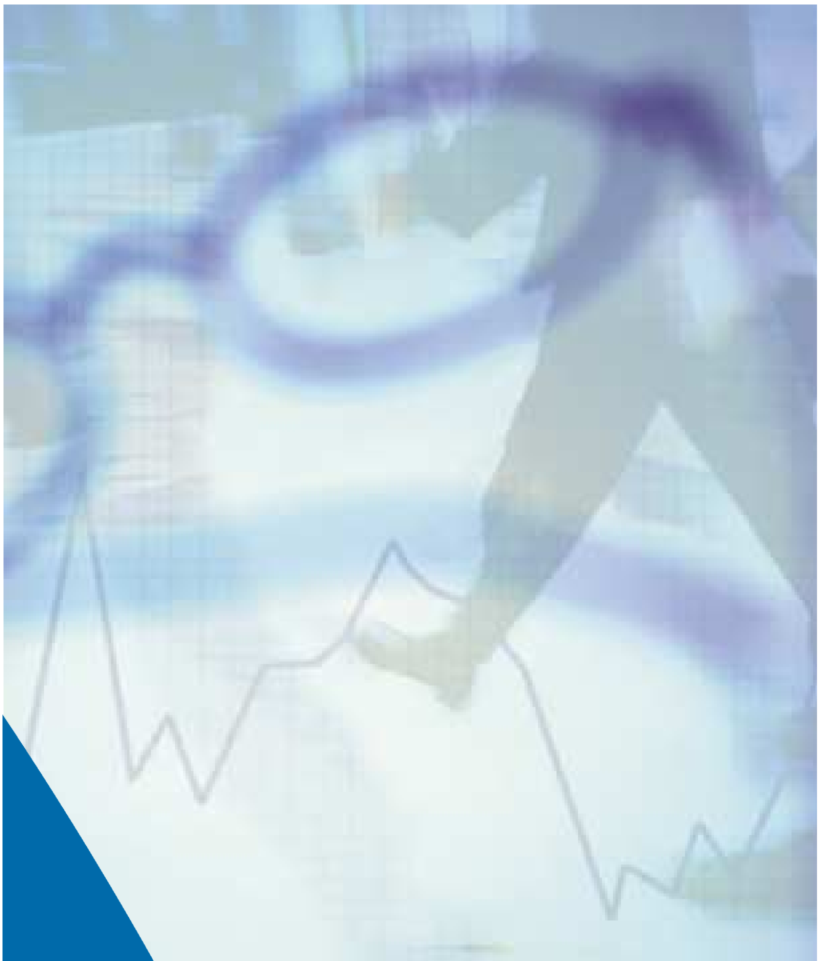
CIPFA

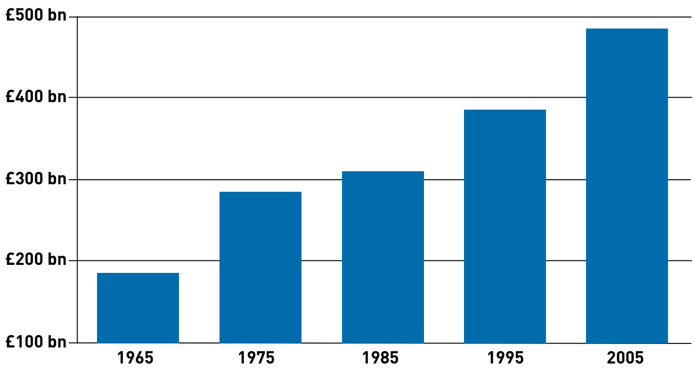
PUBLIC SPENDING REVIEW



AT THE HEART OF
PUBLIC SERVICES

PUBLIC SPENDING REVIEW

Annual public spending in the UK is expected to exceed £500 billion for the first time by 2005-06. This figure is 3 times the size of its equivalent total 40 years ago, and while public spending reached a plateau in the mid to late 1990's, the last 5 years from 1998 to 2003 has seen a marked annual increase, over and above the rate of inflation.



The Government realised that modern best practice was needed to enhance the increasing complexity of managing spend of this order, and the Chancellor's Comprehensive Spending Review of 1998 (CSR) introduced a new system of control over public finances through to the next election. The CSR replaced the Chancellor's Autumn Statement, the outcome of the traditional annual bid and review process in which spending departments were allocated Government funds on a year by year basis. The focus of CSR is on finding new ways of controlling spending by Government departments, ensuring that spending is properly aligned with the Government's priorities. As a result of the Review, the availability of new cash for spending on departmental programmes has become dependent on the identification and achievement of defined objectives. Public Service Agreements between the Treasury and the spending departments make it clear that future money will be withheld if agreed targets are not met.

The 1998 CSR was a comprehensive review of departmental aims and objectives, and crucially included a zero-based analysis of every spending programme, with a view to determining the best way of delivering Government objectives. The CSR has been followed by 2 successive biennial reviews, in 2000 and 2002.

The new financial planning and control regime

The traditional system had been much criticised on the grounds that it led to a "boom and bust" cycle of spending. For example, health expenditure might increase in response to a hospital beds crisis, only to be cut back substantially in the next year's plans to reduce increasing Government borrowing. The Spending Review approach is intended to break this cycle, and also to promote longer term investment, such as transport infrastructure, which has tended to suffer from traditional short term financial management.

Spending Reviews form part of a new planning and control regime. This regime divides Government spending into 2 types:

- "Departmental Expenditure Limit" spending (DEL), which is planned and controlled on a 3 year basis through the Spending Reviews, and
- "Annually Managed Expenditure" (AME), which is reviewed twice each year as part of the Budget and the pre-Budget report process. AME is the kind of expenditure which it is not practical to control on a 3 year planned basis. Examples of AME are social security payments, which are demand led, or local authority self financed expenditure.

DEL and AME added together make Total Managed Expenditure (TME). DEL represents an increasing proportion of TME over time, and reaches 59% of TME in the plans for 2005-06. The table below shows the trends in public spending over the period covered by the 2002 review.

Total Managed Expenditure to March 2006

All numbers in the 2002 Spending Review were presented on a full resource basis; the depreciation adjustment to the DEL avoids counting the same investment twice.

	2002-3	2003-4	2004-5	2005-6
	£ billion			
Total Managed Expenditure	418.4	454.6	481.5	511.4
Made up of:				
Departmental Expenditure Limits	239.7	263.5	279.8	301.0
Resource budget	228.5	249.3	263.7	283.1
Capital Budget	21.3	25.2	27.6	30.1
Less depreciation	-10.1	-11.1	-11.5	-12.2
Annually Managed Expenditure	178.7	191.2	201.7	210.4
Department AME	134.3	143.8	150.6	156.5
Other AME/Adjustments	44.4	47.4	51.1	53.9

The 2002 Spending Report noted that AME spending is growing at 3% a year in real terms, with DEL growing at 5.2%. Much of the DEL increase is concentrated in certain sectors, notably Health, Education, Transport, and International Development.

Government fiscal policies

The Treasury quotes 4 key principles that are reflected in the CSR and in subsequent Spending Reviews:

- consistency with a long-term, prudent and transparent regime for managing the public finances as a whole;
- the judgement of success by policy outcomes rather than resource inputs;
- strong incentives for departments and their partners in service delivery to plan over several years and plan together where necessary; and
- the proper costing and management of capital assets to provide the right incentives for public investment.

Achievement of these principles enables the Government to meet two firm fiscal rules:

- the Golden Rule, which states that over the economic cycle, the Government will borrow only to invest and not to fund current spending; and
- the Sustainable Investment Rule, which states that net public debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. Other things being equal, net debt will be maintained below 40 per cent of GDP over the economic cycle.

The new 3 year cycle

This note is mainly concerned with DEL spending. The purpose of controlling DEL spending in this way is to enable the Government to manage public finances over the long term, providing departments and their service provision partners with the means and the incentives to plan for service delivery over a number of years. This is a radical change from the traditional system of annual expenditure limits.

A Spending Review is carried out every 2 years, covering the next 3 years.

- The 1998 CSR covered the financial periods from 1999/2000 to 2001/2002.
- The 2000 Spending Review covered the financial periods from 2001/2002 to 2003/2004
- The latest Spending Review, in 2002, covers the financial periods from 2003/2004 to 2005/2006.

The key point of all 3 Reviews is that firm 3 year DEL spending plans have been set on each occasion. In contrast to the traditional arrangements, any DEL resources that are unspent at the end of the financial year may be carried forward into the next year. And each of the 2 Reviews after the initial CSR has taken the last financial year of the preceding plan as its start point. This enables the plans to be rolled forward from Review to Review. The corollary of breaking the tradition of annuality is that the DEL limits will be strictly enforced. Although there is a small DEL reserve, intended to deal with genuine emergencies that could not have been foreseen at the time of setting the budgets, in most circumstances departments will be expected to adjust priorities to manage within their agreed limits.

The DEL approach improves financial stability as public service managers are now able to plan on a reasonable medium term timescale. Departments no longer have any reason to use up annual provisions as the year end approaches, with insufficient regard to value for money considerations. Equally, from the point of view of central Treasury management, there is much less scope for departments to seek increased funds on an annual basis.

Separate budgets are set for resource (current) expenditure, and for capital expenditure. The Treasury believes that this is necessary to prevent departments from cutting capital investment in order to alleviate current resource problems, hence creating greater pressures in the future. This is also consistent with the Golden Rule fiscal policy described above. Capital investment decisions are taken in the context of **Departmental Investment Strategies (DISs)**, which set out each department's plans to ensure that the right capital infrastructure will be in place to enable the delivery of its objectives.

A further development away from tradition is the introduction of **Cross Cutting Reviews**. The traditional system was not conducive to coherent control of major policy areas and initiatives where these were represented by spending programmes controlled by more than one department. Fifteen full cross-departmental reviews were included in the 2000 Spending Review, covering a wide range of areas, including the criminal justice system, nuclear safety, crime reduction and conflict prevention in sub-Saharan Africa. A further seven Cross-Cutting Reviews were included in the 2002 Spending Review. The Treasury reports that "these reviews resulted in a wide variety of new working arrangements, including the refocusing of departmental programmes and the creation of pooled budgets and management structures".

Targets and performance measurement

An essential element of the new approach is the introduction of **Public Service Agreements (PSAs)**. These are closely linked to the DEL allocations. They are output targets, representing the outcomes that departments are expected to deliver from the resources that have been agreed through the DEL process. Progress against PSA targets is monitored continuously, and reported in detail in departments' annual reports. From 2002, departments have also published progress against PSA targets in a new performance report, published in the autumn. The original targets in the 1998 CSR were comprehensive, but it was felt that they were too many to allow for sufficient focus. The number of PSA targets has therefore been reduced in the subsequent Reviews, to enable better focus on the key objectives. However, to support the delivery of these key objectives, the 2000 Review introduced a set of lower level input targets and milestones, and Technical Notes, that explain how performance against PSA targets is measured.

The introduction of PSAs marked an end to any possibility of "something for nothing" in the public services. Education, for example, was presented as the biggest winner in the 2002 Review, with its budget rising by some £10 billion over the 3 year period, and with an increased emphasis on grant going directly to schools. But the money is dependent on schools achieving their targets, and heads will find that they lose funds if they fail.

PSAs are the essential control that the Chancellor needs so that he can demonstrate the value for money generated by the planned increase in Government spending over the next 3 years. Overall, Government spending is planned to increase by some 15% (2005/2006 compared to 2003/2004). By comparison to provisional outturn figures for 2001/2002, the 5 year increase is some 35%. Increases of this order were avoided during the Labour Government's first term of office due to a combination of retaining the previous Government's low spending plans and a strong economy that reduced cyclical spending on social security payments; business leaders and individual voters will be expected to contribute increased tax revenue, and will need to be assured that greater productivity in public service will follow.

Accounting changes

The abandonment of annuality has accelerated the need for an accounting system that is better attuned to long term financial management. **Resource Accounting and Budgeting (RAB)** has been introduced, applying best practice from the commercial world to central Government. Resource Accounting is being introduced in 2 stages. Stage 1, for the plans included in the 2000 Review, excluded non cash costs such as depreciation. These will be brought into the DEL from 2003/2004 – the 2002 review was presented on both a "near cash" and a full resource budgeting basis, in order to provide a transitional arrangement.

Conclusions

The Spending Review brings into central Government finance several concepts and approaches which CIPFA believes will add substantial value:

- medium/long term planning, which will reduce the need for departments to spend up to budget in any one year;
- resource accounting and budgeting, which, when fully in place and understood by financial managers, will help to provide truer pictures of performance than traditional cash based accounts, and
- a system of performance target setting and monitoring which will provide the essential feedback and control to ensure that public money is used effectively.

Acknowledgements:

For more detailed material, see the Treasury's website (http://www.hm-treasury.gov.uk)