The Fiscal Alternative

Public finance choices for the left

Andrew Harrop | October 2018

ICAEW

FABIAN SOCIETY

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Fabian Society, 61 Petty France, London SW1H 9EU

General secretary, Andrew Harrop
Deputy general secretary, Olivia Bailey
Editorial director, Kate Murray
Assistant editor, Vanesha Singh

Designed by Georgie Lowry, www.gslowrydesign.co.uk

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ABOUT THE FABIAN SOCIETY

The Fabian Society is Britain's oldest political think tank. Since 1884, the society has played a central role in developing political ideas and public policy on the left.

Through a wide range of publications and events the society influences political and public thinking, but also provides a space for broad and open-minded debate, drawing on an unrivalled external network and its own expert research and analysis.

The society is alone among think tanks in being a democratically-constituted membership organisation, with over 7,000 members. During its history the membership has included many of the key thinkers on the British left and every Labour prime minister. Today it counts more than 200 parliamentarians in its number. Member-led activity includes around 50 local Fabian societies, the Scottish and Welsh Fabians, the Fabian Women's Network and the Young Fabians, which is itself the leading organisation on the left for young people to debate and influence political ideas.

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

ABOUT THE PROJECT

The Fiscal Alternative is the final output of a joint Fabian Society and ICAEW project, Public Finance Choices for the Left. The five-month debate included a series of articles from the two organisations and from invited experts; and a half-day event with policy makers, commentators and Labour politicians. The main focus of the project was on the options facing an incoming Labour government. However many of the ideas presented were not party-political and could be embraced by the current government in the 2018 budget and 2019 spending review.

The report draws on a wide range of articles and presentations prepared for the project. The main chapters are based on three online articles by Andrew Harrop published in June and July 2018. The report also includes extracts from the expert commentary published during the project. It represents the views of the authors only, not the organisational views of either the Fabian Society or ICAEW.

ABOUT THE AUTHOR

Andrew Harrop has been general secretary of the Fabian Society since 2011. He has led the society's work on economic, fiscal and public spending policy and was secretary to the 2013 Fabian Commission on Future Spending Choices. He was the lead author for the commission's final report 2030 Vision and has also written reports on measuring economic success (2014), public services after neo-liberalism (2014) and the future of social security (2016).

Earlier in his career Andrew was director of policy and public affairs at Age UK and a researcher for the New Policy Institute and for a backbench Labour MP. He stood as a Labour candidate in the 2005 general election. He has been the chair of governors of a school and children's centre in London and treasurer of a Brussels-based EU think tank, the Foundation for European Progressive Studies.

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SUMMARY

This report examines the UK's future fiscal policy choices. Its main aim is to consider the options and dilemmas that would face an incoming Labour government after the next general election. But many of the recommendations could be adopted by today's Conservative administration too and the report addresses key issues for the 2018 budget and 2019 spending review.

It looks at strategic options for tax and spending (chapter 1); reform of the fiscal framework to ensure it is not biased against activist government (chapter 2); and questions of devolution and geographic equity (chapter 3).

1. Future spending choices

End austerity: The deficit on current spending has been closed and under Labour's proposed fiscal rules, austerity can end immediately. By contrast, under the present Conservative fiscal framework, expenditure is set to fall as a share of GDP until the mid-2020s – notwithstanding the prime minister's repeated promises to end spending cuts. The UK therefore faces a fundamental political choice at the 2018 budget and 2019 spending review. There is no clear case for continuing to pursue the overall spending surplus which the current government is targeting. Conservative minsters should abandon their current fiscal strategy and adopt rules closer to those of the Labour party. By 2025, with Labour's fiscal rules and tax strategy, UK current expenditure could be up to £100bn higher than under present Conservative plans.

Grow the economy: Future economic performance will be just as important for the path of the UK's public finances as the different tax policies and fiscal rules of the rival political parties. If Brexit leads to recession, the UK will have £20bn to £50bn less to spend in 2022 than under existing Office for Budget Responsibility (OBR) assumptions. On the other hand, if economic growth returns to pre-crisis levels there will be £30bn more than expected. Politicians should concentrate less on managing the public finances within the constraints of existing growth forecasts, and more on how to accelerate growth in GDP and productivity. Avoiding a Brexit-related recession must be ministers' top priority.

If Brexit leads to recession, the UK will have between

£20-£50 billion

less to spend in 2022 than under existing Office for Budget Responsibility (OBR) assumptions

Raise spending over time: Politicians should plan public spending with a long-term perspective and think about the share of GDP that should be spent on key government functions. A future Labour government will probably wish to increase spending as a percentage of GDP in the fields of health and care, pensions, education and investment – and should not permit the percentage spent on working-age social security to fall. A lot of extra money will be needed to deal with existing and future spending pressures so there will be little left over to pay for new entitlements. This issue was overlooked by the Labour party in its 2017 manifesto, which outlined expensive new programmes but did not set out plans for adequately funding existing areas of spending. Public spending probably needs to rise by at least 4 percentage points of GDP in the coming years, which will bring UK expenditure to around the median for other advanced economies. Any further increases beyond this level will only be possible in the future if politicians are prepared to noticeably increase the taxes paid by middle-income households.

2. Fiscal policy for an activist state

A future government committed to greater state activism should review the rules and conventions of the public finances. But economic activism and fiscal prudence will need to go hand-in-hand.

Don't let crude and narrow rules stop public ownership: Decisions about the public ownership of businesses should be based on a true economic appraisal of the costs and benefits, not the artificial pressure of fiscal rules. The existing bias against borrowing to acquire productive assets should end. The Treasury's main focus with respect to public enterprises should be the potential cost of contingencies in the event of problems, not their impact on the national debt when all is well. Future ministers should therefore consider a broad scorecard of debt measures that would allow them to: distinguish between the debt of general government and of public enterprises; and favour borrowing when it creates assets. The OBR should scrutinise related judgements and decisions.

Relax restrictions on capital investment: Public investment should not be included in rules governing the annual fiscal deficit, because investments should be made whenever there is a clear financial and social return. Appraisals should be conducted by expert independent bodies at the level of individual projects or categories of investment. Investment funded from borrowing can increase GDP and tax revenues and therefore pay for itself. This possibility should be taken into account by the OBR in its analysis of the public finances. Borrowing has its limits however and future ministers should make the long-term affordability of public debt the main constraint on how much they borrow for investment.

Tackle 'fiscal illusions': Fiscal illusions such as the private finance initiative (PFI) and the English student funding system should be robustly scrutinised and constrained to remove artificial incentives that promote less public delivery and control. Future ministers should take financial decisions transparently in a way that takes account of long-term liabilities and assets as well as short-term savings and costs.

Create neutrality between tax and spending choices: Decisions to raise spending or give up money through higher tax reliefs are currently presented and scrutinised in very different ways, even when they have the same effect on the exchequer. A framework should be created that brings neutrality to the choice of whether to 'spend' on tax allowances or on social security, for example. Future ministers should assess rival policies to achieve similar goals on their merits and not on their impact on headline measures of tax or spending.

3. Fiscal geography and devolution

Investigate geographic variations in spending: England has very large regional variations in public service spending per capita, with spending in London almost 50 per cent higher than in the East Midlands. The next government should review all the national formulae used to allocate public service funding (and also the extent to which actual spending allocations deviate from these rules). Revenue support grants for councils also needs to be restored. The process for equalising resources should either be run by central government or by expert commissions representing localities.

Public spending per capita is almost

50%

higher in London than in the East Midlands

Make taxes more progressive to redistribute between communities: Regional variations for tax revenues are greater than for public spending, which is a sign of well-functioning fiscal union in an economically unequal nation. London and other rich communities transfer a significant share of their prosperity to the rest of the UK. But under a progressive tax system, London would pay still more in tax than it does now, since raising taxes on high incomes, profits and wealth will increase the tax take on wealthy London residents. These tax rises should be a higher priority than 'levelling-down' public service spending in the capital.

Devolve public service budgets: Where localities have sufficient governance and accountability in place, they should be able to run a single public service budget. Over time they should acquire full financial control over how to allocate resources between local services to achieve national standards and requirements as well as their own local priorities.

Proceed with caution on tax devolution: A government committed to geographic fairness should only devolve taxes with great caution because the tax-raising capacity of different communities varies hugely. For example, the current scheme of business rates devolution should be scrapped. There is a good case for reforming council tax to fully reflect property values or replacing it with land value tax. But this will increase revenue inequalities so would need to be accompanied by a new equalisation scheme. In the long term, a truly federal model is likely to be fairer than the patchy and piecemeal devolution of individual tax-raising powers.

1. Future spending choices

End austerity

Five years ago, the Fabian Society's 2013 commission on future spending choices published proposals for public spending under a Miliband-led government.[1] In the intervening years, the economic and the political terrain has changed beyond recognition. The 2013 Fabian report was published when the fiscal deficit was still very high. The commission recommended real increases in spending but suggested this should be at a slower pace than GDP growth until the public finances were in balance. It was a plan for less reckless and painful austerity.

Now the deficit on current spending has been eliminated. This creates the economic headroom to start to debate post-austerity spending choices, since the Labour party's proposed fiscal framework seeks to balance only day-to-day spending. A future government following this rule – rather than the Conservatives' commitment to an overall fiscal surplus – now no longer needs to raise taxes or cut spending just to shrink the deficit. Governments can plan to increase spending in line with economic growth, even without tax rises.

The UK therefore faces a fundamental choice at the 2018 budget and the 2019 spending review. On existing Conservative plans, current spending will continue to fall as a percentage of GDP for the foreseeable future. The Office for Budget Responsibility (OBR) Spring 2018 projections show spending falling from 34.6 per cent of GDP this year to 33.3 per cent in 2022 (see Figure 1). Even then the Conservatives' fiscal goal of a balanced budget would not be met. Under the OBR's economic assumptions, achieving a balanced budget (without the tax share rising) would require current spending to contract to around 32.4 per cent of GDP by the mid-2020s.

The OBR spring 2018 projections show current spending falling to

33.3%

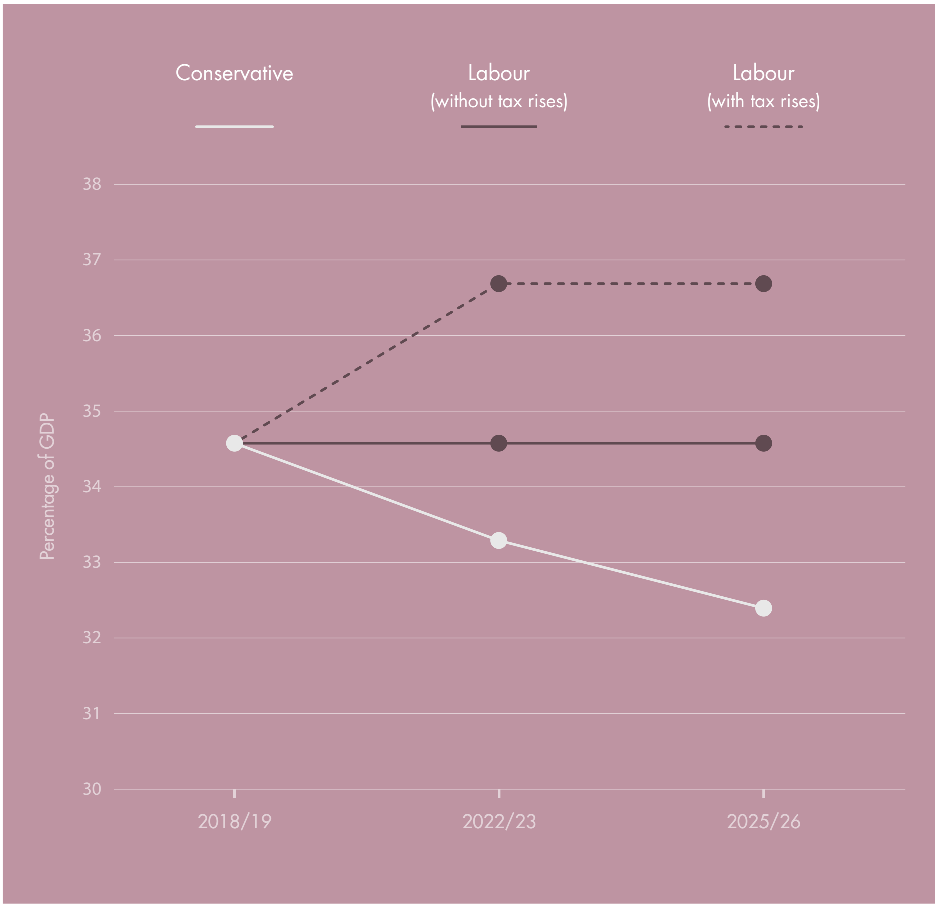
of GDP in 2022 (from 34.6% in 2018)

LABOUR'S PROPOSED FISCAL CREDIBILITY RULE[2]

- Close the deficit on day-to-day spending over five years
- Make sure government debt is falling at the end of five years
- Borrow only to invest

When the Monetary Policy Committee decides that monetary policy cannot operate (the 'zero-lower bound'), the Rule as a whole is suspended so that fiscal policy can support the economy. Only the MPC can make this decision.

Figure 1: Scenarios for current spending as a percentage of GDP



		2018/19	2022/23	2025/26
Percentage of GDP	**Conservative**	34.6	33.3	32.4
	Labour (without tax rises)	34.6	34.7	34.7
	Labour (with tax rises)	34.6	36.7	36.7
2018/19 prices (billion)	**Conservative**	£743	£756	£768
	Labour (without tax rises)	£743	£787	£823
	Labour (with tax rises)	£743	£833	£870
Difference from Conservative plans	**Labour** (without tax rises)	£0	£31	£54
	Labour (with tax rises)	£0	£77	£102

Note: scenarios based on OBR Spring 2018 projections (Economic and Fiscal Outlook, OBR, Spring 2018) using Fabian Society assumptions

EXPERT VIEW

"Warned of five years of cuts to public services, households have now endured eight. The OBR show at least five years more to come, and there's no commitment that even by 2022-23, if a Conservative chancellor is in place they won't still be arguing for the need to tighten our belts."

Geoff Tily and Kate Bell, TUC

"Moderation needs to go in both directions. Recent governments have displayed what could be characterised as a 'surplus bias' where chancellors favour running a surplus even where there is no economic justification for doing so. It is as important to guard against this form of bias as it is to prevent 'deficit bias': the tendency Chancellors have had in the past to overspend."

Catherine Colebrook, IPPR

There have been recent hints that the Conservative position may shift. At her 2018 party conference the prime minister said: "A decade after the financial crash, people need to know that the austerity it led to is over." But this statement is hard to square with the present Conservative fiscal framework which mandates another five years of austerity. While this remains in place it is hard to entertain government claims to be ending austerity. What's more, the deficit goal has very little justification. No serious case has been made for why the UK needs to run a balanced budget, when all the global and historic evidence shows that advanced economies can achieve sustainable public debt while running modest deficits. Conservative ministers should abandon their fiscal framework and adopt something closer to the Labour party's plans.

Under Labour's proposed fiscal rules, current spending could remain constant as a share of GDP even without tax rises (see Figure 1). And if tax rises on the scale of the party's 2017 election plans were also introduced, then current spending could rise appreciably as a share of GDP. This means that if Labour's alternative fiscal framework was introduced next year it would create huge scope for additional current spending over Conservative plans during this parliament. On the basis of the OBR's most recent economic assumptions, by 2022 Labour would be able to spend £31bn more than Conservative plans, simply as a result of their different fiscal rules

By 2022, under Labour's fiscal rule it would be possible to spend

£31bn

more than Conservative plans without raising taxes

– and by 2025 it would be £54bn more. The divergence would be even greater once Labour's tax plans are taken into account – in the region of £75bn in 2022/23 and £100bn by 2025/26.

The political context has also transformed since the last Fabian Society report on fiscal policy choices. Austerity fatigue has set in and the proportion of people who want an increase in tax and spending has risen fast since 2015, according to the British social attitudes survey.[3] We have a radical left-wing Labour leadership which has shifted the 'Overton window' when it comes to the limits of conceivable tax and spending choices. The Brexit referendum has revealed deep public unease with the British body politic and created the greatest political crisis the UK has faced since 1945. Future governments will need to deliver answers to Leave voters that go well beyond the technical design of Brexit.

On the left, perhaps the political change is best symbolised by the different personalities and instincts of two of Labour's shadow chancellors. Ed Balls was a social democrat schooled in an era when Labour was paranoid about media attacks on every tax or spending pledge. By contrast, John McDonnell sees little point in obscuring his commitment to higher spending and tax. At the 2017 election he promised to raise taxes by four times as much as Balls did.

But in other ways, perhaps Balls and McDonnell are not so very different. Then and now, Labour is signed up to fiscal discipline with credible rules to set public debt on a downward path and keep borrowing under control. Both the 2015 and 2017 manifestos presented an orthodox fiscal prospectus of European social democracy. Labour under Jeremy Corbyn promised to go further and faster than under Ed Miliband. But the tax and spending plans the party presented last year would have only taken the UK towards the median among OECD countries for revenue raising and public spending.[4]

Grow the economy

A great deal is now made of the political choice facing the UK with respect to fiscal policy – and the gulf between the parties is indeed wide. But Britain's economic prospects are just as important when it comes to the outlook for public spending. In spring 2018 the OBR forecast real cumulative GDP growth for the four years from April 2019 at a sluggish 5.5 per cent. But Brexit brings very large downside risks to this projection. A cliff-edge no-deal Brexit could easily precipitate a recession and any economic contraction would make a huge dent in the nation's spending power.

In spring 2018 the OBR forecast real cumulative GDP growth for the four years from April 2019 at a sluggish

5.5%

To illustrate this, Figure 2 looks at the simple case where current spending remains constant as a share of GDP under a range of economic scenarios. With a 2019-2020 recession the UK would end up in 2022 with current spending £20bn to £50bn less than under the OBR's existing growth assumptions. Alternatively, if the economy returned to good health (with annual productivity growth returning to post-1945 norms) then spending could be £30bn higher than under the OBR's economic projections.

Figure 2: Illustration of current spending in 2022/23 under four scenarios for cumulative growth in real GDP (all assume today's level of current spending as a percentage of GDP)

Scenario	4 years cumulative real GDP growth	Current spending (18/19 prices)	Variation from OBR projection
OBR central projection	5.5%	£784bn	-
Pre-2008 trend	10%	£817bn	+£33bn
1990 style recession	2.5%	£762bn	- £22bn
2008 style recession	-1.6%	£731bn	-£53bn

This illustration demonstrates how dependent we are on economic growth for higher public spending. The Fabian Society's 2018 report, Raising The Bar, explored policy strategies for increasing economic growth.[5] Some of the drivers of economic growth can only be influenced indirectly – especially global economic conditions. Others will take a long time to progress, such as many of the proposed solutions to low productivity growth contained in the rival industrial strategies of the government and opposition. But public policy choices can also have a rapid and direct impact on growth. Austerity suppressed GDP growth after 2010 (by at least two percentage points of GDP and probably more).[6] Similarly, analysts argue that the Brexit decision has already left the economy two percentage points smaller than it would otherwise have been.[7] A no-deal withdrawal from the EU is obviously likely to cause much more harm than this. But on a more positive note, public investment can lead directly to increased growth over both the short and long term.

Therefore, there is a case for saying that politicians have focused too much on managing the public finances within the expected constraints of economic growth – and not enough on driving economic expansion, through fiscal and other policy measures. As a result, when growth forecasts have been revised downwards, budgets have had to be adjusted just to comply with fiscal rules. We won't ever know what would have happened to the public finances during the 2010s if the government had taken a more expansionary approach to fiscal policy. But we do know that the Conservative austerity strategy has left the economy smaller than it otherwise might have been, while still requiring at least 15 years to balance the public finances. If a future government focuses first on achieving high and sustainable growth, it may be that the public finances will then look after themselves.

EXPERT VIEW

> "When it comes to the health of the nation's budget, tax and spend still dominates debate. Whether the sums will add up for the funding of individual policies rightly receives significant scrutiny – but the much bigger impact on the budget of the way the economy is working is often seen as something outside the scope of fiscal debate."
>
> *Geoff Tily and Kate Bell, TUC*

> "All fiscal rules to date have betrayed their designers' over-optimism about the degree of control policymakers can exert over the public finances, at least in the short term."
>
> *Catherine Colebrook, IPPR*

Raise spending over time

The central conclusion of the 2013 Fabian commission remains just as true today as it was back then. The commissioners' call was for politicians to lift their eyes to the horizon and think backwards on public spending choices from the viewpoint of a decade or more ahead. The report called for a '2030 vision' because once you have a long-term direction of travel for tax and spending, the short-term choices fall into place.

Fiscal policy makers should sign up to this long-term perspective now. First, politicians from all parties should explicitly state that overall spending as a share of national income needs to rise in the 2020s in order to deliver the welfare state that people want. Second, they should make the case for a rebalancing of spending. For unless action is taken, we will pour ever more money into support for older people (which is no bad thing in itself) and squeeze spending on education, children, working-age social security and investment. To illustrate this point Figure 3 shows how, in the 2022–2027 parliament, Conservative policies might see health, care and pensions rise from 35 per cent to 38 per cent of total government expenditure.

Figure 3: Actual and projected public spending in key areas (percentage of GDP)

	Actual spending			Projection	
	2007/08	2010/11	2017/18	2022/23	2027/28
Health	7.4	8.2	7.3	7.0	7.7
Long-term care	1.2	1.3	1.0	1.1	1.3
Education	5.0	6.3	4.3	4.0	4.0
Pensions	4.9	5.7	5.2	5.1	5.1
Other social security	5.1	7.4	5.9	5.2	4.9
Net investment	2.2	2.9	2.1	2.3	2.3
Total expenditure	**39.0**	**44.8**	**38.8**	**37.6**	**37.5**
Health, care & pensions (% of total expenditure)	35	34	35	35	38

Sources: Fiscal Sustainability Report (OBR, 2017 and earlier editions); OBR Public Finance Databank; expenditure and caseload forecasts (DWP Spring 2017); Fabian Society calculations and assumptions. Note: programme spending for 07/08 and 10/11 is not all corrected for subsequent revisions to GDP; 27/28 totals assume non-pension social security is uprated by CPI.

When looking a decade ahead politicians should think about the size of individual spending programmes in relation to GDP. The last Labour government famously did this with respect to NHS spending and international development and since then the UK has also explicitly signed-up to the NATO target for defence spending. But in other areas the long, grinding years of austerity led to the reference point for budget-setting becoming existing nominal or real spending, which translates into declining expenditure relative to the size of the economy.

An austerity mindset led Labour to come unstuck at the last election on the fight against poverty. The party did not begin by thinking about the share of the economy that should be spent on social security but instead proposed a modest increase of around £4bn to the Conservatives' welfare spending plans. These plans were themselves predicated on something close to a cash freeze for social security spending and a cut of 0.3 percentage points as a share of GDP. As a result, Labour's 2017 proposals would have reduced benefit spending relative to the size of the economy and increased poverty and income inequality. This is remarkable given the party's left-wing leadership.

To make strategic choices in future, politicians need to think about public spending in relation to the size of the economy. The faster the economy grows the more it will be possible to increase revenues and spending. But the flip-side of this is that a future government will need to cut its coat according to the cloth. If economic growth remains sluggish or if there is a major recession in the coming years, we have seen in Figure 2 how the economy will be smaller and the spending choices therefore harder. Admittedly, if economy-wide earnings grow less fast, then less money is needed to raise pensions and public sector pay. But it is far easier to reprioritise between budgets when the size of the pie is growing at a decent pace than when the choices are zero-sum.

So what options should politicians be considering? In many areas of government activity the default should be for spending to rise in line with economic growth. But in some areas, expenditure needs to rise by more than this to reflect population and health trends – in particular pensions, NHS and social care spending. Meanwhile, in other fields politicians will want to make a policy choice to increase spending faster than GDP. For example, at the 2017 election, the Labour party committed to increasing capital investment and education spending by more than 1 per cent of GDP each. Both of these proposals have much to commend them. As Figure 3 shows, before the financial crisis education spending was 5 per cent of GDP while it is 4 per cent today: this decline cannot be right for a society committed to high skills and social justice. Meanwhile if investment choices are made wisely then debt-funded capital investment can pay for itself through higher future growth.

But when you look at all the options side-by-side the costs start to mount. Across health, care, education, social security and investment over five years, Labour could easily wish to increase public spending by 4 percentage points of GDP. Under this scenario spending would shift from being a bit below the UK's post-1945 average at the start of the next parliament, to a bit above it by the end – in line with spending from 1965 to 1985. Raising spending to this level would place the UK in the middle of the pack when it comes to public spending in advanced western economies.

At the 2017 election, Labour committed to increasing both capital investmest and education by more than

1%

Even spending increases on this scale would leave little room for new entitlements (such as free higher education or social care) unless the economy was growing briskly: most of the money would be needed to adequately fund existing provision. The 2017 Labour manifesto did not sufficiently recognise this point. The party set out plans for how it would fund new entitlements but in most areas it did not explain how to pay for growth in existing government activities to reflect rising need and the pressure of recent cuts.

Expenditure increases along these lines do not amount to radical socialism, but they still imply a significant transition over a fairly short space of time. As things stand in the next few years the UK tax take will remain broadly unchanged: the OBR expects receipts as a share of GDP to remain unchanged until 2022 and then to rise by 0.5 percentage points in the five years following (according to the 2017 Fiscal Sustainability Report).

Labour says it will borrow to pay for extra investment but not for current spending. So the party would need to raise taxes to pay for more day-to-day expenditure. Labour would probably need to increase revenues by more than 2 percentage points of GDP, which is in line with the package it proposed at the 2017 election. The difference is that a higher share of the extra money would need to pay for business-as-usual activities, not new promises.

EXPERT VIEW

> "There is an equilibrium to be struck between creating the conditions to encourage economic growth, running government efficiently and setting sustainable tax rates. That equilibrium has been struck at different points in different countries. If it is to be struck at a point where tax rates are high, incentives for business and enterprise will also need to be high."
>
> *Ross Campbell, ICAEW*

Last year, most of Labour's tax policies directly targeted big business and people earning more than £80,000 (although the effects would have rippled out across the economy). From an egalitarian perspective this is highly desirable but it remains to be seen whether these measures would raise as much as Labour hopes (because of tax-minimising behavioural responses by firms or high-earners). Nevertheless, Labour can probably find ways to raise spending on this sort of scale without the accompanying tax rises being too visible for most families.

Sooner or later, extra expenditure can't just be paid for just by the top 5 per cent however. Spending can be raised by 4 per cent of GDP on the basis of Labour's current approach. But if the long-term plan is for a Scandinavian welfare state then taxes for everyone will have to rise. A significantly larger state, alongside balanced public finances, eventually requires that middle-income households pay more. Public attitudes are now shifting towards accepting this premise. If politicians are to fulfil their ambitions for a revitalised welfare state, they need to start thinking about how to prepare the country for broad-based tax rises.

EXPERT VIEW: SPENDING THE MONEY WELL

"One way or another Labour will need to arrive at some sense of priorities over time, a time scale for putting things right, and a process for arriving at these decisions pretty fast after being voted into office. And it shouldn't really wait until Jeremy is on the threshold of Number 10 before engaging in this.

Planning where to spend money and how much is to be paid for by tax is crucial. Whatever money is to be spent in an area should be spent well, and a modernised version of the public service agreements of the past, that linked departmental allocations to achieving goals makes lots of sense – be they about tackling poverty or regional imbalance; reducing carbon footprints or waiting times in hospitals (as long as they are not turned into cascades of targets and performance indicators at the front line).

Making sure funding goes more into preventative work (the fence at the top of the cliff) not just acute need (the ambulance at the bottom) is also crucial if politically difficult, and changing government accounting, planning cycles and value for money assessments to embrace this could be transformative.

The 2013 Fabian commission on future spending choices proposed a new Office for Public Performance to ensure that spending was done well; and a stronger more independent Office for Budget Responsibility to show there were no attempted fiddles going on. This still makes lots of sense and would help a radical Labour government show it was serious in terms of value for money, to reassure the public as well as the markets.

Those who think a tough Treasury is an obstacle to a radical left policy and want to weaken it and even break it up, get it all wrong: a well led and strong Treasury is an essential agent and anchor for such change."

Dan Corry, former Number 10 and Treasury adviser

EXPERT VIEW: REPAIRING THE DAMAGE

"One problem with establishing priorities for additional funding is the sheer scale of the cuts.

Government statistics show that between 1996/97 and 2009/10 UK real public expenditure on services increased from £438bn to £715bn (in 2016-17 prices).[8] If this rate of increase had continued after 2010, by 2016/17 (the most recent year for which full figures are currently available) public expenditure on services would have been around £930bn.

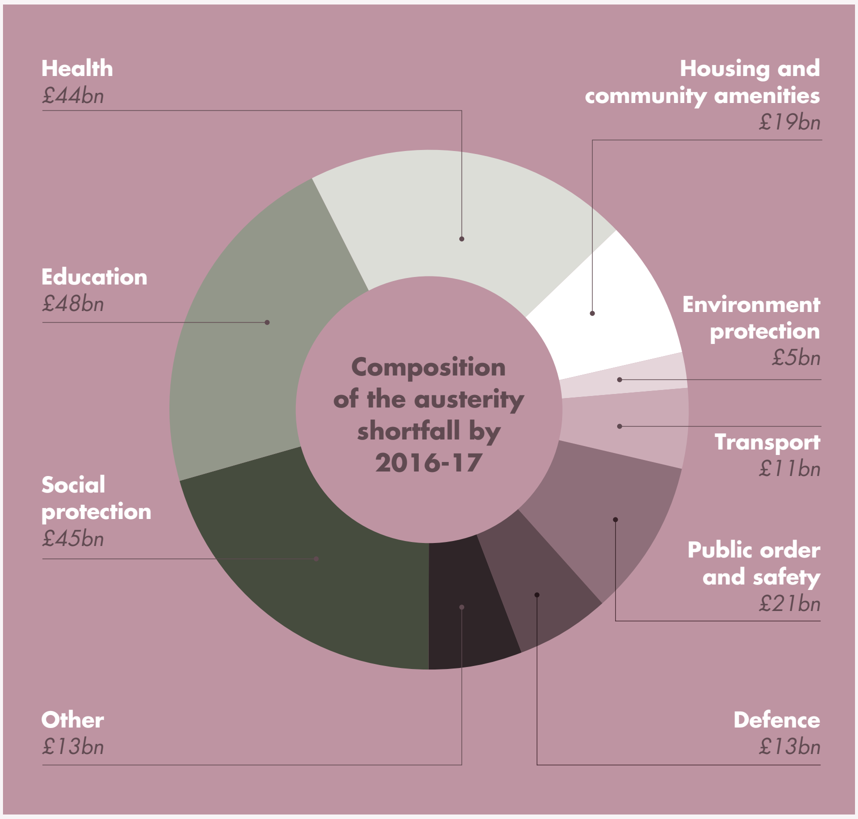
In reality expenditure on services was £710bn – a real-terms fall of £5bn over eight years. The difference between £930bn and £710bn is £220bn, which I call the 'austerity shortfall' – the extent to which the austerity programme of post-2010 governments has reduced spending relative to underlying trend growth in spending.

Looking at spending across the UK as a whole, we can decompose this shortfall into various different types of service using the United Nations classification of functions of government breakdown. Figure 4 shows the composition of the shortfall in terms of which types of service have suffered the biggest cuts in terms of billions of pounds compared to spending growth before the crash, whereas Figure 5 presents the austerity shortfall as a percentage of what spending on each service would have been in the absence of spending cuts.

Figure 4 shows that the largest austerity shortfalls by spending category are for education, health, and the 'social protection' category – which includes transfer payments such as benefits and tax credits, and social care spending. Given that analysis of the OBR policy measures database shows cuts to social security benefits of £25bn by 2016-17, we can assume that around £25bn of this is transfer payments with the other £20bn being cuts to social care. The next two biggest shortfalls are in public order and safety (including police and fire services) and housing and community amenities.

Figure 5 looks at the austerity shortfall in terms of percentages for each service category and shows a different pattern of results. Measured like this, the largest shortfalls in spending are for housing

Figure 4: Composition of the 'austerity shortfall' by 2016-17 (£bn)



and community amenities (where the shortfall equals 68 per cent of total spending), public order and safety (44 per cent) and education (36 per cent). Shortfalls for health and social protection, while large in cash terms, are smaller as a percentage of total spending on these services than in the other categories.

What does this analysis mean for what a future government's spending priorities should be? In terms of where to spend the most additional resources relative to current budgets, I would argue that Figure 5 is the most instructive, because it shows which spending areas have been the most starved of additional cash in the era of austerity relative to the pre-crash period.

Housing and community amenities, in particular, have suffered a catastrophic fall in funding of over two-thirds, and reversing at least some of this has to be a priority. The large shortfalls in spending for public order and safety and education also reflect the increasingly parlous condition of police forces and schools across many parts of the country. By contrast, the shortfall in spending on health and social protection, while substantial, is smaller in percentage terms

Figure 5: Composition of the 'austerity shortfall' by 2016-17 (as a percentage of spending on each service)

(although very large in cash terms). The media's focus on the crisis in the NHS might lead us to believe that health spending has been the main casualty of austerity, but Figure 5 shows that housing, police and education services have suffered even greater restraint.

The crude cash shortfall comparisons presented here are not the whole story; cuts to spending have human consequences which are devastating in some cases – for example the DWP's statistics on the number of benefit claimants who died after their claims were stopped, or the calculations of lives lost due to NHS cuts. The next government will need to make a systematic appraisal of the impact of spending cuts on wellbeing and human suffering to reach an informed decision on where the extra money should be spent."

Howard Reed, Landman Economics

2. Fiscal policy for an activist state

The Labour party's 2017 manifesto promised a decisive shift in the economic role of the state. The party promised a major increase in capital expenditure with the creation of a national transformation fund, a national investment bank with a capitalisation of £250bn, a big rise in R&D spending and the creation of publicly-owned enterprises in key sectors including rail, post, energy and water.

Labour is also committed to fiscal responsibility and the party needs to develop its plans for a more activist state in a way that is compatible with prudent controls on the public finances. This is the right thing to do for future generations but it will also be essential in the short term to give markets confidence as they adjust to the novel context of a Corbyn government. Economic activism and fiscal prudence will need to go hand-in-hand.

This does not mean accepting all the existing rules and conventions of the public finances however. Labour has already said it will set fiscal rules that are more accommodating to public investment, which is an essential first step. Future ministers should now consider other ways in which the UK's fiscal and public accounting framework should change to achieve the party's goals.

Enable public ownership

When it comes to fiscal policy the UK treats publicly-owned businesses no differently from government delivery paid for by taxpayers. This is because we report and target debt for the whole public sector including public corporations. An exception is made for state-owned banks and Labour's proposed investment bank, which will borrow commercially, should be included in this category.

By contrast the EU and most advanced economies measure debt with respect to the narrower concept of 'general government' – ie national, devolved and local administrations excluding public enterprises. Additionally, our headline measure of public debt only reports liquid financial assets and liabilities. So, if the government borrows to buy or create a non-financial asset the public finances appear to worsen, even if the real economic effect is neutral or positive.

The transfer of Network Rail in 2014 into the public sector is a good example of the combined effects of these policies. The move was presented as detrimental because it increased public sector net debt by £30bn (about

2 per cent of GDP) and annual borrowing by 0.2 per cent of GDP.[9] But the public sector also took on Network Rail's assets which are valued at £280bn in the 2015/16 whole of government accounts.[10] Because these assets are illiquid, they do not offset public debt, as it is usually measured. But it is hard to see how their transfer into the public sector diminished fiscal sustainability.

By targeting public sector net debt, the Treasury has created a presumption against the state taking on extra liabilities even when they are more than matched by assets or future revenue streams. Under the next government, decisions about nationalising businesses or creating new public enterprises should be based on a true economic appraisal of the costs and benefits, not the artificial pressure of fiscal and accounting rules.

Politicians should therefore consider using a basket of fiscal indicators that paint a fuller picture. For example, ministers could report on general government debt as well as public sector debt so the impact of public enterprises on liabilities is transparent. This would allow these businesses to take on debt to finance commercially sound investments without such tight control from the Treasury. The government's main focus with respect to these companies should be the potential cost of contingencies in the event of problems, not their impact on the national debt when all is well. Additionally, a future government should also target a broader measure called public sector net worth, which includes assets as well as liabilities. This would mean that borrowing to acquire productive assets would be viewed more positively than ordinary deficit spending.

Adopting a scorecard of debt measures will matter for the Labour party because large scale nationalisations will breach its proposed public debt rule, if this is based only on the present measure of public sector net debt. The party has promised that debt will fall between the start and end of each parliament but major acquisitions will push up debt a lot, on this standard definition. A broader basket of measures would allow Labour to exempt specific transactions from its rule, if they could be shown to have no negative impact on other debt indicators. But this whole initiative must be pursued in a spirit of transparency not obfuscation. It will be essential for the OBR to robustly scrutinise all judgements and decisions.

EXPERT VIEW

"There are always concerns on the left that matters like nationalisation or spending on housing appear to make things much worse in the public accounts when they are in fact about buying or creating assets. As long as the asset is well managed financially in the public sector, and the houses meet needs and return revenues, this should not matter, and the 2013 Fabian report suggested a number of changes to the accounts to make this more obvious. Whether a change to the accounting rules here is the key or just to get people more focused on the true balance sheet effects is debatable. It would certainly help though if they were changed so that private finance, that can at times be helpful, was only used when it has real advantages rather than to circumvent accounting rules."

Dan Corry, former Number 10 and Treasury adviser

Relax restrictions on public investment

Labour's fiscal rule on borrowing departs from present Conservative policy in order to increase capital expenditure. It permits a future government to borrow to invest by mandating that only the current budget should be balanced within five years. This leaves room for a great deal of extra public investment – indeed significantly more than Labour promised in 2017.

At the level of individual projects there should be a presumption in favour of investment whenever a project has a clear financial or social return for government. The case for social housebuilding illustrates the point because investing in social housing generates future rents, lowers benefit expenditure and brings broader social and economic benefits.[11] Artificial, top-down constraints on viable investments should be relaxed or removed – and it is therefore particularly welcome that the prime minister has announced an end to the cap on councils borrowing to build housing. The national infrastructure commission and similar bodies should instead lead on the robust appraisal of the viability of projects or categories of investment.

There may also be a case for revising how the fiscal impacts of investment decisions are assessed. Taking account of the assets created as well as the liabilities is obviously important, as discussed in the context of public enterprises – the fiscal framework should report the impact of investment on net worth not just public debt.[12] But a pro-investment fiscal framework also needs to factor in the impact of capital spending on growth. At present the OBR's economic forecasts reflect the economic and revenue impacts of capital investment in boosting short-term demand. But the office does not publish alternative scenarios for the UK's long-term growth and associated fiscal sustainability under different public investment strategies. By contrast recent Organisation for Economic Cooperation and Development (OECD) modelling shows that a permanent increase in UK public investment of 0.5 per cent of GDP could be expected to lead to a long-term increase in GDP of up to 3.5 percentage points, with knock on impacts on tax receipts and public debt. The OBR should examine these issues in its regular reports on the medium and long term public finances, especially where it is likely that investment may raise debt in the short term but lower it over time.

Recent OECD modelling shows that a permanent increase in UK public investment of 0.5% of GDP could lead to a long-term increase in GDP of up to

3.5%

However, politicians also need to recognise that investment funded by borrowing eventually has its limits. The same OECD paper suggests that the UK could fund higher investment through borrowing for a parliament and still end up with a lower ratio of debt to GDP than would have otherwise been the case. But this will not stay true forever. Funding investment from borrowing for a whole decade would increase the future long-term path of debt. Therefore eventually Labour's deficit rule will not provide a sufficient constraint for long-term fiscal sustainability. This may not matter in practice however, as it is the party's sustainable debt rule that will actually determine its room for manoeuvre. The ultimate limits of debt-funded investment need to be determined by the affordability of public debt in future decades.

EXPERT VIEW: KEEPING TO THE SPIRIT OF THE RULES

"Experience over the last 20 years suggests that pursuing a narrow debt target, underpinned by strict accounting conventions, can push politicians towards under-investing in infrastructure and inappropriately favouring private finance and asset ownership over the public alternative

The spirit of the debt targets that UK chancellors have signed up to is a commitment to strengthen – or at least not substantially weaken – the UK's balance sheet position. In practice the official definition of public debt that has been targeted is a measure of accumulated debt issuance, net of any short-term financial assets – but not other assets – held by the public sector. Investing public money in new infrastructure will raise this measure of debt, even though in return the public sector may acquire a valuable asset that could boost future growth and tax revenues.

Conversely, selling off a government asset for less than its market value will improve this measure of debt, even though it weakens the government's underlying financial position. The political saliency of the headline measure of debt increases the attractiveness of private financing to ministers because privately financed projects do not contribute to public sector debt.

To avoid decisions about whether and how to finance infrastructure being driven by an excessive focus on whether or not a new project will add to the targeted measure of public debt, the Treasury should be more transparent about how decisions are made and what the costs and benefits were judged to be of alternative ways of financing the investments. Such transparency would help those outside government assess whether decisions had been made simply to meet the letter but not the spirit of the debt target.

Experience under Labour, coalition and Conservative governments has shown that an excessive fixation on meeting the letter of the fiscal rules but losing sight of the underlying principle can lead to undesirable outcomes. It is difficult to write down a set of rules that would guard against all political gaming. But greater transparency about the basis on which investment decisions are made would help the OBR and other independent observers judge whether government actions meet the spirit as well as the letter of the rules."

Gemma Tetlow, Institute for Government

The Institute for Government is a non-party political think tank working to make government more effective.

Tackle 'fiscal illusions'

The last Labour government was guilty of what the International Monetary Fund (IMF) calls 'fiscal illusions' – ie actions to keep liabilities off the public balance sheet in order to reduce headline debt. The most notorious example of this is the public finance initiative (PFI) and its successors. These schemes were initially conceived to transfer the risk of cost over runs to contractors but they quickly became a mechanism for postponing the recognition of liabilities to manage public debt. Similarly, Network Rail was deliberately established as a non-profit company to keep it off the balance sheet, despite being effectively controlled by ministers. The company's shift into the public sector only followed changes to accounting rules to counter these illusions.

These two examples show why exposing 'fiscal illusions' is an important issue for Labour politicians in particular. In both cases the possibility of a 'fiscal illusion' created incentives for less public delivery and control than would otherwise have been the case. If government accountants and the OBR are required to police and call out these illusions, it is likely to level the playing field in favour of state-delivered solutions.

University funding in England is a case in point and it lies at the heart of Labour's plans for power. The post-2012 student loan system is an outstanding example of a fiscal illusion. Coalition ministers turned government grants into loans in order to spare universities from the austerity facing the rest of the public realm. But the loans are an accounting sham that postpone the recognition of public expenditure, allowing spending to take place that does not count towards the deficit today. This is because almost half the value of student loans will eventually be offset by public subsidies.[13] However these loan write-offs will only count as public spending in the distant future when they eventually take place. As a result the additional costs of Labour's plan to replace tuition loans with grants will be much lower over the long term than in their first year. A future fiscal framework needs to be designed to make sure that this is visible.

One way to expose fiscal illusions is to make better use of accrual accounting in budgeting because private-sector style accounts record changes to liabilities and assets alongside annual revenue and expenditure. This approach would also force the government to be more upfront about contingent liabilities when making decisions, which might generate more debate about big and risky projects like new nuclear plants or HS2. The 2013 Fabian Society commission on future spending choices discussed the recent development of whole of government accounts (WGA) which seek to create accrual accounts for the whole public sector. The commission said that WGA should be used to inform future budget decisions not just as a 'rear-view mirror'. Since then there has been little progress on this front and the WGA seem to be little known or used.

Create neutrality between tax and spending choices

Finally the presentation and scrutiny of the public finances should be reformed so that policy decisions involving tax and spending choices are treated neutrally. The House of Commons public accounts committee has been highly critical of the inadequate evaluation of tax reliefs with respect to their costs or policy goals.[14] Comparable spending programmes receive far more attention within and beyond government. HMRC does publish useful data on the costs of what it calls 'tax expenditures' but this information is never set beside information on public spending. In future, politicians should insist that parallel tax and spending options with the same end should be evaluated side-by-side.

Tax reliefs and allowances are often used as an alternative to spending to artificially suppress expenditure, which is another form of fiscal illusion. The ONS is tougher on this than it used to be. Under Gordon Brown it classed a large proportion of tax credit spending as a form of tax relief but today it treats so-called 'tax-free childcare' as a spending programme. Nevertheless, governments of all sides have sought to reduce expenditure as a share of GDP by doing as much as they can through tax reliefs.

The most worrying case in recent years has been the 'spending' of billions of pounds on raising the income tax personal allowance under the guise of helping low-income families. Income transfers have been cut simultaneously and poor working families have been left worse off by the policies combined. This illustrates how public spending is usually more progressive and better targeted than comparable tax reliefs. A future government that is pro-state and pro-equality should therefore remove any incentives to choose tax reliefs in place of expenditure. The Labour party has already said it will review all tax reliefs. Next it should go further and create a permanent framework to ensure they are always designed and scrutinised on the same terms as public spending.

3. Fiscal geography and devolution

Fiscal geography and local taxation are controversial issues in UK politics. Successful reform goes unnoticed, while failures and botches are punished hard. The most extreme manifestation is the case of Margaret Thatcher, who lost power over the poll tax in 1990. And just last year Theresa May was seriously wounded in the 2017 election campaign by controversial school funding reforms.

As a result, inaction often wins the day even when reform seems ripe. Tony Blair bottled a routine revaluation of council tax in England, leaving our main local tax still today based on 1990 valuations. The Barnett formula for allocating money between the nations of the UK has been untouchable for 40 years to the huge benefit of Scotland and detriment of Wales. And there are still unwarranted differences in local NHS allocations even though ministers have been trying to address the problem since 1970.[15]

With this backdrop it would be no surprise if a future government were to choose the path of indecision or incremental revision over radical reform. Nevertheless, the Labour party has hinted that it wants to think from scratch about fiscal geography and localism. In its 2017 manifesto Labour called for long-term reform of the allocation of public spending to ensure that 'no nation or region of the UK is unfairly disadvantaged'. It promised a constitutional convention to extend democracy at every level and to consider the option of a more federalised country. In England it pledged to devolve more power – along with more funding – and to initiate a review to ensure sustainable long-term funding for local government looking at council tax, business rates and options such as land value tax. So what are the main issues the next government will need to consider?

Investigate geographic variations in spending

Public spending per capita varies widely between the nations and the English regions in ways that are, on the face of it, hard to justify. Figure 6 presents spending on most public services (ie the total excluding social protection, which is mainly social security). The data reveals that expenditure per capita is almost 50 per cent higher in London than in the East Midlands and although the capital is the clear outlier there is wide variation across the rest of England too. Allocations to Scotland, Wales and Northern Ireland derive from the Barnett Formula.

Figure 6: Regional variation in public spending per capita, 2016/17, by function (UK =100%)

	Public order and safety	Transport	Education	Health	Total (exc. social protection)	Social protection	Total (inc. social protection)
North East	113%	67%	96%	108%	**100%**	114%	**106%**
North West	104%	85%	96%	106%	**100%**	106%	**103%**
Yorkshire & the Humber	95%	77%	96%	97%	**92%**	101%	**96%**
East Midlands	90%	51%	94%	89%	**86%**	97%	**90%**
West Midlands	93%	72%	97%	101%	**93%**	101%	**97%**
East	81%	77%	95%	86%	**86%**	93%	**89%**
London	140%	217%	121%	122%	**127%**	90%	**111%**
South East	77%	85%	91%	88%	**88%**	90%	**89%**
South West	79%	70%	90%	92%	**87%**	101%	**93%**
England	97%	98%	98%	99%	**97%**	98%	**97%**
Scotland	111%	143%	114%	107%	**123%**	108%	**116%**
Wales	94%	87%	101%	102%	**105%**	116%	**110%**
Northern Ireland	152%	71%	110%	102%	**119%**	123%	**121%**

Source: HM Treasury

The key question is how much of these variations are warranted and what criteria for determining fairness should be used. For example, London's high spending is mainly linked to the higher costs of delivering services (property is more expensive and earnings are higher). The city also receives money to take account of need, as it has high levels of poverty and deprivation as well as great wealth.[16] But with such wide gaps, it is legitimate to ask whether there are unjustified historic differences too.

And elsewhere in England, are differences in need sufficiently driving spending variations? A comparison of Figure 6 and 7 shows that in England outside London higher spending is linked to lower regional prosperity. But the relationship is quite weak. The East Midlands fares worst as it is both economically disadvantaged and a low recipient of public service

Figure 7: Regional variation in expenditure, revenue and economic indicators per capita, 2016/17 (UK=100)

	Public expenditure	Public revenue	Workplace GVA	Resident primary income	Resident total resources	Resident expenditure
North East	105%	78%	73%	75%	80%	84%
North West	101%	83%	88%	82%	86%	88%
Yorkshire & the Humber	96%	82%	79%	81%	84%	85%
East Midlands	93%	87%	80%	86%	88%	91%
West Midlands	96%	81%	83%	83%	87%	81%
East	91%	105%	91%	106%	104%	100%
London	109%	150%	177%	153%	142%	131%
South East	92%	118%	109%	117%	113%	118%
South West	96%	94%	88%	92%	96%	102%
England	98%	102%	103%	103%	102%	102%
Scotland	113%	96%	94%	93%	94%	98%
Wales	107%	76%	73%	75%	81%	85%
Northern Ireland	119%	81%	76%	76%	82%	86%

Source: ONS Note: the Treasury and ONS have different measures of regional public expenditure which are not comparable but reveal similar patterns. Some of the ONS measures of regional prosperity are new and classified as 'experimental'.

spending. A range of economic measures are included here and they all show a similar pattern. From the perspective of households, 'resident primary income' is probably the best indicator of a region's prosperity prior to government redistribution (workplace gross value added or GVA reports the economic output of businesses in a region; and resident total resources and resident expenditure are measures of prosperity after redistribution).

The greatest geographic variety is found within the relatively small spending areas of public order and transport (this is true whether London is included or excluded). But health spending also varies significantly. Education spending is more uniformly distributed, even before the new school funding reforms, and is less related to economic disadvantage than health expenditure. Meanwhile social security spending is allocated by demand-led UK-wide rules so variations directly reflect differences in the population – eg the number of pensioners, disabled people and people receiving means-tested benefits.

It is no doubt possible to explain many of these disparities by examining the data in more granular detail – at the level of individual budgets or localities. But the differences at least demand investigation and a future government should seek to review all the national formula used to allocate funding. For example, when the Conservatives came into power they reduced the extent to which social deprivation is used to allocate NHS budgets. They also cut council grants which particularly hurt poorer areas with less capacity to raise revenue locally and this should be reversed.

Politicians should also examine the extent to which allocations vary from those determined by formulae because of protections for 'losers' and caps on growth for 'winners'. In recent years there has been little scope to close historic inequalities because spending has been stagnant or falling permitting little convergence each year. But in the context of rising budgets after austerity, there will be scope to align designated and actual allocations more quickly without cash losers emerging.

EXPERT VIEW

"At the local level within England there has been a huge redistribution of spending from relatively deprived areas to relatively affluent areas, largely as a result of the current government's decision to phase out the revenue support grant to local authorities, meaning that they need to raise all their funding from local taxation by 2020. Reintroducing revenue support grants – to reverse a catastrophic decline in funding for local authorities in the poorest areas – needs to be a priority."

Howard Reed, Landman Economics

Make taxes more progressive to redistribute between communities

Regional levels of taxation per capita vary a great deal, reflecting differences in economic output and average earnings. Figure 7 shows that these gaps are far larger than comparable variations in spending. This is what we should expect from a well-functioning fiscal union in an economically unequal nation: the tax revenue raised is skewed to reflect ability to pay while spending is broadly uniform, with only a degree of variation to reflect levels of need and cost.

However, this process of geographic redistribution leads to very different fiscal economies in each region. For example, Figure 8 shows that public spending accounts for over half the North East economy and the fiscal transfer the region receives is around one fifth of its economic output. These tax and transfer numbers are important, particularly in the context of the 'London question'. We've seen that public service spending per capita in the capital is high. But relative to the size of London's economy the city actually has low levels of spending. If London were a nation state it would have amongst the lowest public spending of any advanced economy (and spending is low relative to residents' incomes not just workplace economic output, so this is not just down to people commuting to businesses from outside the city). London also pays a lot of tax and even with its high spending per capita, the city makes a fiscal transfer to the rest of the UK that is equivalent to 8 per cent of its economic output. This is the 'London nationalist' case against reducing the city's public service spending.

But there is actually a good case for saying London should be paying still more tax. The capital is by far the richest UK region but, relative to its residents' primary incomes, it pays much the same amount of tax as everywhere else (in fact, a little less than the UK average). This demonstrates that the UK tax system is not progressive when viewed from a geographic perspective. Taxation should be more effective at taxing high incomes, wealth, property and profits and this would lead to London having a higher incidence of tax than other regions.

An incoming government wishing to distribute more from the capital and other wealthy areas should therefore focus first on better revenue raising. The alternative, of seeking to suppress public service spending in London, may also be required in the end but it is politically controversial and will not necessarily be viewed as fair in relation to population need and delivery costs. Introducing progressive tax increases should be the priority.

Figure 8: Regional expenditure and revenue, 2016/17

	Spending per capita	Revenue per capita	Difference	Spending as a % of GVA	Revenue as a % of residents' primary income
North East	£12,335	£8,628	-£3,707	64%	52%
North West	£11,805	£9,125	-£2,680	51%	50%
Yorkshire & the Humber	£11,294	£9,114	-£2,180	55%	51%
East Midlands	£10,866	£9,557	-£1,309	51%	50%
West Midlands	£11,268	£8,973	-£2,295	52%	49%
East	£10,649	£11,549	£900	44%	49%
London	£12,847	£16,545	£3,698	28%	49%
South East	£10,836	£12,988	£2,151	38%	50%
South West	£11,300	£10,328	-£971	49%	50%
England	£11,472	£11,318	-£153	42%	50%
Scotland	£13,237	£10,539	-£2,698	53%	50%
Wales	£12,623	£8,372	-£4,251	66%	51%
Northern Ireland	£13,954	£8,941	-£5,014	70%	53%

Source: ONS

Devolve public service budgets

The Conservative government's view on local spending autonomy has been contradictory. When David Cameron came to power he preached localism; scrapping hundreds of targets and pooling dozens of grants into fewer, more flexible budgets. New responsibilities have also been devolved, both to councils and new city-regions. But often this has been without sufficient money, as in the case of council tax benefit; and the new city-region mayors have been created with very limited budgets and revenue powers.

Meanwhile in other ways the Conservatives have been centralisers. The government has driven through the nationalisation of schools funding with the mass roll-out of academies and now the introduction of direct funding of all schools from 2020. In the case of social care, new national requirements were introduced along with a new grant fund to partially compensate for insufficient council money.

A future government should think afresh about which tier of government should make what sort of fiscal decision. The core of the tax and social security system, which secures revenue for government and equalises living standards for citizens, should remain a national government responsibility. With the partial exception of Scotland, we remain a single political community where people expect government to raise taxes and provide support to people consistently. For this reason, benefits such as attendance allowance and housing benefit should not be localised in England, as some have suggested.

An England-wide allocation system is also required for achieving equitable spending power for public services between areas. The various departmental grants and spending formulae for distributing resources should either stay in the hands of government or be devolved to expert commissions made up of representatives from localities. This is particularly important when the state imposes minimum national standards or requirements on local public services. Local areas cannot be expected to deliver national policy without fair national funding. For example, there is a case for a designated budget for adult social care now that all councils must meet high basic requirements (a point made in the recent Fabian Society report, Take Good Care).[17]

On the other hand, there should be far more local autonomy in the deployment as opposed to the allocation of funding. Where localities have sufficient governance and accountability, they should ideally be able to operate on the basis of a single public service budget designed to meet all national standards and requirements. This implies pooling budgets between local public agencies, including local government, NHS, probation, skills, employment and transport. It also means localising school funding and making local areas the commissioners of school places again, albeit with a fairer schools funding formula.

Single local public service budgets coordinated by local government may be particularly important for the financial sustainability of councils, because otherwise their finances will become totally lopsided as social care absorbs an ever-rising share of their spending. Careful thought will also need to be given to the allocation of powers and money between local authorities and city-regions. Contested responsibilities could be exercised by different tiers in different parts of the country to reflect local political and economic geography.

Proceed with caution on tax devolution

There is a growing interest in enhancing local revenue-raising powers as well as spending autonomy. The government is rolling out its policy of localising business rates although the pace of change has recently slowed. New revenue-raising powers have recently been handed to Scotland and other parts of the UK are watching with interest. Independent reviews like the London Finance Commission have proposed devolving a significant range of taxes within England.[18]

Compared with other countries, revenue-raising in the UK is highly centralised, so there is a *prima facie* case for localising some taxes. However The Tax Detox, a 2015 Fabian Society report, found significant public scepticism and hostility to transferring tax-raising powers to local areas.[19] In a series of focus groups participants raised concerns about inequality, inefficiency and the limitations of local democracy. Moreover, significant challenges are created by the UK's very large geographic inequalities and the variations in tax bases that this creates.

Initial differences in tax bases can be corrected by grants based on appropriate equalisation formulae that are designed to take into account different local revenue-raising capacities. But such systems do not necessarily stay fair, because over time richer areas can raise more new income than poorer areas with the same percentage tax rises (this is why councils in poorer areas have been more heavily hit by recent grant cuts and why the new council tax social care precept favours richer areas).

EXPERT VIEW

> "The difficulty in the UK of moving to a system of local tax raising is that there is a significant disparity in wealth, incomes and industrial activity between regions. There is a lack of a strong correlation between infrastructure and investment needs of different regions and their potential taxable revenues. It might make matters worse in many parts of the UK if the balance of taxation between central and local government was shifted to local government without a corresponding rebalancing of economic activities between regions".

Ross Campbell, ICAEW

Low-income areas are also less likely to be able to grow the size of their tax base through economic development. When a tax base starts small, impressive percentage growth will translate into less extra cash, compared to when a tax base was larger to begin with (this explains why more affluent areas are more likely to benefit from the retention of business rates). Additionally, growth in a property-related tax base is not necessarily linked to economic or employment growth (which might be within a locality's control) as recent research on business rate retention has uncovered.[20]

Taking all this into account a future government that places a high priority on geographic fairness should proceed with caution on tax devolution. In particular, the present model of business rates localisation (introduced for the sake of creating economic incentives for councils) is unequal, complex and empirically unsound. There is a good case for ending it in its current form. In the long term, if politicians want to move beyond a national system, they could consider much more radical devolution of tax-raising powers but with an equalising formula that assumes each region will raise a similar share of (say) residents' primary incomes using their own mix of tax measures. Such a federal solution would be a huge step in the UK context but it might have more chance of securing equality between areas than the patchy and piecemeal devolution of individual tax powers.

EXPERT VIEW

"The current government's policy is to allow councils to retain a portion of the growth in their business rates above a certain level. An incoming Labour government would need to decide whether to continue with this policy. Retention is problematic because allowing councils to retain some of their business rates will mean that those least in need will benefit the most, while those most in need will see less gain. Because yield from business rates also varies according to accidents of history, devolution would allow richer areas to benefit. London generates the most income from business rates – the North East the least. The City of Westminster collects over 7 per cent of all the business rates in England, the City of London just under 4 per cent. So a policy of retention would allow areas to have greater control of their finances and destiny but risks allowing London to grow further and faster to the detriment of the rest of the country."

Iain McClean and Martin Rogers, British Academy

This takes us to the question of reforming council tax. There is significant interest on the left in wholesale reform of our main local tax; either to make charges fully proportionate to property prices or to replace council tax with a land value tax. New technologies also open the prospect of regular revaluations, based on real home sales data. From a national perspective there is much to commend in these ideas, as the new tax would be much more progressive and would create a fiscal dampener on house price rises. A tax of around 0.4 per cent a year on the value of a home (a little more if it were just the value of the land) could yield roughly the same revenue as council tax and leave a clear majority paying less than they do now. There is also a good case for absorbing stamp duty into any new system to remove a barrier to moving home.

A tax of around

0.4%

a year on the value of a home could yield roughly the same revenue as council tax and leave a clear majority paying less than they do now

However, from a local perspective these moves would exacerbate the equalisation challenges that already exist because areas with cheap properties would end up with still smaller tax bases than at present. If a future government were to proceed with reform it might need to take a wholly novel approach to local government finance too. Perhaps we need a local/national hybrid tax where the money councils raise is centrally pooled and then redistributed. For example, each council might specify its own tax yield and collect the tax at this rate, but then pay in or take out from a pooling scheme until its revenue per property reflected not each property's actual value, but the income that would be raised by the local tax rate if it had been levied on the median property in England.

There are no doubt other solutions which address the same dilemma and can resolve the tensions between redistributive and geographic fairness. It is time to grasp one. For decades politicians have ducked resolute decisions on local taxation and finance. A government committed to social justice and local devolution must take firm action.

EXPERT VIEW

"In a unitary system central government is the solution. The taxation revenue raised in London and the South East is pooled and redistributed – London's net fiscal surplus is over £26bn and increasing. But devolution, especially fiscal devolution, puts that at risk … In 1976 the Layfield Committee called for governments to choose between reviving local government via a robust tax such as local income tax and making councils agents of local government. That challenge remains."

Iain McClean and Martin Rogers, British Academy

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