FISCAL FALLOUT

The challenge ahead for public spending and public services

Ian Mulheirn, Nida Broughton, Ben Lucas and Henry Kippin

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EXECUTIVE SUMMARY

In October 2010, the Coalition Government set a course for public spending that represented its defining mission. It was hoped that four years of unprecedented cuts and tax rises would fully repair the public finances by 2014–15, in time for the next election. Since then the economy has performed more poorly than expected, and growth in its underlying productive potential also appears to have been weak. These developments have profound consequences for the Coalition's plans, and for the ways in which policymakers think about the delivery of public services.

This joint report, by the Social Market Foundation (SMF) and the Royal Society of Arts (RSA), sets out to explore these consequences. In the first part, the SMF deploys new analysis to estimate the scale of the challenge for the public finances that is likely to be revealed in this year's Autumn Statement. It then goes on to assess what this will mean for public services at the next spending review, set for 2013. In the second part of the report, the RSA sets out its own views on how the productivity of public services can be enhanced to help meet that looming challenge.

PART ONE – THE SCALE OF THE CHALLENGE AHEAD
IAN MULHEIRN & NIDA BROUGHTON, SMF

Last November, the Office for Budget Responsibility (OBR), the independent fiscal watchdog, advised the Government that it would have to find further cuts or tax increases in order to eliminate the structural deficit on the current budget within five years, as the Treasury's fiscal mandate dictates. In response, the Treasury announced £15 billion of additional annual spending reductions by 2016–17.

But this £15 billion gap wasn't the whole story. The upward trend in benefit spending – driven by changes such as the ageing population and rising rents pushing up housing benefit claims – means that further discretionary cuts are planned after 2014–15 to keep the deficit under control. At the time of the last Budget then, in response to the OBR's assessment, the Government was implicitly scheduling some £26 billion[1] of cuts to annual public spending by 2016–17 in order to fulfil its fiscal mandate. The detail of where these cuts would fall was left to the next spending review.

This autumn that prognosis looks set to get significantly worse for the public finances. In this part of the report, the SMF sets out to examine just how much worse, and what it will mean for spending on public services at the next spending review.

Economic growth has been lower than the OBR anticipated in March. The economy appears to have grown by just 0.3% over the first nine months of this year. That is just one third of the expansion forecast by the OBR in March. Independent forecasters still expect the economy to ***shrink*** by 0.3% in 2012. That compares to the OBR's March prediction of 0.8% ***growth***. If the current trend persists, these dynamics will push public borrowing above the OBR's March forecast for the year by some £9 billion. Yet over the same period of economic stagnation, paradoxically, unemployment has fallen significantly and business

1. In 2016–17 prices

indicators suggest that many UK firms are running up against capacity constraints, with less room to expand output if demand does pick up.

New analysis by the SMF in this paper quantifies the implications of this for the public finances. We replicate and update the models used by the OBR to assess the gap between the economy's current output and its potential – known as the output gap. This variable is pivotal in assessing how much government borrowing will fall once the economy bounces back to its potential, and how much of the deficit is 'structural', requiring spending cuts or tax rises to eliminate.

Updated with fresh data from the first three quarters of 2012, the OBR's models suggest that the output gap is now significantly smaller than was expected at the time of the watchdog's March assessment. If the OBR uses these results as it has in the past, it looks set to advise the Chancellor that the structural deficit is now 1.1% of GDP larger than previously expected.

As a result of these developments since March, an ***additional*** £22bn of tax rises or spending cuts – on top of the £26bn already implied - will apparently be needed by 2017–18 in order to get the Government's spending plans back on track and put the public finances into structural surplus within five years.

Deciding how to distribute fully £48bn of fiscal pain by 2017–18 is the task that looms at the next spending review, currently planned for autumn 2013.[2] The Government has given no indication that it plans increased taxes to fill some of the yawning gulf between revenue and expenditure implied by the OBR's models. On these plans, cuts to public spending must fall on Annually Managed Expenditure (AME) – primarily social security transfers – or on government departmental spending on public services such as law and order, transport and local government services. At the last budget the Chancellor hinted at his desire to find £10.5bn of annual spending reductions from the AME budget.

Taking these indications as the starting point, this paper illustrates what the apparently necessary cuts will mean for spending on public services over the three years, 2015–16 to 2017–18. It is beyond the scope of this paper to comment on whether such a degree of consolidation is necessary or its composition appropriate.

If the Government spreads the cuts evenly across all departments, including health and international development, real terms cuts to departmental budgets will be around 11% over the period. But if health, education and international development budgets are held constant in real terms (as largely happened at the last spending review) the scale of cuts for remaining departments would average an eye-watering 23% over the three years after 2014–15.

Twenty-three per cent budget cuts, for a department like the Department for Work and Pensions for example, would be equivalent to halving its spending on Jobcentre Plus and all employment programmes. The same proportion taken from the Home Office would be equivalent to axing a third from crime and policing expenditure. All of this is on top of the cuts already planned by 2014–15.

2. We assume that the transfer of excess cash from the Bank of England's Asset Purchase Facility to the Exchequer will not have an impact on the size of the structural deficit.

Finally, we also illustrate how departmental spending will have changed across the two spending reviews covering the period between 2010 and 2018. The results show that if protections are retained for some departments after 2015, others such as the Home Office, Business Innovation and Skills and Local Government spending will be over 40% smaller than they were at the start of the decade.

This paper seeks neither to promote further cuts nor to argue against them. Nor does it offer any judgement on the appropriate composition of the necessary fiscal consolidation, divided between tax rises, social security cuts and public spending cuts. Instead it seeks to identify the scale of the challenge ahead according to the OBR's usual analysis and the Government's outline plans. On this basis, making the implied savings is going to be extremely challenging, involving far more difficult trade-offs than even those taken in the 2010 spending review. It is clear that substantial further cuts to spending on public services are on the way. Working out how to do more with less will therefore be the defining challenge of the next spending review.

PART 2 – A STRATEGIC SPENDING REVIEW?
BEN LUCAS AND HENRY KIPPIN (RSA)

The analysis in Part 1 throws down extraordinary challenges for policymakers. The next spending review will force decisions that fundamentally re-shape the British state in the short term, as well as profoundly change our economy, public services, and livelihoods over the long term. More than ever, it is vital that these decisions be long-term and strategic.

Given the scale of the necessary spending cuts identified in the SMF's analysis, it is clear that neither absorbing cuts within AME, nor forcing incremental cuts to departmental spending, are sustainable fiscal solutions. The welfare budget is not a bottomless pit for cuts, and we will incur a massive human cost if it continues to be treated as one. Neither can we keep salami-slicing government departments as they are currently configured.

More fundamentally, despite the massive cuts and reforms being prosecuted by the Coalition government, there is little coherence between our national strategies for fiscal sustainability, sustainable growth and public service reform. This is a problem. The big challenges of the future – responding to growing and changing demand, improving inadequate and unequal social outcomes, and creating inclusive growth and prosperity – are complex, multi-layered, and interrelated. They require a joined up and coherent approach that cuts across traditional service divides, geographical boundaries and the historical relationship between citizen and services.

This new approach must start with a frank discussion about the way we make policy, how we deliver it, and what we measure and value in public services. A spending review rooted in Whitehall and designed from the centre outwards cannot adequately provide this.

The RSA proposes a Social Productivity Spending Review based on three core principles, starting from a rebalancing of the relationship between central government, localities and citizens.

1. **Rebalance and realign:** The starting point for the current and previous spending reviews is too focused on delivery from the centre, too protective of siloed budgeting and top-down departmental management, and not serious enough about the potential for a multi-polar political economy. Urbanisation and the continued growth of cities is one of the most significant social and economic trends across the world. The quality of leadership and the capacity to innovate and create competitive advantage within cities will be critical to their success in the future. So we propose a new starting point: fundamentally rebalancing revenue-raising and expenditure towards local government and away from Whitehall and kick-starting collaboration and integration across the public service landscape.
2. **Citizen-side innovation:** Our public service operating framework is too Whitehall-centric, too stuck in a rational-individualist mindset, and not concerned enough with the collaborative role public services and citizens can play in reducing demand and transforming delivery. In response we propose new 'mechanics' that focus much more on managing demand, building capabilities and giving citizens the tools to generate their own social and economic value.
3. **Manage for social productivity:** We are behind the curve in assessing performance based on public service productivity and the social and economic value that services create, and not transparent enough about the way citizens themselves contribute to, and benefit from, public services. In response we propose a new performance framework explicitly focused on driving economic productivity and social value through public spending and the delivery of services.

Part 2 of this paper makes a case for a new framework based on social productivity. Its starting point is strong relationships between citizens and services and between different sectors of society as a whole. This simple analytical starting point suggests some radical reforms to the way public services are designed and delivered. For the state, this will require a shift from social protectionism and economic liberalism to social and economic productivity. For citizens, this will mean a change from guaranteed service entitlements to a new deal based on reciprocity, in which we are expected to make a contribution to society and to make the most of our opportunities. In return we can expect support when we need it as well as help to develop our capabilities so that we can lead the lives we choose.

In essence, the RSA calls for a new social contract: an overarching change in the character of our public services and our relationship to them. It requires an active state, strong public services and an ethos of social citizenship. It is a large scale system change, something which cannot be imposed but requires popular consent and local insight. This itself should be seen as an opportunity rather than a hurdle – a chance to engage citizens and practitioners in open dialogue about the challenge we face as a society. The time for this conversation is now.

PART 1: THE SCALE OF THE CHALLENGE AHEAD

IAN MULHEIRN & NIDA BROUGHTON

CHAPTER 1: SPENDING CUTS – THE STORY SO FAR

The Coalition came into Government in 2010 with a plan to repair the public finances within one parliament. Declaring that Britain's deficit in 2009 was the largest in its peacetime history,[3] the Government set itself a fiscal mandate to eliminate the structural deficit on the current budget within a five year period – at the time, 2015–16. To prevent the continual rolling forward of the mandate, a supplementary target was set out: to have debt falling as a proportion of GDP in the fixed year 2015–16.

In light of recent developments it seems unlikely that the Government is on course to meet its debt target.[4] But the focus of this report is the Government's fiscal mandate to eliminate the structural deficit and its implications for public spending.

Part of the deficit – the 'cyclical' part – will automatically disappear as economic output returns to its potential level. For example, the Government finances will benefit from an upturn in revenues from taxation as incomes and profits increase, and less spending on items such as Jobseeker's Allowance and housing benefit, as economic output bounces back to its potential level.

But the remaining 'structural' part of the deficit will persist once output reaches its potential level, reflecting a combination of excessive spending before the crash, the damage done to the economy by the recession and subsequent stagnation, and sluggish growth in productivity since 2008. This structural deficit will not be automatically eliminated as the economy recovers and must instead be tackled through cuts to public spending or higher taxes.

Box 1.1: Current budget deficits and net borrowing

The current budget is the difference between receipts – mainly made up of tax revenues – and current public sector spending. Current spending excludes capital spending to finance investment. It includes all other spending ranging from social security spending to the day-to-day costs of delivering public services.

In any one year, public sector net borrowing is made up of borrowing to finance capital investment and borrowing to finance current spending. This means that the deficit on the current budget equals public sector net borrowing excluding any borrowing to finance investment.

In June 2010, the Government set out its plans to achieve what then appeared to be the cuts and tax rises necessary to meet its mandate. These plans involved cutting 8.8% in real terms from departmental current spending, and 24.8% in real terms from capital spending between 2010–11 and 2014–15.[5] The October 2010 Spending Review distributed those cuts across the departments. Spending in some departments, such as health, was kept near constant in real terms. As a consequence, other departments were expected to cut current spending by much more. For example, Environment, Food and Rural Affairs was expected to cut its current spending by 29%, and the Home Office by 23% by 2014–15.[6]

3. HM Treasury, *Spending Review 2010*, (London: HMSO, 2010)
4. Ian Mulheirn, "Osborne will need to bend his fiscal rules", *Financial Times*, August 28, 2012
5. HM Treasury, *Budget 2012* (London: HMSO, 2012).Annex A
6. HM Treasury, *Spending Review 2010*, (London: HMSO, 2010)

ONE ROUND OF CUTS WAS NOT ENOUGH

But these cuts now appear to be insufficient to achieve the Government's aims. By the time of the last budget, two problems had already given rise to the need for more spending cuts or tax rises.

First, the Treasury had planned to hold public spending broadly constant in real terms after 2014–15. But doing so implies cuts because some parts of government expenditure grow over time if policies remain unchanged. Specifically, the Government had forecast that resource annually managed expenditure (see Box 1.2), of which social security spending is the largest component, will continue to rise by 1.8% per year after 2014–15, on current plans.[7] This is because underlying factors that determine the cost of the social security system, such as the number of pensioners or the increases in the rent covered by Housing Benefit, are not within the Government's control. On unchanged social security policies, some £11bn of savings must be found from departmental spending by 2016–17 to hold overall spending constant.[8]

Second, in November 2011, only a year after the 2010 Spending Review, the OBR was already warning that, due to developments in the economy, the Government would fail to meet its fiscal mandate without more cuts or tax rises. In response, the Government made explicit plans to cut spending by a further £15bn by 2016–17.[9]

By the 2012 Budget, then, the Treasury was planning to cut some **£26 billion** from annual spending over the two years 2015–16 and 2016–17. Exactly where these cuts would fall was left to the next spending review, and the actual cuts until after the next election. Nevertheless, Budget 2012 pointed out that without cuts to social security, spending on public services would have to be cut by 3.8% per year in real terms in the two years after 2014–15. Indeed, just to keep the pace of cuts to public services to the same rate as in the current spending review period from 2011 to 2015, the Treasury estimated that social security spending would need to be reduced by £10.5bn per year by 2016–17.

The combined impact of these spending plans was forecast to leave the Government's structural finances in surplus in 2016–17 at 0.5% of GDP, leading the OBR to assess that the Government had a greater than 50% chance of meeting its fiscal mandate.

So at the time of the last Budget the challenge for the Coalition to get the public finances back to balance had expanded beyond the current spending round and well into the next parliament. The detailed decisions on where to save £26 billion were left until the next spending review. But since then, as this report demonstrates, things appear to have deteriorated even further.

New analysis in this paper shows that even £26 billion of cuts now looks insufficient to achieve the plans set out by the Government at Budget 2012. Poor economic performance and high levels of public borrowing mean that the Government is unlikely to eliminate the structural deficit without even greater spending cuts or tax rises after 2014–15. The next

7. HM Treasury, *Budget 2012* (London: HMSO, 2012).Annex A
8. HM Treasury, *Budget 2012* (London: HMSO, 2012)., Annex A, and authors' calculations
9. HM Treasury, *Autumn Statement 2011* (London: HMSO, 2011)

chapter outlines the recent developments that point to a worsening in the government finances, and what these mean for the scale of the challenge. Chapters 3 and 4 outline how the total cuts needed from 2014–15 onwards could be made and the impact this will have on departments including health and education.

Box 1.2: Types of Government current expenditure

HM Treasury splits Government expenditure (total managed expenditure, or TME) into two categories: annually managed expenditure and departmental expenditure limits.

Annually managed expenditure (AME)

Current AME is made up of spending that tends to be volatile and demand-led. This spending can and does fluctuate even in the absence of specific discretionary policy measures. For example, a large proportion of AME is made up of social security benefits. The precise amount of benefits paid out in a particular year is not entirely within Government's direct control: it can set the rate of benefits, but it cannot control the number of people eligible (e.g. the number of people over State Pension Age) or the cost of rented accommodation, which drives housing benefit expenditure, for example. The total cost of AME also depends on factors such as inflation and the level of unemployment.

Departmental expenditure Limits (DEL)

In contrast to AME, DELs are the departmental budgets that dictate spending on public services. DELs are set at spending review exercises, the last of which was in October 2010 and set departmental spending for the years 2011–12 to 2014–15. DEL includes a very wide range of spending including the administrative costs of running departments, but also all other spending that isn't included in AME. For example, the Department for Education's DEL includes spending on schools, employing teachers, workforce training and development, standards and qualifications, and children's services such as Early Years and Sure Start.

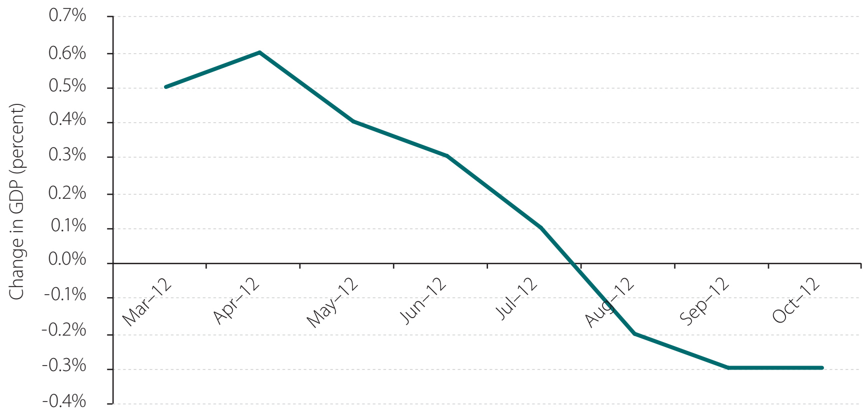
CHAPTER 2: DEVELOPMENTS SINCE BUDGET 2012

Since the OBR's last assessment in March 2012, the economy has not developed as expected. As this new analysis shows, the implications of those developments for the public finances and the looming spending review are substantial.

LOWER GROWTH AND HIGHER BORROWING

Growth so far in 2012 has been disappointing. The economy grew by 0.3% in the first three quarters of 2012 – just one third of the level the OBR anticipated in March.[10] Independent forecasters have been downgrading their forecasts for the year between March 2012 and October 2012. Whereas in March, the economy was expected to growth over the course of 2012, independent forecasts of GDP growth in 2012 are now averaging around -0.3% – an alarming deterioration in the outlook. Similarly for 2013, while independent forecasts for next year's growth were 1.7% in March – compared to a prediction of 2.0% from the OBR – they now average just 1.1%.[11]

Chart 2.1: Average GDP growth in 2012 as forecast by independents

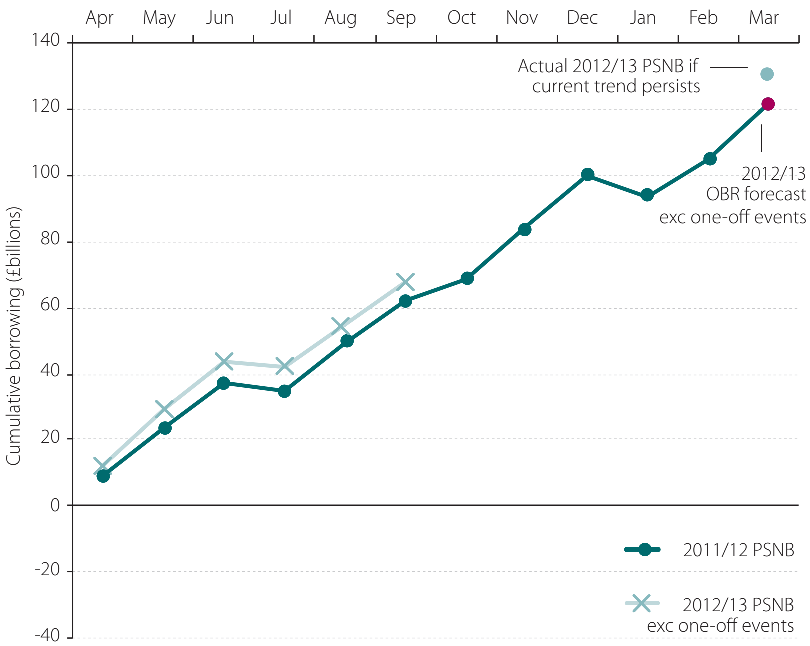


Source: HM Treasury, Forecasts for the UK Economy (London: HMSO, March 2012, April 2012, May 2012, June 2012, July 2012, August 2012, September 2012, October 2012).

The weakness in the economy has been reflected in public borrowing as tax receipts have disappointed. In March 2012, when the OBR published its *Economic and Fiscal Outlook,* it expected public sector net borrowing to fall from 2010–11 onwards and the economy to return to growth in 2012. However, since then, new data suggests disappointing news. Public sector net borrowing (PSNB), excluding one-off events that have affected this year's figures, stands at £67.3 billion for the period April to September 2012.[12]

10. Office for National Statistics, *Gross Domestic Product Preliminary Estimate,* Q3 201
11. HM Treasury, *Forecasts for the UK Economy* (London: HMSO, March 2012, April 2012, October 2012).
12. Office for National Statistics, Public Sector Finances, September 2012 (http://www.ons.gov.uk/ons/dcp171778_283489.pdf). The actual PSNB for the year to date is £30.3 billion lower since the public finances benefited from two one-off events: the transfer of the Royal Mail Pension Plan and the closure of the Bank of England Special Liquidity Scheme. Stripping out these events gives a better picture of the underlying state of the public finances.

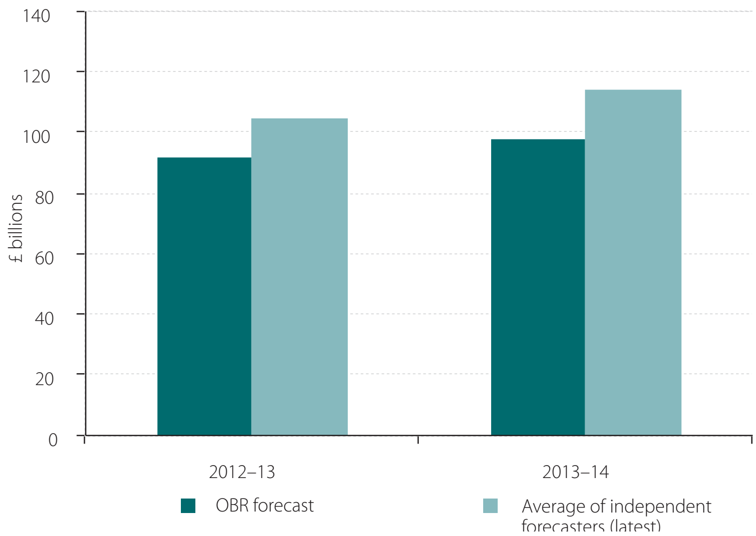
Chart 2.2: Underlying public sector net borrowing, 2011–12 and 2012–13



Source: Office for National Statistics, *Public Sector Finances*, September 2012

Chart 2.2 tracks underlying PSNB so far in 2012–13, showing how it compares to borrowing in 2011–12. At the current rate of overshoot, it is likely that PSNB for this year will be £9 billion or 10% higher than forecast by the OBR back in March.[13] Independent forecasters – including banks, economic experts and consultancies – are predicting an even bigger borrowing overshoot: 14% above the OBR's March forecast in 2012–13 and 17% above in 2013–14.[14]

Chart 2.3: Public sector net borrowing: OBR versus independent forecasters



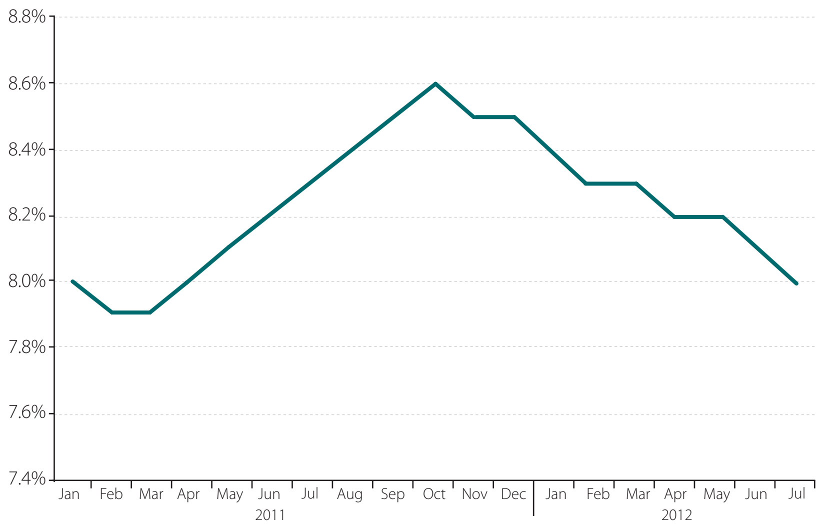
Source: Office for Budget Responsibility, *Economic and Fiscal Outlook* (London: HMSO, March 2012), HM Treasury, *Forecasts for the UK Economy* (London: HMSO, October 2012).

13. Assuming that the current gap between PSNB in 2012/13 exc one-off transfers and PSNB in 2011/12 remains at 8%.
14. We assume that the transfer of excess cash from the Bank of England's Asset Purchase Facility to the Exchequer will not have a significant impact on the size of the structural deficit. This seems likely since, once the asset purchase programme is unwound, the underlying state of the public finances – and hence the part of the deficit that requires policy action to eliminate - will be largely unchanged. The OBR will make a judgement on this in its next Economic and Fiscal Outlook.

How worried should we be about higher public borrowing? The answer depends whether that extra borrowing is a temporary phenomenon that will disappear once the economy revives, or whether it seems permanent, requiring further tax rises or spending cuts to eliminate. One might expect that, all else equal, higher borrowing simply reflects the economy slipping further below its potential output level. If this were the case then higher-than-expected borrowing would be temporary, reversing itself in future years as the economy bounces back to that potential level. But the following analysis suggests a more worrying explanation.

Despite disappointing growth and consequently poor borrowing figures, other indicators tell a different story. Most notably, unemployment has been falling since Autumn 2012, and stands at 8%, as of July 2012.

Chart 2.4: Falling unemployment



Source: Office for National Statistics, Labour Market Statistics, October 2012 (http://www.ons.gov.uk/ons/rel/lms/labour-market-statistics/october-2012/index.html)

This is of course a good story in itself, but it has worrying implications for the UK's future potential output and hence the size of the persistent part of the deficit. All else equal and with underlying productivity growing as normal, a deterioration in output such as that seen over the past few quarters would be reflected in higher unemployment. The apparent contradiction between the trends in GDP and unemployment has sparked economic debate about the so-called productivity puzzle (see Box 2.1). If more people are in work, but output is falling, then this suggests that the UK economy is becoming less productive.

Box 2.1: Explanations for the productivity puzzle

Rising employment and falling unemployment, in a context of falling output, indicate falling productivity per worker. But could the reduction in worker productivity simply be explained by the growth in part-time employment, such that productivity per hour worked

There has been a fall in average hours worked as the proportion of part-time workers in the labour force has increased. This partly explains the fall in productivity per worker, but doesn't account for the entire drop. While output per worker is 3.7% lower than immediately prior to the 2008 recession, output per hour is only 2.5% lower.[a] However, even output on a per hour basis has been falling recently, suggesting that there are other factors limiting productivity of the UK economy.

A recent ONS analysis of the issue has suggested a number of potential factors that may have reduced productivity.[b] These include:

- The 2008–09 recession adversely affected high-productivity sectors of the economy, such as manufacturing;
- Lags in the response by firms to lower demand, as some businesses decide to 'hoard' skilled staff in anticipation of the economy picking up;
- The impact of the downturn in lending on firms. This may in turn be reducing firms' investment in capital and innovation, damaging productivity;
- Over-exuberance in the financial sector pre-recession resulting in capital being diverted to areas with less potential for returns;
- The loss of human capital, as those who have been unemployed for a long period of time lose skills.

a. Office for National Statistics, *The Productivity Conundrum, Explanations and Preliminary Analysis*, October 2012 (http://www.ons.gov.uk/ons/dcp171766_283259.pdf)
b. Ibid.

There are a number of possible explanations for the productivity puzzle, as set out above. Some of these factors, such as staff 'hoarding', are likely to be temporary. Others – in particular those related to the financial sector – may have reduced the UK's actual potential to grow. There is an important debate about the cause of the puzzle, but it appears that the UK economy may not be as far below potential output as previously thought because potential output itself has fallen since the OBR's last assessment.

This is profoundly important for two reasons. First, the economy has less far to bounce back, so we may be permanently poorer than we thought we were. Second, together with higher borrowing, it means that even more public spending cuts or tax rises than those announced to date will be required to return the public finances to structural balance within five years. The OBR will reflect these things in its advice to the Chancellor in the run-up to the Autumn Statement. So what is it likely to say?

THE NARROWING OUTPUT GAP

As part of its assessment of the Government's performance in achieving its fiscal targets, the OBR publishes a twice-yearly Economic and Fiscal Outlook. The assessment includes an estimate of where UK economic output is relative to its potential level. This estimate of the 'output gap' is central to its assessment of the state of the public finances since it determines how much of the deficit will fall away when the economy returns to 'normal' and how much will require cuts or tax rises to eliminate. A large negative output gap implies that the economy has a long way to bounce back, hence the structural part of the deficit is small. A small negative output gap suggests that the economy is near its capacity, hence the bulk of any borrowing will remain when it returns to normal.

Box 2.2: The output gap

The potential output of an economy is the maximum level of output that is sustainable in the medium to long-term. If an economy is operating at potential, it is operating at full capacity, with no further room to grow sustainably, in the absence of any long-term productivity improvements that could increase an economy's potential itself. Growth in potential output is often equated with "trend growth" – the long-term trend in economic growth.

The actual level of output may differ from the potential level in a boom or a downturn. The difference between actual and potential output is called the output gap, and is usually expressed as a percentage of potential output.

The output gap is negative when the economy is below its potential – actual output is below potential output, indicating some spare capacity in the economy. This spare capacity would allow output to be increased relatively quickly if demand picked up. In March 2012, the OBR estimated that the output gap in 2011 was -2.7% of potential output. It predicted that this would fall slightly in 2012 before slowly rising to zero in around 2017.[a]

As described in more detail in this section, the size of the output gap is a pivotal determinant of whether the Government is likely to succeed in its fiscal mandate to reduce the structural deficit at the end of the rolling five-year period. This is because the structural, or cyclically-adjusted deficit is the part of the deficit that will not be automatically eliminated as the economy recovers from recession.

The SMF has replicated the watchdog's models used to determine this crucial variable. As we set out below, there is significant disagreement about the size of the output gap among experts. We do not seek to replicate the OBR model as an endorsement of its approach or results, but because it is the OBR's advice, informed by these models, that dictates what policy action will be proposed at the next spending review.

Our analysis suggests that – assuming no changes to its methodology – the OBR's forthcoming analysis, published at the Autumn Statement, is likely to show a narrowing of the output gap. According to the OBR's models, the economy appears to be closer to its potential, despite the absence of growth, suggesting that the economy's potential is more impaired than previously thought.

Box 2.3: How the OBR measures the output gap

The OBR has two approaches to measuring the output gap – the 'aggregate composite' and 'principal components analysis' methodologies. The OBR also looks at the estimates produced by other forecasters in coming to a judgement.[a]

Each of the two methodologies involves looking at indicators of spare capacity in the economy. These indicators shed light on how close firms think they are to operating at full capacity, and evidence of how much spare capacity there is in the labour market. A large amount of spare capacity would indicate that firms – and the economy – could increase output relatively quickly if demand picked up. Limited spare capacity would indicate that there is little scope to rapidly expand output.

a. For more detail, see Office for Budget Responsibility, Briefing paper No. 2: Estimating the Output Gap (London: HMSO, April 2011) and Office for Budget Responsibility, Working paper No. 1: Estimating the UK's Historical Output Gap, (London: HMSO, November 2011).

Aggregate composite

The aggregate composite approach involves combining various survey-based indicators of spare capacity and recruitment difficulties. A combination of little spare capacity and significant recruitment difficulties would indicate that firms see little room to expand output, and would therefore suggest that the economy is close to potential.

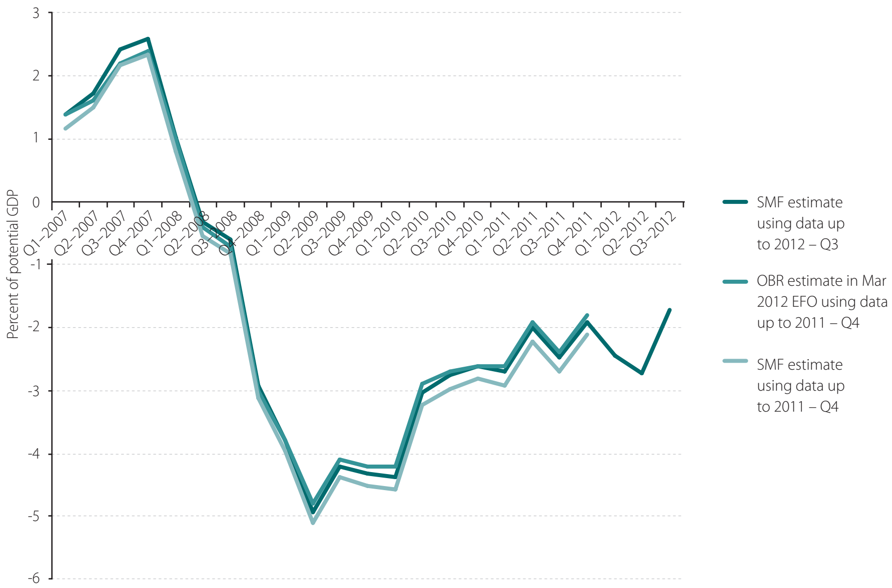
The surveys cover manufacturing and services firms. The indicators are combined using weights corresponding to the importance of the sector to the UK economy. For example, the weight placed on indicators relevant to the manufacturing sector corresponds to the share of UK output accounted for by manufacturing.

Principal components analysis

The principal components analysis approach involves both survey-based indicators and ONS data on average earnings growth. As with the aggregate composite approach, surveys cover both recruitment difficulties and capacity, and span both manufacturing and services firms. In addition, the principle components analysis model includes a survey-based indicator of the level of business activity in financial services firms. The weights placed on different indicators are determined by the OBR through a statistical analysis of the data, to determine which variables appear to have the most predictive power.

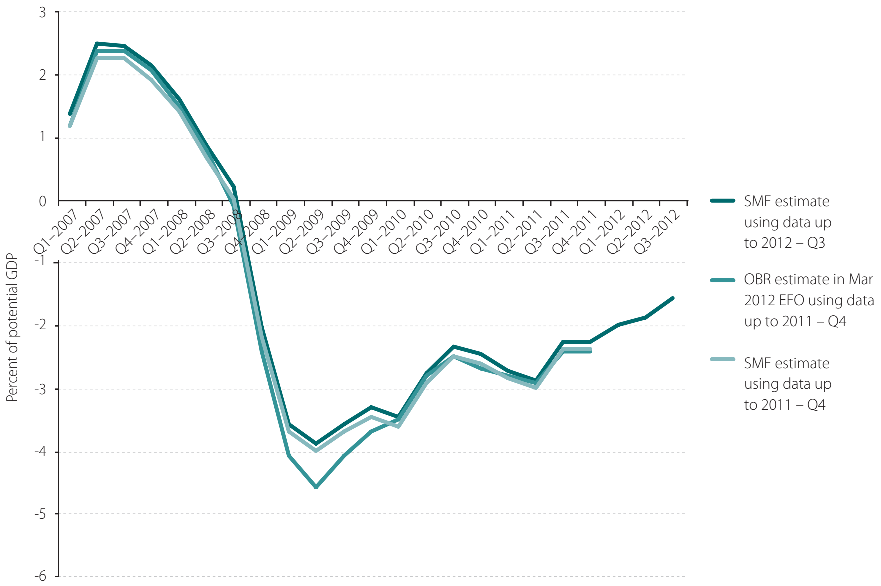
The OBR uses two models to estimate the size of the output gap (See Box 2.3). It then uses the results of the models and its own judgement to put a figure on the size of the output gap. The OBR's March 2012 Economic and Fiscal Outlook estimated the output gap using these two models up to 2011 Q4. At that point, it judged that the output gap stood at -2.5% of potential GDP.[15] The charts below show the path of the OBR's aggregate composite and principal components model when the SMF replicated the two models and updated them with three quarters of new data that has become available since the Budget.[16]

Chart 2.5: Aggregate composite output gap estimates



15. Office for Budget Responsibility, Economic and Fiscal Outlook (London: HMSO, March 2012),
16. Data sources underlying the SMF's calculation are set out in the following OBR papers: see Office for Budget Responsibility, Briefing paper No. 2: Estimating the Output Gap (London: HMSO, April 2011) and Office for Budget Responsibility, Working paper No. 1: Estimating the UK's Historical Output Gap, (London: HMSO, November 2011).

Chart 2.6: Principal components output gap estimates

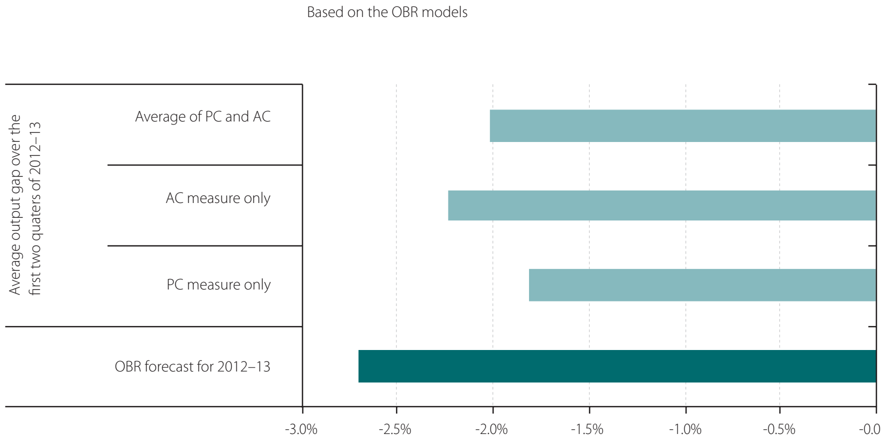


Our updated replication suggests that since then, the aggregate composite estimate has narrowed to -1.7% in 2012 Q3 from -1.9% in the last quarter of 2011. The principal components analysis estimate has narrowed to -1.6% from -2.4%.[17] Analysis of previous OBR reports suggests that in coming to a judgement on the size of the output gap, the OBR has generally placed more weight on the results of the principal components approach.[18] The principal components model suggests that the average output gap over the first two quarters of the 2012–13 financial year is -1.8%. This reflects the picture of falling unemployment despite negative economic growth – the productivity puzzle.

So the new data suggest that the output gap has narrowed over time since the OBR's March 2012 report. But in addition to this, the output gap looks substantially smaller than the OBR's forecast of -2.7% for 2012–13 as a whole (see chart 2.7). On the OBR's favoured measure, there appears to be one third less room for the economy to bounce back than previously assumed. Combined with higher borrowing than forecast, this suggests serious implications for the proportion of this year's extra borrowing that is structural. That, in turn, suggests that more fiscal consolidation than previously thought is now required at the next spending review. Some other forecasters, however, appear to be telling a less negative story than these results imply (see boxes 2.4 and 2.5).

17. In the OBR's methodology, estimates of the output gap in previous quarters changes when new data is added. The OBR's estimates in March 2012 for the last quarter of 2011 were -1.8 (aggregate composite) and -2.5 (principal components)
18. Analysis of the last four Economic and Fiscal Outlook shows that in coming to a judgement on the current output gap, the OBR places more weight on the principal components approach. The principal components approach has given a number that is on average 0.05 percentage points away from the OBR's judgement of the output gap, whereas the aggregate composite approach has been, on average, 0.2 percentage points away. If we exclude the OBR's first Economic and Fiscal Outlook, this changes to 0.03 and 0.4 respectively, i.e. the OBR has placed even more weight on the principal components approach in recent reports.

Chart 2.7: Output gap in 2012–13: OBR forecast vs SMF's new estimates



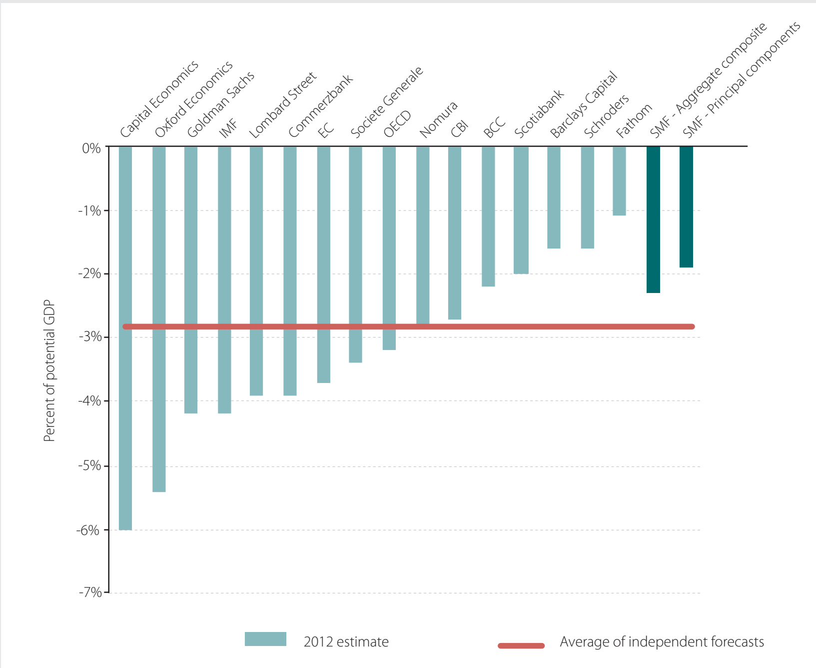
Note: PC = principal components, AC = aggregate composite

Box 2.4: Are the OBR's models right?

Other independent forecasters are split on the size of output gap in 2012 and the change since 2011, with some, such as Oxford Economics, forecasting an increased output gap of -5.4% in 2012, compared with Barclays Capital, who are forecasting a narrowing to -1.6%.[a]

The results we obtain by extending the OBR's preferred model – the principal components approach – to 2012 suggest an average output gap of -1.9% over the first three quarters of 2012. Overall, the average of independent forecasts of the output gap comes to -2.9% for 2012,[b] higher than the OBR forecast in March 2012, and substantially higher than the figures we obtain by extending the OBR's models. Chart 2.8 below shows a selection of the latest estimates made by independent forecasters, against the average of all independent forecasters.

Chart 2.8: Output gap forecasts for 2012



Source: HM Treasury, *Forecasts for the UK Economy* (London: HMSO, March 2012, October 2012), SMF calculations

On average, independent forecasters have revised their output gap estimates for 2012 from -2.6% to -2.9% between March 2012 and October 2012.[c] Of those who have revised their output gap in this direction, most put the change down to falls in their GDP forecast, and/or a reassessed outlook for the productive potential of the economy. They are therefore estimating a larger negative output gap.

Yet the OBR's method appears to be giving estimates that are moving in the opposite direction. Given views of independent forecasters and the concerns with elements of the OBR's models (see Box 2.5), there is a question as to whether the OBR will adopt the results of its output gap models. But moving away from those results simply because the answers they give are uncomfortable would appear hard to justify.

a. HM Treasury, Forecasts for the UK Economy (London: HMSO, March 2012, October 2012)
b. Ibid.
c. HM Treasury, Forecasts for the UK Economy (London: HMSO, March 2012, October 2012). Note that these forecasts were the latest available at the time of each Treasury publication.

As set out earlier, the OBR has, in the past, tended to place more weight on its principal components model. In keeping with this, we outline what an output gap of -1.8% – the figure estimated by the principal components model for the first two quarters of 2012–13[19] – would mean for the OBR's assessment of the Government's fiscal performance.

Box 2.5: Why might the OBR models under-estimate the output gap?

There is wide variation in forecasters' views of the output gap, reflecting the complexity in disentangling permanent and temporary changes in growth. Broadly, forecasters are split on whether the economy's potential is permanently lower than previously thought or whether the economy is simply going through a severe recession and that in time it will recover to levels of trend growth seen prior to the downturn. Forecasters have different models for calculating the output gap, and differ in the weight they put on various indicators and their interpretation of the data.

There is some scepticism about the reliability of business survey data on capacity levels, which are used as inputs in the OBR's models. In some cases, firms may be reporting immediately available capacity rather than their long-run capacity. Historical data suggests that business survey measures of capacity tend to move with actual output rather than potential output – as if survey respondents "find capacity" when output rises sharply and "lose it" when output falls.[b] If this is happening, the OBR models could be under-estimating the size of the output gap. One piece of evidence to support this story is the fact that UK firms have been running large surpluses.[c] This suggests that they would have the ability to expand capacity relatively quickly if demand recovered.

Due to these concerns about reliability, some forecasters, such as Oxford Economics, place more weight on labour market indicators such as the difference between current unemployment levels and estimates of NAIRU[d] – a measure of the level of unemployment that would exist if an economy was operating at its long-run potential.[e] Based on this, Oxford Economics are currently forecasting an output gap of -5.4% for 2012.

Recently, Capital Economics has argued that the OBR's March 2012 estimate of the output gap suggests that the recession caused a permanent loss of output of around 9% of GDP. They argue that this appears implausible. Capital Economics has suggested that even assuming the economy was operating 2% to 3% above potential in 2007, and that the

19. Specifically, we assume that the output gap for 2012–13 is the average of that for the first two quarters

financial crisis dealt a permanent blow to the economy of 5% of GDP, this would suggest an output gap of 6% this year – way above what the OBR's models suggest (See Box 2.4).[f]

a. Bank of England, Quarterly Inflation Report (London: Bank of England: November 2011).http://www.bankofengland.co.uk/publications/Documents/inflationreport/ir11nov.pdf
b. Bill Martin, Is the British Economy Supply-Constrained? A Critique of Productivity Pessimism, (London: UK-IRC, July 2011).
c. Office for National Statistics, Profitability of UK Companies, Q2 2012, October 2012 (http://www.ons.gov.uk/ons/rel/pnfc2/profitability-of-uk-companies/q2-2012/stb-profitability-of-uk-companies-2012q2.html)
d. the Non-Accelarating Inflation Rate of Unemployment
e. Oxford Economics, The UK Long-Term Outlook, (Oxford: Oxford Economics, January 2012).
f. Capital Economics, Is the Output Gap a Crack of a Chasm?, (London: Capital Economics, October 2012)

A SMALLER OUTPUT GAP AND HIGHER BORROWING MEAN A LARGER STRUCTURAL DEFICIT

As explained above, the size of the output gap is a pivotal determinant of how much public borrowing will persist even once the economy recovers, and hence whether the Government is likely to succeed in its fiscal mandate. The bigger the output gap, the further the economy is from potential output, and the higher the proportion of the deficit that can be expected to automatically disappear as the economy recovers. However, the shrinking output gap suggested by this analysis indicates that a large proportion of the deficit is structural.

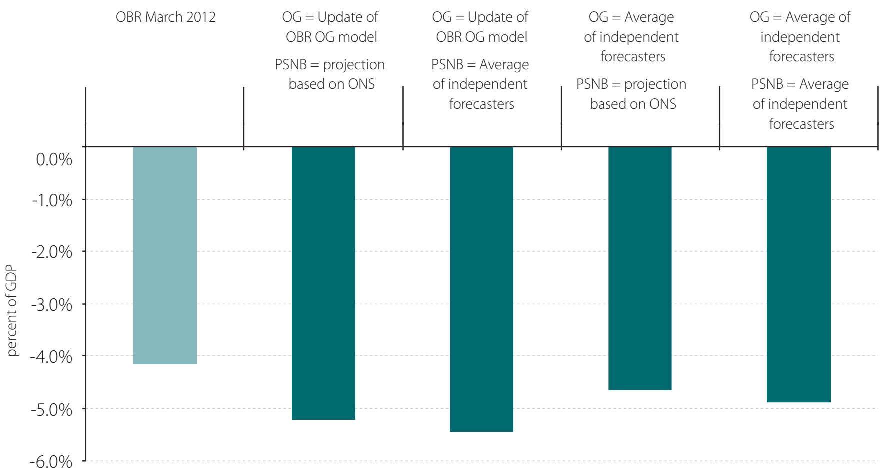
The updated output gap estimate can be combined with the public sector net borrowing figure for 2012–13 implied by the latest ONS figures to re-calculate the structural element of the current budget[20][21] This – our central estimate – suggests that if the OBR's advice adheres to the results of its output gap models, it will find that the structural deficit in 2012–13 is **1.1 percentage points of GDP higher than its March 2012 forecast**.[22] This equates to a £17 billion bigger structural deficit in 2012–13.

In the graph below, we test the impact of changing our assumptions. Independent forecasters are currently predicting higher borrowing levels for 2012–13 than that implied by simply projecting forward the ONS data, as we have done. If these forecasts are right, the OBR's main model will imply an even bigger addition to the structural deficit of 1.3 percentage points of GDP.

But as set out earlier, there is substantial uncertainty around the size of the output gap. Independent forecasters are currently also predicting a larger output gap than our OBR-based forecast. A larger output gap – in line with the average of independent forecasts – results in an additional structural hole 0.5 percentage points larger than that predicted by the OBR in March (see chart 2.9).

20. This is also referred to as the cyclically–adjusted, or structural current budget (CACB)
21. Here we assume the Principal Components Analysis estimate since this is the method that the OBR had tended to draw upon in past assessments.
22. The OBR calculates the cyclically adjusted current budget for a given year using the following equation: Cyclically adjusted current budget = current budget - (0.5 X output gap for current fiscal year) - (0.2 X output gap in previous fiscal year)For more detail, see Office for Budget Responsibility, Working paper No. 3: Cyclically Adjusting the Public Finances (London: HMSO, June 2012)

Chart 2.9: Estimates of the structural surplus on the current budget for 2012–13



Notes:

1. In our central estimate, PSNB is calculated assuming that the current year-on-year percentage gap between 2011–12 and 2010–11 PSNB persists to the end of the year. In comparing the two years, we exclude the one-off impacts of the Royal Mail pension plan and the Special Liquidity Scheme.
2. The output gap calculated is based on the OBR's principal components model
3. Independent forecasts of public sector net borrowing are taken from HM Treasury, Forecasts for the UK Economy (London: HMSO, October 2012).
4. Independent forecasts of the annual output gap are available from HM Treasury's Forecasts for the UK economy. We have converted these output gaps into fiscal years on a simple assumption. E.g. 2012–13 output gap = 0.75*output gap in 2012 + 0.25*output gap in 2013
5. We have assumed that public sector net investment and nominal GDP in 2012–13 remains unchanged from OBR estimates and forecasts in March 2012

CHAPTER 3: THE CHALLENGE AHEAD

The previous chapter set out what the OBR's models are likely to say about the state of the economy and what it means for the size of the structural deficit this year. This Chapter brings that analysis together with the cuts that were already pencilled in for after 2014–15 to identify the full scale of the fiscal challenge ahead.

WHAT DOES THIS MEAN FOR THE GOVERNMENT'S FISCAL MANDATE?

In March 2012, the OBR forecast that by 2016–17 the current budget would be in structural surplus by 0.5% of GDP. If the OBR uses its models as it has in the past, our analysis suggests that its updated forecast this December will instead show a structural deficit on the current budget of 0.6% in that year unless further policy action is taken: the Government will not have succeeded in eliminating the structural deficit by 2016–17.[23]

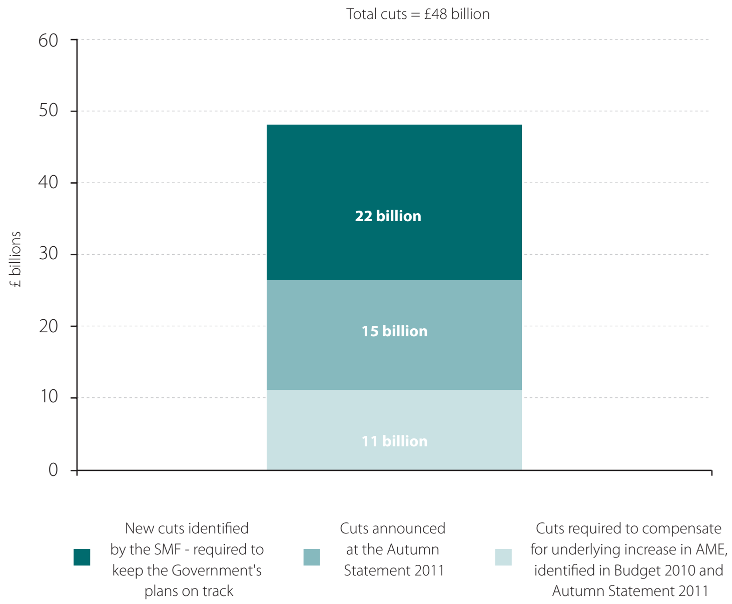
As the Government's fiscal mandate is based on a rolling five year period, its target now is to eliminate the deficit by 2017–18. Assuming the gap in the structural deficit persists as a proportion of GDP, our analysis suggests that the OBR will have to recommend to Government that its fiscal mandate will not be met without further cuts to reduce the structural deficit. This is because the Government will still be running a structural deficit by 2017–18, to the tune of -0.3% of GDP. To eliminate the structural deficit, extra cuts of £6 billion will be required by 2017–18. But doing this much would represent a significant loosening of fiscal policy compared to the plans set out in Budget 2012. To get back on track to achieve those plans, the extra cuts would have to be bigger still.

Back in March, the OBR did not forecast spending and receipts in 2017–18 as at the time, this was beyond the rolling five year period for the Government's fiscal mandate. The furthest ahead it looked was to 2016–17, when the Government was forecast to be enjoying a structural surplus of 0.5% of GDP. We have estimated what the finances would have looked like in 2017–18 if Government had managed to remain on the planned spending path to 2016–17 and letting the finances evolve on standard assumptions in 2017–18.[24] In this previous, rosier scenario based on Budget 2012, the Government would have had a structural surplus on the current budget of 0.8% in that year. If Government now wants its finances to achieve that position by 2017–18, this new analysis suggests it will have to implement **extra cuts or tax increases of £22bn per year by 2017–18**. This is in addition to the £26bn of cuts already implied in the 2012 Budget (see Chapter 1).

In total, then, having initially planned to eliminate the deficit by 2014–15, the Government must soon decide how to distribute some £48bn[25] of fiscal pain after 2014–15 in order to achieve its aims (see chart 3.1).

23. We assume that the gap in the CACB persists as a percentage of GDP
24. Between 2016–17 and 2017–18, we assume that receipts stay constant as a percentage of GDP, resource AME grows by 1.8% (the same rate as in the average of the previous two years), resource DEL stays flat in real terms, and that real GDP growth is equal to trend GDP growth (2.3%) plus "catch-up" growth of 0.4%. We assume the output gap closes from 0.4% to zero in 2017–18.
25. 2017–18 prices

Chart 3.1: Calculating the £48 billion: Total cuts to current spending after 2014–15?



Note: 2017–18 prices

Box 3.1: Could the cuts be less than £48 billion?

Our analysis suggests that in the next spending review, Government will have to decide how to allocate £48 billion worth of cuts or tax rises after 2014-15. This figure is based on what Government would need to do to get the public finances back to where they would have been in 2017-18 if public finances had evolved as hoped in Budget 2012. At the forthcoming Autumn Statement, however, the Government may choose to target a different level of cut. In this box, we summarise the main reasons why a different level of cuts might be planned.

1. **OBR chooses to base its output gap estimate on the results of the aggregate composite model.** As we set out in Section 2, the OBR has, to date, placed much more weight on its principal components analysis model in assessing the output gap. We have followed this convention to re-calculate the structural deficit. Switching to the aggregate composite model would give a larger output gap and a smaller structural deficit, reducing the cuts needed from £48 billion to £45 billion.
2. **OBR adopts the consensus output gap.** Given the views of independent forecasters, the OBR may decide to ignore its models and assume a larger output gap, based on the average of independent forecasts. This shift would appear hard to justify (see Box 2.4), but it would also give a smaller structural deficit estimate, reducing the cuts needed from £48 billion to £37 billion (see chart 2.9)
3. **Government chooses to ease up on earlier plans and simply extend the current pace of annual cuts into 2017-18.** Current plans involve the Government cutting total spending by 0.9% in both 2015-16 and 2016-17 – a simple extension of the pace of cuts implemented in the 2010 spending review. The Government might therefore decide to ease up on earlier plans and extend the 0.9% cuts for a further year in 2017-18, allowing it to meet the mandate albeit less comfortably. Taking this route would mean targeting a total cut of around £40 billion rather than £48 billion by 2017-18.

> **4. Government chooses just to target structural balance by 2017–18.** If the Government loosens its fiscal policy stance and plans spending cuts only just to hit its target of eliminating the structural deficit, it would have to find additional cuts of around £33 billion rather than £48 billion by 2017-18. This would represent a significant loosening of the plans outlined at the last Budget, however.

The three ways the Government can plug the gap are:

1. Increasing revenue from taxation.
2. Reducing current annually managed expenditure (AME), a category of spending that is primarily made up of social security spending.
3. Reducing current departmental expenditure limits (DEL), a category of spending that includes the costs of delivering public services – employing teachers, doctors, police and others – as well as a wide range of other costs associated with different departments' functions.

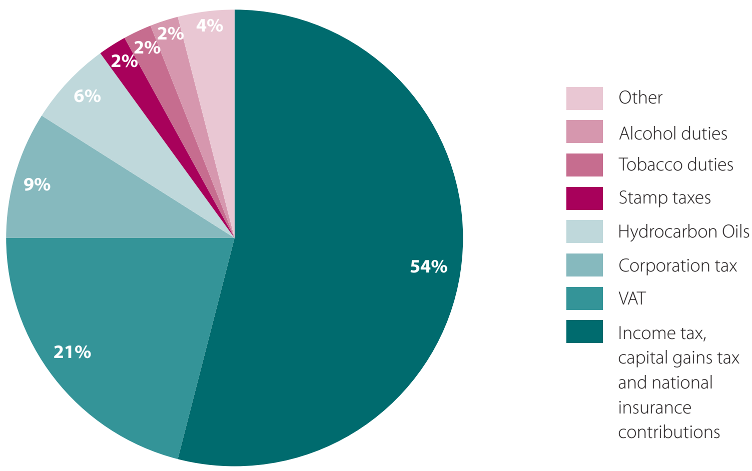
In the rest of this chapter, we give a sense of the ways that the Government can make the necessary savings after 2014–15 without reference to the third of these options, spending on public services.

First we look at the scale of tax increases that would be required; then we examine the kind of AME cuts that could be implemented. Chapter 4 then goes on to look at the implications for spending on public services if the Government sticks to current plans to leave taxes unchanged and save £10.5bn from AME after 2014–15. None of these scenarios are intended as policy recommendations, rather they are set out here to show the different trade-offs facing Government.

FILLING THE GAP THROUGH TAXATION

Total central Government receipts came to around £533 billion in 2011–12. Most of this was made up of tax receipts.

Chart 3.2: Breakdown of 2011–12 tax revenues



Source: HMRC, HMRC Tax & NIC Receipts (London: HMSO, October 2012) (http://www.hmrc.gov.uk/stats/tax_receipts/tax-nic-receipts-info-analysis.pdf)

Very substantial tax increases would be required to fill the £48 billion fiscal hole in 2017–18 – equivalent to £42 billion in today's prices. In the event that the Government did want to make substantial in-roads into the deficit through taxation it would have to focus on raising income tax, national insurance contributions or VAT: changes in other taxes are unlikely to make a significant dent in the deficit (See Chart 3.2).

Table 3.1, below, shows a range of options for raising substantial amounts of revenue through taxation. These are rough estimates, assuming no 'behavioural responses'. In reality, when tax rises, individuals tend to take steps that reduce their tax bill, for example, by working fewer hours or engaging in tax avoidance schemes. Therefore, these numbers are likely to over-estimate the actual amount raised. Even in the absence of any behavioural responses, we can see that to fix the public finances through tax rises alone would mean changes on the scale of adding four percentage points to VAT and raising the basic rate of income tax from 20% to 24%.

Table 3.1: Tax options quantified

	Annual amount raised in 2017–18 (2017–18 prices)
Decrease all income tax personal allowances by 10%	£6.8 billion
Increase VAT from 20% to 22%	£12.8 billion
Increase Class 1 employee main rate national insurance contributions by 4 percentage points	£18.0 billion
Increase VAT from 20% to 24%	£25.6 billion
Increase basic rate of income tax by 4p	£21.3 billion
Halve higher rate tax relief on pension contributions[23]	£9.0 billion
Cap ISA holdings at £15,000[24]	£1.3 billion

Source: HMRC, Tax Expenditures and Ready Reckoners, Direct Effects of Illustrative Tax Changes (http://www.hmrc.gov.uk/stats/tax_expenditures/table1-6.pdf), SMF estimates

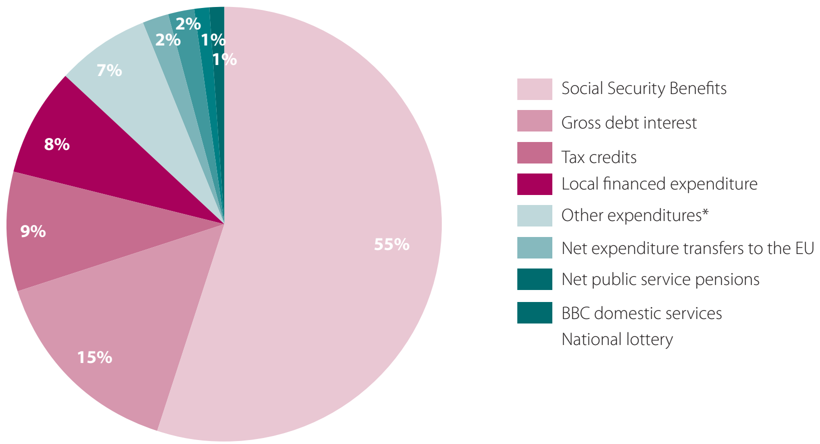
Note: The final year for which Ready Reckoner figures are available is 2014–15. We estimate the amount raised in 2017–18 by assuming the figure for 2014–15 remains constant as a percentage of GDP

Filling the gap by cutting annually managed expenditure (AME)

Current AME spending in 2011–12 amounted to around £305 billion (see chart 3.3). The largest component of AME is social security spending, including the state pension and other pensioner benefits, and tax credits. The next largest category is debt interest, something that is beyond the direct control of the Government. This means that welfare cuts are the main candidate for reducing AME spending.

26. Author's calculations. Value of net pensions tax relief, less employers' NICs relief, multiplied by the proportion of tax relief received by higher rate taxpayers. Pensions Policy Institute, Pension Facts (London: PPI, 2011). Assuming the value raised in 2017–18 is the same in real terms.
27. Based on calculations and HM Revenue and Customs, "Individual Savings Account Statistics" (London: HMRC, 2011). HMRC, "Estimated costs of the principal tax expenditure and structural reliefs", (http://www.hmrc.gov.uk/stats/tax_expenditures/table1-5.pdf).

Chart 3.3: Breakdown of 2011–12 resource AME expenditure



Source: HM Treasury, *Public Expenditure Statistical Analysis, National Statistics Release, Section 2, Chapter 5* (London: HMSO, 2012), Table 5.2.
Notes: "Other expenditures" include non-cash items, student loans, accounting adjustments and other departmental expenditure.
This breakdown does not include the negative figure for 2011–12 financial sector interventions.

The Chancellor has already indicated plans to cut £10.5 billion from welfare spending – although it is not yet clear where these cuts could fall. Finding the planned £10.5bn will be hugely controversial, and will likely include some of the measures shown in Table 3.2 below.

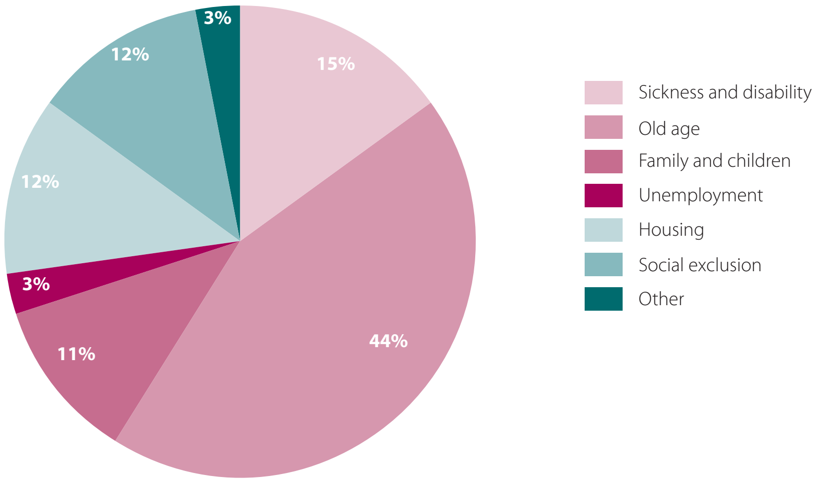
Table 3.2: AME options quantified

	Annual amount saved (2017–18 prices)
Providing Winter Fuel Payments and free TV licenses only to those on Pension Credit	£2.0 billion[28]
Scrapping free bus travel for the over-60s	£1.2 billion[29]
Two-year working age benefits freeze from April 2013	£4.5 billion[30]
Cut housing benefit for under 25s	£2.3 billion[31]
Roll child benefit into the universal credit	£2.8 billion[32]

Clearly, going further than the planned £10.5bn would be very unpalatable. Options could include extending the working age benefits freeze for further years or freezing pensions. So far the Government has tended to steer clear of suggesting cuts in benefits to pensioners. But pensioner spending accounts for a huge proportion of total social security – 44% in 2011–12. If pension-related benefits were protected, the rest of the benefits bill would have to bear the brunt of the cuts.

28. Assumes that savings are in proportion to the proportion of Pension Credit recipients in the pensioner population.
29. Based on Department for Transport, http://www.dft.gov.uk/topics/local-authorities/funding
30. James Brown, Andrew Hood and Robert Joyce, The £10bn question: where could the Chancellor find welfare cuts? (London: IFS, October 2012).
31. James Brown, Andrew Hood and Robert Joyce, The £10bn question: where could the Chancellor find welfare cuts? (London: IFS, October 2012).
32. Value of Child Benefit less planned savings on higher rate taxpayers from 2013, less spending on current tax credit claimants receiving more than the Family Element.

Chart 3.4: Spending on Social Security 2011–12



Note: Spending on social protection excluding personal social services. "Social exclusion" includes benefits to individuals who are socially excluded or at risk of social exclusion. These benefits include income support. Source: HM Treasury, *Public Expenditure Statistical Analysis, National Statistics Release, Section 2, Chapter 5* (London: HMSO, 2012), Table 5.2.

Implementing a £10.5 billion cut to benefits will require significant changes to the benefits system. There is already much concern about the economic and social impact of proposed cuts on individuals and families of working age. In the absence of tax rises, if these cuts are not made, spending on public services will have to be cut by even more than planned.

The next chapter explores the implication for spending on public services on the government's current plans.

CHAPTER 4: SHRINKING DEPARTMENTS: THE NEXT SPENDING REVIEW

The next spending review is looming, and could come as soon as autumn 2013. What does the analysis of this paper mean for that important event? The last chapter touched on some alternative ways to deal with the deficit. In this chapter, we outline what cuts to departmental expenditure would look like at the next spending review if the Government sticks to the plans it has outlined: to cut the social security bill by £10.5bn and keep taxes unchanged. There will be doubts about whether such deep social security cuts and no further tax increases is politically viable, but it is the direction of travel outlined by the Government, and hence the starting point for the analysis of this chapter.

Implementing the current plan would mean total cuts to departmental expenditure of £37 billion[33] by 2017–18. To achieve this, departmental expenditure would have to fall by an average of 11% in real terms, over the three years to 2017–18.

There are several ways that Government could distribute this level of cuts. Below, we show the impact of two different strategies for cutting annual spending on public services by £37 billion between 2014–15 and 2017–18.[34]

A) Spread the cuts evenly across all departments

The first option is to spread the pain across all departments equally, on the grounds that after the last spending review, cutting £1 from any department's budget will be as hard to do as finding the same amount from another's. This would mean that each department would suffer a 3.7% real terms cut every year over 3 years – a total real cut of 11%, between 2014–15 and 2017–18.

B) Protect spending on the NHS, international aid and education

In the 2010 Spending Review, the health and international development budgets were protected from cuts. The Department for Education was relatively protected – under the 2010 Spending Review plans, it was to take a -3.4% real cut between 2010–11 and 2014–15, compared to an average cut of -8.3% across all departments.[35] This reflected the fact that spending on schools was held constant in real terms. If, at the next spending review, the Government wanted to continue to protect education, health and international development from cuts, other departments would see a real cut of 23% over between 2014–15 and 2017–18. Protecting health, education and international aid would more than double the pain for other departments.

The cash equivalents of the cuts required to annual budgets under scenarios A and B, in 2017–18 prices, are shown in Table 4.1, below.

33. 2017–18 prices
34. We use planned 2014–15 departmental spending as set out in the 2010 Spending Review as our baseline.
35. HM Treasury, Spending Review 2010, (London: HMSO, 2010)

Table 4.1: Budget cuts at the next spending review (2017–18 prices)

Department	Budget cuts (£bn) No departments protected	Budget cuts (£bn) NHS, International development & Education protected
Health	12.6	-
Education	6.2	-
Defence	2.8	6.0
Communities & Local Government	2.8	5.9
Business, Innovation & Skills	1.6	3.3
International Development	1.1	-
Work & Pensions	0.9	1.8
Home Office	0.9	1.9
Justice	0.8	1.7
Transport	0.5	1.1

WHAT COULD THESE CUTS MEAN FOR PUBLIC SERVICES?

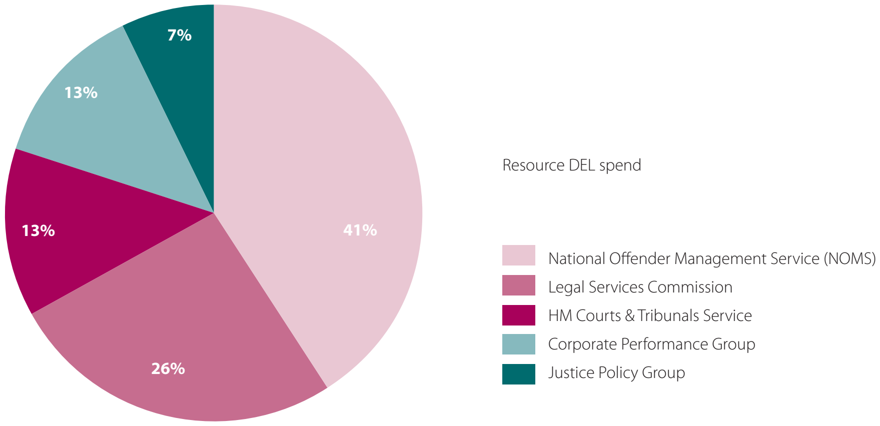
In the abstract, it can be hard to understand what this scale of cuts will mean for the vital public service functions provided by different government departments. In this sub-section, we therefore set out what the cuts outlined above could mean for the choices faced by three different departments in the three years to 2017–18. The departments shown are chosen for illustrative purposes and are based on the current Resource DEL spending breakdowns for the Ministry of Justice, the Department for Work and Pensions and the Home Office.[36]

Ministry of Justice

Currently, the largest area of departmental spend for the Ministry of Justice is the National Offender Management Service, which comprises both prison and probation services. This is followed by the Legal Services Commission which provides legal aid, and the courts and tribunal services.

36. In practice, the way in which Resource DEL breaks down may have changed in different departments by 2014–15, depending on how the cuts announced as part of the 2010 Spending Review were implemented.

Chart 4.1: Ministry of Justice current departmental spending, 2011–12



Source**:** Ministry of Justice: *Annual Report and Accounts 2011–12* (London: HMSO 2012).
Note: excludes depreciation

If the Ministry of Justice's annual budget in 2014–15 breaks down in the same way, then a £800 million cut – the level required if cuts were spread evenly across departments – would be roughly equivalent to:

- Cutting a quarter of the National Offender Management Service – i.e. the prisons and probations budget; or
- Cutting around 40% of the Legal Services Commission – i.e. the legal aid budget; or
- Cutting around 80% of the courts and tribunals service budget.

A £1.7 billion cut – required if NHS, education and international development are to be protected – would be roughly equivalent to:

- Halving spending on the National Offender Management Service – i.e. prisons and probations budget; or
- Cutting over 80% of the Legal Services Commission – i.e. the legal aid budget.[37]

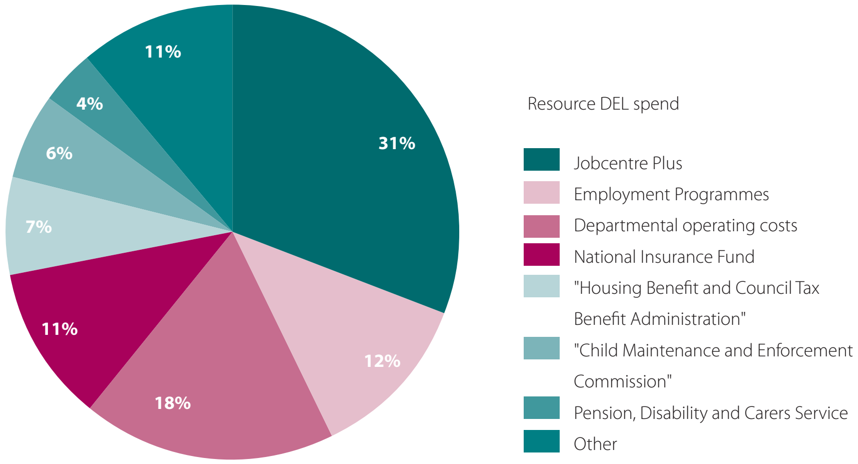
These reductions will, of course, come on top of the tight squeeze on spending in these areas over the 2011-15 spending round.

Department for Work and Pensions

Currently, the largest area of departmental spend for the Department for Work and Pensions is Jobcentre Plus and employment programmes, which together make up over 40% of total Resource DEL for the department.

37. These illustrative numbers refer to Resource DEL spending – current departmental expenditure, excluding annually managed expenditure

Chart 4.2: Department for Work and Pensions current departmental spending, 2011–12



Source: Department for Work and Pensions: *Annual Report and Accounts 2011–12* (London: HMSO 2012)

If the DWP budget after 2014–15 breaks down in the same way, then a £900 million cut – the level required if cuts were spread evenly across departments – would be roughly equivalent to:

- Cutting a quarter of spending on Jobcentre Plus and employment programmes – reducing the amount of job-seeking assistance for the unemployed; or
- Cutting around 60% of departmental operating costs; or
- Cutting around 60% of spending on housing benefit and council tax administration, the Child Maintenance and Enforcement Commission and the Pension, Disability and Carers Service.

A £1.8 billion cut – required if NHS, education and international development are to be protected – would be roughly equivalent to:

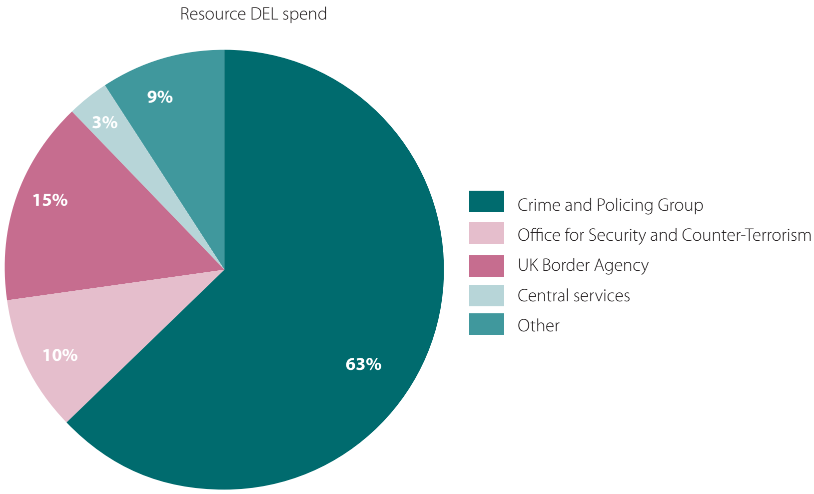
- More than halving combined spending on Jobcentre Plus and employment programmes; or
- Cutting departmental operating costs and housing benefit and council tax administration costs by around 90%.[38]

Home Office

Just under two-thirds of the Home Office's current departmental spend is on crime and policing. The two largest areas of spend after this are on the UK Border Agency and the Office for Security and Counter-Terrorism.

38. These illustrative numbers refer to Resource DEL spending – current departmental expenditure, excluding annually managed expenditure

Chart 4.3: Home Office current department spending, 2011–12



Source: Home Office: Annual Report and Accounts 2011–12 (London: HMSO 2012)

If the Home Office's budget after 2014–15 breaks down in the same way, then a £900 million cut – the level required if cuts were spread evenly across departments – would be roughly equivalent to:

- Cutting over 15% of spending on crime and policing; or
- Cutting over 40% of costs from the UK Border Agency and the Office for Security and Counter-Terrorism.

A £1.9 billion cut – required if NHS, education and international development are to be protected – would be roughly equivalent to:

- Cutting over a third of crime and policing spend; or
- Cutting spend on the UK Border Agency and the Office for Security and Counter-Terrorism by around 90%.

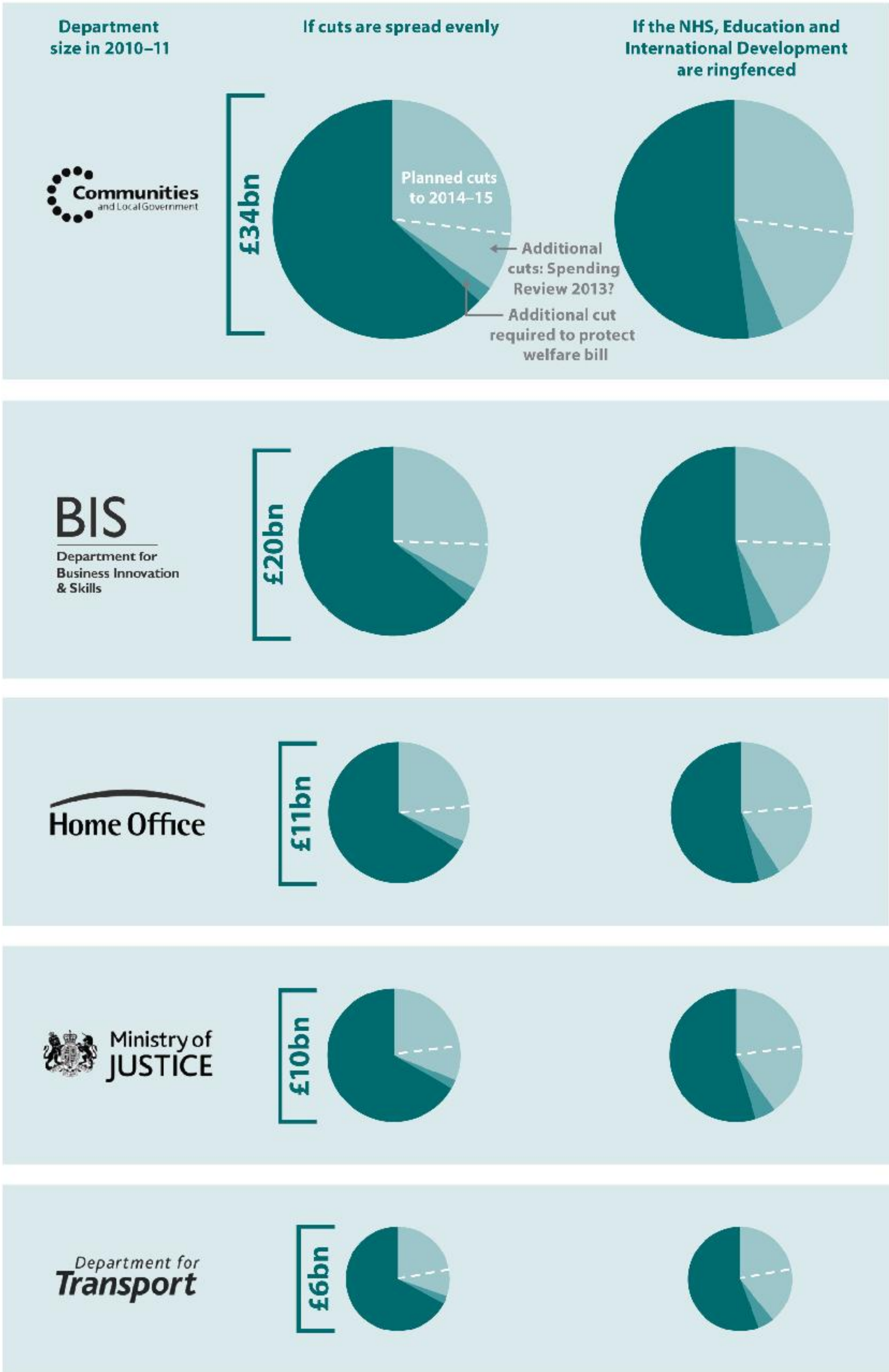
AN EIGHT-YEAR SQUEEZE

The cuts we have outlined above come on top of cuts already planned to take place by 2014–15 as part of the 2010 Spending Review. Stepping back from the challenge of the next spending review, then, it is worth considering what the cumulative effects of these cuts to public services will amount to across the whole period between 2010–11 and 2017–18. The impact is huge.

The diagram below shows the implications of the total cuts between 2010–11 and 2017–18 – including the additional cuts required after 2014–15, for a selection of departments. Protecting NHS, education and international development spending would pile further pain onto the remaining departments: for example, Home Office spending would have been slashed by around 40%, in real terms, since 2010.

If taxes are unchanged and cuts to social security cannot be made, many departments would be approaching half the size they were in 2010 by 2018.

What will the departments look like in 2017–18?



Note: department sizes based on Resource DEL in 2017–18 prices

The Communities & Local Government budget is split into communities and local government. In the chart above, we show the local government budget – the largest of the two

The OBR models may not be right, but any advice based on them in the Autumn Statement will highlight a large hole in the public finances. The appropriate way to fill that hole is beyond the scope of this paper, but on the government's current plans, public spending will be hit hard.

PART 2: A SOCIAL PRODUCTIVITY SPENDING REVIEW

Ben Lucas & Henry Kippin

The Social Market Foundation has set out a dramatic challenge to Government as it prepares for a possible spending review in a year's time. They argue that to meet its 'fiscal mandate' and remain on its planned financial path, the Coalition must identify £48 billion of cuts by 2017–18. The Chancellor has already signalled controversial plans for £10.5 billion worth of cuts to the welfare bill. But whatever the outcome here, it is clear that departmental expenditure (DEL) will bear the brunt of the cuts, implying average real terms budget reductions of some 11 per cent over the three years from 2015–16 to 2017–18.

These figures throw down extraordinary challenges for policymakers. Spending decisions are always a compromise between competing economic, social and political imperatives. But the next spending review will force decisions that fundamentally re-shape the British state in the short term, as well as profoundly change our economy, public services, and livelihoods over the long term. More than ever, it is vital that these decisions be long-term and strategic, and that the analysis provided by the SMF is used to prompt a different kind of spending review.

Given the scale of the necessary spending cuts identified in the SMF's analysis, it is clear that neither absorbing cuts within annual managed expenditure (AME), nor forcing incremental cuts in DEL are sustainable fiscal solutions. The welfare budget is not a bottomless pit for cuts, and we will incur a massive human cost if it continues to be treated as one. Neither can we keep salami-slicing government departments as they are currently configured. We need a new approach. This must start with a frank discussion about the way we make policy, how we deliver it, and what we measure and value in public services.

This essay is an attempt to start this process. It makes a case for a new approach based on three hypotheses:

1. *The starting point is wrong:* we are too focused on Whitehall, stuck in a rational-individualist mindset, and not concerned enough with the collaborative role public service providers and citizens can play in reducing demand and transforming delivery.
2. *The mechanics are flawed:* we must abandon our obsession with delivery from the centre and stop protecting siloed budgeting and top-down departmental management. Alongside this we must get serious about the potential for a multi-polar political economy with revenue-raising and expenditure taking place as much within local government as centrally.
3. *We measure the wrong things*: we should be measuring performance based on public service productivity and the social and economic value that we create, and become more transparent about the contributions of, and benefits to, citizens and communities.

In this chapter we argue for a different kind of strategic spending review (SSR) with a different starting point and a new operational framework based on social productivity. It is the beginning of a blueprint for change, and we do not underestimate the scale of reform it implies. But for public services to be fit for purpose over the long term, we need to start thinking differently today. The following pages suggest how.

THE PROBLEM

Short term concerns have understandably dominated the Government's agenda. As the SMF has observed, it came to power with two 'fiscal rules': to 'eliminate the structurally adjusted deficit within a five year period'; and 'to have debt falling as a proportion of GDP' by 2015–16. As we know, significant cuts in public expenditure, with more to come, have been made in an attempt to stick to these 'fiscal rules'. Meanwhile the private sector – to whom wealth generation is perennially entrusted – has struggled to perform under fragile economic conditions and within a double-dip recession.

At the same time, the Coalition is prosecuting ambitious reform agendas in the 'big ticket' areas of public spending – that is, health, education, welfare and public safety; has re-vamped the country's growth infrastructure, scrapping Regional Development Agencies (RDAs) and introducing Local Enterprise Partnerships (LEPs); and has introduced legislation to free up local government, albeit under severe financial constraints.

Yet despite this massive upheaval and reform, there is little coherence between our national strategies for fiscal sustainability, sustainable growth and public service reform. This is a problem. The big challenges of the future – responding to growing and changing demand, improving inadequate and unequal social outcomes, and creating inclusive growth and prosperity – are interrelated and require a joined up and coherent approach.

- Responding to growing and changing demand: the impact of demographic change will be profound and is well known to policymakers. The OBR, for example, estimates that health spending alone will rise by 2.4 percentage points of GDP between 2015-16 and 2016-61.[1] Research commissioned for the 2020 Public Services Commission from Professor Howard Glennerster of the London School of Economics predicted that an additional 6 per cent of GDP would need to be spent on public services by 2030 to meet the social costs of an ageing society and to maintain existing cross-party social policy commitments.[2] Demand for services is not only rising but changing, with health, social care and community services anticipating more complex case loads and a clear shift away from 'traditional' social problems.

  At a local level, the fiscal impact of rising demand is daunting. The Local Government Association have estimated that the cost of meeting rising demand for statutory services such as adult care and waste could leave local government with a funding gap of £16.5 billion by 2019–20. Assuming that social care and waste costs are met in full, this means that other services would have to be cut by 66 per cent.[3] None of this

1. Office for Budget Responsibility, Fiscal Sustainability Report (London: OBR, 2012).
2. Howard Glennerster, 'Financing our Future Welfare States' (London: 2020 Public Services Trust, 2010).
3. Local Government Association, Funding outlook for councils from 2010/11 to 2019/20: Preliminary modelling (London: LGA, 2012).

takes account of the further cuts identified as necessary by the SMF after 2014–15. Birmingham City Council has given a stark illustration of the impact of these cuts on the UK's second largest city, warning that some £600 million of cuts could result in 'the end of local government as we know it'.[4]

- Improving inadequate outcomes: high profile policy reviews from Marmot, Hills, Milburn, Tickell and others illustrate the limitations of our existing service delivery models in the face of these new demands, and challenge the preconception that our current ways of working can deal with the complexity of the social and economic challenges we face. If we care about equalities, social mobility, social prosperity or service productivity, we need a different approach to public service delivery and a focus on achieving outcomes in more creative and less siloed ways. The human cost and economic impact of not tackling problems proactively is huge. For example, the Christie Review of 2011 estimated that 'as much as 40 per cent of all spending on public services [in Scotland] is accounted for by interventions that could have been avoided [through] a preventative approach'.[5] Writing recently for the RSA, Dame Clare Tickell noted that 'the impact of wider system failure can be very high', citing the cost of children in care at £2.9 billion and the cost of drug misuse at an estimated £77.7 billion in the UK.[6]

- Creating more inclusive and rebalanced economic growth: how the UK can shift from a uni-polar model of growth based around London to a multi-polar growth model– in which prosperity is driven by several cities – is the big economic challenge of our time. If we are to build on the new foundations of LEPs, City Deals and more independent local government, we need a more strategic approach that engages the public, private and social sectors as partners. As Cities Minister Greg Clark MP has argued, 'for too long governments treated [different parts of the country] as if they were all the same, making them conform to a Whitehall template'.[7] We now need to combine what the RSA 2020 Public Services Hub has called 'shared spaces' for negotiated local growth[8] with joint working and resource-sharing across the public, private and social sectors to combat high unemployment and drive more inclusive entrepreneurialism and growth.

These complex and multi-layered challenges for public services require a response that cuts across traditional service divides, geographical boundaries and the historical relationship between citizen and services. A spending review rooted in Whitehall and designed from the centre outwards cannot adequately provide this.

4. Patrick Butler, "Birmingham city council warns of 17% spending cuts", the Guardian, October 23, 2012. Available online at: http://www.guardian.co.uk/society/2012/oct/23/birmingham-city-council-cuts-warning
5. Commission on the Future Delivery of Public Services, Report on the Future Delivery of Public Services by the Commission chaired by Dr Campbell Christie (APS Group Scotland, 2011).
6. Claire Tickell, Families with Multiple Problems: Plugging the Gap (London: RSA, 2012).
7. Cited in Deputy Prime Minister, Bold deals to set more cities free for growth, October 29, 2012, http://www.dpm.cabinetoffice.gov.uk/news/bold-deals-set-more-cities-free-growth
8. Henry Kippin, Heidi Hauf and Atif Shafique, Business, Society and Public Services: a social productivity framework (London: RSA, 2012).

AN EMERGING CONSENSUS?

As a society, we are more diverse, demanding and knowledgeable than ever. We live, work and socialise in ever different and often more complex ways. The inequalities between us are damagingly pervasive and stubborn. We are, in many respects, unrecognisable from the UK of the post-war era.

Characteristics of Tomorrow's Public Services?
Social Citizen Driven
Responsibility enhancing
Productive
Preventative
Collaborative
Insight driven
Integrated
Entrepreneurial
Relational

Policymakers across the spectrum agree. They know that public services must evolve and adapt – displaying fluidity, agility and adaptiveness, as well as offering a safety net and a sense of social solidarity. Policymakers even agree on many of the characteristics of public services in 2020 and beyond: they must, for example, build resilience, foster co-production, reduce dependency and use technology to drive down costs and reduce demand over the long term.

Yet we fail to achieve these goals today because we are trying to fit these characteristics into an operating model designed in the 1940s. Through the beginnings of New Public Management in the 1980s, targets, choice and voice in the 1990s and 2000s, to 'big society' and open public services today, we have seen patchy outcomes from policy innovations because our starting point is wrong.

A NEW OPERATING FRAMEWORK

The RSA 2020 Public Services Hub has called for a new operating framework based on the concept of social productivity. Its starting point is strong relationships between citizens and services and between different sectors of society as a whole. Value in public services is not transactional: it is the product of a nuanced relationship. It is not just about delivering services to meet needs, it is about enabling people to achieve their goals; to be capable, autonomous and socially responsible.

This simple analytical starting point suggests some radical reforms to the way public services are designed and delivered: shifting resources away from traditional departmental and sectoral priorities towards the things that citizens need to build strong and capable communities with rich networks of social and economic capital.

So far, so conceptual. But we can also see the relevance of this framework at the coalface. The RSA 2020 Public Services Hub has developed a body of work that shows what social productivity approaches look like in practice, working over the last two years with partners in local and central government and across the spectrum of public service sectors. Based upon this experience, we are calling for a SSR based on seven strategic priority changes, each representing a new deal between government, citizens and the practitioners and policymakers who deliver our public services.

What ties these priorities together is a new social contract: an overarching change in the character of our public services and our relationship to them:

- For the state, this will require a shift from social protectionism and economic liberalism to social and economic productivity.
- For citizens, this will mean a change from guaranteed service entitlements to a new deal based on reciprocity, in which we are expected to make a contribution to society and to make the most of our opportunities. In return we can expect support when we need it as well as help to develop our capabilities so that we can lead the lives we choose.

A SOCIAL PRODUCTIVITY SPENDING REVIEW

Our proposal is for a Social Productivity Spending Review based on three core principles, starting from a rebalancing of the relationship between central government, localities and citizens.

These principles are:

1. Rebalance and realign
2. Citizen-side innovation
3. Manage for social productivity

FIRST PRINCIPLE: REBALANCE AND REALIGN

We have argued that the starting point for the current and previous spending reviews is outdated. It is too focused on delivery from the centre, too protective of siloed budgeting and top-down departmental management, and not serious enough about the potential for a multi-polar political economy. Urbanisation and the continued growth of cities is one of the most significant social and economic trends across the world. The quality of leadership and the capacity to innovate and create competitive advantage within cities will be critical to their success in the future. So we propose a new starting point: fundamentally rebalancing revenue-raising and expenditure towards local government and away from Whitehall and kick-starting collaboration and integration across the public service landscape. The next spending review should include these two priorities:

Priority 1: Rebalance public finance away from Whitehall

To truly reflect the changing social and economic realities of the UK, an SSR must force a rebalanced model of public finance – both in terms of expenditure and revenue-raising – away from Whitehall and towards cities and counties. City Deals and the model of negotiated autonomy they are premised on provide a basis for this. We need to see a reduction in the size and scope of Whitehall and an increase in the power local government has to borrow, invest and respond to social and economic opportunity.

The 'smart' or 'intelligent' cities movement shows the potential of collaborative governance at a city level to drive new investment and create both jobs and social and environmental value. The Treasury's own Total Place and Community Budget pilots demonstrate the efficiencies that can be generated via a 'whole place' way of working. Lord Heseltine in his report "No Stone unturned: In pursuit of growth" argues that a single funding pot from which cities and city regions could bid to run their own integrated public service and growth strategies could add up to £49 billion of expenditure over four years, combining current funding streams on skills, local infrastructure, employment support, housing and business support. If other aspects of the Department for Work and Pensions empire, such as out of work benefits, were added in, the pot could be even larger.

Negotiated deals should work on the basis of local control over a larger 'pot' of resources (exploring the feasibility of retaining potential AME savings), in return for delivering material efficiencies across the board through integrated working and better demand management. Working coherently at a place level would force a rethink of the DEL-AME equation, with localised welfare, preventative spending such as community budgets, and integrated health and social care raising questions around fair allocation and return on investment.[9]

Why should the Treasury care?

- Total Place pilots mapped some £82 billion of area-based public spending, with many pilots identifying huge overlap and inefficiencies.

9. i.e. who invests, and in whose garden does the fruit fall….

- Massive potential for new revenue-raising and growth, as highlighted in the recent Heseltine review.
- Long-term potential to re-think the DEL/AME equation at a local level.

Priority 2: Get beyond the rhetoric on collaboration and integration

We know that some of the most substantial savings across health and public services can come from collaboration between agencies and integration of functionality around people, place and outcomes. In the US, for example, healthcare provider Kaiser Permanente bases its hugely successful operating model on 'tight integration...close coordination (between care settings)', and 'a strong emphasis on prevention'.[10] In local government, shared services between adjacent local authorities – for example between Westminster, Kensington and Chelsea and Hammersmith and Fulham – have already yielded significant savings. There is clearly much more that can be done to develop this opportunity.

The potential for strategic collaboration, co-ordination and integration is also there in the new combined authority for Greater Manchester and in some of the other City Regions. The starting point is not forcing integration through command and control, but developing incentives for it to occur at an organisational level. Negotiated autonomy should drive this process by encouraging public service agencies and businesses to work together to draw down a single pot of funding from Whitehall to deliver certain services. Lord Heseltine's suggestion of a bidding process for these funding pots could reinforce this.

An example of collaborative practice is Academies and Free Schools. Having decoupled from local authorities these now need to go to scale to generate efficiencies, spread good practice and embed local relationships. We are already seeing the emergence of Federations of Schools, a process which needs to be encouraged if we are to avoid local fragmentation of services. A similar process will need to take place in public health.

An SSR should develop strong incentives to collaborate beyond the fiscal bottom line. Managing for productivity and social value is key. However, we must also draw from the lessons of early City Deals to create new devolved governance mechanisms that can support and legitimise integrated services at different levels of government.

Why should the Treasury care?

- Shared services and integrated functions can generate massive back-and-front office savings for government.
- Incentives to manage for outcomes can enable 'more for less' deals with real-terms savings and the potential of re-investment in the front-line.
- Future demand will swamp the health, social care and housing sectors without better integration across organisations and sectors.

10. McKinsey Quarterly, "What Health Systems Can Learn from Kaiser Permanente: An interview with Hal Wolf", mckinseyquarterly.com, July 2009.

SECOND PRINCIPLE: CITIZEN-SIDE INNOVATION

We have argued that our public service operating framework is flawed. It is too Whitehall-centric, too stuck in a rational-individualist mindset, and not concerned enough with the collaborative role public services and citizens can play in reducing demand and transforming delivery. In response we propose new 'mechanics' that focus much more on managing demand, building capabilities and giving citizens the tools to generate their own social and economic value. The SSR should look at the following three priorities:

Priority 3: Get serious about demand management

Public services are obsessed with supply side management, responding to demand by rationing delivery without understanding the underlying dynamics and local drivers of demand growth. If we carry on this way, and as the Local Government Association has previously argued, our services will simply be overwhelmed by a level of demand they cannot possibly meet.

An SSR should start with the networks, capacity and assets of local communities, using methodologies such as the RSA's Connected Communities and Changemakers to build a comprehensive picture of the UK's social resources. It must use this evidence to push resources towards preventative intervention, service innovation and 'soft' initiatives that reduce the need for expensive, acute service provision.

The SSR must also encourage devolution of decisions to communities of place and interest, for instance via local welfare budgets and 'socialised' individual budgets; the use of social investment models; and 'negotiated autonomy' deals.

The rising cost of adult care will represent one of the biggest future demand pressures. Responding to this should involve a combination of a Dilnot based solution for the cost of professional care together with much greater social innovation in lower intensity family and community based care. Japanese-influenced Care Credits systems (piloted for example in Windsor and Maidenhead) are one example of this. At the other end of the spectrum, low cost, better outcome models based on creative used of personal and combined budgets should be encouraged. The Shared Lives approach embodies this ethos, whereby voluntary carers are matched with adults with care needs, with each arrangement creating an average annual saving of £13,000.[11]

It is at a local level that these innovations can most effectively take place. Councils like Oldham and Sunderland have begun to develop innovative approaches based on decentralising services; developing local commissioning capacity; and taking a community leadership role in brokering and catalysing neighbourhood behaviour change by extension reducing demand for public services.

11. See Alex Fox, "White Paper highlights Shared Lives and micro-enterprises", blog posted on July 11, 2012, http://alexfoxblog.wordpress.com/2012/07/11/white-paper-highlights-shared-lives-and-micro-enterprises/

Why should the Treasury care?

- There is the potential for significant reductions in demand for services by enabling behavioural change and citizen contributions.
- This approach also provides new customer insight to realign and target public resources more effectively.
- Localised working promotes responsive services and preventative interventions, saving money over the long term.

Priority 4: Promote 'UK Flexicurity' in the welfare system[12]

Helping make work pay and making welfare just and affordable are key policy priorities for Government. An SSR should open up debate around the contributory principle and explore the potential of flexible lifetime welfare accounts that can integrate economic and social contributions through citizens' life-cycles. It should draw on the evidence around innovations such as E-Citizen Portfolios in the Netherlands, Germany's Virtual Labour Market, and experiments in the UK with time banking and community dividends.

The SSR should place greater emphasis on how the public sector can, at the national and local level, more effectively support work through training accounts, hours exchanges and promotion of the Living Wage. It must explore the trade-offs between targeted and early support for those who need it and new benefit conditionalities based on social contributions. Progressive taxation of all universal benefits could provide a means of promoting fairness within the welfare system and should be explored more thoroughly as a policy option. The Living Wage is a potentially transformative policy that can help not only to make work pay and reduce the welfare burden, but also drive wider productivity and value growth in sectors that have been blighted by low skills and low pay.

These signal broader shifts in the way we balance social and economic contributions and benefits. The longer-term goal is a more reciprocal and supportive welfare system.

Why should the Treasury care?

- Active labour market policies support quick transitions back into work, and can support flexible and part-time working.
- Progressive taxation of universal benefits reduces the state's welfare burden over the long term.
- Social accounts and smart conditionality maximise the role citizens can play in improving public outcomes, reducing their cost base.

12. Flexicurity is a welfare model based on a balance between flexible labour-markets, active labour-market policies and benefits that are designed to smooth transitions between unemployment and work. For more information, see Per Kongshoj Madsen, A new perspective on labour markets and welfare states in Europe, (Aalborg: Centre for Labour Market Research,2006). Also see Graeme Cooke, National Salary Insurance: Reforming the welfare state to provide real protection (London: IPPR, 2011); and Henry Kippin, Anglo-Flexicurity: insuring against unemployment in the UK (London: Social Market Foundation, 2009).

Priority 5: Enable the next generation of digital services

Successive UK governments have experienced great success and notable failures in using technology to deliver public services. Particular barriers to change at a central, local and organisational level include bridging the 'digital divide', working with legacy systems, changing cultures and dealing with complex procurement issues. Yet we are arguably at a tipping point for e-government, where new consumer mobility, better procurement practices, next-generation technology, proactive efforts to broaden inclusion and more open government can move digital working into the mainstream of public service delivery. In areas such as online learning and remote care, the impact on current business models could be transformational.

There are numerous examples of how this might work. In Denmark, the value of open data to the energy and construction markets has been estimated at up to Euro2.7 billion.[13] In the UK, Gov.uk demonstrates how well-designed and simple digital services can improve the service user experience, speed up processing and improve government responsiveness overall. Cloud technology, 'big data' and the use of analytics can improve customer segmentation and personalised delivery across health and public services, with one council aiming to save more than £1m in annual operating costs through a new 'cloud' deal, for example. The Cabinet Office has also been effusive about the potential of open data to drive a new wave of entrepreneurship.

Why should the Treasury care?

- Streamlining and improving service delivery through online models could release significant savings and create opportunities for reinvestment.
- Open data is already creating opportunities for new businesses and to improve public service productivity.
- Inclusive digital services such as online learning and remote care have the potential to transform local providers' reach and operating models.

13. See Open Government Partnership Blog, "Open data and economic growth: which link, if any?", blog posted on July 20, 2012, http://blog.opengovpartnership.org/2012/07/open-data-economic-growth/

THIRD PRINCIPLE: MANAGE FOR SOCIAL PRODUCTIVITY

We have argued that public management measures and manages for the wrong things. We are behind the curve in assessing performance based on public service productivity and the social and economic value that services create, and not transparent enough about the way citizens themselves contribute to, and benefit from, public services. In response we propose a new performance framework based on social productivity – that is, explicitly focused on driving economic productivity and social value through public spending and the delivery of services. The SSR should develop this as two priorities:

Priority 6: Drive productivity through public spending

A core aim of the SSR should be to increase the proportion of state spending on services that will boost productivity and catalyse local growth – such as infrastructure, skills, education and industrial support. As the SMF has argued, we need to get beyond the notion that 'boosting the economy in the short-run, expanding its long-run potential and strengthening investor confidence are incompatible goals'.[14] Yet doing this means unpacking two preconceptions:

- First, that spending in certain areas such as healthcare should be a priori ring-fenced. Health spending makes up almost one pound in three of total DEL spending. As a consequence protecting NHS spending at the next spending review would require cuts from other departments to be half as big again over the period 2015/16 to 2017/8.
- Second, that public spending can be a catalyst for economic growth, and not inevitably a brake on it. Conservative MP Nick Boles has gone further, arguing that departmental budgeting should be predicated on 'convincing evidence' of its impact on productivity within the broader economy.[15] The success of the SSR should therefore be gauged not only by proportions of DEL and AME saving, but by the extent to which public service reform can contribute to improved public sector productivity, and growth in the wider economy.

Why should the Treasury care?

- Future competitiveness – and therefore economic growth – requires strong physical and digital infrastructure, a solid and adaptive skills base, and a well-networked industrial base. Creating this infrastructure should be a priority for public spending
- Improving public sector productivity means improving outcomes and boosting output whilst reducing the cost base of government, with massive implications for areas such as healthcare.
- In areas where citizens' dependency on the public sector is high and local government has an active role in the local economy, there is an opportunity for smarter procurement and commissioning to promote local growth.

14. Ian Mulheirn, Osborne's Choice: Combining fiscal credibility and growth (London: Social Market Foundation, 2012)
15. Quoted from a speech at the Resolution Foundation, "Raising Living Standards", 10 July 2012, http://www.resolutionfoundation.org/events/raising-living-standards-nick-boles-mp-and-lord-an/

Priority 7: Commission for social and economic value

We need to see a substantial shift away from outsourcing only to create efficiency savings, to a public sector which commissions on the basis of measurable social and economic value. The SSR must signal how Government can help stimulate market growth and local provider innovations through smarter procurement.

This is reflective of international trends. The U.S. has, for example, made a commitment that '23 per cent of every procurement budget should be allocated to SMEs'.[16] The Brussels-based Government of the Future Centre has estimated that public procurement budgets make up approximately 17 per cent of GDP across the EU countries, pointing to the significant potential impact of explicitly using procurement to create social and economic value.[17]

Furthermore, social and economic value should not be mutually exclusive concepts. As the Transition Institute has found, a growing number of new public sector spin-outs are blending a 'social value ethos' with ambitious growth plans.[18] The Coalition has done much to encourage the development of public service spin-outs and other new forms of service delivery. Yet this has too often been disconnected from broader social and economic goals, particularly at a local level. If Government is to realise the productive potential of new delivery models, they must be part of the story of how the public sector can collaborate more effectively with other actors to support growth and create better social outcomes for service recipients in the future.

Why should the Treasury care?

- The Cabinet Office has recognised and is already exploring the social and economic value of public service spin-outs.
- Better commissioning can help improve social outcomes and foster new markets for social and economic innovation.
- The Public Services (social value) Act mandates 'social value commissioning' but there is a need to unpack this concept and embed it in local practice.

16. See Civic Agenda, Driving a Culture of Innovation and Enterprise with SMEs: Conference Report (London: Civic Agenda, 2012). Available online at: http://www.nationalprocurementconference.co.uk/wordpress/wp-content/uploads/2011/12/PB-Report-v5.pdf
17. Government of the Future Centre, Driving Public Entrepreneurship (Brussels: Lisbon Council, 2011).
18. Sabina Khan, Jill Oxenham and Dom Potter, Social Value Ethos: Lessons from practitioners embedding a social value ethos into public service spin-outs (London: Transition Institute, 2011).

LEGITIMACY AND CONSENT – THE KEY ENABLERS

What we are proposing is large scale system change. Change on this scale requires popular consent. It cannot simply be imposed.

Far from being an insurmountable hurdle, this should be seen as an opportunity. The public needs to be engaged in an open dialogue about the choices we face as a society. That requires politicians nationally and locally to be honest about the scale of the challenges and the range of options which are available to us. A key measure of an SSR's success should be to what extent a new consensus is formed about how public services should be organised and delivered in an era of austerity and low growth.

The process for achieving this should involve four key elements:

- **Open-source policy making:** there needs to be a clear commitment on the part of Government to an evidence based analysis of public service performance, outcomes and demand pressures. All key data along with Whitehall analysis and advice about strategic options should be published online, and there should be an open invitation to research centres, academia, think tanks and pressure groups to contribute their own data and expertise. The OBR's remit could be widened to include an oversight role that would help ensure accuracy and independence.
- **Engaging civil society institutions:** to some extent, the process should also be the outcome. So, if the aim is to strengthen civil society and the productive relationships between citizens, communities, social institutions and the state, then the process should reflect this. As Professor Gerry Stoker argues in a forthcoming book,[19] this implies structured dialogue with institutions representing citizens, voluntary sector organisations, business, local authorities and trade unions about how to create a new settlement. This process is one in which both ownership of the problem as well as the solution should be shared with a much wider range of organisations and institutions.
- **Local engagement:** this institutional engagement should also be mirrored at local level in two ways. First, through 'shared spaces' beyond silo boundaries, such as LEPS, Local Economic Leadership Panels, Community Budget Boards and Community Leadership Boards. Second, through public consultation and local deliberation using techniques such as participatory budgeting, crowd-source policymaking and citizen juries.
- **Strong leadership:** changes on this scale will require strong leadership across the political parties and at both national and local level. Political leaders must be prepared to develop long-term strategies for change, have the confidence to make the case for these, and stick to the course when it comes to implementation.

19. Simon Griffiths, Henry Kippin and Gerry Stoker (eds.), Public Services: A New Reform Agenda (London: Bloomsbury Academic Press, forthcoming, May 2013)

CONCLUSION

This is a very ambitious proposition. We are under no illusions about how big the challenge would be to change the basis of our public services settlement. But as William Beveridge famously said of his 1942 report: "a revolutionary moment in the world's history is a time for revolutions, not patching". We would argue that we are now at a comparable moment of discontinuity, facing the longest period of austerity, low growth and decline in living standards for generations. Unfortunately, early indications suggest that, due to political constraints, the 2013 spending review will be less a strategic review and more an indication of top line numbers for the public sector as a whole. It seems increasingly likely that it will fall to the next government – of whichever party or combination of parties – to undertake the fuller, strategic review of spending that the circumstances call for.

There is still much that can be done between now and then. We have sketched the outline of a potential new settlement; the challenge for us and other think tanks and civil society institutions is to start filling in more of the detail. In the meantime, a number of innovative local authorities and voluntary sector organisations are also developing new models for co-operation, collaboration, integration, shared services and economic growth. These are the test beds and innovation labs which policy makers should be studying to piece together a picture of the 2020 public services that a SSR will need to enable.