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INSTITUTE FOR GOVERNMENT

The cost of Covid-19

The impact of coronavirus on the UK's public finances

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About this report

The coronavirus pandemic has prompted the deepest recession in the UK for 300 years. To manage this, the government, like many others, has enacted several policies to keep the economy afloat through lockdowns and steep drops in activity. This has come at great cost to the public finances. This report, a 'snapshot' edition of the Institute for Government's annual *Whitehall Monitor* report, seeks to calculate that cost by assessing the impact on public finances wrought by the pandemic, using government data for the 2020/21 financial year to 22 September.

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Summary

The coronavirus pandemic is above all a public health crisis. Globally, more than 28 million people have been infected with the Covid-19 virus; approaching one million have died. Both numbers continue to rise. Fighting the spread of Covid has led governments around the world to impose restrictions on the public, curtailing basic liberties and everyday activities to protect people's health.

These steps have had profound economic consequences. Although the first cost of Covid has been to human life and health, measures taken to address the crisis have sent economic output tumbling. Business activity and people's livelihoods have been put on hold or curtailed, culminating in the biggest shock to the UK economy in 300 years. The increased spending by the government coupled with reduced tax revenue has had a dramatic impact on the UK's public finances. We estimate that announcements made by the government up to mid-September 2020 imply that the cost of Covid to the UK government – in the form of increased public borrowing – will be £317.4 billion in 2020/21 alone.

This paper analyses the impact that the pandemic has had on the UK's public finances in the current financial year. We calculate the cost of Covid to the public purse, drawing together data on government spending and tax revenues, as well as calculating the impact on the spending of government departments. We also compile data on the cost of the pandemic to the finances of local authorities in England. This paper examines the impact of government announcements made up to 22 September 2020.

The pandemic and the government's economic response to it are both ongoing, meaning that it is difficult to provide a consistent and comprehensive breakdown of every aspect of the cost of Covid. Indeed, since this report was drafted the UK alert level has gone up, and new restrictions brought into effect across the country – which the prime minister has indicated may persist for six months. Those restrictions – and the package of further tax and spending measures announced by the chancellor on 24 September – have not been factored into this report, but the findings presented here, based on publicly available figures, illustrate the key questions facing the government as it approaches decisions about spending next year and beyond.

Our findings include:

- Public borrowing in 2020/21 will be £317.4bn above the government's plans. This is the effective 'cost of Covid' so far to the public finances in the current year. The details of this are set out overleaf in Figure 1 and Table 1.

- The majority of this (£192.3bn) is the result of specific policy decisions taken by the government, including measures to try to insulate households and businesses from the worst of the crisis.

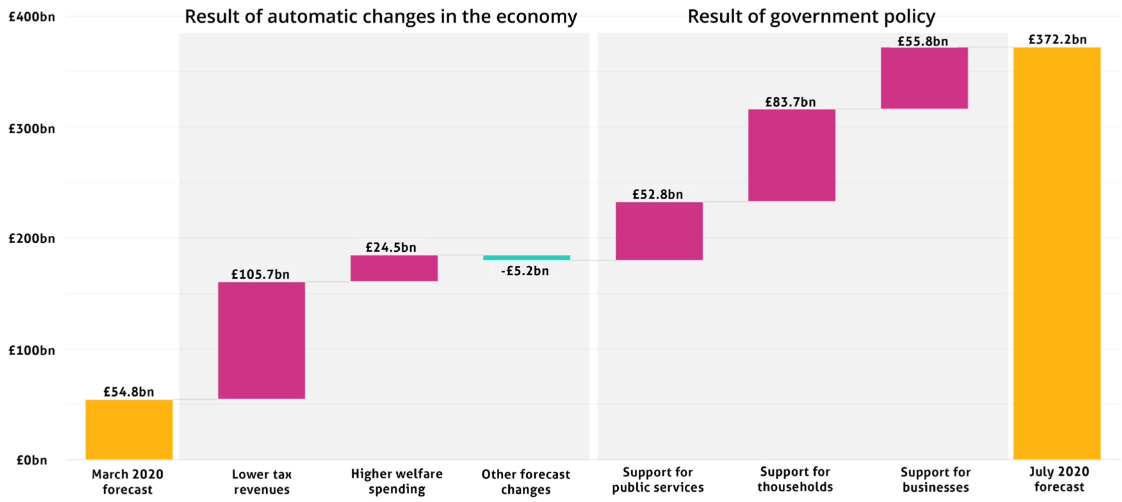
- The government's decision to support businesses and households through Covid means, we estimate, that it has absorbed nearly two thirds (64.5%) of the pandemic's hit to the private sector.

- Reduced output has also hit tax revenues and led to higher welfare spending, pushing planned borrowing up by a further £125bn.

- Government departments are expected to spend 19% (or £76.3bn) more than their allocated budgets this year to meet the demands of the coronavirus response.

- The day-to-day running costs of central government departments are £600m more than planned.

Figure 1: **Change in forecasts for 2020/21 public sector net borrowing, March–July 2020**



Source: Institute for Government analysis of OBR, Fiscal Sustainability Report, July 2020; and OBR, Covid policy measures database. Chart adapted from OBR, Fiscal Sustainability Report executive tables, C3.

Table 1: **The Cost of Covid-19 to the UK's public finances in 2020/21**

Support for businesses £55.8bn	Lower tax revenue £105.7bn
Support for households £83.7bn	Higher welfare spending £24.5bn
Support for public services £52.8bn	Changes in forecast -£5.2bn (saving)
Total result of government policy £192.3bn	**Total result of automatic changes £125bn**

Total cost of Covid-19 (change in public borrowing in 2020/21) £317.4bn*

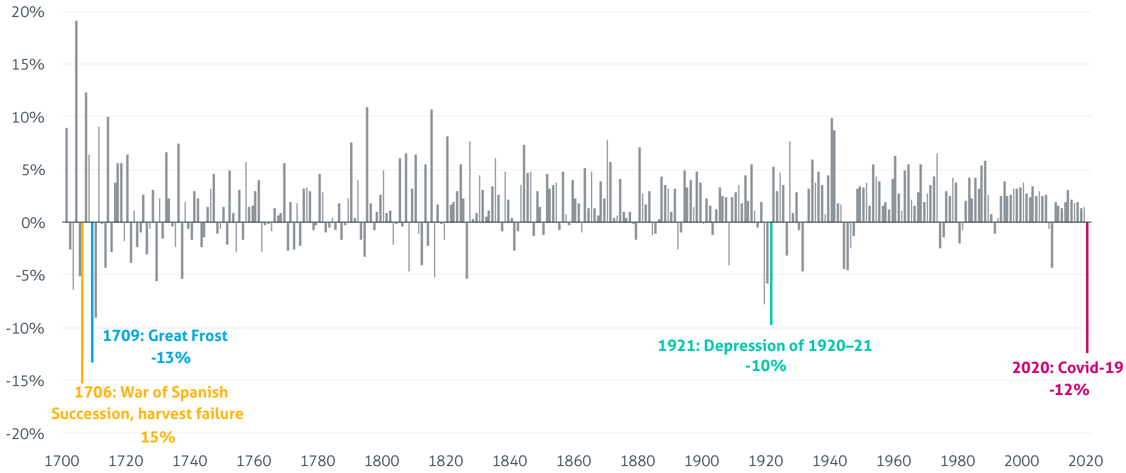
* Note that numbers in this table do not sum due to rounding.

Although this paper focuses on the current financial year, there is considerable uncertainty about the future of the pandemic and its longer-term economic effects. As the government imposes renewed restrictions on social interactions and approaches decisions this autumn about public spending next year and beyond, it faces several difficult questions about how long-lasting the impacts of Covid will be and what further support public services, businesses and households need from the government. Uncertainty about the course of the pandemic, and its economic impact, mean that the government will need to take a flexible approach in its decision making.

The scale of the economic shock

Coronavirus is the largest hit to the UK economy in 300 years

Figure 2: **Year-on-year changes in UK GDP, 1701–2020**



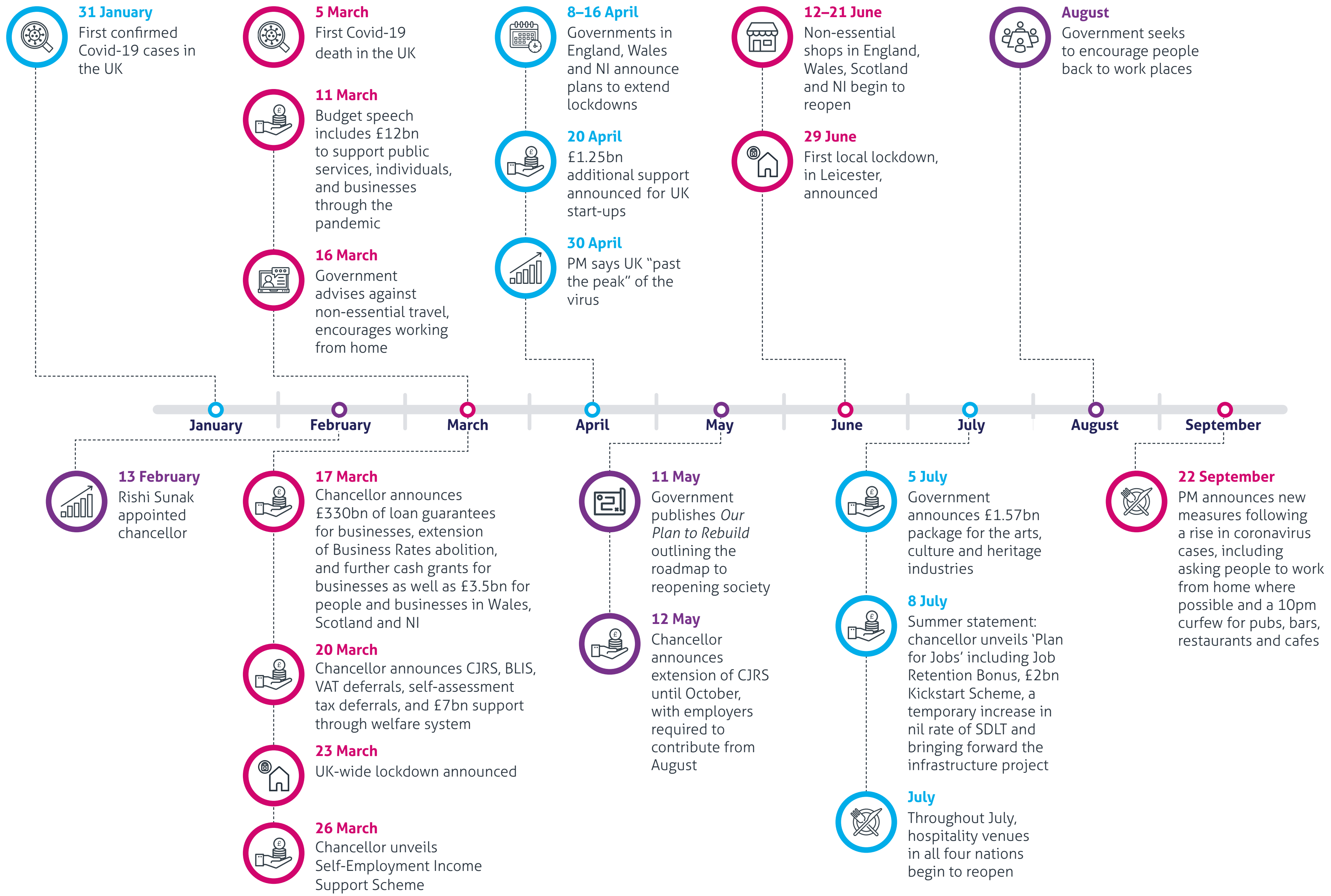
Source: Institute for Government analysis of Bank of England, 'A millennium of macroeconomic data for the UK' for pre-2016 data. Post-2016 data taken from OBR, Fiscal Sustainability Report supplementary tables, July 2020.

The coronavirus pandemic – and the resulting lockdown and social distancing measures enacted by the government – has led to a huge economic contraction in the UK, as in many other countries. Estimates vary, but many forecasters predict that output in the UK will be at least 10% lower in real terms in 2020 than in 2019. The latest central projection from the Office for Budget Responsibility (OBR), the UK's official forecaster, suggests output will fall by 12.4% this calendar year (and by 13.3% over the financial year 2020/21). As a result, UK economic output is expected to be £336 billion lower this financial year than was forecast in March.

As Figure 2 shows, a fall in output of this magnitude is larger than anything experienced in the UK in the last 300 years. The last time output fell so sharply was when Britain's largely agricultural economy was hit by the Great Frost of 1709, causing a 13.4% contraction. Since then, only the Depression of 1920–21 – when output fell by 9.7% – has come close to the scale of the economic hit from Covid-19.

In response, the government has announced a raft of new policies over the past six months. These are set out in Figure 3. In his budget in March 2020, the chancellor, Rishi Sunak, included £12bn in funding for public services, businesses and individuals in response to the worsening pandemic. In normal times, that would have been a substantial increase in public spending – but it has been dwarfed by the scale of government intervention announced since.

Figure 3: **Timeline of selected UK government Covid-19 spending and tax announcements, and key moments in the pandemic, January – September 2020**



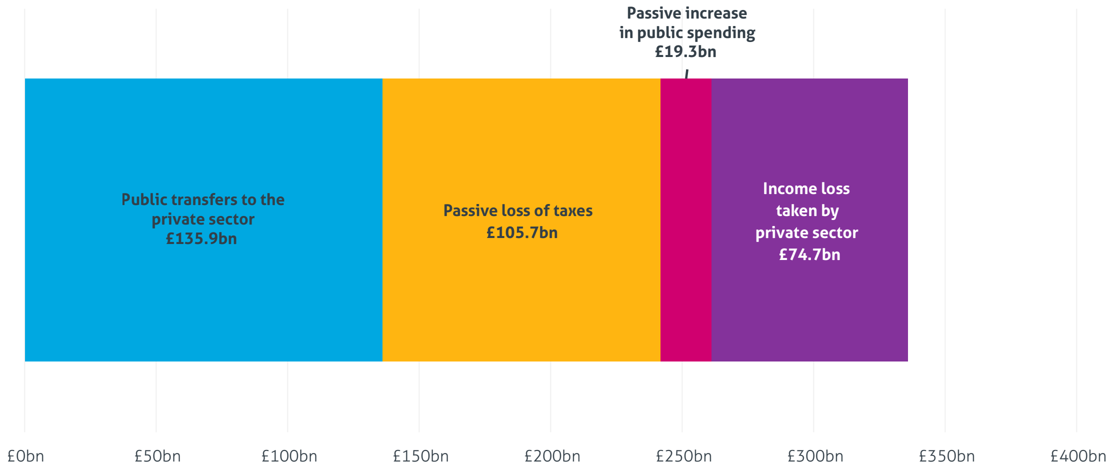
Source: Institute for Government analysis of government announcements on GOV.UK.

The government has insulated the private sector

The pandemic and lockdown have been a major threat to households and businesses, reducing their income. To address this, many of the measures announced by the government have sought to insulate businesses – and their workers – from the worst of the economic hit. Of the £192.3bn cost of the government's policy decisions in response to Covid, £139.5bn has gone on support for businesses and households. This is more than double the additional £52.8bn that the government has spent on public services in response to the pandemic.

As a result, we estimate that the government has absorbed 64.5% of the total income hit that the private sector would otherwise have experienced – as shown in Figure 4.[*]

Figure 4: **GDP loss caused by the Covid-19 pandemic, 2020/21**

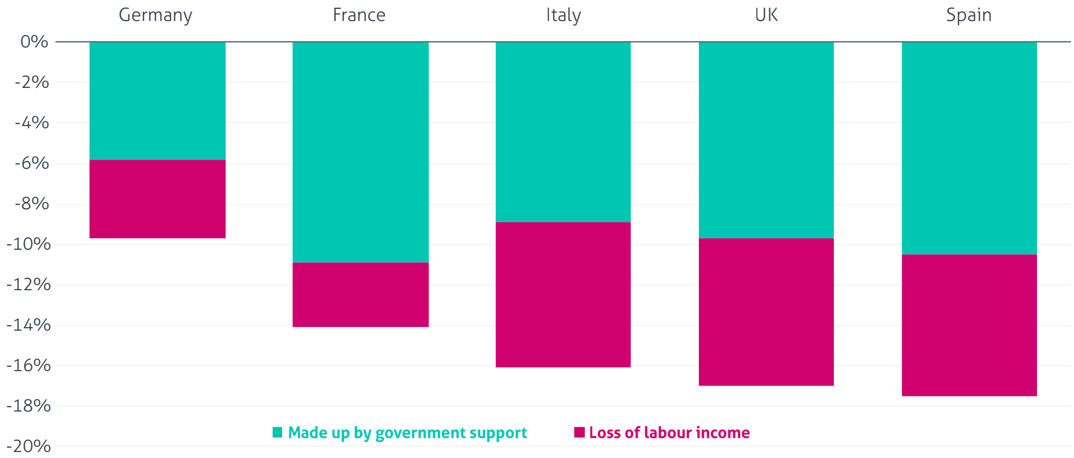


Source: Institute for Government analysis of OBR, Policy measures database and Fiscal Sustainability Report, July 2020.

Focussing specifically on the support that has been provided to households (in particular through the furlough scheme and income support for the self-employed), Bloomberg Economics has estimated that the government has replaced 57% of the income that UK households would otherwise have lost during the lockdown.[1] As Figure 5 shows, this is a similar level of generosity to that shown by the governments of three of the other four largest European economies – Germany (60%), Spain (60%) and Italy (55%) – but less generous than France (77%).[2]

[*] Figure 4 shows that total transfers to the private sector have amounted to £135.9bn. This is slightly smaller than the £139.5bn figure cited elsewhere in this report for total government support for businesses and households. The difference between these numbers is explained by a small number of policies announced in July 2020, which provide support to the private sector but which are not simply transfers of cash – for example, the Green Homes Grants.

Figure 5: **Estimated percentage loss of labour income, and government support, UK and other countries**



Source: Institute for Government analysis of data from Bloomberg Economics.

By adopting 'the logic of state insurer' and propping up business and household income, the government has tried to invest in the future – hoping that intervention now will mitigate the risk of weaker economic growth, and thus lower tax revenues and need for higher spending, in the longer term.[3]

As schemes for business and households are set to end in the coming months,[*] the burden of the economic shock will increasingly move back to the private sector. But absorbing these costs has already had a significant impact on public finances. The £139.5bn spent on support for the private sector in response to the coronavirus is two-and-a-half times what total public sector borrowing for 2020/21 was forecast to be in March.

[*] The largest of which being the Coronavirus Job Retention Scheme, or furlough, due to end on 31 October. The scheme is the topic of an upcoming Institute for Government paper.

Spending

The government will spend £181bn more than it forecast in March

In the March budget, overall government expenditure – including all spending by government departments on policy programmes and administration, as well as on demand-led public services like benefits – was forecast to be £928bn in 2020/21.[4] But that figure has dramatically increased, as a result of both the government's policy decisions and automatic stabilisers that result in higher public spending when the economy is weaker. The only saving that the government has made is on debt interest payments, which are projected to be £13.9bn lower this year than forecast in March (despite higher debt issuance) because of the fall in government borrowing costs since the start of the crisis. The latest official forecasts suggest that spending in 2020/21 will now be £1,108bn – £181bn more than the government expected to spend.

Figure 6: **Breakdown of discretionary spending increases announced by the government**

Source: Institute for Government analysis of OBR, Coronavirus policy measures database. Includes announcements contained in FSR and subsequently, up to September 2020.

A large part of the increase in public spending has been discretionary – that is, driven by the government's policy choices. Figure 6 breaks down the discretionary spending decisions announced by the government since the start of the Covid crisis.

Additional spending on the administration and delivery of public services amounts to £52.8bn, including funding for ventilators and personal protective equipment (PPE), as well as the Test and Trace programme. The government has also spent more on public services such as schools and transport, which have experienced major changes in demand and ways of working as a result of the pandemic.

But far larger sums have been spent on transfers to the private sector, meaning that businesses and households have been less exposed to the economic hit from Covid than they might otherwise have been. Transfers to households are expected to total £83.7bn, mostly through employment support schemes such as the Coronavirus Job Retention Scheme (CJRS, or furlough) and the Self-Employed Income Support Scheme (SEISS), as well as temporary increases in rates of Universal Credit.

A further £38.3bn is expected to be handed to businesses this year. This will partly be through business grants and partly through losses expected to accrue to the government on allegedly temporary loans – as the Bounce Back Loans Scheme (BBLS) and the ability for firms to delay VAT payments to the end of the financial year. While these policies should in principle have no significant cost to the public purse, the OBR expects a significant share of the loans will not be repaid and that some firms will go out of business without paying the tax they owe. For example, a total of £30.9bn of loans had been made through the BBLS by 5 July, but the OBR estimates that £16bn will eventually be written off.

The UK economy shrank in the first two quarters of 2020. The impact of this on employment rates was mitigated by the CJRS and SEISS. However, even with these schemes, the unemployment rate rose and the number of benefits claims has risen sharply. More than one million people applied for Universal Credit in the first three weeks of the lockdown; on one day alone, the Department of Work and Pensions, which manages the scheme, received 2.2 million calls.[5] By July 2020, the claimant count had reached 2.7 million, an increase of 116.8% since March.[6]

As claims have risen, so has their cost to the government – with the OBR predicting welfare spending will be £24.5bn (or 1.1% of GDP) higher this year than projected in March. In normal times, this would be a large increase in spending. But this year it has been eclipsed by the cost of new policy announcements.

Government department's budgets have risen by £76bn

As part of the September 2019 spending round, budgets were announced for each department for 2020/21. Each department was given an expenditure limit for the year, comprising of both capital and resource spending on policy programmes and administration – known as DEL.[*] Across all central departments, as of March 2020 DEL was expected to be £411.0bn.[**] But figures published by the OBR in July suggest that DEL will be £76.3bn (or 18.6%) higher.[***] This includes all policy announcements up to and including the chancellor's summer economic statement in July.

Figures showing the breakdown of additional spending by department are not as up to date as the OBR's estimates for the overall DEL increase. However, Figure 7 provides an indication of which departments have had the largest budget increases relative to the 2019 spending round plans, using data available on announcements made before 4 May 2020. By that point, an extra £45bn had been allocated to departments, with almost every department's expenditure limit having risen compared to the 2019 spending round plans, as Figure 7 shows. Only the Foreign Office, Department for Education, and Department for International Development (since merged with the FCO) have not had budget increases.

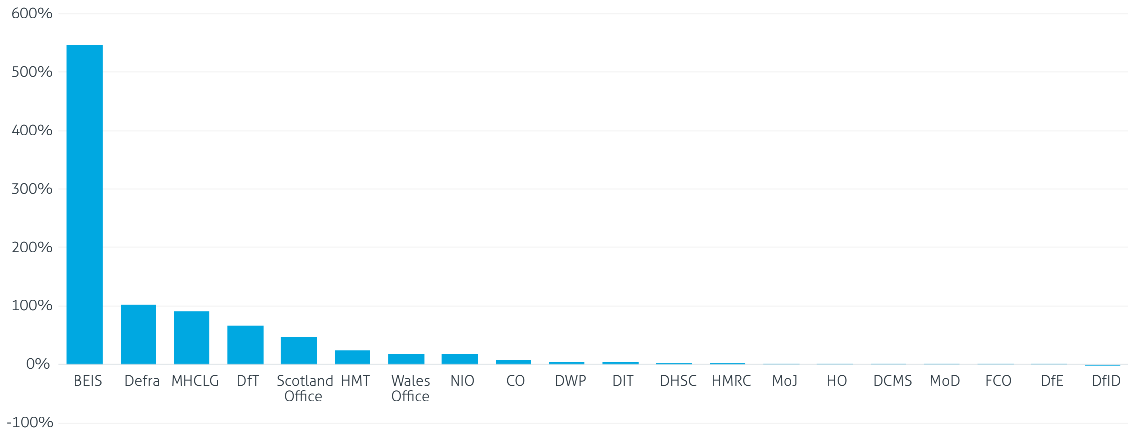
* DEL refers to planned spending by a department, for example on programmes or administration. This is distinct from Annually Managed Expenditure (AME), which varies according to demand – for example, welfare spending.

** This figure is for Total Managed Expenditure in DEL, as published by the OBR in the March Economic and Fiscal Outlook. This is a slightly different measure of DEL to that used by HM Treasury.

*** This figure is calculated using the OBR's 'Coronavirus Policy Monitoring Database'.

The Department for Business and Industrial Strategy (BEIS) has had the largest budget increase (£13.2bn, 546% above the 2019 spending review prediction). Defra's budget has more than doubled, and both MHCLG and DfT's budgets rose by over 50%. However, departments with the largest percentage increases are not necessarily those whose budgets have risen the most in absolute terms. For example, DHSC's budget increased by £4.6bn, the fourth-largest amount of any department, but its spending is so large that this only represented a 3.3% increase. By contrast, the Treasury's budget rose 23.7%, although this was actually only a £0.1bn rise in absolute terms.

Figure 7: **Change in departmental DEL for 2020/21 (£bn) between 2019 spending round and 2020 public expenditure statistical analyses**



Source: Institute for Government analysis of HMT, Spending Review 2019; and PESA, July 2020. RDEL excludes depreciation. We have also discounted the cost of changes due to transfers and classification changes.

Some of this increase may have been driven by factors other than Covid – for example, unanticipated additional costs of preparing for Brexit and small policy changes made at the March budget. But the sheer size of the increases across so many departments indicates that it is the pandemic that has been the dominant factor.

This increase in departments' budgets will have implications for the spending review that the government is planning in the autumn. Decisions on future departmental settlements will need to reflect higher than expected levels of spending.

Departments are spending an extra £600m on running costs

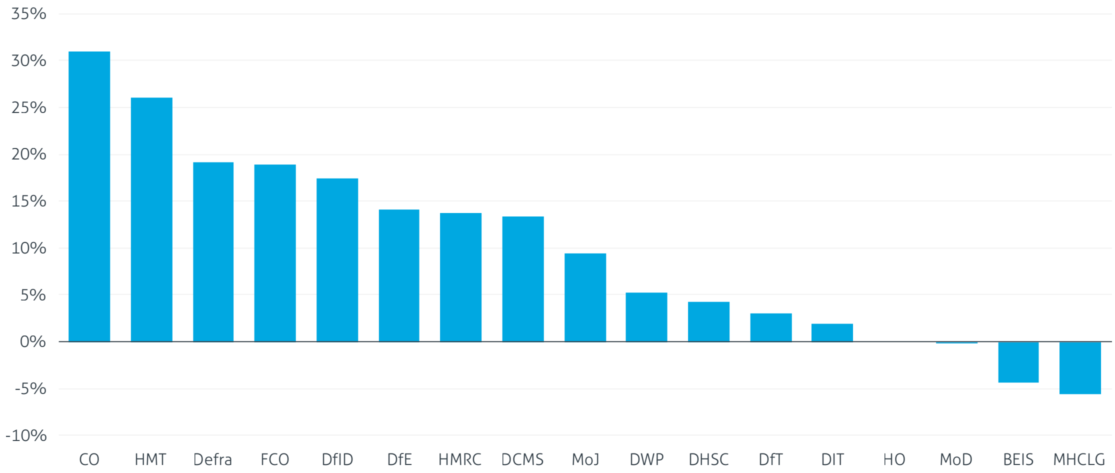
The overall increases in government spending in the current financial year, as outlined above, are overwhelmingly driven by the need to deliver and administer new and newly expanded existing policies and programmes in response to the pandemic. Some of the increase, therefore, has resulted from higher costs in the day-to-day running of government departments – things like paying staff, renting office space and IT costs.

At the 2019 spending review, departments were allocated £10.9bn to spend on their running costs in 2020/21. But the latest figures show that (as of 4 May) departments were expecting to spend £11.5bn on their running costs this year – an increase of £600m (or 5.5%).* This is only a fraction of the cost of Covid to the UK public

* These figures are across all government departments listed in spending review 2019 and PESA 2020 documents.

finances – but it marks large increases for several departments, as shown in Figure 8. At a time when the government is contemplating major reform of the civil service, these increased running costs may lead to more debate about how government works.

Figure 8: **Percentage change in 2020/21 departmental administration budgets between 2019 spending round and July 2020 public expenditure statistical analyses**



Source: Institute for Government analysis of HMT, Spending Review 2019; and PESA, July 2020. Excludes DExEU, small and independent bodies, single intelligence account, and law officers' departments. Data published prior to FCO–DfID merger.

Every department except the Home Office, Ministry of Defence, BEIS, and MHCLG is expecting to spend more than originally budgeted on their running costs. The Cabinet Office (CO), which has played a crucial role in co-ordinating the government's response to Covid, was expecting to spend almost a third more than it planned. Usually, the CO has low running costs – meaning that any increase will always seem large proportionally. But it has also been responsible for major advertising and public information campaigns, as well as overseeing contracts to procure medical equipment – as discussed below.

Other departments with notable rises in running costs include:

- HM Treasury (up 26%)
- Defra (up 19.2%)
- FCO (up 18.9%)
- DfID (up 17.4%)
- DfE (up 14.1%)

Some of these departments have had greatly increased workloads due to the pandemic. The Treasury has been responsible for quickly developing much of the government's economic response to Covid – and HMRC for implementing the CJRS and SEISS, as well as "more than 60 provisional policy changes or easements to help respond to the impact of coronavirus."[7] The FCO had to help organise the repatriation of British citizens from overseas in the early stages of the pandemic. To do all this, many departments have had to recruit additional staff. Appearing before the Public

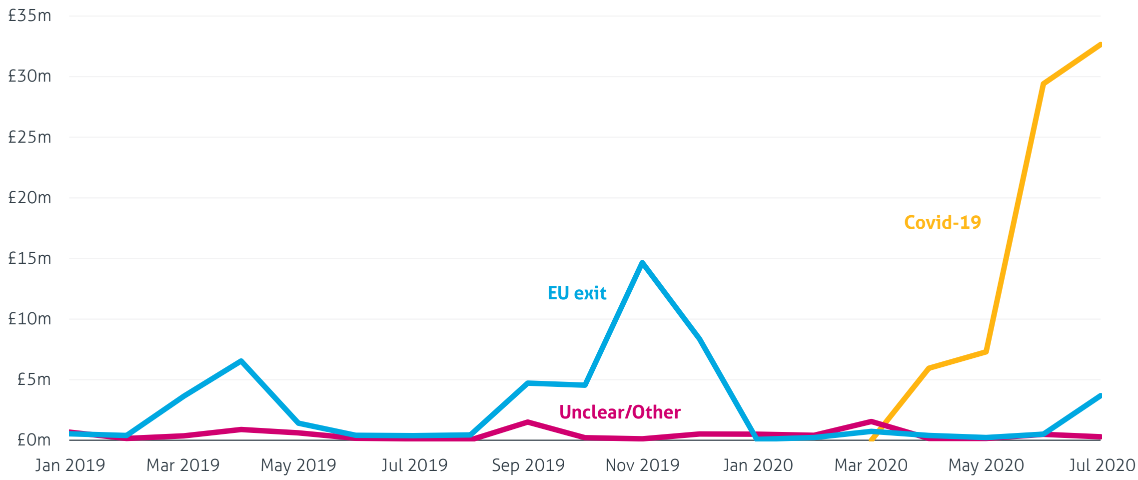
Accounts Committee in June, chief operating officer of the civil service and Cabinet Office permanent secretary Alex Chisholm stated that "we are looking to recruit more people" to deal with the dual challenges of Covid-19 and preparation for Brexit.[8]

It is also likely that the shift to remote working – with large numbers of civil servants working from home – has resulted in higher costs in the short term. Although departments may have saved some money, for example on travel costs, they have also had to provide equipment to enable effective homeworking.

Currently, the data does not exist to detail exactly where each department's additional administration spending has gone. However, the monthly data each department publishes on large items of spending offers some clues as to why departments are costing more to run.[*] We set out some illustrative examples below:

Example 1: Covid advertising and public education campaigns

Figure 9: **Cabinet Office monthly spending on media, marketing and advertising campaigns by campaign area, January 2019 to July 2020**



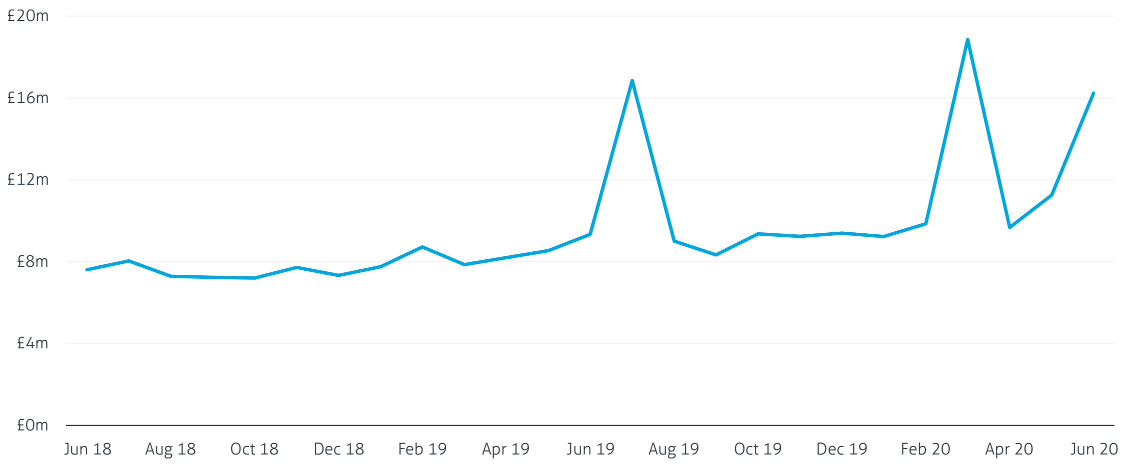
Source: Institute for Government analysis of Cabinet Office, spend over £25,000 datasets, January 2019 to July 2020.

Throughout the pandemic, government advertising campaigns have been essential in keeping the public informed of measures needed to combat Covid. The Cabinet Office took control of the main government messaging campaigns, meaning that its spending on advertising rose sharply. As shown in Figure 8, in June and July the CO spent over £66m on advertising campaigns. 92% of this spending was on Covid messaging – vastly more than was spent at the height of the major (if flawed) 'Get Ready for Brexit' campaign in late 2019. In June and July 2020 alone, the Cabinet Office spent more on marketing and media than during the whole of 2019 (£51m).

* Spend over £25,000 data is supposed to be published monthly by each department. It covers spending on goods and services that have been rendered in that month (though occasionally payments may be highlighted as being for the previous month). Departments do not share a common categorisation of their spending, so we have worked to identify and standardise categories as much as possible.

Example 2: Web hosting

Figure 10: **HMRC monthly spending on physical and virtual hosting, June 2018 to June 2020**



Source: Institute for Government analysis of HMRC, £25,000 spending datasets, January 2018 to June 2020.

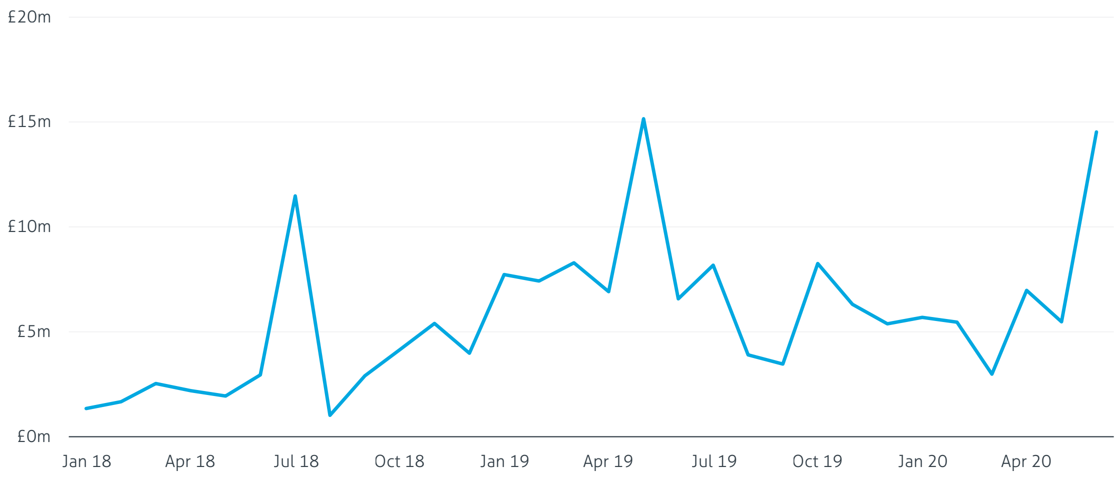
Some departments have had to rapidly design and implement new digital services as part of the government's response to Covid. This is likely to entail increased costs for web hosting, through which departments store data or run digital services.

HMRC has had to set up the largest new end-to-end digital services, including to administer the CJRS and SEISS. Its spending on physical and virtual web hosting has considerably increased throughout the pandemic, as shown in Figure 10. Spending peaked in March at £18.9m, as the departments began to prepare new systems for the CJRS and SEISS schemes – and over £10m of this was spent in the final week of March alone, showing how quickly the department had to turn around its economic response packages. The chief digital and information officer at HMRC has stated that they worked to deliver schemes in six weeks that would usually have taken several years to design and roll out.

Monthly spending on web hosting has since remained high, averaging £12.4m across April, May, and June, compared to an average monthly spend of just over £9m in 2019.

Example 3: Consultancy spending

Figure 11: **Cabinet Office spending on consultancy services, January 2018 to June 2020**



Source: Institute for Government analysis of Cabinet Office, £25,000 spending datasets, January 2018 to June 2020.

In responding to the pandemic, the government has sought to quickly increase its capacity and the range of expertise that it can draw on. Government departments have signed a raft of contracts with various consultancy firms to support its work on Covid. According to research firm Tussell, 106 Covid-19-related contracts, worth £109m, have been signed with consultancy firms since March 2020.[9]

In June 2020, the Cabinet Office spent £14m on consultancy and advisory services, almost double its average monthly spend in 2019. Some of this is being spent on non-Covid issues – such as Brexit – but over £9m of the department's spending on consultancy in June was related to the pandemic. As Figure 11 shows, monthly CO spending on consultancy services tends to be variable, rising at key moments such as preparation for no-deal. The increases during the pandemic fit with this longer-term pattern of spending more on consultants at times of urgency.

But the use of consultants has emerged as central to the current government's ways of working. Reportedly, some within the government are keen to use consultants to get around what they perceive as civil service intransigence.[10] As well as the Cabinet Office, many other departments have signed contracts with consultants to work on Covid. For example:

- A £1.4m Department of Culture Media and Sport contract with PwC to help run an emergency fund supporting small charities through the crisis[11]
- Two £400,000 contracts with EY to manage the publicity of the Track and Trace system (DHSC) and to improve the purchasing of PPE (DIT)[12]
- A £563,000 DHSC contract with McKinsey in May for it to advise on the "vision, purpose, and narrative" of the replacement body for Public Health England.[13]

There can be good reason for government to make use of consultants. But signing so many contracts in such a short space of time inevitably raises questions about value for money – something that the government should not lose sight of, even in the midst of a pandemic.

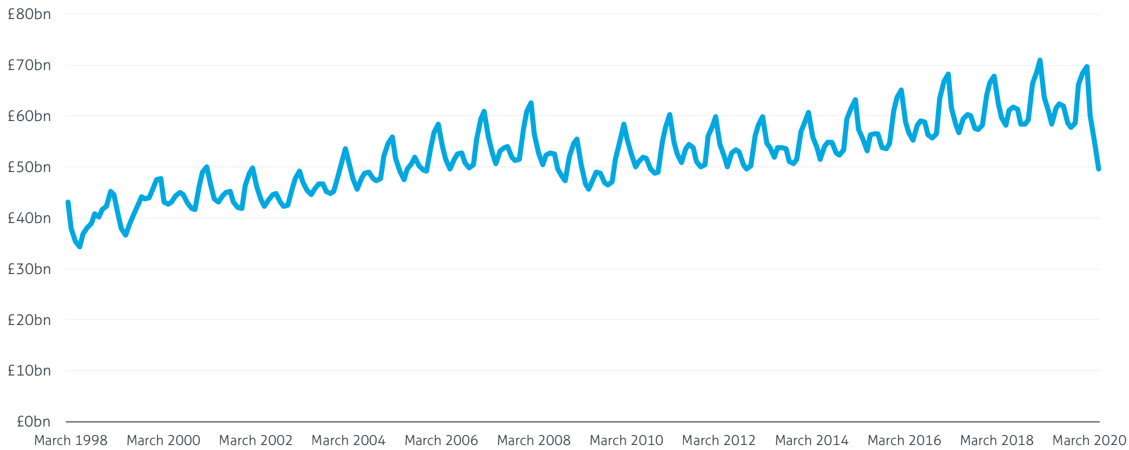
Taxation

Tax revenues have fallen to the lowest level since 2012

The £317.4bn that the government is spending over and above its plans for the current year is the result of both discretionary measures – that is, policy choices – and automatic changes that increase public borrowing when the economy is weak. The largest automatic change has been the decline in tax revenue as economic output has shrunk. As Figure 1 showed, this is expected to reduce tax revenues by £105.7bn this year compared to what was forecast in March. Tax revenues have been further reduced by the government's decision to cut and defer some taxes to help the private sector cope with coronavirus disruption. These measures are expected to reduce revenues by a further £13.7bn this year.

As Figure 12 shows, the three-month rolling average of tax receipts fell to £49.7bn in May 2020. This was the lowest level in real terms (after adjusting for economy-wide inflation) since November 2012, when the exchequer received £49.6bn.

Figure 12: **UK government monthly revenues (three-month rolling average, real terms), March 1998 to June 2020**



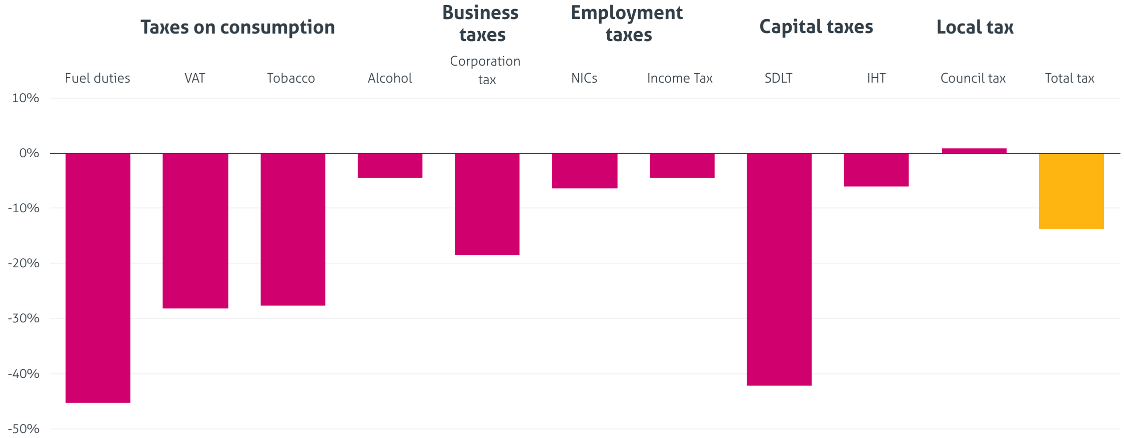
Source: Institute for Government analysis of ONS, public sector current receipts data, July 2020.

The fall in overall revenues is because almost every major tax yielded lower revenues in the spring of 2020 than in the same period in 2019, reflecting the dramatic fall in economic activity that came with lockdown.

As shown in Figure 13, employment-related taxes – income tax and National Insurance contributions (NICs) – have both fallen (by 5% and 6% respectively). However, both have been insulated from steeper falls by the government's interventions in the labour market, which have protected earnings more than might otherwise have been the case.[*]

[*] For example, the OBR estimates that the gross cost of the CJRS will be £52.0bn in 2020/21 but £5.0bn of this cost will be recouped through higher tax revenues.

Figure 13: **Percentage change in tax revenues (by tax), April to June 2020**



Source: Institute for Government analysis of HMRC data.

Revenues of other taxes have also declined. Corporation tax has fallen by almost a fifth, and Stamp Duty Land Tax (SDLT) is down 42% compared to the same period last year – reflecting the effective shutdown of the housing market. With more people working from home during lockdown, fuel duty fell 45% compared to the same period last year. Similarly, the sharp decline in activity in the hospitality sector is likely to have contributed to reductions in tobacco and alcohol revenues – although tobacco revenues have historically proven volatile, especially in the spring.*

Some other falls in revenue are the result of government policy choices – though this is much less of a factor than automatic declines in revenue driven by reduced output. The OBR projects that tax receipts will be £136.5bn lower this year than they forecast in March – with only £14.2bn of this shortfall accounted for by specific government decisions on tax.

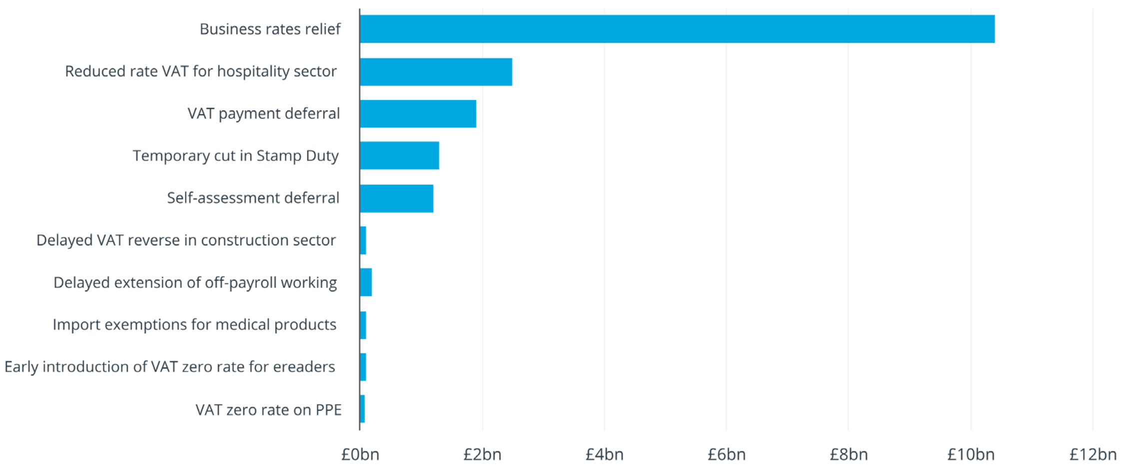
For example, VAT revenues were down 28% over the first three months of 2020/21 compared to the same period last year. As a measure to support businesses, the government has opted to allow VAT payments to be deferred to the end of the tax year. This means that, in cash terms, in recent months the government has not raised any net VAT – that is, total VAT repayments have exceeded new receipts. The deferral scheme ended on 30 June, though deferred revenues do not have to be paid until the end of March 2021. A bump in revenues is therefore expected at the end of the financial year, although there is some uncertainty about how large this will be. The OBR has predicted that 5% of the deferred payments will never be made, costing the government £1.9bn.

* Reasons for this include clearance behaviour by manufacturers, especially in April and May. See HMRC, tobacco duty statistics.

The business rates 'holiday' is the biggest tax cut

While the government has allowed businesses and individuals to delay paying some taxes – to ease cash flow – it decided to go one step further on business rates and cut the amount that is owed. In the March 2020 budget, the chancellor announced that retail, leisure and hospitality businesses with a rateable value of less than £51,000 would be eligible to have their business rates scrapped for the 2020/21 financial year, to help them deal with the impact of Covid.* Shortly afterwards, this was extended to all properties in those sectors, regardless of their value. This is predicted to cost the Treasury more than £10bn, making it the largest single tax policy measure announced in the government's coronavirus response, as shown in Figure 14.

Figure 14: **Government tax policy measures, by size**



Source: Institute for Government analysis of OBR, Coronavirus measures database. Includes measures in the Fiscal Sustainability Report and subsequently announced up to September 2020. Costs shown are estimated costs to receipts.

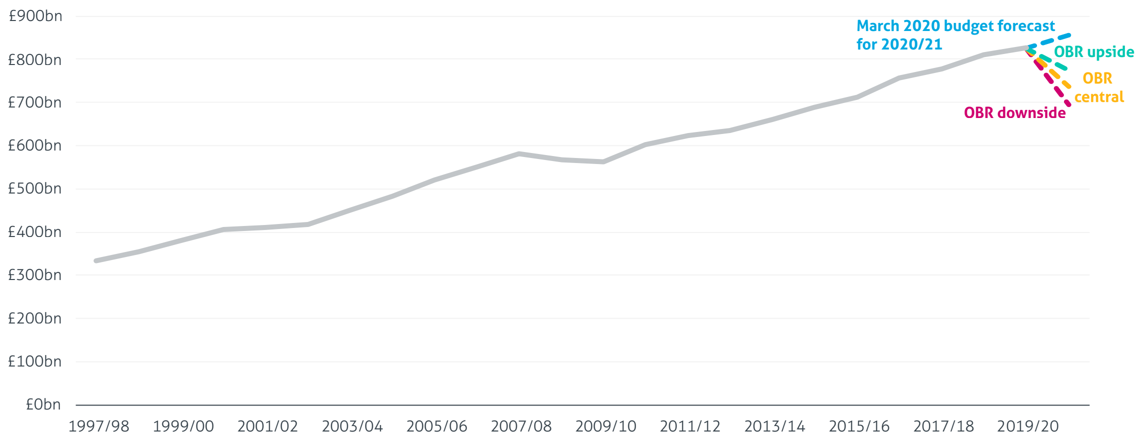
According to the chancellor, this means that almost half of all commercial properties in England will pay no business rates.[14] But although this has been framed as an exceptional measure in response to Covid, it raises questions about the long-term future of business rates. This is only the latest in a series of cuts that have been made to business rates – by way of freezes and holidays – in recent years. The Treasury also announced a review into business rates at the 2020 budget, which is due to report in the autumn – though it is unclear how the broader economic situation will affect this. Any decision that the chancellor makes on business rates will have major implications for the public finances of local authorities, something addressed in the following section of this paper.

* This decision followed earlier announcements of a planned 50% retail discount, and a discount for pubs, for the 2020/21 financial year.

Tax revenues are set to fall even further

The outlook for the rest of the current financial year does not look any better. The OBR's latest central scenario, shown in Figure 15, implies tax revenues falling to £736.4bn in 2020/21 – a sharp fall from the £826bn collected in the previous financial year,* and far below the £872.9bn forecast for 2020/21 at the March budget.

Figure 15: **Total UK tax revenue (real terms), 1997/98 – 2019/20 and projected for 2020/21**



Source: Institute for Government analysis of OBR, Public finances databank and Fiscal Sustainability Report, July 2020.

If the OBR's central scenario is accurate, then tax revenues in the current year will be down almost 11% (in real terms) on the last financial year. This would be the biggest annual fall in revenue since at least 1955, when comparable data was first available. For comparison, when the UK last experienced a major economic shock – during the 2007/08 financial crisis – the government's revenue fell by just 2.5% in real terms.

Even in the OBR's most optimistic 'upside' scenario, tax revenue still falls to £773.8bn – and in its worst-case scenario, to just £693.7bn. This means that the fall in revenue compared to last year could lie anywhere between 6% and 16%. The question isn't whether tax revenues will fall in 2020/21, it is how sharply.

This fall in tax revenues will have a major effect on the public finances. Because revenues have fallen so much – and, crucially, more than GDP has fallen – tax revenue as a proportion of GDP has also fallen. Last year, tax receipts stood at 37.3% of GDP, and in the March budget were forecast to fall to 37.1% in 2020/21. But given the prime minister's 22 September announcement of continued restrictions – which could last for six months – it is likely that economic recovery will take longer, meaning revenue may shrink even more as a proportion of GDP.

* Throughout this section, we adjust the OBR scenarios to account for the tax cuts announced in the 'summer economic update' using estimated costs from the OBR policy monitoring database. This is only an approximation: in reality the tax cuts could have broader economic effects that will lead to tax revenues increasing, and the cost of the measures will depend on economic conditions so the costing would not be the same in the upside, central and downside scenarios.

Local authorities

Local authorities have been on the frontline of much of the Covid-19 response, while also experiencing reductions in their income from taxes, fees and charges. This matters for two reasons. The first is that services overseen by local authorities – from adult social care to the filling of potholes – are things that affect most citizens' lives on a daily basis. If local authorities are forced to make changes to their provision due to pressures in their finances, this will have tangible effects – likely to be felt all the more keenly after a decade of austerity that has already left overall local authority budgets at roughly half of their 2010 levels.[15] Second, central government will need to take into account the situation in local authorities as they contemplate what to do in the autumn.

Local authorities are spending more

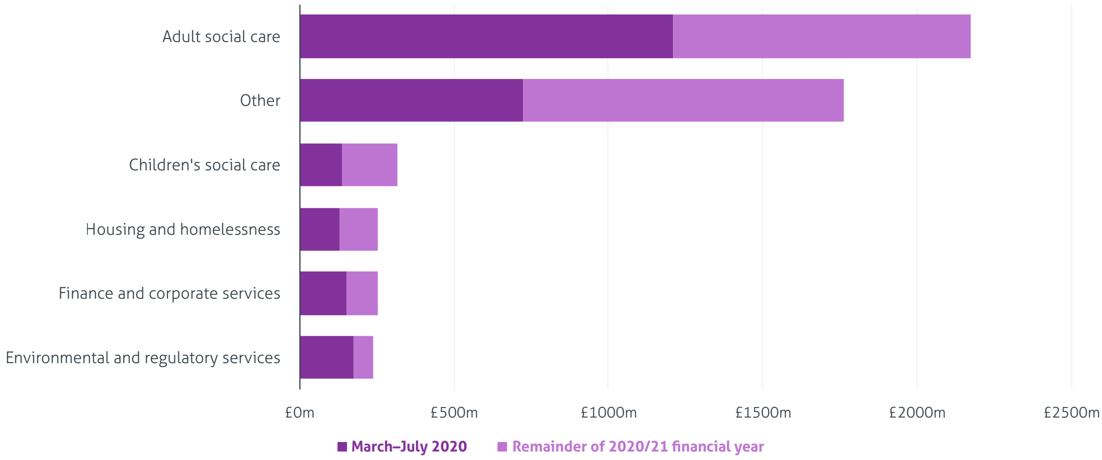
Across England, local authorities are expecting to spend more than they had planned to in the current year as a result of Covid disruption.[*] In July, local authorities reported to MHCLG that they expected to spend almost £5bn more in 2020/21 than originally budgeted. Between March and July, councils had already spent half of this total.

While £5bn is local authorities' latest 'best guess' of the full-year costs of Covid, it is worth noting that this estimate is already £0.6bn higher than the estimate councils produced a month earlier.[**] The additional costs for some services have started to fall as the months pass – for example, additional spending on environmental and regulatory services fell from £56m in April to £35m in July. However, in areas such as adult social care and homelessness services, additional monthly spending has so far stayed broadly stable.

As Figure 16 shows, adult social care is the area of local government spending expected to increase most sharply compared to previous plans. Local authorities have reported that they expect to spend an extra £2.2bn on adult social care services – to meet additional demand, workforce pressures and to pay for extra personal protective equipment (PPE) – with £1.2bn extra having already been spent by the end of July.

* Given issues with data comparability, we focus only on English local authorities in this report.
** Data from the third round of the MHCLG survey.

Figure 16: **Additional expenditure by English local authorities due to Covid-19, by service area, March-July 2020 and remainder of 2020/21 financial year**



Source: Institute for Government analysis of MHCLG, Local authority financial management information, August 2020.

Costs to local government in England have also increased in other areas as a direct result of Covid-19. An extra £2.3bn is expected to be spent on local government activities, including children's social care (£318m), public health (£237m) and homelessness and rough sleeping services (£254m). A further £574m of costs is expected to be incurred from local authorities having to delay projects or being unable to make planned savings.

Using earlier survey responses from councils, Kate Ogden and David Phillips, economists from the Institute for Fiscal Studies, estimate that councils are expecting the largest proportionate increases in spending on homelessness and adult social care.[16] Using their estimate of councils' planned spending for 2020/21, the figures above imply that Covid is expected to result in a 12% increase in spending on adult social care and a 15% increase in spending on housing and homelessness services compared to the original plans for this year.[*]

Additional spending pressures have varied across councils. This is both because of differences in local demographics, which will have affected demand for services, and because councils have chosen to respond in different ways to the pandemic. Ogden and Phillips estimate, for example, that just over a quarter of councils predict that Covid-related pressures will add no more than 5% to their spending this year, while nearly a fifth predict those pressures will raise their spending by at least 10%. Most of those with the lowest expected spending pressures are shire district councils, which are not responsible for adult social care services.

[*] Authors calculations based on Table 2.2 of Ogden and Phillips (2020) and MHCLG rounds 3 and 4

The biggest hit to revenues is through fees and charges

As well as higher than expected spending, local government is also contending with depleted revenues. English local authorities are expecting that their total revenues will be £6.2bn lower this year than originally forecast.

As Figure 17 shows, the largest cash fall in revenue is expected to come from sales, fees and charges – including, for example, parking charges and fees for using council-run leisure facilities – which are projected to fall £2.1bn short this year of what councils had budgeted for.* As a result, Ogden and Phillips estimate that councils in England are expecting their total non-tax revenues to be around 5.1% lower this year than they had budgeted for.**

Councils are also expecting large shortfalls in revenues from council tax (£1.6bn) and business rates (£1.6bn), as a result of various rate holidays and freezes – and higher unemployment exempting more people from council tax.***

Figure 17: **Expected revenue loses, by type, for English local authorities, 2020/21 financial year**

Source: Institute for Government analysis of MHCLG, Local authority financial management information, August 2020.

However, the impact of this will not be the same across all English local authorities. Different tiers of local authorities have different funding sources and so some are more exposed than others to loss of particular types of income. Local authorities which are heavily reliant on income from sales, fees and charges – usually lower-tier authorities – are much more likely to feel a major hit to their finances. Ogden and Phillips estimate that a third of English local authorities are expecting their non-tax revenues to fall less than 5% short of original expectations, while one in six expect to lose at least 20%. All but two of the councils that are forecasting at least a 10% loss of non-tax revenues are shire district councils, while shire counties are predicting non-tax income losses of no more than 3%.****

* MHCLG, COVID-19 Local Authority Financial Information, Round 4, July 2020.
** Table 2.2 of Ogden and Phillips
*** As Geraghty (2020) sets out, shortfalls in business rates and council tax do not create a resources problem until 2021/22. However, shortfalls can nonetheless create in-year cash flow problems for councils. www.local.gov.uk/lg-futures-work-impact-covid-19-collection-fund
**** Page 24 of Ogden and Phillips (2020)

As Ogden and Phillips highlight, councils' income losses and extra spending needs are not well correlated – for example, some councils have experienced large increases in spending requirements but small income losses, while others have experienced both small increases in spending and small income losses.

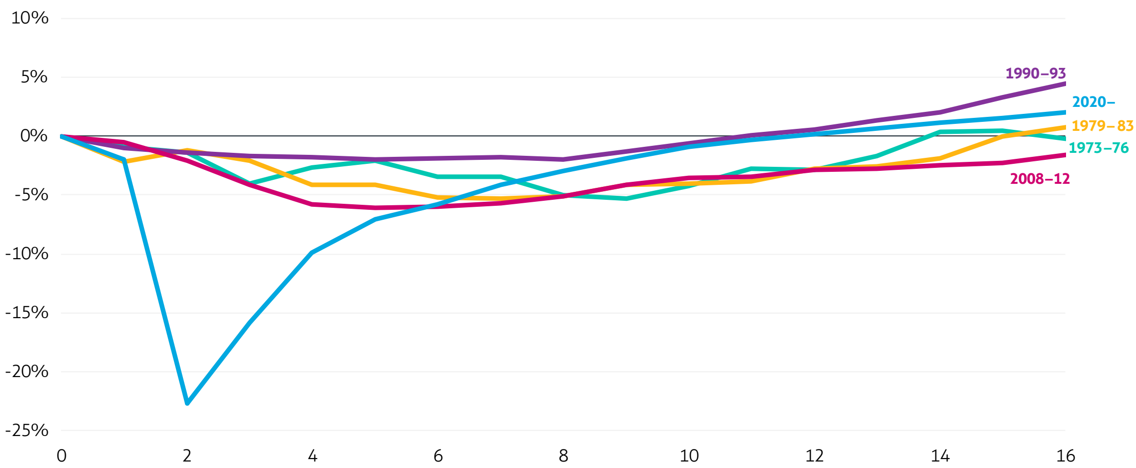
Central government is compensating councils for some – but not all – of their extra spending needs and revenue losses. The government has announced £5.5bn of extra grant funding for local authorities. The majority of this (£3.6bn) has been given out as general purpose grants, with smaller amounts earmarked for specific purposes, such as infection control in adult social care services (£600m), a council tax hardship fund (£500m) and funding to support Test and Trace services (£300m). Some of these grants imply additional responsibilities for councils as well as extra money. Councils' financial pressures have also been eased by the ability to claim help from the furlough scheme and through the NHS sharing some of the costs of additional adult social care services. The government has also announced provisional plans to compensate councils for some of their lost income from sales, fees and charges.

Conclusion

Covid-19 has already taken a toll on the UK's public finances, with government decisions up to the middle of September helping to push up public borrowing by £317.4bn in the current financial year alone. The key question now is what more might be needed this year and how quickly the economy and public finances will recover thereafter – and that depends on the future course of the pandemic and need for restrictions affecting the economy.

The UK has had four recessions in recent times, and recovery from them – as shown in Figure 18 – has tended to be slow and gradual. Following the 2008 financial crisis, for example, it took the UK five years to return to its pre-crisis level of output. The OBR's central projection – which was last updated in July – suggests that the economy will rebound more quickly from the pandemic, recovering its pre-crisis peak within three years. This would make the pandemic a sharp, but short, shock.

Figure 18: **GDP growth trajectories (percentage change from pre-crisis peak) for the last four UK recessions, by number of quarters since the start of recession, and 2020 onwards (projected)**



Source: Institute for Government analysis of ONS, GDP chained volume measures: seasonally adjusted (ABMI), June 2020.

There is some reason to think that recovery of the public finances might be quick. The recession has been driven by the acute nature of the pandemic – a specific set of circumstances that have led to the curtailing of much usual economic life. If a safe and effective vaccine can be found and distributed, and life can return to something approaching normality, then economic activity should also quickly recover. But it is notable that in the four recessions since 1973, it was the shallowest (in 1990–93) that yielded the fastest recovery – and all were far shallower than the hit caused by Covid. The hope is that the specific circumstances of the current recession buck this trend.

But infection rates in the UK are once again rising, leading to new local and national restrictions on the hospitality sector, and the call for those who can to once again work from home. Progress is being made on vaccines, but few experts predict one to be ready until 2021. In his statement on 22 September, the prime minister said that

> **"We will spare no effort in developing vaccines, treatments, new forms of mass-testing but unless we palpably make progress we should assume that the restrictions that I have announced will remain in place for perhaps six months."**

Further restrictions are possible as the pandemic persists into the winter.

The prospect of continued restraints on economic activity means that the vast cost of Covid to the public finances may yet increase in the current financial year – and spill over into subsequent years. This will partly be due to continued depressed economic activity – resulting in lower tax revenues and higher welfare spending.

Indeed, following the drafting of this report, on 24 September the chancellor unveiled his Winter Economic Plan, a package of tax and spending measures designed to address the impact of continued restrictions. Having come under pressure to extend the furlough scheme, Sunak has instead adopted the new Job Support Scheme, which will begin in November. The government will subsidise employees who are working at least one-third of their usual hours, but the system's design means that the government will pay no more than 22% of an employee's wages, rather than 80% as under the CJRS. Some tax measures, such as the VAT cut to the hospitality sector, will be extended. But the chancellor has also made clear that not all jobs can be saved, and that some restructuring of the economy is likely. There are still difficult policy decisions facing the government in the coming months.

Detailed costings of these measures are yet to be announced – but they will almost certainly push borrowing still higher, and suggest that the cost of Covid will spill over into subsequent financial years. For a government that has sought to move away from the austerity of the past decade, and which has spoken of its desire to 'level up' regions of the UK, these will be particularly politically fraught choices.

Ministers in the coming months will need to balance public health and economic concerns, even as they try to comprehend the full scale of the pandemic. The end of the Brexit transition period – with the timing of a trade deal looking ever tighter – further adds to the uncertainty. This means that the government must be prepared to be flexible in its approach in the coming months. An important first step would be to replace the planned three-year spending review with a one-year round, meaning ministers will have the chance to reassess next year, when they have more clarity on both Covid and Brexit.

At the same time, the government should not lose sight of value for money. It is understandable that during the midst of an acute health and economic crisis, the government is more relaxed about signing contracts that do not go through usual procurement processes or pursuing policies that may not demonstrate clear evidence of value for money. But this cannot and should not be sustained. Casual talk of expensive 'moonshots' that may be either unfeasible or have limited benefits is unhelpful. With the public purse already bearing such huge costs as a result of Covid, policies to aid the economic recovery – and assist in the public health crisis – need to be effective. This should also help to build political support for tricky decisions.

The pandemic has not gone away, and neither have constraints on economic activity. The key question is when it will be possible for the economy to return to any kind of normality – and the answer to this, as well as the government's response, will determine the future of the UK's public finances in the coming years.

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