Section 4

The Spending Review

This Spending Review is a big moment for the Chancellor, the Government and the country. It is the first time since 2015 that a multi-year spending trajectory will be set out, and comes at a crucial period, as the recovery from the pandemic appears to be taking hold.

This recovery means reduced Covid-related spending pressures, but one key task for the Chancellor at this Spending Review is to decide (or at least signal) which departments will receive how much funding to deal with the costs of the pandemic in the years ahead.

The Chancellor will also continue the work of his immediate predecessors in unwinding austerity. We know already that the Chancellor is set to continue with the trend of the last decade in prioritising health spending over other areas; this, coupled with a tight overall spending envelope, implies spending cuts for unprotected departments in 2022-23. By 2024-25, unprotected departments are set to still have budgets that are, on average, one-fifth lower than in 2009-10 when measured in real terms per capita.

Finally, coming after a Cabinet reshuffle which prioritised 'levelling up' and just before the crucial COP26 summit at which net zero will take centre stage, this Spending Review will be the Chancellor's key moment to set out how the Government plans to meet new priorities for the decade ahead.

Day-to-day spending is set to rise at under 3 per cent in real terms each year

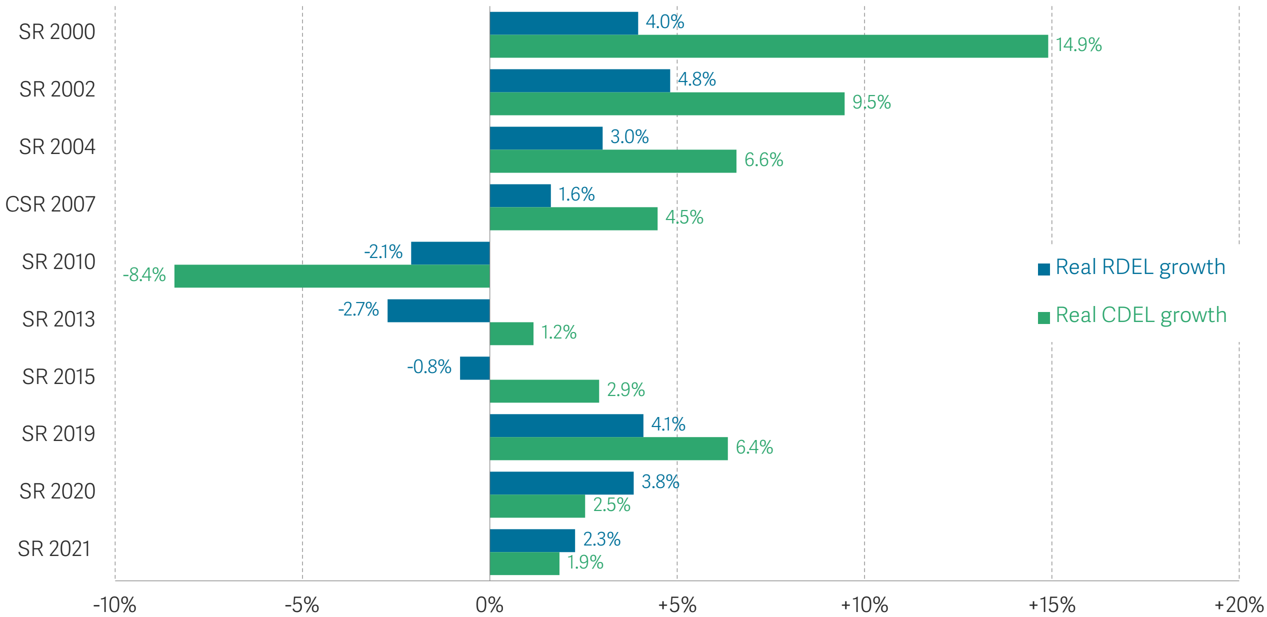
The Spending Review will provide the details of departmental spending for the three years 2022-23, 2023-24 and 2024-25 (with the overall amount to be spent already set by the Chancellor in early September at £408 billion in 2022-23, rising to £440 billion by

2024-25).[40] This amount of spending is broadly in line with the plans that the Chancellor pencilled in immediately before the pandemic, and it is substantially higher than the path of spending set out by Philip Hammond in March 2019.

In his letter launching this Spending Review, the Chancellor claimed that it would outline the "largest real-terms increase in overall departmental spending for any Parliament this century".[41] It is true that, over the Parliament as a whole, the rate of increase in spending is substantial (even excluding the costs of the pandemic, which increased day-to-day spending by over £100 billion in 2020-21, the Treasury report total departmental spending increasing at 3.9 per cent a year), but part of this had already been announced by Rishi Sunak's predecessors.

FIGURE 23: **After three Spending Reviews in which spending fell in real terms, this is the third Spending Review in a row in which real terms increases are planned**

Average annual change in real (GDP deflator adjusted) day-to-day departmental spending (RDEL) and departmental capital investment (CDEL) as detailed at each spending review: UK



NOTES: Nominal RDEL & CDEL are deflated using contemporaneous forecasts of the GDP deflator. SR 2021 figures are deflated using the RF macroeconomic model forecast of the GDP deflator which has been smoothed between financial year 2019-20 and 2022-23 to remove the impact of pandemic-related volatility.
SOURCE: RF analysis of HM Treasury, various spending review documents.

Rather than looking at the total change across the Parliament, the usual approach of looking at Spending Review periods shows that the Chancellor will be outlining a spending program which will see real resource departmental (RDEL) spending increase

40 HM Treasury, Chancellor launches vision for future of public spending, September 2021.
41 HM Treasury, Spending Review 2021 launch letter, September 2021.

by an average annual rate of 2.3 per cent – a significant increase, but smaller than those announced in a number of other Spending Reviews this century (Figure 23).[42]

Capital spending (CDEL) will increase at a slightly slower rate of 1.9 per cent, but it is important to note here that the level of capital spending in the UK is already at historic highs, with the majority of the rise in capital (or investment) spending announced in this Parliament occurring between 2019-20 and 2021-22. We discuss capital spending further below.

BOX 4: **Differences between GDP deflators**

The GDP deflator is a measure of general inflation in the economy that captures changes in the prices of all goods and services produced in the UK economy. To calculate the growth in government spending over and above the growth in prices in the economy, the nominal spending figures must be adjusted using a forecast of the GDP deflator. The most recent OBR forecast of the GDP deflator was produced in March 2021; since then, consumer prices have risen faster than was anticipated, and so it is likely that the forecast of the GDP deflator will also be changed in the updated Economic and Fiscal Outlook which will be released alongside the Spending Review.

As a result, we instead use an implied GDP deflator – produced using the Resolution Foundation economic scenario – to convert spending into real terms. The difference between these two forecasts in shown in Figure 24. While the OBR March 2021 forecast implies a 1.8 per cent fall the deflator between 2020-21 and 2022-23, and therefore a higher real value for a given fixed cash spend over this period, the RF forecast instead implies a 0.9 per cent increase in the deflator, resulting in a lower real value for a given fixed cash amount over the period.

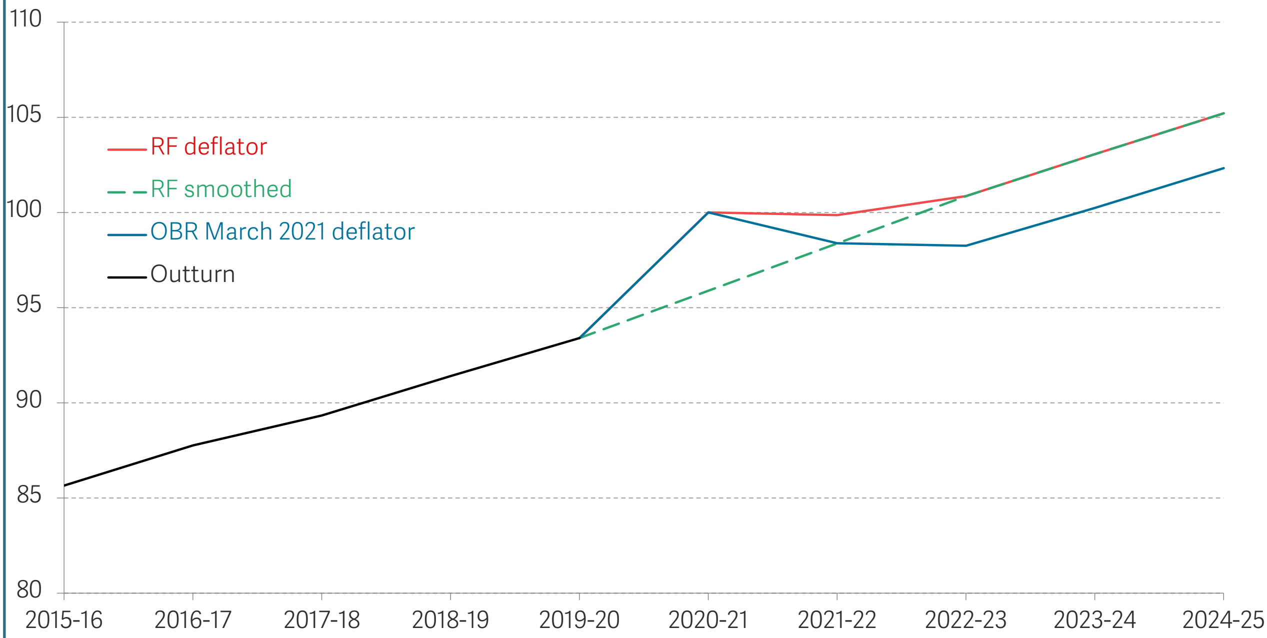
The pandemic-related volatility in the deflator also means that year-to-year changes in real spending will be substantial regardless of whether significant decisions have been taken around departmental spending. Additionally, as the OBR pointed out in their November 2020 EFO, part of this volatility is due to the difficulty in measuring changes in real government expenditure on education and healthcare during the pandemic.[43]

42 This annualised growth rate would be 3.2 per cent if spending were deflated using the GDP deflator forecast by the OBR in March 2021; this, however, falls to 2.8 per cent when using the implied deflator from the Resolution Foundation economic scenario which takes account of the higher-than-forecast outturn in inflation this year and next. The 2.3 per cent growth rate we report results from smoothing the GDP deflator in order to mitigate the impact of pandemic related volatility (see Box 3 for more detail on deflators). By contrast, using the smoothed deflator means the change in spending between 2019-20 and 2020-21 would be larger than that reported when using the unsmoothed deflator.

43 OBR, Economic and fiscal outlook, November 2020.

FIGURE 24: **Updated GDP deflators imply lower growth in real-terms spending**

GDP deflator, outturn, OBR March 2021 forecast, and Resolution Foundation forecast: UK



Source: RF analysis of OBR, Economic and Fiscal Outlook.

To avoid this issue, we use a smoothed version of our deflator that grows at an equal annual rate between 2019-20 and 2022-23 to conduct our analysis. We report real spending changes in 2020-21 terms in this document, which, relative to using the unsmoothed deflator, implies lower increases in real spending over the Spending Review period, as plans are deflated by a larger amount at the start of the period.

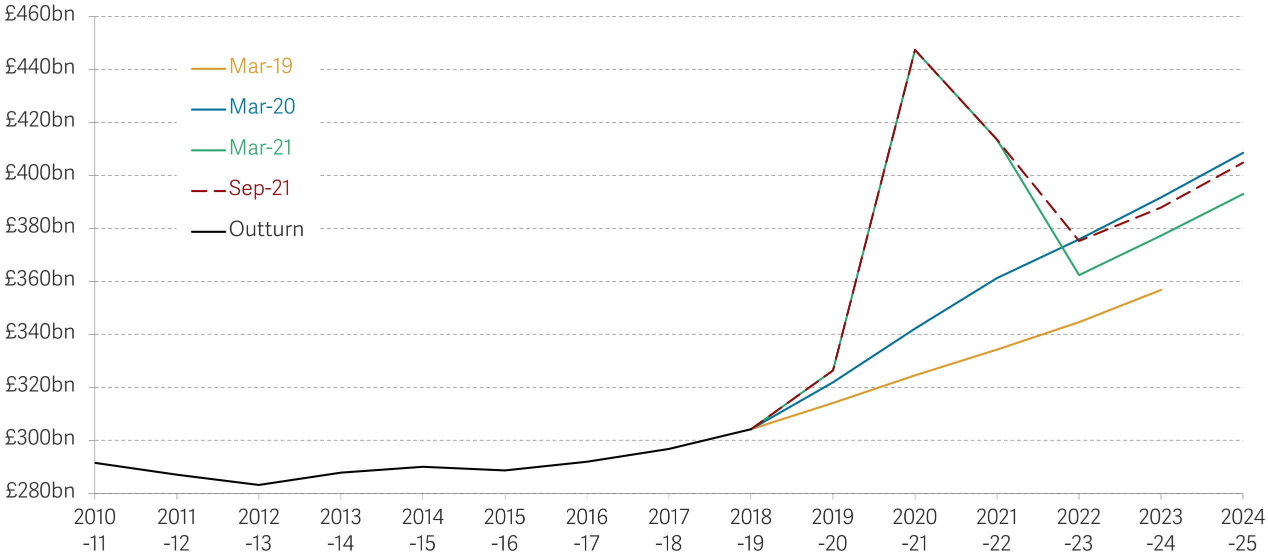
Two-thirds of the increased spending over the Review period is going to the Department of Health and Social Care

Although the level of departmental spending has hardly changed from the Chancellor's pre-pandemic forecasts, its composition has. Two big changes have taken place. First, in March 2021, the Chancellor reduced the overall spending envelope by £13 billion relative to his pre-pandemic plans. This still left a more generous plan than that set out by Philip

Hammond in March 2019, as shown in Figure 25, but nonetheless reflected a decision to have lower departmental spending than was pencilled in at the March 2020 Budget.

FIGURE 25: **The recent health and social care announcement has returned the spending envelope to the Chancellor's pre-pandemic plans**

Nominal Resource Departmental Expenditure Limits, as forecast in March 2019, March 2020, March 2021 and September 2021: UK



NOTES: The projected values for September 2021 Spending Review use HM Treasury figures and adjust these using the numbers outlined by the OBR in March 2021 to reconcile these figures with PSCE in RDEL.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, various; and HM Treasury, Chancellor launches vision for future of public spending, September 2021.

The second change in spending, announced by the Chancellor on 7 September 2021, then boosted health and social care spending by almost the same amount as was previously removed from overall departmental spending plans (see the dashed line in Figure 24). Taken together, these decisions leave overall spending plans broadly unchanged relative to pre-pandemic plans, but the mix of spending is different, with spending more concentrated on the priority areas of health and social care.

After these announcements, the real annual increase in day-to-day spending for the NHS and social care across the Spending Review period is set to be 3.8 per cent - growing more than twice as fast as spend on all other departments (around 1.3 per cent per year).[44] Indeed, of the changes to 2024-25 spending announced since the start of the pandemic, total spending has been cut by £16 billion while the health and social care spend has risen by £14 billion. This focus on health spending is understandable given the impact of the pandemic as well as the structural pressures of an aging population, but it does mean that other departmental budgets remain very tight, with little space to

44 These figures have been deflated using the RF macroeconomic model forecast of the GDP deflator which has been smoothed between financial year 2019-20 and 2022-23 to remove the impact of pandemic related volatility. If using the unsmoothed deflator spending for the NHS and social care instead grows at an annualised rate of 4.3 per cent vs. 1.8 per cent for other all spending.

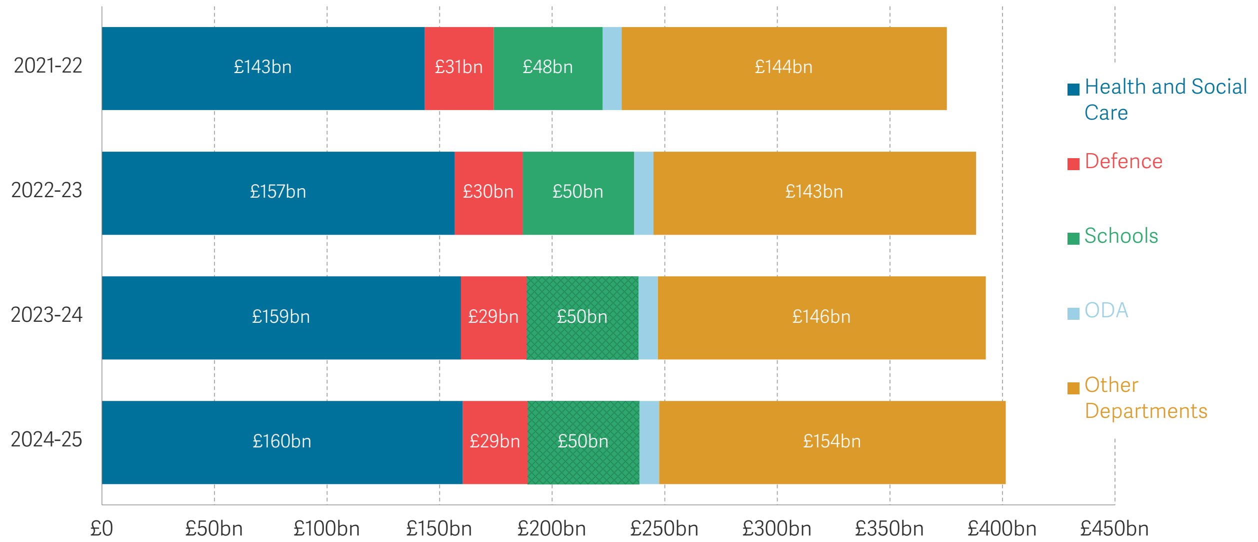
address some of the pandemic pressures that they may face, or any of the longer-term strains inherited from a decade of austerity.

Commitments on health spending, schools, defence and ODA mean unprotected departments are under pressure in the near-term

Given that most of the big departmental spending decisions have already been made, we are able to estimate the near-term implications for unprotected departments. Figure 26 shows that pre-committed spending on health and social care, protected spending on defence and schools, and statutory commitments on Overseas Development Assistance (ODA) account for £230 billion of an overall £375 billion of total spend, or over 60 per cent of total day-to-day spending.[45]

FIGURE 26: **Accounting for already-committed spending reveals small real funding increases for most departments**

Real (GDP deflator adjusted to 2020-21 prices) Resource Department Expenditure limits by committed and other departments: UK



NOTES: Commitments to the schools budget only extend to 2022-23, but we assume this funding level is fixed in real-terms for 2023-23 and 2024-25. Real Resource Department Expenditure Limits are calculated by deflating nominal figures by the GDP deflator implied by the RF macroeconomic model which has been smoothed between financial year 2019-20 and 2022-23 to remove the impact of pandemic related volatility. Health and Social Care includes additional local authority funding for social care, with the Spending Review set to provide detail of the split between DHSC and local authority budgets of the spending increase announced on 7 September 2021.
SOURCE: RF analysis of HM Treasury, Chancellor launches vision for future of public spending, September 2021 and various policy announcements.

45 The final budget for the Department of Health and Social care itself has not yet been set, but on 7 September 2021 the Government provided details of funding for the 'Department of Health and Social Care Group & additional local authority social care grants', no split between funding for departments was provided within this budget line and so we have included all of this funding within the Department of Health and Social Care in this analysis.

If the schools funding uplift is maintained in real terms in 2023-24 and 2024-25, then budgets for these protected areas will rise by £17 billion between 2021-22 and 2024-25, compared to just £10 billion for unprotected areas (with the majority of this increase for unprotected areas taking place in 2024-25).[46] Box 5 further outlines our assumptions concerning ODA over this spending period.

BOX 5: Impact of changes to Official Development Assistance (ODA) spending commitments

In 2015, the UK Government used the International Development Act to put into law a commitment to spend 0.7 per cent of Gross National Income (GNI) per calendar year on ODA – resources sent either directly to developing countries or via multilateral organisations to promote the economic development and welfare of developing countries.[47] This saw aid spend rise from £8.5 billion in 2010 (or 0.57 per cent of GDP) to £14.5 billion in 2020.

In the November 2020 Spending Review, the Government temporarily reduced this legal commitment to 0.5 per cent of GNI, citing the damage inflicted on the public finances by the pandemic. This means that ODA spending in 2021 is estimated to be £11.3 billion (roughly £8.4 billion in RDEL and £2.9 billion in CDEL), or £3.2 billion less than was spent in 2020 and £4.5 billion lower than a 0.7 per cent commitment (see Figure 27). The Chancellor stated that spending would return to 0.7 per cent of GNI "when the fiscal situation allows".

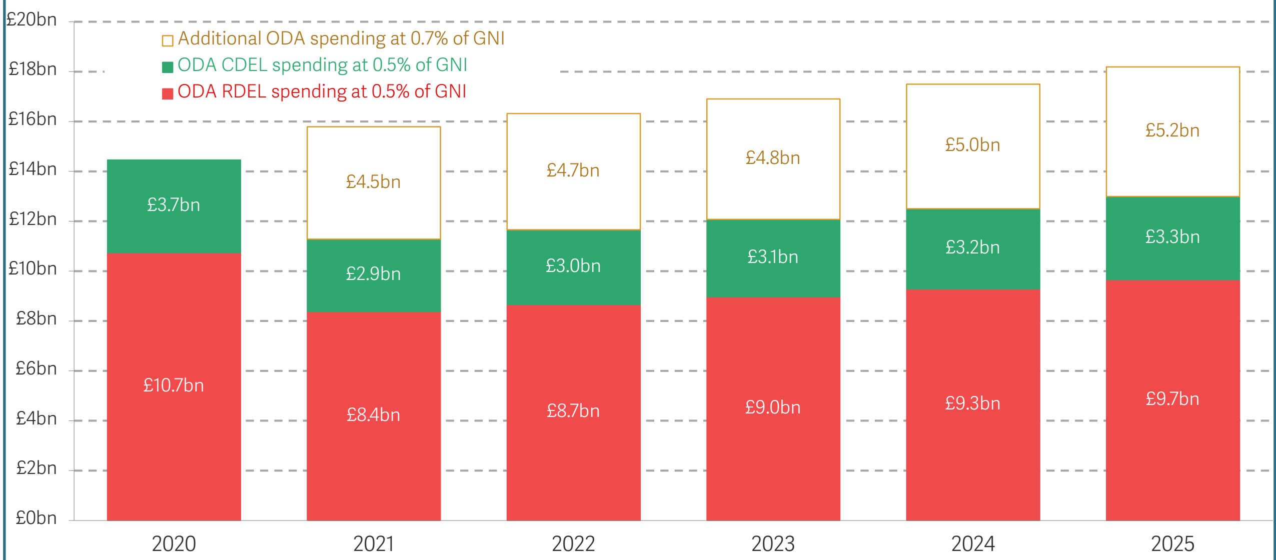
In July 2021, the Government outlined the conditions which would need to be met in order for ODA spending to return to the legally binding level. The two tests are that, on a sustainable basis:

1. The UK has a current budget surplus - namely government receipts exceed all current spending (excluding net investment spending); and,
2. UK public sector net debt – excluding the Bank of England - is declining as a proportion of GDP.

46 If the schools allocation were frozen in nominal terms, the rise in allocation to unprotected areas would be £15 billion in real terms over the forecast period.
47 See Foreign, Commonwealth & Development Office, Statistics on International Development: Provisional UK Aid Spend 2020, April 2021.

FIGURE 27: **ODA spending is forecast to remain below 2020 levels in nominal terms throughout this Parliament**

Actual and forecast nominal ODA spending: UK



NOTES: Gross National Income is forecast using the RF macroeconomic model. The split of ODA spending between Resource Departmental Expenditure Limit (RDEL) and Capital Departmental Expenditure Limit (CDEL) is assumed to match the average splits for Department for International Development between 2016-17 and 2020-21, prior to being merged into the Foreign & Commonwealth Office.
SOURCE: RF analysis of OBR, Economic and fiscal outlook, March 2021; Foreign, Commonwealth & Development Office, Statistics on International Development: Provisional UK Aid Spend 2020, April 2021.

The OBR's fiscal forecast will be considered each year and, if the Government "expects to meet the fiscal tests described above in the following financial year", and these continue to be met even if ODA spending were returned to 0.7 per cent of GNI, then aid spending would be restored to this level. [48] At this point, the rules would cease to apply. The implication of these rather convoluted rules is that any increases in the ODA budget would likely come from an increase in the overall spending envelope, rather than from reassigning spending from other departments or government functions.

Under the OBR's March 2021 forecast, public sector net debt was set to decline as a percentage of GDP only from fiscal year 2024-25, and the UK would continue to have a current budget deficit at the end of the forecast horizon in 2025-26. Under our revised outlook for the economy and public finances, we now forecast the current budget to be in surplus by financial year 2024-25, and public sector net debt will decline as a proportion of GDP only from 2024-25 to 2025-26. Moreover, the headroom for meeting the current budget rule with a higher level of ODA would be tight. As a result, we expect that the Government will continue

48 UK Parliament, Treasury Update: Statement made on 12 July 2021, 12 July 2021.

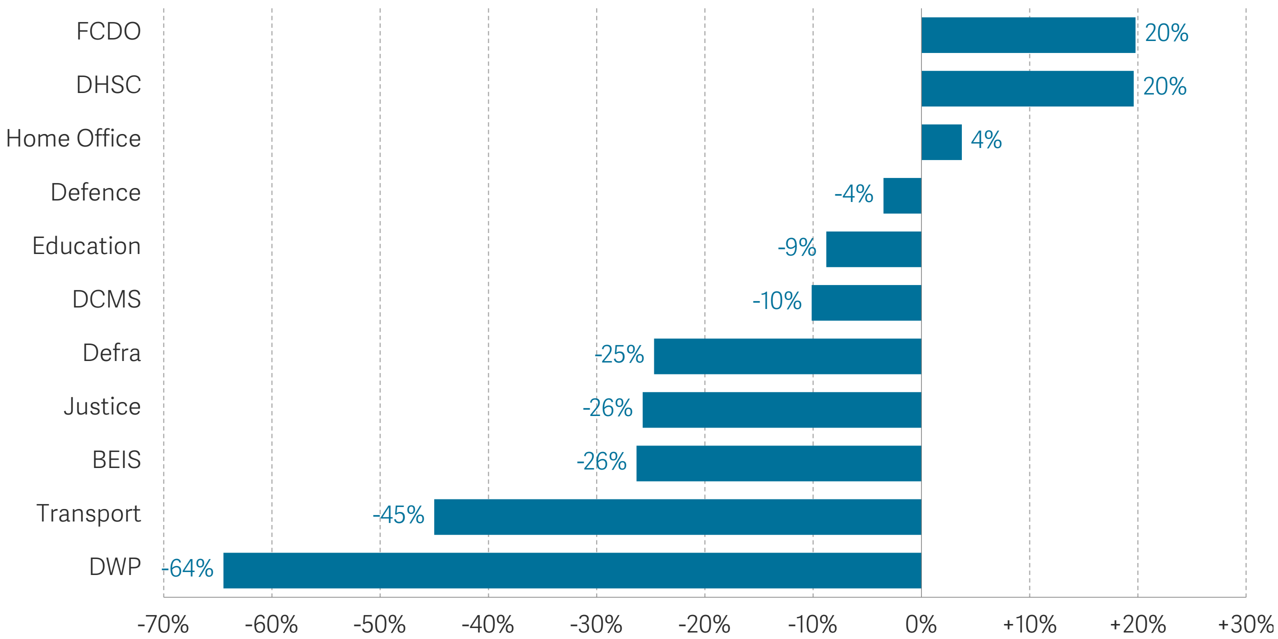
to save nearly £5 billion a year from reduced ODA spending during this parliament roughly £3.7 billion of which will be saved from the RDEL envelope, equivalent to around 3 per cent of unprotected RDEL in 2024-25. There is, however, obvious uncertainty around this central case.

The backdrop to this Spending Review is a decade of cuts for unprotected areas of spending

The Chancellor may have broken with the austerity of the 2010s, with overall day-to-day spending growing rather than falling in real terms, but he is continuing with the same broad departmental prioritisation. As we showed above, the NHS is set to benefit most from the future spending increases, much in the same way that it did so throughout the past decade.

FIGURE 28: **Some departments have shrunk considerably since 2009-10**

Percentage change in real (GDP-deflator adjusted) RDEL spending, by department: 2009-10 to 2019-20



NOTES: Comparison of departmental spending levels shown adjusts as far as is possible for machinery of government and other related spending changes. FCDO; Foreign, Commonwealth & Development office; DHSC, Department of Health and Social Care; DCMS, Department for Digital, Culture, Media & Sport; Defra, Department for Environment, Food and Rural Affairs; DWP, Department for Work and Pensions. Real Resource Department Expenditure Limits are calculated by deflating nominal figures by the GDP deflator implied by the RF macroeconomic model which has been smoothed between financial year 2019-20 and 2022-23 to remove the impact of pandemic related volatility.
SOURCE: RF analysis of HM Treasury, PESA tables, various.

There are some differences (with the reduction in ODA spending the most notable) but broadly the spending priorities in this review are set to be in line with what has come before. As Figure 28 shows, real-terms budgets for both the Foreign, Commonwealth and Development Office (FCDO) – which has recently subsumed the Department for International Development – and the DHSC were 20 per cent higher pre-pandemic than a decade earlier. In stark contrast, the Department for Transport's day-to-day budget fell by almost half, and the budget for the Department for Work and Pensions fell by over 60 per cent in real terms, between 2009-10 and 2019-20.

The need for extra Covid-19 spend could place additional pressure on already stretched departmental budgets in 2022-23

During the height of the pandemic, the Chancellor set aside a Covid-19 reserve of funding on which departments could draw down (with HM Treasury's agreement) to fund pandemic-related spending pressures. This reserve has not been extended to 2022-23, despite the clear spending pressures that some departments will face.

Instead, the Chancellor has made clear that only in exceptional circumstances where "reform and efficiencies are not sufficient to fund essential activity" will extra Covid-19 related spending be funded from outside of existing budgets.[49] This approach implies that, rather than using further borrowing to fund continued pandemic-related spending pressures, the Chancellor is erring on the side of spending restraint; it also implies that is he is unlikely to fund any other spending needs with tax rises, as was the case with the large boost to NHS and social care spending announced in September.

This approach could be seen as one that seeks to avoid taking on additional long-term spending commitments: when funds are released to support an area of spending, it can be difficult to turn the taps off in later years. But in broad terms, the aversion to using borrowing to fund ongoing pandemic pressures is unnecessary: using borrowing cushions the state (and the economy) from the impact of the pandemic, and further increases in borrowing are affordable. And there are some clear candidates for receipt of extra funding, including the Department of Transport (who will have an ongoing requirement to continue the subsidy of Train Operating Companies while travel patterns remain substantially different to before the pandemic).[50]

The Chancellor's suggested approach of dealing with ongoing pressures implies that departments facing Covid-19 related pressures that are not deemed exceptional will have to divert some of their core spending to dealing with backlogs or catch-ups. And these Covid-19 related pressures will come on top of an already very tight year for unprotected departments. Existing commitments on health, education and ODA mean that, even

49 HM Treasury, Spending Review 2021 launch letter, September 2021.
50 The OBR's Fiscal Risks Report suggested that extra spending in the region of £3 billion would be required to cover the costs of ongoing related Covid-19 pressures for the Department of Transport in 2022-23, declining to £1.2 billion by 2024-25. See: OBR, Fiscal Risks Report, July 2021.

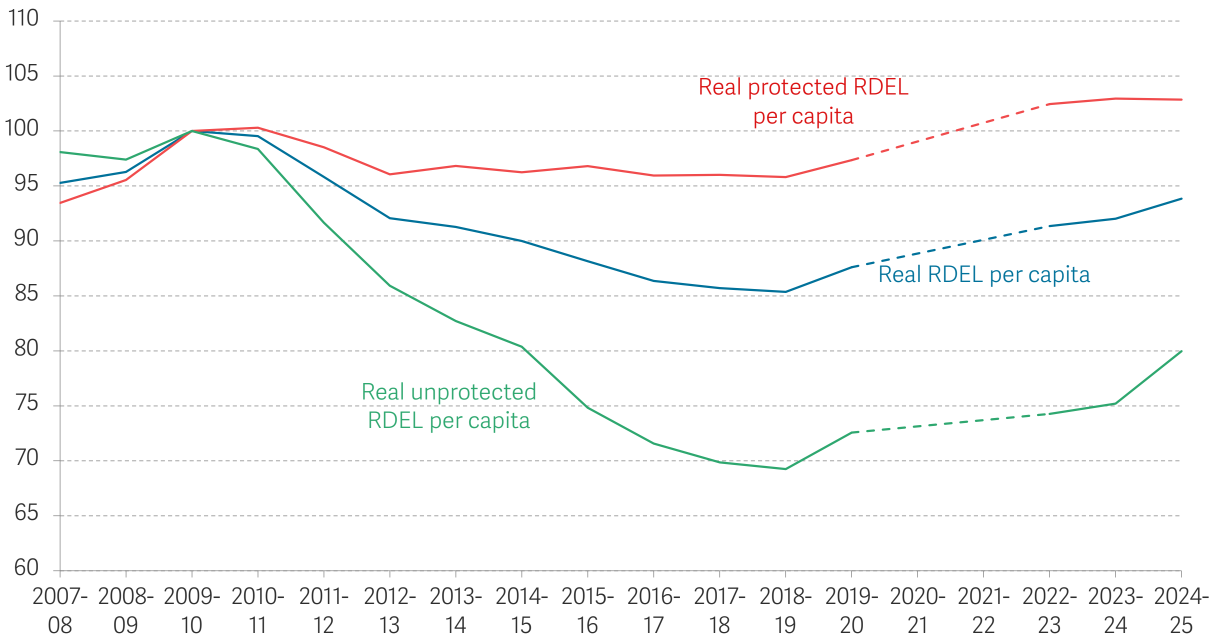
before Covid-19 pressures are accounted for, the remaining departments will experience, on average, a small funding cut in 2022-23 (as shown in Figure 28). Austerity is over when it comes to overall spending, but unprotected departments will have one more year of very tight spending settlements before more substantial increases later in the Spending Review period.

But there is more funding for unprotected departments in later years

In the final year of the Spending Review period, the health budget is forecast to grow by a small amount, leaving more funds available (within the envelope set out by the Chancellor) for other departments. In particular, RDEL is set to increase by £22.5 billion between 2023-24 and 2024-25, with DHSC spending only growing by £4.5 billion, leaving an £18 billion increase for other areas.

FIGURE 29: **One-third of the cuts to departmental budgets in the 2010s are forecast to be reversed by 2024-25**

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



NOTES: Dotted lines are the implied linear path between pre-pandemic and post-pandemic spending, removing the impact of temporary pandemic related spending. Deflated using the RF macroeconomic model forecast of the GDP deflator which has been smoothed between financial year 2019-20 and 2022-23 to remove the impact of pandemic related volatility.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, various; HM Treasury, Budget and Spending Review documents, various.

Depending on decisions made in relation to education and other protected components of spending, this final year of the Spending Review period could involve relatively large increases (in the region of 7 per cent in real terms) in day-to-day spending for unprotected departments. However, this would still leave unprotected day-to-day departmental spending 20 per cent below its 2009-10 level by 2024-25 on average, and would mean that only one-third of the cuts since 2009-10 (in real per capita terms) to unprotected departments had been reversed.

However, these spending projections should be treated with some caution. It does not seem likely that NHS spending will increase by as little as is currently pencilled in for 2024-25: if it transpired, it would be the second lowest increase in the DHSC's budget since 2009-10. Given the recent history of governments increasing NHS spending at pace (even before the pandemic), it seems reasonable to assume that some of the funds currently pencilled in for unprotected areas of spending in 2024-25 will be allocated to the health budget instead.

Capital spending will remain a key plank of the Government's approach in the coming years

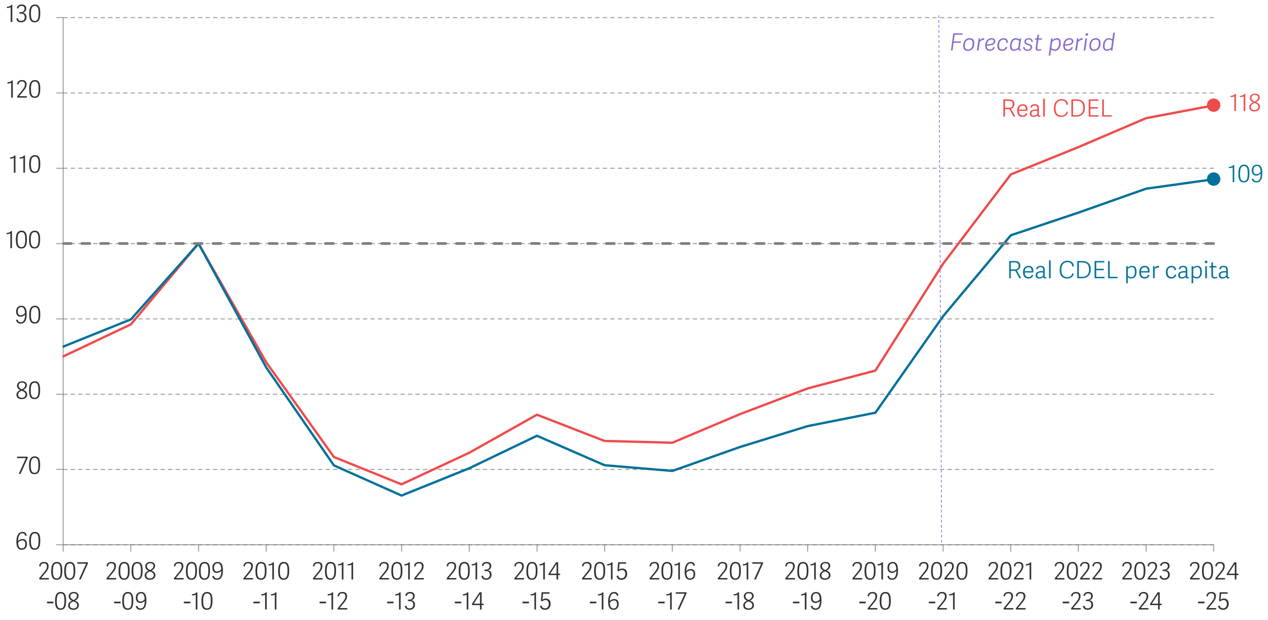
The third task of this Spending Round will be to provide funding for the Government's investment priorities.

After the 2019 Election, the Government indicated that it planned to ramp up capital spending significantly, with the Chancellor announcing ambitious capital spending targets in March 2020. The pandemic got in the way of the Government's plans for longer-term capital spending, but we expect the Chancellor to use the Budget and Spending Review as an opportunity to show how the rest of the Parliament will focus on the Government's key priorities.

The capital spending envelope set aside at the time of the March 2020 Budget implies an outlook for capital spending that looks very different from that for unprotected departments. As shown in Figure 30, real-terms capital department expenditure limits (CDEL) is set to surpass pre-austerity levels of spending this year both in real and real per-capita terms.

FIGURE 30: **Capital spending is set to rise above pre-austerity levels this year**

Indices of real-terms capital departmental expenditure limits: UK, 2009-10 = 100 (GDP-deflator)



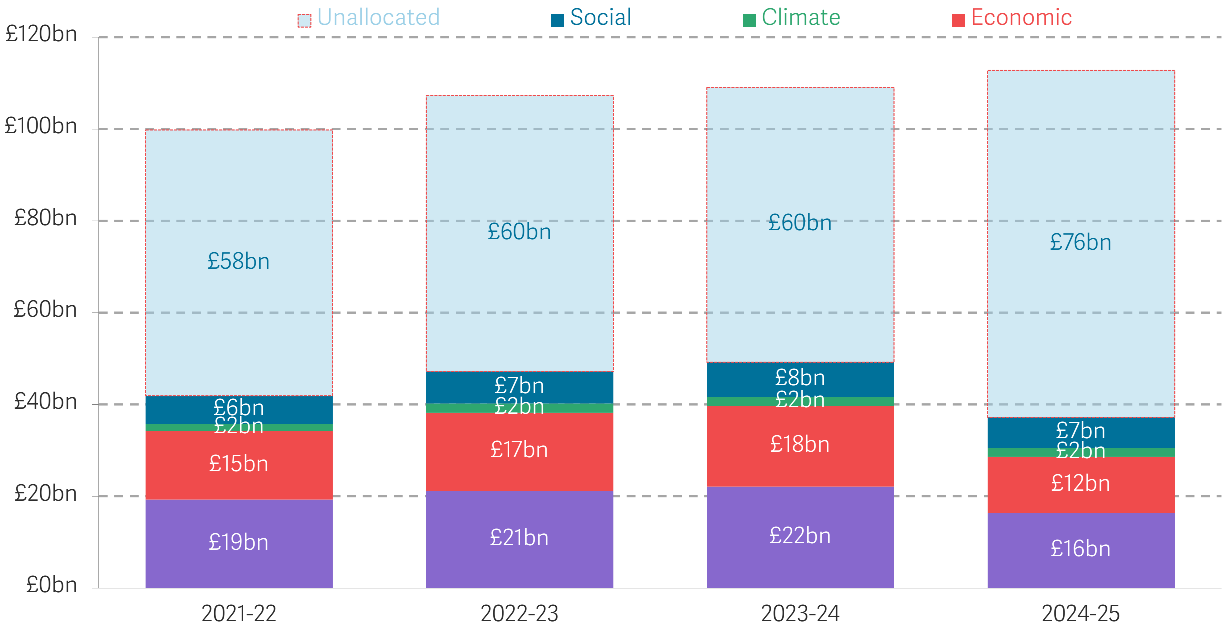
NOTES: Deflated using the RF macroeconomic model forecast of the GDP deflator which has been smoothed between financial year 2019-20 and 2022-23 to remove the impact of pandemic related volatility.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2021.

As shown in Figure 31, significant new capital spending has been announced – including some net zero initiatives and for projects to add to the country's economic infrastructure. But less than half of the new capital spending has been allocated.

Looking ahead, there are two key priorities for capital spending: 'levelling up' and net zero, and it would not be surprising to hear more about how the Government plans to spend the money earmarked for capital spending either in or just before the Spending Review

FIGURE 31: **Much of the additional capital spending envelope announced since the election remains to be allocated**

Gross departmental capital spending, by type: UK, 2021-22 to 2024-25



NOTES: Figures exclude extra Covid-19 funding.
SOURCE: HM Treasury.

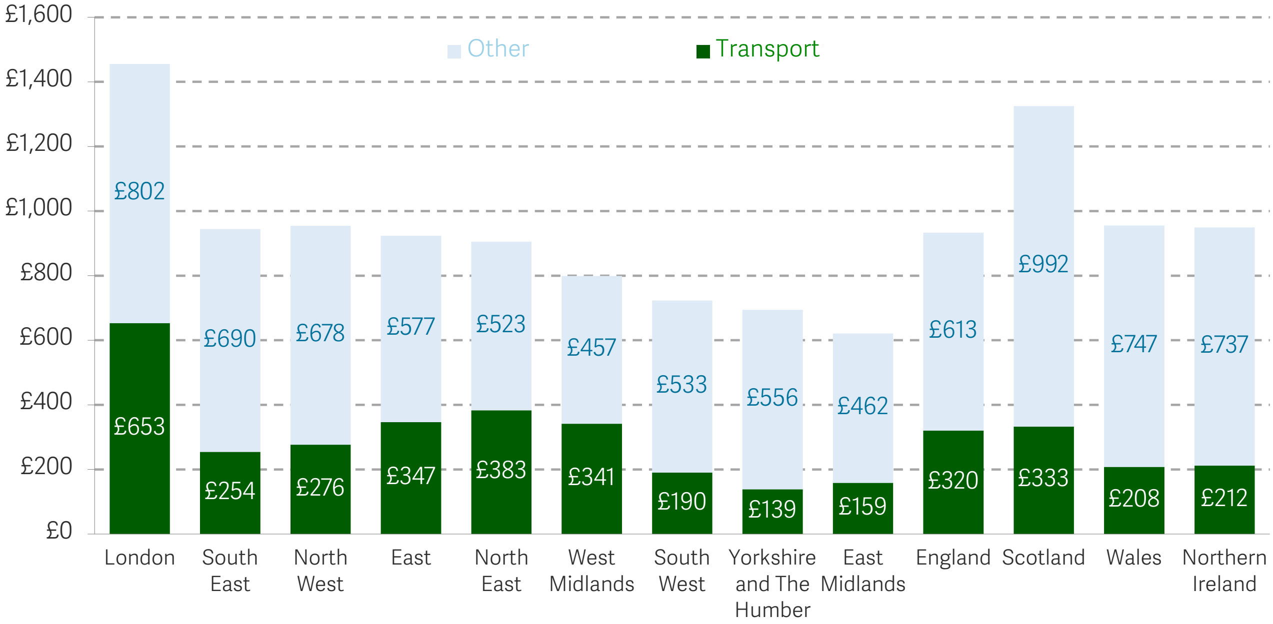
On levelling up, although it now looks likely that further detail will come in a post-Spending Review white paper, the Government has indicated that a key priority will be transport, with a focus on improving connectivity beyond London. This is understandable: as shown in Figure 32, per capita capital spending on transport in London was nearly double that in any other region.

On net zero, hosting the COP26 summit (which starts the week after the Budget and Spending Review) should bring a renewed focus on policies to drive the transition. In this context, although the Government has put in place ambitious targets, it has not yet put in place policy measures to match that ambition.[51]

51 J Marshall & A Valero, The Carbon Crunch: Turning targets into delivery, The Economy 2030 Inquiry, September 2021.

FIGURE 32: **Prior to the pandemic, per capita capital spending on transport in London was almost double that of any other country or region of the UK**

Per capita capital spending by government function and region: 2018-19

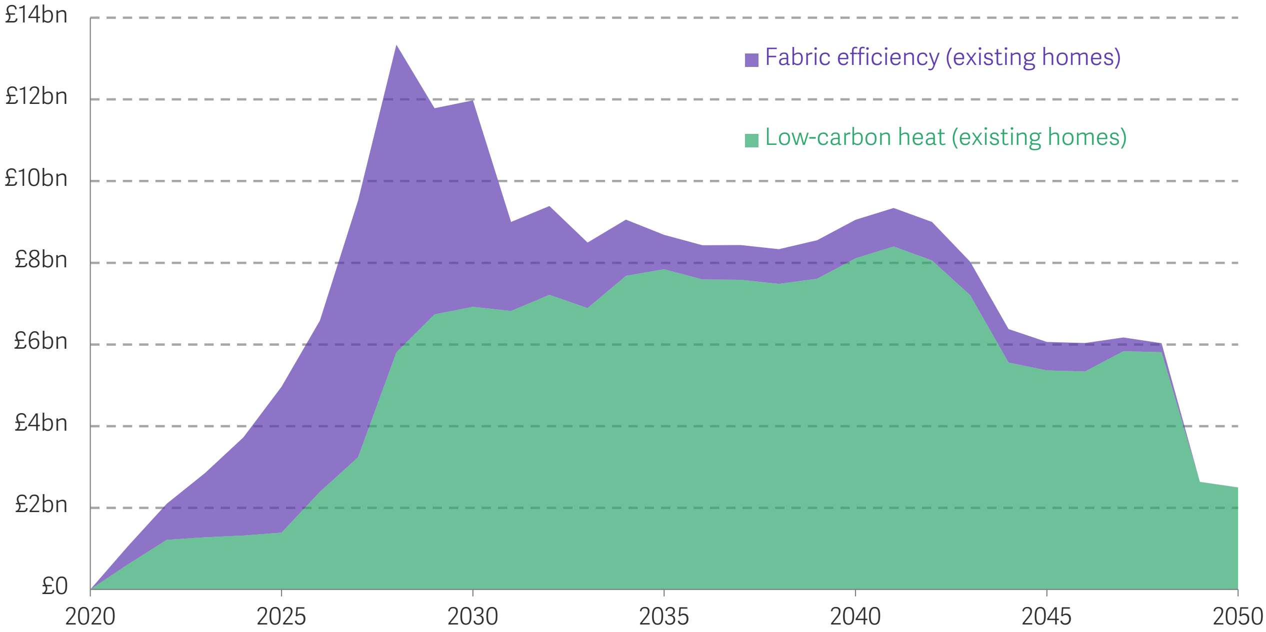


Note: Capital spending on transport includes capital spending through Transport for London. North West 'other' includes environmental protection spending on the decommissioning of Sellafield.
SOURCE: RF analysis of HM Treasury, Country and regional analysis: November 2018.

On capital spending, the key areas are in decarbonising domestic heating, public buildings and transportation. The Conservative Party's 2019 election manifesto pledged around £3 billion each year for climate-related investment by 2023-24, but the Climate Change Committee estimates that much more capital spending will be needed – around £75 billion between 2022 and 2031 – to improve energy efficiency and drive a shift to low-carbon heating (see Figure 33). The private sector will need to cover the majority of this, but the OBR has assumed that the Treasury will need to cover 44 per cent of this, in part to protect lower-income households and ensure sufficiently-swift progress. Other key decisions are on how to offer regulatory certainty on the phasing out of new gas boilers, and whether to move the burden of environmental levies away from the electricity needed to power heat pumps and onto gas.

FIGURE 33: **The pathway to net zero will require significant capital spending on home insulation and low-carbon heat**

Selected forecast annual capital costs required relative to a hypothetical fossil fuel counterfactual: UK



SOURCE: The Climate Change Committee, Sixth Carbon Budget, December 2020.

The problem for the Government in this area is how to balance the new priorities with older ones that have not gone away. While the Government's 'levelling up' and net zero agendas are rightly the main focus of attention, other areas remain long neglected. As discussed in our previous work, these areas include social housing, as well as supporting science and R&D spending.[52]

52 A Bailey, R Hughes, L Judge & C Pacitti, Euston, we have a problem: Is Britain ready for an infrastructure revolution?, Resolution Foundation, March 2020.