

6. Public spending and pay¹

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Summary

- The government's fiscal consolidation plan involves significant and sustained real cuts to spending on public services. Departmental spending is forecast to be cut in real terms by 10.6% between 2010–11 and 2014–15. This would reduce departmental spending as a share of national income to 21.7% in 2014–15, the level it was back in 2002–03.
- A spending review is scheduled for 2013 to allocate spending cuts between departments in 2015–16. On average, departmental spending is set to be cut by a further 2.4% in real terms, but the government has pledged to protect NHS spending, international aid and non-investment spending on schools from real-terms spending cuts. This would leave other 'unprotected' departments facing cuts to their non-investment budgets of 2.8% and to their investment budgets of 4.9%.
- Forecasts also imply further cuts to departmental spending between 2015–16 and 2017–18. In the absence of further policy announcements, departmental spending looks set to fall by 18.6% in real terms between 2010–11 and 2017–18. If the NHS, schools and aid spending were protected from cuts through to 2017–18, then 'unprotected' departments would face budget cuts averaging 33.2% over this seven-year period. To mitigate this, further tax rises or more cuts to social security benefits after the next general election might well be on the cards.
- The public sector paybill accounts for about half of total non-investment spending by departments. To date, cuts to the public sector paybill have largely been achieved through cuts in employment rather than cuts in average pay per head. Public sector employment has fallen by about 5% (300,000) between 2010–11 and 2012–13.
- The OBR forecasts that general government employment will fall by 900,000 between 2010–11 and 2017–18. This assumes the total paybill is cut at broadly the same rate as non-investment departmental spending. However, plans submitted to the Treasury by government departments suggest that the central government paybill will be cut by more than non-investment spending up to 2014–15. Incorporating these plans up to 2014–15 implies that general government employment will be 200,000 lower in 2017–18 than forecast by the OBR. If the trend of larger cuts in the paybill continues through to 2017–18, general government employment would be 300,000 lower than OBR forecasts by 2017–18.
- The government has not yet set public sector pay awards beyond 2014–15. The number of future job cuts could be reduced by maintaining tight pay awards. The OBR currently assumes that pay-per-head will grow in cash terms by 3% per year between 2014–15 and 2017–18. If this were reduced to 2% per year (similar to that under the current pay awards), then the total number of net job losses could be reduced by 140,000. Before setting future public sector pay policy, it would seem prudent for the government to investigate the impact of the current pay freeze on public sector recruitment and retention, and the relative effects of workforce quality, workforce size and cuts to non-labour inputs on public service quality.

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6.1 Introduction

The government is currently partway through implementing a planned seven-year fiscal consolidation package, and is relying heavily on cuts to public spending to achieve its planned reduction in public sector borrowing. Total public spending is planned to be cut by 4.6% in real terms between 2010–11 and 2017–18. However, spending on some areas, such as debt interest payments and spending on social benefits (particularly pensioner benefits), is forecast to grow in real terms over this period (by 35.3% and 4.6% respectively), meaning that the pressure on public service spending is even greater. Spending by Whitehall departments on the delivery and administration of public services is forecast to fall by 18.6% in real terms between 2010–11 and 2017–18.

Since a large proportion of departmental spending goes to pay public sector workers (about half of non-investment spending in 2010–11), it is unsurprising that these spending cuts are partly being delivered through cuts to public sector pay and employment. Pay in the public sector is being squeezed, with freezes in headline pay levels in 2011–12 and 2012–13 (except for the lowest-paid workers), and 1% average increases in each of 2013–14 and 2014–15. In addition, the Office for Budget Responsibility (OBR) is currently forecasting that general government employment² will fall by over 900,000 between 2010–11 and 2017–18.

This chapter starts by discussing the outlook for departmental spending and the decisions made by the government to date: Section 6.2 describes the decisions taken in the 2010 Spending Review, shows how spending settlements for departments might pan out in 2015–16, and discusses the trade-off between departmental spending and tax increases or social security spending cuts that the latest official public finance projections suggest will be faced in 2016–17 and 2017–18. It ends by describing what effect the government's decisions have had on the changing composition of public spending. Section 6.3 then focuses on public sector pay and employment. The contribution of each of these to the spending cuts experienced to date is described, followed by a discussion of the outlook for public sector employment, pay and government pay policy. Section 6.4 concludes.

6.2 Departmental spending since 2010–11

The overall outlook for departmental spending

For the purposes of planning public spending HM Treasury divides total public spending into 'departmental expenditure limits' (DEL) and 'annually managed expenditure' (AME). The former are annual limits for departmental programme and administration expenditure, which are usually planned some years in advance in Spending Reviews and are essentially the amount that Whitehall departments spend on the administration and delivery of public services. The latter contains items of spending that the Treasury argues are less under its direct control, such as social security and debt interest spending (which will be affected by the prevailing economic conditions at the time), spending by local authorities financed from council tax and spending by public corporations.³

² This definition includes central and local government but excludes public corporations.

³ The government actually has greater control over some aspects of AME than its classification suggests; for example, the number of people qualifying to receive particular benefits under given rules may be out of the

The October 2010 Spending Review set total departmental spending for the four years 2011–12 to 2014–15, and allocated this DEL budget between departments. These plans have been revised slightly subsequently, with the 2011 and 2012 Autumn Statements allocating additional capital (investment) spending and planning some further cuts to departments' resource (non-investment) spending. In addition, the OBR expects departments to underspend against their current budget allocations in 2012–13, 2013–14 and 2014–15. The latest OBR forecast is for total DEL to be 10.6% lower in real terms by 2014–15 than its 2010–11 level. (If the total DEL forecast for 2014–15 were unchanged since the 2010 Spending Review, this would imply a real DEL cut of 9.9% from its 2010–11 level.) This cut to DEL is planned to fall disproportionately on investment spending, with capital DEL forecast to fall by 21.1% in real terms over this four-year period and resource DEL forecast to fall by 9.0%.

Table 6.1. Implied departmental spending growth after 2014–15

	Spending, 2010–11 (2012–13 prices)	<i>Implied departmental spending growth</i>			
		2010–11 to 2014–15	2014–15 to 2015–16	2015–16 to 2017–18	2010–11 to 2017–18
Average annual real growth rate					
Total managed expenditure	£724.9bn	–0.8%	–0.1%	–0.6%	–0.7%
<i>of which:</i>					
Annually managed expenditure	£331.2bn	1.4%	2.1%	2.0%	1.6%
Departmental spending limits	£393.7bn	–2.8%	–2.4%	–3.4%	–2.9%
<i>of which:</i>					
Resource DEL (excl. depreciation)	£341.4bn	–2.3%	–1.7%	–3.7%	–2.6%
Capital DEL	£52.3bn	–5.8%	–8.1%	–0.5%	–4.6%
Cumulative real growth rate					
Total managed expenditure	£724.9bn	–3.3%	–0.1%	–1.2%	–4.6%
<i>of which:</i>					
Annually managed expenditure	£331.2bn	5.5%	2.1%	4.0%	12.1%
Departmental spending limits	£393.7bn	–10.6%	–2.4%	–6.6%	–18.6%
<i>of which:</i>					
Resource DEL (excl. depreciation)	£341.4bn	–9.0%	–1.7%	–7.3%	–17.1%
Capital DEL	£52.3bn	–21.1%	–8.1%	–1.0%	–28.3%

Notes: Forecasts for TME, DEL and AME include measures announced in the 2012 Autumn Statement. AME and DEL figures are adjusted to reverse the effects of the business rate retention policy and the localised council tax reduction schemes (which have changed the definition of some spending between DEL and AME) in order to provide a more consistent comparison over time. Total managed expenditure has been adjusted for the effects of Spectrum auction receipts (2000–01 and 2012–13), the transfer of the Royal Mail Pension Fund into the public sector (2012–13), the closure of the Asset Purchase Facility (2012–13 onwards) and the reclassification of Bradford & Bingley and Northern Rock Asset Management (2012–13 onwards).

Source: Authors' calculations using table 1.1 of HM Treasury, *Public Expenditure Statistical Analyses 2012* (http://www.hm-treasury.gov.uk/pespub_pesa12.htm), table 2.4 of HM Treasury, *Autumn Statement 2012* (http://cdn.hm-treasury.gov.uk/autumn_statement_2012_complete.pdf) and table 4.21 and table D (in box 4.2, including correction at http://budgetresponsibility.independent.gov.uk/wordpress/docs/Correction-to-Table-D-in-Box-4_2.pdf) of OBR, *Economic and Fiscal Outlook*, December 2012 (<http://cdn.budgetresponsibility.independent.gov.uk/December-2012-Economic-and-fiscal-outlook23423423.pdf>).

government's control, but it can determine the qualification criteria and the generosity of the payment concerned. In addition, over a third of future social security spending is on state pensions, which is relatively easy to predict.

The government has not made explicit plans for departmental spending after 2014–15. However, given its policy assumption for total spending (total managed expenditure, TME), and the OBR's forecasts for AME in the absence of any new policies, there is an implicit forecast for future departmental spending.⁴ The current implied forecast for real growth in departmental spending after 2014–15 is described in Table 6.1. While total public spending is planned to be essentially frozen in real terms between 2014–15 and 2015–16, AME is forecast to increase by 2.1%, implying that departmental spending would be cut by 2.4% in real terms in 2015–16. Given the government's stated policy assumption for public sector gross investment (a real freeze after 2014–15), within departmental spending capital spending is implied to be cut to a greater extent than resource spending, by 8.1% in real terms as opposed to 1.7%. In part this is due to the temporary boost to capital spending allocated for 2014–15 in the 2012 Autumn Statement – in the absence of that extra £2.95 billion in 2014–15, capital spending in 2015–16 would only be 1.3% lower in real terms than in 2014–15.

Between 2015–16 and 2017–18, total public spending is forecast to be cut by 0.6% a year on average in real terms. Given that AME is still forecast to be growing (by an average 2.0% a year), this leaves departmental spending facing implied cuts of 3.4% a year on average (3.7% a year average real cuts to resource spending and 0.5% a year average real cuts to capital spending). Of course, these years will form part of the next Parliament, and a future government may choose to top up the total spending plans or reduce AME spending further in order to mitigate these implied cuts to departmental spending. Growth in AME spending over this period is discussed in more detail in Box 6.1.

Box 6.1. Growth in AME, 2014–15 to 2017–18

Over the period of the government's fiscal consolidation, 2010–11 to 2017–18, total public spending is forecast to be cut by an average 0.7% a year. However, this aggregate disguises marked differences in the growth of different components of public spending: AME is actually forecast to increase in real terms, while DEL spending is forecast to be cut by an average 2.9% a year in real terms. The cuts to DEL spending could be reduced, within a given total spending envelope, if the government introduced new policies that reduced AME spending. However, by definition, AME includes many areas of spending that are less easy for the government to control in the short run. Table 6.2 describes the forecast growth in the largest components of AME over the period 2010–11 to 2017–18. Spending on social security and tax credits (the largest single component of AME, accounting for nearly two-thirds of AME in 2010–11) is forecast to increase by an average 0.6% a year over these seven years, contributing around 24% to the total real increase in AME. By 2017–18, spending on social security and tax credits is expected to be 4.6% greater than it was in 2010–11. In large part, this increase is due to increased spending on pensions: forecasts from the Department for Work and Pensions (DWP) suggest that spending on the state pension in Great Britain, which accounts for nearly half of all benefit expenditure administered by DWP, will increase by nearly 20% in real terms between 2010–11 and 2017–18 (an average annual real increase of 2.5%).

⁴ The government's stated policy assumption is that, after 2014–15, TME should continue to fall at the same average annual real rate as over the Spending Review period and public sector gross investment should remain constant in real terms (paragraph 4.114 of OBR, *Economic and Fiscal Outlook*, December 2012 (<http://cdn.budgetresponsibility.independent.gov.uk/December-2012-Economic-and-fiscal-outlook23423423.pdf>)). The reason that the growth rate of TME described in Table 6.1 is not constant after 2014–15 is that the government excludes from its measure of 2014–15 spending the effect of some measures announced in the 2011 and 2012 Autumn Statements and the OBR's forecast underspends.

Table 6.2. Growth in components of AME

	2010–11 (£ billion, 2012–13 prices)	Average annual real growth			
		2010–11 to 2014–15	2014–15 to 2015–16	2015–16 to 2017–18	2010–11 to 2017–18
AME	317.6	1.6%	1.9%	1.8%	1.7%
<i>of which:</i>					
Capital AME	15.6	–4.9%	0.3%	–0.2%	–2.9%
Resource AME	302.0	1.9%	2.0%	1.9%	1.9%
<i>of which:</i>					
Social security and tax credits	203.5	0.5%	0.9%	0.7%	0.6%
<i>of which:</i>					
State pension (GB)	73.3	3.2%	1.8%	1.6%	2.5%
Gross debt interest payments	44.9	2.6%	7.1%	6.7%	4.4%
Locally-financed expenditure	23.5	2.0%	2.1%	1.9%	2.0%
Net public service pensions	5.9	20.3%	7.2%	5.8%	14.1%
Other	24.1	5.4%	–1.0%	–0.6%	2.7%

Notes: Resource AME excludes depreciation. AME in this table is defined according to the OBR definition, and includes only those components that are included in the fiscal aggregates of public sector current expenditure and public sector gross investment. The figures therefore differ from those presented in Table 6.1, where AME is defined according to the HM Treasury definition that includes some other components. A reconciliation between the two definitions is provided by the OBR Economic and Fiscal Outlook Supplementary Fiscal Tables.

Sources: Office for Budget Responsibility, Economic and Fiscal Outlook, March 2012 (Table 4.17) and December 2012 (Table 4.18). State pension spending in Great Britain from Department for Work and Pensions, Benefit Expenditure Tables, medium-term forecast.

Gross debt interest payments, locally-financed expenditure (the part of local authority spending financed through council tax), and net public service pension payments (i.e. payments to those receiving these pensions less the contributions of current members) are also all forecast to be growing in real terms. Together these areas of spending comprised less than one-quarter of AME in 2010–11, but they are forecast to account for 71% of the total real increase in AME over the seven years to 2017–18. Importantly, the level of spending on these areas is largely out of the government's immediate control.

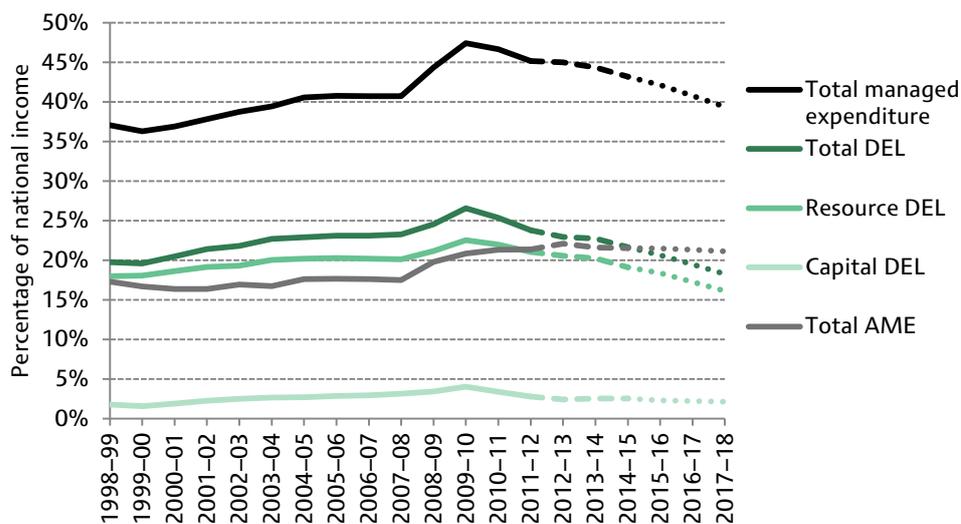
Other resource AME includes transfers to EU institutions, single-use military expenditure, spending on the BBC and spending on environmental levies (which is largely balanced by receipts), along with some smaller areas of spending. Together these areas of AME are forecast to grow by an average 2.7% a year in real terms between 2010–11 and 2017–18.

To achieve a reduction in future AME that would have a significant impact on the possible growth rate of DEL spending, a future government would likely have to look at further reductions to spending on social security and tax credits for working-age individuals or decide to cut back on spending on pensioners. Some options are described in more detail in Chapter 8.

Taking the period of the government's planned fiscal consolidation as a whole, in the absence of new policies total departmental spending would be cut by 18.6% in real terms between 2010–11 and 2017–18. Capital DEL is currently forecast to be cut by 28.3% over this seven-year period, and resource DEL by 17.1%.

Figure 6.1 describes what these projected real growth rates imply for TME, DEL and AME as a share of national income through to 2017–18, and how this compares with the levels seen since 1998–99 (the earliest year for which consistent data exist). Departmental spending increased rapidly under the last Labour government, from 19.7% of national income in 1998–99 to 23.2% in 2007–08. Over this period, AME spending was essentially unchanged at around 17.5% of national income. Total public spending, departmental spending and AME as a share of national income all increased particularly rapidly in 2008–09 and 2009–10. However, this was more to do with unexpectedly low levels of national income (due to both inflation and real growth over these years being lower than expected at the time of the October 2007 Comprehensive Spending Review) than a deliberate policy decision to increase spending as a share of national income over this period.

Figure 6.1. Departmental spending, 1998–99 to 2017–18



Notes: As Table 6.1. Resource DEL includes depreciation. Solid lines indicate out-turn data. Dashed lines indicate Treasury plans for the remaining years of the 2010 Spending Review period. Dotted lines indicate OBR forecasts for DEL on the basis of unchanged policies.

Source: Resource DEL, capital DEL and total managed expenditure are authors' calculations using HM Treasury, *Public Expenditure Statistical Analyses* (various years), HM Treasury, *Autumn Statement 2012* (http://cdn.hm-treasury.gov.uk/autumn_statement_2012_complete.pdf) and Office for Budget Responsibility, *Economic and Fiscal Outlook December 2012* (Supplementary Material). Total DEL is calculated as the sum of resource DEL and capital DEL. Total AME has been calculated as the residual between TME and total DEL.

The government is planning to cut DEL as a share of national income from 25.3% in 2010–11 to 21.7% in 2014–15. This would bring departmental spending back to the share of national income that it was in around 2002–03. The implicit forecasts for departmental spending suggest it would fall to 18.3% of national income by 2017–18 – the lowest level seen over the two decades since the DEL/AME framework for planning public spending was introduced. AME, on the other hand, is not forecast to fall as a share of national income over this period – by 2017–18, it is forecast to amount to 21.1% of national income, around the same as in 2010–11. An implication of this is that from 2015–16 onwards, AME will outstrip DEL for the first time and will account for more than half of total spending.

Figure 6.1 also splits departmental spending into resource DEL and capital DEL. Resource DEL spending is to be cut from 22.0% of national income in 2010–11 to 19.1% in 2014–

15, and is implied to fall further to 16.1% by 2017–18. Capital DEL is to be cut from 3.4% of national income in 2010–11 to 2.5% in 2014–15, and is implied to fall to 2.1% by 2017–18. The majority of departmental spending is therefore not on investment. Capital DEL increased from below 10% of total DEL in 1998–99 to over 15% in 2009–10, and is forecast to fall back to around 12% of total DEL by 2017–18.

Spending Review 2010 (2011–12 to 2014–15)

The October 2010 Spending Review allocated total DEL between Whitehall departments for the four years 2011–12 to 2014–15. These plans have been revised slightly subsequently, with the 2011 and 2012 Autumn Statements allocating additional capital spending and planning some further cuts to departments' resource spending. In addition, the OBR is forecasting that departments will underspend against their allocated budgets in 2012–13, 2013–14 and 2014–15 (by £7.5 billion, £4.5 billion and £3.5 billion respectively). The latest forecast cuts between 2010–11 and 2014–15 by department are described in Figure 6.2 – these figures for individual departments do not include the OBR's forecast underspend as the OBR has not specified which departments it expects to underspend or by how much.

The relative winners from the 2010 Spending Review allocations were: the Department for International Development, which saw an increase in its budget so that overseas aid spending could be increased to 0.7% of gross national income by 2013, in line with the government's commitment; the Department for Energy and Climate Change (DECC), which saw an increase in its capital budget, in large part to fund the development of carbon capture and storage (CCS) technology; and the NHS, for which the Prime Minister promised real budget increases each year over the course of this Parliament. The biggest loser from the Spending Review was the Department of Communities and Local Government (DCLG), which is forecast to see a two-thirds reduction in its Communities budget – in large part due to cuts to spending on social housing.^{5,6}

To date, we only have out-turn data for the first year of the 2010 Spending Review period, 2011–12. In 2011–12, the majority of Whitehall departments actually underspent on their budgets. Figure 6.3 shows, for departments that underspent by more than £0.1 billion, the proportion of their budgets that were surrendered through Budget Exchange with agreement of HM Treasury (and will therefore be available to spend in 2012–13) and the proportion of their budgets that were underspent and will not be transferred into future years.⁷ The department that underspent the largest proportion of its budget was the Department for Energy and Climate Change, whose £0.4 billion underspend was 13.6% of its 2011–12 budget. This is largely due to an underspend on developing CCS technology. In absolute terms, the largest underspender was the NHS – the biggest Whitehall department – which underspent by £1.8 billion (of which only £0.3 billion was

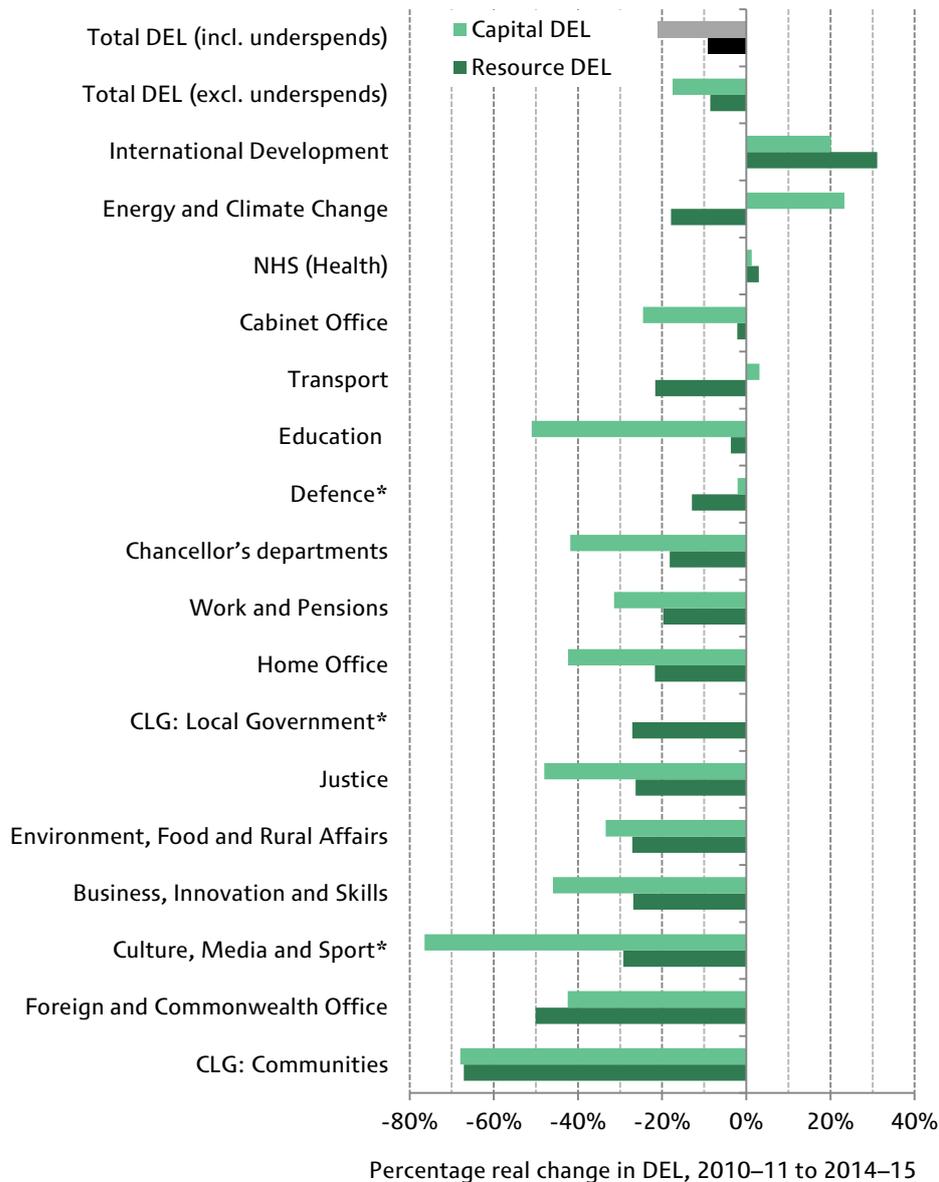
⁵ The DCLG is unique in that it has two separate DELs. The 'CLG: Local Government' DEL includes Revenue Support Grant, national non-domestic rates, and related grants to local authorities in England that support services that are typically the overall responsibility of other government departments (such as police and social services). The 'CLG: Communities' DEL includes the department's main programme expenditure and administration costs.

⁶ For more detail on the 2010 Spending Review settlements, see R. Crawford, C. Emmerson, D. Phillips and G. Tetlow, 'Public spending cuts: pain shared?', in M. Brewer, C. Emmerson and H. Miller (eds), *The IFS Green Budget: February 2011*, IFS Commentary 117, 2011 (<http://www.ifs.org.uk/budgets/gb2011/11chap6.pdf>).

⁷ The Budget Exchange system allows departments to carry forward underspends of up to 1% of resource DEL and 2% of capital DEL from one year to the next, provided that the underspend is forecast in advance of the January Supplementary Estimates.

surrendered through Budget Exchange), which is equivalent to 1.7% of its 2011–12 budget.

Figure 6.2. Spending changes, 2010–11 to 2014–15, by department

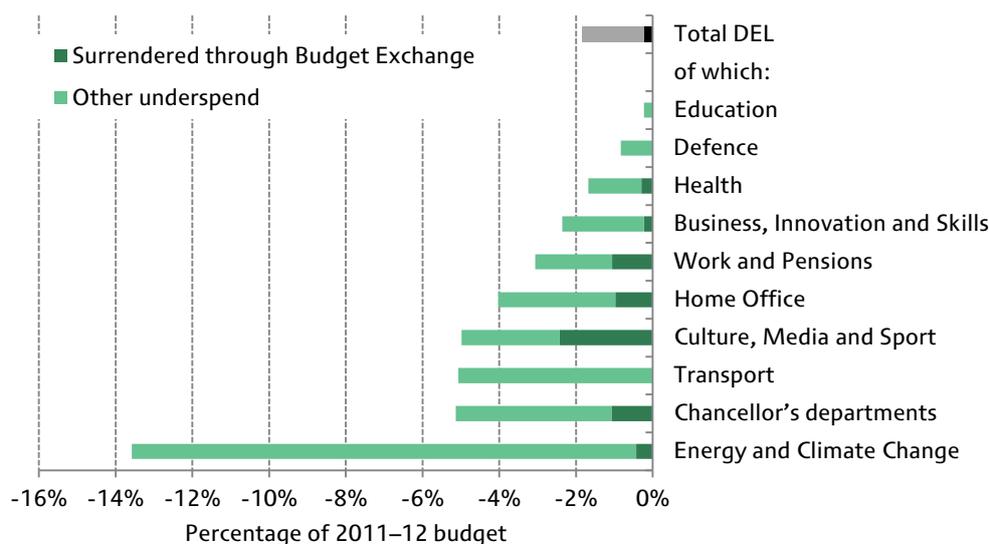


* The Ministry of Defence budget excludes the cost of 'MOD operations and peacekeeping', which are met from the Special Reserve. CLG: Local Government does not have a capital DEL budget. Culture, Media and Sport includes costs associated with the Olympics.

Note: Figures for individual departments do not include the OBR's forecast underspend against planned budgets in 2014–15 since only a total underspend across DEL has been forecast. 'Chancellor's departments' includes HM Treasury, National Savings and Investments, Government Actuary's Department, HM Revenue and Customs, National Investment and Loans Office, Royal Mint and Crown Estate Office. Personal Social Services is included in CLG Local Government.

Source: Authors' calculations using table 1.12 of HM Treasury, *Public Expenditure Statistical Analyses 2012* (http://www.hm-treasury.gov.uk/pespub_pesa12.htm), adjusted for table 2.2 of HM Treasury, *Autumn Statement 2012* (http://cdn.hm-treasury.gov.uk/autumn_statement_2012_complete.pdf). Table 1.18 of Ministry of Defence, *UK Defence Statistics 2011* (<http://www.dasa.mod.uk/modintranet/UKDS/UKDS2011/ukds.php>).

Figure 6.3. Underspends by department, 2011–12



Notes: Includes departments that underspent by more than £0.1 billion. Culture, Media and Sport includes costs associated with the Olympics. 'Chancellor's departments' includes HM Treasury, National Savings and Investments, Government Actuary's Department, HM Revenue and Customs, National Investment and Loans Office, Royal Mint and Crown Estate Office.

Source: Authors' calculations using HM Treasury, *Public Expenditure Statistical Analyses* (2011 and October 2012 National Statistics update) and *Supplementary Estimates 2011–12* (http://www.hm-treasury.gov.uk/psr_pse_201112.htm).

While small underspends are not normally surprising (indeed, it would be amazing if every department managed to spend its allocation exactly every year), in an era when most departments are facing budget cuts these underspends that are not qualifying for Budget Exchange are somewhat more strange. One possible explanation is that Whitehall departments have looked ahead to the cuts they face in 2012–13, 2013–14 and 2014–15 and decided that over-delivering on the cuts in 2011–12 would leave them better placed to keep within these tight budgets going forwards. Underspends could also be indicative of a political desire to be seen to be able to deliver the government's planned budget cuts (or aversion to being seen to be unable to control spending), or alternatively simply be symptomatic of poor financial management. The OBR has forecast further underspends against the Treasury planned DEL budgets in each year 2012–13 to 2014–15 (discussed in more detail in Chapter 5) – while an underspend looks likely for 2012–13 given data on central government spending to date, it remains to be seen how accurate its forecast is for years beyond that.

Spending Review 2013 (2015–16)

The government has stated that it will hold a Spending Review in the first half of 2013, at which point it will set out the allocation of DEL between departments for 2015–16. As described above, on average in 2015–16 departmental spending is to be cut by 2.4% in real terms, with a 1.7% cut in resource DEL and an 8.1% cut in capital DEL. However, not all departments will see these average cuts in their budgets. The 2012 Autumn Statement says that, 'In line with the policy set at Spending Review 2010, spending on health, schools and ODA [Official Development Assistance] will be protected from further

reductions'.⁸ This means that the other 'unprotected' departments will see larger than the average cut to their budgets.

Figure 6.4 shows two possible ways in which the spending cuts could be allocated between departments. In both scenarios, the total budget for the NHS in England is frozen in real terms, the Department for International Development (DFID) sees its total budget increase in line with nominal national income (which should enable spending on international aid to be maintained at 0.7% of gross national income) and, within the education budget, resource spending on schools is frozen in real terms. In addition, we assume that the Treasury will allocate £1 billion of resource spending and £0.5 billion of capital spending in 2015–16 to the Reserve (in other words, an amount unallocated between departments, which can then be made available to departments in future as need arises) and that no money will be allocated to the Special Reserve (which is used to fund the net additional costs of military operations). To the extent that a greater proportion of DEL than this is allocated to the reserves in 2015–16, the required DEL cuts across departments will be greater than those illustrated in Figure 6.4. The spending allocations for the devolved administrations of Scotland, Wales and Northern Ireland are calculated according to the Barnett formula and are discussed in Box 6.2.

The 2012 Autumn Statement stated that the government 'will operate on the principle that departmental resource budgets will continue on the same trajectory in 2015–16 as over the period of Spending Review 2010'.⁹ We assume, by contrast, in the 'same trajectory' scenario described in Figure 6.4, that all 'unprotected' Whitehall departments receive the same percentage cut to their capital DEL as each other, while the real cut to their resource DEL is a fixed proportion of the real cut to their resource DEL budget between 2010–11 and 2014–15. Each 'unprotected' Whitehall department would be required to cut its real-terms resource budget by 46% of its average annual real cut over the 2010 Spending Review period in order for the government's cut to overall resource DEL spending to be achieved.

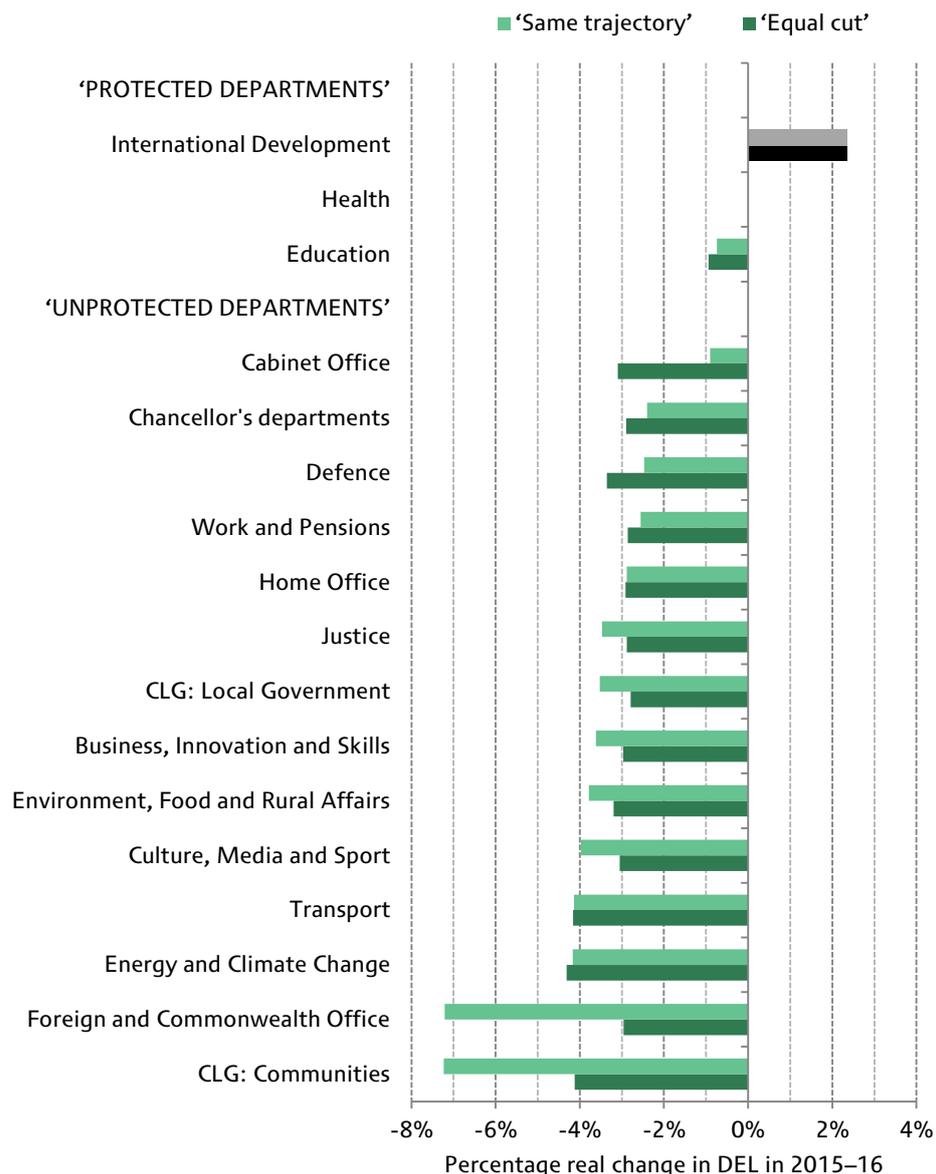
This 'same trajectory' scenario implies a worse settlement for those departments that saw their resource budgets cut by a larger-than-average amount in the 2010 Spending Review, such as the Communities part of the Department for Communities & Local Government and capital-intensive departments such as Transport and Energy & Climate Change. Whilst in some sense this might be interpreted as being a continuation of the government's priorities to date, departments that will have delivered large budget cuts since 2010–11 may not find it so easy to do so again. For example, a large proportion of the reduction in the DEL budget of the Department for Business, Innovation & Skills over the 2010–11 to 2014–15 period is being achieved through a dramatic change in the way in which teaching in higher education institutions is funded – shifting the burden from the taxpayer to future graduates.¹⁰ To achieve an equivalent budget reduction in 2015–16 would require BIS to cut the non-higher-education aspects of its budget significantly (which might, for example, conflict with the government's recent policies to protect science spending, which is largely administered by BIS).

⁸ Paragraph 2.15 of HM Treasury, *Autumn Statement 2012* (http://cdn.hm-treasury.gov.uk/autumn_statement_2012_complete.pdf).

⁹ Paragraph 2.15 of HM Treasury, *Autumn Statement 2012* (http://cdn.hm-treasury.gov.uk/autumn_statement_2012_complete.pdf).

¹⁰ An analysis of the government's higher education reforms can be found in H. Chowdry, L. Dearden and G. Wyness, *Higher Education Reforms: Progressive but Complicated with an Unwelcome Incentive*, IFS Briefing Note 113, 2010, revised 2011 (<http://www.ifs.org.uk/publications/5366>).

Figure 6.4. Possible spending allocations by department



Notes: The Ministry of Defence budget excludes the cost of 'MOD operations and peacekeeping', which are met from the Special Reserve. 'Chancellor's departments' includes HM Treasury, National Savings and Investments, Government Actuary's Department, HM Revenue and Customs, National Investment and Loans Office, Royal Mint and Crown Estate Office. Personal Social Services is included in CLG Local Government. Figures for individual departments' spending in 2014-15 do not include the OBR's forecast underspend. Therefore to the extent that a department underspends against its 2014-15 budget, its percentage budget cut in 2015-16 would be lower than illustrated above for the same cash settlement in 2015-16.

Source: Authors' calculations using HM Treasury, *Public Expenditure Statistical Analyses 2012* (http://www.hm-treasury.gov.uk/pespub_pesa12.htm), HM Treasury, *Autumn Statement 2012* (http://cdn.hm-treasury.gov.uk/autumn_statement_2012_complete.pdf), Ministry of Defence, *UK Defence Statistics 2011* (<http://www.dasa.mod.uk/modintranet/UKDS/UKDS2011/ukds.php>) and H. Chowdry and L. Sibieta, *Trends in Education and Schools Spending*, IFS Briefing Note 121, 2011 (<http://www.ifs.org.uk/bns/bn121.pdf>).

Box 6.2. Spending Review 2013 and the devolved administrations

The devolved administrations of Scotland, Wales and Northern Ireland are funded largely through block grants from the Treasury; it is then up to the administrations to decide how this funding is allocated to different public services. The allocations made to Whitehall departments in the 2013 Spending Review will determine the change in the level of these block grants for 2015–16.

Changes in the block grants to the devolved administrations are determined by the Barnett formula (the levels of spending are determined by the levels of spending that existed before the introduction of the Barnett formula, and the changes in spending in each year since). The Barnett formula is designed to apply the same pounds-per-head nominal change in ‘comparable’ English spending automatically to Scotland, Wales and Northern Ireland. For example, if there is a £1 billion cash increase (decrease) in comparable English spending, the Scottish government would see a £99.2 million increase (decrease) in its block grant, the Welsh Assembly Government a £56.9 million increase (decrease) and the Northern Ireland Executive a £34.3 million increase (decrease), since the populations of Scotland, Wales and Northern Ireland are forecast to be 9.92%, 5.69% and 3.43% of the English population (respectively) in mid-2013 according to the ONS 2010-based population projections. ‘Comparable’ English spending is spending in England on functions that are devolved to Scotland, Wales and Northern Ireland. The Barnett formula is therefore not applied to changes in spending by Whitehall departments that is deemed to benefit the whole of the UK (for example, defence) or, for a given nation, to changes in spending on functions that are not devolved to that nation (for example, changes to spending on benefit administration by the Department for Work and Pensions will only affect Northern Ireland, as DWP’s spending covers England, Scotland and Wales).

Table 6.3. Implied real block grant change for the devolved administrations

	Real change, 2014–15 to 2015–16	Real change, 2010–11 to 2015–16
Scotland	-1.6%	-12.0%
Wales	-1.6%	-12.6%
Northern Ireland	-1.7%	-13.2%
UK	-2.4%	-12.8%

The implications of the ‘same trajectory’ scenario for the budgets of the devolved administrations in 2015–16 are calculated according to the Barnett formula and are shown in Table 6.3.^a The real cuts to the block grants of Scotland, Wales and Northern Ireland are smaller than the average real cut to departmental spending across the UK as a whole (1.6%, 1.6% and 1.7% respectively, compared with 2.5%). In part this is because spending deemed to benefit the whole of the UK (such as defence) is projected to be cut by more on average than spending on England (large parts of which – for example, health – have been relatively protected). However, in part this effect also arises simply because of the way the Barnett formula works. The level of spending per head is greater in Scotland, Wales and Northern Ireland than it is in England, and so the same pounds-per-head reduction in spending would represent a smaller proportionate budget cut to Scotland, Wales or Northern Ireland than it would to England.

^a The ‘Barnettable’ proportions of each department’s budget are assumed to be broadly the same as in the 2010 Spending Review statement of funding. For more explanation of the Barnett formula, see box 6.2 of R. Crawford, C. Emmerson, D. Phillips and G. Tetlow, ‘Public spending cuts: pain shared?’, in M. Brewer, C. Emmerson and H. Miller (eds), *The IFS Green Budget: February 2011*, IFS Commentary 117, 2011 (<http://www.ifs.org.uk/budgets/gb2011/11chap6.pdf>).

For comparison, therefore, Figure 6.4 also shows an ‘equal cut’ scenario, in which all ‘unprotected’ Whitehall departments see the same percentage change in their resource budgets (a real cut of 2.8%) and the same percentage change in their capital budgets (a real cut of 4.9%).¹¹ The different percentage changes in total DEL across different departments under this scenario arise from the different compositions of their total budget – those for which capital spending accounts for a larger proportion of their budgets, such as the Department for Energy & Climate Change and the Department for Transport, have a slightly larger-than-average total DEL cut.

Table 6.4. Total real DEL cuts since 2010–11 (‘same trajectory’ scenario)

Cumulative real growth between 2010–11 and 2015–16	Capital DEL	Resource DEL	Total DEL
CLG: Communities	–69.5%	–70.8%	–70.0%
Foreign and Commonwealth Office	–45.3%	–53.8%	–53.2%
Culture, Media and Sport	–77.6%	–32.0%	–45.3%
Business, Innovation and Skills	–48.6%	–29.4%	–31.5%
Environment, Food and Rural Affairs	–36.7%	–29.6%	–31.1%
Justice	–50.5%	–28.8%	–30.1%
CLG: Local Government	N/A	–29.6%	–29.5%
Home Office	–45.2%	–23.9%	–25.5%
Work and Pensions	–34.7%	–21.7%	–22.2%
Chancellor’s departments	–44.7%	–20.0%	–21.3%
Defence	–6.8%	–14.3%	–12.5%
Transport	–1.9%	–23.8%	–11.0%
Education	–53.4%	–4.1%	–10.1%
Cabinet Office	–28.2%	–2.4%	–7.0%
Health	1.3%	3.0%	2.9%
Energy and Climate Change	17.3%	–19.8%	3.8%
International Development	22.9%	34.2%	31.8%
Total	–27.5%	–10.5%	–12.8%

Notes: CLG: Local Government does not have a capital DEL budget. Personal Social Services is included in CLG Local Government. Culture, Media and Sport includes costs associated with the Olympics. The Ministry of Defence budget excludes the cost of ‘MOD operations and peacekeeping’, which are met from the Special Reserve. ‘Chancellor’s departments’ includes HM Treasury, National Savings and Investments, Government Actuary’s Department, HM Revenue and Customs, National Investment and Loans Office, Royal Mint and Crown Estate Office.

Source: As Figure 6.4.

The implications of the ‘same trajectory’ settlement described in Figure 6.4 for the total budget cut each government department would have experienced since 2010–11 are described in Table 6.4. The biggest casualty by far would be the Department for Communities and Local Government, which would see a 70% reduction in its Communities budget by 2015–16. Many other departments would see their budgets cut by around 20–30%. The departments of international development, health and education are relatively ‘protected’, although it is worth bearing in mind that the Department for Education is projected to see its investment budget more than halved between 2010–11 and 2015–16. The relative winners aside from these ‘protected’ departments would be

¹¹ To illustrate the sensitivity of these numbers to the assumption that £1 billion of resource DEL and £0.5 billion of capital DEL will be allocated to the reserves in 2015–16, if instead £2 billion and £1 billion were allocated respectively, the average cut across departments’ resource and capital budgets would be 3.6% and 6.4%.

the Department of Energy & Climate Change and the Department for Transport. The latter is projected to have fared particularly well given that it is such a capital-intensive department,¹² with a cut to its capital DEL of just 1.9%, compared with an average across all departments of 27.5%.

Spending in the next Parliament (2016–17 and 2017–18)

The last two years of the government’s current forecast horizon, 2016–17 and 2017–18, fall in the next Parliament, and so decisions regarding the level and allocation of spending across departments in those years will be made by the next government. Unless departmental spending is increased at the expense of either higher borrowing, higher taxes or lower social security spending than pencilled in by the current government, the implication is that real departmental spending would have to be cut by 6.6% over 2016–17 and 2017–18, an average cut of 3.4% a year. As shown in Table 6.1, this would be a greater average annual real DEL cut than currently forecast for either the 2010 Spending Review period (2.8%) or 2015–16 (2.4%).

Figure 6.5. Trade-off between cuts to departmental spending and tax increases or social security spending cuts

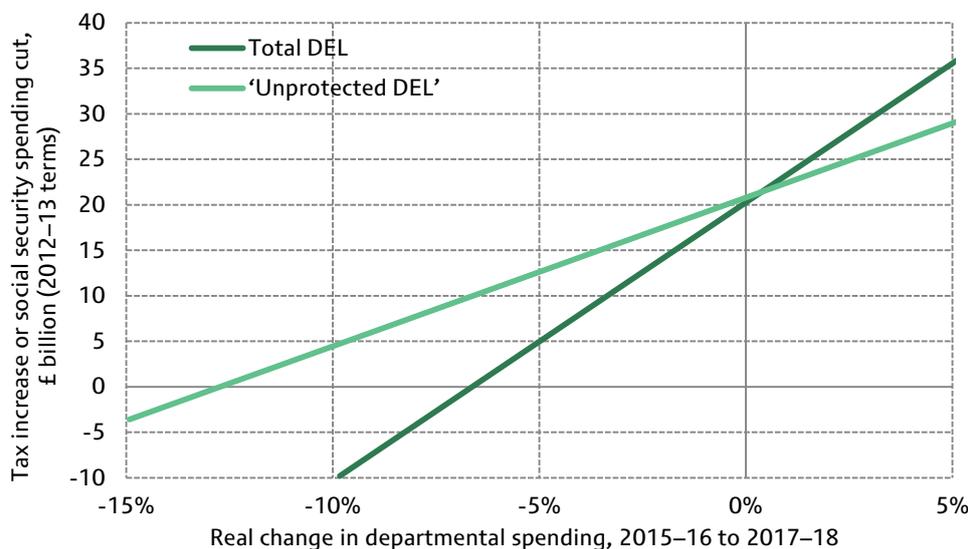


Figure 6.5 describes how tax increases or further cuts to social security spending could be used to reduce this required cut to departmental spending. Reducing the average annual cut to DEL to 2.8% (the same as over the 2010 Spending Review period) – in other words, a cut of 5.5% over the two-year period – would require around £3 billion to be raised from a combination of tax increases and social security spending cuts. To put this in context, increasing the standard rate of VAT by 1 percentage point would raise around £5 billion.¹³ To keep DEL spending constant in real terms between 2015–16 and 2017–18 would require tax increases or social security spending cuts amounting to some £20 billion.

¹² The Department of Transport’s capital DEL accounted for nearly 60% of its total DEL in 2010–11, compared with an average across all departments of 13%.

¹³ Alternatively, for example, increasing the basic rate of income tax by 1 percentage point would raise around £4 billion, while reducing the income tax personal allowance by £900 would raise around £5 billion. Source: <http://www.hmrc.gov.uk/statistics/expenditures/table1-6.pdf>.

If a future government making these decisions chose to protect spending on health, schools and international aid, as the current government has done since 2010–11, the choices in 2016–17 and 2017–18 for other, ‘unprotected’ departments would be somewhat more difficult. If the total budget of the NHS and the non-investment budget for schools were frozen in real terms between 2015–16 and 2017–18, and the total budget of the Department for International Development were increased in line with national income, then all other areas of departmental spending would see their budgets cut by 12.7% between 2015–16 and 2017–18 (an average real annual cut of 6.6%) in the absence of any further tax increases or spending cuts. Over the whole seven-year period since 2010–11, these ‘unprotected’ areas of departmental spending would then have seen their real budgets cut by 33.2%.

Figure 6.5 shows how the cuts to these ‘unprotected’ areas of spending could be traded off against further tax increases or social security spending cuts. Reducing the average budget cut between 2015–16 and 2017–18 across these ‘unprotected’ areas to 10.5% (an average annual cut of 5.4%, the same as the average over 2010–11 to 2014–15 for these areas) would require tax increases or spending cuts amounting to around £4 billion. Reducing the real cut across the ‘unprotected’ areas over the two-year period to 5.5% would require tax increases or spending cuts amounting to around £12 billion.

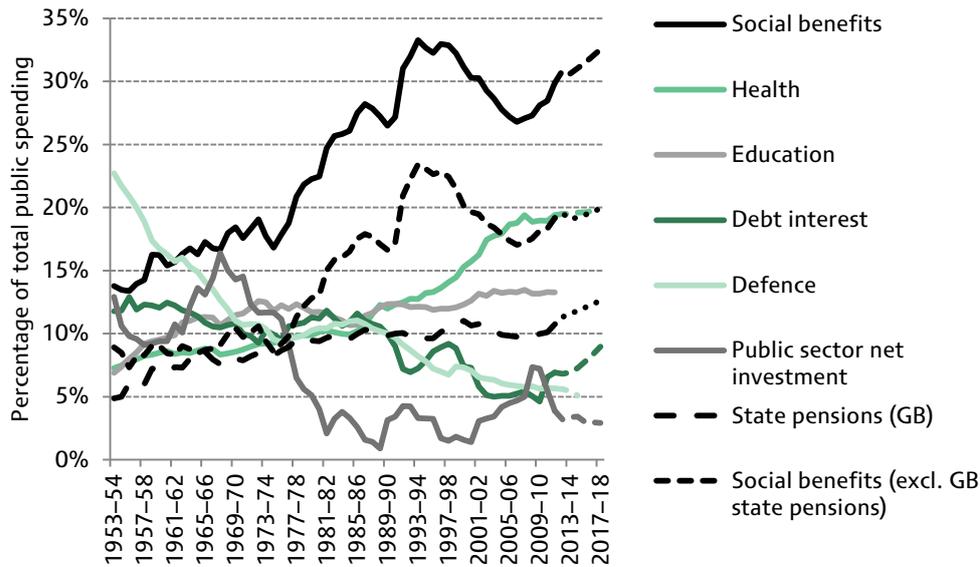
The changing composition of spending over time

The implications of the government’s spending choices since 2010–11 for the composition of public spending are described in Figure 6.6. Spending on net social benefits (social security plus net tax credits) is forecast to increase from 28.5% of total spending in 2010–11 to 32.5% by 2017–18 (as total spending falls significantly and spending on net social benefits increases slightly in real terms). This is, however, simply the continuation of a long-run trend of social security taking up a rapidly increasing share of public spending, which was only tempered in the early 2000s when spending on public services was increased significantly by the Labour government. Were the government to cut spending on net social benefits in order to finance higher spending on public services by, say, £12 billion by 2017–18, net social benefits spending would increase only slightly as a share of total spending to 31.0%.

Figure 6.6 also splits out social benefit spending into spending on state pensions (in Great Britain) and other social security (and net tax credit) spending. The relative importance of spending on state pensions has been steadily increasing over time – from just under 5% of total public spending in the early 1950s to 10.1% in 2010–11. In future, the proportion of spending going on state pensions is forecast to increase slightly more rapidly, reaching 11.8% in 2014–15 and 12.6% in 2017–18. These increases are dwarfed, however, by the increased proportion of spending going on other social security benefits: spending on net social benefits excluding state pensions (in Great Britain) increased from 8.5% of total spending in 1974–75 to 18.3% in 2010–11 (with particularly large spikes in between associated with the recessions of the late 1980s and early 1990s). Spending on net social benefits excluding state pensions is also forecast to increase in relative importance in future, reaching 19.9% of total public spending in 2017–18.

The relative protection afforded to health spending by the current government is forecast to result in health also taking up an increasing proportion of total public spending. This is, again, the continuation of a long-run trend: health spending has been taking up an increasing share of public spending since the inception of the NHS. The rate of increase is, however, forecast to be much lower than that over the past two decades.

Figure 6.6. The changing composition of public spending



	2010–11	2014–15	2017–18
Total public spending (% of national income)	46.7	43.2	39.4
Percentage of public spending on:			
Net social benefits	28.5	31.0	32.5
of which:			
State pensions (Great Britain)	10.1	11.8	12.6
Other	18.3	19.2	19.9
Health	19.0	19.6	19.9
Education	13.3	–	–
Central government gross debt interest	6.6	7.3	9.0
Defence	5.7	5.1	–
Public sector net investment	5.5	3.4	2.9

Notes: Health spending forecast assumes total real UK health spending constant in real terms between 2010–11 and 2017–18. To the extent that the devolved administrations do not maintain real spending on the NHS since 2010–11, this will overstate future health spending. Defence spending forecast assumes that total defence spending grows at the same rate as the combined budget of the Ministry of Defence and the Special Reserve. ‘–’ indicates that forecasts are unavailable.

Source: Out-turn data are from the Office for National Statistics (series ANLY for net social benefits, JW2Z for net investment, JW2P for gross debt interest payments), Office of Health Economics for health spending, ONS Blue Books and HM Treasury *Public Expenditure Statistical Analyses* (various years) for education and defence spending, and DWP Benefit Expenditure Tables for GB state pension spending. Forecasts are from OBR *Economic and Fiscal Outlook December 2012* (table 4.18 for net investment; Supplementary Fiscal Tables: table 2.28 for net social benefits and gross debt interest payments), DWP Benefit Expenditure Tables (for GB state pensions) and authors’ calculations (for health and defence).

The coalition government’s cuts to defence spending are also in line with long-run trends. Defence spending has been accounting for an ever-smaller proportion of total spending since the late 1980s: in 1985–86, defence spending accounted for 11.0% of total spending; by 2010–11, this had fallen to 5.7%; and the projections in Figure 6.6 suggest it could fall further to 5.1% by 2014–15.

Spending on gross debt interest payments has also been falling (both as a share of total spending and as a share of national income) since the 1980s. However, the large increase in public sector net borrowing and, consequently, public sector net debt since the financial crisis has meant that the relative importance of debt interest payments is on the

increase again. While gross debt interest payments in 2010–11 accounted for 6.6% of total spending, by 2017–18 they are forecast to account for 9.0%.

Public sector net investment as a share of total spending is forecast to fall sharply under the coalition government, from 5.5% of national income in 2010–11 to 2.9% by 2017–18. This trend is in marked contrast to that over the preceding decade, under the Labour government, but results in a similar proportion of total spending as was invested on average in the 1980s and 1990s.

6.3 Public sector pay and employment

In the previous section, we showed that current plans imply that departmental spending will be cut by just over 10% in real terms between 2010–11 and 2014–15, with larger cuts to capital spending (over 20%) than to resource spending (9%). Since about half of resource (non-investment) departmental spending is on pay, it would be difficult to deliver such spending cuts without also cutting the paybill, either through real-terms reduction in pay per head, reductions in employment or both. In this section, we consider how the spending cuts to date have been delivered, and what the outlook is for public sector pay and employment in future.

Composition of the spending cuts to date

Departmental spending consists of a range of different elements. Table 6.5 shows the total level of central government spending within resource DELs on different items: paybill, gross procurement and other spending. The level of spending on these items is shown for 2010–11, 2012–13 and 2014–15 (all in 2012–13 prices), as are the expected total real-terms changes in each item between 2010–11 and 2012–13 and between 2010–11 and 2014–15. Together, spending on these areas comprises the total level of resource DEL spent by central government. Education spending is separated out from each of these figures due to large discontinuities resulting from the significant growth in the Academies programme – the level and change in the education DEL is shown separately. Current grants to local government are also shown separately. The total level of resource DEL therefore represents the sum of central government resource DEL (excluding education), education resource DEL and grants to local government.

We focus on the central government paybill here (which excludes local government workers) because figures for the local government paybill are not currently available up to 2012–13. However, in 2010–11, the paybill for local government workers (including teachers in maintained schools) was £80.9 billion (2012–13 prices).¹⁴ The central government paybill we consider here thus represents just over half of the total general government paybill (about £174.5 billion in 2010–11). The total paybill, including both local and central government, represented about a half of total resource DEL in 2010–11.

Gross current procurement represents expenditure on goods, services, rental payments, and payments for contract and agency staff and also includes the purchase of services from GPs. As such, gross current procurement is likely to include wages and salaries for

¹⁴ This figure is taken from table 7.8 of HM Treasury, *Public Expenditure Statistical Analyses 2012* (http://www.hm-treasury.gov.uk/pespub_pesa12.htm) and relates to pay for local government workers in the UK as a whole.

Table 6.5. Departmental resource spending by economic category over period covered by 2010 Spending Review (2010–11 to 2014–15)

	<i>£ billion, 2012–13 prices</i>			<i>Total real-terms change</i>	
	2010–11	2012–13	2014–15	2010–11 to 2012–13	2010–11 to 2014–15
Pay*	93.6	87.8	82.1	–6.3%	–12.3%
Procurement*	119.3	118.6	113.6	–0.6%	–4.8%
Other*	16.5	15.1	15.3	–8.7%	–7.2%
Reserves		1.9	3.9		
Central government resource DEL (excluding education)	229.5	225.2	218.8	–1.8%	–4.6%
Current grants to local government*	58.0	49.5	43.4	–14.6%	–25.2%
Education	53.7	52.4	52.1	–2.4%	–3.0%
Total resource DEL	341.2	327.2	314.3	–4.1%	–7.9%
<i>Total resource DEL (post 2012 Autumn Statement)</i>	341.4	321.3	310.6	–5.9%	–9.0%

* Due to discontinuities created by the growth in the Academies programme, we have excluded education spending from all categories. Education spending indicates all spending by both maintained schools and Academies.

Notes: Resource DEL excludes depreciation. Data on spending by economic category are taken from PESA 2012 and therefore do not include the additional cuts to DEL announced in the 2012 Autumn Statement. In the absence of these policy changes the real change in total resource DEL between 2010–11 and 2014–15 would be a cut of 7.9% (penultimate row) rather than the cut of 9.0% described in Table 6.1 and shown in the last row of this table.

Source: Authors' calculations based on tables 1.12 and 2.1 from *Public Expenditure Statistical Analyses 2012* (http://www.hm-treasury.gov.uk/pespub_pesa12.htm); table 2.2 from *Autumn Statement 2012* (http://cdn.hm-treasury.gov.uk/autumn_statement_2012_complete.pdf); HM Treasury.

individuals undertaking work for the public sector but who are not officially public sector workers.¹⁵

Looking at the different items of spending, a number of patterns emerge. First, cuts to local government grants (excluding education) are large and front-loaded, with nearly two-thirds of the total 25% cut expected to be delivered by the end of 2012–13. The main elements of local government spending (excluding education) are social care, police and transport. In last year's Green Budget, we analysed plans for local government spending up to 2011–12 and showed that spending on some smaller elements of local authority spending were experiencing relatively large cuts proportionate to their size (planning and development, libraries, and leisure and culture), whilst other services were relatively protected (social care, fire services, and environment and refuse).¹⁶

Second, the central government paybill is being cut in real terms, with a total planned cut of 12% by 2014–15 spread evenly over time. The cuts to the central government paybill are also proportionately much larger than the planned cuts to central government resource spending within DEL (excluding education), indicating that departments are

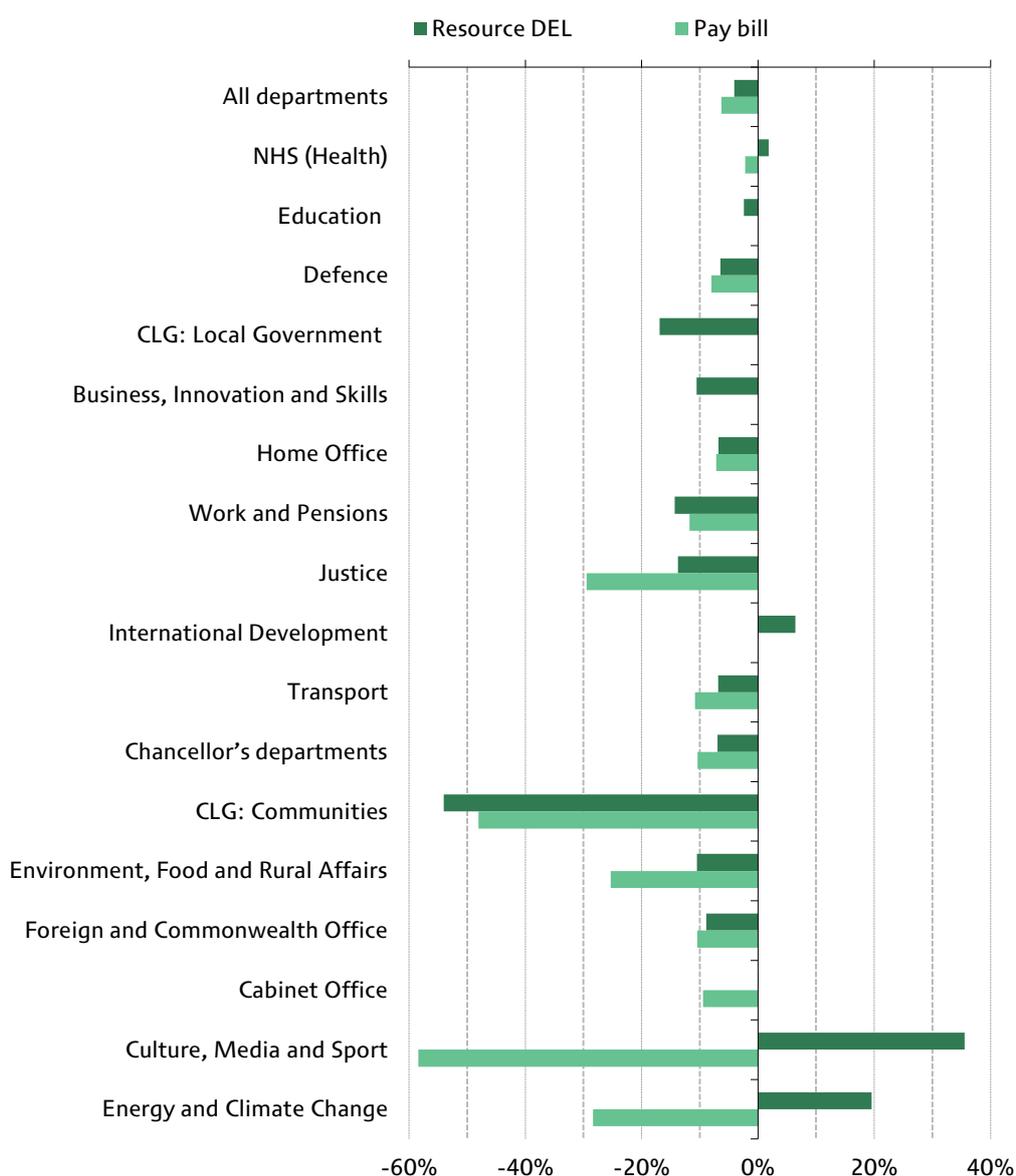
¹⁵ Further details about these categories can be found in HM Treasury, *Public Expenditure Statistical Analyses 2012* (http://www.hm-treasury.gov.uk/pespub_pesa12.htm).

¹⁶ See R. Crawford and D. Phillips, 'Local government spending: where is the axe falling?', in C. Emmerson, P. Johnson and H. Miller (eds), *The IFS Green Budget: February 2012*, IFS Commentary 122, 2012 (<http://www.ifs.org.uk/budgets/gb2012/12chap6.pdf>).

squeezing the paybill by more than the overall cuts to their budgets. Furthermore, these figures are likely to underestimate the underlying cuts to the paybill, as they include the cost of redundancy schemes, which is likely to be increasing between 2010–11 and 2012–13.

Cuts to procurement spending are much smaller than cuts to other items of spending and compared with the overall planned cuts to department spending, with most of the cuts back-loaded to the period after 2012–13. The largest component of current procurement spending comes from the NHS (£58 billion in 2012–13), which includes the purchase of services from GPs and the cost of agency staff. This is expected to have grown by 2.4% in

Figure 6.7. Percentage changes in resource spending and paybill by department (2010–11 to 2012–13)



Notes: Resource DEL excludes depreciation. Changes in the paybill are not shown for Education or for CLG: Local Government; nor are they shown where the paybill represents less than 10% of total resource DEL. Departments are ordered by the total size of their resource DEL budget in 2010–11.

Source: Authors' calculations based on tables 1.12 and 2.1 from *Public Expenditure Statistical Analyses 2012* (http://www.hm-treasury.gov.uk/pespub_pesa12.htm); HM Treasury.

real terms between 2010–11 and 2012–13. This growth in NHS procurement spending is the main reason why overall procurement spending has not fallen by more over the period. Non-NHS procurement spending is expected to fall by 3.6% in real terms between 2010–11 and 2012–13.

Table 6.5 also shows planned cuts to resource spending for the Department for Education. Here, we see that this department is relatively protected compared with other departments, experiencing smaller cuts up to 2012–13 and up to 2014–15, which mainly result from the relative protection offered to non-investment schools spending in the 2010 Spending Review.

In the last row of the table, we show the changes in resource DEL spending after announcements in the 2012 Autumn Statement. This shows that resource spending is now expected to fall by more in real terms, largely due to the OBR's expectation that departments will not spend all of their budgets each year (although the level of underspending by individual departments has not been forecast), but also due to further measures announced in the 2012 Autumn Statement.

In order to analyse the cuts in the paybill in more detail, Figure 6.7 shows, for each government department, the expected cut to its paybill between 2010–11 and 2012–13 and the planned cut in its total resource DEL over the same period. In this context, the paybill again only relates to employees of central government; it thus excludes teachers in maintained schools and local government employees. The paybill is expected to have fallen in real terms across all departments shown. Furthermore, in most cases, the cut in the paybill has been proportionately greater than the cut to resource DEL. For instance, in the case of the NHS, the paybill has fallen in real terms, whilst overall resource DEL has risen in real terms.

Fall in the public paybill: job losses or cuts to pay per head?

To what extent are reductions in the total paybill across departments between 2010–11 and 2012–13 down to reduced numbers of employees and to what extent are they due to lower pay per head? Focusing on the first of these, Figure 6.8 shows levels of employment in the public (light green) and private (dark green) sectors over time. Financial sector employees are included in the private sector throughout for consistency. The public sector here includes employees of central government, local government and public corporations.

The absolute size of the public sector workforce grew in the first part of the 2000s, reaching about 6.1 million workers by 2005. Between 2005 and 2010, the size of the public sector workforce hovered at just over 6 million workers, with little change during the financial crisis. In contrast, the private sector workforce grew through to 2007 and then shrank during the financial crisis, with a fall of over 800,000 employees between the start of 2008 and the end of 2009. As a result of these changes, the public sector workforce represented 21% of the total workforce by the end of 2009, a similar level to that seen in the mid-2000s but slightly higher than in 1999 (around 20%).

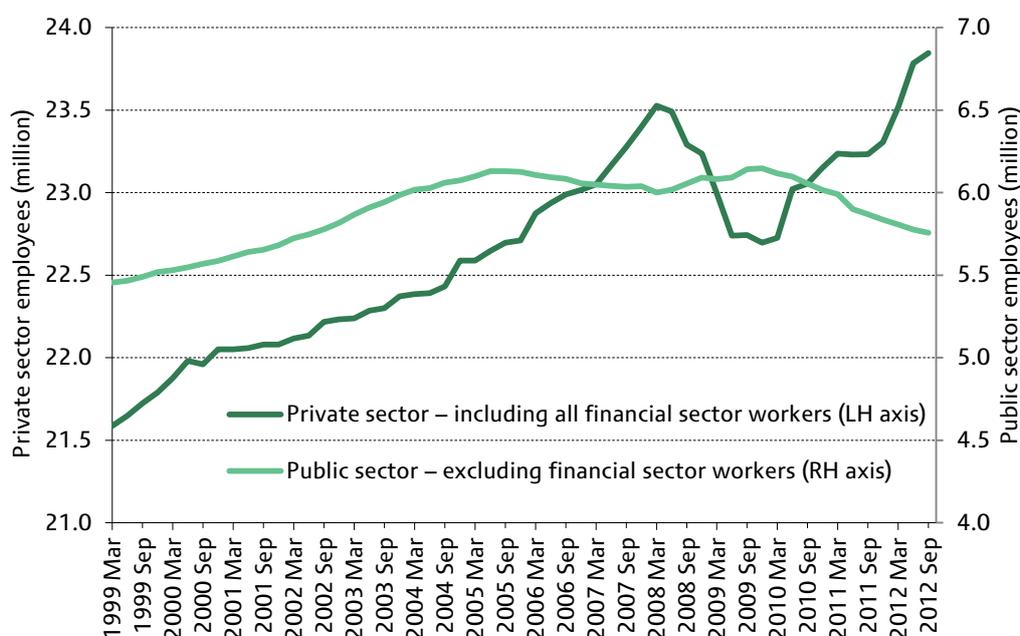
Between the start of 2010 and the third quarter of 2012 (the latest available set of figures), the overall level of employment has risen by a little over 750,000. However, as one would expect, the public and private sectors experienced quite different trends over this time. The public sector workforce fell by 360,000 or by about 6%, whilst the private

sector workforce grew by over 1 million workers to reach a higher level than that seen before the crisis¹⁷ (see Chapter 3 for more information on public sector outputs and productivity). As a result of these trends, the public sector workforce is about the same size as it was in 2002 and is a smaller share of total employment (just over 19%) than at any point since at least 1999.

Changes in employment are different in different areas of the public sector. Table 6.6 shows employment levels across different areas of the public sector for 1999 (Q2), 2010 (Q3) and 2012 (Q3). These figures exclude workers in publicly-owned financial corporations.

The overall level of public sector employment fell by about 300,000, or 5%, between 2010 and 2012 (slightly less than the figure quoted above due to falls in public sector employment during the first two quarters of 2010). Nevertheless, there were still about 300,000 more people employed in the public sector in 2012 than there were in 1999. About one third of the fall in public sector employment since 2010 can be accounted for by job losses in public administration, which includes the civil service, non-departmental public bodies and many functions of local government. There were also falls of around 10% in the number of jobs within the police force (including both officers and civilians),

Figure 6.8. Employment by public and private sectors, over time



Notes: For comparability over time, publicly-owned financial corporations (RBS and Lloyds Banking Group) are excluded from the public sector series and included in the private sector series. Both series are seasonally adjusted. Public sector includes projected number of employees in former public sector further education colleges, with the projection based on the level remaining constant at 196,000 since 2012Q1.

Source: Office for National Statistics, Public Sector Employment Statistics, December 2012 (<http://www.ons.gov.uk/ons/rel/pse/public-sector-employment/q3-2012/index.html>); authors' calculations.

¹⁷ In absolute terms, the ONS measure of total employment shows an increase of 500,000 (1.8%) in the year to 2012Q3, a fifth of which can be attributed to the number of people on government schemes. While the inclusion of those on government schemes has been criticised – see, for example, <http://www.guardian.co.uk/uk/2013/jan/15/statistics-doubt-coalition-500000-jobs> – this follows international standards (set by the International Labour Organisation) and has been consistent over long periods.

Table 6.6. Public sector employment by area of public sector

	Headcount (thousands)			Change (2010 to 2012)	
	1999	2010	2012	Absolute (‘000)	Percentage change
Education	1,396	1,689	1,683	-6	0%
National Health Service	1,212	1,588	1,553	-35	-2%
Public administration	1,180	1,189	1,082	-107	-9%
Other public sector	730	698	639	-59	-8%
Other health and social work	391	352	306	-46	-13%
Police	230	289	261	-28	-10%
HM Forces	218	196	183	-13	-7%
Construction	110	48	43	-5	-10%
Public sector employment	5,467	6,055	5,756	-299	-5%
<i>Of which:</i>					
General government	5,106	5,719	5,457	-262	-5%
Central government	2,346	2,768	2,661	-107	-4%
Local government	2,760	2,957	2,802	-155	-5%
Public sector corporations	361	330	293	-37	-11%

Notes: 1999 refers to Q2, whilst 2010 and 2012 refer to Q3. The industrial classification is largely based on SIC07 (<http://www.companieshouse.gov.uk/infoAndGuide/sic/sic2007.shtml>). Education includes teachers, but not workers in the higher education sector. It also includes projected numbers of former public sector employees in further education and sixth-form colleges (based on the level remaining constant at 196,000 since 2012Q1), which were officially reclassified to the private sector from 2012Q2 onwards. Police includes police officers and civilian staff. Workers in Academies are included in local government throughout the period and are excluded from central government. Industry-level figures may not sum to total public sector employment as the industry-level series are seasonally adjusted independently of total public sector employment.

Source: Office for National Statistics, Public Sector Employment Statistics, December 2012 (<http://www.ons.gov.uk/ons/rel/pse/public-sector-employment/q3-2012/index.html>); Office for National Statistics (<http://www.ons.gov.uk/ons/about-ons/what-we-do/publication-scheme/published-ad-hoc-data/labour-market/january-2013/estimated-employment-in-academies.xls>); authors' calculations.

health and social work outside of the NHS, and other elements of the public sector. In contrast, job losses within the NHS were much smaller (2%) and there were no net job losses within the education sector over this period.

When forecasting public sector employment levels, the OBR has focused on general government employment, which excludes workers in public sector corporations.¹⁸ At the foot of Table 6.6, we thus also show changes in these two components of public sector employment over the period. These show that general government employment has fallen by about 5% between 2010 and 2012, or by about 260,000. This is only slightly below the 300,000 fall in general government employment forecast by the OBR between 2010–11 and 2012–13.¹⁹

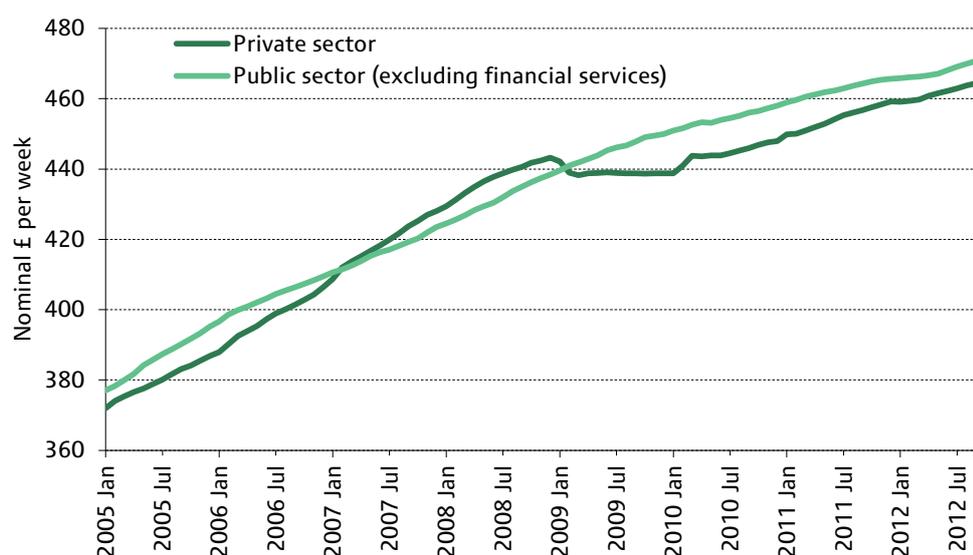
¹⁸ Public sector corporations are public sector bodies that are market entities (defined by having more than 50% of production costs covered by sales of goods and services). For instance, Royal Mail, Manchester Airport and the commercial arm of the BBC (BBC Worldwide) are public sector corporations. For more information, see <http://www.ons.gov.uk/ons/guide-method/classifications/na-classifications/index.html>.

¹⁹ These forecasts relate to the final quarter of each financial year and are thus not fully consistent with figures shown in Table 6.6.

We can also break general government employment down into central and local government.²⁰ This breakdown shows that net job losses have been slightly larger in absolute and proportionate terms in local government than in central government. Local government employment has fallen by 5% between 2010 and 2012 (or by just over 150,000), with central government employment falling by around 4% (just over 100,000). It is worth noting that a large part of the education workforce will be included in local government, but we already know that there have been no net job losses within education.

Figure 6.9 shows the level of average weekly earnings in the private and public sectors (excluding financial corporations in the public sector) between January 2005 and October 2012, with both series shown in nominal terms. In later analysis, we show that the difference in hourly wage rates between public and private sector workers is currently much larger than this difference in average earnings, which is likely to reflect differences in hours worked and the proportion of part-time workers. All such raw differences are also likely to reflect the different characteristics of workers across the public and private sectors, with public sector workers more likely to be female and possessing higher education levels, on average.

Figure 6.9. Average weekly earnings in the public and private sector (rolling 12-month averages)



Notes: Measured as a 12-month rolling average of monthly (not seasonally adjusted) average weekly earnings. Includes bonuses.

Source: Authors' calculations using Office for National Statistics series KA4U for the public sector (excluding financial services) and series KA4O for the private sector, derived from the Monthly Wages and Salaries Survey (<http://www.ons.gov.uk/ons/rel/lms/labour-market-statistics/december-2012/index.html>).

²⁰ We include workers in Academies within local government and exclude them from central government. According to official definitions, workers in Academies are part of central government and workers in maintained schools are part of local government. However, due to large numbers of conversions to Academy status over this period, including Academies within central government would have led us to underestimate the underlying cut to central government employment. If we were to include Academies within central government instead, central government employment would have seen an increase over this period (between 2010 (Q3) and 2012 (Q3), the number of workers in Academies is estimated to have grown from 42,000 to 242,000).

Before the financial crisis, earnings growth was stronger in the private sector than in the public sector. As a result, average earnings in the private sector were slightly above those in the public sector by the end of 2008, despite having been slightly below public sector earnings in 2005.

During the financial crisis and recession, average earnings in the private sector flatlined. In contrast, public sector earnings continued to grow at pre-crisis levels. In large part, this reflects the fact that the pay of many public sector workers, including teachers, NHS workers and the police, was subject to three-year settlements from 2008 through to 2011. These settlements were made shortly after the 2007 Comprehensive Spending Review, before the recession happened and before it was known that private sector earnings would stop growing. In this sense, the increase in public sector earnings relative to the private sector over the financial crisis was not the intended result of public policy. Indeed, groups not covered by three-year pay settlements (for example, local government workers and senior administrators in central government) received much tighter settlements in 2009–10 than workers subject to three-year settlements. The three-year settlement for (non-senior) civil servants was abandoned in favour of a pay freeze for 2009–10.

Since the end of the financial crisis, private sector earnings have grown again, but only by a total of 4.0% in cash terms between 2010 and 2012.²¹ Public sector earnings grew at the slightly slower pace of 3.3% over the same period. However, since 2008, average public sector earnings have grown by more than average private sector earnings (by 7.6% in total, compared with 4.9%).

The slow growth in average public sector earnings since 2010 largely reflects the government's decision to freeze the level of public sector pay scales in 2011–12 and 2012–13 for all but the lowest-paid workers (those earning a full-time equivalent of £21,000 or less received a pay rise of £250 per year over the two years, an increase of at least 1.2% per year). The fact that nominal public sector pay has increased during 2011 and 2012 despite this pay freeze will be due to the combination of pay rises for the lowest-paid workers, and 'pay drift'-- the increase in paybill per head over and above the increase in basic pay awards. Pay drift can occur as a result of compositional changes in the workforce. For instance, a freeze in hiring of less experienced workers may increase the proportion of higher-paid workers. There would also be a shift towards higher-paid workers if more lower-paid workers left or lost their jobs. Pay drift can also occur when workers are moved faster up pay scales than previously, or when pay scales are changed to remove increments at the bottom of the pay scale or increase the number of increments at the top.²²

Focusing on the period covered by the 2010 Spending Review, average earnings in the public sector increased 3.3% between 2010 and 2012 (comparing average earnings over the 12 months ending October 2010 with average earnings over the 12 months ending October 2012). This amounts to a real-terms fall of 1.5% using the GDP deflator as a

²¹ Comparing the average over the 12 months ending October 2010 with the average over the 12 months ending October 2012.

²² It should be noted, however, that the existence of pay scales and increments in the public sector does in itself lead to pay drift. Given that workers generally move up pay scales, as long as they move up pay scales at the same rate (and have new workers entering at the bottom and workers leaving at the top at a constant rate), the proportion of the workforce at each point will remain the same. Only if there is reduced intake at the bottom, increased retention at the top or faster movement up the pay scale will the pay scale's existence cause pay drift.

measure of economy-wide inflation. This suggests that real-terms falls in pay-per-head are making a relatively small contribution to the overall cuts in the paybill, with falls in employment playing a much larger role. It is also noteworthy that the central government paybill is expected to fall by just over 6% in real terms between 2010–11 and 2012–13, and central government employment by around 5%, directly implying a relatively small contribution from real-terms falls in pay-per-head.

The GDP deflator is the measure of economy-wide inflation usually used to calculate real-terms changes in public spending. Since here we are seeking to examine the contributions of falls in employment and falls in real pay-per-head to real-terms changes in the public sector paybill (and, by extension, real-terms changes in public spending), for consistency we also use the GDP deflator to calculate real changes in pay-per-head. If we instead used the consumer price index as a measure of inflation, average public earnings would have fallen by 4.0% in real terms over this period. This implies a larger impact on household living standards than suggested by the previous figure.

In summary, between 2010–11 and 2012–13, the central government paybill (excluding education) has fallen by over 6% in real terms, with an equally large fall expected between 2012–13 and 2014–15. Equivalent figures for the local government paybill are not yet available. However, we have been able to examine trends in public sector employment and pay-per-head. These show that falls in the overall public sector paybill have largely been driven by job losses, with public sector employment levels having fallen by about 5% between 2010–11 and 2012–13; real-terms falls in pay-per-head are making a smaller contribution.

Outlook for public sector pay and employment

In this section, we describe the current outlook for public sector pay and employment up to 2014–15 (the last year for which the government has announced any policy on public sector pay), and set out the trade-offs and choices facing the government in terms of setting levels of public sector pay and employment in 2015–16 and beyond.

Forecasts for general government employment

In the 2011 Autumn Statement, the government announced that pay awards will be set on average at 1% in each of the two years 2013–14 and 2014–15, although it has not set out whether this is to be uniform across the public sector or whether some workers are to receive larger or smaller increases. Table 6.7 shows the OBR's forecasts for public sector and private sector earnings growth in 2012–13 and beyond, given this announced pay policy. The OBR expects average pay in the public sector to grow by 1.9% in 2012–13, 2.2% in 2013–14 and 2.5% in 2014–15 (greater than the headline pay award of 1.0% because of its estimate of 'pay drift', described above, which is currently 1.0% per year). From 2015–16 onwards, the OBR's assumption is that there will be annual nominal pay growth of 3% in the public sector, compared with around 4% in the private sector. This figure for public sector earnings growth appears to be based on an assumption that settlements will average around 2% while wage drift will account for annual increases of around 1%. The assumption about settlements is inevitably somewhat arbitrary but would imply settlements being close to projected CPI inflation.

Table 6.7. Forecasts of public and private sector earnings and employment

	2012–13	2013–14	2014–15	2015–16	2016–17	2017–18
<i>OBR assumptions</i>						
Total UK employment (million)	29.6	29.6	29.8	30.0	30.2	30.5
General government employment (million)	5.2	5.1	5.0	4.8	4.7	4.6
General government employment (share)	17.6%	17.2%	16.8%	16.0%	15.6%	15.1%
<i>Average % growth in:</i>						
Earnings	2.6	2.4	3.0	3.8	4.0	4.0
Public sector pay	1.9	2.2	2.5	3.0	3.0	3.0
Implied private sector pay	2.7	2.4	3.1	3.9	4.2	4.2
Implied change in unconditional public sector pay differential since 2011–12 (cumulative)	–0.8ppts	–1.0ppts	–1.6ppts	–2.5ppts	–3.7ppts	–4.8ppts
Implied change in unconditional public sector pay differential since 2007–08 (cumulative)	+1.8ppts	+1.6ppts	+1.0ppts	+0.1ppts	–1.1ppts	–2.2ppts

Notes: Private sector pay growth is authors' calculations using the forecasts of public sector pay, total earnings growth and the share of workers in general government employment (GGE). The implied change in the public sector pay differential is estimated as the forecast growth in public sector pay less forecast growth in private sector pay. The forecast fall in GGE includes the reclassification of workers in further education colleges and sixth-form college corporations to the private sector, which occurred in 2012–13, which led to an extra fall of nearly 0.2 million in that year. Note that OBR forecasts GGE in 2017–18 and then assumes a constant fall in GGE in each year from 2010–11 to 2017–18. The implied change in unconditional public pay differential since 2007–08 uses authors' calculations from the Labour Force Survey that show the unconditional pay differential rising by 2.6 percentage points over the period 2007–08 to 2011–12. Source: Total employment and average earnings growth OBR forecasts are from tables 4.1 and 3.5 of the OBR *Economic and Fiscal Outlook* December 2012. General government employment is from table 1.10 of OBR *Supplementary Economy Tables – December 2012*. Average growth in public sector pay is from table 2.26 of OBR *Supplementary Fiscal Tables – December 2012*. Implied private sector earnings and change in public–private differential are authors' calculations from data in named sources. All measures of earnings growth are in nominal terms.

Given these assumptions about paybill per head, one needs a forecast of total paybill in order to forecast general government employment. The OBR does this by making the, apparently neutral, assumption that total paybill will rise in line with resource DEL over the period to 2017–18.²³ On this basis, the OBR's latest projections show general government employment falling by a total of 900,000 between 2010–11 and 2017–18.²⁴ As a result, general government employment would fall to about 15% of total employment in 2017–18.

²³ It also takes into account local authority self-financed expenditure and BBC current expenditure, although in 2011–12 resource DEL was 91% of the aggregate spending relevant to paybill used by the OBR to forecast general government employment.

²⁴ These figures exclude the reclassification of workers in further education and sixth-form colleges to the private sector, which occurred in 2012–13.

These projections depend crucially on the assumption that total paybill falls in line with total resource DEL. However, data from the Public Expenditure Statistical Analyses 2012 (which are based on spending plans submitted to the Treasury by government departments) show that the central government paybill is actually forecast to fall at a faster rate than the central government resource DEL over the next few years. This is shown in Table 6.5. These figures suggest that, from 2010–11 to 2014–15, the central government paybill (excluding education) will fall by 3.2% a year on average compared with a 1.2% a year fall in central government resource DEL (excluding education).

For the OBR to be right, this pattern would have to unwind quite sharply after 2014–15. This might happen if cuts to non-pay elements of spending take longer to deliver or if further cuts to the paybill are harder to implement after a period of pay freezes and significant net job losses. However, there are other scenarios to consider.

Suppose that the pattern of central government paybill falling 2 percentage points faster than resource DEL (RDEL) happens up to 2014–15, as departmental plans suggest, and that the local government paybill falls at the same rate as total RDEL over this period. After 2014–15, one possibility is that the total paybill falls in line with RDEL (call this scenario A). If this happens, then the total paybill would fall by 17.9% in real terms between 2010–11 and 2017–18, compared with 14.5% as forecast by the OBR. This would lead to a total fall in general government employment of 1.1 million by 2017–18 – 200,000 more than the OBR forecasts.

If however, the trend of cutting the central government paybill more quickly than RDEL were to continue through to 2017–18 (call this scenario B), then total paybill would fall by 20.1% in real terms between 2010–11 and 2017–18. This would lead to an additional fall in general government employment of 300,000 by 2017–18 compared with OBR forecasts, implying a fall of 1.2 million since 2010–11.

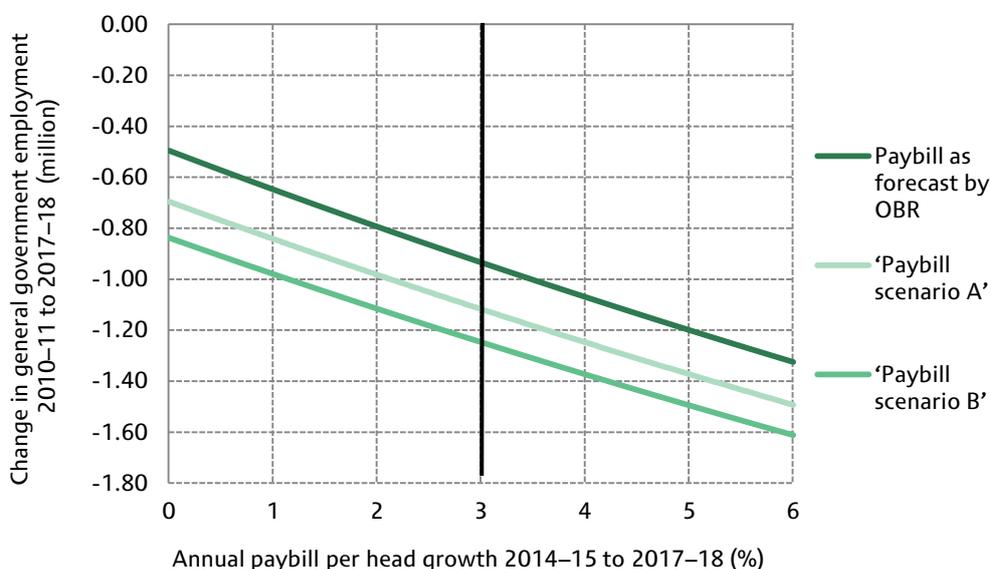
This suggests that the OBR forecast of a 900,000 fall in the total number of public sector workers by 2017–18 is a relatively low estimate, and that in fact the change in employment levels may be more likely to be in the order of 1.1 to 1.2 million.

Of course, there is substantial uncertainty surrounding future government employment forecasts, and the actual out-turn will depend upon the spending choices made by individual departments as well as government public sector pay policy. The government has yet to announce any pay headline settlements for 2015–16 and beyond, and so employment forecasts through to 2017–18 are particularly speculative. The government could reduce the scale of public sector job losses relative to current forecasts by announcing headline pay awards beyond 2014–15 that reduce the growth in public sector pay per head below that currently assumed by the OBR (3.0% per year in cash terms between 2014–15 and 2017–18). It is worth noting that this implies private sector earnings are forecast to rise faster than 3% after 2014–15.

Figure 6.10 highlights the trade-off between public sector pay and jobs. Currently, the OBR forecasts 3.0% annual paybill-per-head growth in the three years to 2017–18. This would imply a decline in general government employment of 900,000, 1.1 million or 1.2 million under the OBR forecasts for the total paybill, scenario A and scenario B respectively. Assuming the forecast total paybill is constant, cutting paybill-per-head growth by 1 percentage point in each of the three years to 2017–18 (for example, reducing paybill-per-head growth from 3% to 2%) could lead to 140,000 fewer job losses

by 2017–18. Note that under scenario B, even zero paybill-per-head growth between 2014–15 and 2017–18 implies job losses of more than 800,000.

Figure 6.10. Trade-off between paybill-per-head growth and general government job cuts by 2017–18



Notes: Change in general government employment excludes the reclassification of further education and sixth-form colleges to the private sector. The black vertical line at 3.0% signifies the current OBR assumption for paybill-per-head growth in the three years to 2017–18. 'Paybill scenario A' and 'Paybill scenario B' are two alternative forecasts for the change in the total general government paybill. Paybill scenario A assumes that the paybill falls 1.1 percentage points faster than RDEL from 2010–11 up to 2014–15 and at the same rate as RDEL from then until 2017–18. Scenario B is that the real paybill falls 1.1 percentage points faster than RDEL from 2010–11 to 2017–18.

Public sector pay policy

Whether or not the government should announce a headline pay award for years beyond 2014–15 partly depends on the effect such an announcement (and the award itself) would have on recruitment and retention in the public sector. It also depends on the impact it would have on public service quality (both in terms of the trade-off between quality and quantity within the public sector workforce and in terms of the trade-off between the workforce and the other inputs into public service provision such as equipment). In large part, the ease with which the public sector can recruit and retain quality staff will depend on the comparability of the overall remuneration packages between the public and private sectors, with headline pay being the most significant component of those packages.

Table 6.8 uses Labour Force Survey data to examine the average difference between private and public sector wages²⁵ and the extent to which it is explained by observed characteristics. The first row shows the average percentage point difference between wages in the public and private sectors in the year to the end of the third quarter of 2012. On average, a public sector worker earns 25.1% more than a private sector worker, with female public sector workers having a higher raw differential. Controlling for age, experience, qualifications and region, the average differentials fall to 7.5% for women and

²⁵ Note that this analysis is based upon usual hourly wages as opposed to average weekly earnings as presented in Figure 6.9.

2.0% for men, the latter of which is only statistically significantly different from zero at the 10% level. On average, these results give an estimated public–private sector wage differential of 5.2% in the period 2011Q4 to 2012Q3.

Table 6.8. Estimated average public–private hourly wage differentials (2011Q4 to 2012Q3)

	Male	Female	All
Raw differential	+21.9*** (1.3)	+27.3**** (1.0)	+25.1*** (0.8)
Controlling for age, experience, qualifications and region	+2.0* (1.1)	+7.5*** (1.0)	+5.2*** (0.7)

Notes: The wage differentials controlling for various factors are estimated by ordinary least squares (OLS). Each number is the coefficient estimate from regressing log hourly wage on a dummy variable for public sector worker and controls as indicated on the left-hand side of the table. Both regressions in the last column ('All') also contain a sex dummy. All control variables in the last column are interacted with the individual's sex. All regressions are weighted using LFS income weights. The second row of estimates control for a vector of important variables, to capture observed differences between private and public sector workers. These are: highest qualification (higher degree, degree, non-degree higher education qualification, A level (or equivalent), GCSE (or equivalent), any other qualification or no qualification); dummies for 12 regions of the UK; age and age squared, both of which are interacted with a three-category qualification variable (indicating higher education, secondary education or other/no education); and experience (calculated as Age – Age left education) and experience squared. Hourly wages are calculated using usual hours as reported by the survey respondents. Survey respondents are only included the first time they are observed in the LFS. Robust standard errors are reported in parentheses. *, ** and *** indicate statistical significance at the 10%, 5% and 1% levels respectively.

Source: Authors' calculations using Labour Force Survey data, 2011Q4 to 2012Q3.

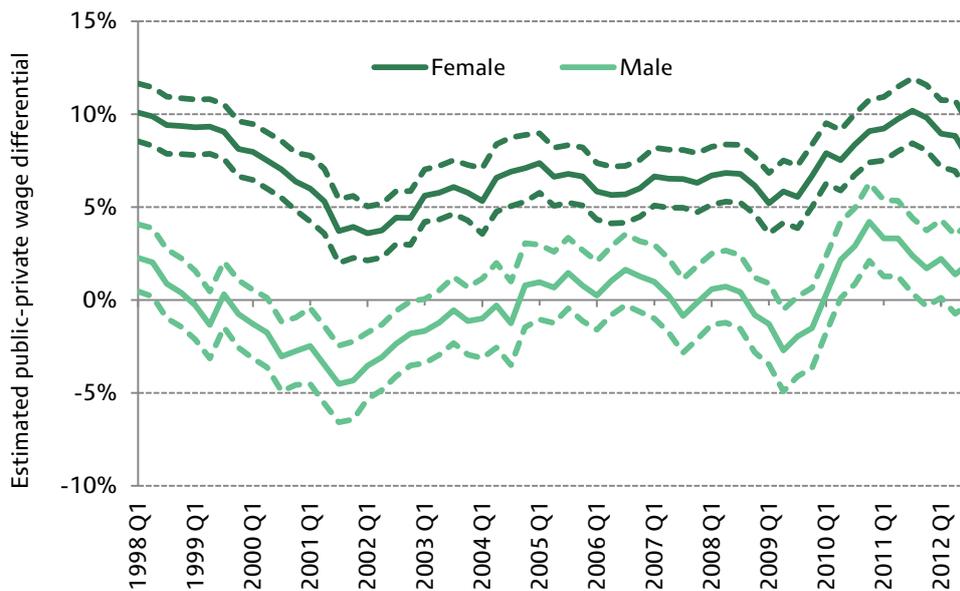
It is possible that these numbers are capturing unobserved differences between public and private sector workers, and therefore do not reflect a true pay 'premium' per se. In addition, there may be differences in non-pay elements of worker's remuneration, such as the value of pensions, pay in kind and holiday rights, or differences in the risk to employment, income or pension wealth, or differences in the flexibility of working arrangements, that mean that total remuneration is more (or less) comparable than a difference in pay alone would suggest. However, understanding how the pay differential has changed over time is still interesting, not least because, to the extent that non-pay differences between the public and private sectors are constant over time, changes in the estimated pay differential would reflect changes in the true public (or private) sector premium over time.²⁶

Figure 6.11 presents the estimated public–private hourly pay differential since 1998, for men and women separately. The public sector pay differential increased during the recession, such that there was a significant positive public sector premium for men as well as women by early 2011, which had not been seen since 1998. As can be seen with reference to Figure 6.9, this was not the result of a conscious policy decision, but instead the result of stagnant nominal pay in the private sector. As seen in Figure 6.11, the estimated male public sector premium reached its peak in the fourth quarter of 2010 and the peak for females came in the third quarter of 2011. Since then, the estimated pay differential has fallen by 2.2 and 2.7 percentage points for men and women respectively.

²⁶ If anything, over the last 20 years, it is likely that the non-pay elements of remuneration – in particular, pensions – have moved in a way that benefits the public sector more than the private sector (with the exception of those at the very top of the earnings distribution), as private sector pension schemes have become relatively less generous and more risky with the move towards defined contribution schemes. For more details, see R. Crawford, C. Emmerson and G. Tetlow, 'Occupational pension value in the public and private sectors', IFS Working Paper, WP10/03, 2010 (<http://www.ifs.org.uk/publications/4804>).

How might the public-private wage differential evolve going forwards? The estimates in Figure 6.11 show that public sector pay was about 7.5% higher than private sector pay for women, and 2.0% for men, in the year to September 2012. Between 2011-12 and 2014-15, the OBR estimates that private sector pay will outperform public sector pay by 1.6 percentage points (see Table 6.7). However, as shown in Figure 6.11 and Table 6.7, this forecast squeeze in public earnings relative to private earnings comes after a period during the recession in which the public pay differential rose substantially. This means that if public and private sector earnings turn out as forecast, it would reduce the public-private pay differential in 2014-15 to a similar level to that seen in the three years before the financial crisis.²⁷

Figure 6.11. Estimated average public-private hourly wage differential over time



Notes: The estimated public-private differential is estimated controlling for age, experience, qualifications and region, as in the final row of Table 6.8. The dashed lines represent 95% confidence intervals. Each data point is based on a four-quarter LFS sample, ending in the labelled quarter.
Source: Authors' calculations using Labour Force Survey data.

The public-private sector differential is estimated to fall less quickly over this period than was expected last year,²⁸ largely because the OBR's implied forecast for private sector pay growth has fallen sharply since its 2011 Autumn Statement. This means that the government's headline pay awards for 2013-14 and 2014-15 now look more generous relative to the private sector than they did when they were announced.

In this context, what is the outlook for public sector pay policy beyond 2014-15? The overall objective of the government should be to achieve the planned cuts to departmental spending with the minimum detrimental impact on public service quality. However, this involves a number of difficult trade-offs: there is a trade-off between

²⁷ The implied change in the public-private pay differential reported in the final row of Table 6.7 will be an underestimate of the change in the estimated conditional public sector premium going forward if at least part of the estimate of pay drift of 1.0% p.a. is due to an increase in the proportion of highly skilled workers.

²⁸ See C. Emmerson and W. Jin, 'Public sector pensions and pay', in C. Emmerson, P. Johnson and H. Miller (eds), *The IFS Green Budget: February 2012*, IFS Commentary 122, 2012 (<http://www.ifs.org.uk/budgets/gb2012/12chap5.pdf>).

squeezing pay and reducing employment (outlined above), but also the government could continue cutting non-labour inputs into public service provision. All of these might be expected to have a negative impact on public service quality, but as yet the future relative importance of these three choices is not clear. In addition, the effect that future pay squeezes might have on recruitment and retention is far from known.

This suggests that, instead of committing to long-term pay awards, it would be sensible for the government to maintain the ability to respond to changes in private sector pay or the revealed effect of different types of spending cuts on service quality in future. The fact that, during the recession, public sector pay continued to grow while private sector pay was stagnant implies that public sector pay awards were not responsive enough to conditions in the private sector during this period. Finally, it should not be forgotten that the public sector is not a single entity. The effects of squeezing pay on the quality of the workforce, and the effects of cutting workforce quality, workforce size or non-labour inputs on the quality of service delivered, will likely differ substantially across different parts of the public sector. It would seem sensible therefore, if the government is to make headline pay awards, that it makes higher awards in sectors that appear to suffer recruitment and retention problems, or where workforce quality is having a more serious impact on service quality, and lower awards in sectors that do not appear to suffer such problems.

6.4 Conclusions

The government's fiscal consolidation plan involves significant and sustained real cuts to departmental spending. Over the four years of the 2010 Spending Review period (2011–12 to 2014–15), departmental spending is forecast to be cut by 10.6% in real terms. Some areas of spending such as the NHS and non-investment spending on schools were protected from cuts over this period, and aid spending has increased in line with the government's international commitment. That has left other departments facing cuts to their budgets of 12.7% over these four years.

Additional cuts to departmental spending of 2.4%, on average, are planned for 2015–16. These will be allocated to departments in a Spending Review early this year, but the government has already pledged to protect again the NHS, non-investment spending on schools and aid spending. This means that the other 'unprotected' areas will see, on average, a 2.8% cut to their non-investment budgets and a 4.9% cut to their capital budgets. Given the government's pledge to allocate the spending cuts in a similar way in 2015–16 to that over the 2010 Spending Review period, departments such as Defence might be expected to do well, at least relative to other 'unprotected' departments, and departments such as Communities and Local Government relatively badly even relative to other 'unprotected' departments.

The government has also pencilled in plans for total spending in 2016–17 and 2017–18, which, in the absence of new policy action, would leave departmental spending facing further cuts of 6.6% over these two years. This would bring the total real cut to departmental spending since 2010–11 to 18.6%. If the government continued its protection of the NHS, schools and aid, other areas of departmental spending would be facing cuts of 12.7% over these two years, or a reduction in their real budgets of a third since 2010–11. The start of the next Parliament therefore brings no end to the difficult decisions regarding the appropriate balance of taxation and spending and, within spending, between social security spending and public services and between different

public services. If such further cuts to departmental spending are not possible without a decline in the quality or quantity of public services that is unacceptable to politicians or to voters, then higher borrowing, further tax increases or social security spending cuts – perhaps after the next general election – must be on the cards.

Of the cuts to non-investment departmental spending seen to date, a disproportionate amount has come from cuts to the public sector paybill. Between 2010–11 and 2012–13, the paybill across departments (excluding education and local government) is expected to fall in real terms by 6.3%. So far, cuts to the overall public sector paybill have largely been achieved through reductions in employment rather than reductions in the real level of pay per head. Public sector employment fell by 5% (300,000) between 2010 and 2012, although with marked differences across different parts of the public sector. Employment in public administration, health and social work outside the NHS, and the police has fallen by around 10% over these two years, whilst in the NHS employment has fallen by 2% and there have been no net job losses within education.

The OBR is currently forecasting a fall in general government employment of 900,000 between 2010–11 and 2017–18. However, these forecasts are based on the assumption that the general government paybill is cut at broadly the same rate as resource DEL. Central government departments are currently forecasting that their paybill will fall significantly faster than central government resource DEL over the period 2010–11 to 2014–15. If they were to achieve this, and then revert to cutting paybill at the same rate as RDEL, the implied fall in general government employment would increase to 1.1 million by 2017–18. If the trend of larger cuts to the paybill continue to 2017–18, the total fall in general government employment would reach 1.2 million in 2017–18.

The government could attempt to reduce the number of job losses (or the size of cuts to non-pay spending) by announcing further policies to restrain public sector pay awards after 2014–15. For example, squeezing annual paybill-per-head growth by 1 percentage point per year in the three years to 2017–18 could lead to 140,000 fewer job losses by 2017–18. However, it seems more prudent for the government to investigate the impact the current pay restraint is having on public sector recruitment and retention, and the relative effects that workforce quality, workforce size and the cuts to non-labour inputs are having on public service quality, before making new policy announcements. Furthermore, it would be advisable for the government to maintain flexibility in awarding more or less generous pay awards to different parts of the public sector in response to these factors, rather than imposing a uniform award across all workers.