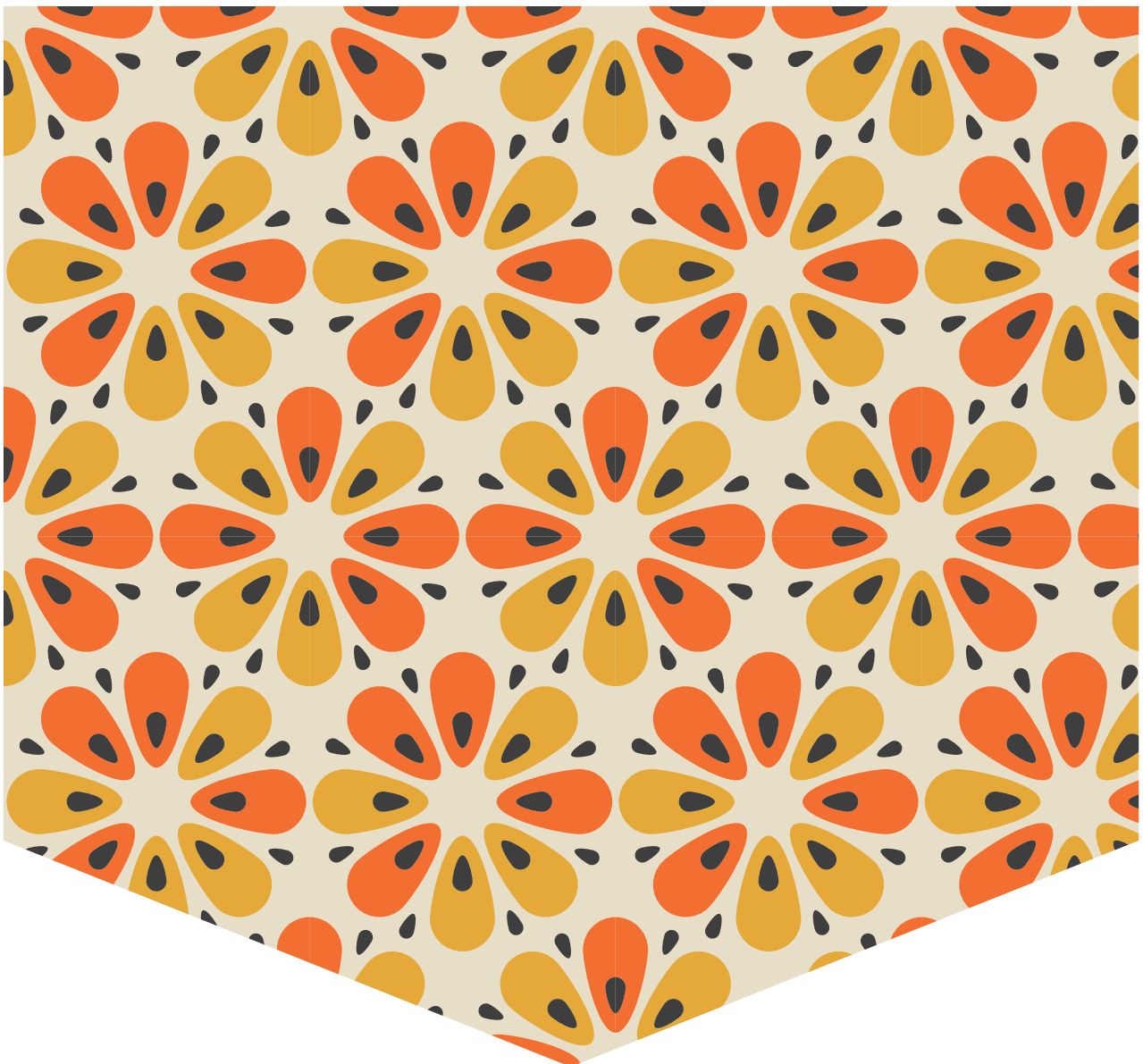


# The shape of things to come

Charting the changing size and shape of the UK state

**Matthew Whittaker**

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## Executive Summary

### **The coming election could have profound implications for the shape of the UK state for decades to come**

The general election campaign we have just entered, the fourth in a decade, will inevitably be dominated by Brexit. But the domestic policy agenda is also sure to feature – not least because the major parties appear to be aligned in their determination to pull away from the austerity decade by pursuing ambitious (code for big) new spending plans. And while Brexit will of course generate a lot of heat, it is on the domestic agenda that we must hope the parties can shed most light. That's because the UK's public finances are currently at a turning point, and the agenda laid out by the next government has the potential to define what happens in the UK for many years to come.

The need for the parties to present strategic, wide-angle approaches to their new spending plans – resisting the temptation to deliver no more than sticking plasters and election enticements – rests on the coming together of three factors, relating to the past, the present and the future of the public finances.

Looking backwards, the spending restraint of the austerity period and the political priorities pursued by successive governments within this constraint has placed major strain on a number of public services. In short, the size of the state has changed over the past decade but so too has its shape.

Focusing on the present, whoever forms the next government will need to locate their spending plans within a new fiscal framework. The existing fiscal rules that guide the government's approach are no longer in effect, and are in any case about to expire in some instances. The ambitions the parties set out for growing the size of the state must therefore sit alongside coherent new rules that reflect today's economic realities (the low interest rate environment and current heightened risk of recession for instance) while supporting continued fiscal sustainability. We can't expect the election debate to major on the technicalities of deficit and debt rules, but serious visions for the future of Britain should rest on serious new fiscal outlines too.

Looking forwards, the next government must also contend with the demographic headwinds that are about to start blowing. While we have long discussed the ageing society, its real impact is only due to start hitting over the course of the next parliament as members of the large baby boomer generation retire in significant number – with effects that then build over the decades that follow. In the absence of policy change, this demographic march has profound implications for both the size and shape of the UK state – in many ways doubling-down on the policy-driven shifts recorded over the past decade.

### **The two biggest parties appear aligned in their ambition to increase state spending – potentially returning it to 1970s levels**

The austerity programme delivered since 2010 has produced an unprecedentedly long pause in the real-terms spending growth that has characterised the majority of the post-WWII period. Total managed expenditure (TME) increased by just £5 billion (or 0.6 per cent) between 2010-11 and 2018-19, with this eight-year flat-lining eclipsing the six-year pause recorded in the 1980s and far outstripping any other previous period of austerity.

And measured on a per capita basis instead – which much better captures the lived experience of austerity – the restraint appears even more marked. Government spending per person is set to come very slightly under £13,000 in 2019-20 (in 2018-19 prices),

which remains 3.6 per cent down on the 2010-11 peak of £13,465. Under the plans in place ahead of the election, this peak isn't expected to be surpassed until 2023-24. Such a 13-year pause would almost double the seven-year record associated with privatisation in the 1980s.

But the direction of travel has shifted over the past year. Philip Hammond promised to deliver an end to austerity during the latter part of his tenure as Chancellor, and Sajid Javid has followed through. The Spending Round set out in September concerned itself with only 43 per cent of TME (that part relating to Whitehall departmental expenditure limits, or DEL) and it looked only one year into the future (updating plans for 2019-20 and 2020-21), but it was nevertheless a big deal.

The Chancellor added £2.1 billion to the existing 2019-20 spending plans, along with an extra £13.4 billion for 2020-21. That translates into a plan to raise real-terms DEL by £13.8 billion (or 4.1 per cent) in 2020-21 relative to 2019-20 – the biggest average annual increase in departmental budgets earmarked at any spending round since 2002.

As a share of GDP then, TME now appears to be on an upward trajectory once again. The current plans result in spending rising to 40.6 per cent of GDP; still well down on the immediate post-crisis peak of 46.6 per cent, but slightly above the ratio recorded just before the crisis struck, and well up on the 37.4 per cent of GDP logged between 1985-86 and 2007-08.

Nevertheless, the UK state remains relatively modest by international standards. The UK's expenditure-to-GDP ratio increased from 80 per cent of the OECD average in 1998 to 96 per cent in 2006. And it very briefly surpassed it following the financial crisis, peaking 1 per cent above the average in 2012. But it has since fallen back, and currently stands at around 95 per cent of the OECD average. The UK state spends more in relative terms than the US, Korea and Ireland, but significantly less than France, Finland and Sweden.

However, pre-election plans look like they will be quickly replaced by new ones that push the size of the UK state somewhat higher – whoever forms the next government.

In presenting the Spending Round, Sajid Javid also spoke of his ambition to establish a “new economic plan” over the years beyond 2020-21 that would shift the UK economy from “recovery” to “renewal”. He placed a particular emphasis on capital spending, saying that the “first priority of our new economic plan will be to rebuild our national infrastructure”. In more concrete terms, during his bid for the Conservative Party leadership back in the summer he outlined plans for a £100 billion (multi-year) “National Infrastructure Fund” targeted outside London. We might therefore expect the party’s manifesto to provide more detail of these ambitions, maintaining the Spending Round momentum on current expenditure and introducing new targets for capital spending.

Labour’s ambitions are longer-established and even further reaching. Its 2017 election manifesto included more than £70 billion in new spending pledges, comprising £48.6 billion of day-to-day spending (covering both departmental spend and social security payments) and £25 billion of capital (as part of a pledge to deliver a ten-year £250 billion “National Transformation Fund”). It is possible that some of the spending increases set out in September’s Spending Round could lower the extra funding required of a future Labour government to meet its previous policy goals. But the party has outlined a range of additional ambitions in recent months that imply that it intends to set out a 2019 manifesto pledge that is similar in scale to the 2017 one.

Of course, we won’t know the full extent of the two parties’ plans until we get the next set of manifestos. But we can present illustrative scenarios in order to explore what pursuing such ambitions might mean for the size of the UK state.

Our modelling suggests that a ‘Conservative’ approach that delivers on the Spending Round commitments on current spending and thereafter maintains the value of that expenditure as a share of GDP, alongside delivering a £20 billion annual boost to the capital budget (on the assumption that something along the lines of the proposed “National Infrastructure Fund” is delivered over five years), would lift TME to 41.3 per cent of GDP by 2023-24. A similar outcome could alternatively be delivered by rolling the capital programme out more slowly, but very

modestly increasing day-to-day departmental spending as a share of GDP. Such a spending total would be higher than in any pre-crisis year since 1984-85, and would fall only slightly under the 42 per cent average recorded between 1966-67 and 1984-85.

Following a Labour approach that tops up the post-Spending Round baseline to the tune of £49 billion of current spending and £25 billion of capital spending by 2023-24, lifts TME to 43.3 per cent of GDP. That would take us back to 1982-83, and would stand as the ninth highest spending total in the entire post-war period.

These scenarios are indicative at this stage, but they are in line with the rhetoric we've heard from the two parties to date. What stands out is that both would push the UK state close to – or even above – 1970s levels of spending. The election therefore has the potential to reverse the Thatcher revolution on the public finances – despite parts of what the state did in the 1970s sitting today in private hands.

### **Ambitions for growing the size of the state sit against a backdrop which has been changed significantly by austerity**

Ahead of the introduction of ambitious new spending plans, the shadow of austerity remains all too real for large parts of the public sector – and for many households too. That shadow provides the context for the new spending plans being presented in the parties' manifestos.

While real-terms TME has been broadly flat over the period since 2010, the split between different government functions has shifted considerably. For example, annually managed expenditure – that part of state spending which is less within the direct control of government, such as social security, debt interest and student loans – has continued to rise over the period. Flat TME has therefore converted into falling DEL, with the departmental total falling from 47 per cent of overall expenditure in 2009-10 to just 43 per cent in 2019-20.

Within that DEL total, the split between current spending (resource DEL, or RDEL) and capital spending (capital DEL, or CDEL) has remained largely unchanged – though the CDEL

profile has been particularly volatile. Taking a longer view however, capital spending has been steadily recovering from the lows of the 1980s and 1990s since the turn of the century. On current plans, public sector net investment is projected to rise to 2.6 per cent of GDP in 2020-21 – the highest level of investment since 1978-79 (outside of a fiscal stimulus-related spike in 2008-09 and 2009-10).

Drilling down into the RDEL total – a figure which has fallen as a share of total spending (from 39 per cent in 2009-10 to 36 per cent in 2019-20), fallen as a share of GDP (from 18 per cent to 14 per cent) and fallen in real-terms (remaining some 5.2 per cent down on its 2009-10 peak in 2019-20) – we can see how policy choices have driven a profound shift in the nature of the UK's public services. Spending on some departments and functions – like the NHS, foreign aid, schools and defence – have been subject to protection and prioritisation in different periods since 2010. That has meant that the burden of a falling overall envelope has rested heaviest on the remaining services – especially so given the large scale of many of the protected areas.

Day-to-day per capita spending on the Department of Health and Social Care is therefore on course to have risen by 14 per cent between 2009-10 and 2019-20, with increases of 7 per cent recorded by both the Department for International Development and the Home Office too. But the Local Government budget is due to have been cut by three-quarter (77 per cent), with several other departments (including Work and Pensions, Transport, Housing and Communities, and BEIS) facing cuts of between one-third and one-half.

Such a profile has resulted in overall RDEL being increasingly health-dominated. The share of spend accounted for by the Department of Health and Social Care has increased by a third (from 31 per cent to 40 per cent) between 2009-10 and 2020-21. With the Department for Education and the Ministry of Defence broadly holding their share, and DFID increasing its to a still very modest 2 per cent of all RDEL, the remaining public services have experienced a 26 per cent reduction (from 38 per cent to 28 per cent).



We have seen similarly marked changes in the composition of spending when focusing on social security. The overall total has risen by 24 per cent in real-terms since 2007-08 (taking the pre-crisis total as the baseline to avoid cyclical effects), but that equates to a 32 per cent increase for pensioner spend and a 16 per cent increase for all other individuals.

Demographic and economic trends have clearly contributed to this divergence of experience, but policy choices have been at play too. One of those choices – the decision to lift state pension age – has actually pushed back against the scale of increase in pensioner spending that we might otherwise have seen. But the pensioner bill has been pulled in the opposite direction by the deliberate decision to protect the generosity of the State Pension via the introduction of the triple lock. And that decision stands in direct contrast to the series of sharp cuts made to the access and generosity of working-age and child benefits. By 2023-24, pensioner social security spend per person is set to be 21.4 per cent higher than in 2007-08, whereas the per person spend for those under pension age is projected to be up by just 3.5 per cent.

Just as health has increasingly come to dominate departmental spending then, so too has the State Pension accounted for an increasing share of the social security total. Its share is set to rise by 19 per cent between 2007-08 and 2020-21 (from 37 per cent to 44 per cent – more than two-fifths of all welfare spending). The biggest proportional increase is actually due to disability and incapacity benefits, which are set to increase their share by 33 per cent (from 14 per cent in 2007-08 to 19 per cent in 2020-21). In contrast, the share allocated to Child Benefit over the same period is due to fall by 24 per cent (from 7 per cent to 5 per cent).

Taken together, these changes in public service and social security priorities have produced a profound shift in what the UK state does. Spending on health accounts for 20 per cent of total spend today, up from 18 per cent in 2007-08 and just 14 per cent in 1997-98. Likewise, spending on old age social security now takes up 17 per cent of the total, up from 15 per cent in 2007-08 and 14 per cent in 1997-98. The biggest proportional declines over the past 20 years have been recorded in defence and public order,

with the former falling by 28 per cent (from 7 per cent to 5 per cent) and the latter dropping by 23 per cent (from 5 per cent to 4 per cent).

### **The parties' election promises must also be grounded in the presentation of a robust new fiscal framework**

Even before accounting for any post-election spending surge, the fiscal rules look set to be broken, leaving the UK effectively without a fiscal anchor. In laying out ambitious new spending plans as part of the election campaign therefore, the political parties must also take time to explain the fiscal framework they would want to put in place to ground that expenditure.

The 2017 Labour manifesto included proposals for tax rises that would entirely match its £49 billion current spending pledge, alongside explicit plans for shifting to a new deficit rule that excluded capital spending. The proposed debt rule was less explicit though, with any significant increase in capital expenditure along the lines set out in our 'Labour' spending scenario almost inevitably requiring the establishment of a higher debt target (or a switch to focus on debt servicing costs instead). We might expect the Conservatives to take a broadly similar approach, reflecting Sajid Javid's shared emphasis on raising capital spending. But meeting such a target would be made significantly harder by any attempt to follow through on the expensive tax cut pledges made by Boris Johnson during his leadership campaign. Fitting the parties spending ambitions within a new fiscal framework will therefore not be straightforward.

It will not be enough for the parties to simply tweak or extend the existing framework. Instead, they should reflect on the lessons of the past 20 years of fiscal rule development, seize the opportunities of the present, and respond to the challenges of the future. Global economic slowdown, the elevated risk of a UK recession and the prospect of Brexit around the corner all mean the new framework will need to guide fiscal policy through a period of unprecedented near-term uncertainty. But it must also enable it to address looming long-term economic, social, and environmental pressures. That means developing a set of rules

that are both more robust and more flexible; safeguarding fiscal sustainability in the long run while allowing policy to respond to a range of potential economic scenarios over the medium term.

### **And the next government must also contend with the implications of the coming demographic headwind**

Looking to the future, demographic change is set to continue the trend put in train by active policy choices over the past two decades – namely, rapidly increasing spending on old age and health. Combined, such spending currently accounts for 13 per cent of GDP. In ten years that figure could be 15 per cent, and may rise as high as 20 per cent by the middle of the century. That would mean spending on these two functions would go from accounting for 29 per cent of all (non-interest) spending in 1997-98 to 36 per cent today and 44 per cent by 2037-38. By 2067-68, health and old age social security might account for 50p of every £1 spent.

Absent any change in approach in relation to other aspects of spending, overall government expenditure would need to continue rising as a share of GDP in order to meet increasing health and pension demand. That is, even before accounting for any spending promises set out by the next government as part of its election campaign, TME is on course to rise to 41 per cent by the end of the 2020s, 44 per cent by the end of the 2030s and 49 per cent by 2067-68 – well above the post-war peak of 46.6 per cent recorded in 2009-10.

Such significant changes are not inevitable, of course. Future governments could choose to change the offer to their citizens – restricting access to healthcare and to pensions, or shifting some functions into the private sector. Equally, they could choose to squeeze spending on other services – effectively doubling down on the trends of the austerity decade. Alternatively, governments might try to deliver this significantly larger state – but to do so they will need to secure correspondingly large increases in government revenues.

Crucially though, these demographic pressures will start to build over the course of the next parliament – meaning the different election contenders need to start developing their responses

now. Matching new spending *preferences* with growing spending needs will be a key challenge for the next government.

Alongside Brexit, we can expect the coming election campaign to be characterised by something of an arms race on spending. But before firing the gun on that race, it is important that our politicians take a step back and consider the past, present and future not just of the size of the UK state, but also its shape.

Given that importance, we'll be publishing two more pieces in this series over the coming weeks: one that focuses on changing shape of the UK's tax base and one that looks at social security trends – spending time in both instances considering what the various parties' election manifestos might mean for the *shape* of things to come.

## Section 1

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### Introduction

Next month's general election will, of course, be dominated by Brexit. But it also has the potential to play a major role in defining Britain's domestic policy agenda for years to come. That's because the UK's public finances are at something of a turning point. Austerity has come to an end, and electioneering politicians are already articulating their willingness to turn the spending taps back on. But they are doing so against the backdrop of a triple public finance challenge that relates to the recent past, the present and the near future.

Looking first to the recent past, there is the need to deal with the fallout from austerity and the strain it has placed on many public services and on some household finances. Thinking about the here and now, the next government will need to establish a new fiscal framework that builds on the experience of past rules and meets the changed economic realities of today. And casting forward, the ageing society is set to create a fiscal headwind that very significantly increases the spending pressure on certain parts of the public sector over the course of the 2020s and beyond.

The nature of this triple challenge increases the importance of taking a wide-angle, strategic approach to spending in the coming years. Simply backing some favoured horses and offering voter-friendly giveaways risks producing a spending profile that is lopsided, inefficient, or unsustainable. In short, the election debate should focus not just on the *size* of the UK state being proposed by different parties, but also on its *shape*.

That's where this report comes in. It takes a step back, by considering how the spending profile of the UK state has shifted over the longer term and how it might evolve over the coming years – all by way of providing context for the debate that is sure to follow. More specifically:

- Section 2 focuses on how the *size* of the state has changed and how it might change further over the coming years. It explores movements in government spending and government receipts, alongside what that has meant for the country's fiscal position.
- Section 3 focuses instead on the *shape* of the UK state, drilling down into trends in different aspects of spending. It looks at how the balance of both public service and social security spending has shifted over time, with a particular emphasis on changes since the financial crisis and the subsequent era of austerity.
- Section 4 brings both elements of spending together to give a sense of how the overall purpose of the state has changed over the past two decades and how demographic change will affect things over the years to come.
- Section 5 offers some concluding thoughts.

This is the first in a series of three pieces on the fiscal backdrop to the coming election. As the campaign develops, we will publish our analysis of the main political parties' plans for tax and for welfare – taking the evolution of the country's position on both areas as their jumping off points.

## Section 2

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### About the size of it

A decade of austerity in the public finances has resulted in an unprecedented pause in spending growth, with total managed expenditure rising by just £5 billion (or 0.6 per cent) in real-terms between 2010-11 and 2018-19. But that pause is now over, with a rare political consensus about the desirability of a bigger state meaning that spending will almost certainly expand further over the coming years – whatever the composition of the next government. Measured relative to the size of the economy, that means government spending looks to be heading back towards the heights of the 1970s. It has also moved closer to the OECD norm over the past 20 years, though it remains below the average for the time being.

Government revenues have also been rising, with receipts relative to the size of the economy expected to reach their highest level since 1985-86 in 2019-20. They will, however, remain some way short of the spending total. That leaves the three main components of the current fiscal framework under considerable pressure. Alongside setting out bold new spending plans ahead of the election, the political parties must therefore also be clear about what fiscal rules they intend to use to underpin their approaches to growing the UK state.

### Spending Round 2019 has returned government expenditure to mid-2000s levels

The Chancellor declared at September's Spending Round that he was "turning the page" on austerity and "writing a new chapter in our public services".<sup>1</sup> For now, though, that chapter stretches only one year into the future and is restricted to the 43 per cent of government spending (total managed expenditure, or TME) that comprises Whitehall departmental expenditure limits (DEL). And while the changes in the Spending Round only go some way to reversing the cuts made since 2010, it does nevertheless herald a significant change of direction.

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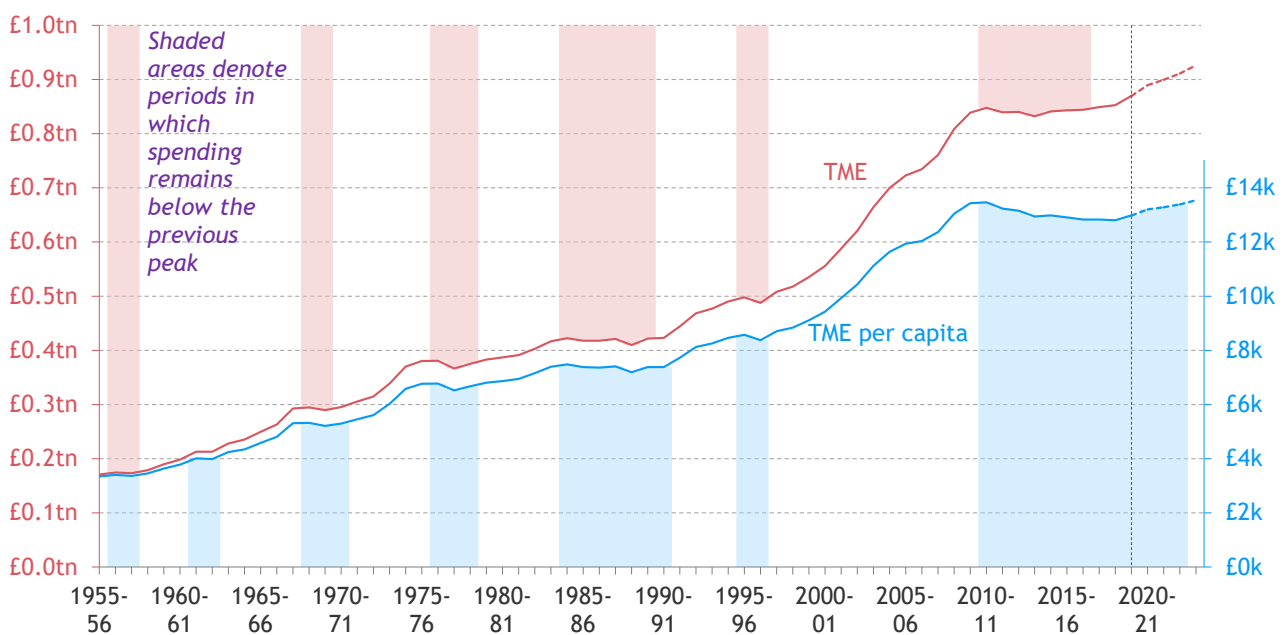
<sup>1</sup> HM Treasury, "Spending Round 2019: Sajid Javid's speech", 4 September 2019

Indeed, the Chancellor announced an extra £2.1 billion of spending in 2019-20 and an extra £13.4 billion in 2020-21 relative to previous plans. That converts into a year-on-year real-terms increase in departmental spending in 2020-21 of £13.8 billion, or 4.1 per cent – the largest average annual increase in departmental budgets set out at any spending round since 2002.

As Figure 1 shows, the return of spending growth has certainly been a long time coming. Since peaking at £848 billion in 2010-11 (in 2018-19 prices), TME has been broadly flat for eight years. That’s the longest pause in spending growth in modern times, eclipsing the six-year period associated with privatisation in the 1980s and contrasting with average annual real-terms growth of 3 per cent recorded between 1956-57 and 2010-11.

**FIGURE 1: Austerity has resulted in an unprecedentedly long pause in UK spending growth**

Total managed expenditure: UK, 2018-19 terms (GDP-deflator)



NOTES: Figures are adjusted for Spending Round 2019, including only those increases in departmental expenditure limits set out for 2019-20 and 2020-21; other forms of expenditure are assumed to be in line with those published at the 2019 Spring Statement. For the period beyond 2020-21, we assume that TME growth is in line with the March Spring Statement forecast. All figures are presented following various methodological changes introduced by the ONS (in relation to the treatment of student loans and public sector pensions for instance) in September 2019.

SOURCE: RF analysis of OBR, Public Finances Databank

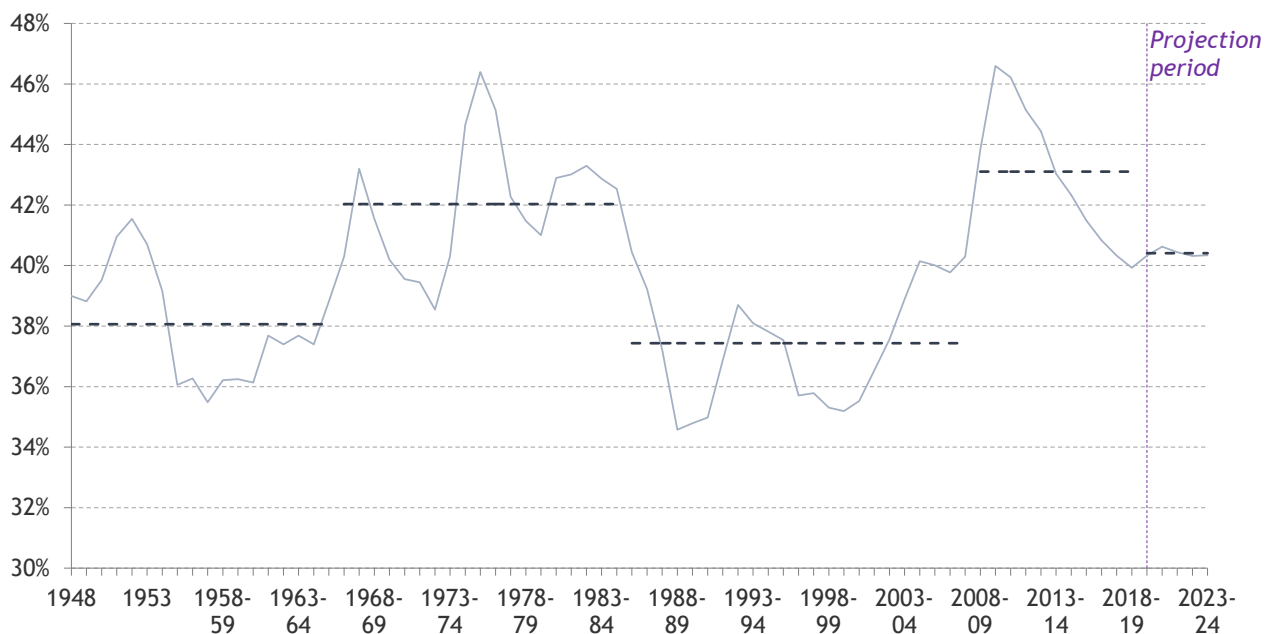
And the spending restraint is even more marked when measured on a per capita basis – an approach which better reflects the lived experience of austerity. Applying the combined Spring Statement and Spending Round projections, the 2010-11 peak of £13,465 wouldn’t be surpassed until 2023-24; such a 13-year hiatus would be almost double the previous seven-year record recorded in the 1980s.



The post-crisis real-terms pattern has converted into a much more marked rise and fall in expenditure relative to the size of the economy. On that basis, Figure 2 shows that TME jumped in 2008-09 and 2009-10 (as output contracted and spending increased), before falling in every year since. The Spending Round effect is clear once again, however, helping to set spending back on an upward trajectory this year (2019-20) and returning it to 40.6 per cent of GDP in 2020-21. That’s broadly in line with its level just before the financial crisis struck, and significantly above the average recorded in the two decades prior to that.

FIGURE 2: **Government spending as a share of GDP is back to early-2000s levels**

Government spending as a share of GDP: UK



NOTES: Switch from calendar year to financial year from 1955-56. Figures are adjusted for Spending Round 2019, including only those increases in departmental expenditure limits set out for 2019-20 and 2020-21; other forms of expenditure are assumed to be in line with those published at the 2019 Spring Statement. For the period beyond 2020-21, we assume that TME growth is in line with the March Spring Statement forecast. All figures are presented following various methodological changes introduced by the ONS (in relation to the treatment of student loans and public sector pensions for instance) in September 2019. SOURCE: RF analysis of OBR, Public Finances Databank

## Given the main parties’ pre-election stances, spending looks set to head back towards 1970s levels over the coming years

This restoration of spending growth increasingly looks like marking the beginning of a new era for the public finances and reflects a new consensus on spending across the political divide. Heading into the fourth election in a decade there appears to be broad agreement around the need to turn the spending taps back on.

For example, alongside laying out some specific totals for 2019-20 and 2020-21, the Chancellor used the Spending Round to talk up his ambition to establish a “new economic plan” that would focus on shifting the UK economy from “recovery” to “renewal”. The clear implication was that he hoped to increase spending further still in the coming years – especially in relation to capital expenditure.<sup>2</sup>

Following the cancellation of the 6 November Budget and the decision to delay the full, multi-year Spending Review that had been scheduled for this year into 2020, it’s not yet clear exactly what “renewal” entails. But he has talked previously about delivering a £100 billion (multi-year) “National Infrastructure Fund” targeted outside London, so we might expect to see further details of his capital spend ambitions in the forthcoming manifesto.<sup>3</sup> What’s beyond doubt is that he envisages a growing role for the state.

The Labour Party’s ambitions in this direction are longer-held, with the 2017 election manifesto including new spending pledges that added more than £70 billion a year by 2021-22.<sup>4</sup> That total comprised £48.6 billion on day-to-day spending (including on things like tuition fees, childcare, the NHS, social care, public sector pay and benefits) and a ten-year £250 billion (i.e. £25 billion a year) “National Transformation Fund” covering transport, energy, communications and housing infrastructure. And the recent party conference doubled down on the bigger state idea, with new pledges on scrapping prescription charges, free legal support and a new Youth Service, for example.<sup>5</sup>

Having ‘turned a page’ then, spending is now likely to rise higher still over the forecast period – whatever the outcome of next month’s election. We won’t know precisely what the parties are planning for the coming years until the election manifestos are published, but it is worth speculating on what might be in store. To do so, we set out two indicative scenarios:

- ‘Conservative’: we take spending in 2020-21 as given, and allow RDEL to grow in line with GDP thereafter (reflecting an assumption that, having established a new baseline for day-to-day spending at the Spending Round, the Chancellor will as a minimum want to maintain that base). With the Conservatives having said nothing of note on benefit spending in recent months, we assume that annually managed expenditure (AME) grows in line with the Spring Statement plans. We add in extra spending on CDEL, to reflect the Chancellor’s stated ambition in this area. For the purposes of establishing an annual figure, we assume his promised £100 billion

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<sup>2</sup> He stated that “the first priority of our new economic plan will be to rebuild our national infrastructure”. HM Treasury, “Spending Round 2019: Sajid Javid’s speech”, 4 September 2019. See A Corlett et al, [Rounding up: Putting the 2019 Spending Round into context](#), Resolution Foundation, September 2019 for a fuller analysis.

<sup>3</sup> “Team Saj Launch Speech: Tomorrow’s Leader, Today”, 12 June 2019

<sup>4</sup> T Bell, “Examining the Labour Party’s economic radicalism”, Top of the Charts, Resolution Foundation, 20 September 2019. See also [Funding Britain’s Future](#), Labour Party, May 2017

<sup>5</sup> A Hossein-Pour, “At-a-glance: Here’s everything new that Labour announced at 2019 conference”, PoliticsHome, 24 September 2019

National Infrastructure Fund relates to a five-year parliamentary term, thereby adding £20 billion to the previous CDEL budget by the final year of the forecast period.<sup>6</sup>

- ‘Labour’: we again take spending in 2020-21 as given,<sup>7</sup> and thereafter add in the additional spending pledged in the 2017 manifesto.<sup>8</sup> In total, we add £48.6 billion of day-to-day spending by 2023-24 (pushing the original manifesto target date out by two years to reflect the passing of time since publication), split between RDEL and benefits (AME), along with £25 billion of capital spending. We then plot a linear trajectory to the 2023-24 target.

Figure 3 presents the outcomes of these two scenarios. Under the indicative ‘Conservative’ approach, spending rises to 41.3 per cent of GDP by 2023-24. That would be higher than in any pre-crisis year since 1984-85, and would fall only slightly under the 42 per cent average recorded between 1966-67 and 1984-85. The ‘Labour’ scenario takes spending higher still: to 43.3 per cent by 2023-24. That would easily surpass the 1970s average, and be higher than any pre-crisis year since 1982-83. Indeed, spending as a share of GDP would only have been higher in eight years in the post-war period.

Ahead of the publication of the election manifestos these scenarios are no more than speculative. But they reflect the rhetoric delivered by the two biggest parties and should therefore provide some indication of the direction of travel on spending. What’s noticeable is that, under either approach, expenditure ends up much closer to the average recorded in the 1960s and 1970s than to the average of the 1980s and 1990s.

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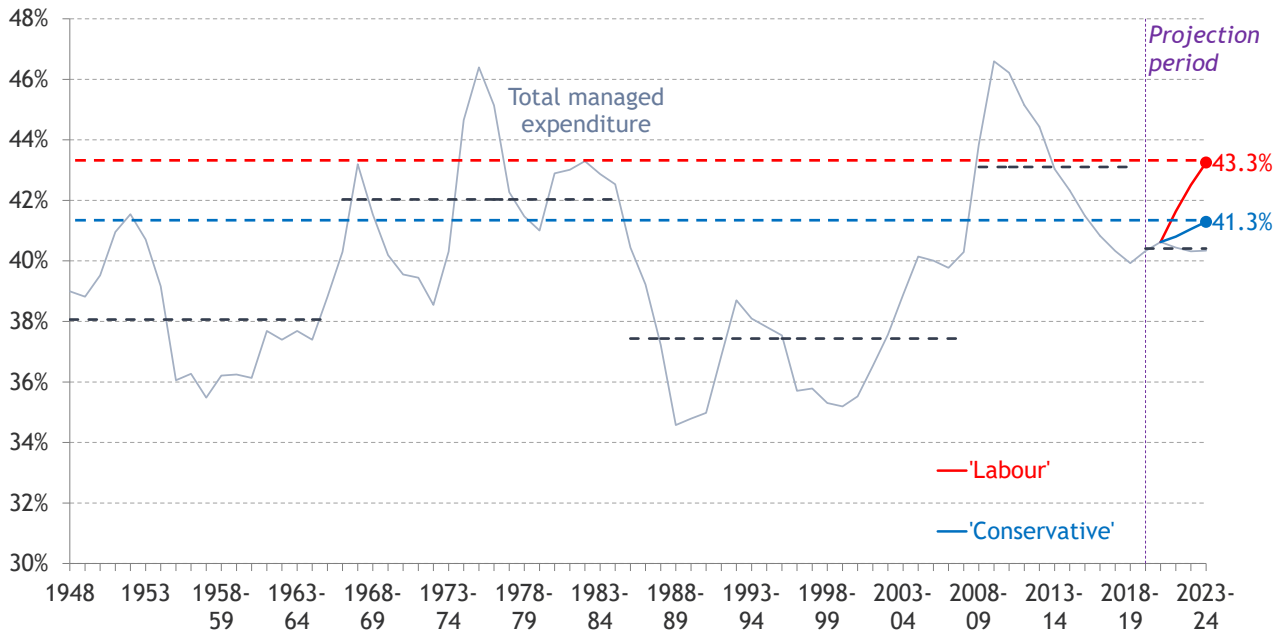
<sup>6</sup> The roll out of such a capital programme could of course be slower, producing a smaller annual boost to the CDEL total. But it would take only a very small increase in RDEL spending as a share of GDP to offset any such slowdown. That is, the same outcome might be achieved via a different, plausible, policy mix.

<sup>7</sup> An incoming Labour government could choose to change the 2020-21 spending baseline, but we have assumed the same starting point as in the ‘Conservative’ scenario for simplicity. The destination at the end of the forecast horizon is, in any case, unaffected.

<sup>8</sup> We make no adjustment for inflation.

**FIGURE 3: Future spending plans could push the size of the state back towards 1970s levels**

Government spending as a share of GDP: UK



NOTES: See notes to Figure 2. 'Conservative' scenario takes the post-Spending Round 2019 trajectory as the base and then grows RDEL in line with GDP, CDEL in line with hitting an additional £20 billion a year by 2023-24, and AME in line with the Spring Statement 2019 projection. 'Labour' scenario takes the post-Spending Round 2019 trajectory as the base, and then grows RDEL and AME in line with hitting an additional £48.6 billion by 2023-24 and grows CDEL in line with hitting an additional £25 billion a year by the end of the forecast horizon.

SOURCE: RF analysis of OBR, Public Finances Databank

## Such a surge in spending would bring the UK's expenditure-to-GDP ratio only broadly in line with the OECD average

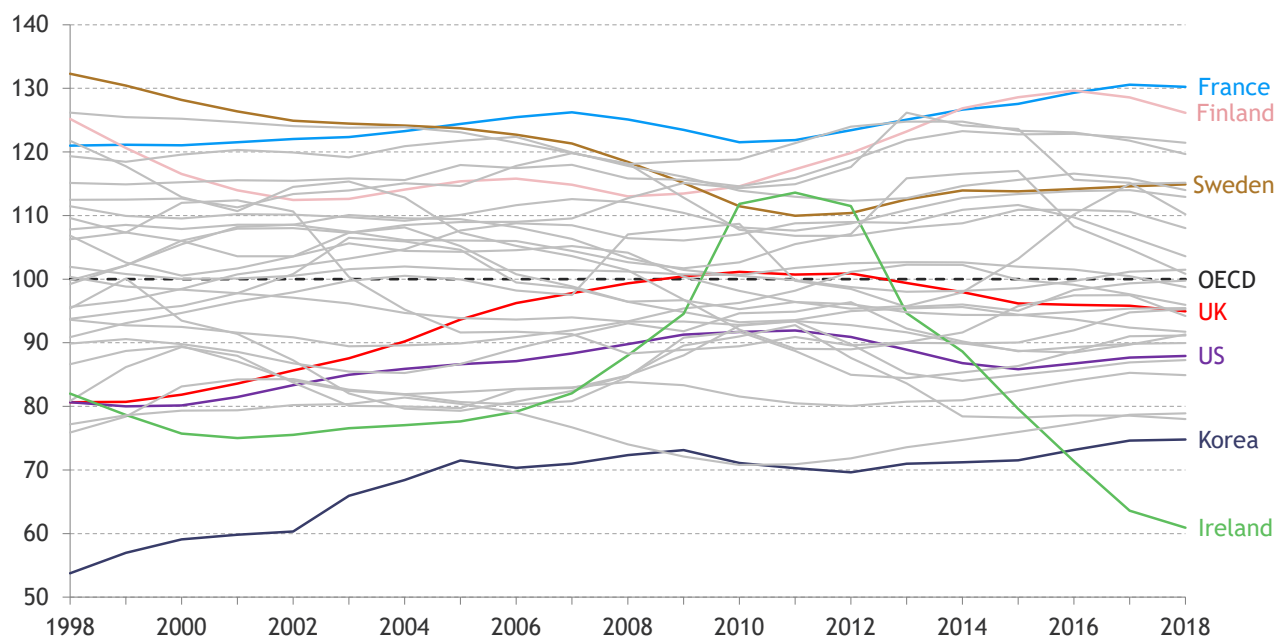
Changes of such an order would obviously be a very big deal from a domestic perspective. But it is worth reflecting on the fact that the UK's current expenditure-to-GDP ratio remains a little below the advanced economy norm.

Figure 4 compares the ratio of government spending as a share of GDP across all OECD countries for which such data is available,<sup>9</sup> and shows the UK rapidly approaching the OECD average (the '100' line) ahead of the financial crisis (increasing from 80 per cent in 1998, to 96 per cent in 2006): indeed it briefly surpassed it in the immediate aftermath (peaking 1 per cent above the average in 2012). However it has since fallen back in relative terms, with the austerity period driving it back down to 95 per cent of the OECD average by 2018.

<sup>9</sup> In order to maintain international comparability, we use the OECD-published figures for spending (rather than ONS- or OBR-published data), with no adjustment for Spending Round 2019 or recent technical accounting adjustments.

**FIGURE 4: UK spending as a share of GDP approached the OECD average ahead of the financial crisis, but has since fallen back below it**

Indices of government spending as a share of GDP: OECD average = 100 (three-year averages)



NOTES: Excludes Japan, Luxembourg, Mexico and Turkey. UK figures are not directly comparable with those presented elsewhere in this note.

SOURCE: RF analysis of OECD, *General Government Accounts*

The scale of the spending increases implied by recent Conservative and Labour rhetoric might therefore mark a change of direction for the UK, but it would likely only bring the country more closely in line with the advanced economy average.

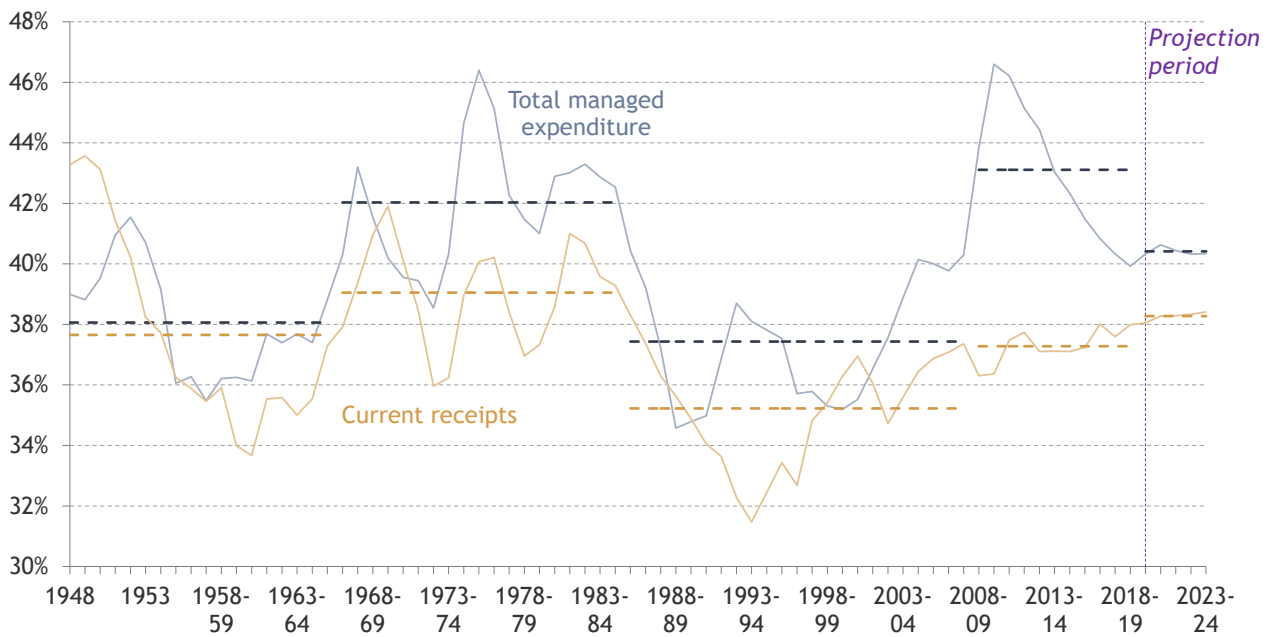
## But spending increases are being promised at a time when the existing fiscal framework already looks under significant strain

Spending is only one side of the fiscal equation of course. Figure 5 adds government receipts to the picture, showing that these have increased as a share of GDP in recent years. Based on the trajectory set out at the Spring Statement (with the Spending Round making no difference in this instance), the level is projected to reach 38.3 per cent of GDP in 2020-21. That's the highest level recorded since 1985-86, and only slightly down on the average recorded between the mid-1960s and mid-1980s.

The simultaneous growth in revenue and reduction in expenditure as a share of GDP over the past decade has helped narrow the gap between government revenue and spending that opened up at the time of the financial crisis. But that narrowing appears to have halted now, with spending projected to continue to outstrip receipts in the coming years – even before adding in potential post-election spending increases.

**FIGURE 5: The gap between spending and receipts has narrowed considerably, but remains in place**

Government spending and receipts as a share of GDP: UK



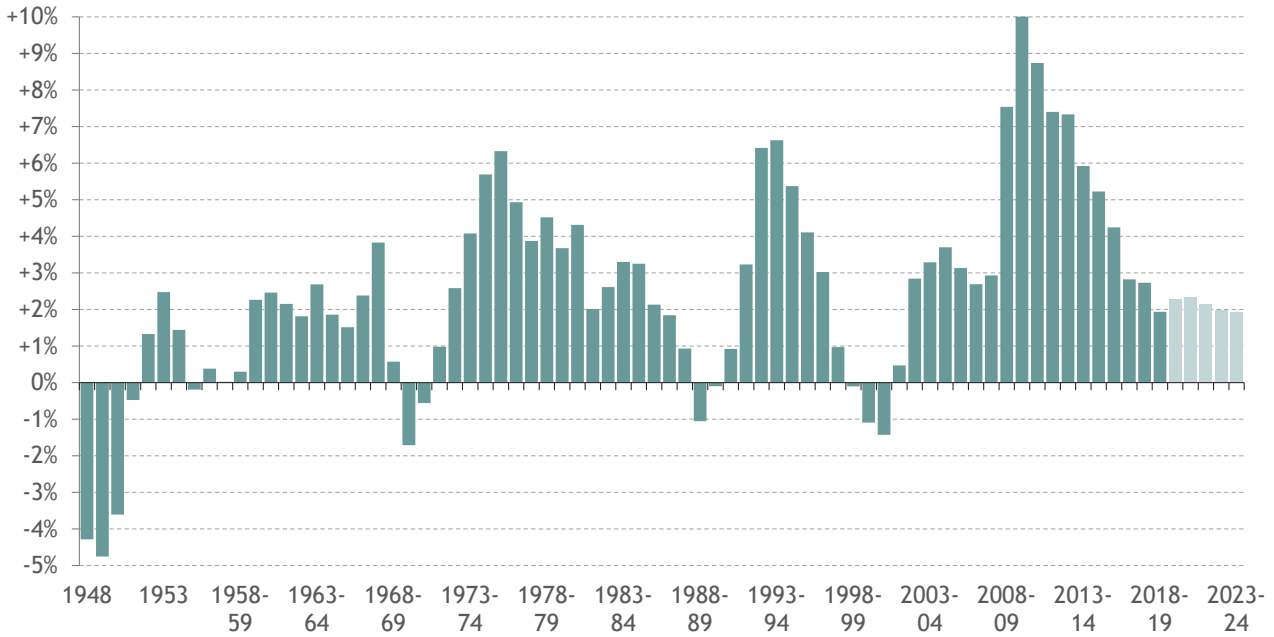
NOTES: Switch from calendar year to financial year from 1955-56. 'SR19' = Spending Round 2019 and includes only those increases in departmental expenditure limits set out for 2019-20 and 2020-21; other forms of expenditure are assumed to be in line with those published at the 2019 Spring Statement. For the period beyond 2020-21, we assume TME grows in line with the growth rates in place at March's Spring Statement. All figures are presented following various methodological changes introduced by the ONS (in relation to the treatment of student loans and public sector pensions for instance) in September 2019. SOURCE: RF analysis of OBR, Public Finances Databank

As Figure 6 shows, that is very much in keeping with successive governments' positions. An overall budget surplus was secured in just 12 of the 71 years between 1948 and 2018-19, with the deficit averaging 2.5 per cent a year. On current plans, the average is set to drop slightly below that level (2.1 per cent) between 2019-20 and 2023-24.

Such an outcome on the deficit has obvious consequences for the stock of debt too, slowing the pace at which it can be reduced relative to the size of the economy. Figure 7 presents the long-run picture. The post-crisis surge in the debt-to-GDP ratio is clear, with only very modest reductions in recent years. As of 2018-19, public sector net debt (PSND) stood at 81.7 per cent of GDP, down slightly from the 2016-17 peak of 83.8 per cent but still up significantly on the 2007-08 level of 34.4 per cent. As things stand it is set to continue falling, but only very modestly.

**FIGURE 6: The deficit is at a 17-year low, but no longer expected to fall much further in the coming years**

Overall deficit (public sector net borrowing, PSNB) as a share of GDP: UK

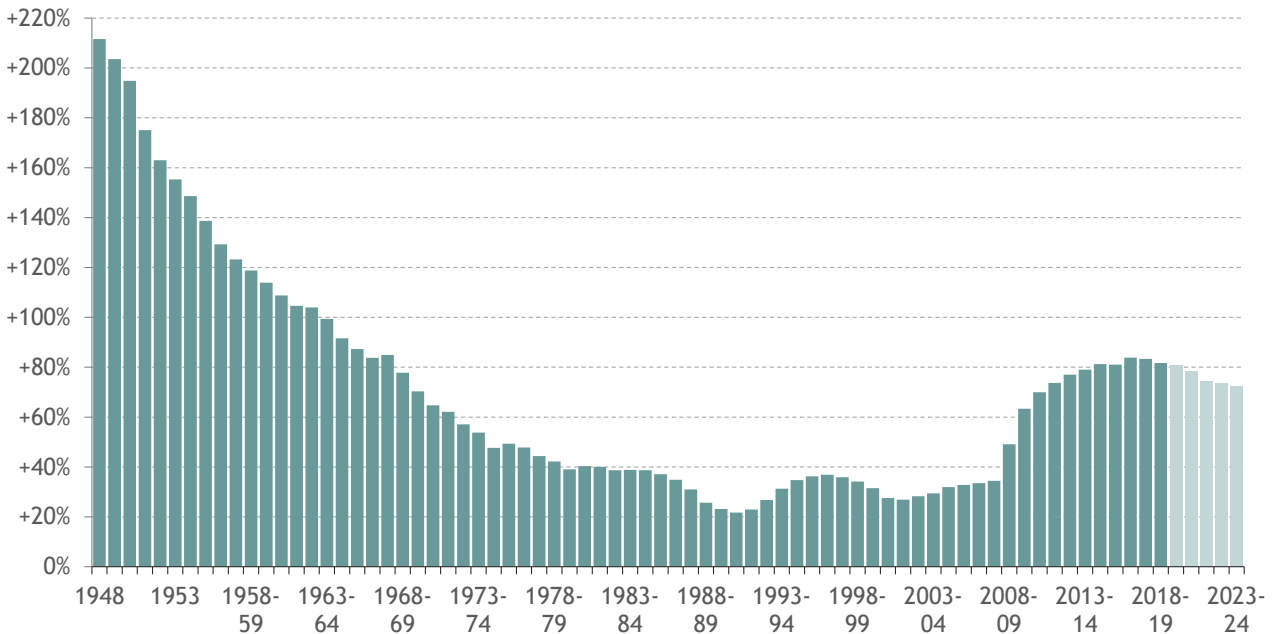


NOTES: Switch from calendar year to financial year from 1955-56. For the period beyond 2020-21, we assume TME grows in line with the growth rates in place at March’s Spring Statement. All figures are presented following various methodological changes introduced by the ONS (in relation to the treatment of student loans and public sector pensions for instance) in September 2019.

SOURCE: OBR, Public Finances Databank

**FIGURE 7: Debt remains elevated, and is on course to fall only modestly as a share of GDP**

Public sector net debt as a share of GDP: UK



NOTES: Switch from calendar year to financial year from 1955-56. For the period beyond 2020-21, we assume TME grows in line with the growth rates in place at March’s Spring Statement. All figures are presented following various methodological changes introduced by the ONS (in relation to the treatment of student loans and public sector pensions for instance) in September 2019.

SOURCE: OBR, Public Finances Databank and Bank of England

Given where we are post-Spending Round 2019, it is clear that the fiscal framework that guides the government's approach is no longer in effect.

For example, the main fiscal 'mandate' – which requires (structural) borrowing to be below 2 per cent of GDP in 2020-21<sup>10</sup> – is almost certainly on course to be broken. Back at the Spring Statement, the government appeared to have £27 billion of headroom against the target. But the combination of the new Spending Round plans and ONS accounting adjustments associated with the public finance treatment of student loans and public sector pensions<sup>11</sup> has removed that headroom. With the economy performing less well and the in-year 2019-20 borrowing figures trending higher than projected at the Spring Statement, borrowing currently appears on course to overshoot by some £16 billion.<sup>12</sup>

Likewise the longer-term 'fiscal objective' of balancing the overall budget has long been abandoned in practice. It featured prominently in both the 2015 and 2017 Conservative Party manifestos, with the 2015 publication declaring for instance that:

*"The only way to keep our economy secure for the future is to eliminate the deficit entirely and start running a surplus. Anything less would be to ignore the lessons of the past".<sup>13</sup>*

But it had effectively been abandoned when Philip Hammond was still Chancellor,<sup>14</sup> and now appears to be even further out of reach.

And once we factor in Sajid Javid's desire to boost capital spending in the coming years and the Prime Minister's preference for tax cuts,<sup>15</sup> the 'supplementary target' of having debt falling as a proportion of GDP after the 2020-21 also looks under considerable threat.

## The spending debate that is set to characterise the election campaign must therefore be informed by some new fiscal rules

For the Conservatives then, the 'turning of the page' on spending must come alongside a re-writing of the fiscal rules.<sup>16</sup> Indeed, speaking at the Spending Round, the Chancellor promised just such a refresh ahead of the Budget: stating that it would meet "the economic priorities of today – not half a decade ago".<sup>17</sup>

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<sup>10</sup> HM Treasury, [Charter for Budget Responsibility: autumn 2016 update](#), 17 January 2017

<sup>11</sup> ONS, [Public sector finances, UK: August 2019](#), 24 September 2019

<sup>12</sup> R Hughes, J Leslie, C Pacitti & J Smith, [Totally \(net\) worth it: The next generation of UK fiscal rules](#), Resolution Foundation, October 2019

<sup>13</sup> [Conservative Party Manifesto 2015](#)

<sup>14</sup> See for example, M Whittaker et al, [Super, smashing, great: Spring Statement 2019 response](#), Resolution Foundation, 14 March 2019

<sup>15</sup> T Bell, ["Tax cuts for the rich are not the answer to the questions 21st century Britain is asking"](#), Resolution Foundation, 10 June 2019

<sup>16</sup> And we have set out detailed thoughts on what that should entail. See R Hughes, J Leslie, C Pacitti & J Smith, [Totally \(net\) worth it: The next generation of UK fiscal rules](#), Resolution Foundation, October 2019.

<sup>17</sup> With the fiscal mandate relating explicitly to the deficit in 2020-21, a new set of rules for subsequent years would have needed developing even in the absence of the government's change of direction on austerity. HM Treasury, ["Spending Round 2019: Sajid Javid's speech"](#), 4 September 2019



With the Budget now cancelled, we must hope that the proposed Conservative framework is presented in the party's manifesto. It will surely include a looser deficit target, with Sajid Javid promising the Conservative Party conference that he would be "taking advantage of incredibly low interest rates and borrowing to build".<sup>18</sup> A deficit target focused on current spending looks most likely.

The new approach to debt is harder to second guess, with no mention of it in Sajid Javid's conference speech. But we might again expect a rule that provides greater room than the existing one – reflecting the fact that capital spending cannot be removed from PSND in the same way that it can be removed from the borrowing target. Either a higher debt-to-GDP ceiling or a new focus on debt servicing costs (accounting for today's low interest rate environment) could feature.

The Labour Party too must underpin its election spending plans with a new fiscal framework proposal. We might expect something similar to the approach set out in 2017, where the party outlined a 'fiscal credibility rule' that committed it to eliminating the current budget deficit within five years (with the manifesto laying out a sizeable programme of planned tax rises that precisely matched the proposed £48.6 billion increase in current spending)<sup>19</sup> and ensuring debt was falling by the end of the parliament.<sup>20</sup> But the latter part of this pledge is hard to square with the increased capital spending included in our 'Labour' scenario above.

Overall then the UK state, while much reduced in size as a share of national output over the past decade, is significantly larger than it was in the 1980s and 1990s – and is likely to expand further in the coming years. For now that proposed expansion looks to be resting in part on government borrowing, adding some urgency to the need for the next government to establish a new fiscal framework.

But what about what the state actually *does*? How has the composition of government spending shifted over the austerity period, and what are the implications for the priorities facing the next government? That's the issue we turn to in the next section.

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<sup>18</sup> The Conservative Party, "The Chancellor's Speech to Conference 2019", 31 October 2019

<sup>19</sup> [Funding Britain's Future](#), Labour Party, May 2017

<sup>20</sup> [Labour's fiscal credibility rule](#), Labour, 2017

## Section 3

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### Taking shape

Spending priorities naturally change over time, reflecting changes in political, economic and demographic backdrops. But the shifting shape of the state has been particularly pronounced over the course of the austerity decade, with the prioritisation of some key aspects of spending within a tight overall budget inevitably squeezing resources for many functions.

Annually managed expenditure has accounted for a growing share of total spend – with the State Pension accounting for a large part of that – leaving less leftover to be shared across departments. Within that departmental total, the split between current and capital spend has been relatively even, though the capital profile has been somewhat volatile. And within the reduced current departmental total, an increasing share has gone to health and international aid, leaving many other departments facing very sizeable reductions in spending.

### As austerity has altered the size of the UK state, so too has its shifted its shape

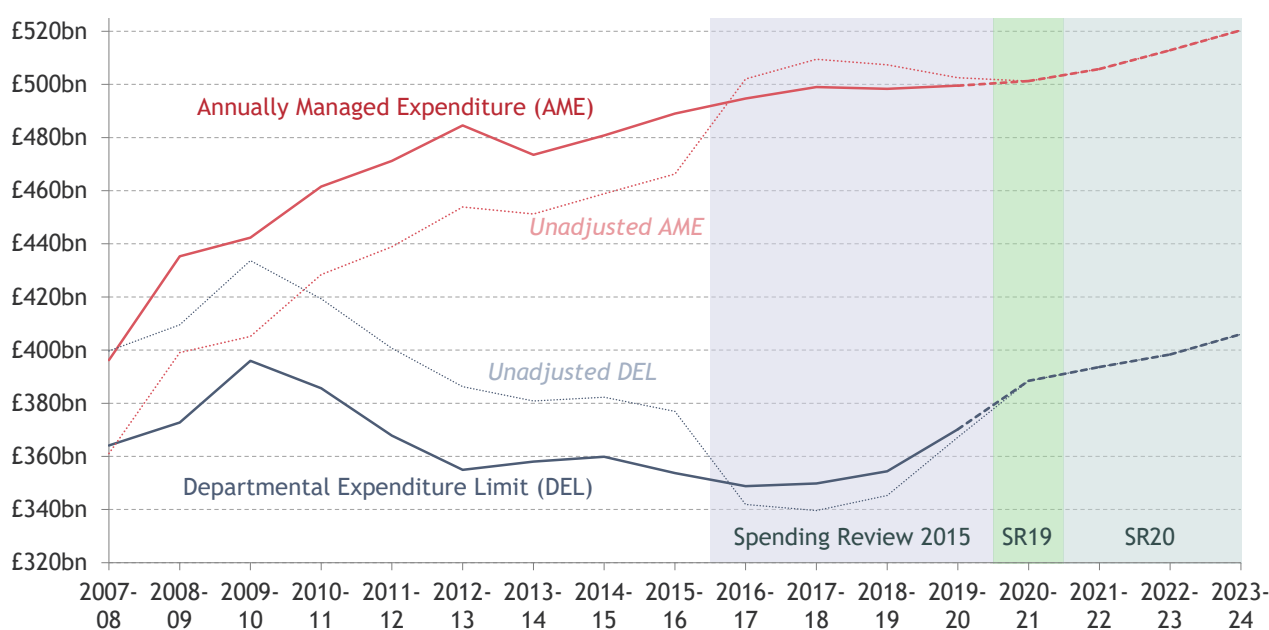
As noted in Section 1, real-terms TME has been broadly flat over the past decade – representing a break from the usual steady upward trend recorded over previous decades. Within that overall constraint however, the resources flowing to different forms of spending have varied somewhat. By drilling down into the different splits that exist within the total, we can determine where the biggest spending squeezes have occurred – and what that has meant for the overall shape of the UK state.

The first split worth considering is that between the departmental expenditure limits (DEL) that were the subject of the recent Spending Round, and the annually managed expenditure (AME) total which is less predictable and less directly controllable<sup>21</sup>

Figure 8 shows that AME has continued to rise throughout the period of austerity, reflecting both cyclical factors associated with the financial crisis and deliberate policy choices. Adjusted for inflation and removing the effects of past reclassifications, AME stands at an estimated £500 billion in 2019-20; up from £442 billion in 2009-10. In contrast, adjusted-DEL stands at an estimated £370 billion; well down on the 2009-10 peak of £396 billion. The 43 per cent of TME allocated to DEL in 2019-20 therefore marks a significant drop from the 47 per cent recorded in 2009-10. Following the Spending Round however, that share is set to climb back up to 44 per cent by 2023-24.

**FIGURE 8: Within the broadly unchanged overall spending total, an increasing amount has been spent on annually managed expenditure**

Total managed expenditure: UK, 2018-19 prices (GDP-deflator)



NOTES: DEL and AME figures are adjusted to remove discontinuities, where possible, such that the back series are consistent with the latest forecast. This includes major ONS classification changes and HMT policy decisions to switch spending between DEL and AME. Examples include the switching of Council Tax Benefit from AME to DEL in 2013-14 and the switching of localised business rates from DEL to AME in 2013-14. These data have been adjusted to account for recent methodological shifts relating to public sector pensions and student loans, with the entirety of this revision assumed to sit within AME.

SOURCE: RF analysis of OBR, Economic and Fiscal Outlook

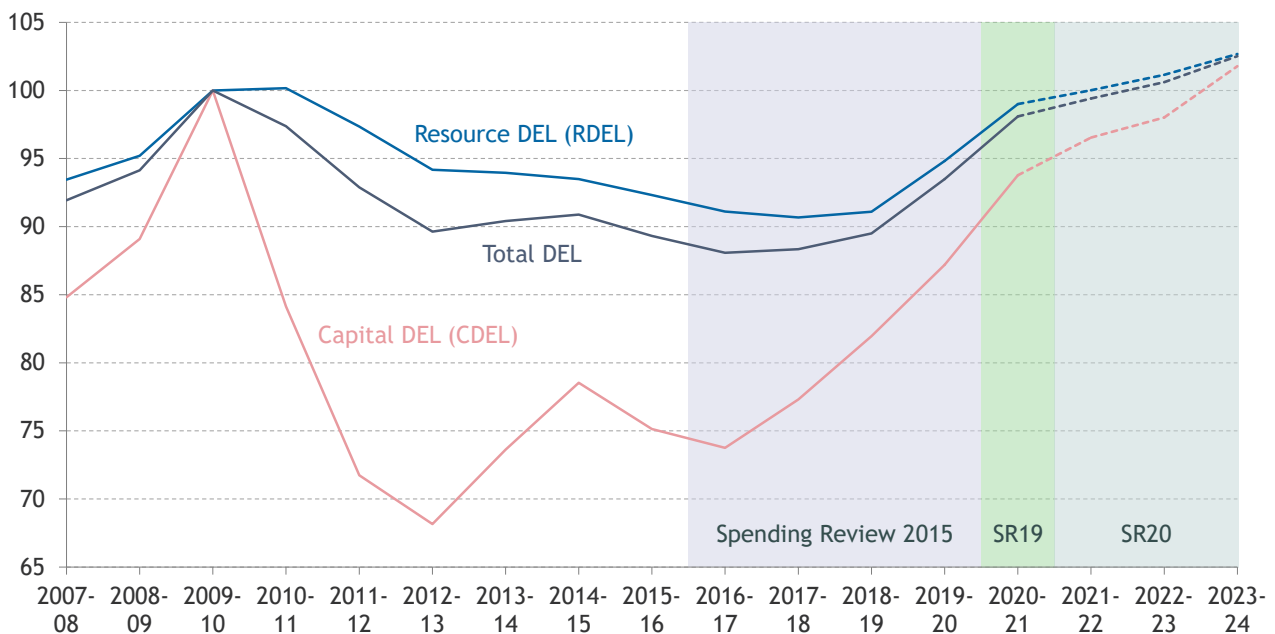
<sup>21</sup> It includes social security payments (accounting for around half the total), locally financed expenditure (12 per cent) and debt interest payments (9 per cent) for instance. It also includes student loans and public sector pensions – areas which have been subject to significant recent revision.

## Departments have accounted for a falling share of total spending, but the split between current and capital spending remains broadly unchanged

Focusing in more detail on DEL – in order to consider trends in spending on public services – we can observe still more shifts in the nature of government spending. Figure 9 splits overall DEL by that element which relates to day-to-day spending (*resource DEL*, or RDEL) and that which relates to investment spending (*capital DEL*, or CDEL).

**FIGURE 9: Even after the increases set out in Spending Round 2019, day-to-day departmental spend remains below its 2010-11 peak**

Departmental (DEL) spending in real-terms: UK, 2009-10=100 (GDP-deflator)



NOTES: DEL and AME figures are adjusted to remove discontinuities, where possible, such that the back series are consistent with the latest forecast. This includes major ONS classification changes and HMT policy decisions to switch spending between DEL and AME. Examples include the switching of Council Tax Benefit from AME to RDEL in 2013-14 and the switching of localised business rates from RDEL to AME in 2013-14.

SOURCE: RF analysis of OBR, Economic and Fiscal Outlook

As of 2019-20, RDEL is down 5.2 per cent on its 2009-10 peak. The extra spending set out for 2020-21 as part of the Spending Round is set to narrow that gap to 1 per cent, but – ahead of any post-election spending increases – RDEL is set to be just 2.7 per cent higher in 2023-24 than it was in 2009-10.

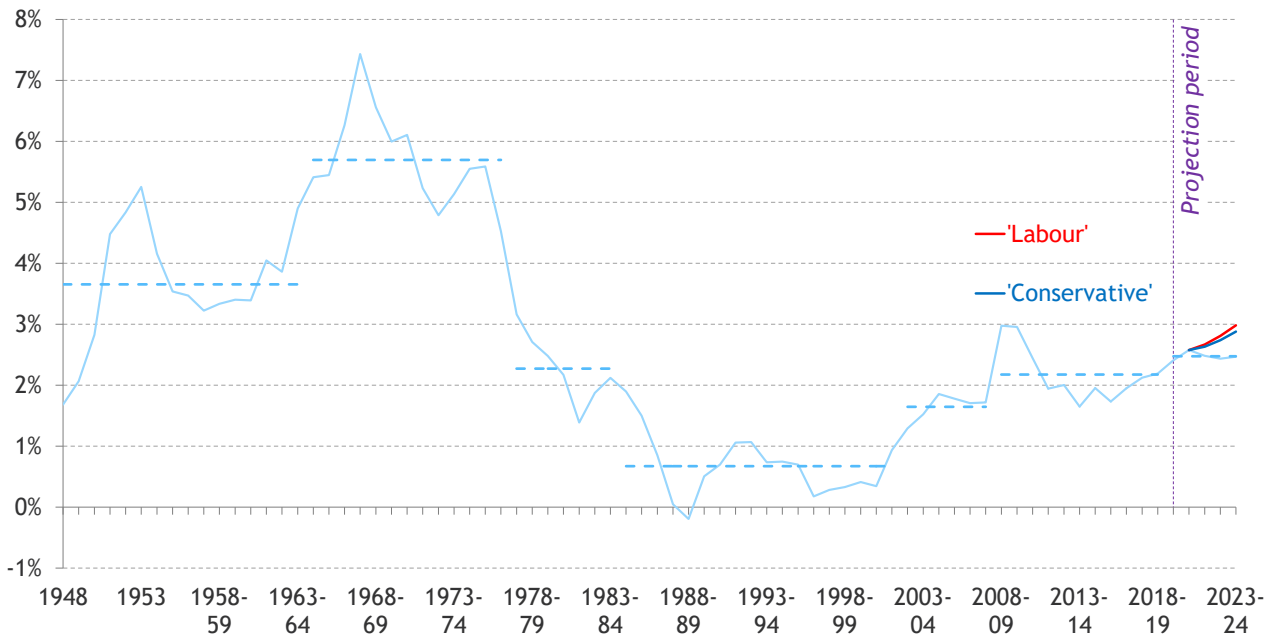
CDEL has fallen further (and evolved more erratically), to stand 13.2 per cent, down on 2009-10 in 2019-20. But that is a product of the spike in capital spending associated with the fiscal stimulus delivered in the immediate post-crisis period. Taking the more appropriate baseline of 2007-08, we can see that the 2019-20 CDEL total is up 2.8 per cent

(compared with equivalent growth of 1.5 per cent in RDEL). The split between RDEL and CDEL has barely altered over this timeframe.<sup>22</sup>

The longer-run trend in capital spending is more clearly shown in Figure 10. It details public sector net investment (PSNI) in the period since 1948, and highlights the long upward drift from the lows of the 1980s and 1990s recorded since the turn of the century. After adding in the effect of the recent Spending Round, PSNI is projected to rise to 2.6 per cent of GDP in 2020-21. Outside of the spike in 2008-09 and 2009-10, that would be the highest level of investment since 1978-79.

FIGURE 10: **Net investment could be returning to mid-1970s levels**

Public sector net investment as a share of GDP: UK



NOTES: Switch from calendar year to financial year from 1955-56. See notes to Figure 3.  
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook

By way of illustration, the chart also plots the PSNI paths that would be associated with the 'Conservative' and 'Labour' scenarios described in Section 2. It is worth stressing again that these scenarios are speculative ahead of the publication of the election manifestos, but they are in line with the prevailing rhetoric in the two parties. In both instances, PSNI would rise to levels last prevailing in the mid-1970s – before the era of privatisation.

<sup>22</sup> Nevertheless, RDEL has fallen as a share of TME from 40 per cent in 2007-08, to 39 per cent in 2009-10 and 36 per cent in 2019-20. And it has fallen as a share of GDP from 16 per cent in 2007-08 and 18 per cent in 2009-10, to just 14 per cent in 2019-20.

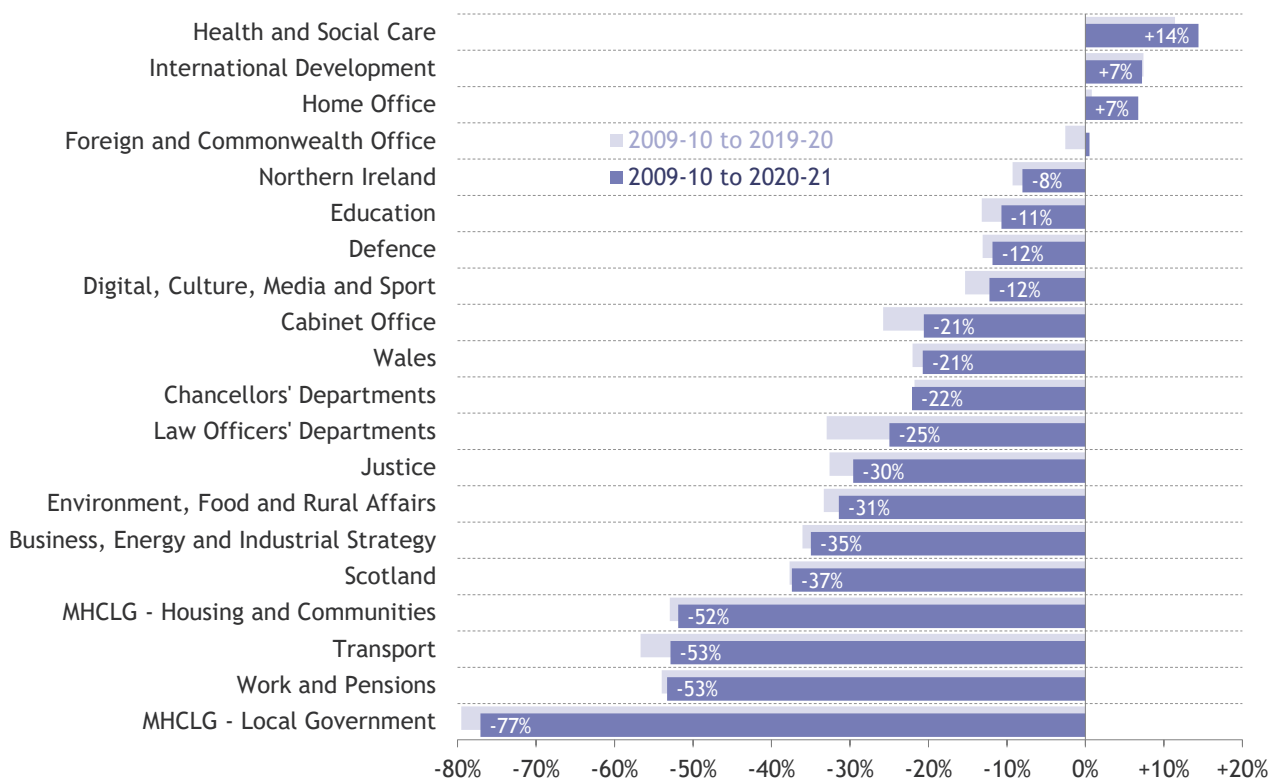
## But the split in spending across departments is much altered, resulting in very sizeable reductions in some departmental budgets

So overall spending has been broadly flat over the past decade, and departmental spending remains lower today than it was back in 2009-10. But how has this tighter spending backdrop played out across different public services?

Figure 11 offers some insight. It details the real-terms per capita change in RDEL spending recorded between 2009-10 and 2019-20 across different government departments, alongside the post-Spending Round plans for 2020-21. It shows that the new plans have the effect of reversing sizeable elements of austerity in some departments, but that very significant funding cuts are set to remain in place in many cases.

**FIGURE 11: Spending Round 2019 reversed part of the austerity cuts to departmental spending, but budgets remain much smaller than they were in many areas**

Cumulative real-terms change in per-capita RDEL since 2009-10: UK (GDP-deflator)



NOTES: Figures are adjusted as far as possible to account for machinery of government changes.

SOURCE: RF analysis of HMT, PESA, various and HMT, Spending Round 2019

It highlights also just how markedly outcomes vary across different departments. At one extreme, Local Government RDEL per capita is due to be three-quarters (77 per cent) lower in 2020-21 than in 2009-10, while many other departments (including Work

and Pensions, Transport, BEIS, Scotland and Justice for example) are facing reductions of between roughly one-third and one-half. But at the other end of the spectrum, the overall drop in per capita RDEL is translating into *increases* of 1 per cent (Foreign & Commonwealth Office), 7 per cent (Home Office and International Development) and 14 per cent (Health & Social Care).

These differences of course reflect competing political priorities. The NHS has been consistently protected from the spending cuts of the past decade for instance, and the above-inflation five-year funding settlement announced in June 2018 was sold as an explicit attempt to “regain core performance and lay the foundations for service improvements”.<sup>23</sup>

Other services have received partial protection or prioritisation at different times too. For example, Spending Review 2010 protected the real-terms schools budget for 5-16 year-olds and committed the government to increasing foreign aid spending to 0.7 per cent of gross national income from 2013. Additional pupil premium protection was included in Spending Review 2013<sup>24</sup> while Spending Review 2015 added a pledge to ensure defence spending didn’t drop below 2 per cent of GDP before the end of the decade. Such protections, delivered within a shrinking overall spending envelope and often applying to already large parts of the spending total, have resulted in the ‘residualisation’ of many other public services.

The impact of all this is apparent in Figure 12, which details how the composition of RDEL has shifted across departments over the austerity decade. The most obvious change is the huge increase in the share of RDEL flowing to Health & Social Care, with the proportion increasing by a third (from 31 per cent to 40 per cent) between 2009-10 and 2020-21. The shares accounted for by the Department of Education and the Ministry of Defence have remained broadly unchanged, and the Department for International Development has grown quite considerably (while still only accounting for 2 per cent of total RDEL). In contrast, the share flowing to all other departments is down by 26 per cent (from 38 per cent in 2009-10 to 28 per cent in 2020-21).<sup>25</sup>

The distribution of capital spending across departments has altered less dramatically, though. Transport, which accounts for the largest share of the total, has increased its share by 12 per cent (from 20 per cent in 2009-10 to 22 per cent in 2020-21). And BEIS, which has the second largest capital budget, has lowered its share by 10 per cent (from 16 per cent to 14 per cent).

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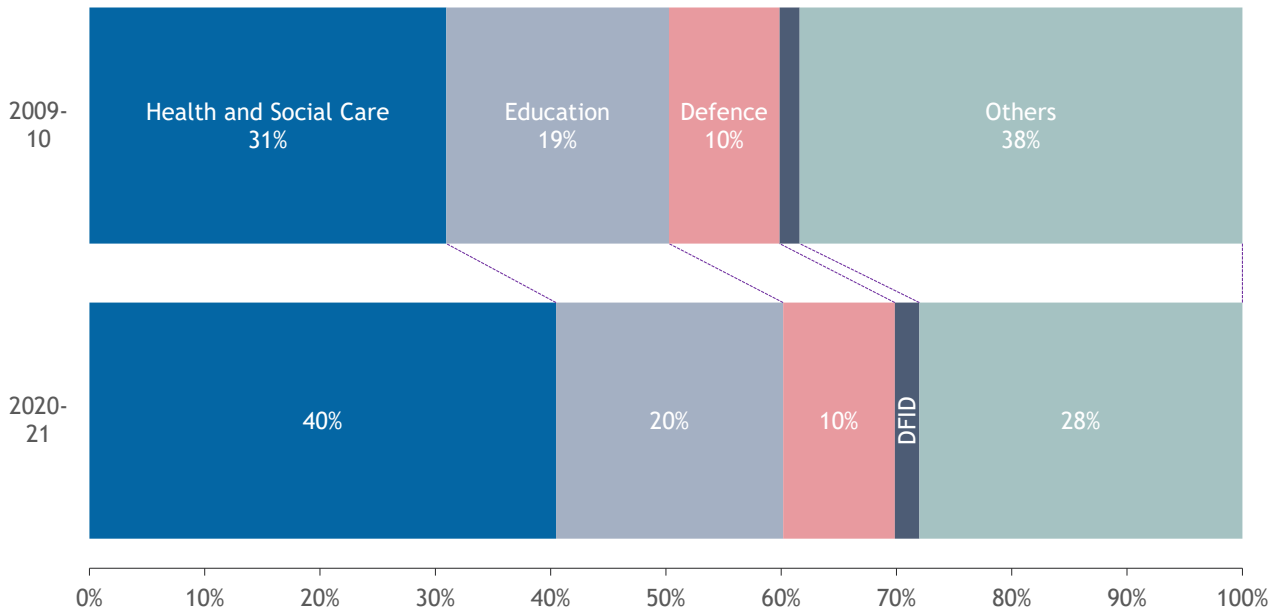
<sup>23</sup> DHSC press release, “Prime Minister sets out 5-year NHS funding plan”, 18 June 2018

<sup>24</sup> The premium was introduced in 2011 to provide publicly-funded schools in England extra money to help them raise the attainment of disadvantaged children. The Spending Review committed to maintain the rates of payment.

<sup>25</sup> Within this total, the share of RDEL going to the Home Office is up 23 per cent (from 3 per cent to 4 per cent). But the share going to Local Government is down 73 per cent (from 7 per cent to 2 per cent), the share accounted for by Work & Pensions is down 64 per cent (5 per cent to 2 per cent), the Transport share is down 45 per cent (from 2 per cent to 1 per cent), and Housing & Communities is down 44 per cent (1.4 per cent to 0.8 per cent).

**FIGURE 12: 40p of every £1 spent by government on day-to-day departmental spending is accounted for by health, up from 31p in the pre-austerity era**

Composition of RDEL by department: UK

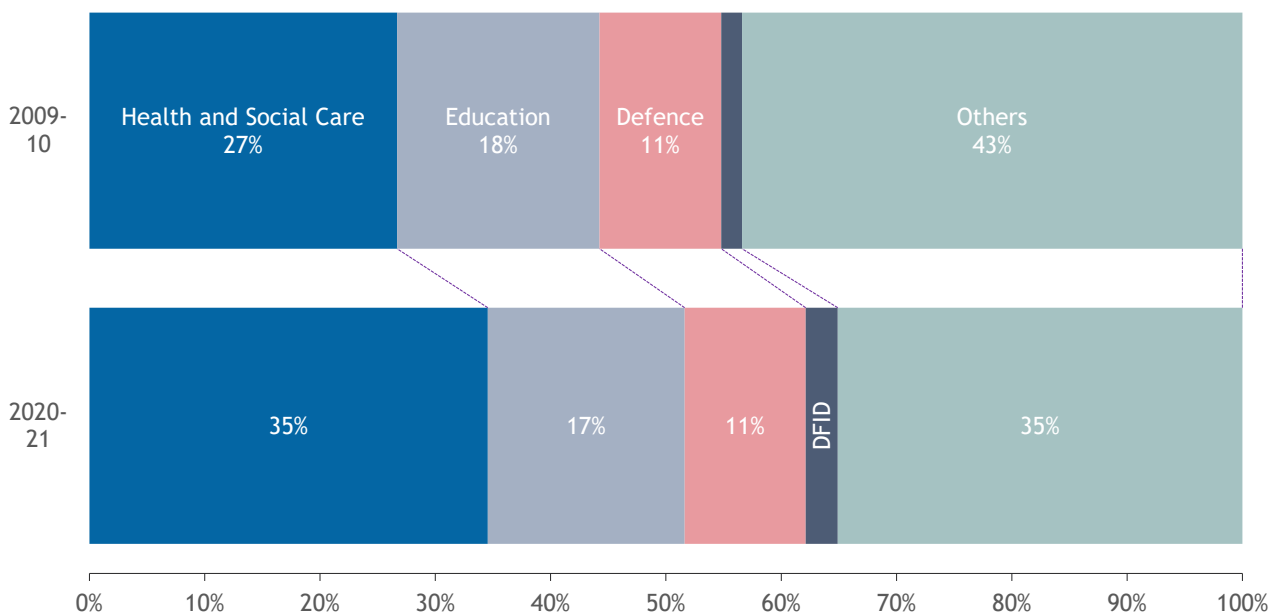


NOTES: Figures are adjusted as far as possible to account for machinery of government changes.  
SOURCE: RF analysis of HMT, PESA, various and HMT, Spending Round 2019

Taken together, it is the RDEL movements which dominate though – reflecting the much larger amounts involved – as highlighted by the change in composition of total DEL set out in Figure 13.

**FIGURE 13: After accounting for capital spending too, health accounts for one-third of day-to-day departmental expenditure, up from one-quarter in 2009-10**

Composition of total DEL by department: UK



NOTES: Figures are adjusted as far as possible to account for machinery of government changes.  
SOURCE: RF analysis of HMT, PESA, various and HMT, Spending Round 2019

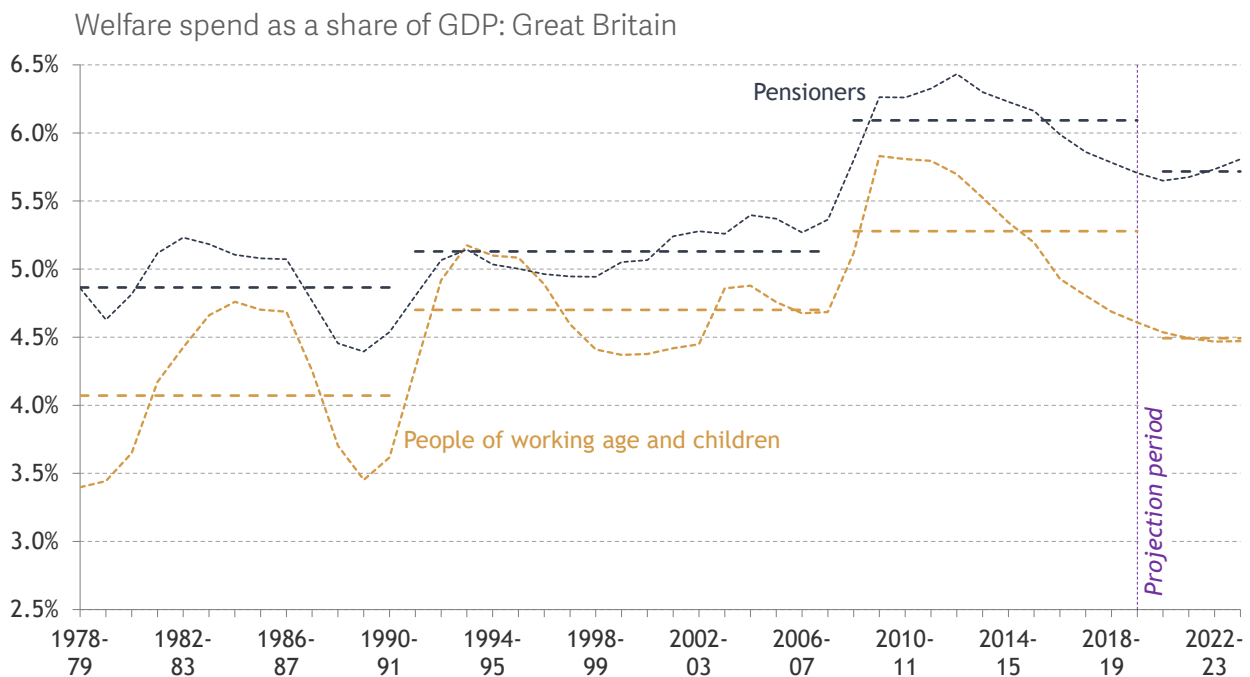


## The nature of social security spending has also changed considerably, with pensioner and working-age totals diverging

Switching to a consideration of what sits beneath the trend in AME over the past decade, it is worth focusing on what has happened to its biggest single component: social security. As with DEL, the overall trend masks movement within the total – with the split between spending on pensioners and on others being the major point of interest.

The share of GDP accounted for by social security spending among both pensioner and non-pensioner groups has shifted not just in this more recent period, but dating back to the late-1970s. This is shown in Figure 14, which focuses on Great Britain rather than the UK. It highlights the cyclical nature of spend on non-pensioners in particular, but also the extent to which the gap in spending between pensioners and others narrowed over the three decades prior to the financial crisis before widening thereafter.

**FIGURE 14: Welfare spending has accounted for a rising share of GDP over time, but the proportion flowing to non-pensioners has fallen markedly in recent years**



NOTES: Council Tax Benefit was abolished in 2013-14, with support instead transferring to the local level. These figures include adjustments to account for this shift.  
 SOURCE: RF analysis of DWP Benefit Expenditure Tables, MCHLG, Scottish government and Welsh government data

Between 1978-79 and 1990-91, pensioner benefit spending amounted to an average of 4.9 per cent of GDP while spending on working-age adults and children amounted to 4.1 per cent of GDP. That 0.8 percentage point gap more than halved between 1991-92 and 2007-08, with pensioner benefit spend rising only modestly to 5.1 per cent of GDP and

other spending jumping to 4.7 per cent of GDP. Indeed, a combination of elevated non-pensioner spending during the early 1990s recession, and a reduction in the pensioner total, meant that the former actually outstripped the latter for a brief period in the mid-1990s.

The gap widened again in the aftermath of the financial crisis, however. Spending rose for both groups – driven in part by the initial pass-through of the inflation spike in the form of benefit uprating – with the average social security spend between 2008-09 and 2019-20 jumping to 6.1 per cent of GDP for pensioners and 5.3 per cent of GDP for others; but the 0.8 percentage point gap of the 1980s was restored.

Under the projections set out at the Spring Statement, that gap looks set to widen to 1.2 percentage points. That's the product of combining a return to growth in the pensioner social security spend (with the average from 2019-20 to 2023-24 projected to stand at 5.7 per cent of GDP) with a continued fall in non-pensioner spending (such that the average from 2019-20 to 2023-24 is projected to drop to just 4.5 per cent of GDP – taking it back below the pre-crisis average).

In single-year terms, social security spending on pensioners is set to rise from 5.4 per cent of GDP in 2007-08 to 5.8 per cent of GDP in 2023-24 (an 8.3 per cent rise); whereas spending on working-age adults and children is set to fall from 4.7 per cent of GDP to 4.5 per cent of GDP (a drop of 4.6 per cent) over the same period. Measuring the spending totals in real-terms instead of relative to the size of the economy, the projected changes over the 16-year period stand instead at 32 per cent for pensioners and 16 per cent for others.

These spending trends are driven in part by underlying economic conditions and by demographics. Expenditure on unemployment benefits spikes during recessions, for instance. And the timing of the arrival of the baby boomer cohort into retirement affects the pensioner welfare bill. But clearly policy choices matter too.

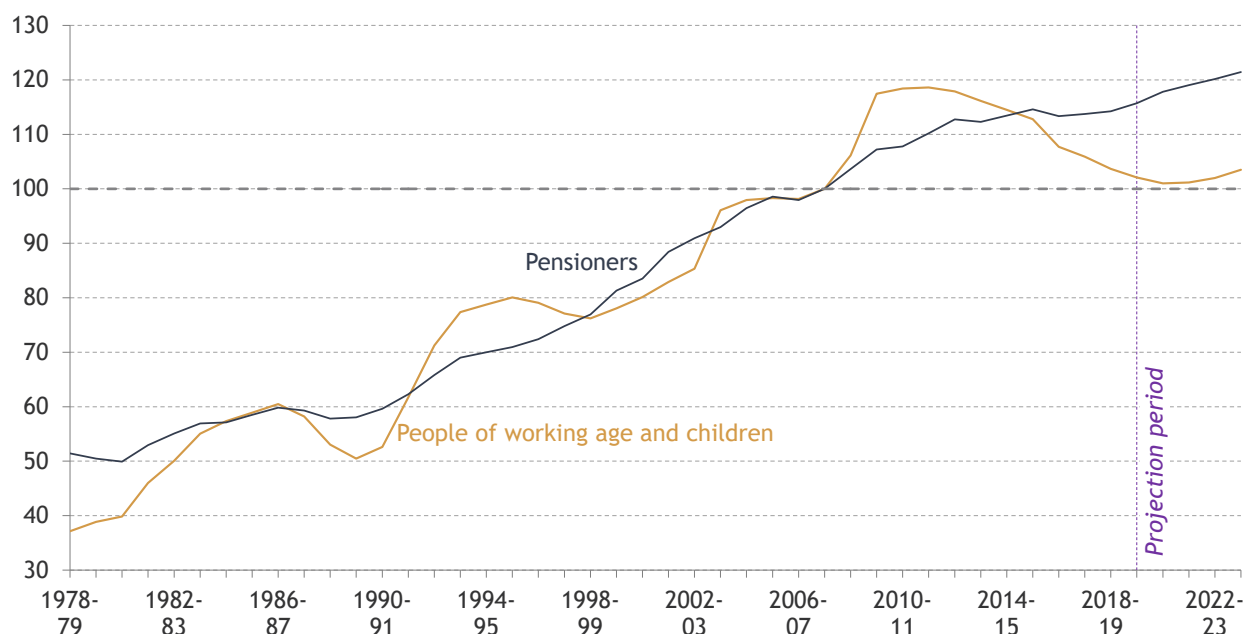
The raising of the State Pension age in recent years (first for women and more recently for all), has helped to slow growth in State Pension spending. But the other big factor over the past decade has been the political decision to protect the State Pension (via the introduction of the triple lock in 2011, whereby its value grows each year by highest of inflation, earnings or 2.5 per cent) while cutting the generosity of working-age benefits.

Indeed, selected initial real-terms cuts have been followed by a four-year freeze in the cash value of many benefits, and supplemented by changes in eligibility rules<sup>26</sup>

The distinction between demographics and policy choice is brought out in Figure 15. It shows the value of social security spending for the two population groups adjusted for their size – that is, the per person generosity of the different benefit payments.

**FIGURE 15: Increased spending on pensioners has been driven not just by demographics but by rising generosity too**

Real-terms welfare spend per person: Great Britain, 2007-08 = 100 (GDP-deflator)



NOTES: Council Tax Benefit was abolished in 2013-14, with support instead transferring to the local level. These figures include adjustments to account for this shift. Population statistics are adjusted to account for changes in the State Pension Age over time.  
SOURCE: RF analysis of DWP Benefit Expenditure Tables, MCHLG, Scottish government, Welsh government data and ONS population statistics

Again the cyclical nature of spending on the working-age and children group is evident, with spikes coinciding clearly with economic turmoil. But what's also clear is the broadly similar directions of travel followed by the per capita measures ahead of the financial

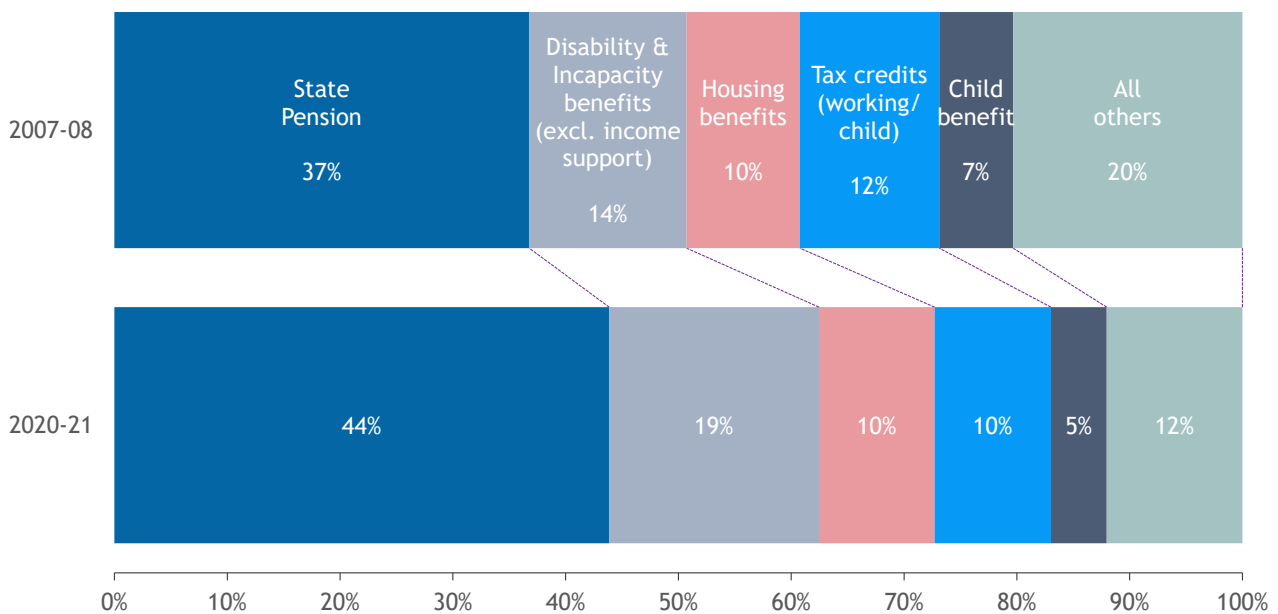
<sup>26</sup> We can consider some of the larger cuts in more detail. For example, the cash values of Child Benefit, Universal Credit, (non-disability) Tax Credits, Housing Benefit limits, Jobseeker's Allowance, Income Support, and Employment and Support Allowance (except the support group component) have all been held constant in cash terms between 2015-16 and 2019-20. This has led to a 6 per cent real-terms cut in the level of those benefits. In addition, the introduction of a two-child limit means children born after 6 April 2017 are no longer eligible for the child element of Universal Credit or tax credits if they already have two older siblings in receipt. The £545 family element payable to all tax credit and Universal Credit recipients with children was likewise removed from April 2017, as was the family premium in Housing Benefit. From the same date, the work-related activity component of Employment and Support Allowance (ESA) and the Universal Credit equivalent (payable to those claimants assessed as falling into the "Work-Related Activity Group") was also abolished – bringing the payment into line with Jobseeker's Allowance. Income disregards and work allowances in Universal Credit have also been cut back. Housing Benefit has been cut for some by the tightening of the Local Housing Allowance and by the introduction of an under-occupancy reduction for those in social housing who live in a property that is deemed to have more bedrooms than needed. The benefits cap has also placed a limit on the maximum any single family can receive in social security payments. The tightening of Child Benefit eligibility from January 2013 also produced large savings for the government.

crisis. They have diverged very markedly in recent years however. As of 2019-20, per person social security spend is up in real-terms relative to 2007-08 by 15.7 per cent among pensioners but just 2.1 per cent among working-age adults and children. And by 2023-24, those figures are projected to stand at 21.4 per cent and 3.5 per cent respectively.

Once again then, the post-crisis phase has made a significant difference to the composition of overall social security spending. Figure 16 presents the details. It makes clear the increased dominance of the State Pension in the overall picture, with the share allocated to this payment increasing by 19 per cent (from 37 per cent to 44 per cent) between 2007-08 and 2020-21.<sup>27</sup>

**FIGURE 16: The share of all welfare spending accounted for by the State Pension has jumped from 37 per cent to 44 per cent**

Composition of welfare spending: Great Britain



NOTES: 'State Pension' includes State Pension transfers. 'Disability & Incapacity benefits' includes Armed Forces Independence Payments, Attendance Allowance, Disability Living Allowance, Mobility Allowance, Personal Independence Payments, Employment & Support Allowance (and UC equivalents), Incapacity Benefit, Invalidity Benefit, Severe Disability Allowance and Sickness benefit. 'Tax credits' cover Working Tax Credits, Child Tax Credits and the Working Family Tax Credit. 'Child Benefit' additionally includes One Parent Allowance and Guardian's Allowance. Council Tax Benefit was abolished in 2013-14, with support instead transferring to the local level. These figures include adjustments to account for this shift in the 'All others' category. War Pensions are also added back in, having been removed from DWP data after 2001-02. SOURCE: RF analysis of DWP Benefit Expenditure Tables, MCHLG, Scottish government and Welsh government data

In proportional terms however, the 33 per cent increase in the share of total spending

<sup>27</sup> The use of 2007-08 as a starting point differs from the public services analysis set out in Figure 12 and Figure 13, which considered how the shape of expenditure had changed since 2009-10. That's in order to avoid taking as our start year a period in which recession-relevant welfare spending was particularly elevated. We are concerned in this instance instead with how today's social security make up compares with the steady-state that existed ahead of the crisis.

accounted for by disability and incapacity payments (from 14 per cent to 19 per cent) is even more pronounced. In contrast, the share of spending accounted for by Child Benefit has fallen by 24 per cent (from 7 per cent to 5 per cent). And the share of all benefits not otherwise listed is down 41 per cent (from 20 per cent to 12 per cent).

Austerity has dominated the fiscal landscape over the past decade, with much attention drawn to the range of areas in which government spending has been cut or in which historical rates of growth have at least been lowered. But the protection and prioritisation of some forms of expenditure within this constrained overall spending envelope has resulted in a very significant change in what the state does – both in terms of public services and in terms of social security.

That leaves the suspicion that at least some of this change is the product of a series of politically pragmatic decisions taken in isolation, rather than a carefully crafted strategic overview. Yet when these individual spending changes in public services and in welfare are added up, they result in a significant reshaping of the role of the state. And it is a reshaping that is likely to continue in the coming years as demographic headwinds start to blow with increasing intensity. That's the focus of the next section.

## Section 4

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### Shaping the future

The role of the state has shifted significantly over the past two decades, with spending on pensions and health accounting for a growing share of the total. In contrast, the shares of defence, public order and safety and housing and community services have all shrunk. These have largely been the result of policy choices – set within an overall context of a state that has grown in size over the longer period, but been subject most recently to an unprecedented decade of austerity.

Even more profound changes look set to follow over the medium-term, flowing this time from demographic pressures. Crucially, our ageing population is likely to push in the same direction as the policy choices that have prevailed over the past two decades, concentrating state spending even more on the old and the sick. Absent cuts in other spending or a change in how the state seeks to meet this demand, the implication is that total expenditure will need to continue to rise as a share of GDP.

**Taken together, our state is now significantly more focused on health and on the old than has been the case in the past**

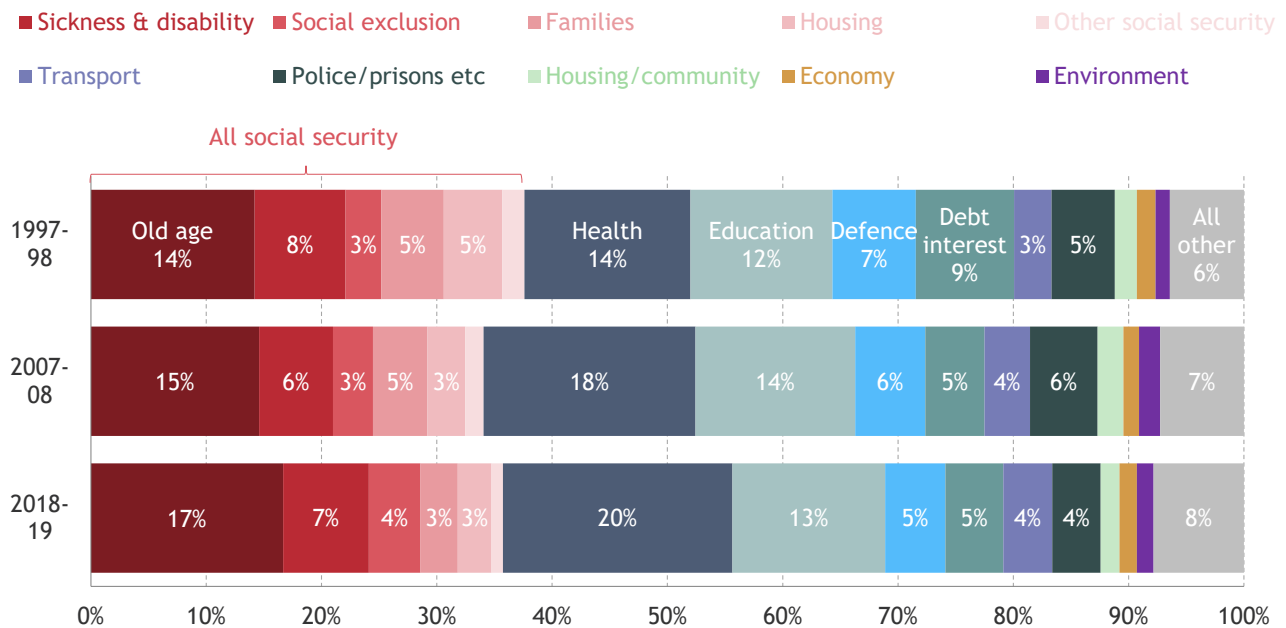
Figure 17 brings together the analysis of public service and social security spending set out in Section 3, showing how the share of overall UK government spending allocated to different *functions* has evolved since 1997-98.<sup>28</sup> Six important conclusions stand out.

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<sup>28</sup> The timeframe considered differs once again from that used in earlier sections. In this instance the analysis runs only to 2018-19, reflecting the latest year for which such detailed 'function' data is available. It therefore takes no account of the expenditure set out as part of Spending Round 2019. We have, however, made a manual adjustment to the education total (and the overall total) to account for the new student loans accounting treatment.

FIGURE 17: Public sector expenditure is increasingly focused on health and on old age social security

Composition of public sector expenditure by 'function': UK



NOTES: All other' includes: culture & religion, agriculture, energy, general public services and EU transactions. Education spend is adjusted to account for the new student loan accounting treatment. SOURCE: RF analysis of HMT, PESA, various; Eurostat, ESA 2010 Table 1100; ONS, Public sector finances

- First, the share of total spending accounted for by social security has fallen over the longer period. The 2018-19 total (36 per cent) is higher than the 2007-08 one (34 per cent), but it is down 5 per cent on the 1997-98 figure (38 per cent).
- Secondly however, within that overall reduction the share allocated to old age welfare spending has increased. Having accounted for 14 per cent of public sector expenditure in 1997-98, such spending now comprises 17 per cent of the total.
- Third, the other big increase relates to health. Such spending (covering medical services, medical research and central services) accounted for £1 of every £5 spent on the public sector in 2018-19, up by 38 per cent on the 1997-98 share – twice the proportional increase recorded in relation to old age welfare spending.
- Fourth, the share of spend allocated to defence has fallen by 28 per cent (from 7 per cent in 1997-98 to 5 per cent in 2018-19). A similar pattern holds in relation to the share of spending accounted for by public order and safety, which has fallen by 23 per cent (from 5 per cent to 4 per cent).
- Fifth, spending shares have increased significantly in relation to transport (up 30 per cent over the period) and the environment (up 17 per cent). But they have fallen for housing/community services like housing development, street lighting and community development (down 16 per cent) and general economic and labour affairs (down 7 per cent).

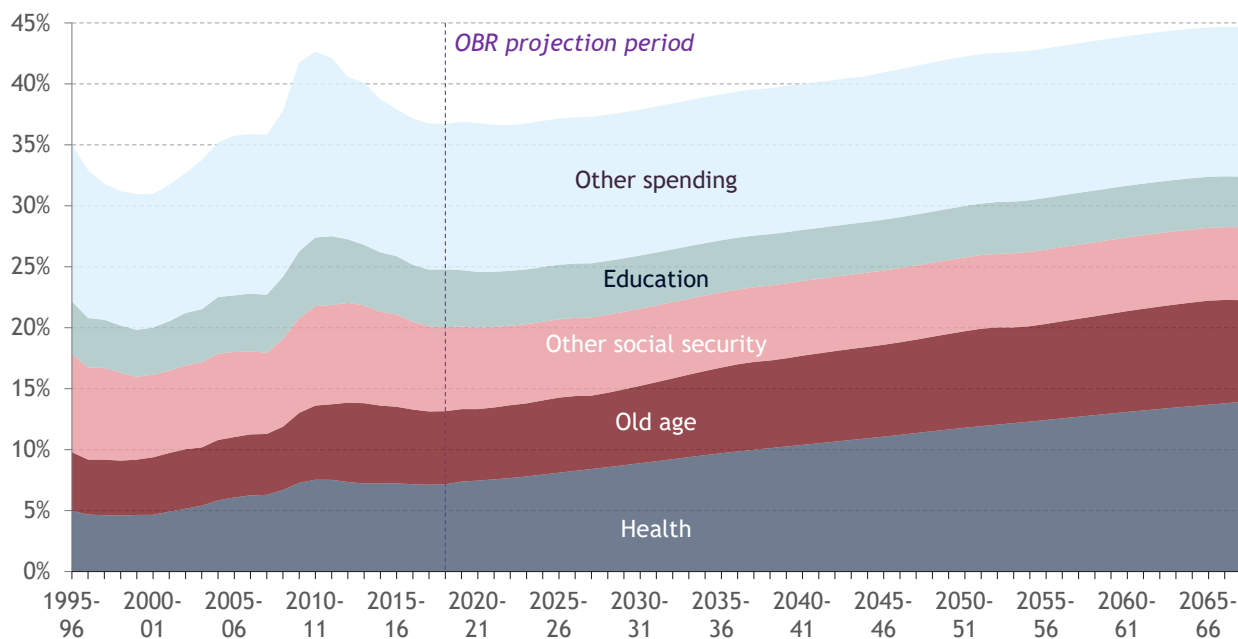
- Sixth, the biggest proportional drop of all relates to debt interest payments. Such expenditure accounted for 9 per cent of public sector spend in 1997-98, but just 5 per cent in 2018-19. This has occurred despite the large increase in public sector debt over this period, and is driven by the historically low level of today's interest rates.

## And the expectation is that this policy-driven shift will continue into the future, driven this time by demographic change

Figure 18 amalgamates some of the *function* groupings above and uses OBR projections to consider how expenditure on each might evolve over the coming decades. It is, of course, only as good as the assumptions that underpin it – but it has the merit of being predominantly policy neutral.<sup>29</sup> That is, the trends described are those which might apply in the absence of policy change, and are therefore driven primarily by demographic and economic factors.

**FIGURE 18: The share of GDP accounted for by spending on health and old age social protection could rocket over the coming decades**

Outturn and projected non-debt interest public sector expenditure as a share of GDP: UK



NOTES: 'Other spending' includes: defence, police/prisons, housing/community, economy, environment, culture & religion, agriculture, energy, general public services and EU transactions. Education spend is adjusted to account for the new student loan accounting treatment.

SOURCE: RF analysis of HMT, PESA (various) and ONS, ESA Table 11; OBR Fiscal Sustainability Report 2018; ONS, Public sector finances

<sup>29</sup> More specifically, the OBR modelling includes the spending set out under the five-year NHS funding settlement, but not the departmental totals detailed in Spending Round 2019. It assumes also that the State Pension triple-lock remains in place throughout. In this analysis, debt interest payments are removed from the total – in line with the OBR approach.



It suggests that, all else equal, non-debt interest spending as a share of GDP is set to rise considerably over the coming years. Relative to the 2018-19 outturn, the spending-to-GDP ratio is projected to rise by 22 per cent by 2067-68. Applying such an increase to the 30.9 per cent of GDP baseline recorded (including debt interest) in Figure 2, results in TME ending the period at 48.8 per cent of GDP – a figure well above the post-war peak of 46.6 per cent of GDP reached in 2009-10. If the next government chooses to increase spending on some functions above that demanded by the demographic headwind, then this increase may end up being even greater still.

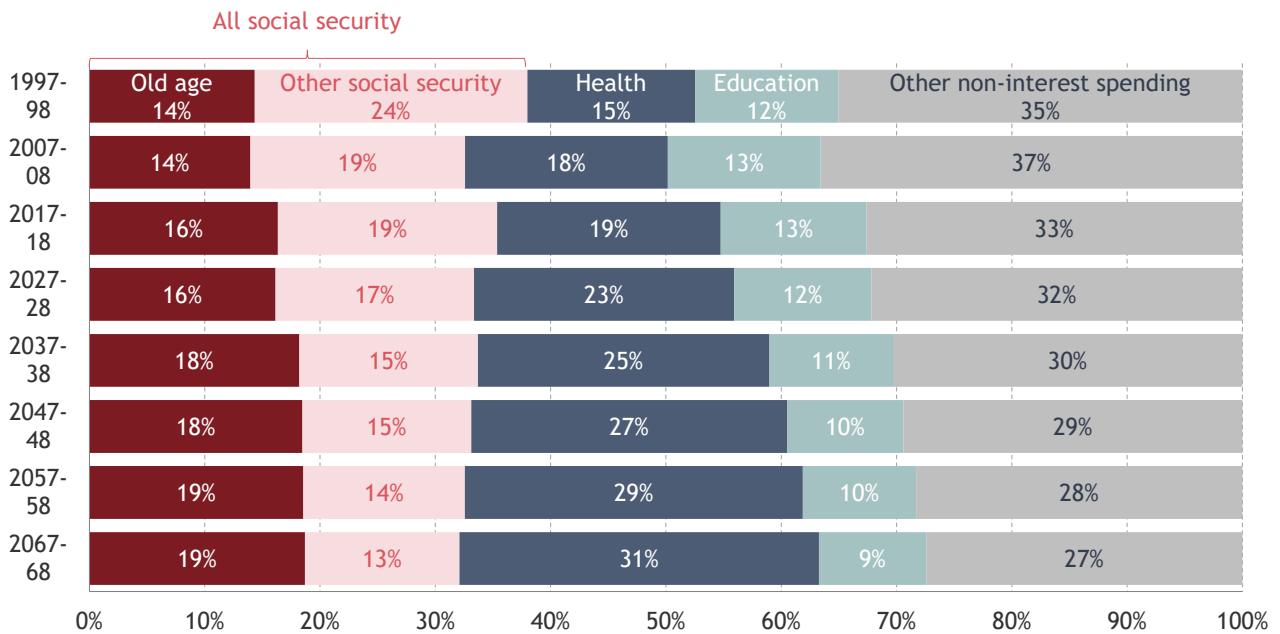
That's obviously a very significant change, and one that doesn't necessarily have to come to pass. But even if only *some* of this increase is delivered in practice, it still has very important implications for all of our futures: implications that the next government would do well to contemplate as it sets out its new programme of spending priorities.

It is important therefore, to understand what is driving the projected increase. The answer lies overwhelmingly with the projected trends in spending on old age social security and on health – factors which lie in turn with the ageing of our population. Such expenditure is modelled to rise from a combined 13 per cent of GDP in 2018-19, to 15 per cent of GDP by 2028-29 and 17 per cent of GDP by 2038-39. By the end of the projection, in 2067-68, health (14 per cent) and old age (8 per cent) spending is together expected to amount to 22 per cent of GDP – up two-thirds (67 per cent) on the 2018-19 ratio.

Put another way, as shown in Figure 19, old age social security and health expenditure could together account for half (50 per cent) of all non-debt interest spending by 2067-68. Within this, health spending on its own could account for close to one-third (31 per cent) of the total. In contrast, the share of total spending accounted for by non-old age social security drops from 19 per cent in 2017-18 to 13 per cent in 2067-68 under this modelling. And the share flowing to education falls from 13 per cent to just 9 per cent.

**FIGURE 19: Spending on health and on the old could account for nearly 50p of every £1 of non-debt interest spending by the middle of the decade**

Outturn and projected composition of non-debt interest public sector expenditure on services: UK



NOTES: All other' includes: defence, transport, police & prisons, housing, the economy, the environment, culture & religion, agriculture, energy, general public services, debt interest payments and EU transactions.  
 SOURCE: RF analysis of HMT, PESA (various) and ONS, ESA Table 11; OBR Fiscal Sustainability Report 2018

But these proportions are calculated on the assumption that increased spending on health and on the old does nothing to crowd out expenditure on other functions. Future governments will almost certainly adopt policies designed to head off some part of the challenge.

That may involve meeting the increased healthcare and pensions bill by squeezing spending on other services – doubling down on some of the austerity-related trends. Alternatively, it may involve altering the healthcare or pension offer available to citizens – reducing access, scaling back provision and/or pushing some services into the private sector. Simply meeting the increased bill will require a big increase in government revenues – and therefore tax. All of the choices are difficult, and all represent further fundamental change in the nature of the British state.

## Section 5

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### Conclusion

With austerity now over, the coming election campaign is set to be marked not just by Brexit but by a flurry of new spending promises. Some of these will be designed to ease pressures in those public services most visibly and most immediately under strain; some will focus on supporting future economic growth – with both main parties talking up the need for a renewed period of investment in infrastructure; some will inevitably be made with an eye to winning votes.

Yet it is vital that political parties take a step back too, in order to design a spending plan that simultaneously tries to deal with the legacy of austerity and the coming challenges from demographic change. This will mean implementing a new fiscal framework that reflects the realities of today's economy and offers sustainability for the public finances.

Such plans must operate against the backdrop of a state that has already changed in a significant way. Austerity has of course played a key role, producing an unprecedentedly long pause in spending growth. This of course sets the context within which all other decisions are made. But the policy choices we have made within that constrained context have had a profound impact too, concentrating a greater share of expenditure on healthcare and on the old and squeezing out many other functions.

Heading into the 2020s, the ageing of our population is set to double-down on this policy-generated change, driving ever more public resource towards supporting the old and the sick. There are therefore many tough decisions ahead, and likely further profound changes in the nature of what the state does. The outcome of the 2019 election could go a long way to determining how that plays out.

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For more information on this report, contact:

**Matthew Whittaker**

Deputy Chief Executive

[matthew.whittaker@resolutionfoundation.org](mailto:matthew.whittaker@resolutionfoundation.org)

Resolution Foundation

2 Queen Anne's Gate

London SW1H 9AA

Charity Number: 1114839

@resfoundation

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