

# Survey of public spending in the UK

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## Preface

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# Executive summary

Over the second half of the twentieth century, government spending fluctuated between around 35% and 45% of national income, growing in real terms by an annual average rate of 2.8% between 1948–49 and 1999–2000. After a period of sustained increases in public spending over the 2000s, the financial crisis and associated recession in 2008 led to a sharp increase in spending as a share of national income. In response, spending cuts were announced by the coalition government that imply total government spending remaining essentially flat in real terms – and therefore falling as a share of national income – between 2010–11 and 2018–19.

Pre-crisis, UK government spending was at around 40% of national income. This level was not particularly high, either by the UK's own historical standards or by international standards. However, over the financial crisis the UK government experienced a particularly large increase in spending as a share of national income. Without policy action, this would have led to high government spending in 2013–14, both relative to pre-crisis levels and relative to other countries.

## Spending on each of the main functions over time

- The composition of spending has changed over time, as a result of demographic trends, the economic cycle and the priorities of governments. In 2013–14, the largest areas of government spending were social security (29.3% of the total), the NHS (18.1%) and education (12.6%), all of which received large increases in their funding through the 2000s under the last Labour government. The NHS and education have also been afforded relative protection in the cuts to public spending planned over this parliament, and so will see their shares of total spending increase further still.
- Spending on **social security** has risen as a share of total spending over time; the two most recent major increases were the expansion of tax credits at the beginning of the 2000s and the increase associated with the economic downturn at the end of the 2000s. Pensioners have received just over half of all social security spending since 1978–79, with spending on this group forecast to increase by 125% in real terms between 1990–91 and 2018–19. This real-terms increase has been driven by a greater number of pensioners, as well as by a forecast increase in spending per pensioner of 93% over that period. Under the government's planned cuts, relative protection has been afforded to spending on pensioner benefits, increasing further the share of social security payments devoted to this group.
- **Health** spending has experienced significant growth since 1949–50, at an average annual real rate of 3.9% up to 2013–14. After uneven growth

between the 1970s and the late 1990s, the last Labour government oversaw an acceleration of the increases in spending on the NHS, to around 7% of national income prior to the recession. While other departments have experienced budget cuts as part of the coalition government's programme of austerity, spending on the NHS is being frozen in real terms. This 'protection' nonetheless represents a tight funding environment for the NHS, as spending levels are likely to lag behind demographics-driven demand.

- The UK is not an outlier in terms of how much it spends on healthcare as a share of national income. However, compared with other countries, a relatively large proportion of health spending is undertaken by the public sector.
- **Education** spending rose in real terms until the mid-1970s, as the school-leaving age and the number of pupils rose. The education budget also grew substantially under the Labour government in the 2000s, despite a slight decline in the number of pupils over that period, with secondary and further education seeing the largest real-terms increase. In the recent cuts to spending on public services, spending on schools has been protected, but other areas of education spending have not. Higher education has seen the largest cuts in public funding, though this has been more than offset by an increase in fees paid by students. The funding received by universities has increased in real terms since 2011–12.
- After significant real-terms growth in **defence** spending up to the early 1980s, defence spending fell, from 5.0% of national income in 1985–86 to 2.5% in 1997–98. Defence spending rose gradually in real terms through the 2000s, reflecting commitments in Iraq and Afghanistan, though the decline as a share of national income continued. This trend of falling spending as a share of national income is set to continue, as the defence budget is facing sharp cuts up to 2015–16.
- Spending on **public order and safety** grew strongly between 1978–79 and 2008–09, fluctuating around 2% of national income. The departments that are responsible for most of this spending, such as the Home Office and the Ministry of Justice, are facing particularly large cuts up to 2015–16, marking a change in the prioritisation of these areas.
- Spending on **net debt interest payments** since 1953–54 has fluctuated between 1.5% and 4.5% of national income, with a trough occurring in 2005–06, prior to the financial crisis and recession. Debt interest payments are forecast to grow in real terms at an average annual rate of 7.1% from 2009–10 to 2018–19, reaching around 2.9% of national income by 2018–19.
- **Transport** spending has fluctuated between around 3% and 4% of total spending for most of the last three decades, but fell significantly over the 1990s. This decline was reversed by the last Labour government, which announced long-term plans for higher spending in this area. In the wake of

the financial crisis, the Department for Transport is due to have its budget cut at an average annual real rate of 2.1% between 2008–09 and 2015–16.

- Spending on **official development assistance** (ODA) was 0.7% of national income in 2013, as the UK government met its pledge to achieve this target. The UK government devotes a relatively high proportion of its GNI to ODA by international standards.

## Planning UK public spending

- For planning purposes, total spending is divided into two components, each of which accounted for roughly half of total spending in 2013–14. **Departmental expenditure limits (DELs)** are set some years in advance and cover spending that is relatively easy to control. **Annually managed expenditure (AME)** includes components that are more difficult to plan in advance.
- Each department's spending limit (or **DEL**) is split into capital and current spending. DELs are allocated between departments in **Spending Reviews**, which fix spending for a number of future years, though in reality allocations can and do change. For example, in the 2013 Autumn Statement, the government announced a cut to most departments' budgets, just six months after their allocations had been set in the 2013 Spending Review. Departments have some flexibility over when they spend their budgets, as they can apply to transfer a certain proportion of their budget to a future year.
- The current system of planning public spending is the latest stage of a system that has been evolving since the early 1990s. Over time, horizons for public spending planning have lengthened, and there has been increased focus on controlling spending while also providing incentives for departments to plan efficiently.
- In the 2013 Spending Review, the government announced that it would apply a cap to some elements of spending within AME, covering just over half of all welfare spending. This cap is intended to improve policymaking by forcing the government to make active decisions over whether to allow unanticipated increases in covered spending. Other countries have also imposed caps on some elements of government spending, though other countries' caps tend to be slightly more flexible in their design.

## Current issues in public spending

- The financial crisis and associated recession meant that a significant fiscal consolidation was necessary to restore the public finances to a sustainable long-run path. When the coalition government came to power, it announced a five-year consolidation package, although since then the economic outlook

has worsened and the government has announced further **spending cuts**. By 2018–19, total public spending is forecast to be reduced to 37.8% of national income, only slightly above its share in 2001–02.

- Different areas of spending are facing very different cuts. Overall departmental spending is to be cut by 2.2% a year on average between 2010–11 and 2015–16. However, protection for health, schools and official development assistance means that ‘unprotected’ departments will be cut by an average of 4.5% a year.
- **Investment** spending is currently at a historically low level, following sharp declines in spending since the early 1970s and after the recent financial crisis.
- Current spending plans imply that, by 2018–19, spending on public services will be at around its lowest level since 1948–49, although there is some uncertainty over whether a future government would decide to implement all of the currently announced cuts.
- Looming on the horizon are significant pressures coming from an ageing population; official projections from the Office for Budget Responsibility (OBR) suggest that as the population ages, spending on the state pension, health and social care will increase. Despite reforms to the state pension system that will save 0.4% of national income in the long run, the OBR’s forecasts imply that, by 2063–64, the ageing population will have offset most of the reductions in public spending from the austerity measures planned between 2013–14 and 2018–19.

# 1. Introduction

This briefing note provides an overview of public spending in the UK. It begins in Section 2 with a description of total public spending in the UK, how this has changed over time and a brief international comparison. Section 3 describes the current allocation of public spending between different areas and then focuses on how the amounts received by eight particular areas have changed over time. The first seven areas considered are: social security, health, education, defence, public order and safety, net debt interest payments and transport. Together, these areas of spending account for nearly 80% of overall public spending. The final area of public spending considered is spending on official development assistance, which the government aimed to increase to 0.7% of gross national income in 2013. Section 4 explains how the current government plans spending and it gives a brief history of how and why this system for planning public spending has evolved. Section 5 comprises a discussion of some current issues in public spending, including: recent cuts to government spending, investment spending in a historical context, regional spending, the proposed cap on some items of spending and some future pressures on public spending. Section 6 concludes.

Data for most of the spending series that underlie the tables and figures in this briefing note are also available from the IFS website.<sup>1</sup>

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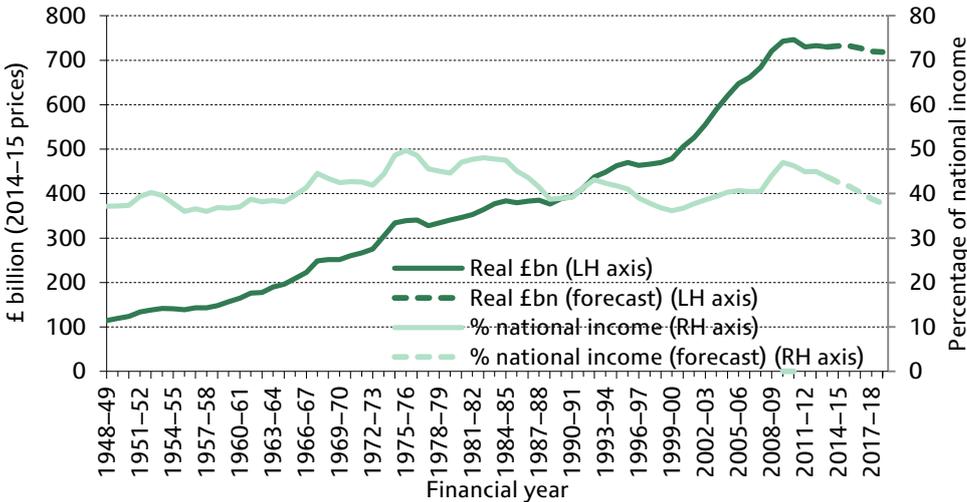
<sup>1</sup> [http://www.ifs.org.uk/tools\\_and\\_resources/fiscal\\_facts](http://www.ifs.org.uk/tools_and_resources/fiscal_facts).

# 2. Public spending in the UK

## 2.1 Total public spending

In the financial year 2013–14, the UK government spent £714.2 billion, or 43.8% of the UK’s national income. This translates into just over £11,000 for every person in the UK, or just under £14,000 per adult.<sup>2</sup> The total amount of public spending is set out each year in the Budget, as an aggregate derived from the National Accounts called *total managed expenditure* (TME). This aggregate comprises expenditure by the entire public sector – namely, central government, local authorities and public corporations. Figure 2.1 shows TME in real terms (that is, after adjusting for economy-wide inflation) and as a share of national income since 1948–49, including the latest forecasts up to 2018–19.

Figure 2.1. TME in real terms and as a percentage of national income, 1948–49 to 2018–19



Note: TME is adjusted for £23.5 billion of negative investment arising from the sale of the 3G spectrum in 2000–01, £2.3 billion of negative investment from the 4G spectrum sale in 2012–13 and £28 billion of negative investment due to the transfer of Royal Mail’s pension assets in 2012–13. These adjustments are made throughout this briefing note.

Source: TME is from the ONS series KX5Q in the ONS Public Finances Supplementary Release. GDP is ONS series BKTLL from table A2 of the UK Economic Accounts. Deflators are derived from ONS series YBHA and ABMI. Projections are from the OBR’s *Economic and Fiscal Outlook: March 2014*.

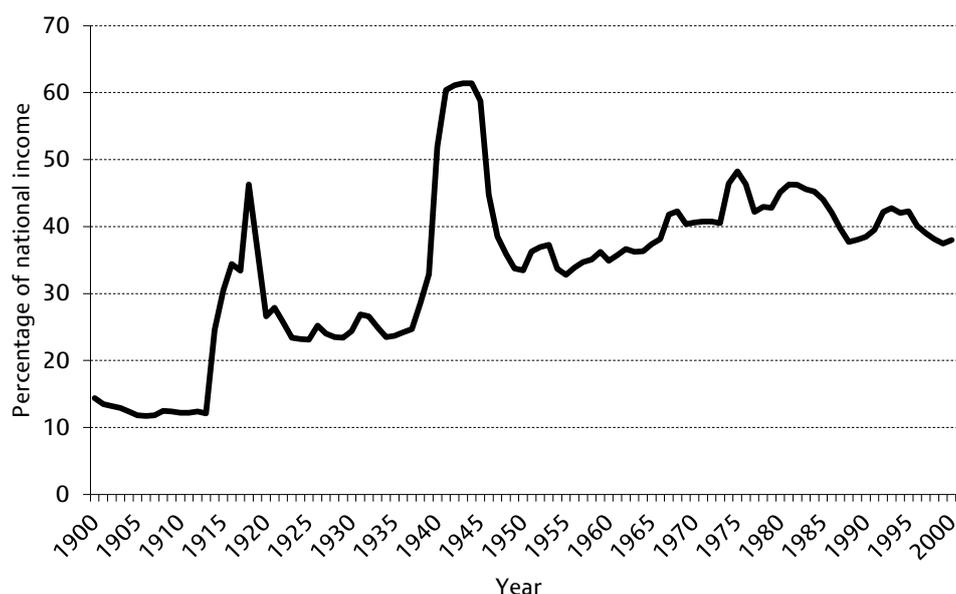
During the second half of the twentieth century, TME grew relatively steadily in real terms, with an average annual growth rate of 2.8% between 1948–49 and 1999–2000. Total spending then accelerated under the Labour government of the

<sup>2</sup> With the adult population defined as those aged 16 and over. UK population figures from the Office for National Statistics, <http://www.ons.gov.uk/ons/taxonomy/index.html?nscl=Population+Estimates+by+Age+and+Sex>.

2000s, increasing at an average annual rate of 4.5% between 1999–2000 and 2009–10. These increases stalled following the financial crisis and associated recession, as the coalition government restrained government spending; TME is projected to be essentially flat in real terms between 2009–10 and 2018–19.

Figure 2.2 uses an alternative measure of government spending – general government expenditure – to look at spending over a longer period. This is a narrower measure of government spending than TME because it excludes spending by public non-financial corporations, such as the formerly nationalised utilities.

Figure 2.2. General government expenditure over the 20<sup>th</sup> century



Source: T. Clark and A. Dilnot, ‘Long-term trends in British taxation and spending’, IFS Briefing Note 25, June 2002, <http://www.ifs.org.uk/bns/bn25.pdf>.

Fluctuations in public spending can be driven by two factors: first, the natural variability of the economic cycle; and second, active policy decisions to curb or boost spending. Figure 2.2 illustrates two examples of the latter, as the two sharp spikes in general government spending coincided with the First and Second World Wars. General government spending as a percentage of national income was relatively low (below 30%) in the 1920s and 1930s, grew rapidly during the Second World War, and fell back to about 10 percentage points above its pre-war level in the 1950s. From the 1960s onwards, the fluctuations in the path of general government expenditure are very similar to those shown in Figure 2.1 for TME.

World wars and other active policy decisions are not enough to explain every fluctuation in spending shown in Figures 2.1 and 2.2. TME tends to rise as a proportion of national income during periods of economic weakness, which is particularly evident in the recession of the late 2000s in Figure 2.1, but also in the recessions of the early 1980s and the early 1990s. This happens both because

recessions are associated with slow growth in national income and because certain components of public spending (for example, spending on social benefits and debt interest payments) tend to rise during recessions. The former makes the denominator of the fraction relatively small (particularly important during the late 2000s recession, as inflation was, and is, exceptionally low) and the latter makes the numerator larger. Conversely, during the boom of the late 1980s, the ratio of TME to national income fell.

Changes in TME under the last Labour government, between 1997–98 and 2007–08, are more easily explained with reference to active policy decisions than the economic cycle. Labour came into power in 1997 having promised to stick to two years of Conservative spending plans (in 1997–98 and 1998–99), in an attempt to reform its reputation for poor fiscal management. It achieved an average annual real increase of 0.7% in those two years, compared with the previous government's average between 1978–79 and 1996–97 of 1.8%. However, after these two years of restraint, there was a significant loosening of the purse strings.

Growth in public spending accelerated over the 2000s relative to the rate of growth seen in the second half of the twentieth century, even though it was a period of relative prosperity. Between 1999–2000 and 2007–08, Labour increased public spending by an average annual rate of 4.6%, targeting areas such as reducing child and pensioner poverty. Public spending rose as a share of national income but, as this was a policy choice rather than being driven by 'natural' variability of the economic cycle, it represented a *structural* increase in public spending.

In 2008–09, the financial crisis and associated recession drove up real government spending and led to a significant fall in GDP. Both of these factors led to a sharp increase in TME as a share of national income, from 40.6% in 2007–08 to 47.0% in 2009–10. The recession opened up a hole in the public finances – that is, a permanent increase in the difference between the government's receipts and spending. Emmerson, Keynes and Tetlow (2013) show that, with no policy change, the UK's public finances would have been on an unsustainable path.<sup>3</sup>

The 2010 Conservative election manifesto pledged to implement an austerity programme consisting of 20% tax increases and 80% spending cuts, and the emergency Budget in June 2010 set out plans that roughly would have achieved this.<sup>4</sup> These initial plans implied restoring TME to the same proportion of GDP as it was just prior to the financial crisis, continuing and extending plans that had

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<sup>3</sup> C. Emmerson, S. Keynes and G. Tetlow, 'Public finances: outlook and risks', in C. Emmerson, P. Johnson and H. Miller (eds), *The IFS Green Budget: February 2013*, Institute for Fiscal Studies, London, 2013, [http://www.ifs.org.uk/budgets/gb2013/GB2013\\_Ch5.pdf](http://www.ifs.org.uk/budgets/gb2013/GB2013_Ch5.pdf). Also see R. Crawford, C. Emmerson and G. Tetlow, 'Disease and cure in the UK: the fiscal impact of the crisis and the policy response', in G. Giudice, R. Kuenzel and T. Springbett (eds), *UK Economy: The Crisis in Perspective*, Routledge, Abingdon, 2012.

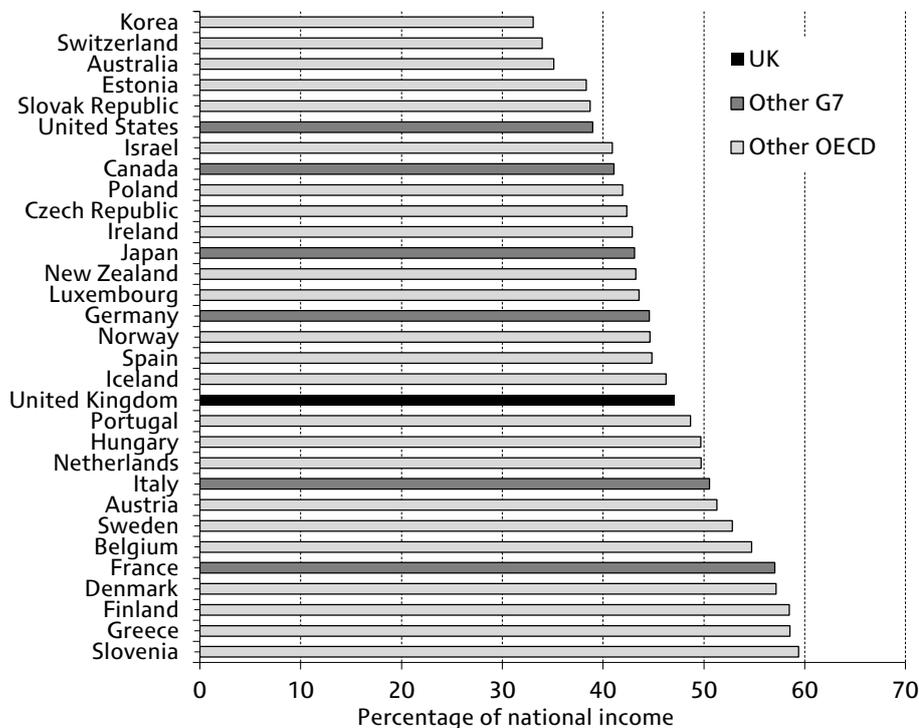
<sup>4</sup> See G. Tetlow, 'Public finances: more done, more quickly', presented at IFS Briefing, 23 June 2010, <http://www.ifs.org.uk/budgets/budgetjune2010/tetlow.pdf>.

already been set out by the previous Labour government. Since then, partly in response to a worsening economic outlook, the planned cuts have been extended, so that by 2018–19, TME is forecast to fall to 37.8% of national income, only slightly above its share in 2001–02.

## 2.2 Total public spending in an international context

In 2013, the UK was not an outlier by international standards in terms of government spending as a share of national income. UK total government disbursements, as measured by the OECD, were 47.1% of national income. As shown in Figure 2.3, this gave the UK the thirteenth highest level of public spending as a proportion of national income out of the 31 countries for which the OECD has consistent data, and the third-highest out of the G7 countries.

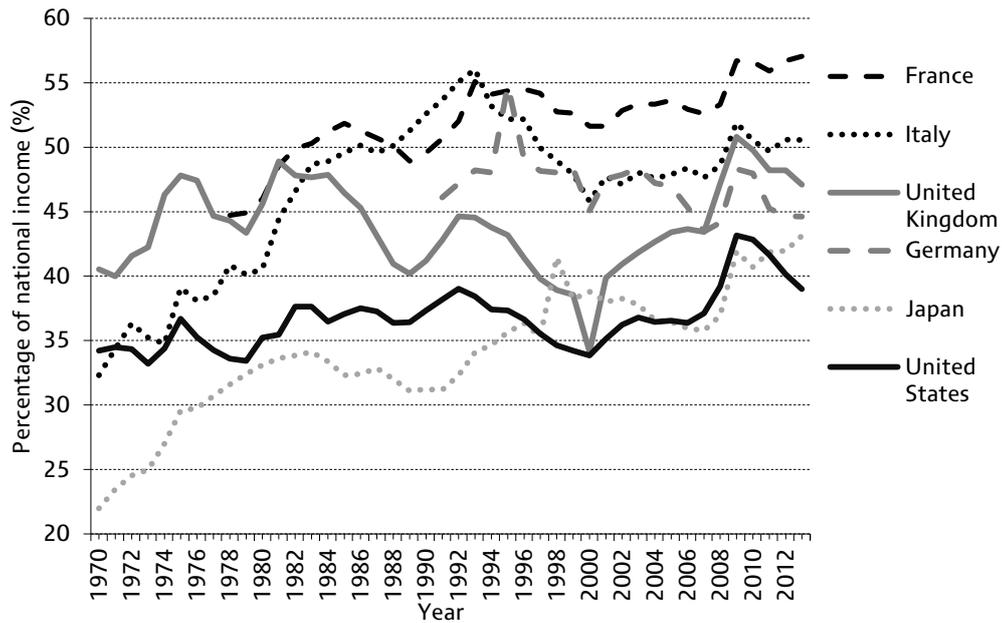
Figure 2.3. Total public spending, OECD countries, 2013



Note: Figures refer to general government total disbursements.  
 Source: Economic Outlook No. 95 – May 2014, <http://www.oecd.org/>.

Figure 2.3 masks the different path of government spending in the UK relative to other developed countries; if the snapshot shown in Figure 2.3 had been taken ten years earlier, the UK would have appeared to have relatively lower spending as a share of national income. Figure 2.4 therefore shows how the changes in government spending as a proportion of national income in the UK between 1970 and 2013 compared with the experience of a selection of other countries. All countries shown saw increases in government spending during the recession of the early 1990s, which were then reversed by the late 1990s.

Figure 2.4. Total public spending in selected countries, 1970 to 2013



Note: As for Figure 2.3. UK spending in 2000–01 is not adjusted for the sale of the 3G spectrum, and spending in 2012–13 adjusted neither for the transfer of assets from the Royal Mail pension plan to the public sector nor for the sale of the 4G spectrum.

Source: As for Figure 2.3.

In 2000, the UK had lower government spending as a share of national income than Italy, France or Germany. The expansion of government spending over the early to mid-2000s brought the UK closer towards these three European countries, which typically either maintained or saw falls in their levels of public spending as a share of national income over this period. All countries saw their public spending rapidly increase as a share of national income between 2007 and 2009 as a result of the recession. The position of the UK shown in Figure 2.3 should be taken in the context of the increase in UK government spending of 7.4% of national income between 2007 and 2009 – this was the largest among the countries shown in Figure 2.4.

### 3. Spending on each of the main functions over time

In this section, we examine seven of the areas individually – social security, health, education, defence, public order and safety, net debt interest payments and transport. Together, these areas of spending accounted for 78.2% of total spending in 2013–14, and the biggest of these – social security – accounted for 29.3% by itself, or £6,200 per family. At the end of this section, we also look briefly at spending on official development assistance, which amounted to £11.4 billion in 2013, or around £300 of spending per family in that year.<sup>5</sup>

Table 3.1. UK government spending by function, 2013–14

Area of spending	Percentage of TME	Percentage of GDP	£ per family
Social security	29.3	12.8	6,200
Health	18.1	7.9	3,800
Education	12.6	5.5	2,700
Net debt interest payments	5.9	2.6	1,300
Defence	5.1	2.2	1,100
Public order and safety	4.2	1.9	900
Transport	2.8	1.2	600
Recreation, culture and religion	1.6	0.7	300
Environmental protection	1.6	0.7	300
Housing and amenities	1.6	0.7	300
Agriculture, fisheries and forestry	0.8	0.3	200
Enterprise and economic development	0.8	0.3	200
Science and technology	0.6	0.3	100
Other	14.8	6.5	3,100
Total	100.0	43.8	21,200

Note: All £ figures are in nominal terms. Data may not sum due to rounding.

Source: Social security spending is derived from DWP Benefit Expenditure Tables and includes HMRC estimates of child benefit payments and tax credits. Net debt interest payments are from ONS series JW2L and JW2P and exclude the effects of the asset purchase facility. Other spending figures are consistent with HM Treasury, *Public Expenditure Statistical Analyses 2014*, <https://www.gov.uk/government/statistics/public-expenditure-statistical-analyses-2014>. Figures for the number of families in the UK estimated for 2013–14 using a combination of IFS calculations based on the 2012–13 Family Resources Survey and the 2013 Families and Households ONS release, based on the Labour Force Survey (<http://www.ons.gov.uk/ons/publications/reference-tables.html?edition=tcn%3A77-328237>).

Table 3.1 shows where government spending in 2013–14 went, by function, as a share of TME, as a share of GDP and in terms of pounds per family. Social

<sup>5</sup> ODA figures are published on a calendar-year basis.

security, health and education spending are by far the largest components of spending, covering three-fifths of all spending, or £12,800 of a total £21,200 of public spending per family. As we will describe below and later in Section 5.1, this share is set to increase, continuing a long-term shift in the structure of the state.

In the past, the composition of TME has changed as different areas of spending have been affected differently by demographic trends, the economic cycle and the priorities of successive governments. Table 3.2 shows the average annual real increases in spending over different periods within the seven largest areas, alongside the changes in TME, net investment and current spending.

**Table 3.2. Real increases in spending in the main areas**

	<i>Annualised average real increase, %</i>				
	<b>Long-term trend</b>	<b>1978–79 to 1996–97</b>	<b>1996–97 to 2007–08*</b>	<b>2007–08 to 2010–11</b>	<b>2010–11 to 2013–14</b>
Social security	4.5	3.9	2.5	4.5	1.6
Health	3.9	3.7	5.9	3.0	0.9
Education	3.8	1.8	4.7	2.4	–2.1
Net debt interest payments	2.3	1.2	–2.7	19.2	–0.4
Defence	–0.1	–0.1	1.4	2.5	–4.1
Public order & safety	3.0	4.4	4.0	–1.3	–4.5
Transport	1.7	1.0	5.1	–1.3	–3.7
TME, of which:	2.9	1.8	3.6	3.0	–0.7
Net investment	2.6	–4.6	14.9	4.3	–15.3
Current spending	2.9	2.1	3.2	2.9	0.1
National income	2.7	2.7	3.2	–1.5	1.1

\*Defence trend is 1998–99 to 2007–08.

Note: ‘Current spending’ includes depreciation. Long-term trends are annual average increase between 1948–49 and 2013–14 for TME, current spending, net investment, net debt interest payments and social security; between 1949–50 and 2013–14 for health spending; between 1953–54 and 2013–14 for education; between 1953–54 and 1997–98 for defence; and between 1978–79 and 2013–14 for public order and safety and for transport. The time period 1978–79 to 1996–97 is chosen to show how spending evolved over the course of the Conservatives’ time in office, with 1978–79 being the last full year of the preceding Labour government and 1996–97 being the last full year of John Major’s government. For consistency with this approach, we would ideally split the last two periods at 2009–10, rather than 2010–11. However, in 2009–10 – the last full financial year covered by Gordon Brown’s Labour government – spending was distorted by the government bringing forward investment spending and some other temporary fiscal stimulus policies.

Source: Public sector social benefits from ONS series ANLY. GDP deflator derived from ONS series ABMI and YBHA. Office of Health Economics. HM Treasury, *Public Expenditure Statistical Analyses 2013* and previous PESAs. OBR Supplementary Fiscal Tables March 2014. DWP Expenditure Tables 2014. Net debt interest payments from ONS series JW2L and JW2P. GDP from ONS series BKTL.

Social security, education and health spending all grew at least as quickly as TME between 1978–79 and 2007–08, and therefore increased as a share of TME over that period. Real spending on these areas also grew more quickly than national income, so spending on these areas also increased as a share of national income. Health spending in particular has experienced substantial growth, with average annualised real increases between 1978–79 and 1996–97 of 3.7% under the Conservative governments and 5.3% between 1996–97 and 2010–11 under Labour and the first year of the coalition.

Other areas of spending have historically grown more slowly than TME or national income, and so have fallen in their relative importance. Examples include defence and net debt interest payments. Up to 2007–08, the latter had grown over time, but generally more slowly than TME. Under the Conservatives between 1978–79 and 1996–97, real average annual growth in net debt interest payments was just 1.2%; and under the Labour government between 1997–98 and 2007–08, these payments fell by an average of 2.7% in real terms per year. A major factor contributing to this decline was a reduction in market expectations of long-run interest rates, which was associated with inflation targeting from 1992 and then the independence afforded to the Bank of England in 1997.

The financial crisis and associated recession had dramatic implications for public spending. The fourth column of Table 3.2 shows that spending increased in real terms between 2007–08 and 2010–11, while GDP fell. The real-terms increase arose because, as GDP fell, cash spending plans – which had been set pre-crisis in the October 2007 Spending Review – ended up equating to a larger share of national income. From 2010–11, the government began a long programme of real-terms cuts to spending, planning to reduce TME by an average real rate of 0.5% per year between 2010–11 and the end of the forecast horizon in 2018–19.<sup>6</sup>

In the final column of Table 3.2, which shows average real changes to spending over the first three years of the coalition’s fiscal tightening, compositional changes arise from some areas being cut less than others. While areas such as health and schools have largely been protected from real-terms cuts, other areas (including parts of the education budget other than schools) have faced (and will continue to face) large cuts, such as spending on public order and safety, which has been cut in real terms by an average annual rate of 4.5% between 2010–11 and 2013–14.

In contrast, net debt interest payments are forecast to increase rapidly, at an average annual real rate of 7.2% between 2007–08 and 2018–19 (or by a

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<sup>6</sup> This takes 2010–11 as the base year, which underestimates the extent of the cuts in two ways: first, some investment spending was moved from 2010–11 into 2009–10 (i.e. depressing the baseline) as part of a package of temporary fiscal stimulus measures during the financial crisis and recession; second, on coming into power in 2010–11, the coalition implemented about £6 billion of in-year cuts. However, the former reason means that taking 2009–10 as the base year would tend to overstate the extent of the cuts.

cumulative 215%).<sup>7</sup> This is a reversal of their decline since 1996–97, and is a consequence of the significant increase in the stock of UK public sector debt. This increase is far more rapid than that in any other individual area of public spending we consider in this briefing note over the same period.

Table 3.3 shows how different real growth rates have contributed to the size of spending areas relative to national income over the last 60 years. Together, spending on social security, health and education has increased as a share of national income by 15.8 percentage points, whereas TME has risen by just 4.2 percentage points. Therefore, other areas of spending, such as defence and transport, have declined in relative importance.

**Table 3.3. Spending as a percentage of national income in the main areas**

	<i>Percentage of national income, %</i>				
	<b>1953–54</b>	<b>1978–79</b>	<b>1996–97</b>	<b>2007–08</b>	<b>2013–14</b>
Social security	4.9	9.2	11.5	10.6	12.8
Health	2.9	4.4	5.3	7.0	7.9
Education	2.7	5.4	4.7	5.4	5.5
Net debt interest payments	2.8	3.8	2.9	1.5	2.6
Defence	9.0	4.5	2.7	2.3	2.2
Public order & safety	-	1.5	2.0	2.2	1.9
Transport	-	1.6	1.2	1.4	1.2
TME, of which:	39.6	45.1	39.0	40.6	43.8
Net investment	5.1	2.5	0.7	2.2	1.5
Current spending	34.5	42.6	38.3	38.4	42.4

Note: Net investment spending and current spending may not sum to TME exactly because of rounding. ‘Current spending’ includes depreciation.

Source: As Table 3.2.

The bottom three rows of Table 3.3 illustrate the changes in current and net capital spending over the last 60 years, and the shifts in emphasis on each. For example, between 1978–79 and 1996–97, there was a dramatic decline in net investment, from 2.5% of national income to just 0.7%. The increases in net investment implemented by the Labour government (14.9% average annual real increase from 1996–97 to 2007–08) were not quite enough to restore investment to its previous share of national income, though they did shift the balance of spending towards capital spending, as current spending only increased by 0.1 percentage points of national income over the same period. In contrast, between

<sup>7</sup> This increase of 7.2% is very different from the annual average real fall of 0.4% described in Table 3.2 between 2010–11 and 2013–14. The latter reflects low RPI inflation in 2012, which temporarily depressed interest payments on index-linked annuities in 2013–14, as well as the low cost of refinancing debt in that year. Section 3.6 describes trends in debt interest spending in more detail.

2007–08 and 2013–14, net investment declined as a share of national income, whereas current spending increased, marking a shift away from capital spending. As an illustration of just how significant the changes were, the ratio of current to gross investment spending increased from 6:1 in 1978–79 to 17:1 in 1996–97, before falling to 14:1 in 2013–14.

Net investment will be discussed in more detail in Section 5.2; meanwhile, the remainder of this section describes the long-term trends in each of the seven largest areas of spending, with the last section (3.8) providing a brief discussion of official development assistance.

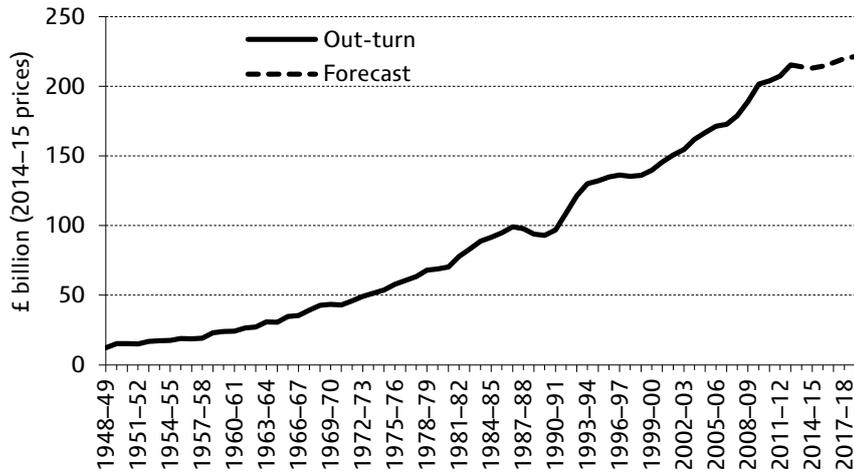
### 3.1 Social security

Social security is the largest single component of public spending. As a share of TME, social benefit spending increased from 10.8% in 1948–49 to a peak of 29.4% in 1996–97, before falling to 26.1% in 2006–07. The financial crisis and associated recession boosted social security spending as a fraction of total spending to its 2012–13 peak of 29.4%, and from 2014–15 spending on social security is projected to increase further as a share of overall spending, to 30.8% by the end of the forecast horizon in 2018–19. Real-terms spending on social security and tax credits, from fiscal year 1948–49 onwards, can be seen in Figure 3.1a. The same spending presented as a share of national income is shown in Figure 3.1b.

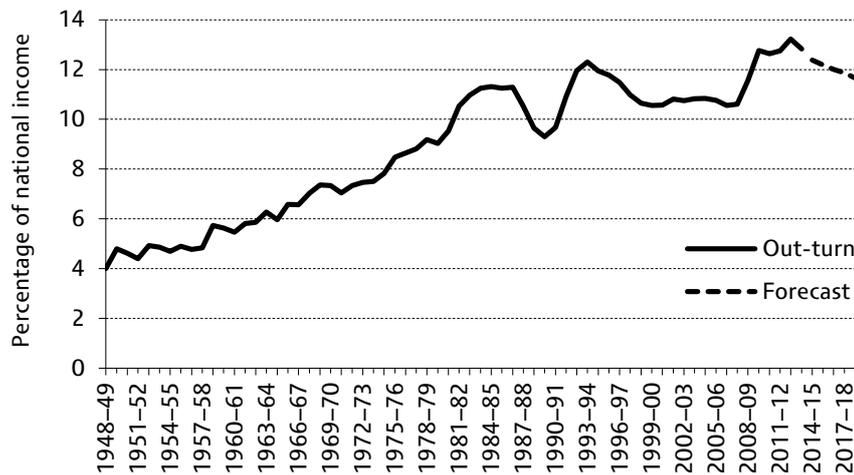
Social security spending can increase for two reasons. First, for a given set of eligibility criteria and benefit generosity, the population eligible for benefits may increase – for example, because of an economic downturn increasing the number of unemployed people or because of an ageing population increasing the number of state pension claimants. Second, government policy may increase or decrease the generosity of the social security system, or loosen/tighten the eligibility criteria for benefits, which would raise or lower social security spending on a particular population.

Figure 3.1. Social security spending, 1948–49 to 2018–19

a. Real terms



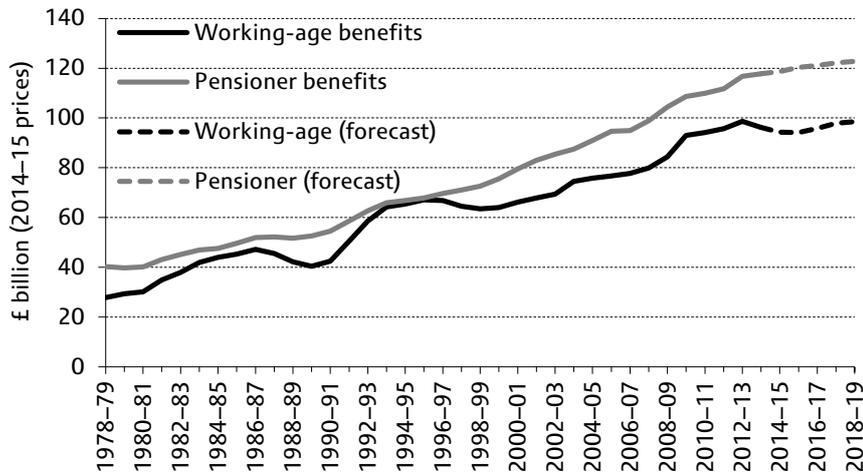
b. Share of national income



Source: Authors' calculations based on DWP Benefit Expenditure Tables released after the 2014 Budget and OBR's March 2014 Fiscal Supplementary Tables. Deflators are derived from ONS series YBHA and ABMI.

Figure 3.2 shows real spending on social security split between spending on the pensioner and working-age populations. Spending on both groups has clearly risen over time, and spending on pensioners has consistently accounted for over half of total benefit spending since before 1978–79. The solid black line shows three periods of accelerating spending on working-age benefits: first, during the early 1990s; next, after the Labour government took office in 1997–98 up until 2003–04; and finally at the end of the 2000s. The first and last of those were due to recessions driving up working-age benefit spending, whereas the acceleration from 1997–98 to 2003–04 happened in a period of relative prosperity, as the government expanded spending on areas such as tax credits. As working-age benefit spending was increasing more quickly than unemployment, this period of expansion represented an increase in benefit generosity *per head*, rather than an increase in the number of claimants.

Figure 3.2. Real spending on working-age and pensioner benefits, 1978–89 to 2018–19

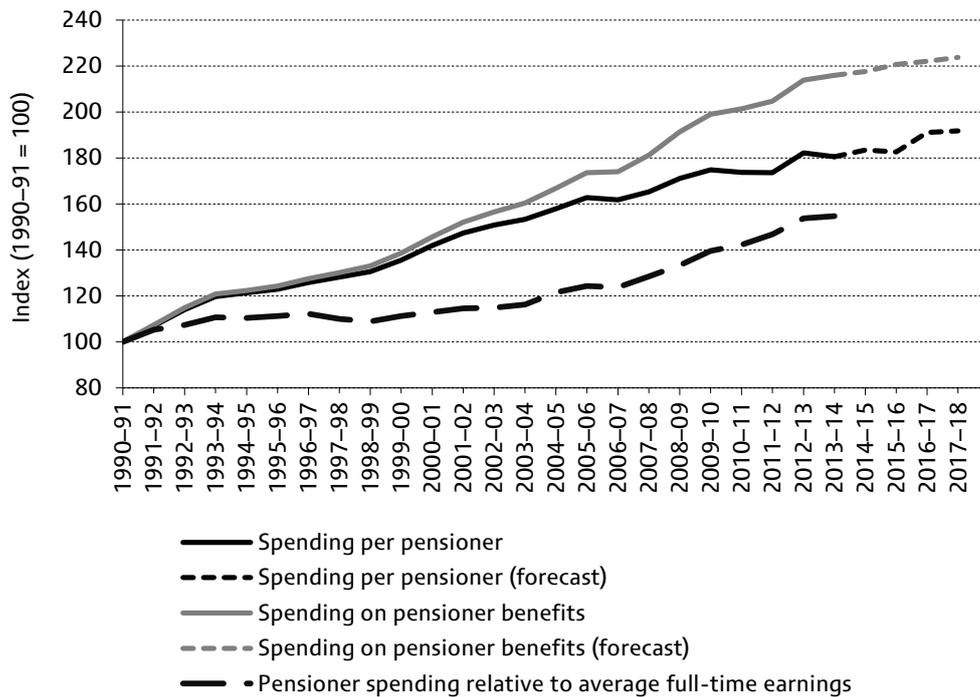


Note: Benefits aimed at children are included in the ‘working-age benefits’ category (i.e. benefits accrue to parents). Council tax benefit is excluded from social security spending as in the National Accounts it is taken to be a negative tax. Figures are expressed in real terms by inflating using the GDP deflator.

Source: Authors’ calculations based on the DWP 2014 Benefit Expenditure and Caseload Tables, at <https://www.gov.uk/government/statistics/benefit-expenditure-and-caseload-tables-2014>. GDP deflators are derived from ONS series YBHA and ABMI.

Real-terms spending on pensioner benefits has been increasing fairly consistently since 1978–79. Figure 3.3 gives an indication of how much of the general expansion in social security spending was because of an increase in the underlying eligible population and how much was because of discretionary policy action (either contemporaneous or as a result of previous reforms increasing the generosity of pension accrual coming into effect). The figure shows that between 1990–91 and 2018–19, spending on pensioners is forecast to more than double, increasing by 125% in real terms, while spending per pensioner is forecast to increase by rather less, by 96% in real terms over the same period.

Figure 3.3. Real spending on pensioner benefits, total and per pensioner, 1990–91 to 2018–19



Source: As for Figure 3.2. Population estimates from the Office for National Statistics, available at <http://www.ons.gov.uk/ons/taxonomy/index.html?nscl=Population+Estimates+by+Age+and+Sex>. Number of women above the state pension age derived using authors' approximation. Earnings series is for adults in full-time work, as included in the DWP Abstract of Statistics 2013, available at <https://www.gov.uk/government/publications/abstract-of-statistics-2013>.

Figure 3.2 allows us to compare forecasts for spending on working-age and pensioner benefits, both during the recession and under the coalition's policy of austerity. Total social security spending is forecast to increase in real terms up to 2018–19 but, within this, pensioner benefits have been largely protected whereas real spending on working-age benefits is forecast to fall in real terms between 2012–13 and 2015–16 (before starting to increase again).

So far, the government has largely protected pensioners from benefit cuts, by 'triple-locking' the basic state pension (uprating it each year by the greatest of CPI inflation, earnings growth and 2.5%) and preserving the value of most means-tested benefits for pensioners.<sup>8</sup> This protection will become increasingly expensive as the population ages – in the very long term, the OBR forecasts that uprating the state pension with the 'triple lock' rather than with earnings will

<sup>8</sup> The exception is the pension credit savings credit, which in 2012–13 represented 13% of spending on the pension credit, or £1 billion (DWP expenditure and caseload tables 2014, <https://www.gov.uk/government/publications/benefit-expenditure-and-caseload-tables-2014>).

increase spending on pensioners by as much as 0.9% of GDP by 2062–63.<sup>9</sup> We discuss the increasing pressure of an ageing population in Section 6.

## 3.2 Health spending

Over the last 60 years, spending on health (primarily via the NHS) has grown significantly – both as a share of public expenditure and as a share of national income. Between 1949–50 and 2013–14, it went from 9.3% of TME to 18.1%. An increase in total health spending (both public and private) over this period is unsurprising, for at least three reasons: first, demographic changes have increased the proportion of elderly people in the population; second, there is a general propensity of societies to spend a higher share of their income on health as that income rises; and finally, advances in medicine mean we are now able to treat a wider range of ailments. These factors are likely to outweigh the countervailing pressure from technological improvements and the expiry of patents, which should reduce the cost of treatments over time.

Figure 3.4a shows how health spending has grown steadily in real terms, at an annual average rate of 3.9% between 1949–50 and 2013–14. This is strong growth compared with 2.9% average annual real growth of TME over the same period, although this growth has not been consistent over time. Health spending grew steadily from the early 1950s up to the early 1970s, both in real terms and as a share of national income (shown in Figure 3.4b). From the early 1970s until the late 1990s, however, it was more common to have large real increases in spending for one or two years in a row, interspersed with years of lower spending growth. As an example, the annual real increases in health spending were 5.0% and 6.3% in 1993–94 and 1994–95 respectively (shortly after the introduction of the NHS internal market reforms), but real spending growth in 1995–96 fell to 2.5%.<sup>10</sup>

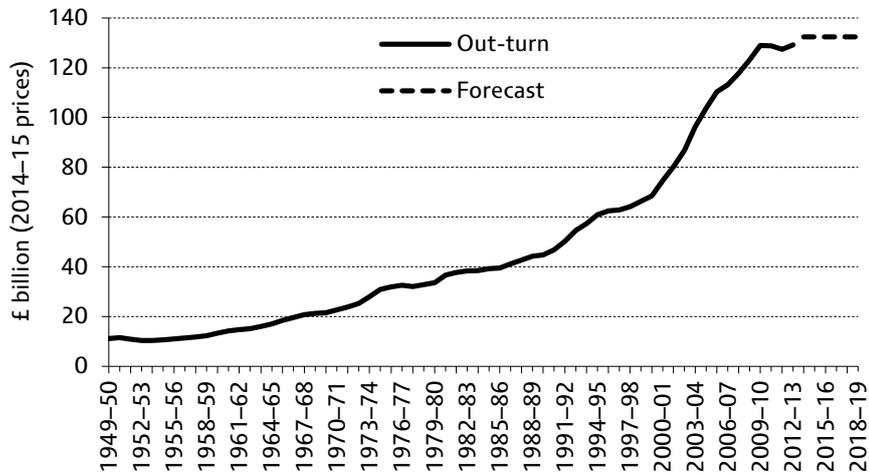
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<sup>9</sup> Pages 8–9 of OBR, *Fiscal Sustainability Report*, July 2013, [http://budgetresponsibility.org.uk/wordpress/docs/2013-FSR\\_OBR\\_web.pdf](http://budgetresponsibility.org.uk/wordpress/docs/2013-FSR_OBR_web.pdf).

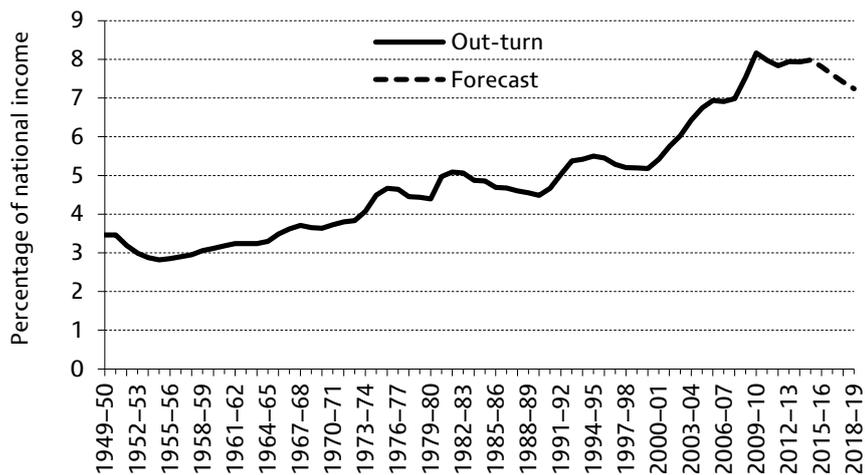
<sup>10</sup> For further information on NHS funding, see R. Crawford and C. Emmerson, *NHS and Social Care Funding: The Outlook to 2021/22*, Institute for Fiscal Studies and Nuffield Trust, July 2012, <http://www.ifs.org.uk/publications/6228> and C. Emmerson, C. Frayne and A. Goodman, *Pressures in UK Healthcare: Challenges for the NHS*, Institute for Fiscal Studies, Report C081, May 2000, <http://www.ifs.org.uk/publications/1889>.

Figure 3.4. Health spending, 1949–50 to 2018–19

a. Real terms



b. Share of national income



Note: Assumes that prior to 1978–79, the NHS represented the same proportion of overall health spending as it did in 1978–79 (100.2%). Beyond 2013–14, a real-terms freeze in health spending is assumed.

Source: Office of Health Economics for NHS spending prior to 1978, and various editions of *Public Expenditure Statistical Analyses* (PESA) thereafter.

Under the Labour government from 1997–98, real spending on health accelerated. Whereas the annual average real growth rate of health spending between 1978–79 and 1996–97 was 3.7% a year, this rose to 5.7% between 1996–97 and 2009–10. This contributed to the longest period of sustained real spending growth seen in the history of the NHS.

The substantial increases in health spending over the 2000s were determined in light of the recommendations of the Wanless Review, an independent review of the health service in the UK that was undertaken by Derek Wanless and

completed in April 2002.<sup>11</sup> The aim was to achieve a world-class health service: the Wanless Review said an average annual real increase in NHS spending of 4.2–5.1% over the 20 years between 2002–03 and 2022–23 would be required to deliver the ‘high quality health service’ envisaged.

However, since 2010–11, growth in health spending has stalled, as the NHS budget has been effectively frozen in real terms. This is relative protection, as other departments have seen real-terms cuts, but it still implies a fall in NHS spending as a proportion of national income. Figure 3.4b shows the projected decline in health spending as a share of national income, assuming that health spending is frozen in real terms beyond 2013–14. This real-terms freeze that has already been announced for NHS spending until 2015–16 will almost certainly lead to the government spending less than recommended by the Wanless Review. Another report by researchers at IFS examines the future pressures the NHS is likely to face under various funding scenarios. Among its findings are that, in the long run, even if NHS spending were to increase in line with growth in national income, and assuming that NHS productivity growth were to keep pace with the rest of the economy, spending would lag behind demographics-driven demand.<sup>12</sup>

Because spending on the NHS contributes such a large fraction of overall spending, real-terms protection for the NHS over the current parliament, alongside cuts to overall departmental spending, has significant implications for other areas. In 2009–10, the NHS represented 25.8% of total departmental spending; under current plans, it will represent 31.0% by 2015–16.<sup>13</sup>

## Private and public health spending in the UK

The vast majority of health expenditure in the UK is financed publicly – 84% in 2010. Figure 3.5 shows how public and private health expenditure, each as a proportion of national income, have changed over time. Private health expenditure has been gradually increasing since the mid-1970s, from 0.5% in 1975 to a peak of 1.6% in 2009. However, the increase in public spending as a share of national income has been much greater, which has led to a declining proportion of health spending taking place via the private sector.

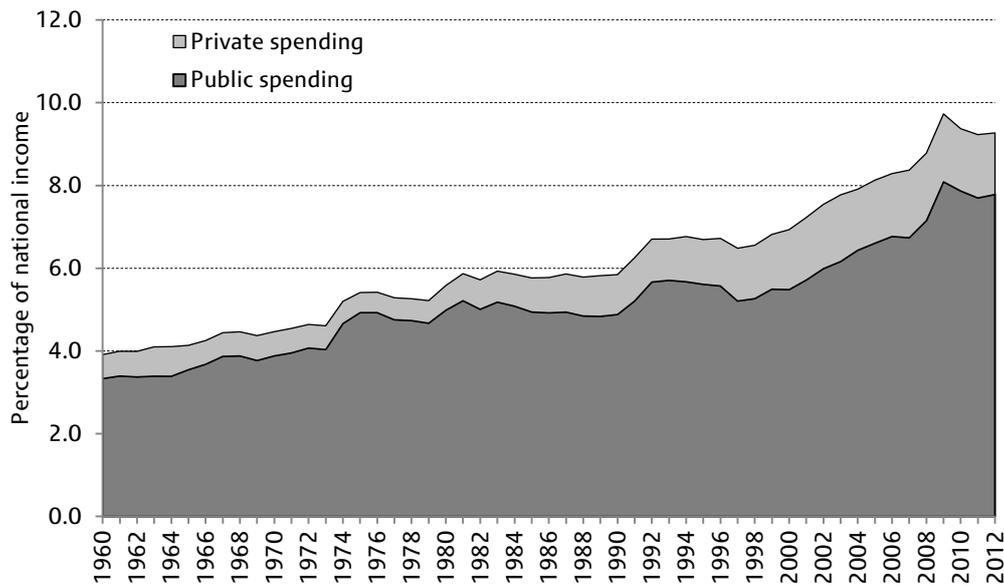
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<sup>11</sup> D. Wanless, *Securing Our Future Health: Taking a Long-Term View*, HM Treasury, London, April 2002, <http://www.yearofcare.co.uk/sites/default/files/images/Wanless.pdf>.

<sup>12</sup> R. Crawford and C. Emmerson, *NHS and Social Care Funding: The Outlook to 2021/22*, Institute for Fiscal Studies and Nuffield Trust, July 2012, <http://www.ifs.org.uk/publications/6228>.

<sup>13</sup> Table 1.10 of *Public Expenditure Statistical Analyses 2014*, <https://www.gov.uk/government/statistics/public-expenditure-statistical-analyses-2014>. Overall DEL in 2015–16 adjusted to include £11.4 billion of extra spending that was transferred out of departmental spending from 2013–14 with the business rates localisation reform.

Figure 3.5. Private and public health expenditure in the UK, 1960 to 2012



Source: OECD Health Statistics (database), OECD health data, health expenditure and financing (available at [stats.oecd.org](http://stats.oecd.org)).

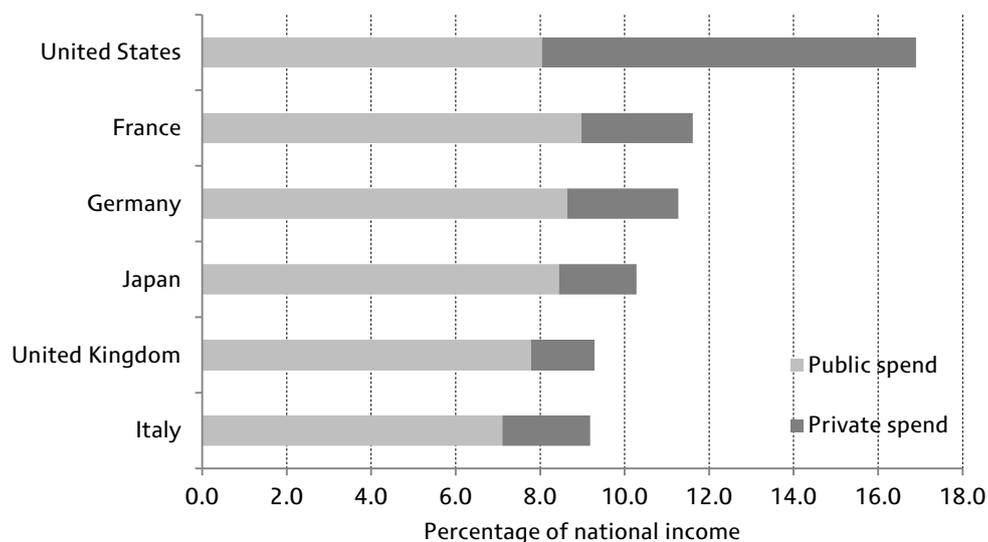
The rapid increases in NHS spending over the 2000s could in part be responsible for the relatively slow growth in private health spending over the same period. The increase in NHS spending, and the consequent improvement in services and reduction in waiting times, reduced the quality differential between the NHS and the private sector. This could have reduced individuals' willingness to pay extra for private health care, and so the increases in NHS spending may have crowded out some health spending that would otherwise have occurred privately. In addition, reduced waiting lists could have reduced private healthcare provision mechanically, as some private healthcare packages only offer services if the NHS waiting list for a particular procedure is over a certain length. It is clear from Figure 3.5, however, that total health care spending in the UK increased rapidly as a share of national income over the 2000s, and so most of the increase in NHS spending did represent additional UK health spending. Another report by researchers at IFS investigates further the relationship between public and private health spending and documents the rise of publicly funded but privately provided healthcare.<sup>14</sup>

Figure 3.6 shows how UK health spending (as a share of national income) compared with spending in five other major economies in 2012. The UK is similar to Italy and Japan in terms of how much it spends on health as a proportion of national income, but it spends less than France and Germany, and more than 7% of national income less than the US. Not only does the UK spend less in total on

<sup>14</sup> S. Arora, A. Charlesworth, E. Kelly and G. Stoye, *Public Payment and Private Provision: The Changing Landscape of Health Care in the 2000s*, Institute for Fiscal Studies and Nuffield Trust, May 2013, <http://www.ifs.org.uk/publications/6712>.

health than the US does as a share of national income, but the US even has higher public spending on healthcare than the UK. Figure 3.6 also shows that a relatively high proportion of health spending in the UK is funded publicly. Public spending made up 84% of total health spending in the UK, compared with 82% in Japan, 77% in Italy, Germany and France, and just 48% in the US.

**Figure 3.6. Spending on health as a share of national income in selected major economies, 2012**



Source: OECD Health Statistics (database), OECD health data, health expenditure and financing (available at [stats.oecd.org](https://stats.oecd.org)).

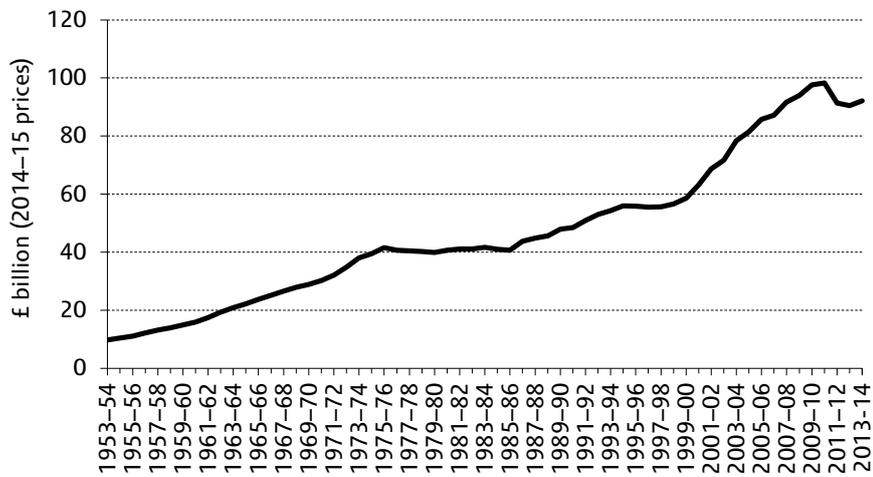
### 3.3 Education

Education spending almost doubled as a share of total spending between 1953–54 and 1973–74, from 6.9% to 12.5%. It then remained fairly stable, dipping in the early to mid-1980s, before rising to around 13% throughout the 2000s. In real terms, the average annual increase in education spending between 1953–54 and 2013–14 was 3.8%. Figure 3.7a shows the alternating periods of flat and rising real education spending over the second half of the twentieth century.

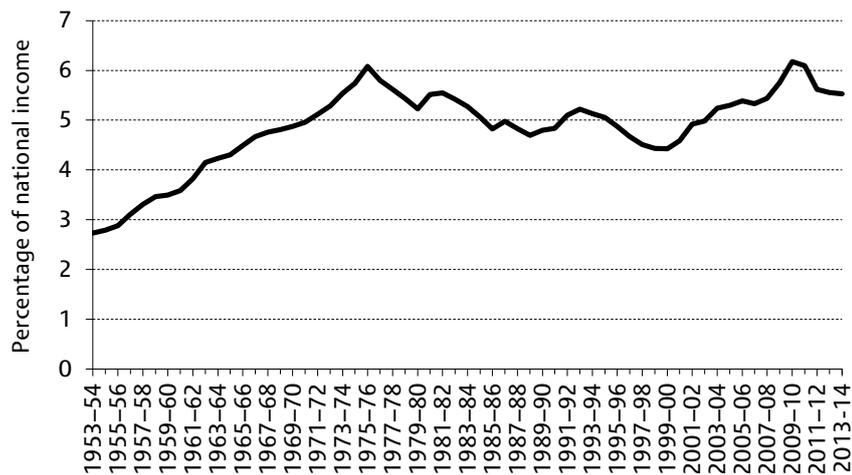
Spending on education is driven by a combination of demographics and demand. Spending on primary and secondary education, for example, is a function of the number of school-age children. By contrast, spending on higher education depends not only on the student-age population but also on how large a proportion of that population chooses to go to college or university (and, in recent years, what fraction of this service is publicly funded). Figure 3.8 shows the number of pupils in state primary and secondary schools between 1947 and 2013, with projections up to 2018.

Figure 3.7. Education spending, 1953–54 to 2013–14

a. Real terms



b. Share of national income



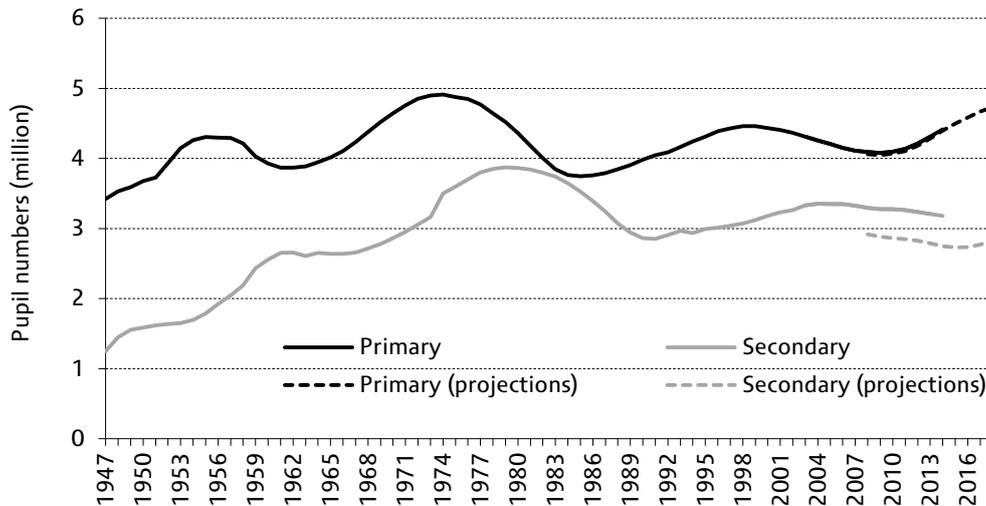
Source: Table 4.2 of HM Treasury, *Public Expenditure Statistical Analyses 2014*. Previous editions of PESA. ONS Blue Book 1997. HM Treasury.

The rise in the school-age population from the 1950s until the mid-1970s was accompanied by increases in education spending. Public spending on education then began to stagnate in the 1970s, at the same time as the number of school children began to decline.

In the 1990s, when the number of pupils picked up, spending did not rise to match the increase. The number of pupils in England rose from 6.8 million in 1990–91 to 7.5 million in 1998–99, but spending on education as a proportion of national income fell by 0.4 percentage points over the same period.<sup>15</sup>

<sup>15</sup> A more appropriate comparison would be between pupil numbers and spending on schools; unfortunately, a consistent historical series for schools spending is not available – for more information on the difficulties in getting consistent education-related series over time, see the 24

Figure 3.8. Pupils in state primary and secondary schools in England, 1947 to 2018



Note: The minimum school-leaving age was increased from 14 to 15 in April 1947 and from 15 to 16 in September 1972. Figures shown up to 2013 are total pupils. Projections are for full-time equivalents in state-funded schools; projections for secondary school pupils include only those aged 15 and under.

Source: Historical series from Department for Education and Skills, 'Statistics of education', February 2003, <http://webarchive.nationalarchives.gov.uk/20100520035316/http://www.dcsf.gov.uk/rsgateway/DB/SBU/b000384/b01-2003.pdf>. Figures from 2003 are from Department for Education, 'Schools, pupils and their characteristics: January 2014', <https://www.gov.uk/government/statistics/schools-pupils-and-their-characteristics-january-2014> and Department for Education, 'National pupil projections: future trends in pupil numbers – July 2014', <https://www.gov.uk/government/publications/national-pupil-projections-trends-in-pupil-numbers-july-2014>.

The Labour government from 1997 reprioritised education and increased education spending much more quickly, at an average annual real rate of 4.4% between 1996–97 and 2009–10 (compared with an average annual real increase of 1.8% between 1978–79 and 1996–97). As we can see from Figure 3.8, the number of pupils was declining very slightly in the 2000s. So spending per pupil rose and may, in some sense, have been 'catching up' with the increase in the number of pupils seen in the 1990s.

Spending on schools has been one of the areas that have been relatively protected from spending cuts over recent years.<sup>16</sup> As with health spending, this protection has come in the form of a real-terms freeze rather than a continuation of the relatively large annual increases seen in the 2000s. However, although overall

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House of Commons Library Standard Note 'Education: historical statistics', <http://www.parliament.uk/briefing-papers/SN04252/education-historical-statistics>.

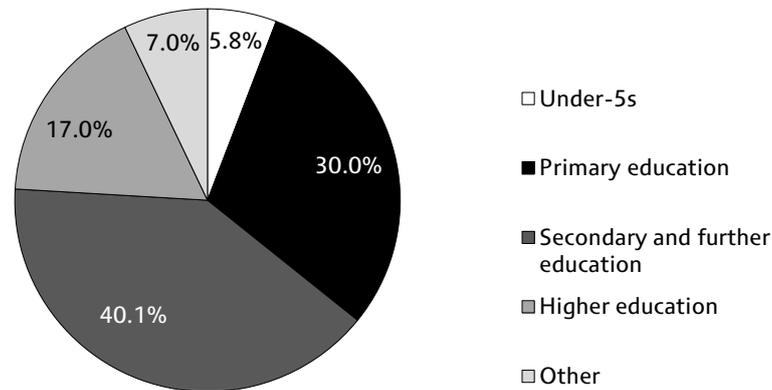
<sup>16</sup> Schools spending covers less than education spending, as it does not include spending on 'early years' education, support for families and children, and education for 16- to 19-year-olds or universities.

schools spending has been protected, the allocation of spending between schools has not been constant. In 2010, the government announced a nominal freeze of per-pupil funding, combined with a new ‘pupil premium’, targeted at disadvantaged pupils, as well as a reform to the school funding formula, which would simplify the method of allocating funds between schools.<sup>17</sup>

### Education spending by sub-function

Figure 3.9 shows a breakdown by function of education spending in 2013–14, giving a picture of how much the government spends on each level of education. The figure shows that spending on primary and secondary schools and further education accounts for the bulk of total education spending (70.1% in 2013–14). The next-largest spending item is higher education, which in 2013–14 accounted for 17.0% of education spending, while spending on the under-5s accounted for 5.8%.

Figure 3.9. Education spending by sub-function, 2013–14



Note: ‘Other’ category includes subsidiary services to education, research and development in education, and education not definable by level (equivalent to training).

Source: HM Treasury, *Public Expenditure Statistical Analyses 2014*.

Under the Labour government, over the 2000s, the areas of fastest growth in spending were schools, early years education and further education; higher education spending grew relatively slowly.<sup>18</sup> In contrast, during the coalition government’s programme of austerity, all areas of public education spending are facing cuts, though of different magnitudes. The area facing the smallest cuts is spending on schools; the coalition government pledged to protect current (i.e.

<sup>17</sup> The options for reform are assessed in detail in H. Chowdry and L. Sibieta, ‘School funding reform: an empirical analysis of options for a national funding formula’, IFS Briefing Note BN123, November 2011, <http://www.ifs.org.uk/publications/5754>.

<sup>18</sup> Interested readers should refer to H. Chowdry and L. Sibieta, ‘Trends in education and schools spending’, IFS Briefing Note BN121, October 2011, <http://www.ifs.org.uk/publications/5732>.

non-investment) spending on schools in real terms. The area facing the largest cuts is higher education spending, though these cuts to public funding of higher education were largely offset by a significant reform in 2012–13, which changed how higher education is financed. Previously, universities would receive most of their funding from a combination of tuition fees and central government funding. Following the financing reform, the balance of funding shifted away from central government grants (which were cut substantially), towards student fees, as the cap on tuition fees was raised from £3,375 per year for 2011–12 entrants to £9,000 per year for 2012–13 entrants. The cap was increased to allow higher education institutions to raise at least as much as (if not more than) the reduction in central government grants that they received. Thus the cuts in public funding for higher education overstate the cuts to universities' budgets: since 2011–12, total higher education funding has actually increased in real terms.<sup>19</sup>

### International comparisons of education spending

Table 3.4 shows how the UK's education spending in 2010 compared with that of four other major economies. These figures include both public and private education spending, apart from Italy, which only includes public education spending for primary and secondary levels. At 6.5%, the UK spent a higher share of national income on education than Italy, Japan, and France, and a lower share than the US at 7.3%.

Table 3.4. Spending on education in selected major economies, 2010

	<i>Spending as a share of national income (%)</i>	<i>Relative spending per student (UK=100)</i>			<i>Relative spending per student per unit of average income (UK=100)</i>		
		Primary	Secondary	All tertiary	Primary	Secondary	All tertiary
Italy	4.7	89	82	60	97	91	66
Japan	5.1	89	95	101	89	95	101
France	6.3	71	104	95	73	107	97
<b>UK</b>	<b>6.5</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>
US	7.3	120	119	161	91	90	122

Note: Indices for spending per student are taken from figures that were converted into US dollars using purchasing power parities. Italy's figures on primary and secondary education include only spending on public institutions.

Source: OECD, *Education at a Glance*, 2013, <http://www.oecd.org/edu/eag.htm>.

<sup>19</sup> For further information on the 2012–13 reforms to higher education financing, see C. Crawford, R. Crawford and W. Jin, *The Outlook for Higher Education Spending by the Department for Business, Innovation and Skills*, IFS Report R86, November 2013, <http://www.ifs.org.uk/publications/6907>.

The second to fourth columns show spending per student at primary, secondary and tertiary levels, relative to the UK (indexed to 100).<sup>20</sup> They show that, as well as spending a higher proportion of its national income on education, the US spends more per pupil at all stages of education than any other country shown. Relative to the UK, the US spends 20% more per pupil at primary and secondary school level, and just over 60% more on tertiary education per head.

Relative spending per head may be driven by both the size of the economy (a country with higher income per capita can afford to spend more per pupil) and the relative prioritisation of education. For example, as the US is the richest of the countries shown, it is reasonable for it to spend the most per head. In order to adjust for relative income and show an indicator of public spending priorities, the final three columns of Table 3.4 show spending per head per unit of average income, or spending per pupil taking into account different income levels.

In terms of spending per head, for primary, secondary and tertiary education, the UK lies somewhere in the middle of the other five countries shown. However, as a share of national income, the UK actually spends more per head on primary and secondary education than any of the other countries (apart from French spending on secondary education).

Making the adjustment for national income levels does not have much effect on the ranking of tertiary education spending per head – the US spends so much more on this that, even after adjusting for its higher national income, it still spends 22% more than the UK per student.

### 3.4 Defence

Defence spending grew substantially in real terms between the late 1950s and the early 1980s, but then fell dramatically between the mid-1980s and the end of the 1990s – see Figure 3.10a. The decline began shortly before the end of the Cold War, when the UK's five-year commitment to NATO (to increase defence spending by 3% a year) ended. This decline was slowly reversed after the end of the 1990s, as defence spending was increased to fund the 'war on terror' and UK military commitments in Iraq and Afghanistan. Defence spending then started to fall again after 2010–11, in preparation for the UK's withdrawal from Iraq (at the end of 2011) and from Afghanistan (planned for 2014) and in the context of overall spending cuts from 2010–11.

As a result of the strong economic growth experienced in the UK between the late 1990s and the late 2000s, and despite the increase in spending in real terms over that period, Figure 3.10b shows defence spending fell as a share of national income. Defence spending as a share of TME has also been in gradual decline

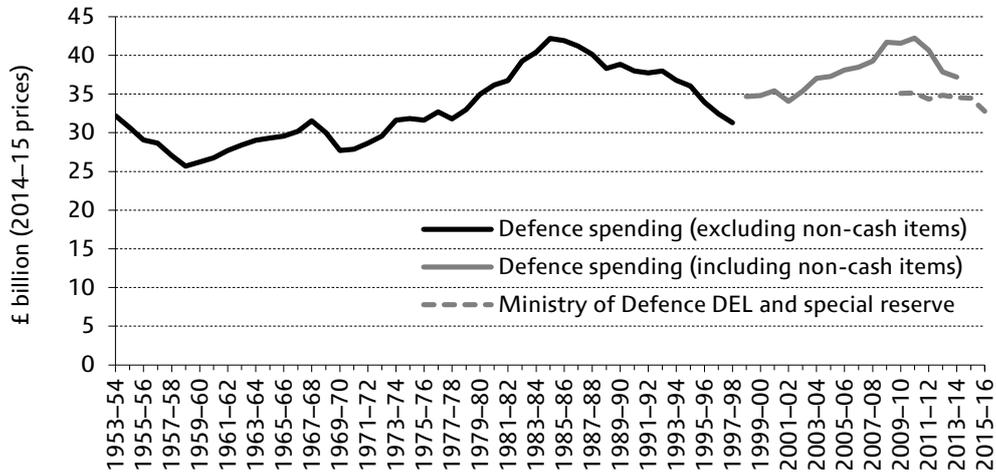
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<sup>20</sup> The underlying figures are in US dollars, adjusted for purchasing power parity differences.

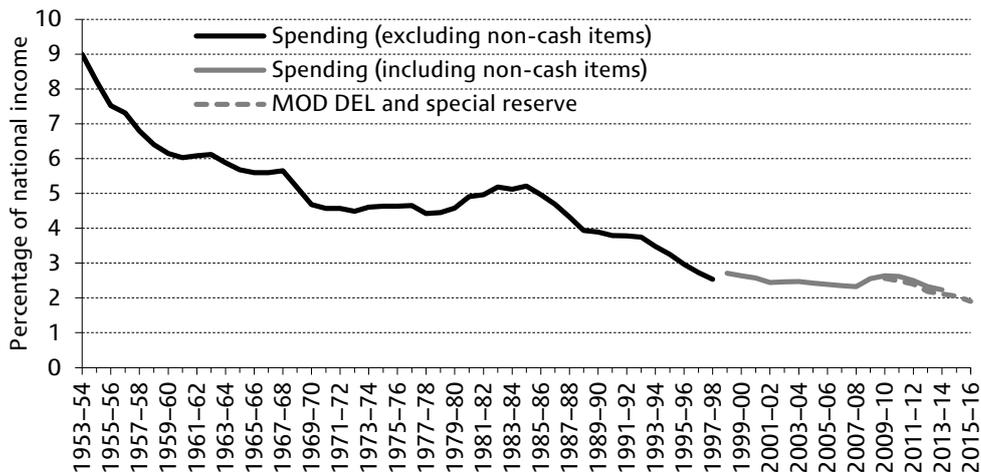
since the mid-1980s, falling from 11.0% in 1985–86 to 6.7% in 1997–98, and reaching 5.1% by 2013–14.<sup>21</sup>

Figure 3.10. Defence spending, 1953–54 to 2015–16

a. Real terms



b. Share of national income



Note: Special reserve is a sum of money assigned for unanticipated increases in the need for defence spending, and is a cap rather than a target for extra spending in this area. Defence spending is slightly higher than MoD DEL as some defence spending is allocated to the Cabinet Office.

Source: Historical data and projections for UK defence spending are from HM Treasury, *Public Expenditure Statistical Analyses 2014* and previous PESAs. MoD DEL is from PESA 2014, <https://www.gov.uk/government/statistics/public-expenditure-statistical-analyses-2014>.

<sup>21</sup> The 2013–14 figure includes non-cash expenditure (e.g. capital charges, depreciation and changes in provisions), whereas the figures for earlier years exclude these non-cash costs. Therefore, the comparison understates the decline in defence spending as a share of TME.

Figure 3.10 shows three series as it is not possible to get a long-run series for defence spending on a consistent basis. The first, from 1953–54 to 1997–98, is total UK defence spending, excluding spending on ‘non-cash’ items such as capital charges, depreciation and changes in provisions. The second, from 1998–99 to 2013–14, is total UK defence spending including these non-cash items. Non-cash items account for a relatively large proportion of defence spending (around a quarter in 2012–13), because the Ministry of Defence (MoD) owns a large quantity of fixed assets such as buildings and machinery, which result in large capital charges.<sup>22</sup> The third series shown is the MoD DEL (which includes non-cash items), plus the special reserve, for which there are projections of spending up to 2015–16. This series follows a similar pattern to UK defence spending, but is at a slightly lower level, as departments other than the MoD also undertake some defence spending.

Forecasts are shown with the caveat that defence spending is extremely difficult to forecast, because the costs of operations and conflict prevention fluctuate significantly from year to year: they were £586 million in 2001–02 but £1.4 billion in 2002–03.<sup>23</sup> When the UK fights wars or deploys troops abroad, money sometimes has to be found at short notice. The November 2002 Pre-Budget Report announced the creation of a special contingency reserve of £1 billion ‘to meet overseas and defence needs in the fight against global terrorism’.<sup>24</sup> The government has continued to maintain the special reserve to make provision for the costs of military operations in Iraq and Afghanistan, as well as the UK’s other international obligations. As of the March 2014 Budget, £0.8 billion was allocated to the special reserve for 2014–15 and £1.1 billion for 2015–16.<sup>25</sup>

The line on Figure 3.10a representing the combined MoD DEL and special reserve shows a decline in real terms from £35.1 billion in 2010–11 to £32.8 billion by 2015–16; this reflects reduced commitments to Afghanistan, but also the departmental budget cuts happening throughout Whitehall under the coalition’s austerity programme.

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<sup>22</sup> See Section 4 for a discussion of various components of total government spending, including a definition of DEL. Source: Ministry of Defence Statistical Release, September 2013, available at [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/279994/2013.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/279994/2013.pdf).

<sup>23</sup> Source: Ministry of Defence, *The Government’s Expenditure Plans 2007–2008*, Cm 7098, London, July 2007, [http://www.mod.uk/NR/rdonlyres/95BBA015-22B9-43EF-B2DC-DFF14482A590/0/gep\\_200708.pdf](http://www.mod.uk/NR/rdonlyres/95BBA015-22B9-43EF-B2DC-DFF14482A590/0/gep_200708.pdf).

<sup>24</sup> Source: Paragraph 1.13 of HM Treasury, *Pre-Budget Report 2002*, London, November 2002, [http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/prebud\\_pbr02\\_index.htm](http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/prebud_pbr02_index.htm).

<sup>25</sup> Source: Table 2.4 of HM Treasury, *Budget 2014*, London, March 2014, <https://www.gov.uk/government/publications/budget-2014-documents>.

The outlook for total public spending going forwards is likely to place pressure on the defence budget. In October 2010, the government published its *Strategic Defence and Security Review*, setting targets for national security capabilities by 2020, in the context of a tight budgetary framework.<sup>26</sup> It set out plans for priority areas that would be relatively protected from spending cuts, pencilled in cuts to the civilian workforce and highlighted opportunities for asset sales and efficiency savings.

Even before the cuts were planned, a 2009 paper by Professor Malcolm Chalmers – a former special adviser to foreign secretaries Jack Straw and Margaret Beckett – concluded: ‘What is clear is that, given the extent of savings that are likely to be required in the next Defence Review, not all existing capabilities – far less legitimate aspirations for new capabilities – can be afforded. A moment of choice for British defence decision-makers, as significant for its foreign policy as the decision to withdraw from East of Suez in the 1960s, is fast approaching’.<sup>27</sup>

### 3.5 Public order and safety

Spending on public order and safety (POS) includes the criminal justice system (which itself includes police spending, the Crown Prosecution Service, the criminal courts, and the prison and probation services), immigration and citizenship functions, and the fire services.

POS spending constituted 3.3% of TME in 1978–79, and rose steadily as a fraction of total spending to peak at 5.9% in 2001–02, but then fell to 4.2% in 2013–14. Figure 3.11a shows POS spending growing steadily in real terms from 1978–79 to 1996–97 (under the last Conservative government), at an annual average real rate of 4.4%. This is a higher growth rate over this period than for any of the other areas examined in this briefing note, including health spending. From 1996–97, this growth stalled until around March 2000, at which point spending in this area began to grow more rapidly again, at an average annual rate of 4.6% between 1999–2000 and 2008–09; but this was a slower growth rate than experienced by health and education spending over the same period. Strong economic growth at the same time meant that the growth in spending as a share of national income was much less dramatic: spending on POS as a share of national income has fluctuated between 1.9% and 2.4% of national income since 1989–90.

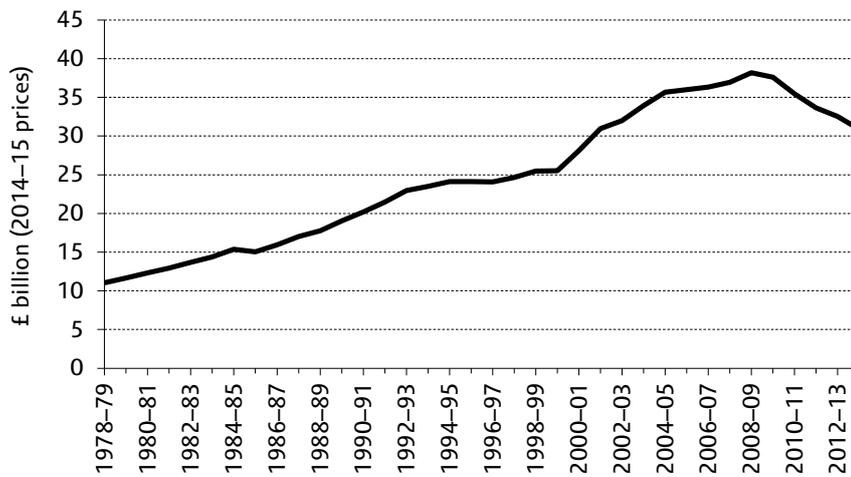
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<sup>26</sup> Ministry of Defence, *The Strategic Defence and Security Review: Securing Britain in an Age of Uncertainty*, October 2010, <https://www.gov.uk/government/publications/the-strategic-defence-and-security-review-securing-britain-in-an-age-of-uncertainty>.

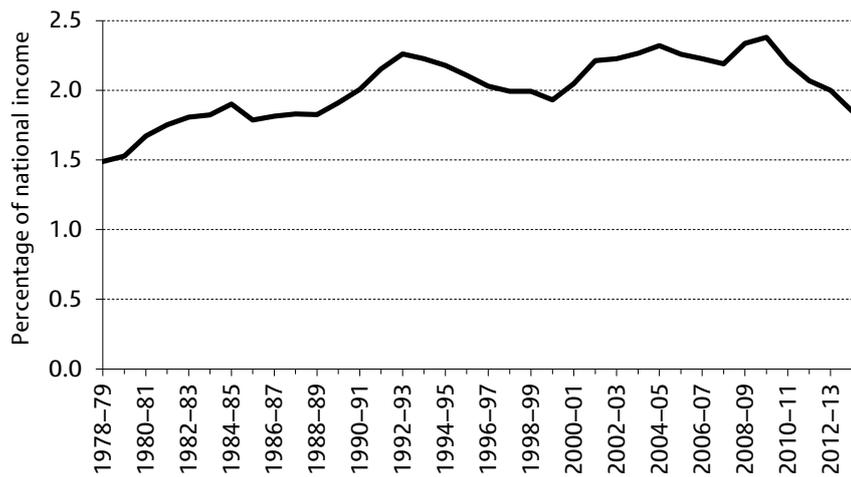
<sup>27</sup> M. Chalmers, ‘Preparing for the lean years’, Royal United Services Institute, Future Defence Review, Working Paper 1, July 2009, [http://www.rusi.org/downloads/assets/FDR\\_Working\\_Paper\\_1.pdf](http://www.rusi.org/downloads/assets/FDR_Working_Paper_1.pdf).

Figure 3.11. Spending on public order and safety, 1978–79 to 2013–14

a. Real terms



b. Share of national income



Source: HM Treasury, *Public Expenditure Statistical Analyses 2014* and previous PESAs.

From 2009–10, spending on POS has fallen both in real terms and as a share of national income, as shown in Figures 3.11a and 3.11b. Local authorities typically carry out about half of total spending on these functions. As they do not publish multi-year budgets, it is difficult to project spending on POS for future years. However, the Home Office and Ministry of Justice, which are responsible for most of the rest of POS spending in England, are facing annual average real cuts to their budgets of 5.6% and 8.1% respectively between 2010–11 and 2015–16.<sup>28</sup>

<sup>28</sup> Source: HM Treasury, *Public Spending Statistical Analyses*, July 2014, <https://www.gov.uk/government/publications/public-expenditure-statistical-analyses-2014>.

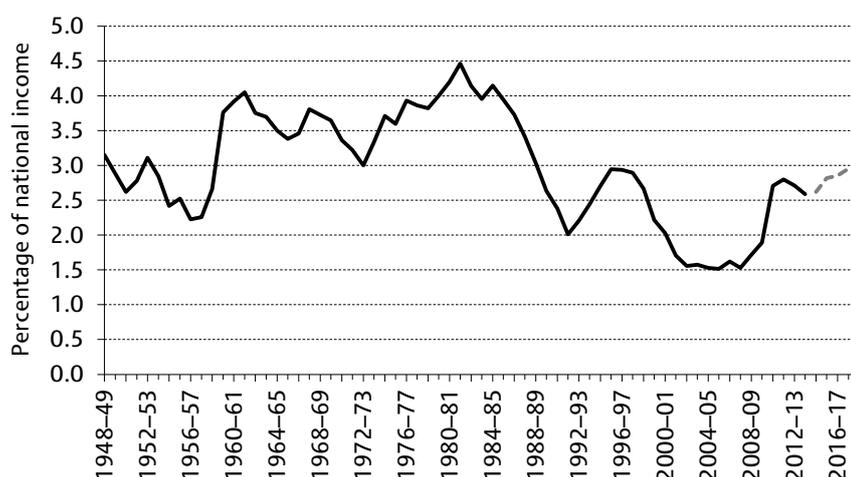
### 3.6 Debt interest payments

Net debt interest payments, which are the cost of servicing public sector debt, were £42.3 billion in 2013–14, equivalent to 2.6% of national income. This cost depends on three main factors: the stock of debt, the cost of borrowing (i.e. the interest rate) and inflation. The greater the stock of debt, or the higher the rate of interest payable on the borrowed funds, the greater will be the debt interest payments. Also, since most UK government bonds are nominal rather than indexed, the higher inflation is, the more quickly will the real value of the existing debt stock be reduced, and the lower will be the real borrowing cost on that debt. Higher inflation therefore reduces the real cost of servicing public sector debt, although it would likely increase the cost of financing new borrowing.

Figure 3.12 shows the evolution of spending on debt interest since 1948 and Figure 3.13 puts this in context by illustrating the stock of debt over the same period. Figure 3.13 includes two different measures of UK government debt: ‘public sector net debt’ (excluding the temporary impact of financial interventions) and ‘national debt’. Public sector net debt is a more comprehensive measure than national debt, but is only available from 1974.

National debt fell from a peak of around 270% of national income immediately after the Second World War, to 214% in 1948.<sup>29</sup> Strong growth in national income will tend to reduce the level of the debt stock as a proportion of national income, as illustrated in Figure 3.13 between 1955 and 1970 when strong economic growth drove down the ratio of debt to national income.

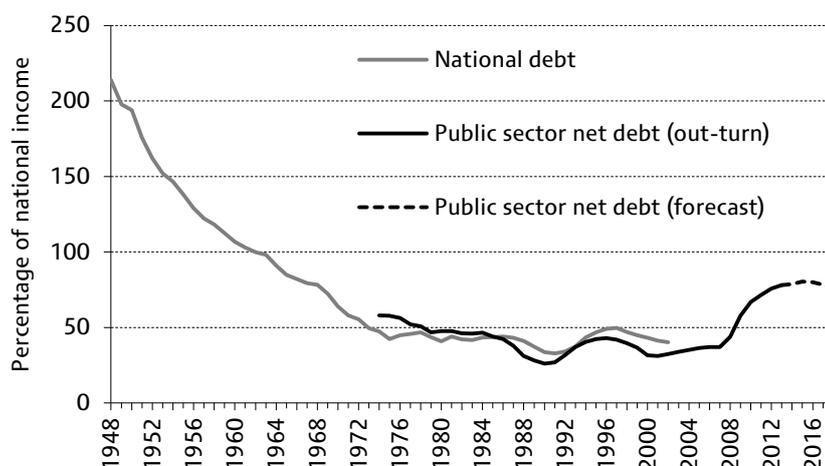
Figure 3.12. Public sector net debt interest payments as a share of national income, 1948–49 to 2018–19



Source: Net debt interest payments are from ONS series JW2L and JW2P (out-turns) and the OBR March 2014 *Economic and Fiscal Outlook* (forecasts), excluding the effects of the Asset Purchase Facility.

<sup>29</sup> OBR, *Fiscal Sustainability Report*, July 2013, [http://cdn.budgetresponsibility.independent.gov.uk/2013-FSR\\_OBR\\_web.pdf](http://cdn.budgetresponsibility.independent.gov.uk/2013-FSR_OBR_web.pdf).

Figure 3.13. Public sector net debt as a share of national income, 1948 to 2018



Note: National debt is on a calendar-year basis. Public sector net debt is on a financial-year basis. Source: National debt is from the Debt Management Office. Public sector net debt is from the ONS series HF6W. Forecasts from the Office for Budget Responsibility's March 2014 *Economic and Fiscal Outlook*.

Figure 3.12 shows that spending on net debt interest payments increased as a share of national income from the early 1970s to the mid-1980s, while Figure 3.13 shows that the national debt as a share of national income was fairly stable over the same period (if anything, it was declining). The government ran deficits over this period, particularly during the recessions of the mid-1970s and early 1980s, but was able to do so without increasing debt as a share of national income. The high inflation of the period meant that, despite the recessions, nominal national income growth was high and so the debt burden was not increased. The higher spending on debt interest therefore stemmed not from the higher debt stock but from the higher costs of borrowing. Investors who had seen the real value of their government bonds reduced substantially by inflation started demanding significantly higher nominal interest rates, increasing the cost to the government of borrowing.

During the late 1980s, both inflation and public sector debt fell, and so spending on net debt interest payments decreased. Then, in the recession of the early 1990s, government borrowing increased and (in the absence of the high inflation seen in the 1970s) public sector net debt increased as a share of national income. Spending on debt interest payments therefore also increased quickly, but then declined in the late 1990s as both the debt stock and expected inflation fell.

The 2008–09 recession saw government borrowing increase rapidly, and public sector net debt increased from 37.1% of national income in 2007–08 to 78.0% by 2013–14. This increase was much larger than experienced in previous recessions, for two main reasons.

First, the last Labour government chose to use active fiscal policy in an attempt to reduce the impact of the recession, which was not the case in the recessions of the early 1980s or the early 1990s. This came at the cost of greater government borrowing – and therefore debt – but may have been prudent, as interest rates on government bonds were, and remain, particularly low. The cheap cost of borrowing for the government could be driven by at least three factors. First, investors may have been confident that low inflation would persist, after over a decade of low inflation overseen by the independent Bank of England. Second, the sovereign debt crisis in the eurozone and perceived heightened risk in private investments led investors to flee to the (relatively) safe haven of UK government debt, reducing the cost of interest payments. Finally, the programme of quantitative easing by the Bank of England involved buying large quantities of government bonds, depressing further the cost of interest payments. The cost of borrowing to soften the impact of the recession is therefore less than that faced by previous governments.

Second, unlike the recessions of the early 1970s, early 1980s and early 1990s, the most recent recession has been deflationary. Economic growth has been weak: after a fall in nominal national income of just over 3% between 2008 and 2009, there was an inconsistent recovery, with a temporary bounceback to 2010 followed by sluggish growth, although growth picked up sharply in 2013. The increased government borrowing has therefore led to a rapid increase in net debt as a share of national income. This rapid increase is projected to lead to an increase in spending on debt interest payments, which are forecast to grow in real terms at an average annual rate of 7.1% from 2009–10 to 2018–19.

Net debt as a percentage of national income is forecast to exceed anything seen in the last 40 years. Despite this, net interest payments fell in 2012–13 and remained constant in 2013–14 as a share of national income due to the effects of one-off financial transactions and low inflation.<sup>30</sup>

The increase in spending forecast to be needed for debt interest payments over the coming years will put pressure on other areas of government spending. In 2007–08, net debt interest payments accounted for 3.8% of TME, whereas in 2013–14 they made up 5.9% and they are forecast to increase further to 7.7% by 2018–19.

### 3.7 Transport

Transport spending accounted for 2.8% of TME in 2013–14, slightly below its average historical importance: it has fluctuated between 3 and 4% of total spending for most of the last three decades. Figures 3.14a and 3.14b show the

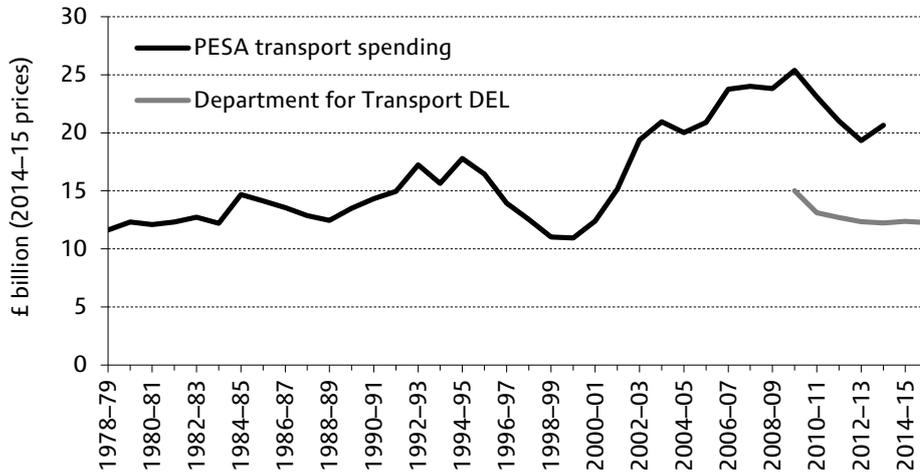
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<sup>30</sup> The fees received by HM Treasury from financial institutions benefiting from the Special Liquidity Scheme offset debt interest payments, but are only one-off payments.

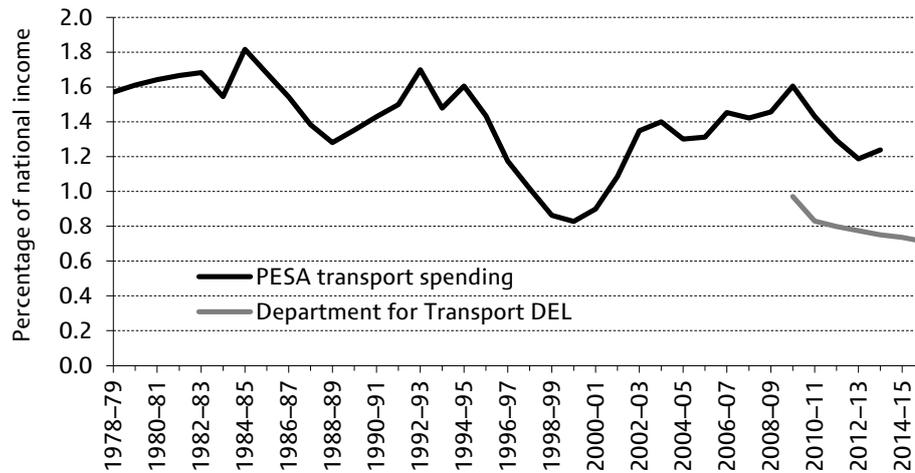
changes over time in transport spending (in real terms and as a proportion of national income).

Figure 3.14. Transport spending, 1978–79 to 2015–16

a. Real terms



b. Share of national income



Source: HM Treasury, *Public Expenditure Statistical Analyses 2014* and previous PESAs. Budget 2014.

After a peak in transport spending in the early 1990s, spending in this area fell dramatically until March 2000, when it started to increase rapidly again, at an average annual real growth rate between 1998–99 and 2007–08 of 9.0%, faster even than growth in health and education spending over this period. This planned increase was set out in 2000, in the government’s *Transport Ten Year Plan*,<sup>31</sup> and supplemented at successive Spending Reviews, which, prior to the

<sup>31</sup> *Transport Ten Year Plan 2000*, <http://iobi.swan.ac.uk/wp-content/uploads/2012/09/Road-Strategy-2000-Transport-10-Year-Plan.pdf>.

financial crisis, had set out long-term plans to increase transport spending by an annual average real rate of 2.3% from April 2008 to March 2019.<sup>32</sup>

The financial crisis and the subsequent tightening of spending reversed the long-term plans for increases in transport spending. In contrast to the substantial increases in real transport spending seen between 2000–01 and 2009–10, between 2009–10 and 2015–16 the Department for Transport’s budget is planned to be cut at an average annual real rate of 3.3%. Given these cuts, it is unlikely that the long-term plans set out pre-crisis will be realised.

### 3.8 Official development assistance

The Department for International Development administers most of the UK’s official development assistance (ODA), of which the UK gave £11.4 billion in 2013, or 0.7% of gross national income (GNI).<sup>33</sup> This was a sharp increase over spending in 2012 (as shown in Figures 3.15a and 3.15b); this was required to achieve the government’s pledge to meet the UN target for aid spending (of 0.7% of GNI). This goal of 0.7% is a long-standing international recommendation from a commission set up by the World Bank in 1969, subsequently endorsed by the UN, and later in 2005 by those at the G8 summit in Gleneagles, Scotland.

Figure 3.16 shows that, even in 2012, before the UK had met its pledge, the UK devoted a relatively high proportion of GNI to ODA by international standards. However, ODA spending still represents a tiny fraction of overall spending, and committing to 0.7% of GNI has negligible effects on the amount of money available for other areas of spending. The Scandinavian countries give a comparatively large share of their GNI in ODA – in excess of the 0.7% target – in contrast to countries such as Greece, Japan, Italy and the US, which are all far short of 0.7%. However, the low figure for the US excludes the significant private flows of aid that originate in the US and are not captured in the ODA measure. For further analysis of UK development aid, see chapter 7 of the 2012 Green Budget.<sup>34</sup>

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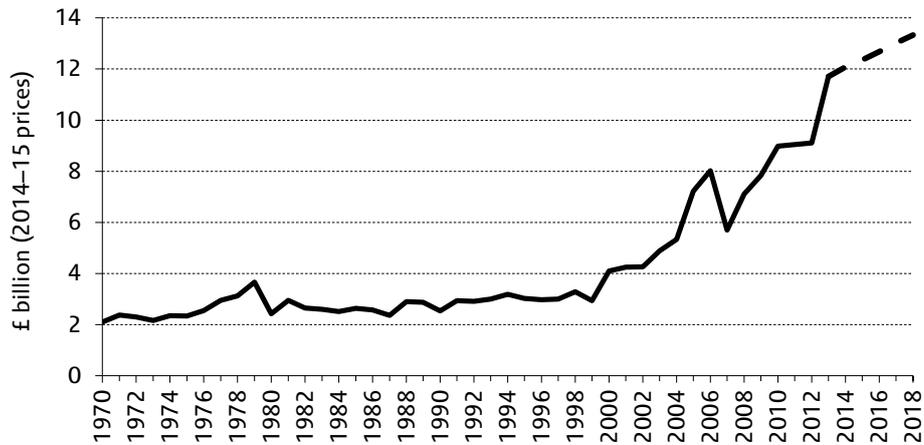
<sup>32</sup> This was confirmed in the 2007 Comprehensive Spending Review, [http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/d/pbr\\_csr07\\_complereport\\_1546.pdf](http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/d/pbr_csr07_complereport_1546.pdf).

<sup>33</sup> Source: Department for International Development, <https://www.gov.uk/government/publications/provisional-uk-official-development-assistance-as-a-proportion-of-gross-national-income-2013>. Official development assistance is defined by the OECD at <http://www.oecd.org/dac/stats/officialdevelopmentassistancedefinitionandcoverage.htm>.

<sup>34</sup> E. Fitzsimons, D. Rogger and G. Stoye, ‘UK development aid’, in C. Emmerson, P. Johnson and H. Miller (eds), *The IFS Green Budget: February 2012*, Institute for Fiscal Studies, London, 2012, [http://www.ifs.org.uk/budgets/gb2013/GB2012\\_Ch7.pdf](http://www.ifs.org.uk/budgets/gb2013/GB2012_Ch7.pdf).

Figure 3.15. Official development assistance, 1970–2018

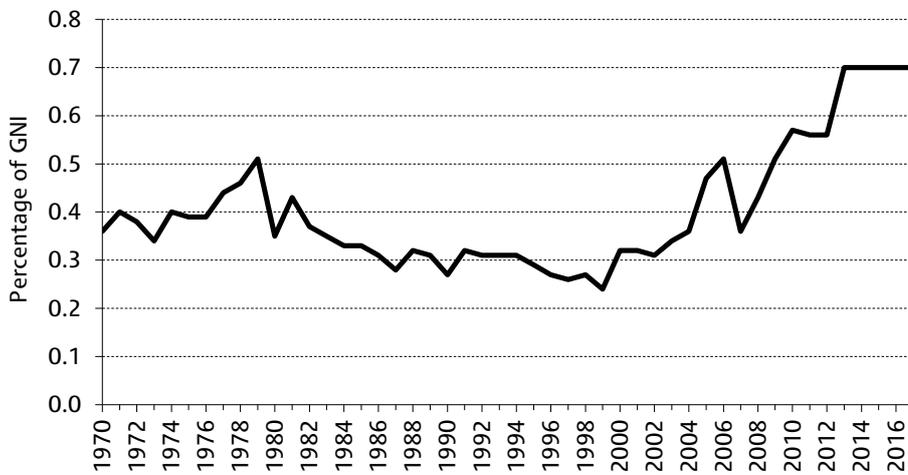
a. Real terms



Note: Forecast assumes that ODA remains at 0.7% of GNI in future, and GNI is assumed to grow in line with the Office for Budget Responsibility’s March 2014 forecasts for GDP growth. Calendar year deflators from HM Treasury.

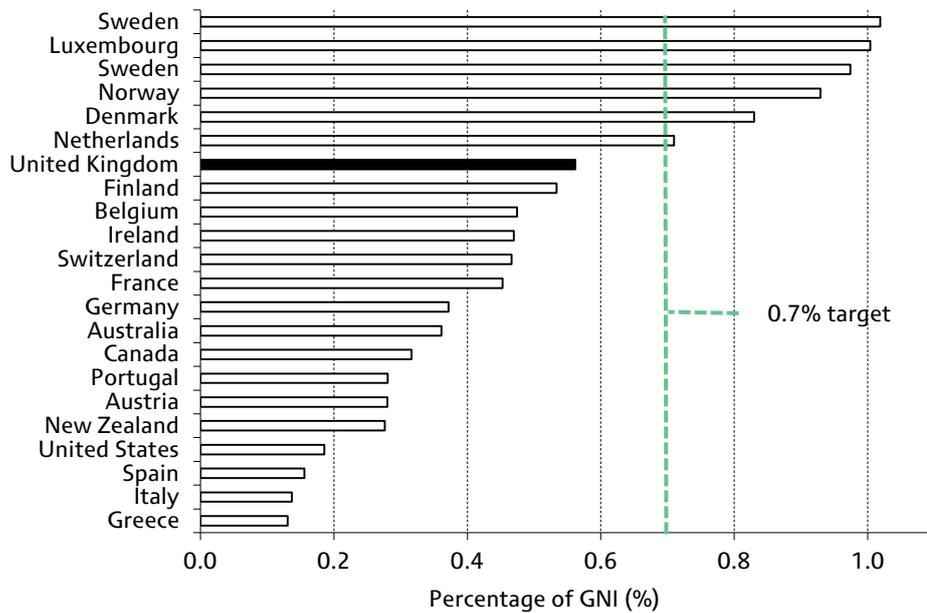
Source: *Provisional UK Official Development Assistance as a Proportion of Gross National Income 2013*, April 2013, <https://www.gov.uk/government/publications/provisional-uk-official-development-assistance-as-a-proportion-of-gross-national-income-2013>.

b. Share of gross national income



Source: As for Figure 3.15a.

Figure 3.16. ODA given by the UK and other countries as a percentage of gross national income, 2012



Source: OECD, <http://www.oecd.org/dac/stats/TAB04e.xls>.

## 4. Planning UK public spending

This section describes how public spending is defined and planned in the UK.

### 4.1 Elements of TME

For planning purposes, total managed expenditure (TME) is divided into two components:

- **Departmental expenditure limits (DELs)** cover spending that the government argues can be controlled rather than being driven by demand. For example, most spending on the NHS, transport and education falls into this category. DELs are supposedly ‘firm limits’ for departments’ spending, set several years in advance. Since 1998, they have been determined in Spending Reviews, which have typically been held once every two or three years. The most recent was ‘Spending Review 2013’, which set departmental limits for the financial year 2015–16.
- The remainder of spending is allocated annually. It is known as **annually managed expenditure (AME)**. The major components of AME are social security payments, debt interest, and spending by local authorities. These components are the ones that are more difficult to plan in advance, though the government can (for example) control social security spending by changing the qualification criteria or generosity of particular benefits. Currently, the Office for Budget Responsibility (OBR) publishes forecasts for AME based on announced policies; since the 2014 Budget, these forecasts have been supplemented with a cap, which applies to some elements within AME. This annual cap is discussed in Section 5.4.

In 2013–14, DELs accounted for 51.8% of TME, with AME accounting for 48.2%.<sup>35</sup> Between 1998–99 and 2009–10, DELs grew at an average rate of 4.7% per year while AME grew at an average 3.6% per year. However, DELs are being affected disproportionately by the spending cuts planned until 2018–19: the OBR has forecast that DELs will fall by an average rate of 2.7% a year between 2009–10 and 2018–19, whereas AME will increase by an average of 2.2% a year over the same period.<sup>36</sup>

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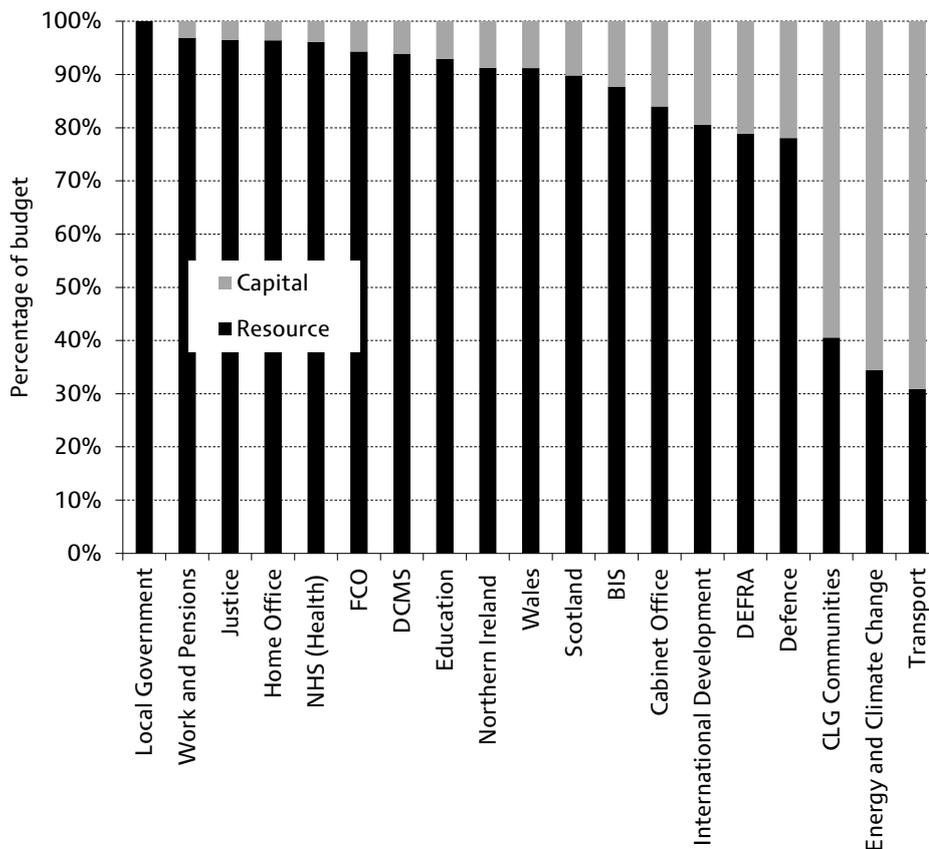
<sup>35</sup> This is after adjusting for some large transfers between DEL and AME – such transfers make it difficult to obtain a consistent series for these going back in time.

<sup>36</sup> This is on the basis of the OBR’s assumption that no further policy changes to either taxes or welfare spending will be made beyond those already announced.

## Capital and resource spending

Both AME and DELs are divided into one budget for capital spending (i.e. for spending that adds to the public sector’s fixed assets) and another for spending on other items, known as ‘resource’ spending. A department cannot transfer funds from its capital budget to its resource budget, although it can transfer money in the other direction; this separation of DELs into non-fungible capital and resource components was designed to encourage departments to undertake the public investment they were budgeted to do.

Figure 4.1. Departmental expenditure limits for each department, 2013–14, ranked in order of capital intensity



Note: BIS is the Department for Business, Innovation and Skills; DCMS is the Department for Culture, Media and Sport; DEFRA is the Department for Environment, Food and Rural Affairs; FCO is the Foreign and Commonwealth Office. The ‘Northern Ireland’ category refers to the Northern Ireland Executive and does not include the Northern Ireland Office. Resource budgets exclude depreciation. The CLG Communities budget is adjusted for £10.9 billion of extra resource spending, to reflect local authorities’ new powers to retain business rates. Defence budget *includes* the cost of operations. Business, Innovation and Skills budget is adjusted by –£0.3 billion capital DEL to remove financial transactions associated with the Green Investment Bank. Budget for CLG Communities is adjusted to remove £0.8 billion of capital financial transactions.

Source: HM Treasury, *Public Spending Statistical Analyses 2014*,

<https://www.gov.uk/government/publications/public-expenditure-statistical-analyses-2014>.

Figure 4.1 shows the division of total DELs by department for 2013–14, the most recent year for which actual (as opposed to planned) allocations are available. Overall, 11.4% of departments’ total DELs was allocated to capital spending,

though there are vast differences in capital intensity across departments. The most capital-intensive are the Communities budget of DCLG and the Departments for Energy & Climate Change and Transport, with their capital DELs accounting for around two-thirds of their total DELs. On the other end of the scale is the Local Government budget of DCLG, of which none was allocated as capital DEL.

The distinction in DELs between capital and non-capital spending has given the government the ability to target each type of spending separately. When the Labour government introduced the distinction, long-standing underinvestment in the public sector was seen as a problem, and the ‘ring fencing’ of capital DELs helped to correct this. However, this separation did not stop capital spending being cut sharply between 2010–11 and 2012–13 (as discussed further in Section 5.1). This approach also has the potential disadvantage that if departments have a certain proportion of their budgets set aside for capital spending, irrespective of the benefits of that capital spending relative to the current spending that could be done in its place, then a situation could arise in which capital spending projects of low value to the public get commissioned while current spending ones of higher value do not.

## 4.2 How and when is spending allocated?

The Labour government implemented the current system of Spending Reviews, where DELs are formally fixed for a number of future years. Table 4.1 lists all UK Spending Reviews along with the dates for which departmental limits were set. There has in the past been some overlap between two consecutive Spending Reviews – for example, the Spending Review of July 2002 revised plans already made for the 2003–04 tax year. This has not, however, been the case for the three most recent reviews.

Table 4.1. Spending Reviews

<b>Date of Spending Review</b>	<b>Number of years covered</b>	<b>Dates for which departmental limits set</b>
July 1998	3	April 1999 – March 2002
July 2000	3	April 2001 – March 2004
July 2002	3	April 2003 – March 2006
July 2004	3	April 2005 – March 2008
October 2007	3	April 2008 – March 2011
October 2010	4	April 2011 – March 2015
June 2013	1	April 2015 – March 2016

The overall TME envelope is set in advance of a Spending Review, usually in the preceding Budget; the Spending Review then allocates resources between DEL and AME and splits the DELs by department. In some cases, departmental budgets have been announced in advance of the Spending Review (for example,

protection for the NHS and schools was announced in the 2013 Budget), and so the Spending Reviews allocate what is left.

The spending plans set out in the Spending Reviews are fairly fixed, though in the past when the public finances turned out to be stronger than anticipated, departmental spending was often topped up. Top-ups are much less common in the current economic climate than they were in the early 2000s, and indeed the 2013 Autumn Statement announced that 1% would be cut from most departments' resource DELs in 2015–16. These plans for 2015–16 spending had been announced just six months earlier.

If departments spend more than they are initially allocated, they can face penalties.<sup>37</sup> If a particular project is turning out to be more expensive than planned for, departments can request extra funds from the 'reserve'. This is a cash amount set aside at each Budget for these unanticipated overspends, allocated with approval from the Treasury.

Because of recent pressures to cut overall public spending, in the past few years departments have actually tended to underspend relative to their initial allocations set out in the Spending Reviews. An underspending department can use the process of 'budget exchange' to allow a transfer of resources to the following financial year, though with two conditions. The first is that the transferred resources must be below a certain cap (proportional to the size of the department) and the second is that the request for a transfer must be made before final spending plans are set out to parliament in the February 'supplementary estimates' (i.e. shortly before the end of the financial year). Beyond February, the department effectively 'loses' any unspent funds. This system is designed to allow departments flexibility in their plans, but not to allow them to carry forward unplanned underspends.

### 4.3 How did we get to this method of planning public spending?

Gordon Brown introduced the division of public spending into DELs and AME in 1998. It represented the next step in a gradual evolution in the planning of public spending that has been under way since the early 1990s. This evolution has seen a lengthening of the time horizons of public spending planning and an increased focus on controlling departmental spending, and is a development of previous techniques to try to minimise the extent to which the public spending framework produces inefficient incentives for departments.

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<sup>37</sup> Although in practice this is extremely rare, there is evidence that the limits are binding; even in the recent climate of real-terms cuts to budgets, departments have been underspending relative to their set limits. For the OBR's assumptions regarding departmental underspends, see page 128 of OBR, *Economic and Fiscal Outlook*, March 2014, <http://budgetresponsibility.org.uk/economic-fiscal-outlook-march-2014/>.

Prior to 1992, public spending was set annually, usually following bilateral negotiations between the Treasury and each spending department. This approach had two main disadvantages. First, it was difficult to take a strategic decision on the overall level of public spending or on the priorities within the total. Second, the lack of distinction between cyclical and non-cyclical components meant that spending might be allowed to ‘creep up’ following recessions as falls in cyclical spending masked increases in discretionary spending, or increases in cyclical spending during recessions could potentially crowd out other worthwhile programmes, particularly public investment.

In 1992, the system was reformed to give the government greater power to manage aggregate public spending in a ‘top-down’ way and to create a greater distinction between cyclical and non-cyclical spending. Over each summer, the government set out the ‘control total’, or the sum of each department’s total planned spending for the next three fiscal years. This was a step towards the current distinction between DELs and AME, as it was intended to create a distinction between cyclical and non-cyclical spending. The control total roughly corresponds to DELs today, although it included several components of spending that are currently included in AME, such as predictable parts of social security spending including child benefit and the basic state pension. Therefore the control total represented a much higher fraction of total spending than do DELs today (85% compared with just over 50% in 2013–14).<sup>38</sup>

To allow some flexibility for public spending to react to unanticipated events, each year’s planned control total included a reserve, which was not allocated to individual departments. This reserve was allocated as extra spending or removed from the spending plans altogether in the Budget prior to the spending year in question, though any department that failed to spend its control total in a given year lost the unspent money. In many respects, the control total can be regarded as a forerunner of the Labour government’s DEL approach.

The Labour government came into power in 1997 and claimed that this way of planning public spending led to underinvestment (or inefficient investment) in public services. Its three major criticisms can be summarised as follows:

1. The second and third years of the spending limits set annually were only indicative, and were frequently revised upwards, creating an uncertain environment for departments to plan expenditure.
2. The lack of distinction between current and capital spending invited departments to cut back on investment when times were tight instead of cutting current spending – in other words, avoiding short-term pain at the longer-term cost of underinvestment in public services.

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<sup>38</sup> Source: Chapter 6 of A. Dilnot and C. Giles (eds), *Options for 1997: The Green Budget*, IFS, London, October 1996; PESA 2014; ONS series for TME: JW2Q, JW2S and JW2Z.

3. The inability of departments to carry cash forward to the next financial year encouraged a ‘use it or lose it’ mentality, which resulted in some wasteful spending.

In response, Labour imposed a new fiscal framework. Its response to each issue listed above was as follows:

1. It set ‘firm and fixed’ totals at each Spending Review (though, as mentioned above, these were sometimes adjusted).
2. It imposed the separation of capital and resource budgets.
3. It introduced ‘end-of-year flexibility’ in 1998, so that rather than losing any unspent funds, departments could now transfer as much money as they wanted to subsequent financial years.

This third action had surprisingly little effect on the proportion of departmental spending occurring at the end of a financial year, and it allowed departments to accumulate large entitlements to their unspent resources. In 2011 the coalition government introduced a new ‘budget exchange’ regime, which imposed a cap on the amounts that could be moved between years.

Under the Labour system, a distinction was made between DEL and AME, where AME was defined as spending that could not ‘reasonably be subject to firm, multi-year limits’.<sup>39</sup> AME was not capped, as the intention was to control it on a discretionary basis. The coalition government has since argued that this approach was flawed, and has imposed a ‘welfare cap’, setting a cash limit on a large slice of spending on social security spending and tax credits, which is a large component of AME spending. This will be discussed in greater detail in Section 5.4.

## 4.4 Measuring public spending

### Resource accounting and budgeting

Until the end of the 1990s, spending was listed in a department’s budget in the year in which it took place. Public spending was either ‘current’ or ‘capital’, the former being spending on items such as wages and the latter being spending on fixed items such as buildings, vehicles and machinery. In 1996, the government decided to change from cash-based budgeting to **resource accounting and budgeting (RAB)**, for consistency with the European System of Accounts. The aim of RAB is to provide an accurate account of a department’s *underlying financial position* in any given year, rather than a snapshot of how much cash went into/out of that department. For instance, depreciation of fixed assets does not show up in cash-based spending plans, because the department is not

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<sup>39</sup> HM Treasury, National Archives, [http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/spend\\_plancontrol.htm#Departmental\\_Expenditure\\_Limits\\_DEL\\_and\\_Annually\\_Managed\\_Expenditure\\_AME](http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/spend_plancontrol.htm#Departmental_Expenditure_Limits_DEL_and_Annually_Managed_Expenditure_AME).

literally paying cash for it each year. But it is a genuine annual cost that worsens the department's asset position. If, for example, a department buys an item of machinery worth £10 million that has a resale value of £0 at the end of 10 years, then (under 'straight-line' depreciation) the department 'loses' £1 million-worth of machine each year, although the loss does not take the form of a cash payment. RAB takes this loss into account.

The move to RAB took place in two stages. In Spending Review 2000, the DELs were given on an 'accruals' basis. Under accruals accounting, costs and revenues are matched to the years in which they occurred, as opposed to the years in which the cash entered or left the department. The second stage was the incorporation of non-cash costs, such as depreciation and 'cost of capital' charges (which reflect the opportunity costs of holding capital), into resource DELs. This happened in the 2002 Spending Review.

All current spending is in the **resource budget** (resource DEL + resource AME). Unlike the old current budget, the resource budget includes the costs of depreciation, 'cost of capital' charges, provisions for future costs, and grants paid to the private sector.

The **capital budget** (capital DEL + capital AME) includes only departmental spending on items that create new assets on the balance sheet of the *government*. Grants to non-governmental organisations to fund those organisations' investments are not included, because the grants do not change the government's net asset position.

## Clear line of sight

In 2007, the government announced the 'Clear Line of Sight' (CLOS) project, which aimed to clarify and simplify the existing range of measures of public spending. The three main measures to be harmonised were the figures published by the Treasury at each fiscal event (also used by the government internally to control spending), the February supplementary estimates, which were the spending totals approved by parliament, and the resource accounts, which record what has been spent after the event. Before 2010, these measures were quite different from each other, with each on a different basis, including and excluding different components of public spending.

CLOS was implemented from 2010 and consolidated the three main measures of public spending, so that each would include the same budgets and parliament would approve the same measure that was actually used by the government to control spending. From 2011–12, the supplementary estimates, departmental budgets and (with a few exceptions) resource accounts were presented on the same, comparable basis. This will allow greater within-year comparability of public spending measures and help to achieve consistent information on public spending.

## How the various parts of TME relate to the fiscal aggregates

The resource budget of all government departments measures the government's spending on various current items. It is closely related to public sector current expenditure (PSCE). The connection between these fiscal measures is shown in Figure 4.2. Similarly, capital DELs and capital AME relate to public sector net investment (PSNI), as shown in Figure 4.3.

Figure 4.2. The components of public sector current expenditure

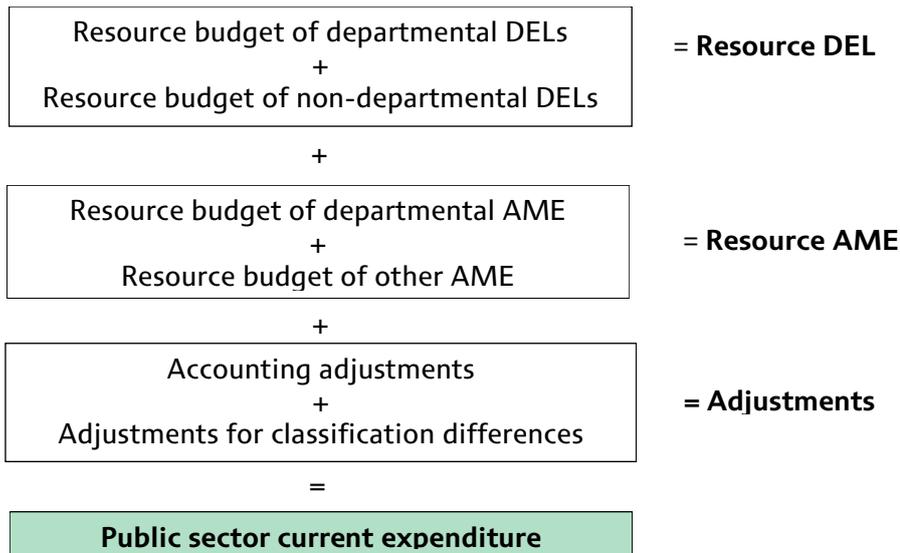
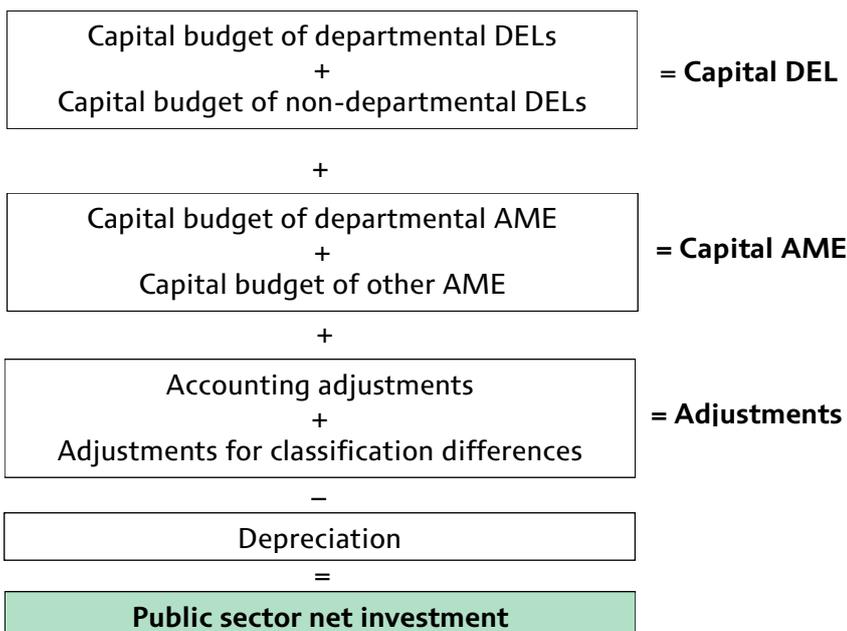


Figure 4.3. The components of public sector net investment



Figures 4.2 and 4.3 show the components of PSCE and PSNI, as defined by HM Treasury. However, the OBR also publishes components of PSCE and PSNI, using slightly different definitions of DEL and AME. For example, the OBR splits public sector current expenditure into 'PSCE in RDEL' and 'PSCE in AME'. 'PSCE in AME' is similar to the Treasury's definition of AME but also includes some additional accounting adjustments. 'PSCE in RDEL' is similar to the Treasury's definition of resource DEL (RDEL) but excludes some items of spending that HM Treasury would include in RDEL. The OBR defines public sector gross investment as the total of 'PSGI in CDEL' and 'PSGI in AME', less depreciation. 'PSGI in CDEL' excludes items that HM Treasury includes in capital DEL (CDEL), such as single-use military expenditure and net lending to the private sector.<sup>40</sup> In practice, the difference between the two sets of measures can be fairly small; in 2013–14, the difference between HM Treasury's RDEL (excluding depreciation) and PSCE in RDEL was £0.5 billion.

**Total managed expenditure** is the sum of public sector current expenditure, public sector net investment and depreciation.

Public sector current expenditure plus depreciation, when subtracted from public sector current receipts, gives the **current budget surplus**. So an increase in resource spending that increases public sector current expenditure (or depreciation) will reduce the current budget surplus.

**Public sector net borrowing** in a given year reflects the difference between PSNI and the current budget surplus (or, equivalently, the difference between TME and current receipts). So a larger amount of capital spending in a given year adds to public sector net borrowing and increases the public sector net debt ratio.

## One-off adjustments

In order to understand the path of public spending over time, it is necessary to separate underlying trends from the effects of large one-off transactions. The major distortive transactions of recent years are described below, and can broadly be separated into financial sector interventions following the financial crisis and sales of large public sector assets.

### *Financial sector interventions*

The government responded to the financial crisis by spending large sums of money injecting capital into banks on the verge of collapse and temporarily taking some financial organisations into public ownership. Most of this spending represented only a temporary injection into the private sector, in that when the

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<sup>40</sup> For a reconciliation of the HM Treasury and OBR definitions of RDEL and PSCE in RDEL, and CDEL and PSGI in CDEL, see table 2.14 in the Fiscal Supplementary Tables of the Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2014, <http://budgetresponsibility.org.uk/economic-fiscal-outlook-march-2014/>.

government unwinds its investment in the financial sector, it will recoup at least some of the money spent.

Including these temporary financial interventions in the spending figures makes it harder to see underlying trends and real changes to spending policy. This is why the OBR and the Office for National Statistics (ONS) publish spending figures excluding these one-off changes, and borrowing and debt figures both excluding and including these interventions. We favour the measures that exclude the interventions, as these give a better indication of underlying trends in spending and the public finances.

### *Large one-off asset sales and transfers*

The most recent major sales of public assets (which we adjust for in this briefing note) are the sales of the 3G and 4G spectrums and the transfer of Royal Mail's pension assets to the public sector.

The government raised £23.5 billion from the sale of the 3G spectrum in 2000–01, and £2.3 billion was raised from the sale of the 4G spectrum in 2012–13. These counted in the National Accounts as sales of a public asset – in other words, negative public sector investment. Although these sales did represent the loss of an asset (and a windfall gain) to the government, including them in PSNI makes this measure look artificially low in the sale years, masking the underlying trends, and it also has no bearing on the quantity or quality of public services provided (in contrast to, for example, the case of the government deciding to sell a large number of schools, which would have a more direct effect on the quality and quantity of public services provided; thus there would be a stronger argument for including this in the headline measures).

When Royal Mail's pension assets were transferred to the public sector in 2012–13, this counted as £28 billion of negative investment. Although the assets transferred reduced public sector net borrowing in 2012–13, there are corresponding future liabilities, which are larger than the assets and which do not appear in the figures. The liabilities will have to be met at some point in the future, and so including the transfer of the assets as negative investment not only distorts investment trends but also gives a misleading impression of the state of the public finances.

## 5. Current issues in public spending

### 5.1 Public spending cuts

The financial crisis and associated recession meant that a significant fiscal consolidation became necessary to restore the public finances to a sustainable long-run path.<sup>41</sup> With no policy action since the 2008 Budget, based on the OBR's forecasts in March 2014, spending would have been 46.8% of national income by the end of the forecast horizon in 2018–19, well above its historical average.

The coalition outlined its response to the problem shortly after it came to power in May 2010, announcing extra in-year cuts of £6.2 billion and, in the June 2010 emergency Budget, a five-year 'consolidation' package. The latter was expected to reduce the permanent difference between revenues and current spending to zero by the end of 2015–16. Total spending was forecast to return to 39.8% of national income by 2015–16, just below its share in 2004–05.

Since the June 2010 Budget, the UK economy has performed considerably worse than expected. Weaker economic growth has depressed tax receipts and raised the same cash spending plans to a higher share of national income. The government's response has been largely to extend the length of the consolidation package further into the next parliament, rather than increase the size of the spending cuts during the current parliament. In the 2013 Autumn Statement, extra spending cuts were pencilled in for the next parliament (in 2018–19) even though there was no increase in the size of the fiscal hole to be filled. The coalition's plans for spending, as of the March 2014 Budget, are to bring TME to 37.8% of national income by 2018–19, only slightly above its share in 2001–02.

The overall changes in TME mask significant differences in the distribution of the cuts and a changing structure of the state. This change is happening in three main ways. First, the emphasis of spending is moving away from the provision of public services and towards spending on social security. Second, as the cuts within DELs and within AME are unevenly distributed, the balance of services and the types of benefits that the state provides are changing. Third, capital spending has been cut relative to current spending.

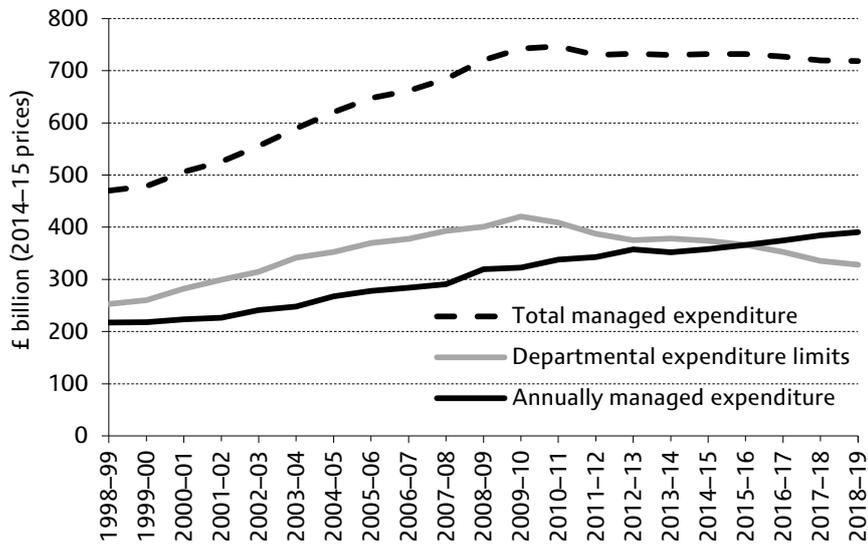
Figure 5.1 illustrates the first change, by showing the profile for total public spending up to 2018–19 and the relative decline in DELs as a share of total spending. Real increases in AME and real cuts to DELs mean that, whereas DELs made up 56.6% of TME in 2009–10, by 2018–19 they are forecast to represent 45.6% of TME. If we think of DELs as (broadly) spending on public services and

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<sup>41</sup> C. Emmerson, S. Keynes and G. Tetlow, 'Public finances: outlook and risks, in C. Emmerson, P. Johnson and H. Miller (eds), *The IFS Green Budget: February 2013*, Institute for Fiscal Studies, London, 2013, [http://www.ifs.org.uk/budgets/gb2013/GB2013\\_Ch5.pdf](http://www.ifs.org.uk/budgets/gb2013/GB2013_Ch5.pdf).

AME as spending on social security and debt interest, Figure 5.1 represents a shift towards the latter.

Figure 5.1. Spending, 1998–99 to 2018–19



Note: Data in the figure are adjusted to transfer £11 billion in 2013–14 and 2014–15, £12 billion in 2015–16 and 2016–17 and £13 billion in 2017–18 and 2018–19 from AME to DEL to offset effects of the business rates retention policy. DELs up to 2015–16 have been explicitly set in Spending Reviews, but beyond this DELs are the residual of TME and AME as forecast by the OBR. Source: TME from ONS series KX5Q. Historical DEL taken from HM Treasury, *Public Expenditure Statistical Analyses 2014* and previous PESAs. Deflators derived from ONS series for real and nominal GDP (ABMI and YBHA).

Even within AME and DELs, cuts have been highly uneven. Section 3.1 showed that, within AME, spending on pensioner benefits has been protected relative to spending on working-age benefits, though both are increasing in real terms between 2010–11 and 2018–19. Figure 5.2a shows real-terms DELs in 2010–11, 2012–13 and 2015–16, while Figure 5.2b describes how the overall cut to DELs has been allocated across departments. DELs are only known up to 2015–16, as they have only been set up to that financial year; detailed plans for 2016–17 and beyond will be set out by the next government.

Up to 2015–16, the balance of spending has been shifting towards health, schools and official development assistance spending (though the last of these is still a tiny fraction of overall spending), as the coalition agreement in 2010 contained a commitment to protect spending on these areas. This commitment to protect such a significant proportion of overall spending (approximately 40% of DELs in 2010–11) turned an average annual real cut across all departments of 2.2% between 2010–11 and 2015–16 into an average annual cut across unprotected departments of 4.5%.

Figure 5.2a. Real departmental expenditure limits in 2010–11, 2012–13 and 2015–16 (2014–15 prices)

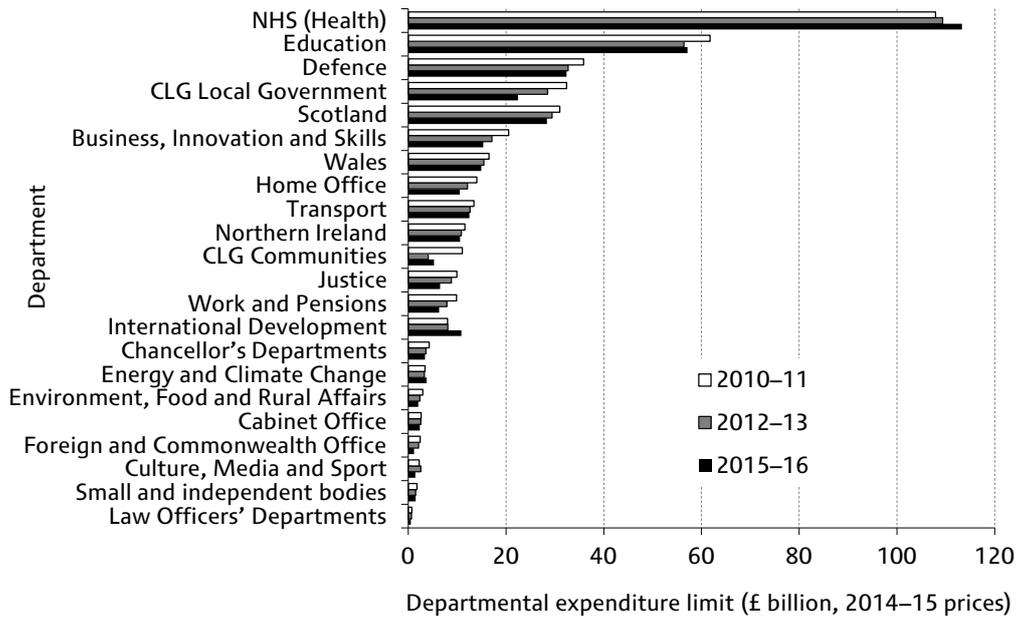
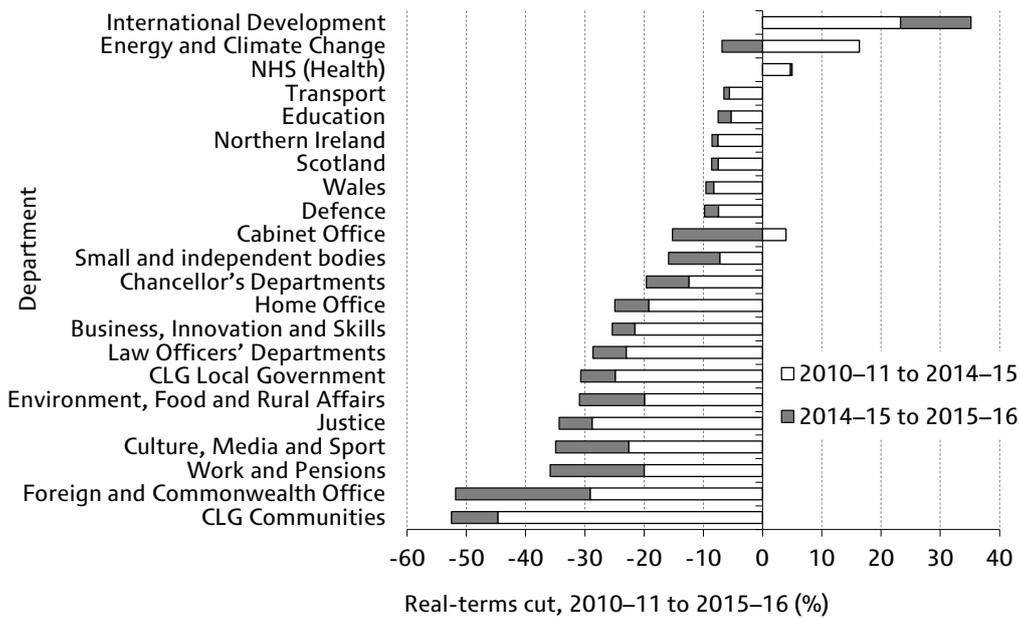


Figure 5.2b. Distribution of real spending cuts across departments

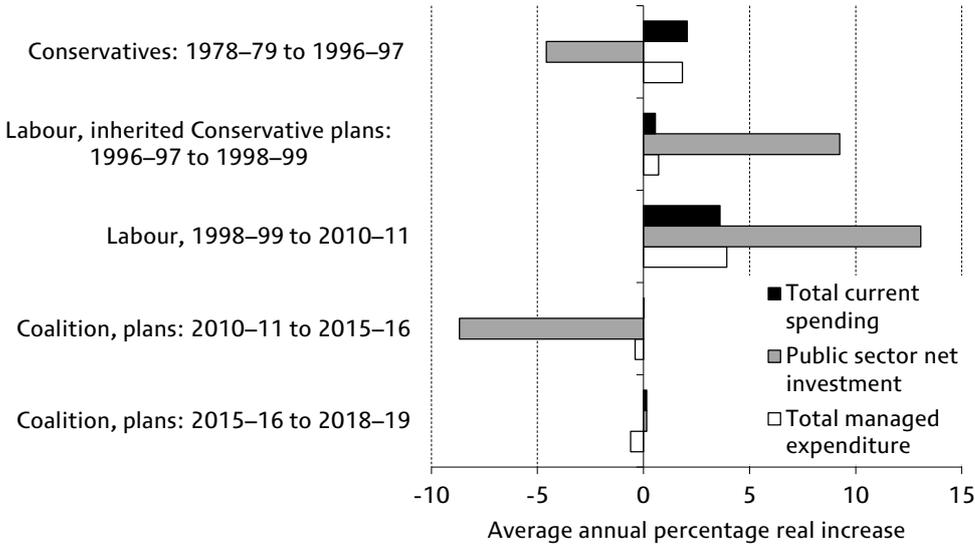


Note: The Personal Social Services budget is included within the CLG Local Government budget for all years shown. Prior to 2013–14, spending within DWP RDEL is adjusted to be transferred to CLG Local Government, and the Scotland and Wales budgets are adjusted to get a consistent series over time. Defence DEL excludes spending on the ‘cost of operations’, as in later years this is included in the ‘special reserve’ (not shown). BIS DEL is adjusted by –£0.3 billion in 2013–14, –£0.7 billion in 2014–15 and –£1.6 billion in 2015–16 to remove financial transactions associated with the Green Investment Bank. Budget for CLG Communities is adjusted to remove £0.8 billion of capital financial transactions in 2013–14 and £1.6 billion in 2014–15, and to add £0.5 billion in 2015–16. The sum of DEL across departments does not equal total DEL due to these adjustments. Source: HM Treasury, *Public Spending Statistical Analyses 2014*, <https://www.gov.uk/government/publications/public-expenditure-statistical-analyses-2014>.

Figure 5.2 shows how the NHS budget will have increased on average in real terms, in stark contrast to the Communities and the Foreign and Commonwealth Office budgets, both of which will have seen real cuts of over 50% by the end of 2015–16. To give an idea of the magnitude of the shift in the emphasis of what the state does, in 2009–10, £1 in every £4 allocated to departmental spending was spent on the NHS; if real-terms protection continued up to 2018–19, by then health spending would represent £1 in every £3.

There has been a shift in the prioritisation of capital and current spending since the beginning of the coalition government. The 2010 Spending Review planned to cut investment spending by departments in real terms by 15.9% over the four years up to 2014–15 (compared with a 7.3% cut in departmental current spending), whereas the 2013 Spending Review announced a 0.5% real increase in departmental investment spending alongside a further 2.5% real cut in departmental current spending in 2015–16. Further cuts to departmental budgets announced in the 2013 Autumn Statement, alongside extra funding for departments such as the Department for Energy and Climate Change, mean that the relative cuts described above hide this picture. Figure 5.3 puts the departmental cuts between 2010–11 and 2015–16 in the context of overall spending by previous governments, illustrating the stark difference between the coalition’s spending plans and those of other governments over the last 35 years. By the end of 2013–14, 43.5% of the planned cuts to public spending had been implemented, and the government was four years through a planned nine-year squeeze. Decisions so far have altered the structure of the state, towards spending on pensioner benefits, health and schools, and away from areas such as investment, public order and safety, and social security for the working-age population. It remains to be seen how the next government will distribute the cuts planned for after the next election.

Figure 5.3. TME, current spending and investment spending



Source: As for Table 3.2.

## 5.2 Public sector net investment in context

Changes in investment spending can happen for several reasons:

- **Need** – investment might fall sensibly with privatisation of previously nationalised industries as the private sector would invest instead of the government.
- **Cost-benefit ratios** – investment is more likely to take place when there are projects with low costs and/or high benefits and when government can borrow cheaply to raise the funds.
- **Financial constraints** – the government might be constrained by its own total spending plans or fear that the markets might judge that spending is unsustainable.
- **Politics** – short-termist policymakers may choose lower investment, worried that their opponents will reap the rewards. Alternatively, the existence of ‘pet projects’ may stimulate investment.

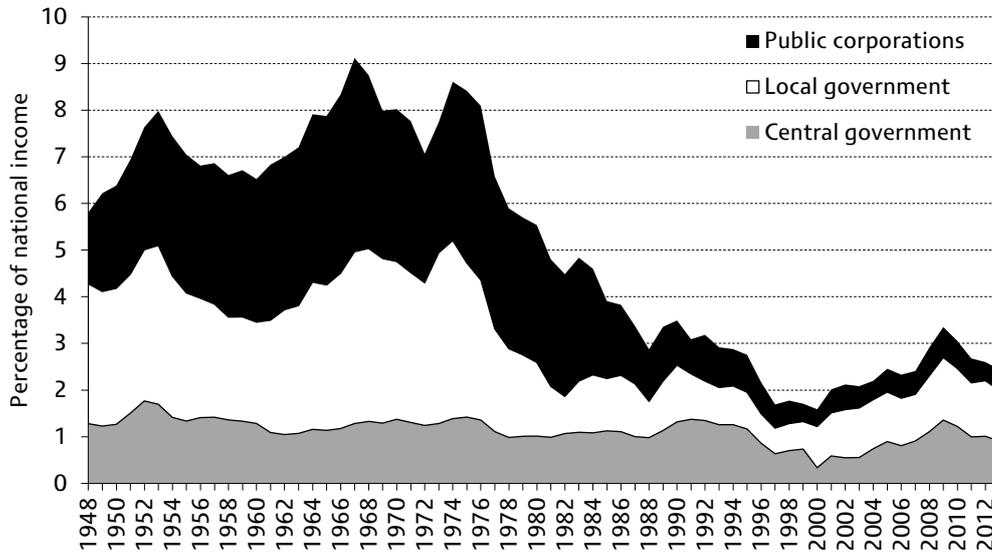
Following the financial crisis and associated recession, the Labour government brought forward investment spending to act as a temporary fiscal stimulus, and public sector net investment as a share of national income rose from 2.2% in 2007–08 to 3.4% in 2009–10. In 2010–11, the reversal of the temporary boost to investment spending, combined with pressure to cut overall spending, led PSNI to fall from its 2009–10 peak to 1.6% of national income by 2012–13. Figure 5.5 later puts this fall in historical context, showing that the overall decline in PSNI that has happened since 2009–10 is small relative to the fall since the early 1970s.

Figure 5.4 presents an indicator of public sector investment – ‘gross fixed capital formation’ – split by which public sector institution is doing the investment. It shows that the first ‘wave’ of decline in public sector investment, in the 1970s, was attributable to the fall in investment by local authorities. The main causes of this drop in local authorities’ investment were the transfer of public housing to private ownership and the decline in the building of new council houses. Public corporations were the chief source of the next wave of public investment decline, owing to the privatisation of nationalised industries and utilities in the 1980s. The third wave reflected a squeeze in central government investment from 1991 to 2000.<sup>42</sup>

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<sup>42</sup> For more information on the history of investment spending, see T. Clark, M. Elsby and S. Love, ‘Twenty-five years of falling investment? Trends in capital spending on public services’, IFS Briefing Note 20, November 2001, <http://www.ifs.org.uk/bns/bn20.pdf>.

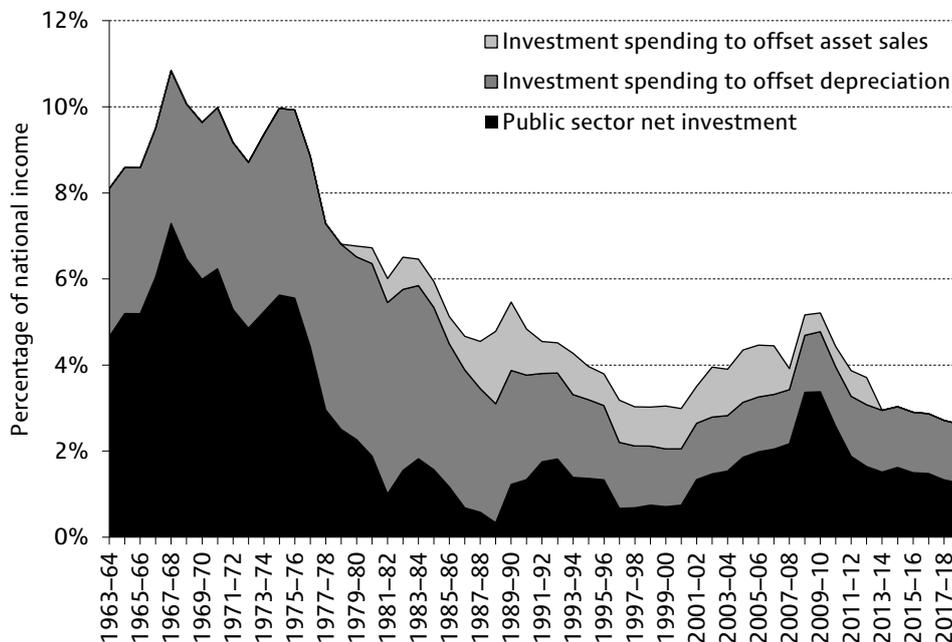
Figure 5.4. Gross fixed capital formation by the public sector as a share of national income, 1948 to 2013



Note: The data in 2005 are adjusted for the transfer of nuclear reactors from British Nuclear Fuels (a public corporation) to the Nuclear Decommissioning Authority (classified as central government).

Source: UK Economic Accounts, series NMOA, NMES, FCCJ and BKTL.

Figure 5.5. The components of gross publicly sponsored investment as a share of national income, 1963–64 to 2018–19



Source: Depreciation and PSNI are from the ONS series JW2S and JW2Z (July 2014 Public Finances Supplementary Tables), with projections consistent with the March 2014 *Economic and Fiscal Outlook*. Asset sales are from HM Treasury, *Public Expenditure Statistical Analyses* and the OBR's Fiscal Supplementary Tables of the March 2014 *Economic and Fiscal Outlook*.

The Labour government, on coming to power in 1997, argued that this third wave of reductions in investment resulted in an accumulation of overdue maintenance work on the public sector's assets.<sup>43</sup> The government also wanted to invest in new assets to fulfil its aim of creating 'world class public services', and to this end the government increased public sector investment from 2000 onwards and, as can be seen in Figure 5.4, investment by central and local governments rose steadily over the 2000s.

Figure 5.5 shows the level of public sector net and gross investment over time including projections forward to 2018–19. PSNI is a different measure of investment from 'gross fixed capital formation' (shown in Figure 5.4), as it takes into account natural depreciation, and can be thought of as the amount by which the government is adding to its capital stock.

Figure 5.5 does not include estimates of PFI-financed investment, i.e. investment financed initially by the private sector on behalf of the government. Although this form of investment represents a non-negligible share of overall investment, it is not enough to offset the long-term decline in public sector net investment shown in Figure 5.5.<sup>44</sup> Figure 5.5 shows the dramatic decline in PSNI after the temporary boost in 2009–10, to a share of national income in 2013–14 last seen 10 years previously, in 2003–04. This is despite capital budgets being ring-fenced in the public spending planning process described in Section 4.3. However, the cuts to investment spending do seem to have been halted, so that investment spending as a proportion of national income is now forecast to be broadly flat until the end of the forecast horizon.

Also shown on Figure 5.5 is how much of public sector investment takes place purely to offset the effects of depreciation, i.e. approximately half in 2013–14. PSNI on its own can be thought of as how much the government is adding to the stock of its assets, whereas the sum of PSNI and spending to offset depreciation is equal to public sector gross investment, or total spending on investment. Spending to offset depreciation has also fallen since the 1960s – for example, as the government sold a large portion of its stock of social housing wealth and was no longer responsible for offsetting the depreciation on those houses.

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<sup>43</sup> A 2000 HM Treasury paper asserted that under its predecessors 'capital programmes were cut as a way of meeting short-term current pressures, with long-term detrimental effects' (page 2 of HM Treasury, *Planning Sustainable Public Spending: Lessons from Previous Policy Experience*, London, 2000).

<sup>44</sup> See, for example, chart 2.3 of HM Treasury's 2002 Spending Review document, which shows PFI between when it began in the early 1990s and the mid-2000s (available at [http://webarchive.nationalarchives.gov.uk/20071204130111/http://hm-treasury.gov.uk/media/9/B/dis\\_whitepaper02.pdf](http://webarchive.nationalarchives.gov.uk/20071204130111/http://hm-treasury.gov.uk/media/9/B/dis_whitepaper02.pdf)).

## 5.3 Regional spending

England receives lower spending per person than the other nations of the UK, as a result of the 1888 Goschen formula. To address this perceived inequity, since 1978 spending allocations for the various countries of the UK have been determined by the **Barnett formula**. This formula is designed to apply proportionate shares of any cash increase (or decrease) in comparable English spending automatically to Scotland, Wales and Northern Ireland as well. For a given cash increase in spending on England, the other countries receive the same per-head cash increase. The population estimates specified in the formula are currently updated annually on the basis of mid-year population estimates. One of the effects of assigning the same cash increase per person to each country is that, when cash spending is rising over time in England, spending levels per capita will grow less quickly in Scotland, Wales and Northern Ireland, so will gradually converge across the UK.<sup>45</sup>

However, in the context of overall spending cuts, a given cut to spending in England will lead to a proportionately smaller cut to spending in the devolved administrations. For example, between 2010–11 and 2015–16, total DELs are set to be cut by 10.5% in real terms. However, over the same period, the DEL allocations for Scotland, Wales and Northern Ireland will face cuts of just 8.6%, 9.6% and 8.5% respectively.<sup>46</sup> With lower spending per head in England to begin with, this will lead to a *divergence* in overall spending per head, the opposite of the original intention of the formula.

Regional differences in spending per person may reflect a sensible allocation of spending. For example, some public services might require more spending in non-English territories than in England to achieve the same standard of public service, because service quality depends on population density, which is higher in England than elsewhere. Emergency healthcare, for instance, is harder to deliver to a widely dispersed rural population than to a metropolitan one. Likewise, low-density areas require more primary and secondary education spending than do high-density ones if pupils are to live within a reasonable distance of a school. Another factor might be differences in underlying conditions, such as the health of countries' populations. Age-standardised mortality rates in Scotland are higher than those in most regions of England, which might justify higher healthcare spending per capita.<sup>47</sup>

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<sup>45</sup> This will not, however, be true if the population of the other countries is growing significantly less quickly than the population in England. For more information on the Barnett formula, 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*, 2011, <http://www.ifs.org.uk/publications/5460>.

<sup>46</sup> Source: Public Expenditure Statistical Analyses, 2014.

<sup>47</sup> Source: Page 45 of Scottish Government, *Government Expenditure and Revenue Scotland 2011–12*, March 2013, <http://www.scotland.gov.uk/Topics/Statistics/Browse/Economy/GERS>

Spending on social protection is not determined by a central formula, but rather by individuals' incomes and circumstances. The distribution of benefit spending per head is therefore affected by regional differences in demographic structure and economic conditions.

Table 5.1 shows identifiable spending per head in the separate countries relative to the UK average (identifiable spending is spending that can sensibly be allocated to one particular country). The devolved administrations have higher identifiable spending per head than England: identifiable spending per head in each of the devolved nations is at least 12% higher than spending per person in England. Spending on both identifiable public services and social protection are higher in each of the devolved administrations than in England, with Northern Ireland displaying the largest difference compared to England, with more than 35% more spending per head on public services.

**Table 5.1. Identifiable spending per head by country of the UK, 2012–13**

	<b>Identifiable spending on public services per head (UK average = 100)</b>	<b>Spending on education per head (UK average = 100)</b>	<b>Spending on health per head (UK average = 100)</b>	<b>Spending on social protection per head (UK average = 100)</b>	<b>Total identifiable spending per head (UK average = 100)</b>
England	96	99	99	98	97
Scotland	122	105	109	107	116
Wales	108	99	101	113	110
Northern Ireland	130	113	109	116	124

Note: Identifiable spending on public services includes spending that can be allocated to a particular region on general public services, defence, public order and safety, economic affairs, environmental protection, housing and community amenities, health, recreation, culture and religion, and education. Total identifiable spending includes all identifiable spending on public services, as well as spending on social protection. Social protection is not the same as benefit spending, as it includes spending items such as public sector pensions, social services and personal care. Examples of spending that is not included in this analysis (about 14% of overall spending) include the majority of defence spending, overseas representation and spending on tax collection. The figures shown may differ slightly from those derived from GERS, which calculates regional spending for Scotland and the UK as a whole and allocates spending slightly differently from PESA.

Source: Table 9.15 of *Public Expenditure Statistical Analyses*, 2014.

and page 18 of Office for National Statistics, *Population Trends*, 134, Winter 2008, <http://www.ons.gov.uk/ons/rel/population-trends-rd/population-trends/no--134--winter-2008/index.html>. David Eiser has estimated that Scotland's relative needs for public spending on education and health are approximately 6% higher than England's needs, compared with higher actual spending in Scotland that he calculates to be 17%. This is based on Scotland's higher required health spending because its population has relatively poor health, combined with slightly lower per capita education spending needs, because Scotland has relatively few school-age pupils. Source: D. Eiser, 'Estimating Scotland's spending needs', Scottish Fiscal and Economic Studies, October 2013, <http://scotfes.com/2013/10/24/estimating-scotlands-spending-needs/>.

There is a significant body of recent research at IFS analysing public spending in Scotland, in the context of the 2014 referendum on Scotland's independence.<sup>48</sup> Some of the research describes Scotland's unusual situation of having both higher public spending and higher household income per person than the UK average – unusual since spending is typically higher in low-income areas. The research also shows that higher spending in Scotland on public services is driving much of the higher spending per head, with public service spending in Scotland in 2011–12 being £1,128 per person above the UK average of £6,803 (in 2013–14 prices).<sup>49</sup>

An investigation of social security spending in Scotland and Wales compared with the rest of the UK found that, in 2011–12, Wales spent £3,540 on benefits per person, compared with £3,238 in Scotland and £3,150 in England.<sup>50</sup> This situation is driven by several factors. First, there is a demographic aspect, with a higher concentration of pensioners in Scotland and Wales than in the UK as a whole, which dominates the offsetting effect of there also being relatively few children. Second, Scotland has a relatively high concentration of people receiving a disability benefit. Somewhat offsetting these two, spending on housing benefit is lower in Scotland than in both England and Wales because, although there are a similar fraction of claimants, average rents are lower in Scotland.

Beyond the spending plans already set out, and conditional on Scotland remaining in the UK, the path of overall spending could be determined entirely by a combination of the Barnett formula and varying demographics and economic circumstances. However, if devolved administrations were to exercise their tax-raising powers, as announced for Wales in November 2011 and as granted to Scotland via the 2012 Scotland Act, then extra revenues might be raised to increase spending per head further above that in England.

## 5.4 Spending caps

Since 1998, there has been a distinction between DELs and AME within overall spending. As described above, a cash cap on DEL is effectively set at each Spending Review. In contrast, AME is forecast on the basis of current policy, and so there has been no official 'cap', reflecting its initial definition by HM Treasury as spending that 'cannot reasonably be subject to firm, multi-year limits'.

However, as mentioned in Section 4.1, the government announced in the 2013 Spending Review that in future it would impose a nominal cap on certain elements of AME. The level of this cap was then set in the March 2014 Budget.

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<sup>48</sup> See [http://www.ifs.org.uk/research\\_areas/99](http://www.ifs.org.uk/research_areas/99).

<sup>49</sup> B. Deaner and D. Phillips, 'Government spending on public services in Scotland: current patterns and future issues', IFS Briefing Note BN140, September 2013, <http://www.ifs.org.uk/publications/6858>.

<sup>50</sup> D. Phillips, 'Government spending on benefits and state pensions in Scotland: current patterns and future issues', IFS Briefing Note BN139, July 2013, <http://www.ifs.org.uk/publications/6818>.

This section gives a brief summary of the design of the cap and some examples of spending caps chosen by other countries.<sup>51</sup>

The new ‘welfare cap’ will include just over half of all welfare spending (55.4% in 2013–14), covering items such as disability and incapacity benefits, housing benefit (other than for the unemployed) and the pension credit. The main exclusions from the cap are spending on the state pension (spending on state pension benefits in Britain accounts for 39.5% of all UK welfare spending) and some countercyclical elements of welfare spending such as jobseeker’s allowance and housing benefit paid to the unemployed.<sup>52</sup>

The cap has been set, in nominal terms, at the level of the current forecast for welfare ‘in scope’ of the cap. If total spending on these covered areas increases above the cap because of policy decisions, the Chancellor will have to either cut eligibility or generosity for the benefits in scope or win a vote in parliament to increase the cap. The same rules would apply if spending on these covered areas increased by more than 2% purely as a result of forecasting changes. Increases of 2% are not unheard of, which suggests that the cap could be a constraint.<sup>53</sup>

The broad case for such a cap is that forcing the government to make an active decision over whether to allow benefit spending to increase may lead to better policymaking. Having a credible limit on elements of welfare spending will transfer risk away from the public finances but will increase the risk to future income borne by those potentially eligible to benefits.

The UK is not the first country to impose a cap on elements of social security spending. The Netherlands, Finland and Sweden all have their own versions of a ‘welfare cap’, with some key differences between them outlined in Table 5.2. Across the three other countries there is variation in the flexibility of the cap: a nominal, multi-year, fixed cap – of the type chosen by the UK – being the least flexible.

Good policymaking considers the generosity of each individual benefit and makes trade-offs between different areas of spending. An overall cap seems like a fairly blunt tool for achieving sensible economic policy, but may help to improve the control of overall spending and sustainable fiscal policy.

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<sup>51</sup> For more detail on the rationale behind and implications of the government’s proposed spending cap, see R. Crawford, C. Emmerson and S. Keynes, ‘Public finances: risks on tax, bigger risks on spending?’, in C. Emmerson, P. Johnson and H. Miller (eds), *The IFS Green Budget: February 2014*, Institute for Fiscal Studies, London, 2014, [http://www.ifs.org.uk/budgets/gb2014/gb2014\\_ch2.pdf](http://www.ifs.org.uk/budgets/gb2014/gb2014_ch2.pdf).

<sup>52</sup> Figures from table 4.28 of Office for Budget Responsibility (2014), *Economic and Fiscal Outlook: March 2014*, <http://budgetresponsibility.org.uk/economic-fiscal-outlook-march-2014/>.

<sup>53</sup> Forecast welfare in scope increased by more than 2% between the 2011 and 2012 Budgets, as described by G. Tetlow, ‘Economy bouncing back more strongly but policy choices have increased long-run risks to the public finances’, presentation at IFS Post-Budget Briefing 2014, <http://fsmevents.com/ifs/ifs-march-2014/session02/slides.pdf>.

Table 5.2. Spending caps in the UK and other countries

Country	Description of its cap
Netherlands	Real-terms cap, set at the beginning of each parliament. Separate caps for central government spending, social security and healthcare. Pensions and unemployment insurance included. Debt interest payments excluded.
Finland	Real-terms cap, set for the next three years but updated annually. Covers about 80% of all budgeted spending. Includes pensioner spending. Excludes cyclical items such as unemployment benefits, but includes the effects of any policy changes to these areas.
Sweden	Nominal cap, set three years in advance; in practice, not updated (apart from to reduce it). Covers all of public spending (including spending on public services) less debt interest.
UK	In addition to existing nominal caps on departmental spending. Nominal ‘welfare’ cap, set until the end of this parliament. Excludes pensioner spending and unemployment benefits.

Source: Government of the Netherlands, <http://www.government.nl/issues/budget/budget-rules> and Dutch Ministry of Finance <https://www.google.co.uk/url?sa=t&rct=j&q=&esrc=s&source=web&cd=7&ved=0CFUQFjAG&url=http%3A%2F%2Fwww.rijksbegroting.nl%2Fbinaries%2Fpdfs%2Fthis-site-in-english%2Fpublic-finance-def.pdf&ei=6kk5Ur3PFobJ0QWWy4DIDw&usg=AFQjCNFtvSEkE02nCQe7e1Bwn-CMixjBtQ>. Finland State Treasury, <http://www.valtiokonttori.fi/vuosikertomukset/public/default.aspx?nodeid=20132&culture=en-US&contentlan=2> and Finland Ministry of Finance, [http://www.financeministry.fi/vm/en/04\\_publications\\_and\\_documents/01\\_publications/01\\_budgets/20130514Howthe/Kehyskaesikirja\\_enku\\_toukokuu\\_2013.pdf](http://www.financeministry.fi/vm/en/04_publications_and_documents/01_publications/01_budgets/20130514Howthe/Kehyskaesikirja_enku_toukokuu_2013.pdf). Government of Sweden, <http://www.government.se/content/1/c6/16/42/99/71221b84.pdf>.

## 5.5 Future pressures on public spending

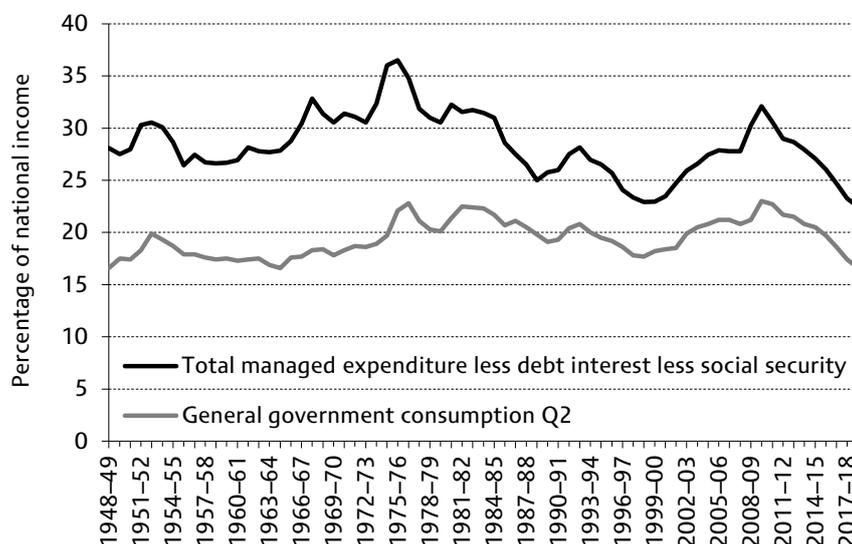
Beyond the next election in 2015, it is unclear what will happen to the composition of public spending. The government has set departmental spending limits up to the 2015–16 financial year, but beyond that there is only a plan for TME, a forecast for AME based on announced policies, and an implied forecast for DELs.

If current policy were to be implemented (and assuming no further reforms of welfare spending), then Figure 5.6 illustrates how, by the end of the forecast horizon, spending on public services (defined as total spending less that on social security and debt interest, and alternatively as ‘general government consumption’) will be at its lowest level since records began in 1948–49 (around or slightly below the level seen at the end of the 1990s).<sup>54</sup> It is unlikely that the

<sup>54</sup> ‘General government consumption’ is an alternative indicator of public services spending, as it includes government current spending on goods and services but excludes ‘transfer payments’ (that is, benefit payments). This measure of spending is available over a long time period and is therefore useful for examining long-run changes in spending on public services on a consistent basis.

large cuts will be implemented without some fall in either the quantity or quality of public services, in which case voters may find such cuts to public services spending unpalatable.

Figure 5.6. Spending on public services



Source: TME from ONS series KX5Q. Debt interest out-turns from ONS series JW2L and JW2P; debt interest forecasts from OBR, *Economic and Fiscal Outlook: March 2014*. Social security derived from HMRC and DWP's benefit and tax credit expenditure forecasts, March 2014. General government consumption from chart 3.39 of OBR, *Economic and Fiscal Outlook: March 2014*.

The next government may, of course, choose a different mix of spending, or higher taxes, or even higher borrowing. The Chancellor has suggested an extra £12 billion of cuts to social security to ease the pressure on public services<sup>55</sup> and the Shadow Chancellor Ed Balls has stated that he would achieve at least a current budget surplus by 2020, which is compatible with up to approximately £25 billion more current spending (or lower taxes) than the coalition government is planning. It therefore seems that there is still scope for a significant change in the current plans.

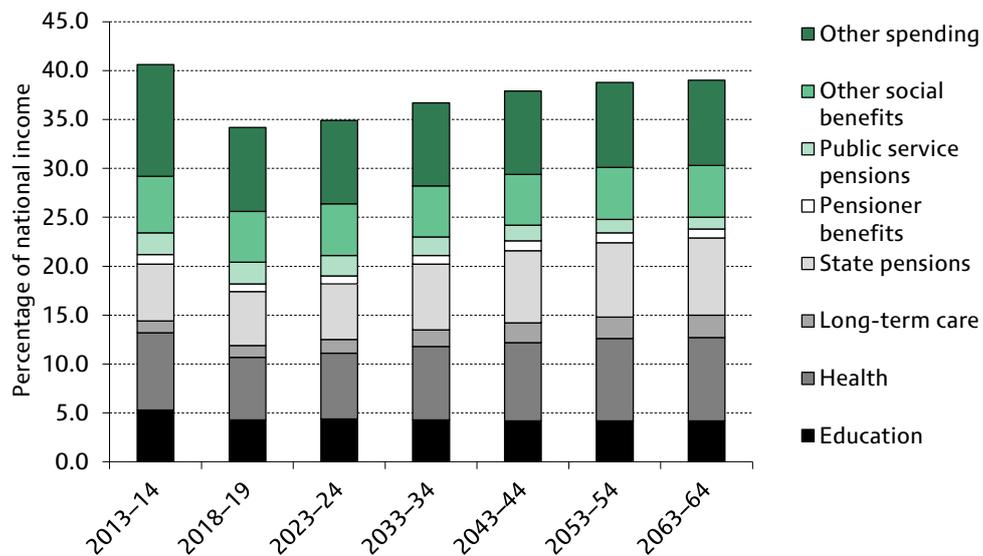
Any change in the size or speed of the current consolidation will happen in the context of another looming pressure on the public finances – namely, the UK's ageing population.

Figure 5.7 describes the likely impact of these pressures, showing the OBR's latest long-term projections for spending (made in July 2014). The OBR's projections are for public spending (excluding spending on debt interest) to increase from 34.3% of national income in 2018–19 to 39.1% of national income by 2063–64. Whereas most components of spending shown in Figure 5.7 are

<sup>55</sup> This is discussed further in R. Crawford, C. Emmerson and S. Keynes, 'Public finances: risks on tax, bigger risks on spending?', in C. Emmerson, P. Johnson and H. Miller (eds), *The IFS Green Budget: February 2014*, Institute for Fiscal Studies, London, 2014, [http://www.ifs.org.uk/budgets/gb2014/gb2014\\_ch2.pdf](http://www.ifs.org.uk/budgets/gb2014/gb2014_ch2.pdf).

projected to remain fairly stable as a share of national income, spending on the state pension, health and long-term care are set to increase as the baby boomers retire and the population ages. By 2063–64, the effects of this ageing population will have offset most of the reductions in public spending from the austerity measures planned between 2013–14 and 2018–19.

Figure 5.7. OBR July 2014 long-term spending projections, excluding debt interest payments



Note: Other spending excludes interest and dividends. The state pension figures include the cost-saving effects of the single-tier pension, affecting those reaching the state pension age after April 2016, as well as the planned future increases in the state pension age.

Source: OBR, *Fiscal Sustainability Report*, July 2014, <http://budgetresponsibility.org.uk/fiscal-sustainability-report-july-2014/>.

The increase in state pension spending over the next few decades arises not only because of the growing number of pensioners but also because policy changes and changes in work patterns mean that future pensioners will have higher average state pension entitlements than their predecessors.

The government has reformed the state pension to offset some of this increase; the Pensions Act 2014 reformed the state pension system to introduce a new ‘single-tier’ pension, which, in the long run and compared with unchanged policy, will be less generous to almost everyone other than the self-employed.<sup>56</sup> The figures above include the OBR’s estimate that this reform will reduce spending as

<sup>56</sup> Department for Work and Pensions, *The Single-Tier Pension: A Simple Foundation for Saving*, January 2013, <https://www.gov.uk/government/publications/the-single-tier-pension-a-simple-foundation-for-saving--2>. For additional analysis of the effect of the single-tier reforms, see R. Crawford, S. Keynes and G. Tetlow, *A Single-Tier Pension: What Does It Really Mean?*, IFS Report R82, 2013, <http://www.ifs.org.uk/publications/6796>.

a share of national income by 0.4 percentage points by 2063–64.<sup>57</sup> However, even with the reform, state pension spending is forecast to increase from 5.8% of GDP in 2013–14 to 7.9% by 2063–64.

Health spending is also forecast to increase as a share of national income as the population ages. The increase in forecast health spending in the OBR's central scenario is entirely driven by an ageing population. An even larger increase in health spending might be required if the health sector experiences lower productivity growth than other sectors of the economy, as it has in the past (perhaps due, for example, to the fact that healthcare is relatively labour intensive). The OBR presents alternative forecasts for health spending, projecting forward weaker productivity growth, which would increase health spending by 5.9% of national income above the 8.5% of national income in 2063–64 shown in Figure 5.7. However, there are also reasons to think that health spending could be somewhat lower in the future – the increase in health spending suggested in Figure 5.7 might be an overestimate if people at a given age become healthier as the age structure of the population changes – in other words, if the age–spending profiles change.

Finally, an ageing population is also likely to increase required spending on long-term care. The OBR has forecast that spending on long-term care will increase from 1.4% of national income in 2020–21 to 2.3% in 2063–64, taking into account the government's announced reforms to this area, which are to make the system more generous on average.

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<sup>57</sup> OBR, *Fiscal Sustainability Report*, July 2014, <http://budgetresponsibility.org.uk/fiscal-sustainability-report-july-2014/>.

## 6. Conclusions

Over the third quarter of the twentieth century, government spending rose as a share of national income, from just under two-fifths in 1948–49 to nearly half in 1975–76. This trend was gradually reversed over the next 25 years, so that in 1999–2000 spending as a share of national income was nearly below its lowest share seen since 1948–49.

The Labour government over the 2000s chose to increase public spending significantly relative to national income, although by 2007–08, on the eve of the financial crisis, spending was 40.6% of national income – not particularly high by historical standards. However, the crisis and associated recession left fixed spending plans as a much larger share of national income; by 2009–10, spending had shot up to 47.0% of national income, and weakened public finances prompted the last Labour government to plan, and this coalition government to implement, significant cuts to public spending.

As well as seeing an increase in public spending as a share of national income, under Labour the composition of public spending changed, towards spending on social security (particularly pensioners), education and the NHS and away from defence, public order and safety, and local government. The cuts in the wake of the financial crisis have largely reinforced this changing composition, as those areas that were prioritised in the 2000s have been largely protected from cuts. However, over the 2000s, the Labour government increased investment spending significantly but, in contrast to education and the NHS, the cuts did not reinforce this prior trend. Investment was cut dramatically in the wake of the recession and is now at historical lows, though the cuts appear to have stalled.

The planning framework for public spending has been gradually improved since 1992, with each reform learning from lessons in the past. The framework has evolved in order to curb growth in public spending and lead to an optimal allocation of spending cuts. The separation of current and capital spending, which was meant to discourage departments from cutting capital spending to fund current spending, was insufficient to prevent the huge cuts to capital spending seen from 2010–11, though it is arguably a more sensible planning framework than the UK government has had in the past. The recent development of a ‘welfare cap’ could improve public policymaking, by preventing the upward creep of spending by forcing the government to make active spending decisions.

Such spending restraint is likely to become more necessary in the future, as the ageing population puts pressure on public services such as the NHS. By 2063–64, according to the Office for Budget Responsibility, these pressures from ageing are likely to have reversed most of the effects of the consolidation on the public finances.