The Outlook for the 2015 Spending Review

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Executive summary

- The plans set out by the Chancellor in the July 2015 Budget imply that departmental spending is to be cut by £11.3 billion (3.2%) in real terms between 2015–16 and 2019–20. Within that, capital (investment) spending is planned to increase by £4.9 billion (11.5%) while resource (non-investment) spending is planned to be cut by £16.2 billion (5.1%).
- In the absence of further changes to the government's planned level of total spending or forecasts for non-departmental spending, it will be cuts of this order that the upcoming Spending Review will allocate between departments.
- The government has already pledged to increase real-terms resource spending on the National Health Service, the Ministry of Defence and official development assistance and essentially to freeze real-terms resource spending on schools. Taken together, these pledges amount to around £7.6 billion by 2019–20. This means that other 'unprotected' departmental resource spending would need to be cut by £23.7 billion (18.8%) between 2015–16 and 2019–20. These departments also experienced significant cuts in recent years: the cut between 2010–11 and 2019–20 would be £64.9 billion (38.8%).
- After taking account of resources that will be devolved through block grants to Scotland, Wales and Northern Ireland through the possible operation of the Barnett formula, this would leave other Whitehall departments facing an average cut to their resource budgets of around 27% between 2015–16 and 2019–20. Over the period from 2010–11 to 2019–20, the total real cut to this resource spending would reach around 50%.
- In practice, some departments would be expected to fare better than this and others worse, depending on the government's priorities. In response to a request from HM Treasury, departments have provided an assessment of the implications of cuts to their resource budgets of 25% and 40% between 2015–16 and 2019–20.

1. Introduction

On 25 November 2015, HM Treasury will publish the results of its latest Spending Review, allocating budgets to Whitehall departments for the four financial years 2016–17 to 2019–20. This short briefing note sets the scene, clarifying what we already know about the government's plans for spending over this period and therefore what might be expected in November in terms of the scale of cuts and the allocation across departments.

We do not produce any predictions about the outcome of the Spending Review. However, we do provide an illustrative example of the cuts that would be required across 'unprotected' departments if all departments saw their resource (non-investment) budgets cut by the same proportion. This enables us to give a sense of the scale of the implications for these departments of the protection the government has already announced for some areas of spending.

This briefing note is accompanied by an online tool that allows you to make your own changes to departments' resource budgets and see how these stack up against the plans set out by the Chancellor in the July 2015 Budget. This is available at www.ifs.org.uk/tools_and_resources/spending-review-2015-guide.

Irrespective of how spending is allocated between departments, the next parliament will be a challenging one for public services as a whole. Total public spending is forecast to be cut from 39.6% of national income in 2015–16 to 36.3% by 2019–20, the lowest share of national income spent since 2000–01.[1] Excluding spending on social security and debt interest, other 'public service' spending is forecast to fall from 26.1% to 23.8% of national income. This would also be the lowest level of this spending since 2000–01 (with the four-year period from 1997–98 to 2000–01 being the only years since the Second World War in which this measure of spending has been below 24% of national income).

2. The total departmental spending envelope

In the July 2015 Budget, the Chancellor planned that total public spending ('total managed expenditure', TME) would increase from £742.3 billion in 2015–16 to £804.4 billion in 2019–20. Taking into account forecast inflation from the Office for Budget Responsibility (OBR), this would imply real spending of £746.9 billion in 2019–20 (in 2015–16 prices) – a real-terms increase of 0.6%.[2] The Office for Budget Responsibility forecasts that by 2019–20 the government will have 'eliminated the deficit' and will achieve a budget surplus of 0.4% of national income. In 2020–21, the government's planning assumption is that public spending will grow in line with national income, which implies a real-terms increase of 2.4%.

For planning purposes, total public spending is divided into two broad components: departmental expenditure limits (DEL) and annually managed expenditure (AME).[3] DEL, which is now just under half of total public spending, is allocated to government departments to spend on administration and delivery of public services – typically done in Spending Reviews. AME, which is currently just over half of total public spending, is spending that is deemed harder to control as it is demand-led, such as welfare spending and debt interest payments. The latest OBR forecast suggests that AME will grow by 4.1% in real terms between 2015–16 and 2019–20. This means that DEL will need to be cut by 3.2% over this period to keep to the government's total spending plans (see Table 1). This implies an average real cut to DEL of 0.8% per year – which is smaller than the average annual cut of 2.1% implemented between 2010–11 and 2015–16. Taking the period since 2010–11 as a whole, the July 2015 Budget plans imply a cut to DEL of 12.7% between 2010–11 and 2019–20.

[1] This would be the fourth-lowest share of national income devoted to total public spending since the Second World War (after 1957–58 at 35.8%, 1999–2000 at 36.0% and 2000–01 at 36.2%).

[2] If inflation were to turn out differently, then by default this would mean that real-terms changes in spending would turn out differently (for example, higher-than-expected inflation would imply a smaller real-terms increase or larger real-terms cut than currently expected). However, the government could respond to the change in forecast inflation by changing cash spending plans (as in effect happened over the last parliament).

[3] For more information, see Office for Budget Responsibility, 'A brief guide to the UK public finances', 2015, http://budgetresponsibility.org.uk/wordpress/docs/Brief-guide-to-the-public-finances-July-2015.pdf or Keynes and Tetlow, 'A survey of public spending in the UK', 2014, http://www.ifs.org.uk/publications/1791.

Table 1. Latest forecasts for total departmental spending

£ billion, 2015–16 prices	2015–16	2016–17	2017–18	2018–19	2019–20	2020–21
Total public spending (TME)	742.3	741.7	741.8	743.4	746.8	764.9
of which:						
Annually managed expenditure (AME)	384.9	386.0	393.3	396.6	400.7	402.4
Departmental expenditure limits (DEL)	357.5	355.7	348.4	346.8	346.2	362.4
DEL % change on previous year		*–0.5%*	*–2.0%*	*–0.4%*	*–0.2%*	*4.7%*
DEL % change since 2015–16		*–0.5%*	*–2.5%*	*–3.0%*	*–3.2%*	*1.4%*
DEL % change since 2010–11	*–9.9%*	*–10.3%*	*–12.2%*	*–12.6%*	*–12.7%*	*–8.6%*

Note: To provide a consistent comparison over time, figures for AME and DEL in 2010–11 are adjusted for the subsequent movement of the Network Rail grant, council tax benefit and localised business rates.
Source: 2010–11 estimated based on HM Treasury, *Public Expenditure Statistical Analyses*. 2015–16 onwards are from table 2.2 of HM Treasury, *Summer Budget 2015* (DEL is resource DEL excluding depreciation plus capital DEL; AME is resource AME plus depreciation plus capital AME). Deflated using GDP deflators from Office for Budget Responsibility, *Economic and Fiscal Outlook: July 2015*.

In the rest of this document, we assume that the DEL spending envelope for the Spending Review – that is, the total amount of money available to be allocated between departments – will be as shown in Table 1 (i.e. the figures suggested by the July 2015 Budget based on current AME forecasts). Under this assumption, the 2015 Spending Review would be looking to allocate around £11 billion of real-terms cuts to departments' annual budgets by 2019–20.

In practice, the government has not explicitly set the spending envelope. The HM Treasury document announcing the Spending Review stated that 'all areas of public expenditure will be in scope including departmental budgets and Annually Managed Expenditure'.[4] In other words, the government may be looking to reduce AME in order to loosen the cuts required to DEL. However, in practice, it seems reasonable to assume that the DEL forecasts laid out in the July 2015 Budget (shown in Table 1) will form the basis of the settlement allocated between departments, and that is the assumption we maintain in the rest of this briefing note.

Resource and capital budgets

Each department has two separate DEL budgets: a *resource* budget for day-to-day spending and a *capital* budget for investment spending. The July 2015 Budget plans are for total departmental capital spending to increase in real terms between 2015–16 and 2019–20 by £4.9 billion (11.5%). In contrast, resource spending will be cut by £16.2 billion (5.1%) – see Table 2. This implies an average cut to resource DEL of 1.3% per year – somewhat lower than the average annual cut of 1.9% implemented between 2010–11 and 2015–16.

The planned cuts to resource DEL are not smooth. The July 2015 Budget plans imply only around £1.3 billion need by found in 2016–17, but an additional £7.2 billion in 2017–18, a further £5.7 billion in 2018–19 and an additional £1.9 billion in 2019–20. However, the pressure on departments in 2016–17 may be greater than these figures imply, since from 2016–17 the public sector faces higher employer National Insurance contributions due to the ending of contracting out into defined benefit pension schemes. HM Treasury has

[4] Page 19 of HM Treasury, 'A country that lives within its means: Spending Review 2015', Cm 9112, 2015, https://www.gov.uk/government/publications/spending-review-2015-a-country-that-lives-within-its-means.

estimated that this will cost public sector employers £3.3 billion in 2016–17.[5] Hence the effective cut in 2016–17 could be more like 1.5% rather than the 0.4% shown in Table 2. The largest forecast cut to resource DEL in a single year is 2.3% in 2017–18, which is smaller than the cuts achieved in 2011–12 and 2012–13 (3.2% and 3.1% respectively). The profile for the change in capital DEL is also far from smooth, but investment spending is inherently lumpy.

Table 2. Latest forecasts for resource and capital departmental spending

£ billion, 2015–16 prices	2010–11	2015–16	2016–17	2017–18	2018–19	2019–20
Total departmental spending	**396.7**	**357.5**	**355.7**	**348.4**	**346.8**	**346.2**
Of which:						
Resource DEL	**346.5**	**315.1**	**313.8**	**306.6**	**300.9**	**298.9**
% change on previous year			*–0.4%*	*–2.3%*	*–1.9%*	*–0.6%*
% change since 2015–16			*–0.4%*	*–2.7%*	*–4.5%*	*–5.1%*
% change since 2010–11		*–9.1%*	*–9.4%*	*–11.5%*	*–13.2%*	*–13.7%*
Capital DEL	**50.2**	**42.4**	**41.9**	**41.8**	**46.0**	**47.3**
% change on previous year			*–1.2%*	*–0.2%*	*9.9%*	*2.8%*
% change since 2015–16			*–1.2%*	*–1.4%*	*8.4%*	*11.5%*
% change since 2010–11		*–15.5%*	*–16.5%*	*–16.7%*	*–8.4%*	*–5.9%*

Note and source: As Table 1.

The planning of capital and resource spending is being undertaken somewhat separately in the 2015 Spending Review. The government has asked departments to set out plans for how they would reduce their resource budgets (specifically, asking departments to model the implications of cuts of 25% and 40%), but the government has stated that capital spending will be considered separately and across departments 'to identify the areas of spending that will achieve the best economic returns'.[6]

3. Allocations between departments

The full allocation of DEL between government departments will not be known until the Spending Review is published in November, but the government has already made a number of announcements about the allocation of spending to some areas. In this section we describe these commitments and illustrate what they could imply for other areas of spending.

In doing so, we take as our reference point departments' actual budgets in 2015–16 (as published by HM Treasury in July 2015). This is likely to be different from the approach taken by HM Treasury for the figures published in the Spending Review, which will probably be calculated using departments' 'baseline' budgets in 2015–16, excluding temporary or one-off items of expenditure. It is also important to note that simple comparisons of budgets over time will not capture changes in responsibilities between departments over time.

[5] Table 2.1 of HM Treasury, *Budget 2013*, HC1033, 2013.

[6] Pages 19 and 20 of HM Treasury, 'A country that lives within its means: Spending Review 2015', Cm 9112, 2015.

Pre-announced settlements[7]

Health

The government has announced that it will increase NHS funding in England by £10 billion in real terms between 2014–15 and 2020–21. The profile of this spending increase is unknown, other than that £2 billion of the increase is planned to occur in the current year (2015–16).[8] In the calculations that follow, we assume that the increase happens linearly after this year – i.e. that the Department of Health (DH) receives a £1.6 billion increase in its budget each year between 2016–17 and 2020–21. This implies a £6.4 billion (or 5.7%) real increase in the DH resource budget between 2015–16 and 2019–20 (and an £8 billion real increase between 2015–16 and 2020–21).

Schools

The government has also committed to protecting per-pupil non-investment spending on schools in nominal terms. Based on current forecasts for inflation and student numbers this commitment would imply a maximum cut in schools' resource spending of £0.3 billion (or 0.6%) in real terms between 2015–16 and 2019–20.

Defence

The government has pledged to raise the Ministry of Defence (MoD) budget by 0.5% per year in real terms up to 2020–21. We assume that this pledge applies to non-investment spending by the MoD (given the focus of the HM Treasury Spending Review document on resource spending); this could require an increase in the MoD resource budget of £0.6 billion (2.0%) in real terms between 2015–16 and 2019–20.[9]

Spending on official development assistance

The government has legislated a commitment to spend 0.7% of national income on official development assistance (ODA). This is forecast to require a real-terms increase in ODA spending of around £1.2 billion (9.8%) between 2015–16 and 2019–20.[10] The Department for International Development (DfID) is responsible for the majority of ODA (86% in 2014) and so can expect to see its budget grow over the next parliament. Under the assumptions that around 26% of ODA spending is capital (this is the proportion of the DfID budget that is capital in 2015–16) and that capital spending on ODA grows in line with total capital DEL over the period 2015–16 to 2019–20, resource spending on ODA would need to increase by around £0.9 billion (9.3%) in real terms.

Other commitments

The government has made a number of other commitments to a variety of smaller areas of spending – for example, 'making available an additional £1.5 billion a year towards the end of the Parliament to increase spending on the military and intelligence agencies' and the additional £0.3 billion a year that has been pledged to improve HM Revenue and

[7] The commitments below are made in HM Treasury, 'A country that lives within its means: Spending Review 2015', Cm 9112, 2015.

[8] Paragraph 1.77 of HM Treasury, *Summer Budget 2015*, HC 264, 2015.

[9] This is calculated using the MoD resource DEL budget of £28.1 billion in 2015–16. However, this budget includes the 'likely initial drawdown of funding from the Special Reserve for the net additional cost of military operations'. If the government commitment applies to increasing only the MoD defence capability budget, then the increase in real spending required will be slightly smaller.

[10] This is calculated by assuming that ODA spending in 2013–14 is equal to 0.75×ODA spending in 2013 + 0.25×ODA spending in 2014, that ODA spending between 2013–14 and 2015–16 grows in line with GDP, and that ODA spending between 2015–16 and 2019–20 grows in line with GDP.

Customs (HMRC)'s tackling of non-compliance and tax evasion.[11] We do not explicitly take account of these, since it is always the case that within departments' budgets there will be some areas of spending that are relatively protected and others less so. It is less clear what effect these commitments would have on any department's total resource budget allocation.

Implications for other departmental spending

The main areas of protected resource spending set out above are summarised in Table 3. Together we estimate that these protections amount to around £7.6 billion (in 2015–16 prices) by 2019–20. This implies that other areas of departmental resource spending will need to be cut by £23.7 billion (18.8%) in real terms between 2015–16 and 2019–20. This would bring the cuts to these other areas of departmental resource spending since 2010–11 to £64.9 billion (38.8%).

Table 3. Summary of main spending commitments pre-announced

	Budget in 2015–16 (£bn)	*Change 2015–16 to 2019–20*		*Change 2010–11 to 2019–20*	
		£bn (2015–16 prices)	%	£bn (2015–16 prices)	%
Resource DEL	**315.1**	**–16.2**	**–5.1**	**–47.6**	**–13.7%**
of which:					
Health	111.9	+6.4	+5.7%	+14.2	+13.7%
Schools	39.5	–0.3	–0.6%	+2.0	+5.4%
Defence	28.1	+0.6	+2.0%	–1.7	–5.5%
ODA	9.2	+0.9	+9.3%	+2.8	+38.3%
Implied other RDEL	126.3	–23.7	–18.8%	–64.9	–38.8%

Note: 'Health' is the Department of Health budget, 'Schools' is spending on ages 5–16 schooling, 'Defence' is the Ministry of Defence budget (including estimated outlay on operations) and 'ODA' is estimated spending on official development assistance.
Source: Authors' calculations based on HM Treasury, *Public Expenditure Statistical Analyses 2015* (for total resource DEL, health and defence), Conservative Campaign Headquarters (for schools), Department for International Development, *Statistics on International Development 2014* (for ODA) and OBR, *Public Finances Databank* (for deflators).

However, it is important to note that this 'other' resource DEL includes the block grants paid to the devolved administrations of Scotland, Wales and Northern Ireland to fund the provision of public services in their jurisdictions. The changes in these grants are traditionally calculated according to the Barnett formula, based on the change in the budgets allocated to the Whitehall departments responsible for delivering public services in England.[12] HM Treasury has indicated that this will be largely the case again in this Spending Review.[13] Since spending on health and schools in England has been protected, part of the block grant to the devolved administrations will be protected too. Exactly how much the grant allocated to Scotland, Wales and Northern Ireland will change depends on

[11] Page 14 of HM Treasury, 'A country that lives within its means: Spending Review 2015', Cm 9112, 2015; paragraph 1.171 of HM Treasury, *Summer Budget 2015*, HC 264, 2015.

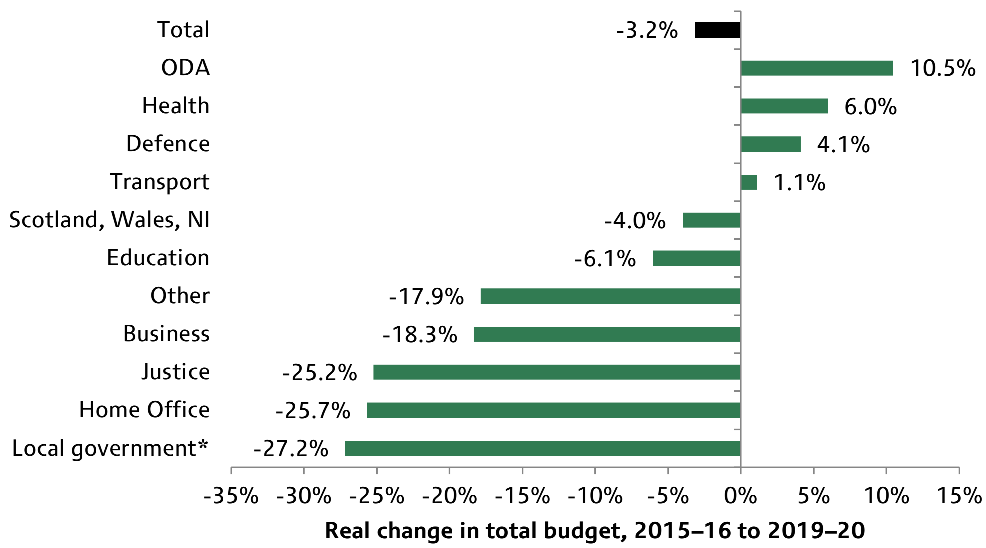
[12] For greater explanation of the Barnett formula, see, for example, D. Phillips, 'Business as usual? The Barnett formula, business rates and further tax devolution', 2014, http://www.ifs.org.uk/publications/7442.

[13] 'For the majority of spending, the Barnett formula will apply in the normal way at the Spending Review, and devolved administration allocations will be calculated by the Treasury on the basis of the settlements reached with UK government departments' (page 19 of HM Treasury, 'A country that lives within its means', Cm 9112, 2015).

how much is allocated to *each* department, since not all the functions of the various Whitehall departments are devolved and the functions that are devolved vary by nation.

We estimate that, if all unprotected departments were to see the same percentage cut to their resource budgets and if the block grants for Scotland, Wales and Northern Ireland were calculated using an approximation to how the Barnett formula may operate,[14] then the resource budgets of Scotland, Wales and Northern Ireland would be cut by an average of 5.2% between 2015–16 and 2019–20. That would imply that other unprotected Whitehall departments would see their resource budgets cut by 27.2% (£21.3 billion). Over the period from 2010–11 to 2019–20, this would bring the total real cut to unprotected resource spending, outside of that done by the devolved assemblies, to 50.3% (£57.7 billion). Figure 1 shows the implications for departments' total DEL budgets if we assume that all departments see the same percentage change in their capital DEL budgets (an increase of 12.3%) and that all unprotected departments see the same percentage change to their resource DEL budgets (a cut of 27.2%). The change in total DEL differs across departments because departments differ in their capital intensity – i.e. the proportion of their total budget that is accounted for by capital. For example, the Department for Transport is relatively capital intensive (capital DEL accounted for 72% of its total DEL in 2015–16) and so would actually experience a small increase (1.1%) in

Figure 1. Illustrative example of one possible spending allocation



Note: Scenario assumes that all departments (except Scotland, Wales and Northern Ireland) receive a 12.3% increase in their capital budgets and that all unprotected departments (except Scotland, Wales and Northern Ireland) receive a 27.2% cut to their resource budgets. The budgets of Scotland, Wales and Northern Ireland are determined according to the Barnett formula, which given the scenario above implies an average increase in capital DEL of 5.8% and an average cut to resource DEL of 5.2%. ODA is official development assistance.
* 'Local government' is the central government grant to local authorities. Note that local authorities also receive revenue from council tax and business rates.

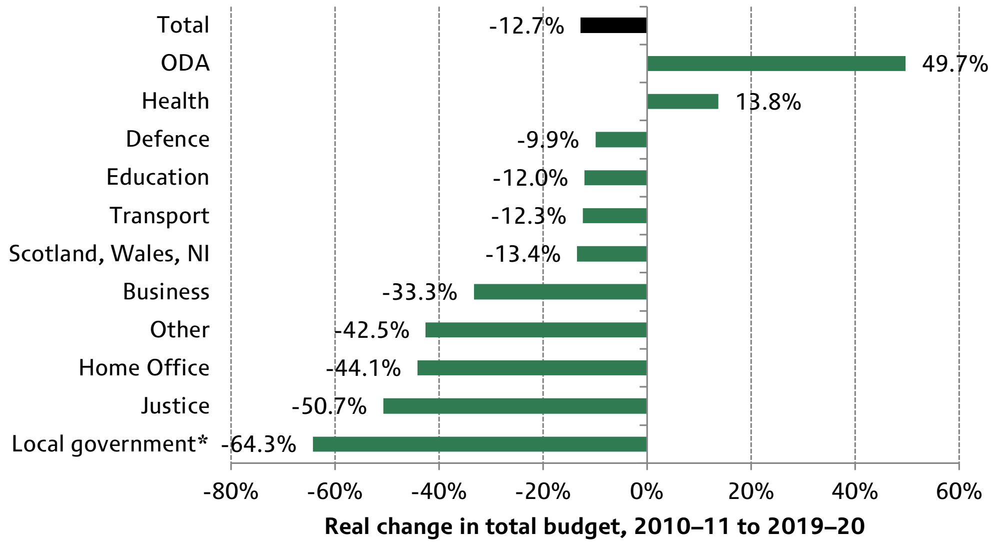
[14] The Barnett formula used by HM Treasury in the upcoming Spending Review will likely differ to that employed in these calculations for two reasons. First, the factors we use for the proportion of each department's budget that is devolved for each nation are based on the 2010 Spending Review factors with an adjustment for the impact of the business rates retention policy. We expect HM Treasury will calculate new factors for each department based on the current programmes being funded by each department. Second, in February 2015, the coalition government announced that it would introduce a 'funding floor' for Wales (https://www.gov.uk/government/news/landmark-funding-announcement-and-new-powers-for-wales-in-st-davids-day-agreement). The details of how this will operate have yet to be published, but it is likely to affect the calculation of the block grant for Wales in the 2015 Spending Review.

its total DEL budget under this illustrative scenario, while the Home Office is much less capital intensive (only 4% of its 2015–16 budget was capital) and so would experience a relatively large cut (of 25.7%) to its total budget.

It should be noted that the DEL grant to local government is just one source of revenue for English local authorities – they also raise revenue from council tax and business rates, and these sources of revenue are forecast by the OBR to rise in real terms over the parliament. Taking into account this revenue, the spending power of local authorities under the scenario presented above would be cut by substantially less than the 27.2% cut to Local government DEL presented in Figure 1.

Figure 2 shows the implications of this illustrative spending settlement for the change in departments' budgets since 2010–11.[15] For example, under this scenario the total budget cut from 2010–11 to 2019–20 faced by the Ministry of Justice would be 50.7%.

Figure 2. Impact of illustrative spending allocation on change in departments' budgets since 2010–11



Note: Scenario as in Figure 1. Adjustments for classification changes set out in footnote 15.
* As for Figure 1.

4. Conclusions

This briefing note has set out the implications of the government's July 2015 Budget plans for departmental spending over the period 2015–16 to 2019–20. We have provided one simple illustration of a possible allocation of cuts across departments taking into account the possible operation of the Barnett formula – this scenario assumes that all departments see the same percentage change in their capital budgets and that all unprotected departments see the same percentage change in their resource budgets. This scenario implies cuts to unprotected departments' resource budgets of 27.2% and cuts to total budgets that vary depending on the capital intensity of the department. An

[15] In doing these calculations, we have made some adjustments for classification changes that affect the consistency of departments' budgets over time – in particular: we adjust the transport budget to remove the Network Rail grant prior to 2015–16; we adjust the local government budget to remove the equivalent of retained business rates prior to 2013–14; and we adjust the local government, Scotland and Wales budgets to include council tax benefit prior to its localisation in 2013–14.

accompanying online calculator allows you to explore alternative ways of sharing the cuts to spending between departments (www.ifs.org.uk/tools_and_resources/spending-review-2015-guide).

A key question remains about whether or not spending cuts of this magnitude, on top of those delivered over the last parliament, are achievable. On the one hand, the coalition government demonstrated the ability to hold down spending, with many departments actually underspending their allocated budgets over the last parliament. On the other hand, further spending cuts (particularly with many of the same departments potentially seeing the biggest cuts again) will get harder as presumably easy efficiency savings have been identified and delivered, while demand and wage pressures continue to increase.