Institute for Fiscal Studies

IFS Green Budget Chapter 5

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Spending Review 2021: plans, promises and predicaments

5. Spending Review 2021: plans, promises and predicaments

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Key findings

1. **At the Spending Review on 27 October, the Chancellor faces a dilemma.** He has announced a £14 billion top-up to his March 2021 spending plans, alongside a manifesto-breaking increase in National Insurance contributions. Overall funding for public services is planned to increase at a faster rate than at Labour's 2007 Spending Review. Rishi Sunak, a Conservative Chancellor, is set to oversee a lasting increase in the size of the state of around 2% of national income. **But still he faces an unpalatable set of spending choices.**

2. The latest overall spending envelope, set and published in early September, is more generous than those previously pencilled in at the March 2021 Budget, **but still marginally less generous (around £3 billion lower in 2024−25) than those published in March 2020**. In other words, despite the substantial pressures placed on public services by the pandemic, the Chancellor is planning to spend no more overall than he was prior to COVID-19.

3. **These plans imply a tight settlement for many areas of government over the next two years.** Sticking to them would mean overall public service funding increasing year on year, **but would require cuts to unprotected budgets (which include local government, prisons, further education and courts) of more than £2 billion in 2022−23.** This could be difficult to reconcile with the government's promises on levelling up and social care reform. **The Chancellor's plans imply more wiggle room in the medium term**: funding for unprotected budgets is set to grow by more than 8% in 2024−25, the final year of the Spending

[1] The author is grateful to Tom Hart, Yani Tyskerud and Ross Warwick for helpful comments and suggestions.

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Review period, after real-terms cuts over the previous two. **Mr Sunak might consider bringing some of that funding forward to the next two years, when pandemic-related pressures on departments are likely to be at their most acute.** If he wished, he could do so without spending any more overall.

4 **In reality, an ever-growing NHS budget and top-ups needed elsewhere will likely eat into the amount available for unprotected budgets** in 2024−25. Plugging a possible £5 billion shortfall in the NHS budget in 2024−25, plus an extra £4 billion or so to return overseas aid spending to 0.7% of national income (which the government claims to be committed to), would be more than enough to require further real-terms cuts to unprotected budgets in that year. **A difficult two years for areas such as local government and justice could very easily become a difficult three.**

5 Most of the unprotected budgets facing potential cuts under the Chancellor's current plans were cut hard through the 2010s. For instance, **despite recent increases in the day-to-day budget for the Ministry of Justice and the Law Officers' Departments (which includes the Crown Prosecution Service), core spending in 2021−22 for each is still set to be 21% lower in real terms than in 2009−10**. Meanwhile, health spending has risen steadily, and is set to account for an ever-growing share of day-to-day public service spending: 44% by 2024−25, up from 42% in 2019−20, 32% in 2009−10 and 27% in 1999−2000.

6 The Chancellor's plans allow for additional spending to deal with pandemic-related pressures on the NHS, but **make no allowance for virus-related spending on other services**. COVID-19 pressures on other parts of the public sector will not simply dissipate after this year: ongoing support for public transport operators and a catch-up package for schools could easily require £3 billion of extra spending each year. **The Chancellor should be prepared to make additional funding available via a 'COVID-19 Reserve'**, but is right to set out spending plans of individual departments for the remainder of the parliament. **After sensibly following the advice in last year's Green Budget to set budgets for only one year in the 2020 Spending Review, now is the time to return to the certainty and stability of multi-year budgeting**, while retaining the flexibility to respond to changing conditions.

7 **Many public sector workers – particularly those who are more experienced and higher earning – are still earning substantially less than their equivalents in the past.** For instance, pay levels for experienced teachers in 2021 are 8% lower in real terms than in 2007, and average real-terms pay for NHS dentists fell

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by more than a third between 2006–07 and 2019–20. More generally, during the sustained period of public sector pay restraint in the years after 2010, pay awards in the public sector failed to keep pace with private sector pay growth. But over the past two years, average public and private sector earnings have grown at roughly the same rate. The Spending Review will not make direct public sector pay awards, but could provide an indication of future pay policy – including whether the pay freeze for most public sector workers will come to an end next year. **There was some logic to the public sector pay freeze in 2021, but extending it risks having a damaging effect on recruitment, retention and motivation.**

5.1 Introduction

A Spending Review is an important economic and fiscal event. It is an opportunity for the government to think carefully about its priorities and objectives, balance off competing demands, and allocate huge sums of public money towards meeting its goals. That makes it an important political event, too, and a potential source of conflict and tension within Whitehall.

The past two Spending Reviews have been limited in scope, each covering only a single year: the 2019 review was scaled back because of the uncertainties of Brexit, and – following a recommendation in last year's IFS Green Budget – the 2020 review because of the even greater uncertainties of COVID-19. In the autumn of this year, the Chancellor, Rishi Sunak, intends to hold a Spending Review, setting out expenditure plans until at least the end of this parliament. He is right to do so. As the shoots of economic recovery emerge, now is the time to provide public services with the certainty and stability of multi-year budgets, to enable them to plan for a recovery from the impacts of the pandemic.

This year's review promises to be highly significant, and highly revealing. The final spending plans will represent the culmination of many behind-the-scenes arguments, and will set the scene for inevitable disputes to come. Over the rest of this parliament, we will undoubtedly see numerous stand-offs between departments with legitimate cases for additional spending, and a parsimonious Treasury with one eye on the public finances, acutely conscious that it cannot say yes to everything. The balance struck by Mr Sunak in the forthcoming Spending Review will provide insight into how these arguments are likely to be resolved, into how public services will fare over the next few years, and into the government's broader economic and fiscal strategy.

Of course, some of the big decisions have already been made. On 7 September, the Chancellor confirmed his spending totals for the next three years (the 'envelope') – topping up his previous plans by around £14 billion per year in the process. This additional spending (announced alongside a corresponding increase in tax) is earmarked for health and social care. After also

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accounting for the government's existing promises and commitments on defence, schools and overseas aid, this means that getting on for two-thirds of the spending pot has already been pre-allocated ahead of the Spending Review.

Yet there remain many meaningful – and difficult – decisions and trade-offs to be made. Those trade-offs will be made all the more difficult by three important, related factors.

The first is the huge pressures placed on public services by the COVID-19 pandemic. The government's 7 September announcement included substantial sums to help the NHS deal with pandemic-related pressures: sums which the analysis in Chapter 6 suggests ought to be 'enough' to meet those pressures, at least for the next two years. But no such allowance has been made for virus-related spending elsewhere. Other areas – most notably schools and public transport operators – are also likely to require billions of additional financial support in the coming years, though the appropriate scale of that support is far from certain. Rather than try to meet these pressures from within existing budgets, the Chancellor would be wise to meet future pandemic-related costs out of a 'COVID-19 Reserve', in order to retain the flexibility to respond to changing conditions, while acknowledging the ongoing need for (temporary) virus-related spending.

The second factor is the tightness of the Chancellor's spending plans for 'unprotected' areas not fortunate enough to be covered by existing commitments – particularly in the near term. Between this year (2021−22) and next (2022−23), for example, *overall* departmental day-to-day budgets are set to grow by 6.2% in real terms (i.e. over and above inflation). The Department of Health and Social Care – the immediate beneficiary of the latest tax rise – is set for real-terms growth in excess of 12%. But unprotected budgets are facing a real-terms cut of 2.5%, or more than £2 billion, in that year. Such a tight settlement for areas such as local government, prisons and further education would pose considerable challenges – not least because of the ongoing impacts of the pandemic.

The third factor is the scale of the government's broader policy ambitions. Boris Johnson has announced his long-awaited reforms to social care funding, but it remains to be seen whether adequate funding will be provided for councils to implement them successfully while meeting a myriad of other budget pressures (see Chapter 7). The Prime Minister has also promised an ambitious 'levelling up' agenda, to address the UK's substantial regional inequalities – an issue covered in last year's IFS Green Budget (Davenport and Zaranko, 2020). The details and objectives of the agenda remain vague and ill-defined; a White Paper is expected later in the year, which may shed some light – but will presumably also come with a price tag. It would be challenging, to say the least, to make progress on each of these fronts – social care reform and levelling up – while cutting local government grants over the next two years, yet that is what the Chancellor's latest spending plans imply. The government is also committed to an ambitious

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'net zero' target and is especially keen to make visible progress ahead of the COP26 summit in Glasgow later this year (see Chapter 8). That could mean substantial amounts of public expenditure over the forthcoming Spending Review period.

The upshot is that the 2021 Spending Review still promises to be a tricky one. There will be no full-throated return to austerity, and the pandemic is expected to result in a permanent increase in the size of the state. But as it stands, some areas are still facing budget cuts over the next two years. Others will avoid cuts, but will not get the support that they think is required.

Improvements in the economic and fiscal outlook might provide the Chancellor with some breathing room and allow him to make more funding available for public services, without the need for another round of tax rises or an increase in borrowing relative to previous plans. That is especially likely to be the case in the short term. But given the scale, breadth and likely persistence of pressures created by the pandemic, and the seeming inevitability of future top-ups to the NHS budget, the additional headroom is unlikely to be enough to meet the many demands for additional funding. Some areas will be left wanting. To govern is to choose, and the Chancellor has some unenviable choices to make.

We now proceed as follows. Section 5.2 lays out the Spending Review process and the government's framework for planning and controlling public spending. Section 5.3 describes recent trends in spending, including how different departments' budgets have fared since 2010. Section 5.4 considers some of the key areas where the Chancellor will be under pressure to allocate additional funds. These include public services disrupted by the pandemic – most notably the NHS – but also public sector pay awards, social security (including the triple lock) and the government's stated policy priorities (such as social care reform, levelling up and net zero). Section 5.5 sets out the Chancellor's existing spending plans and the various commitments that limit his room for manoeuvre at the forthcoming Spending Review. Section 5.6 analyses the implications of these, and discusses some of the options and trade-offs facing the Chancellor. Section 5.7 concludes.

Readers should note that the first half of this chapter is backwards-looking. Those interested only in analysis of the outlook for the 2021 Spending Review should skip to Section 5.4, on page 205. Those in even more of a hurry and only wanting to look at the implications of the Chancellor's latest plans and the quantification of the trade-offs he faces might wish to skip to Section 5.6, on page 221.

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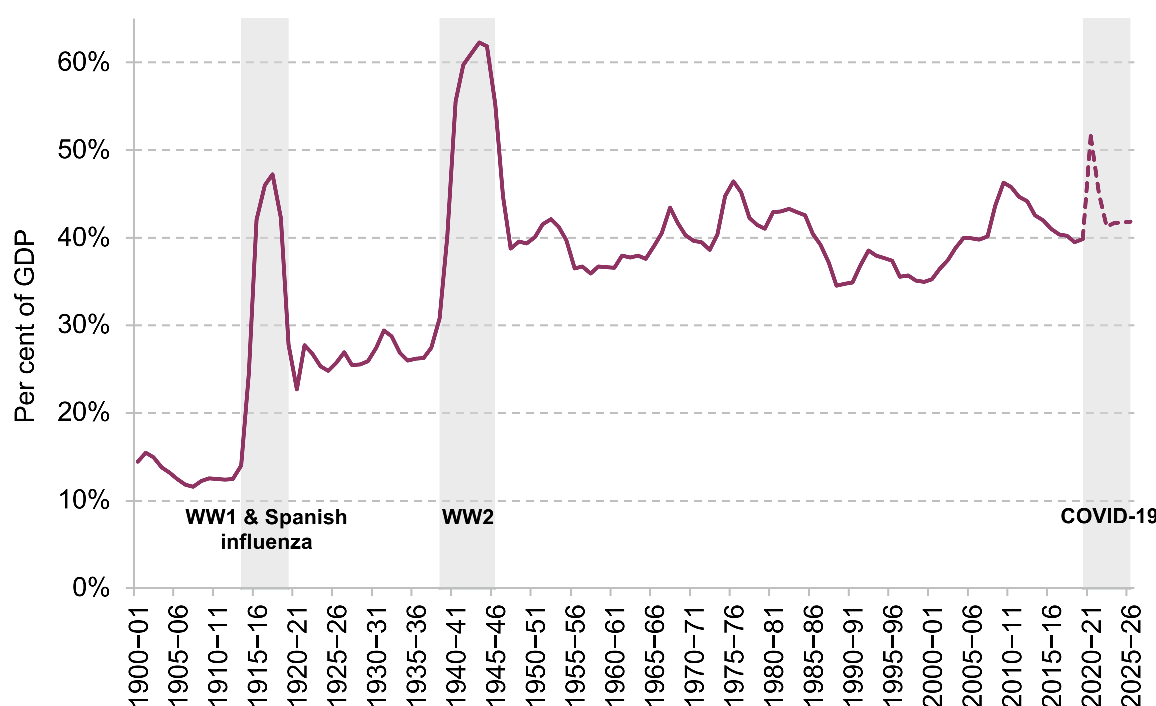
5.2 The fiscal framework and the planning of public spending

The backdrop

This year's Spending Review will be held as government spending as a share of the economy – one measure of the size of the state – falls from its highest level since the end of the Second World War. Figure 5.1 shows how total government spending as a share of GDP has evolved over the past 120 years. In 2020−21, as the economy contracted and the government appropriately expended huge sums in emergency support, UK government spending amounted to more than 50% of the entire economy for the first time since 1945−46.

Figure 5.1. Total managed expenditure as a share of GDP, 1900−01 to 2025−26



Note: Dashed lines denote forecasts as of the March 2021 Budget, updated to reflect September 2021 spending announcements and Citi's latest forecasts for the economy.

Source: Office for Budget Responsibility Public Finances Databank, accessed July 2021, and HM Treasury, 'Chancellor launches vision for future public spending', 7 September 2021.

As the economy recovers and emergency support is withdrawn, this increase is expected to be reversed – but not in full. Following the latest spending announcements on 7 September, and on the basis of Citi's 'central' forecast for economic growth (Chapter 2), government spending is expected to stabilise at 41.8% of national income, around 2% of national income higher than its pre-pandemic level. A little over one-third of this increase is from higher investment spending

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(an increase which was planned pre-pandemic), with the remaining two-thirds or so coming from higher day-to-day spending (on social security and public services).

In other words, the pandemic will be followed by a permanent increase in the size of the state. This mirrors what happened in the aftermath of the First and Second World Wars: spending fell as a share of national income, but not all of the way back to its pre-war level. Notably, this is not what happened following the financial crisis: while the crash did lead to a spike in spending as a share of national income, this was reversed fully over the subsequent decade.

The spending framework

While total government spending shot up during the pandemic to more than 50% of GDP (or, equivalently, more than £1 trillion), not all of this spending is subject to the Spending Review process. Since 1998, when the first Spending Review was held by then-Chancellor Gordon Brown, government spending has been divided into the following two totals:

- **Departmental expenditure limits (DEL)** can be broadly thought of as spending by central government on public services, and encompasses spending that can be controlled (rather than being driven by, for example, the economic cycle). This spending is allocated between departments, often for three or four years at a time, at Spending Reviews. It includes spending on things such as the NHS, the courts system, the police and schools. Within DEL, departments are set separate resource (current, or day-to-day) and capital (investment) budgets.
- **Annually managed expenditure (AME)** includes spending items which are more volatile and demand-led, or which lie outside of central government's immediate control. In other words, it covers the categories of spending that are more difficult to plan and control: those which the government argues cannot reasonably be subject to firm multi-year limits. This includes things such as debt interest payments and spending on social security benefits and state pensions, as well as spending by local or devolved governments financed through the taxes that they control.

Together, DEL and AME add up to total managed expenditure (TME), or total government spending, which amounted to £886 billion in 2019−20 and shot up to £1,094 billion in 2020−21. TME is broken down into its various components in each year in Figure 5.2. It can be seen that the composition of government spending changed during the pandemic. Most notably, COVID-19 income support schemes (such as the furlough scheme and the Self-Employment Income Support Scheme) did not exist pre-pandemic, but accounted for 7% of all spending in 2020−21.

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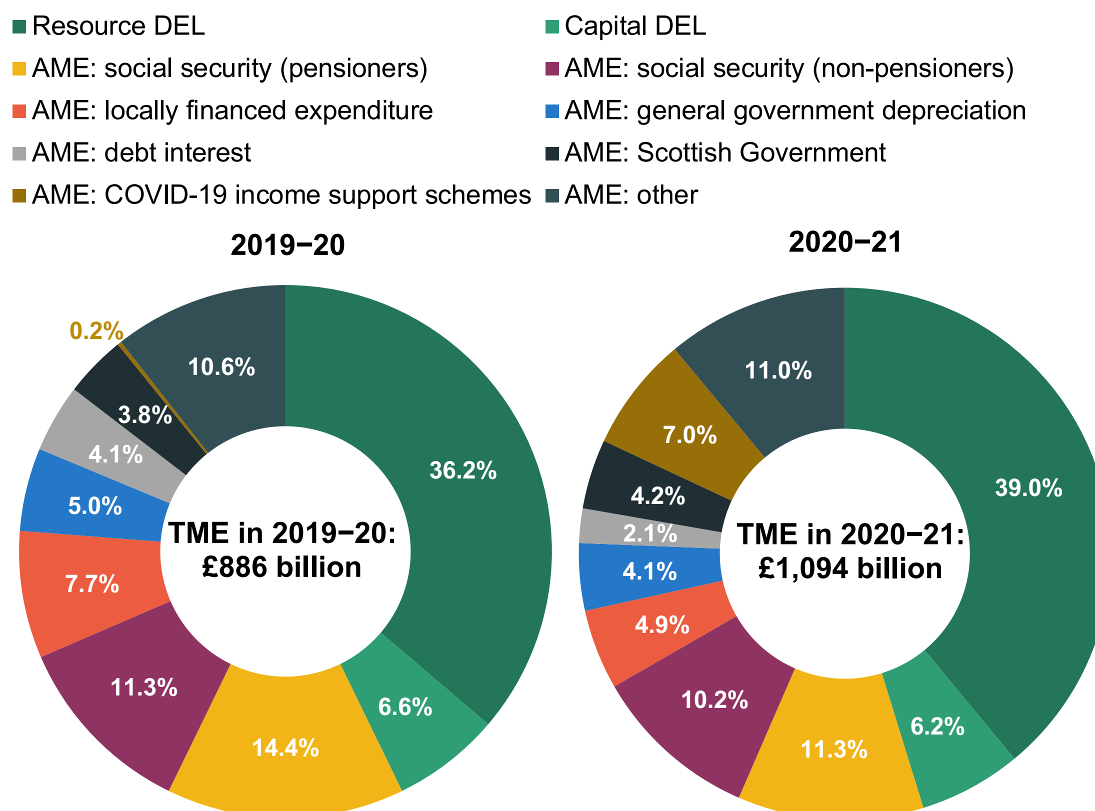
Figure 5.2. Components of total managed expenditure (TME) in 2019–20 and 2020–21



Note: £ billion figures shown are nominal (cash terms), and reflect the latest estimates at the time of writing. 'Resource DEL' and 'Capital DEL' denote the OBR's definition of PSCE in RDEL and PSGI in CDEL, respectively. COVID-19 income support schemes include the Coronavirus Job Retention Scheme and the Self-Employment Income Support Scheme. Other components of AME include, for example, net public service pension payments, spending by funded public sector pension schemes, spending by the BBC and public corporations, current VAT refunds, environmental levies, expenditure transfers to the EU and student loans.

Source: Author's calculations using OBR Public Finances Databank (accessed 29 July 2021) and table 3.14 of OBR March 2021 Economic and Fiscal Outlook, with the pensioner/non-pensioner split calculated based on DWP Benefit Expenditure and Caseload Tables 2021.

The focus of the Spending Review will be departmental budgets within DEL. The Treasury uses a slightly broader definition of DEL than that shown in Figure 5.2 for its control total (to include block grants paid to the Scottish Government) but, even then, only around half of all spending falls within scope. It is important to remember that despite all of the emphasis on and theatre

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around the Spending Review, there is a huge chunk of spending – around half of the total – that is not subject to the process or to firm annual limits.[2]

Departmental budgets are then split into a resource (current, or day-to-day) and a capital (investment) component:

- **Resource DEL (RDEL)** accounts for almost 40% of total spending and around 85% of total DEL. It covers the day-to-day running and administration costs of public services, so includes things such as staffing costs.
- **Capital DEL (CDEL)** accounts for 6−7% of total spending and around 15% of total DEL. It covers money spent building or maintaining physical government assets, such as roads and buildings.

Resource and capital budgets are planned and managed separately. This distinction was originally introduced to address a perceived bias against capital investment in the 1980s and 1990s: when times were hard and budgets tight, there was a belief that departments would cut back on investment projects to meet day-to-day spending pressures (HM Treasury, 1998). The separation was thus introduced to encourage departments to undertake the public investment that they had been budgeted to do. The separation between the two is not always clean, however (discussed in Box 5.1), and this did not stop the government from cutting capital DEL sharply in the years after 2010 (discussed in the following section).

As is implied by the name, departmental expenditure limits are a set of annual spending limits for departments. In practice, departments tend to spend less than the limit, because there are very strong incentives not to overspend (Crawford, Johnson and Zaranko, 2018), and departments show a particular tendency to undershoot their capital budgets (Atkins, Tetlow and Pope, 2020). Departmental underspending during the pandemic is discussed in Box 5.2 later.

Box 5.1. The murky distinction between capital and investment spending

The separation of departments’ resource and capital budgets was introduced in 1998 to prevent investment spending from being cut back to meet short-term pressures on day-to-day expenditure, and thus to protect against departments’ tendency to underinvest. The distinction is based on a public accounting definition: capital spending is defined as ‘expenditure on fixed capital assets, capital grants and the acquisition of certain financial assets acquired or sold for policy reasons’ (HM Treasury, 2021a). Fixed assets are defined as goods and services that are used in production for more than one

[2] The 2010 and 2015 Spending Reviews included parts of AME – in particular, spending on working-age social security – within the envelope, but this approach remains the exception rather than the rule. For more detail on previous Spending Reviews and on how the spending framework has evolved over time, see Crawford, Johnson and Zaranko (2018).

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year: roads, bridges and buildings are some obvious examples. This distinction is seen as worth protecting because such spending – 'investment' – can produce future benefits or promote economic growth.

The challenge is that the accounting definition of what constitutes investment spending does not always align with an economic concept of 'investment'. Economists might cast the net more widely, to include other types of spending that produces long-run returns. Education is an obvious example: investment in human capital (such as spending on schools, further education colleges or training) can produce substantial long-term economic benefits. We might like to design a fiscal framework that protects this 'economic' definition of investment spending. But there is no precise definition, and there are clearly some fuzzy edges. Most might agree that (at least some) spending on education is an 'investment' in the future, but it is much harder to judge where to draw the line when it comes to other areas, such as spending on healthcare, or rehabilitation programmes for prisoners.

In the absence of such a definition, we rely on a precise accounting distinction between current and capital expenditure. Under the existing framework, the education services produced by schools, colleges and universities are treated as being consumed by students in the process of acquiring knowledge and skills (United Nations, 2008). Spending on those areas is thus treated as current rather than capital spending, because it does not produce a fixed asset as understood in the system of national accounts.

This may sound like an obscure and technical debate about accounting definitions – and it is. But it has important implications, particularly when the outlook for current ('day-to-day') spending is tight and the government employs fiscal rules that explicitly favour capital spending. The current Chancellor has indicated that he is willing to borrow for capital expenditure, but that he wants all day-to-day spending to be paid for out of tax revenues (i.e. he wants to achieve current budget balance). To achieve that objective, he has set out a tight set of spending plans that leave very little room for additional current expenditure (discussed in Section 5.6). That could lead to a situation where there is plenty of funding sloshing around for capital projects but where current spending projects are squeezed – regardless of the respective merits of the two. In other words, there could be instances where capital spending projects of low value to the public get commissioned while current spending ones of higher value do not, because they do not meet an accounting definition of 'investment'. The Treasury's recent reluctance to provide substantial funds for schools to catch up on lost learning during the pandemic is perhaps a case in point (Sibieta and Zaranko, 2021).

One option occasionally floated is to simply reclassify large chunks of expenditure on education as investment spending. It is important to distinguish here between the UK's public accounting framework and the Chancellor's fiscal rules. There is nothing to stop the Chancellor from changing his fiscal rules to allow him to borrow to pay for capital spending *and* spending on education, if he thinks that the long-term benefits would justify doing so. He could even come up with a new spending definition for his fiscal rules,

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such as borrowing only to pay for 'growth-enhancing spending' – if such a category could be defined – without making any changes to the UK's national accounts. But such a change would no doubt lead to furious lobbying from departments seeking to have their spending programmes classified as 'growth-enhancing', and would set a precedent for future targets to be similarly gamed. Sticking to the ONS's interpretation of international accounting rules is cleaner. Chapter 4 contains a further discussion of the issues around the design of the fiscal framework.

Ultimately, if the government wishes to spend more on an area such as education, and is willing to borrow more in order to do so, it should say so explicitly and make the case on its own terms with a clear argument of the potential long-term benefits.

Multi-year budgeting (at least in theory)

The introduction of Spending Reviews in 1998 also saw the advent of multi-year budgeting to replace the previous annual spending cycle. In setting 'firm and realistic multi-year limits', the objective was to give departments a solid base for planning their spending and operations (HM Treasury, 1998). It meant the end of the annual Public Expenditure Survey, which was frequently used by departments to bid for extra funds, or by the Treasury to make incremental cuts. Multi-year budgeting was an explicit attempt to move away from this annual tinkering. Departmental spending plans were initially set for three years at a time (with planning periods often overlapping), but in recent times have covered as many as four years and as few as one (Table 5.1).

Table 5.1. Past Spending Reviews

Date of Spending Review	Number of years covered	Financial years for which departmental limits set
July 1998	3	1999−00 to 2001−02
July 2000	3	2001−02 to 2003−04
July 2002	3	2003−04 to 2005−06
July 2004	3	2005−06 to 2007−08
October 2007	3	2008−09 to 2010−11
October 2010	4	2011−12 to 2014−15
June 2013	1	2015−16
November 2015	4 (5 for capital DEL)	2016−17 to 2019−20 (to 2020−21 for capital DEL)
September 2019	1	2020−21
November 2020	1	2021−22

Source: HM Treasury Spending Reviews (various).

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The two most recent Spending Reviews have both covered just a single year. The September 2019 Spending Review, held by then-Chancellor Sajid Javid just a few months before the December 2019 general election, was limited to a single year, setting departmental resource budgets for 2020−21 only. In announcing a 'fast-track', single-year Review, the government cited the need for departments to focus on delivering Brexit (HM Treasury, 2019). The prevailing Brexit-related uncertainty at the time also undoubtedly fed into the decision.

In 2020, Chancellor Rishi Sunak announced his intention to hold a Comprehensive Spending Review to set plans for the remainder of this parliament. In the event, following a recommendation in last year's IFS Green Budget (Zaranko, 2020), the Review was sensibly limited to just a single year (2021−22) due to the huge amount of COVID-related economic uncertainty.

This year's Spending Review is an opportunity to move back towards multi-year budgeting – a framework which, in normal times, represents a strength of the UK's system for the planning and control of public expenditure (and one that is unusual internationally). Setting departmental limits for the next three years (2022−23, 2023−24 and 2024−25) would provide departments a basis on which to plan up to and beyond the next general election. The pandemic is not behind us, and future virus-related spending seems a certainty (even if the scale of such spending is far from certain). But that should not prevent the Treasury from providing departments with some certainty, stability and predictability over their 'core' budgets used to deliver their usual services. Any additional virus-related spending could and should be funded separately from a 'COVID-19 Reserve'. That way, the Chancellor can retain the flexibility to respond to changing conditions, while acknowledging the fact that some COVID-19 spending will need to continue.

5.3 Recent trends in spending

The decade prior to the pandemic saw the longest sustained squeeze on public spending on record. As part of a broader austerity programme, departmental budgets faced deep cuts in the years after 2010, with particularly large cuts to investment budgets in the first few years of the coalition government. Overall departmental spending started rising again after 2016−17, but most departments entered the pandemic with a smaller budget than a decade previously. Following the onset of the pandemic, departments have been allocated huge sums to deal with the impacts of COVID-19. This section discusses each of these trends.

Resource and capital budgets since 2010

Resource and capital budgets fared very differently during the 2010s. Between 2009−10 and 2017−18, resource DEL was cut by 9.1% in real terms (1.2% per year). It was increased by an average 1.7% per year over the next two years, such that it in 2019−20 it was 6.0% lower than a

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decade previously. In other words, despite a decade of near-uninterrupted (though relatively anaemic) economic growth, day-to-day spending by central government on public services was 6.0% lower in 2019−20 than ten years previously (and 12.3% lower in per-capita terms, as the population grew over this period). But spending was on an upwards trajectory pre-pandemic, and under the government's March 2020 plans, the post-2010 cuts to overall RDEL would have been reversed in real terms by 2021−22, and the per-person cuts reversed by 2024−25.[3]

Capital budgets followed a more tumultuous path. Between 2009−10 and 2012−13, capital DEL was cut by almost a third (32.0%) in real terms – a remarkable amount to cut from budgets in such a short time, and an even bigger cut than was originally planned. Capital budgets then followed a bumpy path upwards over the following seven years, which undid around half of the initial cuts. Capital DEL in 2019−20 was 16.9% lower in real terms than in 2009−10 (and 22.5% lower in real per-person terms). The government had, however, pencilled in large increases in capital DEL for subsequent years: Spending Review 2020 planned for average annual real-terms growth of 15.9% in 'core' (non-virus) departmental capital budgets between 2019−20 and 2021−22.

Figure 5.3 shows that resource DEL shot up in 2020−21 to more than 20% above its 2009−10 level (largely but not entirely due to virus-related spending), but is expected to fall back in 2021−22 as pandemic-related support is withdrawn. (A breakdown of the government's COVID-19 spending is provided later in this section.) Under current forecasts, overall resource DEL in 2021−22 (including virus-related spending) will be 14.2% higher in real terms than in 2009−10.

Capital DEL also increased sharply in 2020−21 but, unlike in the case of resource DEL, this was largely due to a pre-planned increase in spending rather than a virus-related increase. And rather than falling back, the growth in capital DEL is set to accelerate in 2021−22. The outlook for capital spending in the forthcoming Spending Review period is covered in Section 5.5.

[3] This slightly overstates the generosity of the government's spending plans, because from 2019−20 those figures include between £5 and £6 billion of additional RDEL relating to a fall in the discount rate used in setting employer contribution rates to public service pension schemes. Additionally, the planned increase in RDEL was part-funded by direct savings from EU contributions that the UK will no longer pay. See footnote 6 of Emmerson, Pope and Zaranko (2019) and Zaranko (2020) for further details.

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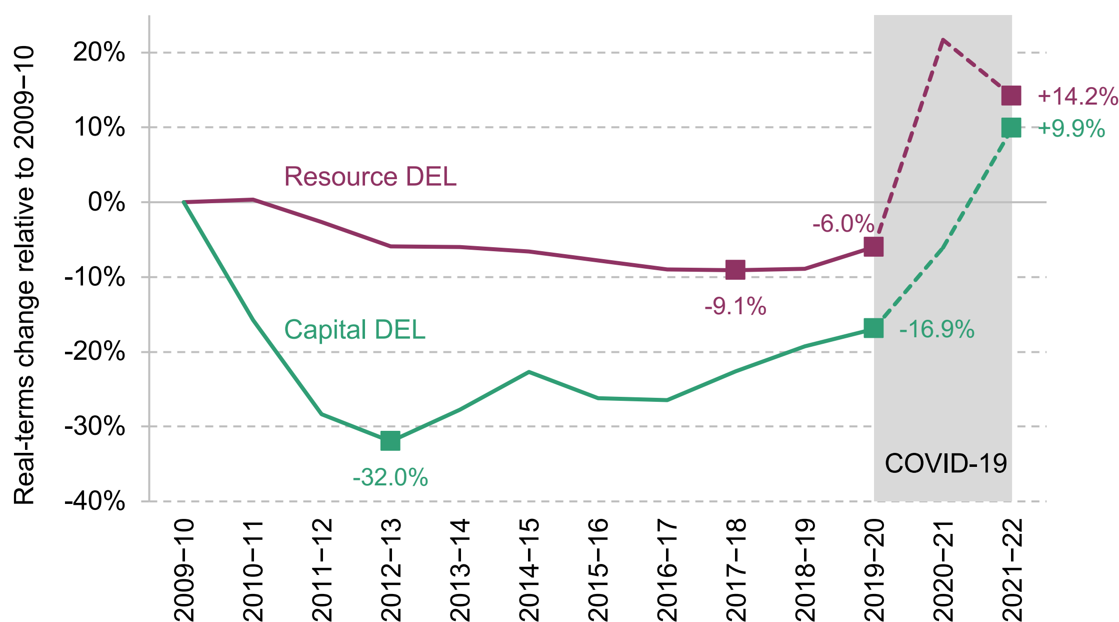
Figure 5.3. Changes in resource and capital DEL since 2009−10



Note: 'Resource DEL' and 'Capital DEL' here denote the OBR's definition of PSCE in RDEL and PSGI in CDEL, respectively, adjusted for historical discontinuities. The resource DEL figures for 2019−20 onwards are also adjusted to remove additional resource spending related to employer pension contributions. Figures for 2020−21 and 2021−22 include COVID-19 spending.

Source: Author's calculations using OBR Economic and Fiscal Outlook (October 2018 and March 2021), HM Treasury Public Expenditure Statistical Analyses (various) and ONS June 2021 GDP deflators.

Non-COVID spending by departments

A large part of the increase in resource and capital DEL since 2019−20 is a result of virus-related spending programmes, which are discussed in more detail in the following subsection. Here, we ignore spending related to COVID-19 and instead look at how different departments' 'core' (non-virus) budgets have evolved since 2010, taking resource and capital spending in turn.

Figure 5.4 plots the percentage change in major departments' core resource (day-to-day) budgets between 2009−10 and 2021−22. A few key patterns emerge.

- **Most departments saw sharp cuts in the initial years after 2010.** These cuts were especially deep for the Ministry of Justice (MoJ), the Law Officers' Departments (which includes the Crown Prosecution Service), the Department for Work and Pensions (DWP), the Department for Transport (DfT), the Department for Environment, Food and Rural Affairs (DEFRA) and the Housing and Communities budget within the Ministry of Housing, Communities and Local Government (MHCLG). The Home Office also saw sharp cuts after 2010−11, and the Department for Culture, Media and Sport (DCMS) saw sharp cuts after the 2012 London Olympics.

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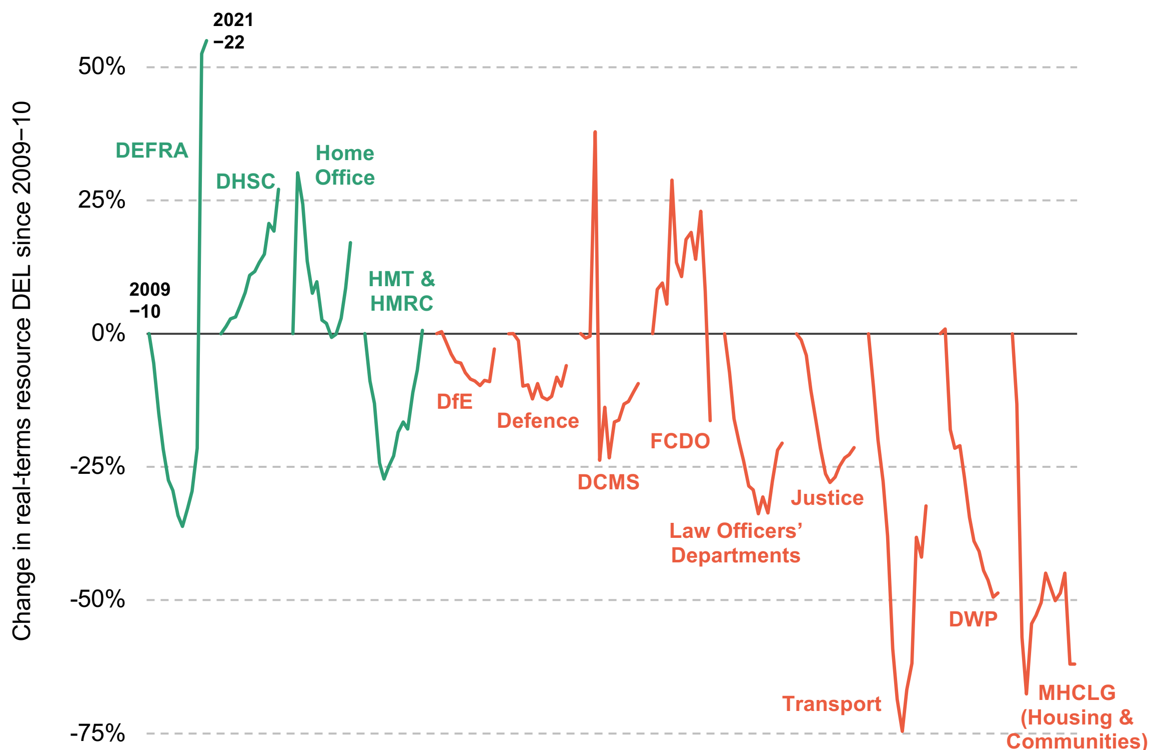
- **This was not the case for all departments.** The Department of Health and Social Care (DHSC) budget increased steadily over the 2010s, and has grown to account for an ever-growing share of day-to-day public service spending: 44% by 2024−25, up from 42% in 2019−20, 32% in 2009−10 and 27% in 1999−2000. The Foreign, Commonwealth and Development Office (FCDO) budget also grew steadily (up to 2019−20).[4] Health spending is discussed in more detail in Chapter 6; aid spending is discussed in Section 5.5.

Figure 5.4. Percentage change in departmental 'core' (non-virus) resource budgets, 2009−10 to 2021−22



Note: Figures for 2020−21 and 2021−22 are 'core' resource DEL spending plans from the March 2021 Budget and exclude COVID-19 funding. All figures are for resource departmental expenditure limits, excluding depreciation. DEFRA = Department for Environment, Food and Rural Affairs; DHSC = Department of Health and Social Care; HMT = HM Treasury; HMRC = HM Revenue and Customs; DfE = Department for Education; DCMS = Department for Culture, Media and Sport; FCDO = Foreign, Commonwealth and Development Office; DWP = Department for Work and Pensions; MHCLG = Ministry of Housing, Communities and Local Government. DEFRA figures for 2020−21 and 2021−22 include direct payments to farmers, replacing those previously made under the EU Common Agricultural Policy.

Source: Author's calculations using HM Treasury Public Expenditure Statistical Analyses (2015−21 editions), HM Treasury Budget 2021 and HM Treasury June 2021 GDP deflators.

[4] Note that the FCDO was created in September 2020 through a merger of the Foreign and Commonwealth Office (FCO) and the Department for International Development (DfID); Figure 5.4 shows the percentage change in the combined budget of both pre-merger departments. The spending growth over the 2010s was driven by increases in the DfID, rather than the FCO, budget.

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- **Most departments have seen budget increases in recent years.** This has in part reflected a deliberate decision by the government to increase departmental budgets in the face of pressures on public services, as well as a general move away from a policy of 'austerity' at the two most recent Spending Reviews. But, notably, some of the largest increases have been for departments with significant post-Brexit responsibilities (DEFRA, the Home Office and HMRC). In fact, these three departments are the only ones (other than DHSC) that are set to have a budget in 2021−22 higher than it was in 2009−10. The DEFRA budget, in particular, has rocketed upwards in 2020−21 and 2021−22 as the department took on responsibility for agricultural payments previously undertaken by the EU.
- **For the most part, these recent increases have not been enough to undo the post-2010 cuts.** For instance, despite recent increases in the budget for the Ministry of Justice and the Law Officers' Departments, core spending in 2021−22 for each is still set to be 21% lower in real terms than in 2009−10. In the case of the DWP, resource spending is set to be almost 50% lower, and for the Housing and Communities budget, more than 60% lower.

This clearly shows that departments and public services did not fare equally over the decade prior to the pandemic. But the tendency to favour some areas over others is not just a feature of the period after 2010. Figure 5.5 shows how planned growth rates in selected areas compared with what was planned for overall growth in resource DEL at each Spending Review since 1998. A positive figure indicates that spending in that area was planned to grow faster than the average department; a negative figure indicates that it was planned to grow more slowly than the average. Again, a few clear patterns emerge.

- **Health spending almost always receives above-average settlements** (i.e. the blue triangles are almost always above the zero line). The exceptions to this have been the most recent two Spending Reviews, where overall resource DEL was planned to grow by 4.1% and 3.8%, respectively, compared with 3.1% and 3.5% for the Department of Health and Social Care.[5] A similar story can be told for the education budget (shown by the red circles).
- **International development did much worse than average at the most recent Spending Review, but this is an exception to the rule.** At every Spending Review held between 1998 and 2015, the international development budget did better than average, and sometimes significantly so. But the 2020 Spending Review planned a 15% cut to the Foreign, Commonwealth and Development Office budget, far below the 3.8% increase planned overall.

[5] Note that the Spending Review 2020 figures exclude any COVID-19 funding. Note also that these figures refer to *planned* spending, and that health spending has historically tended to grow significantly faster than planned (Zaranko, 2021).

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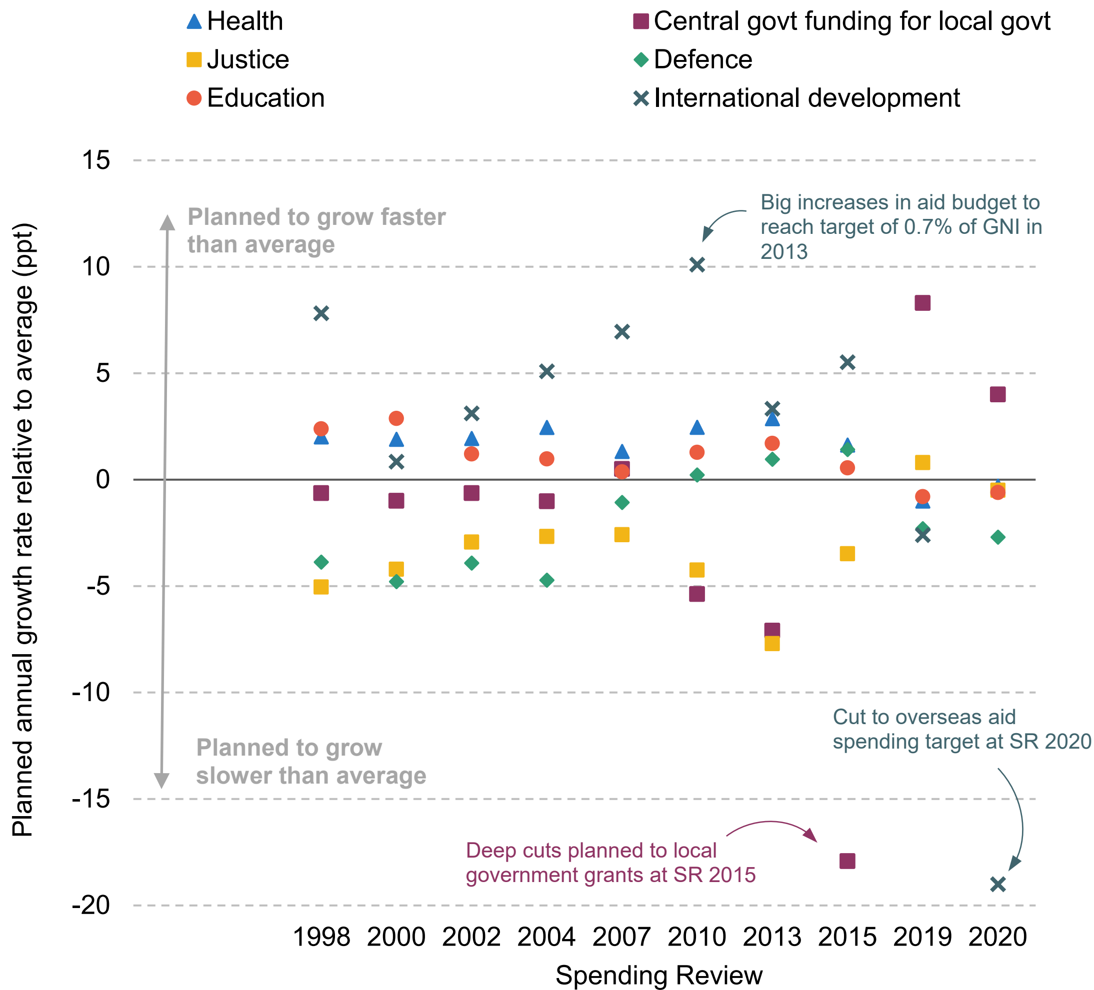
Figure 5.5. Planned growth in resource (day-to-day) funding in selected areas, relative to the average, by Spending Review



Note: Figures denote planned real-terms growth, not the out-turn. A figure of zero would indicate that spending in that area was planned to grow at the same rate as overall resource DEL. Real growth rates are taken from the SR documents if published, and calculated using nominal spending plans and contemporaneous GDP deflator forecasts if not. 'Education' refers to the Department for Education and Employment at SR 1998 and SR 2000, to the Department for Education and Skills at SR 2002 and SR 2004, to the Department for Children, Schools and Families at SR 2007, and to the Department for Education from SR 2010 onwards. 'Health' refers to the Department of Health from SR 1998 to SR 2015, and the Department of Health and Social Care from SR 2019 onwards. 'International development' refers to the Department for International Development from SR 1998 to SR 2019, and the Foreign, Commonwealth and Development Office at SR 2020.

Source: Author's calculations based on various Spending Reviews.

- **Some areas that have almost never been prioritised historically have done better at recent Spending Reviews.** At every Spending Review held between 1998 and 2015, the Ministry of Justice was awarded below-average budget increases, and thus languished in the bottom part of the chart. But at the two reviews since, the awards have been above or close to the average. Local government (or, to be specific, central government funding for local government) is another such area: at seven of the eight reviews held between 1998 and 2015,

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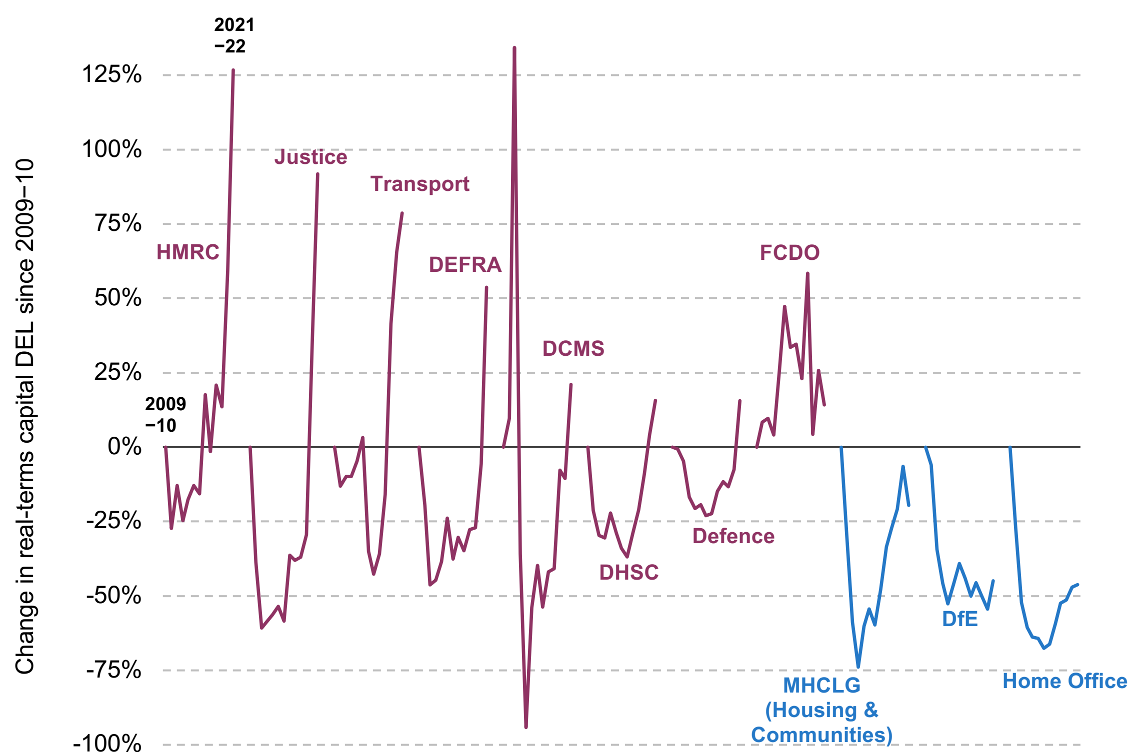
planned increases were below average (and in the case of the 2010, 2013 and 2015 Spending Reviews, substantially below average). Yet in recent years, recognition of the need for additional resources for social care has led to funding for local government growing at a faster-than-average rate (albeit after a decade of swingeing cuts). Local government funding is discussed in more detail in Chapter 7.

The analysis thus far in this section has been concerned with departments' resource (day-to-day) budgets. Figure 5.6 instead shows how major departments' core *capital* budgets evolved between 2009−10 and 2021−22. The percentage changes are greater than those for resource budgets, in part because capital spending is inherently 'lumpier' but also because capital budgets were cut faster and then subsequently increased faster over the 2010s (as shown in Figure 5.3). There are a few key takeaways.

Figure 5.6. Percentage change in departmental 'core' (non-virus) capital budgets, 2009−10 to 2021−22



Note: Figures for 2020−21 and 2021−22 are 'core' capital DEL spending plans from the March 2021 Budget and exclude COVID-19 funding. All figures are for resource departmental expenditure limits, excluding depreciation. HMRC = HM Revenue and Customs; DEFRA = Department for Environment, Food and Rural Affairs; DCMS = Department for Culture, Media and Sport; DHSC = Department of Health and Social Care; FCDO = Foreign, Commonwealth and Development Office; MHCLG = Ministry of Housing, Communities and Local Government; DfE = Department for Education.

Source: Author's calculations using HM Treasury Public Expenditure Statistical Analyses (2015−21 editions), HM Treasury Budget 2021 and HM Treasury June 2021 GDP deflators.

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- **All areas other than international development (FCDO) saw cuts to their capital budget after 2010.** In the case of the MoJ, Housing and Communities, the Department for Education (DfE) and the Home Office, these early cuts were in excess of 50%. The DCMS budget was increased during the 2012 London Olympics, and then cut almost to zero the following year.
- **Most departments saw growth in their capital budgets between 2016−17 and 2019−20, and all are set for budget increases between 2019−20 and 2021−22.** For most departments, this will be enough to take their core capital budgets in 2021−22 above their 2009−10 level. The exceptions are Housing and Communities, DfE and the Home Office.
- **Some departments are set for extremely rapid growth in their capital budgets this year (2020−21) and next (2021−22).** This is especially true for HMRC (for investments in the UK's post-Brexit customs system), Justice (for delivering 18,000 additional prison places), Transport (for, amongst other things, HS2) and DEFRA (for flood defences).

The spending response to the COVID-19 pandemic

The government's response to the coronavirus has involved spending huge sums of public money. The National Audit Office (NAO) estimates that the total lifetime cost of the government's COVID-19 response will come to £372 billion – equivalent to more than £5,500 for every person in the UK (NAO, 2021). This spending has provided essential support to businesses, public services and households in the government's role as insurer of last resort. As shown in Figure 5.1, this has led to an expansion in the size of the state to its largest level since the Second World War.

Figure 5.7 shows how this total breaks down into broad categories of support. Of the total, £150.8 billion (41%) is classified as support for business. Within that, by far the largest item is the Coronavirus Job Retention Scheme (CJRS, or the furlough scheme), with an estimated lifetime gross cost of £61.6 billion.[6] (While classed as support for business, this will clearly have benefited many millions of households. For more discussion of the furlough scheme, see Chapter 9.) The next-largest items of business support are: the Bounce Back Loan Scheme (estimated lifetime cost due to non-repayment of £22.8 billion); business rates holidays for selected sectors (£18.2 billion); grants to small businesses and hospitality and leisure businesses (£11.1 billion); and a reduced rate of VAT for hospitality, accommodation and attractions (£7.8 billion). A full breakdown can be downloaded from the NAO website (NAO, 2021).

[6] Note that this figure was the estimate of the lifetime cost at the time of the NAO's report. The latest statistics from HMRC indicate that a cumulative £68.5 billion has been claimed (HMRC, 2021).

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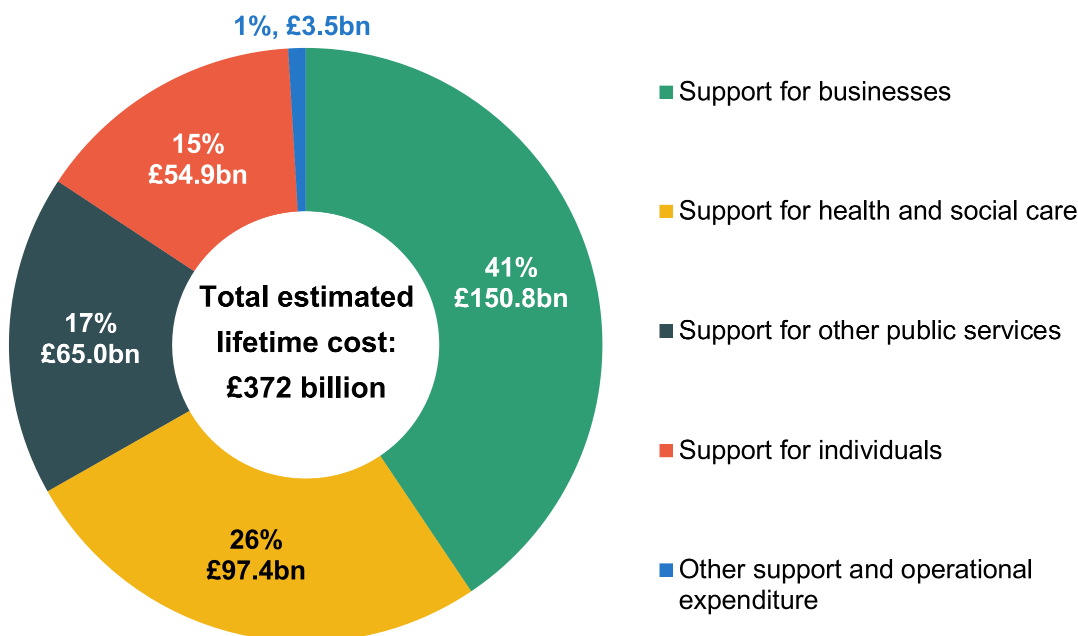
Figure 5.7. Estimated lifetime cost of COVID-19 response, by category, as of May 2021



Source: National Audit Office, COVID-19 cost tracker, accessed 12 August 2021.

A further £97.4 billion (26% of the total) has been provided as support for health and social care. The largest items within this total are spending on NHS Test and Trace (£38.1 billion) and procurement of personal protective equipment (£16.9 billion). A more detailed discussion of virus-related health spending, and the extent to which such spending might need to continue, can be found in Chapter 6. Within the NAO's estimate of the lifetime cost of support for other public services (£65.0 billion, or 17% of the total) is £25.9 billion of support for the devolved administrations and £12.9 billion of emergency measures for the railways. The estimated £54.9 billion (15%) of support for individuals contains £27.3 billion for the Self-Employment Income Support Scheme (SEISS), £6.9 billion for the temporary £20 per week uplift to universal credit, and £5.4 billion for the temporary cut to stamp duty.

Not all of this spending is relevant for the forthcoming Spending Review, however. Many of the largest spending items – such as the furlough scheme, SEISS and expected write-offs on virus-related loan schemes – are inherently unpredictable and demand-driven and so fall within AME, outside of the expected scope of this year's Spending Review. Here, we are interested in the funding provided to departments in the form of additional DEL.

Figure 5.8 therefore shows the amount of virus-related resource DEL provided to departments. This amounted to £140.6 billion in 2020−21 and £68.0 billion in 2021−22. However, it is unlikely that all of this funding will ultimately be spent, as discussed in Box 5.2.

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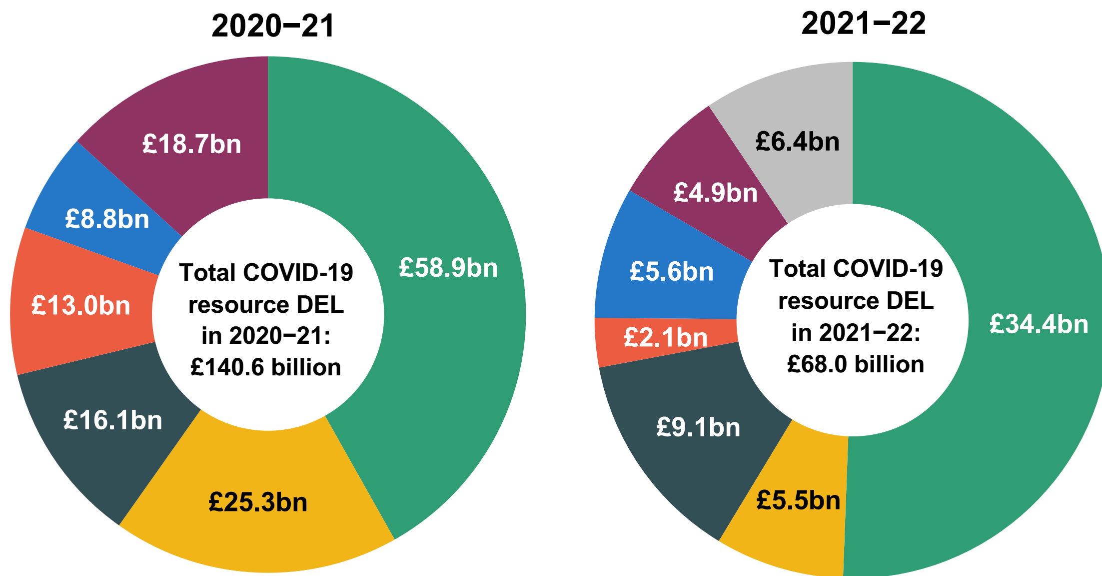
Figure 5.8. COVID-19 resource DEL allocated to departments in 2020−21 and 2021−22



Note: Figures are for departmental expenditure limits only, and so do not include items such as the Coronavirus Job Retention Scheme, which falls within annually managed expenditure. Figures may not sum due to rounding. £11.8 billion of the COVID-19 Reserve for 2021−22 was yet to be allocated as of March 2021. Of that, £5.4 billion was allocated to DHSC in early September, leaving £6.4 billion remaining; some (or all) of this amount may have been allocated in the interim.

Source: Author's calculations based on HM Treasury March 2021 Budget and Department of Health and Social Care, '£7 billion for NHS and social care for COVID-19 response and recovery', press release 18 March 2021, and 'Additional £5.4 billion for NHS COVID-19 response over next 6 months', press release 6 September 2021.

Box 5.2. Departmental underspending

Departmental expenditure limits are, by definition, set as limits. There are strong incentives for both officials and ministers to avoid breaching expenditure limits. The responsible minister must write to the Treasury setting out the size of the breach, why it occurred, and what remedial action is being taken in response (HM Treasury, 2021b). Ministers and officials can be hauled before the Public Accounts Committee to explain themselves, and additional spending may need to be approved by parliament. Plus, any overspend against the control total can also mean an offsetting reduction in the corresponding total in the following year. It is perhaps not surprising, then, that departments tend to underspend their limits, even during times of austerity (Crawford, Johnson and Zaranko, 2018).

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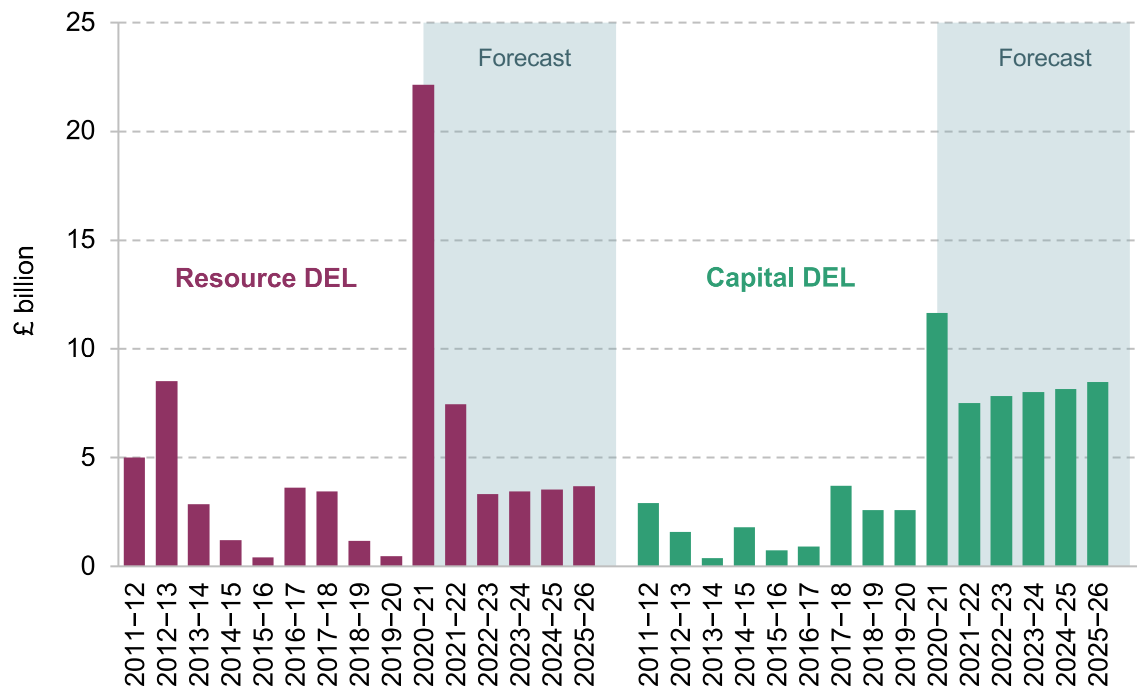
Figure 5.9. Departmental underspends against final plans, 2011−12 to 2025−26



Note: Figures denote the total underspend against plans published in Public Expenditure Statistical Analyses (PESA), net of any additional spending carried forward from earlier years via Budget Exchange. 2020−21 figures are provisional out-turns; figures for 2021−22 onwards are OBR forecasts.

Source: Office for Budget Responsibility, Economic and Fiscal Outlook March 2021, supplementary expenditure table 3.5.

Figure 5.9 shows departmental underspends against final plans since 2011−12, split by resource and capital. In the years prior to the pandemic, resource and capital underspends were broadly similar, despite the resource budget being more than five times larger. This illustrates departments' particular tendency to undershoot their capital budgets (Atkins, Tetlow and Pope, 2020).

Departmental underspending was particularly high in 2020−21: more than £22 billion in the case of RDEL and almost £12 billion in the case of CDEL. This reflects two factors: first, the huge additional sums allocated during the pandemic, not all of which departments ultimately needed to (or were able to) spend; and second, the fact that during the pandemic, many departments struggled to spend their allocation as successive lockdowns hit hiring and procurement plans, and the construction sector ground to a halt.

The Office for Budget Responsibility (OBR) forecast for underspends in future years is also shown in Figure 5.9. While RDEL underspends are forecast to fall to around £3.5 billion from 2022−23 (only slightly above the pre-pandemic average), capital underspends are forecast to remain high, at around £8 billion per year. This reflects the fact that the government has topped up capital budgets in recent years and is planning to ramp up departmental capital budgets quickly – something that history teaches us is

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hard to do (Crawford, Johnson and Zaranko, 2018; OBR, 2020). In the March 2020 Budget, the OBR assumed that 20% of the additions to planned capital spending would go unspent, implying that around 8% of total CDEL plans would go unspent in each year (in line with the experience of the 2000s). These underspends are incorporated into the OBR's forecasts for the public finances.

A few key points can be drawn from Figure 5.8:

- **The Department of Health and Social Care has received by far the greatest amount of COVID-related resource DEL** – more than 40% in 2020−21, and more than 50% in 2021−22. This illustrates the importance of future COVID-related health spending to the outlook both for overall RDEL and for other, smaller, departments. We return to this issue later in the chapter, but a more detailed discussion of the spending pressures on the NHS can be found in Chapter 6.
- **Local government is the second-largest recipient of COVID-related RDEL in 2021−22.** This funding has helped councils to meet the costs of new responsibilities (e.g. enforcement of public health measures) and the additional costs for existing services (most notably adult social care), and compensated them for lost income. These pressures will not vanish at the end of 2021−22. Local government funding is discussed in detail in Chapter 7.
- **The Treasury has more than £6 billion of unallocated funding in its 2021−22 COVID-19 Reserve.** The 2020 Spending Review provided £55 billion to support the response to the virus in this financial year. As of the March 2021 Budget, £36.2 billion had been allocated. A further £7 billion was allocated to the NHS and social care in late March, and a further £5.4 billion in September. Based on the latest available figures, then, there is approximately £6.4 billion available for the remainder of the financial year. No such reserve exists for future financial years, an issue to which we return in Section 5.6.

5.4 Spending pressures

Pressures on public services

The legacy of COVID-19

The previous section described the huge sums allocated to public services in the face of huge pandemic-related pressures. These pressures will not conveniently dissipate at the end of this financial year: COVID-19 is likely to have an effect on many public services for years to come.

Central among these pressures are those facing the health service, which are discussed in more detail in Chapter 6. These include the ongoing direct costs of the pandemic (such as the need to treat patients with COVID-19 and 'long COVID', personal protective equipment, and vaccines) and other indirect costs (such as increased demand for mental health services, and the need to

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catch up on care that was not provided during the pandemic). In Chapter 6, we estimate that meeting these various pressures could require an additional £9.1 billion in 2022−23, £6.2 billion in 2023−24 and £5.5 billion in 2024−25. These are similar in scale to recent estimates from the Office for Budget Responsibility, though with a different time profile (OBR, 2021).[7]

On 7 September, the government announced a new funding settlement for health and social care, funded by a corresponding increase in tax. This is discussed in detail in Chapter 6. Here, we simply note that while the money looks as if it will be 'enough' to meet pressures on the NHS in the near term, that is less likely to be the case in the medium term: by 2024−25, we estimate a potential shortfall of around £5 billion (an issue to which we return in Section 5.6). In any case, history teaches us that we ought to expect the NHS settlement to be revised upwards (Zaranko, 2021).

The OBR also produced estimates of the funding pressures on two other major spending areas:

- **Transport:** Sharp reductions in passenger numbers during the pandemic have posed severe financial difficulties for railways and public transport operators. The National Audit Office estimates that the lifetime cost of the Department for Transport COVID-19 response will come to £18.4 billion (NAO, 2021), and the department has been allocated £13.0 billion and £2.1 billion of resource DEL in 2020−21 and 2021−22, respectively (Figure 5.8). How much support is required going forward depends hugely on future patterns of working and commuting. The OBR assumes a 25% shortfall in rail passenger income in 2022−23, easing to 10% by 2024−25. This would require a further £3.0 billion of support in 2022−23, falling to £2.1 billion in 2023−24 and £1.2 billion in 2024−25 (OBR, 2021).
- **Education:** Successive lockdowns and other virus-related disruptions have meant that pupils have lost something like half a year's worth of schooling. In June 2021, Sir Kevan Collins, the government's 'Education Recovery Commissioner', resigned over the size of the proposed catch-up package. The government has suggested that more money could be announced at the Spending Review: the Prime Minister described the £3.1 billion in catch-up funding announced so far as being 'just for starters' (Johnson, 2021a). The OBR estimates that a catch-up package for schools could amount to £1.3 billion per year for each of the next three years, noting that these estimates are highly uncertain and sensitive to the specific type of intervention that is actually pursued.

The OBR's estimates of funding pressures on public transport and education, along with IFS estimates of NHS funding pressures, are shown in Figure 5.10. Combined, these amount to

[7] The OBR estimates that pandemic-related health funding pressures could require £7.6 billion of additional funding in 2022−23, £6.9 billion in 2023−24 and £6.7 billion in 2024−25. The estimated total required over the three years is therefore extremely similar (£20.8 billion under our estimates, versus £21.1 billion under the OBR's) but funding would need to be much more front-loaded under the IFS scenario.

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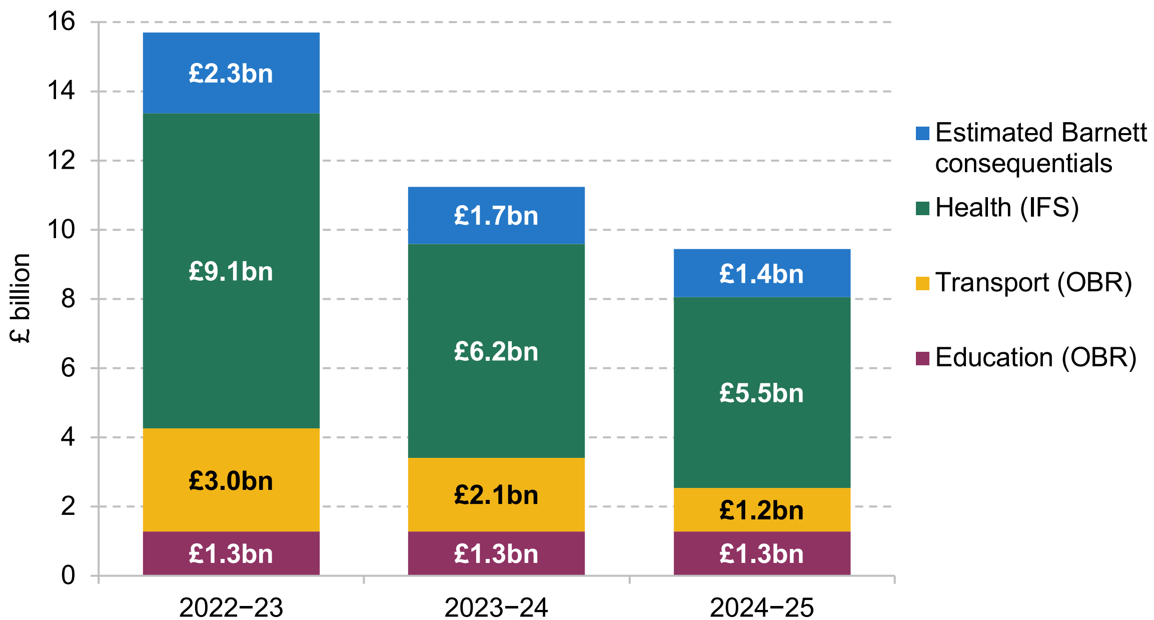
£13.4 billion in 2022–23, falling to £9.6 billion in 2023–24 and £8.0 billion in 2024–25. Once we also account for the Barnett consequentials of these (the corresponding increase in grant funding for Scotland, Wales and Northern Ireland via the Barnett formula), the cost rises to £15.7 billion in 2022–23, £11.2 billion in 2023–24 and £9.4 billion in 2024–25.

Figure 5.10. Estimates of selected pandemic-related spending pressures



Note: 'Health' denotes IFS estimates of the net cost to the health service of pandemic-related pressures. For a detailed discussion of these estimates and the assumptions underlying them, see Chapter 6. 'Transport' and 'Education' denote OBR estimates of pandemic-related pressures on those areas, details of which can be found in chapter 2 of the 2021 Fiscal Risks Report.

Source: Chapter 6 of IFS Green Budget 2021, HM Treasury Spending Review 2020 and OBR Fiscal Risks Report July 2021.

It should be emphasised that this is not an exhaustive list. It does not, for example, include any estimate of the pandemic's financial impact on councils (discussed in Chapter 7), or the courts system (where backlog of cases in the Crown Court in England and Wales grew to almost 60,000 in the first quarter of 2021, up 45% on a year earlier (Ministry of Justice, 2021a)). But we judge these areas to be the most likely large sources of funding pressure. In any case, as was discussed in Section 5.2, there is a strong case for continued use of a 'COVID-19 Reserve' so that funds can be allocated flexibly as needed, rather than earmarking all virus-related funding for specific public services in advance.

Pre-existing funding pressures

The funding pressures on public services are not just a story of the pandemic. Many areas were showing signs of strain even before COVID, particularly those that faced deep budget cuts in the

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years after 2010 (Institute for Government, 2019). An obvious example is the prison service. Between March 2011 and March 2020, the number of prisoner-on-prisoner assaults in England and Wales almost doubled, and the number of assaults on prison staff more than trebled (though the number of both types of incident fell back during the pandemic) (Ministry of Justice, 2021b).

Other services will be placed under increasing pressure by demographic changes – at both ends of the age spectrum. While an ageing population is set to increase demand for social care services (discussed in Chapter 7), further education colleges are braced for an expected 17% rise in the number of 16- and 17-year-olds between 2019 and 2024 (Sibieta and Tahir, 2021).

Other departments have acquired substantial new post-Brexit responsibilities. Figure 5.4 showed that funding for DEFRA, HMRC and the Home Office has sharply increased in recent years as these departments took on additional responsibilities relating to agricultural subsidies, customs and immigration.

Public sector pay

In 2020−21, the government spent £222 billion employing around 5.4 million public sector workers (HM Treasury, 2021a). What happens to the pay of those workers is an important determinant of the path for day-to-day spending.

The decade prior to the pandemic saw a prolonged squeeze on public sector pay. Public sector pay was frozen in cash terms for all but the lowest-earning employees in 2011−12 and 2012−13; pay scales were then increased by 1% per year in cash terms in the years that followed, before the pay cap was lifted in 2017. Despite above-inflation pay awards in recent years, average earnings in the public sector in the first quarter of 2020 were 1.5% lower than a decade previously, while average earnings in the private sector were 1.9% higher.[8] This ongoing pay restraint in the public sector meant that on the eve of the pandemic, the gap between average public and private sector pay was at its lowest level in decades (Zaranko, 2020). Or, put another way, public sector pay was at its lowest level *relative to private sector pay* since at least the early 1990s.

During the early stage of the pandemic, however, public sector pay outperformed private sector pay – just as was the case during and immediately after the Great Recession. Figure 5.11 shows that in April−June 2020, average total earnings in the public sector were 4.1% higher (in cash terms) than a year earlier, while they were 2.6% *lower* in the private sector. This reflects the fact that private sector workers could (unlike public sector workers) have been placed on furlough

[8] Source: Author's calculations using ONS series KAD8 (public sector excluding financial services average weekly earnings), KAC4 (private sector average weekly earnings) and L522 (CPIH index).

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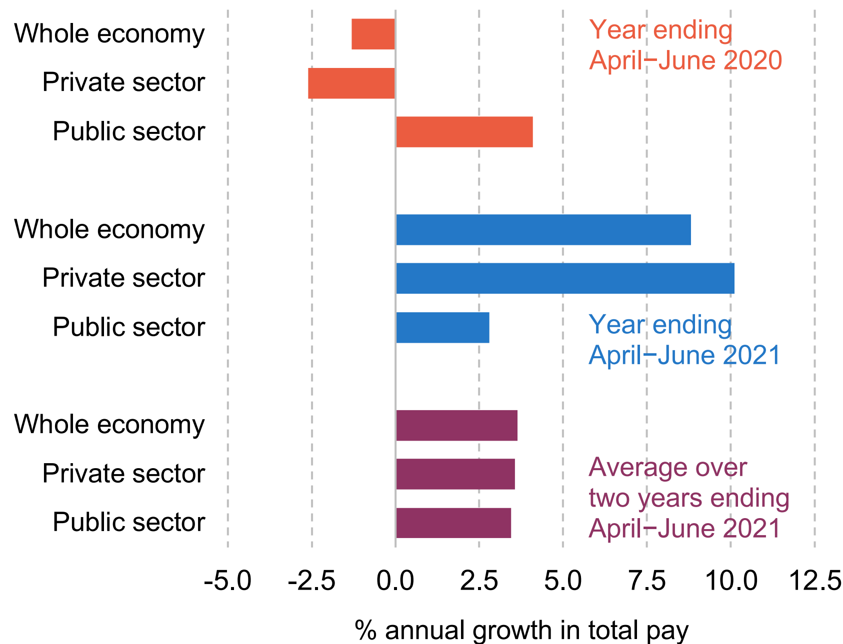
Figure 5.11. Annual growth in average total weekly earnings by sector



Note: Figures denote the growth in total pay in the period in question. Great Britain only.

Source: Author's calculations using Office for National Statistics, 'Average weekly earnings in Great Britain: August 2021', https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/bulletins/averageweeklyearningsingreatbritain/august2021.

(which could be associated with a 20% cut in weekly earnings) during the pandemic and associated lockdowns, and is despite the fact that job losses in the private sector were concentrated among the lower-paid. It was in this context that the Chancellor announced a pay freeze for most public sector workers at the 2020 Spending Review.

Private sector earnings have since bounced back. In April−June 2021, average private sector earnings were 10.1% higher than a year previously, compared with 2.8% in the public sector.[9] This means that over the two years ending April−June 2021, average public and private sector earnings will have grown at roughly the same rate (shown by the lowest two bars in Figure 5.11).

Despite two years of pay growth, many public sector workers are still earning substantially less than their equivalents in the past – particularly more experienced and higher-earning public sector staff. Pay levels for experienced teachers were 8% lower in real terms in 2021 than in

[9] The high figure for average private sector pay growth is due in part to a base effect (the latest months are compared with low base periods when earnings were initially hit by COVID-19) and a composition effect (job losses have been concentrated among low earners, thereby increasing average earnings of those in work), plus the fact that many workers will be coming off furlough (and receive a 25% pay rise at that point).

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2007, compared with 4−5% for less experienced teachers (Cribb and Sibieta, 2021). NHS hospital consultants experienced an average 8.7% real-terms pay cut between March 2011 and March 2021, compared with 4.1% for junior doctors and 4.8% for nurses, midwives and health visitors (see Chapter 6). Average real-terms pay for NHS dental associates and NHS dental practice owners in England fell by an astonishing 32% between 2006−07 and 2017−18, and these are estimated to have continued to fall since.[10] The average salary for a senior civil servant fell by 10.9% in real terms between 2010 and 2020.[11]

There was some logic to the public sector pay freeze for 2021. But it cannot continue indefinitely. If pay awards in the public sector fail to keep pace with those in the private sector in the years ahead, after failing to do so in the decade prior to the pandemic, the government risks failing to attract and retain the skilled workers needed to deliver high-quality public services. The School Teachers' Pay Review Body, for example, is 'firmly of the view that a pay pause for teachers of more than one year risks a severe negative impact on the competitive position of the teaching profession, jeopardising efforts to attract and retain the high-quality graduates necessary to deliver improved pupil outcomes' (STRB, 2021). Three-quarters (76%) of police officers surveyed in 2020 said that they were unfairly paid for the risks and responsibilities of their job during COVID-19 and just 10% thought that the pay was fair compared with employees doing similar work in other organisations (PRRB, 2021). The public sector has not struggled with recruitment during the pandemic-induced recession, while private sector jobs have been hard to come by and workers are attracted by the security and stability of employment in the public sector. But as the economy and labour market bounce back, questions around public sector pay are certain to come to the fore.

The Chancellor will not make direct pay awards at the Spending Review – those will come next year, following the usual process of consultation with the Pay Review Bodies – but he could provide an indication of the government's overall pay policy and, in particular, whether the public sector pay freeze will come to an end next year. Departments' day-to-day budgets will also need to be set with future pay awards in mind.

Social security

At the 2010 and 2015 Spending Reviews, then-Chancellor George Osborne included large parts of the working-age social security budget within the scope of the Spending Review. Mr Sunak is

[10] A series break means that it is not possible to compare average dentist earnings across the full period. Source: Author's calculations using NHS Digital Dental Earnings and Expenses Estimates and ONS series L522 (CPIH index).

[11] Source: Author's calculations using figure 3.8 of Senior Salaries Review Body Report 2021 (SSRB, 2021) and ONS series L522 (CPIH index).

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not expected to take a similar approach this autumn. But the outlook for social security spending still has important implications for the Spending Review.

The Chancellor has stated his intention to achieve current budget balance by the middle of the decade: to have all day-to-day expenditure covered out of tax revenues, so that the government is borrowing only to invest. Day-to-day expenditure includes social security. So, any decision that increased the social security bill would, all else being equal, mean less funding available for public services if the Chancellor wishes to target the same level of current budget deficit.

A detailed analysis of the issues around social security spending is beyond the scope of this chapter, but there are two important issues to note.

The first is that the Secretary of State for Work and Pensions confirmed on 7 September that the ‘triple lock’ on the state pension is to be suspended this year: instead, the state pension will be uprated by the higher of inflation or 2.5% (Coffey, 2021).

The second is the reversal of the temporary uplift in entitlements to universal credit (UC) and working tax credit (WTC) of £20 per week. This will already have taken place by the time of the Budget and Spending Review, meaning a £1,040-per-year drop in the income of around 5 million lower-income families receiving UC, as monthly awards drop by around £86 between September and October.

The fact that decisions on these areas have already been made means that we perhaps should not expect any major social-security-related announcements in the autumn fiscal event. But if the Chancellor did decide to do something in this sphere – to help low-income families in the face of rising gas bills, for instance – then this would have implications for his overall spending plans.

Promises, promises

Even without any major policy changes, there would be substantial upwards pressure on public spending. But the government also has an ambitious set of broader policy goals. Delivering on them could require additional spending running into the tens of billions. Here, we ignore the government’s recent announcements on reform of the social care funding system (discussed in Chapter 7), and focus on two other big policy areas: levelling up and the transition to net zero.

Levelling up

The UK is one of the most geographically unequal countries in the developed world. The current government has made tackling those deep-seated inequalities a central part of its domestic policy agenda. In last year’s IFS Green Budget, we showed that the levelling-up agenda is complicated by the fact that the areas hit hardest by the immediate economic impacts of the pandemic – such

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as London – are not, in general, those that were most economically disadvantaged pre-pandemic (Davenport and Zaranko, 2020).

A year on, and the details and objectives of the levelling-up agenda remain nebulous and ill-defined. Much of the focus so far has been on capital spending projects: investments in green technology or public transport, for instance. Currently, public spending on transport and on research and development (R&D) is heavily concentrated in London and the South East (Davenport and Zaranko, 2020). Increasing spending on these in other parts of the country could help with levelling up. But the Prime Minister has also stated that levelling up will not be to the detriment of London and the South East (Johnson, 2021b). This suggests, then, that any additional spending on investment in the regions is likely to come from an increase in overall transport or R&D spending, rather than cuts to the amount spent in London and the South East. Given that capital budgets are planned to rise over the coming years, and more than half is yet to be allocated (as discussed in Section 5.5), this is unlikely to pose too many problems for the Chancellor.

Levelling up cannot just be about capital spending, though. In many cases, day-to-day (current) spending could be as, if not more, effective. That is particularly true of funding for local government and further education.

Local governments will play an important role in levelling up. Council funding was cut substantially over the 2010s, with the largest cuts falling on more deprived areas (Harris, Hodge and Phillips, 2019). In the face of ever-growing pressures on adult and children's social care budgets, councils were forced to squeeze everything else – including the spending programmes that one might expect to be most helpful in promoting local economic growth.[12] The outlook for local government funding is discussed in Chapter 7. Here, we simply note that further cuts to local government funding would be difficult to reconcile with a coherent levelling-up agenda.

The Prime Minister has talked about the importance of practical and vocational education to levelling up (Johnson, 2021b). Yet funding per student aged 16–18 fell by over 11% in real terms between 2010–11 and 2020–21 in further education and sixth-form colleges, and by over 25% in school sixth forms (Sibieta and Tahir, 2021). The government allocated an extra £400 million to colleges and sixth forms in the 2020–21 financial year, but with 5% growth in student numbers in 2020, this, at best, restores funding back to 2018–19 levels, leaving most of the cuts over the last decade in place. An extra £570 million will be required by 2022–23 just to maintain spending per student in real terms from 2020–21 onwards (Sibieta and Tahir, 2021). A

[12] Between 2009−10 and 2019−20, councils in England reduced spending on planning and development services by 59% in per-person terms (Harris, Hodge and Phillips, 2019). This includes, among other items, spending on economic development, community development, economic research and business support.

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government serious about boosting further education in order to level up might wish to spend even more.

Net zero

The government has a legislated goal to reduce net greenhouse gas emissions to zero by 2050. The fiscal costs of achieving this goal could be significant (though the costs of inaction would likely be greater still). The OBR provided detailed analysis of the fiscal risks presented by climate change in the July 2021 Fiscal Risks Report (OBR, 2021). In its reference scenario (based in turn on the Bank of England's 'early action' scenario), the fiscal impact of achieving net zero, without offsetting spending cuts or tax rises, adds 21% of national income to public sector net debt in 2050–51 (equivalent to £469 billion in today's terms). Direct government spending on the net zero transition is just one component of this.[13] The potential impact of the transition to net zero on the public finances is discussed in more detail in Chapter 3.

The Climate Change Committee estimates that net zero investment, plus the operating costs of emissions removals, will have a cumulative whole-economy cost of around £1.4 trillion between 2020 and 2050. How much of that will be borne by the public sector is unknown: the government has not set out its position or expectations. The OBR therefore makes a set of assumptions about the share of the costs borne by the government over the next 30 years in each sector.

In the OBR's central scenario, the state bears around a quarter (27%) of the £1,408 billion cost over the three decades. When combined with the state's share of the savings from more energy-efficient buildings and vehicles, the net cost to the public sector is £344 billion, equivalent to an average of around £11 billion per year (both in 2019 prices). Figure 5.12 shows that these costs are expected to rise steadily between now and 2030, before levelling off and falling after 2035.

The OBR also produces a 'low public spending variant', intended to represent a lower bound in which the government deals only with its own assets (and bears far less of the cost of insulating the homes of low-income households, for instance). In this case, the government would bear 13% of the overall net costs (£152 billion over the full period, or around £5 billion per year, in 2019 prices). In addition, the OBR produces a 'high public spending variant' in which the state takes on almost all infrastructure costs in the vehicles, residential buildings, industry and removals sectors. That would mean the state bearing 41% of all net costs (£557 billion in total, or around £18 billion per year, in 2019 prices).

[13] The overall net fiscal impact also includes: lost tax receipts from (among other things) the shift to electric vehicles, which pay no fuel duty or vehicle excise duty; higher receipts from carbon taxes; the indirect fiscal consequences of lower GDP, which results from a higher and steadily rising carbon price; and additional debt interest costs. Taxes and climate change are discussed in Chapter 8.

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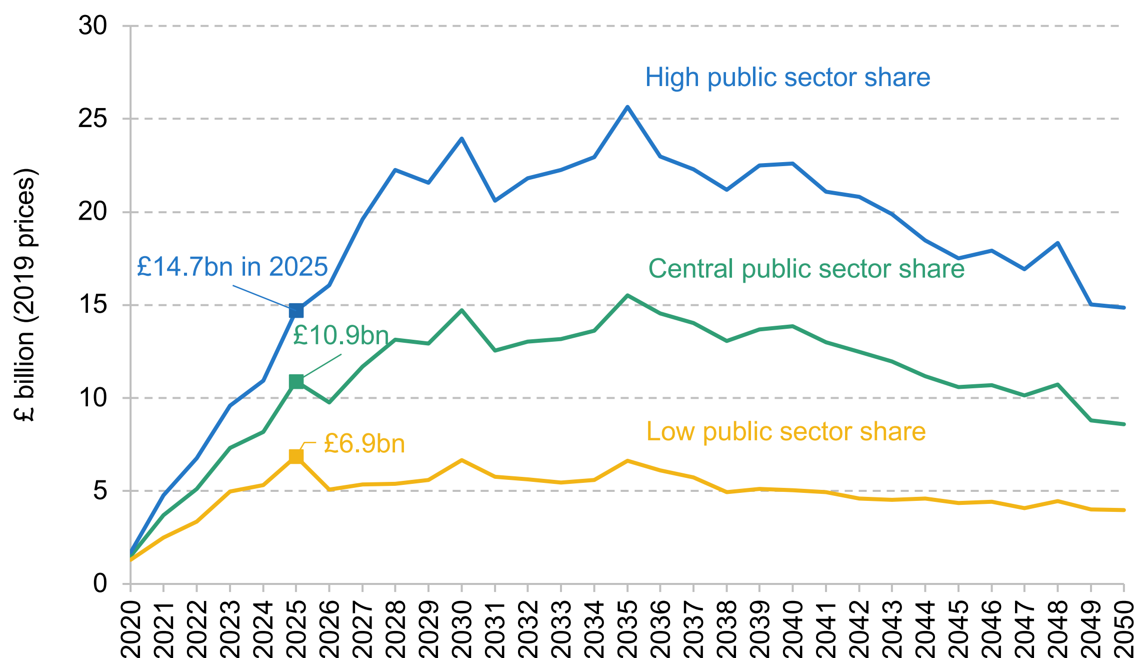
Figure 5.12. OBR estimates of costs to the public sector of the transition to net zero



Source: Office for Budget Responsibility, Fiscal Risks Report July 2021.

The headline is that the transition to net zero is expected to come at a substantial, but affordable, cost to the public sector. Under the OBR's central scenario, net zero spending of around £8 billion per year could be required over the forthcoming Spending Review period (rising to around £11 billion by 2025). The equivalent figures for the 'low public spending' and 'high public spending' variants are around £5 billion and £10 billion per year, respectively. It is essential to note that the costs of meeting the net zero target are not actually projected to be a long-run issue. Much of the spending is projected to happen soon – during the period to be covered by this Spending Review. That is especially true in the 'low public sector share' scenario in Figure 5.12. This autumn, if the government is serious about its ambitious net zero commitment, Mr Sunak will need to tackle these issues head on.

5.5 Existing plans and commitments

Existing commitments

Some areas already have multi-year spending settlements that cover part or all of the three-year period expected to be covered by this year's Spending Review (2022−23 to 2024−25). These include recent announcements on health and social funding, but also previously agreed settlements with schools in England and the Ministry of Defence. These are summarised in Table 5.2.

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Table 5.2. Confirmed spending settlements ahead of the Spending Review (£ billion)

				Spending Review 2021 period		
	2019−20	2020−21	2021−22	2022−23	2023−24	2024−25
DHSC RDEL	133.4	140.3	147.0	164.8	171.4	175.9
Schools RDEL	44.4	47.6	49.8	52.2	-	-
Defence RDEL	29.5	30.8	31.6	31.6	31.4	31.6
Defence CDEL	10.3	11.7	14.4	15.6	16.0	16.0

Note: Figures up to 2021−22 are for 'core' funding, excluding COVID-19 spending, in nominal (cash) terms. 'DHSC' refers to the Department of Health and Social Care; 'Schools' refers to schools in England; and 'Defence' refers to the Ministry of Defence. RDEL refers to resource departmental expenditure limits, excluding depreciation; CDEL refers to capital departmental expenditure limits.

Source: HM Treasury Spending Review 2020, Budget 2021, and 'Chancellor launches vision for future public spending' (7 September 2021).

As can be seen in Table 5.2, the schools settlement runs only to 2022−23, whereas we expect the Spending Review to cover the period up to 2024−25. Therefore, for the purposes of the modelling that follows, we make assumptions over what happens to schools spending in the later years of the forecast period. Specifically, we assume that the schools budget is held flat in real terms after 2022−23. Pupil numbers are set to fall by 1.2% between 2022 and 2025 (Department for Education, 2021) and so this would equate to increases in real per-pupil spending. We judge this to be more realistic than flat real per-pupil spending, given the government's commitment to increasing teacher starting salaries to £30,000 by September 2023 (Cribb and Sibieta, 2021).

The government is also committed in the near term to spending 0.5% of gross national income (GNI) on official development assistance (ODA, or overseas aid), down from the previous objective to spend 0.7%, which was met each year between 2013 and 2020. This commitment means that, following the initial one-off cut, aid spending will need to grow at least as fast as the wider economy over the coming years in order to maintain its share of national income. On top of that, the government has pledged to increase ODA spending back to 0.7% of GNI 'once the fiscal situation allows'. In July 2021, Chancellor Rishi Sunak provided more detail, stating that the 0.7% target would be reinstated when the government is no longer borrowing to fund day-to-day spending (i.e. running a current budget deficit) and when underlying debt (excluding the Bank of England) is falling 'on a sustainable basis' (Sunak, 2021). In our central modelling, we assume that ODA remains at 0.5% of GNI for the entirety of our period of interest (taking growth forecasts from Citi's central scenario in Chapter 2), and additionally assume that 80% of ODA falls within the resource budget (in line with the resource/capital split of the Department for International Development budget in 2019−20). In Section 5.6, we also consider a scenario in which ODA returns to 0.7% of GNI in 2024−25.

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Box 5.3. Official development assistance and IMF Special Drawing Rights

Special Drawing Rights (SDRs) are an international reserve asset created by the International Monetary Fund (IMF), and can be exchanged for the currency of IMF member states. The IMF has announced a 2021 special allocation of SDRs, which is intended to 'boost global liquidity … address the long-term global need for reserves, build confidence, and foster the resilience and stability of the global economy' and to provide particular support to lower-income countries (IMF, 2021).

Along with other high-income countries, the UK is expected to reallocate (at least some of) its SDRs to help support the response to and recovery from COVID-19 in developing countries, most likely via the IMF's Poverty Reduction and Growth Trust (PRGT), a vehicle for concessional finance for low-income countries. Under international rules governing what counts as foreign aid, part of any reallocation via the PRGT – which could run into the billions over the three-year review period – could count towards the 0.5% ODA target.

That would mean, all else being equal, higher spending on ODA. In theory, then, if the government were determined to meet its 0.5% target exactly (and not to exceed it), it may spend less on other aid programmes than it otherwise would have done in the absence of the SDR reallocation (Worley and Saldinger, 2021). That could mean additional cuts to departmental aid budgets, on top of those already made as a result of the contraction in UK national income and as part of the move from a 0.7% to a 0.5% of GNI target between 2020 and 2021. This would cause further disruption to affected programmes and spending areas (Hughes et al., 2021).

Whether this possibility will bear out in reality is currently unclear. For instance, the economic outlook has improved in recent months (see Chapter 2), and the level of UK national income is expected to be higher – meaning that a higher level of cash spending is needed to achieve a given percentage of GNI. If the government were on track to undershoot its 0.5% target this year as a result, a reallocation of SDRs could be one means of making up this possible shortfall, without increasing departmental spending allocations.

Given the uncertainty around how any reallocation of SDRs might affect other ODA spending, we assume for the remainder of this chapter that any ODA resulting from a reallocation of SDRs is in addition to any ODA spending currently planned.

Table 5.3 provides a summary of the government's estimated resource commitments over the Spending Review period, based on the assumptions outlined above. More than £250 billion of resource funding has already been committed in each year – a little more than 60% of total planned resource DEL.

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Table 5.3. Estimates of the government's resource spending commitments

	Plans	Spending Review 2021 period		
	2021−22	2022−23	2023−24	2024−25
£ nominal billion				
DHSC RDEL	147.0	164.8	171.4	175.9
Schools RDEL	49.8	52.2	53.3	54.4
Defence RDEL	31.6	31.6	31.4	31.6
ODA RDEL (estimated)	9.1	9.5	9.8	10.2
Total protected RDEL	237.5	258.1	265.9	272.1
£ real billion (2021−22 prices)				
DHSC RDEL	147.0	165.0	168.2	169.1
Schools RDEL	49.8	52.3	52.3	52.3
Defence RDEL	31.6	31.6	30.8	30.4
ODA RDEL (estimated)	9.1	9.5	9.6	9.8
Total protected RDEL	237.5	258.5	261.0	261.6

Note: Figures for 2021−22 are for 'core' funding, excluding COVID-19 spending. 'DHSC' refers to the Department of Health and Social Care; 'Schools' refers to schools in England; and 'Defence' refers to the Ministry of Defence. Schools figures for 2023−24 and 2024−25, and ODA figures for all years, are calculated based on assumptions outlined in the text.

Source: Author's calculations using HM Treasury Spending Review 2020, Budget 2021, Public Expenditure Statistical Analyses 2020, June 2021 GDP deflators, and 'Chancellor launches vision for future public spending' (7 September 2021); Foreign, Commonwealth and Development Office, Statistics on International Development: Provisional UK Aid Spend 2020; and Office for Budget Responsibility, Economic and Fiscal Outlook, March 2021.

These figures actually understate the 'true' amount that has been committed, however, because all else being equal, higher spending on the health service and schools in England translates into more funding for the devolved governments in Scotland, Wales and Northern Ireland via the Barnett formula. Combined, the DHSC and schools settlements imply around £3.8 billion of additional funding for the three devolved governments in 2022−23, with a further £1.4 billion in 2023−24 and a further £1.1 billion in 2024−25. But the total effect on the Scottish, Welsh and Northern Irish block grants depends on what happens to funding for other devolved areas. If, for example, the entire increase in English DHSC and schools spending were offset by a cut to spending on English local government or justice, the two would cancel out and there would be no 'net' Barnett consequential. Were higher DHSC and schools spending accompanied by only modest cuts to 'unprotected' areas in England, part of that cut would be passed on to the devolved nations in the form of a negative Barnett consequential, offsetting only part of the

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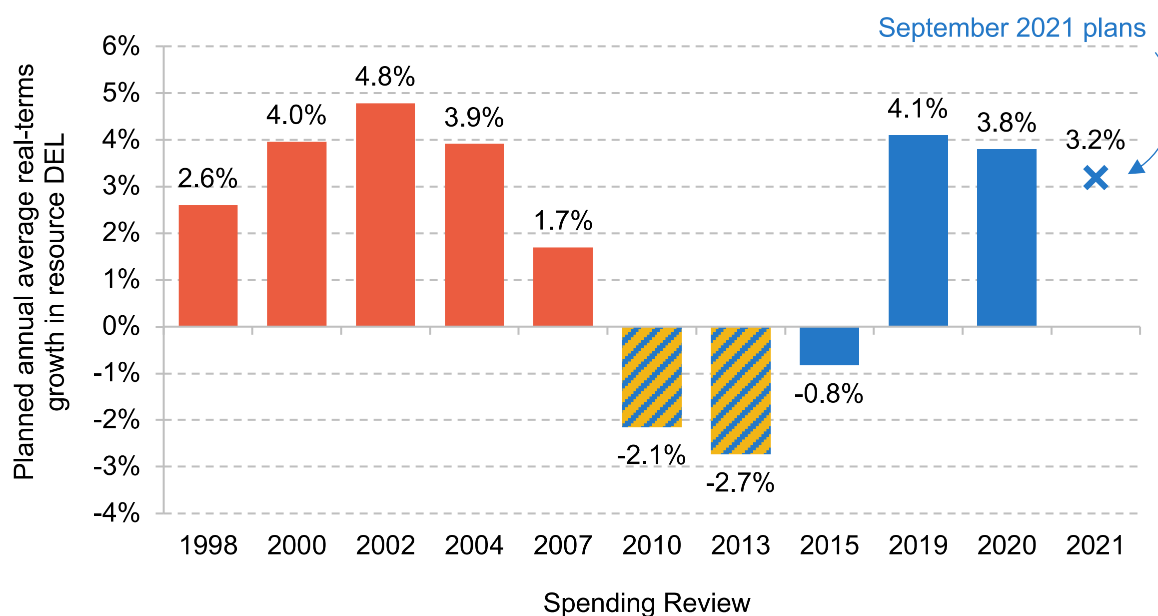
increase from higher DHSC and schools spending. The modelling in Section 5.6 takes this into account.

Existing plans for overall resource (day-to-day) spending

These existing commitments – most of which fall within the resource, rather than capital, budget – will have to be met from within the overall spending envelope: the total pot of money to be divvied up between departments at the Spending Review. On 7 September, the Chancellor published the Spending Review 2021 envelope (HM Treasury, 2021c). Under these plans, departmental resource (day-to-day) budgets will grow at an average real-terms rate of 3.2% between 2021−22 and 2024−25 (up from 2.1% under the plans published at the March 2021 Budget).[14]

Figure 5.13. Planned real-terms average annual growth in resource budgets, by Spending Review



Note: Figures denote the *planned* average annual growth rate in day-to-day spending on public services (resource departmental expenditure limits excluding depreciation). The Spending Review 2020 figure is the average real-terms growth rate between 2019−20 and 2021−22 due to the atypical movement of the GDP deflator during the pandemic. The Spending Review 2021 figure is the average real-terms growth rate between 2021−22 and 2024−25.

Source: Author's calculations using HM Treasury Spending Review documents (various), HM Treasury GDP deflators (various), HM Treasury Budget 2021, HM Treasury 'Chancellor launches vision for future public spending' (7 September 2021) and OBR March 2021 Economic and Fiscal Outlook.

[14] Note that the 3.2% average real-terms growth rate is calculated relative to the 2021−22 figure for 'core' resource DEL, which excludes COVID-related spending.

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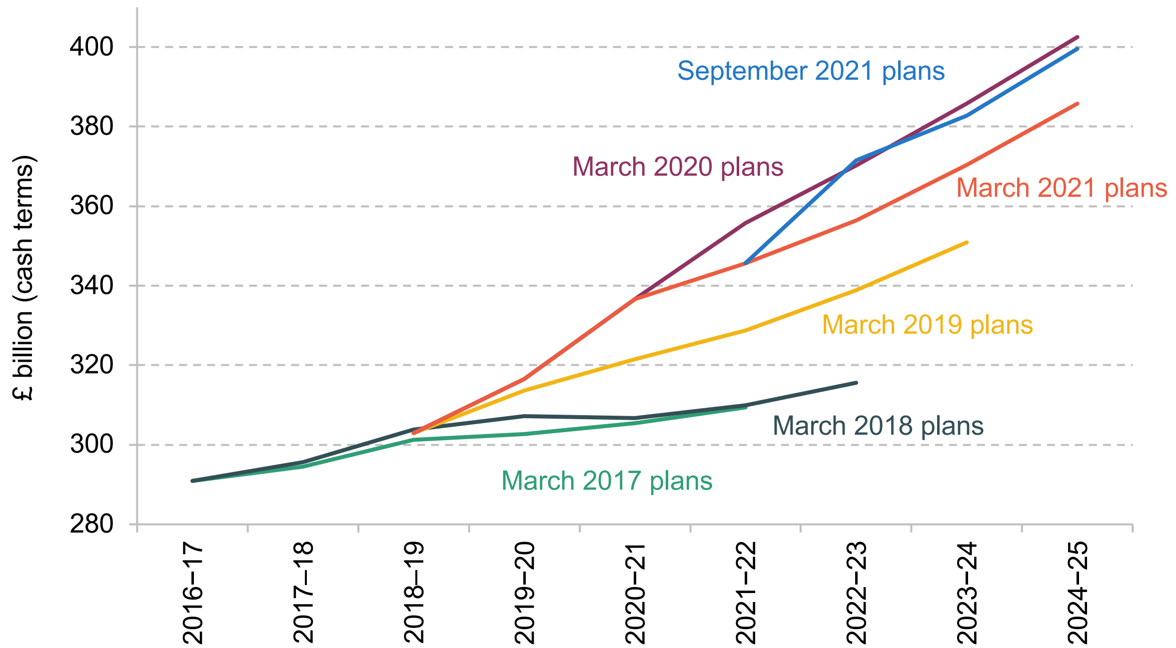
Figure 5.14. Successive plans for departmental resource budgets



Note: All figures are for the OBR definition of PSCE in RDEL, adjusted for historical discontinuities. We have additionally adjusted for statistical and classification changes at each fiscal event, such that all figures are presented on a consistent March 2020 basis. This is a different measure of spending from that used by HM Treasury as its control total and these figures are not, therefore, directly comparable to the figures published in March or September 2021, or to the figures used elsewhere in this section; they are merely intended to illustrate how plans have changed over time. March 2021 figures are for 'core' budgets and exclude additional public service spending provided in response to the COVID-19 pandemic.

Source: Author's calculations using OBR Economic and Fiscal Outlook (various), HM Treasury Spending Review 2020, HM Treasury Budget 2021 and HM Treasury 'Chancellor launches vision for future public spending' (7 September 2021).

Figure 5.13 compares this with planned spending growth at previous Spending Reviews. It shows that 3.2% annual real growth would be slower than that seen at the two most recent (one-year) Spending Reviews, when resource budgets were planned to increase by around 4% above inflation, but would represent a more generous settlement than was seen at the four Reviews prior to those (2007, 2010, 2013 and 2015). It also shows that this is far from a return to the deep cuts of the 2010s.

The latest spending envelope topped up previous (March 2021) plans by £12–15 billion per year. This is just about enough to return to the spending trajectory pencilled in pre-pandemic, reversing most, but not quite all, of the £14–17 billion annual cuts from plans between March 2020 and March 2021 (Figure 5.14).[15]

[15] Note, however, that this top-up includes approximately £1.7 billion per year to compensate public sector employers for the costs of the increase in employer National Insurance contributions (and subsequently the health and social care levy). The modelling of 'unprotected' spending in Section 5.6 will take this into account.

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This point is worth dwelling on for a moment. Despite the substantial pressures placed on public services by the pandemic (some of which were discussed in Section 5.4), the Chancellor is planning to spend no more overall than he was prior to COVID-19 – and in the case of the final year of the period (2024−25), around £3 billion less.

The spending announcements made on 7 September included funding to meet the pressures on the NHS over the next couple of years (the adequacy, or otherwise, of this funding is assessed in Chapter 6). But no explicit allowance has been made for virus-related spending in other areas, such as education or public transport. The Chancellor has indicated that some additional virus-related funding might be considered, but only in the 'immediate term' and only in 'exceptional circumstances' (HM Treasury, 2021c). Any persistent pandemic-related pressures will likely need to be met from within departments' budgets – which will, in many cases, be considerably lower than might have been expected pre-COVID. Section 5.6 explores what this might mean for 'unprotected' areas not covered by a pre-existing commitment.

Existing plans for capital (investment) spending

The government has also pencilled in a set of capital spending plans, under which capital DEL is set to grow at an average annual real-terms rate of 2.8% after 2021−22. This will follow rapid growth in 2020−21 and 2021−22, though, such that over the course of the parliament (2019−20 to 2024−25), capital DEL is set to grow at an average real-terms rate of 8.1% per year.

There is also a set of pre-existing commitments on capital spend. Among these is the multi-year set of capital budgets agreed with the Ministry of Defence at the 2020 Spending Review (which run up to 2025−26). The government has also committed to a number of transport spending programmes, including £22.6 billion for high-speed rail between 2021−22 and 2024−25, plus £17.5 billion and £18.0 billion for Network Rail and the Road Investment Strategy, respectively, over the same period. There also exist smaller commitments covering climate-change-related projects (e.g. investment in carbon capture and storage), R&D funding, hospitals, prisons, the further education (FE) college estate, and housing. These various commitments, along with the government's provisional plans for overall capital DEL, are shown in Figure 5.15.

These commitments, while sizeable, amount to less than half of overall capital DEL in each year (and only around a third of the total in 2024−25). There is still some £60 billion of capital funding to allocate in each year. The Chancellor therefore has substantially more room for manoeuvre with regard to departments' capital budgets than he does for resource budgets. For that reason, the remainder of the analysis in this chapter will focus on resource DEL, where the trade-offs are more acute.

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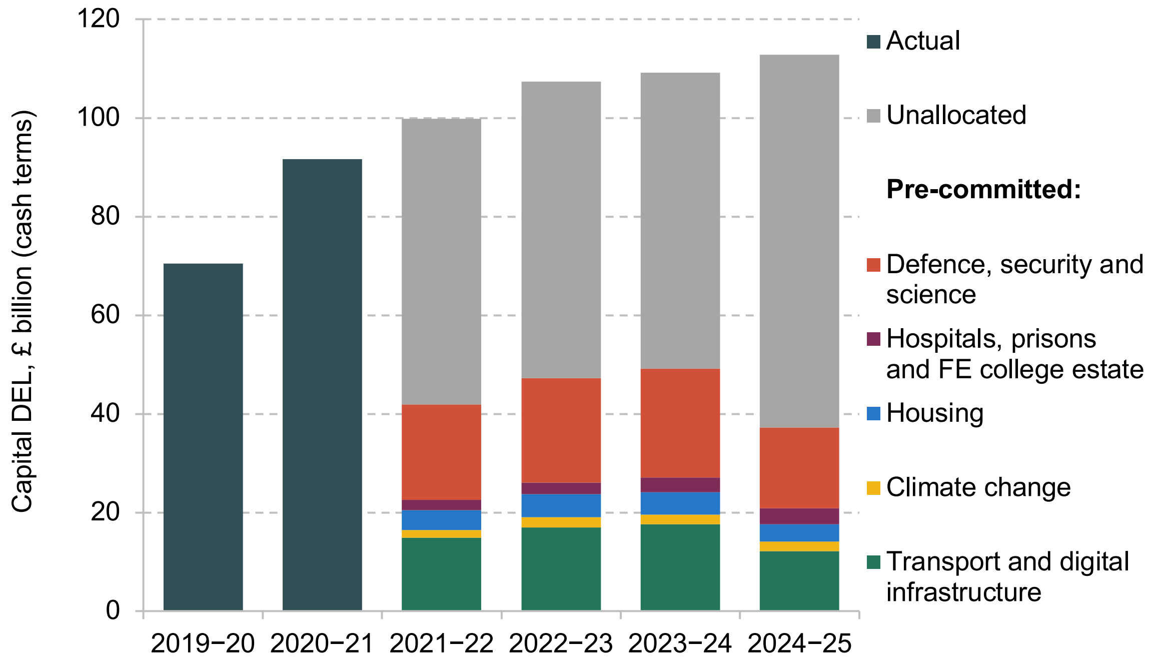
Figure 5.15. Planned departmental ‘core’ capital spending



Note: Figures exclude COVID-19 funding. ‘Defence, security and science’ includes the Ministry of Defence capital settlement and R&D funding.

Source: Author’s calculations using HM Treasury, Spending Review 2020, table C.6.

5.6 What does this mean for the Spending Review?

What do the Chancellor’s latest plans imply for different areas?

Under the spending plans outlined by the Chancellor on 7 September, resource DEL (departmental day-to-day budgets) is set to grow by 3.2% per year in real terms (and so by 10.0% over the three years from 2021−22 to 2024−25). This is shown by the purple line in Figure 5.16.

The Department of Health and Social Care budget – and within it, the NHS England budget – is set to grow at a faster rate. Over the three years, the DHSC resource budget is set to grow by 15.0% in real terms, though this growth is extremely front-loaded: 12.3% in year one, 1.9% in year two and 0.5% in year three. This is because of the substantial sums provided to the health service to meet pandemic-related pressures in the near term, and the more limited nature of support after that point. The sums provided to DHSC in the first two years might be ‘enough’, but the analysis in Chapter 6 implies a possible shortfall of around £5 billion in 2024−25. We return to this below.

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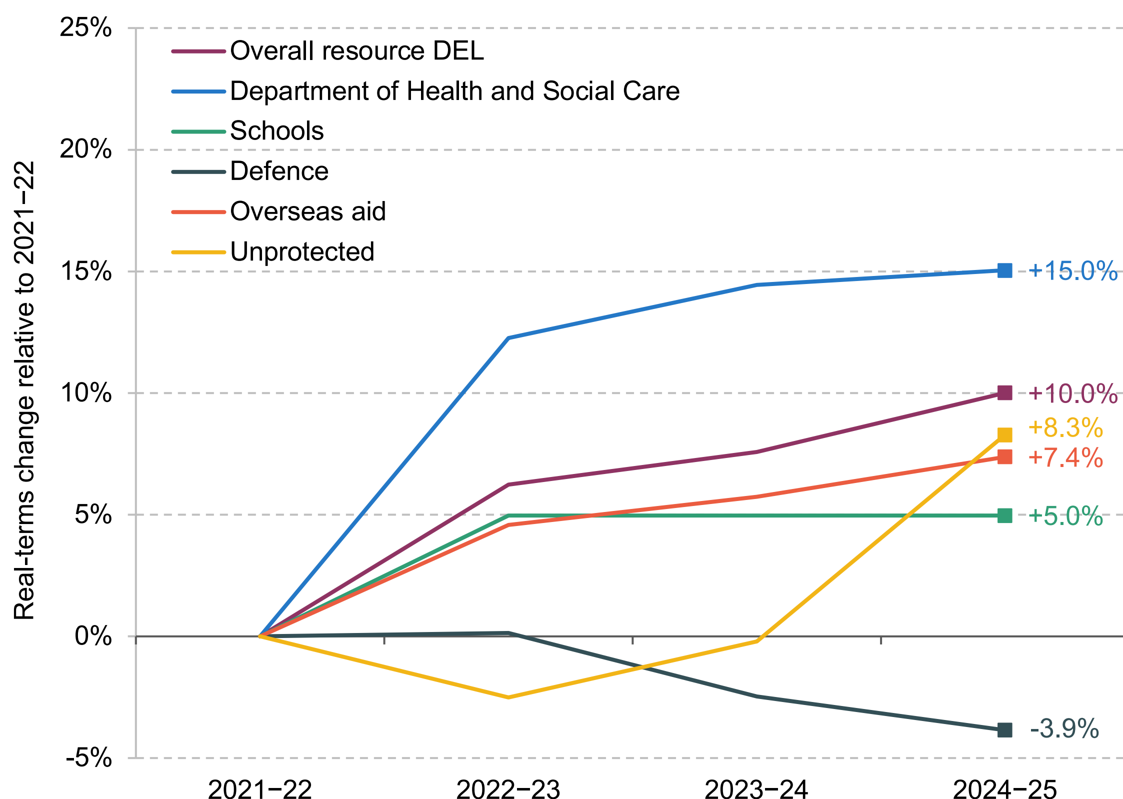
Figure 5.16. Projected real-terms change in day-to-day public service funding under the government's September 2021 spending plans



Note: Overseas aid denotes an estimate of the resource element of ODA, which is assumed to remain at 0.5% of GNI for the full period. All other figures are for resource DEL, excluding depreciation.

Source: Author's calculations using assumptions outlined in the text and all sources for Table 5.3.

The resource component of ODA would be expected to grow by 2.4% per year (7.4% over three years) to keep pace with growth in the wider economy and maintain aid spending at 0.5% of national income. The schools budget would grow by 5.0% in the first year, then flatline (as per our assumptions in Section 5.5, which would translate into rising real per-pupil spending). Under its long-term settlement, the MoD's capital budget (which amounts to around one-third of the total MoD budget) is set to increase by more than 40% over the parliament, and by around 7% over the Spending Review period. The MoD resource budget, on the other hand, is actually set to fall by 1.3% per year (3.9% over three years), as can be seen in Figure 5.16.

As discussed in Section 5.5, greater spending on the English NHS and schools system means greater funding for the Scottish, Welsh and Northern Irish devolved governments, via the Barnett formula. Once these Barnett consequentials are accounted for, the government's plans and commitments imply a 2.5% real-terms cut to unprotected budgets in 2022−23 (or,

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equivalently, a £2.3 billion cut in 2021−22 prices).[16] Then, in subsequent years, as the pace of growth in the DHSC budget slows, the schools budget flatlines and the MoD budget starts to fall, more money would be freed up for unprotected areas. Those budgets would see real-terms growth of 2.4% in 2023−24 and 8.5% in 2024−25. Combined, that would mean an 8.3% increase over the three years (shown by the yellow line in Figure 5.16).

A short-term squeeze, followed by medium-term ease?

That would represent an extremely tight settlement for unprotected departments over the next two years, including a real-terms cut of more than £2 billion in 2022−23. Budgets in 2023−24 would be no higher, on average, than in 2021−22. Affected areas include things such as prisons, the courts system, local government, further education, the police, international trade and HMRC. As discussed in Section 5.4, many of these services are facing substantial pressures and challenges – whether from the pandemic, Brexit, a decade of austerity, or demographic trends.

And remember, while the Chancellor has provided additional cash to deal with COVID-related pressures on the NHS, no such funding has been provided to deal with pandemic-induced backlogs and disruptions elsewhere. If the Chancellor sticks to his latest spending envelope, but further virus-related expenditure is required (to deal with the backlog in the courts system, for instance, or to pay for a learning catch-up programme in schools), then the money would need to be found from within other budgets (i.e. from cuts to other services). If anything, then, the figures in Figure 5.16 likely understate the potential squeeze facing unprotected budgets in the near term.

On the face of it, though, while unprotected budgets would be squeezed in the near term, there might appear to be more than enough to go around in the medium term. Figure 5.16 clearly shows that unprotected budgets would – under these assumptions – be in line for a real-terms budget increase over the three-year period, including growth in excess of 8% in 2024−25. Taking the period as a whole, then, it might appear that there is little to worry about – and certainly no need to worry about a 'return to austerity'. Perhaps – but there are two relevant points to consider here.

The first relates to the time profile of spending. Budget increases for areas such as local government, the Department for Transport and HM Courts & Tribunal Service are likely to be heavily backloaded, based on the analysis above. But the pressures facing those areas – particularly those related to the pandemic – are likely to be heavily front-loaded and at their most acute over the next two years. The Institute for Government recently suggested that the

[16] This allows for the fact that a portion of the cut to unprotected budgets in 2022−23 would be 'devolved' to Scotland, Wales and Northern Ireland. It also adjusts for the £1.7 billion or so of additional funding provided to compensate public sector employers for the extra costs associated with the new health and social care levy.

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Chancellor ought to bring funding forward to ease COVID-19 disruption for other public services (Pope, 2021).

If he wished, the Chancellor could re-profile his spending totals to provide more funding in the near term, while spending the exact same amount over the three-year Spending Review period, and smoothing the growth in unprotected budgets. To illustrate, consider the case where £5.7 billion (in cash terms) is removed from plans for 2024–25, and £3.5 billion and £2.2 billion is added to plans for 2022–23 and 2023–24, respectively. Cumulative spending would be left unchanged, but this would allow for constant real-terms growth in unprotected budgets of around 1% per year, rather than the famine-and-feast of sharp cuts followed by sharp increases. That would likely allow for more efficient planning of services and better allow departments to deal with immediate virus-related pressures.

Second, do we really believe that 'protected' budgets will face such a tight settlement in 2024–25? Under the plans published on 7 September, the DHSC budget is set to increase by just 0.5% in real terms in 2024–25, and (within that) the NHS England budget by just 1.2%. History teaches us that the NHS budget is almost always topped up (Zaranko, 2021), and the analysis in Chapter 6 suggests that a top-up in 2024–25 seems all but certain. Below, we show that top-ups to the NHS or other protected budgets could very easily eat into the amount available for other, less fortunate, areas.

An alternative scenario: what if the Chancellor provides a top-up to NHS and aid budgets?

The Chancellor is facing a myriad of calls for additional funding in the face of spending pressures across the public sector. He will not be able to please everyone. But top-ups in at least some areas seem likely. Here, we consider two areas in which that seems particularly likely: the NHS and aid budgets. To be clear: this is not intended as an exhaustive list of the places where the Chancellor might need to find more money. Instead, the intention is to illustrate just how easily the real-terms increases implied for unprotected budgets in 2024–25 could fail to materialise.

First, the NHS. The new health and social care funding settlement, announced on 7 September, provided substantial amounts to deal with virus-related pressures over the coming two years. But these plans appear to allow for little or no long-term additional costs as a result of the pandemic, suggesting that the newly announced funding might be insufficient to meet COVID-related pressures in the medium term (see Chapter 6). These plans imply a potential shortfall of around

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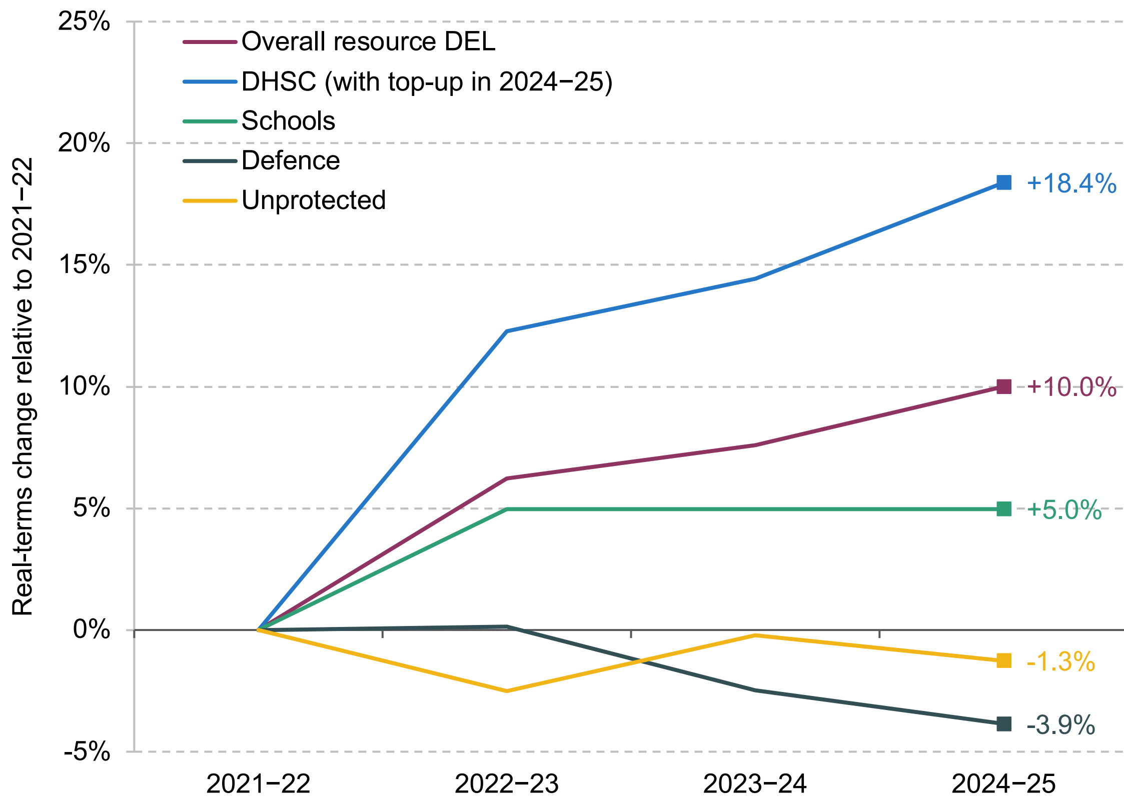
£5 billion in 2024−25. Here, we assume that the NHS England budget is topped up by that amount to meet ongoing pandemic-related cost and demand pressures on the health service.[17]

Second, overseas aid spending. The Chancellor has committed to returning ODA spending to 0.7% of national income 'once the fiscal situation allows' (for full details, see Section 5.5). It is possible that with an improving economic outlook (such as the 'central' and 'optimistic' scenarios discussed in Chapter 3), the Chancellor's conditions could be met during the Spending Review period. Here, we consider the case where the government returns ODA to 0.7% of national income in 2024−25, which would require additional (resource) spending of around £4 billion in that year.

Figure 5.17. Alternative scenario: projected real-terms change in day-to-day public service funding with top-ups for the NHS and aid budgets in the final year



Note: All figures are for resource DEL, excluding depreciation. Overseas aid would grow by more than 50% over three years in this scenario, and is excluded from the chart in order to preserve the vertical axis.

Source: Author's calculations using assumptions outlined in the text and all sources for Table 5.3.

[17] Note also that if the NHS budget were to exceed its planned growth rate by the average amount by which it has done so historically (i.e. 1.4 percentage points, in real terms), that would also imply spending £5 billion extra in 2024−25. See Zaranko (2021) for details.

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Table 5.4. Resource spending totals under existing plans and alternative scenario

	Plans	Spending Review 2021 period		
	2021−22	2022−23	2023−24	2024−25
Existing (September 2021) spending plans (£ billion, 2021−22 prices)				
Total resource DEL[a]	385.0	409.0	414.2	423.5
Total protected resource DEL	237.5	258.5	261.0	261.6
Other (non-COVID) resource DEL	147.5	150.5	153.2	162.0
of which: estimated unprotected	*90.3*	*88.0*	*90.1*	*97.8*
Alternative scenario: a top-up to NHS and aid budgets (£ billion, 2021−22 prices)				
Total resource DEL[a]	385.0	409.0	414.2	423.5
Total protected resource DEL	237.5	258.5	261.0	270.5
Other (non-COVID) resource DEL	147.5	150.5	153.2	153.1
of which: estimated unprotected	*90.3*	*88.0*	*90.1*	*89.1*

[a] Resource DEL figure for 2021−22 excludes spending provided to deal with COVID-19.
Note: All figures are expressed in 2021−22 prices using June 2021 GDP deflators, and may not sum due to rounding. Protected RDEL includes DHSC, schools in England, the Ministry of Defence and ODA (as per Table 5.3). ‘Other (non-COVID) RDEL’ includes the estimated block grants to the devolved governments in Scotland, Wales and Northern Ireland as well as ‘estimated unprotected’.

Source: Author’s calculations using assumptions outlined in the text and all sources for Table 5.3.

What would this mean for unprotected budgets? Figure 5.17 shows that in this scenario, rather than growing in the final year of the period, unprotected budgets would face another round of real-terms cuts. Table 5.4 shows that these cuts would amount to around £1 billion over three years. The key point to take from this is that higher spending elsewhere – whether it is on the NHS and overseas aid, or something else – could easily eat into what is available for unprotected budgets.

In other words, it would not take much for a difficult two-year period (as implied by existing plans) to turn into a difficult three-year period for unprotected services. That would pose considerable challenges. Among other things, it could threaten the successful roll-out of the government’s new social care funding reforms, jeopardise the levelling-up agenda, and limit the amount available to spend on the transition to net zero. The Chancellor’s plans do not signify a full-throated return to austerity, but they do point to a difficult period ahead, with delicate trade-offs abounding.

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Or might the Chancellor just top up his plans again?

The illustrative scenario above assumes that the Chancellor would provide additional funding to the NHS and to the ODA budget without increasing his overall spending plans (the line for total resource DEL is identical for both scenarios in Table 5.4). In other words, it assumes that he sticks to his spending envelope.

But will he? The NHS and overseas aid are not the only areas clamouring for additional funding: the Chancellor will face a cacophony of calls for extra cash. After all, his latest plans still imply spending less on public services than was planned in the March 2021 Budget (Figure 5.14), and no allowance has been made for virus-related spending outside of health. Cuts to unprotected services will be difficult to deliver, and ongoing pandemic pressures are likely across huge swathes of the public sector – not least for education and public transport providers. An improvement in the economic and fiscal forecast is likely (see Chapters 2 and 3), perhaps providing some room for manoeuvre. Mr Sunak might, therefore, be tempted to top up his spending plans.

The scale of any top-up would, of course, depend on what the Chancellor was trying to achieve. Returning to pre-pandemic plans for overall resource DEL would mean spending an additional £3 billion in 2024−25. Returning ODA spending to 0.7% of national income and providing additional funding for pandemic-related pressures on education and transport (see Figure 5.10) would require an additional £7 billion in that year. Adding an extra £5 billion for the NHS in 2024−25 to plug a possible shortfall (see Chapter 6) would take the total to £12 billion. Given the scale of the government's ambitions on social care reform, levelling up and net zero, one could easily imagine top-ups on an even larger scale.

5.7 Conclusion

The Chancellor's dilemma is this. He has announced a £14 billion a year top-up to his March 2021 spending plans alongside a manifesto-breaking increase in National Insurance contributions. Overall funding for public services is planned to increase at a faster rate than at Labour's 2007 Spending Review. Rishi Sunak, a Conservative Chancellor, is set to oversee a lasting increase in the size of the state of around 2% of national income. But still he faces an unpalatable set of spending choices.

Sticking to his plans would mean making cuts next year to some unprotected budgets. Many of those budgets – which include things such as local government, prisons, courts and further education – are already facing major challenges, from a combination of the pandemic, Brexit, a decade of austerity and demographic trends. The Chancellor has announced funding to meet pandemic-related pressures on the NHS, but has made no allowance for virus-related spending

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on other services. Ongoing support for public transport operators and a catch-up package for schools (to take just two examples) could easily require £3 billion of extra spending each year. If the Chancellor allocates funding towards COVID-19 catch-up without increasing his overall envelope or rowing back on his commitments to areas such as the NHS, defence, schools and overseas aid, he will have to make even bigger cuts to unprotected budgets. Making meaningful progress in areas such as social care reform, levelling up and the net zero transition could additionally require tens of billions of spending each year. His plans might imply more wiggle room by the end of the parliament for unprotected services, but more likely an ever-growing NHS budget will swallow most – if not all – of that up.

In short, then, this Spending Review still promises to be a tricky one. There are no easy options, but the decisions made will be of major economic, fiscal and political importance.

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