



Tough choices

The 2004
Spending
Review

Peter Robinson

Tough choices: The 2004 Spending Review



Institute for Public Policy Research
30-32 Southampton Street
London WC2E 7RA
Tel: 020 7470 6100
Fax: 020 7470 6111
www.ippr.org
Registered Charity No. 800065

The Institute for Public Policy Research (ippr) is the UK's leading progressive think tank and was established in 1988. Its role is to bridge the political divide between the social democratic and liberal traditions, the intellectual divide between academia and the policy making establishment and the cultural divide between government and civil society. It is first and foremost a research institute, aiming to provide innovative and credible policy solutions. Its work, the questions its research poses and the methods it uses are driven by the belief that the journey to a good society is one that places social justice, democratic participation and economic and environmental sustainability at its core.

Report design by Rory Fisher

ippr 2004

Tough choices: The 2004 Spending Review



About the author

Peter Robinson has been Senior Economist at the Institute for Public Policy Research since October 1997. He leads the IPPR teams dealing with economic, employment and industrial policy and public service reform including health and education and the funding of public services. He was a co-author of the final report resulting from the IPPR's Commission on Public Private Partnerships. He is also a Research Associate at the Centre for Economic Performance at the London School of Economics and teaches in the Social Policy Department at the LSE



Executive Summary	1
Introduction	5
The public finances 1997-2007: an overview	9
Labour's spending reviews, 1998-2004	21
The Public Service Agreement Targets	29
The 2004 spending review: slicing the pie	36
Conclusions: The dilemmas of the 2004 review	54
References	56



Executive Summary

The context for the 2004 spending review

The 2004 spending review in July will effectively set the priorities for policy and for public spending for the next Parliament. This makes the 2004 review at least as important as the contents of Labour's future election manifesto and far more important than the 2004 Budget.

The pamphlet reviews the tough choices the government will have to make in the review. Giving certain policies priority will inevitably mean de-emphasising others and in the context of relatively tight constraints on overall spending, the relative losers in the 2004 review will be all too apparent.

It is important to emphasise that these tough choices will have to be faced regardless of how the economy or the public finances are expected to evolve over the next few years. Even if things work out as the Treasury hopes, the 2004 review will still have to address difficult trade-offs.

The debate over whether the government is likely to meet its two key rules of thumb for fiscal policy will reach its head in 2006 at the time of the next spending review and after the likely date of the next general election. This debate has little relevance for the 2004 review.

For the period covered by the 2004 spending review any further significant increases in public spending will have to be paid for by significant increases in taxation. If significant increases in taxation are ruled out – which is almost certainly the case ahead of the general election likely in 2005 – then so are further significant increases in public spending.

Taxation and user charges, both paid for by individuals, are the only two options for funding public services – there is no third way. It is not clear that user charges are more acceptable to individuals than taxation. User charges in areas such as transport will make no significant contribution during the period covered by the 2004 spending review, though they should make a bigger contribution over the long run.

The Gershon review on 'efficiency' savings is being used to avoid the issue of setting spending priorities. Its recommendations would involve significant changes in public policy and require primary legislation and would appear to cut across some key themes of the public service reform agenda. The Gershon



Executive summary

review focuses on inputs and processes and not the outputs and outcomes of public services.

The key parameters for the 2004 spending review

Over the three year period covered by the 2002 spending review, that is up to 2005-06, spending is planned to grow at the relatively fast pace of 4.8 per cent a year in real terms. However, over the two-year period that is effectively covered by the 2004 review, that is 2006-07 and 2007-08, the growth in spending will slow to 2.7 per cent a year, a decline of about three-fifths.

From 1999-00 to 2005-06 public spending will have risen by four-and-a-half percentage points of GDP, from 37.4% to 41.9%. Over the period covered by the 2004 spending review, public expenditure will be held roughly constant as a proportion of GDP.

There are two known parameters for the 2004 spending review:

- total spending in 2007-08 is planned to be 42.1% of GDP (unless this total is altered significantly in the 2004 Budget), little changed from 41.9% in 2005-06
- health spending is planned to be 7.9% of GDP, up from the 7.2% in 2005-06.

Given that spending on items such as debt interest will remain roughly constant as a proportion of GDP, it is a matter of simple arithmetic that the resources available for all the public services other than health will fall modestly from 31.1% of GDP to 30.6% of GDP. If this sounds modest, it needs to be seen in the context of the trends from 1999-00 to 2005-06, when spending on all the public services other than health rose from 27.4% of GDP to 31.1%.

In effect the spending review process is about dividing up a given spending pot that has been decided by the Treasury. Literally we are slicing up the pie baked by the Chancellor. The 2004 spending review is all about slicing the remaining pie up once health has taken its cut.

The spending review process has two halves. Along with carving up spending, it sets the Public Service Agreement (PSA) targets for the delivery of key policy objectives agreed between the Treasury and the spending departments.

After the 2002 spending review the government found itself with 130 PSA targets. It cannot, however, have 130 priorities. The 2004 review is likely to see a further reduction in the number of targets. However, more importantly



Executive summary

the government will need to be clearer about which of those targets it gives priority to, so that it can allocate resources accordingly.

There may be a possible conflict between the objectives the government feels it has to give priority to in order to maintain public support and win elections and the objectives it would really want to secure in order to advance its core goal of achieving social justice.

The conclusions of the 2004 spending review

There are few public services where spending as a proportion of GDP can be cut without that impacting on the services offered and the outcomes achieved.

It is clear that making room for the rising share of **health** spending must involve making unpalatable choices in one or more of the other core areas of spending.

Only for the **economic services** is it feasible to think that spending in all likelihood could decline as a proportion of GDP as some programmes of industrial and agricultural support are reduced or even eliminated. However, it is hard to say how much this would save as a proportion of GDP and some powerful lobbies would be offended.

Defence spending might be frozen in real terms, which would mean that it would fall by one-tenth of one percentage point of GDP over the period covered by the review. However, there should be pressure for the **development** budget to rise as a proportion of national income. And over the long-term freezing the defence budget must force policy makers to face up to reality of whether Britain can continue to 'punch above its weight' in the international arena by having such capable armed forces.

The only other likely options for a declining share of the public spending pot are **transport** or **housing**, for the simple reason that cutting these budgets has been so easy in the past. However, a renewed bust in transport spending would carry with it a large political price and make it more difficult to achieve an ambitious agenda in relation to congestion charging over the medium and long term. For these reasons it should be avoided, though this is not good news for housing. Elsewhere in the **environmental services**, the pressures for spending seem unlikely to abate.

In the **personal social services**, the government's ambitions for some key services allied to the historic trend for expenditure in this area to rise to meet identified needs implies spending may continue to increase as a proportion of



Executive summary

GDP. If the government wants to make further progress in reducing poverty and in the absence of rapid progress in tackling economic inactivity, the **social protection** budget may also need to rise as a proportion of GDP.

The logic of all these arguments leads to the conclusion that the **education** budget should *not* rise significantly if at all as a proportion of GDP over the period of the next spending review, if the government wishes to meet other pressing priorities. Politically, this is likely to prove very hard for the government to sell, especially as the Conservative Opposition has signalled that spending on schools will be one of its priorities.

It is likely that the share of **law, order and the protective services** will be maintained, though as with education this implies a significant deceleration in the rate of growth of real spending compared with the first half of this decade. This will also be hard to present to a public that does not believe that crime has fallen.

The government must face up to some tough choices in relation to industrial and agricultural support, defence and housing and lowered expectations in education and law and order. If we think in terms of the targets for key policy outcomes rather than just spending totals, the government will have to reconcile meeting those targets necessary to retain electoral support and those targets that might write this government's place in the history books. The stakes could not be higher.



“Being in power is tough. It involves tough choices;”
(Tony Blair, 2003)

Introduction

The importance of the 2004 Spending Review

All governments have tough choices to make in determining which programmes and policies they are going to give priority to and committing the resources to match those priorities. For Labour governments the dilemma is always particularly acute because they tend to have greater ambitions for what public policy might be able to achieve, but matched with a desire to show that they can efficiently manage the public finances. In this sense the current government is not that different from any previous Labour administration.

Labour since 1997 has, however, institutionalised the process of setting priorities for spending and for the targets in relation to outputs and outcomes that those resources are geared towards achieving, through the spending reviews. These have taken place every two years since 1998, so the 2004 review will be the fourth. It will also in many ways be the most important to date. The 2004 review will cover the period from 2005-06 to 2007-08. With a general election likely to take place in 2005 or at the latest 2006, this review will effectively set the priorities for policy and for public spending for the next Parliament. In many ways this makes the 2004 review at least as important as the contents of Labour’s future election manifesto. There are very few public policies that do not have implications for resources and with the spending review also setting key targets for public policy, it would be difficult for a manifesto to signal major commitments that had not already been taken into account in the spending review.

The aim of this pamphlet is to review the tough choices that the government will have to make in the 2004 review. The fact that policy makers talk endlessly about the need to make tough choices and to set priorities does not mean that they are very good at it. Faced with competing claims on resources, real problems in deciding where to deploy extra resources to maximum effect and massive lobbying from both within and without government, one could have some sympathy for politicians trying to strike the right balance. As this pamphlet will show, this time around the government is going to have to take decisions that will profoundly disappoint some people. Giving certain policies priority inevitably means de-emphasising others and in the context of relatively tight constraints on overall spending, the relative losers in the 2004 review will be all too apparent.



Introduction

It is important to emphasise that these tough choices will have to be faced regardless of how the economy or the public finances are expected to evolve over the next few years. There has been much discussion as to whether the government's projections for the economy and for overall levels of spending and taxation are realistic or not, as we discuss below. However, this pamphlet takes the Treasury's projections as the basis for analysis, to make the point that even if things work out as the Treasury hopes, the 2004 review will still force difficult choices.

This pamphlet takes a strategic view, looking at the key choices that will have to be made across the public services as a whole by looking at the core areas of spending. Necessarily then it cannot be a detailed analysis of every single area and it cannot explore all the choices that will have to be faced up to. Individual lobbies will, by definition, make a strong pitch for their area being the priority without signalling the trade-offs they would make elsewhere. This pamphlet is all about the potential trade-offs. It approaches these trade-offs from a clear sense that policy and spending priorities should be geared towards the achievement of social justice. Of course this term can mean different things to different people, which is why even those coming to the debate with a similar set of value judgements could end up with a different set of priorities.

A review of two parts

The title 'spending' review could lead one to forget that the spending review process has two important components to it. Firstly, it sets out the government's plans for a large proportion of public spending over a three-year period, detailing the resources that will be available in different policy areas. Secondly, the allocation of those resources is accompanied by formal Public Service Agreement (PSA) targets setting out the objectives that each government department and agency should achieve, given the resources they have been allocated. In principle these two components are intimately linked in that the resources are allocated to help ensure that the policy objectives can be achieved. In a rational system, a government would set its objectives first and then figure out what resources are necessary to achieve those objectives, so that the PSA targets would drive the spending decisions. In practice of course this is way too rational a picture of how government works, with spending allocations determined in large part by historical patterns and commitments.

Nevertheless, it is an important discipline to think about spending priorities in terms of the objectives a government wants to achieve. Indeed in deciding what the priorities might be for the 2004 review this pamphlet will have to

Introduction

reflect some value judgements on what the policy priorities should be for a Labour government committed to social justice. This means deciding which targets it is most important for a Labour government to deliver on, which is not a straightforward matter at all. This pamphlet is not, therefore, going to be only an exercise in number crunching – the choices to be faced up to in the 2004 review will help determine the character of this Labour government in quite a profound way.

The Treasury – gamekeeper turned poacher

At the heart of the spending review process is of course Her Majesty's Treasury. It sets the parameters for the overall levels of public spending and taxation within which priorities then have to be set. It negotiates with individual departments over the resources to be allocated and over the PSA targets that are to be met. The Treasury's key role as the UK's public finance department of course predates the current spending review process. Indeed for those inclined to believe that all public policy (including the spending review process) started from scratch in 1997, there have been an endless succession of attempts over the decades to make the process of policy review and the associated allocation of resources a more systematic and rational one.

However, the current spending review process is different in one key respect. The Treasury is jointly responsible with individual spending departments for the delivery of certain key PSA targets (but not others). Some of these targets (e.g. the child poverty target) have important spending implications. The Treasury is thus institutionally committed to the delivery of some of the government's objectives more than others. There is, however, a further twist to the story. The spending review process only actually covers about three-fifths of total public spending – in the jargon the Departmental Expenditure Limits (DELs) that are negotiated with government departments. Two-fifths of public spending is under the heading Annually Managed Expenditure (AME), which covers a lot of items such as paying the interest on the national debt which can not be planned in any real sense and which it is not therefore appropriate to include in any review process. However, AME also includes the whole of the social protection budget (social security and tax credits) which makes up over one-quarter of total public spending and is vital to the delivery of the government's objectives for reducing poverty. This bit of the budget is, as the name suggests, decided on an annual basis and largely by the Chancellor personally who exercises more control over social security and tax credits than the Department for Work and Pensions.

There are two important implications of this. Firstly, it seems a fundamental flaw in the spending review process that the single biggest item of public



Introduction

spending is excluded from that process. The implications of this are drawn out in the pamphlet. Secondly, the Treasury has emerged as effectively the largest spending department – it would be wholly misleading to think of the Treasury solely as a finance ministry holding the ring between competing spending departments. Of course this seems rather inevitable given the enormous political and intellectual appetite of the current Chancellor, but it does force us to look at the spending review process in a clear light.

There is one final introductory point to make. Whitehall only directly controls the spending of Whitehall and its departments and agencies. Many public services are delivered by local government in England and by the devolved administrations in Scotland, Wales (and Northern Ireland when the devolved institutions are functioning). These devolved and local bodies can set their own policy and spending priorities - indeed that is the very purpose of devolution. This does not stop Whitehall from making predictions about future levels of spending on the NHS or on education, despite these being almost wholly devolved services. In effect Whitehall assumes that local and devolved bodies will have very similar priorities to the government, an assumption that is probably not wide of the mark given the common pressures that are faced.

The remainder of this pamphlet looks at the trends in and the choices to be made in terms of the use of public resources in two ways. It looks chronologically at how spending patterns have evolved and are evolving and it looks thematically at the core areas of public spending that one could map out as an aid to analysis. It then concludes by setting out a plausible set of outcomes from the 2004 spending review.

The public finances 1997-2007: an overview

Labour when in Opposition did make one tough choice when it signalled that it would if elected broadly stick to the Conservative Government's spending plans for the first two years in office. This was an important component of a broader political strategy for signalling that a Labour government could be trusted to manage the nation's economy and its public finances. The Chancellor's two key fiscal rules, or rather rules of thumb, for the size of the budget deficit and of the debt-GDP ratio (see box overleaf), were also part of this strategy. Of course it implied a risk that Labour in government would be seen to be slow in addressing many of the pressing commitments it faced and meeting the expectations of its supporters.

The 1998 Comprehensive Spending Review was the first major political opportunity to signal that this 'new' Labour administration was prepared to commit itself to significant extra expenditure to meet certain objectives. It was accompanied by the first set of Public Service Agreement targets and also by some unhelpful creative arithmetic that raised excessive expectations. However, the first year or so of the period covered by the first spending review (1999-00 to 2001-02) also revealed an unintended consequence of that long period of constrained public spending under the Conservatives and then under Labour for its first two years. Departments appeared to find it difficult to increase spending again once the constraints had been loosened, with the result that spending undershot significantly during the first year of the review.

Figure 1 shows how the overall totals for public spending and taxation have evolved over the period from 1989-90 to 2002-03, with the Treasury's forecasts for the public finances out to 2008-09, one year beyond the period covered by the 2004 review (2005-06 to 2007-08). The gap between the two lines shows the size of the budget deficit or surplus as a proportion of GDP.

From 1993, successive Conservative and Labour Chancellors had constrained spending and raised taxes to tackle the large budget deficit that emerged in the early 1990s. It is clear, however, that the swing into a modest budget surplus between 1998-99 and 2000-01 was largely unintended, reflecting in part a much sharper fall in public spending as a proportion of GDP than would have been deemed desirable under a Labour government. In fact spending fell by three-and-a-half percentage points of GDP between 1996-97 and 1999-00, to 37.4 per cent of GDP, a lower proportion than in any year since the 1960s.

To understand the circumstances of the 2004 review it is, however, necessary, to look at the period between 1999-00 and 2003-04. Public spending will have

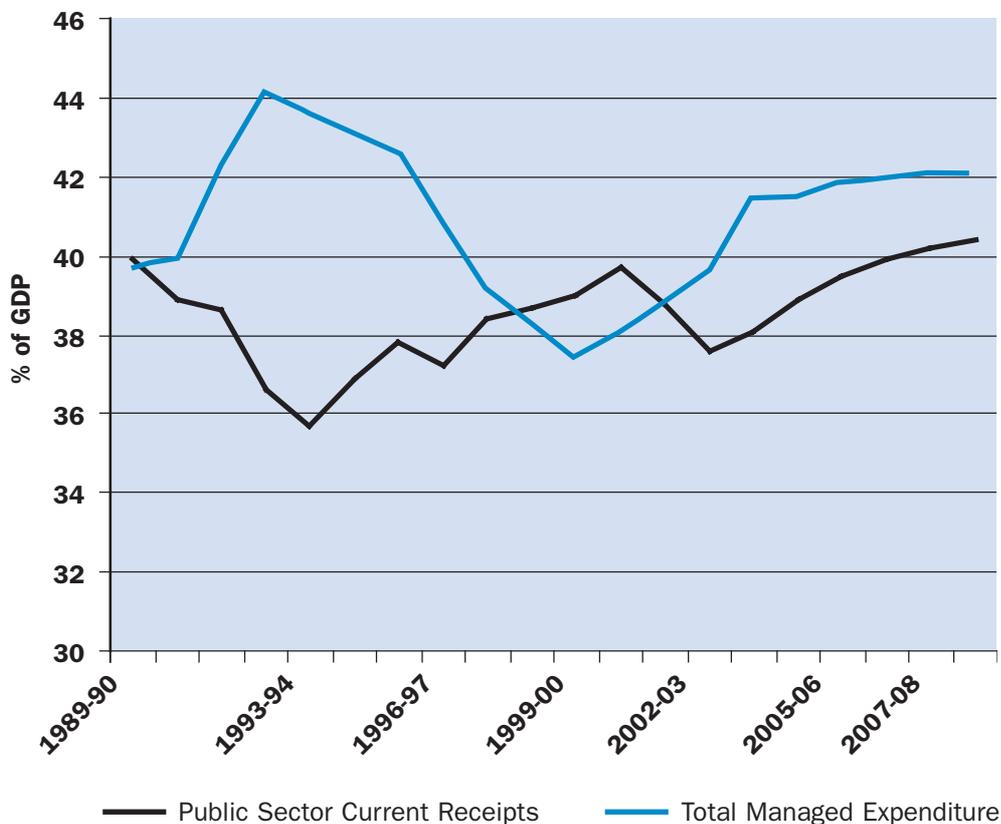
Tough choices: The 2004 Spending Review



The public finances 1997-2007: an overview

risen by about 4 percentage points of GDP over this four-year period. Over the same period, the tax take as a proportion of GDP will have fallen a little. Labour's belated rapid increase in public spending has been paid for by allowing the overall public finances to swing from a modest budget surplus (of 1.7% of GDP in 1999-00) to a budget deficit forecast in the 2003 Pre-Budget Report to be 3.4% of GDP in 2003-04. Now as the box below explains this

Figure 1: Public Sector Current Receipts and Total Managed Expenditure as Percentage GDP



does not have significant implications for the 2004 spending review, in terms of creating any immediate problems with the overall sustainability of the public finances. However, this 'trick' of financing a large increase in public spending by allowing the public finances to swing in this way can only be done once. Even if forecasts for the budget deficits that the government intends to run over the period to 2008-09 turn out to be correct, the government cannot further increase spending through the borrowing route without being seen to take risks with the public finances.

Box 1: The government's fiscal rules

Every now and again the Treasury and respected economic bodies such as the National Institute for Economic and Social Research and the Institute for Fiscal Studies engage in debate about the sustainability of the public finances. Table 1 sets out the government's forecasts for the public finances out to 2007-08, the last year covered by the 2004 spending review, along with the forecasts of NIESR and the IFS, as they were early in 2004. The Treasury was forecasting annual budget deficits at around 2% of GDP over the three-year period covered by the 2004 review. The two independent bodies were forecasting budget deficits at around 3% of GDP, partly because they think spending may be a little higher but mainly because they think tax revenues will not be as robust as the government believes. These differences in forecast deficits have implications for whether the government is likely to meet its own rules of thumb for fiscal policy.

Table 1: Contrasting assessments of the Government's Fiscal Rules (% of GDP)

	2003-04	2004-05	2005-06	2006-07	2007-08
Spending	41.4	41.4	41.9	41.9	42.1
Taxation	38.1	38.9	39.5	39.9	40.2
Budget Deficit	3.4	2.6	2.4	2.1	1.9
Public Sector Net Debt	32.8	33.8	34.6	35.1	35.4

Source: HM Treasury, Pre-Budget Report 2003

	2003-04	2004-05	2005-06	2006-07	2007-08
Spending	41.2	41.7	42.2	42.5	42.5
Taxation	38.0	38.4	38.7	39.2	39.4
Budget Deficit	3.3	3.3	3.5	3.3	3.1
Public Sector Net Debt	33.3	35.1	36.6	37.9	39.0

Source: National Institute Economic Review, January 2004

	2003-04	2004-05	2005-06	2006-07	2007-08
Spending	41.4	41.6	42.1	42.2	42.4
Taxation	38.1	38.6	39.0	39.2	39.6
Budget Deficit	3.3	3.0	3.1	2.9	2.7
Public Sector Net Debt	32.7	34.1	35.5	36.8	37.8

Source: Institute for Fiscal Studies Green Budget, January 2004

In 1998 the government set itself two rules of thumb for fiscal policy:

- the *golden rule* states that on average over the economic cycle, the government will borrow only to fund investment and not current spending
- the *sustainable investment rule* states that public sector net debt as a proportion of GDP will be held at a stable and prudent level

From the start these rules of thumb have caused endless discussion, focussed on such questions as what constitutes investment and what constitutes current spending, how do you define an economic cycle and what would be a stable and prudent level of net debt? The government defined the latter at 40% of GDP and as Table 1 shows the Treasury's forecasts suggest that the net-debt ratio would rise to only 35% of GDP by 2007-08. The IFS and NIESR have the net-debt ratio rising to 38-39% of GDP. These bodies, and the Conservative Opposition, have pointed out that once other public sector liabilities, including those arising from the Private Finance Initiative, are counted, the ratio could rise above the 40% level by 2007-08. However, the 40% level is itself quite an arbitrary choice and is lower than the levels of net debt that have been sustained historically in the UK and lower than in many other industrial economies currently.

As for the golden rule, the Treasury has, again rather arbitrarily, chosen the seven-year period from 1999-2000 to 2005-2006 as representing a complete economic cycle over which the government should have borrowed only to finance investment and not current spending. The Treasury believes that the golden rule will be met over this period while the IFS and NIESR think there is a significant risk it will not.

What importance do these debates have for the 2004 spending review? The answer is very little. It is not until 2006 that there will be a resolution of the dispute about whether the government has met its golden rule. This will therefore form an important backdrop to the 2006 spending review. At this time there will also be further debate about whether the golden rule will be likely to be met over the economic cycle assumed to start in 2006-07 and whether the net-debt-gdp ratio is going to rise beyond the government's self-imposed 40% target. If the government is seen to be breaking either of its own fiscal rules, this will be profoundly embarrassing.



However, the point is that this debate will reach its head in 2006 at the time of the next spending review and after the likely date of the next general election. At this time, if the government is seen to be breaching either or both of its fiscal rules it will be under enormous pressure to reduce the rate of growth of public spending further and/or raise taxation if it is to keep its reputation intact. 2006 is of course likely to creep up rather more quickly than the government might anticipate.

However, for the purposes of the 2004 spending review, this debate can be put to one side. The government is not going to reduce the rate of growth of public spending further and/or raise taxation ahead of the next election based on forecasts of the public finances that are subject to wide margins of error.

For the period covered by the 2004 spending review any further significant increases in public spending will have to be paid for by significant increases in taxation. If significant increases in taxation are ruled out - which is almost certainly the case ahead of the general election likely in 2005 - then so are further significant increases in public spending.

Indeed the Treasury in the 2003 Pre-Budget Report in outlining its forecasts for the public finances signalled that over the period of the 2004 review (2005-08) public spending as a proportion of GDP would remain roughly constant at around 42 per cent. It is highly unlikely that this 'spending envelope' will be altered significantly in the 2004 Budget. We already know then the broad constraints facing the government in making its tough choices in the 2004 spending review. Just to reiterate, having increased public spending by four percentage points of GDP between 1999-00 and 2003-04, over the period covered by the 2004 review spending as a proportion of GDP will remain broadly stable.

Rules of thumb for public spending

To understand the significance of this 'freezing' of public spending as a proportion of GDP, it is necessary to understand some of the pressures facing the public sector. It is very important, however, not to think in too deterministic a fashion about trends in public spending. Much of what happens to public spending is a matter of political choice. The Conservative government chose to increase public spending rapidly ahead of the 1992 election and then chose after 1992 to retrench sharply. The Labour government chose to keep to the previous government's spending plans in its first two years in office and then

chose to rapidly increase spending. It has almost certainly chosen not to increase taxation significantly ahead of the 2005 election and it has chosen to give spending on the NHS top priority, thus establishing the other key parameter for the 2004 spending review.

There are, however, some underlying pressures facing the public sector which help explain why freezing public spending as a proportion of GDP poses some real challenges. Of course, freezing public spending as a proportion of GDP allows for some real growth in spending. For the period covered by the 2004 review the official cautious assumption is that the economy will grow at an underlying rate of 2.5 per cent in each year to 2006-07 and at 2.25 per cent a year from that point on. So holding public spending constant as a proportion of GDP allows real growth in spending of about 2.5 per cent a year. Assuming inflation also at around 2.5 per cent a year, cash or nominal spending will grow at around 5 per cent a year.

However, some real growth in spending is needed in most areas of public expenditure just to allow a similar level of service to be provided and, as importantly, to be seen to be provided by service users. There are at least four important reasons for this:

- 1) Public sector pay and productivity. It has long been recognised that the real costs of public services will tend to rise over time due to their labour intensive nature and the difficulty of securing measured productivity improvements in public services. The public services are no different from many private services in this respect: the real cost of a haircut tends to rise over time for much the same reasons. Of course this does not mean that public sector productivity cannot be meaningfully improved, and the economist Sir Tony Atkinson has been tasked to look at the measurement issues that are faced within the public sector. It does mean, however, that some real terms increases in spending are required to ensure that over time public sector pay can broadly keep pace with pay in the rest of the economy, necessary if the public sector is able to recruit and retain staff.
- 2) The demand for public services. It has also long been recognised that the demand for some key public services like health tends to rise faster than the underlying rate of growth of average incomes (in the jargon of economists, some public services have a high income elasticity of demand). Over time people want to spend more of their extra income on services like health, that play such an important role in determining quality of life. Of course people's expectations about how much more of these services they will consume are not fixed. These expectations can be influenced by policy makers who through their rhetoric often serve to

Tough choices: The 2004 Spending Review



The public finances 1997-2007: an overview

ratchet them up. Indeed early in 2004 the government was still making announcements about how much it was going to spend on, for example, school capital programmes, thus exciting further expectations, and all this just ahead of a spending review when some expectations will have to be disappointed.

- 3) Technological change. Although technological change often brings about a reduction in costs, in some areas it also creates pressures for higher spending. In health the supply of new procedures and new drugs seems to generate its own demand. In defence sophisticated new equipment always seems to cost significantly more than the equipment being replaced.
- 4) Demographic change. There is much discussion of the impact of the ageing of the population on public spending in OECD countries, with possible pressures on spending on health and long-term care and on pensions. This is a complex area: some analysis suggests that the impact of an ageing population on health spending could be exaggerated as a high proportion of the health costs related to older people are concentrated in their last months of life. In the UK the impact of ageing on state pension costs are forecast to be quite modest, but only because the UK government has chosen to provide quite modest state pensions.

This last observation reiterates the point that we should not think that any of these factors are in any sense deterministic. Public sector labour costs can be carefully controlled, the demand for services can be managed, we can choose not to provide new drugs or new military equipment and we can act to offset the impact of ageing through raising the state pension age, for example. There is a great deal of choice that can be exercised, even if there are always significant political difficulties in doing so.

If we look across the OECD as a whole there is no overall trend for public spending to be rising in each and every country. In relation to health spending there does appear to be a clear trend for both public and private spending on health to rise as a proportion of GDP. Total health spending in OECD countries rose by about one percentage point of GDP between 1990 and 2001, equally divided between public and private spending (OECD 2003a). On the other hand there does not appear to be a trend for public and private spending on education to rise as a proportion of GDP (OECD 2003b). This shows the importance of looking at the trends in specific sectors rather than just looking at headline totals of public spending.

Box 2: Funding Public Services

When we look at sectors such as health and long-term care, we see that in many countries the costs of publicly commissioned services are met in part through the levying of charges on those people using the services. In practice these user charges are often quite modest and yield limited resources (Robinson, 2004).

However, it is important to emphasise that taxation and user charges are indeed the only two options for funding public services – there is no third way. It is sometimes argued that the accessing by the public sector of private finance through such schemes as the Private Finance Initiative (PFI) and other forms of Public Private Partnerships (PPPs) offers another way of getting more resources into the public sector. However, in the end the entire cost of building a hospital or school using a mechanism such as the PFI will fall on the taxpayer as the private consortium that has built and is running the asset is paid through a stream of annual payments. If the PFI has been used to build a bridge or a toll road then the user charges will generate the stream of payments used to fund the infrastructure. The PFI/PPPs do not in themselves provide one extra penny of new resources for public services (IPPR, 2001).

There is another key issue to clarify from the outset. Both taxes and user charges for public services can be formally paid by either individuals or in some cases by third parties such as employers (or insurance companies). In a reasonably competitive labour market the actual incidence of employer contributions to social security schemes or to direct charges for health, childcare or other services will ultimately fall on employees in the form of lower gross wages. There is plenty of evidence that this prediction from any economics textbook is close to what happens in reality. So whether it is user charges or taxation, in the end it is individuals who have to bear the cost of funding public services, one way or the other. And it is not at all clear that user charges are a more politically acceptable means for individuals to fund public services than taxation.

In practice where user charges are used in place of or as a supplement to taxation, they should help advance and should not prejudice the attainment of key public policy outcomes (economic, social or environmental), rather than just being about raising revenue. So charging



for road use can help reduce congestion and other environmental costs while raising revenue for public transport improvements. As we discuss below, transport is one area where there is significant extra scope for raising revenue from an extension of user charging, but only on a long-term time scale. We might be wary, however, of extending charges in other areas such as health if they deterred people from using services that we want them to use.

The public spending data presented here are presented *net* of user charges. *Gross* spending on the NHS is a little higher than the totals presented here in that some health spending is covered by user charges for prescriptions, dental and eye care, for example. So the headline totals presented in the analysis are those which have to be covered by taxation (or borrowing).

The trends in public spending in the UK for some key public services are presented in table 2. These trends are presented in terms of the annual average growth rate in real spending, that is adjusted for inflation, over the time periods shown. Most of the analysis in the pamphlet will be presented in terms of spending as a proportion of GDP, but this alternative way of showing the data will help illustrate some important points about the trends in public spending. The time periods in table 2 are the ones we are going to use throughout the pamphlet to show how spending has been evolving and to show the stark choices that will have to be faced up to in the 2004 spending review.

1989-90 is a good starting point because it represents the peak of the economic boom of the late 1980s. Public spending and taxation vary significantly with the economic cycle, so that to understand the underlying trends it is necessary to try and compare similar points in the cycle. The UK had by 2003-04 benefited from about a decade or so of steady economic growth, and so comparing public spending at this point with spending at the end of the 1980s is very informative.

Tough choices: The 2004 Spending Review



The public finances 1997-2007: an overview

Table 2: Annual average real growth rates in spending (%)

	1989-90	1996-97	1999-00	2002-03	2005-06
	1996-97	1999-00	2002-03	2005-06	2007-08
Health	3.5	3.2	6.9	7.3	7.3
Education	2.0	1.2	6.6	6.1	?
Transport	0	-7.8	12.4	8.4	?
Law/Order/ Protective Services	3.0	2.3	7.1	5.0*	?
Social Protection	5.1	-0.1	3.0	3.4	?
Defence	-3.2	-0.5	0.8	1.7	?
Total Expenditure	2.3	0.0	4.3	4.8	2.7

Note: *Criminal Justice (England and Wales)

Table 2 confirms the astonishing fact that in the first three years of the Labour government up to 1999-00, public spending did not rise at all – it was effectively frozen in real terms. Over the next three years to 2002-03 spending rose by an average of 4.3 per cent a year in real terms, which is significantly faster than the rate of growth in the economy, and so of course spending rose as a proportion of GDP. Over the three year period covered by the 2002 spending review, that is up to 2005-06, spending is planned to continue to grow at the relatively fast pace of 4.8 per cent a year. However, over the two-year period that is effectively covered by the 2004 review, the growth in spending will slow to 2.7 per cent a year, close to the underlying rate of growth in the economy. So the rate of growth in spending will decline by about three-fifths.

If we look at some key areas of spending, we can see that two – health and law and order/protective services – have shown consistent growth in spending at or above the underlying rate of growth in the economy over the whole period since 1989-90, regardless of who has been in power. As we will see below this means spending as a proportion of GDP has increased in both these areas. Education spending rose at a more modest pace in the period from 1989-90 to 1999-00 and therefore fell as a proportion of GDP, though spending rose rapidly from that point. Public spending on transport did not grow at all in real terms in the period from 1989-90 to 1996-97 and fell sharply in Labour's first three years in office. The sharp increase in spending from 1999-00 represents therefore a period of catch-up which, we will show below, will leave transport spending as a proportion of GDP at about the same level in 2005-06 as it was in 1996-97. Defence spending fell steadily in real terms over the 1990s. Since 1999-00 there have been modest real terms increases in spending but below the underlying rate of growth in the economy so that as a proportion of GDP

defence spending has continued to edge downwards. Finally, spending on social protection – social security and tax credits – increased sharply in the early 1990s in large part because of the recession, but was roughly constant in real terms over the period from 1996-97 to 1999-00. What is particularly interesting, however, is that spending on social security and tax credits has since 1999 grown at around 3 per cent a year, slightly faster than the underlying rate of growth in the economy, so that the social protection budget has risen as a proportion of GDP.

What of the period covered by the 2004 spending review? The only thing we know for certain is that health spending will continue to grow at an annual rate of 7.3 per cent per year, or roughly three times the underlying rate of growth in the economy as a whole. This is a long-standing commitment first set out at the time of the publication of the first Wanless report in 2002 (Wanless 2002). As we will spell out in more detail below, given that overall spending is set to grow at around the underlying rate of growth in the economy, once health has taken its cut, the share of all the other public services together as a proportion of GDP will have to fall slightly, though only by about half a percentage point of GDP.

This then will be the central theme of the 2004 spending review: **after health has taken its cut, how will the remaining resources be shared across the rest of the public services?**

The way of presenting the data set out in Table 2 helps us to think about the various outcomes that we could map out for the different public services.

- Public spending can rise in real terms faster than the underlying rate of growth in the economy and therefore as a proportion of GDP. This has been the trend in health spending for a long time and this will continue over the period covered by the spending review. The interesting question is whether any other areas of spending, such as education, will see their share of GDP continue to rise after 2005-06?
- Spending can rise at around 2.5% a year in real terms and so remain roughly constant as a proportion of GDP. This was the case with education if we average out over the whole period from 1989-90 to 1996-97.
- Spending can rise in real terms but slower than the underlying rate of growth in the economy, so that it falls as a proportion of GDP. One example would be defence spending since 1997.
- Spending can be frozen in real terms, so that it only rises in line with inflation, which means over time it will fall quite a bit as a proportion of GDP. One example would be transport spending if we average out over the period from 1989-90 to 1996-97.

Tough choices: The 2004 Spending Review



The public finances 1997-2007: an overview

- Spending can fall in real terms, which means an even sharper fall in spending as a proportion of GDP. One example would be defence in the early 1990s.
- Finally, spending can be reduced in cash or nominal terms, which means a very sharp fall in real terms and as a proportion of GDP. One example would be transport spending between 1996-97 and 1999-00.

One way then of conceptualising the choices facing the Labour government in 2004 is to ask which of these six outcomes will apply to the different public services, with the only certainty being that health spending will fall under the first heading.

The plans outlined by the Shadow Chancellor Oliver Letwin in February 2004 can also be analysed in this way (Conservative Party, 2004). From 2006 the Conservatives plan to reduce the rate of growth in spending to about 1.7% a year in real terms initially and then to just 1.1% a year. This compares with Labour's plans to reduce spending to an annual real rate of growth of 2.7%. Spending on the NHS and on schools would initially rise faster than the underlying rate of growth of the economy and therefore as a proportion of GDP. Spending on pensions and other benefits would also rise in real terms but not as a proportion of GDP. However, to accommodate these commitments spending on all other areas would have to fall in real terms and some areas might even see reductions in spending in cash or nominal terms. These self-imposed constraints would make any spending review under the Conservatives an even more fraught exercise.



Labour's spending reviews, 1998-2004

This section presents the trends on public spending in a different way. Figures 2-7 look at spending as a proportion of GDP for each of the periods since 1989-90 across the public services. Presenting this information in the form of a set of pie charts should of course resonate. In effect the spending review process is about dividing up a given spending pot that has been decided by the Treasury, between the various competing uses. Literally we are slicing up the pie baked by the Chancellor.

Figures 2-7 slice up the total spending pie into eleven main categories of spending. Nine of these cover the core areas of spending:

- health
- education
- transport
- law, order and protective services
- defence and overseas (including overseas development and foreign affairs)
- social protection (social security and tax credits)
- personal social services
- economic services (trade and industry, employment and agriculture)
- housing and environmental services

A tenth category is a residual one covering the costs of such items as central administration and tax collection, net payments to the EU budget and culture, arts, media and sport. The final category includes items such as debt interest and other adjustments including the net cost of public sector pensions. For the purposes of analysing the choices faced in the 2004 spending review, this last category is put to one side. Items like debt interest, though large, are determined by the accumulation of past policy decisions in relation to the path of government debt and cannot be affected once the governments overall fiscal policy has been fixed.

The tenth category includes elements of spending that the 2004 review will focus on. Although to be brutal some areas of spending like the arts are too small to worry about in the grand scale of things, 'efficiency savings' in central administration is definitely on the agenda, as we discuss below in relation to the Gershon review. There will be a fractious debate over the EU budget in the lead up to June 2005 when European leaders are due to sign off spending for the period from 2007-13, but we can not prejudge the outcome of this debate to throw light on the 2004 spending review.

Tough choices: The 2004 Spending Review



Labour's spending reviews, 1998-2004

If we put 'efficiency savings' to one side for the moment, the most difficult choices are faced in dividing up the spending pie between the nine core areas of spending outlined above, or rather the eight areas other than health, as the size of its pie has already been fixed. Of course there are also decisions to be made about the allocation of resources *within* each of these core areas. These choices are discussed below, but the obvious ones which might spring to mind would include the relative weight of spending within the education total, between early years provision, primary and secondary and post-compulsory education. We have set up some of the core areas so as to deliberately illustrate the nature of some of the choices that might have to be made, for example between the defence and overseas aid budgets.

Box 3: The Gershon review and 'efficiency savings'

Politicians often claim that they do not have to face up to tough choices in setting spending priorities, because they can always find ways of reducing 'waste'. The current government tasked Sir Peter Gershon from the Office of Government Commerce to identify opportunities for efficiency savings in the lead up to the 2004 review. By all accounts he has extended his remit to cover large swathes of the public service reform agenda. But there lies the rub: a lot of what he might recommend would require significant changes in public policy and would involve primary legislation. It would also appear to cut across some key themes of the public service reform agenda including the so-called 'new localism' and the 'personalisation' of services.

One key theme in Gershon is the assumption that there are significant economies of scale to be achieved through the joint purchasing of goods and services by government departments and local authorities. This might seem straightforward when applied to commodity goods like office supplies or even back office services such as personnel. However, at a more complex level, 'smarter' purchasing of, for example, military equipment has, to say the least, an unproven record. In this context Gershon's commercial background at the defence contractor BAE Systems is rather ironic. Moreover, Gershon also appears to want to see a centralisation of the purchasing of social care, for example, with purchasing taking place not at the local authority level but at the regional or even national level. This would require primary legislation to change the statutory functions of local government. More fundamentally, it would seem to fly in the face of the argument that the best *outcomes* in terms of

service delivery are achieved when the commissioning of those services is done by agencies closest to service users, which are almost certainly not going to be centralised purchasing agencies. It is also not clear how such centralised agencies could deliver more 'personalised' services, which is another key feature of the government's reform agenda.

Other Gershon 'efficiency' measures would also impact on fundamental issues of public service reform, including the configuration of the public service workforce, for example in relation to the use of non-teaching staff in schools. The review argues for the spreading of 'best practice', for example in relation to the length of hospital stays, but this would seem to require a thorough review of the incentives structures facing health providers. It notes the potential role of electronic patient records in the NHS or the use of on-line curricula in schools, though the precise impact of such initiatives on the *outcomes* from the public services remains contentious. The review also appears to contain some breathtakingly sweeping suggestions, such as the gains from having just one means test for all tax credits and benefits for working age people. If only reform was that simple.

Overall, the Gershon review appears to be what you would expect from asking someone with a corporate background to look at complex public service reform issues, in that many of the reforms might seem obvious in a corporate context but are less so in a complex democracy. Ironically given the underlying purpose of the spending review and the wider public service reform agenda, the Gershon review appears to focus on *inputs* and *processes* and not *outcomes*.

In the context of the analysis presented here, most of the alleged savings from the Gershon review would come *within* departmental and local authority budgets and not under the heading of central administration. It would involve a hoped for reallocation of resources within the core areas of public spending that we are analysing.

Of course it is difficult for an incumbent government to emphasise too much any large-scale savings from eliminating 'waste', as this leaves it open to the obvious charge that this 'waste' must have accumulated during its time in office. It is easier for Opposition politicians and others to say that cutting 'waste' will allow for other priorities to be met without any pain. However, once one starts to look at the details of what is presented by Opposition politicians or government efficiency reviews, they raise as many questions as answers.

To get a better understanding of the nature of the hard choices that will have to be faced up to, it is worth going back in detail over how the shares of the different core areas of spending have changed over time.

1989-90 – 1996-97: Labour's inheritance

Despite all the 'smaller state' rhetoric of the Conservative government, the overall size of the public spending pie in 1996-97 was bigger than in 1989-90. In part this was because of the impact of the early 1990s recession, which can be seen most obviously in the much bigger slice of spending going to the social protection budget, which was absorbing 12.5% of GDP by 1996-97, up from 10% of GDP in 1989-90. However, it is also worth emphasising the very large increases in spending on core services that took place ahead of the 1992 general election. Over the whole period, health's share rose from 4.8% of GDP to 5.5% of GDP. However, health was not the only area to see its share of spending rise under the Major government.

- spending on personal social services as a proportion of GDP rose from 0.9 to 1.2%
- spending on law, order and protective services rose from 1.9% of GDP to 2.1%

The share of the education budget as a proportion of GDP changed little, as did the overall share of the economic services. However, transport and especially housing and defence all saw quite significant reductions in their shares.

1996-97 to 1999-2000: A slow start

As has already been pointed out, spending was effectively frozen in real terms over the first three years of Labour government and thus declined sharply as a proportion of GDP. The Labour government was at pains to point out, however, that the continued economic recovery and the continuation of the previous government's efforts to reduce the large budget deficits of the early 1990s, helped reduce the claims on public resources from social security and debt interest. This freed up resources for other public services. Between 1996-97 and 1999-00, spending on social protection fell from 12.5% of GDP to 11.3% and public sector debt interest fell by nearly one per cent of GDP. This freed up about two per cent of GDP for other public services, but spending on the eight core areas other than social protection still fell from 21.5% of GDP to 20%. As a result none of the core services saw their share of spending as a proportion of GDP rise significantly.

Tough choices: The 2004 Spending Review



Labour's spending reviews, 1998-2004

- spending on health, law and order and the personal social services saw their shares remain roughly constant. These were the same three areas to see their shares rise as a proportion of GDP in the period up to 1997.
- despite the Prime Minister's top three priorities of 'education, education and education', spending on education actually edged down from 4.7 to 4.5% of GDP.
- the share of spending also fell in the other core areas and particularly sharply in defence, transport, housing and also the economic services.

This just goes to show how much continuity there was in these first three years of Labour government with the spending patterns of the previous government. Of course this was in part deliberate in that the Labour government consciously chose to stick to the previous government's spending plans for two years. However, the failure to get spending going in the third year was obviously unplanned.

It may also be a surprise to see the share of spending on economic services decline so much, despite the New Deal (or rather new deals), financed through the windfall tax on the utilities, being the only major immediate new spending commitment of the Labour government. In fact spending on the new deals has consistently undershot plans and amounted to less than £500 million in 1999-00, a figure which like the arts budget gets lost in the grand scale of things.

1999-00 to 2002-03: getting spending going

In presentational terms then the first Comprehensive Spending Review unveiled in 1998, covering the three-year period 1999-00, 2000-01 and 2001-02, turned out to rather backfire. Having excited such expectations in 1998 it was not until two years later, in 2000-01 that public spending increases really began to get going.

Meanwhile in 2000 there was another spending review. At this point it is probably worth clarifying why spending reviews that cover three years worth of spending plans nevertheless take place every two years. It is simply that the last year of one review becomes the first year of the next review. So the 2000 Spending Review covered the period 2001-02, 2002-03 and 2003-04. The spending review process means that the division of the cake for the three-fifths of spending covered by the reviews now takes place once every two years rather than every year, which is hardly revolutionary. This may be one reason why since 2000 they have been referred to just as 'the spending review' and not the 'comprehensive' spending review.

Tough choices: The 2004 Spending Review



Labour's spending reviews, 1998-2004

2002-03 is an important point at which to take stock, in this pamphlet written early in 2004, simply because it is the last year for which we have pretty full data on what was actually spent, rather than what the government planned to spend or has chosen to highlight publicly. Over the three years from 1999-00, spending as a proportion of GDP rose by over two percentage points and in all nine core areas of spending, though at different paces.

- health, education and law, order and protective services have seen the biggest increases, though along with the social protection budget fixed annually by the Chancellor.
- Only defence saw spending as a proportion of GDP decline, but with an increase in the overseas aid budget picking up the slack.

These figures thus reveal more clearly than perhaps anything else the priorities of the Labour government, in a way that contains few surprises. Health and, rather belatedly perhaps, education emerge as the top priorities in terms of actual spending, with the two together absorbing 1.3 percentage points of the overall 2.3 percentage point increase in total spending as a proportion of GDP. Law, order and protective services and also the personal social services continued, like health, to steadily raise their share of GDP. The increase in the share of the social protection budget is a surprise only in the context of the spending reviews, though each annual Budget and Pre-Budget Report has heavily featured the Chancellor's announcements on benefits and tax credits. Indeed the only notable spending commitment in the 2003 Pre-Budget Report were the extra resources for child related tax credits needed to ensure that the government hits its pledge on reducing child poverty by a quarter by 2004.

2002-03 to 2005-06: ratcheting spending up further

The third spending review in 2002 set spending plans for the three-year period covering 2003-04 to 2004-05 and 2005-06. Over this period the overall increase in spending is planned to amount to 2.2 percentage points of GDP. Health and education are planned to absorb 1.5 percentage points of this, or about two-thirds, confirming even more clearly their status as the two priority areas.

As far as one can ascertain given that spending is fixed annually, the social protection budget will also rise modestly as a proportion of GDP. In fact, given the need to continue to make progress in tackling child poverty and in delivering in other areas such as pensioner poverty, there will always be pressure in each annual Budget and Pre-Budget Report to increase the generosity of benefits and tax credits. This important factor will be discussed further below.

Tough choices: The 2004 Spending Review



Labour's spending reviews, 1998-2004

By 2005-06, if the government's plans work out, total public spending as a proportion of GDP will be only a little higher than in 1996-97 – 41.9% of GDP versus 41.0%. Its composition will have changed significantly, however.

- health spending will have risen from 5.5% of GDP to 7.2% and education spending from 4.7% to 5.6%.
- spending on law, order and protective services and the personal social services as a proportion of GDP will also have increased significantly
- public spending on transport and housing and environmental services as a proportion of GDP should in 2005-06 be roughly back to where they were in 1996-97
- the defence budget will have fallen as a proportion of GDP and the overseas aid budget will have risen
- the economic services along with the social protection budget will both be smaller as a proportion of GDP, but critically the trend for the social protection budget as a proportion of GDP is now up, not down.

There are in fact some striking continuities here with the period before 1997. Three out of the big four winners under Labour – health, law, order and protective services and the personal social services – also saw their share of spending as a proportion of GDP rise under the Conservatives. There are clearly some common underlying factors driving up spending in these areas, or a commonly shared set of policy priorities between Labour and Conservatives. Education has more clearly been a priority for significant extra public spending under Labour, so the Prime Minister's famous assessment of his top three priorities has not been completely wide of the mark, though health has actually been the top priority, as everyone probably recognises.

2005-06 to 2007-08: what's left after health

The 2004 spending review will cover the three-year period 2005-06, 2006-07 and 2007-08, though spending for 2005-06 was already set in the 2002 review and the Chancellor has clearly signalled that spending in this year will not be revisited. Effectively then the 2004 review will only cover two years and spending in the final year, 2007-08, will presumably be re-considered in the 2006 review, if one takes place in the next Parliament. So 2006-07 is the one year that only the 2004 review will fix spending for, and only for the three-fifths of spending covered by the spending review.

Nevertheless, as the introduction spelt out, the 2004 review will be critical in setting the agenda for the next Parliament. We only have two known parameters for this review:

Tough choices: The 2004 Spending Review



Labour's spending reviews, 1998-2004

- total spending in 2007-08 is planned to be 42.1% of GDP (unless this total is altered significantly in the 2004 Budget), little changed from 41.9% in 2005-06
- health spending is planned to be 7.9% of GDP, up from the 7.2% in 2005-06.

Given that spending on debt interest etc. will remain roughly constant as a proportion of GDP, it is a matter of simple arithmetic that the resources available for all the public services other than health will fall modestly from 31.1% of GDP to 30.6% of GDP. If this sounds very modest, it needs to be seen in the context of the trends from 1999-00 to 2005-06. Over this period spending on all the public services other than health rose from 27.4% of GDP to 31.1%. At the very least then the period where public services other than health might look forward to enjoying a significantly higher proportion of the nation's resources, is at an end. For most public services, spending as a proportion of GDP will have to remain stable or will have to fall in the next Parliament.

Just to illustrate this point for law, order and the protective services: a constant share of spending as a proportion of GDP over the period from 2005-06 would mean spending rising at only half the rate in real terms achieved over the period from 2002-03 to 2005-06 and little more than a third of the rate achieved over the period 1999-00 to 2002-03 (see Table 1). Achieving such a significant deceleration of spending growth in any of the core public services will not be easy.



The Public Service Agreement Targets

At this point it is probably worth taking a break from the spending figures and looking in more detail at the other half of the spending review process – the setting of targets for the delivery of key policy objectives agreed between the Treasury and the spending departments. As was argued earlier, in principle the way that a rational policy process should work is that the government would first decide on its priorities in terms of the policy objectives it wants to achieve and would then make decisions about the allocation of resources to match those priorities. Deciding which are the key PSA targets that the government is likely to give priority to should thus help us to decide how the spending cake is likely to be divided up.

PSA targets were first introduced in the 1998 comprehensive spending review. This set around 600 targets, but most of these focussed on processes and inputs within particular departments and were not really that strategic. By the time of the 2000 review the number of PSA targets had been reduced to around 160 and more clearly focussed on the key outputs and outcomes that departments were expected to deliver. The less important objectives in relation to processes and inputs and some intermediate outputs were relegated to separate Service Delivery Agreements (SDAs). The 2002 review saw the number of targets fall further to around 130. The 2004 review is likely to see a further reduction in the number of targets as the government concentrates on each department's key objectives for policy outputs and outcomes, with the SDAs abolished altogether. However, a range of key targets for the outputs and outcomes to be achieved by the government will remain.

There are three obvious questions to ask in relation to the targets in the 2004 review:

- 1) Will any targets be dropped?
- 2) Will there be any significant new targets, signalling a possible shift in priorities?
- 3) Will the review highlight the targets that the government sees as particularly important?

The successive spending reviews have in fact featured many of the same targets, albeit in updated form. This is illustrated in Figure 8 in relation to post-compulsory education. This is one policy area where the number of targets in relation to key outcomes has actually risen after each review. Only one set of targets in relation to the achievement of lower grade GCSEs died in the 2002 review. Several of the key targets relate to outcomes to be achieved by 2007 or 2010, for example the target for 50% of the age cohort to enter higher

The Public Service Agreement Targets

education, and so are likely to be unaltered in the 2004 review. The 2004 review will update some of the other targets, for example in relation to the achievement of higher grade GCSEs, to cover the period from 2006-08. One target – relating to the Learning and Skills Sector – does not fit well the PSA framework as it does not focus clearly on outcomes and may be dropped. It is unlikely that in this area of policy the 2004 review will feature any new major targets – delivering the current ones has been proving problematic enough.

There has been much criticism of the government's target-setting culture. Ill-thought through targets can distort priorities in unhelpful ways, leading public

Figure 8: PSA Outcome Targets

1998 Review	2000 Review	2002 Review
Increase % of 16 year olds achieving 5+ GCSEs A-C from 45-50% by 2002	Increase % achieving 5+ GCSEs A-C by 4 percentage points, 2002-04	Increase % achieving 5+ GCSEs by 2 percentage points each year 2002-06
Increase % 16 year olds achieving 1+ GCSEs A-G from 92-95% by 2002	Increase % achieving 5+ GCSEs A-G (inc Maths and English) to 92% by 2004	
Increase % of 19 year olds at level 2 from 72-85% by 2002	Increase % at level 2 by 3 percentage points, 2002-04	Increase % at level 2 by a further 3 percentage points 2004-06 By 2004, 28% of young people to start a Modern Apprenticeship by age 22 By 2010, 90% of young people to participate in a FT programme fitting them for entry into HE or skilled employment by age 22
		Reduce by at least 40% number of adults in UK workforce not at level 2 by 2010 with 1 million adults already in workforce to achieve level 2 by 2003-06
	Increase HE participation towards 50% of 18-30 year olds by 2010 (and secure fair access and reduce non-completion)	HE target unchanged Challenging targets for minimum performance and value-for money in the Learning and Skills sector
	Reduce number of adults with literacy and numeracy problems by 750,000 by 2004	Improve basic skills of 1.5 million adults, 2001-07, with milestone of 750,000 by 2004

The Public Service Agreement Targets

service managers to concentrate on what is being measured in relation to the targets rather than what might really matter. However, an equally important criticism is that Whitehall has a habit of setting targets and only then figuring out how to measure progress towards their achievement, never mind worrying about any unforeseen or unintended consequences. The setting of targets shows up some of the processes employed by government in their worst light. Targets are often set with little public consultation by the policy elites at the centre of Whitehall, with no ‘testing’ of their validity or no attempt to secure a wider buy-in to the targets, especially by those tasked to deliver them on the front line.

However, it has to be said that all governments set targets. This is true whether the process is closed and the targets implicit, or where the process is closed and the targets are explicit (as with the current regime) or where the process is more open and the targets are explicit (which would be the ideal). Whatever else they achieve, the PSA targets concentrate minds in Whitehall - ministers and officials see their careers linked, at least in part, to the achievement of the Delivery Plan linked to each of those targets. Which makes it all the more important that the targets are got right and that everyone is clear about the priorities expressed in those targets. It would also help if the targets were clearly thought through before they were launched so that so much time and attention did not need to be taken up trying to figure out how to measure progress towards them.

The government in 2002 found itself with 130 PSA targets. It cannot, however, have 130 priorities. There must be an implicit pecking order in the PSA targets that are set out in the spending reviews. One clue about that pecking order is to identify those targets that the Treasury is jointly signed up to delivering in its role as the department driving large areas of economic, social and environmental policy. Another clue of course is to look at where the most resources are being allocated. A final clue is to focus on what ministers talk most about, which in turn is a function of what they think will resonate most with the public.

This last point raises the issue of whether there is a possible conflict between the objectives the government feels it has to give priority to in order to maintain public support and win elections and the objectives it would really want to secure in order to advance its core goals. It is well known that the Chancellor worries about the apparent lack of popular enthusiasm for the goal of eliminating child poverty by 2020, an objective he clearly feels passionately about as do others in the government. Likewise, objectives in relation to delivering international development goals are important to many in the government and outside, but are not the objectives that sway election results.



The Public Service Agreement Targets

Famously Labour entered the 1997 election with five pledges. All were carefully calculated to appeal to the electorate, but they did not relate to key outcomes for public policy and would probably not now make it as PSA targets! In order to get at this key question of what are the government's *real* priorities out of 130 PSA targets, the box below looks at the five targets you might expect to appear on a fantasy 2005 election pledge card if the aim was to convince the electorate that the Labour government was delivering. It also outlines the five targets that might be most important for delivering social justice.

Box 4

Five targets to win the election

Reduce the maximum wait for an outpatient appointment to 3 months and the maximum wait for inpatient treatment to 6 months by the end of 2005 ... and 3 months by 2008 (Dept. Health 2002 PSA Target)

By 2010, increase participation in Higher Education towards 50% of those aged 18-30. Also, make significant progress ... towards fair access... (DfES 2002 PSA Target)

Reduce crime and the fear of crime ... including by reducing the gap between the highest crime areas and the best comparable areas. (Joint Home Office/Criminal Justice System 2002 PSA Target)

Focus the asylum system on those genuinely fleeing persecution by taking speedy high quality decisions and reducing significantly unfounded asylum claims (Joint Home Office/Lord Chancellor's Department 2002 PSA Target)

Reduce congestion on the inter-urban trunk road network and in large urban areas in England below 2000 levels by 2010 (Dept. Transport 2002 PSA Target)

Five targets to achieve social justice

Reduce substantially the mortality rates from the major killer diseases by 2010 ... and reduce inequalities in health outcomes (Dept. Health 2002 PSA Targets).

Reduce by at least 40% the number of adults in the UK workforce who lack NVQ 2 or equivalent qualifications by 2010 ... (DfES 2002 PSA Target)



The Public Service Agreement Targets

Reduce crime and the fear of crime ... including by reducing the gap between the highest crime areas and the best comparable areas. (Joint Home Office/Criminal Justice System 2002 PSA target)

Reduce the number of children in low-income households by at least a quarter by 2004, as a contribution towards the broader target of halving child poverty by 2010 and eradicating it by 2020 (Joint HMT & DWP 2002 PSA Target)

In the three years to Spring 2006, increase the employment rates of disadvantaged areas and groups – people with disabilities, lone parents, ethnic minorities, people aged 50 and over, those with the lowest qualifications (DWP 2002 PSA Targets)

One target – in relation to reducing crime and the fear of crime – arguably fits well both public concerns and those that might result from a focus on delivering social justice. However, tackling crime and tackling the fear of crime are of course *two* separable objectives in practice. As we discuss below, the government can and does point to statistics showing that crime has been falling, but this seems to have done little to alter public perceptions. The problem here appears to be convincing the public that the crime figures are to be trusted.

The commitment of the Prime Minister and the Chancellor to the child poverty target is unquestioned and delivering it would seem to be central to the goal of achieving social justice. One of the most important challenges facing the government is making this issue resonate more strongly with the electorate. The public's concern with the asylum issue, fed at least in part by media coverage, appears to make this the more politically salient issue, which is depressing.

The juxtaposition of the two health targets best illustrates the point about the salience of the PSA targets to different audiences. Reducing waiting times for treatment in the NHS is seen as key to convincing the electorate that this important public service is improving. However, the ultimate goal of health policy, as opposed to policy for just the NHS, is to improve health outcomes and reduce inequalities in those outcomes. This is also what any focus on achieving social justice would lead one to emphasise. There is clearly some overlap between these two types of objectives, in that health outcomes for patients are unlikely to be improved if they have to wait excessively for necessary treatment. On the other hand, health providers argue that an



The Public Service Agreement Targets

excessive focus on targets for waiting times might lead to neglect of patients with greater needs but who have not been waiting that long. More fundamentally, a focus on health outcomes might lead to areas other than the NHS being given priority for resources, given that those outcomes are also impacted on by low incomes, poor housing and so on.

This then puts the problems with the PSA targets regime in their starkest light. The targets can distort priorities within services and across services if the government is not clear about what its priorities really are and communicates this effectively.

In post-16 education, the 2004 spending review will almost certainly force the Department for Education to make some tough decisions in relation to how quickly it can move towards achieving the 50% target for higher education enrolment while also committing resources to reducing the number of adults lacking basic qualifications. It is this latter aspiration which is important for reducing social exclusion, but the government's political authority is staked on delivering in higher education. The targets to improve the employment rates of disadvantaged areas and groups relative to the overall employment rate is clearly key to achieving the goal of full employment that has long been central to the aspirations of the centre-left.

In transport and environmental policy, the 2002 PSA target to reduce congestion has already been effectively abandoned, as road use is continuing to increase on the back of rising real incomes and a fall in real fuel prices. A review of the government's 10-year transport plan will form part of the 2004 spending review process, so this is one area of policy where the government will have to come up with some new and credible targets. The government will need to convince people that transport is not its one clear failure, as is widely perceived.

Now of course many will contest the lists of top priorities set out above. In the end any set of priorities must reflect one's value judgements. But the point needs to be reiterated: the government cannot have 130 equal priorities, so there must be an implicit or explicit ordering of the PSA targets. The priorities set out above are based in part on what ministers seem to talk most about. We have seen that the actual patterns of spending since 1997 reveal health and education as the two top priorities. The targets that the Treasury is jointly signed up to reveal some of the Chancellor's priorities, with the child poverty target clearly paramount. Some of the Treasury's other joint targets, such as the one aimed at reducing the productivity gap with other leading economies, manage to neither resonate with the public or to be necessary in achieving social justice. Other joint Treasury targets not included above are, however,

Tough choices: The 2004 Spending Review



The Public Service Agreement Targets

important, certainly in relation to social justice, including those relating to narrowing regional disparities and achieving international development goals. Other targets relating to climate change are also important in the context of the sustainability of the social and economic progress we would like to make. Some targets, for example in relation to international development goals, will require some tough choices to be made in the 2004 spending review

The rest of this pamphlet will look within the core areas of public spending to think further about the pressures facing different parts of the public sector. But in the end you cannot think about the priorities within, say, education, without coming back to the big picture of how education stacks up against the other core areas and how spending priorities should reflect the outcomes that we want to achieve.

The 2004 spending review: slicing the pie

As discussed earlier, there are two known parameters for the 2004 review:

- total spending in 2007-08 as a proportion of GDP will be little changed from 2005-06 at around 42%
- health spending is planned to be 7.9% of GDP, up from the 7.2% in 2005-06.

As a result the resources available for all the public services other than health will fall modestly by about one half of one percentage point of GDP. The 2004 review is all about slicing the remaining pie up once health has taken its cut. Each core area of public spending will have its lobbies, inside and outside of government, arguing the case for it to be given priority. The spending review is of course an inherently political process, with the relative winners and losers the product of political calculation at the highest levels of government. It is helpful to look at the pressures and priorities within each of the core areas of spending, but only if we keep the overall picture in mind. This section will look at those core areas before an attempt to suggest the most likely range of outcomes from the review. As the process of setting priorities must produce relative losers as well as winners, the suggested outcomes are bound to be controversial.

Health: catching up with Europe

It was surprising that a 'new' Labour government that wanted to eschew 'tax and spend' and focus on outcomes in the public services ended up with a headline target as unsubtle as raising health spending in the UK as a proportion of GDP to the EU average. Nevertheless, it is this target that sets one of the key parameters for the 2004 spending review.

In 2000, gross public and private spending on health in the UK was about 7.3% of GDP (figure 9). This compared with a weighted EU average of about 9.0% of GDP in 2000, up from about 8.0% of GDP in 1990. We have also seen that, regardless of which government has been in power, public spending on health in the UK has been rising steadily as a proportion of GDP.

It is common to ascribe these trends in health spending to a range of technological and demographic pressures, the rising expectations of the population and the need for real pay to rise in a sector where productivity improvements are hard to measure and secure. However, figure 9 shows such a wide variation in spending across OECD countries that there must be other factors at play. Indeed different health care systems are probably differentially



The 2004 spending review: slicing the pie

effective in containing the growth in health care costs and perhaps at tempering public expectations, with the NHS often quoted as an example of one of the more efficient. It is interesting to note that one or two countries such as Denmark did not see any significant increase in spending on health as a proportion of GDP in the 1990s. So the choice of the UK government to try and match spending in other EU countries is just that, a choice, freely entered into, not something pre-ordained by pressures on spending that have to be accommodated.

By the last year covered by the 2004 review, 2007-08, gross health spending as a proportion of GDP in the UK is forecast to be 9.4%. This relies on the assumption that private spending on health will remain stable at around 1.2 to 1.3% of GDP, while public spending rises sharply as already mapped out by the government. The implications of this rise in gross spending on the NHS for the net spending that must be financed out of taxation also needs to assume that the revenue raised by user charges will remain roughly constant as a proportion of GDP.

It is a plausible assumption that the weighted EU average spend on health care will have increased over its 2000 level by 2007-08, so the UK government is trying to hit a target that is moving upwards. Nevertheless, it is also plausible to think that by 2007-08 the UK will be close to the weighted EU average. However, because of the lag in collecting comparative data we will not know this until about 2010, so there will be plenty of room for debate in the meantime. By this time it is entirely possible that the UK will be seen to be devoting a somewhat higher share of national resources to health than countries like Sweden. We had better hope that health outcomes in the UK by this date match those of countries like Sweden, or the Labour government will have undermined one of the main arguments for the NHS – its relative cost-effectiveness.

This of course is the key point about all these extra resources for the NHS. By 2010, the government aims to have achieved its PSA targets on health outcomes relating to mortality rates from key diseases and inequalities in health. These health outcomes are the result of many factors other than the resources available to or the effectiveness of the NHS, but therein lies another set of issues as to whether the improvement of health outcomes desired is best achieved by putting so many resources into the NHS. Already of course there is a gathering debate about how effectively the NHS is using these resources and why the outputs from the NHS do not appear to be rising as quickly as the inputs (see for example OECD, 2004)

Tough choices: The 2004 Spending Review



The 2004 spending review: slicing the pie

Figure 9: Expenditure on health as % of GDP in 2000

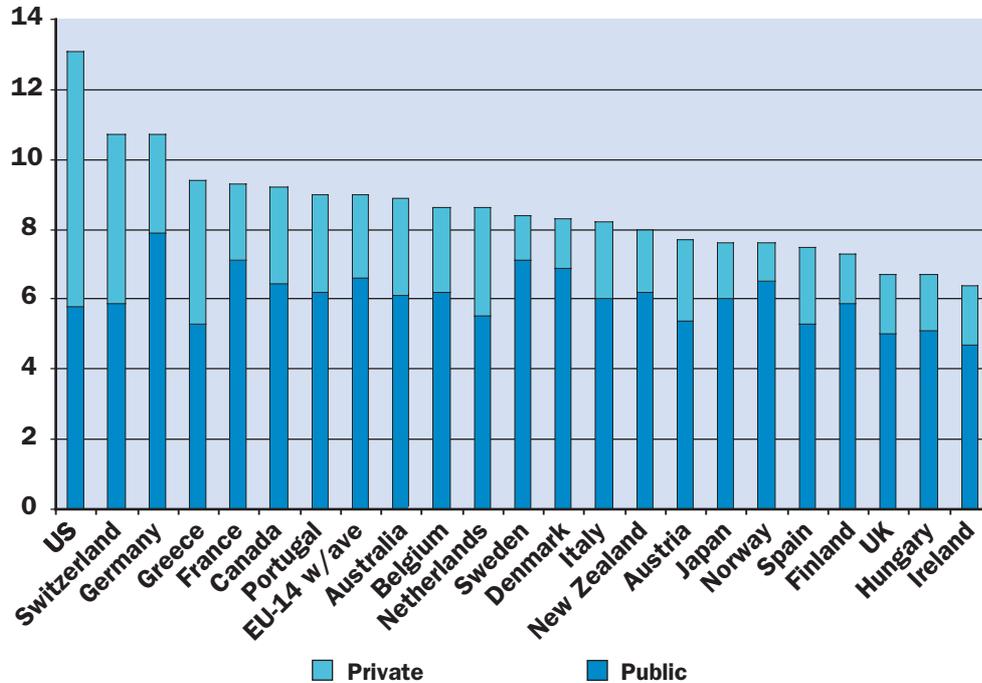
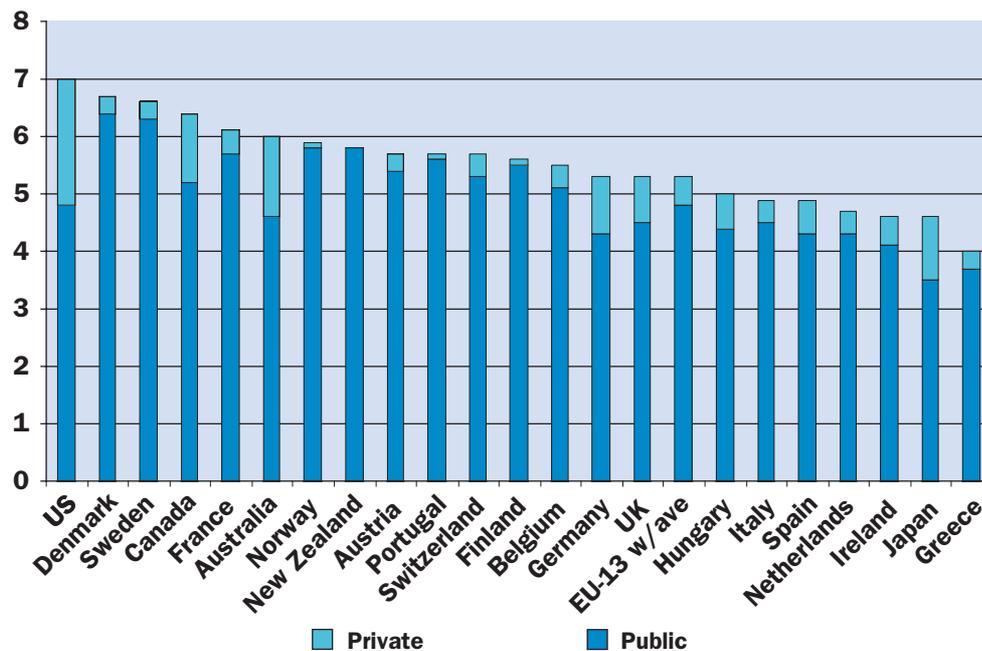


Figure 10: Expenditure on education as % of GDP in 2000





The 2004 spending review: slicing the pie

A pamphlet about the 2004 spending review is not the place to get into this set of debates in any depth. The government's plans for health spending have been set out. To scale them back would represent a u-turn with severe political consequences. The key PSA targets have also been set. Any discussion of the 2004 spending review has to take the plans for health as a given.

Education: having caught up with Europe, what now?

There is no formal target for raising education spending as a proportion of GDP to the EU average. There was a target in the first Parliament to raise spending on education as a proportion of GDP, a target that was actually missed, in that spending in 2000-01 was 4.6% of GDP compared with 4.7% of GDP in 1996-97. However, this was not known at the time of the 2001 election, so the government got away with it, which just shows that lags and revisions in data can be helpful sometimes.

In 2000, public and private spending on education in the UK was about 5.3% of GDP (figure 10). This was the same as the weighted EU average, which was also about 5.3% of GDP in 2000. The EU weighted average had *not* increased over the period since 1995. We have also seen that public spending on education in the UK did not rise as a proportion of GDP over the 1990s: it was 4.6% of GDP in 1989-90 and also in 2000-01.

So the trends in education spending in this country and in others are not the same as the trends in health: there is no steady upwards movement in education spending as a proportion of GDP. The choice of the Labour government to significantly increase public spending on education to 5.6% of GDP by 2005-06 is precisely that, a choice, and not something driven by inevitable pressures on the education budget. If private spending on education in the UK remains constant as a proportion of GDP at around 0.7%, total spending on education could be 6.3% of GDP by 2005-06. Interestingly, given the absence of any obvious trend in the weighted EU average education spend, there is a good chance that by 2005-06, education spending in the UK will be up to one percentage point of GDP higher than the average for the EU. We will not know this until 2008 or 2009 given the lags in the data. We must hope that by this time the outcomes of the UK education and training system will be seen to match and indeed exceed most other EU countries.

The education and training world thus enters the 2004 spending review, lacking the same arguments that have been deployed by their health colleagues to argue for a significantly higher share of national income. International comparisons do not suggest that the UK education system is particularly under-funded, at least not in comparison with the EU average.



The 2004 spending review: slicing the pie

Sometimes the US is held up for comparison in education, though presumably this should also prompt the same comparison for health. However, figures 9 and 10 show that for both health and education, higher levels of spending overall in the US reflect in both cases higher levels of private spending. This suggests a possibly fruitful agenda for Conservative politicians but not necessarily for a Labour government.

It is hard then to argue for education's share of the total pie to continue increasing based on international comparisons. However, education remains in all the government's rhetoric, one of its top priorities. Moreover, the period of significantly increased education spending after 1999-2000 also saw a schools funding 'crisis' in 2003 and a fractious debate over differential tuition fees as the government sought to increase higher education funding in part by levying greater user charges. So thinking about it in domestic political terms, education does not look 'under-funded', whatever the international comparisons might say.

Table 2 showed that education spending over the period since 1999-00 has been rising at an annual rate of over 6% in real terms. Holding education's share constant as a proportion of GDP would imply the rate of growth in spending after 2005-06 more than halving to just 2.5% a year. On the other hand if the government tried to maintain the same rapid growth in education spending, total public spending on education would rise to 5.9% of GDP by 2007-08. This would mean that health and education together would reduce the resources available for all the rest of the public sector by over 1% of GDP.

As hinted at earlier, another key problem for the government will be how it reconciles the different priorities *within* the education budget. The government has some ambitious PSA targets in relation to both school education, and post-16 education as figure 8 showed. It also has a potentially ambitious agenda to take forward in relation to early years services and an extension of childcare provision, with the Department for Education and Skills now the lead department on these issues. The early years debate is dealt with in more detail below.

Nearly three-fifths of total education spending is on schools, where the government will not want to see any repeat of the problems experienced in 2003. Over the period since 1999-00 it has been higher education, including student support, that has seen its share of the total education budget fall. The introduction of variable tuition fees from 2006-07 will make little difference initially, as they will only affect first-year students in that year. The contribution of higher tuition fees will build up by 2008-09, but this will take us into the period covered by the 2006 spending review. The government has been



The 2004 spending review: slicing the pie

signalling that it gives high priority to the targets for improving basic qualifications and skills amongst adults, with an indication that this implies a more robust attitude towards the levying of fees for courses in further education at level 3 and above.

There are no easy choices to make either about the overall size of the education budget or the priorities within that budget. In practice it is hard to see how education spending can rise that much faster than the underlying rate of growth in the economy after 2005-06. If the government wants to ensure that schools are seen to remain adequately funded and that further progress is made on the early years agenda, it is further and higher education that may face a relative squeeze. The government is likely to make fitful progress towards its 50% target for higher education enrolment, but because the data relating to this target are both ill-understood and come out with a very significant time lag, they could get away with this. More worryingly perhaps for the social justice agenda, they could also make limited progress on higher levels of attainment for disadvantaged adults.

Transport: still the cinderella service

Transport is the one area of public policy where the government has few boasts it can make. Spending was heavily squeezed in the first three years of the Labour government and the belated rapid rise in spending from 2001-02 will merely restore public spending on transport as a proportion of GDP to its 1996-97 level by 2005-06. The government's 10-year transport plan announced in July 2000 has been knocked off course by the fuel tax revolt and the seemingly intractable problems of the railway industry (Grayling 2004). Public funding for the railways has risen sharply as a proportion of the total transport budget, at the expense of relative share of the roads budget. The government now admits that road traffic will grow faster and congestion will increase and not fall as required by one of the Government's key PSA targets.

Transport is one key area where the status quo in policy terms is not an option. The government has stated that the ten-year transport plan will be revised in 2004 as part of the spending review process and rolled forward to 2015. This will have to include some key revisions to the current set of PSA targets, in relation to congestion for example.

However, one of the other 'golden rules' of the public finances over the recent past is that when things get tight, it is the transport budget that gets hit first and hardest. Certainly in the light of the overall tight constraints facing the government, it is hard to see transport remaining a priority for extra public spending financed through taxation. This is a key reason why the issue of user

Tough choices: The 2004 Spending Review



The 2004 spending review: slicing the pie

charges in transport will have to rise up the political agenda. The relative success of the London congestion charge has set a useful precedent, which will no doubt be followed by other cities. It is also possible that major new roads schemes might be accompanied by tolls, with the M6 relief road setting the precedent here.

The ippr has put forward proposals for introducing a nation-wide system of congestion charging by 2010 using GPS technology (Foley and Fergusson, 2003). In order for a nation-wide system to achieve its objectives in relation to reducing congestion and emissions, it would need to be revenue raising. It could indeed raise very significant amounts of revenue, even if offset by tax reductions elsewhere, for example in vehicle excise duty. There is a catch, however. Such a system is unlikely to come into operation before 2010. It will not, then, help the government out of the dilemmas it faces in the 2004 spending review. Rather this review should ideally signal the intermediate steps that could be taken, for example in relation to tolling, to help sustain necessary transport investment and sensitise the public to charging for road use. These steps could take place at the same time that the government sets out to patiently make a consistent case for a national scheme of congestion charging.

Meanwhile, the dilemmas in transport spending will remain particularly acute. Precisely because transport spending will have been rising so rapidly since 2000-01 (see table 2), if spending after 2005-06 slowed down even to the underlying rate of growth of the economy, the pace of deceleration will be significant. As it is very hard to see tax financed public spending on transport rising as a share of GDP after 2005-06, this is the best that could be hoped for.

At the same time, however, the railways could be gobbling up much of the extra resources that are available, making it difficult for the government to achieve its other objectives for transport policy. One solution here would be a significantly faster rate of increase in rail fares, so rail users bear more of the costs, rather than taxpayers. This would undoubtedly be unpopular. However, if the roads budget is seen to be squeezed after 2005-06, this will make it all the more difficult to sell the more widespread use of tolling and the eventual introduction of a nation-wide system of congestion charging. On the other hand if local transport budgets take the strain, those government objectives most related to achieving social justice, for example through improving bus services more heavily utilised by lower income groups, could be under threat.

A key issue for the government in transport policy, therefore, is how it avoids the charge of allowing 'bust to be followed by boom to be followed by bust' in



The 2004 spending review: slicing the pie

terms of public spending on transport. It is the nature of acute dilemmas that they are hard to reconcile.

Law, order and protective services: everyone's priority

There are two key reasons for believing that the budgets for the police, prisons, and the administration of justice and the immigration system, will remain consistently high priorities.

- regardless of changes in government, the share of this core area of spending has over time steadily increased as a proportion of GDP
- the public appears to continue to regard crime and migration as two of its top priorities and policy makers are fully aware of this.

On the other hand the expectations that have been generated by such rapid increases in spending over the period from 1999-2000 onwards will have to be tempered. As was pointed out earlier (table 2), even if the budget for criminal justice in England and Wales increases after 2005-06 at the underlying rate of growth in the economy, it will involve spending rising at less than half the rate experienced in the first half of the decade.

Nearly half of the budget in this core area goes on the police, who have also seen their share of the overall total rise a little. However, in no other area does there appear to be such a sharp contrast between public perceptions and expectations and what policy makers would want to claim on the basis of the available evidence. They would want to point out that the British Crime Survey suggests a fall in the total number of crimes committed since 1995, which they would want to link with the extra resources that have been deployed in this area. Public perceptions of the trends in crime are very different, with large numbers continuing to believe that crime is getting worse (discussed in IFS 2004). The set of contrasting statistics showing that the number of crimes recorded by the police has risen may play some role in shaping these perceptions. That this is a result of an increase in the efficiency of the police in recording crime following the introduction of the National Crime Recording Standard in 2001 is hard for people to digest. Crime may have been reduced, but the fear of crime has not. In no other area of public policy has Disraeli's dictum about the perceived unreliability of statistics continued to haunt policy makers.

Meanwhile, the continued expansion of the prison population creates further spending pressures. In relation to migration a reduction in asylum applications to the UK and restrictions on migrant's access to benefits should temper the pressures on spending. However, overall this seem to be another core area of



The 2004 spending review: slicing the pie

public spending where the circumstances – and particularly the expectations of the public – make it highly unlikely that the government will want to give any signals that it will receive a much lower priority in the future. Spending on this core area did edge down a little as a proportion of GDP in the middle part of the 1990s, but it would take a very brave set of politicians to signal that the resources for fighting crime were no longer a priority.

Defence and overseas services: conflicting pressures

So far we have not come up with any obvious candidates for spending to fall as a proportion of GDP, which the logic of the spending review suggests must happen in some areas. Defence seems an obvious candidate, as spending here has been falling as a proportion of national income since the early 1980s and this trend has continued at a more muted pace under the current Labour government. On the other hand, the government still aspires for Britain to be able to ‘punch above its weight’ in the international arena and this has significant resource implications.

At the same time as facing these pressures on the defence budget, Labour has been making progress in increasing spending on overseas development assistance as part of a wider agenda for Britain to make a significant contribution to achieving the Millennium Development Goals to reduce poverty in developing countries. In 1999 the UK’s net overseas development assistance budget was 0.24% of gross national income (GNI). This had increased to 0.3% of GNI by 2002 and is planned to reach 0.4% of GNI by 2005. This should mean that Britain will meet an EU-wide aspiration for development assistance to reach an average of 0.39% of GNI. Britain will still be measurably short of the long established ambition for the richer countries to meet the UN target for 0.7% of GNI for development assistance. It is clearly inconceivable that Labour would allow the development assistance budget as a proportion of GNI to slip back again after 2005. The key question for the 2004 spending review is whether spending will continue to rise faster than the underlying rate of growth in the economy, to that it continues upward as a share of national income. That the Chancellor believes passionately in these issues bodes well.

However, how do ambitions in the field of international development sit alongside the ambition for Britain to be able to ‘punch above its weight’? The relative commitment of countries to global security issues is often measured by the share of the defence budget as a proportion of GDP. Unfavourable comparisons are drawn between the US, spending just over 3% of GDP in the early part of this decade and the average for the European members of NATO, which is under 2% of GDP. Britain devoted 2.4% of GDP to defence in 2002-03,



The 2004 spending review: slicing the pie

well above the European average. There is thus a considerable price tag attached to the UK being able to ‘punch above its weight’.

Given the need for pay in the armed forces to keep pace with the rest of the economy and given the expense of new equipment, it is probably a reasonable rule of thumb that a given level of spending as a proportion of GDP buys you a given level of defence capability. If defence spending was to fall significantly below around two-and-a-half per cent of GDP, it is hard to see how Britain’s defence capabilities could be maintained at current levels. The timelines for major defence procurements are very long. For example, 2004 is likely to see the need to finalise plans to build two new sizeable aircraft carriers with their accompanying aircraft, which will come into service in 2012 and 2015. If defence spending was to be frozen in real terms from 2005-06, then spending as a proportion of GDP would by 2015 fall below 2%. This would render current procurement plans unachievable and probably require significant reductions in the size of the armed forces. The Defence White Paper of December 2003 managed to address none of these issues (MoD, 2003).

The 2004 spending review should be one of the most important watersheds for defence since the end of the cold war, the point at which the aspiration to ‘punch above our weight’ meets the realities of setting spending priorities. However, over the two-year period covering 2006-07 and 2007-08, freezing defence spending in real terms would actually only shave one-tenth of one percentage point of GDP off total public spending. With the need for the overseas development budget to maintain or increase its share, this core area of public spending will not in fact be able to make that much of a contribution to resolving the government’s medium term spending problems. And we are able to reach that conclusion without once mentioning the costs of the continuing conflict in Iraq.

Social protection: missing at the feast

The social protection budget is another budget where one would want to plan over a longer time horizon than the two years effectively covered by the spending review process. The obvious reason for this is the historic pledge to eliminate child poverty by 2020, though there is also a need for a long horizon over which to set policy for pensions and benefits for other key groups. How ironic then that this is the one core area of spending where decisions are made annually by the Chancellor and there is no explicit longer term planning.

As we have seen, since the government began to make progress on its ambitious social agenda, in part through generous increases in benefits and tax credits carefully targeted at families with children and pensioners, the



The 2004 spending review: slicing the pie

social protection budget has increased slightly as a proportion of GDP. The logic is inescapable that it must continue to maintain if not increase its share as a proportion of GDP if the government is to continue to make progress against its poverty objectives. Poverty is defined in relative terms, so that the threshold rises in line with the growth in median average incomes. The main factor determining the underlying real rate of growth in median incomes is the underlying rate of growth of productivity, which in turn is also the main driver behind the underlying rate of growth of GDP. Just for relative poverty to remain constant we would expect that the government would have to keep key benefits and tax credits growing in line with median real incomes and to make inroads into relative poverty, further increases in their relative generosity would be required. So the period after 2000-01 when the social protection budget has been increasing as a proportion of GDP is probably indicative of a trend that would probably have to continue if the government is serious about tackling poverty.

To get a sense of the scale of resources required, we can go through the exercise of seeing how much it would cost to halve child poverty, as the government is pledged to do by 2010, if it was done in one fell swoop in April 2004 (Brewer, 2003). It would cost £5.5 billion or about one half of one percentage point of GDP. This of course is equal to the amount of the *reduction* in spending outside of health that the government needs to achieve in the 2004 spending review.

The government has placed great emphasis on work as an important route out of poverty, which suggests a continued emphasis on spending on employment programmes, which is discussed further below when we look at the economic services. The government is faced with the significant challenge of making inroads into the still relatively high levels of economic inactivity amongst key groups, including sick and disabled people. In so far as it is able to achieve this, some of the pressures on the social protection budget may be alleviated. However, in relation to those claiming benefits related to sickness and disability, policy makers are now on their third attempt since 1995 to arrest the growth in the numbers of recipients. It would not be prudent to anticipate rapid progress over the period from 2005-06 to 2007-08 that would allow one to arrive at a different judgement about the trends in the social protection budget.

Early years services and childcare

It might seem strange to want to break off from discussing the social protection budget to address this important area of public policy. However, it is in the context of the government's child poverty pledge and its ambitions to



The 2004 spending review: slicing the pie

boost employment that this agenda needs to be addressed. This is because the expansion of childcare and early years provision is seen to meet two separable objectives:

- allowing more parents, and specifically mothers, to go out to work in the formal economy and
- improving the cognitive and emotional development and health of young children.

It is often asserted that public policy in relation to childcare and early years services allows both objectives to be achieved simultaneously. However, the precise configuration of services and their funding can have an impact on which of these objectives are implicitly being given priority. There is a complex and controversial literature on whether mothers working full-time or part-time when their children are very young, does or does not have an impact on their development, dependent in turn on the form of childcare being provided. There is also a debate about the kind of experiences that pre-school provision should emphasise and how early or late an emphasis on skills such as literacy or numeracy should be introduced. One study has been especially influential in persuading British policy makers to give greater emphasis to early years provision, but interestingly it revealed that the benefits for children were the same regardless of whether provision was full-time or part-time (Sylva et al 2003). On the other hand full-time childcare might be most likely to boost the labour force participation of women.

It is important then for policy makers to clarify which of the two broad objectives – the development of children and/or female labour force participation – they wish to prioritise. This distinction is also likely to help decide how the costs of provision should be divided between the state and the individual, which will be another key feature of the debate in this area. The other difficult trade-off here is that boosting female labour force participation may help reduce child poverty over the medium term. Fostering the better development of today's children may help improve their lifetime incomes and those of their children over the very long run - but probably beyond even the time scale of the 2020 pledge on child poverty.

The 2004 spending review process has been informed by separate childcare and child poverty reviews. The 2004 review will almost certainly try to signal that childcare is a priority area for the government and there may be a new PSA target here. However, what the spending review process cannot easily do is address the trade-offs between spending on childcare and early years services and spending on benefits and tax credits, because the latter are excluded from the review. So the spending review process does not allow one



The 2004 spending review: slicing the pie

to take an all-round view of the government's social justice agenda. The fact that most policy makers share as articles of faith both the aspiration to tackle child poverty and the desire to further develop early years services does not make these choices any easier.

The extra gross costs to the taxpayer of providing universal full-time childcare to all 1-4 year olds would be £7.3 billion at 2003 prices, assuming that parents paid 25% of the costs (Hawksworth 2003). The net costs will be lower depending on the extent of any increase in labour force participation as this would result in extra tax revenue and reduced benefit payments. The extent of these net costs to the public finances depends on the assumptions made about the size of the increase in labour force participation, but under any plausible assumptions these costs would always be significant. Of course the government might want to do other things as well as or instead of offering universal full-time childcare to 1-4 year olds, such as expand Sure Start and children's centres or open all primary schools from 8-6 to help the parents of primary school age children work full-time. The more options there are, the higher the net cost will be.

Unfortunately, one could reach a very pessimistic conclusion here. The overall pressures on the government's budget might put beyond reach any really ambitious new agenda in relation to more generous provision for childcare and early years services. Alternatively the government might find that in order to continue to increase spending on the range of departmental priorities that are covered by the spending review, it does not have any resources left over to continue to increase annually the tax credits and benefits necessary to meet its poverty pledges. Either of these outcomes would be deeply disappointing for all those who want to believe that the current government can deliver social justice.

Personal social services: the surprise winner

It is perhaps the most surprising thing to discover that under successive governments the personal social services have been consistent winners in terms of spending as a proportion of GDP. It is surprising because the commissioners and providers of social care always see themselves as under-funded and their contribution and importance under-appreciated. Part of the problem of course is that the social care world most closely compares itself with the NHS. Funding increases are often more generous in health and the issues generated by the boundary problems between health and social care services often seem to result in blame falling on the social care side.

The 2004 spending review: slicing the pie

There is, however, another explanation that throws into stark light one of the key dilemmas facing all the public services. Although by 2002-03, the personal social services were absorbing 1.5% of GDP compared with just 0.9% of GDP in 1989-90, this growth in resources has had to keep pace with ever growing identified needs amongst a series of vulnerable populations. It is this juxtaposition of needs and resources that helps to resolve the paradox that spending can carry on rising, but the social services feel under constant pressure.

This observation does not help in terms of resolving the dilemmas over the 2004 spending review. Is it an option for a Labour government to attempt to hold the rate of growth of spending on the social services to less than the underlying rate of growth in the economy so that the budget for this core area shrinks as a proportion of GDP? The Conservative government did not manage to achieve this during the 1990s. Moreover, those difficult linkages between health and social care mean that if social services are struggling with resources, there will be a knock on effect on the NHS, which the government will want to avoid. Finally, the government has set out an ambitious agenda for the social services, not least in its Green Paper on children's services (HMT 2003). It expects local authorities to be establishing children's trusts by 2006 to bring together the commissioning of children's social services and education and related services. As this process will be taking place during the period covered by the spending review, it will not be good public policy to deny local authorities the resources to make these reforms work. At the same time the government will be facing other pressures, to offer more assistance to carers, for example.

The personal social services are almost certainly then going to have to continue to be surprise winners in the spending stakes, at least in the sense that spending will need to rise in line with and maybe even a little bit faster than the underlying rate of growth in the economy.

Economic services: a case for cutting?

The Labour government has continued the long-running trend of shifting relative resources away from supporting sectors and firms in the British economy towards supporting individuals. This is consistent with the objective of making more efficient the functioning of a market economy, by allowing structural change to take place and resources to be transferred from declining sectors, while helping individuals to adjust to that structural change. The trends in this core area of spending do therefore illustrate Labour attempting to come to terms with the market economy. However, the government also faces strong industry lobbies and has a heartfelt desire to show that it is 'friendly' to



The 2004 spending review: slicing the pie

business, which is not at all the same as wanting to foster an efficient market economy. It also has a Chancellor whose feels the need to signal his commitment to the 'enterprise' agenda by launching a host of new, if relatively small, initiatives in each Budget.

Public spending on the economic services as defined here accounted for about 1.7% of GDP in 2002-03, spread across a number of Whitehall departments, the devolved administrations and other agencies. Nearly a third of this consisted of spending on agriculture, fisheries and food, including market support under the Common Agricultural Policy. Just over a quarter represented spending on employment and training programmes. The science budget and support for technology was a further significant component, accounting for just under one-fifth of the total. Regional and other industrial support accounted for a relatively modest one-seventh of the total. Other costs reflect the continuing legacy of support for some older industries, but also the setting of the regulatory framework for a modern market economy in terms of competition and trade policy, the protection of consumers and the regulation of the labour market.

This core area of public spending thus contains some of the areas the government has given the greatest priority to, certainly in terms of its rhetoric, but also in terms of the allocation of resources. This includes the science budget, spending on the new deals and other employment and skills programmes and a significant part of the budgets of the Regional Development Agencies and their counterparts in the devolved nations. Allied to these areas of spending are some of the PSA targets the government would regard as amongst the most important, including those related to closing the productivity gap, improving employment rates amongst disadvantaged groups and narrowing regional disparities in prosperity. The latter two targets would feature highly on any list related to the achievement of social justice. The 2004 Budget has already been flagged up as a Budget for science, enterprise and skills, though in spending terms this is likely to mean less than one might think.

However, this core area also includes several areas of spending that are frequently the targets for criticism, sometimes well founded and sometimes not. The Conservatives have criticised the alleged ineffectiveness of the new deal programmes and pledged their abolition. Others have called for the dismantling of the Department for Trade and Industry. Many observers doubt the cost-effectiveness of elements at least of the industrial and regional support programmes. Many more feel that agricultural support uses up resources that could definitely be better utilised elsewhere. Here then is potentially some real 'waste' waiting to be eliminated.



The 2004 spending review: slicing the pie

Is it practical politics to cut back spending sharply in some of these areas? Certainly not the science or the employment and training budgets. Criticism of the new deal employment programmes is wide of the mark, in relation to both their scale and their impact. In 2002-03 they cost just £600 million, about one half of one tenth of one percentage point of GDP. The programmes aimed at young people and lone parents have been successful in boosting employment rates - though rather than helping 460,00 young people to find jobs as the 2003 Pre-Budget Report claimed, employment might have risen by about 17,000 amongst this target group (OECD 2004). Part of the problem here is the government's own spinning. Those who advocate the abolition of the DTI need to be aware that its single biggest item of spending is science, accounting for over two-fifths of the departmental budget. Having given such great prominence to a series of generous settlements here, it seems unlikely that sharp reductions in science spending would go down well.

There is certainly a very good case for questioning the effectiveness of many of the DTI's business support programmes, as the DTI itself has claimed it would do in a review of its spending. Whether this will lead a department of state to voluntarily recommend a reduction in its budget seems unlikely. The Treasury, however, is likely to point out that the department has been the one most guilty of consistently under-shooting its allocated budget. If tough choices are to be made, the DTI's programmes would seem to be the place to make some of them. On the other hand the RDAs now administer many of these programmes and have collectively become a very powerful lobby in their own right. Signalling a reduction in their budgets in the summer of 2004 ahead of referendums on elected regional assemblies in the autumn is not practical politics. And although the DTI runs a plethora of programmes, expenditure on each one is modest. Halve the DTI's spending on industrial and regional support programmes and you save £600 million – one half of one tenth of one percentage point of GDP.

Support for agriculture amounts to half a percentage point of GDP – just the amount needed in terms of a reduction in overall spending given the commitments to health. However, much of that is support mandated under the CAP and the government decided in February 2004 to *redistribute* agricultural subsidies in England away from being linked to food production towards management of the land and rural environment over an eight-year period from 2005. This will not, however, free up resources for other priorities. While there must undoubtedly be scope for reductions elsewhere in the agriculture budget, the rural lobby is another force that the government has come to have some regard for, not least in terms of its ability to generate disruptive demonstrations in Whitehall.



The 2004 spending review: slicing the pie

The economic services might then be one core of public spending where the rate of growth of spending overall could be reduced so that it fell as a proportion of GDP. But over the two years effectively covered by the spending review it seems unlikely that this one area alone could create the savings in the overall public finances that the government needs to find. Once you look at particular areas the scope for reductions in spending seem modest and there are powerful lobbies waiting to challenge any proposed cuts.

Housing and environmental services: pressures and choices

Public spending on housing and environmental services accounted for about 1.6% of GDP in 2002-03. Of this, housing alone accounted for only one-quarter of the total. The remainder covered spending on environmental protection, urban and rural development and a range of day-to-day environmental services administered by local authorities. The housing budget was slashed in the 1990s - public spending on housing fell from 1% of GDP in 1989-90 to 0.3% of GDP in 2001-02. As a proportion of GDP it will barely recover under the plans outlined in the 2000 and 2002 spending reviews. Spending on all the other environmental services was fairly constant as a proportion of GDP over the 1990s. Even at times of fiscal stringency the refuse has to be collected and EU environmental directives have to be met.

This latter observation means that the rate of growth of overall spending on environmental services is unlikely to be easily constrained. It has been pointed out that the implementation of EU requirements relating to waste management might cost £1 billion a year or about one tenth of one percentage point of GDP (Smith and Ekins 2003). Even without the push from the EU, environmental objectives are high on the government's agenda and the quality of local environmental services are high on the public's agenda. The government also has a major rhetorical and practical commitment to the rural and urban agendas and there are powerful lobbies here, including the RDAs. On the other hand many of the questions asked about the effectiveness of the DTI's industrial and regional support programmes should also be asked of some of the government's urban policy initiatives.

One consequence of the dramatic reduction in the housing budget in the 1990s was the virtual cessation of new local authority build, with the housing associations not able to take up much of the slack. Policy makers worry about the overall reduction in all forms of new house building by the private or social sectors, which has fallen to post-war lows, and the rising real cost of housing which has been the consequence. The Treasury has commissioned Kate Barker to look into this issue. There are only two ways to *fund* new housing



The 2004 spending review: slicing the pie

investment, whether it is private or social housing: the users of housing can pay (those in social housing through their rents) or the public can pay out of tax revenue. Much ingenuity can be spent on devising *financing* mechanisms for housing investment, but in the end it is individuals that pay for their housing, either as individuals or collectively as taxpayers. If as a nation we want to devote a higher proportion of the nation's resources to housing investment, this has to be at the expense of something else.

In terms of the 2004 spending review, it is inconceivable in the context of all the pressures facing the public finances that housing's share of public funding as a proportion of GDP will rise. It could even be one candidate for squeezing further, for the simple reason that it has proved such a good target in the past. Of course this would leave the government open to the charge that housing was one area where the government was going to leave spending as a proportion of GDP lower than it inherited in 1996-97 when public spending was 0.6% of GDP. However, if you give absolute priority to health, the consequences for other areas of policy have to be accepted.

Overall, given the government's environmental objectives and the constraints imposed by meeting EU directives, even if housing gets squeezed again, this is not one of the core areas of public spending where expenditure as a proportion of GDP is likely to fall significantly.

Conclusions: The dilemmas of the 2004 review

It should by now be clear that there is only a set of very hard choices to be faced up to in the 2004 spending review. If we re-cap the discussion on the nine core areas of public spending, it is clear that making room for the rising share of **health** spending must involve making unpalatable choices in one or more of the other core areas of spending. Table 3 sets out the likely paths for spending as a proportion of GDP for those areas. In reading it, one must come back to the basic arithmetic that spending outside of health must fall by half a percentage point of GDP, which means one or more of the other core areas of spending must see their share fall. If the shares of any areas other than health are likely to rise, this makes it even more important that the shares of some other core areas must fall.

Table 3: Public Spending Choices to 2007-08

	(Spending as a % of GDP)
Health	Up from 7.2 to 7.9
Education	Constant
Transport	Constant or Declining
Law, Order and Protective Services	Constant
Defence and Overseas	Decreasing Marginally
Social Protection	Constant or Increasing
Personal Social Services	Increasing
Economic Services	Decreasing
Housing and Environmental Services	Constant

Only for the **economic services** is it feasible to think that spending in all likelihood could decline as a proportion of GDP as some programmes of industrial and agricultural support are reduced or even eliminated. However, it is hard to say how much this would save as a proportion of GDP and some powerful lobbies would be offended. **Defence** spending might be frozen in real terms, which would mean that it would fall by one-tenth of one percentage point of GDP over the period covered by the review. However, there should be pressure for the **development** budget to rise as a proportion of national income. And over the long-term freezing the defence budget must force policy makers to face up to reality of whether Britain can continue to 'punch above its weight' in the international arena by having such capable armed forces.

The only other likely options for a declining share of the public spending pot are **transport** or **housing**, for the simple reason that cutting these budgets has

Tough choices: The 2004 Spending Review



Conclusions: The dilemmas of the 2004 review

been so easy in the past. However, a renewed bust in transport spending would carry with it a large political price and make it more difficult to achieve an ambitious agenda in relation to congestion charging over the medium and long term. For these reasons it should be avoided, though this is not good news for housing. Elsewhere in the **environmental services**, the pressures for spending seem unlikely to abate.

In the **personal social services**, the government's ambitions for some key services allied to the historic trend for expenditure in this area to rise to meet identified needs implies spending may continue to increase as a proportion of GDP. If the government wants to make further progress in reducing poverty and in the absence of rapid progress in tackling economic inactivity, the **social protection** budget may also need to rise as a proportion of GDP.

The logic of all these arguments leads to at least one surprising conclusion. The **education** budget should not rise significantly if at all as a proportion of GDP over the period of the next spending review, if the government wishes to meet other pressing priorities. Politically, this is likely to prove very hard for the government to sell, especially as the Conservative Opposition has signalled that spending on schools will be one of its priorities. It is likely that the share of **law, order and the protective services** will be maintained, though as with education this implies a significant deceleration in the rate of growth of real spending compared with the first half of this decade. This will also be hard to present to a public that does not believe that crime has fallen.

Would table 3 add up if in fact we added some numbers? That is to say if we were more explicit about the shares of GDP likely to be devoted to public spending in the eight core areas outside of health, would it be possible to illustrate how the necessary half-a-percentage point reduction in spending as a proportion of GDP could be attained? The answer is no. Even with plausible assumptions about the core areas that could be squeezed and those that would probably require the same or a higher proportion of resources, it is very difficult to make the numbers add up.

And there lies the dilemma of the 2004 spending review. Even if the government faces up to some tough choices in relation to industrial and agricultural support, defence and housing and lowered expectations in education and law and order, it might still face yet further tough choices. If we think in terms of the targets for key policy outcomes rather than just spending totals, the government will have to reconcile meeting those targets necessary to retain electoral support and those targets that might write this government's place in the history books. The stakes could not be higher.



References

- Blair, T. (2003), Opening Plenary in Progressive Politics, Vol. 2.3, September 2003, Policy Network.
- Brewer, M. (2003), 'What do the child poverty targets mean for the child tax credit? An update', Institute for Fiscal Studies Briefing Note No. 41, IFS.
- Conservative Party (2004), 'Medium Term Expenditure Strategy: Avoiding Labour's Third Term Tax Rises'.
- Foley, J and Fergusson, M. (2003), 'Putting the brakes on climate change', IPPR, 2003.
- IPPR (2001), 'Building Better Partnerships: The final Report of the Commission on Public Private Partnerships', IPPR 2001.
- Grayling, T. (2004), 'Social justice, sustainable mobility and the ten-year transport plan', forthcoming in Foley, J., (ed.) 'Sustainability and Social Justice', IPPR 2004.
- Hawksworth, J. (2003) 'Universal childcare provision in the UK: towards a cost-benefit analysis', PricewaterhouseCoopers, August 2003.
- Her Majesty's Treasury (2003), 'Every Child Matters', September 2003.
- Ministry of Defence (2003), 'Delivering Security in a Changing World: Defence White Paper', MoD, December 2003.
- OECD (2003a), 'Health at a Glance: OECD Indicators 2003', OECD 2003.
- OECD (2003b), 'Education at a Glance: OECD Indicators', OECD 2003.
- OECD (2004), 'OECD Economic Surveys 2004: United Kingdom', OECD 2004.
- Robinson, P. (2004), 'How do we pay? Funding Public Services in Europe', The Centre/IPPR 2004.
- Smith, D. and Ekins, P. (2003), 'Report to Green Alliance: Public spending on the Environment (Spending Round 2004)', Policy Studies Institute, 2003.



References

Sylva, S. et al (2003), 'The Effective Provision of Pre-School Education (EPEE) Project: Findings from the Pre-School Period', Institute of Education, University of London

Wanless, D. (2002), 'Securing our Future Health: Taking a Long-Term view', HM Treasury, April 2002.



Figure 2: 1989-1990
Total Spending 39.7% GDP

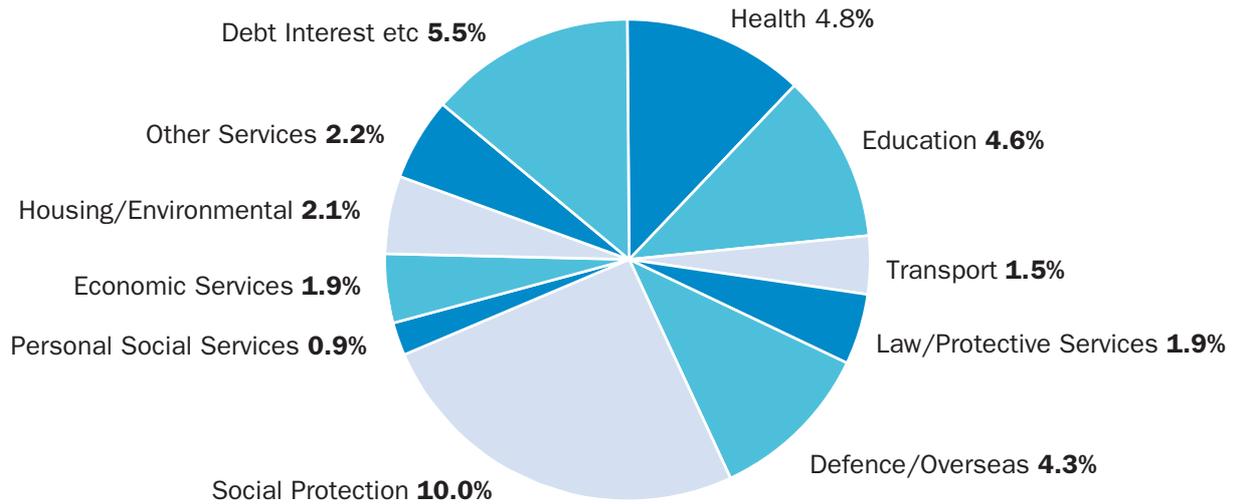


Figure 3: 1996-97
Total Spending 41% GDP

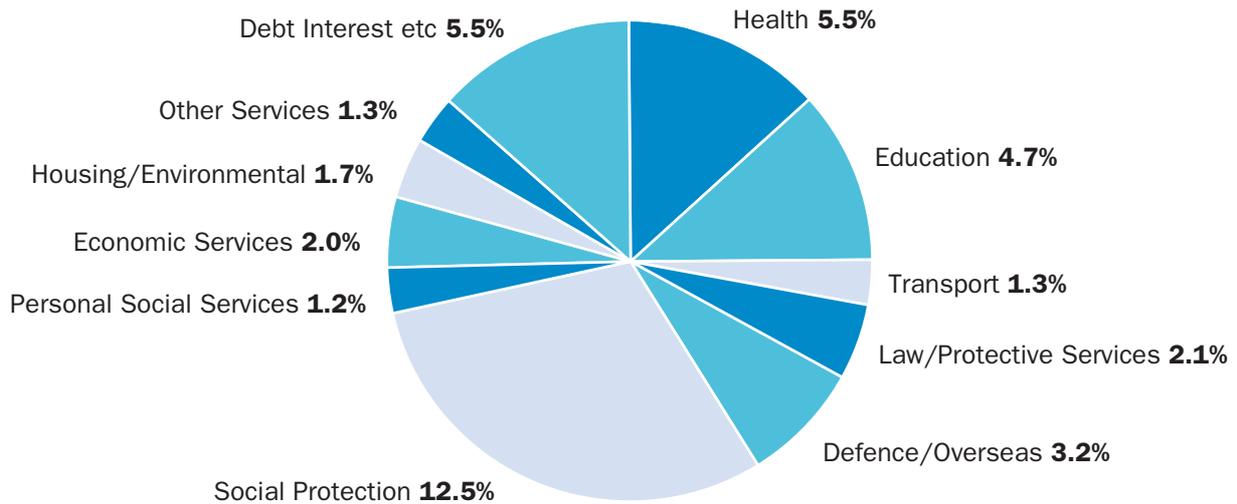




Figure 4: 1999-2000
Total Spending 37.4% GDP

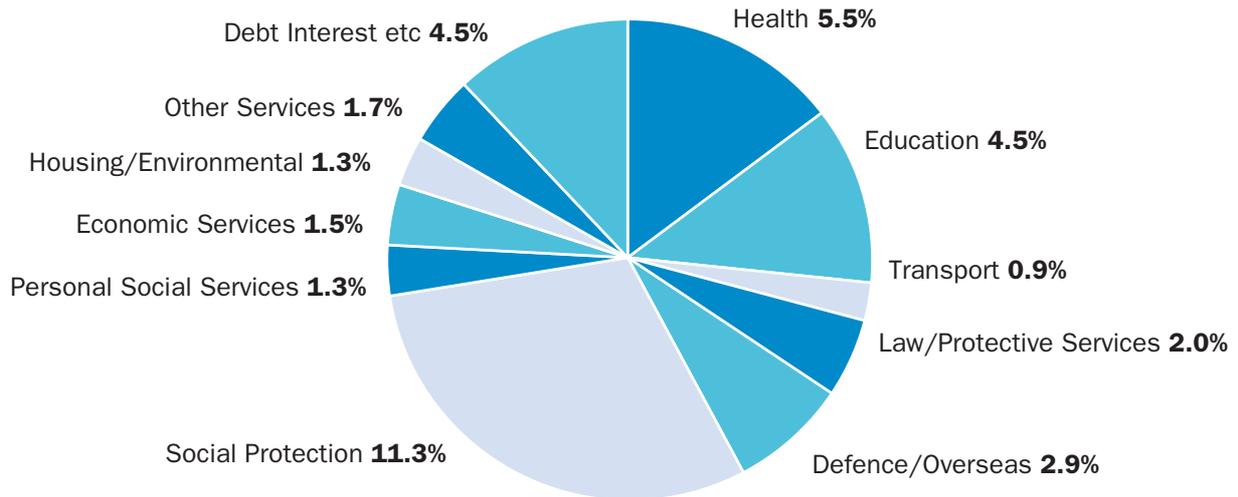


Figure 5: 2002-2003
Total Spending 39.7% GDP

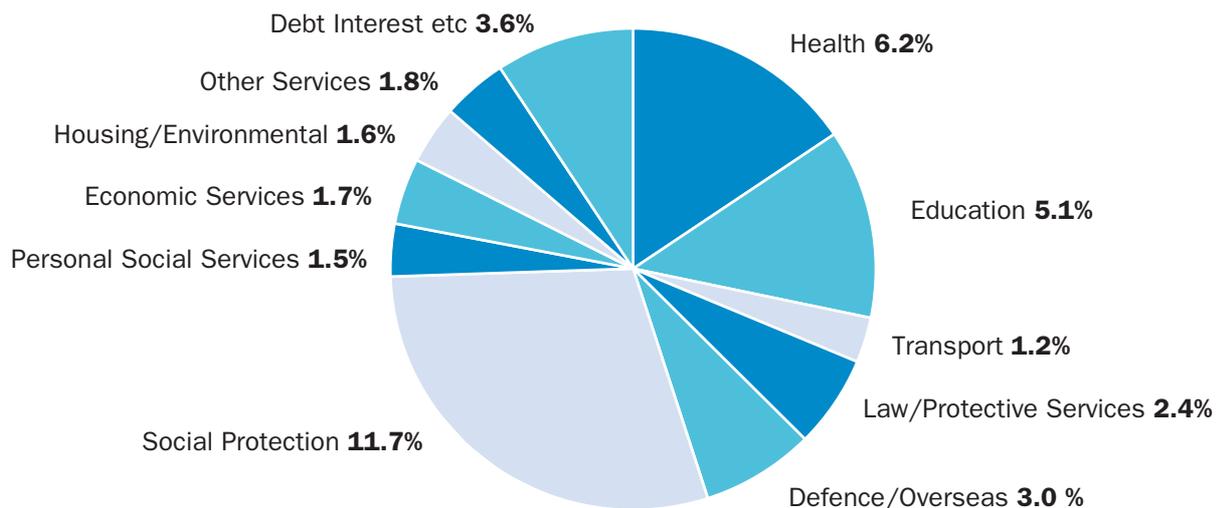




Figure 6: 2005-2006
Total Spending 41.9% GDP

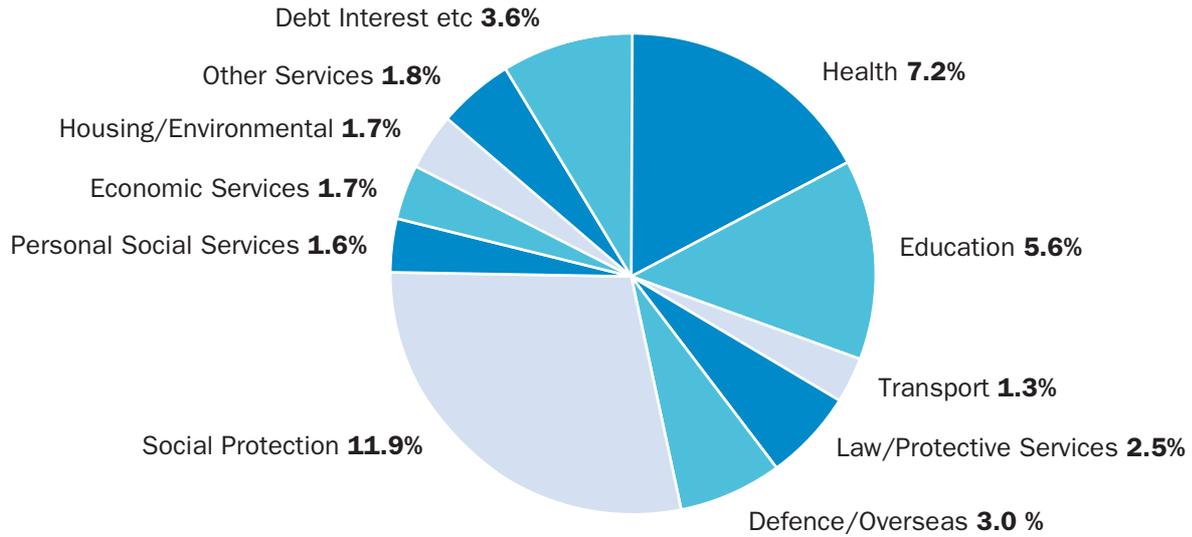


Figure 7: 2007-2008
Total Spending 42.1% GDP

