The state of the public finances

Introduction

Since 2010, successive UK governments have been striving to repair damage to the public finances left by the global financial crisis. Austerity measures have helped reduce the budget deficit considerably – cutting the shortfall between what the state spends and what it earns by two-thirds – but economic and political circumstances have forced the government to adapt its plans along the way. Most significantly, last year's vote to leave the EU created considerable economic uncertainty and this year's general election triggered speculation that under public pressure, austerity may be coming to an end.

This section of *The State of the State* explores the state of the public finances and the outlook for public spending.

The certainty of uncertainty

In the wake of the 2008 global financial crisis, the UK entered its deepest recession since quarterly data was first published in 1955. The economy finally returned to its pre-crisis level in 2014 and has now grown for four-and-a-half years, showing some of the best growth levels among the major economies.

However, uncertainty began to drive a slowdown in corporate recruitment and investment in early 2016 when the date of last June's EU referendum was set. Deloitte's quarterly survey of chief financial officers – a recognised barometer of corporate sentiment – found confidence sank to a three-year low as the vote loomed.[7] And the consensus among economists ahead of the referendum was that the UK economy could experience a significant negative shock if the electorate voted to leave the EU.

Of course, economic indicators in the immediate aftermath of the referendum result were mixed. Within one month, the FTSE 250, which tracks companies reliant on UK income and sterling, was down £27 billion and the pound had fallen 13.5 per cent against the dollar. But at the same time, the FTSE 100 which includes more international companies was up by £70 billion. Through the rest of 2016, growth remained robust and the end of the year saw the fastest upturn in consumer spending for a decade.

However, economic performance this year has not been as encouraging with growth at 0.2 per cent in the first quarter and 0.3 per cent in the second. Looking ahead, forecasts are largely subdued, and the International Monetary Fund (IMF) has downgraded its forecast for UK growth in 2017 by 0.3 percentage points to 1.7 per cent.

There is little doubt that exiting the EU has created a pervasive sense of uncertainty for many UK businesses. Last year saw a 1.5 per cent dip in business investment as corporates held back from major decisions and this summer, 43 per cent of CFOs rated the level of economic uncertainty as 'high' or 'very high', with the effects of EU exit topping their list of risks.[8]

Since the referendum, Whitehall has established new machinery of government, built capacity and capability within the Civil Service, given official notice of the UK's decision to leave, engaged business in its thinking, published a series of position papers and begun the negotiation process. But it is still too early to identify what the final, detailed framework for exiting the EU will be.

In the medium term, uncertainty looks set to remain a characteristic of the UK economy that government will seek to mitigate through engagement with business and flexible fiscal policy. Ultimately, uncertainty is an inherent part of leaving the EU.

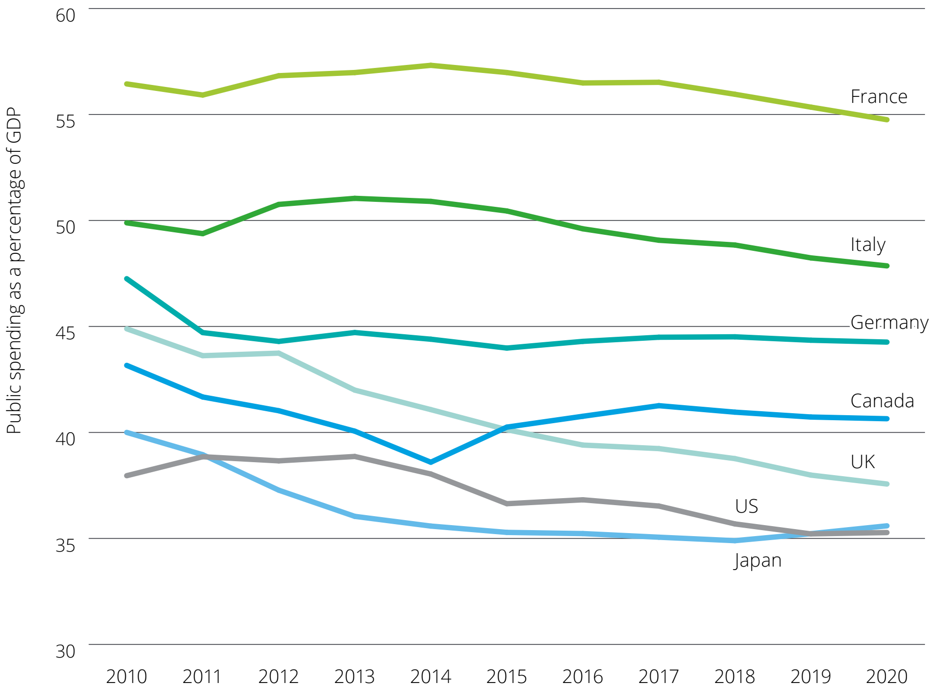
Deficit elimination goes on

The 2008 global financial crisis hit the UK's public finances hard, creating a deficit that grew to a post-war record in 2010 when the state spent £152 billion more than it earned. Forming a coalition government that same year, the Liberal Democrats and Conservatives unified behind a common purpose to eliminate the deficit and deliver an annual budget surplus so that the state's income would exceed its spending. Ultimately, they halved the deficit by initiating a period of public sector austerity and achieving 80 per cent of their deficit reduction through public spending cuts.

Globally, the 2010-15 UK government stood out in its commitment to austerity measures. Figure 2 shows public spending as a percentage of GDP in the G7 nations and how it is changing over this decade. The UK's distinctive profile shows a clear reduction of some 16 per cent, or eight percentage points over ten years compared to relatively modest reductions elsewhere.

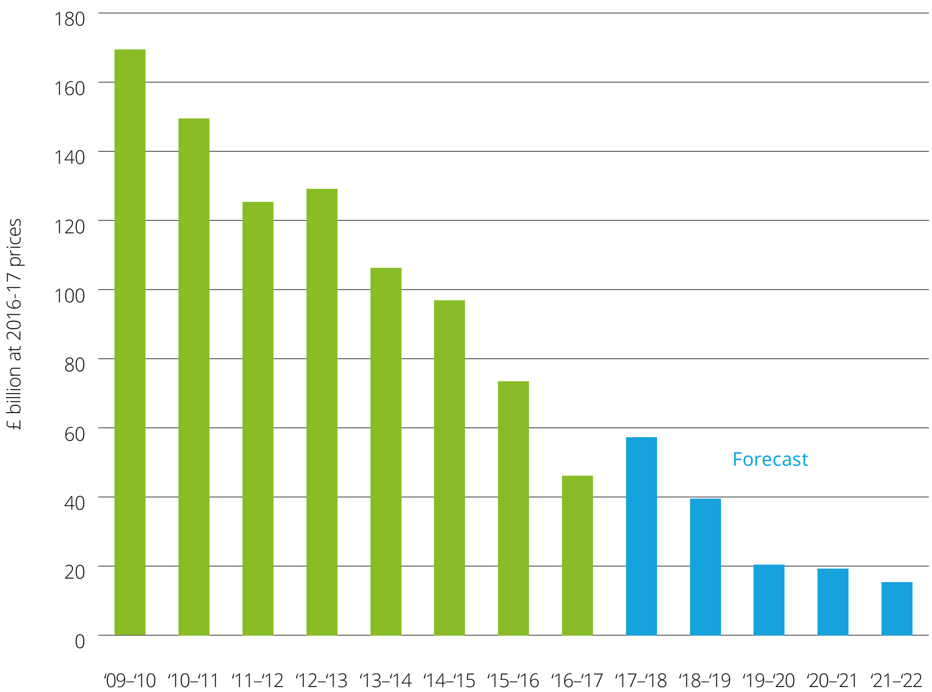
This year, the UK's deficit is expected to come down to £58.3 billion. Figure 3 shows how the deficit has reduced since 2010 and its expected path to 2022.

Figure 2. Public spending in the G7



Source: IMF World Economic Outlook, April 2017

Figure 3. The path of deficit reduction



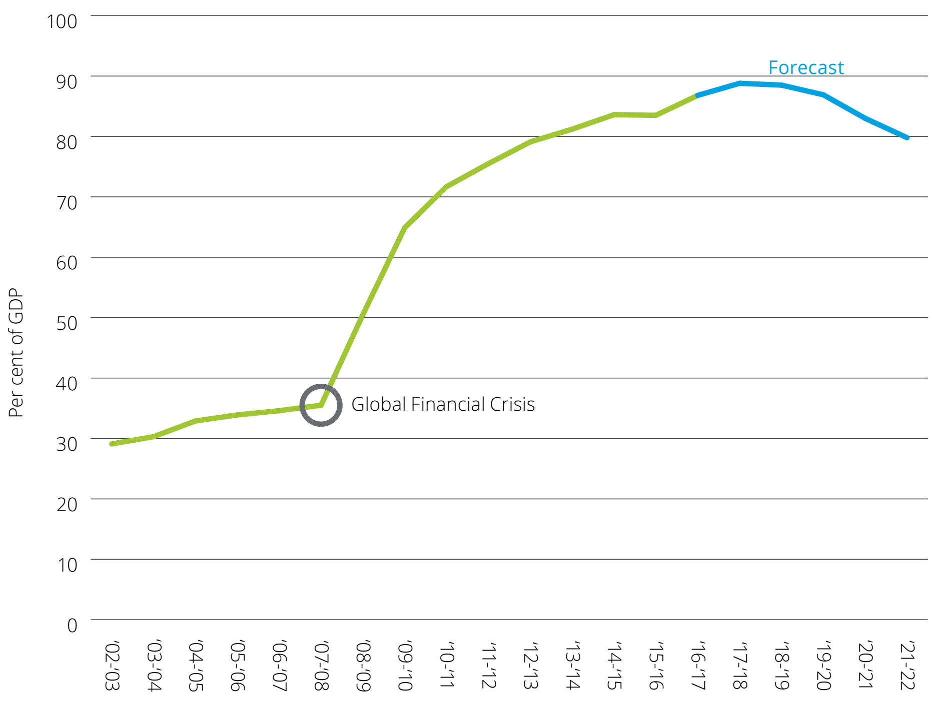
Source: Office for Budget Responsibility

This year could represent the summit of the UK's public sector debt mountain.

The summit of the debt mountain

When governments run a deficit, they plug the shortfall between income and spending by borrowing. Since the global financial crisis, the UK government's debt has more than trebled to £1.8 trillion, as shown in Figure 4, which represents 88 per cent of GDP. That level of debt comes at a price: this year, the government will spend £46 billion on interest – almost equalling the UK's defence budget – and such significant debt levels expose the UK to greater risk in the event of an economic shock. For those reasons, the government remains committed to reducing its debt as a share of GDP from 2020-21. Official forecasts suggest that debt measured this way could peak in this financial year and begin to fall next year, ahead of the government's target. If correct, this year could represent the summit of the UK's public sector debt mountain.

Figure 4. The summit of the debt mountain



Source: Office for Budget Responsibility

Is this the end of austerity?

After the June 2017 general election, Chancellor Philip Hammond reflected that voters had become "weary of the long slog" of public spending cuts and as a result, many commentators heralded the end of austerity.[9] The Chancellor's assessment certainly reflects the sentiment in our citizen survey, which finds that the public's attitude to austerity has hardened.

However, spending plans are continuing on the path set in the 2016 Autumn Statement. That saw a policy shift towards investment, reflecting a call by the Organisation for Economic Co-operation and Development for advanced economies to move away from austerity measures and invest in infrastructure to boost sluggish economic growth. The IMF has been recommending since 2013 that the UK should increase its infrastructure spending, and last year called on all G20 nations to do so in a bid to stimulate short-term demand and encourage private investment. Autumn Statement 2016 answered that call by confirming a total of £170 billion commitments to housing, economic infrastructure and research and development from 2017-18 to 2021-22.

While speculation on the economic impact of leaving the EU may attract all the headlines, the government's approach to eliminating the deficit and paying down debt remains a highly salient factor in the UK's financial status. In September, credit ratings agency Moody's downgraded the UK's rating to Aa2, two steps below the highest level, citing "the pressure to increase spending in the coming years" as one of the key drivers behind its decision.[10]

Striking a balance between public spending, infrastructure investment and restoring the public finances is at the heart of the government's fiscal challenge. In Germany, the government has built a budget surplus of €56 billion since amending its constitution to prohibit deficits in the wake of the global financial crisis. However, its development bank has calculated that Germany has also built an investment backlog of €126 billion, with transport and schools in the greatest need of maintenance.[11, 12,]

While Autumn Statement 2016 committed to greater capital spending, austerity is more concerned with spending on day-to-day administration and public services – and there is no indication that this spending is set to return to the levels of growth seen in the decade before the financial crisis.[13] In fact, government departments are expected to come under particular pressure in 2019-20 when their resource budgets face the third steepest fall of any year since this austerity decade began.[14]

Of course, these spending plans may change. But if the government remains committed to eliminating the remaining £58.3 billion of its annual deficit, a blend of continued austerity and tax adjustments will almost certainly be required. OBR analysis suggests that if deficit elimination continues at the pace it is expected to be falling by 2021-22, the deficit will not be eliminated until 2025-26.

Powering up the UK economy

Restoring the public finances and leaving the EU are not the only factors that will shape our future prosperity. The UK, along with other advanced economies, has for some years been in the midst of a long-term transition towards a more technological, automated and skills-rich economy. Leaving the EU has added a further dimension to that transition, and sharpened debates on the role of migration in the UK's skills mix – issues that have been recognised in the government's proposals for an Industrial Strategy.

While this transition may be long-term, the pace of change in the next two decades is expected to be brisk. Working with researchers at Oxford University, Deloitte has forecast that 35 per cent of jobs in the UK are highly susceptible to automation within the next ten to fifteen years, and lower-paid jobs in industries that are often dependent on non-British labour are most likely to be affected. But our research also suggests that technology tends to create four times as many jobs as it destroys.[15] All of this suggests that the UK is at a turning point in how its workforce is shaped to meet future challenges.

Ultimately, Deloitte's research in this area points to these recommendations:

Develop the UK's immigration system to recognise the personal choices of international talent and the needs of certain sectors for access to particular types of labour

Deloitte research this year found that the UK remains a highly attractive destination for international talent, with a survey of non-British nationals concluding that 89 per cent see the UK as quite or highly attractive as a place to live and work. But uncertainty driven by leaving the EU, coupled with intense competition from other countries, means that the UK may need to try harder in order to attract and retain talented workers. Our recommendation is that the UK's immigration system is developed in ways that recognise that talented people with in-demand skills tend to be mobile and willing to exercise choice over where they live and that certain sectors are disproportionally reliant upon European labour of varying types – not just highly skilled – so a new immigration system should recognise and be flexible enough to manage this.

Invest to upskill current and future workers

The UK's skills needs are changing. Automation is reducing the number of low paid jobs and placing a new emphasis on cognitive abilities, workplaces are requiring more collaborative approaches to meet complex challenges and technology is allowing for new and creative solutions and products. As a result, Deloitte research has concluded that cognitive, collaborative and creative skills will be the most marketable in the UK's job market in the coming years. Our recommendation is that policymakers, businesses and educators continue working together to adapt current education and training systems to meet these needs. Our interviews with university vice-chancellors, explored later in this report, illustrate how higher education sees this challenge.

Embrace digital and invest in the deployment of technology

Our recommendation is that businesses explore how technology might bridge skills shortages and boost productivity. There is nothing new in this – self-service checkouts, robots in warehouses and automated menu systems for call centres are among technologies that have become the norm in recent years. Transport could be a particularly important sector for the UK's future if government and business could seize the opportunities in self-driving cars. The UK is well-placed among eight auto manufacturing nations vying for first-mover advantages in what is shaping up into a $10 trillion industry.[16]

Work at a regional level to create an appropriate local response

Deloitte's survey of non-British workers within the UK found considerable regional variations in moving intentions. In the Northern Powerhouse region, only 21 per cent of EU nationals are considering moving to another country, compared to 59 per cent in London. On top of that, different parts of the UK enjoy different concentrations of industries. Fortunately, government policy across all of the UK's administrations has shifted towards regional planning and our recommendation is that business, educators and government in each region engage as effectively as possible to create a shared agenda and plan for the future economy.

The government's balance sheet

The UK government is a world leader in public sector financial reporting, and for the past seven years has published the largest consolidated annual public sector accounts in the world: Whole of Government Accounts (WGA). They allow for a perspective on the public sector's underlying financial health and sustainability and an extract of the most recent WGA report, for the financial year 2015-16, is shown in figure 5.

Figure 5. The government's balance sheet

Statement of revenue and expenditure

£ billion	2015-16	2014-15 restated	Notes
Revenue	**(693.9)**	(659.9)	Includes services provided by councils such as social care, as well as EU income. The latter is largely passed onto third parties as farming subsidies, for example
Total expenditure	**742.2**	751.3	Spending which includes £222.5 billion on social security benefits, £193.3 billion on staff costs and £192.1 billion on goods and services
Financing costs of long-term liabilities	187.4	65.1	Includes £52.1 billion of pension financing costs and £127.9 billion of provision financing costs
Revaluation of financial assets and liabilities	8.1	(4.5)	The net loss on revaluations and disposals of assets and liabilities
Net expenditure for the year	**243.8**	152.0	The shortfall between the government's income and expenditure in accounting terms

Statement of financial position

£ billion	2015-16	2014-15 restated	Notes
Assets	**1,742.4**	1,683.3	Assets – what the state owns – include the rail and road networks, military equipment, land and buildings
Liabilities	**(3,728.4)**	(3,558.5)	Liabilities – what the state owes – include government borrowings, banknotes in circulation and public sector pension schemes
Net liability	**(1,986.0)**	(1,875.2)	Net liability – the difference between assets and liabilities – has increased by six per cent or £110.8 billion

Source: Whole of Government Accounts 2015-16, HM Treasury

In his report on this year's accounts, the independent Comptroller and Auditor General (C&AG) recognised that WGA have become increasingly important to the UK's public financial management and are used by key institutions in their commentary on government finance. He went on to note that HM Treasury has significantly improved how the accounts are presented, providing an "insightful narrative", and made recommendations to embed them further in the UK's public financial management.[17]

A notable development in the latest WGA is a five per cent rise in the government's liabilities, taking the total to £3.7 trillion. That is mainly due to a rise in government borrowing to meet the deficit shortfall but there has also been a significant rise in provisions – the amounts set aside for probable future obligations – in relation to nuclear decommissioning and clinical negligence.

The provision for nuclear decommissioning, which estimates how much it will cost to clean 17 of the UK's earliest nuclear sites over a programme expected to last 120 years, has increased from £83 billion in 2014-15 to £182 billion in the latest accounts. Most of that liability relates to Sellafield, and as the Nuclear Decommissioning Authority recognises, the oldest parts of the site were created during the Cold War in some haste, with no plans for decommissioning.[18] Increases in the estimate for cleaning the site generally come from an improved understanding of its complexity and last year's transfer of the organisation that operates Sellafield into the private sector is expected to accelerate progress of the clean-up.[19]

Over the same timescale, the provision for clinical negligence claims against the NHS in England has gone up from £29 billion to £58 billion. NHS Resolution, formerly the NHS Litigation Authority, reported a five per cent reduction in the number of claims, although their overall value has increased. As WGA reports, the NHS has taken significant steps to reduce clinical negligence, including improved professional standards and a new Statutory Duty of Candour which provides patients with a prompt apology and accurate information when care goes wrong.[20]

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