The Spending Review 2010 has been analysed extensively for more than a week. Now the dust is settling, what are its implications for the public service industry and investors?

The 2010 Spending Review (SR 2010) has already had more column inches, and TV and radio airtime, devoted to it than any Financial Statement we can remember. The depth of coverage was at least as great as any budget, and certainly way beyond the coverage of any previous Spending Review. Indeed we would take a bet that the majority of ordinary punters are under the impression that this was the first Spending Review there has ever been; in fact the first was in 1998 making this one the sixth.

The reason that all the other Spending Reviews were of interest only to policy wonks was of course that they were about reallocating resources between Departments within an ever-growing public spending total (or envelope as it is known in the jargon). This one, most definitely, was not.

In the face of this unprecedented depth of coverage (helped, it has to be said, by a relative openness and willingness to make information available on the part of Ministers and the Treasury) there is less need for basic analysis of overall trends than has been the case in recent years. The Institute of Fiscal Studies' (IFS') briefing immediately after a Budget, Pre-Budget Report or Spending Review used to be required viewing simply to get behind the Chancellor's smoke and mirrors, and understand what the overall impact on total and Departmental spending was actually going to be. This time the briefing way still useful and informative but no longer quite so essential.

The main reason for this was that instead of accentuating only the positive (in both senses of the word), like his Labour predecessors, Mr Osborne was happy to explain how much each Department would lose. And while he stated the reductions in annual rather than cumulative four year terms (6% a year sounds so much better than 25%) the Treasury Red Book did include an additional column in all the key tables, showing the total fall (or, more rarely, increase) over the Spending Review period.

Undaunted by this flood of data, however, we think there is still some value in yet further analysis, not so much of what we already know but more, to borrow a phrase, of the known unknowns that are yet to come. In addition, there are some wider policy changes that were hinted at in the Spending Review which have potentially major implications for the public service industry and other providers of services to government.

So as ever, we have tried in this paper to get behind the immediate figures and provide some answers to the following questions:

- who are the immediate winners and losers from the spending review (both Departments and programmes);
- what will happen in the next few months to change and add to this picture (the known unknowns) especially at programme level;
- what are the wider messages to emerge from the detail in the Spending Review documents; and
- what does it all mean for companies and their investors?

The overall settlement: winners and losers

One trick Mr Osborne has definitely learnt from his predecessor-but-one is the big political flourish at the end of a major financial statement. His peroration focused on the fact that the total reduction in spending proposed in SR 2010 is only 19%, compared to the 20% implied by Mr Darling's March budget. While the IFS later disputed this, arguing among other things that Mr Osborne had left out of his calculations the £6bn he is saving this year compared to Labour's plans, there is no doubt that the overall reduction in Departmental spending is somewhat lower than the 25% or more promised/threatened in the June budget.

The main reason for this is simple: this was the first Spending Review to include within its scope some parts of Annual Managed Expenditure (AME), which includes welfare benefits and debt interest. All previous calculations of expected cuts in Departmental spending on services (Departmental Expenditure Limits or DELs) have assumed steady AME rises, mainly to reflect uplifting of benefits in line with inflation But by building in reductions to AME, first in the June emergency budget and again in SR 2010, the saving which has to be found from cuts to DELs is correspondingly lower.

Figure 1 shows what a difference this makes.

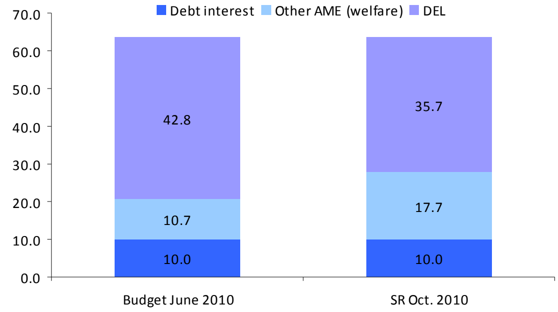

Figure 1 – Make up of current spending reduction

My Osborne now has to raise "only" £36bn from cuts in DELs, compared to the £43bn set out in the June 2010 budget, and £27bn implied by Labour's March budget.

At the Departmental level, the big "winners" from this still severe, but somewhat less draconian than expected, pruning are Health, International Development, Schools, Defence, and Work and Pensions (see Figure 2). Health and International Development were of course already "protected", and DWP is now the only other Department with a positive settlement thanks largely to the additional up-front spending (£2bn over four years) needed to enable the introduction of a single unified benefit – the Universal Credit. The overall fall in the Education current budget is much smaller than most and hides a miniscule (0.1%) real terms rise in the Schools Budget, while the

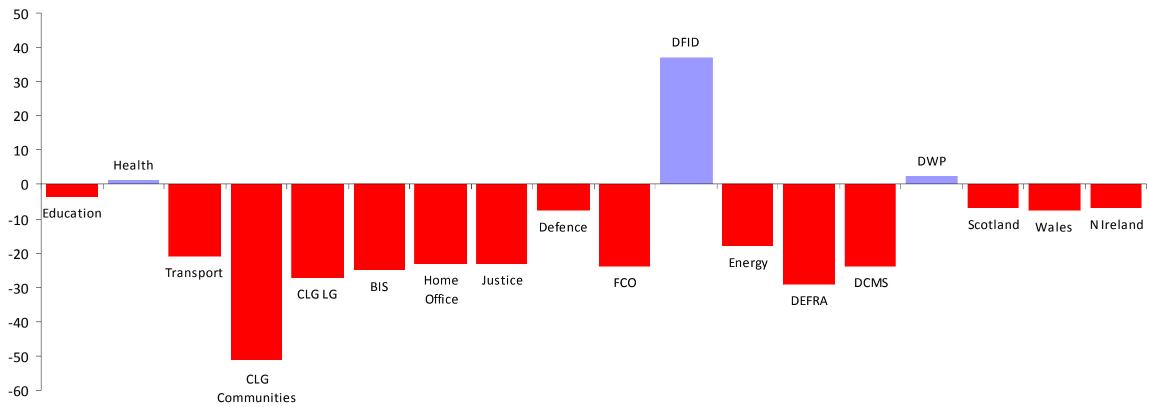

Figure 2 – Winners and losers, current spending

defence budget has been similarly part protected.

While many Departments face cuts of 25% or more by 2014/15, the biggest single loser in terms of service impact is probably local government in England, which has already been hit by a disproportionate share of the interim efficiency savings announced in the Emergency Budget, and now faces real terms cuts of 7% a year alongside a Council Tax freeze. Conversely, Scotland, Wales and Northern Ireland are better off than they might have expected.

The pain of cuts in capital spending is much more evenly spread (Figure 3). The government plans to cut public sector net investment by £17bn (46%) by 2014/15, around £2bn less than in the June Budget and now almost exactly the same as Labour planned in March 2010. The biggest losers are Education and Housing, which accounts for the bulk of the huge (74%) reduction in the Communities capital budget over the spending review period. The falls in both these areas (and across the capex budget as a whole) are relatively front-loaded. In Education, the government has already cancelled Building Schools for the Future, and the CLG Communities budget (most of which goes to the Homes and Communities Agency for investment in social housing) will fall by more than half from £6.8bn in 2010/11 to £3.3bn in 2011/12. Across all programmes, investment will fall by a full quarter in 2011/12 and by a further 21% in the following three years.

There are no real winners here since investment is rising in only two Departments, in both cases from a very low base. The additional investment in the Department for Energy and Climate Change, mainly to create "one of the world's first commercial scale carbon capture and storage (CCS) demonstration plants", amounts to only £1bn over the Spending Review period and investment actually falls by £200m in 2011/12. Other relative winners (or less adversely affected losers) are health and transport, where the Transport Secretary's previous experience as shadow Chief Secretary may have helped him protect at least some of the budget – though some major road schemes, such as the long planned A14 upgrade in Cambridgeshire, have been dropped and many others face an uncertain future.

Known unknowns

The Spending Review is of course only the start of the process of assessing the impact of the planned changes on individual programmes, a

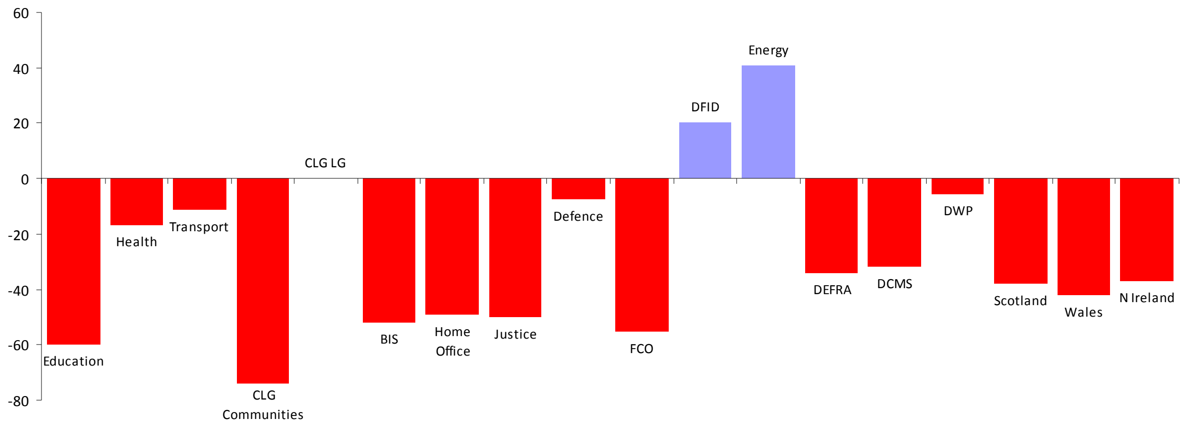

Figure 3 – Winners and losers, capital spending

process which will take weeks, months or, in some cases, years. However we know roughly what will happen in some key areas (at least at total spending level) and can make intelligent guesses at what will happen in others.

Based on this mixture of initial information and guesswork, the table overleaf attempts to provide an assessment of key programmes whose prospects are broadly positive, negative or neutral so far as the public service industry is concerned. We would emphasise that "positive" here is sometimes a relative term, since most programmes will see spending cut in real terms, and even the relatively protected areas, notably health and schools, face rising demand that will put them firmly in negative territory. However from the point of view of companies and investors which are active in the public sector (as opposed to e.g. public sector employees, for whom the outlook is arguably more uniformly negative) many programmes (e.g. skills) can reasonably be put in the positive column because investment will remain substantial and historically high despite significant cuts, and companies do at least now have a sound basis for forward planning. Others areas are positive (notably welfare to work) because the government is planning increased investment but aims to pay for it from future savings. This means that the bare Spending Review numbers give a misleading picture of both the upside potential and downside risks for companies and investors. We discuss this further below.

Wider messages

As is always the case with major financial statements, the bare numbers do not tell the whole story. The Chancellor's statement and the Spending Review report contained a number of indicators of longer term government intentions which are highly relevant, and potentially important, to companies and investors. We would highlight four key themes.

Public service reform

The Coalition government arguably deserves some credit for not claiming that all the savings required can be achieved by efficiency gains: it has admitted that there will be pain, and many front line programmes will experience real reductions. Nevertheless, it is planning substantial reductions in administration budgets that are subject to plans that have yet to be announced. In line with the Conservatives' election commitment to reduce Whitehall by a third, every Department faces a reduction in its administration budget of at least 33% and in some cases more, with said budgets falling in total from £15.8bn this year to £11.4bn in 2014/15. Plans for how these major savings will be achieved are not yet forthcoming, and SR 2010 states that “Later this year, each government department will publish a business plan setting out the details of its reform plans” and “To maintain the momentum for reform and consult further on how better to deliver services, the government will publish a reform White Paper early in the New Year”.

Positive	
Social care	Additional resources of £2m. Commitment to extend/roll out personal budgets
Further education and skills	25% cut but still £3.2bn. Additional funding of £250n for new apprenticeships
Prison management	Possible further outsourcing/independent provision in both prisons and probation
Prisoner rehabilitation	Commitment to extend provision in both prison and community
International development programmes	Major increase in both current and capital funding
Low carbon technologies	Additional investment in carbon capture and other technologies of £1bn
Welfare to work	New Work Programme expected to be worth £3-4bn funded from future savings
Neutral	
Schools – current	Resources flat including pupil premium. Pupil numbers rising 0.7% per year
Health - capital	Funding cut by less than other Departments and still high by historic standards
Health - current	Protection will not meet demand and inflation. Assumed £20bn efficiency savings
Transport	Substantial cuts but less than expected
Defence support	Cuts in new equipment budgets may feed into extended support
Social housing repair and improvement	Major downturn in new build likely to shift focus to repair and improvement
Negative	
Social Housing – new build	Major reductions in HCA funding. Only 150,000 new starts planned over 4 years
Schools - capital	Academies/free schools will not compensate for the ending of BSF
Higher education	Many HE institutions likely to be unable to cover loss of funding from higher fees
Prison building	Government committed to end short sentences and reduce prisoner population
Community regeneration	74% cut in Communities budget. Regional Growth Fund only £1.5 bn over 3 years
Defence equipment	Major new investment severely squeezed
All major IT investment	Already a presumption against new IT schemes costing more than £1m

Readers of our previous commentaries will be familiar with our scepticism about the achievability of efficiency plans, and the evidence from the National Audit Office and others about the failure of various Labour plans, from Gershon onwards, to achieve the efficiency gains promised. However our own and others' discussions with officials across the public sector suggest a real recognition that "this time it's different" and initiatives such as the "super council" being mooted by Westminster, Kensington and Chelsea and Hammersmith and Fulham seem to reinforce this.

The move to localism

Before the election there was much scepticism (which we shared) that the government would genuinely try to devolve power once it had its hands on the levers of that power. Now the criticism centres on its decision to devolve power at a time of falling expenditure, with that old adage, "Governments with money centralise and claim the credit, those without decentralise and spread the blame" being much in evidence.

However the government's strategy is somewhat more explicit than this. It has effectively said to local government. "We will give you more power, in exchange for less money." The commitment of both coalition parties to localism goes way back, well beyond the current financial crisis. Now more than 90 (ninety) ring-fenced grants to local authorities will be replaced by fewer than ten, and the Spending Review confirms the continuing evolution of the previous government's Total Place initiative (which in simple terms was about joining up and controlling separate public spending pots at local level) into a system of community-based budgets which will "pool departmental budgets for families with complex needs".

But perhaps the most important example of this exchange of power for money is the decision to "reduce spending on Council Tax Benefit by 10 per cent and localise it from 2013 -14". This means that councils will have 10% less to spend, but they will decide how to spend it in terms of entitlement, subject to "protecting the most vulnerable". This sets an important precedent of councils determining eligibility for and the level of benefit as well as administering its provision within centrally-imposed rules. It will be interesting to see how councils respond, and whether the discretion is widened to other benefits, as some councils have lobbied for.

Payment by results

In two adjacent paragraphs, under the heading of "Sharing Responsibility", the government promises two potentially huge changes to the delivery of public services. The first is a commitment to payment by results and, by extension, the part or total funding of payment from future savings. The government is already implementing outcome-based payments in welfare to work, through the Work Programme, and is now extending this approach to prisoner rehabilitation. The Spending Review proposes to extend payment by results and "innovative payment mechanisms" to a raft of further areas, including "community health services, processing services, prisons and probation and children's centres".

This has potentially huge implications for the future funding of public services if the government can make it work, though that is by no means certain. It means that service providers will be much more explicitly challenged to find solutions to problems and treat causes not symptoms. It also means that those providers will need to find much greater quantities of working capital to fund the services they provide and cover the period until they receive payment, with that payment likely to incorporate a higher level of reward and risk. As Lord Freud, the architect of the original payment by results/invest to save regime in welfare, has been known to comment, the government is effectively trying to introduce "service-based PFI".

Presumed use of independent providers

The second change reflects the government's view, set out expressly in the Spending Review, that "while it should continue to fund important services, it does not have to be the default provider." The government says that it will "look at setting proportions of appropriate services across the public sector that should be delivered by independent providers, such as the voluntary and community sectors and social and private enterprises. This approach will be explored in adult social care, early years, community health services, pathology services, youth services, court and tribunal services, and early interventions for the neediest families."

In terms both of considering this approach and naming specific services, this is a proposal which has not been seen since the Thatcher/Major years. It is currently only a proposal under consideration, and may not be implemented, but clearly reflects a part ideological, part pragmatic view that public service delivery would benefit from a more mixed economy of provision, and that this view needs to be centrally imposed rather then left to commissioning bodies to decide.

Implications

As is the case following any budget or Spending Review, the true implications of SR 2010 will emerge over many months. But as is equally the case, some initial assessments can be made.

First, we now have some certainty after many months where we had none. Forward budgets have been set for an unprecedented four years, and while there have been sharp reductions in percentage terms many programmes remain substantial, and much larger in real terms than they were only a few years ago. There is likely to be some dusting off of existing business plans and information Memoranda, and generation of new ones, by companies which have been looking for equity investment but have been unclear about their prospects. Equally, investors might want to take a fresh look at assets which have been on the market recently, but have not been able to give enough confidence about future income streams.

Second, we can expect a steady stream, if not a flood, of new opportunities for public service companies that can help the public sector deliver its reform plans and save money overall. As we commented in our last briefing, many organisations have been considering further outsourcing or public/private partnerships of one sort or another, but have been hanging fire until they knew the worst. Margins are bound to be tight, possibly as tight as they have ever been, but the scale of opportunity may provide some compensation.

Thirdly, we can expect to see considerable innovation by public, private and third sector bodies in the delivery of services. Irrespective of whether the government goes ahead with proposals to define a proportion of services to be delivered by third parties, it is clearly going to push ahead with new service delivery models and challenge the public sector more explicitly to use the resources of the private and third sectors where and when it makes sense to do. Equally, the private sector needs to respond and show an appetite for innovation and risk. (And yes we know we and many others have said this sort of thing before, but this time we think it really could be different.)

Lastly, the government is clearly going to push ahead with efforts to develop new payment models that will, to some extent, decouple service provision from immediate funding. If these initiatives can be made to work, they will potentially have as great an impact on the delivery of public services as the Private Finance Initiative had on the building of public assets. Clearly this will have major implications both for service providers and for those who provide them with capital.

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