Sustainable public spending

Dominic Webb

Spending cuts will not be evenly shared across the public sector

With the budget deficit at a historically high level, the outlook for public spending will be extremely tight for several years. One of the early tasks for the new government will be a spending review, detailing public expenditure plans for the next few years and, in particular, where cuts in spending will occur.

The public finances are currently in an unsustainable state. Borrowing is forecast to be over 11% of GDP this year. Almost a quarter of public spending in 2010/11 will be financed through borrowing. This is a greater proportion than will be financed through any single tax: income tax is forecast to raise £146 billion in 2010/11 compared with borrowing of £163 billion.

Borrowing on this scale increases the national debt and means higher debt interest payments in the future. It may also lead to higher interest rates across the economy as a whole, although to date the interest rate on government borrowing has remained relatively low.

The tough outlook for public spending stands in marked contrast to recent years. Since 1997, public spending has grown much faster than the economy as a whole. It is forecast to reach 48.1% of GDP this year, compared with 36.3% in 1999/00.

Total public spending is projected to be over £700 billion this year. The largest areas of spending are social protection (which includes benefit payments), health and education.

HARD TO CUT

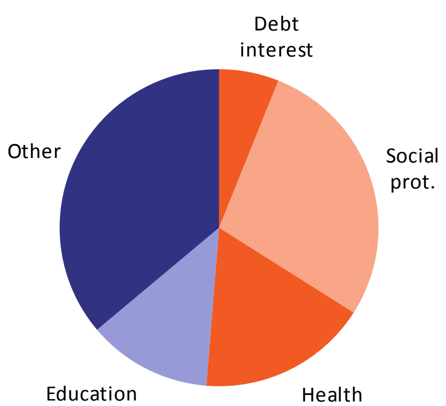
Some types of public spending are hard to cut in the short term, such as social security payments and debt interest payments. These two categories account for nearly £240 billion – around one-third – of public spending. Spending on these 'non-discretionary' areas will tend to rise as a proportion of the total as other spending is cut.

MANIFESTO COMMITMENTS

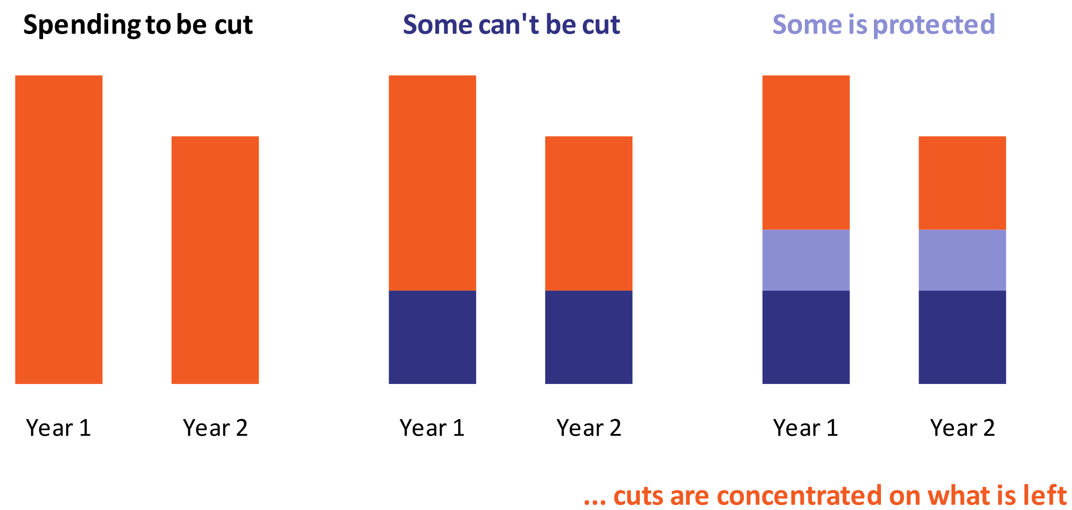
Within the remaining two-thirds of spending, commitments have been made to protect certain large budgets. For example, the Conservative manifesto pledged that spending on health would increase every year in real terms. Labour committed itself to protect spending on frontline schools and the NHS. The combined budgets of the Department of Health and Department for Children, Schools and Families come to around £165 billion – nearly a quarter of total public spending.

Debt interest, social protection and health make up more than half of Government spending

Planned total managed expenditure by function, 2010/11



Diagrammatic representation of public spending problems



WHAT'S LEFT

Commitments to protect certain budgets, combined with other areas of expenditure which are hard to reduce in the short term, mean that cuts will have to be focused on relatively limited areas of public spending. The result is that cuts in these areas will be much deeper than if reductions had been spread more evenly across all areas of public spending.

Based on plans set out in the 2010 Budget, the Institute for Fiscal Studies has estimated that 'unprotected' areas of spending could fall by between 20 and 25% by 2014/15. Will the spectre of such cuts result in pressure to reconsider spending on protected areas, tax increases or the speed of deficit reduction? What is certain is that the incoming Chief Secretary to the Treasury will face a much tougher task in the next spending review than his recent predecessors.

PUBLIC SECTOR PAY

One potential source of savings is the public sector pay bill.

In 2008/09, total public sector pay was around £160 billion. A public sector pay freeze would save around £6 billion a year in wages compared with the case in which a 4% pay rise was awarded.

It is probable, however, that the saving to the Treasury would be lower once the impact on tax revenue and means-tested benefits is taken into account.