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Spending Review 2019: deal or no deal

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Key findings

- **This Wednesday the Chancellor will allocate funding to departments for the next financial year, 2020–21.** This departmental spending (DEL) is £375 billion this year. Of that about £61 billion is capital spending, on which decisions have largely already been taken for next year (it is due to rise by nearly 5% in real terms). The remaining £314 billion is the day-to-day spending (resource DEL) which will be the subject of this week's allocations. In addition the government spends £468 billion a year which it designates as Annually Managed Expenditure (AME) – on social security and debt interest for example. We do not expect this to be covered by Wednesday's announcements.

- **More than 70% of these day-to-day spending totals are "protected" or have been largely determined by announcements prior to the spending review.** English NHS spending is set to rise by £4.1 billion next year, and schools spending by £1.8 billion while the government is committed to keeping defence and overseas aid spending to at least 2% and 0.7% of national income respectively.

- **The government's spending commitments to date (on the NHS, defence, aid, police, further education and schools) imply increasing day-to-day spending on those priority areas by around £9 billion next year (in today's prices).**

- **Given these commitments, day-to-day spending next year will need to be between £4 and £5 billion higher than implied by plans set out in the Spring Statement simply to avoid further cuts in other areas.** Given the OBR's spring forecasts, this could be accommodated while staying within the government's fiscal rule.

- **Borrowing (cyclically adjusted) this year was forecast by the OBR at £29 billion in the spring and was due to be £19 billion next year, though borrowing is coming in above forecast so far this year.** Borrowing of £19 billion in 2020–21 would be £27 billion below the maximum £46 billion consistent with the government's fiscal rule which says borrowing should be below 2% of national income. However changes to accounting for student loans mean that headroom will in fact stand at about £15 billion next year.

- **But the next set of forecasts from the OBR, due later this year, are likely to reflect a deterioration in the near-term outlook for the economy and public finances.** This could mean the Chancellor's £15 billion of apparent headroom shrinks. He may claim that he is keeping planned borrowing next year within 2% of national income but new OBR figures due later this autumn could suggest otherwise. That's why OBR forecasts and significant fiscal events have been aligned up to now. The fiscal watchdog may get to bark too late.

- **Keeping debt falling as a share of GDP would (on forecasts from the spring) be consistent with up to £22 billion of additional borrowing next year, rising to £25**

billion by 2023–24. But again, a worsening of the economic outlook would reduce the Chancellor's space for tax cuts or additional spending.

- **The potential change to economic forecasts in the event of a no deal Brexit are an order of magnitude greater.** Recent OBR analysis suggested that even a relatively benign no deal scenario would push the UK economy into recession, make the UK permanently poorer and result in higher borrowing to the tune of £30 billion a year from 2020–21 onwards.

Introduction

This Wednesday the new Chancellor will outline his spending plans for the next financial year, 2020–21. Those plans will set the current (day-to-day) budgets for government departments. They may also top up capital budgets, which have in fact already been allocated at the last spending review, in 2015. It is possible that some changes to welfare spending will be announced, though these generally come outside of the spending review process.

Mr Javid enters the spending review with government borrowing at a 17 year low, just £23.6 billion (1.1% of GDP) in 2018–19. Big increases in NHS spending are already baked into government forecasts. Under normal circumstances, this could be the spending review that decisively ends austerity. Given the Office for Budget Responsibility's forecasts in the spring, the Chancellor could have up to £15 billion to play with while still keeping the structural deficit below 2% of national income – this being the currently effective fiscal target. Key commitments on schools and police are easily accommodated within that, with plenty left over to ensure that other public services are not cut next year.

This sounds like an enviable position to be in after nearly a decade of austerity. But the Chancellor is still left with some tough choices, trade-offs and uncertainties. The greatest of these uncertainties surrounds Brexit. A crucial determinant of how much we, as a country, can afford to spend on public services is the performance of the wider economy. The ongoing uncertainty over the nature of our departure from, and future relationship with, the European Union means that the outlook for the UK economy is highly uncertain. A 'no-deal' departure from the EU that causes short-term disruptions and permanent damage to the productive potential of the UK economy would, in the long term, mean less money available to spend on our public services.

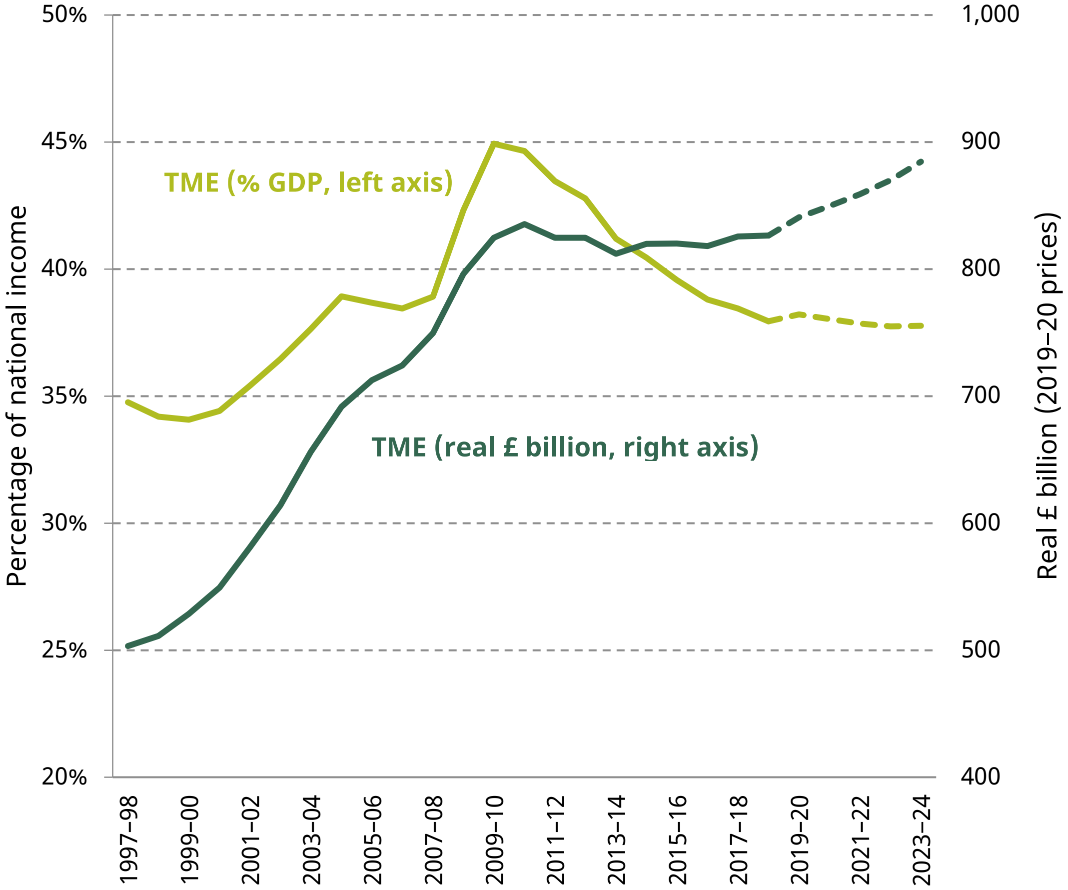
Even setting aside this uncertainty over the Brexit outcome, the economy appears to be growing less quickly than forecast by the OBR back in the spring, while so far this year spending has grown somewhat faster than planned. Since the OBR will not be producing any new forecasts alongside these spending announcements the Chancellor will no doubt rely on their published forecasts from March. The chances are that the next set of numbers produced by the OBR, due alongside the Budget, whenever that might occur over the next couple of months, will be less positive. That £15 billion of apparent headroom may turn out to be more illusion than reality.

Given the pronounced degree of economic uncertainty, it is understandable that the government has chosen to set departmental budgets for a single year (2020–21) only. This will, however, mean that another spending review will need to be carried out and published in 2020.

Spending to date

This week's spending review will come on the back of almost a decade of cuts to public spending. Overall government spending, as measured by Total Managed Expenditure, has fallen from a peak of 44.9% of national income in 2009–10 to 37.9% in 2018–19 (see Figure 1). Over that period total spending has remained broadly flat in real terms, but has fallen in per-person terms by 6.2%.

Figure 1. Total managed expenditure in real terms and as a percentage of GDP



Note: Dotted lines show forecasts on the basis of March 2019 provisional spending plans.

Source: Office for Budget Responsibility, Public Finances Databank (accessed July 2019) and HM Treasury GDP deflators, June 2019 release.

Not all public expenditure will be covered by this week's spending review. Because they have historically tended to cover a period of at least three years, only areas of spending that can be reasonably planned and controlled on a multi-year basis are subject to the spending review process. For example, when it comes to spending on things like schools and hospitals, the government can decide how much it wants to spend over the coming years, set budgets accordingly and – for the most part – expect those budgets to be stuck to. This portion of spending – that which central government can effectively control – is known as 'departmental expenditure limits', or DEL, and is allocated at spending reviews. It is these budgets that Mr Javid will set this week.

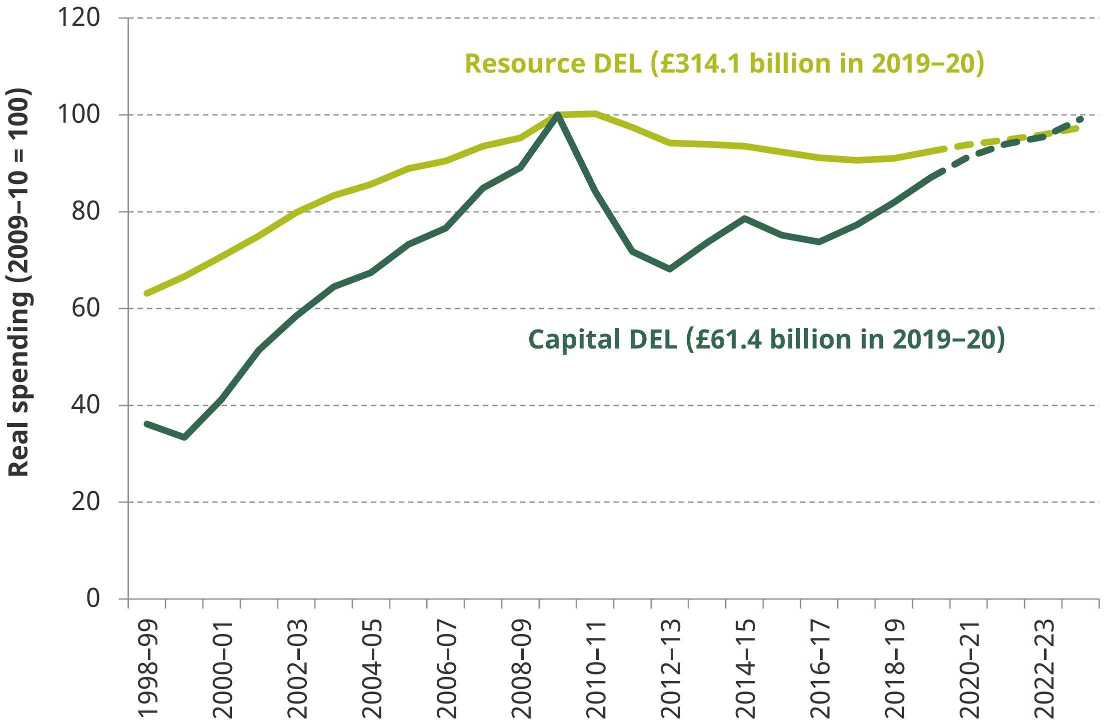
Other elements of spending – on debt interest and social security benefits, for example – that are more affected by factors outside of government control are not subject to the same budgetary processes. This is classified as 'annually managed expenditure', or AME. We do not expect any changes to AME in the spending review.

Departmental expenditure limits (DEL, the portion of spending that will be allocated at this week's spending review) is set to amount to around £375 billion in 2019–20, equivalent to 44% of total spending, or 16.8% of national income. Overall DEL is then split between resource (day-to-day) budgets and capital (investment) budgets. Of the total of £375.5 billion in total DEL, £314.1 billion is resource DEL (RDEL) and £61.4 billion is capital DEL (CDEL).[1] The two have fared very differently over the past 20 years, as shown in Figure 2. 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. Between 2009–10 and 2018–19, RDEL was cut by 9.0% in real terms (14.8% in real per capita terms) while CDEL was cut by 18.1% (23.3% in per capita terms). On the basis of provisional spending plans from the spring, both RDEL and CDEL are now set to increase but remain below their 2009–10 level at the end of the forecast period in 2023–24. That would represent a remarkable degree of spending restraint over that 14 year period.

The 2015 spending review set 5 years of capital budgets, up to and including 2020–21. On the basis of those plans, capital spending by departments will increase by £3 billion in real terms (4.8%) between 2019–20 and 2020–21. In contrast, firm day-to-day departmental budgets do not exist beyond next March. Underpinning the March 2019 Spring Statement forecasts were a set of provisional spending plans for the next five years. These would see day-to-day spending increase by £4.5 billion in real terms (1.4%) between this year and next. The government could, however, choose to spend more by raising taxes or planning a higher level of borrowing in the upcoming Budget.

[1] Note that here, and throughout, we are referring to OBR definitions of Public Sector Current Expenditure in Resource DEL (PSCE in RDEL) and Public Sector Gross Investment in Capital DEL (PSGI in CDEL), adjusted for historical discontinuities. See supplementary expenditure table 4.3 of OBR Economic and Fiscal Outlook, March 2019. Note also that this differs from the HM Treasury definition of Resource DEL excluding depreciation. A reconciliation is published in supplementary expenditure table 4.4 of OBR Economic and Fiscal Outlook, March 2019, https://obr.uk/efo/economic-fiscal-outlook-march-2019/

Figure 2. Resource and capital departmental expenditure limits



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

Source: Authors' calculations based on supplementary expenditure table 4.3 of the OBR's March 2019 Economic and Fiscal Outlook, table A.1 of the OBR's October 2018 Economic and Fiscal Outlook, HM Treasury's Public Expenditure Statistical Analyses (various) and June 2019 GDP deflators.

Spending commitments

The government is already committed to £4.1 billion of additional spending on the English NHS in 2020–21 relative to 2019–20, rising to £17.0 billion by 2023–24 (in today's prices).[2] On the basis of current plans, that would take health spending to 42% of total departmental spending by 2023–24, up from 23% at the turn of the millennium. Voltaire once quipped that while some states have an army, the Prussian army had a state. On current trends, we are heading for a National Health Service with a state attached.

On top of the five-year NHS settlement, the government is committed to spending (at least) 2% of national income on defence and 0.7% on overseas aid. If capital budgets for defence and aid grow in line with overall capital spending, the government can leave day-to-day budgets for those areas broadly flat and remain on track to meet those commitments.

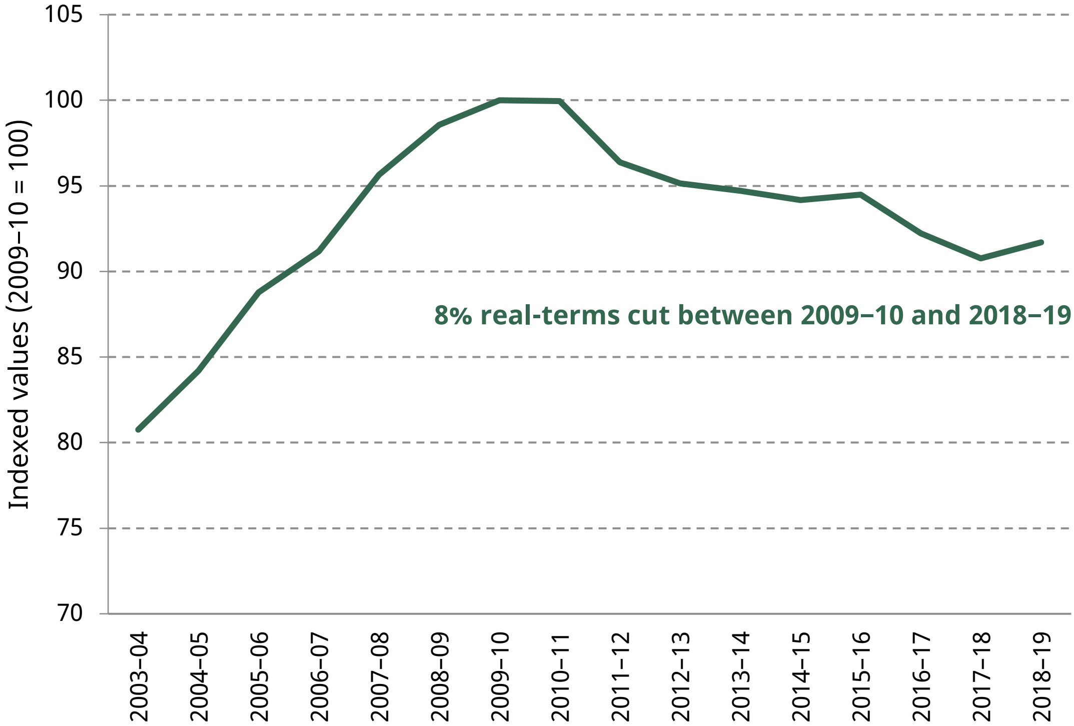
The new Prime Minister promised as part of his campaign to increase spending on schools. On Friday the government announced it would increase schools spending by £4.3 billion by 2022–23 (in today's prices), with a £1.8 billion increase next year. Since 2009–10, school spending per pupil has fallen by 8% in real terms (as shown in Figure 3). The additional spending announced by the government should be sufficient to reverse most of these cuts by 2022–23.[3] The Chancellor has also announced a £400 million funding increase for further education and sixth form colleges next year.[4]

2 This does not include the Barnett consequentials of the NHS funding settlement for Scotland, Wales and Northern Ireland, which amount to £0.9 billion, £0.5 billion and £0.3 billion respectively in 2020–21 (in today's prices).

3 C. Farquharson and L. Sibieta, '2019 annual report on education spending in England: schools', Institute for Fiscal Studies, 30 August 2019, https://www.ifs.org.uk/publications/14344

4 'Chancellor announces £400 million investment for 16-19 year olds' education', Department for Education and HM Treasury, 31 August 2019, https://www.gov.uk/government/news/chancellor-announces-400-million-investment-for-16-19-year-olds-education

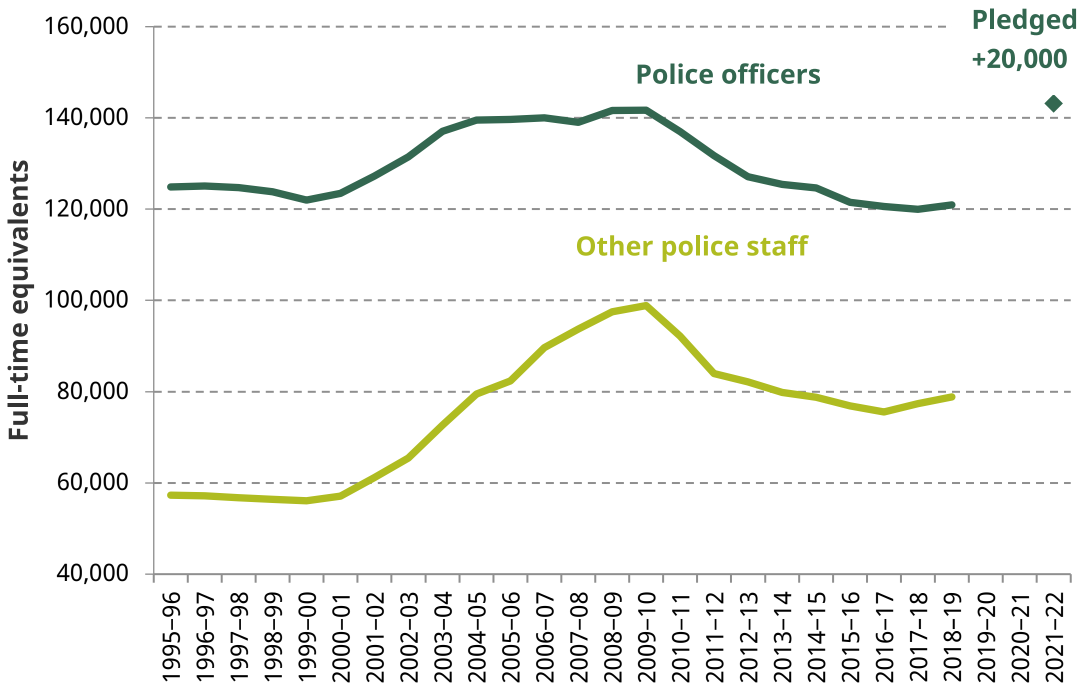
Figure 3. Changes in per pupil school spending in England, 2003–04 to 2018–19



Note and source: see Figure 3.1 and Appendix B of C. Farquharson and L. Sibieta, '2019 annual report on education spending in England: schools', Institute for Fiscal Studies, 30 August 2019, https://www.ifs.org.uk/publications/14344

The Prime Minister has also pledged to hire an extra 20,000 police officers in England and Wales by 2022. An extra 20,000 police officers would represent an increase of more than 16% in police numbers (see Figure 4) and come at a cost of around £1.1 billion per year. What this means for next year's budgets depends on how quickly the government wishes to deliver on this pledge. It is clear that one would struggle to increase the number of police officers to the desired extent immediately. Delivering on the police recruitment pledge gradually could mean around £550 million of extra spending in 2020–21, rising to £1.1 billion by 2021–22.

Figure 4. Number of police officers and other police staff in England and Wales



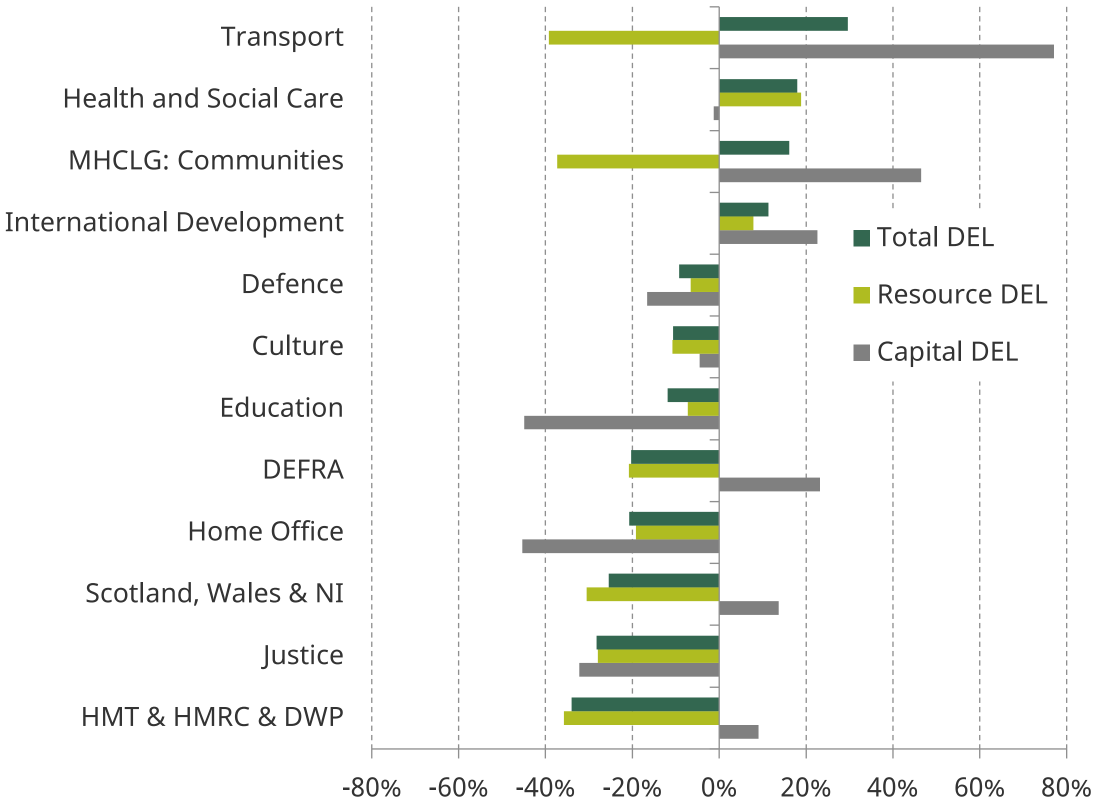
Note: Figures refer to the total number of full-time equivalent workers employed at the end of each financial year (31 March) and exclude those on career breaks or maternity/paternity leave. Other police staff includes general police staff, police community support officers, designated officers and traffic wardens.

Source: Table S1 of Home Office, *'Police workforce, England and Wales: 31 March 2019'*, July 2019, https://www.gov.uk/government/statistics/police-workforce-england-and-wales-31-march-2019

Together, these 'protected' areas (the NHS, defence, overseas aid, the police, further education and schools) amount to more than 70% of day-to-day spending. If we take just the areas protected before the recent Conservative party leadership election (NHS, defence and overseas aid) the equivalent figure is 53%. This means that ahead of the Spending Review, a huge chunk of spending has already been at least partially determined. In some cases spending plans have now largely been set (such as the NHS), while other promises are more likely to create something of a spending floor (such as the police, where the government could decide to increase the police budget by more than that needed to pay for 20,000 additional officers).

What might happen outside these protected areas? The cuts delivered to date have not fallen evenly across departments. This is illustrated in Figure 5, which shows the real change in departmental budgets between 2010–11 and 2019–20. Some departments have clearly been harder hit than others. The Ministry of Justice resource budget was cut by 28% over this period, and the Department for Environment, Food and Rural Affairs (DEFRA) resource budget by 21%. In contrast, the Department of Health and Social Care saw its day-to-day budget increased by 19% over the same nine year period. Capital and resource budgets have in many cases fared very differently: some departments, such as Transport, have seen a sizeable reduction in their resource budget alongside a substantial increase in their capital budget.

Figure 5. Real-terms departmental budget changes, 2010–11 to 2019–20

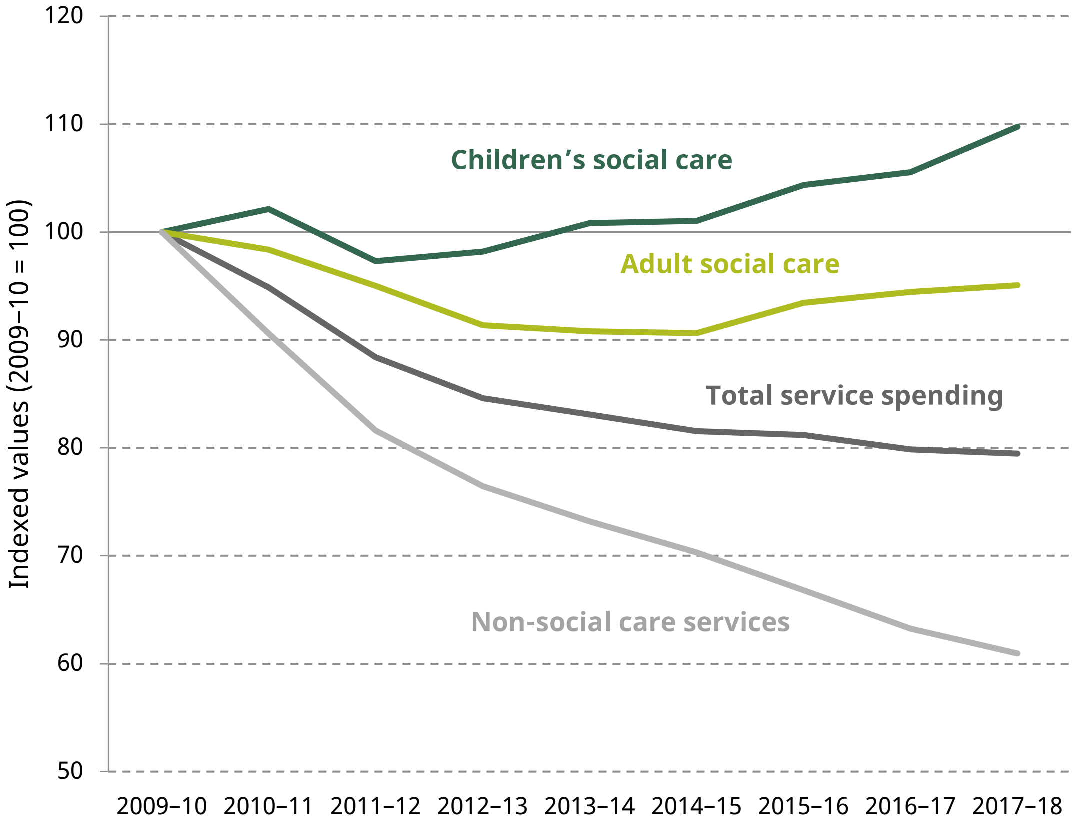


Note: Resource budgets here exclude depreciation.

Source: Authors' calculations using HM Treasury Public Expenditure Statistical Analyses (various) and June 2019 GDP deflators.

Not all public services fall neatly into departmental budgets. Local government spending, for example, is funded in part by central government grants and in part through local taxation. Between 2009–10 and 2017–18, local government spending on services in England fell by 21% in real terms. Within that total, however, councils prioritised spending on services like adult social care (down 5%) and children's social care services (up 10%). Other (non-social care) services have faced cuts on average of almost 40%, as illustrated in Figure 6.

Figure 6. Real terms changes in local government service spending in England, 2009–10 to 2017–18



Source: N. Amin Smith and D. Phillips, 'English council funding: what's happened and what's next?', Institute for Fiscal Studies Briefing Note BN250, 29 May 2019, https://www.ifs.org.uk/publications/14133

Amidst budget squeezes and growing demand, many public services are showing signs of strain. The data suggest that many public services coped reasonably well with the first few years of cuts, but service quality is now in some cases showing clear signs of deterioration (see The Institute for Government's Performance Tracker, which provides a detailed discussion and assessment of how public services have performed since 2010 in the face of budget cuts[5]).

The government is therefore under pressure to increase spending on public services across the board, not just among the headlining service areas where commitments have already been made.

5 Institute for Government, Performance Tracker, https://www.instituteforgovernment.org.uk/our-work/performance-tracker

The cost of "ending austerity"

Meeting the government's promises on the NHS, defence, overseas aid, police and schools will mean increasing day-to-day spending on those areas by around £8.8 billion to £9.3 billion next year, depending on how quickly the police pledge is met. This is summarised in Table 1. As described above, the day-to-day spending increase next year in the absence of changes to taxes or planned borrowing is only £4.5 billion. The Chancellor would therefore need to top up the spending plans of his predecessor by around £4.3 billion to £4.8 billion to avoid real terms cuts to other areas of spending where no commitments have been made. To avoid making per capita cuts those areas, he would need to top up plans by between £4.8 billion and £5.4 billion.

Table 1. Cost of avoiding further cuts to unprotected areas of spending in 2020–21

	Extra spending in 2020–21 (2019–20 prices)
Total day-to-day spending increase if no change to tax or borrowing:	£4.5 billion
Announced commitments:	
NHS, defence, aid	£5.9 billion
Schools	£2.0 billion
Further education	£0.4 billion
Police (depending on speed of meeting commitment)	£0.6 billion to £1.1 billion
Total of day-to-day spending commitments:	£8.8 billion to £9.3 billion
Top up to total day-to-day spending required to avoid cuts to other spending areas	£4.3 billion to £4.8 billion

Note: Figures may not sum due to rounding. All increases relative to 2019–20 baseline. Figures for the NHS, schools and further education include the estimated Barnett consequentials for Wales and Northern Ireland, and figures for the police include Barnett consequentials for Northern Ireland. Barnett consequentials for Scotland are not included as the OBR defines Scottish government expenditure as falling outside of PSCE in RDEL, within AME.

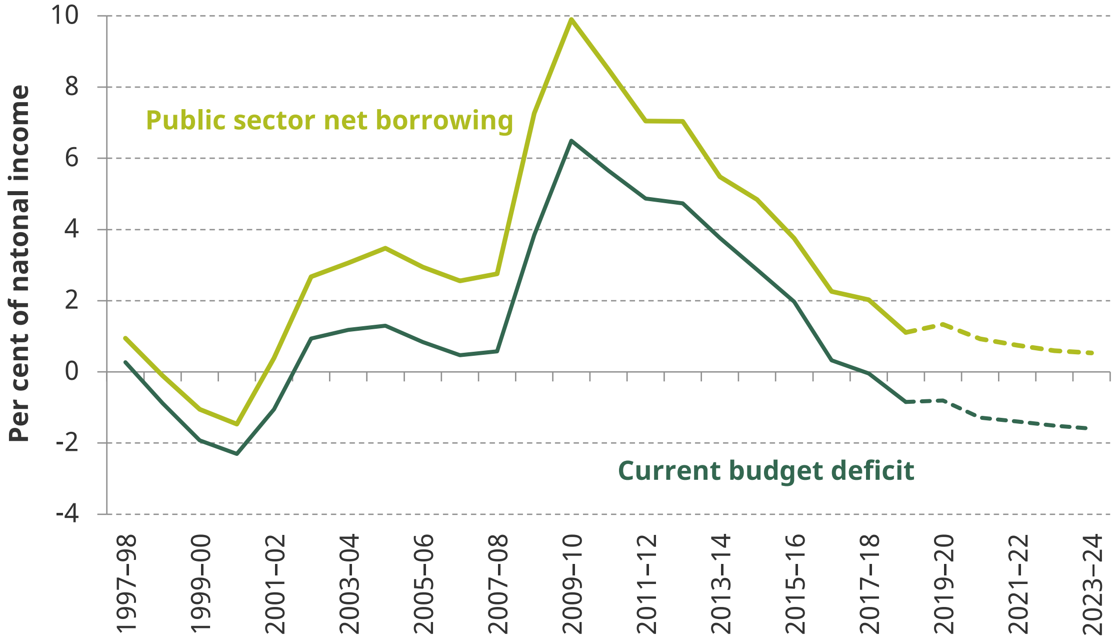
Source: Authors' calculations using Office for Budget Responsibility, Economic and Fiscal Outlook, October 2018, and Economic and Fiscal Outlook, March 2019, HM Treasury Public Expenditure Statistical Analyses, July 2019, HM Treasury, Budget 2018, and June 2019 GDP deflators. Total day-to-day spending refers to the OBR definition of PSCE in RDEL, available on a consistent historical basis in table 4.3 of Office for Budget Responsibility, March 2019 Economic and Fiscal Outlook, supplementary expenditure tables.

All this is to say that, given firm commitments we know about, day-to-day spending next year will need to be between £4 and £5 billion higher than implied by plans set out in the Spring Statement simply to avoid further cuts in other areas – including local government (which is where social care spending sits), and justice. Increasing spending on these services, or topping up capital budgets, would of course push that number higher.

Can the Chancellor afford this?

Is this affordable? In one sense, yes. Figure 7 shows the path of borrowing since 1997–98, including the latest OBR forecasts for the next five years. The headline deficit (the gap between total spending and total receipts, as measured by public sector net borrowing) is currently lower than in any year since 2001–02. Similarly, the government ran a surplus on the current budget (i.e. current receipts exceeded current spending) in 2017–18 and 2018–19 for the first time since 2001–02.

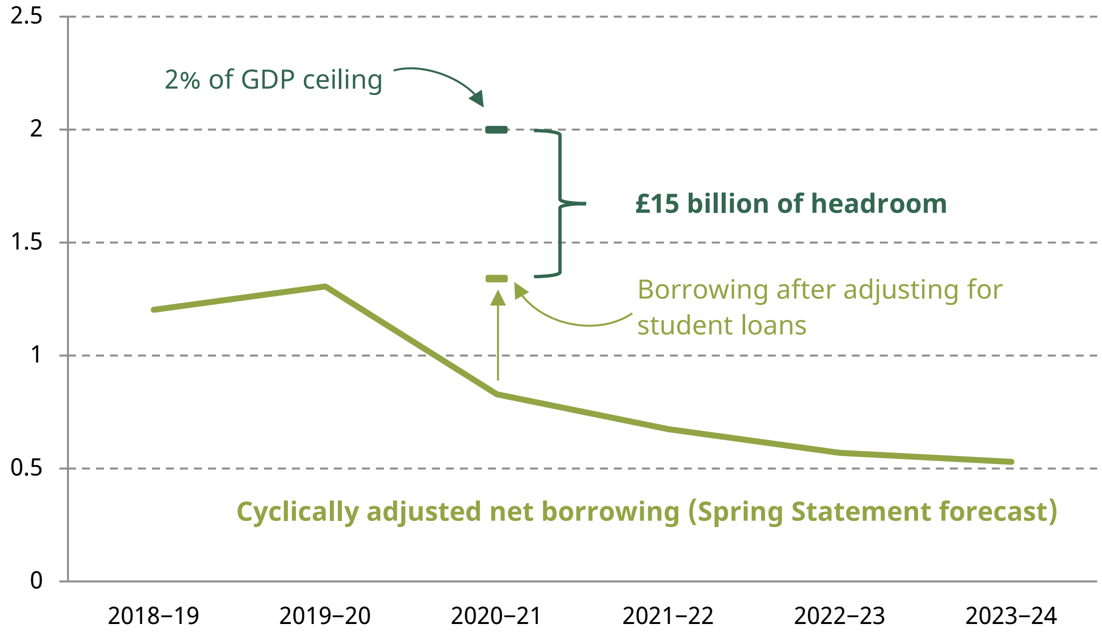
Figure 7. Measures of the public sector deficit since 1997–98



Source: OBR Public Finances Databank

The government's fiscal mandate is expressed in terms of a different measure of borrowing, known as the 'structural' deficit (a measure of borrowing that strips out the effects of the economic cycle). The Chancellor is required to keep the structural budget deficit below 2% of GDP in 2020–21. On Spring Statement forecasts, once one accounts for the changing treatment of student loans in the National Accounts, borrowing should come in around £15 billion (0.7% of GDP) below this ceiling next year (as shown in Figure 8).

Figure 8. Spring Statement forecasts for cyclically adjusted net borrowing



Source: Authors' calculations using OBR Public Finances Databank (accessed August 2019) and Chart B.4 of OBR Economic and Fiscal Outlook, March 2019, https://obr.uk/efo/economic-fiscal-outlook-march-2019/

However, since the spring other forecasters, like the Bank of England and NIESR, have downgraded their view of growth this year and next and hence now think the economy will be smaller in 2020–21 than they thought earlier in the year. If the OBR were to downgrade its forecasts by a similar amount to the Bank – who now estimate that GDP will be 0.4% smaller next year than they thought in May – that would probably add around £5 billion to borrowing. This would be on top of any extra borrowing resulting from higher-than-expected spending so far this year. Should the Chancellor then announce £4 to £5 billion of additional spending this week, he would be left with very little room for additional manoeuvre.

One, perhaps defensible, way around this dilemma would be for the Chancellor to point out that when the 2% deficit commitment was made student loans were accounted for differently. If he were to target a deficit measured as it was when the target was first announced he could buy himself an additional £12 billion or so of headroom. Given that the 2% target is itself largely arbitrary that might be a reasonable argument to make, but it would surely create some doubt around the seriousness with which Mr Javid actually takes his fiscal rule.

An alternative benchmark of affordability, which the prime minister has reiterated, is a desire to ensure that outstanding debt falls year on year as a fraction of national income. Stripping out the accounting effects of Bank of England interventions debt is due to fall from 73.9% of GDP this year to 73.2% in 2020–21, 72.4% in 2021–22 and 71.6% in 2022–23 (according to OBR spring forecasts).[6]

[6] The equivalent headline figures which include the effects of the Bank's term lending scheme are 82.2%, 79.0%, 74.9% and 74.0% of GDP. Source: Chart 4.8 in OBR Economic and Fiscal Outlook, March 2019, https://obr.uk/efo/economic-fiscal-outlook-march-2019/

The recent OBR Fiscal Risks Report examined by how much primary borrowing could increase while ensuring that debt continues to fall as a share of GDP each year.[7] In the absence of growth forecast revisions, the OBR estimated that borrowing would have to rise by around £22 billion over and above current plans in 2020–21 for debt (excluding the Bank of England) not to fall as a share of GDP in that year, rising to around £25 billion by 2023–24.[8] That is, on the basis of the OBR's March forecasts, keeping debt falling (slowly) as a share of GDP over the coming years would leave the Chancellor with space for around £20 billion of additional spending or tax cuts. Once again though lower growth would reduce room for manoeuvre.

Keeping debt (on this measure) falling next year is then only slightly less constraining next year than the 2% deficit rule.

A further consideration for the Chancellor when deciding how much of his 'headroom' to spend will be the potential for changes in departmental responsibilities post-Brexit that necessitate an increase in funding. For instance, if HM Revenue and Customs (HMRC) gain responsibility for additional customs arrangements at the border, it may require a considerable increase in resources. If the Department for the Environment, Food and Rural Affairs (DEFRA) has to develop and maintain domestic regimes for agricultural and fisheries, new staff would presumably need to be hired on a permanent basis, necessitating a permanent increase in the department's budget.

The Treasury has already allocated a total of £6.3 billion towards preparations for leaving the EU, £4.2 billion of which is for 2019–20.[9] The biggest beneficiaries so far have been HMRC, the Home Office and DEFRA.[10] Whether or not this spending proves to be temporary or permanent most likely depends on the nature of our departure and future arrangements with the EU. Given that departments and the Treasury still do not have a good idea of what their responsibilities will be after Brexit, it would be prudent for the Chancellor to hold a larger than normal amount in reserve to be distributed between departments at a later date.

7 Primary borrowing is defined as public sector net borrowing, excluding net debt interest payments. See Chart 8.8 and section 8.33 of Office for Budget Responsibility, Fiscal Risks Report, July 2019, https://obr.uk/frr/fiscal-risks-report-july-2019/

8 Note that when combined with the change in the accounting treatment of student loans, additional borrowing of this scale in 2020–21 would mean breaching the fiscal mandate.

9 HM Treasury press release, 'Chancellor announces billions to turbo-charge no deal preparations', 31 July 2019, https://www.gov.uk/government/news/chancellor-announces-billions-to-turbo-charge-no-deal-preparations

10 See Table E.6 of HM Treasury, 'European Finances 2018', https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/814387/190618_HMT_2018_Annual_Statement_on_European_Finances_print.pdf, and sections 3.6 and 3.8 of HM Treasury Public Expenditure Statistical Analyses, July 2019, https://www.gov.uk/government/statistics/public-expenditure-statistical-analyses-2019

A No-Deal Brexit

The changes to the economic forecasts if we leave the EU with a deal are likely to be modest, yet even those modest changes could have a significant impact on the Chancellor's room for manoeuvre if he is to meet his fiscal rules. The potential change to economic forecasts in the event of a no deal Brexit are an order of magnitude greater.

The OBR recently analysed the fiscal implications of the less severe of the two 'no-deal, no-transition' scenarios modelled by the International Monetary Fund (IMF).[11] The upshot of the OBR analysis is that leaving the EU in this kind of 'no-deal' scenario would push the UK economy into recession, make the UK permanently poorer, and result in higher borrowing to the tune of £30 billion a year from 2020–21 onwards (relative to the OBR's March 2019 forecast).[12]

Of course, there is a great deal of uncertainty around forecasts of this nature, but the headline is clear: a disruptive 'no-deal' scenario would blow a hole in the public finances that in the long term would need to be filled through some combination of tax rises and spending cuts. Given that, one might have expected the new Prime Minister and Chancellor to exercise some caution in announcing expensive tax cuts and making difficult-to-reverse spending commitments before the uncertainty is resolved.

[11] Chapter 10 of Office for Budget Responsibility, Fiscal Risks Report, July 2019, https://obr.uk/frr/fiscal-risks-report-july-2019/

[12] It is important to note that this would not represent the total fiscal impact of Brexit, and is by no means a worst-case scenario. If, for example, the UK also suffers from major short-term border disruptions, the economic cost and associated hit to the public finances would be greater. This scenario also assumes no discretionary fiscal response.