

Statejacket

Reshaping the State

ONWARD➤

Caroline Elsom

About Onward

Onward's mission is to develop bold and practical ideas to boost economic opportunity, build national resilience, and strengthen communities across all parts of the United Kingdom. We are not affiliated to any party but believe in mainstream conservatism. Our vision is to address the needs of the whole country: young and old, urban and rural, for all communities across the UK – particularly places that have too often felt neglected or ignored by Westminster.

We believe in an optimistic conservatism that is truly national – one that recognises the value of markets, supported by a streamlined state that is active not absent. We are unapologetic about standing up to vested interests, putting power closer to people, and supporting the hardworking and aspirational.

Thanks

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Foreword



Foreword

“How did you go bankrupt?” Bill asked

“Two ways”, Mike said. “Gradually, then suddenly.”

Ernest Hemingway, *The Sun Also Rises* (1926)

Political debate operates at different levels. Much of ours focuses on proximate issues – a ministerial scandal, a surge in small boats, a particularly horrific crime. But there are also long-term trends, which may burn more slowly, but ultimately scorch the deepest. Chief amongst these in modern Britain is the size and affordability of the state, and the severe risk to the public finances it now represents.

This paper, and the *Reshaping the State* programme it launches, is incredibly important. It is a deeply sobering read. Britain is going bankrupt, and has been for a long time. We are now at grave risk of entering the “suddenly” phase of Hemingway’s words a century ago.

It is now over 25 years since the budget was last in surplus, let alone bearing down on the debt. By 2030, public sector net debt (PSND) is projected to have quintupled since the 2008 financial crisis. Even using the Chancellor’s preferred measure in her fiscal rules of public sector net financial liabilities (PSNFL) rather than PSND, the figure may be lower, but the trajectory is broadly similar.

We are not alone among western societies in facing these challenges. In August 2025, the German Chancellor Friedrich Merz warned, “The welfare state that we have today can no longer be financed by what we produce in the economy.” But Britain’s challenges of an overmighty state and an underperforming economy are particularly acute, testified to most eloquently by the fact we now pay more than any G7 economy to finance our debt – a risk premium priced in by the financial markets.

Worse still, we now have a Parliament dominated by Labour MPs who are apparently totally unable to countenance any reductions in public spending. When the Government tried to make welfare reforms earlier this year,

ministers were forced into humiliating retreat, and ended up in the ludicrous position of actually increasing the total cost to the taxpayer.

I served as Chief Secretary to the Treasury 2021-22, and it is my sincere conviction that if anything, the financial markets still underprice the risks to Britain's fiscal sustainability. As Caroline Elsom sets out in this paper, the estimate of debt relative to GDP by the 2070s reaching 270% in the OBR's Fiscal Sustainability report is based on an optimistic assumption of productivity growth at around 1.5% per year: a rate which has not been achieved since before the global financial crisis. In other words, the extent of the sheer unsustainability of our public finances is almost certainly being understated.

Much of our political discourse is still oblivious to this ticking timebomb. Government ministers have spent the summer airily opining about scrapping the two child benefit cap, while Reform – currently leading in the polls – rank this as just one of a number of hugely expensive policy commitments. The public largely believe that the Conservative Government 2010-24 implemented deep austerity. The reality is that it did nothing of the kind: some parts of the state, like local government, suffered deep cuts, but others continued to grow apace, and the Covid pandemic then destroyed all spending discipline.

We are now in a very dangerous place. We need radical, comprehensive reform to restore not only financial sustainability, but also to end the deep dysfunctionality that now characterises much of the operation of the British state. It is a sickening irony that government in this country has never cost more to achieve less.

There is a way out of this situation, but it will be a long and hard one, and will involve very frank and difficult conversations with the public. If we fail to act, the spectre of 1976 looms large again in our national story. Arthur Miller warned, “An era can be said to end when its basic illusions are exhausted.” Now is the time for an end to illusion. It is time to reshape the state.

Sir Simon Clarke
Director, Onward
August 2025



Introduction

A fiscal crisis looms in Britain's future. Heading into the autumn, the Chancellor is facing a range of unpalatable choices if she is to maintain the confidence of the country's creditors. Barely a year into power, having won a landslide majority in the 2024 General Election, the Labour Government already appears out of options and political capital.

The coming crisis is the product of a state that has been growing in scope and scale for decades. Expansion has been driven by politically expedient largesse. It has delivered an NHS the size of Portugal's entire economy, but one that ranks poorly for avoidable excess deaths. It provides a welfare system that is due to grow by a fifth in the next five years, while a fifth of working-age people are not looking for work.

The path and composition of public spending today, and therefore the state itself, is fundamentally unsustainable, uncontrollable and unfair. Unsustainable due to an aging population that is set to draw on further health and welfare spending. Uncontrollable due to the scale of spending decisions that are treated as non-discretionary or ceded ever further away from those who should be making them. And unfair to those who pay taxes to fund the services of today that they may never benefit from themselves.

While it should be evident to any politician that drastic action is needed to alter this trajectory, they choose instead to remain bound by a bureaucratic, legal and political straitjacket of the status quo: the "statejacket". The statejacket sees ministers come and go, only able to pursue a tinkering approach to reform which they know will be insufficient to avert the crisis. It is the height of insanity - continuing to do the same thing but hoping for a different outcome. But there is still time to recover with an intensive course of treatment.

Onward's new research programme, *Reshaping the State*, will make the case for a fundamental re-think of the state's functions and composition. Together with Onward's programmes on *Rebuilding our Economy* and *Renewing our Social Contract*, these three new areas of focus confront the most significant challenges facing Britain today, launching with *The Turnaround* and *The Anti-Social Contract* respectively.

Statejacket starts by confronting the scale of the problem and the incentives that have led to the current situation at a national and local level, and the state's relationship to individuals. This diagnosis does not seek to apportion blame, but to understand how the narrow range of policy decisions are leading to ever more perverse outcomes.

The research stream it launches will uncover areas of policy that have been woefully neglected, recommending whether some state functions would be better delivered entirely differently - or not at all. In the work that follows, *Reshaping the State* will set out the difficult and urgent trade-offs that must be made for the country to break free of the current constraints and thrive.

1. National level

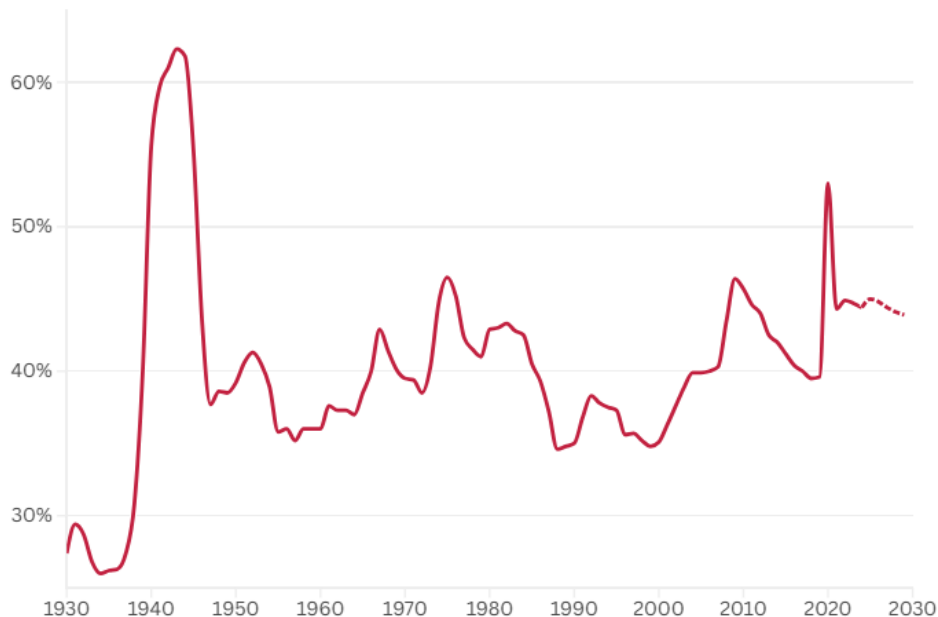
The Prime Minister is grappling with the same challenges as his predecessors: public services which require ever more resources to sustain, whilst struggling at the same time to deliver the quality and range of services that the public has been led to expect. Meanwhile, tax rates, already at record highs, are unable to raise enough revenue while low growth and high inflation persist. As the situation continues unaddressed, debt costs will account for an ever-greater share of spending while delivering no public good.

The state on steroids

Over the last 75 years, the state's share of the UK economy has generally fluctuated at around 40% of GDP. The COVID-19 pandemic saw a dramatic period of state expansion that took its share of GDP to levels only previously exceeded during the Second World War.¹

Figure 1 - Total managed expenditure as a % of GDP

Source: OBR²

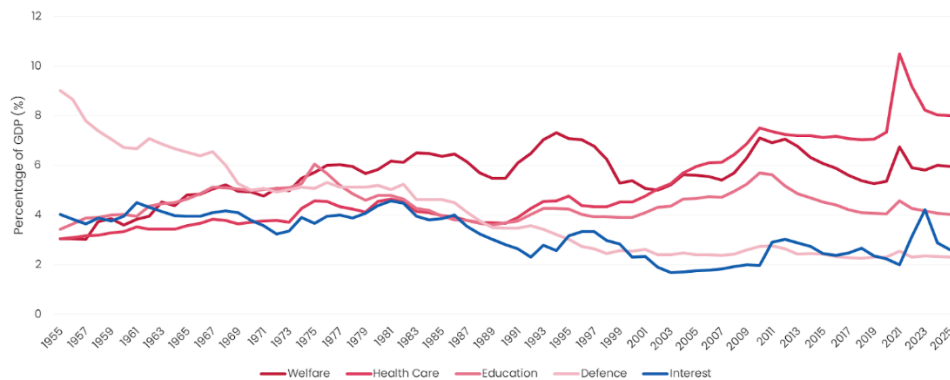


Spending as a proportion of GDP hit 53% in 2020-21, far outstripping the previous post-war peaks reached during the 1976 IMF crisis and the 2008/09 global financial crisis. Crucially, the latest Office for Budget Responsibility (OBR) forecast indicates that the state is unlikely to contract back to 40% over the decade following the pandemic. Unlike previous less severe crises, the path back to normal looks longer and less certain – the big state seems here to stay.

To understand why the post-Covid expansion persists, it is necessary to look at the radical change in the composition of spending. Since the end of the Cold War, declining defence spending has made way for significant relative increases in health and welfare.⁴ Health spending was protected after the global financial crisis relative to welfare and education which saw their shares as a proportion of GDP fall. Much larger cuts fell outside of these areas, principally in local government. Public services like the NHS, schools and prisons now account for roughly two thirds of day-to-day spending.⁵

Figure 2 - Components of total managed expenditure as a % of GDP

Source: UK Public Spending³

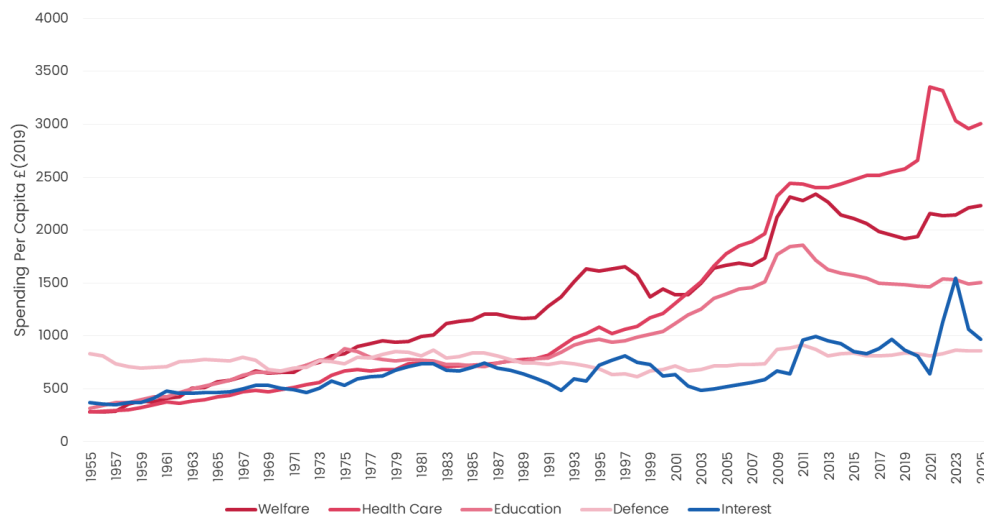


The ambition to reach 2.6% of GDP on defence spending by 2027 and 3% by an indeterminate time in the next parliament, would bring a striking diversion away from previous reliance on the “peace dividend” if actively pursued. With further pressure from NATO to increase defence spending to 3.5% of GDP plus another 1.5% per year in related industries, this may well need to be revised up again at future fiscal events.

The outlook for the relatively larger state remaining over the medium term reflects the deep growth crisis that is accompanying this fiscal crisis. As explained in Onward's *The Turnaround*, real net GDP per head is barely higher in today's prices than it was at the pre financial crisis peak.⁴ Sluggish growth has dampened living standards and eroded the tax yields available to pay for heightened spending. The state is now costing each person the equivalent of £3,000 in health spending, around £2,200 in welfare spending, £1,500 in education spending and £1,000 in debt interest, versus around £400 per person for each of these costs in 1955 in 2019 prices.⁵

Figure 3 - Spending per capita

Source: UK Public Spending⁶



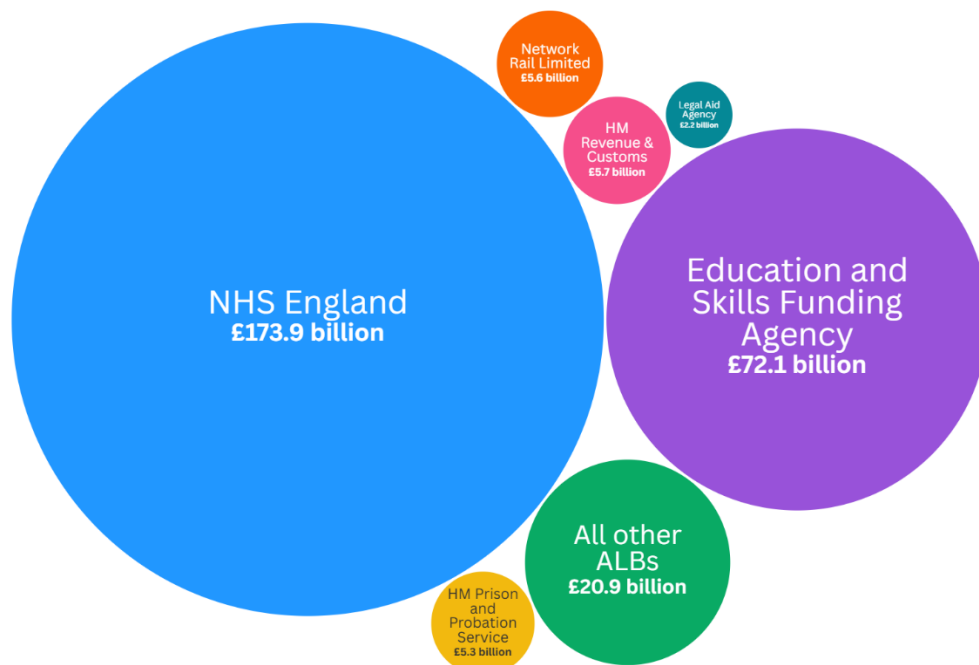
Flighting the “flab”

The growing headline figures for individual departments masks the reality that the ministers are not directly in control of this spending. A convenient way to get around a political problem is for ministers to put distance between themselves and the final decision. Creating an arms-length body brings some protection for ministers by replacing their direct decisions with process. Re:State's (formerly Reform think tank) recent report, *Quangocracy*, sets out the series of “wrong” reasons that mean ministers are strongly incentivised to set up ever more bodies to take on difficult or “stuck” challenges, especially after a crisis.⁷

The result is that over 60% of day-to-day spending now happens through arms-length bodies.⁸ Promises of a “bonfire of the quangos” or the Prime Minister’s new pledge to trim down the “flabby” state are easy rhetoric, but difficult in practice. In the last decade alone, the number of central government public bodies has increased from 474 to 603 (excluding those in the devolved nations).⁹ In its first six months in office, the new Labour Government had announced plans to create 18 new quangos.¹⁰

Figure 4 - Resource departmental expenditure limits (RDEL) for the largest arm’s-length bodies, 2023-24

Source: Cabinet Office¹¹



The Prime Minister has at least pledged to scrap the biggest and second biggest quangos of all - NHS England (NHSE) and the Education and Skills Funding Agency - while promising that every quango will face a review. While the savings from merging NHSE back into its parent department will be significant, estimated at £500 million per year, it is still only around 1% of its current total day-to-day spending. Greater savings will require the Government to start actively making choices about what the NHS will stop doing, not just business as usual under new management.

NHSE is a perfect example of the cumulatively damaging impact that a quango can have on the talent pool of a parent department. Although many quangos are set up with the specific intention of providing expertise outside of civil service salary bandings, such as scientific or clinical roles, higher pay is often also awarded to those without such specialism. Pay across all quangos averages 20% more than departmental pay.¹²

A near carbon copy of policy teams exists in both NHSE and the Department of Health and Social Care for non-clinical roles. This results in an internal brain drain, with officials moving sideways from the department to NHSE for pay rises while essentially carrying out the same policy role. Across Whitehall, a melee of generalists rotate through the lower ranks of the civil service, awaiting their own opportunity to move to more lucrative quangos. This leaves ministers with less experienced staff from which they can garner advice to negotiate with ever more powerful quangos. At the same time, the ministers are blocked from bringing in their own experts by pay constraints that are unenticing to external senior leaders.

Unchecked quangos can end up operating as stakeholders themselves, employing public affairs teams to lobby the government for expensive, unrealistic or interest-driven policies. This leads to nonsensical situations like two separate quangos each using taxpayers' money to argue with each other, rather than the Government taking a unified position on the policy trade-off at hand. For example, the Agricultural and Horticultural Development Board advocates for expanding Britain's meat and dairy industry while the Climate Change Committee recommends a radical reduction in meat and dairy consumption to meet net zero by 2050.¹³

The Office for the Pay Review Bodies - a quango - sets the parameters for a £100 billion public sector pay bill.¹⁴ Pay review bodies are notionally independent panels set up with the intention of providing the government with advice on how much to pay public sector workers. However, several of the pay review bodies have terms of reference that neither include a responsibility for setting pay in a way that improves public services nor in a way that is broadly comparable to pay in similar jobs.¹⁵ The value of pay review bodies as a useful arbiter between government and the unions has therefore been steadily eroded by the government having to repeatedly override unaffordable recommendations, fuelling deep distrust of the process by politicised unions.

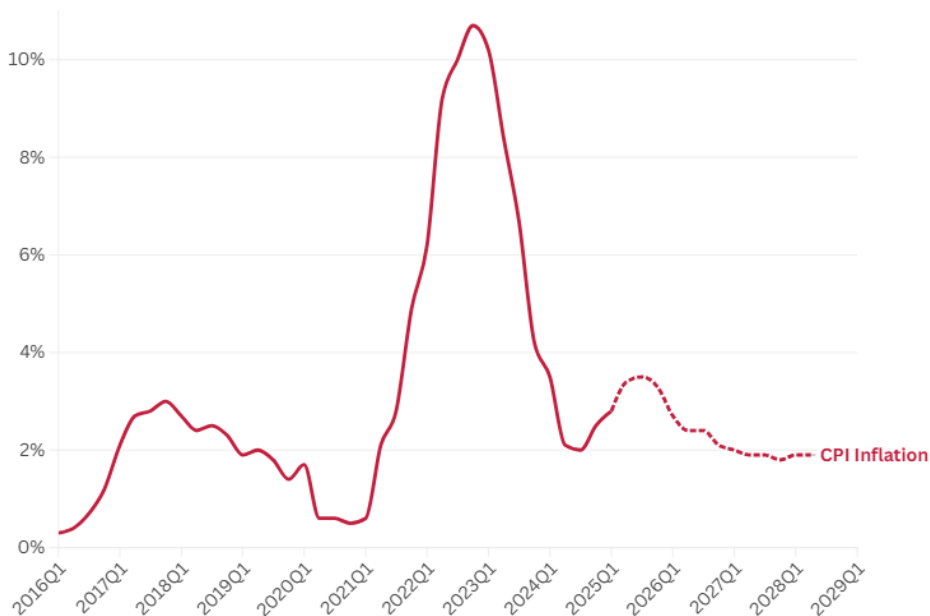
The state has engineered a system whereby ministers end up in public fights with the very bodies that were meant to solve a difficult issue on their behalf. While setting up a quango may send a helpful signal about “taking the politics out” of a serious issue, rationalising their number or their functions then comes at immense political expense. But the long term cost of not taking control of the decisions that attract such a large portion of government spending is even greater. And ministers will still face the blame for bad decisions quangos make along the way while the bodies claim the credit for any improvement.

Ratcheting up

A further way in which ministers have constructed processes that cede control is by relying heavily on index-linked spending ratchets. Indexation may help to bring a degree of certainty that spending will keep up with prices, but it also avoids making necessary trade-offs on a yearly basis. When inflation spikes due to external events like global energy prices changes, damage becomes permanent. With inflation set to remain above the Bank of England’s 2% target until at least 2027, the Government is on course for huge spending increases without active policy change.¹⁶

Figure 5 - CPI inflation since 2016 with forecast

Source: Bank of England¹⁷



Benefits, the state pension and public sector pensions are all index-linked. After a 1% cap during its early rollout, Universal Credit (UC) rates (and most legacy benefits) were frozen from 2016 to 2020, but since then have ratcheted up quickly, now surpassing the temporary uplift levels during Covid. Personal Independence Payment (PIP) rates were uprated with CPI after the 1% cap was lifted in 2016. In 2023-24 alone, high inflation meant that all CPI-linked rates have increased by 10.1%.¹⁸

Since 2016, the UC standard allowance has increased by just over a quarter, while the PIP daily living standard component has increased by a third.¹⁹ Therefore, the cumulative effect of PIP remaining unfrozen and now also benefitting from high inflation means that its relative generosity of PIP has outstripped UC, continuing to strengthen the incentive to claim disability benefits.

Meanwhile, the state pension triple lock has seen rates rise much faster than working age benefits and salaries. At the time of its introduction, it has been reported that it was only expected to cost £50 million per year.²⁰ The Institute for Fiscal Studies projects that by 2050, the government will be spending an extra £18 billion per year due to the triple lock, which equates to adding roughly 2p to both basic and higher rate income tax.²¹ As set out in Onward's *The Anti-Social Contract*, successive governments have become trapped by this policy that is unsustainable, uncontrollable and unfair, yet supported by both older and younger voters.²²

Delay then repay

It is now over 25 years since the budget was last in surplus, let alone bearing down on the debt. By 2030, PSND is projected to have quintupled since the financial crisis. Even using the Chancellor's preferred measure in her fiscal rules of public sector net financial liabilities (PSNFL) rather than the previously used public sector net debt (PSND), the figure may be lower, but the trajectory is broadly similar.

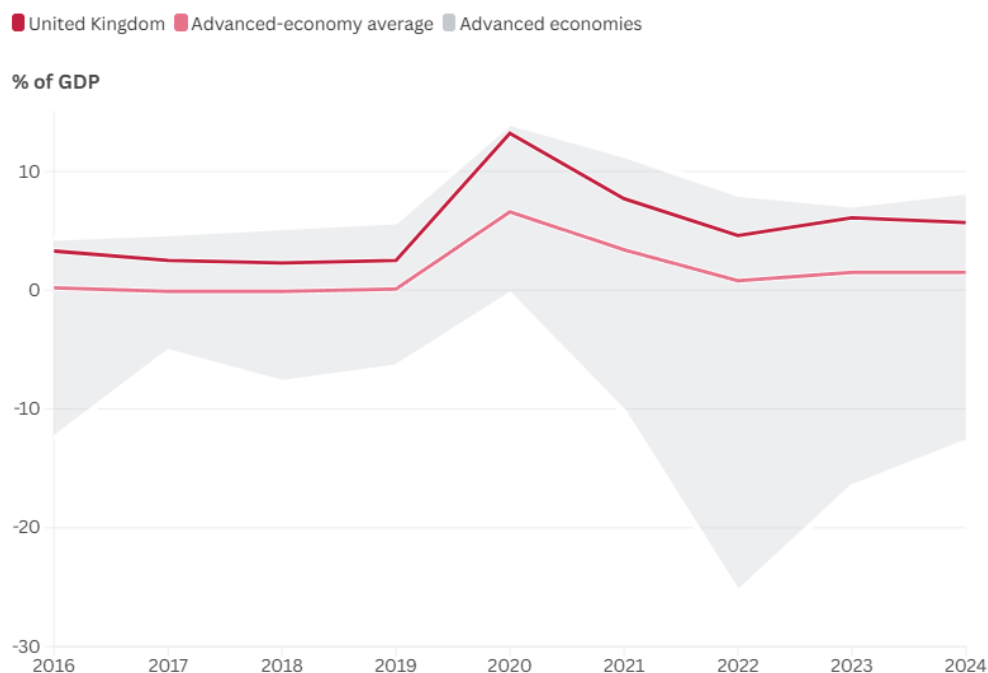
Net debt interest had been falling prior to the pandemic, but is now back up too. This reflects PSND relative to GDP hovering between 90-100% since 2020 compared to around 80% in the 2010s.²³ The OBR's latest report on whether

current policies are sustainable into the future indicate that debt could climb to 270% of GDP in fifty year's time.²⁴

While countries across the world faced many of the same global shocks, the UK's persistent inability to get a grip of borrowing has left it in a particularly vulnerable position. At the end of 2024, government debt had reached the sixth highest among advanced economies and the fourth highest in Europe.²⁵ 30-year gilts have since reached their highest rate since 1998, while 10-year gilts are at their highest level since 2008.²⁶

Figure 6 - Borrowing across advanced economies

Source: OBR, IMF²⁷



Indeed, nine of the last 10 fiscal rules or frameworks since 1997 have included a measure of getting debt falling as a share of GDP, but across the same timeframe PSND (excluding the Bank of England) has risen from 28% of GDP to 90%.²⁸ Almost all have followed the same predictable pattern: borrowing more in the next couple of years, then hoping debt will start falling. In reality, the future belt tightening is loosened, there is an economic shock or performance is worse than expected. When promising to delay then repay, inevitably the latter never comes.

Less for more

Productivity and efficiency savings continue to be relied on heavily for future salvation. The estimate of debt relative to GDP by the 2070s reaching 270% in the OBR's Fiscal Sustainability report is based on an optimistic assumption of productivity growth at around 1.5% per year: a rate which has not been achieved since before the global financial crisis.²⁹ Based on the current productivity growth rate of 0.5%, PSND relative to GDP would hit almost 650% of GDP in the same timeframe.³⁰

Public sector productivity is 20% lower than it was in 1995, whereas in the private sector it has increased by 50%.³¹ Slow growth in public sector productivity is estimated to cost the UK economy £80 billion annually, and this could rise to £170 billion by 2030 if left unaddressed.³² Yet the adoption of productivity-enhancing technology is inconsistent and often actively resisted. The average tenure length of a Secretary of State is just two years, when productivity savings are often years, sometimes decades away.³³ Under these short time horizons, pushing for departmental reorganisation and internal capital spending is rarely a high priority when the public demand immediate improvements on the frontline.

There appears to have been little attempt by the new Government to consider what would need to be implemented in individual departments in order to make them more productive. The 2025 Spending Review documents assume near uniform 15% administrative efficiencies across departments by 2029/30, despite their very different staffing mixes and functions.³⁴ Several different departments received individual and cross-cutting funding allocations for digital investments, but many aspects remain ambitions without having clear implementation plans.

Unrealistic efficiency drives can ultimately have the opposite effect intended by leading to multiple in-year reprioritisation exercises that result in raiding capital budgets – those often funding the most significant productivity improvements. Even in the longer term, the gains from productivity increases alone are not enough in isolation to save a government committed to still doing everything it is already doing now, let alone anything more. Hoping for better productivity in the future, while continuing the same reliance on capital transfers to plug day-to-day spending gaps, will not meet these needs.

The capital doom loop

Capital budget raids to pay for day-to-day-spending are frequently framed as the worst kind of short-sighted decision by ministers. But the idea that these are the “easy option” mischaracterises the series of incentives that lead to this phenomenon. They often involve the most directly quantifiable political harm – cancelling building programmes in multiple constituencies, or destroying a transformational project that ministers want as their legacies after leaving office.

Yet the last decade is littered with delays and U-turns on major infrastructures projects and technology upgrades. The current crisis in prison capacity is a prime example of the doom loop that can occur. It starts with the feast and famine approach to announcing capital funding that are an inevitable part of the political cycle, with the push committing to as many brand new facilities as possible in one go over a long time horizon. Nine new prisons were pledged in the 2015 Spending Review – just three have opened to date.³⁵

Since then, costs have increased dramatically due to repeated planning delays, contractor failures and construction industry inflation.³⁶ These factors lead to the repeated need to send business cases back through ever more lengthy value for money assurance processes as confidence in the delivery of the programme wanes. Major projects become caught in the need for the delivery department, its quangos (HM Prison and Probation Service in this case), Cabinet Office, HMT and No.10 all being involved in approvals at both senior civil service, special adviser and ministerial level.

The inevitable outcome of so many different parts of the state being involved in the process is further delay and expense while the savings the service transformation was meant to deliver remain unrealised. When a decision is required at fiscal events as to how to cover higher-than-expected day-to-day running costs, the rational choice is to reallocate likely underspends from capital programme delays that would otherwise be reabsorbed by HMT.

Information games

Chronic under-investment in technology and information systems within government has left it years behind the private sector in capability. While many

companies have enhanced their back office systems and customer services with artificial intelligence (AI), “government by spreadsheet” still remains the norm across Whitehall. Even in parts of the state which have adopted new AI-enabled systems, like the federated data platform in acute NHS trusts, these systems often fail to realise all their possible quality improvement and cost savings by having to interact with archaic processes beyond their boundaries.

Failure to exploit the full potential of unifying information systems across government leaves ministers making slower, suboptimal decisions. Rather than being able to draw information out almost instantaneously and then quickly iterate questions until the answer is found, ministers are forced into lengthy commissioning processes. Advice then arrives back with them months later, having not answered the question in the way intended, having failed to produce a saleable solution or having simply come too late to be viable anymore. This is exacerbated further when policy issues cut across multiple government departments or quangos with separate internal clearance processes.

Information security concerns are often cited to caution against unleashing new technology in government. But a state forced to email spreadsheets between officials or left waiting for crucial information in a crisis is already one that is provably less secure. The same narrow policy choices will continue to be presented until the architecture propping up the state is modernised, revealing the “unknown unknowns” that were not previously possible at all.

Politically trapped

The Conservatives have learned the hard way that credibility on the public finances matters, as outlined in Onward’s *Breaking Blue* following the Conservatives’ election defeat.³⁷ The change of Government has seen opinion about whether the balance of taxes and spending is right worsen still. YouGov’s monthly tracker on whether the Government is taxing and spending the right amount has seen an uptick in those thinking both taxes and spending are too high since the General Election, with this figure remaining above 40% for 8 of the last 9 months – at least 5% higher than at any time in the last 5 years.³⁸

Once Labour’s new policy commitments and public sector pay rises are accounted for, many of the apparent uplifts in departmental budgets in the Spending Review 2024 are real terms cuts. Cutting budgets without cutting policy commitments leaves tax rises either means failure to deliver or inevitable

tax rises to plug the gap further down the line. Even those on the furthest left of British politics struggle to find a combination of tax hikes which even begin to reach the revenue needed to sustain the public finances. Analysis by the CPS of the tax raising plans from Jeremy Corbyn 2019 manifesto or from the IPPR struggle to raise more than a fifth of the shortfall needed to fill the void, before accounting for their damaging impact on growth.³⁹

The Reform party's tax and spending commitments are equally alarming. Analysis by the Economist indicates that the tax cuts in their manifesto plus commitments made since the election total just under £200 billion.⁴⁰ Planned spending rises approximately offset some tax rises and spending cuts. Their plans also include 5% in unspecified efficiency savings, but as discussed above, these are notoriously difficult to find at least in the short term and therefore cannot be automatically relied on now. This leaves the £200 billion in tax cuts largely unfunded. To give a sense of scale, this is roughly equivalent to the entire budget of the NHS and four times the size of the tax cuts planned in the 2022 "mini-Budget".

2. Local level

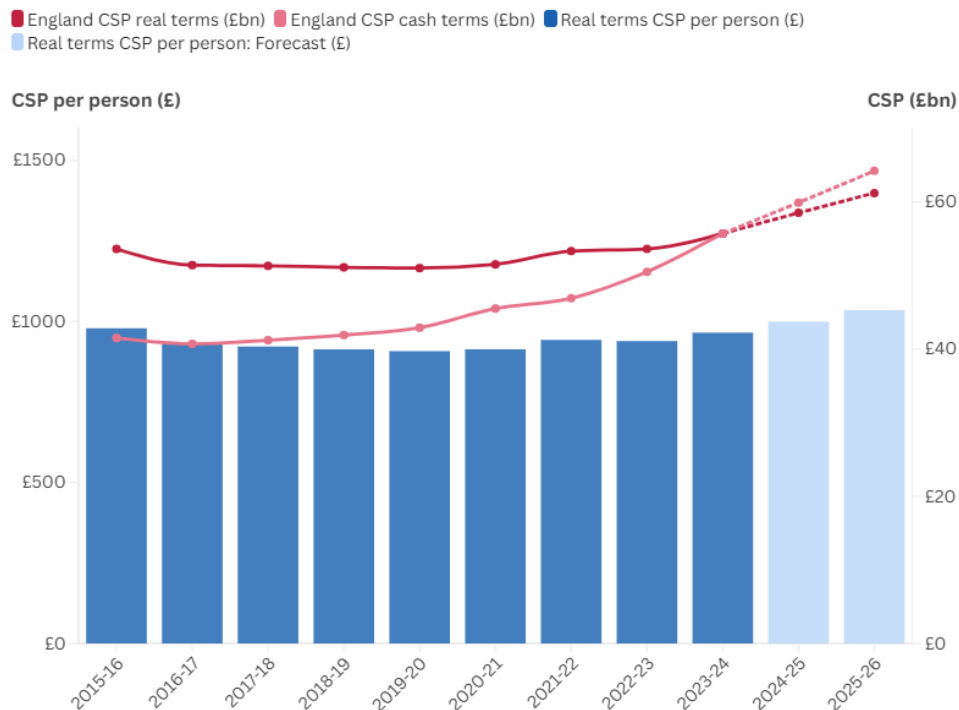
The shape of local government has been slowly evolving since the two-tier system was introduced in the 1970s. While spending on services at a national level has been growing, local government funding has been sharply reduced over the last 15 years. This change has been made alongside unprecedented growth in the statutory duties that local government is expected to discharge. Despite some of these additional responsibilities coming alongside devolution, the UK remains one of the most centralised democratic countries in the world.

Squeezed settlements

Since 2010, local authority spending power has been substantially diminished. Despite widespread council tax rises in part covering the shortfall, core spending power was down by about a fifth since over the decade to 2019/20.⁴¹ Between 2010/11 and 2015/16 core spending power fell by a quarter.⁴²

Figure 7 - Local authority core spending power per person

Source: NAO⁴⁴



While more central government grant funding has been made available in the last five years, core spending power still remains 14% below 2010/11 levels, with a gap of almost £12 billion nationally.⁴³ This is part due to high-than-expected inflation eroding increases. Real term core spending power of local government per person decreased by 1% from 2015/16 to 2023/24, although it is now rising.

The challenging funding backdrop for local authorities has coincided with the legal duties being greatly increased. A review in 2011 identified almost 1,300 statutory duties which local authorities were required to fulfil.⁴⁵ In July this year it was reported that the Deputy Prime Minister was planning to deploy artificial intelligence to review the now 20,000 pieces of legislation that apply to local authorities.⁴⁶

Since 2018, there have been a slew of high profile council bankruptcies that have focussed attention on the dire state of many councils' finances. While many of the bankruptcies so far have been a consequence of specific risky investment decisions or historic legal issues, councils across the country and the political spectrum are now sounding the alarm about no longer being able to carry the growing burden of budgetary pressures within ever more squeezed financial settlements.

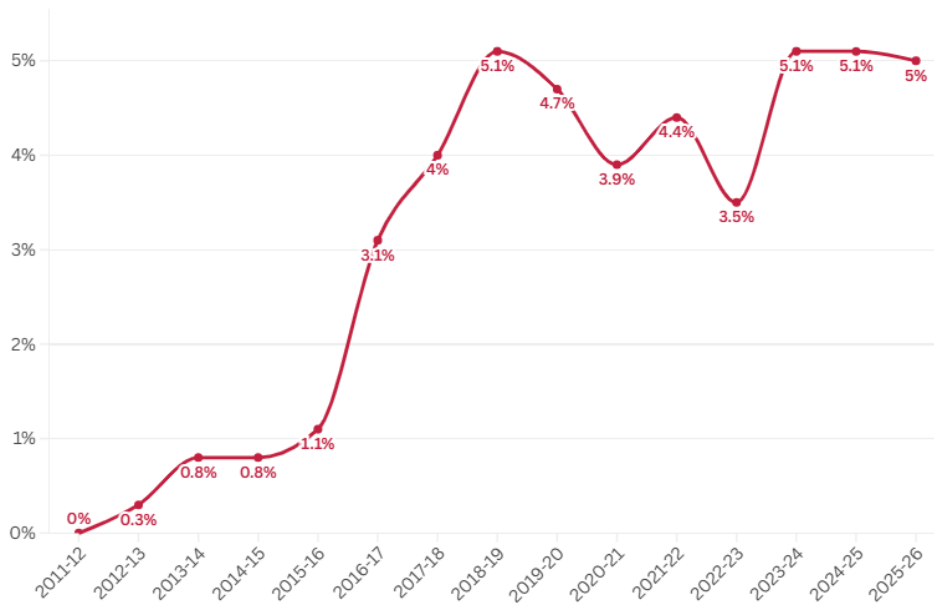
Hidden precepts

Councils raise revenue largely through council tax, business rates and fees or charges. While councils can set their own rates, they are constrained by caps for increases in precepts for general services at 3% and adult social care at 2%. However, a growing number of additional precepts have been introduced that are levied through council tax but do not go to the council, including for Police and Crime Commissioners (PCCs), Fire and Rescue Authorities, mayoralities and Parish or Town Councils. The Spending Review 2025 assumes that all councils increase council tax by the maximum amount each year, meaning that those who do not face a compounding penalty.⁴⁷

The array of precepts levied through council tax are poorly understood by the public. Non-council precepts are often increased by the maximum amount as those setting them have no incentive not to ask for as much as possible, when few voters will make the connection.

Figure 8 - Annual percentage change in average Band D council tax (including parish and adult social care precepts) in England

Source: MHCLG, Onward analysis⁴⁸



In some areas such as Wandsworth, the mismatch between the mayoral precept and the local precept is already so great that next year the mayoral precept alone is likely to exceed the council's share of the average Band D household's council tax bill. Labour's Local Government White Paper proposes a series of reforms including ever more precepting powers for new mayoralties, which will confuse the issue even more unless bills are separated.⁴⁹

Death by 1,000 grants

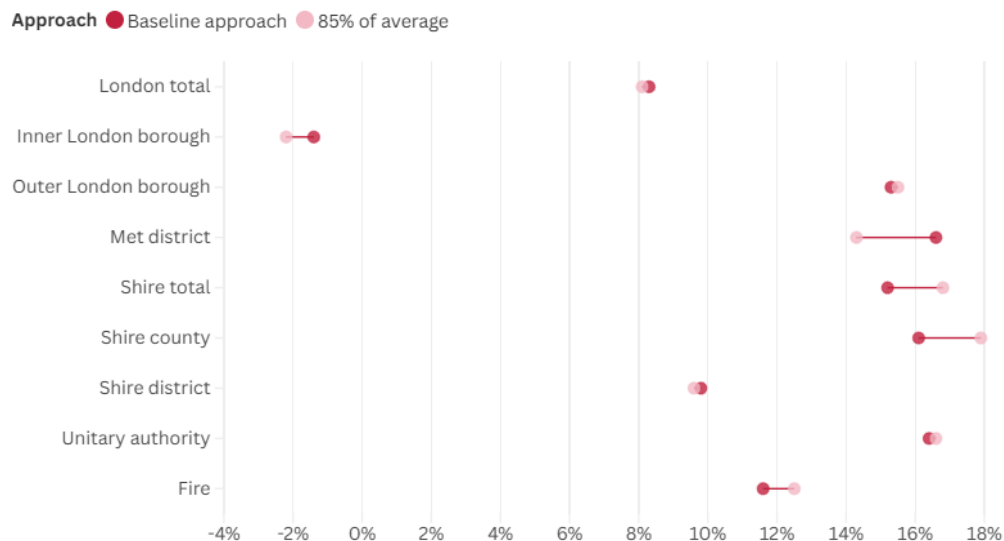
The incentive for councils, mayors, PCCs and others to act in the best interests of the community is further diminished by grant structures. Only half of business rates revenue is retained by councils, despite several attempts over the last decade to increase the proportion retained. This lessens the incentive for local authorities to promote local growth from which they could raise greater revenue. Instead, revenue is taken by central government and then gifted back (with a significant top-up) to local authorities but with conditions attached.

Areas with lower revenue are topped up significantly, while those who raised more face a tariff. In the first half of the 2010s, less well-off areas struggled as all areas saw central government grant funding cut in flat percentage terms.⁵⁰ Those who had relied more on grant funding therefore lost a greater proportion of their total budget. This trend has been reversed since Covid as the most deprived areas have seen greater increases than wealthier areas which generate more revenue.

The rebalancing of funding settlements does not address the fundamentally broken link between local politicians and the local economy. This link is likely to weaken further still under the Labour Government's plans outlined in the Fair Funding Review. The push for full equalisation, where local funding settlements are hypothecated on a notional maximum council tax level and a complex needs-based formula, lowers the cost of bad policy choices and reduces the incentives to grow the local economy. Experiencing higher deprivation, high delivery costs and growing numbers receiving support within a council's boundaries risks becoming a tool for getting more funding from central government. This reduces the incentive to focus on delivering efficient services, local job opportunities and helping people to live independently.

Figure 9 - Cash terms changes in funding by council type under full equalisation vs current average in England, 2025/26 to 2028/29

Source: Institute for Fiscal Studies, *Onward analysis*⁵¹



As block-grant funding has been reduced, some of the shortfall has been replaced by a growing number of competitive grants. In 2022-23 local government bodies received more than £10 billion in competitive grant funding across around 300 schemes with over 11,000 individual awards.⁵² These schemes create significant waste both centrally and locally, often for small amounts of money that are limited in duration. It is inevitable with competitive grants that some councils create entire new teams or divert resources from service delivery to bid for funding that they will never receive.

The resultant waste from piecemeal schemes makes it more difficult to achieve ultimate objectives. For example, the Future High Streets Fund, the Levelling Up Fund, the Town Deals and the UK Shared Prosperity Fund all have similar goals.⁵³ However, their differing terms, announcement times and timescales mean that local authorities are forced to satisfy separate requirements for each. This can lead to inefficient “double-dipping” for the same projects and also means that larger, more transformational projects that could have been achieved if the funding was rolled into a single pot never happen.

Designed brinkmanship

Low costs to failure are already harming local democracy. Given the limited options for councils to raise revenue, a growing number are finding themselves on the brink of bankruptcy. The Exceptional Financial Support (EFS) framework was introduced in 2020-21 to provide financial support through capitalisation, whereby normal finance rules are relaxed so the local authority may borrow money or sell assets to balance day-to-day spending.

The EFS system means that struggling councils need to descend further into crisis before they are allowed to raise council tax above the cap or make capital transfers. By then, options often involve borrowing more, rather than addressing the issue that led to the crisis in the first place. EFS deals are negotiated individually by councils with the Ministry of Housing, Communities and Local Government, making it difficult for the public to understand how seemingly punitive measures, including large council tax rises, have been decided or who is to blame. This damages the already weak link at local elections between voting for parties with meaningfully different policies when all are bound to the same centrally-set plan.

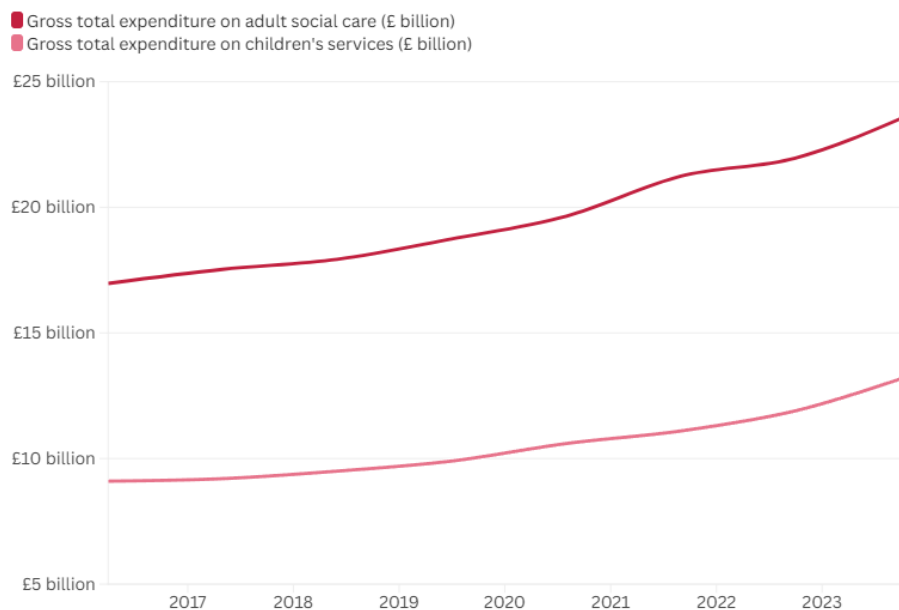
A system that forces councils to the edge of ruin before allowing them flexibility incentivises risk-taking to cover structural deficits. With limited options to raise revenue, investment in financial schemes with high yields becomes a highly attractive option. However, a deeply dysfunctional audit market left many of these investment practices to continue unchecked. As of late 2024, only 1% of councils had published externally audited 2022/23 accounts on time.⁵⁴ At the same time, the increase in riskier investments, off-balance sheet liabilities and capitalisation has made the task of auditors more complex. In addition, one in five internal audit roles were also vacant.⁵⁵

The social care stranglehold

The uneven balance of power and accountability is most apparent when considering how councils spend the majority of their funding. In 2023/24, local authorities in England spent an average of 58% of their budgets on adult and children's social care, with some councils spending as much as 80% of their budget on these services.⁵⁶ Looking ahead, to meet demand pressures and rising costs, the OBR 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.⁵⁷

Figure 10 - Expenditure by local authorities on adult social care and children's services

Source: CIPFA, Onward analysis⁵⁸



For adult social care, while councils can make some active choices about commissioning and investments in local care services, their options are limited. Demographics, wealth and the management of their local NHS services – all largely outside their control and responsibility – are likely to be the biggest determinants of how well social care functions in their area, not innovation in local policy. Despite this being such a significant area of local spending, there is little local policy choice to be made. They are simply delivering a nationally set policy that they cannot control while being accountable for the consequences at the ballot box.

The Labour Government's Casey Commission is likely to make this situation worse, at least in the short term.⁵⁹ The first phase, due in 2026, is a “national care service” which has previously been referred to in trade union campaigns for a new pay structure similar to those that exist in the NHS.⁶⁰ Implementing this would significantly raise the cost of care by increasing the rates paid to those working in the sector, which makes up the majority of care commissioning costs.⁶¹ For example, previous estimates of raising minimum pay in adult social care to the National Living Wage plus 65p put this at £600 million per year.⁶²

The wider question about models of care will not be covered until the second phase of the Casey Commission. This phase is only expected to report on the eve of the next General Election. Calls for this process to create a consensus on a plan for social care risks missing the opportunity for radical change once again. Charging reform plans that were consistently delayed under the Conservatives only ever asked a limited question – how to protect people from having to sell their homes to pay for their care – and therefore only received a narrow answer on that particular aspect of the system. While public support for policy is important, the Casey Commission may fall into the same trap of prizing agreeability over outcomes. There is already no shortage of ideas around different options for delivering care, but there has been a shortage of those willing to take decisions in which there will always be winners and losers.

In children's social care too, there has been rapid rises in demand dictated by statutory duties without local authorities receiving enough from central government to cover the full costs. Key drivers of this are the numbers of children assessed as having special education needs and looked after children. Since 2014, the number of children and young people with education, health and care plans (EHCPs) has risen by 140%, from 240,183 in 2014/15 to 575,973 in

2023/24.⁶³ The vast majority (88%) of these are for non-physical developmental or mental health needs. Council spending on school transport for children with SEND alone has almost doubled since 2018.⁶⁴

A SEND reform plan has been promised in the autumn as part of the Schools White Paper, but its scope remains unclear. £760 million in additional funding has been allocated in the Spending Review for this, but for many councils this will not come soon enough.⁶⁵ The statutory override, which keeps the cumulative impact of EHCP deficits off local authority books until March 2026, has masked part of the issue. A survey conducted by ISOS Partnership found that 25% of local authorities said that they would be insolvent within a year and another 25% would be insolvent within three years if the statutory override was removed.⁶⁶

Overlapping boundaries diluting responsibility

Local authorities are not the only manifestations of the state at a local level. There is a tangle of overlapping administrative boundaries for services such as health and policing which further confuses lines of responsibility. The drive to devolve some services closer to home but not to place them under local government authority has led to an inefficient and opaque structure, with no mechanism for true local accountability for these services to voters.

For instance, Integrated Care Board (ICB) areas vary wildly in size, with the largest ICB covering roughly six times as many people as the smallest.⁶⁷ While some fit comfortably within a single local authority area, others have multiple different local authorities to contend with. In the North East and North Cumbria ICB area there are twelve different upper-tier authorities, each with their own priorities for spending key health-related budget lines like the Public Health Grant and the Better Care Fund.

Cross-cutting services that require coordination between these layers and boundaries end up falling through the cracks. Mental health services for those with the most serious psychiatric conditions and those in crisis are a prime example of this. Not only do NHS mental health trusts have to coordinate services with different geographies for both policing and social care, they also cover different areas from the acute trusts. The Care Quality Commission's most recent State of Care report highlighted instances of people having to wait several months, and in some cases years, for treatment in the community,

which requires joint arrangement between trusts and the local authority.⁶⁸ The end result is a system in which those who may pose a serious risk to themselves or others too often fall through the cracks.

3. Individual level

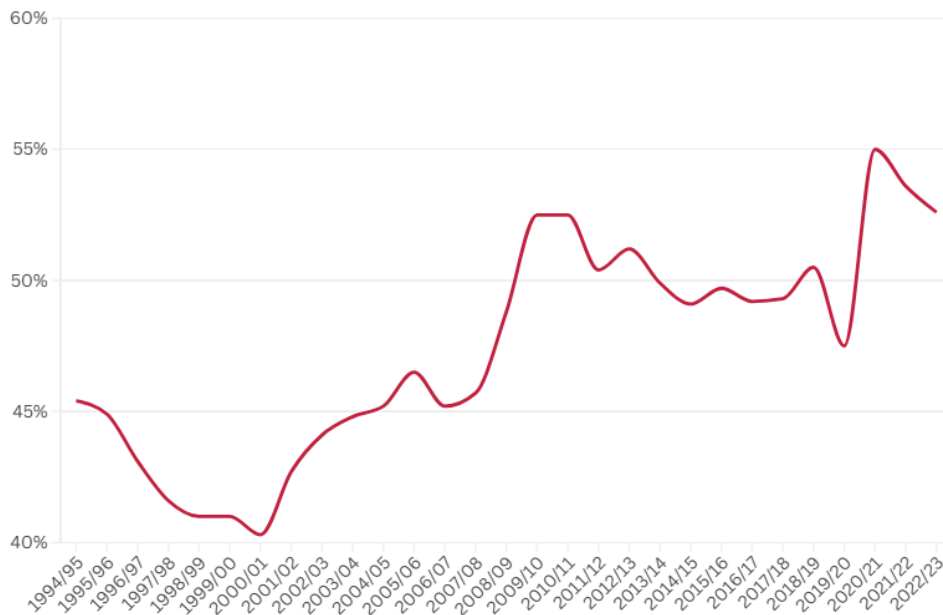
The product of broken incentives in government at a national and local level is a state that makes it rational for individuals to act in a way that is neither in their best interests, nor the best interests of the country. Changes to ease of access and the relative generosity of state entitlements have tipped the balance further away from rewarding those contributing the most. People are left less free to provide the life that they may want for themselves and their children, making suboptimal decisions about work, family life and retirement.

Contributors and recipients

Onward's *The Turnaround* and *The Anti-Social Contract* document well the importance of maintaining the link between effort and reward, both for economic sustainability and basic fairness. Together they highlight how the median income in the UK at £37,430 is below the level needed to be a net fiscal contributor.⁶⁹

Figure 11 – Individuals in households claiming more in benefits than tax paid

Source: ONS⁷³



Those at the lower end of the income distribution are directly subsidised by Universal Credit which continues into work. Fiscal drag from the freezing of personal tax thresholds since 2021, has meant more people have entered high tax brackets by stealth.⁷⁰

A shrinking tax base with those on higher incomes paying an ever-larger share distorts the incentive to work harder for higher reward or to progress to higher paid work. In 2000/01, just under 44% of households were net recipients from the state.⁷¹ The relationship has now reversed, with almost 54% of households being net recipients in 2023.⁷² This is in part a feature of the aging population who draw on the state pension and pensions credit, but this does not explain the whole of the shift.

New cliff-edges

The stated aim of UC at its inception was to smooth the transition into work and to encourage people to take on more hours once in work. For example, the 16- and 30-hour thresholds in the legacy Tax Credit system had had a distortionary impact on working hours, with both under- and overpayment at the end of the year after retrospective calculations which often pushed claimants into debt. UC promised a tapered system where claimants would always be better-off working and increasing their hours. In reality, its implementation has created several new cliff-edges that work against the incentive to work.

The taper itself currently takes away 55p of every £1 earned above the work allowance. Those earning above the income tax personal allowance and the national insurance contribution threshold start losing yet more income, with an effective marginal tax rate that could hit 87%. Some claimants will also lose more if their childcare costs are above the UC maximum reimbursement, although only 3% claim the maximum amount.⁷⁴

A harder to quantify factor that lowers the incentive to work is the plethora of additional concessions that are available to those in receipt of certain benefits or below certain income thresholds. These range from free school meals and free prescriptions to legal aid and court fee remission. The Covid-19 pandemic also saw several significant new schemes rolled out nationally, including the Household Support Fund and the Holiday Activities and Food Programme. In addition, many councils operate their own discretionary schemes that provide

everything from school uniform grants to leisure centre memberships and cultural passes, which taken together can amount to extensive extra entitlements.

The cumulative effect of benefits passported via UC and other benefits is that it increases the fear of “losing everything” when coming off benefits. When the state offers support with almost every imaginable facet of life automatically for those remaining on benefits (or else has more complex or uncertain criteria if not on benefits) then the risk of trying work or working more is perceived as much greater. Most passported benefits and more, including the generous Motability scheme for new cars, are also available to those on disability benefits. This adds the additional incentive not just to stay on UC, but to eliminate risk even further through permanent entitlement passported by claiming PIP as well.

Higher up the income distribution, cliff edges have been created in the system that present perverse incentives for families. The withdrawal of child benefit after £60,000 and the income tax personal allowance after £100,000 means that families experience wildly varying effective marginal tax rates as they earn more.⁷⁵ While benefits are calculated at a household level, tax is calculated on an individual basis. This means that families are incentivised to have two lower earners rather than one higher one.

Alongside the aging population, the end result of these penalties is the tax burden falling onto fewer people’s shoulders. Around 60% of income tax revenue in 2022/23 came from the top 10% of earners.⁷⁶ As outlined in Onward’s *The Prosperity Package*, the top 1% of earners pay 28% of all income tax, a proportion which has risen by almost seven percentage points since 1999.⁷⁷ Given that higher earners are more internationally mobile, revenue will continue to shrink as more people decide to leave the country, especially with recent changes to non-domiciled status. The 10,800 high net worth individuals who left the UK in 2024 are estimated to have paid as much income tax as 500,000 average households.⁷⁸ The loss of this revenue is disastrous for an already low growth economy.

The triple-lock delusion

The incentives the state imposes on older people are perhaps the most destructive of all. As discussed above, the triple lock on pensions is disastrous

for the long-term sustainability of the public finances. But beyond that, it has embedded the illusion that the Government will provide a generous income for people later in life, while the NHS will pick up the rest of their needs should they fall ill.

Despite auto-enrolment boosting uptake, still around 20% of private sector employees and 80% of self-employed workers are not saving into a private pension at all.⁷⁹ According to a survey by the Alzheimer's Society, half of the public incorrectly believe that dementia care costs are covered by the NHS, when these costs are largely borne by individuals and their families.⁸⁰ While the triple lock has made the state pension more generous relative to average wages, its celebration has perpetuated misconceptions about a state-provided safety net for older people that lessens the perceived need to save through working life.

As the characteristics of the cohort reaching retirement age each year changes with rises in the state pension age, the problem is only going to get worse. Healthy life expectancy - the number of years a person is expected to live in good health - has not kept pace with overall rises in life expectancy. Average healthy life expectancy is around 62 years in good health, which will leave many spending their final working years in poor health or early retirement.⁸¹

This in turn means starting to draw down their savings or starting a claim for UC and PIP, which at their higher awards are more generous than the state pension and higher rate of Attendance Allowance. Raising the state pension age to reduce the burden on the state therefore does not necessarily release the savings that might be expected and could even end up costing more as people drop out of the workforce before retirement and onto working age benefits.

A further time-bomb is coming as more people reach retirement age without the financial asset of a home to rely on. The number of households aged 65 and over who are renting is projected to roughly double by 2033, surpassing a million.⁸² This has serious consequences not just for the housing benefit bill for those above state pension age but also for the ability of many to pay for their own social care needs, further exacerbating the burden on local authorities.

All of these factors make it more important that the future sustainability of the triple lock is reviewed with urgency and considered alongside social care reform. The mismatch between expectations of a safety net paid into through

tax that will be there in older age and the level of private savings needed for a comfortable retirement cannot continue to go unaddressed. And the sooner this is confronted, the longer those working now will have to adjust to the change.

Conclusion

It will take difficult and decisive action to change the collective mindset that has led, at every level, to a state that actively limits, prescribes and involves itself in every part of family, community and work life, while taking away individuals' means to live on their own terms. The result of these forces is the shape of the state seen today: spending commitments that politicians appear unable to prevent growing, let alone reverse. The state's expanding reach has seen society become less free, dynamic and prosperous, while requiring ever more resources to sustain itself.

The dire fiscal situation facing the country in the months ahead has not exclusively been made in the last year, nor just in the last 15 years, but it is one that has been exacerbated by recent decisions and indecision. Continuing to operate within the "statejacket" will carry on producing results that prize process before outcome. Time and opportunities to avoid what could become a truly uncontrollable crisis are running out.

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