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Debt dramas

Putting the public finances in context ahead of general election 2024

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Summary

The public finances have already emerged as a key battleground in this election. This is a common feature of UK elections, with the weight given to the issue partly reflecting a system of government in which the winner has more complete control over the levers of spending and taxation than in most advanced economies. But in recent years, our national preoccupation with fiscal policy has been amplified by an unprecedented peace-time rise in public debt.

So far, the daily cut and thrust of the election campaign has involved both main parties accusing the other of making specific unfunded commitments. Both are focusing less on the far more material, big-picture fiscal challenges we face. So, in this briefing note, we step back and ask how we got to where we are today, discuss where the public finances might be heading, and consider what this means for whoever forms the next government.

The size of the state has shrunk and then expanded since 2010, ending up in a similar place to where it started…

Following the 2010 election, there was a clear goal of shrinking the size of the state. There were deep cuts to overall government spending (total managed expenditure, or TME), leading to an unprecedented nine-year fall in spending. TME fell as a proportion of the economy from 46.5 per cent in 2009-10 to 39.5 per cent in 2018-19 – the equivalent of £1,500 per household in today's money. But the fall in spending happened more slowly than planned, with the cuts pencilled in at Budgets immediately following the 2010 and 2015 elections slated to be the fastest since the 1980s.

Since 2018, the size of the state has started to increase once again. Successive fiscal events saw political decisions taken to start to reverse public spending cuts. Indeed, the Spending Round in 2019 delivered the largest increase in day-to-day spending on public services (resource departmental expenditure limits, or RDELs) since Spending Review 2002. Since the 2019 election, initial plans to undo around one-quarter of the cuts to day-to-day spending and three-quarters of cuts to public investment during the 2010s by 2024-25 have been delivered.

But a much larger rise in the size of the state proved necessary when the pandemic hit, and then again during the cost of living crisis. TME hit a post-war peak of 53.1 per cent of GDP in 2020-21. So, by the end of the most recent Parliament, the size of state was just 2.4 percentage points lower than where it started in 2009-10 (at 44 per cent of GDP in 2024-25). This has moved the UK from having a relatively small state – smaller than all but two of the eleven rich countries we have comparable data for in 2019 – to an average-sized one in 2022.

…but its shape has changed significantly

Day-to-day public service spending as a proportion of the economy fell by a quarter during the austerity years, dropping from 18.3 per cent in 2009-10 to a low of 13.9 per cent in 2018-19, equivalent to a drop of nearly £40 billion in 2024-25 prices. All departments, except the Department of Health and Social Care (DHSC), had their budgets reduced sharply. The cuts to Transport (61 per cent), Housing and Communities (56 per cent) and the Department for Work and Pensions (46 per cent) reduced real, per-person spending by at least half. On top of that, capital budgets (capital departmental expenditure limits, or CDEL) were cut by around a third as a proportion of GDP from 3.8 per cent to 2.6 per cent over the 2010s. Welfare spending also saw significant reductions, which was down by a fifth relative to the size of the economy between 2009-10 and 2019-20, equivalent to a drop of £49 billion. Cuts were inflicted most heavily on non-pensioner benefit spending, which fell by a quarter as a proportion of GDP, compared to one-tenth for pensioner benefits.

Since 2010, day-to-day spending on public services has become even more concentrated in health, with the budget of the DHSC set to increase by 22 per cent in real, per-person terms between 2009-10 to 2024-25. This reduced the gap in health spending between England and Scotland from 10 per cent to 1 per cent in real, per-person terms from the start of the 2010s to 2022-23. This meant that by 2024-25, 42p of every £1 of day-to-day spending is set to be on health, up from 32p in 2009-10.

The pandemic and cost of living crisis have also prompted a rise in other components of spending. Debt-interest costs are set to rise by 1.5 percentage points of GDP between 2019-20 and 2024-25, as the cost of living crisis triggered a huge rise in longer-term interest rates and levels of public debt have increased. Similarly, welfare spending is expected to rise by 1.2 percentage points by 2024-25 (three times what was expected in the Spring Budget 2020), mainly reflecting the important decision by the Government to protect benefit incomes from rises in inflation.

Overall since 2010, while the size of the state is not vastly different, the shape of the state has changed significantly. There has been a fall in day-to-day spending on public services: on a real, per-person basis, day-to-day spending on public services is set to be 6 per cent below 2009-10 levels in 2024-25, a fall from 18.3 per cent in 2009-10 to 15.4 per cent in 2024-25 as a proportion of national income. And this has been partially offset by the rise in debt interest, which has nearly doubled from 1.8 per cent of GDP in 2009-10 to 3.2 per cent in 2024-25.

Spending pressures have led to a rise in taxes – but not enough to stop debt rising

As spending pressures have increased since 2019, so have taxes. The tax-to-GDP ratio is set to rise by around 4 percentage points between 2019-20 and 2024-25. The majority of this comes from higher taxes on income, with Income Tax alone up by the equivalent of £2,200 per household between 2019-20 and 2024-25. Another key component was the rise in Corporation Tax, which contributed an increase in the tax-to-GDP ratio of 1.4 percentage points between 2019-20 and 2024-25.

This upward pressure on taxes, driven by the expanding size of the state, has been exacerbated by weak economic growth. Since 2010, had GDP growth continued at pre-financial-crisis rates, the economy would be more than 20 per cent bigger, with annual receipts roughly £200 billion higher. The UK's tax-to-GDP ratio is currently forecast to continue rising, with National Account taxes increasing by a further 0.7 per cent of GDP over the next four years, reaching 37.1 per cent of GDP by 2028-29, the highest level since 1948.

Increases in taxes have offset over 90 per cent of the rise in total public spending since 2019. And, although taxes have risen, it has not been enough to stop debt rising. Public debt is set to increase by 15 percentage points of GDP between 2019-20 and 2024-25, the second largest rise over a parliament since the Second World War, and the largest rise in the G7 (to 2023). This has left underlying debt on course to reach 92 per cent of GDP by 2024-25, according to the OBR's March 2024 forecast, its highest level since the early 1960s.

The uncertainty surrounding the fiscal outlook dwarfs sums involved in political arguments around small policy changes

At the time of this year's Budget, the OBR forecast implied that the Government had just £9 billion of headroom against its binding fiscal rule of bringing down underlying debt in the fifth year of the forecast, the second lowest since the inception of the OBR. But there is significant uncertainty over how this outlook could change ahead of the next government's first fiscal event. Looking ahead, there is certainly scope for fiscal 'windfalls'; for example, the costs of servicing debt could fall if the Bank of England cuts its policy rate more quickly than already built into the fiscal forecasts as inflationary pressures recede in the coming months (every 1 percentage point of lower long- and short-term interest rates reduces borrowing by around £12 billion by the end of the OBR's forecast).

But there is also a significant risk that the outlook could be much worse than expected. Even if Bank of England rate cuts eventually feed through into lower debt-servicing costs, current market pricing implies borrowing would be just over £2 billion a year higher on average between 2024-25 and 2026-27. There are also additional costs that have become clearer since the OBR's March forecast. These include one-off compensation for the victims of infected-blood products, estimated to be around £10 billion; and increased spending on asylum applications and migration policies, which could plausibly increase spending by an additional £4 billion each year.

In addition, despite somewhat faster-than-expected growth in Q1 2024, the OBR's forecast for productivity growth – the key assumption underpinning growth in future tax receipts – remains above levels sustained since 2010. If the OBR made a modest change to its assumption about future productivity growth by closing half of the gap between its current assumption for longer-term productivity growth (1.1 per cent) and the post-financial-crisis (2013 to 2019) average (0.7 per cent), this would add around £17 billion to borrowing by the end of the forecast period.

The combined impact of these fiscal-forecast factors would be enough to put underlying public-sector net debt on a rising path, with debt £72 billion higher by 2028-29, and rising as a proportion of GDP by £12 billion, breaking both main parties' commitments to have debt falling as a share of national income in the final year of the forecast.

Spending plans that could prove very difficult to deliver mean that neither main party has a credible plan to get debt falling

But the OBR's forecast for debt to fall in the final year of the forecast relies on spending plans that imply £19 billion of cuts to unprotected departments – such as Justice, the Home Office and Local Government – by 2028-29. Spending reductions on this scale could be very difficult to deliver, not least because some public services remain under severe pressure. For example, the proportion of crime victims not satisfied with the police increased from three-in-ten in 2010-11 to four-in-ten by 2022-23; around one-in-four crown court cases took over a year to be dealt with compared to one-in-twenty in 2014; and the proportion of people not satisfied with the way the councils are run has increased from three-in-ten in 2012 to four-in-ten by 2023. This means that the quality of some public services is lower than at any time since the Conservative Party came to power in 2010. Removing the cuts to unprotected departments, and combining them with our fiscal forecast factors, implies that around £33 billion of savings would be needed to get debt falling as a proportion of GDP.

Spending commitments from the main parties add to these challenges but are dominated by them. At the time of writing (ahead of manifestos being published), both parties appear to have small, unfunded spending commitments. For example, the Conservative Party has said it would increase defence spending to 2.5 per cent of GDP by 2030-31, which would require the Government to spend around £4 billion more on defence by 2028-29. While official announcements claimed that this additional spending would be funded mainly through plans to shrink the size of the Civil Service, this would imply even larger cuts to unprotected departments. For its part, the Labour Party also has some small spending commitments which are currently seemingly unfunded: for example, the proposal for a 'Fair Pay Agreement' in social care which would increase public spending if it increased pay levels in the sector. And both main parties have set out unfunded policy aspirations beyond the specific commitments made so far. For example, the Conservative Party has said its goal is to entirely scrap worker National Insurance, a tax that currently brings in more than £50 billion. And the Labour Party has said that it too would raise defence spending to 2.5 per cent of GDP, "as soon as resources allow".

Whichever main party forms the next government, it is likely that additional policy commitments – at least those announced so far in the campaign – will increase government borrowing and debt, but only marginally. Indeed, it is very striking that the commitments made so far have been relatively small compared to the size of those made at the 2019 election, when both the Conservative Party and the Labour Party set out specific policies which added much more significantly to debt.

The biggest fiscal challenge isn't election commitments made by the main parties, but underlying uncertainty and the deliverability of existing government plans. This means that, while the outlook remains very uncertain, and despite their relatively muted spending ambitions so far, neither main party appears to have a fully credible plan to respond to these key fiscal risks and get debt to fall by the end of the next parliament.

Even if there is little to choose between the parties in terms of the net impact on the public finances from their commitments so far, that is not to say both parties are indistinguishable in terms of their attitude to tax and spend. On taxes, the Labour Party has said that it will put in place a number of small tax rises to pay for its specific spending increases, including on health and education. The Conservative Party have focused rhetorically on lower tax, with more details of specific policy likely to forthcoming in the manifesto.

There are options for the next government to consider if uncertainty turns into bad news after the election

So, with an uncertain economic outlook, pressures on spending unlikely to dissipate, taxes at historic highs and headroom against getting debt falling already wafer thin, it is likely to be an unenviable fiscal inheritance for winner of the election. If bad news arrives, history tells us that taxes often rise after elections. But there are options, proposed as part of the wider fiscal debate, that could be deployed. Two examples of these could include:

- Tweaking the fiscal rules, from a target based on public sector net debt excluding the Bank of England, to one focused on total debt, which would expand an incoming government's capacity to borrow by £16 billion in 2028-29; and

- Asking the Bank of England to move to a system of 'tiered' reserves remuneration which would reduce spending on debt interest by up to £8 billion by 2028-29.

These options are not without cost – and so far, neither main party has said that it intends to pursue them – but they could offer potential strategies for managing the downside risks to the fiscal outlook if they crystallise during the next parliament. And of course, the next government would also have scope to reprioritise spending plans: rather than reducing spending on day-to-day public services, or capital, other spending commitments – included in annually managed expenditure – could be reduced. Finally, looking beyond the next five years, the UK is likely to need to run surpluses to put public debt on a sustainable path. This puts the onus on parties to locate plans for looser fiscal policy in the next parliament within a longer-term strategy to put debt on a decisive downward path.

Our fiscal debate has become detached from fiscal reality

The focus of debate in an election is understandably on the new announcements made by the main parties, and the extent to which such plans are fully funded, or whether they necessitate an increase in borrowing. But a far more important issue is the wider fiscal context. Despite the significant uncertainties, delivering the spending plans that both parties are implicitly or explicitly signing up to poses substantial challenges. As things stand at least, neither main party can be confident that they have a robust plan to meet the big-picture challenges we face as a country.

The public finances will be a key election battleground

Management of the public finances has already been hotly debated during this election campaign. Fiscal policy commonly plays a relatively large role in UK election debates, partly reflecting a system of government in which the winner has more complete control over the levers of spending and taxation than in most advanced economies.[1] But our focus on the public finances has been amplified by our recent history of an unprecedented peace-time rise in public debt since the financial crisis.

To date, the election debate has involved both main parties accusing the other of making specific unfunded commitments. What we have heard less about is the far larger fiscal challenges that we face. In this briefing note we discuss the fiscal context to the upcoming election. We start by setting out how we got to where we are today, before moving onto where the public finances are heading over the next parliament, and what that means for whoever forms the next government.

The fiscal challenges the next government will face are a product of past economic shocks and policy choices

The pre-election state of the public finances is a product of economic circumstances and policy decisions taken by successive governments since the financial crisis. Below we discuss both, distinguishing between the periods from 2010 to 2019, a period in which decisions were taken to shrink the state; and from 2019 to 2024, a period in which large shocks and higher spending increased the size of the state markedly.[2]

The 'austerity' years led to a shrinking of the state, but not by as much as planned

The period from 2010 to 2019 saw a shrinking of the state, as deep cuts were made to public spending. The coalition government set itself the task of bringing down the deficit which had increased sharply during the 2008 crisis. What followed was the longest pause in state spending as a share of the economy on record (Figure 1), with nine consecutive years of falling total manged expenditure (TME), as a proportion of GDP, eclipsing the six-year pause in the 1980s. These cuts were equivalent to £1,500 per household in 2024-25 prices.

However, the cuts would have been even swifter and more severe had they followed the actual plans set out following the 2010 and 2015 elections. Both sets of post-election plans proposed the most substantial peacetime cuts over a five-year period, surpassed

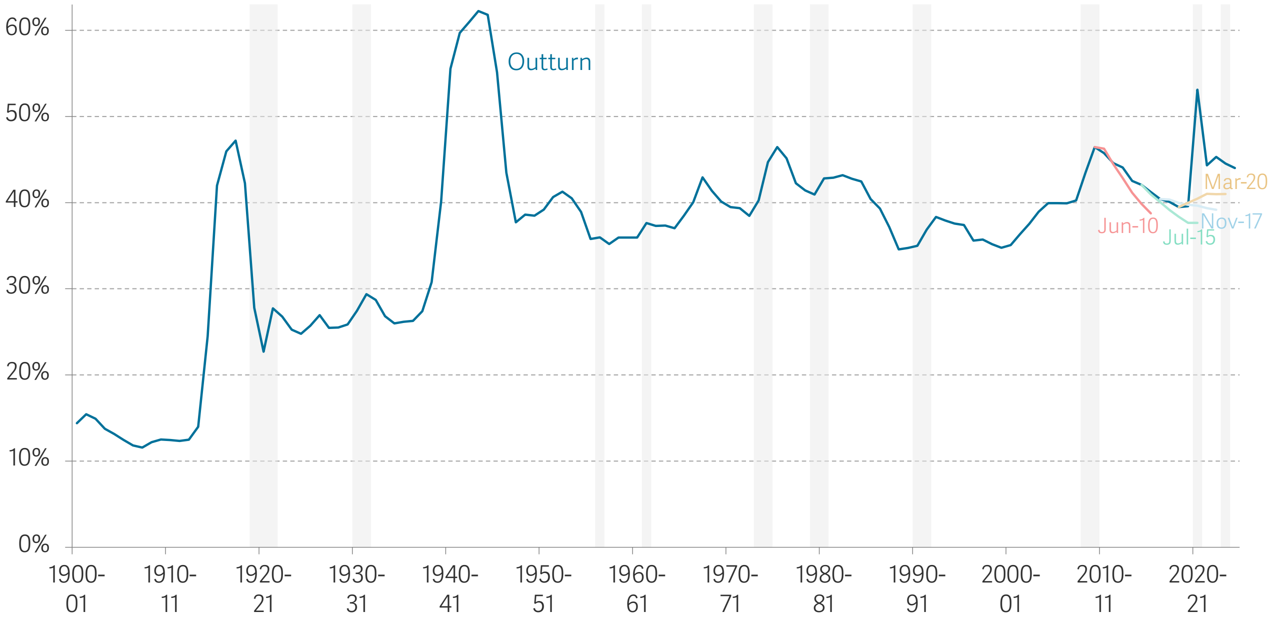
1 For a very clear explanation of why public spending decision are tightly controlled by the government of the day, see: G Tetlow, J Marshall & G Dalton, Government spending: how does parliament approve it?, Institute for Government Explainer, February 2021. For more on how the UK fiscal debate compares to that in other advanced countries, see: L Barnes & T Hicks, Partisan Politics and Fiscal Policy: (Why) are the left perceived as debt-profligate, Working Paper, 2023.

2 In this note we primarily use the fiscal years 2009-10 to 2019-20 and 2019-20 to 2024-25 to assess these two periods. The latter period includes one full fiscal year (2024-25) for which we do not have historical data but for which OBR forecasts, made at the time of the Budget in March 2024, will give an accurate read of the Government's plans.

only by those made in the 1980s. Budget 2010 proposed cuts 1.5 times larger than those actually implemented, and in 2015, George Osborne intended to shrink the size of the state to levels not seen since the early 2000s.

FIGURE 1: **Between 2009-10 and 2018-19 the state got smaller, but it has grown since**

Total managed expenditure as a proportion of GDP: UK, outturn and forecasts



NOTES: Shaded lines indicate recessions.
SOURCE: RF analysis of OBR, Public Finances Databank & Historical official forecasts database.

Since 2018, the state has expanded once again and by 2024 has reached a level comparable to 2010

There was a clear change of tack towards ending austerity in the late 2010s; in 2018, Prime Minister Theresa May declared that 'austerity' is over after eight years of spending cuts. Decisions made under Theresa May ensured the first increases in real, day-to-day spending on public services per-person since the financial crisis a decade earlier. And in the 2019 general election run in, the new Conservative-Party leader, Boris Johnson, made significant pledges that would ultimately bring austerity to a close.[3]

Since 2019, the political desire to end austerity, combined with the unprecedented global pandemic shock and a cost of living crisis, has significantly increased the size of the state. The pandemic was a massive shock to the economy, leading to total public spending rising from 39.6 per cent of GDP in 2019-20 to a post-war peak of 53.1 per cent of GDP in 2020-21. Since then, total public spending has fallen back as a proportion of GDP to an estimated 44.0 per cent in 2024-25, comparable to the pre-austerity peak of 46.5 per cent.

Not all of this was anticipated. Boris Johnson's Government planned to grow the state, but

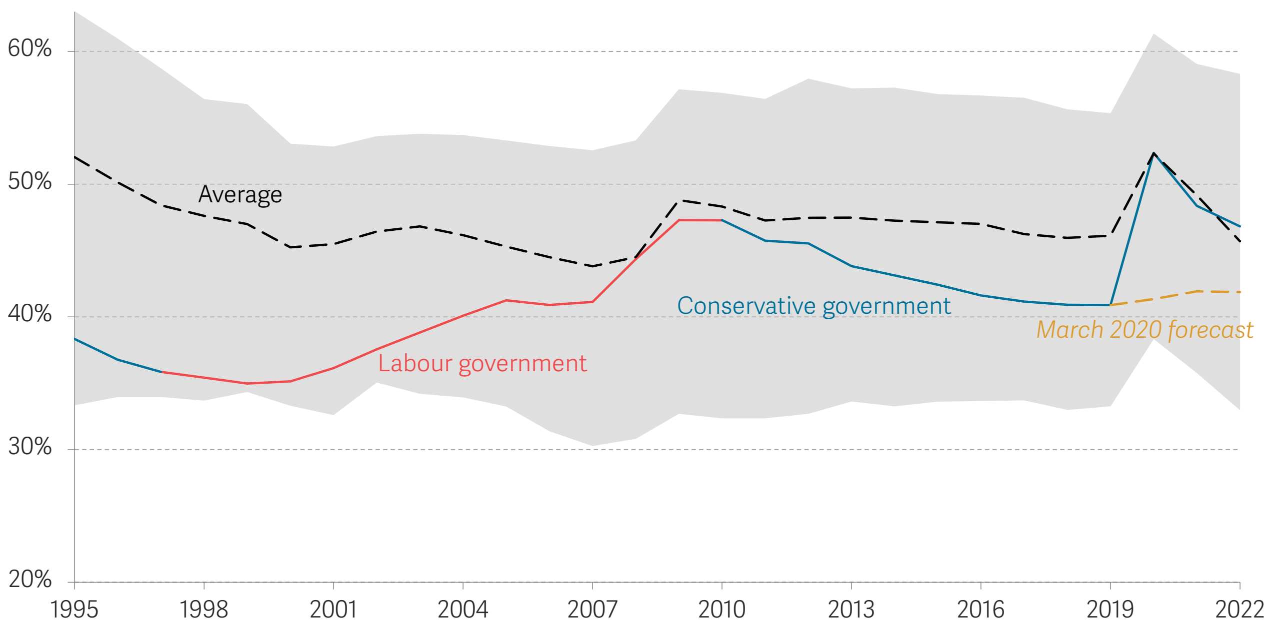
3 H Stewart, Theresa May pledges end to austerity in Tory conference speech, The Guardian, 3 October 2018.

the pandemic and a cost of living crisis made the rise in total spending even more dramatic. In March 2020, the first major fiscal event after the 2019 general election, TME was forecast to rise by 1 per cent of GDP between 2019-20 and 2023-24: it has instead risen by 5 per cent (equivalent to an additional £96 billion). This largely reflects the Government dealing with a particularly difficult set of economic shocks.[4] But, new governments often end up spending more than planned pre-election due to unforeseen events, new political priorities or pressure not to cut public services.

The unexpectedly large splurge in government spending since 2019 has left the UK as an average-sized rich state internationally, when we were aiming to continue as a small one. Figure 2 highlights that the gap between the rich country average and the UK grew over the 2010s as austerity rolled back the size of the state more so than in other countries. By 2019 the average rich country spent around a tenth more than the UK (46 vs 41 per cent, as a proportion of GDP), and we had the smallest state other than Switzerland and the US.[5] However, after a particularly large fiscal response to the pandemic, government spending in 2022 has settled at a level comparable to other rich countries (47 per cent vs 46 per cent), around 12 per cent above what was expected after the 2019 general election (the yellow forecast line Figure 2).

FIGURE 2: **The UK has ended up as an average sized rich state, but we were aiming to continue as a small one**

Total expenditure of central government as a proportion of GDP: UK & comparable OECD countries



NOTES: Comparable countries include Austria, Canada, Denmark, Germany, Finland, France, Netherlands, Norway, Sweden, Switzerland, United States.
SOURCE: RF Analysis of OBR, Historical official forecasts database; OECD, Total expenditure of general government, percentage of GDP.

4 P Brien & M Keep, Public spending during the Covid-19 pandemic, House of Commons Library, September 2023.
5 All facts relative to eleven other rich countries for which we have comparable data (Austria, Canada, Denmark, Germany, Finland, France, Netherlands, Norway, Sweden, Switzerland and US).

Overall, the size of the state has fluctuated since 2010, contracting in the 2010s and expanding since 2018. By 2024-25, TME as proportion of national income has settled at 44 per cent, just 2.4 percentage points lower than where it started in 2009-10.

The shape of the state was changed during the 2010s, mainly via departmental cuts

Next, we turn to what sits beneath the overall change in the size of the state by unpicking how the shape of the state changed during the 2010s and the period since 2019. TME can be broadly split into total departmental spending (otherwise known as total departmental expenditure limits or TDEL) and money which is spent outside the budget control of individual departments (annually managed expenditure or AME).

Between 2009-10 to 2019-20, the shape of the state was altered mainly via cuts to day-to-day spending on public services (resource departmental expenditure limits, or RDELs) and to a lesser extent welfare (which, when combined with benefits, tax credits, pensions and debt interest spending makes up the bulk of AME). These two areas make up nearly nine-tenths (88 per cent) of the cuts in the 2010s.[6]

As Figure 3 highlights, this period saw large cuts to day-to-day departmental spending. RDEL as a proportion of the economy fell from its peak of 18.3 per cent in 2009-10, to a low of 13.9 per cent in 2018-19, before ticking up to 14.4 per cent in 2019-20 after Prime Minister Theresa May declared an end to austerity. In real, per-person terms, RDEL spending fell by 15 per cent between 2009-10 and 2018-19. Only the Department for Health and Social Care (DHSC) escaped this period without any real, per-person cuts. On the other hand, departments like Transport (61 per cent), Housing and Communities (56 per cent) and the Department for Work and Pensions (46 per cent) had their budgets slashed by one-half or more.

Departmental funding for capital spending (or CDEL) was also cut back very sharply during the 2010s, falling by around 1.2 percentage points of GDP, or by around a third (31 per cent). Cuts on this scale, between 2009-10 and 2019-20, are equivalent to £27 billion relative to holding investment fixed at its 2009-10 level of GDP.

It's important to acknowledge that the financial crisis led to a particularly large spike in public-sector spending, following unprecedented government intervention to rescue banks, at a time when the UK already had one of the largest budget deficits in the industrial world.[7] The subsequent austerity period aimed to repair the public finances following the financial crisis. If we take the earlier pre-crisis baseline of 2007-08, before the rise in spending related to the financial crisis, then the cuts to resource and capital

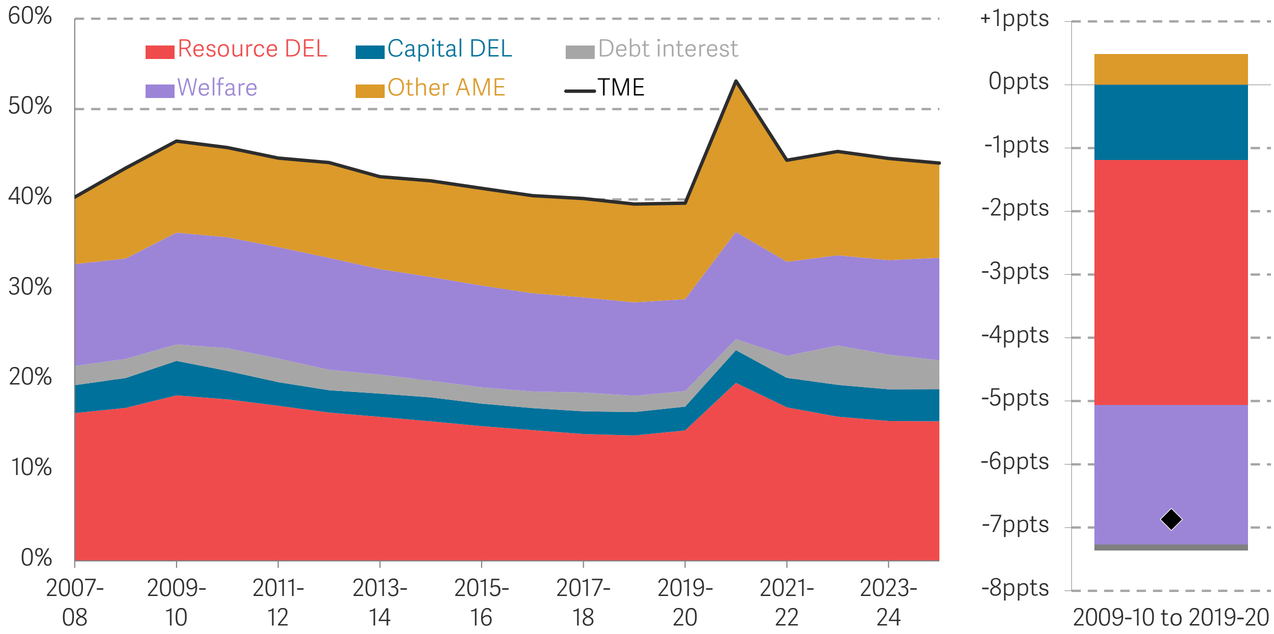
6 The other element of TDEL is capital investments delivered by departments (capital departmental expenditure limits or CDEL). And, other AME includes unfunded public service pensions, environmental levies, and locally financed expenditure.
7 J Riley & R Chote, Crisis and consolidation in the public finances, Office for Budget Responsibility, September 2014.

departmental budgets are reduced significantly by around two-thirds (63 per cent) and one-half (48 per cent), respectively.

Figure 3 makes clear that the other big change to the shape of the state over the 2010s relates to welfare spending, which fell by one-fifth (17 per cent) from 12 to 10 per cent of GDP between 2009-10 and 2019-20. This is equivalent to £49 billion worth of cuts between 2009-10 and 2019-20, compared to holding welfare spending constant relative to its share of GDP in 2009-10. Below-inflation uprating of working-age benefits and benefit freezes – like the four-year benefit freeze for working-age benefits announced by George Osborne in the Summer Budget 2015 – significantly cut welfare spending over the 2010s.[8]

FIGURE 3: **Austerity years shrunk the state mainly via cuts to day-to-day departmental spending**

Total managed expenditure as a proportion of GDP, by component: UK



NOTES: Other AME includes unfunded public service pensions, environmental levies, and locally financed expenditure.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook; and DWP, Benefit Expenditure Tables.

But the fall in welfare spending as a proportion of GDP over the 2010s hides some important differences between non-pensioner and pensioner benefits. In the recovery period following the recession until 2012-13, welfare spending was stable as non-pensioner benefits and pensions were uprated annually with inflation.[9] Since 2012-13, however, cuts were inflicted most heavily on non-pensioner benefits, which fell by around

8 M Brewer et al., Social Insecurity: Assessing trends in social security to prepare for the decade of change ahead, Resolution Foundation, January 2022.
9 Welfare spending, as a proportion of GDP, tends to be counter-cyclical with peaks shortly after recessions. See: Office for Budget Responsibility, An OBR guide to welfare spending, November 2017; M Brewer et al., Social Insecurity: Assessing trends in social security to prepare for the decade of change ahead, Resolution Foundation, January 2022.

one-quarter (23 per cent) as a proportion of GDP, compared to a fall of one-tenth (13 per cent) for pensioner benefits. On a real, per-person basis, non-pensioner benefits were cut at three times the rate of pensioner benefits (16 per cent vs 5 per cent).

During this period, the overall non-pensioner population on benefits remained stable, while the caseload fell by 7 per cent. The fall in non-pensioner benefits caseload is explained by a range of factors including (but not limited to): the fall in unemployment-benefit claims as the labour market approached full employment and rising health-related benefit claims pushing in the opposite direction.[10] In contrast, the rise in the State Pension age reduced the pensioner caseload.[11] As a result, between 2012-13 and 2019-20 real-terms welfare spending per-recipient fell for non-pensioner spending but rose for pensioner spending (-12 per cent vs +7 per cent).[12]

The state has grown by much more than expected since 2019 due to huge economic shocks

Spending Round 2019 unveiled the largest increase in day-to-day spending on public services at any spending review since 2002.[13] And in the first Budget after the 2019 election, further substantial increases in day-to-day spending on public services were planned, equivalent to a rise of 0.9 percentage points of GDP between 2019-20 and 2024-25 (as shown in Figure 4). The Government also placed capital spending front and centre of this Budget, with plans to increase public investment to 3 per cent of GDP – a level only reached once since the 1970s. Additionally, the then-Chancellor Rishi Sunak reiterated the Government's 'Levelling Up' agenda and promised to "invest more in our nations, cities and towns".[14]

Since then, the Government stuck to its guns by unwinding some of the austerity years and increasing public investment, at least in aggregate terms.[15] As shown in the right stacked bar in Figure 4, day-to-day departmental and capital spending increased by around one percentage point of GDP between 2019-20 and 2024-25, reversing around one-quarter of the RDEL cuts and three-quarters of the cuts to capital spending during the 2010s.

A series of unexpected shocks, however, have put significant pressure on other elements of government expenditure. No forecaster could have foreseen the global pandemic, let alone the cost-of-living crisis. These economic crises have led to a raft of government

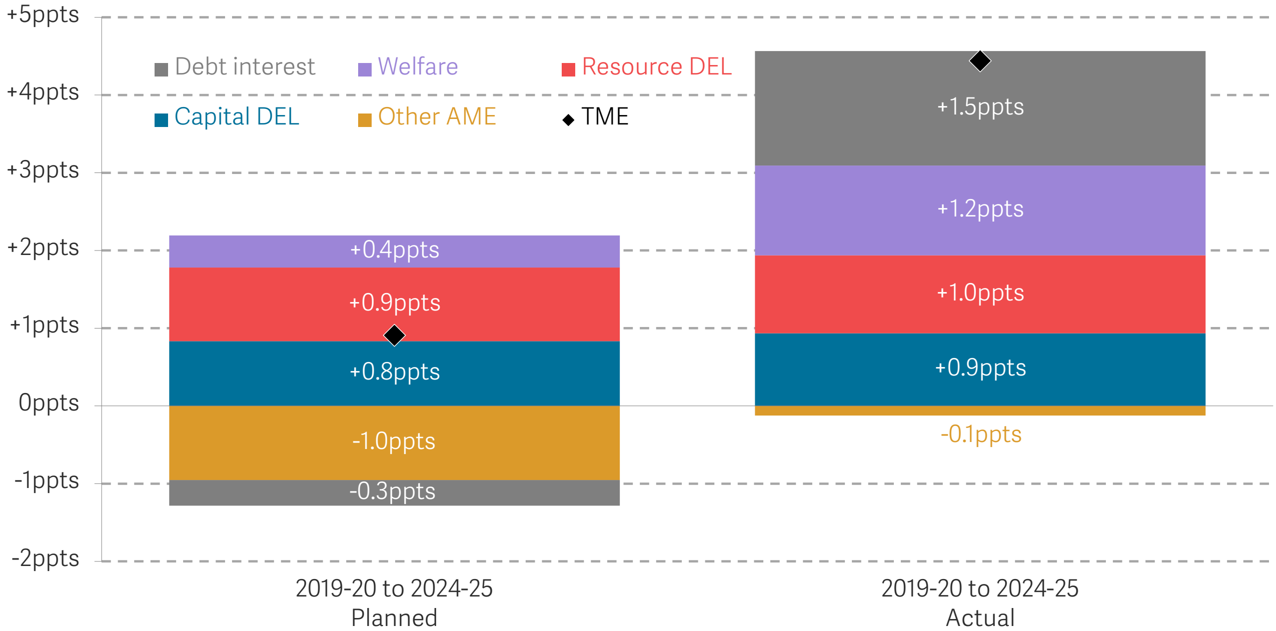
10 Office for Budget Responsibility, Welfare Trends Report, May 2022.
11 https://obr.uk/forecasts-in-depth/tax-by-tax-spend-by-spend/welfare-spending-pensioner-benefits/, accessed 29 May 2024.
12 Source: RF analysis of DWP, Benefit Expenditure Tables.
13 A Corlett et al., Rounding up: Putting the 2019 Spending Round in context, Resolution Foundation, September 2019.
14 R Sunak, Spring Budget 2020: Rishi Sunak's speech, HM Treasury, March 2020.
15 There are other metrics to assess the extent to which austerity has been undone: for example, assessing the change in departmental budgets in real terms or accounting for population size. We draw on these metrics later on in this note.

support schemes, as well as a tightening of interest rates to curb record inflation. The cost of living crisis has triggered a huge rise in longer-term interest rates, to pre-financial-crisis levels, with around a decade of falls wiped out in less than two years. This is in stark contrast to the fall of 0.3 percentage points that was forecast in March 2020. The result is that debt interest costs have risen by 1.5 percentage points of GDP.

Similarly, welfare spending is set to have risen by 1.2 percentage points as a proportion of national income between 2019-20 and 2024-25, three times what was expected in Spring Budget 2020. This largely reflects the Government taking the important decision to uprate benefits in line with CPI inflation throughout the cost of living crisis, despite political pressure for below-inflation uprating. At the same time, there has been an unexpected rise in disability and incapacity spending. We next turn to unpack these expected and unexpected changes.

FIGURE 4: **The state has grown by more than expected since 2019 reflecting unexpected economic shocks**

Change in total managed expenditure (TME) as a proportion of GDP, by component: UK



NOTES: Other AME includes unfunded public service pensions, environmental levies, and locally financed expenditure.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook; and DWP, Benefit Expenditure Tables.

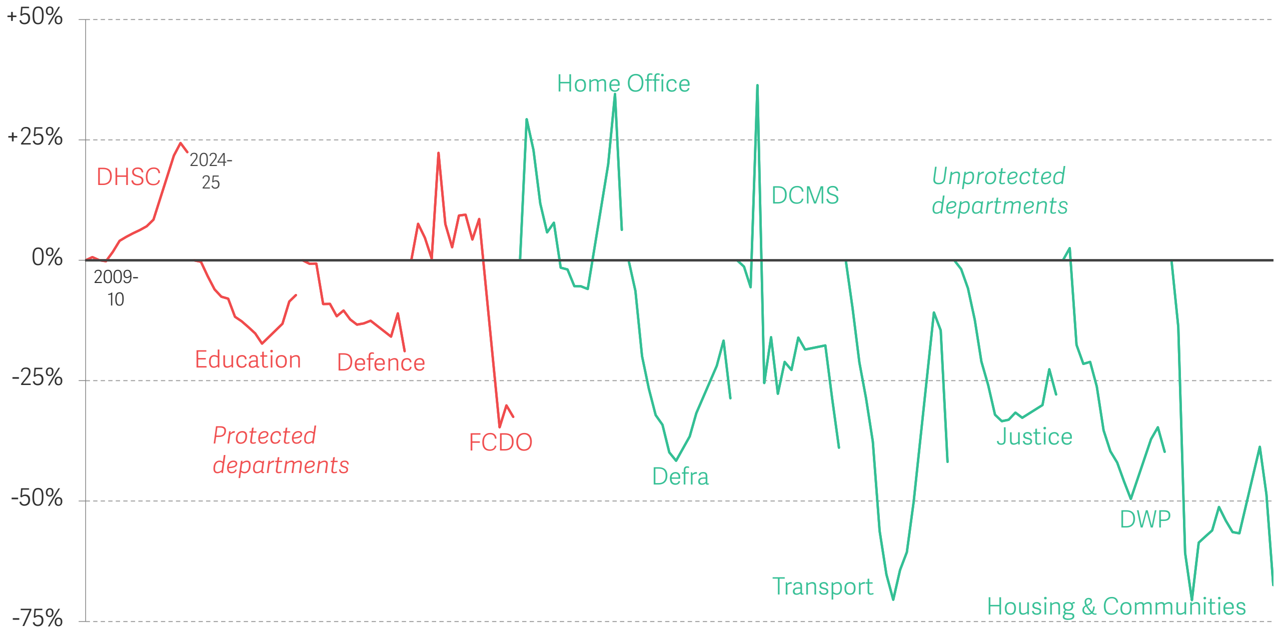
Since 2010, health spending has grown but all other departments have been cut

Some undoing of the impact of the austerity years on day-to-day spending on public services was both expected and desirable. After falling by 9 per cent in real terms between 2009-10 and 2018-19, equivalent to a drop of £38 billion in 2024-25 prices, real RDEL increased by almost exactly this same amount between 2019-20 and 2024-25, and surpassed its 2009-10 peak for the first time (outside of the pandemic years) in 2022-23. Adjusting for changes in the size of the population, however, reflects how spending has moved in line with actual demands on public services. On this 'real, per-person' metric, spending plans for 2024-25 are still 6 per cent below 2009-10 levels, but this is substantially smaller than the 11 per cent gap back in 2019-20.

However, these overall totals hide vast differences in how the nature of day-to-day spending on public services has changed at a departmental level. Figure 5 shows how real, per-person RDEL across departments has changed between 2009-10 and 2024-25.[16] For some departments there has been some unwinding of austerity. For example, as of 2019-20, real-terms per-person resource spending in the Department for Education's (DfE) budget had been shrunk by 17 per cent since its peak in the 2010s and DEFRA's budget had fallen by 39 per cent. But over the entire 2009-10 to 2024-25 period, the falls are more muted, at around 7 per cent for the DfE and 29 per cent for DEFRA. On current plans, however, some departments have actually seen their budgets cut consistently over the past 15 fiscal years: day-to-day defence spending fell by 13 per cent between 2009-10 and 2019-20, with this fall set to be even larger (19 per cent) if we take the whole period between 2009-10 to 2024-25.[17]

FIGURE 5: **Since 2010, health spending has grown but all other departments have been cut**

Change in real, per-person resource departmental expenditure limits between 2009-10 and 2024-25: UK



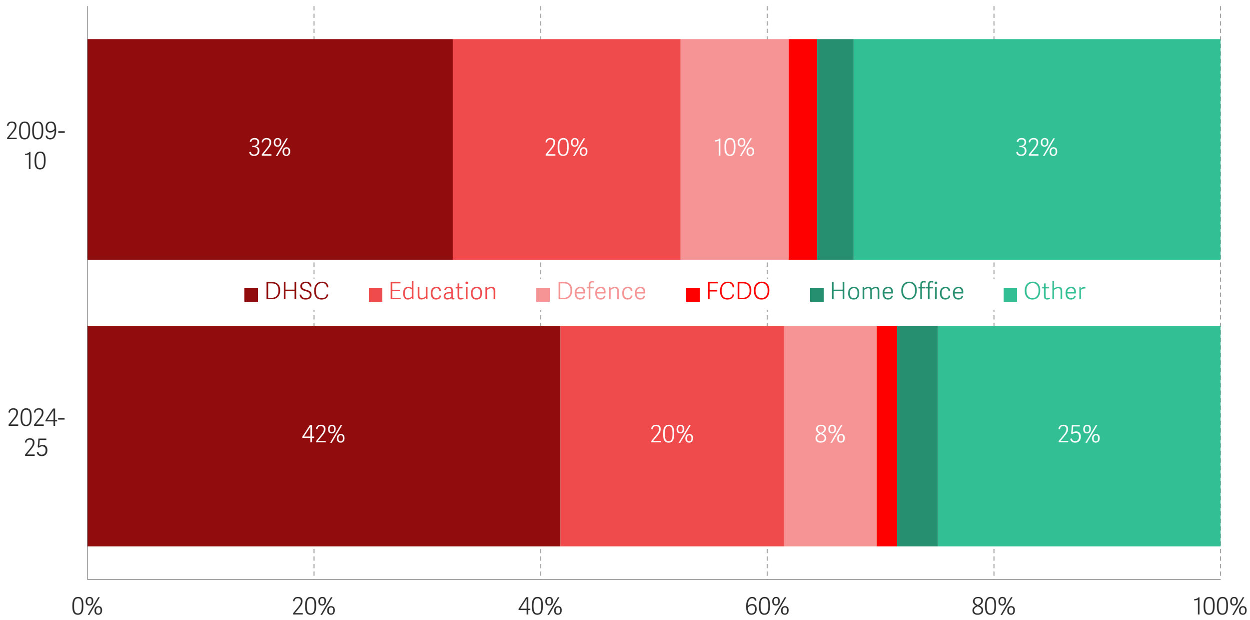
NOTES: DHSC (Department for Health & Social Care), FCDO (Foreign, Commonwealth & Development Office), Defra (Department for Environment, Food & Rural Affairs), DCMS (Department for Digital, Culture, Media & Sport), DWP (Department for Work & Pensions). Note that change can be driven by policy (e.g. FCDO via overseas aid cut to 0.5% of GNI in 2021-22) and classification changes (e.g. large increase in Transport driven by reclassification of Network Rail from AME to DEL in 2019-20).
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, various; HM Treasury, Budget and Spending Review documents, various.

16 The population base for departments specific to England (including Education and the DHSC) can be assumed to grow in line with the UK population, as England's population growth mirrors that of the UK.
17 The budget for 2024-25 (obtained via the 2024 Budget publication) does not yet include the agreed additional funding from the Treasury Reserves. See: https://twitter.com/DefenceHQ/status/1766059626854769080, accessed 29 May 2024.

Where do these changes leave the overall shape of day-to-day spending on public services? As Figure 6 makes clear, everyday departmental spending has become increasingly skewed towards the DHSC, which makes up 42p in every £1, based on plans for 2024-25, up from 32p in every £1 in 2009-10. Our ageing society requires more from this service, so this increase in health and social care spending should come as little surprise.

FIGURE 6: **Day-to-day departmental spending has become increasingly skewed towards health and social care**

Proportion of resource departmental expenditure by department: UK



NOTES: FCDO refers to Foreign, Commonwealth & Development Office. Other includes the likes of Home Office, Department for Environment, Food & Rural Affairs, Department for Digital, Culture, Media & Sport, Department for Work & Pensions, Transport, Justice and Ministry of Housing, Communities & Local Government, and block grants for devolved administrations.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, various; HM Treasury, Budget and Spending Review documents, various.

Public sector investment increased substantially between 2019-20 and 2024-25 – but this rise looks much less flattering if we exclude student loans and Covid-19 spend

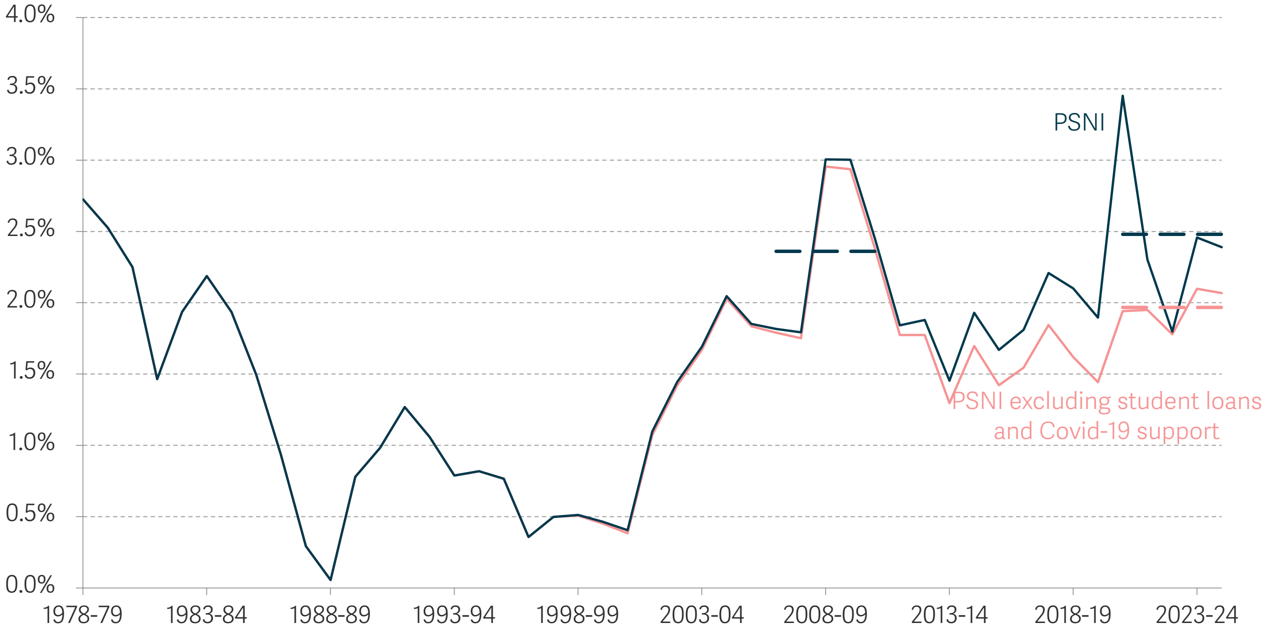
The second element of government expenditure that grew in line with the plan set out after the 2019 general election is investment. Public investment spending plans were increased substantially, such that public investment reached 3.5 per cent of GDP in 2020-21. And although capital investment is now set to fall back to 2.4 per cent of GDP by 2024-25, this still remains a level which has only been surpassed five times over the past 45 years.

However, public sector net investment (PSNI) over the most recent Parliament looks much less flattering if we exclude elements traditionally not considered as 'investment'.

As shown in Figure 7, PSNI includes the element of student loans which are expected to be written off (those students who don't earn enough money to pay it back), as well as Covid-19 loan schemes (which affects the 2020-21 fiscal year).[18] Removing student loans reduces PSNI as a proportion of GDP from 2.4 to 2.1 per cent in 2024-25, equivalent to £9 billion. The result of this overall adjustment means that average investment as a proportion of GDP over the most recent Parliament looks significantly lower than the final five years of the previous Labour government (2.0 per cent compared to 2.4 per cent).

FIGURE 7: **Public sector investment has increased since 2019-20, but much of this reflects student loans and our response to the pandemic**

Public sector net investment as a proportion of GDP: UK



SOURCE: RF Analysis of OBR, Economic & Fiscal Outlook, various, Public Sector Finances Databank; Bank of England, A millennium of macroeconomic data for the UK, 2020.

The cost of servicing public debt has reached record highs

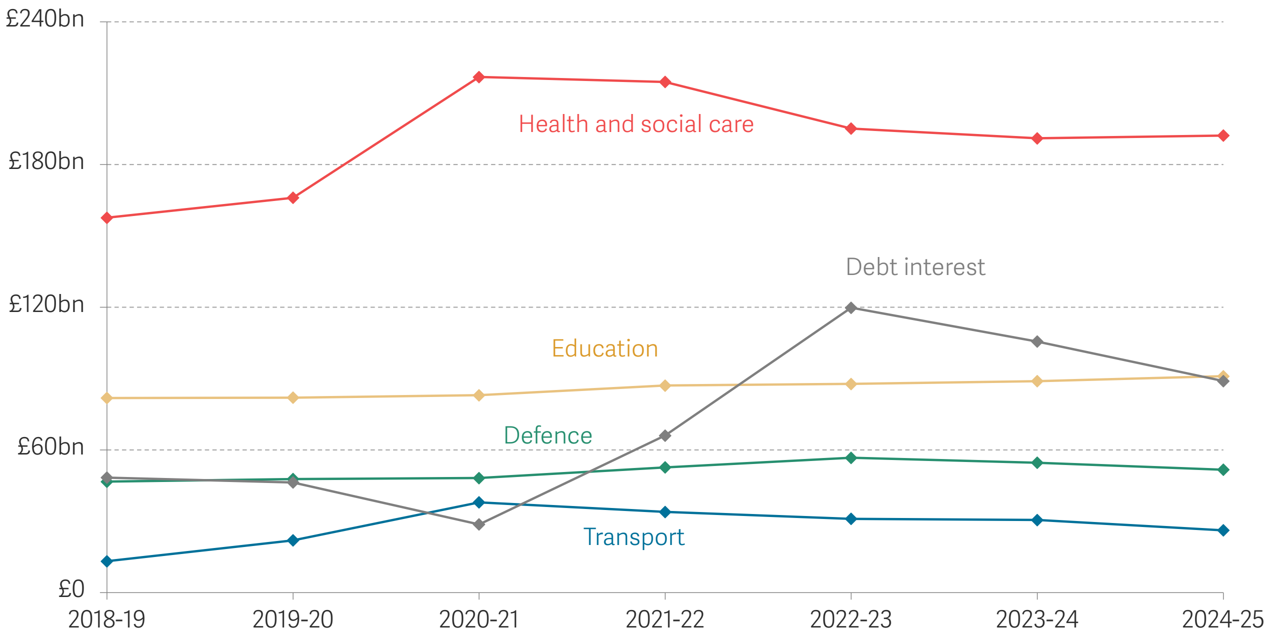
If some unwinding of austerity and an increase in capital spending was expected, then the surge in debt interest spending has been anything but. During the 2010s, the government spent an average of about £50 billion on servicing its debt (in 2024-25 prices). Nobody could have anticipated that debt interest spending would have reached a post-war high in 2022-23, of around £120 billion in today's prices or 4.4 per cent of GDP. The surge in interest payments for the government was caused by interest rates rising from historically low levels, in order to curb the largest inflation shock in 40 years. Real long-term interest rates are up 4 percentage points since 2021, reversing nearly a

18 For a more detailed discussion of the effect of student loans on PSNI and a wider discussion of what public investment is, see: B Zaranko, Public investment: what you need to know, Election 2024, Institute for Fiscal Studies, April 2024.

decade of falls. On top of this, public sector debt has grown in recent years as a result of the pandemic, household support during the cost-of-living crisis, and the fact that around one-quarter of UK government debt is indexed to inflation.[19]

To put this rise in context, Figure 8 plots debt interest costs compared to how much is spent (including day-to-day and capital) on four of the largest government departments between 2018-19 and 2024-25. Debt interest costs now dwarf almost every government department apart from the DHSC. The rise in debt interest between 2020-21 and 2022-23 alone is equivalent to the planned budget for the Department for Education in 2024-25 (£91 billion).

FIGURE 8: **The unexpected surge in interest rates has pushed debt interest to historic highs**
Real total departmental expenditure limits by department and central government debt interest: UK



NOTES: Deflated to 2024-25 prices using the OBR forecast for the GDP deflator.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook.

The unexpected rise in inflation and ill-health have increased pressure on welfare spending

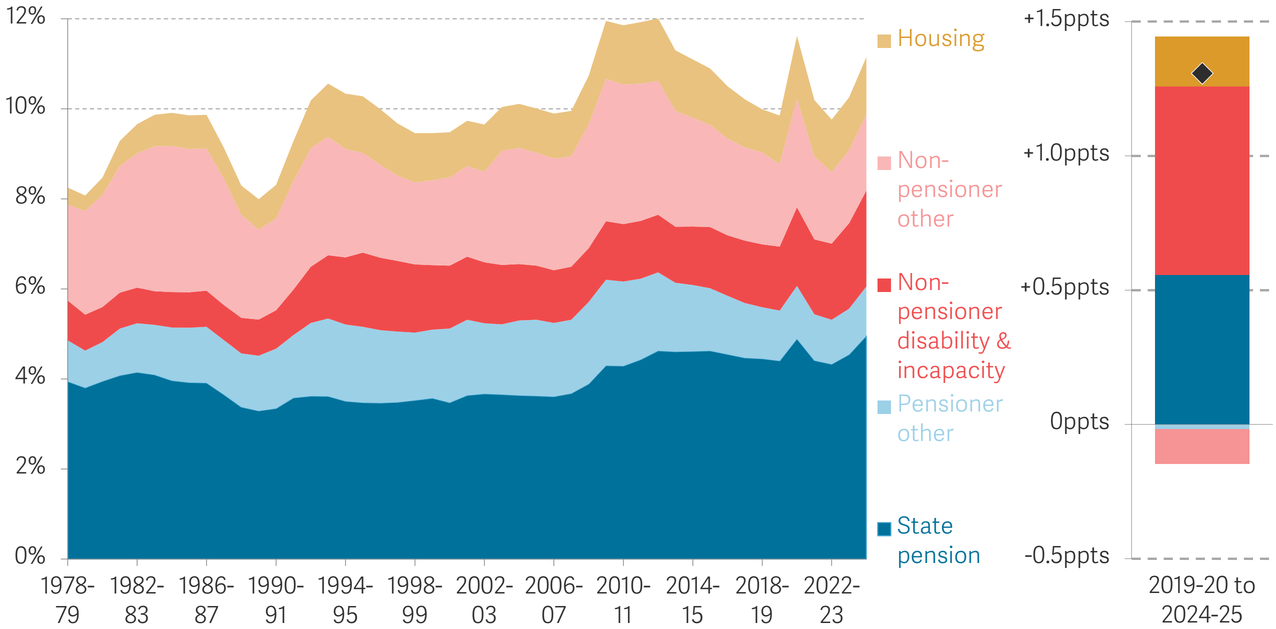
The other element of government spending that has risen by more than expected is welfare, which has risen during the most recent Parliament. This is primarily a function of the inflation shock, with the 'triple lock' ensuring the State Pension rose at least in line with prices, and discretionary decisions each year meaning most child and working-age benefits did too.[20]

19 National Audit Office, Managing government borrowing, July 2023.
20 The triple lock is a government commitment to uprate the basic and new State Pension each year by the highest of earnings growth, inflation or 2.5 per cent.

On the other hand, changes in caseloads have played a relatively minor role on overall welfare spending. But there have been some significant changes sitting below the aggregate story of rising welfare spending. Figure 9 illustrates how the broad elements of welfare spending have changed over the longer-term (the left chart) and zooms in on the change during the most recent Parliament (the right chart). Two changes stand out. First, State Pension spending, driven by an ageing population (as well as the decision to protect pensioner benefits via the triple lock), makes up almost half of the rise in welfare spending since 2019-20. Second, there has been an unexpectedly large rise in non-pensioner disability and incapacity spending relative to the size of the economy, which has risen to levels not seen since the 1990s. We will be exploring these changes, as well as the recent rise in housing benefit expenditure, in further detail in two forthcoming general election notes on the overall welfare state and disability benefits.

FIGURE 9: **Welfare spending has become more skewed to non-pensioner disability spend and the State Pension**

Welfare spending as a proportion of GDP, by component: GB



NOTES: Other non-pensioner spending includes Universal Credit, legacy benefits (Working Tax Credit, Child Tax Credit, Income Support, Job Seekers Allowance and Employment and Support Allowance), as well as other smaller benefits including the likes of Bereavement benefits and Christmas bonus. Housing benefits – which covers pensioners and non-pensioners - includes the Universal Credit element.
SOURCE: RF analysis of DWP, Benefit expenditure and caseload tables 2024; Scottish Fiscal Commission, Scotland's Economic and Fiscal Forecasts, various.

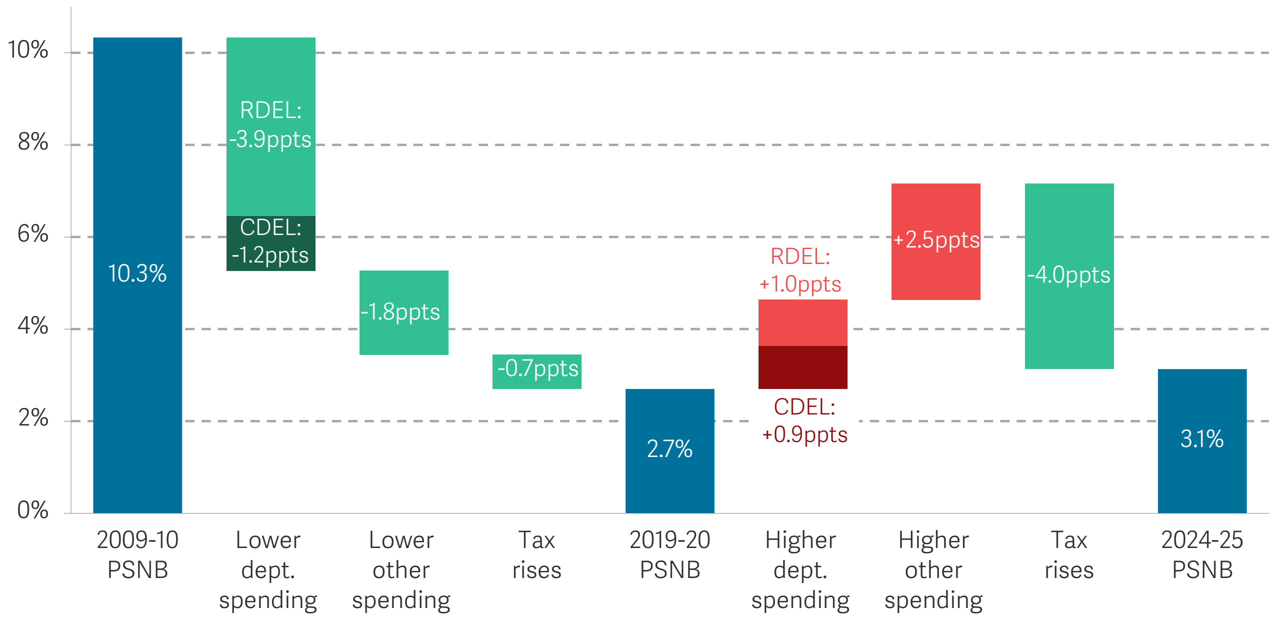
Overall then, while the size of the state now is not vastly different from 2010, the shape of the state has changed significantly. Day-to-day spending on public services, on a real, per-person basis, is set to be 6 per cent below 2009-10 levels in 2024-25 – equivalent to a fall from 18.3 per cent of national income in 2009-10 to 15.4 per cent by 2024-25. But this fall has been partially offset by the rise in debt interest which has nearly doubled from 1.8 per cent of GDP in 2009-10 to 3.2 per cent in 2024-25.

A bigger state since 2019 has put upward pressure on taxes

Rising spending pressures have resulted in significant increases in taxes since 2019. Looking at the longer-run trends in both tax and spending, set out in Figure 10, the reduction in the size of the state between 2009-10 and 2019-20 took place while the overall tax take was relatively stable, with receipts rising just 0.7 percentage points as a proportion of GDP. In contrast, the expansion of the state since 2019-20 has prompted a large rise in taxes, with the tax take increasing by 4 percentage points of national income, offsetting over 90 per cent of the most recent Parliament's spending increases.

FIGURE 10: **A larger state since 2019-20 has come with a large rise in taxes**

Change in public sector net borrowing as a proportion of GDP, by source: 2009-10 to 2024-25

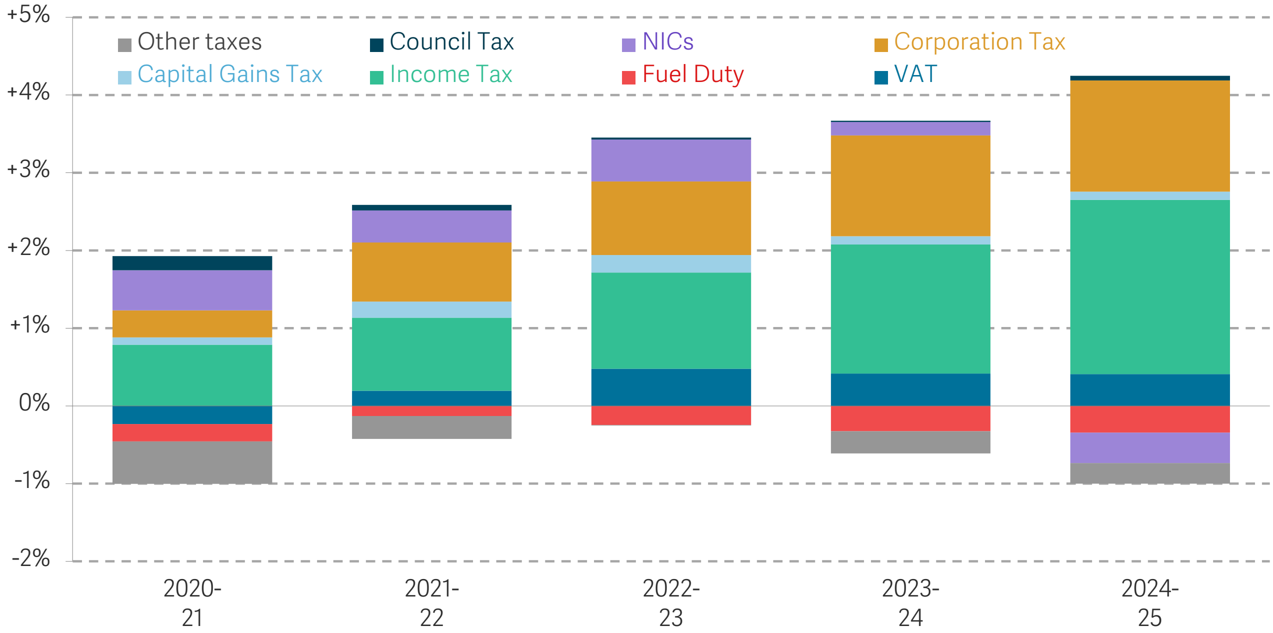


NOTES: 'Other spending' is Annually Managed Expenditure, and taxes are Public Sector Current Receipts.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2024.

These tax rises have been concentrated on incomes and profits with much of this driven by policy choices. As illustrated in Figure 11, Income Tax rises represent the largest share of tax increases since 2019-20, where receipts have risen by 2.2 per cent of GDP (or £2,200 per household), primarily but not exclusively driven by the choice to freeze tax thresholds back in 2021. Corporation Taxes are a close second, with a rise of 1.4 per cent of GDP between 2019-20 and 2024-25, despite the introduction of full expensing of qualifying capital investment during this period.[21]

FIGURE 11: **Tax rises have primarily been driven by Corporation and Income Tax hikes**

Changes in National Account taxes, as a proportion of GDP, relative to 2019-20: UK



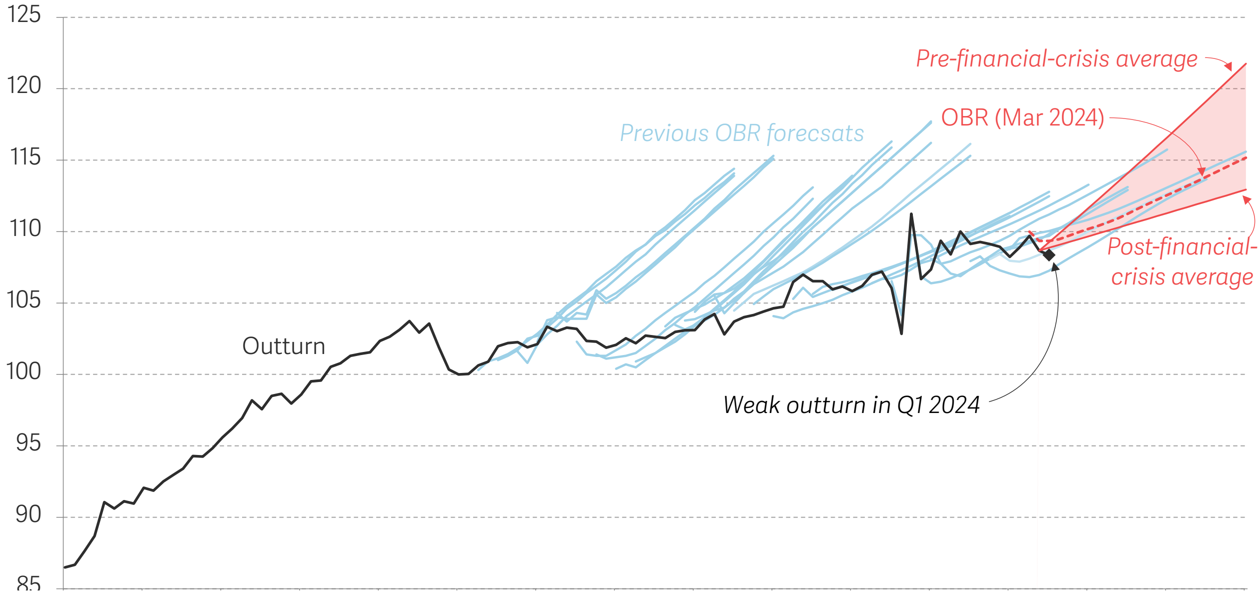
NOTES: Other taxes include Stamp Duty Land Tax; Tobacco, Alcohol, Vehicle Excise and Air Passenger Duties; Environmental and Energy Profit Levies; Inheritance Tax and other public sector taxes and receipts.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2024.

Weak economic growth since 2010 has contributed to the upward pressures on taxes. Although quarterly GDP growth was stronger than expected in Q1 2024 at 0.6 per cent, the big picture remains one of weak growth since the financial crisis.[22] The key underlying driver of this has been weak productivity growth, which, as shown in Figure 12, has repeatedly undershot OBR forecasts. Consequently, GDP is more than 20 per cent below its pre-financial crisis trend, the equivalent of around £23,000 in higher output per UK household. In previous work we estimated that, using a simple mapping from GDP to tax receipts, cash receipts would be around £200 billion higher in 2019-20 had growth continued at pre-2009 levels.[23] And, as weak growth has led to disappointing tax receipts, the need to address spending pressures has led to additional measures to raise taxes.

21 Forthcoming Resolution Foundation work will consider the tax changes we've seen over the most recent Parliament in more detail.
22 Resolution Foundation & Centre for Economic Performance, LSE, Ending Stagnation: A New Economic Strategy for Britain, Resolution Foundation, December 2023.
23 K Shah, J Smith & D Tomlinson, Under pressure: Managing fiscal pressures in the 2020s, The Resolution Foundation, February 2022.

FIGURE 12: **Productivity growth has been disappointing since 2010**

Index of output per hour, OBR forecasts and outturns (Q1 2009 = 100): UK

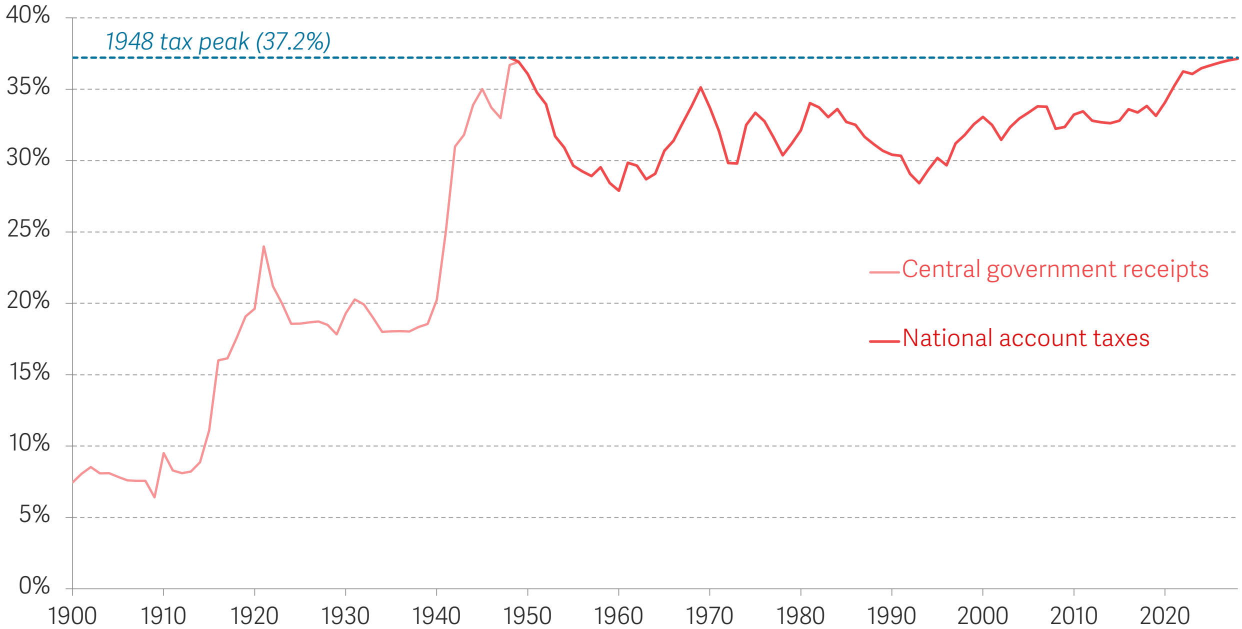


NOTES: Pre-financial crisis average is taken from 1997 to 2007; and the post-financial crisis average is taken from 2013 to 2019.
SOURCE: RF analysis of ONS, National Accounts & Labour Market Statistics; OBR, Economic and fiscal outlook, various.

Looking ahead, the UK's tax-to-GDP ratio is currently forecast to continue rising, reaching 37.1 per cent of GDP by 2028-29, a further 0.7 per cent of GDP rise over the next four years.

FIGURE 13: **The tax-to-GDP ratio has risen substantially since 2019-20**

National Account taxes as a proportion of GDP: UK, 1900 to 2028-29



SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2024.

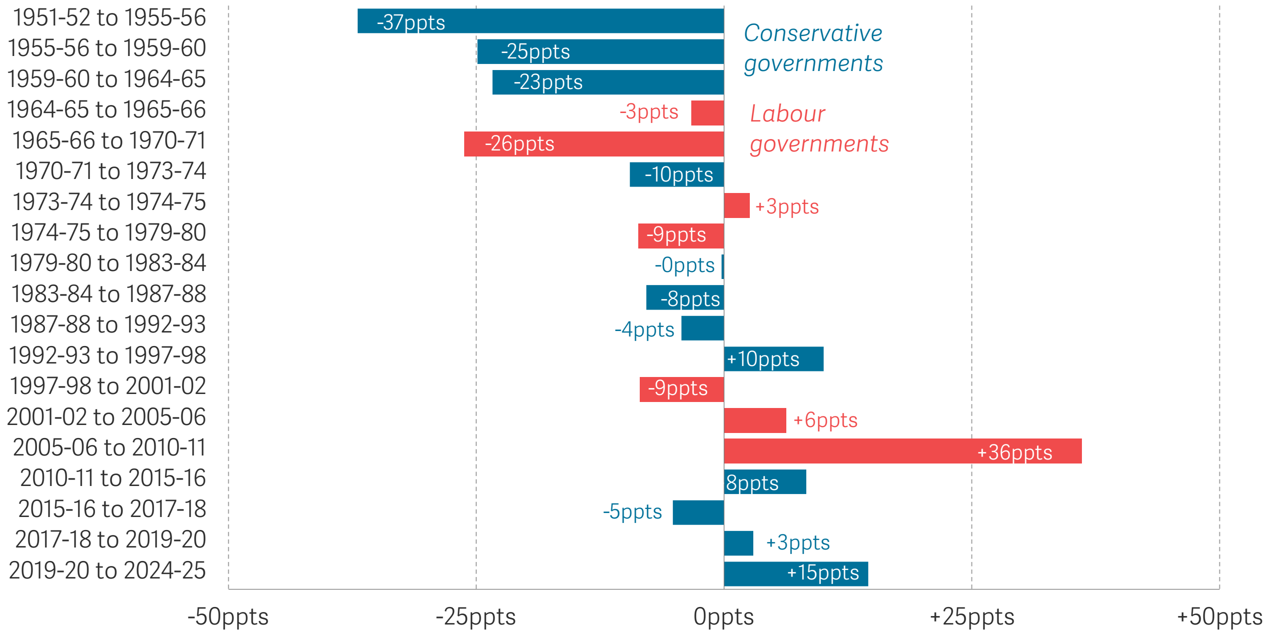
This rise partly reflects tax hikes already pencilled into the OBR's forecast, including Fuel Duty and Stamp Duty rises expected in 2025-26, and further tax threshold freezes in future years of the forecast. The combined impact of these changes leaves taxes at their highest level as a proportion of GDP since 1948, and their second highest level since the turn of the 20th Century (Figure 13).

The shocks and policy choices of the past have left us with higher debt and falling net worth

Although taxes have risen between 2019-20 and 2024-25, this has not been enough to prevent debt rising. Over that time, then, debt is set to have risen by 15 percentage points of GDP (see Figure 14). This is the second largest rise over a parliament since the Second World War, surpassed only by the Parliament that includes the financial crisis, which saw a rise of 36 percentage points of national income. The preceding two Parliaments saw a much smaller rise in debt and a fall respectively, with austerity policies leading to a 2 percentage-point decrease in debt as a proportion of GDP between 2015-16 and 2019-20. However, two consecutive crises since have left public sector debt set to reach 92 per cent of GDP by 2024-25, its highest level since the early 1960s. As discussed in Box 1, these factors have also led to a deterioration in broader measures of the public-sector balance sheet.

FIGURE 14: **The most recent Parliament has seen the second highest rise in debt since the Second World War**

Percentage point change in public sector net debt excluding the Bank of England as a proportion of GDP, by Parliament: UK, 1951-52 to 2028-29

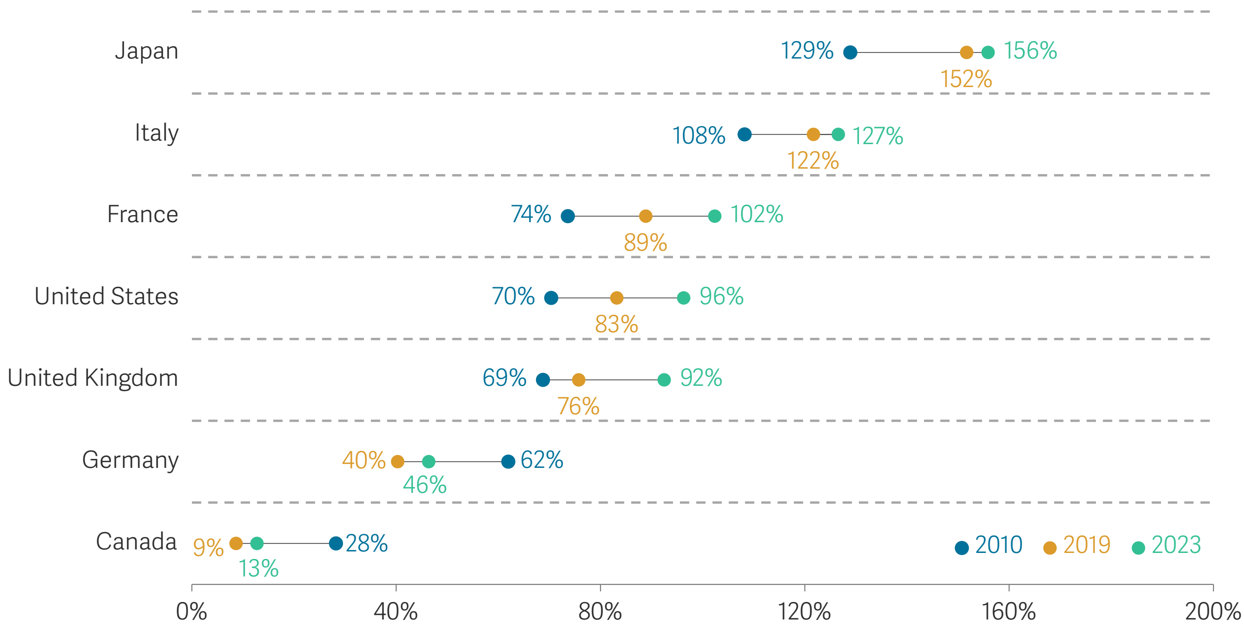


NOTES: Public sector net debt including the Bank of England is used pre-1997-98, in practice there are only small differences between these measures before the financial crisis.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2024.

International comparisons show that the UK has experienced the largest rise in general government net debt in the G7 between 2019 and 2023, seeing debt rise by more than 3 percentage points more than the US and France, who saw the next largest rises. Despite the upward trajectory of our debt stock, which was exacerbated by the financial crisis, pandemic and cost of living crisis, the UK isn't an outlier in terms of the overall size of our national debt. As shown in Figure 15, the overall size of the UK's debt stock remains lower than four other economies in the G7, with all of these advanced economies (excluding Germany and Canada) seeing similar rises in debt since 2010, reflecting the fact that many other advanced economies are dealing with similar legacies of successive crises, and are facing up to similar future challenges, including the costs of reaching net zero and demographic changes.

FIGURE 15: **The UK's debt stock is not particularly large compared to other G7 economies**

General government net debt as a proportion of GDP: G7 countries



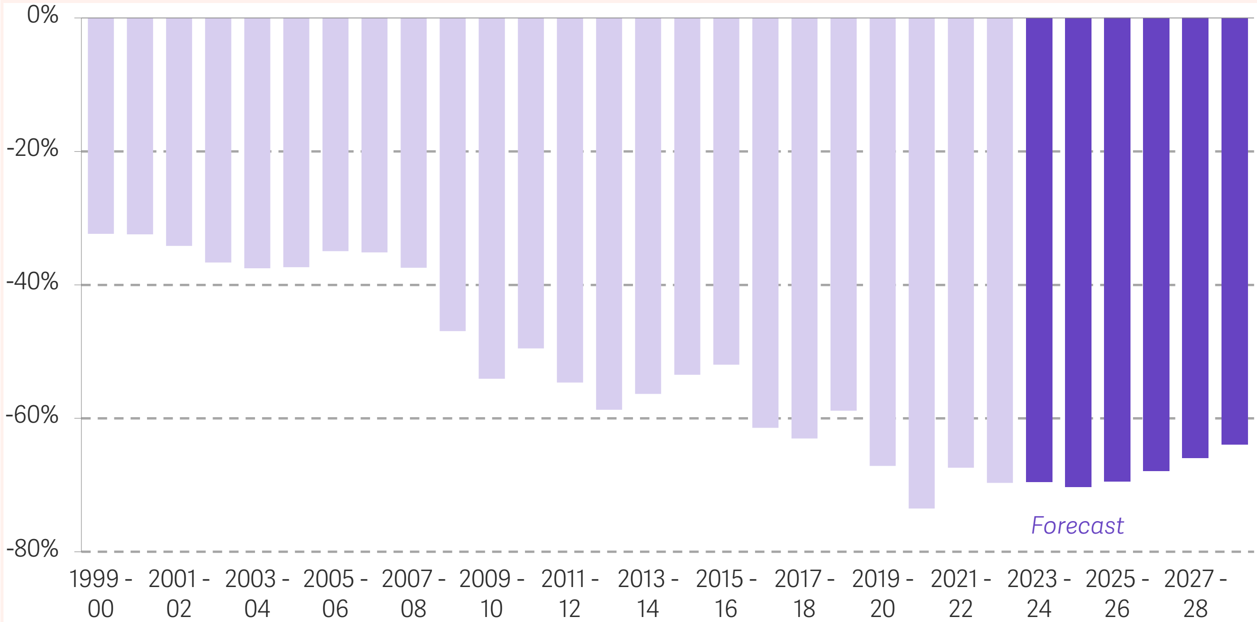
SOURCE: RF analysis of IMF, World Economic Outlook, April 2024.

BOX 1: **Public sector net worth since 2019-20**

Looking at broader balance sheet measures which include the UK's non-financial assets (including buildings and other physical assets not included in the UK's net debt measures), the picture is similar to that from looking at debt, with public sector net worth set to have weakened by 3.1 percentage points of GDP by 2024-25 (see Figure 16). This reduction in net worth is driven primarily by the increase in net debt discussed above. However, the impact on net worth over the most recent Parliament is lower than that seen in net debt, given liabilities such public sector pensions owed to nurses and teachers have reduced in value, due to the recent hike in interest rates, offsetting some of the impact of higher debt.

FIGURE 16: **Public sector net worth has also declined, by over 3 percentage points of GDP**

Public sector net worth as a proportion of GDP, outturn and forecast: UK



NOTES: This measure of public sector net worth uses the OBR's adjusted GFSM accounting treatment, including unfunded pension liabilities, but recording gilt liabilities at face value.
SOURCE: RF analysis of ONS, Public sector finances; OBR, Economic and Fiscal Outlook, March 2024.

The risks facing the fiscal outlook are much larger than the sums involved in election debates about announced policies

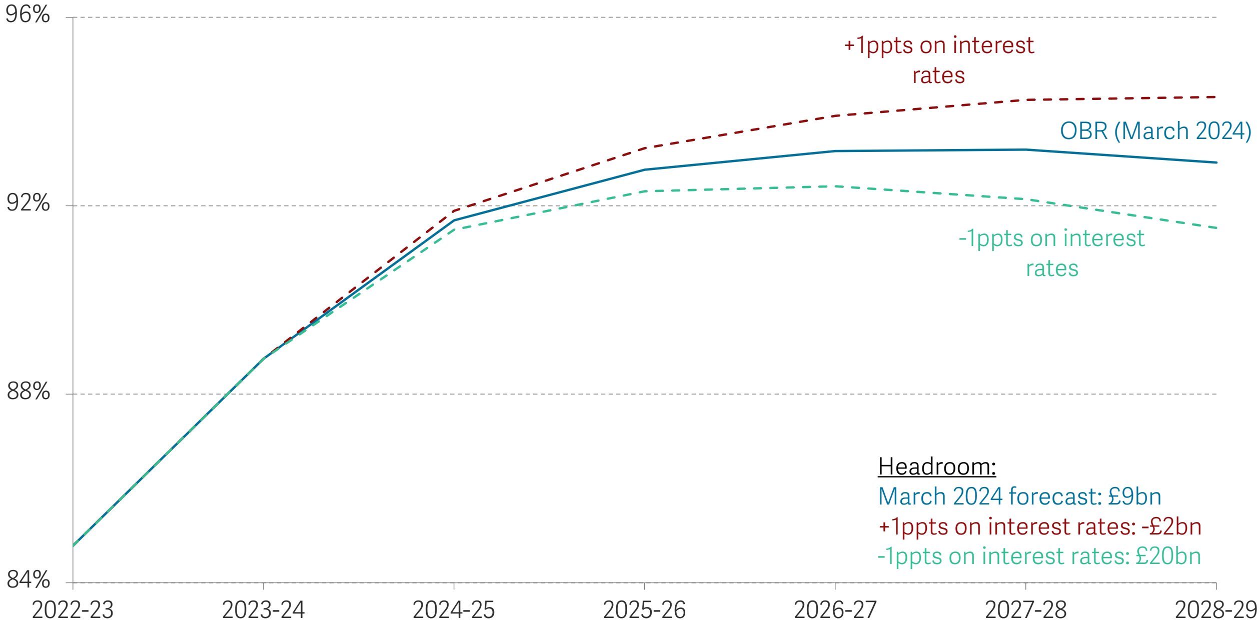
The election debate so far has involved both main parties accusing the other of making specific unfunded commitments. What we have heard less about is the far larger fiscal challenges that we face.

One way of gauging these challenges is to focus on the forecast for underlying debt as a proportion of GDP, where the current Government has set itself a fiscal rule to have it falling in the fifth year of the forecast (2028-29). In the OBR's latest forecast (March 2024), that rule was set to be met, with debt peaking at 93.2 per cent of national income in 2027-28, but the amount of 'headroom' or breathing space against that rule was extremely slim, at just under £9 billion (less than a third of the £29 billion on average that previous Chancellors have budgeted against their rules). This reflects the fact that debt is forecast to be barely falling by the end of the forecast period, with high debt interest costs and costly payments to cover the cost of quantitative easing keeping debt levels stubbornly high.

There is significant uncertainty surrounding how this outlook could change, even before the next government's first fiscal event. There is certainly scope for fiscal 'windfalls'; for example, the costs of servicing debt could fall if the Bank of England cuts its policy rate in response to receding inflationary pressures in the coming months. Every 1 percentage point of lower long and short-term interest rates reduces borrowing by around £12 billion by the end of the OBR's forecast (Figure 17).

FIGURE 17: **Changes in market interest rates could be a source of future windfalls, or further pressure on the public finances**

Public sector net debt, excluding the Bank of England, as a proportion of GDP, OBR forecast and various scenarios: UK



SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2024.

But there is also a significant risk that the outlook could be worse than expected. While there are reasons for thinking that interest rates could fall, current market expectations for interest rates suggest a deterioration in the fiscal outlook. Changes in market expectations since the OBR's March 2024 forecast have added an average of around 0.4 percentage points to in the Bank Rate across the forecast period, with longer-term interest rates on government debt also slightly higher. If these market expectations persist, they are likely to push up debt interest costs in the OBR's next round of forecasts, as well as increasing some partially off-setting revenues (i.e. interest received by government, as well as self-assessment taxes on interest income). Taking these net effects together, the changes in the expectations of interest rates seen since the March 2024 forecast, would increase borrowing by just over £2 billion a year on average between 2024-25 and 2026-27.

And there is potential for even more dramatic changes in the OBR's macroeconomic forecasts. As shown in Figure 12, the OBR is assuming that average annual productivity growth continues at a rate between the pre- and post-financial crisis average (just over 1 per cent average annual growth over the forecast) – roughly in line with the assumptions of other economic forecasters by the end of the forecast period.[24] However, current data and outlooks from institutions like the Bank of England suggest a more pessimistic outlook for productivity growth. The most recent outturn data for productivity recorded annual growth of just 0.1 per cent in Q1 2024, far lower than the OBR's assumption, and the UK's average performance between 2013 and 2019 was closer to growth of three-quarters of a percentage point. The OBR has previously produced scenarios that illustrate the significant impact that a half percentage point downgrade to productivity growth would have on the government's balance sheet, estimating this would add over £40 billion to government borrowing by 2028-29.[25] If we scale this down to a 0.2 percentage point downgrade – i.e. a modest change that closes half of the gap between the OBR's assumed productivity growth rate of around 1.1 per cent and the post-financial-crisis average of around 0.75 per cent –this would add £17 billion to borrowing in 2028-29.

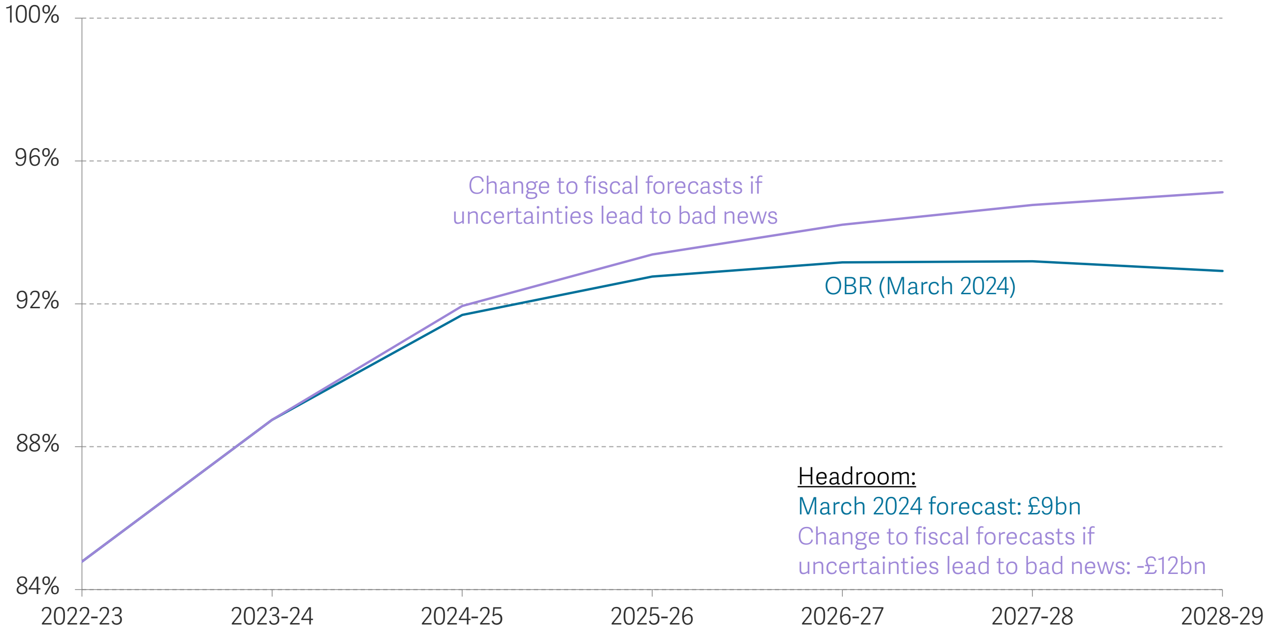
There are also additional costs that have become clearer since the OBR's March 2024 forecast, and may be reflected in future rounds of the forecast. The largest of these is compensation for those affected by the infected-blood scandal, which could cost the Government £10 billion.[26]

Collectively these factors would increase underlying public sector net debt, putting it on a rising path (see Figure 18). In 2028-29, the level of debt would be £72 billion, or over 2 percentage points of GDP, higher, and the Government's headroom to have debt falling in 2028-29 would be reduced from a slim margin of £9 billion, to being missed by £12 billion. Given that the Labour Party has committed to similar fiscal rules as those currently in place, this will prove challenging for whoever forms the next Government.[27]

24 HM Treasury, Forecasts for the UK economy, May 2024.
25 Office for Budget Responsibility, Economic and Fiscal Outlook, November 2023.
26 N Triggle, Infected blood victims could get £2m compensation, BBC News, 21 May 2024. There are also likely to be additional costs recorded in future OBR forecasts in relation to the Post Office Horizon scandal, although these are likely to be much smaller cash flows than those relating to the Infected Blood Inquiry, so have not been reflected in the scenarios below. For more detail on these payments (and other policy risks to the fiscal position), see Office for Budget Responsibility, Economic and fiscal outlook, March 2024.
27 R Reeves, Rachel Reeves Mais Lecture 2024, Labour Party, March 2024.

FIGURE 18: **Future OBR forecasts have the potential to put debt on a rising path**

Public sector net debt, excluding the Bank of England, as a proportion of GDP, OBR forecast and scenario: UK



NOTES: Market rates to update debt interest costs were taken as of 17 May 2024.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2024; OBR, Economic and Fiscal Outlook, November 2023; Bank of England, Yield curves.

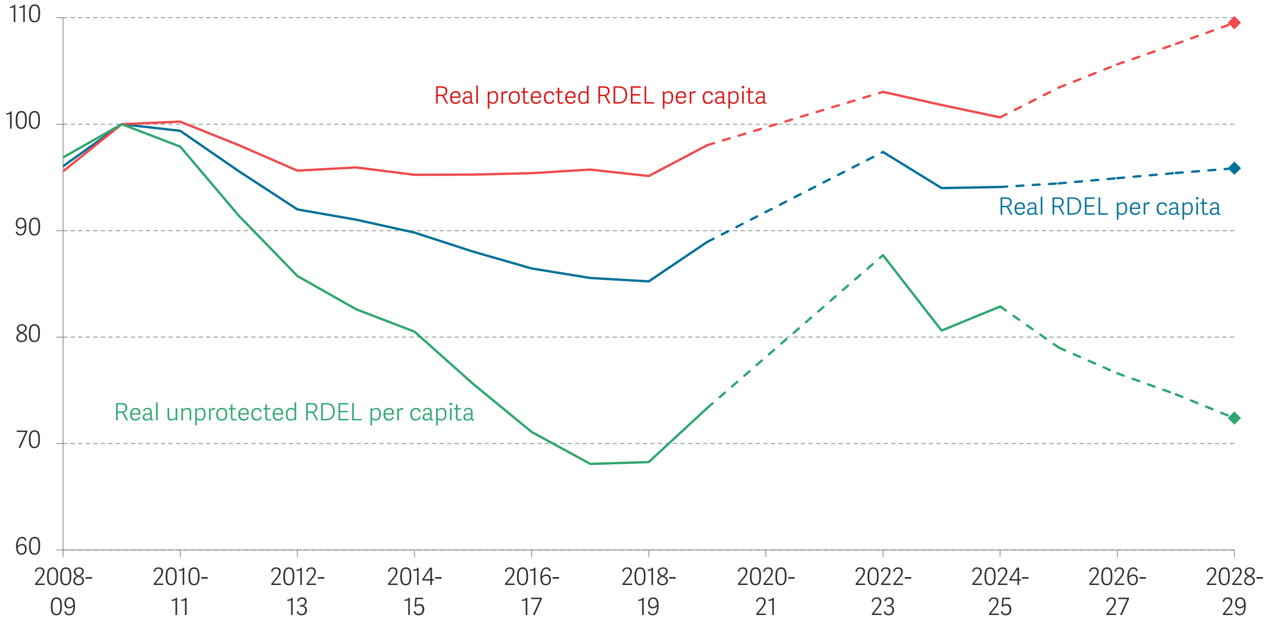
The assumptions about public service spending underpinning current forecasts could prove difficult to deliver

On top of potential downgrades to the OBR's economic forecasts, there are also several spending assumptions included in the March forecast that could prove difficult to deliver – and if undelivered, this would further reduce or eliminate the headroom on the fiscal rule to have debt falling.

As shown in Figure 19, the Government's current plans for spending in the next parliament imply significant real, per-person cuts to spending for unprotected departments. The protection of budgets for NHS England, Education, Defence and the FCDO budgets implies real, per-person spending cuts to 'unprotected' departments – such as Justice, the Home Office and local government – of 13 per cent between 2024-25 and 2028-29. Cuts on this scale – equivalent to £19 billion – would amount to repeating nearly three-quarters of the cuts made during the 2010 to 2015 Parliament.

FIGURE 19: **Current plans to cut departmental budgets look difficult to deliver**

Indices of real, per-person resource departmental expenditure limits (2009-10=100), all departments, 'unprotected' departments and 'protected' departments: UK



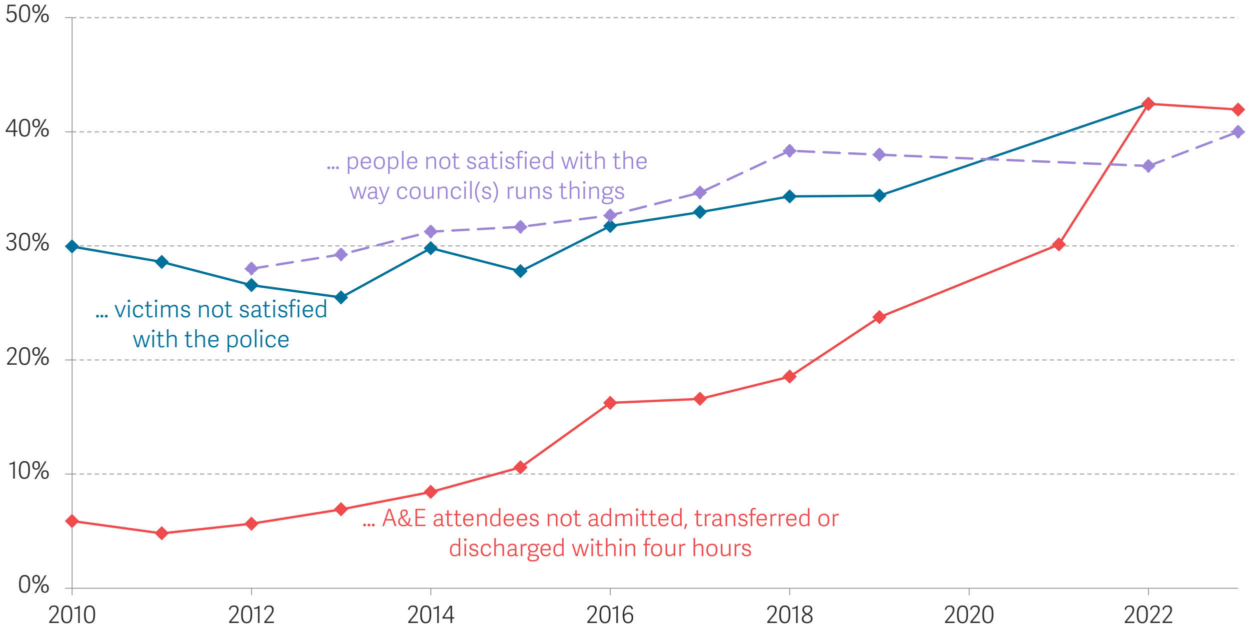
NOTES: GDP deflator adjusted. Protected budgets include NHS England, Education, Defence and Foreign, Commonwealth and Development Office. NHS budget is assumed to grow by 3.6 per cent a year in real terms; Education budget is assumed to be flat in real terms and topped up for projected costs of childcare policies; Defence is assumed to grow with nominal GDP; and Foreign, Commonwealth and Development Office budget is assumed to grow in line with 0.5 per cent of GNI. Figures include the impact of the Barnett formula.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, various; HM Treasury, Budget and Spending Review documents, various.

Delivering these cuts in the face of already crumbling public services and the public desire for more, not less, spending on public services would likely prove very challenging.[28] As Figure 20 shows, the proportion of crime victims not satisfied with the police increased from three-in-ten in 2010-11 to four-in-ten by 2022-23, for example. Another creaking public service is the crown court: around one-in-four crown court cases took over a year to be dealt with compared to one-in-twenty in 2014.[29] Likewise, the proportion of people not satisfied with the way their council runs things has increased from three-in-ten (28 per cent) in 2012 to four-in-ten (40 per cent) by 2023. Prisons are reaching breaking point, too, as the Ministry of Justice expects the prisoner population to increase at three times the pace of prison capacity.[30] Even the NHS, with its spending largely protected, has seen backlogs mount: the proportion of accident and emergency attendees, not admitted, transferred or discharged within four hours has skyrocketed from 6 per cent in 2010 to 42 per cent by 2023.

28 When asked in a recent YouGov poll, nearly three-in-five of the public supported prioritising funding public services over tax cuts, double the number who supported prioritising tax cuts. Source: YouGov, "Do you believe that the government should prioritise...?", February 2024.
29 G Richard & N Davies, Performance Tracker 2023: Criminal courts, Institute for Government, October 2023.
30 S Hoddinott et al., Performance Tracker 2023: Public services as the UK approaches a general election, Institute for Government, October 2023.

FIGURE 20: **Public services remain under pressure**

Proportion of people, victims and A&E attendees reporting either not being satisfied or where services are struggling to deliver, England



SOURCE: RF analysis of Institute for Government, Performance Tracker; ONS, Crime Survey for England and Wales; NHS England, A&E attendances and emergency admission statistics.
NOTES: Data on victims not satisfied with the policy covers England and Wales. Victims not satisfied with the police figures are for financial years. A&E figures are 12-month averages for Type 1 attendances.

The pressures on public services make the current plans for departmental budgets look difficult to deliver. The IMF has also expressed this view, producing analysis suggesting far higher spending totals are likely to be required in future.[31] If the next Government were unwilling to implement real, per-person spending cuts for unprotected departments, then this would add £19 billion to government borrowing in the final year of the forecast. Indeed, final estimates of Home Office spending for the 2023-24 fiscal year showed that the department had spent around £4 billion more than had been budgeted on the cost of asylum and migration, with this additional funding taken from the Government's reserves.[32] Given that these costs are likely to continue into the medium term, it is plausible to assume that an addition £4 billion of borrowing is likely to be needed, if the Government is to avoid permanently using its reserves to fund asylum costs.

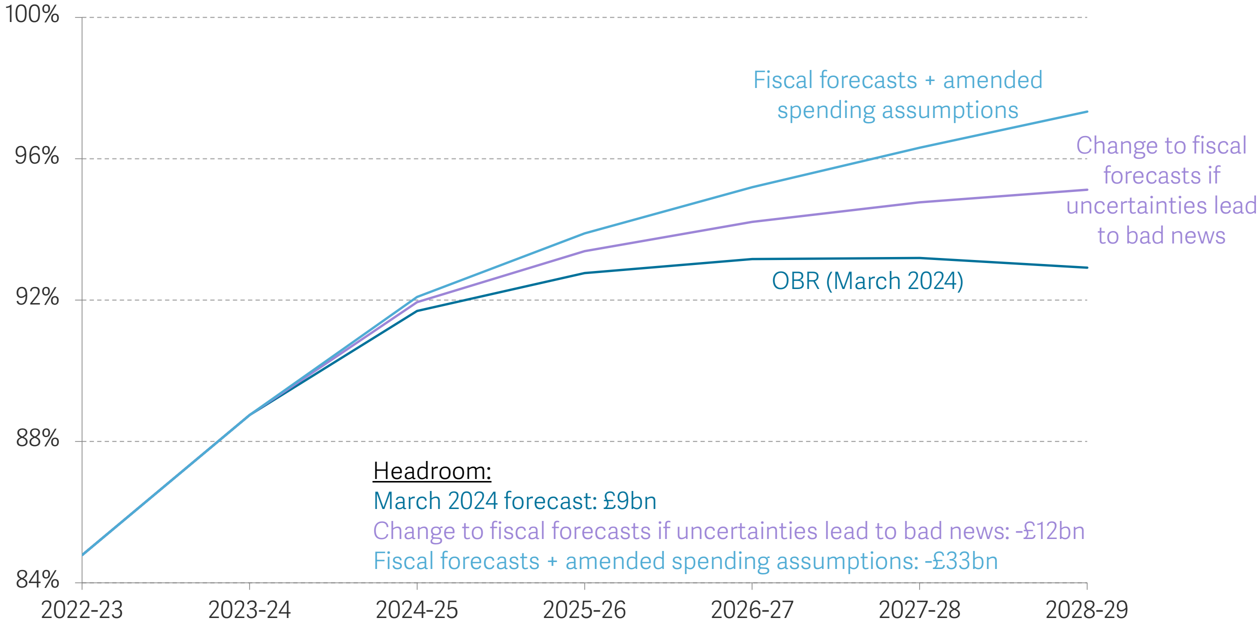
Considering both the macroeconomic factors and the adjustments to spending assumptions together, suggest a significant deterioration in the outlook for the public finances if these uncertainties surrounding the forecasts crystallise. As shown in Figure 21, this would set underlying public sector net debt on a consistently rising path over the forecast period and leave debt over 4 percentage points of GDP (£144 billion) higher than

31 IMF, United Kingdom: Staff Concluding Statement of the 2024 Article IV Mission, May 2024.
32 Home Office, Supplementary Estimates Memorandum (2023/24) for the Home Office, February 2024.

the OBR's latest forecasts in 2028-29. As such, this would erode the 'headroom' against the current the target of having debt falling, taking it from £9 billion of 'headroom', to breaking the target by a margin of £33 billion.

FIGURE 21: **A more realistic forecast of the Government's fiscal position suggests debt is on a rising path**

Public sector net debt excluding the Bank of England as a proportion of GDP, OBR forecast and various scenarios: UK



NOTES: Market rates to update debt interest costs were taken as of 17 May 2024.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2024; OBR, Economic and Fiscal Outlook, November 2023; Bank of England, Yield curves; Home Office, Supplementary Estimates Memorandum (2023/24) for the Home Office, February 2024.

By comparison, spending commitments from the main parties only add marginally to these challenges

Both main parties have made recent policy announcements which appear to be unfunded. For example, the Government has said it would increase defence spending to 2.5 per cent of GDP by 2030-31, which would require the Government to spend around £4 billion more on defence by 2028-29.[33] The Government has said that this additional spending would be paid for through plans to shrink the size of the Civil Service. But this would imply even larger cuts to unprotected departments, and so would be very difficult to deliver. The Labour Party also has some small spending commitments which are currently unfunded: for example, the proposal for a 'Fair Pay Agreement' in social care would increase public spending if it increased pay levels in the sector.[34]

33 Cabinet Office, Defending Britain, April 2024.
34 Labour Party, Labour's Plan to Make Work Pay: Delivering a New Deal for Working People, May 2024.

In addition to these specific commitments, both parties have discussed aspirational policy measures during the campaign. For example, the Conservative Party has suggested that its goal is to entirely scrap worker national insurance, a tax that currently brings in more than £50 billion.[35] And the Labour Party has said that it too wants to raise defence spending to 2.5 per cent of GDP, "as soon as resources allow".[36]

While there may be little difference between the parties in terms of the net impact on the public finances from their commitments so far, their approaches to tax and spending are distinct. On taxes, the Labour Party has said that it will put in place a number of small tax rises to fund specific spending increases, including on health and education.[37] Meanwhile, the Conservatives Party has so far focused rhetorically on lowering tax, with more details of specific policy likely to be forthcoming in the manifesto.[38]

Given the rhetoric of both parties, it seems likely that the manifestos will focus primarily on funded commitments. Overall, the commitments made by both parties thus far have been relatively small compared to the scale of those promised in the 2019 election, perhaps reflecting a recognition that the next Government faces much more significant fiscal constraints than those expected back in 2019.[39]

Ultimately, the scale of the fiscal uncertainties set out above are likely to be much larger than the potential impact of additional policy commitments, and look like they are going to be the decisive factor placing debt on a rising path into the 2030s. Despite their thus far relatively muted spending ambitions, neither party is likely to be on track to see the UK's debt fall over the next parliament under current conditions.

There are options for the next government to consider if uncertainty turns into bad news after the election

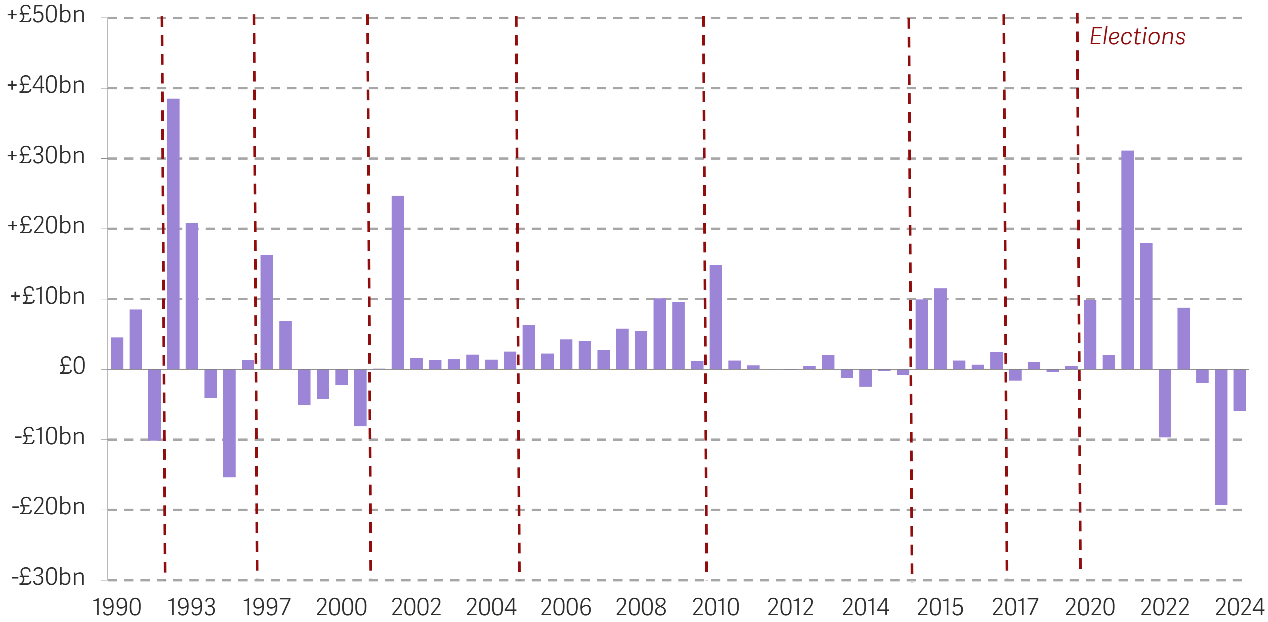
So with an uncertain economic outlook, pressures on spending unlikely to dissipate, taxes at historic highs and headroom against getting debt falling already wafer thin, it is likely to be an unenviable fiscal inheritance for winner of the election.

So how might the next government respond? In this context, history tells us that taxes often rise, particularly after elections (see Figure 22): in the year following nearly every election since 1992, taxes have risen, as governments increase their fiscal room for manoeuvre.

35 HM Treasury and The Rt Hon Jeremy Hunt, Spring Budget 2024 speech, March 2024.
36 K Whannel & C Geiger, Keir Starmer: Labour commitment to nuclear weapons unshakeable, BBC News, April 2024S Young, UK's Labour Party aims to boost defence spending to 2.5% of GDP, Reuters, April 2024.
37 K Starmer, Let's Get Britain's Future Back, Labour Party, April 2024.
38 See for example, J Scott, Conservatives promise tax cut for pensioners with 'triple lock plus', Sky News, 28 May 2024 and S P Chan & M Ross, Inheritance tax against Tory values, says Hunt, The Telegraph, 24 May 2024.
39 R Hughes et al., Playing by their own rules?, Resolution Foundation, November 2019.

FIGURE 22: **Taxes have risen in the year following nearly every election since 1992**

Net long-term annual impact of tax policy announcements at each fiscal event since 1990: UK



NOTES: Impacts in 2028-29, with past values uprated in line with nominal GDP. Based on forecasts from the time of each fiscal event (actual impacts on tax revenue may have differed).
SOURCE: RF analysis of OBR, Policy measures database.

But there are other options, proposed as part of the wider fiscal debate, for the next Government to respond to fiscal bad news. Below we discuss two specific examples – small changes to the fiscal framework and introducing a system of 'tiered' reserves remuneration – which have been discussed by others.

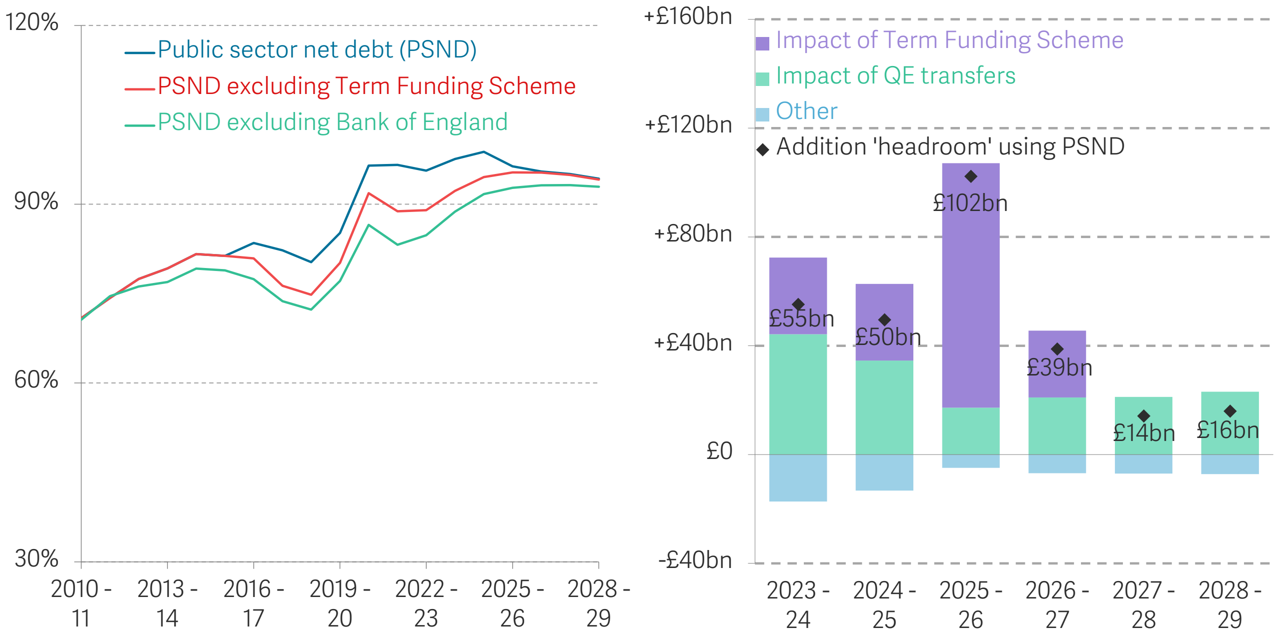
Taking the first of these, a relatively small change to the fiscal rules that has been discussed which would expand an incoming government's capacity to borrow is to move from a target for public sector net debt excluding the Bank of England, to focus just on public sector net debt (including the Bank).[40] The current approach of excluding the Bank of England from the target measure of debt was adopted to abstract from the impact of the Bank of England's Term Funding Scheme on debt.[41] The Term Funding Scheme was a lending scheme that (for various accounting reasons that didn't reflect additional fiscal pressures) added significantly to debt while the lending was taking place, then reduced it dramatically as the loans were paid back (the gap between the blue and red lines in the left panel of Figure 23). Excluding these impacts from the debt target was sensible while the scheme was in place, but the Term Funding Scheme will have wound up completely by the final two years of the forecast.

40 As part of a recent Treasury Committee review of the impact of the Bank of England's Quantitative Tightening policy, the Committee discuss the implications of changing the target measure of debt. House of Commons Treasury Committee, Quantitative Tightening, Fifth Report of Session 2023-24, January 2024.
41 Bank of England, Term Funding Scheme with additional incentives for SMEs (TFSME) – Market Notice, March 2020, accessed 3 June 2024.

After the Term Funding Scheme ended, the main difference between net debt including and excluding the Bank of England will be the impact of transfers from HM Treasury to the Bank to cover costs relating to quantitative easing (the green bars in the right panel of Figure 23). These costs are captured in public sector net debt including the Bank of England, but are partly captured as valuation effects from the point quantitative easing took place, rather than just as cash transfers when the Bank makes losses selling the gilts it holds. As a result, moving to a public sector net debt target including the Bank of England would add around £16 billion to the Government's headroom – at the cost of a relatively small change to the fiscal framework. This change may prove tempting for whoever is in government following the election, although it will offer limited additional borrowing space in the years ahead as the Bank of England winds down its quantitative tightening programme and active sales draw to a close. To be clear, such an approach does not represent a substantive change in the fiscal position. Instead it is an economically-justifiable change to the way total debt is measured for fiscal rules.

FIGURE 23: **Moving to a public sector net debt target, including the Bank of England, would expand the next government's headroom to have debt falling**

Public sector net debt (PSND), various measures (left panel), additional headroom from a PSND target compared to PSND, ex. Bank of England, by source (right panel)



SOURCE: RF analysis of ONS, Public sector finances; OBR, Economic and Fiscal Outlook, March 2024.

A second example of a policy that has been raised in the public discourse that could be used to help manage fiscal pressures that may arise in the coming years, is to change the approach to remunerating reserves issued by the Bank of England.[42] The UK's debt-servicing bill includes the cost of paying Bank Rate on reserves created by the Bank of England to purchase gilts during quantitative easing. The government could ask the Bank

42 P Tucker, Quantitative easing, monetary policy implementation and the public finances, Institute for Fiscal Studies, October 2022.

of England to move to a system of tiered reserves, reducing the proportion of reserves that are remunerated in this way which would reduce spending on debt-interest by up to £8 billion by 2028-29. It is important to recognise that such an approach is effectively a tax on commercial banks and so would likely result in higher charges for banks' services. The fiscal benefits of pursuing this policy would also reduce significantly in future, as the Bank sells off the gilts it bought during quantitative easing, so it would at best deliver a temporary boost to the public finances.

To be clear, we are not advocating these options and they are not without cost, and so far, neither main party has said that it intends to pursue them. But, given the pressures outlined in this briefing note, they are measures that could be considered by a new government looking to manage some of the risks to the fiscal situation that may crystallise in the next parliament. Of course, another option a future government may consider would be to reprioritise its spending commitments. As set out above (see Figure 19), it is unlikely that significant spending cuts will be realisable on departmental spending budgets, given the pressures continuing to mount on public services. And further cuts to public investment spending would likely be economically damaging. However, it is possible that a future government could choose to reduce some of its ongoing expenses (annually managed expenditure, or AME).

The long-term challenges to the public finances mean that, beyond the next parliament, tighter fiscal policy is likely to be required. Our previous work has shown that putting the public finances on a sustainable footing means we are likely to need to run surpluses.[43] This puts the onus on parties to locate plans for looser fiscal policy in the next parliament, within a longer-term strategy to put debt on a decisive downward path.

Our outsized fiscal debate needs a reality check

As we approach the election, it is clear that we will be hearing a lot about how both main parties would manage the public finances. Both want to avoid looking like they have unfunded spending – or tax-cutting – plans. But recent policy changes and economic shocks have left us with a larger state, rising taxes and ever-higher debt, a difficult combination for whichever party wins the next election. At the Budget, the headroom against the Government's self-imposed fiscal rule of reducing public debt by the fifth year of the forecast was wafer thin at just £9 billion. And this was predicated on spending plans that imply difficult-to-deliver cuts to unprotected departments. To make matters worse, since the Budget, new demands on the public finances have come to light, interest rate expectations have risen, and the macroeconomic outlook may yet worsen. This could easily leave the next Government over £30 billion away from getting debt falling, the stated aim of both main parties. In short, history and politics has left the fiscal debate detached from this reality.

43 S Pittaway & J Smith, Built to last: Towards a sustainable macroeconomic policy framework for the UK, Resolution Foundation, October 2023.

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