



# AUSTERITY BY STEALTH?

OPTIONS FOR THE CHANCELLOR  
AT THE COMING SPENDING REVIEW

CHANCELLOR OF THE EXCHEQUER



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## CONTENTS

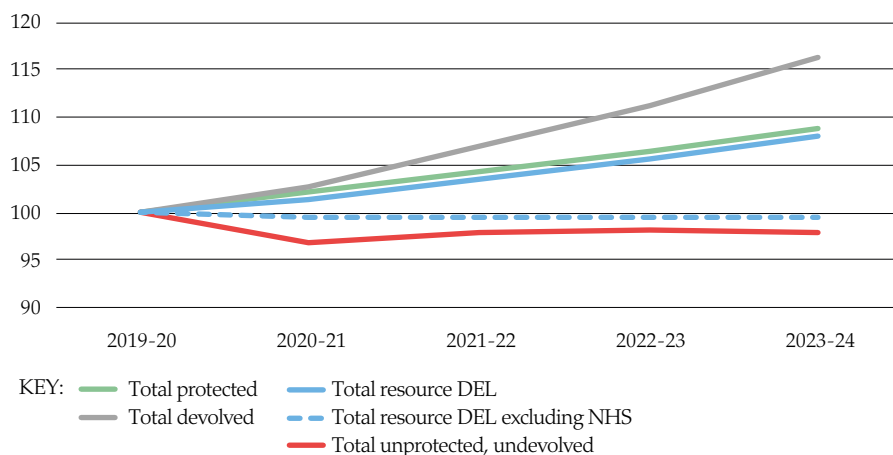
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**EXECUTIVE  
SUMMARY**

The next 15 months present a critical period for UK fiscal policy. At the 2018 Autumn Budget, the chancellor will announce the amount of money available for government services from 2020 onwards. Over the course of 12 months, up to autumn 2019, the Treasury will then negotiate individual spending plans with each government department – locking in government fiscal decisions, small and large, for up to a four year time period.

The decade of austerity so far has arguably been the worst economic policy error in a generation. As a consequence, living standards have suffered substantially. Office of Budget Responsibility (OBR) analysis suggests that the isolated effects of discretionary cuts have suppressed gross domestic product (GDP) by a cumulative 15% between 2010/11 and 2017/18, or £10,000 per household. Furthermore, this damage is unlikely to have been fully, or even largely offset by monetary policy. Interest rates have been near their effective lower bound – a minimum rate below which further reductions have little or no positive effect on spending in the economy – for a decade, while so called ‘quantitative easing’ is thought to be a less than perfect substitute for lower interest rates. If living standards don’t improve faster than the historical average, then these losses could become permanent.

Public goods and services have borne a particularly severe cost. Local government funding has been cut in half between 2010/11 and 2017/18. Schools funding will have fallen by 6.5% per pupil between 2015/16 and 2019/20. On average, public sector pay is more than 5% lower today than it was in 2010/11. Even the NHS, which has been relatively protected, saw its growth in funding constrained to just 1.1% per year between 2009/10 and 2014/15 – the slowest period of growth since the 1950s – and coinciding with

**PROJECTING THE GOVERNMENT'S CURRENT PLANS FORWARD WOULD  
SEE NON-PROTECTED BUDGETS CUT BY A FURTHER 2.1% IN REAL TERMS***Indices for resource DEL, selected disaggregates, 2019/20=100, 2019/20 to 2023/24*

Source: See Figure 5

the slowest increase in life expectancy since the 1970s. Public services are in dire need of a new settlement and a boost in resources to achieve it.

In announcing the overall envelope for the next spending review, the government is therefore presented with a choice. The first is to roll forward a continuation of the harmful status quo. The second is to show responsibility and flexibility in view of the needs of the economy and society as a whole.

Against this backdrop, this paper, which is the first in a new series of work looking at the future of public service in the 2020s, sets out initial findings. Using the New Economics Foundation's (NEF's) new departmental spending model, we project forward and simulate a government spending review settlement across three illustrative scenarios – focusing in particular on health, social care and schools funding. These include: a 'core' scenario, projecting forward the most likely government plans at this point in time; a 'maintaining standards' scenario, setting out new funding to prevent a further deterioration in services; and an

'improving outcomes' scenario, which provides additional resources to recover some of the ground lost since the onset of austerity in 2010.

We find that unless the government changes course, the chancellor's recent claim that there is "light at the end of the tunnel" will amount to hollow rhetoric. In June, the government announced a further £20.5 billion for the NHS by 2023/24. But outside of this increase for the NHS, and despite having endured 10 years of cuts by 2019/20, overall spending on services is currently on course to see no average increase at all. Furthermore, if government rolls forward its current protections for areas such as police and defence, then in the absence of new money this will have to be funded by further cuts to services elsewhere. As a consequence, budgets for things like prisons and public health could see an average real terms cut of 2.1%, or 4.1% per capita, during the first half of the 2020s.

But reversing this trajectory is entirely possible. Walking out of the government's "tunnel" is a question of

choice. We estimate that our illustrative scenario for keeping up with demand pressures in health, social care and schools services would cost an extra £14.6 billion (or 4% of overall resource DEL) per year by 2023/24 compared to our projection of current government plans. Our illustrative scenario for improving service outcomes beyond this would cost a total of £31.8 billion (10% of resource DEL) in 2023/24.

Crucially, we show that these illustrative scenarios are realistic and fundable. The current fiscal rules – targets for debt and borrowing – are overly restrictive and consequently harmful to the economy. They focus too heavily on creating fiscal space – room for further borrowing – and not enough on how and when to use it. Nonetheless, even within its own deficit targets, our analysis shows that government has the space to borrow tens of billions more per year, compared to its current plans. Higher progressive taxation could also present a complement or alternative to borrowing. We set out analysis showing a number of options capable of raising significant revenue, targeted at those most able to pay.

But if the chancellor fails to take this opportunity to learn from the lessons of the past, we could be living with the consequences of lost living standards for years, if not decades, to come.

## 1. INTRODUCTION

Over the coming year and a quarter, the Treasury will be negotiating with departments across Whitehall to set annual budgets for up to four years from 2020/21. The overall spending envelope – the aggregate amount of funding available – will be announced on or around this year's Autumn Budget.<sup>i</sup> The spending review itself is expected a year later, and will set out the detail beneath this envelope, with spending plans across departments.

The spending review is therefore a key event in the fiscal and political cycle. It represents the government's most important tool for planning medium-term expenditure. It also locks in macro fiscal policy and priorities into department budgets over a short to medium-term time frame. The decisions made during this process will therefore affect both the level and composition of public spending for up to half a decade.

In recent years there has been an observable change in government rhetoric on fiscal policy. The language and arguments of 'austerity' have dominated the political conversation for the past three elections.<sup>ii</sup> In many quarters, the act of reducing 'the deficit' became synonymous with political, if not economic, virtue – and the UK's three main parties framed their relative positions on the economy largely in terms of the extent and pace of their deficit reduction plans.<sup>iii</sup>

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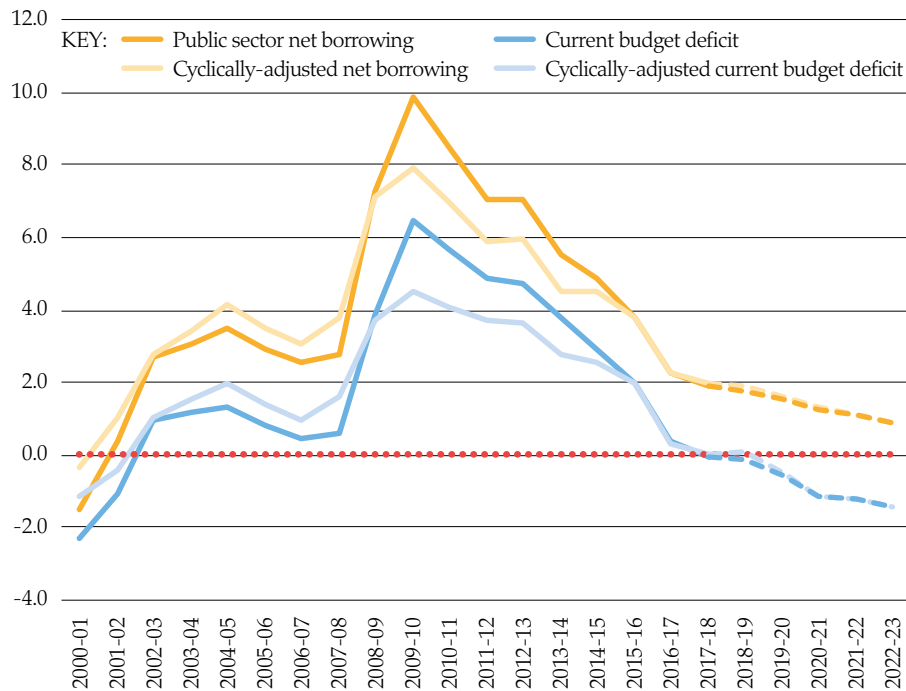
i This envelope pertains to what is described in government accounting terms as 'departmental expenditure limits' (DEL). DEL in fact makes up around 46% of total public expenditure, with the remainder made up by reactive spending known as 'annually managed expenditure' (AME). See section 2.0 for a further discussion.

ii There is no one definition of 'austerity', but a common interpretation of its meaning might be the discretionary reduction in public spending to meet perceived goals of macroeconomic policy.

iii 'The deficit' often refers to annual public sector net borrowing (PSNB), which is the difference between annual public receipts and public expenditure.

**FIGURE 1 THE CURRENT BUDGET WILL BE IN SURPLUS BEFORE THE NEXT SPENDING REVIEW**

*Public sector net borrowing, current budget deficit and cyclically adjusted budget deficit as a proportion of GDP (%), outturn and forecasts, 2000/01 to 2022/23*



Source: NEF analysis using Office for Budget Responsibility [OBR] (2018c). Public finances databank. <http://obr.uk/data/>

NB: dashed lines show projected figures.

More recently, however, the public and political mood seems to have shifted. Phillip Hammond's succession as chancellor from George Osborne also saw a subtle but important change in the fiscal rules themselves. This was also partly forced on the chancellor by weaker economic projections as a result of the vote to leave the European Union.<sup>iv</sup> In 2015 the fiscal rules obliged government to achieve a surplus on overall borrowing by 2019/20,<sup>i</sup> but at the end of 2016 this was revised to target a deficit of less than 2% of GDP on the cyclically adjusted budget by 2020/21<sup>ii</sup> (See Figure 1).<sup>v</sup>

Part of the explanation for this observable change in tone and policy may be that the initial goodwill of voters towards austerity has deteriorated,<sup>3</sup> as the lived impact of almost a decade of spending cuts has become more widely felt. It may in part also reflect a reduced readiness to blame the pre-2010 Labour governments for today's economic challenges of underemployment and weak wage growth. It is also possible that the academic case against excessive and discretionary deficit reduction has begun to be heard, especially among younger voters who are themselves more likely to vote than previously.

Possibly most important of all, however, are the borrowing figures themselves. The deficit is disappearing. The 2017/18 financial year marked the first tipping point, with public receipts

iv Fiscal rules are made up of aggregate level targets, usually pertaining to levels of public borrowing and or debt.

v Both fiscal rules also included targets for falling debt to GDP and a cap on welfare spending.



exceeding day-to-day spending (all public expenditure excluding capital investment) for the first time since 2001/02. This is described as a surplus on the 'current budget'. By 2019/20, there will even be a surplus after adjusting for where the UK is believed to be in relation to the economic cycle – in other words accounting for the fact that borrowing should be low given the length of time that has passed since the last recession. Crucially, overall borrowing is expected to be just 1.3% of GDP by the 2020/21, well under the 2% target by the start of the spending review period. Because this is smaller than the rate of expected GDP growth, the ratio of debt to GDP is therefore also projected to fall throughout the early 2020s.<sup>vi4</sup>

Austerity to date has caused both acute and chronic economic pain. OBR analysis suggests that the isolated effects of cuts were worth a cumulative 15% of GDP between 2010/11 and 2017/18, or £10,000 per household.<sup>5</sup> Monetary policy was also constrained during this period, which means it is unlikely that the effects of austerity on GDP were wholly or even largely offset.<sup>6</sup> A further direct consequence of lower GDP was that the deficit took twice as long to close compared with the coalition government's original plans – and consequently, the public debt ratio also rose higher than originally forecast. If living standards don't improve faster than the historical average, then household losses could become permanent. This means there are powerful arguments for further fiscal expansion, including beyond the amount allowed by the government's current fiscal rules (see Section 5.1 for a brief discussion).

To this end, the current fiscal rules are overly restrictive. They focus too heavily on creating 'fiscal space' – room for further borrowing – and not enough on how and when to use it. But a projected surplus on the current budget, and falling debt to GDP, means the Treasury also has room to manoeuvre on spending even while still complying with its own limits to borrowing. In theory, this means the coming spending review should allow for some reversal of austerity within the government's own fiscal rules for the first time since the financial crisis. But with public services almost universally squeezed for cash across government departments, the question becomes whether and to what extent government will offer a reprieve – and if so, which priority areas will stand to gain the most?

In this briefing we use new modelling and the latest policy announcements to start to answer this question. We focus particularly on the likely spending options in health, social care and schools, and the implications these might have for the rest of devolved and non-devolved spending. The paper proceeds as follows. In the next Section we set out a brief assessment of the trajectories of department spending so far since the beginning of the decade. Alongside this we also set out a discussion of the OBR's latest spending projections and their sensitivities to forecasts and fiscal rules. Section 3 sets out a review of different spending scenarios and projections in health, adult social care and schools, respectively. Section 4 presents findings from new analysis using the NEF departmental spending model, and Section 5 discusses the government's possible options for creating the fiscal space for a reversal in austerity.

vi The repayment of loans under the Bank of England's Term Funding Scheme, which would reduce net public debt on the Bank's balance sheet, is also expected to contribute to falling total net debt in the 2020s

## 2. BACKGROUND TO THE SPENDING REVIEW

Government spending reviews focus only on the types of expenditure that are most amenable to multiyear planning. Spending reviews therefore only plan for areas where demand is relatively predictable and stable, such as service delivery, public administration and grant making. This type of spending is described in the public accounts as 'departmental expenditure limits' (DEL). Spending reviews therefore exclude areas where government has less control over demand, known in accountancy terms as 'annually managed expenditure' (AME). AME includes things like the costs of social security, which rise and fall with the business cycle, and the cost of debt financing that can move as a function of market interest rates, among other things. Between them, DEL and AME make up 100% of public expenditure – described by OBR as 'total managed expenditure' (TME) – with the value of AME usually a little higher relative to DEL.

A spending review helps steer almost half of all government spending. At the highest level, this is disaggregated into two types of DEL: day-to-day spending, known as 'resource DEL'; and investment spending, known as 'capital DEL' – with the majority made up by resource DEL. Together, these are expected to be worth almost £375 billion in 2018/19, 46% of TME or just under 18% of GDP (see Table 1). The analysis in the rest of this paper focuses primarily on resource DEL.

### 2.1 THE DECADE SO FAR

There have been three spending reviews since the coalition government first took office in May 2010. The first spending reviews from the coalition government and subsequent Conservative government established department plans from 2011/12 to 2015/16. Under these plans, public spending was cut significantly. By 2015/16, day-to-day spending had

**TABLE 1 SPENDING REVIEWS HELP DIRECT ALMOST  
HALF OF PUBLIC SPENDING**

*Break down of total managed expenditure, £ billion, % TME and % GDP,  
nominal prices, 2018/19 plans*

		£ billion	% total public expenditure	% GDP
<b>Inside spending review</b>	Resource DEL	322.5	39.7	15.2
	Capital DEL	52.4	6.4	2.5
<b>Outside spending review</b>	AME	437.9	53.9	20.7
<b>Total</b>		<b>812.9</b>	<b>100.0</b>	<b>38.4</b>

Source: NEF analysis using Office for Budget Responsibility [OBR] (2018e). March 2018 Economic and fiscal outlook – supplementary fiscal tables: expenditure. <http://obr.uk/efo/economic-fiscal-outlook-march-2018/>

NB: Resource DEL (RDEL) is defined as public sector current expenditure (PSCE) in RDEL

fallen on average by just under 8% in real terms and 11% per capita, compared to the 2010/11 baseline.<sup>vii</sup> Overall, investment fell by just under 18% per capita. The lion's share of this tightening came in the first two years of the parliament, with the Treasury deviating from their initial plans and trajectory after 2012 due to concerns that the cuts were having a significantly adverse effect on economic growth.<sup>7</sup>

The current spending review (2015/16 to 2019/20) set out a more modest average trajectory for DEL. Resource spending in real terms is set to fall by a further 1.5 % from 2015/16 to 2019/20 (relative to the 2010/11 baseline), but with the largest cuts in 2018/19 and 2019/20 (see Figure 2). However, this means day-to-day spending in 2019/20 compared with 2010/11 will be more than 9% lower after adjusting for inflation, almost 15% lower after accounting for population growth and 23% lower after adjusting for growth in GDP. Real investment spending is expected to rise above 2010/11 levels by 2019/20 for the first time, although it

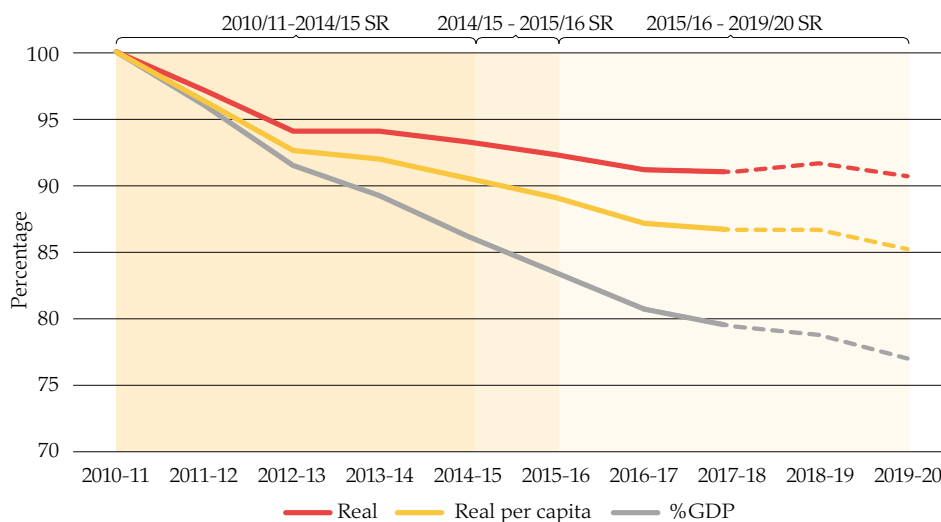
will remain below 2010/11 levels after adjusting for population growth and higher GDP.

The pattern of cuts across departments, however, has not been uniform. For the first half of the decade, the NHS, schools funding and international aid all received varying degrees of protection from the overall squeeze on DEL. In the summer of 2015, much of defence spending was added to the list of protected budgets and this was followed by further protections announced at the 2015 spending review in November, including for police. These protections were largely funded out of deeper than average cuts to non-protected departments. For example, while real-terms NHS spending is expected to be 9.7% higher in 2017/18 compared with 2010/11, local government budgets will have seen an average cut of more than half. Even departments with some level of protection have had a varied experience, and many have also seen declining resources in real terms, especially relative to population growth. Per pupil spending on schools, for example, will have fallen by 6.5% between 2015/16 and 2019/20, despite its relative protection.

vii This baseline was made up of a mixture of legacy spending plans from the previous Labour government set out before the 2010 election and the first in-year cuts made by the new coalition government in June 2010.

**FIGURE 2 DAY-TO-DAY SPENDING PER PERSON WILL BE CUT BY UP TO 15% THIS DECADE**

Indices for resource DEL nominal, real and real per capita as well as relative to GDP, 2010/11=100, 2010/11 to 2016/17 (outturn) and 2017/18 to 2019/20 (plans)



Source: NEF analysis using Office for Budget Responsibility [OBR] (2018e). March 2018 Economic and fiscal outlook – supplementary fiscal tables: expenditure. <http://obr.uk/efo/economic-fiscal-outlook-march-2018/>

NB: Resource DEL (RDEL) is defined as public sector current expenditure (PSCE) in RDEL. Dashed lines show OBR projection.

As a result, the proportion of spending within overall DEL afforded some form of protection is growing, with fiscal tightening disproportionately cutting into unprotected pots. By the final year of the current spending review in 2019/20, 'protected' spending outside of devolved departments will account for 82% of overall resource DEL, with non-protected budgets making up the remaining 18%.

## 2.2 EXISTING FORECASTS FOR THE NEXT SPENDING REVIEW

Outside of a spending review period, the OBR constructs forecasts for DEL by asking the Treasury to specify policy assumptions for overall spending going forwards.<sup>8</sup> The current OBR forecasts, made in March 2018, therefore provide the best estimate for the spending review envelope that the Treasury is likely to announce in autumn 2018. Based on these forecasts, resource DEL might be expected to be broadly flat across the period, remaining well

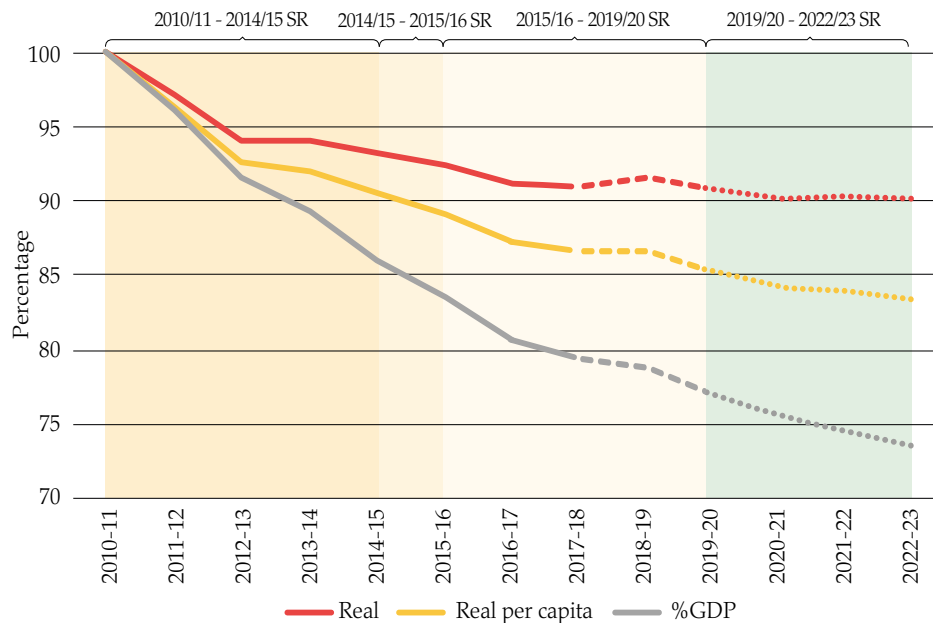
below 2010/11 levels after adjusting for inflation, population change and GDP (respectively, see Figure 3).

The above notwithstanding, the actual spending review envelope will largely be at the Treasury's discretion. This will be subject to Treasury policy decisions over taxation and spending, which will in turn take into account the fiscal implications of any forecast changes between March and November 2018, and the fiscal rules at the time of announcing the envelope. At the spring statement in March, the chancellor made clear that he was willing to make some use of this discretion, saying:

*"If, in the Autumn, the public finances continue to reflect the improvements that today's report hints at, then, in accordance with our balanced approach, and using the flexibility provided by the fiscal rules, I would have capacity to enable further increases in public spending and investment in the years ahead"<sup>9</sup>*

**FIGURE 3 DAY-TO-DAY SPENDING IS FORECAST TO REMAIN WELL BELOW 2010/11 LEVELS IN REAL TERMS FOR THE COMING SPENDING REVIEW PERIOD**

*Indices for resource DEL nominal, real and real per capita as well as relative to GDP, 2010/11=100, 2010/11 to 2016/17 (outturn), 2017/18 to 2019/20 (plans) and 2020/21 to 2022/23 (forecast)*



Source: NEF analysis using Office for Budget Responsibility [OBR] (2018e). March 2018 Economic and fiscal outlook – supplementary fiscal tables: expenditure. <http://obr.uk/efo/economic-fiscal-outlook-march-2018/>

NB: Resource DEL (RDEL) is defined as public sector current expenditure (PSCE) in RDEL. Dashed lines show OBR projection. Dotted line shows NEF projection

Forecasts normally change for one of two main reasons. The first is deviations in the underlying economic data between one baseline and the next. The second is changes in forecasting methodology or assumptions, including correcting for past errors. There is precedent for each of these to affect the trajectory from one forecast to the next to the tune of tens of billions of pounds, and in either direction.<sup>10</sup> Modest improvement in some of the economic data since March, attributable in part to the good weather, has led some economists to speculate that this could lead to an upward revision in DEL at this autumn's budget.<sup>11</sup> But the extent to which methodological changes from the OBR could either support or offset this – or indeed have no effect – is currently uncertain.

What is easier to predict, however, is that government policy decisions are likely to push up the overall envelope for DEL, relative to the current forecast. The main reason for this was a major announcement on the NHS made by the Prime Minister in June. The government now intends to spend an extra £20.5 billion (2018/19 prices) of resource DEL on the NHS by 2023/24, and has specified that this money will come from a combination of tax rises and a 'Brexit dividend'.<sup>12</sup> In reality, the Brexit dividend is unlikely to exist. The effect of the so-called Brexit 'divorce bill', combined with the negative fiscal implications of Brexit due to lower tax receipts and higher welfare spending, is currently expected to exceed any savings made from no longer making annual contributions to the EU budget over the period of the next spending

review. For this reason, and in the absence of an alternative source of tax revenue, it is possible that the 'Brexit dividend' will in fact be funded by extra UK borrowing. Nonetheless, this would be still be exogenous to the current forecasts, meaning that DEL is likely to rise by at least the £20 billion that has so far been announced for the NHS.

Any increases in spending which do not also see a corresponding increase in overall DEL, however, will necessarily imply larger cuts to department budgets elsewhere. It is also possible that further discretionary expansions to DEL could be met through further tax rises. The government is reportedly considering scrapping the freeze in fuel duty to help pay for the NHS<sup>13</sup>, and recently also cancelled a planned reduction in national insurance contributions (NICs) for the self-employed.<sup>14</sup> The expected green paper on social care is also likely to outline new sources of revenue.<sup>viii</sup> Private sources of wealth in particular are expected to make a greater contribution in one form or another to help meet rising demand (see Section 3.2.2 below for a brief discussion).

Even within the government's current fiscal rules, there is also space for modest increases in borrowing over the coming spending review to fund further increases in aggregate DEL. The government's present targets oblige the Treasury to keep public sector net borrowing below 2% of GDP from 2019/20 and for debt to fall as a proportion of GDP every year thereafter (see Section 1 above).<sup>15</sup> NEF analysis of OBR forecasts shows that government could increase annual borrowing by up to £24.1 billion without breaching the 2% target, although borrowing the maximum value consistent with this target would make it less likely for debt to

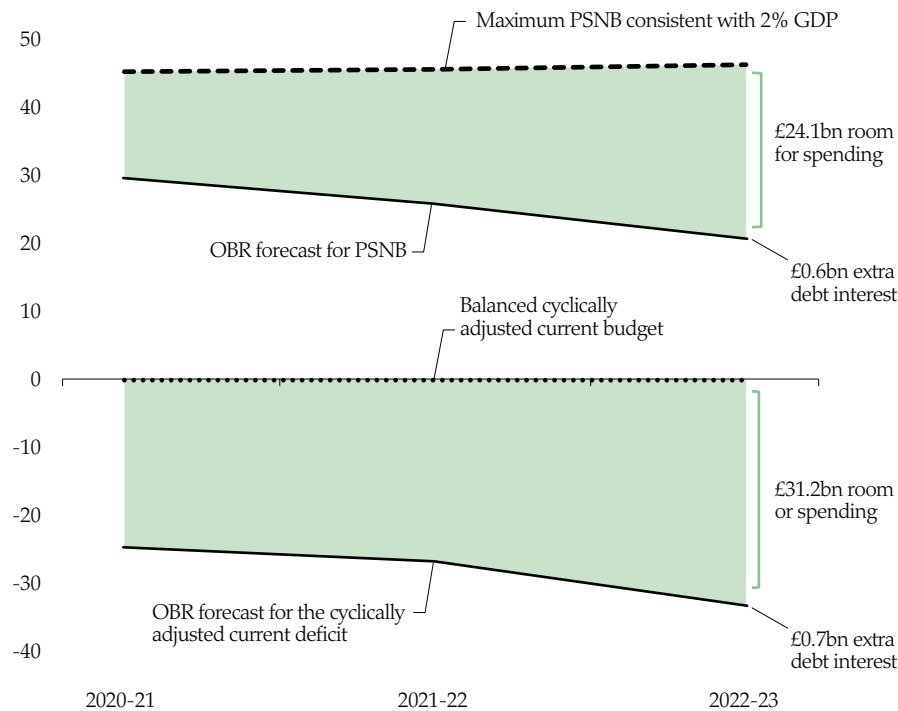
continue falling as a proportion of GDP from 2022/23.<sup>16</sup> In addition, it could compromise the government's further objective to balance the overall budget in the next parliament.<sup>17</sup> Further NEF modelling also shows that were the current fiscal rules to target a balanced budget on day-to-day spending only – similar to the rules adopted by both the coalition government between 2010 and 2015, as well as the current Labour Party – then annual borrowing to finance resource spending could rise by up to £31.2 billion (see Figure 4).<sup>18</sup> There could also be additional borrowing for investment on top, but the chance that overall debt would start to rise again from 2022/23 would increase.

A number of academic commentators and research institutes, including NEF, would recommend significant further fiscal expansion compared to current government plans.<sup>19</sup> The reasons for this are twofold. First, with interest rates on government debt so low, there is an opportunity now to make new capital investments at low (and in some cases negative) real interest rates, while creating significant public value in the future. Second, there is a powerful argument that fiscal policy should have a greater role in overall demand management – particularly given that monetary policy is currently constrained by an effective lower bound (ELB) to interest rates. We return to these points briefly in Section 5.1.

viii It should be noted that the extra revenues raised in this case may be used to items of spending under AME rather than DEL.

**FIGURE 4 THE GOVERNMENT HAS ROOM FOR FURTHER BORROWING**

*Public sector net borrowing (OBR forecast and counterfactual) consistent with target for 2% GDP and cyclically adjusted current budget deficit (OBR forecast and counterfactual consistent with a balanced cyclically adjusted current budget) and estimates for implied spending room minus debt interest, £ billion, 2018/19 prices, 2020/21 to 2022/23*



Source: NEF calculations based on Office for Budget Responsibility [OBR] (2018c). Public finances databank. <http://obr.uk/data/> and Office for Budget Responsibility [OBR] (2018d). Fiscal sustainability report – July 2018. <http://obr.uk/fsr/fiscal-sustainability-report-july-2018/> and

NB: NEF modelling has shown that both the maximum PSNB scenario and a balanced cyclically adjusted current budget deficit would be consistent with debt falling as a proportion of GDP in 2020/21 and 2021/22. In part, this is due to the repayment of loans under the Bank of England's Term Funding Scheme, which would reduce net public debt on the Bank's balance sheet. But there would be an increased chance that debt could rise marginally year-on-year thereafter.<sup>20</sup> Debt interest estimated using OBR forecasts for gilt yields.<sup>21</sup>



### **3. PRIORITIES FOR THE NEXT SPENDING REVIEW**

In this section we set out a discussion of high-level considerations for the next spending review with a particular focus on three areas of expenditure: health, adult social care and schools. These key areas of interest are almost entirely devolved items of expenditure. It should be noted therefore that our discussion and analysis largely pertains to England only unless specified otherwise. For our analysis presented in Section 4 we do however estimate the implications of any Barnett Allocations for devolved funding.

In the sections that follow, we briefly discuss each of these three key areas in turn, setting out their treatment under recent spending reviews and laying out some of the illustrative options to improve service delivery from 2019/20 onwards.

#### **3.1 HEALTH**

##### **3.1.1 A review of health spending**

The UK's health infrastructure faces mounting pressures. Changes in demography, health profiles and health expectations from society are leading to rising demand, while technological change is opening new frontiers of provision. In many ways, these changes are a reflection of a successful health service, but together they also contribute to rapidly rising cost pressures over the medium to long term.

Partly as a consequence of these pressures then, health spending in England has been growing. But the rate of increase over the past 10 years in particular has not kept up with need. Since the creation of the NHS in 1948, health spending has grown by an average of 3.7% a year. But the last few years have seen health spending rise slowly compared to this historical average. Between 2009/10 and 2014/15, it grew by only 1.1% – the lowest



five-year average increase since the 1950s.<sup>22</sup> This drying up of resources has contributed to a deterioration in the quality of care: A&E attendances, waiting times, and admissions have surged in recent years, the number of ‘non-urgent’ operations being cancelled has grown, and the NHS is struggling to meet a number of targets across the board.<sup>23</sup> This period of constrained funding has also coincided with the slowest growth in life expectancy since the 1970s.<sup>24</sup>

The above notwithstanding, and compared to other government departments, the health budget has been relatively protected from government cuts since 2010. The NHS has received a series of commitments to increase its budget in real terms, culminating in the most recent announcement to increase spending by £20.5 billion by 2023/24, compared with 2018/19.<sup>ix</sup>

But while the NHS has been protected, the same commitments have not been afforded to other areas within the Department for Health, such as public health and Health Education England (the organisation responsible for education, training and workforce development). This has had serious impacts on services. According to the British Medical Association (BMA), reductions in public health spending and investment in particular are contributing to “unacceptable variation in the quality and quantity of services”,<sup>25</sup> and public health cuts have been blamed for the UK’s worsening health outcomes.<sup>26</sup>

### 3.1.2 Maintaining the status quo

The Institute for Fiscal Studies (IFS) together with the Health Foundation has estimated that in order to maintain

our levels of healthcare service provision in the face of demographic and cost pressures, the Department of Health needs an additional £27 billion in real terms by 2023/24 compared to 2018/19. Similar findings have been made by IPPR<sup>27</sup> and the Resolution Foundation<sup>28</sup>, among others. This represents an average annual growth rate of 4.1% – slightly higher than the 3.4% average growth rate implied by the government’s most recent commitment, although the government’s plans are not directly comparable given they only pertain to resource spending and the IFS estimates include capital. Once allowances for capital spending and other items outside the NHS are removed, the government’s announcement is slightly higher than the minimum level needed to ensure NHS resource spending keeps up with demand. Therefore in our modelling of the status quo scenario, we use the government’s plans for the NHS combined with the non-NHS health budget protected in real terms.

### 3.1.3 Improving outcomes

In order to improve outcomes of our health services, additional funding is needed to increase pay, improve mental health treatment and hospital targets, as well as additional funding for public health and other parts of the health budget. For the analysis, we use IFS and Health Foundation estimates needed to ‘modernise’ health budgets. Further detail around key areas is provided below:

*Staff pay* – Pay for most NHS staff has been capped or frozen since 2010-11, resulting in real-terms pay decreases. Between 2011/12 and 2014/15, consumer price inflation rose by 6%, while NHS pay rose by just 2%.<sup>29</sup>

ix Note that this additional £20.5 billion includes over £3 billion as part of the Agenda for Change pay deal

Real-terms pay growth in the private sector over this period was about 4%.<sup>30</sup> Declining pay has contributed to weakening staff morale and increasing issues with recruitment and retention of staff, necessitating a false economy in temporary agency staff to fill the gaps.<sup>31</sup> If staff had received pay increases of 2% in real terms since 2009/10, earnings per FTE would be about 20% higher than they are now. Lifting pay for health professionals above inflation to reverse all or some of this wage erosion is likely to reduce staff churn, improve morale and contribute to better outcomes for patients. Our modelling allows for 3% real growth in salaries year on year from 2020-21.

*Mental health* – the NHS’s own Five Year Forward View has identified mental health as an area of significant under-provision.<sup>32</sup> Only four in 10 (39.4%) of those with a mental health disorder are estimated to receive treatment. Given that 15.7% of people have a common mental health disorder, this means that at any one time, 9.5% of the population have a common, untreated condition.<sup>33</sup> Parity of esteem for mental health within the NHS has been afforded significant rhetoric from government in recent years. But for treatments to be improved without reducing outcomes in other areas, significant additional funding is required. Our modelling allows for an increase in mental health treatment rates from 39% to 70%.

*Public health* – the majority of public health spending is distributed through a ring-fenced grant to local authorities. Public health spending represents a key discretionary tool both in terms of combating inequalities in health provision and as a means of preventing and mitigating against weak health outcomes before they incur additional – and far higher – costs on NHS and social care budgets. The previous government’s policy of additional

investment in so-called ‘spearhead’ areas with relatively low life expectancy, or significant gaps in life expectancy between rich and poor, showed success before it was reversed<sup>34</sup>. Additional investment in public health could be used to improve access to healthcare for vulnerable groups, as well as address the social determinants of health, including the physical environment. Our modelling diverges slightly from the IFS/Health Foundation scenario as we believe reducing health inequalities to be of particular importance, and public health budgets are an important tool to do this. Inequalities in life expectancy and healthy life expectancy are nearly all worsening.<sup>35</sup> ONS data shows that healthy life expectancy at birth now differs by 18 years across local areas.<sup>36</sup> Thus we suggest increasing public health budgets by an additional 1% above inflation over the IFS/Health Foundation plans of 1 percentage point above resource DEL growth.

### 3.2 ADULT SOCIAL CARE

#### 3.2.1 A review of care spending

The UK government spent a total of £24.7 billion on social care budgets in 2018/19, of which £16.1 billion was spent on adult social care and £8.6 billion for children’s social care.<sup>37</sup> This funding helps to provide care across the life course, with adult social care funding split roughly equally between working-age adults and those over 65. Much of the gap in projected funding is driven by future demand growth from the over-65s, due to an ageing population, but demand is also rising as more adults with physical or mental health needs are living longer.<sup>38</sup> In the discussion below, we focus on adult social care only.

Unlike healthcare, public social care in England is rationed through both means and need testing. The majority

of care is not publicly funded; it is provided on an informal basis by family or friends, or purchased privately. Of those who do receive formal social care, approximately half privately finance at least part of their care.

Social care budgets have been cut sharply over the two recent spending review periods. Between 2009/10 and 2017/18 there was a 38% fall in central government funding for social care. Approximately 400,000 fewer people now receive support, and spending per adult among those that do still receive something has fallen by 4.8%.<sup>39</sup>

Social care is the responsibility of local authorities, but until recently these services were predominantly funded through central government grants. However, a combination of reforms to local government financing – which have made funding growth more closely linked to growth in local business rates – and central government cuts, have seen local government funding significantly constrained. Between 2010/11 and 2017/18, central government funding has been cut by 49.1%, forcing local authorities to use contingency reserves to deliver basic services.<sup>40</sup> The National Audit Office estimates that one in 10 local authorities have less than three years' of reserves remaining.<sup>41</sup>

Our current model of care is not fit for purpose, and the consensus over the need for significant reform is near universal among politicians, practitioners and experts.<sup>42,43</sup> A number of options to overhaul the system have been proposed, including expanding provision of free personal care from Scotland to the whole of the UK, or adjusting the means test to limit lifetime costs of care – one example of this being the 'cap and floor' model proposed by the Conservatives in the 2017 general election.<sup>44</sup>

Currently, the means test for publicly funded social care in England has an upper threshold for net wealth – savings and assets but not normally housing wealth – of £23,250. Anyone with combined assets beyond this threshold is not eligible to public support. A change to this threshold, or in the types of assets subject to the means test, would affect the number of people eligible for greater public support. In 2017, the Conservative Party proposed raising this threshold to £100,000, but crucially the means test was also proposed to include housing wealth. The government also said there would be a lifetime cap on the cost of care that would need to be met privately, but no further details have yet been given on the level at which this cap would be set. Analysts have protested that this would likely mean more people would have to pay for their care through selling their homes, and the proposal proved unpopular with the public.<sup>45</sup> This has therefore not been included in the modelling as it is primarily an alternative form of funding rather than a means to improve outcomes.

The government is planning a green paper on social care which was due in the summer of 2018 but has since been delayed.<sup>46</sup> Nonetheless, irrespective of the precise model for reform, growing pressures will necessitate some level of higher public spending commitment.

### 3.2.2 Maintaining the status quo

As our population ages and rising numbers of people live with long-term conditions, the costs of providing care services are rising. Using a model from the Personal Social Services Research Unit, (PSSRU), based at LSE, the IFS estimates that to maintain current levels of access and quality will require a yearly growth rate of 3.7% in real terms.<sup>47</sup> However, current levels of provision are becoming increasingly

unpalatable politically, and more importantly current levels of provision are becoming intolerable for the individuals and families dependent on care for a decent quality of life.

### 3.2.3 Improving outcomes

In order to improve social care outcomes, we have focused on free personal care as an option to expand domiciliary care as well as additional funding for local authorities to support local authorities through the current and coming revenue and expenditure turmoil they are facing. A critique of the free personal care model is that it does not include residential care – and this should just be considered a first step in the expansion and reform of social care.

*Expanding provision with ‘free personal care’* – Under this model, personal care (including personal hygiene, continence, diet, mobility, counselling and simple treatments) is provided to anyone aged over 65 solely based on need, abolishing the means test completely. This level of care has been provided in Scotland for free since 2002. Extending to England would increase fairness in the health and social care system, ensuring that people affected by disabilities and illnesses such as dementia are not penalised compared to those affected by illnesses treated by the NHS. It would also align universal eligibility for social care with healthcare, making it easier to integrate. It would also bring the prospect of future savings to NHS budgets through a higher level of integration..<sup>48</sup> Although the Scottish model does not allow for an improvement of the needs threshold and thus will not expand access or quality of care for people with high or moderate need, the evidence from Scotland is that it has supported far higher numbers of over-65s to receive care in their own homes..<sup>49</sup>

*Reducing inequalities in local authority finance* – As discussed above, there have been extensive reforms in local authority funding, resulting in a 49.1% real-terms reduction in government funding for local authorities since 2010/11..<sup>50</sup> Part of the shortfall for social care has been met by allowing local authorities to raise council tax faster than they would have otherwise on the condition that increases in revenue are hypothecated to meet care costs only – the so-called social care precept. However, it is expected that this will still leave funding for social care down by more than a quarter (28.6%) compared with 2010/11 by 2017/18..<sup>51</sup> Furthermore, due to the distribution of the value of homes and thus potential council tax revenues, not all councils can raise the same amount from the precept. In order that any social care funding increases to not exacerbate existing inequalities, additional finance should be targeted at those local authorities who are struggling most.

## 3.3 SCHOOLS SPENDING

### 3.3.1 A review of education spending

Education has experienced multiple reforms over the past two decades. Spending levels have similarly oscillated. Between 2010/11 and 2015/16, education spending fell by about 14% in real terms – compared to an average annual growth rate of 5% during the late 1990s and early 2000s – taking it back to the same level it was in 2005/06.

Within education spending as a whole, schools funding has received some relative protections. Between 2010/11 and 2015/16, per pupil funding for schools stayed broadly flat..<sup>52</sup> However, since 2015/16, and despite commitments to protect the overall schools budget in real terms,

per pupil funding has fallen due to rising pupil numbers. The IFS estimates that between 2015/16 and 2019/20, spending per pupil will fall by 6.5% in real terms in England. This will be the first time schools have seen real-terms cuts in spending per pupil since the mid-1990s, and the biggest real-terms fall in school spending per pupil for at least the last 30 years.<sup>53</sup>

The consequences of this squeeze are that schools are struggling. More than one in four local authority secondary schools are operating a budget deficit, and eight out of 10 academies are in deficit.<sup>54</sup> Teacher salaries have been capped and there is evidence this is affecting retention. Although the cap has since been lifted in theory, and the DfE has confirmed that additional money will be provided to schools to meet pay related costs over a threshold of 1%, no new money has been provided for the Department overall – therefore these changes will need to come from existing education budgets.

There is significant variation in funding per pupil between geographical areas and between schools. National government allocates funding to local authorities, who then distribute it to schools using a local funding formula based on deprivation and pupil numbers amongst other things. The amount distributed by the government to local authorities is considered flawed and inconsistent – leading to wide variation in funding per pupil between similar schools – and is due for reform. The government plans to replace the 152 local formulas with a single national funding formula which will recalculate the core funding schools receive from governments – including maintained schools, academies and free schools – to be more consistent. However, delays in consultation meant

that these reforms are unlikely to take place until 2020/21 at the earliest. These reforms are not expected to change the envelope of education funds but will inevitably create new winners and losers within the system.

### 3.3.2 Maintaining the status quo

In order to ensure that schools funding at aggregate grows in line with demand, the schools budget will need to grow by an average of 2.5% per year.<sup>55</sup> However, this will still leave levels below their starting point at the beginning of the decade.

### 3.3.3 Improving outcomes

In order to improve pupil outcomes, we suggest returning per pupil funding levels to 2009/10, and for per pupil funding to subsequently be protected in real terms. This will allow for a fully funded increase in staff pay as well as sufficient resource to provide high quality education to pupils.

*Staff pay* – There is evidence that staff pay is significantly affecting retention. The pupil-to-teacher ratio has increased since 2010 and teacher numbers are falling; full-time teacher vacancies in state-funded schools have risen from 380 in 2010 to 920 in 2016 and there is a much higher rate of temporarily filled positions.<sup>56</sup> Although the government announced increases in teacher pay of between 1.5% and 3.5% earlier this summer depending on seniority, costing the Department for Education (DfE) more than £500 million between 2018/19 and 2019/20, this money is expected to be found from current budgets,<sup>57</sup> leading to an effective cut for non-pay bill spending.

*Smoothing effects of funding allocation reforms* – As discussed above, the impacts of proposed funding reforms are expected to be highly variable

across local areas. Initial proposals for the NFF would have meant deep cuts for schools without high needs pupils,<sup>58</sup> and as a response the government has announced a basic amount of funding per pupil of at least £4,800 per pupil in secondary schools (£3,500 in primary schools).<sup>59</sup> This will depress the relative additional funding for schools with pupils with higher needs and will likely increase inequalities in educational outcomes and crucially depress social mobility. We allow for an additional 5% of the schools budget to be added in, so that the minimum funding per pupil can be preserved at 2009/10 levels but that further spending can be targeted to the schools and pupils that need it most.



## 4. MODELLING THE NEXT SPENDING REVIEW

Given the urgent needs of public services, what impact will the spending review have? NEF has custom built a new model of UK departmental spending, consistent with UK Treasury accounting and OBR forecasting data, to help answer this question. This paper is intended as the first in a series of reports to make use of this new analytical capability.

The objective of the present modelling is to project forward illustrative policy options across and within three key areas of expenditure, namely health, adult social care and schools, and fit these into a wider simulation of departmental budgets. We do this in order to stress-test implications of different options for overall funding patterns.

### 4.1 OVERVIEW OF SCENARIOS

For the purposes of this paper, we project forward three main scenarios for the next spending review.

- *Core:* Our core scenario adopts the OBR projection for total resource DEL, rolled forward for one additional year to 2023/24<sup>x</sup> – the likely final year of a four year spending review – and revised upwards to reflect the profile of additional spending that has been announced for the NHS.<sup>xi</sup> To simulate individual department and sub-department budgets within

x We assume that four years is the most likely length of the next Spending review, given that the previous two multiyear Spending reviews were also four years long. Given 2023/24 is currently one year beyond the OBR's five year rolling forecast period, we project this final year using the percentage change in overall DEL between 2021/22 and 2022/23.

xi Our core scenario therefore assumes that all the new money announced for the NHS is exogenous to the most recent OBR forecast, given that the implication of government announcements is that money will be raised either through new taxes or new borrowing. If, however, the so called 'Brexit dividend' is funded through cuts to departments, rather than additional borrowing, the overall spending envelope would be expected to be lower.

**TABLE 2 SUMMARY OF NEF MODELLING SCENARIOS**

	Core scenario	Maintaining outcomes scenario	Improving outcomes scenario
<b>Healthcare</b>	Additional money pledged for NHS in June 2018 (additional £20.5 billion between 2018-19 and 2023-24)	Non-NHS health spending (including public health) protected in real terms	Modernised NHS scenario (as modelled by the IFS and Health Foundation, see Section 3.1.3 above)* – including funding for improving mental health outcomes and staff pay bills). In addition, we increase public health budgets by 1% year above inflation with funding to be targeted at addressing health inequalities
<b>Social care</b>	No protections in DEL	Keeping up with current levels of access and quality – implying a real terms 3.7% annual increase in social care funding over core allocations.** This is allocated to the DHSC to distribute to local authorities as needed.	Extending the model of free personal care in Scotland for over-65s to England*** as well, based on costings and modelling from the King's Fund and Health Foundation <sup>60</sup>
<b>Schools</b>	Schools spending protected in real terms at 2019/20 levels	Schools spending protected in real terms per pupil at 2019/20 levels	Schools spending returned to 2009/10 per pupil levels in real terms, plus an increase of 5% on the above schools budget
<b>Other</b>	<i>See appendix for details of protected budgets</i>	All 'unprotected' budgets rise in real terms to allow for additional funding to protect pay bills in real terms, among other priorities	As in 'Maintaining outcomes'

\* Our calculations assume that modernisation starts in 2020/21, the first year of the next Spending review

\*\* We assume that increased funding starts in 2020/21, the first year of the next Spending review. This would mean that any funding gaps relative to demand that are created before that year would need additional money to reverse.

\*\*\* Free personal care in Scotland is largely funded out of devolved resource DEL. Our modelling therefore assumes the same for England. However, it is possible that over time such a scheme may be more appropriately scored under AME.

DEL, we roll forward all current major 'protections' from the current plans into the next spending review period, taking the latest government plans for 2019/20 as our baseline.<sup>xii</sup> Devolved and non-protected budgets are then projected forward, also from respective 2019/20 baselines, using an equation that allocates remaining funding within total DEL such that both the overall spending envelope isn't breached but

that the Barnett Formula is satisfied with respect to all relevant department budgets.

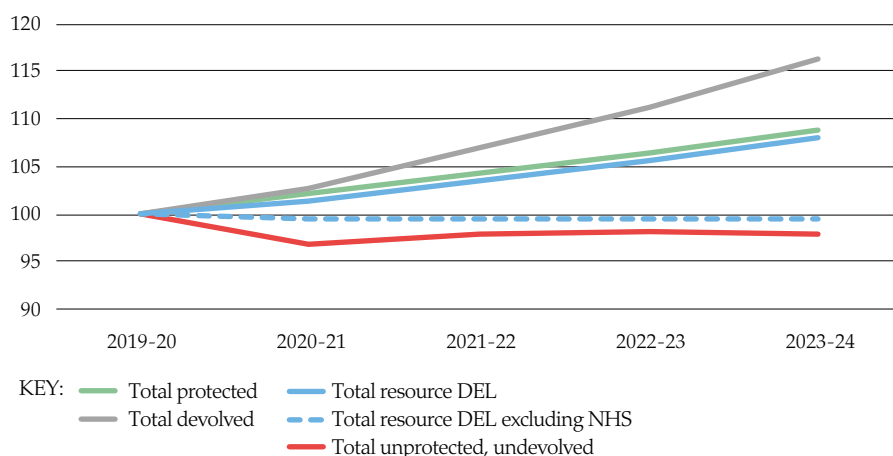
*Maintaining outcomes:* Our second scenario projects forward additional spending (relative to the core scenario above) within health, adult care and schools consistent with the cost of fully meeting increased demand pressures while also maintaining the current level of provision. All departments without a more generous protection already in place also see their budgets protected

xii Excluding the NHS, which has now been superseded. A full list of our protections is detailed in Appendix A1.



**FIGURE 5 PROJECTING THE GOVERNMENT'S CURRENT PLANS FORWARD WOULD SEE NON-PROTECTED BUDGETS CUT BY A FURTHER 2.1% IN REAL TERMS**

*Indices for resource DEL, selected disaggregates, 2019/20=100, 2019/20 to 2023/24*



Source: See appendix A2

NB: Excludes depreciation, reserves and OBR allowance for underspend and so these figures are not directly comparable with the OBR's estimates for PSCE in RDEL used elsewhere in this report.

in real terms in this scenario in order to provide new money for pay to rise at least in line with inflation.

- *Improving outcomes:* Our final scenario sets out illustrative plans for improving outcomes beyond simply meeting projected demand pressures. These include proposals described in Section 3 above in addition to the real terms uplift in otherwise non-protected budgets set out in 'maintaining outcomes'. Our three scenarios are summarised in Table 2 above.

#### 4.2 MODELLING RESULTS

We present below a summary of our modelling results for resource DEL for each of our key budgets of interest in addition to the following aggregations for remaining departments:

- Total protected budgets<sup>xiii</sup>
- Total devolved budgets (made up of departmental budgets for Scotland, Wales and Northern Ireland)

- Total non-protected, non-devolved budgets

Our summary table below projects values for resource DEL in 2023/24 (the final year of a four-year spending review period) alongside existing plans for the 2019/20 financial year (the final year of the present spending review period). Results are estimated in real terms and on a per capita basis.

For our core scenario, the overall picture is bleak. Despite the chancellor claiming there was "light at the end of the tunnel",<sup>61</sup> and after already enduring a decade of austerity by 2019/20, the current plans imply no additional money on average for departments outside of the NHS. In fact, without an upward revision to the overall envelope by £20.5 billion in light of the prime minister's announcement, overall resource DEL will see no increase in real terms.<sup>62</sup> Even with the extra money for the NHS, non-protected budgets are currently due to experience further average cuts of 2.1%,

xiii See Appendix A1

**TABLE 3 SUMMARY OF RESULTS FROM NEF SPENDING REVIEW MODELLING**

Annual estimates for the 2019/20 baseline compared with 2023/24 illustrative projections for our 'core scenario', 'maintaining standards scenario' and 'improving standards scenario', resource DEL all £s in 2018/19 prices

	2019/20 - Baseline		2023/24 - Core scenario				2023/24 - Maintaining scenario				2023/24 - Improving scenario			
	Current plans (£)		Projection (£)		Change from baseline (%)		Change from core (£)		Change from baseline (%)		Change from core (£)		Change from baseline (%)	
	bn	per capita	bn	per capita	per capita		bn	per capita	per capita		bn	per capita	per capita	
NHS within DHSC	119.9	1789	136.8	1999	14.1%	11.7%	0.0	0	0.0%	11.7%	7.4	108	5.4%	18%
Non-NHS within DHSC (inc. public health)**	3.7	55	3.6	52	-2.1%	-4.1%	5.3	78	147.9%	137.8%	8.3	121	231.5%	218%
MHCLG - local government (including social care)**	5.3	80	5.2	76	-2.1%	-4.1%	1.7	24	32.0%	26.6%	5.9	86	112.9%	104%
Schools within DfE	50.1	747	50.1	731	0.0%	-2.1%	2.2	32	4.3%	2.2%	6.4	94	12.9%	11%
Total protected***	214.6	3202	233.5	3413	8.8%	6.6%	13.5	198	5.8%	12.7%	32.4	474	13.9%	21%
Total non-protected, non-devolved	48.8	728	47.8	699	-2.1%	-4.1%	3.0	44	6.3%	2.0%	3.0	44	6.3%	2%
Total devolved	36.9	550	42.8	626	16.2%	13.8%	2.2	32	5.0%	19.6%	4.9	72	11.5%	27%
<b>Overall Resource DEL****</b>	305.4	4557	330.2	4825	8.1%	5.9%	14.6	214	4.4%	10.6%	31.8	465	9.6%	16%
<b>Overall Resource DEL excluding additional NHS announcement July 2018</b>	305.4	4557	303.5	4435	-0.6%	-2.7%								

Source: See appendix A2

\* Current plans from PESA

\*\* Protected in 'Maintaining' and 'Improving', but not in 'Baseline' and 'Core'

\*\*\* See appendix A1 for a full list of budgets and their protections. Public health and social care are excluded from protected budgets in 'Baseline' and 'Core'. Large percentage increases in our 'Maintaining' and 'Improving' scenarios (respectively) for local government are a consequence of the majority of social care currently being funded from outside of MHCLG resource DEL.

\*\*\*\* Includes an additional £20.5 billion for the NHS by 2023/24

NB: Additional money for social care was scored as DHSC for the purposes of devolved allocations under the Barnett Formula

NB: 'Resource DEL' excludes depreciation, reserves and OBR allowance for underspend and so these figures are not directly comparable with the OBR's estimates for PSCE in RDEL used elsewhere in this report or 4.1% on a per capita basis between 2019/20 and 2023/24 (see Figure 5 below). This would mean potential funding cuts for vital services such as prisons (£70 million cut), housing and planning including homelessness prevention (£30 million cuts) and public health (£80 million cuts).

By contrast, our ‘maintaining standards’ scenario would effectively end austerity across the board, freeing up additional funds to maintain public sector salaries in real terms and ensuring that key budgets for health, social care and schools all kept pace with expected demand growth. Our modelling estimates suggest this would cost an additional £14.6 billion compared with our projections for the government’s current plans, or 4% of overall resource DEL. Reversing a meaningful portion of the cuts seen since 2010 across health, social care and schools and improving outcomes beyond those implied by 2019/20 levels of spending, in line with our illustrative ‘improving outcomes’ scenario would require an increase in spending of £31.8 billion, or 10% of resource DEL.

## 5. FUNDING THE NEXT SPENDING REVIEW

Our results show that without an expansion in the OBR's current projection for overall DEL, public spending will continue to be cut across a swathe of vital services well into the 2020s – likely pushing a number of services already at breaking point into further crisis. Current government plans imply a 2.1% real-terms cut on average for all non-protected budgets which provide funding for vital services such as in further education, local government, prisons and public health. These cuts to non-protected spending will become even more severe if government pledges to meet higher demand for key services without new funding. Any further cuts to large swathes of government services should not be an option for consideration. The economy and society cannot afford further austerity.

In announcing the overall envelope for the next spending review this autumn, the government is therefore presented with a choice. The first is to roll forward a continuation of a deeply harmful status quo. The second is to show responsibility and flexibility in view of the needs of the economy and society. Below we briefly discuss the two most likely options for expanding the envelope for resource DEL in a responsible way.

### 5.1 USING 'FISCAL SPACE' RESPONSIBLY

It is highly likely that the economy is currently demand deficient and operating below its full capacity. This would imply a significant multiplier effect on GDP and living standards as a result of increased government spending funded from higher borrowing.

A detailed look at the data beyond the unemployment rate casts doubt on the official view of the Treasury and the Bank of England that the economy is operating at close to full potential. The

OBR estimates that the UK ‘output gap’ – the difference between what the economy is producing and its potential given available technology and people’s willingness to work – is slightly positive. This would suggest that increased spending from government may increase inflation rather than raise real living standards. However, underemployment, weak wage growth, weak growth in GDP and low-productivity growth – compared with their respective historical trends – all point to low demand and spare potential in the economy, casting doubt on the government’s official view.<sup>63</sup> Both the Organisation for Economic Co-operation and Development (OECD) and the IMF estimate a slightly negative output gap for the UK, while Oxford Economics estimate a one that is significantly negative and consistent with an economy that is demand poor.<sup>64</sup>

There is also an argument that to the extent the output gap has closed, this has happened as a result of *potential output falling*<sup>65</sup> to meet a lower level of *actual* output, rather than the other way around.<sup>66</sup> It is likely that government austerity will have played a part in this by lowering investment in innovation, and that reversing that trend should be part of the solution to a higher output potential in the future.<sup>67</sup> Others go further and argue that weak productivity is simply the result of wage adjustment to (austerity induced) low demand.

The evidence of spare capacity in the economy means the arguments to expand borrowing for at least the short- to medium-term are mounting. The isolated impact of increased spending would be expected to increase GDP and tax receipts. The OBR estimates a multiplier on government spending of 0.6 for day-to-day department spending. We therefore estimate that under our ‘maintaining

outcomes’ scenario, GDP could be £8.8 billion higher compared with our core scenario, and £19.1 billion higher in our ‘improving outcomes scenario’. Tax receipts would also be higher, partly due to the share of tax in new GDP growth and partly due to spending by departments coming back to the Treasury directly, for example via Income Tax and NICs paid through Pay-As-You-Earn (PAYE).<sup>68</sup> The IMF, however, estimates higher multipliers than the OBR, with a range of between 0.9 and 1.7.<sup>69</sup> Using these estimates, GDP could be as much as £24.8 billion or £54.1 billion higher under our two counterfactual scenarios, respectively. Besides multipliers on demand, increased public spending on services would also be expected to raise the overall potential through the supply-side of the economy, in the form of improved skills and human capital.<sup>70</sup>

If the Bank of England believes these multiplier effects to be inflationary, they may respond by increasing interest rates faster than would otherwise have been the case. Overall we believe this would be an error until the case for a zero output gap is unequivocal. But even if the Bank were to raise rates prematurely, there remains a strong case for further borrowing and fiscal stimulus, even within orthodox views of managing the economy.

This is because the Bank of England needs interest rates to rise before the next recession in order for monetary policy to be an effective tool for stimulating the economy. Interest rates are currently at their effective lower bound (ELB) – a minimum rate below which further reductions have little or no positive effect on spending and demand – while so-called ‘quantitative easing’ is thought to be a less than perfect substitute for a rate cut.<sup>71</sup> On average, the UK experiences a recession every 10 to 15 years.<sup>72</sup> Almost 10 years on from the last crisis – and with Brexit

uncertainty looming – the UK needs to create much more headroom between present interest rates and their effective floor, or else risk orthodox policy being unable to respond.

There are arguments in favour of further borrowing in the short term, then, whichever way the chips fall. The Bank of England will either judge that there is spare capacity in the economy, in which case further public borrowing and spending will cause living standards to rise faster than they might otherwise have done. Alternatively interest rates will rise to offset inflation, creating more headroom from the ELB but with the advantage that the effect on living standards would be at least partially offset by high public spending. Although allowing the economy to realise its full potential is clearly preferable, both outcomes would arguably be an improvement on raising interest rates without any fiscal stimulus – the policy prescription we are seeing today.

Given the present need for higher borrowing and spending, the current fiscal rules risk are harming the economy by putting excessive, near arbitrary limits on fiscal space. For this reason, and outside of our work on public services, NEF is planning a separate programme of research in 2019 looking at the balance between monetary and fiscal policy and asking how governments can make best use of fiscal space.

But even within the government's own constraints, there is room for some increase in borrowing. Projecting forward the same analysis from Figure 4 above into the final year of a four-year spending review period suggests government could increase annual borrowing by £24 billion (2018/19 prices) by 2023/24 and still be compliant with their current deficit

target.<sup>xiv</sup> Moving to something similar to Labour's fiscal rules could allow for a further £30 billion of borrowing to finance resource spending in 2023/24, with further room to borrow for investment on top.<sup>73</sup> This level of borrowing in the early years of the next spending review would be unlikely to increase public debt from one year to the next. In part this is due to the repayment of loans under the Bank of England's Term Funding Scheme, which would reduce net public debt on the Bank's balance sheet.<sup>74</sup> However, it should be noted that the chances debt could rise again in the final two years of a four-year period would increase.<sup>75</sup>

## 5.2 EXPANDING PROGRESSIVE TAXATION

The government could equally increase fiscal space by expanding the tax base. There are a number of possible options with the potential to raise significant additional receipts at the required order of magnitude, which a present or future government could consider. This notwithstanding, there remain significant challenges to large tax rises. Besides the administrative tests, there is also a key tension between raising revenues in a politically acceptable way but without focusing the tax base too narrowly on the very richest – which can increase the volatility and vulnerability of receipts. The options briefly discussed below include, but are not limited to, those that might be usefully considered by a current or future government. They have largely been selected on the basis of 'readiness' and the availability of data for accurate costings. Further options, which require further policy development such as increasing the amount of revenues that

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xiv To the extent that the so called Brexit 'dividend' is funded through further borrowing, this will also need to be found from within this overall fiscal space

might be collected from concentrations of wealth should also be a medium-term policy pursuit. Each of these options would, however, come with political challenges.

### **Reverse corporation tax cuts**

At 19%, the UK has among the lowest rates of corporation tax in OECD, and the lowest in the G7. This was not always the case. Rates have fallen significantly in recent years, from 30% in 2008 to a planned 17% from 2020. Bringing the effective rate of corporation tax closer into line with comparable economies abroad would imply a basic rate of around 24%.<sup>76</sup> HMRC's illustrative modelling suggests that restoring the basic rate of corporation tax to 24% would raise well in excess of £15 billion (2018/19 prices) per year by 2023/24,<sup>77</sup> while restoring to 30% would raise well over £30 billion. The distributional impact of corporation tax is hard to measure and remains highly uncertain. However, the current academic literature tentatively suggests that a larger portion of the burden is borne by shareholders, rather than company employees and consumers.<sup>78</sup> To the extent that this is true, it is likely that a rise in corporation tax will raise proportionately more from wealthier households, relative to poorer ones.

### **Reverse increases in the personal allowance of income tax**

Since 2010/11, both Conservative governments and the coalition government before them have sought to rapidly increase the personal allowance of income tax, from £6,475 in 2010/11 to a planned £12,500 by 2020. Distributional analysis shows that this move is highly regressive.<sup>79</sup> Three important reasons for this include: first, a higher personal allowance gives nothing back to those out of work who tend to make up the poorest households in society; second, the personal allowance is worth double

to most households with two people in work (these households tend to be better off on average than households with one person in work); third, the personal allowance is worth 40p on the pound to most of the richest 15% of tax payers (those earning between £46,351 and £100,000) compared to 20p in the pound for lower incomes. HMRC's modelling suggests that restoring the personal allowance to £10,000, for example, would raise in excess of £15 billion (2018/19 prices) per year by 2023/24 compared with current plans.<sup>80</sup>

### **Abolish the Upper Earnings Limit of NICs**

For employees on PAYE, the marginal rate of national insurance contributions (NICs) drops from 12% to 2% on earnings above the Upper Earnings Limit of £892 per week – equivalent to £46,350 per year. This schedule is therefore highly regressive, with higher income households and individuals paying proportionately less employee NICs than those with a lower income. HMRC's analysis suggests that abolishing the upper earnings limit such that those above it paid the same marginal rate of NICs compared with those below could raise more than £10 billion (2018/19 prices) per year by 2023/24.<sup>81</sup>

### **Replace inheritance tax with a lifetime gift tax**

In recent years a number of organisations have raised the possibility of switching from an inheritance tax system to a system of taxing 'lifetime gifts'. The key advantage would be that the tax is levied on the recipient of a bequest, rather than on the estate itself, and that bequests are considered cumulatively across a lifetime rather than at a snapshot in time. This is preferable from the point of view of progressivity, given that it is the wealth or income of the recipient that is of most relevance. It also means that the best way of avoiding the tax –

giving estates away to multiple people to take advantage of each person's respective tax free allowance – would have the positive side effect of causing wealth to be spread more broadly, not less.<sup>82</sup> The Resolution Foundation recently proposed a version of a gift tax that would replace inheritance tax and have a net positive fiscal impact to the exchequer of around £6 billion (2018/19 prices) by 2023/24.<sup>83</sup>

### **Introduce a formula based income tax**

A comparatively radical proposal for income tax and NICs that has been proposed in recent months by the IPPR Commission on Economic Justice is to replace the current schedule of marginal tax rates with a 'formula based' system.<sup>84</sup> In effect, tax bands would no longer exist, and for most incomes the marginal rate would rise at a slow pace between a new tax-free allowance and a new threshold for the top marginal rate. Every taxpayer's marginal rate, as well as their average rate, would depend on their own precise level of income. The proposals could be highly redistributive, raising between £6 and £16 billion in 2017/18 (depending on design, 2017/18 prices) while still seeing higher post tax incomes for everyone outside of the top 25% highest income taxpayers.

The overall multiplier effect on spending funded through taxation would likely be lower than those estimated in Section 5.1 above since part of the increase in economic consumption would be offset by a dampening of demand from higher taxes. Since those on the highest incomes are least likely to spend all their resources – what economists call a lower 'marginal propensity to consume' – the more progressive the tax rises, the less likely it is that the public spending multipliers would be fully offset by the effects of higher taxes.



## 5. CONCLUSION

At the 2018 Autumn Budget, the chancellor will announce the amount of money available for government services from 2020 onwards. Over the course of 12 months to autumn 2019, the Treasury will then negotiate individual spending plans with each government department – locking in government fiscal decisions, small and large, for up to a four-year time period.

Against this backdrop, this paper, which is the first in a new series of work looking at the future of public services in the 2020s, sets out initial findings. Using NEF's new public spending model, we project forward and simulate a government spending review settlement across three illustrative scenarios – focusing in particular on health, social care and schools funding. These include a 'core' scenario, projecting forward the most likely government plans at this point in time; a 'maintaining standards' scenario, setting out new funding to prevent a further deterioration in services; and an 'improving outcomes' scenario, which provides additional resources to recover some of the ground lost since the onset of austerity in 2010.

We find that unless the government changes course, the chancellor's recent claim that there is "light at the end of the tunnel" will amount to hollow rhetoric. After a decade of austerity, and in the absence of additional funding for the NHS, the government's current direction implied by the OBR suggests a further cut of 0.6% on average across departments in the first half of the 2020s. For services with no current spending protections, this would mean a cut of 2.1% overall, or 4.1% per capita.

But reversing this trajectory is entirely doable with enough political will and the right selection of policies. Our modelling shows that government could effectively and meaningfully end austerity, or even reverse a portion of the harm caused in recent years by expanding spending by between £14.6 to £31.8 billion by 2023/24, compared with our projection for current government plans. Furthermore, there exists realistic means of financing this expansion. Our analysis shows that government has the space to borrow up to £24 billion more than the current plans, even within its own fiscal rules. We also identify options for tax rises, focused on the most able to pay, capable of raising tens of billion extra in revenue per year. But if the chancellor fails to take this opportunity to learn from the lessons of the past, we could be living with the negative consequences for years if not decades to come.

## **APPENDIX 1.**

### **LIST OF PROTECTED BUDGETS AND THEIR PROTECTION RULES**

In the 2015 Spending Review, the government outlined budget protections for some areas of spending, in attempt to maintain its core priorities notwithstanding significant cuts to services.

For our core scenario, and in the absence of any new policy announcements, we assume these same protections will be rolled forward into the next spending review period, in addition to the £20.5 billion announced for the NHS. We do not include protections for 16-19 education and extra funding for the arts and museums because the wording of these commitments implied they were time limited to the present spending review period. Within resource DEL these protections include the following:

- Maintain spending on defence at 2% of GDP\*
- Maintain spending on overseas aid at 0.7% of GNI
- Maintain spending on schools in England in real terms
- Maintain spending on policing in real terms

\* For the modelling, resource DEL defence spending was kept constant as a proportion of GDP as not all defence spending is resource DEL

## APPENDIX 2.

### LIST OF SOURCES USED IN NEF'S DEPARTMENTAL SPENDING MODEL

Data description	Source	Link
TME, DEL, AME outturn (2007/08 - 2016/17) and forecast (2017/18 - 2022/23)	Economic and Fiscal Outlook 2018	<a href="http://obr.uk/efo/economic-fiscal-outlook-march-2018/">http://obr.uk/efo/economic-fiscal-outlook-march-2018/</a>
Departmental outturn and plans, 2013/14 - 2019/20	Public Expenditure Statistical Analyses 2018	<a href="https://www.gov.uk/government/statistics/public-expenditure-statistical-analyses-2018">https://www.gov.uk/government/statistics/public-expenditure-statistical-analyses-2018</a>
Barnett formula comparability percentages and appropriate population proportion for devolved administrations' block grants	House of Commons 2018	<a href="https://researchbriefings.parliament.uk/ResearchBriefing/Summary/CBP-7386">https://researchbriefings.parliament.uk/ResearchBriefing/Summary/CBP-7386</a>
GDP	Second estimate of GDP, ONS	
Population	National population projects: 2016, ONS	<a href="https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationprojections">https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationprojections</a>
Modernising NHS (used in improving outcomes scenario for NHS)	IFS and Health Foundation, 2018	<a href="https://www.ifs.org.uk/uploads/publications/comms/R143.pdf">https://www.ifs.org.uk/uploads/publications/comms/R143.pdf</a>
Social care - keeping up with demand	Kingsfund and Health Foundation, 2018	<a href="https://www.kingsfund.org.uk/sites/default/files/2018-03/Approaches-to-social-care-funding.pdf">https://www.kingsfund.org.uk/sites/default/files/2018-03/Approaches-to-social-care-funding.pdf</a>
Social care - costs of free personal care	Kingsfund and Health Foundation, 2018	<a href="https://www.kingsfund.org.uk/sites/default/files/2018-03/Approaches-to-social-care-funding.pdf">https://www.kingsfund.org.uk/sites/default/files/2018-03/Approaches-to-social-care-funding.pdf</a>
School pupil numbers and projections	National pupil projections, ONS 2018	<a href="https://www.gov.uk/government/statistics/national-pupil-projections-july-2018">https://www.gov.uk/government/statistics/national-pupil-projections-july-2018</a>

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