Background to the 2013 Spending Review

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The Chancellor will present the 2013 Spending Review to the House of Commons on the 26 June. This will divide government spending in the year 2015/16 between departments.

In total, the Departmental Expenditure Limit for all departments will be reduced by 2.8% in real terms compared with 2014/15. However, the NHS, schools and international development budgets will be protected, meaning that some of the other departmental budgets will face larger reductions.

This Note explains the economic and public finance background to the Spending Review. Some key concepts and trends in public expenditure are analysed, including current and capital spending and the distinction between Departmental Expenditure Limits and Annually Managed Expenditure.

Some of the likely announcements in the Spending Review include:

- The NHS, schools and international development budgets will be protected from spending reductions.
- Savings totalling £11.5 billion from current spending.
- Capital spending plans to 2020/21.
- A review of Annually Managed Expenditure which will introduce a “firm limit” on some areas of welfare spending.

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1 What is a Spending Review?

Spending Reviews divide total government spending between departments. The current system of Spending Reviews was introduced in 1998 by the previous Labour Government. Spending Reviews were held under the Labour Government in 1998, 2000, 2002, 2004 and 2007.[1] The most recent Spending Review was conducted under the current Government in October 2010.

Generally, the decisions taken in Spending Reviews determine the share of government expenditure that each department will receive over several years. For example, the 2010 spending review determined departmental budgets for the period 2011/12 to 2014/15. However, the 2013 Spending Review will determine departmental budgets for a single financial year – 2015/16.

The 2013 Budget set out total government spending for the period covered by the 2013 Spending Review. Total Managed Expenditure (TME) in 2015/16 will be £744.7 billion.[2] This represents a very small real terms increase in TME compared to 2014/15. Since the NHS, schools and international development budgets will be protected in 2015/16, the 2013 Spending Review will announce real terms cuts to the budgets of some other departments.

Secretaries of State will seek to reach settlements with the Treasury over the size of their budget for 2015/16. In order to expedite this process, the Chancellor has reformed the "Star Chamber" of senior cabinet ministers to arbitrate on the budgets of departments that cannot settle bilaterally with the Chancellor and Chief Secretary to the Treasury.[3]

Once a minister has settled their department's budget for 2015/16, they will be allowed to join the Star Chamber and help decide on the budgets of other departments. It is hoped that the threat of Ministerial colleagues deciding the budgets of rival departments will be enough to hasten decisions from more reluctant Secretaries of State. The Star Chamber was formed during the negotiations for the 2010 Spending Review, but although it met to discuss "general spending review decisions," it was never used to interrogate or make a decision on a particular department's budget.[4]

The precise details of the settlements reached with departments will only be announced on the 26th June. There have been some concrete announcements about the contents of the Spending Review which are discussed later in the note. Further speculation should be treated with caution.

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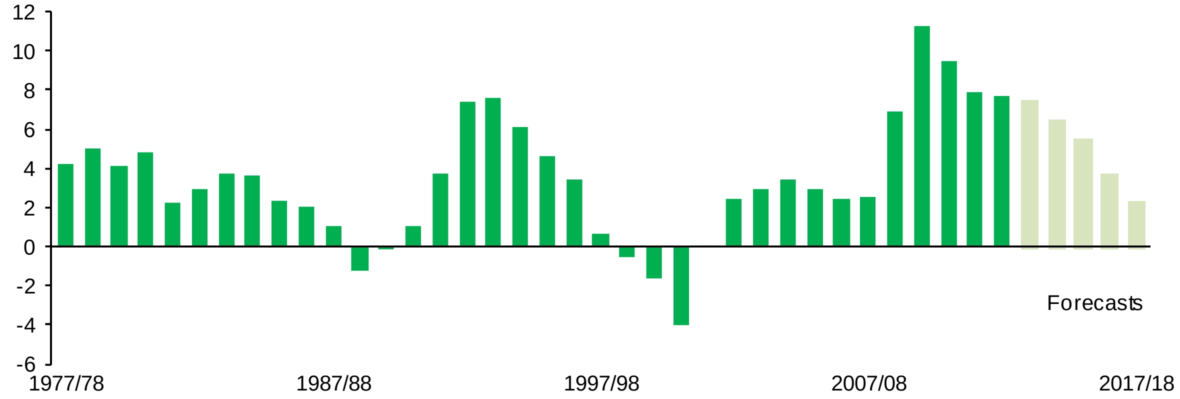
[1] Institute of Fiscal Studies, *A survey of public spending in the UK,* September 2009, p 10
[2] HM Treasury, *Budget 2013*, HC 1033, March 2013, Table 2.3, p 68
[3] Financial Times, *Osborne threatens overspending ministers with the 'star chamber'*, 29 May 2013
[4] Guardian, *George Osborne plans to harness £11.5bn savings via new star chamber*, 29 May 2013

2 Public finances background

In 2012/13, the budget deficit was £120 billion, equivalent to 7.7% of GDP. Total government debt was £1.2 trillion, 75.2% of GDP.

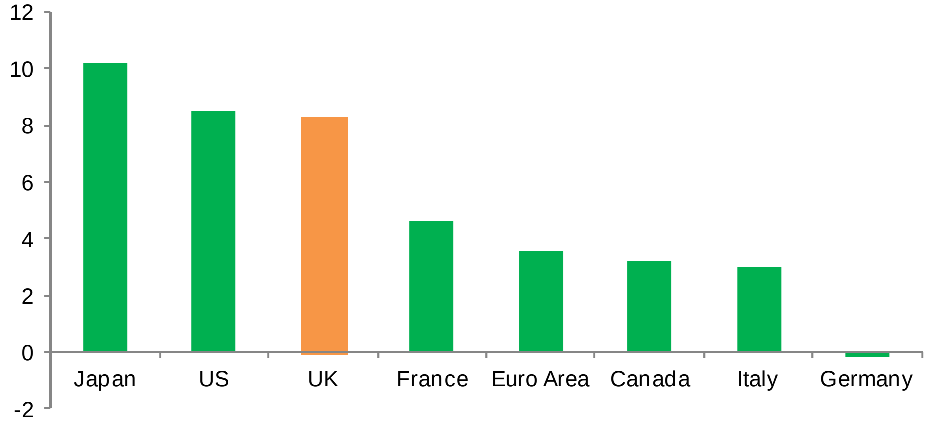
Public sector deficit as a % of GDP
Source: Office of Budget Responsibility (OBR)



In 2009/10, the financial year before the current government came to power, the budget deficit was £159 billion, 11.2% of GDP. It has fallen in each financial year since then, although the deficit in 2012/13 (£120 billion) was only marginally lower than the deficit in 2011/12 (£121 billion). It is forecast to fall to £43 billion in 2017/18, 2.3% of GDP.

The UK's budget deficit is among the largest of the major international economies. Among the G7 countries, only Japan and the US had budget deficits in 2012 which were higher as a proportion GDP than the UK deficit (10.2% in Japan and 8.5% in the US).

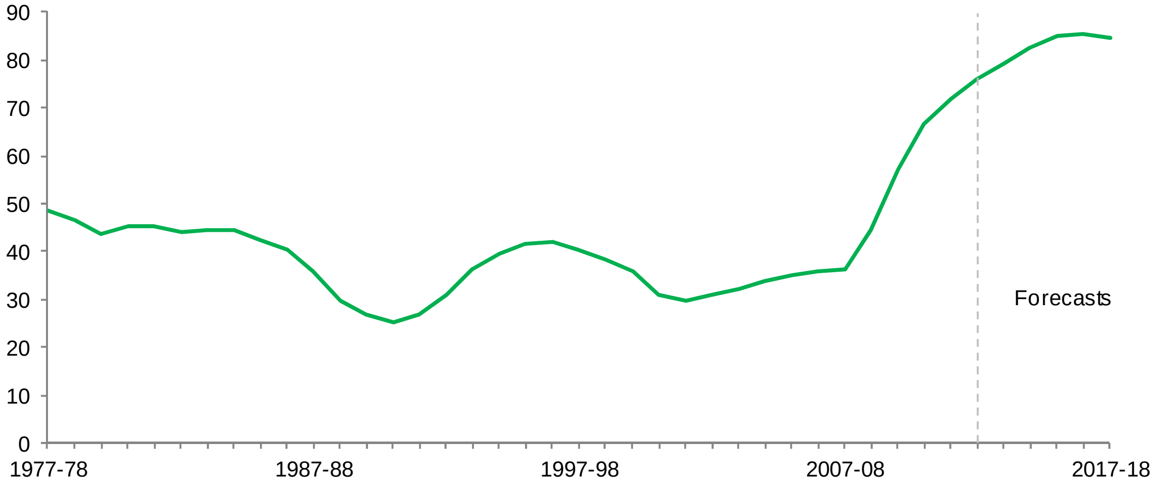
Government deficits as a % of GDP in major international economies, 2012
Source: IMF World Economic Outlook Table A8, April 2013



Figures compiled on a different basis and should not be compared with UK figures quoted elsewhere; Calendar year

The continuing budget deficit in the UK means that the government has to borrow more money each year, which is added to the stock of public sector debt. Debt as a proportion of GDP is forecast to rise from 71.8% in 2011/12 to 85.6% in 2016/17. In 2017/18 it is forecast to fall slightly to 84.8%. This will be the first fall in total government debt as a proportion of GDP since 2001/02 compared to 2000/01, when debt fell from 30.8% to 29.8%.

Public sector net debt as a % of GDP
Source: OBR



2.1 Fiscal consolidation plans

The June 2010 Budget stated that reducing the UK budget deficit was "the most urgent task facing this country."[5] The 2013 Budget reiterated this commitment – the first tenet of the Government's "plan for the economy" is:

- "Fiscal responsibility to deal with our debts with a credible deficit reduction plan."[6]

The Government's plan to reduce the deficit and ultimately reduce total government debt involves two components: reducing government spending and increasing taxes. The Government has chosen to reduce more of the deficit using spending reductions than tax rises. The following table shows the cumulative, combined impact of the previous Labour Government's and the current Government's spending and taxation policies in each year. By 2015/16, spending reductions will make up 80% of total fiscal consolidation.

Fiscal consolidation plans, £ billions
Total discretionary consolidation

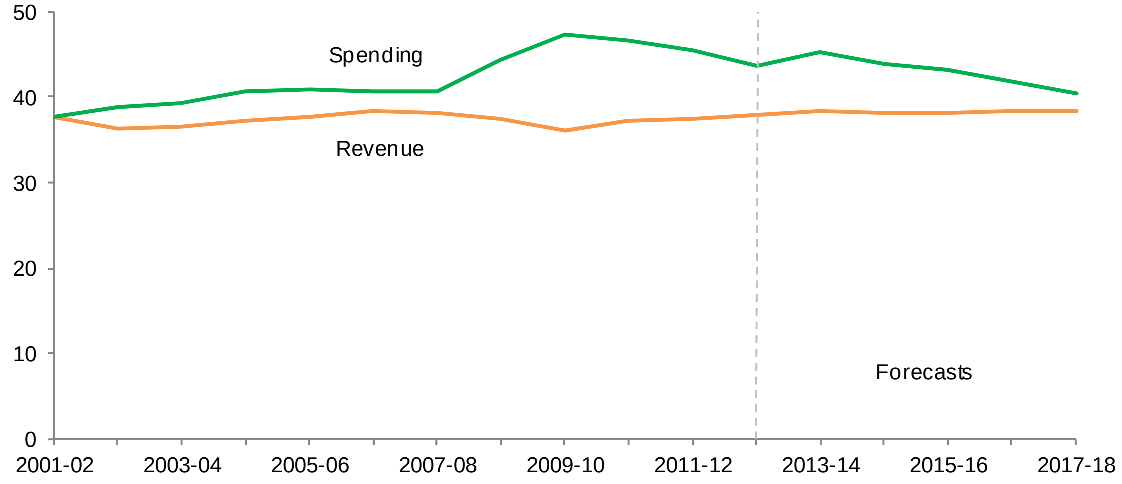
	2011/12	2012/13	2013/14	2014/15	2015/16
Spending	23	53	58	80	105
Tax increases	18	21	25	23	25
Spending as a % of total consolidation	*56%*	*72%*	*70%*	*77%*	*80%*

Source: HM Treasury, *Budget 2013,* Table 1.4, pp 27

The following chart shows that fiscal consolidation since the beginning of this Parliament will reduce the gap between the forecast level of public spending and revenue. However, in 2017/18, public spending will total 40.5% of GDP, whilst public sector revenues will total 38.3% of GDP, so there will still be a deficit that year of 2.2% of GDP.

[5] HM Treasury, *Budget 2010*, HC 61, June 2010, p 1
[6] HM Treasury, *Budget 2013*, HC 1033, March 2013, p 1

Public spending and revenue as a % of GDP
Source: OBR



It is worth noting that although revenue as a proportion of GDP remains broadly flat over this period, GDP fell significantly in 2008 and 2009, meaning that revenue fell broadly in line with GDP. This, combined with rises in public spending, meant that the deficit grew from 2.7% of GDP in 2007/08 to over 10% in 2009/10.

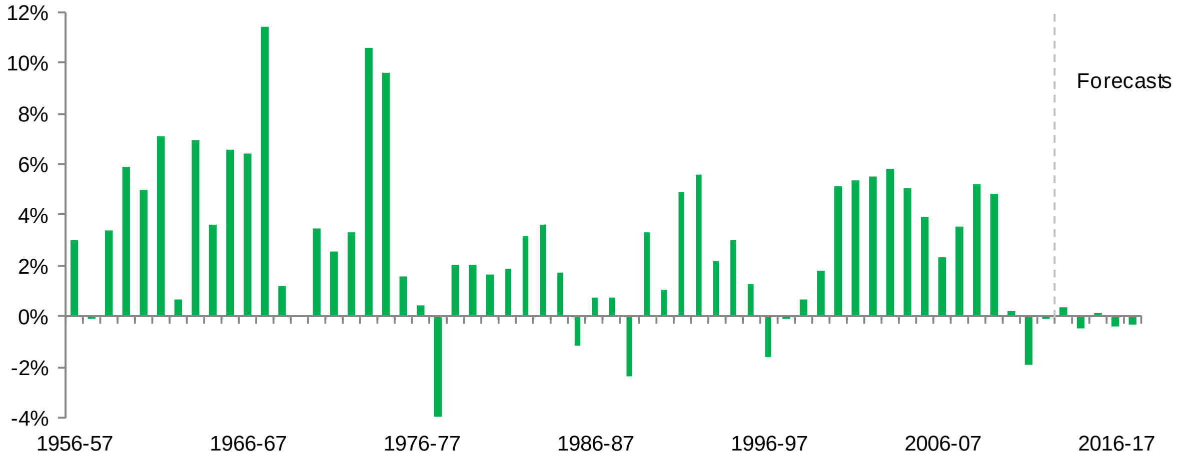
3 Public spending

This section examines public sector spending in some detail, firstly in the context of historic public spending growth; secondly by looking at the distinction between capital and current spending; and thirdly by examining another important distinction in public spending, Departmental Expenditure Limits and Annually Managed Expenditure.

3.1 Historic context

Public spending increased by 3.2% a year on average between 1956/57 and 2009/10. Between 2010/11 and 2016/17, public spending is forecast to fall by 0.3% a year on average.

Annual % change in public spending (real terms)
Source: Office of Budget Responsibility



The period of low or no growth in public spending since 2010/11 is the most prolonged period of spending restraint since the Second World War. On only a handful of occasions over this period has public spending fallen in real terms – once in the mid-1970s, again in the mid and late-1980s and in the mid-1990s. Generally, when spending has fallen in the past, it has begun rising again after one or at the most two years. From 2011/12, public spending is forecast to fall or grow by less than 0.4% for a minimum of eight years in succession.

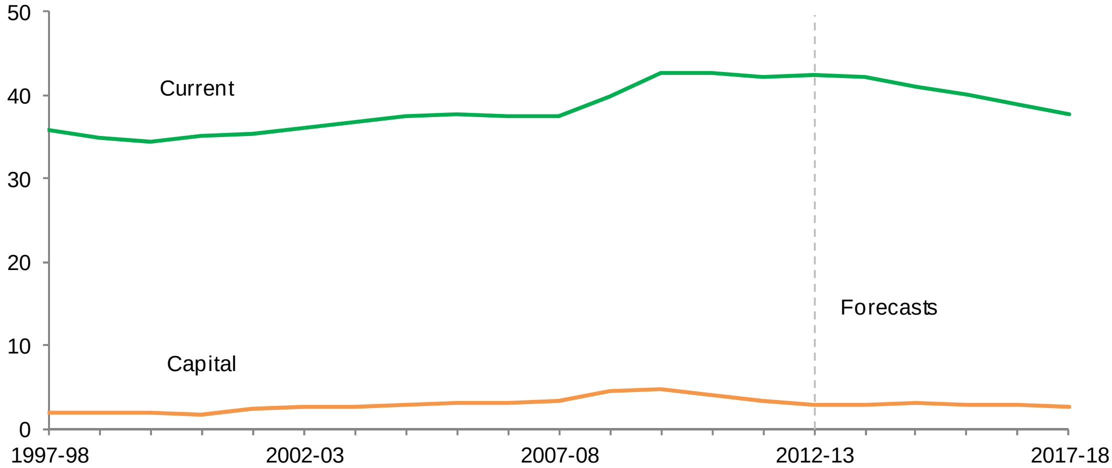
The current period of austerity is also noteworthy because it contrasts strongly with the immediately preceding era. Between 2000/01 and 2009/10, public spending increased by 4.7% a year on average, over a percentage point more than the average for the period since 1956/57.

3.2 Current and capital spending

Current spending is on items that are consumed in the process of providing public services. This means that current spending normally recurs each year. Current spending includes the salaries of public sector workers such as teachers or civil servants and social security benefits such as the state pension. Current spending makes up the vast majority of public spending each year.

Capital spending is on items that are counted among the assets of the government. It includes expenditure on items such as military equipment, land, buildings and machinery. Capital spending makes up a far smaller portion of public spending than current spending.

Current and capital spending as a % of GDP
Source: OBR; capital spending=public sector gross investment



In 2011/12, capital spending was 3.3% of GDP, whilst total current spending was 42.2% of GDP. Both capital and current spending increased following the economic downturn in 2008/09. Current spending increased from 37.5% of GDP in 2007/08 to 42.6% in 2009/10. Since then current spending has remained between 42% and 43% of GDP. Capital spending rose from 3.3% of GDP in 2007/08 to 4.8% in 2009/10, but has since fallen to 3.3% and is forecast to tall to around 3% for the next five years.

3.3 DEL and AME

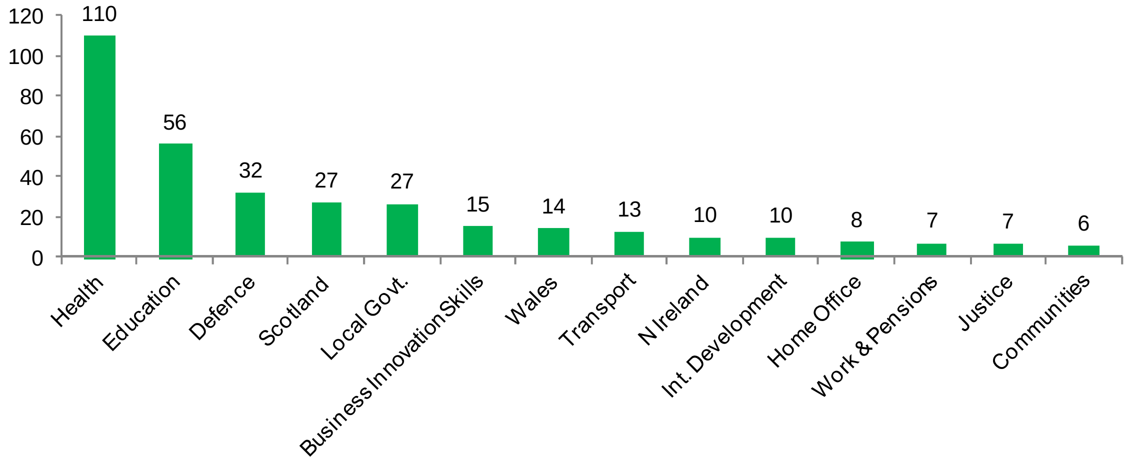
Public spending is also categorised into Departmental Expenditure Limits (DEL) and Annually Managed Expenditure (AME). DEL and AME are divided into current and capital spending.

DEL

DEL is spending which can be planned several years ahead. This type of spending includes the salaries of most public sector workers, most of the NHS budget and the administration costs of most government programmes.

The total DELs (current DEL and capital DEL) of the largest government departments in 2014/15 are set out in the table below.

Total DEL in 2014/15 - £ billions
2012/13 prices (excludes departments with DEL <£5 billion)
Source: 2013 Budget, Table 2.4, GDP deflator



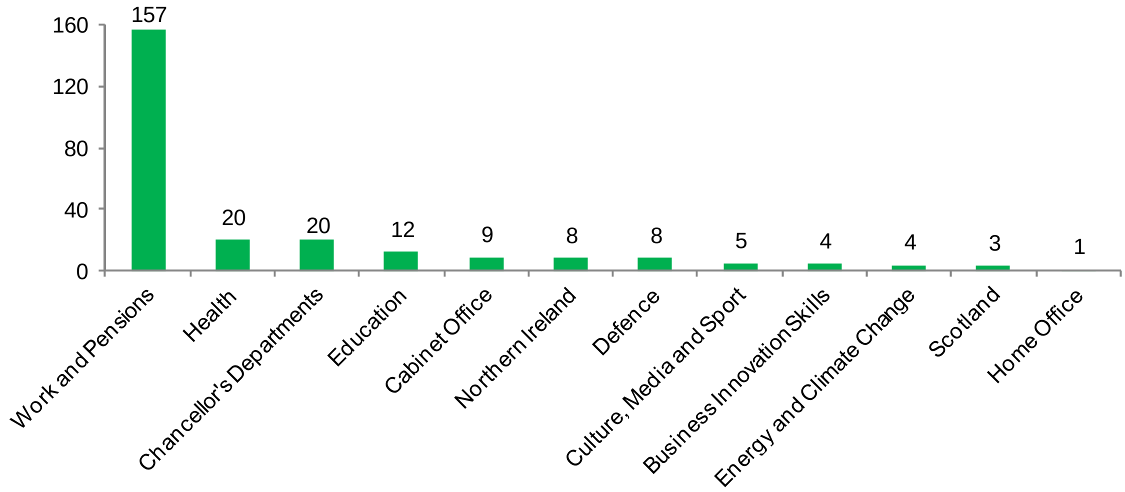
The total DEL of the Department of Health and the Department for Education alone will make up 47% of DEL in 2014/15.

AME

AME is spending which it is more difficult to predict and plan several years ahead. It includes spending on social security benefits and national debt interest. The total AMEs (current AME and capital AME) for government departments with AME of more than £1 billion are shown below.

Total AME is dominated by the Work and Pensions budget. Work and Pensions AME which is mainly made up of money paid to social security benefit recipients, such as pensioners and people claiming unemployment benefits, totalled £157 billion in 2011/12. This was 51% of total AME. The next largest departmental AME was Health, worth £20 billion, around 6% of total AME in 2011/12. (Note that total AME includes some spending which is not assigned to departments – ‘resource other AME’ and ‘capital other AME.’)

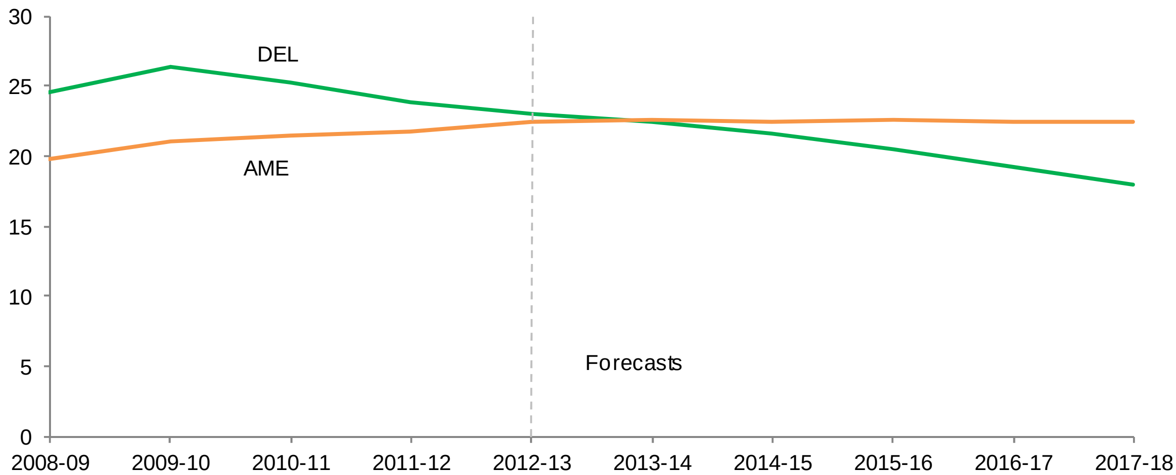
Total AME in 2011/12 - £ billions
2012/13 prices (excludes departments with AME <£1 billion)
Source: PESA update April 2013; GDP deflator



Trends in DEL and AME

Historically, total DEL has made up a larger proportion of TME than total AME. However, in recent years, this trend has been reversed.

Total DEL and Total AME as a % of GDP
Source: OBR



In 2012/13, DEL is forecast to be 23.0% of GDP, whilst AME is forecast to be 22.4% of GDP. In 2013/14, DEL and AME are forecast to be roughly the same proportion of GDP: 22.5% and 22.6% respectively. After this, AME is expected to be roughly stable as a proportion of GDP (so rising in real terms) whilst DEL is expected to fall as a proportion of GDP. In 2017/18 AME is forecast to be 22.5% and DEL is forecast to be 18.0% of GDP.[7]

The rise of AME and the relative decline of DEL is largely explained by the rise in the social security budget. In particular, demographic changes such as the aging population mean that more people are becoming eligible for pensioner benefits, which are counted as AME. The seemingly inevitable rise in AME is something that the Government have stated they will address in the 2013 Spending Review.

[7] OBR, *Economic and Fiscal Outlook*, March 2013, Table 4.15, p 118. The 2012/13 DEL figure is adjusted to exclude the impact of the Royal Mail Pension transfer.

4 What has been announced so far?

The 2013 Spending Review will divide government spending in 2015/16 between departments. The total amount of money available in that year has already been set out in the 2013 Budget. In 2015/16, TME will be £744.7 billion. In real terms, this is 0.2% more TME in 2014/15 and 1.9% less than TME in 2010/11, the year before the current spending review period.[8]

Although the precise split between DEL and AME has yet to be announced, the 2013 Budget does set out figures for "implied DEL" in 2015/16.[9] These figures suggest that total DEL in 2015/16 will be 2.8% below total DEL in 2014/15 in real terms. This reduction in DEL will not be divided evenly between all government departments.

Overall, the Treasury have stated that they want to "make savings from current spending of £11.5 billion in 2015/16."[10]

4.1 Protected budgets

The 2013 Budget states that the NHS budget and the schools budget will "be protected" in real terms. The international development budget will be preserved at 0.7% of Gross National Income.[11] These budgets will account for 46.5% of total DEL in 2015/16.

Excluding this sizable portion of spending from the calculations means that if the fall in total DEL were distributed evenly over the remaining departmental budgets then they would each fall by 5.2% in 2015/16 compared with 2014/15. It is unlikely that equal reductions will be applied to all departmental budgets.

It is important to note that health, schools and international development spending were also protected in the 2010 Spending Review. This means that the reductions in spending since 2010 have fallen more heavily on the other departments. Those same areas will be asked to find further cuts in 2015/16, meaning that the Government is seeking to reduce the budgets of departments that have already seen significant reductions in some cases.

4.2 Some departments reach agreement

The Chancellor has announced that spending levels for 20015/16 in seven small government departments were agreed in late May 2013.[12] These departments are the Ministry of Justice, Communities and Local Government, Northern Ireland, the Foreign Office, the Treasury, the Cabinet Office and the Department for Energy and Climate Change.

The Chief Secretary to the Treasury announced on the 14th June that a further six departments have agreed their budgets for 2015/16. These departments are the Home Office, the Department for Environment, Food and Rural Affairs; the Department for Culture, Media and Sport; the Scottish Office; the Welsh Office; and the Law Officers' Departments which include the Crown Prosecution Service.[13]

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[8] HM Treasury, *Budget 2013*, March 2013, Table 2.3, p 68
[9] *Ibid*
[10] *Ibid,* Para 1.51, p 24
[11] *Ibid*
[12] BBC, *Seven departments agree new cuts,* 28 May 2013
[13] BBC, *Spending Review: Home Office agrees cuts with Osborne,* 14 June 2013

Between them, the spending reductions announced in these departments make up around £3.5 billion or "less than a third" of the £11.5 billion of savings that the Chancellor is aiming for in the 2013 Spending Review.[14]

4.3 Capital spending increased

The 2013 Budget announced that capital spending will be increased by £3 billion a year from 2015/16 onwards.[15] This additional capital spending will be transferred from current spending, meaning that total current spending will fall by £3 billion a year. This fall in current spending will be included in the £11.5 billion of savings in 2015/16.

The 2013 Budget also announced that:[16]

> The Government will take a long-term approach to capital as part of the 2015/16 Spending Round, setting plans out to 2020/21 for the most economically valuable areas of capital expenditure.

This commitment to plan capital spending 2020/21 was elaborated on by Danny Alexander, Chief Secretary to the Treasury, in a recent speech. He stated that government would "make commitments" on infrastructure and other areas of capital spending only after departments had demonstrated the "economic value" to the regions and to long term growth of these instances of capital spending.[17]

4.4 Pay progression reformed

Some civil service workers are subject to contracts which entitle them to pay increases each year. This is known as 'progression pay'. The 2013 Budget announced that the Government will seek to further control public sector pay though "reforms to progression pay."[18]

4.5 Efficiency savings

The 2013 Budget states that efficiency programmes which have been running for the duration of the current Spending Review period will be extended into 2015/16.[19]

In addition, the Department for Education will publish a review of efficiency in school alongside the 2013 Spending Review. The Ministry of Justice published a strategy and action plan for increasing efficiency in the criminal justice system in early June 2013.[20]

4.6 Community Budgets pilots extended

Community Budgets are being piloted in four areas of the country. In these areas, providers of public services are able to share budgets in an effort to reduce duplication of expenditure and find other potential efficiencies and savings. The Spending Review will announce plans to extend these pilots to other areas of the country.[21]

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[14] *Ibid*
[15] HM Treasury, *Budget 2013*, March 2013, Para 1.52, p 24
[16] *Ibid*
[17] Danny Alexander, *Speech to the Greater Manchester Chamber of Commerce,* 30 May 2013
[18] HM Treasury, *Budget 2013*, March 2013, Para 1.54, p 25
[19] *Ibid,* Para 1.57, p 25
[20] Ministry of Justice, Her Majesty's Inspectorate of Constabulary and HM Crown Prosecution Service Inspectorate, *Stop the Drift 2 – A Continuing Focus on 21st Century Criminal Justice,* 4 June 2013
[21] HM Treasury, *Budget 2013*, March 2013, Para 1.58, p 25

5 AME review

The 2013 Budget announced that the Spending Review will introduce a

> …firm limit on a significant proportion of AME, including areas of welfare spending[22]

This echoes the 2011 Budget which stated that the Government was "considering options for strengthening control over AME by increasing the amount of spending that is managed within fixed budgets."[23] This move is in response to the recent and forecast increases in AME spending discussed above.

The undertaking to place a 'firm limit' on some aspects of AME spending raises questions about what exactly the Government can limit within AME spending. By definition, the type of expenditure included in AME is difficult to forecast, meaning that it would be difficult to introduce a meaningful limit. For example, debt interest payments are determined to a large extent by the bond markets' long term confidence in the UK economy. Although steps can be taken to increase investor confidence, ultimately, the cost of borrowing is out of the government's hands.

Other aspects of AME spending are more obviously under the control of government. The conditions for benefit expenditure are determined entirely by government. By changing the eligibility criteria for certain benefits, the government are able to reduce the number of people entitled to claim certain benefits and so reduce AME spending.

However, the 2013 Budget states that the AME limit "will be designed in a way that allows the automatic stabilisers to operate to support the economy."[24] This suggests that areas of AME spending which increase when the economy as a whole declines in order to support demand will be at least partially exempt from the AME limit. This type of spending includes unemployment benefits such as Jobseekers Allowance and Income Support.

In addition, The Prime Minister's spokesperson stated in February 2013 that "pensioner benefits are fully protected for the entirety of this Parliament – including for the year 2015/16."[25] Pensioner benefits include the Winter Fuel Allowance and free television licences as well as the state pension. These benefits, combined with unemployment benefits mentioned above, make up around 57% of benefit expenditure in 2013/14.[26]

This implies that over half of the benefit component of AME will be protected in the Spending Review, meaning that any AME limit on benefit expenditure will be imposed on other areas. The Financial Times has recently reported Treasury sources as suggesting that housing benefit and tax credits may be areas where AME spending can be firmly limited without damaging the automatic stabilisers or contradicting assurances made on other areas of policy.[27]

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[22] *Ibid,* Para 1.62, p 26
[23] HM Treasury, *Budget 2011*, March 2011, Para 1.51, p 21
[24] HM Treasury, *Budget 2013*, March 2013, Para 1.62, p 26
[25] Intergenerational Foundation, *Cameron extends commitment to protecting pensioner benefits*, 5 February 2013
[26] DWP, *Benefit expenditure tables* and House of Commons Library calculations
[27] Financial Times, *Osborne's dilemma over pensioner benefits,* 8 April 2013