

PRESSURES AND PRIORITIES

THE LONG-TERM OUTLOOK FOR BRITAIN'S PUBLIC FINANCES



REPORT

Kayte Lawton and Amna Silim

September 2012
© IPPR 2012

ABOUT THE AUTHORS

Kayte Lawton is a senior research fellow at IPPR.

Amna Silim is a researcher at IPPR.

ACKNOWLEDGMENTS

The authors would like to thank Graeme Cooke, Tony Dolphin, Kanishka Narayan, Jonty Oliff-Cooper, Nick Pearce and James Purnell for input on the project and comments on earlier drafts.

Special thanks to the advisory panel for the project for sparing the time to help us develop and test our arguments: John Appleby, Nicholas Barr, Craig Barker, Nick Bosanquet, Niki Cleal, Chris Curry, Howard Glennerster, Paul Johnson and Jonathan Portes.

Many thanks also to A4e for providing generous financial support for the project. The authors retain responsibility for the contents of this report.

ABOUT IPPR

IPPR, the Institute for Public Policy Research, is the UK's leading progressive thinktank. We produce rigorous research and innovative policy ideas for a fair, democratic and sustainable world.

We are open and independent in how we work, and with offices in London and the North of England, IPPR spans a full range of local and national policy debates. Our international partnerships extend IPPR's influence and reputation across the world.

IPPR
4th Floor
14 Buckingham Street
London WC2N 6DF
T: +44 (0)20 7470 6100
E: info@ippr.org
www.ippr.org
Registered charity no. 800065

This paper was first published in September 2012. © 2012
The contents and opinions expressed in this paper are those of the author(s) only.

IDEAS to
CHANGE POLICY

CONTENTS

Executive summary	2
The evolution of Britain's public finances	2
Population ageing and the UK public finances over the long term.....	4
The uncertainty of long-term projections.....	4
Policy implications	6
Introduction	8
1. The evolution of Britain's public finances	10
Public spending in 2012/13 and the 2010 spending review.....	14
2. Population ageing and the UK public finances over the long term	17
The implications of population ageing for the public finances	18
Spending pressures to 2060: services and benefits for an ageing population.....	21
The impact of ageing on tax revenues over the long term.....	24
3. The uncertainty of long-term projections	26
The accuracy of the medium-term forecasts.....	26
National prosperity	26
Demographic change	27
Health in old age	28
Prices and productivity in public services.....	29
Uprating benchmarks for benefits, pensions and tax thresholds	30
Falling revenues.....	31
4. Policy implications	32
Raise the long-term rate of growth and the employment rate	33
Increase tax revenues	34
Identify priorities for public spending	35
Reform public services	36
References	38

EXECUTIVE SUMMARY

Current political debates are dominated by an argument about the impact of austerity on the UK's prospects for economic growth. Some blame the Coalition's decision to take £100 billion out of public spending over the course of the spending review for continuing weak growth, while others believe that austerity will win market confidence and secure Britain's long-term economic future.

These debates rarely stretch to an informed examination of the possible drivers of tax revenues and public spending over the long term, and the political choices implied by these trends.

Yet this is vital given continued population ageing, technological change and the rising demand for public services generated by growing national prosperity over the long run. These trends have driven decisions about the structure of public spending over the last 50 years, but often in the absence of strategic thinking about the impact of such decisions over the short, medium and long term or the trade-offs implied by different priorities.

This report sets out the major drivers of rising demand for public spending in key areas and highlights the political choices available to citizens and policymakers in determining the impact of these trends on the UK public finances over the next 50 years. It is the first report from IPPR's project on long-term trends in the UK's public finances.¹ A second report will consider in greater detail the policy implications raised in this report.

The evolution of Britain's public finances

Over the last 50 years, total public spending in the UK has usually been higher than total government receipts. Receipts were generally higher in the 1960s and 1970s, averaging around 41 per cent of GDP, than in the 1990s and 2000s, when they accounted for 37 per cent of GDP on average, following a consistent decline during the 1980s and early 1990s. Total public spending was also higher on average in the 1960s and 1970s, at 44 per cent of GDP, compared to an average of 41 per cent in the 1990s and 2000s. Public spending grew faster in the UK than in most other advanced economies during the 2000s.

The bulk of public spending in the UK has typically been concentrated in health, education, social security and defence. Spending in the first three areas as a share of GDP increased significantly between the early 1950s and the late 1970s: combined expenditure on health, education and social security doubled from 10 to 20 per cent of GDP over this period. The rise in health and education spending levelled off in the 1980s as the Conservative government sought to curb rising pressures on public sector budgets. Social security spending is more closely linked to economic conditions, peaking at around 12 per cent of GDP as a result of the early 1990s recession despite reforms designed to rein in expenditure.

The increase in spending on benefits and pensions reflects their growing generosity and coverage as well as the increasing number of pensioners. Rising spending on state pensions is particularly important for explaining the sharp increase in total welfare expenditure up to the early 1980s. Since then, the benefits system has become increasingly complex and child and working-age benefits have accounted for a growing share of total expenditure.

Rising spending on welfare, health and education has been a feature of all advanced economies over the last half century. The most significant driver of this has been rising

¹ For more, see <http://www.ippr.org/research-project/44/8607/pressures-and-priorities>

prosperity, since these items are 'superior goods', meaning that demand rises faster than incomes. In the UK, most of this extra demand has been met by public spending, although private spending as a share of GDP rose slightly from the 1980s.

Demographic change has also pushed up spending on pensions and healthcare. However, most age-related healthcare costs occur in the last year of life, so the impact of ageing on health spending should not be overstated.

Rising spending has also been driven by the growing costs of inputs. Since public services tend to be labour-intensive and often require highly skilled workers, real wages in the public sector tend to increase faster than GDP in the long run. Technological change and medical advances have also driven up costs in the NHS more than they have improved productivity.

Shifts in the level and structure of public spending in the UK have also been driven by political choices. Between 1997 and 2010, total public spending rose by an average of 3.4 per cent a year in real terms, compared to an average of 1.6 per cent a year between 1979 and 1997. During these periods, governments were facing similar pressures to increase public spending, but while the Conservative government sought to contain rising cost pressures (with mixed results), Labour chose to meet rising demand and invest in services. Health and education spending rose sharply from 1999 onwards as a result.

While healthcare, education and social security have received relatively generous settlements over the last half century, spending in other areas has been squeezed – particularly in defence and capital spending. Defence spending accounted for 7.5 per cent of GDP in 1955 but dropped to 2.6 per cent by 2010. Falling defence spending reflects shifting priorities for the UK on the global stage and the changing geopolitical context.

Capital spending averaged 5 per cent of GDP annually in the 1960s, but fell to 0.5 per cent in 1997 before recovering somewhat to 2.8 per cent in 2010. The large decline in capital spending since the mid-1970s is partly due to the privatisation of public corporations but also reflects large reductions in local authority house building and central government infrastructure investment. Concerns about the long-run economic impact of underinvestment in infrastructure led the Labour government to increase capital spending from 1999, but it is still low by historical standards.

Governments have also been able to offset rising spending in some areas because of lower debt interest payments. These fell considerably from the mid-1980s, with low and stable interest payments offsetting most of Labour's increase in social spending between 1999 and 2007.

In 2012/13, it is expected that health, education and social security spending will account for around two-thirds of total public spending, representing more than one-quarter of UK GDP. More than half of the social security budget will be directed at pensioners.

The 2010 spending review announced a total real terms cut in public spending of 3.2 per cent over the four years to 2014/15 or 0.8 per cent a year. However, since spending on social security and interest payments is expected to rise by almost 6 per cent over this period, most government departments are faced with larger real-terms cuts than are implied by this headline reduction rate.

The spending review protected the NHS budget in real terms, which increased pressure on other departmental budgets. The education budget is being cut by 3.4 per cent in real

terms; defence by 7.5 per cent. Capital spending is once again being squeezed, falling by more than a quarter in real terms over the four-year period.

These trade-offs echo those made in previous tight spending rounds. Rather than increasing tax revenues to pay for rising demand for public spending in key areas, politicians have typically sought to switch spending from other areas and to keep total spending roughly stable. Popular services like the NHS are usually protected while capital investment and defence budgets are squeezed, with little debate about the long-run economic impacts. In the 2010 spending review, pensioner benefits have also largely been protected while many working-age benefits have been frozen in real terms or had their coverage reduced. Looking ahead to the next spending review, the government may opt to reduce total welfare spending to allow for smaller cuts in departmental spending. The long-term impacts of these decisions and trade-offs are rarely factored into the policymaking process.

Population ageing and the UK public finances over the long term

Looking to the future, the UK population will continue to age, which will drive up demand for state spending on pensions, pensioner benefits, healthcare and long-term care. Over-65s are expected to account for roughly one-quarter of the total population by 2036, up from around 17 per cent in 2010. The additional demands created by population ageing do not imply that the UK welfare state is inherently unsustainable but it is important to recognise how these shifts will continue to shape the structure of public spending over the coming decades.

The Office for Budget Responsibility (OBR) produces projections of the long-term state of the public finances assuming that current policy does not change over the next 50 years and economic growth is steady. If current policy remained in place, demographic change would cause public spending to rise from the early 2020s onwards, once the effects of the current round of fiscal constraint have faded away. Revenues would remain broadly stable as a share of GDP so a growing gap would emerge between spending and receipts, implying rising government borrowing. Public sector debt would increase to almost 90 per cent of GDP by 2061, compared to a pre-recession level of around 40 per cent.

The OBR projects that, on current policy, health spending would account for 9 per cent of GDP by 2061/62, up from 7 per cent in 2016/17 (at the end of the current round of fiscal consolidation). Spending on state pensions and pensioner benefits would rise from 7 per cent to 10 per cent of GDP over the same period, and would account for one-quarter of total government non-interest spending. Long-term care would see the biggest increase in demand, although it is expected to represent just 3 per cent of total spending in 2016/17. Spending on areas not directly linked to older people, such as education, defence and non-pensioner benefits, would be stable as a share of GDP over the long term.

Population ageing is expected to have a less marked impact on tax revenues, which are projected to remain relatively stable over the next 50 years under current policy assumptions. People in retirement continued to pay income tax and VAT, the two major tax earners in the UK. Revenues from national insurance contributions (NICs) are projected to fall slightly over the long term because people do not pay NICs once they have reached the state pension age.

The uncertainty of long-term projections

The OBR's mandate requires it to only consider current policy but it is clear that changes to government policy over the next 50 years will affect the size and structure of both

revenues and public spending. In addition, there is substantial uncertainty around the long-term economic and demographic projections that underpin the OBR's analysis, as well as a range of other factors not considered directly by the OBR that will affect the evolution of the UK's public finances.

The OBR's long-term projections are based on the medium-term outlook for 2016/17 produced in March 2012. The OBR estimates that if the actual primary balance (the difference between total non-interest spending and revenues) in 2016/17 is worse by 1 per cent of GDP then net debt under current policy would reach 130 per cent of GDP by 2061/62. On the other hand, if the primary balance turns out to be better than predicted by 1 per cent of GDP then debt would fall to less than 40 per cent.

Stronger-than-predicted economic growth over the long term would also see lower debt levels even as an ageing population increases demand for more public spending. OBR analysis shows that a higher fertility rate or high net migration would increase the proportion of the population in the labour market over time, pushing up GDP relative to public spending in the long run. In a scenario in which there was zero net migration over the long term, public sector net debt in 2061/62 would be more than double the expected level under current policy, rising to nearly 200 per cent of GDP.

Long-term demographic projections are always subject to a substantial margin of error, particularly when predicting the number of the very old and the very young, who tend to generate the highest demand for public spending. Higher-than-expected longevity in the future would put substantial pressure on spending on state pensions and pensioner benefits in particular, which are already projected to rise significantly under current policy assumptions. Alternatively, if the UK's recent rise in fertility rates could be sustained then a younger-than-expected population would cause GDP to rise faster than spending.

The health of future cohorts of older people will also determine how much extra demand there is for public healthcare spending. It is thought that health in old age will improve in the future because of historical reductions in smoking and other improvements in health behaviours. However, there is a lot of uncertainty about the future health status of people experiencing greater longevity.

Spending pressures in public services will also be affected by the price of inputs and the efficiency with which they are used. Many analysts believe that productivity in public services could be improved so that outputs and quality can be retained or even increased without raising spending. However, estimates suggest that productivity growth in health and education has been broadly flat over the last decade. The OBR estimates that if productivity in the health sector grew at 0.8 per cent a year instead of the 2.2 per cent it assumes for the whole economy then the additional health spending required to maintain outputs would push up debt levels to more than 230 per cent of GDP by 2061/62.

Technological and medical advances have increased the cost of delivering healthcare over the last 50 years and are likely to have a similar impact in future. Future public sector pay settlements will also determine labour costs: the OBR assumes that public sector pay will rise in line with average earnings over the next half century, but this is far from certain. Less generous pay settlements would enable outputs to increase without requiring more spending, providing an alternative solution if productivity gains prove elusive. However, this would have to be balanced against the consequences for recruitment and retention within a high-skill workforce.

Political choices about how to increase the value of state pensions and benefits and how to uprate tax thresholds have a large effect on the public finances. The OBR assumes that state benefits and thresholds for income tax and national insurance contributions will rise with earnings over the long term, even though this contradicts existing government policy, which is to increase these values in line with CPI inflation in most cases.² The OBR argues that increasing benefits and tax thresholds with inflation over a number of decades would not be politically sustainable. Its assumptions mean that revenues from labour taxes (the largest source of government receipts) remain broadly constant as a share of GDP, whereas under current policy they would rise, providing additional revenues to offset rising demand for spending. Similarly, under current policy, benefit spending would be substantially lower in future than the OBR estimates. The additional revenues and reduced expenditure created by less generous uprating assumptions would have to be balanced against the distributional and political implications.

The OBR also highlights the impact of long-run declines in key revenues sources driven by non-demographic factors, such as decarbonisation, the running down of North Sea oil and gas reserves and continued falls in smoking. These trends will cause revenues from vehicle excise duty, VAT on fuel and fuel duty, tobacco duties and receipts from North Sea oil and gas levies to fall as a share of GDP over the next 50 years. The main OBR modelling does not incorporate these scenarios, but their negative impact on future government receipts are fairly certain given current trends. Each of the affected revenue streams contribute only a relatively small amount to total receipts, but their combined impact suggests that, under the OBR's assumptions, total government receipts can be expected to follow a mildly negative trajectory over the next 50 years.

Policy implications

The OBR's projections of long-term fiscal sustainability tell us what will drive rising demand for public spending and what will drive falling revenues. Politicians will choose whether and how to respond to these trends, and have a range of options available to them. We have identified four key approaches.

- 1. Raise the long-term rate of growth and the employment rate:** Governments have typically found it hard to sustain real-terms falls in public spending and, in the past, strong growth has been vital for achieving fiscal consolidation. Over the long term, OBR analysis shows that higher-than-projected growth rates would significantly reduce the size of the 'fiscal gap' in 2061/62 without requiring any changes to current tax and spend policies. Similar effects could be achieved through high net migration, a higher fertility rate or if the employment rate among the existing population could be substantially improved. For example, the fiscal impacts of ageing would look very different if more older people stayed in work longer.
- 2. Increase tax revenues:** Falling revenues from some sources suggest that taxes may need to rise in other areas to make up the shortfall in future. Politicians and citizens also need to decide if total revenues should be higher in the long term to pay for some of the extra demand for services and benefits. Additional revenues could come from increasing tax rates for the big earners, like VAT and labour taxes, reducing expenditure on tax reliefs like pension tax relief, or allowing fiscal drag (where revenues rise as a share of GDP because tax thresholds are not increased in line with earnings).

² The basic state pension will increase by the highest of the increase in average earnings, CPI inflation or 2.5 per cent. Pension credit rises in line with earnings.

3. **Identify priorities for public spending:** Population ageing is pushing spending priorities in particular directions, but often there is little debate about whether these are the right priorities over the long term. This should involve some tough questions about national strategic priorities and the trade-offs inherent in different choices. If we squeeze capital spending to protect the NHS budget, will we have the right infrastructure in place to support jobs and growth? If we protect pensioner benefits but cut back on transfers to working-age adults, do we risk damaging work incentives and pushing up poverty among working-age families to intolerable levels?
4. **Reform public services:** Continuing cost pressures in public services also imply the need for further radical reform to limit rising demand or reduce the cost of public provision. This could include increasing investment in preventative public services and further reforms to the state pension. Market reforms should be considered that limit the cost to the state of market failures, such as high private sector rents. In some areas, there may be a case for extending private provision, although the likely impacts on equity and efficiency will also need to be taken into account. Significant improvements in productivity in public services would help to meet increased demand without raising spending.

INTRODUCTION

Current political debates are dominated by an argument about the impact of austerity on the UK's prospects for economic growth. Some blame the Coalition's decision to take £100 billion out of public spending over the course of the 2010 spending review for continuing weak growth, while others believe that austerity will win market confidence and secure Britain's long-term economic future. This is a debate focused on the medium term, with the current spending review setting out spending plans to 2014/15 and the prime minister raising the prospect of further spending cuts up to 2020.³

Three- and four-yearly spending reviews have become common over the last 15 years, but policymakers are much less practised in assessing the long-term state of the public finances or considering the long-run implications of policy decisions and wider social and economic changes. The fierce current debate about the impact of spending cuts over the short and medium term does not stretch to an informed examination of the possible drivers of tax and spend over the long-term, and the political choices implied by these trends.

Yet this examination is vital, given continued population ageing, technological change and the rising demand for public services generated by growing national prosperity over the long run. Projections by the Office for Budget Responsibility (OBR) and others suggest that these trends are likely to drive up demand in major spending areas – most notably in healthcare and state pensions – without boosting revenues significantly. In the absence of changes to policy, this implies either that spending will gradually outstrip revenues over the next 50 years, pushing up government debt to unsustainable levels, or that other areas of spending will be squeezed in order to balance the books.

The purpose of this report is to set out the major drivers of rising demand for public spending in key areas and to highlight the political choices available to citizens and policymakers in determining the impact of these trends on the UK public finances over the next half century. The report considers how policymakers have responded to rising demand for public services over the last 50 years and draws on long-term fiscal projections compiled by the OBR and other organisations. We explicitly look further ahead than debates about the current round of austerity do, although the impact of the current spending review and the political choices it implies are likely to have important consequences for the structure of the public finances over the long term.

The lack of 'long-termism' in political debates means that policymakers are rarely required to assess the likely impact of their decisions beyond the short and medium term. Not only does this weaken the effectiveness of policymaking, it also limits the scope for a democratic debate about the UK's national priorities and how the costs of achieving these priorities should be met by individuals, the private sector and the state. Engaging with long-term challenges requires us to confront difficult decisions about our priorities as a nation and the trade-offs that follow.

This report begins in chapter 1 by outlining the evolution of the public finances since the second world war, highlighting the rising demand for public services, pensions and benefits and the implications for other areas of spending. Chapter 2 explores the possible future of the public finances under the most likely scenario (the OBR's 'central projection'), while chapter 3 considers the sources of uncertainty inherent in long-term projections and the range of policy implications this creates. Finally, chapter 4 highlights the political choices on tax and spend implied by long-term fiscal projections, stressing the need

³ See <http://www.telegraph.co.uk/news/politics/david-cameron/9410053/David-Cameron-no-end-in-sight-for-austerity.html>

for prioritisation in public spending, reforms to reduce demand and bring down costs, measures to raise extra revenues, and steps to boost jobs and growth.

This report is the first output from IPPR's project on long-term trends in the UK's public finances.⁴ A second report to be published later in 2012 will explore the policy implications raised in this report in more detail, with a particular focus on the need for prioritisation and reform in public spending. Other IPPR work is considering in greater detail the role of tax reform, employment and growth in improving the long-run sustainability of Britain's public finances and providing the resources to pay for the services, benefits and pensions we want.

⁴ For more, see <http://www.ippr.org/research-project/44/8607/pressures-and-priorities>

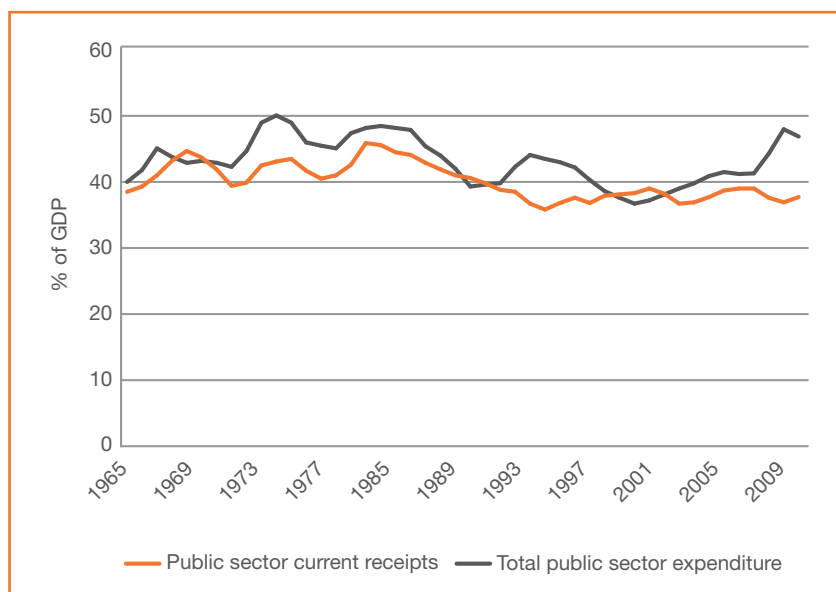
1. THE EVOLUTION OF BRITAIN'S PUBLIC FINANCES

In this chapter, we set out the key trends in public spending and revenues in the UK over the last 50 years and the major drivers of change. Many of these trends will continue to influence future spending and revenues and so understanding how previous governments have responded to these trends holds important lessons for today's policymakers. It also reinforces the fact that none of these trends are new or unexpected; instead, they each reflect long-running and slowly evolving shifts in demography, technology, behaviour and public attitudes.

Over the last 50 years, total public spending and receipts have fluctuated in response to economic conditions and policy decisions. Typically, total public spending has been higher than total receipts, apart from short periods in the late 1960s, late 1980s and late 1990s. On average, total government receipts were higher in the 1960s and 1970s – averaging 41 per cent of GDP – than in the late 1990s and 2000s, when they averaged 37 per cent, following a consistent decline between 1981 and 1993. Total public spending was also higher on average in the 1960s and 1970s, at 44 per cent of GDP, compared to an average of 41 per cent in the 1990s and 2000s, although public spending has tended to be more cyclical than revenues over the last 30 years.

The 2008–09 recession and government response created a particularly large gap in the public finances, pushing up spending by 7 percentage points and lowering total receipts by 2 points. In 2009, the UK had the ninth highest level of public spending among 34 OECD countries, and the 12th highest in 2007, prior to the increase in government outlays that resulted from the 2008 financial crash and subsequent recession (OECD 2011). Public spending grew faster in the UK than in most other large advanced economies after 2000, which partly accounts for the UK's relatively high ranking at the end of the decade (Crawford et al 2009).

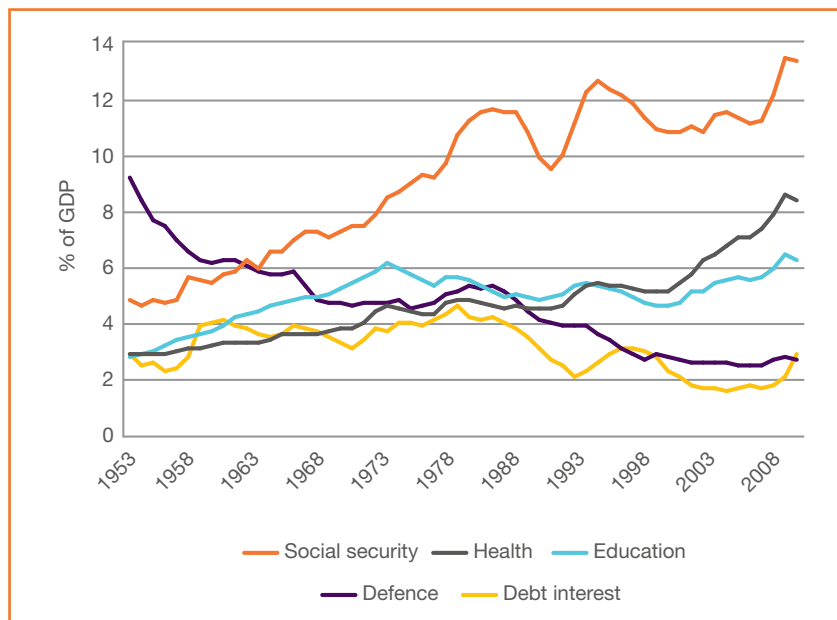
Figure 1.1
Trends in public
spending, 1965 to 2010
(UK)



Source: IFS data: <http://www.ifs.org.uk/fiscalFacts/fiscalAggregates>

The bulk of public spending in the UK has historically been concentrated in health, education, social security⁵ and defence. The most noticeable trend in figure 1.2 is the dramatic rise in social security spending since the early 1950s, reflecting the increasing generosity and coverage of state benefits and pensions, and the growing number of claimants. Social security spending more than doubled between the early 1950s and the early 1980s, rising from 5 per cent to 11 per cent of national income. From the early 1980s, reforms curbed rising benefit and pension spending, although expenditure was driven up to above 12 per cent of GDP during the early 1990s recession and rose to a peak of 13 per cent as a result of the 2008–09 recession.

Figure 1.2
Key components of public expenditure, 1953–2010



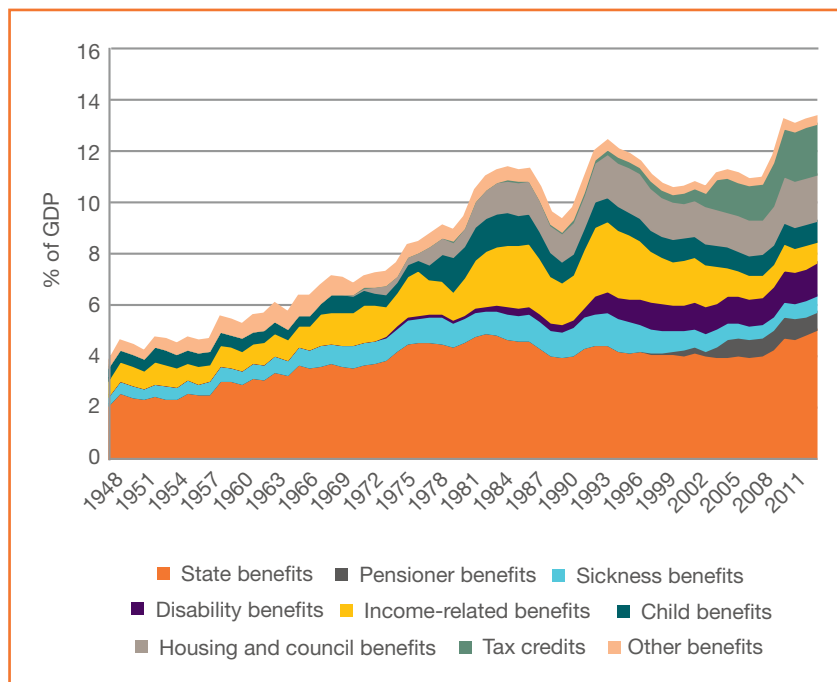
Source: IFS data: <http://www.ifs.org.uk/fiscalFacts/fiscalAggregates>

Figure 1.3 tracks the shifting composition of benefit spending since 1948. The substantial rise in aggregate welfare spending up to the early 1980s was driven primarily by an increase in spending on state pensions, which more than doubled from 2 per cent of GDP in 1948 to 5 per cent in 1982. In contrast, most of the growth in benefit spending from the 1980s has been accounted for by more generous payments for children and working-age adults, although there was also a substantial increase in pensioner benefits from the late 1990s. These shifts mean that although spending on state pensions and pensioner benefits has risen significantly in real terms over the last 40 years, they have accounted for a falling share of total benefit payments. Up to the early 1970s, state pensions accounted for around 55 per cent of aggregate benefit spending, falling to a projected 43 per cent in 2012/13.

Figure 1.3 also shows the substantial expansion in the range of contingencies for which cash transfers are available. Until the early 1970s, welfare spending was focused on just three key areas: state pensions, unemployment and sickness benefits, and child benefit. The last 40 years have seen the introduction or expansion of benefits to subsidise rents and rates (currently housing benefit and council tax benefit), disability benefits, tax credits for low-income families, and pensioner benefits to top up the state pension.

⁵ In this report, we use the terms ‘social security’ and ‘welfare’ to describe all government spending on cash transfers, including pensions, benefits and tax credits.

Figure 1.3
Benefit spending by
function, 1948 to 2012



Source: DWP benefit expenditure tables: <http://research.dwp.gov.uk/asd/asd4/index.php?page=expenditure>; HMRC annual reports, various years

Note: 'Tax credits' includes family credit, working families tax credits, disable persons tax credits, child tax credits and working tax credits; 'pensioner benefits' includes winter fuel payments, free TV licences and pension credit; 'sickness benefits' includes statutory sick pay, invalidity benefit, incapacity benefit and employment and support allowance; 'income-related benefits' includes carers allowance, jobseekers' allowance, unemployment benefits and income support; disability benefits includes disability living allowance and attendance allowance.

The other key areas of rising public spending in the post-war era have been healthcare and education. Health spending rose fairly steadily from around 3 per cent of GDP in the early 1950s to 4.5 per cent at the beginning of the 1980s, when the Conservative government sought to contain rising cost pressures. During the 1980s, health spending continued to increase in real terms, with an average growth rate of 3.2 per cent, but was broadly flat as a share of output. After 1999, health spending increased to over 8 per cent of GDP in 2010, rising by an average of 6.3 per cent a year, twice as fast as under the Conservative governments of 1979 to 1997 (Chote et al 2010).

Education spending increased consistently up to the mid-1970s to reach 6 per cent of GDP, before falling a little and then stabilising at around 5 per cent in the 1980s and 1990s. Education spending experienced a less dramatic increase than health spending from 1999, rising by around one-third to 6 per cent of GDP in 2010 (ibid).

Rising spending on core public services like health and education as a share of output has been a feature of all advanced economies over the last half century. The most significant driver of increased expenditure has been the additional demand generated by rising national prosperity. Healthcare and education are generally considered to be 'superior goods', which means demand rises faster than income.⁶ Oliveira Martins and de la Maisonneuve (2006) estimate that rising national income explains about two-thirds

6 The income elasticity for superior goods is higher than 1 by definition; 'normal' goods have an income elasticity between 0 and 1, meaning that demand rises with income but not as fast as income; 'inferior goods' have a negative income elasticity, meaning that demand falls with income.

of the real-terms rise in total health spending in the UK between 1981 and 2002. In most OECD countries, this additional demand has primarily been met by rising public spending, although private spending tends to rise when public spending growth is weak or is cut in real terms. In the UK, private health spending increased from 0.5 per cent of GDP in the mid-1970s to 1.4 per cent in 1999. However, private health spending started to decline when NHS budget settlements became more generous from 1999/00 (Crawford et al 2009). Despite some small shifts in public and private spending, the general contours of social provision have remained remarkably stable in the UK over the last 30 years, with the majority of provision remaining publically funded and controlled (Hills 2011).

Demographic change has also driven changes in public spending, particularly rising spending on state pensions and the NHS. However, the direct impact of ageing on healthcare expenditure has been not been as large as might be suggested by the increase in longevity in the UK over the last 50 years. Older people account for the majority of healthcare expenditure but this is primarily the result of the high costs associated with death. Population ageing delays these costs but does not increase them. However, once death-related costs are stripped out, older people still have a slightly higher demand for healthcare than younger age groups (Seshmani and Gray 2004). As a result, Oliveira and de la Maisonnette (2006) estimate that demographic pressures accounted for around 6 per cent of rising health expenditures in the UK between 1981 and 2002, with Breyer et al (2010) finding similar results across OECD countries.

On the supply side, rising public spending on healthcare and education can also be explained by increases in the cost of inputs. These services are labour intensive and require highly skilled workers, which tends to cause real wages to rise faster than GDP (Taylor-Gooby 2012); at the same time, technological and medical advances have pushed up healthcare costs more than they have improved productivity (Wanless 2002). Oliveira and de la Maisonnette (2006) estimate that technology and rising prices caused health spending to increase by just under one-third in the UK between 1981 and 2002. The Wanless review of long-term healthcare needs estimated that technological and medical advances have had an even more pronounced impact on health spending, contributing around 2 percentage points to the annual real rate of growth in healthcare spending through the 1980s and 1990s.

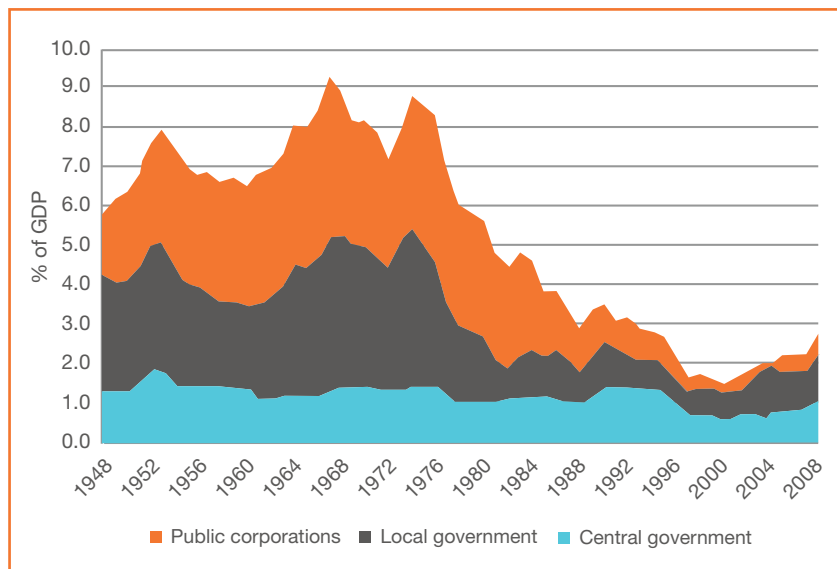
These factors explain the general trend towards rising public spending on health and education in the UK over the last 50 years, but spending in any given period is also strongly influenced by policy decisions, which reflect the political choices made by governments. Between 1997 and 2010, total public spending increased by an average 3.4 per cent a year in real terms, compared with 1.6 per cent a year under the Conservative governments of 1979 to 1997 (Chote et al 2010). The Labour governments made a political decision to respond to rising demand (and earlier underinvestment) by rapidly expanding health and education expenditure, although total social spending in 2007/08 – just prior to the financial crisis – was little higher than it had been in the early 1990s (Hills 2011). In contrast, Conservative governments between 1979 and 1997 primarily sought to contain rising cost pressures by limiting the real terms growth of departmental budgets, although with mixed results. Rising demand and increasing cost pressures in public services are likely to continue over the next half century, but the actual impact on the public finances will reflect the political decisions taken by governments.

Such decisions are evident in trends in spending areas that have been given a lower priority as demand for healthcare and education has risen. In 1955, the UK government

spent more on defence (7.5 per cent of GDP) than on education and healthcare combined (5.7 per cent of GDP). Over the next two decades, defence spending as a share of national income was cut by almost half, and continued to decline over the 1980s and 1990s (see figure 1.2). Falling defence spending reflects shifting priorities for the UK on the global stage as well as the changing geo-political context.

From the mid-1970s, successive governments also chose to squeeze capital spending, in part to fund the growing provision of publically-funded benefits, pensions, healthcare and education without pushing up total public spending. Total gross capital spending fell from almost 9 per cent of GDP to less than 2 per cent between the mid-1970s and the late 1990s. This was partly driven by the privatisation of public corporations from the 1980s, but was also the result of large falls in local government capital investment caused by the transfer of publically-owned housing to the private sector and a dramatic reduction in council house building. This reflected the decision by Conservative governments in the 1980s to subsidise rents rather than house-building, transferring a significant proportion of expenditure from local authority capital budgets to the benefits bill. To a lesser extent, central government capital spending was also squeezed between 1991 and 2000, before total capital spending started to rise slightly from the early 2000s onwards, partly in recognition of the economic impact of 30 years of public sector underinvestment in housing and infrastructure (Crawford et al 2009).

Figure 1.4
Public sector gross fixed capital investment, 1948 to 2008 (% of GDP)



Source: Crawford et al 2009

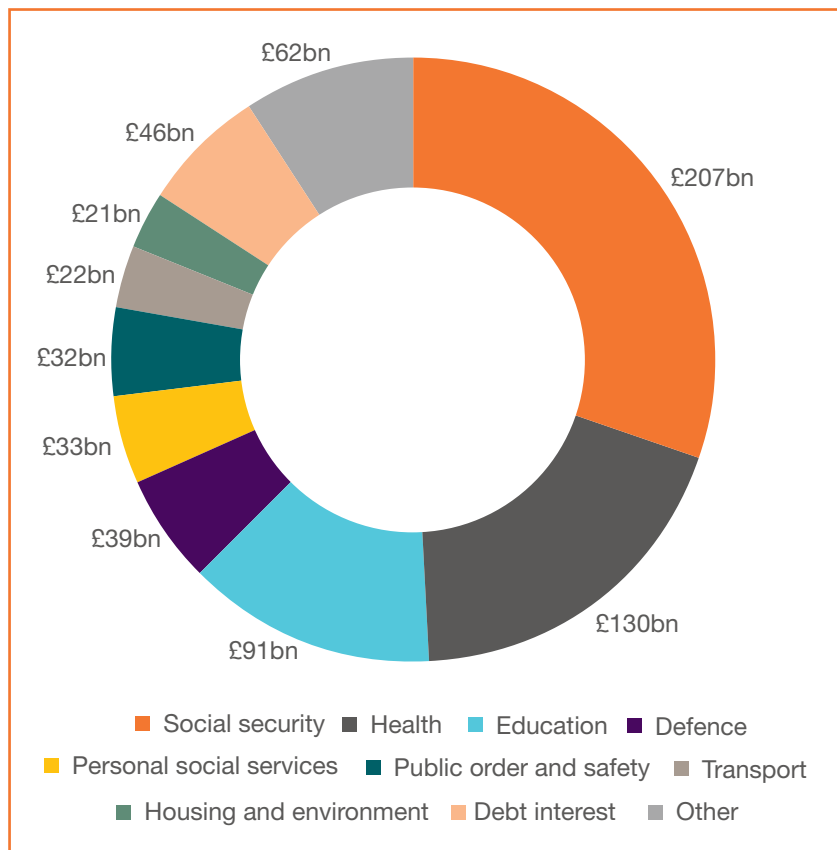
More recently, higher public spending on health, education and social security has been partly offset by relatively low debt interest payments (see figure 1.2 above). Between the mid-1980s and 2001, debt interest payments as a share of GDP more than halved from around 4 per cent to less than 2 per cent, with a brief spike in the early 1990s. Interest payments remained low and stable until the 2008–09 recession, which offset most of Labour’s increase in social spending after 1999/00 (Hills 2011).

Public spending in 2012/13 and the 2010 spending review

Three areas continue to dominate government spending in 2012: health, education and social security. Together, they represent nearly two-thirds (63 per cent) of total public

spending, with social security and health accounting for half of all public spending. Over half the social security budget for 2012/13 will be directed at pensioners, through state pensions, pension credit and other pensioner benefits (including housing benefit and council tax benefit paid to pensioner households) (OBR 2012a).

Figure 1.5
Composition of UK
public spending,
2012/13 (forecast)



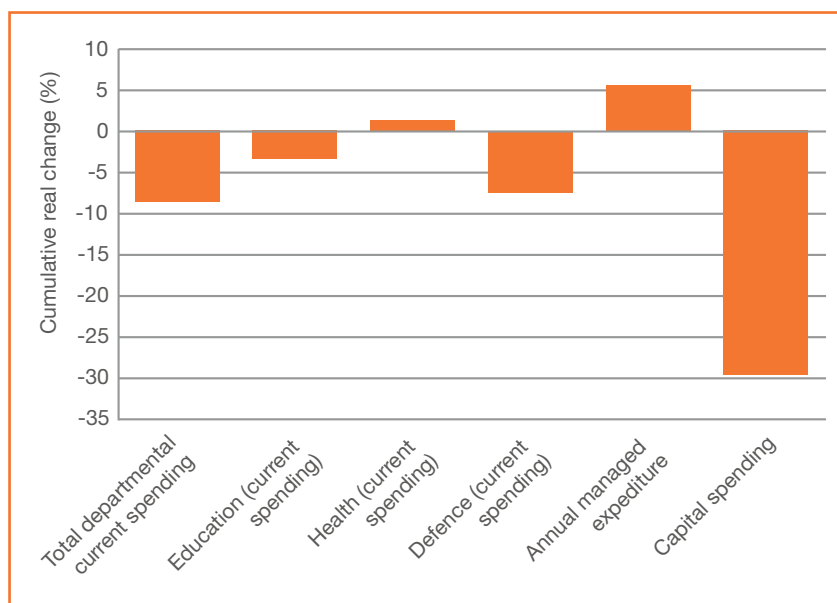
Source: HM Treasury 2012a

The 2010 spending review, which set government spending parameters for the period 2011/12–2014/15, contained reductions in spending totalling 3.2 per cent in real terms, or 0.8 per cent a year. Since annual managed expenditure – or AME, primarily made up of debt interest payments and benefit spending – is forecast to rise by 5.9 per cent in real terms over the spending review period, the cuts to departmental spending will be larger than the headline cuts in total public spending. Departmental budgets will be cut by an average of 10.9 per cent in real terms over the course of the 2010 spending review. Further reductions in total spending have since been announced for 2015/16 and 2016/17, which will bring the total real terms fall in public spending in the six years to 2016/17 to 5.0 per cent (OBR 2012b). AME is forecast to grow by a further 3.4 per cent in real terms across 2015-16 and 2016-17, implying further significant cuts to departmental budgets (OBR 2012a).

On current estimates, total public spending will fall from 46.5 per cent of GDP in 2010/11 to 42.2 per cent in 2014/15, and to 39.0 per cent by 2016/17 (OBR 2012b). This is designed to enable the government to generate a structural budget surplus by 2016/17 and so allow the Coalition to stick to its primary fiscal rule of balancing the cyclically-adjusted current budget over a rolling five-year horizon.

Within the spending review, the NHS budget has been protected from real-terms cuts and will experience real growth of 1.3 per cent over the spending review period, or 0.4 per cent a year. However, this compares to average annual real growth of 5.5 per cent over the 2000s and represents the tightest four-year funding settlement for the NHS in the last 50 years (Crawford and Emmerson 2012).

Figure 1.6
Real-terms change in spending implied by the 2010 spending review, 2011/12–2014/15



Source: HM Treasury 2010, OBR 2012b

All other major spending departments (apart from international development) will experience real-terms cuts over the course of the spending review period. Education spending is forecast to fall by 3.5 per cent in real terms; in stark contrast with a 28 per cent real terms increase between 2004 and 2011. Defence spending is being cut by 7.5 per cent. Capital spending is particularly badly hit, and is expected to fall by more than a quarter (27 per cent) in real terms over the next four years.

The decisions taken in the 2010 spending review are largely in line with those made in previous tight spending rounds, with the NHS budget protected and less popular areas like defence and capital spending receiving fairly large cuts, although education is also being cut this time. This is to some extent a continuation of the overall story that emerges from patterns of public spending since the second world war. Up to the end of the 1990s, successive governments relied on falling defence and capital spending to fund rising spending on health and education, and particularly on social security. The Conservative governments of 1979–1997 also tried to limit the impact of rising demand by curbing public spending in key areas, with mixed results (Timmins 2001). More recently, the previous Labour government oversaw sharp increases in health, education and capital spending, made possible by very low real debt interest payments, an increase in borrowing compared to 1999 levels and flat benefit spending as a share of GDP until the 2008–09 recession. At no time has rising demand for public spending in some areas been met by increasing tax revenues, and nor was total public spending allowed to rise substantially over long periods of time.

2. POPULATION AGEING AND THE UK PUBLIC FINANCES OVER THE LONG TERM

The underlying trends that have driven up demand for, and the cost of, public services, pensions and benefits over the last half century will continue to exert pressure on public spending over the next 50 years. In this chapter we examine how the public finances might evolve if future governments were to meet rising demand and higher costs over the long term without at the same time putting in place reforms that boost growth, raise revenues, reduce spending in some areas or improve public sector productivity.

The chapter draws on projections produced by the OBR for their *Long-term Fiscal Sustainability* report published in July 2012, which cover a 45-year period from 2016/17 (the last year of the OBR's March 2012 medium-term outlook) to 2061/62 (OBR 2012a). The assumptions in the OBR medium-term outlook are therefore 'locked into' the long-term projections of fiscal sustainability. The OBR produces a central long-term projection, based on the most likely future scenarios, along with a series of variants based on alternative scenarios of population change, economic conditions, health in old age and public sector productivity.

Under its mandate, the OBR is required to assume that government policy does not change over the long term, so the projections can only reflect current policy decisions that have been factored into existing public spending commitments. They exclude uncosted policy commitments, such as substantially reducing child poverty (as required by the 2010 Child Poverty Act) or the full costs of tackling climate change.⁷ Within the restrictions of modelling only current policy decisions, the OBR must make some general assumptions about future economic conditions and public spending. In the 'central projection', whole economy productivity is expected to grow by 2.2 per cent a year and employment rates by year of birth and gender are projected forward based on past changes.⁸ Per-capita public spending is calculated for gender and year-of-birth cohorts and then held constant as a share of GDP.

While it is current government policy to uprate benefits and tax thresholds in line with CPI inflation, the OBR argues that, over the very long term, this policy would lead to lower benefit rates and more fiscal drag (where earnings rise faster than the value of tax thresholds, causing more people to pay tax at a higher rate) than policymakers would realistically allow. The OBR therefore assumes that tax thresholds and benefit rates rise in line with earnings from 2017/18. The implications of this significant assumption are discussed in the next chapter.

The requirement to include only existing policy decisions in the long-term projections means that the OBR's central projection of long-term fiscal sustainability primarily reflects demographic change (as well as the uprating assumptions discussed above and in the next chapter). As per-capita spending by age and sex is held constant as a share of GDP, and employment rates by age and gender are broadly constant, the main driver of future spending and revenues is simply the additional number of people in each age-sex group.

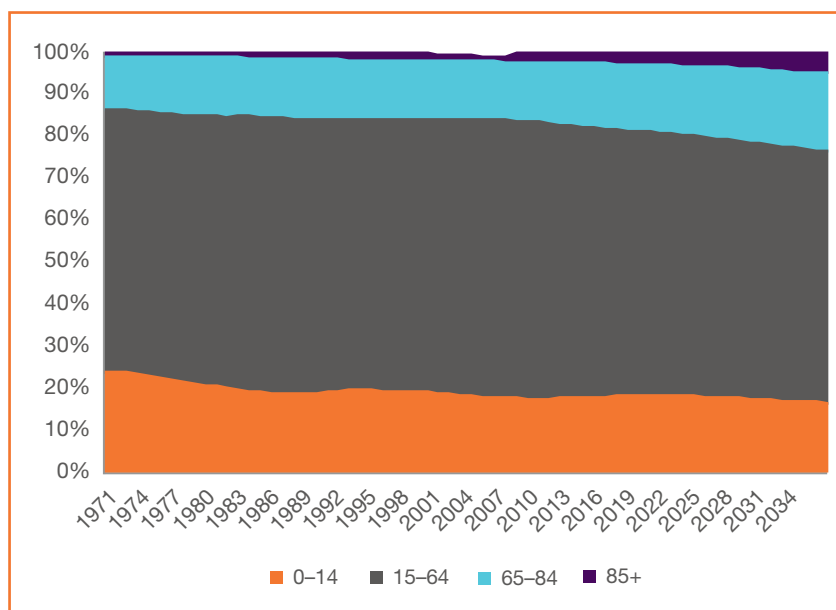
The demographic assumptions used in the OBR projections are based on population projections produced by the ONS in 2010. Figure 2.1 shows the UK's actual and projected population by age group from 1971 to 2036. Between 1971 and 2010, the proportion of the population aged 65 and over increased by a quarter, from 13.4 per cent to 16.6 per cent. This cohort is expected to grow to 23.3 per cent of the total population by 2036.

7 The Committee on Climate Change estimates that achieving the government's climate change targets will require additional investment in infrastructure and technology totally up to £16 billion a year by 2030, although the costs of failing to prevent dangerous climate change are expected to be far larger (CCC 2010).

8 This is in line with average productivity growth rates between 1961 and 2010.

The population aged 85 and over has grown particularly rapidly, rising from 0.9 per cent to 2.3 per cent of the total population between 1971 and 2010, and is expected to double between 2010 and 2036, rising to just under 5 per cent. The share of the population accounted for by working-age adults (those aged 16 to 64) is expected to fall from 66.0 per cent in 2010 to 60.2 per cent in 2036.

Figure 2.1
Proportion of population
by age, 1971 – 2036



Source: ONS 2011a, 2011b

Notes: After 2010, these estimates are forecasts based on the ONS 2010-based low variant population projections.

Population ageing is not a new phenomenon in the UK and future ageing will take place slowly and steadily, with no dramatic increase in the proportion of older people in the population. In fact, the UK, alongside the US and the Nordic countries, is already in a mature phase of the ageing process (Oliveira Martins and de la Maisonneuve 2006). Demographic pressures will be stronger in countries with a rapidly ageing population and where labour market participation is relatively low but expected to rise, driving up demand for formal care services. This points to Japan and the Mediterranean countries as facing the greatest demographic challenges among the advanced economies.

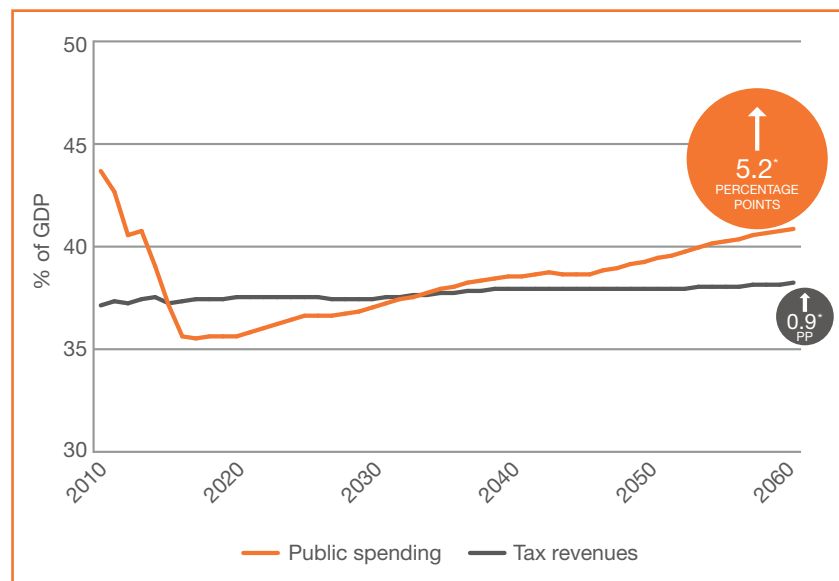
The implications of population ageing for the public finances

There has been a growing concern from at least the late 1980s that the welfare states of advanced economies will be increasingly unable to cope with the rising demand for public spending created by population ageing. This followed a narrative that emerged from the early 1970s implying that modern welfare states were unsustainable in the light of apparently insatiable demand, increasingly volatile economic conditions and intensified global economic integration (Castles 2004). Such ‘crisis accounts’ have consistently proved to be significantly exaggerated – the previous chapter of this report shows there has been no persistent rise in overall public spending as a share of national income over the last 40 years. The continued challenges of population ageing, combined with technological change and growing demand for high-quality public services, will influence priorities in public spending but do not imply that the welfare state is inherently unsustainable or facing an unmanageable crisis.

Total public spending in 2016/17 is forecast to stand at 39.0 per cent of GDP and remain broadly flat for the following four years. In the OBR's central projection, spending would start to rise from 2021/22 and then continue on an upward trajectory, rising to 45.3 per cent of GDP by 2061/62. However, on existing policy and the OBR's assumptions, total receipts would remain relatively stable over the same period, rising from 37.9 per cent of output in 2016/17 to 39.2 per cent in 2061/62.

The OBR focuses on non-interest spending and tax revenues⁹ as its primary measure of long-term fiscal sustainability. The projected paths of both are set out in figure 2.2 and show a similar trend to total spending and receipts. Without reforms to curb increases in public spending, non-interest spending is projected to increase by 5.2 percentage points between 2016/17 and 2061/62 while revenues increase by less than 1 point. Under this scenario, spending would outstrip revenues from the mid-2030s with the gap growing to 2.6 per cent of GDP by 2061/62. This creates an annual deficit on the primary balance, the difference between total non-interest spending and revenues. A primary balance in deficit implies that additional government borrowing will be necessary to fill the gap.

Figure 2.2
Projected non-interest public spending and revenues (OBR central projection), 2011–2061

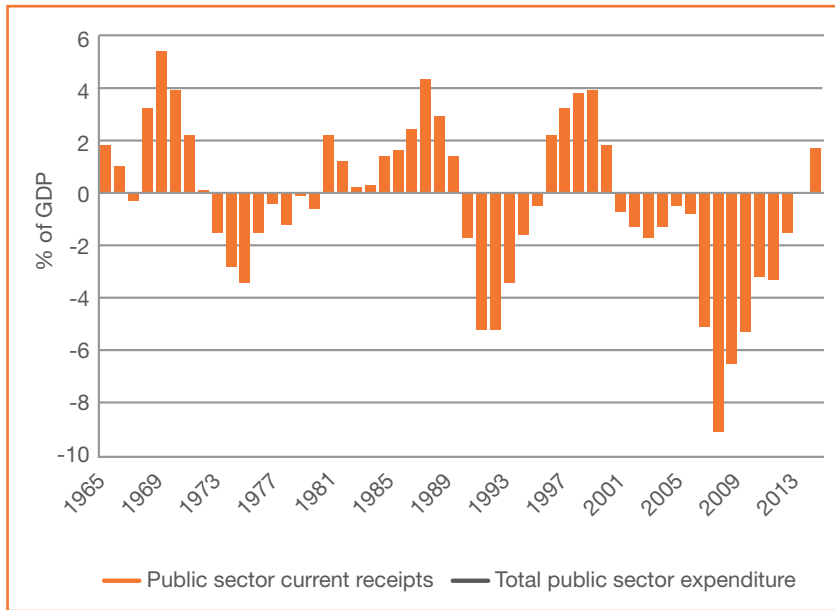


Source: OBR 2012a
* Increase from 2016/17–2061/62

Figure 2.3 shows the actual and projected UK primary balance from 1965 to 2016, with forecasts from 2011 based on the OBR's March 2012 forecasts. Over the last half century, before the 2008–09 recession, the primary balance fluctuated between a range of +/- 6 per cent of output. The 2008–09 recession was the deepest and longest in the post-war era, causing the most serious deterioration in the primary balance of the last 50 years. The primary balance had a deficit of 9.1 per cent GDP in 2009 and 6.5 per cent in 2010. The current round of fiscal tightening is designed to shrink the primary balance until it falls to zero in 2015/16 and then generates a surplus of 1.7 per cent of national income in 2016/17 (OBR 2012b).

9 Non-interest spending includes all capital and current spending apart from debt interest payments; non-interest tax revenues include all revenue sources but exclude revenues from interest, dividends and rents

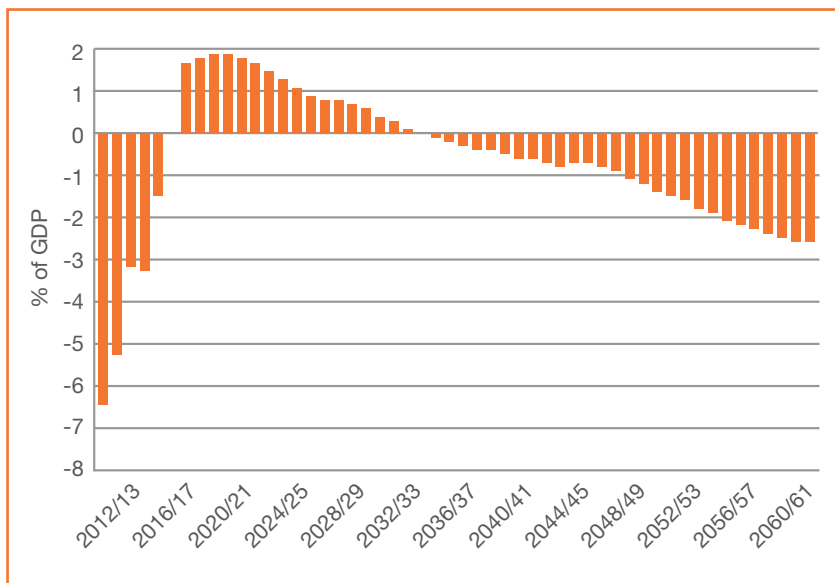
Figure 2.3
Primary balance,
1965–2016



Source: IFS data: <http://www.ifs.org.uk/fiscalFacts/fiscalAggregates>; OBR 2012b
Note: Figures up to and including 2011 are actual outcomes; figures after 2011 are forecasts taken from OBR 2012b.

The OBR's long-term outlook for the primary balance under current policy assumptions is set out in figure 2.4, reflecting the growing gap between spending and revenues projected from 2021/22.

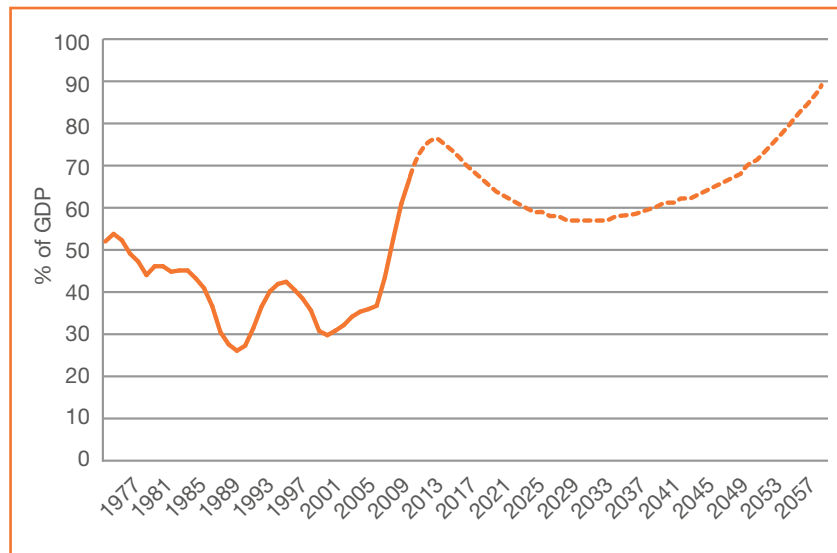
Figure 2.4
Primary balance under
the OBR central long-
term fiscal projection,
2010/11 to 2061/62



Source: OBR 2012a

A consistently downward trend in the UK's primary balance implies annual growth in public sector borrowing, driving a continuing increase in public sector debt. In the OBR's central long-term projection, debt would start rising again from 2035, reaching 70 per cent of GDP by 2052 and 89 per cent by 2061.

Figure 2.5
Actual and projected
public sector net debt,
1977–2061



Source: OBR 2012a, HM Treasury (2012b)
Note: Outturns to 2011/12; projected from 2012/13.

Looking back over the very long term, public sector net debt (PSND) has often been substantially higher than the level implied by the OBR long-term fiscal projections. PSND peaked in the last century immediately after the second world war, reaching 237 per cent of output in 1946. Between 1918 and 1961, PSND never fell below 100 per cent of GDP, driven up and maintained at high levels by two world wars and the great depression.

These comparisons should not be a source of complacency when considering the implications for debt of the OBR's long-term fiscal projections. PSND during the last century was high at its peaks but governments did not maintain or increase high debt levels over any significant period of time. PSND was on a downward trajectory between 1932 and 1940, and again from 1946 until the mid-1970s, with sharp rises clearly resulting from major economic shocks rather than from underlying rising cost pressures in public services, pensions and benefits.

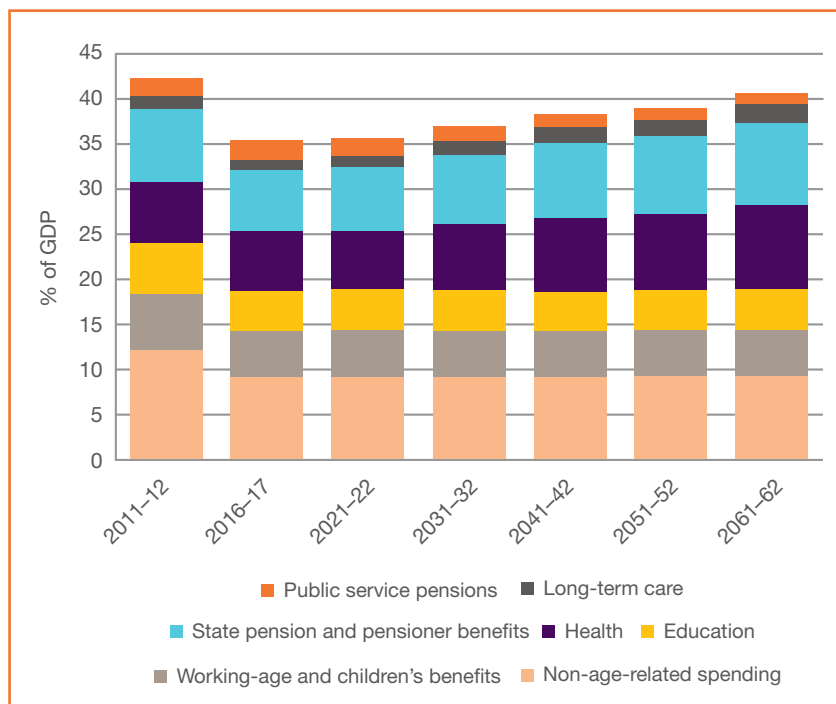
In contrast, the OBR's long-term projections imply an ever-increasing debt burden, giving governments no buffer to respond to inevitable future economic shocks. PSND is forecast to more than double from its pre-recession 2007 level of 37 per cent of GDP to 76 per cent in 2014/15 as result of the 2008-09 recession and slow recovery. A worsening of the public finances on the same scale in 2040 could see PSND rise from 60 to 120 per cent of GDP. Evidence from the OECD suggests that debt-to-GDP ratios of above 70 per cent start to have an impact on economic growth (Sutherland et al 2012).

Spending pressures to 2060: services and benefits for an ageing population

Under the OBR's central projections, demographic change driven by population ageing is the primary driver of the projected increase in public spending relative to national income from 2016/17. Without policy reforms, spending on services and benefits used disproportionately by older people (healthcare, social care and pensions) would rise as a share of national income to 2061, while spending in other areas (including education, non-pensioner benefits and non-age related spending like defence) would remain broadly flat at just under one-fifth of GDP.

In the OBR's modelling, the two large spending areas likely to see increasing demand because of population ageing are healthcare and pensioner benefits (including state pensions). Under the OBR's central projection, total healthcare spending would rise from an estimated 6.8 per cent of national income in 2016/17 to 9.1 per cent of GDP by 2061, while the combined cost of state pensions and pensioner benefits would increase from 6.7 to 9.5 per cent of GDP over the same period. Projections of healthcare spending take account of the very high health costs in the final year of life, which are modelled separately. By 2061, spending on healthcare, state pensions and pensioner benefits would account for almost one-fifth (18.6 per cent) of Britain's national income. However, state pensions in the UK (and other English-speaking nations) are typically less generous than the more strongly contribution-based systems of countries like France, Germany and the southern European countries (Castles 2004). Combined with the slower pace of ageing in the UK, this means that future pressures on pension spending are likely to be less severe than in many other advanced economies.

Figure 2.6
Projected non-interest public spending as a proportion of GDP, 2011/12–2061/62



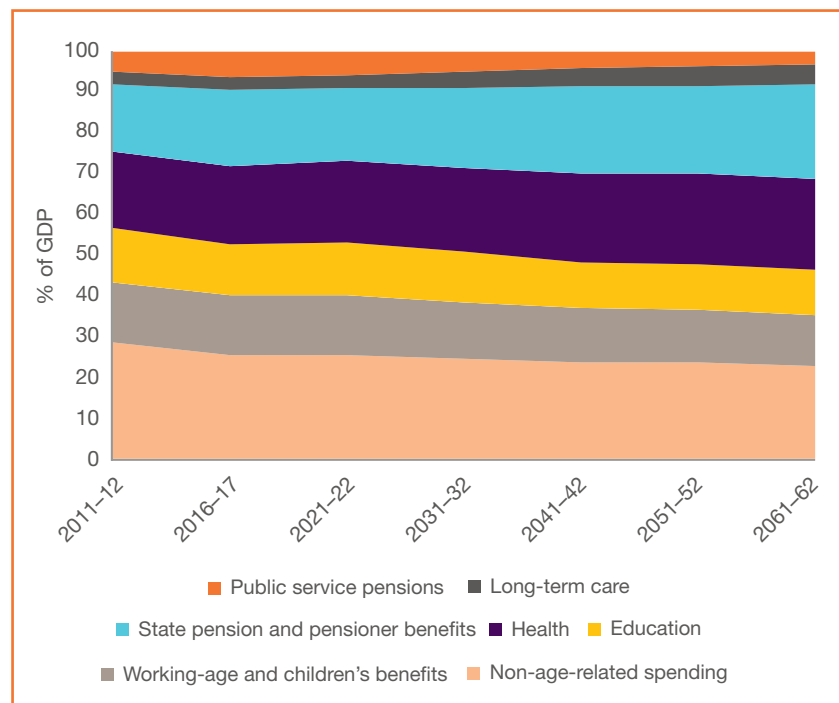
Source: OBR 2012a

Figure 2.7 shows how the composition of public spending would shift over the next half century as a result of rising spending on the older population under current policy. Pensioner benefits and state pensions would represent almost a quarter (23.2 per cent) of all non-interest spending in 2061,¹⁰ up from less than one-fifth (18.8 per cent) in 2016/17.

¹⁰ The OBR's projections reflect announced increases in the state pension age, which is due to rise to 65 for women by November 2018, before rising to 66 for both men and women by October 2020. It is then due to rise to 67 between 2026 and 2028 and again to 68 between 2044 and 2046. Qualifying ages for pension credit, winter fuel payments, disability living allowance and attendance allowance rise in line. There is no modelling of the single tier pension.

Health spending would account for more than one-fifth (22.2 per cent) of non-interest public spending. Long-term care, which currently accounts for a relatively small proportion (3.1 per cent) of total public spending, would rise by more than 50 per cent to reach nearly 5 per cent of spending. In total, in the absence of changes to current policies, spending on health, state pensions and long-term care would account for half (50.4 per cent) of all non-interest public spending by 2061 up from 41.0 per cent in 2016/17.

Figure 2.7
Projected composition
of non-interest public
spending, 2011/12–
2061/62

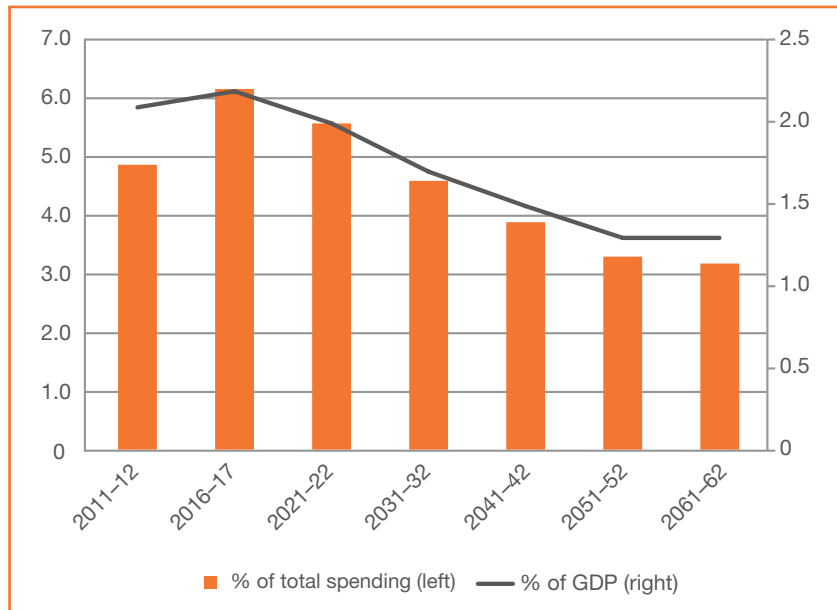


Source: OBR 2012a

The one area of age-related spending that is projected to fall both as a proportion of GDP and of total spending by 2061 is public service pensions. This is a result of steady increases in the pension age, the switch to uprating pensions in payment by CPI rather than RPI, and reforms by the previous Labour government that increased employer contributions. Spending on public service pensions is projected to fall from 2.2 per cent of GDP in 2016/17 to 1.3 per cent in 2061, despite the growing number of pensioners in receipt of a public service pension. This is the one significant recent example of a policy reform that has been successful in reducing spending pressures associated with ageing.

Further reforms in this area are planned following publication of the Hutton review of public service pensions conducted in 2011. The proposed reforms are not included in the OBR's central projections and the potential net savings associated with these reforms are contested (see Emmerson and Wenchao 2012).

Figure 2.8
 Projected spending on public service pensions as a share of GDP and total spending, 2011–2061



Source: OBR 2012a

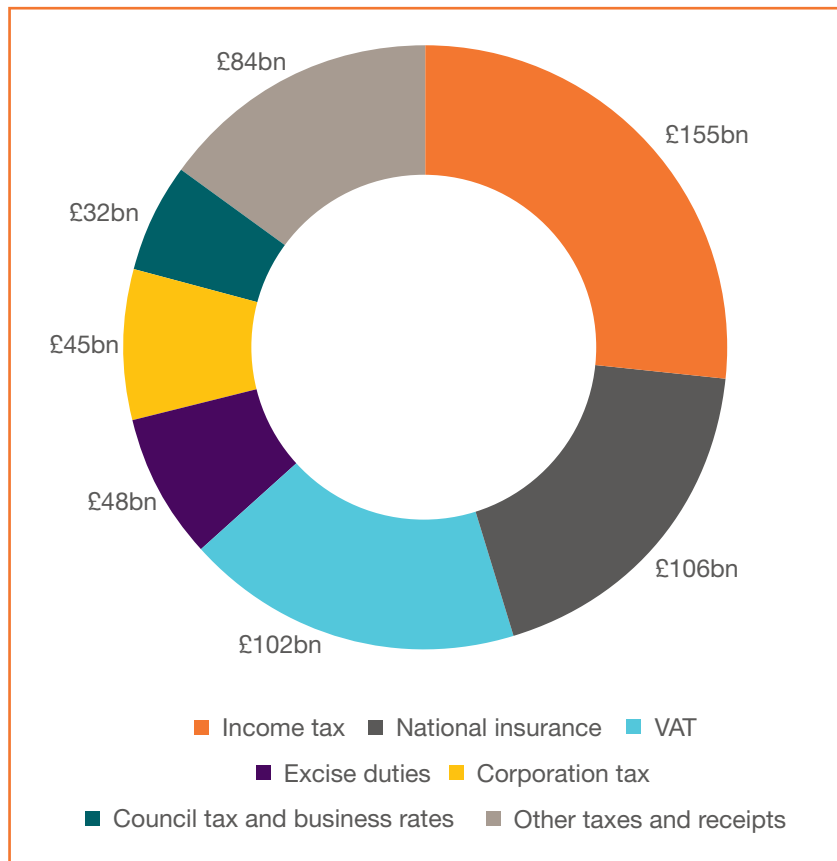
The impact of ageing on tax revenues over the long term

In contrast to the upward shift in spending, the OBR’s central projections and assumptions imply relatively stable tax revenues over the next half century. Figure 2.9 (over) shows the estimated composition of revenues in 2012/13: labour taxes (income tax and national insurance contributions) and VAT are the UK’s major sources of revenue, representing almost two-thirds of total revenues between them.

In the absence of policy changes and under the OBR’s assumptions that tax thresholds are uprated in line with earnings over the long term, the UK’s ageing population has a less pronounced impact on revenues than on spending. People in retirement continue to pay income tax on pension and investment income as well as VAT and other consumption taxes, while a relatively large proportion of this population will no longer contribute to output (because they have left the labour market), so revenue streams from these sources would increase slightly relative to GDP. However, national insurance contributions (NICs) would fall as a proportion of output because individuals stop paying NICs once they reach the state pension age.

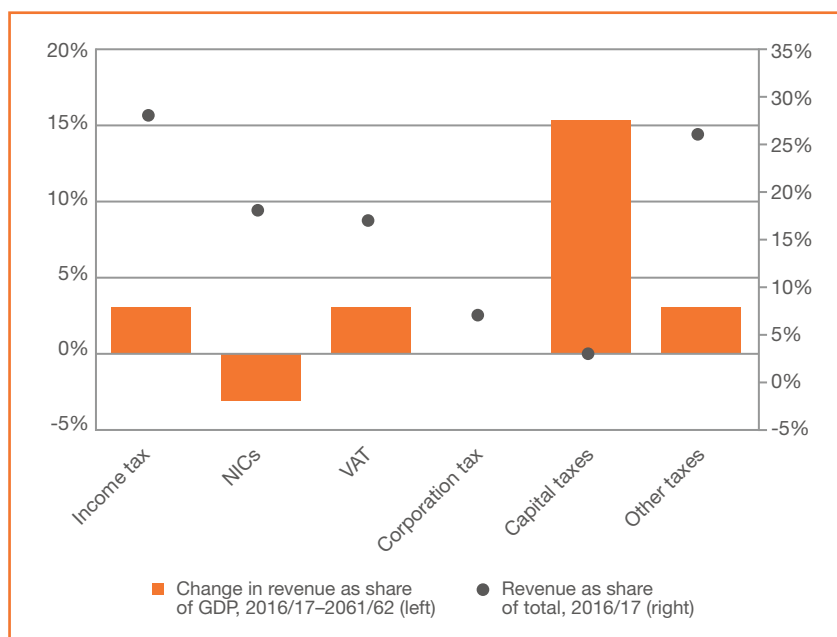
Capital taxes (which include inheritance tax, capital gains tax and stamp duties) are the one area where the ageing population would generate additional revenues and the OBR projects a 15 per cent increase in revenues from this source by 2061. Rising capital tax revenues reflect the growing proportion of older people in the population, who often sell businesses and other assets at or near retirement, and leave bequests to the next generation. However, since capital taxes are forecast to represent just 1.3 per cent of total revenues in 2016/17, the large increase in revenues from this source would have a very modest impact on overall revenues over the long term.

Figure 2.9
Estimated composition
of tax revenues, 2012/13



Source: HM Treasury 2012a
Note: 'Other taxes' include oil royalties, capital taxes, vehicle excise duty and non-tax receipts.

Figure 2.10
Projected trends in
revenue, 2016/17–
2061/62



Source: OBR 2012a

3. THE UNCERTAINTY OF LONG-TERM PROJECTIONS

There is a great deal of uncertainty inherent in long-term economic and demographic projections of the kind that underpin the OBR's conclusions. A number of factors that are not reflected in the OBR's central projection, including changes in behaviour, social attitudes, technological change and economic conditions, are also likely to affect future revenues and spending pressures. The scale and impact of these drivers are often hard to predict even over relatively short time horizons, let alone over the next half century. Perhaps most importantly, the future structure and size of the UK's public finances will be determined by policy changes that the OBR cannot model.

In this chapter, we set out the major sources of uncertainty in long-term projections of spending and revenues. The goal is to understand how variable the future picture is, but also to identify major drivers of spending and revenue that may be susceptible to policy reforms.

The accuracy of the medium-term forecasts

The OBR's long-term fiscal projections published in July 2012 take as their starting point the medium-term economic and fiscal forecasts produced in March 2012 by the OBR covering the period up to 2016/17. The forecasted fiscal position in 2016/17 is therefore 'locked into' the long-term projections and OBR analysis shows that the long-term fiscal forecasts are extremely sensitive to the medium-term outlook (OBR 2012a). The OBR estimates that, if the actual primary balance in 2016/17 is worse by 1 per cent of GDP than in the March 2012 forecast, net debt would stand at 130 per cent of GDP by 2061/62, rather than 89 per cent as indicated by the central projection. On the other hand, if the primary balance in 2016/17 is better than currently projected by 1 per cent of GDP, then debt would fall to less than 40 per cent of output, everything else being equal, by 2061/62.

National prosperity

Rising prosperity has been a major driver of increased demand for public spending over the last half century. Despite the current period of weak economic growth and sluggish growth in real median earnings, over the long term, Britain is likely to experience rising prosperity on a par with that achieved over the last half century. Rising demand for public services and benefits resulting from general improvements in national income is therefore likely to continue to put pressure on public sector budgets. There is likely to be a ceiling on the amount of national income citizens are prepared to spend on public services, otherwise at some point in the future such demands would consume that income in its entirety. However, it is not clear where that ceiling is or when it will be reached.

The precise rate of future economic growth over the long term will also have a significant impact on the future public finances. To give a sense of the impact of alternative long-run growth rates on the public finances, the OBR models the fiscal implications of annual productivity growth of 1.7 and 2.7 per cent (compared to 2.2 per cent in the central projection). Under current policy assumptions, annual productivity growth of 1.7 per cent would see debt rising to 126 per cent of GDP by 2061/62. Given the uncertainty surrounding the economic recovery, weaker long-run growth rates may be a feature of the UK economy in the future. Stronger-than-predicted productivity growth, at 2.7 per cent a year, would see debt falling until the early 2050s, with a small rise to 62 per cent of GDP by 2061/62. In the OBR's projections, higher productivity growth reduces public spending as a share of national income because some spending, like the state second pension, rises in line with prices. Total revenues as a share of national income remain stable because revenues are assumed to rise in line with earnings, which are linked to productivity. Alternative assumptions about the uprating of tax thresholds therefore have important implications for the impact of higher-than-projected growth rates on future revenues.

Demographic change

Alternative population projections over long time horizons can vary remarkably with even small differences in underlying assumptions (OBR 2012a). However, it is clear that the UK's population will continue to age because this trend is driven by events that have already happened – the post-war baby boom, the long-run decline in fertility, and historical improvements in longevity. Uncertainty in demographic projections stem from uncertainty about future rates of longevity, fertility and net migration, given the range of economic, social and policy influences to which they are subject.

Assessments of projections carried out over the last 50 years have found that demographers have particular difficulty in accurately projecting the number of very old and very young people (Shaw 2007). Previous projections have tended to assume that increases in longevity will start to tail off in the future, but in practice this has not happened because of continued innovations in healthcare (IMF 2012). It is therefore likely that the ONS's central population projections underestimate future longevity. Projections constructed for the Wanless review of long-term healthcare needs used the high life expectancy variants of the ONS projections as their central projection, precisely for this reason (Wanless 2002).

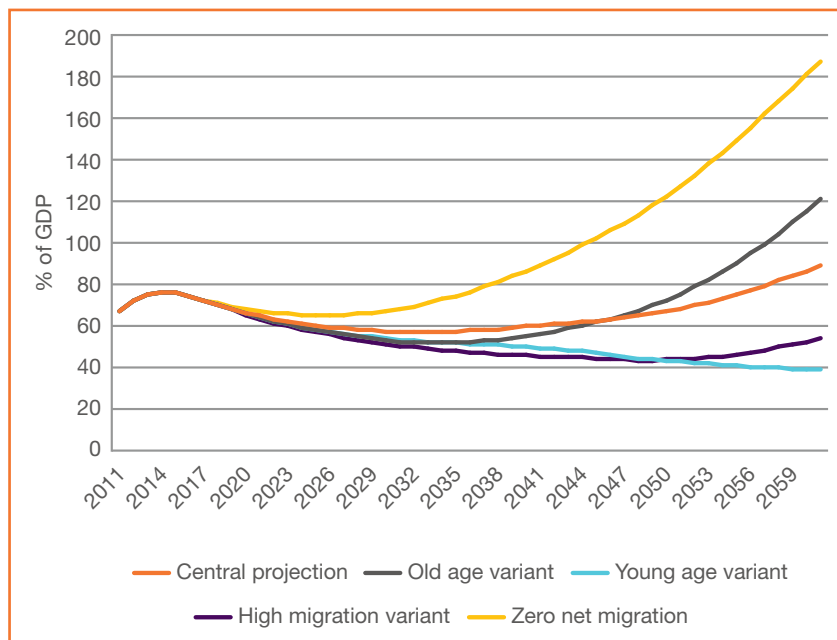
Higher-than-expected longevity rates will have the greatest impact on demand for state pensions, pensioner benefits and long-term care. Unlike healthcare, demand for long-term care is closely correlated with age and costs do not increase substantially in the run-up to death. Oliveira and de la Maisonneuve (2006) estimate that people aged 65 and above account for 82 per cent of public spending on long-term care in the OECD. However, spending on long-term care represents a small proportion of total public expenditure in the UK, so any additional increase in spending caused by higher than expected longevity will make only a modest contribution to future spending pressures.

In contrast, state pensions and pensioner benefits are expected to account for almost one-fifth of total non-interest public spending in 2016/17. Higher-than-expected average longevity that drives up the cost of pensions and pensioner benefits could have a substantial impact on total public spending over the long run, in the absence of reforms to limit coverage or generosity. The IMF estimates that a three-year 'longevity shock' (where average life expectancy turns out to be three years longer than projected) would increase pension costs by between 1.5 and 2.0 per cent of GDP on average in advanced economies (IMF 2012).

Figure 3.1 (over) shows how public sector net debt could evolve under alternative demographic scenarios. If the UK has a higher fertility rate over the long run in future than implied by the ONS's central population projection, the health of the public finances would be dramatically improved, without the need for reforms to tax or public spending. In this scenario, the OBR projects that debt would follow a downward trajectory over the next 50 years, returning to its pre-recession level of around 40 per cent of output by 2061/62. A high net migration scenario would also see substantially lower debt levels over the long term, although debt would start to rise from the early 2050s.

Alternatively, a zero net migration scenario implies very high levels of debt from the 2030s in the absence of other policy reforms that raise taxes or lower aggregate spending. Both future fertility rates and net migration are probably less certain than longevity, with net migration being particularly sensitive to economic cycles and policy decisions.

Figure 3.1
Public sector net debt under alternative demographic scenarios, 2011–2061



Source: OBR 2012a

Health in old age

A major source of uncertainty for future healthcare spending stems from the changing health of older people, and since the NHS accounts for around one-fifth of public spending, even relatively small variations in projected health spending could have a substantial impact on the long-term sustainability of the public finances.

Currently, except in the final year of life, older people require only slightly higher levels of healthcare than younger generations, but this need could be greater if the health of the older population deteriorates as the population ages. Between 1981 and 2006, life expectancy at age 65 increased faster than *healthy* life expectancy at age 65 for both men and women, suggesting that as the population aged in this period, a growing proportion of the additional years of life were spent in ill-health (Thane 2012).

The Wanless review of long-term healthcare needs concluded that health in old age will probably improve in future, driven by historical reductions in smoking and general improvements in health behaviours linked to rising levels of education and income (Wanless 2002). These improvements are likely to more than offset the effects of rising rates of obesity, the major source of deteriorating population health in future. However, Wanless also found substantial uncertainty surrounding the future health status of people experiencing greater longevity.

The OBR central projections assume that healthcare spending by age and gender remains static over the next 50 years, which implies that additional years of life expectancy will be spent in ill-health. But if the conclusions of the Wanless review are broadly correct, then future demand for healthcare is probably overstated in the central projection. Recognising this, the OBR model an alternative scenario where the number of years in ill health declines by one year every year over the next half century. The impact of this scenario on public sector net debt is shown in figure 3.2 (p29), with net debt following a similar trajectory to that of the central projection but slightly lower from the mid-2030s.

Prices and productivity in public services

Rising incomes, demographic change and health in old age create uncertainty around future demand for public services, pensions and benefits. Other drivers will affect the costs of delivering public services over the next half century, particularly in healthcare.

Technological change and rising real wages have been responsible for a substantial proportion of increasing health spending over the last 50 years, and it is likely that these pressures will continue in future. The timing and scope of technological and medical advances are particularly difficult to predict, and governments often find it difficult to resist demand for new treatments. Although technology is often cited as key to improving public sector productivity, the reductions in unit costs that technological advances may generate are likely to be more than offset by the rising cost pressures associated with advances that enable a greater number of people to be treated and for longer periods of time (Wanless 2002).

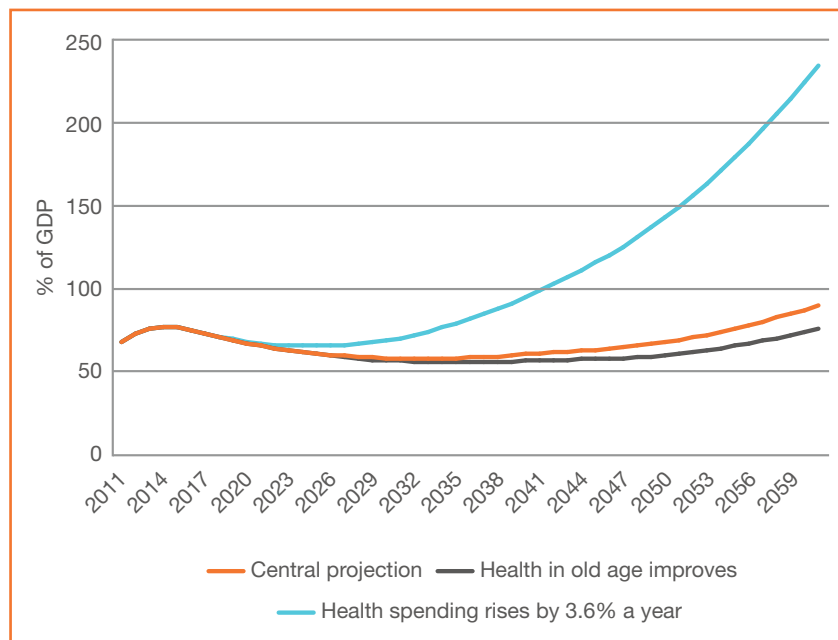
The cost of delivering public services in future will also be determined in part by trends in public sector pay. Over the long term, politicians may find it difficult to resist demands for real wage growth in the public sector on a par with that experienced in the private sector. Strong real wage growth may also be required to recruit and retain highly specialised staff, particularly in the NHS (Taylor-Gooby 2012). In some parts of the public sector and publically-funded services, most notably in social care, wages are arguably too low, with knock-on effects for the quality of care. An ageing population and growing care workforce may create rising pressure to improve wages in this sector over the long term.

Variations in public sector productivity growth will also have a considerable impact on future public spending. Productivity growth rates in the public sector over the last 20 years, particularly in health, are contested, with major challenges associated with the definition and measurement of productivity growth in areas where quality is a vital part of output. Analysis from the ONS has concluded that health sector productivity fell by 2.7 per cent between 1995 and 2009, an average annual fall of 0.2 per cent (Hardie et al 2011). Similar analysis found no change in productivity in the publically-funded education sector between 1996 and 2008 (Ayoubkhani et al 2010). However, the methodology used in this analysis has been strongly criticised for failing to properly adjust for improvements in the quality of services over that period (Black 2012).

The OBR's central projections assume that public sector productivity will rise in line with productivity in the economy as a whole, at an average 2.2 per cent a year. Given the difficulties in measuring quality-adjusted productivity growth in public services, it is difficult to know whether this is realistic.

Recognising this uncertainty, the OBR projects the impact on the public finances of annual productivity growth in the NHS of 0.8 per cent, in line with one estimate of health sector productivity growth since 1979, rather than 2.2 per cent. This would require per-capita health spending to increase by 3.6 per cent a year (rather than 2.0 per cent as in the central projection) if wages and outputs in the health sector were to keep pace with those in the wider economy. Compared to the central projection, this scenario more than doubles net debt by 2061/62, to 233 per cent of GDP. This implies that there are potentially large gains to be made from raising productivity growth rates in the NHS. It also implies that public sector wages, or outputs or quality may be sacrificed if productivity cannot be improved.

Figure 3.2
Impact on net debt of
alternative scenarios
for health spending,
2011–2061



Source: OBR 2012a

Upgrading benchmarks for benefits, pensions and tax thresholds

A key determinant of future spending will be the approach that future governments take to upgrading the value of state benefits and pensions. Over long periods of time, alternative approaches to upgrading will result in dramatically different levels of total benefit spending and therefore of aggregate public expenditure, since pensions and benefits account for almost one-third of total public spending. In June 2010 the government committed to upgrading most benefits and tax credits by CPI (that is, in line with the consumer price index) from April 2011. The main exceptions are the state pension, which will rise in line with the ‘triple lock’ – the higher of RPI (the retail price index), earnings or 2.5 per cent – and pension credit, which will be linked to average earnings (HM Treasury 2010).

However, across all its modelling, the OBR assumes that working-age benefits and tax credits, and all benefits paid to pensioners apart from the state pension, are upgraded with earnings over the long term. The result is that total pensioner benefits (including housing benefit and council tax benefit paid to pensioners) are 0.4 per cent of GDP higher in 2031/32 than if the OBR upgraded pensioner benefits in line with actual current government policy. The OBR’s assumption about the future value of working-age benefits has a larger effect relative to current policy assumptions, adding 1.6 per cent of GDP to benefit expenditures by 2031/32. In total, the OBR’s assumptions mean that, everything else being equal, spending on state pensions and benefits would be 2.0 per cent of GDP higher in 2031/32 than if their value was increased in line with actual current government policy. This would shift the primary balance from a small surplus of 0.3 per cent of GDP in 2031/32 to a very healthy surplus of 2.3 per cent.

The OBR argues that the value of working-age benefits relative to average earnings would decline so significantly over a 50-year time horizon as to make current government policy unrealistic over the long term. For example, jobseekers’ allowance (JSA) is currently worth 17 per cent of median earnings; however, if it was increased in line with CPI inflation then its value relative to median earnings would fall to 11 per cent by 2030 and just 5 per cent by 2060. In practice, successive governments have chosen to allow the

value of key working-age benefits, particularly JSA and income support, to fall behind various benchmarks of average earnings and household spending power over the last three decades. The real value of JSA and its predecessors has not changed since the late 1970s, while the real value of per-capita household consumption more than doubled between 1978 and 2007 (Kenway 2009). Given that governments of all parties have chosen not to maintain the value of key working-age benefits relative to average earnings over the last 30 years, it is not axiomatic that they would in future.

Throughout its analysis, the OBR's assumptions also depart from current government policy by increasing the value of thresholds and allowances for income tax and NICs in line with projected average earnings from 2017/18 rather than CPI inflation. The government announced in April 2011 that the underlying indexation basis for almost all direct taxes will be CPI from April 2012 (HM Treasury 2011).¹¹ If thresholds and allowances were uprated in line with current policy over the long term, the OBR estimates that fiscal drag (caused by average earnings tending to rise faster than prices over the long term) would add around £103 billion in today's money to income tax and national insurance revenues by 2031/32. This is equivalent to an extra 2.6 per cent of revenues as a share of national income, taking the total tax take in that year to 40.1 per cent of output and generating a healthy primary surplus of 2.9 per cent of GDP. The continued cumulative improvement in revenues would eliminate the deficit projected for 2061/62 under the OBR's central projection without any changes to current government policy.

The OBR assumes that tax thresholds and allowances rise with earnings after 2016/17 because they argue that the political implications of uprating thresholds in line with CPI imply this policy is unsustainable in the long run. Continuing current uprating policy to 2031/32 would create 3.8 million more higher-rate taxpayers than under an uprating policy based on average earnings. As a result, the higher rate (40 per cent) of income tax would kick in at annual earnings 33 per cent above the median, compared to 84 per cent above the median in 2016/17.

Falling revenues

The OBR also highlights the impact of long-run declines in key revenue sources driven by non-demographic factors. These scenarios are not incorporated into the main OBR modelling but, given current trends, their negative impact on future revenues is fairly certain. Driven in part by the need to decarbonise key sectors of the economy, shifts in policy, behaviour and technology are expected to reduce revenues from vehicle excise duty, and VAT on fuel and fuel duty, over the next 30 years. Improved fuel efficiency is forecast to lower fuel duty revenues from 1.8 to 1.0 per cent of GDP by 2040 – or even further if recent trends in falling car use continue (OBR 2012a, Pendleton and Bradley 2011). Oil and gas production peaked in 1999 and is forecast to continue a downward trajectory over the next three decades, driving North Sea oil and gas revenues down from 0.7 to just 0.05 per cent of GDP by 2040 (OBR 2012). The continuing decline in smoking is expected to half the value of tobacco duties by 2040, which accounted for 0.6 per cent of revenue in 2010/11.

Each of these revenue streams contributes only a relatively small amount to total receipts. Yet the combined impact of these reductions in income indicate that revenues are likely to be on a mildly downward trajectory over the next half century, in the absence of reforms that raise additional revenues from alternative sources and under the OBR's assumptions that thresholds for labour taxes will rise with earnings over the long term.

¹¹ For the duration of this parliament, the employer NICs threshold will increase by RPI; the income tax personal allowance will rise in line with the government's aspiration for a £10,000 allowance.

4. POLICY IMPLICATIONS

The OBR's projections of future public spending and tax revenues set out how the public finances may evolve after 2016/17 in the absence of any changes to current government policy. Clearly, this is an unrealistic scenario since future governments will undoubtedly change current policy on spending, taxation and growth in unpredictable ways. The OBR projections tell us what will drive demand for more public spending – politicians will choose whether and how to meet this demand.

In this chapter, we set out the choices available to current and future governments and citizens in deciding how to react to long-run trends that continue to push up demand for public spending without raising revenues to match. Our starting assumption is that the option to simply allow the debt-to-GDP ratio to rise over the long term should not be available, since this is unsustainable and potentially damaging to the UK's long-term growth prospects. The aim should be to see net debt falling rather than rising over the long term, although there is no ideal target for public sector debt. Given the high level of debt created by the 2008–09 recession, and continued rising demand in key areas of public spending, this is likely to require action on a number of fronts, including boosting growth, raising more taxes, identifying priorities for public spending, and reforming key spending areas.

The OBR produces measures of the action required on tax, public spending and growth to achieve various debt targets, alongside estimates of the impact of alternative demographic scenarios. The OBR's preferred measure is the 'fiscal gap' – the permanent increase in revenues or fall in total spending as a share of GDP (or combination of the two) needed in a given year to achieve a particular debt-to-GDP ratio at some future date. The estimated size of the fiscal gap in 2017/18 under two debt targets and various scenarios is set out in table 4.1.

Table 4.1
Fiscal gaps in 2017/18
under various scenarios

	Fiscal gap under debt targets, 2061/62 (improvement in primary balance required as % of GDP)	
	40% debt-to-GDP ratio	75% debt-to-GDP ratio
Central projection	1.1	0.3
<i>Economic variants</i>		
Low productivity	1.7	1.0
High productivity	0.5	-0.3
<i>Demographic variants</i>		
High migration	0.3	-0.5
Zero net migration	3.0	2.3
Young age structure	0.0	-0.9
Old age structure	1.7	1.0
Increased health spending and better health in old age	3.9	3.1

Source: OBR 2012a

The first debt target would return debt levels to their pre-recession level by 2061/62; the second would keep debt at the level forecast for 2016/17. Under the central projection, returning debt to pre-recession levels by 2061/62 would require either a permanent increase in tax revenues or a permanent cut in total public spending (or a combination of the two) in 2017/18 equivalent to 1.1 per cent of GDP, or approximately £17 billion in today's money. Some options for how this could be achieved are given in the rest of this chapter, to illustrate the kind of reforms that may be necessary. This does not necessarily mean that a 40 per cent debt target is an appropriate goal for the UK.

Raise the long-term rate of growth and the employment rate

Economic growth has a key role to play in improving the public finances over the long term. In the past, large fiscal consolidations in the UK and elsewhere have almost always been achieved in periods of strong growth, with GDP growth accounting for a significant reduction in public spending as a share of national income (Sutherland et al 2012). Even in relatively short periods of fiscal tightening, governments have found it difficult to generate and sustain real falls in total public spending. Weak growth in the UK therefore poses a considerable challenge to the Coalition government's current round of fiscal consolidation.

Over a longer time horizon, strong economic growth could help to offset the impact of real-terms increases in public spending on the public finances. In table 4.1, the size of the permanent adjustment in revenues or public spending required in 2017/18 to hit a debt target of 40 per cent in 2061/62 is halved if the economy turns out to be more productive than the OBR projects. A higher fertility rate or high net migration would remove the need for any fiscal adjustment in 2017/18 under the OBR's modelling to reach the same debt target, because of the additional output created by a larger working-age population.

High net migration comes with political trade-offs that also need to be considered, such as the extra resources required to fund local services for larger populations and challenges around integration and cohesion. The UK fertility rate experienced an unexpected rise in the 2000s, rising from an average of 1.68 to 1.98 live births per woman and bringing the fertility rate back to levels last seen in the mid-1970s. This is partly explained by an increase in net migration, with migrants having higher average fertility rates than the native British population. More generous state benefits for families with children also had an impact (Brewer et al 2008).

Raising the overall employment rate of the existing and projected UK population could also have a positive impact on the public finances. The OBR's modelling assumes that employment rates among older people (and other groups) remain fairly static as the population ages. But the fiscal impacts of population ageing could look very different if older people stayed in work longer. There could also be big fiscal gains to be made from raising the employment rate among mothers or people with long-term health conditions. This will require substantial additional investment in childcare and social care, to enable more women to work, as well as reforms to improve opportunities for flexible working. Over time, these investments might pay for themselves, but the upfront cost would have to be covered by diverting spending from other programmes or allowing aggregate public spending to rise in the medium term.

The biggest challenge here is the difficulty in shifting the long-term growth rate of the UK economy. Over the last 50 years, the UK annual growth rate has averaged 2.5 cent despite considerable economic transformations and it is likely that average growth rates will be maintained at this level over the next 50 years, notwithstanding the ups and downs

of economic cycles. The relationship between GDP and demand for public services, pensions and benefits also implies that, over the long term, higher rates of growth could be associated with a faster increase in demand for public spending, offsetting to some extent the benefits of boosting growth.

Increase tax revenues

Over the last 50 years, previous governments of all parties have struggled to raise taxes to pay for rising demand for public services and benefits, and the rising cost of delivery. The increase in public spending under the previous Labour government in the absence of higher tax revenues led to the common accusation that the UK was attempting to create a Scandinavian-style welfare state funded by a US-style tax system (Toynbee and Walker 2010).

There is an important political decision to be made by policymakers and citizens about whether total revenues should be higher as a share of GDP over the long term. Revenues as a share of GDP were on average 4 points higher in the 1960s and 1970s than in the 1990s and 2000s, with no discernible impact on economic performance. Over the long term, tax revenues as a share of national income could be increased in a number of ways. As well as helping to raise additional revenues to pay for the greater demand for public spending, some of these measures may be needed to fill the gap left by declining revenues from fuel taxes, North Sea revenues and tobacco duties.

First, revenues from existing taxes, particularly big earners like labour taxes and VAT, could be increased by explicitly increasing rates or lowering thresholds and allowances. For example, under the OBR's central projection, the £17 billion 'fiscal gap' created by a 40 per cent debt target for 2061/62 is equivalent to an extra 4p on the basic rate of income tax or increasing VAT from 20 to 23 per cent. Permanent tax increases on this scale would mean that all the increased demand for state pensions, healthcare and long-term care projected by the OBR could be met without reforming public spending.

Second, the tax base could be expanded, for example by identifying new sources of taxation, such as additional taxes on property and other forms of wealth; or by removing exemptions in existing taxes, such as zero-rated items in the VAT system. Charging the standard rate of VAT on food, books, and children's clothes would add around £20 billion to revenues in 2011/12, but with very significant political and distributional consequences. Reducing tax avoidance and evasion could also be important here, with estimates suggesting that these practices cost the UK up to £25 billion a year in lost revenue (TUC 2008). Tackling tax avoidance and evasion is challenging – successive governments have promised to reduce lost revenues with mixed results.

Third, governments could seek to reduce expenditure on tax reliefs, particularly large and relatively unproductive reliefs like higher-rate pension tax relief and tax-exempt savings vehicles like ISAs. The total additional revenues raised from these two sources would be around £9 billion in 2011/12.

Fourth, the fiscal drag created by raising labour tax thresholds in line with CPI inflation over the long term would raise substantial additional revenues relative to the OBR's projections. It would also create many more higher-rate taxpayers and require many more low-paid workers to start paying income tax. In all cases, the extra tax revenues raised from any of these sources would have to be balanced against political considerations and other priorities, including the sustainability of tax revenues, the distributional implications and the possible impact on economic growth and market stability.

Alternatively, a decision not to substantially raise revenues as a share of GDP over the long term implies either a need to curb growth in aggregate public spending on a significantly larger scale than would otherwise be the case or an ever-increasing debt ratio, with all the risks to long-term economic growth and stability that that brings with it.

Identify priorities for public spending

Prioritisation has always been a feature of decisions about public spending. However, in chapter 1 we saw how priorities in public spending have often been driven by short-term interests rather than a consideration of trade-offs and consequences over the short, medium and long term. We could be much smarter about how we set priorities and consider the trade-offs and risks of different choices over different time horizons.

Spending priorities should be determined by a clear set of national strategic objectives, developed through democratic debate and acknowledged as likely to evolve over time. This will require citizens to make some major decisions about what kind of country the UK will be in future, including such questions as:

- Should the government have a core role in promoting economic growth and prioritise state investment in the drivers of growth?
- Do we want a benefit system capable of providing strong and broad cash protections against worklessness, ill health and in retirement, or should we simply seek to deliver a basic safety net for the poorest?
- Should we prioritise maintaining the value and scope of direct cash transfers to low- and middle-income families or focus on providing high-quality public services that many of the same families benefit the most from?
- Are we happy to see a growing share of social spending directed at older people while provision for working-age adults or children is squeezed?
- Are there core public services that should receive generous budget settlements – perhaps health, education or social care – while others are implicitly allowed to decline in coverage and quality? If so, in which areas are we prepared to see quality and output fall?
- Should Britain continue to operate as a dominant military player or develop an alternative global role?

Prioritisation is particularly important in relation to the social security budget given its relative size, the limited scope for efficiency savings, and the substantial and certain spending pressures created by increases in longevity. This implies a need either for reforms that limit the generosity or coverage of some or all benefits or for squeezes on other spending areas to pay for rising demand for state pensions and pensioner benefits. To some extent, this trade-off has been settled in the past by holding down the real value of key working-age benefits while allowing the value of state pensions and other pensioner benefits to rise at a faster rate (either in line with RPI inflation or earnings), as well as by curbing public spending on infrastructure and defence.

Similar trade-offs are implied by the Coalition government's decisions on welfare spending in the 2010 spending review. The value of tax credits and child benefit have been frozen for a number of years, and the latter removed from higher earners, while the government has committed to the 'triple lock' for state pensions, earnings-linked increases for pension credit, and retaining universal pensioner benefits like winter fuel payments. Measures to hold down spending on working-age benefits would be increasingly necessary if the coverage and generosity of state pensions and pensioner benefits is to be maintained

without pushing up aggregate welfare spending, and particularly if the total benefits bill is to be cut. This implies falling relative living standards for workless families and would probably drive up rates of poverty among working-age adults and families with children, although pensioner poverty would continue to fall. These are the kinds of distributional implications that need to be factored in to decisions about where to focus public spending.

Reform public services

As well as finding ways to better prioritise public spending, continuing cost pressures also imply the need for further radical reform to limit rising demand or reduce the cost of provision. Reforms in five key areas may have the scope to contribute to lowering cost pressures in public spending.

- 1. State pension reform:** Given that state pensions and pensioner benefits are projected to account for around 10 per cent of national income by 2061/62, limiting demand for state pensions could potentially make a significant contribution to stabilising the public finances. Existing reforms will increase the state pension age to 68 by 2046, reducing the projected rise in pension spending over this period by half (Cawston et al 2011). Uncertainty about future longevity means that this estimate could be too high and costs may revert to a steeper upward trajectory after 2046. An alternative approach would see the state pension age linked to actual or projected increases in longevity, stripping out some of the uncertainty about future pension costs.
- 2. Preventative public services:** The majority of public spending is currently focused on reactive services and benefits, responding to acute health and social problems once they have occurred. Cost savings may be possible over the long term if public spending were to become more ‘curative’, reducing demand for expensive interventions. The scale of cost savings will depend on the upfront investment required to deliver high-quality prevention programmes. There continues to be great interest in preventative public services but significant challenges in delivery: it requires a shift in attitudes and skills in the public sector, and the payoffs tend to be less tangible than for acute interventions and only to emerge over many years (Muir 2012). Identifying the areas that are best suited for early intervention approaches – which could include many parts of the health service, criminal justice system and early years services – and rigorously assessing the long-term savings that prevention could make in each area are key challenges.
- 3. Private provision:** Demand for ‘superior goods’ like healthcare and education does not fall away simply because governments choose to spend less on them. Overall, social spending from public and private sources has risen by around 150 per cent over the last 30 years, with private spending rising to offset periods of falling public spending, although with very different distributional outcomes (Hills 2011). Private provision of social protection already has an important place in the UK welfare state, whether through private and occupational pensions, university tuition fees or families paying for social care. Greater private provision may have a role in some areas, and new models of user charging and joint-financing could help to limit risks to individuals and ensure more equitable outcomes (Glennerster 2010). But in many areas, collective provision will remain the most efficient and equitable approach, as both Labour and Conservative governments have previously found when they have attempted to shift a greater share of health and pension spending into the private sector (Hills 2011).

4. **Market reform:** Reforms that limit the impact of market failures on the public purse will also have a role in limiting increases in public spending or freeing up resources to redirect to priority areas. This will involve measures to reduce demand for public spending ‘upstream’ by requiring the private sector to do more. This could include reforms designed to lower private rents, which would reduce the housing benefit bill, or to cut spending on winter fuel payments by reforming the energy market and so reducing the cost of domestic energy.
5. **Productivity growth in the public sector:** Perhaps the most politically popular approach to reforming public spending is to improve productivity in key services, since it implies that output and quality can be maintained but on a reduced budget, or that more can be delivered without increasing spending. Some commentators argue that productivity growth fell during the 2000s due to rising spending and that productivity will improve as budgets are cut (Cawston et al 2011). However, automatic productivity improvements on the required scale are unlikely without active reform. Options include increased automation in areas that do not need to be labour intensive (such as maths teaching); delivering routine services on a larger scale (such as routine surgery); enabling public sector workers to be more innovative; and improving recruitment and reward systems (Muir 2012). In practice, productivity improvements are very hard to deliver in the public sector, particularly if quality is to be retained (Taylor-Gooby 2012). Productivity improvements also cannot be applied to the one-third of public spending that goes on social security, so they are not a panacea for limiting total public spending. An alternative to achieving faster rates of productivity growth would be to allow public sector pay to fall behind economy-wide pay levels over time, in contrast to the OBR’s assumptions. This would enable output in the public services to be increased without requiring more resources, but there could be considerable trade-offs in terms of the living standards of public sector workers and retention and recruitment in skilled public sector roles.

Growing pressures on the public finances are neither new nor unmanageable and do not imply a future crisis in the welfare state. But more sustainable, efficient and democratically legitimate responses than those often achieved in the past require serious public debate about the scale of the challenge, the political decisions they imply, and the inevitable trade-offs involved. Difficult decisions and a clear-sighted assessment of costs and trade-offs will be required on policies on growth, tax and public spending. A further report in this series will explore in greater detail the nature and scale of these political choices, as well as the fiscal rules and frameworks that may be required.

References

- Ayoubkhani D, Baird A, Munro F and Wild R (2010) 'Education productivity', *Economic and Labour Market Review*, 4(1): 55–60
- Black N (2012) 'Declining healthcare productivity in England: the making of a myth', *The Lancet*, 13 February 2012. [http://www.thelancet.com/journals/lancet/article/PIIS0140-6736\(11\)61782-0/fulltext](http://www.thelancet.com/journals/lancet/article/PIIS0140-6736(11)61782-0/fulltext)
- Brewer M, Ratcliffe A and Smith S (2008) *Does welfare reform affect fertility? Evidence from the UK*, London: Institute for Fiscal Studies
- Breyer F, Costa-Font J and Felder S (2010) 'Ageing, health and healthcare', *Oxford Review of Economic Policy*, 26(4): 674–690
- Castles F (2004) *The future of the welfare state: crisis myths and crisis realities*, Oxford: Oxford University Press
- Cawston T, Haldenby A, Nolan P, Parsons L and Trehwhitt K (2011) *Old and Broke: The long-term outlook for the UK's public finances*, London: Reform
- Chote R, Crawford R, Emmerson C and Tetlow G (2010) *Public spending under Labour, 2010 election briefing note no 5*, London: Institute for Fiscal Studies
- Committee on Climate Change [CCC] (2010) *Fourth Carbon Budget: Reducing emissions through the 2020s*, London
- Crawford R, Emmerson C and Tetlow G (2009) *A Survey of Public Spending in the UK*, London: Institute for Fiscal Studies
- Crawford R and Emmerson C (2012) *NHS and social care funding: the outlook to 2021–22*, London: Nuffield Trust
- Emmerson C and Wenchao J (2012) 'Public sector pensions and pay' in Emmerson C, Johnson P and Miller H (eds) *The IFS Green Budget, February 2012*, London: Institute for Fiscal Studies
- Glennerster H (2010) *Financing the United Kingdom's Welfare States*, London: Public Services 2020 Trust
- Hardie M, Cheers J, Pinder C and Qaiser U (2011) *Public service output, inputs and productivity: Healthcare*, Newport: Office for National Statistics
- Hills J (2011) 'The changing architecture of the UK welfare state', *Oxford Review of Economic Policy*, 27(4): 589–607
- HM Treasury (2010) *Spending Review 2010*, London: HM Treasury
- HM Treasury (2011) *Budget 2011*, London: HM Treasury
- HM Treasury (2012a) *Budget 2012*, London: HM Treasury
- HM Treasury (2012b) *Public Finances Databank, 26 June 2012*. www.hm-treasury.gov.uk/d/public_finances_databank.xls accessed 12 July 2012
- International Monetary Fund [IMF] (2012) 'The financial impact of longevity risk', *Global Financial Stability Report (April 2012)*, Washington DC
- Kenway P (2009) *Should adult benefits for unemployment now be raised?* York: Joseph Rowntree Foundation
- Muir R (2012) *The Long View: Public services and public spending in 2020*, London: IPPR. <http://www.ippr.org/publication/55/9209/the-long-view-public-services-and-public-spending-in-2030>

- Office for National Statistics [ONS] (2011a) *2010-based national population projections, 26 October 2011*. <http://www.ons.gov.uk/ons/rel/npp/national-population-projections/2010-based-projections/index.html> accessed 3 April 2012
- Office for National Statistics [ONS] (2011b) *Mid-1971 to mid-2010 population estimates, 21 December 2011*. <http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-247414> accessed 3 April 2012
- Office for Budget Responsibility [OBR] (2012a) *Fiscal Sustainability Report 2012*, London
- Office for Budget Responsibility [OBR] (2012b) *Economic and Fiscal Outlook, March 2012*, London
- Oliveira Martins J and de la Maisonneuve C (2006) *The drivers of public expenditure on health and long-term care: an integrated approach, OECD Economic Studies no 43*, Paris: OECD
- Organisation for Economic Cooperation and Development [OECD] (2011) *Government at a glance 2011*, Paris
- Pendleton A and Bradley L (2011) *Untying the knot: Decoupling oil and road transport*, London: IPPR. <http://www.ippr.org/publication/55/8106/untying-the-knot-decoupling-oil-and-road-transport>
- Seshmani M and Gray A (2004) 'Time to death and health expenditure: an improved model for the impact of demographic change on healthcare costs', *Age and Ageing*, 33: 556–561
- Shaw C (2007) 'Fifty years of UK national population projections: how accurate have they been?' *Population Trends*, 128: 8–23
- Sutherland D, Hoeller P and Merola R (2012) *Fiscal Consolidation: How much, how fast and by what means? OECD economic policy papers no 1*, Paris: OECD
- Taylor-Gooby P (2012) *A left trilemma: progressive public policy in the age of austerity*, London: Policy Network
- Thane P (2012) *Demographic Futures: Addressing inequality and diversity among older people*, London: British Academy
- Timmins N (2001) *The Five Giants: A biography of the welfare state*, London: Harper Collins
- Toynbee P and Walker D (2010) *The Verdict: Did Labour change Britain?* London: Granta
- Trades Union Congress [TUC] (2008) *The Missing Billions: The UK tax gap*, London
- Wanless D (2002) *Securing Our Future Health: Taking a long-term view*, London: HM Treasury