6. Public spending cuts: pain shared?

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Summary

- The government's six-year plan to reduce borrowing will see public spending brought down from its peak of 47.4% of national income in 2009–10 to 39.3% by 2015–16. The period from April 2011 is set to be the tightest five-year period for public spending since at least the Second World War. Out of 29 leading industrial countries, the IMF forecasts that only Iceland and Ireland will deliver sharper falls in spending as a share of national income than the UK between 2010 and 2015.

- The 2010 Spending Review set out broadly where the cuts will fall over the four years starting in April 2011. The big winners were the Department for International Development and the investment budget of the Department of Energy and Climate Change: both are to receive large spending increases by 2014–15. The areas that will see the largest cuts are housing, higher education and the Department for Environment, Food and Rural Affairs. There will also be deep cuts to local authority grants, the Home Office and the Ministry of Justice.

- The government has committed to real increases in the NHS budget each year between 2010–11 and 2014–15. If achieved, these will result in a continuation of the long-term trend for the NHS to take up an increasing proportion of public service spending.

- Within the nations, the Scottish parliament appears to have made similar decisions to those made for England; the Welsh Assembly government has chosen not to protect NHS spending from spending cuts, thereby reducing the scale of the cuts required elsewhere; and the Northern Ireland Executive appears to have chosen to cut spending on schools by more than spending on further and higher education.

- The last time the UK government attempted to implement real public spending cuts (in the 1990s), it was successful at sticking to its cash plans, but lower-than-expected inflation meant that the planned real cuts were not delivered as quickly as intended. The current government's planned cuts to public spending are far greater than those attempted at that time, and achieving these more ambitious plans will be more difficult.

- Delivering such tight spending plans will, as identified by the government, require 'a robust framework to control spending'. There are improvements that can be made to the current system – in particular, Spending Reviews should routinely consider as wide a set of spending areas as possible and not only departmental programme expenditure.

- The government should be prepared to review its 2010 Spending Review settlements in a couple of years' time in the light of any changes to the economic and fiscal outlook or of particular difficulties faced by departments in delivering spending cuts that are palatable to the government and the wider public.

6.1 Introduction

Over the last few years, the public finances have weakened significantly: annual borrowing and the stock of public debt have both increased sharply. The government is planning a substantial reduction in borrowing over the next few years to help return the UK's public finances to a sustainable footing, as discussed in more detail in Chapter 2. To deliver this reduction in borrowing, the government is planning – much like the previous Labour government was – to rely heavily on deep spending cuts. By 2014–15, our estimates suggest that 73% of the planned fiscal tightening is to come from cuts to spending (with the other 27% coming from a discretionary net tax increase). This compares with 70% of the fiscal consolidation to come from spending cuts planned in Alistair Darling's March 2010 Budget (with 30% coming from a net tax rise).[1]

The planned cut in total public spending over the five years from April 2011 will be larger in real terms than the UK has seen in any other five-year period since the end of the Second World War. This chapter begins in Section 6.2 with a description of the historical trends in public spending and how these compare with the plans for total spending over the next five years and with the overall spending reductions planned in other similar countries over the same period.

Which departments win and lose over the next four years will be an important determinant of which households fare better and worse from the overall fiscal consolidation. Unfortunately, estimating the losses to households from public service cuts is difficult (see Chapter 8). We are, however, able to document the allocation of cuts across Whitehall spending departments announced in the October 2010 Spending Review. Section 6.3 sets out the relative winners and losers from this review across Whitehall departments and highlights how the timing of the cuts varies between departments. It then describes the decisions on allocating the spending cuts that have been made by the devolved administrations in Scotland, Wales and Northern Ireland for their jurisdictions.

One key risk to the future strength of the public finances is that the government might not be able to deliver the planned squeeze on public spending. In Section 6.4, we look back to the last time the UK government tried to cut public spending substantially (the mid-1990s) to see what lessons can be drawn.

The 2010 Spending Review highlighted the need for 'a robust framework to control spending' in order to deliver the current spending plans.[2] In Section 6.5, we discuss some of the problems with the current regime for planning and controlling public spending, and some ways in which it could be improved to enhance the government's ability to deliver lower public spending at least cost to the quality and quantity of public services provided. Section 6.6 concludes.

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[1] See R. Crawford, 'Where did the axe fall?', presentation at IFS 2010 Spending Review briefing, 21 October 2010 (http://www.ifs.org.uk/publications/5311).

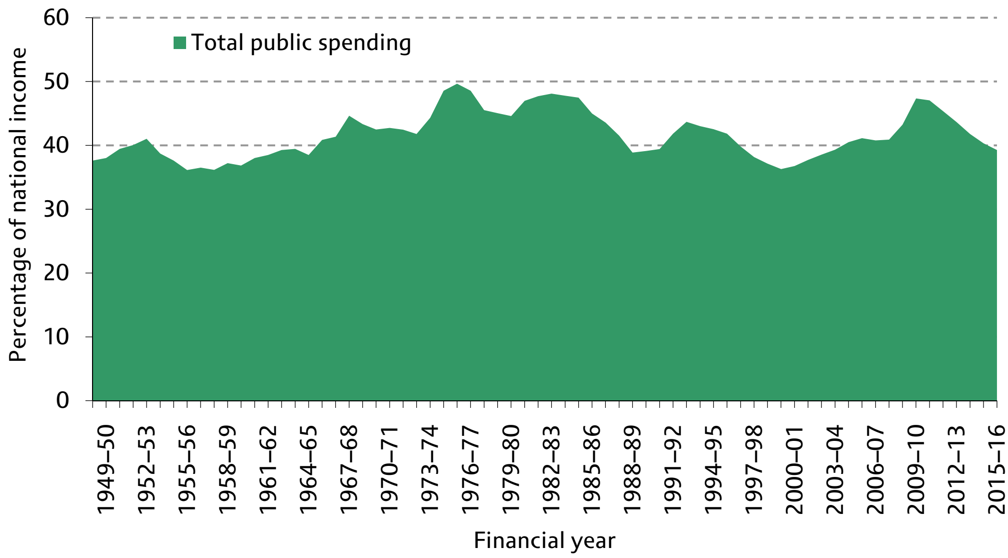
[2] Page 18 of HM Treasury, *Spending Review 2010*, Cm 7942, 2010 (http://cdn.hm-treasury.gov.uk/sr2010_completereport.pdf).

6.2 Trends in UK public spending

Total spending since 1948–49

The Office for Budget Responsibility (OBR) forecasts that Total Managed Expenditure (TME), the broadest measure of government expenditure, will be £698.2 billion in 2010–11. This equates to 47.1% of national income, or just over £26,400 for each of the 26.4 million households in the UK. Figure 6.1 shows how public spending as a share of national income has varied since 1948–49. The level seen in 2009–10 (47.4% of national income) was the highest level since 1984–85, when public spending accounted for 47.5% of national income.

Figure 6.1. Total public spending



Note: Figures for 2007–08 to 2009–10 are on a basis that includes the temporary effects of financial sector interventions, while those for 2010–11 onwards are on a basis that excludes these.
Sources: Out-turn figures for public spending from ONS series ANLT, ANNW and ANNZ from table 2.3C of *Financial Statistics Freestanding Time Series Data* (http://www.statistics.gov.uk/statbase/tsdtimezone.asp). Forecasts from Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2010* (http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html). GDP is ONS series BKTL from table A2 of *United Kingdom Economic Accounts* (http://www.statistics.gov.uk/statbase/tsdtimezone.asp).

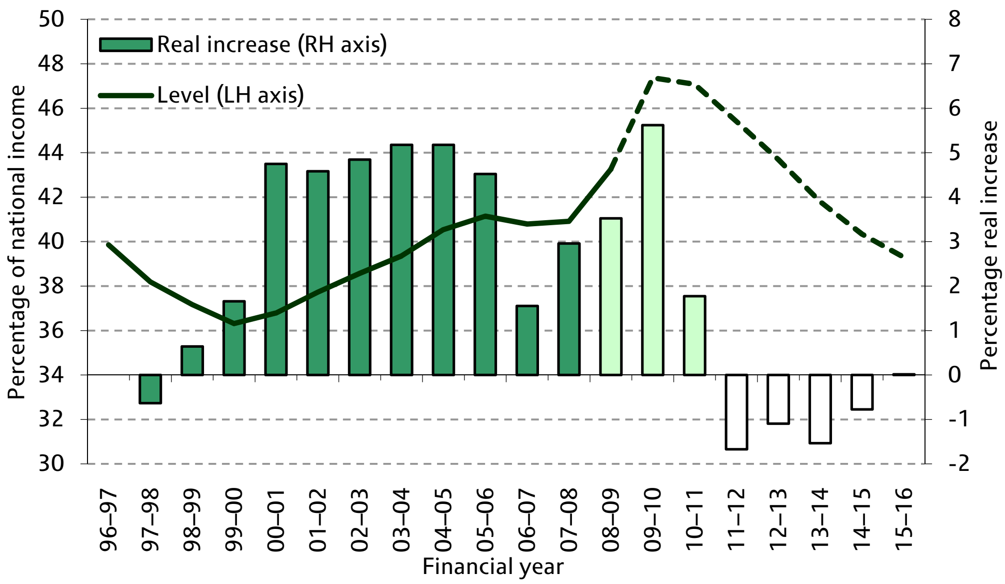
Growth in public spending under Labour

As shown in Figure 6.2, under the previous Labour government there were relatively large real increases in total public spending in most years: growth in spending exceeded 4% a year in real terms in each year from 2000–01 to 2005–06. The spending plans for 2008–09, 2009–10 and 2010–11 were set in the 2007 Comprehensive Spending Review (CSR). At the time of its publication, this set out a tighter settlement than those made since 2000–01, with real growth in TME planned to average just 2.0% a year. Had the economy followed the path forecast by the Treasury at the time, this would have led to public spending falling as a share of national income.

But the actual real increase in TME over this period was much greater. Most spending on public services had been set in cash terms, so when inflation turned out to be lower than expected, real-terms spending was correspondingly higher; in addition, cash spending on social security benefits and debt interest payments was higher than expected as a result of the recession. The resulting increase in spending as a share of national income has been even more dramatic – increasing from 40.9% of national income in 2007–08 to

47.4% in 2009–10 – because the cash value of national income is now much lower than was previously forecast (reflecting both a shrinking real economy and lower-than-expected inflation). So, it would be fair to say that the increase in spending as a share of national income between 1999–2000 and 2007–08 was intended, but the increase that occurred between 2007–08 and 2010–11 was not.

Figure 6.2. Total Managed Expenditure



Notes: Light green bars represent the years covered by the CSR 2007. 2011–12 to 2014–15 are the years covered by the 2010 Spending Review. The figures for 2015–16 are based on the government's statement that TME will be held fixed in real terms between 2014–15 and 2015–16 (paragraph 4.81 of the OBR's November 2010 *Economic and Fiscal Outlook*); detailed spending plans for this year will not be set until the next Spending Review. Figures for 2007–08 to 2009–10 are on a basis that includes the temporary effects of financial sector interventions, while those for 2010–11 onwards are on a basis that excludes these.
Sources: Figures for TME are from table B1 of HM Treasury, *Public Sector Finances Databank*, 11 January 2011 (http://www.hm-treasury.gov.uk/d/public_finances_databank.xls). Figures for GDP and the GDP deflator are from HM Treasury (http://www.hm-treasury.gov.uk/data_gdp_fig.htm).

Two key subsequent changes to the original 2007 CSR spending plans were then implemented by the Labour government. First, some investment spending originally planned for 2010–11 was brought forward into 2009–10 as part of the fiscal stimulus package aimed at limiting the length and depth of the recession. Second, in order to reduce borrowing in 2010–11, planned investment spending in the National Health Service (NHS) in England was reduced. Both serve to reduce the growth rate of spending in 2010–11.

The fiscal consolidation under the coalition government

In order to bring public sector borrowing back down to a sustainable level, the government has planned a six-year fiscal consolidation package, which started in 2010–11. Of the £126 billion tightening that is planned by 2015–16, we estimate that 76% is to come from cuts to public spending. The resulting real changes in TME over the next five years (2011–12 to 2015–16) are shown by the white bars in Figure 6.2. Over this period, TME will fall in real terms by an average 1.0% a year, which will make it the tightest five-year period for public spending since at least the Second World War. As a share of national income, public spending will peak in 2009–10 at 47.4%, before being brought down to 39.3% by 2015–16, which is around the same level of public spending as a share of national income as was last seen in 2003–04.

An international comparison

The rapid increase in UK public spending as a share of national income that occurred as a result of the financial crisis and recession was not unique. Among 29 advanced economies (listed in the note to Table 6.1), the UK had the 5th largest increase in government spending between 2007 (i.e. pre-crisis) and 2010, but this only moved the UK from being the country with the 16th highest level of government spending (as a share of national income) to the 14th highest. Table 6.1 also shows that the government's planned cuts to spending between 2010 and 2015 are the 3rd largest, smaller than only those of Iceland and Ireland. The IMF's forecasts suggest this would result in the UK seeing the 9th smallest increase in government spending as a share of national income between 2007 and 2015, and maintaining its mid-table position with the 19th highest level of government spending in 2015.

Table 6.1. General government expenditure as a share of national income in the UK compared with 28 other advanced economies

	UK rank	Notes
General government expenditure		
Level		
2007 (pre-crisis)	Equal 16th highest	
2010	14th highest	
2015	19th highest	
Change		
Increase, 2007 to 2010	5th largest	Ireland, Finland, Slovenia & Spain larger
Reduction, 2010 to 2015	3rd largest	Only Iceland and Ireland larger
Increase, 2007 to 2015	9th smallest	

Notes: Measure is general government expenditure as a percentage of GDP. The 28 advanced economies on which data comparable to the UK are available are: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hong Kong, Iceland, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Slovak Republic, Slovenia, South Korea, Spain, Sweden, Switzerland and the United States.
Source: Statistical table 5, page 121 of International Monetary Fund, 'Fiscal exit: from strategy to implementation', *Fiscal Monitor*, November 2010 (http://www.imf.org/external/pubs/cat/longres.cfm?sk=24220).

Spending on public services since 1948–49

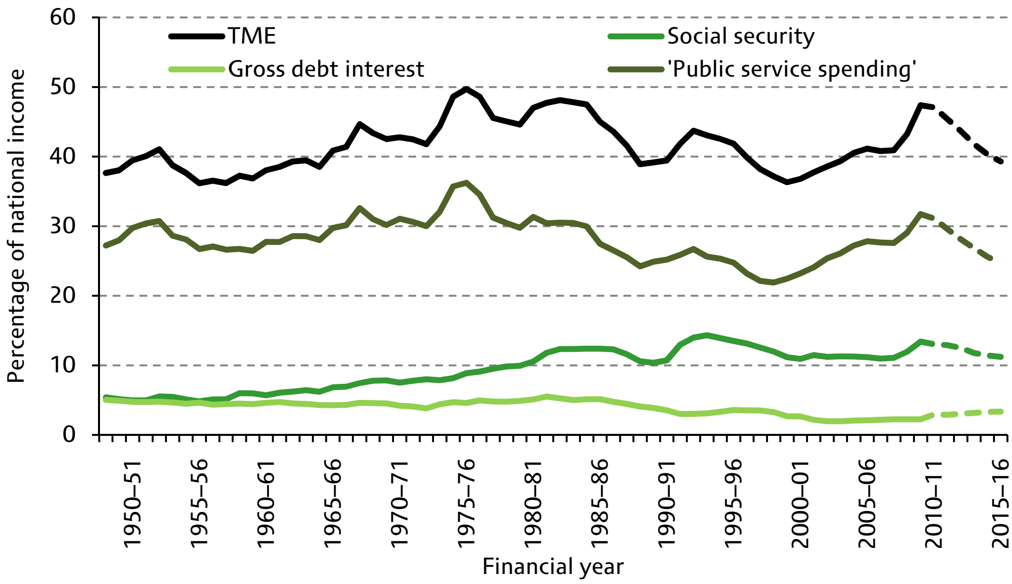
The composition of total public spending has changed somewhat over time. Figure 6.3 splits TME into three components of spending: social security, gross debt interest payments and a residual which we refer to as 'public service spending'.

Spending on debt interest payments was fairly stable at around 5% of national income until the late 1980s; it then fell gradually until the mid-2000s. Despite the rapid increases in public sector net debt over the last couple of years (from 36.5% of national income in 2007–08 to 53.6% in 2009–10), spending on debt interest payments is forecast to rise only slightly as a share of national income by 2014–15 as interest rates are expected to remain very low, by historical standards.

Spending on welfare payments (social security benefits and tax credits) rose steadily from the end of the Second World War to the early 1980s as the welfare state grew and the number of pensioners increased. Since then, it has fluctuated around 12% of national income, with higher spending during the last three recessions, and lower spending during the economic boom that occurred in the second half of the 1980s.

Public service spending as a share of national income has been much more volatile. It climbed to over 35% of national income in 1975–76, but then fell steadily to a post Second World War low of 22% in 1998–99. The decline in public service spending during the 1980s and 1990s was due to a combination of factors, including the sale of council homes, the privatisation programme, cuts to the defence budget (from 1983) and a fall in education spending as a share of national income. The Labour government reversed this trend, and the period from 1999–2000 to 2005–06 saw a deliberate increase in spending on public services, in particular school education, services for pre-school children and the NHS. In contrast (as mentioned above), the rapid increases in public service spending in 2008–09 and 2009–10 were more to do with unexpectedly low levels of national income than a policy decision to increase public service spending as a share of national income.

Figure 6.3. Composition of total public spending



Notes: Figures for spending on social security are 'public sector social benefits' for the years up to 2009–10, and total spending on social security benefits and tax credits forecast by the OBR in its November 2010 *Economic and Fiscal Outlook* thereafter. 'Public service spending' is the residual of Total Managed Expenditure less spending on social security and public sector gross debt interest. The government has said that between 2014–15 and 2015–16, TME will be held constant in real terms; figures for social security and debt interest spending in 2015–16 are OBR forecasts under unchanged policy. Figures for 2007–08 to 2009–10 are on a basis that includes the temporary effects of financial sector interventions, while those for 2010–11 onwards are on a basis that excludes these.

Sources: Historical data from ONS series ANLY, ANLT, ANNW, ANNZ and ANLO from table 2.3C of *Financial Statistics Freestanding Time Series Data* (http://www.statistics.gov.uk/statbase/tsdtimezone.asp). Forecasts are from Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2010* (http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html).

The plans set out by the government in the October 2010 Spending Review for the next four years imply public service spending declining rapidly as a share of national income, falling from 31.7% in 2009–10 back to 25.6% of national income in 2014–15, a level last seen in around 2002–03. Detailed spending plans for 2015–16 have not yet been set out, but the OBR forecasts for social security and debt interest spending suggest that, given the level of total spending that the government pencilled in for 2015–16 in the June Budget, public service spending would fall further to 24.7% of national income. If delivered, this would return public service spending as a share of national income to a level last seen in 2001–02.

6.3 Spending Review 2010

In October 2010, the government published the outcome of the long-awaited Spending Review, which set out government spending plans, the budgets of individual Whitehall departments, and grants to the devolved administrations for the four years 2011−12 to 2014−15. This section starts by setting out which government departments were relative winners and losers from this review, and highlights how the timing of the cuts varies between departments. We then discuss the settlements received by the devolved administrations and how each of the regions is choosing to prioritise its spending.

Allocations to Whitehall spending departments

Detailed plans for certain components of public spending were set out in the October 2010 Spending Review. This included all items of spending that are deemed to benefit either the UK as a whole or multiple regions of the UK, along with all spending that is deemed to benefit England alone. These items of spending are administered by Whitehall departments. The respective grants for the devolved administrations were calculated on the basis of these settlements for Whitehall departments. This subsection discusses the spending settlements for Whitehall departments, and the next subsection discusses the grants to the devolved administrations. As far as possible, we make clear in this subsection which components of Whitehall spending cover only England.

The size of spending cuts

The plans set out in the 2010 Spending Review imply that Departmental Expenditure Limits (DELs) – that is, annual limits for departmental programme expenditure – would, on average, be reduced from their 2010−11 level by 11.7% in real terms by 2014−15. Figure 6.4 shows how the pain of DEL cuts was shared out between Whitehall departments by describing how much higher or lower each department's total budget will be in 2014−15, in real terms, compared with its 2010−11 level. Table 6.2 additionally describes how much lower/higher their resource and capital budgets will be, and what proportion of the real change in their total budget over this period will be accounted for by changes in capital spending.

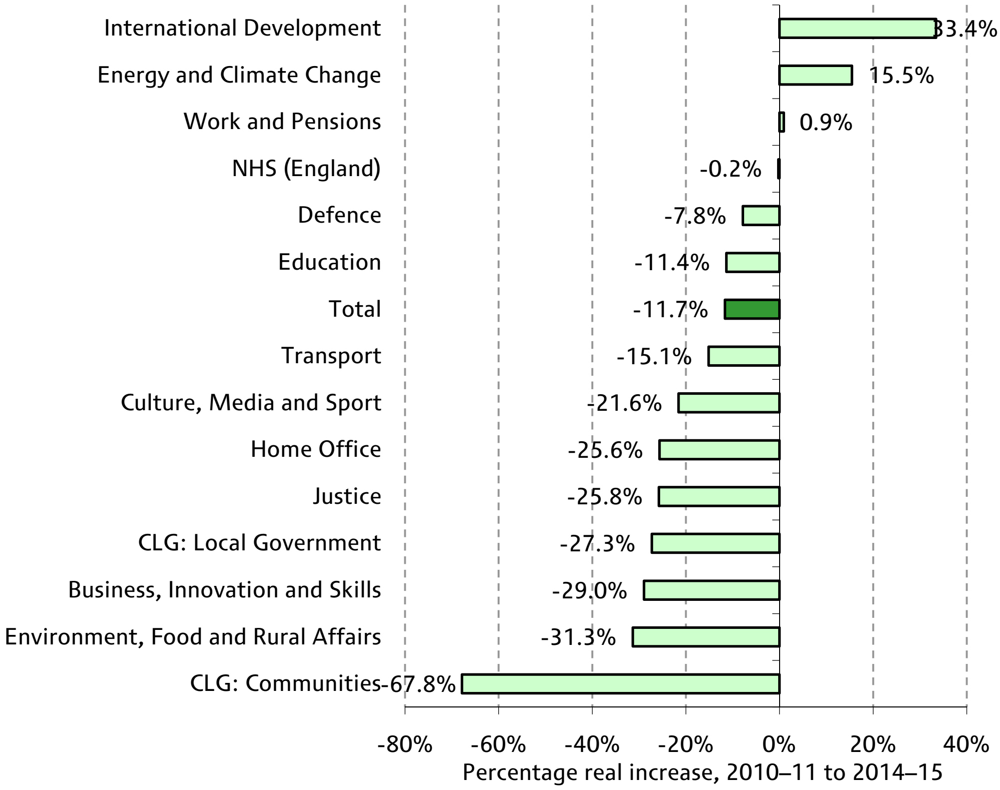
For many departments, a large part of their budget is spent on the pay of their employees. Implementing these spending cuts in the way that minimises the impact on the quality and quantity of public services is therefore likely to involve a combination of real cuts to pay levels and reductions in the size of the workforce. This is discussed in more detail in Chapter 7.

The undisputed winner from the Spending Review was the Department for International Development (DfID), whose budget will increase by one-third over the next four years. This is driven by the government's commitment to spend 0.7% of gross national income (GNI) on Official Development Assistance (ODA) by 2013.[3]

The Department of Energy and Climate Change (DECC) also fared relatively well and will see its budget increase by 15.5% in real terms by 2014−15. This is a result of a sharp

[3] All overseas aid spending is deemed to be for the benefit of the UK as a whole.

Figure 6.4. Spending changes, by department



Notes: Figures show the real-terms percentage change in the department's budget by 2014–15, from its 2010–11 level. Culture, Media and Sport excludes the 2012 London Olympics.
Sources: Authors' calculations using cash spending plans from HM Treasury, *Spending Review 2010* (http://www.hm-treasury.gov.uk/spend_sr2010_documents.htm) and GDP deflators from Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2010* (http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html).

(43.7%) increase in its budget for investment spending to help reduce carbon emissions, through, for example, greater use of carbon capture and storage (CCS) technologies; the resource budget of the department will be cut by about one-quarter over the period.[4] (See Chapter 11 for a detailed discussion of environmental policy.)

At the time of the October 2010 Spending Review, the cash spending plans for the NHS in England implied that its budget would increase slightly faster than the economy-wide inflation that had been projected by the OBR alongside the June 2010 Budget. However, in its November 2010 publication, the OBR revised upwards slightly its forecast for economy-wide inflation. As a result, the latest projections suggest that the NHS in England will see a slight decline in its budget, after economy-wide inflation, over the course of this parliament. Were the planned levels of cash spending and the forecast economy-wide inflation to occur, the government would not have met its pledge to increase spending on the NHS in real terms each year over the next four years.[5] But the

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[4] About one-fifth of DECC's programme spending is devolved to Scotland, Wales and Northern Ireland (http://cdn.hm-treasury.gov.uk/sr2010_fundingpolicy.pdf).

[5] Section 22 of HM Government, *The Coalition: Our Programme for Government*, 2010 (http://www.direct.gov.uk/prod_consum_dg/groups/dg_digitalassets/@dg/@en/documents/digitalasset/dg_187876.pdf). Note that the government's pledge to increase spending on the NHS in real terms is defined relative to economy-wide inflation, not NHS-wide inflation. To the extent that these are different (e.g. because wage inflation or the increases in drug prices, to which the NHS is particularly susceptible, are higher or lower than economy-wide inflation), the government's pledge may be met (or missed) even if spending on the NHS increases by less (or more) than NHS-specific inflation.

Table 6.2. Spending changes by department: resource and capital

Department	Real increase 2010–11 to 2014–15: % total budget	% resource budget	% capital budget	Proportion of change from capital
International Development	+33.4	+35.0	+13.1	8.1%
Energy and Climate Change	+15.5	–24.6	+43.7	*
NHS (England)	–0.2	+0.8	–18.4	*
Defence	–7.8	–5.3	–8.4	28.1%
Education	–11.4	–4.0	–59.5	68.2%
Transport	–15.1	–18.5	–11.8	47.0%
Culture, Media and Sport	–21.6	–21.6	–54.7	33.9%
Home Office	–25.6	–22.8	–43.4	13.4%
Justice	–25.8	–20.8	–54.7	14.3%
CLG: Local Government	–27.3	–27.3	–	-
Business, Innovation and Skills	–29.0	–15.9	–49.7	16.6%
DEFRA	–31.3	–27.6	–39.7	26.2%
CLG: Communities	–67.8	–48.8	–73.4	81.8%
Total	**–11.7**	**–8.1**	**–29.5**	**34.5%**

Notes: * indicates that the change in the capital budget is greater than the total tightening. Culture, Media and Sport excludes the 2012 London Olympics. Resource spending includes depreciation; capital spending figures refer to gross capital spending.
Sources: As Figure 6.4.

Prime Minister, David Cameron, has stated that 'We are not breaking that promise. We want to see NHS spending increase by more than inflation every year'.[6] This suggests that he wishes to find more money for the NHS between now and 2014–15. The Spending Review left £3.3 billion of department spending in 2011–12 unallocated (known as the DEL reserve), some of which could be used to top up spending on the NHS if the government wished to do so. However, it is not clear that giving the money to the NHS in light of higher-than-expected economy-wide inflation is the best use of this reserve (not least because other government departments could also see the purchasing power of their planned cash spending allocation reduced by the higher-than-expected level of economy-wide inflation).

The Ministry of Defence (MoD) and the Department for Education (which provides education services in England only) were also relative winners, in that they will see less than the average cut experienced across departments over the next four years. The MoD settlement was reached after the Strategic Defence and Security Review, published just before the Spending Review in October 2010.[7] This set out the defence and security pressures facing the UK over the coming years and how these could be handled within a constrained budget. It included proposals to cut substantial assets from all three of the armed forces – such as the decommissioning of the navy's flagship (HMS Ark Royal),

[6] Hansard, 15 December 2010, column 902 (http://www.publications.parliament.uk/pa/cm201011/cmhansrd/cm101215/debtext/101215-0001.htm#10121530000010).

[7] HM Government, *Securing Britain in an Age of Uncertainty: The Strategic Defence and Security Review*, Cm 7948, 2010 (http://www.direct.gov.uk/prod_consum_dg/groups/dg_digitalassets/@dg/@en/documents/digitalasset/dg_191634.pdf).

reducing the number of Challenger 2 battle tanks by 40%, and removing Harrier jets from service in 2011.[8]

Over two-thirds of the cuts to education spending in England are accounted for by cuts to capital spending; the resource budget of the department will be cut by just 4% by 2014–15, but the capital budget will be cut by 60%. The cut to capital spending will largely be achieved by the government's decision to scale back substantially school refurbishment and building programmes, while the government has chosen to ensure that, on average, schools' resource spending per pupil is not cut in cash terms.[9]

The Department for Transport (which provides transport services to England and is also responsible for the rail network in Wales and a limited number of UK-wide functions, such as the Maritime and Coastguard Agency) fared relatively well for a capital-intensive department, with a real cut to its total budget of 15.1% by 2014–15.

Both the Home Office and the Ministry of Justice – which are responsible, among other things, for policing, prisons and the courts in England and Wales, and for UK immigration – will see their budgets cut by around one-quarter. The Department for Business, Innovation and Skills (whose main remit areas include higher education and skills training in England and funding for the UK-wide research councils) will also see a relatively large cut, of 29.0%, to its budget over the next four years, which will predominantly be delivered by a dramatic change in the way in which teaching in higher education institutions in England is funded – shifting the burden from the taxpayer to future graduates.[10] The Spending Review indicated that higher education non-investment spending would be cut by 40%, including very deep cuts (of the order of around 80%) to higher education teaching budgets, by 2014–15.[11]

The biggest loser from the Spending Review was the Communities budget of the Department for Communities and Local Government (DCLG).[12] This is mostly due to cuts to spending on social housing in England: the department's capital budget will be cut by nearly three-quarters by 2014–15 (a cut in cash terms from £6.8 billion in 2010–11 to £2.0 billion in 2014–15), accounting for over 80% of the overall cut to the Communities budget.

The Local Government budget of DCLG is also forecast to see a relatively large real cut, of 27.3% by 2014–15. The picture for local authorities in England, however, is not as bleak as this perhaps suggests. Local authorities also have spending financed from their council tax revenues, which is under their direct control and unlikely to fall to the same extent.

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[8] For analysis of the Strategic Defence and Security Review, see M. Codner and M. Clarke (eds), *A Question of Security: The British Defence Review in an Age of Austerity*, I. B. Tauris, London, 2011 (http://www.rusi.org/publications/rusibooks/ref:O4CBD5CE6D4EEA/).

[9] For a discussion of variation in per-pupil spending changes, see L. Sibieta, 'Pupil premium: simple and transparent financial incentive', IFS Observation, December 2010 (http://www.ifs.org.uk/publications/5371).

[10] An analysis of the government's higher education reforms can be found in H. Chowdry, L. Dearden and G. Wyness, *Higher Education Reforms: Progressive but Complicated with an Unwelcome Incentive*, IFS Briefing Note 113 (http://www.ifs.org.uk/publications/5366).

[11] Page 44 of the Browne Review of Higher Education Funding shows the teaching grant falling from £3.5 billion to £0.7 billion, which would equate to an 82% cut in real terms if it occurred between 2010–11 and 2014–15 (http://www.bis.gov.uk/assets/biscore/corporate/docs/s/10-1208-securing-sustainable-higher-education-browne-report.pdf).

[12] The DCLG is unique in that it has two separate DELs. The 'CLG: Local Government' DEL includes Revenue Support Grant, national non-domestic rates, and related grants to local authorities in England that support services that are typically overall the responsibility of other government departments (such as police and social services). The 'CLG: Communities' DEL includes the department's main programme expenditure and administration costs; most of this expenditure is deemed to benefit England only.

Box 6.1. Changing priorities: composition of public service spending over time

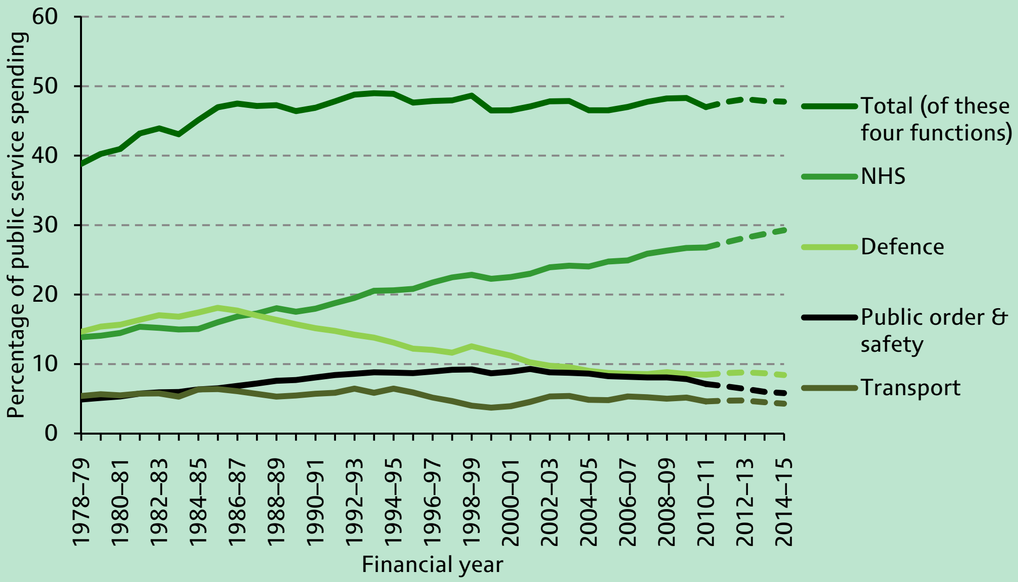
Figure 6.5 shows how current government spending priorities compare with those over the last 30 years, by considering how the proportion of public service spending in four key areas (the NHS, defence, public order and safety, and transport) has changed over time and is forecast to change over the next four years.

The relative protection afforded to the NHS by the government is consistent with the priorities of recent governments. The NHS accounted for a steadily increasing proportion of public service spending from 1984–85, when it was just 15.0%, reaching 26.8% in 2010–11. Our estimates suggest that it could reach nearly 30% in 2014–15.

The increase in the proportion of public service spending on the NHS has been largely matched by a decline in the percentage accounted for by defence spending – down from a high of 18.1% in 1985–86, to a forecast 8.4% in 2014–15. The proportion of public service spending on public order and safety is forecast to continue (although slightly more rapidly) the gradual decline that began in the 2000s, and the proportion spent on transport is also forecast to fall slightly. The total proportion of public service spending going on in these four areas has remained fairly steady since the mid-1980s, at around 47–48%, and is forecast to continue to do so.

The significant area of spending omitted from Figure 6.5 is education spending. Unfortunately, in a departure from the practice of previous Labour spending reviews, the Treasury has not published an estimate of total UK education spending (or even total education spending in England) and – unlike for the other areas of spending – we do not feel we can confidently make an estimate given the available information.

Figure 6.5. Composition of public service spending



Notes: Total public service spending is calculated as in Figure 6.3. Forecasts for spending by function are constructed as follows: assume NHS spending in England remains 84% of total UK NHS spending; assume the Department for Transport's DEL budget remains 60% of total UK transport spending; assume defence spending is the sum of the DEL budgets of the Ministry of Defence, the Security and Intelligence Agencies and the Special Reserve; assume that the sum of the DEL budgets of the Home Office, the Justice Department and the Law Officers' Departments remains 60% of total UK spending on public order and safety.

Sources: Figures for total public service spending as Figure 6.3. For historical spending by function, see http://www.ifs.org.uk/ff/lr_spending.xls. Forecasts are authors' calculations based on the 2010 Spending Review (http://www.hm-treasury.gov.uk/spend_index.htm) and HM Treasury, *Public Expenditure Statistical Analyses 2010* (http://www.hm-treasury.gov.uk/pespub_pesa10.htm).

Indeed, Treasury figures from the Spending Review indicate that total spending by local authorities in England will fall by only 14% in real terms between 2010–11 and 2014–15.[13]

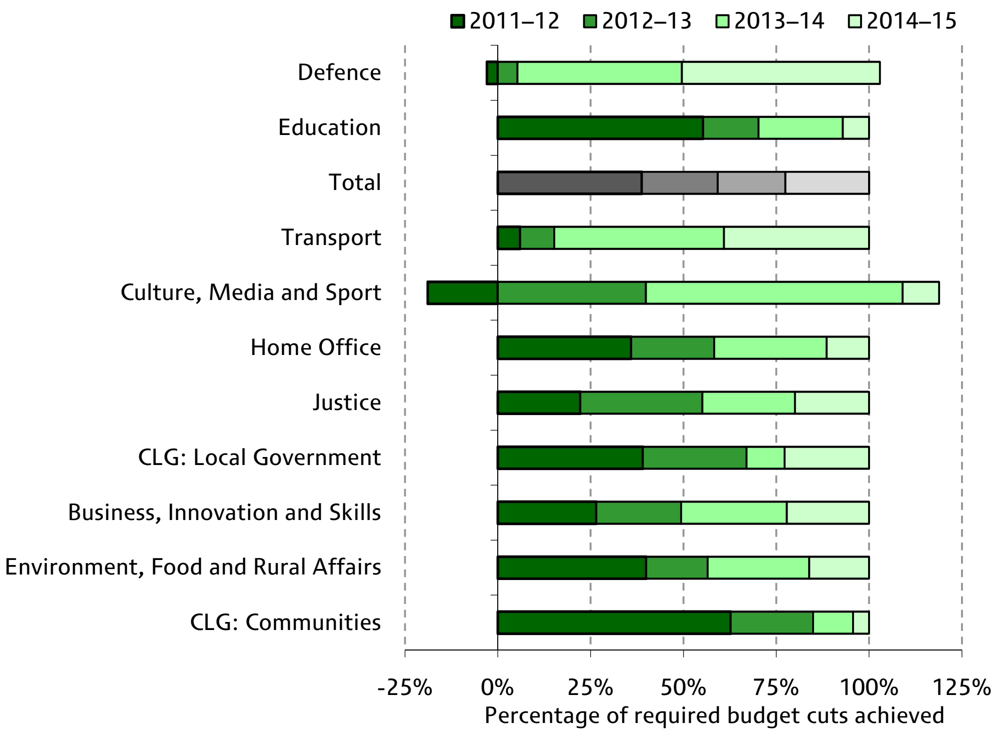
The relative protection of health spending continues a long-term trend for NHS spending to constitute an ever-increasing share of total public spending. This and other longer-term trends in the composition of public spending are briefly discussed in Box 6.1.

The timing of spending cuts

The plans set out in the Spending Review do not imply the same growth rate for departments' budgets each year between 2011–12 and 2014–15. DfID, for example, is set to receive most of its budget increase in 2013–14; this is consistent with the government meeting its target for ODA spending in 2013 without putting pressure on other departments' budgets in the previous two financial years. DECC will see most of its budget increase in 2012–13; the major new spending commitment that DECC has is to build a commercial-scale CCS demonstration plant, for which the contract is not planned to be awarded until December 2011.

Figure 6.6 shows the profile of the spending cuts over the next four years for the main departments experiencing cuts. If the profile were completely smooth, 25% of the required budget cuts would be achieved in each of the four years. If less than 25% of the required cuts are achieved in 2011–12, or less than 50% achieved during 2011–12 and 2012–13, then the cuts are 'back-loaded': in other words, the budget cuts are delayed towards the end of the period. Conversely, if more than 25% is done in the first year, or more than 50% in the first two years combined, then the cuts are 'front-loaded' and the

Figure 6.6. Time profile of departmental spending cuts



Notes: Departments are ordered by increasing size of real budget cut (from top to bottom), as in Figure 6.4.
Sources: As Figure 6.4.

[13] Table 1 of the 2010 Spending Review (http://www.hm-treasury.gov.uk/spend_sr2010_documents.htm).

department's budget is being cut more at the beginning of the period. The bar for total departmental spending shows that, overall, the departmental cuts are front-loaded, with nearly 40% of the total tightening being achieved in the first year. The rest of the tightening is achieved fairly evenly across the remaining three years.

The cuts to Education and CLG Communities are very front-loaded: in both cases, more than half of their total budget cut is set to occur in 2011–12. These two departments have the majority of their budget cuts coming from cuts to capital spending (68.2% and 81.8% respectively). It is perhaps relatively easy to cut capital spending quickly simply by no longer going ahead with previously planned (but not yet commissioned) capital projects. CLG Local Government also has its cuts front-loaded.

The MoD and Department for Transport, by contrast, have their budget cuts very back-loaded, and are set to experience only relatively small real cuts to their budgets before 2013–14. The armed forces are currently deployed in overseas conflict, and so budget cuts that reduce the capabilities of the armed forces would be particularly difficult to implement before these activities have been reduced. The Department for Transport is capital intensive, but the nature and scale of its investment projects might mean that many of those for 2011–12 are already under way and therefore less appropriate to cut back; the government's investment in Crossrail is perhaps the most high-profile example.

Public spending in Scotland, Wales and Northern Ireland

The total spending budgets of the devolved administrations depend on the spending decisions made by the UK government, as set out in the previous subsection, but the devolved administrations have considerable leeway over how to spend their budgets and they need not adhere to the same priorities as chosen for England. Therefore, the cuts to many areas of public spending just described refer to spending in England only.

We now turn to examine how the budget allocations to the devolved administrations are determined, what the 2010 Spending Review settlement for each of the nations is, and how the devolved administrations are planning to spend their budgets. Where possible, we provide comparisons across the nations, though this is difficult in many cases.

Allocating resources to the nations: the Barnett formula

The devolved administrations in Scotland, Wales and Northern Ireland are funded largely through block grants from the Treasury; it is then up to the administrations to decide how this funding is allocated to different public services and departments (except for a small number of exceptional items that are ring-fenced by Whitehall).

Changes in (but not the levels of) the Treasury-assessed DEL for the devolved administrations are determined by the Barnett formula (the levels of spending are determined by the levels of spending that existed before the introduction of the Barnett formula). The formula is designed to apply the same pounds-per-head change in 'comparable' (a term we define below) English spending automatically to Scotland, Wales and Northern Ireland.[14]

[14] For example, if there is a £1 billion cash increase in comparable English spending, the Scottish government would see a £100.3 million increase in its block grant, the Welsh Assembly government a £57.9 million increase and the Northern Ireland Executive a £34.5 million increase, since the populations of Scotland, Wales and Northern Ireland are 10.03%, 5.79% and 3.45% of the English population (respectively) according to the mid-2009 population estimates (http://www.statistics.gov.uk/statbase/product.asp?vlnk=15106). The level of spending per head is higher in the devolved administrations than in England; hence one of the implications of the Barnett formula is that, as cash spending per head in England rises (falls), spending levels per capita will converge (diverge) across the UK. This is termed the 'Barnett squeeze'.

Box 6.2. Calculating the changes in the devolved governments' DELs

Not all functions of the various departments in Whitehall are devolved to Scotland, Wales and Northern Ireland, and the functions that are devolved vary by nation. To take account of this, the various sub-programmes of each department are given a weight that reflects whether the function is fully devolved (100%) or not devolved (0%). For example, the Rail Network Grant is devolved to Scotland and Northern Ireland (so is given a weight of 100% for these nations), but not devolved at all to Wales (so is assigned a 0% weight). A weighted sum of the individual percentages for each departmental sub-programme is used to calculate an overall percentage of a department's expenditure that is devolved; this will vary by nation. This departmental average is used to determine how changes in Whitehall departmental spending affect grants to the devolved administrations. For transport, for example, the overall percentages for the Department for Transport are 100% for Northern Ireland, 98.0% for Scotland and 73.1% for Wales. Therefore a £1 per head increase in the budget of the Department for Transport would boost grants to Northern Ireland by £1 per head, Scotland by 98p per head and Wales by 73.1p per head. A list summarising the areas (called comparable functions) devolved to each of the nations can be found in the Spending Review's supporting documents.[a]

Changes in grants to the devolved administrations are calculated using departmental average percentages because changes at the level of the sub-programme are generally not known at the time grants are determined (i.e. at the Spending Review). If all sub-programmes see their spending change by the same proportion, then using the departmental average generates an appropriate change in grants to the devolved administrations to cover comparable functions. However, if the proportional changes in spending differ by sub-programme, then the changes in funding for the devolved administrations may not reflect the changes in the amount spent on comparable functions in England.

The October 2010 Spending Review provides a fairly extreme example of this. Overall, the Local Government (LG) portion of the budget for DCLG was cut in the Spending Review by 19.6% in cash terms (equivalent to the 27.3% real-terms cut mentioned in Figure 6.4). The largest sub-programme of this is national non-domestic rates payments (comprising 82.7% of the budget). Because this tax is fully devolved to Scotland and Northern Ireland, and is set and collected by these devolved administrations, one would not want changes in non-domestic rates revenues in England to generate changes in grants to the devolved administrations. For this reason, Scotland and Northern Ireland are given a weight of 0% for this item. In contrast, non-domestic rates are not fully devolved to Wales so the item is given a weight of 100%. This translates into the overall weight for DCLG:LG budget changes being 17.3% for Scotland and Northern Ireland but 100% for Wales.

At the sub-programme level, the overall cut to the DCLG:LG budget is made up of cash *increases* in national non-domestic rates payments, which are more than offset by cash cuts to other sub-programmes. Because the changes in grants to the devolved administrations are calculated at the department level, this means Scotland and Northern Ireland will see a cut of only 17.3% of the overall (19.6%) cash cut in DCLG:LG, rather than a combination of 0% of the increase from national non-domestic rates receipts and 100% of the larger cash cut to other sub-programmes, which together would have resulted in a much larger cut.

As a result, Scotland and Northern Ireland will receive approximately £400 million and £150 million, respectively, more a year by 2014–15 than if the Barnett formula were applied at the sub-programme level within the DCLG:LG budget. Given that forecasts are already made for non-domestic rates revenue, it is feasible, and almost certainly fairer, to apply the Barnett formula in this instance separately for the DCLG:LG spending from non-domestic rates payments (using a 0% weight) and the other programmes covered by DCLG:LG (using a 100% weight) when calculating how much the Scottish and Northern Irish budgets should be affected by changes in the DCLG:LG budget.

a. See page 15 and annex B of HM Treasury, *Funding the Scottish Parliament, National Assembly for Wales and Northern Ireland Assembly: The Statement of Funding Policy*, 2010 (http://cdn.hm-treasury.gov.uk/sr2010_fundingpolicy.pdf).

The Barnett formula is applied to changes in 'comparable' English spending: that is, spending in England on functions that are devolved to Scotland, Wales and Northern Ireland. It is, therefore, not applied to any changes in spending by Whitehall departments that is deemed to benefit the whole of the UK (for example, defence), and, for a given nation, it is not applied to increases in spending on functions that are not devolved to that nation since spending by Whitehall will cover both England and that nation (for example, changes to spending on benefit administration by the Department for Work and Pensions (DWP) affect only Northern Ireland, as DWP's spending covers England, Scotland and Wales).[15] Because many Whitehall departments fund a mix of programmes – some of which are devolved and others not – calculating how much funding should be given to the devolved governments is not as simple as might be expected; this is discussed in more detail in Box 6.2.

The Barnett formula was intended to be a temporary solution, in place until a formula that went beyond population weighting and paid more attention to the differing needs of the various parts of the UK could be designed and agreed.[16] Despite the Conservative Party stating that it was committed to a review of the needs of the nations[17] and the Liberal Democrat 2010 election manifesto[18] pledging replacement of the Barnett formula, the UK government currently has no plans to reform this system. Perhaps unsurprisingly – given that Wales is thought to lose from the status quo while Scotland and Northern Ireland are thought to benefit – the Welsh Assembly government supports the

[15] Determining what spending counts as benefiting the whole of the UK involves an element of discretion that can lead to disagreements between the UK government and the devolved governments. For instance, all spending on the London 2012 Olympics (including that used for regeneration and transport in East London) is counted as UK-wide, so no additional money is provided to Scotland, Wales or Northern Ireland under the Barnett formula. Similarly, expenditure on the Royal Botanic Gardens in Kew (London) is counted as UK-wide, whilst spending on the Royal Botanic Garden in Edinburgh and the National Botanic Garden of Wales must be financed by the devolved administrations.

[16] Assessments of needs were conducted in 1979, 1993 and 2009 but were not acted upon (with the 1993 estimate unpublished until 2009). The most recent assessment of needs was the Holtham Commission on government funding for Wales, which found that Wales receives less and Scotland and Northern Ireland more than if a needs-based formula were used. See Independent Commission on Funding and Finance for Wales, *Fairness and Accountability: A New Funding Settlement for Wales*, 2010 (http://wales.gov.uk/docs/icffw/report/100705fundingsettlementfullen.pdf).

[17] This commitment was stated in an interview by Philip Hammond for the BBC (discussed at http://www.bbc.co.uk/blogs/davidcornock/2010/04/welsh_policies_fail_to_make_th.html) and set out in a similar pledge made by David Cameron at the launch of the Conservatives' Welsh manifesto (see http://tinyurl.com/cameron-barnett-wales).

[18] *Liberal Democrat Manifesto 2010* (http://network.libdems.org.uk/manifesto2010/libdem_manifesto_2010.pdf).

replacement of the Barnett formula, but the Scottish government would rather the Barnett formula be retained than reformed.[19]

Spending Review 2010: devolved administrations' allocations

Table 6.3 shows Treasury figures for DEL allocations to each of the devolved governments for each year between 2010–11 and 2014–15, and the cumulative real-terms cut relative to the 2010–11 baseline.[20] It should be noted that the DEL allocations are not the same as total departmental spending in the nations, as some spending by other central government departments covers England and Wales, Great Britain or the entire United Kingdom. In other words, the Welsh DEL budget is required to fund a different set of public services from the Scottish budget, which in turn covers different public services from the Northern Irish budget. In addition, this means it is not possible to compare changes in DEL grants to the devolved administrations with changes in DEL spending in England.

Table 6.3. Planned DEL allocations to the devolved administrations

Department	2010–11 £ billion	2011–12 £ billion	2012–13 £ billion	2013–14 £ billion	2014–15 £ billion
Scotland					
Resource DEL	24.8	24.8	25.1	25.3	25.4
Capital DEL	3.4	2.5	2.5	2.2	2.3
Total DEL	*28.2*	*27.3*	*27.6*	*27.5*	*27.7*
Real DEL cut relative to 2010–11	–	–5.6%	–6.6%	–9.4%	–11.1%
Wales					
Resource DEL	13.3	13.3	13.3	13.5	13.5
Capital DEL	1.7	1.3	1.2	1.1	1.1
Total DEL	*15.0*	*14.5*	*14.5*	*14.5*	*14.6*
Real DEL cut relative to 2010–11	–	–5.7%	–7.7%	–10.1%	–11.9%
Northern Ireland					
Resource DEL	9.3	9.4	9.4	9.5	9.5
Capital DEL	1.2	0.9	0.9	0.8	0.8
Total DEL	*10.5*	*10.3*	*10.3*	*10.3*	*10.3*
Real DEL cut relative to 2010–11	–	–4.3%	–6.4%	–8.8%	–11.2%

Notes: Real DEL cuts relative to 2010–11 refer to cumulative real-terms reductions in DELs between the 2010–11 baseline and any given year.
Sources: Authors' calculations using the 2010 Spending Review (http://www.hm-treasury.gov.uk/spend_sr2010_documents.htm) and GDP deflator forecasts from Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2010* (http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html).

[19] See http://wales.gov.uk/newsroom/improvingpublicservices/2010/100525spending/?lang=en and page 97 (of the PDF) at http://www.publications.parliament.uk/pa/ld200809/ldselect/ldbarnett/139/139.pdf: 'If you are saying to me would I prefer to go from where we are just now to a needs-based formula, I think we are better to stay with where we are'.

[20] As explained in the previous subsection, changes to the DELs for the devolved administrations were determined in the 2010 Spending Review using the Barnett formula and the UK government's decisions on spending on Whitehall departments.

The next three subsections consider the spending decisions that have been made by the devolved administrations in Scotland, Wales and Northern Ireland respectively. Where possible, comparisons are made between countries. However, this is not an easy task, for two reasons. First, departmental structures are different in the different nations. For example, higher education is funded through the Department for Business, Innovation and Skills in England, but is part of the education departments in the other nations. Second, information on future spending plans in Scotland and Wales is less complete than in England: Wales has produced draft plans until 2013–14, and Scotland only for 2011–12. Northern Ireland, like the UK government, has plans up to 2014–15.

Spending in Scotland

The block grant from Whitehall for services managed or funded by the Scottish government is to be cut in real terms by 11.1% between 2010–11 and 2014–15 (made up of a 7.3% cut in current expenditure and a 38.8% cut in capital expenditure), as shown in Table 6.3. Table 6.4 shows the Scottish government's planned DELs by department for 2011–12, the only year for which a detailed budget has been produced.

Table 6.4. Planned departmental expenditure limits in Scotland

Department	2010–11 £ million	2011–12 £ million	% change (real terms)
Other Health & Wellbeing portfolio	581	486	–18.3%
Justice	1,435	1,267	–13.8%
Finance & Sustainable Growth	2,473	2,219	–12.5%
Administration	262	236	–12.1%
Rural Affairs & the Environment	594	539	–11.5%
Office of the First Minister	280	255	–11.1%
Education and Lifelong Learning	2,715	2,481	–10.8%
Crown Office & Procurator Fiscal	118	108	–10.7%
Local Government	9,585	9,046	–7.9%
Scottish Parliament & Audit Scotland	99	96	–5.2%
Health	11,082	11,272	–0.8%
Total	29,224	28,007	–6.5%

Notes: The 6.5% real-terms cut reported here is larger than the 5.6% reported in Table 6.2 because the Scottish government has decided to delay the in-year cuts made by the Treasury in 2010–11 until 2011–12. Furthermore figures for total DELs do not correspond to those in the 2010 Spending Review as the Scottish Budget includes an over-allocation of £100 million per year.
Sources: Scottish Draft Budget 2011–12, http://www.scotland.gov.uk/Publications/2010/11/17091127. GDP deflator forecasts from Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2010* (http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html). Authors' calculations.

The largest department – the Department of Health – is, as in England, a relative winner, suffering by far the smallest cut in real expenditure. The only other departmental budget seeing smaller-than-average cuts is the budget for the Scottish Parliament and Audit Scotland. Similar to England, spending on each of housing and regeneration (within the Wellbeing portfolio), justice, and further and higher education (within the Education and Lifelong Learning portfolio) is being cut significantly (by 21.3%, 13.8% and 14.2% respectively, in real terms).

At present, Scottish students and students from non-UK EU countries studying in Scotland do not make any contribution to the cost of their university education, though students from England, Wales and Northern Ireland pay £1,820 in fees per year. The Scottish government is now consulting on how best to increase universities' sources of revenue as it implements the significant cuts that it has announced for the higher education budget in 2011–12. A Green Paper has been published which outlines options, including the option of graduate contributions from Scottish students and higher fees for students from the rest of the UK.[21]

Central government grants to local authorities in 2011–12 are planned to be £11,548 million (£322 million of this coming from the budgets of other departments and £2,180 million from non-domestic rates revenue[22]), down from £11,986 million in 2010–11 (of which £324.5 million was from the budgets of other departments and £2,071 million from non-domestic rates revenue).[23] This represents a real-terms cut of 6.0%, slightly less than the average cut to DELs (but slightly higher than the cuts planned to overall spending managed by the Scottish government including Annually Managed Expenditure). The Scottish government has said that this settlement is more generous than the settlements given to English local authorities; it is true that it is a smaller percentage cut, but the local government budget in Scotland covers a broader range of functions than that in England. In particular, the local government budget in Scotland covers most spending on schools, spending that in England is counted as part of Department for Education spending, which faces smaller cuts than local government in 2011–12 (and over the Spending Review period as a whole).

Spending in Wales

The Welsh Assembly government's DEL (consisting of a grant provided by Westminster and non-domestic rates revenues) is due to be cut in real terms by 11.9% (consisting of a real-terms cut of 8.1% in current spending and 41.4% in capital spending), as shown in Table 6.3. The Welsh Assembly government presented a draft budget in November 2010 which included draft spending plans for the three years to 2013–14. Table 6.5 shows the planned DEL budgets by department.[24]

Planned spending cuts in Wales are distributed more equally across departments than in either England or Scotland. This is primarily because the Welsh government has chosen not to protect health from spending cuts: health spending is due to fall by 8.1% in real terms by 2013–14, compared with a fall of just 0.2% in England by this date (a fall which, as we discussed above, is arising only because estimates of economy-wide inflation have risen since the UK government set out cash spending plans for the NHS). This is an important policy difference, and, given the size of the health budget (41% of spending by the Welsh Assembly government in 2010–11), means that cuts in other departments are significantly smaller than they would be if the health budget were instead protected to the extent it is in England. For example, if the Welsh health budget were to be frozen in real terms, cuts to other departmental budgets of 16.9% would be required by 2013–14, rather than the 11.4% planned in the draft budget.[25]

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[21] Scottish Government, *Building a Smarter Future: Towards a Sustainable Scottish Solution for the Future of Higher Education*, 2010 (http://www.scotland.gov.uk/Resource/Doc/335256/0109656.pdf).

[22] Transfers to local government funded by non-domestic rates are counted as part of Annually Managed Expenditure in Scotland (and therefore do not appear in Table 6.4), whereas in England they are included in DCLG's Local Government DEL.

[23] As in England, the Scottish government threatened local authorities with larger cuts to their budgets if they did not agree to a council tax freeze.

[24] The draft budget is due to be revised on 1 February, after the Green Budget goes to print; the following figures are correct at the time of writing but may not be fully consistent with the revised budget plans.

[25] Perhaps surprisingly given the scale of these cuts, the Welsh Assembly government has maintained its commitment to free prescriptions and free hospital car parking for all.

Table 6.5. Planned departmental expenditure limits in Wales

Department	2010–11 £ million	2013–14 £ million	% change (real terms)
Public Services and Performance	70.4	57.0	–24.7%
Environment and Housing	801.7	678.1	–21.4%
Economy and Transport	973.7	846.9	–19.2%
Central Services and Administration	365.6	318.7	–19.0%
Heritage	157.6	147.0	–13.3%
Rural Affairs	143.3	133.9	–13.1%
Children, Education, Skills	1,878.0	1,849.0	–8.5%
Social Justice and Local Government	4,459.9	4,417.5	–8.2%
Health	6,170.8	6,101.1	–8.1%
Total	15,021	14,549	–10.0%

Notes: The % change (real terms) column refers to the cumulative real-terms change in departmental budgets between the 2010–11 baseline and 2013–14. Figures for total DELs do not correspond to those produced by the Treasury because the Treasury excludes non-cash items (such as depreciation) which are included in the figures constructed by the Welsh Assembly government.

Sources: Welsh Draft Budget 2011–12, http://wales.gov.uk/about/budget/draftbudget2010/?lang=en. GDP deflator forecasts from Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2010* (http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html). Authors' calculations.

The Department for Social Justice and Local Government and the Department for Children, Education, Lifelong Learning and Skills also see cuts of just over 8%. Within the latter department, spending on higher education and student support faces the largest cuts (12.8% in real terms), although these cuts are significantly smaller than those planned in England and Scotland; in Scotland, spending on higher education is due to fall by more in one year than in three years in Wales.

The Welsh Assembly government has chosen to implement a similar system of student fees, maintenance loans and grants, and loan repayment to England, with the exception that Welsh-domiciled students will continue to pay the current level of fees wherever they study in the UK. This means Welsh higher education institutions will be able to charge up to £6,000 per annum, or £9,000 per annum if they can demonstrate a commitment to widening access, but that Welsh students will pay only £3,290 per annum (in real terms). The income repayment threshold will increase to £21,000 for students who start their courses in September 2012 or later, with the real interest rate increasing with income as in England. Because the Assembly will pay part of the fees for Welsh-domiciled students, spending on student support is likely to rise, meaning that the cuts in teaching grants to universities will likely exceed the planned overall 12.8% real-terms cut in higher education spending.

Relative losers include the Economy and Transport department, particularly transport capital spending, which will fall by around 36% in real terms by 2013–14 as opposed to a cut of only 9.5% in the capital spending of the Whitehall Department for Transport by this date. The Environment and Housing department is also to see relatively large cuts, particularly the regeneration and housing budgets (which see real-terms cuts of 34% and 23%, respectively, by 2013–14), although by less than in England (where the Communities element of DCLG, which covers housing and large parts of regeneration spending in England, sees a real-terms cut of 65% by this date). The Public Services and Performances unit, which funds independent institutions such as Estyn (Wales's school inspectorate), and Central Services and Administration spending are also relative losers.

However, as we said above, the cuts to these relative losers are, in general, smaller than the cuts to the departments that are relative losers in Whitehall, because planned cuts to NHS spending in Wales mean smaller cuts are needed elsewhere.

Welsh Assembly government grants to local authorities (including redistributed non-domestic rates) are due to be £4,302 million in 2013–14, down from £4,309 million in 2010–11 – a real-terms cut of 7.2% over the three years. The Welsh Local Government Settlement contains detailed breakdowns of spending by function only for 2011–12, when there is to be an overall real-terms cut of 4.0%.[26] In addition to the Local Government Settlement, a further £487 million will be provided for capital investment to be managed by local authorities from the budgets of other departments, down from £568 million in 2010–11 (a real terms cut of 16.3%). This funding is to finance things such as housing maintenance, schools maintenance and transport investment.

The Welsh Assembly government compiles figures on the planned spending of local authorities, so it is possible to say more than we can about such spending than in England or Scotland. Including spending financed by council tax revenues (estimated at £1,096 million in 2011–12), but excluding the additional capital investment described above, Welsh local authorities are expected to distribute funding in 2011–12 as follows:

- Education spending is to be £2,181 million, down from £2,194 million (a real-terms cut of 3%). Within the education budget, spending on primary and nursery schools is due to rise from £947 million to £958 million, secondary school spending is due to fall from £813 million to £793 million, and special education spending to rise from £225 million to £232 million.
- Social services spending is to be £1,296 million, an increase from £1,267 million (a real-terms cut of 0.2%).
- Spending on roads and transport is to be £225 million, down from £231 million (a real-terms cut of 5.0%).
- Spending on the fire service is due to be £139 million, down from £155 million (a real-terms cut of 12.5%).
- Spending on other services and deprivation is due to be £957 million, up from £947 million (a real-terms cut of 1.4%).
- Spending on capital finance (repayments and interest) is due to be £302 million, down from £304 million (a real-terms cut of 3.1%).

Spending in Northern Ireland

The block grant provided by Westminster for services managed or funded by the Northern Irish Executive is to be cut in real terms by 11.2% by 2014–15 (as shown in Table 6.3), consisting of a real-terms cut of 7.5% in current spending and 39.7% in capital spending.[27] The Northern Ireland Executive has published draft spending plans for the four years to 2014–15.

Table 6.6 shows planned spending by department. Unlike for Wales and Scotland, the planned spending figures include resources raised from part of local domestic taxation

[26] For details, see http://wales.gov.uk/docs/dsjlg/publications/localgov/101123setkeytablen.xls.

[27] The Northern Ireland Executive is also able to borrow up to £200 million per year from the Treasury for capital spending under the Reinvestment and Reform programme, sums on which it pays interest.

(regional rates in the case of Northern Ireland), so the figures are not consistent with those published by the other nations of the UK.

Because of lumpy capital investment (or disinvestment) in 2010–11, the figures for the departments of Agriculture and Rural Development and the Environment should be interpreted with caution; the current budgets for these departments show real-terms cuts between 2010–11 and 2014–15 of 11.9% and 15.1%, respectively.

Like England and Scotland, the health budget is largely protected from cuts. Other relative winners include the Department of Culture, Arts and Leisure, the Department of Finance and Personnel, and the Office of the First Minister and Deputy First Minister, with all facing relatively small real-terms cuts. There are large cuts to the Northern Ireland Audit Office; Enterprise, Trade and Investment; the Northern Irish Assembly and Ombudsman; and the Department for Social Development (which has responsibility for, amongst other things, housing and the management of the benefits system[28]). Unlike England and Scotland, there is a larger cut to the department responsible for schools spending (Education) than to that responsible for further and higher education (Employment and Learning).

Table 6.6. Planned departmental spending in Northern Ireland (including DEL and that funded from regional rates)

Department	2010–11 £ million	2014–15 £ million	% change (real terms)
Environment	312.0	129.1	–62.5%
NI Audit Office	9.8	8.0	–26.1%
Enterprise, Trade & Investment	273.0	234.3	–22.3%
NI Assembly & Ombudsman	53.6	46.6	–21.3%
Social Development	790.7	713.7	–18.3%
Regional Development	1,073.5	1,012.8	–14.6%
Education	2,084.1	1,987.1	–13.7%
Food Standards Agency	9.7	9.3	–13.2%
Justice & Public Prosecution	1,341.4	1292.5	–12.8%
Authority for Utility Regulation	0.5	0.5	–9.5%
Employment & Learning	836.5	842.1	–8.9%
Finance & Personnel	198.1	209.3	–4.4%
Health, Social Services & Safety	4,504.6	4,792.5	–3.7%
OFMDFM	92.2	99.3	–2.5%
Culture, Arts & Leisure	173.2	188.8	–1.3%
Agriculture & Rural Development	51.4	248.3	337.2%
Total	11,804.3	11,814.2	–9.4%

Notes: The % change (real terms) column refers to the cumulative real-terms change in departmental budgets from the 2010–11 baseline to 2014–15. Figures for total departmental spending in each year do not correspond to DELs produced by the Treasury because they include spending financed by borrowing and revenue from the regional component of domestic rates (the Northern Irish equivalent of council tax).
Sources: Northern Ireland Draft Budget 2011–15, http://www.northernireland.gov.uk/index/budget2010.htm. GDP deflator forecasts from Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2010* (http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html). Authors' calculations.

[28] The expenditure figures for the Department of Social Development do not include expenditure on welfare benefits, which are funded directly by the UK Treasury.

The settlement for local authorities (called district councils) has yet to be determined. It should be noted that district councils in Northern Ireland have significantly fewer responsibilities than local authorities in Scotland and Wales. In particular, they are not responsible for education and library services (which are handled by regional education and library boards) or social services (which are managed by health and social service trusts).

Summary

Spending Review 2010 announced that overall departmental spending will be cut by 11.7% in real terms over the period from 2010–11 to 2014–15. However, the spending cuts that were announced were not equally divided across the functions of government. Overseas aid spending will increase substantially over the next four years, in order to meet international commitments. In England, Scotland and Northern Ireland, health spending is, unlike most other departments, protected from deep cuts, though in Wales it is set to experience a larger cut than in the other regions. Meanwhile, spending on higher education teaching and social housing, for example, is – across most regions of the UK – to experience relatively large cuts.

6.4 Did previous spending cuts go to plan?

One key risk to the future strength of the public finances is that the government is not able to deliver the planned squeeze on public spending.[29] This risk could materialise in at least three different ways:

- the government might not be able to pass the legislation required to introduce a cut through parliament;
- a change to the delivery of public services might not bring about the spending reduction that is expected;
- the quality and quantity of public services delivered might be lower than the government – or voters – are prepared to tolerate and the government might choose, or be forced into, revising its plans.

This section therefore looks back to the mid-1990s, the last time a UK government tried to cut public spending substantially, to see what lessons this experience can teach us.

Public borrowing increased dramatically during the recession of the early 1990s. Discretionary tax cuts and spending giveaways in the Conservative government's Budget immediately preceding the 1992 general election further worsened the state of the public finances, but after being returned to power in 1993, the government announced a large fiscal tightening, of which about half was planned to come from restraining the growth of public spending.[30] Between Autumn 1991 and Autumn 1992, the government had revised

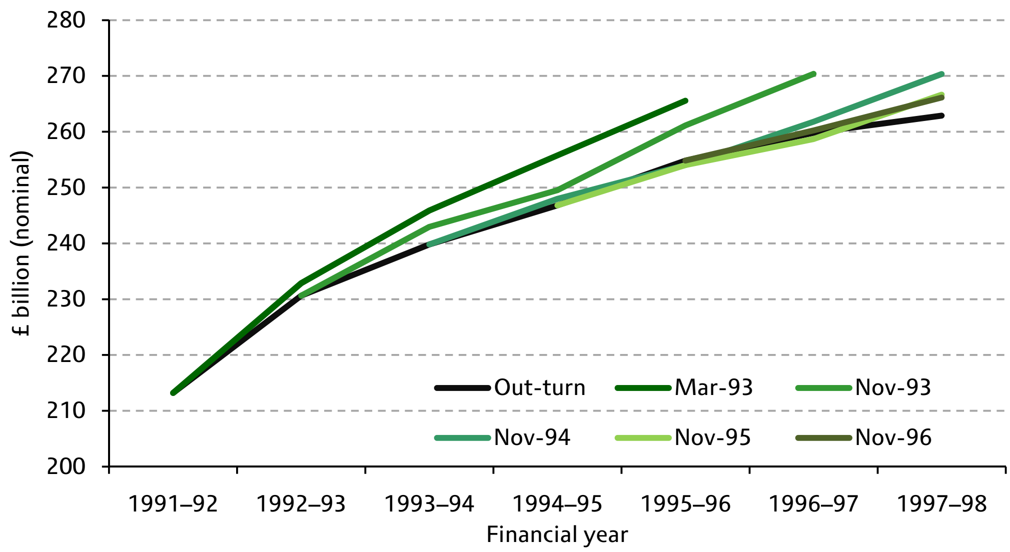
[29] Other key risks to the strength of the public finances are that economic growth turns out to be weaker than expected or that – even with the expected level of growth – the economy nonetheless generates lower tax revenues than expected. These are discussed and quantified in Chapter 2. The outlook for the economy is discussed in Chapters 1 and 4, while Chapter 5 sets out alternative forecasts for tax revenues and borrowing.

[30] The Chancellor at the time, Norman (now Lord) Lamont, has since written 'My second budget was on the eve of the 1992 election, which put one in an impossible position. It was the most political of all my budgets, and it completely wrong-footed Labour, who were not sure whether to oppose or support a low rate band, because of its appearance of help for the lower paid. Looking back on it, it was not a very good budget. But it did help us to win the 1992 election. My next budget, my third budget, helped to lose the 1997 election for the Conservatives, but it was definitely my best budget' (pages 149–150 of Lord Lamont, 'Out of the ashes', in H. Davies (ed.), *The Chancellors' Tales*: *Managing the British Economy*, Polity Press, London, 2006).

down its planned growth in spending, but it was not until the November 1993 Budget – then Chancellor Ken Clarke's first – that a significant real-terms cut in spending was planned (for 1994–95).

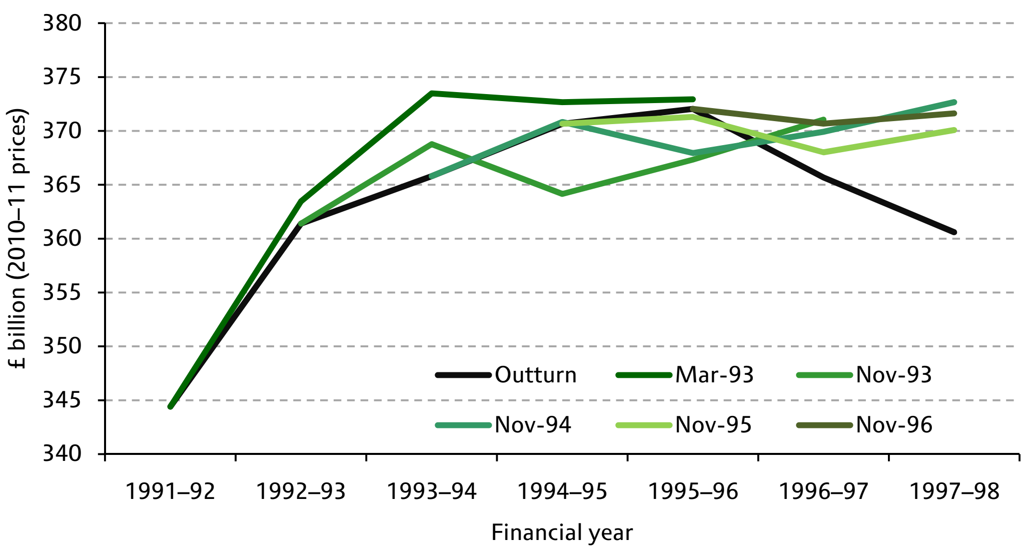
Figure 6.7 shows the out-turn for the New Control Total, the measure of public spending targeted by the then government, and how this compares with the plans set out in various Budgets over the period. The government was actually very successful at meeting its cash spending plans over this period, in many cases actually underspending relative to what had been planned.

Figure 6.7. Control Total: plans and out-turn, nominal terms



Note: Figures for each Budget 'plan' show the nominal growth planned in each statement, applied to the actual out-turn for spending in the relevant base year.
Sources: Out-turn data are from HM Treasury, *Public Expenditure Statistical Analysis,* various years. Budget plans are authors' calculations using HM Treasury, *Financial Statement and Budget Report*, various years.

Figure 6.8. Control Total: plans and out-turn, real terms (2010–11 prices)



Note: Figures for each Budget 'plan' show the real-terms growth planned in each statement, applied to the actual out-turn for spending in the relevant base year.
Sources: As Figure 6.7.

However, it was much less successful at meeting its real spending plans. Figure 6.8 compares the out-turn for the New Control Total with the plans in real terms; the out-turn data account for inflation as it turned out, and each Budget line assumes that inflation turned out to be what was forecast at the time of that Budget. The plans therefore differ from the out-turn both if the cash spending differed from the plans (as was shown in Figure 6.7) and because inflation turned out to be different from what was forecast.

The November 1993 Budget had planned a real-terms cut in spending for 1994–95, but by the time of the November 1994 Budget this real cut was delayed by a year to 1995–96. The November 1995 Budget again delayed the real-terms cut by a further year until 1996–97. The out-turn data show that a real cut was finally achieved in this year. A further large cut to public service spending was also delivered in 1997–98 (the first year of the new Labour government, which had pledged in its election campaign to implement the previous government's spending plans for that year and the next).

In the 1990s, the government successfully met its cash spending plans, but, with inflation repeatedly turning out lower than expected, it failed to achieve real cuts in spending as quickly as it had initially planned. Perhaps the lesson from this period, therefore, is that while real cuts to public service spending can be delivered – they were in 1996–97 and 1997–98 – to do so requires not only an ability to implement cash spending plans but also that inflation turns out as expected.

However, there is an important difference between the Conservative plans in the 1990s and the plans of the current government: the magnitude of the planned spending cuts is very different. The Clarke and Lamont Budgets of 1993 aimed for a fiscal tightening of 3.8% of national income, with roughly a 50:50 split between spending and tax.[31] This therefore implied a far smaller squeeze on public spending than the government's current plans, which aim for a much bigger overall tightening (6.6% of national income), with a greater proportion (73%) to come from spending cuts. The real cuts planned in the 1990s never implied any cash cuts in the Control Total (as shown in Figure 6.7), while those planned for the next parliament do imply cash cuts to DELs. The scale of the task facing the current government is, therefore, far greater than that tackled by the previous Conservative government, and this will clearly make it harder to deliver its cash spending plans.

If the current government is able to keep to its cash spending plans, as was the case for its predecessor during the 1990s, then one risk to deficit reduction will be the possibility that inflation over the next four years undershoots the OBR's forecast. Should this occur, then, in real terms, spending on public services would turn out to be higher than intended by the government, and receipts would be likely to turn out to be lower than intended, with the deficit likely to be commensurately higher.[32] Conversely, were inflation to overshoot the OBR's forecasts, then, assuming the government kept to its cash spending

[31] The Spring 1993 Budget (Norman Lamont's last) and the Autumn 1993 Budget (Kenneth Clarke's first) combined set out discretionary measures that were projected to increase tax revenues by 2.0% of national income in 1996–97. An extrapolation of the data in chart 5.2 (page 87) of the November 1993 Budget reveals that discretionary spending (as measured by the New Control Total) in 1996–97 was cut by around £13 billion in 1992–93 prices, which is 1.8% of national income.

[32] Indeed, as we pointed out in Section 6.2, lower-than-expected inflation and commensurately higher-than-expected real-terms spending is one of the key reasons why the deficit is currently higher than forecast at the time of the October 2007 CSR.

plans, the deficit would be more likely than not to undershoot the latest forecasts, at the cost of real spending on public services being lower than intended by the government.

6.5 The system for planning public spending

Delivering the large cuts to public spending planned for this parliament will require the government to be able to control public spending adequately. The 2010 Spending Review acknowledged the need for 'a robust framework to control spending' and suggested that some changes may be made to the system that was inherited from the last Labour government.[33] This section discusses the issues involved in designing a system for planning public spending and the desirable features such systems should have, before briefly describing the existing spending framework and going on to discuss what problems there have been with the current system and how these might be addressed.

Issues in designing a framework for planning public spending

There are a number of important issues that need to be considered when designing a system for planning public spending.

Time horizon

Setting out fixed departmental spending plans for a longer time horizon gives more certainty to departments, and will make it easier for them to make long-term spending decisions and programme commitments. It also enables multi-year pay deals, which might make it easier to attract and retain appropriate public sector workers. The downside is that governments are then less able to alter (in particular, reduce) public spending if the economic situation turns out to be different from that forecast some years earlier.

Distinguish between cyclical and non-cyclical spending

A helpful distinction in spending is between non-cyclical spending, which the government can reasonably be expected to plan accurately in advance (because it has more direct control over when it is spent), and cyclical spending, which is typically more affected by economic conditions in the short run and so is much less easy for the government to commit to in advance (for example, spending on unemployment benefits and debt interest payments). A system that sets fixed plans for only non-cyclical spending rather than total spending helps to prevent non-cyclical departmental spending creeping up during good times, when cyclical spending is low, and being crowded out in bad times, when cyclical spending is high.

Distinguish between investment and non-investment spending

Providing separate non-transferable budgets for investment and non-investment spending can protect investment spending from being poached for current spending when budgets are tight. (This might be something departments are tempted to do because it might take longer for the electorate to perceive the ill effects of lower investment spending than lower non-investment spending.) It is also a requirement if the government has a fiscal target for the current budget (the difference between total receipts and non-investment spending), which was the case for the previous Labour

[33] Page 18 of HM Treasury, *Spending Review 2010*, Cm 7942, 2010 (http://cdn.hm-treasury.gov.uk/sr2010_completereport.pdf).

government and is the case with the forward-looking fiscal mandate adopted by the coalition government (see Chapter 2 for a discussion). However, if the division of a department's budget into investment and non-investment spending is done poorly, it could result in low-value capital projects bring commissioned while higher-value current spending is not.

Real or cash plans?

Setting plans in cash terms gives departments greater certainty over their future budgets, in the sense that their cash allocations will not change each time official forecasts for inflation change. If they are able to agree with their suppliers and employees the 'prices' that they will face for the period covered by the budget plans, they will also have greater certainty over their future costs and therefore over what they can supply with their budget. Alternatively, setting plans in real terms might give departments greater certainty over the services they will be able to supply from their future budget without the need for long-term contracts with pre-agreed prices. However, setting real plans accurately requires forecasts of inflation specific to each department (so as to reflect adequately the price changes they face), which is impractical. On balance, then, departments may prefer cash plans to real-terms plans based on economy-wide inflation. From the government's point of view, the disadvantage of fixing plans in cash terms, as we explained in Section 6.2, is that, if inflation turns out to be higher or lower than forecast (particularly if this occurs for a number of years in succession), then total spending could turn out to be lower or higher in real terms than intended.

Carrying forward underspends

If departments cannot carry over unspent portions of their budgets for use in future years, they are likely to develop a 'use it or lose it' mentality, resulting in spending splurges as the end of the financial year approaches. Having in place a system by which departments can carry over underspends should discourage this. The disadvantage is that if a certain department consistently underspends its allotted budget, it may imply that the settlement for that department was too high, and the government may instead want to use some or all of that underspend to deliver other spending priorities.

Try to align incentives appropriately

It is desirable that overall government spending is allocated as efficiently as possible. In many areas of government spending, there may be considerable spillovers between different activities, with additional spending on one item leading to lower spending elsewhere, in the same or a different department, and either immediately or at some point in the future. Therefore, when deciding whether or not to do a little more of one activity, it is essential that the potential savings made elsewhere (both immediate and future) are taken into account. This is a role that the Treasury plays in its monitoring of public spending.

The existing spending framework: DEL/AME system

The current method of planning public spending was introduced by the previous Labour government in 1998. TME is split into two components:

- Departmental Expenditure Limits (DELs), which are annual limits for departmental programme expenditure; these can be broadly thought of as the amount central government spends delivering and administrating public services;

- Annually Managed Expenditure (AME), which is expenditure that the previous Labour government argued was not easily subject to firm limits set several years in advance, such as spending on social security benefits and debt interest payments.

The system that has existed since 1998 is that (supposedly 'firm and fixed') cash plans for DELs by department are formally set for several years in advance in periodic Spending Reviews (although they can be, and often were under the previous government, subsequently revised). For example, the October 2007 CSR set DEL spending plans for the three years 2008–09, 2009–10 and 2010–11. Meanwhile, AME forecasts are revised biannually in light of the economic situation.

Within each of the DEL and AME budgets, spending is further subdivided into capital and current (also known as resource) spending. Capital spending can only be used for investment projects, while resource spending is intended to cover day-to-day expenditure but can be used for additional investment if a department so desires.

The Labour government also introduced a system for carrying forward underspends known as end-year flexibility (EYF), which allowed departments to carry over all unspent portions of their budgets for use in future years. Under the EYF system, when departments underspend in a given year, DEL (and thus TME) will be lower than planned by the government, leading to government borrowing being lower than what was planned. Departments can subsequently ask the Treasury for permission to use some of their EYF entitlement. Where permission is granted, the department's DEL will be increased, subject to parliamentary approval of any necessary Supplementary Estimates.[34] Of these increases in DEL, some may be charged to the DEL reserve, while some may require an increase in total public spending. If total public spending is increased, all other things being equal, the take-up of the EYF entitlement will require an increase in government borrowing in that year.

The system introduced by the Labour government has many good features, but there remain some problems. In particular, the division between DEL and AME creates some undesirable effects:

- Spending Reviews are intended to set DEL spending plans after weighing up the relative merits of alternative items of spending across the whole of public services, but they did not (prior to the 2010 Spending Review) explicitly weigh up the relative merits of AME spending at the same time.

- In many cases, actions by departments have an impact on AME spending. To pick a direct example, spending by DWP on employment programmes for the unemployed is intended to reduce future social security expenditure. However, to the extent that DWP cares only about its DEL spending, it is not clear that it would face the correct incentives to spend money on such programmes.

Some of the problems surrounding AME spending under the existing system were highlighted by the Chancellor, George Osborne, in oral evidence to the Treasury Select Committee's inquiry on the Spending Review:

> I think that's one of the big challenges facing the Treasury, the annually managed expenditure bill, because there has been no incentive on

[34] Supplementary Estimates are the means by which the government seeks from parliament sufficient funds and authority for the bulk of departmental expenditure. The Main Estimates are presented to parliament in the Budget each year. Supplementary Estimates are then used to seek additional resources, or to reallocate existing resources to new activities, and are presented in June, November and February as required.

> Government Departments to control those budgets. We are looking at whether this whole framework of DEL–AME needs to be revisited, particularly the AME part of it, because this is a very large budget – I think virtually half of Government spending. Although it's called 'annually managed expenditure', it's not really managed. So we are looking at a new framework and I hope to say more about that in the Budget on 23 March.[35]

The current system also exhibits two potential obstacles to achieving properly aligned incentives. First, to the extent that departments' budgets are not entirely fungible across years, they might not be able to take full account of potential future savings when deciding whether or not to spend more on a particular item up-front. Second, without creating prohibitively large departments, it is not possible to assign all activities between which there are spillovers to single departments; therefore, a given department may not take full account of savings made to another department's budget when setting its own spending plans. Therefore, it will always be sensible for the Treasury (or similar) to play a role in ensuring that such spillovers are taken into account when spending decisions are made.

Potential improvements to the existing system

The 2010 Spending Review mentioned particular aspects of the existing system for planning public spending that could be improved upon. The two most important were improving the incentives to control AME spending and replacing the existing EYF system. These and other possible improvements to the system are discussed in more detail below.

Greater control of AME spending?

Since AME spending is not subject to firm limits, departments that are responsible for some AME spending may not have the same incentives to manage it as they do their fixed DEL budgets. If there is reasonably large scope for departments to engage in activities that could reduce their AME spending, then there could be an argument for including these parts of the AME budget within DEL instead. For example, additional monitoring by DWP might reduce fraudulent benefit claims. If such elements of AME were included in departments' DELs instead, departments would have a greater incentive to undertake activities that reduced their AME spending. However, the difficulty with assigning some elements of AME spending to DELs is that they also depend on factors that are outside a department's control. It may not be possible or desirable for departments to have to bear the risk of fluctuating spending needs from within their DEL when such fluctuations are beyond their control. Therefore, it is probably only feasible to allocate to DELs those components of AME that can reasonably be planned in advance.[36] These include the following, for example:

- State pensions: In June 2010, the Department for Work and Pensions forecast that spending on the basic state pension, the State Earnings-Related Pension Scheme and

[35] http://www.publications.parliament.uk/pa/cm201011/cmselect/cmtreasy/544/10110402.htm.

[36] Under the previous Conservative government, the measure of spending known as the '[New] Control Total' (for which the government set three-year plans) included not just departmental spending but also all non-cyclical social security spending, which included spending on the state pension, Child Benefit and non-means-tested payments to lone parents and those with disabilities.

the State Second Pension would amount to £70 billion in Great Britain in 2010–11, which is over one-fifth of all AME.[37] As the government determines the generosity of payments and the eligibility criteria, the number of recipients of the state pension and the value of their entitlements should be relatively easy to predict for the next few years, given current National Insurance records of those approaching the state pension age.

- Child Benefit: Spending on Child Benefit is forecast by HM Revenue and Customs to be £12.2 billion in 2010–11, which is 4% of all AME.[38] The government determines the generosity of payments and the eligibility for Child Benefit, and the number of recipients is relatively easy to predict, and so spending on Child Benefit over the next few years could be planned in advance. However, the plan to withdraw Child Benefit from families containing a higher-rate income tax payer from January 2013 will make this harder to forecast in the future.
- Employer contributions to public service pensions: At the moment, public sector employers and employees make contributions towards the cost of the occupational pensions that the employees accrue an entitlement to each year. However, these contributions are currently insufficient to cover the estimated true cost of the pension provided.[39] As a result, the Treasury each year implicitly makes an additional contribution towards the pension. This arrangement is likely to lead to departments underestimating the true cost to the taxpayer of a public sector worker and, potentially, lead to an inefficient mix of inputs. It would be better if the implicit Treasury subsidy were instead included in the departments' budgets (with an offsetting increase in those budgets). If this were the case, departments would be more likely to allocate resources efficiently between additional staff and additional spending on other items than is currently the case.

However, it is not clear that overall spending on many of these more easily predictable components of AME is actually particularly responsive to the activities of departments. For example, given the rules of the state pension system, DWP (the government department that most obviously has a stake in this element of spending) would probably only be able to reduce spending on this item if there were a high level of fraudulent claims, which seems unlikely to be the case; similarly for Child Benefit. Thus it is not clear that doing this reallocation would result in more efficient use of AME spending.

The areas that would remain in AME, which are genuinely hard to plan because they depend on uncertain factors such as levels of employment or earnings (in the case of in-work and out-of-work benefits) or interest rates (in the case of debt interest payments), are those where control over spending is less good. But, in many cases, this results from the same uncertainty that will make incentivising departments to control such spending hard.

However, even if including in a department's DEL that spending that can reasonably be expected to be influenced by its activities did not result in any greater control over AME spending, it would make it clearer how much AME spending is genuinely out of the

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[37] Department for Work and Pensions, *Benefit Expenditure Tables: Medium Term Forecast*, June 2010 (http://research.dwp.gov.uk/asd/asd4/index.php?page=medium_term).

[38] Public finances supplementary table 1.4 of Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2010* (http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html).

[39] Source: Table D.1 (page 180) of HM Treasury, *Public Expenditure Statistical Analysis 2010* (http://www.hm-treasury.gov.uk/d/pesa_2010_complete.pdf).

government's immediate control, which would help to give a more accurate picture of the uncertainties in the government's spending projections. Furthermore, it seems that in the case of public service pensions, mentioned above, such a reallocation would better align incentives and therefore lead to an improved allocation of public spending overall.

A broader remit for Spending Reviews

Even if some components of AME cannot be included in departments' DELs for the purposes of managing money on a year-by-year basis, there are strong arguments for considering a broad measure of public spending when conducting Spending Reviews. In this respect, Spending Review 2010 was a welcome improvement on previous practice under the Labour government, since it considered not just DELs but also the vast majority of AME spending.[40]

Considering AME spending alongside DELs in Spending Reviews enables the government to consider the whole package that individuals are receiving from the state, rather than just some components. Two examples perhaps illustrate this point:

- When deciding on the optimal package of support for children, it might be better to choose a level of schools spending at the same time as deciding what level of benefits to offer to families with children, rather than making the two decisions separately.
- The DEL for DWP includes the cost of running Jobcentre Plus and administering benefit payments, while its AME budget includes the actual value of benefit payments. A concern with this arrangement is that, if DWP were to employ additional advisers to encourage those on out-of-work benefits to move off benefits and into paid employment, then the direct costs of these advisers would count against the department's DEL but any subsequent reduction in benefit spending would not (since it is in AME). So it would be desirable during Spending Reviews to take account of both these considerations when determining the priorities for government spending.

Reforming end-year flexibility?

The government has said it wants to replace the existing EYF system. Departments have taken advantage of the existing EYF facility since its introduction in 1998. It is estimated that their combined cumulative underspend at the end of 2009–10 was £18.9 billion, or 5.0% of total DEL for 2010–11. The top five cumulative underspenders (in £ billion) are shown in Table 6.7.

In the 2010 Spending Review, the government announced that the EYF scheme – and all the accumulated stocks of underspends – would be abolished at the end of 2010–11. The Treasury's stated reason was that if departments attempted to spend their EYF entitlements, this would further increase the deficit and harm the government's fiscal consolidation plans over the parliament. The government said that EYF would be replaced 'with a new system from 2011–12 which will retain an incentive for departments to avoid wasteful end-year spending and strengthen spending control'.[41]

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[40] One caveat to this is that there were some components of spending that were theoretically included in the Spending Review envelope but where pre-existing government commitments suggested cuts were unlikely. One notable example is spending on state pensions: this comprises almost half of social security spending but the increases in the generosity of state pensions committed to in the coalition agreement, and announced in the Budget of June 2010, made it very unlikely that the government would then cut this spending in the October 2010 Spending Review.

[41] Page 18 of the 2010 Spending Review.

Table 6.7. Cumulative underspending by five departments with the largest EYF 'carry-forward' to 2010–11

Department	Cumulative DEL underspending, £bn: Resource	Capital	Total	Total planned DEL 2010–11, £bn	Underspend as a % of 2010–11 DEL
Health	3.7	1.8	5.5	103.8	5.3%
Education	0.8	2.2	2.9	58.4	5.0%
Business, Innovation & Skills	1.0	0.5	1.4	18.6	7.6%
Energy & Climate Change	1.0	0.2	1.2	2.9	42.3%
CLG Communities	0.3	0.9	1.2	9.0	13.2%
Other departments	4.6	2.0	6.6	185.5	3.6%
Total	11.5	7.4	18.9	378.2	5.0%

Note: Planned DEL for 2010–11 is on a Spending Review baseline basis, which excludes one-off and time-limited expenditure.
Source: Underspending figures are from table 6 of HM Treasury, *Public Expenditure 2009–10: Provisional Outturn* (http://www.hm-treasury.gov.uk/d/peowp200910.pdf); 2010–11 planned DELs are from the 2010 Spending Review.

As we said earlier, some ability to carry forward money from one year to the next is desirable to reduce incentives for departments to spend money wastefully at the end of the financial year. That is, an implicit tax rate on departmental underspends of 100% is too high. However, the implicit tax rate of 0% that existed under the EYF system may be too low – at least for some elements of spending. If a department fails to spend all of its capital budget in one year, then it might be best to allow it to roll forward all of this underspend into the next year; such underspends may reflect delays in the commissioning process for an investment project, rather than reflecting that the project is no longer needed. Conversely, if a department fails to spend all of its current budget – which is intended to cover day-to-day running costs of departmental programmes – in one year, it is less clear that it will need to spend all of that money the following year. It might, therefore, be sensible for the Treasury to apply a tax rate greater than 0%, but less than 100%, to current budget underspends and apply a 0% tax rate to capital underspends. In any case, the 'problem' of significant underspending by government departments is likely to be far less of an issue during the current era of deep spending cuts than it was during the previous 10 years.

Balancing certainty on spending for departments with certainty for government

The current government chose in its 2010 Spending Review to set firm spending plans for the four years from April 2011 to March 2015. This has the advantage discussed above of enabling departments confidently to sign up to longer-term contracts, which will typically be denominated in cash terms, but the disadvantage of exposing the government's real spending plans to the risk of inflation being different from what is forecast.

One option to balance the interests of departments and central government might be, in Spending Reviews, to set firm cash spending plans for the early years covered by the review, while setting real-terms spending plans for later years. These real-terms plans could then later be converted into firm cash plans. This is similar to how the existing spending framework used to operate: originally, Spending Reviews set spending plans for three years, but the third year became the first year of the subsequent Spending Review, and spending plans for that year could therefore be revised if required.

The government's decision to set out a plan for spending for each of the next four years was a good idea, as having detailed plans should make the government's commitment to reducing public borrowing more credible, not least with investors (see Chapter 3 for a discussion of the UK's susceptibility to a fiscal crisis). However, there are additional reasons why it might be sensible to review the current plans in a couple of years' time. First, the cuts to some areas of spending are of such a magnitude that there is a risk that they lead to unacceptably large reductions in the quantity or quality of the public services delivered in some areas. The government would be sensible to review the plans alongside the latest information at, say, the halfway stage, in order to assess whether they remain its preferred allocation. Second, the economic outlook remains uncertain and it is possible that the economy and public finances will perform better or worse than the OBR's current forecast. If this happens, the government's fiscal stance may end up being tighter or looser than currently intended, in which case the government may again want to review its spending plans.

6.6 Conclusion

Probably the defining domestic policy challenge for this parliament will be returning the public finances to a sustainable footing. The new government has announced a six-year borrowing reduction plan, which relies heavily on cuts to public spending – public spending as a share of national income is forecast to be brought down from 47.4% in 2009–10 to 39.3% by 2015–16.

The pain of these spending cuts will not be shared equally among departments, and the 2010 Spending Review set out broadly where the axe will fall over the next four years. Two departments that fared particularly well are the Department for International Development and the Department of Energy and Climate Change, both of which are due to see relatively large real increases in their budgets. The NHS budget also fared better than other departments, and is set to continue its trend over the past 25 years of taking up an increasing proportion of public service spending.

The decisions made about spending levels for Whitehall departments had implications (through the Barnett formula) for the total grants received by the devolved administrations, but the devolved administrations are able to prioritise spending differently from the choices made for England within their overall budgets. A complete like-for-like comparison is not possible due to differences in, for example, departmental responsibilities, but it appears that the choices made by the Scottish parliament are similar to those made in England, with the NHS being protected from deep spending cuts and significant cuts to spending on housing, justice, and further and higher education. A different pattern emerges in Wales, where NHS spending is being cut, meaning that the cuts elsewhere are, on average, considerably lower than they would otherwise have been (and lower than the cuts to equivalent departments in England). Northern Ireland – like England and Scotland – has chosen not to cut the NHS budget significantly, but – unlike in England and Scotland – does appear to have chosen to cut spending on schools by more than spending on further and higher education.

Some good news for the UK government could be garnered from the fact that the last time a UK government attempted to limit the growth of public spending (in the early 1990s), it was quite successful at sticking to its cash spending plans. However, history also suggests that unexpectedly low out-turns for inflation can mean those same cash plans can result in higher-than-planned spending in real terms, meaning they do not necessarily deliver as much of a reduction in borrowing as was expected. Therefore, one risk to the deficit reduction plan is that the cash spending limits are adhered to but inflation comes in lower than forecast by the OBR. Given that the government's spending cuts imply the tightest five years for public spending growth since at least the Second World War, the impact in different areas is inevitably uncertain and the government is likely to come under pressure to increase spending on areas where people become particularly unhappy about the effects the cuts are having. A review of the Spending Review allocations in 2012 would be sensible.

Delivering the tight spending plans set out by the government is likely to require close control of public spending, and the 2010 Spending Review recognised the need for 'a robust framework to control spending'. There are a number of ways in which the new government could seek to build on the improvements in public spending management that began with the introduction of the New Control Total in 1992. Ensuring that the widest possible set of spending areas are considered alongside one another when setting spending priorities in Spending Reviews should be a first step, and Spending Review 2010 was a welcome move in that direction. Beyond that, the government should ensure that departments' incentives to allocate spending most efficiently are aligned as well as possible, including through a new system for handling departmental underspends. The case for allowing departments to carry forward most, if not all, of any unspent allocation remains strong, and particularly so in the case of capital spending.