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SPENDING ROUND 2019
A FISCAL INSIGHT

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The Spending Round 2019: an end to austerity?

On 4 September 2019, the Chancellor of the Exchequer announced the UK Government's plans for departmental spending in 2020-21 in the Spending Round 2019.

This ICAEW Fiscal Insight analyses the effect of this announcement on the public finances.

Planned departmental spending of £434.2bn in 2020-21

- Departmental current spending up by £13.8bn or 4.1% to £352.3bn
- Departmental capital spending up by £3.9bn or 5.0% to £81.9bn
- This is £13.4bn more than set out in the March 2019 Spring Statement

Increases in current spending

- £4.1bn for health, including £3.9bn for NHS England
- £2.2bn for education, including £1.8bn for schools and £400m for further education
- £1.3bn for law & order, including £750m for more police
- £1.0bn for social care, with the prospect of a further £0.5bn from council tax precepts

Increases in capital investment

- £2.2bn for transport, including HS2, Network Rail and Highways England
- £1.9bn for international development

Effect on the public finances

- Total managed expenditure in 2020-21 of £878.6bn, 2.4% more than this year
- With student loan accounting change deficit is £46.2bn or 2.0% of GDP
- Economic forecasts not refreshed, updating them would likely increase the deficit further
- The government is likely to breach its fiscal targets for 2020-21

An end to austerity?

- All departments' current budgets will increase by at least inflation
- Welfare spending is still being cut
- The Spending Round is for one year only

"The increases in public spending announced in the Spending Round 2019, combined with an 'end of austerity' message, are designed to be attractive to voters in the forthcoming General Election.

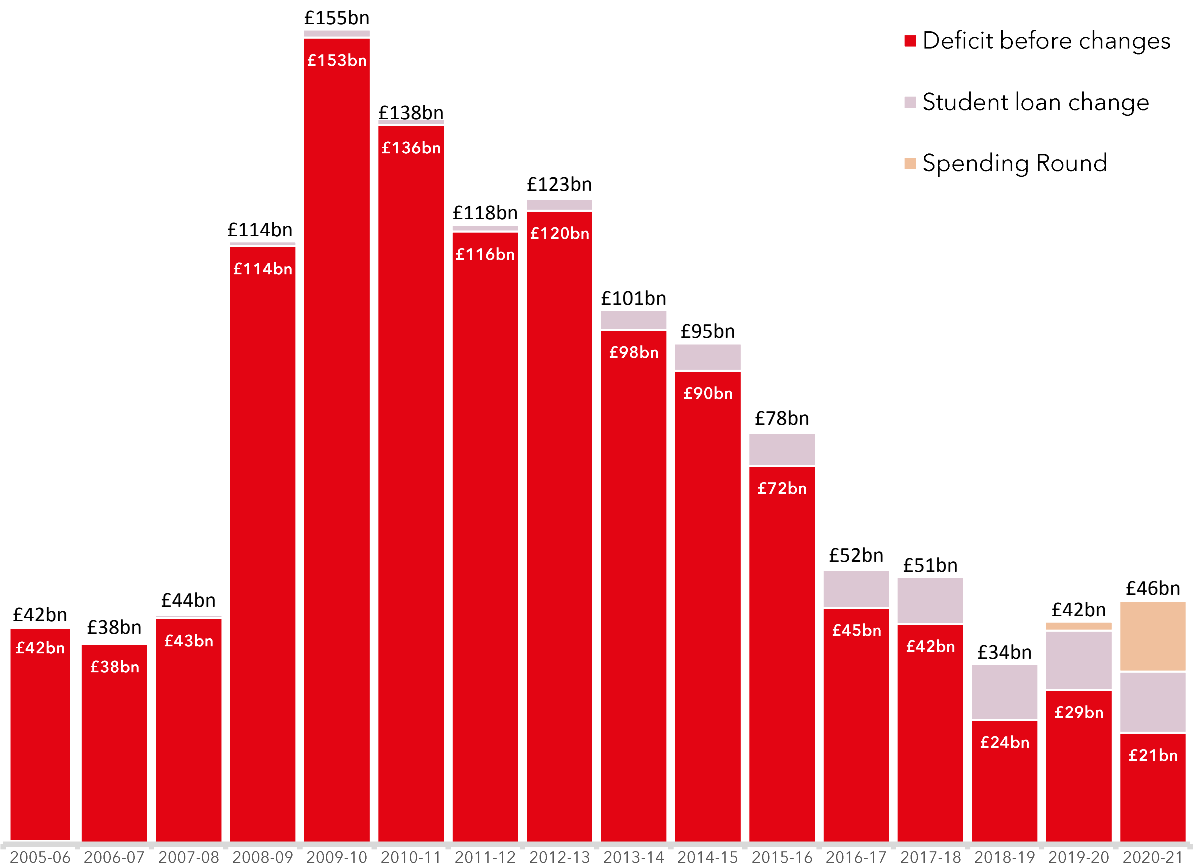
The lack of a Budget or updated economic forecasts means that the effect on the overall public finances is unclear. Borrowing will rise, albeit cushioned by extremely low interest rates. The previous Chancellor's much vaunted 'headroom' is likely to disappear once higher spending is combined with a weakening economy and improved accounting for student loans. Fiscal rules are likely to be deferred or abandoned completely.

In reality, many of these spending increases were likely even without the prospect of an election. There was always a limit to how far public service budgets could be cut without adverse consequences, and it appears this point has been reached. Rising crime, struggling schools, a dysfunctional justice system, deteriorating health outcomes, and the fraying of many other public services would have made it difficult to justify continuing to cut budgets further.

Unfortunately, the big questions have been deferred yet again. We do not know how the government plans to finance the rapidly rising costs of health, social care and pensions for an increasingly long-lived population, nor is there any sign of a long-term fiscal strategy to address the government's growing liabilities."

Martin Wheatcroft FCA
Advisor to ICAEW on public finances

Figure 1 – Fiscal deficits since 2005-06



Sources: OBR; ONS; HM Treasury: *Spending Round 2019*.

Context

The Spending Round 2019 was unusual in that it was not accompanied by a Budget setting out how those plans would be funded, nor by updated economic forecasts from the Office for Budget Responsibility (OBR) to indicate the expected effect on the overall public finances.

This is also the second year running that the three-year Spending Review has been delayed and replaced by a one-year plan.

Departmental current expenditure

Resource departmental expenditure limits (Resource DEL) excluding depreciation is expected to increase by £13.8bn to £352.3bn after adjusting for inflation.

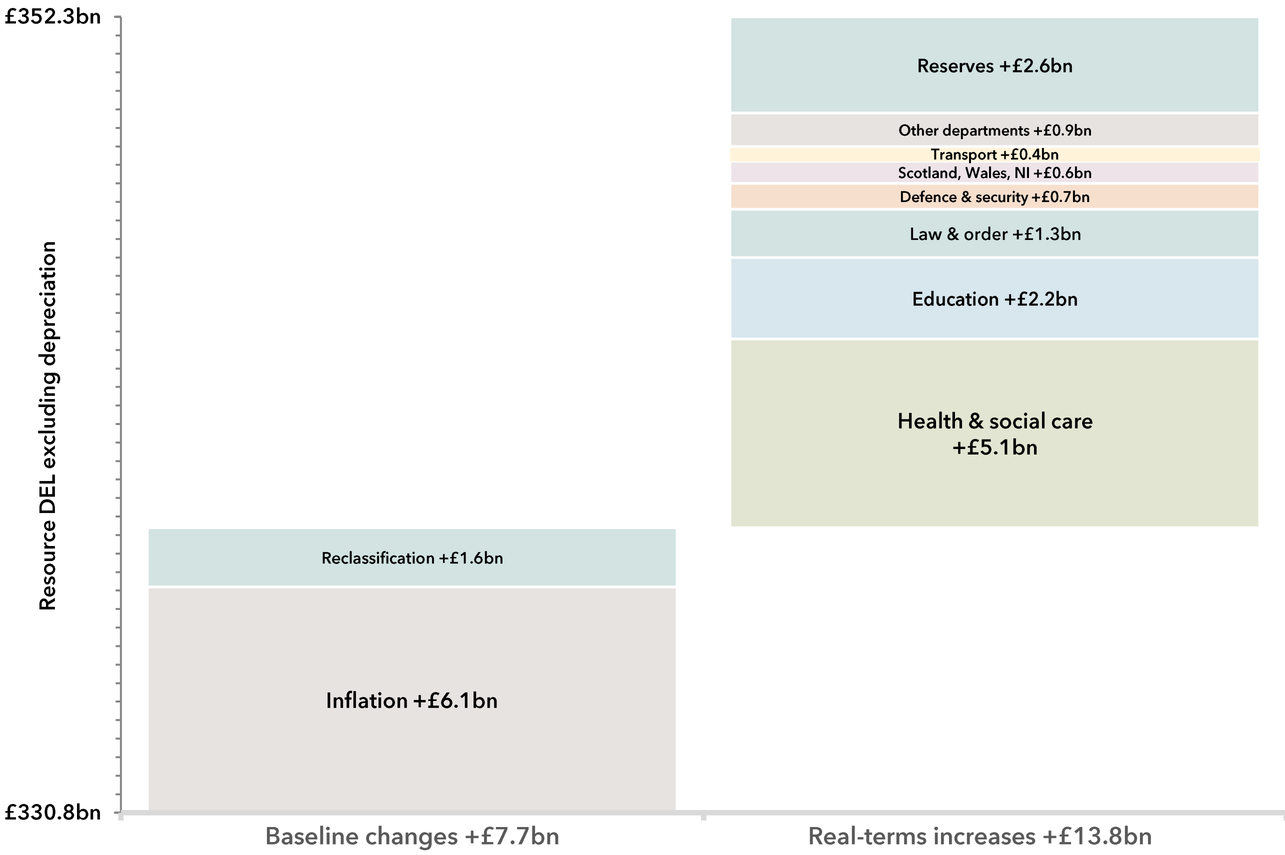
The Chancellor described the Spending Round as an 'end to austerity' with all government department budgets increasing at least in line with inflation. However, this does not mean the end of all spending cuts next year; plans to cut welfare payments (not included in departmental budgets) remain in place, while efficiency and other savings will still need to be found within departmental budgets.

Although many of these increases will be welcome after years of budget cuts, additional money for health and social care will only go part way to address growing demand from an increasingly long-lived population. Similarly, the increase in the education budget is not sufficient to address the growth in school pupil numbers over the last decade.

The largest increases are on health, education, law & order, social care, and reserves. The latter is a centrally held budget that can be allocated during the course of a financial year to departments as and when needed; e.g. to the Ministry of Defence for active military operations.

Figure 2 illustrates the change from departmental current spending in 2019-20 to 2020-21.

Figure 2 – Change in Resource DEL excluding depreciation from 2019-20 to 2020-21



Source: HM Treasury: *Spending Round 2019*.

Increases in NHS England, English schools, police and other budgets will result in consequential increases for the devolved administrations in Scotland, Wales and Northern Ireland under the Barnett formula. Some of these areas are now funded by devolved taxes in Scotland and, to a lesser extent, Wales, reducing the net effect on the departmental budgets reported centrally.

The NHS England and English schools' announcements are part of multiple year settlements (five years for the former and three years for the latter), providing greater certainty for decision makers and allowing them to plan ahead. The increases in other areas are for one year only, with uncertainty as to medium-term funding allocations, making it more difficult for those departments to plan ahead. They will need to submit new bids as part of next year's deferred three-year Spending Review.

The OBR has noted that not all planned spending increases are spent in practice, providing potential 'upside' in their twice-yearly forecasts. This is especially the case with unexpected one-off budget increases, where departments can sometimes find it difficult to fully utilise the additional money available to them.

One surprise in the announcement was the very small increase in the budget for overseas development assistance, which is legally required to be at least 0.7% of national income. The statutory increase has instead been almost entirely redirected to the capital budget (see below).

Table 1 provides more detail on the increases by department.

Table 1 – Real-terms increases in Resource DEL excluding depreciation

Area	£bn	%	Headline increases
Health	4.1	3.1%	**£3.9bn NHS England** £150m training
Education	2.2	2.2%	**£1.8bn English schools** **£400m further education**
Law & order	1.3	0.6%	**£750m for more police** £0.3bn prisons, probation and courts £100m prison security £80m Crown Prosecution Service
Local government	1.0	12.4%	**£1.0bn for social care** (Plus £0.5bn for social care from council tax precepts)
Defence & security	0.7	1.9%	£0.6bn defence capabilities £0.1bn security services
Devolved administrations	0.6	2.1%	£0.6bn Scotland less £0.5bn from devolved taxes £0.5bn Wales less £0.2bn from devolved taxes £0.2bn Northern Ireland
Transport	0.4	11.4%	£0.2bn railway maintenance £0.2bn bus services
Other departments	0.9		£243m nuclear decommissioning £0.1bn overseas development assistance £0.1bn preparation for 2021 census £106m welfare processes and support for claimants £68m air quality, biodiversity and animal health £54m homelessness and rough sleeping £46m Birmingham Commonwealth Games £30m decarbonisation schemes
Reserves and other	2.6		£2.6bn additional 'reserve' budget held centrally
Total real-terms increase	**13.8**	**4.1%**	

Source: HM Treasury: *Spending Round 2019*.

The increase in the defence budget was also smaller than some had expected, despite heightened international tensions and a major lobbying campaign. In practice, most of the increase will be absorbed by foreign exchange movements as a result of sterling weakness, with a relatively small amount left over for enhancing defence capabilities. The Ministry of Defence will be hoping for a more generous settlement in the three-year Spending Review in 2020.

The Chancellor also announced an additional £160m for Scottish farmers, outside of departmental budgets.

As is common with government financial announcements, many of the headlines were generated by relatively small amounts of money in the context of the overall budget. For example, the £46m for the Birmingham Commonwealth Games is 0.01% of departmental spending and 0.005% of total managed expenditure.

Despite that, some of the increases can be extremely material to the individual public services concerned. For example, the £400m announced for further and sixth form education will make a significant difference to an area that has been starved of funding over the last decade. Similarly, the £80m for the Crown Prosecution Service is a 14.5% increase in its budget, which should enable it to address issues with legal pay, recruit new prosecutors, and prosecute more cases.

Departmental capital expenditure

Capital departmental expenditure limits (Capital DEL) are expected to increase by £3.9bn to £81.9bn after adjusting for inflation.

This comprises £5.0bn in increases in individual departmental budgets, less £1.1bn in lower reserves and other changes; as set out in Table 2 and illustrated by Figure 3.

Table 2 – Real-terms increases in Capital DEL

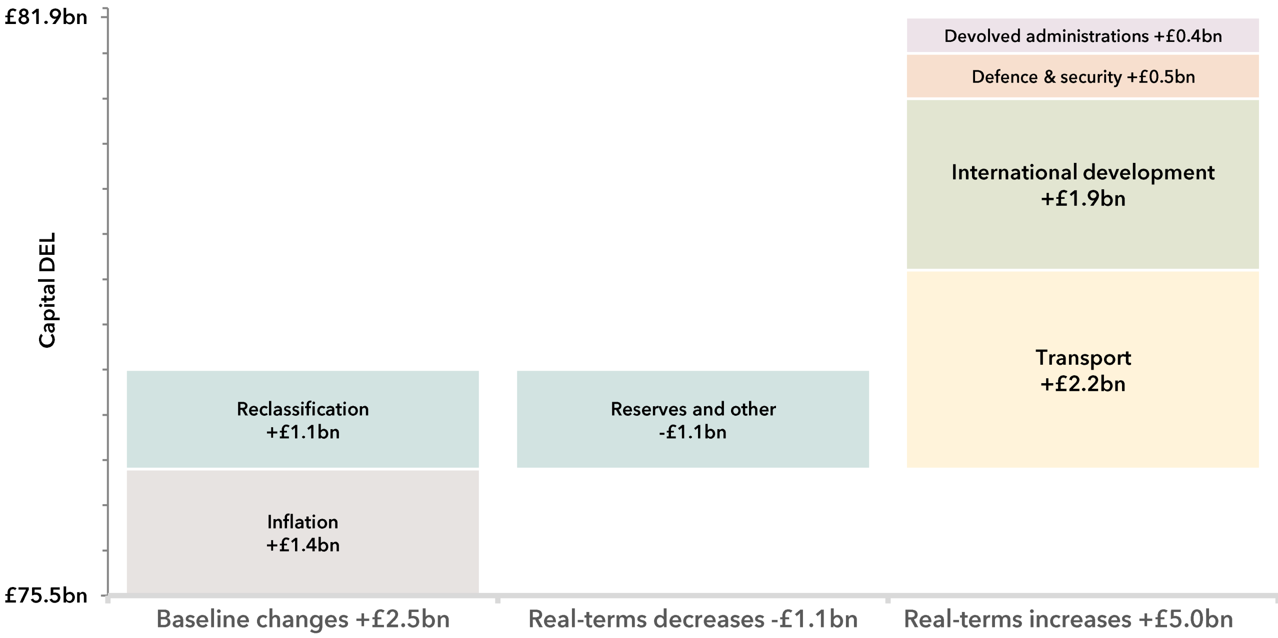
Area	£bn	%
Transport	2.2	14%
International development	1.9	73%
Defence	0.5	5%
Devolved administrations	0.5	5%
Reserves and other	(1.2)	-
Total real-terms increase	**3.9**	**5%**

Source: HM Treasury: *Spending Round 2019*.

The additional capital spending announced with the Spending Round relates to international development and, to a lesser extent, defence.

Most of the increase in capital expenditure on transport infrastructure had been agreed in previous spending rounds, together with associated allocations to the devolved administrations in Scotland, Wales and Northern Ireland.

Figure 3 – Change in Capital DEL from 2019-20 to 2020-21



Source: HM Treasury: *Spending Round 2019*.

Although the increased funding for transport capital expenditure is significant, it will still leave the UK as one of the lowest investors in transport infrastructure amongst developed economies. There is also a risk that some or all of the approximately £5bn spend planned for the High Speed 2 (HS2) project in 2020-21 may not happen if a review of the project's viability decides against continuing.

The decision to increase the international development capital budget instead of current spending was unexpected. It probably helped the government increase other departmental current budgets by more than might otherwise have been considered.

The additional capital funding could be used to invest in international development banks (similar to the Asian Infrastructure Investment Bank that the UK invested in several years ago), or to provide loan finance to support local businesses in developing countries.

Currency movements from the weakness in sterling and cost overruns are likely to absorb most of the additional money provided for defence, so there is unlikely to be much in the way of incremental defence equipment obtained for the UK's armed forces.

Total managed expenditure (TME)

Although departmental budgets are expected to increase by 4.3%, the overall public spending budget is forecast to increase by a lower rate of 2.4%, as set out in Table 3.

This reflects forecasts for annually managed expenditure (AME) and other expenditure lines that have not updated since March 2019. These are expected to be flat overall after taking account of inflation, with an increase in the budget for the state pension offset by decreases in the welfare budget and in budgets for other areas.

Table 3 – Total managed expenditure

Area	£bn	%
Resource DEL excluding depreciation	352.3	+4.1%
Capital DEL	81.9	+5.0%
Departmental spending	**434.2**	**+4.3%**
State pension	101.5	+0.8%
Welfare	130.7	-0.1%
Other AME	212.2	-0.4%
Total managed expenditure	**878.6**	**+2.4%**

Source: HM Treasury: *Spending Round 2019*.

% changes are in real terms, i.e. adjusted for inflation.

The changes in the state pension and welfare budgets are lower than might be expected given that the population is expected to grow by around 0.6% in 2020-21. The former 'benefits' from increases in the state pension age, slowing the rate of growth in the number of pensioners, while the latter implies cuts in welfare on a per capita basis in the order of 0.7% in 2020-21, with some areas of welfare faring worse than others.

Other spending includes local government spending, will not be finalised until the first quarter of 2020. The numbers have not been updated for the £0.5bn additional rises in council tax to fund social care spending proposed in the Spending Round.

One of the contributors to the real-terms reduction in other spending is lower interest costs, with the government paying much lower interest rates on new borrowing used to refinance existing debts when they are repaid.

Effect on the deficit

The changes announced in the Spending Review should increase total managed expenditure by £13.4bn compared with the amount forecast by the OBR in March 2019, increasing the forecast deficit for 2020-21 of £21.2bn to £34.4bn.

In addition, the Office for National Statistics (ONS) is planning to change its approach to recording student loans to better reflect the fact that many loans will not be fully recovered, rather than waiting thirty years until the loans are finally written-off.

This change is expected to increase the forecast deficit for 2020-21 by £11.6bn to £46.2bn, as set out in Table 4.

Table 4 – Fiscal deficit

Area	Receipts £bn	Spending £bn	Deficit £bn	Deficit / GDP
March forecast	844.0	(865.2)	(21.2)	(0.9%)
Spending Round	-	(13.4)	(13.4)	(0.6%)
Revised totals	**844.0**	**(878.6)**	**(34.6)**	**(1.5%)**
Student loans accounting change			(11.6)	(0.5%)
Revised forecast deficit			**(46.2)**	**(2.0%)**

Sources: HM Treasury: *Spending Round 2019*; ICAEW calculations.

This is not a forecast update, as the OBR has not refreshed their economic model for more recent developments and changes in expectations for economic growth.

The Institute for Fiscal Studies (IFS) has suggested that if the forecasts were updated that there would be lower tax revenues from weaker economic growth, increasing the deficit by a further £4.5bn.[1] This would result in a forecast deficit of £50.7bn or 2.2% of GDP, in breach of one of the government's fiscal targets, which is for the deficit in 2020-21 to be below 2%.

The IFS have further suggested that in a 'no deal Brexit' that the deficit could increase by a further £30bn in 2020-21, to in the order of £81bn.

An end to austerity?

The Spending Round marks a turning point for spending on public services, with all departmental budgets increasing by inflation at the very least. This is a significant change after a decade of cuts in most departmental budgets.

However, further cuts are still planned in the welfare budget, and so this may not feel like the end of austerity for those dependent on benefits.

Perhaps more concerning is the decline in optimism about the prospects for economic growth. Warning signals suggest that a global recession could be approaching, while many economists are worried about the potential adverse effect of Brexit on economic activity even with a deal.

It may therefore be too soon to call this as the 'end of austerity' as claimed by the Chancellor. The Spending Review next year may be presented in a very different economic environment, potentially constraining the ability of the government to increase departmental budgets over the three years from 2021-22 onwards. A decision to stimulate the economy with tax cuts would put further pressure on the public finances.

The longer-term outlook is not positive for the public finances. The OBR's long-term forecasts indicate that they are on an unsustainable path, with an increasingly long-lived population driving significant increases in spending on pensions, health and social care over the next few decades. For example, the number of people over 75 is expected increase by 82% over the next 25 years from 5.7m to 10.4m.

This will put further pressure on budgets for public services. With no further ability to 'raid' the defence budget, other budgets would need to be constrained significantly if tax rises are to be avoided or a radical restructuring of the social contract between government and citizens undertaken, even if economic growth returns to more 'normal' levels.

An end for austerity, perhaps. But for how long?

[1] IFS: *Chancellor ends austerity for public services – but risks breaching current fiscal rules*.

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