

# UK Spending Review October 2010

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*This is a note to contribute to a discussion of the UK government's Spending Review, published on 20<sup>th</sup> October. It looks at the causes and scale of the deficit that the coalition government inherited and the previous government's plans to reduce it. It then looks at the three main elements of expenditure savings, capital expenditure, welfare savings and departmental efficiencies. It then attempts to classify the spending reductions. It takes a short detour to look at the Canadian experience in the mid-1990s, asks what are the distributional consequences and ends by asking whether the process of control is likely to change.*

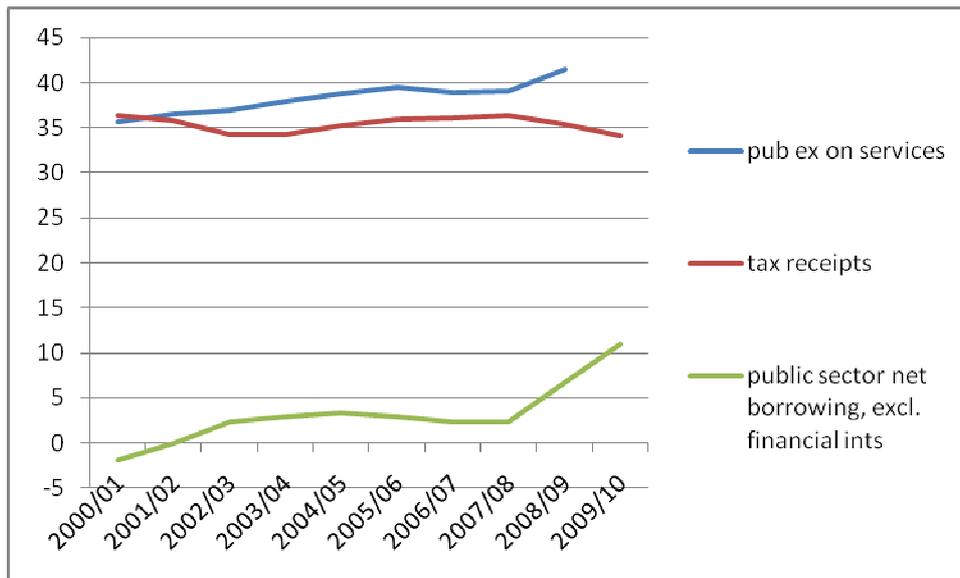
## Contents

<b>How did the deficit get so big?</b> .....	2
Fig 1 Spending on services, tax receipts and net borrowing as a % of GDP 2000-2001 to 2009-2010 .....	2
Fig 2 Total Managed Expenditure and Current Receipts, 1997-8 to 2009-10 .....	2
Fig. 3 Total Public Sector Employment, United Kingdom, 000s.....	3
<b>What is the coalition doing to cut the deficit?</b> .....	3
Table 1 Deficit and debt projections (% of GDP), March and June 2010.....	4
Table 2 Total Managed Expenditure .....	4
Table 3 Departmental Capital Budgets .....	5
Table 4 Administration budgets.....	6
<b>What kinds of cuts?</b> .....	6
Table 5 SR Annual savings comparing 2010/11 with 2014/15 £bn .....	7
<b>What did they learn from Canada?</b> .....	7
Fig 4 Canada Federal Government Total Public Service Employment 1993-2008.....	8
<b>What are the likely distributional consequences of the SR 'welfare reforms' and spending adjustments?</b> .....	8
Fig 5 Review estimate of distributional impact .....	9
Fig 6 IFS estimate of distributional impact .....	10
<b>Has the process of managing of public expenditure changed?</b> .....	10
<b>Other Issues</b> .....	10

## How did the deficit get so big?

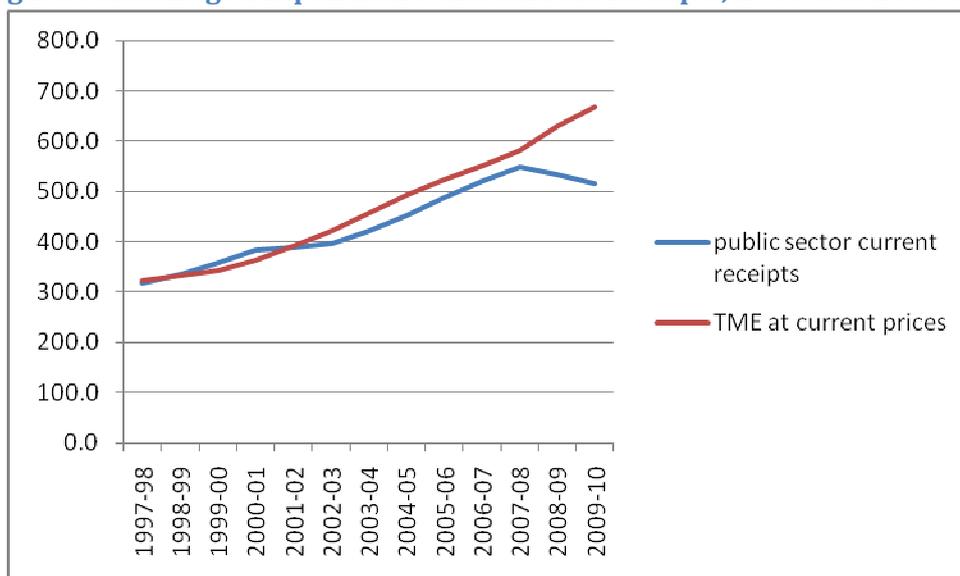
The deficit that the new government<sup>1</sup> inherited had been growing since 2001 at least, but it accelerated after 2007 as the tax revenues sharply fell with the recession. Taking away the impact of the rescue of the financial sector, spending on services grew from 35.7% of GDP in 2000-2001 to 41.5% of GDP in 2008-2009. Meanwhile tax revenues as a % of GDP fell over the period from 36.3% to 35.4%, with a 1 percentage point dip in 2008-2009. These figures are graphed, along with the net borrowing (less financial sector intervention spending) in Fig. 1

**Fig 1 Spending on services, tax receipts and net borrowing as a % of GDP 2000-2001 to 2009-2010**



The cash spending and net revenue figures, in current prices, are shown in Fig 2.

**Fig 2 Total Managed Expenditure and Current Receipts, 1997-8 to 2009-10<sup>2</sup>**



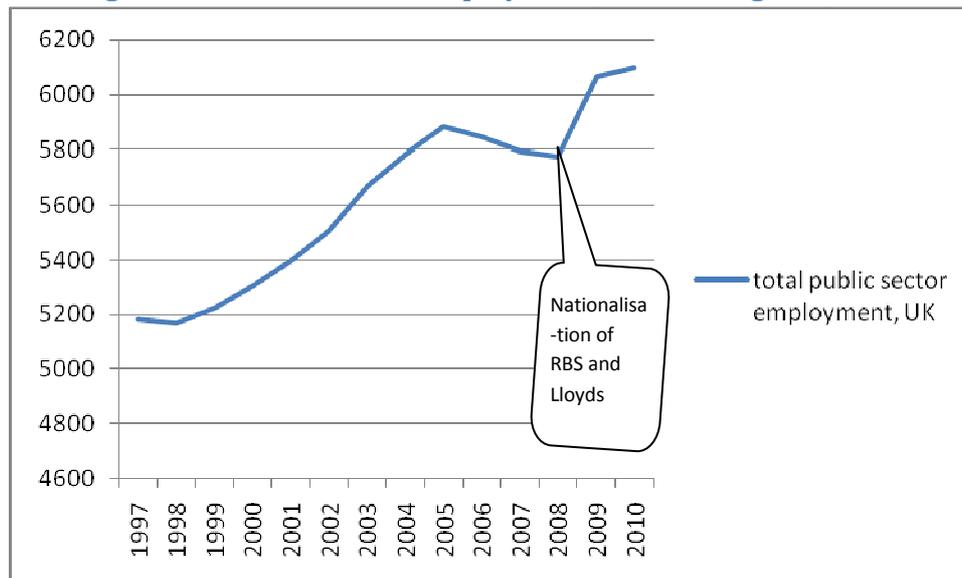
<sup>1</sup> The Labour Party, in government since 1997, lost the 2010 general election to a coalition of Conservative and Liberal Democrat parties, who formed a new government on May 10<sup>th</sup>.

<sup>2</sup> HM Treasury, Public Finances Database, June 2010

The Review states that the deficit in 2010 -11 is £149bn, or 21% of the total spend of £697bn. Of course this is an estimate and the outturn depends on the actual tax take over the year. The 2010 budget planned to reduce it by £128bn by 2014-15.

The increases in service spending mostly went to education and health, which increased their spend as a % of GDP from 4.6% to 5.8% and from 5.5% to 7.7% of GDP respectively. During most years of the Labour governments 1997-2010 there were increases in the numbers of people employed in the public sector, following a period of annual reductions during the previous administrations, as is shown in Fig 3<sup>3</sup>. Clearly, reversing the growth in spending would involve reversing the growth in personnel. Leaked estimates for the reduction in jobs indicate 480,000.

**Fig. 3 Total Public Sector Employment, United Kingdom, 000s**



### What is the coalition doing to cut the deficit?

We should start with some clarification of terms. First, ‘budget cut’. If a budget has already been passed by Parliament and then a supplementary budget is passed, with smaller expenditures that could be described as a budget cut. In a pluriannual budget system, like that of the UK, then a revision to future years in the three-year budget could probably also be described as a cut. But can a projection of spending that increases total spending in each year be described as a ‘cut’? It is only a cut in comparison with some other figure that might otherwise have been chosen. With a change of government, downward revisions of previous plans have been described as a cut, despite the fact that there is a cash increase in spending in every year over the period.

The second definition we need to agree on is ‘real terms’. The 2010 CSR projects a ‘real’ 8.3% cut in Departmental Programme and Administrative Budgets between 2010-11 and 2014-15. In cash terms, the total for 2014-15 is 2.3 bn higher than 2010-11, or an uplift of 0.7%. Inflation between the two dates is assumed to be 9%, to arrive at an 8.3% real terms cut. However, planning is done in cash terms, not ‘volume’ (where budgets are adjusted for price changes). In practice, therefore the rate of ‘real’ (after inflation) cuts depends on the rate of inflation of public sector costs. One of the

<sup>3</sup> Source: Office for National Statistics, database, July 2010

proposals in the CSR is a freeze on public sector pay, which will, if it sticks, produce 0% inflation for the wages and salaries element.

The other terms we need to be clear on are the ones used in the document: 'Departmental Expenditure Limit' represents the cost of providing services, 'Annually Managed Expenditure' is the cash that flows through the department, such as benefits or subsidies, 'Total Managed Expenditure' is the sum of these two. DEL is divided into current and capital expenditures. In some cases the figures used include and in other cases exclude depreciation.

The Labour government produced its last budget in March 2010, which was replaced by the Coalition budget in June. The June budget proposed to reduce the deficit faster than the March one. The proposed deficit and outstanding debt of the two budgets are reproduced here:

**Table 1 Deficit and debt projections (% of GDP) , March and June 2010**

	08-9	09-10	10-11	11-12	12-13	13-14	14-15	15-16
Deficit, March 2010 budget	6.7	12.2	11.2	8.6	6.9	5.3	4.2	
Deficit June 2010 budget	6.8	11.3	10.1	7.6	5.6	3.6	2.2	1.2
Debt, March 2010 budget	55.5	71.4	80.5	86.0	88.7	88.7	89.2	88.7
Debt June 2010 budget	55.8	71.2	78.9	83.6	85.5	84.9	83.1	80.4

The last Labour budget of March 2009 proposed to reduce the deficit to 4.2% of GDP by 2014/15, while the June budget proposed a reduction to 2.2% by that year. To do this the budget proposed a TME of £737.5 bn in 2014/15, a figure that was revised upwards by £2bn in the SR.

We now look at the headline figures: the proposed TME. Table 1.1 of the SR is reproduced below:

**Table 2 Total Managed Expenditure**

**Table 1.1: Total Managed Expenditure**

	£ billion				
	Plans		Forecasts		
	2010-11	2011-12	2012-13	2013-14	2014-15
<b>CURRENT EXPENDITURE</b>					
Resource Annually Managed Expenditure	294.6	307.8	319.5	329.1	344.0
Resource Departmental Expenditure Limits	342.7	343.3	345.0	349.6	348.7
<b>Public sector current expenditure</b>	<b>637.3</b>	<b>651.1</b>	<b>664.5</b>	<b>678.6</b>	<b>692.7</b>
<b>CAPITAL EXPENDITURE</b>					
Capital Annually Managed Expenditure	7.8	7.3	6.7	6.4	6.9
Capital Departmental Expenditure Limits	51.6	43.5	41.8	39.2	40.2
<b>Public sector gross investment</b>	<b>59.5</b>	<b>50.7</b>	<b>48.5</b>	<b>45.6</b>	<b>47.1</b>
<b>TOTAL MANAGED EXPENDITURE</b>	<b>696.8</b>	<b>701.8</b>	<b>713.0</b>	<b>724.2</b>	<b>739.8</b>
<b>Spending Envelope for Spending Review 2010<sup>1</sup></b>		<b>641.6</b>	<b>646.7</b>	<b>651.6</b>	<b>660.9</b>
<i>Of which:</i>					
<b>Resource spending envelope</b>		591.6	598.9	606.7	614.5
<i>of which Annually Managed Expenditure</i>		248.4	253.9	257.2	265.8
<i>of which Departmental Expenditure Limits</i>		343.3	345.0	349.6	348.7
<b>Capital spending envelope</b>		50.0	47.8	44.8	46.4
<i>of which Annually Managed Expenditure</i>		6.5	6.0	5.6	6.2
<i>of which Departmental Expenditure Limits</i>		43.5	41.8	39.2	40.2

<sup>1</sup> The envelope is defined as Total Managed Expenditure less BBC domestic services, National Lottery, net expenditure transfers to EU institutions and debt interest.

The first thing to note is that TME in 2014-15 is 6% higher than it is in 2010-11, in cash terms. The 'cut' in cash terms applies only to gross investment, a reduction from £59.5bn to £47.1, a reduction of 21%.

Where these capital expenditure cuts fall is shown in SR Table 2, which is reproduced here:

**Table 3 Departmental Capital Budgets**

**Table 2: Departmental Capital Budgets (Capital DEL)**

Capital DEL	£ billion					Per cent
	Baseline <sup>1</sup>	Plans				Cumulative real growth
	2010-11	2011-12	2012-13	2013-14	2014-15	
Education	7.6	4.9	4.2	3.3	3.4	-60
NHS (Health)	5.1	4.4	4.4	4.4	4.6	-17
Transport	7.7	7.7	8.1	7.5	7.5	-11
CLG Communities	6.8	3.3	2.3	1.8	2.0	-74
CLG Local Government	0.0	0.0	0.0	0.0	0.0	-100
Business, Innovation and Skills	1.8	1.2	1.1	0.8	1.0	-52
Home Office	0.8	0.5	0.5	0.4	0.5	-49
Justice	0.6	0.4	0.3	0.3	0.3	-50
Law Officers' Departments	0.0	0.0	0.0	0.0	0.0	-46
Defence	8.6	8.9	9.1	9.2	8.7	-7.5
Foreign and Commonwealth Office	0.2	0.1	0.1	0.1	0.1	-55
International Development	1.6	1.4	1.6	1.9	2.0	20
Energy and Climate Change	1.7	1.5	2.0	2.2	2.7	41
Environment, Food and Rural Affairs	0.6	0.4	0.4	0.4	0.4	-34
Culture, Media and Sport	0.2	0.2	0.2	0.1	0.1	-32
Olympics <sup>2</sup>	1.0	1.1	0.2	0.0	-0.1	-
Work and Pensions	0.2	0.2	0.3	0.4	0.2	-5.5
Scotland <sup>3</sup>	3.4	2.5	2.5	2.2	2.3	-38
Wales <sup>3</sup>	1.7	1.3	1.2	1.1	1.1	-41
Northern Ireland <sup>3</sup>	1.2	0.9	0.9	0.8	0.8	-37
HM Revenue and Customs	0.2	0.3	0.1	0.1	0.1	-44
HM Treasury	0.0	0.1	0.0	0.0	0.0	-30
Cabinet Office	0.0	0.0	0.0	0.1	0.0	-28
Single Intelligence Account 4	0.3	0.4	0.3	0.3	0.3	-2.8
Small and Independent Bodies	0.1	0.1	0.1	0.1	0.1	-52
Reserve	2.1	1.0	1.0	1.0	1.1	-
Special Reserve	0.7	0.7	0.8	0.8	0.8	-
<b>Total Capital DEL</b>	<b>51.6</b>	<b>43.5</b>	<b>41.8</b>	<b>39.2</b>	<b>40.2</b>	<b>-29</b>

<sup>1</sup> As at all spending reviews, baselines exclude one-off and time-limited expenditure and therefore may not sum to 2010-11 total. Cumulative real growth is calculated using the 2010-11 baseline.

<sup>2</sup> Olympics is included within DCMS DEL.

<sup>3</sup> The Government agreed that as part of the £6.2bn cuts to 2010-11 budgets the Devolved Administrations could defer their cuts to 2011-12. The settlements presented here assume the Welsh Assembly Government and the Northern Ireland Executive take their cuts in 2010-11 and the Scottish Executive take their cuts in 2011-12. These settlements are subject to change as the Devolved Administrations finalize their spending plans.

<sup>4</sup> Includes SIA contribution to National Cyber Security Programme

Of the £11.4 billion cut, £4.2bn falls in education, £4.8bn on CLG Communities, £2.1bn on Scotland Wales and Northern Ireland.

The second significant cut is in the welfare programme, a cut of £7.04bn to 2014-15, achieved by reducing eligibility for Employment and Support Allowance (£2.01bn saving to 2014-15), stopping child benefit from higher rate taxpayers (£2.5bn) and cuts in tax credits and other allowances. In addition, £3.5 billion is saved by changes to other cash flows, including increasing employee contributions to pensions (£1.76bn), retaining carbon reduction revenues (£1.02bn) and other measures.

The third set of savings is in 'Administration'. Administration is part of DEL and the review contains a simple, across the board cut of 33%, apart from three departments who are singled out for 40+ per cent cuts. The reductions imply an 11% cut in each of the first three years of the review period. The numbers are shown in Table 4

**Table 4 Administration budgets<sup>4</sup>**

**Table A.11: Administration budgets**

	£ million					Per cent
	Baseline <sup>1</sup>		Plans			Cumulative real growth
	2010-11	2011-12	2012-13	2013-14	2014-15	
<b>Administration budgets</b>						
Education	508	466	432	401	372	-33
NHS	5,074	4,500	4,000	3,715	3,715	-33
Transport	295	272	252	233	216	-33
CLG Communities	452	399	360	323	289	-42
Business, Innovation and Skills <sup>2</sup>	918	838	687	641	609	-40
Home Office	731	650	598	562	538	-33
Justice	704	655	606	561	517	-33
Law Officers' Departments	69	64	61	57	51	-33
Defence <sup>3</sup>	2,183	2,025	1,877	1,736	1,598	-33
Foreign and Commonwealth Office	248	229	212	196	182	-33
International Development	128	121	112	103	94	-33
Energy and Climate Change	236	218	202	187	174	-33
Environment, Food and Rural Affairs	652	601	555	515	478	-33
Culture, Media and Sport	180	166	151	129	116	-41
Work and Pensions	1,541	1,483	1,290	1,166	1,105	-35
HM Revenue and Customs	1,025	945	875	812	754	-33
HM Treasury	158	153	148	133	117	-33
Cabinet Office	177	163	151	140	130	-33
Single Intelligence Account	82	82	74	62	61	-33
Small departments <sup>4</sup>	404	375	350	315	300	-33
<b>Total administration budgets</b>	<b>15,765</b>	<b>14,404</b>	<b>12,993</b>	<b>11,986</b>	<b>11,415</b>	<b>-34</b>

<sup>1</sup> As at all spending reviews, baselines exclude one-off and time-limited expenditure. Cumulative real growth is calculated using the 2010-11 baseline. Administration budgets have been expanded to include Arm's Length Bodies and this is reflected in increased 2010-11 baselines compared to 2010-11 outturn. Cumulative real growth is calculated using the 2010-11 baseline.

<sup>2</sup> Department for Business, Innovation and Skills administration budget reductions include Regional Development Agencies (RDAs) administration reductions.

<sup>3</sup> Baseline and indicative savings based on MoD's current Administrative Costs Regime (ACR). The MoD will revise this regime to take account of wider administrative costs. See Chapter 2 text for details.

<sup>4</sup> Regulators, independent bodies and public corporations have been excluded because they are excluded from the administration budget regime. CLG Local Government and the Devolved Administrations do not have administration budgets.

## What kinds of cuts?

One way of classifying the 'cuts' is to divide them into these categories:

- Capital spending: future capital spending is relatively easy to cut, especially where contracts have not been finalised and no penalties occur.
- Cuts in the volume of services: simply provide either fewer services or smaller quantities of them.
- Cuts in transfer payments: this can be done either by reducing eligibility (giving money to fewer people) or reducing generosity (giving those who do receive transfers less money)
- Cuts in debt charges, either because of smaller outstanding debts or changes to interest rates.
- Cuts in 'overheads', especially the costs of being a government (policy advice etc.)
- Cuts in costs, either by reducing salaries or prices of goods and services purchased.

Most of the proposed reductions between 2011-12 and 2014-15 can be allocated to these categories, as shown in Table 5.

<sup>4</sup> Spending Review, Annex A p. 87

**Table 5 Spending Review Annual savings comparing 2010/11 with 2014/15 £bn**

Capital spending reductions	11.4
Volume of service reductions:	13.0
Of which	
Local government	6.4
Business Innovation and Skills	3.0
Home Office	1.5
Justice	1.3
DEFRA	0.6
Transfers	8.2
Of which:	
Entitlements	5.2
Generosity	3.0
Debt charges	10.0
Overheads (‘smaller central government’)	5.9
Cost reductions	13.6
Of which	
Pay freeze	3.3
Efficiency savings <sup>5</sup>	6.0
Administration budgets	4.3
Total (this classification)	62.1

### **What did they learn from Canada?**

The Canadian government had a large deficit in the mid 1990s, with a debt: GDP ratio of 73% in 1993, when a new, conservative government was elected. The new government, with its Treasurer, Paul Martin decided to cut spending through budget cuts, with a small increase in taxation. The ratio of cuts to tax rises was 7:1. The 1995 budget reduced spending so that by 1997-8, spending was 20% lower than in 1994. The target was to get the deficit down to 3% of GDP by 1997-98. More than simply reducing the deficit, Martin said in his budget speech in 1995 that his intention was to: “redesign the very role and structure of government itself. Indeed, as far as we are concerned, it is the very redefinition of government itself that is the main achievement of this budget.”

The process through which this was done was not to apply uniform reductions across departments. As Martin reported after the first budget:

“We therefore rejected a uniform, across-the-board approach to meeting our deficit targets. Instead, we launched a comprehensive review of virtually all programs to identify those where a continuing federal role was still justified and to find ways to deliver our services more efficiently. The prime minister appointed a special committee<sup>6</sup> of ministers to consider proposed departmental spending cuts. This involved my colleagues directly in the tough job of examining spending, line by line, and thus fostered an even stronger buy-in to our budget goals. The process was disciplined by a firm requirement that the individual spending cuts had to add up to a predetermined level of savings needed to meet our budget targets. Once the departmental amounts were ratified, it was left to individual ministers to establish priorities within their own areas of responsibility so as to achieve their sub-targets. “

<sup>5</sup> Since the review does not say how these will be made, there may be some double counting with admin savings

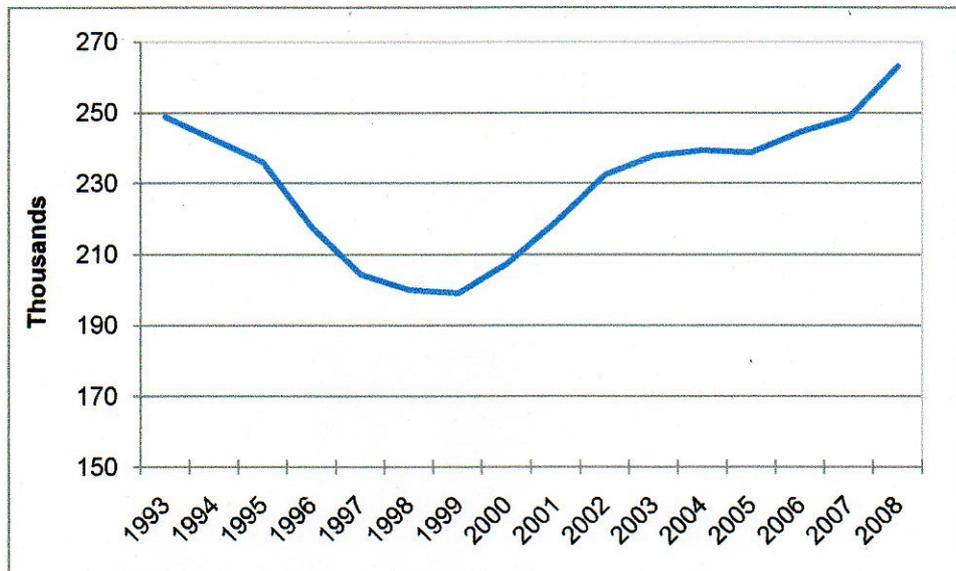
<sup>6</sup> Paul Martin, (1995), ‘The Canadian experience in reducing budget deficits and debt,’ Proceedings, Federal Reserve Bank of Kansas City, p 217

This experience was frequently referred to by the coalition during the Review period, prompted by Patrick Nolan of the 'Reform' think-tank. The ambition, the timescale and the process used to generate the SR in the UK were similar to the Canadian experience of that time.

This is perhaps not the place for an analysis of the success of the Canadian approach, but there is a strand of opinion in Canada that the cuts delayed the economic recovery, and that it was only the (low) interest rate policy after 1997, promoting investment and growth, that generated increased tax revenues and tackled the deficit.

One thing we do know is that the cuts in Federal government civil servant numbers was temporary, as shown in Figure 4<sup>7</sup>:

**Fig 4 Canada Federal Government Total Public Service Employment 1993-2008**



Source: Treasury Board of Canada Secretariat.

### **What are the likely distributional consequences of the SR 'welfare reforms' and spending adjustments?**

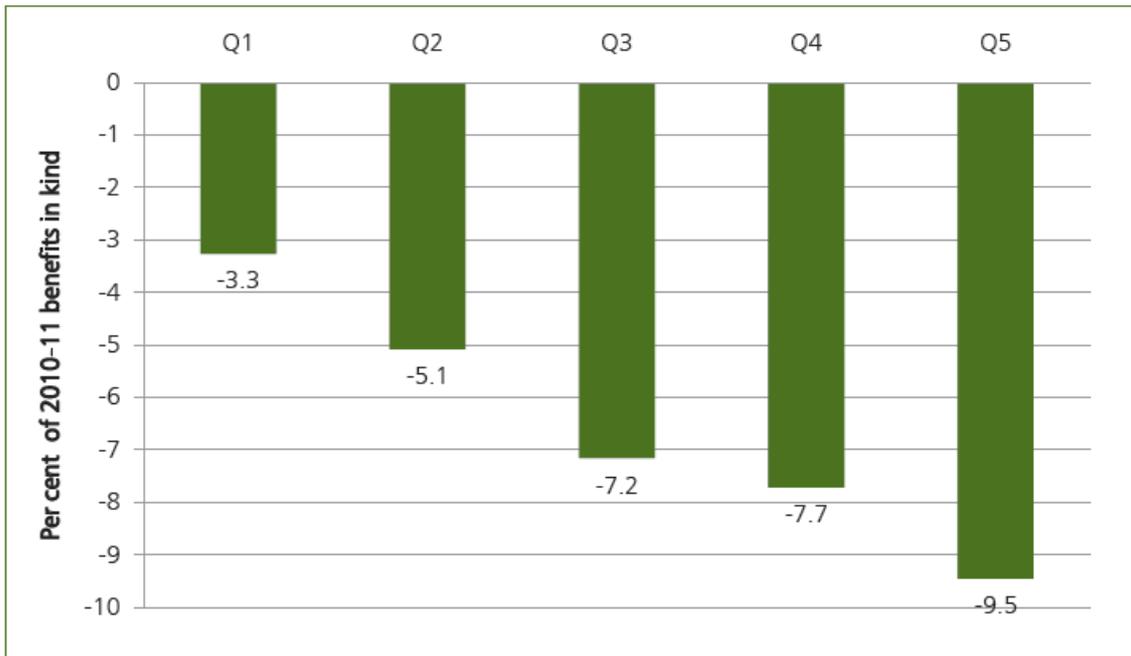
After 20<sup>th</sup> October there was public debate about the incidence of losses and gains from the SR. The review itself has an Annex, 'Distributional Impact Analysis'. The analysis is based mostly on a calculation of the impact of the changes on households' consumption of 'benefits in kind' in public services, divided onto 5 income quintiles. The analysis produces a very neat graph, reproduced as Figure 5<sup>8</sup>:

<sup>7</sup> 'Public Service reductions in the 1990s: Background and Lessons Learned', Library of Parliament (Canada), Background Paper, 2010-20-E, 12 April 2010

<sup>8</sup> Spending Review p.95

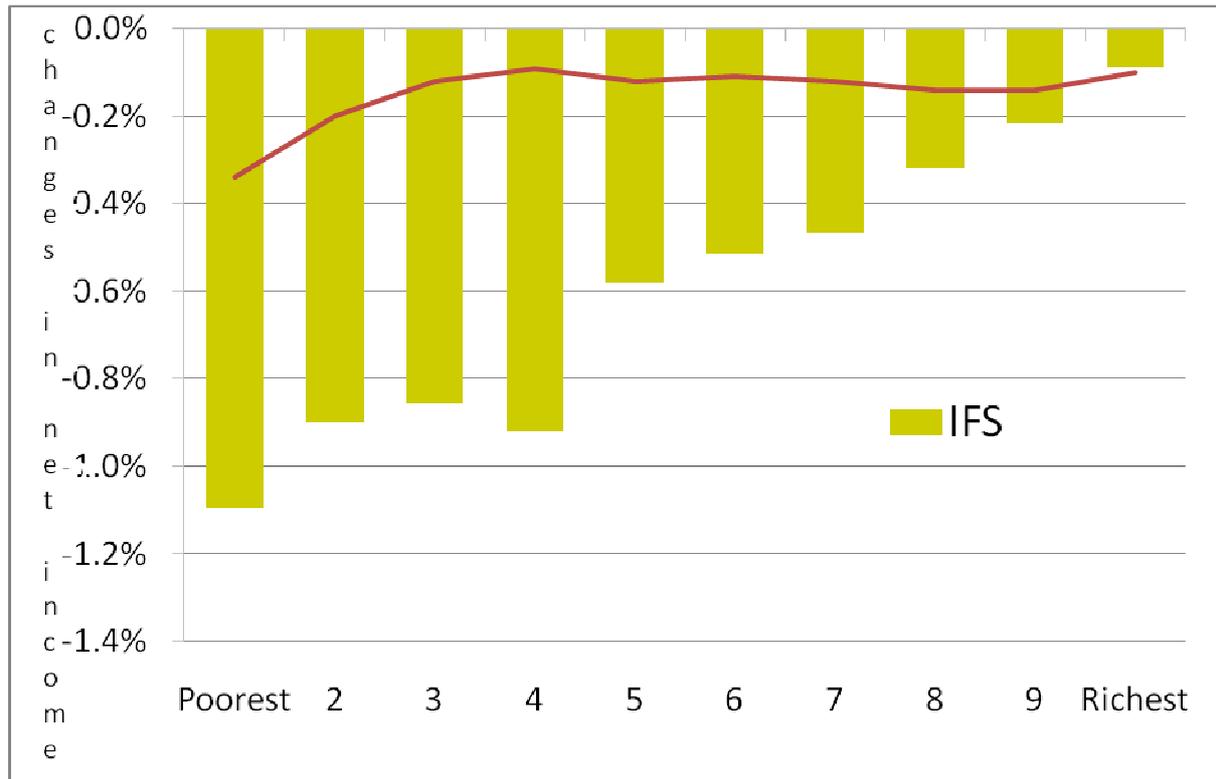
## Fig 5 Review estimate of distributional impact

Chart B.3 Changes in benefits in kind as a percentage of 2010-11 household consumption of benefits in kind.



The Institute of Fiscal Studies did a broader analysis, and included items omitted by the Treasury, including Housing Benefit; Employment and Support Allowance; Disability Living Allowance; the way in which in-year income changes affect tax credit awards and Council Tax Benefit. Their analysis also produced a neat graph, reproduced at Figure 6:

**Fig 6 IFS estimate of distributional impact**



### Has the process of managing of public expenditure changed?

The Review announced the end of Public Service Agreements, an element of the hierarchical process of performance management that was introduced in 1998. Departments will instead have to produce a business plan which sets out its vision and priorities to 2014-15, a structural reform plan and a set of indicators, which will be approved by the government in time for the start of the Review period in April 2011. This sounds superficially very similar to the previous process, but we will have to wait and see how different the newly adopted indicators are from the series produced for the PSAs.

It would surely be cynical to suggest that changing the performance targets would make it difficult to see the service level and quality consequences of the budget reductions. Before the spending review, the government had done away with the Comprehensive Area Assessments, a process through which local authorities, health authorities and other government agencies made periodic assessments of the economic and social conditions of their areas. Given the reductions in local government spending, it is likely that the outcomes for most areas will be negative, but there will be no systematic, published assessment.

### Other Issues

Beyond the scope of this note are many issues about the spending review and its impact. The economic issue is whether the macro-economic effect of the spending reductions and their consequent increases in unemployment will reduce aggregate demand and therefore slow the rate of economic growth and recovery. The fiscal effects of a slower recovery would be to postpone the reduction of the deficit because of its impact on the tax take.

The other main issue is feasibility: the welfare changes, especially the £2bn saving of the Employment and Support Allowance, which is dependent on currently unemployed people classified as medically unable to work getting jobs; the cuts in running costs of departments of 33% over four years have never been achieved before and are likely to incur redundancy payments that will partly offset the savings. In turn, the £10bn reduction in debt charges is dependent on the other savings being made.

Other EU member states have taken a more conservative approach to debt and spending reduction. Germany plans an 80bn Euro reduction, split in a ratio of cuts to tax rises of 65:35. The UK June 2010 budget estimated a £128 bn reduction, split 74:26. France has budgeting for a freeze on spending, excluding debt charges and pensions and anticipates 100,000 job reductions.

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