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BRIEFING

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Putting Spending Review 2020 into context

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Summary

The economic backdrop to this mid-pandemic Spending Review is a grim one, with lasting damage being done to household and public finances. In the face of that reality the Chancellor has ramped up coronavirus spending this year and next, while quietly beginning to bring down longer-term spending plans, and largely ignoring the reality of tax rises to come.

The initial economic hit from coronavirus may not be quite as catastrophic as the Office for Budget Responsibility (OBR) previously thought, but it is still staggering so. The UK economy is set to shrink by 11.3 per cent this year, the biggest decline in over three centuries. Welcome news on vaccines means the economy will bounce back, but the recovery will be ultimately incomplete, with the economic 'scarring' leaving it permanently 3 per cent smaller, or £1,400 for every adult in Britain.

Of course, big Brexit decisions will also be taken in the coming weeks, with the OBR expecting a no deal Brexit to permanently knock another 1.5 per cent off the size of the UK economy, on top of the 4 per cent that is baked into the forecast assuming a deal is done. This means the economic scarring from the worst-case Brexit outcome would be almost double the long-term cost of the coronavirus crisis.

More welcome news came on jobs. The peak in unemployment is now expected to be 7.5 per cent in the middle of 2021 – lower and later than previously thought. This would still mean unemployment rising by a million to reach 2.6 million, equalling the levels of the financial crisis, but below those of the 1980s and 1990s recessions.

However, a lastingly-smaller economy means lower wages, forecast to down by £1,200 a year per worker in 2025 compared to pre-pandemic expectations. The hit to household incomes that follows from that comes on top of the unprecedented financial crisis and Brexit-induced living standards squeeze of the 2010s. As a result, household incomes, which grew by 40 per cent in the 15 years prior to 2008, are set to have increased only by a quarter of that (10 per cent) in the 15 years since. Against that backdrop, it makes no sense for the Chancellor to have failed to extend the £20 a week boost to Universal Credit into next year, leaving 6 million households wondering if they are set to lose over £1,000 a year just at the time when the OBR expects unemployment to reach its peak.

The public, as well as household, finances will be hit by post-pandemic economic scarring. The Chancellor's policy response is the main reason that borrowing this year (£394 billion) will be more than twice the peak seen during the financial crisis, but the smaller economy will push borrowing up by £57 billion by the middle of the decade.

Faced with a grim economic outlook, and an ongoing public health crisis, Rishi Sunak has

chosen to double down on coronavirus spending, which is set to total around £335 billion (£12,000 per household) over this year and next. The British state has never seen anything like this outside of World War Two, with government spending as a share of the economy reaching 56 per cent.

In contrast to spending like there's no tomorrow on the pandemic, the Chancellor set out plans to spend less when tomorrow arrives. He does not intend for any coronavirus-related spending to be permanent and, without mentioning it in his speech, set out a reduction of £10 billion in planned normal public service spending next year, rising to £13 billion in 2024-25.

Cuts to the aid budget (saving £4 billion) have taken the lion's share of the attention on the 2021-22 Spending Review itself. Overall, the Review has seen non-coronavirus day-to-day public service spending rise by 4 per cent next year in cash terms (compared to a very large 7.8 per cent rise this year). Big spending increases have gone to the usual priorities such as health, but also to departments taking on new responsibilities post-Brexit, including HM Revenue and Customs (up 20 per cent in cash terms) and the Department for Environment, Food & Rural Affairs (whose budget more than doubles over two years).

But looking further ahead, the cuts to planned spending, alongside the Chancellor's professed intention to return aid spending to 0.7 per cent of GDP and ongoing protections for NHS and Schools spending, mean it will not feel like the end of austerity for many public services. Unprotected departments' day-to-day spending will remain almost a quarter lower in real per capita terms in 2024-25 compared to 2009-10, with the Department for Transport and the Ministry of Justice lower by 45 per cent and almost a quarter respectively.

In contrast, the Chancellor stuck to the ambitious capital spending targets he set in March. Public sector investment is still set to average 2.9 per cent of GDP over the next five years, the highest sustained level since the late 1970s. Half of the £27 billion real increase in spending from 2019-20 to 2021-22 is set to be spent on a combination of increases for the defence, health, transport and science budgets. Rishi Sunak also announced a new £4 billion 'Levelling Up Fund', under which Whitehall will allocate grants of up to £20 million to local areas that submit bids with the support of local politicians. A commitment to addressing regional inequalities in capital spending is welcome – alongside revisions to the Green Book in this vein – but a highly centralised (and potentially politicised) system of small grant funding is unlikely to deliver the lasting structural change needed.

There is no immediate pressure to set out plans for a fiscal consolidation, with the cost of servicing the government's debt next year set to be £20 billion less than previously expected. But once the recovery is secured, tougher choices will come. Balancing the current budget by the end of the parliament will require around £27 billion of fiscal consolidation. That figure is likely to increase when the Chancellor recognises that his idea there will be no permanent increase in spending post-pandemic is, what you might politely call, optimistic for a Government wanting to be known for ending austerity and levelling up Britain. So, once a recovery has been secured, the bulk of consolidation will need to come from the tax rises that the Chancellor largely declined to mention this week. Which taxes those will be, like which Brexit we can expect, are questions left for another day.

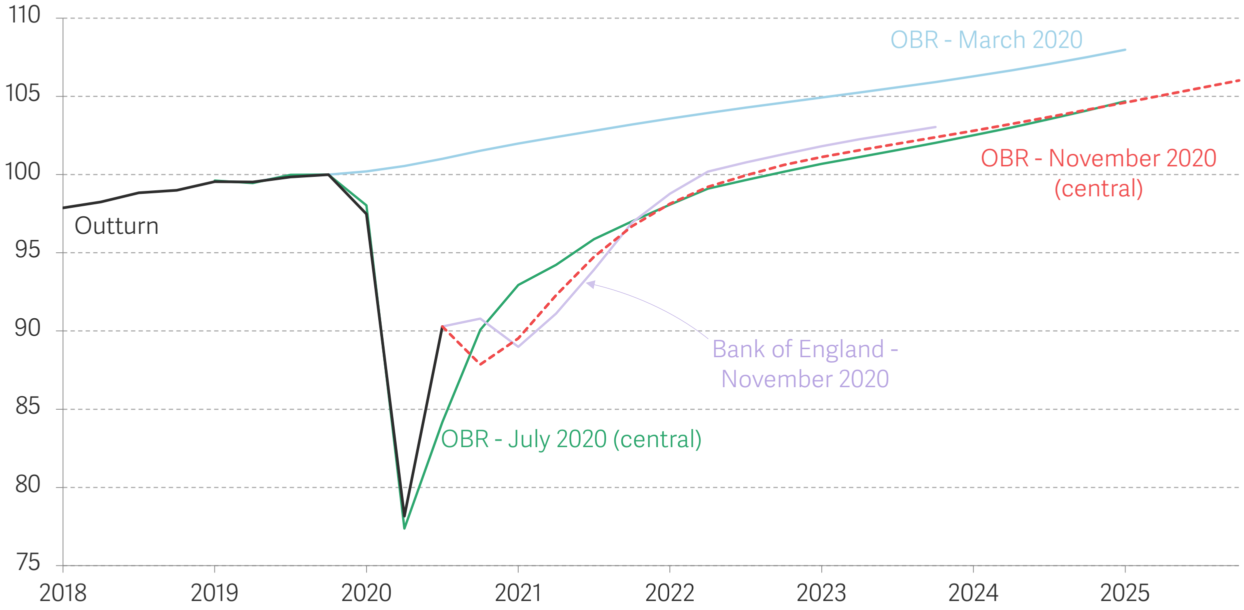
The OBR expects the recovery from the pandemic to be delayed, protracted and incomplete

The latest OBR forecasts of the UK economy make for grim reading.[1] Indeed, despite a stronger starting point than expected at the time of the July Fiscal Sustainability Report (FSR), the OBR is forecasting that 2020 will be the worst year for economic growth in more than 300 years, with economic activity falling in real terms by 11.3 per cent this year.[2] Figure 1 puts this forecast in context. The impact of the increase in coronavirus cases since September, which has necessitated tighter restrictions in all parts of the UK, is clear, with GDP expected to fall 3 per cent in the final quarter of 2020. The OBR's central expectation is that social distancing restrictions across the UK, equating roughly to the Tier 3 restrictions in England in place prior to the lockdown, will need to be in place until the start of Spring. The OBR then expects that warmer weather allows loosening of restrictions before a widespread rollout of vaccines is underway in the second half of 2021. Together this means that the OBR is more pessimistic about the near-term outlook, but expects activity to recover faster during 2021 (GDP is expected to grow by 5.5 per cent in 2021) than was the case in its July FSR forecast.

1 OBR, Economic and fiscal outlook – November 2020.
2 The July forecasts are in OBR, Fiscal sustainability report – July 2020.

FIGURE 1: **The UK is set to have the worst year for economic growth in 300 years**

Select forecasts and outturn of the level of real GDP, index (2019 Q4 = 100)



SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, various; Bank of England, Monetary Policy Report, November 2020.

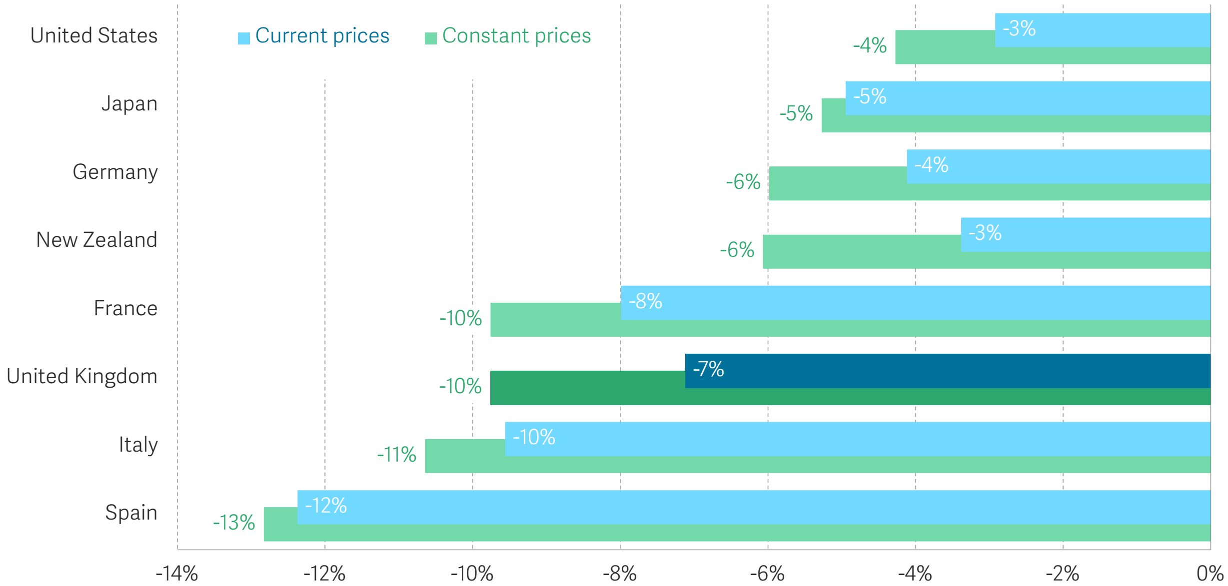
BOX 1: **The UK's poor economic performance in an international context**

There has been much focus on the UK's relative economic performance, with the UK apparently faring worse than comparable countries, particularly in the second quarter of 2020.[3] While it is true that the UK is set to have the worst year for economic growth in more than 300 years, this would be in line with France, and somewhat better than other comparable countries like Italy and Spain, as shown in Figure 2. Some of this poor relative performance is due to measurement choices made by the ONS, particularly in the health and education sectors. But this only partially explains the gap, because when we look at nominal – or current price – output, which largely removes differences in measurement across countries, economic activity will still fall further in the UK this year than Germany, Japan, and the US.[4]

3 See BBC, Coronavirus: UK worst hit among major economies, August 2020.
4 See C Giles, UK's poor GDP performance rooted in weak household spending, November 2020.

FIGURE 2: **The UK's economic output in 2020 will be close to (but not bottom) of the international league table**

Forecast change in annual GDP, 2019 to 2020: selected countries



NOTES: Current prices GDP measures economic output as the total final expenditures at purchasers' prices adjusted for exports and imports (i.e. in nominal terms). Constant prices GDP is measured in real terms. Both series are expressed as changes in local domestic currencies.
SOURCE: RF analysis of IMF, World Economic Outlook, October 2020.

The remaining gap partly reflects the structure of the UK economy: the service sector in the UK comprised 79 per cent of total economic activity in 2019, the third highest share in the OECD and 10 percentage points higher than Germany, meaning social restrictions will tend to have a larger effect on the economy. But, perhaps more importantly, the spread of the coronavirus and the restrictions that have needed to be put into place as a result of that spread also seem to have had a large effect in the UK. Of the eight countries shown in Figure 2, the UK has had the highest average level of restrictions in place over the whole of 2020 to date.[5] Spain and Italy also had higher-than-average level of restrictions in place over 2020, highlighting the economic benefits of controlling the virus and thus reducing the necessity for social distancing.

But this crisis is far from over, and it is too soon to definitively compare outcomes across countries. There could be substantial revisions to data, and more work is needed to harmonise results. More importantly, policy in the months ahead, not least the success of a vaccination programme and continued provision of fiscal support for the economy, will materially impact the overall economic impact of the pandemic across countries.

5 Strength of restrictions are measured using the Oxford University – Blavatnik School of Government Stringency index from 01 January to 09 November.

The OBR expects the recovery to be protracted, with GDP only surpassing its pre-crisis level towards the end of 2022. This is because, despite accounting for nearly 90 per cent of the fall in GDP this year, consumption recovers relatively slowly. Government expenditure plays an important role in driving growth in 2021, but that boost fades thereafter, highlighting the need for fiscal policy to play a larger role in supporting the recovery than in previous crises.[6] The OBR projects that there will be an output gap in every year of the forecast, leaving scope for additional fiscal support to increase GDP and reduce unemployment without causing inflation to rise above the Bank of England's target.

The long-term economic 'scarring' from this crisis is equivalent to £1,400 for every adult in Britain

The OBR expects the economic impact of the pandemic to last, forecasting that the economy will be 3.1 per cent smaller in 2025 Q1 than they had predicted in its March forecast. That is equivalent to around £1,400 for every adult in Britain.

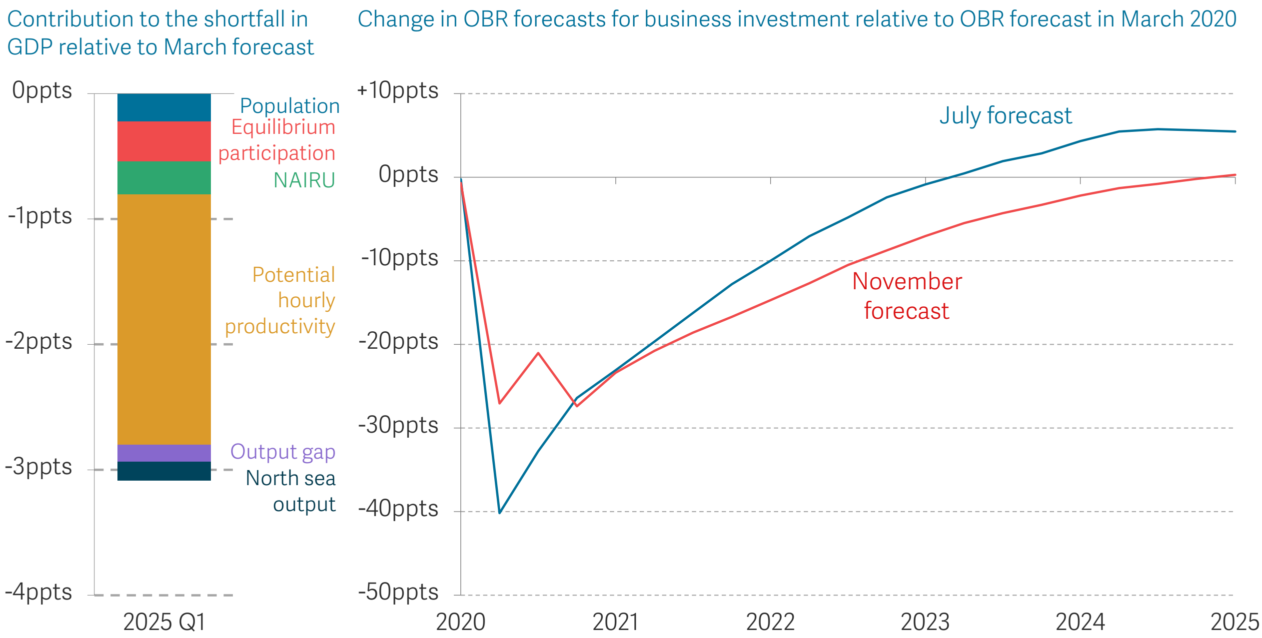
The majority of that scarring impact reflects persistent weakness in productivity. The left-hand panel of Figure 3 provides a breakdown of the scarring impact into contributions from the supply side of the economy. It shows that 65 per cent of the shortfall in GDP in 2025 reflects lower productivity, with the rest coming from lower migration and the impact of the crisis on the labour market (for example, through persistently higher unemployment). In turn, weaker productivity reflects lower business investment, which tends to reduce how much output can be produced by a given amount of labour. The right-hand panel of Figure 3 shows that business investment has already fallen by a quarter in the crisis relative to its pre-crisis path and is now expected to recover only by 2025. This poor performance is even more striking because real business investment has barely increased since 2016, reflecting heightened uncertainty following the EU referendum. It is likely that recent positive news about prospects for a coronavirus vaccine will act to reduce uncertainty in the coming months, but investment weakness remains a key challenge for the UK economy. This provides a strong rationale for the Government's major increases in public sector investment, discussed later in this note.

The coronavirus crisis is one source of economic scarring, but the potential for a 'no deal' Brexit is another: this is discussed more in Box 2.

6 For a more detailed analysis of the macroeconomy in the recovery phase, see: G Bangham, A Corlett, J Leslie, C Pacitti & J Smith, Unhealthy finances: How to support the economy today and repair the public finances tomorrow, Resolution Foundation, November 2020

FIGURE 3: **The main driver of economic scarring is poor growth in investment**

Contribution to shortfall in GDP relative to March forecast, and OBR forecasts for business investment relative to OBR forecast in March 2020: UK



NOTES: 'NAIRU' stands for non-accelerating inflation rate of unemployment. The forecasts for business investment are shown relative to the quarterly level set out in the OBR's March 2020 forecast. Both the OBR forecasts shown are the central scenarios.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, November 2020, Financial Stability Report, July 2020.

BOX 2: **The OBR's Brexit assumptions**

The OBR has incorporated the effect of Brexit in its forecasts in two ways. First, their baseline forecasts assume the outcome of negotiations is a 'typical' free-trade agreement and incorporate the impact of the new migration regime.[7] The OBR has then additionally modelled a scenario where the UK-EU negotiations result in the UK leaving the transition period with no deal.

The estimated impact of transitioning to a free-trade agreement is a fall in the long-run level of GDP of 4 per cent relative to the UK being an EU member. This rises to 5.5 per cent in a no deal scenario, almost twice the scarring from the coronavirus crisis. This reinforces the importance of decisions taken in the next few weeks for both the fiscal challenges facing the Chancellor in the coming years, as well as for household living standards and prosperity.

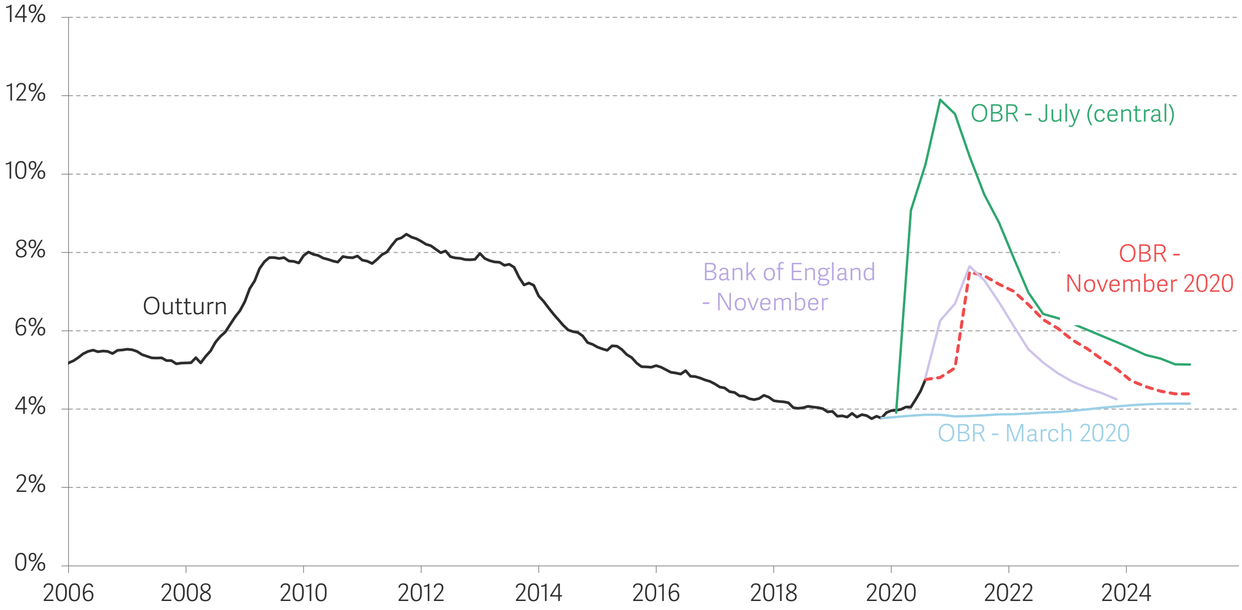
7 The OBR estimate the long-run economic effect of a free trade agwreement using a range of published estimates from the government and external sources. For more details, see: OBR, Discussion paper No.3: Brexit and the OBR's forecasts, October 2018.

The unemployment peak is set to be lower and later, but would see a million more people out of work in the coming months

The OBR's forecast for unemployment offers a much improved outlook compared to their July FSR. This reflects both the stronger starting point for GDP, but also the fact that the option of full furlough under the Coronavirus Job Retention Scheme (JRS) has been extended until the end of March. This means that the predicted fall in output in 2020 Q4 – caused by the reintroduction of social distancing restrictions– translate into falls in hours worked rather than job losses.

FIGURE 4: **Unemployment is set to peak in 2020 Q2, at a lower level than after the financial crisis**

16+ unemployment rate, outturn and successive OBR projections and Bank of England forecast: UK



SOURCE: OBR, Economic and Fiscal Outlook, various; OBR, Fiscal Sustainability Report, July 2020; Bank of England, Monetary Policy Report, November 2020.

However, the OBR still expects a significant increase in unemployment next year. The 16+ unemployment rate is now set to peak at 7.5 per cent in 2021 Q2, or around 2.6 million people. This is similar to the levels seen after the financial crisis (when unemployment peaked at 2.7 million at the end of 2011), but lower than the levels seen in the 1980s and 1990s recessions. The near-term peak in the OBR's unemployment forecast is now very similar to the Bank of England's November forecast, in which the unemployment rate is expected to peak at 7.7 per cent, also in 2021 Q2. The OBR assume that unemployment will fall back more slowly, however. At the end of 2022, for example, the OBR expect the unemployment rate to be 1.2 percentage points higher than does the Bank of England. Nonetheless, the unemployment rate is expected to return to 4.4 per cent, close to pre-crisis levels, by 2025-26.[8]

This more optimistic unemployment forecast assumes that firms will not make workers redundant when the JRS comes to an end. Because the scheme is now expected to end around the same time as the OBR expects a vaccine to be rolled out, this raises the likelihood of firms holding onto workers, even though demand will remain below pre-pandemic levels.

In response to a deteriorating labour market, the Chancellor announced a new scheme – called Restart, and costing £2.9 billion over three years – to help the long-term unemployed find work, in addition to further funding for job centres (see Box 3 for more details). The Chancellor's strategy for dealing with looming high unemployment appears to be focusing on providing job-finding support for the unemployed (in addition, of course, to stemming flows out of work, with the extension of the JRS). What is missing from this strategy are significant efforts to stimulate new job creation. Ultimately, the effectiveness of the Restart scheme, or any other back-to-work measures, will depend on the strength of the labour market and the number of new jobs created. We have previously argued, for example, that the Government should use public spending to directly create many new jobs, prioritising social care, along with jobs improving the energy efficiency of the housing stock.[9]

BOX 3: **The Restart scheme**

The Chancellor has announced a Restart scheme to help the long-term unemployed find work. It will share key features with the Work Programme, which operated between 2011 and 2017. Under the Work Programme, Job Centres referred the long-term unemployed – those out of work for over 12 months – to independent providers, who received payments if they helped those clients into work. A new evaluation of the scheme, published yesterday, finds that it was effective in getting people into work (participants spent 46 additional days in employment over a two-year period compared to similar individuals who did not participate). It was also found to

8 The OBR forecast embodies a small amount of labour market scarring, with the participation rate expected to be lower throughout the forecast thanks to earlier retirement and a rise in 'discouraged' workers. The unemployment rate is also expected to be persistently higher, reflecting structural economic changes brought about by the pandemic.

9 N Cominetti, L Gardiner & H Slaughter, Full Monty: Facing up to the challenge of the coronavirus labour market crisis, Resolution Foundation, June 2020.

have delivered a net positive financial return for the Exchequer.[10] The Work Programme cost £2.9 billion, the same as has been allocated to Restart, but this was spread over six years rather than three, suggesting the new scheme will be able to help more people, or offer more intensive or different types of support.

Although evaluations have found the Work Programme was effective, it also had flaws that the new scheme should not repeat. This includes a lack of minimum service standards, an over-reliance on price (rather than quality) when allocating contracts to private sector providers, and the fact that performance in generating employment placements was worst for the most disadvantaged groups.[11] And the new scheme will pose a major delivery challenge, in part because the market for employment-support providers has shrunk considerably in recent years.[12]

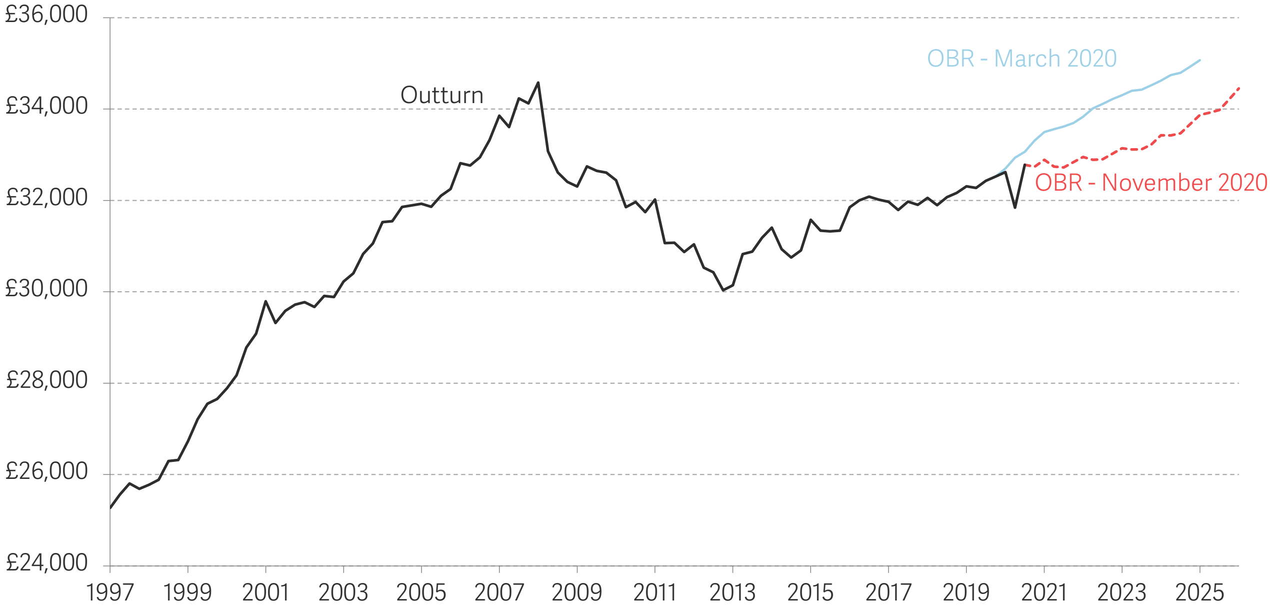
Pay growth looks set to remain very weak

The OBR expects a smaller economy and higher unemployment to feed through into much weaker pay growth. As Figure 5 shows, earnings fell sharply in the second quarter of this year, as many workers moved onto the JRS and saw their earnings fall. Although pay growth has since returned, as workers moved off furlough, earnings growth is expected to remain persistently weak. As a result, inflation-adjusted earnings are expected to be 3.4 per cent (or £1,200) lower by 2025 than the March forecast. As Figure 5 makes clear, this continued weakness comes after over a decade of lost pay growth, and on the OBR's measure, earnings will remain below pre-financial crisis levels through to 2026 (though it is worth noting that real regular pay returned to its pre-financial crisis peak this year on the usual average weekly earnings measure).[13] Against this backdrop, the Chancellor announced that he would be freezing pay for most public sector workers for the upcoming financial year, as Box 4 sets out.

10 N Cominetti & H Slaughter, Low Pay Britain 2020, Resolution Foundation, September 2020.
11 Learning and Work Institute, 'Work and skills for the long-term unemployed', November 2020.
12 Learning and Work Institute, 'Time to act: Tackling the looming rise in long-term unemployment', October 2020.
13 The OBR uses an implied measure of average earnings based on the National Accounts measure of wages and salaries. On the Average Weekly Earnings measure (based on regular pay, rather than total pay), real earnings returned to their pre-financial crisis peak in February 2020, dipped below that level during the spring lockdown, and then returned to the previous peak in August.

FIGURE 5: **In the long run, earnings are forecast to be much lower than the OBR expected in March**

Real average annual employee earnings (CPI-adjusted to 2019-20 prices), outturn and successive OBR projections



SOURCE: OBR, Economic and Fiscal Outlook, various.

BOX 4: **Public sector pay**

The Chancellor has announced a pay freeze for most public sector workers in 2021-22, excluding frontline NHS staff. And while those earning below £24,000 a year will receive pay rises of 'at least £250', this too is likely to represent a cut to real pay for many.[14]

In part, the Chancellor has justified this decision by the need to maintain 'fairness' between public and private sector pay. Earnings in the private sector fell sharply in the depths of the crisis, while public sector pay growth continued. More recently, private sector pay growth has picked up, partly reflecting a compositional effect caused by a higher rate of job losses amongst low earners. This has left private sector wages 1.6 per cent higher than before the crisis.[15]

A lot of attention has focused on pay gaps between public and private sector workers. There are a number of ways to estimate the earnings gap, but all show that the public sector pay premium has narrowed over the past decade, having

14 For example, a worker earning £24,000 who receives a £250 pay rise (1.0 per cent in nominal terms) will see their pay fall in real terms if CPI inflation reaches the OBR's projection of 1.3 per cent.

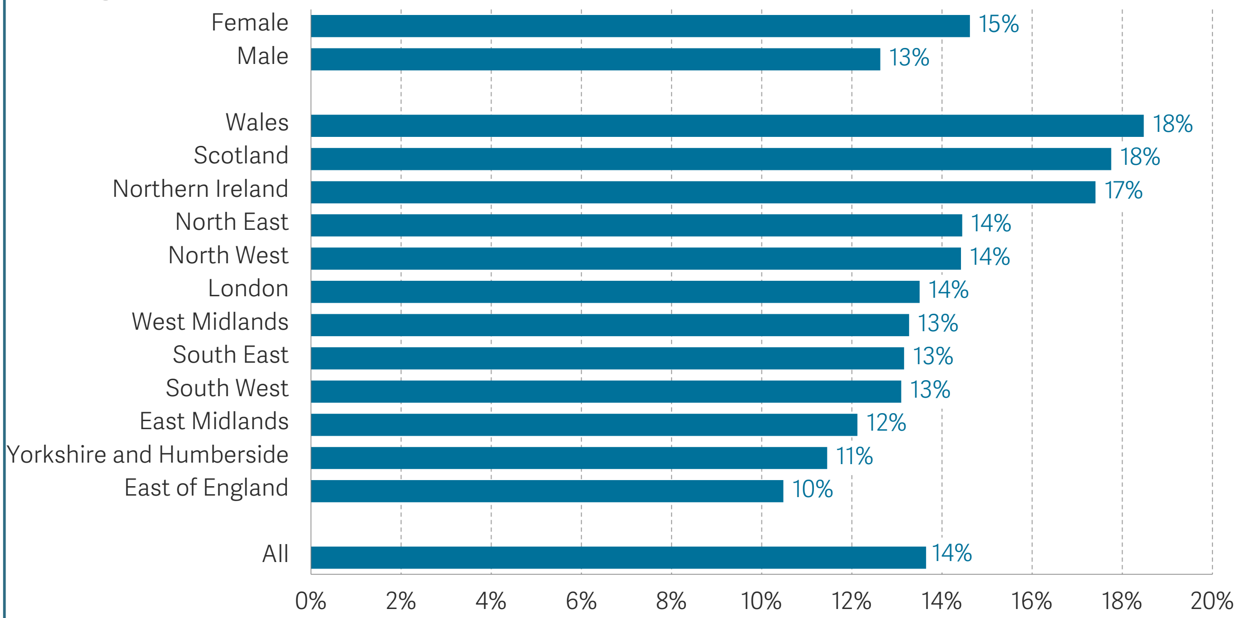
15 Comparing the three months to September with the three months to February, after adjusting for CPIH inflation. Source: RF analysis of ONS, Labour Market Statistics (Average Weekly Earnings).

grown during the financial crisis.[16] Indeed, the Institute for Fiscal Studies estimates that it fell to zero in 2019-20.[17]

What is clear is that the burden of a pay freeze will not be evenly spread. Figure 6 shows that women are more likely than men to be affected by the freeze, and the devolved administrations, as well as regions in the north of England, have the highest share of affected workers.

FIGURE 6: **Workers in Wales, Scotland and Northern Ireland are most likely to be affected by the pay freeze**

Share of workforce (aged 16+) affected by the public sector pay freeze, by sex and region: UK, Q3 2020



NOTES: We assume that people working in the public sector, and not in the 'human health activities' industry division, and earning at least £24,000 a year will be affected by the pay freeze.
SOURCE: RF analysis of ONS, Labour Force Survey.

Another key policy announcement that affects the lowest earners was the uprating of the National Living Wage (NLW) for April 2021. It will rise by 19p – higher than the rate of forecast inflation – and the age threshold has been lowered from 25 to 23 (see Box 5 for more details).

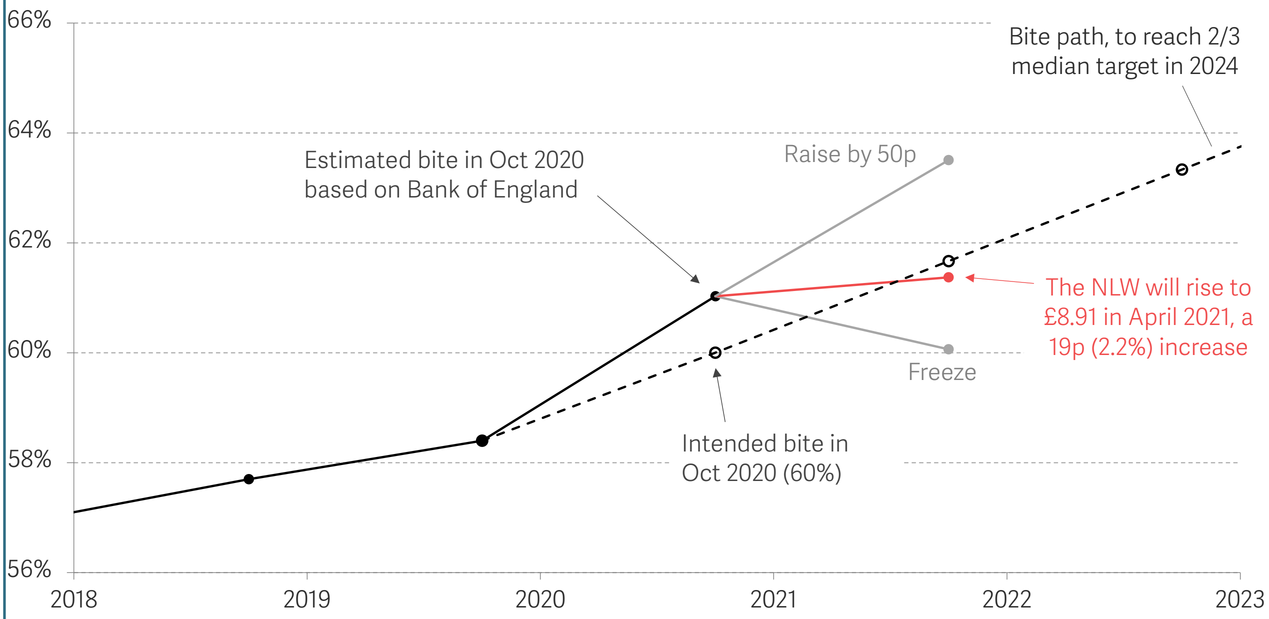
16 For example, see: Office for National Statistics, Public and private sector earnings: 2019, September 2020.
17 B Zaranko, Spending Review 2020: COVID-19, Brexit and beyond, Institute for Fiscal Studies, November 2020.

BOX 5: **The National Living Wage**

The Chancellor announced that the NLW – the minimum wage rate for adults aged 25 and above – will rise by 19p (2.2 per cent) in April 2021, reaching £8.91. This is slightly above the OBR's forecast of CPI inflation for 2020 Q2 of 1.3 per cent, meaning workers on the NLW will experience a small real-terms pay increase. The uprating follows the recommendation by the Low Pay Commission (LPC), who advise the Government on minimum wage setting.

FIGURE 7: **A modest 19p rise in the NLW is likely to return it to its target path relative to median hourly pay**

The 'bite' of the National Living Wage relative to median hourly pay for workers aged 25+: UK



NOTES: Outturn 25+ median hourly pay is derived from the Low Pay Commission's published tables on the bite of the NLW. This is projected forward using the Bank of England's forecast of Average Weekly Earnings in its November 2020 Monetary Policy Report, with the 2020 forecast a linear interpolation between 2019 and 2021.
SOURCE: RF analysis of Low Pay Commission, 2019 report; Bank of England Monetary Policy Report, November 2020.

The 2021 increase will be the smallest increase since 2013, and lower than the increase that would have been expected had the pandemic not struck. This is thanks to the fact that the Government's target for the NLW is set relative to median pay (specifically, to reach two-thirds of median hourly pay by 2024), and so lower pay growth results in a lower cash target for the NLW. Measures of earnings are currently affected by the loss of pay experienced by some furloughed workers, so it is hard to know exactly where the NLW stands relative to itws target path. In Figure 7, we take the Bank of England's latest earnings forecast and interpolate between their 2019 and 2021 values. This implies that the NLW was above its target path in 2020, and that a 19p uprating in 2021 will (more or less) return it to being on track to reach two-thirds of median pay in the middle of this decade.[18]

As always, minimum wage policy involves balancing the benefits of raising the pay of the lowest-paid workers against the risk to the jobs of those same workers (along with other potential effects such as inflation or business closure). The vast empirical literature on minimum wages tends to find that they have only 'small' employment effects,[19] even those which focus on the impact of the minimum wage during the financial crisis.[20] However, the UK's minimum wage was much lower then, and there are additional uncertainties in this crisis around firms' ability to afford a higher minimum wage, especially given the crisis has been concentrated on the lowest-paying sectors.[21] A modest increase is therefore a sensible decision in the midst of this crisis.

But given a small uprating this year, it is welcome that the Government has not abandoned the longer-term target to 'end low pay' by 2024. It's also welcome that the Chancellor has stuck to the plan (again, following the advice of the LPC) to lower the age threshold for the NLW to 23-year-olds in April 2021 – down from 25. The Government's intention is to lower the age threshold further to 21 by 2024.

Overall, despite very significant Government support, incomes have taken a big hit

A combination of rising unemployment and weak pay growth are set to result in a big hit to household incomes. After a sharp fall in household incomes in the second quarter of this year, they are set to recover in the second half of the yea, but then fall further as unemployment spikes in the second quarter of 2021 (see Figure 4). In the longer term,

18 The LPC themselves undertook a similar calculation, and concluded that an uprating of 35p (to £9.06) would have kept the NLW on its target path. This means that they recommended (and the Government agreed to) a more cautious uprating than implied by the NLW target path. See Low Pay Commission, November 2020.Low Pay Commission 2020 Summary of Findings, November 2020.

19 A Dube, Impacts of minimum wages: Review of the international evidence, Department for Business, Energy and Industrial Strategy and HM Treasury, November 2019.

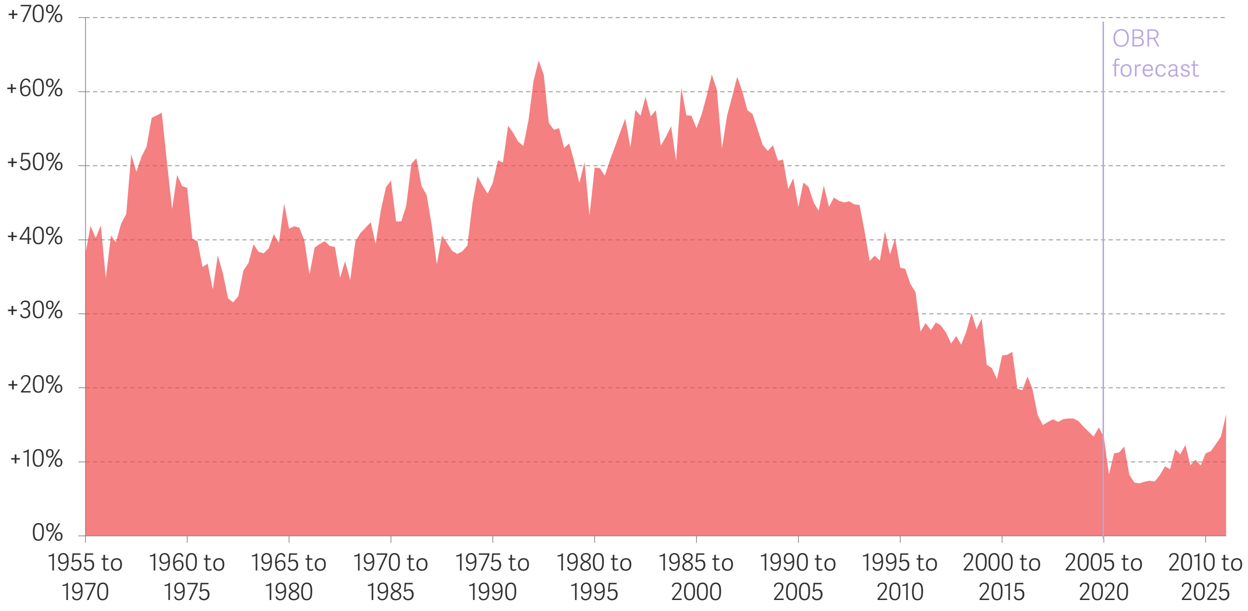
20 R Dickens, R Riley & D Wilkinson, Re-examining the impact of the national minimum wage on earnings employment and hours: the importance of recession and firm size, Low Pay Commission, January 2012.

21 N Cominetti & H Slaughter, Low Pay Britain 2020, Resolution Foundation, September 2020.

a smaller economy will have a lasting impact on incomes, and, by 2025, real household disposable income (RHDI) per capita is forecast to be 2.7 per cent lower than the OBR expected earlier this year. The result, as Figure 8 shows, is to compound the income squeeze of the past decade. In the fifteen years to 2008, ahead of the financial crisis, RHDI per capita grew by 40 per cent; in the fifteen years since (to 2023), incomes will have grown by a quarter of that – just 10 per cent.

FIGURE 8: **The last 15 years have been the worst on record for real household disposable incomes**

Fifteen-year growth rate in Real Household Disposable Income per capita



NOTES: Includes NPISH.
SOURCE: RF analysis of ONS and OBR.

Notably absent from the Spending Review was a decision about whether the £20 per week increase to Universal Credit and Working Tax Credit will persist. Although the DWP confirmed that most benefit rates and tax credit rates and allowances will rise in April 2021 in line with inflation as usual, the statement was clear that this did not imply that the £20 per week rise would persist. Instead, the Government said that "it will continue to assess how best to support low-income families, which is why we will look at the economic and health context in the new year". However, it has already decided that LHA rates, which were increased in March to bring them up to the 30th centile of local rent levels, will be frozen in cash terms in 2021, and that this is the default position for future years too. This suggests we are going back to the position we were in between 2012 and 2020, repeating the error of separating out housing support from rent levels.

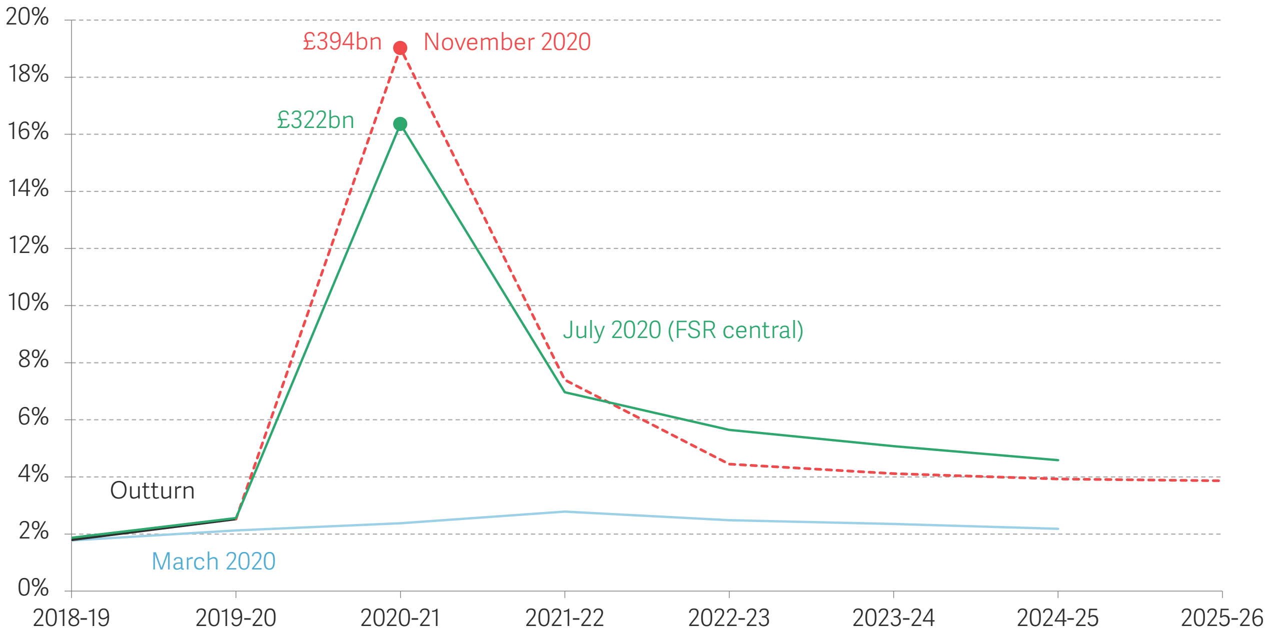
Not announcing the continuation of the £20 per week makes little sense. Recent RF work shows that half (54 per cent) of adults from families in the lowest income quintile have borrowed in recent months to cover everyday costs such as housing and food, and almost one-in-three (29 per cent) adults that has had a persistently low income through the pandemic say they cannot afford basic items such as fresh fruit and vegetables every day, or to turn on the heating when required. Universal Credit is providing the key safety net benefit for those unable to benefit from the JRS or the Self-Employment Income Support Scheme. Taking £1,000 off the annual income of 6 million low-income households next April would cause a living standards crisis, directly leading to a 5 per cent fall in incomes the bottom quarter of the income distribution in April next year, and implementing a fiscal contraction at that time risks derailing any hope of an economic recovery. It makes no sense, politically or economically.

The 2020-21 deficit is forecast to reach a peacetime record of £394 billion

The key figure many will have been anticipating in the OBR's forecast of the public finances is the total public sector borrowing that will take place this year – an eye-watering £394 billion. This marks a peacetime record, with the borrowing rate of 19 per cent of GDP last exceeded during the final year of the Second World War in 1944-45. As illustrated in Figure 9, this is also significantly higher than both the borrowing of £322 billion forecast in the OBR's Fiscal Sustainability Report back in July, and their updated £372 billion forecast in August.

FIGURE 9: **Public sector borrowing is set to peak at £394 billion this year**

Public sector net borrowing as a proportion of GDP: outturn and successive forecasts

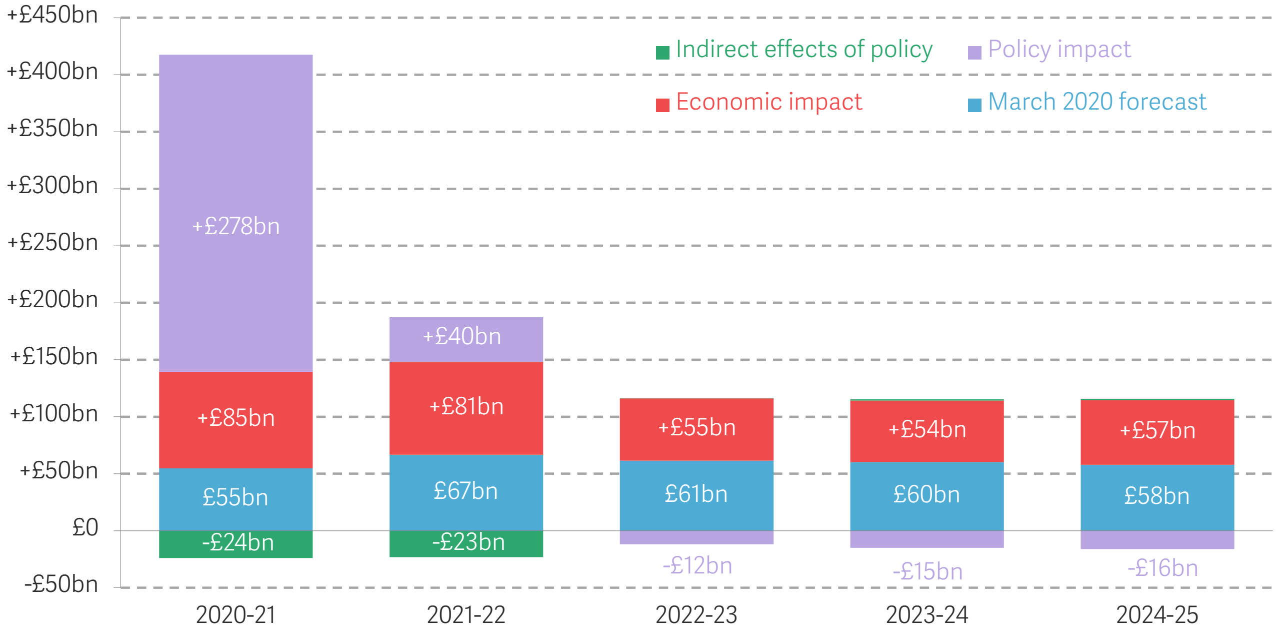


NOTES: July 2020 forecast excludes OBR costings of Summer Economic Update measures (the most recent revised borrowing forecast published by the OBR reached £372.2bn).
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2020 and November 2020; OBR, Fiscal Sustainability Report, July 2020.

As shown in Figure 10, the increase in the OBR's latest estimates of borrowing are largely due to significantly more government spending on policy measures, adding a total of £278 billion to borrowing in 2020-21. This includes significant policy costs announced since the OBR's previous forecast, with the recent extension of the JRS and Self-Employment Income Support Scheme (SEISS) contributing an extra £21 billion, and additional public services spending since the Winter Economy Plan a further £64 billion. Pushing in the opposite direction are the OBR's estimates of the impact of government policy on the economy, which acts to reduce the deficit by around £24 billion in 2020-21, as well as the lower public spending plans set out in the Spending Review (a subject we return to shortly) The amount by which tax revenues have fallen and welfare spending increased as a result of the smaller economy has also fallen since the OBR's July forecast, with this now expected to increase borrowing by £85 billion in 2020-21, as opposed to the £125 billion previously forecast. This is largely the result of a somewhat less-weak-than-feared outlook for the labour market than the FSR scenario produced in July.

FIGURE 10: **Policy measures are set to add £278 billion to borrowing in this year**

Public sector net borrowing by source: March 2020 forecast and additional borrowing forecast in November 2020



SOURCES: RF analysis of OBR, Economic and Fiscal Outlook, November 2020.

It is worth noting that these forecasts for borrowing in 2020-21 remain significantly below outturn borrowing in the most recent monthly public finance figures published by the Office for National Statistics. OBR analysis suggests borrowing has so far been lower than forecast (excluding the impact of loan scheme write-offs, that now elevate forecasted figures by an estimated £30 billion), due to a combination of lower-than-expected central government spending, and stronger income tax, NICs and VAT revenues, reflecting stronger real GDP growth than expected over the summer.12

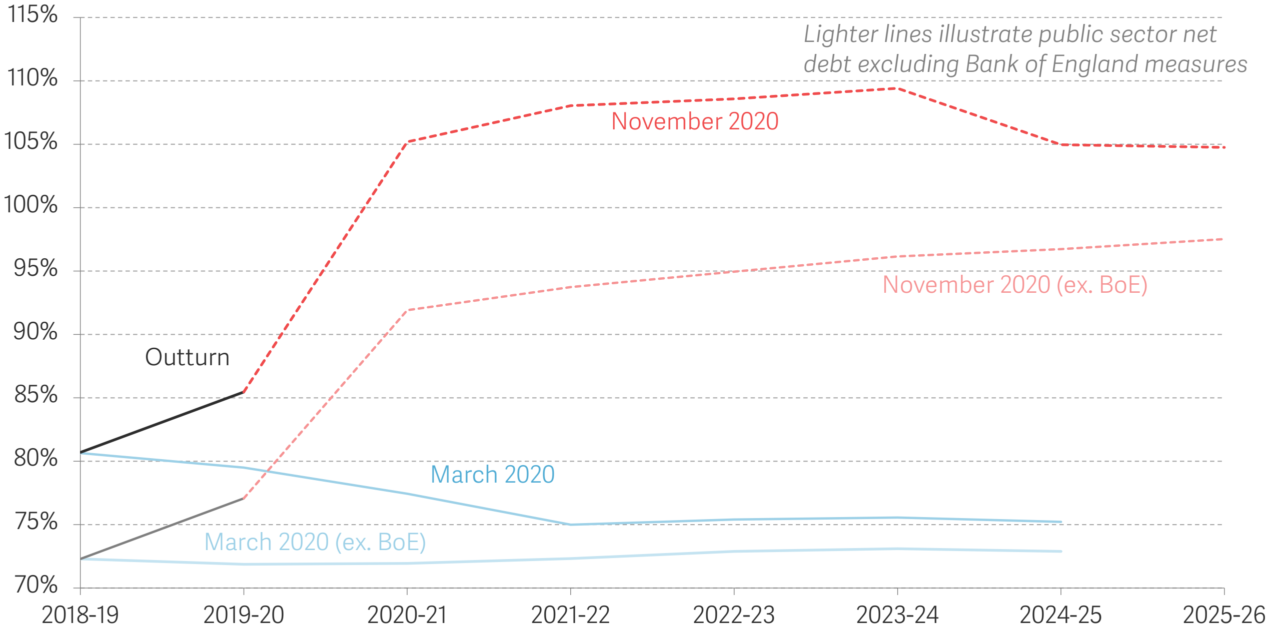
Looking further ahead, some lasting damage to the public finances is likely

As shown in Figure 10, while dramatically elevating borrowing this year, most policy spending 'drops out' of the forecast from 2022-23 onwards, meaning the key fiscal challenge the Government faces is caused by the effect of persistent economic scarring. In the OBR's forecast, borrowing remains elevated by £57 billion above the March forecast by 2024-25, reflecting an economy that is forecast to be around 3 per cent smaller. Adjusting to this new, more challenging state of affairs for the public finances will be central to the Government's fiscal policy in the coming years. It is worth noting, however, that such a 'structural' increase in borrowing – of just over two per cent of GDP – would be far lower than that experienced after the financial crisis, when structural borrowing reached 6 to 10 per cent of GDP.[22]

The structurally-higher borrowing contributes to rising public sector debt, which is forecast to reach 109 per cent of GDP (Figure 11). Debt remains on a rising trajectory by the end of the forecast (abstracting from the falls in debt at the end of the forecast that relate to the unwinding of one of the Bank of England's loan schemes[23], rather than any improvement in the Government's finances).

FIGURE 11: **Debt is set to peak at 109 per cent of GDP, and to be on a rising path in 2025-26 (excluding the impact of the Bank of England)**

Public sector net debt as a proportion of GDP, including and excluding Bank of England: outturn and successive forecasts



SOURCES: RF analysis of OBR, Economic and Fiscal Outlook, November 2020.

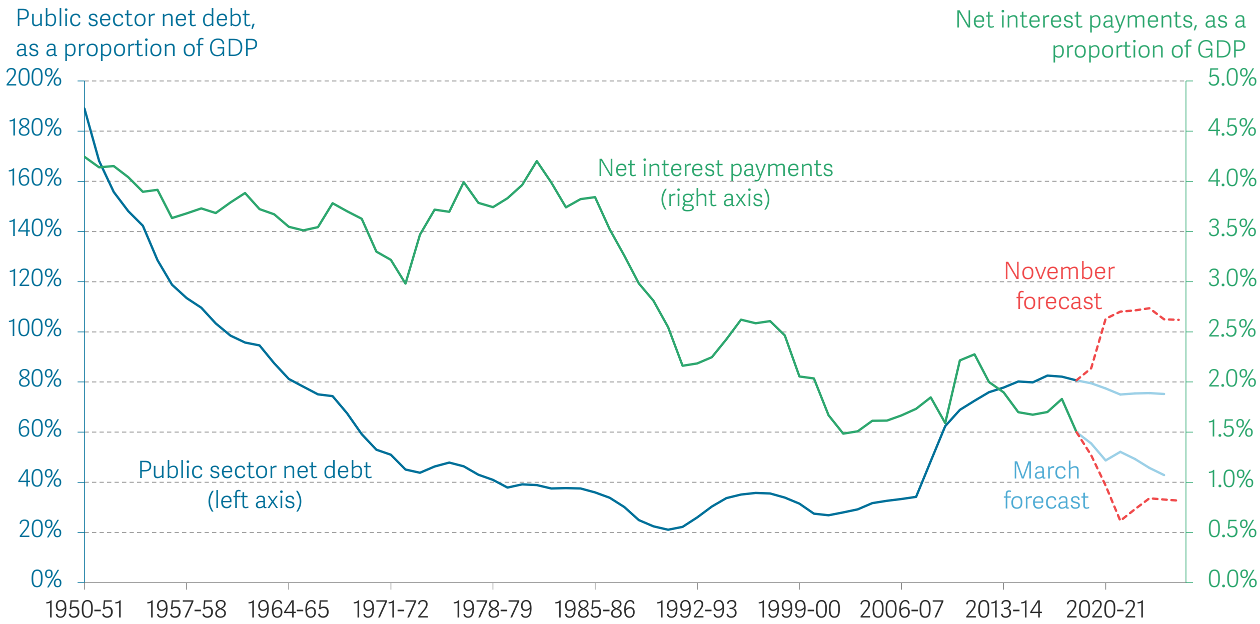
Although the overall size of the Government's debt stocks has dramatically increased due to the crisis, the forecast costs of paying the interest on this debt has actually fallen significantly compared to previous forecasts (Figure 12). The combination of low forecast inflation and gilt yields – the latter partly reflecting £450 billion in extra quantitative

22 Institute for Fiscal Studies, Fiscal facts: tax and benefits, Figure 2 in 'Fiscal response to the crisis'.
23 This refers to the Bank of England's Term Funding Scheme with additional incentives for SMEs (TFSME), which is forecast to add £150 billion to public sector net debt by 2021-22, with this being fully paid back and so 'dropping out' of the forecast over 2024-25 and 2025-26.

easing this year – means that the costs of servicing government debt is forecast to fall by around £20 billion next year compared to pre-crisis forecasts, despite war-time levels of borrowing.[24]

FIGURE 12: **Debt stocks have risen significantly, but debt interest payments remain low**

Public sector net debt and net interest payments as a proportion of GDP: outturn and forecast



NOTES: Historical outturn spliced with the long-term time series of net interest payments published in Chart 1.1 of the OBR's Fiscal Risks Report, July 2019.
SOURCE: RF analysis of OBR, Fiscal Risks Report, July 2019 and OBR, Economic and Fiscal Outlook, November 2020.

The path of the public finances may be clearer, but big questions remain unanswered

Set against a backdrop of a huge economic hit and an on-going health crisis, the Chancellor rightly chose not to use the Spending Review as an opportunity to achieve his stated aim to 'balance the books'.[25] With the economic recovery yet to get properly underway, greater spending, rather than premature fiscal tightening, will be needed next year.[26]

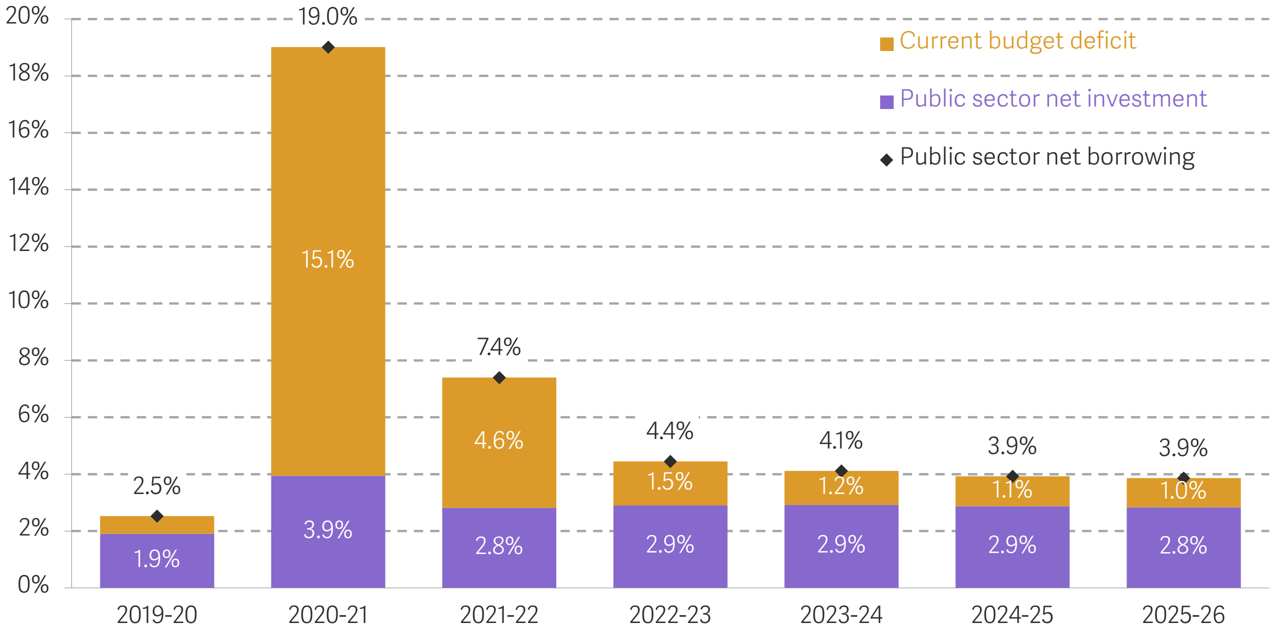
But traditional metrics of fiscal sustainability suggest a significant consolidation will be required once the recovery has been secured. The OBR's analysis suggests that

24 Quantitative easing has the effect of lowering debt interest payments, as gilts purchased through the Asset Purchase Facility are effectively refinanced at the Bank Rate, which has been lower than the gilt rate since the financial crisis. For more information see OBR, The direct fiscal consequences of unconventional monetary policies, March 2019.
25 BBC News, 'Rishi Sunak vows to 'balance books' despite pandemic', 5 October.
26 G Bangham, A Corlett, J Leslie, C Pacitti & J Smith, Unhealthy finances: How to support the economy today and repair the public finances tomorrow, Resolution Foundation, November 2020.

eliminating the current budget deficit would require a consolidation of around £27 billion. Aiming to go further, and see the debt-to-GDP ratio sustainably fall in a way that anticipates the impact of future recessions, would require a much bigger consolidation. This is because nearly three quarters of the Government's borrowing by the end of the forecast period is down to high levels of capital spending that affects debt levels but not the current budget deficit, as Figure 14 shows. However, in an era requiring high public sector investment, not least to achieve our net zero ambitions, it is preferable for any future consolidation to focus on public sector net worth, a metric that effectively excludes capital spending from consolidation totals, while incentivising value-for-money investments.[27]

FIGURE 13: **Capital spending adds close to 3 per cent of GDP to the deficit by 2025-26**

Public sector net borrowing as a proportion of GDP: current budget deficit and public sector net investment



SOURCES: RF analysis of OBR, Economic and Fiscal Outlook, November 2020.

Spending is set to rise by £281 billion in 2020-21

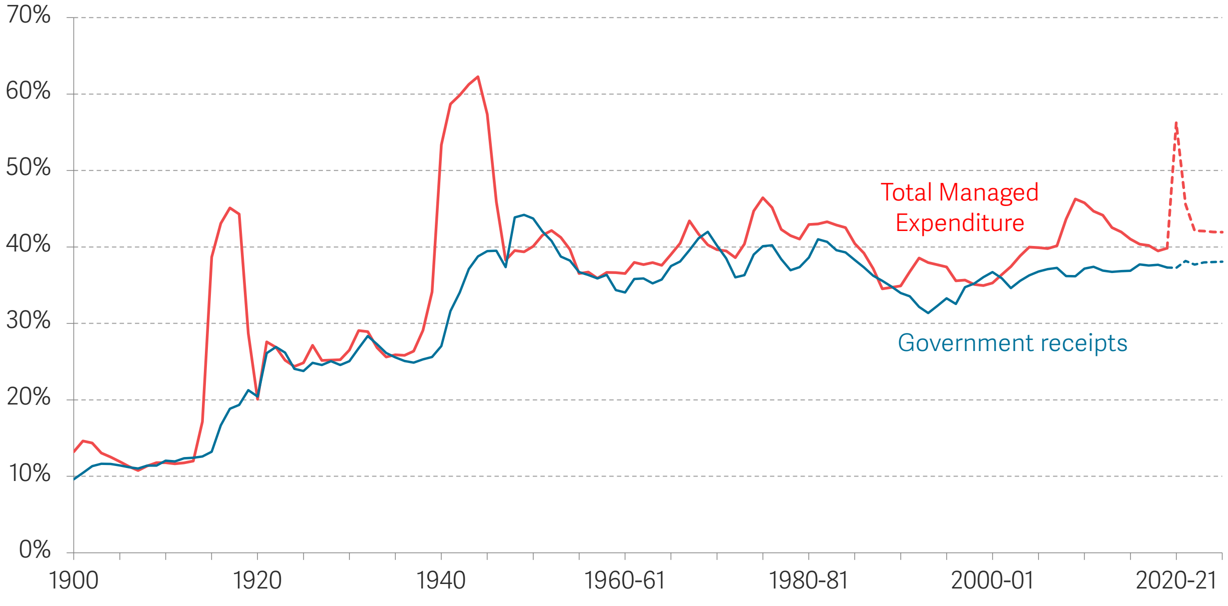
Although the long-run damage to the economy and public finances is the key driver of the extent of any required consolidation, the pandemic-related spending increases are the main driver of unprecedented borrowing this year. This crisis has necessitated huge increases in public spending – both for the health system and wider economic support –

27 G Bangham, A Corlett, J Leslie, C Pacitti & J Smith, Unhealthy finances: How to support the economy today and repair the public finances tomorrow, Resolution Foundation, November 2020.

as the country has mobilised itself to one single end: to combat and mitigate the effects of coronavirus. Only in wartime have we ever seen comparable levels of public spending. But, as in the Second World War, the OBR expects spending to return to normal once the crisis abates. Figure 14 shows that total public spending is set to be 56 per cent of GDP this year, falling to 42 by 2025-26.

FIGURE 14: **The size of the state has reached a peacetime record this year, and is set to remain elevated next year**

Total Managed Expenditure and government receipts as a percentage of GDP



SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, November 2020: Bank of England, A millennium of macroeconomic data for the UK.

We now turn to the underlying components of this spending, looking at what has driven the huge increases during the coronavirus period, but also any lasting changes beyond. Here it is important to distinguish between three broad categories of spending: Annually Managed Expenditure (AME): day-to-day spending determined by statutory rules and outside of the direct remit of government departments to control (mostly welfare spending and public pensions); Resource Departmental Expenditure Limits (RDEL) – day-to-day spending on public services and within the scope of departments to control (healthcare, education, police, etc.); and Capital Departmental Expenditure Limits (CDEL) – government investment spending on longer term projects.

Spending increases during the pandemic are dominated by additional incomes support and funding the public health response

Turning first to AME, spending has increased by an astonishing £100 billion in just one year, a 22 per cent increase, driven by the Government's policy measures. This year will see an estimated £63 billion paid out via the JRS and £21 billion of payments under the SEISS. An extra £19 billion has been spent on welfare payments, largely as a result of an increase caseloads and the £20 per week increase to Universal Credit and the Working Tax Credit. The reduced forecast for debt interest costs mentioned above pushes the other way, though.

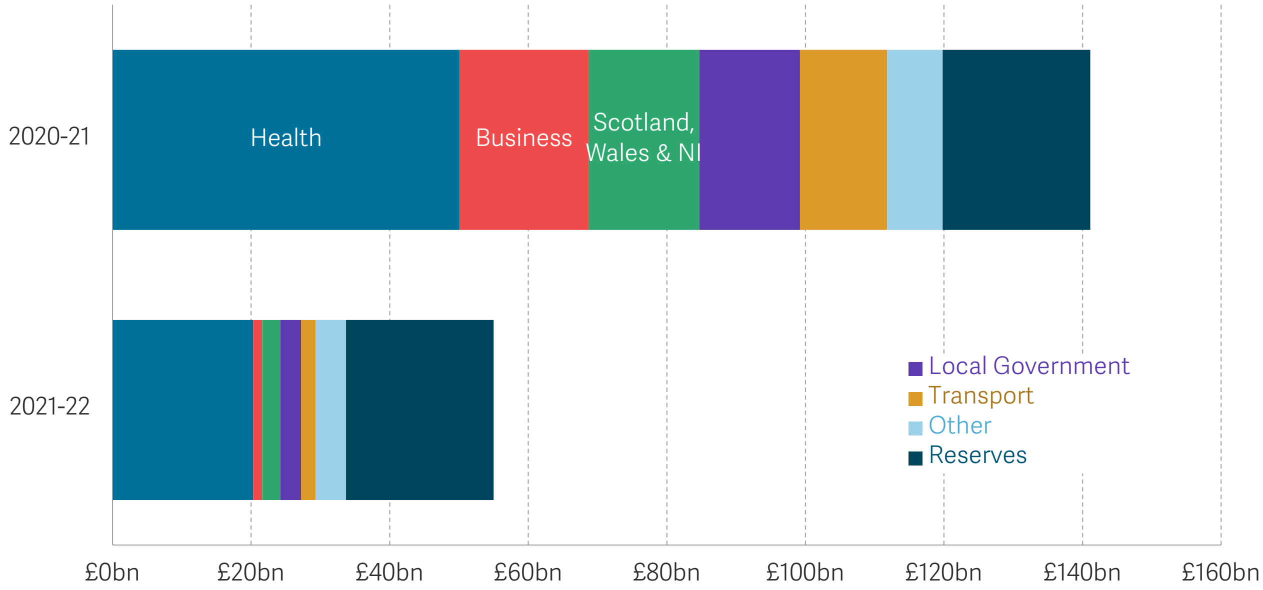
RDEL has also surged between 2019-20 and 2020-21. Rather than a 6.5 per cent increase as was planned at Spending Round 2019, the actual growth in RDELs is likely to be around 40 per cent this year, way beyond anything experienced outside wartime. Key drivers of this £132 billion increase are: £50 billion of additional spending by the Department of Health and Social Care, a £19 billion increase in spending by the Department for Business, Energy, and Industrial Strategy (including grants to businesses), and £13 billion more for the Department for Transport (including payments to keep trains and buses running with few passengers).

The Chancellor is assuming almost 40 per cent of this year's departmental coronavirus spending will carry forward into 2021-22

In the face of grim economic and public finance forecasts, the Chancellor announced further spending for responding to the pandemic. The need to deliver the largest vaccination programme seen in the UK for decades, as well as continued spending pressures in a variety of parts of the public sector – ranging from additional staff in DWP who are providing vital assistance with job search to continued subsidies to public transport – saw him extend coronavirus-related spending into next year. In particular, the Chancellor's departmental budget setting for 2021-22 allocates £34 billion to departments for day-to-day coronavirus-related spending, with a further £21 billion held in reserve, in total as much as the entire schools budget. Although significant, as Figure 15 shows, this is a fall of over 60 per cent compared to the coronavirus funding allocated to departments this year.

FIGURE 15: **Coronavirus-related departmental spending is planned to fall by more than 60 per cent next year**

Components of coronavirus-related day-to-day departmental spending: 2020-21 and 2021-22



SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, November 2020; HM Treasury, Spending Review 2020, November 2020.

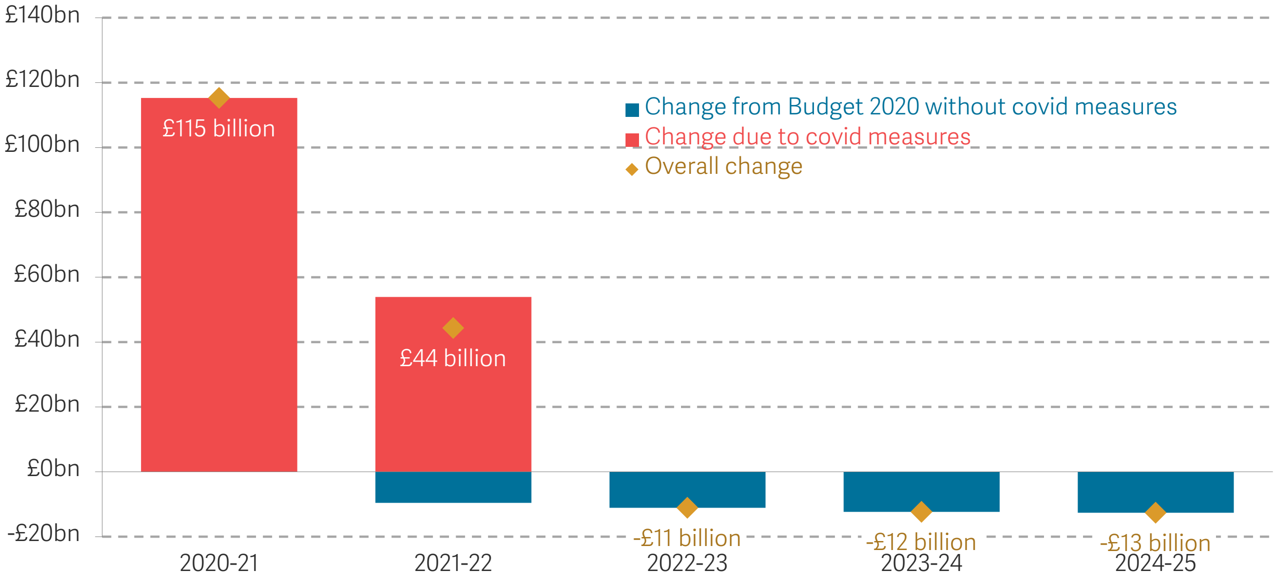
Maintaining a large proportion of this additional funding in a reserve is very sensible, acting as a buffer to public finances if more spending if required. However, it is important that HM Treasury is responsive to changes in departments' coronavirus-spending needs in the year ahead, and isn't tightly bound to the allocations set out in the Spending Review should spending needs be different than planned.

But, crucially, the Chancellor has reined back previous spending increases, with non-coronavirus spending now set to be £10 billion lower in 2021-22

In contrast to spending like there's no tomorrow on the pandemic, the Chancellor set out plans to spend less when tomorrow arrives. He does not intend for any coronavirus-related spending to be permanent and, without mentioning it in his speech, set out a reduction of £10 billion in planned non-coronavirus public service spending next year, rising to £13 billion in 2024-25, as Figure 16 shows.

FIGURE 16: **Underlying departmental spending has been cut by £10 billion next year relative to plans in the March Budget**

Changes in real (GDP-deflator adjusted) Resource Departmental Expenditure Limits since the March 2020 Budget



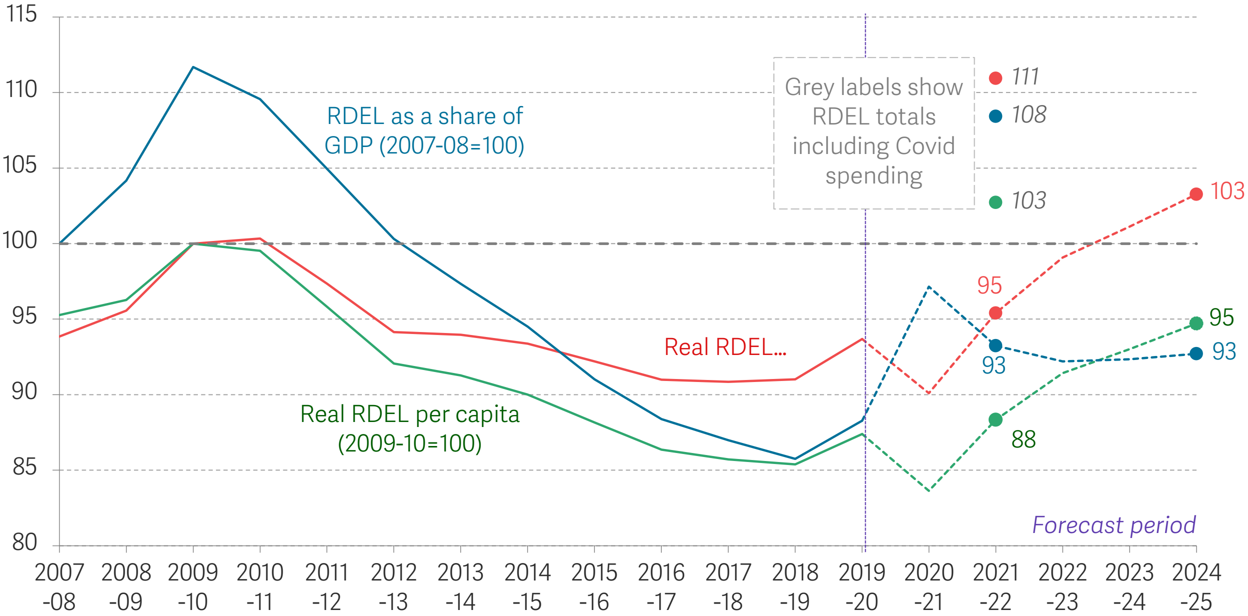
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, November 2020; HM Treasury, Spending Review 2020, November 2020.

That £10 billion spending reduction in 2021-22 means the previously pencilled-in (and large) 6.7 per cent nominal increase in RDEL has been cut to 4.8 per cent. The cuts to the aid budget (saving £4 billion) have taken the lion's share of the attention in the 2021-22 Spending Review, but there are other noticeable changes. For example, the Ministry of Justice is seeing an increase in RDEL of just 1 per cent from 2020-21 to 2021-22, whereas HMRC's budget is set to increase by 20 per cent. Indeed, the Department for Environment, Food and Rural Affairs has seen its RDEL more than double from 2019-20 to 2021-22. This reflects new financing arrangements in line with the department's new responsibilities, from customs to agricultural subsidies, as the UK leaves the EU.

Looking further ahead, non-coronavirus RDEL spending is set to return to its 2009-10 level over the next few years, as shown in Figure 17. However, after adjusting for inflation and population growth, RDEL will still be at 95 per cent of its 2009-10 level in 2024-25.

FIGURE 17: **Non-coronavirus day-to-day departmental spending will still be below its 2009-10 level in 2021-22**

Indices of resource departmental expenditure limits (RDEL) per capita: including and excluding coronavirus-related spending



NOTES: RDEL total adjusted for public service pension adjustment (see OBR, Economic and Fiscal Outlook, October 2018) and for return of EU spending to UK (see Resolution Foundation, New Chancellor. BIG Budget: Spring Budget 2020 response, March 2020.) GDP-deflator adjusted.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, November 2020; HM Treasury, Spending Review 2020, November 2020.

The rhetoric around public spending increases doesn't match the reality for some departments

The tension between the rhetoric of having ended austerity for public services and the reality becomes clearer when we look in more detail at the spending pressures in the years beyond 2021-22. The Chancellor said in his speech that after "getting the country through coronavirus", the second priority of the Spending Review was "stronger public services".[28] This is no surprise given, for example, that a majority (53 per cent) of UK adults favour more spending on health, education and social benefits funded through increased taxation, compared to just 31 per cent in 2010.[29]

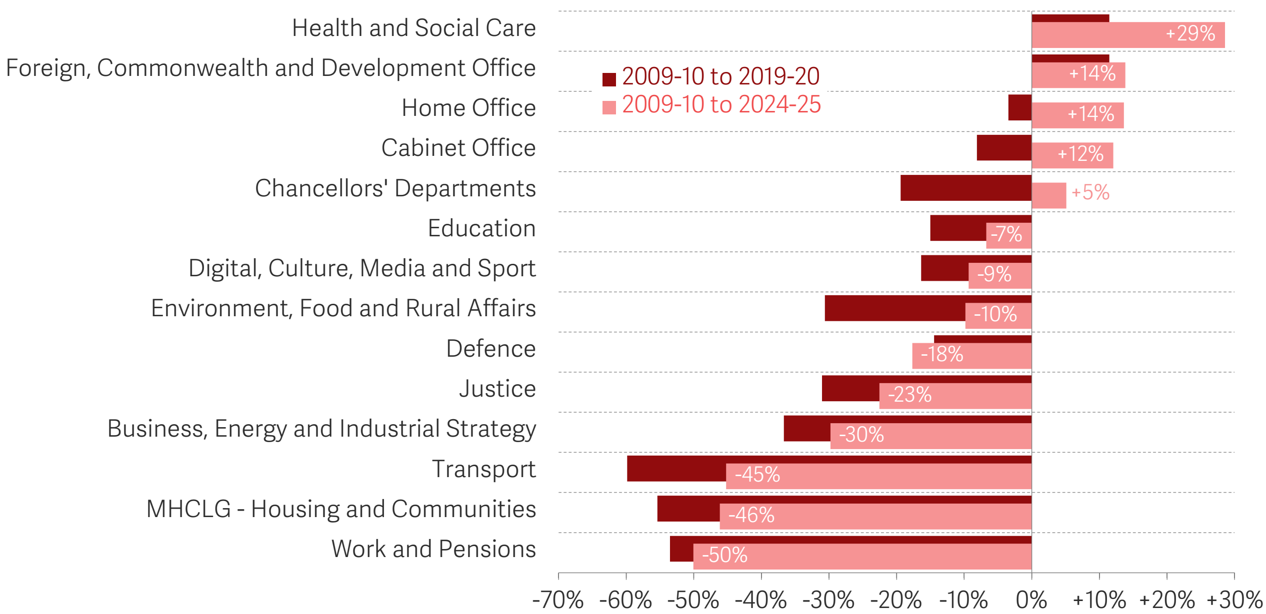
But not all departments are equal beneficiaries of the funding for public services that the Chancellor mentions. The 'winners' are those departments for which Rishi Sunak has reaffirmed his commitment to multi-year increases in budgets. For example, the budget for NHS England is set to increase from £123.7 billion in 2019-20 to £148.5 billion in 2023-24, and the schools budget is set to increase from £44.4 billion in 2019-20 to £52.2 billion in 2022-23. The Home Office budget will also grow significantly.

28 Rishi Sunak, Spending Review 2020 speech, November 2020.
29 NatCen Social research, British Social Attitudes 37, Key time series, 2020.

Figure 18 puts the impact of these increases in the context of the change in core departmental day-to-day spending since 2009-10, assuming that the budgets of protected departments increase in line with GDP in the years beyond existing plans. It shows that, in per capita real-terms, the Department of Health and Social Care's (DHSC) budget is set to be 29 per cent higher in 2024-25 than in 2009-10, the Home Office budget 14 per cent higher, and the Education budget (which has not always enjoyed protections since 2010) 7 per cent lower.

FIGURE 18: **Day-to-day departmental spending changes have been very different across Whitehall**

Cumulative real-terms (GDP-deflator adjusted) change in per capita resource departmental expenditure limits since 2009-10



NOTES: Figures are adjusted as far as possible to account for machinery of government changes.
SOURCE: RF analysis of HM Treasury, PESA tables, Spending Review 2020; OBR, Economic and Fiscal Outlook, November 2020.

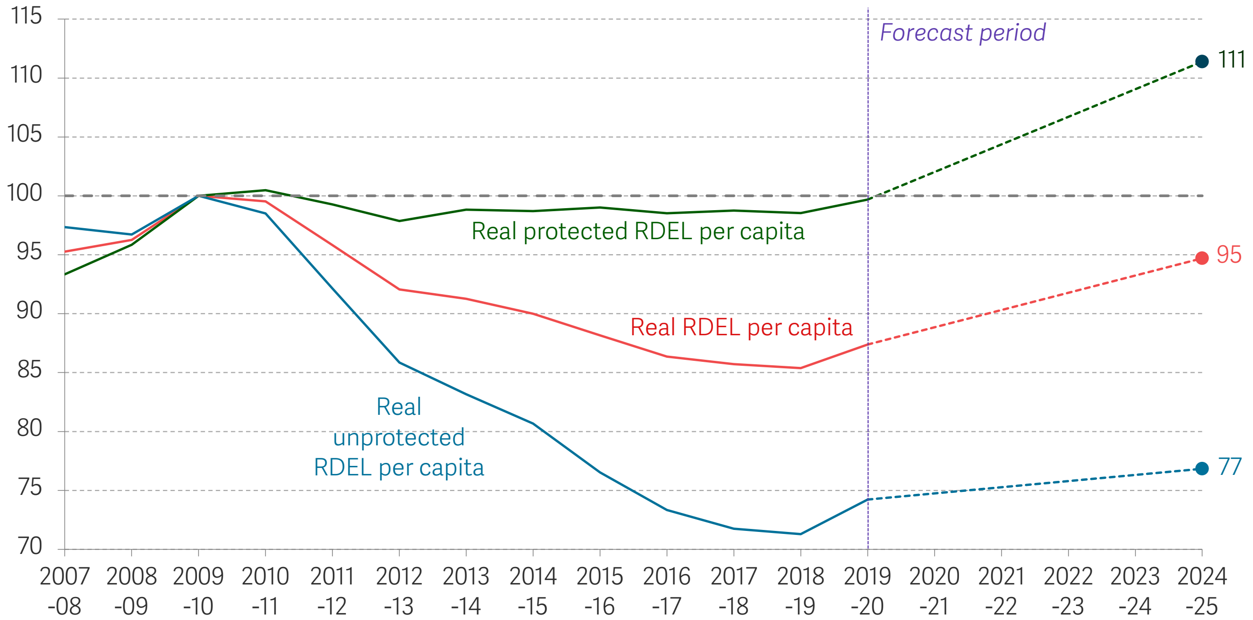
However, this positive picture is not replicated across all of Whitehall. The £10 billion cut to non-coronavirus RDEL budgets in 2021-22 means that there is less room for other budgets to increase within the annual 2.1 per cent real increases in RDEL pencilled in for future years. Although the Chancellor has said that in the Overseas Development Assistance (ODA) budget is set to fall to 0.5 per cent of Gross National Income (GNI) the short-run, this does nothing to relieve long-run spending pressures if, as the Chancellor has suggested, it returns to 0.7 per cent of GNI in the near future. This explains why our projection for spending in the Foreign, Commonwealth and Development Office (FCDO) in 2024-25 is 14 per cent higher in real per-capita terms than in 2009-10: we assume that the temporary cut to ODA is reversed by the middle of the decade.

Perhaps surprisingly, one area where the Chancellor has provided more space for other departments is in the Ministry of Defence budget. Rather than increasing it in line with GDP (as we had assumed at previous fiscal events), the Government has now confirmed that, in cash terms, defence RDEL is flat, at around £31.5 billion between 2021-22 and 2024-25. This makes it the only department for which the day-to-day spending picture is currently set to decline materially in real terms per-person over the next four years. Instead, most of the boost to defence spending trailed in advance of the Spending Review is confined to capital budgets.[30]

Detailed spending allocations for other departments for years beyond 2021-22 will be published at the next Spending Review, but, with the information and assumptions about protected departments set out above, we can infer the path of spending for unprotected departments to 2024-25.[31] Strikingly, these assumptions suggest that the Transport, Work and Pensions, and Housing and Communities RDEL budgets will still be about half as small as in 2009-10 in real per capita terms (see Figure 17).

FIGURE 19: **Different parts of Whitehall have fared very differently over the past decade**

Indices of real-terms (GDP-deflator adjusted) per capita resource departmental expenditure limits (RDEL) limits, all departments: 'unprotected' departments and 'protected' departments (2009-10=100)



NOTES: RDEL total adjusted for public service pension adjustment (see OBR, Economic and Fiscal Outlook, October 2018) and for return of EU spending to UK (see Resolution Foundation, New Chancellor. BIG Budget: Spring Budget 2020 response, March 2020.). Protected departments: DHCS, FCDO and Education.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, November 2020; HM Treasury, PESA, Spending Review 2020.

30 See PM statement to the House on the Integrated Review: 19 November 2020.
31 We assume the same growth for all unprotected RDEL budgets, derived from the residual RDEL spending after protected departments allocations are deducted from the overall RDEL total published by the OBR.

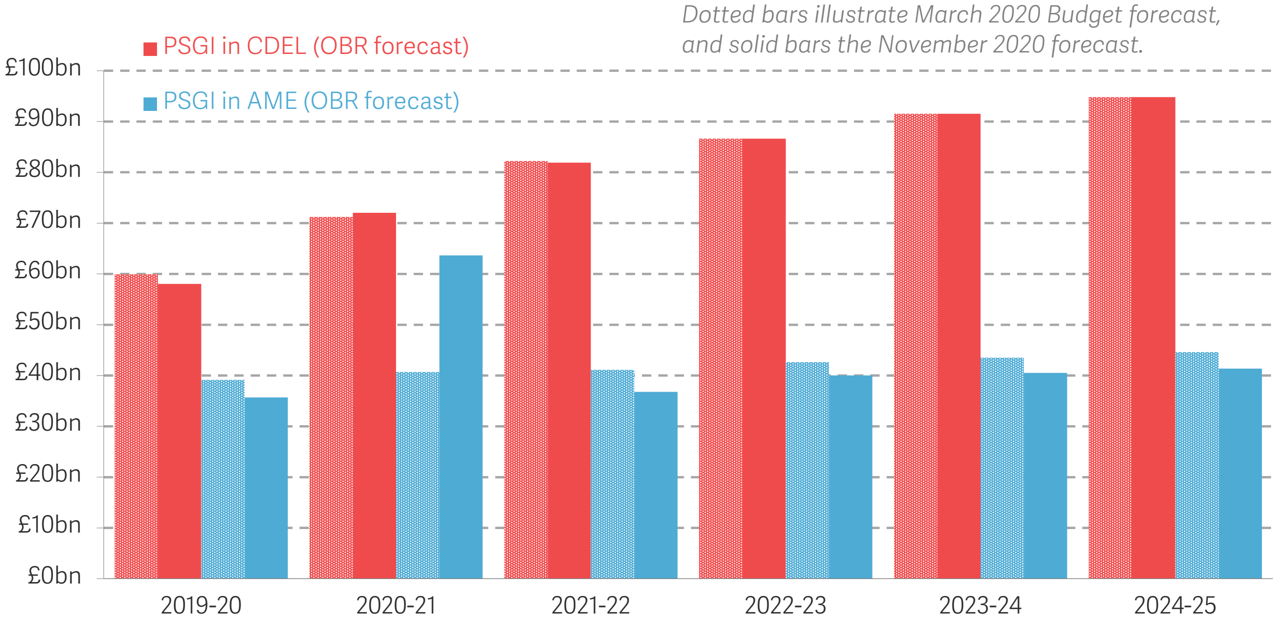
Protected departments' budgets (i.e., those of DHSC, FCDO and Education) are set to be 14 per cent higher in 2024-25 than in 2009-10. In sharp contrast, as Figure 19 shows, unprotected departments' budgets are still set to be almost a quarter lower than in 2009-10 when measured in real per capita terms.

A continued commitment to high capital spending is at the core of the Government's 'levelling up' agenda

In contrast to changes in day-to-day spending, capital spending has been less affected by short-term pandemic-related spend, and the Chancellor has stuck to the ambitious capital spending targets he set back in March.

FIGURE 20: **Capital spending limits have largely been set in line with March forecasts**

Public Sector Gross Investment in Departmental Expenditure Limits and Annually Managed Expenditure, March and November forecasts (£ billion)



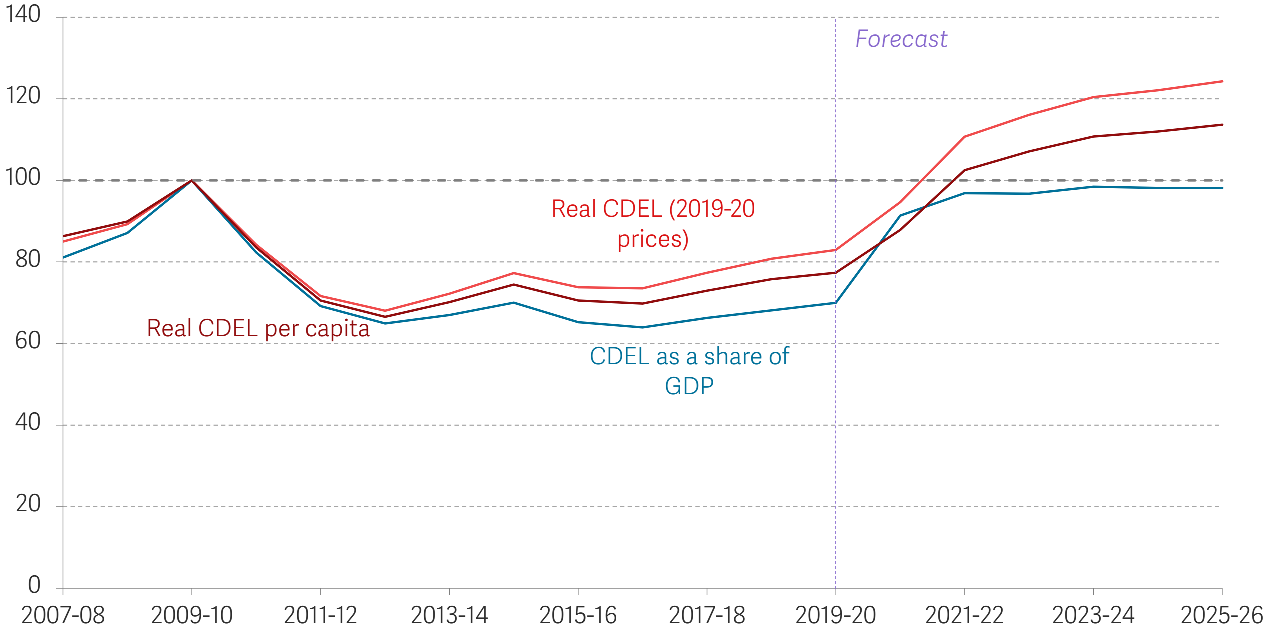
SOURCE: RF analysis of HM Treasury, Spending Round and Spending Review documents.

As shown in Figure 20, OBR forecasts of CDEL budgets in March and November are virtually identical in nominal terms. While the November forecasts include higher CDEL spending due to coronavirus in 2020-21, this has a far less significant effect on overall total limits than does the change in RDEL spending, with the Treasury estimating just £9.1 billion was added to CDEL due to coronavirus this year. Treasury estimates suggest that, including this coronavirus spending, CDEL spending is set to reach £100.4 billion in 2021-22, a real increase of £27 billion across the two-year horizon to 2021-22. But the OBR assumes a significant underspend of these estimates, bringing down total CDEL spending by £7.3 billion in 2021-22.

As a result of the continuation of March's ambitious investment plans, real-terms CDEL is set to return to pre-austerity levels by 2021-22, and, in per capita terms, CDEL spending is set to rise significantly above pre-austerity levels in the final years of the forecast (Figure 21).

FIGURE 21: **Sticking to the Budget 2020 plans means that CDEL is set to exceed pre-financial crisis levels**

Indices of real-terms (GDP-deflator adjusted) and real-terms per capita Capital Departmental Expenditure Limits (CDEL), and CDEL as a share of GDP (2009-10=100)



SOURCE: RF analysis of OBR, Economic and fiscal outlook, November 2020.

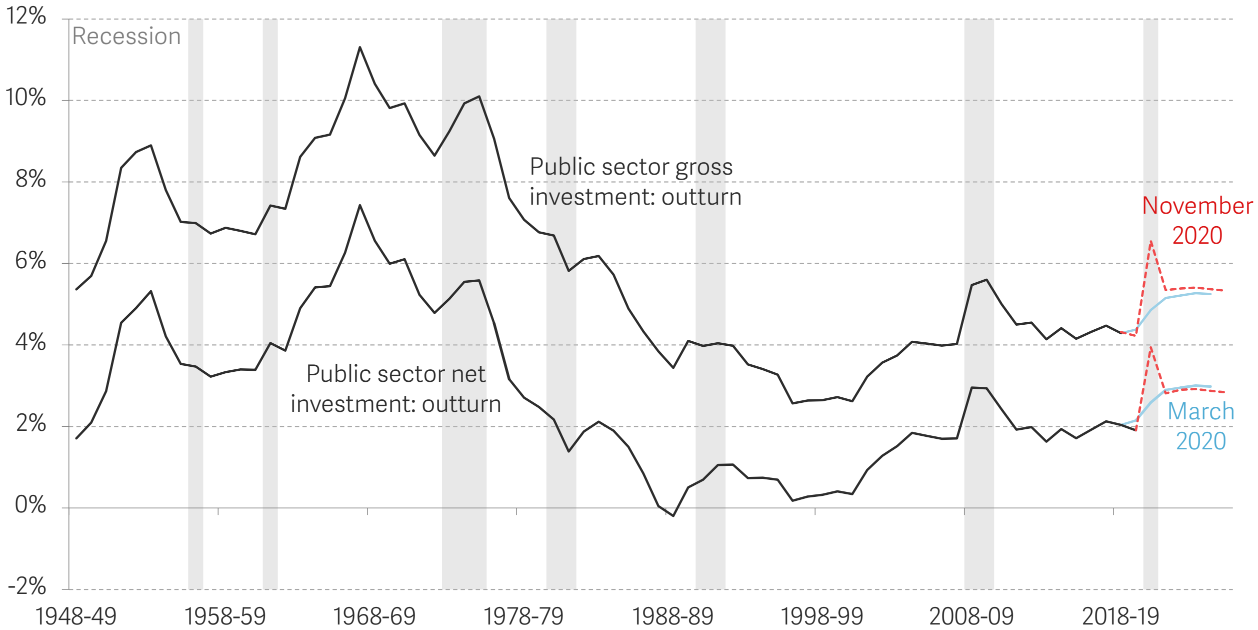
A more complete measure of Government capital spending – that is, total public sector net investment – is set to peak at around 4 per cent of GDP in 2020-21, largely as a result of the projected £29 billion write-offs of government-guaranteed loans. This is a far higher cost than forecast by the OBR back in July, reflecting the extension of the loan scheme and greater pessimism over default rates.[32] As shown in Figure 22, this peak in public sector net investment in 2020-21 means the Chancellor would break the fiscal rule set out in the 2019 Conservative manifesto, which limited investment spending to a maximum of 3 per cent of GDP.[33] But that breach is temporary. The bigger picture is one

32 Estimates in the BEIS Annual Report and Accounts 2019-20 suggest that, for the Bounce Back Loan Scheme: 'Not all loans are expected to default, with losses estimated as at September 2020 to be in a range of 35-60%.' Previous OBR estimates of default rates for this scheme were 40 per cent.
33 The Conservative and Unionist Party, Our Plan: Conservative Manifesto 2019, December 2019

of significant capital spending planned, with the average rate of net investment from 2021-22 to the end of the forecast horizon reaching 2.9 per cent, the highest sustained level of investment since the 1970s.

FIGURE 22: **Public sector net investment is set to reach 4 per cent of GDP in 2020-21**

Public sector net investment and public sector gross investment as a proportion of GDP: outturn and projections



SOURCE: RF analysis of OBR, Economic and fiscal outlook, November 2020.

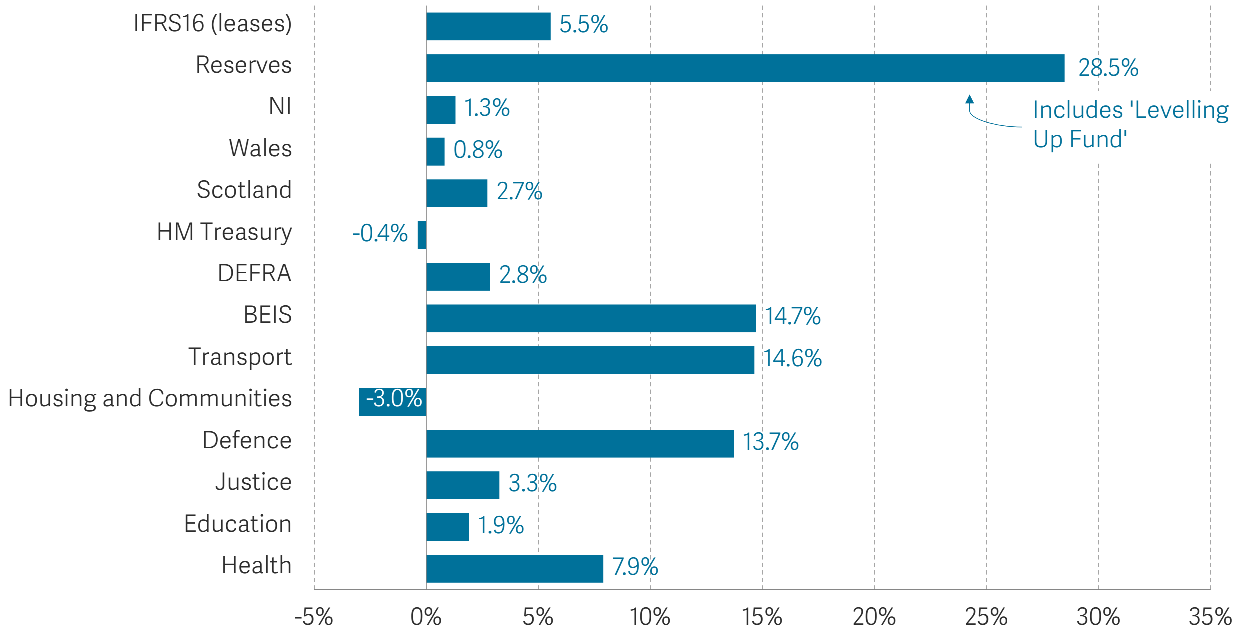
Although the weakness of private investment provides a strong rationale for boosting public investment, there are questions about how sustainable these plans are. As shown in Figure 22, investment tends to fall in the aftermath of recessions, with capital spending seen as a politically 'easier' target than current spending budgets during previous fiscal consolidations. Unless the Chancellor chooses a different approach to his fiscal framework that delivers sustainable public finances while maintaining high levels of public investment, history is likely to repeat itself once very high capital spending comes into conflict with the need to repair the public finances while honouring manifesto commitments to avoid tax rises.

The Spending Review set out little change in future capital spending, and said nothing about how this might fit into future fiscal policy, but the Chancellor set out significantly more detail on the allocation of this capital spending. In particular, Figure 23 shows that around half of the £27 billion real increase in CDEL set out by the Treasury from 2019-20 to

2021-22 will largely benefit the Defence, Transport and Health budgets, as well as boosting R&D spending allocations in the Department for Business, Energy and Industrial Strategy.

FIGURE 23: **Capital spending rises are dominated by defence, transport, science and health**

Proportion of increase in real Capital Departmental Expenditure Limits (CDEL) from 2019-20 to 2021-22 accounted for by increases in the budgets of selected departments, excluding coronavirus spending



NOTES: Excludes departments given far lower CDEL allocations, 'IFRS16 (leases)' refers to funding to implement accounting changes in the International Financial Reporting Standard for lease accounting; 'DEFRA' refers to the Department for Environment, Food and Rural Affairs; 'BEIS' refers to the Department for Business, Energy and Industrial Strategy'.
SOURCE: RF analysis of HM Treasury, Spending Round and Spending Review documents.

On housing, the Chancellor confirmed the funding for the Affordable Homes Programme aimed at supporting 180,000 new homes, as previously announced.[34] One at least partially new announcement was an extension of the National Home Building Fund: this was created in 2016 and provides loans for development and infrastructure to facilitate house building. The fund will now include £4.8 billion of capital grants for land remediation and infrastructure, as well as £2.2 billion of loan finance for developers. These announcements are encouraging, but there was little clarity on how much of this funding is additional to previously-announced sums, and there is evidence that the Fund has so far failed to disburse as much funding as intended, meaning challenges remain in ensuring the effectiveness of this investment.[35]

34 MHCLG, Jenrick unveils huge £12 billion boost for affordable homes, Press Release, September 2020.
35 For more details on the background of the National Home Building Fund, see: S Menary, Why is the Home Building Fund failing to reach small builders?, January 2020.

The Spending Review again returned to 'levelling up' as a theme, with a key policy announcement the creation of a 'Levelling Up Fund'. This £4 billion pot will be used to allocate grants of up to £20 million to local areas that submit bids to central government with the support of local politicians. Capital spending has, in per capita terms, been highly unequal across the UK's regions and nations in recent years[36], but it is unclear that a highly centralised system of small grants is the answer. The UK already has one of the most centralised systems of capital spending in the world, with the UK the eighth lowest out of 35 other OECD countries surveyed in the proportion of its capital spending allocated by central government.[37] A new system of micro-grants, administered via central government, risks inefficiency and politicisation, compared with more conventional forms of devolved capital funding, which could also have been meaningfully used to further the Chancellor's levelling up agenda.

In more positive news for the addressing of regional inequalities in capital spending, the Spending Review saw the announcement of changes to the Treasury's approach to assessing capital projects. The so-called 'Green Book' sets out the approach to project appraisal and evaluation, including cost-benefit analysis methodologies.[38] These include the relative weightings given to economic and social returns, to economy-wide benefits and reductions in regional inequalities, and to short-term and long-term costs and benefits. In previous work, we have called for the Green Book methodology to be updated to place greater weight on narrowing regional disparities in productivity and living standards, and less on narrow cost-benefit analyses.[39] The announced changes go some way to implementing these, with a re-focussing of project appraisal towards strategic objectives – including addressing regional inequalities – rather than more narrow cost-benefit analyses. Also welcome is the announcement of a review of the Green Book framework with respect to climate change, which poses significant challenges for the framework.

Conclusion

This Spending Review takes place against a difficult economic backdrop. A permanently smaller economy in turn places huge pressures on both household and public finances.

Against that backdrop, the Chancellor has chosen to double down on truly exceptional levels spending to tackle coronavirus today, while hoping to be able to avoid any of those increases becoming permanent. Indeed, he has actually set out plans to cut

36 A Bailey, R Hughes, L Judge & C Pacitti, Euston, we have a problem: Is Britain ready for an infrastructure revolution?, Resolution Foundation, March 2020.
37 A Bailey, R Hughes, L Judge & C Pacitti, Euston, we have a problem: Is Britain ready for an infrastructure revolution?, Resolution Foundation, March 2020.
38 HM Treasury, The Green Book: Central government guidance on appraisal and evaluation, 2018.
39 A Bailey, R Hughes, L Judge & C Pacitti, Euston, we have a problem: Is Britain ready for an infrastructure revolution?, Resolution Foundation, March 2020.

non-coronavirus public service spending from next year. As a result, austerity will feel anything but ended for many public services. A huge cut to benefits is also currently planned for this coming April, just as unemployment is expected to be reaching its peak level. In contrast, the highest sustained level of investment spending since the 1970s is still planned.

There is no immediate pressure to set out plans for a fiscal consolidation, with the cost of servicing government debt next year much lower than had been expected. But once the recovery is secured, tougher choices will come. Tax rises, notably absent from the Chancellor's announcements, will then move centre stage. Which tax rises, and whether they take place before or after the next election, are all questions for another day.

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