briefing notes

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CHALLENGES FOR THE JULY 2002 SPENDING REVIEW

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The government has stated that it wants to deliver world-class public services.[1] This is likely to require additional funding for public services. In addition, the aim to eliminate child poverty within a generation and halve it by 2010 has been reiterated by the government both before and after the election and is very likely to require increases in benefits going to families with children at a rate above the growth in earnings.[2] This Briefing Note looks at the parameters under which the forthcoming Spending Review will operate and assesses what it might mean for government spending departments.

Since July 1998, spending limits for government departments have been set every two years in Spending Reviews, with the last one occurring in July 2000. This revised the existing plans for 2001–02 and set out plans for 2002–03 and 2003–04. The next Spending Review is due this July – it will reconsider plans for 2003–04 and set out departments' allocations for 2004–05 and 2005–06, the last years of this parliament. In the April 2002 Budget, the Chancellor announced the NHS allocations and overall spending plans for those years, leaving the division between other departments and the amount left over for non-departmental spending for Spending Review 2002 in July.

By 2005–06, total government spending is forecast to be £511 billion (current prices), an average annual real-terms increase of 4.3% over this year's forecast of £418 billion. This represents an overall increase of 13.4%. As a share of national income, the public sector is set to grow from 39.8% in the current financial year to 41.8% in 2005–06.[3] This will still be lower than the average 44.0% of national income that was spent publicly over the 18 years from 1979–80 to 1996–97. UK public spending will still be relatively low by

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[1] Section 2, 'World class public services: how investment and reform will improve public services', in Labour Party, *Ambitions for Britain* (Labour's manifesto 2001), London, 2001 (www.labour.org.uk/lp/new/labour/labour.wwv_main.main?p_cornerid=364778).

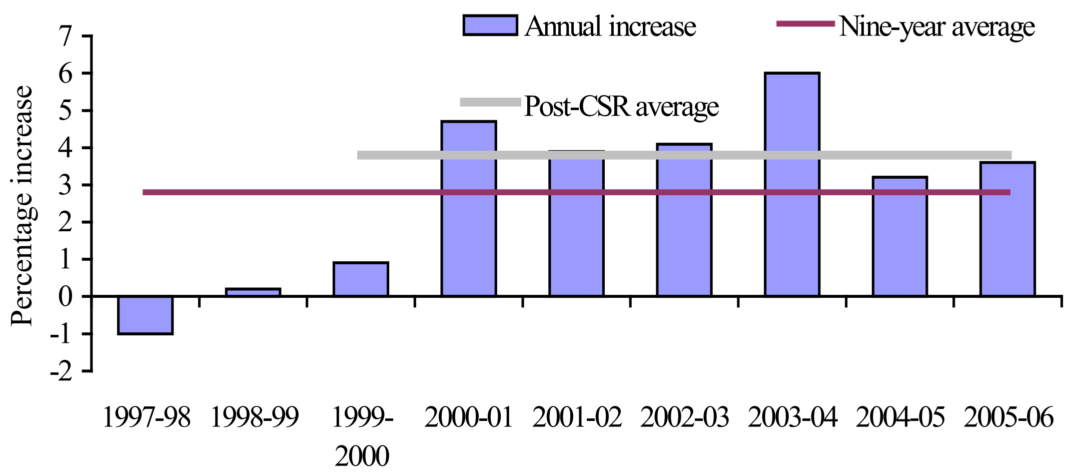
[2] M. Brewer, T. Clark and A. Goodman, *The Government's Child Poverty Target: How Much Progress Has Been Made?*, Commentary no. 88, Institute for Fiscal Studies, London, 2002 (www.ifs.org.uk/inequality/childpov.pdf).

[3] Figures on public spending as a share of national income from 1970–71 to 2005–06 can be found in Appendix A.

international standards, although some countries – for example, the USA and the Republic of Ireland – are likely to be spending substantially less.[4]

Figure 1 shows the average annual increase in total managed expenditure (TME) – overall public sector spending – since Labour came into office in 1997. Taken together, the first three years saw no real growth in spending, despite the fact that 1999–2000 was planned to be the first year of significant spending increases unveiled in the July 1998 Comprehensive Spending Review (CSR). Low spending in 1997–98 and 1998–99 was due to a combination of historically low plans (which were set out by the Conservatives and retained by Labour) and a strong economy which reduced cyclical spending such as expenditure on social security benefits. The planned increases in 1999–2000 did not materialise due to underspending by departments and to lower debt interest payments and cyclical spending as strong growth continued. Overall, departmental spending did increase slightly in Labour's first three years – by an annual average of 0.3% – but this was counterbalanced by a decrease in the remainder of government spending, also averaging 0.3% per year.

Figure 1. Real increase in total managed expenditure



Source: HM Treasury, *Public Expenditure Statistical Analyses 2002–03*, Cm. 5401, London, 2002.

Since April 2000, though, there have been sustained increases in public spending. Overall spending is set to increase by an average of 3.8% in real terms per annum from 1999–2000 to 2005–06 using the plans unveiled in the April 2002 Budget. The 4.3% average increase between 2002–03 and 2005–06 will therefore be higher than the post-CSR average – mainly due to the 6.0% real increase we can expect to see between this year and next. Over two Labour parliaments, from 1996–97 to the end of 2005–06, we can

[4] See figure 2.3 of C. Emmerson and C. Frayne, 'Overall tax and spending', in T. Clark and A. Dilnot (eds), *Election Briefing 2001*, Commentary no. 84, Institute for Fiscal Studies, London, 2001 (www.ifs.org.uk/election/ebn2.pdf).

expect to see spending increase at an average annual real rate of 2.8% – higher than the 2.6% average real increase in GDP expected over the same period.[5]

Approximately half of government spending falls into departmental expenditure limits (DELs) and has been allocated in Spending Reviews since July 1998, when 'fixed' spending plans were set on a three-year basis. The remaining half of government expenditure contains items that are more difficult to plan adequately in advance (such as social security payments, which in part depend on the level of unemployment and earnings in any particular year); this is planned on an annual basis, as its name – annually managed expenditure (AME) – suggests.

The July 2002 Spending Review will reconsider the DELs for 2003–04 that were given as the last year of plans in the July 2000 Spending Review and have been amended in subsequent announcements by the Treasury. Overall spending for that year should stand at £455 billion, with £206 billion falling in AME and £249 billion in DELs – although the AME figure is a forecast based on the expected performance of the economy. Of the £249 billion in DELs, £1.6 billion was added in the April 2002 Budget and will be allocated to departments in July. Overall spending is set to be £481 billion in 2004–05 and £511 billion by 2005–06, although the split between AME and DELs – and therefore the exact amount to be allocated between departments – is not yet known.

Alongside the announcement of the overall spending plans in Budget 2002, the Chancellor announced the level of NHS spending going forward until 2007–08. The amounts until 2005–06 are shown in Table 1 and indicate that NHS spending will increase by £22 billion over the next three years in nominal terms, representing an average annual real increase of 7.4%. This is considerably higher than the 3.8% annual average increase that the NHS has received since April 1954.

Table 1. Government spending going forward (£ billion)

	2002–03	2003–04	2004–05	2005–06
Reviewed/determined in July 2002?	No	Yes – £1.6 bn to be allocated	Yes – within overall TME total	Yes – within overall TME total
AME spending	189	206	Not known	Not known
DEL spending	230	249	Not known	Not known
TME	418	455	481	511
Of which:				
Current spending	*404*	*435*	*459*	*487*
Capital spending	*14*	*20*	*22*	*24*
NHS spending	65	72	79	87
TME excluding NHS	353	383	402	424

Source: HM Treasury, *Public Expenditure Statistical Analyses 2002–03*, Cm. 5401, London, 2002.

[5] For a more extensive exposition of public spending trends, see T. Clark and C. Emmerson, 'Improving public services?', in A. Dilnot, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2002*, Commentary no. 87, Institute for Fiscal Studies, London, 2002 (www.ifs.org.uk/gb2002/chap3.pdf).

Once NHS spending has been accounted for, government spending will still increase in real terms by an average of 3.7% per year for the three years, enabling the government to increase spending in its priority areas, such as education and benefits for low-income families with children. As the largest increase in total spending will occur between 2002–03 and 2003–04, the average increase in government spending excluding the NHS between 2003–04 and 2005–06 is forecast to be lower, at 2.7%.

Table 2. Average percentage increases in spending

	2002–03 to 2005–06	2003–04 to 2005–06
From April 2002 Budget announcements		
Total government spending	4.3	3.4
Of which:		
Current spending	3.8	3.2
Capital spending	15.7	7.7
NHS spending	7.4	7.3
Government spending excluding NHS	3.7	2.7
Assuming no change to education spending from current plans for 2003–04, followed by two years of 5.8% increase each year		
Education spending	5.7	5.8
Government spending excluding NHS + education	3.3	2.1
Assuming no change to social security spending from current plans for 2003–04, followed by two years of 3.7% increase each year		
Social security spending	4.1	3.7
Government spending excluding NHS + social security	3.5	2.2
Government spending excluding NHS + social security + education	2.9	1.2

Sources: HM Treasury, *Public Expenditure Statistical Analyses 2002–03*, Cm. 5401, London, 2002; authors' calculations.

Table 2 presents both the increases set out in the April 2002 Budget and some possible paths that government spending might take within the overall limits given in the Budget. Although the AME/DEL split has not been announced before the Spending Review, the current capital split has been. While overall government spending is forecast to increase at an average rate of 4.3% per year between 2002–03 and 2005–06, the increase in capital spending is set to be much higher. Over those three years, capital spending is forecast to increase by 15.7% per annum on average, rising from £14 billion this year to £24 billion by 2005–06, with most of the increase occurring between this year and 2003–04. (Between 2003–04 and 2005–06, the average annual rate of increase in capital spending is forecast to equal 7.7%.)[6] As capital spending will still represent less than 5% of total government spending, this rapid growth does not heavily constrain non-capital (i.e. current) spending, which can also grow, albeit at a lower rate. Given these large increases in capital spending, we can expect either to see significant increases in infrastructure

[6] A discussion of trends in public sector capital spending can be found in T. Clark, M. Elsby and S. Love, *Twenty-Five Years of Falling Investment? Trends in Capital Spending on Public Services*, Briefing Note no. 20, Institute for Fiscal Studies, London, 2001 (www.ifs.org.uk/public/bn20.pdf).

within the departments that gain most from the Spending Review or that there will be sizeable increases in spending in departments that are already capital-intensive, such as transport.

Education has been one of the government's priority areas since 1997. Should the government wish to continue increasing education spending at the same rate as forecast over April 1999 to March 2004, for the two years after 2003–04 (the figure for 2003–04 is assumed to remain fixed), the rest of government (excluding education and the NHS) can still grow at 3.3% on average per annum for the next three years or at 2.1% between 2003–04 and 2005–06. An equivalent assumption on the rate of growth of social security benefits yields increases of 3.5% and 2.2% for government spending excluding the NHS and social security. Finally, putting both of these assumptions together would allow government spending on departments and functions other than the NHS, education and social security to increase at a rate of 2.9% over the next three years or at 1.2% between 2003–04 and 2005–06.

This allows increases in social security spending of 3.7% a year in real terms over the two years from April 2004 to March 2006 – the same as the average expected increase over the period from April 1999 to March 2004. Whether this is sufficient to allow the government to make significant progress towards its child poverty target will depend on what happens to the level of unemployment and whether the government wishes to increase the benefits available to other groups, such as pensioners, further.

While there is no reason to believe that the government will choose to increase spending in these areas at exactly the rates assumed in our calculations, it is surely realistic to assume that it will want to continue to increase spending on education. It is also clear that its commitment to end child poverty within a generation will require sustained increases in social security benefits. The calculations in Table 2 indicate that, while the government is in a position to announce such increases in July, there will be very little scope to increase spending in other areas, beyond the plans outlined already for 2003–04. This is because the remainder of government spending will only be able to grow by 1.2% for the two years beyond which current plans exist for all except £1.6 billion of the £455 billion to be spent. This represents a modest increase that is less than half of predicted GDP growth for those years in real terms. Of course, it may be the case that the increases in education spending seen so far are deemed sufficient and that the government's priorities lie in other departments, such as transport, the Home Office and defence. Either way, the government is in a position to increase spending considerably in the areas it chooses to prioritise, but not without making some difficult choices as to which departments will not gain much from the Spending Review.

Our analysis assumes that the three-year spending plans are, as the Chancellor has asserted, fixed. In the past few years, these plans have often been rewritten. If the government finds that the increases in spending that it has planned up to the next election are not sufficient to meet its desire to deliver world-class public services and to progress towards eliminating child poverty, it could make the decision to allocate more funds. This would, as always, require either higher levels of public borrowing or higher levels of tax revenues than implied by the latest Treasury forecasts.

Appendix A. Historical series of government spending

Table A.1. Public spending as a percentage of GDP, 1970–71 to 2005–06

	Current spending[a]	Net investment	Total managed expenditure
1970–71	36.5	6.1	42.7
1971–72	37.2	5.3	42.5
1972–73	37.0	4.8	41.8
1973–74	39.2	5.2	44.4
1974–75	43.3	5.5	48.8
1975–76	44.4	5.5	49.9
1976–77	44.5	4.3	48.8
1977–78	42.9	2.9	45.8
1978–79	42.7	2.4	45.2
1979–80	42.6	2.2	44.8
1980–81	45.5	1.8	47.3
1981–82	47.2	0.9	48.1
1982–83	47.0	1.5	48.5
1983–84	46.3	1.8	48.3
1984–85	46.5	1.5	48.1
1985–86	44.3	1.2	45.5
1986–87	43.4	0.7	44.1
1987–88	41.4	0.7	42.1
1988–89	39.0	0.4	39.4
1989–90	38.5	1.2	39.7
1990–91	38.5	1.4	40.0
1991–92	40.5	1.8	42.3
1992–93	42.2	2.0	44.2
1993–94	42.0	1.6	43.6
1994–95	41.7	1.5	43.2
1995–96	41.2	1.4	42.6
1996–97	40.4	0.7	41.0
1997–98	38.7	0.6	39.2
1998–99	37.7	0.7	38.4
1999–2000	37.1	0.5	37.6
2000–01	37.8	0.6	38.4
2001–02	38.0	1.2	39.2
HM Treasury forecasts			
2002–03	38.4	1.4	39.8
2003–04	39.2	1.8	41.0
2004–05	39.5	1.9	41.4
2005–06	39.8	2.0	41.8

[a]Including depreciation.

Source: HM Treasury, *Public Finances Databank, April 2002*, London, 2002 (www.hm-treasury.gov.uk/Economic_Data_and_Tools/data_index.cfm).