

# A Survey of Public Spending in the UK

Carl Emmerson, Christine Frayne and Sarah Love\*

*Institute for Fiscal Studies*

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## 1. Introduction

This Briefing Note provides an overview of public spending in the UK. It describes the components of public spending and examines trends in expenditure in each of six main areas. Section 2 provides an overview of total public spending in the UK. Section 3 explains how the current government plans public spending. Section 4 describes the current allocation of public spending and then focuses on how the amount received by each of the six main spending areas has changed over time. Section 5 comprises a discussion of recent trends that affect all of the spending areas, such as the advent of the Private Finance Initiative (PFI). Section 6 concludes.

## 2. Total public spending in the UK

In the fiscal year 2002–03, the UK government spent £419 billion,<sup>1</sup> or 39.7 per cent of the UK's national income. This translates into just over £7,100 for every person in the UK, or about £9,000 per adult. The total amount of public spending is set out each year in the Budget. This expenditure appears in the National Accounts as an aggregate called **total managed expenditure (TME)**. TME comprises expenditure by the entire public

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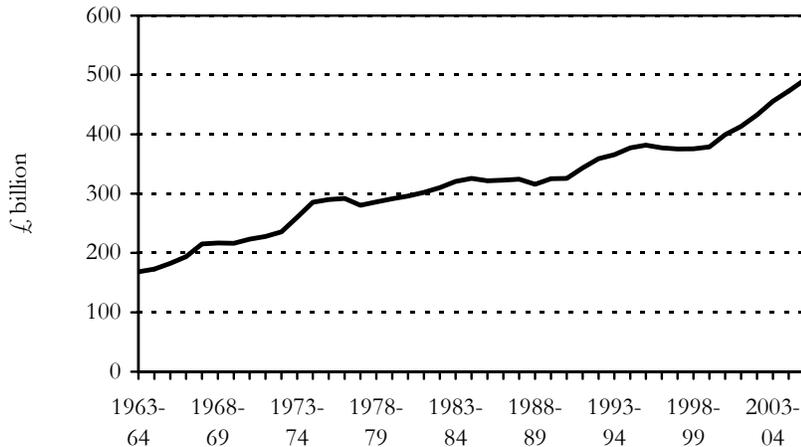
\*Address for correspondence: Institute for Fiscal Studies, 7 Ridgmount Street, London, WC1E 7AE; email [Carl\\_Emmerson@ifs.org.uk](mailto:Carl_Emmerson@ifs.org.uk), [Chris\\_Frayne@ifs.org.uk](mailto:Chris_Frayne@ifs.org.uk) or [Sarah\\_Love@ifs.org.uk](mailto:Sarah_Love@ifs.org.uk).

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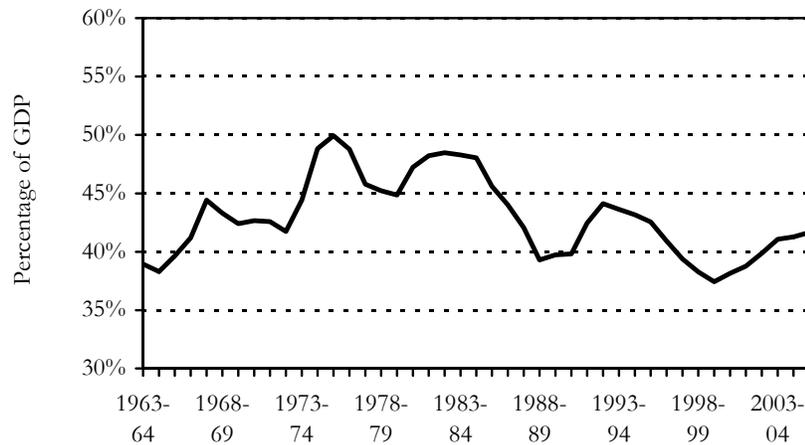
<sup>1</sup>Source: HM Treasury, *Public Finances Databank*, London, October 2003 ([www.hm-treasury.gov.uk/Economic\\_Data\\_and\\_Tools/data\\_index.cfm](http://www.hm-treasury.gov.uk/Economic_Data_and_Tools/data_index.cfm)).

sector – namely, the central government, local authorities and public corporations. Figure 2.1(a) shows TME in real terms since 1963–64 and the latest government projections to 2005–06, and Figure 2.1(b) shows what percentage of national income TME has accounted for over the same period.

**Figure 2.1(a). TME in real terms (2003–04 prices), 1963–64 to 2005–06**



**Figure 2.1(b). TME as a percentage of national income, 1963–64 to 2005–06**



Source: Table 3.1 of HM Treasury, *Public Expenditure Statistical Analyses 2003*, Cm. 5901, London, May 2003 ([http://www.hm-treasury.gov.uk/media/8/81937/pesa\\_03\\_652.pdf](http://www.hm-treasury.gov.uk/media/8/81937/pesa_03_652.pdf)).

Figure 2.1(a) shows that TME has grown steadily in real terms. Figure 2.1(b) shows that public spending as a share of national income tends to fluctuate in line with the economic cycle. During the recessions of the early 1980s and early 1990s, TME as a share of national income rose. This was both because national income grew slowly and because certain components of public spending (for example, spending on means-tested benefits and debt interest payments) tend to rise during recessions. The former makes

the denominator of the fraction relatively small and the latter makes the numerator larger. Conversely, during the booms of the late 1980s and late 1990s, the ratio of TME to national income fell. However, the recent increase in TME's share of national income since April 2000 has taken place during relatively strong economic conditions. So this increase reflects a structural change in spending, i.e. an increase in the amount of public spending over and above the 'natural' variability that occurs over economic cycles. This structural increase has had both discretionary components (such as the decision to increase the generosity of the benefits system) and non-discretionary ones (such as demographic changes that have increased the number of pensioners).

Figure 2.1(b) also shows that the current magnitude of public spending as a share of national income represents a decline relative to the levels of the mid-1970s, during the previous Labour government. TME peaked at 49.9 per cent of national income in 1975–76 and only in 2003–04 has it reached the 41.0 per cent of national income that it comprised at the end of the Major Government's term of office.

In IFS Briefing Note 25, Clark and Dilnot use an alternative measure of government spending – *general government expenditure* – to look at spending over a longer period. General government expenditure is a narrower measure of government spending than is total managed expenditure, because the former excludes spending by public non-financial corporations, such as the formerly nationalised utilities. Government spending as a percentage of national income was relatively low (below 30 per cent) in the 1920s and 1930s, grew rapidly during the Second World War and fell back to about 10 percentage points above its pre-war level in the 1950s. From the 1960s onward, the fluctuations in the path of general government expenditure are very similar to those shown in Figures 2.1(a) and 2.1(b) for TME.<sup>2</sup>

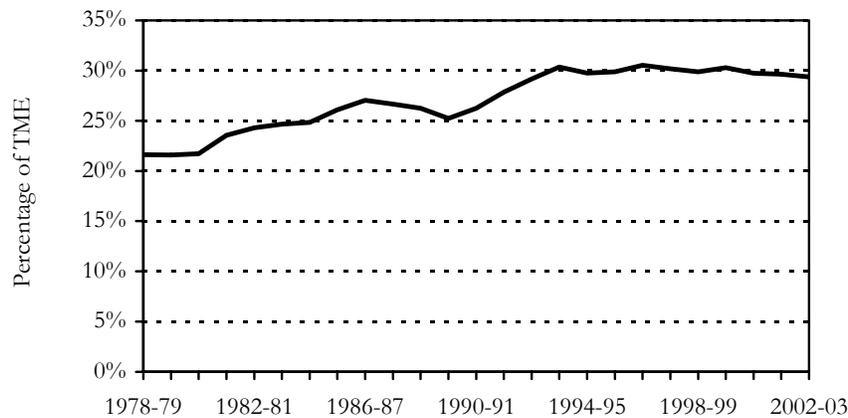
Since 1963–64, for the whole period shown on the graphs, the average annual real increase in TME was 2.4 per cent. The average real rate of increase during the Conservative years of 1979 to 1997 was 1.5 per cent and that under the current Labour government from April 1997 to March 2003 has been 2.3 per cent. The plans from April 2003 to March 2006, if realised, imply growth averaging 4.4 per cent a year.

The largest component of public spending is social security. The proportion of public spending that goes on transfer payments has increased relative to that which goes towards the purchase of goods and services. Figure 2.2 illustrates that between April 1979 and March 2003, the percentage of public spending devoted to social security transfer payments rose from 21.6 per cent to 29.4 per cent, reaching a peak of 30.5 per cent in 1996–97. In other words, the proportion of public spending that was devoted to transfer payments rose during periods of relatively weak economic performance, fell during the stronger economic growth of the late 1980s, but has barely fallen during the boom of the late 1990s. Clark and Dilnot's longer-term analysis shows that government spending on benefits rose as a percentage of general government expenditure from about 15 per cent in 1946 to just over 30 per cent in 2000.

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<sup>2</sup>See T. Clark and A. Dilnot, *Long-Term Trends in British Taxation and Spending*, IFS Briefing Note 25, June 2002 (<http://www.ifs.org.uk/public/bn25.pdf>).

**Figure 2.2. Government spending on social security benefits as a percentage of total public spending, 1978–79 to 2002–03**



Source: *Public Expenditure Statistical Analyses 2003*.

### ***The elements of TME***

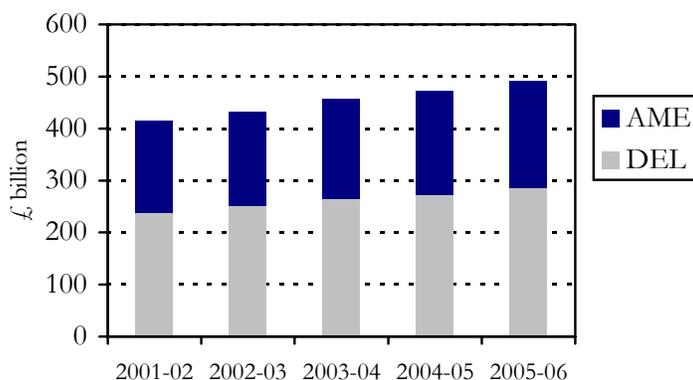
For planning purposes, TME is divided into two components – departmental expenditure limits and annually managed expenditure.

**Departmental expenditure limits (DELs)** cover spending that can be directly controlled rather than being demand driven. For example, most spending on the NHS, transport and education falls into this category. DELs are supposedly ‘firm limits’ for departments’ spending over a three-year period. Since 1998, they have been determined in Spending Reviews once every two years. The most recent such review – *2002 Spending Review* – fixed the limits for non-NHS departments until 2005–06. Spending limits for the NHS have been pre-announced for the period until March 2008. The next Spending Review is expected in Summer 2004 and will, for the remaining departments, plan public spending until 2007–08.

The remainder of spending, which cannot sensibly be planned for in advance, is allocated annually. It is known as **annually managed expenditure (AME)**. The major components of AME are social security payments, debt interest and spending by local authorities. The Treasury publishes forecasts of AME in each Pre-Budget Report and Budget. These normally take place in autumn and spring of each year respectively.

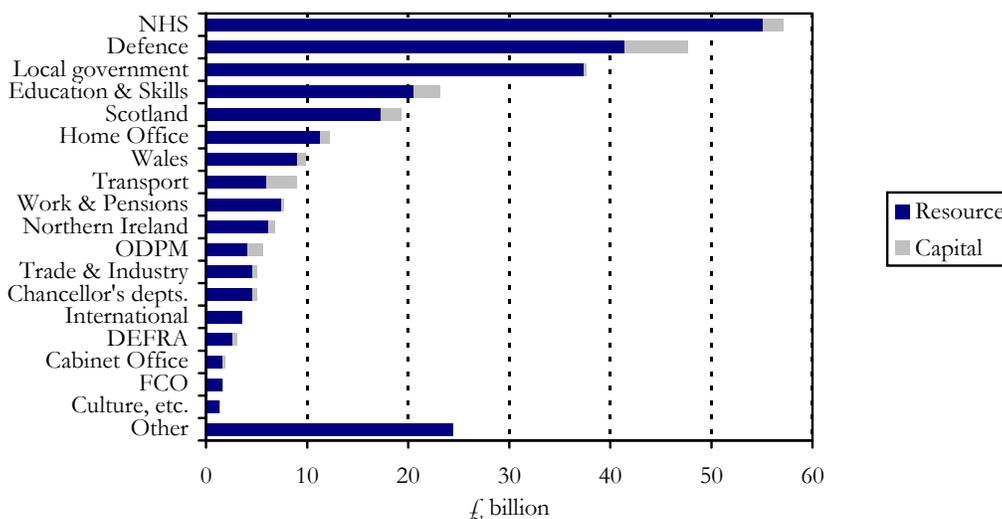
Over the period shown in Figure 2.3, DEL grew slightly faster than AME between April 2001 and March 2003. But from April 2003 to March 2006, both DEL and AME are forecast to grow at an annualised average real rate of 4.5 per cent.

**Figure 2.3. How TME is split between DEL and AME, in real terms (2003–04 prices), 2001–02 to 2005–06**



Source: Table C11 of HM Treasury, *Budget 2003*, HC 500, London, April 2003 ([http://www.hm-treasury.gov.uk/budget/bud\\_bud03/bud\\_bud03\\_index.cfm](http://www.hm-treasury.gov.uk/budget/bud_bud03/bud_bud03_index.cfm)).

**Figure 2.4. Departmental expenditure limits for each department, 2002–03**



Note: ODPM stands for ‘Office of the Deputy Prime Minister’; DEFRA stands for ‘Department for Environment, Food and Rural Affairs’; ‘Culture, etc.’ refers to the Department for Culture, Media and Sport; and ‘FCO’ stands for ‘Foreign and Commonwealth Office’. The ‘Northern Ireland’ category refers to the Executive only, and does not include the Northern Ireland Office. The Chancellor’s departments include Inland Revenue, HM Customs & Excise, HM Treasury and the Office for National Statistics. The distinction between ‘resource DEL’ and ‘capital DEL’ is explained in Section 3.

Source: Table C12 of *Budget 2003*.

Figure 2.4 shows the division of total DELs by department for 2002–03, the most recent year for which actual (as opposed to planned) allocations are available. The DELs are

split into capital and non-capital ('resource') components.<sup>3</sup> The graph shows that in 2002–03 the NHS had the largest DEL and accounted for over a fifth of total DELs by itself. The Ministry of Defence had the highest capital DEL, with £6.3 billion. The Department for Transport had the highest ratio of capital DEL to total DEL, making it the most capital-intensive department. The Department for Transport's capital DEL comprised a third of its total. Overall, 7.7 per cent of departments' total DEL was allocated to capital spending. The amount and form of capital spending done by the public sector is discussed in Section 5.

Figure 2.4 shows the allocations to government *departments*, which differ from the amounts allocated to spending *functions*. (The latter are shown in Figure 4.1.) For example, the DEL of the Department for Education and Skills does not represent the total amount spent on education because it excludes the share financed by local authorities and education spending in Scotland, Wales and Northern Ireland. The DEL of the Department for Work and Pensions is only a small proportion of total spending on social security because, as was mentioned above, most of this spending takes the form of AME. Also, the amount spent on defence appears to be far higher in Figure 2.4 than in Figure 4.1 (which shows spending by function in terms of TME) because Figure 2.4 includes spending on non-cash items,<sup>4</sup> such as depreciation – in particular, the Ministry of Defence's non-cash expenditure included an exceptionally large £10.3 billion item in 2002–03. The Ministry of Defence's DEL for 2003–04 is planned to be £36.9 billion, which is £10.8 billion less than in 2002–03 and is more representative of the 'normal' relative magnitude of the defence DEL in recent years. Cash spending on defence was £25.0 billion in 2002–03.

### 3. The planning of UK public spending

#### *Why does the government divide total public spending into DEL and AME?*

The division of public spending into DEL and AME was first suggested in 1998. It represents the most recent stage in the planning of public spending of a gradual evolution that has been taking place since the early 1990s. This evolution has seen an extension in the time horizons of public spending planning and an increased focus on controlling departmental spending. The government has asserted that its 'fiscal and public spending framework has been designed specifically to avoid the mistakes of the past'.<sup>5</sup> But when one compares the new system to its predecessors, it is clear that the new framework does not represent a radical change. Rather, it is a development of previous techniques to minimise the extent to which the public spending framework produces inefficient incentives for departments.

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<sup>3</sup>The distinction between the two is explained in Section 3.

<sup>4</sup>A 'non-cash item' is an expense that does not take the form of a cash payment but still reflects a loss of resources. Depreciation (i.e. the loss of value of assets as they age), notional 'cost of capital' charges and future spending items that have to be financed out of today's budget (which require some of that budget to be set aside) are the main types of non-cash expenses that departments incur. Non-cash spending, and its implications for departments' budgeting, is discussed in the subsection 'Resource accounting and budgeting' in Section 3.

<sup>5</sup>Source: Page 18 of HM Treasury, *Planning Sustainable Public Spending: Lessons from Previous Policy Experience*, London, November 2000 (<http://www.hm-treasury.gov.uk/media/BE324/86.pdf>).

### *Public Expenditure Surveys and the control total*

Prior to 1992, public spending was determined in annual Public Expenditure Surveys. These usually took the form of a series of bilateral negotiations between the Treasury and each spending department. This made it difficult for the government to take a strategic decision on the overall level of public spending or the priorities within the total. Also, the lack of a division in the spending total between cyclical and non-cyclical components was seen as enabling the spending total to 'creep up'. For example, a rise in discretionary spending after a recession could be masked by the fall in cyclical spending. Conversely, the rise in cyclical spending during recessions could potentially crowd out other programmes, particularly public investment.

In 1992, the system was reformed to give the government greater power to manage aggregate public spending in a 'top-down' way. Each summer, the government set out the departments' total planned spending for the next three fiscal years. This amount was known as the 'control total', and was published in the autumn Budget. For example, the November 1996 Budget planned the control total for the years 1997–98, 1998–99 and 1999–2000. However, the plans for years two and three were not intended to be 'set in stone', and were often increased for certain functions such as the NHS. Any department that failed to spend its control total in a given year forfeited the unspent money.

Each year's government spending included, in addition to the control total, other items such as the cyclical component of social security, central government debt interest payments and various accounting adjustments. Unlike DELs, the control total included non-cyclical social security spending, such as that on child benefit and the basic state pension, and only excluded social security payments that were highly cyclical by nature (such as unemployment benefits). All of these social security spending items are now in AME. The control total therefore accounted for a larger proportion of total public spending (about 85 per cent)<sup>6</sup> than do DELs.

To allow some flexibility for reaction to unanticipated events, each year's planned control total included a reserve, which was not allocated to individual departments. This reserve was allocated as extra spending or removed from the spending plans altogether in the Budget prior to the spending year in question.

After the control total was introduced, the Conservative government managed to meet its cash spending plans for the rest of its term in office. Therefore, the reforms of 1992 should be recognised as an improvement in the planning of public spending. In many respects, the control total can be regarded as a forerunner of the Labour government's DEL approach.

### *The Labour government's criticisms of the control total*

The Labour government that came to power in 1997 argued that the control total method of budgeting hindered departments from spending and investing money in a

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<sup>6</sup>Source: Chapter 6 of G. Davies, A. Dilnot, C. Giles and D. Walton (eds), *Options for 1997: The Green Budget*, Commentary 56, IFS, London, October 1996.

calculated and efficient fashion.<sup>7</sup> The ‘indicative’ nature of the control totals for two and three years ahead meant that they could be revised substantially up to a year in advance, which created an uncertain environment for departments to plan expenditure in. The fact that the totals were not divided into current and capital spending meant that, if budgets were tight, departments might be tempted to cut back on investment to meet more pressing needs such as public sector workers’ wages. This was because the effects of underinvestment on service quality take several years to become apparent whereas the effects of cutting back on current spending are noticeable much sooner.

If departments had cash to spare, they were not able to ‘roll over’ money from one year to the next, so they acquired a ‘use it or lose it’ mentality. This led to concerns that spending towards the end of the financial year might be used suboptimally.

The Labour government argued that, taken together, the factors outlined above created a situation of underinvestment in public services.<sup>8</sup>

### *The Spending Reviews*

The Labour government replaced a system in which control totals were determined annually with one in which departmental spending within DELs is formally fixed for three years in Spending Reviews. There have now been three such reviews: *Comprehensive Spending Review* in 1998 (planning for April 1999 to March 2002), *Spending Review 2000* (planning for April 2001 to March 2004) and *2002 Spending Review* (planning for April 2003 to March 2006). Each review was published in July and each revised the forecast for the last year covered by its predecessor. For instance, *Spending Review 2000* forecast that the DEL for 2003–04 would be £245.7 billion and *2002 Spending Review* revised that figure upwards to £263.5 billion.<sup>9</sup> A fourth Spending Review is expected to report in July 2004.

It is important to note that the Spending Reviews do not set the total level of TME. Before each Spending Review, the *Economic and Fiscal Strategy Report*, which is now published each spring at the same time as the Budget, sets out the next three years’ worth of spending. These figures form an ‘envelope’, within which the Spending Review can fill in more detailed proposals. The *Comprehensive Spending Review* was preceded by an *Economic and Fiscal Strategy Report* in June 1998 and the latter set the TME. The Spending Review allocated the TME to DEL and AME, then split the DEL by department. Likewise, in 2000, the March Budget set the TME and planned NHS spending to March 2004. In 2002, the April Budget set the TME and planned NHS spending until March 2008 (whereas all other departments’ plans, which were announced in July 2002, only extended to March 2006).

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<sup>7</sup>It enumerated its criticisms in HM Treasury, *Planning Sustainable Public Spending: Lessons from Previous Policy Experience*, London, November 2000 (<http://www.hm-treasury.gov.uk/media//BE324/86.pdf>).

<sup>8</sup>For more information about public sector investment, see T. Clark, M. Elsy and S. Love, ‘Trends in British public investment’, *Fiscal Studies*, 2002, vol. 23, pp. 305–42.

<sup>9</sup>Sources: Table A1 of HM Treasury, *Spending Review 2000*, Cm. 4807, London, July 2000 ([http://www.hm-treasury.gov.uk/Spending\\_Review/Spending\\_Review\\_2000/spend\\_sr00\\_index.cfm](http://www.hm-treasury.gov.uk/Spending_Review/Spending_Review_2000/spend_sr00_index.cfm)); table A2 of HM Treasury, *2002 Spending Review*, Cm. 5570, London, July 2002 ([http://www.hm-treasury.gov.uk/Spending\\_Review/spend\\_sr02/spend\\_sr02\\_index.cfm](http://www.hm-treasury.gov.uk/Spending_Review/spend_sr02/spend_sr02_index.cfm)).

As well as enabling departments to plan their spending with a greater degree of confidence, the new system of setting three-year spending totals also helps the government to plan to meet its 'fiscal rules' (more on which later). These rules constrain public spending over the course of a complete economic cycle. So it is helpful for the government to plan its medium-term spending projections at the same time as it predicts medium-term revenue forecasts. This should ensure that the two are compatible with the requirements of the 'fiscal framework'. In a recent example of such planning, the April 2002 Budget announced discretionary tax increases that were deemed necessary to fund the spending increases allocated in the subsequent *2002 Spending Review*.

Departments' DELs are divided into one DEL for capital spending (i.e. for spending that adds to the public sector's fixed assets) and a separate one for spending on other items, known as 'resource' spending. The distinction between capital and resource spending will be explained in more detail in the next subsection. A department cannot compensate for exceeding its resource DEL in a given year by using some of its capital DEL for non-capital spending, and therefore doing less capital spending than it had planned. It was intended that the separation of DELs into non-fungible capital and resource components would encourage departments to undertake more public investment. AME is also divided into capital and resource components.

While the government sees the 'ring-fencing' of capital DELs as a way to help correct long-standing underinvestment in the public sector, the approach has potential drawbacks. If departments have a certain proportion of their budgets set aside for capital spending, irrespective of the benefits of that capital spending relative to the benefits of the current spending that could be done in its place, then a situation could arise in which capital spending projects of low value to the public get commissioned while current spending ones of higher value do not. The fact that Spending Reviews occur biennially could help mitigate this problem.

Instead of forgoing any money that is not spent in the year to which it is allocated, departments can now carry funds over from one fiscal year to the next by accruing an 'end-year flexibility' (EYF) entitlement.<sup>10</sup> Under the EYF scheme, departments retain an entitlement to all of their unspent DELs from previous years (less any adjustments for any DEL Reserve claims agreed during the course of the year). The government hopes that this will remove the incentive for end-of-year 'splurges'.

So far, the limits set by DELs have been more like 'firm floors' than the firm spending totals they were intended to be. Even though the latest format for spending plans has only been in operation since April 1999, many departments' DELs have been revised upward. For example, the NHS has received additional funds in 2000–01, 2001–02,

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<sup>10</sup>EYF was introduced in HM Treasury, *Economic and Fiscal Strategy Report 1998: Long Term Stability and Investment*, Cm. 3978, London, June 1998 ([http://www.hm-treasury.gov.uk/Documents/UK\\_Economy/Economic\\_and\\_Fiscal\\_Strategy\\_Report\\_1998/ukecon\\_efsr\\_index.cfm](http://www.hm-treasury.gov.uk/Documents/UK_Economy/Economic_and_Fiscal_Strategy_Report_1998/ukecon_efsr_index.cfm)).

2002–03 and 2003–04. However, the new system of DELs has not yet been tested in a period of weak economic growth.

### ***Resource accounting and budgeting***

Prior to the changes announced in 1998, public spending was either ‘current’ or ‘capital’. The former was spending on items such as wages and the latter was spending on *fixed* items such as buildings, vehicles and machinery. Spending was listed in a department’s budget in the year in which it took place.

In 1998, the government decided to change from cash-based budgeting to **resource accounting and budgeting (RAB)**. The aim of RAB is to provide an accurate account of a department’s *underlying financial position* in any given year, rather than a snapshot of how much money went into/out from that department as cash. For instance, depreciation does not show up in cash-based spending plans because the department is not literally paying cash for it each year. But it is a genuine annual cost that worsens the department’s asset position. If, for example, a department buys an item of machinery worth £10 million that has a resale value of £0 at the end of 10 years, the department ‘loses’ £1 million-worth of machine each year, although the loss does not take the form of a cash payment. RAB takes this loss into account.

The move to RAB took place in two stages. In *Spending Review 2000*, the DELs were given on an ‘accruals’ basis. Under accruals accounting, costs and revenues are matched to the years in which they occurred, as opposed to the years in which the cash entered or left the department. The second stage of the move to RAB was the incorporation of non-cash costs, such as depreciation and ‘cost of capital’ charges (which reflect the opportunity costs of holding capital), into DELs. This happened in *2002 Spending Review*.

The move to RAB means that several items of spending that were previously regarded as part of departments’ capital budgets are now treated as annual costs, and have been moved into resource budgets. So the new non-capital-spending DELs are broader, and the capital DELs narrower, than were their pre-RAB equivalents.

- All current spending is in the **resource budget** (resource DEL + resource AME). Unlike the old current budget, the resource budget includes the costs of depreciation, ‘cost of capital’ charges, provisions for future costs and grants paid to the private sector.
- The **capital budget** (capital DEL + capital AME) includes only departmental spending on items that create new assets on the balance sheet of the *government*. Grants to non-governmental organisations to fund those organisations’ investments are not included because the grants do not change the government’s net asset position.

### ***Public spending plans and the government’s fiscal rules***

Public spending and taxes are set jointly to ensure adherence to the ‘fiscal rules’. These are:

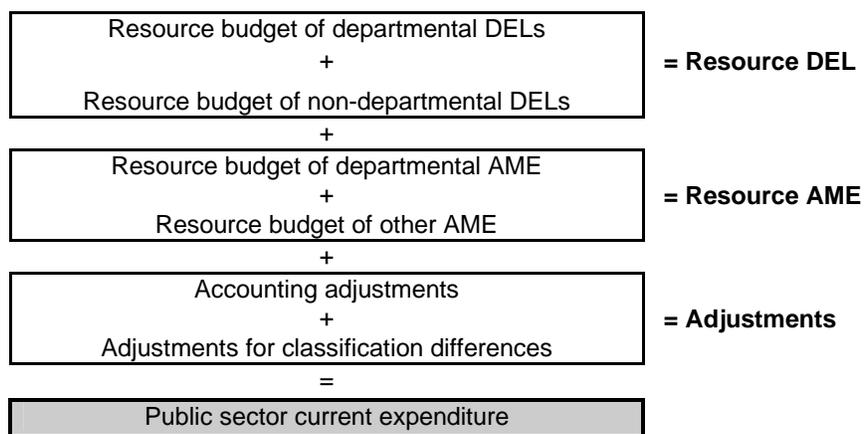
- **The golden rule:** over the economic cycle, the government will borrow only to invest and not to fund current spending. In other words, the **surplus on the current budget** – the difference between government receipts and current public spending (including depreciation) – will not be negative.
- **The sustainable investment rule:** over the economic cycle, the ratio of net public sector debt to GDP (known as the **net public debt ratio**) will be set at a ‘stable and prudent’ level, defined by the Chancellor as below 40 per cent of GDP.

A fuller discussion of the rationale behind these rules and the UK’s record of adherence to them can be found in IFS Briefing Note 16.<sup>11</sup> The government also looks at two measures of borrowing. **Public sector net borrowing (PSNB)** is the difference between current receipts and total public spending, measured on an accruals basis.<sup>12</sup> The **public sector net cash requirement (PSNCR)** measures the public sector’s actual borrowing in cash terms. (It was formerly known as the *public sector borrowing requirement (PSBR)*.) The PSNCR indicates the public sector’s actual cash requirements in a given year, and the central government component is a key determinant of the value of gilts to be sold in that year. Although these borrowing measures do not measure compliance with the fiscal rules, the amount of borrowing in one year feeds into the net public debt ratio in the next.

*How the various parts of TME relate to the fiscal aggregates*

The resource budget of all government departments measures the government’s spending on various current items. It is closely related to public sector current expenditure. The connection between the two fiscal measures is shown in Figure 3.1.

**Figure 3.1. The components of public sector current expenditure**



Public sector current expenditure, when subtracted from public sector receipts, gives the current budget surplus. This must be zero or positive over the complete economic cycle

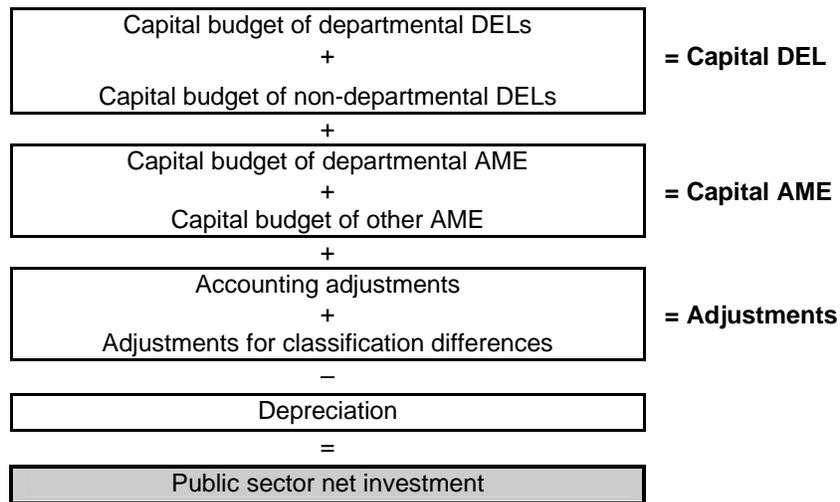
<sup>11</sup>C. Emmerson, C. Frayne and S. Love, *The Government’s Fiscal Rules*, IFS Briefing Note 16, September 2003 (<http://www.ifs.org.uk/public/bn16.pdf>).

<sup>12</sup>The PSNB is calculated on an accruals basis.

for the golden rule to be met. An increase in resource spending that increases public sector current expenditure will reduce the current budget surplus. This would affect either the government’s ability to meet the golden rule or the margin of comfort with which it does so.

Similarly, capital DEL and AME relate to public sector net investment, as is shown in Figure 3.2. The PSNB in a given year reflects the difference between public sector net investment and the current budget surplus. So a larger amount of capital spending in a given year means an increase in public sector net investment. This then adds to the PSNB and increases the net public debt ratio, which must remain at or below 40 per cent if the sustainable investment rule is to be met.

**Figure 3.2. The components of public sector net investment**



*Issues in public spending*

Fiscal aggregates and divisions of spending into DEL versus AME or resource versus capital may be useful for controlling overall spending and for gaining a broad overview of the government’s biggest spending items. But someone who reads a sentence in the Budget along the lines of ‘The resource budget of Department X will increase by a total of £Y billion over the next three years’ may have other queries that aggregate measures alone cannot answer. One key question is ‘Will the increase make a noticeable difference to whatever service it is being spent on?’. This will depend, in turn, upon the answers to the following:

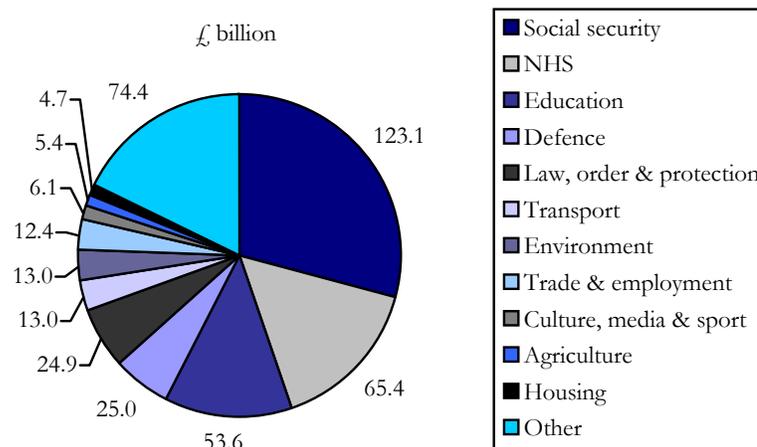
- What real rate of annual growth does £Y billion translate into?
- Is £Y billion generous compared with previous increases?
- What will Department X spend the increase on?
- For how long will the increase be maintained?

In other words, one must consider each public spending area in more detail and place current spending figures in a historical context. Section 2 began with the observation that the UK government spent about £9,000 per adult in the last fiscal year. The next section will explore in more detail what the government spends that money on and how the sums of money being spent compare with those of the past 25 years.

#### 4. Spending in each of the main areas over time

Figure 4.1 shows where the UK government's spending in 2002–03 went by function. The six spending areas that we will examine individually – social security, the National Health Service (NHS), education, defence, law, order & protection and transport – together comprised about 70 per cent of total spending. The biggest of these – social security – accounted for 29 per cent by itself. The UK government's spending per person amounted, in 2002–03, to about £2,000 on social security, £1,100 on the NHS, £900 on education, £400 each on defence and law, order & protection and £200 on transport. We can therefore account for, and explain changes in, most of government spending by understanding what changes have taken place in these six areas.

**Figure 4.1. UK government spending by function in 2002–03, measured as total managed expenditure**



Notes: Figures for the NHS are taken from table 7.2 of HM Treasury, *2002 Spending Review*, Cm. 5570, London, July 2002 ([http://www.hm-treasury.gov.uk/Spending\\_Review/spend\\_sr02/spend\\_sr02\\_index.cfm](http://www.hm-treasury.gov.uk/Spending_Review/spend_sr02/spend_sr02_index.cfm)). Figures for other functions are taken from table 3.2 of HM Treasury, *Public Expenditure Statistical Analyses 2003*, Cm. 5901, London, May 2003 ([http://www.hm-treasury.gov.uk/media/81937/pesa\\_03\\_652.pdf](http://www.hm-treasury.gov.uk/media/81937/pesa_03_652.pdf)). All figures are on a resource accounting basis and exclude non-cash items (such as capital charges and depreciation). The category 'Other' includes spending on international cooperation & development, central administration, debt interest and accounting adjustments.

Table 4.1 shows the real average annual rate at which public spending in each of the six main areas has increased over time. Spending on social security, the NHS and education has generally grown faster over the past few decades than have total public spending, current spending and national income. These three areas have therefore increased their respective shares of public spending. The NHS has experienced particularly substantial growth, with average annualised real increases of over 3 per cent under the Conservative

and Labour governments since 1979. Since April 1997, real growth in NHS spending has been more than twice as large as real growth in national income. Spending on law, order & protection has also regularly experienced high real growth until March 2003, although between April 2003 and March 2006 this rate is set to fall to 1.1 per cent a year.

**Table 4.1. Real increases in spending in the six main areas**

	Long-term trend	Annualised average real increase, %		
		April 1979 to March 1997	April 1997 to March 2003	April 2003 to March 2006
Social security	3.7	3.5	1.7	2.0
NHS	3.6	3.0	5.6	7.3
Education	4.0	1.5	4.1	5.8
Defence	-0.3	-0.3	-0.5	0.8
Transport	n/a	0.5	1.8	4.9
Law, order & protection	n/a	4.0	4.8	1.1
TME, of which:	2.4	1.5	2.3	4.4
Net investment	-1.4	-4.3	7.9	30.0
Current spending	2.9	2.1	2.3	3.8
GDP	2.4	2.1	2.8	2.8

Notes: Social security long-term trend is January 1949 to December 2000 and 'April 2003 to March 2006' is inferred from figures that exclude spending by local authorities. NHS long-term trend is April 1950 to March 2003. Education long-term trend is January 1953 to December 1996. Defence long-term trend is January 1954 to December 1996. Transport 'April 2003 to March 2006' is based on the update of the *Transport Ten Year Plan*. Law, order & protection 'April 2003 to March 2006' is inferred from figures that exclude spending by local authorities. TME, net investment, current spending and GDP long-term trends are April 1964 to March 2003.

Sources: HM Treasury, *Public Expenditure Statistical Analyses 2003*, Cm. 5901, London, May 2003 ([http://www.hm-treasury.gov.uk/media/81937/pesa\\_03\\_652.pdf](http://www.hm-treasury.gov.uk/media/81937/pesa_03_652.pdf)) and previous PESAs; Department of the Environment, Transport and the Regions, *Transport Ten Year Plan*, London, July 2000 ([http://www.dft.gov.uk/stellent/groups/dft\\_transstrat/documents/page/dft\\_transstrat\\_503944.hcsp](http://www.dft.gov.uk/stellent/groups/dft_transstrat/documents/page/dft_transstrat_503944.hcsp)); Office for National Statistics, *Blue Books*; HM Treasury Public Spending Statistics ([http://www.hm-treasury.gov.uk/economic\\_data\\_and\\_tools/national\\_statistics/natstat\\_index.cfm](http://www.hm-treasury.gov.uk/economic_data_and_tools/national_statistics/natstat_index.cfm)); Department of Health Annual Reports; Office of Health Economics; HM Treasury, *2002 Spending Review*, Cm. 5570, London, July 2002 ([http://www.hm-treasury.gov.uk/Spending\\_Review/spend\\_sr02/spend\\_sr02\\_index.cfm](http://www.hm-treasury.gov.uk/Spending_Review/spend_sr02/spend_sr02_index.cfm)).

These expansions have been at the expense of other spending areas. Defence, in particular, has experienced a lengthy period of falling spending. Similarly, the consistent growth in the rate of current spending contrasts with the long-term decline in net investment. This decline is discussed in more detail in Section 5. The changes in current and capital spending have had dramatic effects on the composition of public spending. The ratio of current to net investment spending has increased from 7:1 in 1963–64 to 37:1 in 2002–03, hitting a peak of 102:1 in 1988–89. The ratio is predicted to be 19:1 in 2005–06.

Table 4.2 shows spending in the same areas as a percentage of national income at various points over the past 40 years. Once again, social security, the NHS and education are the main areas of growth, although the table shows that education's share of national income expanded during the 1960s and 1970s and more or less stagnated thereafter. TME itself did not occupy a much larger share of national income in 2002–03 than in 1963–64. But within TME, current spending's share grew significantly during the 1960s and 1970s, while net investment's share is less than a quarter of what it was in 1963–64.

**Table 4.2. Spending as a share of national income in the six main areas**

	Percentage of GDP, %			
	1963–64	1978–79	1996–97	2002–03
Social security	6.4	9.8	12.4	11.7
NHS	3.4	4.5	5.3	6.2
Education	3.9	5.3	4.7	5.1
Defence	5.6	4.4	2.9	2.4
Transport	n/a	1.7	1.3	1.2
Law, order & protection	n/a	1.5	2.1	2.4
TME, of which:	38.9	45.2	40.8	39.7
Net investment	4.5	2.4	0.8	1.0
Current spending	30.8	38.4	38.5	37.3

Note: Net investment and current spending do not sum to TME because TME also includes depreciation.  
Sources: See Table 4.1.

### ***Social security***

Social security is the largest single component of public spending. Its share of general government expenditure has risen from about 15 per cent just after the Second World War to 30 per cent by the late 1990s.<sup>13</sup> As a share of TME, social security spending increased from 21.6 per cent in 1978–79 to a peak of 30.5 per cent in 1996–97 and fell slightly to 29.4 per cent in 2002–03.

Social security spending in real terms, from fiscal year 1978–79 onwards, can be seen in Figure 4.2(a). The same series presented as a share of national income is shown in Figure 4.2(b). Figures 4.2(a) and 4.2(b) use a series of data entitled ‘social protection’ published in the *Public Expenditure Statistical Analyses* (PESAs). The series includes only part of the cost to the government of the working families’ tax credit, the working tax credit and the child tax credit.<sup>14</sup>

Social security is anomalous in that, unlike other spending areas, the majority of its spending is planned on an annual basis. The total DEL for the Department for Work and Pensions (DWP), which administers social security, was set in the *2002 Spending Review* at less than £8 billion from 2003–04 to 2005–06 – compared with AME for social security of over £100 billion. However, spending on the basic state pension and on child benefit alone added up to £47.3 billion in 2002–03, which was 39.3 per cent of total benefit and tax credit expenditure in the UK.<sup>15</sup> The numbers of individuals entitled to these benefits are largely unresponsive to the economic cycle.<sup>16</sup> This suggests that a large

<sup>13</sup>Source: T. Clark and A. Dilnot, *Long-Term Trends in British Taxation and Spending*, IFS Briefing Note 25, June 2002 (<http://www.ifs.org.uk/public/bn25.pdf>).

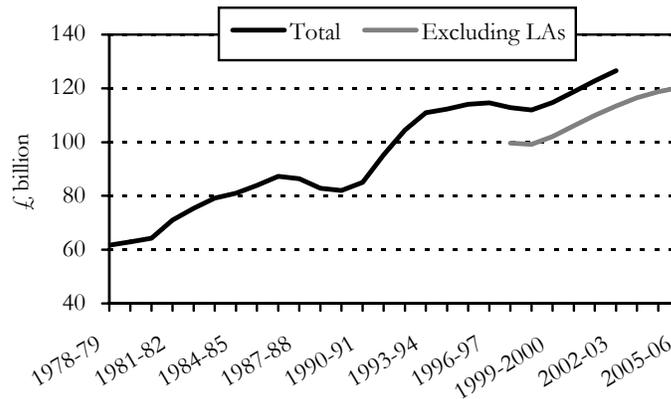
<sup>14</sup>Note that it is difficult to find a consistent series that includes all relevant social benefits and tax credits and excludes those normally not regarded as social security spending. The *Blue Book* also publishes a series entitled ‘Total social benefits’ on a calendar-year basis. This includes some of the mortgage interest tax relief as social assistance spending and also counts certain employee benefits and pensions as social benefits.

<sup>15</sup>Source: Department for Work and Pensions, *Benefit Expenditure Tables* (<http://www.dwp.gov.uk/asd/asd4/expenditure.asp>).

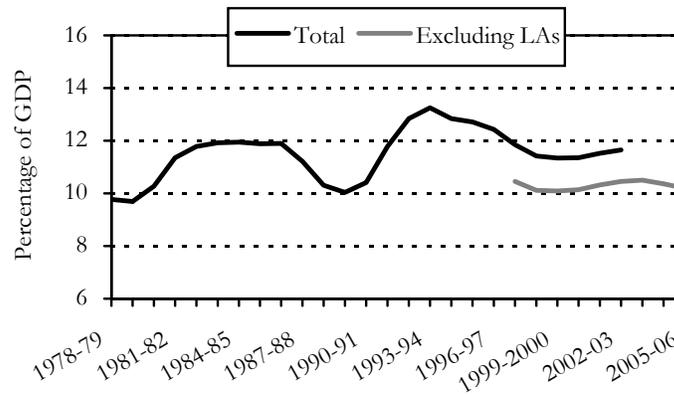
<sup>16</sup>At least, the number of pensioners and the number of children aged under 16 are unresponsive. The number of young people aged 16 to 18 in full-time education might react to the state of the economy.

component of AME can be forecast with reasonable accuracy more than a year in advance. Indeed, the Conservative government was able to include a large proportion of social security spending in its control total.

**Figure 4.2(a). Social security spending in real terms (2003–04 prices), 1978–79 to 2005–06**



**Figure 4.2(b). Social security spending as a share of national income, 1978–79 to 2005–06**



Source: *Public Expenditure Statistical Analyses 2003* and previous PESAs.

Much of the variation in social security spending over time is due to fluctuations in the economic cycle, as Figure 4.2(a) shows and Figure 4.2(b) accentuates. For example, social security spending dipped markedly during the late 1980s mainly because rising incomes and falling unemployment reduced people’s reliance on benefits such as income support and support for the unemployed. A similar dip in spending occurred in the late 1990s. This was partly because Labour’s tight spending limits allowed benefits only to be increased in line with prices for the government’s first two years and partly because of strong economic performance, which delivered rising incomes and falling unemployment. Estimates produced in 2001–02 suggested that a 100,000-person drop in

the number of people unemployed would lead to a reduction in benefit expenditure of £610 million.<sup>17</sup>

The recent increase in social security from 1999–2000 to the present has taken place during a period of falling unemployment. According to the DWP, resource budget spending on benefits for those of working age has actually fallen from £15.9 billion in 1998–99 to an estimated £14.9 billion in 2002–03, and it is predicted to fall further to £12.3 billion in 2005–06.<sup>18</sup> Over the current economic cycle to date, unemployment has been falling or stable, while asset prices have fluctuated markedly. This means that the effect of the current economic cycle will have been relatively more pronounced in the case of tax revenues and relatively less pronounced in the case of public spending.

The cause of the spending growth is an increase in the number and generosity of payments, such as ‘in-work’ benefits, benefits for pensioners and tax credits. Tax credits in particular have become a prominent part of Labour’s welfare policy.<sup>19</sup> The credits accounted for 0.6 per cent of GDP in 2001–02. This proportion is predicted to double by 2005–06. More than half of the £23 billion increase in the total spending on social benefits between 1998–99 and 2005–06 will be spending on tax credits.<sup>20</sup> Some of this reflects a relabelling of spending that previously took the form of normal benefits. For example, spending that was part of family credit, which counted as public expenditure, became part of the working families’ tax credit (WFTC) in October 1999. The Office for National Statistics (ONS) continued to classify WFTC benefits as public spending but the Treasury preferred to regard them as negative taxation (i.e. it deducted them from tax revenues rather than adding them to public spending). In April 2003, the working tax credit and the child tax credit replaced the WFTC. From now on, the ONS will count the new credits as negative taxation whenever the value of the credits does not exceed the tax liability of the household receiving them (i.e. whenever the household pays the same or less in taxes). The tax credits will only count as public spending whenever the credits add up to more than the recipient household’s tax liability (i.e. whenever the household receives a payment). Although the credits cost the same amount however they are classified, the change in ONS labelling will have the effect of reducing both tax receipts and social security spending relative to their amounts under the previous ONS system. This change in classification has not altered the amount of redistribution carried out by the government but has lowered the headline measures of taxation and spending.

Labour has also continued to weaken the link between contributions and entitlements to benefits. Recent reforms, such as cuts in the generosity of contributory benefits, have directed a greater proportion of spending towards benefits that relate to recipients’ current circumstances. Specific ‘client groups’, such as children and pensioners, have been major beneficiaries, as have low earners.

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<sup>17</sup>Source: Department for Work and Pensions, *Annual Report 2001*, Cm. 5260, London, 2001.

<sup>18</sup>Source: Department for Work and Pensions, *Department for Work and Pensions Departmental Report 2003*, Cm. 5921, London, May 2003 (<http://www.dwp.gov.uk/publications/dwp/2003/dwpreport/index.asp>).

<sup>19</sup>See G. Kaplan and A. Leicester, *A Survey of the UK Benefits System*, IFS Briefing Note 13, updated November 2002 (<http://www.ifs.org.uk/taxsystem/benefitsurvey.pdf>), for a guide to the current benefits system.

<sup>20</sup>Source: M. Brewer, T. Clark and M. Wakefield, ‘Social security in the UK under new Labour: what did the third way mean for welfare reform?’, *Fiscal Studies*, 2002, vol. 23, pp. 505–37.

Looking ahead, the government's commitment to eradicating child poverty within a generation<sup>21</sup> and the imminent retirement of the 'baby boomers' indicate that social security spending will probably continue to increase in real terms. The component of social security spending that is done by local authorities (LAs)<sup>22</sup> is not included in the spending projections of PESAs, because the LAs' spending by function for future years is not known. However, Figures 4.2(a) and 4.2(b) have a grey line that shows the series of actual and planned social protection spending, *excluding* LAs' share, from 1997–98 to 2005–06. Between 1997–98 and 2002–03, LAs' share of social protection spending comprised between 10 and 12 per cent of the total. If one assumes that this proportion remains unchanged in the future, the grey lines in Figures 4.2(a) and 4.2(b) imply that social security spending will increase modestly in real terms over the next few years and will stabilise as a share of GDP. Other data sources, such as *2002 Spending Review* and the 2003 Budget, suggest that social security spending will follow a broadly similar pattern. Of course, these series only incorporate spending announcements up to the present, so any further government announcements that increase social security spending will change the prognosis. The accuracy of the projections also depends on that of the macroeconomic forecasts. In *Budget 2003*, the Treasury assumed for its projections that UK claimant unemployment will increase slightly from 0.93 million in 2002–03 to 1.03 million in 2005–06. If unemployment were to rise by a larger amount, then, in the absence of any change in policy, social security spending would increase by more than is currently being forecast. Section 5 of this Briefing Note also considers the effects on future social security spending of the government's policy commitments with respect to children's and pensioners' poverty.

### ***The National Health Service***

Spending on the NHS has grown as a share of public expenditure. Between 1978–79 and 2002–03, it went from 9.9 per cent of TME to 15.5 per cent. The fact that overall health spending (i.e. public and private) has increased as a share of national income is not surprising, for at least three reasons: the demographic changes that have increased the proportion of elderly people in the population; the general propensity of societies to spend a higher share of their income on health as that income rises; and the increase in the range of treatable ailments.

Figure 4.3(a) shows that spending on the NHS has also grown steadily in real terms. From April 1979 to March 1997, NHS spending rose at an average annual rate of 3.0 per cent. Between April 1997 and March 2003, this increased to 5.6 per cent. According to the plans set out in *2002 Spending Review*, the rate is set to rise to 7.3 per cent between April 2003 and March 2008. During the NHS's previous period of high growth, which was the five years from April 1971 to March 1976, the average annual real increase was 6.4 per cent. This five-year average will be surpassed at the end of this financial year, by which point the average annual real increase over the five-year period from April 1999 to March 2004 will have been 7.2 per cent. The average annual increase in NHS spending in

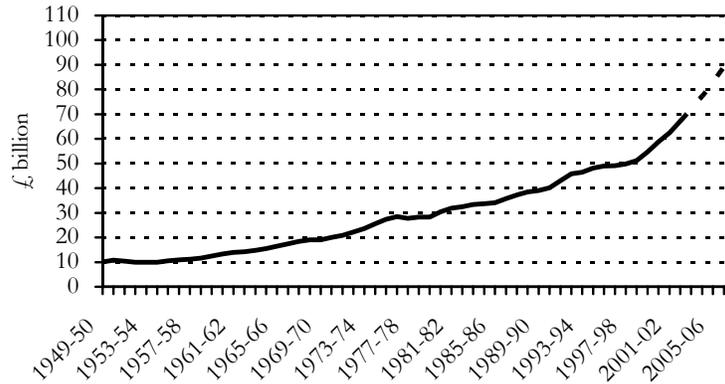
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<sup>21</sup>See Department for Work and Pensions, *Public Service Agreement for the Department of Work and Pensions* ([http://www.dss.gov.uk/publications/dss/2001/dwp\\_psa/psa.pdf](http://www.dss.gov.uk/publications/dss/2001/dwp_psa/psa.pdf)).

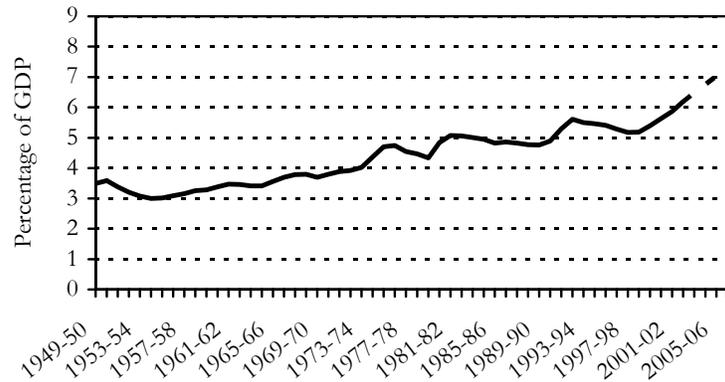
<sup>22</sup>LAs administer a range of social security payments, such as council tax benefit.

real terms from April 1950 to March 2003 has been 3.6 per cent. If the predicted spending increases take place, the average annual rate of real growth from April 1950 to March 2008 will be 3.9 per cent.

**Figure 4.3(a). Historical and forecast NHS spending in real terms (2003–04 prices), 1949–50 to 2007–08**



**Figure 4.3(b). Historical and forecast NHS spending as a share of national income, 1949–50 to 2007–08**



Sources: Department of Health Annual Reports; Office of Health Economics; 2002 *Spending Review*.

The forecast spending increases will be not only larger than those of past decades but also more sustained. Historically, the NHS has often received large real increases in spending for one or two years in a row, interspersed with years of lower spending growth. For example, the annual real increases in NHS spending were 7.5 per cent and 5.0 per cent in 1980–81 and 1981–82 respectively, but spending growth in 1982–83 fell to less than 2 per cent. These fluctuations in the rate of spending growth have amplified the peaks and troughs in NHS spending as a share of national income that can be seen in Figure 4.3(b).

Spending on the NHS is currently planned for a longer period than is that on other functions. Public spending forecasts extend until March 2008. The Prime Minister has

stated that he would like UK health spending as a share of national income to reach the European average by 2005.<sup>23</sup> In 1998, the weighted European average (i.e. the ‘raw’ average adjusted for differences in countries’ national incomes) was 8.5 per cent of national income if the UK was included and 8.9 per cent if it was excluded.<sup>24</sup> The unweighted averages were 7.9 per cent and 8.0 per cent respectively. The *2002 Spending Review* predicts that public and private UK health spending as a percentage of national income will reach 8.0 per cent in 2003–04, 8.3 per cent in 2004–05, 8.7 per cent in 2005–06 and 9.0 per cent in 2006–07.

Figure 4.4 shows how the share of national income that the UK spends on health compares with that of five other major economies. All of the other five countries except Japan spend a higher share of national income on health than does the UK. The USA, which is the biggest spender on health in the OECD, devotes a share of national income that is 80 per cent higher. As well as spending a relatively low share of national income on health, the UK also funds a relatively high proportion of that share publicly. Of the UK’s total spending on health, 82.2 per cent is public expenditure, compared with 78.3 per cent in Japan, 76.0 per cent in France, 75.3 per cent in Italy, 74.9 per cent in Germany and just 44.4 per cent in the USA.<sup>25</sup>

The recent increases in NHS spending have been determined in light of the recommendations of the Wanless Review, an independent review of the health service in the UK that was undertaken by Derek Wanless and completed in April 2002.<sup>26</sup> The Review included recommendations about the amount of resources that should be spent on the NHS over the next 20 years. The government agreed to meet the spending figures they implied to March 2008 in the April 2002 Budget.<sup>27</sup> If the current government and its successors adhere to the spending recommendations of the Wanless Review beyond March 2008, then NHS spending for the UK will continue to increase above the rate of growth of national income until March 2023.<sup>28</sup>

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<sup>23</sup>See *Hansard*, 28 November 2001, column 964.

<sup>24</sup>Source: C. Emmerson, C. Frayne and A. Goodman, *How Much Would It Cost to Increase UK Health Spending to the European Union Average?*, IFS Briefing Note 21, January 2002 (<http://www.ifs.org.uk/health/bn21.pdf>).

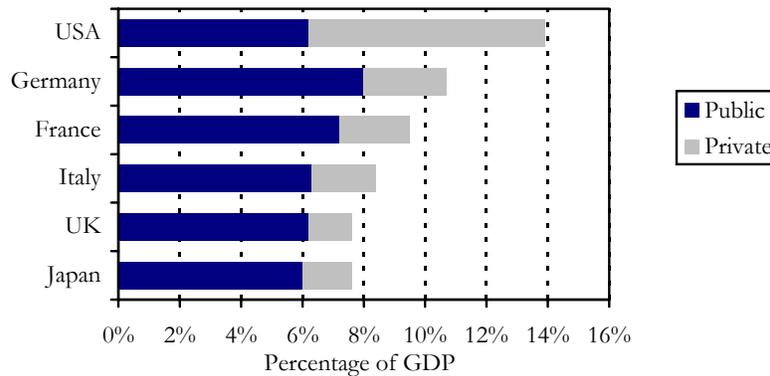
<sup>25</sup>OECD, *OECD Health Data 2003*, July 2003 ([http://www.oecd.org/document/16/0,2340,en\\_2649\\_34631\\_2085200\\_119656\\_1\\_1\\_37443,00.html](http://www.oecd.org/document/16/0,2340,en_2649_34631_2085200_119656_1_1_37443,00.html)).

<sup>26</sup>D. Wanless, *Securing Our Future Health: Taking a Long-Term View*, HM Treasury, London, April 2002 ([http://www.hm-treasury.gov.uk/consultations\\_and\\_legislation/wanless/consult\\_wanless\\_index.cfm](http://www.hm-treasury.gov.uk/consultations_and_legislation/wanless/consult_wanless_index.cfm)).

<sup>27</sup>See the Budget 2002 Press Notice of 17 April 2002, [http://www.hm-treasury.gov.uk/budget/bud\\_bud02/press\\_notices/bud\\_bud02\\_presshmt1.cfm](http://www.hm-treasury.gov.uk/budget/bud_bud02/press_notices/bud_bud02_presshmt1.cfm).

<sup>28</sup>Source: Chapter 5 of the Wanless Review, <http://www.hm-treasury.gov.uk/media//47779/chap5.pdf>. If the government adheres to the Review’s spending recommendation beyond March 2008, then public spending on the NHS will grow by an average annual rate of between 4.4 and 5.6 per cent from April 2008 to March 2013, between 2.8 and 4.0 per cent from April 2013 to March 2018 and between 2.4 and 3.5 per cent from April 2018 to March 2023.

**Figure 4.4. Spending on health as a share of national income in selected major economies, 2001**



Note: Figures for Japan are for the year 2000.

Source: OECD, *OECD Health Data 2003*, July 2003

([http://www.oecd.org/document/16/0,2340,en\\_2649\\_34631\\_2085200\\_119656\\_1\\_1\\_37443,00.html](http://www.oecd.org/document/16/0,2340,en_2649_34631_2085200_119656_1_1_37443,00.html)).

The Department of Health produces breakdowns of NHS spending on hospital and community health services (HCHS) by year. Figure 4.5 shows the breakdowns for the years 1988–89, 1995–96 and 2000–01 to indicate how the composition of NHS spending has altered over the past 13 years. The graph reveals that the percentage of spending that goes on acute hospital treatment has increased steadily from 45.1 per cent in 1988–89 to 51.7 per cent in 2000–01. The proportions spent on mental health and learning disabilities have risen during the 1990s. The proportion of HCHS spending that the elderly receive has fallen from 14.1 per cent in 1988–89 to 8.8 per cent in 2000–01. One should remember that the elderly receive a large portion of spending through other parts of the health budget, so a decline in HCHS spending on them does not necessarily mean that fewer healthcare resources are being devoted to their needs.<sup>29</sup>

One area of health spending that experienced a large and abrupt decline in the 1990s was investment. Publicly funded health investment reached a post-1978 peak of 0.37 per cent of GDP in 1992 and fell to 0.18 per cent by 2000.<sup>30</sup> The Department of Health estimated in its 2000 *Departmental Investment Strategy* that this decline in investment had caused a backlog of £3.1 billion worth of maintenance to develop. Investment and training together currently comprise about 11 per cent of the NHS's budget, but it is intended that this percentage will increase.<sup>31</sup> The capital budget of England's part of the NHS is

<sup>29</sup>For more information about NHS spending, see C. Emmerson, C. Frayne and A. Goodman, *Pressures in UK Healthcare: Challenges for the NHS*, Commentary 81, IFS, London, May 2000

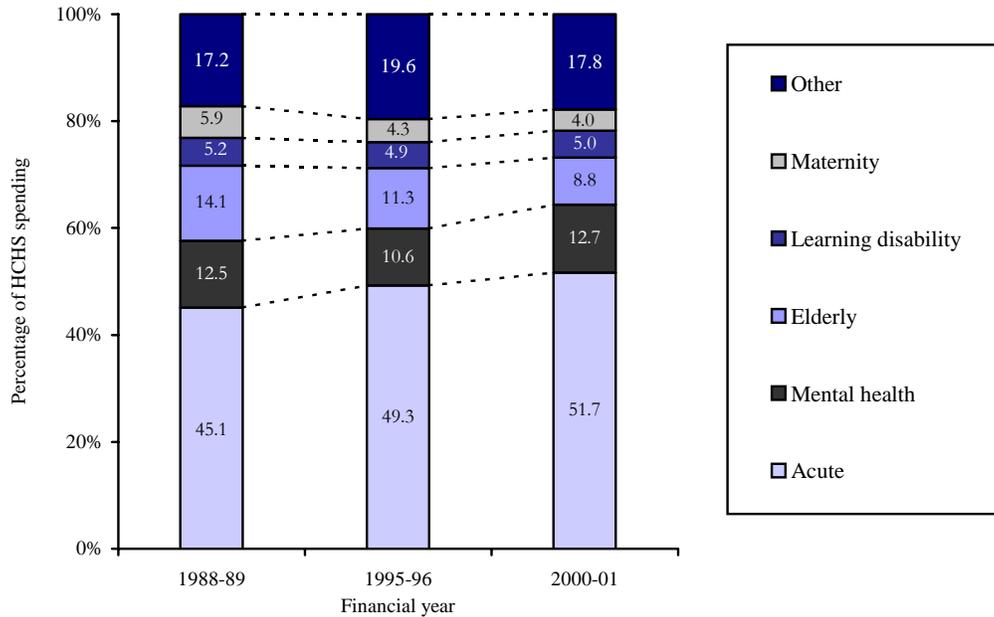
(<http://www.ifs.org.uk/health/nhsspending.pdf>), and C. Propper, 'Expenditure on healthcare in the UK: a review of the issues', *Fiscal Studies*, 2001, vol. 22, pp. 151–83.

<sup>30</sup>Source: Page 331 of T. Clark, M. Elsyby and S. Love, 'Trends in British public investment', *Fiscal Studies*, 2002, vol. 23, pp. 305–42.

<sup>31</sup>Source: Department of Health, *Delivering the NHS Plan – Expenditure Report*, London, April 2003.

planned to increase in nominal terms from £2.2 million in 2002–03 to £6.1 million in 2007–08.<sup>32</sup>

**Figure 4.5. Composition of hospital and community health services (HCHS) gross current expenditure in 1988–89, 1995–96 and 2000–01**



Source: Department of Health departmental reports.

### ***Education***

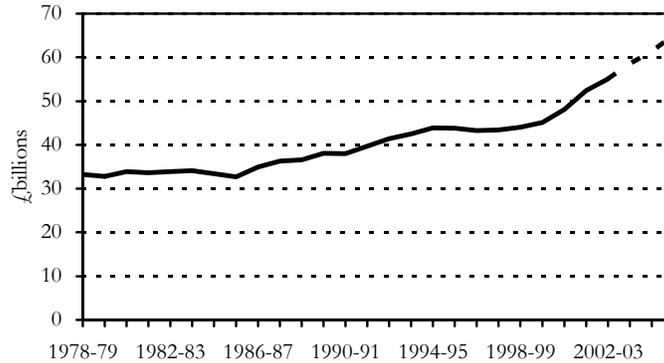
The percentage of general government expenditure devoted to education spending rose steadily from 7.3 per cent in 1953 to 13.3 per cent in 1973. By 1979, it had fallen to 12.2 per cent. With the exception of a temporary drop to 11.0 per cent in the mid-1980s, education spending as a share of general government expenditure has remained stable at around 12 per cent from then until the present. Similarly, measured as a share of TME, education spending has been steady at between 10 and 13 per cent for the past 25 years.

In real terms, the average annual increase in education spending between 1953 and 1996 was 4.0 per cent.<sup>33</sup> Figure 4.6(a) shows that education spending remained almost unchanged in real terms between 1978–79 and 1985–86, after which it rose gradually until 1994–95, levelled off again, then recently began to increase at a faster rate from April 2000. Viewed as a percentage of national income, education spending has fluctuated around 5 per cent (Figure 4.6(b)).

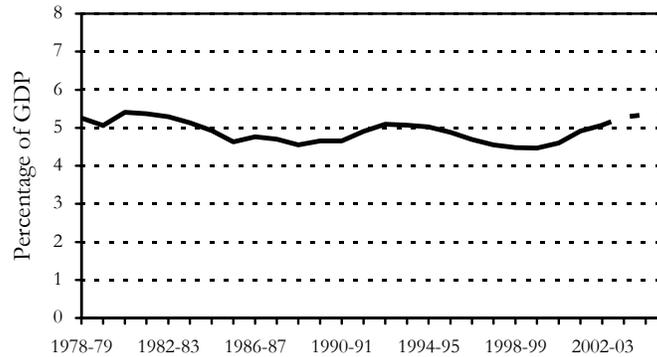
<sup>32</sup>Source: Table 7.1 of *2002 Spending Review*.

<sup>33</sup>Source: Office for National Statistics, *Blue Books*, various years.

**Figure 4.6(a). Historical and forecast education spending in real terms (2003–04 prices), 1978–79 to 2005–06**



**Figure 4.6(b). Historical and forecast education spending as a share of national income, 1978–79 to 2005–06**

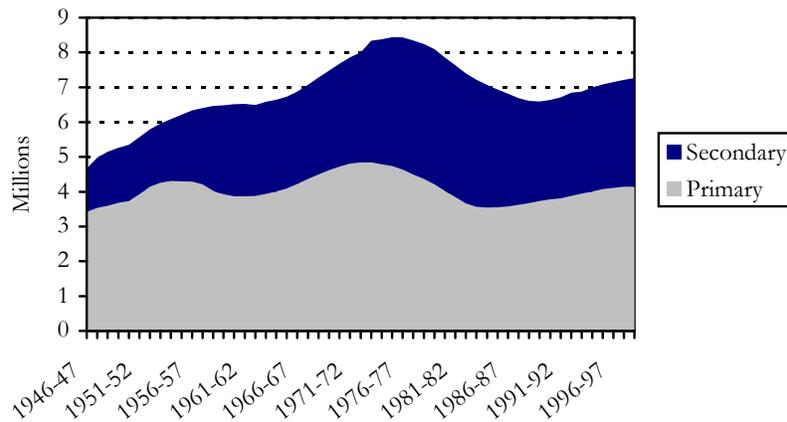


Source: *Public Expenditure Statistical Analyses 2003* and previous PESAs.

Spending on education is driven by a combination of demographics and demand. Spending on primary and secondary education, for example, is a function of the number of schoolchildren. By contrast, spending on higher education depends not only on the student-age population but also on how high a proportion of that population goes to college or university. The rise in the school-age population from the 1950s until the mid-1970s was accompanied by increases in education spending. Figure 4.7, which presents the number of children in school from 1946–47 to 1998–99, shows that between 1946–47 and 1975–76, the number of school pupils increased from 4.7 million to over 8.4 million.

Education’s share of national income began to stagnate in the 1970s at the same time as the number of schoolchildren began to decline. By 1989–90, there were only 6.6 million schoolchildren. However, the link between education spending and demographics may recently have become weaker: a rise in the number of school-age children in the 1990s (from 6.6 million in 1990–91 to 7.3 million in 1998–99) did not result in an increase in the share of national income spent on education.

Figure 4.7. Pupils in primary and secondary schools, 1946–47 to 1998–99



Note: The minimum school-leaving age was increased from 15 to 16 in 1972.  
 Source: Office for National Statistics, *Social Trends 30*.

As with health, the Labour government has begun to increase substantially the amount of public spending on education and plans to continue this increase at least until March 2006. The average annual increase in real education spending was 1.5 per cent between April 1979 and March 1997 and 4.1 per cent between April 1997 and March 2003. The *2002 Spending Review* forecasts that real spending on education will rise by an average of 5.8 per cent a year from April 2003 to March 2006. While these increases are substantial, they have only just brought the share of national income spent on education back past the peak of 5.1 per cent seen in 1992–93 under John Major. The level of 5.4 per cent that was reached in 1980–81 is not set to be exceeded until 2005–06.

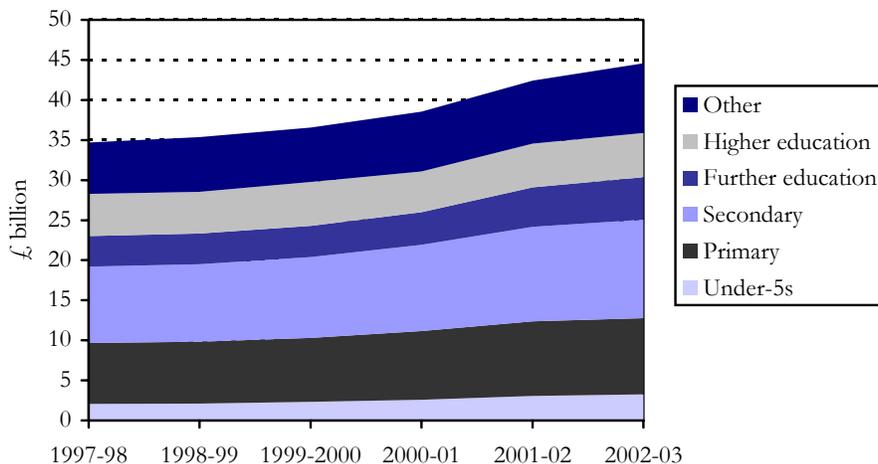
Within education spending, local authorities and devolved administrations are responsible for a sizeable share of school expenditure. Each LA receives a grant from central government, based on the Standard Spending Assessment (SSA) calculations, but LAs have discretion as to exactly how much money to spend on different functions. The *2002 Spending Review* expects that LAs will continue to deliver around 50 per cent of education spending until 2005–06. Local governments' spending lies outside the main resource accounting and budgeting totals and is not predicted by function beyond the current year.

Figure 4.8 shows a breakdown by function of education expenditure *for England only* by central and local government for the period from April 1997 to March 2003. This is taken from the most recent Annual Report of the Department for Education and Skills (DfES).

Overall, spending on primary and secondary schools accounts for only half of total education spending. The next-largest spending item is higher education, which accounts for between 12 and 15 per cent of education expenditure. Student support for those in higher education comprises about a quarter of 'other' spending each year. Further education accounts for about 11 per cent of the spending total, and expenditure on the

under-5s for 6 to 7 per cent. Figure 4.8 reveals that in England under the current Labour government, annual spending on the under-5s has had the greatest proportional increase. From 1997–98 to 2002–03, it has grown by a total of 59.5 per cent in real terms. The biggest single contributor to the increase in total expenditure has been secondary education, which accounts for £3.8 billion of the £13.7 billion increase in annual education spending between 1997–98 and 2002–03. By contrast, real annual spending on higher education grew by only 5.5 per cent over the same period. The central government plans to continue these large increases in spending on schools and young children. In cash terms, total spending by the DfES on ‘Sure Start’, a programme aimed at pre-school-age children, will increase from £0.6 billion in 2002–03 to £1.5 billion in 2005–06 (a 150 per cent increase); spending on schools from £7.9 billion to £10.0 billion (a 26.6 per cent increase); higher education spending from £6.6 billion to £8.1 billion (a 22.7 per cent increase); and further education spending from £6.7 billion to £8.3 billion (a 23.9 per cent increase).<sup>34</sup> This public spending will be supplemented by that of the LAs.

**Figure 4.8. Education spending by function in real terms (2003–04 prices), for England only, 1997–98 to 2002–03**



Notes: The category ‘Other’ includes capital spending on schools (only resource budget spending is broken down by age group) and student support. The category ‘Further education’ includes adult learning.  
 Source: Department for Education and Skills, *Departmental Report 2003*, Cm. 5902, London, May 2003 (<http://www.dfes.gov.uk/2003deptreport/downloads/index.cfm>).

Table 4.3 shows how the UK’s education spending in 2000 compared with that of five other major economies. The UK spent a higher share of national income on education than Japan, Italy and Germany and a lower share than the USA and France. All of the other five countries spent more per student on primary and secondary education than did the UK. The USA, in particular, spent 80 per cent more per student than the UK did on primary education and almost one-and-a-half times as much as the UK on secondary

<sup>34</sup>Source: Table 3.1 of DfES, *Departmental Report 2003*. Bear in mind that the percentage increases refer to the numbers in cash terms.

education. When the amount spent per student is adjusted to reflect differences in income per capita, the gap between the UK and other countries in primary and secondary education narrows but still remains. The share of national income that the UK spent on higher education was lower than that of the USA, Japan and Germany and higher than that of France and Italy.

**Table 4.3. Spending on education in selected major economies, 2000**

	Education spending, % of GDP	Spending per student, relative to UK			Spending per student per unit of average income, relative to UK		
		Primary	Secondary	All tertiary	Primary	Secondary	All tertiary
Japan	4.7	142	105	113	136	100	108
Italy	4.9	154	120	84	153	120	83
Germany	5.3	108	114	113	103	109	108
<b>UK</b>	<b>5.3</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>
France	6.1	116	127	87	115	127	86
USA	7.0	180	148	211	130	106	152

Notes: Indices for spending per student are taken from figures that were converted into US dollars using purchasing power parities. Italy's figures only include spending on public institutions and the USA's figures only include spending on public and independent private institutions.

Source: OECD, *Education at a Glance*, Paris, 2003.

### *Defence*

Defence spending has declined dramatically, both in real terms and as a share of GDP, since the mid-1980s. Its share of TME fell from about 11 per cent in 1985–86 to 5.9 per cent in 2002–03. The decline began shortly before the end of the Cold War, when the UK's commitment to NATO to increase defence spending by 3 per cent a year ended. The decline appears to have halted, and partly reversed, since the end of the 1990s.

Figures 4.9(a) and 4.9(b) exclude spending on 'non-cash' items such as capital charges, depreciation and changes in provisions. These items account for a large proportion of defence spending, because the Ministry of Defence (MoD) owns a large quantity of fixed assets such as buildings and machinery. For example, in 1998–99 the MoD had a total resource budget of £33.3 billion. Non-cash items made up about £13.6 billion, or 41 per cent, of that resource budget.<sup>35</sup>

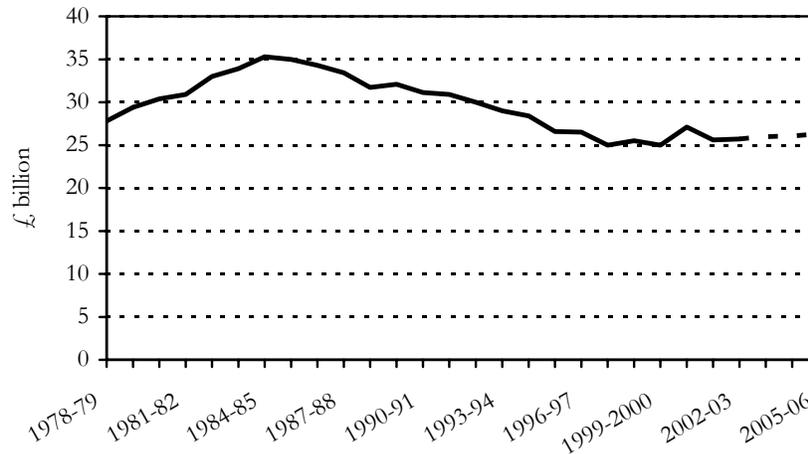
Defence spending is difficult to forecast because the costs of operations and conflict prevention fluctuate significantly from year to year: in 1999–2000 they were £467 million, but in 2002–03 they had risen to £1.6 billion.<sup>36</sup> When the UK fights wars or deploys troops abroad, money sometimes has to be found at short notice. For example, the November 2002 Pre-Budget Report announced the creation of a special contingency reserve of £1 billion 'to meet overseas and defence needs in the fight against

<sup>35</sup>Source: Tables 1.7 and 1.10 of Public Expenditure Statistical Analyses 2003.

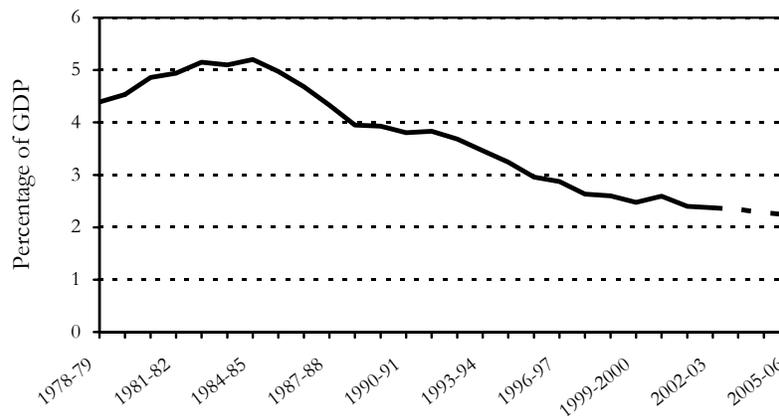
<sup>36</sup>Source: Ministry of Defence, *Ministry of Defence: The Government's Expenditure Plans, 2003–04 to 2005–06*, Cm. 5912, London, May 2003 ([http://www.mod.uk/linked\\_files/publications/gep\\_03\\_04.pdf](http://www.mod.uk/linked_files/publications/gep_03_04.pdf)).

global terrorism'.<sup>37</sup> The subsequent April 2003 Budget increased this reserve to £3 billion 'to cover the full costs of the UK's military obligations in Iraq'.<sup>38</sup> If the UK maintains a sizeable military presence in Iraq, further public spending may be needed. The calculations of both the International Institute for Strategic Studies and the Centre for Defence Economics imply that the ongoing costs of deploying troops could be over £1 billion a year.<sup>39</sup>

**Figure 4.9(a). Historical and forecast defence spending in real terms (2003–04 prices), 1978–79 to 2005–06**



**Figure 4.9(b). Defence spending as a share of national income, 1978–79 to 2005–06**



Note: Sales of married quarters are excluded.

Source: *Public Expenditure Statistical Analyses 2003* and previous PESAs.

<sup>37</sup>Source: Page 3 of HM Treasury, *Pre Budget Report 2002* ([http://www.hm-treasury.gov.uk/Pre\\_Budget\\_Report/prebud\\_pbr02/report/prebud\\_pbr02\\_repindex.cfm](http://www.hm-treasury.gov.uk/Pre_Budget_Report/prebud_pbr02/report/prebud_pbr02_repindex.cfm)).

<sup>38</sup>Source: Page 10 of HM Treasury, *Budget 2003* ([http://www.hm-treasury.gov.uk/budget/bud\\_bud03/bud\\_bud03\\_index.cfm](http://www.hm-treasury.gov.uk/budget/bud_bud03/bud_bud03_index.cfm)).

<sup>39</sup>See 'Public finances fall £3bn deeper into the red', *Daily Telegraph*, 1 October 2003, and K. Hartley, 'The economics of the UK-Iraq conflict', 2003 (<http://www.york.ac.uk/depts/econ/research/documents/iraq.pdf>).

Between April 2003 and March 2006, defence spending is forecast to rise by an average of 0.8 per cent a year in real terms, and to continue to fall as a share of national income, if current projections are met.

### *Transport*

Looking at Figures 4.10(a) and 4.10(b), one can see that transport spending, as measured in the PESAs, increased until 1992–93, albeit with a substantial dip and then recovery in the late 1980s. After 1992–93, it fell dramatically until March 2000, before increasing from April 2000 onwards.

The government published the *Transport Ten Year Plan* in July 2000 and updated it in December 2002.<sup>40</sup> The plan contains public expenditure figures from 1991–92 to 2010–11. These figures are calculated on a different basis from those used in the PESAs. They exclude public expenditure that directly supports private investment and include only spending done by the Department for Transport (DfT), whereas the PESA series includes all public spending on transport, regardless of which government department it came from. However, as Figures 4.10(a) and 4.10(b) show, the trends are similar whichever series one uses. The updated figures from the *Ten Year Plan* show that public spending on transport is predicted to increase gradually in real terms until at least March 2011. As a share of national income, however, it is predicted to reach about 1.2 per cent of GDP in 2003–04 but then to decline. Note that the amounts in the *Ten Year Plan* are not firm government commitments and may be revised in future Spending Reviews.

The government intends to modernise and expand the capacity of Britain's transport infrastructure significantly.<sup>41</sup> This will require considerable investment. The spending figures in the *Ten Year Plan* imply average annualised real increases in public spending of 4.9 per cent from April 2003 to March 2006. Over the same period, the *2002 Spending Review*, which includes other areas that are growing more quickly in its definition of transport spending, suggests that the average annual real increase in public spending on transport will be 8.3 per cent.

Looking beyond the current Spending Review's horizon, the figures contained in the *Ten Year Plan* imply average annual real growth from April 2006 to March 2011 of just 0.7 per cent. Such increases would cause public investment in transport to remain at around 1.0 per cent of national income between April 2003 and March 2011. It is not yet clear whether such modest increases in public spending will suffice to fulfil the government's transport ambitions. If not, the figures for public spending on transport may need to be higher than those set out in the *Ten Year Plan*. One area for which future public spending is particularly uncertain is rail transport: if Network Rail needs to increase the amount it charges train operators for using the tracks in order to maintain the rail infrastructure to

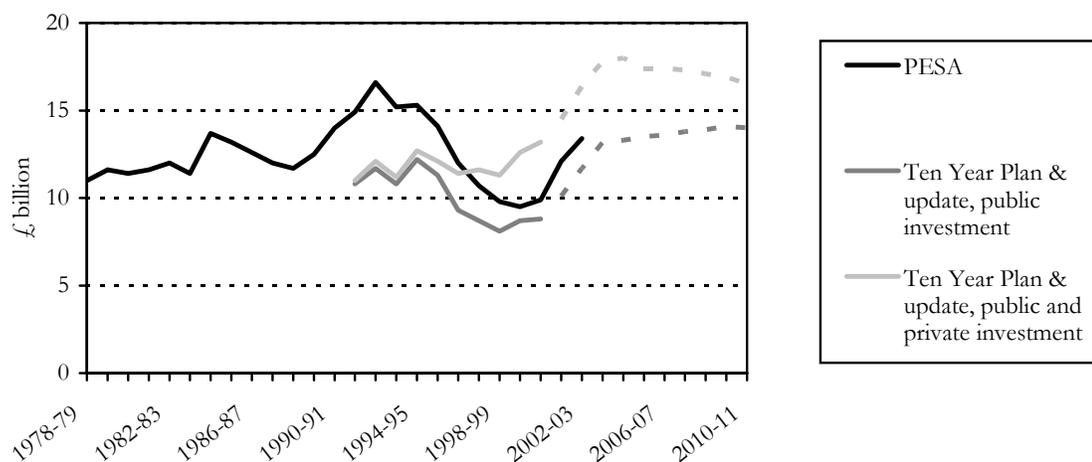
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<sup>40</sup>Department for Transport, *Transport Ten Year Plan 2000*, London, July 2000 ([http://www.dft.gov.uk/stellent/groups/dft\\_transstrat/documents/page/dft\\_transstrat\\_503944.hcsp](http://www.dft.gov.uk/stellent/groups/dft_transstrat/documents/page/dft_transstrat_503944.hcsp)); Department for Transport, *Transport Ten Year Plan 2000: Delivering Better Transport – Progress Report*, London, December 2002 ([http://www.dft.gov.uk/stellent/groups/dft\\_transstrat/documents/page/dft\\_transstrat\\_023008.hcsp](http://www.dft.gov.uk/stellent/groups/dft_transstrat/documents/page/dft_transstrat_023008.hcsp)).

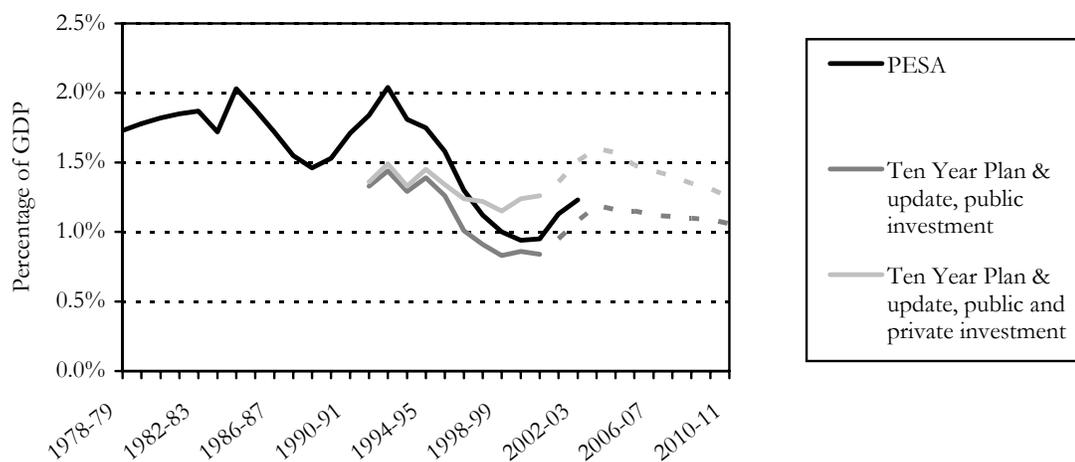
<sup>41</sup>See, for example, the 'Summary' section of the *Transport Ten Year Plan*.

an acceptable standard, the Strategic Rail Authority may require more money from taxpayers to fund its subsidies to the train companies.

**Figure 4.10(a). Historical and forecast transport spending in real terms (2003–04 prices), 1978–79 to 2010–11**



**Figure 4.10(b). Historical and forecast transport spending as a share of national income, 1978–79 to 2010–11**



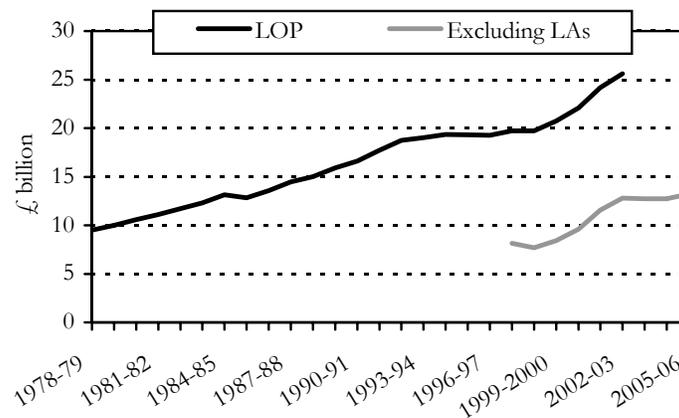
Note: The 'Ten Year Plan & update' series uses figures from the original plan for the period until March 2001, after which the figures are from the update. The figures in the *Ten Year Plan* differ slightly from those in the plan update because the former do not include the public sector grant that was required to fund the private sector investment in the Tube, which was done under a Public Private Partnership (PPP).  
 Sources: *Public Expenditure Statistical Analyses 2003* and previous PESAs; Department for Transport, *Transport Ten Year Plan 2000*, London, July 2000 ([http://www.dft.gov.uk/stellent/groups/dft\\_transstrat/documents/page/dft\\_transstrat\\_503944.hcsp](http://www.dft.gov.uk/stellent/groups/dft_transstrat/documents/page/dft_transstrat_503944.hcsp)); Department for Transport, *Transport Ten Year Plan 2000: Delivering Better Transport – Progress Report*, London, December 2002 ([http://www.dft.gov.uk/stellent/groups/dft\\_transstrat/documents/page/dft\\_transstrat\\_023008.hcsp](http://www.dft.gov.uk/stellent/groups/dft_transstrat/documents/page/dft_transstrat_023008.hcsp)).

The government may be hoping that private investment in transport will compensate for the reduction in public investment's share of national income. It intends a large proportion of total investment to be done by the private sector in the form of Public Private Partnerships (PPPs). PPPs are discussed in more detail in Section 5 of this Briefing Note. The *Ten Year Plan* update predicts that, of the £120.3 billion of investment that it is hoped will take place between 2001–02 and 2010–11, £56.6 billion will come from the private sector. Figures 4.10(a) and 4.10(b) show the effects of including private investment on the *Ten Year Plan's* public spending predictions: transport spending is predicted to peak at 1.6 per cent of national income in 2003–04, but to decline thereafter.

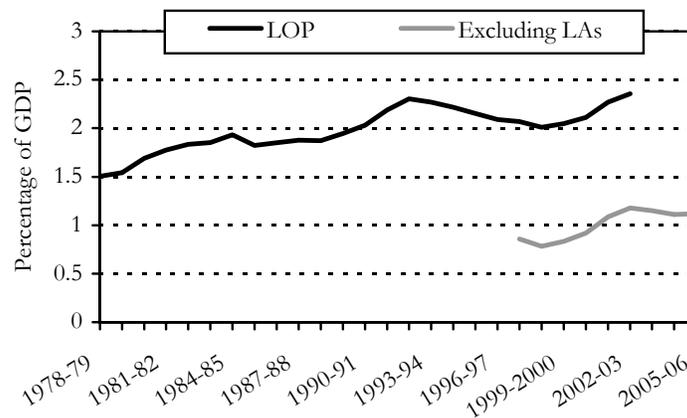
### ***Law, order and protection***

Spending on law, order and protection (LOP) comprised 3.3 per cent of TME in 1978–79 and 5.9 per cent in 2002–03. LOP includes the Criminal Justice System (which

**Figure 4.11(a). Law, order and protection spending in real terms (2003–04 prices), 1978–79 to 2005–06**



**Figure 4.11(b). Law, order and protection spending as a share of national income, 1978–79 to 2005–06**



Source: *Public Expenditure Statistical Analyses 2003* and previous PESAs.

encompasses the police, the Crown Prosecution Service, the criminal courts and the prison and probation services), immigration and citizenship functions, the Fire Service, civil defence, and other constitutional and community services. Local authorities typically carry out over half of total spending on these functions. So Figures 4.11(a) and 4.11(b), like the graphs in the section on social security spending, have a grey line that shows the series on actual and planned spending on LOP *excluding* the LAs' share.

Figure 4.11(a) shows that LOP spending grew steadily in real terms from April 1979 until March 1995, at a real average annual rate of 4.6 per cent. This represents higher growth than in any of the other areas this Briefing Note has examined, including the NHS. After remaining constant in real terms for two years, LOP then grew at an annual average of 4.8 per cent from April 1997 to March 2003. Figure 4.11(b) shows that LOP as a share of national income has fluctuated around an upward trend, from about 1.5 per cent in 1978–79 to almost 2.5 per cent in 2002–03. If LAs' share of LOP spending remains just over a half until 2005–06, the graphs suggest that total spending will increase in real terms at a slower rate than it has done recently, and that as a share of national income it may stabilise and then begin to decline.

## 5. Recent issues in public spending

### *Spending in the countries of the UK and the Barnett formula*

Spending allocations for the various countries of the UK have been determined since 1978 by the 'Barnett formula'. According to the formula, a specified proportion of any increase in England's budget in a given spending area is also given to the rest of the UK.<sup>42</sup> One of the effects of this is that spending levels per capita will eventually converge across the UK. Because the non-English territories in the UK began with higher levels of per capita spending in most of the main spending areas, a budgetary increase that brings up England's spending at a certain real-terms rate will, by the mechanical operation of the formula, bring up spending in the rest of the UK at a lower rate.<sup>43</sup>

According to *Public Expenditure Statistical Analyses 2003*, total 'identifiable' public spending on services<sup>44</sup> was, in 2001–02, £5,012 per capita in England, £5,882 in Wales, £6,246 in Scotland and £6,626 in Northern Ireland. Public spending per capita in 2001–02 for several of the main services is shown in Table 5.1. The disparity in public spending per capita is due to several factors. For example, some public services might require more spending in non-English territories than in England to achieve the same standard of public service because service quality depends on population density, which is higher in England than elsewhere. Emergency healthcare, for instance, is harder to deliver to a widely dispersed rural population than to a metropolitan one. Likewise, low-density areas require more primary and secondary education spending than do high-density ones if

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<sup>42</sup>The formula is now updated annually on the basis of mid-year population estimates.

<sup>43</sup>For more information on the origins and operation of the Barnett formula, see the University of Aberdeen's Centre for Regional Public Finance web site, <http://www.abdn.ac.uk/crpf/> – in particular, <http://www.abdn.ac.uk/crpf/barnettoriginal.pdf> (D. Heald and A. McLeod, 'Public expenditure', paragraphs 530 and 532–6 in *Constitutional Law, 2002, The Laws of Scotland: Stair Memorial Encyclopaedia*, Butterworths, Edinburgh, 2002).

<sup>44</sup>This means spending that could meaningfully be apportioned by country according to which country benefited, as opposed to spending on, for example, a nationwide public good such as defence.

pupils are to live within reasonable distances of a school. Another factor might be differences in underlying conditions such as the health of countries' populations. For example, age-standardised mortality rates in Scotland are higher than those in any region of England.<sup>45</sup> So Scotland might require higher spending per capita on healthcare than England to achieve the same level of health in both countries. Payments in other spending areas, such as social protection, are made on the basis of individuals' incomes and circumstances. Therefore the differences between regions' social protection spending per capita do not necessarily reflect an intentional regional policy.

**Table 5.1. Identifiable public spending per capita on services in the countries of the UK, 2001–02**

	England	Scotland	Wales	Northern Ireland	UK
Social protection	1,809	2,007	2,112	2,204	1,852
Health & personal social services	1,224	1,435	1,355	1,373	1,253
Education	815	986	891	1,048	841
Roads & transport	195	229	177	146	195
Law, order & protection	379	346	368	701	385
Total	5,012	6,246	5,882	6,626	5,207

Note: The 'Total' is not the sum of the itemised components because other components (for example, trade & industry, agriculture and culture, media & sport) are included in it.

Source: Table 8.6b of *Public Expenditure Statistical Analyses 2003* (corrigendum issued on 10 June 2003).

The effect of the Barnett formula on rates of spending growth can be seen with respect to the planned increases in education and NHS spending. Real-terms spending on education and skills will increase between 2002–03 and 2005–06 by an average of 6.0 per cent a year in England and 5.7 per cent in the whole of the UK. With respect to spending on the NHS, between April 2003 and March 2008, spending in England will rise by an annualised real average of 7.4 per cent, while spending in the whole of the UK will rise by a slightly smaller 7.3 per cent.

The Scottish Parliament and Executive and the National Assembly for Wales also have the option of supplementing the funds for education that they are given by the central government. Scotland can increase education spending either by raising the basic rate of income tax or by cutting spending in other areas, whereas Wales can only do the latter.

### ***Public sector investment and the Private Finance Initiative***

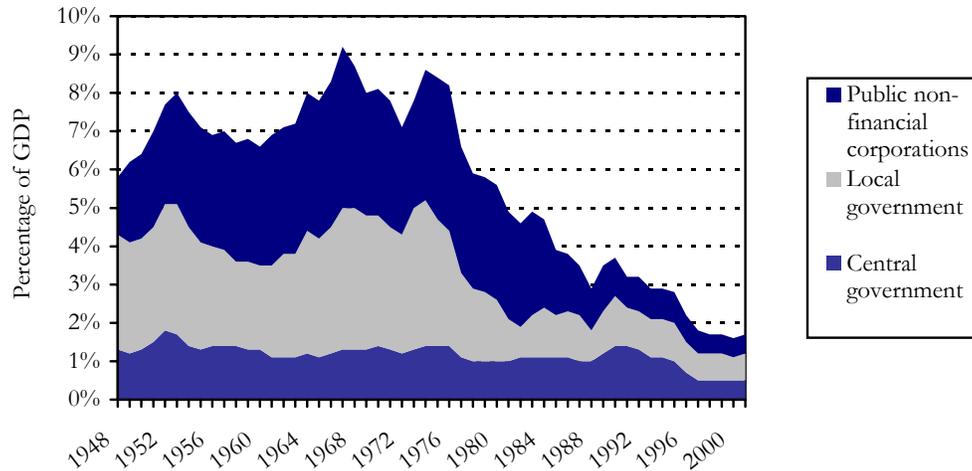
Section 4 mentioned that public sector investment has declined significantly over the past few decades. Figure 5.1 shows the magnitude of this decline. It shows public investment by central government, local government and public non-financial corporations as a share of national income from 1948 onwards.<sup>46</sup> The graph shows that the first 'wave' of decline in public sector investment, in the 1970s, was attributable to the fall in

<sup>45</sup>See table 7.3 of Office for National Statistics, *Regional Trends 36, 2001 edition*, London, 2001 ([http://www.statistics.gov.uk/downloads/theme\\_compedia/regional\\_trends\\_2001/rt36.pdf](http://www.statistics.gov.uk/downloads/theme_compedia/regional_trends_2001/rt36.pdf)).

<sup>46</sup>Investment is measured using the *Blue Book* series of 'gross fixed capital formation', which excludes changes in the levels of inventory.

investment by local authorities. The main cause of this drop in LAs' investment was the transfer of public housing to private ownership and the decline in the building of new council houses. Public corporations were the chief source of the next wave of public investment decline, due to the privatisations of nationalised industries and utilities in the 1980s. The third wave reflects a squeeze in central government investment, which began in 1991 and has only very recently come to an end.

**Figure 5.1. Gross fixed capital formation by the public sector as a share of national income, 1948 to 2001**



Source: Office for National Statistics, *Blue Books*.

The government has argued that this decline in investment has resulted in an accumulation of overdue maintenance work on the public sector's assets. Specifically, the publication *2002 Spending Review Departmental Investment Strategies: A Summary* referred to estimated backlogs in 1997 of 'in excess of £7 billion in schools; over £3 billion for NHS buildings; up to £6.75 billion on local authority roads; and £10 billion on council housing'.<sup>47</sup>

As well as offsetting the depreciation of existing government assets, the government wants to invest in new assets to fulfil its aim of creating 'world-class public services'.<sup>48</sup> To this end, the government intends to increase significantly the level of public sector investment.<sup>49</sup> To do this, it will increase both conventional public sector investment and investment under the Private Finance Initiative (PFI). Figure 5.2 illustrates the relative importance of PFI compared with other public sector investment. The series used in this graph differs slightly from that in Figure 5.1. It is on a financial-year, not a calendar-year, basis and it includes proceeds from the sale of fixed assets, whereas the figures for gross

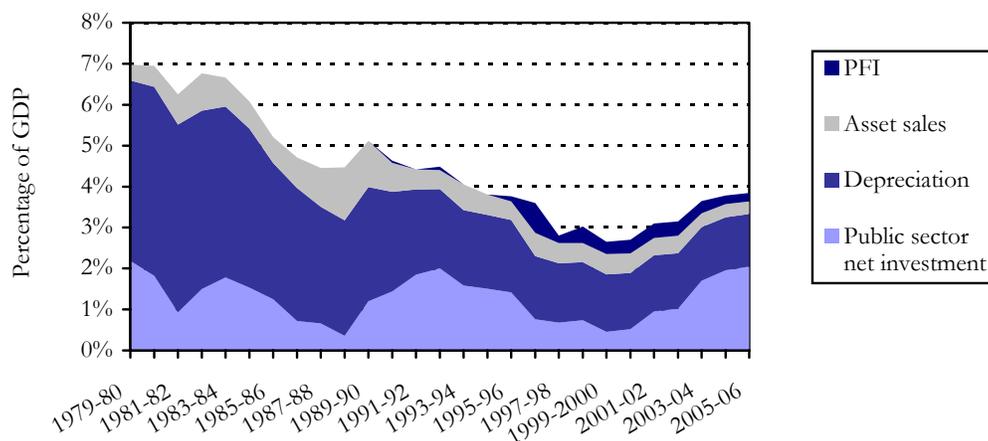
<sup>47</sup>Page 5 of HM Treasury, *2002 Spending Review Departmental Investment Strategies: A Summary*, Cm. 5674, London, December 2002 ([http://www.hm-treasury.gov.uk/media//343A6/dis\\_whitepaper02.pdf](http://www.hm-treasury.gov.uk/media//343A6/dis_whitepaper02.pdf)).

<sup>48</sup>See section 2, 'World-class public services: how investment and reform will improve public services', of Labour Party, *Ambitions for Britain: Labour's manifesto 2001*, London, 2001 (<http://www.labour.org.uk/ENG1.pdf>).

<sup>49</sup>See, for example, paragraph 1.2 of HM Treasury, *PFI: Meeting the Investment Challenge*, London, July 2003 ([http://www.hm-treasury.gov.uk/media//648B2/PFI\\_604a.pdf](http://www.hm-treasury.gov.uk/media//648B2/PFI_604a.pdf)).

fixed capital formation have asset sales deducted. Also, unlike Figure 5.1, it includes planned investment to 2005–06.

**Figure 5.2. The components of gross publicly sponsored investment as a share of national income, 1979–80 to 2005–06**



Source: Data provided by HM Treasury and *Public Finances Databank*.

Figure 5.2 shows that, if the plans are met, public sector net investment will increase between April 1999 and March 2006 from 0.5 per cent of national income to 2.0 per cent. However, in 2002–03, it was still at half the level seen in 1992–93. Likewise, total publicly sponsored investment (i.e. including asset sales, investment to offset depreciation and PFI) is still relatively low. In 2002–03, it was below the levels seen between April 1979 and March 1997.

PFI delivers a larger share of publicly sponsored investment now than it did when it began in the early 1990s. However, its total size is still low: PFI accounted in 2002–03 for 0.4 per cent of national income, relative to total publicly sponsored investment of 3.1 per cent. PFI accounted for 11.1 per cent of public sector investment in 2002–03 and, given the deals signed so far, this share is set to fall to 5.3 per cent by 2005–06. In short, the magnitude of actual and planned PFI investment is insignificant relative to the historical decline in public sector investment since the late 1970s, and it will only make a modest contribution to the planned rise from the investment ‘trough’ of 1999–2000.

On the basis of the deals that have currently been signed, estimated annual payments for services provided under PFI will peak in nominal terms at £6.0 billion in both 2006–07 and 2007–08 and decline to £1.2 billion by 2028–29. Of course, these figures do not represent the final amounts of PFI investment until March 2029 because more deals are expected to be signed by then. Of the estimated £9.8 billion of capital spending under PFI expected to be done in 2003–04, the Department for Transport accounts for £6.6 billion, or 67 per cent. As Table 5.2 shows, 2003–04 is predicted to be a year with an unusually large amount of PFI capital spending. This is largely because it includes the capital expenditure done under the London Underground Limited Public Private Partnerships (LUL PPP) contracts. The LUL PPP investment makes up a large part of

the £12.4 billion worth of deals at the preferred bidder stage (the final stage before financial details are finalised and contracts signed).

**Table 5.2. Projection of estimated capital spending by the public sector under both conventional finance and the Private Finance Initiative, by year and status of the contract**

	2003–04	2004–05	2005–06
Total signed deals (£bn)	9.8	3.7	3.2
Total at preferred bidder stage (£bn)	12.4	1.7	0.2
Total PFI investment (£bn)	22.3	5.4	3.5
Public sector gross investment (£bn)	33.4	38.2	41.3
Total publicly sponsored gross investment (£bn)	55.7	43.6	44.8
PFI investment as a percentage of total publicly sponsored gross investment	40.0	12.4	7.7

Note: The 2003–04 figures include the estimated capital value of all LUL PPP contracts, both the signed and the unsigned.

Source: Tables C16, C18 and C19 of *Budget 2003*.

For a discussion of the arguments for and against using the private sector to finance and manage public sector investment in addition to just building the fixed assets, see section 3.2 of the 2002 IFS Green Budget.<sup>50</sup> For a discussion of the effects of PFI upon the government's ability to comply with the fiscal rules, see section 2.1 of the 2003 IFS Green Budget.<sup>51</sup>

### ***Departments' underspending under the new budgetary regime***

The extent to which some government departments have in recent years left part of their budgets unspent has become a controversial issue. As this Briefing Note mentioned earlier, government departments no longer have to forgo any money that they fail to spend and can, instead, accrue an 'end-year flexibility' (EYF) entitlement to all of their unspent DELs. Departments appear to have taken advantage of this new ability. It is estimated that their combined cumulative underspend at the end of 2002–03 is £9.4 billion.<sup>52</sup> This equals 3.7 per cent of total DEL for 2003–04, or 2.1 per cent of TME.<sup>53</sup> The Department for Education and Skills (DfES) has the largest cumulative EYF entitlement in 2003–04, of some £1.7 billion in resource spending and £0.1 billion in capital spending, followed by the Department for Work and Pensions (DWP) with about £1.4 billion and £0.1 billion respectively. The 'top five' cumulative underspenders are shown in Table 5.3.

<sup>50</sup>A. Dilnot, C. Emmerson and H. Simpson, *The IFS Green Budget: January 2002*, Commentary 87, IFS, London, January 2002.

<sup>51</sup>R. Chote, C. Emmerson and H. Simpson, *The IFS Green Budget: January 2003*, Commentary 92, IFS, London, January 2003.

<sup>52</sup>Source: Table 6 of HM Treasury, *Public Expenditure 2002–03 Provisional Outturn*, Cm. 5884, London, July 2003 (<http://www.hm-treasury.gov.uk/media//D0689/PEOWP2002-03.pdf>).

<sup>53</sup>Percentage of DEL is calculated using DEL figure from table B4 of *2002 Spending Review*, which is on a 'stage 1' RAB basis, i.e. excluding certain non-cash costs. Percentage of TME is calculated using TME figure from table C11 of *Budget 2003*.

**Table 5.3. Cumulative underspending by the five departments with the largest EYF ‘carry-forward’ to 2003–04**

	Cumulative DEL underspending (£bn)			Total planned DEL 2003–04 (£bn)	Underspend as a % of 2003–04 DEL
	Resource	Capital	Total		
DfES	1.7	0.1	1.8	25.6	7.2
DWP	1.4	0.1	1.5	7.5	19.5
DTI	0.6	0.5	1.1	4.9	23.2
ODPM	0.4	0.6	1.0	6.2	16.2
Scotland	0.6	0.3	0.9	19.2	4.6
Other departments	2.1	0.9	3.0	189.5	1.6
<b>Total departments</b>	<b>6.8</b>	<b>2.5</b>	<b>9.4</b>	<b>252.9</b>	<b>3.7</b>

Note: ODPM’s underspending is the sum of underspending on its main programmes and underspending on its local government functions.

Source: Underspending figures taken from table 6 of *Public Expenditure 2002–03 Provisional Outturn* and planned DELs taken from table B4 of *2002 Spending Review*. Both the underspending and the planned DEL figures are on a ‘stage 1’ RAB basis, i.e. excluding certain non-cash costs.

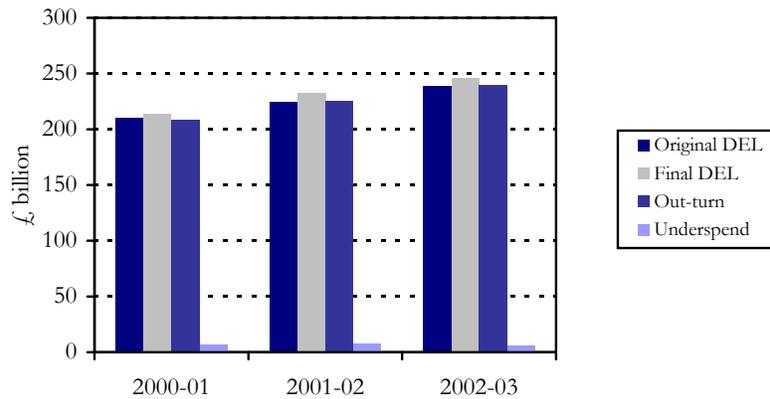
Table 5.3 shows that, while the absolute sums of money that departments have accumulated as EYF entitlements are small compared with overall public spending, they are substantial when considered as a percentage of individual departments’ DELs. The Department of Trade and Industry (DTI), for example, has accumulated an underspend that amounts to just under a quarter of its 2003–04 DEL. An underspend of this magnitude could influence the amount of public money that the DTI is allocated in the 2004 Spending Review. Given that the government has other spending priorities and commitments (more on which below) and the fact that the DTI now has a large ‘pile of cash’ that it could, in theory, spend at any time, the Treasury might suggest that the DTI does not need DELs as large as those that it has received in recent years and cut the DELs for 2005–08 accordingly. However, such an action would restore the incentive for departments to rush spending for fear of losing future allocations.

Has the extent of underspending become larger or smaller in the past few years? On the one hand, it is estimated that only one department – the MoD – breached its final DEL limit in 2002–03.<sup>54</sup> All of the other departments underspent. On the other hand, the scale of underspending was, for most departments, relatively minor. The provisional out-turn for DEL in 2002–03 was only 2.4 per cent, or £5.8 billion, below the final limit of £238.9 billion. Figure 5.3, which shows underspend as a share of final DELs for 2000–01 to 2002–03, suggests that annual underspend has been declining as a share of DEL. Also, spending is now, if anything, growing faster than the government’s plans allow. The Treasury’s publication of *Public Sector Finances October 2003* reveals that central government current spending in the first seven months of 2003–04 is 9.2 per cent higher than it was during the same period of last year. *Budget 2003*’s forecast for 2003–04 implies an increase of 7.0 per cent for the year as a whole. Similarly, public sector net investment

<sup>54</sup>Final DEL’ differs from ‘original DEL’ because it includes changes made during the course of the year, such as transfers of functions between departments and the addition of EYF entitlements that departments decide they may want to draw down during the course of the financial year.

is outstripping its predicted rate of growth.<sup>55</sup> If this trend continues, one possibility is that departments will have spent some of the accumulated underspends from previous years. Indeed, the recent Winter Supplementary Estimates for 2003–04 indicate that departments have requested an extra £6.6 billion of resource spending, of which £2.5 billion comes from EYF entitlements.<sup>56</sup> The Department for Work and Pensions, the Department of Trade and Industry and the Office of the Deputy Prime Minister – all of which have accumulated particularly large underspends – are requesting that they be allowed to draw down EYF entitlements.

**Figure 5.3. Total underspend relative to final DEL in real terms (2003–04 prices), 2000–01 to 2002–03**



Source: Public Expenditure Provisional Outturn White Papers.

### *The government's policy commitments*

The Labour government has stated several major aims and commitments in previous publications and speeches regarding public services. These commitments may constrain the amount and allocation of public spending in future years. The biggest such commitments are:

- to deliver 'world-class' public services;<sup>57</sup>

<sup>55</sup>For more details, see IFS Public Finances Bulletin, 20 November 2003 (<http://www.ifs.org.uk/press/pubfinnov03.pdf>).

<sup>56</sup>See HM Treasury, *Central Government Supply Estimates 2003–04: Winter Supplementary Estimates*, HC 15, London, November 2003 ([http://www.hm-treasury.gov.uk/media//E74A9/winter\\_supp03\\_932.pdf](http://www.hm-treasury.gov.uk/media//E74A9/winter_supp03_932.pdf)).

<sup>57</sup>See section 2, 'World-class public services: how investment and reform will improve public services', of Labour Party, *Ambitions for Britain: Labour's manifesto 2001*, London, 2001 (<http://www.labour.org.uk/ENG1.pdf>).

- to eliminate child poverty within a generation and halve it by 2010;<sup>58</sup>
- to end pensioner poverty;<sup>59</sup>
- to increase towards 50 per cent the proportion of people aged 18 to 30 who participate in higher education by the end of the decade.<sup>60</sup>

All of the above aims will place upward pressure on public spending. With regard to the NHS, if the government wants to continue to adhere to the recommendations of the Wanless Review, it will have to continue to increase spending on the NHS in real terms beyond March 2008. Transport, another key public service, will require real spending increases until at least March 2011, according to the *Ten Year Plan*. It is also unclear whether or not the increases in transport spending in the *Ten Year Plan* will suffice to deliver a ‘world-class’ transport system.

To eliminate child poverty, the government has a variety of policy options. If it were to eliminate child poverty solely by spending more on its existing range of tax credits and benefits, this will have considerable costs. In IFS Briefing Note 41, Brewer estimated that spending a further £1 billion on the child tax credit might reduce the number of children in poverty to 3.1 million by 2004–05, in line with the government’s target.<sup>61</sup> An alternative would be to increase the number of parents in employment, which would raise parental incomes.

In IFS Commentary 93, Goodman, Myck and Shephard analysed the extent and depth of pensioner poverty and the effect that the government’s reforms are likely to have. They found that all of the policies from 1997 to 2004 that were directed at pensioners’ welfare increased pensioner incomes by a total of £7 billion a year. However, because pensioner poverty is defined in relative terms and the median income across the whole population has risen, the number of pensioners in poverty has only fallen by about a fifth between 1996–97 and 2001–02.<sup>62</sup> This suggests that eradicating pensioner poverty will require still more public spending. Furthermore, because pensioners are generally retired, employment growth would not reduce pensioner poverty. Indeed, to the extent that raising employment increases the average income among non-pensioners, such an increase would make the problem of pensioner poverty worse, since it is measured in relative terms.

With respect to the aim of increasing participation in higher education, in IFS Commentary 94, Goodman and Kaplan considered how much extra public money this

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<sup>58</sup>See Department for Work and Pensions, *Public Service Agreement for the Department of Work and Pensions* ([http://www.dss.gov.uk/publications/dss/2001/dwp\\_psa/psa.pdf](http://www.dss.gov.uk/publications/dss/2001/dwp_psa/psa.pdf)).

<sup>59</sup>See Gordon Brown’s speech to the Labour Party conference, 30 September 2002.

<sup>60</sup>See chapter 5 of Department for Education and Skills, *The Future of Higher Education*, Cm. 5735, London, January 2003 (<http://www.dfes.gov.uk/highereducation/hestrategy/pdfs/DFES-HigherEducation.pdf>).

<sup>61</sup>Source: M. Brewer, *What Do the Child Poverty Targets Mean for the Child Tax Credit? An Update*, IFS Briefing Note 41, London, November 2003 (<http://www.ifs.org.uk/inequality/bn41.pdf>).

<sup>62</sup>Page 1 of A. Goodman, M. Myck and A. Shephard, *Sharing in the Nation’s Prosperity? Pensioner Poverty in Britain*, Commentary 93, IFS, London, March 2003 (<http://www.ifs.org.uk/inequality/comm93.pdf>).

would require if the proposals outlined in the government's recent White Paper<sup>63</sup> were to come into effect. They found that, taking into account both the financing changes and the increase in student numbers, the total cost would be about £3.2 billion a year, of which £1.4 billion would be met by students' fees and £1.8 billion would come from public spending. The total cost of expanding participation in higher education to 50 per cent of young people while maintaining funding per student at its current level – i.e. without taking account of the White Paper's proposals to increase the level of funding per student – would be £1.1 billion. This cost would be shared between students and taxpayers. This number is based on the number of 'full-time equivalent' students in higher education in England in 2003–04. An increase in the population of 18- to 30-year-olds would increase the number of extra students required to hit the 50 per cent participation target, which would increase costs further.<sup>64</sup>

## 6. Conclusions

Public spending, measured as total managed expenditure, accounts in 2003–04 for about 41.1 per cent of national income. In 1999–2000, it accounted for only 37.4 per cent, the lowest share since the early 1960s. The largest component of public spending is social security. Spending on social security benefits has more than doubled in real terms between 1978–79 and 2002–03, and now accounts for just under a third of TME. It has fluctuated as a share of national income because of the link between spending on benefits and the state of the economy, but the overall trend has been one of substantial increases. The current Labour government's recent commitments to reduce child and pensioner poverty indicate that further increases in parts of the social security budget are likely. The NHS, too, has experienced significant increases in spending, both in real terms and as a share of TME and national income, despite fluctuations in the rate of spending growth from one year to the next. If the government's spending plans are adhered to until 2007–08, the amount spent on the NHS in real terms will be nearly 10 times greater than that spent in 1949–50. As a share of national income, NHS expenditure is forecast to be 7.7 per cent in 2007–08, compared with 3.5 per cent in 1949–50.

Spending on other main public services (education, transport, and law, order & protection) has been increasing but the rise has been less dramatic over the past 25 years. Spending on education declined gradually as a share of national income from 1978–79 until 1999–2000 and has only recently begun to recover. Public spending on transport halved as a share of national income over an even shorter period: it was 2.0 per cent in 1992–93 and 0.9 per cent in 1999–2000. By 2002–03, it had increased to 1.2 per cent. Public spending on law, order & protection rose steadily in real terms between 1978–79 and 2002–03 but declined as a share of national income between 1992–93 and 1998–99. Growth in public spending on law, order & protection is likely to be modest over the next three years. Defence spending fell as a share of national income by over a half, from

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<sup>63</sup>Department for Education and Skills, *The Future of Higher Education*.

<sup>64</sup>All figures in this paragraph are taken from pages 41 and 42 of A. Goodman and G. Kaplan, 'Study Now, Pay Later' or 'HE for Free'? An Assessment of Alternative Proposals for Higher Education Finance, Commentary 94, IFS, London, June 2003 (<http://www.ifs.org.uk/education/comm94.pdf>).

over 5 per cent in the mid-1980s to about 2.4 per cent in 2002–03. The planned real-terms increases in defence spending between 2003–04 and 2005–06 will lead to a continued fall in defence spending as a share of national income.

The government's new framework for planning public spending has been in operation since June 1998. Now might be an appropriate time to consider making revisions to the framework, in light of issues such as large departmental underspending, the inclusion of all of social security benefit expenditure in annually managed expenditure and the difficulty of planning defence spending on a three-year basis.

The current government's aspirations with regard to the quality and usage of public services indicate that public spending on two of the main pillars of the 'welfare state' – education and health – will grow at a rate that outpaces the growth in national income over the remainder of the current planning period and quite possibly beyond that. Similarly, the government's ambitions to reduce poverty among certain large segments of the population (families with children and pensioners) suggest that the third pillar – social security spending – may also have to increase its share of national income. Substantial reductions elsewhere seem difficult, given the government's broader commitments in areas such as transport, law & order and defence. Overall, the planned public spending increases presage a period in which the proportion of national income that is spent by the government increases. The latest public finance statistics estimate that total managed expenditure's share of national income has risen from 37.4 per cent in 1999–2000 to 39.7 per cent in 2002–03 and will rise further to 42.0 per cent in 2007–08.

The government will once again have to confront tough choices in the Spring 2004 Budget and the subsequent Summer 2004 Spending Review. To what extent should the UK increase its levels of public spending, and therefore taxation? How much money needs to be made available for spending on areas of lower priority? These issues are particularly pressing at present, given the emphasis that the government places on improving public services and the fact that its fiscal rules currently constrain the amount of spending that can be undertaken without further explicit increases in taxation.

## Appendix A. Historical series of government expenditure

**Table A.1. Public sector expenditure,  
in £ billion and as a percentage of GDP, 1970–71 to 2007–08**

Year	Public sector current expenditure		Public sector net investment		Total managed expenditure	
	£bn	% of GDP	£bn	% of GDP	£bn	% of GDP
1970–71	17.3	32.6	3.2	6.1	22.6	42.7
1971–72	19.7	33.3	3.1	5.3	25.1	42.5
1972–73	22.2	33.1	3.2	4.8	28.1	41.8
1973–74	26.2	35.0	3.9	5.2	33.2	44.4
1974–75	34.6	38.8	4.9	5.5	43.6	48.8
1975–76	44.3	39.9	6.1	5.5	55.5	49.9
1976–77	51.8	39.9	5.6	4.3	63.3	48.8
1977–78	58.0	38.4	4.3	2.9	69.1	45.8
1978–79	66.3	38.4	4.2	2.4	78.2	45.2
1979–80	79.4	38.2	4.5	2.2	93.1	44.8
1980–81	96.6	40.8	4.3	1.8	111.8	47.3
1981–82	110.6	42.6	2.4	0.9	124.9	48.1
1982–83	120.9	42.7	4.2	1.5	137.5	48.5
1983–84	130.4	42.3	5.5	1.8	148.7	48.3
1984–85	141.0	42.6	5.1	1.5	158.9	48.1
1985–86	148.7	41.0	4.5	1.2	165.3	45.5
1986–87	155.8	40.1	2.8	0.7	171.2	44.1
1987–88	166.4	38.6	2.8	0.7	181.5	42.1
1988–89	173.7	36.2	1.7	0.4	189.0	39.4
1989–90	187.4	35.7	6.3	1.2	208.4	39.7
1990–91	203.3	36.1	8.2	1.4	225.3	40.0
1991–92	228.6	38.4	11.0	1.8	251.9	42.3
1992–93	247.8	40.3	12.4	2.0	272.1	44.2
1993–94	262.3	40.1	10.4	1.6	284.6	43.6
1994–95	275.2	39.8	10.4	1.5	298.1	43.2
1995–96	287.2	39.4	10.3	1.4	310.5	42.6
1996–97	297.8	38.5	5.9	0.8	315.6	40.8
1997–98	305.2	37.1	5.6	0.7	322.7	39.2
1998–99	313.9	36.1	6.4	0.7	332.7	38.3
1999–2000	326.6	35.5	4.1	0.5	343.6	37.4
2000–01	348.9	36.2	5.0	0.5	367.1	38.1
2001–02	367.4	36.5	9.5	0.9	390.7	38.8
2002–03	394.0	37.3	10.7	1.0	419.1	39.7
<i>HM Treasury forecasts</i>						
2003–04	422	38.1	19	1.7	456	41.1
2004–05	447	38.1	23	2.0	485	41.3
2005–06	475	38.4	25	2.1	517	41.7
2006–07	500	38.4	27	2.1	544	41.8
2007–08	524	38.5	31	2.2	573	42.0

Source: HM Treasury, *Public Finances Databank*, London, October 2003 ([www.hm-treasury.gov.uk/Economic\\_Data\\_and\\_Tools/data\\_index.cfm](http://www.hm-treasury.gov.uk/Economic_Data_and_Tools/data_index.cfm)).

Main findings Austerity has flipped public attitudes to tax and spending Our survey finds that eight years of austerity has seen a turnaround in attitudes to tax and spending. As austerity began in 2010, more than half of the public backed spending cuts to restore the public finances. Citizen views differ significantly across the UK's four countries Recent years have seen an acceleration in the public policy differences between the devolved administrations, and our survey finds that citizen attitudes also differ. For example, people in Scotland are more likely to believe that taxes should be higher to pay for more public services, people in Northern Ireland are less likely say they have felt the effects of austerity and people in Wales are the most likely to say that public services listen to their needs.