

October 15, 2010

More spending reallocation than spending cuts

On October 20, the coalition government will present the outcome of its public spending review to 2014-15. Spending departments have been asked to identify cuts of between 25% and 40% in what is generally agreed to be the defining issue for the coalition government.

This note sets out a brief description of the issues.

The central points are:

- Total public spending is forecast to fall by only 3.6% in real terms between 2010-11 and 2014-15
- In 2014-15, total spending will be 40.9% of GDP – exactly the same as in 2007-8
- This represents an increase in spending in real terms of over £13 billion (in 2010-11 prices) compared with 2008-9
- Many departments do face significant cuts in discretionary spending (on average around 20%, relative to 2010-11), because many other items of expenditure will rise – either because the rise is unavoidable, or because the government has decided to protect some areas of spending.

This note sets out a baseline for evaluating the impact of the spending review on departments.

Taking account of announced spending commitments, it calculates the changes in departmental budgets that would arise if the percentage change in unprotected discretionary spending was equal for all departments. This baseline can be compared to figures published on October 20 to identify which departments have done well or badly in the review.

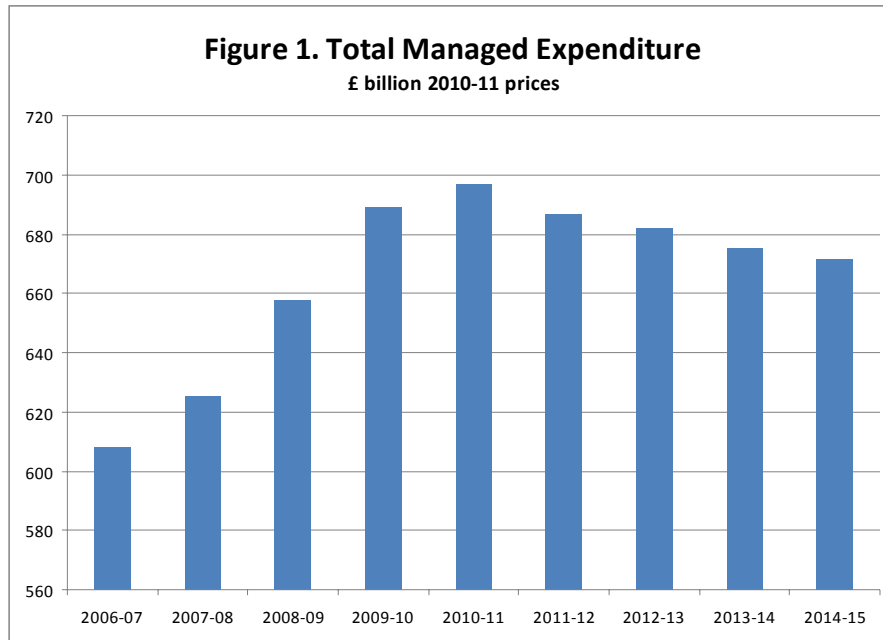
In the baseline estimates, the largest areas of change to 2014-15 are (all values are in 2010-11 prices):

- Increase in payments of interest on government debt of over £14 billion from 2010-11 (and £25 billion since 2008-9)
- Increase in Department of Health of around £2 billion from 2010-11 (and £14 billion from 2008-9)
- Reduction in Department of Education of over £4 billion from 2010-11 (and over £9 billion from 2008-9)

Total Spending in 2014-15

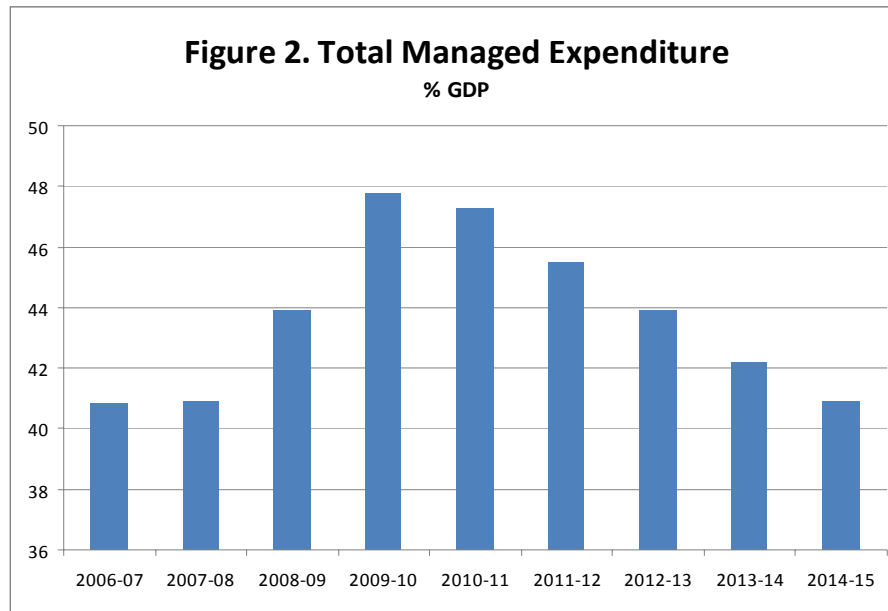
In 2010-11 prices, total public spending¹ was £658 billion in 2008-9, rising to £689 billion in 2009-10. At the end of the three-year spending review, the government plans to spend £671 billion.

As Figure 1 shows, spending will fall in real terms after 2010-11; but this is only relatively slowly offsetting the very steep rise in real spending that took place towards the end of the last government.



Expressed as a proportion of GDP, the government plans to reduce total spending to 40.9% of GDP by 2014-15. This is identical to the ratio in 2007-8. Figure 2 shows that – expressed as a proportion of GDP – the decline in spending over 5 years after 2009-10 only offsets the very steep rise that took place in two years, 2007-9.

¹ Total Managed Expenditure (TME).



Allocation of Spending: a baseline

Since total spending is not forecast to fall beyond recent levels, why are the planned cuts so large? The answer is that there will be a very significant reallocation of spending.

Below we set out a baseline for the allocation of spending cuts across government departments. We identify where particular spending plans were fixed at the time of the June Budget: we do not take into account any more recent announcements and quasi-announcements. We then calculate the impact on each department's budget if remaining cuts were allocated proportionately.

Total public spending is determined in two parts. Departmental Expenditure Limits (DELs) are set on a three year cycle: the last review was in 2007. Annually Managed Expenditure (AME) is expenditure which cannot be directly controlled, but is effectively driven by demand. The main items in AME are social security benefits, tax credits and debt interest payments.

We identify plans in the June Budget in two parts. First, we use the forecast for increases in total AME set out by the Office for Budget Responsibility. We separate interest payments, and assume that the rate of increase in spending on the Department of Work and Pensions is proportional to the increase in social security benefits. The remaining rise in AME is allocated to departments in proportion to their AME in 2010-11.

For DEL spending, the government announced that NHS spending will not be cut in real terms: we hold that constant in real terms. It also announced that it plans to raise overseas aid to 0.7% of Gross National Income: we assume that this also holds. Given these factors,

we then calculate the required percentage fall in total DEL spending, and apply that percentage fall to all departments.

Finally, we add together the projections for AME and DELs. The resulting projection is not a forecast of the outcome of the spending review. Rather it is a baseline. Deviations from this baseline announced in the spending review will indicate whether a department has done well or badly in the review.

The results of this analysis are shown below. Figure 3 shows the baseline changes by department, comparing 2014-15 to 2010-11, in 2010-11 prices. There is a significant rise in interest payments, of over £14 billion. In these baseline estimates, the largest falls are amongst the largest unprotected departments: Education, Defence and Communities and Local Government.

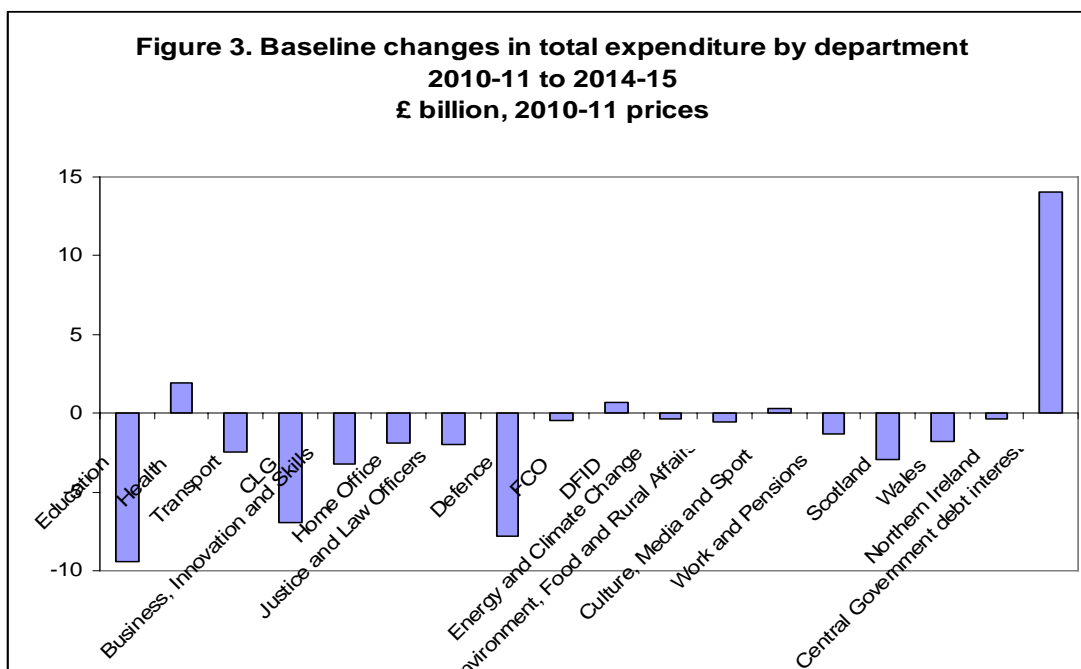
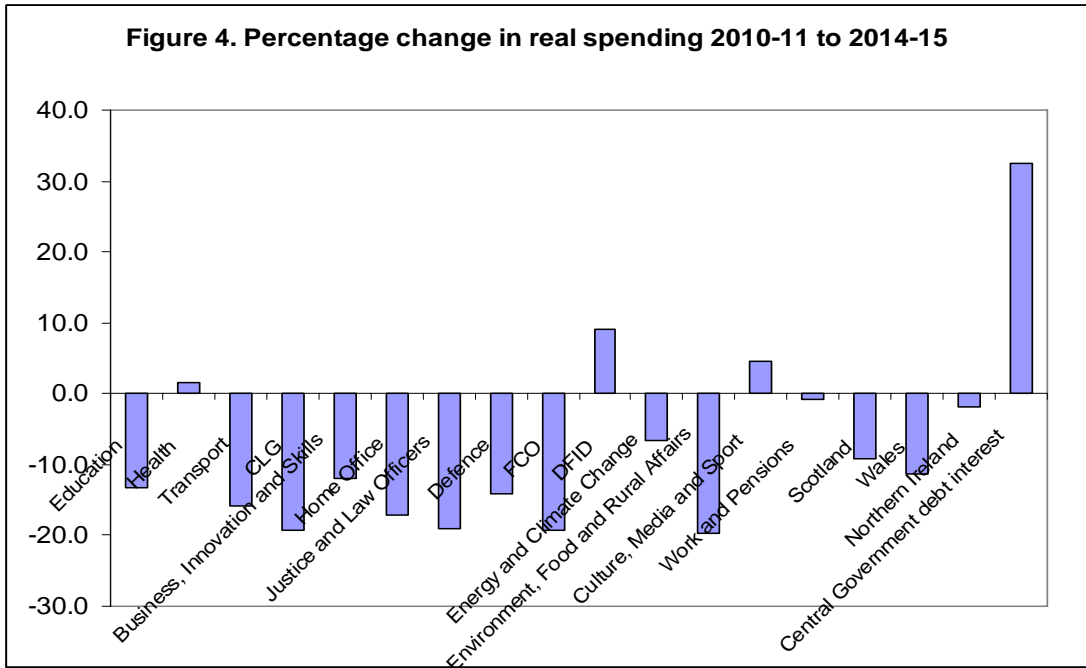
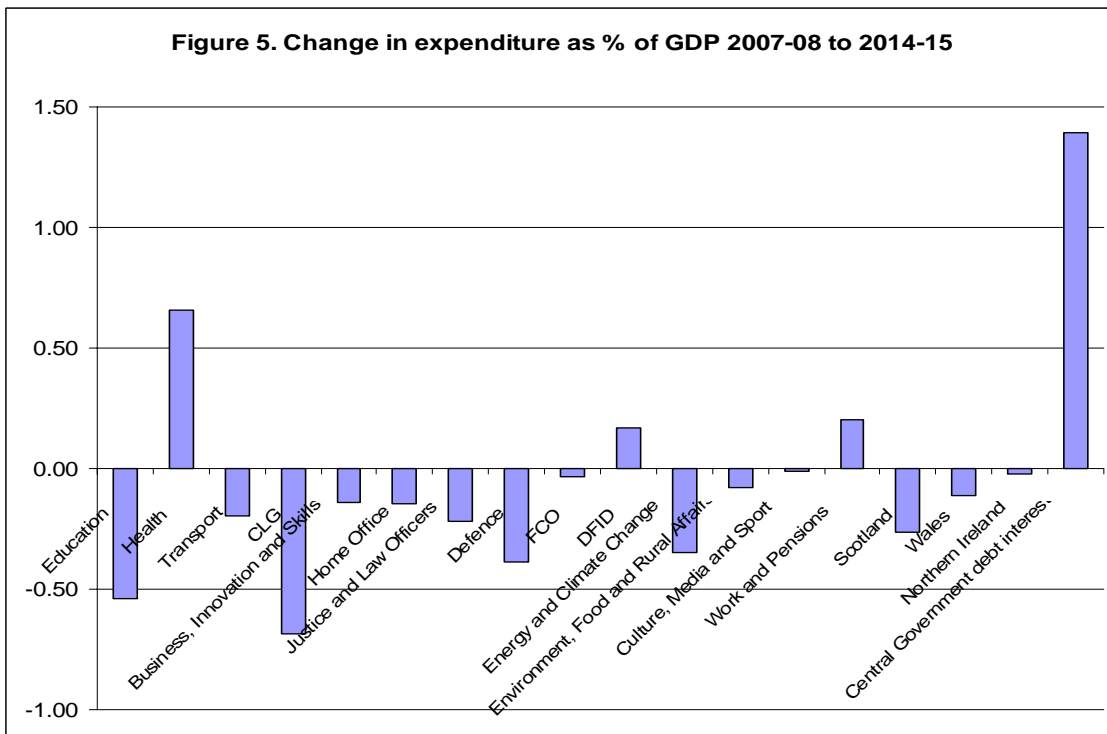


Figure 4 expresses these changes in percentage terms. The rise in interest payments is now even more apparent, at well over 30%. The protected departments have moderate rises. Beyond that, however, the baseline estimates indicate significant percentage falls – of over 10% in aggregate - in most departments.



An alternative comparison is with 2007-8, since in both 2007-8 and 2014-15 expenditure is planned to be 40.9% of GDP. Figure 5 shows how expenditure by department is expected to change as a percentage of GDP between these two years: these changes sum to zero.



Again, debt interest stands out, consuming nearly 1.5% of GDP more in 2014-15 than in 2007-8. Health also shows a significant rise of well over 0.5% of GDP. The departments that are most significantly hit in this baseline assessment are Education and Communities and Local Government. In each case, their spending would fall by more than 0.5% of GDP.

We stress again that these projections are not forecasts of the outcome of the spending review. Rather they are intended to provide a baseline assuming that departments face the same proportionate cut, after taking into account existing spending commitments.

Data Sources

We use data from various official sources, including the OBR Budget forecast in June 2010, and Public Sector Statistical Analyses (PESA), 2010.

Table C13 of the OBR Budget forecast presents forecasts for total expenditure split into four components: current expenditure and capital expenditure, each split into Departmental Expenditure Limits (DEL) and resource Annually Manage Expenditure (AME). DELs are set on a three timetable by successive comprehensive spending reviews, and represents spending that can be controlled rather than being driven by demand. AME cannot be easily planned in advance; its most important elements are social security payments and debt interest.

PESA 2010 allocates both DELs and AME to departments, although some elements of AME are not allocated.

We translate all data into 2010-11 prices using a GDP deflator. We identify spending commitments for individual departments. We expect total health spending to be a little under £124 billion in 2010-11 prices. We allocate this to departments based on the allocation in PESA 2010 Table 5.1. We forecast overseas aid based on estimates from DFID, with the aim of reaching spending of 0.7% of GNI in 2014-15. Only part of the aid spending is attributed to DFID, but we assume that DFID spending increases in proportion to the total increase in overseas aid. We assume AME spending for the Department of Work and Pensions increases at the same rate as the forecast for AME social security spending in the OBR budget forecast.

Apart from this, there is a cut in real DEL spending and a rise in AME spending in real terms. We project the same proportionate change from 2010-11 for all other spending. We then aggregate DEL and AME spending to assess the overall effects on department budgets.