4. Public spending pressures

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Summary

- The Pre-Budget Report contained projections for total public spending for the whole period to be covered by next year's Comprehensive Spending Review. If implemented, these would imply public spending falling by 0.7% of national income over the three years to 2010–11. This would be equivalent to £8½ billion in today's terms.
- Keeping to these spending plans would require tough choices. Under plausible scenarios for health, education and overseas aid, they would leave other spending growing at just 0.8% a year after economy-wide inflation. This compares with an expected 1.9% a year over the remainder of the current spending review and with 3.8% over the years to date covered by Labour's spending reviews.
- Recent years have seen increases in social security and tax credit expenditure, helping the government towards its targets for reducing child and pensioner poverty. If growth in spending on social security and tax credits were held to 2.2% a year in real terms (the average forecast for the period since Labour came to power), then this would require real cuts across the rest of government spending (i.e. excluding health, education and overseas aid). While this was achieved during Labour's first two years in office, a repeat would be hard to square with pledges to improve other services such as transport and law and order. Spending restraint in 1997–98 and 1998–99 was assisted by large falls in unemployment and debt interest payments, both of which are unlikely to be repeated.
- Mr Brown could set a spending envelope different from that in the Pre-Budget Report. One option would be to keep spending constant as a share of national income. Given reasonable assumptions about health, education, overseas aid, and social security and tax credit expenditure, this would allow other spending to grow by 1.3% a year in real terms. This would require an extra £8½ billion in today's terms after three years, but would still be less generous than Labour's current or previous spending reviews.

4.1 Introduction

The 2004 Spending Review set out plans for spending by each government department through to 2007–08. The Treasury has announced that the 2007 Comprehensive Spending Review (CSR) will set out departmental spending plans for the three financial years beginning in 2008–09. These plans have a particular significance for at least three reasons. First, they are likely to be a key determinant of the path of public spending in the run-up to, and the period

immediately after, the next general election. Second, a change in Prime Minister is expected before the end of the period covered by the forthcoming CSR, which means that the allocations might be one measure of any change in direction of government policy under a new premiership. Third, as discussed in Chapter 5, the expected growth of overall public spending over this period is also crucial in determining the extent to which new tax-raising measures are required for the Treasury to be able to expect to meet its 'golden rule' with the degree of comfort that it considers necessary.

The December 2005 Pre-Budget Report (PBR) contained figures for overall public spending through to 2010–11. This was the first time that government projections included the whole period that will be covered by the 2007 CSR. However, these figures are illustrative only, and the ceiling below which the 2007 CSR will operate has not yet been announced: the Treasury could decide that the ceiling should be set higher, or indeed lower, than the figures that are contained in the PBR. Indeed, in giving evidence to the House of Commons Treasury Select Committee on 8 December 2005, the Chancellor Gordon Brown stated, with reference to the PBR spending figures, that: 'These have been our working assumptions for a number of years, but these are not necessarily the final figures'.[1]

We begin in Section 4.2 by comparing the growth in overall spending implied by the plans set out in the Pre-Budget Report with what has happened since Labour came to power in May 1997.[2] We then look at the growth in spending in some of the main areas where Labour has manifesto commitments: health, education, overseas aid, and social security and tax credits. In Section 4.3, we present a possible 2007 CSR allocation given the figures for overall spending set out in the PBR and an interpretation of the government's stated priorities. We contrast this to alternative allocations that would be possible under three different illustrative scenarios, two of which would be more generous than the figures set out in the PBR and one of which would be substantially less generous. Section 4.4 describes the Treasury's latest projections for longer-term spending pressures resulting from demographic change. Section 4.5 concludes.

4.2 Trends in public spending since 1997

Total managed expenditure

The broadest measure of government spending is known as total managed expenditure (TME), which measures all spending by the public sector. In 1996–97 – the last full financial year before Labour came to power – TME was 40.6% of national income. As shown by the solid line in Figure 4.1 (and the right-hand axis), it fell to 37.0% of national income in 1999–2000. This happened for a number of reasons, including:

- the incoming Labour government choosing to stick to the spending plans set out in Kenneth Clarke's November 1996 Budget in 1997–98 and 1998–99;

[1] Source: Response to Question 389, http://www.publications.parliament.uk/pa/cm200506/cmselect/cmtreasy/uc739-iii/uc73902.htm.

[2] For more details on the evolution of public spending in the UK, see C. Emmerson, C. Frayne and S. Love, *A Survey of Public Spending in the UK*, IFS Briefing Note no. 43, 2004, http://www.ifs.org.uk/bns/bn43.pdf.

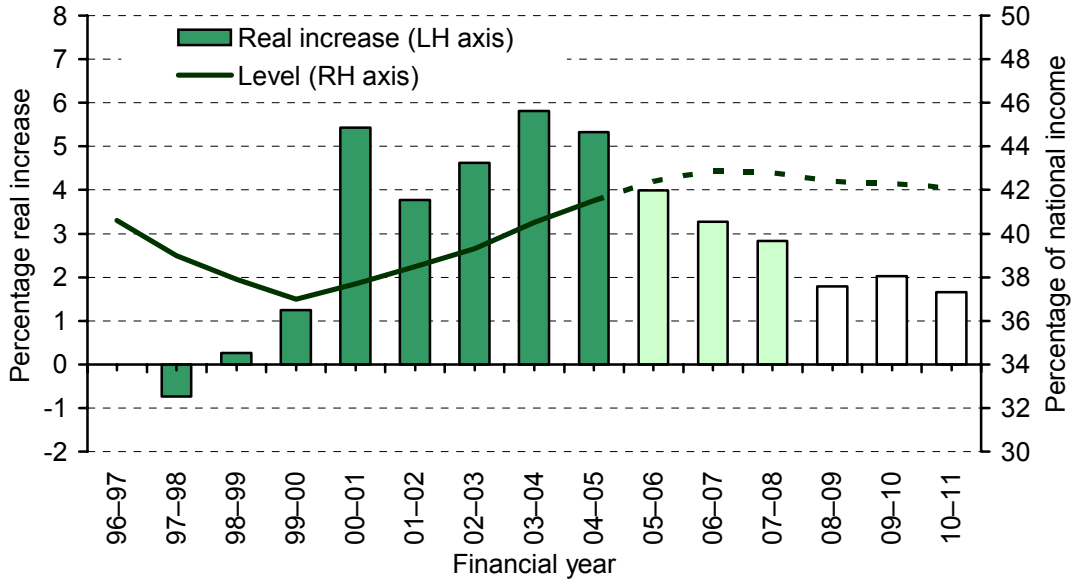
- strong economic performance, which was associated with falling unemployment;
- reductions in debt interest payments, arising from falling government debt and falling nominal and real interest rates;
- government departments spending less than their allocations in 1999–2000.

Public spending has since increased, reaching 41.5% of national income in 2004–05.

The bars in Figure 4.1 (and the left-hand axis) show the annual increase in spending after taking account of economy-wide inflation. Relatively large increases in spending were seen in each year from 2000–01 to 2004–05. Spending for the years from 1999–2000 forward has been determined in spending reviews, the first of which was the July 1998 Comprehensive Spending Review and the latest of which was the July 2004 Spending Review (there were also spending reviews in July 2000 and July 2002). Looking forwards, the period covered by the 2004 Spending Review (2005–06, 2006–07 and 2007–08, as shown by the light green bars in Figure 4.1) is expected to see the real increases in spending gradually decline over time.

As mentioned in Section 4.1, the 2005 Pre-Budget Report also published, for the first time, provisional spending figures that covered the whole of the period of the 2007 CSR. The real increases implied by these plans are shown in the hollow bars in Figure 4.1. If implemented, these would be the lowest increases in public spending since 1999–2000. As shown by the dotted line (and the right-hand axis), they would involve public spending as a share of national income declining to 42.1% in 2010–11. While this would be more than the level inherited by Labour when they came to power (40.6% of national income), it would be lower than the average level of spending seen during either John Major's premiership (42.6% of national income) or Margaret Thatcher's premiership (44.6% of national income).

Figure 4.1. Total managed expenditure



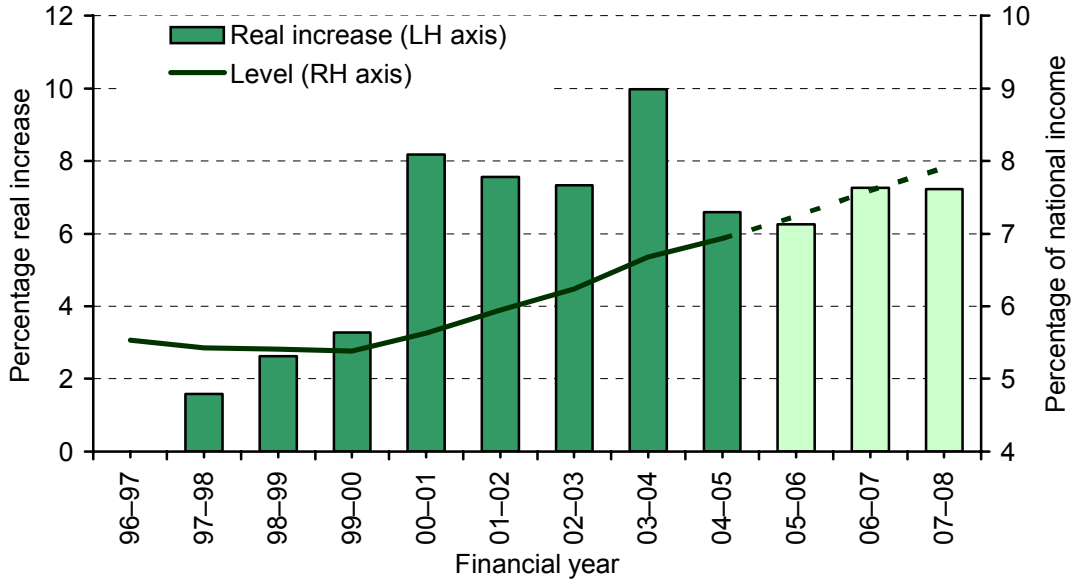
Note: Growth in real spending is calculated by deflating spending by growth in the GDP deflator; while this might not be the appropriate deflator for the increase in the cost of goods and services purchased by public spending, it could be considered the most appropriate deflator when considering the cost to the taxpayer.
Source: HM Treasury, Public Finances Databank, December 2005, http://www.hm-treasury.gov.uk/media/576/54/public_fin_databank_dec_05.xls.

We now examine trends in spending on some of the areas with manifesto commitments: health, education, overseas aid, and social security and tax credits.

Health spending

Figure 4.2 shows the level of UK health spending as a percentage of national income (on the right-hand axis) from 1996–97 to 2007–08, which is the last year for which we have firm Treasury spending plans. Also shown in the figure is the increase in health spending each year, after taking account of economy-wide inflation, from 1997–98 to 2007–08. The real increases in health spending during Labour's first three years in office were lower than real growth in the economy; therefore health spending declined slightly as a share of national income (from 5.5% of national income in 1996–97 to 5.4% of national income in 1999–2000). Since then, the NHS has received the largest sustained increase in spending since its inception in 1949.[3] This has increased spending to 6.9% of national income in 2004–05. Under the increases that were announced as part of the 2002 Spending Review (the NHS was given a five-year allocation in 2002, whereas other government departments received three-year allocations), health spending is set to increase further to 7.9% of national income in

Figure 4.2. Health spending



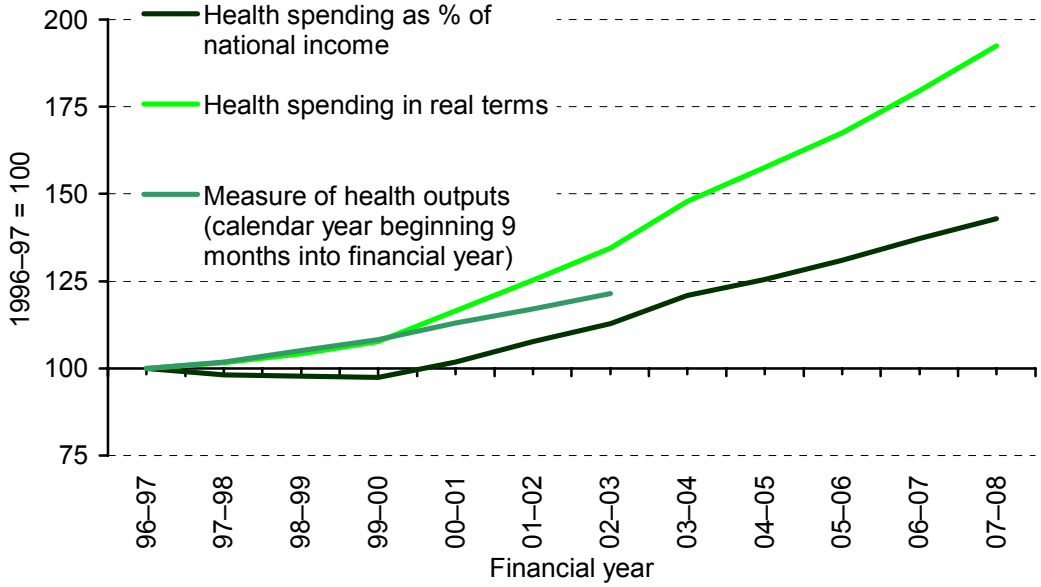
Notes: Figures refer to public sector health spending figures based on the UN Classification of the Functions of Government (COFOG), the international standard, as used in the Public Expenditure Statistical Analysis. Growth in real health spending is calculated by deflating spending by growth in the GDP deflator; while this might not be the appropriate deflator for the increase in the cost of goods and services purchased by health spending, it could be considered the most appropriate deflator when considering the cost to the taxpayer.
Sources: Period to 2004–05 from HM Treasury, *Latest Functional Data*, July 2005, http://www.hm-treasury.gov.uk/media/344/99/latest_functional_tables_peowp05.xls; period from 2005–06 onwards from table 8.2 of HM Treasury, *2004 Spending Review: Stability, Security and Opportunity for All: Investing for Britain's Long-Term Future: New Public Spending Plans 2005-2008*, Cm. 6327, 2004, http://www.hm-treasury.gov.uk/spending_review/spend_sr04/report/spend_sr04_repindex.cfm.

[3] For more details of NHS spending over time, see C. Emmerson, C. Frayne and A. Goodman, *Pressures in UK Healthcare: Challenges for the NHS*, IFS Commentary no. 81, 2000, http://www.ifs.org.uk/comms/nhsspending.pdf.

2007–08. If delivered, this should bring total healthcare spending (including private spending) in the UK to around the weighted average of health spending across EU countries in 2002.[4]

The large increases in NHS funding have been allocated with the intention of providing higher quantity and quality of care than would otherwise have been possible. Figure 4.3 shows the level of health spending both in real terms and as a share of national income (i.e. the same series as shown in Figure 4.2) with 1996–97 indexed to 100. A measure of NHS outputs is also presented. Measuring the outputs of the health service is particularly difficult; here, we take the measure that has been calculated by the Office for National Statistics for use in the UK's National Accounts (again with 1996–97 indexed to 100). Throughout the six-year period from 1996–97 to 2002–03, this measure of NHS outputs has been increasing. In addition, it rose faster in each of the last three years, when health spending was growing more quickly, than it did in any of the first three years, when health spending was growing less quickly: over the three-year period from 1996 to 1999, measured outputs grew by an average of 2.7% a year, while over the three-year period from 1999 to 2002, they grew by an average of 3.9% a year. It is also noticeable that growth in measured health outputs has not managed to keep pace with growth in health spending after taking account of economy-wide inflation.

Figure 4.3. Health spending and a measure of health outputs



Sources: Figures for spending as for Figure 4.2. Figures on health outputs from Office for National Statistics, *Improvements in the Methodology for Measuring Government Output*, 2005, http://www.statistics.gov.uk/articles/nojournal/ChangestoBlueBook2005.pdf.

The increases in health spending as a share of national income that are planned through to 2007–08 should aid further increases in measured NHS outputs. Further increases in health spending beyond 2007–08 would assist the government were it to want to see further increases in NHS output. Indeed, the Wanless Report of 2002, which recommended the large increases in health spending through to 2007–08 that the Treasury decided to sign up to, also recommended that increases greater than the expected growth in the economy would need to

[4] For more details, see pages 11–13 of C. Emmerson and C. Frayne, *Public Spending*, IFS Election Briefing Note no. 2, http://www.ifs.org.uk/bns/05ebn2.pdf.

continue at least until 2017–18, in order to improve health outputs and outcomes and to close the 'considerable gaps in performance between the UK and other developed countries'.[5]

Education spending

Figure 4.4 shows the level of UK education spending as a percentage of national income (on the right-hand axis) from 1996–97 to 2007–08, which is the last year for which we have Treasury spending plans. Also shown in the figure is the increase in education spending each year, after taking account of economy-wide inflation, from 1997–98 to 2007–08. As was the case with health spending, the real increases in education spending during Labour's first three years in office were lower than real growth in the economy; therefore education spending declined slightly as a share of national income (from 4.7% of national income in 1996–97 to 4.4% of national income in 1999–2000). As was also the case with health, the following five years have seen very large average increases in spending, which have led to education spending as a percentage of national income reaching 5.4% in 2004–05. Under the plans set out in the 2004 Spending Review, education spending is now forecast by the Treasury to jump to 5.7% of national income in 2005–06 and then stabilise at around that level.

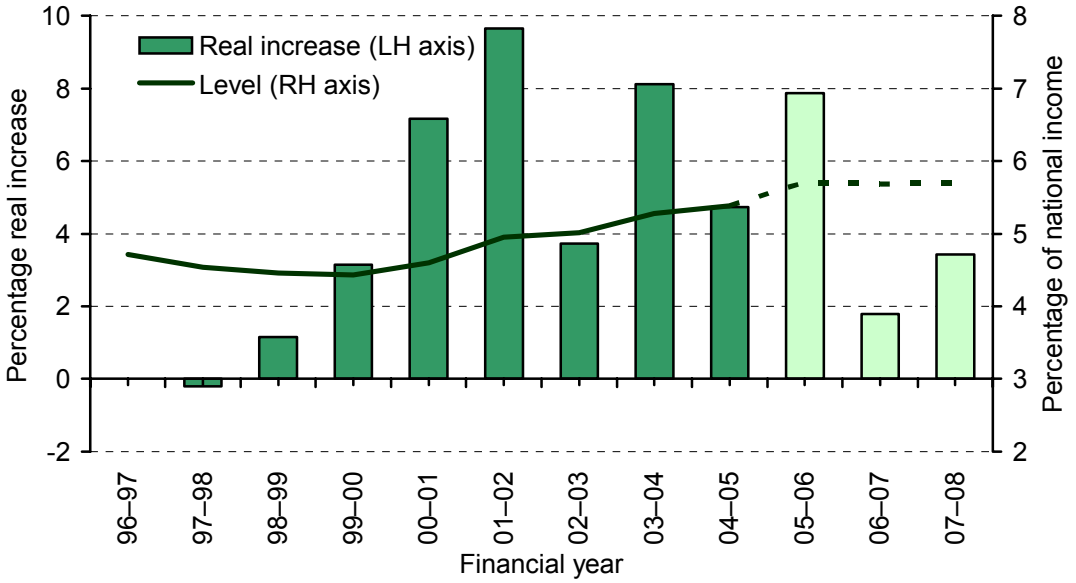
Figure 4.5 shows the same figures on education spending, both in real terms and as a share of national income, but with 1996–97 indexed to 100 (on the left-hand axis). There are various potential indicators for the quality and quantity of education service provided by the government. One possible indicator for primary and secondary schools is average class sizes. This is also shown in Figure 4.5 (for England), again with 1996–97 indexed to 100 (on the right-hand axis). The figure shows that primary class sizes rose between 1996–97 and 1997–98 and then fell sharply over the following four years before stabilising. In contrast, secondary class sizes rose gradually between 1996–97 and 2000–01 but have since fallen back, and by 2004–05 they were back at the level they were at in 1996–97.

Although class sizes are just one potential proxy for quality in education provision, Figure 4.5 shows that, in particular during the first new Labour parliament, the increases in education funding were associated with falls in average primary class sizes, which were a stated priority as highlighted by the government's 1997 manifesto pledge to 'reduce class sizes for five, six and seven year-olds to 30 or under'.

The planned increase in education spending could be used to help reduce school class sizes. Further increases in education spending beyond 2007–08 would also assist the government were it to want to reduce class sizes further. Of course, the government might not want to continue reducing class sizes. However, it has stated objectives for increasing the quantity and quality of education provided – for example, increasing the number of years young people stay in education. In his March 2005, Budget Speech, Gordon Brown stated: 'Our goal should now be that children not only start education at 3 but also continue in education or training

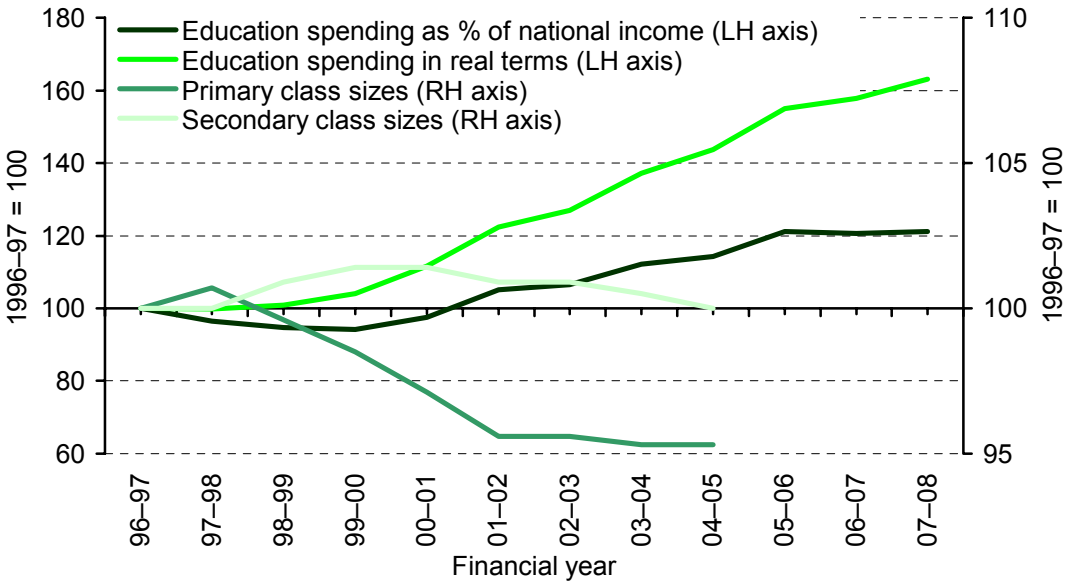
[5] Source: Table 5.1 of HM Treasury, *Securing Our Future Health: Taking a Long-Term View*, Final Report of the Wanless Review, 2002, http://www.hm-treasury.gov.uk/Consultations_and_Legislation/wanless/consult_wanless_final.cfm.

Figure 4.4. Education spending



Note: Growth in real education spending is calculated by deflating spending by growth in the GDP deflator; while this might not be the appropriate deflator for the increase in the cost of goods and services purchased by education spending, it could be considered the most appropriate deflator when considering the cost to the taxpayer.
Sources: Period to 2003–04 from HM Treasury, *Latest Functional Data*, July 2005, http://www.hm-treasury.gov.uk/media/344/99/latest_functional_tables_peowp05.xls; period from 2004–05 onwards from table B19 of HM Treasury, *Pre-Budget Report 2005*, Cm. 6701, 2005, http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr05/report/prebud_pbr05_repindex.cfm.

Figure 4.5. Education spending and average school class sizes



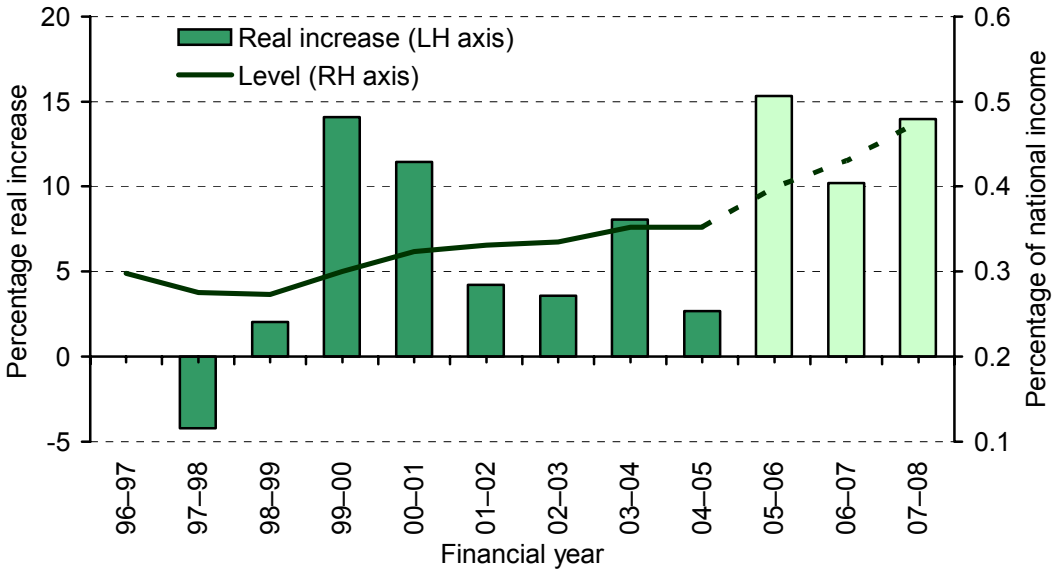
Sources: Figures for spending as for Figure 4.4. Figures on average primary and secondary class sizes refer to England only and are taken from chart C, section 3.3 of Department for Education and Skills, *Trends in Education and Skills: Schools*, http://www.dfes.gov.uk/trends/.

until 18. Not 11 years of learning as in the past but 15 years'. In 2004, 79.3% of 17-year-olds were in education or training.[6]

Official development assistance

One area where there is a firm government spending commitment for the period beyond 2007–08 is spending on official development assistance (ODA): the 2005 Labour Party manifesto states that 'Now, for the first time ever the UK has a clear timetable – 2013 – for achieving the UN target of 0.7 per cent of national income devoted to development'.[7] Figure 4.6 shows the level of spending on ODA as a share of national income since 1996–97 through to the end of the existing plans in 2007–08 (right-hand axis). Again, the bars show the real increase in spending for each year from 1997–98 to 2007–08 after taking account of economy-wide inflation (left-hand axis). By 2004–05, spending on ODA was at 0.35% of national income compared with 0.30% of national income in 1996–97. Very large increases in ODA spending, averaging 12.1% a year in real terms, are planned for the next two years. If delivered, this should increase ODA spending to 0.48% of national income. While substantial, it would still be 0.22% of national income, or £2.7 billion in 2005–06 terms, below the government's target of 0.7% of national income for 2013.

Figure 4.6. Official development assistance



Note: Growth in real ODA is calculated by deflating spending by growth in the GDP deflator; while this might not be the appropriate deflator for the increase in the cost of goods and services purchased by ODA, it could be considered the most appropriate deflator when considering the cost to the taxpayer.
Sources: Period from 2004–05 onwards from table 15.2 of HM Treasury, *2004 Spending Review: Stability, Security and Opportunity for All: Investing for Britain's Long-Term Future: New Public Spending Plans 2005-2008*, Cm. 6327, 2004, http://www.hm-treasury.gov.uk/spending_review/spend_sr04/report/spend_sr04_repindex.cfm. For figures prior to 2004–05, we assume that the growth in ODA is the same as the growth in spending on 'international services' in HM Treasury, *Latest Functional Data*, July 2005, http://www.hm-treasury.gov.uk/media/344/99/latest_functional_tables_peowp05.xls.

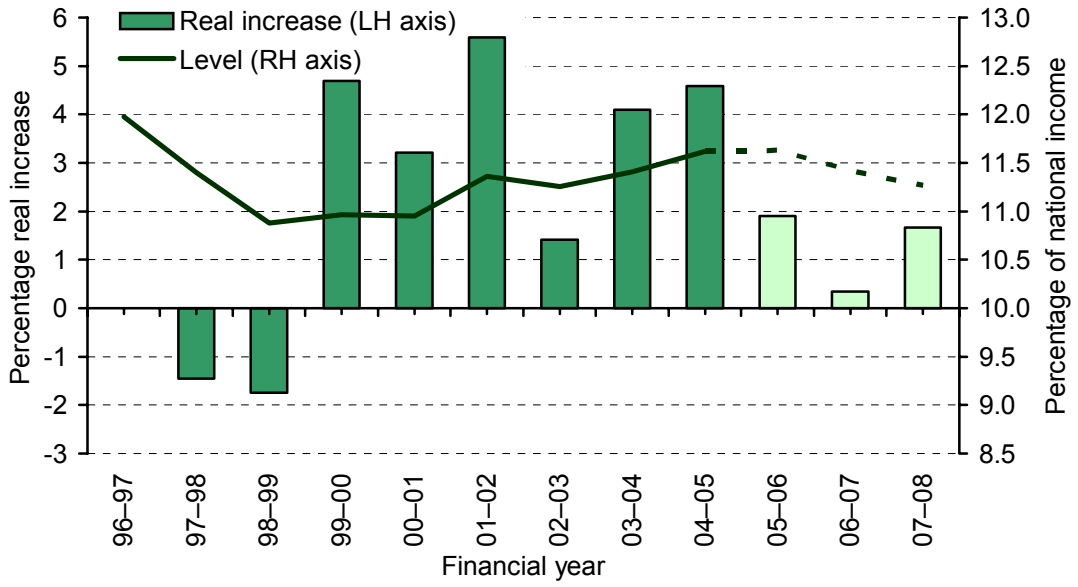
[6] Source: *Participation in Education, Training and Employment by 16-18 Year Olds in England: 2003 and 2004*, First Release SFR27/2005, 2005, http://www.dfes.gov.uk/rsgateway/DB/SFR/s000587/index.shtml.

[7] Page 90 of Labour Party, *The Labour Party Manifesto 2005*, 2005, http://www.labour.org.uk/manifesto.

Social security and tax credit expenditure

By far the largest element of government spending is that given to individuals in the form of social security or tax credit payments. In 2005–06, this is predicted by the Treasury to be 27.4% of TME. Therefore the path of social security spending is a particularly important determinant of the path of overall public spending. Figure 4.7 shows the level of social security and tax credit expenditure as a percentage of national income (on the right-hand axis) from 1996–97 to 2007–08, which is the last year for which we have Treasury spending plans. Also shown in the figure is the increase in this component of spending each year, after taking account of economy-wide inflation, from 1997–98 to 2007–08. In 1997–98 and 1998–99, social security spending fell both in real terms and as a share of national income. This was the result of a combination of the government's decision to implement the spending plans that it had inherited for those two years and of the strong performance of the economy, which was associated with falling unemployment. Since 1998–99, spending on social security and tax credits has increased from 10.9% of national income to 11.6% of national income in 2004–05. Despite this increase, it is still below the 12.0% of national income that was spent in the last full year of the last Conservative administration's period in office. The increases in spending that have occurred since 1998–99 have, to a large extent, been targeted at both lower-income pensioners and lower-income families with children (for example, through the pension credit and the child tax credit respectively). Figure 4.7 also shows that the Treasury is forecasting

Figure 4.7. Social security and tax credit expenditure

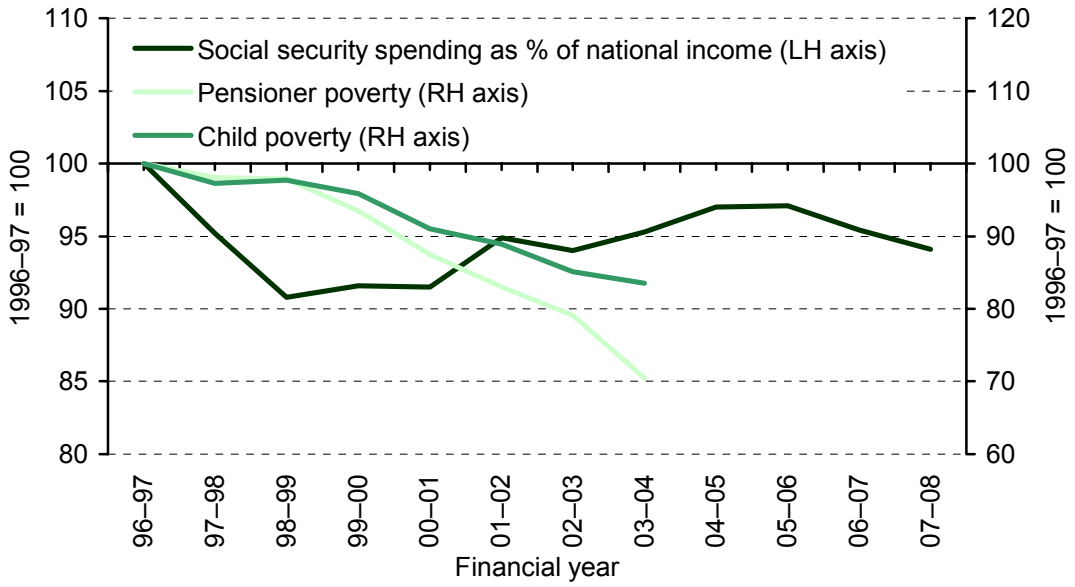


Notes: Figures refer to spending on both social security benefits and tax credits. Growth in real social security and tax credit spending is calculated by deflating spending by growth in the GDP deflator; while this might not be the appropriate deflator for the increase in the cost of goods and services purchased by social security and tax credit spending, it could be considered the most appropriate deflator when considering the cost to the taxpayer.
Sources: Period from 1999–2000 to 2003–04 from HM Treasury, *Latest Budgetary Data*, July 2005, http://www.hm-treasury.gov.uk/media/344/A1/latest_budgetary_tables_peowp05.xls; period from 2004–05 onwards from table B17 of HM Treasury, *Pre-Budget Report 2005*, Cm. 6701, 2005, http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr05/report/prebud_pbr05_repindex.cfm; for figures prior to 1999–2000, we assume that the growth in spending on social security benefits and tax credits is the same as the growth in spending on 'social protection' in HM Treasury, *Latest Functional Data*, July 2005, http://www.hm-treasury.gov.uk/media/344/99/latest_functional_tables_peowp05.xls.

real increases averaging just 1.0% a year over the next two years. This would lead to spending on social security and tax credits falling to 11.3% of national income.

Figure 4.8 shows the same figures on spending on social security and tax credits as a share of national income, but with 1996–97 indexed to 100 (on the left-hand axis). Also shown in Figure 4.8 are measures of child and pensioner poverty, again with 1996–97 indexed to 100 (on the right-hand axis). The measure used is the percentage of the relevant group who are in households with incomes below 60% of the income of the median household in that year (with income being measured after housing costs).[8] The figure shows that there were slight falls in both child and pensioner poverty over the two-year period between 1996–97 and 1998–99, with much larger falls in both measures of poverty over the following five years between 1998–99 and 2003–04. This latter period corresponds to the period in which social security and tax credit expenditure was increasing as a share of national income. The increases in expenditure on social security and tax credits in 2004–05 might well lead to further falls in both pensioner and child poverty. Further increases in at least some elements of the social security and tax credit budget as a share of national income are likely to be required if the government is to continue reducing both pensioner and child poverty. Child poverty is the subject of a long-standing government commitment, repeated in the 2005 Labour Party manifesto, to 'end child poverty in a generation', while the Chancellor has stated the government's ambition 'to end pensioner poverty in our country'.[9]

Figure 4.8. Social security spending, and child and pensioner poverty



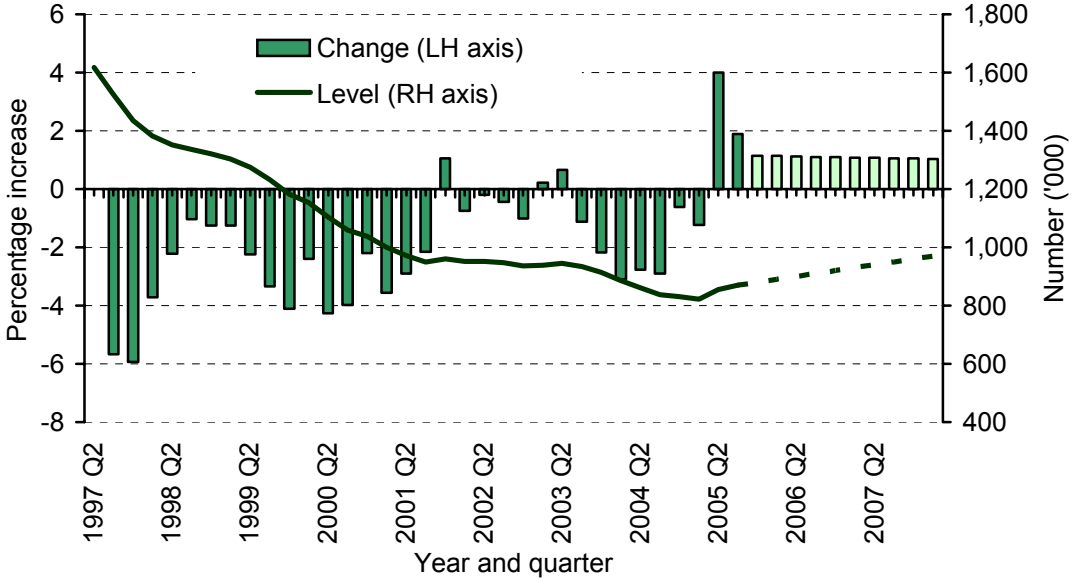
Sources: Figures for spending as for Figure 4.7. Figures on child and pensioner poverty refer to the percentage of the group that are in households whose income after housing costs is below 60% of the contemporary median household after-housing-cost income, from Department for Work and Pensions, *Households Below Average Income 1994/95 to 2003/04*, 2005, http://www.dwp.gov.uk/asd/hbai/hbai2004/contents.asp.

[8] For more details of changes in both inequality and poverty in recent years, see M. Brewer, A. Goodman, J. Shaw and A. Shephard, *Living Standards, Inequality and Poverty*, IFS Election Briefing Note no. 9, 2005, http://www.ifs.org.uk/bns/05ebn9.pdf.

[9] Gordon Brown, Labour Party Conference, 30 September 2002.

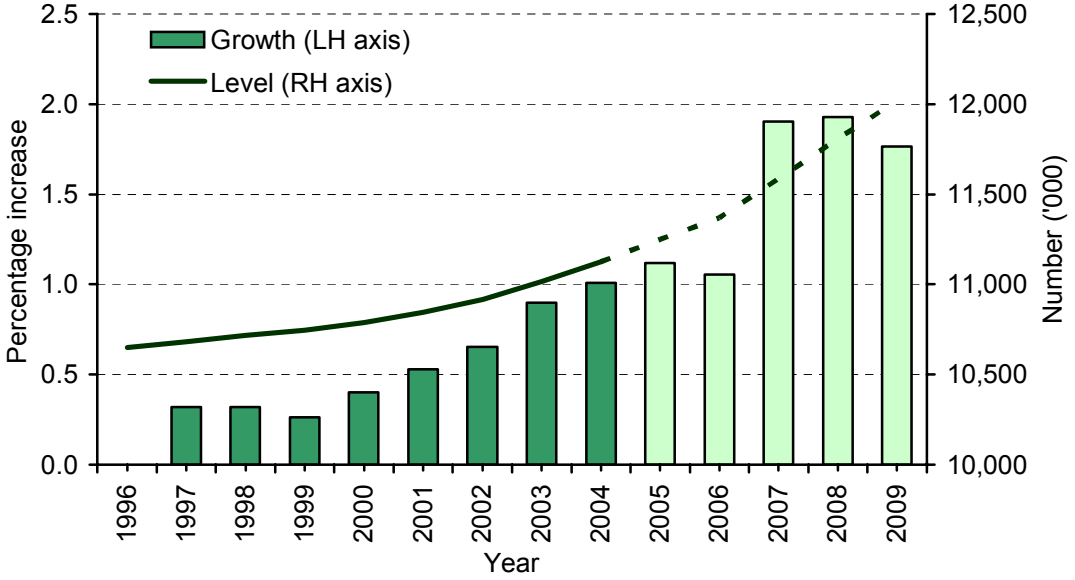
If the government does want to continue reducing both child and pensioner poverty over the period covered by the 2007 CSR, then this might be more likely to require overall increases in the social security and tax credit budget than it did in the period since 1997. As shown in Figure 4.9, this is because the period between 1997 and 2004 saw almost continuous falls in the number of people who are registered unemployed, with particularly large falls over the

Figure 4.9. Further falls in unemployment not expected



Sources: Figures to 2005 quarter 3 taken from Office for National Statistics website, http://www.statistics.gov.uk/StatBase/tsdataset.asp?vlnk=430&Pos=1&ColRank=1&Rank=422. HM Treasury's assumption for period to 2007–08 taken from box B.1, page 214 of HM Treasury, *Pre-Budget Report 2005*, Cm. 6701, 2005, http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr05/report/prebud_pbr05_repindex.cfm.

Figure 4.10. Growth in pensioner population expected to accelerate



Sources: Figures to 2004 from table 1.4 of Office for National Statistics, *Population Trends: Winter 2005*, http://www.statistics.gov.uk/downloads/theme_population/PopTrends122v1.pdf, with 1997 estimated from interpolation from 1996 and 1998 data. Figures from 2005 onwards from Government Actuary's Department website http://www.gad.gov.uk/Population/index.asp.

first four years of this period. (The line and the right-hand axis show the level of claimant-count unemployment, while the bars and the left-hand axis show the quarter-on-quarter change.) Over the period to 2007–08, the Treasury's projections for expenditure on social security and tax credits (which were presented in Figure 4.7) assume that unemployment will rise slightly from 870,000 currently to 970,000 in 2007–08.

Another increasing pressure on the social security budget is that the baby boomers born just after the Second World War are now starting to reach the state pension age. Figure 4.10 shows the number of people aged above the state pension age from 1996 to 2009 (right-hand axis) and the percentage increase in the pensioner population for each year from 1997 to 2009 (left-hand axis). This shows that between 1996 and 2004, the UK pensioner population increased from 10.6 million to 11.1 million – an average increase of 0.5% a year. Over the next five years, it is forecast by the Government Actuary's Department to increase by an average of 1.6% a year, reaching 12.0 million in 2009. Indeed, DWP's latest forecast (which assumes that the pension credit guarantee is indexed to average earnings) is that spending on social security benefits to pensioners will increase by an average 2.7% a year over the period from 2005–06 to 2010–11, after economy-wide inflation, which is faster than the expected growth in national income over this period.[10]

4.3 Scenarios for the 2007 CSR

This section looks at potential allocations for the 2007 CSR, given the trends in public spending since Labour took office in May 1997 and the government's stated objectives. We do this first under the assumption that the Treasury chooses to keep departments to the spending plans implied by the December 2005 Pre-Budget Report. We then contrast this allocation to alternatives that would be possible under three different illustrative scenarios, two of which would be more generous than the figures set out in the PBR and one of which would be substantially less generous.

'2005 Pre-Budget Report scenario'

The December 2005 Pre-Budget Report contains figures for TME that imply it growing by an average of 1.8% a year in real terms over 2008–09, 2009–10 and 2010–11,[11] as shown in the top panel of Table 4.1. If implemented, this growth would be lower than the 3.2% a year average increase in spending that the Treasury is forecasting for the 11-year period between 1996–97 and 2007–08, i.e. the period from when Labour came into power to the last year for which 'firm and fixed' spending plans have been announced. It would also be lower than the 3.0% a year real growth in TME that is forecast for the next two years, but it would be more

[10] This comprises spending on the basic state pension, SERPS, pension credit, housing-related benefits, attendance allowance, disability living allowance and other pensioner benefits. Source: Table LT.3 of Department for Work and Pensions, *Benefit Expenditure Tables*, 5 December 2005, http://www.dwp.gov.uk/asd/asd4/long_term.asp.

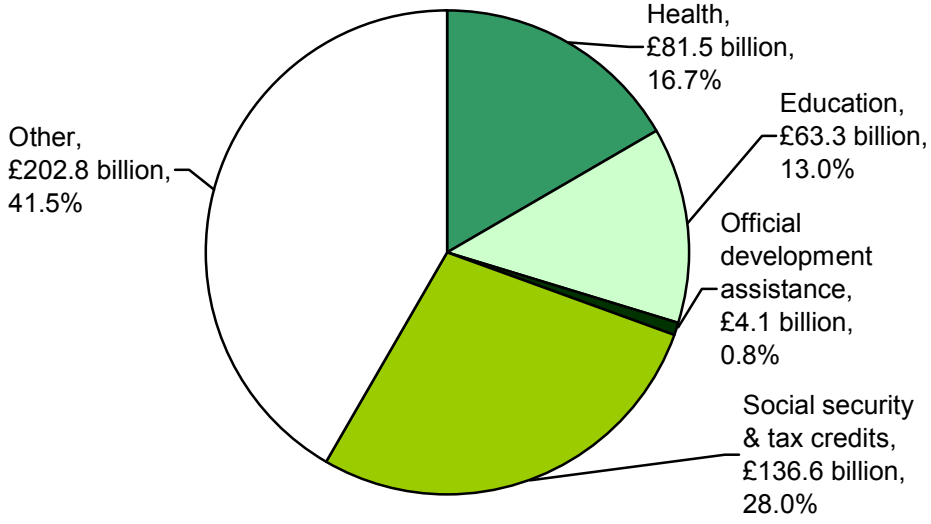
[11] This growth is calculated using the figures in table B.9 on page 220 of HM Treasury, *Pre-Budget Report 2005*, Cm. 6701, 2005, http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr05/report/prebud_pbr05_repindex.cfm. Paragraph B29 of the PBR implies that, due to rounding, in fact TME will grow slightly faster than this.

Table 4.1. Possible 2007 CSR allocation under 2005 PBR spending plans

	Real average annual growth in	Possible future allocations: 2007 CSR (2007–08 to 2010–11)	Existing Labour plans: first 11 years (1996–97 to 2007–08)	Inherited Conservative spending plans: first 2 years (1996–97 to 1998–99)	Spending Reviews to date: last 7 years (1998–99 to 2005–06)	Current plans: next 2 years (2005–06 to 2007–08)
	PBR projections					
	Total managed expenditure	1.8	3.2	–0.2	4.3	3.0
	Memo: GDP growth	*2.4*	*2.8*	*3.2*	*2.6*	*2.6*
	Possible allocations					
(1)	Health spending	4.4	6.1	2.1	7.0	7.2
	TME minus (1)	1.2	2.7	–0.6	3.8	2.2
(2)	Education spending	2.4	4.6	0.5	6.3	2.6
(3)	ODA	10.5	7.2	–1.1	8.4	12.1
	TME minus (1), (2), (3)	0.8	2.3	–0.7	3.3	1.9
(4)	Social security and tax credit spending	2.2	2.2	–1.6	3.6	1.0
	TME minus (1), (2), (3), (4)	–0.1	2.4	–0.2	3.1	2.6

Note: Growth in real spending is calculated by deflating each component of spending by growth in the GDP deflator; while this might not be the appropriate deflator for the increase in the cost of goods and services purchased, it could be considered the most appropriate deflator when considering the cost to the taxpayer.
Sources: See Figures 4.1, 4.2, 4.4, 4.6 and 4.7 for sources on spending projections. Health spending growth for three-year period from 2007–08 to 2010–11 taken from 'fully engaged' scenario in table 5.1 of HM Treasury, *Securing Our Future Health: Taking a Long-Term View*, Final Report of the Wanless Review, 2002, http://www.hm-treasury.gov.uk/Consultations_and_Legislation/wanless/consult_wanless_final.cfm. Other figures are authors' calculations/assumptions.

Figure 4.11. Composition of total managed expenditure in 2004–05



Note: The largest components of 'other' spending are public order and safety (£28.7 billion), defence (£28.2 billion) and public sector debt interest (£24.5 billion).
Sources: See Figures 4.1, 4.2, 4.4, 4.6 and 4.7 for sources for spending in 2004–05.

generous than the average cut of 0.2% a year that was implemented during Labour's first two years in office. It would also be lower than the expected growth in the economy over this period.

The bottom panel of Table 4.1 sets out a possible allocation of the PBR spending totals between health, education, ODA, social security and tax credits, and other spending. Figure 4.11 shows that the four areas of public spending considered in this section made up nearly 60% of public spending in 2004–05. Of course, the Treasury could choose to implement a larger or smaller overall spending envelope, which is something that we turn to in the next subsection (see Table 4.2).

Health spending

Partly as a result of the Treasury choosing to implement the recommendations of the Wanless Report, health spending is set to grow by an average of 7.0% a year over the seven-year period between 1998–99 and 2005–06. The Wanless Report also sets out three different scenarios for NHS spending over the period from 2008–09 to 2012–13.[12] These three different scenarios, from the least to the most optimistic (in terms of the cost to the taxpayer of progressing towards a 'world-class health service'), are referred to as 'slow uptake', 'solid progress' and 'fully engaged'. The Wanless Report states (page 35) that 'fully engaged' would require the following:

> levels of public engagement in relation to their health are high: life expectancy increases go beyond current forecasts, health status improves dramatically and people are confident in the health system and demand high quality care. The health service is responsive with high rates of technology uptake, particularly in relation to disease prevention. Use of resources is more efficient.

The Wanless Report estimated that under this 'fully engaged' scenario, NHS spending would need to grow by an average 4.4% a year over the five-year period from 2007–08 to 2012–13. Were the 'solid progress' scenario to be met, then increases of 4.7% a year were estimated to be required, whereas under the 'slow uptake' scenario, the corresponding figure was for increases of 5.6% a year. In Table 4.1, we assume that the government believes that the 'fully engaged' scenario has been met and that it chooses to allocate real increases of 4.4% a year to the NHS. Of course, given that the Wanless Report was published in 2002, it is quite possible that a lower or higher increase in spending would be required to progress towards the standard of healthcare that was deemed 'world-class' by that report. Indeed, the Treasury is currently undertaking a re-evaluation of the Wanless calculations and it could conclude that larger or smaller allocations would be appropriate.[13]

Allocating health a real increase of 4.4% a year in real terms (as shown in row 1 of Table 4.1) would, if the PBR figures for TME are retained, leave real increases of 1.2% a year across all non-health areas of government spending.

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[12] The report also contains spending plans for 2013–14 to 2017–18 and 2018–19 to 2022–23 under each of the same three scenarios. See table 5.1 of HM Treasury, *Securing Our Future Health: Taking a Long-Term View*, Final Report of the Wanless Review, 2002, http://www.hm-treasury.gov.uk/Consultations_and_Legislation/wanless/consult_wanless_final.cfm.

[13] Source: 'National Health Service: winter crisis', *The Economist*, 8 December 2005, http://www.economist.com/World/europe/displayStory.cfm?story_id=5280734&no_na_tran=1.

Education spending

For education spending, we assume that the government chooses to increase spending in line with growth in the economy (line 2 of Table 4.1). The 1997 New Labour manifesto contained a high-profile pledge to increase spending on education as a share of national income, while Gordon Brown has, since then, reiterated ambitions to further improve education outcomes going forward. Given this, and the fact that education spending has risen as a share of national income since Labour came to power, it would be surprising for the government to now choose to reduce it as a share of national income. Of course, it could allocate more than 2.4% a year (after economy-wide inflation), although it is worth noting that, as shown in Table 4.1, over the two-year period from 2005–06 to 2007–08, education has only been awarded an average real increase of 2.6% a year.

Official development assistance

With ODA, we assume that the government wants to implement constant real increases in spending in order to reach 0.7% of national income in 2012–13. This would imply real increases of 10.5% a year in real terms over the period covered by the 2007 CSR (line 3 of Table 4.1). While this would be a substantial increase (it implies a £3.0 billion cash increase in annual spending over the three-year period), it is actually slightly lower than the 12.1% a year that is planned on average over the two years from 2005–06 to 2007–08.

Other spending (1)

Under the scenario where the overall spending envelope is set to the plans laid out in the Pre-Budget Report, and that health spending is increased by 4.4% a year, education spending by 2.4% a year and ODA by 10.5% a year, then spending on other items would be constrained to grow by an average of just 0.8% a year in real terms. This would be significantly below the average annual increase of 3.8% a year seen over the seven-year period from 1998–99 to 2005–06. It would also be significantly below the 1.9% a year that is planned over the two years 2005–06 to 2007–08. It would, however, still be more generous than the first two years in which Labour was in office, when spending on these components was cut by an average of 0.7% a year in real terms.

Social security and tax credit spending

As discussed in Section 4.2, a large proportion of public spending is on social security and tax credit transfers. As a result, the generosity of any given spending envelope on public services will depend in large part on growth in this component of the budget. In Table 4.1, we assume that spending on social security and tax credits grows by 2.2% a year in real terms (line 4). This is slightly lower than expected growth in the economy over this period, but is equal to the growth in social security spending that has been seen over the 11-year period between 1996–97 and 2007–08. Of course, this period contains some large increases in the generosity of payments to low-income families with children and lower-income pensioners. However, as described in Section 4.2, this period also saw large falls in unemployment and lower growth in the pensioner population than are expected going forward. Moreover, the government might wish to continue to increase the generosity of some elements of the social security and tax credit system in order to deliver further significant reductions in relative child and pensioner poverty.

Other spending (2)

Under the scenario where the overall spending envelope is set to the plans laid out in the Pre-Budget Report, and that health spending is increased by 4.4% a year, education spending by 2.4% a year, ODA by 10.5% a year, and social security and tax credit spending by 2.2% a year, then spending on other items would need to be cut by 0.1% a year over the three years covered by the 2007 CSR. While this could be achieved – indeed, Labour implemented a slightly larger average annual real cut during its first two years in office – it might not prove consistent with aspirations for public services that we have not considered in this chapter, such as law and order and transport. In the case of transport spending, the Department for Transport's update to the 10-year transport plan suggests that expenditure will need to remain constant as a share of national income over the period from 2007–08 to 2014–15.[14] The reduction in the growth of the EU rebate that the Prime Minister has agreed to since the Pre-Budget Report was published will also add to pressures on spending over the period from 2008. Moreover, the low spending growth over the two years from 1996–97 to 1998–99 would have been assisted by falls in debt interest payments due to a combination of falling debt levels and reductions in interest rates. In contrast, both we and the Treasury expect debt levels to rise slightly over the next few years (see Chapter 5), while Morgan Stanley's analysis suggests that, if anything, real interest rates are likely to increase (see Chapter 6).

Illustrative alternative scenarios

All of the discussion in the previous subsection assumes that the Treasury decides to keep to the spending projections that were set out in the 2005 Pre-Budget Report. As made clear by the Chancellor in his evidence to the House of Commons Treasury Select Committee, the Treasury could take a different view. Therefore this subsection sets out three alternative scenarios for growth in TME over the 2007 CSR period and describes the potential implications under the assumption that education, health, ODA, social security and tax credit expenditure all grow at the rates assumed in Table 4.1.

The first alternative scenario is that the Treasury decides to keep public spending constant as a share of national income (see panel B of Table 4.2). This is the assumption that was made in the January 2005 IFS Green Budget.[15] Under the allocations for health, education and ODA that were set out in Table 4.1, this would leave other areas of public spending with a 1.7% a year real increase over the three-year period from 2007–08 to 2010–11, compared with 0.8% a year under the scenario where the PBR allocations were kept to. Were spending on social security and tax credits to grow by 2.2% a year (again as set out in Table 4.1), then this would allow spending on other items of public spending to grow by an average of 1.3% a year. This compares with an average annual real cut of 0.1% if the PBR spending totals were kept to. However, even this would be less generous than the plans for the two-year period from 2005–06 to 2007–08, where this component of spending is expected to grow by 2.6% a year in real

[14] See figure 4.11b of C. Emmerson, C. Frayne and S. Love, *A Survey of Public Spending in the UK*, IFS Briefing Note no. 43, 2004, http://www.ifs.org.uk/bns/bn43.pdf, and annex A of Department for Transport, *The Future of Transport*, Cm. 6234, 2004, http://www.dft.gov.uk/stellent/groups/dft_about/documents/divisionhomepage/031259.hcsp.

[15] See table 4.5 on page 69 of R. Chote, C. Emmerson, D. Miles and Z. Oldfield (eds), *The IFS Green Budget: January 2005*, IFS Commentary no. 98, http://www.ifs.org.uk/budgets/gb2005/index.php.

terms, let alone than the seven-year period between 1998–99 and 2005–06, when it grew by an average of 4.1% a year in real terms (see Table 4.1).

The second alternative scenario is where spending on health, education and ODA are as set out in Table 4.1 and that all other spending is kept constant as a share of national income (i.e. increased by 2.4% a year after economy-wide inflation; see panel C of Table 4.2). This would require TME to grow by 2.8% a year in real terms over the three-year period from 2007–08 to 2010–11, which is significantly higher than the 1.8% a year real growth implied by the Treasury's PBR figures. It would, however, allow increases in 'non-health, non-education and non-ODA spending' that were more generous than those allocated over the next two years (i.e. the 2.4% in Table 4.2 is greater than the 1.9% a year growth shown for these components of spending over the two-year period from 2005–06 to 2007–08 in Table 4.1).

Table 4.2. Possible 2007 CSR allocation under illustrative alternative scenarios

		Real spending growth over 3 years from 2007–08 to 2010–11
(A)	**'Baseline' scenario: TME as Pre-Budget Report projection**	
	Total managed expenditure	1.8
	TME excluding health, education and ODA	0.8
	TME excluding health, education, ODA, social security and tax credits	–0.1
(B)	**Alternative scenario 1: TME to remain constant as % of GDP**	
	Total managed expenditure	2.4
	TME excluding health, education and ODA	1.7
	TME excluding health, education, ODA, social security and tax credits	1.3
(C)	**Alternative scenario 2: non-health, education & ODA spending to remain constant as % of GDP**	
	Total managed expenditure	2.8
	TME excluding health, education and ODA	2.4
	TME excluding health, education, ODA, social security and tax credits	2.4
(D)	**Alternative scenario 3: TME to remain constant in real terms**	
	Total managed expenditure	0.0
	TME excluding health, education and ODA	–2.0
	TME excluding health, education, ODA, social security and tax credits	–4.9

Note: Growth in real spending is calculated by deflating each component of spending by growth in the GDP deflator; while this might not be the appropriate deflator for the increase in the cost of goods and services purchased, it could be considered the most appropriate deflator when considering the cost to the taxpayer.

A third alternative scenario is where TME is frozen in real terms – so that none of the benefits of economic growth are given to public spending (see panel D of Table 4.2). Under this scenario, it would only be possible to allocate health, education and ODA the amounts set out in Table 4.1 if spending on other items were cut by an average of 2.0% a year. In addition, if spending on social security and tax credits grew by 2.2% a year over this period, then other spending would need to be cut by 4.9% a year in real terms.

Each of the three alternative scenarios set out above has growth in TME over the period covered by the 2007 CSR different from that pencilled into the Pre-Budget Report. It would require higher taxation, higher borrowing or some combination of the two, relative to the path for the public finances shown in the PBR, to finance either of the first two alternative scenarios, as they involve higher total public spending. The third alternative scenario would facilitate lower taxation, lower borrowing or some combination of the two, relative to the figures contained in the PBR, as it would involve lower total public spending.

Table 4.3. Annual cost of different illustrative alternative scenarios

	Average annual growth	**Additional funding required** (2005–06 terms)	**Spending cut/increase over 2007 CSR** (2005–06 terms)
(A) Baseline scenario: TME as PBR projection	1.8	no change	–£8½ bn
(B) Alternative scenario 1: TME constant as % of national income	2.4	+£8½bn	no change
(C) Alternative scenario 2: Non-health, education & ODA spending to remain constant as % of national income	2.8	+£15bn	+£6½ bn
(D) Alternative scenario 3: TME to remain constant in real terms	0.0	–£27bn	–£35½ bn

Note: Growth in real spending is calculated by deflating each component of spending by growth in the GDP deflator; while this might not be the appropriate deflator for the increase in the cost of goods and services purchased, it could be considered the most appropriate deflator when considering the cost to the taxpayer.

The spending figures set out in the Pre-Budget Report (scenario A in Tables 4.2 and 4.3) imply that TME as a percentage of national income would fall from 42.8% of national income in 2007–08 to 42.1% of national income in 2010–11. Under the first alternative scenario (scenario B in Tables 4.2 and 4.3), it would remain at 42.8% of national income. This implies that in 2010–11, spending would be 0.7% of national income higher than that set out in the PBR. In current terms (using 2005–06 national income), this is equivalent to £8½ billion, as shown in Table 4.3. In other words, to implement this scenario would require the Treasury to raise an additional £8½ billion in 2010–11 in today's terms, either from increased borrowing or increased taxation. Given the lack of room to manoeuvre relative to the fiscal rules, new tax-raising measures would seem more likely than sole reliance on increased borrowing.

Under the second alternative scenario (scenario C in Tables 4.2 and 4.3), TME would increase as a share of national income from 42.8% in 2007–08 to 43.3% in 2010–11. This would leave it 1.2% of national income higher than set out in the PBR. In current terms (using 2005–06

national income), this is equivalent to £15 billion, as shown in Table 4.3. Given the constraint placed by the two fiscal rules, this would be expected to necessitate additional tax-raising measures. Under the third alternative scenario (scenario D in Tables 4.2 and 4.3), TME would fall as a share of national income, from 42.8% in 2007–08 to 39.9% in 2010–11. This would leave it 2.2% of national income lower than set out in the PBR. In current terms (using 2005–06 national income), this is equivalent to £27 billion, as shown in Table 4.3. This saving could be used both to increase caution in the public finances by reducing expected borrowing and to deliver significant tax-cutting measures.

In Table 4.3, we also show each scenario as a 'cut' or 'increase' in public spending, using a baseline in which spending is held constant as a share of national income. Whether this is an appropriate way to define a 'cut' is debatable, but this was the method used by the Labour Party when characterising the Conservative spending proposals during the 2005 election campaign.

4.4 Longer-term pressures on spending

Alongside each year's Pre-Budget Report, the Treasury publishes illustrative projections of public spending over time horizons of up to 50 years, well beyond the period of the forthcoming Comprehensive Spending Review. These projections help capture long-term pressures on the public purse, notably demographic factors that are likely to increase the demand for spending on the young (child-related benefits and education spending) and the old (pensions, healthcare and long-term care). An important caveat is that these forecasts are inevitably subject to very wide margins of error and will also be very sensitive to the various assumptions that have to be made.

The projections assume that 'current policies' continue, which is, of course, unlikely. For example, the projections assume the means-tested support available to pensioners through the pension credit guarantee will rise in line with average earnings. But the Treasury points out that 'decisions related to the indexing of the Pension Credit will be made on a Budget and Spending Review timetable in the context of resources and priorities' and that the assumption of earnings indexation over the long term 'should not be taken as the Government's policy'. This is despite the fact that the Prime Minister, in his foreword to the 1998 Pensions Green Paper, stated, with reference to the minimum income guarantee (the predecessor of the pension credit guarantee), that 'Over the longer term our aim is that it should rise in line with earnings so that all pensioners can share in the rising prosperity of the nation'. The Treasury has suggested that this represents an upper bound on possible generosity: 'These projections are based on the scenario that the parameters of the pension credit are uprated in such a way as to lead to an upper estimate of the possible cost of the Pension Credit in the long term'.

Table 4.4 shows that the Treasury expects upward pressure on public spending over the next 50 years, and to a greater degree than it did a year ago. This in part reflects the fact that the ageing of the population is now expected to be more pronounced.

Table 4.4. HM Treasury's long-term public spending projections (percentage of national income)

	December 2004			December 2005		
	2003–04	**2053–54**	***Change***	**2004–05**	**2054–55**	***Change***
Education	5.1	5.2	*+0.1*	5.5	5.4	*–0.1*
State pensions	5.0	5.6	*+0.6*	5.0	6.6	*+1.6*
Health	6.9	9.5	*+2.6*	7.2	9.8	*+2.6*
Long-term care	1.0	1.5	*+0.5*	1.2	1.9	*+0.7*
Public service pensions	1.5	2.2	*+0.7*	1.5	2.1	*+0.6*
Total age-related	**19.5**	**24.0**	***+4.5***	**20.4**	**25.8**	***+5.4***
Other	21.1	19.1	*–2.0*	20.7	19.5	*–1.2*
Total	**40.6**	**43.1**	***+2.5***	**41.1**	**45.3**	***+4.2***

Sources: HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, 2005, http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr05/assoc_docs/prebud_pbr05_adlongterm.cfm; HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, 2004, http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr04/assoc_docs/prebud_pbr04_adlongterm.cfm.

4.5 Conclusion

The Pre-Budget Report pencilled in figures for total public spending that encompass, for the first time, the whole of the period set to be covered by the 2007 Comprehensive Spending Review. If implemented, these would imply public spending falling by 0.7% of national income over the three-year period. By 2010–11, this would be equivalent to £8½ billion in today's terms.

Should the Treasury choose to keep to these spending plans, some tough choices would need to be made in the 2007 CSR. Under plausible scenarios for spending on health, education and overseas aid, it would leave other spending growing at just 0.8% a year in real terms over the three-year period from 2007–08 to 2010–11. This compares with expected growth in this spending of 1.9% a year over the two-year period from 2005–06 to 2007–08 and 3.8% a year over the seven-year period from 1998–99 to 2005–06.

Recent years have seen increases in social security and tax credit expenditure as a share of national income, which have enabled the government to make significant progress in its objectives of reducing, and eliminating, child and pensioner poverty. If spending growth on social security and tax credits were held to an average of 2.2% a year in real terms (which is the average annual increase forecast to 2007–08 since Labour came to power), then this would require the 2007 CSR to identify real cuts across other areas of government spending. While this was achieved during Labour's first two years in office, it is not clear that it could be repeated, given stated objectives to improve other services such as transport and law and order, and the fact that spending restraint in those first two years was assisted by large falls in unemployment and debt interest payments, both of which are unlikely to be repeated. Further, the first two years of the Labour government were followed by substantial increases over the period to date.

The Chancellor has confirmed that the 2007 CSR envelope could differ from the spending figures set out in the Pre-Budget Report. One option would be to keep public spending constant as a share of national income. Given reasonable assumptions about health, education,

overseas aid, and social security and tax credit expenditure, this would allow other spending to grow by 1.3% a year in real terms. However, even this would be less generous than the spending plans for the two-year period from 2005–06 to 2007–08, where this component of spending is expected to grow by 2.6% a year in real terms, let alone than the seven-year period between 1998–99 and 2005–06, when it grew by an average of 4.1% a year in real terms. This scenario would also require an additional £8½ billion of financing in today's terms, which would most likely have to come from new tax-raising measures.

Keeping all non-health, education and overseas aid spending constant as a share of national income would allow a much easier settlement for the 2007 CSR. However, this would necessitate much greater funding, of £15 billion in today's terms. Alternatively, the Chancellor could choose to set a lower spending envelope: for example, freezing total public spending in real terms would require deep cuts if elements such as health, education and social security expenditure were to be as projected in this chapter, but would allow both borrowing to be reduced and significant new tax-cutting measures to be implemented.