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Institute for Fiscal Studies

The IFS Green Budget October 2024

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In association with Citi and funded by the Nuffield Foundation

The IFS Green Budget: October 2024

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Foreword from Citi

We are delighted to be collaborating again with IFS on the production of the Green Budget in what is now our seventh annual collaboration. IFS continues to shine a critical and objective light on the key issues facing the UK public finances. IFS reports are always essential reading for policymakers, investors and corporate leaders alike.

The new UK government has promised the delivery of economic stability with tough spending rules. The Chancellor has made constant reference to the challenges faced by the UK public finances, but she reiterated in her recent speech to the Labour Party Conference that there would be no increases in income tax, National Insurance or VAT in the forthcoming Budget, but also no return of austerity. The self-imposed tightrope walk across the public finances makes the 30 October Budget a particularly critical one.

The focus on tight spending by an incoming Labour government has so far been taken well by financial markets, although UK consumer confidence measures have been disappointing in recent months while some areas of the public sector have seen substantial pay increases. It is important that any tax changes within the forthcoming Budget are made within a framework aimed at improving overall tax design, a point that IFS has already noted. It is also important that any changes to the rules on government borrowing are spelled out in a compelling and coherent manner.

Citi's Economics team has again provided a major contribution to the Green Budget with a detailed chapter on the UK economic outlook. I would like to thank Benjamin Nabarro, Citi's Chief UK Economist, for his detailed work in support of this year's Green Budget. I would also like to thank IFS for the opportunity to collaborate again on the Green Budget.



Andrew Pitt

Head of Global Insights

Citi

Foreword from the Nuffield Foundation

The Nuffield Foundation is one of the longest-standing supporters of the work of IFS. We believe it represents the gold standard in impartial, evidentially rigorous research. It is the constant point of independent reference for assessing the most important fiscal decisions facing any British government. Over the past eight years, Nuffield has supported over 20 IFS projects on many topics – across Tax and Welfare, Education and, most recently, the Justice system. However, the Green Budget remains the landmark publication of the IFS year, framing public debate on the state of the public finances ahead of the Chancellor's Budget and Spending Review. It is not only an annual audit of the government's fiscal position and policy options but it also shapes the wider public policy agenda over the longer term. This is especially the case this year as Rachel Reeves prepares to deliver her first Budget, one of the most significant in a generation.

If the challenge for the United Kingdom is to reset the terms of the relationship between a caring and productive society, the areas on which Green Budget has focused this year identify the pressure points in that equation. In devoting specific chapters to public sector pay, child poverty, capital gains tax, social care and public spending, it addresses some of the critical and interleaved questions that may determine the public verdict on the new government – the quality and affordability of public services; the obstacles facing young people from disadvantaged backgrounds in leading fulfilled and economically productive lives; the strains on the intergenerational social contract as the population ages; and the government's philosophy of taxation – the terms on which both public spending can be financed and enterprise encouraged.

The debate over the Budget will inevitably be engulfed in political rhetoric; amidst the heat, there will be an urgent need for some light to be shed. The Green Budget, in addition to getting to the heart of the complex trade-offs facing any Chancellor, also displays IFS's rare ability to translate these into the accessible language of wider public discourse. In so doing, it is a genuinely emancipatory and inclusive force. This quality makes it central to the Nuffield Foundation's ambition – to advance social well-being, to champion research that can make for better policy, and to support those who translate policy into effective practice and so make people's lives better. The Green Budget is an anchor to that purpose and we are proud to continue to support it.



Tim Gardam

Chief Executive

Nuffield Foundation

Preface

Welcome to the IFS 2024 Green Budget.

This year's edition will be the first produced under a Labour government during my tenure as Director of IFS. Given the change of government, this year's Budget will be particularly significant, likely signalling the broad direction of policy on tax and spending for the rest of the parliament. It will also be the first ever in the UK presented by a female Chancellor.

Ms Reeves inherits a difficult legacy. The economy has grown faster than expected this year, but the recovery is not yet secure, and productivity growth remains disappointing. Even if much-needed reforms can be delivered, growth is unlikely to come fast enough to ease the painful choices the Chancellor will need to make if she is to stick to her own fiscal rules. There is speculation that the details of the debt rule will be changed, but the specific definition matters less than making a coherent case for any borrowing and ensuring any investment is well spent. And Ms Reeves will still be constrained by her commendable commitment to aim for current budget balance over the medium term.

Much of the challenge was foreseeable. Existing spending plans always looked implausibly tight. Agreeing in full to the recommendations of the Pay Review Bodies may have been unavoidable given recruitment and retention problems across the public sector, not to mention widespread industrial action. But it will be expensive. If the government wishes to avoid real-terms cuts to budgets for public services – one interpretation of its pledge that there will be 'no return to austerity' – it could need to find an extra £20 billion a year. Even that would not be enough to deliver ambitious improvements.

Budgets early in the parliament of a new government often do see big tax rises. But Ms Reeves has given herself little room for manoeuvre. Substantial increases to some taxes are already pencilled in and factored into forecasts. Labour's manifesto put many of the tools best suited to significant revenue-raising out of reach. The challenge will be raising revenue from the remaining options without exacerbating the worst features of the UK tax system and damaging growth. A chapter with Arun Advani and Andy Summers of CenTax looks in depth at capital gains tax, a rise in which has been widely predicted. The challenge here is to implement sensible reform, not just to raise rates – doing the latter in isolation would risk economic damage and may not raise much revenue in any case.

Tackling child poverty is high up the agenda. A 6 percentage point fall in relative child poverty was achieved during the last period of Labour government, in large part as a result of a massive increase in the generosity of the benefit system. The current government has so far resisted calls to remove the two-child limit, which we find is currently the most cost-effective

way of reducing the number of children in poverty through the benefit system. Whatever the government does do, it should consider how changes affect the depth of poverty, not just the numbers that make headlines.

We have heard rather less about the challenges facing social care – growing demand from working-age adults, rising costs and unforgivable geographic variation in provision. But surely we cannot duck this for the rest of the parliament. An early decision to scrap charging reforms legislated by the previous government leaves the problem of high and difficult-to-insure care costs unresolved.

We are delighted to continue our collaboration with Citi, now in its seventh year. We are grateful both for their financial support for the Green Budget and for their chapter on the outlook for the UK economy. This provides superb insights and vital context for the rest of the Green Budget's analysis.

We are also very grateful to the Nuffield Foundation for the funding it has provided to support the Green Budget. Our most important aim for the Green Budget is to influence policy and inform the public debate. At this crucial moment, which will set the scene for the next five years, we are delighted that this work could be supported by the Nuffield Foundation, for which these are also central aims.

The continuing support that the Economic and Social Research Council (ESRC) provides for our ongoing research work via the Centre for the Microeconomic Analysis of Public Policy at IFS (ES/T014334/1) underpins all our analysis in this volume and is gratefully acknowledged.

Data from the Annual Survey of Hours and Earnings, the Family Resources Survey and the Labour Force Survey are available from the UK Data Service. This work uses research data sets that may not exactly reproduce National Statistics aggregates. The data owners and suppliers bear no responsibility for the interpretation of the data in this book.

As with all IFS publications, the views expressed are those of the named chapter authors and not of the institute – which has no corporate views – or of the funders of the research.



Paul Johnson

Director

Institute for Fiscal Studies

Citi Research & Global Insights

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The Nuffield Foundation

The Nuffield Foundation is an independent charitable trust with a mission to advance social well-being. It funds research that informs social policy, primarily in Education, Welfare, and Justice. The Nuffield Foundation is the founder and co-funder of the Nuffield Council on Bioethics, the Ada Lovelace Institute and the Nuffield Family Justice Observatory.

The Nuffield Foundation has funded this project, but the views expressed are those of the authors and not necessarily the Foundation.

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1. UK economic outlook: navigating the endgame

Benjamin Nabarro (Citi)

Key findings

1. **The UK's economic performance over the past two decades is hard to describe as anything other than a policy failure.** Productivity growth has been dire – with per-worker growth over the past decade the weakest on average since at least 1850. The innovative engine behind the UK economy seems to have stalled. In 2014, a little under 6% of all firms in the UK (14,000) were ‘high-growth firms’ – employing at least 10 people and growing their headcount by more than 20% per annum for three years running. This has fallen to just under 4% now. Macroeconomic resilience also seems to have suffered as low growth, low investment and weak income growth have all fed back into one another.
2. **The growing global challenges surrounding ecological and geopolitical transition should add to a sense of urgency.** These imply further economic headwinds to growth in the years ahead, alongside heightened volatility. More physical investment will be required to ameliorate these effects. But this does not constitute a strategy for addressing the UK's existing growth shortfall. **High debt levels, a structural external financing gap and elevated rates volatility mean the stock of outstanding debt is a growing vulnerability.** In this sense, the UK likely finds itself in a worse position than the US or the Euro Area.
3. The UK needs to lift growth despite these growing challenges, in the context of limited policy space. Here we think the focus should be on boosting intangible and ICT investment, alongside broader efforts to improve diffusion from the technological frontier. **Both growth and resilience will need to be areas of focus.** The UK, as a small open economy, remains particularly exposed to future shocks. Efforts to bolster resilience, as well as better coordinating monetary and fiscal policy, will be crucial to navigating these shocks better in future. In our view, **without countercyclical ‘burden**

sharing' between monetary and fiscal policy, structural efforts to lift trend growth are unlikely to be successful.

4. **The cyclical outlook we present here is one of near-term 'sogginess' and medium-term optimism.** Globally, we think the near-term outlook is likely to remain somewhat weak. Supportive factors for demand – in particular, significant fiscal support – are beginning to fade. Continued structural uncertainties in China – recent stimulus notwithstanding – remain a headwind across Europe. And US growth exceptionalism does appear to be gradually fading as the impact of tighter monetary policy feeds through. **We expect global activity to fall back in the second half of this year.** This implies fading external support for UK growth as we move into 2025. External inflationary influences are also likely to continue to fade.
5. **The UK economy has surprised to the upside since the start of 2024.** We now expect real GDP growth of 1.0% this calendar year, compared with a forecast of just 0.1% back in January. **But these welcome improvements are not yet indicative of a secure economic recovery.** Instead, they primarily reflect transient improvements in capacity as energy prices have fallen back. For now, the outlook for the core domestic demand engines for the UK remains subdued. A sharp improvement in real incomes since the start of the year has not yet translated into stronger consumer spending. Firm sentiment and investment intentions have improved but remain on the defensive side. And public consumption is likely to prove constrained. **We expect growth to remain positive but weak in the near term, with real GDP increasing by 0.7% next year.**
6. A procyclical monetary policy approach risks slowing the recovery in our view. Structural changes have slowed the transmission of monetary policy into economic activity. **The effects of higher interest rates may become more material as many parts of the economy are forced to borrow once more; around half of the cumulative effect of monetary policy is still to be felt.** This will suppress demand, just as the supply side of the economy begins to recover. Better news in the latter case reflects lower energy prices, and rebalancing between labour and non-labour inputs in production. This is cause for optimism, although monetary headwinds will make it difficult to capitalise immediately. **We expect growth to accelerate markedly through 2026 and 2027 as monetary and fiscal constraints are eased.**
7. The outlook for the household sector should improve modestly in the months ahead, although household sentiment remains somewhat defensive. **Much will depend on developments in the household saving rate. The 'cash' saving rate – i.e. excluding the imputed equity of pension funds – has climbed from 3.4% just before the pandemic to around 8% now.** This has been pushed higher by a

combination of uncertainty, consumption smoothing and balance sheet impairments. In the months ahead, we think the saving rate may come down modestly as uncertainty dissipates – although we expect the rate to remain elevated as households overall are significantly less well off now than before the pandemic. **We expect private consumption to increase by only 0.6% in 2025, compared with 1.5% in the Bank of England's baseline estimate.** The outlook for firms should improve as supply growth picks up and costs decline, though any gains will come from a weak base. Business investment should recover gradually as interest rates fall.

8. Excess labour demand – present through 2022 and 2023 – has now been eliminated. We think most recent data suggest the labour market is continuing to loosen. Vacancies have continued to trend down over recent months, if perhaps at a more moderate pace than last year. Private employment dynamics also look weak, at least according to the PAYE data. **As public sector employment growth slows, we think the unemployment rate will increase to 4.9% next year and 5.3% in 2026.** The risks here seem broadly balanced, although a flattening in the Beveridge curve would, if anything, imply a faster pass-through from lower vacancies into higher unemployment from here. We expect a modest loosening of the labour market to weigh on wage growth and consumer confidence into 2025.
9. The UK's inflation process over recent years has been primarily 'conflictual' in that high wage growth and services inflation both reflect efforts to make up for large losses associated with an adverse terms-of-trade shock. This, we think, has contributed to sticky wage and services price inflation over recent months. But increasingly we think there are signs that these effects are beginning to fade, with the real income loss associated with the shock now having been more than fully absorbed. **Evidence of further 'agitation' around either inflation or nominal wage growth seems limited, and confined to a few specific quarters.** And forward expectations for both wages and prices are now broadly consistent with the inflation target. The natural decay in the UK's inflation processes primarily reflects the relatively high 'cost of conflict' rather than the demand-destructive impact of higher rates. Inflation seems to have broadly returned to target without much direct input from monetary policy. To the degree that the latter now weighs on demand and slack, **we expect to undershoot the inflation target through 2026.**
10. **The Monetary Policy Committee (MPC) remains in an inflation-averse state of mind.** Having cut rates for the first time in August, we expect the committee to ease policy only gradually over the coming months as evidence around inflation continues to accumulate. However, if the labour market does loosen through the first half of next year, we think that is likely to signal the committee should pick up the pace. **In our**

view, a continued focus on the upside risks around inflation, while understandable, is increasingly inappropriate. We expect the MPC to cut rates into accommodative territory through 2025–26 as policy refocuses on the risks around the labour market, and monetary policy is forced to correct for a procyclical monetary and fiscal stance through 2023 and 2024.

11. After two decades of stagnation, change is needed. **The outlook is for a period of near-term sogginess, followed by a more robust cyclical acceleration as supply-side improvements continue to materialise. This may provide a window of opportunity.** Already, in the past decade, the gap between what the UK economy can support, and what has societally been promised, has widened. This is combined with the potential for an intermittently binding external liquidity constraint that also poses more acute risks. In a context of growing international rates volatility, the UK does not have time to spare.

1.1 Introduction

The UK's economic performance over the past two decades can only be fairly described as a policy failure. In the wake of the financial crisis, trend productivity growth has decelerated more abruptly than elsewhere. That has been accompanied by acute fiscal policy error through the financial crisis and then the post-COVID period – both of which have added further embedded losses. The result is increasingly pronounced economic weakness, constraints on fiscal policy and a widening gap between what the UK can produce and what society demands. The outlook presents opportunities for meaningful structural reform, but also reaffirms the risks associated with continued inaction.

In the near term, the outlook is framed by underlying improvements around the supply side of the economy, but also continued sogginess on spending and demand. We expect growth to remain subdued into 2025, decelerating from 1.0% this year to 0.7% next, as policy headwinds continue to bear down on the recovery. However, we think this is likely to precede a fuller economic recovery through 2026 and 2027 as improvements in supply are realised.

Unemployment, in the meantime, will increase to around 5.2% by early 2026 as a margin of excess labour demand emerges, before falling back thereafter. We expect inflation to remain in a 2–3% range in the near term before decelerating more fully through the end of next year as stronger energy effects fade and slack bears down on domestic prices. We expect an undershoot in headline CPI through much of 2026.

Here, our outlook is framed by three themes.

First, and on the more optimistic side, we do see potential for some ‘catchup’ on the supply side after the recent shock-induced stupor. The large shocks that have buffeted the UK in recent years are either fading or reversing. Excess global manufacturing capacity seems to be increasingly feeding into lower UK import prices. Energy prices also seem likely to moderate further – recent geopolitical news notwithstanding. In the UK, these supportive headwinds are then complemented by improving productivity as input prices fall, capacity comes back online and production rebalances in a more capital-intensive direction. The net implication is that near-term supply growth is likely to be around 2% or so – stronger than the 1.4–1.5% long-term trend that is often assumed.

Second, the outlook for the demand side of the economy is, if anything, deteriorating. Over recent years, fiscal policy has stimulated in response to supply shocks. Some adjustment will be required as this procyclical fiscal stance is gradually unwound. This has also brought fiscal policy increasingly into conflict with monetary policy which has been forced to be more aggressive to offset the impact of fiscal support. The implication is that the UK will likely see concurrent fiscal and monetary headwinds into the end of 2025 as the supply shocks that have so far driven this cycle begin to fade. Demand headwinds could be compounded by balance sheet impairments accrued during the pandemic, which we continue to think will keep household saving somewhat elevated. We think a rise in unemployment may be the result.

The third factor is a lingering degree of inflationary aversion on the part of monetary policy. This is understandable given the experience of recent years, but perhaps no longer the right approach. As inflation has jumped in recent years, the scale of the monetary policy response has reflected a desire to weigh disproportionately against the risk of embedded inflation, as well as offsetting the impact of a procyclical fiscal stance. This has meant a more activist and hawkish stance. However, the balance of risks has materially shifted. Supply shocks are reversing. Fiscal policy is inflecting. Inflation is fading. And the labour market appears increasingly vulnerable. The full spectrum of risks should increasingly be incorporated into policy deliberations going forward, rather than simply those around inflation. In our view, the Monetary Policy Committee (MPC) is already too slow on the turn. This adds to the risk that policy is ultimately cut into accommodative territory in the years ahead to make up lost ground.

Together, these points suggest that good economic news is coming, but its realisation may be deferred rather than immediate. In the very near term, the UK faces the legacy of the latest round of macroeconomic policy mistakes. But, once adjustments have been worked through, a window of opportunity should emerge. It is vital policy utilises that momentum to drive a more meaningful structural improvement.

Below, we begin by discussing the structural challenges posed by the economic inheritance (Section 1.2). We then turn to the global and domestic outlook for activity (Section 1.3), before

turning to the labour market in Section 1.4, inflation in Section 1.5 and policy conclusions in Section 1.6.

1.2 The economic inheritance

On 28 February, Chancellor Rachel Reeves warned that the incoming Labour government would face ‘the worst economic situation since Second World War’.¹ We would not go that far. But Ms Reeves does take the helm after two decades of chronic economic mismanagement. If the UK’s 20th century economic experience was framed by three mistakes – return to the gold standard and austerity in the wake of the 1929 crash (Eichengreen, 1992; Gwiazdowski and Chouliarakis, 2021; Heffer, 2024); a failure to engage with Europe from a position of strength in the 1950s (May, 1998); and the conflation of serious supply reform with expedient demand stimulus in the early 1970s (Morrison, 1974) – then all three errors have been repeated to some degree in the space of a decade and a half. The result has been abject economic performance. Trend UK productivity growth has collapsed to near-record lows. And various measures of public service performance and well-being – including improvements in longevity – have stalled (Health Foundation, 2019).

This should be a call to arms. Poor performance, when sustained, becomes harder to reverse and more uncertain in its institutional consequences (Eichengreen, 2018). It is also likely that the global macroeconomic and financial environment is becoming more adverse. Lifting trend growth is likely to be essential if the UK is going to deal with the choppy waters ahead and make the economic transitions required by major ecological and geopolitical challenges.

In this section, we consider what explains the slump in productivity and what might be needed for the UK to transition to higher growth. We then turn to some key issues with the UK’s macroeconomic resilience, and to some legacy macro-financial risks which will constrain the Chancellor’s policy options.

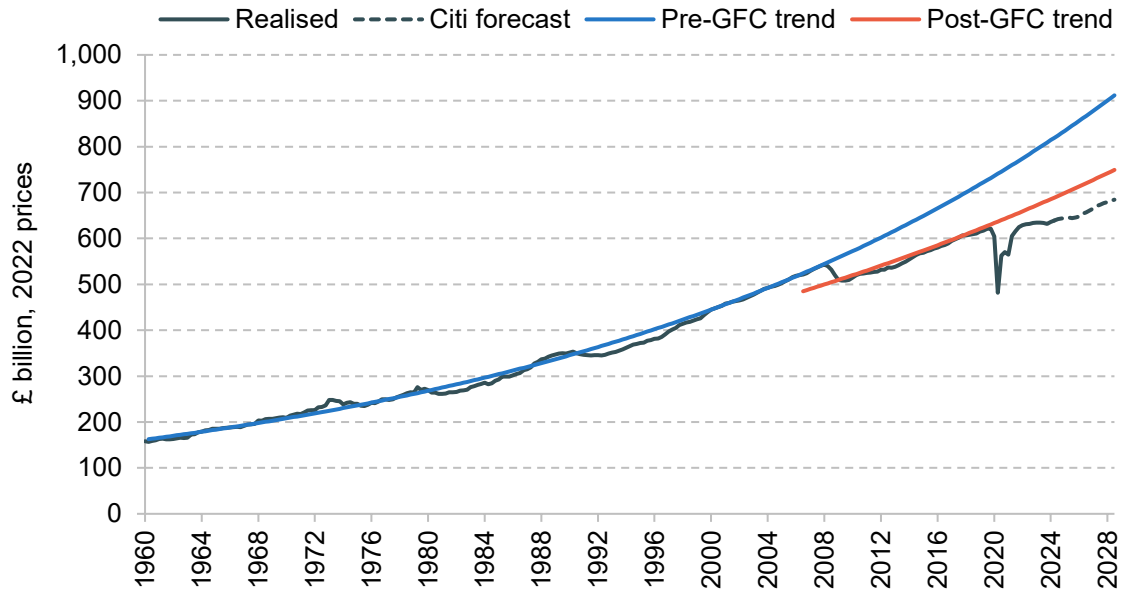
What will it take to get higher growth?

UK economic activity is 36% lower than it would be had it continued to grow in line with its 1997–2008 trend. This compares with 31% in the Euro Area and 24% in the US, comparable countries that – at least in the latter case – have faced similar shocks. While most advanced economies have experienced slower trend growth, the decline in the UK has been particularly severe. This has been compounded by a further relative deterioration in the UK’s post-COVID

¹ <https://news.sky.com/story/labour-will-inherit-worst-economic-situation-since-second-world-war-shadow-chancellor-warns-13083097>.

performance, with UK GDP now 6.1% short of its pre-pandemic (2014–19) trajectory, compared with 4.3% in the Euro Area.

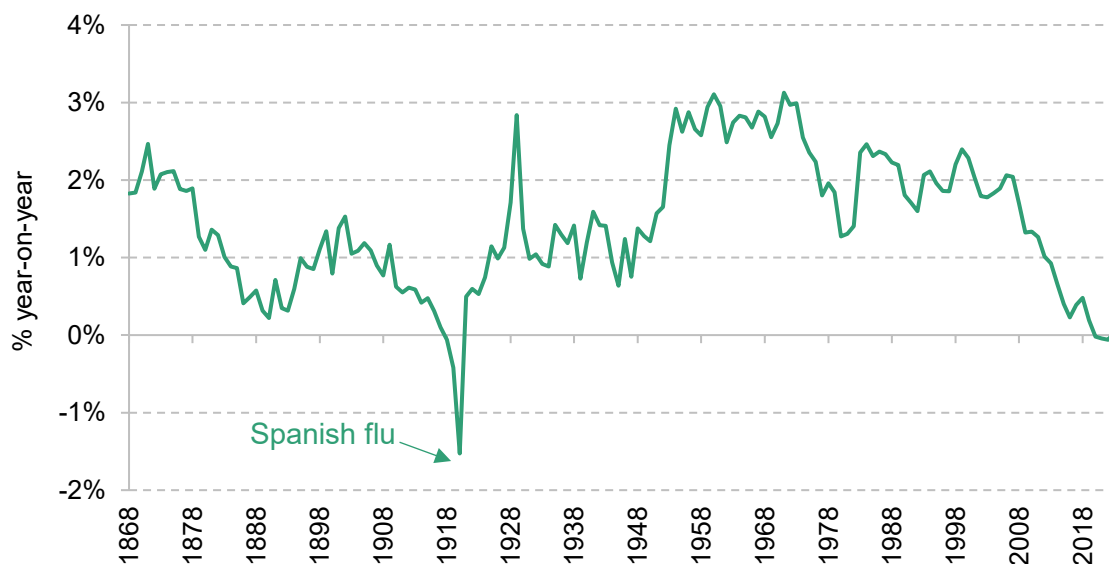
Figure 1.1. UK GDP versus historical trends



Note: Pre-GFC trend here is calculated between 1960 and 2007 and post-GFC trend is 2010–19, where GFC is Great Financial Crisis.

Source: ONS.

Figure 1.2. UK potential growth in GDP per worker (10-year moving average of year-on-year % growth)



Note: Potential GDP is measured here by taking observed GDP adjusted by an Okun rule. This is then divided by the number of workers. In more recent years, we have taken OBR estimations of potential. Average is taken over a 10-year rolling window.

Source: ONS, OBR, Thomas and Dimsdale (2016).

This slow growth in UK output is despite a material increase in labour supply. Productivity – measured by output per worker, or per hour worked – has therefore fared even worse (Van Reenen and Yang, 2024). The recent decline in potential output per worker in the UK is unprecedented since the late 19th century (see Figure 1.2). Nicholas Crafts, before his passing last year, noted that the slump in productivity growth is unprecedented in the last 250 years (Crafts and Mills, 2019).

A simple growth accounting exercise is useful here. The decline in real GDP growth in the UK – of around 1.8 percentage points (ppts) on average between 1995–2006 and 2007–19 – can be decomposed into changes in: labour supply (+0.1ppt); human capital, as measured by average years of schooling (–0.2ppt);² physical capital (–0.5ppt); and total factor productivity (–1.2ppt).³ The last is by far the largest driver. According to these data, total factor productivity (TFP) in the UK was 4.6% *lower* in 2019 than in 2007 (similar to the fall in France). Over the same period, TFP has increased by 2.2% in Germany and 5.1% in the US.

What explains this weakness? Here it is worth taking the decomposition above with a pinch of salt. TFP is measured as a residual – effectively describing those activity improvements that cannot be explained by physical capital, labour or human capital. The outcome is therefore heavily dependent on what kind of capital data are used. Using some more granular data, such as the OECD KLEMS data, suggests slower capital deepening has contributed to a more abrupt productivity slowdown here than it has in France, Germany or the US (Van Reenen and Yang, 2024). But this faster slowdown is concentrated in either digital infrastructure or intangible assets, rather than major capital projects. We think this helps explain the faster fall in simpler measures of TFP, which are likely to reflect this deceleration in intangible investment as a residual.

Decelerating digital and intangible investment fits with the pattern of UK growth after the financial crisis, with a faster slowdown in productivity in intangible-intensive sectors – many of which faced a particularly abrupt credit crunch (Goodridge and Haskel, 2022; Bailey et al., 2022). Ahn, Duval and Sever (2020) find there was a materially larger reduction in intangible investment in indebted firms than in less indebted equivalents or indeed in investment in tangible assets across OECD countries. The subsequent increase in many firms' preference for internal liquidity seems to have been persistent, with a widening gap between the cost of capital

² For details, see https://www.rug.nl/ggdc/docs/human_capital_in_pwt_90.pdf. See also Feenstra, Inklaar and Timmer (2015).

³ Decomposition of change in real GDP growth between 1995–2006 and 2007–19, assuming a Cobb–Douglas constant-returns-to-scale production function. Citi analysis based on Penn World Tables and ONS data. Compares the UK with a weighted average of France, Germany and the UK. Similar benchmark countries are used in other studies, such as Van Reenen and Yang (2024).

and the rate of return required for firms to deem projects worthwhile – their ‘hurdle rate’ (Cunliffe, 2017; Melolinna, Miller and Tatomir, 2018).

These more persistent effects have effectively strangled investment in digital and intangible assets over recent years. In fact, we think the impact has been twofold. First, these challenges have weighed heavily on investment in the first instance. Second, they have also limited firm entry and competition. For firms of a certain size, borrowing against cash flow is possible, enabling incumbents to continue to grow. But for smaller firms, the ‘tyranny of collateral’ is more obviously binding (Cecchetti and Schoenholtz, 2017 and 2018). For example, in the UK, a 2015 survey found that 90% of all lending to small and medium enterprises (SMEs) was secured against some kind of physical collateral (Haskel and Westlake, 2022). This has limited reallocation, weighing on growth. This has also enabled a degree of strategic underinvestment on the part of incumbents. In an oligopolistic market, investment becomes something of a strategic game. If other firms dial back, this can quickly be perpetuated across the sector at large.

The logic here is involved and difficult to prove. But a decline in reallocation and competition does fit the broad patterns we see in the data. We also know that the gap in firm productivity levels between sector ‘leaders’ and laggards has been widening for some time (Andrews, Criscuolo and Gal, 2015; Autor et al., 2020). While the contribution to growth of the 10% most productive firms – outside of the financial sector – has been roughly constant over time, the contribution of the ‘upper middle’ (those between the 50th and 90th percentiles of productivity) has more than halved since the financial crisis (Office for National Statistics, 2022). Given the associated concentration of the growth slowdown in more intangible-intensive sectors, it is plausible that financial constraints are weighing on both new entry and broader digital investment.

What will it take to improve this picture? We think the focus should be on institutional arrangements for investment. For example, improving the tax treatment of certain kinds of equity finance could help, and also allow a better sharing of risk and reward between firms and lenders (Hosono, Miyakawa and Takizawa, 2017). For now, the tax treatment continues to favour debt finance (Adam, Delestre and Nair, 2022). Encouraging larger firms, which can borrow against proven intangible expertise, to finance smaller equivalents could also boost investment, as well as improving the sharing of expertise.^{4,5} Much more work will be needed here to shift the balance.

⁴ Haskel and Westlake (2022) note that many larger firms are often able to borrow on the basis of cashflow covenants, but this is usually only available to larger firms. See also Lian and Ma (2021).

⁵ The literature on foreign direct investment speaks to potential productivity benefit associated with investment agreements if also associated with knowledge sharing. See Baldwin (2016).

Aside from finance, a range of other challenges have impeded reallocation. Four stand out:

- Technological issues associated with frontier firms, and associated challenges around competition policy, as incumbency advantages count for more.
- Low labour mobility, as high housing costs have disincentivised workers from moving to more productive regions. Young renters are less likely to move than in the past, and rental prices have tended to grow more quickly than wages in faster-growing areas (Judge, 2019).
- Weak transport infrastructure, particularly in large UK cities outside of London. Only 40% of the urban population can reach these city centres by public transport in 30 minutes, compared with 67% in continental Europe (Rodrigues and Breach, 2021). This has stunted ‘thick market’ effects that can otherwise boost the efficacy of local labour markets.
- Growing skills shortages, particularly in STEM subjects (Stansbury, Turner and Balls, 2023). OECD analysis marks the UK out as suffering a particularly severe mismatch between workers’ fields of study and job requirements, and a greater extent of workers ‘underqualified’ for their jobs (Deb and Li, 2024). Falling spending on adult skills, from an already low base, will not have helped.

In all cases, these effects risk inhibiting competition at the frontier, and more broadly limiting productivity growth. And their effect has been to gradually bear down on business dynamism – i.e. the rate of firm turnover. Here the fall has been significant and consistent over recent years (see Figure 1.3). This, we think, is a function of both ‘pull’ and ‘push’ factors. On ‘pull’ factors – drivers that are pulling capacity from less productive areas – a thinning in the number of growth opportunities has also meant a decline in the number of ‘high-growth’ firms.⁶ In 2014, a little over 6% of all firms in the UK (14,000) were defined as ‘high-growth’ firms. This has fallen to just under 4% now. Brexit may have played a role here, with many such firms historically utilising single market membership to boost their growth (Freeman et al., 2022).

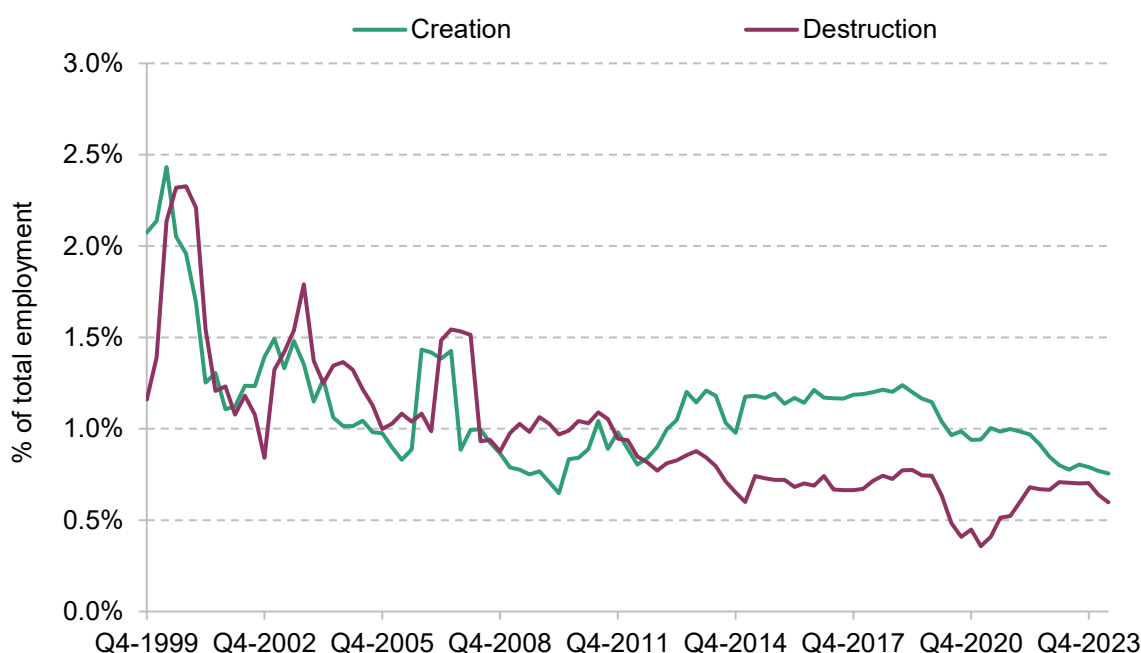
There have also been ‘push’ factors – i.e. capacity remaining ‘trapped’ in suboptimal allocations for longer. Here the most obvious cases have been in the initial period after the financial crisis and in the post-COVID period. In the former case, weak financial institutions may have played a role, with weak financial balance sheets creating an incentive not to recognise losses. But increasingly through the pandemic the same effect has operated, even as financial institutions have remained robust. In part, this may reflect the direct impact of sweeping subsidies, which allowed some firms to cling on. It may also be that in a more intangible-intensive economy,

⁶ Here we are defining these in terms of employment. ‘High-growth’ firms are defined by the OECD as firms employing at least 10 people and enjoying employment growth of more than 20% per annum for three years running.

firms have an incentive to protect sunk costs – in the form of firm-specific assets – until they become unviable from a cash-flow perspective. This can take some time.

While less ‘churn’ may sound like a good thing, a moderate rate of firm failure and creation is indicative of a healthy process of ‘creative destruction’ that supports innovation and productive reallocation. The scale of the reduction here should be a growing cause for concern.

Figure 1.3. UK job destruction and creation owing to firm turnover (% of total employment)



Note: Measure reflects the share of total employment that is reallocated owing to firm creation or destruction per quarter.

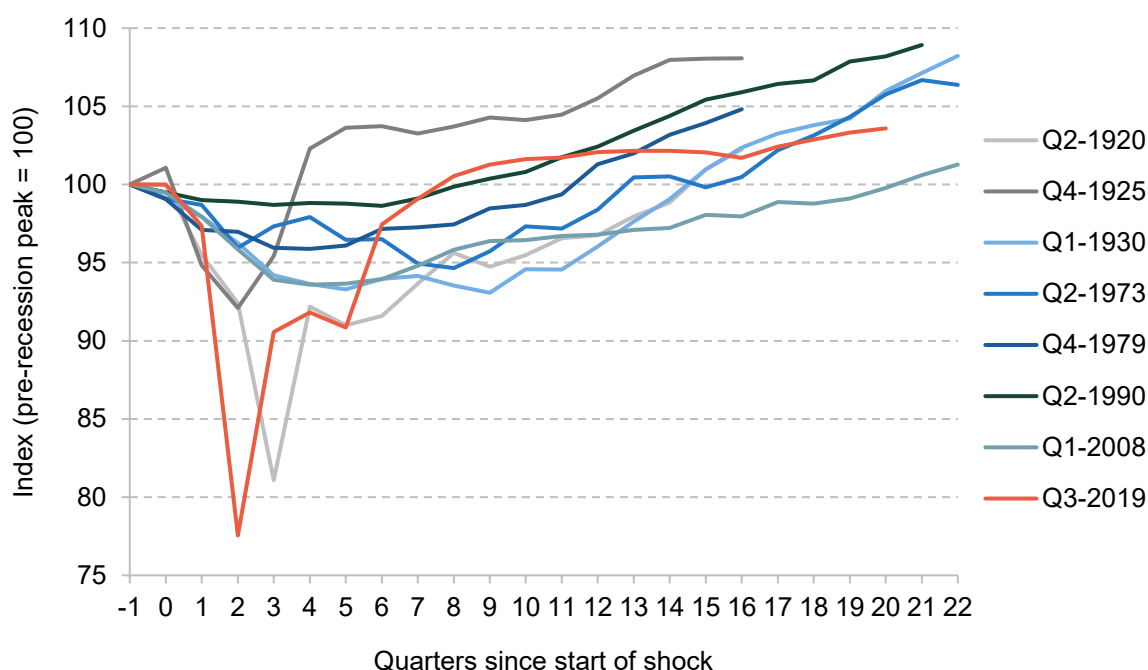
Source: ONS.

Improving macroeconomic resilience

The ability of the economy to recover from macroeconomic shocks is important. Supply shocks are – as we note below – growing more frequent. And the UK, as a small open economy, is often especially exposed. Unfortunately, the UK’s performance in this respect seems to be getting worse. Its cumulative recovery from the pandemic has been comparatively underwhelming. And as shown in Figure 1.4, the cumulative recovery in real GDP since the pandemic has been weaker than the UK’s recoveries from previous shocks, except for the Great Financial Crisis. Now, as then, we think the loss in the level of GDP is unlikely to be made up anytime soon.

While the financial crisis and the pandemic were very different shocks, we think both episodes highlight some key macroeconomic vulnerabilities that may impede future economic recovery.

Figure 1.4. Real GDP recovery from various macroeconomic shocks



Note: Figures show the cumulative GDP recovery, with the index linked to the pre-recession peak. The data for the latest cycle run to the end of 2024, with 2024 Q3 and Q4 numbers Citi nowcasts.

Source: ONS.

First, there has been a structural decline in macroeconomic flexibility. Sectoral reallocation, particularly in an acute context, seems to have slowed. The UK's recovery after the financial crisis, for example, was characterised by an unusually high dispersion of relative prices and capital returns (Broadbent, 2012). This reflected challenges reallocating resources across different economic sectors (Barnett et al., 2014). Significant shifts in relative prices are evidence of similar challenges in the post-pandemic period. In recent years, these have also been accompanied by an increase in wage dispersion. In part, this may reflect some of the skills issues above, and an associated drop in intersectoral job mobility. In 2006, 52% of all job moves were to a different industrial (SIC) sector, but this had fallen to 37% in the latest data. The gap between tasks in jobs that are being hired for, and those jobs that are being dissolved, is increasingly stark (Nabarro, 2022a).

For the UK, this is a particularly pressing issue, especially when it comes to reallocation between the tradable and non-tradable sectors. In a more volatile global supply and rates environment, one of the ways the UK can adjust to – for example – an adverse shock in global rates markets would be to devalue the currency, and reallocate more domestic production towards the tradable sector (Broadbent, 2011). If that is becoming increasingly difficult, then more of the associated loss must be absorbed by domestic demand. That is a more painful process.

Second, the UK has suffered from a lack of systematic coordination between monetary and fiscal policy. Both in the period after the financial crisis, and in the response to the terms-of-trade shock in 2021–22, monetary and fiscal policy worked against one another. In the former, fiscal consolidation arrested balance sheet repair, limiting the impact of monetary loosening. In the latter, sweeping cash support limited the effective propagation of the original price shock, and also worked against tightening monetary policy. Early evidence suggests relative success at the height of the pandemic, with monetary and fiscal policy working ‘hand in glove’ – although there is an argument this went somewhat too far with the benefit of hindsight (and the efficacy of the vaccines). At best, this is self-defeating. But at worst, the UK macroeconomic response has not just been imbalanced, but often particularly poorly selected – favouring the instrument that is least appropriate. As we note below, in recent history this has reflected the use of an instrument with a long outside lag – interest rates – to address an immediate inflationary risk, instead of an instrument with a much shorter outside lag acting in the opposite direction. That has forced monetary policy to do more in order to secure the necessary insurance. The implication is a weaker outlook now as further policy adjustment works through.

Third is an absence of strategic economic leadership. At times of great uncertainty, providing some strategic clarity can be crucial to triggering an effective investment response. In a context of reallocation, this can be relatively powerful. One way of thinking about this is the effective cost of capital in an investment decision being a function of the rate of interest, the depreciation rate and the expected change in valuation. In the event of economic reconfiguration, at least a portion of the existing asset base is likely to fall in value. But the present value of new investment should, by contrast, be elevated. Appropriate policy interventions can protect investment by separating the former and the latter (Vines and Wills, 2020). That, in turn, can help reduce scarring via capital deepening (Krugman, 2009). Unfortunately, when confronted by this in the recent past, official silence has been deafening.

Managing macro-financial risks and navigating new constraints

In the face of the chronic growth challenge, the most obvious, and indeed tempting, response may be a large debt-financed programme of public investment – a fiscal ‘throw of the dice’. We think this impulse should be resisted for two reasons. First, many of the challenges described above require reform, not only investment. That in turn requires care. And second, and perhaps more importantly, recommendations for such ‘shock therapy’ pay insufficient attention to the risks the UK increasingly faces as a large dual-deficit economy – one with both a government current budget deficit and a current account deficit. Looking forward, we think this will limit policy’s room for manoeuvre.

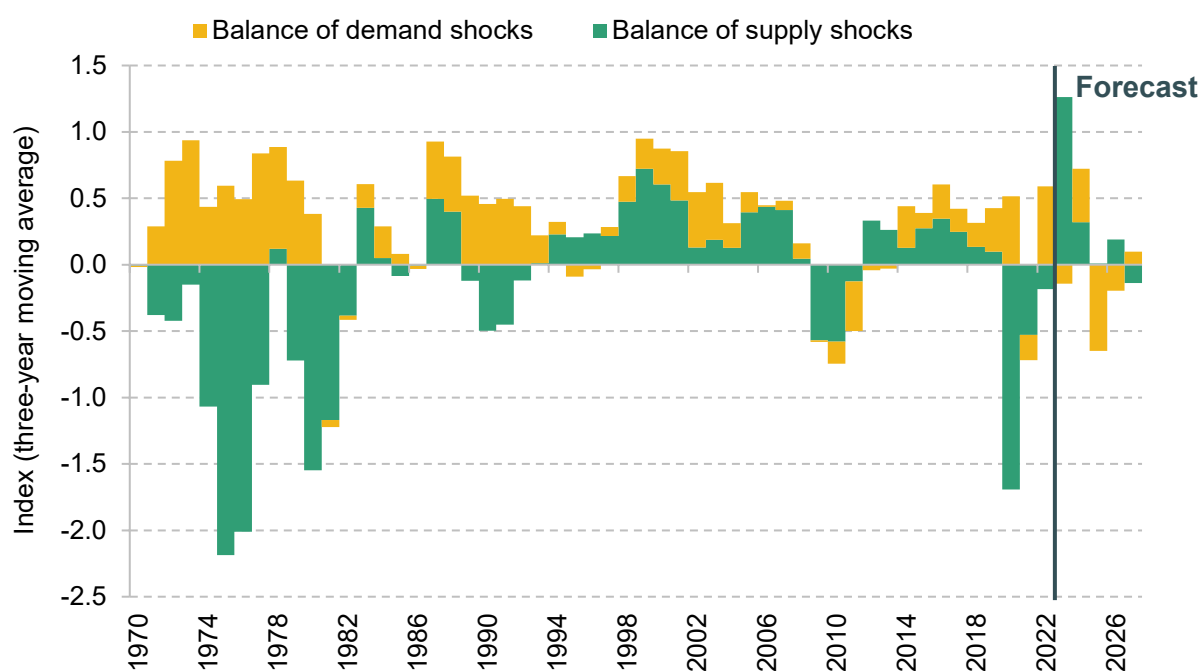
The fundamental issue here is the combination of a high debt stock, increasing volatility on the supply side of the global economy, and the continued need for the UK to attract international capital. As we have seen in recent years, the risk of adverse supply and price shocks seems to be

increasing. Figure 1.5 shows the trend over recent decades, with supply generally a benign and mildly positive economic force through the 1990s and early 2000s. Since the financial crisis, however, this has changed. And rates volatility has begun to increase.

The implication, we think, is that we now need to take the outstanding debt stock rather more seriously. The ‘risk’ scenario is as follows.

A further adverse supply shock – such as a major increase in the price of tradable goods – hits. Inflation begins to rise. Rates, globally and domestically, move (further) above nominal GDP growth. In response to a fall in growth and real incomes, the government feels compelled to offer sweeping support. As more capital is demanded, investors begin to wonder when and how the UK will move from a large primary budget deficit to a surplus sufficient to stabilise debt in the medium term – particularly in a context of higher rates. Given higher existing debt levels, investors may be less patient, and increasingly demand a premium. As yields move higher, the underlying fiscal position worsens. This dynamic begins to feed back on itself.

Figure 1.5. Decomposition of macroeconomic volatility, 1970 to 2027



Note: Supply and demand shocks are identified using an agnostic identification procedure (Uhlig, 2005). A positive demand shock is characterised as a positive shock to both output and inflation. A positive supply shock is a positive shock to output but a negative shock to inflation. A negative supply shock is characterised as a negative shock to output and a positive shock to inflation. A negative demand shock is characterised as a negative shock to both output and inflation. The bars show the net balance each year, on a three-year rolling-average basis. Figures for 2023 to 2027 are Citi forecasts.

Source: Thomas and Dimsdale (2016), Uhlig (2005), ONS, Citi Research.

To be clear, the vulnerability here is not the stock of debt per se but stems from the traded character of government bonds ('gilts') and the UK's external financing gap. The former means that buyers of UK sovereign debt can exert some market power, effectively going 'on strike' until they are happy with the level of yields. The latter means that in the event of such speculative stress, the UK cannot resort to more forceful forms of financial repression to act as a circuit breaker. As we saw in October 2022, market maker of last resort operations are viable but – as the Bank was clear at the time – can only arrest the violence of the move, and not offer an effective yield cap. Speculation could also see the currency devalued. But given the weakness of the initial response of the current account, this would do little to address the external financing need as trade values would likely not react. Specifically, as we discussed above, the response of domestic production to the exchange rate seems to have become increasingly muted. This means more adjustment is now pushed to domestic demand. At best, these dynamics can immediately demand a tightening policy response, with painful results. At worst, they could force the UK to close its external financing gap very quickly, with potentially disastrous results.

These vulnerabilities are to some extent unique to the UK. In the US, reserve currency status limits the buyer power of bondholders. In the Euro Area, as in Japan, a large current account surplus enables a greater degree of domestic control, at least hypothetically. It is plausible that these governments could find the capital to fund domestic liabilities if they could find a means to direct them. In the UK, there is no such recourse.

Structural changes in the gilt market are further adding to the vulnerability here. Domestically, traditional demand for longer-duration bonds seems to be falling as defined benefit pension schemes wind down.⁷ This leaves the overall debt servicing burden more sensitive to changes in market rates. And the UK remains dependent on foreign buyers of sovereign assets. As gilt holdings in the Bank of England's Asset Purchase Facility wind down, this dependence is only likely to increase. This should engender caution surrounding further 'goodwill' – especially as global investment inflows move away from traditional allies.

Fundamentally, alongside a solvency issue, there is a lingering liquidity issue that will stalk UK fiscal policy for some time to come. This, we think, is especially relevant to discussions around the public balance sheet. While it may be appropriate to pay greater attention to the balance sheet position in time, issuing gilts to build physical assets would still reflect an increase in fiscal risks for the UK (see Chapter 2). This needs to be both reflected and managed.

For policy, we see three implications:

⁷ <https://www.reuters.com/markets/rates-bonds/uk-debt-chief-sees-less-value-long-dated-gilt-issuance-2024-03-06/>.

- 1 *Higher and more volatile rates should mean more concern around outstanding debt, and stronger preferences for a smaller outstanding stock.* Over recent decades, such concerns have been effectively rendered moot by the trend decline in rates. That is unlikely to be as supportive going forward. This should suggest some concern about a further ‘ratchet up’ in outstanding debt, especially if supply shocks become more common.
- 2 *Creative solutions are needed to address investment demands, without accruing even more conventional debt.* Here, the underlying risk emanates from the buying power of bondholders and their ability to go ‘on strike’. Other avenues of bolstering the asset base may offer better trade-offs from a liquidity point of view. Structures such as co-investment are by no means risk free but, to the extent they enable investment without adding to the stock of liabilities that could be speculated upon, they could create a better trade-off between risk and benefit than merely funding such schemes up front.
- 3 *The macroeconomic policy balance in the event of further cost shocks probably does need to be re-appraised.* We would argue for fiscal policy to show some initial restraint in the event of shocks, and that monetary policy should be a little more passive. Fiscal expansion not only increases pressure on funding. But to the degree it forces monetary policy to be even more aggressive, this in turn can feed back into the medium-term rates profile. That can fuel speculation about the UK’s capacity for fiscal pain. Not only is a rates-driven response to such shocks ineffective or painful economically, it is also financially risky – at least if higher rates are expected to persist for some time.

Summing up: charting a better path

The UK is likely to face a series of strategic demands for resources in the years ahead – for the net zero transition, in response to geopolitical risks or for investment in public services (particularly in health and social care as the population ages). While ignoring these demands would ultimately be economically harmful, these investments are unlikely to deliver meaningful growth. In fact, they are likely to cost.

To meet these challenges, policymakers need to act urgently to boost growth and improve the UK’s ability to recover from future shocks. Transitioning to a high-growth, high-investment equilibrium will require greater policy focus on: the treatment of intangible assets, improving skills, labour mobility and business dynamism. Such efforts will likely need to be accompanied by a more thoughtful playbook in terms of managing supply shocks, particularly when it comes to the balance between monetary and fiscal instruments.

This reform agenda must now be delivered within more pronounced policy constraints, and in a context where the risks of overstepping those constraints are plausibly greater. This should temper the impulse to rely primarily on significant increases in debt-funded public investment. We are sure public investment will be part of the answer, but this will need to be funded partly

via lower consumption – i.e. some combination of higher taxes or lower day-to-day public spending – and supported by structural reform. Gains cannot come without some initial pain.

In this sense, the Chancellor does inherit some difficult challenges. If funding costs do normalise as expected and economic capacity begins to improve, it is essential that any resulting fiscal space is put to more productive use. But success will depend, first and foremost, on broader structural reform.

1.3 The economic outlook: avoiding a hard landing

After a period of subdued supply growth, we see potential for a modest degree of catchup in the years ahead. However, that supply-side optimism is checked somewhat in the near-term by lingering consumer caution, modest fiscal consolidation, and lagged effects from higher interest rates. We expect demand to remain somewhat subdued, and a margin of slack to emerge over time. Rate cuts, most likely into accommodative territory, are likely to follow.

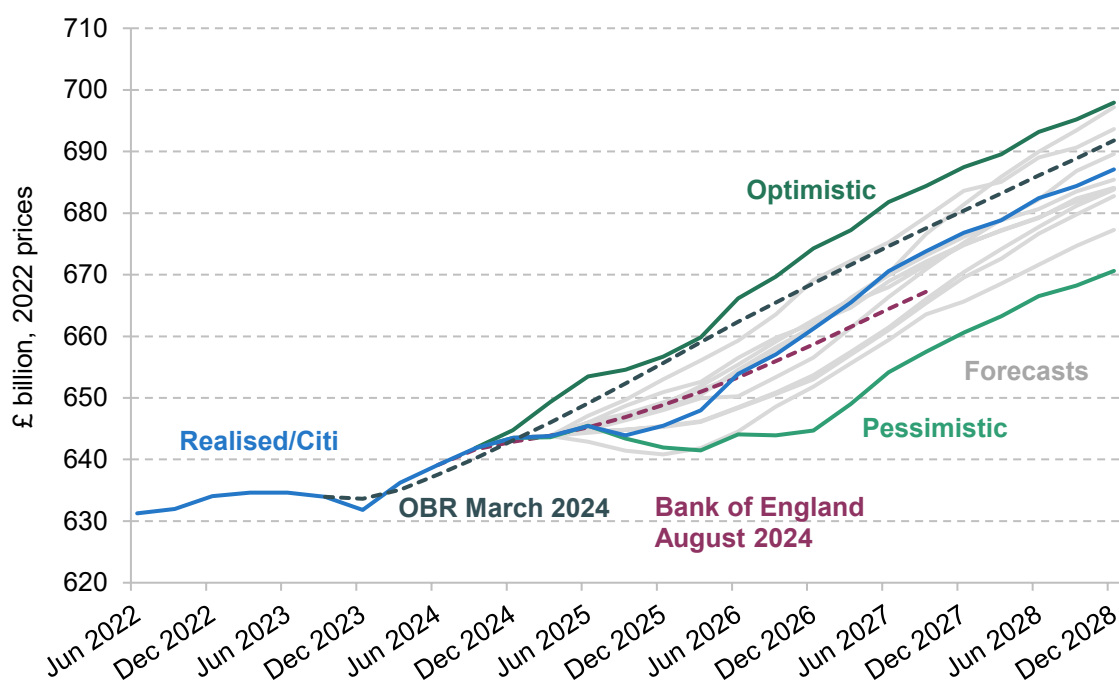
The risks remain substantial. Globally, there are some signs of labour market loosening in the US, although we anticipate only a modest slowdown, and a swift recovery in 2025. Structural uncertainties in China also remain a concern, generating we think a downside skew to the risks around external demand. The traded component of inflation looks likely to remain relatively soft, with goods prices likely easing in relative terms.

Domestically, the key question increasingly surrounds the saving rate. On the household side, real income growth is not yet feeding through into higher consumption. Firms are also still cautious. We expect some modest improvement through the remainder of this year, as uncertainty continues to fade. But still high interest rates alongside a meaningful deterioration in household balance sheets suggest a more persistent increase in household saving.

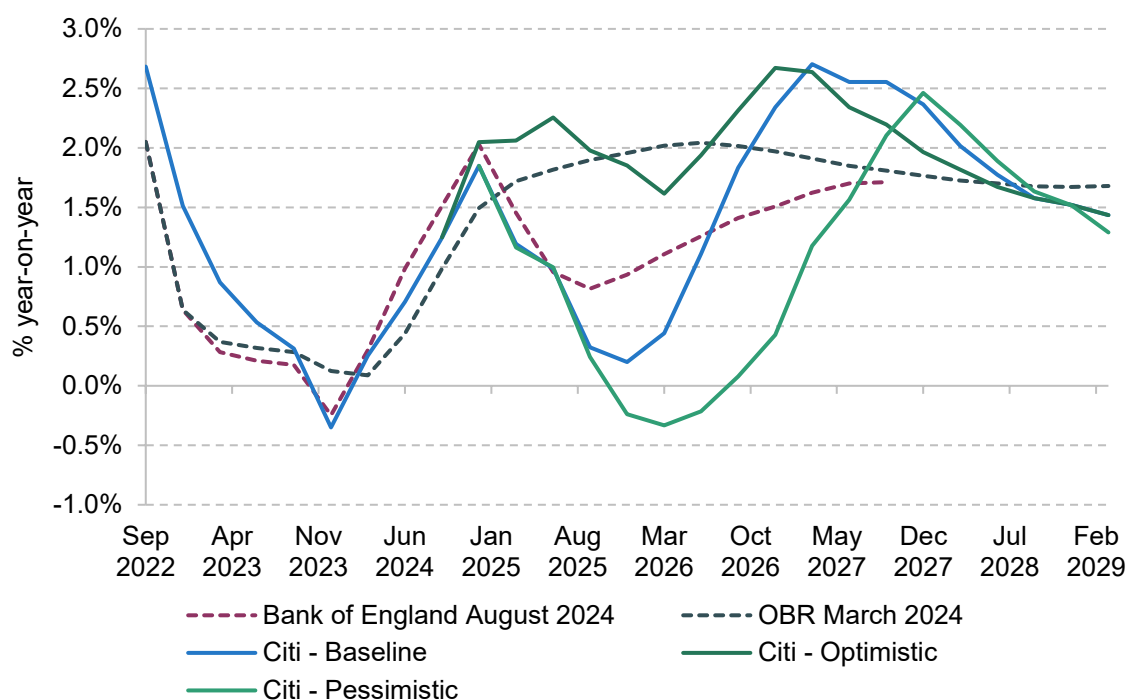
In our baseline scenario, we expect UK GDP to increase by 1.0% this year, but by only 0.7% next year, as shown in Figure 1.6. While we remain cautious into 2025, we expect growth to accelerate markedly through 2026 and 2027 as the monetary and fiscal constraints are eased back and catchup potential is subsequently realised, before normalising through the second half of the forecast horizon.

Figure 1.6. Real GDP under different scenarios

Panel A. Real GDP, chain-linked volume measure (£ billion, 2022 prices)



Panel B. Real GDP growth (% year-on-year)



Note: The graph shows our baseline forecast alongside the Bank of England's modal, market-conditioned forecast for August, and our optimistic and pessimistic scenarios. The latter are discussed in Box 1.1. The OBR forecast is taken from the March 2024 economic and fiscal outlook. Historical forecasts in Panel A are indexed back to the last realised data point at the time the forecast was made.

Source: OBR, Bank of England, ONS, Citi Research.

Given the degree of uncertainty, we also present two alternative scenarios for real GDP in Figure 1.6. In the optimistic scenario, we assume that energy commodity prices fall more quickly. In the pessimistic, we model the impact of a large procyclical fiscal stimulus in the US, which under certain assumptions may weaken the UK's economic outlook. These are intended to illustrate the potential sensitivity of our baseline estimates to different shocks, and to give a sense of what scale of shock would be required to deliver economies of different sizes by the end of the forecast period. These alternative assumptions are discussed more fully in Box 1.1 later, and their impacts on the trade-offs facing the Chancellor at the upcoming Budget are addressed in Chapter 2.

In this section, we begin with the recent UK recovery, then turn to the global economic outlook, trends on the supply side of the UK economy, the outlook for demand and for households and firms, and recent trade underperformance.

How secure is the UK's economic recovery?

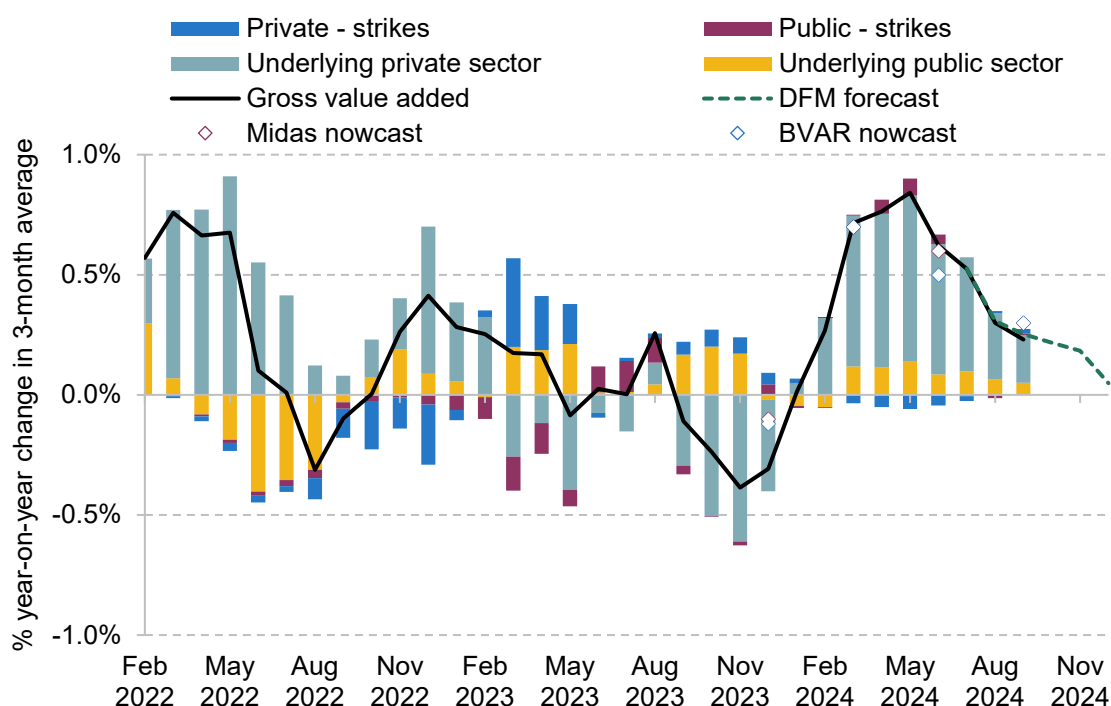
The UK economy has surprised to the upside since the start of 2024. We now expect real GDP growth of 1.0% this calendar year, compared with forecasts of just 0.1% back in January. Revisions in the forecasts of the Monetary Policy Committee of the Bank of England have been equally dramatic: from year-on-year GDP growth of 0.2% to 1.2% as of August, at least in the MPC's market-conditioned baseline (Bank of England, 2024b).

Unfortunately, while welcome, we think these improvements are not yet indicative of a secure economic recovery. This is for three reasons. First, a reasonable share of the upside surprise in the year to date only compensates for a strikingly weak end of 2023. Second, and associated, the pickup in growth that has occurred has remained sectorally narrow and has been unusual. Specifically, most of the growth has been concentrated in the non-consumer, untraded, business-to-business services sector such as 'scientific research and development'. As energy prices have fallen, we think many of these sectors have been 'turned back on'. And third, those sectors that have driven the recent improvement have generally been those to lag, rather than lead, in a cyclical upswing.

Indeed, it seems the underlying 'engines' of demand in the UK are not yet obviously motoring. In recent quarters, public consumption has been surprisingly strong, perhaps reflecting in part the overspend noted by the new Chancellor in the 29 July spending audit (HM Treasury, 2024). These effects, however, may not last. And there does not seem to be much scope for a sustained consumer-led economic recovery. The tradable sector is already contracting, with global demand likely to soften further. There is little in the data as yet that implies to us that there will be a sustained, demand-led economic upswing. We expect quarterly growth to fall slightly to 0.3% in Q3 and 0.2% in Q4 before falling further into 2025. Figure 1.7 shows a breakdown of the drivers of recent growth, as well as our nowcasts into the end of the year. A correlation-weighted

average of the soft data would suggest underlying quarterly activity growth of around 0.2 percentage points. Expectations remain a little more buoyant, although these too have softened in recent months.

Figure 1.7. Nowcast of UK gross value added



Note: BVAR and Midas nowcasts are products of a Bayesian VAR model and a mixed frequency sampling model respectively. Our main nowcast is based on a dynamic factor model (DFM) of roughly 120 survey indicators.

Source: ONS, Citi analysis.

The global outlook: subdued demand

In this subsection, we consider the economic outlook for the world's largest economic blocs – China, Europe and the US – in turn, and then what this may mean for the UK.

China

China's economic growth has slowed. We now forecast growth of 4.7% in 2024, versus 5.0% at the start of the year. Some of the softer data – such as consumer confidence – appear somewhat worse. Recent weakness is attributable to two main factors.

- 1 *Industrial misallocation.* The decentralisation of government investment decisions, coupled with central direction, seems to have led to industrial duplication in several target areas. For instance, Liu (2024) argues that China can now produce almost twice the volume of solar panels that the global market can absorb. As higher rates have curbed demand for capital

goods, a supply glut has emerged, and manufacturing PMI surveys reflect weak demand and falling prices.

- 2 *Domestic real-estate troubles.* Residential property prices have been falling for nearly a year, undermining consumer confidence and increasing precautionary saving. Consumer confidence has suffered as a result, and much of the consumption data – such as retail sales – have remained soft.

Stimulus is crucial to turning around China's woes. With CPI hovering just in inflationary territory, the longer it takes for a more forceful reaction to emerge, the greater the probability the Chinese economy finds itself caught in some kind of deflationary trap.

Recent interventions have provided some limited relief in the property market, but have thus far been predominantly monetary.⁸ To date, fiscal support to the consumer appears modest – with policymakers still seemingly minded to do 'as little as possible' rather than 'whatever it takes'. We expect growth to remain soft into 2025, and global goods inflation to remain subdued.

Europe

We expect real GDP growth in the Eurozone to average around 1%, although with a clear divide between core and peripheral economies. Spain and Greece are growing at 2–3%, driven by strong service sectors. German growth is much weaker, reflecting weaker external demand from China, and domestic competition from Chinese imports, which are increasingly competitive (rather than complementary).

Europe's trade challenges are both structural and cyclical. Structurally, European manufacturers are grappling with increasingly direct competition from China and high unit costs, especially for energy. European households pay some of the highest electricity costs globally, which is eroding market share. Unit costs in March 2023 were \$0.21 per kWh in France but \$0.52 in Germany, compared with \$0.18 in the US, \$0.08 in China and \$0.47 in the UK. Mario Draghi, former Prime Minister of Italy, has called for a significant increase in public investment to address some structural issues (Draghi, 2024), but political barriers make this unlikely.

Cyclically, the question is for how long services output can be sustained while manufacturing growth falters. This will depend primarily on the labour market. Softening in manufacturing hiring has so far been offset by public sector strength, and falling structural unemployment in the periphery. However, there is a risk the labour market will loosen further, especially as fiscal

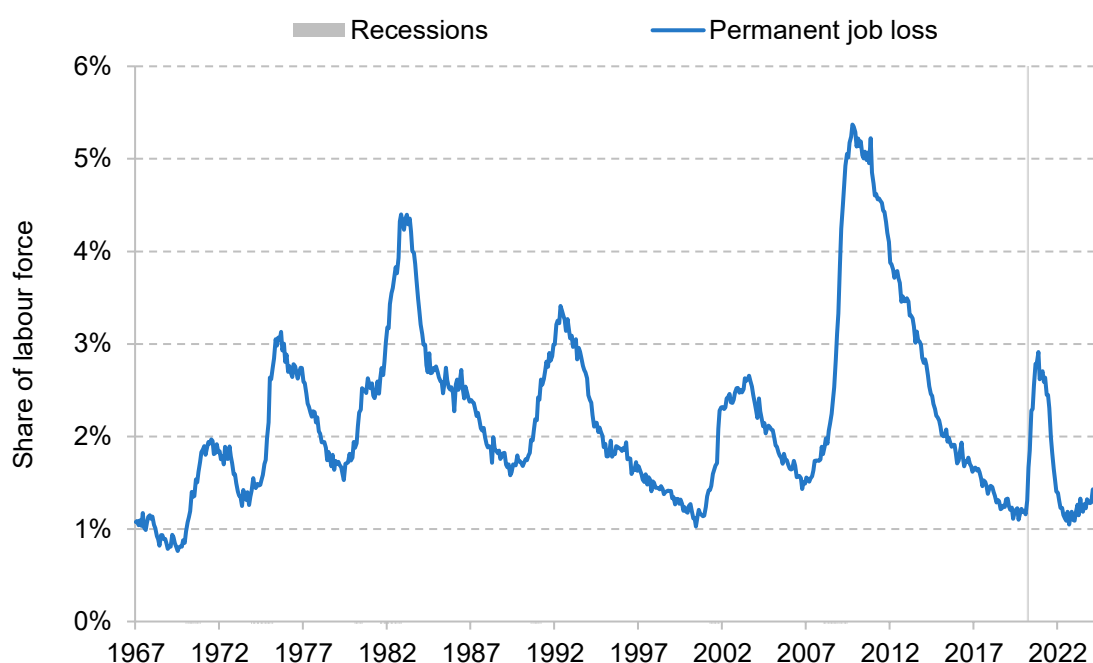
⁸ In May, multiple steps were taken to stabilise the property market. These included the removal of the mortgage rate floor, a provident fund loan rate cut and a cut to the minimum downpayment ratio. Subsequent government direction included the establishment of a local government buy-back programme, where unsold property would be converted to social housing, and a People's Bank of China relending programme for social housing. Four months on, it is clear that the intervention has had a limited impact, with recent research questioning whether it was even net stimulative (Sheets, 2024). However, more recent measures could have a larger impact.

tightening continues in the European core – a similar potential concern in the UK. This risk will be compounded by slowing growth in the US.

US

After stronger-than-expected growth in the first half of the year, the outlook for the US is finely balanced – between a ‘hard landing’ with a weakening labour market and a ‘soft landing’ where activity remains stable even as inflation eases. Historical comparisons might suggest a hard landing, with the ‘Sahm Rule’ – an early recession indicator linked to a loosening labour market – already triggered, as shown Figure 1.8. But this cycle has been anything but typical, and consumer spending has been fairly robust, countering recession fears for now.

Figure 1.8. Recessions and permanent job losses in the US since 1967



Source: BLS.

We do expect US economic growth to slow toward the end of the year. A further softening in labour demand is a key concern, if this increases the household saving rate. For now, we anticipate a modest slowdown and a swift recovery through 2025, although the outcome could be less benign.

Commodity prices and interest rates

Recent events and associated risks notwithstanding, commodity prices are expected to come down – near-term political risks notwithstanding. Oil prices have already fallen by 17% since April, in part reflecting the tepid outlook for aggregate demand. Prices have increased sharply in recent days as the geopolitical temperature has increased. Uncertainty has increased as a result.

Nonetheless, in the medium term, we expect an expansion of supply, with continued pressure from OPEC members for a lifting of production quotas and non-OPEC production continuing to outpace forecast aggregate demand growth. Citi's commodities team expects oil prices to fall to as low as \$60/bbl over 2025 as these effects feed through. We expect gas prices in Europe to remain broadly stable (barring further shocks).

We also expect shipping prices to normalise, after another period in which prices have been unusually elevated. For instance, the WCI Shanghai to Rotterdam index – an estimate of the cost of container freight – climbed sharply through 2024, peaking at four times the 2023 rate. Attacks in the Red Sea have driven a large-scale rerouteing around the Cape of Good Hope, elongating journey times and cutting capacity. But prices have begun to fall once again.

On interest rates, much will depend on the outcome of the US presidential election at the start of November, but the global picture is one of improving supply and somewhat subdued demand. All three major transatlantic central banks have now begun to ease policy. The Federal Reserve cut rates in September from 5.3% to 4.8% and pencilled in two more quarter-point rate cuts in 2024. We anticipate the Fed will seek to return to a 'neutral' policy rate fairly quickly over the coming months to minimise the risk of a further labour market deterioration. We expect the European Central Bank to seek further reassurance around wage and price setting, and to cut rates more gradually, although later rate cuts may ultimately prove larger overall.

What might this mean for the UK?

Altogether, demand tailwinds globally are beginning to fade. This reflects demand-based uncertainty in the US and structural concerns in China, and subdued manufacturing and consumer demand in Europe. Our earlier forecasts reflected an anticipated recovery in Chinese domestic output and some associated spillovers in European production. The former has proven disappointing and US 'growth exceptionalism' has become more pronounced.

As a result, we have revised down our forecasts for global growth in 2025. In our baseline assessment, global activity falls back in the second half of the year. External inflationary influences are also likely to be fading.

We now expect UK-trade-weighted global GDP growth of 1.8% this year and 1.5% next, before a gradual recovery to an annual rate of 2.0% in the medium term. This implies little external support for UK growth as we move into next year, and indeed tradable support fading somewhat.

Otherwise, our UK forecast is conditioned on the following assumptions:

- UK-trade-weighted global real GDP growth of 1.5% in 2025, 1.6% in 2026 and 1.9% in 2027, a little softer than other recent official forecasts.

- Oil prices to fall to around \$70/bbl, based on the oil futures curve. Here we see risks skewed to the downside given the views of our commodity team above.
- Gas prices to fall gradually to 73.4 pence per therm over the forecast horizon.
- UK-weighted export prices to fall by a further 2% next year, before recovering through 2026.
- Trade-weighted sterling to settle in an 82–83 range, 2.5–3.0% higher than earlier in the year.

Box 1.1. Alternative scenarios

As in previous years, we complement our baseline forecast with two alternative scenarios, in this case based primarily on differences on the conditioning assumptions.

In our **optimistic scenario**, we assume that global commodity prices fall more quickly. Global oil prices fall to a little over \$50/bbl, a further 25% decline from current levels, and compared with \$70/bbl in our baseline scenario. We assume European gas prices follow a similar profile, perhaps reflecting a more accommodative deal around the transit of gas through Ukraine. We assume that a 10% supply-driven reduction in oil and gas prices boosts medium-term capacity by 0.15–0.2% and 0.3% respectively. We also assume a modest front-loaded benefit from lower household saving as residual inflation-related uncertainties fade. In this scenario, we would expect real GDP to end up around 1.8% stronger than our baseline forecast, as shown on Figure 1.6.

Our **pessimistic scenario** focuses on the UK's external financial vulnerabilities. We model the impact of a large (5%), procyclical, permanent tax cut in the US. We have opted for a deliberately large move here to explore the risks associated with a shift in global interest rates; we are interested in this, rather than the impact of the tax cut per se. On the spillovers to the UK, we assume a 0.35 spillover from US to UK real GDP – a relatively high 'real economic' effect. But we then assume that the scale and procyclical nature of the stimulus mean a larger sell-off at the longer end of the US curve as inflation concerns grow, with associated spillovers into UK rates. We assume UK funding costs increase by around 1% at a five-year horizon, less than half the increase in the US. And we assume that the Federal Reserve responds to the associated stimulus, resulting in a fully offsetting rate-hiking cycle. We assume the Federal Reserve would increase Fed Funds rates by 2.5–3.0ppt, weighing on subsequent US GDP. We assume that much of the effect of the funding shock must be absorbed via domestic demand – reflecting the inelastic nature of the UK's external account. We expect that by the end of the forecast horizon, real UK GDP would be around 2.4% lower under this scenario than in our baseline.

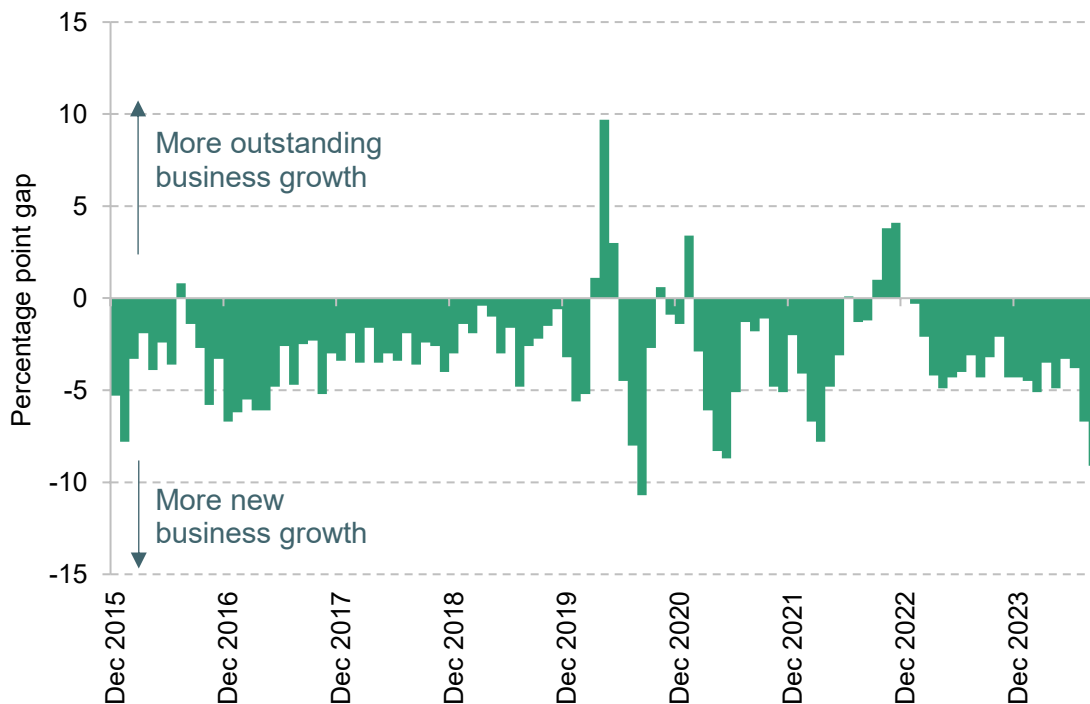
Improvements on the supply side

In the near term, we think the supply side of the UK economy will continue to recover. Three supportive trends are continuing to work though.

First, the last remnants of temporary labour matching issues have diminished. In recent years, extensive cash support for firms and the continuation of the furlough scheme through much of 2021 locked workers into existing employment, even as the shape of the economy changed. This led to a severe tightening of the labour market – especially in sectors with high churn in normal times – and a sharp deterioration in labour market matching overall (Nabarro, 2022a). This has also resulted in a period of discretionary labour hoarding as firms grew more uncertain about their ability to hire. As these effects have gradually faded, the reallocation of labour has improved, enhancing underlying capacity.

Second, there have been reductions in energy and food prices facing firms. Here, supply losses result from function-specific capital and from belated price adjustments. This can make it more challenging to adjust to sudden, large asymmetric or technology-specific shocks, such as a surge in energy prices. Take the example of a takeaway pizza shop. If gas prices suddenly double, but output prices adjust only slowly, then the firm may choose to reduce capacity temporarily in order to minimise the loss – at least until such time as output prices and input costs are in better balance. Capacity utilisation becomes a dimension of capacity adjustment. The PMI data illustrate this shift (see Figure 1.9): during the energy crisis, outstanding business grew very quickly relative to the overall volume of new orders, consistent with firms cutting back on capacity. Since then, the gap between these growth rates has widened again. With energy prices facing many parts of the commercial economy only just beginning to fall, further improvements are expected.

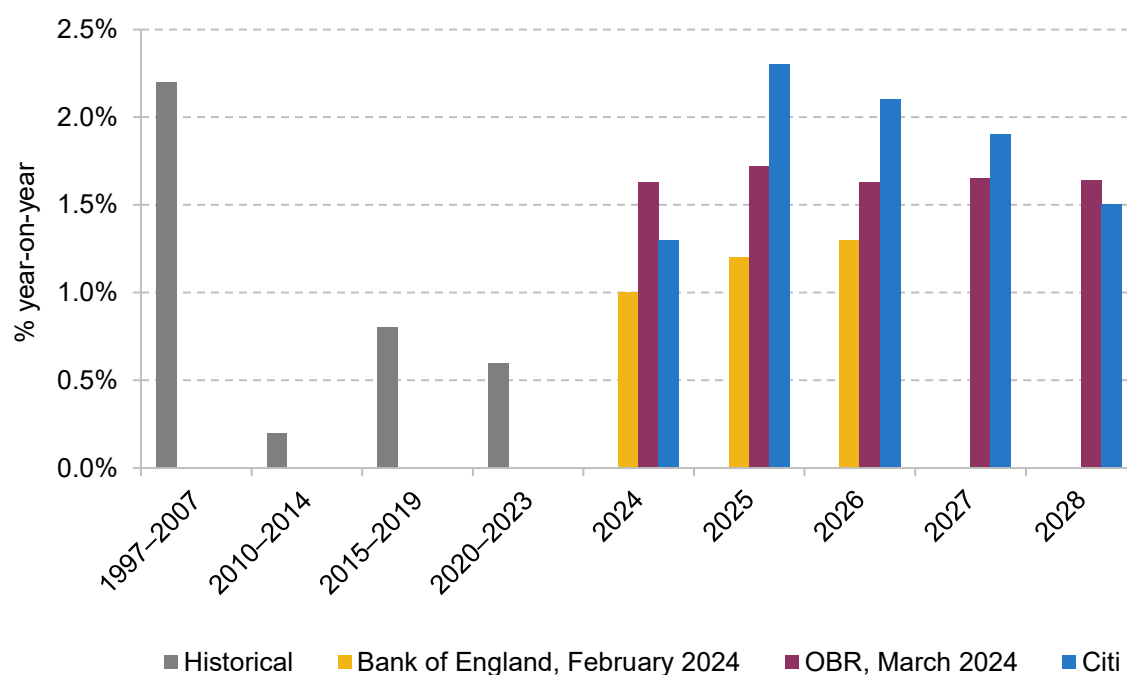
Figure 1.9. Percentage point gap between growth in outstanding business and new business



Source: IHS Markit.

Third, the relative price of labour and non-labour inputs is shifting again. In 2022, as input prices increased sharply, labour became relatively cheap. Alongside discretionary labour hoarding, this is one reason firms did not reduce staffing in 2022 despite cutting back on capacity. Such shifts are particularly important in the UK and, historically, they explain why unemployment fell less than expected after the financial crisis but by more than anticipated in the early 1990s, for example.⁹ Over the past 18 months, the relative cost of labour initially fell, incentivising labour-intensive production. This trend has since reversed as energy prices fell and wages increased. We expect the relative price of labour to continue to rise in the coming months as costs continue to fall back – at least relative to wages. This should drive productivity enhancements as production becomes more capital intensive. But this suggests aggregate demand must grow more strongly if the labour market is to be kept on an even keel. Historically, this has not been the norm.

Figure 1.10. Year-on-year growth in potential GDP, UK



Note: Grey bars cover periods of several years.

Source: ONS, Bank of England, OBR, Citi analysis.

Currently, we estimate the UK's long-term potential growth rate at around 1.4–1.5%. This is consistent with the ONS's latest population estimates, alongside our view of trend productivity growth. In the near term, however, we think capacity can grow somewhat faster than this as

⁹ The UK is a small open but also services-orientated economy. As a result, the relative price of labour can move around significantly. The production side of the economy is also relatively sensitive to associated changes as labour and capital are more easily substituted.

these supply shocks wane, as shown in Figure 1.10. Unfortunately, substantial scarring remains likely. But we think modest catchup effects are more likely than not. Compared with the Bank of England, we anticipate stronger potential growth through 2025 and 2026 as these benefits materialise.

Monetary and fiscal policy are both likely to depress demand

With the supply side improving, we expect the constraint on economic activity to shift to the demand side, primarily due to the legacy of policy during the pandemic. The current challenge is the result of two factors. First was a procyclical fiscal approach during the energy and cost shocks of 2022–23, with fiscal policy effectively offering sweeping support in response to a supply shock. Second, and associated, was the anti-inflationary insurance taken out by monetary policy over the same period. In both cases, the UK economy faces a period of adjustment ahead – with policy headwinds likely continuing to build.

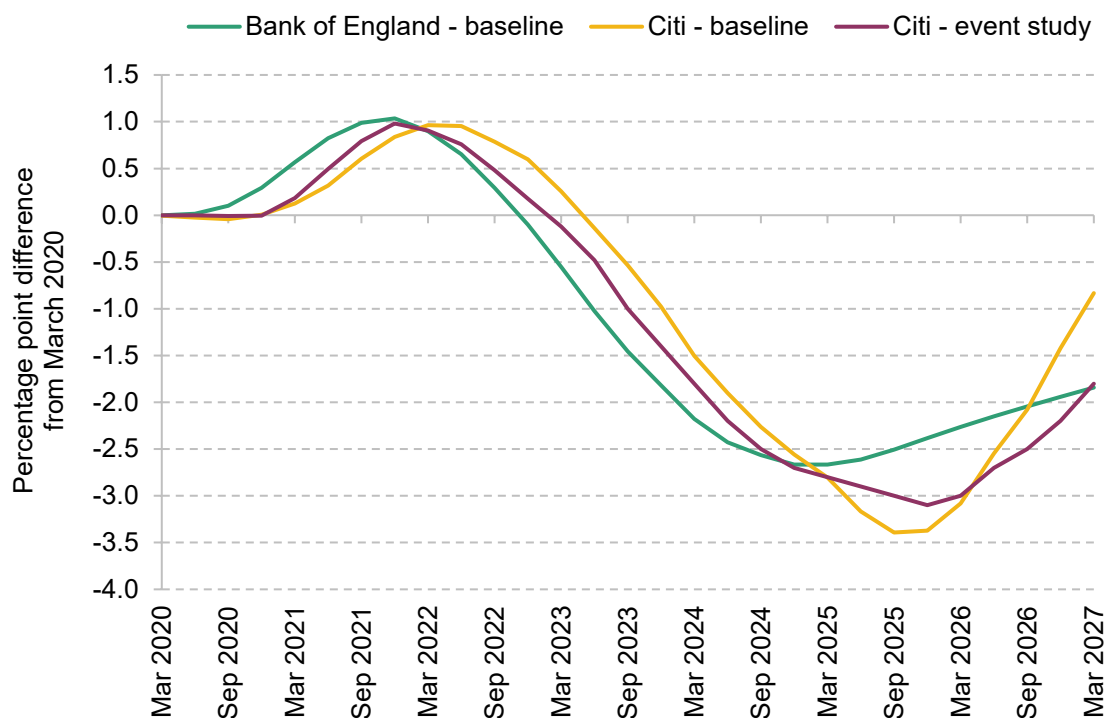
The key debate centres on the transmission of monetary policy. One view holds that the overall macroeconomic effects of the rate increases of recent years have been limited. While by no means the collective view of the MPC, Bank staff did note in August that the majority of the impact of previous rate rises on real GDP may already have been felt (Bank of England, 2024b). Others have noted the risk that rates may be even less ‘restrictive’ than the MPC had thought (Greene, 2024). While not the intention of policy 18 months ago, that would suggest that in fact policy has not been hugely powerful, with relatively little further effect to come.

While this view remains plausible, we think it sits at one (optimistic) end of a wide range of plausible outcomes. Estimates of Bank staff, for example, are based on a 2015 model (Cloyne et al., 2015) which itself is sensitive to modest specification changes (such as the period over which the model is estimated). And this is only one model among many. Other approaches over the same period – such as an event study approach (shown in purple on Figure 1.11) – would suggest a greater effect to come.

And with respect to the recent data – which show some signs of life in the housing market and a slight uptick in credit growth – these continue to be buffeted by some of the oddities of the recent cycle, in particular the large increase in monetary holdings through the early part of the pandemic. This has sheltered large swathes of the economy from higher capital costs, as households and businesses had accumulated internal liquidity between 2020 and 2022. With holdings now back at trend, credit growth is beginning to increase. But so too are effective interest rates.

Indeed, as we see it, the risk around any historical estimate of policy transmission is probably skewed towards a longer lag rather than a shorter one. Five key structural changes are notable and relevant in our view:

Figure 1.11. Modelled impact of changes in Bank Rate since 2020 on UK GDP (% of GDP)



Note: The Bank of England Baseline here is based on Cloyne et al. (2015), incorporating the changes in rates only. The purple line shows an 'event study' approach based on MPC announcements and speeches by MPC members. The series is then orthogonalised against the subsequent data themselves, as suggested by Bauer and Swanson (2022). The event study series is based on a two-hour window around these announcements. The Citi Baseline estimate is based on a five-variable SVAR model, estimated 1971–2019.

Source: ONS, Bank of England, Cloyne et al. (2015), Bauer and Swanson (2022), Citi analysis.

- 1 The proliferation of fixed-rate lending.** Fixed-rate mortgages accounted for 95% of new mortgage lending in 2019, compared with 40% in 2010. This shift has slowed the impact of higher rates on cash flow and provided greater near-term security for households, slowing transmission into the household sector.
- 2 Larger financial asset holdings.** Both households and firms are generally carrying more interest-bearing assets. Respectively, this reflects an older population and recent government-backed support for businesses. This meant households and firms enjoyed an up-front boost from stronger interest income as rates rose.
- 3 Improved household equity.** Greater equity in the housing market has provided a buffer against deteriorating credit conditions, even as house price growth has stalled. Lower household debt – and a concentration of that debt among those with more cash assets – has ameliorated any precautionary saving response.
- 4 Declining business creation.** The UK has experienced a long-term decline in business dynamism, as discussed in Section 1.2, resulting in lower net new corporate lending for the

same level of activity. This, and the fact that existing firms often have substantial cash reserves, has slowed the impact of rising borrowing costs on activity and employment.

- 5 Increased substitutability between labour and capital.** Over the past decade, the UK economy has become more specialised in sectors where the effects of rate changes on employment tend to manifest more slowly, reflecting a greater degree of substitutability between capital and labour. The initial impact of rate hikes may be to lower productivity, with impacts on employment coming later.

All of this to us implies lower, slower transmission from rates to activity. The changes here can be roughly grouped into three structural changes.

First, in an equilibrium sense, there is less probably demand for new credit at any single point in time. Historically, this has tended to be how most of the demand-destructive effects of policy materialised, and often at a relatively rapid pace (Bernanke and Gertler, 1995). We think this mechanism is less powerful now. On the firm side, that reflects the trend reduction in business dynamism we noted above, and the shift towards intangible assets that are more often financed via internal liquidity (Caggese and Pérez-Orive, 2020). On the household side, that also reflects the shift towards older age groups, who consume fewer durables and have less demand for housing credit (Guerrón-Quintana and Kuester, 2019; Wong, 2019). Among this group, there may also be more ‘target savings’ behaviour, which offsets the traditional savings boost from higher rates.

Second, the precautionary response associated with higher debt and interest rate volatility also seems truncated. This also reflects the shift towards an older population. We know that historically in the UK, indebted households have tended to have a more violent reaction to changes in debt servicing as binding liquidity constraints loom (Cloyne, Ferreira and Surico, 2020). Today, fewer households are in this position, with fewer mortgaged households and a larger offsetting base of financial assets. And similarly, corporate deleveraging over recent years and self-funding of an increasing share of investment leave investment less responsive to changes in rates.

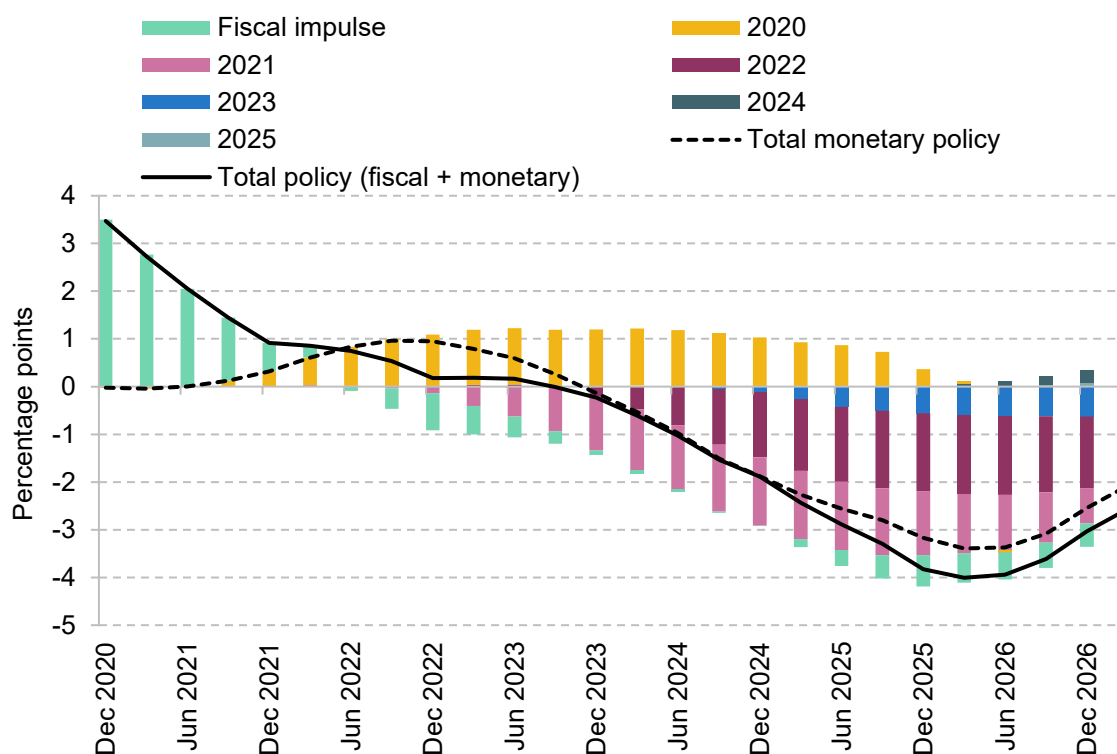
Third, just as transmission has grown more dependent on cash-flow effects, changes in mortgage structure and asset holdings have attenuated their impact. Hence initially both households and firms have enjoyed something of an income boost from higher rates as the rate of return on assets accelerated but debt servicing costs were unchanged. In more recent months, that has begun to reverse, implying a growing headwind to income growth in the months ahead.

This would suggest policy transmission overall may be a little lower, but crucially also slower. Here we think it is useful to think about policy transmission as reflecting three separate steps: the transmission from Bank Rate to financial conditions, the transmission from financial

conditions directly to activity, and then the rebalancing of activity in response to the shock to financial conditions. The second and third steps are likely to take time.

Alongside headwinds from monetary policy, fiscal policy is also likely to exert downward pressure on activity. The details will depend on what the new Chancellor does in her inaugural Budget on 30 October, but the fiscal inheritance (discussed more fully in Chapter 2) suggests some fiscal consolidation is to be expected over the coming years. The combination of fading prior support (including energy grants and similar) with a further tax increase of £15–20 billion in the autumn – even if this was focused in areas with low fiscal multipliers and was accompanied by top-ups to day-to-day spending (£5 billion) and investment (£10 billion) – would still suggest a headwind from fiscal policy into next year. The combined policy impulse is shown on Figure 1.12.

Figure 1.12. Combined impact of monetary and fiscal policy on UK GDP level (percentage point deviation from trend)



Note: Monetary policy impact here is based on the Bank and associated market rates modelled through a SVAR impulse response. This has been discounted to reflect some of the structural changes listed above. It has also been pushed back by a quarter – reflecting the arguments above. The fiscal impulse is based on the cumulative impact of all discretionary changes since the onset of the pandemic. Here we have excluded the Energy Price Guarantee and the Energy Bill Relief Scheme. Some of the public spending during the height of the pandemic has also been discounted, reflecting reported waste.

Source: ONS, Bank of England, OBR, Wolf (2020), Citi analysis.

Further headwinds to demand, as we note below, increase the risk of a rise in the unemployment rate in the months ahead. This, we think, could have been avoided with policy that was more appropriately calibrated previously and that reflected a better-balanced policy mix. As many of the MPC's more 'dovish' members noted through 2022, hiking rates in the face of recent supply shocks risked weighing on demand just as the effect began to ebb (Tenreyro, 2023).

Nonetheless, monetary policy was forced to take out an increasing degree of insurance as fiscal policy became more and more stimulative. The resulting drag speaks to the limitations of using an instrument with a long lag to address a near-imminent inflation concern – a feature that often requires monetary policy to overshoot, but also risks dragging at precisely the wrong time.

Consumption still subdued with households not dissaving yet

Household consumption remains the single most important component of UK GDP. It has also been central to the UK's post-COVID economic underperformance. Private consumption is now 8.7% below its pre-pandemic trend, well above the shortfall seen in the Euro Area, and 1.3% below its pre-pandemic level. The hope for 2024 was that falling inflation and rebounding real incomes would drive a recovery in consumption. This has yet to materialise.

Consumers seem to be shifting their spending rather than increasing it. Recent figures show a modest improvement in retail sales as goods prices fell, but offset by slowing momentum in the consumer services sector. This is supported by industry trackers such as the Coffey Peach Index, which remained subdued over the summer, with nominal growth in the low single digits.¹⁰ While business-to-business services have continued to grow, growth in consumer-facing services has stalled.

Looking ahead, we expect consumer spending to strengthen, particularly retail spending. Consumer confidence has improved, although the upward trend seen through late 2023 and early 2024 has paused as real income growth stabilised. As real income gains feed through, they should begin to boost consumption more noticeably. Some surveys, such as recent PMI data, indicate improving consumer demand – at least in the anecdotes – and we expect growth to pick up by the end of the year (S&P PMI, 2024).

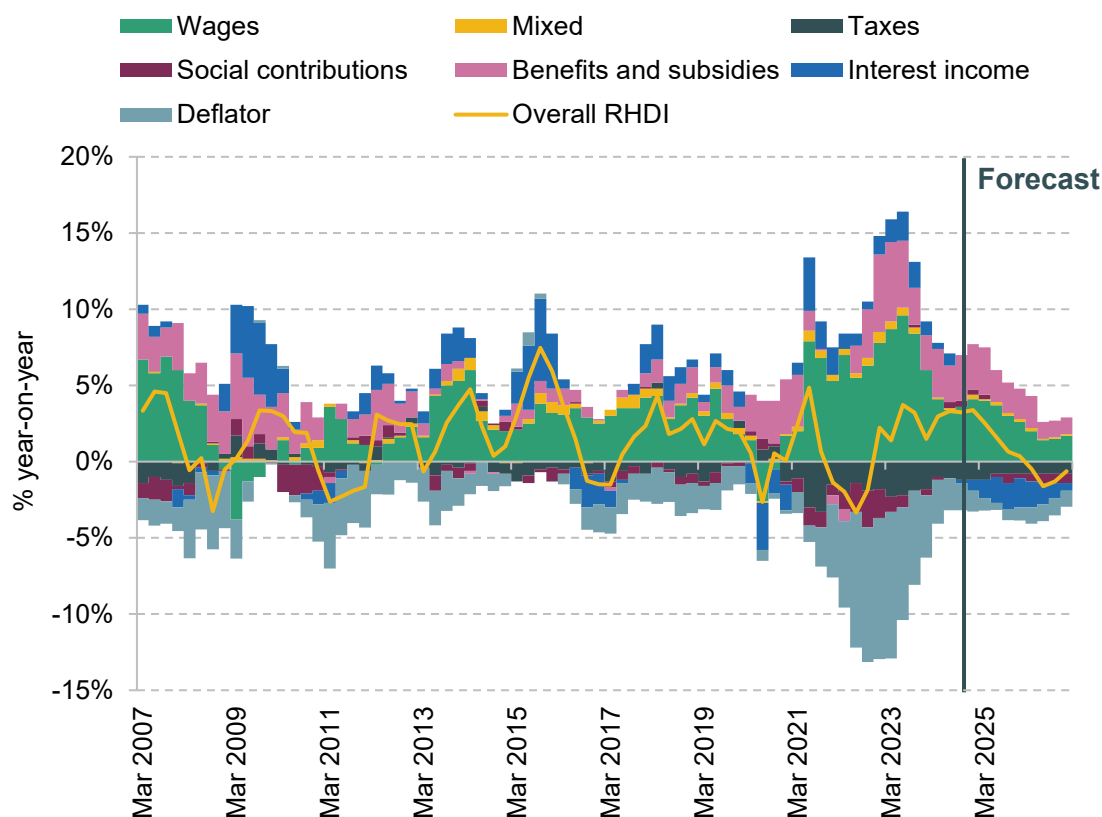
However, the scope for a sustained consumer-led economic recovery seems to be narrowing.

Most of the recovery in real incomes has already occurred. Annual growth in real household disposable income (RHDI) has hovered at around 3–4% since 2023 Q2, as faster nominal wage growth has accompanied slower price growth. We anticipate some additional momentum in the fourth quarter as public sector pay deals are finalised. Beyond that, we expect nominal wage

¹⁰ Nominal growth across hospitality establishments is estimated to have fallen from 5.2% year-on-year in March to 1.3% now, suggesting further reductions in volumes.

growth to slow and interest income to fall. As shown in Figure 1.13, growth in RHDl is expected to steadily decline through 2025 and turn negative in 2026.

Figure 1.13. Real household disposable income growth, UK (% year-on-year)



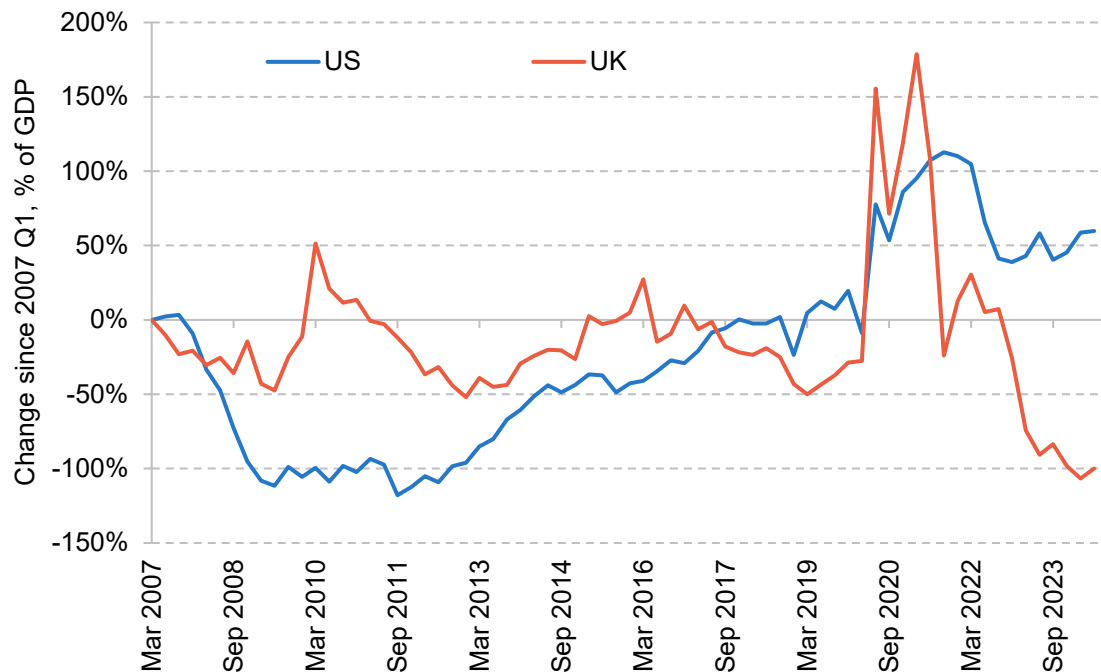
Source: ONS, Citi analysis.

As consumption has remained subdued, even as household incomes have grown, household saving rates have climbed sharply. The headline saving rate was 9.8% in Q2, compared with 6% on the eve of the pandemic. The ‘cash’ saving rate – i.e. excluding the imputed equity of pension funds, and once the adjustments in the 2024 Blue Book have been accounted for – has climbed from 2–3% before the pandemic to around 8% now. This is shown in Figure 1.15 later.

The degree of optimism about consumer spending hinges on how quickly saving rates might fall. We expect only a gradual normalisation of saving rates, driven by three factors.

- 1 A decline in precautionary saving.** Households tend to increase savings in the face of inflation uncertainty. In particular, as inflation first surges, households may save more as they are cognisant of the erosion of nominal asset values but may overlook the reduction in nominal liabilities (Schnorpfeil, Weber and Hackethal, 2023). This was evident as consumer confidence plummeted in 2022, but this effect seems to have diminished, with consumer confidence now aligned more closely with current real wage, unemployment and inflation figures.

Figure 1.14. Net worth of the private non-financial sector: percentage point change since 2007 Q1 (% of GDP)



Note: The graph shows the change in net worth of the private non-financial sector since 2007 Q1, measured as a share of GDP. In both the US and UK cases, pension entitlements have been excluded from the calculation on grounds of relevance. In the UK's case, corporate real assets have been calculated by taking the total nominal value of the market sector and multiplying it by the GOS share of non-financial corporates. Housing wealth is calculated via the total number of privately owned dwellings, multiplied by the average house price. UK data are taken from the ONS accumulation accounts; US data are from the Federal Reserve system.

Source: BEA, Federal Reserve, ONS.

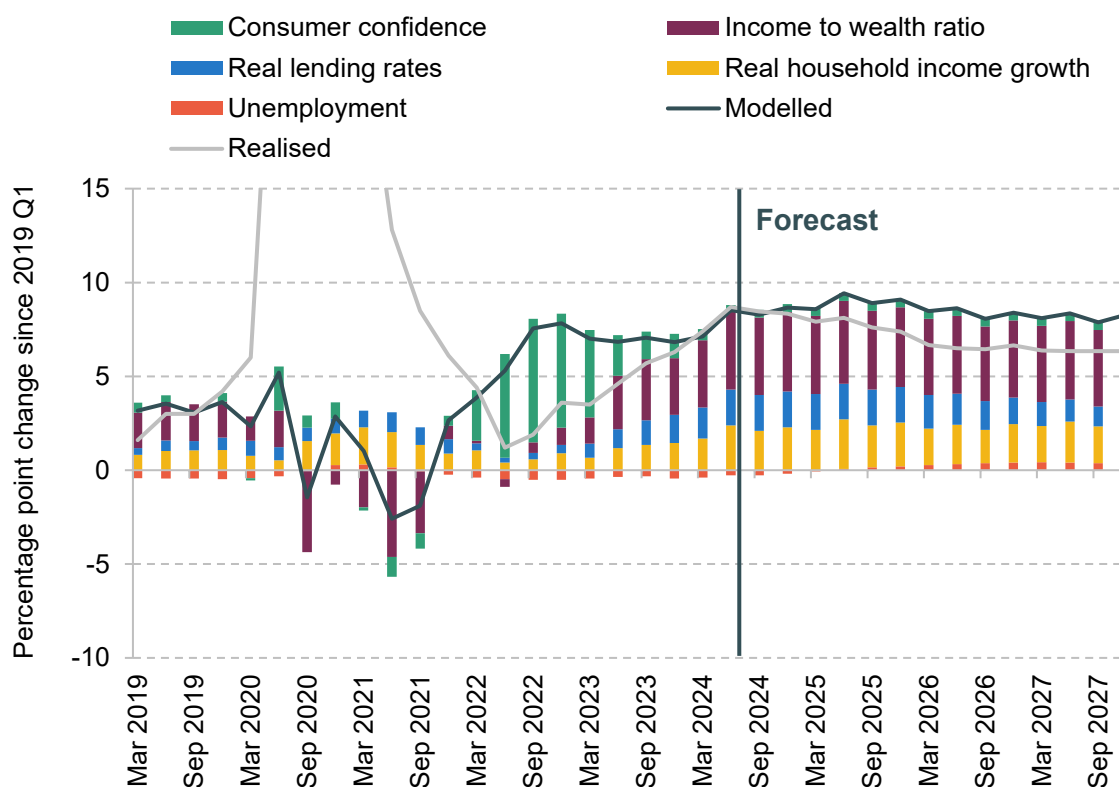
- 2 Consumption smoothing.** Households typically save during income spikes and dissave when incomes fall, so that large swings in real income growth have large but short-lived impacts on inflation. We observed this in 2022–23, as rising costs led to households dissaving, followed by an increase in saving rates in recent quarters as incomes recovered. This dynamic should stabilise as real income growth slows, pushing the saving rate down somewhat from recent highs.
- 3 Household balance sheets.** During past inflationary periods, households typically held real assets financed by nominal liabilities. An older population now holds more financial assets, often in deposits or bond-based investments, and these have performed poorly, impacting household balance sheets. Indeed, household (and firm) balance sheets appear to be weaker as we emerge from the pandemic. Figure 1.14 shows the development of net worth in the private non-financial sector (which includes both households and firms, excluding those in the financial sector), incorporating both real and financial assets and liabilities. In the UK, net worth is now nearly 90% of GDP lower than it was in 2007 – falling from 630% to

542% of GDP. This is in contrast to the experience in the US, for example, where net worth is now nearly 60% above – up from 521% to 580% of GDP.

One argument holds that as interest rates fall and income drivers shift from interest income to wages in the coming months, the household saving rate will start to come down. We agree with this to some extent. However, as shown in Figure 1.15, our modelling suggests that a sharp drop in the ratio of household net worth to real incomes explains some of the recent rise in saving rates. These effects should be somewhat more persistent. And to the degree real rates fall, we think these will remain higher than on the eve of the pandemic. We expect cash saving rates to fall modestly as real income growth slows, but remaining perhaps 5% of income above the rate in 2019.

We see the main upside risk as a significant rally in nominal house prices, which is plausible as interest rates fall. For now, most soft data suggest nominal house price growth remains at or slightly below inflation, and we expect growth to remain in the low single digits. But a stronger recovery could mean a faster consumption recovery in the months ahead.

Figure 1.15. Changes in households' cash saving rate: percentage point change since 2019 Q1



Note: Model here consists of unemployment, real household income growth, real lending rates, consumer confidence and the income to wealth ratio, and is estimated as a simple OLS model based on data from 1996 to 2019.

Source: ONS, Bank of England, GfK, Citi analysis.

The combination of falling real household disposable income growth and only a slow decline in saving rates suggests that consumption growth is likely to be weak into 2025. We expect private consumption to increase by only 0.6% in 2025, compared with 1.5% in the Bank of England's baseline estimate.

Firm profitability and the prospects for investment

The outlook for firms should improve as supply growth picks up and costs decline, though any gains will come from a weak base. Profitability and viability challenges are expected to persist.

Business investment has been underwhelming recently. After rebounding in 2022–23, it has since stagnated, with transport investment stabilising but machinery, construction and intangible investments remaining flat. The reasons for this underperformance primarily relate to uncertainty and the rising cost of capital – which, on a weighted average basis, is up about 4 percentage points since interest rate hikes began. This latter increase would historically have reduced business investment by 10–15%, all being equal. We think this has now largely passed through. Other challenges, such as higher energy prices and issues with key capital imports, may also have contributed. But these should now be beginning to fade.

As costs ease and interest rates fall, we expect business investment to recover gradually. However, rates are still high, and many firms, particularly in the CBI survey, cite the cost of capital as a major barrier to investment. And although investment intentions have risen slightly, the recovery has been weaker than anticipated, especially given the UK's historically low investment levels. While larger firms are more optimistic, smaller businesses remain cautious (Xero, 2024). Overall, sentiment remains somewhat defensive.

While the sequential picture is improving, we think such benefits will come through only gradually. This is for two reasons.

First, firms have been tapping into internal funds, limiting the pool of available capital remaining for intangible investment. To the extent that firms were using internal liquidity – often financed at lower rates – to stay afloat, they are now facing the expiration of these effective subsidies. Those relying on liquid deposits may face renewed challenges as their capital costs rise. These effects have been material. The government-backed corporate loan schemes left corporate deposits in early 2022 around £80 billion above their pre-COVID trend. These are now around £30 billion below.

Second, there continues to be pressure on profit margins. ONS data suggest private non-financial corporate profit shares are about 2–3% of GDP lower than pre-pandemic. Survey and ONS data suggest that the picture here has stopped getting worse but nonetheless the level has deteriorated. The latest business demography data suggest that roughly the same number of jobs are being lost

to firm destruction as are being created by firm formation. This is in contrast to the period prior to the pandemic, where more jobs were created, and suggests some challenges remain.

On the private residential side, we are more optimistic, expecting investment growth of 1.8% in 2025 and 6.4% in 2026. This optimism is based on stronger housing market activity and potential support from new government planning reforms. Our forecast assumes the annual construction rate of new dwellings will rise from a current run rate of around 200,000 to 300,000 by the end of the parliamentary term. While lower than Labour's manifesto pledge – which was for 1.5 million homes over the parliament – a more gradual increase seems plausible given the sector's concerns over skill shortages. Since new home construction represents 20% of sector output and 6% of GDP, this would contribute about 0.5% to overall activity over five years, accounting for offsetting increases in imports.

Overall, while the UK is expected to converge slightly with G7 investment levels, this recovery will take time, especially until interest rates fall more significantly.

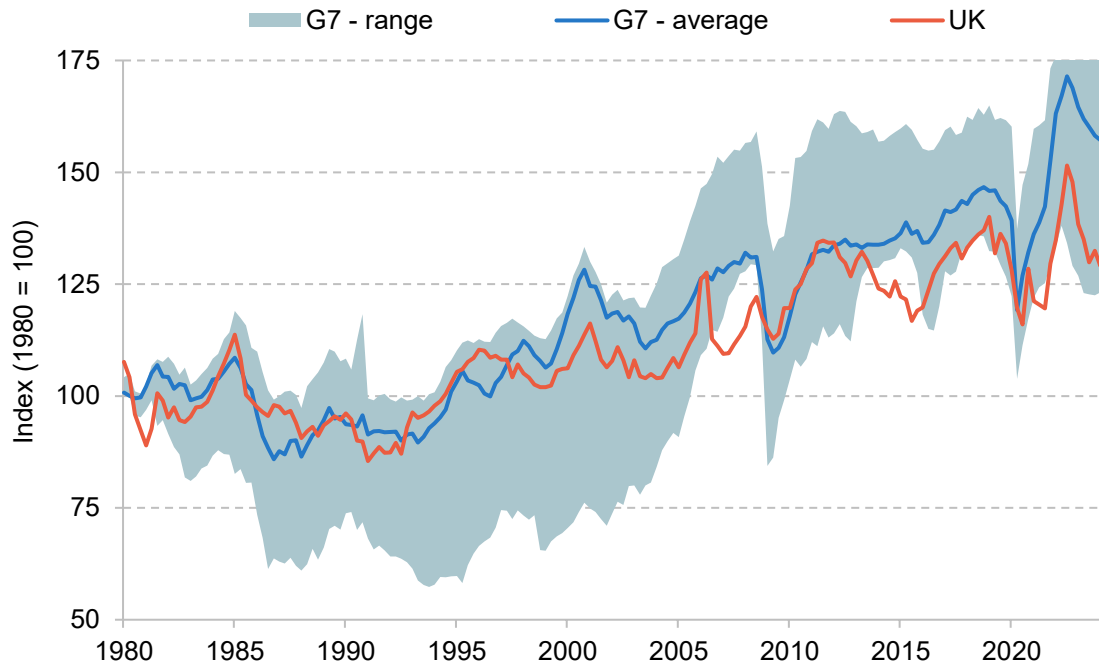
Trade underperformance

On trade, the UK continues to underperform relative to international benchmarks. Since 1980, the UK's trade intensity (imports and exports, as a share of GDP) has increased by 33%, compared with an average of 57% across other G7 countries. As shown in Figure 1.16, this gap is much wider than in 2019 and comes despite advantages such as a strong UK services trade, which has generally recovered better post-pandemic.

The UK's trade dynamics have been heavily buffeted by global developments over recent years. Goods trade, particularly to the EU, initially fared relatively well through 2021–22. This was likely due in part to global supply chain challenges associated with the end of pandemic lockdowns. In the period since, UK goods exports to both EU and non-EU countries have slumped back, particularly relative to G7 comparators, as shown in Figure 1.17. The symmetrical weakness in exports to both the EU and non-EU may reflect the importance of EU trade as a complement to UK goods exports elsewhere.

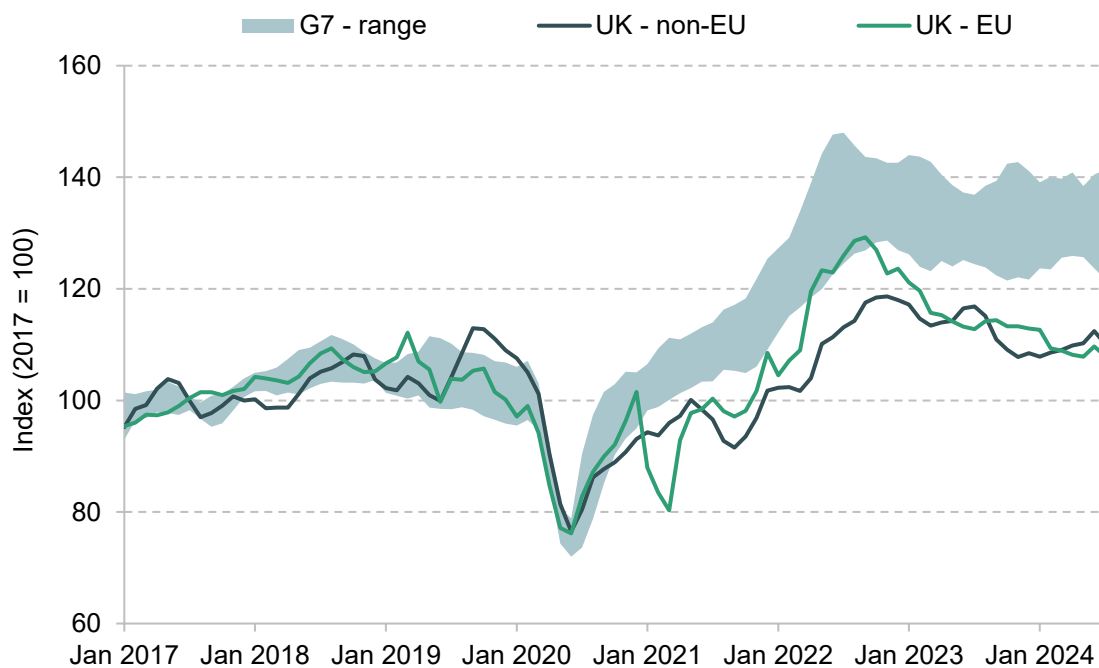
Turning to services, there have been striking differences in trends by sector – particularly when it comes to trade with the EU. Intellectual property exports to the EU have grown by 56% since 2019 Q4. Construction and travel exports to the EU have fallen while increasing strongly to non-EU destinations. Overall, services growth has been marginally stronger to non-EU destinations, but by less than expected. The exception is the financial sector, where exports to the EU have grown at a marginally faster rate than exports elsewhere.¹¹

¹¹ Here the data are somewhat complicated by firm relocations, particularly of US-headquartered entities.

Figure 1.16. Trade intensity since 1980, UK and G7

Note: Graph shows trade intensity – measured as imports and exports divided by GDP. The level is then indexed back to an average over 1980.

Source: National statistical offices.

Figure 1.17. Goods exports since 2017

Note: The graph shows four-quarter average levels. The UK series excludes erratics such as non-monetary gold.

Source: ONS, national statistical offices.

On imports, there is growing evidence that additional UK–EU trade frictions have hurt the UK consumer over recent years. The import price deflator on food from the EU has increased by almost 50% since 2019, while the equivalent for food imports from non-EU destinations has increased by around 18%. If EU food import prices had increased at the same rate as their non-EU equivalents, this would amount to a £273 reduction in the annual food bill of the average UK household, if fully passed on by retailers and producers.¹²

Altogether, the UK does seem to be struggling with international competitiveness. The tradable sector contracted 1.0% in the four quarters to 2024 Q2.¹³ The UK current account deficit has widened again to around 4%, although we expect this to shrink through 2025 due to lagging domestic demand. For now, we remain less immediately concerned about the capital account deficit than in previous years, with more currently financed via net direct investment. Although risks remain, this somewhat reduces the UK’s reliance on potentially volatile portfolio inflows.

1.4 Labour market risks

The labour market has loosened over the past two years, and labour supply and demand are now broadly in balance. However, the economic outlook suggests the labour market is likely to continue to weaken as labour demand remains subdued. That adds to the risk of a further increase in unemployment ahead.

Our concerns stem from three observations. First, as labour demand has fallen back, there are signs of something of a deterioration in labour matching as ‘thick market’ effects have dissipated. That suggests a faster transmission from further reductions in vacancies into unemployment. Second, high labour costs – at least relative to non-labour equivalents – increase the risk of a more abrupt period of labour shedding – particularly when paired with weak corporate balance sheets. And third is the continued, and prominent, role of public sector employment growth in propping up the employment aggregates. As we move into next year, we are unsure this is likely to last.

Indeed, we currently expect the unemployment rate to increase to 4.9% next year and 5.3% 2026. In this section, we look at the dynamics of labour demand and supply, changes in employment and the degree of slack, and consider the recent role of changes in the National

¹² The latest edition of the family spending bulletin from ONS (Office for National Statistics, 2024a) shows the average UK household spends £63.50 on food and non-alcoholic beverages per week. This is £3,302 on an annualised basis. Around 40% of all foodstuffs are imported. Assuming a 20.9% reduction in the price of these imports, that would suggest an 8.3% reduction in food costs overall. That equates to £273.

¹³ This figure takes the year-on-year change in tradable sector GDP for 2024 Q2. Here, the tradable sector is defined by the share of imported and exported content in the supply and use tables, a definition that is borrowed from Broadbent et al. (2019).

Living Wage. A softer labour market is neither necessary to return inflation to target, nor affordable in the context of a lacklustre recovery. For the Bank of England in particular, that suggests remaining attentive to the risks around the real side of the economy.

Further softening of labour demand

Labour demand in the UK has fluctuated in recent years. Following a near-total shutdown during COVID-19, hiring rebounded sharply in 2021–22. In the latter half of 2021, vacancies were increasing by about 280,000 per quarter, even as the furlough scheme worked against labour separation. Since then, much of the hiring backlog has been addressed, but underlying demand has also decreased.

Despite increased activity at the start of this year, there are few signs that labour demand is ticking up again. Currently, there are 857,000 open vacancies, down from 1.3 million in mid-2022. The latest three-month change shows a decrease of 39,000 job advertisements per quarter – just under half the peak rate of decline during the Great Financial Crisis. Thus, while the rate of decline may have moderated, it remains high.

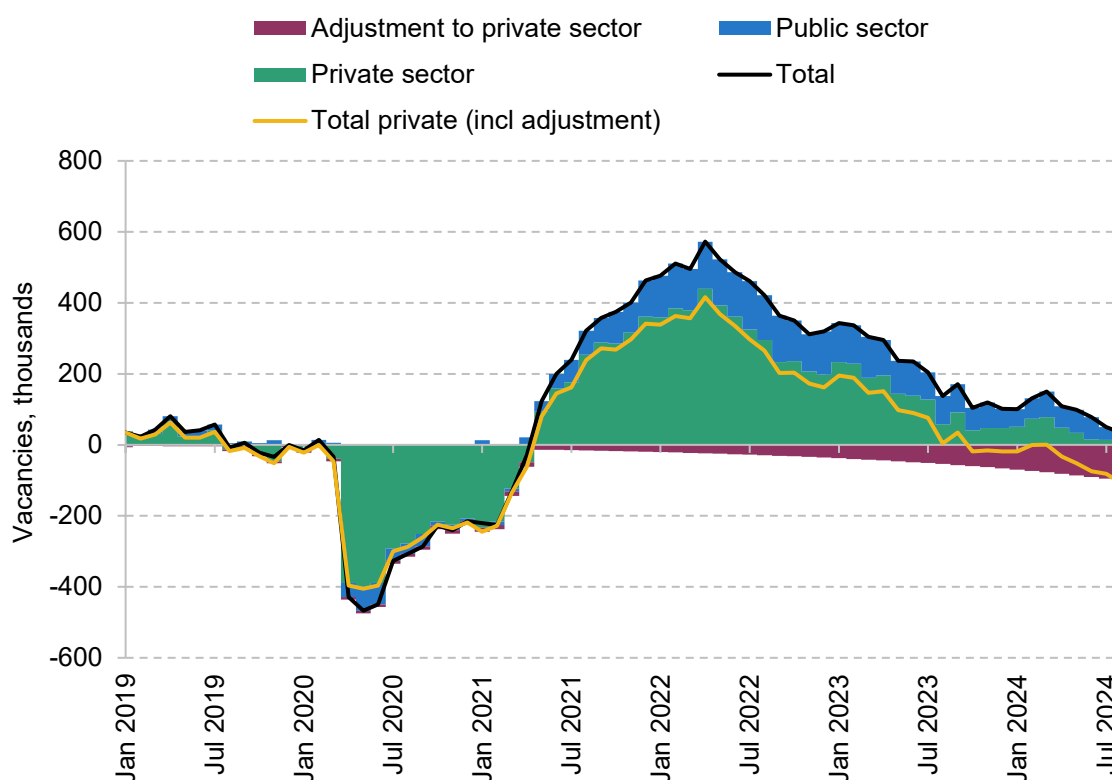
We believe the headline vacancy figure likely overstates labour market strength for two reasons.

First, there has been a trend increase in overall job postings in recent years as online recruiting has become more common, lowering advertising costs. Our structural model suggests that a 10% reduction in the cost of advertising a vacancy can lower the equilibrium ‘vacancy rate’ by 0.2–0.3 percentage points.¹⁴ Since 2018, we estimate that the expansion of online platforms has reduced the average advertising cost by around 15%, implying a 105,000 reduction in the equilibrium vacancy level. Adjusting for this, vacancies are currently below the level seen in 2019, as shown in Figure 1.18.

Second, tighter labour market conditions are now mainly a public sector phenomenon. The latest headline vacancy data (not adjusting for the trend discussed above) show 33,000 more overall vacancies than in 2019, but that includes 41,000 more vacancies in public administration, education and healthcare. Given the limited substitution between public and private sectors, this suggests the private sector labour market is already somewhat looser than in 2019.

¹⁴ This is based on the UK’s pre-COVID Beveridge curve and a structural search and matching model. See Yashiv (2007).

Figure 1.18. Adjusted vacancy measures, UK



Note: The adjusted measure reflects the impact of a 15% drop in the average cost of advertising a vacancy on the headline vacancy rate. Private sector excludes public administration, education and health.

Source: ONS.

Looking ahead, much of the soft data suggest continued declines in labour demand in the coming months. Daily vacancy data from Indeed.com have trended down recently, while Adzuna's figures have stabilised at a lower rate than the ONS headline numbers indicate. Most survey indicators of labour demand and workforce growth indicate stagnation or further reductions. Established surveys such as the KPMG–REC report show ongoing contractions in both temporary and permanent listings. The Decision Maker Panel (DMP) employment growth index has also moderated to 1.1% year-on-year, down from 1.7% at the year's start. With aggregate demand likely to remain soft, we expect labour demand to continue to weaken gradually into next year.

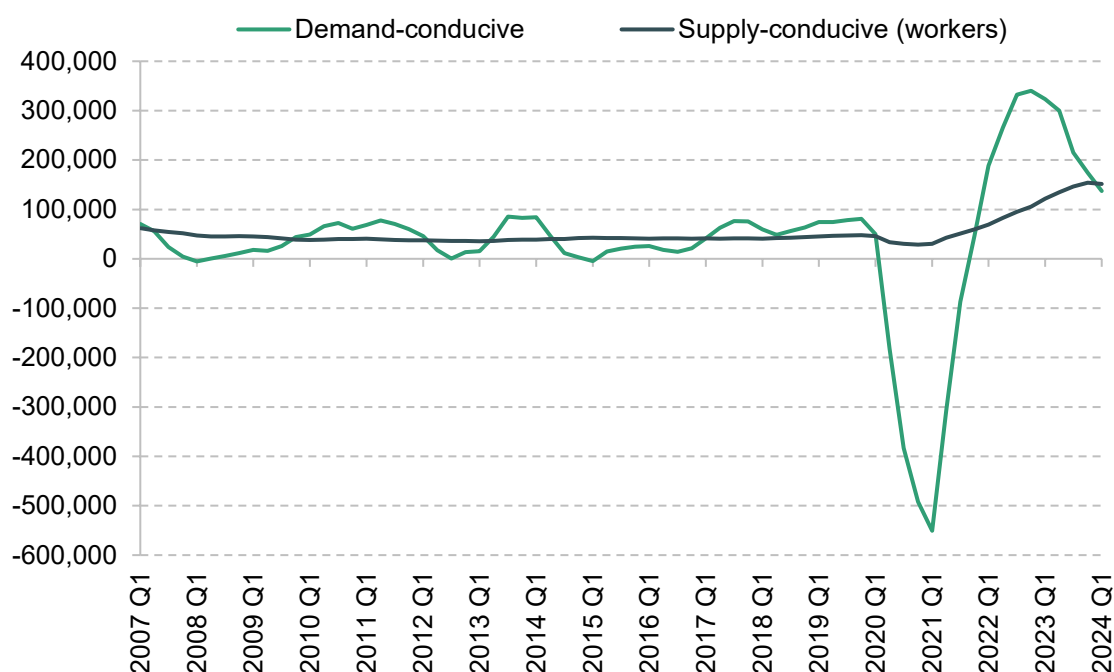
Labour supply continuing to rise

While labour demand appears to be weakening, there are signs that underlying labour supply is continuing to recover. In addition to an improvement in labour matching as post-COVID distortions have eased (as discussed in relation to supply-side improvements in Section 1.3), underlying aggregate labour supply has also continued to normalise.

There have been two main drivers.

The first has been both an increase and a shift in the composition of net immigration. Higher-than-expected overall immigration has resulted in stronger workforce growth. The latest ONS population projections suggest cumulative workforce growth of 5.2% between 2021 and 2026, for example, versus 2.6% in 2023 Q1 estimates. Immigration flows into the UK are also becoming more conducive to supply. For instance, Figure 1.19 shows the net impact of changes in visa applications through the tourist, student, dependant and worker routes – weighting each by their propensity to work. In 2021–22, a strong recovery in tourism alongside large refugee flows likely added more to demand in the first instance. Increasingly, that balance is shifting in favour of supply.

Figure 1.19. UK entry visa approvals, weighted by propensity to work



Note: Data based on numbers of entry clearance visas.

Source: HM Government.

Second, on the domestic front, the participation rate seems to have stabilised. It has declined since the onset of the pandemic, with more than 673,000 more people reported by the Labour Force Survey (LFS) as being inactive owing to ill health than in January 2020 and an increase of 311,000 in the number of economically inactive students.¹⁵ But the participation rate does seem to have stopped falling, despite some increases in those out of work owing to caring

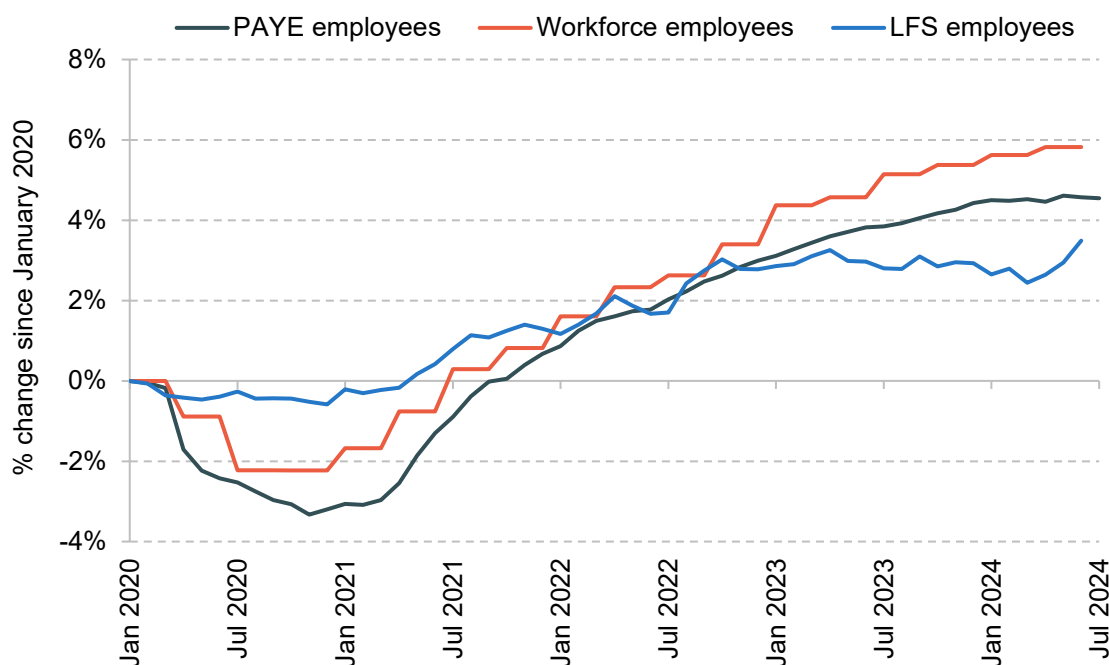
¹⁵ Note these LFS estimates are somewhat dated. The headline LFS aggregates are still based on out-of-date population estimates from late 2023.

responsibilities. With the working-age population set to continue growing, that suggests overall labour supply will pick up.

Employment levelling off

In contrast, much of the employment data suggest that growth is slowing, particularly in the private sector, although different sources conflict somewhat. The Labour Force Survey indicates that employment growth is now picking up, but only after a prolonged period of flat or falling growth. We give more weight to payroll and workforce job estimates given the sampling issues with the LFS. As shown in Figure 1.20, these suggest stronger growth in 2022 and 2023, but weaker growth more recently.

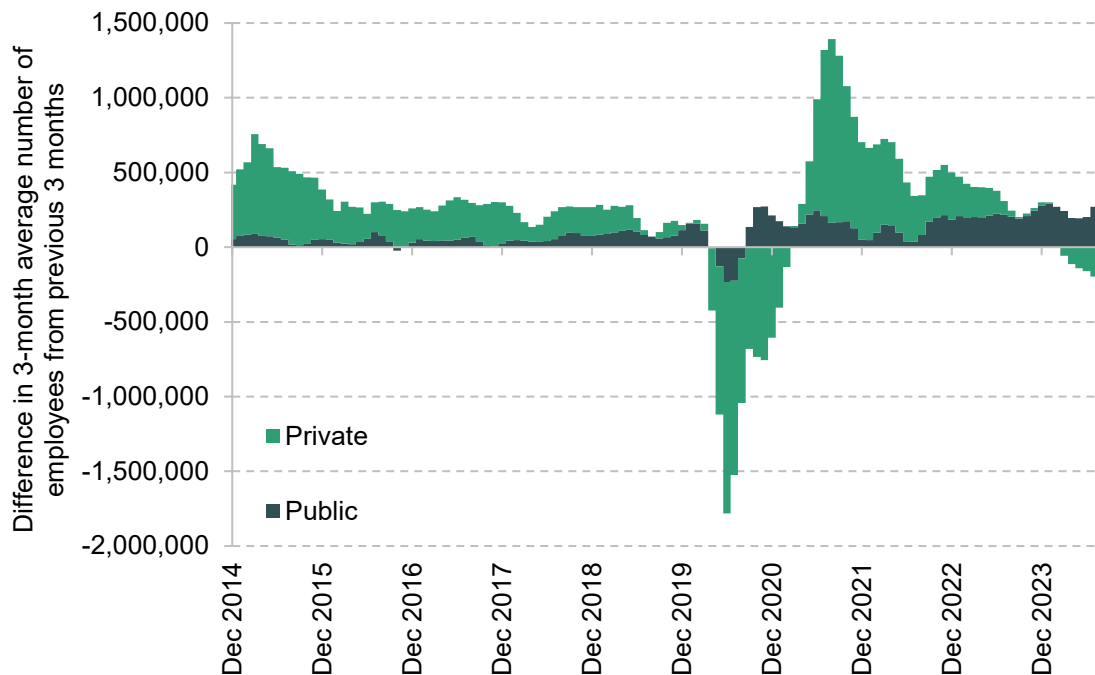
Figure 1.20. Measures of UK employee growth (% deviation since January 2020)



Note: In all three cases, the focus is on employee growth. The graph shows the cumulative percentage change since January 2020.

Source: ONS.

As with the vacancy data, the headline overall trends may paint a rosier picture than the detail. Both the PAYE and LFS data, once adjusted for classification changes, indicate a significant decline in private employment in recent months. As shown in Figure 1.21, the PAYE data show that the three-month rate of private employment growth has fallen to its lowest level since 2020 Q2, with 14 sectors reporting a decrease in PAYE employment – the highest number since August 2020. The adjusted LFS data also reflect this decline, showing a quarter-on-quarter drop of 190,000 in private employment – again the weakest growth since 2020, matched only during the Great Financial Crisis.

Figure 1.21. Employee growth in the UK, by public and private sector employers, from PAYE data

Note: Public sector comprises public administration, education and health.

Source: ONS.

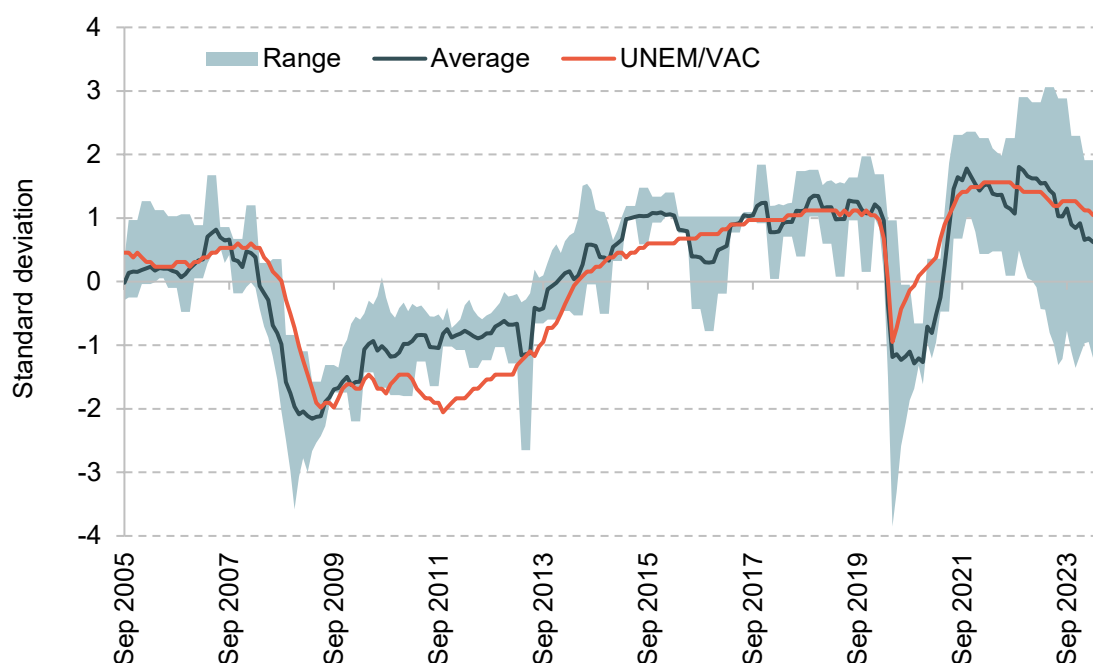
This weakness is mirrored in survey data. While some indicators, such as the Lloyds Business Barometer and the Purchasing Managers' Index (PMI) employment indicator, have held up better, others are giving a more cautious signal. For instance, the latest KPMG–REC survey reported further declines in permanent placements, and the PMI data have started to moderate recently.

Labour market becoming less tight

With aggregate labour supply increasing and headline employment stagnating, we think the labour market is loosening, as shown in Figure 1.22. Interpreting this is complicated by the absence of reliable Labour Force Survey data (Broadbent, 2023). The unemployment rate has remained somewhat volatile – increasing to 4.4% in 2024 Q1, only then to fall sharply. Nonetheless, the claimant count has continued to increase, perhaps a little faster than what would be implied by the change in eligibility alone.¹⁶ And data around hiring difficulties and slack also suggest a marginally looser labour market now than in 2019.

¹⁶ Specifically, the Office for National Statistics (2024b) estimates that changes in eligibility for universal credit should have added 180,000 to the claimant count over the six months from April 2024. The claimant count has increased by 223,000 over this period.

Figure 1.22. Measures of labour market tightness in the UK



Note: The unemployment to vacancies ratio is inverted and shown in the UNEM/VAC series. The 'Average' series shows various other indicators, the range of which is shown by the shaded area. All data here are normalised over the period 2005–19.

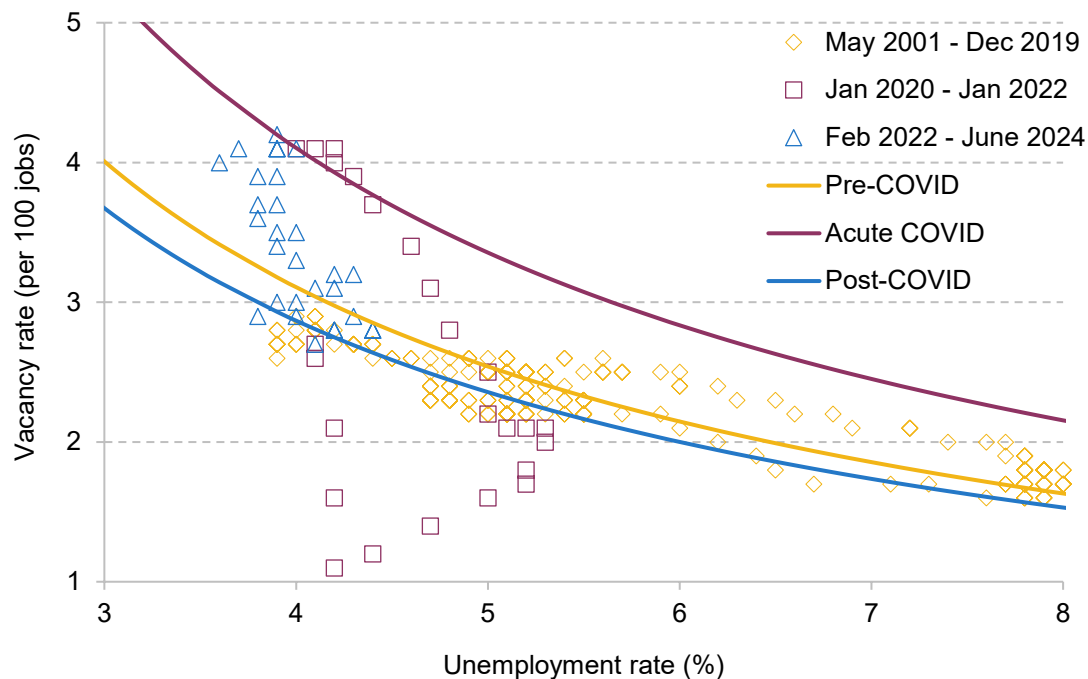
Source: ONS, CBI, Bank of England, KPMG–REC.

If labour demand softens further, as we expect it to, the pass-through into unemployment may accelerate. The fall in vacancies so far has been relatively painless, with only modest impacts on frictional unemployment. The reason is that the associated vacancies primarily reflected a temporal mismatch. As this has been worked through, workers could often move within similar sectors and to firms in the same geographic areas. Matching was very effective. As a result, the reduction in vacancies has fed through into unemployment to only a very limited extent. This is shown on Figure 1.23. In the period since January 2022 (as shown by the blue triangles), the curve has been strikingly steep.

Much of this adjustment to temporal mismatches has now taken place. And broader 'thick market' effects will also dissipate as vacancy numbers fall. These dynamics have often been a little more abrupt in the UK, reflecting a faster flattening of the Beveridge curve.¹⁷ But there are now signs of this. There is already an increasingly marked divergence in the level of vacancies across regions, and low flows of labour across sectors and regions, for example. Any fall in vacancy numbers may now translate more quickly into higher unemployment.

¹⁷ This all comes down to a variable in a search and matching model known as 'sigma' which is the rate at which the Beveridge curve flattens as vacancies fall. In the US, this value is relatively low, meaning a more robust labour market overall. In the UK, that variable seems to have been somewhat higher, at least historically. See Figura and Waller (2022).

Figure 1.23. Beveridge curve for the UK



Note: Pre-COVID covers the 2001–19 period. Acute COVID covers 2020 and 2021. Post-COVID covers the post-2021 period.

Source: ONS.

Further large increases in the National Living Wage would bring risks

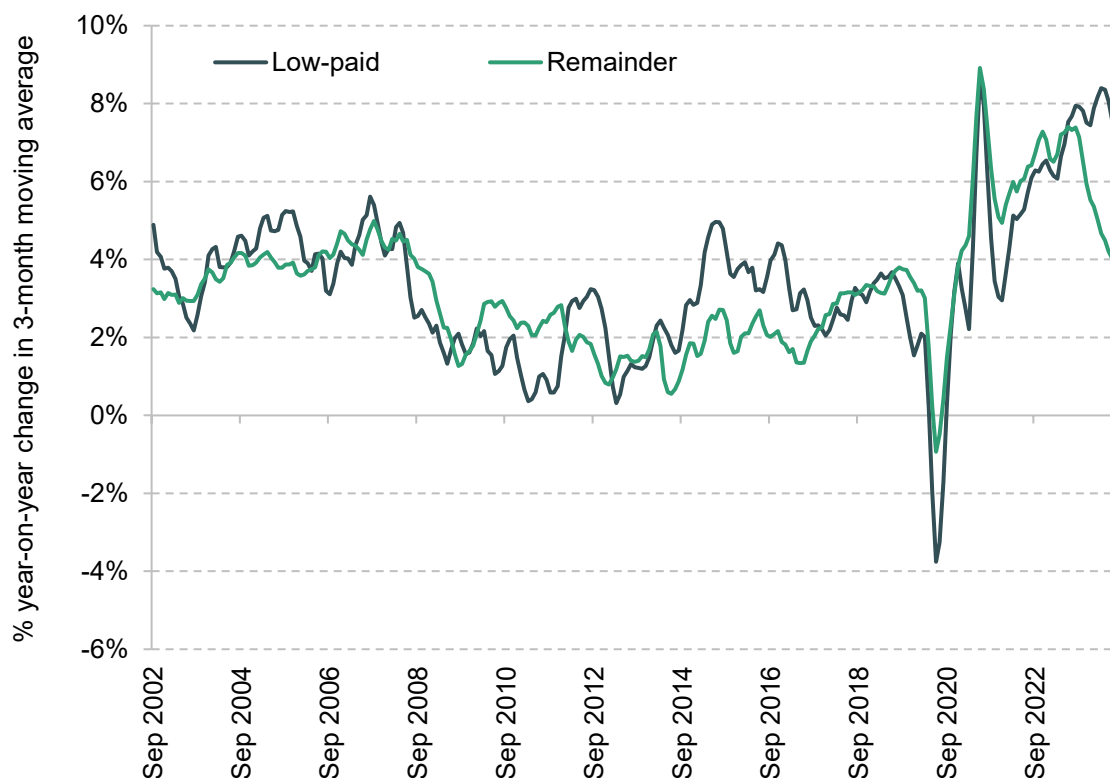
We discuss the outlook for wage growth in more detail in Section 1.5. But the final point we want to make here is that there are some modest signs that increases in the National Living Wage (NLW) are beginning to lead to some job destruction. This increases the risk if the government were to push ahead with further large increases.

Currently, private sector regular pay is growing at 4.9% year-on-year (three-month average). However, in ‘low-paid’ sectors – where over 50% of workers earn within £1 per hour of the NLW – wage growth is at 7.1%. This compares with 3.8% in non-low-paid sectors, as shown in Figure 1.24, suggesting that underlying wage growth (apart from the impact of the NLW) may be slowing.

The NLW has already been increased significantly in recent years, with a 39.3% increase in the headline hourly rate since 2019. The Low Pay Commission’s latest guidance suggests a further 5.8% increase in April would be needed to keep pace with forecast growth in median pay (Low Pay Commission, 2024). Even before the sharp increase in the NLW over the pandemic, pay growth and productivity have broadly kept pace with one another (Teichgräber and Van Reenen, 2021). This does not suggest substantial monopsony power, which has previously enabled

increases in the minimum wage to drive increases in both labour demand and pay growth. The Competition and Markets Authority has also noted that labour market concentration has remained stable or declined over recent decades, with residual issues increasingly concentrated in certain regions and sectors (CMA Microeconomics Unit, 2024).

Figure 1.24. Private sector wage growth in the UK, in high- and low-paid sectors



Note: Low-paid sectors here include agriculture, retail, transport, hospitality, administrative services, recreational services and personal services. Data exclude arrears and bonus payments. Seasonally adjusted using X-13.

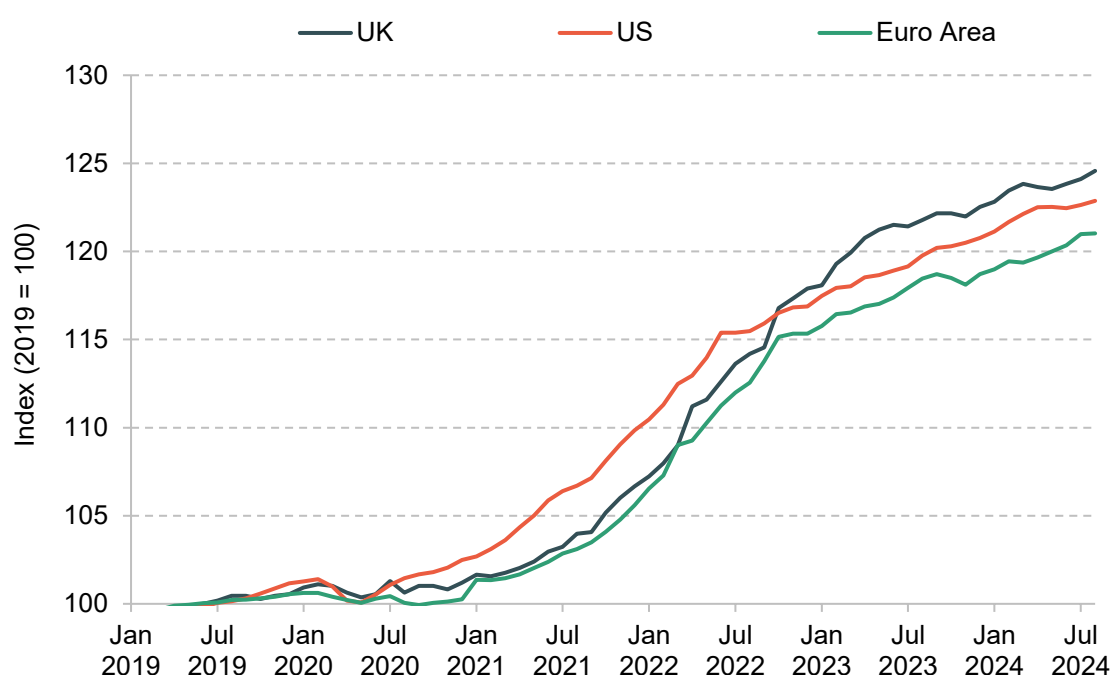
Source: ONS.

That is reason for caution. Over the past year, demand has slowed sharply in sectors more exposed to the NLW. Quarterly employment growth in sectors with 50% of workers either at or within £1 of the National Living Wage rate have now seen PAYE employment growth fall to 3.3 standard deviations below its post-2015 average. For other sectors, the drop is 2.5 standard deviations. There may of course be other drivers of this, and the NLW has been tremendously successful in boosting both employment and pay over recent decades. From here, further boosts to the incomes of lower-paid workers may require different tools.

1.5 Wages and inflation: a cessation of hostilities?

The UK has experienced a recent surge in inflation, with CPI peaking at 11% in October 2022, well above the 2% targeted by monetary policy. Cumulative growth in consumer prices since the pandemic now exceeds that in the US or the Euro Area, at 25%, as shown in Figure 1.25. Having hiked the bank rate successively from 0.1% in 2021 to 5.25%, the Bank of England cut the rate in August by 0.25 basis points, but seems determined to secure more evidence of disinflation before embarking on a more deliberate easing cycle.¹⁸

Figure 1.25. Cumulative consumer price inflation since 2019



Source: National statistical offices.

The inflation surge resulted directly from three large cost shocks: to core goods in 2021, energy prices in 2022, and then food prices. Second-round effects through wage growth and services inflation, once established, have taken time to fade as indexation and other ‘mechanical’ effects have continued. The persistence of both wage and price inflation speaks to a lingering margin of ‘conflictual inflation’ resulting from the incompatibility of real wage and firm margin demands, as well as fiscal stimulus. We think this sits at the heart of any residual concern.

¹⁸ <https://www.bankofengland.co.uk/monetary-policy-summary-and-minutes/2024/august-2024>.

Increasingly, our view is that these effects are fading and doing so fully. The complete absorption of the real income shock, alongside moderating inflation and wage expectations, suggests that residual risks are increasingly limited. Looking forward, we continue to place stock in more structural analyses of UK inflation dynamics. These suggest that the UK's inflationary anchor, although battered and bruised, remains intact. In our view, the UK is on course for inflation to return broadly to target next year, and then to undershoot in 2026.

Cost shocks and conflict

The initial surge in UK inflation was predominantly supply-driven, resulting from three successive, large cost shocks:

- The surge in global traded goods prices through 2021 as the economy rebounded after the pandemic but supply chains remained under pressure. At their peak, non-energy industrial goods prices subsequently grew by nearly 8% year-on-year through early 2022 – the fastest growth since the late 1980s.
- The surge in household energy prices following the outbreak of conflict in Ukraine. Falls in inflows of Russian gas over the summer of 2022 drove a dramatic surge in wholesale gas prices, and a sharp rise in household energy prices, with total energy inflation peaking at around 60% year on year.
- Stemming partly from the energy shock, a sudden rise in food prices, which peaked at 19.6% year-on-year in early 2023, the highest since 1977.

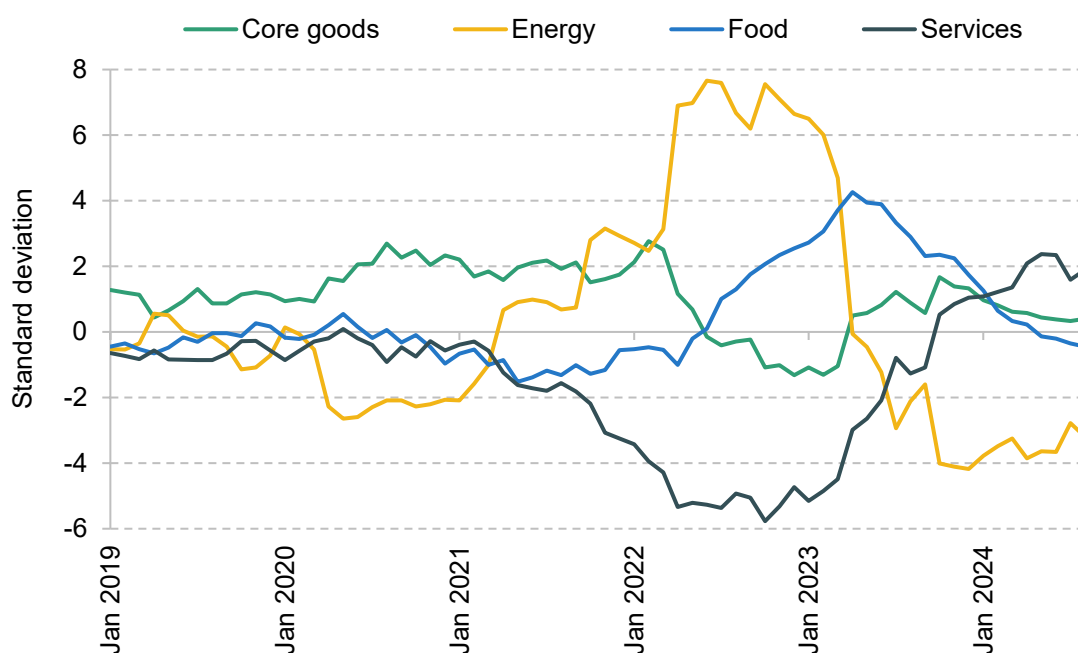
These successive shocks, shown in Figure 1.26, drove a high rate of headline inflation and – importantly – a sharp drop in the real value of domestic incomes. At its peak, before some of the offsetting fiscal interventions, the loss amounted to 5% of GDP, comparable in scale to the worst years during the oil price shock of the 1970s. Inflation became the mechanism by which the pain of this economic loss was shared.

However, the scale of the loss, and the large-scale fiscal offsets, have we think created an environment in which both workers and firms felt able to ‘contest’ the associated effect. The subsequent disparity between the real economic capacity of the UK economy, and the aspirations of workers and firms, has generated persistence in UK inflation as these struggles have gradually worked through (Pill, 2023). Most directly, this has been reflected in the incompatibility of real-wage aspirations of workers, with the margin expectations of firms (Rowthorn, 1977; Lavoie; 2022).

This we think is crucial framing for the UK's inflation process over recent years. One view holds that the domestic labour market has contributed to higher and more persistent domestic inflation. We think this is a misreading of the data. Tighter labour markets may have made it easier for workers to contest reductions in their real income. But in fact we find little evidence of a

‘multiplicative’ effect of labour market tightness onto wage growth – as this argument might imply. And overall the reduction in slack seems to have made only a modest contribution to inflation. We estimate that changes in the ratio of vacancies to unemployed workers have contributed less than 0.5 percentage points to quarterly CPI inflation over the period, and other estimates range from 0.2 to 0.4 percentage points, compared with several percentage points in the US.¹⁹

Figure 1.26. Changes in relative prices within the CPI basket



Note: Measure here shows the annual change in the relative price of given components, compared with the whole index. These effects are then normalised by each item's historical volatility over the period 1995–2019.

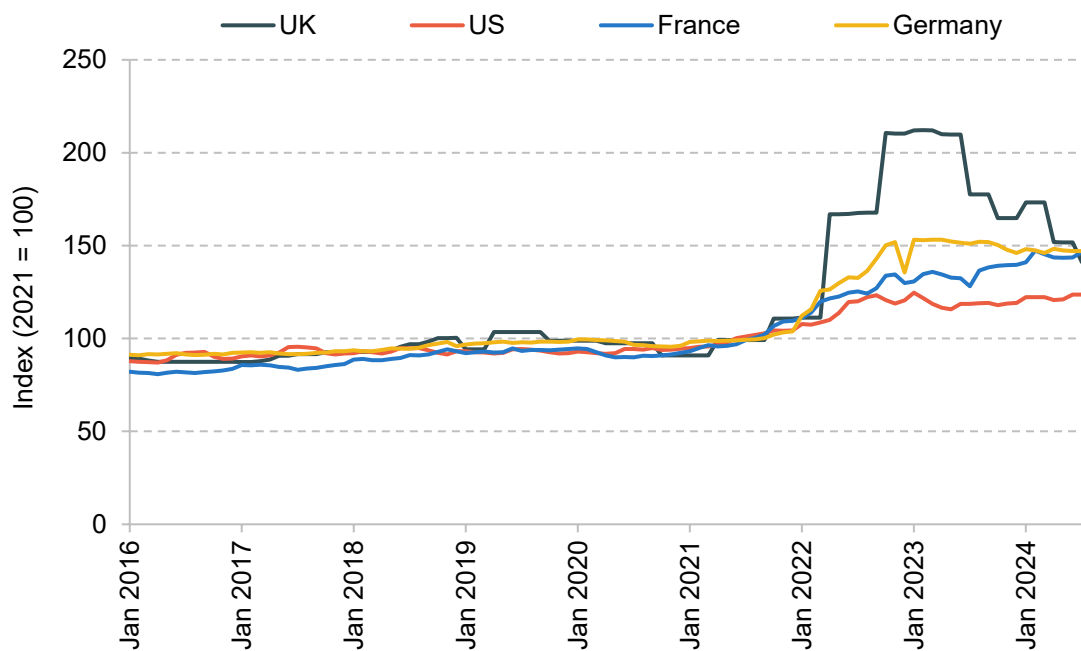
Source: ONS.

Instead, our view is that both wage growth and services inflation have reflected the same fundamental cost shock. The larger response of wage growth in the UK is more closely related to the scale of the shock and associated policy offsets than either a shift in domestic price setting or domestic tightness. Hence in the UK the household energy shock seems to have been materially larger than elsewhere in Europe, with household energy prices increasing further. This has since been compounded by increases in food inflation. The focus of these shocks within the household sector has affected the way inflation has been transmitted, with more conflictual dynamics coming via higher wage demands in the first instance.

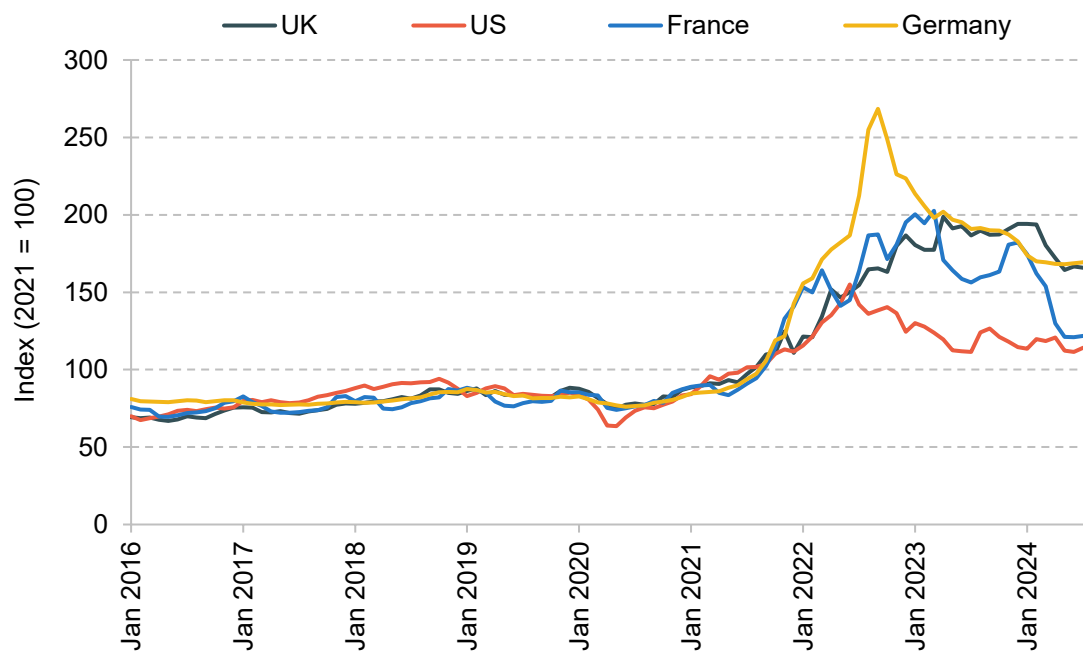
¹⁹ This uses the multi-equation framework set out by Blanchard and Bernanke (2023).

Figure 1.27. Transatlantic energy inflation

Panel A. Consumer price index energy inflation



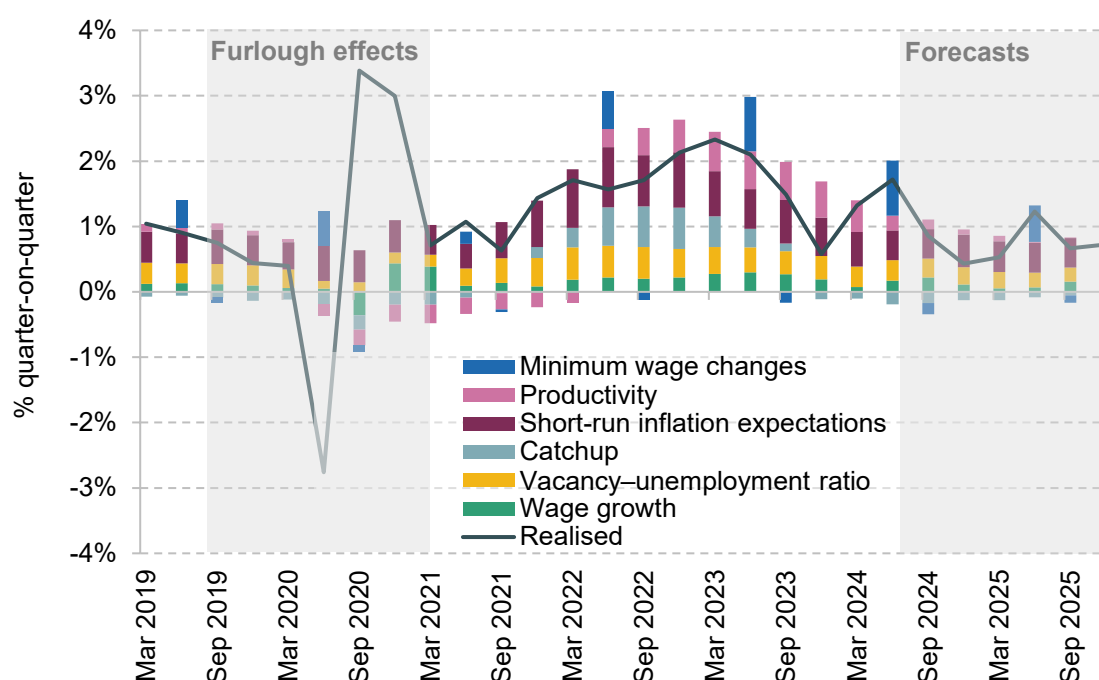
Panel B. Producer price index energy inflation



Note: Data show household energy costs only in Panel A. Panel B covers electricity and piped gas.

Source: National statistical offices.

Figure 1.28. Realised and forecast private sector regular pay growth



Note: The bars show the modelled contributions based on the period 1992–2019. The line shows the realised out-turn, and a forecast from 2024 Q3. Model equation is an auto-regressive distributed lag on the quarterly data, measured with four lags. Variables include: productivity – measured as output per worker; wage growth – using a combination of Average Weekly Earnings (private sector regular pay) and the Average Earnings Index; the vacancy to unemployment ratio; short-run inflation expectations – measured via an average of the Citi/YouGov and Bank of England / Ipsos survey for inflation 12 months ahead (pre-1997 this is measured via NIESR professional forecast expectations); minimum wage changes – measured as the quarterly change in the headline rate; and catchup – measured as the gap between realised and expected inflation 12 months prior. Model is estimated over the period 1992–2019.

Source: ONS, NIESR, Bank of England / Ipsos, YouGov, Bernanke and Blanchard (2023), Citi analysis.

Importantly, once these differences in the distribution of the initial shock are accounted for, evidence of a structural break in inflation is actually very limited. For example, Figure 1.28 shows recent UK wage growth versus a modelled estimate based on the UK's post-1992 experience.²⁰ Higher realised inflation has fed back into higher wage growth, but at a rate entirely commensurate with the behaviour of the UK economy between 1996 and 2019. In other words, there has been an especially large shock, but the impact – owing either to the scale of the shock or to coincident labour market tightness – has not been greater than linear models suggest. Indeed, in Figure 1.28, there is no obvious positive residual, which suggests that wage behaviour has remained in line with that suggested by existing labour market institutions.

How might these dynamics evolve in future? Conventional price and wage behaviour gives us some confidence that the impact of the shock to inflation should fade over time. In a modern

²⁰ The model equation is based on Blanchard and Bernanke (2023).

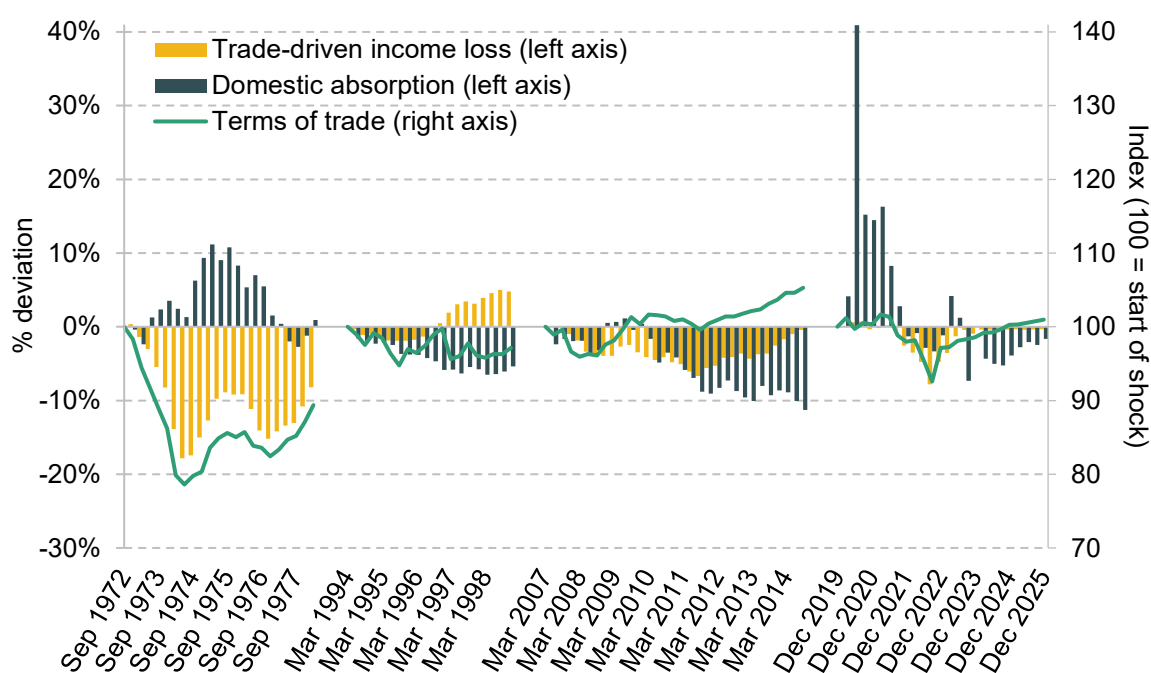
labour market, the only way workers can effectively bargain for higher wages is through frequent job moves. For firms, markets (at least consumer-facing ones) that are largely competitive penalise efforts to recover profit margins. In both cases, the data would suggest that these effects are fading. In our view, while a real loss remains for both firms and households, the relative cost of continuing to contest this distribution is an important reason why these effects should organically fade over time (Guerreiro et al., 2024). These circumstances are very different from those of the 1970s (Brittan, 1979).

We see three conditions that need to hold for a period of conflictual inflation to come to an end:

- 1 The real economic loss associated with the persistent element of the shock needs to have been fully absorbed into incomes.
- 2 Firms and households must expect that the distribution of the shock will continue – i.e. their forward wage and inflation expectations must be stable at target-consistent levels.
- 3 There must be no obvious plans for continuing to contest the distribution or making up lost ground.

All three of these conditions are increasingly being fulfilled.

Figure 1.29. ‘Loss absorption’ of UK terms-of-trade shocks



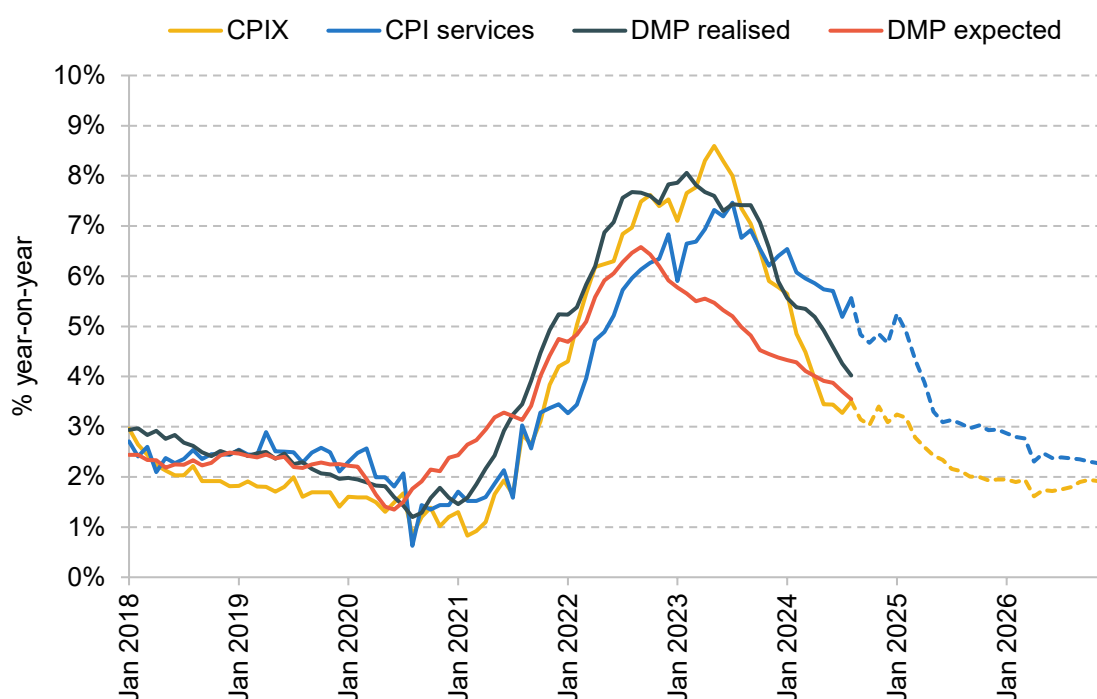
Note: The dark grey bars (domestic absorption) show post-tax income of the private sector, de-trended for labour force and productivity growth. The gold bars (trade-driven income loss) show the change in the relative cost of imports, multiplied by the import intensity.

Source: ONS, Citi analysis.

First, Figure 1.29 shows the real income losses associated with a change in import prices (the trade-driven income loss) and changes in the post-tax incomes of the private sector, detrended for productivity and labour force growth (the degree of ‘domestic absorption’ of that loss). These series must at least align for the process of ‘loss allocation’ to be complete. In the 1970s, this was never achieved, driving accelerating inflation. In every major shock since, such a process has been completed, and current experience more closely resembles these later episodes.

Second, the forward-looking wage and price expectations of both households and firms seem increasingly well-anchored. Our own survey suggests household inflation expectations have fallen back to pre-pandemic levels in recent months (Nabarro, 2024). Firms’ price expectations also seem to be normalising quickly, as shown in Figure 1.30. Other survey data for the services sector, including PMI output prices, are also continuing to trend down.

Figure 1.30. Firm price expectations, and CPIX and services CPI inflation



Note: CPIX denotes CPI excluding energy and are dashed when forecast. DMP realised and expected refer to firms’ own prices.

Source: ONS, Bank of England DMP, Citi analysis.

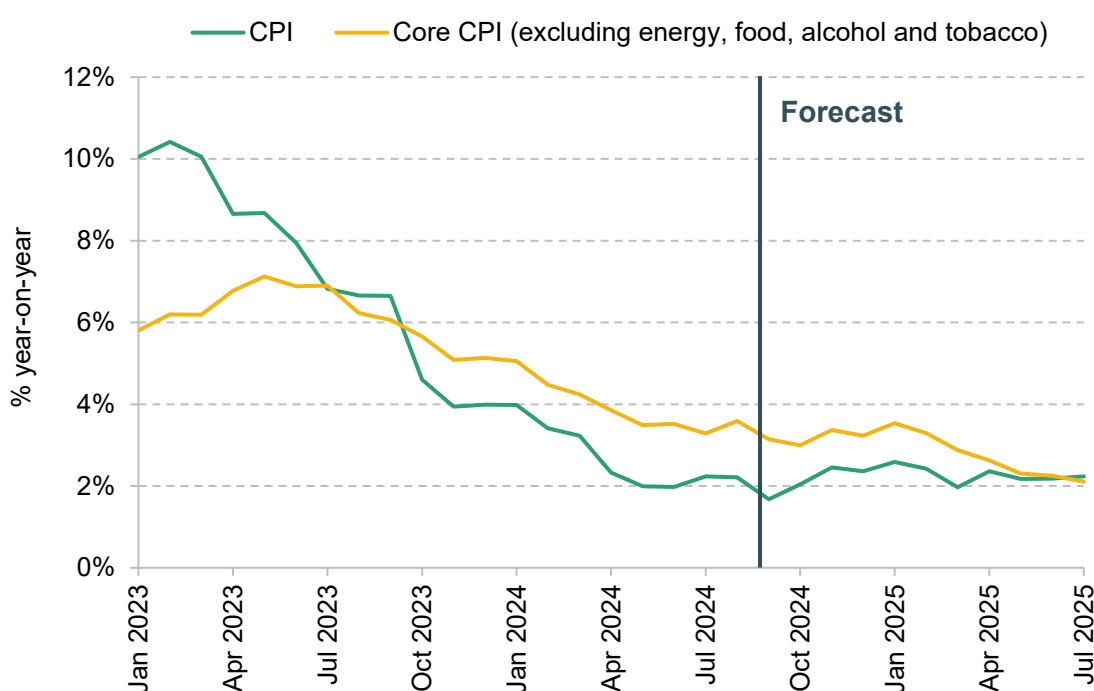
Third, there are few obvious signs that either firms or workers are agitating to shift the allocation of losses, at least in the private sector. The Decision Maker Panel data show a modest improvement in expected firm margins in the year ahead, but ones that are not demonstrably inconsistent with the 2% inflation target being met. And wage expectations – at least in the Bank

of England's latest Agents survey – are expected to be around 2–4% next year.²¹ Strike action, at least in the private sector, has also fallen back to more normal levels, having peaked at the end of 2022.

The outlook for inflation

In our view, this is all consistent with a gradual return of inflation to target. There is early evidence of this, with three-month-by-three-month underlying services inflation now at 4.2%.²² We expect this to fall further in the months ahead, with annual services inflation falling to 4.7% by year-end – materially below the MPC's latest published forecast of 5.3%.

Figure 1.31. Annual CPI inflation, UK



Source: ONS, Citi analysis.

Looking forward, we expect headline inflation to average 2.2% next year and 1.6% into 2026. This reflects the fading of domestic inflation discussed above, as well as:

- Relatively stable household energy inflation. Prices are set to increase into the turn of the year, but current futures suggest these effects should be reversed through the remainder of 2025, leaving overall household energy bills unchanged. Oil prices provide a small disinflationary impulse.

²¹ <https://www.bankofengland.co.uk/agents-summary/2024/2024-q3>.

²² As defined by the MPC in Bank of England (2024a).

- Core goods prices will remain relatively subdued. In part, this reflects weak global demand, as well as the effect of a stronger currency. The latter, all else equal, suggests a 0.3ppt downward effect on headline CPI through to the middle of next year.
- Food prices that will also remain relatively subdued. The currency should exert a downward pressure, and many of the upstream pressures are continuing to ease as lower energy prices feed through.

We think the UK is currently on course to undershoot its inflation target through 2026, particularly as the labour market becomes looser. We expect wage growth to ease to around 3.7% in Q2 next year, and then to around 2.5% through 2026. Headline CPI inflation, we think, will range from 1.5% to 2.0% through 2026.

The outlook for the Bank of England

We think this inflation outlook – alongside the widening slack in the labour market we noted in Section 1.4 – suggests there will be further reductions in Bank Rate in the months ahead. We think such cuts will proceed gradually at first, before accelerating through the first half of next year. We expect Bank Rate to ultimately be cut into modestly accommodative territory, before gradually settling in a 2.5–3.0% range.

The rate-hiking cycle since 2021 has effectively been motivated by two sets of economic factors.

- First, the sequence of adverse supply shocks rendered some kind of policy-driven demand destruction necessary. As these shocks have hit, they have had not just an additive but a multiplicative adverse impact on the supply side of the economy. That has made it difficult for demand to slow organically at the same rate. Fiscal policy has then pushed further in the opposite direction. In a shorter-run sense, that meant some margin of monetary demand destruction was required in order to keep supply and demand in balance amidst uncertainty about how persistent those cost shocks were likely to be.
- Second, with a tight labour market and a large increase in consumer prices, monetary policy has felt it increasingly necessary to lean against the risk of a shift in inflationary regime. High inflation has increased the risk of inflation expectations becoming de-anchored. Policy has felt it increasingly appropriate to lean against the associated scenario, given its possible costs. Here the key factors are high uncertainty and an asymmetry in the costs associated with reversing different policy mistakes. If inflation had become de-anchored, then policy would have faced a materially higher ‘sacrifice ratio’ between inflation and unemployment to reaffirm control.

In recent months, both sets of risks have ebbed. And the MPC chose to cut rates for the first time in four years in August. Nonetheless the tone from the committee has been decidedly cautious – noting the need to keep policy restrictive. And the MPC’s framework still reaffirms the potential

for more persistent inflation. Here the MPC has increasingly been communicating around three ‘scenarios’, including a symmetric fading of inflationary challenges, some residual stickiness (the modal case) and a structural break, implying more persistent inflation.²³ The third scenario is attributed either to an increase in the ‘NAIRU’²⁴ or to less restrictive policy. In this case, a rapid series of cuts would indeed be costly.

In our view, the continued degree of ‘inflation aversion’ reflected in this approach is becoming inappropriate. This is for two reasons.

First, on the inflation side, the risk of de-anchoring from this starting point increasingly depends on a combination of a higher NAIRU and a higher R^* ²⁵ - i.e. inflation must be more persistent for a given degree of labour market tightness, and rates less restrictive than thought. We find that combination increasingly difficult to square with data that generally show inflation to be fading in a conventional manner. It is possible R^* has shifted higher, for example, but then this would not obviously be consistent with the extent of disinflation evident in the data. This particularly costly scenario therefore strikes us as increasingly unlikely.

Second, absent this risk, it is not obvious that the costs of ‘doing too much’ from a policy perspective are now greater than the costs of doing too little. While more aggressive cuts may mean stronger inflation 18 months forward, the associated risk of de-anchoring no longer seems costlier than, for example, an unexpected increase in unemployment. This is the implication of the economy that begins with supply and demand in better balance. A disproportionate focus on inflation alone increasingly makes little sense.

With inflation converging on target and the output gap in balance, we think the MPC should already be making a dash for neutral. Given the committee’s caution, we expect it to cut only at a quarterly pace into the first half of next year, before stepping up the pace from May. This excess of inflationary caution now is likely to imply a larger cutting cycle – ultimately into accommodative territory – through 2026.

An over-reliance on monetary activism is likely to cost the UK here, as it did during the financial crisis. In this case, timing is the main issue – monetary policy can only offer effective countercyclical insurance somewhat belatedly, worsening the trade-off in terms of the risks of a shift in the inflationary regime. But there are also more inherent challenges around the kind of trade-offs monetary policy can achieve in the face of such a sector-specific cost shock. These

²³ <https://www.bankofengland.co.uk/monetary-policy-summary-and-minutes/2024/september-2024>.

²⁴ The non-accelerating inflation rate of unemployment.

²⁵ The real interest rate that is neither expansionary nor contractionary when the economy is at full employment.

reflect a Phillips curve²⁶ that remains quite flat in the UK,²⁷ and margins that – unusually – appear to us to be countercyclical on a monetary policy shock.²⁸ If the aim in the event of conflictual inflation is to realign price and wage setting with a target-consistent wage Phillips curve, monetary policy is increasingly poorly placed to drive these adjustments (Van Der Ploeg and Willems, 2023). This bolsters the arguments we have made in previous editions of the Green Budget for a reappraisal of countercyclical burden sharing in the years ahead (Nabarro, 2022b and 2023).

1.6 Conclusion

The economic outlook we have outlined here combines cyclical softness with medium-term buoyancy and structural vulnerability.

The balance of risks in the UK – as elsewhere – is changing quickly. The last vestiges of ‘conflictual inflation’ seem to be fading, just as monetary policy transmission is dialling up. Having provided fiscal stimulus in response to an adverse supply shock, the UK now faces a period of coordinated monetary and fiscal retightening. This comes at a time when the output gap is effectively already closed. With supply recovering, this risks an unnecessary period of excess capacity. Some warned of this timing mismatch through the early stages of the hiking cycle. With the inflationary risk broadly contained and supply challenges fading, we think some of these warnings are beginning to come to fruition. While the MPC is beginning to shift its position, the committee is probably already somewhat ‘behind the curve’. We expect a modest increase in unemployment next year, and consecutive rate cuts into accommodative territory (below 2.5–2.75%) to follow.

Notwithstanding this cyclical softness, the underlying supply outlook for the UK is improving, and indeed doing so quite quickly. After years where productivity growth has averaged effectively zero, we see scope for catchup. In the near term, a subdued demand outlook will, in the first instance, feed into slack. But that should then enable a robust acceleration as we move into the middle of the parliament as an improving supply picture is realised. The emergence of near-term slack does add to the risk that this potential is only partially utilised, with unemployment instead risking further scarring in the years ahead. For monetary policy in particular, this again speaks to the need to take a balanced view of the risks. But it also suggests

²⁶ The Phillips curve represents the relationship between the rate of inflation and the unemployment rate.

²⁷ Notably, in contrast to the US, we have not seen evidence of a non-linearity in the Phillips curve even as the labour market reached very tight levels. We suspect that may be something to do with the transient nature of the tightness, and the associated end of the furlough scheme – see Nabarro (2024).

²⁸ Here the analysis is undertaken using a proxy-SVAR looking at the response of the labour share to monetary policy surprises. Our analysis finds the labour share falls in the event of a tightening monetary policy surprise – see Nabarro (2024).

there will be a notable window of underlying political and economic opportunity as, cyclically, things become somewhat stronger.

It is vital this space is used wisely. After two decades of effective growth ‘failure’, the UK has accrued an enormous negative ‘public equity’ position – a widening gap between what the British economy can affordably sustain, and the promises upon which firms and households are currently making economic decisions. Previously, this could have been ameliorated by lower and lower rates, although that adjustment has increasingly ebbed. With more supply disruption likely, this gap risks getting worse.

The specific challenge the UK faces is the combination of this poor underlying position with an inelastic external financing requirement. This carries acute risks. The UK faces an urgent need to raise trend growth, but probably already faces tight constraints on doing so. Sweeping public investment interventions such as the Inflation Reduction Act in the US, or even the European public investment plan mooted by Mario Draghi, would not be viable here – at least not on a purely debt-funded basis. The UK will need to be smarter. This, we think, makes it especially important that policy utilises cyclical upswings to its advantage. The middle of this parliament will present a window of opportunity that cannot be missed.

Finally, and more optimistically, we think the UK can lift trend growth over time, despite the constraints. This requires three important things:

- There needs to be a reduction in the rate of policy mistakes. The UK has made some striking, self-imposed macroeconomic policy errors since the financial crisis. Given the weakness of the starting point, these are errors that the UK cannot afford to repeat.
- The UK will need to change its playbook in the face of supply shocks. In part, this reflects the acute external financial vulnerability noted above and the risks subsequently posed by concurrent fiscal expansion and higher policy rates. It also reflects the crude economic cost of crushing investment just as the economy most requires reallocation. While supply growth is now picking up, it does so from a baseline that is more than 6% short of its pre-pandemic trajectory. We do not see that being made up anytime soon.
- The UK will need to develop a cogent strategy for boosting underlying growth. Even if the UK did have space for widespread capital investment, the changes that matter most here involve supporting reallocation, driving intangible investment, and pushing through effective retraining. This requires more than simply spending money.

We think concrete progress can be made in all three areas over the next five years, but this will be a protracted effort. Given the growing supply risks, and associated volatility, the UK economy is currently on unstable ground. The longer these efforts are delayed, the sharper will be the trade-offs that are ultimately required to restore stability.

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2. The outlook for the public finances in the new parliament

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Key findings

1. The new Chancellor, Rachel Reeves, has inherited an **unenviable public finance situation**. Taxes are at a historic high by UK standards and yet debt is high, rising and only barely forecast to decline in five years' time, while many public services are showing obvious signs of strain.
2. This is due to an unwelcome combination of factors that were largely apparent prior to the election. In the March 2024 Budget, annual **debt interest spending was forecast to be around 1.4% of national income (£39 billion in today's terms) higher** over the next few years than the period running up to the pandemic. At the same time, annual **spending on state pensions and social security benefits was forecast to run 1.1% of national income (£32 billion in today's terms) higher** than in 2019–20. The increase in spending on benefits to support those with disabilities and health-related conditions was particularly big – and worrying. Meanwhile, spending on the NHS continues to rise and, for the first time in many decades, the defence budget seems more likely to be increased than cut.
3. There is likely scope for additional, well-directed, growth-enhancing public sector investment. There is widespread speculation that Ms Reeves will redefine the scope of her debt rule to allow more borrowing to fund this additional investment. Many options are available, with principled arguments for and against each. Of course, redefining targets does not change the fiscal reality and, whatever the headline target, **public sector net debt cannot be allowed to rise indefinitely**.

4. **The specific measure chosen matters less than making a coherent case for why the government should be borrowing to pay for more investment**, rather than prioritising investment within a framework that has debt falling (as Ms Reeves declared was her intention before the general election). Perhaps most importantly, the government should then focus on ensuring that the increased investment budget is – and is seen to be – spent effectively.
5. While choosing an easier-to-meet target for the public sector balance sheet would allow Ms Reeves to finance additional investment spending with higher borrowing, **she would still find herself constrained by her commendable commitment to aim to meet all day-to-day spending out of revenues, i.e. to aim for current budget balance over the medium term.**
6. Under Citi's baseline economic scenario and assuming most pressures identified at July's spending audit prove transitory, and after accounting for specific tax and spending measures in Labour's manifesto, **the forecast current budget surplus in 2028–29 could be £17 billion, or 0.5% of national income.** But these restrictive assumptions on spending would still leave spending on some public services falling – even though they already include a £14 billion top-up to plans from the March Budget to fund public sector pay deals and deliver specific manifesto commitments.
7. This would leave the Chancellor with little room for manoeuvre, but the uncertainty around this is illustrated by what happens under different assumptions about the economy. **Under Citi's optimistic scenario, that £17 billion surplus turns into a £40 billion surplus. Under Citi's pessimistic scenario, it turns into a deficit of £16 billion.** All of these incorporate the same, restrictive assumptions on public spending and include tax rises of £9 billion from the manifesto.
8. **If the government wishes to avoid real-terms cuts to day-to-day budgets for all public services, an additional top-up of £16 billion in 2028–29 would be required (on top of the £14 billion to pay for public sector pay deals and specific manifesto commitments).** In the economic environment of Citi's baseline scenario, this would wholly consume the current budget surplus, and leave debt on a rising path – with or without a top-up to investment budgets to allow them to escape cuts as well.
9. But this 'stand-still' solution may well prove incompatible with ambitious targets for service performance. **Ensuring all departments see their day-to-day budgets rise at least in line with national income would require a further top-up of £17 billion (i.e. a total top-up of £47 billion relative to March spending plans, or £14 billion plus £16 billion plus £17 billion).** Combining this with a **fresh £16 billion (0.5% of**

national income) tax rise would restore the forecast current budget to balance in 2028–29. This would, of course, need to come **on top of the £9 billion of specific tax rises set out in Labour’s manifesto**, so would be a tax rise of around £25 billion in total. A net tax rise of this scale would be bigger than in the July 1997 (£14 billion) and October 2010 (£13 billion) Budgets, both of which took place early in the parliament of a new government.

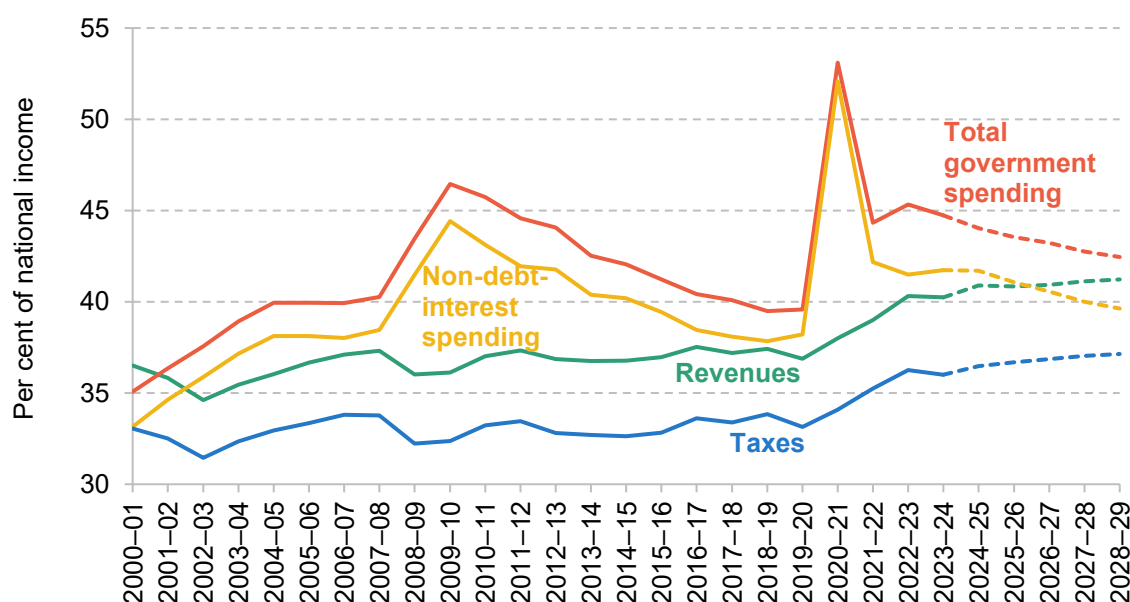
10. **A longer-term focus beyond the five-year forecast horizon might promote better policymaking.** By the end of the parliament, the target year of the fiscal rules will have moved forwards to 2033–34. Based on projections from the Office for Budget Responsibility (OBR), the current budget could by then be in deficit by 1.6%, reflecting spending pressures on areas such as healthcare, and the predictable disappearance of tax bases for fuel duties (as electric vehicles become increasingly common) and tobacco duties. In other words, **further tax rises or spending cuts could be required before the end of the parliament to meet the government’s current budget rule and address known, long-term fiscal pressures.**
11. **Well-designed policies can promote higher economic growth, and more growth would ease some of the sharpest fiscal trade-offs we face.** A ‘Budget for investment’ could undoubtedly find some opportunities for productivity-enhancing projects in the UK. But not all investment is growth-enhancing, and the OBR’s model suggests **the growth-promoting effect of the average public investment project is neither huge nor swift to materialise.** It estimates that a sustained boost to public sector investment of 1% of national income would add less than 0.08% to the sustainable annual growth rate over the next five years and less than 0.05% over the next fifty. As a result, the average public investment project would take a long time to be self-financing.
12. **Policymakers have often chosen to prioritise other objectives over growth** – for example, accepting barriers to trade in return for more regulatory sovereignty when it comes to the EU single market and customs union. The new government’s manifesto commitments on industrial strategy suggest it will balance a whole host of objectives alongside growth, including lower-carbon production processes, reduced geographical inequality, and improved resilience in crises. **These are all entirely valid objectives, but government should acknowledge the very real trade-offs involved.**

2.1 The fiscal inheritance

At the start of a new parliament, we find ourselves with elevated public spending, debt only just forecast to stabilise over the five-year forecast horizon, taxes at historic highs and yet the public realm seems to be creaking. To understand why the new government finds itself with such an unenviable fiscal inheritance, it is instructive to trace out briefly how these trends arose, and some of the drivers behind them.

Despite falling from its peak during the COVID-19 pandemic, total public spending – a measure of the size of the state, shown in Figure 2.1 – remained elevated at 44.7% of national income in 2023–24. This is substantially higher than in 2019–20 on the eve of the pandemic and after a decade of austerity (39.6%) and in 2007–08 on the eve of the global financial crisis (40.3%). At the March 2024 Budget, the previous government was planning to cut the size of the state through a combination of planned real-terms cuts to the day-to-day budgets of unprotected departments and a cash-terms freeze in net investment spending that would see it falling as a share of national income. However, total government spending in 2028–29 was still forecast to be almost 3% higher as a share of national income than before the global financial crisis or before the COVID-19 pandemic.

Figure 2.1. Spending, non-debt-interest spending, revenues and taxes: out-turn and March 2024 forecast

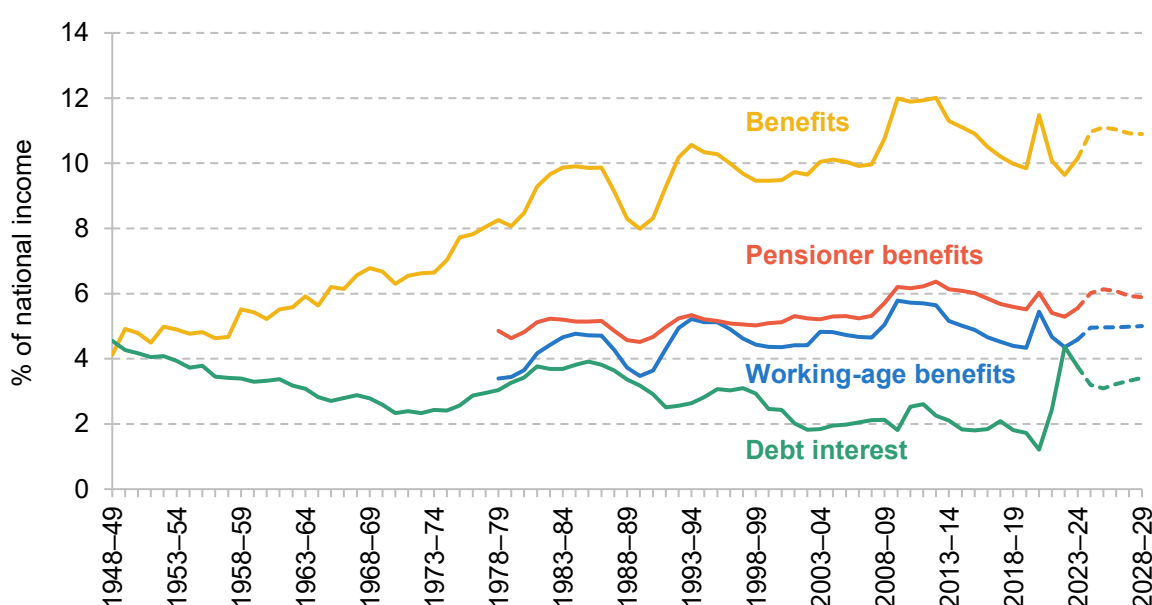


Note: 'Taxes' refers to the National Accounts definition and includes National Insurance contributions and other compulsory payments to the government that do not directly correspond to a service.

Source: Office for Budget Responsibility, public finances databank (July 2024), <https://obr.uk/data/>.

One major factor behind this increase in government spending is higher spending on debt interest. Over the first 20 years of this century, we were spending on average just 2% of national income on debt interest, even as the stock of debt increased massively. That changed in 2022–23 when debt interest spending spiked to levels last seen just after the end of the Second World War, in part reflecting high inflation pushing up debt servicing costs for the approximately one-quarter of UK government debt linked to growth in the Retail Prices Index. Even after this spike had passed, debt interest spending was forecast to remain above 3% of national income at least through to 2028–29, as shown in Figure 2.2.

Figure 2.2. Public spending on benefits (split into working-age and pensioner from 1978–79) and debt interest, as a share of national income



Source: Office for Budget Responsibility, public finances databank (July 2024), <https://obr.uk/data/>; Department for Work and Pensions, benefit expenditure and caseload tables 2024 (May 2024), <https://www.gov.uk/government/publications/benefit-expenditure-and-caseload-tables-2024>.

But even if we set aside the rising costs of servicing debt, non-debt-interest spending was forecast to be 3.5% of national income higher in 2024–25 than on the eve of the pandemic or on the eve of the global financial crisis (as shown in Figure 2.1). Figure 2.2 also shows the level of public spending on social security benefits and state pensions (split, where possible, into payments to working-age households and payments to pensioner households) over time. As a share of national income, a very sharp increase in benefit spending in the late 2000s was reversed over the 2010s. Over this period, there were substantial reductions to the generosity of the working-age benefits system through several years of below-inflation uprating of many benefits and thresholds and through specific reforms, such as reductions in the amount of support some families could receive for their rents and the gradual roll-out of the two-child limit and the removal of the family element (see Chapter 6). In total, reforms implemented between 2010 and 2019 reduced the annual generosity of the benefit system by £987 per household, or

£28 billion (in 2024 prices).¹ Since the eve of the pandemic, this fall has reversed and the share of national income spent on social security benefits and state pensions has increased by more than 1% and is now running at around 11.0% of national income, compared with 9.9% of national income in 2019–20.

In addition, spending on the NHS continues to grow and is now around 1% of national income above the level in 2018–19. Unlike in the two decades following the end of the Cold War, spending on defence has gone up somewhat as well in recent years. Pressure to spend more on the NHS and defence does not seem likely to go away any time soon. However, the previous government was planning to cut total spending further and reduce the increase relative to 2018–19 to around 1% of national income by 2028–29 – despite ongoing pressures from spending on debt interest and benefits. Delivering these cuts through cuts to unprotected departments – while keeping to stated commitments such as the NHS workforce plan and international agreements in areas such as defence and overseas aid – could prove extremely challenging, given that many services already seem to range from creaking to full-blown crisis (Institute for Government, 2024).

Taxes also rose sharply over the previous parliament to help meet the growing financing demands of higher public spending, as shown in Figure 2.1. The total tax take stood at 36% of national income in the year ending in March, which is 3% of national income higher than the level in 2019–20. Despite a series of high-profile tax cuts implemented by the previous Chancellor, Jeremy Hunt, tax revenues were forecast to continue increasing further through to 2028–29. More broadly, while the UK’s appetite for public spending has increased substantially over the course of the 21st century and is now in line with the average of other advanced economies, so far this has not been fully matched by a willingness to meet other countries’ average tax take. As a result, public debt has increased by over 60% of national income since the turn of the century – the second-highest increase among 37 comparator advanced economies (Emmerson, Mikloš and Stockton, 2024a).

Going forward, public sector net debt is only forecast to stabilise by 2028–29, rather than to be on a decisively downward path (see Figure 2.3 later). This is despite Mr Hunt’s plans for borrowing to fall (as shown by the narrowing of the gap between total spending and total revenues in Figure 2.1, and shown directly in Figure 2.4). A combination of low forecast economic growth and high interest rates means much tighter fiscal policy is required to get debt falling. Since these forecasts, the new Chancellor’s ‘spending audit’ has quantified additional spending pressures, including higher public sector pay awards and (yet again) much-higher-than-budgeted spending by the Home Office (Warner and Zaranko, 2024). The fiscal situation already

¹ <https://ifs.org.uk/calculators/what-has-been-distributional-impact-tax-and-benefit-reforms-2010>.

looked challenging at the time of the March 2024 Budget, but additional spending pressures have, if anything, added to the difficulties.

In the following sections, we set out some of those challenges, and Ms Reeves's options for addressing them, in more detail. Section 2.2 describes what we know about her fiscal rules, how they compare with Mr Hunt's, and what changes she might consider. Section 2.3 sets out some of the risks and pressures on different areas of spending and tax. Section 2.4 then analyses the impact that each of Citi's three economic scenarios (set out in Chapter 1) might have on the public finances and characterises some of the options that might plausibly be available to Ms Reeves in her first Budget. Section 2.5 considers a longer-term horizon, with a particular focus on growth-enhancing policies and how they might ease some of the most difficult fiscal trade-offs. Section 2.6 concludes with some recommendations for the new Chancellor.

2.2 The Chancellor's new fiscal rules

The Labour manifesto commits the new government to two 'non-negotiable' fiscal rules, which have since been reaffirmed in Ms Reeves's speech alongside her spending audit:

- to get debt falling as a share of national income by year 5 of the forecast (the debt rule); and
- to bring the current budget into balance (the borrowing rule).

The debt rule looks similar to the 'fiscal mandate' that the previous government was committed to – indeed, at first glance it looks identical. However, the government has so far declined to confirm technical details, and they could make a considerable difference to the ease with which the rule might be met. Most of the content of the next subsection has been pre-released as a standalone piece (Emmerson et al., 2024).

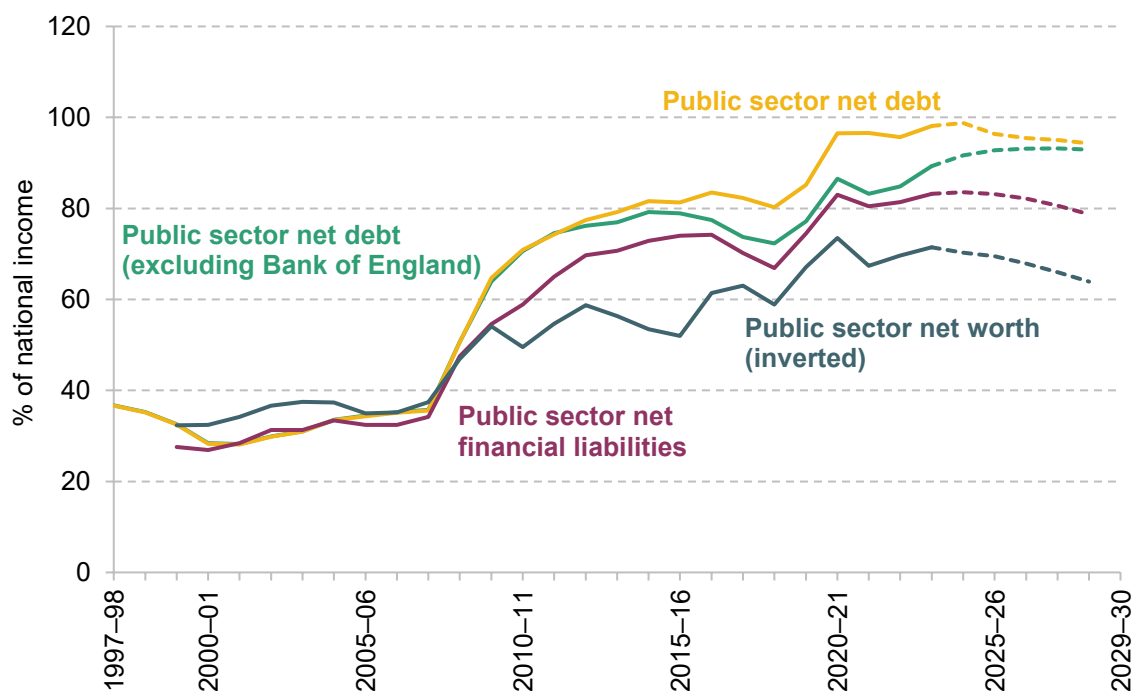
Targeting a different measure of debt

One possible such technical change – and one that has received a lot of attention recently – would be to target a different measure of debt. In practice, this could mean a number of different things. The previous government's fiscal rule targeted public sector net debt excluding the contribution of the Bank of England's balance sheet (PSND ex BoE, often called 'underlying debt'). The largest component of this contribution that is excluded from the measure is loans made by the Bank to large companies under the Term Funding Scheme.

Previous governments have targeted 'headline' public sector net debt (PSND; see Stockton and Zaranko (2024) for a detailed explanation of the difference between PSND and PSND ex BoE). Alternatively, the government could decide to strip out further components from the measure of debt used in its fiscal rule. Examples of debt the government may want to exclude from

consideration include any debt taken on by publicly owned or underwritten banks such as the new ‘National Wealth Fund’, or any valuation losses associated with the Bank of England’s quantitative easing programme.

Figure 2.3. Different measures of the public sector balance sheet: out-turn and March 2024 forecast



Source: Office for Budget Responsibility, public finances databank (July 2024), <https://obr.uk/data/>.

Or, if the government is keen to recognise better the benefits of investment as well as the costs – as Ms Reeves indicated in her recent Labour Party conference speech² – it could target a broader measure of the government balance sheet. One option would be to target public sector net financial liabilities (PSNFL). Another would be to target public sector net worth (PSNW). PSNW nets off the value of liquid financial assets (those that can readily be converted into cash, such as foreign exchange reserves) from the value of the national debt (defined as the public sector’s loan liabilities, debt securities, currency and deposit holdings). PSNFL provides a slightly broader picture, by also netting off illiquid financial assets (such as the student loan book, and the assets held by funded public sector pension schemes, which are less easy to convert into cash) and a broader range of financial liabilities (such as the liabilities associated with funded pension schemes). PSNW provides a broader picture still, by also netting off the estimated value of non-financial assets (such as buildings, roads and other transport infrastructure). The evolution of these three different measures of the balance sheet, along with the March 2024 forecasts from the Office for Budget Responsibility (OBR), are shown in Figure 2.3.

² <https://labour.org.uk/updates/press-releases/rachel-reeves-speech-at-labour-party-conference-2024/>.

There is a debate to be had about the merits of targeting each of these measures (we consider some of the most important ones below). Notably, a commitment to have regard for all of them is already legislated – although it tends to garner far less attention than the main fiscal rules.

But the government will presumably also have (at least) one eye on the impact that adopting each of these measures for the main fiscal rule might have on the government's ability to borrow to invest. To that end, Table 2.1 shows how the government would have been performing against a range of fiscal rules in March 2024 (had it replaced PSND ex BoE with an alternative measure without making any other changes to the structure of the rule). A switch to headline PSND would have added around £16 billion of so-called 'headroom' in March 2024; a switch to PSNFL would have added £53 billion; and a switch to PSNW would have added £58 billion.

Table 2.1. Performance against various fiscal rules, as of March 2024 Budget

Fiscal rule	Margin ('headroom') against rule in March 2024 Budget	Difference in 'headroom' relative to previous debt target
PSND ex BoE falling as a share of GDP in year 5 of the forecast (2028–29)	0.3% of GDP (£8.9 billion)	-
PSND falling as a share of GDP in year 5 of the forecast (2028–29)	0.8% of GDP (£24.9 billion)	+0.5% of GDP (+£16.0 billion)
PSNFL falling as a share of GDP in year 5 of the forecast (2028–29)	1.9% of GDP (£62.0 billion)	+1.6% of GDP (+£53.0 billion)
PSNW rising as a share of GDP in year 5 of the forecast (2028–29)	2.0% of GDP (£66.8 billion)	+1.8% of GDP (+£57.8 billion)
<i>Memo: current budget balance in year 5 of the forecast (2028–29)</i>	<i>0.4% of GDP (£13.6 billion)</i>	<i>+0.1% of GDP (+£4.7 billion)</i>

Note: Figures may not sum due to rounding.

Source: OBR public finances databank (September 2024), <https://obr.uk/data>.

There are three things to note. First, any increase in 'headroom' against these targets would not allow for a large increase in borrowing to fund tax cuts or day-to-day spending, because the government would still be bound by its promise to bring the current budget into balance (a target against which the government would have had just £14 billion of 'headroom' in March 2024). Second, just as a target that requires PSND ex BoE to be falling between year 4 and year 5 of the forecast suffers from major design flaws (flaws which have been extensively discussed elsewhere³), so too would a target for PSNFL to be falling, or PSNW to be rising, between year

³ Emmerson, Mikloš and Stockton, 2023; Emmerson, Mikloš and Stockton, 2024b; Johnson, 2024.

4 and year 5. Third, just because a change to targeting PSNFL or PSNW might add as much as £50 billion to the government's measured 'headroom', this does not mean that the government should increase borrowing by anything like that amount. Indeed, always aiming to have a stock measure (such as debt) falling by the finest possible margin (to 'max out' any 'headroom') breeds an environment where policy flip-flops in response to highly uncertain changes in the forecast.

Relatedly, there is no reason to think that the relative magnitude of the fall in these different measures of debt would look similar in future forecasts. Just because it is easier to meet a PSNFL target today does not mean that will always be the case. There is a danger in choosing a fiscal target opportunistically because it gives the desired answer on 'headroom' at a particular moment in time. There are costs to frequently changing the fiscal rules, and the new government should use this opportunity to choose a fiscal target it is willing and able to stick to in the longer term.

Reducing the impact of Bank of England operations on the targeted measure

The government may wish to switch to headline debt as the target measure and hence reverse a change made only in 2021. IFS researchers welcomed this change at the time and described debt excluding the Bank of England as a 'better measure' (Emmerson, 2021). The change was justified in the 2021 Budget document by saying 'the government has chosen to focus on PSND ex BoE because excluding the Bank of England's contributions to public sector net debt through valuations effects associated with its quantitative easing programme and term funding schemes better reflects the impact of government decisions' and citing the 2021 IFS Green Budget, in which we said that 'it is often appropriate to focus on debt excluding the Bank of England when evaluating the fiscal situation' (HM Treasury, 2021; Emmerson and Stockton, 2021b).

The key reason for a switch to 'headline' debt as a target (beyond the simple one that it might allow the government to borrow a bit more) would be to reduce the impact of Bank of England operations on performance against the fiscal rule for the next few years. The Bank of England is making losses on its quantitative easing programme, and is therefore making claims on the indemnity provided by the Treasury which underwrites those losses. The recognition of these losses is expected to push up PSND ex BoE over the coming years (including in year 5 of the forecast, the only one relevant for the fiscal rule) but to have a much smaller impact on headline PSND in those years (because a bigger chunk of these losses have already been recognised in PSND in the past – see Stockton and Zaranko (2024) for more detail on the specifics). In other words, targeting PSND ex BoE does not actually succeed in taking losses from quantitative easing out of the equation altogether – as the 2021 Budget document quoted above, and indeed the term 'excluding the Bank of England', suggest. Instead, it means the losses are included at a different point in time.

The principled argument for a switch to PSND (or stripping out the impact of Bank of England operations in some other way) rests on the argument that the interaction between these losses and the current debt rule is leading to overly tight fiscal policy. This is where the poor design of the existing debt rule is important. It targets only the change in debt between two years (years 4 and 5 of the rolling forecast period). Losses from the indemnity are lumpy, and if losses are particularly concentrated in the fifth year of the forecast (due to the timing of Bank of England asset sales under quantitative tightening – or more precisely, and even more ridiculously, what the OBR judges the timing of the Bank of England’s asset sales under quantitative tightening might be⁴), then this would lead to a temporary overstatement of the need for a fiscal tightening. In that case, targeting PSND (or stripping out Bank operations in some other way) might be judged an improvement.

But it is hard to argue that the size or profile of lending under the Term Funding Scheme, which the Chancellor has no control over and which carries little risk of default, should be used to determine constraints on borrowing.

As well as the Bank of England, the government could choose to exclude other parts of the public sector from its fiscal rule. In particular, publicly owned or underwritten banks (including the new National Wealth Fund) are included in the public sector for accounting and statistical purposes, and so their debt counts towards the total. The idea behind the National Wealth Fund is that, with its initial capital injection of £7.3 billion, it will seek to take on more debt (leverage its balance sheet) and undertake speculative investments on government priorities such as the net zero transition – much like any other bank, though with different objectives. But if these public investment banks are constrained by the government’s overall debt target, they may be limited in their ability to take on more debt. Of course, we would not want these banks to become over-leveraged, or to take on too many risks. The question here is whether they are better constrained through other means (such as banking regulation). Other countries – such as Germany – exclude debt taken on by publicly owned or underwritten development banks from their fiscal targets; see King and Jameson (2024) for the argument that the UK should do the same.

Instead of starting from PSND (whether ‘headline’ or ‘underlying’) and excluding some aspects, one might take a different approach and target a broader measure than PSND. We turn now to consider two options.

⁴ <https://www.ft.com/content/a3035162-ebfb-40ce-993c-flad3d7ee46c>.

Target public sector net worth (PSNW)?

Changing the measure of debt used in the fiscal target might allow the government to do more borrowing for investment, but would not in itself change the degree to which the benefits of that investment are recognised.

One option, therefore, would be to target PSNW rather than PSND. The arguments for and against doing so are discussed in detail by Zaranko (2023). The key attraction of a PSNW target is that, by capturing a more comprehensive range of liabilities and assets, it can provide a more complete picture of the impacts of government action (or inaction). So, if the government were to borrow to invest in transport infrastructure, the additional debt taken on would show up in the government's liabilities, but the value of the assets created (e.g. new roads or railway tunnels) would also be reflected as a non-financial asset within PSNW. It could also give the government greater incentives to invest in higher-quality projects and to manage and maintain its assets better.

There are, however, considerable downsides to a formal, numerical target for PSNW. Interested readers should consult Zaranko (2023), but the key issue is that changes in PSNW might tell us little about the government's ability to access capital markets or service its debt. Non-financial public sector assets – such as the UK road network, school buildings, prisons, and army barracks – are either extremely difficult to sell, extremely difficult to value, or both. The problem with them being difficult to sell is that they are little use in a fiscal crisis if they cannot be sold off to meet financing needs. The problem with them being difficult to value is that a Chancellor might be more tempted to cut taxes or increase spending in the face of a favourable revaluation (say, if a change in statistical methodology led to the conclusion that the best estimate of the monetary value of the road network is higher than previously thought) than to carry out a fiscal tightening in the light of an unfavourable one.

One option to lessen some of these concerns (previously proposed by Tetlow, Bartrum and Pope (2024)) would be to introduce a target defined in terms of *the impact of policy* on PSNW, rather than the level of PSNW itself. That would limit the degree to which changes in PSNW unrelated to policy (such as methodological changes in how the road network is valued) induce a fiscal policy response. The problem is, the recorded value of many assets created by government investment (the 'replacement cost') bears little relevance to the economic or social value of the asset, or to assessments of fiscal sustainability. In other words, in practice, the measured impact of policy on PSNW might bear little relation to its 'benefits'.

These are very good reasons why more traditional measures of debt, debt interest and borrowing will remain important for fiscal policy, and ought to be considered alongside any target for PSNW.

Target public sector net financial liabilities (PSNFL)?

Another option would be to target PSNFL, a less comprehensive measure of the balance sheet than PSNW. The key difference between a target for debt (PSND) and a target for PSNFL is that PSNFL also includes illiquid financial assets (such as the student loan book) and a broader range of financial liabilities (such as the liabilities associated with funded pension schemes – but not the much larger liabilities from pay-as-you-go pension schemes or the state pension). Notably, it does *not* include the kinds of assets that an increase in investment spending is likely to buy – such as energy pylons or hospitals.

Instead, the main theoretical attraction of a PSNFL target is that in capturing a broader range of government assets and liabilities, it provides a more complete picture of the government's financial position, while removing some of the perverse incentives associated with a narrow focus on PSND (such as the incentive to sell off long-term financial assets for less than their market value, since PSND is reduced by the money raised through the sale but is unaffected by the loss of the asset). In other words, a fiscal rule targeting PSNFL would encourage the government to have greater regard for its financial assets as well as its liabilities.

Table 2.1 shows that in March 2024, a target for PSNFL to be falling in year 5 would have provided the government with more than £50 billion of additional 'headroom' relative to the previous government's target for PSND ex BoE. The difference is largely driven by the differential treatment of student loans. Where student loans are not expected to be repaid, this now (sensibly) scores immediately against public sector net borrowing. But PSND still increases by the full amount loaned out – i.e. even including the amount that is expected to be repaid subsequently. The difference is that the portion of student loans that are expected to be repaid in future are added to the illiquid financial assets captured by PSNFL. So, the same liability appears in both, but in PSNFL this is partially offset by an asset. So when the size of the student loan book increases (e.g. due to growing student numbers or an increase in the amount that students can borrow), PSND will increase by more than PSNFL (or, equivalently, PSND will fall by less than PSNFL).

There are, inevitably, some notable downsides to a PSNFL target. One issue is that, as with PSNW, performance against a PSNFL target would not necessarily be informative about the government's ability to access capital markets or service its debts. The financial assets included in PSNFL but not PSND are illiquid (like student loans, assets held by the local government pension scheme, or mortgage books acquired during the financial crisis). In a financing crisis, where the government is seeking to sell off assets, these are likely to be less useful than liquid assets such as foreign currency holdings, but more useful than non-financial assets (such as the prisons estate or aircraft carriers, which cannot realistically be sold). For that reason, the concerns raised above about PSNW are less acute for PSNFL, but remain concerns all the same. A situation where PSND were on a permanently rising path, even if counterbalanced by the

accumulation of financial assets in the public sector (so, if PSNFL were stable or falling), may still be risky.

Another issue is that departments may also face new incentives to design policies that create financial assets (e.g. student loans rather than a graduate tax to finance higher education) purely because of differences in how the accounting treatment affects ease of compliance with a PSNFL target. There are also methodological challenges to estimating PSNFL (Office for Budget Responsibility, 2016 and 2018). Revisions to PSNFL estimates for past years can be large – for example, in September 2023, estimated PSNFL in 2021–22 and 2022–23 fell by £38 billion and £26 billion, respectively, due to methodological improvements and the incorporation of data on public sector funded pensions that become available with a lag. Forecasts for the future may be even more volatile. This means that measured ‘headroom’ against a PSNFL target – especially one for PSNFL to be falling (since it then matters where you start from) – could be even more prone to wild revisions without a material change in the fiscal situation.

But there is a broader point here. No single measure is a perfect indicator of the health of the public finances, and there is no unambiguously ‘right’ answer. There are principled arguments for and against each of these changes. If the Chancellor really wants her fiscal target to reflect the benefits of investment, that might suggest a target for PSNW. But a formal target for PSNW would come with considerable problems, and we would strongly advise against. Switching to a target for PSNFL would come with fewer problems, and would allow much more space for borrowing for investment (perhaps as much as £50 billion more), but would not meaningfully reflect the benefits of that investment. None of these changes would be costless. Frequent changes to targeted measures risk damaging the transparency and credibility of the fiscal rules, especially if those changes seem opportunistic in the sense that they prevent a bigger fiscal tightening from being enforced. This highlights the importance of ‘future-proofing’ the fiscal rules, and not making a decision based on the very specific set of circumstances faced at one particular fiscal event. Whatever formal fiscal rule the Chancellor chooses, the impact of additional borrowing on debt and debt servicing costs cannot be defined out of existence, or disregarded entirely.

If the government believes it is appropriate to borrow more to spend on some policy priority, then it should not hide behind a ‘technical’ change. If it believes more borrowing is the best – or perhaps only – way to get to net zero emissions and that failure to do so would be more costly than a rising debt path, it should make the case for this. If the government is confident that extra borrowing for investment would be sufficiently growth-enhancing to improve long-term fiscal sustainability, it should make that case (to citizens, as well as to gilt market participants). This could be accompanied by a change in the debt rule to give space for that borrowing and signal the logic behind it, but the crucial thing would be to ensure that the investment funded by that

borrowing is – and is widely seen to be – spent well. And regardless of the precise fiscal rules, debt and debt servicing costs cannot be disregarded entirely.

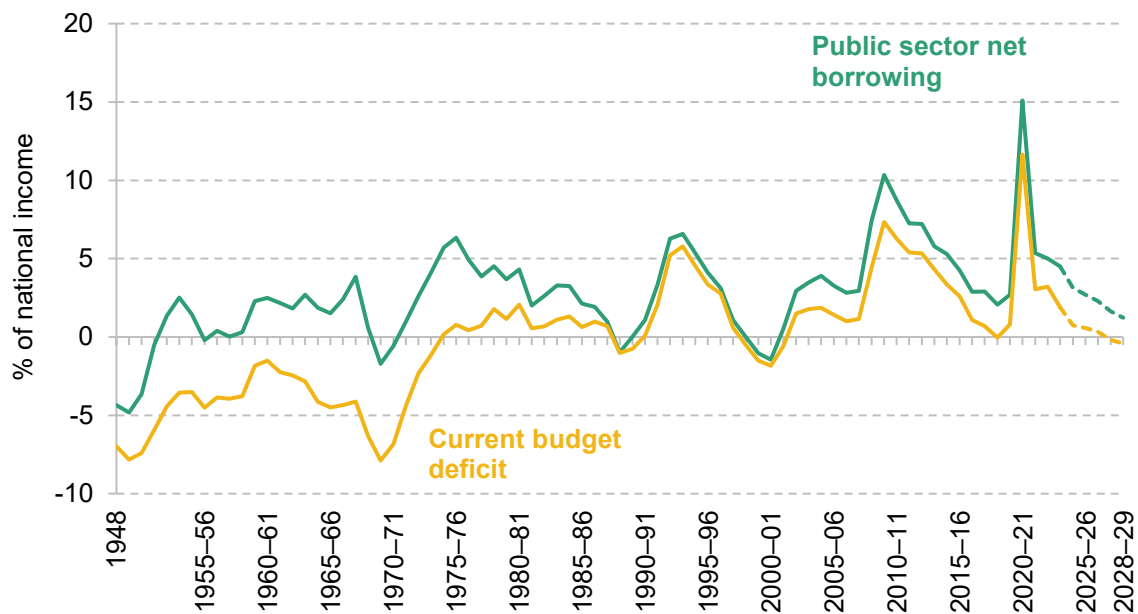
More generally, the government may rightly be concerned that the current debt rule's conclusions about fiscal 'headroom' can swing wildly from one fiscal event to the next even in the absence of significant revisions to economic and fiscal fundamentals. We very much share this concern. But it should then consider the root of this issue: not the measure of debt chosen, but the narrow targeting of the change in debt relative to the change in nominal national income over a 12-month period several years in the future. Put differently, many of the problems identified with the current fiscal framework are downstream of the original mistake – aiming to have debt forecast to fall over the course of one year in five years' time, and by the finest possible margin relative to the inherent uncertainty.

When might the current budget rule start to bind?

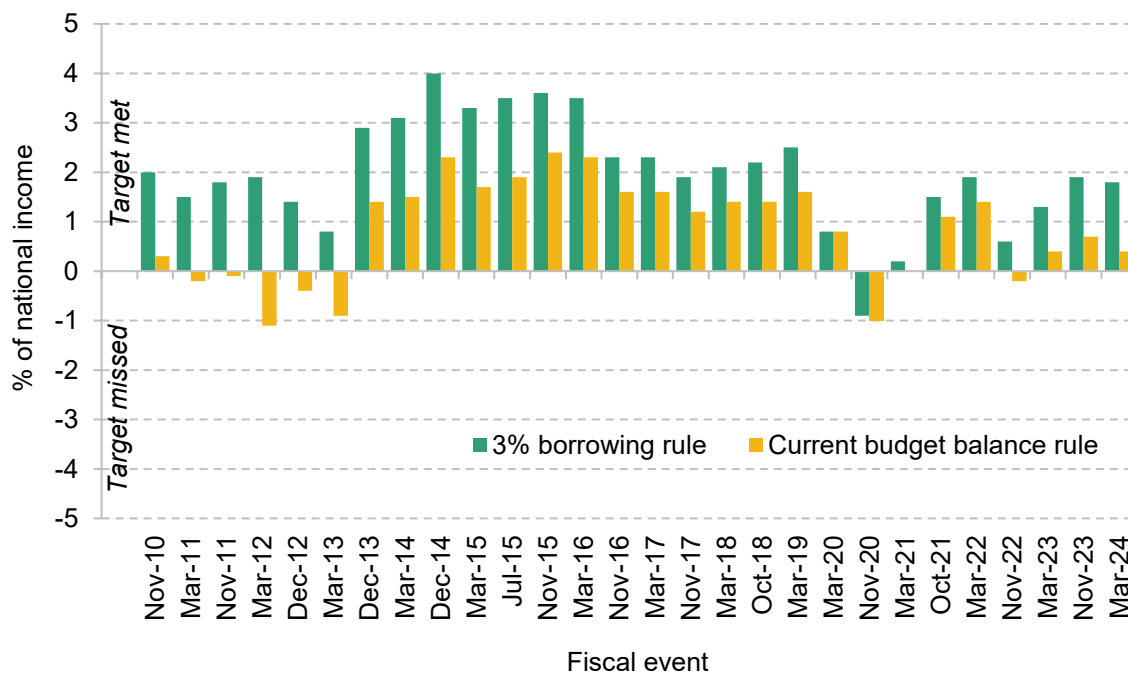
The new government's debt rule, based on what we know so far, looks similar to the previous government's rule – although this is not to say yet-to-be-confirmed details could not turn out to be important, as discussed above. In contrast, the rule for borrowing represents a material and certain change. The previous government's rule (known as the 'supplementary target') targeted overall borrowing, whereas the new government's proposed rule targets the current budget deficit – that is, borrowing excluding government investment. Figure 2.4 shows overall borrowing and the current budget deficit over time, as well as the March 2024 Budget forecast. Both the old and new rules are forward-looking. In other words, they target the forecast level of their preferred measure of borrowing (including or excluding borrowing that can be explained by investment), rather than the out-turn in the current year.

In principle, a target on the current budget deficit need not be more or less constraining than a target for overall borrowing. This will depend on the limits chosen for each of the measures. In the present case, the switch from the old government's rule to the new government's rule makes the rule more constraining under typical circumstances.

Specifically, the previous government's rule capped borrowing at 3% of national income in the fifth and last year of the rolling forecast period. This was an extremely loose rule by historical UK standards. Only on four occasions, out of 57 official UK forecasts that reach five years out (going back to Spring 1984), was a Chancellor planning to borrow more than 3% of national income five years out, and all were in the immediate aftermath of a major economic crisis: Black Wednesday when the UK crashed out of the European Exchange Rate Mechanism, the global financial crisis and the COVID-19 pandemic.

Figure 2.4. Public sector net borrowing and current budget deficit: out-turn and March 2024 forecast

Source: Office for Budget Responsibility, public finances databank (July 2024), <https://obr.uk/data/>.

Figure 2.5. Margin against the former and new government's borrowing rules at past fiscal events since November 2010

Note: Margin is forecast year-5 public sector net borrowing minus 3% (for the borrowing rule) and forecast year-5 current budget deficit (for the current budget balance rule). A positive margin indicates a rule would have been met.

Source: Office for Budget Responsibility, historical official forecasts database, <https://obr.uk/data/>.

The green bars in Figure 2.5 show that in most OBR forecasts since the 2010 Autumn Statement, the previous government's target to have borrowing forecast to be less than 3% of national income in five years' time would have been far from constraining. The new government is instead targeting current budget balance in the fifth forecast year – in other words, it aims to cover day-to-day spending with revenues and borrow no more than it spends on investment, bringing the current budget deficit to zero or running a surplus. Such a rule has much to commend it (Emmerson and Stockton, 2021a): its rolling nature allows a Chancellor to 'look through' disturbances that are expected to be temporary, and targeting the current budget instead of overall borrowing means that Chancellors are not incentivised to cut investment spending to meet the rule.

Since investment spending typically amounts to less than 3% of national income, current budget balance is a more challenging rule to meet than a 3% cap on borrowing. The yellow bars in Figure 2.5 show the margin against the new government's current budget balance rule. The rule would on average have been met by a margin of only 0.8% of national income (£23 billion in 2024–25 terms).

In contrast, the previous government's rule to be on course to borrow less than 3% of national income in five years' time would, over the period since 2010, have been met by an average of 2.0% of national income (£55 billion in 2024–25 terms). Switching from the old rule to the new rule would, on average, have reduced 'headroom' by 1.2% of national income, £32 billion in today's terms or more than 7% of total day-to-day spending on public services.

At the March Budget, the forecast current budget surplus in 2028–29 – or 'headroom' against a current budget balance rule for the fifth forecast year, had it been in place – was £14 billion, or 0.4% of national income (as shown by the very right-hand bar in Figure 2.5). In contrast, overall borrowing was forecast to be 1.8% of national income, meaning that Mr Hunt had 'headroom' of 1.2% of national income against his target to be on course to borrow less than 3% of national income five years out – three times as much as against a current budget balance rule. At the time, the borrowing rule was far from binding, as the debt rule was so much more constraining, leaving 'headroom' of just £9 billion. It is still true that the debt rule would have been more constraining than a current budget balance rule, had such a rule been in place. But only just – 'headroom' against a current budget balance rule would have been just £5 billion higher than against the debt rule in place at the time. A small change in forecast day-to-day spending or revenues would be enough to flip this relationship, meaning that a current budget rule could easily be more binding than the debt rule in its existing form.

In other words, a government willing to amend the debt rule could borrow substantially more to increase investment spending, while keeping to the current budget rule. What changing the debt rule will not do is permit big top-ups to planned day-to-day spending or reductions in the size of

future tax increases, as the government's target for current budget balance would quickly become the binding constraint. As long as the current budget rule remains in place, day-to-day spending increases will have to be funded through tax rises or cuts to other areas – an option that, of course, is also open to those looking to fund additional investment spending.

2.3 Risks and uncertainties

Regardless of their exact definition, the new Chancellor will presumably be meeting her own fiscal rules at the Budget based on the latest official OBR forecast. These forecasts are meant to be a central estimate of the outlook for the public finances over the next five years, but can never perfectly foretell the future. Public services might need top-ups to their budgets to keep them afloat. New policy changes may affect spending on social security benefits and state pensions, and revenues from taxes. Economic growth might surprise us. We could be lucky, and the growth rate could exceed current expectations. However, given that the OBR has been more optimistic than the Bank of England or the average of independent forecasters, it is also at least possible that growth will be a lot slower than the OBR currently forecasts, which would make the fiscal situation even more challenging. Even if expected growth did materialise, revenues could still come in stronger or weaker than forecast depending the composition of that economic growth, and how tax-rich it is. Overall, these uncertainties unfortunately appear asymmetric and will more likely increase spending and reduce revenues than vice versa. Working out which trade-offs to make and how best to navigate an uncertain environment are among the key challenges facing any Chancellor, and this is particularly true in the present climate.

Spending risks

Spending on public services

The March 2024 Budget forecast implied extremely tight spending plans for public services, as we and others have pointed out again and again. Since March, the government has made substantial new commitments on public sector pay. In addition, the July 2024 spending audit highlighted spending pressures in areas such as the asylum system and arising from the previous year's pay round. Consistent with the findings of the spending audit, in-year out-turn data for government spending are running ahead of the March 2024 forecast. While still provisional, these data indicate that day-to-day central government spending on goods and services over the first five months of the financial year is running £8.5 billion (or 5.1%) ahead of the March 2024 Budget forecast.

Chapter 3 sets out a number of scenarios for spending on day-to-day running costs and investment in public services. Compared with the March 2024 forecasts, it concludes that top-ups of £20 billion by 2028–29 would be required just to cover manifesto commitments and maintain the previous government's plans to grow spending by 1% in real terms from a new,

higher baseline that accounts for recent public sector pay settlements (a ‘status quo’ scenario). This would still sign the government up to sharp cuts to spending plans for ‘unprotected’ areas (outside of health, education, childcare, defence and overseas aid) inherited from the previous government. Delivering these cuts would be painful, and not easy to reconcile with lofty ambitions for performance across a wide range of public services.

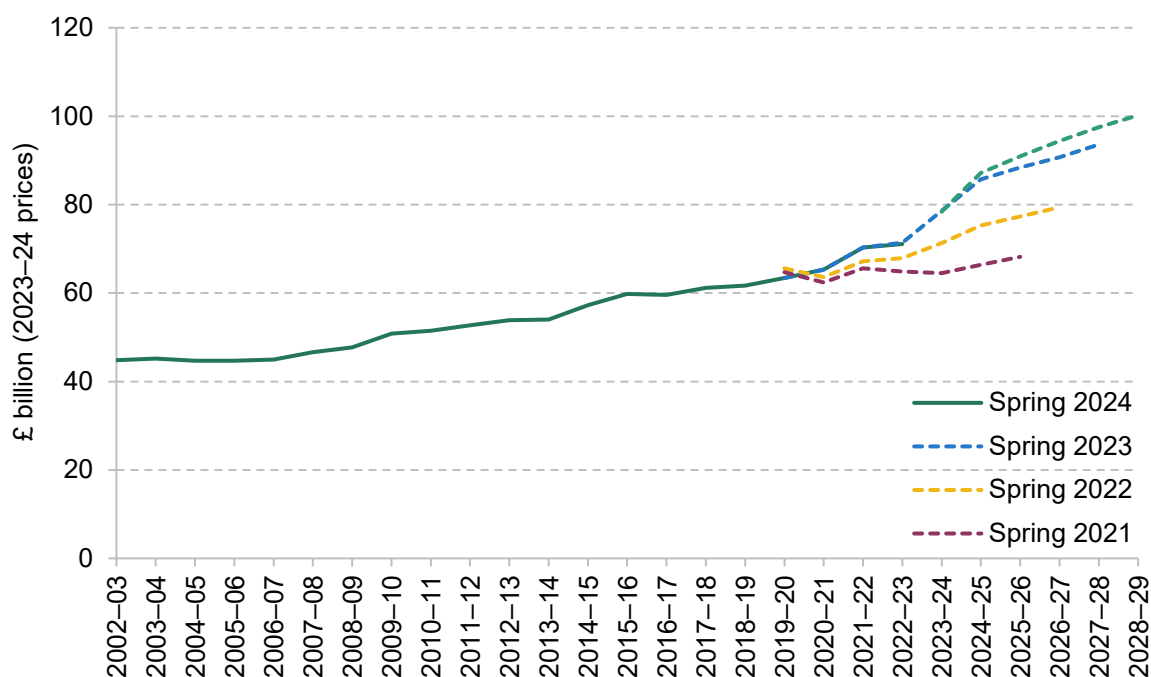
As Chapter 3 further sets out, avoiding real-terms cuts to the day-to-day budgets of ‘unprotected’ departments could require another £16 billion of top-ups in addition to the ‘status quo’ scenario. An additional £4 billion would be needed to avoid real-terms cuts to investment spending, which under inherited plans is frozen in cash terms and hence falling in real terms. In other words, an overall top-up to spending plans of £40 billion could be required, just to allow spending to keep pace with inflation after this year.

But it is not hard to make a case that simply *maintaining* funding in real terms in areas such as further education, courts and prisons will not be enough to deliver significant improvements in service quality envisioned by the government. Similarly, pressures on the public estate – such as the maintenance backlog in the NHS and a need to modernise the prisons estate – may require above-inflation growth in investment budgets. Another benchmark scenario discussed in Chapter 3 is topping up both day-to-day and investment budgets to be constant *as a share of national income*, which would require an additional top-up of £17 billion for day-to-day budgets and £9 billion for investment budgets (i.e. a total increase of £66 billion over and above the March 2024 estimate of spending in 2028–29).

In other words, assumptions for growth in spending that look quite plausible, and indeed modest compared with the increases under the last Labour government in the 2000s, can easily require large top-ups to spending plans.

Welfare spending

Benefit spending to support people with disabilities and long-term health conditions has been rising since the financial crisis, and rising sharply since the pandemic. Under the OBR’s March forecast, this category of spending is set to continue rising in real terms, albeit not quite as fast as it has done since 2020 (see Figure 2.6). Spending in 2024–25 is now forecast to be £87.2 billion, some £20.8 billion, or 31%, bigger than was forecast just three years earlier in Spring 2021. By the end of the forecast period in 2028–29, spending in today’s prices is forecast to be £100.2 billion, which would be an increase of £36.8 billion, or 58%, relative to what was spent in 2019–20. This extraordinary rise would put substantial pressure on the public finances.

Figure 2.6. Benefit expenditure to support disabled people and people with health conditions: out-turn and successive forecasts

Source: Department for Work and Pensions, expenditure and caseload forecasts, successive vintages.

The reasons behind the rise are not fully known (Latimer, Pflanz and Waters, 2024). To the extent that it reflects a persistent worsening of population health, it is clearly worrying above and beyond the fiscal implications. Because the rise is so sharp, historically unusual and incompletely understood, the uncertainty around the forecasts for claims and spending is also elevated. For example, if temporary after-effects of the pandemic are an important driver, or if policies aiming to support health and work capability prove very effective, the rise may abate sooner. But conversely, if the underlying drivers are intractable and persistent, the rise may continue at a similar pace to that in the last few years, which would lead to spending being even higher than is currently forecast.

Beyond benefits to support disabled people and those with health conditions, there are other areas of welfare spending where it may prove difficult to stick to current spending plans. One area of pressure comes from cash-terms freezes: currently, both local housing allowance rates (which cap the support claimants can get to help with housing costs) and the benefit cap (which limits the overall amount working-age adults can receive in most benefits each month) are frozen. Such freezes make benefits progressively less generous over time as their value gets eroded by inflation. Pressure to end these freezes will therefore grow.

More broadly, the government has established a child poverty taskforce, in accordance with its manifesto commitment. The strategy that this taskforce publishes in the spring may recommend using a variety of possible tools to reduce or alleviate child poverty – Chapter 6 outlines some of

the options, including various options for making the working-age benefits system more generous. Calls to remove the household benefit cap entirely, as well as the two-child limit⁵ and what is widely referred to as the ‘bedroom tax’, do not represent government policy at the moment, but do provide an indication of the pressure on current welfare spending plans. As shown in Chapter 6, abolishing these policies could come at an annual cost of £0.5 billion for the household benefit cap, £2.5 billion for the two-child limit (or £3.3 billion for the combination of the household benefit cap and the two-child limit), and £0.5 billion for the so-called ‘bedroom tax’. The spending impact will depend entirely on which options are eventually implemented – but it seems unlikely that an effective strategy would only reshuffle spending, and not put any additional money on the table.

Tax risks

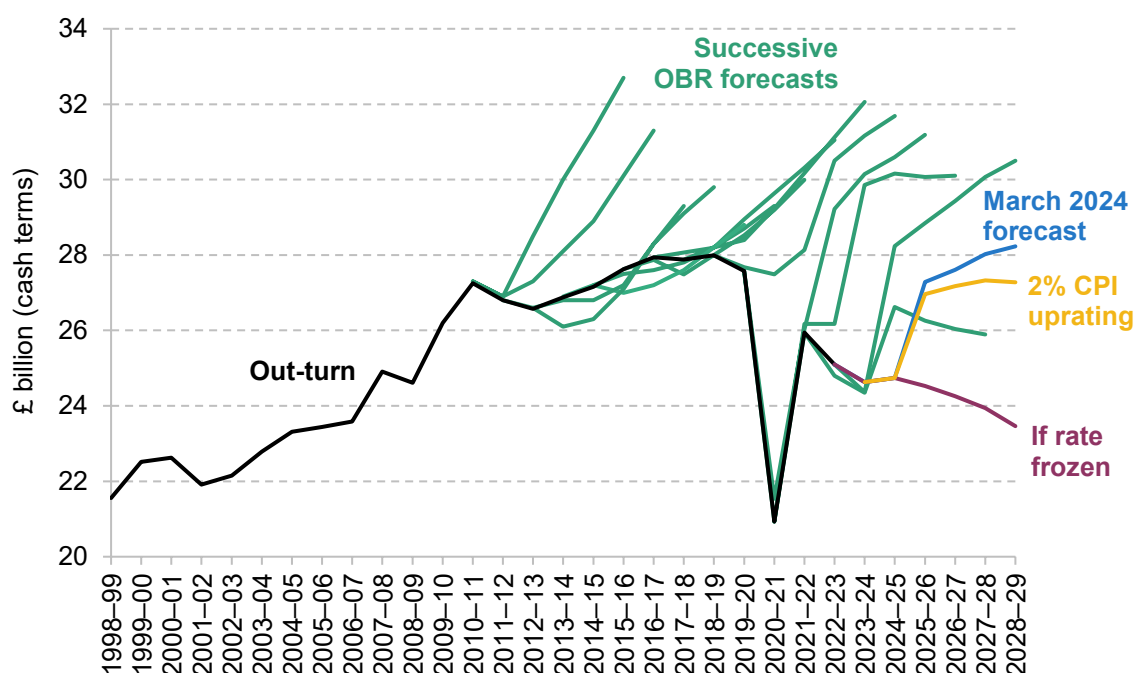
Fuel duties: will the uprating charade continue?

The OBR’s March forecast was for revenues from fuel duties to rise from £24.7 billion in 2024–25 to £28.2 billion in 2028–29. Crucially, this assumes that the supposedly temporary 5p cut in main rates of petrol and diesel duties that was first introduced in 2022–23 and twice extended by the previous government, is allowed to expire in March 2025. On top of this, it assumes rates of fuel duties will be increased each April in line with forecast growth in the Retail Prices Index (RPI). This is stated government policy – and hence what the OBR assumes for its central forecast. However, since 2011, it has been traditional for Chancellors to cancel the forthcoming year’s previously planned increase while continuing to accept forecasts that assume rates of fuel duties will rise in future years. The result of the cumulation of these ‘one-year’ freezes is that revenues from fuel duties in 2024–25 are forecast to be an astonishing £19 billion lower than they would have been, had fuel duties been increased in line with growth in the RPI since 2011. In that case, the rate on standard petrol and diesel would have been 101p per litre instead of its current rate of 52.95p (Waters and Wernham, 2024).

In the March 2024 Budget, the OBR pointed out that if it instead assumed that rates of fuel duties continued to be frozen in cash terms, forecast revenues in 2028–29 would be £23.5 billion. This is £4.8 billion lower than currently forecast and would imply receipts from fuel duties falling slightly in cash terms (unsurprising given the ongoing shift towards electric vehicles). Remarkably – as shown in Figure 2.7 – this would mean that revenues from fuel duties would be no higher in cash terms in 2028–29 than they were 22 years earlier in 2006–07. As a share of national income, revenues from fuel duties would be 0.7% of national income, which would be 1.0% of national income – or £32 billion in 2028–29 – below the 1.7% of national income seen on average during the first decade of the 2000s.

⁵ Seven Labour MPs had the whip removed for six months in July 2024, after voting against the government on an SNP amendment calling for the two-child limit to be abolished.

Figure 2.7. Outlook for revenues from fuel duties



Note: 'If rate frozen' refers to a forecast if rates are kept constant in cash terms from their current level – so the 'temporary' 5p cut becomes permanent. '2% CPI uprating' refers to the suggestion, described in the text, that rates could be increased by the target rate of CPI (2%).

Source: Chart 4.5 of Office for Budget Responsibility, economic and fiscal outlook (March 2024); authors' calculations.

Ms Reeves should bring to an end the charade around the future rates of fuel duties. If she plans to freeze fuel duty rates in cash terms going forward, she should announce that and acknowledge that tax revenues will be lower as a result. If she wants to end the temporary 5p cut to rates of fuel duties and to see them increase in line with the RPI in future, she should say that and then stick to it. Choosing either option could provide greater certainty to motorists and businesses around the likely path for rates of fuel duties, and improve the transparency and predictability of the outlook for the public finances.

Allowing the 5p rate cut to expire and increasing rates in line with the RPI would mean that this April would see a sizeable 6.2p increase in the standard rate of fuel duty from 52.95p to 59.15p (or 7.4p after accounting for 20% VAT on fuel duty). But it should also be noted that the average price of a litre of petrol is now 135.2p compared with 145.6p at the start of 2022,⁶ prior to Russia's invasion of Ukraine and the then Chancellor Rishi Sunak's decision to implement the 5p cut as part of a package of measures to help households and businesses with rising energy prices and the cost-of-living crisis.

⁶ <https://www.racfoundation.org/data/uk-pump-prices-over-time>.

Alongside allowing the 5p rate cut to expire, the new Chancellor could take a new approach to how inflation uprating of rates of fuel duties is implemented. The RPI is a discredited measure of inflation.⁷ A better measure – and one that is typically lower – is the Consumer Prices Index (CPI). Furthermore, given that petrol prices change frequently, it is also far from clear why rates of fuel duties should be increased by forecast annual inflation in April and then left fixed in cash terms for the rest of the financial year.

A more modern system could entail fuel duties being increased by monthly inflation each month. This would benefit motorists who prefer a more gradual increase in fuel prices through the year than a one-off bigger increase in April, and this uprating method might make it politically easier for the Chancellor to actually implement inflation increases as there would be less scope for a high-profile campaign against annual uprating in the run-up to a fiscal event. A potential oddity with using the monthly inflation rate is that fuel prices do not increase gradually through the year – for example, they are typically *lower* in January than in December. This could be smoothed out. Or – even simpler for refineries which remit fuel duties to HMRC – given the target for CPI inflation to be 2% a year, fuel duties could be increased by one-twelfth of 2% on the first of each month (or more precisely by $1.02^{(1/12)}$ each month). This means that, in the longer term and in expectation, fuel duties would increase in line with CPI inflation, while avoiding sharp increases in times of temporarily elevated inflation, and associated concerns around the cost of living.

Our forecast for fuel duties under this policy option is shown by the yellow ‘2% CPI uprating’ line in Figure 2.7. It would reduce revenues from fuel duties, relative to what is currently forecast, by £1 billion in 2028–29. This would be (roughly) the figure that would appear on the Budget scorecard, signed off by the OBR, and the Chancellor could choose to frame the measure as a £1 billion tax cut for motorists. But relative to the implicit inherited policy position of continuing to announce yet another one-year freeze to rates of fuel duties every year, while continuing to pretend that increases will take place in later years, it would actually lead to a £3.8 billion *increase* in revenues from fuel duties in 2028–29. Even under this policy, a medium-term strategy to replace revenues from fuel duties – and help manage the cost of congestion – would still be urgently needed as electric vehicles become increasingly prevalent.

Direct tax thresholds

The current forecast is predicated on an unprecedented length of cash-terms freezes to income tax and National Insurance thresholds. Having been announced by then Chancellor Rishi Sunak,

⁷ In 2020, Sir David Norgrove, Chair of the UK Statistics Authority, said, ‘We continue to urge the Government and others to cease to use the RPI, a measure of inflation which the Government itself recognises is not fit for purpose’ (<https://uksa.statisticsauthority.gov.uk/news/response-to-the-joint-consultation-on-reforming-the-methodology-of-the-retail-prices-index/>). The RPI will be, for all intents and purposes, replaced by CPIH, a variant of the CPI, in 2030.

these first started in April 2021 (with some additional thresholds being frozen from later points), have been kept in place through the recent period of high inflation and are scheduled to run until 2027–28. These freezes will bring a record number of people into the income tax system or into higher tax brackets. Two-thirds of the adult population are expected to pay income tax in 2027–28, compared with 58% before the series of freezes was introduced. The change has been even starker for higher- and additional-rate income tax payers. The number of people paying the higher or additional rate of income tax has more than doubled, from 6% of the adult population in 2010–11 to 13% now, and is expected to reach 15% by 2028–29. These changes will also affect many pensioners. In fact, due to above-average growth in pensioners' income and a real-terms fall in the value of their personal allowance, people aged 65 or over were more likely to pay income tax than those aged 16–64 for the first time ever in 2023–24 (Adam, Miller and Upton, 2024). All this may create pressure on the new government to end the planned six-year freeze early. On the other hand, this has been a very big tax rise – the OBR estimates that threshold changes since 2021 raised £26.7 billion more revenue this year, rising to £39.5 billion in 2027–28⁸ – which has encountered very little evident public resistance, and the temptation to continue with it, and perhaps even extend it, will be considerable.

Manifesto commitments

When we go on to describe scenarios for the public finances below, we include Labour's manifesto commitments on tax (see Table 2.2). In total, these were said to raise £7.4 billion. Recent reports have indicated that the government may have changed its thinking on reforms to 'non-domiciled' tax status, and concluded that this may not, in fact, raise any additional revenue. IFS researchers analysed potential reforms in the summer (Adam and Miller, 2024) and stressed that estimates of the potential revenue impacts were highly uncertain and depend on the detail of the policy. But the biggest purported revenue-raiser in the manifesto was a crackdown on avoidance and evasion. This is a perennially popular measure for parties to include in their manifestos, but an uncertain source of revenue. In addition, an extension of the energy profits levy ('windfall tax') on energy firms was said to raise an average of £1.2 billion annually, still nominally on a temporary basis. Given that under the OBR's March forecast, revenues from the levy were already set to decline to £1.4 billion by 2028–29 and the changes (including an increase in the rate from 35% to 38%, and an extension from March 2029 to March 2030) look relatively modest, the policy may be expected to raise less than that amount, especially in later forecast years.

While precise costings are uncertain, we take the manifesto numbers at face value for the purposes of modelling fiscal scenarios later on in the chapter. One risk to keep in mind, then, is that commitments either will not be implemented (e.g. if the additional reforms to non-domiciled

⁸ See table 3.8 of Office for Budget Responsibility (2024a).

tax status are dropped) or may raise less than estimated in the manifesto. However, these commitments, in aggregate, are modest in scale – so, in quantitative terms, this is unlikely to have major implications for the fiscal outlook.

Table 2.2. Tax and spend measures included in the scenarios

Labour manifesto tax rises	Impact on annual borrowing (average)
VAT and business rates on private school fees	–£1.5 billion
Reforms to non-domiciled status and reduction in tax avoidance	–£5.2 billion
Other	–£1.8 billion
Day-to-day spending increases	2028–29 direct impact on borrowing
Manifesto commitments	+£4.8 billion
Public sector pay deals	+£9.4 billion
Investment spending increases	2028–29 direct impact on borrowing
Manifesto commitments	+£5.6 billion

Note: Details on costings for spending commitments in Chapter 3. Figures rounded to one decimal place. 'Other' includes windfall tax on oil and gas firms.

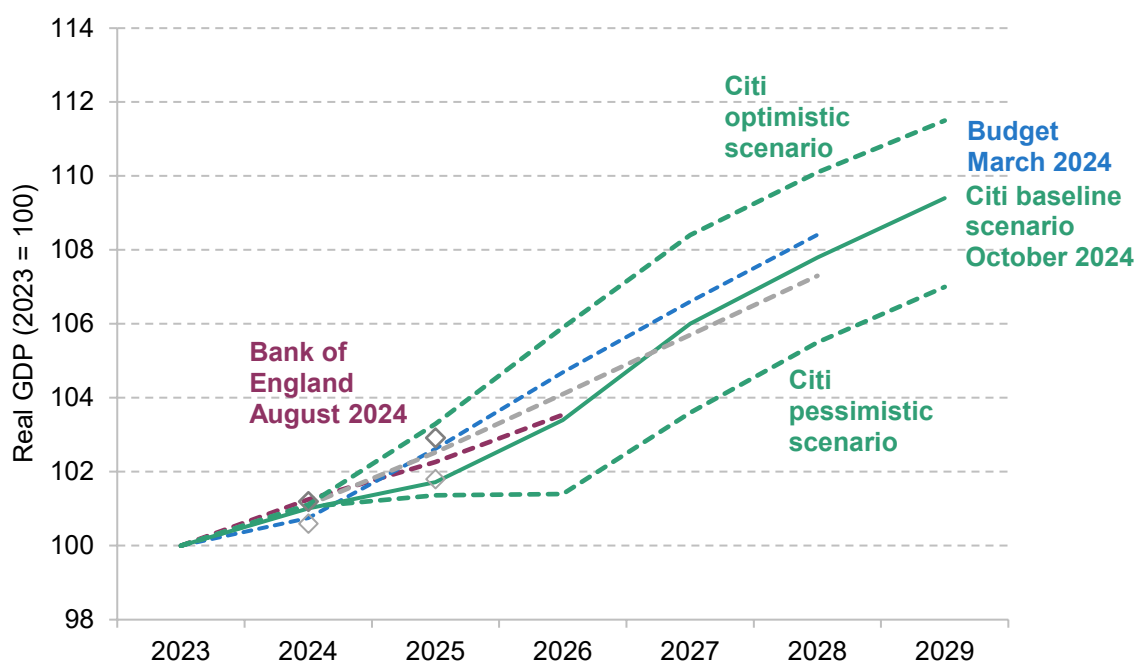
Source: Labour Party (2024); authors' calculations.

How much would a stroke of economic luck help?

A key factor determining the government's room for manoeuvre on tax and spend at the Budget will be the OBR's updated forecast for growth in the economy, earnings, and other underlying drivers of borrowing. In Citi's baseline scenario (see Chapter 1), the average economic growth rate between this year and 2028 is forecast to be 1.4%, slightly below the OBR's March forecast (1.5%) and the same as the consensus of independent forecasters when polled by the Treasury in August (HM Treasury, 2024). In the middle of the forecast period, Citi is much more pessimistic than the OBR. But the difference is much less stark by 2028 when, under Citi's forecast, economic output would be just 0.6% below the OBR's March forecast (see Figure 2.8).

This would be a disappointing growth performance, to say the least. It would fall well short not just of the longer-term average of 2.7% seen before the financial crisis, but even the 1.9% seen between 2010 and 2019, when poor productivity growth was partly compensated for by strong growth in the size of the working-age population and in average hours worked.

Figure 2.8. Forecasts for economic output



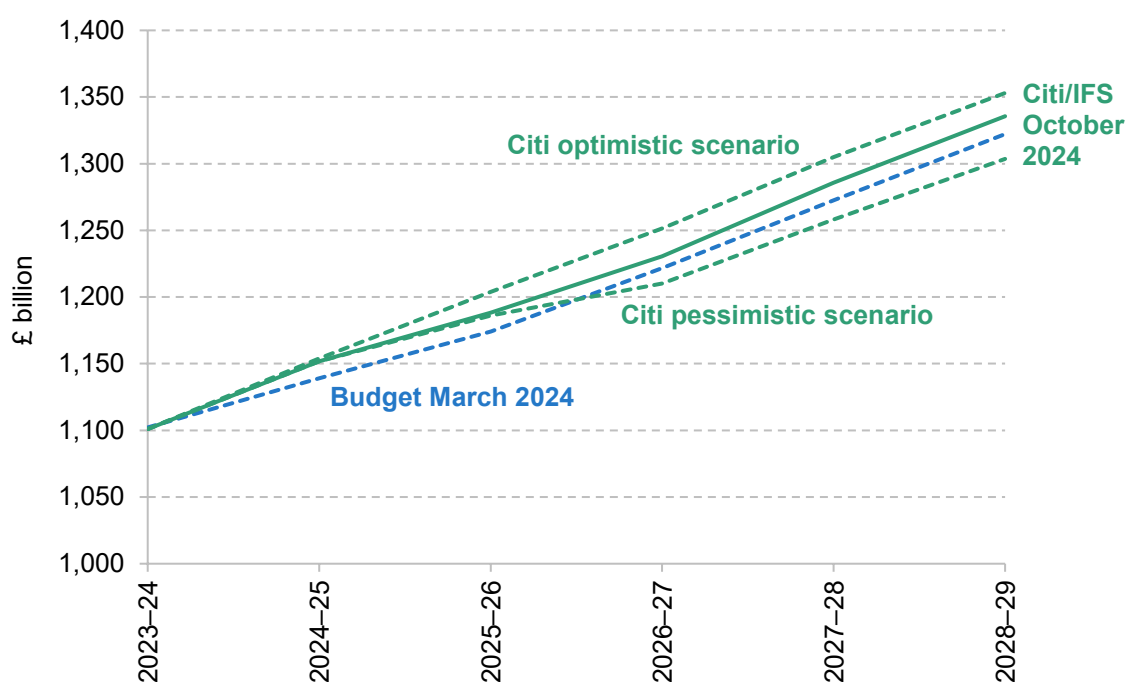
Note: Dashed grey line is the average of independent medium-term forecasts from August 2024; grey diamonds are minimum and maximum independent forecasts for 2024 and 2025 from September 2024.

Source: HM Treasury, survey of independent forecasters (August and September 2024); Office for Budget Responsibility, economic and fiscal outlook (March 2024); authors' calculations.

For the public finances, it is not just economic output that matters, but economy-wide inflation, which determines the cash size of the economy for a given amount of output. Since taxes are generally levied on cash amounts, higher growth in cash terms can shield tax revenues from the impact of lower real-terms growth. This is the case when comparing Citi's baseline scenario with the OBR's March forecast: the cash economy is forecast to be 0.4% *bigger* in 2028 than under the OBR's March forecast.

Citi has also constructed two plausible alternative economic scenarios. In the optimistic scenario, real-terms growth between now and 2029 averages 1.8% per year. This would take us back to growth rates close to those seen over the 2010s, even without the tailwind of strong growth in the size of the workforce. By 2029, real-terms economic output would be 2.3% greater under this scenario than under Citi's baseline scenario. The pessimistic scenario mirrors this, with economic output 2.3% below the baseline scenario by 2029, and real-terms annual growth rates that, on a sustained basis, would be so weak as to be unprecedented in post-industrial times. This would be the result of there being hardly any growth under this scenario in 2025 or 2026 and with subsequent years not then seeing any 'bouncing back' in the form of stronger growth than in the baseline scenario.

Figure 2.9. Revenues including manifesto commitment on tax: out-turn and three scenarios



Note: Public sector current receipts shown.

Source: Office for Budget Responsibility, economic and fiscal outlook (March 2024); authors' calculations.

In the baseline scenario, we forecast that overall government revenues would be £13 billion higher in 2028–29 than under the March Budget forecast (see Figure 2.9). Of this, £9 billion is due to the inclusion of Labour's manifesto commitments. The remainder reflects multiple countervailing effects: income tax and National Insurance contributions (NICs) are *reduced* by £3 billion relative to the OBR March forecast, driven by a lower forecast for employment growth. However, the stock market is forecast by Citi to grow faster than under the OBR March forecast (despite slightly lower real growth and slightly higher cash-terms growth), helping to shore up revenues from capital taxes. While in the long run, growth in the economy and in the stock market tend to align, it is not unusual for the stock market to grow much faster for a period (only to contract sharply later when a recession comes along). In this case, revenues from capital gains tax, stamp taxes and business rates are £4 billion higher in the baseline scenario than under the March Budget forecast. Higher RPI inflation also raises revenues from student loan interest payments.

In the pessimistic scenario, lower growth and the lower earnings, profits and spending associated with it depress revenues by £19 billion relative to the March Budget forecast (despite the inclusion of £9 billion of tax rises from Labour's manifesto). A weaker economy reduces revenues from income tax, NICs and VAT by £28 billion, before accounting for manifesto commitments. Effects on other taxes largely cancel each other out, in particular since the stock

market in this scenario, while weaker than in the baseline scenario, still performs more strongly than under the OBR's March forecast.

In contrast, in the optimistic scenario, stronger economic performance raises revenues from the three big taxes (income tax, NICs and VAT) by £15 billion compared with the OBR's March forecast. In total, including the £9 billion impact of revenue-raising manifesto commitments, revenues in the optimistic scenario are £31 billion higher than in the OBR's March forecast.

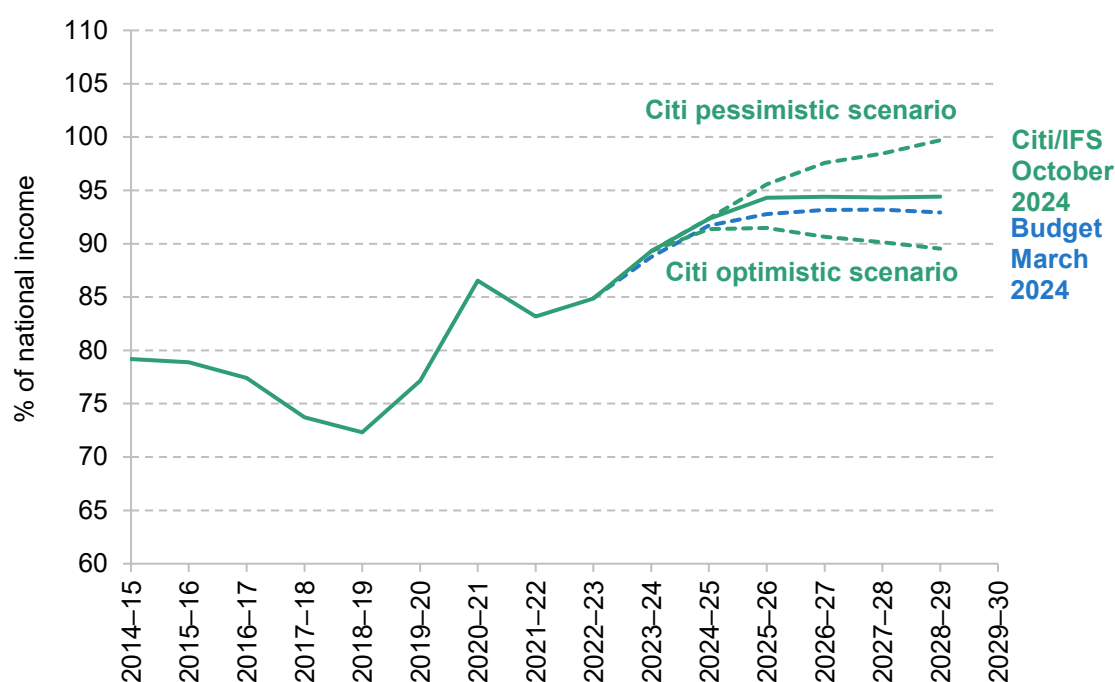
2.4 What does this mean for borrowing, debt and the fiscal targets?

Citi's baseline economic scenario, on its own, does not paint a substantively worse picture for the public finances. But as shown in Table 2.2, the tax rises in the Labour manifesto are forecast to be more than enough to cover the party's specific manifesto commitments on day-to-day spending, but the increase to investment borrowing pushes up borrowing. Add to this even just the mechanical consequences of public sector pay deals from this year and last that the new government signed up to in July, and debt⁹ as a share of national income would be higher over the next few years and could still be rising in 2028–29. This means that, had these policies and forecasts been in place back in March, the fiscal mandate would have been missed – recall that the fiscal mandate aims to have debt as a share of national income forecast to be falling between the fourth and fifth years of the forecast. The forecast rise of 0.1% of national income (from 94.3% to 94.4%; see Figure 2.10) is very small relative to the uncertainty around the forecast, and the difference between it and the decline of 0.3% of national income (from 93.2% to 92.9%) in the March Budget forecast is not economically meaningful – even though the latter meant that Mr Hunt was at that time complying with the letter of his fiscal target.

At the upcoming Autumn Budget – the first in the fiscal year 2024–25 – the fiscal targets will 'roll over' a year: another year will be added to the forecast, and the fiscal mandate will move to targeting the change in the debt-to-national-income ratio between 2028–29 and 2029–30. This rolling-over in itself may be enough for the new government to meet the letter of the fiscal mandate in its existing form. It will depend on many factors, including the OBR's forecast for nominal growth in that year and the real rate of growth in public service spending that the new Chancellor tells the OBR to assume in that year.

⁹ Throughout this section, we use 'debt' to refer to 'underlying debt' (excluding the contribution of the Bank of England's balance sheet), the measure targeted by the previous government's fiscal target.

Figure 2.10. Debt under three economic scenarios



Note: Debt excluding the Bank of England ('underlying debt') shown. At the Autumn 2024 Budget, the target year of the fiscal rules is set to roll forward to 2029-30.

Source: Office for Budget Responsibility, economic and fiscal outlook (March 2024); authors' calculations.

In addition, as discussed in Section 2.2, Ms Reeves may yet choose to change the way debt is measured for the purposes of the fiscal target and, of course, the Budget will contain a package of tax and spending measures that will also affect the outlook for borrowing and debt.

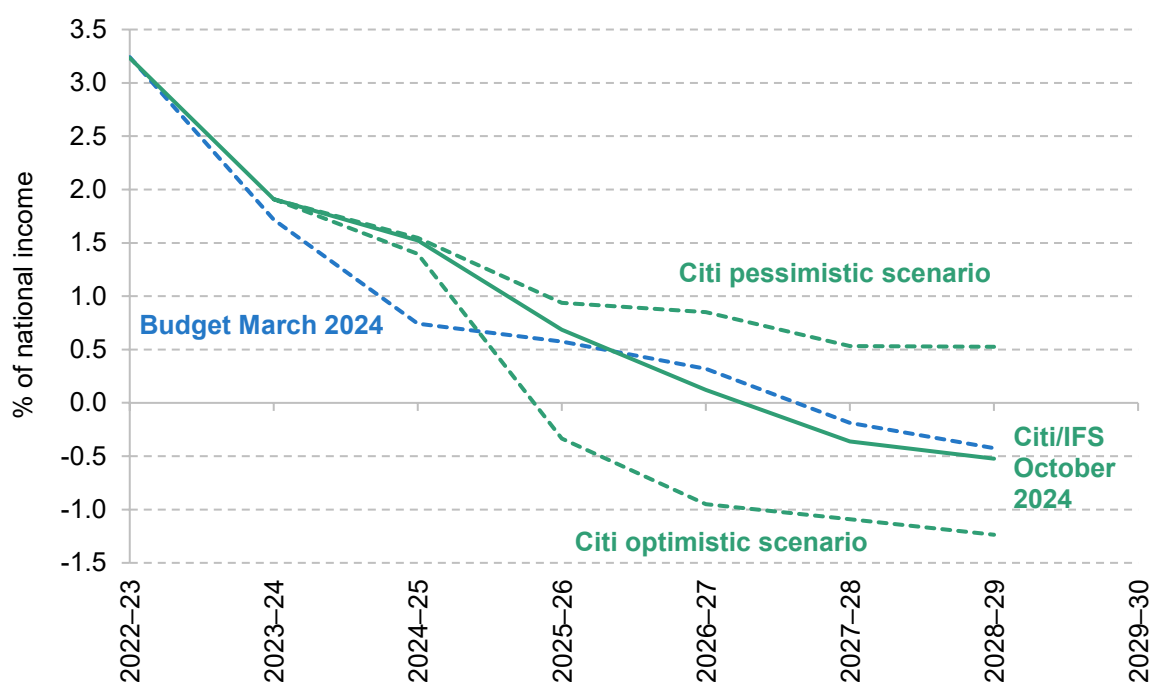
The conclusion that debt would be rising in 2028-29 under Citi's baseline forecast when it was forecast to fall under the March Budget forecast is partly driven by the forecast *profile* of growth. In Citi's baseline forecast, growth in the cash size of the economy in 2028-29 is just 3.4% – roughly the same as the average over the period, but substantially less than in the previous two years. In contrast, under the OBR's March forecast, cash-terms growth in 2028-29 is 3.7%, the same as or very close to the previous two years, and above the average (which is 3.3%, just as in Citi's baseline scenario). More cash-terms growth *in the target year* makes the fiscal mandate easier to meet, because any given increase in debt in £ billion terms will represent a bigger fall (or a smaller rise) in the ratio of debt to cash-terms national income.

This sensitivity of the fiscal mandate to small changes in particular parameters of highly uncertain forecasts means it is not a sensible guide for fiscal policy, as discussed extensively by Emmerson, Mikloš and Stockton (2023 and 2024b) and Johnson (2024). The tendency of the fiscal mandate to 'flip-flop' in response to small forecast changes is exacerbated by Chancellors running fiscal policy in an attempt to meet the target almost exactly in recent years, rather than

maintain any significant buffer. The fact that a poorly designed fiscal target may flip from ‘just met’ to ‘just missed’ – and may flip back to ‘just met’ through the mechanical consequences of the forecast horizon rolling forward – is not a reliable indicator of the health of the public finances. However, the fact that, under all these forecasts, debt is at best stable over the medium term, with a tight spending settlement and taxes at historically high levels, is another reminder of the difficult fiscal environment that any Chancellor who is serious about reducing debt as a share of national income would find themselves in.

During the general election campaign, Labour committed to a second, much more sensible, fiscal rule requiring that the current budget be forecast to be at least in balance by the end of the forecast – in other words, for the government to be borrowing no more than it is spending on investment. This rule is harder to meet as long as government investment five years out is forecast to be less than 3% of national income, as set out in Section 2.2 above.

Figure 2.11. Current budget deficit under three economic scenarios



Note: Citi economic scenarios combined with ‘status quo’ spending assumptions. At the Autumn Budget, the target year of the fiscal rules will roll forward to 2029–30.

Source: Office for Budget Responsibility, economic and fiscal outlook (March 2024); authors’ calculations.

Under Citi’s baseline scenario and assuming tight public service spending plans are maintained (the ‘status quo’ scenario from Chapter 3), there would be a small current budget surplus in 2028–29 – similar to the March Budget forecast (Figure 2.11 and Table 2.3). Keeping the ‘status quo’ spending scenario but assuming the economy evolves along the lines of Citi’s pessimistic scenario leaves the current budget in deficit by £16 billion, or 0.5% of national income. In turn,

the optimistic scenario might deliver a surplus of some £40 billion when combined with the ‘status quo’ spending scenario.

We stress, however, that this spending scenario assumes that none of the pressures identified at the July 2024 spending audit persists into the medium term, except agreed public sector pay deals.¹⁰ If some of the spending risks outlined in Section 2.3 materialise and tax rises are limited to the relatively small commitments made in the manifesto, this forecast current budget surplus could easily evaporate.

Switching to the ‘avoid real cuts’ scenario from Chapter 3 would be one, arguably rather restrictive, interpretation of the commitment of ‘no return to austerity’, restated in Ms Reeves’s speech at Labour Conference 2024.¹¹ This would require additional top-ups to spending of £20 billion, £16 billion of which are on current spending and the remaining £4 billion on investment spending. In other words, the current budget rule would be binding if Ms Reeves wanted to avoid real-terms cuts, as the entire current budget surplus is effectively the same as the top-up required to achieve this. Debt (on the measure used in the existing fiscal target) would be rising throughout the forecast, by about 1% of national income in 2028–29, meaning that, had these forecasts and spending plans been in place in March, the debt rule would also have been missed, and missed by some margin.

Table 2.3. Borrowing in 2028–29 in three economic scenarios, combined with ‘status quo’ spending scenario

	Borrowing	Current budget deficit
<i>Memo:</i>		
<i>March 2024 Budget forecast</i>	<i>£39bn (1.2% of GDP) deficit</i>	<i>£14bn (0.4% of GDP) surplus</i>
Baseline	£42bn (1.3% of GDP) deficit	£17bn (0.5% of GDP) surplus
Optimistic	£19bn (0.6% of GDP) deficit	£40bn (1.2% of GDP) surplus
Pessimistic	£76bn (2.4% of GDP) deficit	£16bn (0.5% of GDP) deficit

Note: Citi economic scenarios combined with ‘status quo’ spending assumptions.

Source: Office for Budget Responsibility, economic and fiscal outlook (March 2024); authors’ calculations.

¹⁰ For the current year, we assume net spending pressures identified in the July spending audit are funded, which is also consistent with in-year out-turns and claims on the Reserve so far.

¹¹ If the baseline scenario actually materialised, there would, *ex post*, still be slight real-terms cuts with this top-up, because inflation in the baseline scenario is slightly higher than in the March Budget forecast. In other words, in this context, the scenario would be better described as ‘no planned real-terms cuts’. However, the difference between the inflation forecasts in the two scenarios is modest.

Under the optimistic scenario, there would be more scope to top up spending plans within the fiscal rules. Chapter 3 calculates that to avoid cuts in day-to-day budgets as a share of national income as forecast at the March Budget, a top-up of £33 billion would be required. Debt is falling by a margin of £20 billion (0.6% of national income) in 2028–29 under this scenario. However, the forecast surplus of £40 billion would be sufficient to allow such a top-up while still being compliant with the target for (at least) current budget balance. Of course, higher growth in this scenario would mean that budgets would not, *ex post*, be constant as a share of (now-higher) national income. Nevertheless, this is still an important benchmark. It highlights how stronger economic performance would make the trade-offs easier to manage. Conversely, the pessimistic scenario would require even tighter spending plans to be delivered – or fresh tax rises to be announced – just to remain on course for current budget balance in 2028–29.

A plausible range of fiscal options

Ms Reeves faces a difficult set of choices at this Budget. But we should not understate the choices she does have, and the material differences between them. If she were willing to bet on a favourable scenario for growth materialising – akin to Citi’s upside scenario – then the £9 billion of tax rises included in this year’s Labour manifesto would be enough to fund the public sector pay deals agreed this year and last, as well as avoid real-terms cuts to ‘unprotected’ departmental budgets while still delivering a current budget surplus and falling debt in five years’ time. But the Chancellor’s fiscal rule is couched in terms of the OBR forecast – its test is not whether she runs a current budget surplus in unforeseen lucky circumstances, but whether the OBR forecasts one in the Budget. So to meet the fiscal rule, it matters less what the Chancellor believes is the most likely scenario, but what the OBR deems ‘central’. Citi’s optimistic scenario would see the economy being 1.7% bigger in cash terms in 2028–29 and interest rates falling more steeply than the OBR forecast in March. Come 30 October, the new forecast is unlikely to move anywhere near as far in the optimistic direction as this.

But it is delivering actual current budget surpluses, or actually falling debt, that is more likely to contribute to fiscal sustainability in the longer term than having the OBR sign off on compliance with a fiscal rule. So it is worth noting that, even if this optimistic scenario were to materialise and ignoring the constraints of the forward-looking fiscal rules, difficult choices would remain: ambitious productivity improvements baked into the NHS workforce plan would still have to be delivered, and departments would still have to prioritise among competing demands. But it would allow the government to claim ‘no return to austerity’, while ending up with a current budget surplus.

Whichever fiscal rule they choose, a prudent Chancellor is going to want their plan to be sustainable in more than an optimistic scenario. The OBR’s new forecast for the Autumn Budget may in fact be gloomier than the previous one in some respects – over the medium term,

economic output would be 1.1% greater under the OBR's March forecast than the average of independent forecasters when they were surveyed by the Treasury in August.

We may think it more likely that the OBR's October Budget forecast will be closer to the baseline scenario. Under that baseline scenario, the manifesto tax rises could be just about enough to avoid planned cuts to unprotected areas such as local government, justice and home affairs while seeing (just) the current budget not moving into deficit in 2028–29. However, debt (on the measure targeted by the existing fiscal mandate, 'underlying' net debt excluding the Bank of England) would still be on a rising trajectory at the end of the forecast period. If, instead, Ms Reeves is willing to sign up to sharp spending cuts to those departments inherited from the March Budget, and only fund the mechanical consequences of the public sector pay deals agreed this year and last, this could deliver a current budget surplus of £17 billion in 2028–29 in the economic environment of the baseline scenario (see Table 2.4).

Of course, meeting the letter of the fiscal rule in terms of the OBR forecast is only part of a fiscal strategy. Problems will all but inevitably arise over the forecast horizon. If policymakers are meeting the rule with no room to spare, this may mean that (very small) current budget surpluses are forecast, but no current budget surpluses materialise when the time comes. This is especially true if policymakers' willingness to spend any 'windfall' from improvements in the forecast is not matched by a similar willingness to respond to deteriorations in the forecast with tax rises or spending cuts (Emmerson et al., 2023). Ultimately, this may pose a risk to fiscal sustainability. If Ms Reeves wanted to ensure that a balanced current budget could be delivered even with the headwinds of Citi's pessimistic scenario, even under the restrictive spending assumptions of the 'status quo' scenario, a tax rise of £16 billion – on top of those set out in Labour's manifesto – would be required to maintain current budget balance in 2028–29.

But is there a way to open up more palatable fiscal options? During the election campaign and since it has been in office, Labour has emphasised the potential of policy to increase productivity, and subsequently take the sharper edges off the fiscal trade-offs. Even in a best-case scenario, policy takes time to make a positive difference to the growth outlook. In the recent past, the OBR has increasingly incorporated policy impacts on growth into its forecast (through 'dynamic scoring') – for example, the (modest but not trivial) expected impact of the expansion to childcare on parents of young children joining the workforce. An OBR discussion paper published in the summer (Suresh et al., 2024) sets out its approach to incorporating impacts of growth from additional public sector investment. Two points are worth drawing out from this. First, the OBR's estimated effects are not huge, and are not large enough for investments to be self-financing in fiscal terms. Second, many of the supply-side benefits are expected to materialise only in the longer term, beyond the government's current five-year forecast horizon. We discuss the potential role of growth-focused policies to ease fiscal trade-offs, and the sorts of delays involved, in more detail in Section 2.5. But as a simple summary, the OBR paper

estimated that a permanent, sustained 1% of GDP increase in government investment would increase potential output by 0.4% after five years and by 2.4% after fifty years. The return to the exchequer would be smaller, given that the government would recoup less than half of this in additional tax revenues.

Table 2.4. Illustrative tax measures needed to eliminate the current budget deficit in 2028–29 under different economic and spending assumptions

	Tax measure to get to current budget balance in 2028–29
<i>Memo: March 2024 Economic and Fiscal Outlook</i>	
— with ‘status quo’ spending scenario	No change (0% of national income)
— with ‘avoiding real-terms cuts’ (£16 billion top-up) scenario	£16 billion tax rise (0.5% of national income)
— with ‘avoiding cuts as a share of national income’ (£33 billion top-up) scenario	£33 billion tax rise (1.0% of national income)
Citi baseline economic scenario	
— with ‘status quo’ spending scenario	£17 billion tax cut (0.5% of national income)
— with £16 billion top-up	£1 billion tax cut (0.0% of national income)
— with £33 billion top-up	£16 billion tax rise (0.5% of national income)
Citi optimistic scenario	
— with ‘status quo’ spending scenario	£40 billion tax cut (1.2% of national income)
— with £16 billion top-up	£24 billion tax cut (0.7% of national income)
— with £33 billion top-up	£7 billion tax cut (0.2% of national income)
Citi pessimistic scenario	
— with ‘status quo’ spending scenario	£16 billion tax rise (0.5% of national income)
— with £16 billion top-up	£32 billion tax rise (1.0% of national income)
— with £33 billion top-up	£49 billion tax rise (1.6% of national income)

Note: Does not include debt interest consequentials of spending top-ups in earlier years.

Source: Authors’ calculations.

In the case of other growth-promoting policies – for example, the potential boost to growth through a less restrictive planning regime – past performance suggests the OBR might want to wait for clear evidence of an impact before reflecting them in its forecasts. It is one thing to say that planning rules will be liberalised, it is another thing actually to legislate the changes, and yet another to see developments happening that would not otherwise have occurred. Long-term

growth-oriented policies are highly unlikely to ride to the rescue at this fiscal event and spare the Chancellor from difficult decisions to cut spending, raise taxes or allow debt to rise by more over this parliament. However, that does not mean such policies are not worth pursuing – far from it. In the following section, we discuss longer-term challenges and opportunities, and particularly consider the conditions under which higher growth brought about by a concerted policy effort could help keep the public finances on a sustainable path.

2.5 Looking ahead

Short-termism is a common, and justifiable, criticism of the UK's fiscal policymaking. Several external commentators have suggested pushing the horizon of the full economic and fiscal forecast or at least some part of it, and/or the target year of the fiscal rules, further into the future. Upon taking office, the new government has emphasised a long-term policymaking horizon as a key aspect of its approach to fiscal and economic policy. For example, it has committed to setting 10-year R&D budgets. In this section, we discuss the fiscal outlook over a longer time frame than the usual five years, touching on demographics, climate change and the net zero transition, the decline of smoking, and how much a long-term focus on growth might be relied upon to ease the government's fiscal conundrum.

At the Budget this March, the target year for the fiscal rules was 2028–29, and the forecast current budget surplus was 0.4% of national income in that year. Each year, the target year for the fiscal rules rolls forward a year. So if the last fiscal event of the parliament were to take place in March 2029 (with a general election due no later than August 2029), the target year would have moved on to 2033–34. While, at present, the medium-term forecasts published alongside fiscal events only cover five years, the OBR does produce a longer-term projection as part of its annual Fiscal Risks and Sustainability Report. Based on the latest long-term projections, and an assumed path for net investment spending, the current budget might be in deficit by 1.6% in 2033–34.¹²

In other words, based on this calculation, the margin against the current budget target would deteriorate over the parliament. By the end of it, tax rises or spending cuts would be required to continue to meet the target. So on this measure, the slightly more distant future looks no less challenging – if anything, more so. This is despite an improving current budget balance over

¹² The September 2024 Fiscal Risks and Sustainability Report's projection takes the March 2024 economic and fiscal outlook as its starting point. To construct the current budget, we assume investment spending remains constant as a share of national income after 2028–29. If the government's Green Prosperity Plan added to investment spending after 2030 (when the energy profits levy is set to expire), it would presumably add to borrowing and leave the current budget unchanged.

time *within* the five-year medium-term forecast horizon, and runs counter to the conventional wisdom that more time always makes a target easier to meet.

Part of the reason for this is that different approaches are taken to forecasting spending on public services for different periods:

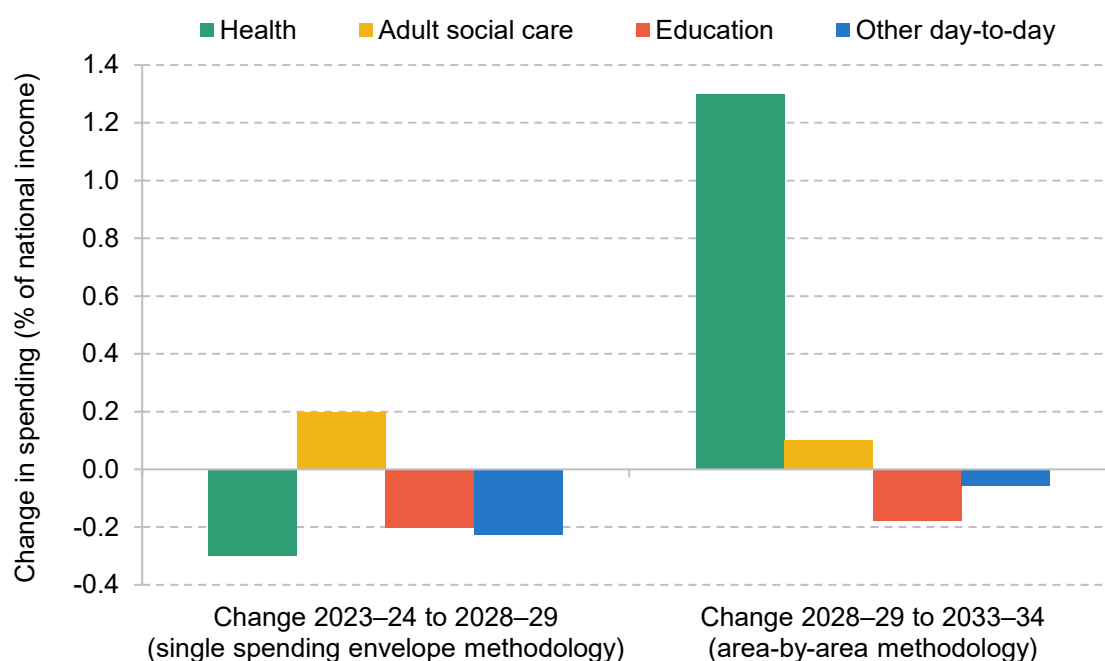
- **For the period covered by the current Spending Review**, planned spending totals for each department are used. Normally (with the notable recent exception of areas such as spending on the asylum system in the current year – see Warner and Zaranko (2024)), these plans are quite accurate.
- **For the period within the five-year forecast horizon but outside the Spending Review**, the Chancellor gives a single envelope for spending on public services, or provides a number for total public spending from which the OBR can derive what would be left for public services given its forecasts for spending on areas such as social security benefits and pensions and debt interest. In the past, this has not been a good guide to eventual out-turns. When the time comes to divide the overall allocation up between departments, substantial top-ups have typically been granted (see Section 3.5 in Chapter 3).
- **To construct the long-term forecast**, the OBR models spending on broad areas including health, adult social care, and education based on forecasts and assumptions for some of the underlying drivers of spending, including changes in incomes, demography and productivity.

Comparing the implied paths for spending on different areas (Figure 2.12) highlights how the two methodologies used for the period after the current Spending Review can come to different conclusions. Using the ‘single spending envelope’ methodology – which at the time of the March 2024 Budget forecast was the case for four out of the five forecast years – is not a credible central forecast of what is likely to happen.

The OBR’s medium-term projection (framed as ‘consistent with the March 2024 *Economic and fiscal outlook*’) is based on the assumption that the overall envelope for day-to-day public service spending will grow by an average of 1.0% per year in real terms. With average forecast real growth in the economy of 1.7%, this implies a reduction in spending as a share of national income. In the absence of department-level spending plans, the OBR projection appears to have assumed a largely proportional sharing of this cut in public spending as a share of national income, with a decrease in health spending of 0.3%, education spending of 0.2% and spending on ‘other’ public services of 0.2%.¹³

¹³ Spending on adult social care, in contrast, is growing in both periods. This is because while grants from central government to English local authorities are within departmental spending, which is being squeezed, much spending by local authorities on social care will be financed through council tax, which is within annually managed spending and is forecast to grow more quickly throughout the period.

Figure 2.12. Projected growth in spending by area as a share of national income based on OBR's 'single spending envelope' and 'area-by-area' methodologies



Note: 'Other day-to-day' excludes health, adult social care, education and welfare including pensions.

Source: Office for Budget Responsibility, Fiscal Risks and Sustainability Report (September 2024).

In contrast, over the following five years, the area-by-area methodology concludes that spending on health as a share of national income is likely to *grow* by 1.3%. This reflects pressures from a growing and ageing population and cost-increasing (rather than cost-saving) technological innovation.¹⁴ But these pressures are not purely a matter for the future – they are operating at all times, and past experience strongly suggests that they are accommodated.

Moreover, commitments in the previous government's NHS Long Term Workforce Plan – which Labour has also signed up to – will require increases in NHS funding well above the overall real-terms annual growth rate of 1.0%. Workforce costs are by far the largest component of public spending on health. So in the case of health, the long-term bottom-up forecast gives a much more realistic picture than the 'stated policy' methodology. The same applies to other areas of spending; Chapter 3 sets out plausible top-ups to currently stated spending plans.

In July's spending audit, the Chancellor announced a series of reforms to spending planning. Those include a commitment to holding Spending Reviews covering at least a three-year period at least every two years and giving the OBR additional powers to question ministers about spending plans. While modest in scale, these changes are sensible as they may help make stated

¹⁴ For example, new drugs or medical technologies are often more expensive than the prior standard of care.

spending plans somewhat more realistic. Very likely, this would lead to medium-term spending plans looking more like the bottom-up longer-term projection, since past governments have generally chosen to accommodate the demographic and other spending pressures it reflects and, at present, we see no reason to expect different from the new government.¹⁵

We discuss pressures on spending and revenues from demographics, the net zero transition and climate change, and other long-term changes in more detail in the following subsections.

Perhaps amending fiscal rules to target a longer time horizon could encourage more focus on these challenges. But this is far from clear-cut: calling them ‘long-term’ fiscal challenges should not distract from the – already known – fact that in order to achieve the best feasible outcomes, policy action is required within the current forecast horizon of five years. Early and gradual action, in advance of known challenges, is often better than sharp policy adjustments only made once an emergency has become impossible to ignore.

Some may be comfortable with allowing debt to rise in the next five years if they expect the government’s policies to lead to higher growth and, hence, contribute to lower debt as a share of the economy over a longer time horizon. But these benefits are uncertain and may only accrue after a very long time, as we also discuss below. There is nothing special about a five-year horizon for a fiscal rule, but there is a trade-off: rules with longer time horizons allow Chancellors more time to adjust gradually to new information and for longer-term investments to bear fruit. But the commitment implied by them is also weaker, as there is a (real or perceived) temptation to let uncomfortable fiscal realities, or unpopular policies, be the problem of the next Chancellor (or even the one after that).

Demographics

Changes to the size and composition of the population are key underlying drivers of spending pressures. Put simply, much public service and welfare spending disproportionately goes to support people at the beginning and towards the end of their life: providing healthcare and education when they are children, and pensions, healthcare and social care when they are at older ages. At the same time, less tax revenue is raised from these groups. The reverse is true of the working-age population, who on average pay more tax and typically receive less support from public services and the benefit system. Therefore, a simple way of summarising the demographic pressures on the public finances is the dependency ratio: the number of children

¹⁵ The commitment to regular three-year Spending Reviews would avoid the recent situation where the spending envelope for nearly all of the forecast horizon was based on tight stated plans for overall public service spending without any detail on where cuts should fall. Commenting on these spending plans to the House of Lords Economic Affairs Committee in January 2024, Richard Hughes, Chair of the OBR, said: ‘Some people have referred to that as a work of fiction. That is probably generous, given that someone has bothered to write a work of fiction, whereas the Government have not even bothered to write down their departmental spending plans’ (<https://committees.parliament.uk/oralevidence/14141/pdf/>). Three-year Spending Reviews and a five-year forecast horizon would still allow for two years of these ‘fictional’ spending plans.

and pensioners per 1,000 people of working age. Under the ONS's most recent population projection, published earlier this year, the dependency ratio rises steadily from 2027–28 onwards. This means that the further we look into the future, the more forecast demographic pressures on spending grow.

Of course, population projections are themselves uncertain and based on assumptions. One of them is that the fertility rate¹⁶ rises slightly over the next decade. Given a large and continuous fall in the fertility rate since its recent peak of 1.9 children per woman in 2010 to under 1.5 in 2022 – with only a small uptick during the pandemic – it would not be too surprising if it instead were to continue its trend and fall further. With fewer children born, this might lead to some savings being scored relative to the current projection in the near term. However, these savings – chiefly on education – could be difficult to achieve in practice: there may be large practical and political obstacles to cutting school funding in line with falling pupil numbers while maintaining quality of provision. And of course, in the longer term, fewer children eventually means fewer working-age people, reversing the positive public finance impact.

On the other hand, the latest projection assumes that net migration will have dropped from recent peaks to its equilibrium level of just under 360,000 people annually. However, every ONS projection since 2000 has underestimated eventual net migration – with the exception of 2020, when immigration collapsed during the initial phase of the COVID-19 pandemic (Sumption, Walsh and Brindle, 2024, figure 6). Total net migration averaged around 250,000 people a year over the course of this century and peaked at 764,000 in 2022. This means that the UK has gained almost 6 million people as a net effect of emigration and immigration over the past 20 years. Recent immigrants are somewhat more likely to participate in the labour market than the incumbent population (Office for Budget Responsibility, 2024a, box 2.3), in part for the simple reason that they are more likely to be of working age and less likely to be pensioners. Like the resident working-age population, they tend to pay more in taxes than they receive in benefits and spending on public services. If net migration were to once again overshoot the projection, and other past trends continued (e.g. employment rates among international students continued to rise), this would have a positive impact on the public finances. This would be especially true – at least on paper – if public service budgets were not increased to help accommodate such an ‘unexpected’ rise in net migration, and public services were left to absorb demand from a faster-growing population from within their existing budgets. Similarly, as the OBR discussed in its recent Fiscal Risks and Sustainability Report (September 2024), some potential changes in the composition of immigrants – for example, if for a given level of immigration, the average

¹⁶ The total fertility rate is the average number of live children that a group of women would bear if they experienced the age-specific fertility rates of the calendar year throughout their childbearing lifespan (Office for National Statistics, 2024).

migrant were higher-earning or stayed for a shorter period of time – would have a favourable fiscal impact.

State pension age

A key policy parameter mediating the impact of population ageing on spending on the state pension and pensioner benefits is the state pension age. Over the next few years, the public finances will be helped by the increase of the state pension age from 66 to 67 for men and women, due between 2026 and 2028. This will reduce borrowing by about £6 billion a year, mostly due to reduced state pension spending but also with a rise in tax revenues from those who delay their retirement and an increase in National Insurance contributions paid by those in work at age 66, offset by an increase in spending on working-age benefits.

Under current legislation – passed by the last Labour government in 2007 – the state pension age will rise from 67 to 68 between 2044 and 2046. The first independent review of the state pension age – led by John Cridland – in 2017 recommended bringing this forward by seven years (to 2037–2039). While the government at the time accepted this recommendation, it did not legislate for it. The subsequent independent review – led by Baroness Neville-Rolfe – in 2023 suggested that the timetable be pushed back to 2041–2043 in the face of longevity at older ages not increasing as quickly as previously projected. The government at the time ‘noted’ this recommendation, but pointed to uncertainties caused by recent shocks – most obviously the COVID-19 pandemic – and said that the state pension age should be reviewed again in the first two years of this parliament. This now needs to happen urgently. Both independent reviews have recommended that individuals should be given at least 10 years’ notice of any increase in their state pension age. That should be kept to, which could only be consistent with an increase in the state pension age in the 2030s (if so desired) if the next review concluded and the government legislated in the next few years.

The net zero transition and climate change

The public finances will be impacted by three climate-change-related processes:

- the cost of mitigating climate change and the transition to net zero (e.g. subsidising households to switch from gas boilers to heat pumps and losing revenue from fuel duties as drivers transition to electric vehicles);
- the cost of adaptation to climate change (e.g. installing air conditioning in hospitals, investing in flood defences and temporarily losing revenue from businesses that have to relocate from flood-prone areas);
- the cost of physical damage caused by climate change (e.g. repairing flood damage to infrastructure and losing tax revenue due to lower output in heatwaves).

The OBR analysed the fiscal cost of the net zero transition itself in 2021 and added analysis on climate-change-related damage this September (Office for Budget Responsibility, 2021 and 2024b).

The range of uncertainty, both over the way climate change will unfold and over future policy decisions, is wide. In a central scenario in 2021, the OBR assumed that the government would have to spend £12–18 billion in today's prices or around 0.4% of national income a year to subsidise the decarbonisation of the economy. At the same time, fuel duty, vehicle excise duty, and other aviation and waste revenues now bring in around 1.7% of national income, but these revenues are expected to fall to close to zero by 2050. When, at the beginning of this section, we described how the current budget deficit is set to grow over the early 2030s – making the government's fiscal rule harder to meet – this calculation included a reduction in revenues from fuel duties. By the end of the parliament, the target year will have moved to 2033–34, when the OBR expects that more than half of the vehicle stock will be electric.

On the other hand, carbon taxation could partly counterbalance additional net-zero-related spending and lost revenue. In the same central scenario from 2021, the OBR assumed that a comprehensive carbon tax introduced from 2026–27 will raise 1.8% of national income in additional revenue a year. This then gradually falls to around 0.5% of national income by 2050 as taxable carbon emissions fall.

The OBR has not updated the 2021 central scenario (dubbed an 'early action scenario'), or commented on whether such early action has become more or less likely in the intervening three years. In addition to the comprehensive carbon tax just mentioned, the 'early action' involves additional net zero-related spending rising to 0.7% of national income by 2027–28. As Figure 3.13 in Chapter 3 shows, current plans (as set at the 2021 Spending Review and adjusted for Labour's manifesto commitments) for 'green' spending fall well short of the OBR's 'early action' scenario. In other words, the 'early action' scenario requires significant policy action within the parliament, and within the forecast horizon at the upcoming Budget. If such policy action was delayed until the 2030s and the private sector did not step up to carry a correspondingly greater share of the whole-economy costs, the OBR estimated that the cumulative effect on debt by 2050 could more than double.

In the OBR's estimate, the annual direct fiscal cost of dealing with damage from floods and heatwaves is much smaller, at only around 0.04% of national income. However, while the net zero transition includes some one-off additional spending (such as retrofitting schools, hospitals and prisons), the costs of climate change damage are expected to continue to accrue indefinitely. A more important fiscal impact is indirect. The OBR estimates that climate change¹⁷ will reduce

¹⁷ The OBR models two scenarios for the rise in global average temperatures by 2100 of below 2°C and below 3°C. The economic impacts of these two scenarios do not differ significantly by 2050.

the size of the economy by around 2% by 2050, adding around 0.4% of national income to borrowing due to lower tax receipts and increased public spending pressures and another 0.3% due to higher debt interest spending. The analysis acknowledges that costs could rise sharply if ‘tipping points’ are breached, and does not include possible international impacts via trade and migration. These could be even harder to model with a sufficient degree of confidence, but could be incredibly important – not least because the UK is expected to suffer a smaller direct impact than many other countries.

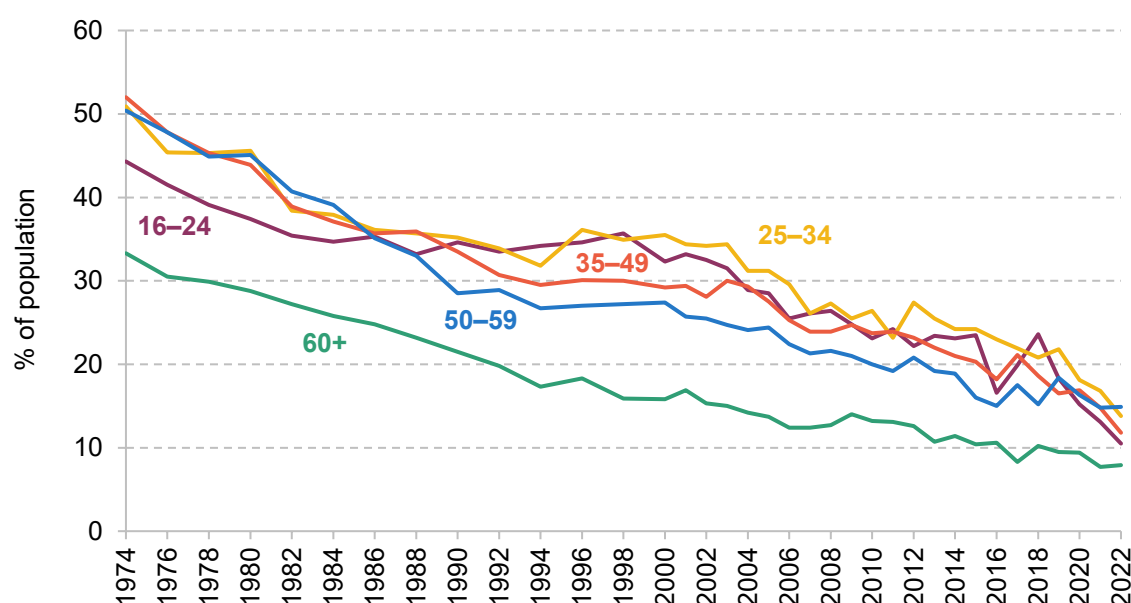
However, there is currently no comprehensive estimate of the costs of climate change adaptation so far. We do not even know how much we invest in adaptation at the moment – that is investment on top of what would have been spent on relevant infrastructure regardless of climate change (Office for Budget Responsibility, 2024b). Forecasting future spending is therefore even more difficult, also given the large uncertainty around the impacts of climate change in different scenarios. The OBR hopes to assess adaptation costs in more detail when more information becomes available. What we do know, however, is that the benefits of adaptation outweigh the costs – often by far – and that delaying action will make tackling the risks even harder (Watkiss, Cimato and Hunt, 2021).

The smoke-free generation

While revenues from tobacco duty have fallen by nearly a third in real terms over the last decade, they still stood at £9 billion in the last financial year. As the ‘smoke-free generation’ starts to account for an increasing share of the adult population, as a result of the plan to legislate so that those born on or after 1 January 2009 will never be able to buy tobacco legally in the UK, this revenue will continue to decrease and – if the policy is successful from a public health perspective – faster than it otherwise would. Just as with the OBR’s assumed carbon tax above, a feature of so-called ‘sin taxes’ is that the more successful they are in shifting the behaviour of businesses and consumers, the less revenue they will raise. In the OBR’s latest long-term projection, it assumes that revenues for tobacco duties decline to approximately zero by 2060.

However, a falling share of cigarette smokers – as shown in Figure 2.13 – has been accompanied by rising prevalence of vaping and e-cigarette use in recent years. Total use of nicotine products among adults – i.e. smoking plus vaping – remains virtually unchanged since 2010. There has been no reduction in the prevalence of smoking amongst young people aged 11–18, even as the prevalence of vaping has increased substantially (McNeil et al., 2022). The OBR’s projection assumes that a vaping duty, introduced at the March 2024 Budget, will be insufficient to replace lost revenue from tobacco duty. With some concern about unclear long-term health impacts of vaping among health researchers and advocates (Darzi, 2024), and added environmental concerns due to improper disposal of single-use vapes, there is scope for increased taxation of vaping products to pick up some of that tab.

Figure 2.13. Share of cigarette smokers in Great Britain, by age



Source: Office for National Statistics, adult smoking habits in Great Britain (2022 edition).

What can policy do for growth, and how long would it take?

One of the new government's 'missions' for office is to secure the highest sustained economic growth in the G7. Certainly, good policymaking can help growth and bad policymaking can hinder it. The government has also indicated a number of broad policy areas where it will be implementing reforms with at least an eye on boosting growth. This includes green investment, planning reform and industrial strategy. But prioritising growth may be harder than it sounds. Often, the reason that growth-friendly policies have not already been implemented is that there are real trade-offs with other legitimate considerations. The pursuit of 'sustained growth' will also require a great deal of patience from policymakers, and an understanding that the rewards will come far too late to benefit even their immediate successors in office. Finally, while policies that can be expected to deliver a modest boost to growth will often be worth pursuing, it is important to realise exactly how modest those responses might be. This subsection briefly describes each difficulty in turn.

There are real trade-offs

In his recent speech at the Labour Party conference, the new Prime Minister, Sir Keir Starmer, stated: 'the time is long overdue for politicians to level with you about the trade-offs this country faces'. He went on to set out some areas where there are genuine trade-offs, such as in criminal justice, energy generation, housebuilding, migration and management of the public finances.¹⁸ In

¹⁸ <https://labour.org.uk/updates/press-releases/keir-starmer-speech-at-labour-party-conference-2024/>.

a similar vein, there are many areas of policy where we know there are reforms that would be good for growth that are not being pursued because other political objectives are prioritised. For example, in trade policy, one of the most effective ways to boost growth would be for the UK to rejoin the EU single market and customs union. But the current government – like its predecessor – has ruled this option out.

Another case comes with the government's stated aims for its industrial strategy. These are far from limited to growth but include a diverse set of objectives: lower-carbon production processes, reduced geographical inequality, improved resilience in crises and more widespread workplace benefits. These are, of course, all perfectly valid objectives to pursue. So we may believe that the government has better information about the most growth-promoting investments than private sector investors. But it has already told us that it would not necessarily choose the investments that lead to the fastest-growing or most tax-rich economy, to the exclusion of all other considerations. Instead, it would choose the ones that offered the best outcomes across this whole range of objectives. Revisiting investment in the net zero transition discussed above, replacing gas boilers with heat pumps is a necessary endeavour to meet emission reduction targets. But it will not allow us to produce more warm homes per person – if it is successful, we will produce exactly the same number of warm homes, but in a lower-carbon way. Government investment and industrial strategy are likely to make trade-offs and prioritise other objectives over growth in many other cases.

The time horizon can be long

As we have described, the new government's fiscal rules, like those of its predecessor, are focused on the usual five-year forecasting horizon. Given we are at the start of the parliament, we can still expect purely self-interested policymakers to have an eye on the next decade; by the end of this parliament, the end of the forecast horizon could be 2033–34. And it is appropriate for policymakers to take a longer-term view; policies that will take an even longer time to improve growth may nevertheless be very worthwhile. However, even if a government expects its policies to lead to a bigger, more successful and/or more tax-rich economy in 20 or 30 years, it will still need to address more near-term public finance challenges in the interim.

It is also important for policymakers to understand *how* long the time horizons might need to be. A focus on a 10 -year horizon will often still be too short. Take the key plank of the government's plan to promote economic growth: planning reform to allow the building of 1.5 million new homes over the parliament. This is a growth-friendly policy. One way in which more housing at more affordable prices in the right locations could add to growth is through increased mobility of workers: high housing costs, especially in major cities, prevent some workers from moving to the places where they could be most productive. To the extent that additional housebuilding could keep house prices and rents down, this barrier to greater labour mobility and higher productivity could be reduced. But most workers do not continually revisit

their decision about which part of the country they would like to live and work in: people buy houses, start families and put down roots. The full benefits of additional housebuilding would likely take at least a generation to materialise, as a new cohort of young people feel more able to start their careers where the most productive firms for their skills and talents are located, rather than being put off from moving by high housing costs.

The scale of the growth impact might not be huge

Policies that led to a modest boost in sustained output could be incredibly worthwhile and, in the best case, public investment may encourage firms to increase their own investment in turn. But even some substantial policies might be expected to deliver remarkably small increases in national income. In a recent discussion paper, the OBR set out its approach to modelling the impact of additional public investment on national income (Suresh et al., 2024). This considers the estimated impact of a permanent, sustained increase in public sector net investment of 1% of national income – that is equivalent to £28 billion in 2024–25. With public sector net investment this year forecast to be £67 billion (2.4% of GDP), that would be a big rise. According to the OBR’s modelling, it would increase sustained output by 0.4% after five years and by 2.4% after fifty years. If correct, this means it would be adding less than 0.05% to the average annual growth rate over the next fifty years (and less than 0.08% to the average annual growth rate over the next five years).

Notably, this calculation is for ‘average’ public investment. Some projects – perhaps well-planned energy and transport infrastructure – may deliver bigger benefits. But some public investment projects, like the aforementioned replacement of polluting infrastructure, or investment in some public services, such as modernisation of the prisons estate, probably have no impact on growth at all. A modest addition to growth is likely still worth having. But it is not huge, and it will not solve all the Chancellor’s problems.

2.6 Conclusions: what should the Chancellor do?

The new Chancellor has inherited an unenviable public finance situation. A combination of much-elevated debt, higher interest rates than we were accustomed to in the 2010s and a weak outlook for growth makes even stabilising debt difficult, let alone getting it on a decisively falling path. Public spending is much higher as a share of national income than prior to either the pandemic or the Great Financial Crisis and yet many public services are showing obvious signs of strain. And taxes are at historic highs – at least by UK standards.

Budgets held in the first few months of a new parliament are often particularly significant, and especially so when there has been a change in the political colour of the Chancellor. The Office

for Budget Responsibility (OBR) estimates that Gordon Brown's July 1997 Budget pushed up revenues by the equivalent of £14 billion a year (in 2024–25 terms), while George Osborne's second Budget in October 2010 contained a net tax rise of £13 billion. On 30 October, a net tax rise of the scale of those two Budgets – or perhaps even bigger than that – does not seem out of the question.

At her inaugural Budget, Rachel Reeves will also set out the details of her fiscal targets. There is much to commend her commitment to aim for current budget balance over the medium term. But the Chancellor is yet to specify her precise target for the public sector balance sheet. Speculation about swapping the measure of debt targeted by the fiscal rule inherited from the previous government for another measure of the balance sheet has been abundant. While there are arguments for and against various options, we have particular concerns about the suitability of public sector net worth as a main fiscal target. It will remain the case that public sector net debt cannot be completely disregarded – whatever its flaws as a measure, it cannot be allowed to increase faster than national income indefinitely.

More fundamentally, there is nothing sacrosanct about how any of these measures is forecast to change between the ends of the fourth and fifth years of the forecast horizon. A serious focus on a longer-term horizon would be welcome but would require confronting the fact that the UK faces considerable fiscal challenges in the 2030s and 2040s due to factors such as the ageing of the population, the demise of fuel and tobacco duties, and costs associated with transitioning to net zero. Whatever measure Ms Reeves chooses, she should also continue with the previous government's sensible policy of reporting the full range of fiscal measures.

If the motivation behind a change in fiscal target is a desire to increase investment spending, combined with a belief that it is better (or only possible) to finance that spending through more borrowing rather than through higher taxes or lower day-to-day spending, then that case should be made explicitly. And, perhaps most importantly, it should then be followed up with a focus on ensuring that the increased investment budget is – and is seen to be – spent effectively. That requires selecting the right set of projects and then designing and delivering them in a cost-effective way, a task that governments have all too frequently failed to achieve.

Choosing an easier-to-meet target for the public sector balance sheet could allow Ms Reeves space to top up planned public sector net investment spending while complying with the letter of her new fiscal rules – though would not change any of the underlying trade-offs. But the Chancellor would still be left with plenty of difficult choices to make on taxation and day-to-day spending, since she will likely have little headroom against her target to achieve current budget balance.

Her room for manoeuvre will be in large part determined by the OBR's new forecast for the path of the public finances. She will also be constrained by the extent to which the spending pressures identified by the new government in July – including its decisions on public sector pay – are expected to persist. Taking Citi's baseline economic forecast and assuming just the public sector pay awards (and not, for example, the sizeable repeated overspends by the Home Office on asylum and immigration) persist, and after accounting for the specific tax and spending measures in Labour's manifesto, we estimate this would leave Ms Reeves with a current budget surplus of around £17 billion in 2028–29 (0.5% of national income). This would be little changed from the March 2024 Budget.

This scenario, however, leaves in place the overall spending assumptions bequeathed by Mr Hunt, under which unprotected spending departments would be facing real-terms cuts at next Spring's multi-year Spending Review. The new government has committed to 'no return to austerity' for public services. This is a similar pledge to that made by the first Chancellor of the previous parliament, Sajid Javid, who just prior to the 2019 general election set out plans that at the time implied no department faced a cut to its budget. Were Ms Reeves to adopt a similar position, again under the Citi baseline forecast, this could be consistent with being on course for current budget balance in 2028–29. But only just.

Simply maintaining day-to-day spending in real terms in areas such as skills, courts and prisons might – given the pressures on public sector pay (Chapter 4) and the desire to deliver significant improvements in service quality – prove to be insufficient. As set out in Chapter 3, an alternative scenario – where all services see their budgets rise at least in line with national income – would require an additional £17 billion of spending in 2028–29. Under Citi's baseline scenario and absent any cuts to spending outside of public services, such as to working-age benefit spending, this would require a tax rise of £16 billion, just to remain on course to deliver current budget balance in 2028–29. This would be on top of the £9 billion tax rise from specific measures set out in Labour's manifesto; so almost a £25 billion tax rise in total.

As ever, there also remains considerable uncertainty around how the economy and the public finances will evolve. Under Citi's optimistic scenario, this higher spending scenario would require no further tax rises to be consistent with current budget balance by 2028–29. But under Citi's pessimistic scenario, the size of the required fresh tax rise would triple to £49 billion, bringing the total tax rise (i.e. including manifesto measures) up to almost £58 billion. This uncertainty has meant that past Chancellors have often built in some 'headroom' rather than aiming to meet their fiscal target precisely. In that spirit, even Citi's baseline scenario could motivate a bigger than £25 billion tax rise from manifesto and new measures. To govern is to choose. And on 30 October, Ms Reeves will need to choose.

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3. Options for the 2024 Spending Review and beyond

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Key findings

1. **This October, the new Chancellor, Rachel Reeves, will conduct a one-year Spending Review**, setting detailed departmental allocations for 2025–26. Alongside this, she will update plans for the overall level of departmental spending – the ‘spending envelope’ – for 2026–27 onwards. Next spring, she will hold a multi-year Spending Review, setting departmental spending totals for 2026–27 onwards. **Her decisions at these Spending Reviews will be of great economic, fiscal and political importance.**
2. **Shortly after taking office, Ms Reeves published Treasury analysis that claimed to reveal £22 billion of additional in-year spending pressures for 2024–25.** Some of these pressures – most notably, additional spending on public sector pay – will be permanent. **This only adds to the scale of what was already a daunting challenge: the new government has inherited a tight set of spending plans** that would see day-to-day spending on public services grow by just 1% per year (implying cuts to some unprotected departments) and cuts to capital budgets.
3. **The overarching challenge facing the Chancellor is that – as has been apparent for some time – those spending plans for future years are almost certainly going to need to be topped up.** Given the pressures on a whole range of public services and the ambitious promises in the Labour manifesto, the only question is one of scale.
4. **The one-year Spending Review to be concluded this autumn will agree final departmental budgets for 2024–25 (in light of in-year overspends) and set detailed allocations for 2025–26.** Here, the key issue is the extent to which budgets for this year and next are increased to reflect recent public sector pay deals and other in-year pressures, and the extent to which departments are instead asked to absorb higher costs. **Which departments are prioritised for additional funding – and**

which, if any, are left facing real-terms cuts – will be revealing, as will the extent to which investment is prioritised over immediate day-to-day pressures.

5. Alongside these short-term allocations, **the even more fiscally consequential choice to be made this autumn is over the spending envelope for the rest of the parliament.** Just to maintain the 1% real growth assumption bequeathed by Jeremy Hunt, fund this year's pay pressures on a permanent basis and honour the specific spending commitments in the Labour manifesto, **we estimate that day-to-day departmental spending (RDEL) will need to be topped up by £14 billion in 2028–29.** This is, in effect, the 'status quo' scenario. Given commitments on areas such as the NHS, defence, aid and childcare (which would see spending on those areas increase more quickly), **this would still mean making cuts to some unprotected public services.**
6. **If Ms Reeves also wishes to avoid making cuts to unprotected budgets, we estimate that she would need to increase her day-to-day spending plans for 2028–29 by a further £16 billion (£30 billion in total, enough to deliver average real-terms growth of 2.0% per year).** Even if these budgets are spared real-terms cuts and rise with inflation, maintaining delivery of public services such as prisons and the police could still be challenging. To instead increase funding for these areas in line with national income would require funding to be topped up by a further £17 billion (or £47 billion in total) in 2028–29. These are illustrative scenarios but highlight that **the required top-ups can get quite large, quite quickly, under seemingly reasonable assumptions.** Even this £47 billion top-up to the day-to-day spending total would only take average real-terms growth to 2.8%: less generous than the 3.3% initially planned at the 2021 Spending Review (though the subsequent surge in inflation eroded that to 2.2%).
7. Ms Reeves and Sir Keir Starmer have indicated that they intend to prioritise capital investment. **We estimate that the Labour manifesto implies an additional £6 billion of capital spending in 2028–29. Even with this increase, capital spending (CDEL) would fall by 0.8% per year in real terms over the next four years.** Avoiding real-terms cuts to departments' capital budgets would require spending to be £10 billion higher in 2028–29 than under previous government plans (£4 billion on top of our £6 billion estimate of Labour's manifesto commitment). Growing capital spending in line with national income would require spending to be £19 billion higher in 2028–29 than previous government plans. This would still be considerably less ambitious than the original Labour plan for £28 billion of additional green investment per year.

8. **Taking day-to-day and capital spending together, we estimate that just delivering the manifesto and funding additional public sector pay pressures would require total departmental spending (TDEL) to be £20 billion higher than current plans in 2028–29.** Avoiding real-terms cuts to unprotected RDEL and overall CDEL on top of this would require a total increase of £40 billion. And growing unprotected RDEL and overall CDEL in line with national income would require a total increase of £66 billion.
9. Some of the in-year spending pressures identified by Ms Reeves stem from the poor budgeting practices of the previous government. **But most stem from the fact that the generosity of departmental budgets has become detached from what those departments have been asked to deliver.** Cumulative economy-wide inflation over the three years covered by the last Spending Review is now forecast to be more than twice as high (15% versus 7%). Departments budgeted for pay awards of around 3%, 2% and 2% in those three years; in the event, they turned out closer to 5%, 6% and 6%. **Had day-to-day funding grown at the rate originally planned, it would have been £10 billion higher in 2023–24** (even after the ad hoc top-ups to budgets for that year). On top of that, the UK population has grown by 1.8 million (2.7%) since 2021–22, versus a forecast of 800,000 (1.1%) in October 2021, which will have added to the pressures on (some) departmental budgets.
10. There was no crystallising moment since the last Spending Review to force the previous government to reassess the adequacy of departmental budgets in light of substantially higher inflation and population growth. Ms Reeves has set out proposed changes to the fiscal framework that would, if kept to, go some way towards addressing this. In particular, holding a three-year Spending Review every two years would reduce the extent to which planning assumptions can be overtaken by events, and reduce the extent to which the generosity of departmental budgets and the demands on departments can diverge. This is sensible, but **the Treasury should also consider introducing a *force majeure* clause that automatically triggers a new Spending Review when inflation or pay awards come in outside of a pre-agreed range.**

3.1 Introduction

Since the new government took office, there has been significant focus on the spending pressures facing departments in the current financial year, 2024–25. According to the Treasury, these pressures amount to some £22 billion over and above what had been budgeted for. It is, of course, customary for a new Chancellor taking office after a change of government to declare,

aghast, that the government's finances are in a worse state than they had expected. Nonetheless, Rachel Reeves does have some grounds for her claim: the extent of some of the pressures does indeed seem to be greater than could be discerned from the outside, and some of the previous government's budgetary practices leave a lot to be desired.

Yet she cannot claim to have been caught unawares by the broader fiscal challenge awaiting her on entering HM Treasury. This has been long apparent and long ignored by both the Conservative and Labour parties. It can be ignored no longer.

The new government has inherited spending plans that would see day-to-day funding for public services grow by 1% per year in real terms after this year. Given commitments on the NHS, defence, overseas aid and childcare, this implies cuts to some unprotected areas of government. These plans also imply cuts to government investment. Avoiding these cuts would require spending plans to be topped up by tens of billions. This was the problem all political parties knew would be waiting if they won the election. To the extent that any of the in-year overspends identified by Ms Reeves prove permanent, they add to the scale of this challenge but leave its broad contours unchanged.

The key problem of the last few years has been that the purchasing power of public service budgets has become detached from the demands and expectations on those budgets. Higher-than-expected inflation (which has unsurprisingly fed through into higher-than-expected pay awards) has eroded the real-terms value of the budget increases set out in the 2021 Spending Review, and higher-than-expected population growth has further reduced the generosity of per-person budgets. In other words, budgets are lower than anticipated and intended, but the pressures on public services have not reduced in line (or at all). This, combined with disappointing public service productivity, helps to explain why public services are in such a poor state.

Given the poor state of many public services, the ambitions and commitments in the Labour manifesto, and the scale of the public sector pay awards announced over the summer, it seems inevitable that the previous government's spending plans will need topping up. The only questions are by how much, and from where this funding will come, given the Chancellor's stated commitment to 'ironclad' fiscal rules and her promise not to raise the main rates of income tax or to increase National Insurance and VAT. It is one thing to sidestep these trade-offs when running for office. But it will not be possible to sidestep them at the Budget and one-year Spending Review this autumn, or at the multi-year Spending Review concluding next spring, when these issues will need to be confronted and considered in the round.

In this chapter, we consider the Chancellor's options at the imminent one-year Spending Review and the forthcoming multi-year Spending Review.¹ The focus throughout is on spending by departments – roughly speaking, spending on public services – as it is this spending that will be subject to the Spending Review process. The reader should bear in mind that this is less than half of all government spending, and that policy decisions on areas such as social security benefits and state pensions (e.g. on the winter fuel payment, the two-child limit, or the freeze to local housing allowance rates) and debt interest (e.g. on changes to reserve remuneration) will also need to be weighed alongside any changes to funding for public services. Changes in the assumptions and drivers of spending on those areas (e.g. the future path for global interest rates, or the rate at which people flow onto health-related benefits) could also ease or heighten the funding constraints on public services.

We begin in Section 3.2 by setting out the spending framework, defining key terms and describing what happens at a Spending Review. In Section 3.3, we draw out lessons from the last Spending Review and suggest ways in which the framework might helpfully be reformed. In Section 3.4, we explore the nature and scale of the future spending challenge, taking into account the previous government's spending plans, Labour's manifesto promises and the in-year spending pressures unveiled in the July spending audit. In Section 3.5, we bring all of this analysis together and assess the options facing the Chancellor, including a number of scenarios for how much of a top-up to existing spending plans might be required. Section 3.6 concludes.

3.2 A beginner's guide to public spending

Some definitions

Total UK government spending in 2023–24 (total managed expenditure, or TME) amounted to a little more than £1.2 trillion. Since 1998, this total has been split into two categories:

- **Departmental expenditure limits (DEL)** can be broadly thought of as spending by central government on public services. The idea is for DEL to encompass spending that can be predicted and controlled by departments (rather than being driven by, for example, the economic cycle). It includes spending on things such as the NHS, the courts system and schools. Within DEL, departments are set separate limits for resource (current, or day-to-day) and capital (investment) spending. These are referred to as resource DEL (RDEL) and capital DEL (CDEL). It is RDEL and CDEL allocations that are agreed with departments,

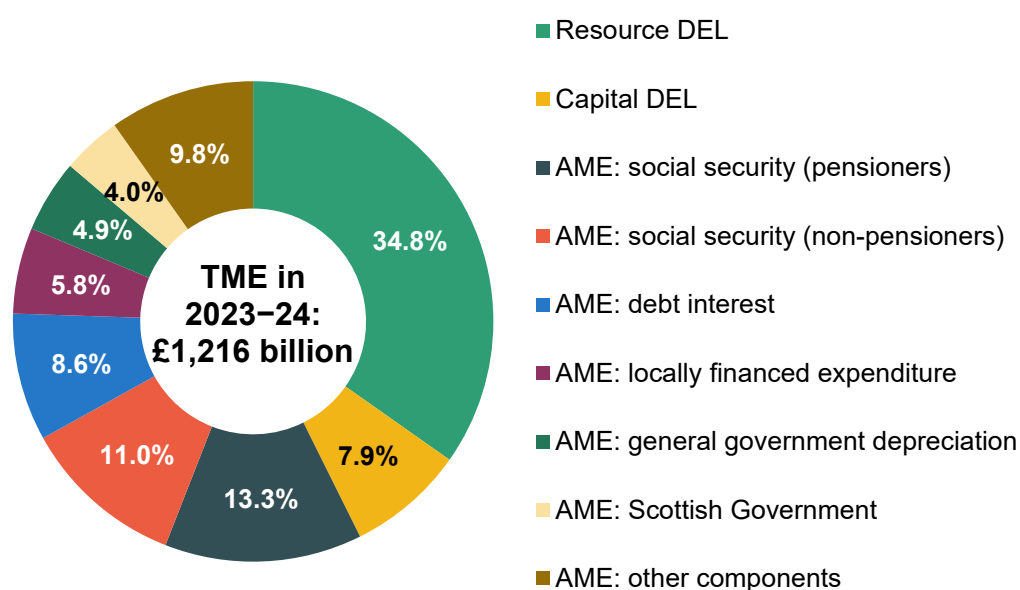
¹ Responsibility for overseeing the Spending Review officially lies with Darren Jones, Chief Secretary to the Treasury, but we frame the choices throughout as being those of the Chancellor, as it will be Ms Reeves who presents the plans to parliament alongside the Budget and who balances the high-level choices over spending, tax and borrowing.

often for multiple years at a time, at Spending Reviews. The measure of RDEL used as the Treasury's 'control total' excludes depreciation.

- **Annually managed expenditure (AME)** includes the categories of spending that are more volatile, demand-led and difficult to plan. This spending – which the government argues cannot reasonably be subject to firm multi-year limits – includes things such as debt interest payments, social security benefits and state pensions. It also includes spending by devolved or local governments financed through the taxes that they control.

Figure 3.1 breaks down TME into its subcomponents within DEL and AME. Around 35% of all spending is classified as resource DEL, or RDEL, and can be thought of as day-to-day spending on most public services, including things such as staff costs. A further 8% of total spending is classified as capital DEL, or CDEL, which covers money spent by departments on building or maintaining physical government assets, such as roads and buildings. Combined, resource DEL and capital DEL make up total DEL (TDEL), which amounted to around 43% of total government spending in 2023–24 (at around the level it has been since 2014–15, down from 48% in 2009–10 which was prior to big cuts to some departmental budgets).

Figure 3.1. Components of total managed expenditure (TME) in 2023–24



Note: £ billion figure shown is nominal (cash terms). Resource DEL refers to OBR definition of public sector current expenditure in resource DEL (PSCE in RDEL). Capital DEL refers to OBR definition of public sector gross investment in CDEL (PSGI in CDEL). 'Other components' of AME includes, for example, net public service pension payments, spending by funded public sector pension schemes, spending by the BBC and public corporations, current VAT refunds, environmental levies, expenditure transfers to the EU, spending on energy support schemes and student loans.

Source: Authors' calculations using table A.7 of OBR March 2024 Economic and Fiscal Outlook, with the pensioner/non-pensioner split calculated based on DWP Benefit Expenditure and Caseload Tables 2024.

Within AME, the biggest items are spending on social security for pensioners (i.e. the state pension and other pensioner benefits, 13.3% of TME), social security for working-age adults and children (11.0%) and debt interest (8.6%). Locally financed expenditure (such as spending by local authorities financed out of council tax and business rates revenues) makes up a further 5.8% of TME. General government depreciation (the reduction in the value of central and local government assets over time) is 4.9% of TME and spending by the Scottish Government (which was moved from DEL to AME in October 2018) accounts for a further 4.0%.

The Spending Review framework

The introduction of the DEL/AME distinction in 1998 also saw the introduction of the Spending Review process. This framework has several key features:²

- **Limited in scope.** Only spending classified as DEL is subject to the Spending Review process. The previous section showed that DEL makes up well under half of overall government spending, and a smaller fraction than it did in the past.³ More than half of all spending therefore falls outside of the scope of the Spending Review process.
- **The current/capital distinction.** Resource and capital budgets (RDEL and CDEL) are set separately. The aim behind this was to encourage departments to undertake the public investment that had been budgeted for, and to discourage them from cutting back investment budgets to meet day-to-day pressures (HM Treasury, 1998). Transfers from CDEL to RDEL are possible but discouraged and must be approved by the Chief Secretary to the Treasury; transfers from RDEL to CDEL are subject to fewer controls (HM Treasury, 2024a).
- **Cash spending limits.** Departmental expenditure limits are set as an annual cash ceiling, with no automatic adjustment or reassessment if costs turn out to be different from what was initially expected. The intention is to provide departments with a greater incentive to control costs.
- **Multi-year budgeting.** Historically, Spending Reviews have tended to cover a period of three years but have covered as few as one (in 2013, 2019 and 2020) and as many as four (in 2010 and 2015) – see Table 3.1. The most recent Spending Review, held in October 2021 when Rishi Sunak was Chancellor and Boris Johnson was Prime Minister, set departmental allocations for 2022–23, 2023–24 and 2024–25. The idea behind multi-year budgeting is to provide departments with some degree of certainty to allow them to plan more effectively and efficiently.
- **Flexibility to move funding between years.** To discourage wasteful spending at year-end, departments have some ability to carry forward unspent funds into future years via ‘Budget

² For a more detailed discussion of these changes and a recent history of public spending control, see Crawford, Johnson and Zaranko (2018). For an even more detailed and comprehensive discussion, see Hood et al. (2023).

³ At the 2010 and 2015 Spending Reviews, some components of AME – most notably, spending on working-age social security – were also included within the ‘envelope’, with savings sought from these budgets in a similar way to those sought from departments. This remains the exception rather than the rule, however.

Exchange', though any underspends must be surrendered in advance and there are limits on how much can be carried forward.⁴

- **A contingency Reserve.** As well as detailed departmental allocations, the overall expenditure limits agreed at Spending Reviews include an unallocated 'Reserve' set aside for 'unforeseen, unaffordable and unavoidable' spending pressures (HM Treasury, 2024a).
- **Integrated into the broader fiscal framework.** Spending Reviews have typically, but not always, been concluded alongside a major fiscal event, such as a Budget or Autumn Statement. One useful purpose they serve is as a crystallising moment, when the government is forced to choose between competing priorities in the round – for instance, whether to give funding to one department or another, whether to prioritise public service spending over social security spending, or whether to prioritise higher public spending over tax cuts or reductions in borrowing.

Table 3.1. Periods covered by Spending Reviews

Date of Spending Review	Number of years covered	Financial years for which departmental limits set
July 1998	3	1999–00 to 2001–02
July 2000	3	2001–02 to 2003–04
July 2002	3	2003–04 to 2005–06
July 2004	3	2005–06 to 2007–08
October 2007	3	2008–09 to 2010–11
October 2010	4	2011–12 to 2014–15
June 2013	1	2015–16
November 2015	4 (5 for capital DEL)	2016–17 to 2019–20 (to 2020–21 for capital DEL)
September 2019	1	2020–21
November 2020	1	2021–22
October 2021	3	2022–23 to 2024–25
<i>October 2024</i>	<i>1</i>	<i>2025–26</i>
<i>Spring 2025</i>	<i>(at least) 3</i>	<i>2026–27 to (at least) 2028–29</i>

Note: Rows in italics refer to Spending Reviews for which the timetable has been announced but which have not taken place yet.

Source: HM Treasury Spending Review documents (various).

⁴ Prior to 2010, departments were automatically able to carry forward 100% of any underspends via the 'End Year Flexibility' scheme – see Hood et al. (2023).

Announcements from the new government

In the spending audit presented to parliament on 29 July, Ms Reeves focused on the scale of the in-year spending pressures facing the government (discussed in the next section), but she also revealed the timetable on which departmental spending plans will be set for the coming years. Alongside the Budget on 30 October, the Chancellor will confirm final spending totals for 2024–25, set detailed departmental allocations for 2025–26 and, presumably, set an overall path for public spending – set what is known as the ‘spending envelope’ – for the subsequent years. The government has then committed to a multi-year Spending Review in Spring 2025, which will set departmental allocations – i.e. allocate the overall envelope – for a minimum of three further years (from 2026–27 to at least 2028–29).

This strikes a welcome balance, sensibly giving departments notice of their budgets for next year while leaving enough time for the government to develop more of a fiscal strategy and decide upon its public service priorities for the remainder of the parliament, ahead of the main event next spring. The options and choices facing the government at these events are discussed in more detail in Section 3.5.

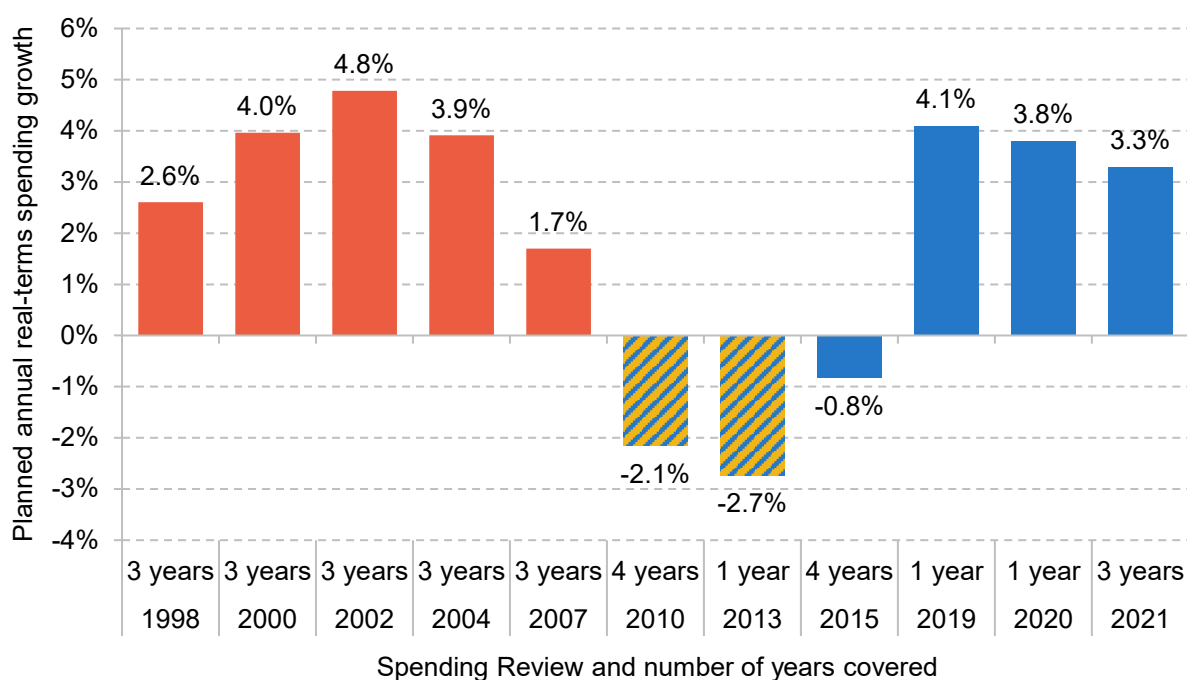
The Chancellor also announced several sensible reforms to the spending framework on 29 July. First, she announced that the Treasury would be required to share its assessment of departments’ financial positions in the current and following financial years with the Office for Budget Responsibility (OBR) before forecasts are made. The intention is to improve the OBR’s ability to forecast under- or over-spends, though one might question why this information was not previously flowing from HM Treasury, and other departments, to the OBR.

Second, she committed to holding a Spending Review every two years, each covering a minimum duration of three years. Having reviews more frequently should prevent planning assumptions from becoming too out-of-date (an issue discussed in more detail below) and make it more difficult for a Chancellor to pencil in unrealistically low spending plans for future years that they have no intention of sticking to. A regular review every two years will also force a crystallising moment upon the government and make it more difficult to kick problems down the road. This is a welcome change and is in line with previous recommendations from the Institute for Government (Tetlow, Bartrum and Pope, 2024).

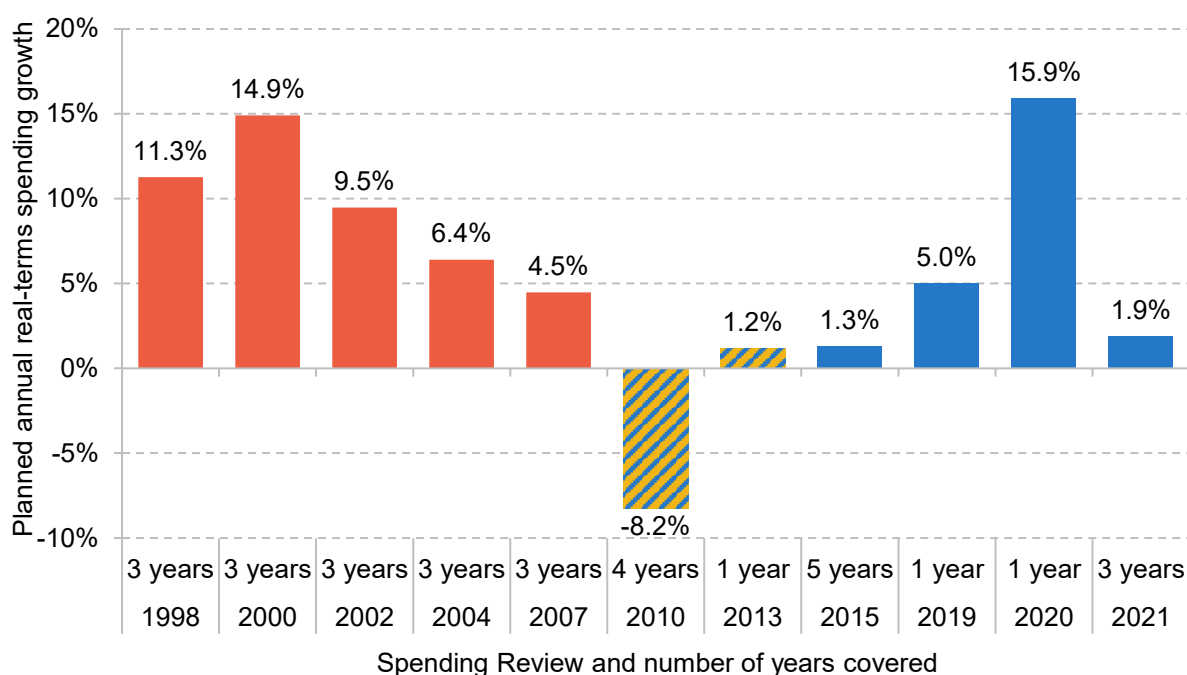
All that said, one potential risk with this new set-up is that the third year of each set of spending plans – the overlapping year, budgets for which will be revisited at the Spending Review two years later – might come to be disregarded, because departments view them as likely to change. This was the experience of the 2000s, when the third year of overlapping Spending Review plans tended to get topped up (Crawford, Johnson and Zaranko, 2018). That could undermine departments’ ability to plan: rather than having three years of budgets they can confidently

Figure 3.2. Planned average annual real-terms spending growth, by Spending Review

Panel A. Resource DEL



Panel B. Capital DEL



Note: Figures denote the *planned* average annual growth rate in Treasury definitions of RDEL (excluding depreciation) and CDEL, and not the out-turn. The Spending Review 2020 figure is the average real-terms growth rate between 2019–20 and 2021–22 due to the atypical movement of the GDP deflator during the pandemic. The colour of each bar denotes the party in government at the time of each Spending Review.

Source: Authors' calculations using HM Treasury Spending Review documents (various) and HM Treasury GDP deflators (various).

regard as firm and fixed, they may have to manage with just two. But even that would be an improvement on the practice of the last few years.

The (intended) generosity of previous Spending Reviews

Figure 3.2 shows the rate of average annual real-terms growth planned for departments' day-to-day budgets (Panel A) and investment budgets (Panel B) at previous Spending Reviews. Note that this is what was *planned*, not what actually happened in the out-turn. These graphs do not reflect any inflation forecast errors nor any subsequent changes to budgets (an issue to which we return below). But they do give an indication of how generous previous Chancellors intended to be at each Spending Review. In both panels, one can see the relative largesse of the 2000s, followed by the sharp cuts of the 2010s, followed by steady real-terms increases planned since 2019.

3.3 Lessons from the last Spending Review

We now turn to a discussion of the experience since the October 2021 Spending Review, which was conducted under the Chancellorship of Mr Sunak, and draw out some lessons for the future. Readers interested only in the outlook for departmental funding at the forthcoming Spending Review may wish to skip this section.

Challenges during the 2021 Spending Review period

Unexpected inflation and the erosion of planned real-terms increases

The main challenge during the 2021 Spending Review period has been that inflation has been much higher than was expected when budgets were set in October 2021. At a Spending Review, departmental budgets are set in cash terms. But what really matters for departments is what those cash budgets can purchase: the number of staff that can be hired, the number of school textbooks that can be purchased, and how many offices can be kept warm in the winter. Higher-than-expected inflation has meant that budgets were less generous *in real terms* than originally intended.

The Treasury uses the GDP deflator, a measure of domestic economy-wide inflation, to measure the inflation faced by departments.⁵ In October 2021, the GDP deflator was expected to grow by 2.3% per year on average between 2021–22 and 2024–25. In the event, inflation over this period has been much higher than that forecast. This is in part because Russia's invasion of Ukraine

⁵ There are concerns that the GDP deflator was a relatively poor measure during the pandemic (https://x.com/BenZaranko/status/1508852409271046145?s=20&t=grSo-zy_KcUejRh40jSUA) and that it may understate cost pressures for certain public services (Sibieta, 2024) but we do not address those here.

pushed up global energy and food prices, and in part because of tightness in the UK's labour market (Office for Budget Responsibility, 2023). The latest official forecasts suggest that the GDP deflator will have increased by an average of 4.7% per year over the Spending Review period, more than double the initial forecast of 2.3% per year. Put another way, cumulative economy-wide inflation over the three years is now forecast to be more than twice as high (15% versus 7% – as shown in Figure 3.5 later).

This higher-than-expected increase in prices has reduced the real-terms generosity of departmental spending plans. At the 2021 Spending Review, cash budgets and inflation forecasts together implied that total day-to-day departmental spending would grow by 3.3% per year in real terms between 2021–22 and 2024–25. Had those cash budgets been left unchanged, higher inflation means that spending would in fact have grown over this period by an average of just 0.9% per year.

In reality, cash budgets did not remain fixed at the levels set out at the 2021 Spending Review: various departments received top-ups to spending at subsequent fiscal events. In some cases, this was to compensate for higher inflation: at the 2022 Autumn Statement, for instance, NHS England was given an extra £3.3 billion for each of 2023–24 and 2024–25 to address financial pressures on the system. In some cases, the top-up was to fund genuinely new policy commitments (not, therefore, increasing the real generosity of core budgets): the 2023 Spring Budget allocated an additional £2.4 billion to the Department for Education in 2024–25 to enact childcare reforms and an extra £250 million to the Department for Work and Pensions to introduce a new employment support programme for disabled people. Figure 3.3 shows how the planned real-terms growth rate in selected day-to-day budgets has in fact changed between the 2021 Spending Review and the 2024 Spring Budget.

The 2024 Spring Budget implied that overall day-to-day spending would grow by 2.2% per year in real terms between 2021–22 and 2024–25, compared with the 3.3% initially planned at the 2021 Spending Review.⁶ Had day-to-day spending grown at the real-terms rate planned in October 2021, departmental budgets would have been around £15 billion higher in 2024–25 than they were set to be at the 2024 Spring Budget.

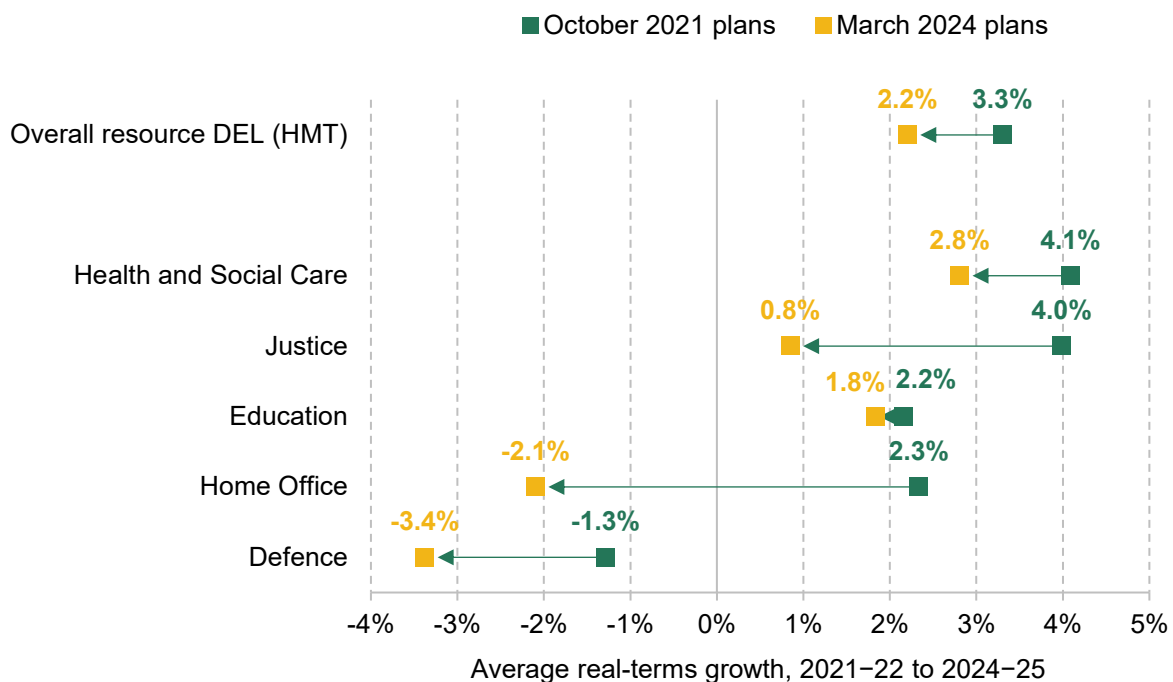
The reduction in the real-terms generosity of plans since October 2021 has not been distributed equally across public services, not least because some departments have been compensated for higher inflation to a greater degree by the Treasury. The Department of Health and Social Care,

⁶ Note that Figure 3.3, as well as reflecting changes in inflation forecasts and 2024–25 departmental allocations, also reflects changes to the 2021–22 baseline between Spending Review 2021 and Spring Budget 2024. This channel helps to explain, in particular, why the fall in the planned growth rate for the Home Office is especially large – out-turn Home Office funding in 2021–22 was higher than planned at the 2021 Spending Review, pushing down the growth rate.

for instance, has received billions of additional funding and so has seen a smaller reduction in its real growth rate (from 4.1% to 2.8%) than justice (from 4.0% to 0.8%) or the Home Office (from 2.3% to minus 2.1%).⁷ The Department for Education has seen a particularly small reduction, with its average real-terms funding growth rate dropping from 2.2% to 1.8% – though this largely reflects additional funding for additional responsibilities, most notably the expansion in childcare subsidies for working families.⁸

The point is that all departments considered here – even those that have received funding top-ups – are worse off than was intended at the time of the last Spending Review. That said, it is also important to stress that day-to-day spending was still growing overall at a rate of more than 2% per year – less generous increases than the recent past, but considerably more generous than the period between 2007 and 2019 (see Figure 3.2).

Figure 3.3. Planned average real-terms growth in selected day-to-day budgets over 2021 Spending Review period, in October 2021 and March 2024



Note: Figures for 2024–25 are as stated in the Spring Budget 2024, and do not account for any in-year top-ups some budgets will receive at the Supplementary Estimates, nor for any allocations of SCAPE funding, nor any other in-year changes.

Source: Spring Budget 2024, Spending Review 2021 and GDP deflators (various).

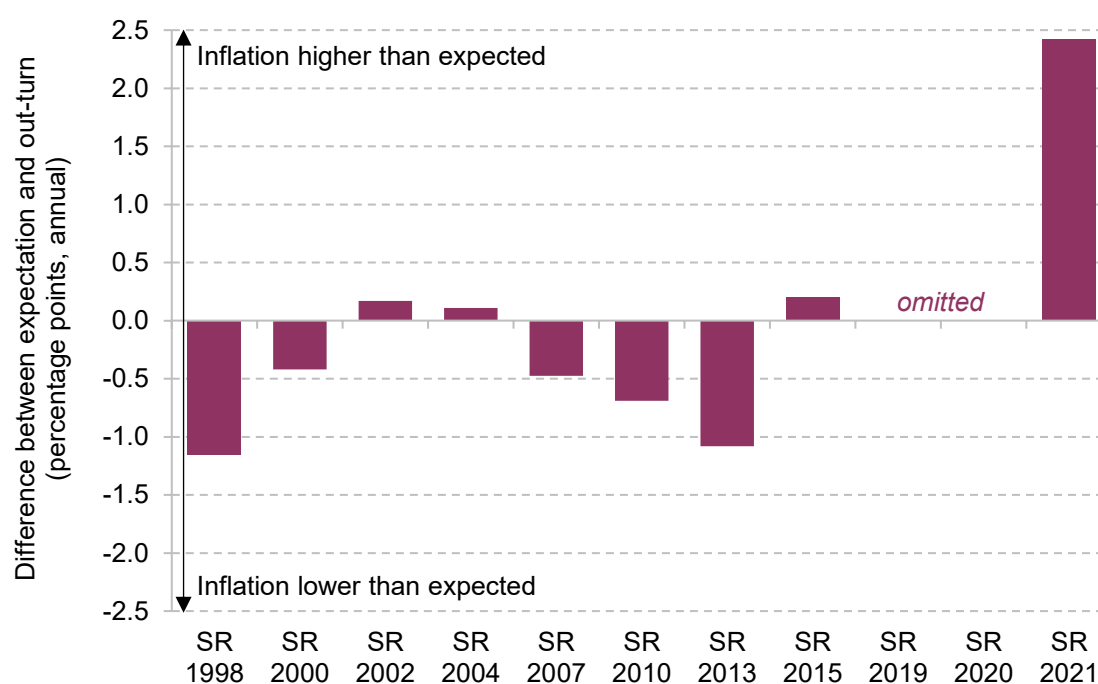
⁷ This does not account for the likely top-up to Home Office RDEL at the Supplementary Estimates later in the financial year – see Warner and Zaranko (2024).

⁸ When spending on new childcare commitments in 2024–25 is stripped out of the Department for Education budget, the real-terms funding growth rate over the 2021 Spending Review period falls to 1.1%.

An additional pressure on (some) departmental budgets has come from faster-than-expected population growth. In October 2021, the UK population was forecast to grow by 1.1% (around 800,000) between 2021–22 and 2024–25. Forecasts from March 2024 point instead to population growth of 2.7% (around 1.8 million) over that period.⁹ This has further reduced the generosity of real-terms budgets *per person*. In some cases (e.g. defence), it is not obvious that a larger population will meaningfully alter the pressures on budgets (though if a bigger population pushes up GDP, then more spending would be required to meet the 2% of GDP NATO target); in others (e.g. GP services), it is more obvious that it will.

When setting budgets for the future, it is necessary to rely on forecasts (of inflation, population growth and much else besides). Economic forecasts will always differ from the subsequent out-turn, to a greater or lesser extent. The problem is that the gap between forecast and out-turn has been much greater over this Spending Review period than in the past and that has coincided with a period when economic conditions have worsened considerably. Departments have, as a result, been asked to absorb much greater unexpected cost pressures than in previous periods.

Figure 3.4. Percentage point difference between expected average annual GDP deflator growth and the out-turn over Spending Reviews since 1998



Note: We exclude the two single-year pandemic Spending Reviews (2019 and 2020) as these were affected by measurement issues with the GDP deflator. Figures for SR 2021 include forecasts for GDP deflator inflation in 2024–25.

Source: Office for Budget Responsibility, Economic and Fiscal Outlook (various).

⁹ These figures have been calculated using supplementary expenditure table 3.3 of the OBR's October 2021 Economic and Fiscal Outlook and detailed expenditure table 4.3 of the OBR's March 2024 Economic and Fiscal Outlook.

Figure 3.4 shows the difference between the expected average growth in the GDP deflator over each Spending Review period since 1998 and the eventual out-turn (excluding the two one-year Spending Reviews in 2019 and 2020 which were affected by measurement issues with the GDP deflator during the pandemic). The forecast error over the 2021 Spending Review period – a 2.4 percentage point difference between the forecast of 2.3% and the out-turn of 4.7% – is by far the largest. Indeed, most of the other errors have been in the opposite direction, with inflation coming in below forecast, meaning that, all else equal, departmental budgets turned out more generous than expected when they were set – with this being particularly true of the Spending Reviews that reported in 1998 and 2013.¹⁰ Below, we consider possible changes that could make the spending framework more resilient to such shocks.

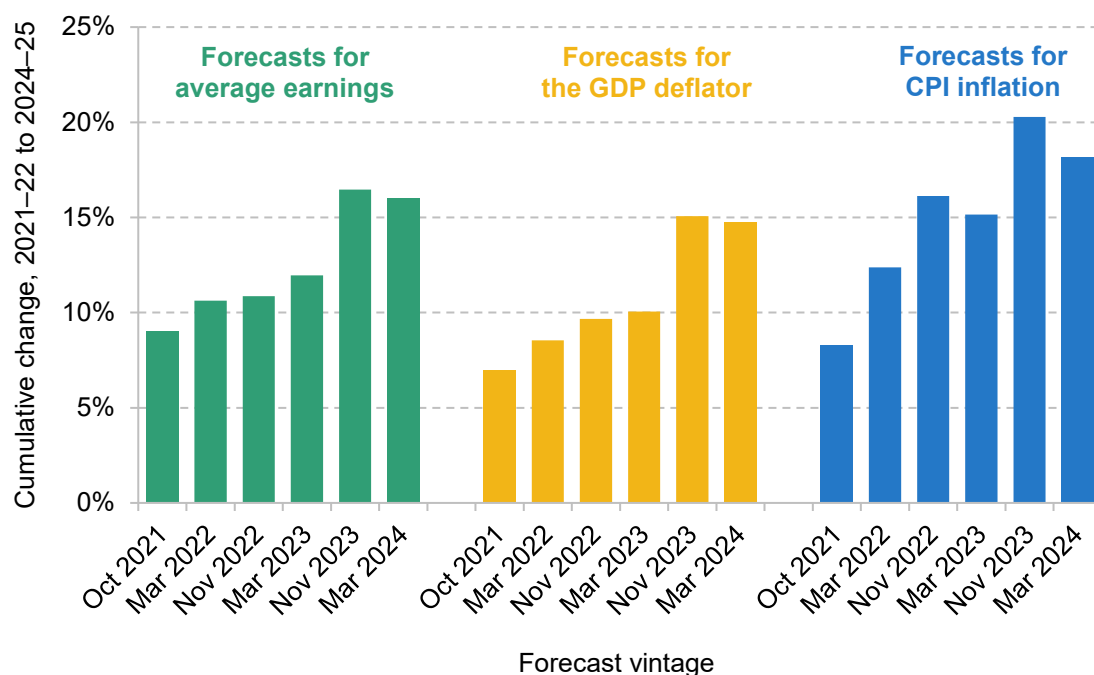
Public sector pay pressures

Public sector pay is an important mechanism through which higher-than-expected inflation affects the generosity of cash-terms departmental budgets. Staff costs account for close to half of departments' day-to-day budgets, and so changes to pay settlements have large overall effects on budgets' purchasing power. Higher inflation and pay growth in the wider economy put pressure on public sector wages to rise, to support the ability of the public sector to recruit and retain workers. Higher public sector wages then mean that departments have to spend a larger amount of their fixed cash budget on staff costs if they want to continue to employ their existing workforce.

At the time of the 2021 Spending Review, the government assumed that pay awards would be around 3% in 2022–23, 2% in 2023–24 and 2% in 2024–25 when setting departmental budgets (HM Treasury, 2024b) – though these assumptions were not made public at the time. These assumptions were made based on forecasts for the two key benchmarks for public sector pay – inflation (typically measured for these purposes by consumer price indices such as CPI rather than the GDP deflator) and private sector earnings growth. As discussed above, inflation turned out much higher than expected. Private sector wage growth was also much higher than previously forecast (with latest forecasts indicating 16.0% growth between 2021–22 and 2024–25, versus a forecast 9.0% in October 2021 – see Figure 3.5). Reflecting this, public sector pay settlements have been higher than expected, averaging 5% in 2022–23 and 6% in 2023–24. The new government has recently agreed pay deals in the range 5–6% for 2024–25.

¹⁰ Note that in the case of the 2010 Spending Review in particular, 'more generous than expected' did not mean 'generous': departments still faced substantial real-terms cuts.

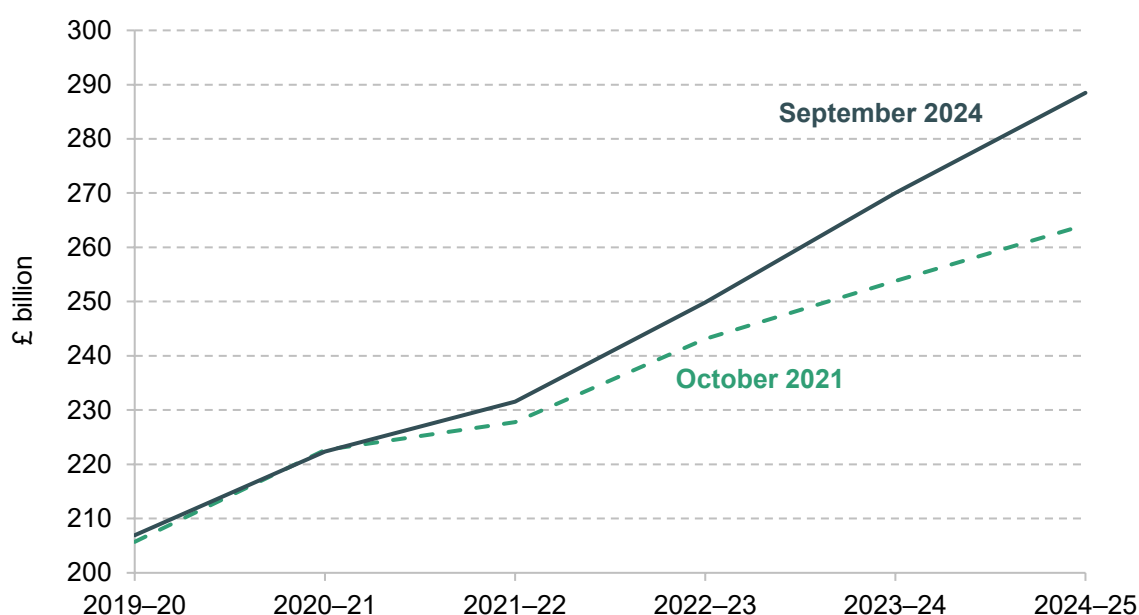
Figure 3.5. Evolution of OBR forecasts for cumulative growth in average earnings, CPI and GDP deflator between 2021–22 and 2024–25



Source: Office for Budget Responsibility, Economic and Fiscal Outlook (various).

So far, departments have, to a large extent, absorbed the pressures from higher-than-expected pay deals within existing budgets. The Treasury estimated these pressures to have been in the region of £11–12 billion for 2024–25 before accounting for the new pay deals (HM Treasury, 2024b). Departments can absorb pay pressures either by reducing spending on other areas or by holding down the number of staff employed. In practice, departments have done both.

Figure 3.6 shows the public sector pay bill over time and compares this with the anticipated public sector pay bill at the time of the Spending Review in October 2021 (constructed using contemporaneous assumptions about pay bill and workforce growth from the OBR). As we might expect, the public sector pay bill has grown much faster than anticipated at the 2021 Spending Review, consistent with the higher-than-expected pay deals. We estimate that the pay bill will, after accounting for the pay awards agreed by the new government in July, come in more than £20 billion (or around 9%) higher in 2024–25 than might have reasonably been expected in October 2021. This compares with a £10.8 billion increase in overall resource DEL in 2024–25, relative to October 2021 plans, as of the March 2024 Budget.

Figure 3.6. Public sector pay bill, as expected in October 2021 and in September 2024

Note: Figures are in nominal terms. We construct October 2021 expectations by taking Office for National Statistics (ONS) figures for the 2019–20 and 2020–21 pay bill and growing these with October 2021 OBR expectations for general government pay bill growth. We construct September 2024 expectations by taking ONS figures (from June 2024) for the general government pay bill until 2023–24, then growing these figures to 2024–25 by 5.5% (average pay deal), 0.5% (pay drift), and expected growth in general government employment according to the OBR.

Source: Office for National Statistics, series NMXS (various); Office for Budget Responsibility, Economic and Fiscal Outlook (various).

Higher-than-expected public sector pay has been a major challenge during the last Spending Review period. But as we will discuss in more detail later in this chapter, these past increases in pay also matter for the next Spending Review, for at least two reasons. First, a higher pay award in any given year that is not offset by lower employment or lower awards in future leads to a *permanently* higher pay bill in subsequent years. Second, just as departments have been asked to absorb most of the costs of higher-than-budgeted pay awards in recent years, Ms Reeves has asked departments to absorb a third of the costs of recently agreed pay increases for 2024–25 (£3.2 billion of the £9.4 billion of costs from 2024–25 awards). Departments have already had to cut back spending on other areas and hold back workforce growth to stay within budget. There is unlikely to be much in the way of low-hanging fruit for a Chancellor seeking further in-year savings. Some of the broader policy challenges around public sector pay are discussed in Chapter 4.

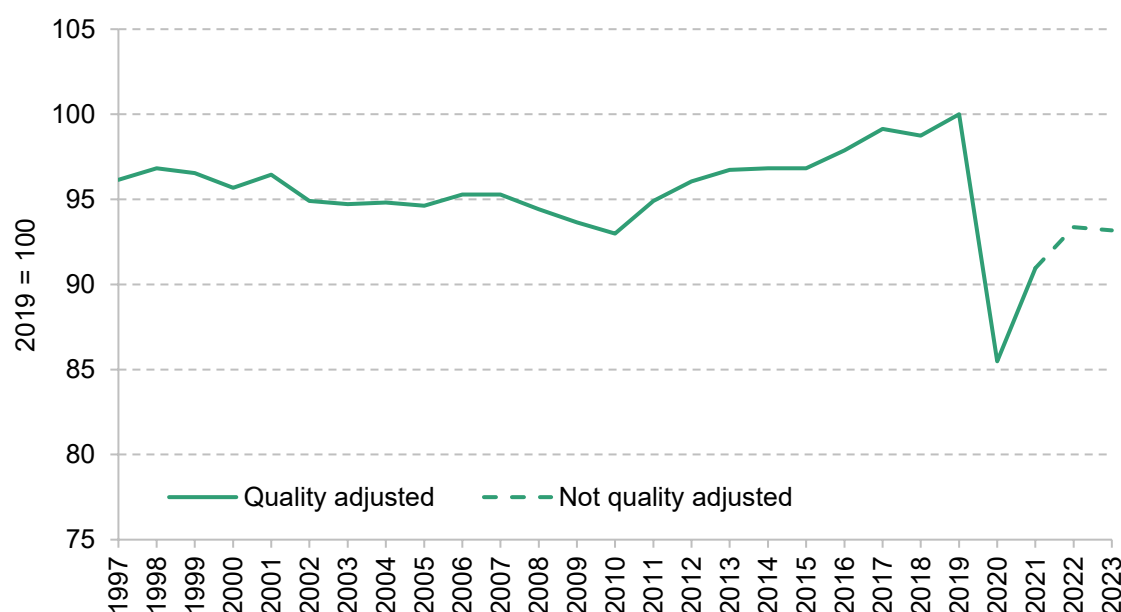
Public service productivity

Another pressure on departmental spending is the large decline in measured public service productivity that has occurred since the start of the COVID-19 pandemic. Lower productivity means that the same set of public service inputs (e.g. doctors and hospital buildings) produce a

lower quantity or lower quality of outputs (e.g. hospital treatments). That means that departments can deliver less with the same level of spending. In the absence of productivity improvements, maintaining – let alone improving – the provision of public services requires more inputs and more spending.

Figure 3.7 shows the official ONS measure of UK public service productivity between 1997 and 2023 (relative to 2019). This measure compares the quantity of inputs used to produce public services with the quantity of services produced, with some adjustments for quality. A higher value means that the same quantity of inputs can produce a greater quantity or quality of services. The measure of productivity for 2022 and 2023 does not yet feature a quality adjustment, as this is produced with a greater lag. Figures for 2022 and 2023 should therefore be seen as provisional.

Figure 3.7. ONS measure of UK public service productivity



Note: Data for 2022 and 2023 (dashed lines) measure public service outputs without any quality adjustments and will be subsequently updated by the ONS to include quality adjustments.

Source: ONS, public service productivity, quarterly, UK, <https://www.ons.gov.uk/economy/economicoutputandproductivity/publicservicesproductivity/datasets/publicserviceproductivityquarterlyuk>.

Measured public service productivity declined between 1997 and 2010, and then increased between 2010 and 2019. At the start of the COVID-19 pandemic in 2020, measured productivity fell by 15% in a year. This was because many public services had higher inputs but could not provide many of their normal services during the pandemic. Measured productivity recovered somewhat in 2021, but in both 2022 and 2023 it remained at 7% below its pre-pandemic level (without taking into account any changes in quality since 2021). We see something similar if we look just at the NHS, the biggest public service (Warner and Zaranko, 2022 and 2023a). These

measures are not perfect, as it is hard to value public sector outputs, but they speak to a key challenge facing the government at the Spending Review: many departments and services are requiring more inputs just to achieve pre-pandemic levels and standards of provision.

Finding a way to improve the productivity of public services would ease the pressure on departmental budgets – it would allow smaller budget increases for the same range and quality of service provision or would allow bigger service improvements from the same amount of spending. But one of the challenges at the forthcoming Spending Review will be that many of the reforms and policies that we might expect to have beneficial impacts on productivity (thereby reducing spending pressures in future years) would incur up-front costs. This is true of capital investments in buildings, equipment and digital infrastructure that might allow staff to work more efficiently (the importance of which was highlighted in the recent Darzi (2024) report) but also of any major reform to how services are organised and delivered. That only adds to short-term spending pressures – yet those short-term costs must be weighed against any long-run benefits from improvements in productivity. One way of interpreting the recent period is as a cautionary tale on the costs of neglecting such efforts. Of course, another challenge is ensuring that any investments or reforms do in fact increase productivity.

Management of in-year spending pressures and use of the Reserve

Another (related) challenge, which has come to the fore since the new government took office, is the emergence of considerable in-year spending pressures for 2024–25. In-year pressures occur when the budgets agreed between the Treasury and departments at the beginning of the fiscal year prove insufficient to meet the demands on services throughout the year.

While the exact sources of pressures on departmental budgets are hard to know in advance, it is more certain that there will be some pressures, somewhere. Shocks can and do come along. For this reason, the resource and capital DEL totals include a Reserve: an unallocated pot intended to fund ‘genuinely unforeseen contingencies that departments cannot absorb within their DELs’, as well as ‘certain special cases of expenditure that would otherwise be difficult to manage, as agreed with the Chief Secretary [to the Treasury]’ (HM Treasury, 2024a).

Over the last Spending Review period, there have been a range of unexpected spending pressures. These include providing energy support to households, firms and public services; spending on military support for Ukraine; and the unexpectedly high costs associated with asylum seekers. Many of these pressures have been met from the Reserve. But in some years the Reserve has proved insufficient to meet the pressures upon it, and the government has met spending pressures by topping up the overall envelope. In 2023–24, for instance, the overall spending envelope was topped up by £4.8 billion at the 2023 Autumn Statement, notionally to meet NHS funding pressures.

Upon taking office, Ms Reeves asked the Treasury to undertake an audit of public spending, which was published on 29 July this year. The audit estimated that the in-year pressures on day-to-day spending stood at £35.3 billion in 2024–25. After accounting for the £9.2 billion Reserve and £4.2 billion of potential underspends (as departments generally do not spend every penny of their budgets, and if anything have a bias towards underspending), this left £21.9 billion of net total pressures on the total RDEL envelope in 2024–25. Table 3.2 breaks down the pressures identified by the Treasury. These were partially offset by £5.5 billion of in-year cuts (including £3.2 billion of cuts to departmental budgets and a £1.4 billion saving from the means-testing of winter fuel payments).

Table 3.2. Day-to-day spending pressures in 2024–25 identified by Treasury audit ('Fixing the Foundations')

Pressure	Value
Public sector pay	£11.6bn
'Normal Reserve claims'	£8.6bn
Asylum	£6.4bn
Railways	£2.9bn
New policy commitments	£2.6bn
Ukraine	£1.7bn
Health	£1.5bn
Total pressures	£35.3bn
Reserve	–£9.2bn
Adjustment for previous forecast underspend and anticipated 'fallaway'	–£4.2bn
Total pressures after allowance for shortfall and Reserve	£21.9bn

Source: HM Treasury, 2024b.

A detailed assessment of each of these spending items is beyond the scope of this chapter. Here, we draw out four key takeaways.

First, some of these in-year pressures were foreseeable. Given that, the new government might reasonably complain about the fact that funding had not been set aside to meet them, but they ought not to have come as a complete shock. The largest single spending pressure comes from the government's decision to accept in full the recommendations of the public sector Pay Review Bodies (for pay awards of between 5% and 6% – see Chapter 4). These are perhaps a little higher than might have been anticipated but were always going to come in higher than the 2% budgeted for and built into departments' plans.

Second, while some of the pressures were foreseeable, the total in-year spending pressures do nonetheless appear to be greater than could be discerned from the outside. Of particular note is the fact that £8.6 billion has already been spent on (or allocated to) ‘Normal Reserve claims’ – a somewhat impenetrable category which seems to include a raft of classification changes, as well as additional funding for things such as the restoration of the Northern Ireland executive and the costs of various public inquiries, such as the COVID-19 inquiry and the inquiry into the NHS infected blood scandal. Given the scale of these claims relative to the overall £22 billion, and the prominence of these in-year pressures in the recent debate, the Treasury ought, at some point, to publish a transparent breakdown.¹¹ If we take the £8.6 billion figure as given, even before considering the costs of public sector pay deals, the asylum system or support for Ukraine (which have been funded from the Reserve in previous years), almost all of the Reserve appears to have already been allocated by the previous government just a few months into the financial year.

Third, some of these in-year spending pressures stem from poor budgeting practices of the previous government that the new government could and should address. The way that the Home Office and the Treasury have budgeted and planned for asylum costs leaves a great deal to be desired, with the Home Office repeatedly submitting plans to parliament that it knows to be insufficient and relying on large top-ups from the Treasury later in the year (see Warner and Zaranko (2024) for a detailed discussion). More generally, the previous government appears to have been overly reliant on the Reserve, using it to fund things that it ought not to have been used for. Recurrent asylum costs are one example. The previous government also appears to have met the costs of new permanent policy commitments from the Reserve, to avoid having to top up the 2024–25 envelope and having this feed forward into future years and affect performance against the fiscal rules (we return to the topic of the baseline in Section 3.4). This is not what the Reserve is for: any new permanent policy commitments should have been met from equally permanent increases in the spending envelope.

Fourth, and most importantly for the purposes of this chapter, the scale and nature of the in-year spending pressures make the Chancellor’s life more difficult as she heads into the Budget this autumn and the multi-year Spending Review next spring. This is because some of the spending pressures – most notably public sector pay – are likely to be largely or even wholly permanent in nature. This, in effect, means that the government will have to spend more in each and every year of the next Spending Review period, even before thinking about any increases in funding for service improvements. We discuss this in more detail in Section 3.4 and consider scenarios and choices for the Spending Review in Section 3.5.

¹¹ The Financial Times recently reported that HM Treasury has declined a freedom of information request asking for a detailed breakdown of the ‘Normal Reserve Claims’ (<https://www.ft.com/content/7f686444-7036-4efc-82e5-971b0f3929fa>).

Some suggestions for improvement

A force majeure clause for Spending Reviews

The overarching problem of the last few years is that the generosity of departmental budgets has become detached from what those budgets have been asked to deliver. In large part this is because unexpected adverse shocks have meant that the planning assumptions on which budgets were based have proven far from what has actually happened.

Despite large differences between planned and actual inflation and pay awards, there was no ‘crystallising moment’ to force the government to re-examine the adequacy of departmental settlements. Although the previous government could have held a Spending Review at any point, it decided not to. Instead, the boost to nominal tax receipts from higher inflation (and a larger population) was used to cut taxes (most notably rates of National Insurance – a cut which the Labour Party supported in opposition) rather than to compensate departments systematically for higher costs (Institute for Fiscal Studies, 2023). Some favoured departments such as the NHS received ad hoc top-ups to compensate for higher costs, but pressures on the Reserve were left to mount, culminating in the £22 billion of in-year spending pressures outlined by Ms Reeves in July.

The Treasury’s 29 July ‘Fixing the Foundations’ document recognises this problem, and the reforms to the spending framework proposed by the new Chancellor go some way towards addressing it. Holding a multi-year Spending Review every two years would help, because it limits the period over which plans and reality can diverge. But it is still only a partial solution.

To see why, consider the experience since the October 2021 Spending Review, when budgets for 2022–23, 2023–24 and 2024–25 were set. Under the new government’s proposed framework, another Spending Review would have needed to be held by the end of 2023. This would have reassessed the 2024–25 budget and set budgets for future years. That would have done nothing to address the fact that budgets for 2022–23 and 2023–24 were eroded by unexpectedly high inflation (with the inflation spike occurring shortly after the 2021 Spending Review was concluded – see Figure 3.5 earlier). Had resource DEL grown at the real-terms rate set out at the October 2021 Spending Review, it would have been £10 billion higher in 2023–24 than it actually turned out to be (even after the ad hoc top-ups to budgets for that year).

This is not to say that the previous government necessarily *should* have topped up budgets for 2023–24 by an additional £10 billion rather than cut taxes, or that departments should always be fully protected against inflation risk. But policy might have benefited from a ‘crystallising moment’ that forced the government to weigh up and confront the reality of its choices in a comprehensive and transparent way.

To that end, the government might helpfully add a *force majeure* clause to trigger a crystallising Spending Review when its planning assumptions are rendered obsolete.¹² This would force the government to undergo a thorough reassessment of its spending allocations when economic circumstances drastically change, rather than relying on discretionary ad hoc adjustments.

Specifically, alongside each Spending Review, HM Treasury should specify its planning assumptions for inflation and private sector pay growth along with a (relatively wide) pre-specified range which the Treasury deems reasonable for departments to manage within their pre-agreed budgets.¹³ The OBR already produces forecasts for the GDP deflator and economy-wide average earnings growth; these could be supplemented with a forecast for private sector pay growth and used as the planning assumptions. The range should be set sufficiently wide that run-of-the-mill forecast errors and department-specific shocks do not fall outside of it; the idea is that the *force majeure* clause would be triggered relatively infrequently – only by extreme macroeconomic events, such as the energy price shock of 2022.

If inflation and/or private sector pay growth comes in outside of that pre-specified range, this would trigger the clause and kickstart a Spending Review. In a world where Spending Reviews take place every two years anyway, all that such a clause would trigger is bringing the review forward by a year. It would be there to introduce a degree of automaticity, rather than relying on government discretion. Box 3.1 discusses in more detail how a *force majeure* clause might be designed, in the context of the period covered by the 2021 Spending Review.

Box 3.1. One possible design of a *force majeure* clause

In designing any *force majeure* clause, the Treasury would need to carefully specify the indicators used and the conditions that trigger it. Take the GDP deflator. Any sensible *force majeure* clause would likely need to reflect OBR forecasts for the GDP deflator, so as to respond in a timely manner to changes in expected inflation and departmental costs. But a clause defined solely in terms of forecasts for future inflation might entirely miss a sharp, short-lived inflation spike that appears only in the out-turn.

¹² This proposal is similar to one previously outlined by Boileau, O’Brien and Zaranko (2022).

¹³ Note that we suggest that the planning assumption is defined in terms of private sector pay growth. The 29 July ‘Fixing the Foundations’ document stated that ‘At SR21 the government set overall budgets in cash terms on an assumption that pay for public sector workforces would increase by around 3%, 2%, and 2% respectively in the three years covered’ (HM Treasury, 2024b) but these assumptions were not made public at the time. The risk of making these assumptions public is that they then serve as a focal point in public sector pay negotiations, thereby encouraging the Treasury to ‘lowball’ its public assumptions, or to ‘game’ any pay awards to come in slightly below the threshold. We suggest instead that the *force majeure* clause be specified in terms of something (private sector pay growth) outside of direct government control, to better capture external shocks.

One potential option would be to design the clause in terms of cumulative GDP deflator inflation over the first two years of the Spending Review period (after which point another Spending Review will happen anyway). If at any point official forecasts suggest that cumulative inflation over those first two years will deviate from a pre-specified range (say, 2.0 percentage points in either direction, relative to the forecasts for those years published alongside the spending plans), the clause would be triggered. This would make use of both out-turn data and the latest forecasts. For example, at the October 2021 Spending Review, cumulative GDP deflator inflation over 2022–23 and 2023–24 was forecast to be 5.0%. By March 2022, this had risen to 6.6%; and by November 2022, this had risen to 8.2% (by that point partially reflecting inflation out-turns for the first half of 2022–23). Under this proposal, this would have triggered the *force majeure* clause and triggered a formal reassessment of spending plans for 2023–24 and 2024–25 in late 2022, when cumulative inflation was forecast to be 3.2 percentage points higher than forecast at the Spending Review (whereas under the new government’s proposals, without a *force majeure* clause, this would not have happened until the autumn of 2023).

Other possible changes

Other possible changes to the framework that might enhance the planning and control of spending include:

- **Align the planning horizons for budgets and pay.** If departments are to be allocated two years of firm and fixed spending plans (with the third year subject to potential revision in a future Spending Review), consideration could be given to whether pay deals also should be set on a two-year basis as standard (with a similar *force majeure* clause to reopen settlements in the case of unexpected changes in inflation or private sector pay).
- **Consider an expansion of the scope of the Spending Review envelope.** The sharp distinction between DEL and AME can create peculiar incentives. For example, the Department for Work and Pensions may be incentivised to seek DEL savings by cancelling an employment support programme, even if that results in higher spending on AME because some people stay out of work for longer. More generally, bringing some components of AME – such as non-cyclical social security spending, like child benefit and the state pension – into the Spending Review envelope might promote better consideration of the trade-offs involved. Reducing AME by £10 billion and transferring this amount to RDEL would increase the average annual real growth rate between 2024–25 and 2028–29 by 0.5%; transferring £10 billion to CDEL would increase the growth rate by 2.0%.
- **Leave the Reserve for genuine unforeseen emergencies.** New permanent policy commitments should not be funded from the Reserve. Nor should recurrent spending items that can be foreseen and planned for in advance. That would leave the Reserve available for what it is intended for: ‘genuinely unforeseen contingencies that departments cannot absorb’ (HM Treasury, 2024b). If a spending item is so volatile and unpredictable that it is extremely

difficult to plan for (an argument that could be made about asylum costs), then it may be better classified as AME rather than DEL.

- **Build in a separate unallocated provision for overseas aid.** For a given desired level of spending on official development assistance (ODA), the government might helpfully allocate a certain fraction to specific programmes and departments and leave an unallocated ‘ODA Reserve’ to meet unexpected demands and world events. This would lessen the need for inefficient in-year cuts to aid programmes and allow the aid budget to be managed more efficiently – see Mitchell, Tyskerud and Zaranko (2024) for more detail.

3.4 The future spending challenge

Pressures and commitments

Public services face considerable pressures across the board, with performance in most public services worse than pre-pandemic (Institute for Government, 2023). Given these pressures, it is perhaps unsurprising that a large part of Labour’s manifesto was dedicated to setting out how the party would improve public service performance. Box 3.2 discusses the range of promises in the Labour manifesto and what they might mean for the forthcoming and future Spending Reviews.

Box 3.2. Manifesto promises and implicit commitments

To understand the implications of Labour’s manifesto for the Spending Review, we can group manifesto commitments for public services into three broad categories.

- The first category of manifesto commitments is the specific and ‘fully costed’ policies relating to public services. For these, the manifesto set out how Labour intended to raise additional funding to pay for them (e.g. charging VAT on private school fees), thereby increasing the overall spending envelope. Such policies include hiring 6,500 more teachers and delivering 40,000 more appointments per week in the NHS. Taken together, this first category amounts to an additional £4.8 billion in day-to-day departmental spending in 2028–29. These policies are relatively straightforward for the Spending Review: Labour has already set out how much it expects them to cost and been clear that the overall spending envelope will be increased accordingly.
- The second category of commitments is the concrete and specific policies that were not included in the manifesto costings. The manifesto reports that these policies ‘will be funded from existing budgets or do not have a cost’. These include commitments to return NHS elective waiting times to their 18-week standard, introduce collective wage-setting in adult social care, introduce specialist rape and sexual offences teams in every police force, and transform further education colleges into specialist technical colleges. The Labour manifesto also committed to setting out the path to spending 2.5% of GDP on defence but did not provide a date for this target (unlike the Conservative manifesto). Even if

all these manifesto policies can be delivered within the current overall spending envelope (a very big if), they will have implications for how funding is allocated between departments.

- The third category is the large number of promises for new reviews and strategies, including a comprehensive strategy for post-16 education, a strategy to reduce child poverty (see Chapter 6), a long-term strategy for transport, an unspecified programme of reform to create a National Care Service, and many others. These commitments themselves might not prove to be particularly expensive over the next Spending Review period. But implementing the many potential recommendations from these reviews could well have serious implications for future Spending Reviews: not least because none seems particularly likely to recommend big reductions in what the state is doing.

All public services will undoubtedly be seeking additional funding to improve performance and to deliver on any relevant manifesto commitments. Funding is not the only thing that matters for performance (productivity improvements, discussed in the previous section, would be most welcome), but it would be hard to achieve sustained improvements in service performance without some funding increases. In the rest of this section, we set out the additional funding that may be needed in a range of scenarios.

The outlook for day-to-day spending under the status quo

It's all about that baseline (and subsequent growth assumption)

In the March 2024 Budget, then-Chancellor Mr Hunt set out an 'envelope' for day-to-day public services that would see overall spending grow by 1% per year in real terms between 2024–25 and 2028–29. These are the spending plans Ms Reeves has inherited. Because the future increases are calculated relative to the total in 2024–25, the level of spending in that year – the 'baseline' – takes on outsized importance.

A key question is the extent to which the £22 billion of net in-year spending pressures for 2024–25 (outlined by Ms Reeves in her July spending audit and discussed above) are permanent and feed through into future years. Consider the pay awards of between 5% and 6% for most public sector workers this year. This adds to the pay bill in 2024–25, but because staff will be paid this higher amount in all future years, and because future percentage increases will apply to this higher amount, it will also increase the pay bill for future years: it is permanent. Here, we make the relatively conservative assumption that it is only these pressures from public sector pay that enter the baseline and affect future years. After accounting for the fact that departments have been asked to make £3.2 billion of offsetting savings, this leaves a net pay pressure of £8.4 billion in 2024–25 that feeds through into future years. Box 3.3 explains the calculation of this baseline in more detail. We then assume that the 1% annual real-terms increases apply to the higher starting point. £8.4 billion extra in 2024–25 grows to £9.4 billion extra by 2028–29.

Box 3.3. Assumptions behind our resource DEL ‘status quo’ baseline

We start from the Spring Budget 2024 figure for resource DEL excluding depreciation in 2024–25 (£462.2 billion). We then add £11.6 billion of public spending pressures (£9.4 billion from 2024–25 pay deals, and £2.2 billion ‘overhang’ from 2023–24 pay deals which spill over into this financial year), subtract £3.15 billion of departmental savings, and subtract £30 million of savings from the cancellation of the social care charging reforms. This gives a net increase in the 2024–25 baseline of £8.42 billion. We note that some of the other spending pressures outlined in the 29 July spending audit could also prove permanent (the £1.5 billion winter top-up for the NHS, for instance), but we make the conservative assumption that all bar public sector pay will prove temporary and do not enter the baseline (in other words, the additional pressures either fall to zero or are funded from within the existing envelope). To be consistent, we assume that all of the immediate savings in the spending audit, bar savings in departments to fund pay pressures and the scrapping of adult social care charging reforms, also do not affect the baseline.

For subsequent years, we assume that the 1.0% real-terms increases (as pencilled in by Mr Hunt) apply to this higher baseline (£470.6 billion, the sum of £462.2 billion and £8.4 billion), using GDP deflator forecasts from the OBR’s March 2024 Economic and Fiscal Outlook. Labour’s manifesto set out £4.84 billion of additional resource spending in 2028–29. We assume that this is additional to the ‘1% envelope’, and grows linearly over time, to the tune of £1.21 billion in 2025–26, £2.42 billion in 2026–27, £3.63 billion in 2027–28 and the full £4.84 billion in 2028–29. Combined, this gives the values shown in Figure 3.8.

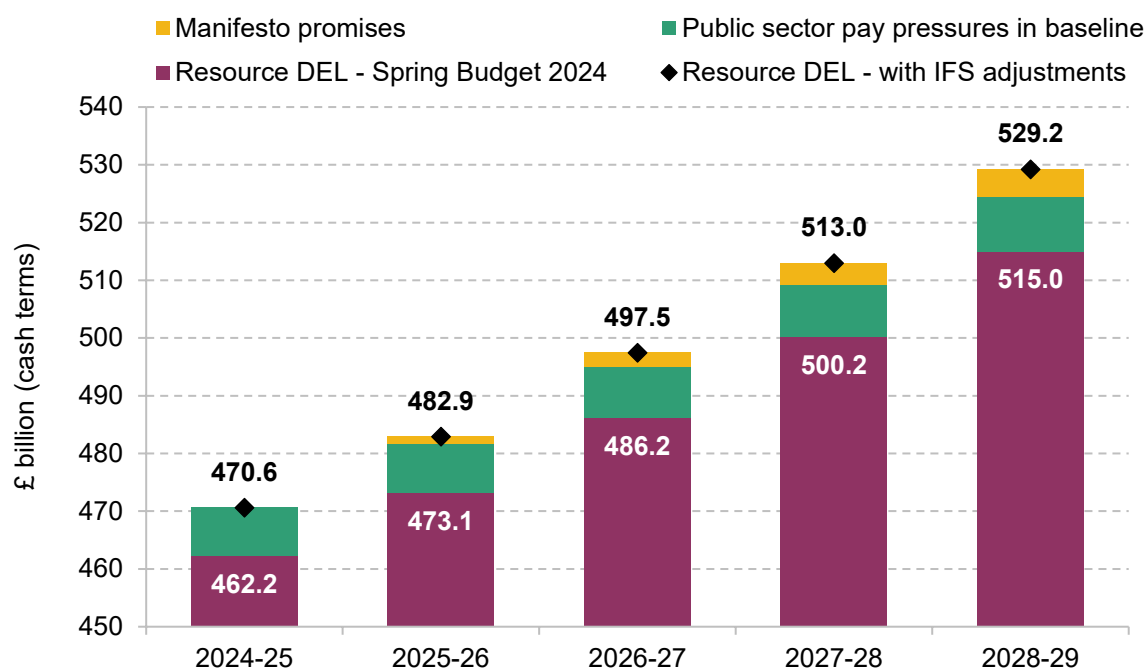
To produce a departmental breakdown, we make a number of further assumptions. The Spring Budget 2024 numbers include £5.35 billion of unallocated ‘SCAPE funding’ (extra funding for departments to compensate for a reduction in the discount rate used to calculate employer pension contributions – see O’Brien and Zaranko (2023) for more details). We allocate this to departments in line with each department’s share of resource DEL in 2023–24. Similarly, the net additional spend from public sector pay deals is allocated according to each department’s share of overall resource DEL in 2023–24. These estimated departmental budgets for 2024–25 act as the baseline for the scenarios set out below.

On top of that, as discussed in Box 3.2, the Labour Party manifesto set out around £4.8 billion of additional spending in 2028–29. (For the purposes of simplicity, we assume that it grows linearly, from £1.2 billion in year 1, to £2.4 billion in year 2, and so on.) That would see overall resource DEL grow by an average of 1.2% per year (up from 1.0% per year without this extra spending).

Combined, this means that just to maintain Mr Hunt’s spending assumption and deliver on Labour’s specific manifesto commitments, Ms Reeves will need to top up her day-to-day

spending plans by £9.8 billion in 2025–26, rising to £14.2 billion in 2028–29 (both in cash terms). This is illustrated in Figure 3.8. More details of the assumptions underpinning this and subsequent analysis are set out in Box 3.3. Different assumptions would give a different answer.

Figure 3.8. Estimated spending top-ups from baseline changes and manifesto promises



Note: See Box 3.3 for details of assumptions.

Source: Authors' calculations using HM Treasury Spring Budget 2024, HM Treasury 'Fixing the Foundations' and Labour Party 2024 general election manifesto.

Implications for unprotected departments

We now consider what might lie in store for day-to-day public service spending (RDEL) of particular departments under a central, 'status quo' scenario – a scenario where spending plans are updated to reflect changes to the baseline and manifesto commitments, and nothing else.

This exercise involves a large number of assumptions, and the figures we present should not be considered to be firm or final; rather, they are indicative of the broad scale of the challenge ahead. The baseline for 2024–25 is constructed using the assumptions outlined in Box 3.3, with most of the public sector pay pressures feeding through as a permanent spending increase, and Labour manifesto commitments adding to the envelope. Combined, as discussed above and shown in Figure 3.8, this means that spending plans for 2025–26 need to be topped up by £10 billion, rising to £14 billion by 2028–29, just to maintain the existing growth assumption and deliver manifesto promises.

We then make the following (somewhat conservative) assumptions about spending on particular public services:

- The **NHS England** budget grows by 3.6% per year in real terms, in line with the historical average for UK health spending and our previous estimate of the funding increases required to deliver the NHS workforce plan, which the Labour manifesto committed to implementing (Warner and Zaranko, 2023b). Note that this may not be sufficient to implement all of the other promised improvements to the health service.
- Spending on **defence** grows in line with GDP, at 1.8% per year in real terms. Note that this would maintain defence spending at its current level as a share of GDP and would not be enough to increase spending to 2.5% of GDP (which the Labour government has committed to, but without a specific time frame).
- The **Foreign, Commonwealth and Development Office (FCDO)** budget also grows in line with GDP, to maintain UK ODA spending at 0.5% of GDP, as legislated. Note that the Labour government has (like the previous government) promised to restore aid spending to 0.7% of GDP ‘as soon as fiscal circumstances allow’, and doing this would require aid spending to grow faster than is assumed here.¹⁴
- Spending on **new childcare entitlements** grows by 31% per year in real terms (from a very low base in 2024–25), in line with previous OBR estimates. Note that this applies to spending only on the new, expanded childcare offer currently being rolled out, and not the total amount spent on childcare.
- The **Reserve** is assumed to grow in line with overall RDEL so as to remain at the same (relatively high) percentage of the total.

Combined, these ‘protected’ areas account for around 47% of overall resource DEL in 2024–25. Block grants to the devolved governments of Scotland, Wales and Northern Ireland (which are determined by the Barnett formula) account for a further 14%, leaving ‘unprotected’ departments with a 38% share. These ‘unprotected’ areas include education, central government grants to local government, and justice.¹⁵ In all of our analysis, we account for the Barnett consequential of both increases to protected budgets and cuts to unprotected budgets.

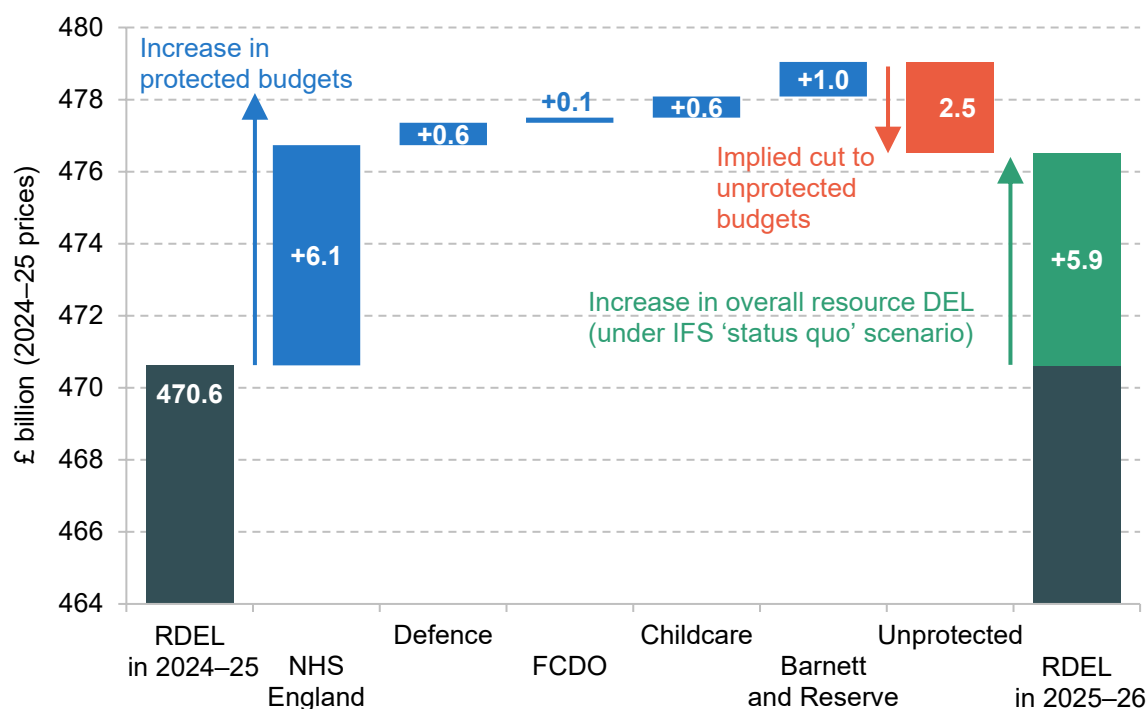
The implied changes in spending on different areas are displayed in Figure 3.9. These are shown in real terms rather than cash terms, in 2024–25 prices, to illustrate better the ‘real’ budget changes implied by these plans.

¹⁴ For a discussion of this commitment and how it might be better designed, see Mitchell, Tyskerud and Zaranko (2024).

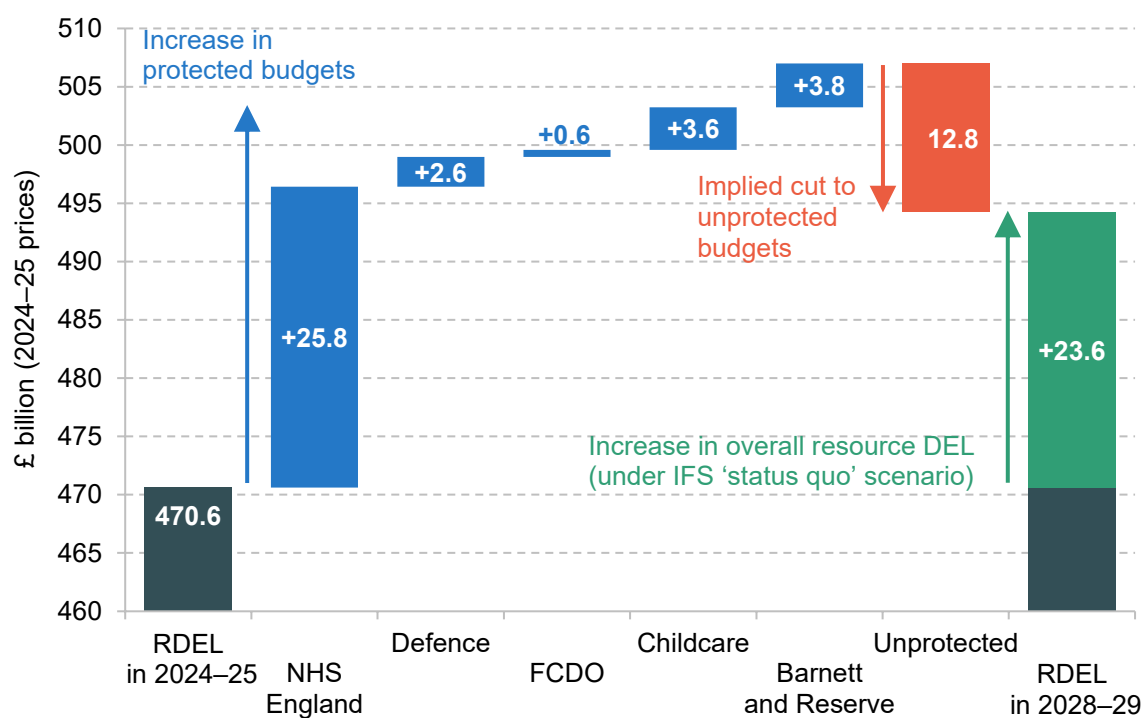
¹⁵ In previous versions of this analysis, we have included schools as a ‘protected’ area, but we choose not to do so here, given the absence of specific commitments from the new government on schools spending.

Figure 3.9. Illustrative scenario for changes in day-to-day funding (relative to IFS estimated 'status quo', adjusted for baseline adjustments and manifesto promises)

Panel A. 2024–25 to 2025–26



Panel B. 2024–25 to 2028–29



Note: RDEL is resource departmental expenditure limits excluding depreciation. 'Barnett' refers to the payments to the devolved governments of Scotland, Wales and Northern Ireland under the Barnett formula. For details of assumptions, see Box 3.3 and the main text.

In Panel A, we show the change between 2024–25 and 2025–26 (the period to be covered by the one-year Spending Review this autumn). There are two key takeaways. First, the (likely) increases for the NHS are far larger in scale than those for other protected areas: what happens to the health budget is the most important single determinant of the overall funding picture. This is both because the health service is much larger than other areas of spending and because we assume it receives a higher real growth rate than most other areas (in line with historical experience). Second, after accounting for the likely increases in protected budgets, unprotected services would be facing real-terms spending cuts. In today's prices (i.e. 2024–25 prices), these cuts would amount to around £2.5 billion, or 1.4%. Avoiding those cuts would require a top-up to 2025–26 spending plans of around £3 billion.¹⁶ This would be in addition to the £10 billion required to maintain the baseline and honour manifesto promises.

In Panel B, we examine the four-year period from 2024–25 to 2028–29 (i.e. the one-year period to be covered at this autumn's Spending Review, and the three years to be covered by the Spending Review in the spring). The picture is similar, but with bigger sums involved. Unprotected departments would be facing cuts of £13 billion in today's prices, equivalent to around 1.8% per year. Avoiding those would require a cash-terms top-up of around £16 billion in 2028–29, over and above the £14 billion of baseline- and manifesto-related top-ups. In Section 3.5, we consider some options for Ms Reeves, were she to decide to top up the spending plans she inherited.

Finally, it is important to stress that these numbers are only illustrative. If the new government decided, for example, to allocate even more money to the NHS, to return aid spending to 0.7% of GDP, or to increase defence spending to 2.5% of GDP by the end of this parliament, the implied cuts to remaining budgets would be larger. In addition, there is nothing particularly special about flat real-terms budgets. In some cases, declining real-terms spending might be perfectly manageable. School pupil numbers are set to fall over the coming years, for instance (Sibieta, 2024). Local authorities may be able to offset real-terms reductions in central government grants if they were permitted to raise council tax bills in real terms (Ogden and Phillips, 2024). Nonetheless, flat real-terms budgets serve as a useful reference point.

The outlook for capital spending

The focus above was on day-to-day spending on public services. We now consider the outlook for investment spending.

¹⁶ This is bigger than the £2.5 billion figure shown in the graph for two reasons: first, it is a cash-terms figure rather than a figure in today's prices; and second, it includes an estimate for the Barnett consequential of an increase to unprotected budgets in England.

Existing plans

Previous government policy was for the overall amount of public investment to fall slightly in cash terms after this year.¹⁷ The most commonly used measure of investment spending, public sector net investment (PSNI), nets off depreciation (roughly, the amount of wear and tear on government assets) to give an estimate of the amount of investment in new assets (taking off the spending needed to maintain the assets we already have).¹⁸ This measure of investment was set to fall in cash terms under previous government plans, from £66.6 billion in 2024–25 to £53.1 billion in 2028–29.

In real terms (i.e. after adjusting for inflation, as measured by the GDP deflator), that would equate to cuts to net investment of around 7% per year. This reduction, combined with a growing economy, was set to result in a decline in PSNI from 2.4% of national income in 2024–25 (a relatively high starting point, by UK standards) to 1.7% of national income in 2028–29. This is illustrated in Figure 3.10. Note that this measure of investment includes things not traditionally considered ‘investment’ (such as the component of student loans that is not expected to be repaid – see Zaranko (2024)). Relatedly, PSNI in 2022–23 was in some sense artificially depressed (by changes to the student loan system, and ‘negative’ investment by funded public sector pension schemes), which makes the spike in 2023–24 in Figure 3.10 appear more dramatic – though there was also a genuinely big increase in capital spending by departments that year.

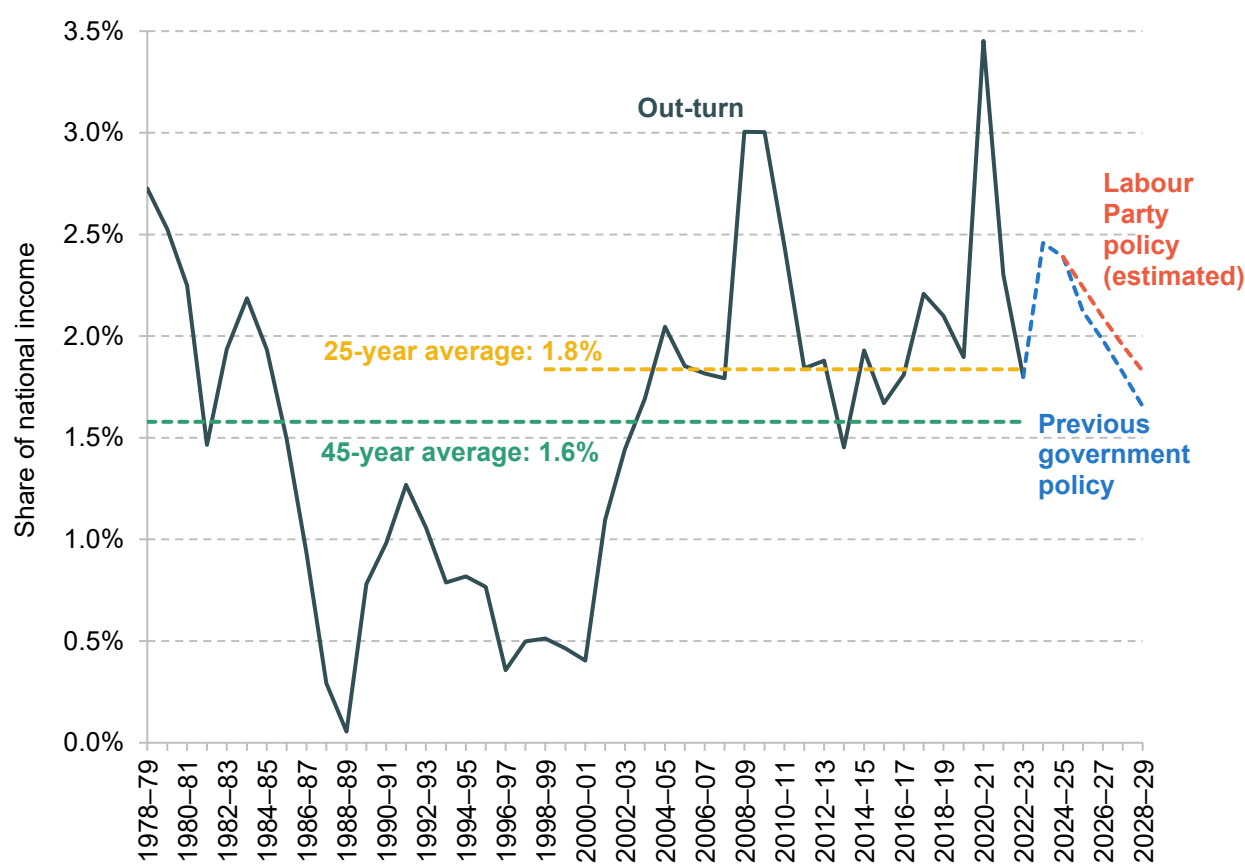
Having rowed back from its previous £28 billion-a-year green investment plan, Labour’s election manifesto promised an average of £4.7 billion per year over the parliament, or an extra £23.7 billion in total. We interpret this as applying to the five years from 2025–26 to 2029–30 and, in the absence of a confirmed spending profile, assume it will be set such that PSNI grows at a constant rate over time. That would see the additional green investment rise from £3.5 billion in 2025–26 to £5.6 billion in 2028–29 (the final year considered in this chapter).¹⁹ The impact of this additional spending on the path of PSNI is shown by the red line in Figure 3.10. Overall investment would still fall as a share of national income (and in real terms), just a little more slowly than under previous government policy.

¹⁷ Spring Budget 2024 plans were for public sector gross investment to fall from £136.0 billion in 2024–25 to £132.1 billion in 2025–26 and £130.6 billion in 2028–29.

¹⁸ For more detail on definitions, see Zaranko (2024).

¹⁹ The full assumed time profile is £3.5 billion in 2025–26, £3.4 billion in 2026–27, £4.2 billion in 2027–28, £5.6 billion in 2028–29 and £7.0 billion in 2029–30, giving £23.7 billion in total. The conclusions of this section are not sensitive to these assumptions.

Figure 3.10. Public sector net investment since 1978–79



Note: 'Labour Party policy' line assumes that a Labour government increases public sector net investment (PSNI) by a cumulative £23.7 billion between 2025–26 and 2029–30 (inclusive), relative to previous government policy, and that the additional investment is scaled up such that PSNI grows at a constant nominal rate between 2024–25 and 2029–30. This means that £16.7 billion of the £23.7 billion is spent between 2025–26 and 2028–29. We additionally allow for a demand boost to GDP from higher net investment spending.

Source: Authors' calculations using the Office for Budget Responsibility's Public Finances Databank and March 2024 Economic and Fiscal Outlook.

To avoid making real-terms cuts to PSNI after this year would require the previous government's spending plans for 2028–29 to be topped up by around £18 billion – some £12 billion more than implied by Labour's election manifesto. To maintain net investment at its 2024–25 level of national income (2.4%) would require 2028–29 spending plans to be topped up by £24 billion – around £18 billion more than Labour's plans would imply.

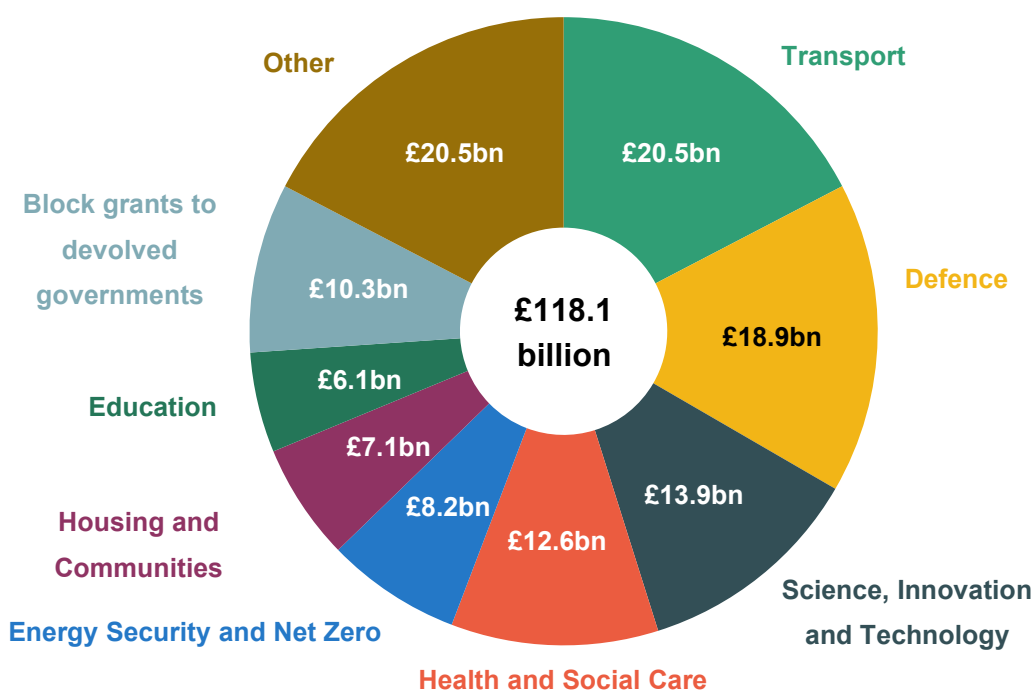
The measure of investment most relevant for the Spending Review is capital DEL – the investment spending done by departments. Spring Budget plans were for capital DEL to fall slightly in cash terms from £118.1 billion in 2024–25 to £116.7 billion in 2028–29. That would equate to an average real-terms cut of 2.0% per year. With (our estimate of) Labour's extra green investment, this would fall to a real-terms cut of 0.8% per year. To avoid making real cuts to overall capital DEL would require a top-up to existing plans of around £10 billion in 2028–29

(or around £4 billion over and above manifesto promises); to maintain capital DEL as a share of national income would require a top-up of around £19 billion (or around £14 billion on top of implied manifesto promises). Section 3.5 discusses this further.

The need to prioritise

The challenge for the new government, then, is that it inherits a set of spending plans that imply large cuts to capital spending. There will be many competing demands upon the total. The government will need to prioritise. Rachel Reeves has already shown some signs of doing so: in her spending audit, she cancelled a number of ‘low value, unaffordable’ transport projects (including the A303 Stonehenge tunnel and the Restoring Your Railway programme) and announced a ‘full and comprehensive review’ of the New Hospital Programme (HM Treasury, 2024b). At the Spending Review, absent a big top-up to planned spending, the overall envelope will be tight. Just as with the resource budget, increases in capital funding for priority areas are likely – given the tight overall envelope – to mean cuts to other areas. That will mean a further round of difficult choices about which projects and programmes to cancel.

Figure 3.11. Capital funding by department, 2024–25



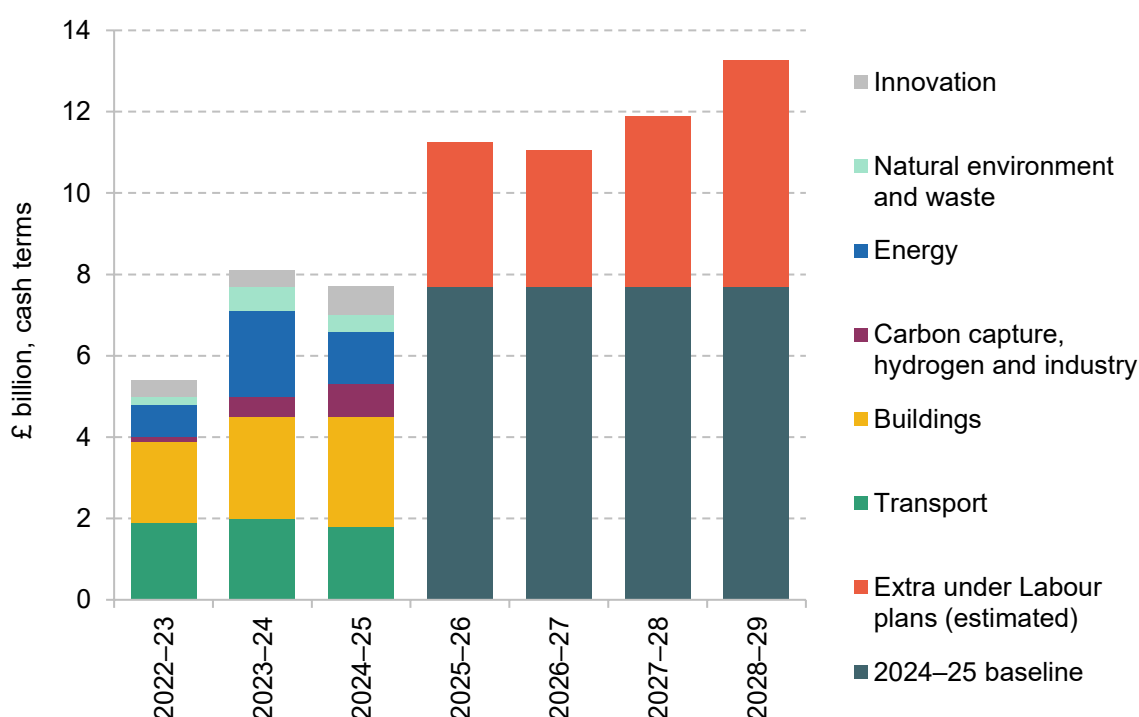
Source: HM Treasury, Spring Budget 2024.

Consider health and defence, two of the departments with the largest capital budgets (Figure 3.11). To deliver the productivity improvements built into the NHS workforce plan, the government may decide that it needs to increase the health capital budget at the same rate as the resource budget, to maintain its capital intensity (if anything, a case could be made that the

capital intensity of the NHS should increase; this case was strongly made in the recent Darzi report (Darzi, 2024)). If the Ministry of Defence resource budget is growing in line with GDP, then the defence capital budget would also need to grow in line with GDP to maintain total defence spending as a share of national income. Delivering those increases would require other departments' capital budgets to be cut by 3.8% per year in real terms, or more than 14% in total over the next four years. That is before considering the need for more capital investment in the prisons estate, in research and development, in transport infrastructure, or anything else.

Another likely area of focus is green investment. Labour pared back its plans for green investment while in opposition, but may now wish to spend more in government. There is no single definition of green spending, and the government does not typically report any consistent measure of how much it spends on green projects. The exception was the 2021 Spending Review, which set out the government's planned emissions-reducing spending. While not perfectly comparable, this gives us a sense of the scale of Labour's plans and how they might compare (shown in Figure 3.12). Even the latest, pared-back version of Labour's green investment plans would – if delivered – represent a considerable increase on the recent past.

Figure 3.12. Breakdown of planned green expenditure at Spending Review 2021 and our estimate of Labour's plans

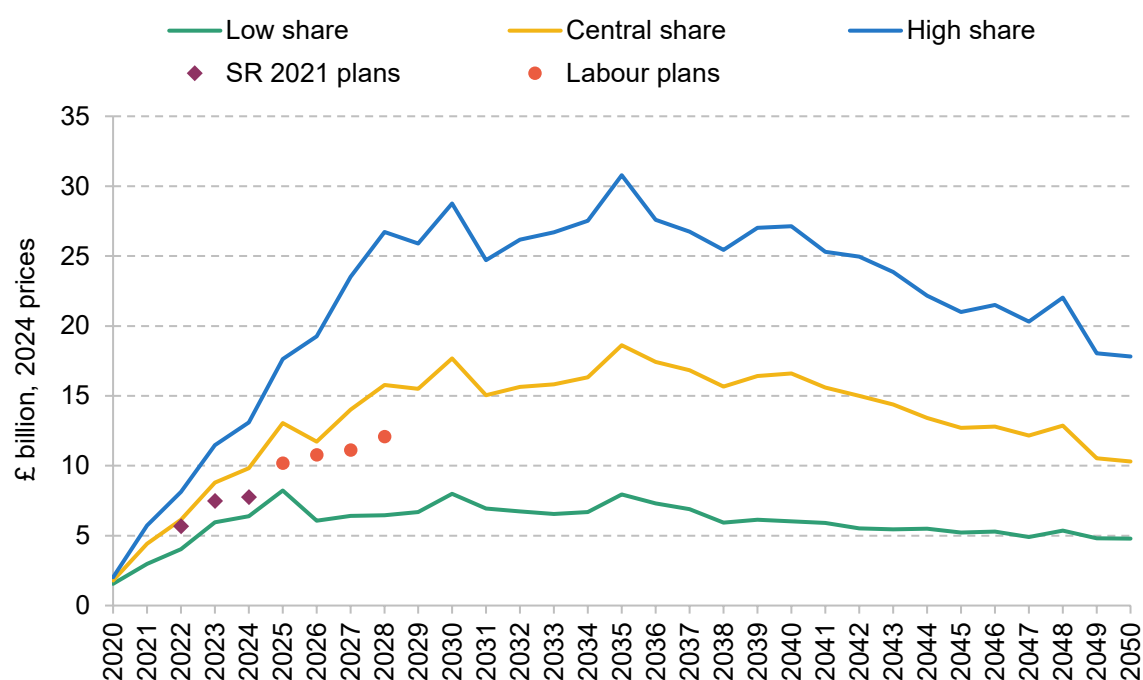


Note: The 2021 Spending Review reported emissions-reducing DEL and AME expenditure, excluding administration budgets. The Labour manifesto uses a broader measure of green spending.

Source: Authors' calculations using HM Treasury Spending Review 2021 and Labour Party manifesto 2024.

One notable feature of Labour’s recent discussion of its investment plans has been the focus on ‘crowding in’ private investment. The new ££7.3 billion National Wealth Fund is explicitly aimed at doing so, for example. It is interesting therefore to put the latest spending plans in the context of the OBR’s previous analysis of how much public and private investment might be required to deliver the transition to net zero (Office for Budget Responsibility, 2021). The Climate Change Committee’s ‘balanced path’ to net zero estimates the total economy costs of the transition. The OBR then varies the share of these total costs that are borne by the government. In the lower variant, the government only pays costs that relate to its own assets; in the central and higher variants, the government pays a share of private sector costs too. Figure 3.13 shows that the 2021 Spending Review and Labour’s plans sit somewhere between the lower and central OBR estimates, consistent with a greater role for the private sector in securing the net zero transition. If the government instead needs to take on a greater share of the costs, that would require higher levels of public investment – meaning either the overall envelope would need topping up, or other areas of capital spending would need to be cut back. Chapter 2 discusses longer-term fiscal consequences of the transition to net zero.

Figure 3.13. OBR estimates of public spending costs of the transition to net zero, alongside plans



Source: Authors’ calculations using OBR Financial Risks Report July 2021, HM Treasury Spending Review 2021 and Labour Party manifesto 2024.

3.5 Options and choices for the Chancellor

We now bring together the analysis of previous sections and discuss the high-level public spending choices facing Ms Reeves in the Spending Reviews this autumn and next spring. To be clear, this is a subset of the choices she will face. For one, we do not discuss here the choices about spending classified as AME (e.g. spending on social security benefits and state pensions). And choices over how much to spend – and on what – will be bound up in questions around the Chancellor’s fiscal strategy and fiscal rules – including how to define government debt (Stockton and Zaranko, 2024). These issues, and the broader public finance implications of potential public spending plans, are discussed in Chapter 2. The focus here is public services and options for departmental spending. The bulk of our analysis focuses on the medium term, as it is the medium-term spending totals which are of most fiscal relevance, but we also consider the specifics of the 2025–26 allocations in Box 3.4.

Box 3.4. Decisions for the one-year Spending Review this autumn

The amount of public spending in 2025–26 is largely irrelevant for the question of whether the government is acting within its fiscal rules. The fiscal rule likely to be binding for this government is that debt should be falling between the fourth and fifth years of the forecast (see Chapter 2), so what matters in the coming Budget will be the forecast levels of debt in March 2029 and March 2030.

In that sense, the most significant decision this autumn will be the setting of the spending envelope for the rest of the parliament. The multi-year Spending Review next spring will be the ‘main event’ in fiscal terms, with 2025–26 budgets significant only to the extent that they affect spending in later years. Nonetheless, the finalising of departmental budgets for 2024–25 (in light of in-year overspends) and the setting of detailed allocations for 2025–26 are still important choices for the Chancellor in her first Budget and will be important for public services over the next year – not least in determining what sorts of pay awards for public sector workers are affordable.

Consider first the budgets for 2024–25. Here, the key choice is the extent to which the £22 billion of in-year spending pressures discussed above are met through additional spending, and the extent to which departments are asked to find offsetting savings. In addition to savings from the ending of the Rwanda migration partnership and the means-testing of winter fuel payments, the July spending audit asked departments to find £3.2 billion of in-year cuts to fund higher pay pressures. Newspaper coverage suggests that this has been met by a ‘Whitehall revolt’.^a The final allocations for 2024–25 at the October Budget will confirm whether these cuts – or, indeed, further cuts – have been found, and from where.

The spending envelope for 2025–26 may then need topping up, to the extent that the net in-year pressures identified in 2024–25 reoccur next year. As discussed in Section 3.4, the additional spending

on public sector pay, at the least, will be permanent. This, combined with manifesto promises, might require a top-up to 2025–26 plans of around £10 billion straight off the bat (see Figure 3.8). Even with such a top-up, Panel A of Figure 3.9 shows that under reasonable assumptions for what might happen to the NHS, defence, aid and childcare budgets, remaining ‘unprotected’ day-to-day budgets would be facing cuts. Avoiding these would require a further top-up of around £3 billion (taking the required top-up to £13 billion). This estimate is sensitive to the assumptions underpinning the analysis: if the NHS England budget grows a bit more slowly (at 2.0% per year, rather than 3.6% per year as we assume) then unprotected budgets might even rise on average without a need for that additional £3 billion top-up. On the flip side, if asylum costs remain elevated and are assigned to the Home Office up front (rather than being met *ex post* from the Reserve), the cuts for other budgets could be even greater.

The point is that funding is likely to be tight. Ms Reeves might need to increase plans for 2025–26 by something like £13 billion just to meet the ongoing costs of recent public sector pay deals, honour manifesto commitments and avoid cuts to unprotected departments (with uncertainty on either side of this figure). Providing meaningful increases to unprotected departments – which include, under our definition, things such as schools, job centres, prisons and grants to local councils – would very likely require an even bigger funding injection.

Under existing plans (those of the previous government), capital budgets will also face real-terms cuts between 2024–25 and 2025–26. Whether or not this is still the case come the October Budget will depend largely on how much of the funding in Labour’s ‘Green Prosperity Plan’ (£23.7 billion over five years) comes on stream in 2025–26. More generally, the extent to which capital budgets are prioritised in the one-year Spending Review this autumn will provide a concrete indication of this new government’s economic and fiscal strategy and attitude towards public investment.

^a <https://www.ft.com/content/5e4cbe80-c759-4c1c-9f3f-bd8a0f4dacc2>.

Possible top-ups to spending plans

Sequencing

The new Chancellor has indicated that departmental allocations for 2025–26 will be set at the Budget and Spending Review on 30 October, alongside a final overall envelope for 2024–25 and 2025–26 (see Box 3.4 for a discussion). At the same time, she will need to update the overall spending plans – the ‘envelope’ – for later years through to 2029–30 (needed for evaluation of performance against the fiscal rules), even if detailed allocations for 2026–27 onwards will not be set out until the multi-year Spending Review in Spring 2025 (and if we are then to have biennial spending reviews that cover three years, then budgets for 2029–30 would not be allocated until a 2027 Spending Review). At the Budget, then, she will need to decide not only

how much funding to provide to individual public services in the coming year, but also how much she wants to spend overall for the rest of the parliament.

These spending totals for future years will not be set in stone. Previous governments have shown a clear tendency, when they actually come to allocate funding between departments at a Spending Review, to top up the spending envelope. At the last four Spending Reviews (between 2015 and 2021), the RDEL envelope for the final year was topped up by an average of 3.7%, relative to the provisional totals that were in place beforehand (which, if history repeats, would correspond to a top-up of £19 billion in 2028–29).²⁰ The Treasury may, as part of its negotiations with spending departments, decide to lowball these provisional totals in the expectation of a top-up later. In what follows, we abstract away from this and focus on the amount by which spending totals for the rest of the parliament might *eventually* need to be topped up, as this is what is most relevant from a fiscal perspective.

How big a top-up in 2028–29?

For the reasons discussed earlier in the chapter – not least the promises in the Labour Party manifesto and the scale of recent public sector pay offers – existing spending plans will almost certainly be increased at the October Budget. The key question is by how much. Figures 3.14 and 3.15 present some possible answers to that question for resource and capital funding, respectively.

Taking resource funding first, Figure 3.14 shows that increasing the spending envelope to reflect this year’s public sector pay announcements would require a £9 billion top-up to plans for 2028–29. Delivering Labour’s manifesto promises would require a further £5 billion. This suggests that, at a minimum, Ms Reeves will need to increase day-to-day spending totals for 2028–29 by £14 billion. That would see overall resource DEL grow – from a higher 2024–25 starting point – by 1.2% per year over the next four years (versus 1% per year under the plans she inherited).

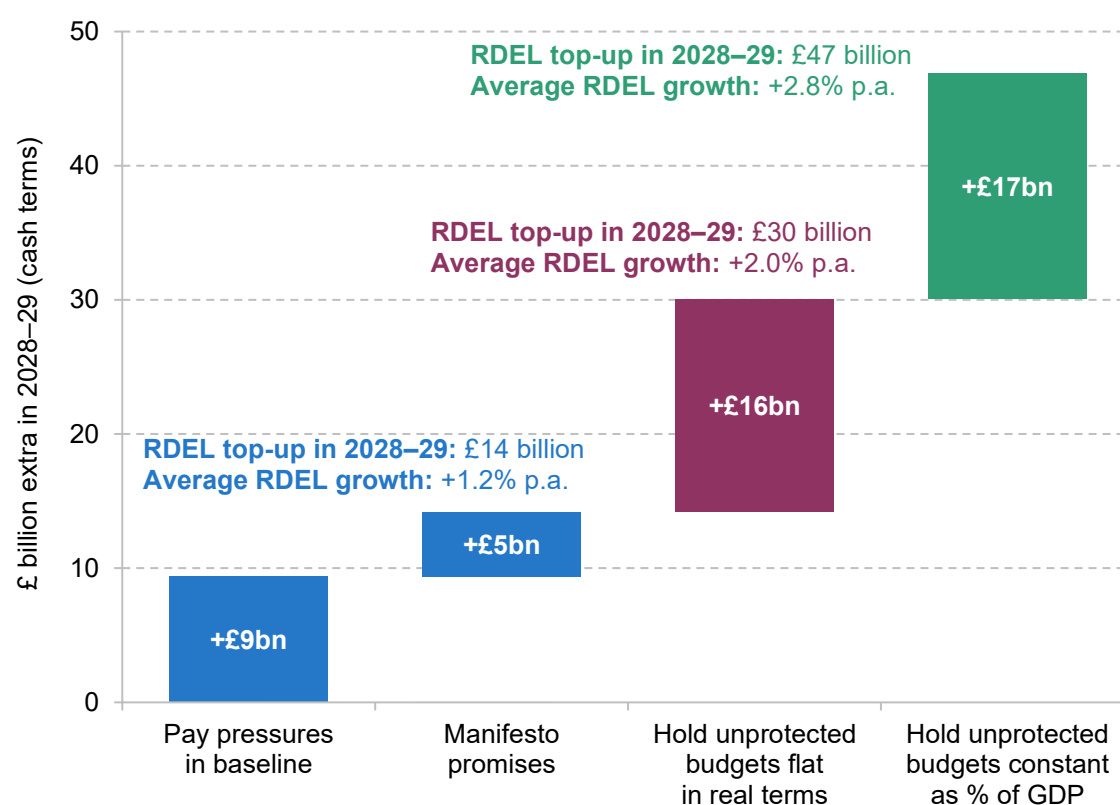
If the Chancellor also wishes to avoid making real cuts to unprotected budgets, she would need to find an extra £16 billion, taking the total to £30 billion. That would result in average RDEL growth of 2.0% per year in real terms – a less generous Spending Review settlement than seen in recent years, never mind during the 2000s (see Figure 3.2).

Flat real budgets for areas such as prisons, courts and adult skills would still be tight and could prove to be incompatible with the government’s objectives for public services. Increasing unprotected budgets in line with GDP instead (to maintain spending as a share of national

²⁰ In a similar exercise, the OBR examined changes in the real growth rate in the RDEL envelope at previous Spending Reviews and concluded that this has been increased, on average, by 1.1% per year (Office for Budget Responsibility, 2024). This would imply a top-up to 2028–29 plans of around £23 billion at the October Budget and Spending Review, slightly higher than our analysis would imply.

income) would require an additional £17 billion in 2028–29 (a total top-up of £47 billion), taking average real-terms RDEL growth to 2.8% per year. In other words, even with a near £50 billion top-up, the day-to-day spending settlement would be less generous than what was announced by the then Chancellor Mr Sunak at the 2021 Spending Review (where original plans implied average real growth of 3.3% per year, though higher-than-expected inflation has reduced that to 2.2% per year – see Figure 3.3). To match that would require a top-up of around £60 billion.

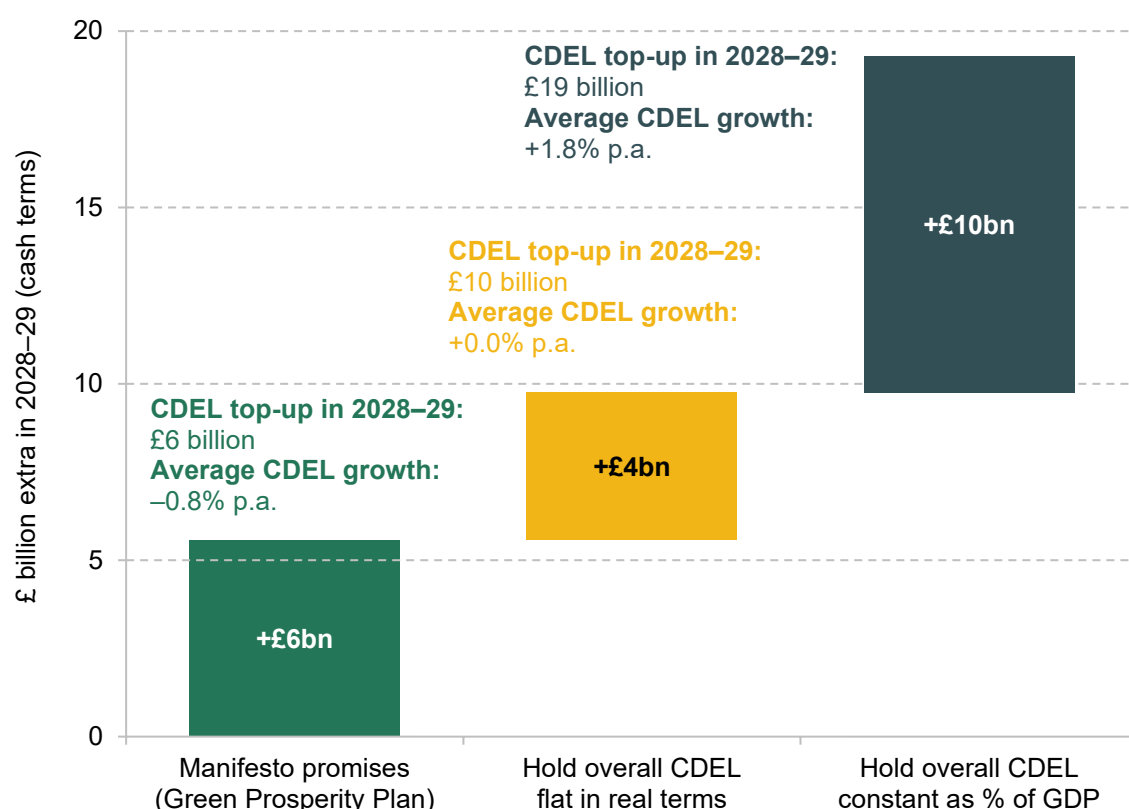
Figure 3.14. Options for topping up the resource (day-to-day) envelope in 2028–29



Source: Authors' calculations based on assumptions outlined in the text.

Turning to capital, our interpretation of Labour's 'Green Prosperity Plan' is that it will mean a £6 billion increase in capital DEL plans for 2028–29 (Figure 3.15). In that scenario, departmental capital budgets would still be falling over the next four years by an average of 0.8% per year. Avoiding those cuts would require a further £4 billion, taking the total top-up to £10 billion in 2028–29. If the Chancellor instead wishes to maintain capital DEL as a share of national income (i.e. to increase it in line with GDP, by 1.8% per year in real terms), a further £10 billion in 2028–29 would be needed, making £19 billion in total (after rounding). The government could, of course, decide to go even further; maintaining capital DEL as a share of national income should not be seen as an upper bound.

Figure 3.15. Options for topping up the capital (investment) envelope in 2028–29



Source: Authors' calculations based on assumptions outlined in the text.

Table 3.3 brings all of this together and considers four high-level scenarios:

- **Status quo.** Increasing the day-to-day spending baseline to reflect public sector pay pressures, maintaining the growth assumptions bequeathed by Mr Hunt, and delivering on manifesto promises would require a total top-up to departmental budgets of **£20 billion in 2028–29** (made up of £14 billion of resource and £6 billion of capital).
- **Avoid real-terms cuts.** Increasing the day-to-day baseline and delivering the manifesto, but also increasing the envelope to avoid real-terms cuts to unprotected day-to-day budgets and to avoid real-terms cuts to overall capital budgets, would require a total top-up of **£40 billion in 2028–29**.
- **Avoid cuts as a % of GDP.** Increasing the baseline and delivering the manifesto, and also maintaining unprotected resource budgets and overall capital budgets as a share of national income, would require a top-up of **£66 billion in 2028–29**.
- **Prioritise capital.** Increasing the day-to-day baseline and delivering the manifesto, and maintaining overall capital budgets as a share of national income – thereby prioritising investment within the total – would require a top-up of **£33 billion in 2028–29**.

Table 3.3. Summary of options for 2028–29 DEL top-ups at the Budget

Top-up scenario	Extra spending in 2028–29 (relative to SB 2024 plans)	Average annual real growth rate
<u>Resource DEL scenarios</u>		
Spring Budget 2024 plans	-	+1.0%
A) Increase RDEL baseline (maintain 1% real growth assumption with net pay pressures in 2024–25 baseline)	£9 billion	-
B) Increase spending envelope to reflect 2024 general election manifesto promises	£5 billion	-
<i>Memo: baseline change and manifesto (A+B)</i>	<i>£14 billion</i>	<i>+1.2%</i>
C) Implement A + B, and also avoid real-terms cuts to unprotected RDEL budgets between 2024–25 and 2028–29 ^a	£30 billion	+2.0%
D) Implement A + B, and also increase unprotected RDEL budgets in line with nominal GDP between 2024–25 and 2028–29 ^a	£47 billion	+2.8%
<u>Capital DEL scenarios</u>		
Spring Budget 2024 plans	-	-2.0%
E) Increase spending envelope to reflect (IFS estimate of) 2024 general election green investment promises	£6 billion	-0.8%
F) Avoid real-terms cuts to overall CDEL between 2024–25 and 2028–29	£10 billion	+0.0%
G) Increase overall CDEL in line with nominal GDP between 2024–25 and 2028–29	£19 billion	+1.8%
<u>Total DEL scenarios</u>		
Spring Budget 2024 plans	-	+0.4%
Status quo: Increase RDEL baseline, deliver manifesto (A+B+E)	£20 billion	+0.8%
Avoid real-terms cuts: Increase RDEL baseline, deliver manifesto, avoid real-terms cuts to unprotected RDEL and overall CDEL (C+F)	£40 billion	+1.6%
Avoid cuts as a % of GDP: Increase RDEL baseline, deliver manifesto, maintain unprotected RDEL and overall CDEL as a share of national income (D+G)	£66 billion	+2.6%
Prioritise capital: Increase RDEL baseline, deliver manifesto, maintain CDEL as a share of national income (A+B+G)	£33 billion	+1.4%

Note: SB 2024 = Spring Budget 2024. Average annual real growth rate is for the period from 2024–25 to 2028–29.

^a Note that the estimates for C and D have been produced on the assumption that A and B are implemented (i.e. the modelling of the cost of avoiding cuts to unprotected budgets assumes that the envelope is topped up to reflect pay pressures in the baseline and manifesto promises).

Source: Authors' calculations using assumptions outlined in the text.

These scenarios are not prescriptive, nor are they exhaustive. Note, for example, that even our most generous top-up to the capital budget (of £19 billion per year by 2028–29) would still be considerably less ambitious than the £28 billion of additional green investment each year originally announced by Ms Reeves. The scenarios are also sensitive to all manner of assumptions. They do, however, illustrate the fact that the required top-ups can get quite large quite quickly under quite modest assumptions. Chapter 2 puts these in the context of the broader public finances and performance against the new government’s fiscal rules.

Prioritise capital?

The previous subsection considered a possible ‘prioritise capital’ scenario, in which capital budgets would increase more quickly than day-to-day budgets. But more generally, when considering its spending options, an important question for the government is the extent to which it wants to prioritise capital spending – investment – relative to day-to-day public services. In her March 2024 Mais Lecture, Ms Reeves, as Shadow Chancellor, promised to ‘prioritise investment within a framework that would get debt falling as a share of GDP over the medium term’ (Labour Party, 2024), and Sir Keir Starmer recently warned the public to expect ‘short term pain for long term good’ (Prime Minister’s Office, 2024). These statements might point to a Spending Review that prioritises higher investment spending, at the cost of lower spending on day-to-day public services – possibly as part of a shift to a higher-investment, lower-consumption economy (Resolution Foundation & Centre for Economic Performance, 2023). This choice is clearly bound up in questions around the fiscal rules and the government’s economic and fiscal strategy more generally. Here, we focus just on the spending side of things and what it might mean to prioritise investment.

Within a fixed overall public spending envelope, there is a direct trade-off between spending an additional £1 on capital and spending an additional £1 on day-to-day spending. Even if the envelope is topped up, there is a choice of whether to prioritise investment or day-to-day spending.

For a government aiming to improve public service performance and productivity, and to focus on long-term solutions rather than short-term sticking plasters, there is a strong case to be made for prioritising capital investment. Across a range of public services – the NHS, prisons, courts, schools – the quality and quantity of buildings and equipment are a key limiting factor on performance (Warner and Zaranko, 2022; Hoddinott et al., 2024; Darzi, 2024). Higher levels of investment – particularly in areas such as transport and energy – could also contribute towards Labour’s growth and clean energy ambitions, plus a manifesto commitment to ‘strategically use public investment where it can unlock additional private sector investment, create jobs, and provide a return for taxpayers’.

But increasing capital spending relative to day-to-day spending would be challenging when the short-term pressures on services are so great. The whole reason behind the original separation of resource and capital budgets was that governments find it easier to cut back on investment when funding is squeezed, rather than things such as staffing numbers or pay. It is rather telling that even with this separation, under past governments there were frequent transfers from capital to resource budgets when public services faced financial pressures. In the Department of Health and Social Care, for example, these capital-to-resource transfers amounted to £0.6 billion in 2014–15, £1.2 billion in 2015–16 and 2016–17, £1 billion in 2017–18, £0.5 billion in 2018–19 and almost £1 billion in 2023–24 (Stoye, Warner and Zaranko, 2024).

One big test for a government that claims to want to prioritise investment will be the extent to which capital budgets are indeed prioritised within the total, and the extent to which those budgets are stuck to rather than transferred to meet day-to-day pressures. Any efforts to meaningfully prioritise investment will involve sacrifices elsewhere (Resolution Foundation & Centre for Economic Performance, 2023; Wilkes, 2024). But for a newly elected government with a large majority and a stated willingness ‘to accept short term pain for long term good’ (Prime Minister’s Office, 2024), the question is surely ‘If not now, then when?’.

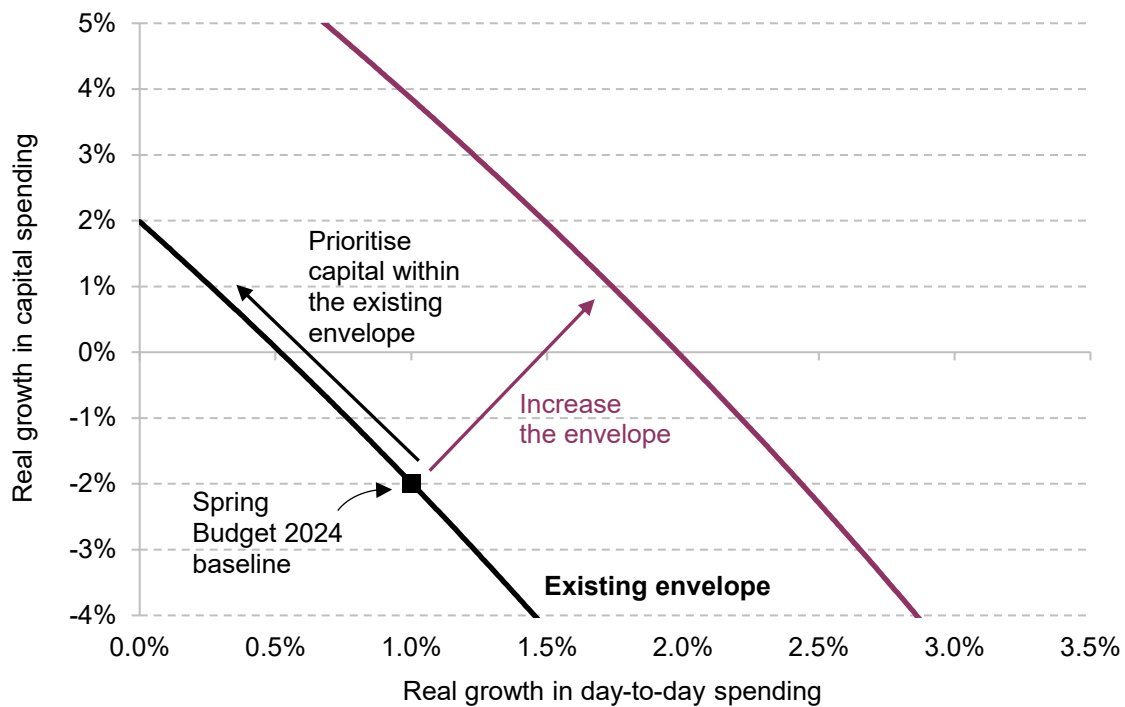
Figure 3.16 illustrates the choices and trade-off that Ms Reeves faces between day-to-day and capital spending. For each panel, the horizontal axis shows the growth rate in day-to-day spending and the vertical axis shows the growth rate in capital spending. Each line represents a fixed overall spending envelope.

Panel A illustrates the high-level choice. From a given starting point, the government can prioritise capital within the existing envelope (moving north-west along the black line) or can expand the envelope (shifting the line out to the right, to the purple line), which would allow for more spending on one or both of resource and capital.

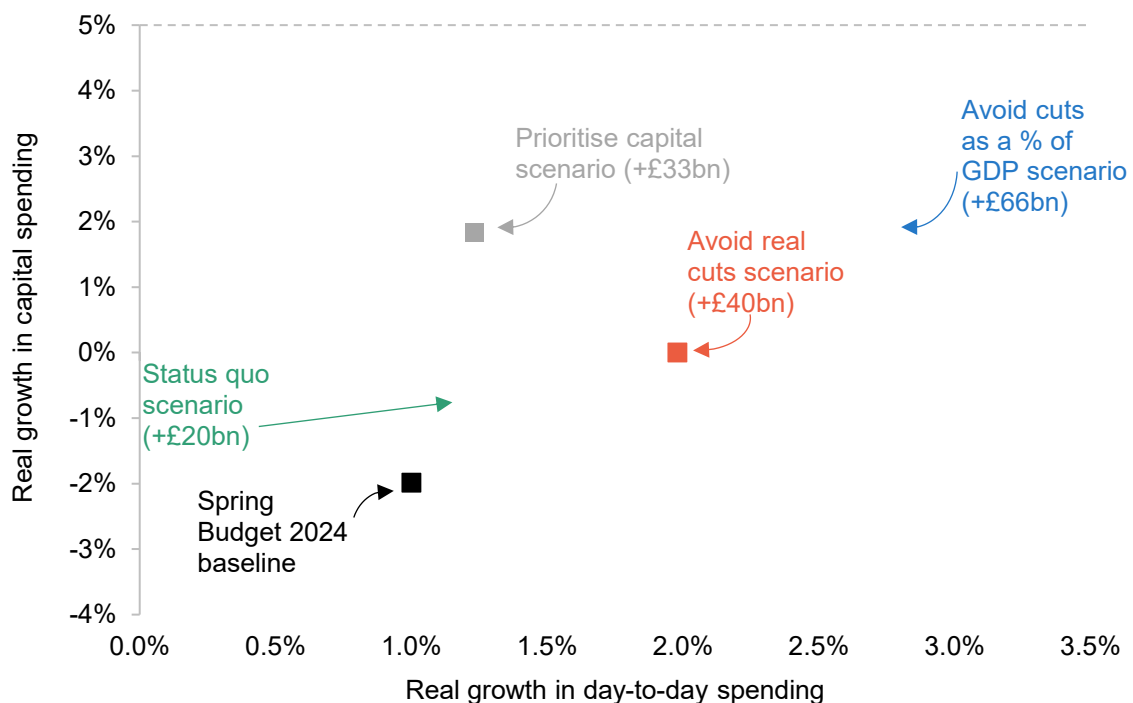
Panel B then shows some specific options, based on the top-up scenarios presented in Table 3.3. The black square denotes Spring Budget 2024 plans. The green square denotes the ‘status quo’ scenario, with a higher baseline due to public sector pay pressures and Labour’s manifesto promises delivered, which would see resource DEL grow by 1.2% per year in real terms and capital DEL fall by 0.8% per year. The red square denotes the ‘avoid real cuts’ scenario (with average 2.0% growth in RDEL and CDEL flat in real terms); the blue square denotes the ‘avoid cuts as a % of GDP’ scenario (with average 2.8% growth in RDEL and 1.8% growth in CDEL); and the grey square denotes the ‘prioritise capital’ scenario (with average 1.2% growth in RDEL and 1.8% in CDEL).

Figure 3.16. Trade-off between real growth rates in day-to-day spending and in capital spending given total spending envelope between 2024–25 and 2028–29

Panel A. Illustrating the high-level choice



Panel B. Some specific options



Note: Figures in parentheses denote the required top-up to the total DEL envelope. Uses our central RDEL and CDEL totals used throughout this chapter.

Source: Authors' calculations based on assumptions outlined in the text.

The key point is that within the total envelopes implied by each of these scenarios (the line of the same colour as the square), Ms Reeves could choose to prioritise capital or day-to-day spending by moving along the line. For example, the ‘avoid cuts as a % of GDP’ line was calculated on the basis that Ms Reeves would grow unprotected RDEL and overall CDEL in line with national income. But with the same total top-up to spending, she could further prioritise capital. For example, if she chose to hold unprotected RDEL flat in real terms, this would mean capital spending could grow at 4.9% per year in real terms within the same overall envelope, rather than at 1.8% if unprotected RDEL grew in line with GDP.

Prioritise the usual departments?

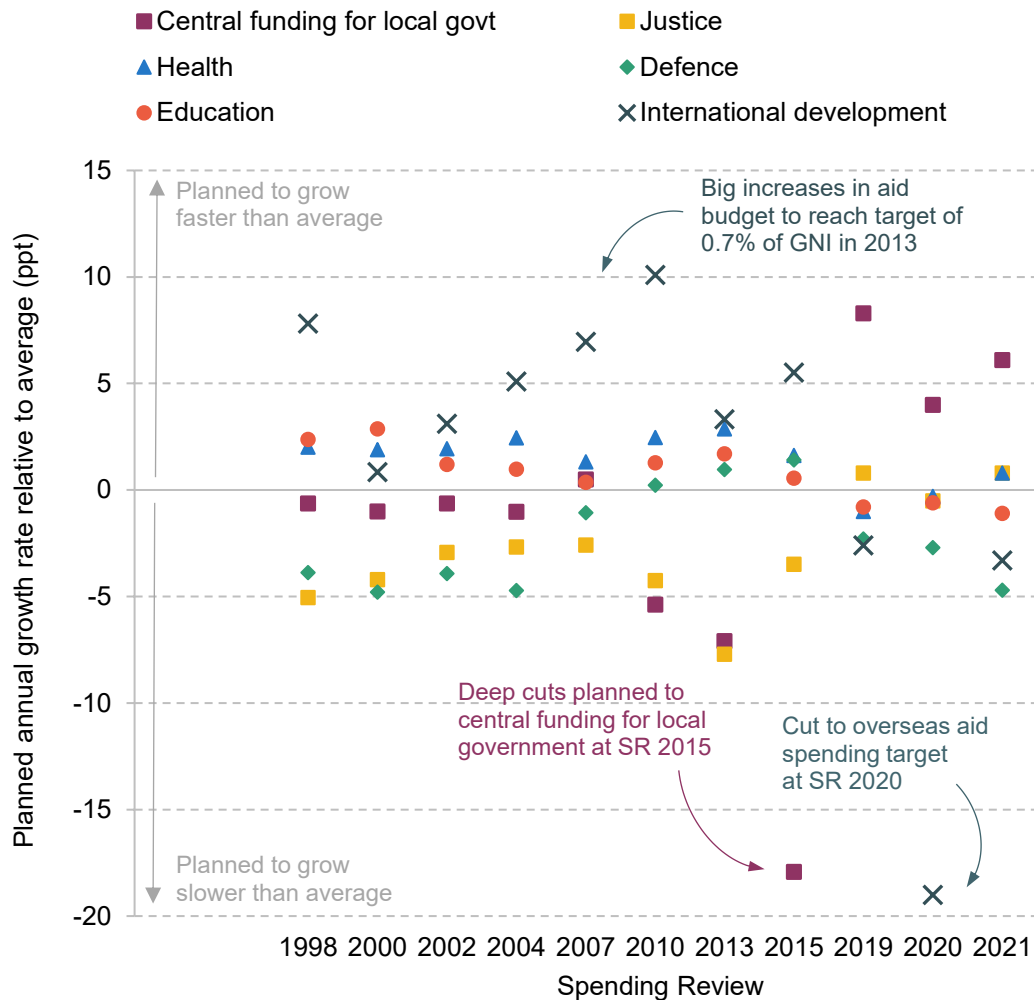
Once Ms Reeves has decided on an overall envelope for day-to-day and capital spending, she must then decide how these are allocated to different departments. While it would be possible to allocate funding growth equally to all departments, this is unlikely in practice. Some departments will inevitably be prioritised over others – because they face greater pressures and/or because they are higher political priorities. Historically, the tendency has been for certain departments to be repeatedly prioritised and for others to do worse than the average. To illustrate this, Figure 3.17 shows the planned growth rate in day-to-day funding for selected departments relative to the all-department average for each Spending Review since 1998. Note this shows the planned growth rate, to capture which departments successive governments intended to prioritise for funding growth, rather than the actual out-turn growth rates.

Between 1998 and 2015, Spending Reviews followed a similar pattern: health, education and international development would receive higher growth rates than average, while justice and (central funding for) local government would receive lower growth rates than average. Since the 2019 Spending Review, the pattern has been very different. Central funding for local government has done better than average at each of the last three Spending Reviews; justice has done close to or better than the average; and education and international development have done worse than average (in the latter case, considerably worse).

It may be that, in a tight funding environment, Ms Reeves decides to prioritise the ‘usual suspects’ – giving above-average increases to health, for example. This is ultimately a question of priorities, but we would sound two notes of caution.

First, many of the traditionally less protected areas of spending have faced large cuts since 2010 (see Figure 3.18). The above-average increases for these areas in recent years were likely the result of a recognition that the scale of these cuts was having a severe adverse effect on service provision. Imposing another round of cuts on services that are under considerable pressure (see Section 3.4), and in many cases still have lower real-terms budgets than was the case 15 years ago, would be challenging, to say the least.

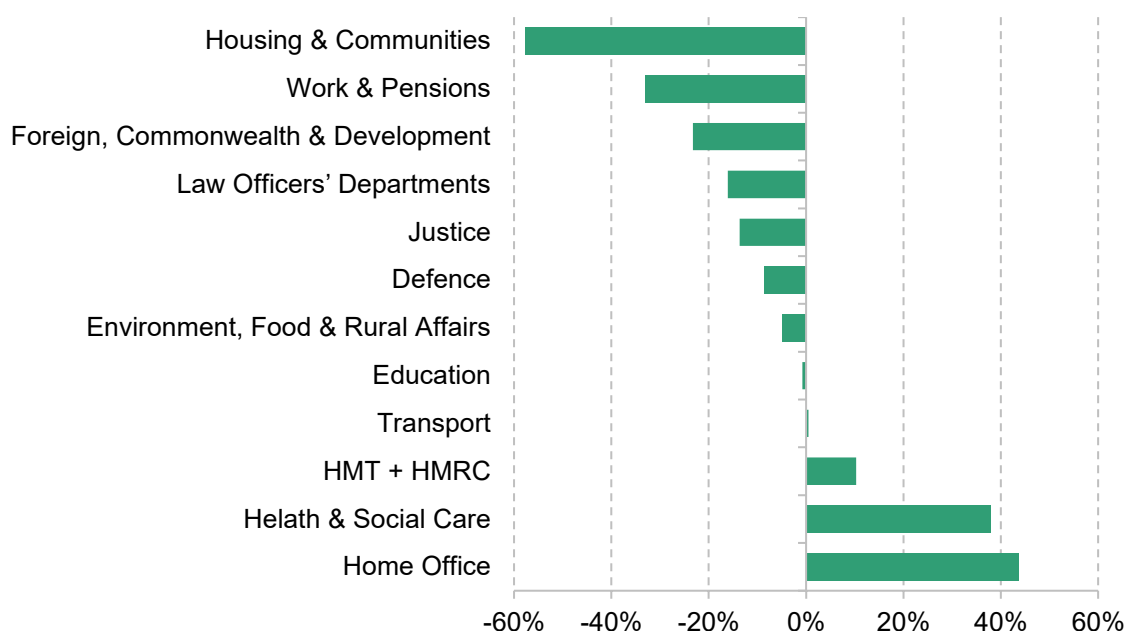
Figure 3.17. Planned growth in resource (day-to-day) funding in selected areas, relative to the average, by Spending Review



Note: Figures denote planned real-terms growth, not the out-turn. A figure of zero would indicate that spending in that area was planned to grow at the same rate as overall resource DEL. Real growth rates are taken from the Spending Review (SR) documents if published, and calculated using nominal spending plans and contemporaneous GDP deflator forecasts if not. 'Justice' refers to the Lord Chancellor's Department from SR 1998 to SR 2002, the Department for Constitutional Affairs at SR 2004 and the Ministry of Justice from SR 2007 onwards. 'Education' refers to the Department for Education and Employment at SR 1998 and SR 2000, the Department for Education and Skills at SR 2002 and SR 2004, the Department for Children, Schools and Families at SR 2007 and the Department for Education from SR 2010 onwards. 'Health' refers to the Department of Health from SR 1998 to SR 2015 and the Department of Health and Social Care from SR 2019 onwards. 'International development' refers to the Department for International Development from SR 1998 to SR 2019 and the Foreign, Commonwealth and Development Office at SR 2020 and SR 2021. Central funding for local government is not the entirety of local government funding, as councils also raise revenue from local taxes.

Source: Authors' calculations based on various Spending Reviews.

Figure 3.18. Real-terms percentage change in day-to-day spending for selected departments, 2009–10 to 2023–24



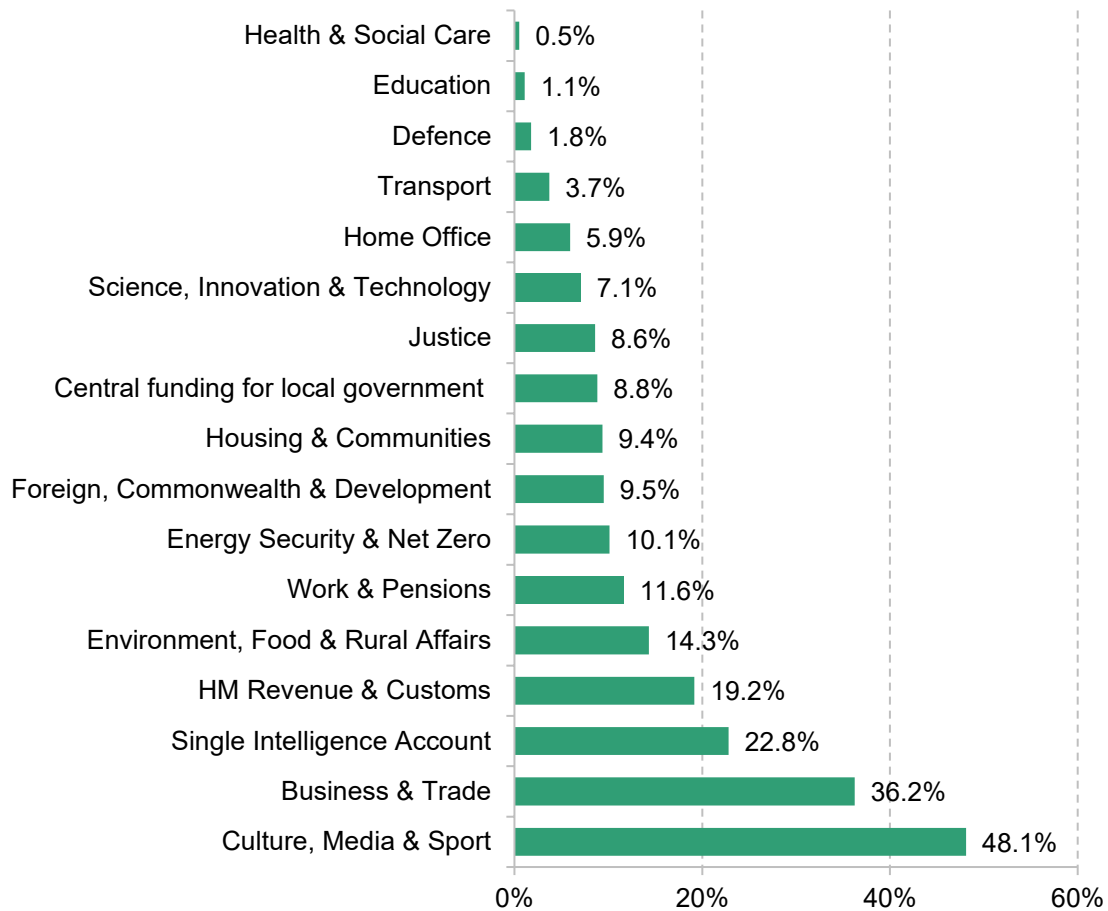
Note: 'Environment, Food & Rural Affairs' bar is adjusted for estimated direct payments to farmers, previously paid by the EU. 'Housing & Communities' excludes Shared Prosperity Fund funding. Only selected departments shown, with some excluded because of the difficulty in making like-for-like comparisons over time due to Machinery of Government changes. Changes are shown up to 2023–24 since final figures for 2024–25 spending are not yet available.

Source: Public Expenditure Statistical Analyses (various) and GDP deflator as of March 2024.

Second, what the Chancellor decides to do with the largest departments will dominate everything else. The three largest areas of spending within DEL – health and education in England, and the UK-wide defence budget – make up around two-thirds of planned day-to-day spending in 2024–25 between them. NHS England alone accounts for more than one-third of the total.

To illustrate the differences in department size, and what these mean for the Spending Review, Figure 3.19 shows the percentage increase in 2024–25 TDEL that could be achieved for different departments with a £1 billion increase in funding. For health and social care, £1 billion would increase funding by 0.5%. But for smaller departments, it would be a much larger increase. For example, £1 billion would increase funding by 8.6% for justice, 14.3% for environment, food and rural affairs or 48.1% for culture, media and sport. In other words, an additional £1 billion in funding would be little more than a rounding error within the NHS but could transform smaller public services. Equivalently, seeking to fund even very small percentage increases in the NHS budget through savings elsewhere would require deep cuts to smaller departments and potentially drastic changes in service provision.

Figure 3.19. Percentage increase in 2024–25 TDEL that can be achieved with a £1 billion increase



Note: Excludes departments with budgets less than £2 billion, budgets for the devolved nations, and small and independent bodies.

Source: HM Treasury's Public Expenditure Statistical Analyses 2024.

Even with the potential top-ups discussed in a previous subsection, the rate of growth in the overall spending envelope is likely to be fairly modest by historical standards (and certainly relative to the last period when Labour was in office). Inevitably, this will require prioritisation and some tough choices about where any additional funding is to be targeted.

3.6 Conclusion

The new Chancellor faces an unenviable balancing act at the forthcoming Spending Review. On the one hand, the Labour manifesto committed to major improvements to public services. While funding is not the only thing that matters, and finding ways to boost public service productivity will be just as – if not more – important, many public services will need more money just to stand still, let alone improve. But Ms Reeves has also promised to stay within her ‘ironclad’ fiscal rules and not to raise the main rates of income tax or to increase National Insurance and

VAT at all. She can, with some justification, point to the scale of the in-year spending pressures as an unhelpful bequest from her predecessor. But the medium-term challenge has long been apparent – even if it was all-but-ignored by both Labour and Conservatives during the recent general election campaign. It can be ignored no longer.

The most important choice for Ms Reeves is how much she wants to top up the overall spending envelopes for 2025–26 and beyond. It seems almost inevitable that there will be some top-up to the previous government’s spending plans, if only to fund costed manifesto commitments and higher public sector pay. But top-ups in the single billions would still imply real-terms cuts to some departments – cuts which might be difficult to reconcile with the promise that there will be no return to austerity. To avoid real-terms cuts to those unprotected departments and to overall capital budgets will require a top-up in the tens of billions – we estimate around £40 billion in 2028–29. Even that would leave spending growing more slowly than we have seen not just under the last Labour government but also relative to what Mr Sunak planned when he was Chancellor at the time of the last Spending Review.

These spending choices – how much to spend overall, how much to prioritise investment over meeting day-to-day pressures, and how much to allocate to particular services – are bound up with broader questions of economic and fiscal strategy. They promise to be highly revealing – and consequential.

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4. Pressures on public sector pay

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Key findings

- 1 **The new government has accepted the pay recommendations of the independent Pay Review Bodies (PRBs)**, meaning that public sector employees will see **their pay increase by between 4¾% and 6% in 2024–25**, depending on occupation. Chancellor Rachel Reeves has put the **cost at an additional £9.4 billion on top of the 2% pay rises budgeted in the 2021 Spending Review**.
- 2 While public sector pay increases for 2024–25 are in line with forecast pay growth in the private sector, pay trends in the two sectors have not followed the same path since 2010. **Public sector pay held up much better than private sector pay between 2009 and 2014, but since then the situation has reversed**. Whilst real private sector pay is now above its level at the start of 2019, **public sector pay is, in real terms, only 1% higher and it is still below where it was in 2010**.
- 3 Median pay relative to the overall hourly pay distribution has evolved differently over time for different public sector occupations. **Broadly, it is better-paid public sector workers who have seen bigger falls in pay**, with doctors' pay slipping from the 95th percentile of the hourly pay distribution to close to the 90th percentile since 2007. Teachers have seen falls from the 87th percentile to the 81st percentile. In contrast, while nurses and those in public administration have seen their pay fluctuate, by 2022 they are at roughly the same point in the distribution as they were in 2007.
- 4 **Each area of the public sector faces specific challenges, though recruitment and retention are common concerns across much of the sector**. In the NHS, there is an increasing reliance on international recruitment and agency staff to fill posts. The NHS 'Long Term Workforce Plan' also aims to increase the number of staff from 1.75 million in 2023 to between 2.3 and 2.4 million by 2036–37, which implies that NHS pay

may have to rise faster than that in the wider economy to ensure NHS careers are sufficiently attractive.

- 5 **The teacher vacancy rate of 0.6% is twice the rate it was pre-pandemic.** Training targets (as set by the Department for Education's Teacher Workforce Model) are being missed by big margins in most subjects, with less than a fifth of the target in business studies and physics being met. Although retention rates are not much lower than between 2013 and 2020, they are lower in subjects that are training the fewest teachers. More-experienced teachers have seen some of the largest real-terms falls in pay since 2010.
- 6 **Police officers**, in contrast to other areas of the public sector, **have seen their pay deteriorate more for those lower down the pay scale.** This is particularly true for constables on the bottom pay grade, whose pay has gone from being around the 34th percentile of the earnings distribution in 2014 to around the 26th percentile in 2023. Many police forces are still experiencing shortages of officers, despite the large efforts made by the Police Uplift Programme.
- 7 The prison service is on the front line of one of the most salient challenges currently facing the public sector – the severe shortage of prison places. In terms of staff, retention is the main challenge. **The leaving rate of prison staff was 13% in 2023, with officers who had been in post for less than a year the most likely to leave.** Although pay has remained stable in relative terms over time, and is in general higher than in 'comparable professions', it is still low compared with the rest of the public sector and the wider economy.
- 8 People on 'senior salaries' make up much less than 1% of the headcount of the public sector. In general, the occupations included in this group are not experiencing challenges to the same extent as other parts of the public sector, though this is not universally true. The largest of the groups – **the senior civil service (SCS) – has seen pay fall in real terms by between 12% and 16% (depending on seniority) since 2013 and is characterised by a large degree of churn**, with 25% of the SCS changing roles or departments, or leaving the SCS entirely, in 2022–23. Of those who leave, almost three-quarters are regarded as 'regrettable' losses. The judiciary (which is also covered in the 'senior salaries' remit) faces severe recruitment challenges, though retention is largely not an issue.
- 9 The Armed Forces have seen a planned big reduction in headcount over time. But the number of individuals choosing to leave before the end of their contracted period has grown above its pre-pandemic level. Although real-terms falls in pay are smaller than

for other public sector occupations, members of the Armed Forces are generally unsatisfied with their pay. **The Armed Forces are in receipt of one of the largest pay rises from the 2024–25 PRB recommendations, alongside doctors and the judiciary.**

- 10 A substantial part of public sector workers' remuneration comes in the form of **generous defined benefit pension accrual**. Members of these public sector arrangements receive, on average, an employer's pension contribution that the government values at at least 23% of salary. Membership of these arrangements generally requires a significant employee contribution in order to participate. Lower-paid workers in particular are more likely to opt out given the size of these contributions: **more than twice as many of those earning £10,000 to £16,000 a year opt out as of those earning over £31,000 per year (13% versus 6%)**. A recurring theme across PRB reports is concerns about the financial implications of high employee pension contributions needed to participate in the schemes and support for greater flexibility in the approach to pensions.
- 11 **The challenges in recruiting, retaining and motivating public sector employees and the need for expansion of the NHS workforce in line with the 'Long Term Workforce Plan' mean that there will be pressure for public sector pay to rise faster than average earnings over the coming parliament.** Based on March 2024 forecasts from the Office for Budget Responsibility, increases in public sector pay in line with average earnings over the next four years would, if the numbers employed remained constant, cost around £6 billion per year by 2028–29. If average public sector pay were to rise by 1 percentage point per year faster than average earnings for four years, the cost would rise to £17 billion per year by 2028–29. This would rise further if the public sector workforce increased in size.

4.1 Introduction

The public sector employs 5.9 million people in the UK, at an annual cost of £270 billion in 2023–24 (including salaries, employer pension contributions and employer National Insurance contributions) – 10% of national income and 22% of total UK government spending. The employment, pay and productivity of these employees are therefore an important determinant of the material standard of living of millions of families, as well as a crucial input into the provision of public services. Public sector pay growth is an important pressure on public spending.

All else equal, higher growth in public sector pay (even if it delivers higher-quality public services) necessitates lower public sector employment, lower spending elsewhere, higher taxation or higher borrowing. It is not surprising that public sector pay can be – as is currently the case – somewhat of a political football, especially following the spike in public sector industrial action in 2023 which continued (albeit at a much lower level) into 2024 (Office for National Statistics, 2024).

One of the new government's first announcements, coming at the end of July 2024, was that it would accept in full the independent Pay Review Bodies' recommendations for increases in public sector pay.¹ These pay awards, averaging 5.5% annual growth in cash terms, formally related to the 45% of the public sector covered by the eight Pay Review Bodies (Institute for Government, 2022). Even for public sector occupations where pay is not formally set by these Pay Review Bodies, pay often follows these trends closely – for example, civil servants' pay will rise by 5% in 2024–25.²

In one of her first acts as Chancellor, Rachel Reeves presented the additional public spending necessitated by the acceptance of these pay awards in full as part of the 'unfunded pressures' inherited from the previous government (HM Treasury, 2024). The awards are estimated to add £9.4 billion to public spending this year in excess of the 2% pay awards budgeted for at the time of the 2021 Spending Review. As our colleagues noted in July (Boileau et al., 2024), with forecasts for private sector wage growth at similar rates, recommendations of this magnitude should not have come as a complete surprise. But looking to the future, a key question remains: to what extent will public sector pay growth continue to be an important pressure for a government trying to both deliver high-quality public services and exercise spending control? Providing an answer to this question is the key aim of this chapter.

This is particularly important because improved public services were a key plank of the Labour Party manifesto in 2024, with improvement of the NHS one the new government's five 'missions'. The manifesto criticised the 'recruitment and retention crises' across public services and pledged to recruit thousands of new teachers and police officers and to improve public service workers' living standards.³ Recruiting and retaining more public sector workers, and improving their living standards, will in part require additional expenditure on public sector pay over the course of this parliament.

¹ <https://www.gov.uk/government/news/chancellor-i-will-take-the-difficult-decisions-to-restore-economic-stability>.

² Only senior civil servants are covered by a Pay Review Body. See <https://www.gov.uk/government/publications/civil-service-pay-remit-guidance-2024-to-2025/civil-service-pay-remit-guidance-2024-to-2025>.

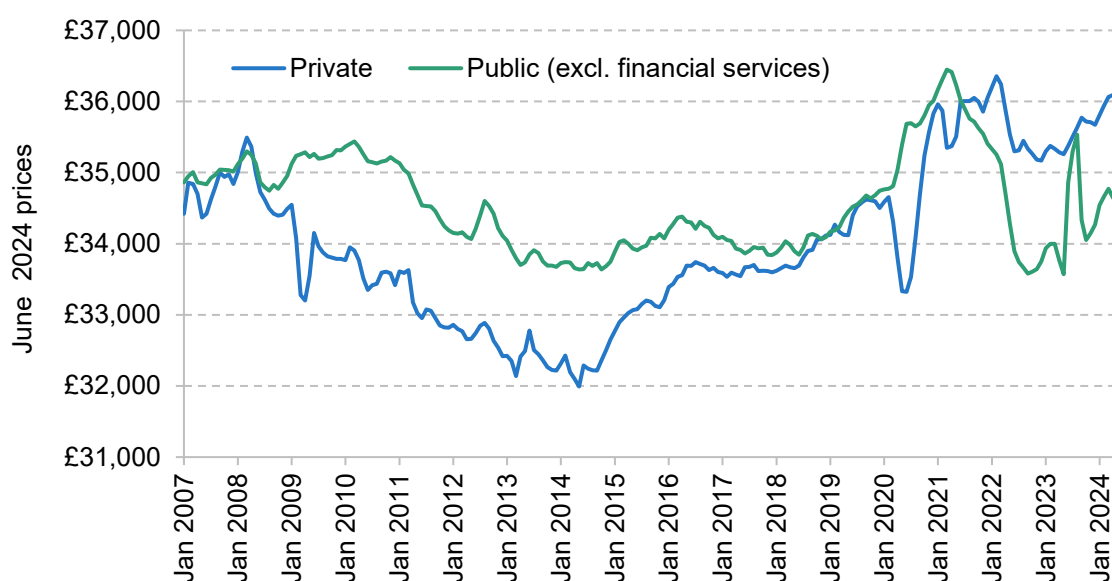
³ <https://labour.org.uk/wp-content/uploads/2024/06/Change-Labour-Party-Manifesto-2024-large-print.pdf>.

It is worth reflecting on the aims of the government in setting the level of public sector pay. Pay plays a key part in attracting new employees, and retaining and motivating existing ones. The public sector workforce is one of the main inputs into public service provision, and pay structures and levels affect whether the right number and mix of staff are available and appropriately motivated to deliver the desired range and quality of public services. In addition, public sector pay is sometimes used as a vehicle for social policy – as a way to increase living standards for particular groups or conduct some redistribution towards lower earners – though the appropriateness of using public sector pay in this way is a matter of debate. The government is generally also looking to achieve its desired aims at the minimum cost. These goals may therefore conflict; the government often has significant market power in the labour market for certain kinds of workers, allowing it to suppress pay to some extent (perhaps most obviously in national defence, policing, healthcare and education). But the ability to do this might still come at the expense of public service performance and, potentially, social policy goals.

Figures 4.1 and 4.2 provide important background information on how public sector pay has performed in recent years. Figure 4.1 shows that average (mean) public sector pay was around £34,500 per year in mid 2024, compared with just over £36,000 for private sector employees. These figures include data on all employees, not just full-time employees.⁴ It is notable from the chart that private sector pay has grown more strongly than public sector pay since 2019, with private sector pay well above its pre-pandemic level in real terms, while public sector pay in Spring 2024 was approximately at the same real-terms level as pre-pandemic. With public sector pay also having grown more slowly than private sector pay in the 2010s, public sector pay was at a similar level in 2024 to its level eight years earlier in 2016, and most remarkably still lower than its 2010 level.

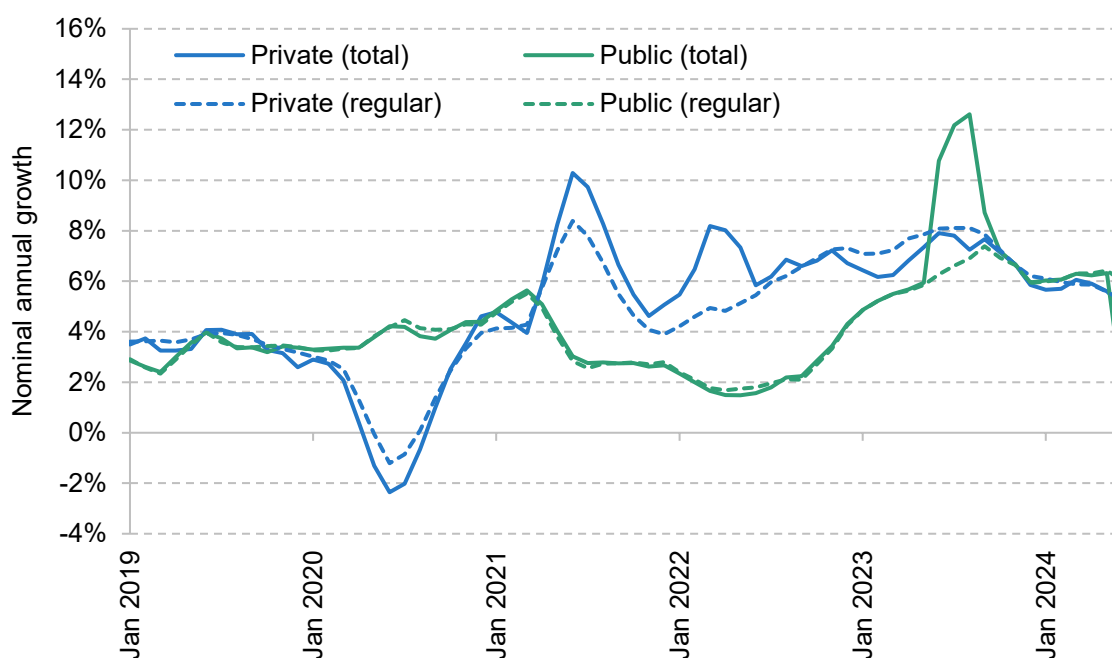
Pay awards are generally expressed in nominal (cash terms). We therefore show nominal growth in public and private sector pay in Figure 4.2. The last government agreed and implemented a set of one-off payments to public sector workers in Summer 2023, generating a spike in total public sector pay (and a corresponding drop in growth a year later). Looking instead at regular pay – a measure that strips out bonuses and arrears – public and private sector pay have been rising at similar rates since Autumn 2023, at a fairly high nominal annual growth rate of around 6% in the most recent year of data. No wonder, therefore, that our colleagues argued that Pay Review Body recommendations averaging 5.5% were ‘not ... a complete surprise’ (Boileau et al., 2024). Since January 2019 (when average public and private sector salaries were at similar levels), private sector (total) pay has grown by 31% in cash terms and 6% in real terms, while public sector (total) pay is up 25% in cash terms and 1% in real terms.

⁴ It should be noted that there are key differences in both the composition and average working hours of these two groups, and that in all these years average *hourly* pay in the public sector is higher than in the private sector as part-time work is more prevalent in the public sector than in the private sector (Boileau, O’Brien and Zaranko, 2022).

Figure 4.1. Real average (mean) annual earnings, by sector

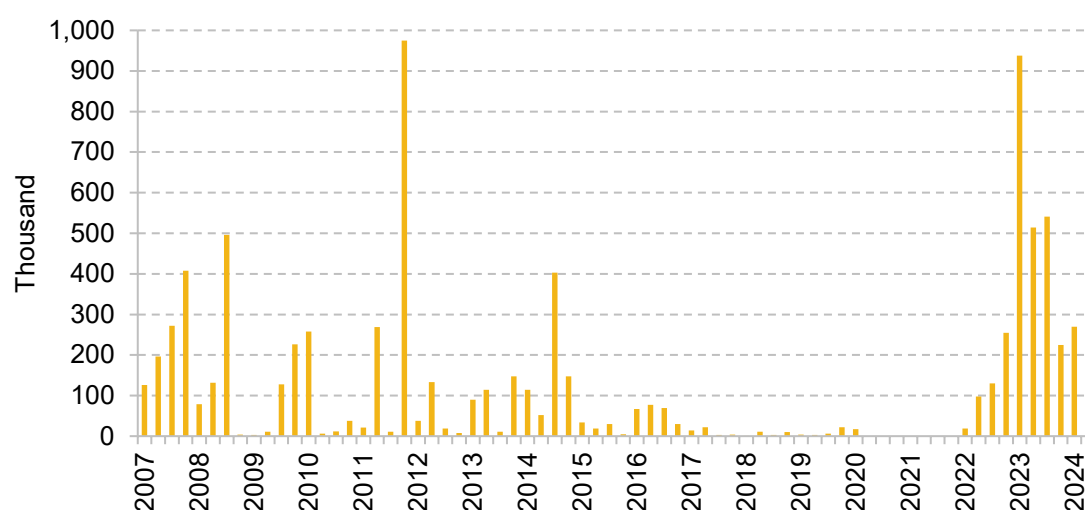
Note: Figures shown are average mean total weekly earnings (including bonuses and arrears) over the previous three months, multiplied by 52, deflated using monthly CPIH. We exclude financial services from the public sector so that it is not affected by nationalisation of banks and subsequent trends in pay in those banks.

Source: Authors' calculations using ONS average seasonally adjusted weekly earnings by sector (table EARN01).

Figure 4.2. Nominal growth in average earnings (total and regular), by sector

Note: Total pay includes bonuses and arrears; regular pay excludes them. Public sector excludes financial services. Nominal growth shown as annual growth between the three months ending the labelled month compared with the same three months a year earlier.

Source: ONS average seasonally adjusted weekly earnings by sector (table EARN01).

Figure 4.3. Working days lost to strike action in the public sector, by quarter

Note: Data not available for February 2020 to January 2022.

Source: Authors' calculations using Office for National Statistics (2024a).

Perhaps not surprisingly, given the falls in real-terms pay in the public sector (and the contrast to the private sector) that have occurred since 2022, there has been significant and high-profile industrial action in the public sector, peaking in 2023, as shown in Figure 4.3. Though 2024 has seen large falls in the number of days lost to strike action in the public sector, there were still 130,000 working days lost to strikes in the second quarter of this year, in contrast to the six-year period from 2015 to 2021 which never saw more than 80,000 working days lost in a single quarter.

The rest of this chapter proceeds as follows. In the next section, we present new evidence on public sector pay in relation to the private sector, and how trends have differed across public sector occupations. This builds in particular on pre-election analysis of these issues from IFS (Cribb and O'Brien, 2024). In Section 4.3, we consider a range of public sector occupations in turn, drawing on the wealth of information on the labour markets and recruitment and retention challenges facing different public sector employers contained in the latest Pay Review Body reports from this summer. Section 4.4 considers some issues in public sector remuneration that cut across the different public sector occupations, and Section 4.5 concludes.

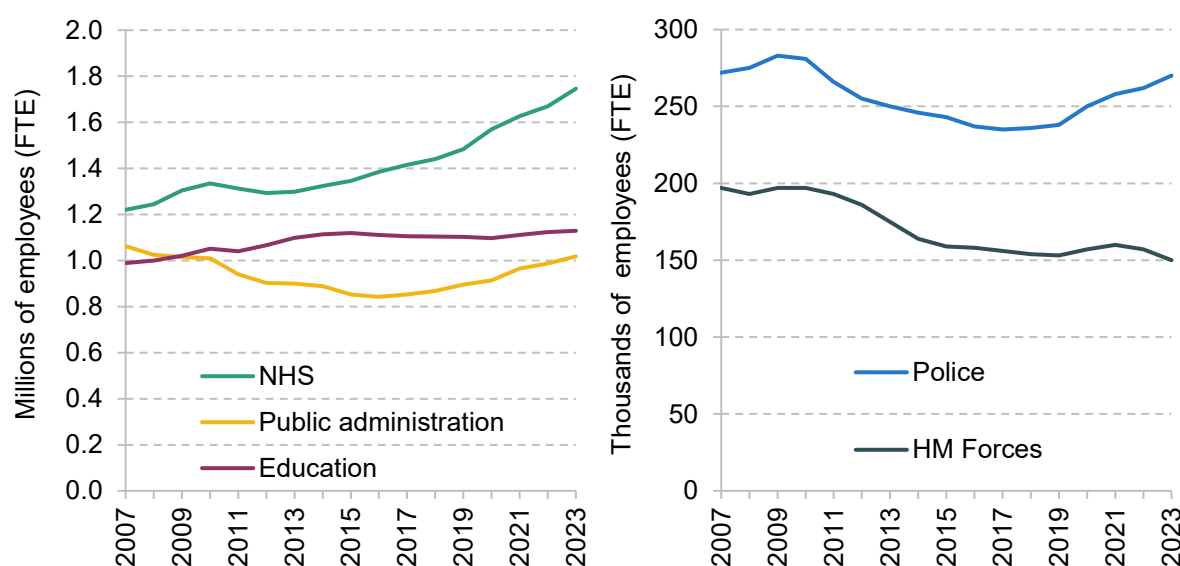
4.2 Trends in pay and employment across the public sector

This section considers key trends in public sector pay in different occupations, using new analysis of microdata to understand where different public sector occupations fit in the pay distribution and how that has changed over time. Figure 4.4 first provides key context for the analysis in this section and the rest of the chapter. It shows trends in public sector employment

(full-time equivalent, FTE) across major parts of the public sector. We focus here on five areas that make up 86% of public sector employment: NHS, education, public administration (i.e. civil servants in central and local government, but not including administrative roles in other public services), police (including civilians) and HM Forces.⁵

The NHS workforce has expanded in every year since 2012, and at 1.75 million in 2023 was 31% larger than in 2010. In contrast, following small rises in the late 2000s and early 2010s, the public sector education workforce has been essentially unchanged at just over 1.1 million since 2015, while the public administration workforce has returned to its 2010 level following significant reductions in headcount between 2010 and 2016. The number of people employed by police forces has seen a similar U-shaped trend, with a 16% fall in employment between 2010 and 2018, followed by an increase after 2019, although the workforce remained slightly smaller in 2023 than in 2010. In contrast, HM Forces has seen no recent increase in its workforce which, at 150,000 (FTE), is down almost a quarter on its 2010 level. In comparison with these trends, private sector employment grew by 15% from 2010 to 2023, and overall employment in the UK grew by 13%.

Figure 4.4. Total full-time-equivalent (FTE) employment in the UK: selected areas of the public sector



Note: Figures are adjusted for the reclassification of English sixth form and further education colleges into the private sector in 2012Q2.

Source: ONS public sector employment statistics, table 4 ('by industry; full-time equivalent').

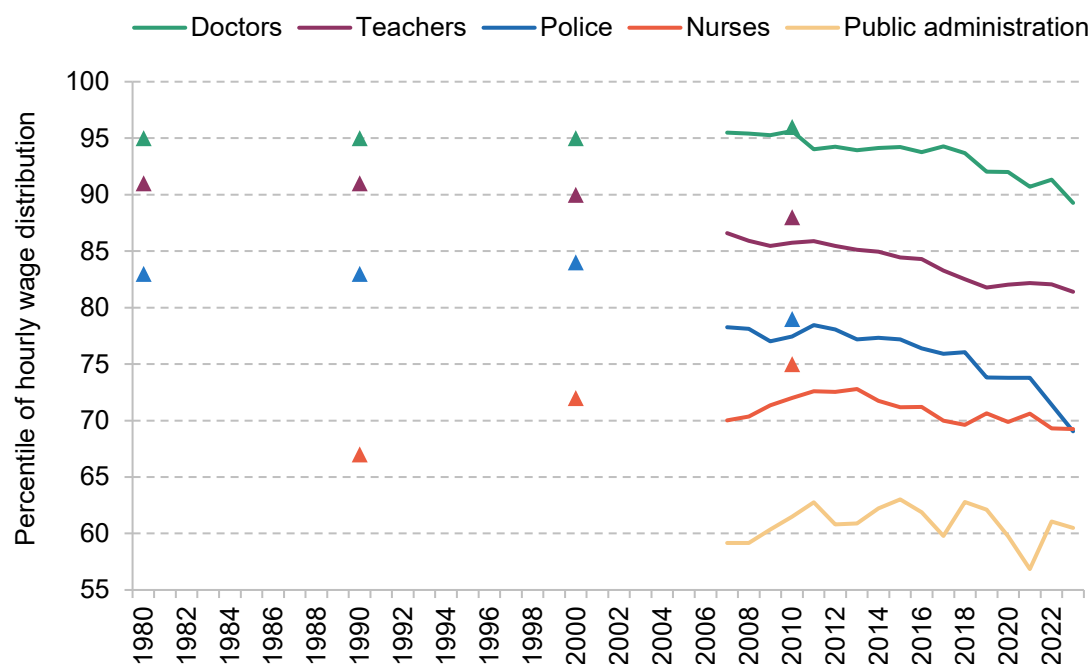
⁵ We focus on these areas as they are available in the ONS public sector employment statistics and are not subject to definitional changes over the period (or in the case of education, face one change which is straightforward to adjust for). The other key group we consider in Section 4.3 is the prison service: at the end of December 2023, there were almost 30,000 full-time-equivalent staff working in prisons (Prison Service Pay Review Body, 2024).

Cribb and O'Brien (2024) showed that different groups of public sector workers have seen differing trends in wages, with higher-paid public sector workers seeing particularly poor pay growth. They showed that the 25th percentile of public sector earnings rose by 16% in real terms between 2007 and 2023. Meanwhile, the 75th and 90th percentiles of public sector pay fell by 8% and 10% in real terms respectively. But it is important not only to compare trends amongst public sector workers, but to consider how pay has changed in other similarly paid jobs. For example, faster wage growth for lower-paid jobs may be necessary if there are falls in pay inequality more generally. As Blundell et al. (2023) show, wage inequality has fallen in recent years, especially towards the bottom of the pay distribution since the mid 2010s.

To account for this, we present new evidence on where the average (median) hourly pay of major public sector occupations fits into the overall hourly wage distribution, from 2007 to 2023. This is supplemented by information from Cribb, Emmerson and Sibiet (2014), who used slightly different data to look at the position of (most of) these occupations in 1980, 1990, 2000 and 2010. As shown in Figure 4.5, higher-earning public sector occupations have fallen considerably down the overall employee pay distribution during the 2010s and early 2020s. In 2007, median pay for doctors was at the 95th percentile of the hourly pay distribution (and strikingly had been there in each of the years 1980, 1990 and 2000), but since 2010 it has gradually fallen such that average doctor pay is now close to the 90th percentile. Doctors are therefore still considerably better paid than the majority of workers in the UK, but to a lesser extent than they have been historically since at least the 1980s.

Average teacher pay has also fallen, from the 87th percentile in 2007 to the 81st percentile by 2023, continuing the trend of falling relative teacher pay during the 2000s. Police pay (for officers, sergeant and below) also continued the downward trend seen in the 2000s, from the 78th percentile in 2007 to the 74th percentile in 2019. Further sharp falls in police pay have been seen since 2019, though these are likely a result of compositional change; as police forces have expanded their workforces, they have become less experienced (and less well paid) on average. In contrast, less well-paid public sector occupations (though still paid above the national average) have not fallen behind similarly paid workers: nurses and public administration workers have seen pay grow at a similar rate to other similarly paid workers, maintaining their relative positions (at around the 70th percentile and 60th percentile respectively). For nurses, there were better pay trends compared with private sector employees from 1990 to 2010, followed by some retrenchment after 2010.

Figure 4.5. Position (percentile) of median pay of major public sector occupations in the overall hourly pay distribution



Note: From 2007 to 2023, the following definitions are used. Doctors: SOC2000 & SOC2010 – 2211; SOC2020 – 221. Teachers: SOC2000 & SOC2010 – 2314 & 2315; SOC2020 – 2313, 2314 & 2315. Police officers (this only includes police officers at sergeant and below): SOC2000, SOC2010 & SOC2020 – 3312. Nurses: SOC2000 – 3211 & 3212; SOC2010 & SOC2020 – 223. Public administration: SIC2003 & SIC2007 – 751.

Source: Figures from 2007 to 2023 are based on authors' calculations from the Annual Survey of Hours and Earnings (ASHE). Figures for 1980, 1990, 2000 and 2010 are reproduced from Cribb, Emmerson and Sibietta (2014), which used the New Earnings Survey (which does not have the same weights as ASHE).

This analysis suggests that it is not only the case that higher-paid public sector workers have seen larger falls in their real-terms pay than less well-paid public sector workers. In addition, they have fallen further down the overall pay distribution, with nurses and public administration (civil servants) seeing their pay hold up better compared with the rest of the workforce than (the higher-paid) teachers, police officers and doctors. This means that, if problems of public sector retention and recruitment were a function of pay alone, we might expect these issues to be especially severe in the higher-paid public sector occupations.

It is also worth noting that these changes, whereby doctors, teachers and police officers (in particular) have slipped down the pay distribution, still hold when accounting for the fact that employer pension contributions are typically much more generous in the public sector than in the private sector. This is shown in Table 4A.1 in the appendix. While, on average, pay in the public sector has compressed (with pay having done better at lower percentiles, as shown in Cribb and O'Brien (2024), and with higher-paid occupations falling down the pay distribution,

as shown above), there is also evidence of within-occupation compression in pay too, though not in all the public sector occupations. The fall in inequality for doctors is most clear, as has been highlighted by Zaranko (2022). As shown in Table 4.1, in 2007–09, a high-paid doctor (at the 90th percentile) was paid double (103% more than) the average doctor. By 2021–23, they were paid 82% more, with falls in inequality also in the lower half of the doctor pay distribution (i.e. the pay of low-paid doctors moved closer to that of the average-paid doctor).

Table 4.1. Percentage difference in hourly pay, within public sector occupations: 90th percentile compared with 50th percentile, and 50th percentile compared with 10th percentile

	Premium of:	
	High-paid relative to average paid (90 th percentile compared with 50 th percentile)	Average-paid relative to low-paid (50 th percentile compared with 10 th percentile)
Doctors		
2007–09	103%	98%
2021–23	82%	77%
Teachers		
2007–09	47%	57%
2021–23	41%	57%
Police officers		
2007–09	27%	37%
2021–23	21%	56%
Nurses		
2007–09	34%	41%
2021–23	39%	47%
Public administration		
2007–09	87%	57%
2021–23	73%	52%

Note: See note to Figure 4.5.

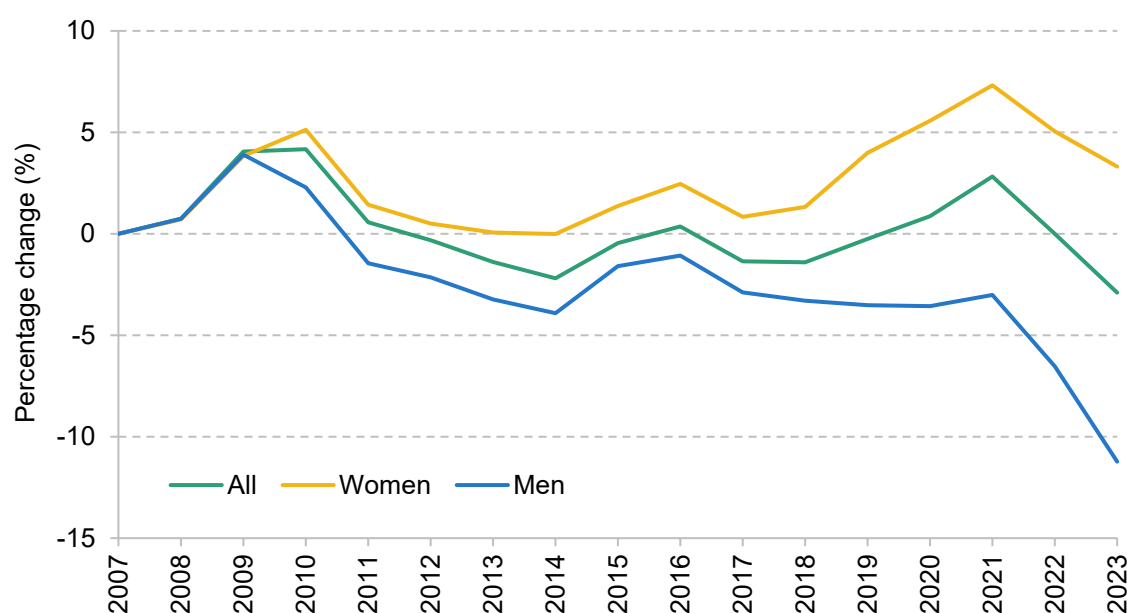
Source: Authors' calculations from the Annual Survey of Hours and Earnings (ASHE).

For teachers, the fall in inequality only came at the top of the distribution (fall in the premium of a high-paid teacher over the average). Public administration also saw falls in pay inequality, in both the upper half and lower half of the distribution. In contrast, for nurses there were small *increases* in pay inequality. And for police officers, as is discussed more in Section 4.3, the most striking finding is that pay inequality in the lower half of the pay distribution widened. In 2007–

09, the median police officer was paid 37% more than a lower-paid police officer (at the 10th percentile). By 2021–23, that gap had risen substantially to 56%.⁶

Another key trend in the public sector is that its workers have long been much more likely to be women than men. In June 2024, the ONS workforce jobs data showed that over 70% of workers in health and education, industries that are mostly made up of public sector employees, were women, in comparison with the 49% they represent in the total UK workforce.⁷ Some parts of the public sector are markedly more male – for example, the police (at 70%) and HM Forces (at 88% in the UK Regular Forces).⁸ On top of this, Figure 4.6 shows how public sector pay has evolved by sex over time. Women have fared better: whilst mean real pay fell by around 4% for men between 2007 and 2019, it rose by the same amount for women. Since then, real pay fell 8% for men, compared with much smaller reductions for women. This may be related to the fact that lower pay grades have received more generous pay awards over time and women are less likely to hold senior roles than men in the public sector (as well as in the private sector).

Figure 4.6. Change in mean real public sector pay for men and women compared with April 2007



Note: All series are deflated using monthly CPIH and then compared with April 2007.

Source: Reproduced from Cribb and O'Brien (2024).

⁶ This rise in pay inequality in the lower half of the pay distribution for police officers is not entirely driven by the potential compositional change occurring since 2019. In 2017–19, this measure of inequality had already risen to 44%, up from 37% in 2007–09.

⁷ Authors' calculations based on ONS workforce jobs statistics for June 2024 from Nomis.

⁸ Sources are Office for National Statistics (2019) for the police and Ministry of Defence (2024) for HM Forces.

4.3 Pay pressures in different public sector occupations

While the data presented in the previous section summarise recent trends in public sector employment and pay, they are backward-looking and do not directly take into account the difficulties public sector employers face at the present time in recruiting, retaining and motivating the right set of staff and in providing high-quality public services more generally.

The independent Pay Review Bodies review a huge amount of evidence in preparing their reports for the government and in forming their recommendations on changes in pay. There is a risk that the wealth of information contained in these reports is underutilised in the debate, in part because they are often between 100 and 200 pages long. In this section, we therefore examine different public sector occupations, based on the information available in the Pay Review Body reports, supplemented with our own analysis.⁹

In addition to considering average pay (as in the previous section), this allows us to examine variation in pay trends, changes in working conditions, the quality of public service delivery, and recruitment and retention problems to help make an informed judgement on the potential future upward pressure on public spending due to public sector pay.

Table 4.2 summarises the main pay recommendations from the Pay Review Bodies (PRBs) for the most recent round (covering 2024–25) and the previous round (covering 2023–24). Across all of them, two clear patterns arise. The first is that recommendations for 2024–25 are generally smaller percentage increases in cash-terms pay than those for 2023–24. This likely reflects the fact that inflation is now back to more normal levels, as well as some moderation of nominal pay growth in the private sector, two of the key external factors the PRBs consider for their recommendations. The second pattern is that for 2024–25 there was less emphasis on particularly increasing the lower bands/salaries for each group. While the 2023–24 PRBs' recommendations in general implied pay compression by boosting the lower end, in the 2024–25 recommendations this was not as consistently evident.¹⁰

⁹ The seven reports used are Armed Forces' Pay Review Body (2024), NHS Pay Review Body (2024), Police Remuneration Review Body (2024), Prison Service Pay Review Body (2024), Review Body on Doctors' and Dentists' Remuneration (2024), School Teachers' Review Body (2024) and Senior Salaries Review Body (2024). The eighth PRB is the National Crime Agency Remuneration Review Body.

¹⁰ One PRB where higher pay recommendations for lower earners is less obvious in 2023–24 is in the NHS, where there was an agreement for a 5% consolidated increase in pay scales. However, the same agreement also led to a non-consolidated additional payment which was larger in percentage terms for lower-paid NHS staff.

Table 4.2. Pay Review Bodies' (2024–25 and 2023–24) recommendations, by group

Group	2024–25 pay recommendations	2023–24 pay recommendations	Number covered by PRB
NHS (including doctors)	6.00% for doctors + £1K for doctors in training 5.50% for other NHS staff	6.00% for doctors 8.10–10.70% for junior doctors 5% for other NHS staff ^a	1,344,866 FTE
Teachers	5.50%	6.50% Starting salary rise to £30K (7.00% increase)	468,693 FTE
Police	4.75%	7.00% Removal of lowest pay band	236,588 FTE
HM Forces	6.00%	5.00% + £1K	183,230
Prison service	5.00%	Varying rates by band between 5.00% and 7.00%, with higher rates for lower bands	64,779 FTE
'Senior salaries'			
Senior civil service	5.00% + £1K uplift to the pay minima	5.50%	6,300 FTE
Senior health leaders	5.00%	5.00%	Around 3,000
Judiciary	6.00%	7.00%	Around 2,200
Chief police officers	4.75%	N/A ^b	231
Senior officers in Armed Forces	5.00%	5.50%	132

^a The NHS Pay Review Body did not make recommendations in 2023–24 as the UK government had already agreed a 5% consolidated award for 2023–24.

^b Chief police officers were not included in the Senior Salaries Review Body in the 2023–24 pay review.

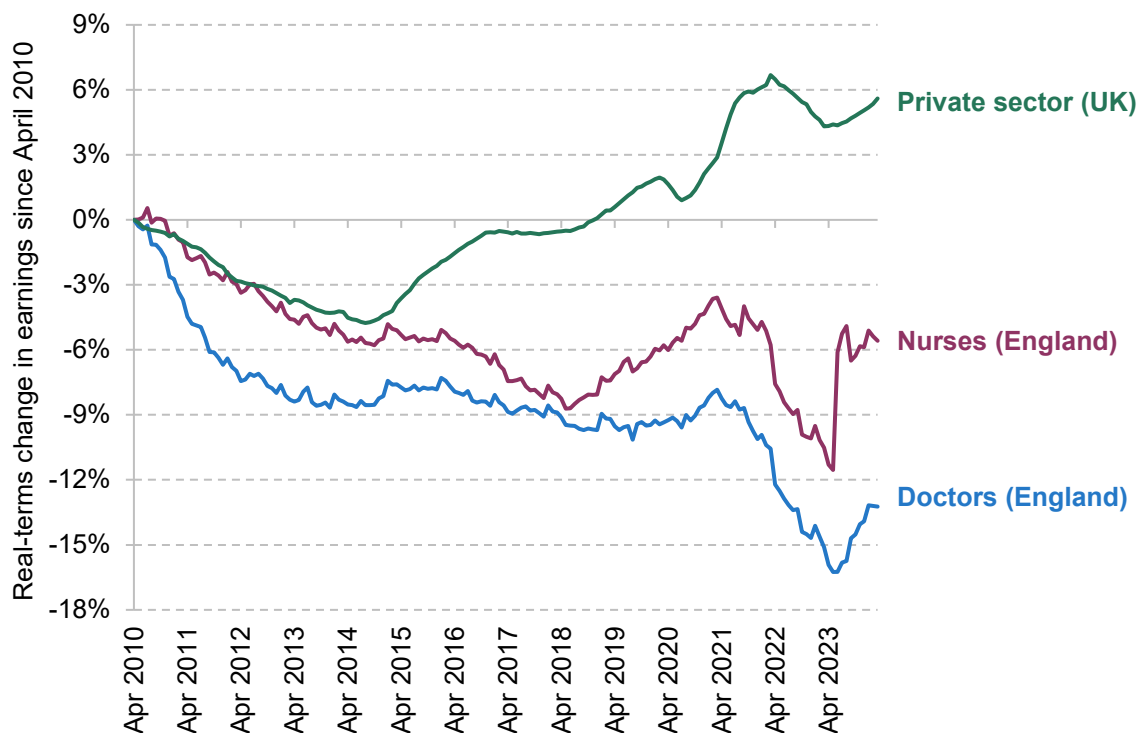
Sources for workforce sizes: those covered by SSRB –

https://assets.publishing.service.gov.uk/media/66a7a3c849b9c0597fdb066e/SSRB_Annual_Report_2024_Accessible.pdf; teachers – <https://explore-education-statistics.service.gov.uk/find-statistics/school-workforce-in-england>; NHS – <https://digital.nhs.uk/data-and-information/publications/statistical/nhs-workforce-statistics/may-2024>; police – <https://www.gov.uk/government/statistics/police-workforce-england-and-wales-31-march-2024/police-workforce-england-and-wales-31-march-2024>; Armed Forces – <https://www.gov.uk/government/statistics/quarterly-service-personnel-statistics-2024/quarterly-service-personnel-statistics-1-april-2024>; prison service – <https://www.gov.uk/government/statistics/hm-prison-and-probation-service-workforce-quarterly-june-2024/hm-prison-and-probation-service-workforce-quarterly-june-2024>.

National Health Service

NHS workers are covered by two PRBs: the NHS Pay Review Body and the Review Body on Doctors' and Dentists' Remuneration. The NHS is the largest part of the public sector; 35% of public sector workers (FTE) worked in the NHS (across the UK) in 2023, or 7% of all employees in the UK. Therefore, pay decisions in the NHS are the most consequential for public spending. Figure 4.7 shows the changes in real-terms pay for two of the most high-profile NHS occupations (using data from England): doctors and nurses. These data go up to March 2024 and so do not reflect the new government's pay offer to junior doctors (now known as 'resident doctors') made this summer, which has recently been accepted by their trade union. The graph shows average (mean) pay for nurses was still down 6% compared with April 2010 in real terms, with average pay for doctors 13% lower than in April 2010. Growth in nurses' and doctors' pay has been much lower than private sector pay growth, particularly since 2015.

Figure 4.7. Changes in real mean earnings per worker since April 2010 for nurses and doctors in the English NHS, compared with the UK private sector



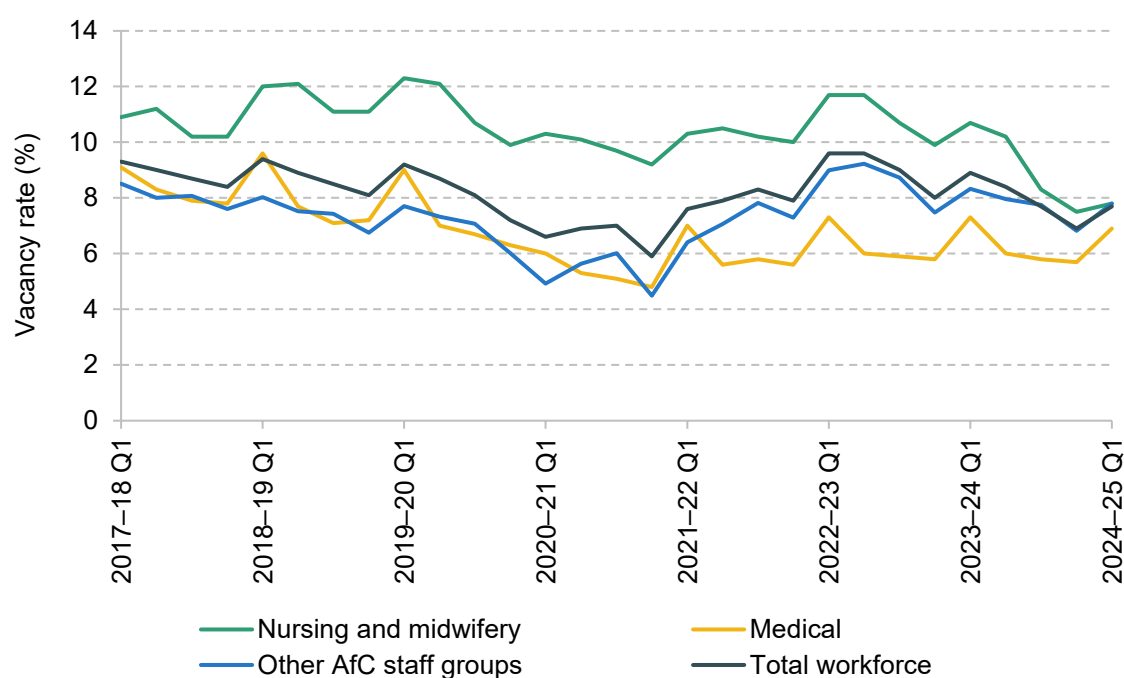
Note: The data are mean annual earnings per person (not per FTE) in NHS trusts and other core organisations in England over the past 12 months, obtained from NHS England data. All series are deflated using monthly CPIH and then compared with April 2010.

Source: Authors' calculations using NHS England 'NHS staff earnings estimates' (table 2b) and ONS average seasonally adjusted weekly earnings by sector (table EARN01).

The NHS PRB report documents a set of recruitment and retention issues in the NHS (excluding doctors), though these issues are not as widespread as in some other areas of the public sector, documented later in this chapter. The vacancy rates for nurses and midwives, and for other NHS

staff, were lower in 2023 than the year before, and indeed at similar levels to or slightly lower than before the COVID-19 pandemic, as shown in Figure 4.8. However, the report highlights the increasing dependence on international recruitment to fill NHS roles, a pattern which, at least in the judgement of the Pay Review Body, opens additional retention risks compared with filling roles locally. The report also criticises high agency staff use – which is one response to failing to fill roles – as being expensive and inefficient. While use of agency staff has fallen in England since 2015, it continues to rise dramatically in Wales and Northern Ireland.

Figure 4.8. NHS vacancy rates: nursing and midwifery and other NHS ('Agenda for Change') staff groups, England



Source: Partially reproduces figure 3.6 of the 2024 NHS Pay Review Body document. Data for nursing and midwifery stem from NHS England, while the Office of Manpower Economics (OME) derives figures for 'other AfC' from what is left over after deducting nursing & midwifery and medical vacancies from the overall total.

The Review Body on Doctors' and Dentists' Remuneration (DDRB) generally finds that recruitment remains strong, though also with significant reliance on immigration: remarkably, half of those joining the medical register in 2022 had been trained abroad. Although medical schools remain oversubscribed, applications to them fell by 9.3% in 2023. Motivation and morale are found to be low, with staff surveys showing them to be lower than pre-pandemic. The report identifies both pay-related and non-pay-related factors that contributed to this, including poor quality of working life for doctors in training.

The PRBs recommended significant cash-terms increases in pay – of 6% for NHS doctors (plus an additional £1,000 for doctors in training) and 5.5% for other NHS staff. For NHS staff, the report does not specifically say that overall pay would need to rise faster than outside earnings in

the future to prevent recruitment and retention issues. However, it does highlight structural pay issues reducing incentives to progress. Unless these are addressed by reducing pay growth for lower earners, addressing them would likely push up pay growth at higher bands in the future.

A key point for the future raised by the DDRB relates to the ‘Long Term Workforce Plan’ (LTWP) which will require continued efforts to make medical and NHS careers attractive. The ageing population will place particular strain on the NHS compared with most other public services. In response, the LTWP aims to increase the number of staff in the NHS by between 800,000 and 900,000 from 2021–22 to 2036–37. Warner and Zaranko (2023) argued in last year’s Green Budget that, given the large increases in desired staffing, growth in NHS remuneration will likely at least need to keep pace with economy-wide average earnings growth and potentially exceed it. The need to expand recruitment to meet demand for healthcare services is therefore a key medium-term pressure facing the NHS and the government, in a way that is more acute than for most other public services, where demand growth is likely to be more moderate.¹¹ We discuss the potential for this to push up the public sector pay bill as a whole in Section 3.5.

School teachers in England

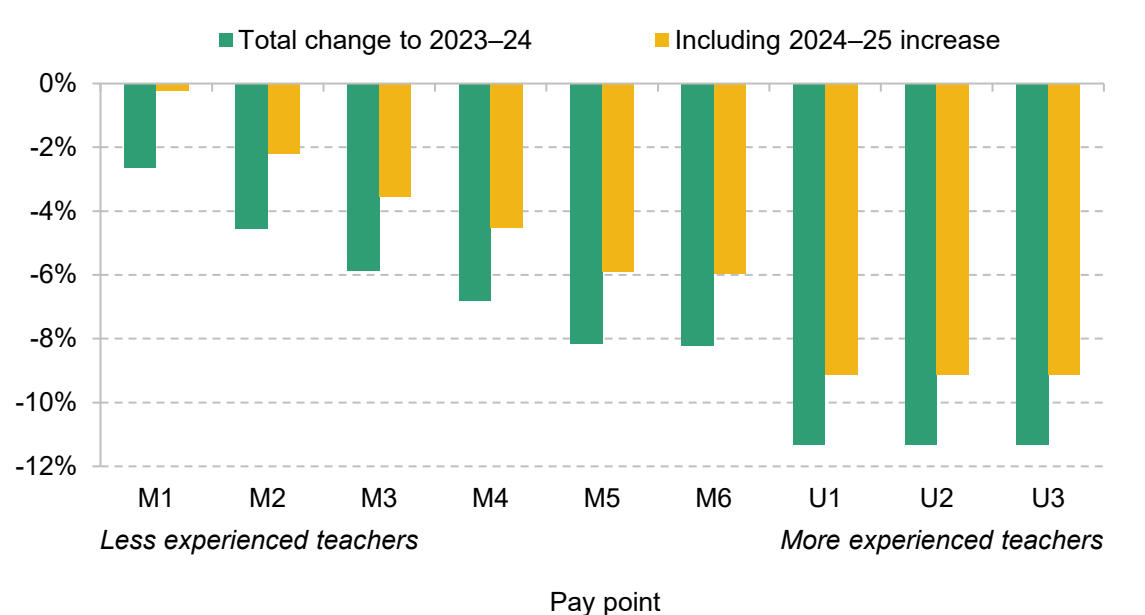
The school workforce in England stands at just short of 1 million workers (FTE); of these, around half (470,000) are teachers. Figure 4.9 shows the real-terms change in teacher pay at different points of the pay scale, with M1 being the least experienced teachers while the most experienced teachers are on the upper scale (points U1 to U3). Many teachers will move up the pay range annually, with teachers at the middle of the pay scale typically having at least five years’ teaching experience.¹²

Between 2010–11 and 2023–24, real-terms teacher pay fell by 11% for experienced teachers on the upper scale, though falls were much smaller for less experienced teachers (the M1 scale point saw a 3% real-terms fall). This reflects a choice to prioritise higher starting salaries over pay for teachers later in their careers and is consistent with the compression of the teacher pay distribution documented in Table 4.1 earlier. Given most teachers at any one time are on the upper scale, it is these falls at the top that have driven down the relative position of school teachers in the pay distribution.

¹¹ Another area that is likely to see rising demand for labour is the adult social care sector. However, social care workers are typically employed by the private sector and their pay is therefore not directly set by government in the same way as for public sector employees. However, pay in the adult social care sector is likely to be affected by other government policies, such as the National Living Wage and the public funding available for adult social care. For more information on this, see Chapter 5.

¹² <https://getintoteaching.education.gov.uk/life-as-a-teacher/pay-and-benefits/teacher-pay>.

Figure 4.9. Real-terms changes in teacher core salary points since 2010



Source: CPIH from <https://www.ons.gov.uk/datasets/cpih01/editions/time-series/versions/48> and OBR economic forecast for inflation (<https://obr.uk/efo/economic-and-fiscal-outlook-march-2024/>); teacher pay in 2010 from the school teachers' pay and conditions document 2010 (<https://dera.ioe.ac.uk/id/eprint/716/1/School%20Teachers%27%20Pay%20and%20Conditions%202010.pdf>); teacher pay in 2023–24 from the school teachers' pay and conditions document 2023 (https://assets.publishing.service.gov.uk/media/65eae75b5b652445f6f21aa4/School_teachers_pay_and_conditions_document_2023.pdf); teacher pay recommendation in 2024–25 from the STRB report 2024 (https://assets.publishing.service.gov.uk/media/66ab42d5ce1fd0da7b59313b/STRB_34th_Report_2024_Accessible.pdf). Updated from Farquharson et al. (2023).

The School Teachers' Review Body (STRB) documents a series of difficulties in the teacher labour market which have plausibly been worsened by the fall in real, and relative, teacher pay. While some measures of recruitment and retention in the NHS are now better than pre-pandemic, that is not the case for teachers. The teacher vacancy rate was 0.6% in November 2023 – much lower than the reported vacancy rate for nursing staff, but twice the teacher vacancy rate pre-pandemic (0.3%).¹³

The number of individuals starting teacher training was 62% of the initial teacher training (ITT) recruitment target in 2023–24, considerably lower than the 90% average pre-pandemic (2015–19).¹⁴ The ITT is a Department for Education metric for judging how many people need to enter formal teacher training courses to maintain a sufficient supply of teachers. It takes account of the fact that there are other routes into teaching than graduate teacher training, such as teachers returning to the profession. The STRB describes the ITT as a 'key indicator of the adequacy of the future supply to the teaching profession as well as a lead indicator of the attractiveness of the

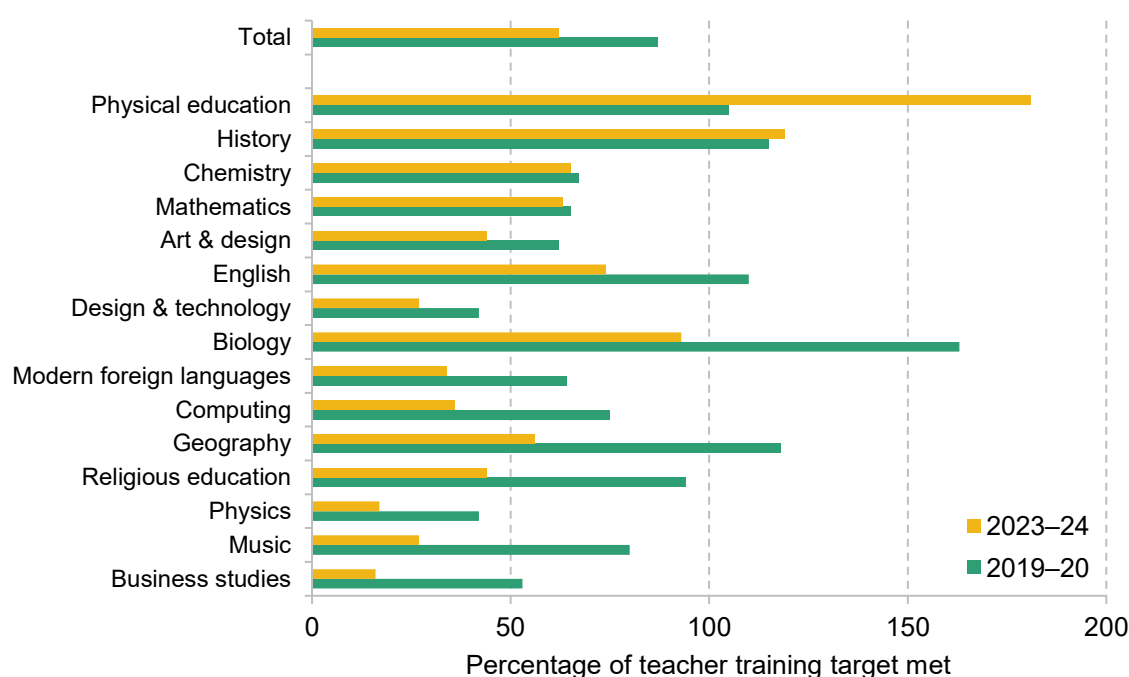
¹³ <https://explore-education-statistics.service.gov.uk/find-statistics/school-workforce-in-england>.

¹⁴ <https://explore-education-statistics.service.gov.uk/data-tables/initial-teacher-training-census>.

profession'. According to this metric, recruitment into teacher training has held up much worse in secondary schools than in primary schools. The government is also expected to miss its recruitment targets in a majority of secondary-level subjects for the 2024–25 school year, some by yawning margins (McLean, Worth and Smith, 2024).

The headline rates mask subject-specific teacher shortages. Figure 4.10 shows the percentage of the ITT met in 2019–20, the final year before the pandemic, and in 2023–24, the most recent full school year, for secondary education. Subjects are arranged by the percentage change between the two time points, with the subjects at the top seeing the smallest falls in recruitment relative to target. The worst subjects in terms of the percentage of the target met in 2023–24 are business studies and physics at only 16% and 17% of their ITT targets, respectively. Along with music, these same subjects have also seen the biggest changes (for the worse) since 2019. Training of teachers in many subjects is below 50% of target, including for modern foreign languages (MFL) and computing, and training rates in most subjects are currently at or near record low levels as a percentage of their targets. Some subjects, such as maths, chemistry, history and PE, have seen little change or indeed improvements in the number of people training in those subjects relative to the target.

Figure 4.10. Percentage of initial teacher training (ITT) target met in 2019–20 and 2023–24, by subject in secondary education



Source: Initial Teacher Training Census (<https://explore-education-statistics.service.gov.uk/find-statistics/initial-teacher-training-census/2023-24>). The chart is similar to analysis in figure 1 in chapter 3 of the STRB report.

The current retention rate among secondary school teachers, though worse than during the COVID-19 pandemic, is roughly the same as was seen between 2013–14 and 2019–20, with just above 8% of teachers aged under 55 leaving their roles in a given school year (although many of these will move to roles in other state-funded schools). This is comparable to the proportion of private sector employees who are recorded as changing their employer in Understanding Society data from 2021–22. In physics, MFL and computing, teachers have also left the profession at persistently higher rates than for secondary school teachers as a whole. As detailed in the STRB report, shortages in these subjects are leading to a higher proportion of teaching hours being delivered by non-specialists, particularly in disadvantaged schools, which is likely to impact negatively on the quality of education pupils are receiving.

An important question that the STRB leaves largely untouched is that of teacher quality. It is nevertheless important and, crucially, is linked to teacher remuneration. Research shows that effective teachers are the most important input into pupil attainment but that observed characteristics are often poor predictors of good teachers.¹⁵ It is hard to know who exactly it is that leaves teaching – the would-be top-performing teachers or lower performers – but it seems likely that it is those with the most attractive alternative options. In many cases, these will be the teachers that schools least want to lose.

Faced with these problems, the STRB recommended that teacher pay at each level of the pay scale should rise by 5.5%. The government has accepted the recommendation and pledged to fund fully the increased costs for schools, which it puts at £1.2 billion when including pay rises for support staff.¹⁶ The effect on pay scales is shown in the yellow bars in Figure 4.9 above. Adopting the recommendations in full is still likely to leave the real pay of experienced teachers 9% below 2010 levels and the real pay of new teachers about the same as in 2010. This pay award roughly matches the recent growth rate of private sector wages (as shown earlier in the chapter and recognised in the STRB report). It is therefore unlikely to ameliorate the decline of teachers' position in the pay distribution, and classroom teacher pay remains relatively low compared with jobs that require similar skills and experience against which the STRB benchmarks these employees.¹⁷

The STRB report suggests two key challenges for the future. The first, explicitly set out in the report, is the extent to which the government, and/or schools, need to make teaching particular

¹⁵ See box 1 in Farquharson et al. (2023).

¹⁶ This contrasts with the earlier reports in 2022 and 2023, which had recommended larger increases at the bottom of the pay scale.

¹⁷ Broadly, its approach suggests that classroom teachers across the pay scale are paid below the median for comparable roles outside the profession. The picture is slightly more favourable for secondary Head and Deputy Head teachers, though primary Heads and Deputy Heads fare worse.

secondary school subjects a more attractive prospect. It may take some targeted additional spending – on pay or through other means – to address this.¹⁸

The second challenge is not set out explicitly by the STRB but is a natural conclusion from the evidence presented and the recommendations made. The report sets out a pattern of deteriorating relative pay and worsening recruitment. But the recommendation of a 5.5% award will at best keep teacher pay from falling further behind the private sector. This is not a criticism of the Review Body, which also has to take into account the budgetary position of schools. But it suggests that the current uplift to pay scales is unlikely to improve materially the current recruitment difficulties, and the government may need to find above-economy-wide pay deals for teachers in the future.¹⁹ Labour also pledged in its 2024 general election manifesto to hire an additional 6,500 teachers in ‘shortage subjects’ with the money raised from levying VAT on private school fees. Although this would only be a 1% increase in the number of teachers in England, it represents an additional pressure in subjects that are already struggling to hire. However, pupil numbers are expected to fall by around 180,000 – or 2.3% – by 2028,²⁰ which could ease the pressure on recruitment slightly.

Police

As shown in Figure 4.4 earlier, the police workforce has been growing in the last five years, and Table 4.3 shows there are currently almost 150,000 officers in England and Wales (out of a total paid police workforce of 236,588 FTE at the end of March 2024²¹). In 2019, the Home Office launched the ‘Police Uplift Programme’, aimed at recruiting more police officers. As a result, the number of recruits rose significantly. In 2022–23 alone, there were more than 16,000 new police officers in England and Wales, the highest yearly increase in the last 20 years. This represented an increase of 28% compared with 2021–22. Recruitment in 2024 fell (reflecting the end of the Uplift Programme), with around 9,500 police officers joining the force, a significant decrease on the previous year, although the number of police officers has still continued to rise slightly. Financial year 2023–24 also saw a significant increase in the number of officers leaving the police force, with one of the highest annual outflows since comparable records began in 2003.

¹⁸ There are differential bursaries by subject, but regular pay does not differ by subject.

¹⁹ One way through this challenge could potentially be a focus on limiting, or reducing, teachers’ workload. The STRB identified workload as a ‘universal concern’, and an important influence on the teacher labour market, and it recognised that more complex pupil needs were increasing demands on teachers. It is beyond our expertise to be able to suggest the extent to which concrete actions could be taken to help improve teacher conditions in this regard.

²⁰ <https://explore-education-statistics.service.gov.uk/find-statistics/national-pupil-projections>.

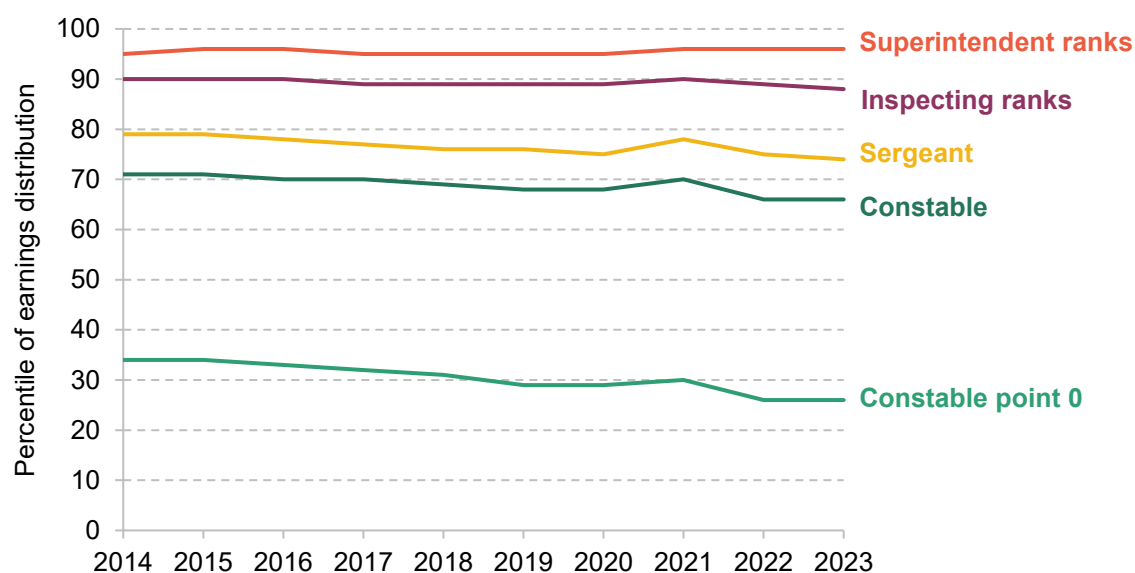
²¹ <https://www.gov.uk/government/statistics/police-workforce-england-and-wales-31-march-2024/police-workforce-england-and-wales-31-march-2024>.

Table 4.3. Number of police officers in England and Wales, stock and yearly flows

	Total, year-end	Inflow	Outflow
2021–22	140,228	12,789 (9.1%)	8,117 (6.0%)
2022–23	147,434	16,328 (11.1%)	9,192 (6.6%)
2023–24	147,746	9,479 (6.4%)	9,080 (6.2%)

Source: Home Office, 2024.

In terms of pay, Figure 4.5 showed the large declines in relative pay of police officers compared with other occupations, and similar statistics are quoted by the Police Remuneration Review Body (PRRB) in its latest report. Moreover, they show that it is not just the average police officer who has seen falls in relative pay. For example, as shown in Figure 4.11, pay point 0 of the constable pay scale has fallen from the 34th percentile of overall earnings in 2014 to the 26th percentile in 2023. A similar pattern (but with a smaller decrease and at a different level) is observed for the top of the constable pay scale. The relative positions of those at higher ranks (inspectors and superintendents) have been more stable. This differential drop across the pay scale, alongside changes in the composition of the force, largely explain the sharp fall in police pay reflected in Figure 4.5.

Figure 4.11. Police pay scale positions in the distribution of earnings, England and Wales

Note: Constable point 0 is the bottom of the constable pay ladder.

Source: Reproduced from chart E.5 of Police Remuneration Review Body (2024), based on OME analysis of police pay scales and the Annual Survey of Hours and Earnings.

These divergent trends over the past decade have resulted in a less concentrated pay distribution within the police service. As shown in Table 4.1 earlier, in 2007–09, an average-paid police officer (at the 50th percentile) was paid 37% more than a low-paid police officer (at the 10th percentile). By 2021–23, they were paid 56% more. The comparison between high-paid and average-paid officers shows relative stability (changing from a 27% gap to a 21% gap). This is very different from other public sector occupations, such as doctors or teachers (discussed earlier), which have seen larger pay compression, with in particular lower earners gaining on average earners. As a consequence, the PRRB reports that some newer officers were struggling financially with the heightened cost of living. It seems that deteriorating conditions for police officers are affecting the very bottom of the pay scale.

How do these trends in pay relate to recruitment, retention and public service quality? At first glance, police officer numbers have been successfully increased despite the restrictions on pay. Having said that, the PRRB points out that to maintain a larger police force, increased recruitment will need to be maintained, and there have been particular issues in recruiting for the Metropolitan Police Service (which makes up a quarter of all police officers in England and Wales). The Met expected to be around 1,400 officers short of its target for total number of officers in March 2024. Surveys point to lower levels of morale than in previous years, and although pay is not the only determinant of this, the PRRB states that it is concerned that falling pay (relative to comparator groups) will ‘unless addressed ... impede policing’s ability to retain a workforce with the skills and capabilities it requires’.

In this context, the PRRB 2024 report recommended annual pay increases of 4.75% for all officers up to and including the rank of chief superintendent. It also suggested that police forces should have the discretion to appoint new constables at higher pay points than usual, particularly in London; and that a set of allowances be increased, notably increasing paid annual leave entitlements, especially for new recruits (from 22 to 25 days, a 1% drop in the working year). While providing an overall uplift to pay scales that is fairly similar both to private sector wage growth and to pay awards in other public sector occupations, these recommendations also target areas where the PRRB has particular concerns: attracting new recruits, especially in London.

What about the future? It is notable that the PRRB sees the need for wholesale reform to police pay. The 2011 Winsor Review²² was the last large review of police pay and conditions. The final report outlined recommendations on faster progression to higher pay and stronger links between pay and skills and between pay and performance. The PRRB indicates that too little has changed since (especially considering the current challenges in retention), and recommends that a new Comprehensive Review of police remuneration should be undertaken before next year’s (multi-

²² <https://www.gov.uk/guidance/police-pay-winsor-review>.

year) Spending Review. It calls for this to examine ‘pay and the mechanics of the coherence of pay scales, allowances, rewarding performance, and the mechanism for progression’. While such a review might result in a rebalancing of pay scales in a way that is almost cost-neutral, it could lead to pressure to reverse, at least in part, some of the relative decline in average police pay seen over recent years.

Prison service

The prison estate in England and Wales has come under significant pressure in the last year, particularly as the prison population has grown faster than operational capacity and there is essentially no room for this to continue.²³ At the end of July 2024, the prison population was 87,479, while useable operational capacity was 88,862. In the face of deteriorating operating conditions (e.g. overcrowding and increasing rates of violence²⁴), several measures have been taken to alleviate pressure on prisons. Among these, the government recently implemented ‘Operation Early Dawn’, a scheme which means that offenders will be summoned to a magistrates’ court only when it is confirmed that a cell in the prison estate is ready for them, should they be remanded into custody.²⁵

At only 64,779 employees (FTE, out of which 30,265 FTE are operational prison service staff), the fiscal consequences of pressure on public sector pay in the prison service are minimal, especially in comparison with the NHS. But the current strain on the prison service means it is worth briefly considering its pay, and challenges, as they are quite different from those in other parts of the public sector. While prison officer salaries are fairly low in the pay distribution compared with other public sector occupations, the gap between the starting band for prison officers and overall median pay has narrowed,²⁶ therefore improving their relative position (see Figure 4.12).²⁷

The prison service still faces challenges with recruitment and particularly retention. Similar to the analysis for police officers, there are high turnover rates among prison staff. The overall

²³ There are 14 prisons in England and Wales run by the private sector, holding 17% of the prison population (House of Commons Library, 2014). The analysis presented in this subsection refers to HM Prison and Probation Service.

²⁴ According to the Safety in Custody Statistics Bulletin, in the 12 months to March 2024, the rate of assaults on staff was 114 assaults per 1,000 prisoners (9,847 assaults on staff), up 24% from the 12 months to March 2023. Additionally, the number of individuals who self-harmed went up by 19% in the same period. (<https://www.gov.uk/government/statistics/safety-in-custody-quarterly-update-to-march-2024>.)

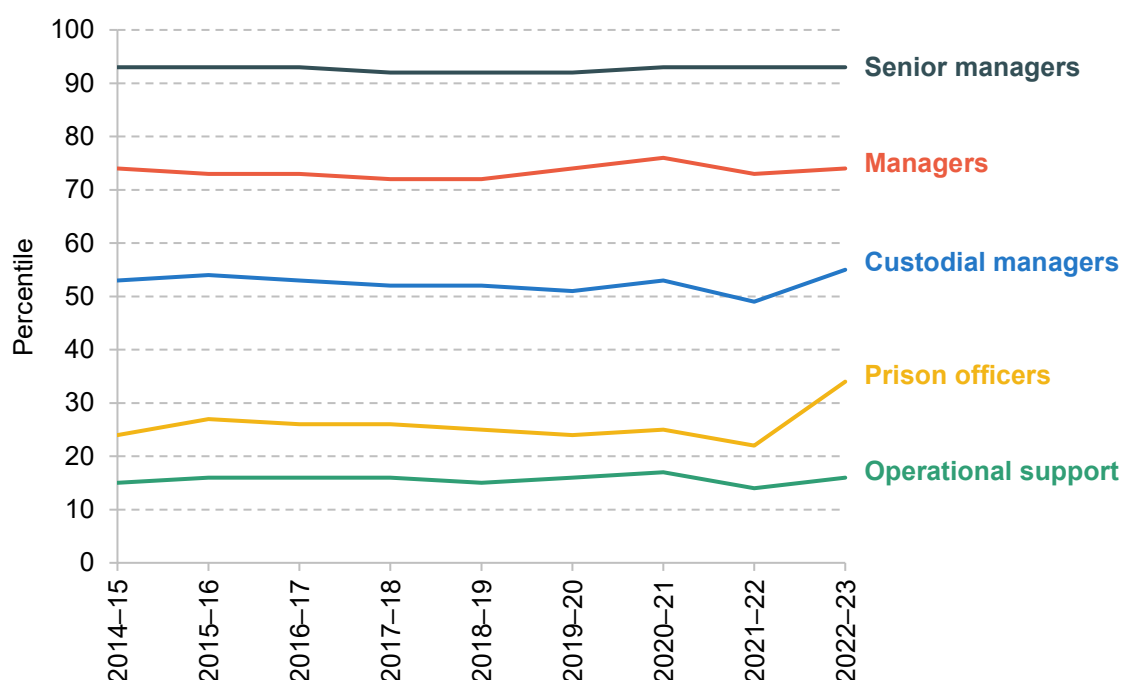
²⁵ <https://www.gov.uk/government/news/process-activated-to-manage-prisoner-movements>.

²⁶ There are some regional issues, with band 3 pay offering much worse terms in London than in other regions, even though its nominal value is higher. Specifically, both the minimum and maximum band 3 pay in London are very close to the 25th percentile of pay among employees in London. Moreover, an HM Prison and Probation Service prison officer earns, on average, more than most comparable occupations (Incomes Data Research, 2019), including private prison officers.

²⁷ Regarding the large improvement for prison officers in the last year, the PRB indicates that it ‘is likely due to restructuring and the pay award linked to the erosion of the amber market supplement as part of the 2022 report’.

departure rate in December 2023 was 13%, with the main reason for leaving across all grades in Prison Service establishments being resignation. The inability to work flexibly is one of the top five reasons why staff leave the service, and leavers with less than one year's service accounted for the largest number of leavers in 2023. These descriptive statistics suggest that turnover is high and that the prison service is struggling to retain new recruits. Working conditions are also important, with the prevalence of violence and other unpleasant working conditions playing a crucial role. As well as improving welfare, reducing levels of violence could lead to direct savings in terms of compensation costs for staff and prisoners and related sickness absence costs, and improve recruitment. This could allow the Prison and Probation Service to redirect spending to other important areas, such as rehabilitation programmes.

Figure 4.12. Prison service pay scale positions (minimum) in the distribution of earnings, England and Wales



Source: Reproduced from figure 3.9 of Prison Service Pay Review Body (2024), based on OME analysis of pay scales and the Annual Survey of Hours and Earnings.

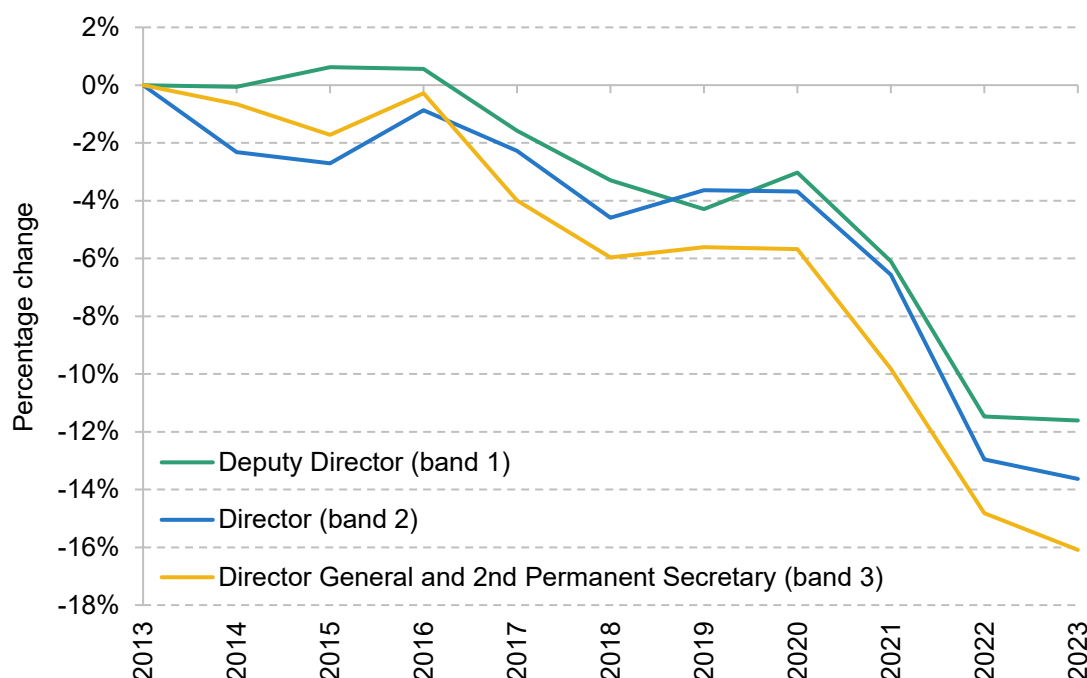
The PRB recommended that from 1 April 2024, most pay bands be increased by 5%, which was accepted in full by the government. The PRB also recommended increases in allowances for specific operations and tasks, as well as a reduction in the length of time taken to progress between the higher bands. It estimates that implementing such recommendations would add approximately £72 million to the total pay bill, an amount that pales into insignificance compared with other parts of the public sector. There is therefore scope for the government to be flexible in order to attract and retain experienced staff in prisons without being too concerned about the impact of these pay decisions on overall public spending.

‘Senior salaries’

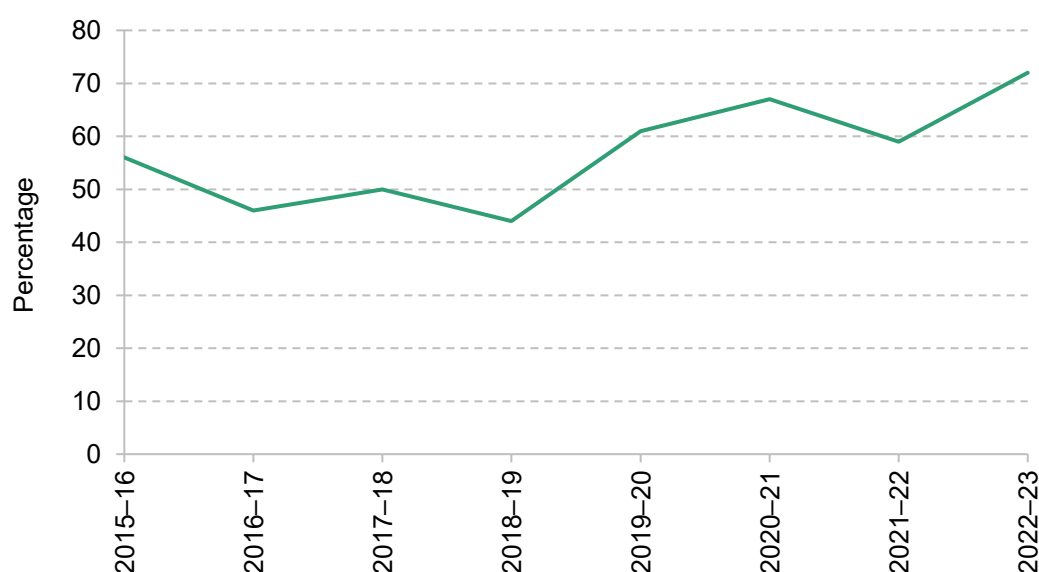
The pay of a relatively small number of senior public servants is reviewed by the Senior Salaries Review Body (SSRB). Its remit covers the senior civil service (SCS), senior officers in the Armed Forces, the judiciary, senior NHS managers and chief police officers. Table 4.2 earlier outlined the pay awards recommended by the SSRB, all of which have been accepted in full by the government. The SSRB covers a broad set of groups. The thing they have in common is that they are senior members of the public sector – but in many ways they look radically different. This is true in the case of the challenges they face. Though not problem-free, recruitment and retention in the senior Armed Forces and for senior police officers are comparatively easy. In contrast, while the judiciary faces almost no issue retaining staff, it is experiencing severe recruitment shortfalls. Among senior NHS leaders, staff turnover is high.

One group facing both recruitment and retention issues is the biggest of the SSRB’s groups – the SCS, i.e. civil servants who are at Deputy Director (band 1) level or above. Figure 4.13 shows how median SCS pay at the three SCS pay bands has changed over time. Between 2013 and 2023, the nominal value at band 1 rose by around £11,500 (16%), but after adjusting for inflation the value fell by 12%. The percentage losses in real-terms pay are greater for the more senior roles – Directors are 14% worse off than in 2013, whilst those at Director General level are 16% worse off in real terms.

Figure 4.13. Real-terms pay compared with 2013 for median senior civil service salaries



Source: Cabinet Office. The data were provided by the SSRB on request. Pay at constant prices was calculated using CPIH for each year.

Figure 4.14. Share of exits from the senior civil service that are graded as ‘regrettable’

Note: Exits are classed as ‘regrettable’ if the staff member is assessed as being a high performer or having particularly high potential.

Source: Cabinet Office data based on exit interviews, reported in SSRB reports.

As is the case with teachers, the SSRB judges that members of the SCS are paid less than for comparable roles in the private sector. The SCS is characterised by a huge degree of churn – in 2022–23, around 25% of senior civil servants changed jobs or left the senior civil service. In the case of the former, changes between departments (which account for over a quarter of the 25%) are often driven by a lack of pay progression in role. Among those leavers who took part in exit interviews, just over two-thirds (68%) cited pay as a significant factor in their resignation.²⁸

The SSRB also highlights the quality of job applicants to the SCS as a concern. Over time, the proportion of posts unfilled after a hiring process and the share of processes that have only one appointable candidate have been rising while the share of candidates considered good or outstanding has been falling – at 54% in 2022–23 (the most recent year of data) compared with 68% in 2018–19. Similarly, as Figure 4.14 shows, the quality of those who leave is often high – at 72%, the share of losses in 2022–23 that were graded as ‘regrettable’ (being graded as a high performer or having particularly high potential) is at its highest since the SSRB has reported it.

The judiciary is the other group where there is clear cause for concern. As already mentioned, the judiciary does not have a problem with retention, but this is for a reason peculiar to the profession – a convention that judges cannot return to private practice – though this is linked to the recruitment issues that the judiciary faces. It may be more of a risk to join the judiciary,

²⁸ This is similar to 2021–22 (67%) but higher than previous years (61%, 64% and 53% in 2018–19, 2019–20 and 2020–21 respectively).

especially if pay is relatively low, given that this means (effectively permanently) giving up a lucrative option outside the judiciary.

England and Wales do not have a career judiciary; individuals practise privately or work as academics before joining the salaried judiciary. This means that the pool of recruits is more diffuse and there is a less distinct pipeline into the profession than for the other SSRB groups. In recent hiring rounds for District Judges (who deal with most cases in county courts), fewer than half of vacancies were filled – a severe shortfall. The recruitment of Circuit and High Court Judges has also faced challenges, with posts remaining vacant in recent years, though in the most recent hiring round all vacancies were filled. These challenges appear to be related to applicant quality as there are enough applicants to fill the roles. Increasing the number of judges is part of the plan to reduce court backlogs (National Audit Office, 2024), which recruitment challenges make more difficult.

Pay stands at around £126,500 for a District Judge, £157,700 for a Circuit Judge and £212,400 for a High Court Judge. Although high compared with the workforce as a whole, it is possible that pay needs to rise further to attract applicants of the right quality, both in applications to become judges in the short term and in the broader pipeline in the longer term. This is reflected in the SSRB's recommendation for judiciary pay being among the highest of all public sector groups in both the 2023–24 and the 2024–25 pay review cycles (see Table 4.2 earlier).

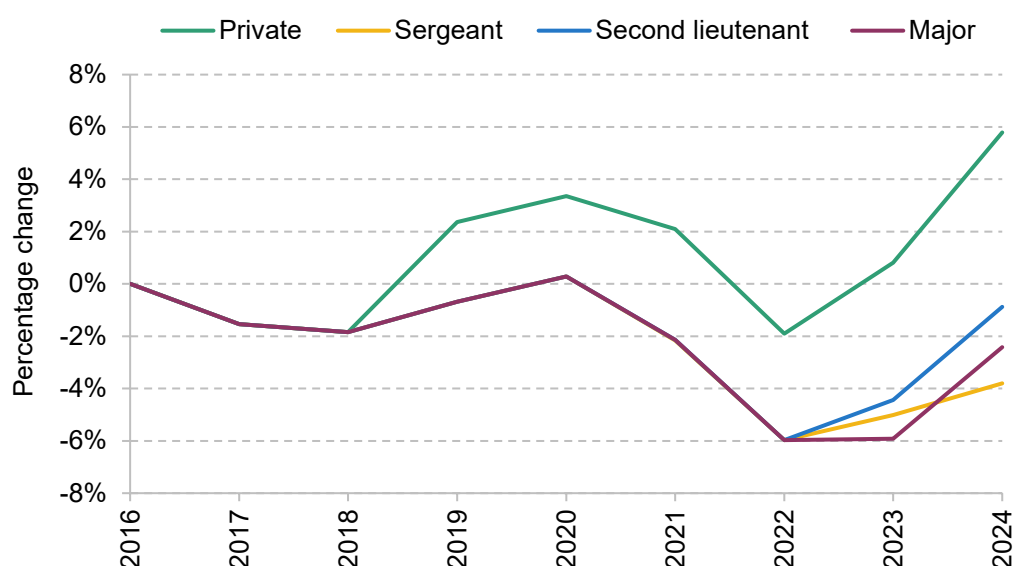
It remains to be seen whether pay increases can combat the problems evident across different groups of senior public servants. The SSRB recommends additional measures, such as a rationalisation of the SCS pay structure.²⁹ Given the small number of people employed in 'senior salaries' positions, the direct exchequer cost of increasing pay, or other parts of remuneration, to ameliorate recruitment or retention problems would be small. But if increasing pay for the SCS, for example, is seen to necessitate (politically) increases in pay that are as large as, or larger than, those for less well-paid civil servants, then the cost to the exchequer would rise substantially.

HM Forces

Set against a background of increasing international tensions, the picture presented in the Armed Forces Pay Review Body (AFPRB) report is concerning. There are recruitment and retention challenges across the three services (Army, Air Force and Royal Navy / Royal Marines), accompanied by broad-based dissatisfaction with pay.

²⁹ The current SCS pay structure is messy and filled with strange incentives – external hires can earn substantially more than internal hires, and it is possible for grade 6 roles (junior to the SCS and managed by them) – to earn more than Deputy Directors, which disincentivises promotion.

Figure 4.15. Real-terms pay compared with 2016 for a selection of Armed Forces ranks



Source: AFPRB reports 2016–24. For Other Ranks, the tables relating to ‘Supplement 1’.

Across the three services, outflows exceeded the number of new entrants, which has fallen to its lowest level since 2019, meaning that the Forces saw a net reduction of around 5,500 personnel over 2023. Some of this was planned.³⁰ But the number of people choosing to leave the services before the end of their agreed contract period has grown above its pre-pandemic level. All three services experienced similar voluntary exits of between 6% and 7% through 2023.

Remuneration is a key part of the picture. Figure 4.15 shows the percentage change in real-terms pay since 2016 (when the current pay scales were introduced) for the pay band minima for a selection of Armed Forces pay levels. These correspond to the bottom and roughly halfway up the ‘Other Ranks’ pay scale (equivalent to privates and sergeants in the Army) and to the bottom and roughly halfway up the ‘Officer’ pay scale (equivalent to second lieutenants and majors in the Army).³¹

What is clear is that the pay of less-experienced Other Ranks has fared better than that of more senior roles. By 2024, privates have seen their pay increase by around 6% in real terms. For the others, pay evolved similarly until 2022, when it diverged. Ultimately, those in the middle of the Other Ranks pay scale (sergeants on the graph) have fared worse, with earnings 3.8% lower in real terms than in 2016. Second lieutenants and majors have lost 0.9% and 2.4% respectively. These falls are less than those for experienced teachers and senior civil servants.

³⁰ See <https://hansard.parliament.uk/commons/2024-02-19/debates/2EDD0FA6-89CE-48F6-8760-B6B27888E509/ArmySize>.

³¹ ‘Other Ranks’ are ranks below officers and make up the majority of the headcount of the Armed Forces.

The AFPRB also compares salaries with the earnings distribution in the population and with other public sector roles. Officer pay has slipped relative to the overall earnings distribution, but starting salaries, at £31,305 in 2023, still compare favourably with other public sector professions – higher than Fast Stream civil servants but lower than doctors. Other Ranks, who make up the majority of the Armed Forces, have also seen their pay diminish over time and they do have starting salaries that are lower than in other public sector occupations. This may be related to the age, education and experience profile of entrants, however, and the AFPRB notes that, according to the Institute of Student Employers recruitment survey, their starting salaries are higher than starting pay for the average school/college leaver.

Ahead of the 2024 pay increases, members of the Armed Forces were generally unhappy with their pay, though appeared happy with their job in general. In answer to questions relating to satisfaction with their pay and whether they think the pay is fair for the work they do, only around 40% of officers and 30% of Other Ranks answered positively. These proportions have been falling and are at their lowest since 2019. Other measures of morale are less negative and more stable – a little over half of Other Ranks, and two-thirds of officers, said that they are satisfied with their job.

Given these results, and the fact that last year's pay increase, though historically high in nominal terms, still represented a real-terms cut, there is a case for meaningful increases in Armed Forces pay. The AFPRB has recommended a 6% increase at all pay scales for 2024–25, and for new entrants to start at the first point on the pay scale rather than facing a reduced rate of pay for the first six months that they are in training (as is the case currently). The government has accepted these recommendations, which the AFPRB estimates will cost £788 million. They are in contrast to previous years, when pay increased more quickly lower down the pay scale. The 6% increase is above the average for public sector pay recommendations this year, though it remains to be seen whether it is enough to disrupt the broader trends evidenced in the AFPRB's report.

4.4 Issues across the public sector workforce

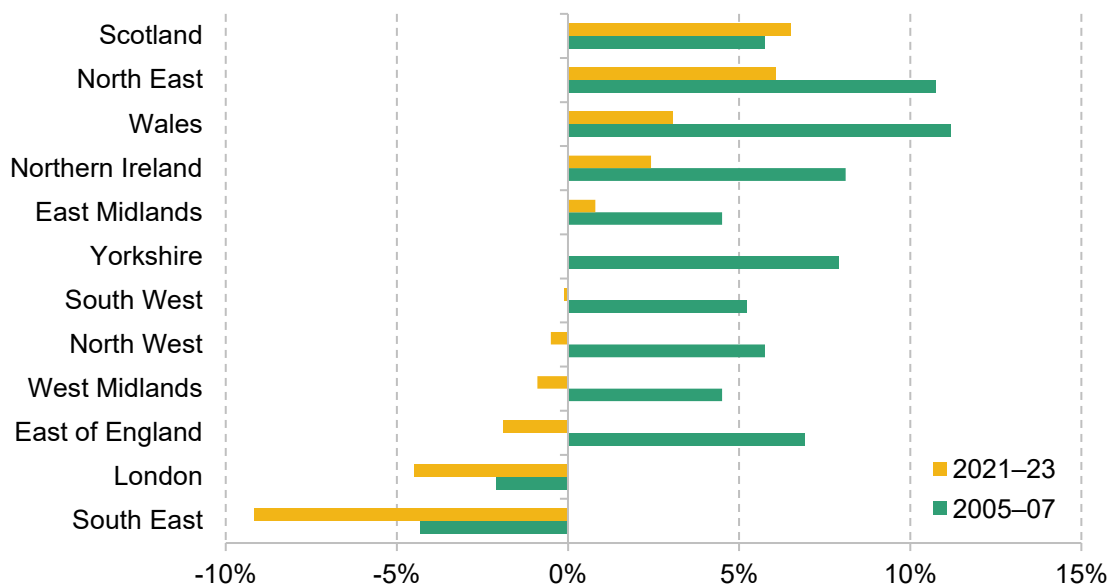
In addition to the occupation-specific issues that we have highlighted in the previous section, the evidence gathered by the Pay Review Bodies points to a number of cross-cutting issues in public sector remuneration which affect many or all of the different public sector workforces. We briefly examine two of these issues here, focusing first on geographical differences in pay (or the lack of them) across the public sector and then on some of the issues regarding public service pensions.

Geographical differences in pay

Overall, public sector employment accounted for 17.9% of total employment in the United Kingdom in June 2024. However, public sector employment as a share of total employment varied markedly across the country (Office for National Statistics, 2024b). Public sector employment is above average in Northern England, Wales, Scotland and Northern Ireland and below average in Southern England. Moreover, these are not small differences. While for Northern Ireland, 26.4% of those employed are working for the public sector, in the South East, this value drops to 15.1%.

Public sector pay scales are set nationally, and generally have higher levels of pay in London than in the rest of the country due to ‘London weighting’. Average teacher pay, for example, varies little across regions outside the capital despite headteachers having large degrees of autonomy over the pay and progression rate of their staff (Fullard, 2021).

Figure 4.16. Public sector pay differential conditional on workers’ characteristics, by UK region and nation



Note: The differential is calculated controlling for age, education, experience and region, all interacted with sex, and interactions between education and experience. Figures are for hourly pay and exclude pension contributions.

Source: Authors' calculations using the Labour Force Survey.

The lack of variation in public sector pay across regions means that public sector employment is more or less attractive depending on how well paid private sector roles are in any given area. Figure 4.16 shows the hourly public sector pay differential, controlling for workers' characteristics, such as their age and education. In 2021–23, hourly public sector pay is lower than private sector pay in London, the South East and East of England and the two are very similar in most of the other English regions. Meanwhile, there is a pay premium to working in

the public sector in the North East of England and the other UK nations. This contrasts to the period before the 2008 financial crisis, when there was a substantial pay premium to working in the public sector in most of the English regions. Scotland is the only part of the UK where the pay differential is essentially unchanged compared with 2005–07, whilst in London and the South East the public sector pay penalty has grown over time.

These features have consequences for staffing, which are highlighted in a number of the PRB reports. In the case of the NHS, there are various concerns about staff relocation due to pay incentives: that staff largely move to places where pay is higher (such as Scotland) and/or that they do not move to areas that are not covered by London weighting. However, with the police and prison services, the biggest recruitment shortfalls are in London, where salaries do not appear to be sufficient to attract or keep staff. Similar features are present for the judiciary, where the PRBs indicate big shortfalls in London and the South East.

These factors are important, as they might have important impacts on the adequacy of regional public service provision. The uncompetitive nature of public sector pay in some areas of the country, and apparent premium relative to private sector employees in other parts of the country, are not new and neither are the issues they create, but to date there has been apparently little appetite to reform public sector pay to more closely reflect the different labour market conditions in different parts of the country. There will be a case for tilting future public sector pay awards towards those areas where pay is lower relative to the private sector, at least in cases where relatively lower-paying areas have greater recruitment and retention challenges than relatively higher-paying areas.

Public service pensions

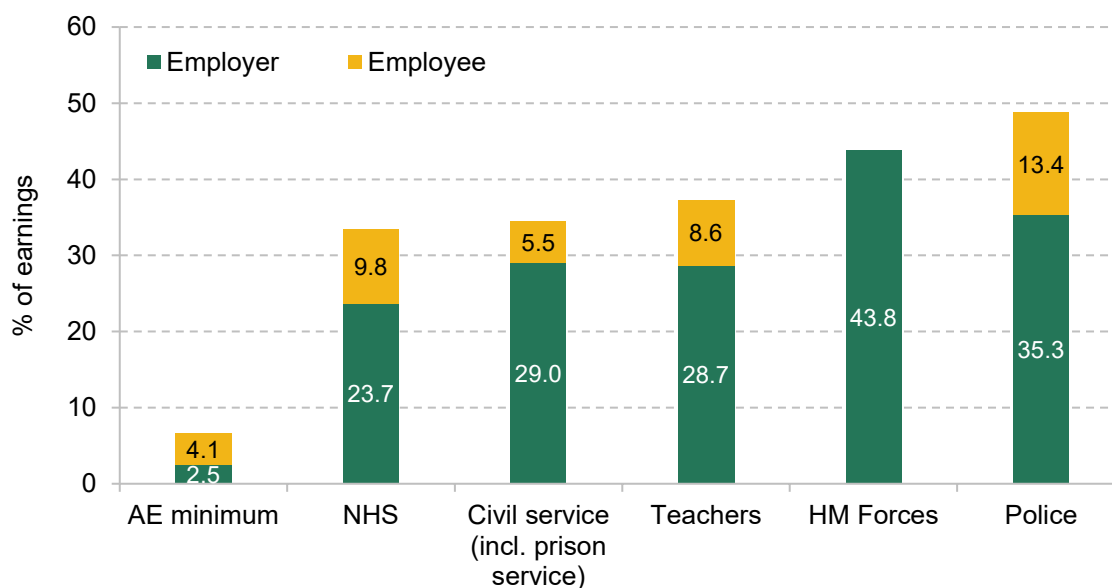
A substantial part of public sector workers' remuneration comes in the form of accrual to a defined benefit pension plan as these schemes have substantial employer pension contributions. Often, to be a member of these arrangements (with the notable exception of the Armed Forces), individuals have to make a significant employee contribution themselves. Table 4.4 shows the official employer and employee contribution rates, the latter often increasing as earnings rise. There are differences across schemes, with employer contribution rates especially high for the police and HM Forces, which also have lower normal pension ages – i.e. members are able to take a full, unreduced, pension from a younger age than their state pension age.

Table 4.4. Employer and employee contributions to public service pension schemes, as a percentage of pensionable pay

	Employer	Employee
NHS	23.7%	£0–£13,259: 5.2% £13,260–£26,831: 6.5% £26,832–£32,691: 8.3% £32,692–£49,078: 9.8% £49,079–£62,924: 10.7% £62,925+: 12.5%
Teachers	28.68%	£0–£34,289: 7.4% £34,290–£46,158: 8.6% £46,159–£54,729 :9.6% £54,730–£72,534: 10.2% £72,535–£98,908: 11.3% £98,909+: 11.7%
Civil service (includes prison service)	28.97%	£0–£34,199: 4.6% £34,200–£56,000: 5.45% £56,001–£150,000: 7.35% £150,001+: 8.05%
Police	35.3%	£0–£27,000: 12.44% £27,001–£60,000: 13.44% £60,001: 13.78%
HM Forces	43.8%	0%
<i>Minimum automatic enrolment contributions</i>	<i>3% of qualifying earnings</i>	<i>5% of qualifying earnings (assuming a minimum employer contribution of 3%)</i>

Note: Contribution rates are for post-2015 pension schemes. The exact bands (and to a lesser extent contribution rates) for employee contributions have changed over time.

Source: NHS – <https://www.nhsemployers.org/publications/nhs-pension-scheme-member-contributions-202425>; teachers – <https://www.teacherspensions.co.uk/employers/managing-members/contributions/calculating-contributions.aspx>; civil service – <https://www.civilservicepensionscheme.org.uk/your-pension/managing-your-pension/contribution-rates/>; police – https://www.legislation.gov.uk/uksi/2024/920/pdfs/uksiem_20240920_en_001.pdf and <https://policepensioninfo.co.uk/wp-content/uploads/2024/01/NPCC-Member-Remedy-Factsheet-Contributions-adjustments.pdf>; HM Forces – https://assets.publishing.service.gov.uk/media/659d2bd0d1a5e60012f1eec8/AFPS_2020_Valuation_Valuation_Results.pdf.

Figure 4.17. Employer and employee contributions, as a percentage of earnings for average earner (£35,000)

Note: Contribution rates are for post-2015 pension schemes. The exact pensionable pay bands (and to a lesser extent contribution rates) for employee contributions have changed over time.

Source: See source to Table 4.4.

These contributions are far higher than the minimum default pension contributions that apply under the automatic enrolment (AE) regulations, as shown in Figure 4.17. Under AE, employees have minimum default pension contributions of 8% of qualifying earnings (i.e. earnings between £6,240 and £50,270), of which at least 3% must come from their employer. So an average earner on £35,000 could, by default, receive an employer pension contribution that was worth just 2½% of their *total* salary. The pension contributions from public sector employers are also higher than those often seen for even high-earning private sector employees (who on average make and receive the highest contributions). On average, the highest-earning fifth of private sector employees saving in a workplace pension scheme have an employee contribution of 5% of their salary and receive an employer contribution worth 8% of their salary (Cribb et al., 2023).

Despite the very high value of employer pension contributions, some of the Pay Review Bodies report difficulties caused by these pension schemes on account of the significant employee contributions that are required. For example, 15% of band 5 staff – the starting band for nurses – and 20% of doctors in core training choose to opt out of the NHS pension, and therefore miss out on the significant employer pension contribution that they would have received. The Police Remuneration Review Body highlights the financial difficulties that many, particularly in the Metropolitan Police, would face in making the large employee contributions needed to participate in the scheme, with 10% now opting out. Opting out of the pension scheme is particularly common for staff from overseas and for lower-paid employees in general: ONS data show that among public sector employees earning £10,000 to £16,000 per year, 13% were not a

member of their employer's pension arrangement in a given year, compared with only 6% for those earning over £31,000.³²

In response to these challenges, some have suggested that there be more flexibility in public pension contributions. Indeed, in a previous Green Budget, Boileau, O'Brien and Zaranko (2022) suggested a reduction in required employee contributions in the public sector alongside a reduction in the overall generosity of the pension (thereby reducing the required employer contribution). This would boost the take-home pay of those who are members, and would be expected to lead to greater numbers choosing to remain in the arrangement. While it would mean the resulting pensions would be lower, they could still be left considerably more generous than what the vast majority of the private sector workforce receives. A theme across the Pay Review Body reports is of enthusiasm for people to have greater flexibility in their participation in pension schemes (in the NHS, doctors', teachers' and police), and NHS Employers reportedly support introducing greater flexibility in the way individuals contribute too. Moreover, there remain questions about whether the very high pension accrual (as reflected by the employer contribution rates) is the appropriate way to structure remuneration in order to encourage recruitment, retention and motivation of staff, particularly given the difficulties identified in recruiting in some parts of the public sector.

4.5 Conclusion

The new government has decided to accept in full the pay recommendations of the independent Pay Review Bodies. Public sector pay awards averaging around 5.5% in 2024–25, similar to the current rates of private sector pay growth and above the forecast growth in whole-economy earnings for 2024–25,³³ mean that most public sector workers are unlikely to see their pay fall compared with their private sector counterparts this year.

And yet challenges for the public sector workforce remain, with the potential for upward pressure on public sector pay in future years in some services and consequences for public spending in those areas. This is in part due to long-running changes in public sector pay which have cut the real value of some public sector workers' pay and eroded their relative position in the pay distribution. This has especially affected higher-paid occupations: doctors, teachers and police officers (and 'senior salaried' employees) compared with nurses and junior civil servants.

³² Table P2 of <https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/workplacepensions/bulletins/annualsurveyofhoursandearningspensiontables/2021provisionaland2020finalresults/relateddata>.

³³ 3.1% was the forecast made in March by the Office for Budget Responsibility, though average earnings data for 2024 so far have been higher than these forecasts.

This chapter has undertaken new analysis and drawn on a wide array of evidence provided in the Pay Review Body reports to examine the potential future pressure on public sector pay coming from different parts of the public sector.

The NHS workforce is the most consequential part (35%) of the public sector workforce. Despite falls in doctors' pay, other NHS workers have seen more favourable trends, and recruitment and retention have held up, albeit with increasing dependence on staff from abroad filling roles. With the pay disputes with doctors resolved, the key challenge facing NHS pay and workforce is training, recruiting and retaining more staff to increase the size of the NHS as the population ages and demands more healthcare, in line with the Long Term Workforce Plan. As Warner and Zaranko (2023) warned in last year's Green Budget, this could necessitate NHS pay growth in excess of economy-wide pay growth.

School teachers make up another important part of the public sector workforce. There the immediate trends are much more concerning than in the NHS, with recruitment rates relative to target running very low, and well below pre-pandemic levels. Recruitment into traditionally shortage subjects has fallen even further, but the latest data show this is now a much more widespread problem than pre-pandemic. With pay for experienced teachers having fallen by 9% in real terms from 2010 to 2024 (and pay for new teachers having regained its 2010 real level), this surely raises the question as to whether pay rises in future should now be targeted towards more experienced teachers. The opposite problem is faced by the police: pay at the lowest levels has been suppressed relative to higher-paid officers, and action is already being taken to target higher pay at starting salaries, perhaps helped by this targeting of pay awards to lower earners being politically easier to deliver.

One area where targeting larger rises towards higher earners is almost certainly justifiable is in the senior civil service, as well as in the judiciary, both of which are experiencing significant problems due to pay. Given the very small number of people involved, even substantial pay rises for these groups would be rounding errors compared with the public sector pay bill as a whole. Pay rises for these groups may therefore not need a financial solution, but perhaps a political one. They would necessitate a government being willing to pay some people more who are well paid when compared with the wider population, but not when compared with what many of them could earn elsewhere.

Where does this leave us? The appropriate path for public sector pay in coming years is likely to be driven in large part by nominal private sector earnings growth, and how it differs across the distribution. If private sector pay growth remains elevated for a number of years, public sector wages will need to grow faster than if private sector pay growth is slower. However, the key challenge for the public finances is not so much how much growth there is in private sector earnings. If private sector earnings growth is high, that is likely to mean strong growth in tax

revenues, which allows the government to increase public service spending and increase public sector pay.

Our reading of the evidence is that there is good reason to believe that there will be pressure in coming years to deliver public sector pay increases that, on average, outstrip private sector wage growth. That is for two reasons. First, as with experienced teachers and less experienced police officers, public sector wage growth has been consistently held down to the extent that it is causing real difficulties recruiting the right number, and type, of public sector workers. And second, the largest public service, the NHS, will need to continue to expand to provide healthcare to a larger, older population, and that expansion is likely to necessitate pay growth in excess of the economy-wide average in coming years.

Table 4.5 provides a quantification on the potential scale of this pressure over the period from this year (2024–25) to 2028–29. It shows how spending on the pay bill might evolve under different assumptions about public sector pay growth. For simplicity of the illustration, we first assume no increases in public sector employment. The first row of the table shows how the government pay bill would rise if public sector pay grows in line with forecast average earnings – this would push spending on the pay bill up by 2% in total, or £6 billion per year by 2028–29. If instead public sector pay grew on average 0.5 percentage points faster than average earnings per year, that would imply a 4% rise in the pay bill (£11 billion per year). And if public sector pay grew 1 percentage point faster than average earnings, that would imply additional spending of £17 billion per year.

Table 4.5. Increases in public spending on the pay bill, 2024–25 to 2028–29, given different assumptions on public sector pay

	% terms	Per year by 2028–29 (2024–25 prices)
Public pay grows in line with average earnings	2.0%	£6 billion
Public pay grows 0.5ppt per year faster than average earnings	4.0%	£11 billion
Public pay grows 1ppt per year faster than average earnings	6.1%	£17 billion
Public sector employment increases by 1% by 2028–29	1.0%	£3 billion

Note: Costings of additional pay assume no growth in the public sector workforce. Nominal values are deflated in line with forecast growth in the GDP deflator and average earnings growth is assumed to follow OBR forecasts from March 2024. Costing of increase in public sector employment assumes no growth in real earnings.

Source: Authors' calculations using the OBR Economic and Fiscal Outlook March 2024.

Of course, the cost to the government of the public sector pay bill could increase in other ways, most obviously through increasing the size of the workforce. For illustrative purposes, Table 4.5 shows the case of increasing the public sector workforce by 1%, which costs around £3 billion per year assuming no real growth in pay. Any real pay growth, of course, would mean the cost of employing more public sector workers would rise too.

While this is not a recommendation for the path of public sector pay, we note that average private sector pay is now 4.7% higher than public sector pay (as shown in Figure 4.1), having been the same as average public sector pay in early 2019. Therefore public sector pay growing by 1 percentage point per year faster than private sector pay over the next four years would approximately close that gap by 2028–29. The £17 billion per year (in 2028–29) estimate therefore illustrates the potential cost of doing so.

It is worth noting that the potential for additional public sector pay increases could eat into the extra resources provided for public services that would be provided by higher real-terms spending. For example, if day-to-day public service spending were to grow at 1% per year in real terms over the next four years, in line with plans from the previous government, that would lead to additional spending of £22 billion per year by 2028–29. Half of this (£11 billion) would be taken up on the additional pay of current public sector workers if public sector pay rose 0.5 percentage points faster than average earnings, leaving only half for additional employment of workers or other day-to-day spending.

This all examines the potential pressure placed on spending by public sector pay. Of course, politicians do have choice on how to set public sector pay and they may resist that pressure. Particularly in the short term, they may be able to suppress pay with only limited effects. Squeezing pay is one way of cutting public expenditure, if that is desired, though it is generally a way that makes it harder to choose which of your staff you keep and which you lose to more attractive opportunities elsewhere. But given the emphasis in the Labour Party's 2024 general election manifesto on public service improvement, in many parts of the public sector it may well be difficult to deliver that without some increase in public sector employment and some significant rises in public sector pay, at the very least targeted at those occupations struggling most with recruitment and retention issues.

Appendix 4A

Table 4A.1. Position (percentile) of median pay of major public sector occupations in the overall hourly pay distribution, including employer pension contributions

		Position (percentile) of median pay for each occupation in the overall hourly pay distribution	
		Pay	Pay plus employer pension contribution
Doctors	2010	96	96
	2019	92	92
	2021	91	90
Nurses	2010	72	73
	2019	71	71
	2021	71	70
Teachers	2010	86	87
	2019	82	84
	2021	82	85
Police	2010	77	82
	2019	74	81
	2021	74	80
Public administration	2010	61	65
	2019	62	67
	2021	57	63

Note: Employer pension contribution is added on to pay for all those who participate in a workplace pension scheme.

Source: Authors' calculations from the Annual Survey of Hours and Earnings (ASHE).

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Data

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5. Adult social care in England: what next?

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Key findings

1. **Local authorities in England have budgeted £24.5 billion for spending on adult social care services in 2024–25.** Around half of this spending goes towards support for working-age adults and around half goes towards support for adults aged 65 and above. Adult social care spending now accounts for more than 40% of all local authority spending on services.
2. Eligibility for government support towards adult social care costs in England is subject to both a financial means test and a needs test. That is, publicly funded adult social care is rationed in two ways: **only those with limited financial resources and assessed social care needs above a certain threshold qualify for support from their local council.** Both the means test and the needs test have become more stringent in the last 15 years. **There is no cap on the costs that an individual can incur.** Around one-in-seven 65-year-olds can expect to incur lifetime care costs of more than £100,000, but **individuals have limited ability to protect themselves against extremely high care costs.** This is the ‘insurance problem’ in social care.
3. **The new Labour government has decided not to proceed with the previous government’s adult social care reforms,** which would have seen the introduction of a lifetime cap on adult social care costs and a more generous financial means test. As a result, despite decades of handwringing, the insurance problem in social care remains unresolved. **This is not an area in need of new technical solutions – the solutions are already known and well understood; it is a question of political priorities.**
4. **The introduction of a lifetime cap on care costs, while welcome, would not be a comprehensive solution to all of the sector’s ills.** Whether or not the charging reforms had gone ahead, there are numerous knotty issues in need of policy attention

and political will. In other words, completely aside from whether we have some sort of lifetime cap on care costs, there are outstanding questions around the social care workforce, the stringency of the needs test, rapidly growing demand for care among working-age adults, geographic variation in provision, and much else. **Scrapping the charging reforms does not park adult social care as an issue.**

5. Demand for care services among working-age adults is growing quickly: **the number of new requests for support from individuals aged 18–64 grew by 18% between 2014–15 and 2022–23 (more than three times faster than population growth for that age group)**, alongside sharp increases in disability benefit claims. These trends signal growing pressure on social care services for younger adults, in addition to the more commonly discussed pressures from an ageing population.
6. In fact, **despite significant growth in the older population, the number of older people receiving state-funded care in England has dropped by 10% since 2014–15 due to tightening eligibility criteria**, and we estimate that public spending on adult social care failed to keep pace with demographic pressures between 2009–10 and 2022–23. Looking ahead, **to meet demand pressures (particularly from an ageing population) and rising costs, the Office for Budget Responsibility projects that UK-wide public spending on adult social care would need to increase by 3.1% per year in real terms over the next decade.** After adjusting for savings from the scrapping of charging reforms, that would see spending rise from 1.3% of national income in 2023–24 to around 1.5% in 2033–34 (and then to 1.9% in 2053–54 and 2.2% of national income in 2073–74).
7. Adult social care is the responsibility of 153 local authorities in England, increasingly funded by local council tax revenues since 2010. **It therefore matters not just how much is spent at a national level, but where it is spent.** In the absence of a well-functioning local government finance system, there is a risk of a severe mismatch between local funding and local needs. This will be of particular importance if the government is serious about introducing a 'National Care Service' with consistent service provision across the country. **At a minimum, the government should commit to implementing, and keeping up to date, new formulas for assessing councils' spending needs** (existing funding is to a large extent based on formulas last updated in 2013 and in some cases, rather ridiculously, using data from as far back as 2001).
8. **Immigration policy significantly affects the adult social care workforce in the UK**, with a growing proportion of employees from non-EU countries, now comprising 16% of the workforce, while EU worker representation has decreased. Monthly applications for Health and Care Worker visas have plummeted from an estimated 18,300 in August

2023 to 2,300 in August 2024. The new government has given no indication that it plans to reverse the previous government's tightening of eligibility for these visas. The trade-off here is a simple one. **If the government wants to decrease the number of migrants entering the care sector, it must be prepared either to accept a smaller workforce (i.e. a deterioration in care quality and/or coverage) or to boost the funding allocated to local authorities to raise wages and attract more domestic workers.**

9. **Successfully implementing various proposed policies and initiatives for the sector – such as the ‘Fair Cost of Care’ reforms and the new ‘Fair Pay Agreement’ aimed at raising fees for providers and wages for care workers, respectively – will likely necessitate additional funding from the government.** Without more detail on what these policies (particularly the Fair Pay Agreement) will entail, it is impossible to say how much more funding. The structure of the adult social care market complicates policy in this area. **Only one-in-six care workers are employed directly by the public sector.** A large majority of care home beds are provided by the private and voluntary sectors, with a significant role for a small number of large providers (the largest 30 care home providers supplied 30% of overall capacity in 2017) and for private equity (which owned approximately 13% of for-profit care home beds as of 2022).
10. Individuals who provide at least 35 hours of care a week may be eligible for carer's allowance of £81.90 per week. **Currently, if the carer earns more than £151 per week after tax, they no longer qualify. This cliff-edge is highly undesirable** and can lead to cases where individuals have to repay large amounts to the Department for Work and Pensions if their earnings edge above the threshold. It would be better to have the £81.90 per week automatically adjust to earnings and be subject to a gradual taper (akin to the taper in universal credit).

5.1 Introduction

The adult social care sector is large, important and growing. In England alone, local authorities spend more than £20 billion on care services for more than three-quarters of a million adults each year. Hundreds of thousands more do not receive state support but pay privately towards their care.

The sector is also marked by its complexity. Care is provided formally, by trained professionals (the sector employs more than 1.5 million people), and informally, by family and friends (an

estimated 5 million people provided at least some informal care in 2021), and often by some combination of the two. Of those trained professionals, a majority work in the private sector, with only around one-in-six employed directly by the state.

Eligibility for local authority funding towards social care costs in England is governed by both a needs test and a means test. The former means that only those with the most severe care needs qualify for state support. The latter means that council funding is provided only to those with financial assets below £23,250: above that level and people must ‘self-fund’. For some people, the value of their home will count towards that asset test; for others, it will not. Even those with assets below the threshold are expected to contribute from their income. Around one-in-seven people at the age of 65 can expect to incur lifetime care costs of more than £100,000, and individuals have extremely limited ability to protect themselves against those costs. This is a far cry from the relative simplicity of a universal, free-at-the-point-of-use, health service.

This complexity, coupled with a lack of political will, is perhaps why – despite decades of handwringing and promises of reform – the ‘insurance problem’ in social care remains unsolved. The previous government legislated for a set of reforms, set to be rolled out from October 2025, which were to increase substantially the generosity of the financial means test and to introduce a lifetime cap on care costs. During the election campaign, the Labour Party promised to introduce a ‘National Care Service’ and a ‘Fair Pay Agreement’ for adult social care, with close to no details on what those policies might mean in practice. The manifesto did not explicitly commit to go ahead with the previous government’s charging reforms, but some of the party’s statements strongly indicated that it would.¹ The Conservatives and Liberal Democrats also committed to the reforms during the campaign.

Then, in Rachel Reeves’s spending audit on 29 July, the new Chancellor declared that ‘it will not be possible to take forward these charging reforms’, with the accompanying document stating that ‘the reforms are now impossible to deliver in full to previously announced timeframes’ (HM Treasury, 2024). The new government faces enormous spending pressures, and it is reasonable to decide to prioritise other public services or different groups within society. But the decision to once again kick sorely needed social care reform into the long grass is disappointing and just the latest in a long string of sorry episodes. The insurance problem within social care remains unresolved. It could and should have been addressed a long time ago.

Yet, the introduction of a lifetime cap on care costs is not a comprehensive solution to all of the sector’s ills. Whether or not the charging reforms had gone ahead, there are several knotty issues

¹ See, for example, Wes Streeting’s comments on the BBC Radio 4 Today programme on 14 June (<https://www.bbc.co.uk/programmes/m00202r1>) and associated press coverage (<https://www.bbc.co.uk/news/articles/cw44del3pd7o>).

in need of policy attention and political will. In other words, completely aside from whether we have some sort of lifetime cap on care costs, there are outstanding questions around the social care workforce, the stringency of the needs test, rapidly growing demand for care among working-age adults, geographic variation in provision, and much else besides. Scrapping the charging reforms does not park adult social care as an issue.

In this chapter, we set out the current state of the adult social care system and its key features. Section 5.2 describes the adult social care system in England. Section 5.3 considers the nature of the insurance problem within social care and the details of the proposals recently scrapped by Ms Reeves. We then turn in Section 5.4 to some of the looming policy challenges under the status quo, grouping these into five broad and interrelated categories: (i) funding and demographic pressures; (ii) interactions with local government finances; (iii) ‘Fair Cost of Care’ reforms and payments to providers; (iv) the adult social care workforce, including immigration and pay; and (v) support for informal carers. We conclude in Section 5.5 by exploring potential future developments for the sector.

Throughout, the focus is on England and the English system, recognising that this is a devolved issue across the UK, and that any decisions on adult social care in this autumn’s Budget and Spending Review – if there are any – will primarily affect England. While many challenges are shared across the four nations, and we occasionally reference changes introduced by the devolved governments of Scotland, Wales and Northern Ireland, a comprehensive analysis of the specific issues facing each part of the UK would be beyond the scope of a single chapter. Some of these key differences are nonetheless worth noting: Scotland offers free personal care; Wales has a more generous means test and a weekly cap on domiciliary care costs; and Northern Ireland operates with a cap on costs managed by health and social care boards rather than local government. Each of these provides possible directions of future travel in England.

5.2 A beginner’s guide to adult social care in England

Adult social care refers to a broad range of non-medical services provided to support individuals with illnesses or disabilities that cause them to have difficulties with activities of daily living, such as washing, eating, getting dressed and using the toilet, as well as general mobility. This includes older adults – who tend to feature most heavily in the debate – but also a considerable number of younger adults, who tend to have more intensive care needs (e.g. due to a severe learning disability). Most social care is provided informally by family, friends and neighbours. For individuals with more substantial needs, or those for whom informal care is not available, formal care is provided by paid carers and may be funded publicly or privately (self-funding).

The focus of this chapter is the publicly funded adult social care system. Before considering possible reforms (including those recently scrapped by the new government), we set out some of the key features of the current system and consider recent trends in spending and provision.

Key features of the system

A local, not a national, responsibility

Publicly funded adult social care in England is largely the responsibility of local, not national, government. The main exception to this is NHS Continuing Healthcare, discussed in Box 5.1 later. There is no England-wide budget allocated to adult social care, nor any ‘national care service’ akin to the NHS. Instead, it is decentralised and arranged and funded by 153 local authorities with responsibility for social care within their geographic areas. These local authorities are subject to statutory requirements which establish a minimum standard regarding duties and needs assessments, but the interpretation and implementation of these can differ widely depending on local priorities and resources. Local authorities are funded by a combination of grants from central government and local tax revenues, and they retain considerable discretion over the services provided in their area (including the extent to which to prioritise adult social care relative to other services, subject to meeting their statutory requirements).

Since 2010, spending on adult social care has been shielded from cuts relative to other services provided by local authorities (in part because of the statutory duty to provide certain care services). As a result, it has grown to account for a larger share of local authority budgets – from around 35% of all service spending in 2010–11 to around 40% in 2015–16 and around 42% in 2023–24 (Ogden and Phillips, 2024a).

Means-tested and needs-tested

Public funding for adult social care is available only for those with care needs above a certain threshold *and* limited financial means. In other words, it is subject to both a needs test and a means test. The latter has both an asset and an income component.

Individuals with assets, savings and other capital of £23,250 (the ‘upper capital limit’) or more are ineligible for state support and are expected to meet the full costs of their care until their assets fall below the threshold. There is no limit to the lifetime costs that an individual can face before qualifying for state support. Their main residence is excluded from this asset test if they, their partner or another dependant continues to live in that home.² Those with assets above

² Deferred payment agreements, where available, allow people to delay paying the costs of their care, in order to prevent people from having to sell their homes during their lifetime. 2,370 new deferred payment agreements were agreed in 2022–23, worth a total of £54.6 million (<https://digital.nhs.uk/data-and-information/publications/statistical/deferred-payment-agreements/2022-23>).

£14,250 (the ‘lower capital limit’) but below £23,250 are eligible for partial support: the council pays for a portion of care costs according to a sliding scale, with individuals charged £1 per week for every £250 of assets above the £14,250 threshold (a charge known as ‘tariff income’). Those with assets below £14,250 are not expected to contribute from their assets towards the cost of their care and are not charged any ‘tariff income’.

How mean is the financial means test? Data from the English Longitudinal Study of Ageing (ELSA) suggest that only 13% of adults aged 65 and above (20% of adults aged 85 and above) had wealth below the upper capital limit (£23,250) in 2018–19. This includes housing wealth, and so is the relevant measure for those entering residential care without a partner or dependant living at home (and so whose main residence would be included in the asset test). When considering those with a partner or dependant living at home (and so whose main residence would be excluded from the test) and individuals in receipt of domiciliary (in-home) care, a more relevant measure would be wealth excluding housing wealth. On this measure, 43% of those aged 65 and above (51% of adults aged 85 and above) have wealth below the upper capital limit. Either way, at a given point in time, most older adults have sufficient assets to be ineligible for local-authority-funded social care.

One reason for this is that the value of the asset thresholds (the lower and upper capital limits) has been frozen in cash terms since 2010–11, at £14,250 and £23,250 respectively. The real-terms value of these thresholds has therefore fallen considerably, during a period when asset prices have risen. Had they been increased in line with the Consumer Prices Index (CPI) since 2010–11, they would have risen to approximately £20,800 and £33,900 in 2023–24, some 46% higher. The means test is becoming more stringent and less generous over time in real terms. Fewer adults are eligible for publicly funded care than would otherwise have been the case (had the thresholds been uprated with inflation).

Even if someone qualifies for local authority funding on the grounds that they have assets below the upper capital limit, they are still required to contribute from their income, including pension.³ This is subject to a minimum income floor, an amount that the individual must be left with after making their contribution. For those receiving care in a care home, this is the personal expenses allowance (PEA), set at £30.15 per week for the 2024–25 financial year; for those receiving care in other settings, the floor is the minimum income guarantee (MIG), which varies according to age and circumstances. The MIG rate for a single adult who has attained pension credit age, for

³ Examples of income that is partially disregarded include: 50% of a private/occupational pension if it is paid to a spouse or civil partner who does not live in the same care home; and if a person receives, or their income is too high for, pension credit savings credit, up to a maximum of £6.95 a week or £10.40 for a couple (Foster, 2024).

example, is £228.70 per week.⁴ This is slightly higher than the minimum level of £218.15 to which a single adult in receipt of pension credit would have their income topped up (UK Government, 2024).

The Care Act 2014 requires local authorities to assess individuals' care needs against national eligibility criteria, though local authorities set their own assessment procedures and have discretion to provide care to those with needs that do not meet the nationally set criteria. Alongside an increasingly stringent means test, the stringency of the needs test also increased over the first half of the 2010s, as councils responded to funding cuts by restricting support to those with the highest assessed needs (House of Commons, 2017).

There is also evidence to suggest that councils interpret and implement these criteria differently (Ogden and Phillips, 2023). In 2022–23, for example, just under half (48%) of individuals aged 65 and over who requested support received some sort of short-term or long-term care from their council. But in one-in-ten local authorities, fewer than a third of those requesting support ended up receiving some, while another one-in-ten local authorities provided support to more than 70% of those requesting it (NHS England, 2023a). Considerable local discretion remains.

The latest figures for 2022–23 indicate that 72% of individuals aged 65 and above receiving community care services (i.e. care outside of a care home) had that care funded by the state (Office for National Statistics, 2023a). In care homes providing care for those aged 65 and above, 51% were in receipt of state support (Office for National Statistics, 2023b). These figures are in line with government estimates in 2022, which suggested that around half of older adults in care received state support towards their care costs (Prime Minister's Office, 2022).

Given the stringency of the asset test (discussed above), these high percentages receiving state support may seem surprising. In large part, they reflect the fact that individuals in greater need of social care tend to be less wealthy than the older population at large. Some of the individuals in receipt of state support will have assets above the upper capital limit but have their care provided via NHS Continuing Healthcare (see Box 5.1). Others will have previously had assets above the limit, but have run down their assets over time, eventually becoming eligible for state support. For many care recipients, their main residence will not count towards the asset test and, as mentioned above, a much larger fraction of people have assets below the £23,250 threshold when housing assets are excluded. These (and other) factors explain the seeming discrepancy.

⁴ The income floors (the PEA and MIG) were also frozen in cash terms between 2015–16 and 2021–22 but have since increased in line with inflation each year. For more detail on the financial means test (including what does and does not count towards the asset and income tests), see Foster (2024).

Box 5.1. NHS Continuing Healthcare

If an individual has both health and social care needs but is assessed as having a ‘primary health need’, then the National Health Service has responsibility for arranging and funding all of that person’s care (both healthcare and social care) via NHS Continuing Healthcare. NHS England budgeted £6.5 billion for these services in 2023–24 (UK Parliament, 2023), around 4% of the total NHS budget for the year. The total number of people assessed as eligible for NHS Continuing Healthcare was 28,838 in the first quarter of 2024–25 (NHS England, 2024).

Unlike access to local-authority-funded adult social care, access to NHS Continuing Healthcare is not means tested: an individual’s income or wealth has no bearing on whether or not they qualify for care.

Access is subject to a needs test – the assessment of whether the applicant has a ‘primary health need’. A national framework, introduced in 2007, provides guidance for such assessments. It states that ‘an individual has a primary health need if, having taken account of all their needs ... it can be said that the main aspects or majority part of the care they require is focused on addressing and/or preventing health needs. Having a primary health need is not about the reason why an individual requires care or support, nor is it based on their diagnosis; it is about the level and type of their overall actual day-to-day care needs taken in their totality’ (Department of Health and Social Care, 2022b).

Individuals with a rapidly deteriorating condition are eligible for ‘fast-track’ support without the need for a full eligibility assessment. Of those who did undergo a full assessment over the first quarter of 2024–25, one-in-five (20%) were found eligible (NHS England, 2024).

There is considerable geographic variation in this ‘assessment conversion rate’. Just 9% of those assessed in Herefordshire and Worcestershire in the first quarter of 2024–25 were found eligible, versus 34% in Dorset (NHS England, 2024). In other words, just as with eligibility for council-funded care, there remains a great degree of local variation despite there being a national framework – variation that is unlikely to be entirely explained by differences in local need.

For individuals who would not otherwise be eligible for public support, the outcome of the eligibility assessment can have considerable financial consequences. If found to have a ‘primary health need’, the NHS will pay for all costs of their social care; if not, the individual may have to spend many thousands of pounds from their income or savings.

Some individuals who are not eligible for NHS Continuing Healthcare but require care from a registered nurse can receive financial support from the NHS-funded Nursing Care programme which provides a fixed weekly contribution (£235.88 as of April 2024 for most) towards nursing care in a care home.

Among younger adults, most care recipients do receive state support. Of those working-age adults (18–64) receiving community care, 93% are state-funded, and 98% of those in a care home for younger adults are state-funded (Office for National Statistics, 2023a and 2023b). A significant fraction of these individuals will have entered adulthood with a disability, which may have limited their ability to work, earn and accumulate assets. It is older adults – who have had time to build up greater levels of wealth – for whom the stringency of the financial means test is more important.

A mix of public and private providers

Even where adult social care services are publicly *funded*, this does not mean that they are publicly *provided*. Councils purchase large volumes of care services from independent providers. An individual may receive care in a private care home but have that care package paid for by the local council.

Around 95% of care home beds are provided by the independent sector (a category that includes private and voluntary sector organisations). The care home sector is fragmented, with around 5,500 different providers in the UK operating 11,300 care homes for the elderly in 2017. The largest 30 care home providers supply 30% of overall capacity. While many providers operate multiple care homes, 80% have just one home, and these single-home providers together supply 29% of all beds (Competition and Markets Authority, 2017). Some of the largest providers are owned by private equity firms, with these firms accounting for around 13% of for-profit care home beds in the UK in 2022 (BBC News, 2021; PHA Group, 2023).

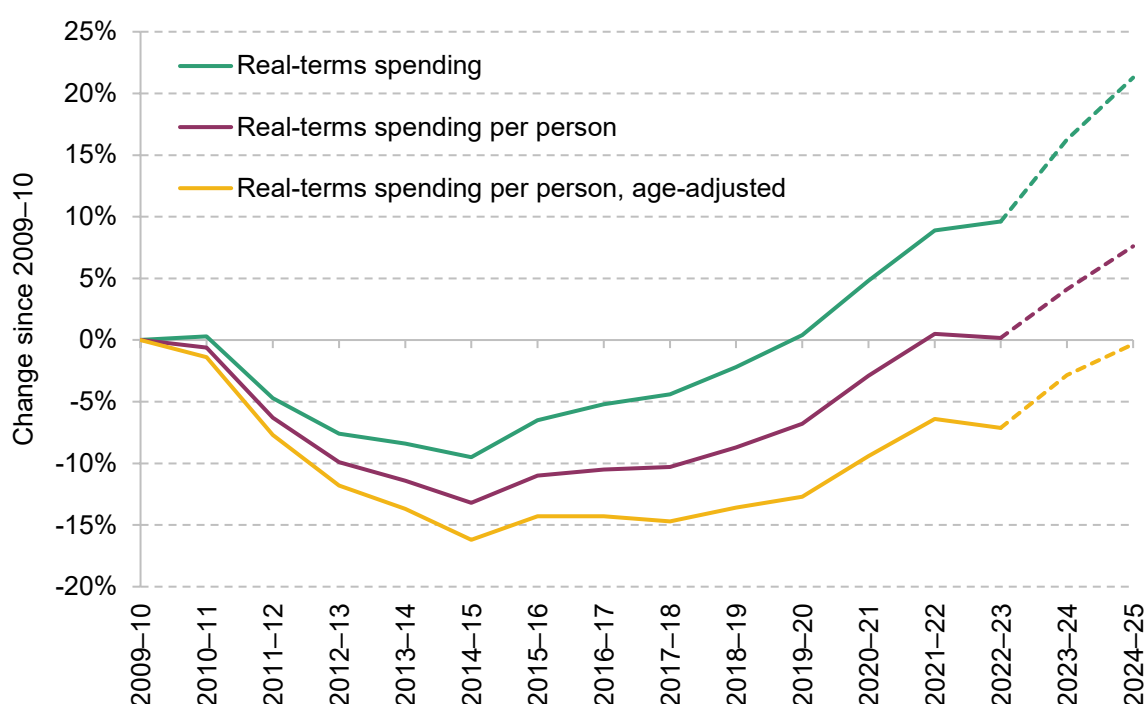
Almost four-in-five care workers in England (79%) are employed by independent providers (Skills for Care, 2023b). A further 5% are directly employed by care recipients and just 16% – around one-in-six – are employed by the public sector (either by local authorities or by the NHS). This means that the government does not (currently) exercise direct control over the pay and conditions of most care workers. It does have an indirect impact, however, through regulation (such as changes to the minimum wage, which is particularly relevant for this sector) and through the fees paid to private providers (discussed in more detail in Section 5.4).

Recent trends in public spending and provision

Spending by English local authorities on adult social care services, net of income from fees (e.g. fees from those who are only eligible for partial support and thus pay ‘tariff income’), stood at £22.9 billion in 2022–23 (NHS England, 2023b). Figure 5.1 shows that spending was cut by around 10% between 2009–10 and 2014–15 before recovering steadily, and by 2022–23

spending was around 10% above its 2009–10 level in real terms (i.e. after adjusting for inflation – social-care-specific costs are discussed in Section 5.4).⁵

Figure 5.1. Percentage change in net current expenditure on adult social care services (age 18+) in England since 2009–10



Source: Authors' calculations using: appendix C of Adult Social Care Activity and Finance Report, England, 2022–23 (<https://digital.nhs.uk/data-and-information/publications/statistical/adult-social-care-activity-and-finance-report/2022-23/appendix-c>); ONS population estimates for England, accessed via Nomis (<https://www.nomisweb.co.uk/>); ONS population projections (<https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationprojections/datasets/z3zippedpopulationprojectionsdatafilesengland>); OBR, Fiscal Risks and Sustainability – July 2022 (<https://obr.uk/frs/fiscal-risks-and-sustainability-july-2022/>); local authority reported out-turns and budgets for 2023–24 and 2024–25 (<https://www.gov.uk/government/collections/local-authority-revenue-expenditure-and-financing>); Better Care Fund funding for 2022–23 (<https://www.gov.uk/government/publications/better-care-fund-policy-framework-2022-to-2023/2022-to-2023-better-care-fund-policy-framework>), 2023–24 and 2024–25 (<https://www.gov.uk/government/publications/better-care-fund-policy-framework-2023-to-2025/2023-to-2025-better-care-fund-policy-framework>); and HM Treasury GDP deflators. Dashed lines show projections.

Spending has then increased further since, as funding for adult social care has been prioritised to a greater extent (e.g. through ringfenced grants and concerted efforts to increase bed capacity to aid discharge from hospitals). Based on local authority spending out-turns and budgets, we

⁵ These real-terms figures are calculated using the GDP deflator, a measure of general economy-wide inflation. This measure may not accurately capture changes in adult social care costs, particularly in recent years when the National Living Wage has been substantially increased.

estimate that net spending was around 16% higher in 2023–24 than in 2009–10 and 21% higher by 2024–25 (as indicated by the green dashed line).⁶

After adjusting for population growth, the reduction in expenditure between 2009–10 and 2014–15 was even more significant, at 13%. Only recently has adult social care spending per person returned to its 2009–10 level. Looking ahead, spending per person is projected to be 4% higher than the 2009–10 level by 2023–24 and 8% higher by 2024–25.

Demand for adult social care services also grew over this period. One, but by no means the only, source of demand growth was demographic change, as the population aged. To account for this, we construct a measure of age-adjusted spending per person, which accounts for changes in the age composition of the population as well as its size. To do this, we attach a weight to each population group based on how much adult social care they use on average (using estimates of social care spending by age published by the OBR, also shown later in Figure 5.3; Office for Budget Responsibility, 2024). This measure suggests that adult social care spending by local authorities has not kept up with demand since 2010. Age-adjusted spending per person declined by 16% between 2009–10 and 2014–15 and, despite subsequent increases, remained 7% below its 2009–10 level in 2022–23 (Figure 5.1). Our estimates suggest that age-adjusted spending per person will return to its real-terms 2009–10 level in 2024–25.

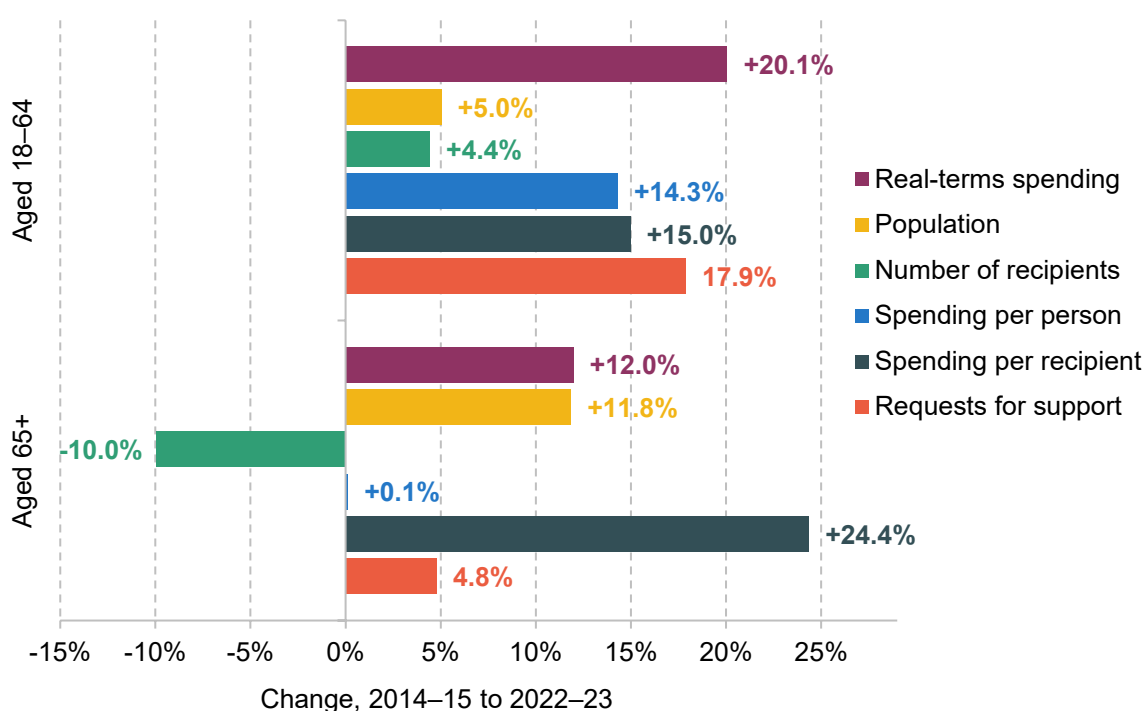
This measure accounts only for changes in demand resulting from population growth and changes in the age composition. It does not account for changes in demand for social care *conditional on age*. Adjusting for changes in the age structure thus would not capture changes in the prevalence of disabilities, or for changes in physical mobility at a given age, for instance. Accounting for population ageing therefore does not account for all possible changes in the demand for care. Further, this is a measure of all adult social care spending, which includes spending on both working-age and older (65+) adults. A consistent measure of spending by age group is not available for the full period, but the available evidence suggests that spending on the pension-age population was cut to a greater extent over the period and that spending on working-age adults was relatively protected (Harris and Phillips, 2018). This would suggest that age-adjusted spending on older adults has seen a bigger decline. We discuss these issues further in Section 5.4.

Overall, a little over half (51.7%) of adult social care spending goes towards those aged 65 and above, and a little less than half (48.3%) goes towards those aged between 18 and 64 (this is

⁶ This projection assumes that net local authority spending excluding the Better Care Fund (BCF) grows in line with what local authorities spent in 2023–24 (£23.3 billion) and have budgeted to spend in 2024–25 (£24.5 billion) and that the BCF expenditure on social care grows in line with what is planned for the NHS minimum contribution to the BCF (£4.76 billion in 2023–24 and £5.03 billion in 2024–25) (Ministry of Housing, Communities and Local Government, 2024; Department of Health and Social Care, 2024).

discussed in more detail in Section 5.4). Figure 5.2 documents how real-terms spending, the population, the number of individuals receiving care, real-terms spending per person and per recipient, and requests for support have changed for the working-age (18–64) and older (65+) populations since 2014–15, when comparable data begin. There are several things to take away.

Figure 5.2. Percentage change in long-term care spending, long-term care recipients and spending per long-term care recipient by age group, England, 2014–15 to 2022–23



Note: Figures are for long-term care, defined as care provided to recipients on an ongoing, non-time-limited basis. Short-term care is excluded.

Source: Authors' calculations using NHS Digital, Adult Social Care Activity and Finance Report, England, 2022–23, <https://digital.nhs.uk/data-and-information/publications/statistical/adult-social-care-activity-and-finance-report/2022-23>.

First, since 2014–15, long-term spending on both age groups grew in real terms, but spending on working-age adults grew faster than that on the 65+ age group (20% versus 12% over the period between 2014–15 and 2022–23).

Second, whereas the number of individuals receiving long-term care aged 18–64 grew roughly in line with the population in that age group (around 5%), the number of long-term care recipients aged 65 and above *fell* by 10% even while the 65+ population *grew* by 12% (with faster growth at older ages, as shown later in Figure 5.5). The reduction in the number of long-term care recipients among the elderly reflects the tightening of eligibility criteria (in terms of both the means test and the needs test) discussed above. This reduction has come primarily from the numbers accessing community-based support, rather than those accessing nursing and residential care homes.

Third, the result has been increases in spending per person and per recipient for the working-age group of similar magnitudes (roughly 15%). Yet, among the older population, spending per person has stayed almost constant while spending per care recipient has grown by almost a quarter (24%).

Lastly, the number of requests for support for the 18–64 age group grew by 18% between 2014–15 and 2022–23, versus only 5% for adults aged 65 and above, reflecting growing demand among the under-65 population (discussed in more detail in Section 5.4).

5.3 Charging reform (or not)

The insurance problem

Social care can be expensive. The DHSC estimates that one-in-seven individuals over 65 will face lifetime care costs of more than £100,000 (Department of Health and Social Care, 2022a). But it is difficult to predict exactly who will end up with a substantial care need in old age. Given its uncertainty and costly nature, many people would like to be insured against this risk. The state could pool individual risks and provide protection – bring the ‘magic of averages to the rescue of the millions’, in Winston Churchill’s words – but in this case does not. This lack of ‘social insurance’ stands in contrast to the provision of healthcare, which is free at the point of use for all residents in England. All but the most asset-poor (those with assets below £14,250) are required to contribute towards the cost of their social care, and those with assets of more than £23,250 are ineligible for any council support, as described in Section 5.2. Even individuals who qualify for public support must contribute from their income (subject to a minimum income floor). Moreover, council-funded care packages might not fully meet individuals’ needs, requiring them to top up out of their own income or savings. There is no limit to the social care costs an individual can face in a year or over their lifetime.

The private market for social care insurance is extremely limited, for reasons explored in Box 5.2. There are few financial products available for a healthy working-age adult, or for someone upon retirement, who wishes to insure against the risks of high care costs in old age. The only products available are immediate needs annuities, purchased upon the onset of a care need. So, individuals face a difficult-to-predict financial risk in old age, which threatens to consume a large fraction of their wealth, which the state does not provide insurance against, and which they are unable to insure themselves in the private market.

Box 5.2. Why is the private market for social care insurance so limited?

The private market for social care insurance (known internationally as long-term care insurance, or LTCI) is limited in the UK and elsewhere. Writing in 2011, the Dilnot Commission concluded that ‘there is currently too much uncertainty involved for the private sector to take on the full risk ... No country in the world relies solely on private insurance for funding the whole cost of social care’ (Dilnot, 2011). There are numerous reasons for this market failure, on both the supply side and the demand side. These include:

- **Correlated risks.** Would-be LTCI providers face uncertainty about how long individuals will live, their future care needs and the costs of meeting those care needs. The key risk from the insurer’s perspective is that care costs turn out higher than expected. The challenge is that this risk is common to each generation (i.e. likely to manifest as many simultaneous claims) and is likely to be serially correlated across generations (Cutler, 1996). For example, a medical advance that increases life expectancy for care recipients might increase average lifetime costs for everyone within a generation and, because medical advances do not get reversed, will increase average lifetime care costs for all future generations of care recipients also. This adds uncertainty, and makes it difficult to insure against, because the insurer cannot diversify either within or across generations of care recipients. Insurers are unwilling to offer full insurance as a result.
 - **Adverse selection.** Providers worry that demand for LTCI will be highest among those with the greatest risk of developing a social care need. Recognising that this will increase expected payouts, insurers respond by raising premiums. At these higher premiums, only the highest-risk individuals are willing to purchase LTCI, and only a small fraction of people end up covered. There is empirical evidence to back up insurer concerns about such ‘adverse selection’: Oster et al. (2010) find that individuals with the genetic mutation for Huntington’s disease, a degenerative disorder, are up to five times more likely to own LTCI.
 - **Low uptake.** There are many reasons why we might expect individuals to demand less LTCI than would be socially optimal, even if it was offered by the market at a ‘fair’ price. People struggle to understand and plan for low-probability adverse events, and this is exacerbated in the English setting by the complexity and opacity of the system: many wrongly expect it to function like the NHS (Dilnot, 2011). Further, individuals in their 60s – the age at which LTCI is typically purchased – systematically underestimate their chances of living to old age (O’Dea and Sturrock, 2023), which could reduce their willingness to pay for LTCI as they underestimate their future needs. Individuals may also decide to substitute away from private care and LTCI and to rely more on informal care from family members – possibly to a degree beyond what is appropriate, if it negatively impacts the carer’s well-being or leads to them substantially reducing their hours of paid work.
-

The Dilnot Commission

The Commission on Funding of Care and Support was established in July 2010 by the newly formed coalition government and was chaired by former IFS Director Andrew Dilnot. In its 2011 report, the Commission concluded that ‘our system of funding of care and support is not fit for purpose, and has desperately needed reform for many years’ (Dilnot, 2011). The report identified the insurance problem described above as the fundamental issue – the fact that individuals face the risk of catastrophic care costs and there is no form of risk pooling to protect them against those costs.

The Dilnot Commission recommended that the government pool risks by introducing a cap on lifetime costs of between £25,000 and £50,000, with a central recommendation of £35,000. It also recommended an increase in the generosity of the means test via an increase in the upper capital limit, above which people must pay the full cost of their care, from £23,250 to £100,000, to provide more protection for many outside the existing means test. It made various other recommendations, such as for a standardised national framework for assessing eligibility for state support and exempting those who enter adulthood with a care need from any form of means test.

The government legislated for Dilnot-style reforms in the Care Act 2014, with a proposed cap of £72,000 and an upper capital limit of £118,000 (and some other differences from the Commission’s proposals). Implementation was delayed in July 2015 and then postponed indefinitely – joining the long list of failed attempts at social care reform (King’s Fund, 2023).

The recently scrapped proposals

In 2019, the Conservatives had a pledge to legislate for long-term reform of social care in their election manifesto. This led to a package of reforms announced by then Prime Minister Boris Johnson in September 2021. These would have increased the generosity of the state’s social care offer – though to a lesser extent than recommended by the Dilnot Commission – in two important ways.

First, an individual’s lifetime care costs would be capped at £86,000, with all spending on personal care after that point to be met by the state regardless of income or wealth.⁷ This was to apply to all individuals regardless of age (with no carve-out for those entering adulthood with a care need, as proposed by Dilnot). The government explicitly argued that this limit would also help to develop the private insurance market by providing ‘greater incentives for the financial

⁷ Only care costs incurred after the introduction of the reforms would count towards the cap – it was not planned to be retrospective.

services industry to provide relevant products that people see the benefit of purchasing’ (Department of Health and Social Care, 2022a).

Second, the means test would be made considerably less stringent. The lower capital limit – the level of assets below which individuals would not have to contribute to their care costs from their savings – was to be increased from £14,250 to £20,000, and the upper capital limit, above which people must pay the full cost of their care, was to be raised from £23,250 to £100,000. More people would qualify for at least some state support, more people would have all of their costs met by the state, and there would be greater protection against the risk of catastrophic care costs. The government expected around two-thirds of older adults to receive some state support towards their care costs following the reforms, up from around half under the existing system (Prime Minister’s Office, 2022).

The initial impact assessment (Department of Health and Social Care, 2022a) suggested that the costs of the combined package might reach £6.2 billion per year by 2031–32 (£4.7 billion in 2021–22 prices). In October 2021, the Office for Budget Responsibility estimated that the funding reforms would cost around 0.25% of GDP in the medium-to-long term, equivalent to around £7 billion in today’s terms.

These changes were announced alongside the introduction of a new tax, a 1.25% Health and Social Care Levy based on National Insurance contributions (NICs), intended to ‘pay for’ the reforms. First introduced as an increase in the rates of NICs (to be later replaced by the new levy), this came into effect in April 2022. It was then scrapped by then Chancellor Kwasi Kwarteng in the September 2022 ‘mini Budget’. This was one of the few tax cuts not to be swiftly reversed by Jeremy Hunt, Mr Kwarteng’s successor (who in fact went on to cut the rates of employee and self-employed NICs further).

These charging reforms were originally planned to come into operation in October 2023. At the November 2022 Autumn Statement, Mr Hunt announced that the roll-out would be delayed until October 2025, which meant not implementing them until the next parliament (a move welcomed by local government at the time, amidst concerns that funding and capacity were not in place to deliver the reforms successfully (Local Government Association, 2022)).

Then, in her statement on 29 July 2024, Ms Reeves declared that ‘it will not be possible to take forward these charging reforms’, with the accompanying document stating that ‘the reforms are now impossible to deliver in full to previously announced timeframes’ (HM Treasury, 2024). The authors’ understanding is that this amounts to a cancellation, not a(nother) delay, of the reforms. It remains unclear whether other aspects of the reforms, such as the right for self-funders to ask their local authority to commission care for them at the local authority rate, will also be scrapped. The decision not to go ahead with the reforms was scored as saving

£1.1 billion in 2025–26 (HM Treasury, 2024), a considerably smaller sum than the eventual long-term savings, which are estimated to amount to £4–£5 billion a year by the end of the parliament (Boileau et al., 2024).

Overall, this leaves the social care system in England roughly where it started: the charging reforms have seemingly been abandoned, and the tax rise introduced to pay for them has been more-than-reversed. The insurance problem remains unsolved.

5.4 Further challenges under the status quo

The adult social care system faces a series of serious challenges in addition to the insurance problem and the charging reforms discussed above. Here, we group these challenges into five broad and interrelated categories: (i) funding and demographic pressures; (ii) interactions with local government finances; (iii) ‘Fair Cost of Care’ reforms and payments to providers; (iv) the adult social care workforce, including immigration and pay; and (v) support for informal carers.

Funding and needs: more money just to stand still

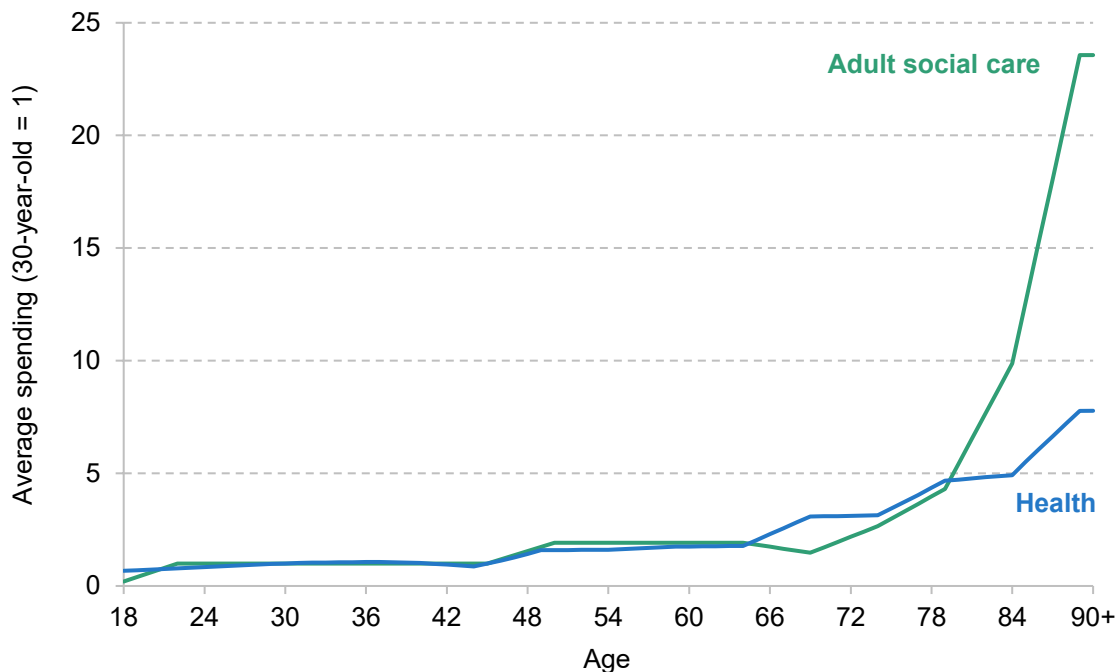
By scrapping the proposals for a lifetime cap on care costs, the new government has decided not to expand the generosity of the state’s offer on adult social care. Relative to a world in which those charging reforms went ahead, the government will save billions. But in the face of growing demand, spending on social care will need to rise just to maintain the system as it is currently configured.

An ageing population

A key source of growing demand for adult social care services is population ageing. Older people are much more likely to have a care need and to use adult social care services. As a result, average public social care spending per person increases significantly with age, particularly after age 70.

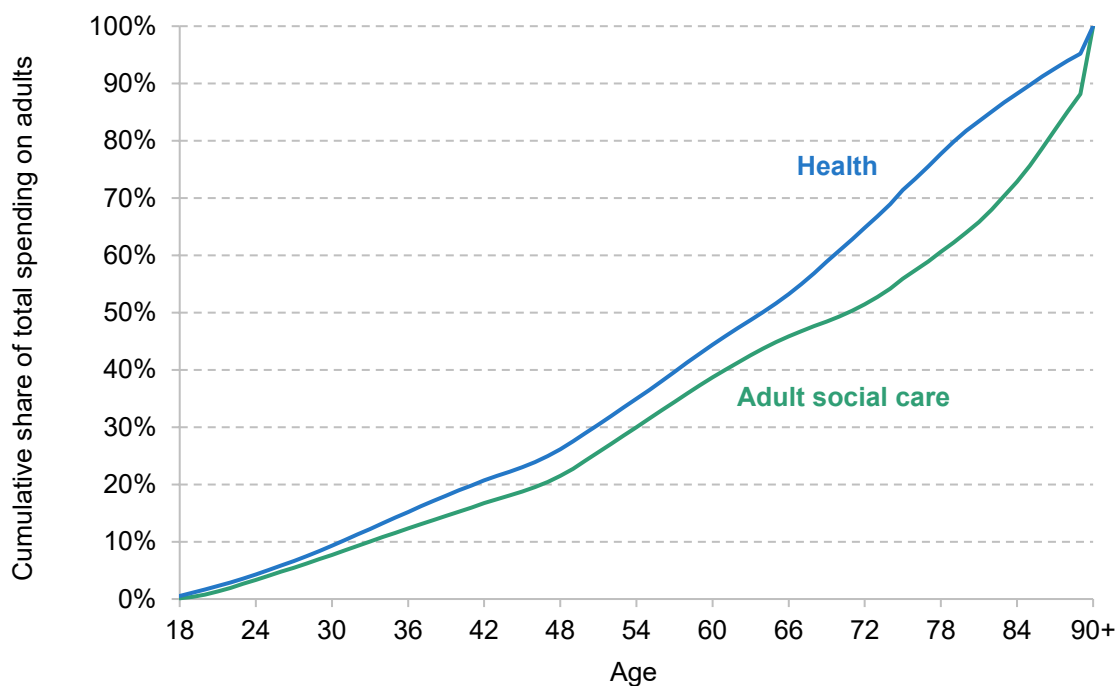
This is illustrated in Figure 5.3, which plots OBR estimates of adult social care spending by age, relative to a representative 30-year-old (Office for Budget Responsibility, 2022). Public spending on adult social care for the average 60-year-old is around twice as high as for the average 30-year-old (an estimated £605 in 2026–27 for an average 60-year-old versus £315 for the average 30-year-old). For the average 75-year-old, it was around three times as high (£941). By age 85, it is more than 12 times as high (around £4,000), and by 90 it is 24 times as high (around £7,400). This is a much sharper increase at older ages than is estimated for healthcare, where spending on a representative 90-year-old is estimated to be around eight times higher than on a 30-year-old.

Figure 5.3. Representative age profile for UK public spending on health and adult social care, relative to a 30-year-old



Source: Authors' calculations using chart 4.11 of OBR, Fiscal Risks and Sustainability – July 2022, <https://obr.uk/frs/fiscal-risks-and-sustainability-july-2022/>.

Figure 5.4. Implied cumulative distribution of UK public spending on health and adult social care, by age

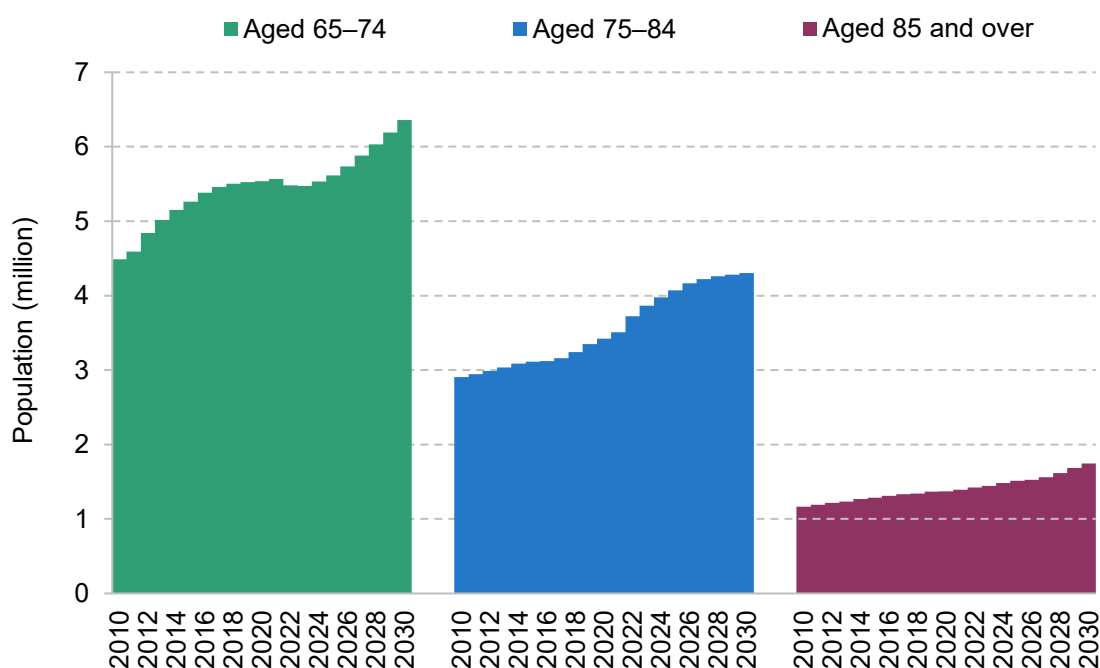


Source: Authors' calculations using chart 4.11 of OBR, Fiscal Risks and Sustainability – July 2022 (<https://obr.uk/frs/fiscal-risks-and-sustainability-july-2022/>) and ONS population estimates for the UK by single year of age in 2022 (accessed via <https://www.nomisweb.co.uk/>).

The relative concentration of adult social care spending at older ages can also be seen in Figure 5.4. The OBR estimates imply that around half (52%) of all adult social care spending goes to individuals aged 70 and above, and around a quarter (27%) to those aged 85 and above. The equivalent figures for health spending – which is less concentrated at the very oldest ages – are 41% and 12% respectively. Note, though, that working-age individuals (who are more numerous) still account for close to half of all adult social care spending; this group is discussed below.

The population at older ages in England has grown substantially since 2010 and is projected to continue to grow between now and 2030. Between 2010 and 2024, the English population aged between 65 and 74 grew by 23.2%, the population aged between 75 and 84 grew by 36.8%, and the population aged 85 and over grew by 27.3% (Figure 5.5). The equivalent figure for the overall population is 10.7%. Between 2024 and 2030, these older groups are again projected to grow more quickly than the population at large, with the greatest proportional increase (17.7%) in the population aged 85 and over – the group that makes heaviest use of adult social care services.

Figure 5.5. Population aged 65–74, 75–84 and 85+ in England



Note: Data for 2010 to 2023 are population estimates. Data for 2024 onwards are (2021-based) population projections.

Source: ONS population estimates – local authority based by five year age band (accessed via <https://www.nomisweb.co.uk/>); ONS principal projection – England population in age groups (<https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationprojections/datasets/tablea24principalprojectionenglandpopulationinagegroups>).

As the population continues to age, demand for care will increase. To the extent that the older population grows wealthier, this may not translate into additional demand for *publicly funded* care, as many will not qualify for state support, especially if the thresholds used in the financial means test continue to be frozen. Pressure on the broader sector will nonetheless continue to grow, and official projections (discussed below) suggest that meeting demographic pressures will necessitate higher public spending on social care in future.

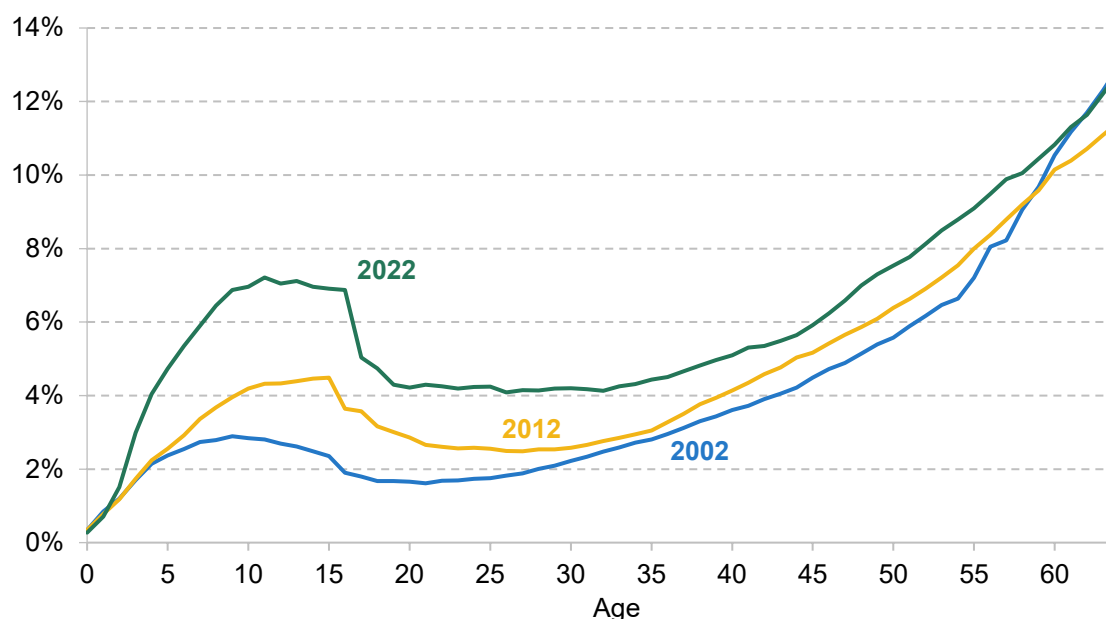
Growing demand at younger ages

Adult social care is often perceived as a service primarily for the elderly, but it plays a crucial role in addressing the needs of working-age adults as well. In 2022–23, a little less than half of total adult social care spending by local authorities in England (48.3%) went towards those aged 18–64. A similar share (49.6%) of spending specifically on long-term care packages goes towards 18- to 64-year-olds. These figures are broadly consistent with the estimates presented in Figure 5.4 for the UK as a whole.

Working-age adults in receipt of adult social care tend to have more severe needs and require more intensive care packages. There are more individuals aged 65 and above receiving long-term care than working-age adults receiving it (370,000 versus 259,000 at the end of 2022–23), but long-term care spending *per recipient* is considerably higher among younger adults (£35,330 at the end of 2022–23) than among adults aged 65 and above (£25,070). Combined, this explains the overall 50:50 split in spending between the two age groups.

Figure 5.2 earlier shows that spending on working-age adults has increased more quickly than spending on older adults since 2014. Changes in how social care spending is broken down mean we cannot say precisely how spending on different groups has evolved over a longer period (e.g. since 2010), but the available evidence suggests that working-age spending was relatively protected and that spending on older adults faced larger cuts over the early 2010s (Harris, Hodge and Phillips, 2019; Crawford, Stoye and Zaranko, 2021).

The substantial increase in spending for working-age adults in recent years reflects the growing demand for support. Figure 5.2 also shows that the number of new requests to local authorities for social care support from adults aged 18–64 grew faster than the number from adults aged 65+. This is consistent with other evidence of sharp increases in disability among younger adults. Banks, Karjalainen and Waters (2023) highlight a sharp rise in disability benefit claims among working-age adults between 2002 and 2022, reproduced in Figure 5.6. The proportion of younger adults claiming health-related benefits has continued to grow since (Ray-Chaudhuri and Waters, 2024; Latimer, Pflanz and Waters, 2024), and we would expect this also to be true of claims for severe conditions that are more likely to result in a care need. There is no simple relationship between rates of working-age disability and demand for adult social care, but we certainly would not expect higher rates of disability to be associated with *less* demand for care services.

Figure 5.6. Share of individuals claiming disability benefits by age (ages 0–64), Great Britain

Note: Values denote the share of individuals, by single year of age, who receive disability living allowance, personal independence payment or attendance allowance. The sharp decline in claim rates around age 16 reflects the fact that the assessment process changes at that age, and child claimants are sometimes ineligible under the adult assessment criteria.

Source: Banks, Karjalainen and Waters, 2023.

We might expect rapid growth in the number of adults diagnosed with learning disabilities to translate into greater demand for long-term care support. In 2022–23, 46% of those aged 18–64 receiving local-authority-funded long-term care did so primarily due to a learning disability, and this accounted for most of the spending on this age group (68%) (NHS England, 2023a). Between 2014–15 and 2022–23, spending on long-term care support rose by 47%, with even greater increases for other types of long-term support, such as memory and cognition support (151%) and mental health support (80%). Meanwhile, the number of monthly claims for personal independence payment (PIP) due to learning disabilities grew by 412% between 2019–20 and 2023–24 (Latimer, Pflanz and Waters, 2024). Recent trends suggest that we might expect demand for social care among working-age adults to grow, and the associated pressures will be in addition to those stemming from the ageing of the population.

Long-term projections

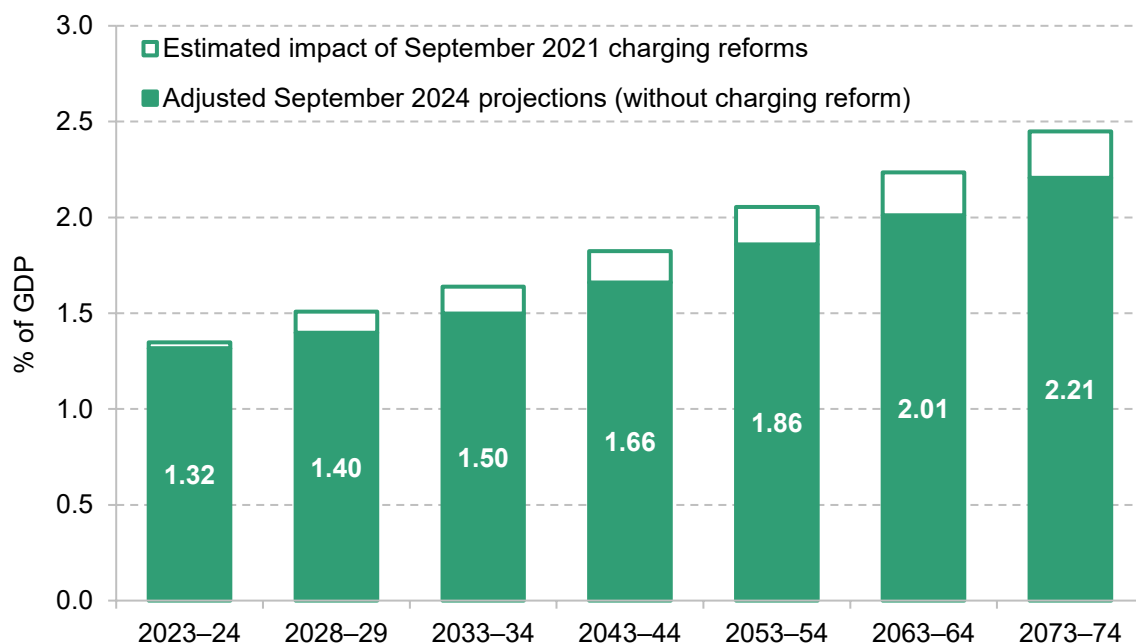
As the population grows and ages, we should expect demand for adult social care services to grow. Meeting that demand, with the system configured as it is, will require additional resources. One estimate, from the Health Foundation, suggests that to meet future demand, adult social care funding in England would need to grow by 3.4% per year in real terms up to 2032–33 (Boccarini et al., 2023). This compares with average real growth of 0.7% per year between 2009–10 and 2022–23, and 2.4% per year between 2014–15 and 2022–23. It is slightly higher

than the average real-terms growth rate implied by official OBR projections over the next decade (3.1% per year).⁸

Figure 5.7 shows the OBR's projections of UK public spending on adult social care as a share of national income, reflecting demand pressures (including from ageing) and growth in costs. After adjusting for the estimated savings from scrapping the charging reforms discussed in Section 5.3, spending is projected to rise from around 1.3% of national income in 2023–24 to around 2.2% of national income in 2073–74.

Importantly, these are *projections* rather than *predictions*: they are estimates of how much spending might be needed to meet the growth in demand and maintain the system as it is. It is possible that future governments will decide not to keep pace with demand; they could decide to reduce or increase the generosity of the system. The point is, more money will be required just for adult social care to stand still.

Figure 5.7. OBR projections of adult social care spending in the UK



Note: Charging reforms refer to the lifetime cap and more generous financial means test announced in September 2021 and discussed in Section 5.3. Estimates for the long-term cost of charging reform come from the July 2022 FRS report, which are combined with long-run projections from the September 2024 FRS report. Figures are for the UK.

Source: Authors' calculations using OBR fiscal risks and sustainability reports, July 2022 and September 2024.

⁸ Note that this adjusts for the recent cancellation of charging reform. Before this adjustment, the OBR's projections imply average real-terms growth of 3.8% per year.

Interactions with local government finance reform

The previous subsection considered the pressures on adult social care funding at a national level. A further set of complications and policy challenges come when we consider how that funding is allocated at a sub-national level, and how this interacts with the local government finance system. Even if funding grows in line with demand at the national level, this does not mean that the same will necessarily be true at every local level.

Different areas have different levels of demand for care services and different local cost pressures. They also have differing abilities to raise revenues themselves through local taxes, such as council tax. To ensure that the same range and quality of services can be provided in different places, the government has historically used measures of assessed spending need and revenue-raising capacity to allocate funding across different parts of the country. There are two problems here. The first is that the main estimates of councils' spending needs are out of date (they have not been updated since 2013 and are based in part on data that are even older). The second problem is that the allocation of most funding has not accounted for even these out-of-date estimates of need properly for many years, or for the revenues councils can raise for themselves.⁹ In practice, this means councils in poorer areas tend to get less than they are assessed to 'need', while the opposite is true for councils in richer areas (Ogden et al., 2022; Ogden and Phillips, 2023).

Failing to account adequately for changing patterns of local need risks a world where the level of funding provided to each area is disconnected from the local demand for services, including publicly funded adult social care services. For example, while the population of England is projected to age over the coming years (as discussed above), the rate of ageing is by no means uniform across the country. Some councils are forecasted to experience much higher growth in their elderly population than others. For example, over the next six years, some local authorities (the Isle of Wight, Dorset, Northumberland) are projected to see the share of the local population aged 65 and over increase by more than 2 percentage points; in others (Bristol, Coventry), it is projected to increase by less than 0.5 percentage points. Some areas are ageing much faster than others and will see much faster growth in demand for care services as a result.

Among the working-age population, recent growth in rates of health-related benefit claims has been broadly proportional to the number of claimants in each area in 2019–20 (i.e. growth across areas has been similar in percentage terms), but the rates of *absolute* growth have been much faster in areas that already have higher claim rates (Latimer, Pflanz and Waters, 2024). For instance, the claim rate in Blackpool has increased from 14.9% in 2019–20 to 19.1% in 2023–

⁹ In recent years, councils with responsibility for social care have been allowed to levy additional increases on bills, with specific grants for social care services allocated to offset much, but not all, of the differences in how much can be raised in each area through these 'social care precepts'. See Ogden et al. (2022) for a discussion.

24, a 28% increase (4.2 percentage points); in Wokingham, the claim rate has increased from 3.1% to 4.3%, a 36% increase (1.1 percentage points). We would not expect these patterns to map neatly onto growth in demand for adult social care services, but we might expect similar amounts of geographic variation.

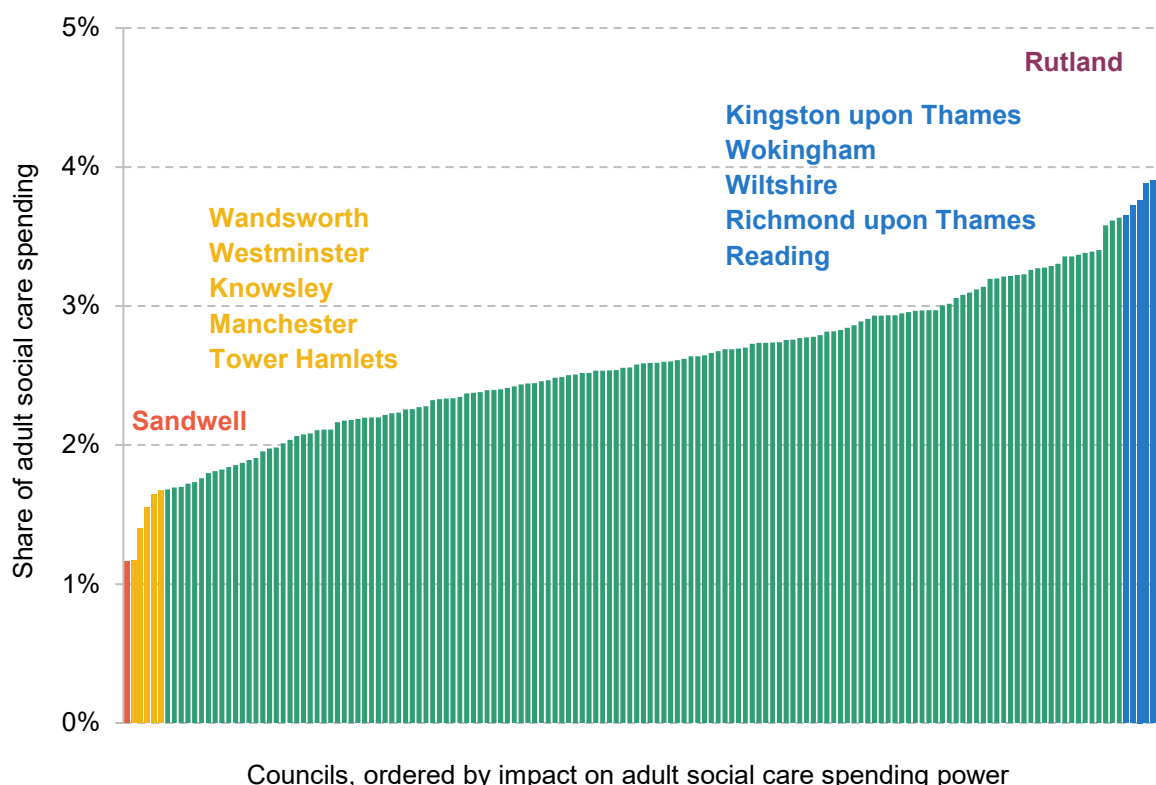
The challenge is that the areas seeing the greatest increase in social care pressures may not be the ones that see the biggest increases in funding.

Local authorities are increasingly reliant on local council tax revenues: the share of local authority funding received from council tax increased from just over a third (36%) in 2010–11 to more than half (56%) in 2019–20 (Ogden and Phillips, 2024a). This hides substantial variation across the country, however, with local authorities in more deprived areas typically less able to raise revenues from council tax and more reliant on grants from central government.

The spending plans inherited by the new government imply real-terms cuts to ‘unprotected’ budgets, including grants to local government (see Chapter 3). That could pose significant financial challenges for the areas more reliant on those grants. For instance, under a scenario in which councils with responsibility for social care were allowed to increase council tax bills by 5%, and grants were cut evenly across the board (by 7% in real terms each year), councils in the most deprived tenth of areas could see their funding rise by only 0.6% in real terms per year, compared with 2.6% in the least deprived tenth (Ogden and Phillips, 2024b). Addressing these imbalances across councils would require significant redistribution of grant funding, potentially leading to very large cuts in the grants to less deprived areas, which it may be politically difficult for the government to impose.

Another way to illustrate this challenge is to consider how much extra adult social care each local authority could purchase for a given percentage increase in its council tax bills. Figure 5.8 shows the percentage increase in adult social care spending that could be afforded from a 2% increase in council tax bills. In some areas – Rutland, Kingston upon Thames, Wokingham – a 2% increase in council tax would allow for nearly a 4% increase in adult social care spending. In 15% of areas, it would pay for less than a 2% increase in adult social care spending (i.e. the adult social care budgets of these councils are already bigger than the total amount that they receive from council tax, so a 2% increase in council tax revenues translates to a less-than-2% increase in adult social care spending). There is no good reason to suppose that the best-placed areas to raise additional funding from local taxes are also those facing the largest growth in demand for adult social care services.

Figure 5.8. Estimated additional spending from 2% council tax rise, as a share of adult social care spending in 2023–24



Note: Estimated revenues from an additional 2% increase in council tax band D rates in 2023–24 as a share of net expenditure on adult social care in 2023–24, for upper-tier local authorities. Net expenditure from spending out-turns, and from budgets for authorities for which out-turns are not available.

Source: Authors' calculations using council tax levels in 2023–24 and local authority revenue expenditure and financing data for 2023–24.

Relying on local taxation to deliver additional funding for services has the potential to undermine efforts to ensure that all councils are equally able to meet local demand and deliver high-quality public services. It could, in other words, lead to wide disparities in service provision – at least if it is not accompanied by a well-designed local government finance system, which is very much the case at the moment. More generally, there is an inherent tension between a desire for greater devolution of taxes and powers to local areas and a desire for consistency in service provision across the country (Phillips, Simpson and Smith, 2018).

The government faces a fundamental decision on whether adult social care is a local or a national responsibility. The Scottish Government is moving towards a 'National Care Service' with the aim of providing more consistent services across Scotland (Phillips, 2022). In England, the Labour Party's general election manifesto proposed 'a programme of reform to create a National Care Service, underpinned by national standards, delivering consistency of care across the country' (Labour Party, 2024).

Any assessment of this (vague) promise will depend on one's view of the appropriate role of local versus central government, and the merits of devolving versus centralising powers. If the goal is to ensure consistent service provision across England, centralising social care funding, with ring-fenced grants allocated based on an up-to-date spending needs formula, could be attractive. Yet this would inevitably also bring major challenges, especially in the transition.

For one, assessing the relative spending needs of different areas is extremely difficult, and there is no guarantee that such a system would in fact lead to consistent service provision (Harris and Phillips, 2018). Maintaining some degree of local discretion might, perhaps counter-intuitively, help to offset the inevitable flaws in centralised needs assessments, with councils able to reprioritise spending across services to better match local needs.

Second, moving to such a system would mean transferring some of the funding currently provided to councils to the new National Care Service. Determining how much to subtract from each council's budget is far from simple. Some areas use their local discretion to spend less than national funding formulas suggest they 'need'. The question then arises: should these councils lose the amount they actually spend? Or the amount central government estimates that they would need to spend to deliver an average quality of service? Or something else? The choices made in this process would have major distributional implications. For a discussion of these and other issues, see Phillips, Simpson and Smith (2018) and Phillips (2022).

Labour's manifesto also promised that 'services will be locally delivered' under its National Care Service, which is either a trivial observation about the nature of in-person services or a commitment to maintaining a role for local authorities. If adult social care is left within councils' remit, one improvement would be to commit to updating spending needs assessments frequently and regularly and redistributing funding accordingly. In a tight funding environment, even that could be more difficult than it sounds. Whatever form the 'National Care Service' takes, interactions with the local government finance system are sure to add complications.

Fees paid to private providers and the 'Fair Cost of Care'

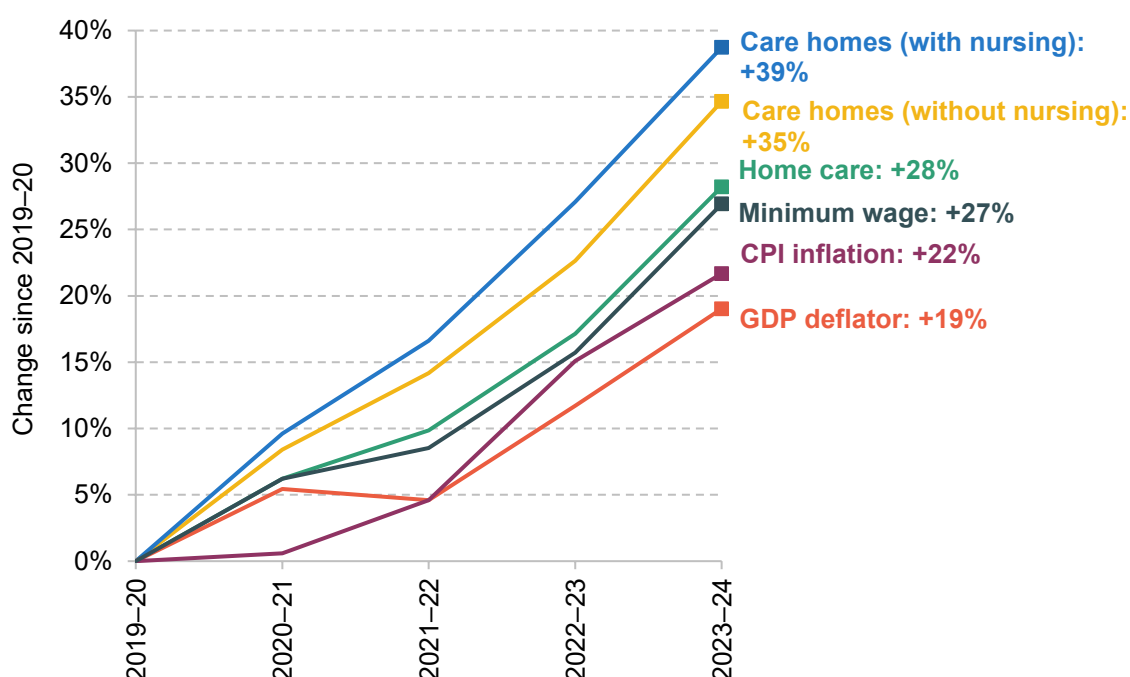
One consequence of the cuts to local government funding over the 2010s was a reduction in the real value of fees they paid to care providers, as local authorities sought to make large savings from their budgets. One estimate suggested that local authorities reduced their fee rates by an average of 6% in real terms between 2010–11 and 2016–17, though this followed substantial increases over the 2000s (House of Commons, 2018).

To compensate for reduced fees from local authorities for publicly funded care recipients, care homes became increasingly reliant on self-funders, who paid significantly higher fees to cross-subsidise. A 2017 study by the Competition and Markets Authority found that self-funders in 'larger providers' were charged 41% more, on average, than those with their places funded by

local authorities and that this was threatening the financial sustainability of the sector – particularly in places with fewer self-funders and thus greater reliance on public funding.

The downwards trend in local authority fees has gone into reverse in recent years. Between 2019–20 and 2023–24, the average fee paid by local authorities for an hour of home care increased by 28% (Figure 5.9). The average fee for a care home place for an adult aged over 65 without nursing increased by 35%, and by 39% for a care home place with nursing. This compares with an increase in the National Living Wage of 27% during the same period (itself a major cost driver) and household inflation of 22% as measured by the CPI.

Figure 5.9. Change in average fees paid by local authorities to external care providers, 2019–20 to 2023–24



Note: Care home figures refer to average fees paid for recipients aged 65 and over. 'Minimum wage' refers to the National Living Wage for those aged 25 and over in 2019–20 and 2020–21, and for those aged 23 and over from 2021–22.

Source: Authors' calculations based on Department of Health and Social Care, 'Market Sustainability and Improvement Fund 2023 to 2024: care provider fees'

(<https://www.gov.uk/government/publications/market-sustainability-and-improvement-fund-2023-to-2024-care-provider-fees>) and 'Improved Better Care Fund: provider fee reporting', 2021 to 2022 (<https://www.gov.uk/government/publications/improved-better-care-fund-provider-fee-reporting-2021-to-2022>) and 2020 to 2021 (<https://www.gov.uk/government/publications/improved-better-care-fund-provider-fee-reporting-2020-to-2021>); Office for Budget Responsibility, economic and fiscal outlook – March 2024 (<https://obr.uk/efo/economic-and-fiscal-outlook-march-2024/>); HM Government, National Minimum Wage and National Living Wage rates (<https://www.gov.uk/national-minimum-wage-rates>).

The increases in local authority fees have, in part, been the result of policy action. The Department of Health and Social Care (2021), acknowledging that ‘a significant number of local authorities are paying residential and domiciliary care providers less than it costs to deliver the care received’, announced a ‘Fair Cost of Care Fund’ to provide local authorities with additional funding to increase the fees paid to providers.

Looking ahead, policy changes may act to increase fees further. The 2014 Care Act included a provision, Section 18(3), allowing individuals who self-fund their care to request their council to commission care on their behalf at the local authority rate. This would limit – or in some cases eliminate – the ability of care homes to ‘cross-subsidise’ by charging higher fees to self-funders, who would gain access to the lower, council-negotiated fees. Setting council fees too low and at the same time closing off the ‘cross-subsidisation’ channel could threaten the financial sustainability and viability of care providers, and quality of care could suffer.

This change has not yet been implemented. One policy decision for the new government is whether to continue down this path. It is unclear, at the time of writing, whether Section 18(3) has been scrapped along with the lifetime cap by the new government. Fees are likely to need to increase in any case, but this is particularly the case if Section 18(3) is triggered. Paying higher fees will require additional funding for councils. This is therefore a decision for the upcoming Spending Review – though additional funding for councils could come from local tax rises (e.g. council tax) rather than additional funding from central government.

As mentioned in Section 5.2, the care home sector is relatively concentrated (Competition and Markets Authority, 2017), with a notable degree of private equity involvement. A review of the (mostly US-based) evidence found that private equity ownership in healthcare (including nursing homes) is associated with increases in costs for patients and/or funders (Borsa et al., 2023). To the authors’ knowledge, there is no good evidence on the impact of private equity ownership on care home prices in the UK. It is possible that changes in ownership and market structure have contributed to recently observed increases in fees.¹⁰ There is evidence from both the UK (Patwardhan, Sutton and Morciano, 2022) and the US (Gupta et al., 2021) that private equity ownership is associated with lower-quality care, which points to a need for careful regulation and monitoring, aside from any debate about fee levels.

Whatever the driving factors behind recent increases in fees, these changes have placed significant pressure on council budgets (Ogden and Phillips, 2024a).

¹⁰ We note that in the market for children’s social care places in England, the Competition and Markets Authority (2022) concluded that ‘the largest private providers of placements are making materially higher profits, and charging materially higher prices, than we would expect if this market were functioning effectively’.

Workforce and pay

The social care workforce: large, growing and low-paid

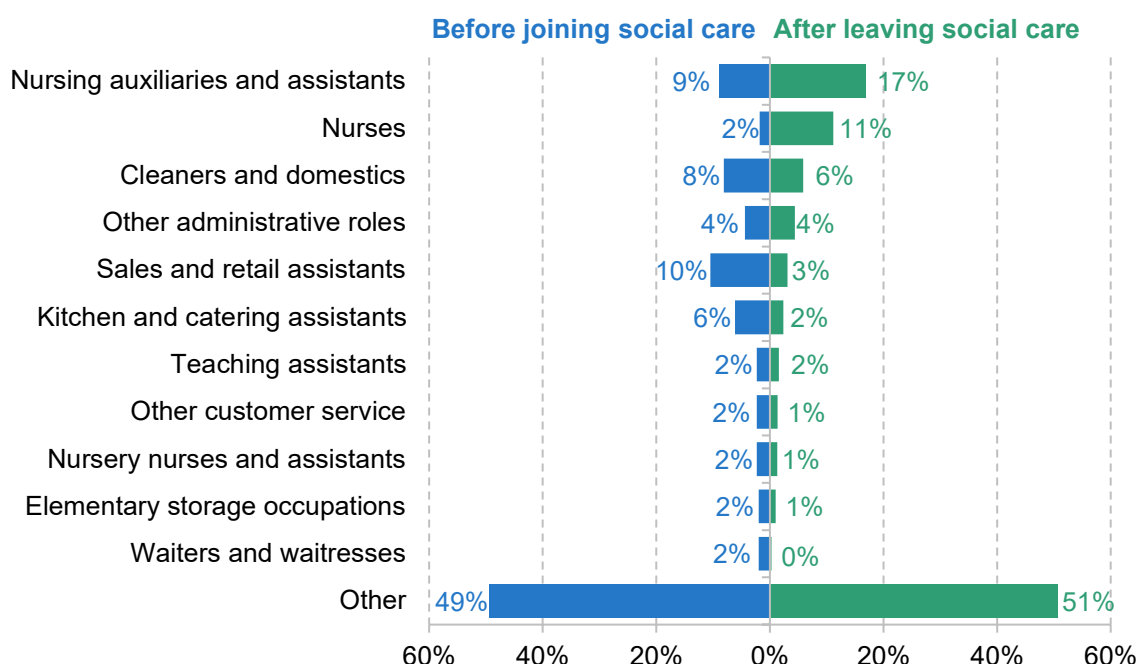
The adult social care sector is large and growing. Approximately 1.52 million people were employed in the adult social care sector in England in 2022–23, with a total wage bill of around £26.6 billion (Skills for Care, 2023a). A recent workforce strategy produced by the sector estimates that the workforce will need to increase by almost a third by 2040 if it is to grow in line with the number of people aged 65 and over – equivalent to more than 500,000 new posts (Skills for Care, 2024a).

That degree of expansion will require the sector to improve its ability to attract and retain staff. That will depend partly upon how pay and conditions in social care compare with those of other occupations. Adult social care is officially defined as a low-paying industry by the UK government (Low Pay Commission, 2023). The median hourly rate for care workers in March 2023 was £10.11. This was slightly above the National Living Wage (£9.50), similar to the median hourly pay for sales and retail assistants (£10.12) and slightly above the median for cleaners and domestic workers (£9.96) (Skills for Care, 2023a). Pay for care workers has fallen in recent years relative to other sectors (Migration Advisory Committee, 2022 and 2023). Pay differentials within the sector have also fallen: in March 2016, compared with a care worker with less than a year's experience, a care worker with at least five years' experience received an average hourly pay premium of 4.4% (33 pence per hour), but by 2023 this had fallen to 0.6% (6 pence) (Skills for Care, 2023a).

The NHS is an important outside option for social care workers. Between 2011–12 and 2021–22, 28% of those who left the care sector went on to nursing auxiliary or nursing roles (Figure 5.10, reproduced from Kelly et al. (2022)). One reason for this is that time working in the social care sector is often used to demonstrate the care experience necessary to apply for many NHS roles. Furthermore, comparable NHS roles tend to pay better: in 2022–23, average care worker pay was £1.33 less per hour than pay for healthcare assistants in the NHS who were new to their roles (NHS Pay Review Body, 2024). NHS workers also benefit from significantly higher employer pension contributions. While social care workers often receive a defined contribution (DC) pension with employer contributions at or near the auto-enrolment minimum of 3% of band earnings (the portion of earnings in respect of which contributions are made), NHS workers receive employer contributions of 23.7% of pensionable earnings as part of the (defined benefit) NHS Pension Scheme.

As pay in the NHS increases – a recent recommendation for a 5.5% pay award for NHS 'Agenda for Change' staff was accepted by the new government (see Chapter 4) – one risk is that this exacerbates staffing shortages within social care, unless pay in the social care sector keeps pace.

Figure 5.10. Occupations of lower-paid social care staff in England prior to taking up and after leaving care roles, 2011–12 to 2021–22



Note: The authors are grateful to the Health Foundation for sharing the data behind the graph. 'Other' includes all occupations outside of the top 11 shown here.

Source: Kelly et al., 2022.

A 'Fair Pay Agreement' for adult social care

The Labour Party's general election manifesto promised a 'New Deal for Working People' with a 'Fair Pay Agreement' in adult social care to help empower workers and trade unions in the sector to negotiate better pay and conditions (Labour Party, 2024). The manifesto is clear that this is intended as a first step towards a greater role for sectoral collective bargaining across the broader economy, and that this will be introduced only after wide consultation.

Without knowing more about what form this agreement will take, it is hard to say much about its likely impact. However, it is anticipated that the agreement will lead to increased wages in the sector. Higher pay is expected to bring benefits in the form of lower turnover, lower recruitment costs and improved quality of care. The beneficial impacts on recruitment and retention might be particularly large if a Fair Pay Agreement leads to improved pay and conditions in adult social care but not in other sectors.

Any benefits from higher pay must be traded off against the costs. Social care is a labour-intensive industry, and an increase in pay rates will increase the cost of providing social care services, which will be borne not only by local authorities, but also by self-funders who will face more expensive care costs. In addition, as noted above, the majority of care providers are

independent (whether for-profit or voluntary). The ways in which these providers might respond to any sector-wide pay increase are key considerations.

The experience following the introduction of the National Living Wage (NLW) in 2016 – which also represented a big increase in staffing costs – is informative. Giupponi and Machin (2018) found that the introduction of the NLW led to higher wages in care homes without large-scale job losses or care home closures. Instead, firms offset the increase in wage costs by reducing care quality (as measured by Care Quality Commission inspection ratings).

Importantly, the introduction of the NLW was not accompanied by an increase in local authority funding or local authority fees for care services, which limited firms' ability to raise prices in response to an increase in staffing costs and pushed them to instead respond by reducing the quality of care. In contrast, a comparable study in the US found that increases in the minimum wage led to *increases* in the quality of nursing home care, because firms were able to charge consumers higher prices (Ruffini, 2022). If this channel is shut down, providers will need to find other ways to adjust.

It may be possible, up to a point, for higher pay to be absorbed by firms via a reduction in profit margins. But, in light of previous warnings about the financial sustainability of the sector, it seems more likely that if the government wishes to avoid the introduction of a Fair Pay Agreement leading to reductions in care quality or care provision, additional funding for local authorities will be required. This would be over and above any funding for the 'Fair Cost of Care' reforms discussed above, which do not allow for any new sectoral pay deal. Additional funding would be particularly necessary if self-funders are allowed to ask local authorities to commission care on their behalf (as discussed above), as this will limit care providers' ability to cover costs by raising the prices they charge to self-funders.

Precisely how much extra funding would be required depends on the outcome of any new sectoral pay agreement – i.e. the scale of any pay rise, and for whom. Recent modelling for the sector estimated that raising pay to the Real Living Wage (currently £12.00 per hour outside of London and £13.15 within London¹¹) and maintaining pay differentials for more senior staff would result in additional public spending of £1.4 billion per year in today's prices (Skills for Care, 2024a). (The total cost – i.e. including the costs borne by individuals or firms – was estimated at £2.2 billion per year.) This would be in line with recent changes made by the devolved governments of Scotland and Wales (Scottish Government, 2023; Welsh Government, 2024).

According to Skills for Care estimates, instead raising pay to the NLW + £1 per hour (and maintaining pay differentials) would result in an additional public spending requirement of

¹¹ <https://www.livingwage.org.uk/what-real-living-wage>.

£2.0 billion per year. National Living Wage + £2 would add £3.6 billion to public spending. Raising pay to match pay in NHS band 2 would require an extra £2.3 billion of public spending (Skills for Care, 2024a). The Migration Advisory Committee estimated in 2022 that raising pay to £11.53 (the then-bottom of NHS band 4) would add between £2.1 billion and £4.2 billion per year to the adult social care wage bill (depending on whether it is a pay floor or whether differentials are retained), not all of which would be borne by the public sector. These estimates provide a helpful sense of scale and illustrate the fact that the cost to the exchequer will depend on the changes in pay and conditions that end up being negotiated.

All in all, it is difficult to see a path to a successful ‘Fair Pay Agreement’ that does not include some additional public funding for councils to increase the fees paid to care providers. That would require higher taxes, lower spending on something else or higher borrowing. The question is then one of distribution preferences – whether the government wishes to transfer resources away from other public services and/or taxpayers (past and present) to the care workers and recipients of publicly funded care who stand to benefit. This is a political choice. Additionally, there is a decision for the government regarding whether this trade-off should be managed at a local or national level. For example, it could involve increasing local council tax bills and reprioritising away from other council services, or alternatively raising national taxes and reducing spending on non-council services. This decision will affect how the burden of funding is distributed.

Immigration

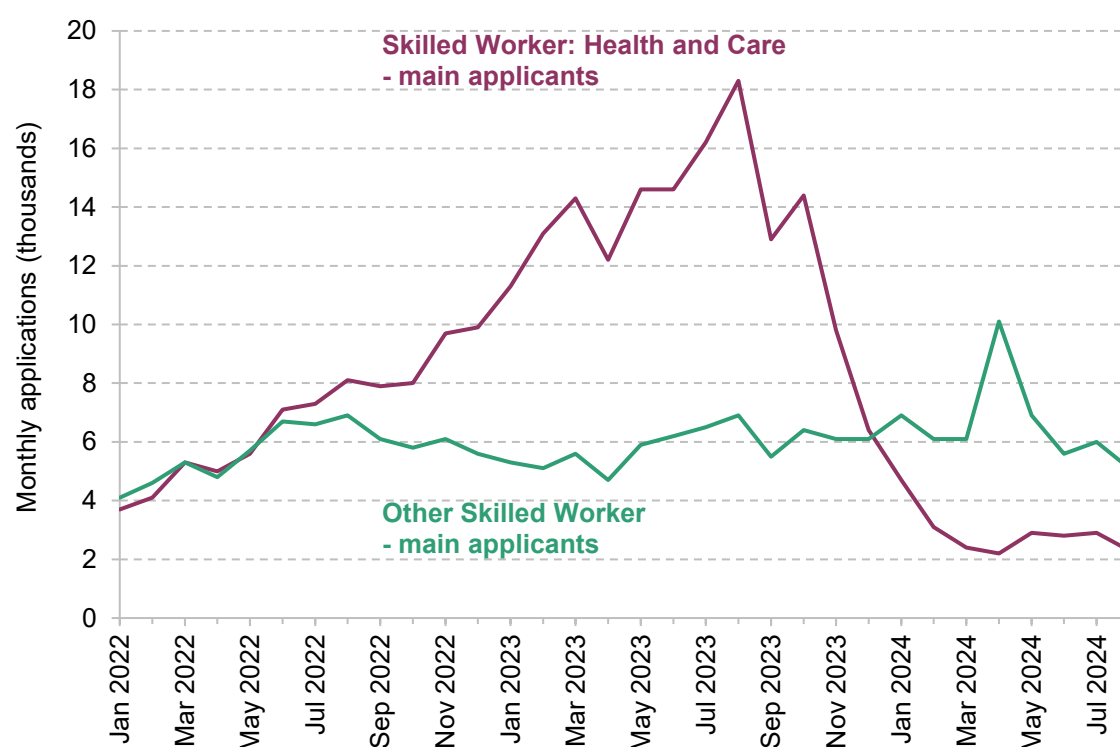
Immigration and immigration policy also influence the degree to which the adult social care sector can attract workers. Non-EU nationals made up 16% of the adult social care workforce in 2022–23, up from 10% in 2016–17 (Migration Advisory Committee, 2023). EU nationals made up a further 7% of the total in 2022–23, meaning that around a quarter (23%) of the social care workforce are non-UK nationals. This is slightly higher than the whole-economy average (with 20% of workers being non-UK nationals in the first quarter of 2023, 13% non-EU nationals and 7% EU nationals) (The Migration Observatory, 2024a).

Recent years – in adult social care and in the wider economy – have seen a substantial increase in the number of workers from non-EU countries and a reduction in the number from EU countries. Between December 2022 and December 2023, growth in the number of non-EU nationals employed in health and social work accounted for almost all of the observed increase in employment in the sector (HM Revenue and Customs, 2024). Within the care sector, there has been a dramatic increase, followed by an equally dramatic decrease, in the number of applications for Health and Care visas (Figure 5.11). This scheme includes health workers (such as nurses) as well as care workers, though most visas issued via this scheme were for the latter (Migration Advisory Committee, 2023). Monthly applications have plummeted from an

estimated 18,300 in August 2023 to 2,300 in August 2024.¹² This drop-off preceded the new restrictions on social care workers' ability to bring dependants from abroad, which came into effect on 11 March 2024, but is presumably related to this and other changes to visa requirements introduced by the last government. There was no such drop-off in the number of 'general' applicants for Skilled Worker visas. The net effect of the earlier influx of staff from abroad, and the latest reversal, is a drop in the vacancy rate in the adult social care sector from 9.9% in 2022–23 to 7.7% in April 2024 and 6.9% in July (Skills for Care, 2024b).

Evidence from the US demonstrates that immigration-induced expansions in the supply of care workers can have positive impacts on patient outcomes (Grabowski, Gruber and McGarry, 2023; Furtado and Ortega, 2023). In other words, for a sector plagued by issues with recruitment and retention, the empirical evidence shows that immigration can bring benefits. It is too soon to assess what impact the recent drop-off in visa applications might have in the UK.

Figure 5.11. Monthly applications for 'Skilled Worker' and 'Skilled Worker: Health and Care' visas, January 2022 to August 2024



Source: Home Office, 'Monthly monitoring of entry clearance visa applications', September 2024 release, <https://www.gov.uk/government/statistics/monthly-entry-clearance-visa-applications/monthly-monitoring-of-entry-clearance-visa-applications>.

¹² This does not include individuals switching from Sponsored Study visas to Skilled Worker visas to take care jobs – a topic discussed in The Migration Observatory (2024b).

Senior members of the new government previously indicated a desire to bring down levels of net migration (The Guardian, 2023). Since taking office, there has been no indication that the new government plans to reverse the last government's tightening of visa eligibility. Social care workers are no longer able to bring dependants (partners or children), for example, and the minimum salaries required to be sponsored for a spousal or 'Skilled Worker' visa have been significantly increased (Home Office, 2024). So, at the time of writing, it appears that the new government shares – at least in broad terms – the last government's desire to bring down levels of migration.

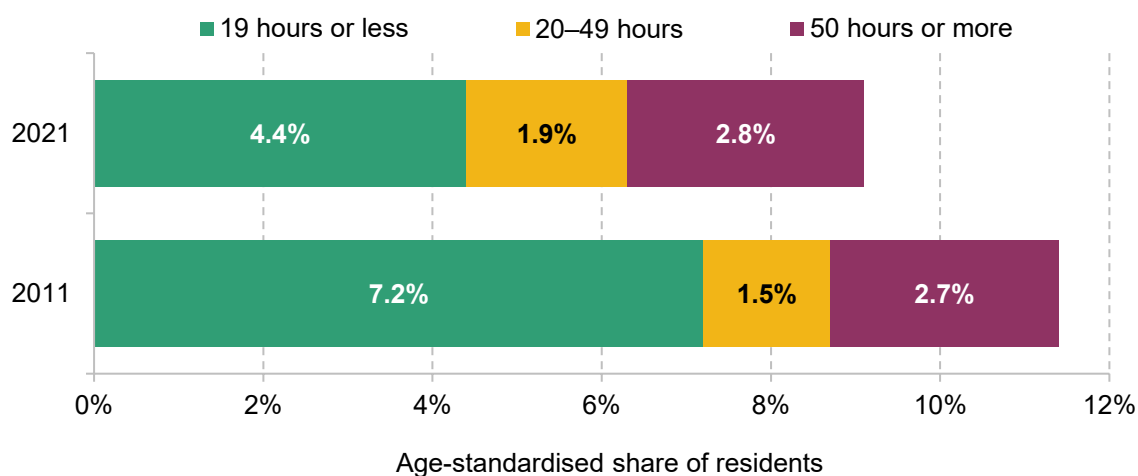
The trade-off here is a simple one. If the government wants to decrease the number of migrants entering the care sector, it must be prepared to either accept a smaller workforce (i.e. a deterioration in care quality and/or coverage) or boost the funding allocated to local authorities to raise wages and attract more domestic workers. Notably, the NHS now has an explicit policy of aiming to reduce reliance on international recruitment (NHS England, 2023c), even if the NHS's long-term workforce plan was entirely silent on how much it might cost to do so (Warner and Zaranko, 2023). There is nothing to stop the government pursuing a similar objective for the care sector – it just needs to accept that it will come at a price.

Support for informal carers

Not all adult social care is provided in the formal sector by paid professionals. The OECD (2023) reports the UK as having an above-average share of informal carers among the population aged 50 and over. Around 5.0 million people in England and Wales aged 5 and above provided informal care in 2021 (Office for National Statistics, 2023c). After adjusting for changes in the size and structure of the population over time, this is a lower proportion of the population than in 2011 (9.0% versus 11.4%) – though the numbers do suggest that a growing fraction of people in England and Wales were providing more than 20 hours of informal care per week (4.7% in 2021, up from 4.2% in 2011). The reductions came in the proportion of people providing fewer than 20 hours of care per week (4.4% in 2021 versus 7.2% in 2011) – see Figure 5.12. The age-standardised proportion of people providing at least some unpaid care varies from around 12% in Neath Port Talbot, St Helens and Ashfield to less than 7% in Wandsworth, Kensington and Chelsea, and Hammersmith and Fulham (Office for National Statistics, 2023c).

An individual with a care need may qualify for government support (such as via personal independence payment, disability living allowance or attendance allowance). If they do, and their carer provides at least 35 hours of care a week, they may be eligible for additional financial support through carer's allowance. Currently, eligibility for carer's allowance is subject to an earnings cliff-edge: if the carer earns more than £151 per week after tax, they no longer qualify for the £81.90 per week payment.

Figure 5.12. Age-standardised proportions of residents aged 5 and over providing unpaid care (weekly hours), 2011 and 2021, England and Wales



Source: Office for National Statistics, 'Unpaid care, England and Wales: Census 2021', <https://www.ons.gov.uk/peoplepopulationandcommunity/healthandsocialcare/healthandwellbeing/bulletins/unpaidcareenglandandwales/census2021>.

This cliff-edge is undesirable and can lead to cases where individuals have to repay large amounts to DWP if their earnings edge above the threshold. It would be better to have the £81.90 subject to a taper if individuals earn above the weekly limit (this could be done in a similar manner to the taper for universal credit, using the Real Time Information (RTI) system, to avoid individuals having to report when their earnings are too high). Furthermore, the level of the benefit might helpfully be defined in terms of a certain number of hours at the National Living Wage and indexed over time accordingly. The weekly earnings limit has roughly held its real-terms value over time (it is 2% higher now in CPI-adjusted terms than in 2010–11). But had it been increased in line with the National Living Wage (for those aged 25 and over) since 2018–19, it would now stand at £175.33, some 16% higher.¹³

The key point is to stress that adult social care policy extends beyond charging reforms and levels of pay for formal carers, and also needs to consider the important role of informal care.

5.5 Conclusion: what next?

The government's statements and manifesto promises provide little clarity on the future direction of adult social care, leaving more questions than answers about what to expect next. The only clear thing is that the government does not intend to go ahead with the introduction of

¹³ At the 2024 general election, the Liberal Democrats proposed that eligibility be expanded by raising the amount that carers can earn, introducing an earnings taper, reducing the number of hours per week required, and extending eligibility to include those in full-time education (Liberal Democrats, 2024).

a cap on lifetime care costs, and so despite numerous pledges, commissioned reports and proposals over the years, meaningful and much needed reform continues to elude the sector.

As with virtually all policy areas, the future of adult social care will depend on political priorities and economic trade-offs. In the short term, key decisions need to be made at both central and local government levels. One looming choice for the Chancellor is how much to provide to local authorities at the one-year Spending Review this autumn and the multi-year Spending Review next spring (see Chapter 3). That will reveal the relative priority given to adult social care, funding for which needs to be traded off against funding for other competing services. At a local level, councils will need to make decisions about council tax increases and how much to prioritise adult social care vis-à-vis other services.

When it comes to possible reforms, it also boils down to a question of priorities. The new government has decided not to prioritise a lifetime cap on care costs. This could reflect a distributional preference and a judgement that, given tight fiscal constraints, protecting the assets of wealthy pensioners who are carrying an uninsured risk of substantial future care costs is not a priority for public funds. If the regressivity of a cap on care costs was the concern, though, this could have been addressed through changes elsewhere in the system. If the government does not wish to subsidise inheritances for the well-off, it could raise inheritance tax or restrict some of the existing inheritance tax reliefs (Advani and Sturrock, 2023), as a perfectly coherent way of funding the change. The main issue appears to be a lack of political will, rather than a lack of feasible solutions. As it is, the means test governing eligibility for state support leaves an important share of the population facing a large and effectively uninsurable financial risk in old age.

Yet, the insurance problem is not the only challenge in this policy arena. When it comes to these other issues – around pay, immigration, the role of local government – it once again boils down to questions around priorities and trade-offs. If we are to have a Fair Pay Agreement, where are the costs to fall? Should care workers and care recipients be the priority, or the councils, taxpayers and users of other services who would lose out? If the government wants to see a reduction in the number of Care visas, is it willing to provide the funding required to raise wages to attract domestic workers? In designing a National Care Service, should the focus be on national standards and consistency in care provision, or on maintaining local discretion and flexibility? What should be the role of the state versus family in the provision of care? And so on.

Ultimately, in the face of an ageing population, demand for adult social care services will grow. Rates of disability among working-age adults also appear to be growing and this could translate into rising demand for care services, particularly relating to learning disabilities. Unless the generosity of the state's offer is pared back, that will mean growing numbers of people

qualifying for state support. In addition, expanding the care workforce to meet growing demand will mean increasing wages to keep pace with, and possibly grow faster than, wages in the wider economy and comparator sectors, raising costs for providers. Higher spending feels inevitable, absent some major changes to the role of government. In some ways, this is similar to the well-known pressures on the health system – only with the added complications of local government involvement, a complicated market structure, the availability of informal care from family members, and an unsolved insurance problem. There is no shortage of policy challenges for the new government to confront.

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6. Child poverty: trends and policy options

Anna Henry and Tom Wernham (IFS)

Key findings

1. The poverty rate is a useful summary measure of how low-income families are faring, comparing their total household income with a specified poverty line. For example, a couple with no children would need to have household income below £17,100 to be classed as living in relative poverty in 2022–23. **For a couple with two young children, the relative poverty line would be £23,900** as they are judged to require a higher household income to maintain a similar standard of living.
2. **Relative child poverty stands at 30% (4.3 million children).** Under Labour governments from 1997–98 to 2010–11, during which there was a policy focus on reducing child poverty, the relative poverty rate for children decreased from 33% (4.2 million children) to 27% (3.6 million children). Half of that decline was reversed from 2010–11 to 2022–23. The **child poverty rate is highest among families with three or more children**, and almost all of the rise in child poverty over the 2010s was concentrated in this group. Children of lone parents, those in rented accommodation, and those in workless households are all also more likely to be in poverty, though the child poverty rate in working families increased from 18% in 2010–11 to 23% in 2022–23.
3. **Overall, the benefits system provides less support for low-income households with children now than it did in 2010.** Though rates of support for families with children are still much higher in real terms than in 1997, the below-inflation uprating of many benefits from 2011 to 2019 made the system less generous. Various other policies, such as the two-child limit, removal of the family premium, the household benefit cap, and cuts to housing support, have also substantially reduced the incomes of affected families. As a result of the first three of these reforms, a typical social renting out-of-work lone parent with three young children has seen their disposable

annual income cut by £4,000, or a fifth, relative to what it would have been had these reforms not been implemented.

4. The government has a number of levers it can pull through the benefits system if it wants to reduce child poverty. Among the policies we consider, **the single most cost-effective policy for reducing the number of children living below the poverty line is removing the two-child limit**. This would cost £2.5 billion a year but would reduce child poverty by 540,000 (4 percentage points) in the long run, equating to an annual cost of around £4,500 per child lifted out of poverty. This compares to removing the household benefit cap, which would reduce child poverty by 10,000 at an annual cost of around £47,000 per child, or increasing LHA rates to the 50th percentile of local rents, which would reduce child poverty by 40,000 at an annual cost of £11,000 per child.
5. **The poverty rate, while a useful summary measure of how those on low incomes are faring, is based on an arbitrarily drawn poverty line**, and does not tell us everything about the impact of reforms on the living standards of children in low-income families. For example, whilst removing the two-child limit would lift large numbers out of poverty, **many of the children deepest in poverty would benefit less if the household benefit cap remained in place**, and households already capped would not gain at all. Removing the household benefit cap alone would lift very few (10,000 children) above the poverty line but would significantly alleviate the depth of poverty faced by some of the poorest children and provide a bigger proportional boost to their incomes. **When designing its child poverty strategy, the government should therefore consider effects of policies across the distribution of incomes, not just around the poverty line.**
6. Labour market policies present another lever the government may pull to reduce child poverty, though they will necessarily be less well targeted. **The government has highly ambitious plans to increase the employment rate to 80%, which could reduce child poverty by 200,000 to 350,000 if achieved** – though hitting that goal will be much easier said than done. Or it could increase the minimum wage. But neither increases in the minimum wage nor widespread increases in employment are likely to be well targeted at low-income households or to give large income gains to those who do benefit.

6.1 Introduction

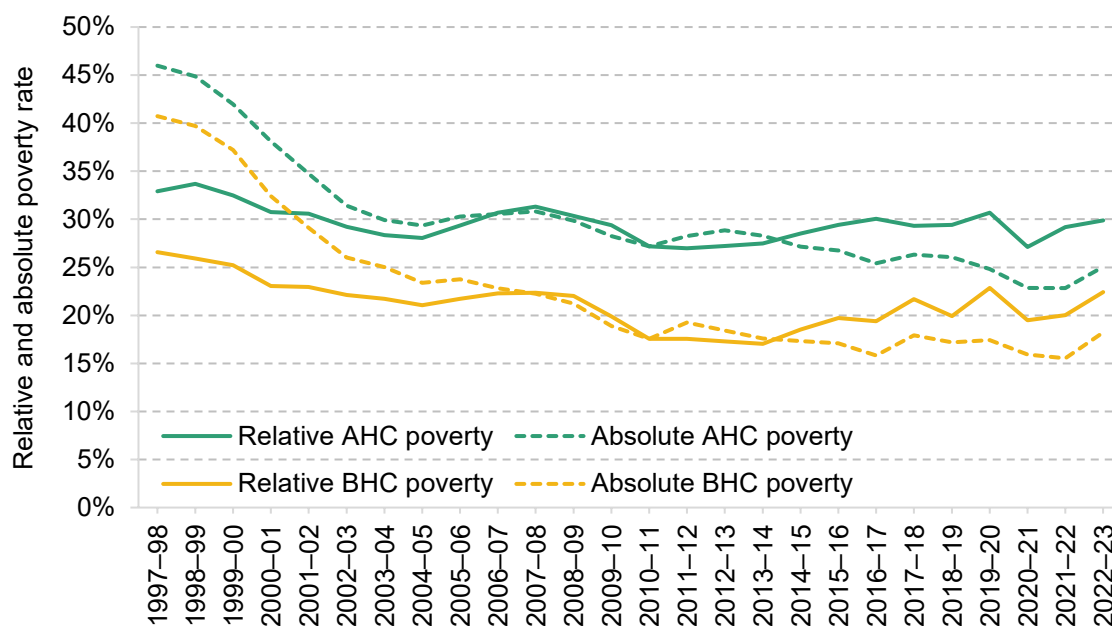
Of the 14.4 million children in the UK, 4.3 million, or 30% of them, are living in relative poverty. This is 3 percentage points (730,000 children) more than in 2010. Tackling child poverty is high up the policy agenda for the new government. The government has set ‘breaking down barriers to opportunity’ for children as one of its five missions, and launched a ministerial taskforce tasked with developing an ‘ambitious’ cross-government strategy to reduce child poverty, to be published in Spring 2025. These words evoke the ambitions of the last Labour government, which oversaw – through big increases in the generosity of financial support for low-income families with children and in the context of favourable economic conditions – a 6 percentage point fall in child poverty. But so far, no specific policies directly targeting income poverty among families with children have been announced.

In this chapter, we begin in Section 6.2 by reviewing trends in child poverty in recent decades and how support through the benefits system has changed over time. We then consider a range of policy options the government has if it wishes to alleviate child poverty. In Section 6.3, we consider potential reforms to the benefits system, and we turn in Section 6.4 to the role that changes in the labour market could play in reducing child poverty. A careful approach to supporting children in low-income households needs to consider how policies affect not only whether children are above or below an arbitrarily drawn poverty line, but also their effects across the income distribution. Section 6.5 concludes.

6.2 How many children are in poverty? How has this changed over time?

In this section, we look at trends in child poverty rates from 1997–98 to 2022–23. We begin by looking at overall trends in child poverty rates. *Relative* poverty is defined as the proportion of children living in households with incomes below 60% of the median household income in the same year and reflects the extent to which the incomes of poorer households with children are keeping pace with the average. A couple with no children would need to have household income less than £17,100 to be classed as living in relative poverty in 2022–23, whereas for a couple with two young children the amount would be £23,900 as they are judged to require a higher household income to maintain a similar standard of living. *Absolute* poverty is defined as the proportion of children in households with incomes below a poverty line that is fixed in real terms (i.e. adjusting for inflation) over time – in this case, we use the official definition of 60% of the median in 2010–11 (and so the poverty lines, and the numbers below them, are identical in that year). For a couple with no children to be in absolute poverty in 2022–23, they would need to have a household income less than £15,600, whereas for a couple with two young children the amount would be £21,800.

Figure 6.1. Relative (solid lines) and absolute (dashed lines) child poverty rates before and after housing costs have been deducted over time



Note: Incomes have been measured net of taxes and benefits. All incomes have been equivalised using the modified OECD equivalence scale. Relative poverty is defined as having income less than 60% of contemporaneous median income. Absolute poverty is defined as having income less than 60% of median income in 2010–11. The 1997–98 to 2003–04 period excludes Northern Ireland.

Source: Authors' calculations using the Family Resources Survey, 1997–98 to 2022–23.

Figure 6.1 shows relative and absolute poverty rates before and after housing costs are deducted (BHC and AHC respectively). Throughout this chapter, we will focus on the measures based on income after deducting housing costs, because this measure is more effective at identifying households with the lowest living standards.¹ Whilst there are also non-income-based measures of children's well-being, such as material deprivation, we focus here on measuring poverty through household income. Over the period 1997–98 to 2022–23, the relative child poverty rate followed a U-shaped pattern, falling from 33% in 1997–98 to 27% in 2010–11, where it stayed until 2014–15. The rate has since risen to 30% in 2022–23. Absolute poverty tends to fall over time as incomes grow, though with weak income growth in recent years, the absolute child poverty rate in 2022–23 was at the same level as in 2016–17.

These trends in poverty rates are driven by a combination of economic conditions and policy changes. Between 1997–98 and 2003–04, the UK saw a period of economic growth, with large rises in employment incomes for low-income families with children (Cribb et al., 2022). In addition, benefit incomes increased for low-income families over this period, largely due to a huge expansion of tax credits as part of a concerted effort to reduce child poverty. Overall, this

¹ See Appendix 6A for a discussion of the treatment of housing costs in measuring poverty.

led to income growth for low-income families with children exceeding median income growth, which consequently brought the relative child poverty rate down. Absolute child poverty fell faster during these six years than during any other period shown. However, from 2003–04 until the financial crisis, reductions in relative child poverty were partially reversed as income growth for poorer households stalled relative to the median.

The period during and immediately following the financial crisis was characterised by much weaker, but overall slightly positive, income growth for low-income families, compared with the decade prior. Income growth at the middle, however, fared even worse over this period. As a result, relative child poverty rates fell during the period 2007–08 to 2013–14, despite the weak income growth for children in low-income families.

From 2013–14 to 2019–20, earnings growth picked up again and income from employment grew, reflecting a sustained increase in employment rates over this period. However, this was largely offset by a fall in income from benefits, both from a cut in the generosity of benefits themselves and from a fall in entitlements to benefits due to rising incomes from employment (Cribb et al., 2022). As the incomes of low-income families are more sensitive to changes in benefit income than the average household, relative poverty rates increased over this period.

By 2022–23, absolute poverty rates were roughly the same as in 2019–20, whilst relative poverty rates were slightly lower, by around 1 percentage point for relative AHC poverty. The fall in relative poverty rates was driven by negative real income growth at the median and stagnant income growth at the bottom of the income distribution as employment earnings and benefit income fell over this period, but incomes at the bottom of the income distribution were propped up by cost-of-living payments (Ray-Chaudhuri, Waters and Wernham, 2024).

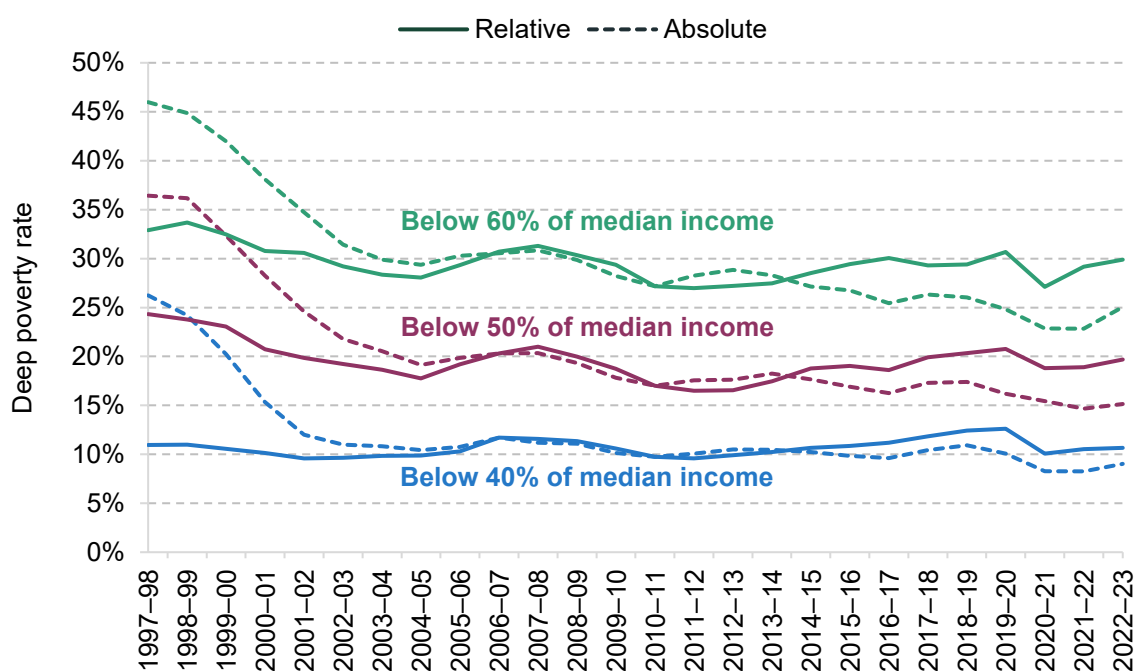
Up until now, we have looked at relative and absolute poverty defined as having income less than 60% of contemporaneous median income (relative poverty) or of 2010–11 median income (absolute). However, of course, people in poverty face varying *depths* of poverty – not all those who are under these poverty lines will face the same living standards. For example, children with household incomes far below the poverty line will face worse living standards than those who have incomes just below the threshold. In order to understand better how children in poverty are faring, there are various other measures of well-being we can look at. One option would be to calculate the total pound amount required to bring all households to the poverty line. Another would be to look at the proportion of children under different, lower, income thresholds.² Here we have taken the latter approach. We have defined two alternative absolute and relative poverty lines. The first, deep relative poverty, is defined as 50% and 40% of

² For a more detailed discussion of measurement issues and alternative measures of living standards, see Bourquin et al. (2019).

contemporaneous median income which in 2022–23 are equivalent to annual household income of £14,200 and £11,400 respectively for a childless couple or £19,800 and £15,900 for a couple with two young children. The second, deep absolute poverty, is defined as 50% and 40% of 2010–11 median income; in 2022–23, these are equivalent to annual household income of £13,000 and £10,400 respectively for a childless couple or £18,100 and £14,500 for a couple with two young children.

Figure 6.2 shows that the proportion of children living with income below 50% of the median has trended in a similar direction to the headline poverty rate, with sharper declines from 1997 to 2010 and sharper rises since. The proportion with incomes below 40% of the median is just over 10%, broadly the same level as in the late 1990s and early 2000s. Difficulties in measuring very low incomes in survey data make it harder to analyse deep poverty, so we should take this finding with a pinch of salt. Measures of deep absolute poverty fell quickly in the period 1997–98 to 2004–05 but have changed less since then.

Figure 6.2. Deep child poverty rates (after housing costs are deducted) over time



Note: Incomes have been measured net of taxes and benefits. All incomes have been equivalised using the modified OECD equivalence scale and have had housing costs deducted. Relative poverty is based on contemporaneous median incomes. Absolute poverty is based on 2010–11 median incomes. The 1997–98 to 2003–04 period excludes Northern Ireland.

Source: Authors' calculations using the Family Resources Survey, 1997–98 to 2022–23.

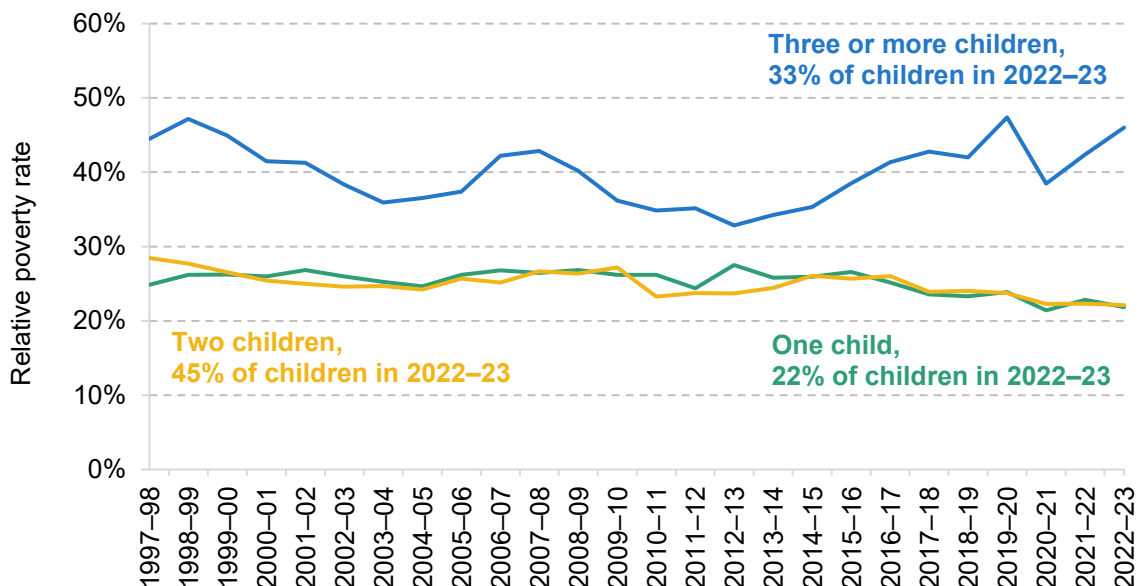
How have poverty rates differed between groups?

We have seen that child absolute poverty rates have fallen since 1997–98, whilst child relative poverty rates have shown a U-shaped pattern, increasing after 2013–14. However, there is significant variation in poverty rates across different subgroups of children. These differences are partly explained by differing characteristics of these subgroups but can also be driven by government policy, particularly around the generosity of benefits. Below we consider family size, whether anyone in the household is in work, the number of adults in the household and housing tenure.

Family size

Figure 6.3 plots the relative child poverty rates between 1997–98 and 2022–23 by the number of children in the family. The poverty rate has always been higher for larger families, with three or more children (in which one-third of children live), than for smaller families. This is a result of two compounding reasons. First, households with three or more children on average have lower unequivalised household income, around 15% lower at the median compared with families with one or two children. Second, we adjust for the fact that the larger the number of people in a household, the more total household income is required to meet the same standard of living. This reduces the ‘equivalised’ income of large families further, to 36% less than the median income of families with one or two children.

Figure 6.3. Relative child poverty rates after housing costs are deducted over time, by number of children in family



Note: Incomes have been measured net of taxes and benefits. All incomes have been equivalised using the modified OECD equivalence scale. Relative poverty is defined as having income less than 60% of contemporaneous median income. The 1997–98 to 2003–04 period excludes Northern Ireland.

Source: Authors' calculations using the Family Resources Survey, 1997–98 to 2022–23.

Since 2013–14, there has been a particularly large increase in relative child poverty rates amongst large families – indeed this explains the entirety of the overall rise in child poverty. In 2013–14, 34% of children in families with three or more children were in relative poverty – a figure that had risen to 46% in 2022–23. This is in part explained by the two-child limit, which prevents claimants from receiving additional child tax credit or universal credit for (most³) third or subsequent children born after 5 April 2017. As time passes, more and more large families will have children born after this date such that the two-child limit will affect a growing proportion of large families, up until 2035 when the two-child limit will have been fully rolled out since at this point all children will have been born after this date. By the time the two-child limit (and family premium removal) is fully rolled out, we estimate that the two-child limit will have added 10 percentage points to the relative AHC poverty rate of larger families.

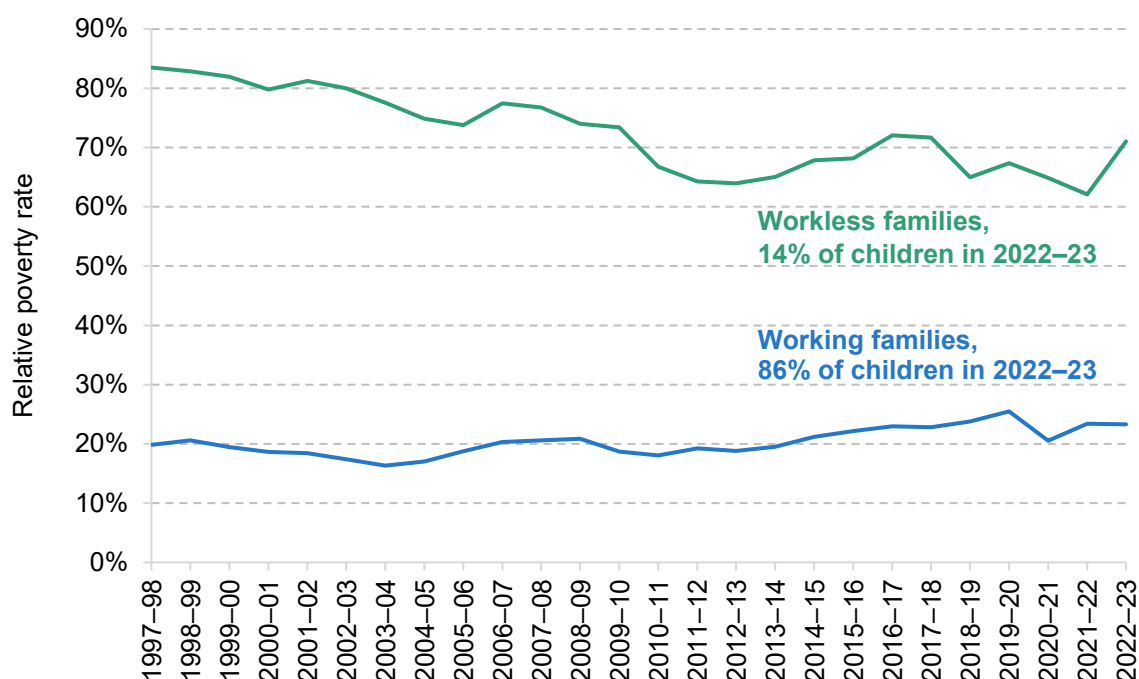
Work status of parents

Figure 6.4 shows relative child poverty rates split by working and workless families (those where no parent is in work). Unsurprisingly, children in workless families (which is 14% of children) are much more likely to be in child poverty than children in families where at least one adult is employed, with poverty rates in the former group at more than two-thirds. However, the child poverty rate amongst workless families has been falling faster than the child poverty rate amongst working families.

The share of children who are in working families has increased over the past decade. In 2012–13, 81% of children were in working families, but by 2022–23 this figure was 86%. This increase of 5 percentage points is more than double the total increase over the 15 years between 1997–98 and 2012–13. As more and more children are in families where at least one adult is working, we would expect the overall rate of child poverty to fall. However, this composition effect is counterbalanced by increasing poverty rates amongst working families (Cribb et al., 2022). Therefore, the typical child in poverty is now much more likely to be in a working family than in a workless family – in 2022–23, around two-thirds of children in relative poverty lived in working families, compared with just over half in 2012–13.

³ There are some exceptions: families with children who are disabled, children who are adopted and the second (or more) child born in a multiple birth, to name a few.

Figure 6.4. Relative child poverty rates after housing costs are deducted in working and workless families over time



Note: Incomes have been measured net of taxes and benefits. All incomes have been equivalised using the modified OECD equivalence scale. Relative poverty is defined as having income less than 60% of contemporaneous median income. The 1997-98 to 2003-04 period excludes Northern Ireland.

Source: Authors' calculations using the Family Resources Survey, 1997-98 to 2022-23.

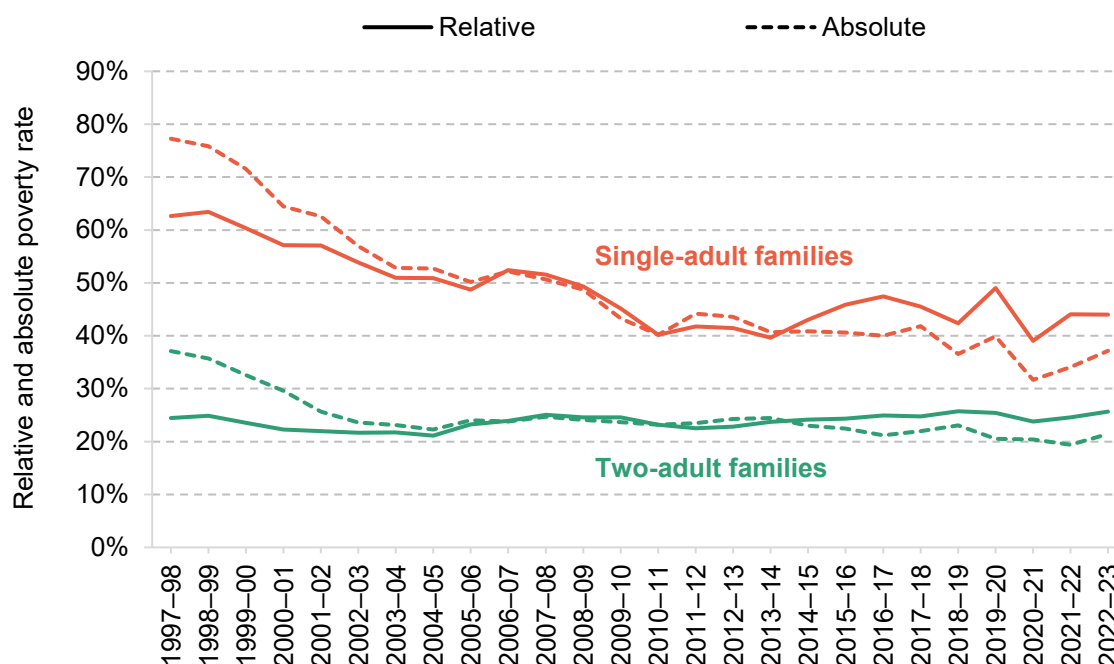
Number of adults in household

Poverty rates amongst lone-parent families have fallen substantially since the late 1990s.

However, some of these gains have been eroded since 2013-14 as relative poverty rates have risen amongst this group. Figure 6.5 shows that by 2022-23, over 40% of children in lone-parent families were living in relative poverty. This was largely due to weak income growth for lone-parent families compared with median incomes. Lone-parent families draw higher proportions of their income from benefits, so were more exposed to cuts to benefits during the 2010s.

Additionally, the gap in poverty rates between children living in lone-parent families and children living with more than one adult has narrowed over time. Figure 6.5 shows that relative child poverty rates in 1997-98 were 2.6 times higher for children with lone parents than for children living in a household with at least two adults. By 2013-14, this gap had shrunk to only 1.7 times higher. The gap in relative child poverty rates has stayed relatively stable since then, remaining 1.7 times higher in 2022-23.

Figure 6.5. Relative (solid lines) and absolute (dashed lines) child poverty rates after housing costs are deducted in single-adult and two-adult families over time



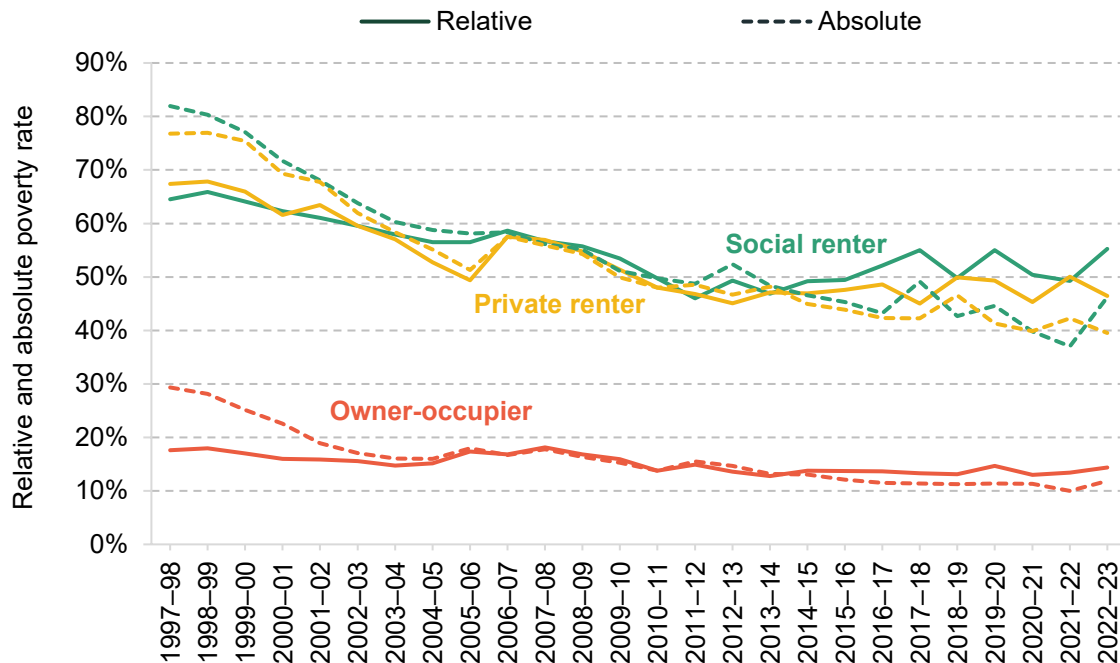
Note: Incomes have been measured net of taxes and benefits. All incomes have been equivalised using the modified OECD equivalence scale. Relative poverty is defined as having income less than 60% of contemporaneous median income. Absolute poverty is defined as having income less than 60% of median income in 2010–11. The 1997–98 to 2003–04 period excludes Northern Ireland. ‘Families’ are defined as a single adult or couple, plus any dependent children, living in the same household.

Source: Authors’ calculations using the Family Resources Survey, 1997–98 to 2022–23.

Housing tenure

Child poverty rates also vary by the tenure of home the child lives in, with children living in owner-occupied homes less likely to be in poverty than their counterparts living in the private or social rented sector. Figure 6.6 shows that in 1997–98, private and social renters’ children were about four times more likely to be in relative poverty and three times more likely to be in absolute poverty than owner-occupiers’ children. Since 2013–14, the rate of relative child poverty for private renters has hovered between 45% and 50%. Over this same period, support received by low-income private renters from the government has become less generous – namely local housing allowance (LHA) rates, which determine the maximum amount of rent support a family can claim, have fallen, holding back after-housing-cost income growth for these families.

Figure 6.6. Relative (solid lines) and absolute (dashed lines) child poverty rates after housing costs are deducted by housing tenure over time



Note: Incomes have been measured net of taxes and benefits. All incomes have been equivalised using the modified OECD equivalence scale. Relative poverty is defined as having income less than 60% of contemporaneous median income. Absolute poverty is defined as having income less than 60% of median income in 2010–11. The 1997–98 to 2003–04 period excludes Northern Ireland.

Source: Authors' calculations using the Family Resources Survey, 1997–98 to 2022–23.

What are the characteristics of children in poverty today?

Above, we have shown the share of children in poverty across various types of families. Table 6.1 now shows the characteristics of children in relative poverty in 2022–23, to get a better sense of which policies may be most effective in moving a large proportion of children out of poverty. Half of children in poverty in the UK were from families with three or more children, despite only a third of all children in the UK living in such families. Similarly, only 14% of all children do not live with a working adult, whereas children from workless families make up over a third of children in poverty. A third of children in poverty are living in privately renting households and 40% in socially renting households, despite the majority of all children living in owner-occupier households. Moreover, a third of children in poverty live with a lone parent, compared with just over a fifth among the whole child population. Poverty rates are higher amongst Black and Asian children and amongst children living in the North of England and in London.

Table 6.1. Characteristics of children in relative AHC poverty compared with all children, 2022–23

Household characteristics	Relative poverty rate amongst each group	Share of children in relative poverty who belong to each group	Share of all children who belong to each group
All	30%	100%	100%
Lone parent	44%	34%	23%
Couple	26%	66%	77%
Working families	23%	67%	86%
Workless families	71%	33%	14%
One child	22%	16%	22%
Two children	22%	34%	45%
Three or more children	46%	50%	33%
Social renter	46%	40%	21%
Private renter	40%	33%	21%
Owner-occupier	12%	28%	58%
North East, North West, Yorkshire	35%	27%	23%
East and West Midlands	33%	18%	17%
East, South East, South West	23%	24%	31%
London	35%	17%	14%
Wales	33%	5%	4%
Scotland	26%	6%	7%
Northern Ireland	25%	3%	3%
White	25%	63%	75%
Mixed & Other	36%	10%	8%
Asian	47%	19%	12%
Black	48%	8%	5%

Source: Authors' calculations using the Family Resources Survey 2022–23.

6.3 How can the benefits system be used to alleviate child poverty?

Child poverty has been pushed further up the policy agenda by the rises in relative poverty seen over the last decade. The new UK government has promised an ‘ambitious strategy’ to reduce child poverty, and the Scottish government has recently rolled out significant new benefits targeted at children in poverty (the Scottish Child Payment and Best Start Grants).

Having examined recent trends in child poverty in the previous section, we now briefly outline the role of benefits policy in supporting children in low-income families and discuss how this has changed over time. We will then analyse some of the options the government has for reducing child poverty through the benefits system. In this section, all calculations are based on Great Britain only, so exclude Northern Ireland.

How are low-income children supported through the benefits system, and how has this changed over time?

The main working-age benefit for low-income families is universal credit. Claimants receive a standard allowance (£4,721 per year for a single person, £7,411 for a couple⁴), plus an extra £3,455 per year for each child living in the family. However, for third and subsequent children born from 6 April 2017, no additional child element is received⁵ – a policy known as the two-child limit. If a household rents, they will receive housing support to help cover their rental costs. For private renters, this housing element may be up to a cap linked to local rents, known as the local housing allowance (LHA). Additionally, low-income families are typically eligible for council tax support to cover some or all of their council tax bill. These benefits are withdrawn as parents’ incomes increase. Families can also receive child benefit (£1,330 a year for the first child, £880 for subsequent children), which is not subject to the two-child limit and not targeted only at lower-income households.⁶ Families on universal credit with incomes (excluding benefits) of no more than £7,400 are eligible for free school meals during term time. If either parents or children are disabled, families may also receive incapacity or disability benefits.

The total benefit amount (not including council tax support) a family receives may not exceed the household benefit cap (£22,020 for a lone parent or couple outside London, £25,323 inside London, with lower caps for single adults without children). There are exemptions if the family

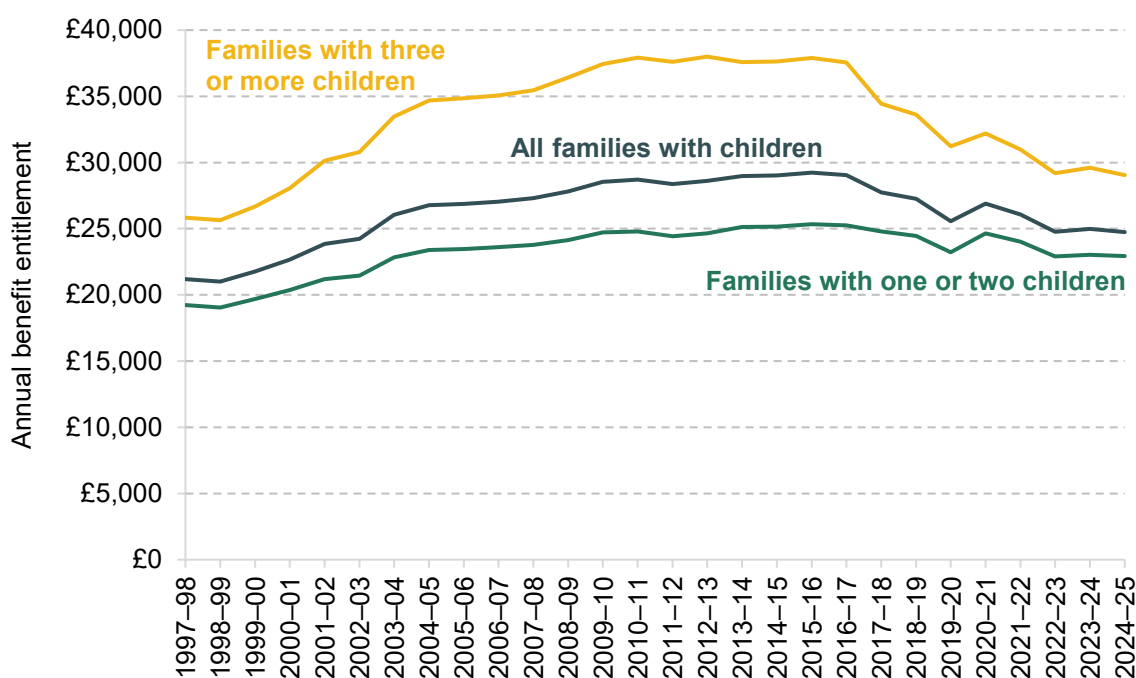
⁴ Under-25s receive less than these amounts.

⁵ There are some specific exceptions, such as when a third child was adopted or the result of a multiple birth.

⁶ However, if either parent the child lives with has an income above £60,000, they are required to pay back some of the benefit as income tax due to the high-income child benefit charge. If one has income over £80,000, they must repay the full amount.

receives any disability or incapacity benefits, and for the first nine months after a universal credit claim triggered by earnings falling below £793 a month if a claimant earned above the threshold in each of the preceding 12 months.

Figure 6.7. Mean benefit entitlements of low-income out-of-work households with children, by family size (real terms, 2024–25 prices)



Note: Graph shows the mean total benefit income received by out-of-work households with children in the bottom 40th percentile of equivalised AHC income. We take data on the current population of workless families with children on low incomes and run these through uprated tax and benefit systems for each year from 1997–98 to 2024–25. Households in receipt of any disability income are excluded from the sample. Benefit entitlements are given in 2024–25 prices.

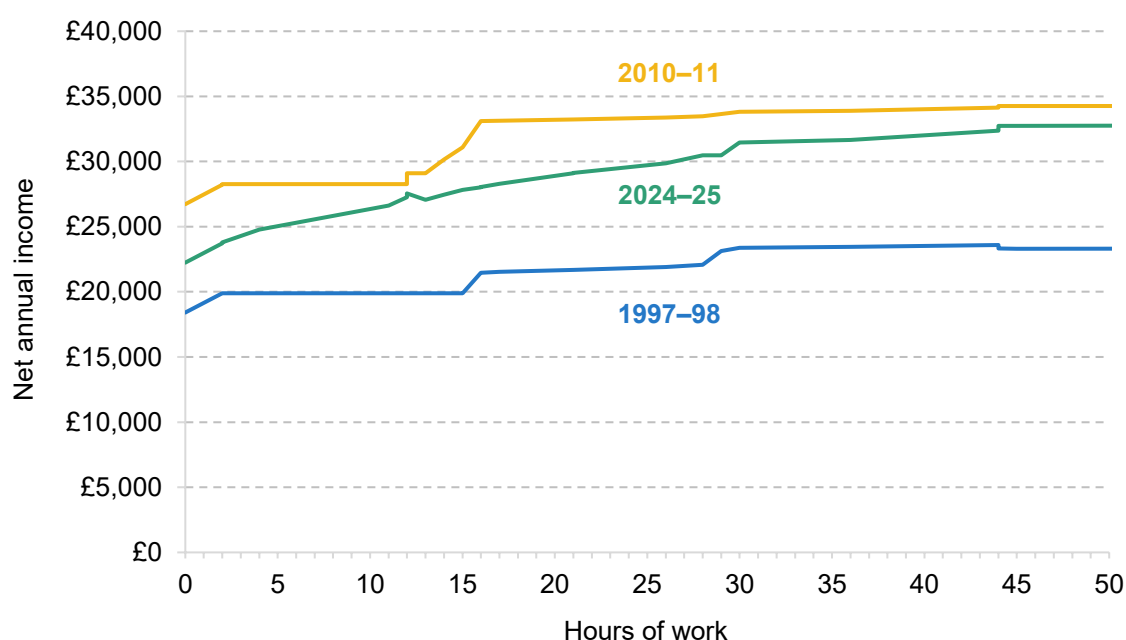
Source: Authors' calculations using the Family Resources Survey 2022–23 and TAXBEN (the IFS tax–benefit microsimulation model).

Figure 6.7 shows the average benefit entitlements for low-income out-of-work families since 1997. From 1997 to 2010, there were significant increases in means-tested support for parents and children – in working and non-working families. Since 2010, the generosity of the system has reduced. This is partly due to most benefits being frozen or uprated below inflation for most of the 2010s. Rates for children remain considerably higher than in 1997 despite these more recent cuts. But elements for parents are slightly lower than in 1997 and, with earnings having increased substantially over that period, provide significantly less insurance for a parent losing their job. Cuts have not only come through headline rates. For example, real-terms cuts to LHA rates from 2011, the introduction of the household benefit cap in 2013 (and its lowering following the 2015 general election), and the roll-out of the two-child limit and phasing-out of the family premium from 2017 have significantly reduced the generosity of the benefits system for families affected by these policies. Larger families have seen the largest falls in their entitlements.

Figure 6.7 shows changes over time for a household without any disability benefit income, but there have also been changes in the generosity of disability and incapacity benefits (which are beyond the scope of this chapter). The poverty rate amongst children living in households with at least one disabled adult has remained stubbornly higher than the poverty rate amongst all children: in 2022–23, the relative poverty rate amongst children living with at least one disabled adult was 35%, 5 percentage points higher than the relative poverty rate amongst all children.

Changing the benefit system has implications for work incentives. Figure 6.8 shows net income at different hours of work for a lone parent on the minimum wage, under the current tax–benefit system, and under the 2010–11 and 1997–98 tax–benefit systems uprated to today’s prices. Increases to benefits for out-of-work families will naturally decrease their incentive to enter paid work, but from 1997–98 to 2010–11, in-work benefits were also increased, helping to mitigate this effect by also increasing the incomes received when parents entered paid work. In a tight fiscal environment, it might not be feasible for increases to benefits targeted at the poorest families with children on lower incomes to be accompanied by large increases in in-work benefits. This means such policies may deter some parents from entering work, further increasing the costs to the exchequer beyond the direct cost of providing the additional benefits.

Figure 6.8. Net income at different hours of work for a lone parent on minimum wage with three children, under tax and benefit systems in 1997–98, 2010–11 and 2024–25 (real terms, 2024–25 prices)



Note: Children are assumed to be 4, 6 and 8 years old. Lone parent is assumed to be a social renter paying £6,000 per year in rent.

Source: Authors' calculations using TAXBEN (the IFS tax–benefit microsimulation model).

What are the government's options for policy reform?

The tax and benefit system provides many levers to pull if the government wishes to redistribute income to reduce child poverty, including altering headline tax or benefit rates or making changes to the structure of the system, perhaps by reversing recent changes. First, we discuss a few of the policy levers available to the government through the benefits system to reduce child poverty. We consider a range of options, based on recent changes to the system that apply in England and Wales, as well as local and devolved initiatives. Later, we will compare the costs of the various policies and their impacts on absolute poverty (in order to focus purely on the effects on lower-income households, as explained in the next subsection) and household incomes.

Increase rates of child support in universal credit

The government could simply opt to increase the rates of benefits paid to parents per child, which would increase the household incomes of 2.9 million households and 5.7 million children: in particular, all households with children who are currently in receipt of Universal Credit, but who are not subject to the household benefit cap, would gain.

Increasing the child element of universal credit – currently £3,455 a year – would roughly mirror the approach taken in Scotland to provide an additional £1,390 per child to families on benefits, through the Scottish Child Payment. However, unlike with the Scottish Child Payment, families subject to the household benefit cap would not see any benefit increase from such a policy, and families subject to the two-child limit would not receive an additional payment for all their children, but only for their first two children. Increasing the child element by £26.70 in line with the Scottish Child Payment would cost £4.3 billion per year.

An alternative approach would be to increase the standard amount of benefits that any family with children receives (regardless of number of children). For example, the government could reinstate the family premium, also being phased out since 2017, which gave low-income families with any number of children an additional £545 per year. Reintroducing it at this level would cost £1.1 billion per year.

Another option would be to increase the standard allowance in universal credit for young parents. The standard amount of benefits received by adults under 25 (or couples who are both under 25) is lower than the amount received by older adults. For example, a single person under 25 receives £3,740 a year, compared with £4,721 for an older adult. The government could increase the standard allowance for young parents to match that of older parents, as proposed by the Liberal Democrats at the last election. This would cost £100 million per year.

Remove the two-child limit

Over time, more and more families are being affected by the two-child limit. The recent rise in child relative poverty has been entirely driven by families with three or more children, and half of children in poverty now belong to such families, so removing the two-child limit would be targeted at a specifically at-risk group. Households affected by the two-child limit are a disproportionately deprived subset of all those in receipt of universal credit (Latimer and Waters, 2024). The cost of removing the two-child limit would initially be £1.7 billion a year, and this would rise to £2.5 billion as the policy is rolled out (note that this assumes the household benefit cap is left in place, thereby limiting the gains for some households; see below).

Table 6.2. Share of children affected by the two-child limit, by group

Group	Share affected (current tax– benefit system)	Share affected (two-child limit and removal of family premium fully rolled out)
All		
All children	13.0%	16.3%
In absolute AHC poverty		
All children in poverty	30.7%	39.9%
Lone parent	25.9%	35.6%
Couple	33.4%	42.3%
In work	31.6%	38.3%
Out of work	29.4%	42.4%
Social renter	34.9%	49.7%
Private renter	26.2%	31.6%
Owner-occupier	30.4%	35.8%
White	29.2%	38.0%
Mixed & Other	35.3%	44.0%
Asian	32.4%	48.1%
Black	33.5%	35.0%
In deep poverty		
All children in deep poverty	15.5%	24.7%

Note: Statistics do not include Northern Ireland. 'In work' indicates that at least one individual in the household is earning any non-zero amount of income from employment. 'Deep poverty' here corresponds to an income below 40% of median inflation-adjusted income in 2010–11 – an absolute definition.

Source: Authors' calculations using FRS 2022–23 and TAXBEN (the IFS tax–benefit microsimulation model).

Table 6.2 shows that over 30% of children in poverty today are affected by the two-child limit, rising to 40% by the time it is fully rolled out. This means the impact on children, and the cost to the exchequer, of removing the two-child limit will grow over time. As shown in Table 6.4 later, the two-child limit means benefit entitlements are less likely to push low-income families above the poverty line, though they still in general push families over the deep poverty line used here. Among those in poverty, children in the social rented sector, and in working households, are also particularly likely to be affected by the two-child limit. Households with an adult of Pakistani or Bangladeshi origin are also more likely to be affected – 43% of children in these households see their household incomes reduced by the two-child limit (Latimer and Waters, 2024).

Increase support for housing costs

With children in households that rent over three times as likely to be in poverty as children in owner-occupier households, increases in the generosity of housing support in universal credit would be targeted to a relatively high-poverty group.

The main option here is to increase LHA rates, which cap the amount of housing support received by private renters on benefits. The generosity of support was reduced in 2011, prior to which LHA rates would track median rents in their local area (specifically, their ‘broad rental market area’ or BRMA), meaning half of local properties could be fully covered. Local housing allowance rates were increased in April this year so that they cover the cheapest 30% of properties in each area based on September 2023 rents, but they are now frozen at this level in cash terms. The freeze means that, with rents growing rapidly (Office for National Statistics, 2024), the proportion of properties with rents that can be covered by housing benefit is shrinking over time. This is a pattern that has played out before: between 2020 and 2023, a freeze in LHA rates while rents were rising meant the proportion of new lets that could be covered by housing benefit fell from 23% to just 5% (Waters and Wernham, 2023). To avoid repeating this and seeing generosity eroded over time, government should index rates of LHA in line with growth in local rents over time. Increasing LHA rates in this way would prevent more households being pushed (deeper) into poverty by rising rents.

The government could go further and increase the proportion of local rents LHA is set to cover. Increasing LHA rates from the 30th to the 50th percentile of local rents would cost the government around £0.5 billion but this is a lower bound as it does not account for families deciding to live in more expensive properties as a result of the policy. To put this policy into context, it would see the LHA rate for a two-bedroom property in Leeds increase from £178.36 to £205.97, for instance. However, any increase in LHA rates would also boost the incomes of many households without children, so would not be particularly targeted at child poverty. Other options include relaxing the rules for how many children must share a bedroom or restoring the five-bedroom rate which was removed in 2011.

Housing benefit is not capped in the same way for social renters – typically, their full rent is covered if they have no other source of income. However, they can be subject to the under-occupancy charge or so-called ‘bedroom tax’, which reduces benefit entitlements for social renters who are deemed to have a spare bedroom. However, only a very small proportion of children are affected by the bedroom tax – it is particularly likely to affect a social renting household after adult children leave home, so the impact on child poverty of removing such a policy would be limited.

Remove the household benefit cap

Introduced in 2013, lowered in 2016 and raised in 2023, the household benefit cap limits the total amount of benefits a family can receive, based on the number of adults and whether they live in or out of London. Removing this cap is another measure the government could take to boost the generosity of the benefits system. Since 2023, the Scottish government has adopted a policy of mitigating the household benefit cap through discretionary housing payments.

Only families with the largest benefit entitlements are affected by the household benefit cap. The latest data from DWP show that 123,000 households were benefit capped in May 2024, which is equivalent to 1.8% of working-age households claiming housing benefit or universal credit (Department for Work and Pensions, 2024). As Table 6.3 shows, among children in poverty it is lone-parent families, out-of-work families, private and social renting families, and families with three or more children who are most likely to be affected. The families most likely to be hit by the household benefit cap are amongst the very poorest, with incomes (including benefits they receive) well below the poverty line.

Once the two-child limit and removal of the family premium are fully rolled out, the household benefit cap will save the exchequer about £0.5 billion per year, or about £3,900 per family affected. The household benefit cap is therefore a policy that affects a small number of families by a large amount each. Evidence produced by the Department for Work and Pensions (and peer reviewed by IFS researchers) suggests that the household benefit cap has incentivised small numbers of people to move into paid work (and, in even rarer cases, move to a cheaper area), but in the large majority of cases, affected claimants have not changed either their employment or their housing choice in response to the policy (Emmerson and Joyce, 2023).

The household benefit cap is set to affect fewer families over time (0.4% of families once the two-child limit is rolled out). As the two-child limit and removal of the family premium are rolled out, fewer large families will hit the cap, since having additional children will not confer as much additional benefit income through universal credit (though they can still receive additional child benefit and support for their housing costs, both of which do count towards the cap). And households that remain affected are increasingly likely to have the lowest disposable incomes. Over time, fewer households will be affected by the cap. In the same vein, the

household benefit cap reduces the impact of policies mentioned earlier, as some families, particularly the very poorest families, would not benefit from any increases in universal credit if they have already reached the household benefit cap.

Table 6.3. Share of children affected by the household benefit cap, by group

Group	Share affected (current tax–benefit system)	Share affected (two-child limit and removal of family premium fully rolled out)
All		
All children	2.2%	1.6%
In absolute AHC poverty		
All children in poverty	9.5%	6.8%
Lone parent	15.8%	11.1%
Couple	5.9%	4.3%
In work	4.8%	3.4%
Out of work	16.9%	12.2%
One child	1.5%	1.5%
Two children	5.8%	5.1%
Three or more children	15.2%	9.9%
Social renter	14.8%	9.1%
Private renter	10.4%	9.4%
Owner-occupier	0.8%	0.0%
White	8.6%	6.3%
Mixed & Other	8.5%	8.2%
Asian	12.2%	6.5%
Black	9.8%	7.6%
In deep poverty		
All children in deep poverty	14.4%	12.1%

Note: Statistics do not include Northern Ireland. 'In work' indicates that at least one individual in the household is earning any non-zero amount of income from employment. Households are exempt from the benefit cap if they claim universal credit but earn a combined after-tax income of at least £793 a month; thus the 'in work' group only refers to those working at a very low level of earnings.

Source: Authors' calculations using Family Resources Survey 2022–23 and TAXBEN (the IFS tax–benefit microsimulation model).

Table 6.4. Annual benefit income of an example out-of-work lone parent social renter with three children, under different policy measures (2024 tax–benefit system and prices)

	No household benefit cap No two-child limit or removal of family premium	With household benefit cap No two-child limit or removal of family premium	With household benefit cap With two-child limit and removal of family premium
UC standard allowance	£4,721	£4,721	£4,721
Housing support	£6,000	£6,000	£6,000
Total child element	£10,365	£10,365	£6,910
Child benefit	£3,102	£3,102	£3,102
Family premium	£545	£545	£0
Total uncapped benefit income	£24,733	£24,733	£20,733
Impact of household benefit cap (£22,020 for this family)	<i>n.a.</i>	<i>–£2,713</i>	<i>£0</i>
Housing costs	<i>–£6,000</i>	<i>–£6,000</i>	<i>–£6,000</i>
Free school meals	£1,442	£1,442	£1,442
Total income after housing costs	£20,175	£17,462	£16,175
<i>Absolute poverty line for this family</i>	<i>£19,756</i>	<i>£19,756</i>	<i>£19,756</i>

Note: Child benefit and support for housing costs, in contrast to the child element of universal credit, are unaffected by the two-child limit. The table assumes council tax is fully covered by council tax support, family lives outside of London in social rented property costing £6,000 per year with no spare bedrooms, and all the children are aged under 14. The poverty line used is the absolute poverty line from 2022–23, uprated by CPI.

The two-child limit and benefit cap effectively represent caps on separate parts of the benefit system, one on child support and the other on housing support. The case for maintaining the benefit cap arguably becomes weaker as the two-child limit is fully rolled out – since fewer families are affected, its removal becomes cheaper, and those that remain affected are seeing a particularly large reduction in their benefit entitlement, relative to their needs incurred due to having both many children and high housing costs.

As an example of these interactions between different policies, Table 6.4 considers a lone parent with three young children. Suppose they were living in social rented accommodation paying about £6,000 a year in rent and not in paid work. They would be eligible for a £4,721 per year standard allowance, plus £10,365 of child element in the absence of the two-child limit (i.e. if all

their children were born before 6 April 2017). They would also receive £3,102 in child benefit, typically have their rent fully covered through universal credit, and receive support for most or all of their council tax (Latimer and Waters, 2024). They would also be eligible for the £545 a year family premium. This would give them an income after housing costs of £18,733. The value of free school meals (if all their children receive them) would take their income to £20,175, above the poverty line (which for this family would be £19,756). But under the two-child limit and removal of the family premium, their income is further reduced by £4,000 or 20%, pushing them into poverty. And even in the absence of these two policies, the household benefit cap would kick in and reduce their income by £2,713 or 13%.

Expand eligibility to free school meals

Free school meals are offered to all state-educated children in England in Reception, Year 1 and Year 2, during term time. They are also available to older children if their families receive means-tested benefits and earn no more than £7,400 a year – just under 25% of pupils in England (Cribb et al., 2023). Unlike some other kinds of non-cash support that low-income families receive, free school meals are included in official income statistics (valued at £2.53 per meal) and therefore have a bearing on the measured poverty rate.

Options for reducing poverty by expanding free school meal eligibility could include increasing the income threshold for universal credit recipients (as is the case in Northern Ireland) or removing the threshold entirely or making them universal.⁷ Free school meals are already offered regardless of income to primary children of older ages in state schools in Wales, Scotland and London due to devolved and local government policy. Whilst expanding free school meals universally would be a less well-targeted approach, it would come with the advantage of removing the cliff-edge in eligibility that currently exists for families subject to means testing – whereby lone parents with three children face the prospect of losing meals valued at around £1,400 by earning even a penny over £7,400 – as well as other potential advantages, such as reducing stigma and improving take-up (Cribb et al., 2023),

Impact of policy options on poverty rate and disposable income

We now compare the costs to the exchequer, and impact on household incomes and poverty, of various policy options, based on the above discussion.

To carry out this exercise, we use data from the Family Resources Survey – the survey used to calculate official income and poverty statistics – and calculate the benefit entitlements of each household. We then calculate how these entitlements would change under various policies based

⁷ The government could also expand access to free school meals to the school holidays, though in practice the Household Support Fund is used for this purpose already.

on the above discussion. Finally, we apply an adjustment to account for the fact that not everyone who is entitled to a benefit will take it up. See Appendix 6B for further technical details of adjustments we make to the data.

Table 6.5 shows, for each policy, the total cost (and, of that, the value of the increase in benefits going to various types of households with children), the number of children lifted out of absolute poverty, the cost per child lifted out of poverty and the reduction in overall absolute poverty. This exercise focuses on absolute poverty, because some of the policies could affect median incomes and therefore the relative poverty line. Measuring the change in absolute poverty allows us to focus solely on the impact on poorer children's household incomes. The table shows the impact of these policy measures once the two-child limit and removal of the family premium are fully rolled out (which in fact is not scheduled to occur until 2035).

First looking at the two-child limit, its removal would eventually cost the government £2.5 billion a year and lift around 540,000 children out of absolute poverty. At £4,510 per child brought out of poverty, this is the most cost-effective child poverty reduction policy of those we model. It is perhaps unsurprising that removal of the two-child limit has such a potent effect on this measure, given the extent of poverty amongst children in large families, as described in Section 6.2. The price tag of £2.5 billion is not a trivial sum, reflecting that affected families can gain up to an additional £3,455 per child per year – for example, a household with five children could see their income grow by over £10,000 a year (unless subject to the benefit cap). But this cost would be well targeted at lower-income children, and children in poverty in particular. The household benefit cap significantly dampens the impact of removing the policy – if the household benefit cap were removed as well, the policy would bring 620,000 children out of poverty, though at a much higher cost of £3.3 billion, and a higher cost per child lifted out of poverty as well.

Note and Source for Table 6.5

Note: The baseline simulated absolute child poverty rate, assuming full roll-out of the two-child limit and removal of the family premium, is 23%. Northern Ireland is not included in this analysis.

Source: Authors' calculations using Family Resources Survey 2022–23 and TAXBEN (the IFS tax–benefit microsimulation model).

Table 6.5. Cost and impact on absolute poverty of various benefit policy measures, ordered by cost per child brought out of poverty

Policy	Annual cost	Of which transfers to households with children in poverty	Of which transfers to households with children in poorest 40% not in poverty	Of which transfers to households with children in richest 60%	Reduction in child poverty, '000s (ppt change)	Annual cost per child brought out of poverty	Reduction in overall poverty, '000s (ppt change)
Remove two-child limit	£2,450m	59%	40%	1%	540 (4 ppt)	£4,510	780 (1 ppt)
Remove two-child limit and household benefit cap	£3,340m	63%	31%	1%	620 (4 ppt)	£5,400	880 (1 ppt)
Remove household benefit cap and two-child limit, and increase child element of UC by £26.70 p.w.	£9,180m	51%	42%	4%	1,189 (8 ppt)	£7,730	1,820 (3 ppt)
Give young parents same standard allowance as older parents	£100m	61%	33%	7%	10 (0 ppt)	£8,810	20 (0 ppt)
Expand free school meals to all children of families on UC	£1,110m	38%	52%	9%	110 (1 ppt)	£10,210	190 (0 ppt)
Increase LHA rates to 50 th percentile of local rents	£450m	21%	34%	5%	40 (0 ppt)	£11,040	90 (0 ppt)
Increase child element of UC by £26.70 p.w.	£4,320m	36%	55%	8%	380 (3 ppt)	£11,410	660 (1 ppt)
Reinstate family premium (£545 p.a.)	£1,110m	37%	53%	10%	90 (1 ppt)	£12,750	170 (0 ppt)
Increase child benefit by £26.70 p.w. for each child	£15,270m	26%	36%	39%	867 (6 ppt)	£17,620	1,500 (2 ppt)
Expand free school meals to all children aged under 18	£3,160m	16%	29%	55%	120 (1 ppt)	£27,360	200 (0 ppt)
Remove household benefit cap	£480m	61%	1%	0%	10 (0 ppt)	£46,560	20 (0 ppt)
Remove under-occupancy charge	£490m	7%	12%	1%	0 (0 ppt)	£102,670	30 (0 ppt)

The following policies cost between £8,800 and £12,800 per child brought out of poverty, and so in that sense are moderately ‘cost-effective’ at reducing the poverty rate: increasing LHA rates; increasing the child element of universal credit; restoring the family premium; increasing the standard allowance for young parents; and expanding free school meals to all on universal credit.⁸ However, the policies differ in terms of who they target – increasing the child element of universal credit or restoring the family premium would spread the benefit fairly broadly among poorer children, whereas increasing LHA rates would benefit only private renting families (and 40% of the cash would go to households without children); expanding free school meals would not benefit pre-school children or younger primary school pupils who are already provided with free school meals universally, while increasing the standard allowance for young parents would be very narrowly targeted at a specific group (parents aged under 25, and would naturally therefore also be targeted at younger children).

The least cost-effective policy for reducing child poverty among those shown is removing the under-occupancy charge (‘bedroom tax’). Very few children in poverty are affected by the under-occupancy charge, so abolishing it would lift very few out of poverty, though it would lift out 30,000 adults.

Another policy shown to have poor cost-effectiveness in reducing child poverty is abolishing the household benefit cap (without other policy changes), with a cost of almost £47,000 per child brought out of poverty. This is not to say that removing the household benefit cap would be ineffective at supporting poorer children’s living standards. In fact, Table 6.5 shows that 61% of the spending on removing the household benefit cap would go to children in absolute poverty, essentially the same proportion as for removing the two-child limit (59%). Additionally, abolishing the household benefit cap would provide a boost to the household incomes of children affected by the policy of just over £4,730 a year on average, as shown in Table 6.6. This is a higher per-household amount than for removing the two-child limit, albeit reaching far fewer households.

The child poverty rate is a valuable measure allowing us to summarise how poorer children’s living standards have evolved over time, both in absolute terms and relative to middle-income families. Indeed, targets based on this measure were set by the UK government under New Labour, and these were then enshrined in law in 2010, before being dropped by the Conservative-led coalition government in 2015. The child poverty rate is still targeted by the Scottish government, and various policies – most notably, the Scottish Child Payment – have been pursued in order to meet the goal of reducing it.

⁸ See the first column of Table 6.5 for details of these modelled policies.

Table 6.6. Impact on disposable incomes of various benefit policy measures, among households with children

Policy	Number of households with children affected (thousands)	Average income change among affected households with children (per year)	% income change among affected households with children
Remove two-child limit	660	£3,710	13%
Remove two-child limit and household benefit cap	760	£4,430	17%
Remove household benefit cap and two-child limit, and increase child element of universal credit by £26.70 a week	3,020	£3,050	12%
Give young parents same standard allowance as older parents	100	£990	5%
Expand free school meals to all on universal credit	1,480	£750	3%
Increase LHA rates to 50 th percentile of local rents	950	£480	3%
Increase child element of universal credit by £26.70 a week	2,920	£1,480	6%
Reinstate family premium (£545 per year)	2,690	£420	2%
Increase child benefit by £26.70 a week for each child	6,670	£2,300	6%
Expand free school meals to all children aged under 18	4,350	£730	1%
Remove household benefit cap	100	£4,730	33%
Remove under-occupancy charge	530	£940	6%

Note: The results assume full roll-out of the two-child limit and removal of the family premium. Northern Ireland is not included in this analysis.

Source: Authors' calculations using Family Resources Survey 2022–23 and TAXBEN (the IFS tax–benefit microsimulation model).

However, whilst a valuable summary measure, the poverty line is necessarily arbitrarily drawn. There is nothing special about 60% of current median income (the relative poverty line) nor about 60% of the 2010 median real income (the absolute poverty line). Hence, focusing entirely

on that line can in some ways be misleading: a policy that takes large numbers of children from just below the poverty line to just above could have a significant impact on the headline poverty rates while making little difference to anyone's living standards. In contrast, another policy might significantly boost the incomes of many households just above the poverty line, or well below it, but make little difference to the headline poverty rate.

Table 6.7. Impact on child deep absolute poverty (real household income below 40% of 2010 median) of various benefit policy measures

Policy	Reduction in child deep poverty, '000s (ppt change)	Cost per child brought out of deep poverty (per year)
Remove two-child limit	110 (1 ppt)	£22,050
Remove two-child limit and household benefit cap	210 (2 ppt)	£15,770
Remove household benefit cap and two-child limit, and increase child element of universal credit by £26.70 a week	300 (2 ppt)	£30,930
Give young parents same standard allowance as older parents	10 (0 ppt)	£6,600
Expand free school meals to all on universal credit	10 (0 ppt)	£76,590
Increase LHA rates to 50 th percentile of local rents	10 (0 ppt)	£59,340
Increase child element of universal credit by £26.70 a week	120 (1 ppt)	£36,210
Reinstate family premium (£545 per year)	40 (0 ppt)	£28,790
Increase child benefit by £26.70 a week for each child	290 (2 ppt)	£52,720
Expand free school meals to all children aged under 18	20 (0 ppt)	£152,950
Remove household benefit cap	30 (0 ppt)	£13,850
Remove under-occupancy charge	10 (0 ppt)	£70,060

Note: The baseline simulated absolute child deep poverty rate, assuming full roll-out of the two-child limit and removal of the family premium, is 7%. Northern Ireland is not included in this analysis.

Source: Authors' calculations using Family Resources Survey 2022–23 and TAXBEN (the IFS tax–benefit microsimulation model).

Another way of illustrating this point is to consider how an analysis of the impact of policies on poverty would change if the poverty line were drawn elsewhere. Table 6.7 shows the impact of the various benefit policies we considered above on the proportion of children in deep poverty, here defined as having a real income below 40% of 2010 median income.

Abolishing the household benefit cap would take 30,000 children out of deep poverty and would do so far more cost-effectively than abolishing the two-child limit, at a cost per child of £13,850 compared with £22,050. Households affected by the household benefit cap tend to be much further below the 60% poverty line. Consequently, while abolishing the two-child limit would boost affected households' incomes by 13% (see Table 6.6), abolishing the benefit cap would confer a much larger proportional increase in incomes of 33% to the (fewer, and poorer) households affected by that policy. But it is also much less likely that this would be enough to bring them above the 60% poverty line, because they tend to be so far below it. Abolishing both the two-child limit and the household benefit cap would reduce the number of children in deep poverty by over 210,000 (or 2 percentage points, compared with a baseline of 7%). Increasing LHA rates looks rather less effective on this measure. Its cost-effectiveness at reducing official child poverty rates, despite much of the cash going to families without children, would come from the fact that it gives a relatively small boost to the incomes of many households with children who are just below the poverty line.

These examples illustrate the importance of considering a policy's impact across the income distribution, and not just on one binary measure.

Again, it is important to note that these policies will have differing effects on work incentives. The policies that are most directly targeted at lower-income families, and therefore at reducing poverty or its depth, are likely to be the ones that weaken those incentives the most. Unlike during the more favourable economic conditions of the early 2000s, it will be very challenging for the government to mitigate any such reforms through concurrent large expansions of in-work benefits.

6.4 How can labour market policy impact the child poverty rate?

The benefits system is not the only means of increasing the incomes of low-income families. The Labour government has said it is targeting a significant increase in the employment rate to 80%, up from 75% at present – equivalent to a rise of 2.2 million people. This target is very ambitious: it would imply a rise in employment roughly equal to that seen between the depths of the Great Recession and the pre-pandemic peak. The historical peak employment rate was

76.2%, right before the pandemic in February 2020, and the Office for Budget Responsibility is not currently forecasting any large increase to employment.

There are plenty of reasons the government might want to raise the employment rate. One possible reason would be to contribute to goals around child poverty. This contribution could be both direct, by increasing the incomes of parents, and indirect – for example, by increasing parents’ labour market experience and therefore long-term earnings potential. How much it might contribute to reducing child poverty would depend to some degree on how increased employment was achieved and on precisely who is moved into paid work. For example, there would obviously be less effect on child poverty if many of those brought into employment are parents in households already above the poverty line or if many are non-parents. Indeed, in these cases, measures of relative child poverty could rise. But there is scope here for moving the dial on child poverty: as discussed in Section 6.2, the rate of child poverty is much lower among working households than among non-working households (19% versus 64% in absolute poverty).

With these uncertainties in mind, we have assessed a scenario for how child poverty might change if this employment target were reached. Our approach is as follows. We take the Family Resources Survey, and randomly select working-age individuals who are not in paid work (excluding lone parents or one parent in each couple with children under the age of 1, who are relatively unlikely to enter paid work). We then predict what their earnings might be if they moved into employment (based upon their characteristics – education, work experience, age, sex, region and lone-parent status – and the observed relationship between those characteristics and weekly earnings among employees). Finally, using TAXBEN, the IFS tax–benefit microsimulation model, we calculate what their in-work tax liabilities and benefit entitlements would be. This gives us the estimated change in their household income, and therefore the poverty rate, were they to move into paid work. For fuller details, see Appendix 6B.

Of course, not everyone is equally likely to be brought into work if there is a big increase in the employment rate. For example, we might expect those with long-term health conditions to be less likely to move into paid work. However, with the disability benefits bill rising considerably, the Labour Party manifesto stated a specific intention to ‘support more disabled people and those with health conditions into work’.⁹ As out-of-work individuals with long-term health conditions are less likely to have dependent children compared with out-of-work adults who do not have a long-standing health condition, who exactly is targeted will be an important factor in deciding how effective increasing the employment rate is at reducing child poverty. Table 6.8 shows illustrative results for two different possibilities. In the first row, we assume that the new

⁹ <https://labour.org.uk/change/kickstart-economic-growth/>.

workers are drawn from all working-age adults currently not in paid work (with equal probability, allowing their predicted earnings to depend on health status). In the second row, we assume that, once again, new workers are drawn from all working-age adults currently not in paid work; however, this time, individuals who have long-standing health problems are only half as likely to move into work. In the bottom row, we assume that only those not reporting long-term health conditions move into work.

Table 6.8. Possible impact of increase in employment on child absolute poverty

Scenario	Reduction in absolute child poverty, thousands (percentage point change)
New workers drawn from all of working age	230 (1.6 ppt)
New workers drawn from all of working age, with working-age individuals with long-standing health problems half as likely to move into work	280 (2.0 ppt)
New workers only drawn from working-age individuals without long-standing health problems	340 (2.4 ppt)

Note: The baseline simulated absolute child poverty rate, assuming full roll-out of the two-child limit and removal of the family premium, is 23%. Northern Ireland is not included in this analysis.

Source: Authors' calculations using Family Resources Survey 2022–23 and TAXBEN (the IFS tax–benefit microsimulation model).

The results show that the number of children who would be brought out of poverty is somewhat sensitive to who moves into employment – and, in any case, this is only one illustrative scenario, so one should not attach too much significance to these precise numbers. But a plausible number is a couple of hundred thousand children moving out of absolute poverty. However, it should be noted that the effect on relative poverty is even less clear-cut; as the employment rate increases, average household income will likely rise, which would move the relative poverty line up (whereas the absolute poverty line is fixed). Even if most of the entries into employment are into low-paid work, other members of the household may still bring total household income close to or above the median, so the relative poverty line could still move up. This could lead to either a fall or an increase in relative poverty, depending on the balance between households moving below the poverty line as it rises and households moving above it because of a boost to household income due to employment. Our simulations show a small fall in relative poverty rates, much smaller than the fall in absolute poverty rates.

The results for absolute poverty are middling compared with the benefit policies described above, despite a very large increase in employment. Part of this is because only 18% of working-age adults who are out of work (excluding main carers of children aged under 1) have children

and are below the absolute poverty line, so a broadly focused drive to increase employment is simply not targeted at this group.

Another factor limiting any policy aiming to reduce child poverty by moving parents into paid work is that many lone parents who might move into work (those who are most likely to be in poverty) would be expected to go into lower-paid or part-time work (which is accounted for in our modelling). This reduces the potential for moves into employment to lift families out of poverty. For example, Codreanu and Waters (2023) found that following reforms requiring lone parents on benefits to move into paid work, almost all who did move into work went into part-time low-paid jobs.

But once again, if the government achieves broad increases in employment, this will have wider benefits beyond reducing child poverty, including providing substantial income boosts to families with children who might already be above the poverty line, and increasing revenues for the government as benefit entitlements fall and tax liabilities increase. Benefit increases, on the other hand, would add to spending and therefore require increased borrowing, tax rises, or cuts elsewhere.

Another approach to reducing child poverty through the labour market could be increasing the minimum wage. Two-thirds of children in poverty are already in working families, so increases in earnings have the potential to increase the household incomes of many poorer children. Further increases to the minimum wage are one possible means of achieving this (albeit only benefiting children whose parents are employed). Minimum wages provide a means of directly increasing the earnings and therefore household incomes of lower-earning employees, with the cost falling on employers (some of which may be passed on, for example, through price increases). One risk of raising the minimum wage is a reduction in employment. So far, there is little evidence of any large adverse effect on employment from previous large rises in the minimum wage (e.g. Giupponi et al., 2024), but that does not guarantee further increases would not have such an effect.

Another perhaps more immediate limitation of such an approach is that, while increasing the minimum wage would be well targeted at employees who are on low hourly wages, this does not necessarily mean it would be well targeted at households – and in particular households with children – that have low disposable incomes. Minimum wage workers are often second (or even third) earners in households, often in the middle of the income distribution (and hence already out of poverty), so the majority of beneficiaries would not be in poorer households. Moreover, since lower-income households, and particularly lower-income households with children, are more likely to be receiving benefits while in work, they tend to keep less of any earnings increase than middle-income households, since as well as paying tax on the additional earnings they also see some of their benefits withdrawn. This means that the minority of beneficiaries

from a minimum wage increase who are in poorer households will often see less of a gain than beneficiaries in households that are less poor.

Indeed, Giupponi et al. (2024) show that it is middle-income households who see the largest cash income increases as a result of minimum wage rises. This decreases the effectiveness of minimum wage rises in reducing absolute poverty, and may mean they actually increase relative poverty, by boosting incomes at the median.

In summary, increases to the minimum wage would not be particularly well targeted at those with the lowest household incomes. They might be an effective instrument for achieving other policy objectives but are unlikely to be sufficient to deliver ambitious reductions in child poverty.

6.5 Conclusion

The government is developing a strategy to reduce child poverty, which is due to be published in the spring, and will be considering a range of policy options. This chapter has shown that some groups of children are at significantly higher risk of poverty than others, such as those in large families, those in workless households and those living in rented accommodation, with implications for the sorts of policies that will be most effective at reducing child poverty.

Options open to the government through labour market policy are unlikely to be well targeted at reducing child poverty – though they may have other desirable outcomes. Increases to the minimum wage provide larger boosts to household incomes in the middle of the income distribution than at the bottom. Increases to employment may bring some children out of poverty (around 200,000 to 350,000 by our estimates) but this relies on the government achieving its very ambitious goal to increase the employment rate to 80%. Efforts to incentivise parents in particular into work in the past have often led to them entering low-paid and part-time work.

Among the options available to the government on benefits policy, removing the two-child limit would be the single most cost-effective policy at reducing the number of children classified as in poverty. It would be a policy well targeted at the group who have driven the rise in child poverty in recent years and would provide a big boost to their incomes. It would cost about £2.5 billion a year in the medium term. But to evaluate policy options solely on that metric would miss important considerations when determining the best way to support poorer children.

The official measure of poverty is a binary indicator, but poverty is experienced in varying depths, and different policies will affect the depth of poverty in different ways. For example, scrapping the two-child limit alone would significantly reduce the number below the poverty line, but many of the poorest households affected by the policy would benefit less than those

closer to the poverty line, as the household benefit cap would prevent them receiving the full additional child element. Removing the household benefit cap alone – at a cost of about £0.5 billion a year – would not lift as many above the poverty line but would target a smaller and much poorer group of children and give the average affected household a proportionally larger increase in income. Removing both policies would have a larger effect still, albeit at significantly increased eventual cost of £3.3 billion a year.

Therefore, when the government chooses which policies to pursue to reduce child poverty, and when the impact of these policies is evaluated, effects across the distribution of incomes should be considered, not just around the official poverty line.

Appendix 6A. The treatment of housing costs¹⁰

The analysis in this chapter is chiefly based on data from the Family Resources Survey (FRS), a survey of around 20,000 households a year, which contains detailed information on different sources of household incomes. We use household income variables derived from the FRS by the Department for Work and Pensions (DWP). These measures of incomes underlie DWP's annual statistics on the distribution of income, known as 'Households Below Average Income' (HBAI).

The key housing costs captured in the HBAI data are rent payments and mortgage interest payments, but they also include water rates, community water charges, council water charges, structural insurance premiums for owner-occupiers, and ground rents and service charges. Mortgage capital repayments are not included, on the basis that these represent the accumulation of an asset (they increase net housing wealth) and are therefore better thought of as a form of saving than as a cost of housing. Costs such as maintenance, repairs and contents insurance are also not included.

When looking at changes in living standards, there is a case for focusing on income measured before housing costs are deducted (BHC). This is because most individuals exercise a choice over housing cost and quality, at least in the medium and long terms, and for those individuals housing should be treated as a good like any other (i.e. the amount that households choose to spend on it should not be deducted from income). For instance, consider two households with the same BHC income, one of which decides to spend a larger fraction of that income on a larger house in a better neighbourhood, while the other has different preferences and chooses to spend the difference on other things. On an after-housing-costs (AHC) basis, the former household would be considered poorer, but we might consider their living standards to be comparable.

¹⁰ This appendix draws heavily on appendix A in Cribb et al. (2024).

There are, however, a number of reasons to focus on income measured AHC in certain circumstances.

First, income measured AHC may provide a better indicator of the living standards of those who do not face genuine choices over their housing, particularly if housing cost differentials do not accurately reflect differences in housing quality. This is likely to be the case for many in the social rented sector, where individuals tend to have little choice over their housing and where rents have often been set with little reference to housing quality or the prevailing market rents.

Second, the existence of housing benefit means that measuring income AHC has an advantage over BHC as a measure of living standards for housing benefit recipients. This is because housing benefit reimburses individuals specifically for their rent. Consider a household with no private income whose rent increases by £10 per week. This might trigger a £10 increase in housing benefit entitlement to cover the rent increase. Hence, AHC income would remain unchanged but BHC income would increase by £10 per week. Therefore, where rent changes do not reflect changes in housing quality – for example, when they simply reflect changes in the rules governing social rents – the subsequent changes in BHC (but not AHC) income can give a misleading impression of the change in living standards of households on housing benefit.

Third, measuring income AHC may be more appropriate than measuring it BHC when comparing households that own their home outright (and so pay no rent or mortgage interest costs) with those that do not. On a BHC basis, an individual who owns their house outright will be treated as being as well off as an otherwise-identical individual who is still paying off a mortgage; an AHC measure, though, would indicate that the former was better off.¹¹ This is particularly important when comparing incomes across age groups – pensioners are much more likely to own their homes outright than working-age adults.

Fourth, comparing changes in AHC incomes may provide better information about relative changes in living standards when some households have seen large changes in their housing costs that are unrelated to changes in housing quality. This is particularly relevant when looking at the period between 2007–08 and 2009–10, as rapid falls in mortgage interest rates reduced the housing costs of those with a mortgage significantly, while the housing costs of those who rent their homes (or own them outright) were not directly affected. When incomes are measured BHC, changes over time in the incomes of all households are adjusted for inflation using a price index that accounts only for *average* housing costs. This will understate the effect of falling housing costs on living standards for those with a mortgage and overstate it for those without a

¹¹ A conceptually better solution to this problem would be to impute an income from owner-occupation and add this to BHC income. Unlike the AHC measure, this would also capture the benefits to individuals of living in better-quality housing. See Brewer and O’Dea (2012) for an example of such an imputation procedure.

mortgage. Changes in income measured AHC do not suffer from this issue, since changes in housing costs are accounted for by subtracting each household's actual housing costs from its income. This difference is important to bear in mind when looking at changes in poverty and inequality. Those towards the bottom of the income distribution (around the poverty line), as well as the youngest and oldest adults, are less likely than average to have a mortgage.

Appendix 6B. Technical appendix

Benefit take-up adjustments

To carry out the policy analysis in this chapter, we use the Family Resources Survey (FRS) in conjunction with TAXBEN, the IFS tax and benefit microsimulation model. TAXBEN calculates the tax liabilities, benefit entitlements and net incomes of individual households for current and historical tax and benefit systems as well as hypothetical systems. Calculations in TAXBEN are usually on an 'entitlements basis', estimating net incomes based on the assumption that families claim all the benefits that they are entitled to. However, in reality, this might not be the case. Instead, we can also calculate net incomes on a 'reported take-up basis', which means that we assign individuals' net incomes based on what they report that they are claiming in the FRS. We take this approach in the analysis for this chapter. The true take-up of benefits is somewhere between reported take-up and full take-up (entitlements): some people do not claim the benefits to which they are entitled, while others do take up benefits but neglect to say so in the household survey. Thus, our estimates may be an underestimate of the overall effects of changes in benefits policy.

Estimating the effect of an increase in the employment rate

As part of our analysis, we model the effects of an increase in the employment rate to the Labour government's target of 80%. We do this in three steps.

First, we estimate the employment earnings of those who are currently not in work (and are also of working age and not in full-time education). We do this by first using a simple Mincer-style regression of those who are in employment. The model we estimate is specified below:

$$\log(Y) = a + \beta S + \epsilon W + \gamma W^2 + \delta X$$

We estimate log earnings, Y , as a function of years of schooling, S , quadratic years of work experience, W , and a vector of characteristics that include age, gender interacted with whether the person has children and if so is a lone parent or in a couple, the region they live in and housing tenure. For the specifications that include individuals with long-standing health problems, we also include an indicator for this as a control. We estimate this model on a sample of working-age adults who are in work and not in full-time education. Once we have estimated

the model, we predict the earnings of those who are not in work (but are also of working age and not in full-time education), were they to enter employment, using propensity mean matching.

Second, we take a random sample of those who are out of work to move into employment, with the sample size selected to meet the employment rate target of 80%. For the specification with no individuals with long-standing health problems moving into employment, the sample is taken from all out-of-work individuals of working age who are not in full-time education and who do not have long-standing health problems. We also do not include the lowest-earning parent of young children (under the age of 1), or lone parents of children under 1.

Finally, we run this modified dataset, containing both the actual reported earnings of those in work and the predicted earnings of the subset of out-of-work individuals we have chosen to move into work, through our tax and benefit microsimulation model, TAXBEN.

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7. Capital gains tax reform

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Key findings

1. **Capital gains tax (CGT) raises around £15 billion per year, less than 2% of total tax revenue.** Revenues have risen significantly over time and are forecast to rise further, partly reflecting the increasing role of wealth accumulation in the UK economy.
2. CGT is paid by around 350,000 people (0.65% of the adult population). **3% of CGT taxpayers realised gains of more than £1 million and this group accounted for two-thirds of CGT revenue.** The average gain among this group of 12,000 people (0.02% of the adult population) was £4 million. Around half of taxable gains relate to unlisted shares in private businesses.
3. CGT rates vary across assets. They are lower than tax rates on earned income and, in most cases, income from capital. These **rate differentials are unfair and create a range of undesirable distortions.**
4. **The design of the tax base is flawed.** Ultimately, by discouraging saving, investment and risk-taking and distorting who holds assets and for how long, it reduces productivity and well-being.
5. Higher rates of CGT would worsen these problems caused by the tax base. But keeping tax rates low cannot solve those problems. **There is a strong case for reform.**

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6. **The tax base could be reformed so that CGT does little to discourage saving and investment.** This requires giving more generous deductions for purchase costs and losses. There are several ways to do this in practice.
7. Ultimately, **we advocate aligning marginal tax rates across all forms of gains and income, while reforming the tax base.** Tax rates could be aligned at any level; for example, rates on capital gains (and capital income) could be increased while rates on employment income were reduced. In practice, the 'big-picture' solution we set out would include substantially higher CGT rates.
8. **Higher CGT rates would increase the incentive for people to leave the UK before realising gains to avoid UK CGT.** One option to address this would be to tax people emigrating from the UK on their accrued but unrealised gains, whilst exempting new arrivals from UK CGT on gains they made whilst living abroad. There are challenges with this approach, but it is operated by some other countries.
9. Steps could be taken towards a better-designed system. Low CGT rates on business assets are poorly targeted at entrepreneurship. They lead to more money being held in companies, but do not achieve the commonly stated policy goal of increasing owner-managers' investment in their own businesses. **Business asset disposal relief should be scrapped in favour of more generous deductions for investment costs. Removing CGT uplift (or 'forgiveness') at death should also be a priority.**
10. **The government should seek to make reform credibly lasting.** It should set out clear principles and a rationale for reform and commit to the new regime for the length of the parliament. Instability and unpredictability are bad for investment.

7.1 Introduction

There is widespread speculation in the run-up to her first Budget that the new Chancellor, Rachel Reeves, will raise capital gains tax (CGT).

Increasing CGT is one option that was not ruled out in the Labour Party manifesto. And it is easy to explain the inequities that arise from taxing capital gains at substantially lower rates than earned income and, in most cases, capital income. Taxable capital gains are heavily concentrated at the top of the income distribution and those receiving gains pay much lower tax rates than people receiving similar amounts but in the form of employment income.

However, at first glance, CGT might not seem like an obvious choice for a Chancellor looking to raise significant sums. According to official estimates of the revenue effects of different tax changes produced by HM Revenue and Customs (HMRC), a 1 percentage point increase in the higher rates of capital gains tax in April 2025 would raise a measly £100 million in 2027–28 while a 10 percentage point increase would actually *reduce* revenue by about £2 billion that year.

In the absence of sufficient information as to how these estimates are produced, it is difficult to assess their credibility. Our view is that HMRC's published estimates are not a good guide to the revenue effect over a longer time horizon and that a rise in CGT rates would, up to a point, raise revenue in the medium run. But increasing headline rates in isolation would involve difficult trade-offs. More revenue would be raised, and with tax rates on capital gains closer to tax rates on income, there would be less distortion to how people chose to work and to take their income. But distortions created by the tax base – the definition of what is subject to tax – would be worsened. Among other things, higher rates would increase unwelcome distortions to commercial decisions about how much to save and invest, which assets to choose and how long to hold them for (see Section 7.3).

Removing the harmful distortions created by the poor design of the UK's CGT should be a key focus of policy. CGT creates unfairness by arbitrarily favouring one action over another and thereby penalising otherwise-equivalent people who behave in the tax-disadvantaged way.

CGT also creates economic inefficiency. The cost to taxpayers of CGT is not just the money they hand over and the resources they spend complying with their obligations, but the lower well-being that results when CGT leads them to change how they behave. For example, there is a cost to people when they hold on to assets for longer than they would want to absent tax considerations. People also waste time and resources undertaking legal arrangements aimed at saving tax by repackaging income into capital gains. And because it leads to reduced investment and skewed patterns of capital allocation, CGT acts to lower productivity. We are collectively made poorer by a poorly designed CGT.

The good news for Ms Reeves is that the tax base could be reformed to greatly reduce – and in some cases largely remove – the distortions to saving, investment and risk-taking. In short, this would require giving more generous deductions for purchase costs and losses and removing CGT uplift (or 'forgiveness') at death. There are several ways that base reforms could be achieved in practice. With a reformed tax base, tax rates could be increased with much less distortion to choices over whether, when or how to invest. We summarise a 'big-picture solution' that involves reforming the tax base while aligning overall marginal tax rates across *all* forms of gains and income (see Section 7.5). This would represent a major change in tax policy, but also offers a significant prize. Importantly, reforming CGT would be worthwhile in its own

right: regardless of how much revenue the government would like to raise, it could raise it in a way that was fairer and less damaging to economic growth and well-being. Reform is even more important if the government wishes to raise additional revenue.

The UK currently charges CGT on disposals that an individual makes while they are UK-resident. Higher CGT rates would increase the incentive for those who have accrued large gains to move to a lower-tax country – to retire abroad, for example – before realising them. One option to mitigate this incentive would be to introduce ‘deemed disposal on departure’ for CGT purposes, matched by ‘rebasings on arrival’ for new arrivals (Section 7.5). Effectively, this would move to taxing gains that *accrued* while a person was living in the UK, rather than those *realised* here. There are challenges with this approach, but it is already operated by some other countries.

If the government chooses to reform only some rates or elements of CGT, there would be inevitable trade-offs that require careful management (Section 7.6). But there are smaller steps that could be taken in the right direction. For example, we describe a reform that would include removing business asset disposal (BAD) relief – a preferential CGT rate for business owner-managers which is not well targeted at entrepreneurship and leads to a range of undesirable distortions – alongside giving up-front tax relief for investment in shares. The new up-front relief could be thought of as a replacement for BAD relief – a reorienting away from tax relief on large gains to tax relief on investment. Empirical evidence suggests that implementing the two measures together would boost investment and raise revenue. It would be a progressive change: revenue would be raised from the top of the income distribution, while recipients of the new relief are less well off: those investing the most, rather than those making the biggest gains, would benefit most.

Reforming the tax base at the same time as increasing rates would create winners as well as losers (see Section 7.8). Those making relatively low returns (e.g. those making low-risk arm’s-length investments and those taking risks that do not pay off) would pay less tax. Those making very high returns – which could reflect some combination of effort and skill, privileged access to scarce opportunities, and luck – would pay more. But note that raising taxes on high returns could equally be described as removing the tax advantages they receive under the current tax system. We do not take a view on how high tax rates should be, but there is no good reason to tax work less heavily if it generates a capital gain than if it generates employment income.

Whatever changes are made to CGT, a decision would have to be made on the transitional arrangements for existing accrued gains (see Section 7.7). Specifically, to what extent would any benefits of a narrower base and any costs of higher rates be applied to gains that have already been accrued but not yet realised? Giving more generous allowances for past investments would come with a cost but not improve incentives. Applying higher tax rates to past gains would be an

efficient way to raise revenue. But it may lead to objections that it is retrospective – though almost all tax increases are retrospective to some degree.

7.2 What is CGT and who pays it?

What is capital gains tax?

CGT is a tax on the increase in the value of an asset between its acquisition and its disposal. Broadly speaking, this means its sale price minus its purchase price.² If an asset is held until death, any capital gain up to that point is subject to uplift (the tax is ‘forgiven’): the deceased’s estate is not liable for tax on any increase in the value of assets prior to death, and those inheriting the assets are deemed to acquire them at their market value at the date of death.

CGT only applies to assets sold by individuals and trustees; gains made by companies are included in profits and subject to corporation tax. The rest of this chapter focuses exclusively on capital gains made by individuals.

Not all assets are subject to capital gains tax. Most notably, increases in the value of owner-occupied homes are exempt from CGT. There is also no CGT charged on assets held within pension funds or Individual Savings Accounts (ISAs) and there are reliefs for various venture capital and employee share schemes.³

Broadly, CGT is based on where people live when they realise capital gains. As such, people who move to the UK can – in principle – be taxed on gains that accrued before they came (though in practice there is a ‘grace period’ during which they are not taxed on gains made on overseas assets), and people who leave the UK can avoid UK tax on gains that accrued while they were here. We return to the specific details below.

As with income tax, there is an annual threshold below which CGT does not have to be paid. In 2024–25, this ‘annual exempt amount’ is £3,000 (having been reduced from £12,300 in 2022–23). This is subtracted from total annual capital gains before calculating the tax due.

² Assets that are acquired or disposed of in other ways (e.g. gifts) are assigned a market value. Transfers to a spouse or civil partner do not trigger a CGT liability: roughly speaking, the recipient is treated as if he or she were the original purchaser of the asset, at the original acquisition date and price.

³ Schemes with CGT advantages include the Enterprise Investment Scheme, Seed Enterprise Investment Scheme and social investment tax relief (see <https://www.gov.uk/guidance/venture-capital-schemes-tax-relief-for-investors> for an introduction), share incentive plans (<https://www.gov.uk/tax-employee-share-schemes/share-incentive-plans-sips>) and employee ownership trusts (<https://www.gov.uk/government/consultations/taxation-of-employee-ownership-trusts-and-employee-benefit-trusts>).

Table 7.1. Capital gains tax rates, 2024–25

Source of gains	Basic rate	Higher rate	Additional rate
Carried interest	18%	28%	28%
Residential property	18%	24%	24%
Business asset disposal relief and investors' relief	10%	10%	10%
Other assets	10%	20%	20%
Exempt assets, and all gains unrealised at death	0%	0%	0%

Source: HMRC.

From April 2024, there are five CGT rate schedules depending on the source of the capital gain (see Table 7.1).

Carried interest is the share of profits from a private equity fund that is paid (in the form of capital gains) to private equity managers – it is effectively a performance fee. Carried interest faces a higher rate of 28%. Business asset disposal (BAD) relief is a preferential 10% tax rate that applies to capital gains on owner-managers' shares in their companies, up to a limit of £1 million of lifetime gains from owner-managed businesses. Investors' relief similarly provides a 10% CGT rate for *external* investors in unlisted trading companies if they hold the shares for at least three years, up to a lifetime limit of £10 million.

Box 7.1. A potted history of capital gains tax

CGT was introduced in 1965 at a flat rate of 30%. Geoffrey Howe introduced indexation allowances in 1982, ensuring that only gains in excess of inflation were taxed. In 1988, Nigel Lawson aligned CGT rates with individuals' marginal income tax rates. In 1998, Gordon Brown scrapped indexation allowances for future years and introduced taper relief, which reduced CGT by more the longer an asset was held and was more generous for 'business' than 'non-business' assets. Taper relief was subsequently made more generous, before then being scrapped by Alistair Darling in 2008. Mr Darling announced a return to a single flat rate, set at 18%, but (following a backlash from business lobby groups) introduced entrepreneurs' relief (now BAD relief), which applied a 10% rate to the first £1 million (later increased to £10 million then reduced back to £1 million) of lifetime gains for some business assets. George Osborne raised the rate to 28% for higher-rate taxpayers in 2010, but then cut it (for most assets) to 20% for higher-rate taxpayers and 10% for basic-rate taxpayers in 2016. The rate for residential property (other than owner-occupied housing) was reduced from 28% to 24% in 2024.

Residential property (except people's main homes, which are exempt) is subject to higher rates of CGT than other assets (except for carried interest). However, the biggest of those other assets is company shares, which are subject to higher overall effective tax rates as a result of corporation tax levied on the company profits from which shares derive their value. But, even accounting for this, capital gains are taxed at significantly lower rates than labour income (Table 7.2 later shows this).

Both the rates and base of CGT have changed many times since its introduction in 1965. Box 7.1 provides a brief history of the main changes. For further discussion, see Adam (2008) and Seely (2020).

What capital gains represent

It can be useful to distinguish, conceptually, between returns that reflect 'normal' and 'excess' returns to capital. Tax has different effects (in terms of both equity and efficiency) depending on whether it is levied on normal and/or excess returns. In short, a tax on the normal return will create a range of distortions, including discouraging saving and investment.

The normal return can be thought of as the return that just compensates savers and investors for the delay in consumption (without any additional compensation for risk-taking). When buying a rental property or shares, for example, a person needs to expect to make at least the risk-adjusted normal return in order to be willing to part with their money.

Returns to capital will often be higher – and sometimes substantially higher – than the normal return. We will refer to all differences from the normal return as 'excess returns' (negative if an asset yields a below-normal return). Such returns can reflect:

- **Luck** in the outcome of risky investments. Since people generally prefer a safe bet, higher-risk investments will generally only be attractive if they offer a correspondingly higher expected return, or **risk premium**; so those who invest in risky assets can earn above-normal returns on average (not just if they happen to get lucky).
- **Economic rents**, which are a return greater than that required to make an investment worthwhile. Rents generally arise from a factor being in limited supply, whether that is land or another natural resource, government-induced restrictions such as taxi licences, monopoly power, unique ideas, private information or brands (including those related to innovators, artists, sports stars and firms).
- **Effort and skill**. Excess returns to capital can directly reflect returns to effort (e.g. where excess returns reflect skill in choosing the best investments or effort that was put into renovating an asset or capturing rents) or indirectly reflect returns to work where labour income is being 'disguised' (e.g. where a company owner-manager pays herself in dividends or capital gains rather than through a salary).

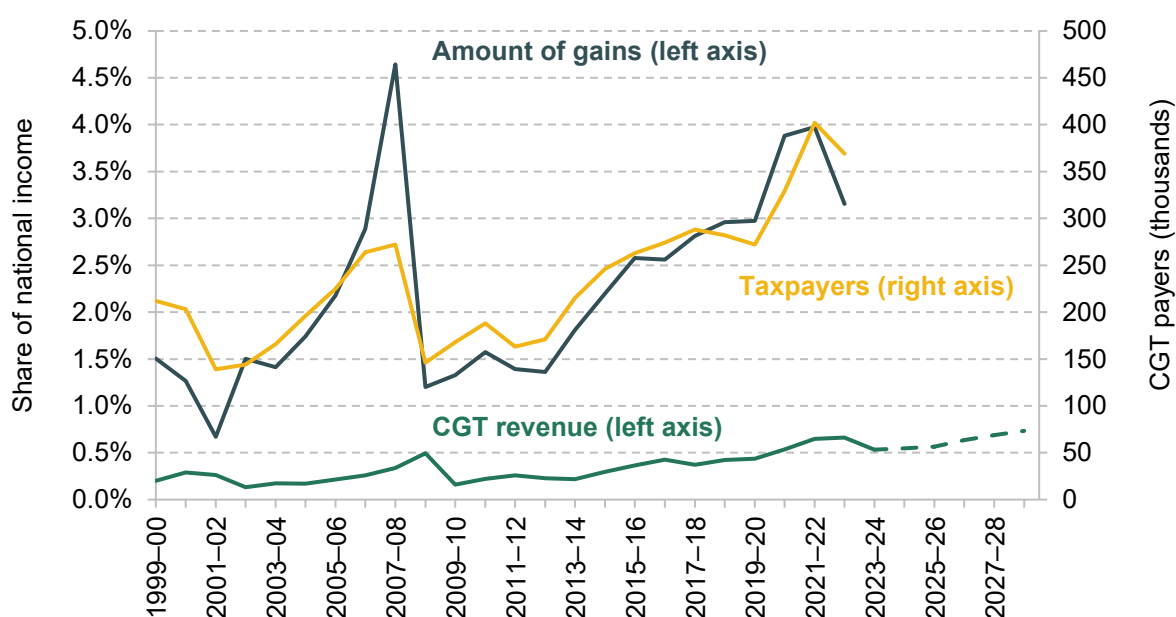
In practice, capital returns (whether in the form of gains or incomes) will often reflect a mix of sources. For example, some houses will have amassed large capital gains both as a result of being located in an area that became more attractive and as a result of substantial renovation. Some business assets will be valuable because their owners were highly skilled and put a lot of effort into building a business, and because the business had a monopoly, and because the owners had some good fortune. Also note that some business owners make no meaningful capital investments at all, such that capital gains can entirely reflect ‘disguised’ labour income.

Capital gains will reflect these underlying factors, as well as what share of a return to capital is realised or taken in the form of gains versus income.

Aggregate gains and revenue

In 2022–23, 370,000 taxpayers realised £81 billion of taxable gains.⁴ Taxable gains were lower than in 2021–22, but have been rising over time. Taxable gains as a share of national income

Figure 7.1. Capital gains, taxpayers and revenue



Note: ‘Amount of gains’ refers to taxable gains measured after the deduction of losses plus attributed gains but before deduction of the annual exempt amount or of taper relief, where relevant. Individuals and trusts are included in all figures. Dashed line is a forecast.

Source: Revenue and GDP measures are from OBR Public Finances Databank, August 2024. ‘Total taxpayers’ is from table 1 of HMRC capital gains tax statistics, August 2024. ‘Amount of gains’ is from Advani and Summers (2020).

⁴ Throughout, taxable gains refer to the gains of CGT taxpayers plus the gains of the small number of people who file a CGT return despite not being liable for any CGT. They are measured before the deduction of the annual exempt amount (and, in the relevant years, before taper relief).

have risen from around 1% of national income in the early 2000s to over 3% (see Figure 7.1). The large spike in gains in 2007–08 occurred as a result of the government preannouncing the removal of taper relief and (for some) an increase in the CGT rate, which gave asset holders an incentive to sell before the policy change was enacted (Seely, 2010a).

CGT raises around £15 billion per year (less than 2% of total tax revenue). As Figure 7.1 shows, CGT revenue – which is affected both by underlying gains and by tax policy choices – has risen over time (as a share of national income) and is forecast by the Office for Budget Responsibility (OBR) to rise further.

Source and distribution of capital gains

Who gets capital gains

Taxable capital gains are very concentrated among a small number of people. In 2022–23, there were 350,000 individuals – 0.65% of the adult population – realising taxable gains.⁵ This is around 100 times fewer than the number of income tax payers (34.6 million) in that year. Less than 3% of UK adults paid CGT at any point over the 10 years from 2010–11 to 2019–20 (Advani, Lonsdale and Summers, 2024a).

Around 60% of individuals who filed a CGT return in 2022–23 realised gains of less than £50,000, and accounted for just 7% of gains and 4% of the CGT revenue.⁶ 3% of CGT taxpayers realised gains of more than £1 million and this group accounted for 62% of gains and 67% of the CGT revenue. The average gain among this group of 12,000 people – who represent 0.02% of the adult population – was £4 million.

For most of the people receiving taxable capital gains, gains are ‘lumpy’ – they accrue over many years and are realised in a single year. The Office of Tax Simplification (2020, para. 1.18) reports that 72% of taxpayers who reported capital gains in the 11 years from 2007–08 to 2017–18 did so in only one of those years.

Advani, Lonsdale and Summers (2024a) find that half (49.1%) of individuals who paid CGT in 2019–20 did not receive gains at any point over the preceding decade. However, many of the other half received gains regularly: almost one in eight (11.6%) individuals received gains at least five times, while a small minority (0.6%) received gains in all 10 years. Averaging across years when gains were realised, the mean capital gain was over twice (2.3 times) as large for individuals who realised gains every year (£441,000) as for one-off gainers (£194,000).

⁵ In addition, there were 20,000 trusts realising gains – bringing the total to 370,000 taxpayers as cited above. Source for numbers in this paragraph: table 2 of HMRC capital gains tax statistics August 2024.

⁶ Figures in this paragraph refer to gains and CGT revenue from individuals (i.e. excluding trusts).

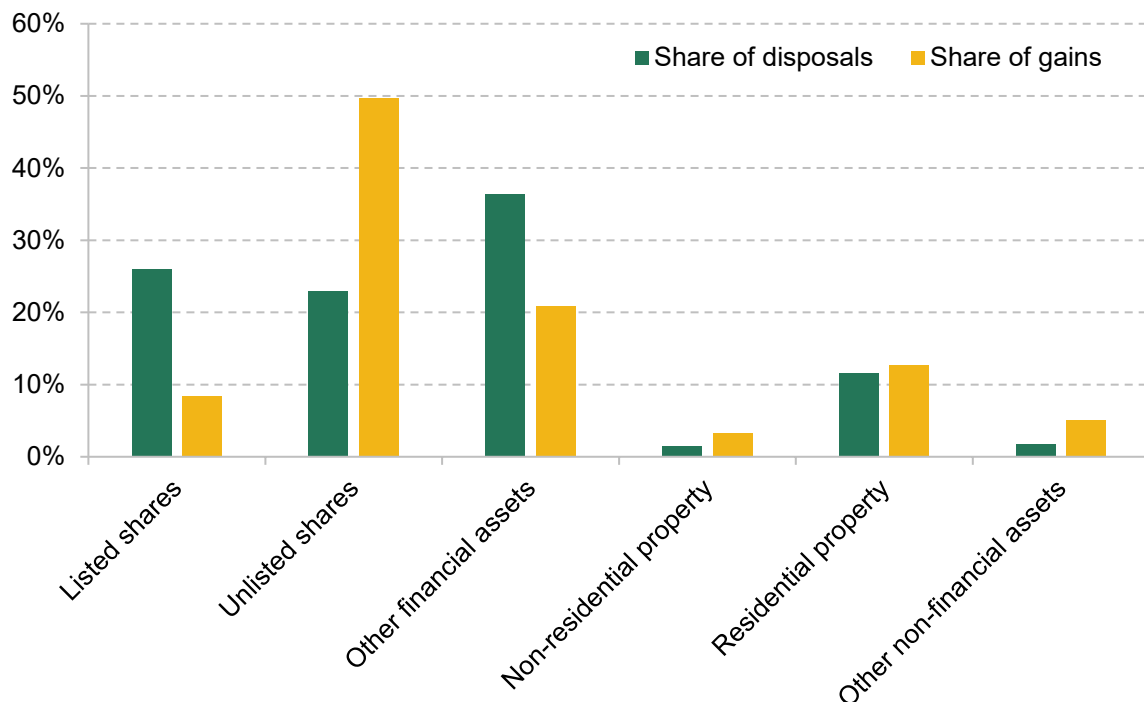
Taxable capital gains flow disproportionately to people who are already in the top 1% of the income distribution (Advani and Summers, 2020; Delestre et al., 2022). In contrast, untaxed capital gains are more equally distributed. This is unsurprising given that owner-occupied housing and investments held in ISAs are exempt from CGT.

Advani, Lonsdale and Summers (2024a) find that taxable gains are disproportionately concentrated amongst certain demographic groups. Although men receive a disproportionate share of overall income (66%), their share of gains is even larger (74%). Taxable gains are also weighted towards the middle of the age distribution. While around half (49%) of individuals with gains are over 60, most of the *value* of gains (56%) goes to taxpayers aged 40–59. There are sharp geographical divides, with most gains in London and the South East. The constituency of Kensington has a larger share of total gains (3.1%) than the entirety of Wales (2.0%).

Capital gains by type of asset

Figure 7.2 shows the distribution of capital gains by asset type, based on both the number of disposals of different assets (green) and the value of the gains received (yellow).

Figure 7.2. Capital gains by asset type, 2021–22



Note: Gains are measured before the deduction of the annual exempt amount. 'Other financial assets' includes assets such as UK and non-UK listed and unlisted securities, unit trusts and loan notes. 'Other non-financial assets' includes intangible assets such as goodwill and tangible assets such as fine works of art.

Source: Tables 7.2 and 7.5 of HMRC capital gains tax statistics August 2024.

Most (85%) disposals were of financial assets. Roughly similar shares (25%) of disposals were of listed shares (those publicly traded on a stock market) and of unlisted shares (in private businesses).

Looking instead by value of gains, a very different picture emerges. Around half of the value of gains related to unlisted shares. The average gain realised on unlisted shares (including those eligible for BAD relief) was more than £120,000. By contrast, on listed shares and residential property, the averages are ‘only’ £18,000 and £61,000 respectively.⁷

‘Carried interest’, which is received by private equity executives and comprises mostly gains in unlisted shares, is received by only around 2,000 individuals (fewer than 1% of CGT payers) but accounts for just over 4% of the value of gains, with a mean gain of £1,281,000 per individual in 2019–20 (Advani, Lonsdale and Summers, 2024a).

Nature of private business gains

Private businesses span a huge range of industries and scales. They cover everything from chemical manufacturer Ineos, with annual profit in 2023 of £1.4 billion and 26,000 employees, to micro-businesses with a sole employee-shareholder, working, for example, as a consultant. While the former makes substantial investments in new capital annually, a consultant setting up a company likely needs little capital outlay and may have no intention of ever employing anyone else. The tax treatment of capital gains relative to earned income, described further below, encourages the setting-up of such low-capital businesses.

Advani et al. (2024) find that over two-thirds of the gains on unlisted shares go to individuals who are company directors, indicating that they are actively working in the business. Many gains reflect minimal initial capital investment by the individual receiving the gain: half of all disposals of unlisted shares yield gains equating to an average annual return of over 100%.

Combining the carried interest of private equity managers with gains that were eligible for entrepreneurs’ relief in 2019–20,⁸ a conservative estimate is that around half of all taxable capital gains are closely linked to people’s occupations (Corlett, Advani and Summers, 2020). That is to say that, while taxed as capital gains, these incomes have many of the characteristics of labour earnings.

⁷ See table 7 of HMRC capital gains tax statistics August 2024.

⁸ At the time, entrepreneurs’ relief was capped at a lifetime limit of £10 million. This was reduced to £1 million from March 2020. Entrepreneurs’ relief was subsequently renamed business asset disposal relief.

7.3 Problems with the design of CGT

A good rule of thumb is that the tax system should aim to be neutral: that is, to treat similar activities similarly.⁹ Our starting point is that taxes should not, without a strong rationale, distort commercial decisions about who holds assets for how long, which assets are chosen and whether remuneration is taken as earnings, dividends or capital gains. Nor should the tax system discourage saving and investment. Yet the current design of capital gains tax distorts all these margins. We briefly summarise the problems that causes below; in Section 7.4, we discuss whether and how the tax system should actively encourage entrepreneurship. We note that the exemption of main homes from CGT (formally principal private residence relief) is a costly relief and creates distortions. Removing the relief would be difficult. The Labour Party has ruled out doing this and we do not discuss the taxation of main homes here.

Ultimately, the fact that the design of CGT discourages some investments and distorts a range of decisions is a source of both economic inefficiency and unfairness.

Economic inefficiency means that, for a given amount of revenue raised, welfare – i.e. how well off people are in a broad sense – is lower than it would otherwise be (if the inefficiencies were smaller). The economic inefficiencies can directly manifest in lower economic output. For example, reduced rates of investment and skewed patterns of capital allocation will mean that, for a given level of revenue, productivity is lower, with this resulting in lower output and incomes.

Unfairness arises because aspects of CGT arbitrarily favour one action over another and thereby penalise otherwise-equivalent people who behave in the tax-disadvantaged way. To give one example among many, consider two people who have made similar investments in their own company and generated similar returns. One takes the return as a flow of dividends (while a higher-rate taxpayer). The other takes the return as capital gains when the company is sold, using another source of income to finance their spending before the point of sale. The first person faces a large and unfair tax penalty relative to the second.

Problems caused by the design of the tax base

Many of the problems created by CGT stem from the design of the tax base – the definition of what is subject to tax. In summary, the design of the tax base penalises saving, investment and risk-taking and leads to a misallocation of capital. For example, it can mean that capital is

⁹ Tax systems should aim to achieve revenue-raising and distributional goals as simply as possible, as equitably as possible, and at the lowest possible cost to taxpayers. With simplicity, equity and economic efficiency in mind, a good rule of thumb is that a well-designed tax system should strive to be neutral. For further discussion of how neutrality relates to the principles that underlie a well-designed tax system, see Mirrlees et al. (2011, ch. 2).

directed away from its most productive use. This creates economic inefficiency and unfairness. The problems are worse at higher rates of CGT. In fact, the efficiency costs created by a distorted tax base rise more than in proportion to tax rates, because low tax rates only change behaviour when the decision is marginal anyway (e.g. when an investment was only just worthwhile); higher tax rates discourage not only more activities, but also more valuable activities. But while lower rates of CGT lessen the problems caused by the base, they cannot fix them. In Section 7.5, we discuss how tax base reforms could directly address the problems described here.

CGT discourages saving and investment

CGT discourages saving and investment in taxed assets. The tax reduces the return the saver can expect to receive on their investment, so **some investments that would have been worthwhile in the absence of taxation are made unprofitable by the tax.**

Suppose I require a return of 4.5% to persuade me to invest – for example, to put more money into my own company or to buy shares or a property. A 20% tax that reduces the return from 5% to 4% will mean an investment I would otherwise have undertaken will now not go ahead. This is undesirable: too little investment will be undertaken if otherwise profitable investments are made unprofitable by tax. And if an individual would rather save his or her money than spend it now, it is difficult to see why taxes should penalise this choice.

This is not an inescapable feature of CGT. As we discuss in Section 7.5, it would be possible to have a tax system that did not discourage marginal investments (those that generate only a ‘normal’ return and whose viability would be threatened by tax) but continued to raise revenue from investments that earn a high (‘excess’) return – which would continue to be viable even with a tax liability – and from capital gains that represent a return to effort and skill (and luck) rather than capital invested.

With the current tax base, however, CGT does discourage saving and investment. Worse, it discourages different investments to different degrees. The magnitude of the disincentive to save depends on the tax rate (or, more precisely, what the tax rate is expected to be when the gain is realised) – which depends on the type of asset and on how much of the return takes the form of a capital gain rather than some sort of income. It also depends on how long the asset is held and on the risk of making a loss that cannot be offset immediately – factors we discuss below. And it depends on the rate of inflation: the disincentive is greater when inflation is expected to be

higher.¹⁰ (This was the motivation behind the system of inflation indexation that existed in some form between 1982 and 2008.)

Lock-in effects disincentivise capital reallocation

Capital gains tax creates a ‘lock-in’ effect. If someone has an asset that has risen in value, there is an incentive to hold on to the same asset, rather than selling it (triggering a tax liability) and reinvesting the money in another taxed asset. In effect, if a person sells an asset after one year, buys another one and then sells it after another year, the value of the tax payments would be higher than if they held a single asset for two years. This disincentive to reallocate capital to a different asset locks people into their existing investments.¹¹

In that sense, CGT acts as a tax on transactions (like stamp duties) and **leads to misallocation of capital**: I will continue to hold on to my existing asset even if someone else could use the asset more productively and I could use my capital more productively elsewhere. The tax system includes reliefs (notably business asset rollover relief and reinvestment relief) specifically intended to mitigate the lock-in effect in some cases, but those are incomplete.¹²

The lock-in effect is exacerbated by the fact that capital gains unrealised when someone dies are not taxed at all: the deceased’s estate is not liable for CGT on any increase in the asset’s value prior to death, and those inheriting the assets are deemed (for future CGT purposes) to acquire them for their market value at the time of death, not the original purchase price. This creates a big incentive to hold on to assets that have risen in value and bequeath them – even if it would be more profitable to sell them and use the proceeds in some other way before death (at which point other assets, including the proceeds from the sale of the original assets, could be passed on instead) and even if it would be preferable to pass on the assets (or the proceeds from selling them) immediately.

¹⁰ Even at low rates of inflation, a tax on nominal capital gains corresponds to a much higher tax rate on real gains: for example, if inflation is 2%, a 20% tax rate on a 5% nominal return corresponds to a 34% tax rate on the real return.

¹¹ Note that the existence of CGT does not create an incentive to hold on to an existing asset if the intention is to consume the proceeds of sale (or reinvest them in a tax-free form such as an ISA).

¹² Under business asset rollover relief, self-employed people who sell certain types of assets used in their business and use the proceeds to buy another asset for use in their business can defer paying CGT on the original asset until they come to dispose of the replacement asset. This can create neutrality between holding on to a qualifying asset and replacing it with another. However, it does not apply to all assets – for example, to selling or buying shares; and as a result it introduces new distortions between qualifying and non-qualifying assets. A second, similar relief to mitigate the lock-in effect in some cases is reinvestment relief, under which CGT on any asset can be deferred if the seller reinvests the gain through the Enterprise Investment Scheme or social investment tax relief up to three years after (or one year before) selling the asset. Again, this is clearly limited in scope and brings its own problems.

Incomplete loss offsets discourage risk-taking

Much discussion of the effect of tax on risk-taking focuses on the rate of tax on successful projects: higher taxes (on gains or income) reduce the rewards to success. But what matters when considering risky projects – that is, projects where the outcome is uncertain – is the treatment of good outcomes relative to bad ones. **Risk-taking is discouraged** by the tax system not as a result of the level of tax on income and gains per se, but because of the asymmetric treatment of upside and downside risk. In effect, the government takes a share in the fruits of success but does not take an equal share in the pain of failure.

The current tax system does not treat profits/gains and losses symmetrically. When people make a loss, they are able to ‘offset’ the loss against other gains such that tax is then levied on the net gain. But loss offsets are incomplete. Losses often cannot be relieved immediately; they can be carried forward to offset in future, but the delay reduces the value of the relief; and sometimes the losses can never be offset at all. As a result, the system discourages risk-taking. Other things equal, that is harmful.

Problems caused by differential tax rates

There are large differences in the *overall* tax rates (i.e. accounting for all levels of tax) levied on capital gains on different types of assets and on gains relative to income (these are shown in Table 7.2 later) – although the lack of indexation for inflation makes comparing effective tax rates on income received now and capital gains realised in the future more difficult.

Gains on different types of assets are taxed at different rates. This skews the allocation of investments (away from what is the commercially best investment towards tax-favoured investments) and penalises people who invest in more heavily taxed assets.

Capital gains are (almost always) taxed at lower rates than capital income, and both capital gains and capital income are (almost always) taxed at lower rates than earnings from employment or self-employment. This creates a bias towards taking any rewards in the form of gains rather than income and towards putting effort into activities that generate gains rather than income.

The incentives created and problems caused by differential rates can be clearly seen for business owner-managers. Tax differentials provide an incentive to work for your own business (through self-employment or as a company owner-manager) rather than as someone else’s employee, even when that is not the most productive choice. They also provide a strong incentive to undertake investments that will result in capital gains rather than income and, where possible, to realise the returns to labour as capital income or gains.

Miller, Pope and Smith (2024) use UK tax records to show that company owner-managers are very responsive to tax incentives. Company owner-managers can choose when and how to take income out of their companies. They can pay themselves a salary, take dividends or take capital gains. Most company owner-managers pay themselves a small salary (equal to the point at which personal taxes become payable) and take any remaining remuneration in the form of dividends or capital gains. Those generating income above the higher-rate threshold retain significant amounts in their company over long periods. Much of this is ultimately withdrawn in the form of capital gains and subject to BAD relief.¹³ The tax savings can be substantial. For example, among owner-managers claiming (what was then) entrepreneurs' relief in 2015, average capital gains were £500,000. This delivers a tax saving of £75,000 relative to if the income had been taxed at 25% (the effective higher rate of tax on dividends in 2015) rather than 10%.¹⁴

These distortions are inefficient. One implication is that people will not always be making the most productive choices over, for example, what type of work to do or which investments to make. They can also reduce people's well-being by, for example, leading them to spend their money later than they would absent the tax incentives.

In principle, the distortions created by BAD relief specifically could lead to a misallocation of capital. However, Miller, Pope and Smith (2024) find no evidence that tax-motivated earnings retention affects investment within the company: the retained earnings are kept as cash or other financial assets – for example, shares in other companies – rather than used to buy assets for use in the business. Preferential rates of capital gains tax for business assets therefore lead to more money held in companies but not to any great misallocation of the capital owned by company owner-managers. This also means that preferential rates are not achieving the commonly stated policy goal of increasing owner-managers' investment in assets for use in their businesses (we return to this in Section 7.4).

Alongside the economic inefficiencies caused by differential tax rates, there is clear unfairness: there is effectively a tax penalty on those people who find it harder to arrange their affairs to take advantage of preferential tax rates.

International issues

There are differences in the taxation of capital gains across countries which can affect people's location decisions. The UK is currently around the middle of the pack for headline CGT rates

¹³ Retained earnings boost the value of a company, such that when a company owner-manager sells or liquidates their company, the retained earnings are taxed as capital gains. It is usually impractical for company owner-managers to sell shares a bit at a time in order to extract money gradually in a way that qualifies for BAD relief.

¹⁴ Note that this will typically reflect gains built up over the lifetime of a company and realised in a single year, so the tax saving will be a one-off for that person, not an annual saving.

compared with other major economies, although there is huge variation in approaches. Like the UK, the US currently taxes long-term gains on most assets at a top rate of 20%. The top rates in France (34%), Ireland (33%), Spain (28%), Germany (26%) and Italy (26%) are somewhat higher than the UK's, and some countries – such as Australia and Denmark – tax capital gains at full income tax rates. However, several countries do not tax capital gains at all, including Switzerland and New Zealand, as well as more typical tax haven jurisdictions. Additionally, some countries such as Ireland and Italy do not tax capital gains on the foreign assets of new arrivals.

Capital gains are generally taxed on a 'residence' basis, meaning that UK residents must pay UK CGT on their worldwide gains, irrespective of where the assets are located.¹⁵ Non-residents only pay UK CGT on gains from UK land and property. Consequently, the main impact of the UK's CGT regime, from an international perspective, concerns the movement of people (into or out of UK residence); investment in UK assets is affected only insofar as that is linked to whether people live in the UK.

Specifically, the UK currently charges CGT on disposals that an individual makes while they are UK-resident. This means that if someone accrues capital gains while living in the UK but then leaves the UK before selling the asset, they pay no UK CGT (unless the gains are from UK land and property or the individual moves back to the UK within six years, in which case they are taxed on the gains they realised while abroad). This creates an incentive for those who have accrued large gains to move to a lower-tax country – to retire abroad, for example – before realising them.

The flip side is that individuals who move to the UK are potentially liable for UK CGT on capital gains that they accrued prior to arrival, if they subsequently dispose of these assets while UK-resident – unless the gains are on foreign assets and they dispose of them within the 'grace period' they get after moving to the UK (four years under the new regime being introduced from April 2025, generally much longer under the 'non-dom' regime that is replacing). That creates a disincentive to move to the UK from a lower-tax country (and an incentive to move to the UK from a higher-tax country).

7.4 Support for entrepreneurship

We describe in the next section how to reform the tax base so that it is neutral with respect to a range of decisions, including investment. Such a tax base would mean that CGT did not discourage investment. But in policy discussion, arguments for preferential CGT rates are often

¹⁵ An exception is the UK's 'non-dom' regime (soon to be replaced by a new four-year regime for foreign income and gains) under which new arrivals in the UK are effectively exempted from UK CGT on their foreign gains for an initial period, despite having UK residence.

predicated on the assumption that the government is not seeking neutrality: it is seeking to actively encourage investment and entrepreneurship. For example, at the point of announcing entrepreneurs' relief, Alistair Darling (then Chancellor) said: 'I am determined that we do as much as possible to encourage entrepreneurship'.¹⁶ In this section, we therefore discuss whether CGT should be used to support entrepreneurship.

It is important to recognise that the difficulty and risk associated with entrepreneurship do not themselves justify favourable tax treatment. If the market rewards for particularly difficult or risky activities are not sufficiently high to compensate for the additional difficulty and risk involved, it suggests that the activities are not worth undertaking: there is no reason for the government to give them special tax breaks. A justification for government intervention arises only if markets fail to provide the appropriate incentives for entrepreneurship.

Markets do sometimes fail, and there is a case in principle for encouraging some types of business activity. For example, some businesses may be particularly innovative but underinvest relative to the efficient level because part of the return to investment flows to other firms which can learn from the new products or processes (i.e. there are 'externalities'). There may also be barriers to entry or obstacles to growth of small businesses, such that the market generates too little activity in the small business sector.

But preferential rates of CGT are poorly targeted at market failures in two ways.

First, the incentives apply much more widely than where there is a rationale for government to try to increase the level of activity. CGT rates are lower than tax rates on employment for everyone, not only in those cases where there may be market failures. There is no clear reason to want to encourage investment in, for example, artwork or second homes. Even BAD relief, which is somewhat targeted, can be accessed by anyone operating a business, not only by those making significant investment or those doing something entrepreneurial. As a result, even though lower CGT rates may boost some of the activities that have externalities, at the same time they create a series of other unintended side effects. These include, for example, more people keeping income in their companies for much longer than they otherwise would.

Second, for those firms generating externalities, lower tax *rates* will often have little effect on incentives to invest. The benefit of lower tax rates accrues disproportionately to those who make high private returns on their activities; those are likely to be viable even without support. It is much more effective to target activities that are only borderline-viable and their specific critical features (such as investment and finance costs) where tax can make a difference to whether projects go ahead. In short, it is more effective to use the tax base.

¹⁶ For discussion of the introduction of entrepreneurs' relief and the source of the quote, see Seely (2010b).

7.5 How to fix CGT

There is a strong case for reforming the structure of CGT. This could be done in a revenue-neutral way or to raise more revenue: however much revenue the government wishes to raise, it could be raised in a fairer and less damaging way.

To recap: the design of the CGT base creates a range of problems, including disincentives to save and invest and incentives to hold on to assets for longer than would otherwise be desirable. These problems would be worse at higher tax rates. But keeping preferential rates of CGT (relative to tax on income) and differential rates across assets also creates various inefficiencies and unfairness. Moreover, low rates of CGT are not well targeted at fixing the problems caused by the tax base. Nor are they well targeted at incentivising entrepreneurship. Any change in CGT rates would, given the current tax base, come with trade-offs – some problems would be made better and some worse.

We propose the following big-picture solution to fixing the design flaws in CGT: the tax base should be changed so that there are full deductions for any amounts of money saved or invested. This is equivalent to saying that the tax base should be reformed so that the normal return to saving and investment (see Section 7.2) is not taxed. In addition, fixing the tax base would require being more generous in the treatment of losses and removing uplift of CGT at death. With a reformed tax base in place, tax rates could be increased with little concern about weakening incentives to invest and take risks. Ultimately, we advocate that overall tax rates – i.e. including all layers of tax – be aligned across all forms of income and gains in order to remove the problems caused by differential rates. This solution was originally set out in Mirrlees et al. (2011).

In this section, we summarise the components of this big-picture reform package. In Section 7.6, we discuss the types of trade-offs that arise if only some parts of the full solution are adopted. In Section 7.7, we lay out the choices that would inevitably have to be made when transitioning to a new system.

Components of reform

More generous deductions for asset purchase costs

Broadly speaking, the way to stop CGT disincentivising saving and investment (in a domestic context) is to give a full deduction for the amount saved – equivalently, to remove the normal return from tax and tax only excess returns (as defined in Section 7.2). There are three ways to achieve this outcome:

- **Up-front deductions:** allow the purchase cost of an asset to be tax-deductible at the time of purchase, rather than only when the asset is later sold (a ‘cash-flow’ tax treatment);
- **A stream of annual deductions:** give a stream of annual tax allowances that represent the normal return on the purchase cost (a ‘rate-of-return allowance’);
- **Deductions at the point of sale:** step up the purchase cost with an interest rate (the normal rate of return) – rather than an inflation rate as used in the past – when deducting it from an asset’s sale price to calculate the taxable gain (‘indexing for an interest rate’).

Here we briefly sketch out these three approaches. The treatment of losses is important for all three approaches and we return to that below. For a detailed discussion, including of caveats and possible reasons to choose one approach over the others, and for worked examples of the different approaches, see Adam and Miller (2021).¹⁷

The cash-flow approach. Under this approach, an individual can deduct the purchase cost of an asset from their income at the point of purchase. When they sell the asset, tax is levied on the full proceeds of sale, without deducting the purchase cost (since that was deducted up front). With a tax rate of 20%, say, the government effectively bears 20% of the cost of the investment and takes 20% of the proceeds. If the value of the proceeds exceeds the cost of the investment, then 80% of the proceeds will exceed 80% of the cost, so any investment that is profitable before tax will be profitable after tax: the tax does not discourage investment. But the government gets 20% of any return in excess of what is required to make the investment worthwhile.

The cash-flow approach is akin to the income tax treatment of pensions (but without the restrictions on when money can be accessed or the ability to take 25% of withdrawals from a pension tax-free): contributions attract tax relief at a person’s marginal tax rate, while income received from a pension is taxable. The cash-flow approach is also already in place for the self-employed when they purchase plant and machinery that qualify for the annual investment allowance: the cost of investment is fully deductible up front and any money received from the business – whether from working with the equipment or from selling it – is taxable. Adam and Miller (2021) describe in detail how a new cash-flow vehicle (which they call a Personal Shareholding Account) could be used to allow people to buy new equity (in their own or others’ companies) in a tax-neutral way.

The rate-of-return allowance. This approach would look a lot like the current capital gains tax, in the sense that there was no full up-front deduction for any amounts saved or invested and tax was levied on the nominal capital gain at the point the gain was realised. The change from the

¹⁷ The neutrality properties of the approaches we summarise here assume that individuals face a constant tax rate, so that deductions are given at the same rate as gains or income are taxed. Properties of the tax are more complicated without constant tax rates. Adam and Miller (2021) discuss.

current system would be to introduce a new annual allowance equal to the normal return on the purchase cost of the asset.¹⁸ This is referred to as a rate-of-return allowance (RRA).

The logic of an RRA is straightforward. To avoid discouraging investment, the normal rate of return – the return required to persuade someone to undertake extra investment – must not be taxed; an RRA is an explicit allowance, each year, for the normal return, ensuring it is deductible from taxable income or gains. If exactly the normal return is earned, no tax would be levied. Any excess returns would be taxed in full.¹⁹ In practice, the normal return (the risk-free interest rate used to calculate the annual allowance) could be measured as the nominal interest rate on medium-term government bonds.

Indexing for an interest rate. Rather than providing an annual RRA, an alternative way the government could ensure that no tax was paid on the normal return would be to adjust the deduction that is given when an asset is sold. Specifically, the taxable capital gain could be calculated as the sale price minus the purchase price indexed (or stepped up) with the (normal) interest rate over the period the asset was held.²⁰ This is the third way to stop CGT from disincentivising saving and investment: levy it on an asset's sale price minus its purchase-price-plus-interest, not just its nominal purchase price. This would be a tax on excess returns.

This approach is somewhat familiar in the UK because indexation for inflation was part of CGT (in some form) from 1982 until 2008, and continued in corporation tax until 2017. The government could reintroduce indexation of capital gains, but for an interest rate (the normal rate of return) rather than an inflation rate.²¹

¹⁸ This does not require using a different rate of return for each person depending on their propensity to save: the normal return is the same for everyone. This might seem surprising, given that people clearly differ in many ways, including in their preferences for spending their money today or saving it for the future. The explanation lies in the difference between people's willingness to save overall and their willingness to save an extra £1. The former will vary, but (under textbook assumptions) the latter should not.

¹⁹ If the 'normal' rate of return is set correctly, the stream of annual allowances under an RRA will have the same present value as the initial investment cost – and therefore of a 100% up-front allowance in a cash-flow tax. That is, in both approaches, 100% of savings or investments are deducted from the tax base in present-value terms (i.e. from the point of view of an investor evaluating the worth of the allowances today), but the RRA spreads the same present value of deductions over a number of years rather than giving them immediately.

²⁰ This would be the outcome under an RRA if the annual allowances, rather than being deducted each year, were rolled up with interest and added to the deductible acquisition cost at the point of disposal.

²¹ If this were done, it would be even more important to ensure that capital losses could be fully offset, since losses relative to such an indexed base cost would be bigger and more common than the nominal losses potentially eligible for relief under the current system.

Importantly, the reform to the tax base we are advocating – regardless of which of the three approaches was used to implement it – would bring a range of benefits, including removing the disincentive to invest, removing the lock-in effect and avoiding biases between assets.²²

Improve loss relief

In order to minimise the extent to which the tax system discourages risk-taking, taxes on capital gains (above normal returns to investment) should ideally be matched by equally generous relief for those making ‘losses’ (including below-normal returns).²³

At present, there are various restrictions on how losses can be offset. Capital losses can usually only be offset against capital gains, even in the same year, and can be carried forward indefinitely but only carried back in very limited circumstances.

There are various ways that loss relief could be made more generous. Broadly speaking, these include: allowing carry-back as well as carry-forward; carrying losses forward (and back) with interest to maintain their present value; and letting people offset their capital losses against income rather than capital gains in a wider range of circumstances (although losses should never be offset at a higher rate than corresponding income/gains would be taxed). There are genuine concerns about the use of artificial losses for tax evasion and avoidance. Care is therefore required in changing the treatment of losses. But we are confident that some improvements are possible.²⁴

Abolish uplift at death

Currently, if someone keeps an asset until they die then no capital gains tax is levied on any rise in its value from when it was acquired until death. This uplift of CGT at death should be abolished.

Uplift at death provides a huge incentive for people to hold on to assets that have risen in value, even if, in the absence of tax considerations, they would prefer to sell them and use the proceeds in some other way, and even if someone else could use the assets more productively. And the ability to escape tax in this way provides a big incentive to set up a business and roll as much money as possible into it, rather than working as an employee. These incentives would be

²² The three approaches we describe are all equivalent in present-value terms: all leave the normal return untaxed but tax excess returns. The interest deduction in the form of an annual RRA or a stepped-up purchase cost can be thought of as compensation for deferring the deduction of purchase costs from the point of acquisition (under the cash-flow approach) to the point of disposal (under the others).

²³ The symmetric treatment of profits and losses can be seen as the government taking an equal share in both the upside and the downside of a risky project. If we fail to treat losses in an equivalent way to profits/gains then the expected tax on (normal) returns to risky projects would be positive, undermining neutrality both over the level of investment and between more and less risky activities.

²⁴ See Adam and Miller (2021) for more detailed discussion.

exacerbated if tax rates on capital gains or income were increased. Abolishing uplift at death would therefore reduce some distortions in its own right, but it would also remove one of the downsides of moving towards alignment of tax rates across different forms of gains and income. Removing uplift at death should be prioritised as one of the first steps taken towards the long-run ideal we set out above.²⁵

There are two ways to remove CGT uplift at death. Those inheriting assets could be deemed to acquire them at their original acquisition cost, rather than at market value at the date of death. They would therefore pay CGT on the full gain when the asset was sold. Alternatively, an asset could be treated as if it had been sold at the point of death, such that the deceased's estate was liable for CGT at the point of death and the individual inheriting the asset would be treated as if they had immediately bought the asset at its market value on the date of inheritance ('deemed realisation').

These reforms would mean that CGT would sometimes be payable on top of inheritance tax (and, under the second option, at the same time). That is not a flaw. CGT and inheritance tax are serving different purposes – inheritance tax is not a substitute for CGT. On death, if an asset has accrued gains, it is appropriate to tax these just as much as if the asset were sold the day before death, when it would currently be taxed.

Align rates

Economic inefficiency and unfairness are caused both by different types of assets' facing different CGT rates and by CGT rates' (almost always) being lower than tax rates on income, including dividends for those in the higher- or additional-rate tax bands and employment income.

Ultimately, we advocate aligning *marginal* tax rates across all forms of gains and income, while making changes to the tax base (as outlined above).²⁶ That is, we recommend aligning rates not only within CGT (across assets) but across capital gains, capital incomes and employment income.²⁷

When looking to align rates, or move towards that goal, it is important to consider all layers of tax. It is only by aligning overall rates – including all layers of tax – that a level playing field can be created. Within CGT, this means accounting for corporation tax such that the CGT rates on

²⁵ The Office of Tax Simplification (2020) also recommended that the government consider removing uplift at death. It highlighted the practical downside that this would increase the number of times difficulties arose because the original acquisition cost by the deceased could not be established (that problem can already arise now, but less often) and suggested some possible responses.

²⁶ Here we have discussed changes to the personal tax base; we recommend equivalent changes at the corporate level.

²⁷ This would need to include reform of venture capital schemes and employee share schemes (including employee ownership trusts) – if they remain unchanged while CGT rates were increased, there could be a large increase in their use.

Table 7.2. Combined marginal tax rates by income form, 2024–25

Source of gains	Basic rate	Higher rate	Additional rate
Carried interest	18%	28%	28%
Residential property	18%	24%	24%
Non-corporate business assets (BADR)	10%	10%	10%
Corporate business assets (BADR / IR)			
<i>with 19% corporation tax</i>	27.1%	27.1%	27.1%
<i>with 25% corporation tax</i>	32.5%	32.5%	32.5%
Other assets – not shares	10%	20%	20%
Other assets – shares			
<i>with 19% corporation tax</i>	27.1%	35.2%	35.2%
<i>with 25% corporation tax</i>	32.5%	40.0%	40.0%
Exempt assets, and all gains unrealised at death	0%	0%	0%
Source of income			
Employment	36.7%	49.0%	53.4%
Self-employment profits	26%	42%	47%
Rent and interest	20%	40%	45%
Dividends			
<i>with 19% corporation tax</i>	26.1%	46.3%	50.9%
<i>with 25% corporation tax</i>	31.6%	50.3%	54.5%

Note: BADR stands for business asset disposal relief. IR stands for investors' relief. We show marginal combined rates including (where relevant) corporation tax at the 19% small profits rate and the main 25% rate. Employment income includes employee and employer National Insurance contributions. Self-employed profits include self-employed National Insurance contributions. Income tax rates are different in Scotland; employment and self-employment lines shown here apply in the rest of the UK.

shares would be lower (to account for corporation tax levied on the underlying profits) than the rates on other assets.²⁸ When considering the rates that apply to employment income, one must account not only for income tax but also for employee and employer National Insurance contributions (NICs). The combined rates of tax on different income sources are shown in Table

²⁸ Note that there is not a single corporation tax rate. Companies with annual profits below £50,000 are subject to a marginal 'small profits' rate of 19%, while those with profits above £250,000 face the main 25% rate. Companies with profits between £50,000 and £250,000 are subject to 'marginal relief' and face a marginal rate of 26.5%.

7.2 (note that income tax rates differ in Scotland).²⁹ Full alignment would require that within the basic-, higher- and additional-rate bands, all of the rates be the same across sources of income and gains.

Tax rates could be aligned at any level; rates on employment income could be reduced while rates on capital gains (and capital income) were increased. If CGT rates were aligned with current (overall) tax rates on labour income, it would require very large rate increases. For example, the rate on ‘other assets – not shares’ within the higher-rate band would need to be increased from 20% to 49%. For shares (which fall within ‘other assets’), and if accounting for corporation tax at 19%, the rate would need to be increased from 20% to 37% (such that the overall rate moved from 35.2% to 49%). As part of alignment, BAD relief would need to be removed. We take no stance on the overall level of tax rates. But we note that, in practice and since employment tax rates are not going to be levelled down to capital gains tax rates (it would represent a huge tax cut), aligning rates (as laid out in our ‘big-picture’ solution) would include substantially higher CGT rates.

International issues

Higher CGT would make the UK a less attractive place for people to live at the time they realised a capital gain. It would affect incentives to work and invest in the UK only to the extent that those are linked to where people live when they realise a capital gain – though there are undoubtedly some such links: for example, people running a business tend to work and invest in the country they live in, and may be reluctant to emigrate purely for tax reasons when they want to sell the business. Non-residents (and corporate investors) investing in the UK would be unaffected by reforms to CGT, except insofar as they applied to investments in UK land and property.

Higher effective rates of UK CGT would thus increase both the incentive for individuals with accrued but unrealised capital gains to leave the UK and the disincentive for such individuals to come to the UK. One option to address this would be for the UK to introduce ‘deemed disposal on departure’ for CGT purposes, matched by ‘rebasing on arrival’ for new arrivals.³⁰ This would ensure that all gains accrued by an individual whilst UK-resident are taxed in the UK, even if

²⁹ Note that, even where higher- and additional-rate taxpayers face similar *marginal* rates on labour and capital income, the lower rate within the basic-rate band means that people who are only higher- and additional-rate taxpayers because of their capital income face lower *average* rates than people whose income comes entirely from labour.

³⁰ Another option used by some countries is to operate a ‘tail’ for CGT purposes, where gains remain taxable on non-residents for a number of years after leaving (the UK currently does this only for people who then move back to the UK within six years). However, international experience indicates that CGT tails can be difficult to enforce and are relatively easy to avoid, and they levy no tax on those who emigrate permanently. Symmetrically, a ‘grace period’ after people arrive in the UK (four years under current plans to be implemented in April 2025, though that is only for gains on overseas assets) can mitigate disincentives for people to come to the UK in the first place, but is not a complete solution.

they subsequently moved abroad, but would correspondingly exempt from CGT any gains accrued prior to arrival.

- **Rebasing on arrival (ROA)** works by granting new arrivals (or returners) to the UK a ‘rebasing’ of their assets to their value at the date of arrival, so that only rises in value after they arrive are subject to UK CGT.
- **Deemed disposal on departure (DDD)** works by treating individuals who leave the UK (i.e. become non-resident for tax purposes) as having disposed of their assets at the end of their final year of residence, thereby bringing into CGT all of the gains that they accrued whilst UK-resident even if they have not made an actual disposal.

In combination, ROA–DDD would in effect move CGT from taxing gains *realised* while living in the UK to taxing gains *accrued* while living in the UK. There are practical challenges with this approach: for example, it would require valuing assets at the points of arrival and departure; and DDD could create cash-flow difficulties for some of those leaving the UK who face a CGT liability despite not selling their assets (though there are possible ways to mitigate this). There would be a number of other difficult design issues to negotiate, beyond the scope of this chapter. But it would clearly be feasible for the UK to adopt ROA–DDD, since the policy is already in operation in Australia, Canada and elsewhere.³¹ The UK is unusual internationally in having no CGT charge on emigrants (unless they move back to the UK within six years).

While ROA–DDD would help to address the concern that higher CGT would lead people to realise gains outside the UK (eating into the potential revenue yield of the tax rise), it would not address the concern that higher CGT rates would lead people to *accrue* gains outside the UK – that is, to live outside the UK while they work and invest to generate capital gains. Indeed, by making it harder for people to live in the UK and accrue gains here without paying CGT, it might make that problem worse. This is similar to the effect that (for example) increasing income tax rates can have on internationally mobile individuals, but for business owners and investors rather than top-earning employees. The likely aggregate impact should not be overstated, though: relatively few of those making large capital gains ever move countries. And people’s decisions over where to live while they work and invest to generate capital gains may be less responsive to taxation than decisions over where to live when they realise those gains.

Potential emigration is therefore a consequence to bear in mind when increasing CGT rates (like international mobility matters for other taxes, to varying degrees) – though note that, on the flip

³¹ The US, Japan and Norway also have DDD for CGT purposes. In the US, a deemed disposal applies upon relinquishing citizenship, which is equivalent (under the US system of citizenship taxation) to becoming non-resident. France and Germany also both operate DDD, although effective implementation is made more difficult within the EU as a result of restrictions imposed by the principle of free movement. In addition to international examples, the UK already operates DDD for companies and trusts: Taxation of Chargeable Gains Act 1992, Section 80 and Section 185.

side, more generous deductions for investment would make the UK a more attractive place for investors to live. But concerns about the mobility of a small number of people should not stop the government from moving towards alignment of tax rates across sources of income and capital gains for the wider UK population. Low rates of CGT across the board are not well targeted at attracting internationally mobile individuals. Most CGT revenue does not come from highly mobile groups, and it is not clear that mobility is closely linked to capital gains specifically (rather than high incomes, or particular industries or activities, or the treatment of those arriving or leaving).

Simplification

CGT is complex. It creates a large burden on taxpayers and on HMRC. Some of the components we have laid out – notably, implementing an RRA or moving to a form of indexation – would add a small amount of further complexity. Although it is worth noting that we do not envisage anything like the complexity that arose under the previous system of indexation, not least because modern IT would make implementing the system significantly less costly. But our big-picture solution would be a substantial simplification overall. Moving towards neutrality reduces the need for – or at least takes the pressure off – boundaries in the tax system and therefore the need to have rules to police those boundaries. For example, under the full solution, there would be no tax incentive to shift between income and capital gains such that it would not really matter whether carried interest or share buy-backs were treated as generating income or capital gains. Significant legal simplification would come from obviating the need for whole swathes of existing anti-avoidance legislation.

In practice, the extent of remaining complexity would depend on which specific reforms were pursued – a cash-flow approach would be simpler than an RRA, for example – and on any transitional arrangements (see Section 7.7).

7.6 Trade-offs and options when making partial reforms to CGT

The previous section set out the components of a fully reformed tax regime for capital gains and income. In the big-picture solution, the tax base changes would apply to all investments, regardless of whether they went on to generate capital incomes or gains. And rate alignment would take place not only within CGT but also in relation to income taxes. A fully reformed system represents a significant prize. It would be less distortionary – and therefore more growth-friendly – because tax would no longer be as much of a driver of how people choose to work or realise returns to their efforts or investments, of asset choices or of the timing of transactions.

Since there would be no big tax differences between similar activities, there would be little need to police boundaries and the system would be much fairer.

But, even if the government accepted this as the right end goal, it is unlikely that it would make all of the changes in the upcoming Budget. More likely is that the government would choose to reform some rates or elements of CGT, possibly leaving the rest of the tax system (i.e. outside CGT) unchanged. In this case, trade-offs would inevitably arise. Here we briefly highlight some of the main trade-offs.

- Reforms to the CGT tax base that provide more generous deductions for purchase costs or losses would reduce distortions and reduce disincentives to invest. But these reforms would cost money (and be a giveaway to relatively rich people). If the government wishes to raise revenue, it will need to do at least some rate rises alongside these base reforms.
- Increases in rates of CGT without removing uplift at death would increase the incentive to hold on to assets until death. We argue that uplift at death should be removed regardless of what other reforms are planned.
- Increases in rates of CGT without changes to the tax base would lessen some distortions, including the incentive to work through one's own business rather than be employed and to realise the returns to investment in the form of gains rather than income, but worsen others, including weakening investment incentives and exacerbating the bias against risk-taking and the lock-in effect. And recall that distortions caused by the tax base rise more than in proportion to tax rates, because low tax rates only change behaviour when the decision is marginal anyway whereas higher tax rates discourage not only more activities, but also more valuable activities.
- Different sources of income are taxed at different rates, so if rates of CGT are changed but tax rates on income are not,³² tax rate differentials (and the associated distortions they cause) will inevitably persist across different types of income and gains. If the government wanted to align the tax rates on gains with the rates on income, it would have to choose which source of income to align with. For example, self-employed profits and dividends are taxed at particularly low rates relative to employment income within the basic-rate tax band (see Table 7.2 earlier). In this case, CGT rates could in principle be moved towards alignment with any of the tax rates on income. If they were aligned (within the basic-rate band) with tax rates on employment income, there would be a strong incentive to take investment returns in the form of dividends rather than capital gains. If they were aligned with dividend tax rates, there would continue to be a tax penalty on employment.
- Higher rates of CGT would weaken work incentives – for example, by increasing the tax on owner-managers' labour supply. (Although note that employees' labour supply would still

³² The Labour Party's election manifesto ruled out increasing the basic, higher or additional rates of income tax.

be taxed more heavily. And increasing tax on capital gains while reducing tax on employment income could even out the treatment of different forms of remuneration without increasing tax on work overall.)

There are many ways in which partial reforms could be done. Here we discuss just two options that would combine reforms to the tax base and to tax rates, assuming that the government will not change tax rates outside CGT.

Advani, Lonsdale and Summers (2024b) also discuss possible reform options and lay out estimates of the revenue and distributional effects of increasing CGT rates while making various changes to the tax base.

Example: index for inflation and align CGT rates with income tax

As part of the big-picture solution, we recommend giving more generous deductions for asset purchase costs. This could be done in several ways, including by introducing an RRA or (equivalently) indexing for an interest rate.

The UK has previously operated a CGT with indexation for inflation. Reintroducing indexing for inflation would eliminate the sensitivity of investment decisions to inflation and would alleviate (but not remove) the disincentives to save/invest, and the lock-in effect. While it would not remove all problems, inflation indexation could be seen as a step towards indexing for an interest rate, and therefore a step in the right direction.

Alongside this partial base reform, the government could increase CGT rates, but not go as far as full alignment with overall tax rates on employment income.

Table 7.3. An illustration of a potential reform to CGT rates

Source of gains	Basic rate	Higher rate	Additional rate
All assets except shares	20%	40%	45%
Shares	8.75%	33.75%	39.35%
Effective rate on shares			
<i>With corporation tax at 19%</i>	26.1%	46.3%	50.9%
<i>With corporation tax at 25%</i>	31.6%	50.3%	54.5%

Note: Headline corporation tax rate is 25%. The small profits rate is 19%.

Source: Authors' calculations.

Assuming that only CGT rates are changed, one option would be to align CGT rates with income tax rates. Specifically, that would mean having two sets of CGT rates (illustrated in Table 7.3). The basic, higher and additional rates of CGT would be 20%, 40% and 45% respectively (matching ordinary income tax rates) for all assets except shares, for which they would be 8.75%, 33.75% and 39.35% (matching the special rates of income tax on dividends). This would be a reduction in the CGT rate on shares for basic-rate taxpayers, and an increase in the rate for other assets and other taxpayers.

CGT rates would be lower for shares than for other assets – just like income tax rates are lower for dividends than for other income – to reflect corporation tax. This is more logical and defensible than the current system where CGT rates depend on the ownership of the business rather than on whether the business profits are subject to corporation tax (and are arbitrarily higher for second and rental homes). Aligning CGT rates with income tax rates is also relatively easy to explain.

This reform would not produce full alignment of tax rates on capital gains across all assets: the effective tax rate (after accounting for corporation tax) would be higher on shares than on other assets. But the alignment across assets would be much closer than it is now, and for the most part this reform would act to align the tax rates on capital gains with those on capital incomes from the same assets.³³

This would rationalise the system and move closer towards overall alignment. Within the current system it is hard to understand why capital gains on shares should be taxed more than dividends at the basic rate but less than dividends at the higher rate; or why ordinary income and dividends are subject to basic, higher and additional rates of tax while capital gains are subject only to basic and higher (no additional) rates.

Taken as a package, introducing indexation for inflation and aligning CGT rates with income tax rates would be more efficient and fairer than the current system. Employment income would still be taxed at higher rates than capital incomes or gains – largely as a result of employer National Insurance contributions – but the disparity would be smaller.

Example: scrap BAD relief and introduce up-front relief for investment

We showed in Section 7.2 that around half of taxable capital gains (by value) come from unlisted shares. Many of these will benefit from business asset disposal relief, the existence of

³³ There would still be a differential tax rate on self-employed profits, which are subject both to income tax and self-employed National Insurance contributions.

which creates very strong incentives to operate via a business and to take returns (including returns to labour) in the form of capital gains rather than income, where possible.

BAD relief (and preferential rates of CGT more generally) is not well targeted at entrepreneurship (see Section 7.4) and leads to a range of undesirable distortions (Section 7.3). Simply removing BAD relief in isolation would come with trade-offs: distortions caused by rate differentials would be lessened (e.g. there would be a reduced incentive to take returns in the form of capital gains) but distortions related to the base would be worse (a higher rate would weaken investment incentives and exacerbate the bias against risk-taking and the lock-in effect). Removing BAD relief would also weaken work incentives by increasing the tax on owner-managers' labour supply (although note it would still be taxed less heavily than for employees).

The downsides of that trade-off could be greatly reduced if BAD relief were scrapped while deductions for asset purchase costs were made more generous.

Adam and Miller (2021) set out one specific option for providing more generous tax treatment of investment in shares. They describe a new vehicle – which they call a ‘Personal Shareholding Account’ (PSA) – that would provide a cash-flow tax treatment (as described in Section 7.5) when people bought newly issued shares. Individuals would receive up-front income tax relief on any money they put into a PSA. Money in the PSA could be used to buy new equity issued by companies, and any dividends or capital gains received within the PSA would not be taxed. But any money the individual withdrew from the PSA would be subject to tax at that point. (Note there would be a single tax rate schedule with no distinction between dividends and capital gains.) That is identical to the current income tax treatment of pensions, except that there would be no 25% tax-free lump sum. The PSA could also be likened to an ISA or to one of the current venture capital schemes (EIS/SEIS/VCTs).³⁴ Unlike any current vehicles, however, it would be available – indeed, intended – for people to invest in their own company (or that of a connected person), not just for arm's-length shareholders. In that respect, it could also be thought of as a replacement for BAD relief – a reorienting away from tax relief on large gains to tax relief on investment. Importantly, the PSA would be better targeted: it would be available to business owners making new investments at the point they invest and in proportion to the amount they invest, rather than available to all business owners regardless of investment, only many years in the future, and worth more to those who make the most money.

In principle, there would be no need for restrictions on when a PSA could be used: the PSA would be well suited to portfolio investment in the stock market and, since it offers neutral rather

³⁴ The Enterprise Investment Scheme (EIS), the Seed Enterprise Investment Scheme (SEIS) and Venture Capital Trusts (VCTs) provide various combinations of income tax relief for amounts invested, CGT relief on returns and other tax advantages for investments that meet qualifying conditions.

than subsidised treatment, there seems little reason to limit the investments. Keeping the availability of the scheme as wide as possible would maximise the economic benefits and help to make the scheme better known. But if the government wanted to ‘test the water’, or were concerned about the potential size of up-front tax relief (although it would get correspondingly more revenue later from taxing withdrawals), then it could impose additional restrictions on PSAs, such as limiting eligible investments to shares in unlisted companies or imposing a cap on the amount that could be invested.

Miller and Smith (2023) empirically estimate the impact on business owners of removing BAD relief (taxing eligible gains at the main 20% rate rather than 10%) while moving to a cash-flow treatment of investment in their own business (i.e. giving individuals up-front income tax relief on any money they put in).³⁵ They find that:

- Removing BAD relief brings benefits (most notably, there is a substantial reduction in people keeping income in their companies for long periods) but leads to a small fall in investment – this is exactly the trade-off we discuss above. It is debatable whether this move, in isolation, would be an improvement.
- Introducing a new up-front relief boosts investment. Moreover, with the new relief in place, the higher rate of CGT has no disincentive effect on investment. (This assumes that there is no effect on people moving their capital into or out of the UK.)

The two measures implemented together work to boost investment and to raise a modest amount of revenue. It is a progressive change: revenue is raised from the top of the income distribution. More specifically, it is raised from people that have made very large gains relative to their investments. Those making large investments and making modest (‘normal’) returns see a tax cut.

7.7 Transition and retrospection

Whatever changes were made to CGT, a decision would have to be made over how to treat existing assets.

The simplest way to introduce reforms to CGT would be to apply them in full to any capital gains realised after the date the reforms were announced. One consequence of this approach

³⁵ To estimate the effects of this policy change, they use a sophisticated model of business owners which captures the different ways in which people can respond to tax changes, including choices over: whether to start a business; whether to incorporate; whether, how much and when to invest; how and when to take income out of a business; and when and how much to work. Underpinning the model is evidence on the activities of business owners and how they respond to tax policy. That evidence uses 20 years of data drawn from personal and corporate tax records held by HMRC and covering all owner-managed businesses (the self-employed and company owner-managers).

would be that higher rates – and any changes to the tax base (such as indexation) – would apply to gains that accrued when the previous system was in place but were realised afterwards, as well as to future investments and accruals. In this scenario, part of the net revenue raised would therefore derive from taxpayers’ past activities rather than their future ones. This is the way that most (although not all) reforms to CGT have been applied in the UK in the past, and is a natural consequence of CGT being a realisation-based, rather than accrual-based, tax.

In economic terms, this is an efficient way to raise revenue: since there is nothing taxpayers can do to change the past, this part of the revenue is raised without distorting people’s behaviour. Taxing the returns to past investment and effort cannot discourage them as they have already happened.

However, the flip side of this is that taxpayers may object that the tax is, in a sense, retrospective. They may have expected the existing CGT regime to persist when they invested and worked to generate the capital gain: the higher tax rate would be applied to gains that had already accrued.

There would be some justice to this complaint. However, it is not a clear-cut, decisive argument against the policy. Retrospection is not binary; it comes in different types and degrees, and almost all tax changes involve some element of retrospection. A rise in inheritance tax or VAT, for example, would also reduce the value of past wealth accumulation. Investors (and others) always face the risk that the government will change policy; violating their legitimate expectations is something governments should try to avoid, but cannot be an absolute block on policy changes. In any case, it seems unlikely that most people would have formed a strong expectation of policy stability in an area such as CGT which has changed so often, and which (when changed) usually does so with full effect for disposals made after the reform date. It is also worth noting that giving more generous allowances for past investments would ‘retrospectively’ benefit taxpayers, who would have expected the less generous regime when they were making their investments. Those making only modest returns would find that most or all of the CGT they were expecting to pay was wiped out by more generous allowances.

There are several ways that governments have previously attempted to reduce the degree of retrospection associated with a CGT reform.³⁶ In very broad terms, they boil down to trying to apply the new regime only to gains that are accrued after the point of the reform. But all of the options for doing that in practice have significant disadvantages. To varying degrees, all would create more complexity, create opportunities to reduce tax liabilities by delaying or accelerating transactions, and reduce the revenue yield of the reform without reducing its economic efficiency cost.

³⁶ We do not discuss the possible approaches here. There is some discussion in Adam (2008). Adam and Miller (2021) briefly say how some of these options could operate for some example reforms.

7.8 Revenue, winners and losers

Revenue

The HMRC Ready Reckoner, as of June 2024, says that small increases in main capital gains tax rates would raise a small amount of revenue, while a larger rate increase would lead to a fall in revenue. For example, a 1 percentage point increase in the higher rates of capital gains tax in April 2025 is estimated to raise just £100 million in 2027–28 while a 10 percentage point increase is estimated to reduce revenue by around £2 billion (HM Revenue and Customs, 2024).

In the absence of sufficient information as to how these estimates are produced, it is difficult to assess their credibility.³⁷ However, based on available evidence, we do not think the behavioural responses to higher rates would be such that a 10 percentage point rate increase would leave us above the revenue-maximising rate. As such, we think it unlikely that the Ready Reckoner figures give a good guide to the revenue effect of higher CGT rates over a longer time horizon.

In any case, the nature and size of behavioural responses, and therefore the effect on revenue, would hinge critically on the exact reform. If, for example, uplift at death remained in place and there was no change to how we tax gains when people emigrate, we would expect higher tax rates to lead more people to hold on to assets until death or emigration and thereby avoid paying CGT. Conversely, removing these opportunities to defer realisation should reduce people's ability to avoid higher tax rates, such that we would expect a rate increase to raise more revenue than under the current tax base.

Aside from increasing rates, some other possible changes to CGT would raise revenue. At current tax rates, and before accounting for behavioural responses, currently available estimates tentatively suggest that the cost of uplift at death is about £1.6 billion (Advani and Sturrock, 2023) and the cost of BAD relief is about £1.5 billion (HM Revenue and Customs, 2023). We would expect removing either relief to mean that more revenue would be raised by an increase in headline rates (because a rate increase would apply to a broader tax base and there would be fewer ways to avoid paying higher rates).

Introducing more generous treatment of purchase costs and/or losses would cost money – though part of the up-front cost would be recouped in the longer run as doing this would reduce the disincentive to invest and take risks. It would also mean that rate increases had less of a disincentive effect. As shown in Section 7.2, a large share of taxable capital gains come from

³⁷ Increasing CGT rates would affect people's behaviour in a variety of ways, some of which would reduce the yield of a rate increase, some of which would increase the yield, and some of which would change the timing of revenue. HMRC publishes information on which types of behavioural response and knock-on effects to other taxes it attempts to account for in the Ready Reckoner figures, but not on its methodology or on the empirical estimates of responsiveness that it uses.

private businesses and a large share of those gains are very large relative to the initial investment. Broadly speaking, this suggests that – to the extent that gains in future are like those in the past – the revenue potential from higher tax rates (on excess returns) is large relative to the cost of giving more generous reliefs for initial investment costs. This of course assumes that higher rates could not be avoided – for example, through holding on to assets until death or emigration or putting wealth into tax-privileged vehicles instead.

For any reform, the amount of revenue raised in the short run would depend on the transitional arrangements: higher rates would raise less if they were not applied fully to gains already accrued (but not yet realised), and more generous treatment of investment costs and losses would cost more if they applied to existing assets and previous years.

Short-run revenue effects also depend on people's expectations about whether and how the CGT regime might change again in future. There is currently anecdotal evidence of people realising gains in advance of the upcoming Budget and in expectation of a rate increase; this could lead to a spike in revenues this year and a fall next year. After the Budget, people might defer selling assets if they anticipate a subsequent reduction in CGT rates. That is, higher rates could temporarily lower revenues if people expect rates will be lowered again. Conversely, people might sell assets more quickly if they think further increases in the CGT rate are on the horizon. These judgements are inevitably highly sensitive to the political context. Policy credibility is crucial. Further policy changes can never be entirely ruled out, but reforms introduced during the first year of a new government with a big majority can perhaps be expected to be more durable than if done shortly before a closely contested election.

Advani, Lonsdale and Summers (2024b) use HMRC tax records to estimate the cost of various reforms to CGT.

Winners and losers

It is also possible to set out, broadly, which types of people would gain or lose under our 'full proposal' (which would entail a reformed tax base and higher marginal CGT rates³⁸). These broad patterns would hold for many smaller steps in that direction.

Where capital gains represent returns to labour (e.g. that of a business owner, a person renovating a house, a skilled investor or a private equity manager), or market power, or luck (such as owning a house in an area where prices rose), the policies we propose would represent a tax increase; if CGT rates were fully aligned with current labour income tax rates then in some cases it would be a very large increase. There is no way to reform CGT effectively without

³⁸ We do not take a position on the level at which tax rates should be aligned; rates on employment income could be reduced alongside increases in rates on capital gains (and capital income).

making this group worse off. But note that this could equally be described as removing the tax advantages they receive under the current tax system. Increasing tax on the returns to work has clear downsides, but there is no good reason to tax work less heavily if it generates a capital gain than if it generates employment income. Increasing tax on capital gains while reducing tax on employment income could even out the treatment of different forms of remuneration without increasing tax on work overall. If reform of the system included lower taxes on employment income as well as higher rates of CGT, employees would gain while those receiving labour returns in the form of capital gains would lose.

For individuals who are investing their money and taking risks, there would be offsetting effects from our proposals. There would be more generous treatment of investment costs and more risk-sharing with the government. Many of those making relatively low returns (e.g. those making low-risk arm's-length investments and those taking risks that do not pay off) would see lower taxes – and this is where tax is likely to make most difference to whether projects go ahead. Those making very high returns – which could reflect some combination of effort and skill, privileged access to scarce opportunities, and luck – would pay more.

Revenue would be raised very progressively. As shown in Section 7.2, taxable capital gains are heavily concentrated at the top of the income distribution.

In all cases, the transition arrangements would have a large effect on the exact winners and losers. Specifically, if reforms applied to existing gains, the winners and losers would include people who had already accrued but not yet realised capital gains (or losses). If any new regime only applied to the future, the winners and losers would only be those people who accrue gains in future.

7.9 Conclusion

Policymakers perceive a tension when setting CGT rates. The desire to create a fair system and stop tax-motivated changes in behaviour to realise returns in the form of capital gains suggests that capital gains tax rates should be similar to income tax rates. But the desire to ensure that tax does not discourage saving and investment is often used to support lower rates. What results is an awkward compromise. The current design of CGT discourages saving and investment and distorts choices people make about which assets to buy and sell and when. And it creates unfairness, with some people able to access much lower tax rates than others. Politicians over the decades have chosen different points on this perceived trade-off but, since neither aim is ever achieved, the system is subject to constant tinkering. Moreover, the compromise creates many boundaries in the tax system – including between capital gains and capital income – which then require great effort to define and police. The UK is not alone here: most governments choose

low capital gains tax rates (relative to income tax rates) on nominal gains, and as a result they face the same set of problems we set out in this chapter.

We argue that the two aims – economic efficiency and fairness – can both be achieved, and the tension overcome, by using tax rates *and* the tax base. The design of the tax base is often overlooked, but it is critical for creating a capital gains tax that does not discourage saving and investment.

We have sketched out a ‘big-picture’ solution that would vastly improve – and in many cases largely remove – the problems of the current system in a domestic context. We have also discussed how the tax treatment of people who enter and leave the UK could be changed so that higher CGT rates do not lead to people leaving the UK in order to realise gains.

Short of a full-scale overhaul of the way we tax capital gains and income, the government would have to manage inevitable trade-offs, since some distortions would be made better and some worse. But there are steps that could be taken in the right direction.

Regardless of how much revenue the government would like to raise, it has an opportunity to implement a system that is fairer and less damaging to economic growth. Making the system less damaging is even more important if the government would like to raise more revenue in the medium term.

The details of any reform will be crucial. The government should take care to get these right. It should also seek to ensure that any reform is credibly lasting. CGT has been reformed many times in the past decades. If people believe that any policy choice will be reversed in future years, it will distort behaviour. For example, people will hold off selling assets if they think there will be a more favourable reform in future. And if people expect rates to rise in future, they will be more inclined to sell assets in advance. Similarly, it is undesirable to leave people thinking that any reform is simply more upheaval, with more unknown reforms likely in coming years. Making a policy change credibly lasting requires setting out clear principles and a rationale for reform, rather than simply tinkering and tweaking to raise a bit more cash. Instability and unpredictability are bad for investment.

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Abbreviations

AE	automatic enrolment
AfC	Agenda for Change
AFPRB	Armed Forces Pay Review Body
AHC	after housing costs
AME	annually managed expenditure
ASHE	Annual Survey of Hours and Earnings
BAD	business asset disposal
BADR	business asset disposal relief
BBC	British Broadcasting Corporation
bbl	barrel
BCF	Better Care Fund
BEA	Bureau of Economic Analysis
BHC	before housing costs
BLS	Bureau of Labor Statistics
bn	billion
BoE	Bank of England
BRMA	broad rental market area
CBI	Confederation of British Industry
CDEL	capital DEL
CGT	capital gains tax
CPI	Consumer Prices Index
CPIH	Consumer Prices Index including owner-occupiers' housing costs
CPIX	Consumer Prices Index excluding energy
CVM	chain-linked volume measure
DB	defined benefit
DC	defined contribution

DDD	deemed disposal on departure
DDRB	Review Body on Doctors' and Dentists' Remuneration
DEL	departmental expenditure limits
DFM	dynamic factor model
DHSC	Department of Health and Social Care
DMP	Decision Maker Panel
DWP	Department for Work and Pensions
EIS	Enterprise Investment Scheme
ELSA	English Longitudinal Study of Ageing
ESRC	Economic and Social Research Council
EU	European Union
ex	excluding
F	forecast
FCDO	Foreign, Commonwealth and Development Office
Fed	Federal Reserve
FIG	foreign income and gains
FRS	Family Resources Survey
FTE	full-time equivalent
G7	Group of Seven countries: Canada, France, Germany, Italy, Japan, UK, US
GDP	gross domestic product
GFC	Great Financial Crisis
GNI	gross national income
GOS	gross operating surplus
GP	general practitioner
GVA	gross value added
H	half
HBAI	Households Below Average Income
HM	Her/His Majesty's
HMRC	Her/His Majesty's Revenue and Customs
HMT	Her/His Majesty's Treasury

ICT	information and communication technology
IFS	Institute for Fiscal Studies
IMF	International Monetary Fund
IR	investors' relief
ISA	Individual Savings Account
IT	information technology
ITT	initial teacher training
K	thousand
KLEMS	capital (K), labour (L), energy (E), materials (M) and service (S) inputs
kWh	kilowatt-hour
LFS	Labour Force Survey
LH	left-hand
LHA	local housing allowance
LHS	left-hand side
LTCI	long-term care insurance
LTWP	'Long Term Workforce Plan'
m	million
M	month
MFL	modern foreign languages
MIDAS	mixed data sampling
MIG	minimum income guarantee
MM	month on month
MPC	Monetary Policy Committee
n.a.	not applicable
N/A	not available
NAIRU	non-accelerating inflation rate of unemployment
NATO	North Atlantic Treaty Organisation
NBER	National Bureau of Economic Research
NHS	National Health Service
NICs	National Insurance contributions
NIESR	National Institute of Economic and Social Research

NLW	National Living Wage
OBR	Office for Budget Responsibility
ODA	official development assistance
OECD	Organisation for Economic Cooperation and Development
OME	Office of Manpower Economics
ONS	Office for National Statistics
OPEC	Organisation of the Petroleum Exporting Countries
p.a.	per year
PAYE	Pay-As-You-Earn
PE	physical education
PEA	personal expenses allowance
PIP	personal independence payment
PMI	Purchasing Managers' Index
PPI	producer price index
ppt	percentage point(s)
PRB	Pay Review Body
PRRB	Police Remuneration Review Body
PSA	Personal Shareholding Account
PSCE	public sector current expenditure
PSGI	public sector gross investment
PSND	public sector net debt
PSNFL	public sector net financial liabilities
PSNI	public sector net investment
PSNW	public sector net worth
p.w.	per week
Q	quarter
R&D	research and development
RDEL	resource DEL
RH	right-hand
RHDI	real household disposable income
RHS	right-hand side

ROA	rebasing on arrival
RPI	Retail Prices Index
RRA	rate-of-return allowance
RTI	Real Time Information
SCAPE	Superannuation Contributions Adjusted for Past Experience (discounting methodology)
SCS	senior civil service
SEIS	Seed Enterprise Investment Scheme
SIC	Standard Industrial Classification
SMEs	small and medium enterprises
SNP	Scottish National Party
SR	Spending Review
SSRB	Senior Salaries Review Board
STEM	science, technology, engineering and maths
STRB	School Teachers' Review Board
SVAR	structural vector autoregression
TAXBEN	the IFS tax–benefit microsimulation model
TDEL	total DEL
TFP	total factor productivity
TME	total managed expenditure
UC	universal credit
UK	United Kingdom
US	United States
USD	US dollars
VAR	vector autoregression
VAT	value added tax
VCT	Venture Capital Trust
YY	year on year

