9. Public spending: set for a squeeze

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Summary

- The government is projecting much slower growth in public spending over its next Spending Review than over any of its previous reviews – and slower than under the 18 years of Conservative governments from 1979 to 1997. The increase of 1.1% a year in real terms would cut public spending by 2.5% of national income over three years – £37 billion in today's terms.
- The squeeze on Whitehall departments may be even more severe, given plausible scenarios for social security and tax credit costs, net debt interest payments, and other non-departmental spending. Total departmental spending may well have to be frozen in real terms over the three years.
- In that event, most departments are likely to see real cuts, with only high priorities such as health and education being allocated any real growth – and even these may see their budgets cut as a share of national income. Capital-intensive departments, such as transport and housing, are likely to suffer more than most due to the planned cash freeze on investment spending.
- The spending squeeze also has implications for some specific government objectives. Earnings indexation of the basic state pension is likely to be delayed, pushing up pensioner poverty. The government is also projected to miss its child poverty target for 2010 – and unless additional resources can be found, it could stay above the target for some time after 2010–11. Lower growth in education spending is likely to squeeze public funding for higher education, which could force funding reforms that may conflict with the government's objectives to widen and increase participation.

9.1 Introduction

The November 2008 Pre-Budget Report (PBR) pencilled in real increases in public spending of just 1.1% a year in 2011–12, 2012–13 and 2013–14, presumably the three years to be covered by the next Spending Review. This is less than a third of the average growth rate seen under the previous five Labour Spending Reviews, and lower than the average growth rate seen during the 18 years of Conservative governments from 1979 to 1997.

As we describe in this chapter, such low increases in total public spending will seriously limit the options available for departmental spending growth. This will result in difficult choices in the next Spending Review, and may prove incompatible with the government's aspirations to improve the quality of public services and reduce poverty.

Section 9.2 compares the growth in overall spending implied by the plans set out in the November 2008 PBR with what has happened since Labour came to power in May 1997 and with what has happened over the longer term. Section 9.3 briefly discusses Labour's previous Spending Reviews. Section 9.4 presents the trade-off that the government is

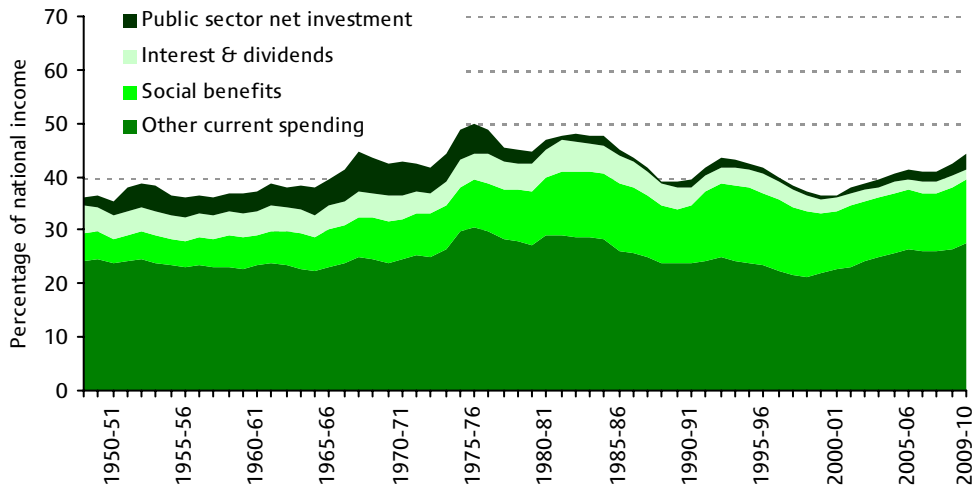
likely to face in the next Spending Review between departmental spending and other areas of public spending if the projections for overall spending set out in the November 2008 PBR are adhered to. We also briefly discuss what this could mean for individual departments. Section 9.5 discusses three policy areas that could be affected by the low spending growth planned: the earnings indexation of the basic state pension, the targets to reduce income poverty among families with children, and a possible squeeze on higher education (HE) funding. Section 9.6 concludes.

9.2 Trends in UK public spending

Total spending since 1948–49

The Treasury predicts that total managed expenditure (TME), the broadest measure of government expenditure, will be £623.1 billion in 2008–09. This equates to 42.6% of national income, or just under £10,150 for every person in the UK.

Figure 9.1. Composition of public spending (TME) since 1948–49



Notes: Projections are from the November 2008 Pre-Budget Report. Current expenditure includes depreciation.
Sources: Measures of public spending are ONS series ANLO, ANLT, ANLY, ANNW and ANNZ from table 2.3C of *Financial Statistics Freestanding Time Series Data*. GDP is ONS series BKTL from table A2 of *United Kingdom Economic Accounts* (http://www.statistics.gov.uk/statbase/tsdtimezone.asp). HM Treasury, *Pre-Budget Report 2008 supplementary material*, London, November 2008 (http://www.hm-treasury.gov.uk/d/pbr08_chartstables_501.pdf).

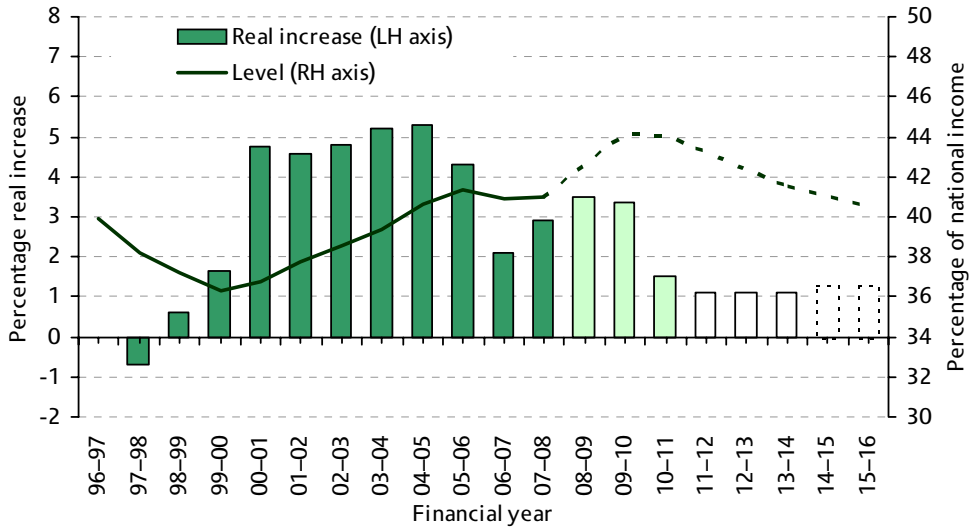
Figure 9.1 shows how public spending as a share of national income has varied since 1948–49. TME climbed from 36.0% of national income in 1948–49 to a peak of 49.8% in 1975–76. Spending on health, education and contributory benefits, such as the basic state pension, grew particularly quickly. Conversely, defence spending fell sharply after the end of the Korean War in 1953. Between 1975–76 and 1998–99, public spending fell as a share of national income, due initially to cuts in public sector net investment and then to cuts in current spending on public services (including education). Public spending fell particularly sharply during the late 1980s and late 1990s as a strong economy reduced expenditure on social benefits and debt interest payments. Conversely, the early 1990s saw public expenditure increase as weak economic performance pushed up these expenditures. Figure 9.1 shows that public spending has risen again as a share of national

income since April 1999. We now describe trends in spending under the current Labour government in more detail.

Growth in public spending under Labour to date

In 1996–97 – the last full financial year before Labour came to power – total public spending stood at 39.9% of national income. As the solid line in Figure 9.2 shows, this had fallen to 36.3% of national income in 1999–2000. This decline reflected a combination of strong economic performance and low growth in spending on public services. Low growth in spending on public services in 1997–98 and 1998–99 had been planned by the previous Conservative government, and the incoming Labour government chose to continue to adhere to these plans once it came into office, in line with Labour's manifesto commitment.

Figure 9.2. Total managed expenditure



Notes: Light-green bars represent the years covered by the 2007 CSR and white bars are illustrative Treasury plans for government spending for years not yet covered by a Spending Review, while the dotted white bars are not explicit government projections but are based on authors' calculations.
Sources: Table B1 of HM Treasury, *Public Sector Finances Databank*, London, December 2008 (http://www.hm-treasury.gov.uk/d/public_finances_databank.xls) and table B10 and paragraphs 2.60 and 6.33 of HM Treasury, *Pre-Budget Report 2008*, London, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_repindex.htm). GDP and GDP deflators up-to-date as of 23 December 2008 from HM Treasury website (http://www.hm-treasury.gov.uk/d/gdp_deflators.xls).

In July 1998, the government presented the results of the first Comprehensive Spending Review (CSR), which set out departmental spending plans for 1999–2000, 2000–01 and 2001–02. The original CSR 1998 plans had been for public spending to increase as a share of national income in each of these three years. However, despite 1999–2000 being the first year under the 1998 CSR plans, expenditure fell rather than rose as a share of national income as some government departments spent less than their allocations. Since then, public spending has increased, reaching 41.4% of national income in 2005–06, due to increases in spending on public services (in particular, education and health) and large increases in the generosity of targeted support aimed at lower-income families with children and lower-income pensioners. Departmental spending plans through to 2007–08 were set out in the Spending Reviews of July 2000, 2002 and 2004, while the CSR of October 2007 set out spending plans for the three years 2008–09, 2009–10 and 2010–11.

A more detailed comparison of original spending plans and out-turns under each of these Spending Review periods is provided in Section 9.3.

The bars in Figure 9.2 (and the left-hand axis) show the annual real[1] increase in spending since 1996–97. Relatively large real increases in spending were seen in each year from 2000–01 to 2005–06. Lower growth in public spending in 2006–07 and 2007–08 meant that public spending stabilised as a share of national income. The unusually low increase in 2006–07 was the result of spending in 2004–05 and 2005–06 being higher than expected (so the planned level of spending in 2006–07 implied a lower real increase).

International comparison of total spending

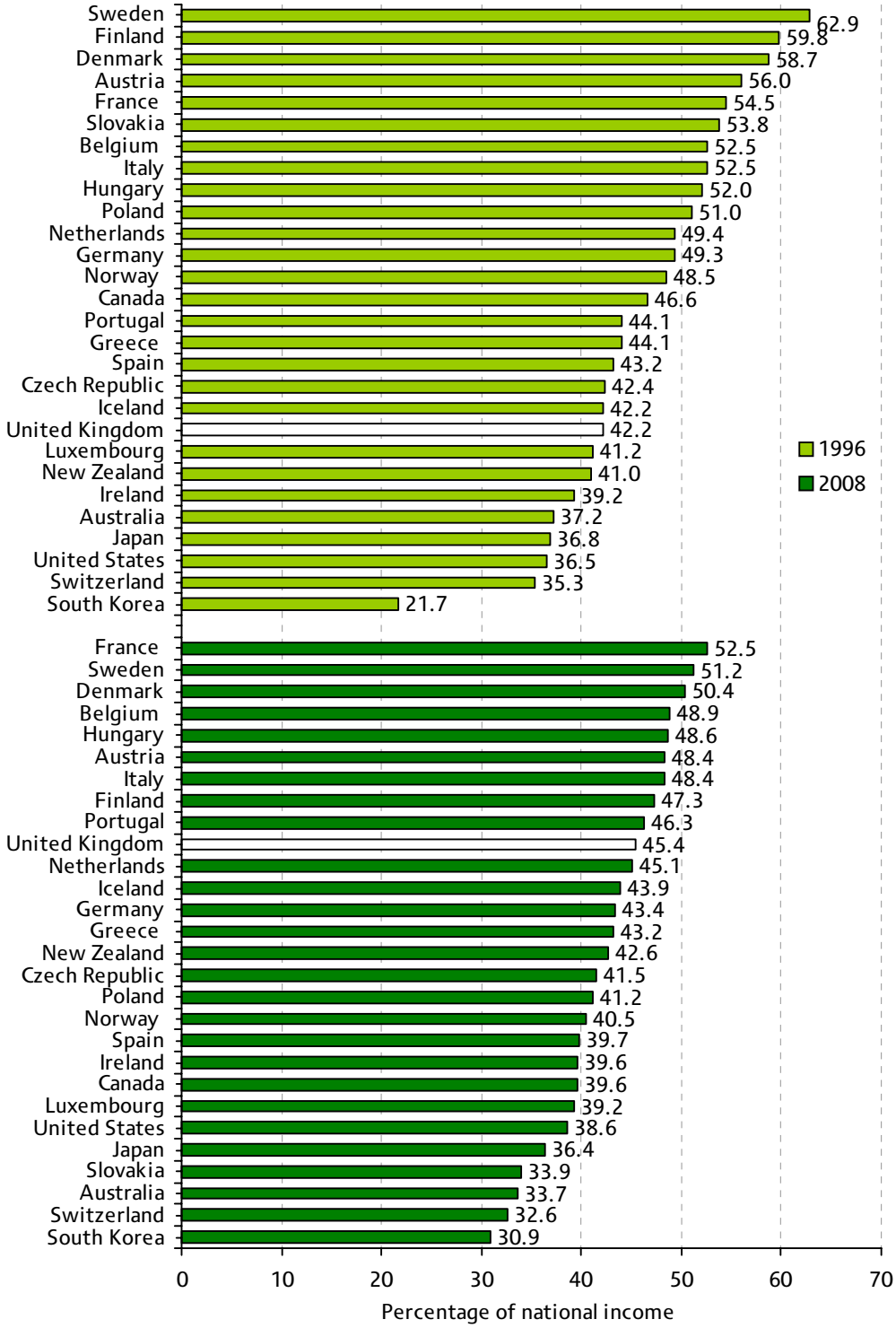
A snapshot comparison of total general government outlays in both 1996 (the year before Labour took office) and 2008 across 28 OECD countries is presented in Figure 9.3. The UK moved from having the 20th highest level of public spending in 1996 to the 10th highest in 2008. In both 1996 and 2008, the highest spenders were countries such as Sweden, France and Denmark where general government spending is over half of national income. At the other extreme, in Slovakia, Australia and Switzerland government outlays in 2008 were about one-third of national income, while in South Korea they were only just over 30%. Among the G7 countries, Italy and France have higher levels of public spending than the UK while Germany, Japan, the US and Canada all have lower levels.

In terms of the change in total government outlays over the period from 1996 to 2008, the UK has the second highest increase (+3.3% of national income) with only the very low-spending South Korea seeing a larger increase (+9.2%). Among the G7 countries, only the UK and the US recorded increases in spending as a share of national income; the other five all reduced their spending. Overall, 21 out of the 28 OECD countries recorded a reduction in total government outlays as a share of national income over this 12-year period. The change in the UK's relative position reflects larger increases in public spending on health and education in the UK than in most of the other countries, and smaller reductions in government debt interest payments.[2]

[1] Throughout this chapter, we refer to changes in 'real' spending, by which we mean spending calculated by deflating spending with growth in the GDP deflator. While this might not be the appropriate deflator for the increase in the cost of goods and services purchased by public spending, it could be considered the most appropriate deflator when considering the cost to the taxpayer.

[2] Data available from OECD statistics (http://stats.oecd.org/WBOS/index.aspx).

Figure 9.3. Total public spending, OECD countries, 1996 and 2008



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

Source: Annex table 25 of OECD, *Economic Outlook No. 83*, November 2008 (http://www.oecd.org/document/61/0,3343,en_2649_34573_2483901_1_1_1_1,00.html).

Planned growth in spending to 2009–10

The October 2007 CSR had planned real increases in spending of 2.0% a year on average over the years 2008–09, 2009–10 and 2010–11, which would have been expected to reduce public spending as a share of national income slightly to 40.8% by 2010–11. This is shown by the black line in Figure 9.4. However, given the weaker outlook for economic growth over this period that the Treasury is now expecting, keeping to those real increases would now imply spending growing as a share of national income. In addition, the November 2008 PBR made significant upwards revisions to the forecasts for real public spending growth over these three years, partly caused by, and partly in response to, the current economic slowdown: real spending is now set to grow by an average of 2.7% a year until March 2011. The extra spending is mainly higher expenditure on social security benefits and tax credits, as a result of rising unemployment, and higher debt interest payments, as a result of higher government borrowing.[3] One further difference between the latest November 2008 PBR plans and previous planned spending is that the government has chosen to bring forward some investment spending originally planned for 2010–11 into 2008–09 and 2009–10 in order to help provide a short-term fiscal stimulus to the economy. This increases expected real growth in spending in 2008–09 and 2009–10 and also reduces expected real growth in spending in 2010–11.

Consequently, as the dotted line in Figure 9.2 and the light-green line in Figure 9.4 show, public expenditure as a share of national income is projected to increase from 41.0% of national income in 2007–08 to a peak of 44.2% of national income in 2009–10. This is higher than the level inherited by Labour when they came to power (39.9% of national income) and equal to the average seen over Margaret Thatcher's premiership (44.2% of national income). What was intended to be the least generous Spending Review is now set to deliver the largest increase in spending as a share of national income, as Figure 9.2 shows.

Impact of PBR 2008 on planned public spending from 2010–11 onwards

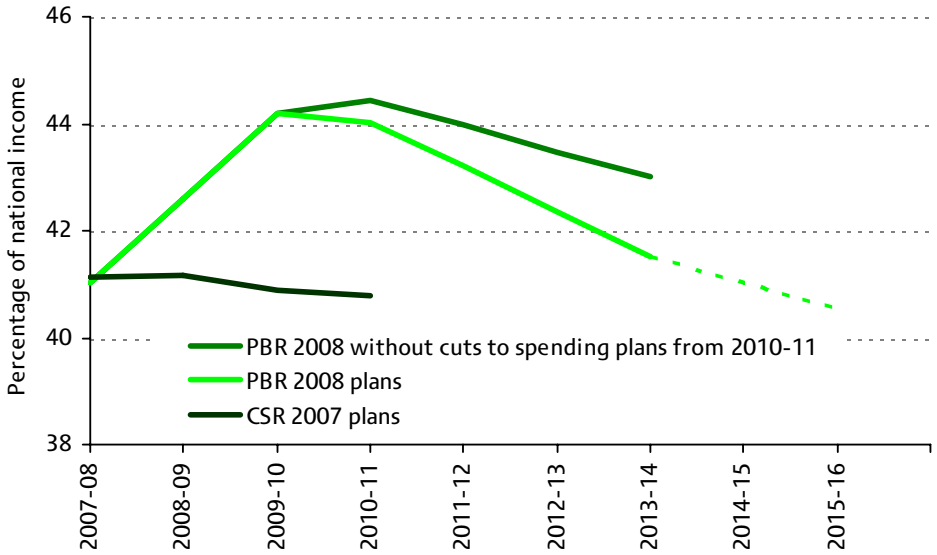
From 2010–11, the November 2008 PBR set out plans for a fiscal tightening. In particular, the government pencilled in lower than previously announced spending in 2010–11 and total real expenditure growth of just 1.1% a year for 2011–12 to 2013–14. This is lower than Budget 2008 plans for this period had implied, and lower than the 2.0% a year planned in the CSR for the period 2008–09 to 2010–11. If delivered, these plans will result in a decline in public spending as a share of national income, down to 41.5% in 2013–14 (shown by the dotted line in Figure 9.2 and by the light-green line in Figure 9.4).

The reduction in spending in 2010–11 comprises an additional £5 billion 'additional value for money savings' that the Treasury claims can be found (though these efficiency savings have yet to be allocated to specific departments) and a cut to the capital budget of the NHS in England. The capital budget of the English NHS was increased by £0.1 billion in 2009–10 but reduced by £1.4 billion in 2010–11, which can be considered as a reduction in the NHS capital budget of £1.3 billion in 2010–11. Taken together, these two changes will reduce total public spending in 2010–11 by £6.3 billion. The effect of these cuts to total spending as a share of national income in 2010–11 is shown by the gap

[3] Projections of spending in these areas had also been revised upwards (though to a much smaller extent) in the 2008 Budget.

between the dark-green line and the light-green line in Figure 9.4 in 2010–11. The effect of lower than previously planned spending growth from 2011–12 onwards on the level of public spending is shown by the divergence of the light-green and dark-green lines in Figure 9.4.

Figure 9.4. Impact of PBR 2008 on total public spending from 2010–11



Notes: The light-green line represents total spending as a share of national income according to the plans outlined in the November 2008 PBR. The dark-green line represents how spending as a share of national income would have looked if no changes had been made to the NHS capital budget or planned efficiency savings in 2010–11 or the planned growth rate from 2011–12 onwards. The CSR 2007 plans have had projected GDP increased by 2% to take account of FISIM (financial services indirectly measured), which is now included in measures of GDP.
Sources: Authors' calculations from HM Treasury, *Pre-Budget Report 2008*, London, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_repindex.htm) and HM Treasury, *2007 Pre-Budget Report and Comprehensive Spending Review*, London, October 2007 (http://www.hm-treasury.gov.uk/pbr_csr07_index.htm).

The changes to the planned public spending cause total spending as a share of national income to fall earlier and faster than it would have done if no active decision to change public spending from 2010–11 had been made. Under the 2008 PBR plans, by 2013–14 total public spending is projected to be 41.5% of national income, compared with 43.0% of national income if the spending plans had not been cut in 2010–11 and the real growth rate of public spending thereafter had not been reduced.

In the 2008 PBR, the Treasury projected that the trend output of the economy would be 4% lower from Summer 2009 onwards as a result of the global credit shock. In other words, trend national income is now thought to be 4% lower each year after Summer 2009 than it would have been had the credit shock not occurred. This reduction in trend national income means that the same government cash spending plans would now be projected to absorb a larger share of national income. This has contributed to the rise in projected government spending as a share of national income seen in Figures 9.2 and 9.4. If the government wanted to share the permanent reduction in national output proportionately between the private sector and the public sector, and so return public spending as a share of national income to the level planned before the global credit shock, then it would need to reduce public spending in each year by about 4%. For instance, in

2013–14 the government would need to reduce public spending in that year by about 1.7% of national income (4% of 43.0%). This would see spending as a share of national income returning to about the level planned under CSR 2007. The lowering of public spending in 2013–14 by 1.5% of national income under the PBR spending plan changes could, therefore, be rationalised by the Treasury as a proportionate response to the fall in trend national income caused by the credit shock.

Even if the government did ultimately want to share the reduction in national output proportionately between the private and public sectors and bring public spending as a share of national income back to around the level planned under the CSR 2007, it still had a choice about the period over which to achieve this. As can be seen in Figure 9.4, the PBR 2008 plans imply that this reduction in public spending as a share of national income will be achieved by around 2015. The government could instead have chosen to extend further the period over which this adjustment takes place. This latter option would allow smaller cuts in spending as a share of national income over the years 2010–11 to 2015–16 but would consequently require these cuts in spending to continue for a longer period in order to bring spending as a share of national income back down to its previously planned level. The spending plan cuts pencilled in by the PBR for 2010–11 onwards would, therefore, help to bring public spending as a share of national income back down to the previously intended levels much faster than leaving spending plans unchanged would have done.

In the November 2008 PBR, the Treasury announced that it intended public sector net debt to be falling as a share of national income from 2015–16, thereby complying with its 'temporary operating rule' – see Chapter 5. The Treasury showed that this can be achieved by keeping public sector net investment (PSNI) constant as a share of national income, while reducing the current budget deficit by 0.5% of national income in both 2014–15 and 2015–16. This improvement in the current budget deficit is similar to that seen over the next Spending Review period, 2011–12 to 2013–14, and so could be achieved if current receipts and current spending grew at a similar rate over 2014–15 to 2015–16 as they did in 2011–12 to 2013–14. If current spending were to grow at 1.2% (the average real growth rate forecast for 2011–12 to 2013–14) and net investment were to grow at 2.5% (the trend rate of growth of the economy – thus keeping investment as a share of national income constant), then total public spending would grow at an average of 1.3% over 2014–15 to 2015–16.[4] As shown in Figures 9.2 and 9.4, this would result in a further fall in public spending as a share of national income to 40.5% in 2015–16, the lowest level seen since 2003–04.

9.3 Spending Reviews under Labour to date

If the government were to stick with total real spending growth of 1.1% a year between 2011–12 and 2013–14, this would be less generous than the plans announced in any of Labour's previous five Spending Reviews.

Table 9.1 compares the relative generosity of each of the reviews. The first column shows the average real spending growth over the three years of the review implied by the

[4] These assumptions about spending growth require government revenues to remain roughly constant as a share of national income in order to achieve a strengthening of the current budget by 0.5% of national income in each year. In other words, this assumption implies negligible fiscal drag over this period.

Treasury's original cash plans. The second column shows the real growth that would have resulted if these cash plans had been kept to, bearing in mind that, in four of the five periods, inflation differed from the rates assumed by the Treasury when the plans were drawn up. Inflation in 1999–2000 and 2000–01 was lower than had been expected at the time of the July 1998 CSR, giving scope for a bigger real increase from given cash plans. Conversely, inflation in 2002–03 and 2003–04 was higher than expected at the time of the July 2000 Spending Review, reducing the real generosity of the cash plans. The third column shows the actual average growth in real spending over each of the Spending Review periods. These figures are essentially the same as those presented in Figure 9.2 – but note that the Spending Review periods overlap and therefore some years are double-counted.

Table 9.1. Comparison of Labour's Spending Reviews to date

Average annual growth in real public spending over:	Original spending plans	Adjusted for subsequent inflation	Eventual out-turn / Latest forecast
Inherited Conservative spending plans April 1997 to March 1999	1.0[a]	0.6[a]	0.0
Comprehensive Spending Review, July 1998 April 1999 to March 2002	2.7	3.4	3.7
Spending Review, July 2000 April 2001 to March 2004	3.2	2.9	4.9
Spending Review, July 2002 April 2003 to March 2006	4.3	4.3	4.9
Spending Review, July 2004 April 2005 to March 2008	3.2	3.3	3.1
Comprehensive Spending Review, 2007 April 2008 to March 2011	2.0	2.3?	2.8?
Spending Review 2010? April 2011 to March 2014?	1.1?		

a. Original plans, and plans adjusted for inflation, from April 1997 to March 1999 refer to GGE(X) rather than TME.

Sources: Eventual inflation and latest spending estimates as Figure 9.2. Figures for each Spending Review from HM Treasury, *Financial Statement and Budget Report November 1996*, TSO, London, 1996; HM Treasury, *1998 Comprehensive Spending Review*, Cm. 4011, London, July 1998; HM Treasury, *2000 Spending Review*, Cm. 4807, London, July 2000; HM Treasury, *2002 Spending Review*, Cm. 5570, London, July 2002; HM Treasury, *2004 Spending Review*, Cm. 6237, London, July 2004; *2007 Pre-Budget Report and Comprehensive Spending* Review, Cm. 7227, London, October 2007. Documents available from http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm and http://archive.treasury.gov.uk/siteindex.html.

Table 9.1 indicates that real spending is now expected to grow faster over the period April 2008 to March 2011 than was envisaged at the time of the CSR 2007. This is a consequence both of inflation being lower than expected over the period as a whole and of the cash value of total government spending increasing above that which was originally planned in response to the current economic slowdown. Annual real growth in spending of 1.1% has been pencilled in for April 2011 to March 2014 (presumably the next Spending Review period), but uncertain future inflation presents some risk to this. If future inflation turns out to be higher than the Treasury projected at the time of the November 2008 PBR, then the cash spending plans pencilled in for 2011–12 to 2014–15 would result in a real increase in spending of less than 1.1% a year.

It is clear that if the government sticks to 1.1% a year real growth in public spending over 2011–12 to 2013–14 (and potentially only increases spending by 1.3% in 2014–15 and 2015–16), then this will be a considerably lower rate of increase than that planned, delivered or set to be delivered over any of the five previous Labour Spending Reviews. It will also be lower than the average real growth of 1.5% a year delivered over the 18-year period of Conservative governments from 1979 to 1997.

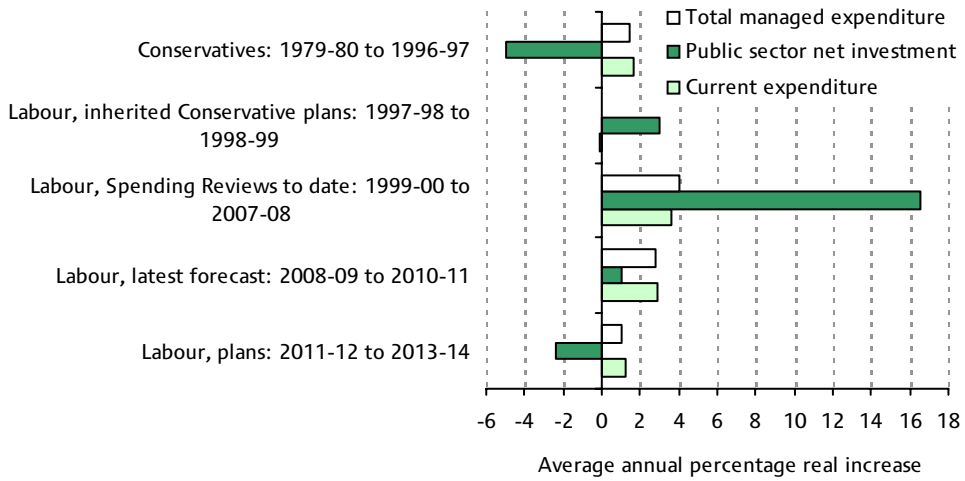
9.4 Scenarios for the next Spending Review

In the November 2008 PBR, the Treasury pencilled in real increases in total managed expenditure (TME) of just 1.1% a year for 2011–12, 2012–13 and 2013–14 – which we will assume is to be the period covered by the next Spending Review (although at the time of writing no announcement to this effect has been made by the government). As can be seen from Figure 9.2, this is the lowest annual growth in TME since 1998–99. This implies that the next Spending Review is going to be very tight, and especially painful for departments which have become accustomed to the large increases in spending they have received in recent years.

The Treasury also indicated in the November 2008 PBR how it intended the 1.1% real annual growth in total spending over 2011–12 to 2013–14 to be split between current and investment spending. Current spending is intended to grow by 1.3% in 2011–12, 1.2% in 2012–13 and 1.1% in 2013–14, giving an average annual growth of 1.2% per year. Public sector net investment, on the other hand, is expected to be held constant in cash terms at £33 billion each year, implying an average annual growth rate over the next Spending Review period of –2.4%.

Figure 9.5 shows the split of TME between current and investment spending under the 18 years of Conservative governments, under the Conservative plans inherited by Labour, under Labour to date, as forecast for the CSR 2007 period and as planned for the next Spending Review period. Whilst the next Spending Review period involves a slowdown in

Figure 9.5. Average TME, current spending and investment spending



Sources: As Figure 9.2.

both current and investment spending, in terms of growth rates the cash freeze and consequent negative real growth in investment spending represents a much bigger change from the recent past.

The planned squeeze on investment spending is in conflict with the government's stated policy regarding investment. In its November 2000 document *Planning Sustainable Public Spending: Lessons from Previous Policy Experience*, the Treasury criticised the investment spending decisions made by the previous Conservative governments, stating:

> *Lesson 5: Avoid a bias against capital investment*
>
> The previous framework made no distinction between capital and current spending, despite their different economic effects. Investment was not protected. As a result, capital programmes were cut as a way of meeting short term current pressures, with long term detrimental effects.

In the November 2008 review of the government's fiscal framework, the Treasury claimed it would continue to support the government's fiscal objectives in the current circumstances:

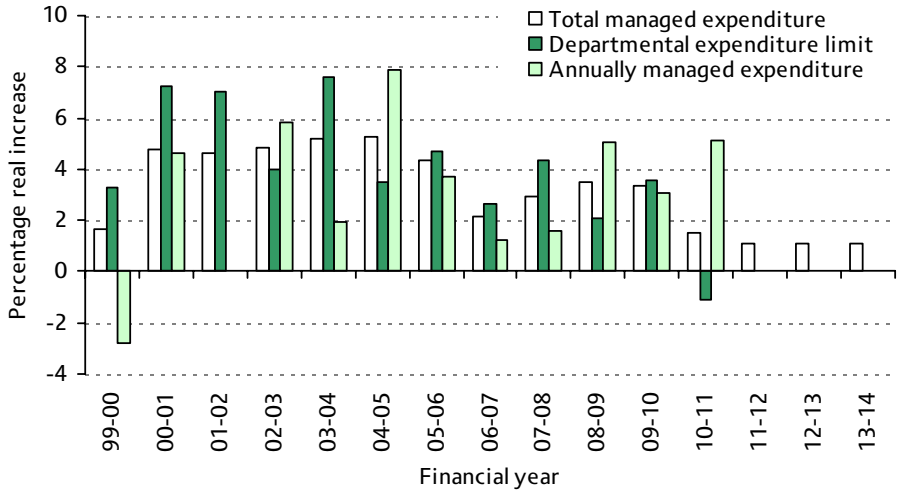
> setting policies to balance the cyclically-adjusted current budget will continue to protect capital spending and support inter-generational fairness, maintaining investment now to support the long-term productivity and competitiveness of the economy.

This stated objective of maintaining investment seems rather inconsistent with the planned cash freeze in investment spending over the next Spending Review period pencilled in by the November 2008 PBR.

For government budgeting purposes, TME is split into two components – departmental expenditure limits (DELs) and annually managed expenditure (AME). DELs are yearly limits for departmental programme expenditure, which are formally set for three years at a time by Spending Reviews (but often subsequently revised). AME is expenditure that is not easily subject to firm limits set several years in advance, such as social security benefit payments. Some areas of spending in AME are largely out of government control in the short term. For instance, social security benefit payments are affected by the prevailing economic circumstances and government debt interest payments depend on past borrowing and market interest rates. By making a distinction in TME between DEL and AME spending, and making projections about areas of spending that can reasonably be predicted because the government has less discretionary control, it is possible to make some predictions about departmental spending over the next Spending Review period.

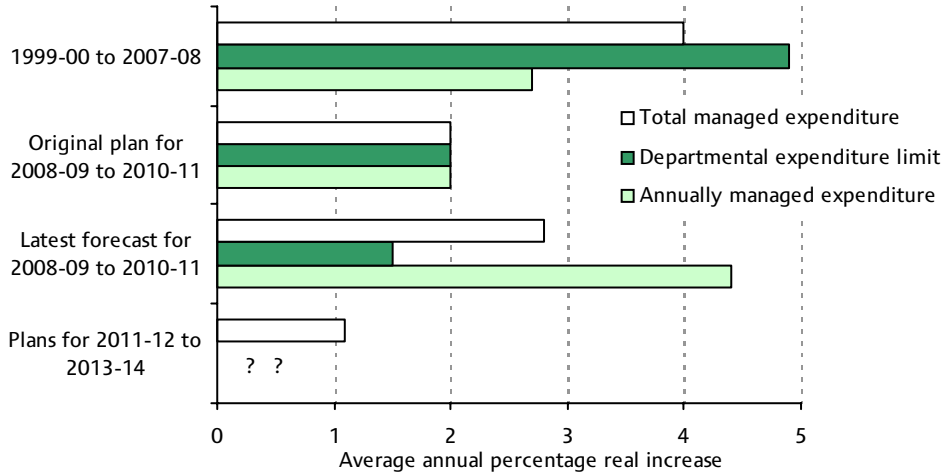
Figure 9.6 shows how the past annual percentage real increases in total spending under the current Labour government have been distributed between growth in DEL and growth in AME. The bars for total expenditure are the same as those in Figure 9.2. In the early years of the current Labour government, when growth in total expenditure was high, DEL grew rapidly relative to AME growth. In recent years and the predicted near future, TME and DEL growth have been and are expected to be lower, whilst AME growth has not been reduced in the same way. Even though departmental spending growth has been somewhat lower in recent years, over the whole period since 1999–2000 it has never been below 2%, with the exception of the current plans for 2010–11. Departmental spending growth is only negative in this year because, as mentioned earlier, the government has brought forward some departmental capital expenditure into the two

Figure 9.6. TME, AME and DEL growth



Sources: TME as in Figure 9.2. DEL and AME are from table 1.1 of the *Public Expenditure Statistical Analyses* 2004, 2005, 2006, 2007 and 2008; all documents available from http://www.hm-treasury.gov.uk/pespub_index.htm. Figures for 2007–08 onwards are from table B16 and paragraph 6.33 of HM Treasury, *Pre-Budget Report 2008*, London, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_repindex.htm).

Figure 9.7. Average TME, AME and DEL growth



Sources: As Figure 9.6.

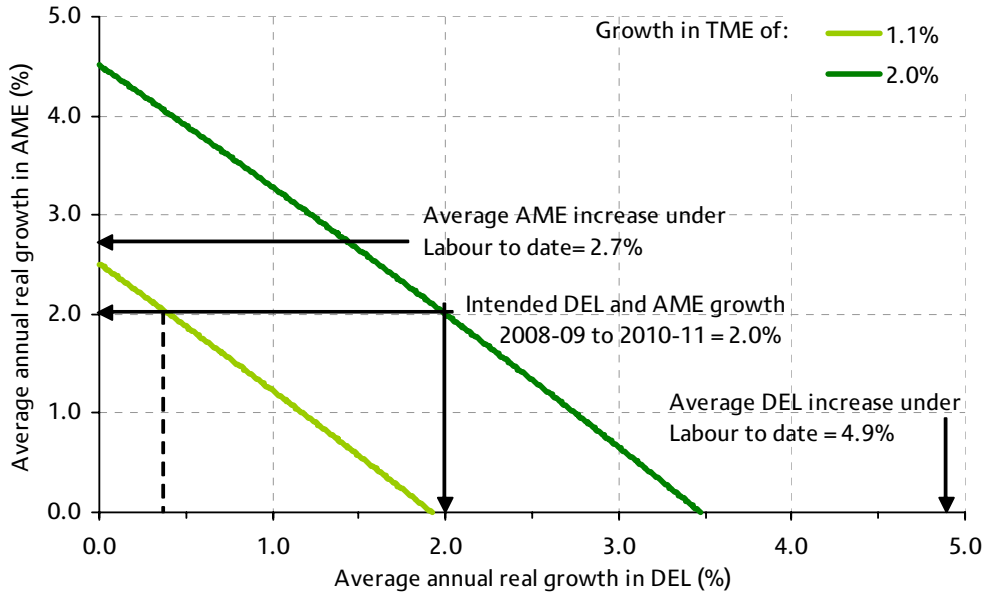
preceding years in an attempt to stimulate the economy in the face of the current economic downturn.

The history of average annual real growth in TME, DEL and AME under Labour to date is summarised in the top three bars of Figure 9.7. Under Labour since April 1999, overall DEL growth has been higher than AME growth, with an average real increase of 4.9% a year compared with 2.7% a year for AME. The 2007 CSR planned for DEL and AME both to grow at 2.0% a year over the period 2008–09 to 2010–11. However, the recent economic downturn has increased AME expenditure – mainly through higher social security payments and debt interest payments. Planned average DEL spending growth has been reduced, in large part due to the £5 billion 'additional value for money savings'

and cuts to the NHS capital budget in 2010–11 that were described in Section 9.2. The net effect is that total spending growth is forecast to be higher than was originally planned.

The 1.1% a year average real increase in TME that the November 2008 PBR pencilled for 2011–12, 2012–13 and 2013–14 is lower than the growth in total expenditure in any year under Labour since 1999–2000. Within this overall spending envelope, there will be a trade-off between growth in departmental spending and growth in AME. The government has yet to make any announcement about these allocations. The diagonal lines in Figure 9.8 show the trade-off between growth in departmental spending and growth in AME over 2010–11 to 2013–14 that is consistent with total expenditure increasing by 1.1% per year (as set out in PBR 2008) and 2.0% per year (the intended growth under CSR 2007 for 2008–09 to 2010–11), included for comparative purposes. The options for the government are limited. In the 2007 CSR, the 2.0% growth in TME was intended to be split equally, with both DEL and AME growing at 2.0%. Even if all the spending growth over 2011–12 to 2013–14 could be allocated to departmental spending, this would result in real increases of only 1.9% a year, which is less than that intended for the CSR 2007 period and considerably less than the average under the current Labour government to date. Growth in AME of 2.0% would lead to DEL growth being restricted to 0.4%. If the government were to allocate the growth over 2011–12 to 2013–14 equally, as was intended for the CSR 2007 period, both DEL and AME would only grow at 1.1% a year. Alternatively, the government could decide to increase TME more quickly than the 1.1% it has currently pencilled in. However, this would require greater financing from either more borrowing or higher tax revenues. If TME were to grow at 2.0% a year instead of 1.1%, then an additional £7 billion would be required in 2011–12, £14 billion in 2012–13 and £23 billion in 2013–14.

Figure 9.8. Trade-off between spending on DEL and AME, 2011–12 to 2013–14



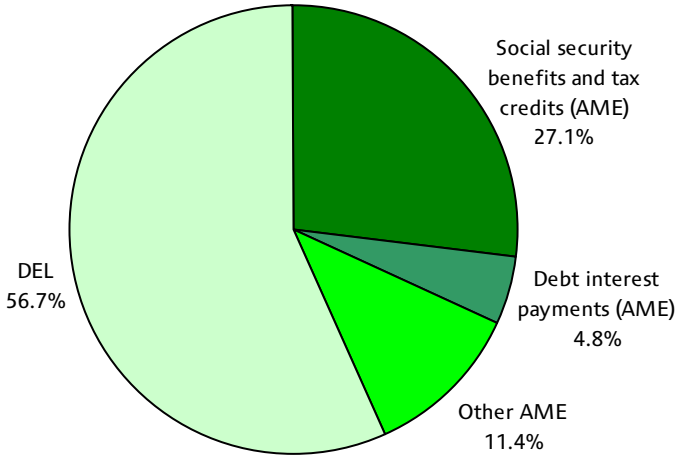
Sources: As Figure 9.6.

The government has yet to indicate how the growth of total expenditure will be allocated between DEL and AME or between departments. However, there are some areas of spending in AME that are largely out of government control. Growth of spending in these

areas can be projected, and subtracting these predictions from the total expenditure growth the government has pencilled in therefore provides an indication of how tight spending growth will need to be for all other sectors of government spending.

Figure 9.9 shows the latest forecast for the composition of TME in 2010–11. Departmental spending is expected to be slightly more than half (56.7%) of total spending. The largest component of AME is social security benefits, which together with tax credits make up more than a quarter of total spending. Debt interest payments are projected to be 4.8% of total government spending in 2010–11, leaving spending on all other areas of AME to contribute only 11.4% to total government spending.

Figure 9.9. Planned composition of TME in 2010–11



Source: HM Treasury, *Pre-Budget Report 2008*, London, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_repindex.htm).

Debt interest payments are an increasingly large component of public spending. In the November 2008 PBR, the government suspended its fiscal rules and announced a large fiscal stimulus package to help the economy through the downturn. Net borrowing is projected to peak at £118 billion in 2009–10, but the public sector net debt is forecast to keep increasing as a share of national income until 2015–16. The implication of this is that interest payments on the accumulated public sector debt will, on average, increase rapidly over the next few years. In the November 2008 PBR, the government projected that real public sector net debt interest payments would grow on average by 7.7% a year between 2010–11 and 2013–14 (rising from 2.1% of national income to 2.4% of national income – see Figure 3.2 for how public sector net debt interest as a share of national income has changed over time). Subtracting this from the 1.1% a year growth in total expenditure that the government has pencilled in leaves only a 0.7% average annual real growth for all other areas of spending, as shown in Table 9.2.

Spending on social security, which accounts for more than half of AME, is largely out of the government's hands. Projections of future benefit expenditure made after Budget 2008 by the Department for Work and Pensions predicted that total benefit expenditure would grow by an annual average of 2.0% per year in the period 2010–11 to 2013–14. Whilst this projection was made before the economy started to enter a recession, the underlying assumptions of economic trends from 2010–11 onwards are largely unchanged between the 2008 Budget and the November 2008 PBR (though the actual levels predicted for 2010 now differ). This implies that the predicted average annual real

growth rate of 2.0% might still be reasonable.[5] This growth rate of 2.0% is based on the assumption that the government re-links the uprating of the basic state pension to average earnings from April 2012 as is currently planned. Assuming that the government now decides this is not affordable in 2012 and delays re-linking until April 2014 (or later), the projected growth rate of total benefit expenditure would be reduced to 1.7% a year over 2010–11 to 2013–14. The effect of changing the uprating of the basic state pension is discussed in more detail in Section 9.5.

Table 9.2. Possible future Spending Review allocations under PBR 2008 spending plans

Real average annual growth in spending on:	
Provisional spending plans	
TME	+1.1
Projections	
Net debt interest	+7.7
Remainder (TME less net debt interest)	+0.7
Projections	
Social security benefits and tax credits	+1.7
Remainder (TME less net debt interest and social security benefits and tax credits)	+0.4
Assumptions	
Other AME (i.e. total AME excluding net debt interest and social security benefits and tax credits)	+1.9
Remainder (total DELs)	0.0
Total AME	+2.5
Total DELs	0.0

If we assume that benefit expenditure grows at 1.7% a year, and that tax credit expenditure grows at the same rate, then all other areas of spending (excluding debt interest payments) would only be able to grow at 0.4% to keep total spending growth at 1.1% a year. This projection for the growth of social security is particularly important since expenditure on social security is over a quarter of total public spending. However, delivering large reductions in future social security spending would, at least in the near term, not be possible without leaving a combination of pensioners, families with children and those receiving incapacity benefits worse off than they would be under current policies.

If other AME increases by 1.9% a year in real terms – the average increase for these areas of spending forecast in the 2007 Comprehensive Spending Review for the period from April 2008 to March 2011 – then total AME would have an average annual real growth of

[5] Budget 2008 forecast that the economy would be operating at trend from 2012 onwards, whereas PBR 2008 forecast that the economy would not return to trend until 2013. Therefore, growth in social security spending may be slightly lower than the Budget forecast over this period as the economy rebounds to trend and consequently unemployment continues to fall. However, for public finance projections, the Treasury assumes unemployment is constant when it is projected by independent forecasters to fall, and so Treasury planned social security spending will not be affected by the new projections of a later return to trend.

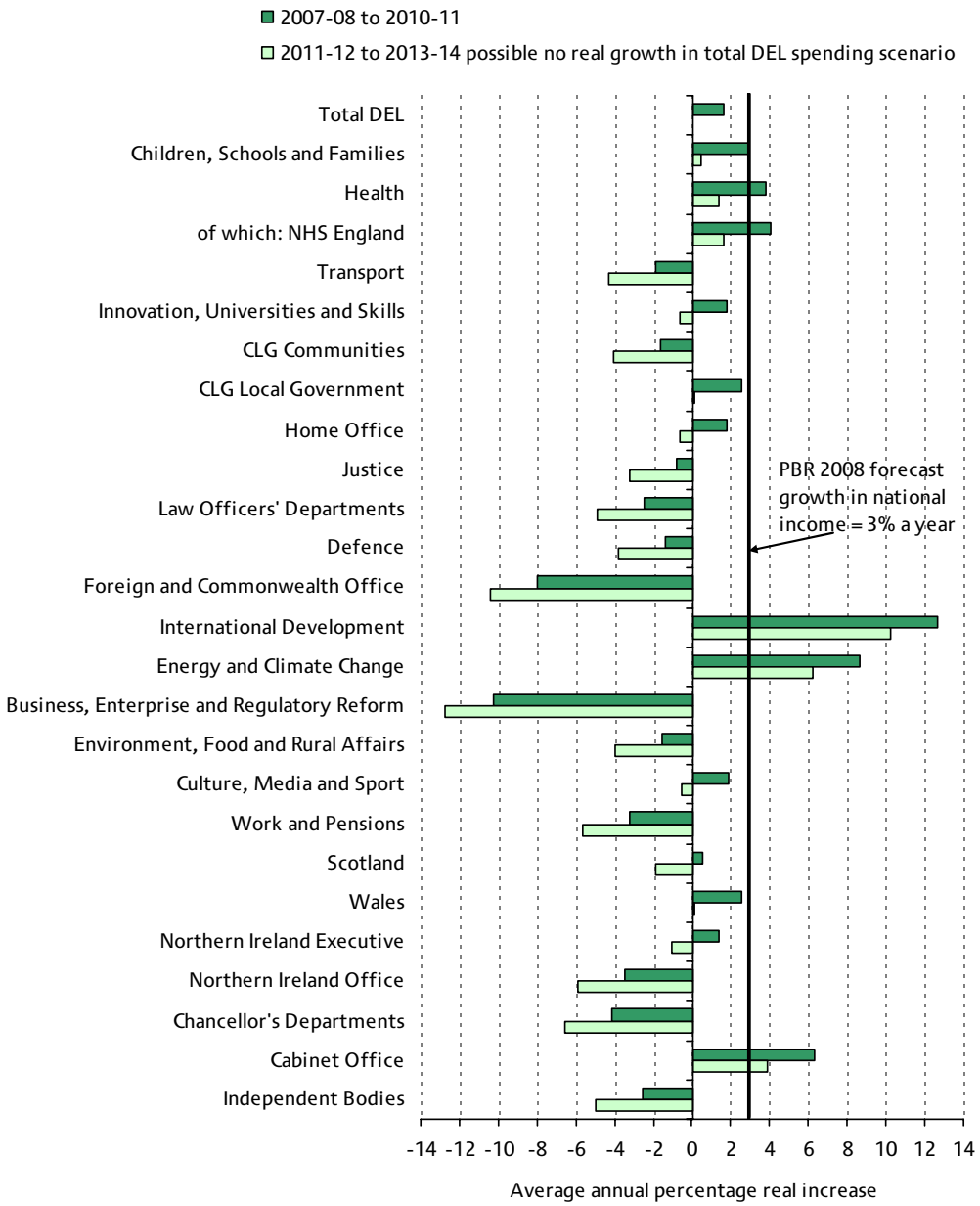
2.5%. This seems a reasonable assumption for the growth of other AME, which is projected to comprise only 11.4% of total public spending in 2010–11 (as shown in Figure 9.9). The largest component in other AME is locally-financed expenditure, which at the time of the 2007 CSR was forecast to account for 39.2% of other AME in 2010–11 and grow over the 2007 CSR period by an average annual real rate of 2.0%. While it may be possible for the government to lean on local authorities to reduce their future spending increases, it has already been doing this in recent years, and applying much further pressure may not be easy. The fastest-growing large component of other AME is net expenditure on public service pensions, which, whilst projected at the time of the 2007 CSR to be only 4.7% of other AME in 2010–11, was projected to grow at an average rate of 13.6% a year over the CSR 2007 period. Again, this is an area of expenditure over which the government has limited direct control as public service pensions expenditure in 2010–11 to 2013–14 will be almost entirely determined by the accumulated pension rights of those already retired or who will retire in this period.

If total AME grows at an average of 2.5% a year and the government sticks with total real spending growth of 1.1% a year, then total departmental expenditure would have to remain frozen in real terms between 2010–11 and 2013–14. The next Spending Review therefore looks set to be a painful one with very tight spending settlements.

How might the spending freeze be divided between departments?

These implied spending plans are so tight that all major spending departments are likely to be affected. As a result of the last Spending Review, over which period total DEL is now forecast to grow by 1.5%, the areas that have done relatively well are health, education, overseas development, energy and climate change, and the Cabinet Office budget for the intelligence agencies. Some departments actually received real cuts in spending – in particular, the Chancellor's Departments, the Department for Work and Pensions, the Foreign and Commonwealth Office, the former Department for Business, Enterprise and Regulatory Reform, and the Northern Ireland Office. Figure 9.10 shows how total DEL growth over the last Spending Review period is being shared out according to the latest forecasts. Also shown in Figure 9.10 is the implied real growth in spending on each area if there is no real growth in total DEL over the next Spending Review period and assuming the pain is shared equally – in other words, each department has an equal percentage point reduction in its annual growth rate over the next Spending Review period compared with over the CSR 2007 period. Only seven departments – Children, Schools and Families; Health; Energy and Climate Change; the Cabinet Office (intelligence agencies); International Development; CLG Local Government; and the Wales Office – would maintain positive real growth rates. The cash squeeze on investment spending (shown in Figure 9.5) means that capital-intensive departments such as transport and housing might find their budgets even more constrained than most, and more constrained than the scenario outlined in Figure 9.10.

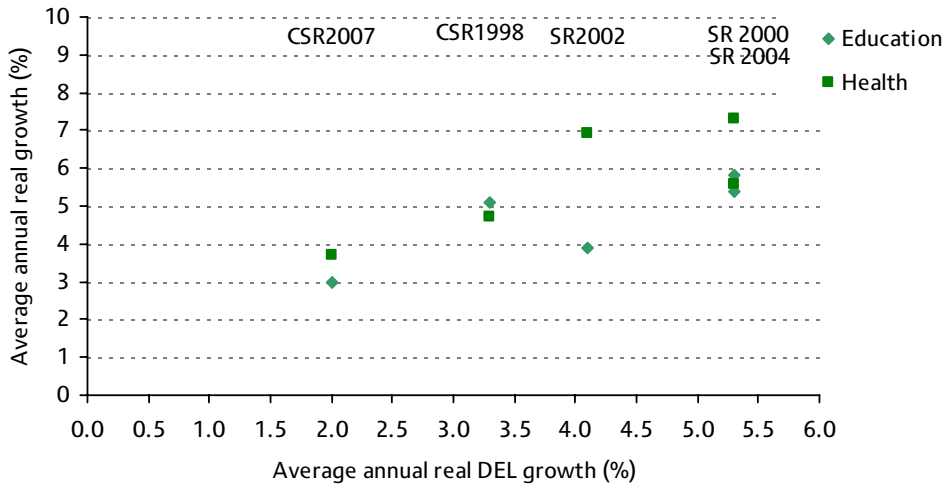
Figure 9.10. Possible departmental spending allocations



Sources: Spending growth projections for 2008–09 to 2010–11 are calculated from projected spending in table B18 of HM Treasury, *Pre-Budget Report 2008*, London, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_repindex.htm) assuming depreciation is the same as that projected in April 2008 (calculated from tables 1.5, 1.10 and 1.12 of *Public Expenditure Statistical Analyses 2008*, available from http://www.hm-treasury.gov.uk/pespub_index.htm). GDP deflators are up-to-date as of 23 December 2008 from HM Treasury website (http://www.hm-treasury.gov.uk/d/gdp_deflators.xls).

Figure 9.10 shows that even health spending would, under these assumptions, start to fall as a share of national income, which is forecast by the Treasury to grow by 3% a year over the three years 2011–12 to 2013–14 (marked by the solid vertical line on Figure 9.10). Spending on education comes from both central government departments and local authority expenditure (which is part of AME). The effect of no real growth in overall DEL on total education spending would depend on how local authorities choose to vary their spending, but Figure 9.10 shows the main department responsible for central government funding of education – the Department for Children, Schools and Families – would have its budget falling as a share of national income under these assumptions. The Department for Innovation, Universities and Skills (DIUS) would even experience a real decline in its budget. This implies that total education spending is likely to fall as a share of national income; the possible consequences of this for higher education are discussed in Section 9.5.

Figure 9.11. Planned spending on education, health and DELs, under Spending Reviews to date



Sources: As Table 9.1

Whilst health and education spending have grown faster than most other spending areas under Labour to date, these settlements have not been invariant to the size of the overall spending envelope. Figure 9.11 shows planned average annual real growth in education and health spending compared with total DEL growth under each of the five Labour Spending Reviews to date. It can be seen that lower planned real DEL growth is associated with less generous planned growth in health and education spending (there is a positive correlation). This suggests that not even these key departments will be immune from the spending squeeze over 2011–12 to 2013–14.

Implications for the quality of public services

The preceding analysis shows that if the government adheres to the overall envelope of 1.1% per year real spending growth over the next Spending Review period, virtually all spending areas will receive very tight settlements (particularly when compared with the real increases in spending that have been delivered under Labour to date). What then does this mean for the future quality of public services?

It may be possible to achieve some real spending cuts without damaging the quality of public services delivered. In response to a question from the Treasury Select Committee regarding the £5 billion extra efficiency savings announced in the November 2008 PBR, Mr Darling answered:

> … if you consider that we spend over £400 billion in public spending on departmental expenditure I defy anybody to tell me it is not possible to find £5 billion worth of efficiency savings. Every public body can. In fact, there is not any organisation in the world that cannot be more efficient if it puts its mind to it.

The government seems confident that the final conclusions of its Operational Efficiency Programme and Public Value Programme – two programmes launched in the 2008 Budget to identify potential efficiency savings in public spending and service provision – will find sufficient savings for public services to be expanded and improved over the next Spending Review period. However, with the government confident that so many efficiency savings have already been delivered in recent years and with an extra £5 billion pencilled in for 2010–11, it will become increasingly difficult to find and root out further inefficiencies.

Even if the government can find and deliver efficiency savings, it is not clear that we should treat these as a way to make spending cuts 'painless'. The government should be aiming to run the public services as efficiently as possible at all times, so presumably it would have wished to implement efficiency savings even if there were no need to make cuts – thereby increasing the quantity and quality of public services delivered for a given amount of spending. Efficiency savings improve the quality of services for a given level of public spending. Spending cuts mean that the quantity and quality of public services will be lower than they would have been in the absence of the cuts (and this is true whether or not efficiency savings are being made at the same time).

The government also has a commitment to re-link the uprating of the basic state pension to average earnings before 2015 and ambitious targets to reduce child poverty and increase international aid, in addition to less specific aspirations for world-class public services. Achieving such objectives would certainly not be helped by setting such tight budgets. The next section looks at some of the unattractive trade-offs that the government might need to consider.

9.5 Potential implications for policy outcomes

The projections in Section 9.4, which imply that there may be no real DEL growth over the next Spending Review period, assume that the indexation of the basic state pension is not re-linked to average earnings during that period, and that no additional funds aimed at reducing child poverty are made available. These policies and the likely impact of the low spending growth planned for the next Spending Review period are each discussed below.

A second implication of the tight growth in total spending highlighted by the projections in Section 9.4 is that education spending could fall as a share of national income. This is in contrast to the manifesto commitments made by the Labour Party in 1997, 2000 and 2005 to increase the share of national income devoted to education over the course of each parliament. Recently, Gordon Brown has focused on schools, with a target

announced in the 2006 Budget to increase spending per pupil in the state sector to the level spent per pupil in the private sector in 2005–06. The CSR 2007 planned for per-pupil funding to rise by almost 10% in real terms, to over £6,600 by 2010–11, but this would still be £2,533 below the target level. If the government intends to continue its policy of increasing schools funding, other areas of education are likely to see their budgets squeezed. Perhaps the most likely casualty would be higher education (HE) – Figure 9.10 indicated the possibility of real decline in the budget of the DIUS over the next Spending Review period. The possibilities for reducing public funding of HE and the likely consequences are therefore also discussed below.

Earnings indexation of the basic state pension

In the 2006 White Paper *Security in Retirement: Towards a New Pensions System*,[6] the government stated (p. 17):

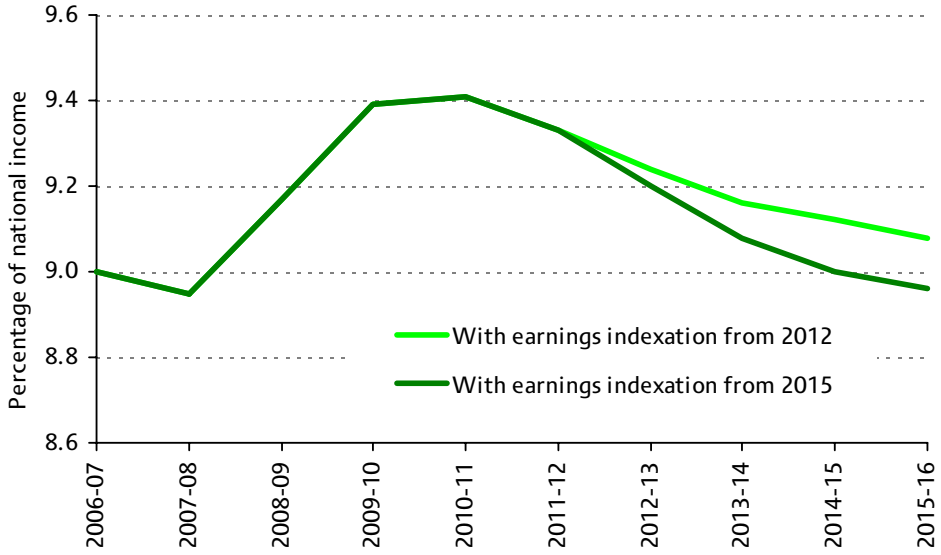
> During the next Parliament, we will re-link the uprating of the basic State Pension to average earnings. Our objective, subject to affordability and the fiscal position, is to do this in 2012, but in any event by the end of the Parliament at the latest. We will make a statement on the precise date at the beginning of the next Parliament.

There is no doubt that the government's fiscal position for 2012 is expected to be considerably worse now than was expected in 2006. Indeed, it is difficult to envisage that the drafters of this paragraph contemplated any possibility of a 'fiscal position' as bad as the one that has since materialised. Therefore it seems likely that re-linking the uprating of the basic state pension to average earnings will be delayed beyond April 2012. The Department for Work and Pensions has projected that implementing the change in 2012 would cost £0.7 billion in 2012–13 and £1.4 billion in 2013–14. Based on these estimates, Figure 9.12 shows the difference in total benefit expenditure when the earnings indexation is introduced in 2012–13 as opposed to being introduced in 2015–16.

Introducing earnings uprating of the basic state pension from 2012–13 would cause real growth in total benefit expenditure over the next Spending Review period to average 2.0% a year. Given our projections, outlined in the previous section, for the growth of net debt interest payments and other AME, this would result in real DEL growth between April 2011 and March 2014 of –0.1% a year, to ensure the overall spending envelope grows by 1.1% a year. Deferring earnings uprating of the basic state pension to beyond this period would lower forecast growth in spending on social security benefits to 1.7% a year and allow spending on DELs to be preserved in real terms. It might therefore be unlikely that the government will want to take on this additional fiscal burden during a period when the public finances already look set to be very tight. The government could delay the change to 2015, by which time a stronger economy and falling debt interest payments may help to relieve some of the pressure on the government's finances.

[6] Available on DWP website at http://www.dwp.gov.uk/pensionsreform/whitepaper.asp.

Figure 9.12. The effect on total benefit expenditure of re-linking the uprating of the basic state pension to average earnings



Source: Authors' calculations from total benefit expenditure predictions from table LT1 of DWP, *Benefit Expenditure Tables Long Run Projections* (http://www.dwp.gov.uk/asd/asd4/LT1.xls?x=1) and costing of earnings uprating the basic state pension from DWP, quoted in the House of Commons Select Committee on Work and Pensions, Fourth Report, session 2005–06 (http://www.publications.parliament.uk/pa/cm200506/cmselect/cmworpen/1068/106807.htm).

Delaying the earnings indexation of the basic state pension would save the government money over the next Spending Review period, but will clearly involve a social cost. Pensioners will have lower increases in their pensions over the period, which may increase income poverty among pensioners, especially among those low-income pensioners not taking up the means-tested benefits to which they are entitled, who are often reliant on the basic state pension for the majority of their income in retirement. Researchers at IFS have estimated[7] that introducing earnings indexation in 2015 as opposed to 2012 would increase the proportion of pensioners living in poverty in 2017–18 from 19.8% to 20.4% (an increase of around 60,000 individuals), where being in poverty is defined as having less than 60% of contemporaneous median household income. Evidence submitted to the Select Committee on Work and Pensions by DWP in 2006 estimated that if the basic state pension were indexed to earnings from April 2012, then 29% of pensioners would be entitled to the means-tested pension credit in 2050, while if the earnings link were delayed until April 2015, this figure would be 32%. The short-term savings to the Treasury of delaying the indexation would therefore be at least partially mitigated by the social and political costs of higher pensioner poverty.

Child poverty

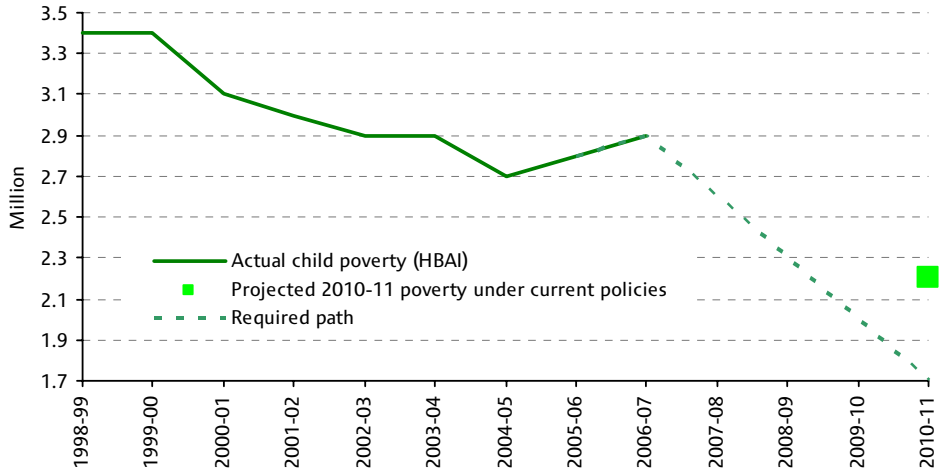
In 1999, the then Prime Minister Tony Blair announced a radical ambition – to 'eradicate child poverty in a generation'. Intermediate targets introduced by the Treasury were to reduce child poverty by a quarter of its 1998–99 level by 2004–05 and by a half of its

[7] M. Brewer, J. Browne, C. Emmerson, A. Goodman, A. Muriel and G. Tetlow, *Pensioner Poverty over the Next Decade: What Role for Tax and Benefit Reform?*, IFS Commentary 103, 2007 (http://www.ifs.org.uk/publications/3991).

1998–99 level by 2010–11, where child poverty is defined as a child living in a household with less than 60% of contemporaneous median household income.

Figure 9.13 shows the level of child poverty since 1998–99. The number of children living in relative poverty fell reasonably steadily between 1998–99 and 2004–05 when it reached 2.7 million children. But despite this, the target for 2004–05 was missed by 200,000 children, and in the following two years child poverty actually increased slightly. The dashed line in Figure 9.13 shows how child poverty would have to fall between 2006–07 and 2010–11 in order to meet the target of no more than 1.7 million children in income poverty in 2010–11, assuming poverty were to fall linearly over that period. The required rate of poverty reduction is faster than that achieved over the first half of the decade. The green square shows the latest projection for the level of child poverty in 2010–11. Assuming current policy remains unchanged, the government is projected to miss the target by 0.6 million children. If the government intends to meet the 2010–11 target, it will need to allocate additional funding in order to do so.[8]

Figure 9.13. Actual, required and projected path of child poverty



Notes: Child poverty is defined as living in households in the UK with less than 60% of median household income (before housing costs) using the modified OECD equivalence scale.
Sources: M. Brewer, A. Muriel, D. Phillips and L. Sibieta, *Poverty and Inequality in the UK: 2008*, IFS Commentary 105 (http://www.ifs.org.uk/comms/comm105.pdf).

The original work forecasting child poverty in 2010 and 2020 showed that under the usual rules for uprating benefits, tax credits and taxes, child poverty would rise significantly between 2010–11 and 2020–21. Even if the government meets the target in 2010–11, it will almost certainly need to find additional funding to reduce child poverty between 2010–11 and 2020–21. This would put more pressure on public spending over the next Spending Review period (2011–12 to 2013–14) and for the two subsequent years of planned low growth in public spending. Alternatively – and perhaps more likely

[8] This assessment was made after Budget 2008, and reported in evidence to the Treasury Select Committee. See Q67 of the oral evidence in House of Commons Treasury Committee, *The 2008 Budget*, HC 430, London (http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/430/430.pdf). There have been no tax or benefit measures announced since then that will have a significant impact on relative child poverty, but work in progress at the time of writing was updating these forecasts to account explicitly for the rises in child poverty since 2004–05, and the current economic conditions. The original forecast was made in M. Brewer, J. Browne and H. Sutherland, *Micro-Simulating Child Poverty in 2010 and 2020*, Joseph Rowntree Foundation, York, 2006 (http://www.jrf.org.uk/bookshop/eBooks/9781859355091.pdf).

if the government is to stick to the provisional spending figures implied by the November 2008 PBR through to April 2016 – the numbers of children living in income poverty might be likely to persist above the government's target for 2010 for some time beyond then.

Higher education

Section 9.4 indicated the possibility of a real-terms freeze in total departmental expenditure over the next CSR period. As Figure 9.10 showed, if the burden of this were spread equally across government departments, DIUS would see its allocations fall in real terms over this period. At the same time, the government views investment in innovation and skills as essential for future national prosperity, so any tightening of the purse strings would pose clear challenges for the government's long-term economic and social objectives. An important aspect of the innovation and skills agenda is higher education (HE), the funding of which will be the subject of a government review later this year. This section explores a variety of options – some of which the funding review is expected to consider – for limiting public spending on HE while still attempting to meet departmental targets and longer-term strategic objectives.

Some cost-saving measures (brought about because DIUS had underestimated the cost of some student support reforms made in 2007) were announced last October, to be implemented in 2009–10.[9] The Secretary of State for Innovation, Universities and Skills, John Denham, set out the following changes:

- A reduction in grants for new students from middle-income families, who will receive partial instead of full maintenance grants. The income thresholds for partial maintenance grants will be reduced, meaning that fewer new students will be eligible for them, as will the generosity, meaning that those who remain eligible will receive less than they would have done otherwise. This is expected to save £100 million a year from 2009–10 onward. However, the government might be reluctant to use this as a vehicle for further reductions in departmental expenditure given its aim of increasing access to HE – particularly amongst those from low- and middle-income backgrounds.
- A cap of 10,000 on the number of additional student places to be created in 2009–10, revised downward from 15,000. This represents a considerable slowdown in the expansion of the HE sector when set against the increases in student numbers of approximately 20,000 in 2006–07, 26,000 in 2007–08 and 15,000 in 2008–09. This would save roughly £30 million in 2009–10,[10] with savings in future years if further caps on additional student numbers are announced. But despite the fiscal pressures operating in the background, a squeeze on HE enrolment would probably not be seen as an attractive option for further savings because it would severely undermine the government's progress towards its target of a 50% HE participation rate by 2010. This objective has already proved challenging in recent years, with the participation rate stubbornly hovering around 40% since the start of the decade. Moreover, the government stated, when the cap was announced, that it still intends to increase HE student numbers year on year.

[9] Written ministerial statement provided to the House of Lords, 29 October 2008; see http://www.dius.gov.uk/speeches/denham_ministerial_statement_291008.html.

[10] Based on latest available estimates of public HE expenditure per student in annex 2 of the DIUS Departmental Report 2008; see http://www.dius.gov.uk/docs/about/21076_DIUS%20AR&A_Web_NEW.pdf.

Commitments made in the same announcement were to maintain the 'unit of funding' (broadly speaking, public expenditure on teaching in HE per student) and the ring-fenced science budget. Fulfilling these commitments while increasing student numbers would make it unlikely that resources could be freed up from the department's HE budget and reallocated towards other areas. Furthermore, Mr Denham pledged to increase investment in further education, limiting the scope for savings elsewhere in the DIUS budget. With these constraints in mind, a few options remain to ease cost pressures during the next CSR period. This year's HE funding review might consider ways of reducing the taxpayer burden of HE while still maintaining the unit of funding and growth in the number of places – in which case it is likely that the private contribution to HE would have to rise.

Raising or removing the cap on tuition fees – currently £3,145 – would be one way of increasing the private contribution. But tuition fees are not payable up front; they are covered in full by a fee loan provided by the government, which is then paid back after graduation in the form of salary deductions. The terms of repayment for the fee (and maintenance) loans are quite favourable to the borrower:

- payments are only made once annual earnings surpass £15,000;
- the interest rate levied is equal to RPI inflation[11] rather than the government's cost of borrowing or a commercial rate (both of which are usually higher);
- any student debt outstanding after 25 years is written off.

These features, collectively known as the 'loan subsidy', ensure that the value of future graduate repayments is lower than the cost to the government of providing the loans. The government has forecast that for every £1 of fee loans issued, only 67 pence will eventually be recouped.[12] The resulting cost to the taxpayer of fee deferral is planned to reach £782 million by the end of the current CSR period; while universities might benefit from charging higher fees, the burden on the taxpayer would grow further if an increase in fees were matched by an increase in fee loans with the same repayment terms as currently. To avoid higher costs, the government could provide an unsubsidised loan to cover any additional fees above the current cap, or it could require the additional fees to be paid up front by students.[13] Alternatively, the government could find savings elsewhere by reducing the amount of research and capital funding allocated to universities, or by abandoning the commitment to maintain the unit of funding (since no time scale was attached to this) and reducing teaching grants to universities at the same time.

Instead of increasing fees, the government could reform the repayment terms themselves in order to reduce the value of the loan subsidy, which may be an attractive option given the sums involved. As maintenance loans are subsidised in the same way as fee loans (at a planned cost of £606 million in 2010–11), the total cost to the exchequer of subsidised

[11] Thus, if inflation falls to 0%, graduates would not pay any interest on their student loans. At the time of writing, DIUS ministers had not announced what they would do in the event of deflation; as the rules currently stand, graduates could receive interest on their student loans if this scenario were to arise.

[12] For maintenance loans, issued with the same repayment terms, only 79 pence out of every £1 lent to students is expected to be recouped. Source: written answer provided to the House of Commons, 4 February 2008 (http://www.publications.parliament.uk/pa/cm200708/cmhansrd/cm080204/text/80204w0046.htm).

[13] For further analysis exploring the government's options if it allows the fee cap to be raised, see J. Chester and B. Bekhradnia, *Funding Higher Fees: Some Implications of a Rise in the Fee Cap*, Higher Education Policy Institute, Oxford, April 2008 (http://www.hepi.ac.uk/pubdetail.asp?ID=250&DOC=Reports).

loans is forecast to reach £1.4 billion per year by the end of the current CSR period – about 13% of the resource DEL budget for HE. There are many ways of making the repayment terms less generous for graduates, some of which – such as replacing the zero real interest rate with the government's cost of borrowing – have been advocated by influential commentators in this area.[14] Recent work by IFS researchers has estimated that if student loans carried a real interest rate of 2.5% instead of 0%, the government would on average save £2,800 per graduate (expressed in today's prices).[15] Increases in the interest rate may raise concerns about the burden of graduate debt levels, but those graduates with the lowest lifetime earnings would be the least affected by this measure because of the debt write-off provision.

Other options to reduce the generosity of the loan subsidy include postponing the debt write-off point, reducing the earnings threshold above which repayments are made, or abandoning the inflation indexation of the earnings threshold (due to start in April 2010). Estimates of the savings from these measures are not available but it is clear that they would increase the total amount of money that graduates repay. However, compared with an increase in the interest rate, these options are more regressive – that is, among those graduates who are making repayments, these options would hit the lowest earners the hardest.[16]

One final aspect of HE funding that has implications for the broader public finances is the student loan book – the portfolio of all loans issued to HE students and the claims on future repayments through the PAYE or self-assessment processes. In the National Accounts, student loans count as public debt as they are financed by the sale of gilts, but because they are financial transactions, they lie outside TME. As a result, the creation of additional loans does not affect expenditure or net borrowing (except through the extra interest payments that must be made to service the new debt). The government announced in Budget 2007 its intention to sell off £6 billion – about a third of the book's total value at the time – worth of student loans by the end of 2010–11, with the possibility of more sales thereafter, and it has since passed legislation enabling it do so. However, selling the rights to student loans would not significantly alleviate the pressure of tighter spending settlements during the next CSR period (although the reduction in public sector net debt, and any resulting falls in debt interest payments, may still be attractive to the government).

9.6 Conclusions

The November 2008 PBR pencilled in 1.1% real annual growth in public spending over 2011–12 to 2013–14, presumably the three years to be covered by the next Spending

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[14] See, for example, N. Barr, *Funding Higher Education: Policies for Access and Quality*, House of Commons Education and Skills Committee, 24 April 2002 (http://econ.lse.ac.uk/staff/nb/Barr_Selcom020424.pdf).

[15] L. Dearden, E. Fitzsimons, A. Goodman and G. Kaplan, 'Higher education funding reforms in England: the distributional effects and the shifting balance of costs', IFS Working Paper WP18/07, October 2007 (http://www.ifs.org.uk/wps/wp1807.pdf). The figure of £2,800 is the authors' own calculation based on a male:female ratio among graduates of 42:58; source: table 1.2 of Higher Education Statistics Agency, *Destinations of Leavers from Higher Education Institutions*, 2007 (http://www.hesa.ac.uk/dox/dlhe_longitudinal/0203/DLHE_Long_2002_03_FINAL.pdf).

[16] One exception to this would be raising the rate at which repayments are made (currently 9%) beyond the £15,000 earnings threshold, thereby making graduates pay off their debt faster. Higher-earning graduates would be the most affected by any increases in this percentage, so it would be a progressive measure (among graduates).

Review. This is less than a third of the average increase in public spending seen over the previous five Labour Spending Reviews, and less than the average growth over the 18 years of Conservative governments between 1979–80 and 1996–97. If delivered, these plans would reduce total public spending by 2.5% of national income over the three years – equivalent to £37 billion in today's terms. However, because the deterioration in the outlook for the UK economy over the next few years has been so large, this spending squeeze will only just be sufficient to bring public spending as a share of national income back down towards the levels planned in the CSR 2007.

If these spending plans are adhered to, difficult decisions would need to be made in the next Spending Review. Under a plausible scenario in which net debt interest payments grow in real terms by 7.7%, underlying social security and tax credit expenditure grow at 1.7%, and all other annually managed expenditure grows at 1.9%, overall departmental spending would have to remain frozen in real terms over the three years 2011–12 to 2013–14.

A real-terms freeze in total DEL would make settlements in the next Spending Review very tight. If the pain were shared equally, so that each department had an equal percentage point reduction in its annual growth rate over the next Spending Review period compared with the CSR 2007 period, only seven departments would maintain positive real growth rates. Even health and education, whilst maintaining positive growth in spending under this assumption, might see their spending fall as a share of national income. The November 2008 PBR also announced a planned cash freeze in investment spending over 2011–12 to 2013–14. This squeeze on investment means that capital-intensive departments such as transport and housing are likely to find their budgets even more constrained than most.

Low growth in education spending could result in a squeeze in public funding for higher education, given Gordon Brown's ambitions for spending on state schools. Whilst opportunities exist for reducing public funding for HE, these generally involve increasing the costs borne by graduates and might conflict with government objectives to widen and increase participation.

The low growth in public spending also has implications for some of the government's specific policy objectives. One likely outcome is that the government will choose to delay the earnings indexation of the basic state pension past April 2012 so that social security expenditure does not grow so quickly at a time when restrictions on overall spending growth are so tight. Those low-income pensioners who do not take up the means-tested benefits to which they are entitled and are reliant on the state pension for their income would lose the most from this change. Latest projections for the government's 2010 child poverty target indicate that the government is on course to miss its own target by 0.6 million children, and would be further adrift of its challenging 2020 target. This could imply that additional resources will need to be found over the next Spending Review period or else the numbers of children in poverty could persist above the government's target for 2010 for some time beyond that date.

The government seems confident that it will find sufficient efficiency savings for public services to be expanded and improved over the next Spending Review period despite the low increase in public spending. However, with so many efficiency savings being delivered in recent years, it will be increasingly difficult to find more. Alternatively, the government could decide to increase public spending more quickly than the 1.1% a year that was pencilled in by the November 2008 PBR, but this would require additional

resources. Increasing real public spending by 2.0% a year over the three years – which is the rate of increase initially intended for the period covered by the CSR 2007 – would require an additional £20 billion in today's terms in 2013–14. These additional resources would have to come from higher taxes or higher borrowing.