

Patrick Nolan

# Fiscal Consolidation and Transforming Government in the United Kingdom

In August 2010 the *Economist* magazine featured on its front cover a mocked-up photo of the United Kingdom's new prime minister, David Cameron, sporting a punk rock-style Union Jack mohawk. This reflected the promise of a new, radical approach to fiscal policy. As the *Economist* (2010) noted: 'Britain has embarked on a great gamble. Sooner or later, many other rich-world countries will have to take it too.'

This article looks at the United Kingdom's recent experiment with fiscal consolidation. It puts this consolidation into its historical and international context and assesses its strengths and weaknesses. It shows that over its first three years the Coalition government failed to create a fiscal policy framework that holds spending on a lower track. However, the June 2013 spending review (for the 2015–16

fiscal year) and recent positioning of the opposition Labour Party indicate that a new approach to fiscal discipline may now be starting to take hold.

## The context for fiscal consolidation

In May 2010 the United Kingdom formed its first coalition government since the Second World War. This government made rescuing the public finances its

most important goal, with the coalition agreement giving deficit reduction precedence over all other measures. As the chief secretary to the Treasury, Danny Alexander, argued: 'we made the decision to cut our cloth to reflect our means, and prove that we could be trusted to restore health to the public finances. Building that trust had two elements: firstly establishing numbers that people believed. And secondly coming up with a credible plan that we could deliver on' (Alexander, 2012).

The Coalition's plan for fiscal consolidation has been widely debated. Yet many of these debates fail to put this fiscal policy into its international and historical context. This is important as data from the International Monetary Fund (IMF) (2013a) show that when they entered power in 2010 the Coalition faced real problems. The build-up of debt was especially significant and reflected both the global financial crisis and the pre-existing tendency of governments to run structural deficits, with governments

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running deficits and public debt increasing every year since 2001–02.<sup>1</sup> The challenge is that, as Corrie, Nolan and Zuccollo showed, ‘the large majority of the current stock of debt is structural and so will not reduce with economic growth. Indeed, less than £45 billion of the total £1 trillion of public debt is purely cyclical. The remainder constitutes debt that will not be offset by the automatic stabilisers once growth returns’ (Corrie, Nolan and Zuccollo, 2013).

Data from the IMF’s *Fiscal Monitor* also show that the Coalition’s plans for deficit reduction to 2015 – a 5.6 percentage point reduction in the cyclically-adjusted primary deficit – are similar to the United States and just above the level of Australia and New Zealand. What stands out is the balance between expenditure cuts and revenue measures, with 75.2% of the consolidation occurring on the expenditure side. This is above the IMF average for developed countries of 51.7%, but is similar to that of Germany and below that of countries like Canada, Spain and New Zealand. Further, as the cyclically-adjusted deficit is expected to persist until 2016–17, gross debt will grow by a further 20.2 percentage points (reaching 99.7% of GDP) between 2010 and 2015.

In historical terms, the consolidation means that by 2014–15 spending will be just above the level of 2008–09 spending in real terms. But this should be seen in the context of the increase in spending prior to 2010. Public expenditure statistical analysis data released by HM Treasury show that between 2002–03 and 2010–11 the government’s total managed expenditure increased in real terms from £521 billion to £704 billion. This was equivalent to a real increase of 35.0%, or an average annual increase of 3.8%. Even with the planned fiscal consolidation, by 2014–15 total spending will be 33.2% higher, transfers will be 55.1% higher and departmental spending will be 16.8% higher than in 2002–03. This is equivalent to average annual increases of 2.4%, 3.7% and 1.3% respectively.

#### The Coalition’s approach

The first stage of the Coalition’s consolidation was the release of an

**Table 1: Fiscal challenges facing the Coalition (share of GDP)**

	2006 (%)	2010 (%)
Tax revenue	37.7	36.6
Expenditure	40.5	46.7
Cyclically-adjusted primary balance (excluding debt repayments)	–3.1	–6.0
Cyclically-adjusted overall balance	–4.7	–8.6
Gross debt	43.0	79.4

Source: IMF (2013a)

**Table 2: Fiscal consolidation in selected countries, 2010–15**

	Change in revenue, 2010–15	Change in expenditure, 2010–15	Change in cyclically-adjusted primary balance, 2010–15	Change in gross debt, 2010–15	Share of consolidation through expenditure reductions (%)
United Kingdom	1.1	–3.4	5.6	20.2	75.2
New Zealand	0.1	–5.3	5.0	4.7	97.6
Australia	2.8	–2.2	5.0	4.6	44.2
Canada	0.6	–2.9	2.9	0.0	82.0
France	3.2	–1.3	3.9	11.8	29.7
Germany	1.1	–3.0	3.3	–6.8	73.1
Spain	0.0	–3.0	5.2	40.3	98.5
United States	3.8	–3.2	5.6	10.2	46.1
Developed-country average	2.3	–2.5	4.2	7.2	51.7

Source: IMF (2013a)

emergency budget in early 2010. This included a fiscal mandate to achieve a cyclically-adjusted current balance by the end of a rolling, five-year forecast period, and for public sector net debt as a percentage of GDP to be falling by 2015–16. Overall fiscal aggregates to achieve this fiscal mandate were then set. These aggregates were based on a target (which was not met) for 80% of consolidation to take place through spending cuts and were mostly based on those proposed by the previous Labour administration.<sup>2</sup> Following this, overall departmental expenditure limits were established and an independent Office for Budget Responsibility (OBR) was created to assess the government’s performance against its fiscal mandate and targets.

Later that year the government completed a spending review for 2010–11 to 2014–15. This translated overall

departmental expenditure limits into individual departmental settlements. Yet not all departments faced a reduction in their budgets and the National Health Service (NHS), Overseas Development Assistance (ODA) and school budgets were protected. As well as these departmental budgets, the basic state pension was uprated in a more generous manner (a triple guarantee of earnings, prices or 2.5%) and the prime minister, David Cameron, ruled out cuts to a number of universal pensioner benefits. This contrasted with the treatment of other groups, with students and younger families losing support (including the significant decision to means-test the child benefit) (Nolan, 2011a).

In June 2013 the Coalition completed a further spending review for the 2015–16 year, which will come into effect one month before the next general election.

As with the previous spending review, the budgets for the NHS, ODA and schools were protected. However, a larger share of the NHS budget was made available to local authorities (thus breaking the ring fence in practice if not in principle) and efforts were made to reduce the cost of pensioner benefits. In particular, it was proposed to restrict access to the winter fuel payment (to reduce take-up by expatriate pensioners in European countries outside the United Kingdom), and pensioner benefits excluding the state pension were included in a budgetary cap on transfer spending.

OBR data show that in cash terms the Coalition kept its spending plans broadly on track (Corrie, Nolan and Zuccollo, 2013). Yet, while there was little deviation from the overall cash path, lower than expected economic growth meant that the Coalition failed to satisfy its fiscal rules. In this respect the Coalition has not been unusual, as this has very much been the pattern of successive governments. As Zuccollo (2012) noted, for the past decade governments have been living by the idiom that ‘rules are made to be broken.’<sup>3</sup> There was also a significant change in the composition of the planned consolidation, with higher than expected spending on transfers (annually managed expenditure) being offset by deeper cuts in departmental budgets (departmental expenditure limits). This increased spending on transfers reflected both higher debt servicing costs and higher welfare spending, although much of this increase in welfare spending was structural (e.g., increasing spending on pensions) and cannot be attributed to the economic cycle (Corrie, Nolan and Zuccollo, 2013).

#### The austerity debates

The Coalition’s fiscal consolidation has (unsurprisingly) been the topic of intense debate (Nolan, 2012). Supporters of the Coalition’s plans have argued that these changes were necessary to signal fiscal discipline, allow the government’s costs of borrowing to fall, and support growth through allowing interest rates to remain low (Lilico, Holmes and Sameen, 2009). They have also (more recently) argued that any easing of fiscal policy may lead

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to monetary authorities beginning to tighten sooner, thus increasing interest rates. Indeed, it has been suggested that to support further growth the Bank of England’s monetary policy mandate requires review rather than easing of fiscal policy (Osborne, 2013).<sup>4</sup>

Critics have, in contrast, argued that reduced government spending has weakened private demand, and that this is especially concerning given the weakness of the eurozone (the United Kingdom’s most important trading partner). It has also been argued that if one-off policy changes (such as the increase in the standard rate of the value added tax (VAT)) and non-tradeables are stripped out of the figures, then underlying inflationary pressures are weak and so the likelihood of monetary policy offsetting an easing of fiscal policy is low. Finally, it has been claimed that with the low cost of government borrowing (possibly due to non-conventional monetary policy and a weak outlook for growth), debt-financed short-term stimulus could come at a relatively low cost and may help to circumvent blockages in the financial system (Nolan, 2012).

Yet the differences between these two camps should not be overstated. Both sides agree on the need for a plan to reduce borrowing to avoid losing the confidence of markets. The differences are largely

ones of timing. Further, both camps have weaknesses in their positions. For example, supporters of fiscal consolidation need to recognise that this involves a trade-off between short-term economic costs and long-term gain, and that, as Reform warned in June 2010, reconciling this trade-off ‘will not be pain free’ (Bassett, Cawston et al., 2010); while supporters of easing fiscal policy need to recognise that ‘multiplier analysis’ provides a much weaker case than commonly assumed for consumption spending funded by debt (Haldenby et al., 2011).

The Coalition made a mistake in understating the likely costs of fiscal consolidation. This reflected a failure to fully grasp the scale of the changes required. It was expected that much of the heavy lifting could be done through reducing waste or administrative costs. While making government and administration work better is important, making cost savings on the scale needed required going beyond incremental improvements. As Ruth Richardson said in a speech in London in September 2010, based on her experience in New Zealand, ‘salami slicing, waste busting media stunts, public servant or special adviser elephant hunting are just exercises that fiddle at the fringes. The real meat lies in asking the fundamental question – does the government have a role at all?’ (Richardson, 2010). By 2013 the National Audit Office had begun to raise similar concerns and noted that there has been insufficient emphasis on delivery of long-term changes and improvement in efficiency necessary to make savings sustainable. As they highlighted, departments still tend to lack a clear strategic vision of what they are to do, what they are not, and the most cost-effective way of delivering it (National Audit Office, 2013).

Many supporters of short-term stimulus spending also failed to consider how its economic impact depends on the type and not just level of spending. International evidence suggests that the return from spending on economic development (such as infrastructure) tends to be higher than from spending on social protection (such as welfare and health) (Gemmell, Kneller and

Sanz, 2009). As the current secretary of state for business, innovation and skills, Vince Cable, wrote while in opposition: 'Without fiscal consolidation it will not be possible to remedy the current gross imbalance in the economy. Without infrastructure investment there will not be a functioning, modern, sustainable, "green" economy for the next generation to work with' (Cable, 2009). Yet, as the House of Commons Public Accounts Committee (2013) showed, the pattern of consolidation has been the opposite of this. Low-value spending such as the poorly-targeted pensioners' winter fuel payments, free TV licences and bus passes should have been cut first, but instead the earliest cuts fell relatively heavily on areas like capital spending.<sup>5</sup>

#### Failing to get a grip on long-term spending

The need for fiscal consolidation does not just reflect immediate factors like the fallout from the global financial crisis. With the ageing of the population, the proportion of people who work and pay the taxes that fund services and transfers (largely funded on a pay-as-you-go basis) is falling (Nolan, Thorpe and Trewitt, 2012). This reflects not only a bulge in the population reaching retirement age but also increasing longevity. Indeed, as Nolan (2013b) has shown, a person retiring in 2010 would have a one-in-six chance of spending three decades in retirement; by 2035 a quarter of people retiring can expect at least 30 years of retirement. This is even with current plans to increase the state pension age. This means major areas of government spending require reform, especially pensions and health.

Yet the Coalition has been reluctant to reduce spending in these two areas. This is like trying to rescue the public finances with one hand tied behind your back. To illustrate the importance of these two budgets: if the Coalition reformed them so that they remained fixed in cash terms, the increase in total spending from 2011–12 to 2014–15 would be 55.1% less. The increase in health spending alone is equivalent to 22.5% of the increase in total spending from 2011–12 to 2014–15 (Corrie, Nolan and Zuccollo, 2013). The overall result is like putting the public finances on a crash diet which actually

**Table 3: The importance of the health, welfare and education budgets**

Total managed expenditure (2014, £ billions)	733.5
Spending on health, welfare and education (2014, £ billions)	380.1
Share of total 2014–15 spending of health, welfare and education (%)	53.3
Share of increase in spending (2011–12 to 2014–15) of health, welfare and education (%)	55.1
Share of increase in spending (2011–12 to 2014–15) of health (%)	22.5

Source: Corrie, Nolan and Zuccollo (2013)

reduces the chances of long-term weight loss. There is a perception that services are being underfunded, while the real drivers of spending have been left untouched.

The growing power of the elderly voting bloc has proven to be a major constraint on pension reform. As Corrie and Nolan (2013) showed, around one quarter of all voters were over 65 in the last general election and this proportion is expected to grow every election to reach one in three by 2050. It is important to think about reducing the long-term costs of pensions, yet recent government policy has gone in the other direction. Although the Coalition brought forward a planned increase in the retirement age, this was offset by the change in the way that the state pension increases over time. The state pension will increase by the highest of earnings, the consumer price index or 2.5% (the so-called triple lock) and this change alone will add around 0.7% of GDP to the cost of pensions by 2040 (Cawston et al., 2011).

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Yet a recent change in the position of the opposition Labour Party towards universal benefits and the Coalition's 2013 spending review have shown that the desire to get to grips with spending on pensions is growing. The Labour Party has proposed means-testing the winter fuel payment (this has been a long-standing position of the Liberal Democrat deputy prime minister, Nick Clegg) and the 2013 spending review included a proposal to withdraw this payment from expatriate pensioners living in other European countries (based on a temperature test). A cap on the overall level of spending on welfare transfers has also been proposed by the Coalition, and both it and the opposition have signalled that this cap will include pensioner benefits. The Coalition's current position is, however, to exclude the state pension from this cap, which will mean its coverage is so narrow as to be practically meaningless. In 2013–14 pensioners will receive 54% of all welfare spending and tax credits, and the state pension alone will account for 75% of these pensioner benefits.

The Coalition has also failed to get to grips with the NHS budget. Again this partly reflects the concerns of the elderly voting bloc: Corrie and Nolan (2013) show that the NHS accounts for 95% of all spending on benefits in kind on the average retired household. Yet the Coalition's approach of ring-fencing the NHS budget has reduced the pressure to innovate and meant that the squeeze on areas of related spending, such as adult social care, has had to be deeper (Cawston et al., 2013). The ring fence has worked against the integration of services and the need to shift care from the acute setting into the community and the home.

The Coalition appears to have recognised problems with the health ring

fence and in the 2013 spending review extended a policy where NHS funds can be used by local authorities to integrate care. Having a funding pool that allows resources to cross departmental boundaries and to go where they will have the best impact on the community is sensible, and is similar to the justice sector fund in New Zealand. Yet this architecture will require a greater focus on joint working – among Cabinet ministers, departmental chief executives and throughout their agencies. Without further progress on civil service reform, it is hard to be confident that the joint fund for health integration will change outcomes in the way hoped. The Coalition government has failed to properly grasp the importance of civil service reform (Haldenby, Majumdar and Rosen, 2013) and the joint fund risks being another source of tension rather than transforming the way government works.

The Coalition government has also failed to grasp the importance of reforming the way in which the NHS is funded. For decades real reform of the funding of the service has remained off the agenda and emphasis has instead been given to reorganising the service to improve resource use. Improving resource use is important, but the narrow basis for funding the NHS means it is out of step with the mainstream of international practice and is vulnerable to the pressure on public finances from population ageing. On average, OECD countries spend 2.7% of GDP on private healthcare, while in the United Kingdom this is just 1.6% (Nolan, 2013a).

**The need for revenue measures**

While the bulk of the fiscal consolidation has taken place on the spending side, the Coalition has sought to make changes on the revenue side too. Yet there appears to have been little recognition that the re-

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quirement for greater revenue (as a share of GDP) is not just a short-term phenomenon. There is a view that once the crisis is over it will be possible to significantly reduce taxation, yet OBR data show that public sector current receipts are expected to average 38.2% of GDP for the next 20 years, while total managed expenditure is expected to average 39.9% (Office for Budget Responsibility, 2012). There is no fiscal headroom for lowering tax burdens

without also going significantly further on entitlement reform.

It could be argued that this is a static view of taxation and that tax relief can, at least partly, fund itself. Yet the priorities in current tax policy do not satisfy this test of expanding the tax base and generating additional revenue. In particular, a major priority of the Coalition has been to increase the personal income tax allowance. This comes at a large revenue loss, and does little for the overall efficiency and fairness of the income tax system as the bulk of the relief goes to people above the level of the allowance (Nolan, 2011b). For most people this tax relief has an impact only on already-earned income and does not improve the return from additional work. It also increases incentives for tax avoidance and evasion, and reflects an approach to tax policy that has been criticised in the United States by the supply-side economist Art Laffer. As Laffer noted: ‘I’ve never said all tax cuts pay for themselves’ (Fox, 2007).

The Coalition’s approach to business taxation has been described as ‘schizophrenic’. On the one hand it has reduced the main rate of company taxation in an effort to create the most competitive tax regime in the G20. On the other it has introduced ad hoc taxes on important sectors of the economy, such as banking (Bassett, Haldenby et al., 2010), and attacked legitimate efforts by corporations to reduce their tax bills. As John Cridland, director general of the Confederation of British Industry, has noted: ‘That confusion of purpose – are we making the UK more tax competitive? Are we sending signals that somehow big business can’t be trusted? – needs reconciling’ (Rowley, 2013). Further, contrary to the political rhetoric, around half of the tax gap can be attributed to small-to-medium enterprises, and Coalition policies are encouraging these businesses to plan their affairs to avoid tax.<sup>6</sup> By cutting company tax rates and increasing personal allowances while making the tax system more hostile towards higher income earners, the Coalition is getting its tax design wrong (with increasingly variable rates encouraging tax planning). The entire

**Table 4: The long-term fiscal outlook – receipts and managed expenditure (share of GDP)**

	2010–11 (%)	2020–21	2030–31	2040–41	2050–51	2060–61
Public sector current receipts	37.3	38.2	38.4	38.9	38.9	39.1
Total managed expenditure	46.5	38.8	40.1	41.6	42.7	45.0

Source: Office for Budget Responsibility (2012)

system needs to be simpler and less open to abuse.

It is also important not to confuse tax rates with tax revenue, and rather than raising tax rates emphasis should go on strengthening the tax base. As Reform (Bassett, Haldenby, et al., 2010), the OECD (Holmes, 2010), the Mirrlees Review (Mirrlees et al., 2011) and the IMF (2013b) among others have noted, the major opportunity for improving the tax base is to close holes in the indirect tax (particularly the VAT) system. The expensive system of pension tax relief is another potential area for reform (Cawston et al., 2011). Yet the Coalition has ruled out a significant expansion of the VAT tax base and has, in fact, performed an embarrassing policy reversal on the extension of VAT to hot takeaway food (dubbed 'pasty-gate' in the media). On pension tax relief, while this is an area that clearly requires reform, the approach taken has been largely designed according to political principles and failed to be a coherent package that increases saving and lowers costs to taxpayers.

## Conclusion

In 2010, when the spending review was launched, a spokesperson from HM Treasury said: 'Anyone who thinks the review is just about saving money is missing the point. This is a once-in-a-generation opportunity to transform the way that government works' (Daily Telegraph, 2010). Yet the Coalition has failed to achieve this vision. This has

been partly, but not wholly, an own goal. By focusing on short-term political priorities rather than long-term reform, the Coalition has made its task even harder. There are emerging signs that this approach may be changing, but concerns remain.

The Coalition failed to properly capitalise on its opportunities over the last three years and it must not waste the final two years of this Parliament. Two key things must happen. First, the Coalition must illustrate that there is no simple relationship between spending money and improving outcomes. Debates in the United Kingdom are heavily biased towards a focus on inputs, such as scorecards of how individual budgets have moved up or down. As the experience in areas such as police reform show, it is possible to reduce inputs and improve outcomes (May, 2013). But this is only possible with reforms that improve the productivity of spending.

Second, the Coalition must give greater attention to the role of civil service reform in fiscal consolidation. As Ruth Richardson wrote, ongoing fiscal prudence requires 'a results-driven and accountable public sector ... a clear idea of what we wanted to achieve and ... to organise services to achieve these priorities' (Richardson, 2010). On this there are, as the current paymaster general, Francis Maude, has noted, important lessons that the United Kingdom could learn from New Zealand (Lodge et al., 2013). The close relationship between

New Zealand's State Sector Act 1988 and Public Finance Act 1989, along with the later Fiscal Responsibility Act 1994, has been reflected in a strong approach to managing budgets, making departments account for their assets and reporting performance. Ensuring that the civil service is more clearly held to account for contributing to governments' fiscal policy objectives is essential if the Coalition is to achieve its mission of doing more with less.

- 1 As Zuccollo (2012) noted, 'measures of the sustainability of the UK government debt show a long history of unsustainable borrowing: the surplus has been great enough to [sustainably] reduce public debt in only six of the past 34 years.'
- 2 The Coalition proposals were for an additional consolidation of £40 billion per year by 2014–15, which was composed of £8 billion a year from net tax increases and £32 billion a year from spending reductions. This is in the context of total discretionary planned consolidation of £113 billion by 2014–15 (thus, Coalition plans represented 35% of the total). In comparison to the Coalition's 80:20 goal, the previous Labour administration proposed that spending measures would contribute 71% of consolidation and revenue measures 29% (Corrie, Nolan and Zuccollo, 2013).
- 3 From 1998 to 2008 the UK had two rules: a golden rule to ensure budget balance and a sustainable investment rule to constrain total debt. These rules did not prevent the increase in government debt in the UK between 2003 and 2008, even before the global financial crisis (Zuccollo, 2012).
- 4 Supporters of the Coalition's plans have also emphasised the need to distinguish the UK from the eurozone. While the experience of eurozone countries is often cited as an example of self-defeating austerity, unlike these countries the UK has its own currency and an independent monetary policy, which can potentially lean against changes in spending and taxation.
- 5 It is important to not overstate the economic benefits of infrastructure spending. While infrastructure can play an important part in lifting the long-run growth potential of the economy, this depends on selecting the right projects and funding arrangements (see, for example, Haldenby et al., 2012).
- 6 The tax gap is the difference between the tax collected and the theoretical liability (amount that should be collected). The estimated tax gap for 2009–10 was around 8% of total revenues. Inaccurate returns from individuals and indirect taxes like VAT made up the biggest proportion of the tax gap. The share of the tax gap which could be attributed to corporation tax, especially of large and very large businesses, was relatively small (Nolan, 2011b).

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