Resolution Foundation

The Uncertainty Principle

Previewing the decisions to be taken at the Autumn Budget and Spending Review 2021

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October 2021

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Executive Summary

After 18 months of providing unprecedented support to an economy ravaged by Covid-19, Rishi Sunak could be forgiven for thinking that the decisions at this coming Budget should be easy by comparison. But no such luck. He faces pressure for more spending on key manifesto pledges, including commitments to 'level up' the economy, and overdue policies to make the net zero transition a reality, as well as urgent calls on spending in order to repair the pandemic's damage to public services. Set against that, he would also like to be the Chancellor of fiscal responsibility, repairing the damage to the public finances before the next election. To complicate these challenges further, this autumn looks set to be messy and unpredictable, with a fuel crisis, supply chain disruption and rapidly rising inflation threatening to derail the recovery.

So, this Budget and Spending Review will not only define this Government's term in office, but also the type of Chancellor Rishi Sunak wants to be. In this report we preview the economic and fiscal outlook, and discuss the key decisions that he faces against this uncertain backdrop.

The good news for the Chancellor is that the starting point for the economy is much stronger than expected

The economic recovery has been much swifter than expected by the Office for Budget Responsibility (OBR) back in March. And the scale of the positive news is not small: the economy is around 4 per cent larger than expected. This leaves the OBR

set to make the largest current-year upgrade to forecast GDP growth in nearly 40 years of fiscal projections, with the rate of growth in 2021 not seen in peace time in nearly a century. About a quarter of this improvement reflects changes to the size of the hit from Covid-19, with the rest reflecting both the better-than-expected performance of the economy while social distancing restrictions were in place, and a more rapid recovery when they were lifted.

But since the rapid bounce back as we came into the summer, slowing consumer spending and supply bottlenecks have weakened the recovery. Aggregate credit and debit card data on 'social' and 'delayable' spending have fallen since August, and were around 10 per cent below pre-pandemic levels at the start of October. All this has meant that GDP growth in July and August was just 0.3 per cent – hardly a booming recovery.

And signs that demand is losing momentum after its rapid recovery earlier in the year are being accompanied by disruption on the supply-side that is leading to sharp increases in inflation. Consumer Price Index (CPI) inflation increased to 3.2 per cent in August, having been just 0.4 per cent in February, almost all of which reflects an increase in goods prices, and the Bank of England's most recent forecast is for inflation to hit 4 per cent by the turn of the year. A cost-push rise in goods prices driven by rising hydrocarbon costs is fundamentally temporary, but, with some goods markets struggling to adjust in the face of the recovery from the pandemic, and some wages rising in the face of labour shortages, there is a key uncertainty over how long-lasting such increases in inflation will prove.

But even such a temporary rise in inflation cannot be dismissed as benign. Higher inflation will weigh on real incomes, with the Bank's forecast implying a fall in real incomes of around 2 per cent (or around £1,000 on annual average household income) by the end of next year, compared to the OBR's March forecast. Together with a £13 billion raid on household incomes from increases in NICs, and sharp cuts to UC, there will be major headwinds to families' spending power in the coming months. All this looks set to mean that aggregate real household income may fall slightly in the coming months and that the outlook for living standards is – at best – little changed since March despite

the stronger economy. In addition, higher inflation could prompt policy makers at the Bank to raise rates, leading to higher borrowing costs for firms and households.

The extent of economic 'scarring' from the pandemic remains highly uncertain

The big judgement on the economy facing the OBR is over its estimate of economic 'scarring' from the pandemic. In March, the OBR assumed the economy would end up 3 per cent permanently smaller relative to its pre-pandemic path. This judgement was optimistic in an historical perspective, representing a lower degree of scarring than any recession since the 1960s. But the stronger economic outlook provides a clear rationale for the OBR to change its judgement, and similar changes have been made by a range of forecasters over the past six months, including the Bank of England (just two out of a dozen forecasters have increased the size of the expected medium-term hit to GDP since the start of the pandemic).

And there are specific reasons to suspect that the amount of scarring will be small. Unemployment is now expected to peak materially lower than was forecast in March, meaning less damage to human capital from long-term unemployment. There are also tentative signs that productivity and labour force growth will be stronger than expected. So our starting point is that the OBR may reduce its estimate of scarring to 2 per cent.

But the reality is that there remains huge uncertainty about the extent of any eventual scarring. This uncertainty should be factored into policy decisions in two ways. First, tightening aggressively in the near term should be avoided, as this runs the risk of increasing scarring. Second, policy for the middle of this decade should take this uncertainty into account: although the Chancellor may be hoping that improvements in the outlook will allow for lower taxes, he should plan for more difficult times.

The improved economic outlook boosts the fiscal position

The improved economic outlook will be matched by positive revisions to the fiscal forecasts. The good news about the economy this year has materially improved the short-term

fiscal position, with borrowing this year set to be £20-30 billion lower than expected in March. The data for this fiscal year already suggests an improvement of around £30 billion, so our view is that there will little or no further improvement in the second half of the year. This is partly because rising inflation means additional debt-servicing costs; and also because the unexpected 'underspend' in Covid-19 support schemes, such as the Coronavirus Job Retention Scheme (JRS), will not continue once those schemes have ended.

But more important for the Chancellor and the public finances is the outlook for the later years of the forecast. If the OBR does assume a smaller amount of scarring, then the forecasts of borrowing in the medium-term could fall by around £10 billion a year. But it is entirely possible that the OBR will stick to its previous 3 per cent judgement; if so, then there would be little, if any, improvement in borrowing after 2021-22.

The Government is expected to announce a new set of fiscal rules to guide policy making from now until the next election. Those rules are likely to commit the Government to not borrow to fund day-to-day spending (i.e. to achieve a current budget balance), and to put debt on a downward trajectory. Our central case is that the Government will meet these rules by 2024-25 under current plans. However, the 'headroom' between the fiscal forecasts and the rules would be the smaller than any set of fiscal rules at the point of introduction since 2015, so even a small downgrade to the economic forecast would knock the Government plans off-track (and such changes must be more likely than usual given the huge economic uncertainty this year and beyond).

But the huge uncertainty means rushing to raise taxes is risky

Fiscal policy has been the main tool of macroeconomic support during this crisis, making up around two-thirds of the boost to the economy provided by policy, substantially higher than during the financial crisis, when about a quarter of support was from fiscal policy. This was partly because the Bank of England was constrained by the lower bound on interest rates, and so unable to provide anything like the support it provided during the financial crisis, and partly that fiscal policy can be more

targeted, which was important, given the highly uneven impact of the pandemic on households and firms.

Given this, it is very surprising how much of the current debate is about when monetary policy might tighten: the key policy discussion should instead be about fiscal policy, which has already started tightening very rapidly on all metrics. The fall in borrowing of 14.1 per cent of GDP in the five years of the OBR's March forecast is more than twice as large as the fastest recorded fall in any five-year period (borrowing fell by 6.7 per cent of GDP in a five-year period following the 1990s recession, but a significant contribution to that was the cut in interest rates of nearly 10 percentage points, reducing debt interest payments).

In particular, the high levels of economic uncertainty at this time should make policy makers more cautious in withdrawing support. Slowing growth and rising inflation both represent real macroeconomic risks but imply different policy responses: more support for slowing growth; tighter policy to control inflation. Reasonable people can disagree how to manage such a trade-off. But our view is that these risks are not symmetric: were the economic recovery to speed up and inflation rise further, the Bank of England could quickly tighten policy if necessary; but if the economy turns out weaker, monetary policy is already at its limit, so cannot provide more support, and fiscal policy is typically slow to change course, which would risk entrenching a weak recovery. Sensible management of these risks, then, demands that the policy makers are cautious in withdrawing support. If the Chancellor is too aggressive in tightening policy, that risks derailing the recovery. If the Bank of England also rush for the exit, there is risk of something worse.

The Spending Review will define government policy at least until the next election

Budget day will also involve the Chancellor setting out the details of the first multi-year Spending Review since 2015. This will provide settlements for individual departments for 2022-23 to 2024-25 on day-to-day and capital spending, and will clarify policy in three main areas.

First, the Spending Review will set out how the Chancellor plans to fund Covid-19 related spending in 2022-23 and beyond. Having previously used a Covid-19 reserve to allocate pandemic-related funding, the Chancellor has signalled that, from next year, pandemic-related costs – such as school catch-ups, court backlogs and transport subsidies – will be funded from additional spending only in "exceptional" circumstances. Instead, most departments will be expected to fund continuing day-to-day Covid-19 related costs from existing budgets; we will find out on 27 October whether any departments will receive extra funding for this.

The second task is to continue the move beyond austerity that Philip Hammond began in 2019. After three Spending Reviews since 2010 that featured real-terms falls in day-to-day spending (2010, 2013 and 2015) this will be the third, after 2019 and 2020, in which real terms day-to-day departmental spending will increase. Although most of this increase comes in the final year of the three-year period, this continues the better news for unprotected departments after a decade of austerity which has involved very large cuts for some: the Department for Transport budget, for example, fell by half in real terms between 2009-10 and 2019-20.

We already know that the Chancellor will be prioritising health spending in this Spending Review, as was the case throughout the 2010s, with health budgets set to grow by 3.8 per cent over the three years to 2024-25 in real terms, compared to an overall real growth rate for day-to-day spending of 2.3 per cent. A large part of this increase in health spending was announced by the Government on 7 September 2021 as part of a new plan for health and social care.

After a reduction in spending plans during the pandemic of a similar amount (around £15 billion a year), this (tax-rise-funded) health and social care funding uplift has returned overall day-to-day spending to the levels planned pre-pandemic. As such, overall day-to-day spending is now more concentrated on health, with other departments facing tighter settlements than if plans had not changed over the past 18 months.

As well as on health spending, the Government has already made commitments on schools, defence and Official

Development Assistance (ODA) spending, together totalling over 60 per cent of day-to-day spending, and so we can estimate how much will remain for unprotected departments in each year. This suggests that, although 2022-23 will be tight for unprotected departments, with budgets falling slightly, on average, in cash terms, the latter years of the Spending Review will involve more generous settlements for much of Whitehall. However, it is likely that unprotected departmental spending will still be 20 per cent below its 2009-10 level in 2024-25, measured in real per-capita terms, with only one-third of the cuts that took place in the 2010s reversed by the middle of the 2020s.

The third task of this Spending Review will be to provide funding for new priorities, from levelling up to net zero. This is likely to be funded through the large capital spending envelope set aside in the March 2020 Budget. Despite a renewed emphasis on investment since the election, less than half of the new capital spending envelope has been allocated. So, we expect to hear more about how this will be spent. On levelling up, the Government has indicated a key area will be transport, particularly improving connectivity beyond London. This is understandable: per capita capital spending on transport was nearly double that in any other region or country of the UK. On net zero, hosting COP26 should provide a catalyst for long-awaited policies to drive the transition to net zero. On investment the priorities should be: measures to accelerate the decarbonisation of domestic heating, retrofit public buildings, and improve the infrastructure for low-carbon transportation (with some policy details expected after the time of completing this report but before the Budget). The problem for the Government is how to balance delivering on these big new priorities for capital spending without neglecting other more long-standing areas needing more spending, including social housing and supporting science and research and development spending.

Section 1

Introduction

The Chancellor has his work cut out in a Budget that will define this Government's term in office

After an exceptional year and a half as Chancellor, with at least eight major sets of policy announcements, you might forgive Rishi Sunak for thinking that things should be getting a lot easier. During that time, he has shown nimbleness and pragmatism in rightly taking decisions that led to unprecedented levels of spending to boost the economy as it faced the largest economic downturn in a century. The centrepiece of the £340 billion in support provided was the £70 billion furlough scheme that has played a key role in shielding the labour market from the ravages of the pandemic.

But the upcoming Budget and Spending Review will be far from straightforward. Now that a vaccine-driven recovery from Covid-19 has seemingly taken hold over the summer, the Budget and Spending Review are set to return to the Government's policy agenda, after some of the big decisions were pushed back by the pandemic. There is no shortage of competing priorities, including: to deliver on promises to 'level up' and reduce regional inequality; measures to meet ambitious targets for delivering net zero; and helping government departments, most obviously the NHS, recover from the ravages of the pandemic. But Rishi Sunak also wants to be the Chancellor of sound public finances, repairing the damage from the pandemic quickly, in the hope of bringing down the (record high) tax burden by the time of the next election.

So, this Budget will both make the Chancellor's own priorities clear and define the sort of Chancellor he wants to be.

Unfortunately, Rishi Sunak faces a messy and unpredictable outlook with clear risks on the horizon

The economic context for this key fiscal event remains clouded in uncertainty. Supply chain disruptions, sharply rising inflation and a fuel crisis have materialised, and threaten

look set to derail the recovery. And with the Covid-19 caseload rising as we move into the autumn, it is clear that the pandemic is far from over.

In this report we preview the difficult decisions for the Chancellor against this uncertain backdrop. To this end, the rest of this report is structured as follows:

- Section 2 discusses the economic outlook, focussing on how economic developments have changed since the Office for Budget Responsibility's (OBR) previous forecast in March 2021.
- Section 3 considers what that means for the public finances, and for the overall stance of fiscal policy.
- Finally, in Section 4, we preview the Spending Review, which will set departmental budgets for both day-to-day and capital spending out to 2024-25; we discuss the implications of spending priorities that the Government has already set out for unprotected departmental spending.

Section 2

The economic outlook

The strength of the economic recovery over the summer has been much swifter than expected by the OBR back in March 2021, with the economy in August now measured to be around 4 per cent larger than expected. This good news means the OBR is likely to make the largest upgrade to the forecast of current-year GDP growth in nearly 40 years. And the rapid bounce back means that growth in 2021 looks set to be the fastest in peacetime for nearly a century.

But it is too soon to declare the pandemic over. The pace of the recovery has slowed across a range of indicators, with GDP growth in July and August just 0.3 per cent – far from a booming recovery. Signs that demand is faltering after its swift bounce back have been exacerbated by disruption on the supply side and some wages rising in the face of labour shortages leading to sharp increases in inflation: CPI inflation reached 3.2 per cent in August, having been just 0.4 per cent in February, and the Bank of England has forecast that it will rise above 4 per cent by the turn of the year. While the causes of this higher inflation are inherently temporary, it is unclear how persistent it will prove. Temporary or not, higher inflation is a problem because it will reduce real incomes by as much as 2 per cent (or around £1,000 on average annual household income) by the end of next year, relative to the previous forecast made by the OBR in March. It could also prompt higher interest rates from the Bank of England. Together with a £13 billion headwind from increases in employer NICs, and sharp cuts to UC, there will be major headwinds to families' spending power in the coming months.

The big judgement facing the OBR is whether to reduce its estimate of economic 'scarring' from the pandemic. This is important because such a change would reduce the OBR's borrowing forecast, creating more room for the Chancellor. In March, the OBR thought that, in the medium-term, the economy would be 3 per cent smaller than it had predicted pre-pandemic. This level of 'scarring' would be lower than any UK recession since the 1960s. While it remains unclear how much of the pre-pandemic trend the economy will recover, there have been tentative signs of improvement in data relating to the longer-term supply-side of the economy since

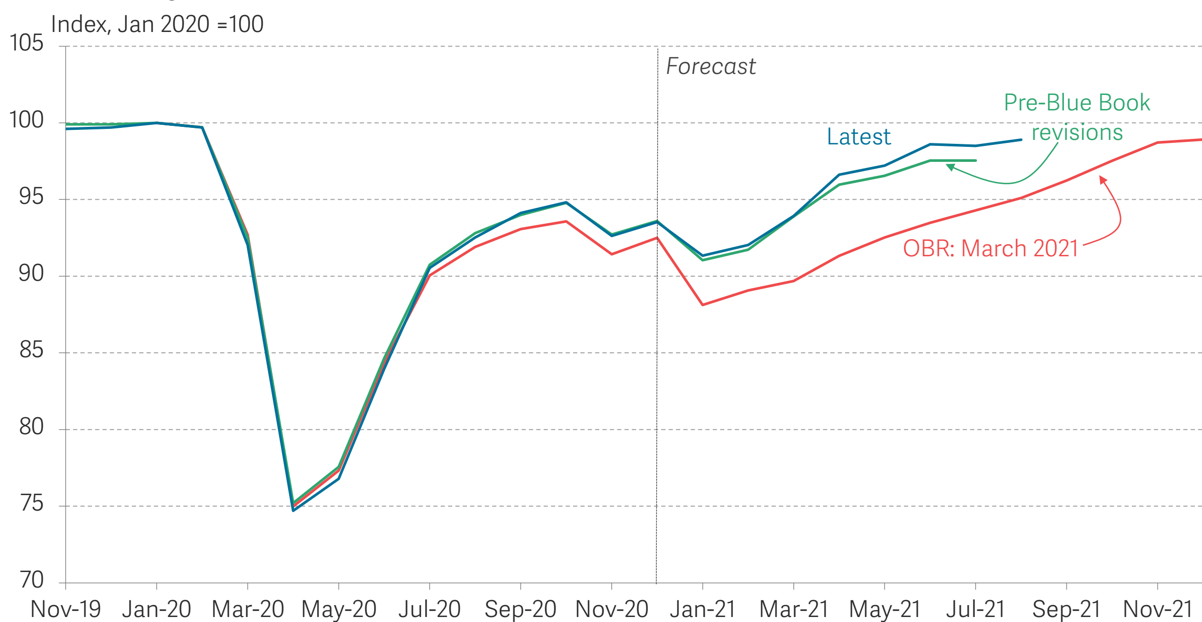
March. Unemployment is expected to peak materially lower, meaning that long-term unemployment will do less damage to the economy. There are also tentative signs that productivity and labour force growth will be stronger than expected. These factors are reflected by the fact that only two out of 12 official and private sectors forecasters have reduced their estimate of the size of the economy in the medium-term in the past six months. But the level of scarring remains hugely uncertain – not least because a key determinant of the extent of eventual scarring will be how successful fiscal policy is in driving a rapid recovery – and the OBR's judgement will have significant impacts on this and future fiscal forecasts.

The good news for the Chancellor is that the economic starting point is much better than expected

Since the OBR made its March forecast, it is clear the economy has surprised on the upside. As shown in Figure 1, GDP in August was around 4 per cent stronger than the OBR expected.[1] Around 1 per cent of that reflects changes to measured size of the economy at the start of the OBR forecast period. The rest reflects the better-than-expected performance of the economy while social distancing restrictions were in place, and a more rapid recovery as they were lifted.

FIGURE 1: **GDP is around 4 per cent higher than the OBR's March forecast**

Monthly index of Gross Value Added, outturn and OBR forecast: UK



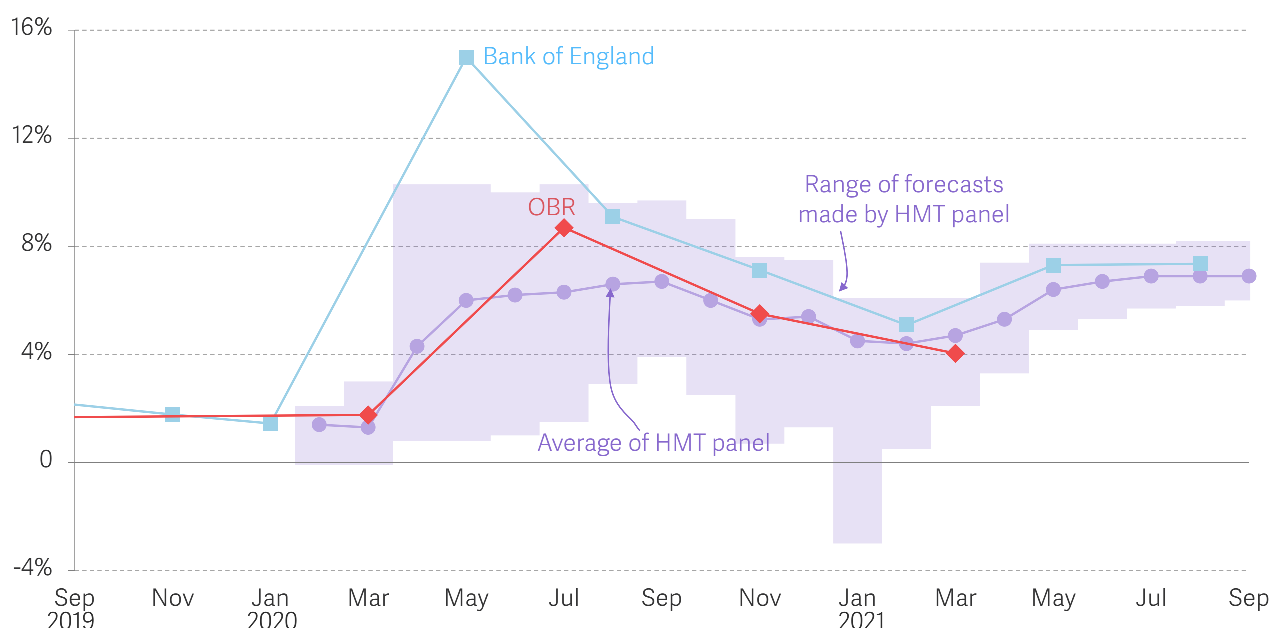
NOTES: The OBR's March 2021 forecast is adjusted for the difference between the quarterly estimate of output and expenditure measures of GDP.
SOURCE: RF analysis of ONS; OBR.

1 The OBR has indicated that its economy forecast was closed on 24 September 2021 and so it will not incorporate the latest vintage of GDP data. See: OBR, Announcement, 15 October 2021.

This improvement is set to lead to a record upgrade in the OBR's near-term growth forecast. The Bank of England's most recent projections – made in August – embody growth of 7.4 per cent this year. If the OBR followed suit, this would be the largest upgrade to current-year growth in nearly 40 years of fiscal forecasting; if it transpired, it would mean that growth for this year would be the fastest in peace-time in nearly a century.[2] And, although the Bank of England remains one of the most optimistic forecasters, as shown in Figure 2, other forecasters have also been upgrading their projections for 2021 growth.

FIGURE 2: **Since March, forecasts for growth this year have been marked up**

Calendar-year forecasts for real GDP growth in 2021, by date of forecast: UK



SOURCE: RF analysis of HM Treasury; Bank of England; and OBR.

The economy was in a 'sweet spot' over the summer, but the outlook has since deteriorated

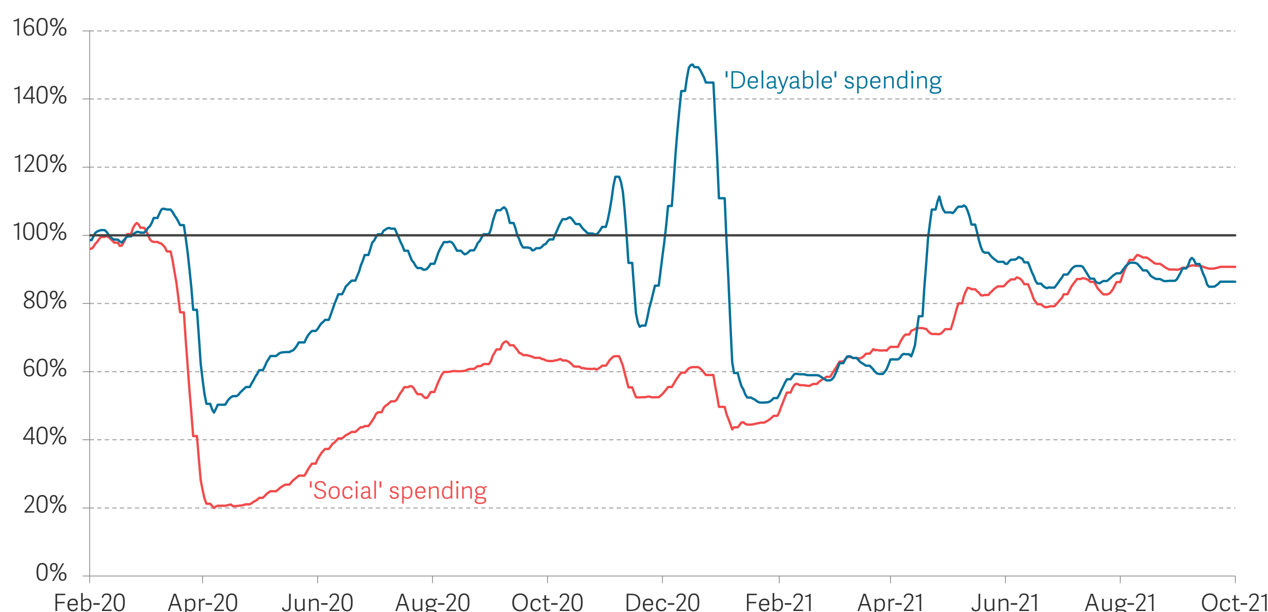
In the UK, a rapid easing in social distancing restrictions has prompted an equally rapid recovery. After Covid-19 restrictions were relaxed more quickly than in any other G7 economy,[3] there has been a rapid revival of social spending, as shown in Figure 3. Meanwhile, 'delayable' spending – such as that on luxury items and durable goods – recovered much more quickly during last year's lockdowns (consistent with families switching their spending to such items as social spending fell during lockdowns) and

2 Source: A Millennium of Macroeconomic Data, Bank of England.
3 Source: Oxford COVID-19 Government Response Tracker, Blavatnik School of Government, University of Oxford, updated 14 October.

subsequently remained at or above pre-pandemic levels.[4] So, as we came into the summer, both social spending and durable spending were strong, prompting a sharp bounce back, with growth picking up more quickly than anywhere else in the G7 in the second quarter (April to June).

FIGURE 3: **Spending data points to a rapid recovery in social spending through the course of this year**

CHAPS credit and debit card purchases, per cent deviation from February 2020, seven-day moving average: UK



NOTES: The series shown in this chart are seven-day moving averages of CHAPS payments made by credit and debit cards to around 100 major UK retail corporates. 'Social' spending includes hospitality, hotels and transport services; 'Delayable' includes luxury items, clothing and footwear and household furnishings.
SOURCE: Bank of England, UK spending on credit and debit cards.

But more recent data on household spending has come as a blow to those who expect a rapid return to pre-pandemic levels of output. As people have returned to social spending, 'delayable' spending on goods has fallen back. This is evident not just in a reduction in 'delayable' credit card spending (Figure 3), which are now around 10 per cent below pre-pandemic levels, but also in official retail sales data. Moreover, social spending growth has plateaued since August this year below pre-pandemic levels. This is consistent with the Resolution Foundation's survey work in which a majority of families reported that they did not plan to return to pre-pandemic spending levels.[5] The central issue here is the extent to which the higher saving rates observed during the pandemic continue in the recovery: if families remain cautious in returning to their previous

4 Most recent data suggest that households have increased savings by more than £200 billion since the start of the pandemic. J Leslie & K Shah, (Wealth) gap year: The impact of the coronavirus crisis on UK household wealth, Resolution Foundation, July 2021.
5 J Leslie & K Shah, (Wealth) gap year: The impact of the coronavirus crisis on UK household wealth, Resolution Foundation, July 2021.

spending habits, then the recovery will be more protracted. This is a key reason why in our previous work we have called for measures to boost household spending.[6]

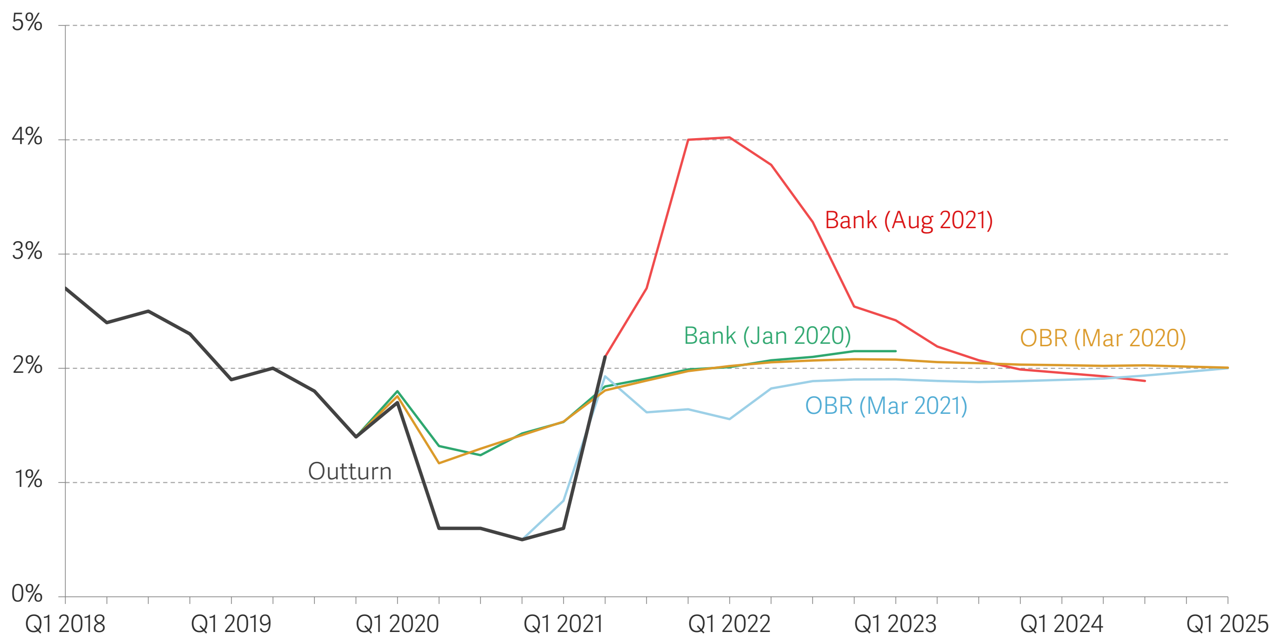
On top of signs that household spending has lost momentum after initially bouncing back rapidly, supply disruptions also threaten the speed of recovery. A key factor here has been the rapid increase in global goods activity. Such markets tend to be more volatile than GDP, and this has been the case over the past 18 months, with activity collapsing at the start of the pandemic and then recovering rapidly through 2021 (and a similar pattern was clear following the financial crisis).[7] All this has prompted sharp rises in global commodity prices, and difficulties in global supply chains, as production struggles to keep pace with recovery in demand (and still facing on-going Covid-related disruption). For the UK, this has been compounded by adjustment to the new trading arrangements with the EU.[8] Reflecting all this, wages for some workers have been rising rapidly in areas where there have been labour shortages.

Rising prices of global goods plus higher commodity prices mean a sharp rise in the prices of the goods we buy. Consumer Prices Index (CPI) inflation increased to 3.2 per cent in August, having been just 0.4 per cent in February. The bulk of that rise reflects an increase in goods prices, with services prices rising much more slowly. For the UK, a key element of the rise in inflation has been the sharp rise in the price of wholesale gas – exacerbated by disruption to the supply of gas to the European market – that will lead to further increases in inflation in the coming months when it feeds through into increases in the 'price cap' on energy bills. As shown in Figure 4, all this led the Bank of England to mark up its inflation forecast by a record amount to 4 per cent around the turn of the year, and they will also prompt a record increase in the OBR's inflation forecast. A key point to keep in mind, however, is that inflation driven by cost pressures in goods markets will be inherently temporary as markets adjust and the rate of price increases slows (even if prices remain high). Cost-driven inflation will only prove sustained if it feeds into higher inflation expectations and affects the wage-bargaining process.[9] Nevertheless, the extent to which higher inflation rates will last is highly uncertain.

6 G Bangham et al., Unhealthy finances: How to support the economy today and repair the public finances tomorrow, Resolution Foundation, November 2020.
7 International Monetary Fund, World Economic Outlook, October 2021.
8 J De Lyon et al, Trading places: Brexit and the path to longer-term improvements in living standards, The Economy 2030 Inquiry, October 2021.
9 J Smith, Macroeconomic Policy Outlook Q2 2021, Resolution Foundation, June 2021.

FIGURE 4: **Inflation is set to be much higher than the OBR expected in March**

Outturns and forecasts for 12-month CPI inflation: UK



SOURCE: ONS, Consumer price inflation; Bank of England, Monetary Policy Report; OBR, Economic and Fiscal Outlook.

However, temporary inflation is not necessarily benign for at least two reasons. First, higher inflation – even if it is temporary - will reduce families' spending power. Higher inflation reduces the amount of goods and services that households are able to afford, eroding the real value of incomes. Figure 5 shows outturns and past OBR projections for aggregate real household disposable income.[10] A combination of the £20 a week uplift to UC, the Job Retention Scheme and other government support packages meant that median household incomes have been more resilient than they have in past recessions despite this being the largest downturn in at least a century.[11]

Figure 5 attempts to update the OBR's March 2021 forecast, accounting for recent income data, the rise in employer National Insurance Contributions (NICs) and the Bank of England's August inflation forecast.[12] By the end of 2022, higher inflation pushes down on real incomes mechanically by around 2 per cent relative to the previous forecast made by the OBR in March, and the rise in National Insurance contributions reduces annual aggregate household incomes by around £13 billion.[13] This simple estimate does not include any behavioural changes in reaction to these developments – most obviously,

10 This national accounts measure includes income from assets – such as housing and equities – as well as labour income and benefits. It also includes the income of non-profit institutions serving households. For a discussion about the issues surrounding income measurement, see: A Corlett, Unequal results: improving and reconciling the UK's household income statistics, Resolution Foundation, December 2017.

11 K Handscomb et al, The Living Standards Audit 2021, Resolution Foundation, July 2021.

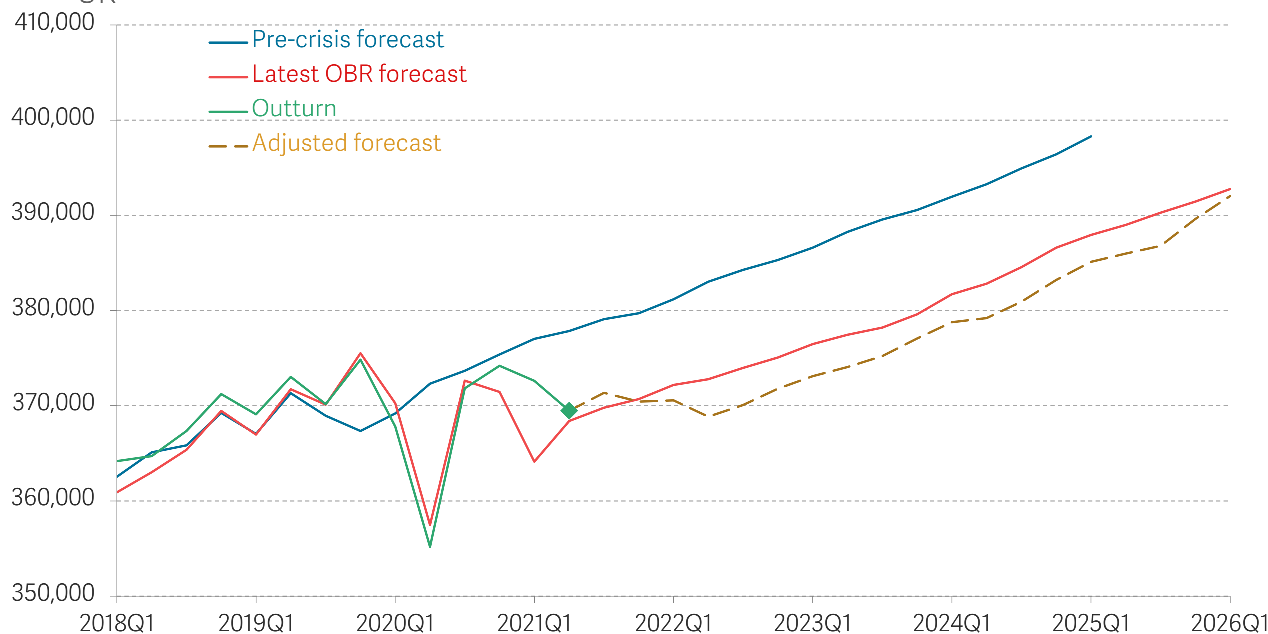
12 T Bell et al, Nationally Insured? New taxes and new spending to address key Department for Health and Social Care priorities, Resolution Foundation, September 2021.

13 We can convert the fall in income into cash terms by dividing the national accounts measures by the number of households. This suggests that, by the end of 2022, inflation-adjusted average income would be expected to be around £1,000 lower.

any changes in wage growth. But, based on this calculation, despite the improvement in the economic outlook, real incomes are likely to be little changed when the OBR updates its forecast.

FIGURE 5: **Higher inflation means the outlook for real household incomes has not improved by as much as have prospects for the economy**

Projections for total disposable household income, chained-volume measure, £ million: UK

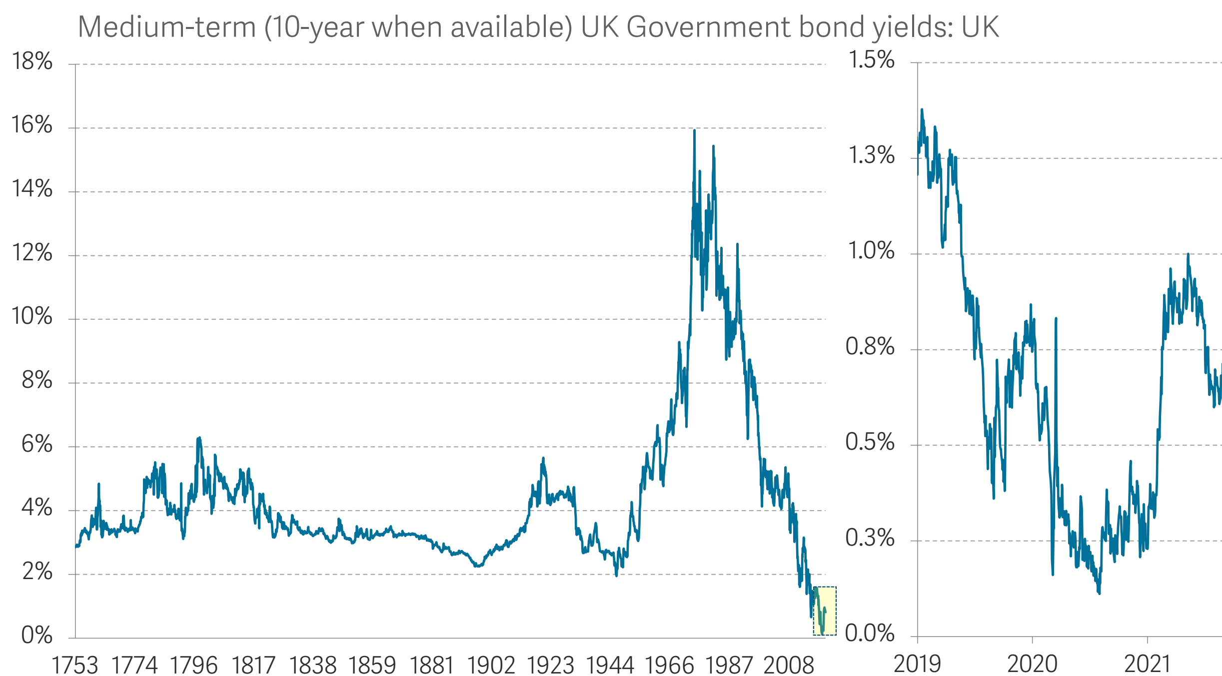


NOTES: Adjusted forecast follows same trend as previous OBR forecast, starting from latest National Accounts outturn data, adjusted in line with the Bank of England's August inflation forecast. Additional National Insurance contributions assumed to reduce income by £13 billion per year. Higher inflation assumed to increase benefit income by £5 billion per year, partly offsetting the overall fall in real incomes from higher inflation.
SOURCE: ONS, National Accounts; OBR, Economic and Fiscal Outlook, March 2021.

The other reason why even temporary inflation should not be seen as benign is because it may prompt the Bank of England to raise rates, leading to higher debt-servicing costs for the government, and a rise in the interest rates paid by firms and households. Indeed, higher inflation has already led to the markets now pricing in an interest rate rise for February, and this in turn has led gilt yields – the cost of servicing UK Government debt – to rise. As shown in Figure 6, although yields remain at incredibly low levels historically, they have increased in recent weeks.

FIGURE 6: **Debt yields have risen sharply in recent month but remain at incredibly low levels historically**

Medium-term (10-year when available) UK Government bond yields: UK



SOURCE: Bank of England, A Millennium of UK Data; Bank of England, Yield Curve Data.

Overall, then, despite the better starting point, the economic outlook has deteriorated in recent months. The Chancellor must, therefore, respond to the risk that things may get worse in the coming months. Increases in inflation, which reduce real household spending, and bottlenecks in supply chains at home and abroad will slow the recovery in the coming months. All of these factors should ultimately prove temporary, but there is a risk that these headwinds persist for longer than expected, leading to a more protracted recovery. And with Covid-19 cases rising as we come into the winter months, it is clear that the pandemic is far from over. In this context, withdrawing support for the recovery prematurely risks a renewed downturn and lasting damage to living standards.

There is a case for thinking that the OBR will reduce its 'scarring' estimate

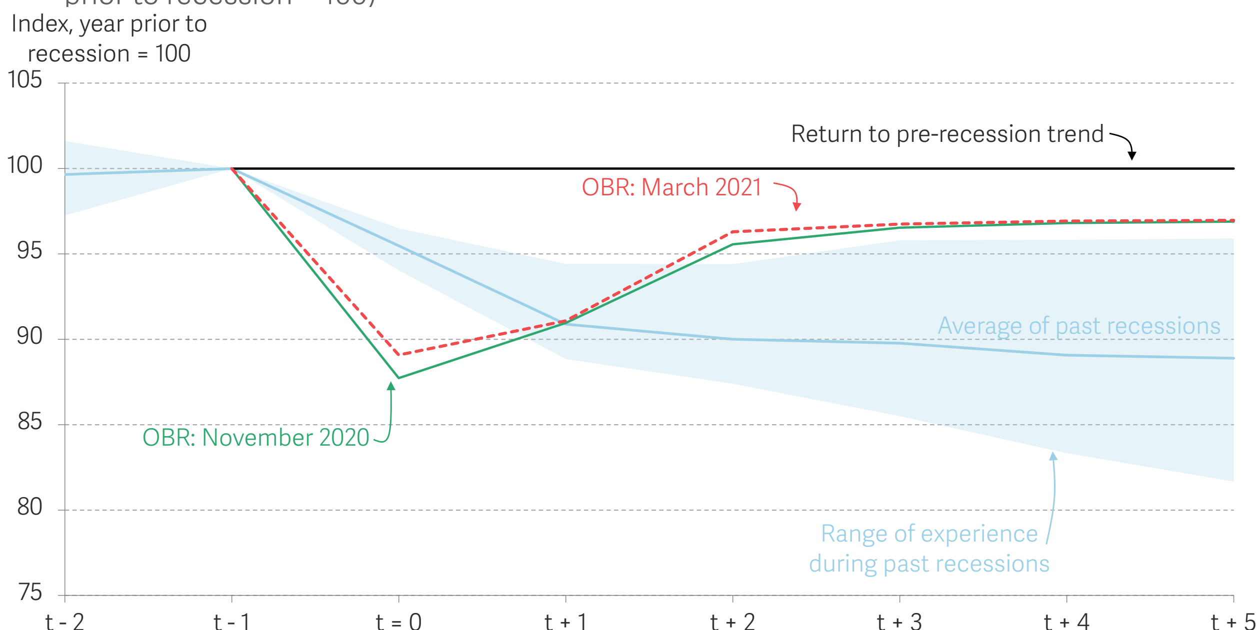
A key judgement for the OBR is whether it reduces its assumed 'scarring' effect of pandemic on the supply-side of the economy. As shown in Figure 7, post-war recessions have tended to leave the economy smaller relative to its previous path. the extent of such scarring has varied considerably, but has tended to be larger than the 3 per cent assumed by the OBR in March. This relative optimism makes sense, though: there are good reasons for thinking scarring might be smaller in this recession, given the lack of an underlying economic cause.[14] But even an assumed level of scarring at 3 per cent reduces

14 It also makes sense given the huge role played by fiscal policy in this recession.

future tax revenues and puts upward pressure on spending, making it harder for the Chancellor to deliver sustainable public finances in future. As a result, any changes to the OBR's scarring assumption could have a significant impact on overall fiscal policy.

FIGURE 7: **Output does not return to its previous trend after recessions**

The level of real GDP relative to pre-recession trend following past recessions (year prior to recession = 100)



NOTES: t = 0 is the year of the recession (first year that GDP growth is negative); swathe includes 1970s, 1980s, 1990s and financial crisis recessions. In the solid line (and for the swathe) trend is estimated to be the average growth rate over five years, five years prior to the start of the recession. The dotted lines show deviation from pre-recession, real time HM Treasury forecasts included in the OBR's historical forecast database.
SOURCE: RF analysis of ONS; OBR, Historical Forecast Database.

There are two ways to think about whether the OBR should revisit its judgement on scarring. The first is to look at the news on the supply side since March; the second is to consider whether the impact of the pandemic has been large enough to lead to 3 per cent scarring. We discuss both of these below.

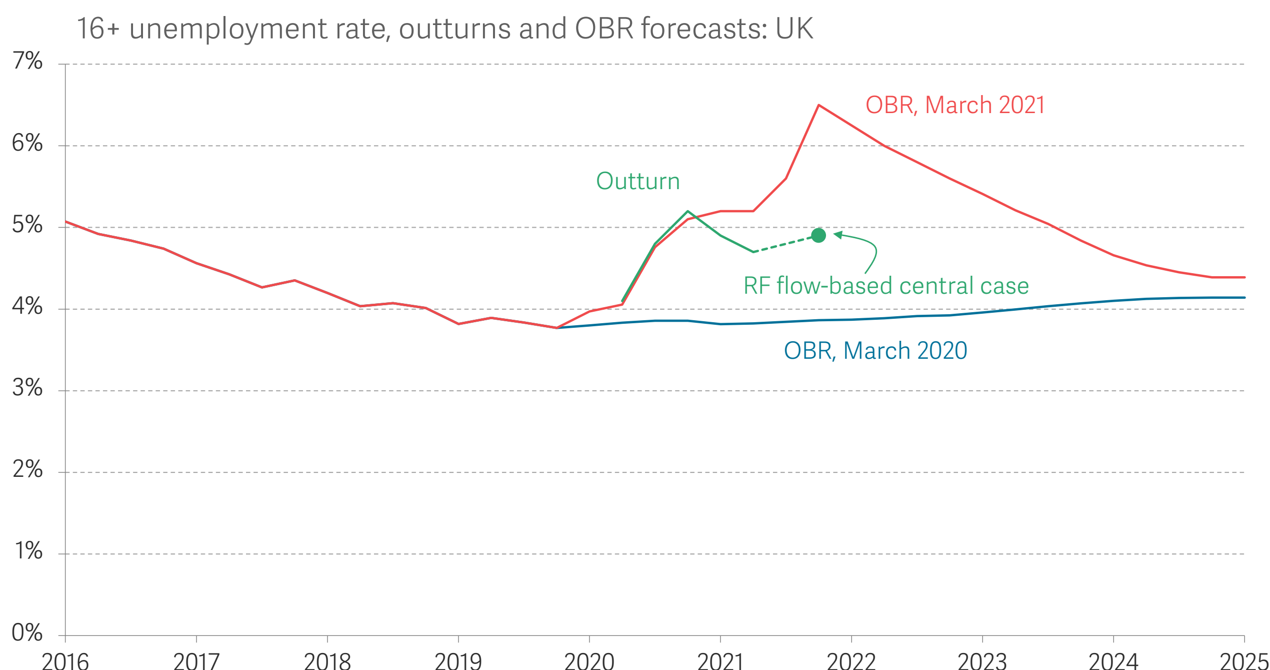
The improvement in the overall economic outlook – and particularly the labour market – provides grounds for thinking that the OBR is likely to reduce its estimate of scarring. The single most important piece of news in this context is on unemployment. Back in March, the OBR expected unemployment rate to peak at 6.5 per cent. But, as shown in Figure 8, unemployment has fallen in recent months and, based on our assessment of recent labour market flows, looks set to peak at around 5 per cent.[15] This is clearly good news,

15 H Slaughter & G Thwaites, Labour Market Outlook Q3 2021: Prospects for unemployment after the Job Retention Scheme, Resolution Foundation, September 2021.

and will mean that the longer-term unemployment rate – a key metric of scarring in past recessions – will not rise to anything like the extent that was expected in March.

FIGURE 8: **Unemployment looks set to peak far lower than expected even in March**

16+ unemployment rate, outturns and OBR forecasts: UK



SOURCE: RF analysis of ONS, Labour market statistics. RF estimate from H Slaughter & G Thwaites, Labour Market Outlook Q3 2021: Prospects for unemployment after the Job Retention Scheme, Resolution Foundation, September 2021.

But it is not just unemployment that matters for scarring. In March, the OBR provided an indicative decomposition of its 3 per cent scarring assumption, which we repeat in Table 1. This suggests that the OBR expected about a third of the scarring impact to come through the labour market – particularly through lower labour market participation – and two-thirds from lower productivity. Evidence on how the supply side is faring is discussed in Box 1, but Table 1 summarises our assessment of the recent evidence. Here the key takeaway is that there has been recent news that suggests the extent of scarring may well be smaller than the OBR thought in March. For example, productivity has come out stronger than expected, reflecting the strength of the recovery, and, although labour market participation has actually been weaker than expected, most of the fall in participation looks plausibly temporary.

TABLE 1: **Our assessment is that the supply-side data has improved somewhat since March**

News on components of supply-side scarring since March 2021

	OBR March 2021 assumed contribution to 'scarring' (per cent)	News since March
Labour market	1.0	+
o/w Population	*0.2*	*?*
o/w Participation	*0.5*	*?*
o/w Unemployment	*0.3*	+
Productivity	2.0	+
o/w Capital shallowing	*0.8*	*?*
o/w Total factor productivity	*1.2*	+
Total	**3.0**	+

NOTES: "+" = Lower scarring; "?" indicates that the data are uncertain and/ or changes are small.
SOURCE: RF analysis; OBR, Economic and Fiscal Outlook.

BOX 1: Evidence on the underlying determinants of economic scarring

In this box, we review the most recent data on the impact of scarring on the supply side of the economy. We focus on the labour market – particularly migration-driven changes in the labour force and how inactivity has evolved – but also look at evidence on the impact of the pandemic on productivity. In each case, a central issue is the extent to which changes in behaviour brought about by the pandemic are likely to become the 'new normal'.

Turning first to the labour force, where the key development is changes in net migration rates. Here a combination of Brexit and Covid-19 have probably led to a significant number of migrants leaving the country. Before the OBR's March forecast, estimates suggested a huge exodus of migrants of the order of 800,000.[16] But subsequent analysis that attempts to adjust for changes to survey methodology suggests around 500,000 migrants may have left the country.[17] On top of this uncertainty about how many migrants have left is additional uncertainty over whether workers who have left the country

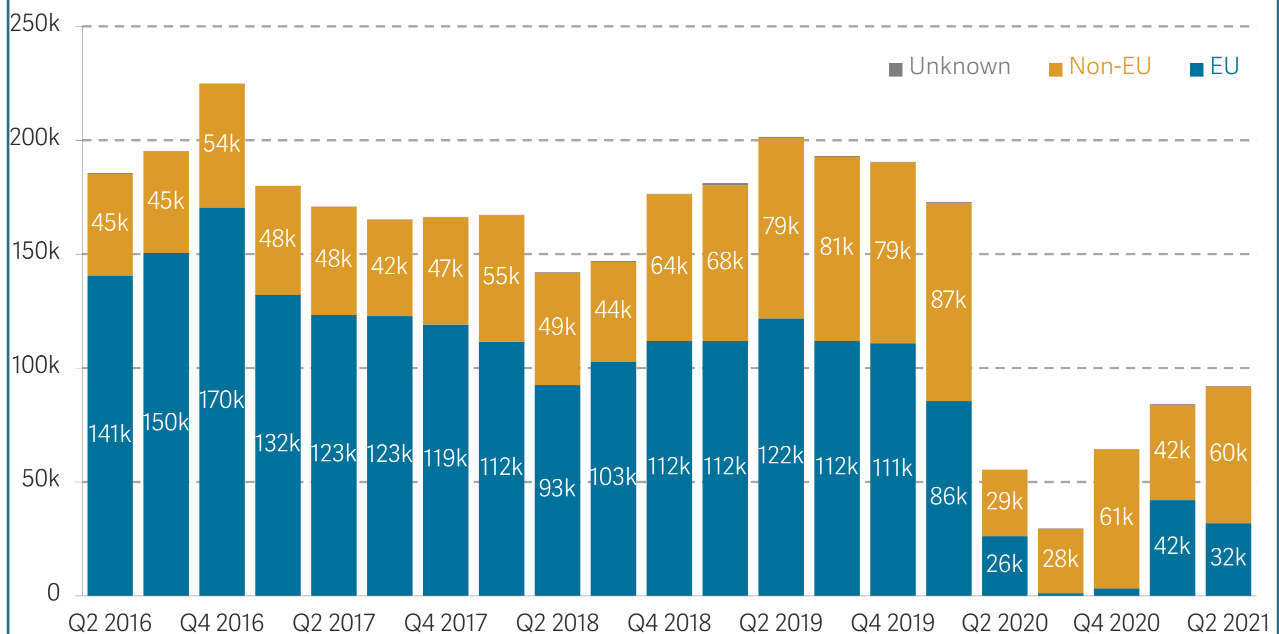
16 M O'Connor & J Pores, Estimating the UK population during the pandemic, Economic Statistics Centre of Excellence, January 2021.
17 G Thwaites, Migration during the pandemic: Have 1.3 million migrants really left the country?, Resolution Foundation, March 2021.

during the pandemic will return. One piece of evidence we do have – data on new National Insurance numbers (or NINo) registrations, shown in Figure 9 – suggests new inward migration flows are recovering, but remain much lower than in 2019. On balance, then, it is not obvious that we have learnt much since March about changes to the number of migrant workers in the UK.

FIGURE 9: **NINo registrations suggest inward migration is recovering but remains well below pre-pandemic levels**

National Insurance Number registrations to overseas nationals: UK

SOURCE: RF Analysis of DWP, National Insurance Number Registrations to Adult Overseas Nationals Entering the UK.



Second, although the lower-than-expected rate of unemployment is good news for future scarring, labour force participation also determines scarring effects. Past recessions have led unemployed workers to become discouraged and either retire or otherwise stop looking for work.[18] Consistent with this, the OBR's breakdown of its scarring judgement from March shows that lower participation accounted for half of the impact of the pandemic on the labour market.

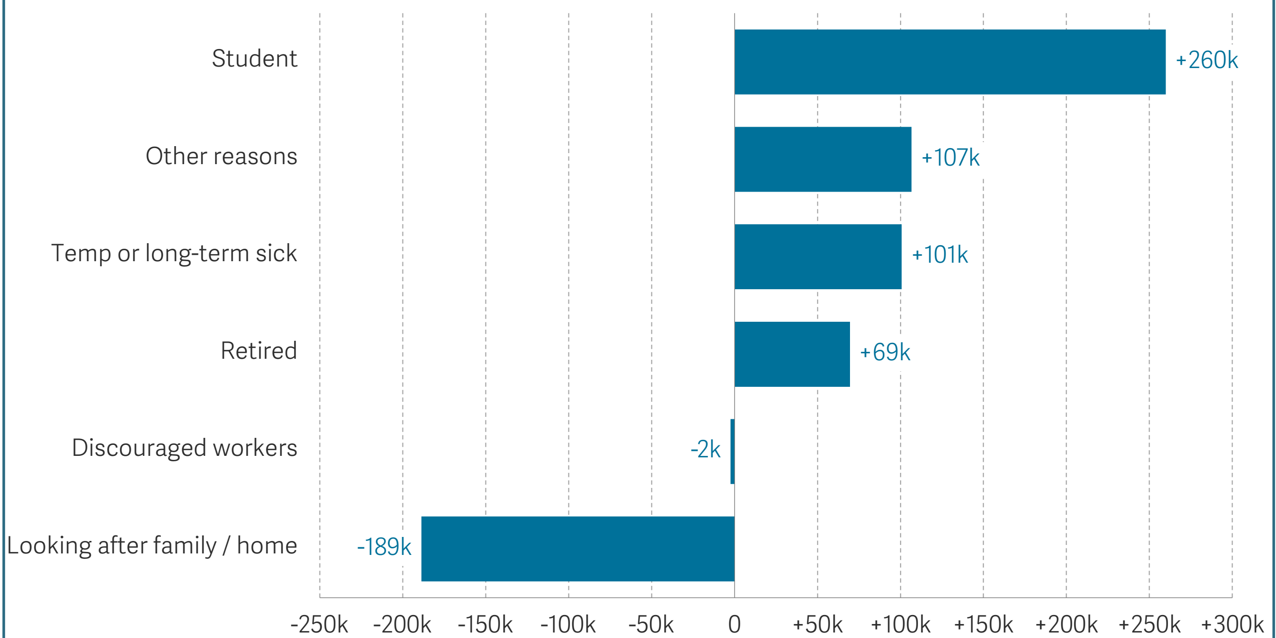
Since March, there has been a further fall in participation, but it is unclear how much this tells us about the longer-term impact of the pandemic. The 16+ participation rate has declined by 0.3

18 For example, see: B Bell & J Smith, 'Health, disability insurance and labour force participation', Bank of England Working Paper No. 218, 2004.

percentage points (or around 100,000 people) since March, and by around 0.5 percentage points since the start of the pandemic. Figure 10 decomposes this rise inactivity by reason; it shows that there has been a rise in the number of people saying they are inactive because they are a full-time student.

FIGURE 10: **Labour force participation has fallen in recent months but the extent to which this will last is uncertain**

Change in the number of working-age people who are economically inactive, by reason: UK, Dec-Feb 2020 to Jun-Aug 2021



SOURCE: RF analysis of ONS, Labour market statistics.

But, because much of this rise reflects a faller in the labour market participation rate of younger students – rather than a rise in the number of students – our view is that this is a temporary blip, and that students will return to their pre-pandemic patterns of working. The other key development is a fall in inactivity among those saying they are looking after family or their home. This has been linked to a rise in carers working from home. If so, and if the pandemic makes home working more common, then this rise in participation could prove longer-lasting. But the rise could also reflect second earners upping their hours to make up for income shocks.[19] The final category of interest is those saying they are retiring. Working-age retirement has been on a downward trend since the financial crisis, but, since the start of the pandemic, the number of working-age people saying that they have retired

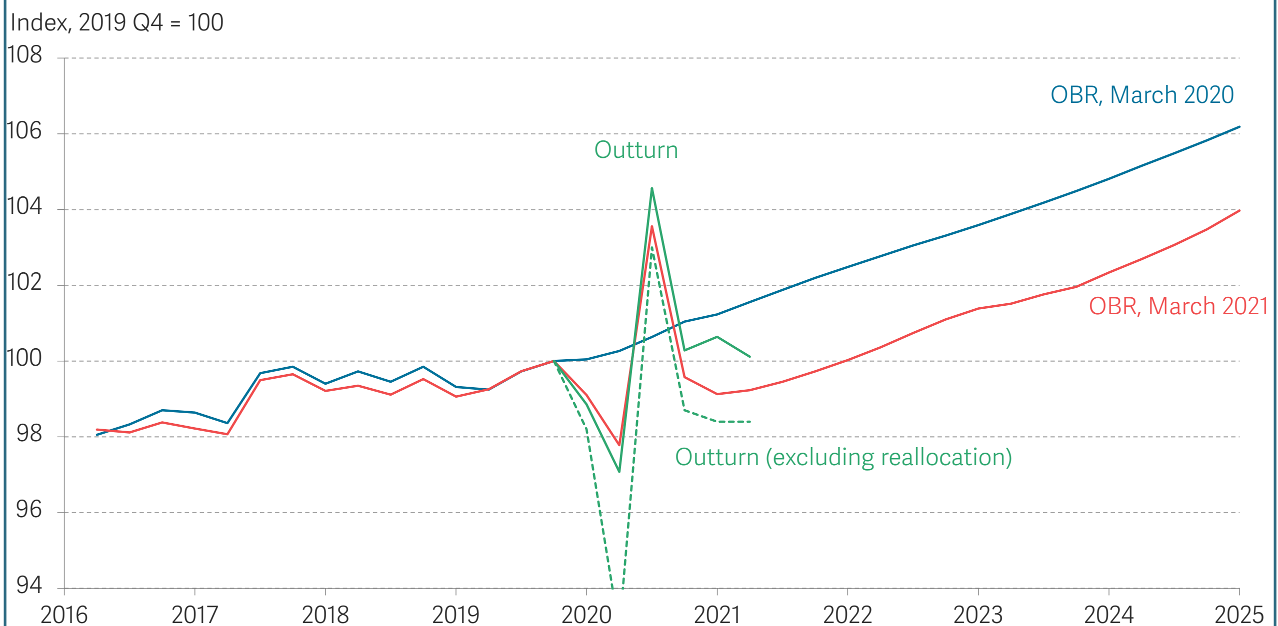
19 For a discussion, see: H Slaughter, Labour Market Outlook Q2 2021, Resolution Foundation, June 2021.

has increased by around 100,000. If this continues, then there may be a lasting reduction in participation from this source. Stepping back, though, labour force participation actually increased in the aftermath of the financial crisis, something that our previous work attributed to the impact of that recession on real incomes, and it is not implausible that we could see something similar following the pandemic.[20] On balance, then, it is not obvious that we have learnt a great deal about prospects for participation – suggesting this is not a place where the OBR is likely to change its scarring assumption.

The 'big ticket' item for the OBR's scarring assumption is labour productivity. Here, the improvement in the overall economic outlook since May means that there has been upside news (see Figure 11).

FIGURE 11: **Productivity has surprised to the upside, but sectoral reallocation effect has been important**

Output per hour, chained-volume index, 2019 Q4 =100



NOTES: 'Reallocation effect' is an estimate of the impact on aggregate productivity of changes in hours worked in relatively more productivity sectors.
SOURCE: ONS, UK productivity flash estimate: April to June 2021; OBR, Economic and Fiscal Outlook, March 2020 and March 2021.

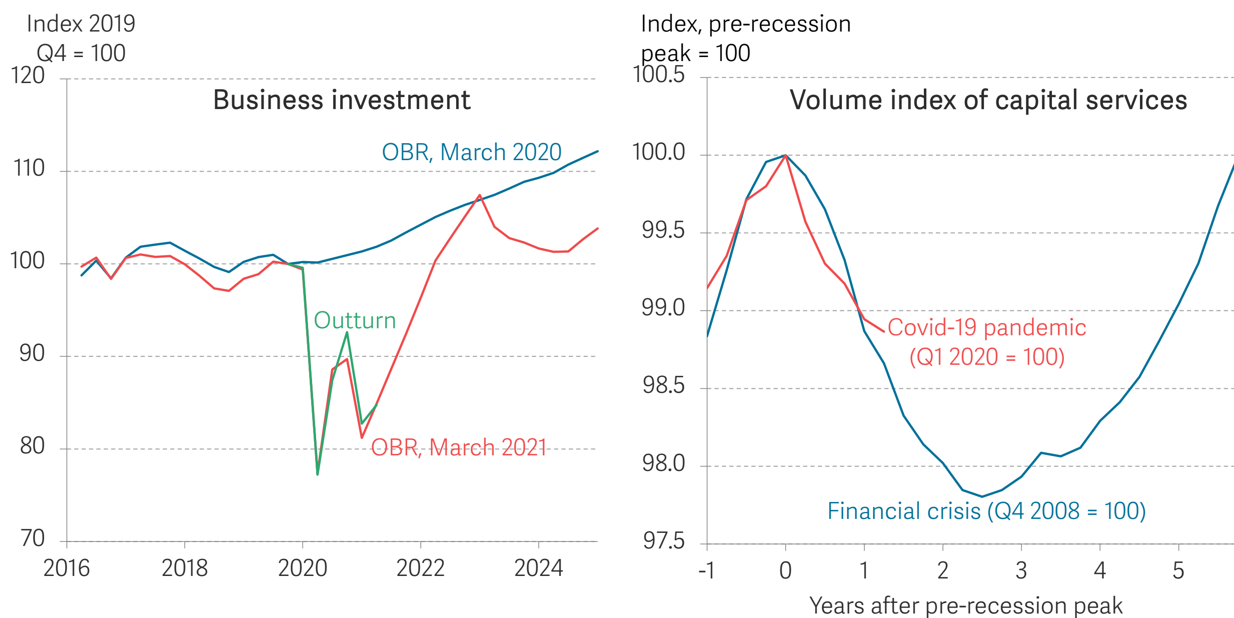
A key factor in driving changes in labour productivity is spending on physical capital. As shown in Figure 12, it is not clear that data on capital spending (i.e. business investment) has been markedly different to the OBR's March forecast, but the fall in investment spending at the start of the pandemic

20 T Bell & L Gardiner, Feel poor, work more | Explaining the UK's record employment, Resolution Foundation, November 2019.

will reduce the amount of capital services available to the corporate sector. A key driver of future capital spending is the 'super deduction' tax policy announced at the Budget in March which, by offsetting the impact of future corporation tax rises, provides an incentive for firms to bring investment forward. There has, however, been mixed evidence on its impact so far, and it is too early to say whether investment will turn out to be stronger or weaker than the OBR's forecast in March.

FIGURE 12: **There has been little news on investment or the capital stock relative to March**

Business investment, chained-volume index and volume index of capital services: UK



NOTES: Volume index of capital services is a measure of the contribution of physical capital to the production process and is estimated using measures of the stock of different types of physical assets such as building and plant and machinery.
SOURCE: ONS, National Accounts and Productivity overview, UK: April to June 2021.

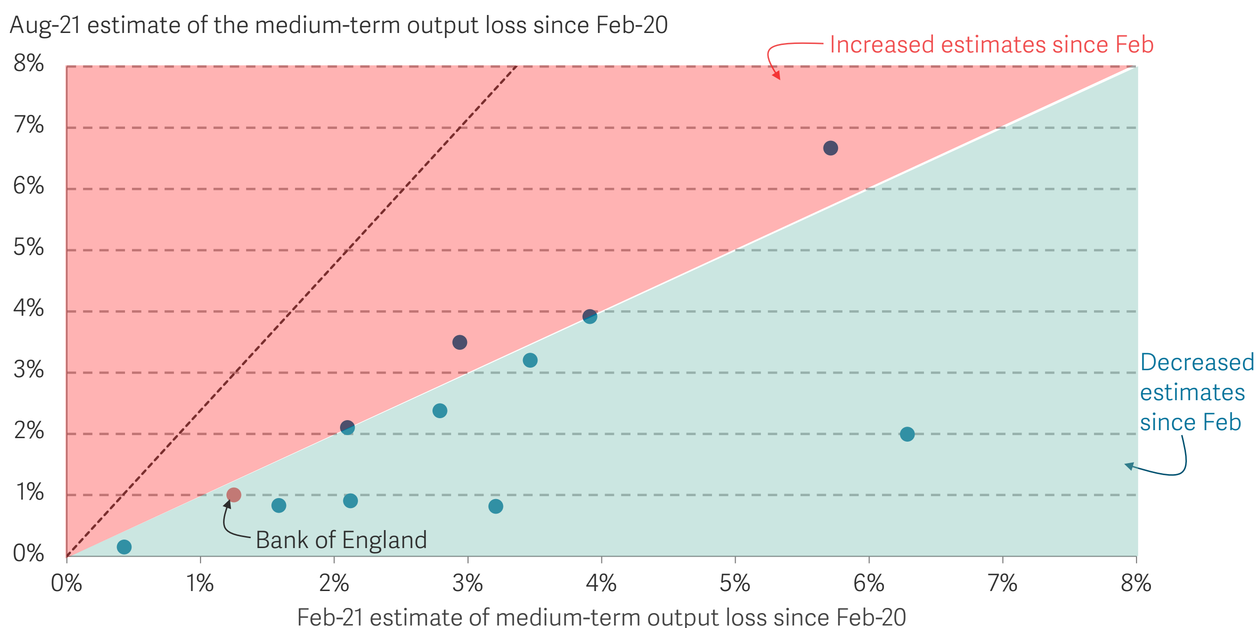
An important point to note in the better-than-expected productivity data is the contribution of reallocation between sectors. As shown in Figure 12, once the impact of changes in hours worked is taken to account, average productivity has been weaker. Because we don't know the extent to which this was factored into the OBR's March projections, it is unclear how this development will change its view of scarring. On the other hand, we would probably expect the boost to productivity from the shift in working patterns during the pandemic to unwind as the economy recovers.

Overall, then, the direction of travel is one of generally small good news on the supply side since March. That said, a huge amount of uncertainty remains, particularly on the key question of the extent to which productivity may turn out weaker.

Like others, our assessment is that the marginal news on scarring has been positive despite the obvious uncertainty. Figure 13 attempts to assess how a range of forecasters have changed their view over the past six months or so.[21] It is striking that only 2 out of 12 forecasters are assuming that the economy will be smaller in the medium term than they did in February (around the same time as the OBR's most recent forecast).

FIGURE 13: **Since March, forecasters have generally reduced their estimates of the extent to which output will be lower in the medium term**

Forecasts for the medium-term loss in output since February 2020: UK



NOTES: Dots compare the forecast level of GDP in February and August 2021 with the level implied by forecasts in February 2020. The level of GDP is estimated by compounding calendar-year growth rates.
SOURCE: HMT, Forecasts for the UK economy; Bank of England, Monetary Policy Report; IMF, World Economic Outlook.

Considering all these factors leads us to conclude that it would not be a surprise if the OBR reduced its estimate of scarring. However, although we agree that the stronger recovery provides grounds for thinking that there might be less scarring now than was expected in March, it is important to recognise the extent of the uncertainty here. Indeed, our judgement is that an assumption of 3 per cent scarring could easily be justified given changes in the size of the labour force, reduced business investment, and the impact of the pandemic on productivity.

That said, neither we nor the OBR can be definitive about the extent of eventual scarring. Crucially, this uncertainty should be factored into policy decisions in two ways. First, rapid tightening in the near term should be avoided, as this runs the risk of increasing the extent of scarring. This might be the case for a number of reasons, for example

21 For the HMT panel, it is necessary to back this out from medium-term forecasts – and so this will conflate other influences on the medium-term outlook in addition to scarring (for example, this could include changes in views about the eventual impact of Brexit).

because business investment turns out weaker than expected. Second, looking further ahead, policy for the middle of this decade should take this uncertainty into account. The Chancellor may be hoping that improvements in the outlook will allow for lower taxes, but he should also plan for the eventuality that the economy turns out to be smaller than expected and that more tax rises are needed.

Overall, then, we expect the OBR to provide the Chancellor with good news on the near-term economic outlook, and probably on the medium-term outlook too. In both cases uncertainty is significant, with a clear risk that the economy ends up being weaker either in the near term or the medium term. And these risks have a key role to play in the Chancellor's decisions on fiscal policy. We turn to those decisions in the next section.

Section 3

The fiscal outlook

The faster-than-expected recovery in economic activity has materially improved the short-term fiscal position, with borrowing likely to be £20-30 billion lower in 2021-22. But, more important for the Chancellor and the economy is the outlook for the later years of the forecast. Here, again, the main message is one of heightened uncertainty. If the OBR reduces its estimate of 'scarring' from this pandemic to 2 per cent of GDP medium-term borrowing could be around £10 billion per year lower. But that is far from certain, and the OBR's medium-term fiscal forecast could easily end up being little changed since March 2021.

Fiscal policy has out of necessity been the main tool of macroeconomic stabilisation during this crisis. This is partly because the Bank of England was unable to reduce interest rates by as much as in the financial crisis. But it is also because the hugely uneven impact of the pandemic on households and firms required targeted fiscal support. Recent debate about the overall stance of macroeconomic policy has failed to recognise this reality and so focused too much on the stance of monetary policy; increases in interest rates will only play a small role in the overall tightening of policy. Instead, fiscal policy is much more important. In this context, the Chancellor must take the huge uncertainty into account. Given that it would be hard to provide more stimulus in a timely manner if growth stalls, policy should avoid withdrawing fiscal support too quickly, as this risks an unnecessarily protracted recovery. Looking further ahead, Rishi Sunak would like to be in a position to reduce taxes in the coming years. But the uncertainty about the longer-term economic impact of Covid-19 means that he must also prepare for a weaker outlook that could require higher taxes.

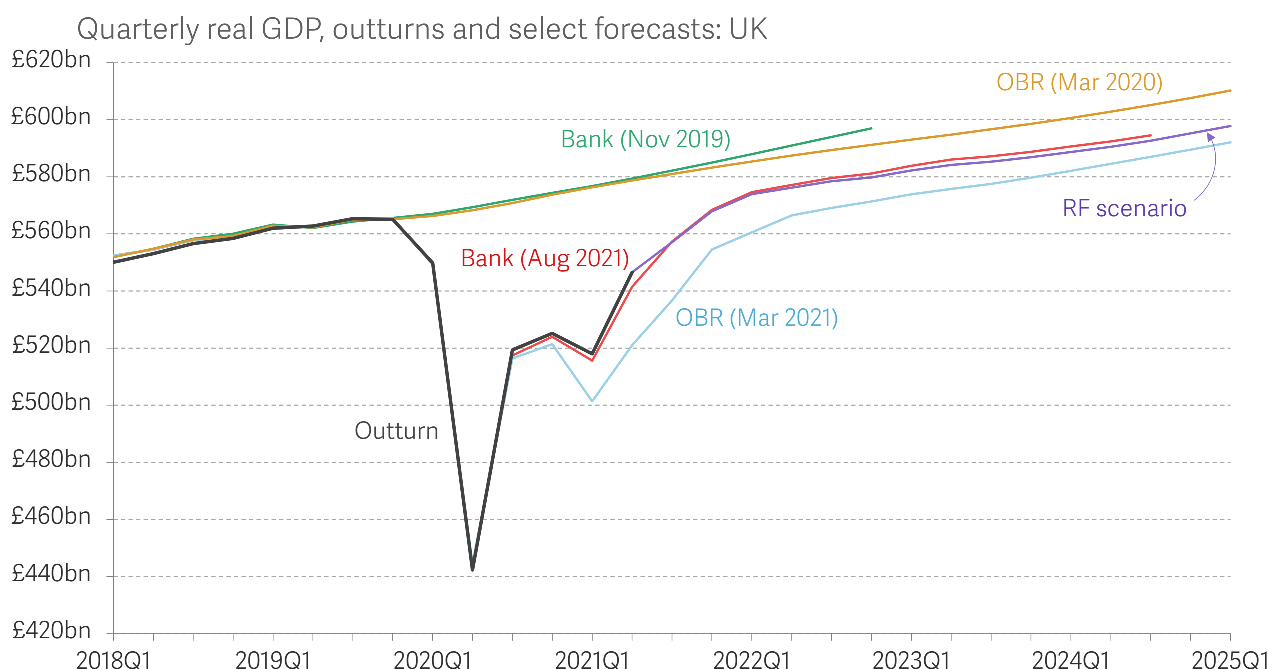
The pandemic required huge increases in government borrowing, but the faster-than-expected recovery means that borrowing will fall sharply

To understand how the change in the economic outlook will affect the OBR's fiscal

forecasts, we construct a scenario in which we assume that that the OBR adjusts its assessment of the medium-term scarring from the pandemic from 3 per cent to 2 per cent.[22] As Figure 14 shows, this leaves the path of GDP close to the Bank of England's most recent forecast, but slightly lower by the end of the forecast period. Our scenario expands on the GDP outlook to include consistent forecasts for the labour market, inflation and other variables which have a material impact on government finances.

FIGURE 14: **GDP growth has beaten expectations but is set to slow**

Quarterly real GDP, outturns and select forecasts: UK



NOTES: Historic forecasts have been adjusted to reflect ONS revisions to the level of GDP.
SOURCE: RF analysis of ONS; OBR, Economic and Fiscal Outlook, March 2020 and March 2021; Bank of England, Monetary Policy Report, November 2019 and August 2021.

The faster-than-expected recovery in economic activity this year has led to a material fall in borrowing relative to the OBR's March 2021 forecast. So far this year, public sector net borrowing (PSNB) has been £32 billion below expectations.[23] This reflects the improvements in the economy discussed above, which have raised current tax revenues, and related smaller-than-expected expenditure on Covid-19 support measures such as the Coronavirus Job Retention Scheme (JRS).

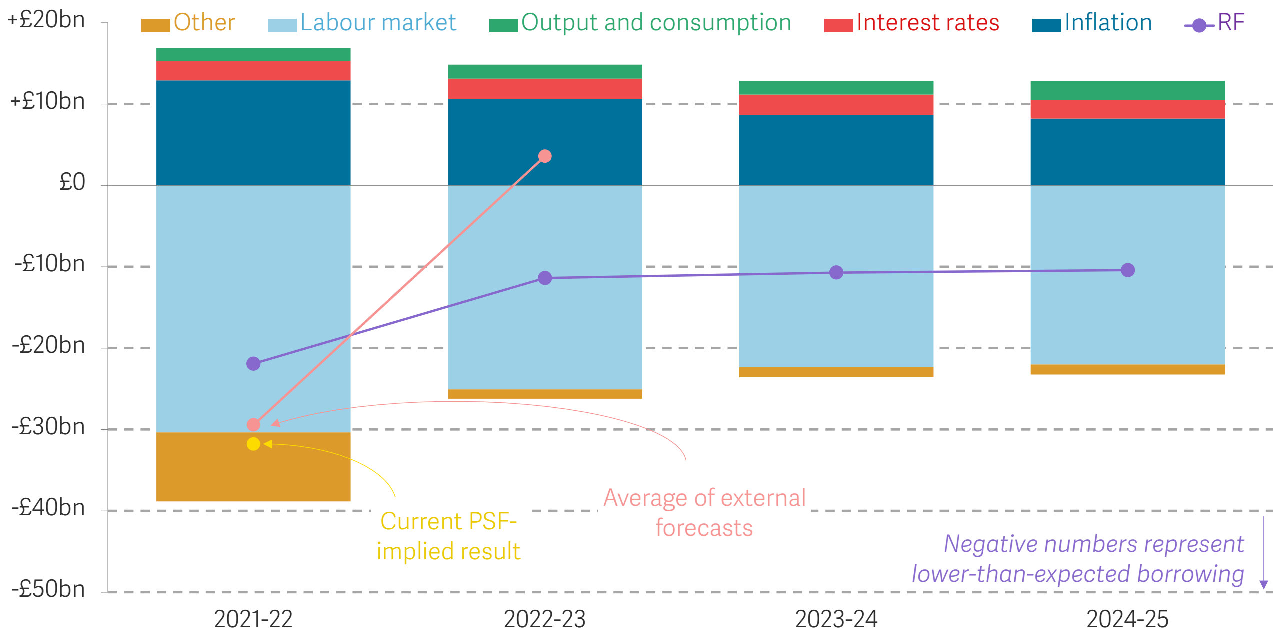
22 The Resolution Foundation fiscal model is used to translate this economic scenario to a revised fiscal forecast. We utilise the OBR's 'ready reckoners' for how changes in the economy feed into government borrowing. Here, the OBR provides summary estimates for how individual economic variables affect specific elements of government spending and revenue. For example, higher employment leads more people to pay income tax and thus higher income tax revenue. These ready reckoners were last published in 2019, so we have amended them to reflect changes in the Government's fiscal position and related policy decisions, although this adds additional uncertainty to our results. For example, we have allowed for the fact that government debt is substantially higher than had been forecast in 2019, and that tax thresholds are different in real-terms from those expected at the time.

23 PSNB has been revised down by an additional £2.5 billion since the OBR's March 2021 forecast due to a change in the discount rate used for public sector pension schemes. This represents an accounting change, rather than something related to changes in the economy or policy, and so we therefore abstract from this revision in subsequent figures. For more information see: ONS, Public sector finances, UK: August 2021, October 2021.

But the economic outlook for the rest of this fiscal year is less positive. Figure 15 shows our central estimate of the change in PSNB since the OBR's March forecast, and the key economic drivers of these changes. We estimate that PSNB in 2021-22 will be around £22 billion below the forecast made in March 2021 – less than the £32 billion improvement seen so far this year. There are good reasons to think that the positive trend seen so far in 2021-22 will not continue into the latter half of this year. For example, some of the improvement in borrowing to date is due to smaller expenditure on government support schemes, like the JRS, which have now ended, and so cannot contribute any more to lower-than-expected spending; and the cost of higher inflation on debt interest is only starting now to have a major effect. Despite this, other external forecasters are currently expecting, on average, borrowing to be £30 billion lower than forecast in March, but there is a huge range in these estimates, ranging from borrowing being £100 billion lower than previously expected to being in line with the OBR's March forecast.[24]

FIGURE 15: **The stronger-than-expected economy since March has improved the fiscal forecast**

Change in public sector net borrowing forecast since the OBR's March 2021 forecast, by economic driver: UK



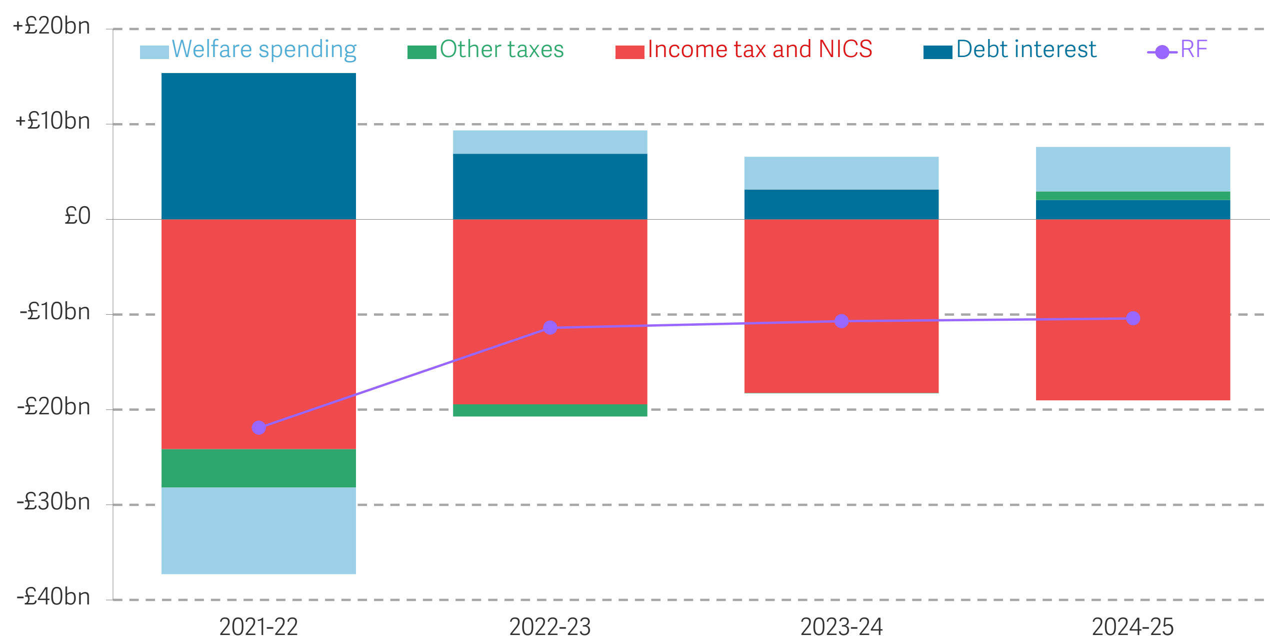
NOTES: Economic scenario used for these figures is based on our analysis of the likely shape of the OBR's upcoming economy forecast, assuming a medium-term scarring assumption of 2 per cent. This scenario draws on the Bank of England's August 2021 forecast and is updated for changes in market rates for UK government debt.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2021; OBR, Fiscal Risks Report, July 2019; Bank of England, Monetary Policy Report, August 2021; Bank of England, Yield Curve; HM Treasury, Forecasts for the UK economy.

24 One area where our central estimate could be too pessimistic is on other areas of government underspend; the latest IFS Green Budget suggests that there will be a £10 billion underspend in the Covid fund , for example (see: S Adam et al., IFS Green Budget 2021, Institute for Fiscal Studies, October 2021). In addition, given the uncertainty around the path of health crisis, it is hard to definitively predict spending demands over the rest of the year, and so we have not allowed for any additional underspending in our 2021-22 forecast.

The improvement to borrowing in later years of the forecast is smaller because it is less affected by the strength of the economy this year, depending instead on the assumption made about the level of scarring. With medium-term economic activity in our scenario roughly 1 per cent higher than the OBR's March 2021 forecast (as a result of a reduced scarring assumption), we estimate that borrowing will be around £10 billion lower than expected. This reflects a stronger forecast for economic output, showing up in a stronger labour market, partially offset by the longer-term effects of the increase in inflation and interest rates in 2021 and 2022.

FIGURE 16: **Higher government spending is more than offset by higher revenue**

Change in public sector net borrowing forecast since OBR's March 2021 forecast, by fiscal driver: UK



NOTES: Economic scenario used for these figures is based on our analysis of the likely shape of the OBR's upcoming economy forecast, assuming medium-term scarring of 2 per cent. This scenario draws on the Bank of England's August 2021 forecast and is updated for changes to the market rates for UK government debt. 'Welfare spending' data includes the impact of lower JRS spending in 2021-22.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2021; OBR, Fiscal Risks Report, July 2019; Bank of England, Monetary Policy Report, August 2021; Bank of England, Yield Curve.

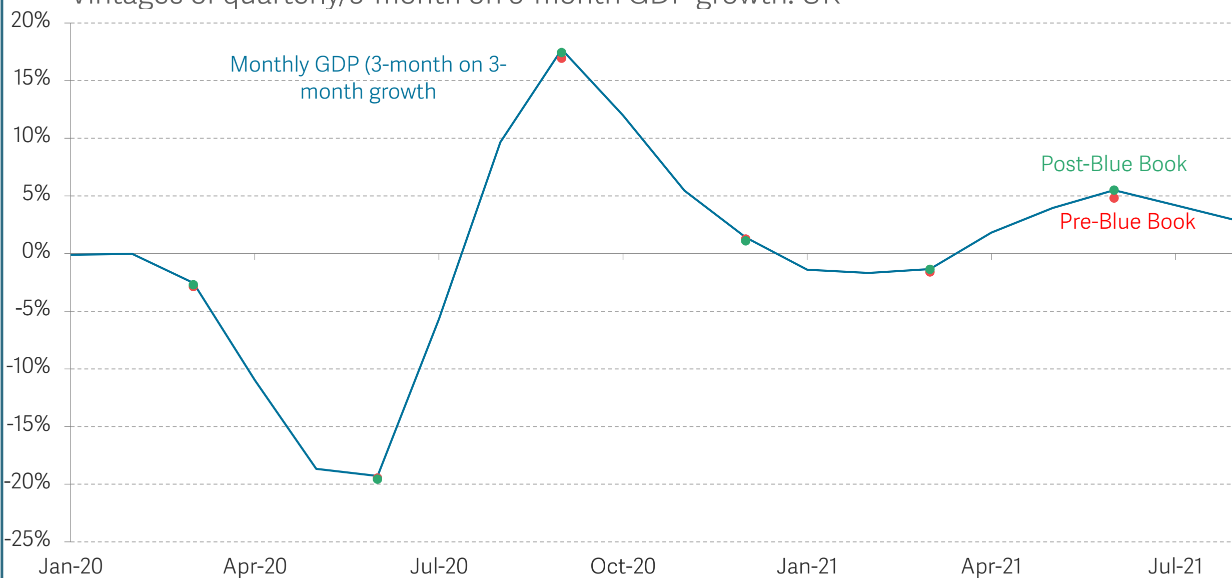
Figure 16 shows the same forecast as Figure 15 but broken down into changes in spending and tax revenue. The impact of higher inflation and interest rates on debt-servicing costs are expected to add substantially to expenditure in 2021-22, but much less so in future fiscal years. This is because the impact of higher inflation on indexed-linked gilts feeds through into measured borrowing at the same time as inflation is elevated (i.e. affecting the 2021-22 fiscal year predominately), and the recent rise in gilt rates have been larger at the shorter end of the gilt curve. The OBR tends to close its forecast several weeks before the fiscal event; this means that more recent rises in gilt rates will not be

factored into forecasts.[25] Recent rises in interest rates could add around a further £2 billion to annual borrowing by 2024-25. We discuss the impact of more recent revisions to GDP data in Box 2.

By necessity, the OBR 'closes' its forecast ahead of the forecast publication in order to allow the Chancellor to make fiscal decisions based on a fixed set of projections. This means no new data releases are inputted into projections. For example, in March 2021, the OBR closed the forecast on 5 February, almost four weeks before publication on 3 March.[26] This practice obviously means that the OBR's projections do not always reflect the latest available information, although it has the option of providing additional analysis of how the new information may change its forecast in future. The forecast closed for the upcoming Budget and Spending Review on 24 September – somewhat earlier than the previous forecast.[27]

FIGURE 17: **News in the latest GDP releases is largely offsetting**

Vintages of quarterly/3-month on 3-month GDP growth: UK



SOURCE: RF analysis of ONS, Quarterly National Accounts & Monthly GDP estimate.

Since the forecast closed, there has been material economic news on the size of the economy, raising the question whether our projections –

25 Our forecast uses gilt rates as of 24 September 2021.
26 OBR, Economic and fiscal outlook, March 2021.
27 See C Giles, Sunak to impose tight spending settlement by using 'old' official data, Financial Times, October 2021.

which incorporate more timely GDP outturns – will be consistent with those in the Budget. Figure 17 shows GDP growth from three successive ONS releases. The OBR forecast will only include the data in red. Since then, the level of GDP has been revised up materially (shown by higher growth in the green dots for 2021), and GDP growth has slowed in July and August (shown by the falling blue line). Our view is that these factors are offsetting. This suggests that, had the OBR included the timeliest GDP data in their analysis, changes to its forecast may be relatively small. So, the recent revisions to GDP should not be a significant source of difference between our analysis and the OBR's, particularly in the context of the large uncertainties affecting the fiscal forecast at the moment.

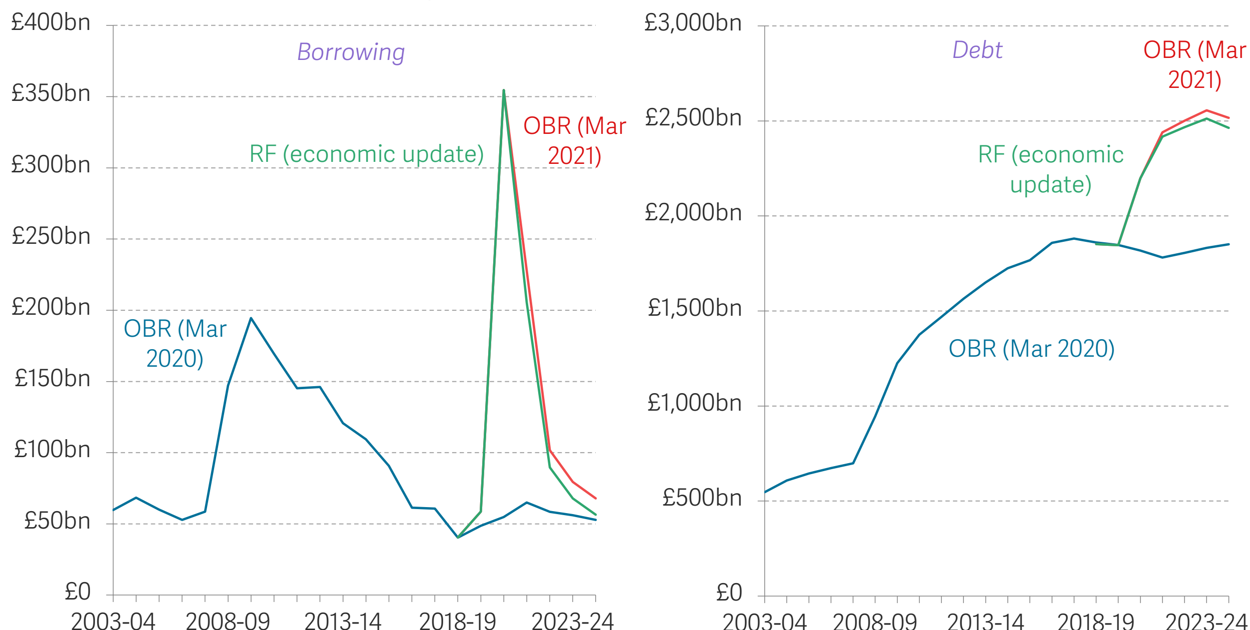
The other major upward pressure on spending comes from higher welfare spending, as many benefit rates are usually increased in line with inflation. But the impact of higher inflation on debt interest costs and welfare spending is more than offset by the increase in tax revenue, particularly from income taxes, as employment and wages are both projected to improve faster than previously expected.

Although these revisions to the borrowing forecast are both material and important, the big picture remains one of extraordinary fiscal support during the pandemic and a swift fall in borrowing back towards pre-pandemic levels (see Figure 18). In historical terms, such a fall in borrowing is utterly unprecedented. Before the pandemic, the fastest recorded fall in PSNB over a five-year period was 6.7 per cent of GDP, following the 1990s recession. The OBR forecast in March was that the five-year fall in PSNB following the pandemic would be more than double that, at 14.1 per cent of GDP.[28] If successful, such a rapid return to lower borrowing would be in marked contrast to the post-financial crisis experience, where a slow economic recovery hampered efforts to improve the Government's fiscal position. From one perspective, this is not surprising: the huge support required during the pandemic largely focussed on one-off schemes (e.g. the JRS), and had to be funded with increased borrowing (unlike in the financial crisis, where some one-off support measures – such as the cost of bailing out banks – did not affect the borrowing figures).[29] But it should also be noted that the fast recovery in the fiscal position is testament to the success of the Government's support schemes in preventing further damage to the supply capacity of the economy. However, although borrowing is set to fall back to pre-pandemic levels, debt will remain elevated, peaking at close to 100 per cent of GDP.

28 This uses OBR data back to 1948. See OBR, Public Finances Databank, August 2021.
29 Purchasing banks as part of the bailout increased debt directly but, as they were accompanied by new public sector assets, did not directly raise borrowing.

FIGURE 18: **the pandemic has led to a significant increase in government debt**

Public sector net borrowing and public sector net debt, outturn and forecasts: UK



NOTES: Economic scenario used for these figures is based on our analysis of the likely shape of the OBR's upcoming economy forecast, assuming scarring of 2 per cent. This scenario draws on the Bank of England's August 2021 forecast and is updated for changes in the market rates for UK government debt. Figures are shown in 2019-20 prices.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2021 and March 2020; OBR, Fiscal Risks Report, July 2019; Bank of England, Monetary Policy Report, August 2021; Bank of England, Yield Curve.

Current fiscal forecasts are consistent with the Government meeting its expected set of fiscal rules, assuming the economy recovers as expected

At the start of the pandemic, the Government rightly chose not to adopt the fiscal rules proposed in the 2019 Conservative manifesto.[30] Instead the Treasury has acted without a defined fiscal framework throughout the pandemic. This is sensible, given that the fiscal rules in place at the time had no mechanism for the suspension of fiscal targets or their reintroduction after a recession. In any case it would have been economically disastrous for restrictive fiscal rules to prevent the Government from implementing measures to protect the economy and deal with the health crisis. But this is not a long-term strategy, and we expect the Chancellor to lay out a new fiscal framework at the upcoming Budget.[31] This is expected to encompass a commitment not to fund day-to-day spending through borrowing (i.e. not to run a current budget deficit) and to have 'underlying' debt falling (this is the measure of PSND which excludes the effects of the Bank of England).[32]

30 These rules were: (i) to achieve a current balance (i.e. not borrow to fund day-to-day spending); (ii) public sector investment not to average more than 3 per cent of GDP; and (iii) if debt interest reached 6 per cent of tax revenue, then the fiscal strategy would be reviewed. For more detail see: Conservative Party, Manifesto 2019, November 2019.
31 See G Parker & C Giles, Rishi Sunak to set out new fiscal rules to rein in UK borrowing, Financial Times, September 2021.
32 Some Bank of England support measures, such as the Term Funding Scheme, increase measured public sector debt but will naturally unwind once the policy has been withdrawn. For more details see OBR, Economic and Fiscal Outlook, March 2021.

If such targets are announced, it would mean that there is a clear consensus between the Conservative and Labour parties that these are the appropriate metrics to target. However, the horizon over which these rules should be achieved has not been made clear by either party. And there is also a broader question over whether this consensus is merited – this is discussed further in Box 3.

BOX 3: **Fiscal rules for the Covid recovery**

The choice of fiscal rules plays an important role in guiding fiscal decisions in the UK. They help enshrine a government's medium-term economic strategy, help set expectations for future policy, and (if well defined) encourage countercyclical policy helping to stabilise the economy through booms and busts. A good fiscal framework should incentivise policy that drives a rapid recovery in the short-run and that repairs the public finances thereafter.

Our previous work set out a set of fiscal rules which could ensure long-term fiscal sustainability while facilitating the key economic reforms the Government intends to pursue, such as achieving its Net Zero and levelling-up agendas, and ensuring appropriate counter-cyclical fiscal policy.[33] This crisis has – if anything – strengthened the case for such a set of rules. Each of the rules – and their key justification – are summarised below:

- A Net Worth Objective: to deliver an improvement in public sector net worth as a share of GDP over five years. This would incentivise prudent investment decisions to address the long-term challenges facing the UK.
- A Structural Current Balance Target: to achieve a cyclically-adjusted public sector current balance of 1 per cent of GDP (and no less than minus 1 per cent) over five years. This requires the Government to keep receipts and day-to-day spending in broad balance (indeed, it means that not only could the government not run a current deficit but it must run a 1 per cent surplus) but would allow it to borrow to invest.
- A Debt Interest Ceiling: to ensure the proportion of revenue spent on debt interest does not exceed 10 per cent. This would ensure that the overall debt burden remains sustainable at all times by taking account of not only the level of debt but also what it costs to service.
- An 'escape clause': to recognise the need for more active fiscal policy given the constraints on monetary

33 R Hughes, J Leslie, C Pacitti & J Smith, Totally (net) worth it: The next generation of UK fiscal rules, Resolution Foundation, October 2019.

policy. The net worth and structural current balance targets would be suspended if the economic outlook deteriorated significantly.

The 'escape clause' is particularly important because, to date, governments faced with economic downturns have simply jettisoned rules and left themselves without a fiscal anchor. One of the points of having fiscal rules is precisely to give guidance on how a government would respond to changed economic circumstances, so constantly abandoning rules is not a good strategy for conducting predictable and effective fiscal policy.

Transitioning back to a defined fiscal framework is helpful as the economy normalises, for all of the reasons highlighted, above but there are some specific challenges with the rules the Chancellor is expected to announce. In particular, our view is that these rules are likely to prove too tight in the near term and too loose in the medium term. This is because the envisaged rules will set out a specific *time* horizon for tightening policy, rather than setting out the *circumstances* in which policy will tighten. This means there is a high likelihood that policy will prove too tight. Another issue is that the expected framework does not fully recognise the new environment of low interest rates. Low rates mean that monetary policy cannot fulfil the primary stabilisation tool for macroeconomic policy. This is because there is simply not enough room to cut interest rates sufficiently in a downturn. This means that fiscal policy must support the economy more during downturns and recoveries. But, equally, policy will need to be ready to do this again during the next recession. To prevent a 'ratcheting' effect, whereby the fiscal position deteriorates during every recession but never recovers, fiscal policy needs to be tighter during boom periods to offset the larger rise in debt during recessions. A simple 'debt falling' rule does not deliver this feature.

One clear issue is that the focus on debt limits hampers the ability to meet the country's Net Zero commitments: achieving Net Zero will require substantial public sector investment, and fiscal rules need to take that into account (as would be the case under a net worth rule).[34]

Finally, a set of fiscal rules without an escape clause (or another mechanism to ensure that stimulus can be provided during a recession) will result in the framework being dropped as soon as a downturn starts. This leaves the Government with no medium-term fiscal strategy and heightens policy uncertainty.

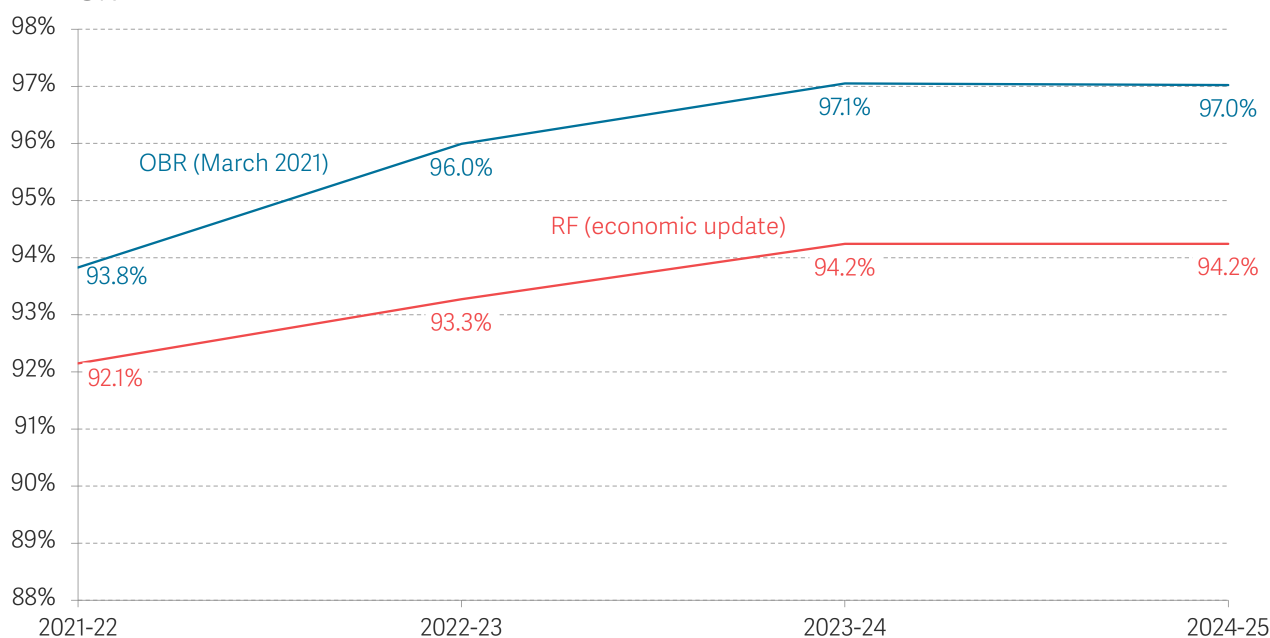
34 For more on the net zero challenges see: J Marshall & A Valero, The Carbon Crunch: Turning targets into delivery, The Economy 2030 Inquiry, September 2021.

Figure 19 presents our updated estimate of underlying debt as a share of GDP, compared to the OBR's March 2021 forecast. In the new forecast, debt is expected to reach 94.2 per cent of the economy in 2024-25, compared to 97 per cent in March.

The level of debt is lower in the updated forecast for two reasons: first, borrowing is expected to be lower throughout the forecast, and so adds less to the debt stock each year; second, the economy is now expected to be larger, which means the debt stock is smaller in relative terms. But what matters for meeting the expected fiscal rule is that debt is on a falling path. In March 2021, the OBR expected this to be the case by 2023-24, but this would only just be met. Our updated forecast also shows that debt is expected to fall only slightly between 2023-24 and 2024-25; this is because GDP growth is, in our scenario, expected to be somewhat slower in 2023-24, offsetting the impact of the lower stock of debt in absolute terms.

FIGURE 19: **Underlying government debt is expected to increase until 2023-24**

Forecasts of public sector net debt excluding the Bank of England, as a share of GDP: UK



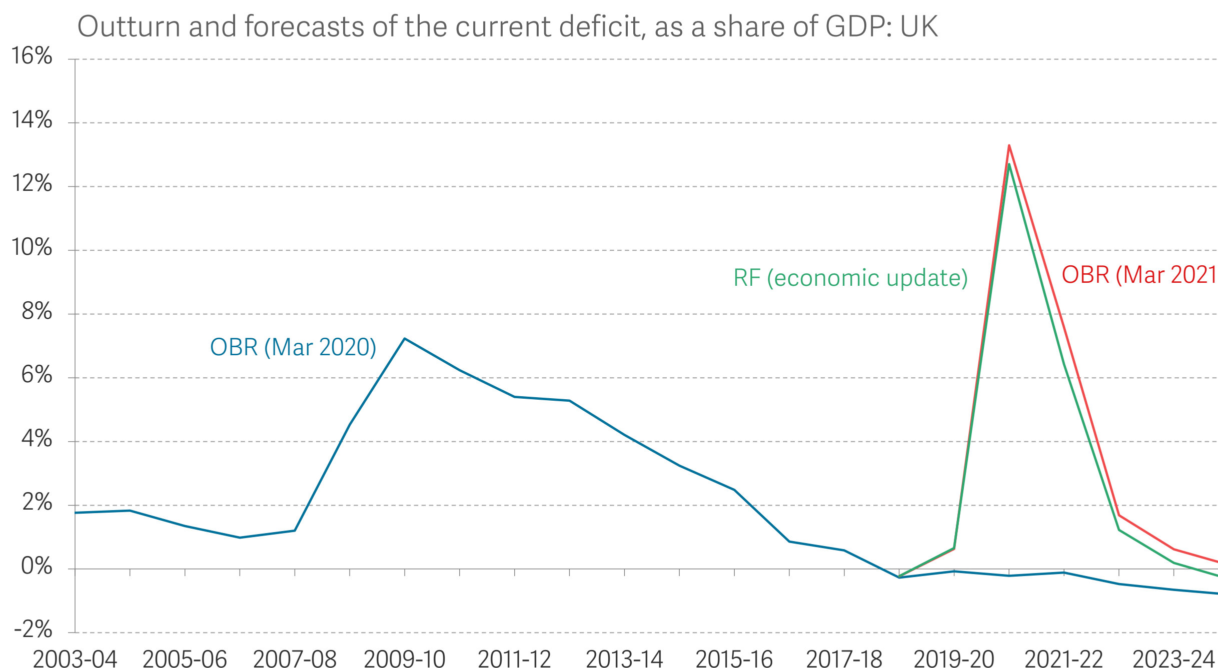
NOTES: Economic scenario used for these figures is based on our analysis of the likely shape of the OBR's upcoming economy forecast, assuming scarring of 2 per cent. This scenario draws on the Bank of England's August 2021 forecast and is updated for changes in market rates for UK government debt.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2021; OBR, Fiscal Risks Report, July 2019; Bank of England, Monetary Policy Report, August 2021; Bank of England, Yield Curve.

There has been a clearer improvement in the forecast for the current deficit. Figure 20 shows that the current deficit should be -0.3 per cent of GDP by 2024-25; the OBR's March forecast expected a deficit of -0.1 per cent that year. This change reflects that

assumed improvements in the medium-term economic outlook will reduce borrowing, and the additional day-to-day spending commitments since the March Budget have been funded with additional taxation.

FIGURE 20: **Forecasts now indicate the Government will achieve a current surplus in 2024-25**

Outturn and forecasts of the current deficit, as a share of GDP: UK



NOTES: Economic scenario used for these figures is based on our analysis of the likely shape of the OBR's upcoming economy forecast, assuming a scarring of 2 per cent. This scenario draws on the Bank of England's August 2021 forecast and is updated for changes in market rates for UK government debt.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2021 and March 2020; OBR, Fiscal Risks Report, July 2019; Bank of England, Monetary Policy Report, August 2021; Bank of England, Yield Curve.

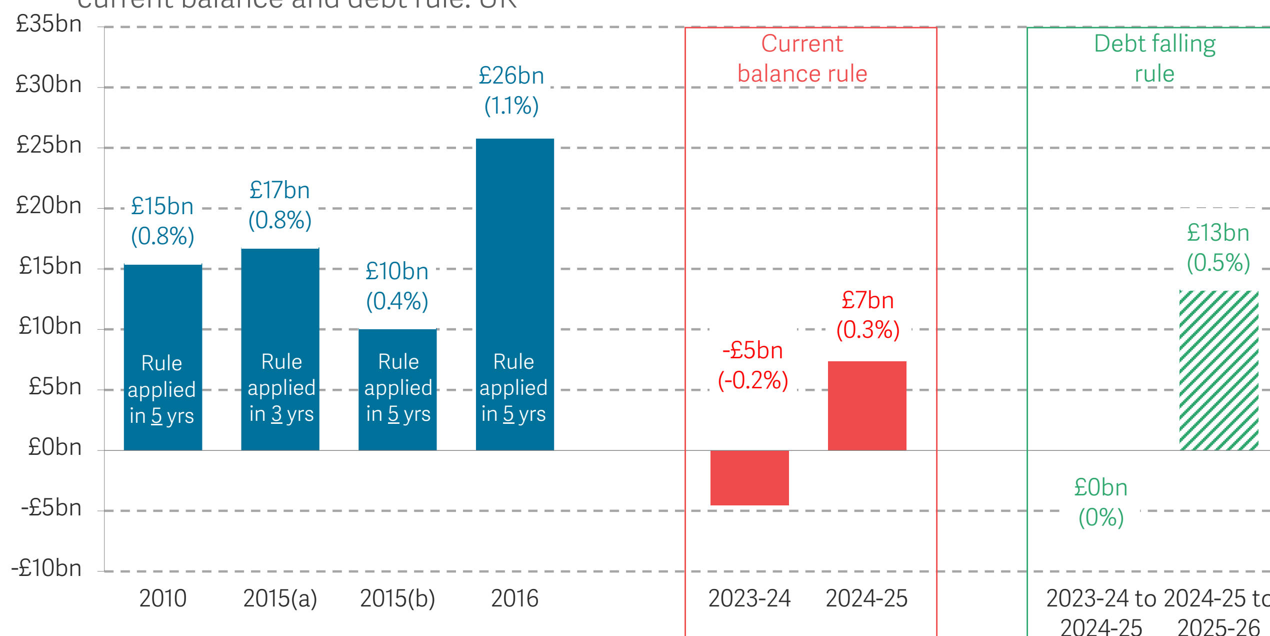
These assessments mean that the Government is on-track to meet its (expected) fiscal rules by 2024-25, but only just. Figure 21 presents our forecasts for the headroom against both rules in the years 2023-24 and 2024-25, compared to the headroom against previous fiscal rule regimes at their announcement. Based on our economic scenario and announced spending and tax plans, the Government is on-track to meet the proposed rules by 2024-25 (by £7 billion and £13 billion for the current balance and debt rules respectively. The current balance rule is projected to be the harder constraint to meet – on current plans, it is set to be missed by £5 billion in 2023-24.

However, the horizon over which these rules are to be set is currently unclear. There is potentially a political incentive to choose a short horizon: the fact that the Government is meeting a set of rules as it heads into the next election would allow it to tell a story of fiscal responsibility, and possibly even indicate that taxes could be cut or spending increased. However, as our updated forecasts suggest, the underlying fiscal position is

likely still to be improving by 2024-25, and setting the horizon of any fiscal rule too early would necessitate tighter fiscal policy during the recovery, which would be costly for the economy.

FIGURE 21: **The Government's likely fiscal rules are on track to be met in 2024-25, but headroom is small relative to previous rule regimes**

Headroom against previously announced fiscal rules and forecast headroom to meet a current balance and debt rule: UK



NOTES: Economic scenario used for these figures is based on our analysis of the likely shape of the OBR's upcoming economy forecast, assuming scarring of 2 per cent. This scenario draws on the Bank of England's August 2021 forecast and is updated for changes in market rates for UK government debt. The forecast for debt changes between 2024-25 and 2025-26 relies on an extrapolation of the Resolution Foundation's fiscal model as the core forecast is only available up to 2024-25; this adds additional model uncertainty to that result. Figures in brackets show headroom as a proportion of contemporaneous GDP.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2021; OBR, Fiscal Risks Report, July 2019; OBR, Historical Forecasts Database; Bank of England, Monetary Policy Report, August 2021; Bank of England, Yield Curve.

Forecasts that show the fiscal rules being met ignore the huge amount of economic uncertainty, and this uncertainty should be influencing policy at the Budget

The estimates of the amount of headroom shown in Figure 21, however, do not account for the unusually high level of economic uncertainty over the next few years. A simple rule-of-thumb suggests that a 1 per cent increase in the size of the economy would result in an improvement in the fiscal position of around a £10 billion fall in annual borrowing.[35] Figure 13 showed the range of estimates of the medium-term pandemic scarring impact

35 This is a very simple calculation relating the tax share of the economy to the increase in the size of the economy – in practise, all things being equal, the improvement would be somewhat larger as spending would likely not rise by as much as the increase in the size of the economy.

from the pandemic is huge. The optimistic end of these estimates would result in the Government easily meeting its fiscal rules. But even a small downgrade in our 2 per cent scarring assumption could result in the rules being missed. Even in less economically-uncertain times, previous Chancellors have chosen fiscal positions that gave them materially higher headroom against their targets (averaging £17 billion since 2010). Having additional headroom enables a government to absorb any deterioration in the economic forecast or unexpected additional spending requirements without requiring a change in the fiscal framework. The implication is, given that the Government's expected rules are set to be only narrowly met, that new tax rises or further spending cuts are likely if the economy does not recover as quickly as expected. But a deterioration in the economy as a result of weak demand should normally be met with more fiscal support, not less – a well-functioning fiscal framework would allow for this, rather than prevent it.

There are also (as ever) longer-term uncertainties. For example, interest rates could rise materially in the future, and this would eventually raise the cost of servicing government debt.[36] There will, without doubt, be recessions in the future, requiring additional fiscal stimulus (as discussed in Box 2). Both of these risks should be taken into account in the Government's plans. Previous Resolution Foundation analysis has found that ensuring that public sector net worth remains stable across the economic cycle requires the Government to target a current balance at the end of the forecast of around £40 billion.[37] Meeting this would ensure that the Government continues to have fiscal space to stimulate the economy in future recessions and limit the cost associated with a possible rise in interest rates.

Given the risks from rising inflation and a possible slowdown in the recovery, the most pertinent risk is that the slowing economy will need more support

The emphasis in the current public debate on when monetary policy should tighten is misplaced given the small role it is playing. The key policy discussion should instead be about fiscal policy, given that small changes in the monetary policy stance will have relatively little impact on the economy. Fiscal policy has played an outsized role in this crisis in part because low interest rates left little room for monetary policy to act. But it has also been the right policy choice: the economic impact of Covid-19 has varied enormously across firms and households, necessitating targeted policy support, rather than a broad-brush stimulus. This change in relative importance is demonstrated in our

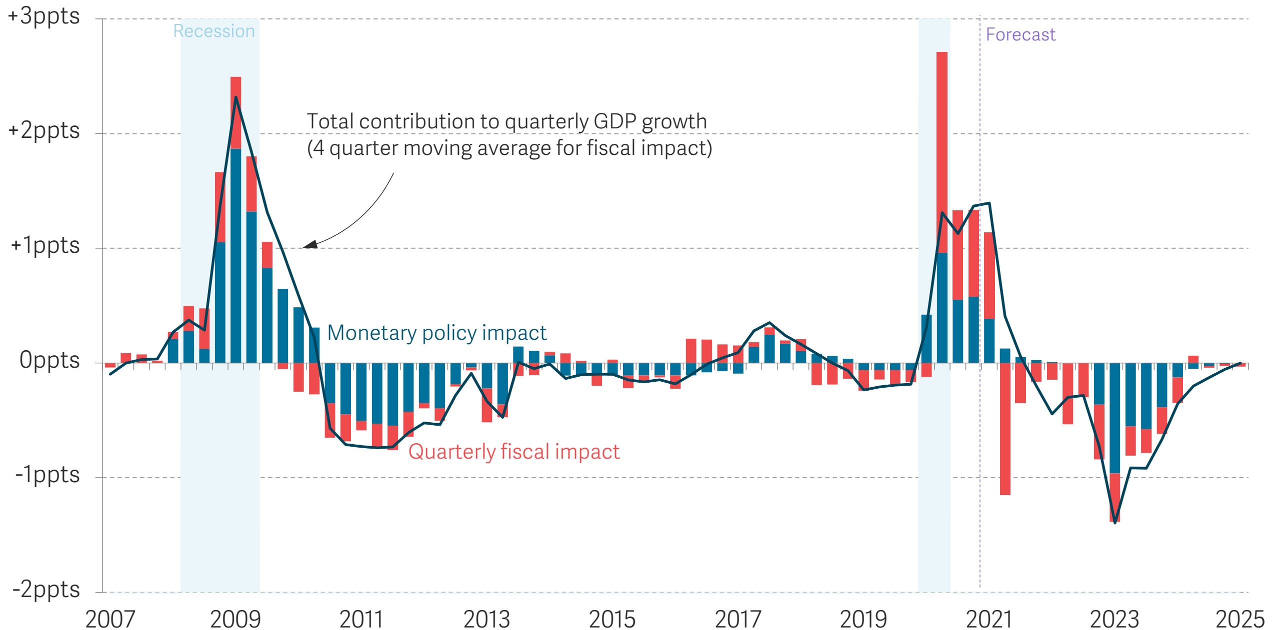
36 Rising long-term interest rates would likely also be accompanied by an increase in trend growth rates, which would make debt servicing easier. See, for example, T Laubach & J C Williams, Measuring the Natural Rate of Interest, The Review of Economics and Statistics 85 (4): 1063–1070, November 2003.

37 See G Bangham et al., Unhealthy finances: How to support the economy today and repair the public finances tomorrow, Resolution Foundation, November 2020.

estimate of the macroeconomic stimulus from monetary and fiscal policy over time, shown in Figure 22.

FIGURE 22: **Fiscal policy has become a drag on economic growth**

Estimated impact of monetary and fiscal policy on quarterly GDP growth, history and forecast: UK



NOTES: Monetary policy impact is calculated using estimates taken from P Bunn, A Pugh & C Yeates, 'The distributional impact of monetary policy easing in the UK between 2008 and 2014', Bank of England Working Papers no.720, Bank of England, March 2018. This covers the Bank of England stimulus during the financial crisis. Subsequent changes in Bank rate and quantitative easing purchases are incorporated using equivalent scaling factors between policy changes and GDP. The fiscal policy impact is calculated based on a UK version of the Hutchins Center Fiscal Impact Measure, adjusted for the OBR's estimate of fiscal multipliers. The values for 2020 and 2021 are based on assuming Bank rate is held at 0.1 per cent and the OBR's March 2021 Economic and Fiscal Outlook.
SOURCE: RF analysis of OBR, various; ONS; Bank of England.

It is clear that fiscal support has now entered an economically-contractionary period, having made up around two-thirds of the policy support during the pandemic, substantially higher than its share of policy support during the financial crisis (roughly a quarter of which was from fiscal policy). The support from fiscal policy is now estimated to have turned negative, i.e. quarterly GDP growth is lower than it would have been – by around 0.5 per cent a quarter – in the absence of fiscal policy. This is caused by the direct withdrawal of support measures, including the JRS and the end to the Universal Credit uplift, and, as they come into effect, increases in taxes (e.g. the corporation tax rise in 2023). But it is also turning negative because the impact of previous support schemes on the level of GDP is estimated to have fallen, thus creating a negative contribution to quarterly growth rates. Indeed, the UK is a relative outlier in the G7 in how fast macroeconomic support is to be withdrawn; only Canada is expected to raise interest

rates faster than the UK, and only the US is introducing substantial new taxes during the recovery.[38]

There are two pressing macroeconomic risks, discussed in detail above: the rise in inflation, which some argue risks becoming entrenched; and the slowing rate of the recovery. Given that fiscal policy is currently the primary tool of macroeconomic stabilisation, what is the right fiscal strategy during the recovery?

One key point is that these risks are not symmetric. For example, were the economic recovery to speed up and inflation to rise as the economy reaches its productive capacity, then the Bank of England could quickly tighten policy.[39] But if the opposite were to happen – the economy started to slow while the government was actively reducing support programmes and raising taxes, as could happen at the end of this year – then monetary policy could do little, and fiscal policy would be much less quick to respond, potentially leading to an unnecessary loss of income for households. In other words, there is a clear asymmetry to these risks because policy has much more scope to reduce demand if it proves too strong, rather than provide more stimulus if the outlook deteriorates.

It is also important for policy makers to consider the relative likelihood of each risk. As discussed in Section 2, the Bank of England now expects inflation to peak at over 4 per cent in 2021 and 2022. But these rises have been driven by normalisation in goods prices from their pandemic lows, as well as supply constraints in specific industries. Broad-based cost pressure from rising wages is yet to materialise and is unlikely to do so while the economy is still below pre-crisis levels (real GDP is still estimated to be below pre-pandemic levels, let alone recovering to the pre-pandemic trend). Even if there is clear evidence that they have materialised, the Bank of England has plenty of scope to raise rates and reduce demand in order to reduce inflationary pressure. So, while reasonable people can disagree, our view is that the risk from high inflation appears limited and relatively easy to contain.

On the other hand, as previously discussed, there are already signs that the economic recovery is slowing, with GDP growing just 0.3% in July and August this year. In addition, the pandemic is not over, both in the UK and globally, and there remain substantial risks to the recovery from increases in case levels during the winter. On balance, we view that a slowdown in economic growth is both a costlier risk and one that is more likely to materialise, and this suggests fiscal policy should be more accommodative over the next year than currently planned.

38 It is also arguable that the tax rises intended in the US are more reflective of the Biden administration's plans to expand the size of the state, alongside the large expansion in government spending.
39 We discussed these issues in more depth in J Leslie & J Smith, Macroeconomic Policy Outlook Q3 2021, Resolution Foundation, August 2021.

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

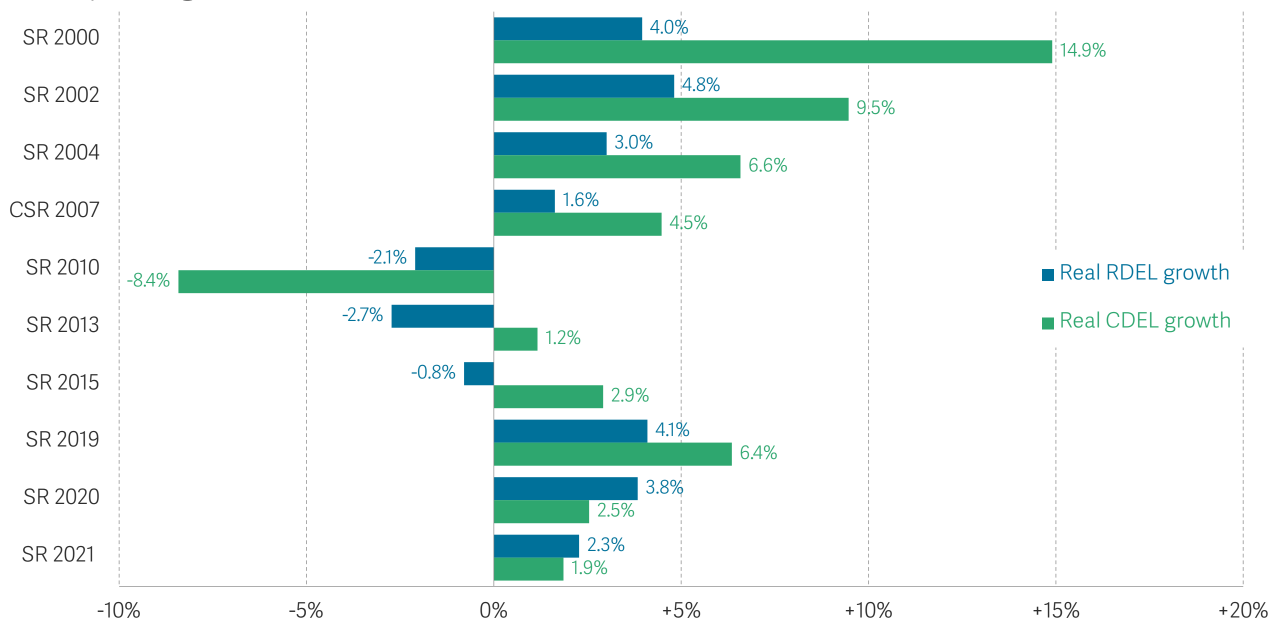
The Spending Review will provide the details of departmental spending for the three years 2022-23, 2023-24 and 2024-25 (with the overall amount to be spent already set by the Chancellor in early September at £408 billion in 2022-23, rising to £440 billion by

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.

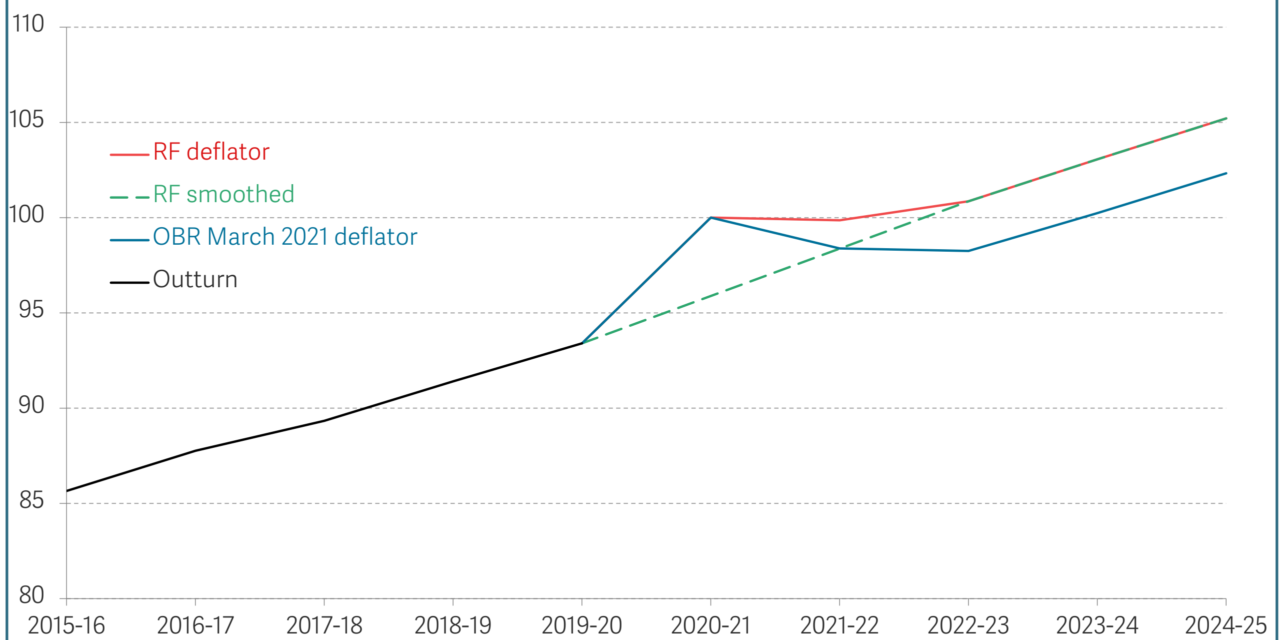
The pandemic-related volatility in the deflator also means that year-to-year changes in real spending will be substantial regardless of whether significant decisions have been taken around departmental spending. Additionally, as the OBR pointed out in their November 2020 EFO, part of this volatility 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.

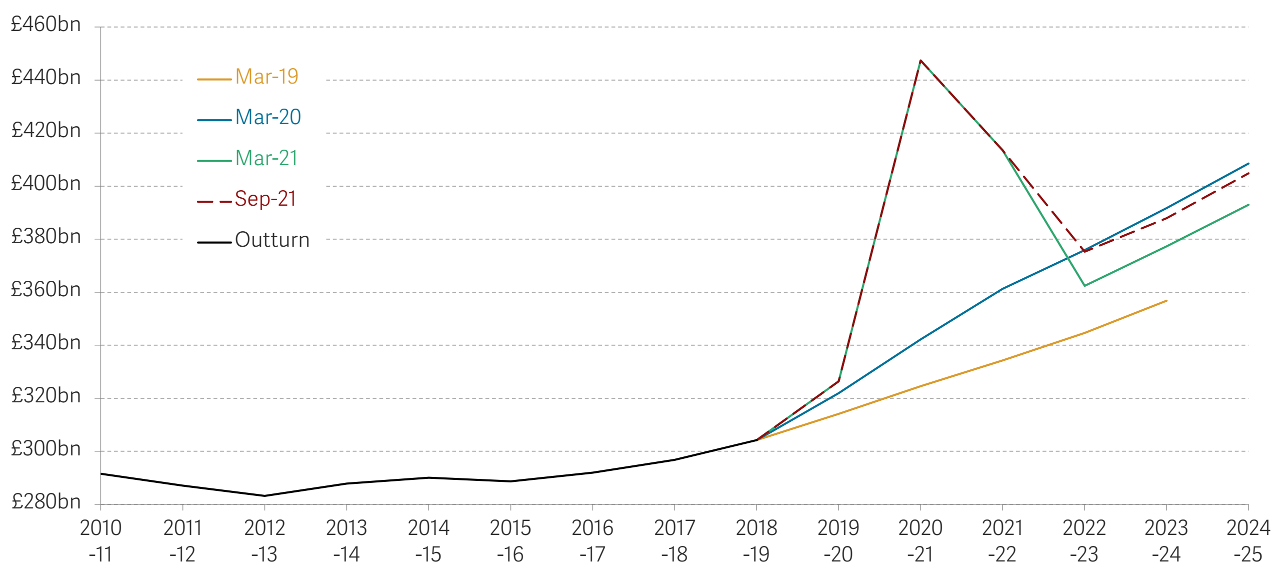
Two-thirds of the increased spending over the Review period is going to the Department of Health and Social Care

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.

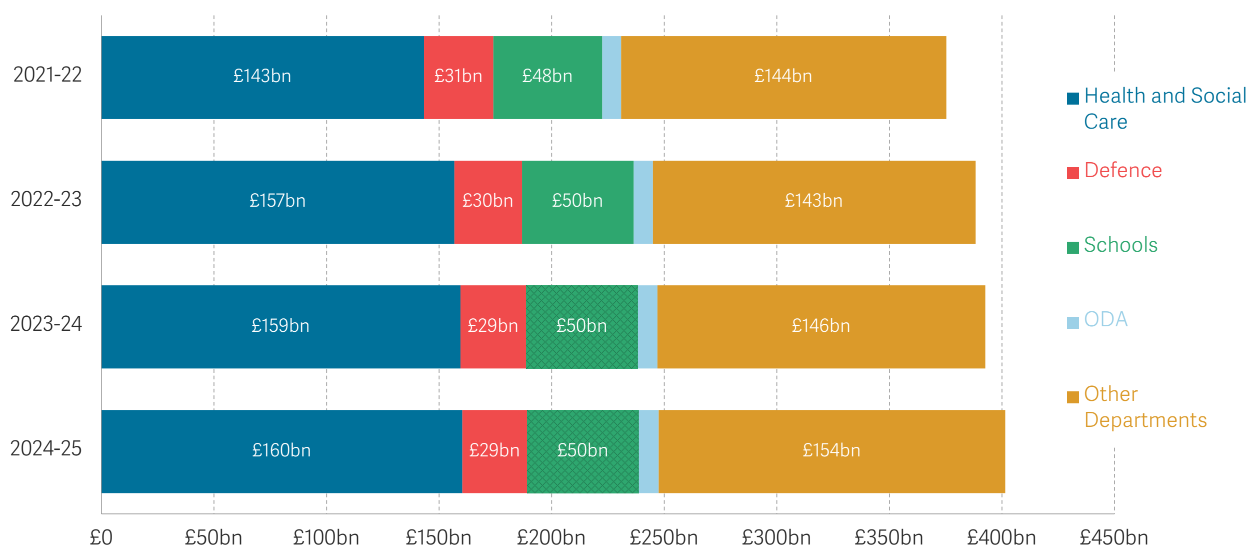
address some of the pandemic pressures that they may face, or any of the longer-term strains inherited from a decade of austerity.

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:

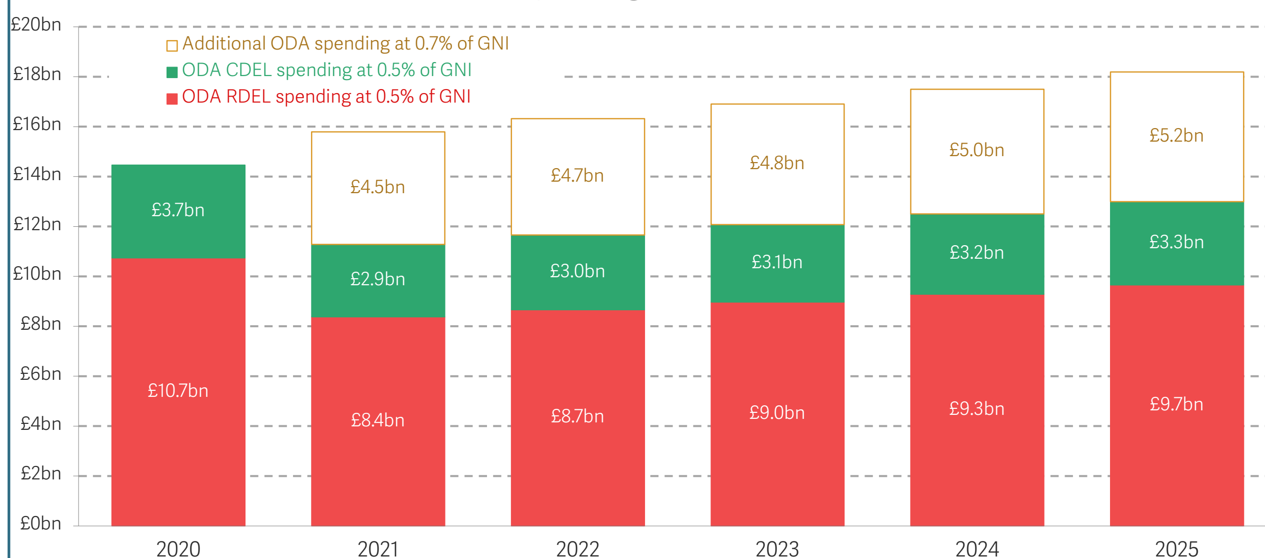
1. The UK has a current budget surplus - namely government receipts exceed all current spending (excluding net investment spending); and,
2. UK public sector net debt – excluding the Bank of England - is declining as a proportion of GDP.

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.

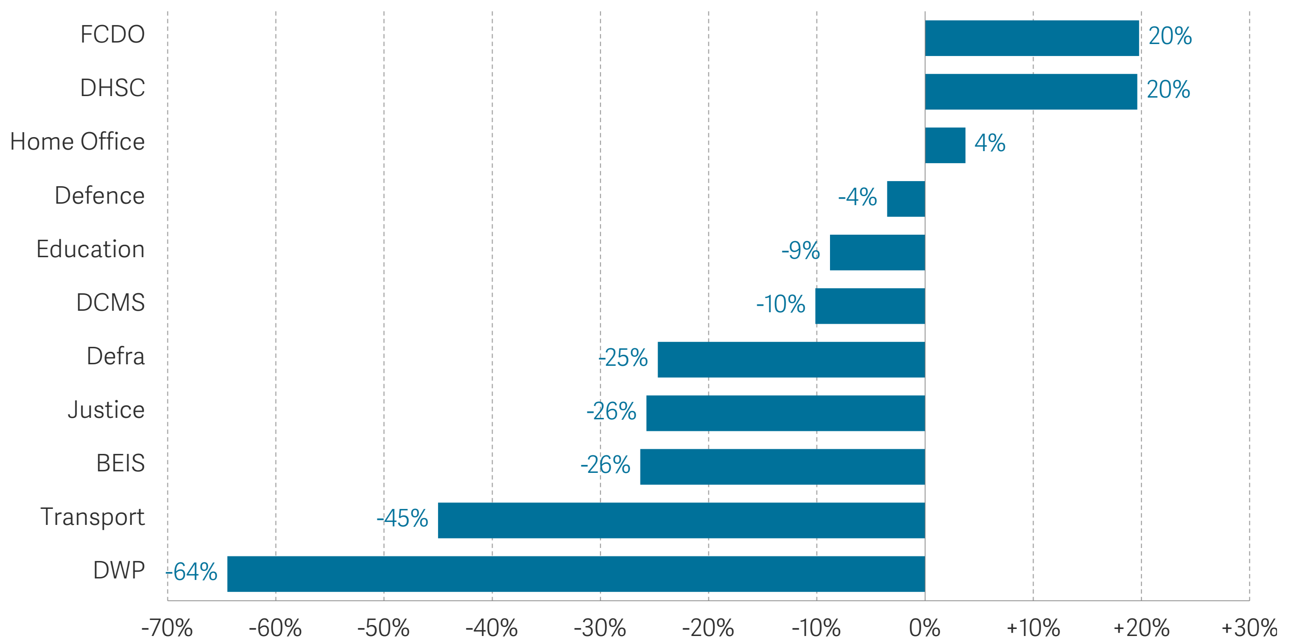
to save nearly £5 billion a year from reduced ODA spending during this parliament roughly £3.7 billion of which will be saved from the RDEL envelope, equivalent to around 3 per cent of unprotected RDEL in 2024-25. There is, however, obvious uncertainty around this central case.

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.

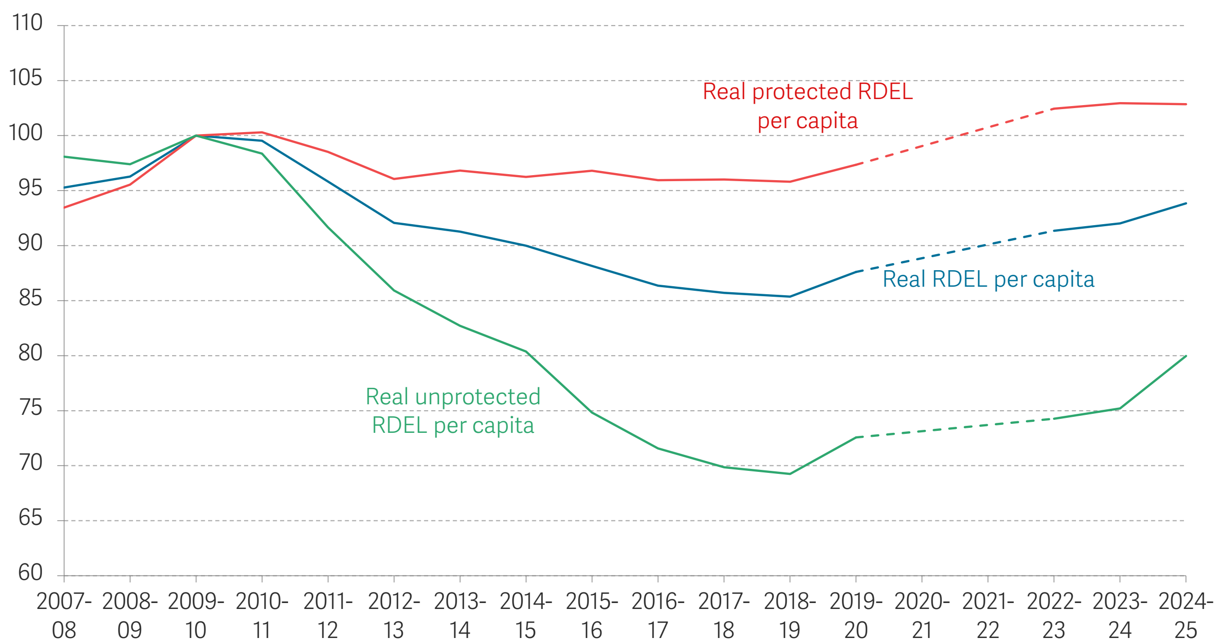
before Covid-19 pressures are accounted for, the remaining departments will experience, on average, a small funding cut in 2022-23 (as shown in Figure 28). Austerity is over when it comes to overall spending, but unprotected departments will have one more year of very tight spending settlements before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

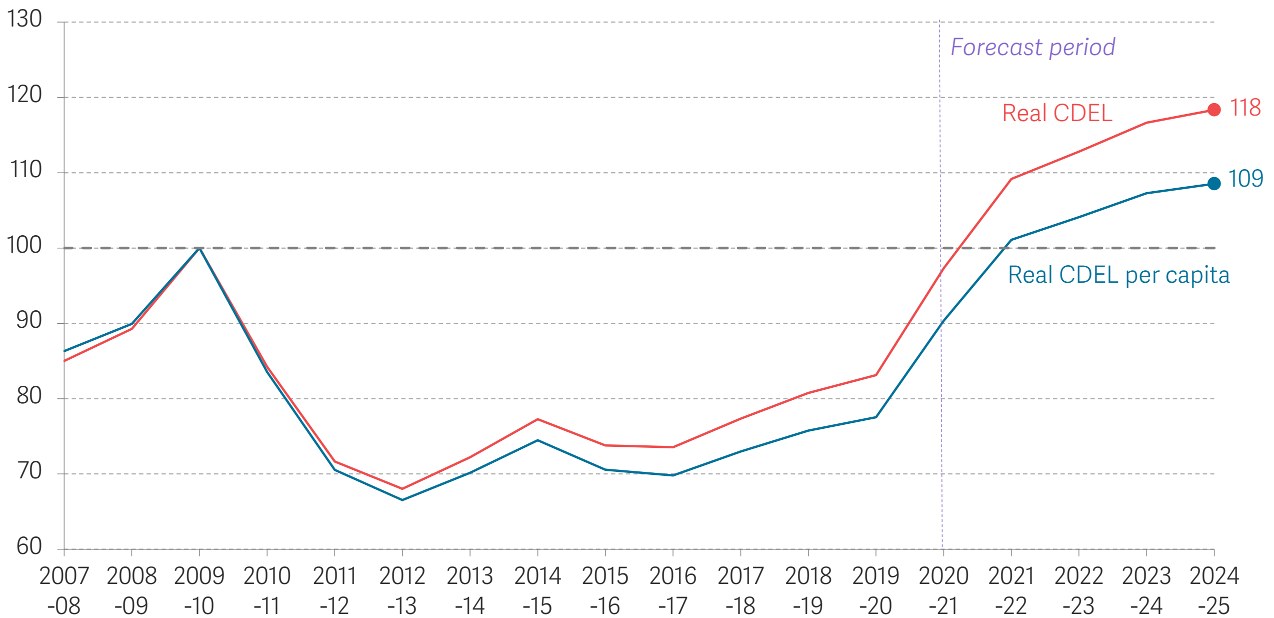
The third task of this Spending Round will be to provide funding for the Government's investment priorities.

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)



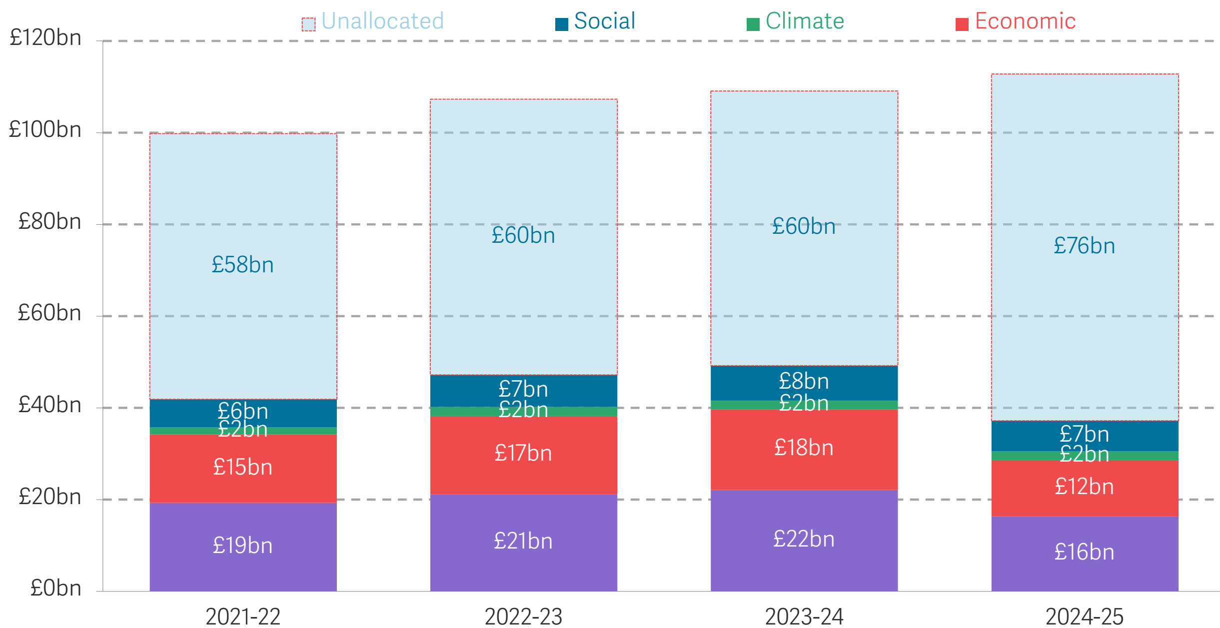
NOTES: Deflated using the RF macroeconomic model forecast of the GDP deflator which has been smoothed between financial year 2019-20 and 2022-23 to remove the impact of pandemic related volatility.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2021.

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.

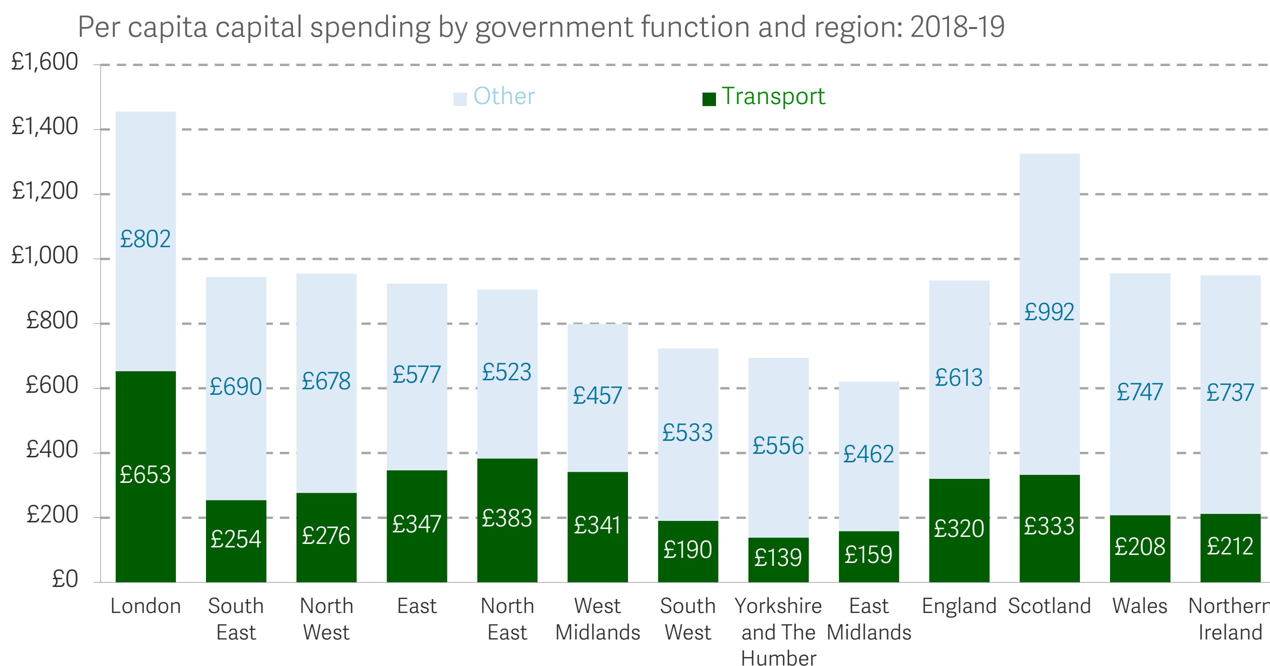
On levelling up, although it now looks likely that further detail will come in a post-Spending Review white paper, the Government has indicated that a key priority will be transport, with a focus on improving connectivity beyond London. This is understandable: as shown in Figure 32, per capita capital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

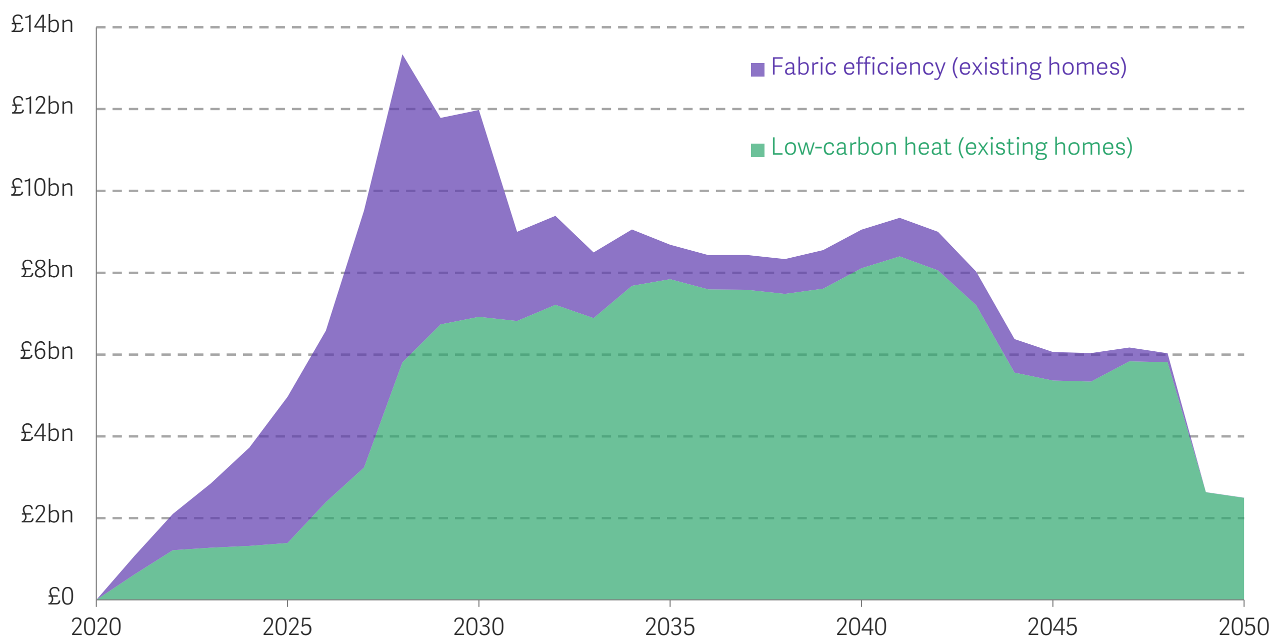


Note: Capital spending on transport includes capital spending through Transport for London. North West 'other' includes environmental protection spending on the decommissioning of Sellafield.
SOURCE: RF analysis of HM Treasury, Country and regional analysis: November 2018.

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.

Resolution Foundation

The Resolution Foundation is an independent research and policy organisation. Our goal is to improve the lives of people with low to middle incomes by delivering change in areas where they are currently disadvantaged.

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