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What does the changing economic outlook mean for the Spending Review?

UKRI Economic and Social Research Council

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Executive summary

As lockdowns are lifted and more economic activity is resumed, the extent, speed and nature of the UK's economic recovery from the pandemic will be a crucial determinant of the Chancellor's options at the upcoming Spending Review, expected this autumn. Recent data releases and independent forecasts have painted a more optimistic picture for the economic recovery in the near term than previous forecasts had suggested. In line with this, Citi's latest economic forecast suggests that growth in both real and nominal terms will be higher this year than official forecasts expected at the Budget in March.

However, while the short-term economic picture has improved, the medium-term outlook contains much less good news, as the pandemic is still expected to have done permanent damage to the economy.

The near-term improvement and permanent cost will be reflected in the government's fiscal position. The current budget deficit – the difference between what the government spends on day-to-day activities and what it raises in revenues – is, under our forecast, improved by £30 billion for 2021−22, relative to the forecast back in March. However, rising debt interest spending and the fading-out of the temporary boost to growth do not open up any additional headroom by the middle of the decade.

What might this mean for the Spending Review? The improvement in the near-term outlook means that if the Chancellor wants to keep within the path for borrowing set out in the March Budget, he could afford a sizeable short-term giveaway. That would likely include further temporary support for the public services put under considerable strain by the pandemic.

But his room for manoeuvre in the medium term is far more limited. The government's existing spending plans imply cuts to some departments, and still make no allowance for additional virus-related spending. Sticking to those plans would mean spending up to £17 billion less on public services per year than what was planned prior to the pandemic, despite rising costs and rising demands. The

Chancellor is facing a cacophony of calls for additional spending – ranging from catch-up funding for the NHS and schools, to more money for local government and the justice system, and demands for a substantial public sector pay rise and an extension to the universal credit uplift. The Office for Budget Responsibility (OBR) estimates that meeting the pressures on just three areas – the NHS, schools and public transport – could require around £10 billion of additional spending per year for each of the next three years. Meeting even a subset of these numerous demands would – without also raising taxes further – likely mean borrowing substantially more than was planned pre-pandemic, and most likely missing the Chancellor's target for current budget balance over the medium term.

Key findings

1 **An improvement in the near-term economic outlook is likely.** Under Citi's latest forecast, we expect higher growth (and consequently higher tax revenues) to reduce borrowing this year (2021−22) by £30 billion, compared with the official forecast at the Budget in March. Nevertheless, this would still leave borrowing at 9.3% of national income, a value which has only been exceeded twice since the Second World War – last year, and during the financial crisis in 2009−10.

2 **While the short-term economic picture has improved, the medium-term outlook contains much less good news.** Under Citi's forecast, the recovery is faster, but not more complete, due to permanent economic damage done by the pandemic. **By the middle of the decade, the cash size of the economy is expected by Citi to be 3% smaller than official pre-COVID forecasts.**

3 **In the medium term, this would leave no headroom against the Chancellor's stated target of current budget balance** – borrowing only to invest, not to fund day-to-day spending. Despite stronger near-term growth under the latest forecasts, in 2024−25 and 2025−26 we expect the current budget to be approximately in balance: essentially unchanged from the forecast in the March Budget. These forecasts

are predicated on large income tax and corporation tax rises and a tight set of departmental spending plans.

4 **The Chancellor could afford a sizeable short-term giveaway** while staying within the path for borrowing set out in the March Budget. **But his room for manoeuvre in the medium term is much more limited**, leaving little-to-no space for permanent giveaways.

5 This sets the scene for a tricky Spending Review later this year. **The government's existing spending plans imply cuts to some departments, and make no allowance for additional virus-related spending**: some top-ups seem inevitable. But a permanent addition to those plans would – unless accompanied by another round of tax rises – on our forecasts mean higher levels of borrowing, and missing the Chancellor's fiscal targets.

6 The economic and fiscal outlook is highly uncertain, and the Office for Budget Responsibility may take a more optimistic view. But **given the scale and range of calls for additional spending, any fiscal wiggle room granted by improvements in OBR forecasts will not be enough to meet the many demands on the Treasury purse**.

1. Introduction

COVID-19 has caused huge short-term economic disruption and dislocation. It is also expected to cause some amount of permanent economic damage, or 'scarring'. Most forecasters – including the Office for Budget Responsibility (OBR), whose forecasts underpin the government's tax and spending plans – expect the productive potential of the UK economy to be permanently reduced as a result of the pandemic. This could arise because workers who lost their jobs during the pandemic are less productive in a new job (or even a new sector) in which their specific experience is less valuable, or because firms that delayed investment decisions during the uncertainty of the pandemic never fully make up for them. Further damage to the economy could be done by the substantial loss of in-person teaching for prolonged periods within the education sector. It will also take the economy time to adjust to any permanent changes in working and spending patterns created by the pandemic. The OBR's March 2021 central forecast included an assumption of 3% medium-term scarring (i.e. the economy will in real terms be 3% smaller in 2025 than it was expected to be pre-pandemic).

Yet there is huge uncertainty around this. The OBR has also produced a pessimistic scenario in which the economy ends up 6% smaller over the medium term, and an optimistic scenario in which the economy fully recovers and the pandemic (and associated lockdowns) do no permanent economic damage. Unfortunately, this optimistic scenario is extremely unlikely to emerge.

The extent, speed and nature of the UK's economic recovery from the pandemic will have important ramifications for the public finances – and in turn for the Spending Review due to be held this autumn. The Chancellor is facing myriad demands for additional spending, not least on the public services put under huge pressure by the pandemic. Yet his existing spending plans imply cuts for some areas after this year.

A sustained improvement in the economic and fiscal outlook might allow him to top up his spending plans without having to resort to further tax rises or higher levels of borrowing than were planned at the time of the March 2021 Budget. But such an improvement, which at the present time does look possible, still would not provide a windfall on the scale necessary to meet all of the demands being placed before the Chancellor. And alongside this he will also need to be mindful that the borrowing done since March 2021 has elevated the stock of government debt, and the way in which this has been financed means that increases in interest rates would quickly, and could sharply, push up debt interest spending.

His room for manoeuvre in the medium term is therefore going to be extremely limited. In other words, the government's current spending plans imply some cuts, but the demands and aspirations for additional spending would (unless tax rises were implemented at the same time) very likely lead to borrowing persisting substantially above that planned prior to the pandemic and could put the public finances on course to miss the Chancellor's stated aim of balancing the current budget.

In this briefing note – which launches the 2021 IFS Green Budget, in association with Citi and funded by the Nuffield Foundation – we analyse the changing outlook for growth and borrowing since the March 2021 Budget, and consider what it might mean for the Spending Review that is expected this autumn. Further analysis will follow in the complete Green Budget volume.

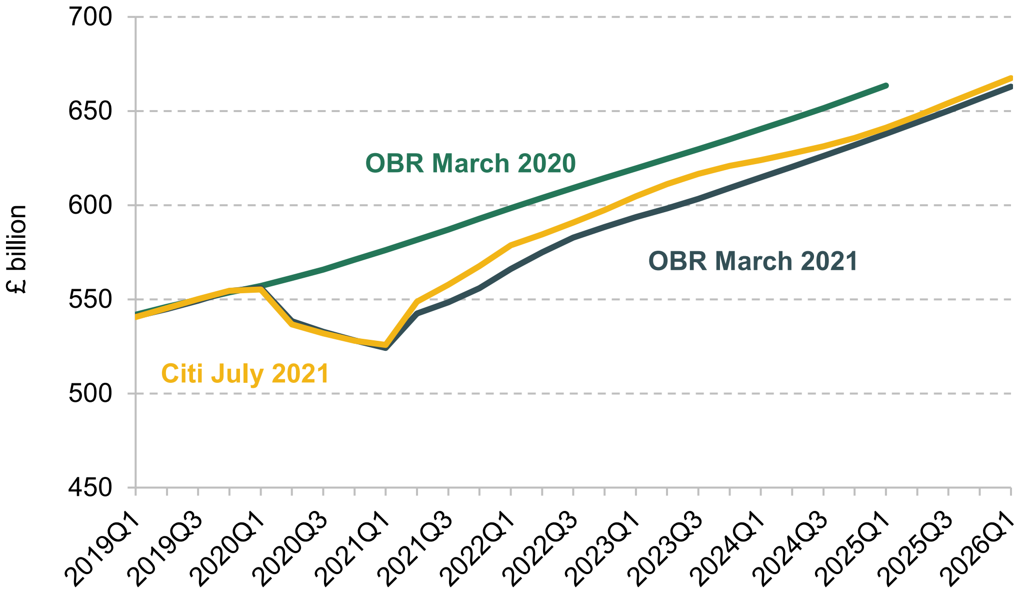
2. An improved outlook for economic growth – but will it persist?

The successful roll-out of the coronavirus vaccine, a strong recovery in consumer spending during the recent easing of lockdown, and some signs of recovery in the labour market have led many forecasters to revise their growth forecasts for the short term. Citi's recent forecast, which underpins the public finance forecast in this briefing note, suggests that in nominal terms the economy was approaching – and may even have reached – its pre-pandemic size in the second quarter of 2021.

While the economy may have already returned to its pre-pandemic *size*, it remains some way below the *growth path* expected pre-pandemic. The Citi forecast suggests this will continue to be the case, with the boost to growth in recent months proving temporary and fading out by the middle of the decade. This is shown in Figure 2.1 and Table 2.1, which compare forecasts for the cash size of the economy (which is a key determinant of the outlook for government revenues).

Stripping out inflation and focusing on growth in real output (as done in Table 2.2) also presents a picture of stronger growth in the short term – an additional percentage point this year compared with the OBR's forecast at last March's Budget, which in normal times would be a very large improvement over such a short time. However, while this is a change in the expected speed of the recovery, it is not a change in its expected completeness. Over the whole period from 2020–21 until 2025–26, real-terms growth is no higher in this new forecast than in the official forecasts at the March Budget.

Figure 2.1. Forecasts for quarterly national income (nominal terms)



Note: Four-quarter rolling averages are shown.

Source: OBR's Economic and Fiscal Outlook, March 2020 and March 2021; Citi forecasts.

Table 2.1. Forecasts for nominal GDP growth

	Forecast growth rate in nominal GDP (%)	
	OBR March 2021	Citi July 2021
2020−21	–5.7	–5.3
2021−22	8.0	10.1
2022−23	4.9	4.5
2023−24	3.5	3.2
2024−25	3.8	2.8
2025−26	3.9	4.1

Source: OBR's Economic and Fiscal Outlook, March 2020 and March 2021; Citi forecasts.

Table 2.2. Forecasts for real GDP growth

	Forecast growth rate in real GDP (%)		
	OBR March 2021	Citi July 2021	BoE May 2021
2020−21	–11.5	–10.9	–10.8
2021−22	9.5	10.5	12.1
2022−23	5.0	3.1	3.3
2023−24	1.5	1.9	1.3
2024−25	1.6	1.3	-
2025−26	1.7	1.6	-

Source: OBR's Economic and Fiscal Outlook, March 2021; Citi forecasts; Bank of England's Monetary Policy Report, May 2021.

3. Implications for borrowing

Changing forecasts for borrowing

A larger economy translates into higher tax receipts. The monthly out-turn data have been showing rapidly recovering revenues, which – as recorded in provisional data – were higher in May 2021 than in May 2019. Our forecast is that revenues over the whole of this financial year (2021−22) will be £856 billion, which would be £37 billion higher than in the OBR's Budget forecast (of £819 billion) in March (Table 3.1). It should be stressed that there remains a huge amount of uncertainty around this forecast; the Green Budget in October will set out forecasts for the public finances under different scenarios for public finances, and the actual Budget expected later in the year will also have the advantage of more information on the paths of the pandemic and the economy and the strength of revenues.

Since taxes are levied on nominal incomes, the nominal size of the economy matters more than its real size for the public finances – especially with the Chancellor having announced that the income tax personal allowance and higher-rate thresholds are to be frozen up to and including 2025−26. Were inflation to turn out 1 percentage point higher than expected, this would lead to the cash freeze in the personal allowance and higher-rate threshold raising an additional £1.1 billion a year. But higher inflation is not unambiguously good news for the Chancellor: the Citi forecast predicts a higher rate of RPI inflation, which would increase the interest due on index-linked government bonds.

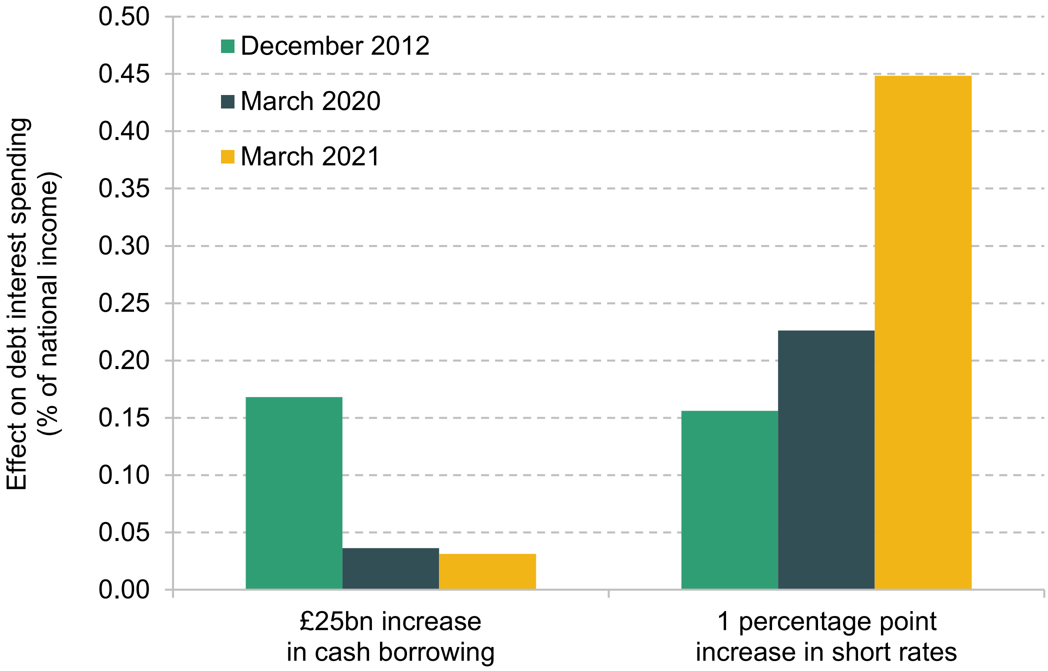
Table 3.1. Forecasts for receipts

	Public sector current receipts (£bn)		
	OBR March 2020	OBR March 2021	Citi July 2021
2019−20	839	828	829
2020−21	873	786	795
2021−22	911	819	856
2022−23	949	885	911
2023−24	985	945	974
2024−25	1,022	994	1,014

Note: Figures are rounded to the nearest billion.

Source: OBR's Economic and Fiscal Outlook, March 2020 and March 2021; Citi forecasts.

Figure 3.1. Sensitivity of debt interest spending to rate rises



Note: Impacts in last forecast year are shown.

Source: OBR's Economic and Fiscal Outlook, November 2020 and March 2021.

In addition, interest rates on government bonds have been rising since the start of the year. This at least partly reflects expectations of a faster recovery and rises in Bank Rate from its current ultra-low level, as investors expect the Bank of England to transition from emergency support for the economy to a less unusual mode of operations. This is good news in principle, but in the current situation, where debt has (for good reasons) been substantially increased and quantitative easing reduces the time it takes for increases in Bank Rate to feed through to debt interest spending, it does come at a non-trivial cost in terms of higher debt interest spending (Figure 3.1).

Nevertheless, the recent increase in interest rates, inflation and higher stock of debt might be expected to increase this year's debt interest spending by perhaps £4 billion relative to its pre-pandemic level, or £17 billion relative to the OBR's forecast in March. Despite this, it is important to remember that the increase in debt interest spending is far, far outweighed by higher revenues thanks to stronger growth with which the increased debt interest servicing costs are associated.

But if, as the Citi forecast suggests, there is little additional 'catch-up' growth towards the pre-pandemic path after this year, then higher interest rates would subsequently become more burdensome for the public finances.

An additional contributing factor to a potential improvement in the borrowing figures is the extent of departmental underspending. Departments underspent by some £34 billion in 2020−21, and provisional data suggest that government spending is coming in lower than expected this year. Our forecast assumes a further £10 billion of underspending (which could arise if, for example, the Treasury does not allocate the entirety of its £55 billion 'COVID-19 Reserve').

The outlook for borrowing in 2021–22 has thus improved (see Table 3.2). At least to some extent, this is likely to feed into future years – though the extent to which this is the case is less certain.

Table 3.2. Forecasts for borrowing

	Public sector net borrowing (£bn)			Current deficit (£bn)		
	OBR Mar 20	OBR Mar 21	Citi July 21	OBR Mar 20	OBR Mar 21	Citi July 21
2019−20	47	57	57	–2	14	14
2020−21	55	355	326	–5	279	244
2021−22	67	234	203	–3	172	141
2022−23	61	107	100	–12	40	33
2023−24	60	85	72	–17	15	2
2024−25	58	74	70	–21	3	–1
2025−26	-	74	66	-	1	–7

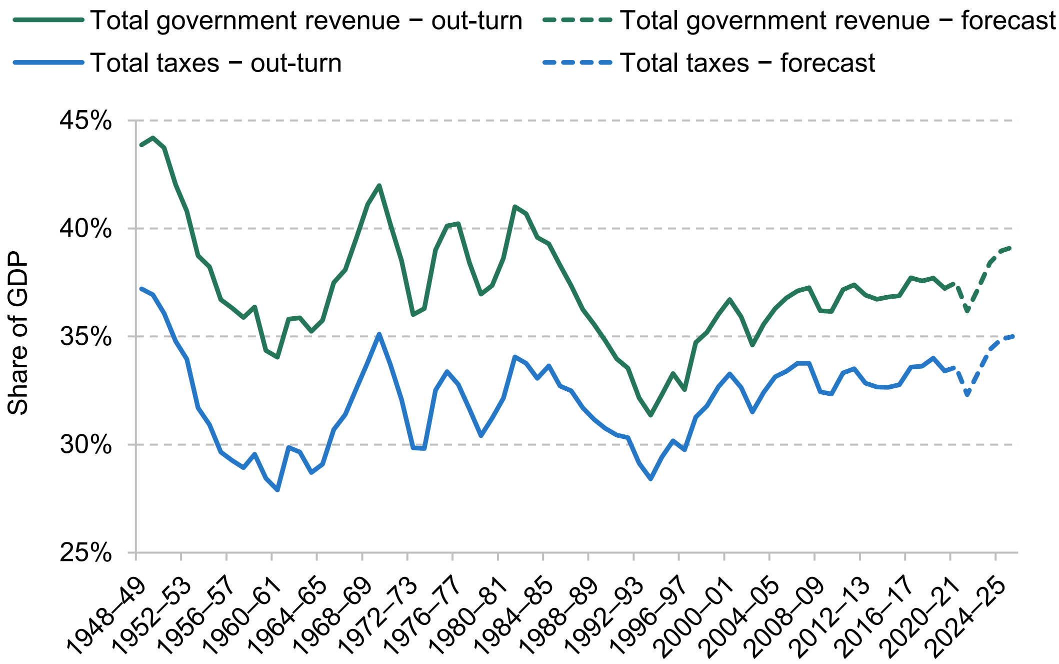
Note: Figures are rounded to the nearest billion.

Source: OBR's Economic and Fiscal Outlook, March 2020 and March 2021; Citi forecasts.

These forecasts are underpinned by future tax rises and a tight set of spending plans

In the March 2021 Budget, the Chancellor's tax and spending plans were set to deliver current budget balance by 2025–26, but only just. Importantly, those plans were predicated on a number of substantial tax rises; in fact, the March 2021 Budget was the biggest tax-raising Budget since Lord Lamont's Spring Budget of 1993. An increase in the main rate of corporation tax from 19% to 25% is expected by the government to raise around £17 billion by 2025−26. And on income tax, a four-year cash freeze in both the personal allowance and the higher-rate threshold is expected to raise £8 billion by 2025−26. The overall tax take is set to increase to its highest sustained level since 1950 (Figure 3.2).

Figure 3.2. UK government revenue over time



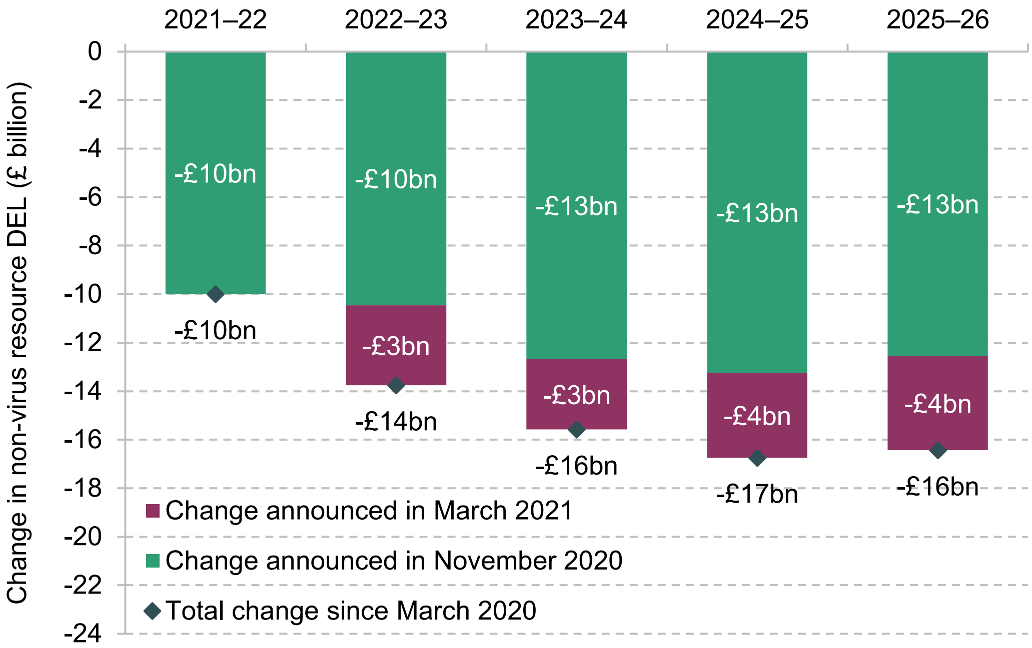
Note: Total government revenue includes all tax revenue and non-tax income, including income from public corporations and interest income.

Source: IFS Taxlab, revenue composition spreadsheet, https://ifs.org.uk/taxlab/data-item/ifs-revenue-composition-spreadsheet; OBR's Public Finances Databank.

In addition, Mr Sunak has cut back his plans for spending on day-to-day public services from April 2022 onwards by between £14 and £17 billion each year relative to what was planned pre-pandemic (Figure 3.3). So, despite the various pressures created by the pandemic, the Chancellor seems to be planning to spend up to £17 billion *less* on public services than was planned pre-pandemic. Under those plans, overall day-to-day spending is set to rise by 2.1% per year in real terms, but these increases would be more than swallowed up by commitments already made to the NHS, schools, defence and overseas aid. As a result, some 'unprotected' budgets would be facing a real-terms cut of around 3% between this year and next.[1]

[1] Zaranko, B. (2021), 'The Chancellor's spending plans are even tighter than they seem', https://ifs.org.uk/publications/15365.

Figure 3.3. Changes to non-virus resource budgets since March 2020

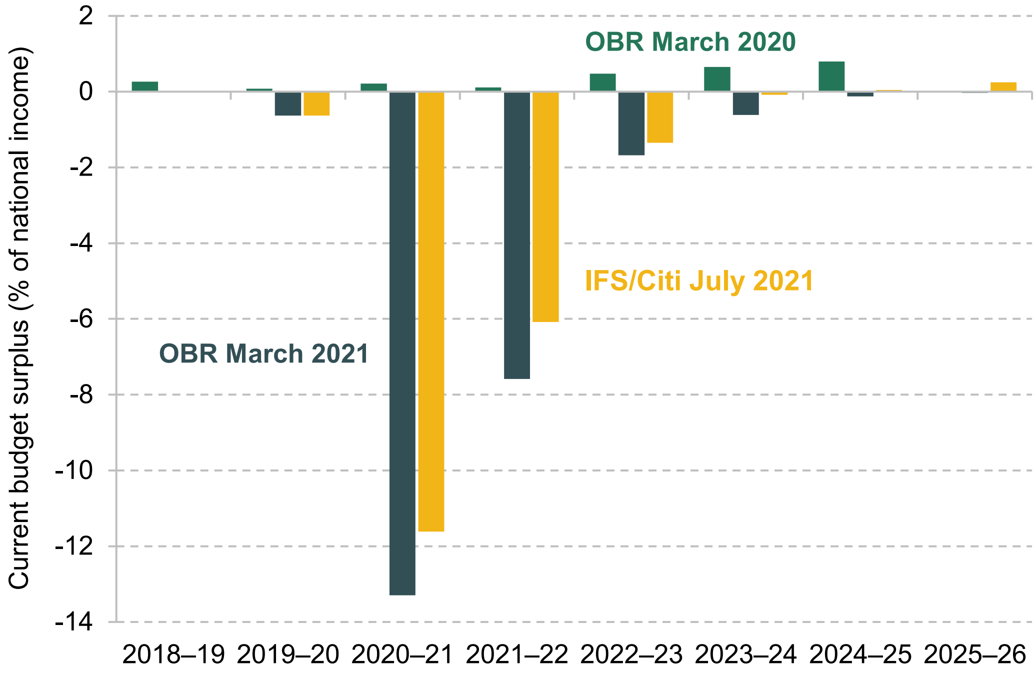


Note: Figures may not sum due to rounding.

Source: Authors' calculations using OBR's Economic and Fiscal Outlook, November 2020 and March 2021.

On the basis of Citi's latest growth forecasts, and assuming that those tax and spending plans do not change, Mr Sunak is now set to achieve current budget balance, running a current budget surplus of around £1 billion in 2024−25 and £7 billion in 2025−26. That is not far from the current deficit figures of around £3 billion and £1 billion (for 2024−25 and 2025−26, respectively) forecast in the OBR's March 2021 Economic and Fiscal Outlook (Table 3.2 and Figure 3.4). These figures are, of course, subject to huge uncertainty. But our central estimate is that the medium-term outlook is largely unchanged: the Chancellor is set to borrow an amount in 2025−26 not dissimilar to what was forecast in March, and – despite cutting spending plans and increasing taxes – slightly more than was forecast pre-pandemic.

Figure 3.4. Forecasts for the current budget surplus



Note: Assumes an exceptional £10 billion underspend on current spending in the financial year 2021–22, partly due to the £55 billion 'COVID Reserve' being only partially drawn down.

Source: Authors' calculations using Citi forecast.

4. What does this mean for the Spending Review?

Higher spending in the near term likely

As discussed above, an improvement in the short-term economic outlook should mean a downwards revision to borrowing in this year. On the basis of Citi's latest forecast, borrowing in 2021−22 could come in around £30 billion lower than was forecast in March 2021. If the Chancellor wants to keep within the path for borrowing set out in March, he can afford a sizeable short-term giveaway.

But it is far from clear that he has much – if any – more room for manoeuvre in the medium term. Any 'windfall' may prove to be largely short-lived. The short-term economic outlook has improved, owing in part to the UK's successful vaccine roll-out, but the medium-term outlook is not necessarily rosier. Under Citi's latest forecast, the UK economy is still set to be around 3% smaller (in cash terms) in 2025 than was forecast by the OBR pre-pandemic. As a result, under that forecast, the Chancellor would be granted virtually no additional headroom against his target for medium-term current budget balance.

The OBR may take a different, and perhaps more optimistic, view. The degree of uncertainty is substantial and different forecasters will make different judgements over the medium-term outlook. But the headline is this: the additional fiscal wiggle room granted to the Chancellor in the medium term is likely to be far less than he is granted in the short term.

The starting point for the Chancellor is a tight set of spending plans that make no allowance for any virus-related spending after April 2022. For the 2021−22 financial year, the Chancellor set aside £55 billion for a COVID-19 Reserve. Following the March 2021 Budget, £36.2 billion of this had been allocated, with a further £7 billion allocated to the NHS and social care in late March, leaving approximately £12 billion for the rest of this year (though it is possible some of this has already been allocated in recent months). For future years, though, no such Reserve exists. Departments' non-virus resource (or day-to-day) budgets are set to grow by 2.1% per year in real terms over the next four years. As discussed above, these plans imply spending up to £17 billion less each year than was planned pre-pandemic. They also imply cuts for some departments next year, as the increases are more than swallowed up by planned increases for priority areas such as the NHS and schools.

Given all of that, how might the Chancellor respond?

In the near term, a clear and pressing demand is for additional funding to support public services' recovery from the pandemic. For the year in progress (2021−22), much could potentially be met from the government's £55 billion COVID-19 Reserve, or from the 'windfall' handed to the Chancellor by stronger growth in recent months. An announcement of additional short-term support seems nearly certain.

But beyond this year, the government has made no allowance for additional virus-related spending. Additional funds will have to be found from somewhere if there is to be any such spending. There is no Reserve set aside in future years that the Chancellor can dip into. And the medium-term outlook for borrowing looks largely unchanged, meaning no 'windfall' that can be spent.

The key challenge for the Chancellor is that many of the demands for additional spending are much broader than for temporary COVID catch-up, and would extend far beyond this year. Indeed, some of the demands would represent a permanent increase in the size of the state, which ought to be financed from corresponding increases in taxes or cuts to spending elsewhere. We discuss some of these demands for additional spending below.

A non-exhaustive shopping list

NHS catch-up

The Chancellor will not be short of demands for additional funding, but the NHS will surely be top of the list. The continuation of the Test and Trace programme, the ongoing vaccination programme, the costs of adapting to social distancing and infection measures, and dealing with the growing backlog for non-virus-related care will all come with a big price tag. The OBR estimates that meeting these pressures could require an additional £7 billion of spending in each of the next three years (on top of existing plans).[2] This would come before any costs associated with 'long COVID', before the costs of a pay rise for NHS staff (discussed below) and before any permanent increase in spending on public health and pandemic prevention. The IFS Green Budget will examine these pressures in more detail.

Schools catch-up

Another high-profile and potentially big-ticket item on the list is schools. Following the resignation of Sir Kevan Collins, the government's 'Education Recovery Commissioner', over the size of the proposed catch-up package, the government hinted that more money could be on the way. The OBR estimates that a catch-up package for schools could amount to around £1 billion per year for each of the next three years, but there will undoubtedly be calls for greater sums still: the OBR estimate would fall short of the £15 billion sought by Sir Kevan, for example. Previous analysis at IFS has suggested that a truly temporary catch-up programme to help students recover from lost learning could, if done well, produce substantial economic returns and, over the long term, potentially more than pay for itself.[3] The challenge would be ensuring that any programme is implemented well and, for the Treasury, ensuring that it is in fact temporary rather than permanent (an issue to which we return below).

Local government

Previous analysis from IFS researchers suggests that across English councils as a whole, government support largely met pandemic-related pressures in 2020−21, and looked like it may also be sufficient to meet the pressures in 2021−22.[4] However, from April 2022 onwards, problems loom. In particular, poorer areas face especially large increases in spending needs from the crisis, but are less able to raise additional local revenue. Central government support – potentially running into the billions –

[2] Office for Budget Responsibility (2021), 'Fiscal risks report – July 2021', https://obr.uk/frr/fiscal-risks-report-july-2021/.

[3] Sibieta, L. (2021), 'The crisis in lost learning calls for a massive national policy response', https://ifs.org.uk/publications/15291.

[4] Ogden, K. and Phillips, D. (2021), 'The government has addressed most of the short-term COVID-19 financial pressures facing English councils, but problems loom in 2022–23 and beyond', https://ifs.org.uk/publications/15371.

could be required to meet those additional pressures. Yet as it stands, grants to local government are among the ‘unprotected’ areas facing a real-terms budget cut in 2022−23.

Public transport operators

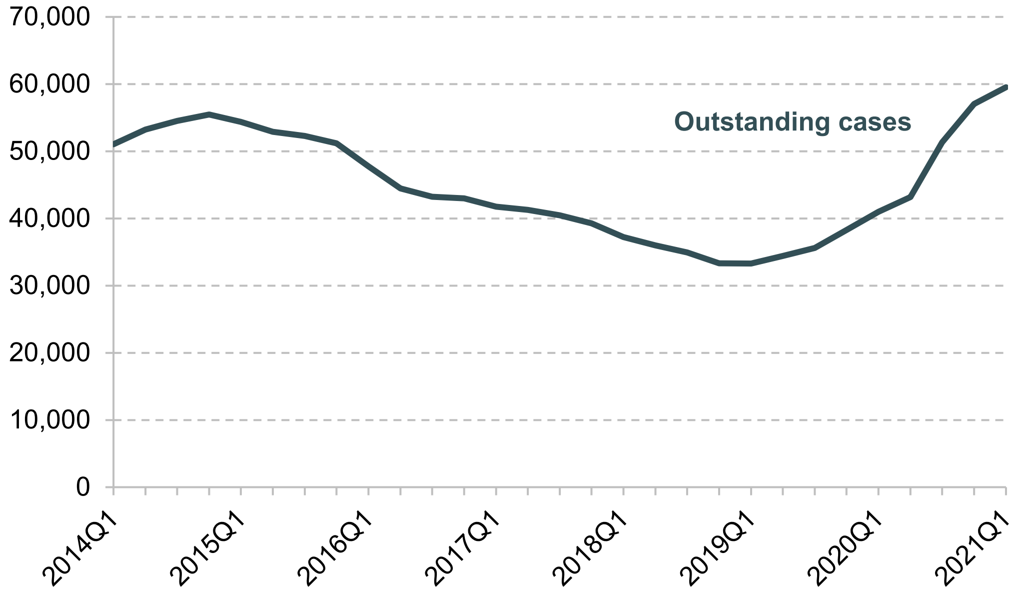
Sharp reductions in passenger numbers during the pandemic have posed severe financial difficulties for railways and public transport operators. The government has extended billions of support to the railways and to Transport for London; the OBR estimates that a further £3 billion of support could be required in 2022−23, falling to £1.2 billion by 2024−25. A great deal depends on future patterns of working and commuting – which are, of course, highly uncertain.

Justice system

The closure of courtrooms during the COVID-19 lockdowns has led to sharp increases in waiting times within the justice system. The 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, and above the previous peak in the fourth quarter of 2014 (Figure 4.1). Previous work from the Institute for Government suggests that these raw figures understate the scale of the problem, owing to the increased complexity of outstanding cases.[5] Ongoing financial support may be required to deal with the backlog, perhaps running into the hundreds of millions each year. On the basis of existing plans, however, the Ministry of Justice could be facing a real-terms budget cut in 2022−23 alongside other ‘unprotected’ areas.

5 Institute for Government, ‘Performance Tracker 2020: criminal courts’, https://www.instituteforgovernment.org.uk/publication/performance-tracker-2020/criminal-courts.

Figure 4.1. Crown Court caseload (England and Wales)



Source: Ministry of Justice, 'Criminal court statistics quarterly: January to March 2021', https://www.gov.uk/government/statistics/criminal-court-statistics-quarterly-january-to-march-2021.

Public sector pay

At the November 2020 Spending Review, the Chancellor announced that in the following year there would be a pay freeze for all but the lowest-paid public sector workers, and NHS England workers, who were offered a 1% pay increase.[6] An ongoing policy of pay restraint would pose major challenges, and the Chancellor will be under pressure to be substantially more generous next time around.

It is true that pay in the public sector has outperformed pay in the private sector during the pandemic.[7] But this will only have partially offset the effects of the previous decade, where average pay in the public sector fell in real terms and fell,

6 NHS staff in Scotland were offered a pay rise of 4% on average.

7 Office for National Statistics (2021), 'Average weekly earnings in Great Britain: July 2021', https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/bulletins/averageweeklyearningsingreatbritain/latest.

relative to pay in the private sector, to its lowest point in decades.[8] For next year, the Royal College of Nursing (RCN) has called for a 12.5% pay rise.[9] Junior doctors have called on the British Medical Association (BMA) to lobby for a 15% pay rise.[10] Pay increases for NHS and other public sector workers – even if, as seems highly likely, they are a lot lower than those called for by the RCN and BMA – would add substantially to the public sector pay bill. Importantly, this would be a permanent, rather than temporary, increase in spending, because any pay award would then be 'baked in' to future years.

Social care reform

On top of the broader pressures on local government, there is growing demand for the government to come forward with a plan for social care reform. Clearly, this would not be a temporary measure, and would represent a permanent increase in the generosity of the welfare state. As such, there would an extremely strong case for it to be financed by a corresponding increase in taxes. The precise cost of any reform package would depend on the details. Sir Andrew Dilnot – who carried out a review of the funding of social care for the coalition government – recently suggested that a funding increase of around £10 billion would 'take us from a system that we should all be ashamed of to a system we could be proud of'.[11]

Universal credit

There are pressures for additional spending outside of public services. Central among these is the call for the £20 per week uplift to universal credit to be made permanent. Currently, it is due to expire at the end of September, which will mean a £1,040-per-year drop in the income of around 5 million lower-income families receiving universal credit, as monthly awards drop by around £86 between

8 Zaranko, B. (2020), 'Spending Review 2020: COVID-19, Brexit and beyond', in Johnson, P., Emmerson, E. and Farquharson, C. (eds), *The IFS Green Budget: October 2020*, https://ifs.org.uk/publications/15048.

9 https://www.rcn.org.uk/get-involved/campaign-with-us/fair-pay-for-nursing.

10 BMJ, 'Junior doctors call for 15% pay rise and censure BMA for inaction over pay review body', https://www.bmj.com/content/373/bmj.n1420.

11 Sir Andrew Dilnot, Today programme, 21 June 2021.

September and October. Cancelling the planned cut, and making the uplift permanent, would cost around £6 billion per year in the long run.[12]

Triple lock

Under the triple lock, the state pension is increased each April by the greatest of growth in prices, growth in earnings and 2½%. Ever since the triple lock was introduced in 2011, the government has used the growth in earnings over the three months to July compared with the previous year to measure this earnings growth. As a result, the basic state pension is now at its highest share of average earnings since April 1987.[13]

A consequence of this form of indexation is that the state pension is ratcheted up as a share of earnings whenever earnings growth is weak (i.e. below 2½% or inflation) and keeps pace with earnings in other periods. This effect is especially stark over the pandemic. In April 2021, the state pension was increased by 2½% while inflation had been running at 0.5% and average earnings had fallen by 1.0% due to many employees being furloughed in Summer 2020.

But growth in average earnings over the three months to May 2021 is currently running at 7.3%,[14] with this being pushed up by employees returning from furlough (those moving from 80% pay to 100% pay are receiving a 25% increase in their weekly pay) and the fact that those losing their jobs are disproportionately lower earners. The figure for growth in average earnings over the three months to July 2021 is expected to be even higher: it could easily exceed 8%, which would increase state pension spending by more than £3 billion relative to the March 2021

[12] For more discussion of the forthcoming expiry of the universal credit uplift, see Waters, T. and Wernham, T. (2021), 'The expiry of the universal credit uplift: impacts and policy options', https://ifs.org.uk/publications/15528.

[13] Emmerson, C. (2020), 'COVID-19 will bring forward the date when the pensions triple lock is unpicked', https://ifs.org.uk/publications/15132.

[14] Office for National Statistics (2021), 'Average weekly earnings in Great Britain: July 2021', https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/bulletins/averageweeklyearningsingreatbritain/july2021.

forecast.[15] (Each additional 1% increase in the state pension adds around £0.9 billion to public spending.)

Our borrowing forecast includes this £3 billion. The protection for pensioners from the fall in earnings in the summer of 2020 is perfectly justifiable. But having done this, it would seem odd – to say the least – to decide to allow pensioners to benefit from the subsequent bounceback in earnings. And to do so at considerable cost to the exchequer, when very difficult decisions over both tax rises and competing spending pressures are being made, would be extremely hard to justify.

The legislation allows the Secretary of State for Work and Pensions to estimate the annual change in the 'general level of earnings in such manner as he thinks fit'.[16] So, one straightforward – at least economically straightforward – decision the Chancellor could make would be to increase the state pension by a different measure of earnings that more accurately reflected the underlying change in living standards being enjoyed by the working population. Underlying growth in average earnings is currently running at around 5%. Indexing the state pension by 5% next April would still increase spending by around £½ billion relative to the March 2021 forecast, but by around £2½ billion a year less than if it were increased by 8%.

When temporary becomes permanent

An improvement in the short-term economic outlook is certainly to be welcomed. From the Chancellor's perspective, it ought to make his life easier in the near term, by providing space to allocate additional funds to struggling or priority areas this year and next, while still borrowing less than was forecast in March.

The problem is that, as discussed above, the medium-term outlook may not have changed all that much. If he still wishes to target current budget balance by the middle of the decade, the Chancellor may be unable to commit to *permanent* spending increases, unless he is also willing to raise taxes.

But one additional challenge for the Chancellor and his team of Treasury officials is that 'temporary' spending programmes have a tendency to become permanent. As

[15] Office for Budget Responsibility (2021), 'Fiscal risks report – July 2021', https://obr.uk/frr/fiscal-risks-report-july-2021/.

[16] Social Security Administration Act 1992, S150A(8), https://www.legislation.gov.uk/ukpga/1992/5/pdfs/ukpga_19920005_300916_en.pdf#page=141.

Milton Friedman said, 'Nothing is so permanent as a temporary government program'. It is far easier to tun the taps on than it is to turn them off again. The uplift to universal credit – for which there are undoubtedly merits in making it permanent – could become an expensive case in point. Another example might be the proposals to extend the school day and increase the amount of one-on-one tutoring. Once schools and parents grow accustomed to these changes – and particularly if the schemes are seen as being well implemented and successful – they may be very reluctant for them to be unwound. The Treasury might therefore shy away from committing to a temporary programme – despite the fact that such a programme could have substantial economic returns – because of fears that it would become permanent. This can lead to suboptimal policymaking.[17]

[17] Sibieta, L. and Zaranko, B. (2021), 'HM Treasury: stingy and short-sighted, or prudent and practical?', https://ifs.org.uk/publications/15472.

5. Conclusion

The most recent data on the public finances, and the judgements of independent economic forecasters, point to an improvement in the near-term economic outlook. As a result, the current budget deficit – the difference between what the government spends on day-to-day activities and what it raises in revenues – would, under Citi's latest forecast, be expected to improve by around £30 billion this year (2021−22). That will be welcome news for the Chancellor: he could afford a short-term giveaway (such as more temporary funding for COVID catch-up) while staying within the path for borrowing set out in the March Budget.

The challenge for the Chancellor is that this improvement in the economic and fiscal outlook may not persist. Any 'windfall' handed to him by the OBR would likely be short-lived – and would certainly not be on the scale required to meet the numerous and wide-ranging demands for additional spending. The government's existing spending plans imply cuts to some departments, and make no allowance for additional virus-related spending.

Some top-ups seem inevitable. To give a sense of scale: returning to the government's pre-pandemic plans for public service spending would require an additional £16 billion per year by 2025−26. The OBR estimates that pandemic-related pressures on just three areas – the NHS, schools and public transport providers – could require around £10 billion of extra spending per year for each of the next three years. Making permanent the £20 per week uplift to universal credit would cost around £6 billion per year. And Sir Andrew Dilnot put the cost of a decent social care system at an additional £10 billion per year.

Meeting even a subset of the myriad demands on the Treasury purse – particularly those that would entail a permanent increase in spending – would, unless accompanied by another round of tax rises, mean borrowing more than is allowed under the Chancellor's fiscal targets, and more than what was planned pre-pandemic. The expected improvement in the economic outlook will be music to the Chancellor's ears, but there will be some difficult, and perhaps unpopular, decisions still to be made.