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The outlook for the 2019 Spending Review

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Key findings

- **The 2019 Spending Review will allocate funding to departments for the 2020–21 financial year, and possibly beyond.** A longer, multi-year review period could aid departmental planning. But given the degree of uncertainty, the Chancellor may opt for a shorter review period to retain more flexibility.

- **The Chancellor's decisions will follow almost a decade of spending cuts.** On a like-for-like basis, departmental spending is more than £40 billion lower in 2018–19 than in 2009–10 and has fallen to a share of national income last seen in 2000–01. At 38.2% of national income, total government spending is roughly where it was in 2006–07.

- **Some areas of spending have been squeezed much harder than others.** For instance, while the Department for International Development enjoyed a 25% increase in its day-to-day budget between 2010–11 and 2019–20 (the final year of the last Spending Review), the Ministry of Justice and Department for Environment, Food and Rural Affairs have each seen a reduction of around 40%.

- **Borrowing is now back to pre-crisis levels.** Debt, however, is 50% of national income higher than it was a decade ago, and is set to fall only slowly over the next few years.

- **The government has already committed an extra £20.5 billion to the NHS by 2023–24.** Given other existing commitments on defence and aid, the path for over half of day-to-day public service spending (£156 billion in 2018–19) has already been largely decided.

- **Before setting individual departmental budgets, the Chancellor needs to decide how much to spend in total.** Due to pre-existing commitments, the overall size of the 'spending envelope' will determine how tight settlements will be for 'unprotected' areas. The latest provisional totals imply an increase in overall day-to-day spending, but cuts to areas outside of the NHS, defence and overseas aid.

- **Over the four years from 2019–20 to 2023–24, the Chancellor would need to find an extra £2.2 billion to avoid real cuts to 'unprotected' spending overall.** He would need to find an additional £5 billion to avoid this spending falling in per-capita terms and £11 billion to avoid it falling as a share of national income.

- **A disorderly Brexit would be likely to lead to lower economic growth in the short and long run, but may not mean less money available at this Spending Review.** This would eventually require lower spending, or higher taxes, than would otherwise have been the case. But a fiscal tightening would not need to happen immediately, and there could be a case for more spending over the next few years, not least to assist with border issues and to mitigate the impacts for the worst-hit sectors or areas.

A Spending Review is due this year

At some point in 2019, the Chancellor will need to publish the outcome of HM Treasury's forthcoming Spending Review. At a minimum, this will set detailed departmental allocations for the 2020–21 financial year, and possibly beyond. The Chancellor is yet to confirm how much he plans to spend overall (what is known as the 'spending envelope'), but did set out some provisional spending totals in the 2018 Autumn Budget for the years up to 2023–24. These provisional totals underpin the official fiscal forecasts and therefore provide an indication of what we might expect.

Of course the economic and fiscal forecasts are always subject to change. In the October 2018 Budget the fiscal outlook improved by around £18 billion a year by 2022–23: a largesse that the Chancellor used to top up his spending plans rather than to cut taxes or reduce the outlook for the deficit. Since then the economic forecasts from the Bank of England have been revised downwards. Whereas in November the Bank of England was forecasting growth over the next current year to be slightly higher than the Office for Budget Responsibility (OBR, 1.7% compared to 1.6%) on the 7 February they revised this forecast down to growth of just 1.2%. A downgrade of GDP of 0.5% would reduce annual GDP by around £10 billion and a rule-of-thumb suggests it would add between around £5 billion and £7 billion to the deficit. Of course the OBR might not revise their forecasts down and it remains the case that the Bank of England is more optimistic than the OBR about growth in 2020 and 2021.

The Spring Statement, scheduled for 13 March, will contain the latest official economic and fiscal forecasts. It will also be an obvious moment for the Chancellor to confirm the envelope for this year's Spending Review. On the other hand, he could wait until more is known about the Brexit deal and its effects on the economy. In any case, it is hard to see how allocations can be delayed beyond the Autumn Budget which, on the basis of past practice, suggests that the overall envelope is likely to be announced before the summer.

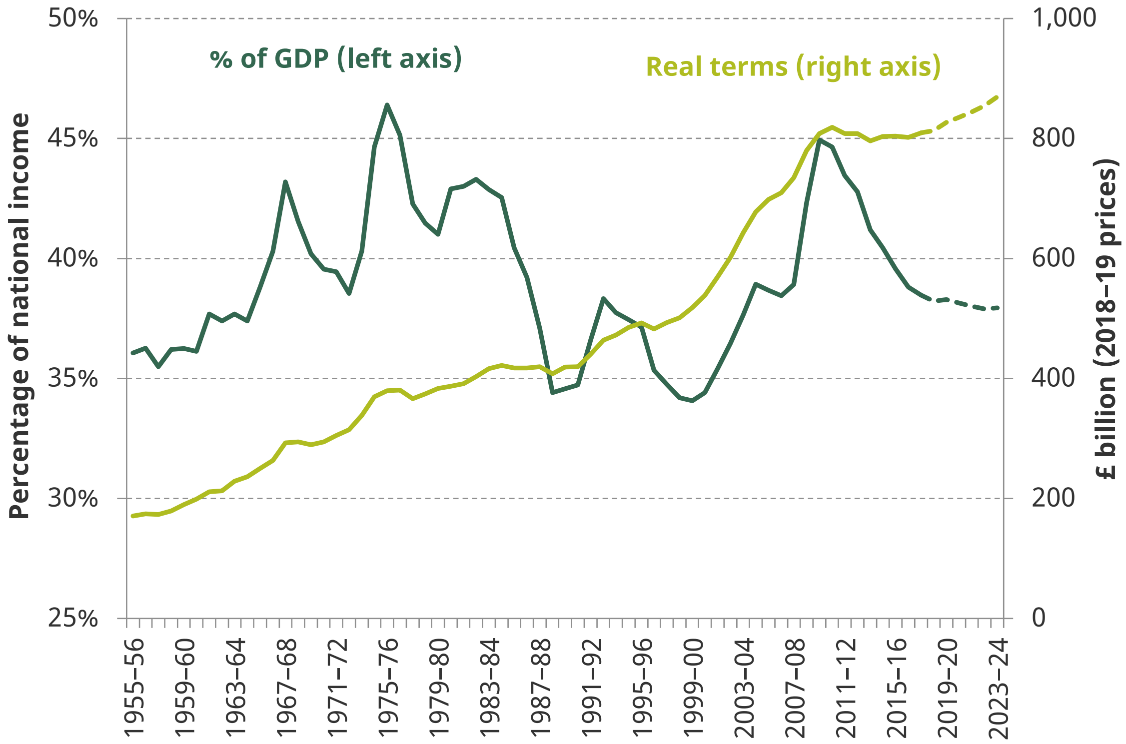
This briefing note provides background and context for the forthcoming Spending Review, outlining the constraints the Chancellor will be working under and the implications of his provisional plans for public service spending.

Historically, Spending Reviews have tended to cover a period of at least three years: the last Spending Review, published in November 2015, set departmental spending plans for the four years up to and including 2019–20. Multi-year spending plans have the advantage of giving departments greater certainty over their future budgets, which can aid long-term planning and make for better policymaking. However, given heightened uncertainty, not least around how the economy will evolve through Brexit, the Chancellor may well decide on this occasion to have a review that covers a shorter period – perhaps even a one-year review covering just 2020–21 – in order to leave more flexibility to respond to future developments.[1]

[1] This would follow the precedent of Spending Round 2013, which set departmental allocations only for the 2015–16 financial year to take spending plans up to the end of that parliament.

Government spending has been squeezed over the last decade

Figure 1a. Total managed expenditure since 1955–56

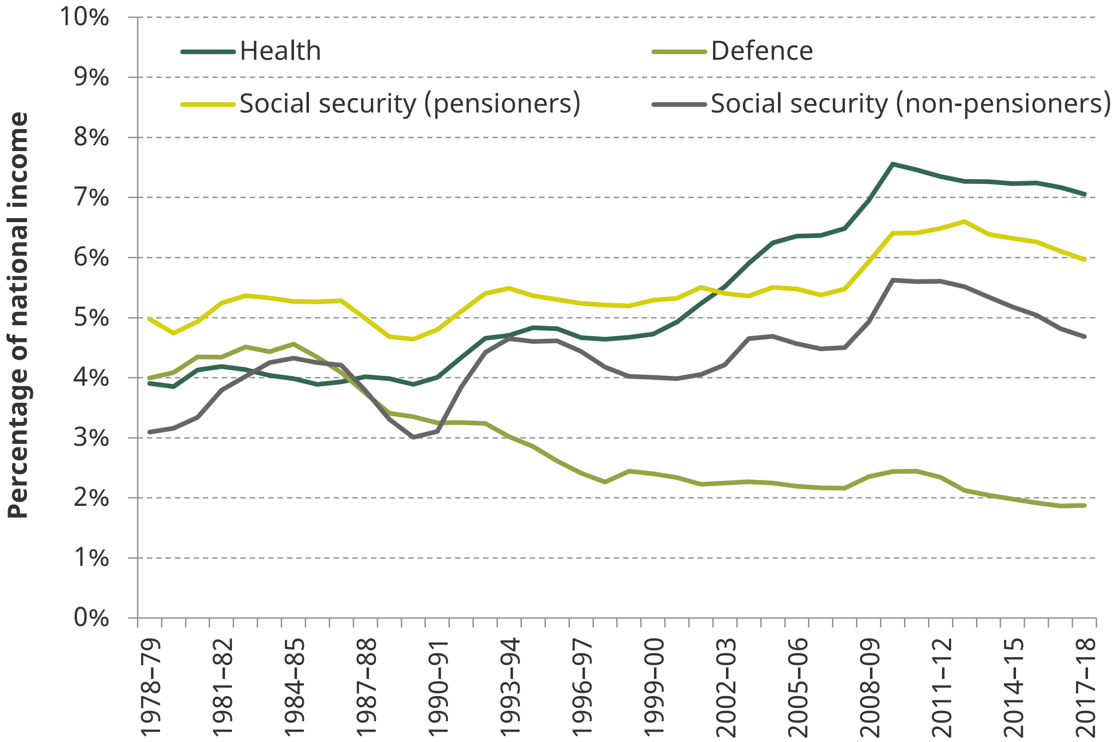


Notes and sources: See end section.

Regardless of precisely which years are covered, this year's Spending Review is likely to pose particular challenges, as it will come on the back of almost a decade of cuts to public spending. Figure 1a shows that total public spending (as measured by total managed expenditure, or TME) is hardly any higher now in real terms than it was a decade ago, marking an unprecedented period of spending restraint. Even 10 years of no real spending growth has only been sufficient to return TME to just below its 2007–08 share of national income – 38.2% this year, down from 38.9% then, while on current plans it is set to fall further to 37.9% of national income by 2023–24. That would return spending to its lowest share of national income since 2003–04, but a level higher than in the late 1980s and 1990s.

UK public spending has varied between 34% and 47% of national income over the last 60 years. Within this, there have been substantial changes in what that money is spent on. Figure 1b shows that the government now spends a much higher proportion of national income on health, and much less on defence, than 40 years ago. Social security spending on both pensioners and non-pensioners has been on a broad upward trend over the past 40 years and increased sharply around the time of the financial crisis, but spending on social security, health and defence have all fallen as a share of national income since 2010.

Figure 1b. Health, defence and social security spending since 1978–79

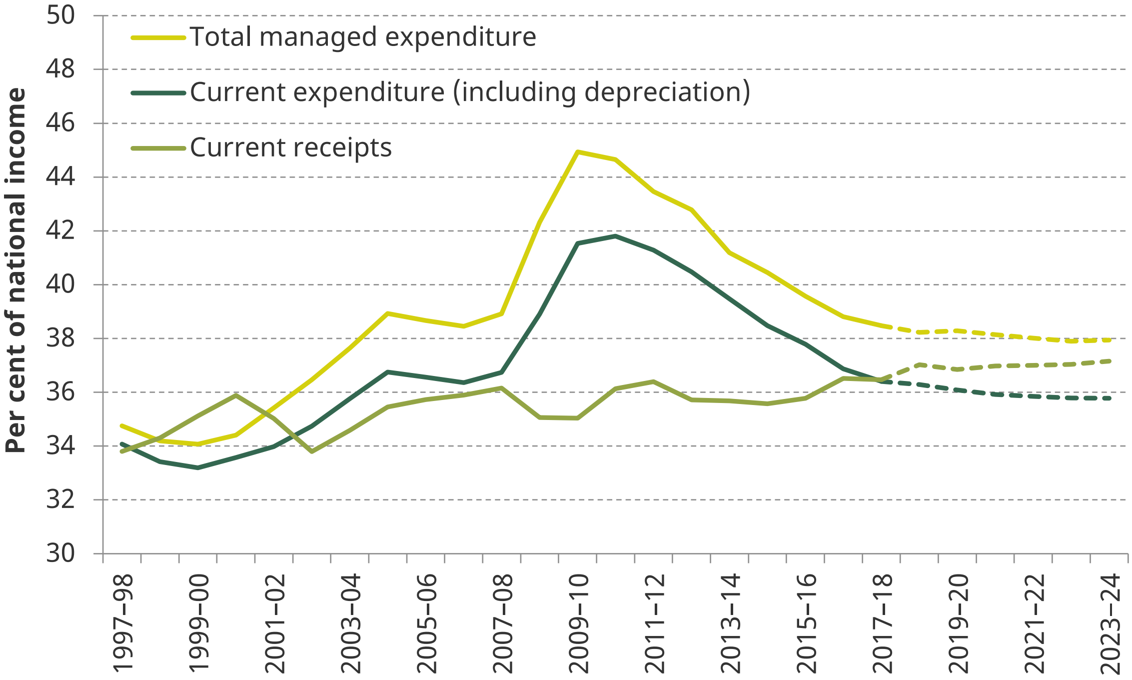


Notes and sources: See end section.

Borrowing is now back to pre-crisis levels, but debt is still much higher

As well as deep spending cuts, recent years have seen a gradual increase in the share of national income collected in taxes, shown as current receipts in Figure 2a. Taxes increased from 35.1% of national income in 1999–2000 to 36.2% in 2007–08, 37.0% now (2018–19) and are heading for 37.2% by 2023–24. Falling spending and rising tax receipts have led to a reduction in government borrowing since 2009–10. Figures 2a and 2b show that the headline deficit (the gap between total spending and total receipts, as measured by public sector net borrowing) fell to 2.0% of national income in 2017–18, the lowest level since 2001–02.[2] The same is true of the current budget deficit (the gap between day-to-day spending and current receipts, i.e. the deficit excluding what is explained by spending on investment): the government ran a small surplus on the current budget in 2017–18 for the first time since 2001–02. This is set to grow to a surplus of 1.4% of national income in 2023–24.

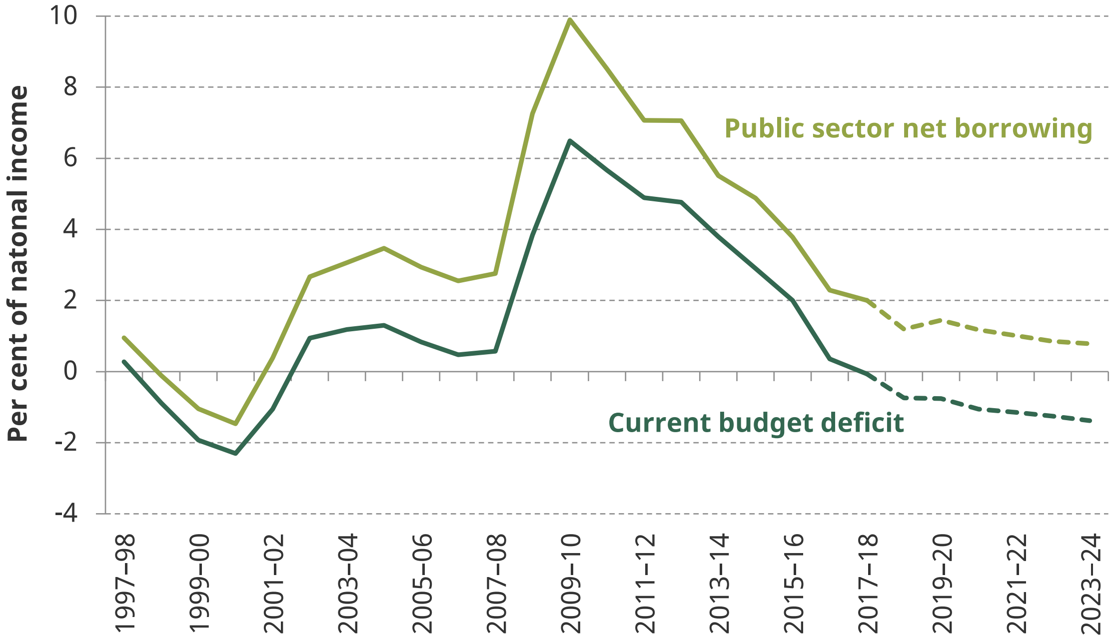
Figure 2a. Public sector receipts and spending since 1997–98



Notes and sources: See end section.

[2] Since the October 2018 Budget, the Office for National Statistics (ONS) has announced a revision to the treatment of student loans in the national accounts. It intends to provide more details on this accounting method in the summer. When this new method is incorporated into the forecasts, it will lead to borrowing being higher – possibly by around £12 billion this year and as much as £17 billion by 2023–24. For details, see J. Britton, C. Emmerson and T. Pope, 'Better accounting of student loans to increase headline measure of the government's deficit by around £12 billion', IFS Observation, December 2018, https://www.ifs.org.uk/publications/13773.

Figure 2b. Measures of the public sector deficit since 1997–98



Notes and sources: See end section.

Figures 2a and 2b show that after years of fiscal restraint, government borrowing has now returned to pre-crisis levels. In contrast, public sector net debt (which can be thought of broadly as the sum of all government borrowing to date) has increased considerably over the last decade, increasing from 35.2% to 85.0% of national income between 2007–08 and 2017–18 (Figure 2c). In other words, the deficit might be 'back to normal' but public sector net debt is now more than double its pre-crisis level and at its highest level in more than 50 years.

Stripping out the temporary effects of the Bank of England Term Funding Scheme (as well as some other activities of the Bank of England),[3] public debt as a share of national income is set to fall only slowly over the next few years, in part because the outlook for growth remains sluggish. This means that debt is set to remain at a high level by historical standards.

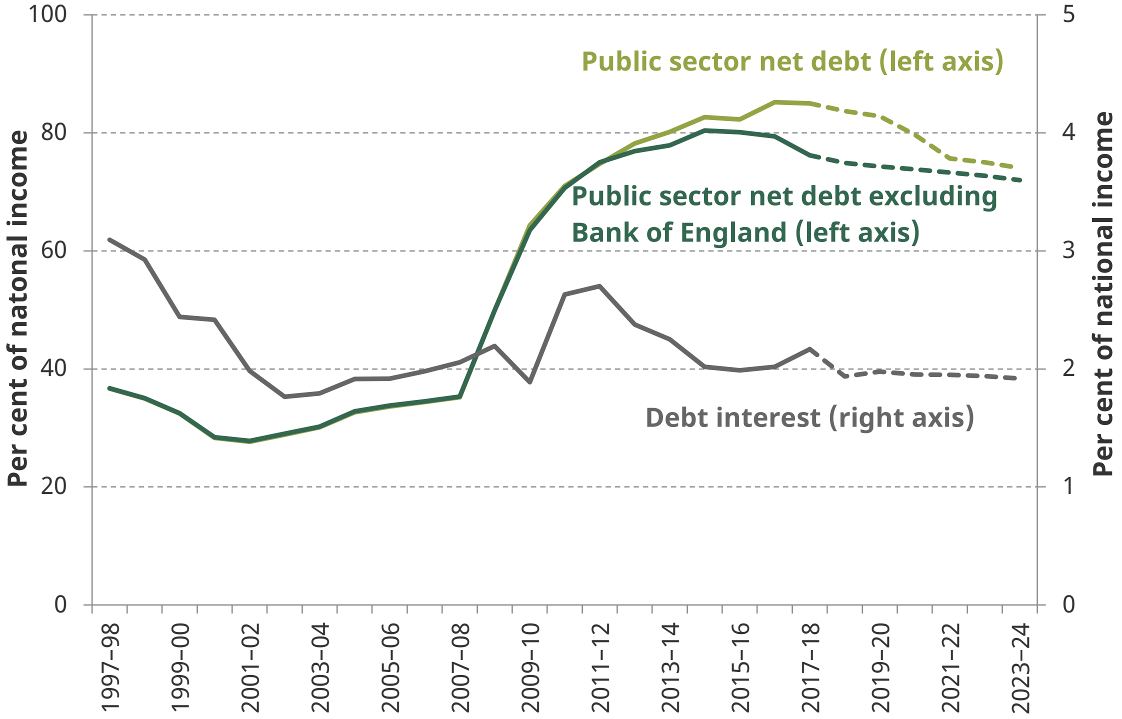
It is striking that, despite debt being 50% of national income higher than before the crisis, debt interest spending is actually less of a burden. Partly these numbers are flattered by Quantitative Easing (which depresses the interest rate on government borrowing), but it is also true that gilt (interest) rates are much lower now than before the financial crisis. When governments are able to borrow at low interest rates – and in particular when long-term interest rates are persistently lower than expected growth rates – the costs of high

[3] Private sector banks are set to repay loans made to them by the Bank of England under the Term Funding Scheme in 2020–21 and 2021–22. For a discussion, see C. Emmerson and T. Pope, 'Risks to the UK public finances', in C. Emmerson, C. Farquharson and P. Johnson (eds), *The IFS Green Budget: October 2018*, https://www.ifs.org.uk/publications/13508.

public debt are lower.[4] In such an environment, the fact that debt is set to fall only slowly is perhaps less of a concern.

There are, nonetheless, benefits to a government having a lower debt-to-GDP ratio, not least to ensure that it has sufficient 'fiscal space' to respond appropriately to economic downturns. The government has set itself an overarching fiscal objective to eliminate the deficit entirely by the mid 2020s – on the latest plans, it would still have a sizeable deficit in 2023–24, suggesting that this 'objective' is more of an aspiration than a plan. The government's less ambitious shorter-term target is to have a cyclically adjusted deficit of less than 2% of national income in 2020–21 – a target against which it has headroom on current forecasts. The Chancellor will need to balance any spending commitments he makes in the Spending Review against the implications for borrowing, debt and his overarching fiscal objectives.

Figure 2c. Measures of public sector debt since 1997–98



Notes and sources: See end section.

[4] O. Blanchard, 'Public debt and low interest rates', American Economic Association Lecture, 4 January 2019, https://www.aeaweb.org/aea/2019conference/program/pdf/14020_paper_etZgfbDr.pdf.

Not all government spending will be covered by the Spending Review

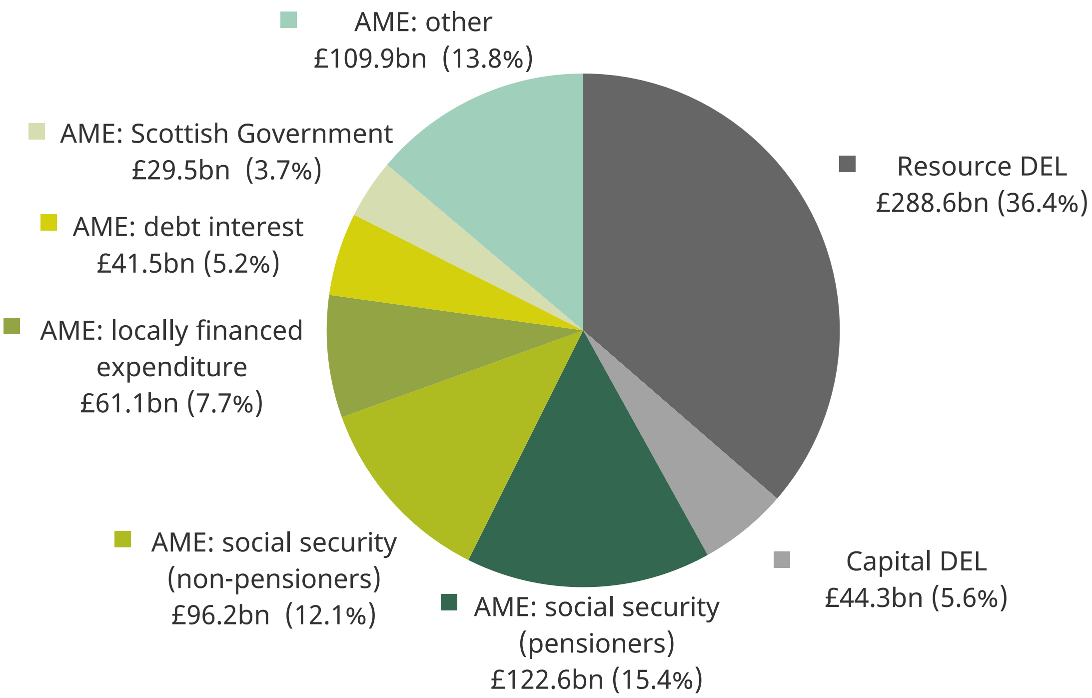
In the past, Spending Reviews have tended to cover a period of at least three years. But some elements of public spending are easier to plan and control on a multi-year basis than others. The government can decide how much it wants to spend on public services such as the NHS or schools over the coming years, set budgets accordingly and (largely) expect those budgets to be kept to. Other elements of spending are more affected by factors outside of government control. For instance, how much the government spends on unemployment benefits will depend on how many people are out of work. Future spending on debt interest payments will depend in part on future borrowing and on future interest rates, which cannot be known in advance. Whether or not devolved administrations, from the Scottish Parliament to local authorities, decide to raise taxes to increase spending is – to an extent − outside of central government control. For this reason, not all expenditure is subject to multi-year limits at Spending Reviews.

Spending that is planned on a multi-year basis is known as 'departmental expenditure limits', or DEL, and is allocated at Spending Reviews. This is designed to be the portion of expenditure that central government can effectively control, and can be broadly thought of as central government spending by departments on the delivery and administration of public services. DEL is split into resource (day-to-day, or RDEL) and capital (investment, or CDEL) budgets, which accounted for 36.4% and 5.6% of total spending in 2017−18, respectively (Figure 3).

The remainder of public spending – that which the government argues cannot reasonably be subject to firm multi-year limits set at Spending Reviews – is classified as 'annually managed expenditure', or AME. By far the largest component of AME is social security, with spending on pensioners and non-pensioners amounting to 15.4% and 12.1% of total spending, respectively (combined they account for nearly half (47.5%) of AME). In total, AME accounts for around 58% of total spending. This proportion has risen in recent years, in part because DEL budgets have been cut while overall AME spending has increased.[5]

[5] In addition, reclassifications have moved some components of spending from DEL to AME (a recent significant example being Scottish Government spending). This comparison also somewhat understates the extent to which the level of DEL can control overall public expenditure, because the budgets of the Scottish and Welsh governments are determined based on the 'Barnett formula', which takes into account departmental spending in England on spending areas that are devolved.

Figure 3. Components of TME in 2017–18



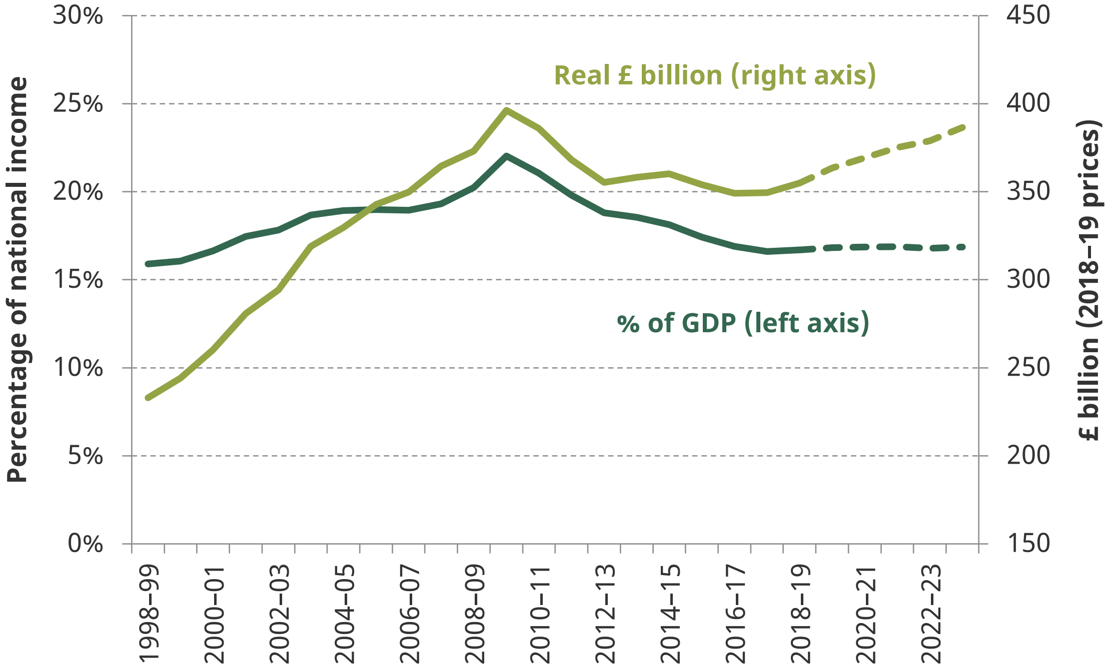
Notes and sources: See end section.

By definition, much spending within AME is more difficult for Whitehall to control on a multi-year basis, and so we might not expect it to be considered at the Spending Review. However, at the 2010 and 2015 Spending Reviews, parts of AME were included within the overall envelope and policy measures were announced to deliver cuts in some of those areas. There is an argument for considering a much broader definition of spending than DEL in the Spending Review in order to trade off, for example, spending on public services on the one hand against spending on social security on the other – and ideally alongside the taxes and borrowing required to fund it. The scope of the overall envelope is a decision the Chancellor will need to make as he prepares for the Spending Review. For the remainder of this briefing note, however, we will focus primarily on departmental spending within DEL.

The outlook for departmental spending

Over the 2000s, total departmental spending climbed steadily as a share of national income, reaching 22.0% of GDP in 2009–10. In the manner of the Grand Old Duke of York, departmental expenditure has since marched back down the hill again, falling to a share of national income last seen in 2000–01 (Figure 4). In real terms, the cut between 2009–10 and 2018–19 amounted to £41.3 billion (in 2018–19 prices), more than 10% of the total. On current plans, between 2018–19 and 2023–24, overall departmental spending is set to stay flat as a share of national income and to increase by £31.6 billion in real terms (£18.2 billion for RDEL and £13.4 billion for CDEL), after adjusting for changes to employer contributions to public service pension schemes.[6] That would still leave total DEL around £10 billion below its 2009–10 peak. This is remarkable: spending in real terms in 2023–24 being below its level 14 years earlier.

Figure 4. Total departmental expenditure

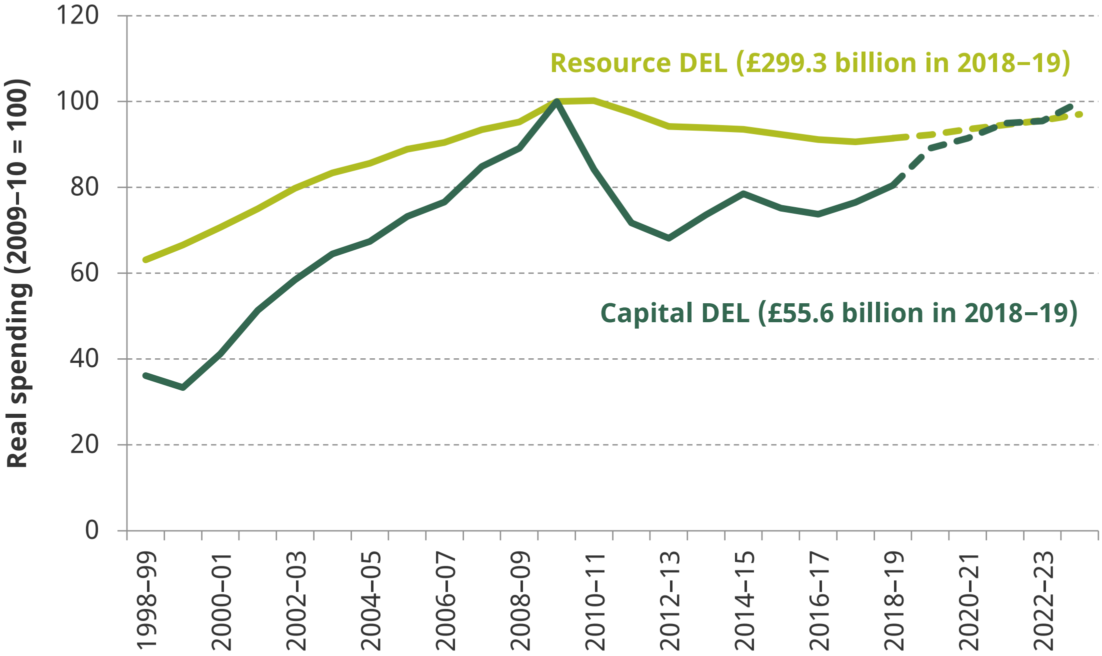


Notes and sources: See end section.

[6] The figures underlying Figure 4 (and subsequent analysis) have been adjusted for a change announced at the 2018 Autumn Budget relating to a reduction in the discount rate used in setting employer contribution rates to public service pension schemes, which increases costs for public sector employers. The government has indicated that it will – for the most part – compensate departments for this increase in costs, which then shows up in government accounts as higher resource DEL, to the tune of £5.4 billion in 2019–20. But because this money is (in effect) sent back to the Treasury, it also appears as a reduction in AME, and so has no effect on total public spending in the medium term. If they are fully compensated, the change will also not affect departments' ability to fund and provide public services. For this reason, we have stripped out the impact of this change on the level of RDEL, so that our analysis better reflects the 'true' change in departmental spending power, which will ultimately determine the range and quality of services that can be provided. For further information on the change to employer contribution rates, see paragraph 4.142 and table A.1 of Office for Budget Responsibility, *Economic and Fiscal Outlook, October 2018*, https://obr.uk/efo/economic-fiscal-outlook-october-2018/ and paragraphs 1.58–1.60 of HM Treasury, Budget 2018, https://www.gov.uk/government/publications/budget-2018-documents.

Cuts since 2010 have not been shared equally

Figure 5. Resource and capital departmental expenditure limits



Notes and sources: See end section.

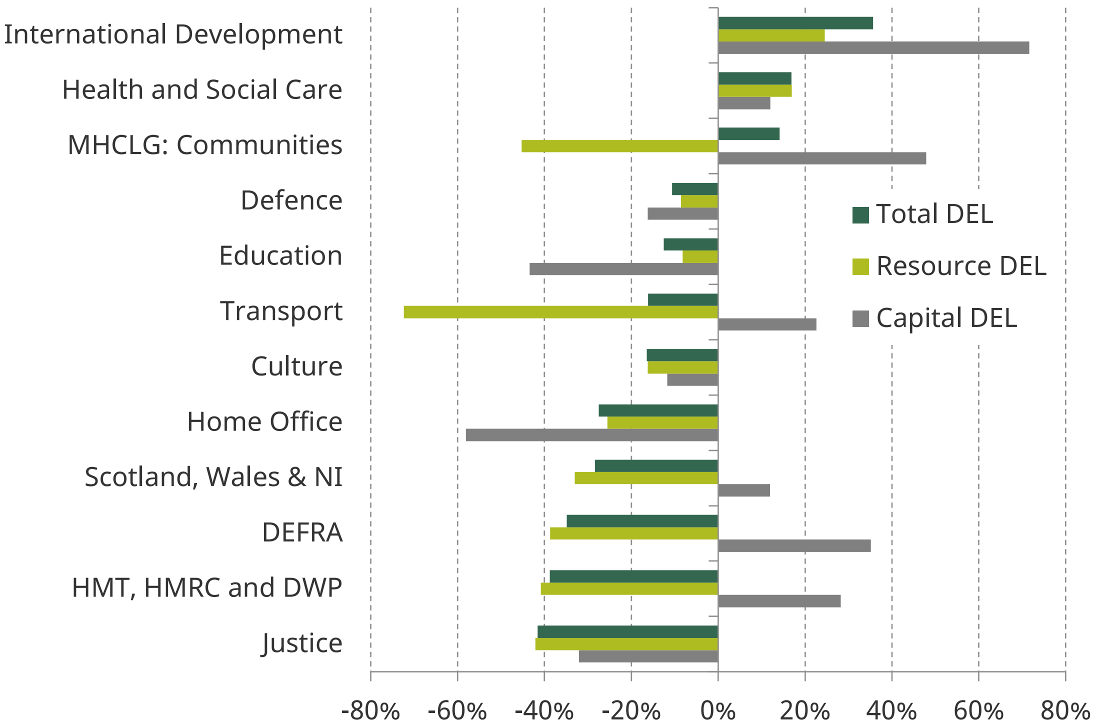
Within overall DEL, resource (day-to-day) and capital (investment) budgets have fared very differently over the past 20 years. Figure 5 shows that in the run-up to 2009–10, capital spending increased at a more rapid rate than did resource spending (an average annual real growth rate of 9.7% for CDEL between 1998–99 and 2009–10, versus 4.3% for RDEL). After 2010, while the majority of the cuts in cash terms fell on the resource budget (owing to its greater size), the relative cuts to the capital budget were considerably deeper. However, capital spending within DEL has steadily increased since 2012–13 and, under the provisional plans set out in the October 2018 Budget, is set to reach its 2009–10 level in real terms by 2023–24.

Resource spending is also set to grow in real terms over the coming years, following an average annual real cut of 1.0% between 2009–10 and 2018–19. Under the Chancellor's provisional spending plans, RDEL is set to grow by 1.2% per year between 2018–19 and 2023–24, and CDEL by 4.4% per year. By 2023–24, total resource spending would be 3.0% lower (or £9.7 billion lower) in real terms than it was in 2009–10.

It would be misleading, however, to conclude from Figures 4 and 5 that by the end of the forecast period, departments would be (more or less) back where they started in 2010. It is unprecedented for departmental spending not to increase in real terms in a decade, and demands on departmental budgets will have increased significantly over that period: between 2009–10 and 2018–19, the UK population grew by 6.8% and real GDP increased by 18.2%, and both are forecast to continue to grow over the next five years. But looking at the aggregate also masks considerable differences across departments because the cuts have fallen far from equally.

These differences are illustrated in Figure 6, which shows the real change in departmental budgets between 2010–11 and 2019–20 (the final year covered by the last Spending Review). Clearly, some areas have been harder hit than others: while the Department for International Development has enjoyed a 25% increase in its day-to-day budget, the Ministry of Justice and Department for Environment, Food and Rural Affairs (DEFRA) have each seen a reduction of around 40%. Many of the public services that have experienced substantial cuts since 2010 are under increasing pressure and showing clear signs of strain.[7]

Figure 6. Real-terms departmental budget changes, 2010–11 to 2019–20

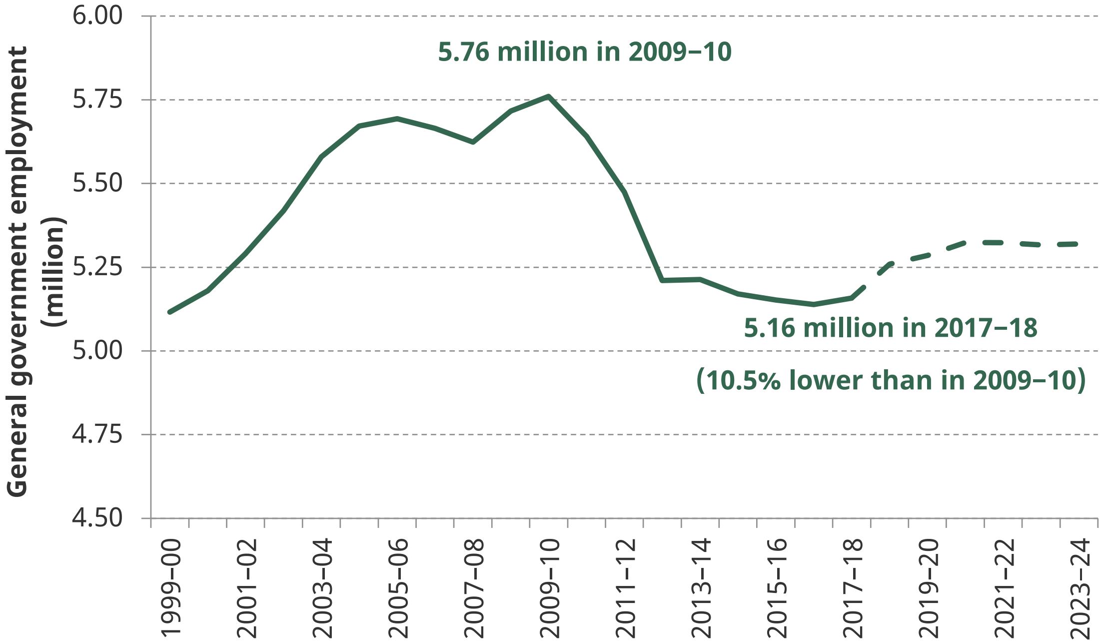


Notes and sources: See end section.

Another consequence of the cuts to departmental spending since 2010 has been a fall in government employment. The number of people employed by general government (i.e. both local and central government) fell by 600,000 between 2009–10 and 2017–18, a reduction of 10.5%, to a level last seen at the turn of the millennium (Figure 7). That number is now forecast to grow between 2017–18 and 2023–24, but will remain far below the level maintained between 2003–04 and 2010–11.

[7] Institute for Government and CIPFA, *Performance Tracker 2018*, https://www.instituteforgovernment.org.uk/publications/performance-tracker-2018.

Figure 7. General government employment since the turn of the millennium

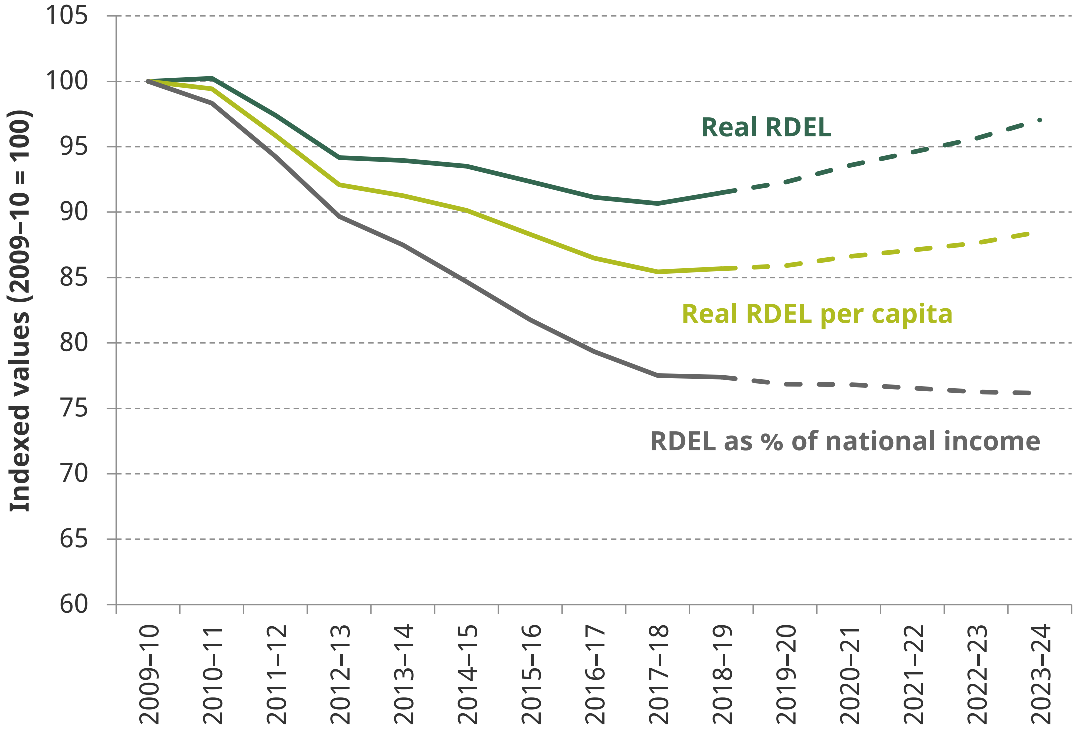


Notes and sources: See end section.

Provisional budget plans imply real increases in day-to-day spending over the next five years, but increases still look modest

At the 2018 Budget, armed with a fiscal windfall from the OBR driven by better-than-expected in-year public finance figures that are expected to persist into future years, the Chancellor chose to revise upwards his plans for public service spending.[8] Rather than continuing on a downward path, RDEL is now set to grow by 6.1% between 2018–19 and 2023–24, outstripping population growth so that per-capita spending is also on an upwards trajectory. But RDEL is still set to grow at a slower rate than the wider economy so will continue to fall as a share of national income (Figure 8).

Figure 8. Forecast change in day-to-day public service spending



Notes and sources: See end section.

Figure 8 also shows that despite the Chancellor's Budget giveaways, day-to-day spending will remain considerably below the level it reached in 2009–10. To return to 2009–10 levels of spending in real terms over the forecast period would require almost £10 billion extra spending in 2023–24; returning to 2009–10 levels in per-capita terms would require £41 billion. This is summarised in Table 1. When looking at spending as a share of national income, a more relevant comparison is 2007–08, prior to the financial crisis and the associated reduction in GDP. To return day-to-day departmental spending to that pre-crisis level as a share of national income would require £54 billion extra spending in 2023–24. Clearly, then, the Chancellor's planned increase in spending will not be enough to reverse the cuts made so far. And to focus on the aggregate level of day-to-day spending ignores how that extra spending will be distributed across departments.

[8] See Institute for Fiscal Studies, Autumn Budget 2018 analysis, https://www.ifs.org.uk/tools_and_resources/budget/526.

Table 1. Resource DEL under Autumn Budget provisional plans

Measure	Notes	Additional annual spending needed to return to 2009–10 level in 2023–24
RDEL	Set to increase by £18.2 billion (6.1%) in real terms between 2018–19 and 2023–24, equivalent to average annual real growth of 1.2%. This compares with average annual real growth of −1.0% over the period from 2009–10 to 2018–19.	£10 billion
RDEL per capita	Projected to grow at a slower rate than overall RDEL due to expected population growth. Set to increase by 3.3% in real terms between 2018–19 and 2023–24 (0.7% per year), but would still be considerably lower than its 2009–10 level.	£41 billion

Notes and sources: See end section.

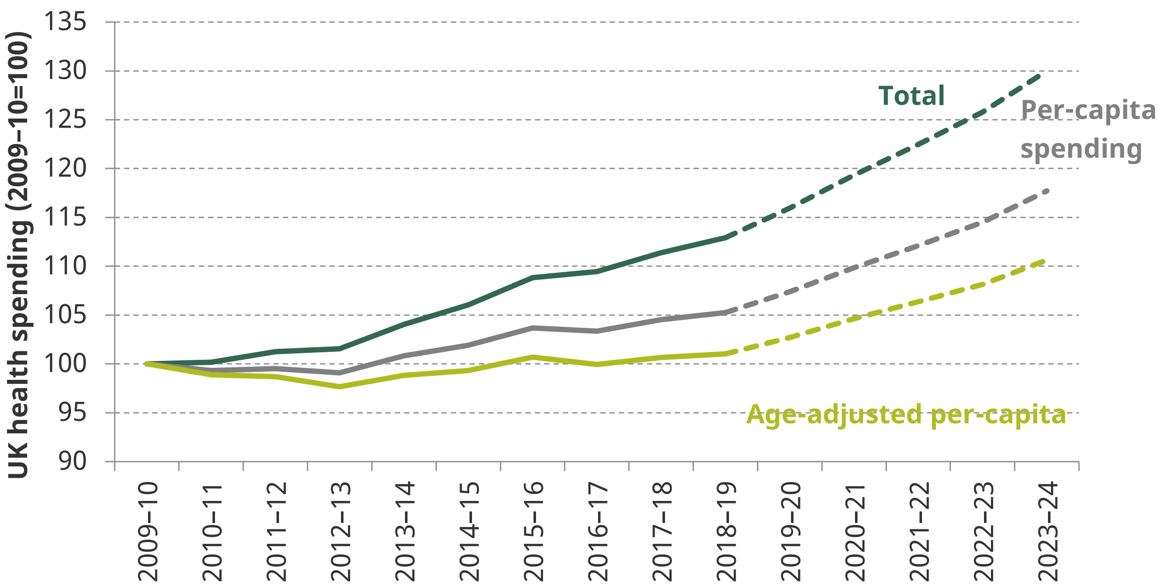
The government has already committed money to the NHS, defence and aid

Just as departments have not equally shared the pain of the cuts, they will not equally share the gains as spending increases. The government has already made a number of large spending commitments prior to the Spending Review – and indeed before setting the overall envelope for the Spending Review. These are:

The NHS: Last June, the Prime Minister promised an extra £20.5 billion in real terms by 2023–24 for front-line services in England alone.[9] Funding for those services will increase at an average real rate of 3.4% over the five years. This applies to the NHS England resource budget only; the capital budget and non-NHS areas such as public health initiatives are not covered, and will have their budgets set at the Spending Review. While increases to these budgets of less than 3.4% a year are perhaps likely, implementing cuts might sit oddly with the announced increases.

Health spending has been relatively protected since 2009–10. But while total spending increased by around 1.4% per year between 2009–10 and 2018–19, population growth meant that spending per person increased by 0.6% per year. And as shown in Figure 9, age-adjusted spending increased by just 0.1% over that period, meaning that spending increases have been almost entirely absorbed by demographic pressures. Going forward, the government's recently announced NHS funding settlement implies that spending growth should outpace both population growth and demographic pressures over the next five years.

Figure 9. Real-terms Department of Health and Social Care spending



Notes and sources: See end section.

[9] 'Prime Minister sets out 5-year NHS funding plan', HM Treasury and DHSC press release, 18 June 2018, https://www.gov.uk/government/news/prime-minister-sets-out-5-year-nhs-funding-plan. Further details of the financial settlement were published alongside the press release at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/717765/nhs-settlement-numbers.pdf.

Defence: The government is committed to continuing to meet the NATO target of spending 2% of national income on defence. For the purposes of our analysis, we assume that the total (i.e. the sum of resource and capital) budgets of the Ministry of Defence (MoD) and the Single Intelligence Account (SIA) increase in line with national income and that the MoD and SIA capital budgets grow in line with overall CDEL.[10]

Overseas aid: The government has a longstanding – and legislated – commitment to meet the United Nations target of spending 0.7% of gross national income on official development assistance (ODA) each year. We assume that the UK continues to meet this target, with spending growing in line with national income. Within the total, we assume that the overall ODA budget has the same capital intensity as the Department for International Development budget and that the ODA capital budget grows in line with overall CDEL.[11]

In total, spending on the NHS, defence and overseas aid amount to £156 billion, more than half of all day-to-day spending. In effect, the government has announced large chunks of spending in advance – and in isolation – without considering it as part of the broader public finances. Ideally, all spending would be considered together, alongside the related issues of how much to raise in taxes and how much can sensibly be financed through borrowing. That is not how the government has proceeded thus far.

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[10] For a more detailed discussion of UK defence spending, see R. Campbell and M. Wheatcroft, 'ICAEW: defence', in C. Emmerson, C. Farquharson and P. Johnson (eds), *The IFS Green Budget: October 2018*, https://www.ifs.org.uk/publications/13508.

[11] For a more detailed discussion of UK aid spending, see A. Baker, S. Crossman, I. Mitchell, Y. Tyskerud and R. Warwick, 'How the UK spends its aid budget', in C. Emmerson, C. Farquharson and P. Johnson (eds), *The IFS Green Budget: October 2018*, https://www.ifs.org.uk/publications/13508.

Current plans imply further cuts for 'unprotected' areas

The scale of the government's commitments across the NHS, defence and overseas aid, together with the spending totals published in the Budget, implies more belt-tightening for all other 'unprotected' areas over the next few years. Indeed even next year (2019–20), which is covered by the existing Spending Review, overall resource DEL is set to grow by £7.9 billion in real terms, of which £5.3 billion is accounted for by additional public service pension contributions,[12] leaving a £2.6 billion increase in departmental spending power. Existing commitments imply that the 'protected' areas (i.e. the NHS, defence and overseas aid) will see their day-to-day budget effectively increase by £3.4 billion next year, meaning that 'unprotected' areas are facing a cut of £0.8 billion.

Looking further ahead to the period (potentially) covered by the next Spending Review, this trend is set to continue. So even as overall RDEL increases by 1.3% per year between 2019–20 and 2023–24, this would not be enough even to cover the NHS commitment in full. . Once we take into account the extra spending needed to meet the government's commitments on defence and overseas aid, the remaining 'unprotected' areas are facing an average annual cut of 0.4% per year. This is summarised in Table 2 and illustrated in Figure 10.

Between 2010–11 and 2018–19, day-to-day spending on roughly these 'unprotected' areas was reduced by around 3% per year.[13] Therefore, while the pace of the cuts may be slowing, for many services an 'end to austerity' is not in sight. That being said, the plans do not imply a significant overall cut to 'unprotected' areas in 2020–21, amounting to only £100 million. A cut of that scale could presumably be easily avoided – and might make a one-year review an attractive prospect for the Chancellor. Although even within this total, some areas of 'unprotected' spending would presumably face budget cuts in order to deliver spending increases to other 'unprotected' areas of spending. And while a shorter Spending Review timetable could be justified by heightened uncertainty, this should not be used as an excuse simply to defer all difficult decisions.

[12] See footnote 6.

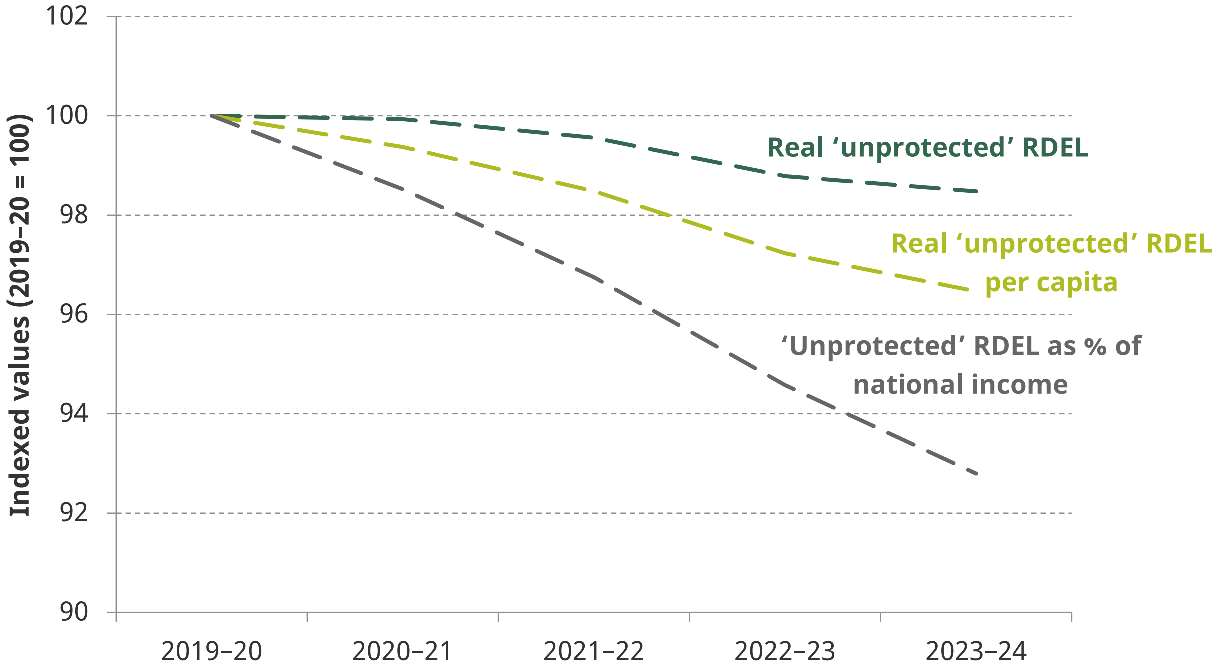
[13] R. Crawford and B. Zaranko, 'Trade-offs for the forthcoming Spending Review', in C. Emmerson, C. Farquharson and P. Johnson (eds), *The IFS Green Budget: October 2018*, https://www.ifs.org.uk/publications/13508.

Table 2. Spending changes implied by Autumn Budget 2018 provisional totals

	2020–21	2021–22	2022–23	2023–24
Panel A: Overall RDEL				
£bn change year-on-year	+4.2	+3.3	+3.5	+4.6
£bn change since 2019–20	+4.2	+7.5	+11.0	+15.6
% change year-on-year	+1.4%	+1.1%	+1.1%	+1.5%
% cumulative change since 2019–20	+1.4%	+2.5%	+3.6%	+5.2%
% average annual change since 2019–20	+1.4%	+1.2%	+1.2%	+1.3%
Panel B: 'Unprotected' RDEL				
£bn change year-on-year	−0.1	−0.5	−1.1	−0.4
£bn change since 2019–20	−0.1	−0.6	−1.7	−2.2
% change year-on-year	−0.1%	−0.4%	−0.8%	−0.3%
% cumulative change since 2019–20	−0.1%	−0.4%	−1.2%	−1.5%
% average annual change since 2019–20	−0.1%	−0.2%	−0.4%	−0.4%

Notes and sources: See end section.

Figure 10. Forecast change in 'unprotected' day-to-day public service spending



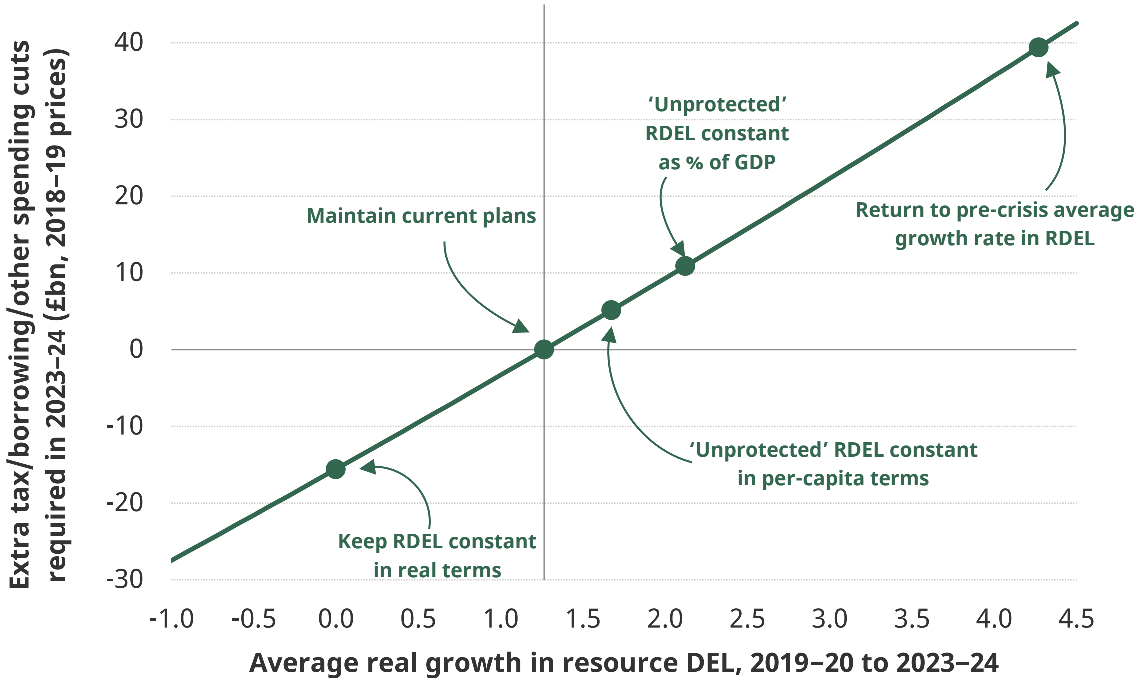
Notes and sources: See end section.

The Chancellor could set the spending envelope above current levels, but on current forecasts that would mean higher taxes, less spending elsewhere or higher borrowing

The overall path for public spending published in the Autumn Budget is not set in stone. Given the pressures on public services and the challenge of imposing further cuts on 'unprotected' areas, the Chancellor may decide to revise upwards his plans for spending. Were a particularly economically harmful Brexit to occur – for example, one that involved significant short-term disruptions – this might also lead to a change in plans (see page 22 for discussion of the issues). In either case, he will need to trade off the level of spending on public services against the level of taxes, borrowing and spending on things such as social security.

Figure 11 illustrates this trade-off for a number of spending scenarios, considering the next four years all together. For instance, holding 'unprotected' RDEL spending constant as a share of national income over this period would mean overall RDEL growing by 2.1% per year, and require additional tax rises, borrowing or spending cuts elsewhere of £11 billion in 2023–24 relative to existing plans. Holding 'unprotected' RDEL constant in real per-capita terms would require an extra £5 billion. And increasing RDEL by 4.3% per year – the average rate of growth before the financial crisis – would require the Chancellor to find an extra £39 billion from elsewhere by 2023–24. In contrast, were he to hold overall RDEL constant in real terms, he could lower taxes or borrowing by around £16 billion relative to what is currently planned – but would need to balance this against the implications for public services.

Figure 11. Trade-offs between real growth in resource DEL and extra borrowing, tax rises or other spending cuts required in 2023–24[a]



[a] All illustrative scenarios assume that economic growth and tax revenues would be unaffected by the decision to make greater or smaller cuts to departments' resource budgets.

Notes and sources: See end section.

All of this is predicated on a smooth Brexit

The analysis so far is based on the October 2018 Budget economic and fiscal forecasts, which are predicated on a smooth and orderly Brexit, but still with receipts forecast to be £15 billion a year lower in the early 2020s than they otherwise would have been as a direct result of Brexit.[14] The impact of Brexit on the economy and the public finances is, to say the least, uncertain. There is agreement among economists that GDP would end up being lower if the UK is outside the EU than it would be had EU membership been maintained and that losses would be greater if the UK also leaves the Single Market and Customs Union.

The government's own assessment[15] suggests that the UK would be poorer outside the EU than if it remained inside. It estimates that if the UK joined the European Economic Area (EEA – meaning the UK would be inside the Single Market but outside the Customs Union), GDP would be between 0.9% and 2.4% lower in 15 years' time (central estimate 1.4%) than if the UK had remained in the EU, with a central estimate that public borrowing would be 0.5% of national income (£11 billion in today's terms) higher as a result. A 'no deal' scenario is projected to lead to GDP being a *further* 6.3% lower in 15 years' time. This assessment suggests the deficit would be a *further* 1.9% of national income higher than in an EEA-style scenario, equivalent to £40 billion in today's terms.[16] Given the size of the projected hits to GDP in these scenarios, these would appear to be relatively benign outcomes for the public finances, and a bigger negative impact would seem possible.

Over the longer term, there would need to be a combination of tax rises and spending cuts to offset any increase in the deficit. Two further years of austerity at the pace seen since 2010 might – very roughly speaking – be sufficient to fill the hole in the public finances that the government study suggests could emerge under a 'no deal' scenario.

Crucially, while there would be advantages in the Chancellor setting out a clear long-term plan for dealing with the fiscal challenges arising from Brexit (alongside those created by other pressures such as the ageing of the population and the likely decline in revenues from fuel duties and vehicle excise duty), it would not be necessary to implement any additional tax rises or spending cuts immediately. Indeed, it would almost certainly make sense to allow the deficit to grow in the short run to help cushion the economy from any short-run costs of a disorderly exit.

Were short-run disruptions to occur, rather than swiftly implementing any new fiscal tightening, the Chancellor might, at the very least, maintain existing spending plans and allow the deficit to rise. He may even wish to consider the case for a temporary giveaway in order to provide additional support through a difficult period and, potentially, to try to limit the long-run damage that short-run disruptions might cause.

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14 Table B.1 in Office for Budget Responsibility, *Economic and Fiscal Outlook, November 2016*, https://obr.uk/efo/economic-and-fiscal-outlook-november-2016/.

15 HM Government, *EU Exit: Long-term economic analysis: November 2018*, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/760484/28_November_EU_Exit_-_Long-term_economic_analysis__1_.pdf.

16 Relative to a 'remain' scenario GDP under a 'no deal' scenario is projected to be between 6.3% and 9.0% smaller in 15 years' time (with a central estimate of 7.7% lower), and government borrowing is projected to be 2.4% of national income higher, equivalent to £50 billion in today's terms.

Absent any discretionary measures, slower economic growth would reduce tax receipts and push up public spending through the operation of the 'automatic stabilisers'. A rough rule of thumb suggests that a 1 percentage point reduction in economic growth would push up the deficit by about 0.7% of GDP, principally because less economic activity means lower tax revenues. In cash terms, this would mean national income being about £20 billion lower, and the deficit about £15 billion greater, than they would otherwise have been.

The case for further fiscal action will depend on the extent to which Brexit affects the supply and demand sides of the economy, and on how monetary policy responds.

The disruption associated with a 'no deal' Brexit would affect the supply side of the economy – for example, by increasing costs for businesses that import and export. But a shock of this nature could also affect demand by reducing both business and consumer confidence.

If Brexit, and in particular a disruptive 'no deal' Brexit, leads to a greater hit to supply than to demand, then inflationary pressures would be more likely to emerge. In such a scenario, a fiscal stimulus aimed at supporting demand – such as a cut in the VAT rate – would not address the underlying structural issues, and thus might not be appropriate in the way that it was back in 2009 in the aftermath of the financial crisis. In contrast, if the drop in demand is greater, then underutilised capacity may be created.

The Bank of England has said that 'The MPC [Monetary Policy Committee] judges that the monetary policy response to EU withdrawal, whatever form EU withdrawal takes, will not be automatic and could be in either direction'.[17] In the case of a substantial negative demand shock, the MPC may decide to reduce interest rates to help cushion the economy. But interest rates are already close to zero, and the MPC may have limited room for manoeuvre. In that case, fiscal policy could play an important role in supporting the UK economy and there may be a strong case for some sort of fiscal stimulus.

Should the Chancellor decide that fiscal policy measures aimed at supporting demand are warranted and appropriate, a key question is then what form those measures should take. As a whole, a well-designed stimulus package would need to be timely, targeted and temporary – timely so that it helps the economy at the right moment; targeted so that it boosts activity where the costs of lost output would otherwise have been greatest; and temporary so that it does not make restoring the long-run health of the public finances harder to achieve.

Under a scenario where the greatest danger is judged to be a loss of consumer confidence, one strategy would be to implement a temporary cut to the main rate of VAT (or to pre-announce a future rise in the VAT rate). This could be expected to stimulate consumer spending in a way that is similar to a cut in interest rates (with consumers being encouraged to make purchases before prices rise). If changes in VAT were fully passed on to consumers through changes in prices, then a 12-month 2½ percentage point reduction

[17] Bank of England, 'EU withdrawal scenarios and monetary and financial stability', https://www.bankofengland.co.uk/report/2018/eu-withdrawal-scenarios-and-monetary-and-financial-stability.

in the main VAT rate could be considered similar in magnitude to a 1 percentage point reduction in the interest rates faced by consumers.

A stimulus package – again, if deemed appropriate – could also include temporary measures aimed at boosting investment. This could be done directly through public investment or through measures aimed at boosting business investment. In fact, the Chancellor has already put both in place. Public sector net investment is forecast to increase by 15% in real terms between 2018–19 and 2019–20. Alongside this, business investment should be boosted (albeit only for a minority of companies) by the temporary increase in the annual investment allowance – which allows companies to deduct 100% of investment immediately against their corporation tax bill – from £200,000 a year to £1 million a year between January 2019 and December 2020. The fact that this measure has already been put in place suggests that the Chancellor is already worried about business investment being subdued during 2019 and 2020 (and is less worried – at least at the moment – about it being subdued after December 2020).

Regardless of the case for a discretionary fiscal stimulus, there may be a case for measures targeted at specific challenges caused by Brexit. Most obviously, additional staff might sensibly be recruited to help mitigate border issues caused by a disorderly Brexit. Similarly, were the numbers out of work to rise significantly, it could be sensible to recruit additional work coaches to DWP's Jobcentres. Departments have already been provided with some additional funding, with over £2 billion allocated in 2019–20, but additional spending – most obviously beyond March 2020 – could well be needed. This year's Spending Review is an obvious opportunity to allocate funding to departments that will be required to perform additional functions post-Brexit.

Short-term dislocations arising from a disorderly Brexit might be likely to have a disproportionate impact on specific parts of the economy – in terms of short-term pain and/or in terms of the likely adverse long-term effects. In this case, the government should consider whether specific measures targeted closely at these parts of the economy – for example, to certain industries or certain locations – could help.

Recent work by IFS researchers suggests that the industries that are most exposed to the risk of trade barriers with the EU being created by a 'no deal' Brexit are: transport equipment; chemicals, pharmaceuticals and refining; and clothing and textiles.[18] So there may be a case for post-Brexit industrial policy to target temporary support at these industries, in order to help them through the adjustment to a new trading environment outside of the EU. This could be either to achieve a (more) managed decline in industries that might be less economically viable once the UK has left the EU, or to prevent particularly costly short-term disruptions having undesirable long-term effects.

In contrast, studies suggest less variation in the impacts of a 'no deal' Brexit across the regions of the UK. One part of the UK that could be particularly adversely affected by an economically bad Brexit would be Northern Ireland (for example, were a 'hard border' to be introduced across the island of Ireland), so consideration could be given to providing additional support to activity there.

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[18] P. Levell and A. Norris Keiller, 'The exposure of different workers to potential trade barriers between the UK and the EU', in C. Emmerson, C. Farquharson and P. Johnson (eds), *The IFS Green Budget: October 2018*, https://www.ifs.org.uk/publications/13463.

What does all of this mean for the forthcoming Spending Review? An economically damaging Brexit would mean that departmental budgets set at some future Spending Review would likely be lower than would otherwise have been the case. But that need not be true at this Spending Review, and indeed there may be good reasons to delay the implementation of any fiscal tightening, and there may even be a case for a timely, targeted and temporary fiscal stimulus package in the short term. We should not expect such a package to impact the Spending Review drastically – the government has already pencilled in substantial increases in capital spending over the next couple of years, while tax policy would be out of scope of the Review. One issue that the Spending Review would need to address in such a scenario would be whether and to what extent the government wished to devote resources to assist with border issues, or to particularly hard-hit sectors or areas to mitigate the most adverse short-term impacts.

Conclusion

This year's Spending Review will allocate funding to departments for the 2020−21 financial year, and possibly beyond. The Chancellor's decisions will come on the back of almost a decade of spending cuts. Borrowing is now back to pre-crisis levels, but debt is 50% of national income higher than it was a decade ago.

Despite the Chancellor's previous promise to set an overall spending envelope, we do not yet know how much the government plans to spend overall. Despite this, the government has made a number of large spending commitments in advance of the Spending Review, covering the NHS, defence and aid. For remaining 'unprotected' areas – which now only amount to around one-fifth of all public spending – the settlements announced in the Spending Review will be important for the planning and delivery of public services. A longer review period – of, say, three years – would aid departments' ability to plan effectively. But this Spending Review will be conducted amidst greater uncertainty than usual, which might lend itself to a shorter, perhaps even one-year, review period.

The provisional totals set out in the Autumn Budget imply that day-to-day public service spending will increase by 6.1% (£18.2 billion) between 2018−19 and 2023−24. This would outstrip population growth, putting per-capita spending on an upward trend. But this would not be enough to meet the cost of the government's existing spending commitments on the NHS, defence and overseas aid while avoiding cuts elsewhere. Other 'unprotected' areas are therefore, on current plans, facing further budget cuts of around 0.4% per year in real terms between 2019−20 and 2023−24, and cuts of 0.9% per year in per-capita spending. This would slow the pace of the cuts experienced by those areas since 2010, but would by no means represent an 'end to austerity'.

Uncertainty surrounding the nature of the UK's withdrawal from the EU means that the forecasts on which the Chancellor's current policy is based could change significantly. A disorderly Brexit on 29 March would be likely to reduce economic growth both in the short and long term, though the magnitude of any effect is extremely uncertain. However, this would not necessarily lead to a radically different Spending Review this year. While spending limits would need to be tighter at some point in the future if economic growth is lower, if anything spending may be slightly higher in the short term to help deal with border issues and to mitigate the worst impacts of a 'no-deal' scenario on particular sectors and areas.

Notes and sources

Figure 1a

Note: Dotted lines show forecasts on the basis of October 2018 provisional spending plans.

Source: OBR Public Finances Databank, January 2019 and December 2018 GDP deflators, https://www.gov.uk/government/statistics/gdp-deflators-at-market-prices-and-money-gdp-december-2018-quarterly-national-accounts.

Figure 1b

Source: Authors' calculations based on various HM Treasury Public Expenditure Statistical Analyses, UK National Accounts, OBR Public Finances Databank and DWP Benefit Expenditure Tables, Autumn Budget 2018.

Figures 2a and 2b

Note: 'Total managed expenditure' is total government spending. 'Current expenditure' excludes spending on investment, while 'current receipts' encompasses total government revenue (from tax and non-tax sources). Public sector net borrowing is the difference between total managed expenditure and current receipts, while the current deficit is the difference between current expenditure and receipts.

Source: Office for Budget Responsibility, Public Finances Databank, January 2019, http://budgetresponsibility.org.uk/data/.

Figure 2c

Source: Public sector net debt from Office for Budget Responsibility, Public Finances Databank, January 2019, http://budgetresponsibility.org.uk/data/; chart 4.16 of Office for Budget Responsibility, *Economic and Fiscal Outlook, October 2018*, https://obr.uk/efo/economic-fiscal-outlook-october-2018/. Gross debt interest ONS series JW2P, with forecasts from supplementary fiscal table 2.41 of the OBR's October 2018 Economic and Fiscal Outlook.

Figure 3

Note: All £ billion figures are expressed in nominal terms. Other components of AME include, for example, net public service pension payments, spending by the BBC and public corporations, current VAT refunds and expenditure transfers to EU institutions.

Source: Authors' calculations using table 4.18 of the OBR's October 2018 Economic and Fiscal Outlook, with the pensioner/non-pensioner split calculated based on DWP Benefit Expenditure Tables, Autumn Budget 2018.

Figure 4

Note: DEL figures for 2019–20 onwards have been adjusted to remove the impact of the change in employer contribution rates to public service pension schemes – see footnote 6.

Source: Authors' calculations using the OBR's October 2018 Economic and Fiscal Outlook (pension adjustments based on table A.1), HM Treasury's Public Expenditure Statistical Analyses (various) and December 2018 GDP deflators.

Figure 5

Note: Resource DEL figures for 2019–20 onwards have been adjusted for changes in public service pension contributions – see footnote 6.

Source: Authors' calculations using the OBR's October 2018 Economic and Fiscal Outlook, HM Treasury's Public Expenditure Statistical Analyses (various) and December 2018 GDP deflators.

Figure 6

Note: Resource budgets here exclude depreciation. Figures for 2019–20 have been adjusted for additional spending announced by the Chancellor in the 2018 Autumn Budget.

Source: Authors' calculations using HM Treasury's Public Expenditure Statistical Analyses (various), Autumn Budget 2018 and December 2018 GDP deflators.

Figure 7

Source: Out-turns for last financial quarter of year taken from ONS series G6NW, with forecasts taken from Office for Budget Responsibility, *Economic and Fiscal Outlook, October 2018*, supplementary economy table 1.12.

Figure 8, Table 1

Note: RDEL refers to public sector current expenditure in resource departmental expenditure limits (PSCE in RDEL). Figures for 2019–20 onwards have been adjusted for changes in public service pension contributions – see footnote 6.

Source: Authors' calculations using Office for Budget Responsibility, *Economic and Fiscal Outlook, October 2018*, with population projections from supplementary fiscal table 2.17 in the OBR's October 2018 Economic and Fiscal Outlook, and December 2018 GDP deflators.

Figure 9

Note: Future projections based on spending plans for England (NHS England RDEL plans and an assumed real freeze in other DHSC spending). Real spending refers to 2018–19 prices. Plans exclude additional spending on NHS pensions.

Source: Authors' calculations using DHSC spending from HM Treasury, Public Expenditure Statistical Analyses, July 2018, ONS mid-year population estimates and population projections, and age spending weights from the Office for Budget Responsibility, *Fiscal Sustainability Report, January 2017*.

Figure 10, Table 2

Note: All figures are adjusted for changes in employer contributions to public service pension schemes. 'Unprotected' RDEL is calculated on the basis of assumptions outlined in the text. All figures in Table 2 are expressed in 2018–19 prices using December 2018 GDP deflators.

Source: Authors' calculations using Office for Budget Responsibility, *Economic and Fiscal Outlook, October 2018* and HM Treasury, Public Expenditure Statistical Analyses, July 2018.

Figure 11

Note: Any extra spending in 2023–24 is relative to the projections published in the OBR's Autumn 2018 Economic and Fiscal Outlook. The growth rate is calculated for resource DEL (as measured by PSCE in RDEL) against the 2019–20 baseline published in the Economic and Fiscal Outlook. The pre-crisis growth rate is calculated as the average annual real rate of growth in PSCE in RDEL between 1998–99 and 2009–10. 'Unprotected' RDEL is calculated on the basis of assumptions outlined in the text. All figures are adjusted for changes to employer contributions to public service pension schemes.

Source: Authors' calculations using Office for Budget Responsibility, *Economic and Fiscal Outlook, October 2018*, with population projections from supplementary fiscal table 2.17 in the OBR's October 2018 Economic and Fiscal Outlook.