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THE CONSERVATIVE PARTY'S MEDIUM TERM EXPENDITURE STRATEGY: A PRELIMINARY ANALYSIS

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Briefing Note No. 46

The Conservative Party's Medium-Term Expenditure Strategy – A Preliminary Analysis

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Oliver Letwin, the Shadow Chancellor of the Exchequer, outlined the Conservative Party's preliminary public spending proposals on 16 February in the form of a 'Medium-Term Expenditure Strategy' (MTES). This Briefing Note summarises and analyses the key points.

What is the Medium-Term Expenditure Strategy?

The MTES sets out the Conservatives' spending plans for the years 2006–07 to 2011–12. If the Conservatives were to win a general election in 2005 or early 2006, this implies that they would stick with Labour's plans for the remainder of the financial year in which they were elected. The MTES plans would then cover at least the rest of the parliament.

The MTES outlines plans for total public spending, broken down into six components:

- schools and the NHS;
- support for pensioners;
- non-pensioner welfare payments;
- other departmental spending;
- other 'annually managed expenditure' (i.e. spending that cannot reliably be planned far in advance, such as debt interest and local authority spending); and
- administration costs.

The MTES is currently only a 'proposal', which Mr Letwin plans to revise in December 2004. The revised version will be able to take into account the details of Labour's Summer 2004 Spending Review. This will set departmental spending plans for 2005–06 to 2007–08 and will incorporate any efficiency

[*] Financial support from the ESRC-funded Centre for the Microeconomic Analysis of Public Policy at IFS (grant number M535255111) is gratefully acknowledged. Any errors and all opinions expressed are those of the authors.

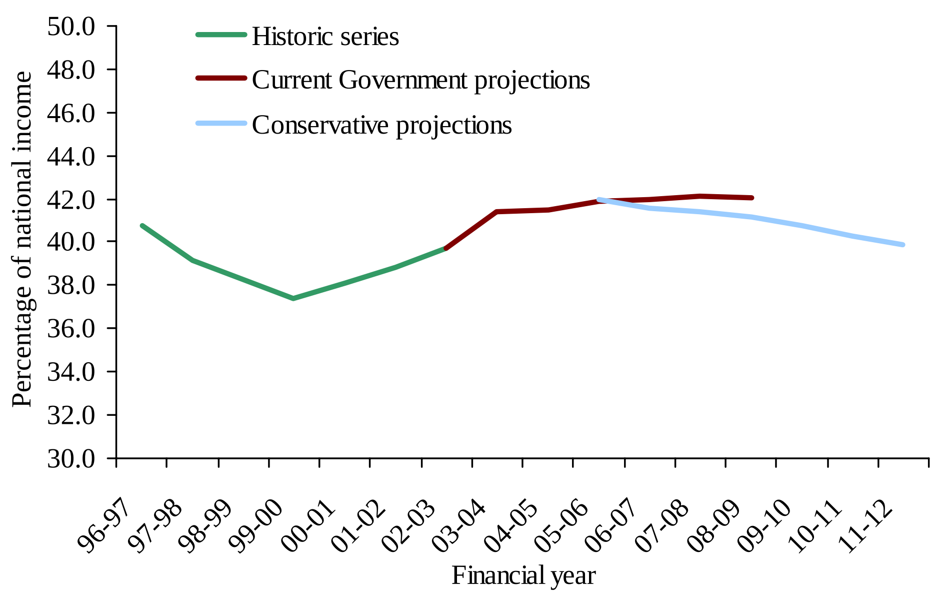
savings identified by the Gershon Review. The revised MTES will also be able to reflect the findings of the Conservatives' own review of government efficiency, headed by 'company doctor' David James.

The Conservatives will explain their approach to government borrowing and taxes in a Medium-Term Fiscal Strategy, which will accompany the revised MTES. It is not yet clear whether the party will adopt Gordon Brown's current fiscal rules or an alternative fiscal framework. Mr Letwin said, 'whilst they are better than nothing, they do not guarantee very much'. This makes it hard to assess if and when the plans would create room for tax cuts.

What will happen to public spending overall?

The Conservatives plan to increase the broadest measure of public spending – total managed expenditure (TME) – by an average of 1.4% a year in real terms between 2005–06 and 2011–12, less than the cautious expectation of 2½% (falling to 2¼%) annual real growth rate in the economy.[1] This will cut spending from 41.9% of national income in 2005–06 to 39.9% in 2011–12, a decline of 2.1% of national income (after rounding) or £23 billion in today's money.

Figure 1. Public spending as a share of national income under Pre-Budget Report and Conservative Medium-Term Expenditure Strategy forecasts, 1996–97 to 2011–12



Although this sounds a large number, it is smaller than the fall in public spending seen during the early years of the current government. TME fell from 40.8% of national income in 1996–97 to 37.4% in 1999–2000, a fall of 3.4% of

[1] The trend rate of growth is expected to fall to 2¼% in 2007–08, due to demographic factors.

national income over three years compared with the fall of 2.1% over six years proposed by the Conservatives. Part of the fall in public spending during the early years of the current government was attributable to strong economic growth and falling unemployment. But even when we exclude these cyclical effects, the drop between 1996–97 and 1999–2000 was still 2.8% of national income.

The Conservative proposals would reverse just under half the increase in public spending as a share of national income that the current government projects for the period from 1999–2000 (when the Labour government ceased being constrained by its pledge to stick to the Conservatives' spending plans) to 2005–06 in the December 2003 Pre-Budget Report. If the Conservatives achieve their plans, by 2011–12 spending will only have returned to the levels of 2002–03 and will still be higher than it was in every year of Labour's first term. On average, spending would be higher in the Conservatives' first term than in Labour's first term and, on Treasury projections, even its more generous second term.

Who are the winners and losers?

The decline in total public spending proposed by the Conservatives may be relatively modest, but it masks much bigger changes in composition. The Conservatives plan to increase the share of national income spent on schools and the NHS, to keep the share spent on pensioners at least constant and to reduce the shares spent on other departmental spending, welfare payments to non-pensioners and administration.

Table 1. Public spending as a share of national income under Conservative Medium-Term Expenditure Strategy, by component, 2005–06 and 2011–12

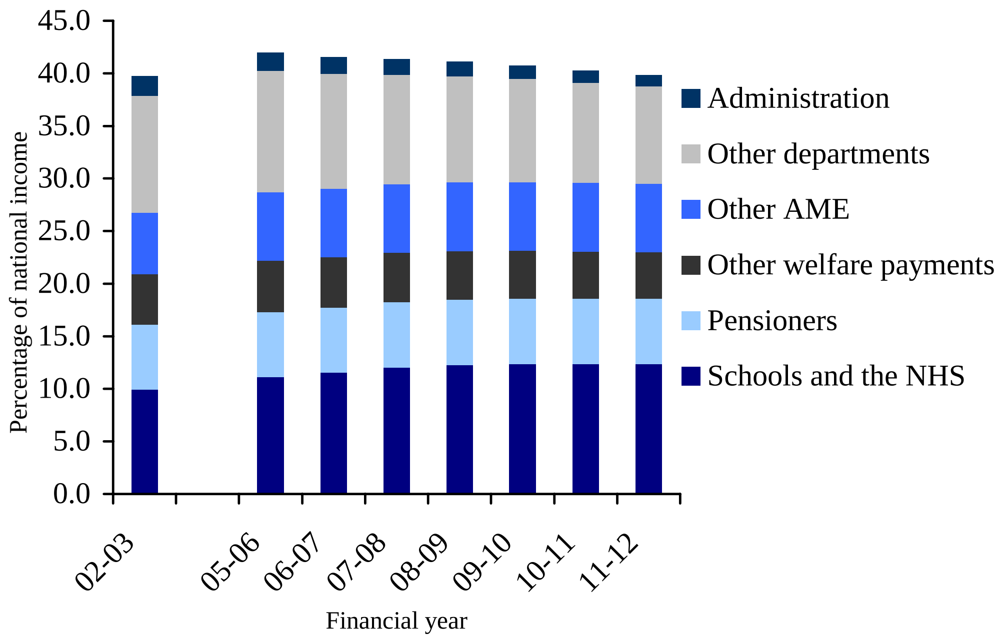
	% of GDP in 2005–06	*% of GDP in 2011–12*	*Difference (% of GDP)*	*Difference (current £ billion)*
Schools and the NHS	11.1	12.4	1.3	14.2
Pensioners	6.2	6.2	0.0	0.0
Other welfare payments	4.9	4.4	–0.5	–5.3
Other departments	11.5	9.3	–2.2	–24.7
Other AME	6.5	6.5	0.0	0.0
Administration	1.7	1.1	–0.6	–7.2
Total managed expenditure	*41.9*	*39.9*	–2.1	–23.0

AME – annually managed expenditure.

Notes: 'Pensioners' excludes net costs from commitment to increase the basic state pension in line with average earnings. 'Other departments' and 'Other AME' exclude savings from abolishing parts of the New Deal programme and a reduction in the generosity in the benefits given to lone parents with older children. Including these items would have little effect on the overall picture. Difference in current £ billion is calculated using money GDP in 2003–04 of £1,111 billion.

Whether or not these plans are deliverable would seem to depend in particular on whether or not administration costs can be cut by a third as a share of national income over six years without a noticeable adverse impact on the quality of public services, and on whether or not it is possible to find the necessary savings from departmental spending on functions other than schools and the NHS when the major areas remaining are the politically sensitive transport and higher education budgets and the Conservative touchstone policy areas of defence and law & order.

Figure 2. Public spending as a share of national income under Conservative Medium-Term Expenditure Strategy, by component, 2002–03 compared with 2005–06 to 2011–12



Notes: 'Pensioners' excludes net costs from commitment to increase the basic state pension in line with average earnings. 'Other departments' and 'Other AME' exclude savings from abolishing parts of the New Deal programme and a reduction in the generosity in the benefits given to lone parents with older children. Including these items would have little effect on the overall picture.

Spending on the **NHS and schools** is projected to rise from 11.1% of national income in 2005–06 to 12.4% in 2011–12, an increase of £14.2 billion in today's money. This increase of 0.2 percentage points of national income per year is smaller than the 0.4 percentage point average annual increase seen under Labour between April 1999 and March 2003. The Conservatives plan to frontload this increase, so that spending on the NHS and schools combined will rise by over 9% in nominal terms in each of the first two years. The Conservatives have not yet announced how they plan to subdivide the increase between these two spending areas. Labour has already announced increases in spending on the NHS that run until 2007–08, whereas plans for education will be announced in this summer's Spending Review. If the Conservatives wished to match Labour's plans for NHS spending in 2006–07 and 2007–08, then within their plans real spending on schools could still grow by an average of 5.5% a year over these two years. Mr Letwin conceded that the introduction of ‘patients’ passports’ and school vouchers would involve extra costs to begin with. The additional expenditure on these items would fall within planned spending on the NHS and schools.

The Conservatives plan to keep constant the share of national income spent on **pensioners**. They intend to increase the basic state pension in line with average earnings, while increasing the (means-tested) pension credit only in line with prices. The government intends to increase the basic state pension in line with prices and said in the 1998 pensions Green Paper that, in the longer term, it aspired to increase means-tested support for pensioners in line with earnings.[2] While the government has committed to increasing the pension credit in line with average earnings for this parliament, it has yet to confirm whether its aspiration will be met beyond this period.

The Conservatives believe they can meet the extra costs of their pension proposals in part by abolishing most of the New Deal for younger people and lone parents and making benefits for lone parents with older children less generous. They also plan to make other savings from the **non-pensioner welfare bill**. They assume that growth in benefits and tax credits to non-pensioners can be held to 3.25% a year in cash terms. This is in line with recent subdued growth in average earnings, but less than the 4.5% a year earnings growth that is thought to be consistent with the Bank of England’s inflation target. It implies that the non-pensioner welfare bill will fall from 4.9% of national income in 2005–06 to 4.4% in 2011–12, without any cyclical improvement in the state of the economy. Whether this is achievable depends in part on whether unemployment remains on a flat or downward trend over the medium term. Most independent forecasters polled by the Treasury think it will, but if the Conservatives believe that the government’s policies have undermined the efficiency of labour and product markets, they might be expected to be more pessimistic.

The Conservatives do not assume that they will be able to make savings from the **remainder of annually managed expenditure**, which is projected to be unchanged between 2005–06 and 2011–12 at 6.5% of national income. This includes spending in areas such as debt interest and local authority self-financed expenditure.

[2] Source: Foreword from the Prime Minister, p. iii of Department of Social Security, *A New Contract for Welfare: Partnership in Pensions*, Cm. 4179, London, 1998: ‘Over the longer term our aim is that [the new minimum income guarantee] should rise in line with earnings so that all pensioners can share in the rising prosperity of the nation’. The ‘minimum income guarantee’ has since been relabelled the pension credit.

The Conservatives believe that they can reduce spending on **administration** – i.e. the running costs of central government – from 1.7% of national income in 2005–06 to 1.1% in 2011–12. The main mechanism will be a freeze on Civil Service recruitment. Some might question whether such a freeze is consistent with ensuring that there are enough sufficiently talented and motivated people in the Civil Service to deliver the ambitious reform and cost-cutting in the public sector that the Conservatives propose. Savings in bureaucracy certainly seem easier to promise in opposition than to deliver in government. For example, Labour promised before taking office in 1997 to shorten NHS waiting lists by cutting 'red tape', but in fact only managed to do so once it had provided a significant increase in resources. In addition, Labour has recently commissioned Sir Peter Gershon to conduct a review identifying possible efficiency savings in the working of government. This suggests that, in so far as there are any substantial savings to be found, they may already have been identified and incorporated into Labour's spending plans by the end of the government's term of office.

The Conservatives plan to make most of their savings from **departmental spending on areas other than schools and the NHS**. The biggest remaining budgets are defence, law & order, transport and higher education, each of which is politically sensitive. The Conservatives plan to freeze spending in these areas in cash terms for two years and then to raise it by 2% a year, in line with the Bank of England's new inflation target but well below recent rates of inflation in the public sector. This implies reducing the share of national income spent in these areas from 11.5% in 2005–06 to 9.3% in 2011–12. For this choice to be credible, the public will need to see concrete examples of functions of government from which the savings will come.

Taken together, the Conservatives are looking, after six years, to have reduced spending on administration, non-pensioner welfare benefits and departmental spending other than on schools and the NHS by 3.3% of national income, or around £37.2 billion in today's money. Of this total, around 15% (£5.3 billion) of the savings will come from welfare, 20% (£7.2 billion) from administration and 65% (£24.7 billion) from other departmental spending. The extra spending on schools and the NHS will eat up £14.2 billion, or almost 40% of the savings.

Will the spending plans leave scope for tax cuts?

In assessing whether the Conservative spending plans leave scope for tax cuts, we assume that the party sticks with Gordon Brown's 'golden rule' – that the government must raise at least enough revenue to meet the cost of non-investment spending on average over the economic cycle. We also assume that the party manages to make all its savings by reducing current spending rather than investment. (This is relatively generous to the Conservatives in calculating the scope for tax cuts. But the Treasury expects net investment this year to account for less than 4% of total public spending, and even once social security benefits, tax credits and debt interest payments are excluded, this figure is still under 6%.) These assumptions and the uncertainty inherent in all forecasts of the public finances mean that any assessment of the scope for tax cuts implied by the spending plans is very tentative.

Because the golden rule only has to be met on average over the economic cycle, it is hard to identify precisely what deficit or surplus is required in any given year. We assume that policy at any given time is consistent with the golden rule if the government would be balancing its current budget if economic activity were running at a sustainable level – i.e. if the economy were at its trend rate of growth, which is assumed, under a cautious scenario, to be 2¼% a year from 2007–08 onwards. But we also note that the current Chancellor has aimed to run a surplus on the current budget of around 0.6% of national income at the end of his forecasting period, giving a safety margin in case there is less spare capacity in the economy than the Treasury thinks.

Our interpretation of the Conservatives' plans implies that current spending would be around 0.4% of national income lower than under Labour in 2006–07 and 0.8% of national income lower in 2007–08. If Gordon Brown's Pre-Budget Report revenue forecasts turn out to be correct, this would mean the Conservatives beginning the next economic cycle with a current budget surplus of 0.4% of national income in 2006–07 and 1.1% of national income in 2007–08.

Table 2. Cyclically adjusted current budget balances as a percentage of national income under the Labour and Conservative spending plans, 2006–07 and 2007–08

	2006–07	*2007–08*
Labour spending plans		
Budget 2003 revenue forecasts	+0.4	+0.6
PBR 2003 revenue forecasts	+0.0	+0.3
IFS 2004 revenue forecasts	–0.8	–0.5
Conservative spending plans		
PBR 2003 revenue forecasts	+0.4	+1.1
IFS 2004 revenue forecasts	–0.4	+0.3

PBR – Pre-Budget Report.

Source: IFS projections calculated using table 3.4 of R. Chote, C. Emmerson and Z. Oldfield (eds), *The IFS Green Budget: January 2004*, Commentary no. 95, Institute for Fiscal Studies, London.

If Mr Letwin were to aim for the same degree of caution in meeting the golden rule that Mr Brown looked for in the last Budget, he would have scope to cut taxes relative to the levels currently forecast by the government by 0.5% of national income in 2007–08. This is around £5½ billion in today's money. Over the following four years, the Conservatives plan to cut spending as a share of national income by 1.5% of national income. This implies that the tax burden could be cut further by a similar amount by 2011–12 while expecting to meet the golden rule looking forward with the safety margin Mr Brown has looked for in the past.

But Labour has already pencilled in a significant rise in the tax burden over the next five years to meet the fiscal rules and to pay for the spending increases we have already seen. So tax cuts of this magnitude would in fact leave government revenues fractionally higher in 2011–12 than the 38.1% of national income forecast for this year in the Pre-Budget Report. In fact, the Conservatives would not be able to cut the tax burden from its current level, but simply halt and reverse the increase Labour has already pencilled in.

As Mr Letwin recognised, IFS (in common with other forecasters such as the International Monetary Fund and the Organisation for Economic Co-operation and Development) has argued that the Treasury may be over-optimistic in the amount of revenue it expects to collect over the next few years. The Treasury will also have to find money to rebuild its contingency reserve for unexpected spending needs. We forecast in our January 2004 Green Budget that the government would begin the next cycle with a current budget deficit of 0.8% of national income in 2006–07 rather than a balance.

If we are right, and if an incoming Conservative government sought consistently to aim to achieve the golden rule looking forward with the degree of caution sought by Mr Brown, Mr Letwin would probably only have scope to stabilise the tax burden at the level he inherited, and perhaps only be able to reduce it towards the end of his forecast period. However, tax revenues as a share of national income would still be above their expected level for 2003–04.

It should be emphasised that these calculations are subject to wide margins of error and, importantly, that they rely on the assumption that the Conservatives retain the golden rule and consistently aim to target it with the same degree of caution that Mr Brown has claimed to do in recent years. We will have a clearer idea whether this is the case when the Conservatives publish their Medium-Term Fiscal Strategy in December.

Conclusion

The Conservative Party has provided a detailed description of its preliminary thinking on public spending should it win the next election. The party plans to cut public spending as a share of national income, reversing just under half the increase seen under Labour since April 1999. But the Conservatives also want to spend a higher proportion of national income on schools and the NHS and to keep the share spent on pensioners constant. This implies a significant squeeze on administration costs, non-pensioner welfare payments and other departmental spending. The Conservatives will need to demonstrate to voters how they can deliver these savings without unacceptable declines in the quality of these public services.

If the Conservatives can reduce public spending as a share of national income on an ongoing basis, this will eventually create scope for tax cuts. But the current government has already pencilled in a significant increase in the tax burden over the next five years. If the Treasury's forecasts for the public finances are unduly optimistic, as a number of independent commentators believe, an incoming Conservative government might also inherit a significant structural budget deficit. This suggests that even if the Conservatives can deliver the spending plans they have announced, if they stick with Gordon Brown's approach to the fiscal rules the tax burden is likely to remain above current levels for years to come.