

# SHAPE SHIFTING

## *The changing role of the state during fiscal consolidation*

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November 2015

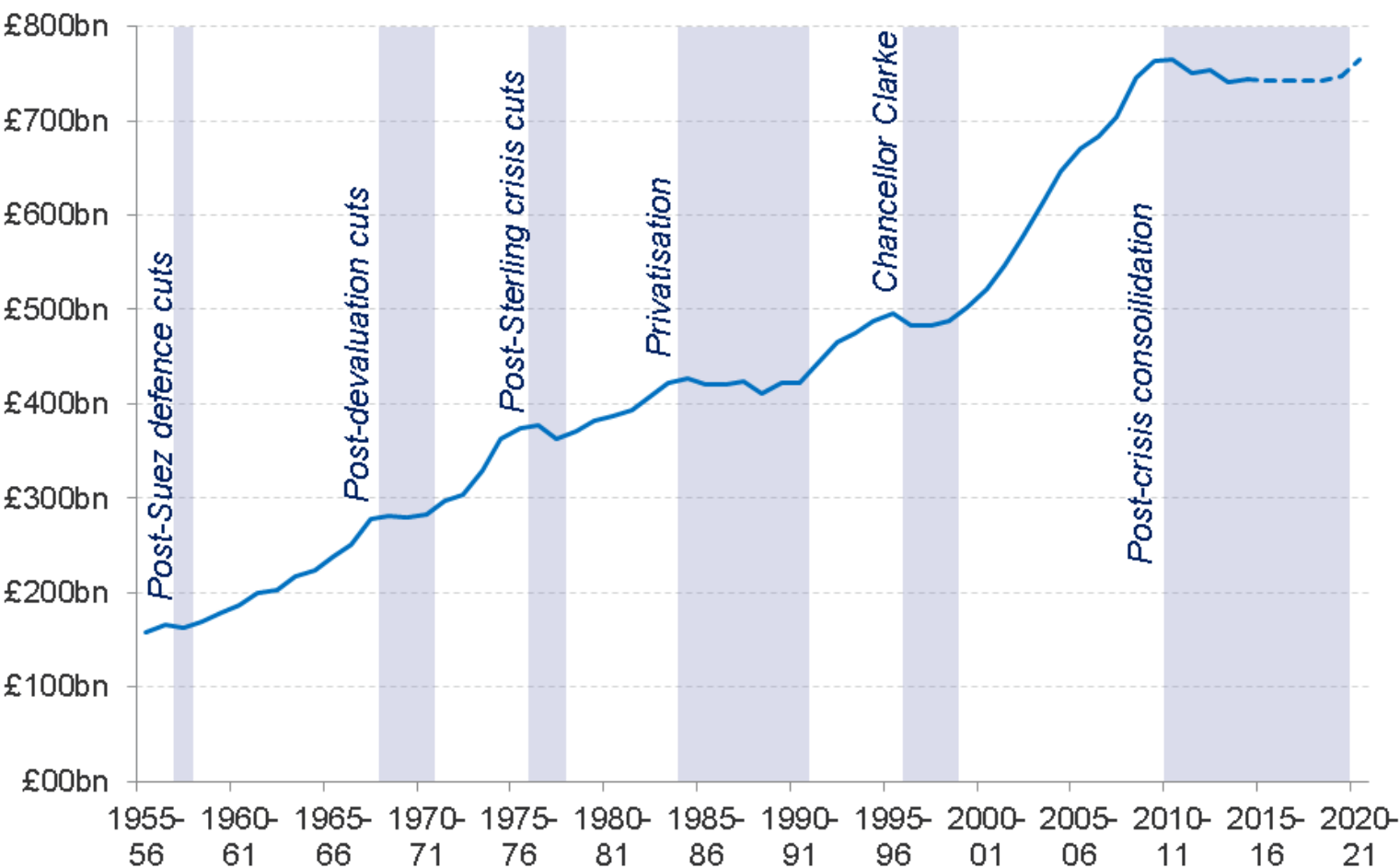
@resfoundation @mattwhittakerRF #SR2015

# THE SHRINKING STATE

*Government spending in an era of fiscal consolidation*

# A decade-long pause in spending growth is unprecedented in modern times

Government spending (2015-16 terms, GDP deflator)

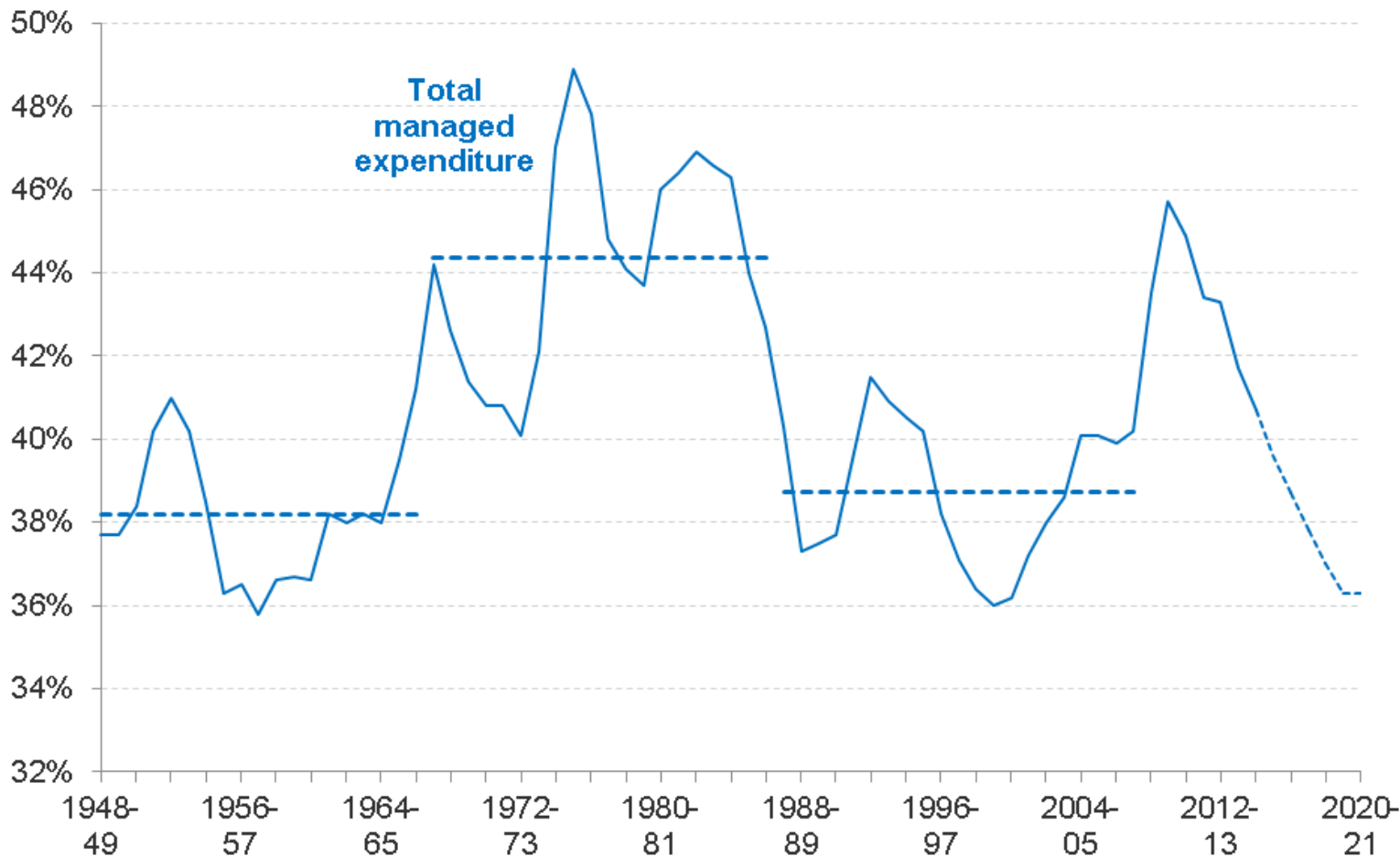


Real spending fell by £25bn between 2010-11 & 2013-14, and has since been essentially flat

Spending will grow by 0.6% between 2015-16 & 2019-20, returning it close to its 2010-11 peak by the end of the decade

# Measured relative to GDP, spending is heading towards its historic low of 36%

Government spending and receipts as a share of GDP



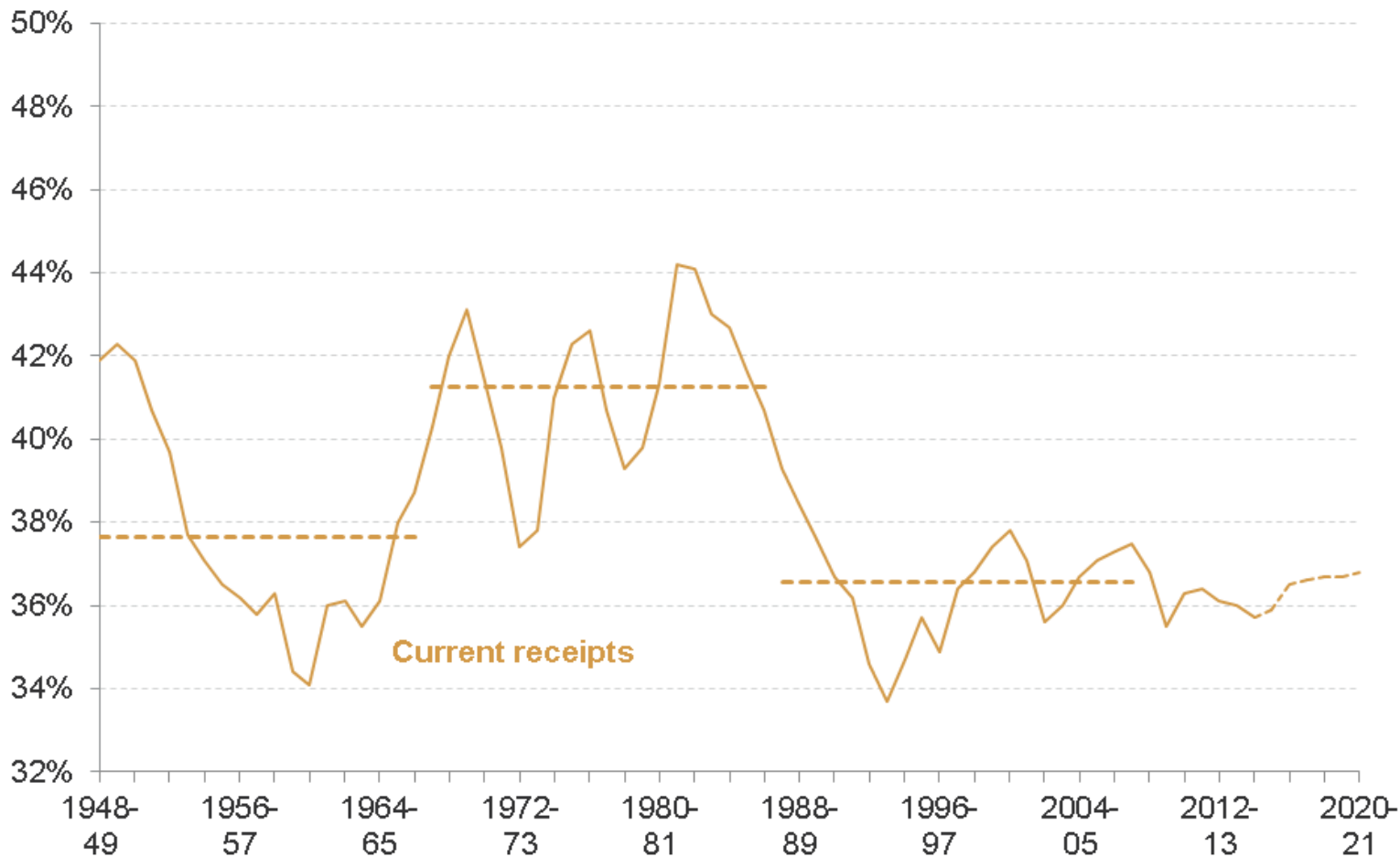
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Public spending is falling rapidly as a share of GDP, continuing a downward drift that is apparent from the 1970s (with privatisation playing an important role)

By 2019-20, TME will only have been lower relative to GDP in 1999-00 and 2000-01

# In contrast to spending, government *revenue* has been broadly steady over recent decades

Government spending and receipts as a share of GDP



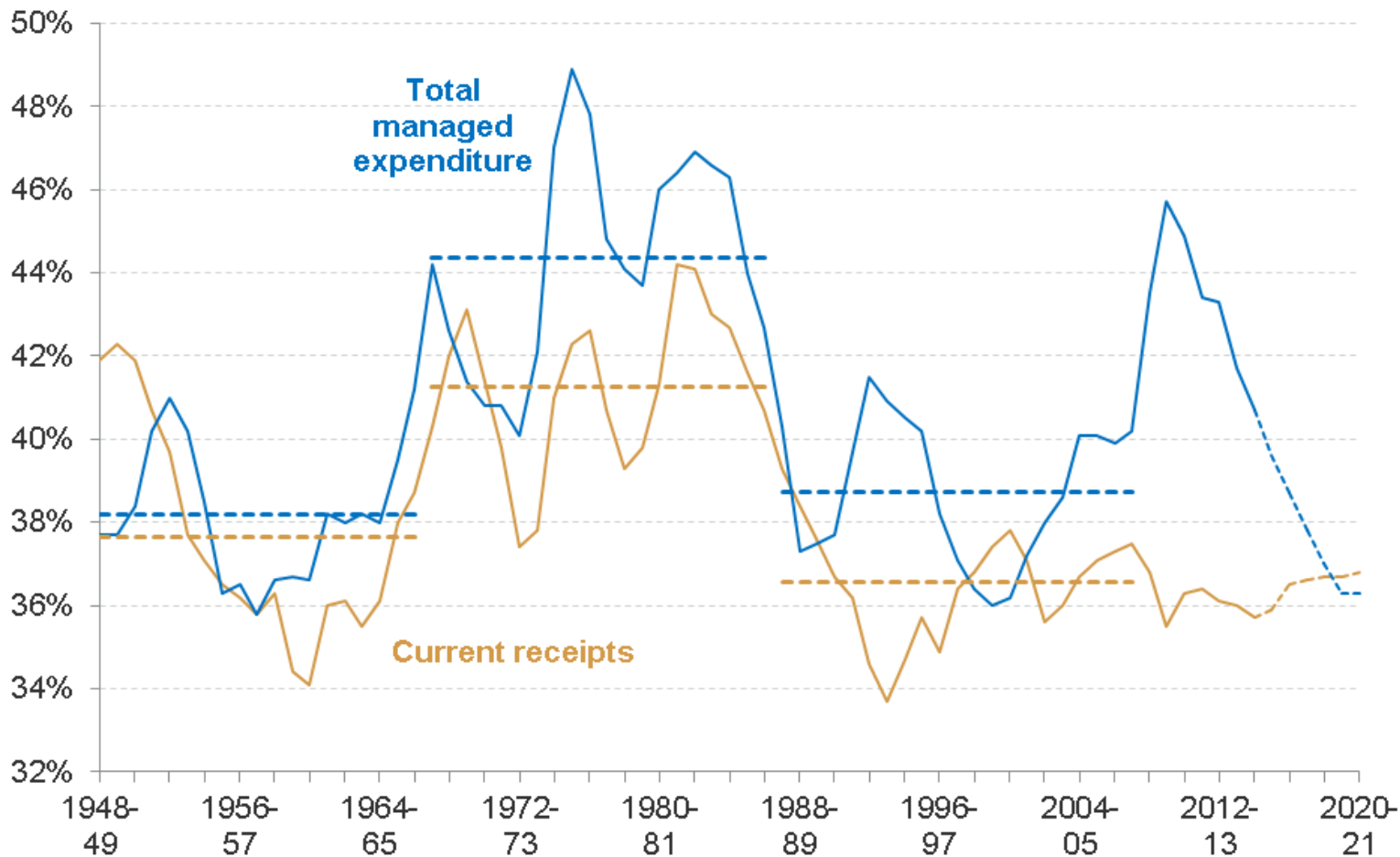
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Government revenue has been broadly flat since the mid-1990s. It hasn't topped 38% of GDP since the mid-1980s

Having fallen sharply after the crisis, it is projected to recover gradually in the coming years but remain below its pre-crash peak

# And spending has been higher than revenue in a clear majority of years

Government spending and receipts as a share of GDP



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Revenue has been greater than spending in just 12 years since 1948-49, with four of those years occurring immediately post-war

After 1950, the longest sustained surplus was three years from 1998-99

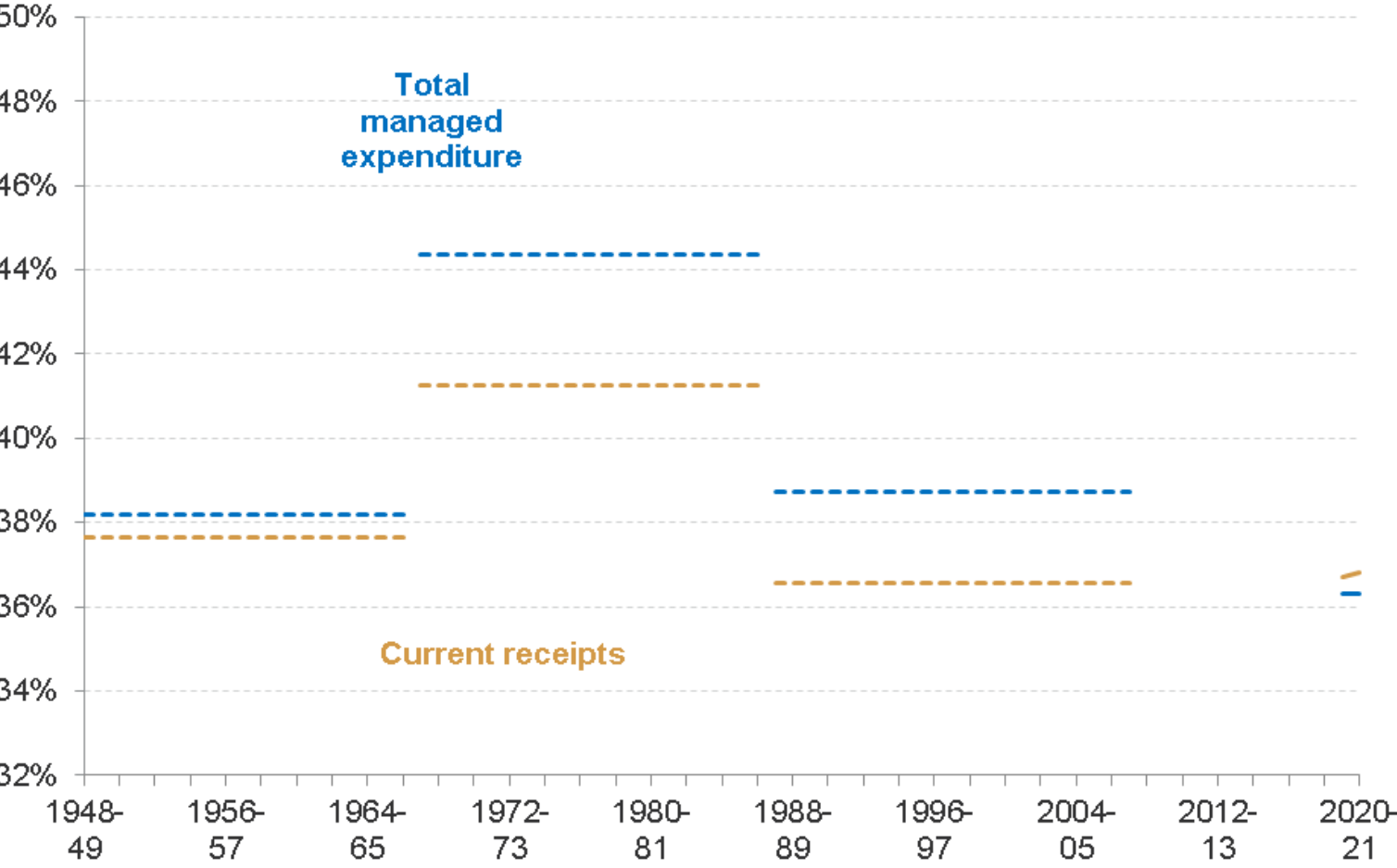


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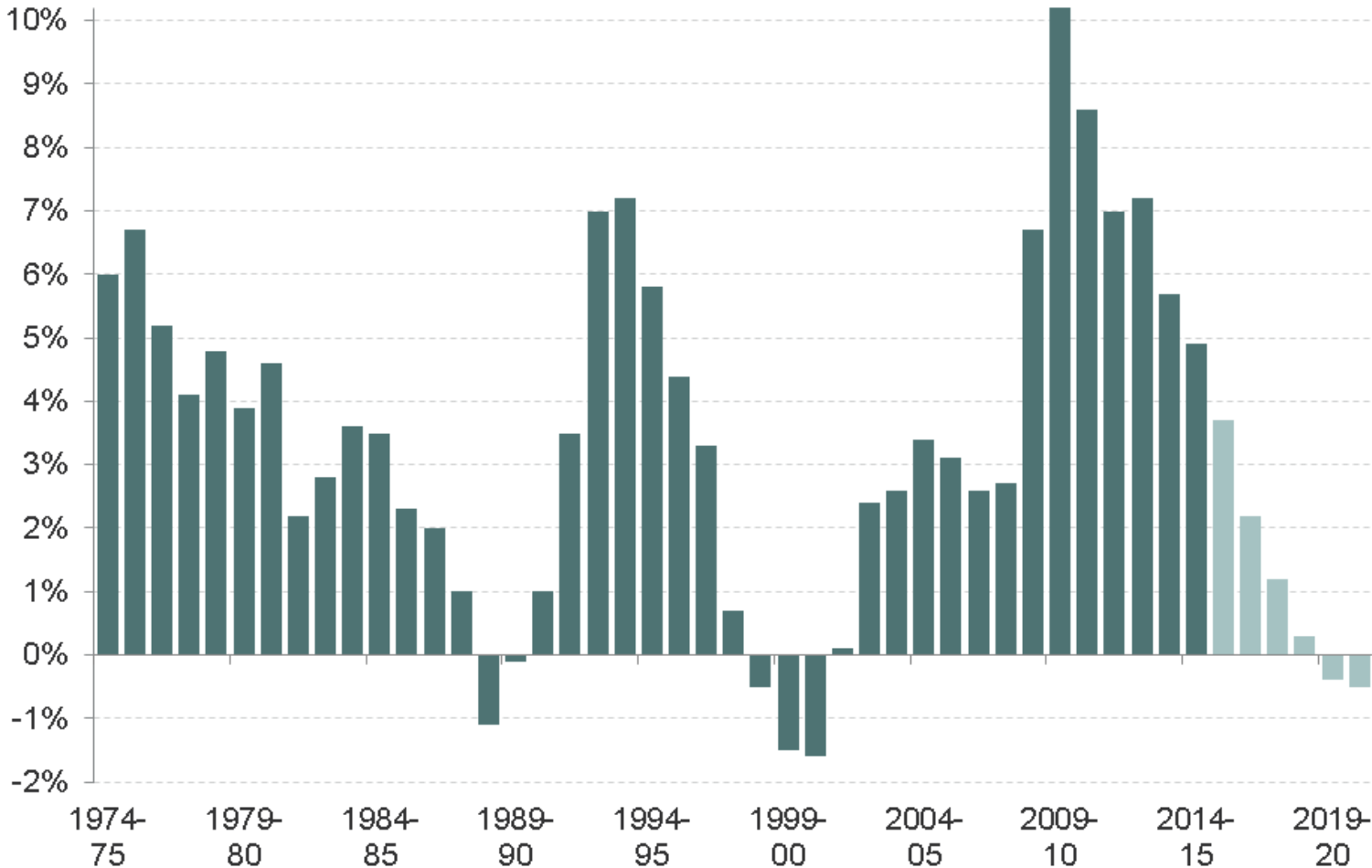
# Meaning the Chancellor's target of sustained surplus during 'normal times' is unprecedented

Government spending and receipts as a share of GDP



# The government has set itself a target of overall surplus by 2019-20

Overall deficit (PSNB) as a proportion of GDP



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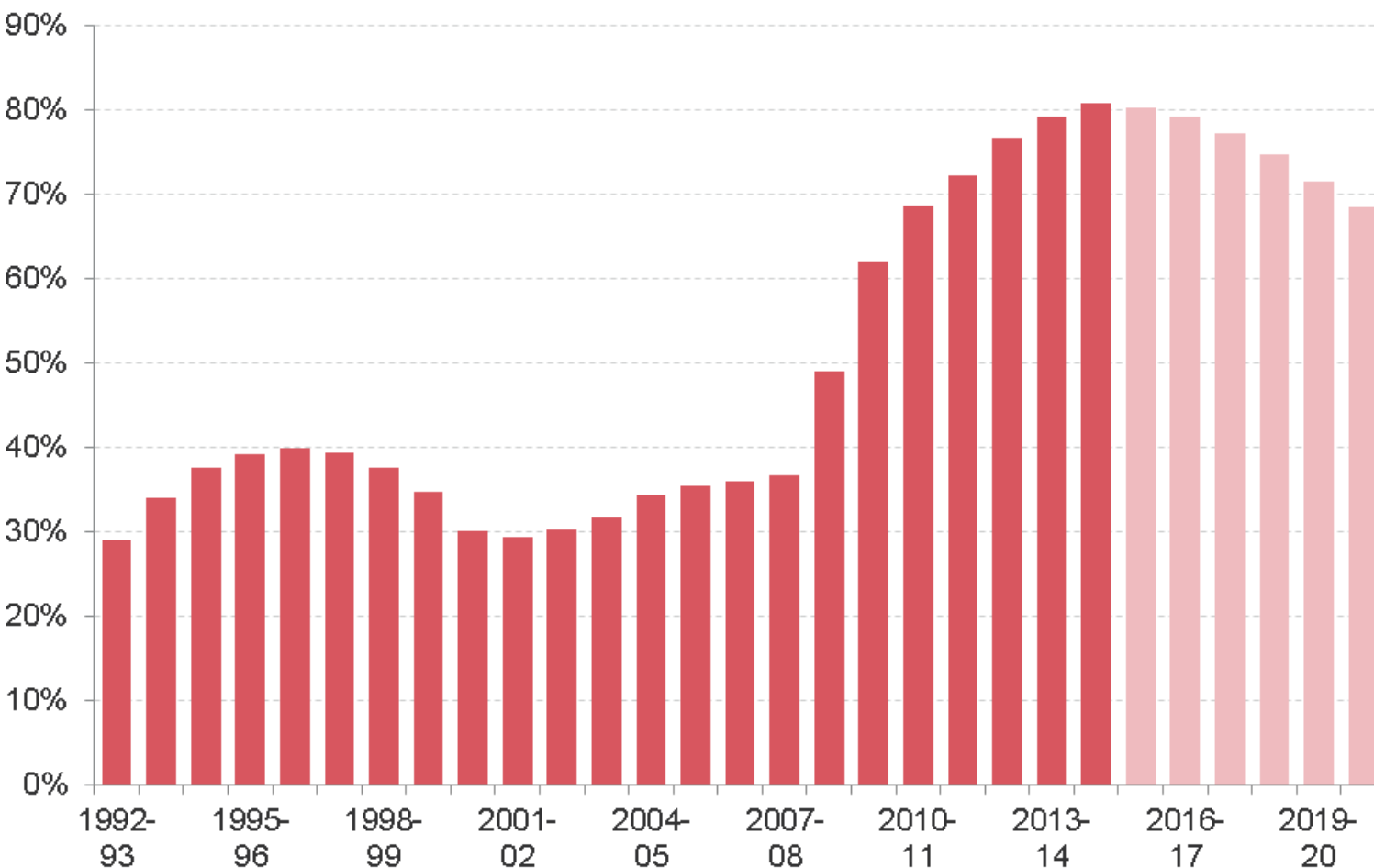
Government is expected to spend 3.7% of GDP (£70bn) more than it raises in revenue this year

Aim is for 0.5% surplus by 2020 – in contrast to a 10.2% deficit in 2009-10 and a 2.7% deficit in the immediate pre-crisis period



# And a falling trajectory for government debt relative to GDP from this year

*Public sector net debt as a proportion of GDP*



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Net debt-to-GDP ratio jumped after the financial crisis, with the government running a large deficit as the automatic stabilisers kicked in

It is now projected to fall back to around 70% by the end of the parliament



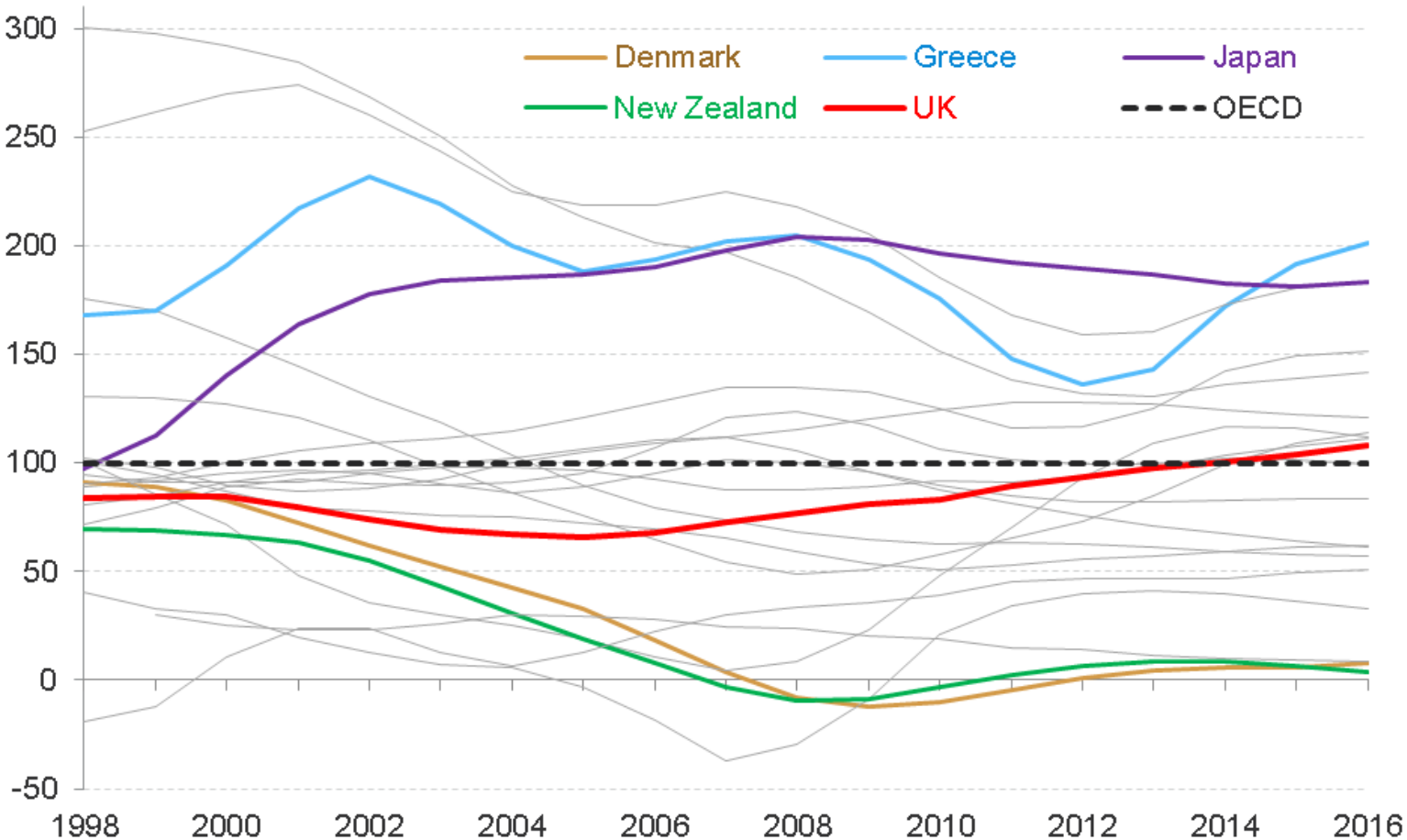
## These trajectories are underpinned by two key articles of faith

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- 1) We need a budget surplus during normal economic times
  - In theory we could run a small deficit without *increasing* debt, but the Chancellor wants to go further
  - The strongest argument for this position is that we need more **fiscal headroom** in readiness for the next downturn (a point made by the Chancellor yesterday)

# But, UK government debt levels remain relatively typical in the OECD

Indices of government debt as a share of GDP: OECD = 100 (3yr ave.)



Notes: Some countries (particularly those with large surpluses) are excluded from the chart for ease of legibility, but OECD line includes all member countries.

UK debt as a share of GDP has moved from being somewhat below the OECD average to being a little above it since the financial crisis



## These trajectories are underpinned by two key articles of faith

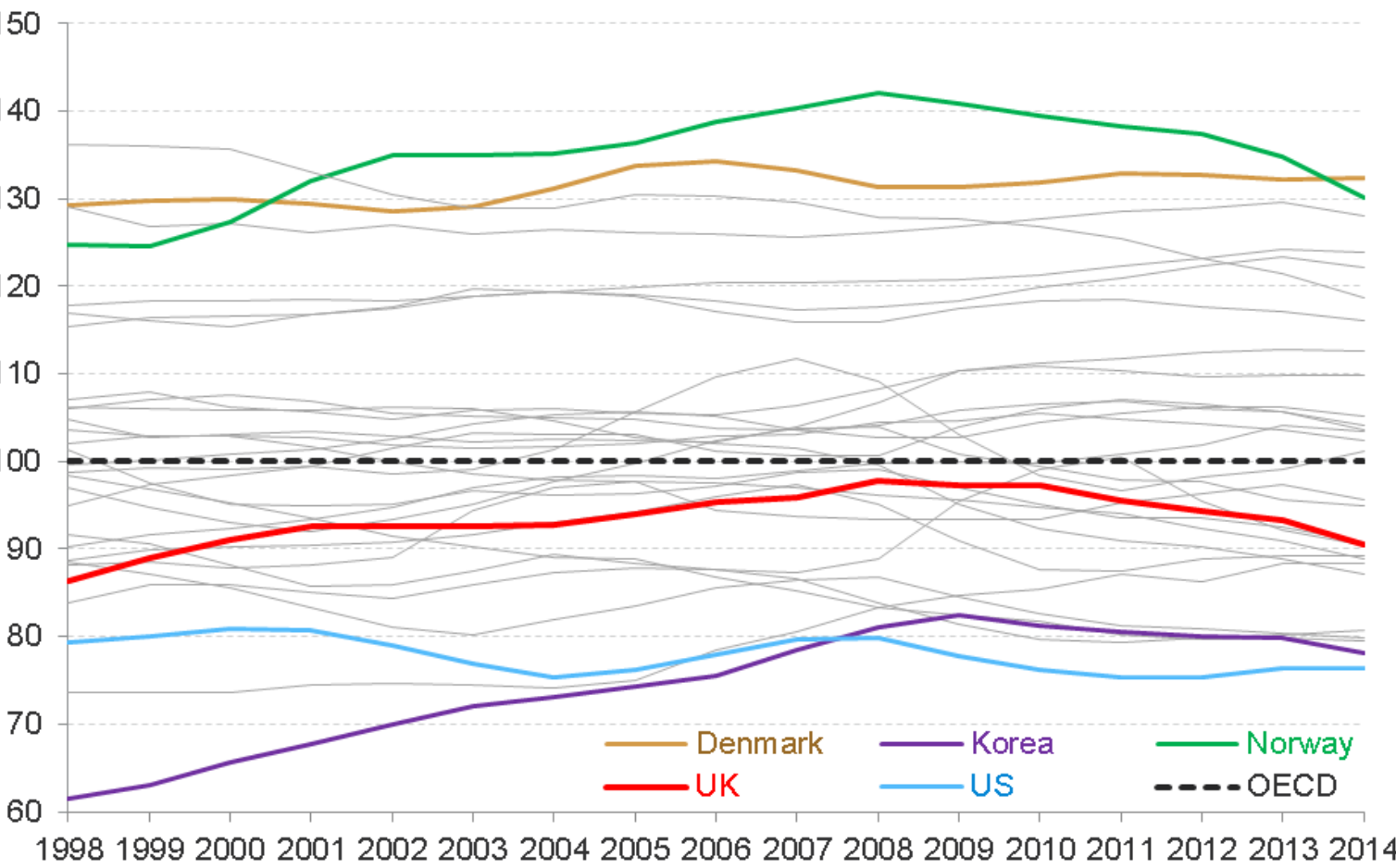
### 2) The heavy lifting on the deficit has to be done by spending

- Government revenue has tended to hover between 36% and 38% of GDP over the last 30 years
- The government has been explicit in its desire to focus on spending cuts rather than tax rises



# UK revenue/GDP approached the OECD average in the 2000s, but has fallen away post-crisis

Indices of government revenues as a share of GDP: OECD average = 100 (3yr ave.)

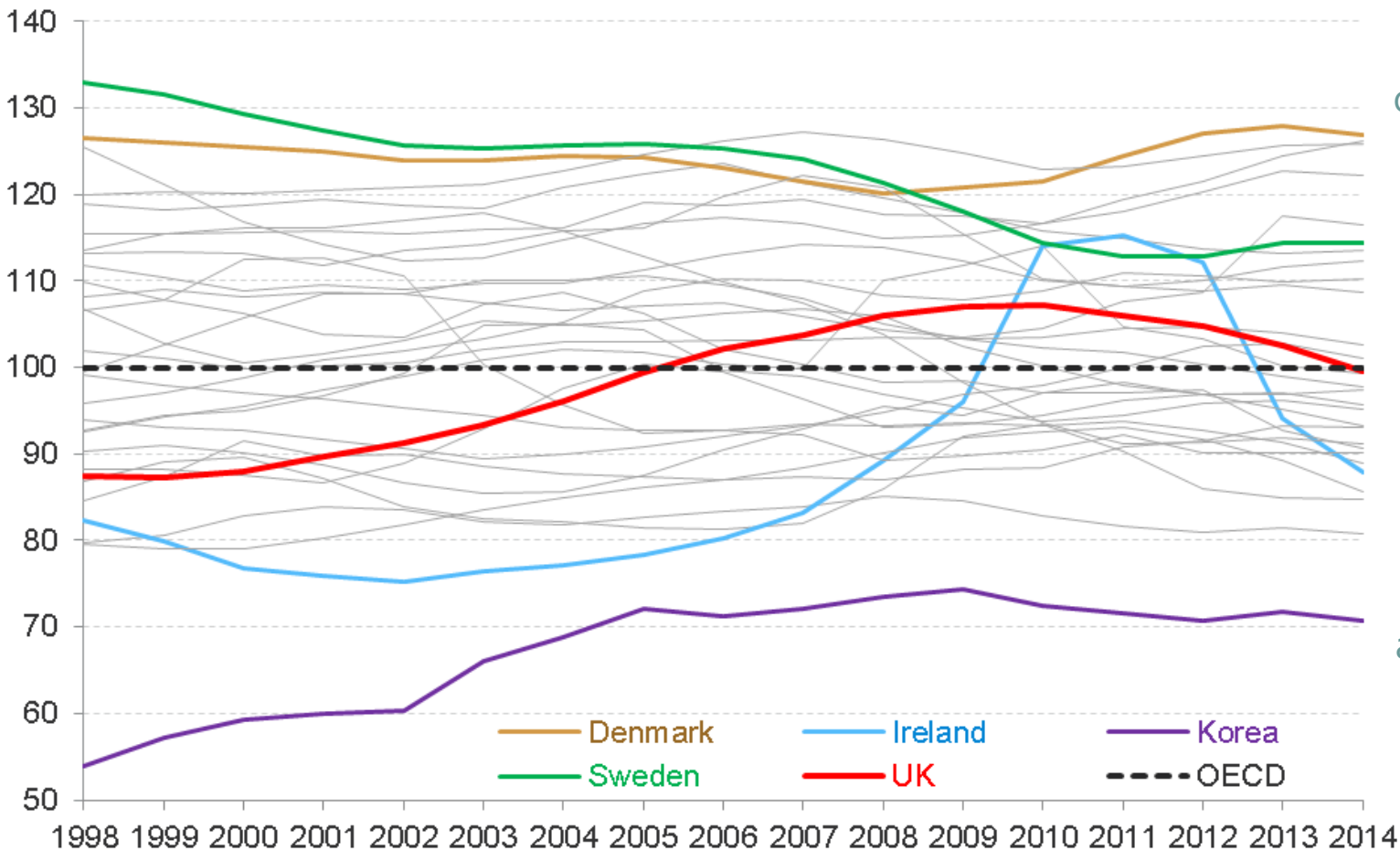


Revenue as a share of GDP rose from around 86% of the OECD average in 1998 to 96% immediately pre-crisis

It has since fallen to around 91% of the OECD level – similar to its 2000 position

# UK spending/GDP has surpassed the average since the mid-2000s, but is now falling back

Indices of government spending as a share of GDP: OECD average = 100 (3yr ave.)



An increase in spending as a share of GDP from around 2001 moved the UK closer towards and then beyond the OECD average

This was more pronounced post-crisis (as GDP fell), but the UK is now back at the OECD average and is likely to move below it as consolidation continues



## While shrinking overall, the *shape* of what the state does is affected by a series of choices

Spending is broadly split between departments (DEL) and welfare (AME)

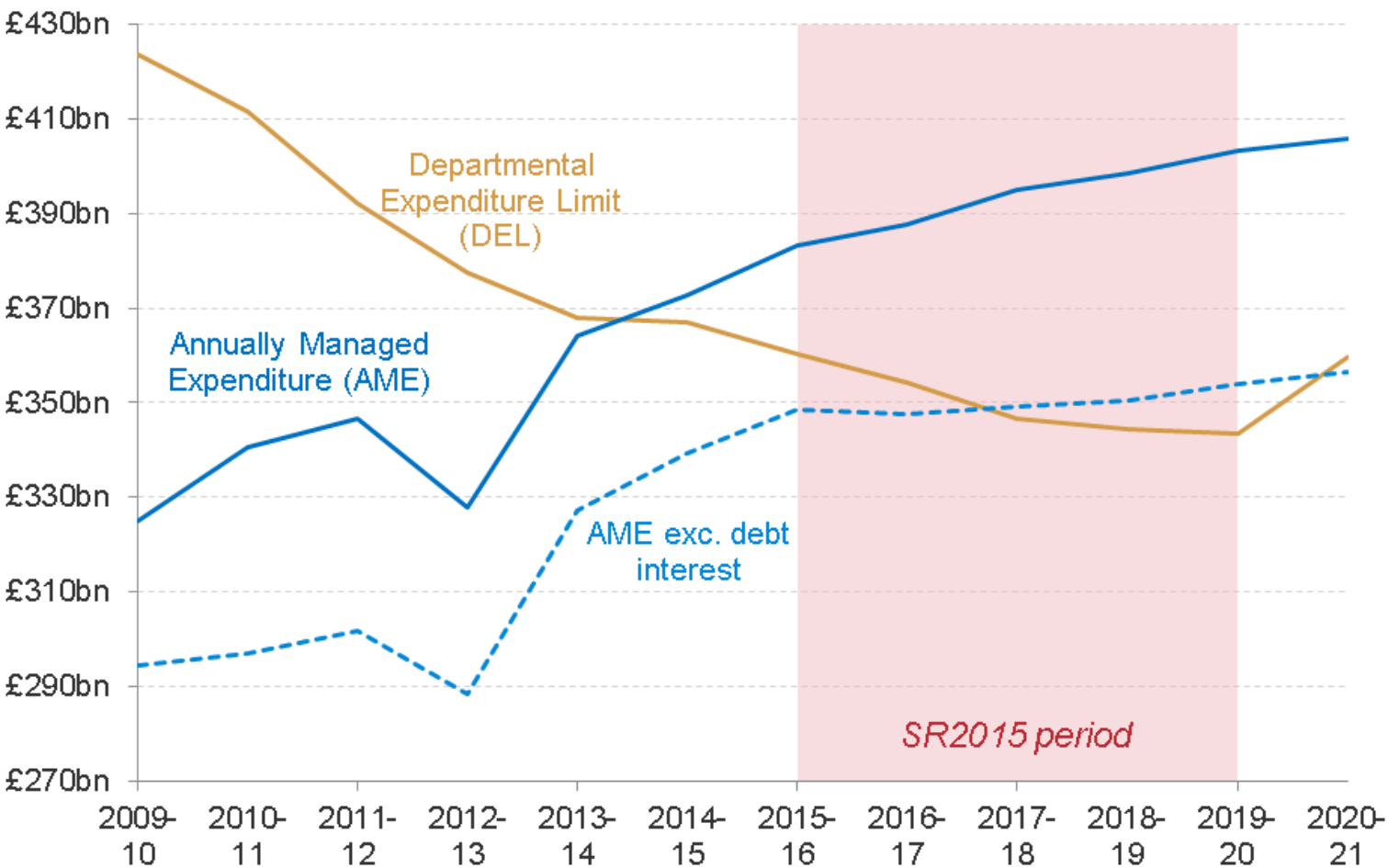
- AME (which includes debt interest) is less directly controllable, but welfare cuts clearly affect this

Within overall DEL and AME envelopes, choices are made about which services and groups to protect

- DEL protection for health, schools, aid and defence
- Welfare protection for pensioner benefits

# AME expenditure is set to continue rising, meaning DEL is falling by £80bn

Government spending (2015-16 prices, GDP deflator)



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Within real-terms TME envelope, AME is projected to rise meaning DEL must fall sharply – being some £80bn lower by 2019-20 than in 2009-10

Beyond 2019-20, the government's planning assumption is that TME will rise in line with GDP, implying a return to growth for DEL in real-terms



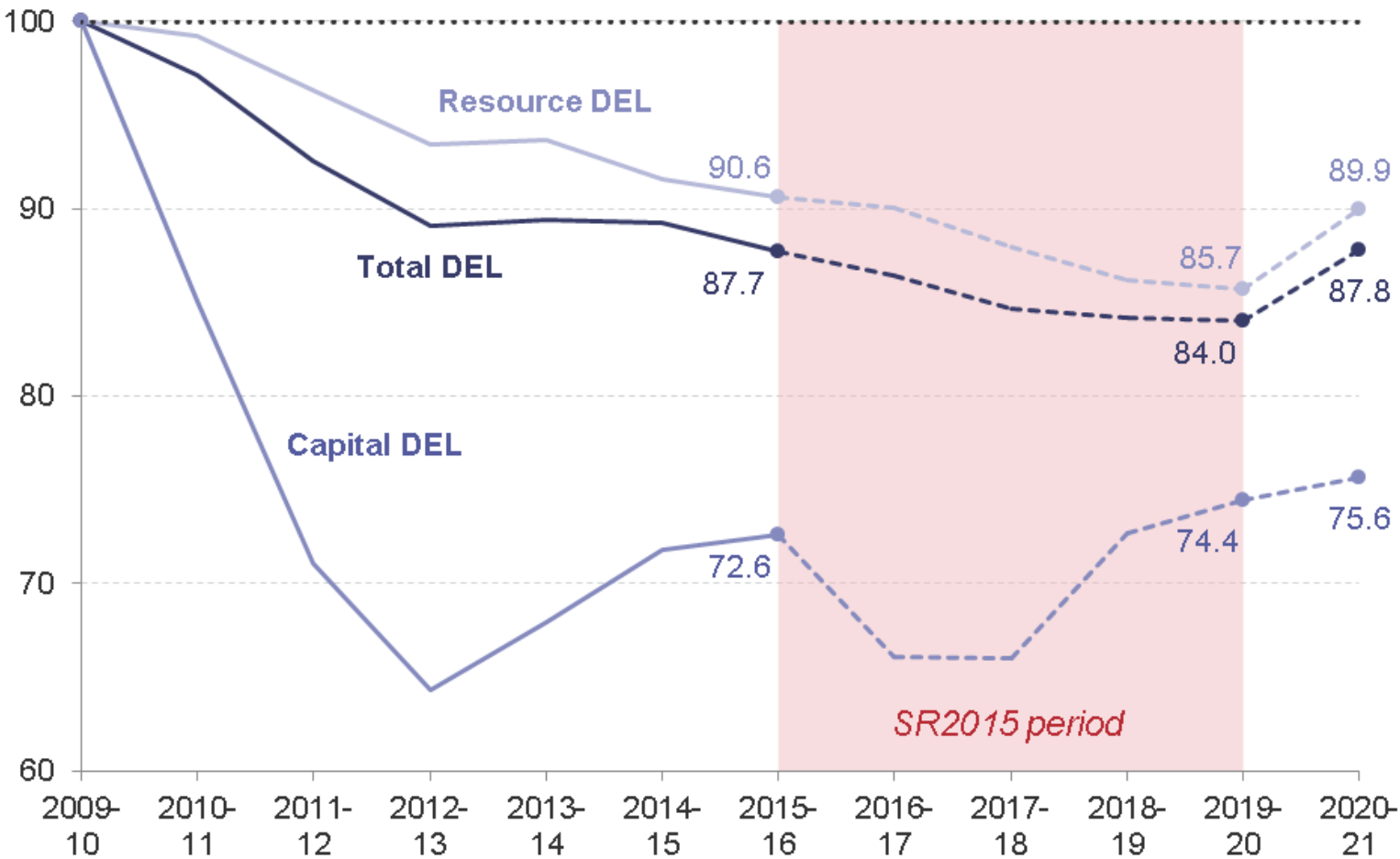


# THE NEW PUBLIC SERVICES MIX

*The split of consolidation across  
resource, capital and departments*

# SR2015 is set to reduce DEL by 4%, taking the cumulative cut since 2009-10 to 16%

Departmental (DEL) spending in real terms: 2009-10=100



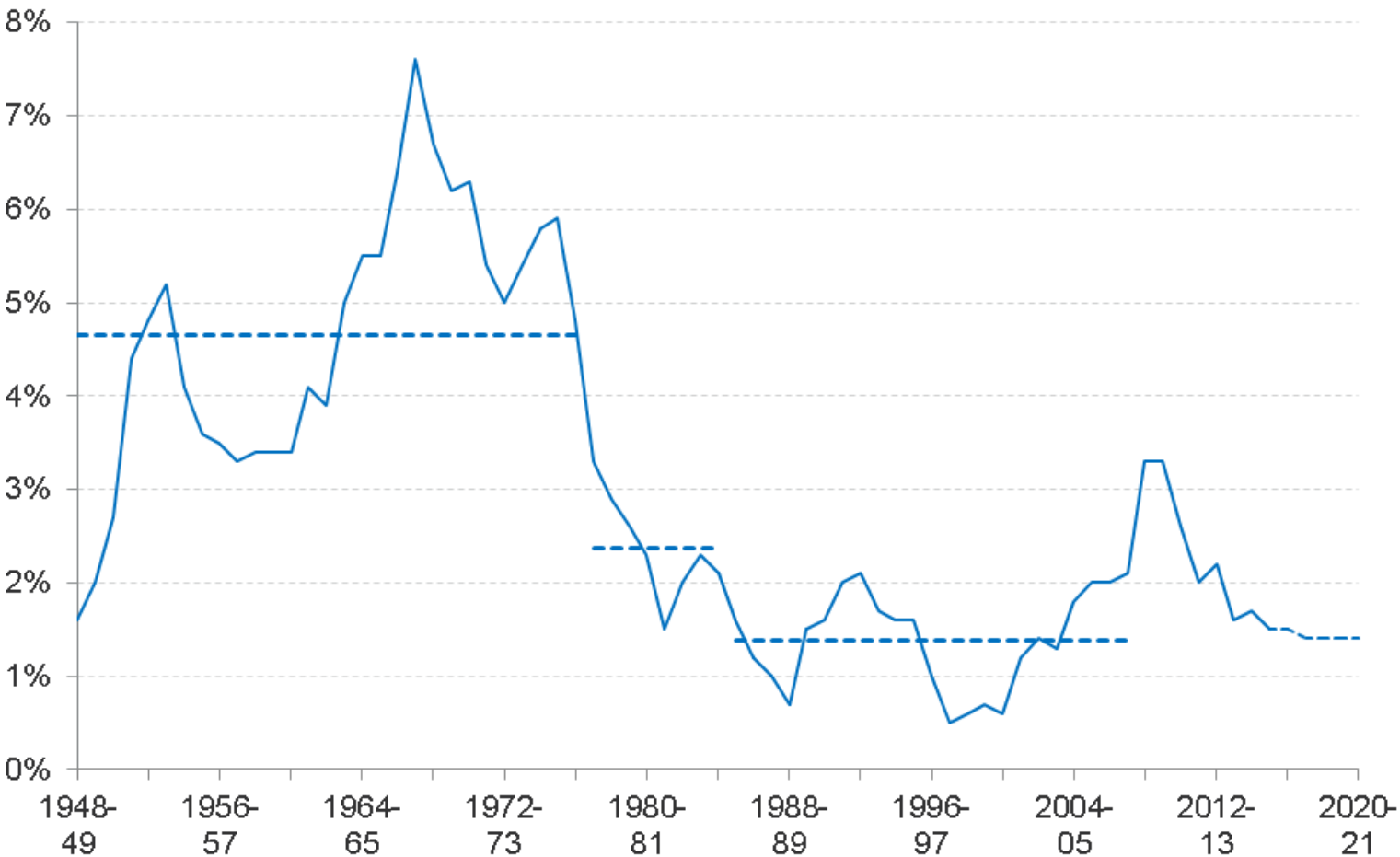
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Resource DEL (day-to-day spend) was cut by 9% between 2009-10 and 2015-16. It is set to fall by a further 5.4% in SR2015, taking the cumulative cut to 14%

Capital DEL (investment) was cut sharply from an inflated 2009-10 base, but rose after 2012-13 and is protected in this parliament

# Despite being protected, public investment is set to fall to its lowest level since 2003-04

*Public sector net investment as a share of GDP*



Maintaining capital spending as a share of GDP leaves PSNI at its 2003-04 level – broadly in line with its pre-crisis average, but down on historic levels

And PSNI as a share of GDP remains some way below the OECD average

# Protections for some elements of RDEL imply much sharper cuts for unprotected areas

## Spending Review 2010 protected

- **Schools** (*5-16 schools budget protected in real terms*)
- **Health** (*real terms increase in NHS funding of 0.4 per cent over the period*)
- **Overseas Development Aid** (*increase to 0.7 per cent of GNI from 2013*)

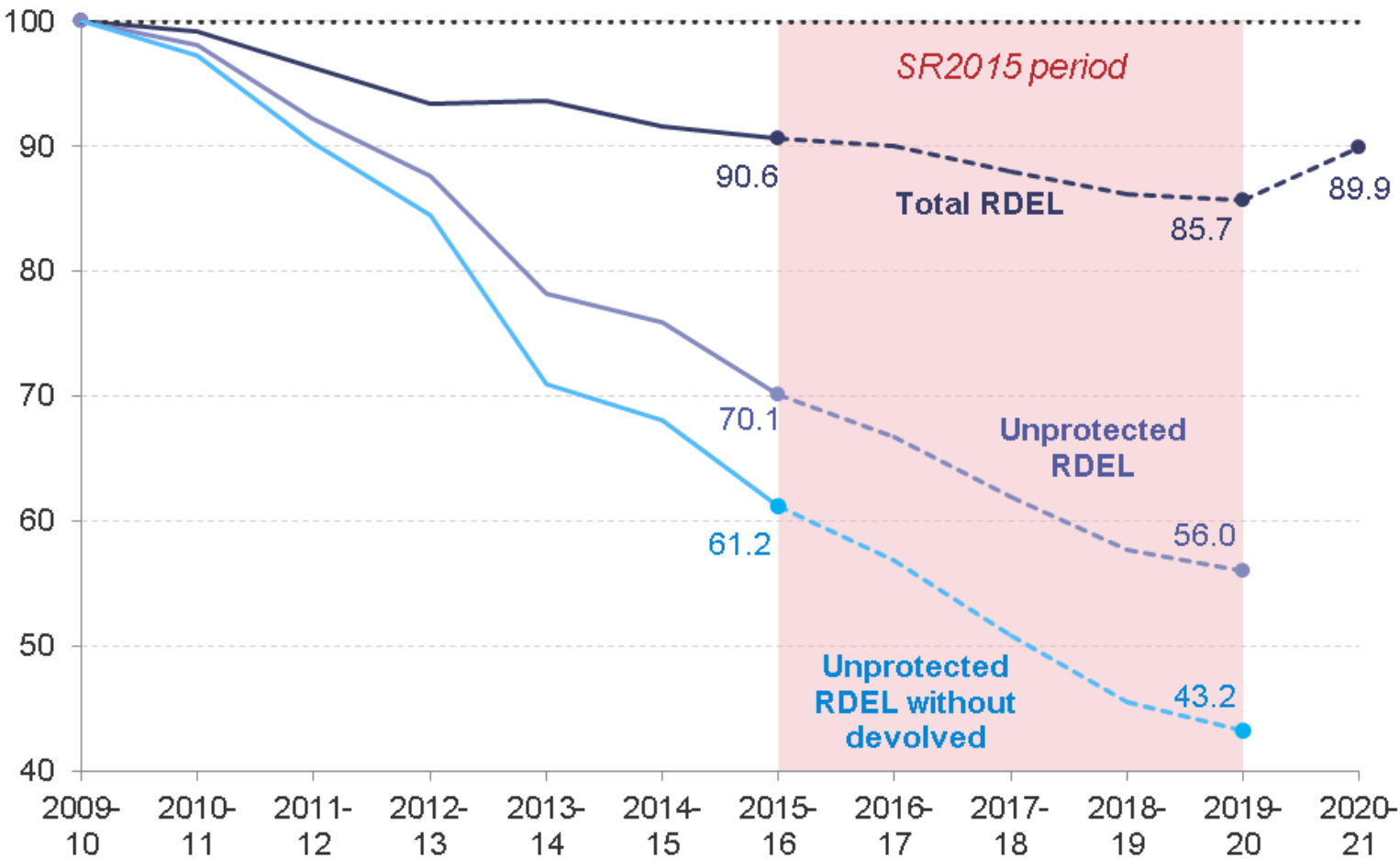
## Spending Review 2013 extended these and pupil premium protection

## Spending Review 2015 is underpinned by similar arrangements

- **Schools** (*RDEL per pupil frozen in nominal terms in 5-16 schools budget*)
- **Health** (*real terms £8bn more for England by 2020 relative to 2015-16*)
- **Overseas Development Aid** (*maintained at 0.7 per cent of GNI*)
- **Defence** (*commitment to spend 2% GDP, resulting in 0.5% pa increase in MOD budget*)
- **Security** (*protecting counter-terrorism spending and increasing intelligence expenditure*)

# Protections for some elements of RDEL imply much sharper cuts for unprotected areas

Resource DEL spending in real terms: 2009-10=100



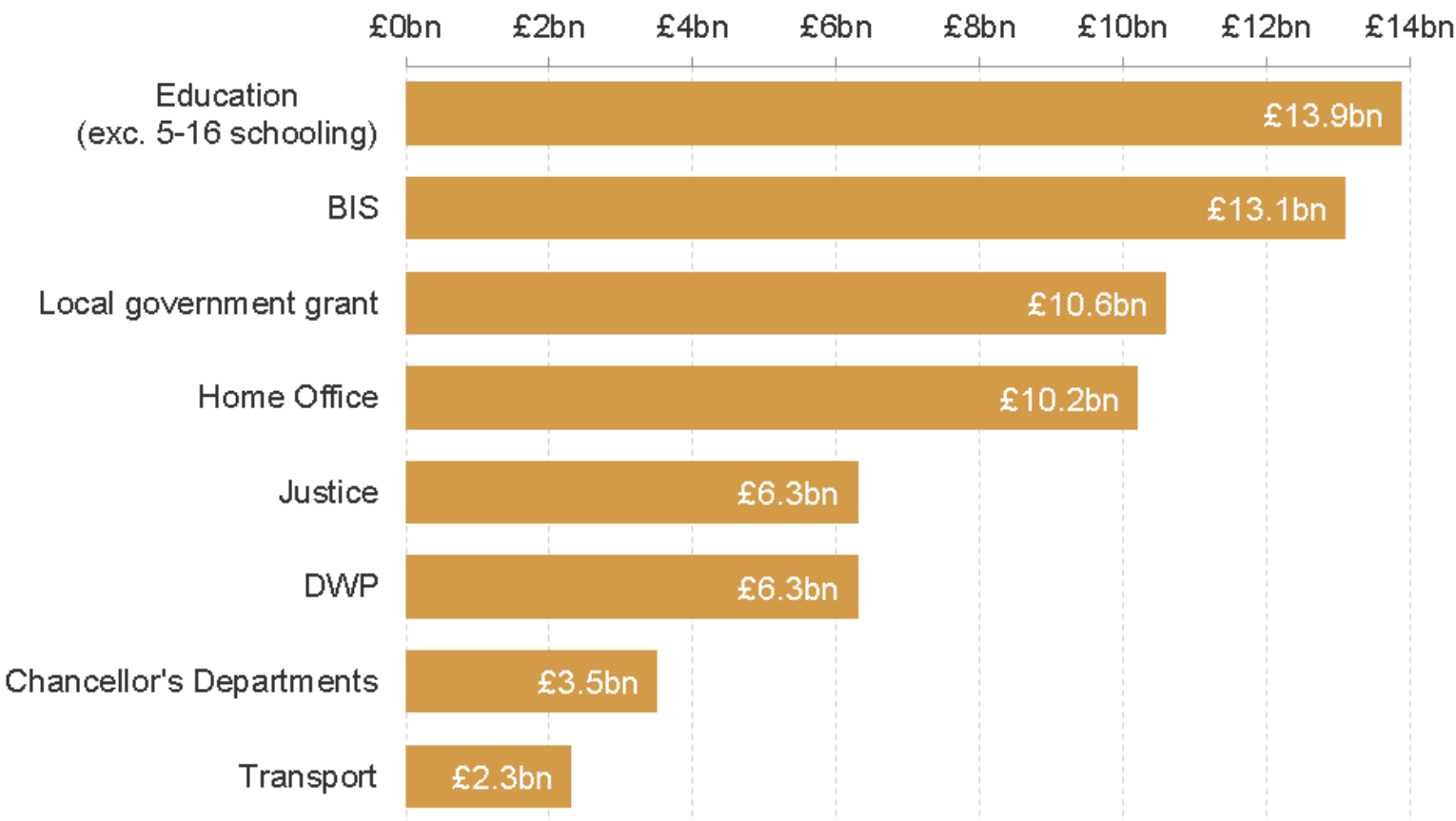
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The protected areas account for around 1/2 of total RDEL, meaning the remaining cuts must be shared across a relatively modest portion of the overall budget

Stripping out Scotland, Wales and Northern Ireland implies cumulative cuts of over 60% for the unprotected departments

# Implying large potential cuts to non-schools education (incl. children's services) and BIS

## Largest unprotected RDEL budgets



SR2015 cuts of around £20bn must be found within a total unprotected RDEL budget of just £80bn

The largest areas of non-schools education, BIS, local government and the Home Office are likely to face the biggest absolute cuts

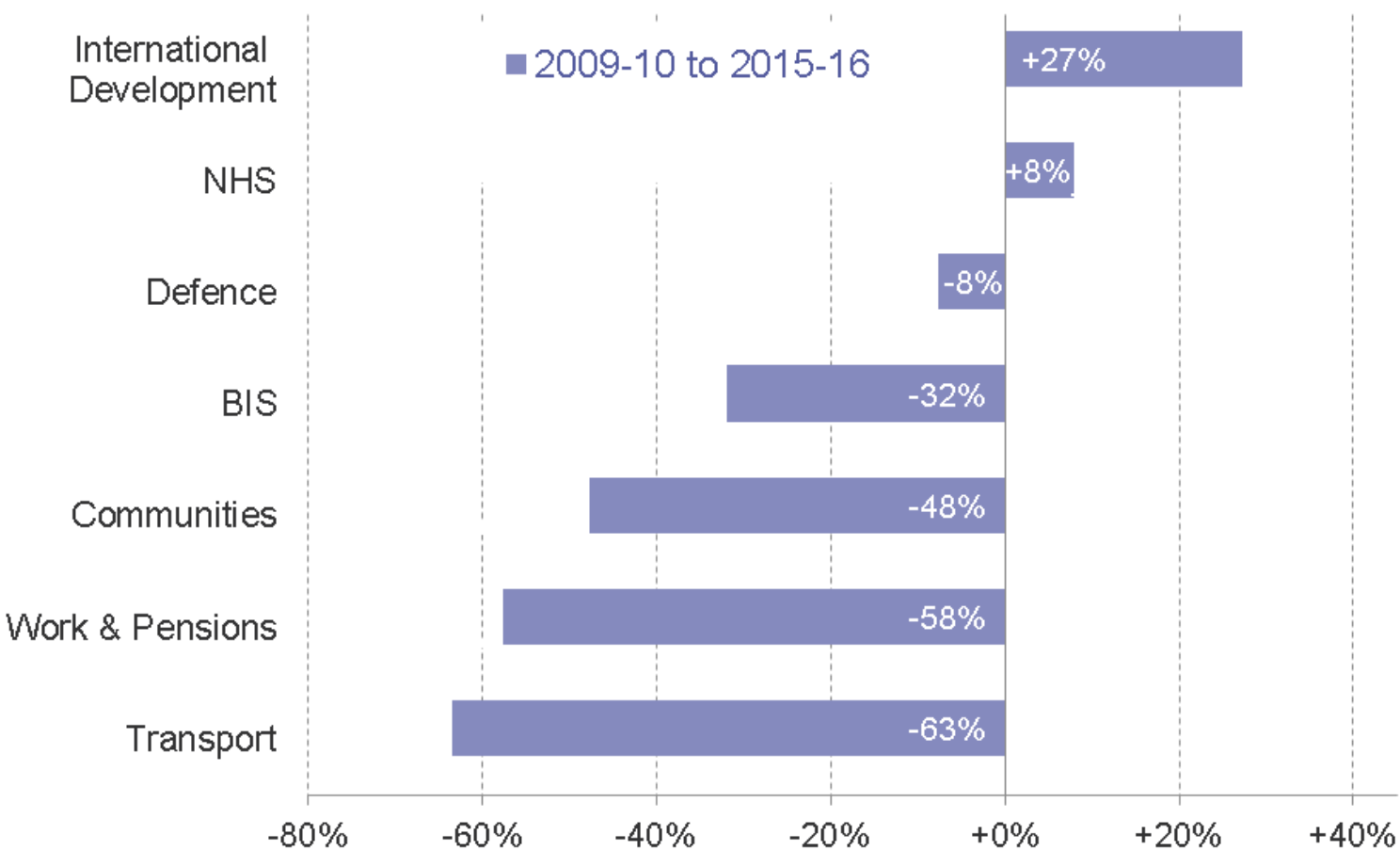
# SR 2015 cuts will come on top of already significant budget reductions since 2010

Many departments have already faced day-to-day budget reductions of between one-third and two-thirds

HMT has asked them to say how they'd make further cuts of between 25% and 40% in preparation for SR2015

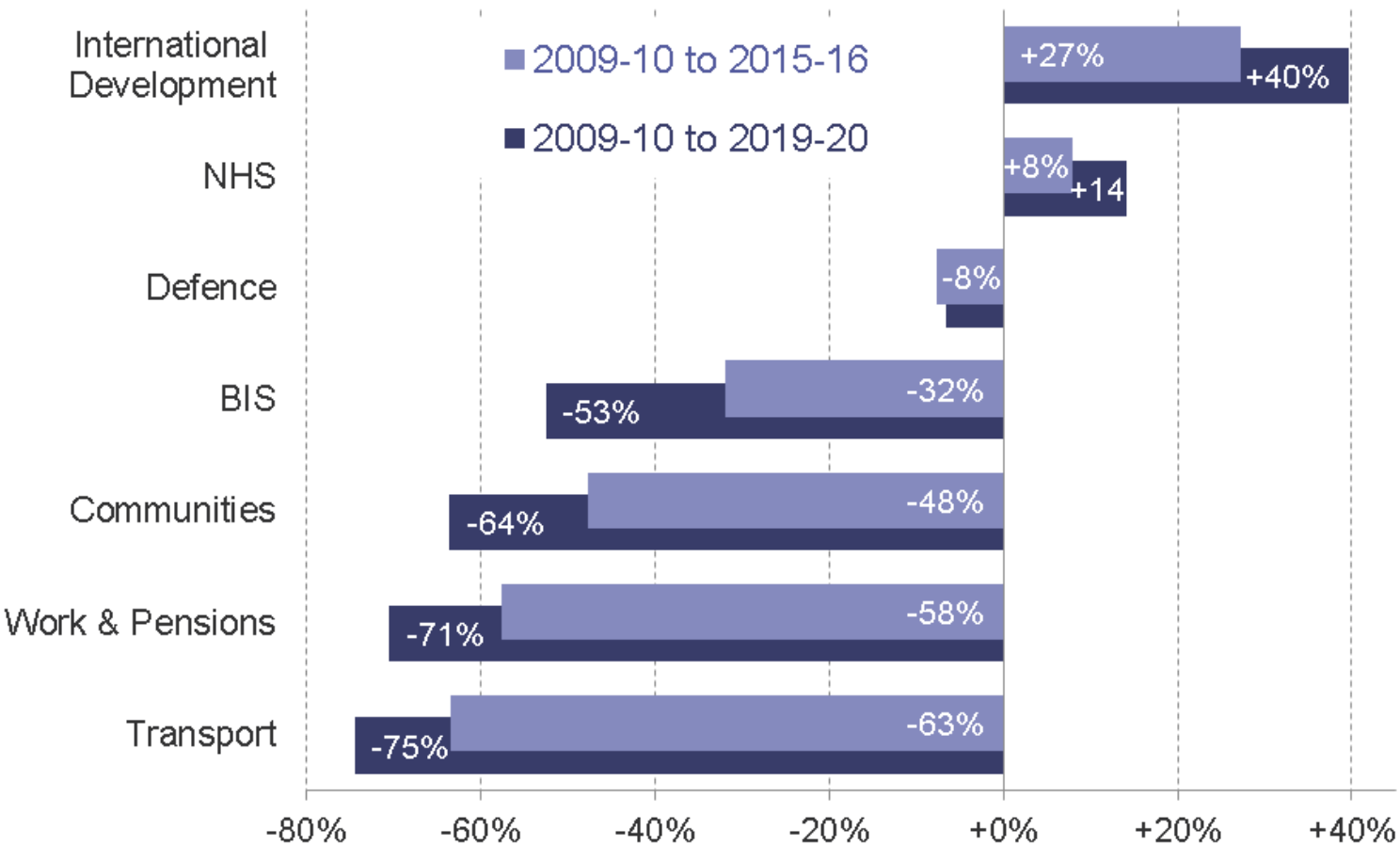
Average annual cuts of 8% have been agreed across DFT, DEFRA, CLG & HMT

Real change in RDEL since 2009-10 (GDP deflator)



# Potentially leaving some departments facing cumulative cuts of up to three-quarters

Real change in RDEL since 2009-10 (GDP deflator)



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Applying the required RDEL cuts equally across the unprotected departments implies an overall shrinking since 2009-10 of more than 75% in Transport and more than 60% in Communities

A number of other departments would face budgets that had halved since 2009-

10

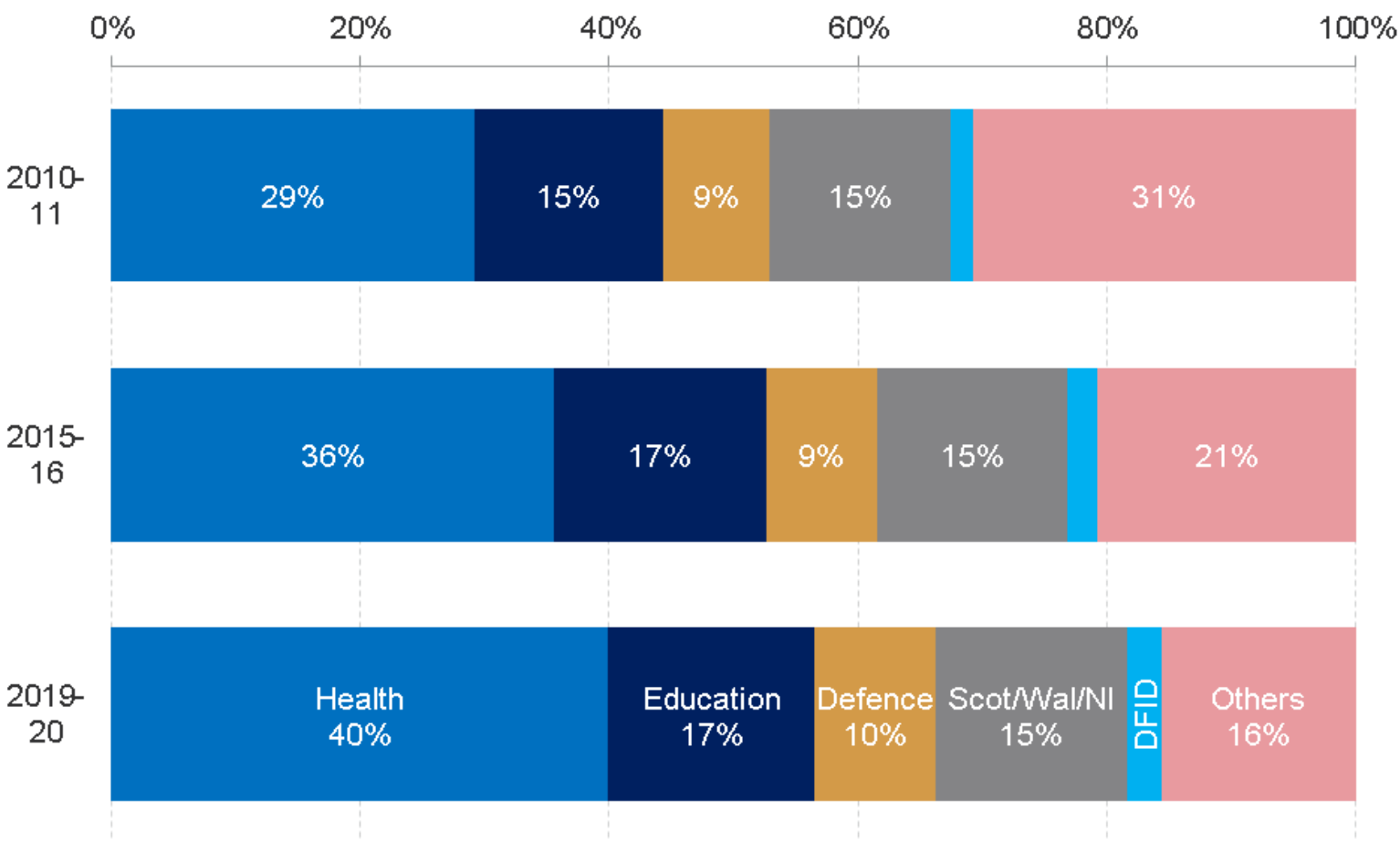


# This decade-long consolidation is fundamentally altering what government does: *RDEL*

RDEL spending on health is set to increase from around 29% of the total in 2010-11 to 40% by 2019-20

In contrast, resource spending outside of the protected areas (and the Barnett departments) will have shrunk from 31% to just 16% of the total

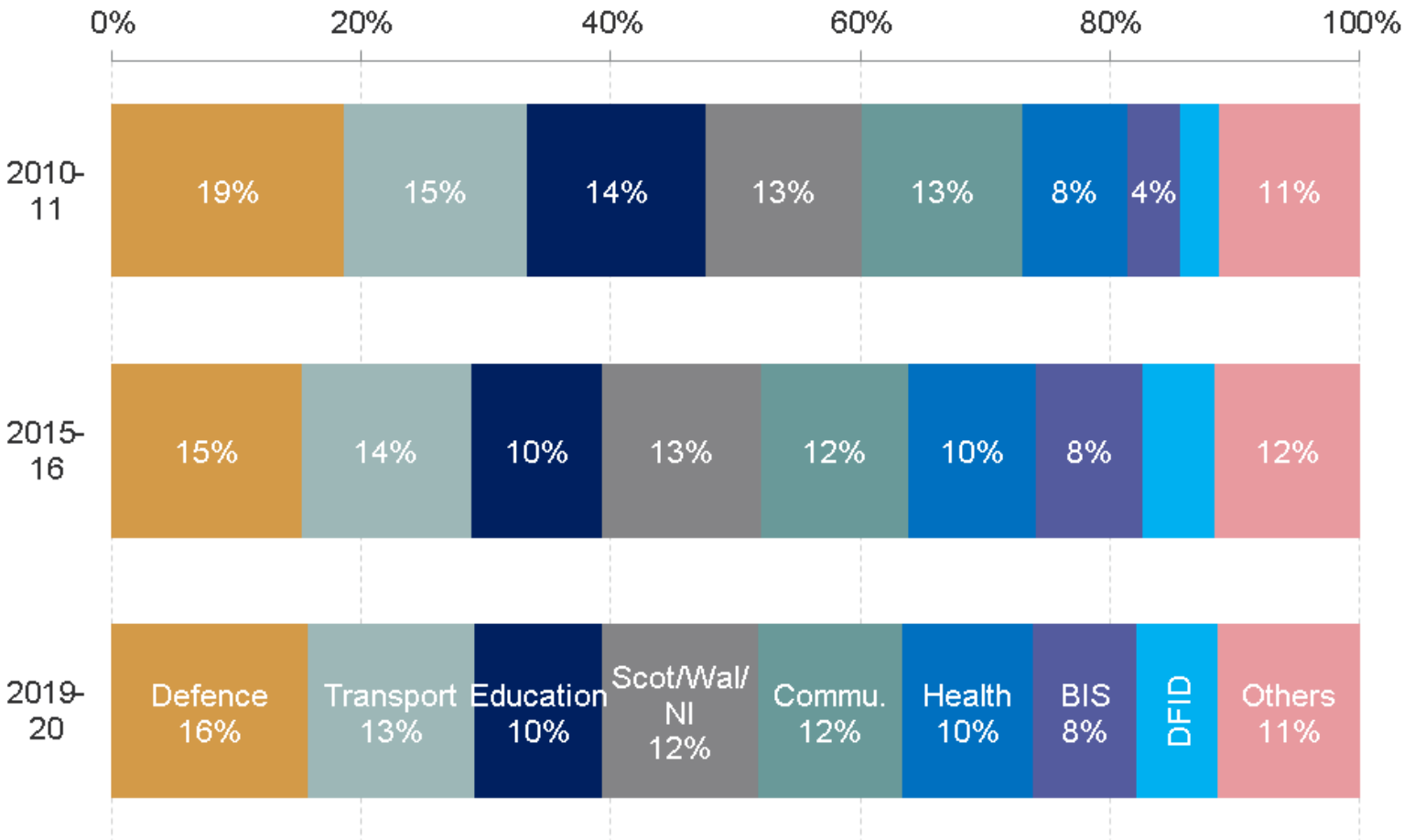
Composition of resource departmental spending



# This decade-long consolidation is fundamentally altering what government does: *CDEL*

The composition of CDEL spending has been relatively steady since 2010, though health has again increased its share a little

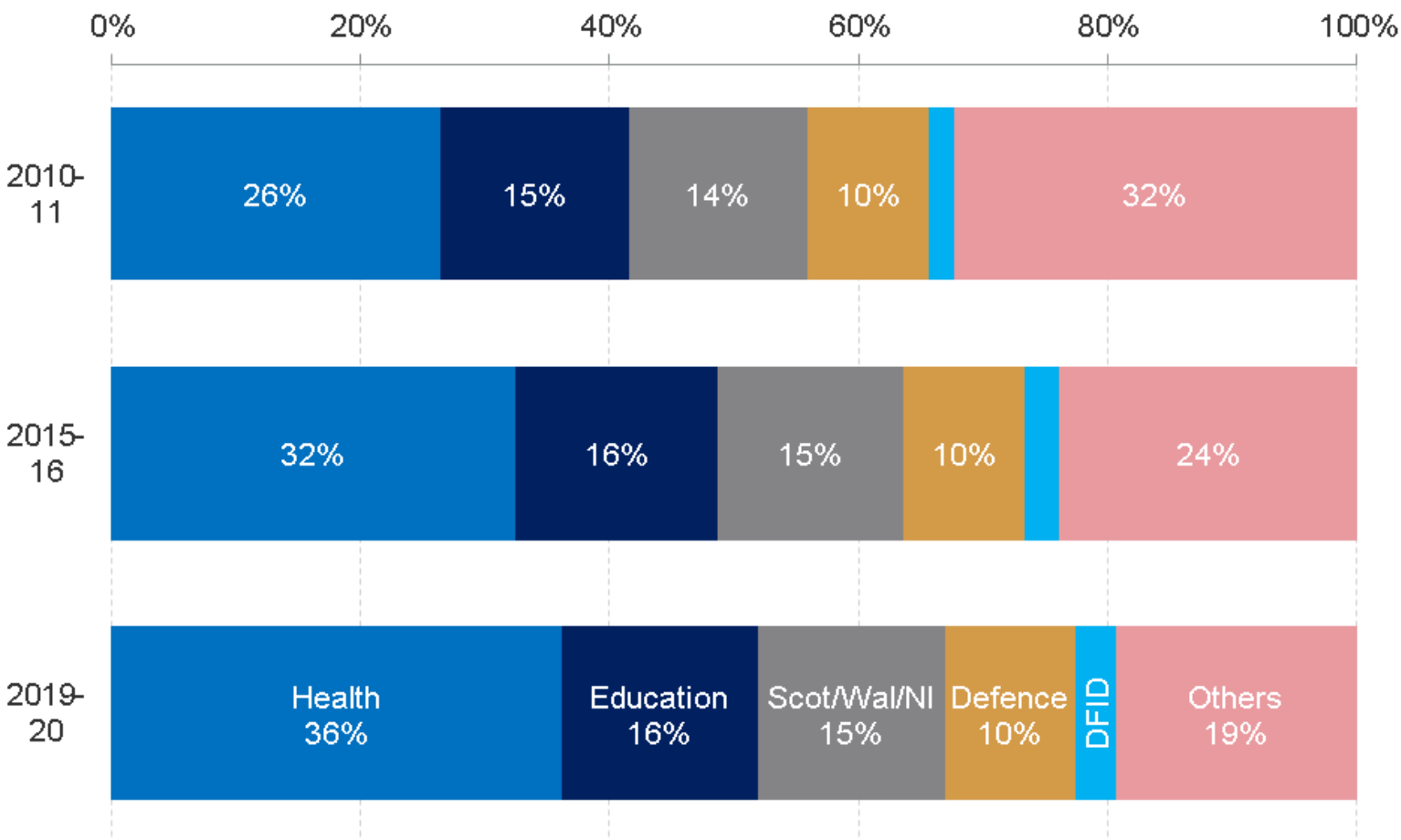
Composition of capital departmental spending



# This decade-long consolidation is fundamentally altering what government does: *total DEL*

Taking all departmental spending together, health is set to increase from just over 1/4 of the total in 2010-11 to more than 1/3 by 2019-20

Composition of total departmental spending

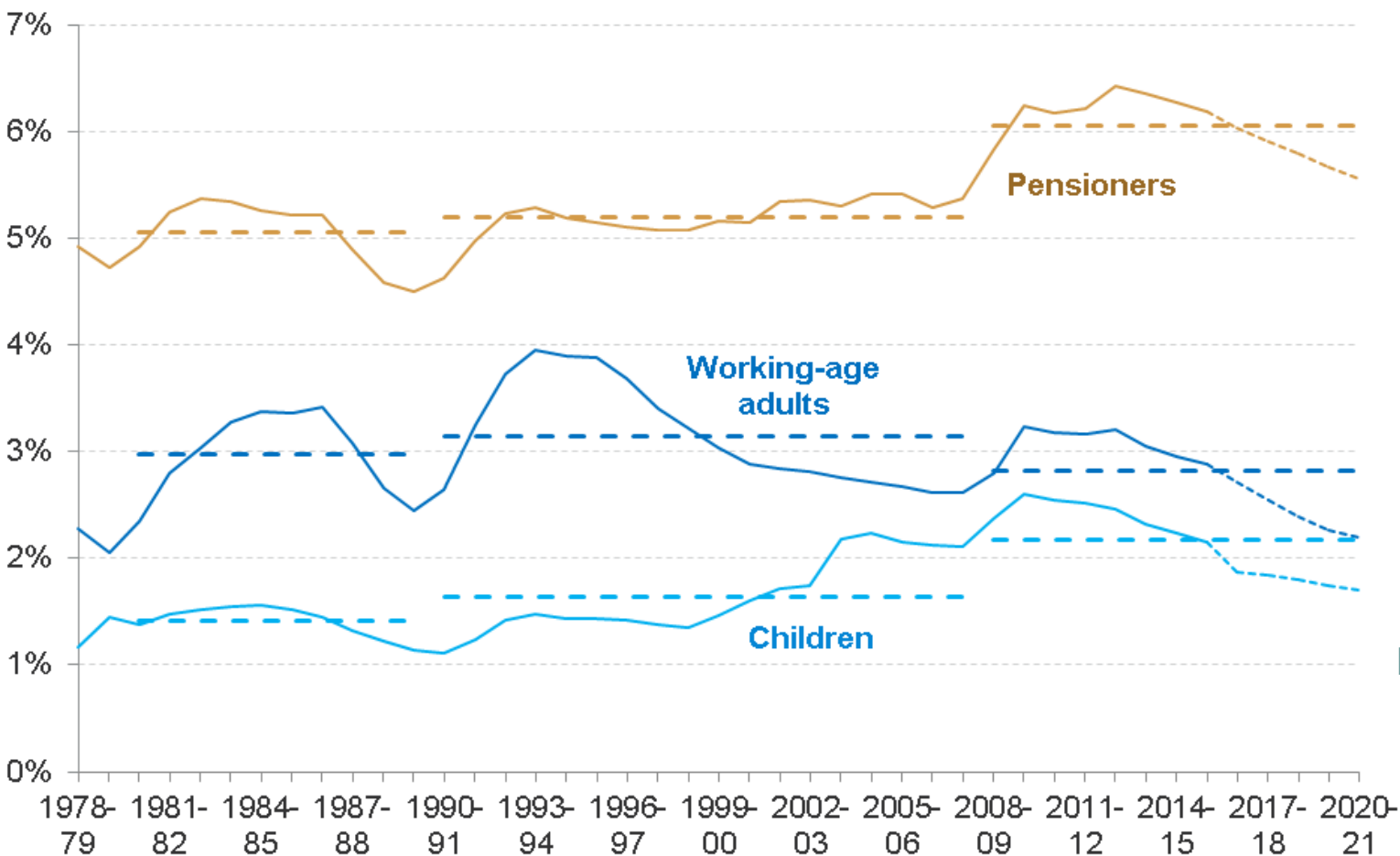


# WELL FAIR?

*The changing distribution of household welfare during consolidation*

# Within the welfare budget, there has been a post-crisis divergence between different groups

Welfare spend as a share of GDP



By 2020, working-age adult welfare is set to fall to its lowest level since 1979; spending on children will be back to its 2002 level; while pensioner spend will fall to its immediate pre-crisis level

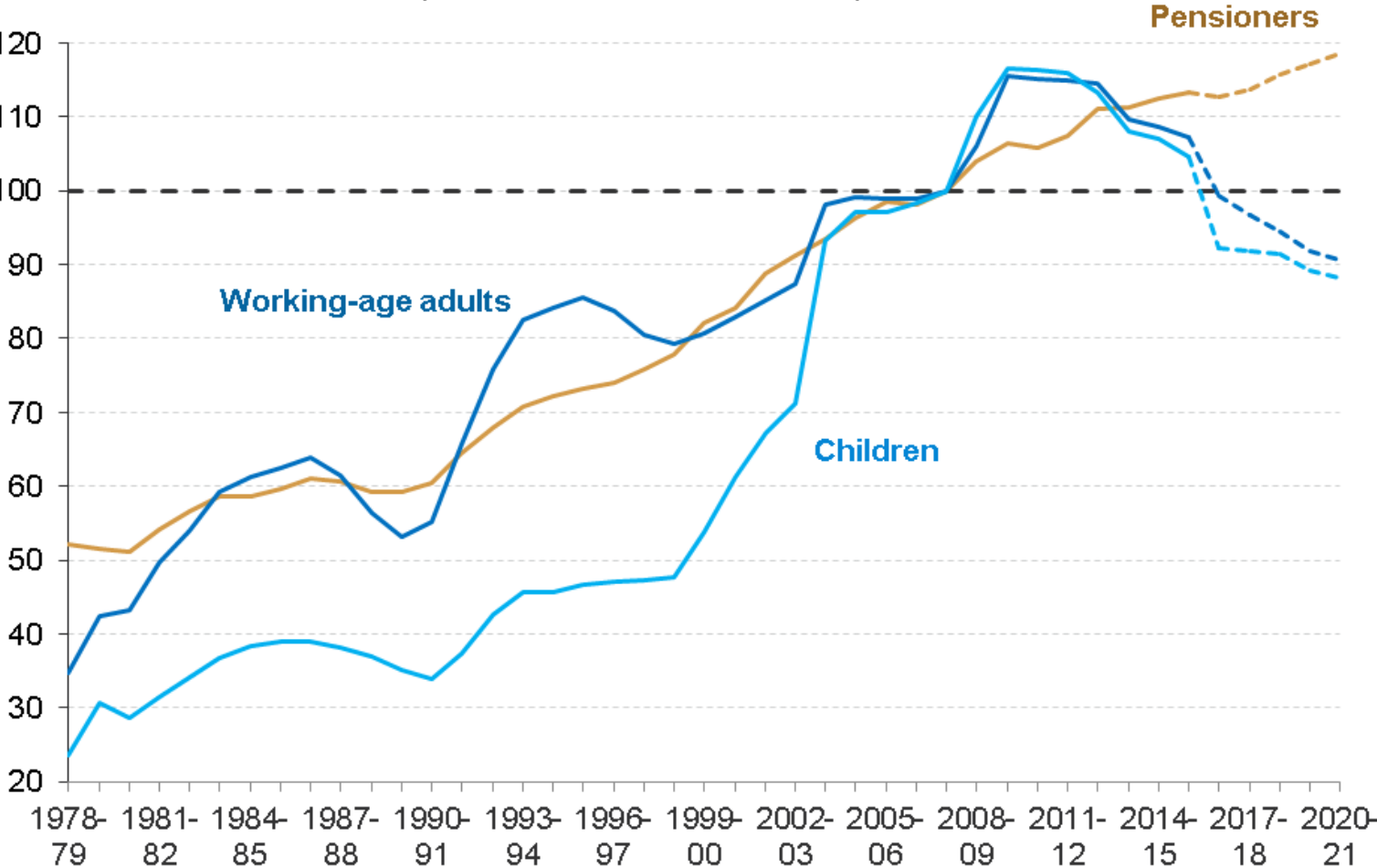
Pensioner reduction is being driven by increasing State Pension age to 66 by 2020

Notes: 'Children' expenditure consists of Child Benefit, child DLA and personal tax credits paid to families with children



# Driven not just by demographics but by generosity too

Per-head value of benefits (2007-08 = 100, GDP deflator)



Benefit payments per head have risen over time, with spend per child rising most quickly

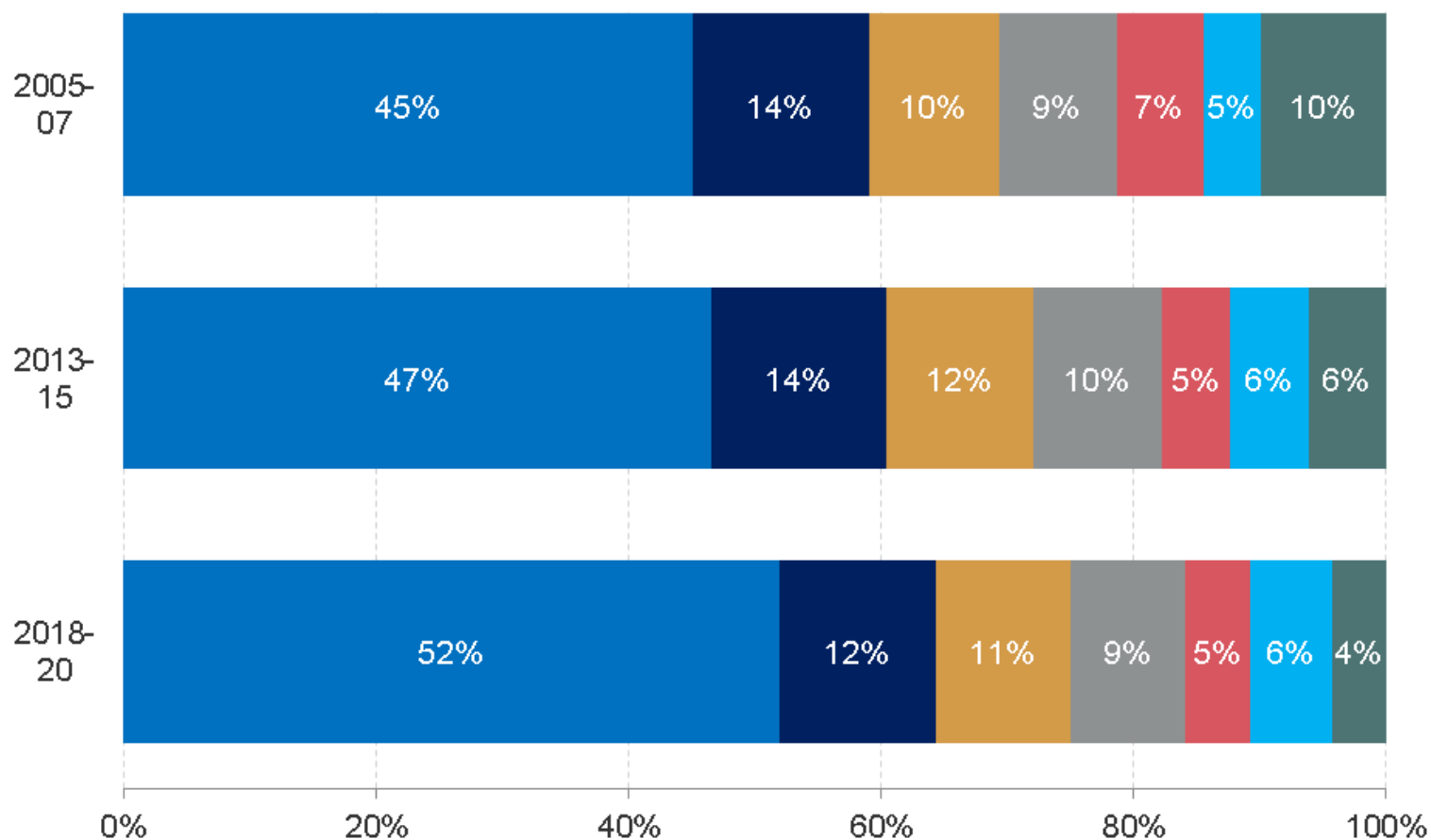
But, by 2020, working-age adult payments per head are set to be 9% lower than pre-crisis, child payments will be 12% down and pensioner payments will be 19% higher

Notes: 'Children' expenditure consists of Child Benefit, child DLA and personal tax credits paid to families with children

# Radically changing the focus of welfare spending

Composition of welfare spending (multi-year averages)

■ Pensioner benefits ■ Tax Credits ■ Housing ■ Disability ■ Child Benefit ■ ESA/IB ■ IS/JSA/other



Pensioner benefits accounted for 45% of total welfare spending immediately pre-crisis, but are set to account for 52% by the end of the decade

In contrast, tax credit and child benefit spending will have fallen from 21% to 17% of the total



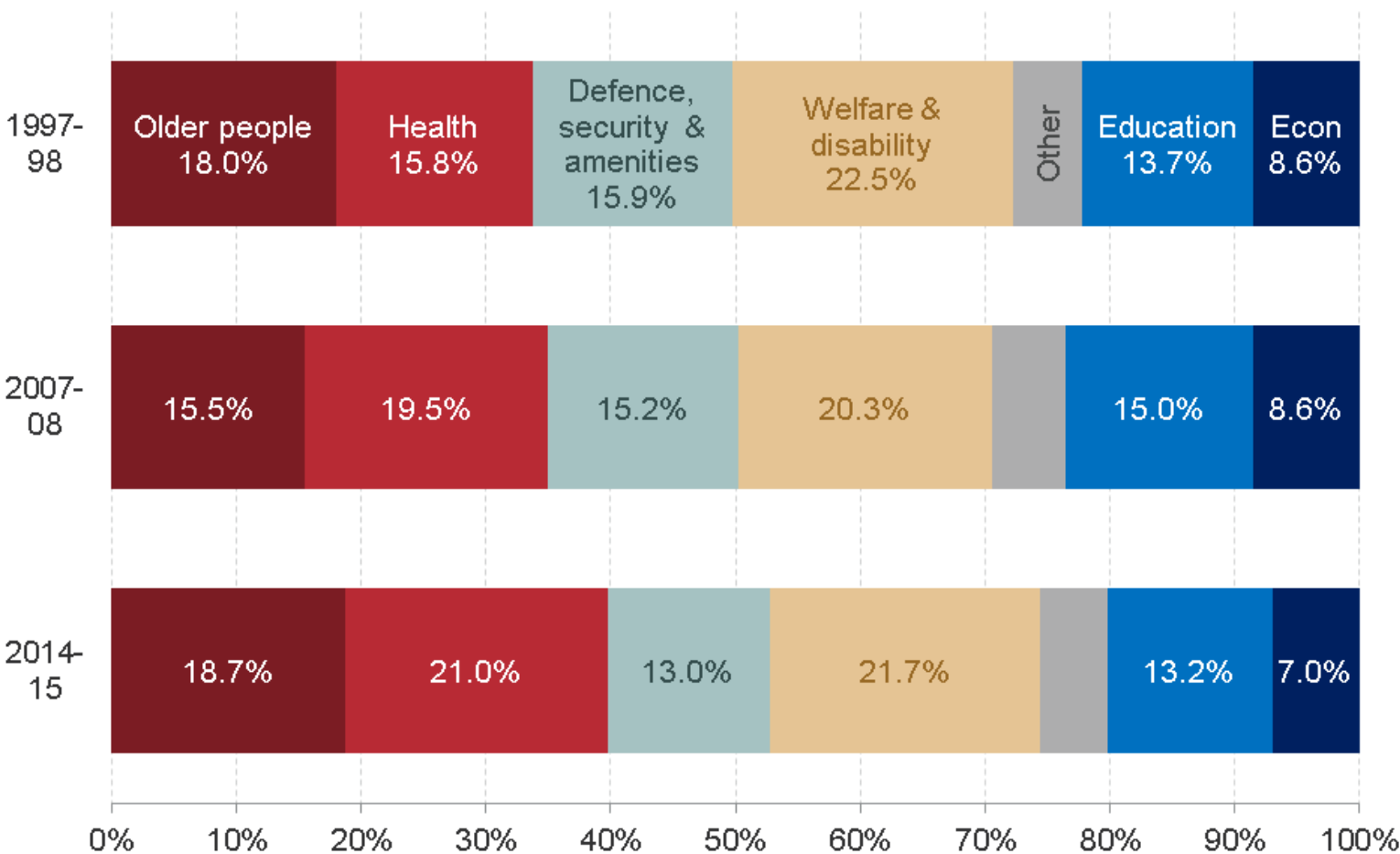
# THE STATE OF THINGS TO COME

*Assessing how the role of the state has  
shifted in recent years*



# Sustained consolidation w/ some protections has profound consequences for what the state does

Composition of government non-debt interest spending



Between 1997-98 and 2007-08, spending on education and economic 'functions' expanded slightly

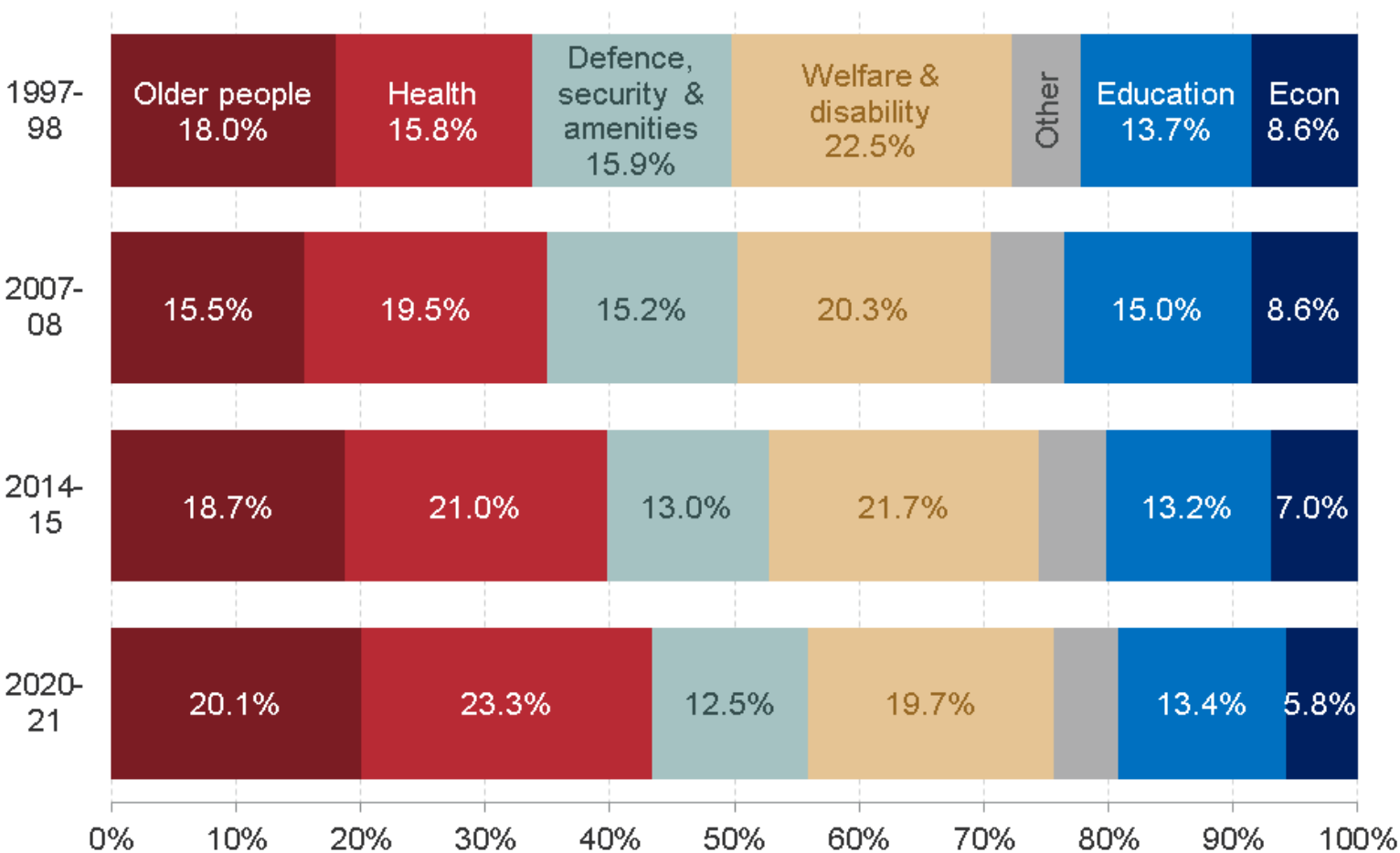
But this share has shrunk post-crisis

Old age and health expenditure has expanded from around 1/3 of the total in 1997-98 to roughly 2/5 today

Notes: 'Econ' covers economic affairs such as R&D and housing development.

# Continued protections at the Spending Review are set to exacerbate this position

*Composition of government non-debt interest spending*



By 2020-21, the share of government spending flowing to older people and health could reach 43%, its highest level since comparable records began in the 1990s

In contrast, the share allocated to education and economic affairs will have reached a new low of 19%

Notes: 2020-21 estimate is calculated by: first applying today's split of functions by department to projections for 2020-21 departmental budget totals; and second by using welfare estimates for different groups.



# The changing size and shape of the state:

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## *some conclusions*

- Underpinned by an assessment that it must both deliver a surplus in order to reduce debt and do so via spending cuts, **the government is set to reduce the size of the state towards historic lows**
- **Subjective choices** about the split between DEL and AME, consumption and investment and different services and groups **fundamentally alter the shape of the state** over time
- In particular, the **nature of the post-crisis consolidation** – allied with demographic changes – is **servicing to increase the share of overall spending on older people and health** while reducing the share going to working-age families and economic growth
- This may or may not be the right balance to strike, but there is a **danger that we fail to check in on these developments until after they occur** – what *do* we want the state to do?