

7. Challenges for public spending

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Summary

- The 2007 Comprehensive Spending Review looks set to be a very 'Challenging Spending Review'. The projections set out in the December 2006 Pre-Budget Report would, if implemented, reduce public spending by 0.5% of national income over the three years to be covered by the review – £7 billion in today's terms.
- These projections may prove incompatible with two key government aspirations: to improve public services and reduce poverty in the UK and overseas.
- Meeting the 2010–11 child poverty target would probably cost at least an extra £4½ billion. Finding this within the PBR spending projections would require difficult choices over other areas of spending. Even if spending in areas such as defence and environmental protection were frozen in real terms, the government would still have to allocate the NHS less than the minimum recommended by the 2002 Wanless Review or cut education spending as a share of national income.
- The most plausible scenario may be one where the Chancellor announces tight initial 2007 CSR settlements in the hope of topping them up at a later stage, as he has done with past reviews. Decisions to increase tax credits to meet the child poverty target could also be deferred to later Budgets and Pre-Budget Reports.
- Unless revenues or spending come in more favourably than expected, the Chancellor might have to choose between fresh tax increases or downplaying the child poverty target. Keeping spending constant as a share of national income in the CSR would require an extra £7 billion a year in today's terms by 2010–11.

7.1 Introduction

This year's Comprehensive Spending Review (CSR) will set out departmental spending plans for the three financial years beginning in April 2008. They will indicate the spending priorities on which Gordon Brown intends to fight the next general election if he succeeds Tony Blair as Prime Minister.

The 2007 CSR could well be dubbed a 'Challenging Spending Review'. As we discussed in Chapter 2, under current revenue forecasts the Treasury's fiscal projections require public spending to fall as a share of national income in order to meet its borrowing projections and therefore be able to expect to comply with both its fiscal rules with the degree of comfort that Mr Brown deems appropriate. This is in contrast to each of the four spending reviews under Labour to date, which have all planned (and, at least to date, delivered) increases in public spending as a share of national income. As we describe in this chapter, reducing public spending as a share of national income would require difficult choices in the 2007 CSR, and

might prove incompatible with the government's aspirations to improve the quality of public services and reduce poverty both in the UK and overseas.

Section 7.2 compares the growth in overall spending implied by the plans set out in the December 2006 Pre-Budget Report with what has happened since Labour came to power in May 1997 and with what has happened over the longer term. We then describe recent trends in spending on health and education, and contrast these to the trends seen over the longer term. Section 7.3 presents the trade-off that the government is likely to face between spending on health, education, transfer payments and other areas of public spending if the projections for overall spending set out in the December 2006 Pre-Budget Report are adhered to. We also describe how the trade-off would change were the Chancellor instead to preserve public spending as a share of national income at its projected 2007–08 level. Section 7.4 compares the latest Treasury estimates of the impact of changing demographics on longer-term public spending pressures with both previous UK estimates and those for other EU countries. Section 7.5 concludes.

7.2 Trends in UK public spending

Total spending since 1948–49

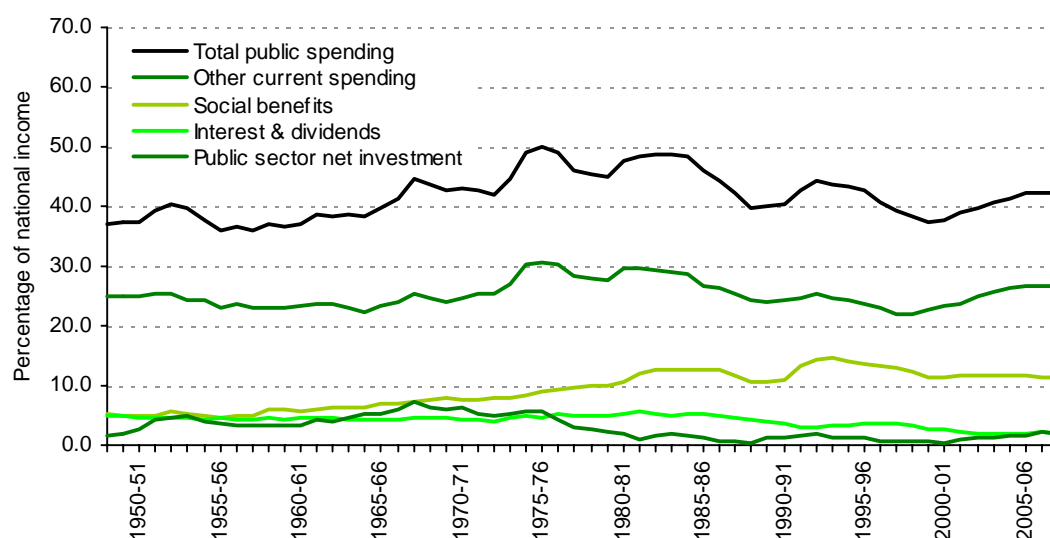
The Treasury predicts that total managed expenditure (TME), the broadest measure of government expenditure, will be £554.6 billion in 2006–07. This equates to 42.5% of national income or just over £9,150 for every person in the UK.

Figure 7.1 shows how public spending as a share of national income has varied since 1948–49. Total spending climbed from 37.1% of national income in 1948–49 to a peak of 50.1% in 1975–76. Particularly large growth occurred in spending on health, education and contributory benefits such as the basic state pension. Conversely, defence spending fell sharply from 9.7% of national income at the end of the Korean War in 1953 to 4.9% of national income in 1975.¹ Between 1975–76 and 1998–99, public spending fell as a share of national income, due initially to cuts in public sector net investment² and then to cuts in current spending on public services (including education). Public spending fell particularly sharply during the late 1980s and late 1990s as a strong economy reduced expenditure on social benefits and debt interest payments. Conversely, the early 1990s saw public expenditure increase as weak economic performance pushed up these expenditures. Figure 7.1 shows that public spending has risen again as a share of national income since April 1999. We now describe trends in spending under the current Labour government in more detail.

¹ For more details, see section 3 of T. Clark and A. Dilnot, *Long-Term Trends in British Taxation and Spending*, IFS Briefing Note 25, 2002 (<http://www.ifs.org.uk/bns/bn25.pdf>).

² For more information about public sector investment, see T. Clark, M. Elsby and S. Love, 'Trends in British public investment', *Fiscal Studies*, 23, 305–42, 2002 (http://www.ifs.org.uk/publications.php?publication_id=2127).

Figure 7.1. Public spending since 1948–49



Notes: Projections are from the December 2006 Pre-Budget Report. Current expenditure includes depreciation. Sources: Measures of public spending are ONS series ANLO, ANLT, ANLY, ANNW and ANNZ from table 2.3C of *Financial Statistics Freestanding Time Series Data*. GDP is ONS series BKTL from table A2 of *United Kingdom Economic Accounts* (<http://www.statistics.gov.uk/statbase/tsdtimezone.asp>). HM Treasury, *Pre-Budget Report 2006*, London, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/prebud_pbr06_index.cfm).

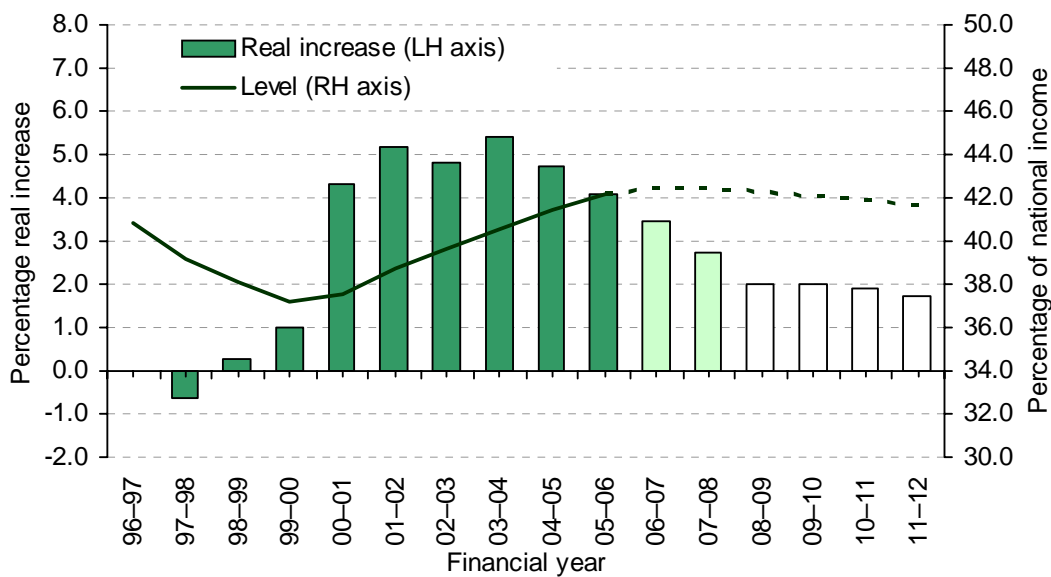
Growth in public spending under Labour

In 1996–97 – the last full financial year before Labour came to power – total public spending stood at 40.8% of national income. As the solid line in Figure 7.2 shows, this fell to 37.1% of national income in 1999–2000. This decline reflected a combination of strong economic performance and low growth in spending on public services. In July 1998, the government presented the results for the first Comprehensive Spending Review, which set out departmental spending plans for 1999–2000, 2000–01 and 2001–02. Despite 1999–2000 being the first year under the 1998 CSR plans, expenditure fell rather than rose as a share of national income due to some government departments spending less than their allocations. Public spending has since increased, reaching 42.2% of national income in 2005–06, which is due to increases in spending on public services (in particular, education and health) and large increases in the generosity of targeted support aimed at lower-income families with children and lower-income pensioners. The subsequent Spending Reviews of July 2000, 2002 and 2004 revised previous plans and set out departmental spending plans until 2007–08.

The bars in Figure 7.2 (and the left-hand axis) show the annual real³ increase in spending. Relatively large real increases in spending were seen in each year from 2000–01 to 2005–06. Lower growth in public spending projected for 2006–07 and 2007–08 (the last two years covered by the 2004 Spending Review) means that public spending as a share of national

³ Throughout this chapter, we refer to changes in 'real' spending, by which we mean spending calculated by deflating spending with 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.

Figure 7.2. Total managed expenditure



Sources: Total managed expenditure from table B1 of HM Treasury, *Public Sector Finances Databank*, London, December 2006 (http://www.hm-treasury.gov.uk/media/A5B/FD/pfd_dec06.xls) and table B8 of HM Treasury, *Pre-Budget Report*, London, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/prebud_pbr06_index.cfm). GDP and GDP deflators up-to-date as of 21 December 2006 from HM Treasury website (http://www.hm-treasury.gov.uk/economic_data_and_tools/gdp_deflators/data_gdp_fig.cfm).

income is expected to grow to 42.5% of national income in 2006–07 and remain at this peak in 2007–08.

Public spending in the years 2008–09, 2009–10 and 2010–11 is to be set in this year's CSR. However, the December 2006 Pre-Budget Report contains provisional plans that imply a further slowing in the growth of public spending: Mr Brown has pencilled in real increases of just 2.0% a year on average for the years 2008–09 to 2010–11. While these are provisional plans, any upward deviation from them would reduce the ability of the Chancellor to meet his fiscal rules with the comfort he is looking for without a commensurate increase in tax revenues. If the spending plans were implemented, these would be the lowest increases in public spending since 1999–2000. As shown by the dotted line, they would involve public spending declining to 41.9% of national income in 2010–11. This 0.5% of national income cut in public spending is equivalent to £7 billion in 2006–07 terms.

The projected level of spending in 2010–11 would be higher than that inherited by Labour when they came to power (40.8% of national income), but lower than the average seen during either John Major's premiership (42.9% of national income) or Margaret Thatcher's (44.9% of national income). The Treasury has also pencilled in a further decline in public spending as a share of national income in 2011–12. If delivered, it would bring public spending down to 41.7% of national income (with the 0.8% of national income reduction in public spending between 2007–08 and 2011–12 equal to £10 billion in 2006–07 terms). It would also be consistent with David Cameron's aspiration to share 'the fruits of economic growth between lower taxes and strengthened public services' since public spending would be growing in real terms but declining as a share of national income. However, while Mr Brown's public

Table 7.1. Comparison of Labour's Spending Reviews to date

Average annual growth in real public spending over:	Original spending plans	Adjusted for subsequent inflation	Eventual out-turn / Latest forecast
<i>Inherited Conservative spending plans</i>			
April 1997 to March 1999	+1.0 ^a	+0.3 ^a	-0.2
<i>Comprehensive Spending Review, July 1998</i>			
April 1999 to March 2002	+2.7	+3.3	+3.5
<i>Spending Review, July 2000</i>			
April 2001 to March 2004	+3.2	+2.9	+5.1
<i>Spending Review, July 2002</i>			
April 2003 to March 2006	+4.3	+4.3	+4.7
<i>Spending Review, July 2004</i>			
April 2005 to March 2008	+3.2	+3.4	+3.4
<i>Comprehensive Spending Review, 2007</i>			
April 2008 to March 2011	+2.0?		

^aOriginal plans, and plans adjusted for inflation, from April 1997 to March 1999 refer to GGE(X) rather than TME. Sources: Eventual inflation and latest spending estimates as Figure 7.2. Figures for each spending review from HM Treasury, *Financial Statement and Budget Report November 1996*, TSO, London, 1996; HM Treasury, *1998 Comprehensive Spending Review*, Cm. 4011, London, July 1998; HM Treasury, *2000 Spending Review*, Cm. 4807, London, July 2000; HM Treasury, *2002 Spending Review*, Cm. 5570, London, July 2002; HM Treasury, *2004 Spending Review*, Cm. 6237, London, July 2004. All documents available from http://www.hm-treasury.gov.uk/spending_review/spend_csr07/spend_csr07_index.cfm or <http://archive.treasury.gov.uk/siteindex.html>.

spending plans from 2007–08 onwards would, if adhered to, comply with Mr Cameron's proposed third fiscal rule, the Chancellor has rejected such a rule on the basis that it could restrict his options for public spending.⁴

Were the 2007 CSR actually to stick with real total public spending growth of 2.0% a year on average, this would also be less generous than the plans announced in any of Labour's previous four Spending Reviews. Table 7.1 compares the relative generosity of each of these reviews. The first column shows the average real spending growth over the three years of the review implied by the Treasury's original cash plans. The second column shows the real growth that would have resulted if these cash plans had been kept to, bearing in mind that in three of the four periods inflation differed from the rates assumed by the Treasury when the plans were drawn up. Inflation in 1999–2000 and 2000–01 was lower than had been expected at the time of the July 1998 Comprehensive Spending Review, giving scope for a bigger real increase from given cash plans. Conversely, inflation in 2002–03 and 2003–04 was higher than expected at the time of the July 2000 Spending Review, reducing the real generosity of the cash plans. The third column shows the actual average growth in real spending over each of the spending review periods. These figures are essentially the same as those presented in

⁴ See, for example, his March 2006 Budget speech: 'I have also received representations that we should adopt a third fiscal rule, that over the economic cycle and regardless of the needs of the economy, infrastructure and services – public spending and investment must, as a matter of principle, always rise slower than growth. Having analysed this proposal against our published plans I have found it would require in the coming year public spending £17 billion lower and £16 billion lower the year after, closing off the possibility of additional investment. I have rejected these representations'. Source: http://www.hm-treasury.gov.uk/budget/budget_06/bud_bud06_speech.cfm.

Figure 7.2 – but note that the spending review periods overlap and therefore some years are double-counted. It is clear that if Mr Brown's assumption of 2.0% a year real growth in public spending for the 2007 CSR is retained, then this will be a lower rate of increase than that planned, delivered or set to be delivered over any of the four previous Labour spending reviews.

Average growth in real TME is shown over different periods of interest (prior to and including Labour's term in office) in Table 7.2. Between Labour coming to power in May 1997 and the end of the current spending review period (March 2008), total public spending is forecast to grow by an average of 3.2% a year in real terms. This is higher than the growth of 1.5% a year over the 18-year period of Conservative Governments from 1979 to 1997 and the growth of 2.5% a year over the longer-term period prior to new Labour taking office. Also highlighted in Table 7.2 is the contrast between the growth in public spending seen during Labour's first two years in office and the period covered by Labour's spending reviews to March 2008 (when spending has grown in real terms).

Table 7.2. Trends in total spending

Period	Current	Capital	Total	GDP growth
<i>Labour</i>				
2007 CSR: April 2008 to March 2011	+1.9?	+2.7	+2.0?	+2.4
Plans to date: April 1997 to March 2008	+2.9	+13.9	+3.2	+2.8
First two years: April 1997 to March 1999	-0.3	+6.7	-0.2	+3.2
Spending reviews: April 1999 to March 2008	+3.6	+15.6	+4.0	+2.7
<i>Conservatives</i>				
April 1979 to March 1997	+1.7	-4.9	+1.5	+2.1
<i>Long-term trend (pre new Labour)</i>				
April 1964 to March 1997	+2.9	-3.4	+2.5	+2.3

Notes: Figures are for average annual growth. Capital spending refers to public sector net investment. Current spending includes depreciation.

Sources: As Figures 7.1 and 7.2.

Table 7.2 also shows the breakdown between growth in current and capital spending. On average over the period from April 1997 to March 2008, Labour is set to increase capital spending by 13.9% a year, though from a very low base, and current spending by 2.9% a year.

The capital spending plans for the 2007 CSR were announced by Mr Brown in his December 2006 Pre-Budget Report statement.⁵ These imply capital spending continuing to grow as a share of national income (2.7% a year compared with expected growth in the economy of 2.4% a year), albeit at a much slower rate than over the period from April 1999 to March 2008. While overall spending plans have not yet been set for the 2007 CSR, the plans contained in the December 2006 Pre-Budget Report, when combined with the capital spending figures that have now been announced, imply that current spending would grow by

⁵ While the December 2006 Pre-Budget Report documentation does not seem to state that the investment figures have been confirmed, Mr Brown's speech to parliament said 'And I can announce the spending review for the years to 2011 will be based on planned capital investment rising from £39 billion last year to £60 billion in 2011-12. Let me give details of the investment we will make over the five years ahead: next year £48 billion, rising in 2008 to £51, then £54, £57 and £60 billion'. Source: http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/prebud_pbr06_speech.cfm.

1.9% a year on average in real terms over the three-year period from April 2008 to March 2011. This compares with growth of 2.9% a year over the period from April 1997 to March 2008, which is also the average growth in current expenditure seen over the longer term prior to Labour coming to power.

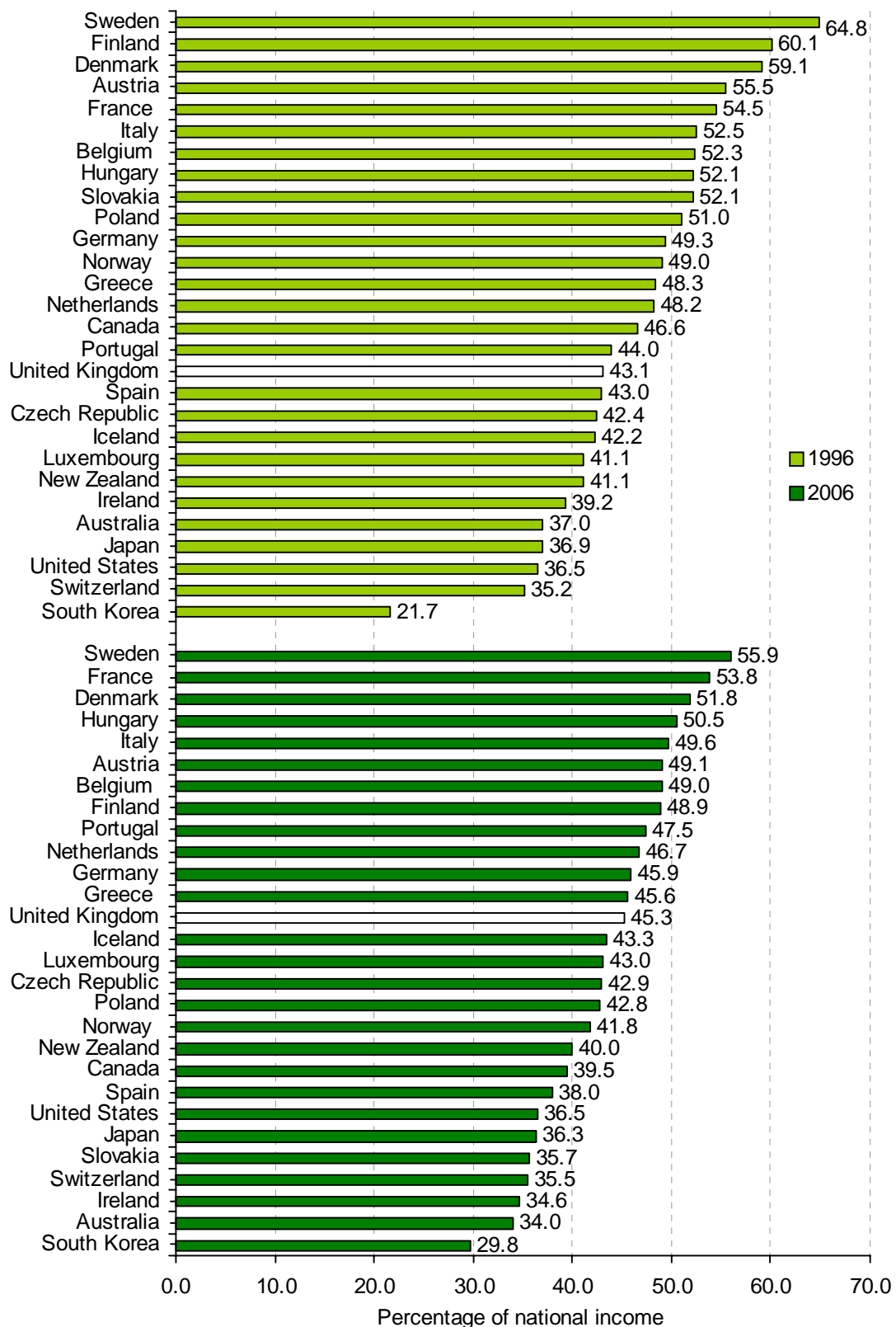
International comparison of total spending

A snapshot comparison of total general government outlays in both 1996 and 2006 across 28 OECD countries is presented in Figure 7.3. The UK moved from having the 17th highest level of public spending in 1996 to the 13th highest in 2006. Both could be regarded as ‘mid-table’ positions. In both 1996 and 2006, the highest spenders were countries such as Sweden, France and Denmark where general government spending is over half of national income. At the other extreme, in Australia and Ireland government outlays in 2006 were just over one-third of national income, while in South Korea they were just under 30%. Among the G7 countries, Japan, the US and Canada all have lower levels of public spending than the UK, while Italy and France have higher levels. Public spending in Germany is similar to (although still slightly higher than) the level in the UK.

In terms of the change in total government outlays over the period from 1996 to 2006, the UK has the third largest increase (+2.2% of national income) with only Portugal (+3.5%) and the very low-spending South Korea (+8.1%) seeing larger increases.

The growth in public spending as a share of national income that has occurred in the UK since Labour came to power in 1997 has not been shared equally across spending areas. Figure 7.4 shows the composition of public spending in 1996–97 and 2005–06, with the figures giving the share of national income allocated to each area. The areas are sorted so that those with the biggest proportionate increases in spending appear at the bottom of the chart and those with the biggest falls in spending appear at the top. Health has seen the largest increase (from 5.5% to 7.2% of national income, as a result of the large increases in spending that we describe in the next subsection), and public sector debt interest has fallen the most (from 3.6% to 2.2% of national income, as a result of falling public sector net debt and lower nominal and real interest rates).

Figure 7.3. Total public spending, OECD countries, 1996 and 2006

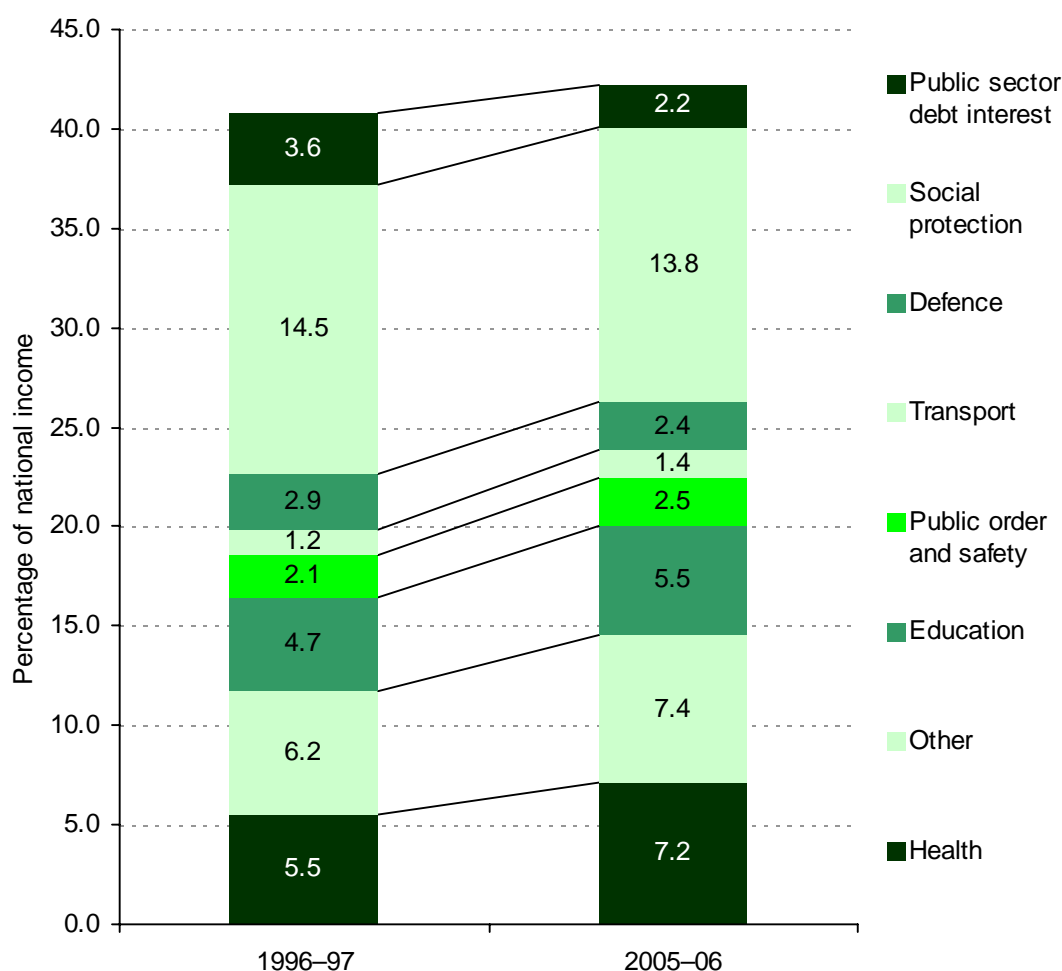


Note: Figures refer to general government total outlays. Figures for the US include outlays net of operating surpluses of public enterprises.

Source: Annex table 25 of OECD, *Economic Outlook No. 80*, December 2006

(http://www.oecd.org/document/18/0,2340,en_2649_201185_20347538_1_1_1_1,00.html).

Figure 7.4. Changing composition of public spending under Labour



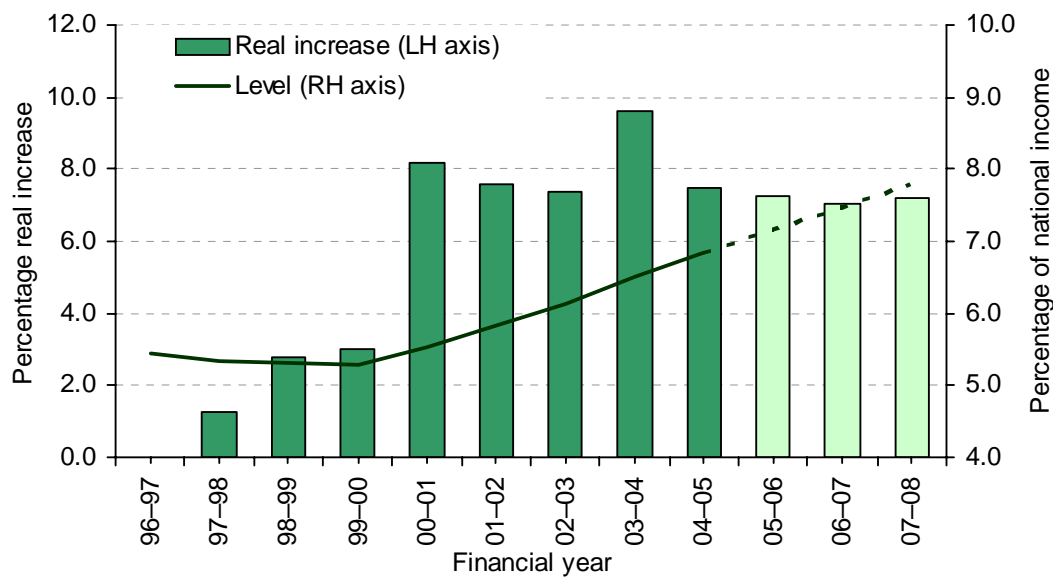
Source: HM Treasury, *Latest Functional Data*, December 2006 ([http://www.hm-treasury.gov.uk/media/588/F4/Excel file of latest functional data, 6th December 2006.xls](http://www.hm-treasury.gov.uk/media/588/F4/Excel_file_of_latest_functional_data_6th_December_2006.xls)).

Health spending

The level of UK health spending as a percentage of national income is shown in Figure 7.5 (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 chart is the real increase in health spending each year. The increases in health spending during Labour's first three years in office were lower than growth in the economy – therefore health spending declined slightly as a share of national income (from 5.4% of national income in 1996-97 to 5.3% of national income in 1999-2000). Since then, the NHS has received the largest sustained increase in spending since its inception in 1949.⁶ This has increased spending to 7.5% of national income in 2006-07. Under the plans set out in Budget 2002 (and re-confirmed in Spending Review 2004), health spending is set to increase further to 7.8% of national income in 2007-08.

⁶ 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 81, 2000 (<http://www.ifs.org.uk/comms/nhsspending.pdf>).

Figure 7.5. Health spending



Note: 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. Sources: Period to 2004–05 from HM Treasury, *Latest Functional Data*, December 2006 (http://www.hm-treasury.gov.uk/media/588/F4/Excel_file_of_latest_functional_data_6th_December_2006.xls). Period from 2004–05 onwards from table 8.2 of HM Treasury, *2004 Spending Review*, Cm. 6237, July 2004 (http://www.hm-treasury.gov.uk/spending_review/spend_sr04/report/spend_sr04_reindex.cfm).

In contrast to other departments, Mr Brown gave the NHS a five-year settlement in Budget 2002. This was justified on the basis of supporting evidence from the Treasury-commissioned Wanless Review. This recommended that to improve both health outputs and outcomes and to close the ‘considerable gaps in performance between the UK and other developed countries’, NHS spending increases would need to exceed the expected growth in the economy at least until 2017–18. Over the period from 2007–08 to 2012–13, the Wanless Review set out three different scenarios for NHS spending.⁷ These are referred to as ‘slow uptake’, ‘solid progress’ and ‘fully engaged’, with the cost to the taxpayer being lowest under the ‘fully engaged’ scenario and highest under the ‘slow uptake’ scenario.

The Wanless Review (page 35) stated that the ‘fully engaged’ scenario 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 Review 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. Increases of 4.7% a year would be required under the ‘solid progress’ scenario and 5.6% a year under the ‘slow uptake’ scenario. Given that the Wanless Review was published in 2002,

⁷ The report also contained spending plans for 2013–14 to 2017–18 and for 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, London.

it is possible that a lower or higher increase in spending would now be thought necessary to progress towards the standard of healthcare that was deemed ‘world-class’ by that report. Indeed, the Treasury is re-evaluating the Wanless Review calculations and it could conclude that larger or smaller allocations would be appropriate.⁸

A comparison between the average real growth in health spending seen over recent years and other periods of interest is shown in Table 7.3. This highlights the generosity of the average real increases of 7.2% a year over the nine years from April 1999 to March 2008. Over the 18 years of Conservative government after 1979, health spending increased by an average of 3.0% a year (which was still faster than average growth in the economy of 2.1% a year), while over the longer period from the birth of the NHS to March 1997 real health spending grew by an annual average rate of 3.4%.

Table 7.3. Trends in health spending

Period	Total	GDP growth
<i>Labour</i>		
Plans to date: April 1997 to March 2008	+6.2	+2.8
First two years: April 1997 to March 1999	+2.0	+3.2
Spending reviews: April 1999 to March 2008	+7.2	+2.7
<i>Conservatives</i>		
April 1979 to March 1997	+3.0	+2.1
<i>Long-term trend (pre new Labour)</i>		
April 1950 to March 1997	+3.4	+2.5

Note: Figures are for average annual growth.

Sources: As Figure 7.5 and C. Emmerson, C. Frayne and S. Love, *A Survey of Public Spending in the UK*, IFS Briefing Note 43, 2004 (http://www.ifs.org.uk/publications.php?publication_id=1791).

International comparison of health spending

In November 2001, the Prime Minister confirmed that he would like to see UK health spending reach the European average by 2005.⁹ At the time, the most recent information on health spending across EU countries was from 1998. As a result of the increases in NHS spending in recent years, the UK met the 1998 unweighted average (8.1% of national income) across the other EU15 countries in 2004 and is set to meet the 1998 weighted average (8.9% of national income) in 2007–08. The unweighted average is less meaningful as it gives as much weight to Luxembourg, which in 1998 had the lowest health spending in the EU (5.8% of national income), as it does to Germany, which had the highest spending (10.6% of national income), despite the fact that the German economy in 1998 was around 115 times larger than the Luxembourg economy.

However, health spending is unlikely to reach the contemporaneous weighted European average by 2007–08 because recent years have also seen increases in health spending in many other EU countries. The unweighted average across the other EU15 countries increased by 1% of national income between 1998 and 2003 (the latest year for which comparable OECD figures for EU countries are available), the same as the increase in UK health spending over

⁸ 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).

⁹ See *Hansard*, 28 November 2001, column 964.

this period. There were particularly large increases in Belgium (from 8.3% to 10.1% of national income), Portugal (from 8.4% to 9.8% of national income) and France (from 9.1% to 10.4% of national income).

In 2003, the UK spent 7.8% of its national income on healthcare (public and private). This was below both the unweighted average of health spending across the other EU15 countries (9.1% of national income) and the more meaningful weighted average of 9.6% of national income.¹⁰ NHS spending, as shown in Figure 7.5, is set to grow by 1.3% of national income between 2003–04 and 2007–08. Assuming that non-NHS health spending (public and private) remains constant as a share of national income, this would bring the UK's health spending up to 9.1% of national income.¹¹ Were health spending in other countries to remain unchanged, the UK would meet the unweighted EU-14 average in 2007–08 but would still be below the more meaningful weighted average.

Looking further afield, the US stands out in any comparison of health expenditure. In 2003, the UK spent 6.7% of national income on health publicly and a further 1.1% on healthcare privately.¹² In the US, public health spending in 2003 was 6.8% of national income – i.e. slightly above the UK level – with a further 8.4% of national income being spent on private healthcare. As a result, total health spending in the US, at 15.2% of national income, was almost twice the 7.8% of national income spent in the UK.

Private spending on healthcare

An additional reason why less progress has been made towards the contemporaneous average EU level of health spending in recent years is that some of the increase in NHS spending has been offset by a fall in private healthcare spending. Figure 7.6 shows public and private health spending as a share of national income from 1960 to 2005. While public spending on health has typically increased as a share of national income over time, we see a less consistent pattern for private spending. Private spending fell from 0.7% of national income in 1964 to 0.5% in 1975, then rose to 1.4% by 2000, before falling again to 1.1% by 2005. This latest decline has coincided with the large increases in NHS spending. Between 2000 and 2005, public health expenditure grew by 1.4% of national income, equivalent to £18½ billion in today's terms. This has been associated with a 0.3% of national income fall in private healthcare spending, which is equivalent to £4 billion in today's terms. As a result, total health spending rose by 1.1% of national income, or £14½ billion in today's terms, over the first five years of this century. The decline in private health spending over this period could, at least in part, have been caused by the increases in public spending. This would be the case if there were improvements in the quality of the NHS – or at least the perception of an improvement in the NHS – which led to individuals choosing not to purchase private medical insurance or not resorting to purchasing private healthcare directly. For example, since Spring

¹⁰ Health spending from OECD, *Health Data 2006: Statistics and Indicators for 30 Countries*, 2006 (http://www.oecd.org/document/16/0,2340,en_2649_37407_2085200_1_1_1_37407,00.html); weighted average calculated using OECD figures on GDP in US\$ using PPPs from <http://titania.sourceoecd.org/vl=4774071/cl=28/nw=1/rpsv/factbook/index.htm>.

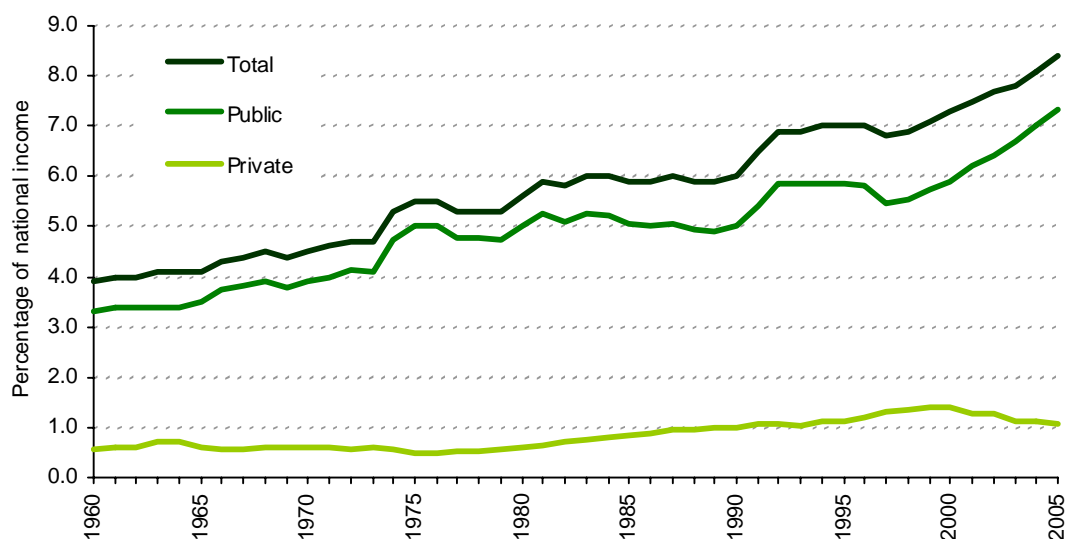
¹¹ The OECD figures suggest that UK health spending reached 8.4% of national income in 2005. Adding the planned increase in NHS spending between 2005–06 and 2007–08 to this figure gives a projection of health spending in 2007–08 of 9.0% of national income.

¹² Source: OECD, *Health Data 2006: Statistics and Indicators for 30 Countries*, 2006 (http://www.oecd.org/document/16/0,2340,en_2649_37407_2085200_1_1_1_37407,00.html).

1998, there have been sharp falls in hospital waiting lists, and previous research has shown that shorter hospital waiting lists lead to fewer individuals choosing to purchase private medical insurance.¹³

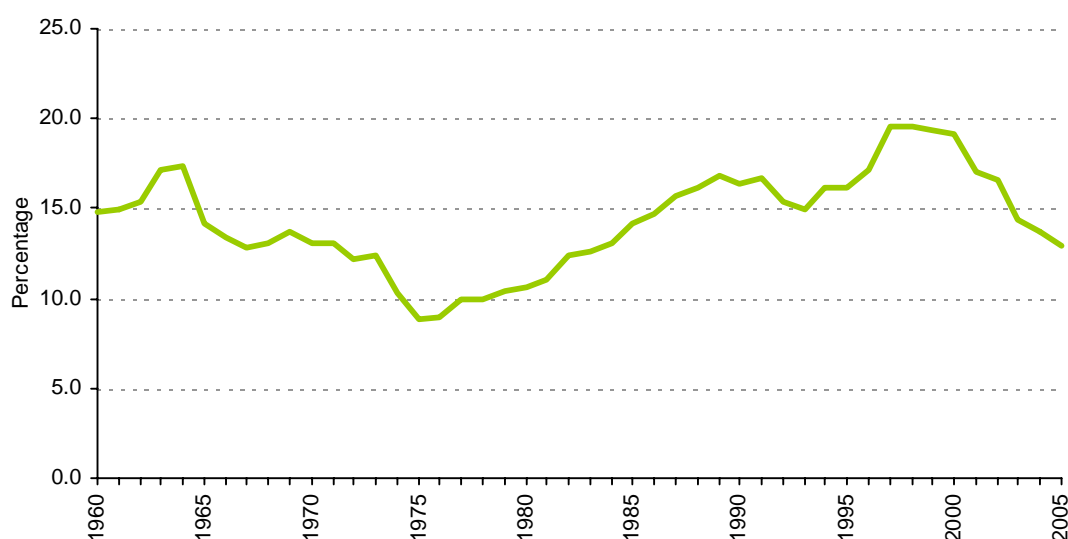
Figure 7.7 contains the same underlying data as Figure 7.6 but instead gives the percentage of UK healthcare expenditure that was privately rather than publicly funded. This shows that private spending declined as a share of total health spending between 1964 and 1975, climbed to a peak of 19.6% of total spending in 1997 and has since fallen back to 12.9%.

Figure 7.6. Public and private health spending



Source: OECD, *Health Data 2006: Statistics and Indicators for 30 Countries, 2006* (http://www.oecd.org/document/16/0,2340,en_2649_37407_2085200_1_1_1_37407,00.html).

Figure 7.7. Private health spending as a share of total health spending



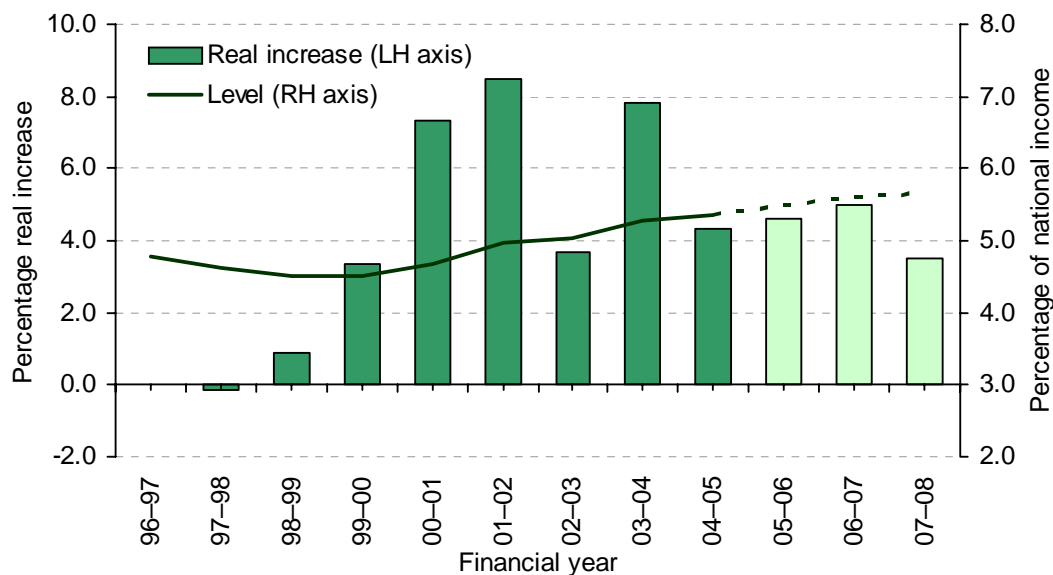
Source: As Figure 7.6.

¹³ T. Besley, J. Hall and I. Preston, 'The demand for private health insurance: do waiting lists matter?', *Journal of Public Economics*, 72, 155–81, 1999.

Education spending

The level of UK education spending as a percentage of national income is shown in Figure 7.8 (on the right-hand axis) from 1996–97 to 2007–08, the last year for which we have firm Treasury spending plans. Also shown in the chart is the real increase in education spending each year. As with health spending, the increases in education spending during Labour’s first three years in office were lower than growth in the economy. As a result, education spending declined as a share of national income (from 4.8% of national income in 1996–97 to 4.5% of national income in 1999–2000). This was despite the 1997 Labour manifesto pledge to ‘increase the share of national income spent on education’. However, the pledge was met over Labour’s first five years, as the increases in 2000–01 and 2001–02 were sufficient to take education spending to 5.0% of national income in 2001–02, slightly higher than in 1996–97. The large increases in education spending over the following five years have brought education spending up to 5.6% of national income in 2006–07, significantly above the level that Labour inherited.

Figure 7.8. Education spending



Notes: Figures refer to public sector education spending figures based on the UN Classification of the Functions of Government (COFOG), the international standard, as used in the Public Expenditure Statistical Analysis. Sources: Period to 2004–05 from HM Treasury, *Latest Functional Data*, December 2006 (http://www.hm-treasury.gov.uk/media/588/F4/Excel_file_of_latest_functional_data_6th_December_2006.xls). Period from 2004–05 onwards from table B18 of HM Treasury, *Pre-Budget Report*, Cm. 6984, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/prebud_pbr06_index.cfm).

Table 7.4 highlights the extent to which the average annual increases in education spending seen over the spending review period (5.3%) are relatively large compared with the increases seen over the 18-year period of Conservative governments after 1979 (1.5%).

Total education spending plans for 2008–09, 2009–10 and 2010–11 have not yet been set. These could be announced at the time of the 2007 CSR, or potentially earlier – for example, the March 2004 Budget announced the education spending figures for 2005–06, 2006–07 and 2007–08 ahead of the July 2004 Spending Review. Mr Brown has, however, already announced the capital spending settlement for education spending for the three years to be

Table 7.4. Trends in education spending

Period	Total	GDP growth
<i>Labour</i>		
Plans to date: April 1997 to March 2008	+4.4	+2.8
First two years: April 1997 to March 1999	+0.4	+3.2
Spending reviews: April 1999 to March 2008	+5.3	+2.7
<i>Conservatives</i>		
April 1979 to March 1997	+1.5	+2.1
<i>Long-term trend (pre new Labour)</i>		
January 1953 to December 1996	+4.0	+2.6

Note: Figures are for average annual growth.

Sources: As Figure 7.8 and C. Emmerson, C. Frayne and S. Love, *A Survey of Public Spending in the UK*, IFS Briefing Note 43, 2004 (http://www.ifs.org.uk/publications.php?publication_id=1791).

covered by the 2007 CSR, and for the last year (2010–11) has announced how this will be split into schools and non-schools capital spending.¹⁴ As a result, capital spending on education is set to grow by 4.3% a year in real terms over the next spending review period. While this will increase capital education spending as a share of national income, it is a considerably lower rate of increase than has occurred in recent years (15.8% a year on average over the 10 years between April 1998 and March 2008). Also known is the split between growth in schools and non-schools capital spending: 4.9% and 2.2% a year in real terms respectively. These are both lower than their growth rates over recent years (16.3% and 14.4% on average a year for schools and non-schools respectively over the nine years between April 1998 and March 2008). So, schools capital spending is projected to rise as a share of national income, while non-schools capital spending is projected to fall slightly as a share of income.¹⁵

In the March 2006 Budget, Mr Brown also announced that ‘our long-term aim should be to ensure for 100 per cent of our children the educational support now available to just 10 per cent’. Subsequent details show that the pledge is to increase real spending per pupil in the state sector to that currently being spent per pupil in the private sector. The gap between the two in 2005–06 was considerable: spending per pupil in state schools was around £5,000 while in private schools it was around £8,000. The increases in schools spending already pledged between 2005–06 and 2010–11 will be sufficient to reduce the gap to £2,400 pupil. To close the gap completely in 2010–11 would cost approximately £17 billion in today’s terms, which, given the constraints placed on the Chancellor by the fiscal rules (see Chapter 3), would not be achievable over the period covered by the 2007 CSR without significant further tax-raising measures. In practice, the pledge will have to be met over a longer time frame. If school spending per pupil were increased in line with expected growth in the economy (2½% a year) then it would take around 14 years to meet the pledge, whereas if it were increased at twice this rate (5% a year) then it would take around seven years to meet it. It is also the case that bringing state spending per pupil up to the 2005–06 private school level of spending per pupil is unlikely to close the contemporaneous gap, as private spending is

¹⁴ Paragraph 6.47, page 148, of HM Treasury, *2006 Pre-Budget Report*, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/prebud_pbr06_index.cfm).

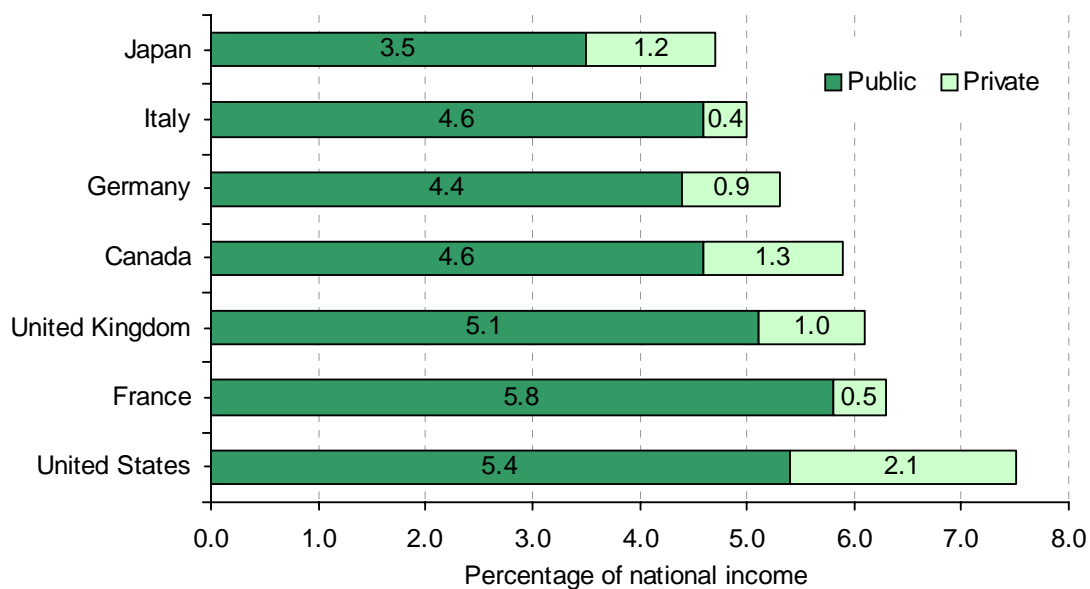
¹⁵ Figures on education capital spending on schools and other, unlike the other public spending figures in this chapter, include capital spending financed through the Private Finance Initiative.

likely also to increase in real terms. Indeed, real increases since 1998 have brought state spending per pupil up to the level spent in the private sector in 1996–97,¹⁶ but increases in per-pupil spending in the private sector over the same period mean that (as mentioned above) the contemporaneous difference in per-pupil spending between state and private schools remains large.

International comparison of education spending

Compared with the other G7 countries, the UK is not a low spender on education, as shown in Figure 7.9. Public spending on education – at 5.1% of national income in 2003 – is slightly below that spent in the US (5.4%) and France (5.8%) but is higher than that spent in Canada, Germany, Italy and Japan. Once private spending on education is included, the UK still devotes the third highest share of national income to total education spending among the G7 economies. One obvious reason why countries might choose to spend different shares of their national income on education is differences in numbers of school-age children.

Figure 7.9. Education spending across the G7 economies, 2003



Note: Figures for Canada refer to 2002.

Source: Table B2.1a of OECD, *Education at a Glance, OECD Indicators 2006*, 2006 (<http://www.oecd.org/edu/eaq2006>).

When we look at per-pupil spending, a slightly different picture emerges. Table 7.5 shows spending per pupil relative to national income across G7 countries. Most striking is Japan. Having relatively few children, Japan spends more per pupil on primary, secondary and tertiary education than the UK despite devoting a smaller share of national income overall to education. At the primary level, the UK spends more per pupil than Germany or France, but less than Italy or the US (as well as Japan). At the secondary level, the UK spends a comparable amount per pupil to Germany, the US and Japan, substantially more than Canada, but substantially less than France and Italy. At the tertiary level, the UK spends substantially less per pupil than the US but substantially more than Germany or Italy.

¹⁶ For further discussion about the pledge, see A. Goodman and L. Sibieta, *Public Spending on Education in the UK*, IFS Briefing Note 71, 2006 (<http://www.ifs.org.uk/bns/bn71.pdf>).

Table 7.5. Education spending per pupil relative to national income, 2003

	% of GDP	Spending per student relative to GDP, UK = 100			
		Primary	Secondary	Tertiary	All
United States	7.5	112	104	160	129
France	6.3	88	124	94	110
United Kingdom	6.1	100	100	100	100
Canada	5.9	n/a	83	102	89
Germany	5.3	76	102	65	83
Italy	5.0	140	121	82	120
Japan	4.7	114	105	103	111

Note: Figures for Canada refer to public institutions in 2002 only.

Sources: Table B1.4 and B2.1a of OECD, *Education at a Glance, OECD Indicators 2006*, 2006 (<http://www.oecd.org/edu/eaq2006>).

7.3 Scenarios for the 2007 CSR

This section takes the overall spending plans set out in the December 2006 Pre-Budget Report and shows possible allocations to (in particular) health and education, given the spending plans that Mr Brown has already announced. One interesting difference between this spending review and the last three spending reviews regards the timing of the spending announcements. In the Budgets of March 2000 and April 2002, Mr Brown announced the spending totals for the NHS (for the periods of 2001–02 to 2003–04 and of 2003–04 to 2007–08 respectively), while in the Budget of March 2004 he announced the spending totals for education (for the period of 2003–04 to 2007–08). To date, the 2007 CSR has followed a different pattern. While the overall spending envelope is yet to be confirmed, several small departments have already had their allocations announced. Settlements for the Home Office and four smaller departments were unveiled in the March 2006 Budget, while settlements for the Department for Constitutional Affairs (DCA) and five further smaller departments were announced in the December 2006 Pre-Budget Report. Not only are more departments' totals being announced sooner (which could be due to the fact that the forthcoming CSR was originally scheduled for 2006) but also, rather than announcing large increases in spending in the headline areas of health and education, Mr Brown is instead choosing to announce early tight budget settlements in areas of spending that might be considered less headline-grabbing.

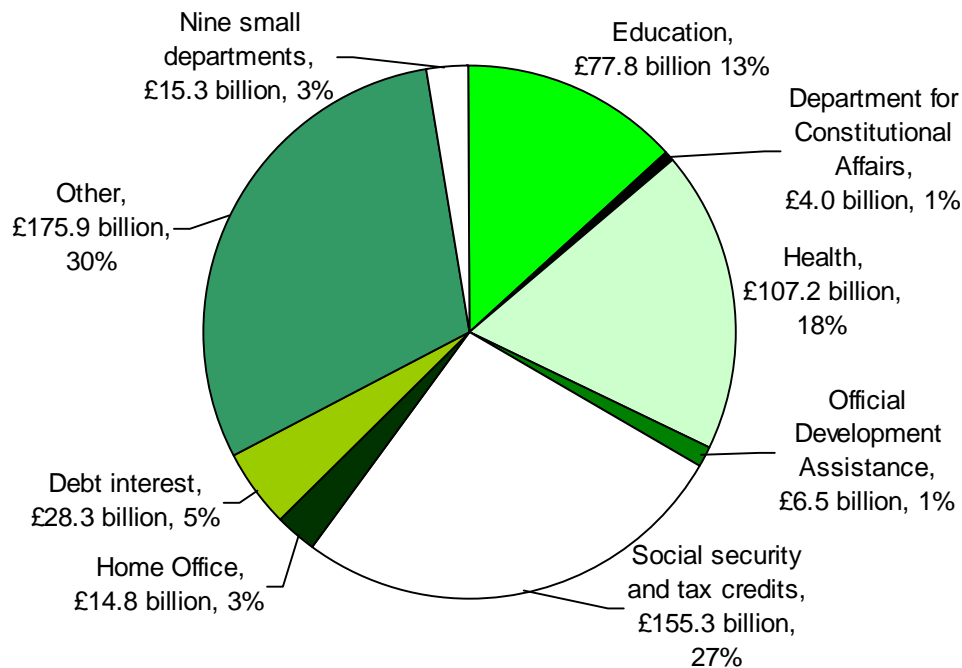
The areas of spending that have already been announced by Mr Brown are the Home Office (a real freeze), the DCA (an annual average cut of 3.5% a year in real terms) and for nine smaller departments (an annual average cut of 5% a year in real terms).¹⁷ Taken together, in 2007–08, these 11 departments have total spending of £34.1 billion or 5.8% of forecast TME in that year. As shown in Figure 7.10, other larger areas of public spending include health,

¹⁷ The nine smaller departments are HM Revenue & Customs, HM Treasury, the administrative part of the Department for Work and Pensions, the Cabinet Office, the Privy Council Office, National Savings & Investments, the Central Office of Information, the Food Standards Agency and the Government Actuary's Department. For more details, see box 6.3, page 143, of HM Treasury, *2006 Pre-Budget Report*, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/prebud_pbr06_index.cfm).

education and social security. This section will consider each of the areas of spending shown in Figure 7.10.

An indication of how tight the settlements are for the Home Office, the DCA and the nine smaller departments is given in Table 7.6. Across all 11 departments, the 2007 CSR allocation is for an average annual cut, after nationwide inflation, of 2.6% a year. This compares with an average real cut of 0.3% a year over the two-year period from April 2006 to March 2008. Delivering these cuts without any unacceptable detrimental impact on service quality will

Figure 7.10. Planned public spending in 2007–08



Note: The largest components of 'other' spending are defence, transport, culture, housing and environmental protection.

Sources: Table 1.12 of HM Treasury, *Public Expenditure Statistical Analyses 2006*, Cm, 6811, May 2006 (http://www.hm-treasury.gov.uk/media/375/5A/cm6811_comp.pdf); HM Treasury, *2004 Spending Review*, Cm. 6237, July 2004 (http://www.hm-treasury.gov.uk/spending_review/spend_sr04/spend_sr04_index.cfm); table B16, page 240, of HM Treasury, *2006 Pre-Budget Report*, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/prebud_pbr06_index.cfm).

Table 7.6. Early tight settlements for 2007 CSR

Real average annual growth in:	Planned growth over 2 years from April 2006 to March 2008	2007 CSR, 3 years from April 2008 to March 2011
<i>Provisional spending plans</i>		
Home Office	+1.6	0.0
DCA	-0.2	-3.5
Nine smaller departments	-2.1	-5.0
All early settlements	-0.3	-2.6

Sources: For 2007 CSR plans, see footnote 17. Planned growth in expenditure from table 1.12 of HM Treasury, *Public Expenditure Statistical Analyses 2006*, Cm. 6811, May 2006 (http://www.hm-treasury.gov.uk/media/375/5A/cm6811_comp.pdf) and HM Treasury, *2004 Spending Review*, Cm. 6237, July 2004 (http://www.hm-treasury.gov.uk/spending_review/spend_sr04/spend_sr04_index.cfm).

undoubtedly be difficult. Indeed, if it were not, then presumably the government would have announced larger reductions in spending in these areas in the July 2004 Spending Review, or preferably even earlier.

Given the overall spending plans set out in the December 2006 Pre-Budget Report, Table 7.7 sets out the growth in spending that could be available for different areas once the allocations shown in Table 7.6 are taken into account. Total managed expenditure is projected by the December 2006 Pre-Budget Report to grow by an average of 2.0% a year over the three-year period from April 2008 to March 2011.

Table 7.7. Possible 2007 CSR allocation under PBR 2006 spending plans

Real average annual growth in spending on:	
<i>Provisional spending plans</i>	
Total managed expenditure	+2.0
Total managed expenditure after refilling AME margin	+1.8
<i>Known allocations</i>	
Home Office	+0.0
DCA	-3.5
Nine smaller departments	-5.0
Remainder	+2.1
<i>Assumptions</i>	
Official Development Assistance	+11.2
Debt interest payments	+2.0
Underlying social security and tax credit expenditure	+1.6
Remainder	+2.1

Sources: As Table 7.6; plus table B16, page 240, of HM Treasury, *2006 Pre-Budget Report*, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/prebud_pbr06_index.cfm).

One of the first decisions for the Chancellor at the time of the 2007 CSR will be to determine how much should be allocated to the AME margin (previously known as the contingency reserve). These are funds not allocated to a particular spending area but kept aside for any unforeseen events – for example, in recent years, tackling BSE and foot-and-mouth disease. To date, Mr Brown has always allocated £1 billion to the first year of a spending review period, £2 billion to the second year and £3 billion to the third year. In Table 7.7, we assume that the same decision is made, which would lead to the remainder of TME growing by 1.8% a year in real terms. Once the departments whose allocations are already known are taken into account, this leaves the remainder of public spending growing at 2.1% a year in real terms.

The bottom panel of Table 7.7 also makes assumptions for growth in spending on Official Development Assistance (ODA), debt interest payments and underlying social security and tax credit expenditure. Recent years have seen very large increases in ODA spending, bringing it up to 0.47% of national income in 2005, a level only exceeded once since 1970 (in 1979).¹⁸ We assume that the government will implement constant real increases in spending

¹⁸ See figure 7, page 21, of Department for International Development, *Statistics on International Development 2001/02–2005/06*, 2006 (<http://www.dfid.gov.uk/pubs/files/sid2006/sid06-full.pdf>).

to bring ODA spending up to 0.7% of national income in 2012–13 (since it has an election manifesto pledge to meet this level in 2013).¹⁹ This would imply real increases of 11.2% a year in real terms over the period covered by the 2007 CSR. While this would be a substantial increase (a £3.2 billion cash increase in annual spending over the three-year period), it is actually slightly lower than the 11.9% a year that is planned on average in 2006–07 and 2007–08.

Spending on debt interest payments and underlying expenditure on social security and tax credits are, in large part, out of the government's hands. As a baseline, we assume that spending in both these areas increases over the 2007 CSR period at the same rate that it is forecast to increase over the two-year period from April 2006. This implies that debt interest spending would grow by 2.0% a year and that underlying expenditure on social security and tax credits would grow by 1.6% a year in real terms; the latter would be less than expected growth in earnings. These assumptions are particularly important since, as shown in Figure 7.10, expenditure on social security and tax credits is over a quarter of total public spending. However, delivering large reductions in future social security spending would, at least in the near term, not be possible without leaving a combination of pensioners, families with children and those receiving incapacity benefits worse off than they would be under current policies.

Table 7.8. Possible scenarios for spending on health and education, given child poverty target and growth in 'other' spending

	'Other spending'	
	grows at current rate (+0.8% a year)	frozen in real terms (+0.0% a year)
Additional £4½ billion allocated to meeting child poverty target		
Social security and tax credit expenditure	+2.5	+2.5
Education and health spending	+2.6	+3.3
No additional funds allocated to meeting child poverty target		
Social security and tax credit expenditure	+1.6	+1.6
Education and health spending	+3.3	+4.1

Notes: Figures are for average annual growth. The largest components of 'other' spending are defence, transport, culture, housing and environmental protection.

Sources: As Table 7.7.

Under this scenario, the remainder of TME would be able to grow by 2.1% a year in real terms. Table 7.8 shows the amounts left over for health and education, given different possible allocations for reducing child poverty and other areas of government such as transport, defence, housing and environmental protection. The top half of the table assumes that the Chancellor makes a further £4½ billion available for increased expenditure on targeted support for lower-income families with children, raising the growth rate of social security and tax credit spending from 1.6% to 2.5%. This is the minimum amount that recent analysis suggests will be needed by 2010–11 in order to give the government a 50:50 chance

¹⁹ The UN General Assembly has had a target for ODA spending as a share of gross national income of 0.7% since 1970.

of meeting its challenging target for child poverty in that year.²⁰ This would leave a very tight settlement for health and education.

If spending on 'other' areas of public spending were increased by 0.8% a year in real terms – the average increase forecast in the 2004 Spending Review for the two-year period from April 2006 to March 2008 – the combined health and education budget could grow by just 2.6% a year in real terms, approximately in line with growth in the economy. Even if spending over all other areas of government were frozen in real terms, the combined health and education budget could only grow by 3.3% a year on average in real terms. This would be almost half the average rate of increase delivered by Labour over the seven-year period from April 1999 to March 2006 (6.5% a year in real terms).

This suggests that it is unlikely that the Chancellor could allocate £4½ billion extra for targeted support to reduce child poverty within the spending totals set out in the December 2006 Pre-Budget Report without compromising stated aspirations for public services, including health and education. The lower half of Table 7.8 sets out an alternative scenario where no additional funds are allocated to reducing child poverty (which would make it very unlikely that the target for reducing child poverty would be met). Under this scenario, allowing other areas of public spending to grow at 0.8% a year in real terms would leave the combined health and education budget growing at 3.3% a year on average in real terms. Freezing spending on other areas would allow the combined health and education budget to grow by 4.1% a year in real terms.

Under the scenarios set out in Table 7.8, one of the more difficult decisions for the Chancellor in the 2007 CSR will be the trade-off between allocating additional funds to education as opposed to health. As described in Section 7.2, Mr Brown's pledge to increase per-pupil schools spending in the state sector to that seen in the private sector in 2005–06 would, if it were to be achieved by the middle of the next decade, require a generous settlement for schools, which in turn is likely to imply a generous settlement for education overall.²¹ However, traditionally, the NHS has received a larger increase in finance than the education budget. The Wanless Review suggested that the NHS budget would, in its most optimistic (i.e. lowest cost to the taxpayer) scenario for health spending, require increases in funding of 4.4% a year over the 2007 CSR period. As shown in Table 7.8, within the spending totals set out in the December 2006 Pre-Budget Report, it does not seem plausible for the budgets of both health and education to receive increases of this amount. The largest increase for the combined budgets that the figures in Table 7.8 suggest is growth of 4.1% a year in real terms.

Table 7.9 shows some potential allocations for health and education under the assumption that the combined budgets of these departments grow by (a) 3.3% a year in real terms and (b) 4.1% a year in real terms. These were the figures shown in Table 7.8, based on the assumptions that no additional funds are found for reducing child poverty and that spending on other areas of public spending is either increased by (a) 0.8% a year or (b) held constant in real terms.

²⁰ M. Brewer, J. Browne and H. Sutherland, *Micro-Simulating Child Poverty in 2010 and 2020*, Joseph Rowntree Foundation, York, 2006 (<http://www.jrf.org.uk/bookshop/eBooks/9781859355091.pdf>).

²¹ While some scope for higher spending on schools could come from trade-offs within the education budget, this would require lower growth in spending on either early years, further education or higher education.

Table 7.9. Illustrative trade-offs between health and education spending

	Health spending	Education spending
Health and education spending growth of 3.3% p.a.		
Health receives Wanless recommended increase	+4.4%	+1.8%
Health receives same increase as under Conservatives	+3.0%	+3.8%
Education spending increases at rate seen over 1997 to 2008	+2.5%	+4.4%
Education spending increases in line with economic growth	+3.9%	+2.4%
Health and education spending growth of 4.1% p.a.		
Health receives Wanless recommended increase	+4.4%	+3.7%
Health receives same increase as under Conservatives	+3.0%	+5.6%
Education spending increases at rate seen over 1997 to 2008	+3.9%	+4.4%
Education spending increases in line with economic growth	+5.3%	+2.4%

Note: Figures are for average annual growth.

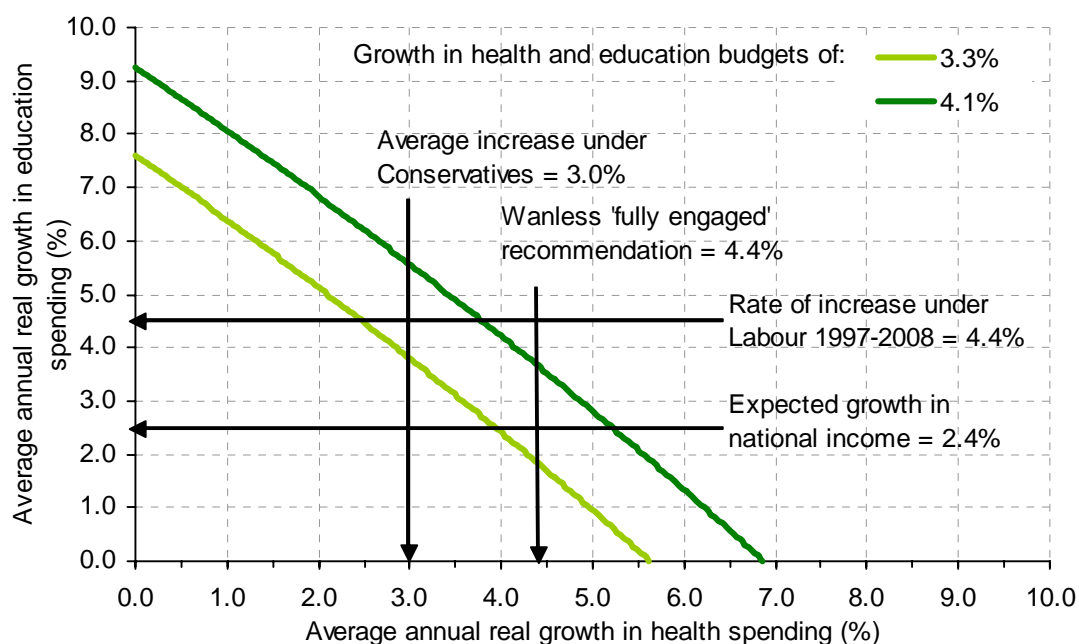
Sources: As Table 7.7.

Under the assumption that the total health and education budget grows by 3.3% a year, and that health receives 4.4% a year, which is the least generous award envisaged in the 2002 Wanless Review, then education spending could grow by only 1.8% a year in real terms – less than expected growth in the economy. This would seem inconsistent with Mr Brown’s rhetoric about the need to increase per-pupil spending in state schools. Increasing health spending by 3.0% a year in real terms, which is the same increase achieved on average by the Conservatives during their 18-year period in office (and led to Tony Blair claiming the day before the May 1997 election that the public had ‘24 hours to save the NHS’), would allow education spending to grow by 3.8% a year. Continuing to increase education spending at the rate seen in recent years (4.4% a year) would require health spending to grow less quickly than it did on average over the Conservative years in office.

The lower half of Table 7.9 shows similar trade-offs under the assumption that the overall health and education budget can increase by an average of 4.1% a year in real terms. Under this scenario, increasing NHS spending by 4.4% a year would allow education spending to grow by 3.7% a year. While this would still be lower than recent increases, it would lead to an expected increase in education spending as a share of national income. This is perhaps around the most likely outcome. However, this scenario assumes that no additional funds are made available for reducing child poverty and that other spending areas – including defence and environmental protection – see no increase in their budgets in real terms. (Other spending also includes transport and housing. However, the fact that capital spending is likely to grow faster than current spending over the 2007 CSR period (as shown in Table 7.2) means that these capital-intensive areas might be less likely to receive a very tight settlement.)

The diagonal lines in Figure 7.11 show all the possible trade-offs between education and health spending were the total budget of these two spending functions to be increased by either 3.3% a year or 4.1% a year in real terms. Also shown are the illustrative trade-offs from Table 7.9.

Figure 7.11. Potential trade-off between spending on education and health



Sources: As Table 7.7.

An alternative spending envelope

The Chancellor might decide to allocate more funds to the 2007 CSR than have been pencilled in by the December 2006 Pre-Budget Report projections. Table 7.10 shows the possible growth rates for the combined health and education budget if spending were to be kept constant as a share of national income, rather than being reduced by 0.5% of national income. In 2006–07 terms, this would make another £7 billion available for spending departments.

Table 7.10. Possible scenarios for spending on health and education, given child poverty target and growth in ‘other’ spending, under assumption of spending constant as a share of national income

	‘Other spending’	
	Grows at current rate (+0.8% a year)	Frozen in real terms (+0.0% a year)
Additional £4½ billion allocated to meeting child poverty target		
Social security and tax credit expenditure	+2.5	+2.5
Education and health spending	+3.9	+4.6
No additional funds allocated to meeting child poverty target		
Social security and tax credit expenditure	+1.6	+1.6
Education and health spending	+4.7	+5.4

Note: Figures are for average annual growth.

Sources: As Table 7.7.

Table 7.10 shows that if no additional funding is required for reducing child poverty, and if the budgets of other spending areas can be frozen in real terms, then combined spending on health and education could grow by an average of 5.4% a year in real terms, which would be the same average increase that Labour is intending to deliver over the period from April 1997 to March 2008. Alternatively, if £4½ billion is used to reduce child poverty and the budgets of other spending departments are increased in line with the 2004 Spending Review settlements, the combined budgets of health and education could grow by 3.9% a year in real terms.

Perhaps most plausibly, with this spending envelope, the Chancellor could settle for a 50:50 chance of meeting the child poverty target by allocating £4½ billion towards it, freeze other spending and increase the combined health and education budgets by 4.6% a year in real terms. This would allow the NHS to receive a settlement in line with the lowest envisaged by the 2002 Wanless Review (4.4%) and for large increases in schools spending to be made in order to progress towards Mr Brown's aspiration of increased per-pupil schools spending. In this scenario, were the NHS to receive a settlement of 4.4% a year in real terms, then education spending could grow by 5.0% a year.

While the spending settlements set out in Table 7.10 may look more appealing to the Chancellor than those set out in Table 7.8, they would require an additional £7 billion of finance. Given the lack of room to manoeuvre against the fiscal rules (as described in Chapter 3), this is likely to require greater tax revenues (as opposed to higher borrowing).

In the past, spending settlements have not in fact been 'firm and fixed', despite Mr Brown's rhetoric which suggests they have been. In particular, the spending plans set out in the 1998 Comprehensive Spending Review for 2000–01 and 2001–02, and the plans that were set out in the Spending Review of 2000 for 2003–04, were subsequently revised upwards.

This might suggest a strategy for the Chancellor with respect to the 2007 CSR. He could announce spending plans along the lines of Tables 7.8 and 7.9, but then increase them at a later stage if necessary. This 'wait and see' strategy might be particularly attractive for additional transfer payments to reduce child poverty. Unless there is an unexpected fall in public spending elsewhere (which, as a result of lower-than-expected unemployment and debt interest payments, is what happened during the period covered by the 1998 CSR), or tax revenues come in more strongly than expected, then fresh tax-raising measures would be required to finance spending beyond that envisaged by the December 2006 Pre-Budget Report. However, by delaying the decision, the Chancellor would have more information on the quality of public services, the evolution of child poverty and the underlying buoyancy of tax revenue.

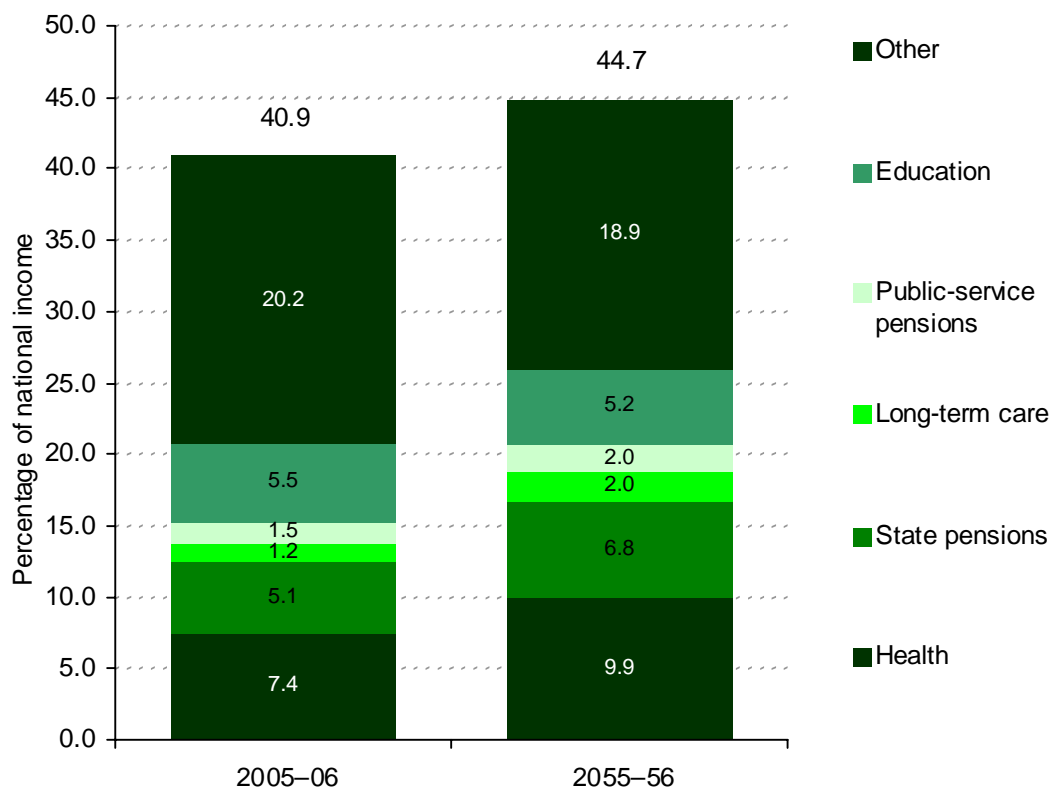
7.4 Longer-term spending pressures

This chapter has focused on past trends in public spending and the key trade-offs for the 2007 CSR. This section provides a short discussion of the Treasury's longer-term spending projections.

Figure 7.12 shows the Treasury's latest projections for spending in 2055–56, compared with the latest estimates for spending in 2005–06. Importantly, these projections take into account

the estimated fiscal implications of the 2006 Pensions White Paper.²² They suggest that public spending will increase by 3.9% of national income (around £50 billion in today's terms) over the next 50 years. This is due to increases in spending on health (2.5% of national income), state pensions (1.7%), long-term care (0.8%) and public-service pensions (0.5%), which are partially offset by falls in spending on education (0.3%) and other spending (1.3%).

Figure 7.12. Latest HMT long-term spending projections



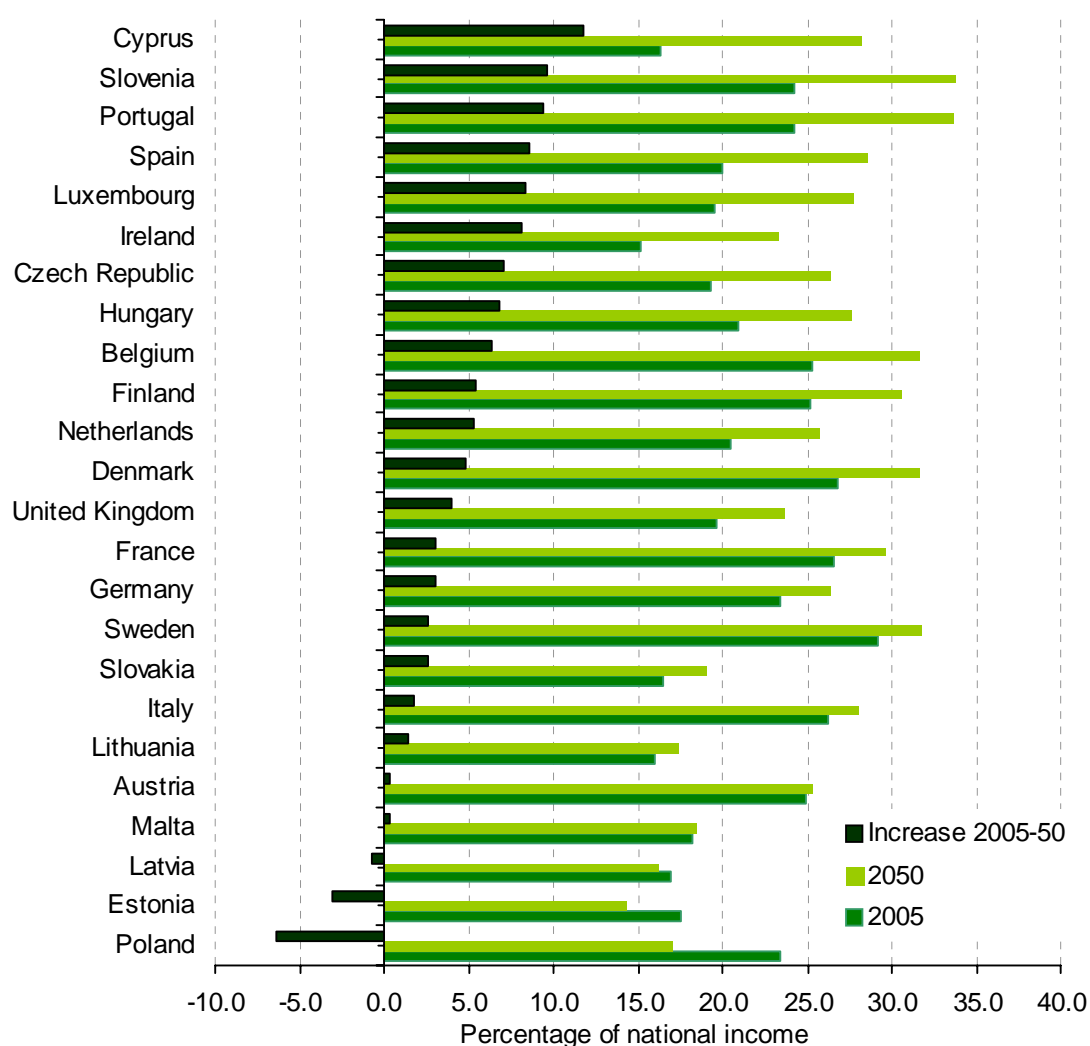
Notes: State pension spending is defined as the sum of the basic state pension, state second pension, pension credit, winter fuel payments, over-75 TV licences and Christmas bonus. Health spending is gross NHS spending. Long-term care spending excludes long-term care provided within the NHS, which is accounted for under Health. Total spending includes gross investment but excludes interest and dividend payments.

Source: Table 5.1, page 40, of HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/assoc_docs/prebud_pbr06_adlongterm.cfm).

This increase in public spending, if it materialises, would require increases in tax revenues as a share of national income. Whether or not any required tax increases would lead to concerns about the international competitiveness of the UK tax system will in part depend on the extent to which the increase in spending in the UK is small or large relative to those in other countries.

²² See Department for Work and Pensions, *Security in Retirement: Towards a New Pensions System*, Cm. 6841, 2006 (<http://www.dwp.gov.uk/pensionsreform/whitepaper.asp>). For a discussion of the impact of state pension reforms, see C. Emmerson, G. Tetlow and M. Wakefield, 'The Pensions White Paper: who wins and who loses?', *PMI News*, August 2006 (http://www.ifs.org.uk/publications.php?publication_id=3717).

Figure 7.13. Projected age-related spending, EU countries, 2005 and 2050



Note: Age-related expenditure consists of total age-related public spending, i.e. spending on pensions, healthcare, long-term care, education and unemployment transfers. Greece excluded due to missing pensions information.

Source: Table 1.1 of Economic Policy Committee and European Commission, *Report on the Impact of Ageing Populations on Public Spending*, 2006 (http://ec.europa.eu/economy_finance/epc/epc_sustainability_ageing_en.htm).

Figure 7.13 shows the percentage of national income spent on age-related expenditures (i.e. pensions, healthcare, long-term care, education and unemployment transfers) across EU countries in 2005 and projections for spending in 2050. The countries are sorted in order of the size of the expected increase. It shows that, of the other 23 countries,²³ 12 expect a larger increase in age-related spending than the UK while 11 expect a smaller increase.

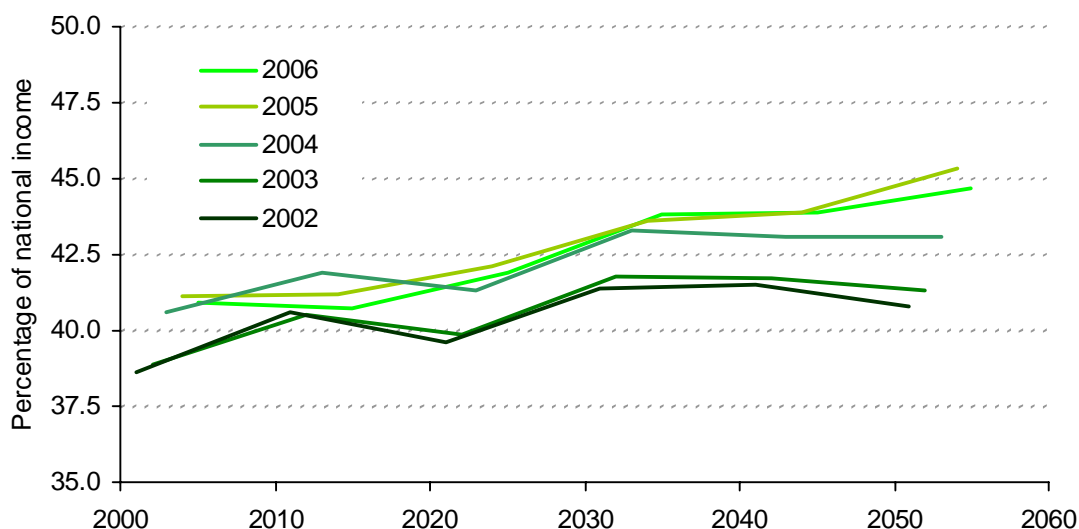
This might suggest that there should be no concern over the affordability of the likely increase in spending in the UK. But the larger EU economies (Germany, France and Italy) are expecting smaller increases in age-related spending, albeit from much larger current, and to

²³ Greece has been excluded from this comparison as data on comparable Greek pension spending are not available. However, previous European Commission estimates suggest that Greece has the largest increase, to the highest level, in pension spending as a share of national income over the next 50 years (see tables I.18 and I.19, pages 59 and 60, of European Commission, 'Public finances in the EMU', *European Economy* 3/2005 (http://europa.eu.int/comm/economy_finance/publications/european_economy/2005/ee305en.pdf)). Thus Greece is likely to face a much larger increase in age-related spending over the next 50 years than the UK.

much larger future, levels than in the UK. How such a pattern of increases in age-related spending would translate into overall public spending will depend on trends in the other components of spending (which, as shown in Figure 7.12, the Treasury believes will fall in the UK). Were a similar fall to occur in the other large EU economies, the share of national income spent publicly in the UK would remain below the share spent in both France and Italy, but would move slightly above the share spent publicly in Germany.

There is considerable uncertainty surrounding the projections for public spending over the next 50 years shown in Figures 7.12 and 7.13. Figure 7.14 compares the successive projections for long-term public spending that have been made by the Treasury since its first *Long-Term Public Finance Report* in 2002. They have shown considerable variation in the near term as well as the longer term. In addition, the variation in estimates for spending in the last year of the long-term forecast horizon is more substantial (at 4.5% of national income) than the largest change in spending over time projected by any one forecast (4.2% of national income). In part, these changes have occurred as a result of estimates of longevity being revised upwards by the Government Actuary's Department. This is not to say that there is no value in producing such projections (not least because publishing details of assumptions and modelling techniques should help to improve the quality of future projections), but it is important to bear in mind that the uncertainties over a long-term horizon will always be considerable.

Figure 7.14. Recent long-term projections for public spending



Note: Years refer to the financial year in which three quarters of the calendar year lies.

Sources: HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, various years, (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/assoc_docs/prebud_pbr06_adlongterm.cfm).

7.5 Conclusion

The 2007 CSR looks set to be a particularly ‘Challenging Spending Review’. The overall spending projections set out in the December 2006 Pre-Budget Report would, if implemented, reduce public spending by 0.5% of national income over the three-year period to be covered by the 2007 CSR. This would be equivalent to £7 billion in today’s terms.

This chapter has shown that keeping to these spending plans would require difficult choices to be both made and delivered. Under a plausible scenario for debt interest payments, for growth in underlying social security benefit and tax credit expenditure and for spending on overseas aid, the combined budgets of health and education would be able to grow by 4.1% a year in real terms, as long as there were a real freeze across the budgets of all other departments. Such an increase would be lower than the 6.4% set to occur over previous Labour spending reviews from April 1999 to March 2008. It would also require other areas of spending – including defence and environmental protection – to receive no increase in their budgets, and it would not make any additional funds available for further progress towards the government’s challenging 2010–11 child poverty target.

Previous analysis suggests that an additional £4½ billion of spending on the child element of the working tax credit would be the minimum required to give the government a 50:50 chance of meeting the child poverty target.²⁴ It would be extremely difficult for the Chancellor to find this without reducing growth in the combined budgets of health and education further. Freezing all other budgets in real terms would allow the health and education budgets to grow by 3.3% a year in real terms, which would lead to the difficult decision over whether to allocate the NHS less than the 4.4% a year minimum recommended by the 2002 Wanless Review or to cut education spending as a share of national income, which seems inconsistent with Mr Brown’s rhetoric over the need to increase spending per pupil in state schools.

Perhaps the most plausible scenario is a tight CSR, with additional finance found for reducing child poverty, and possibly also for improving public services, in later Budgets and Pre-Budget Reports. However, this scenario would require additional resources. Keeping public spending constant as a share of national income over the three-year period to be covered by the 2007 CSR would require an additional £7 billion in today’s terms.

The Treasury’s own public finance projections suggest that there is little room for additional borrowing. As a result, additional finance would require either a pleasant surprise in terms of reduced public expenditure or increased tax revenues on existing policies. There is a parallel here with the last Comprehensive Spending Review of 1998, where the initial spending plans were topped up during a period of lower-than-expected expenditure on social security benefits and debt interest payments as unemployment, debt and interest rates all fell. A similar pleasant surprise on the spending side over the next few years is less likely – not least because unemployment and interest rates have less room to fall. Should greater-than-expected tax revenues not materialise over the next few years, then the Chancellor, whoever he or she may be, will face a difficult choice: whether to downplay the child poverty target, implement further tax-raising measures or tighten further the settlement for public services. Furthermore, as argued in Chapter 5, were revenues to exceed expectations, then the Chancellor should be wary of repeating the history of recent years – spending the proceeds of good fortune early in the economic cycle only to find him or herself having to retrench later on.

²⁴ M. Brewer, J. Browne and H. Sutherland, *Micro-Simulating Child Poverty in 2010 and 2020*, Joseph Rowntree Foundation, York, 2006 (<http://www.jrf.org.uk/bookshop/eBooks/9781859355091.pdf>).