

## 6. Risks to the rules: public spending

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### Summary

- The government's objective of having a budget surplus in 2019–20 is set to be achieved with a level of public spending that will be the lowest as a share of national income for over 60 years with the exception of 1999–2000 and 2000–01. Spending on public services in 2019–20 is set to fall to its lowest level as a share of national income since the early 2000s. Spending on services outside of health will be at its lowest level since at least 1948–49.
- Public service spending by central government and local authorities is forecast to be cut by 1.0% between 2015–16 and 2019–20, compared with 8.3% between 2010–11 and 2015–16.
- A growing and ageing population will increase demands for many public services. Public service spending per person by central government and local authorities is forecast to fall by 3.7% over this parliament and by 14.9% between 2010–11 and 2019–20. While NHS spending is expected to grow by 6.1% in real terms over the parliament, over three-quarters of this real increase will be needed just to keep pace with the changing size and demographic structure of the population.
- In addition, changes to National Insurance contributions will cost public sector employers an additional £3.3 billion a year, while Resolution Foundation estimates suggest that the new National Living Wage could cost more than £1 billion a year.
- The government's spending plans imply that public sector pay will fall to much its lowest level relative to the private sector since at least the mid 1990s, when comparable data are available. This could result in difficulties for public sector employers trying to recruit and retain high-quality, motivated workers and raises the possibility of (further) industrial relations issues.
- The Chancellor has set out £12 billion of cuts to annual spending on working-age benefits and tax credits by 2019–20. This is the same magnitude, but two years later, than pledged in the Conservative Party manifesto. Benefit levels for some groups will reach very low levels relative to earnings by comparison with historical rates. One risk to the public finances is that the latest disability benefit reforms might not deliver as large or swift a cut to spending as forecasts assume.
- Lower expected interest rates or further delay to the expected date at which the Bank of England begins to unwind quantitative easing would reduce expected debt interest spending. But both of these would likely indicate a weaker, not stronger, economy. So, while they would reduce debt interest spending, they would likely signal bad news overall for the UK's public finances.
- Together, the risks to revenues and to spending, combined with the OBR's central estimate of a surplus of (only) 0.5% of national income in 2019–20, suggest that there is a significant chance that the government's current fiscal plans will not deliver the targeted surplus in that year without further tax rises or spending cuts.

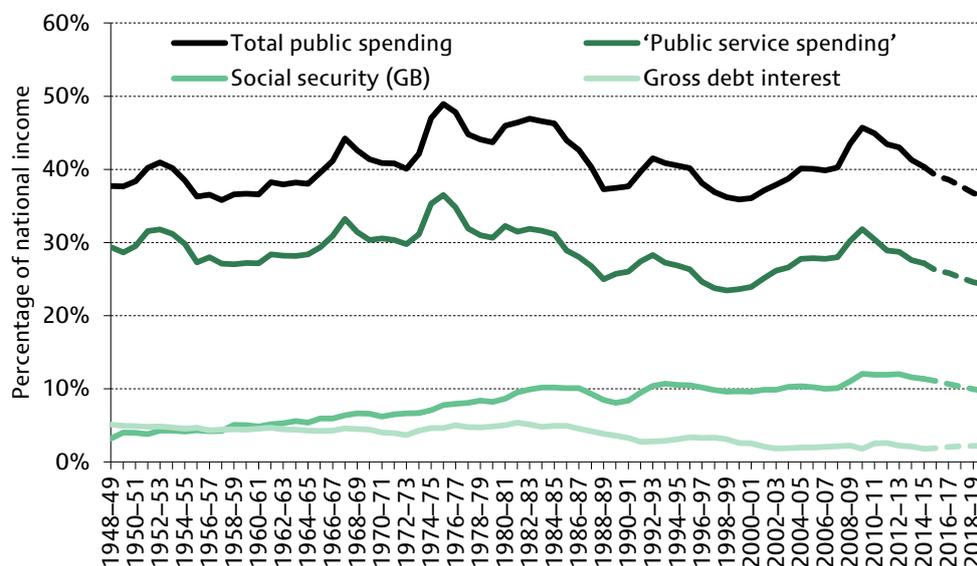
## 6.1 Introduction

The government intends to reach a budget surplus of 0.5% of national income in 2019–20 by increasing tax revenues over this parliament by 1.1% of national income and reducing total public spending by 3.2% of national income. Total public spending (excluding housing associations) in 2019–20 would then amount to 36.1% of national income. This would be the lowest level of public spending for 60 years, with the exception of 1999–2000 and 2000–01 (shown in Figure 6.1).

Within public spending, spending on social security (in Great Britain) is planned to be cut by 1.4% of national income over the parliament, bringing it down to around the share of national income that it was at for most of the period from 1980–81 to 2007–08. Debt interest spending, on the other hand, is expected to increase slightly, by 0.3% of national income, as the recent sharp rise in the national debt feeds through into higher debt servicing costs. This leaves all other areas of public spending, which can broadly be referred to as ‘public service spending’, being cut by 1.9% of national income between 2015–16 and 2019–20. This would reduce public service spending to 24.2% of national income, a low level by recent historical standards. The only other sustained period since the end of the Second World War where spending on public services as a share of national income has been below 25% of national income was throughout the first term of the last Labour government (from 1997 to 2001). For spending on public services outside health, the picture is more dramatic: in 2019–20, this is set to fall to its lowest level as a share of national income since at least 1948–49.

A key question for the government’s ability to achieve a surplus in 2019–20 and thereby meet its new fiscal mandate (discussed in more detail in Chapter 3) is whether or not

Figure 6.1. Public spending over time



Note: Total public spending excludes housing associations throughout; the reduction in total public spending between 2015–16 and 2019–20 on this measure is 3.0% of national income. ‘Public service spending’ is defined as total public spending less gross debt interest and social security spending.

Source: Total public spending is from the OBR’s Public Finances Databank, adjusted for housing associations using table 4.15 of OBR, *Economic and Fiscal Outlook*, November 2015. Social security is Great Britain only, and is from DWP Benefit Expenditure Tables. Gross debt interest is ONS series JW2P, with forecasts from fiscal supplementary table 2.35 of the OBR’s November 2015 *Economic and Fiscal Outlook*.

these spending plans are feasible. The uncertain outlook for economic growth certainly presents some risks. If future growth were to disappoint, then spending plans that have been (at least in principle) fixed in cash terms – such as the budgets allocated to central government departments – would represent larger-than-anticipated shares of national income. In the absence of further policy change, this would likely feed through into higher borrowing, since tax revenues would fall as growth falls. Furthermore, lower-than-anticipated growth would be likely to increase cash spending as well; spending on cyclical benefits, for example, would tend to increase.

Even if future growth evolves as expected, there are risks around the government being able to stick to its planned cash levels of public spending for the parliament. It is these risks that we discuss in this chapter. We start in Section 6.2 by describing in more detail the government's plans for cuts to public service spending over the parliament, the risks to public service quality, and the political risks around whether the plans will be delivered. We then turn to social security spending in Section 6.3 and consider some of the reasons for uncertainty around whether social security spending will be cut as planned. Finally, we discuss debt interest spending in Section 6.4 and the uncertainty around the future level of that spending. Section 6.5 concludes by summarising the risks to the government's spending plans, and drawing together Chapters 5 and 6 to discuss the uncertainty around the government's planned path for deficit reduction.

## 6.2 Public service spending

The measure of 'public service spending' described above is very broad – it includes all public spending outside that on debt interest payments and social security transfers to individuals. A measure for spending on public services more commonly used in recent years has been 'departmental spending' (formally 'departmental expenditure limits' or DELs) – essentially, central government departments' budgets for administration and programme delivery, and the grants given to English local authorities and the devolved administrations of Scotland, Wales and Northern Ireland. Departmental spending was cut by more in real terms<sup>1</sup> over the last parliament than broad public service spending – by 10.4% between 2010–11 and 2015–16 compared with 4.4% (set out in Table 6.1). Going forwards, cuts to departmental spending are planned to continue, with a cut of 2.3% between 2015–16 and 2019–20. This is a significantly slower pace of cuts than over the last parliament (an average 0.6% per year, compared with an average of 2.2% per year) but these cuts come on top of those already delivered, taking the total cut since 2010–11 to 12.4%.

In addition to departmental spending, public services are also funded by 'local authority self-financed expenditure' (LASFE). This is spending financed by revenue raised and retained locally by English local authorities and the devolved administrations of Scotland, Wales and Northern Ireland – namely through council tax and rates on non-domestic properties.<sup>2</sup> LASFE increased by 11.6% between 2010–11 and 2015–16 and is forecast by the Office for Budget Responsibility (OBR) to increase by a further 8.7% between 2015–

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<sup>1</sup> When deflating public service spending, we use economy-wide inflation as measured by the GDP deflator.

<sup>2</sup> For the most part, this revenue is not tied to spending on specific purposes (the police precept on council tax being one exception). Local authorities combine the revenue they raise with block grants from central government to finance all the services they are responsible for, which include social care, transport, environment and refuse services, social housing, and cultural services.

Table 6.1. Change in public spending this parliament and last

	Spend in 2015–16 (£bn)	Real-terms change (%)		
		2010–11 to 2015–16	2015–16 to 2019–20	2010–11 to 2019–20
<b>Total public spending</b>	744.6	–3.1	+1.4	–1.8
<i>Of which:</i>				
Debt interest	35.9	–17.8	+29.8	+6.7
Social security (GB)	210.7	+3.2	–4.2	–1.1
‘Public service spending’	498.0	–4.4	+1.7	–2.8
<i>of which:</i>				
Departmental spending (DEL)	356.8	–10.4	–2.3	–12.4
Local authority self-financed expenditure (LASFE)	46.3	+11.6	+8.7	+21.4
Other <sup>a</sup>	94.9	+17.1	+13.1	+32.4
<b>DEL plus LASFE</b>	<b>403.1</b>	<b>–8.3</b>	<b>–1.0</b>	<b>–9.3</b>

<sup>a</sup> ‘Other’ areas of ‘public service spending’ include net spending on public service pensions, spending by the BBC, transfers to the European Union, depreciation, and spending financed by environmental levies and the National Lottery.

Note: To produce consistent series over time, total public spending excludes housing associations, while central government departments’ spending (DEL) and local authority self-financed spending are adjusted for large classification changes (such as the business rate retention policies, council tax localisation and the reclassification of the Network Rail grant).

Source: Authors’ calculations using HM Treasury, *Spending Review and Autumn Statement 2015*, HM Treasury, *Public Expenditure Statistical Analysis 2015*, DWP, *Benefit Expenditure Tables* and OBR, *Economic and Fiscal Outlook 2015*.

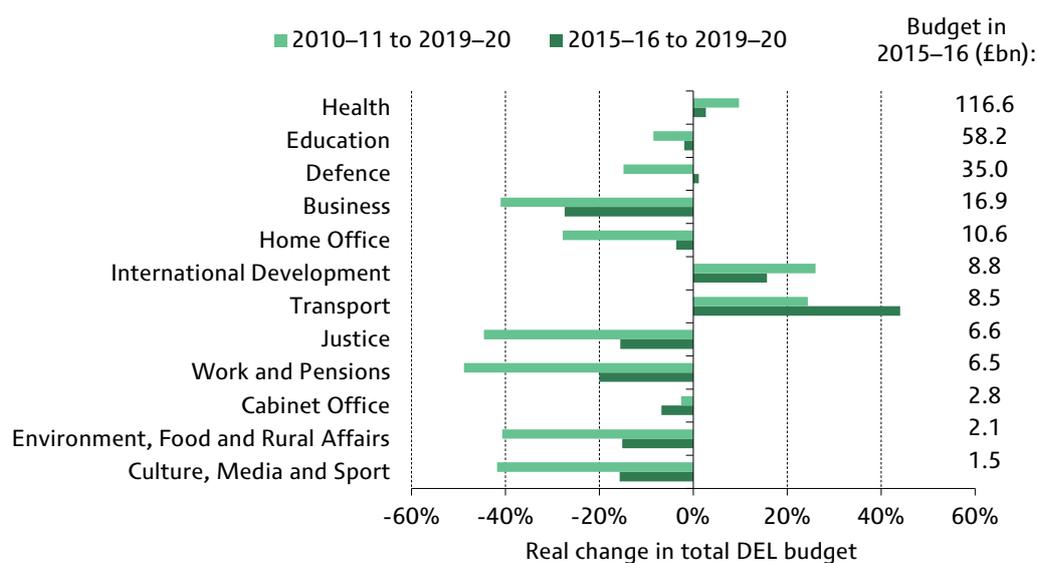
16 and 2019–20. Taking departmental spending and LASFE together, this broader measure of public service spending by central and local authorities is forecast to be cut by 1.0% between 2015–16 and 2019–20 (an average rate of 0.2% per year), compared with a cut of 8.3% between 2010–11 and 2015–16 (an average rate of 1.7% per year).

## Departmental spending cuts

In the Spending Review published in November 2015, the government set out its plans for departments’ budgets for each year up to and including 2019–20. On average, the government plans to cut departments’ budgets by 2.3% in real terms between 2015–16 and 2019–20, but some departments face much harsher budget cuts than others. Figure 6.2 shows the real-terms budget cuts planned between 2015–16 and 2019–20 for the main government departments, ordered by size of department. To highlight that these cuts come on top of those delivered over the last parliament, Figure 6.2 also shows the expected real change in each department’s budget over the whole period between 2010–11 and 2019–20.<sup>3</sup> Across health, education, defence and international development, spending is forecast to grow by 1.7% over the period from 2015–16 to 2019–20, meaning that the cumulative change in these budgets over the nine-year period from 2010–11 will be 0.6%. In contrast, the budgets of other departments are, on average, set to be cut by 7.6% over the next four years, which would bring the cumulative cut since 2010–11 up to 25.8%.

<sup>3</sup> Further discussion of the cuts implemented over the last parliament is available in R. Crawford and S. Keynes, ‘Options for further departmental spending cuts’, in C. Emmerson, P. Johnson and R. Joyce, *The IFS Green Budget: February 2015*, <http://www.ifs.org.uk/publications/7530>.

Figure 6.2. Change in selected departments' budgets, 2010–11 to 2019–20



Note: International Development excludes cross-government official development assistance (ODA) funding from 2015–16 onwards for comparability with the budget in 2010–11; including this funding would imply an 18% real budget increase between 2015–16 and 2019–20 rather than a 16% real budget increase. Transport excludes the capital grant to Network Rail throughout. Defence includes spending on war pensions throughout, but is not adjusted to remove the cost of military operations.

Source: HM Treasury, *Spending Review and Autumn Statement 2015*; HM Treasury, *Public Expenditure Statistical Analyses 2015*; supplementary fiscal tables from the OBR's Economic and Fiscal Outlook, November 2015.

### Health

The largest department, the Department of Health (DH), is expected to see a real-terms increase in its budget between 2015–16 and 2019–20 of 2.7%. This is the result of the government's well-publicised commitment to increase annual NHS spending in England by £10 billion in real terms between 2014–15 and 2020–21 in response to the recommendation of Simon Stevens, the NHS Chief Executive.

The NHS budget (which is a subset of the DH budget) is planned to increase by 6.1% between 2015–16 and 2019–20. However, alongside that, the government expects NHS service provision to increase, in particular with a move towards a seven-day service from hospitals and GPs, and an integration of health and social care services.

In contrast to spending on the NHS, other areas of health spending, such as administration, health spending outside the NHS and spending on training health-care professionals, will be cut by an average of 20.4% over this period. One strategy that has been announced for achieving some of the required cut is that grants for students of nursing, midwifery and allied health subjects will be replaced with loans.

The protection of the NHS from real spending cuts during this parliament builds on a similar commitment last parliament. Over the period 2010–11 to 2019–20 as a whole, the budget of DH is expected to increase by 9.7% in real terms.

### Defence, Transport and International Development

The other main departments that are planned to see increases in their budgets between 2015–16 and 2019–20 are the Ministry of Defence, the Department for International

Development (DfID) and the Department for Transport (DfT). DfID is expected to see a real increase in its budget over the parliament as a result of the government's commitment, enshrined in law, to continue to spend 0.7% of national income on aid each year. The DfT is expected to see a particularly large increase in its budget (44%) due to a £4.5 billion real-terms increase in capital spending.

### **Education**

The Department for Education (DfE) is planned to see a budget cut of 1.9% over the period 2015–16 to 2019–20, a smaller cut than planned for most other departments. The government has pledged to protect day-to-day schools spending per pupil in cash terms over the parliament. This is expected to equate approximately to a real freeze in the budget for day-to-day spending on schools, which accounts for two-thirds of the total DfE budget. Most of DfE funding per student for 16- to 19-year-olds in school sixth forms, sixth form colleges and further education colleges in England is also to be protected in cash terms for the rest of the parliament. Furthermore, the government has promised to increase entitlements to free childcare for 3- and 4-year-olds whose parents are in work; these entitlements will increase from 15 hours to 30 hours a week from September 2017, at an estimated annual cost of around £700 million a year.<sup>4</sup> This means other areas of education spending, such as administration and other spending on early years education, face greater cuts over the coming years than the cut to the overall DfE budget implies. Over the whole period since 2010–11, the total DfE budget is expected to be cut by 8.5%.<sup>5</sup>

### **Home Office**

The Home Office is planned to see a cut to its budget of 3.6% in real terms between 2015–16 and 2019–20. However, within that, police spending has been relatively protected – with central government funding for the police planned to be cut by just 1.4% in real terms – while other areas of the Home Office budget (such as net spending on border, immigration and citizenship services) face greater cuts.

The government expects that increases in the police precept on council tax (which supplements central government grants to the police) will mean that total spending on the police is flat in real terms over the parliament. However, income from central government grants and the council tax precept comprise different fractions of total revenues for different police authorities. Over the last parliament, those authorities that were more reliant on central government grants saw greater cuts to their overall spending power than those that raised a greater fraction of revenues locally.<sup>6</sup> It is currently unclear whether this will also be the case over the coming parliament. It will depend on how the government chooses to change the funding formula that is used to allocate grants between forces; this is the subject of a recent government consultation and ongoing debate.<sup>7</sup>

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<sup>4</sup> Table 2.1 of HM Treasury, *Summer Budget 2015*.

<sup>5</sup> Further detail on how different components of education spending have fared to date is available in L. Sibieta, 'Schools spending', IFS Briefing Note BN168, March 2015, <http://www.ifs.org.uk/publications/7669>.

<sup>6</sup> See R. Crawford, R. Disney and D. Innes, 'Funding the English and Welsh police service: from boom to bust?', IFS Briefing Note BN179, November 2015, <http://www.ifs.org.uk/publications/8049>.

<sup>7</sup> The original Home Office consultation on reforming the police funding formula is available at <https://www.gov.uk/government/consultations/reforming-police-funding-arrangements-in-england-and-wales>. The subsequent House of Commons Home Affairs Committee inquiry report is available as <http://www.publications.parliament.uk/pa/cm201516/cmselect/cmhaff/476/476.pdf>.

### Business, Innovation and Skills

The Department for Business, Innovation and Skills (BIS) faces a large cut to its budget over the coming parliament, although once financial transactions are excluded the real cut planned is 19.2% (or £2.9 billion) rather than 27.4% (or £4.6 billion). Within BIS, some areas are protected, such as spending on science and apprenticeships (which are planned to increase by around £0.5 billion and £0.9 billion respectively by 2019–20), meaning the cuts elsewhere will need to be much greater. One area of spending that is going to be cut is maintenance grants to higher education students from low-income families – these are to be replaced by loans, saving the government over £2 billion per year in the short run.<sup>8</sup> Looking at the whole period since 2010–11, BIS is one of a number of departments that are expected to deliver around a 40% cut to their budget, with a particularly large cut to the BIS budget for funding higher education.<sup>9</sup>

### Cuts to English local government spending

In England, local authority spending on public services is funded by revenue from three main sources: grants from central government (predominantly from the Department for Communities and Local Government, DCLG), revenues from council tax and revenues from business rates. Between 2015–16 and 2019–20, the grants to local authorities from DCLG (which form part of ‘departmental spending’) are planned to be cut by 56% in real terms.<sup>10</sup> However, partially offsetting that, the OBR is forecasting that both council tax receipts and the revenues from the proportion of business rates retained by local authorities will grow by around 9% over the period. Taking these three sources of revenue together, local government spending power is expected to fall by around 7% between 2015–16 and 2019–20.

These cuts come on top of the cuts to local government spending power that occurred between 2009–10 and 2015–16, but represent a slower pace of cuts. Though grants are set to be cut slightly faster over this parliament than last (at an average annual rate of around 17% compared with 13%), receipts from council tax and business rates are forecast to grow more rapidly over the current parliament than they did over the last parliament.

The other notable difference in the planned cuts to local government spending in this parliament compared with the last is that they will be much more equally distributed between local authorities. Previously, cuts in spending power were much greater for local authorities that received a greater proportion of their funding from grants. These are typically poorer local authorities with low council tax bases and/or high spending needs. This pattern arose because DCLG effectively cut all local authorities’ grants by the same proportion, which translated into a larger cut to spending power for those authorities

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<sup>8</sup> In the long run, the saving will be lower than this as not all the loans will be paid back. For a more detailed discussion of this reform, see J. Britton, C. Crawford and L. Dearden, ‘Analysis of the higher education funding reforms announced in the Summer Budget 2015’, IFS Briefing Note BN174, July 2015, <http://www.ifs.org.uk/publications/7904>.

<sup>9</sup> For further detail on changes in BIS non-investment spending over the last parliament, see C. Crawford, R. Crawford and W. Jin, *The Outlook for Higher Education Spending by the Department for Business, Innovation and Skills*, IFS Report R86, November 2013, <http://www.ifs.org.uk/publications/6907>.

<sup>10</sup> The government is also planning to fully devolve business rates by 2020, at which point grants to local authorities will end as full localisation of business rates will actually represent a transfer of significant additional money to councils. The government is expected to be consulting soon on how to devolve business rates fully, and what extra responsibilities it can and should ask local authorities to take on in exchange for the additional revenues.

that were more reliant on central grants than for those authorities with greater local revenue-raising capacity. In contrast, the DCLG's recent 'Provisional Local Government Funding Settlement' (which set out the core grant it plans to give to each local authority in each year from 2016–17 to 2019–20) allocated grants in a way that explicitly takes into account the ability of local authorities to raise revenue locally. The resulting cuts to local authorities' overall spending power are therefore expected to be much more equally distributed, although still greater on average for more grant-reliant authorities. For further detail, see Innes and Phillips (2015) and Innes and Tetlow (2015).<sup>11</sup>

## Risks to delivering the cuts to departmental spending

Whether or not the government achieves its planned cuts to departmental spending over the next parliament will be crucial for the success of its overall deficit reduction plans. One reason for confidence in the government's ability to deliver is its track record over the last parliament. Despite the 10% cut to departmental spending over the last parliament, on the whole departments actually spent less than their budget allocations each year, and particularly so in 2012–13.<sup>12</sup> The cuts planned over the current parliament are also more gradual than those already delivered. On the other hand, one might reasonably assume that any cuts that were easy to identify and deliver were made first and so further cuts may be harder to make.

So past evidence suggests that there is the political will and capacity within government to deliver planned spending cuts. In fact, the forecasts for total departmental spending described above take into account the fact that the OBR expects departments to underspend against their currently-set budgets – for example, by a total of £4 billion in 2019–20 (although these underspends are not factored into the figures for individual departments).<sup>13</sup> This assumption is based on past evidence that departments traditionally underspend relative to any final budget allocation. The question is whether this new round of cuts will nevertheless prove too politically difficult to implement. This risk is not taken into account in the OBR's forecast, although it has in the past chosen to highlight how the planned level of public spending compares with historical precedents, implying that it thinks planned levels might be difficult to achieve.<sup>14</sup>

Whether the planned departmental spending cuts will prove to be politically feasible is uncertain. However, there are at least three important reasons why the real-terms budget cuts presented in Figure 6.2 may actually understate the difficulty facing departments. First, there is rising demand for some public services. Second, these budget cuts may have implications for the ability of public sector employers to recruit and retain public sector

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<sup>11</sup> D. Innes and D. Phillips, 'Council tax rises to ease the pace of cuts to local government budgets', IFS Observation, December 2015, <http://www.ifs.org.uk/publications/8095>; D. Innes and G. Tetlow, 'Central cuts, local decision-making: changes in local government spending and revenues in England, 2009–10 to 2014–15', IFS Briefing Note BN166, March 2015, <http://www.ifs.org.uk/publications/7617>.

<sup>12</sup> The OBR estimates that departments underspent by around £9 billion in 2011–12, £12 billion in 2012–13, £5 billion in 2013–14 and £3 billion in 2014–15 (see fiscal supplementary table 2.18 of the November 2015 Economic and Fiscal Outlook). The reason for the particularly large underspend in 2012–13 is likely political: departments likely came under pressure to reduce their spending in 2012–13 when it became clear there was a risk that, on existing spending plans, borrowing might increase between 2011–12 and 2012–13, which would have been politically awkward for the government.

<sup>13</sup> See table 4.20 of Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2015*, <http://budgetresponsibility.org.uk/efo/economic-and-fiscal-outlook-november-2015/>.

<sup>14</sup> See Office for Budget Responsibility tweet 'Budget moves towards surplus as public spending heads for 80 year low', 3 December 2014, [https://twitter.com/OBR\\_UK/status/540150169355173888](https://twitter.com/OBR_UK/status/540150169355173888).

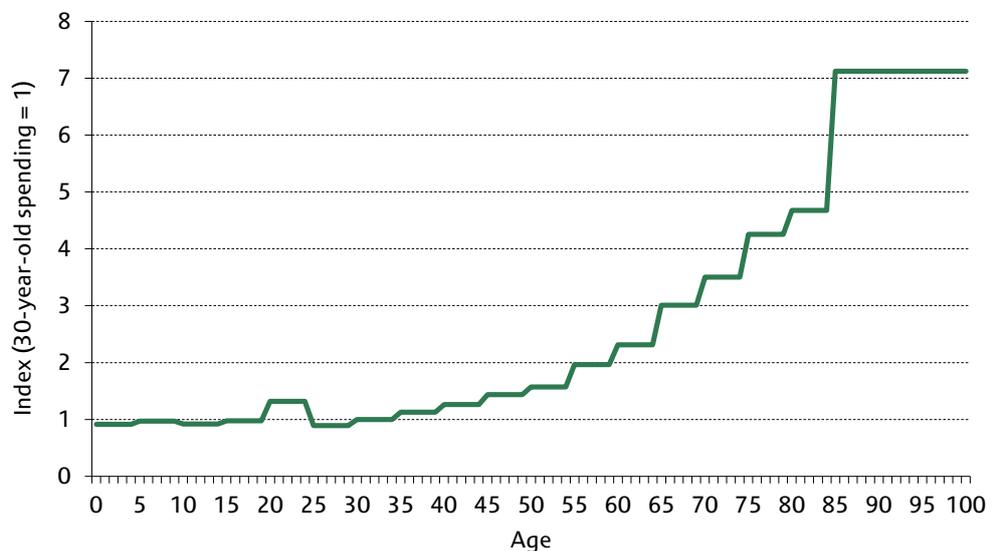
workers of appropriate motivation and quality. Third, there are additional cost pressures facing public sector employers over this period.

### *Increasing demand for public services*

The figures set out in Figure 6.2 describe the changes in departments' budgets in real terms – in other words, after taking into account the cost pressure from economy-wide inflation. Demand pressures are another important factor to bear in mind: the population is forecast to grow by 2.8% between mid 2015 and mid 2019, which will tend to increase pressure on many public services. This means that, while departmental spending is forecast to be cut by 2.3% in real terms over the coming parliament, real public service spending per person is forecast to fall by 4.9%. Between 2010–11 and 2019–20, real departmental spending per person is expected to fall by 17.9%. Taking departmental spending and local authority self-financed expenditure together, this measure of public service spending per person is forecast to fall by 3.7% over this parliament and by 14.9% between 2010–11 and 2019–20.

The UK population is not just growing but is ageing as well. For example, while the population as a whole is forecast to grow by 2.8% over the parliament, the population aged 80 and over is forecast to grow by 10.3%. This places particular demand pressures on public services that are disproportionately used by older individuals, such as health and social care. Older people on average use more, and more expensive, health care. Recognition of these pressures is one reason why NHS spending is planned to be increased in real terms over the coming parliament and why the government has given local authorities the power to raise additional council tax revenues to spend on social care services.

Figure 6.3. Age profile of English health spending, 2011



Note: The age profile for health spending is aggregated from age profiles for Hospital and Community Health Services, Primary Care and prescriptions, weighted according to the share of each of these components of spending within total health spending. The age profiles for the components of spending are based on data published by the Department of Health and therefore relate to health-care use in England.

Source: Authors' calculations based on Department of Health, *Resource Allocation: Weighted Capitation Formula*, 7<sup>th</sup> edition, 2011, <https://www.gov.uk/government/publications/resource-allocation-weighted-capitation-formula>.

Table 6.2. Change in public service spending per person

	Real-terms change	2015–16 to 2019–20	
		Real-terms per-person change	Real-terms per-person (age-adjusted) change
Departmental spending (DEL)	–2.3%	–4.9%	–
DEL + LASFE	–1.0%	–3.7%	–
Department of Health	+2.7%	–0.1%	–
NHS	+6.1%	+3.2%	+1.3%

Note: LASFE is local authority self-financed expenditure. Age-adjusted spending per person for the NHS is estimated using the 2011 age profile of NHS health spending.

Source: As for Table 6.1 and Figure 6.3, plus ONS National Population Projections (2014-based).

Figure 6.3 shows estimated public health spending on individuals of different ages (expressed as a ratio relative to spending on an average 30-year-old) in 2011. This shows, for example, that spending on an individual aged between 70 and 75 is on average three-and-a-half times higher than average spending on a 30-year-old. This means that, while the NHS would need an increase in real spending of 2.8% between 2015–16 and 2019–20 just to keep pace with population growth, a 4.8% increase would be required to keep pace with both the changing size and demographic structure of the population.

As a result, over three-quarters of the planned 6.1% real increase in NHS spending will be needed just to keep pace with the changing size and demographic structure of the population. The NHS also faces demand pressures from the increasing prevalence of some chronic conditions and cost pressures from wages and high-cost drugs. Historically, NHS spending has typically increased at a much faster rate than keeping pace with simple demographic changes would imply. Over the period from 1971–72 to 2010–11, health spending (most of which is spending by the NHS) grew by an average of 4.2% per year compared with population growth of 0.3% and ‘age-adjusted’ population growth of 0.5% per year.<sup>15</sup>

Going forwards, the NHS is hoping to increase productivity by over 2% per year in order to meet the gap between its funding increases and the cost and demand pressures the health service faces. This will be challenging for the NHS: productivity in the NHS is notoriously hard to measure, but the estimates that do exist tend to suggest that annual productivity increases of over 2% would be high by historical standards.<sup>16</sup>

Table 6.2 summarises the real-terms cut and real-terms per-person cut to different areas of public service spending between 2015–16 and 2019–20.

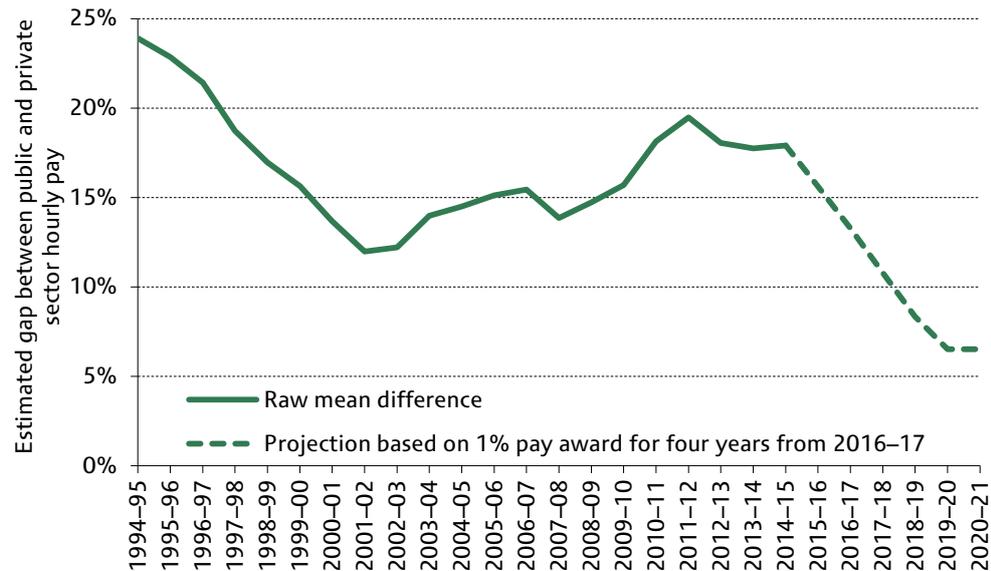
### Public sector pay

Part of the real-terms cut to public service spending over the last parliament was achieved by holding down public sector pay. Pay was frozen in cash terms for all but the lowest-paid public sector workers in 2011–12 and 2012–13, and pay awards were limited to 1% across most of the public sector in 2013–14, 2014–15 and 2015–16. Since private sector wages were also growing slowly over this period, such pay restraint did not have a particularly adverse impact on relative wages. By 2014–15, average pay in the

<sup>15</sup> The last figure assumes that the 2011 age profile of health spending applied throughout the period.

<sup>16</sup> For a review of past estimates of NHS productivity, see annex B of Office for Budget Responsibility, *Fiscal Sustainability Report 2012*.

Figure 6.4. Gap between average public and private pay



Note: Data up to 2014–15 estimated using usual hourly wages from the Labour Force Survey. Projections are based on OBR forecasts.

Source: Authors' calculations using the Labour Force Survey and OBR, *Economic and Fiscal Outlook: November 2015*.

public sector was about the same level relative to the private sector as it had been in 2010–11, and still well above its pre-crisis (2007–08) level.<sup>17</sup> This is shown in Figure 6.4.

However, going forwards, private sector wages are expected to grow more rapidly. The OBR's latest forecast is that average earnings across the private sector will grow by around 17% (in cash terms) between 2015–16 and 2019–20. The government's announced 1% limit on annual pay increases for a further four years from 2016–17 is therefore expected to reduce wages in the public sector to their lowest level relative to private sector wages since at least the 1990s (also shown in Figure 6.4). This could result in difficulties for public sector employers trying to recruit, retain and motivate high-quality workers, and raises the possibility of (further) industrial relations issues.

The restraint on public sector pay in 2016–17 is likely to be felt particularly strongly. Around 80% of public sector workers are members of a defined benefit pension scheme (compared with slightly over 10% in the private sector),<sup>18</sup> and from 2016–17 it will no longer be possible for those with such pensions to contract out of part of the state pension by paying lower National Insurance contributions (NICs). This means that employees will have to pay 1.4% more National Insurance on all earnings between the lower earnings limit and the upper accrual point: this equates to a reduction in take-home pay of up to around £480 per year.<sup>19</sup>

<sup>17</sup> A positive differential can occur due to differences in experience and skill between the two sectors. For more details, see J. Cribb, C. Emmerson and L. Sibieta, *Public Sector Pay in the UK*, IFS Report R97, 2014, <http://www.ifs.org.uk/publications/7395>.

<sup>18</sup> Figure 1 of J. Cribb and C. Emmerson, 'Workplace pensions and remuneration in the public and private sectors in the UK', IFS Briefing Note BN151, <http://www.ifs.org.uk/publications/7396>.

<sup>19</sup> The maximum reduction in annual take-home pay of £480 would apply to employees earning £40,040 or more (who would then be paying 12% NICs rather than 10.6% NICs on earnings between the primary threshold of £8,060 per year and the upper accrual point of £40,040 and who would no longer be receiving a NICs rebate of 1.4% of earnings between the lower earnings limit of £5,824 and the primary threshold).

### Additional cost pressures

The ending of contracting out (paying lower NICs in exchange for a lower entitlement to the state pension) for members of defined benefit pension schemes also has cost implications for public sector employers. From 2016–17, public sector employers will have to pay an additional 3.4% National Insurance on earnings between the lower earnings limit and the upper accrual point for all employees who were previously contracted out – this equates to an increase in the cost of employing an employee of up to around £1,165 per year.<sup>20</sup> HM Treasury estimated that the ending of contracting out would cost public sector employers £3.3 billion in 2016–17.<sup>21</sup> Stripping this additional spending pressure out means that – rather than a real increase in departmental spending and local authority self-financed expenditure of 0.7% between 2015–16 and 2016–17 – spending power is forecast to be essentially flat in real terms between this year and next.

Another possible upwards cost pressure on public sector employers is the government's pledge to substantially increase the minimum wage (for workers aged 25 and over) over the course of the parliament. The so-called 'National Living Wage' (NLW) will be £7.20 per hour in 2016–17, with a target to reach 60% of median earnings by 2020 (which, on current forecasts, would be over £9 per hour). The direct impact of this on public sector employers is likely to be small, since few individuals employed in the public sector are on such low hourly wages: the Low Pay Commission 2015 report found that less than 1% of jobs in the public sector paid the minimum wage in April 2014.<sup>22</sup> However, it is likely to be more of an issue for parts of the public sector that commission services from low-wage employers. One such area is social care, where services tend to be commissioned by local authorities from private and third-sector providers. The Low Pay Commission found that in 2014 around 9% of jobs in the social care sector paid at the minimum wage (and that the social care sector accounted for around 6% of all minimum-wage jobs). The Resolution Foundation has estimated that the new NLW will increase the cost of social care to the public sector by £2.4 billion per year by 2020, compared with a world in which wages increased only in line with inflation (and by £1.4 billion compared with a world in which the National Minimum Wage would otherwise have increased to £8.25 per hour in 2020, which is what the OBR assumed in July 2015 would have happened in the absence of the new NLW).<sup>23</sup>

The new Apprenticeship Levy may also place cost pressure on public sector employers. This is a levy of 0.5% on the part of an employer's pay bill in excess of £3 million per year, which is to be introduced in April 2017. However, alongside this, employers who offer apprenticeship training will be able to access funding for this investment. The government is planning to mandate that public sector bodies with 250 or more employees must have apprentices accounting for at least 2.3% of their workforce.<sup>24</sup>

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<sup>20</sup> The maximum cost of £1,165 would be incurred for employees earning at or above the upper accrual point, for whom NICs would now be payable at 13.8% rather than 10.4% on earnings between the secondary threshold (£8,112) and the upper accrual point (£40,040) and for whom a NICs rebate of 3.4% of earnings between the lower earnings limit and the secondary threshold would no longer be available.

<sup>21</sup> Table 2.1 of HM Treasury, *Budget 2013*.

<sup>22</sup> *National Minimum Wage*, Low Pay Commission Report 2015, Cm 9017, [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/413415/The\\_National\\_Minimum\\_Wage\\_Low\\_Pay\\_Commission\\_Report\\_2015.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/413415/The_National_Minimum_Wage_Low_Pay_Commission_Report_2015.pdf).

<sup>23</sup> L. Gardiner, 'Care to pay? Meeting the challenge of paying the National Living Wage in social care', Resolution Foundation Briefing, 2015, <http://www.resolutionfoundation.org/wp-content/uploads/2015/11/Social-care-NLW.pdf>

<sup>24</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/482754/BIS-15-604-english-apprenticeships-our-2020-vision.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/482754/BIS-15-604-english-apprenticeships-our-2020-vision.pdf).

Therefore, it may be that the cost pressure on public sector employers from the levy is offset by the subsidy they receive for the apprentices employed, some of whom they might have employed in any case. It remains to be seen how onerous different parts of the public sector find the obligation to take on a minimum number of apprentices.

## Summary

Whether or not the government achieves its planned cuts to departmental spending over the next parliament will be crucial for the success of its overall deficit reduction plan. Over the last parliament, the Chancellor was successful at delivering the tight spending plans he initially envisaged. The most direct risk, then, is perhaps not so much to public service spending levels but rather to the quality of services that can be delivered. However, a significant deterioration in quality could in turn lead politicians to decide that more spending is required.

The fact that many of the same departments will be delivering cuts in this parliament as in the last may make the new cuts harder to achieve, as these departments now have smaller budgets and presumably the easiest, and most costless, cuts will have already been done. Rising demand for public services, private sector wage growth and other cost pressures on public sector employers – most obviously the April 2016 rise in National Insurance contributions for the employers of those contracted out into defined benefit pensions – will all make sticking to the intended spending plans more difficult.

## 6.3 Social security spending

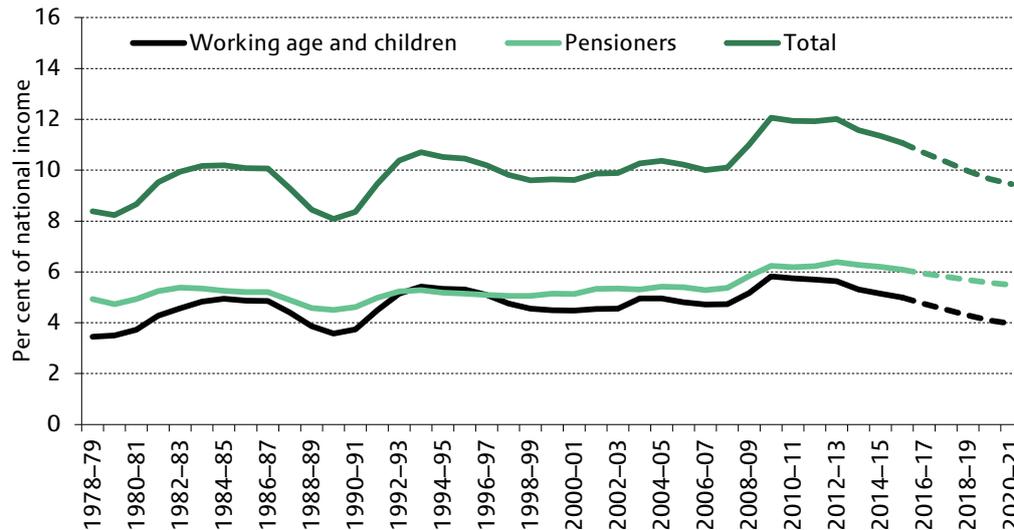
The latest OBR forecast suggests that nominal ‘welfare’ spending across the UK will rise from £217.2 billion this year to £229.4 billion by 2020–21. However, this equates to a real-terms decline of almost £9 billion and means that spending on social security benefits and tax credits is expected to fall from 11.1% of national income to 9.5% over the next five years.

### Planned spending on working-age and pensioner benefits

Figure 6.5 shows how, in Great Britain, this spending is shared between pensioners and working-age families and how this has evolved over time. In 2010–11, just over half of spending on social security benefits and tax credits went to pensioners and just under half to working-age families. Between 2010–11 and 2015–16, spending on benefits to pensioners remained roughly constant as a share of national income (that is, spending grew at a similar rate to growth of the economy) while spending on working-age families fell (because real-terms spending fell rather than growing as the economy did).

In part, this pattern – of a rising share of social security spending being devoted to pensioners – is due to rising numbers of individuals receiving the state pension (despite increases in the female state pension age that have been phased in since 2010) and falling unemployment. However, it has also been driven by policy reforms. Reforms to the benefit system announced by the coalition government that were implemented by 2015–16 are estimated to have reduced social security spending by £16.7 billion relative to what would otherwise have been spent in that year. The brunt of these cuts has been focused on working-age individuals; indeed, the ‘triple lock’ on the state pension and increases to the generosity of the means-tested pension credit are estimated to have

Figure 6.5. Social security and tax credit spending over time



Note: Spending in Great Britain.

Source: Department for Work and Pensions, 'Benefit expenditure and caseload tables 2015', <https://www.gov.uk/government/statistics/benefit-expenditure-and-caseload-tables-2015>.

increased spending on pensioners in 2015–16 by £4.8 billion relative to the plans that the coalition government inherited from the outgoing Labour government.<sup>25</sup>

The latest forecasts suggest that between 2015–16 and 2020–21, annual spending on pensioner benefits will grow by £1 billion in real terms but will not grow as rapidly as the economy, and so spending on pensioner benefits will fall by 0.6% of national income (so we will be spending £11 billion less than we would if spending had grown in line with the economy). This relatively low forecast growth in pensioner benefit spending is very largely due to the planned increases in the state pension age for men and women, which will reduce the number of people reaching state pension age over the next five years.<sup>26</sup> At the same time, spending on working-age benefits is projected to decline by £10 billion in real terms and is thus expected to fall by 1.0% of national income (so we will be spending £19 billion less than we would if spending had grown in line with the economy). If correct, this will lead to spending on benefits and tax credits for working-age families falling to their lowest level as a share of national income since 1990–91.

This fall in working-age benefits is, at least in part, explained by policy reforms. First, there is expected to be a continued reduction in spending from reforms that were announced by the coalition government: in particular, the shift in indexation of most working-age benefits from RPI to CPI will deliver an increasing saving over time, while the shift from disability living allowance (DLA) to personal independence payments (PIP), discussed below, is also expected to reduce spending. Second, the new Conservative government has announced further cuts to spending on working-age benefits – including cuts to universal credit (UC) that are discussed in Chapter 10 – which are expected to

<sup>25</sup> For a discussion of the benefit reforms implemented by the coalition government, see A. Hood and D. Phillips, 'Benefit spending and reforms: the coalition government's record', IFS Briefing Note BN160, January 2015, <http://www.ifs.org.uk/publications/7535>.

<sup>26</sup> Spending on the state pension is forecast to rise by 6.2% between 2015–16 and 2020–21, due to a combination of 8.8% growth in average state pension payments per recipient – from £133 per week to £145 per week in 2015–16 prices – and a 2.4% fall in the number of recipients.

reduce spending by £12 billion in 2019–20 (in cash terms) relative to what would otherwise have been the case.<sup>27</sup>

## **Risks to social security spending**

Of course, spending on social security benefits and tax credits might turn out to be different from the OBR's current central forecast. There are three broad types of reasons why this might occur. Two of these are analogous to the types of risks facing tax revenues that were described in Chapter 5. First, a given social security system may turn out to cost more or less than expected because the population to which it applies is different from what was forecast. For example, the number of children and the incomes of their parents will determine spending on child benefit and a large chunk of spending on UC, but these are not known with certainty. Second, the government might introduce new measures in future that are not reflected in the current forecast. These two risks are not always entirely distinct: most obviously, if it becomes apparent that welfare spending is rising more quickly than expected, the government may introduce new reforms to counteract this (or vice versa). The third reason is that reforms that are already planned may prove operationally difficult to implement and may end up being delayed or reversed. In principle, this type of risk could also apply to the tax system, but in practice, in the UK's recent history, this has been more relevant for social security spending than for tax policies.

The following subsections discuss some of the risks to social security spending, with a particular focus on spending on working-age benefits and tax credits since that is where, perhaps, the greatest uncertainty lies.

### ***Manifesto commitments***

The Conservative Party manifesto set out some specific changes to the working-age social security system and also pledged to cut social security spending by £12 billion by 2017–18.<sup>28</sup> The ambition to cut spending by £12 billion has now been pushed back to 2019–20, but this and the specific measures spelled out in the manifesto have already been incorporated into the OBR's forecast. So there does not appear to be a risk to social security spending from firm policy commitments that are not yet factored into the official forecast.

### ***Is the welfare cap constraining?***

In principle, the Chancellor's welfare cap (see Chapter 3) ought to limit the risks to the public finances of working-age social security spending. This provides a ceiling above which a large chunk of social security spending will not rise. At the moment, this ceiling is set at the level of the forecast for those items of spending as of July 2015. The idea is, therefore, that social security spending can only undershoot, not overshoot, the forecast.<sup>29</sup>

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<sup>27</sup> See A. Hood, 'Benefit and tax credit changes', presentation at IFS post Spending Review / Autumn Statement briefing, November 2015, <http://www.ifs.org.uk/publications/8074>.

<sup>28</sup> The specific cuts in the Conservative Party manifesto are: to freeze the rates of most working-age benefits for two years, to reduce the household benefit cap, and to remove eligibility for housing benefit among recipients of jobseeker's allowance aged 18 to 21. The first has been extended to four years and the other two have been confirmed.

<sup>29</sup> The welfare cap rules allow spending to exceed the cap by up to 2% as a result of forecasting changes but not as a result of new policy action.

However, in practice, the welfare cap has proved much less binding. Spending is already forecast to exceed the cap that was set in July 2015 for each of the next three fiscal years. In other words, even though the welfare cap has only been in operation for less than two years (since the March 2014 Budget), it has already been broken by the Chancellor. It is therefore not clear whether it remains a real constraint on the government's actions.

### *Inflation risk*

Ordinarily, one risk to the outlook for cash spending on working-age benefits and tax credits is that the rate of inflation turns out to be different from the forecast. This is because the rates of most of these benefits are uprated each year in line with inflation.<sup>30</sup> In 2015–16, the Department for Work and Pensions forecasts that total spending on working-age benefits and tax credits across Great Britain will be £95.0 billion. Therefore, roughly speaking, a 1 percentage point deviation in inflation from forecast would reduce or increase spending in cash terms by around £1 billion. But if higher inflation also translates into higher cash tax receipts – for example, from taxes on earnings and consumer spending – then this could easily be offset elsewhere in the public finances.

However, for the four years up to 2019–20, rates of working-age benefits are to be frozen in cash terms. This means that higher (or lower) inflation than forecast would not – at least by default – feed into higher (or lower) forecast spending in cash terms on these benefits. This means that, in real terms, spending on working-age benefits and tax credits is now subject to inflation risk: lower-than-expected inflation would lead to this spending being higher in real terms (and would mean that the policy of freezing benefit rates was delivering a smaller cut to spending than expected), while higher-than-expected inflation would lead to this spending being lower in real terms. Similarly, recipients of the benefits that are being frozen are also exposed to inflation risk: lower-than-expected inflation would boost the real-terms value of their benefits, while higher-than-expected inflation would depress the real value of their benefits.

In terms of the overall public finances, it means that lower-than-expected inflation would, most likely, have a more harmful impact than usual, as we would still get a downgrade in cash tax receipts but this would not be accompanied by the usual reduction in cash benefit spending. Conversely, higher-than-expected inflation would, most likely, be more beneficial to the public finances than usual. Given the sharp drop in the oil price that has occurred since the OBR's last forecast (discussed in Chapter 5), a downwards revision to expected inflation seems more likely than an upwards revision. This would mean that the government's benefit cuts would be less likely to deliver the government's desired £12 billion reduction to spending.

### *Is it possible to continue freezing benefit rates?*

The currently-planned four-year freeze to rates of working-age benefits – which is forecast to reduce spending by £4.0 billion by 2019–20 – is expected to result in these benefits falling in generosity relative to both prices and average earnings. The OBR's latest forecast is for prices, as measured by the CPI, to increase by 7.2% over the next four years, while it expects average earnings to grow (in nominal terms) by 15.4% over the same period.

Over the longer term, it seems reasonable to argue that benefit rates should not be reduced relative to prices, or even earnings, indefinitely since this would reduce the

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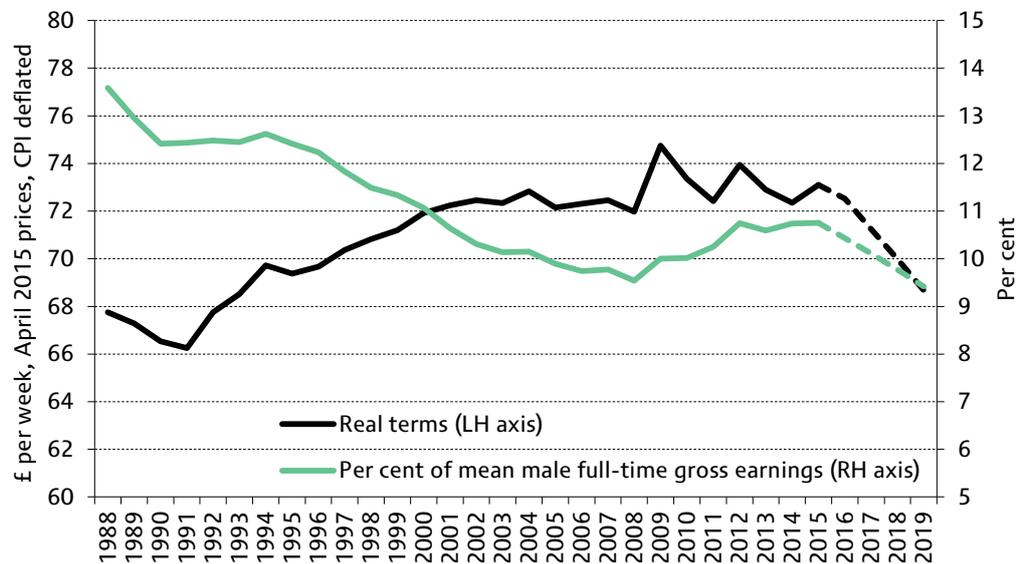
<sup>30</sup> Usually, benefit rates are increased each April by the annual growth in the Consumer Prices Index observed the previous September.

incomes of those not in work further and further below those who are in paid work. But is it plausible that the government can do this for four more years? If the government were to turn out to be unable or unwilling to freeze benefits for so long, this would push future spending up. However, two (somewhat related) pieces of evidence from recent history suggest that the risk to the public finances of these benefits being made more generous could actually be quite small.

First, rates of many working-age benefits have fallen relative to average earnings over quite long periods of time. Figure 6.6 shows the rate of income support for a single childless individual aged 25 or over relative to both prices (as measured by the CPI) and average earnings (as measured by mean full-time male gross earnings) from its introduction in April 1988 to April 2019.<sup>31</sup> Relative to average earnings, its value was cut significantly from the mid 1990s right up to the start of the financial crisis in 2008. In fact, the freeze is only expected to return the value of this benefit to a similar percentage of average earnings to what it was at the eve of the financial crisis in April 2008. The experience from 1994 to 2008 might suggest that reducing the value of this benefit relative to average earnings is not unlikely to happen despite the obvious consequences for the relative living standards of those affected.

Admittedly, a sustained cut in income support (among other benefits) in real terms has less recent historical precedent and could prove more difficult. Figure 6.6 shows that real cuts to the rate of income support for childless single people (aged 25 or over) have not occurred on a sustained basis since it was introduced in April 1988. Over the period up to April 2011, the default was to increase the rate of this benefit in line with inflation as measured by the RPI the previous September. This led to the real value of the benefit, relative to CPI inflation, increasing from about £66 per week in April 1990 to £72 per

Figure 6.6. Income support for a single childless person aged 25 or over



Source: Authors' calculations using data on benefit rates from Department for Work and Pensions, *Annual Abstract of Statistics 2014*, <https://www.gov.uk/government/statistics/abstract-of-statistics-2014>; out-turns for inflation as measured by the CPI and mean full-time gross earnings as measured in the Annual Survey of Hours and Earnings from the Office for National Statistics; and forecasts for the CPI and average earnings growth from the Office for Budget Responsibility.

<sup>31</sup> The rate of jobseeker's allowance for a single childless individual was similar up to April 1997 and has been identical since then.

week by April 2000 (in today's prices). The current rate is £73.10 per week but is expected to fall steadily to £68.67 (in 2015–16 prices) by 2019–20. However, on this front, historical experience perhaps provides less useful insight, since no previous government has actually attempted to implement sustained cuts to income support relative to the CPI. Therefore, history provides little guide to what is likely to happen if a determined government attempts to follow such a policy.

The second reason why these cuts might not prove so difficult is that – though cash freezes represent real-terms decreases in generosity – no claimant will see a reduced entitlement in cash terms. Over the last parliament, the coalition government was able to reduce social security spending considerably (relative to what would have been spent in the absence of reform) through reducing the generosity of indexation. Most working-age benefits were linked to the CPI rather than the RPI and this was followed by a two-year policy of limiting increases in most benefits to 1% a year. Such policies may attract less public attention than other reforms to the benefit system because no one sees an existing benefit entitlement cut in cash terms (unlike, for example, the so-called 'bedroom tax', which has been much discussed but saved far less money). This feature (i.e. that no existing recipients see their entitlements cut in cash terms) is also common to many of the other cuts to social security spending that are now planned for this parliament. In contrast, the controversial cuts to tax credits that were announced in the July 2015 Budget, but abandoned by the Chancellor just four months later in the November 2015 Autumn Statement, were due to result in some existing claimants receiving lower cash payments from April 2016 onwards.

Perhaps the benefit where current indexation might prove hardest to maintain is the planned indexation of the local housing allowance (LHA) caps that apply to housing benefit for private sector tenants, and will from April 2018 apply to new tenants in social housing as well. Until April 2013, these caps were linked to contemporaneous local rents. Since then, though, the default has been to increase them in line with general prices (CPI), and in April 2014 and April 2015 most increases were in fact limited at 1%, while over the next four years they will be subject to the four-year benefit freeze. Were rents to grow particularly quickly in some parts of the country, this might place pressure to increase the caps to prevent housing becoming increasingly unaffordable in those areas.<sup>32</sup>

### *Difficulties in implementing structural reforms*

Recent history suggests that a more significant risk to social security spending appears to be that the structural benefit reforms that are under way might not deliver the reduction in spending that the OBR expects. Two particular reforms are worth mentioning – the replacement of DLA with PIP, and the replacement of most working-age benefits with UC.

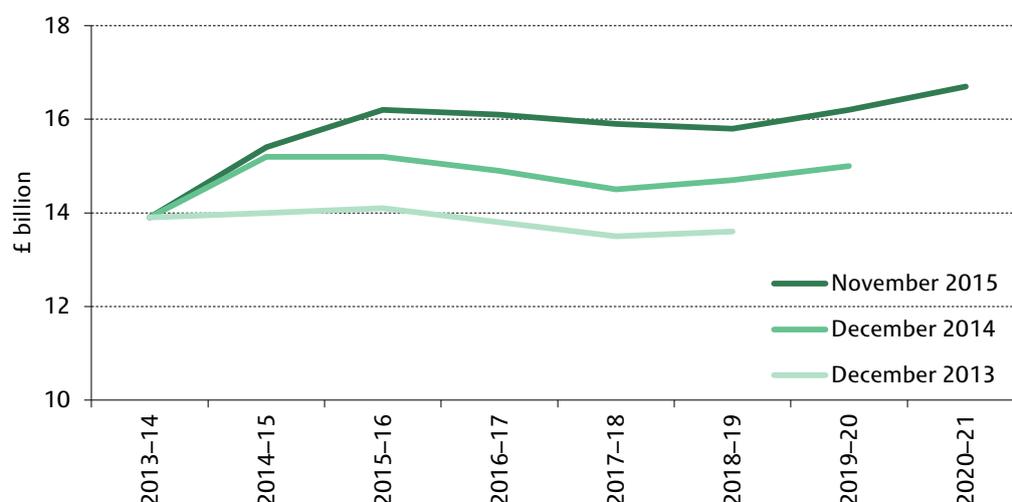
The shift from DLA to PIP – originally announced in the June 2010 Budget – was expected to cut working-age DLA spending by 20% in 2015–16.<sup>33</sup> In its latest forecast, the OBR revised up forecast spending on disability benefits over the next five years. This was

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<sup>32</sup> There are other features of current policy for LHA caps which perhaps pose less risk politically but are undesirable and should be rethought. If rents rise by different amounts in different parts of the country, as is virtually inevitable, then the relative generosity of housing benefit across the country will depend on historical rent differences between areas (i.e. those that applied in 2012, before the change to indexation policy) but not on current ones. Hence, for example, one area could have higher current rents than another area and yet have a less generous housing benefit system.

<sup>33</sup> Source: Department for Work and Pensions, 'Disability living allowance reform impact assessment', 2012, [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/220176/dla-reform-wr2011-ia.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/220176/dla-reform-wr2011-ia.pdf).

Figure 6.7. Successive autumn OBR forecasts for spending on disability benefits



Source: Chart 4.7 of Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2015.

driven by two factors. First, recent data on new PIP claimants suggest that their entitlements are higher than had been anticipated. Second, the OBR now expects it to take longer for the Department for Work & Pensions and its contractors to reassess existing DLA claimants, meaning that it will take longer to transition fully from DLA to PIP and so the expected reductions in spending will take longer to materialise.<sup>34</sup>

Spending on disability benefits in 2018-19 is now forecast to be £15.8 billion, which is £2.2 billion higher than was forecast to be spent in the same year back in December 2013 (as shown in Figure 6.7). A similar phenomenon occurred in the last parliament with the shift from incapacity benefit to employment & support allowance (ESA), with this failing to deliver the reduction in spending that had been anticipated.<sup>35</sup> The latest forecasts from the OBR may prove to be accurate – and could even prove to be an overestimate of how much will be spent – but the lesson from recent history is that we should not be surprised if the reforms once again take longer to implement and deliver less than the intended reduction in spending.

The most significant reform to working-age benefits that is taking place is the introduction of universal credit. As described in Chapter 10, this is now being rolled out considerably more slowly than was initially envisaged.

The full implementation of UC is now expected to reduce social security spending in the long run.<sup>36</sup> Therefore, further across-the-board delays in the roll-out of UC would weaken the public finances. However, the precise impact of further delays in the roll-out of UC on the public finances over the next few years will depend on exactly which part of it is being delayed. New claimants of UC face a less generous system straightaway, and so any (further) delays in when new claims are made to UC rather than the 'legacy' system

<sup>34</sup> The OBR's latest forecast assumes that 45% fewer reassessments will be carried out in 2016-17 than had previously been expected.

<sup>35</sup> See chart 2.4 of Office for Budget Responsibility, *Welfare Trends Report: June 2015*, <http://cdn.budgetresponsibility.independent.gov.uk/49754-OBR-Welfare-Accessible-v0.2.pdf>.

<sup>36</sup> As Chapter 10 sets out, this was not originally the case with the UC scheme under its initial guise. However, recent reforms to the UC system (including those announced in the July 2015 Budget) mean that this is now the expected outcome.

would increase social security spending and weaken the public finances. However, existing claimants moved onto UC receive ‘transitional protection’ – that is, they cannot lose in cash terms at the point they are moved onto the benefit. Therefore, any further delays in when existing claimants are moved over could slightly *strengthen* the public finances in the short term, as some claimants gain from the move to UC, and none lose while transitional protection is in place.

## Summary

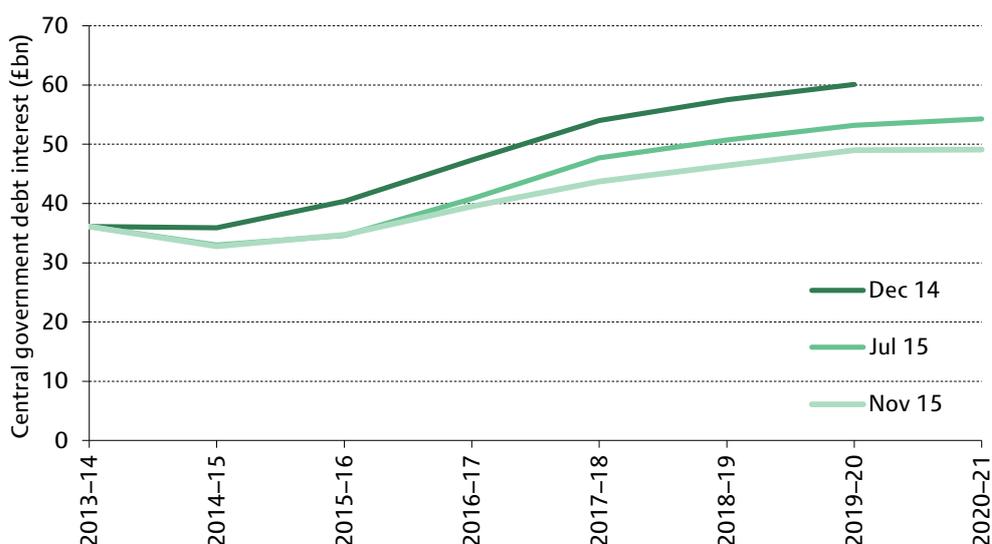
The government has announced cuts to working-age benefits that are estimated to reduce annual spending on working-age benefits and tax credits by £12 billion by the end of this parliament. But the hoped-for savings might not materialise, not least because any further downwards revisions to inflation would mean that the four-year freeze to most working-age benefits would deliver less than the £4.0 billion expected cut to spending in 2019–20. A further significant risk to the public finances is that the shift from DLA to PIP does not deliver as large a cut to spending as, or delivers the cuts less quickly than, the forecasts assume.

## 6.4 Debt interest spending

In 2015–16, debt interest spending is expected to account for 4.8% of total government spending (or £36 billion). Between 2015–16 and 2019–20, spending on debt interest is expected to increase by 30% in real terms, rising to account for 6.2% of total public spending in 2019–20.

In the last two years, there have been substantial downwards revisions to the OBR’s forecast for spending on debt interest – illustrated in Figure 6.8. Most recently, in the November 2015 *Economic and Fiscal Outlook*, forecast central government debt interest spending was £4.2 billion a year lower in 2019–20 and £5.2 billion a year lower in 2020–21 than the July 2015 forecast. This was a significant contributing factor that allowed George Osborne to announce a loosening of the squeeze on ‘unprotected’ public service

Figure 6.8. Successive forecasts for central government debt interest



Note: Figures shown are for central government debt interest net of the Asset Purchase Facility.  
Source: OBR, *Economic and Fiscal Outlook*, various editions.

spending in the November 2015 Autumn Statement without affecting his forecast for total borrowing.<sup>37</sup> With public sector debt expected to stand at £1,599 billion by the end of March 2016 and with the Debt Management Office's illustrative gross financing requirement suggesting it will be seeking to raise over £500 billion over the next five years,<sup>38</sup> it is not terribly surprising that public spending forecasts are sensitive to the assumptions made about future debt interest rates.

Currently, some government debt is held by the Bank of England through the Asset Purchase Facility (APF) as part of the programme of quantitative easing (QE). Interest payments made to the Bank of England on these gilts effectively do not count as central government debt interest spending in the National Accounts, as they would do if these gilts were instead held by a private sector entity. As a result, forecast central government debt interest spending (excluding the APF payments) is sensitive to the assumptions made about when the Bank of England will unwind its QE programme. Part of the reduction in forecast debt interest spending in November 2015 was caused by the OBR pushing back the date at which it assumes the Bank will start to unwind QE, in line with the Bank's statement in the November 2015 *Inflation Report*.<sup>39</sup> This revised assumption alone had the effect of reducing forecast central government debt interest spending by £2.1 billion a year by 2020–21, though it did nothing to change the long-run strength of the public finances.

Even in the absence of the APF, the November 2015 forecast would have included a sizeable downwards revision to forecast central government debt interest spending (to the tune of £2.7 billion in 2020–21) because forecasts of future interest rates were reduced. The government could hope to benefit from downwards revisions to debt interest spending again. However, it is worth noting two things. First, any future interest rate shock is likely to be accompanied by other important changes in the economy. To the extent that lower interest rates are associated with worse economic performance or lower inflation, this would also be expected to be associated with a deterioration in forecast receipts and a lower level of forecast national income. Second, gilts rates are already low by recent historical standards; Figure 6.9 illustrates how the annual average yield on 10-year British securities has declined over the past three decades.

Helpfully, the OBR has provided a reader reckoner which, by taking planned gross gilt issuance over the next few years as given, provides a sense of how sensitive spending on debt interest is to the rate of interest that applies to this issuance.<sup>40</sup> This suggests that a 1 percentage point increase (reduction) in gilt and short rates, from April 2016, would increase (reduce) debt interest spending in 2019–20 by about £8 billion. A further risk surrounds government gilts that have interest payments linked to the rate of inflation as measured by the RPI. This is around one-quarter of the stock of debt already issued

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<sup>37</sup> P. Johnson, opening remarks made at the IFS post Autumn Statement / Spending Review briefing, 26 November 2015, <http://www.ifs.org.uk/publications/8070>.

<sup>38</sup> See Debt Management Office, 'Autumn Statement 2015: revision to the DMO financing remit 2015–16', [http://www.dmo.gov.uk/documentview.aspx?docname=remit/sa251115.pdf&page=Remit/full\\_details](http://www.dmo.gov.uk/documentview.aspx?docname=remit/sa251115.pdf&page=Remit/full_details).

<sup>39</sup> The Bank of England announced in the November Inflation Report that the stock of gilts in the APF will be kept at £375 billion until Bank Rate reaches around 2%. The assumption underlying the OBR's November 2015 forecast is that this will not happen until after 2020–21. In July 2015, the OBR had instead assumed that the APF's gilt holdings would be reduced gradually from 2016–17 onwards. For further details, see paragraph 4.116 of OBR, *Economic and Fiscal Outlook: November 2015*, <http://budgetresponsibility.org.uk/economic-fiscal-outlook-november-2015/>.

<sup>40</sup> Fiscal supplementary table 2.28 of OBR's, November 2015 Economic and Fiscal Outlook.

Figure 6.9. Annual average yield on 10-year British government securities



Source: Bank of England, 'Statistical Interactive Database', series IUAAMNPY, downloaded 11 January 2016, <http://www.bankofengland.co.uk/boeapps/iadb/index.asp?SectionRequired=I&first=yes&HideNums=1&ExtralInfo=true&Travel=NIxIRx&levels=1>.

(outside the APF) and is forecast to increase.<sup>41</sup> The OBR's ready reckoner suggests that a 1 percentage point increase (fall) in RPI inflation from April 2016 would increase (reduce) debt interest payments in 2019–20 by around £5 billion.

## 6.5 Conclusion

The Chancellor's objective to achieve an overall budget surplus by 2019–20 is predicated on the plan to reduce public spending (excluding housing associations) as a share of national income from 39.1% in 2015–16 to 36.1% by 2019–20. This chapter has considered three broad categories of public spending where there is a risk that spending will not evolve as currently expected.

One area where the previous coalition government managed to cut spending significantly and where the Conservative government intends to cut further is spending on public services. The Spending Review published in November 2015 set out plans to cut departmental spending by 2.3% in real terms over the next four years, with the pain shared unevenly across different services. Experience over the last parliament suggests that the Chancellor was successful at delivering the tight spending plans he initially envisaged. In fact, faced with hard spending limits, in aggregate departments underspent their budgets by fairly significant margins – in the last parliament, annual underspends peaked at £12 billion in 2012–13. This provides some reassurance that the spending plans that have been set out for departments in this parliament could be adhered to.

The most direct risk, then, is perhaps not to public service spending levels but rather to the quality of services that can be delivered. But a significant deterioration in quality could lead politicians to decide that more spending is required. The cuts planned for many departments in this parliament come on top of cuts averaging 10.4% in real terms already seen in the last parliament, and it is many of the same departments that will see the biggest cuts again. Presumably, departments will have cut the lowest-value and easiest-to-cut elements of spending first, meaning that their remaining spending is more likely to be noticed if cut and/or more difficult to cut. Some departments have already set

<sup>41</sup> Fiscal supplementary table 2.27 of OBR's, November 2015 Economic and Fiscal Outlook.

out specific plans for how they can reduce spending – for example, the Department for Business, Innovation and Skills and the Department of Health are both replacing grants for students with loans, while the Department for Transport is phasing out the non-investment grant it makes to Transport for London – but for others it is, as yet, less clear how they will balance their books.

In some areas of public services, the government aspires to make radical changes – such as better integrating health and social care services. While bold ambitions are to be welcomed, they will be harder to achieve when budgets are so tight. Achieving these objectives would be easier if money were available to invest up front and/or to compensate any losers from the changes.

One particular pressure that is likely to bear much more heavily on departments in this parliament than the last is the recruitment and retention of staff. Over the last parliament, part of the cut to real-terms public service spending was delivered by freezing public sector pay. Since private sector wages were also growing slowly over this period (and had fallen between 2007 and 2010), this public sector pay restraint did not have a particularly adverse impact on relative wages between the public and private sectors. However, continuing similar policies over the next four years may be more difficult, as private sector wages are expected to grow more rapidly. Continuing restraint on public sector pay could, therefore, make it harder to recruit and retain suitable-quality public sector workers and raises the prospect of worsening industrial relations.

The November 2015 spending settlement was not, however, ultimately as tight as many had expected in advance. One of the factors that allowed George Osborne to ease the squeeze on many departments was a significant downwards revision to the OBR's forecast for spending on debt interest. This was hailed as positive news and no doubt similar revisions in the future would be welcomed with similar optimism. However, it is worth remembering that the recent downwards revisions to debt interest spending reflected lower expected Bank of England interest rates and a delay to the expected date at which the Bank will start to unwind quantitative easing. Both of these are indicators of economic weakness, not strength. Therefore, while higher (lower) interest rates might put upwards (downwards) pressure on debt interest spending, the stronger (weaker) economic growth that would likely accompany them could overall signal good (bad) news for the UK's public finances.

Measures announced by the previous coalition government and the current Conservative government have done much to limit growth in spending on (particularly working-age) social security. As a result, annual social security spending is forecast to decline in real terms by almost £9 billion over the next five years, despite spending on benefits for pensioners being forecast to grow by £1 billion in real terms over the same period. The magnitude of cuts to working-age benefits that have already been announced over the last few years, and Mr Osborne's recent U-turn on planned cuts to tax credits, suggest that further substantial cuts to the welfare budget may be hard to find. However, there are also risks that the planned cuts will not save as much as is anticipated or that the savings do not materialise as quickly. A notable recent example has been the difficulty in moving from disability living allowance to the new system of personal independence payments – this has both taken longer and saved less money than was originally envisaged. This suggests that, notwithstanding the government's supposed 'cap' on some elements of welfare spending, there may be upside risk to this element of spending.

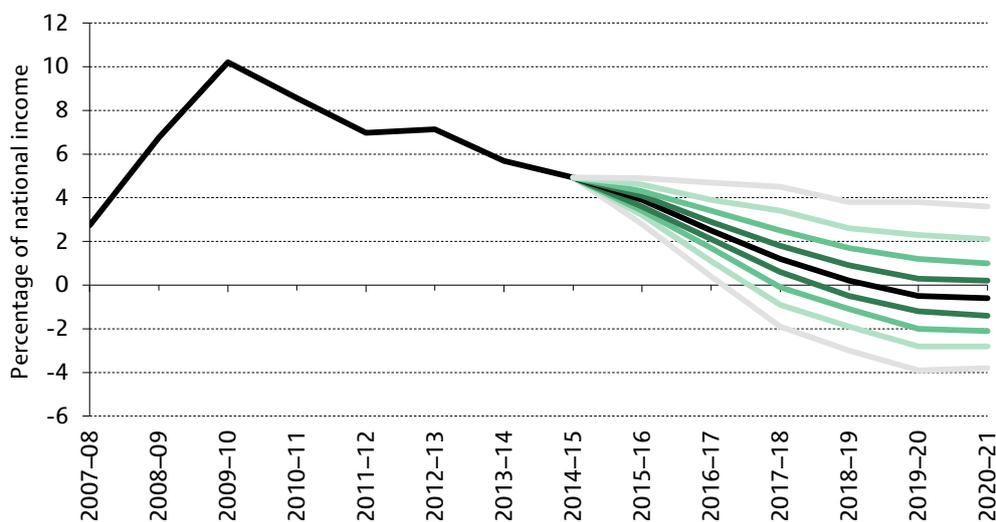
## The outlook for the public finances as a whole

While the latest OBR forecast is that the government will be running a surplus in 2019–20, as ever the outlook for the public finances is uncertain. Figure 6.10 illustrates the likely uncertainty around the OBR’s central projection for borrowing, based on past forecasting performance and assuming that this is informative about the future. The OBR’s central projection is for a 0.5% of national income surplus in 2019–20 based on current policy. However, the fan chart indicates that, based on previous forecast errors, the chance of a surplus in 2019–20 is around 55%: in other words, historic forecast errors suggest there is a 45% chance that some combination of further tax rises and deeper spending cuts would be required to deliver a surplus in 2019–20.

As this chapter and the previous chapter have discussed, there are a number of specific risks facing the public finances over the next few years. Some of these are balanced – with there being an equal likelihood of positive or negative news – but some are biased in one direction. These risks arise both on the tax side and on the spending side and derive both from uncertainty facing the economy and from the actions of politicians themselves.

There will always be uncertainties and risks around future borrowing levels. Many of these risks are difficult for the government to control. To handle these types of risks, the government should ensure that its plans involve some degree of caution and that it remains responsive to new developments. The government’s new fiscal mandate – that, in normal times, the government will run a surplus every year – involves relatively little flexibility (discussed in more detail in Chapter 3). It is reasonable to wonder, given the OBR’s central estimate of a 0.5% of national income surplus in 2019–20 and the risks highlighted in this and the previous chapter, whether the government’s current fiscal plans will prove cautious enough to meet this new fiscal target without requiring potentially highly suboptimal adjustments, potentially made in-year, to tax or spending plans for 2019–20 and beyond.

Figure 6.10. Public sector net borrowing fan chart



Note: The solid black line represents the central OBR projection. Different coloured lines going outwards represent 20% probability bands. For example, the probability that the out-turn will be between the two dark green lines is 20%. Probabilities based on past forecasting errors.

Source: Chart 5.3 of Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2015*, <http://budgetresponsibility.org.uk/efo/economic-and-fiscal-outlook-november-2015/>.