HOUSE OF COMMONS LIBRARY

BRIEFING PAPER

Number 08651, 2 September 2019

Background to the 2019 Spending Round

By Philip Brien
Matthew Keep

Contents:

Contents

Summary

On Wednesday 4th September the Chancellor will present the conclusions of the 2019 Spending Round to Parliament. The Spending Round is part of the financial planning cycle, and will set some of the spending limits for Government departments for financial year 2020-21. This is in place of the full three-year Spending Review that had originally been planned for this year, and which has now been postponed to 2020.

The Government has already made a number of spending commitments, for example in the areas of defence, international aid, and spending on the NHS. It is not yet clear what this means for areas which are not protected in this way, particularly given the fiscal rules which the Chancellor has said he will follow.

Two conditions must be met for the Chancellor to meet his fiscal rules for 2020/21. Firstly, the government's deficit, adjusted for the ups and downs of the economy, must be less than 2% of GDP. Secondly, the debt-to-GDP ratio must be falling in the year. Meeting the first condition should be sufficient to meet the second. On the face of it there is scope for the Government to increase the deficit in 2020/21 to allow for extra spending and still meet its deficit target. The OBR's last forecast gave the Government 'headroom' of around 1.2% of GDP below the 2% target.

However, forecasts are inherently uncertain, and the OBR's last forecast came in March 2019. Since then, there have been tentative signs that the public finances may not be performing as strongly as was expected in 2019/20. Moreover, the official measure of the deficit will soon increase by around 0.5% of GDP when the Office for National Statistics changes how its accounts for the subsidy element of student loans. All this means that the Chancellor may be a little more constrained by the deficit target than first impressions might suggest.

Over the last Spending Review period, most departments have seen small real-terms increases in their spending, at least in terms of the spending totals that are the focus of the Spending Review. There have also been some decreases, the largest of which (in percentage terms) was MHCLG's spending on local government.

There is no formal role for Parliament in the Spending Round, but the plans presented in it will form the basis for the Budget later in the year and the Estimates next year, both of which can be scrutinised and voted on by Parliament. Next year we can also expect the full Spending Review, and it is likely that a number of other policy decisions will be made alongside it.

1. Spending Reviews and Spending Rounds

1.1 The planning cycle

Governments plan much of their spending for the long term in Spending Reviews. These typically take place every two to four years, and cover spending plans for the next few years. These plans take the form of annual limits for each department on their total spending that can reasonably be planned in advance (this is known as 'DEL' spending – see Box 1 below for more details). This covers about half of total public spending; it is then up to the individual departments to allocate their spending within these limits each year. The focus also tends to be on 'resource' spending (meeting day-to-day costs) rather than 'capital' spending (investment in assets).

Spending Reviews, and the plans that they contain, are created in the context of the Charter for Budget Responsibility. This document is created by the Government and laid before Parliament, and sets out the fiscal mandates which the Government is working towards, and which its spending plans are designed to meet.

The process for holding a Spending Review is not laid out in legislation, and Parliament has no official role. Scrutiny of the Government's spending plans takes place through the Budget and the Estimates process, and Select Committees can also investigate them.

Box 1: Types of spending

Public spending in the UK is generally divided into two categories. Spending that can reasonably be planned in advance is controlled under Departmental Expenditure Limits (DEL), while spending that is more volatile or demand-driven is planned each year under Annual Managed Expenditure (AME).

For example, spending of the Department for Work and Pensions on its own staff costs counts as DEL, whereas its spending on welfare benefits is AME because the amount given out in this way cannot be predicted with much certainty in advance.

Spending Reviews generally focus on DEL, although they have also been used to set an expected overall AME total.

Spending can also be divided into 'resource' (day-to-day costs, for example staff salaries or grants) and 'capital' (spending on assets, such as buildings or investments). Spending Reviews can cover both of these.

1.2 Spending Rounds

Although most Spending Reviews cover three or four years, Governments do sometimes use them to cover shorter periods. This happened in 2013, when the Spending Round covered only financial year 2015/16.

In the 2019 Spring Statement, the 2019 Spending Review was announced as covering three years. However, this full Review has now been postponed to 2020. This left financial year 2020/21 without any plans covering it, so the current Spending Round is intended to cover this year only.

As capital budgets are already in place out to the end of 2020/21, the Spending Round will only set resource (day-to-day) budgets.

2. Spending commitments

The Government has already made a number of commitments to spend money, and at least some of these are likely to feature in the Spending Round. Some commitments are legally binding or the result of internationally agreed targets, while others are domestic policies.

2.1 Defence

In 2006, the members of NATO set a target of spending 2% of national GDP on defence. This was intended to increase the defence spending of NATO's European members, which was rather lower than the USA's spending.

The UK consistently meets this target (it is one of only three countries to consistently do so since 2010, the others being the United States and Greece), and has repeatedly committed to continuing to do so (most recently in the 2018 Autumn Budget).

This means that we can expect the Spending Round to include an increase in spending on defence. For comparison, the 2018 Budget saw increases in defence spending of £200 million in 2018-19 and £800 million in 2019-20.

2.2 International aid

Since the passage of the *International Development (Official Development Assistance Target) Act 2015*, the Government has been legally obliged to spend 0.7% of gross national income (GNI) on official development assistance (ODA, the internationally agreed definition of aid) in each calendar year. It has hit this target every year since 2013, and has committed to continuing to do so.

So long as the economy continues to grow, we can therefore also expect to see yearly increases in spending on aid. Most aid spending goes via the Department for International Development, but a large proportion (currently around 25%) is also spent by other departments.

2.3 NHS

In June 2019, then-Prime Minister Theresa May announced a funding plan for the NHS that would increase its funding by £20.5 billion per year in real terms at the end of five years. New Prime Minister Boris Johnson confirmed that this plan would still apply in a statement to the House of Commons in July.[1]

The funding plan calls for "£4.1 billion next year", which suggests that this increase will appear in the Spending Round.

[1] HC Deb 25 July 2019 c1459

The Prime Minister also announced an extra £1.8 billion for NHS frontline services,[2] but as this is capital funding it will probably not appear in the totals in this Spending Round.

2.4 Police

Prime Minister Boris Johnson also announced (in speeches and in the House) that there would be funding for "20,000 extra police…over the next three years".[3] Policing minister Kit Malthouse estimated that the pledge would cost around £500 million in the first year,[4] with estimates of the full cost coming in at around £1.1 billion.[5]

2.5 Education

Mr Johnson further pledged in his statement to the House to "increase the minimum level of per pupil funding in primary and secondary schools and return education funding to previous levels by the end of this Parliament."[6]

This was followed up with the announcement on 30 August 2019 of a funding increase for primary and secondary schools, totalling £14 billion over the three years to 2022-23. This is intended to ensure that per-pupil funding for all schools rises at least in line with inflation.[7]

On 31 August 2019 there was a further announcement of £400 million for further education, covering financial year 2020-21. This was specifically mentioned in the press release as forming part of the Spending Round.[8]

2.6 The end of austerity?

Given the promises in the above areas, it is possible that there will be little scope for the Chancellor to increase spending in other areas as well, particularly as the Chancellor is sticking to the current fiscal rules (see section 3.1). Indeed, the Institute for Fiscal Studies (IFS) have estimated that other "unprotected" areas would see cuts in day-to-day spending next year of around £2 billion if the existing spending plans were to be maintained.[9]

The IFS have also noted that the Government has been suggesting increases in spending, and therefore suggest that the Spending Round will involve higher spending totals than were in the current plans. They

2 Gov.uk, "PM announces extra £1.8 billion for NHS frontline services", 5 August 2019
3 HC Deb 25 July 2019 c1459
4 BBC News, Recruitment of 20,000 new police officers to begin 'within weeks', 26 July 2019
5 Financial Times, Sajid Javid's spending round set to focus on vote winners, 29 August 2019
6 HC Deb 25 July 2019 c1460
7 Department for Education, Prime Minister boosts schools with £14 billion package, 30 August 2019
8 Department for Education, Chancellor announces £400 million investment for 16-19 year olds' education, 31 August 2019
9 Institute for Fiscal Studies, The September 2019 Spending Review: austerity ended, or perhaps just paused?, 9 August 2019

suggest that the Chancellor may spend a third of the £15 billion fiscal headroom in order to increase spending overall.

However, the Chancellor has also said that "at a time when the global economy is slowing, it's important that we don't let our public finances get out of control", which may imply that his spending increases could be limited.[10] The IFS also suggests that the uncertainty in the outlook for the future, particularly around Brexit, may mean that any increases are short-lived.

There is no single definition of austerity but, broadly speaking, it is often thought to mean bringing the deficit down largely through controlling public spending. For some, austerity has been about the reductions seen in day-to-day spending on public services, particularly those services and departments where the Government has not offered any spending protection.

2.7 Spending on Brexit

In July, the Chancellor announced a further £2.1 billion in funding to prepare for a no-deal Brexit. This is in addition to the £4.2 billion already announced for preparations for all Brexit scenarios.[11]

All of this funding is expected to be used in the current financial year, so none of it should appear in the totals in the Spending Round.

[10] Financial Times, Sajid Javid's spending round set to focus on vote winners, 29 August 2019

[11] HM Treasury, Chancellor announces billions to turbo-charge no deal preparations, 31 July 2019

3. The spending round and the 'fiscal rules'

The Chancellor says that he will deliver the Spending Round "within the current fiscal rules".[12] The Government's fiscal rules guide and constrain how it manages the public finances. UK Governments have used such rules since the 1990s. Successive governments have designed their own rules, but they have often focused on government borrowing (often described as the budget deficit) and the debt-to-GDP ratio.[13]

3.1 The current fiscal rules

The current Government has targets for government borrowing and the debt-to-GDP-ratio, which are specific to 2020/21. It also has a 'fiscal objective' for the budget to be in balance by 2025/26. A balance would mean all public spending being met by the government's income, with no need for new borrowing.

The Government's borrowing target focuses on a measure of borrowing adjusted for the ups and down of the economy, known as structural (or cyclically-adjusted) borrowing. The government's target is for structural borrowing to be below 2% of GDP by 2020/21.

The Government's debt rule is for the debt-to-GDP ratio to be falling in 2020/21.

Both targets can be reviewed if there is a significant shock to the UK economy.

Current performance against the rules

In March 2019, the OBR judged that the Government was on course to meet its target for borrowing and debt in 2020/21.

The OBR judged that reaching a budget balance by 2025/26 – the Government's fiscal objective – "looks challenging".[14] A formal judgement wasn't made on the fiscal objective as 2025/26 is currently beyond the OBR's forecast period (of five years).

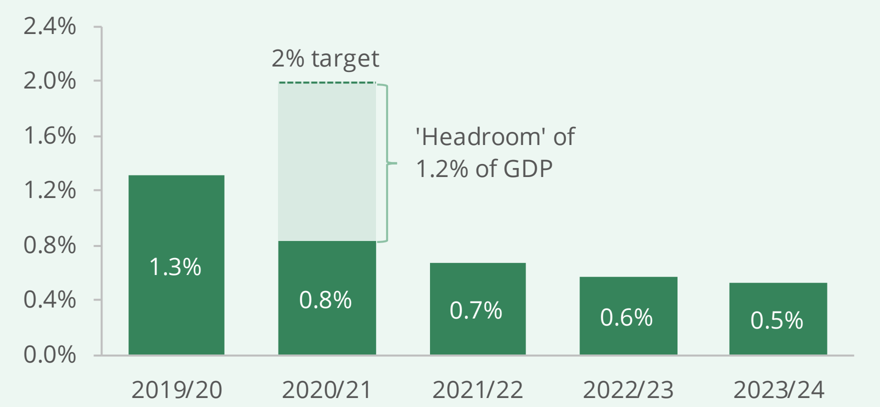
3.2 Scope for extra borrowing in 2020/21

The spending round is likely to result in higher public spending in 2020/21 than was forecast in March 2019 (unless the Government's recent spending pledges are met by cutting back on spending elsewhere). Additional borrowing or increased taxes will be needed to fund the higher public spending. On the face of it, the OBR's March 2019 forecasts suggest that extra spending could be accommodated within the 2020/21 borrowing and debt targets. The reality is more nuanced.

12 "Next week's Spending Round will clear decks to let us focus on Brexit", *The Telegraph*, 27 August 2019
13 A summary is available in paragraph 8.9
14 OBR. Economic and fiscal outlook – March 2019, para 1.44

In its March 2019 forecast, the OBR forecast that structural borrowing would be around 1.2% of GDP below the 2% target of the rule. This is what MPs are referring to when they speak about the Chancellor's 'headroom' – the difference between the Government's self-imposed 2% target and the amount of structural borrowing forecast for 2020/21.

Borrowing rule: structural borrowing forecasts
OBR March 2019 forecasts, % of GDP



The 'headroom' of 1.2% of GDP is equivalent to more than £25 billion of additional borrowing, which on the face of it gives the Government scope to meet its borrowing rule while increasing public spending in 2020/21. Such additional borrowing is unlikely to break the government's debt target. Reaching a budget balance in 2025/26, as required by the Government's 'fiscal objective' would become more challenging.

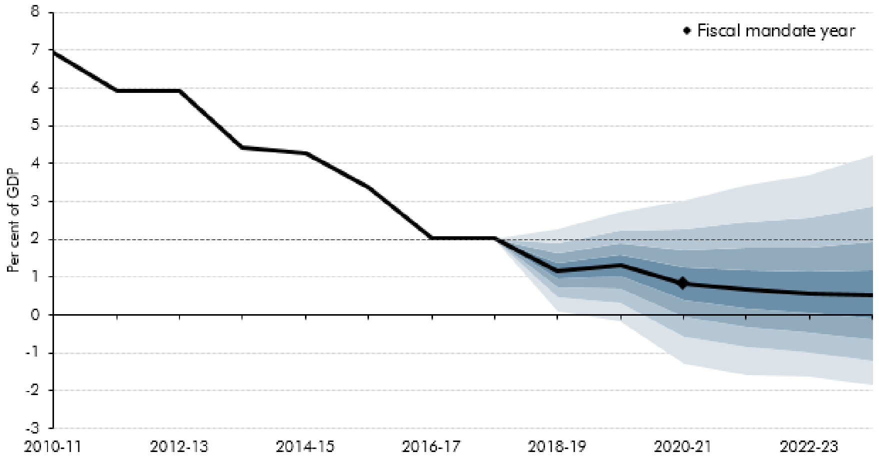
Looking at the 'headroom' available based on the last forecast is, however, a little too simplistic. Other issues need to be considered.

The 'headroom' is based on a forecast

The headroom is not set in stone – it is the difference between the 2% borrowing target and the forecast of structural borrowing in 2020/21.

The OBR's fan chart below shows the range of uncertainty surrounding the forecast. The solid black line shows the OBR's central forecast, with successive pairs of lighter shaded areas around it representing 20 per cent probability bands. The OBR estimates that there is a 75% chance that structural borrowing will be below 2% of GDP, meeting the Government's target. Conversely, they estimate that there is a 25% chance that the target won't be met.

Structural borrowing fan chart



source: OBR. Economic and fiscal outlook – March 2019, Chart 5.4

The actual size of headroom in 2020/21 will depend on how the public finances perform. In the near term, the biggest short-term risk to the public finances appears to be how orderly an exit the UK makes from the EU.

The UK's departure from the EU aside, there have been some tentative signs that the public finances are performing worse in 2019/20 than previously forecast. Borrowing in the first four months of 2019/20 has increased faster than the OBR expected.[15] It is too early in the year to say that the result will be higher borrowing in 2019/20 than forecast, but it does highlight the uncertainty surrounding the public finances.

Changes to how student loans are accounted for will add around 0.5% of GDP to borrowing

In September, the Office for National Statistics will change how it accounts for student loans in the official measure of government borrowing. The change – which is being made so that the deficit better reflects the subsidy element of the loans – will add around 0.5% of GDP to the deficit in 2018/19. As we explained back in 2018, nothing is changing to the actual loans, nor will the underlying strength of the public finances change, but the official measure of government borrowing will increase.

The OBR's March 2019 forecasts did not include the accounting change. It is expected that the change will add around £12 billion to borrowing in 2020/21 following the change, removing 0.5% of GDP of the Chancellor's 'headroom'.[16]

15 OBR. Commentary on the public finances- July 2019
16 OBR. Economic and fiscal outlook – March 2019, para B.21

3.3 Assessing the fiscal rules in the spending round

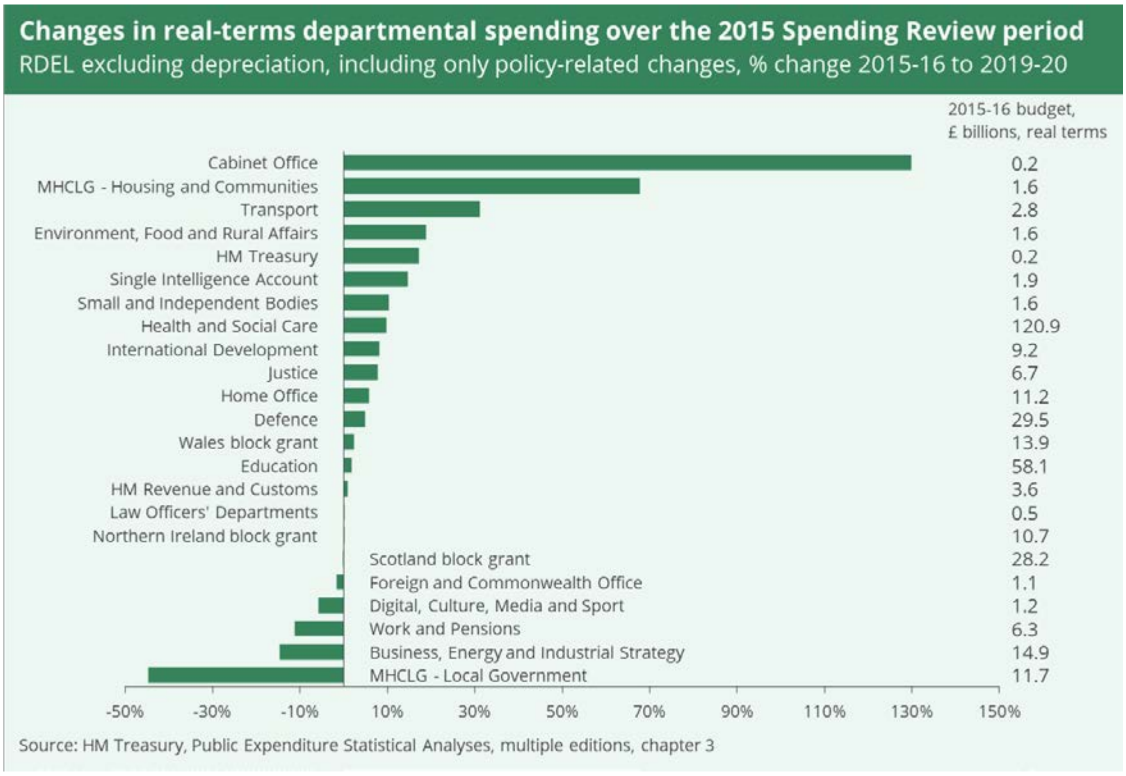
The OBR produces forecasts for the economy and public finances twice a year. One set is published at the Budget, the other at the Spring Statement. The OBR assess the fiscal rules in their forecasts.

The OBR isn't publishing a new forecast alongside the spending round. Without a fresh forecast, it looks difficult to see how the Government can show definitively that decisions taken in the spending round adhere to its borrowing target. The Government may simply have to refer back to the OBR's March 2019 forecast.

4. Spending trends

The most recent Spending Review was in 2015, when plans were set for Government departments out to the current financial year (2019/20). These plans kept overall spending fairly flat in real terms, but the latest figures (revised in 2019) show that the various departments have fared very differently over this period.

Because accounting changes make it difficult to compare departmental spending, we can use Treasury figures to construct indicative totals for what spending *would have been* if only policy-related changes were included in the figures. This is restricted to RDEL spending – that is, day-to-day rather than investment spending, and only those parts which can reasonably be planned in advance.



Looking at spending changes in this way shows that the Cabinet Office has seen the largest percentage increase in funding, and that most departments have seen real-terms increases. The largest decrease was in spending by MHCLG on local government.

Devolved administrations

The 2020/21 day-to-day spending limits (DELs) of the devolved administrations – often described as their block grants – will be determined in the spending round, largely though the Barnett formula.

Broadly speaking, the Barnett formula determines how block grants change from one year to the next, based on changes in the comparable budgets of UK Government departments.

The Barnett formula does not calculate the total block grant; rather it determines how much the block grant should change from one year to the next. The population-based Barnett formula aims to provide each nation the same pounds-per-person change in funding for spending areas which are devolved.

The Library briefing The Barnett formula has more about how it operates and some nuances, including a needs-based 5% uplift Wales receives.

Tax devolution: block grant adjustment

Recent devolution of new powers to Wales and Scotland – particularly over tax – has meant that their block grants are adjusted. The adjustments should mean that neither the UK government nor the devolved nation is financially worse off simply from the initial transfer of power. In the case of a devolved tax, the adjustment results in the devolved nation receiving a smaller block grant as they, rather than the UK Treasury, will receive the revenue from the devolved tax. Devolution related adjustments aren't particularly important in the context of the spending round, but they are for interpreting changes in block grants over time.

The adjustment process is discussed in more detail in HM Treasury's Block Grant Transparency publication. A further summary is available in the Library Insight Devolution (part 2): changes to devolved funding.

5. What happens next?

5.1 The Budget

At some point after the Spending Round, probably before the end of the year, we can expect to see a Budget. This will probably flesh out the Spending Round's plans, and the accompanying forecasts from the OBR will allow us to see how well they follow the fiscal rules.

The Budget will likely be the first opportunity that MPs have to scrutinise the plans presented in the Spending Round – committees may also look at plans in their areas. These plans will also form the basis for the next set of Main Supply Estimates, which will be voted on in July next year.

5.2 Brexit

It is also likely that we will get more clarity before long on the exact form that Brexit will take. This will probably have a significant impact on the spending plans (they may be revised one way or another, depending on the short-term needs of the economy and what the government does in response).

5.3 The 2020 Spending Review

The three-year Spending Review that was originally planned for this year has not been cancelled, merely postponed. It will now take place in 2020 instead, and if it remains a three-year Review it will set spending plans out to 2023-24.

A number of spending decisions were set to be made at the Spending Review (such as on the UK Shared Prosperity Fund, the NHS People Plan, and various education programmes).[17] It is not yet clear whether these decisions will now be made at the Spending Round instead, or will be pushed back to 2020.

[17] See, for example, PQ responses 280964, 280442 and 280463.

BRIEFING PAPER
Number 08651
2 September 2019