcements)
Assessing progress towards the Government’s fiscal targets	Advice on the appropriate design of fiscal targets to meet broad policy aims
Long-term sustainability of the public finances	Scenarios for long-term sustainability, based on proposed alternative fiscal and spending policies
Scrutinise Treasury’s costing of Budget measures	Totally independent costing of policies (ie not signing-off government assumptions)
	Scrutinise or independently assess costs of a wider range of departmental policies
	Independent assessment of costs of alternative policies proposed in Parliament and by Opposition parties

Alongside the OBR we want to explore the case for creating another institution dedicated to improving the quality of public spending. Otherwise there will be a strong watchdog to promote public spending restraint but no

corresponding champion promoting good value and good outcomes from public spending. A powerful, independent 'Office for Public Performance' would be an arms-length body, which might report to ministers or parliament, to police the quality of public spending and to help build public trust and understanding.

Its aim would be to ensure that as much attention is focused on what spending decisions are intended to achieve, as what they cost. It would work as a centre of excellence and champion in driving the public sector to shift towards more outcomes-focused decision-making and evaluation; support continuous productivity improvements; drive out inefficiency and poor practice; and work alongside the early intervention foundation as a centre of expertise on prevention and early intervention. It would be responsible for evaluating practice; promoting and driving change; and benchmarking performance. The office could also assist government to develop and monitor whatever measurable objectives ministers chose to adopt.

These activities overlap with some of the functions of the NAO, although the new body's focus would be forward-looking and contemporaneous. While the NAO does commendable work we think something more is needed, since the current office has a remit that is retrospective and tends to review performance on a programmatic basis. In advance of our final report will give further thought to how this new body could sit alongside the NAO.

### A more participative approach to decision making

We recommend that the process of arriving at spending decisions should be carried out in a more 'participative' fashion, with greater opportunities for involvement by frontline workers and citizens. To make this possible the decision-making process should be flexible and iterative. Ministers should therefore avoid making definitive top-level decisions early in the process.

The practice of recent governments has been to set upper and lower limits for spending in different areas quite early in the decision making process, often with political considerations front of mind. For example, in 2010 the government announced ringfences on schools, the NHS and international development before considering the spending challenges facing other areas. We do not dismiss the value of announcing upper and lower limits on spending, but they should primarily be a tool for communicating priorities and implementing decisions once conclusions have been reached. If they are announced too early opportunities for participation are undermined and competing demands across government cannot be assessed in a neutral and evidence-based manner. We also support the principle of such 'limits' being attached to issues rather than budgets, to avoid artificial constraints which may influence decisions for purely procedural reasons (eg the allocation between health and social care; or the choice between childcare services and cash subsidies).

Ideally decision makers should begin by looking at relatively small blocs of spending (eg individual entitlements or public service programmes). They should consider the rationale for the spending from first principles, in partnership with all the relevant stakeholders; look at evidence of effectiveness, with reference to clear and consistent criteria; and make an assessment of what could be achieved with more or less money. This is sometimes called a 'zero-based' approach though what we are thinking of is as much a mindset

as a methodology; and one that should be part of day-to-day practice not just imposed externally by occasional reviews. The formal methodology of 'zero-based budgeting' has been in use for 35 years and is widely seen as cumbersome and outdated. But the same insights should be reaffirmed in new ways: budget processes should start from small components and first principles; and should seek to leave behind a culture of continual questioning and internal challenge.

It is important not to make grandiose claims for setting budgets from first principles, however. Governments can never truly begin from a blank sheet of paper without reference to existing commitments and the historical evolution of spending. This is not just because of the impacts on 'losers' and the ensuing political consequences. It also touches on history and culture. For example, if we were starting from scratch we might not invent public libraries or subsidise students to live away from home but both are part of our national tradition and identity. So politicians should be robust and challenging in reviewing all existing spending, but at the same time recognise that past decisions are often made for good reason.

Proponents of radical rebalancing of spending may risk having insufficient regard to the downsides of removing or restraining existing spending. For example, while we endorse calls for a greater emphasis on future-oriented investment spending we know there are very strict limits on the potential to 'switch' money from existing social insurance spending, since the largest budgets - the NHS and state pension - are both lean by international standards and face rising pressures. We question whether any move away from the current ringfences for these spending areas would be viable from a social and economic perspective, even before political considerations are taken into account. At a more micro-level, there is much enthusiasm for switching resources from rent subsidies to building new homes. But it would be very hard to live with the consequences if rents continued to rise, despite the best efforts of the public sector to increase housing supply, and there was not enough money to support families to meet reasonable accommodation costs.

These question of the extent to which decisions should be 'top-down' or 'bottom-up' have been highlighted by the recent announcements by both Labour and the coalition to support a 'cap' on social security. Our view is that such a cap can be made to work, but only if it is set at the conclusion of a bottom-up process not as an *a priori* constraint. In particular, ministers need to begin the process of setting an overall cap with a clear view on the possible scenarios for future spending on each underpinning entitlement. This would mean considering all the non-cyclical pressures on social security spending, both those already factored into spending projections (eg demographic change) and contingencies that are not (eg soaring rents driving up housing benefit costs). They should also set out in advance the policy changes they will adopt to comply with a cap (eg job creation schemes; raising the minimum wage; housing market interventions). Ministers will have limited flexibility because many policy options would be impossible or unfair to implement within a three-year spending period, even if they could be over a longer period (eg an unplanned increase to the state pension age; major legislative changes to disability benefits). Therefore without careful bottom-up planning the social security 'cap' could result in arbitrary and unfair cuts to the incomes of poor households.

## The capacity of government

We need strong government to serve the economy and society. Only government can respond to emergencies like the financial crisis or plan over decades, as with pension reform. But there is another sense in which we need strong government: there needs to be the capacity to govern and spend well.

In future, wise public spending may be endangered by the declining capacity of public bodies in the age of austerity. Across the public sector there are fewer policy officials, reduced numbers of senior managers and less resources for audit and scrutiny. During the early stages of austerity it was perfectly understandable for decision makers to prioritise 'front line' provision ahead of management overheads. Indeed, we have heard many examples of significant management savings that have had limited impact on services, at least when they are operating on a 'business as usual' basis. But sooner or later reductions in the capability of public management will prevent innovation, efficiency and wise spending decisions. We do not have evidence to say whether that time has come, but it is an important risk for ministers to consider both in this year's spending review and in 2015 at the start of the next parliament.

## Endnotes

- 1 Public Sector Finances Databank, October 2012, HM Treasury
- 2 Evidence from Jonathan Portes, Director, NIESR
- 3 In principle spending could rise in line with GDP and the deficit be closed through tax rises, but there is no precedent for this actually happening
- 4 Fabian Society calculations looking at alternative timescales for returning public spending to 40.5 per cent of GDP. Source data: Economic and Fiscal Outlook, March 2013, Office of Budgetary Responsibility
- 5 March 2013 EFO, adjusted to constant prices, table 4.18
- 6 Public Sector Finances Databank, October 2012, HM Treasury; publicspending.co.uk; National Accounts at a Glance, 2013, OECD
- 7 National Accounts at a Glance, 2013, OECD
- 8 Although on a cyclically adjusted basis the position will be better in 2017 than 2007, since Labour was running a modest deficit at what turned out to be the peak of the economic cycle. Current projections and assumptions about the economic cycle suggest the current structural deficit will be eliminated by 2017.
- 9 Doron, N and Harrop, A, *No Right Turn*, Fabian Society, 2012; British Social Attitudes 29, NatCen, 2012
- 10 GB benefits and tax credits time series, DWP, March 2013
- 11 Economic and Fiscal Outlook, March 2013, Office of Budgetary Responsibility
- 12 Harrop, A 'The Language of Priorities' in Fabian Review, Summer 2012
- 13 We recognise there are limits on the extent to which information on aggregate spending will shift public attitudes in the absence of other efforts to reassure people regarding the fairness of the social security system.
- 14 Fabian Commission on Taxation and Citizenship, *Paying for Progress: A New Politics of Tax for Public Spending*, Fabian Society, 2000
- 15 Diamond, P and Lodge G, *European Welfare States After the Crisis*, Policy Network, 2013
- 16 Fabian Society calculations using *Fiscal Sustainability Report 2012*, Office for Budgetary Responsibility
- 17 Public Expenditure Fiscal Analyses 2012, HM Treasury
- 18 *Fiscal Sustainability Report 2012*, Office for Budgetary Responsibility
- 19 Fabian Society calculations using *Fiscal Sustainability Report 2012*, Office for Budgetary Responsibility
- 20 *Fiscal Sustainability Report 2012*, Office for Budgetary Responsibility; Public Expenditure Fiscal Analyses 2012, HM Treasury
- 21 Fabian Society calculations using *Fiscal Sustainability Report 2012*, Office for Budgetary Responsibility. These calculations make different assumptions regarding fiscal drag than the headline numbers presented by the OBR
- 22 *Fabian Society calculations using Fiscal Sustainability Report 2012*, Office for Budgetary Responsibility
- 23 Fabian Society calculations using *Public Expenditure Fiscal Analyses 2012*, HM Treasury
- 24 *The deciding time: prevent today or pay tomorrow*, Community Links, 2012
- 25 Heseltine, M, *No Stone Unturned*, Department for Business, Innovation and Skills, 2013

# SPENDING WISELY |

## PRINCIPLES FOR A GOOD SPENDING REVIEW

### Fabian Commission of Future Spending Choices

This is the first report of the Fabian Commission on Future Spending Choices which was established to consider the public spending options for a government coming to power in 2015. The report is published to coincide with the 2013 Spending Round. It looks beyond current short-term debates to ask whether we are having the right sort of conversation about public spending; and what new principles, processes and structures can improve spending decisions. The report calls for debate on wide-ranging institutional reform to achieve wiser spending choices.

The Fabian Commission on Future Spending Choices is a year-long inquiry established to examine public spending choices for the UK Government for the period 2015-2020. It is considering how the UK can reduce its fiscal deficit in a way that maximises prosperity, security, sustainability and social justice. The remit of the inquiry is the UK Government so excludes decisions devolved to Wales, Scotland and Northern Ireland. The commission has conducted its work through eight evidence hearings, by seeking submissions and by commissioning background evidence papers. This work has been supported by an expert advisory network.

The Commission is considering: the purpose of public spending and the values and criteria which should be adopted for determining spending allocations; pressures and priorities for public spending, including issues of long-term sustainability; likely scenarios for overall expenditure between 2015 and 2020; economic reforms which might reduce demand for public spending; how public spending can best support growth, jobs and earnings; and how the public sector can manage with less money.