

Opening remarks

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Welcome to our post spending review analysis.

Let me start by getting a moan off the collective chest of the IFS. The documentation and explanation accompanying yesterday's spending review announcements was woeful. That may not seem like much of a headline. But it matters. Publishing such a small amount of information with so little explanation is not an exercise in open government. Just one example. The Budget said that the Home Office RDEL in 2014–15 would be £7.4bn but the Spending Round said it would be £10.4bn. The explanation for this change is not contained in the Spending Round book, rather it can apparently be found in the "May estimates" somewhere on the unhelpful new Treasury website. The explanation is that the police grant has been moved to the Home Office from the Local Government budget.

What we did find out was that radical changes to the level and composition of public spending will continue. The Chancellor has again set out ambitious plans to reduce and restructure public sector pay. He is looking to create a mechanism to rein in social security spending. And he has confirmed that dramatic changes to the school funding system will be implemented in 2015. What he did not announce was an increase in public sector net investment. Despite the hype net capital spending is not set to rise.

In outline at least, we knew most of this already. And this is not a spending review on the scale of the chancellor's first, 2010, announcements.

But we should not lose sight of the scale of what was announced yesterday. Nor of the radical nature of some of the announcements.

At almost any other moment in the past 60 years announcements of spending cuts of this scale would have created a storm. As would an announcement that 144,000 public sector jobs would go in one year as part of a programme that could see one million jobs lost by 2017-18. Not now. We seem almost to have got used to this level of austerity. We might need to get used to it. Cuts of a similar magnitude are pencilled in for the two years from April 2016 as well. No doubt Treasury and government have been encouraged by the apparently relative ease with which cuts have been implemented so far. But, of course, past performance may not be a guide to future performance.

At some point we are going to have to have a serious debate about whether all of the rest of the fiscal consolidation is really going to happen through spending cuts alone. We are on course not for sharing the consolidation 80% on spending and 20% on tax as the government originally planned but for an 85:15 split. Returning to an 80:20 split for the consolidation as a whole would mean a £6 billion tax increase in the next parliament. Coincidentally this is pretty close to the average tax increase seen in post election budgets in recent decades.

Proposals to reform school funding, public sector pay setting and the control of social security spending are also radical and important.

There were, thankfully, fewer smaller policies announced than in your average Budget. The main consequences of the changes will, quite appropriately, be worked out by the relevant departments. But of course there are still a few little teasers hidden in some of the detail – including changes to policy on

social rents and on student grants. But perhaps the additional change with the greatest potential long term effect is a tax policy – the extension of the council tax freeze into a sixth year. This is looking like one of those habits it is going to be hard to break. In which case a significant and important part of the tax system will be undermined and will wither.

The spending cuts

In large part what we will get in 2015-16 is a clear continuation of spending policies laid out in 2010. Health and schools continue to see their budgets protected from cuts. Even so job losses in the NHS are likely to continue. Most other spending programmes get hit hard, with local government, justice and environment among the perennial losers. Each of those will have lost more than a third of their 2010 Budgets by 2015.

One change in emphasis is that between current and capital spending. The latter was cut much more substantially than the former last time around – in line with the previous government's proposals. This time capital spending has done rather better – though we are hardly entering a new era of massive infrastructure investment. For despite the headlines no increase in capital spending was announced yesterday - at least up to 2017-18. Public Sector Net Investment is going to be broadly flat over the next four years. That means it will fall in 2015-16 to 1.5% of GDP, from 1.6% in 2014-15, and will fall further as a share of national income in 2016-17 and 2017-18.

Overall, though, two facts stand out. First, there are still another £25 billion worth of cuts pencilled in for the two years after 2015-16. That looks tough indeed. Second, the protection of the NHS and schools and pensions at least through to 2015-16 while all else is being cut, is leading to continued change in

the shape of the state. These ring fences will have to be looked at again if we continue to cut overall spending.

Pay and jobs

If you are going to make serious cuts in public service spending you are going to have to make serious cuts to the number of public sector workers and to their pay. And that is just what the government is doing and is planning to do more of. For spending on public sector pay accounts for around half of non investment spending.

Nearly 300,000 public sector jobs have already been lost with a similar number due to go in the next two years. And for 2015-16 the Chancellor suggested that 144,000 more would be lost, perhaps saving getting on for £4 billion in public spending.

Continuing on a similar path could see job losses of around one million by 2017-18.

As Mr Osborne pointed out new jobs in the private sector have more than offset public sector job losses. Our analysis suggests that is true in every region. On the other hand there is no clear correlation between public job losses and private job creation. It turns out that some regions like London where public job losses have been relatively limited are the regions with the biggest increases in private sector employment.

The other half of the equation is the level of pay. Private sector pay has performed so badly that the additional year of 1% pay rises in the public sector in 2015-16 will be enough merely to return the public private pay gap to its pre-recession level. Thus far it is still the case, that despite the years of restraint, average pay in the public sector has risen by more since 2007 than

average pay in the private sector. The additional year of pay restraint looks manageable from that point of view.

Much more potentially dramatic is the proposed abolition of progression pay – whereby some employees automatically see their pay increase with experience. To the extent that this is real it could represent a big long term reduction in the pay package for public employees. We wait to see whether this Chancellorial proposal fares any better than frequent Treasury calls for pay reform in the public sector.

AME and social security

Another ambition set out was to put a cap on elements of social security spending. Perhaps surprisingly, though, no cap was put in place for next year. This remains an aspiration for the future rather than an immediate reality.

What is the role of such a cap?

The first thing to be clear about is that the proposed cap will *not* tackle those bits of annually managed expenditure which are currently expected to rise. Spending on working age social security is actually due to fall. The big increases are due to be in debt interest and public service pensions. Spending on these is rather harder to cap.

Secondly, there have been times in the past when elements of the social security budget do seem to have run out of control. So a mechanism to ensure this is properly managed might help. But this ought to be done for each element of the budget. There seems little good case for trading off, say, increases in the housing benefit bill against, say, pensioner winter fuel allowances.

Finally, one has to ask why a cap is a good idea from 2015-16 but not for 2014-15.

Schools

The schools budget is ringfenced, though other elements of the education budget are being cut. The biggest change to school funding over the next few years though looks like not being in its overall level rather in its distribution. Mr Osborne confirmed that the long mooted national funding formula will be in place from 2015.

The reform will ensure that local authorities with similar characteristics in terms of pupil deprivation and so on will receive similar amounts of money.

This would iron out an array of differences in how local authorities and schools are funded, differences which result in significant funding anomalies.

Otherwise similar local authorities, and therefore schools, can receive very different amounts of funding under the current system. So the introduction of a more rational funding system is to be welcomed. But we should not underestimate its difficulties. Ironing out these differences will help some schools and areas but hurt others. While no doubt reform would come with transitional protection, it will inevitably result in some losing resources.

Council tax

I'm going to end with a few words not about spending but about taxation.

Another year of incentives to persuade councils to freeze council tax levels was announced. Council tax is an important part of the tax system. It is the main tax on property and raises more than £27 billion a year. Freezing it year after year reduces the real value of these revenues. By the end of 2015-16 revenues

will probably be a good £3 billion lower than they would have been in the absence of these policies.

And we know that the more often you offer one-off annual freezes to taxes the harder it is to unfreeze them.

This has the potential to be a major reform to the structure of our tax system. However much council tax payers may welcome it this is not a sensible reform. And it is not one that is being properly announced or debated. We need an effective property tax and we need a robust source of funding for local government. This continuing policy looks set to undermine both.

Conclusions

In one sense there was nothing startling about yesterday's announcements. We knew the broad outline of what was to come. But we must not lose sight of the bigger picture.

The cuts announced were part of the biggest fiscal consolidation since the war. At any other time they would have been considered extraordinary. And there is much more to come.

We need to start the discussion now about the scale and composition of those cuts to come, whether protected spending areas will continue to be protected, and whether we will really avoid further tax increases.