House of Commons

Treasury Committee

Spending Review 2010: Government Response to the Sixth Report from the Committee

Third Special Report of Session 2010–11

Ordered by the House of Commons to be printed 27 January 2011

HC 754
Published on 2 February 2011
by authority of the House of Commons
London: The Stationery Office Limited
£0.00

The Treasury Committee

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The Reports of the Committee, the formal minutes relating to that report, oral evidence taken and some or all written evidence are available in printed volume(s). Additional written evidence may be published on the internet only.

Committee staff

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Third Special Report

The Treasury Committee published its Sixth Report of Session 2010–11, *Spending Review 2010* on 26 November 2010, as House of Commons Paper No. 544–I. The Government Response to this Report was received on 21 January 2011 and is published as an appendix below.

The response from the Government is in plain text and the Committee's conclusions and recommendations are in bold text.

Appendix: Government Response

Economy

1. The Government has embarked on consolidation which is significantly faster and deeper than that envisaged by the previous administration, but that should not obscure the fact that, whilst there is general party political agreement that consolidation is necessary, there continue to be differences over its precise method, timing and pace. (Paragraph 12)

The Government's fiscal consolidation plans will support recovery by providing the right conditions to address the imbalance that built up between the public and private sectors over the past decade. The Government's actions will support private sector confidence and lower borrowing costs, helping families to pay down debts and businesses to invest and create jobs.

As a result of the action taken at the Budget and the Spending Review, the Office for Budget Responsibility's latest central forecast shows that the structural current deficit will be eliminated by 2014–15, a year earlier than required by the Government's fiscal mandate, and debt will begin falling in the same year.

The IMF has supported the policy choices made by the Government, stating that "The plan's credibility has been bolstered by a frontloaded path that achieves the mandate one year early and by a suitable mix of concrete spending and revenue measures"[1].

2. Given that it appears capital spending by Government has the greatest impact on overall growth, we welcome the additional £2.2 billion of capital spending by 2014-15 announced in the Spending Review, compared to the June Budget. We look forward to the forthcoming Autumn forecast, where the new Office for Budget Responsibility's forecasts will be presented. We will use subsequent opportunities to examine further the impact of the Spending Review on economic growth more closely. (Paragraph 18)

[1] *United Kingdom—2010 Article IV Consultation: Concluding Statement of the Mission,* International Monetary Fund, September *2010*

The Government welcomes the Committee's continued interest in the impact of the Spending Review on growth. The Office for Budget Responsibility's *Economic and Fiscal Forecast*[2] shows that Britain's economic recovery is on track, and the Government is on course to balance the books. Their central forecast shows sustainable growth of over 2 per cent for each of the next five years, employment rising in each and every year, and the deficit falling.

'*The path to strong, sustainable and balanced growth*'[3] published on 29 November 2010 set out the Government's framework for long-term growth and launched the Growth Review. This signals a new approach to growth and an attitude shift in government—to put the private sector first when making decisions on tax, regulation and spending. Every part of government will work with business to develop proposals for how government can better serve the private sector. The Growth Review has started with an intensive programme of work, based on the evidence provided by business, to report by Budget 2011.

3. Over the course of the Parliament, we will be monitoring the extent of public sector job losses, the capacity of the private sector to absorb reductions in public sector employment, and the relationship between employment and growth. As a first step, we look forward to the publication of the OBR's updated forecasts of employment later this month. (Paragraph 23)

The number of people in employment has risen strongly and is 286,000 above its trough at the start of 2010.

As set out in the Office for Budget Responsibility's *Economic and Fiscal Forecast*[4], the OBR expects total employment to rise from 29.0 million in 2010 to 30.1 million in 2015. This comprises a rise in market sector employment of around 1.5 million; partially offset by a fall in general government employment of just over 400,000 between 2010–11 and 2015–16.

The OBR presented evidence that this scale of market sector job creation over a period of fiscal consolidation is not unprecedented. The latest labour market statistics suggest that total employment increased by 1.3 million between 1992 and 1998, while general government employment contracted by around ½ million.

The OBR forecast shows an estimated reduction in general government headcount of 330,000 over the period covered by the spending review (by 2014–15). This is around 160,000 less than was forecast at Budget. The bulk of this revision reflects the Government's reforms to welfare and savings made on debt interest.

As announced in the Spending Review 2010,[5] the Government will support employers to do everything that they can to mitigate the impact of workforce reductions by:

- protecting jobs through pay and pensions reform;

[2] *Economic and Fiscal Forecast*, Office of Budget Responsibility, November 2010.

[3] *The path to strong, sustainable and balanced growth,* HM Treasury and the Department for Business, Innovation and Skills, November 2010.

[4] *Economic and Fiscal Forecast*, Office of Budget Responsibility, November 2010.

[5] *Spending Review 2010*, HM Treasury, October 2010.

- ensuring that staff in different public sector workforces and each region will have visibility of suitable vacancies, and encouraging local employers to explore voluntary deals with staff on pay restraint or reduced hours in order to save jobs;
- actively monitoring potential workforce reductions, enabling decisions to be taken in time to mitigate localised impacts; and
- through Jobcentre Plus, supporting employees facing redundancy in making a successful transition to the private sector.

Process

4. The evidence we have received from those within the process suggests that the wider use of the Public Expenditure Committee, and a wide-ranging system of meetings of more select groups reflecting the new coalition arrangements, led to a collective decision making process in reaching the final position outlined in the Spending Review. (Paragraph 30)

5. We note that while the Spending Review was conducted relatively quickly, the Civil Service had clearly been making preparations for it for some time. (Paragraph 32)

6. We are sceptical about how new some of the large savings from the 'Spending Challenge' are in reality. For example the Office of Government Commerce's (OGC) Collaborative Procurement Programme has been running since 2007. (Paragraph 33)

7. Seeking the views of public servants and the general public can produce some worthwhile suggestions for savings and income generation. This has to be set against the resources required to manage and review tools such as the 'Spending Challenge'. Short-term e-consultation can be useful but it cannot be a substitute for longer-term engagement with public sector employees and responsiveness to input from stakeholder groups. The Committee may return to the 'Spending Challenge' to examine its effectiveness. (Paragraph 38)

The Government launched the Spending Challenge to open up the Spending Review process to both public sector workers and members of the public to generate ideas. The Treasury completed a comprehensive review of responses to the consultation process and, as a result, the Spending Challenge made a demonstrable difference to the Spending Review.

While the Collaborative Procurement programme has been running since 2007, the Spending Challenge generated suggestions on where collaborative procurement could be extended. At the Spending Review, the Government announced "central mandation of commodity procurement, with centrally negotiated deals available to local government as well". This represents a much tighter process than previously in place.

In addition, the Spending Challenge generated smaller, but important ideas to strip out waste and bureaucracy across departments for example:

- increasing the portability of the Criminal Records Bureau checks by making greater use of electronic access for employers;

- driving down the costs of in-house government publications, saving at least £0.5 million this year and a further £0.25 million per year in future; and

- ending the production of National Insurance number cards, saving £1 million per year.

The Government committed to taking a new approach to the Spending Review based on openness, innovation and collaboration. The Spending Challenge was an important element of this and formed part of a wider programme of engagement. Over the summer period, Ministers invited stakeholders to contribute their views through events including expert roundtable discussions, regional events and a number of frontline visits to public services across the country.

The Spending Challenge was a time-limited exercise to generate ideas for the Spending Review. The Government recognises the importance of continued engagement with professionals and continues to seek their views across relevant policy areas through various established channels including visits, debates and other fora.

Spending

8. Ringfencing may fulfil electoral promises. But ringfencing can also lead to allocative problems across government as a whole. It could also reduce scrutiny of ringfenced departments. The decision to use the NHS budget to purchase social care and the DfID budget to support fragile and conflict-affected states shows that ringfencing has not been absolute and the Treasury should not be afraid to demand that spending currently ringfenced in certain areas be used where the benefit is the greatest, or where greater value for money can be obtained. (Paragraph 52)

The Spending Review made choices, focusing on reducing welfare costs and wasteful spending to allow the Government to prioritise the NHS, schools and early years provision and the capital investments that support long term economic growth. Making these areas priorities meant that some other departments were required to make greater real terms percentage savings. This approach was necessary to support the Government's priorities of growth, fairness and reform.

The Spending Review met the Government's commitments to increase health spending in real terms in every year of the Spending Review and to spend 0.7 per cent of GNI on overseas aid from 2013. However, as the Committee noted, for both the NHS and the Department for International Development (DfID) these settlements will still be challenging. The NHS will still need to make significant efficiencies to deal with rising demand from an ageing population and the increased costs of new technology. DfID will change the way it delivers aid in order to achieve maximum impact and to further improve transparency and accountability. Running costs will account for only 2 per cent of total spending by 2015, compared to a global donor average of 4 per cent.

Both the Department of Health and the Department for International Development (DfID) have committed to reduce their administration costs by 33 per cent in real terms by 2014-15, ensuring that funding will be focused on key frontline services. The NHS has already committed to deliver up to £20 billion of annual efficiency savings by 2014-15, and developed the Quality, Innovation, Productivity and Prevention programme to help achieve these savings. A wide scale programme of reform will be introduced in the NHS, as set out in *Equity and Excellence: Liberating the NHS,*[6] which will support the delivery of value for money and efficiency savings.

As the Committee noted, the Spending Review set aside funding which will reach £1 billion by 2014-15 within the NHS settlement, to support social care by funding new ways of providing services including reablement services provided by the NHS. This is intended to help break down long-standing barriers between health and social care, leading to benefits for both the NHS and social care. It also recognises that shortfalls in social care funding are likely to have a negative impact on the NHS, so funding for social care helps to support health.

Given the direct linkages between instability and conflict, DfID will double its investment in tackling and preventing conflict around the globe, consistent with the international rules for Official Development Assistance.

9. It is argued that the aircraft carrier contract was unbreakable not just for legal reasons, but also because it was inextricably linked to the strategic need to maintain a stable supply of work for the sole warship-producing supplier in the UK. The National Audit Office will, no doubt, examine this intensively. In evidence to the Liaison Committee the Prime Minister agreed to look into the matter and provide this Committee with the maximum amount of information possible. When we have seen this information we may decide whether and how best to undertake further work. The Treasury should draw on the lessons from the contract to analyse all future Ministry of Defence procurement to ensure that value for money is being obtained, particularly when little competition exists in the market. (Paragraph 61)

10. The Government inherited an over-committed defence budget. Successive governments have tried and failed to deal with over-commitments. The major concern of the Committee is the interaction between the Treasury and the Ministry of Defence over how defence acquisitions, and day-to-day funding, is agreed. In many cases, it may be sensible to accept that the high costs of short-term contracts are offset by the increased flexibility they give. There will however be some long-term projects which cannot be planned within the confines of the Spending Review, as these are in the programmes of many spending departments. The MoD has a poor record of dealing with such contracts. These continuing difficulties suggest that the level of scrutiny given to these contracts by the central departments is not sufficient to prevent serious blunders in procurement. (Paragraph 71)

The Treasury and Cabinet Office were closely involved in the decisions taken in the Strategic Defence and Security Review and will continue to be involved in approving all major procurement decisions made by the Ministry of Defence including, where

[6] *Equity and Excellence: Liberating the NHS,* Department of Health, July 2010.

appropriate, making use of the Major Projects Review Group that draws on expertise from within government and the private sector to scrutinise major government projects.

To improve the overall defence procurement process the Ministry of Defence (MoD) is continuing to implement the Strategy for Acquisition Reform, including measures to: improve transparency through the annual NAO-audited assessment of the Equipment Programme's affordability; apply greater controls in managing the programme; mandate the use of independent costing to avoid 'optimism bias'; and improve skills in cost and time estimation, project management, and other areas.

The appointment of Bernard Gray as Chief of Defence Materiel is also an important step for the MoD, signalling its recognition of the need for substantial change and the intent to make it happen. Furthermore, acquisition is also being addressed as part of the Defence Reform Review, to ensure, as with all other elements of Defence, that the acquisition system is made simpler and more cost-effective, and that it matches accountability to authority.

11. UK military personnel engaged in ongoing operations in Afghanistan must have the necessary equipment. But such operations must not overly colour the shape of defence spending after their expected end. (Paragraph 74)

The Government is fully committed to funding all the Net Additional Costs of Military Operations in Afghanistan from the Treasury Special Reserve, including funding for equipment which qualifies as Urgent Operational Requirements. Over the Spending Review period, the Special Reserve has been forecast at £4.0 billion, £3.8 billion, £3.8 billion and £3.5 billion, reflecting an agreed assumption that troop and activity levels will reduce between 2011 and 2015. While Afghanistan remains the Ministry of Defence's top priority, the Strategic Defence and Security Review and National Security Strategy set out a clear plan to provide adaptable military capabilities suited to the longer term, with resources focussed on both current and emerging threats.

Distributional Analysis

12. We welcome the Treasury's response to our request greatly to increase its distributional analysis, showing the effect of measures in the Spending Review on different households. We recommend the Treasury continues to extend and improve the analysis it provides and takes account of our recommendations in our report on the June Budget. We recommend that the Treasury examine the IFS's proposal that more of the welfare changes can be modelled and included in its analyses. We also recommend that the Treasury publish not just the sources but additional information on the calculations underpinning their distributional analysis to provide further transparency and encourage debate on how the methodology of such analysis might be improved. (Paragraph 83)

The Government recognises the need for greater transparency for effective scrutiny of policy making and has therefore gone further than any Government before in presenting the distributional impacts of its decisions. At the Budget, for the first time ever, the Government presented distributional analysis of how announced changes to taxes, tax credits and benefits affected households across the income and expenditure distributions.

Additionally, for the first time ever, at the Spending Review the Government undertook and published distributional analysis of its spending decisions on households. This was innovative work requiring the development of a new methodology for the purpose. New ground was also covered at the Spending Review by presenting analysis of impacts across the entire four year period of the review.

The Government welcomes the interest shown in this work by the Committee and external commentators. The Treasury values the contribution to the debate made by external organisations such as the Institute for Fiscal Studies and is open to engaging with them to improve the quality of future analysis.

It remains essential that Government policy is informed by analysis that is known to be robust, for example where necessary taking into account policy interactions at an individual household level rather than in aggregate. The Institute for Fiscal Studies have noted that by including more measures, their estimates of the impact of tax and benefit changes may be "more complete, but less precise". However, the Treasury welcomes efforts to extend the scope of tax-benefit modelling, and where this is shown to be robust remains open to exploring ways of including this in its analysis.

The Treasury will seek to work with interested parties to further develop distributional analysis techniques in the coming months.

13. Given the choices made by the Government to employ more spending cuts than tax rises in the consolidation, the evidence suggests that it would have been very hard for the overall consolidation to have been progressive. Fairness and progressivity are two different concepts. Decisions that are technically regressive are not necessarily unfair. Whether or not the consolidation is fair is, and will remain, the subject of political debate. (Paragraph 90)

14. We are confident that the Treasury will update their analysis to take effect of major policy changes. However, given that the Universal Credit is to be introduced gradually, as other major changes may be, care will have to be taken to show both the effect of the long term reforms, and of transitional measures. (Paragraph 91)

Chart B.6 of the *Spending Review 2010*[7] provides an estimate of the overall impact of the fiscal consolidation. This shows that the top 20 per cent of households contribute most to the fiscal consolidation as a percentage of net income and benefits-in-kind. As noted by the Committee, this analysis does not take into account any behavioural responses from reforms, which could be significant. For example the introduction of the Universal Credit to improve financial work incentives through ensuring support is reduced at a consistent and managed rate as people return to work and increase their working hours and earnings, and is likely to make the overall impact of reforms more progressive. As the Government considers future policy changes it will, of course, consider both the long-term and transitional impacts.

[7] *Spending Review 2010*, HM Treasury, October 2010.

15. Claiming child benefit builds up entitlement to the state pension for parents of children under 12 who cannot pay National Insurance contributions. When the Government implements its changes to child benefit, clear information will be essential to ensure that parents are aware that if they simply cease to claim Child Benefit it could affect their pension entitlement. (Paragraph 95)

The Government has given careful consideration to the issue of National Insurance Credits to ensure that the loss of Child Benefit will not have an adverse affect on a parent's pension entitlement. Families where Child Benefit will be withdrawn will be able either to 'opt out' of receiving Child Benefit, or to continue to receive Child Benefit and have payments recovered through their or their partner's tax code. In both cases the Government will ensure that parents will continue to be entitled to National Insurance Credits and the other benefits associated with entitlement to Child Benefit.

HMRC are developing a clear communication strategy to ensure that parents are aware that they can continue to receive National Insurance Credits for pension entitlement if they choose to 'opt out' of receiving Child Benefit.

16. The change to Child Benefit is not being made until 2013. Government will want to carefully consider the issues raised with us in evidence: perverse economic incentives; perceived unfairness; and enforceability. (Paragraph 98)

In developing the proposal to withdraw Child Benefit from families with a higher rate taxpayer, the Government considered economic incentives, fairness and enforceability and will continue to consider these issues.

The decision to withdraw Child Benefit from higher earners is tough but fair. Within the fiscal climate, the Government could not allow people on low incomes to continue to be taxed in order to pay for the Child Benefit of those earning much more. The current threshold for a higher rate taxpayer is around £44,000 and families affected by the policy are within the top 20 per cent of the income distribution of all families (including those without children).

In order to retain the fundamental nature of Child Benefit and also avoid the creation of a new means test for household income, the Government chose to withdraw Child Benefit from families with a higher rate taxpayer using existing PAYE and Self Assessment tax systems. This means that the impact of the policy will be limited to those households containing a higher rate taxpayer, which means that around 80 per cent of all families claiming Child Benefit will be unaffected by the change.

Inevitably introducing a simple change to a universal system could create slight distortions in the behaviour of those who are affected and are close to the margin. However, the Government wanted to create a simple system which ensures that the vast majority of people continue to claim and receive Child Benefit. The methodology for this costing therefore takes into account that there will be a slight behavioural change in those close to the threshold.

17. The Government's housing benefit reforms attempt to reshape the housing market. We shall monitor their effectiveness both in terms of their effect on public expenditure, and on the regional and national housing market, and on the London market. (Paragraph 105)

18. While the economy grew in the last decade, some regions benefited more than others. We agree with the Chancellor that it will be a "major challenge" to ensure that all parts of the United Kingdom benefit from future growth. The Government has announced some policies designed to help achieve this. We will monitor their progress. (Paragraph 112)

The Government agrees that as the economy grew over the last decade some areas have benefited more than others, and is working to ensure that in future all areas are given the opportunities to benefit from private sector led economic growth.

The Local Growth white paper[8] published on 28 October 2010, set out in more detail new initiatives to deliver economic growth, including the Regional Growth Fund which will support those areas that are most reliant on public sector employment, and powerful incentives for local authorities to deliver sustainable economic development including through the establishment of Local Enterprise Partnerships, and options for tax increment financing.

[8] *Local growth: realising every place's potential*, Department for Business, Innovation and Skills, October 2010.