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**REFORM**

# The State of the State 2014-15

## Government's inflection point

UK Public Sector | Thinking people



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## **About Deloitte**

Deloitte LLP offers professional services to the UK and European market. With over 14,500 exceptional people in 28 offices in the UK and Switzerland, Deloitte has the broadest and deepest range of skills of any business advisory organisation. We provide professional services and advice to many leading businesses, government departments and public sector bodies.

With a globally connected network of member firms in more than 150 countries, Deloitte brings world-class capabilities and high-quality service to clients, delivering the insights they need to address their most complex business challenges.

## **About Reform**

Reform is a non-party think tank whose mission is to set out a better way to deliver public services and economic prosperity. Our aim is to produce research of outstanding quality on the core issues of the economy, health, education and law and order and on the right balance between government and individual. We are determinedly independent and strictly non-party in our approach.

# Foreword

Welcome to *The State of the State 2014-15*. Now in its third year, this annual report aims to provide an independent and accessible view of the UK public sector.

Deloitte LLP and Reform have once again collaborated to bring together material from a wide range of public sources – including the government’s accounts, public spending data, the Budget, the Autumn Statement and official economic forecasts – into a single snapshot. We augment that data with insight from roundtable discussions and interviews with executives from across the public services. Our aim is to create a report that helps facilitate a more informed and constructive debate on the operation of the UK state.

This year’s *State of the State* finds the UK public sector approaching a historic inflection point. We are half way through a far-reaching fiscal consolidation programme that is reducing the size of the state. The public sector reform required to achieve the second half of the consolidation looks set to alter the way that many public bodies operate. And the Scottish Referendum has triggered a fundamental rethink of how power is devolved across the UK. In the next five years, the UK and its public sector will change profoundly.

The need to restore the public finances has been hard on government and the public services since 2010, requiring difficult decisions by public sector leaders and executives. But those decisions are about to get harder. Completing the deficit reduction plan will require the Government elected in May 2015 to decide where the next, deeper half of public sector cuts will fall in a 2015 Spending Round. Our research shows that the people running the UK’s public services are justly proud of how they have adjusted to budget reductions so far. It also shows they are apprehensive about the next period of change and challenge.

The public spending outlook may appear bleak and government may need to balance citizen expectation with affordability. But continued reform – based on evidence about what works and driven by effective leaders – will help maximise the public sector’s effectiveness and allow it to thrive as it continues to rise to its challenges.

At its best, the UK public sector leads the way in many areas of modernisation. HM Treasury’s financial management review is revitalising the way public money is managed, the Government Digital Service is helping forge a more citizen-centred digital experience of the state and public bodies across the UK are driving organisational change under significant austerity pressure. Governments around the world are watching ours to learn lessons.



**Mike Turley**  
Vice Chairman,  
Deloitte LLP



**Andrew Haldenby**  
Director, Reform

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# Executive summary

*The State of the State 2014-15* finds the Government moving towards a historic inflection point. In the next five years, the UK's governance, our public sector organisations and citizen experiences of the public services are likely to change profoundly.

Following the global financial crisis, the UK budget deficit reached a record level in 2010. The Government's annual spending was £159 billion more than its income and the newly-elected Coalition Government set out a programme to reduce its annual deficit, mainly through cuts to public spending. As at 2014-15, the UK is just half way through it with the deficit expected to be £96 billion this financial year and eliminated by 2018-19.

A second half of spending cuts will therefore be required. The Government elected in May 2015 will need to set out where those cuts will fall in a 2015 Spending Round announcement, realistically within six months of taking office.

Interviews conducted with senior executives in the local public services suggest that they are justly proud of the way they have managed the first half of the spending cuts. Many added that their organisations and the services they provide have improved as a result of austerity pressures.

However, most of those interviewed had a less positive outlook for the future and the further cuts to come. Many spoke of risk, uncertainty and the prospect of organisational and service failure in the years ahead. They know that the second half of spending cuts will be much harder to deliver than the first and the changes required to cope with them will have profound implications for their organisations, the services they deliver and the expectations of the citizens who experience them. The publication of the 2015 Spending Round that identifies those cuts will therefore be a defining moment for the future of the public sector.

Our interviews also found that local public sector chief executives hope that political leaders offer a more supportive political narrative over public service cuts in the years ahead. Many believe that national and local politicians have a duty to engage citizens in constructive dialogue about the changing limits of the state.

Supporting the public services through such profound budget reductions will be one of the Government's primary challenges in the next five years, along with recasting the UK's governance in the wake of the Scottish referendum, driving continued economic growth and bolstering national security.

*The State of the State* finds that better productivity is central to the UK's advancement in both the private and public sectors and the Government needs to show leadership and direction for a renaissance in both. Private sector improvements, driven by investment in infrastructure, technology and people are needed to secure UK economic growth. Public sector productivity gains, delivered by a package of reforms that should include talent management, demand management and use of technology are fundamental to the future of government. Every one per cent of public sector staff time saved through a productivity measure is worth at least £1.6 billion to the public purse.

Beyond the deficit, the Government will need to turn its attention to reducing its debts. Public sector debt has trebled in the past decade – inevitably as the Government borrows to fund the shortfall in its spending – but when the deficit is eliminated, the £1.4 trillion of UK Government debt will need to be paid down. The UK's current debt levels, ninth highest in the EU as a percentage of GDP, mean that from a technical perspective the UK does not meet the original Euro entry criteria. This level of debt keeps the UK exposed to excessive financial insecurity and burdens the taxpayer. At £1 billion a week, the UK state already spends as much on debt interest as on education, more than it spends on public services in Northern Ireland and Wales combined or three times as much as Whitehall currently saves through efficiencies.

While the next Government may exercise its power to change the way the deficit is reduced, failing to eliminate it is not a viable option. If debt continued to rise, by 2023 debt interest would have risen to three times what the state spends on defence.

*The State of the State 2014-15* recommends that the Government elected in 2015 should focus on its priorities by considering its programme through three lenses.

First, a debt reduction lens would help focus the Government on reducing public sector debt and ensure that spending decisions were assessed for their impact on the state's long term liabilities. That would help restrain public sector spending growth, taking us from a period of austerity into a new era of prudence from 2020.

Second, a productivity lens would help the Government focus on policies to turn around the UK's productivity record and sharpen its vision for further public sector reform by focusing on sustainable productivity gains.

Third, looking at the public sector workforce through a talent lens would help Government manage and deploy its people to best effect. At a time of major headcount reductions and significant change management challenges, it is more important than ever that the public sector has the right people with the right skills in the right jobs.

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# Government in 2014-15

The UK state is a complex mosaic of interwoven public bodies, democratically accountable to 47,691,800 electors, serving a population of 64,105,700 people.<sup>1,2</sup>

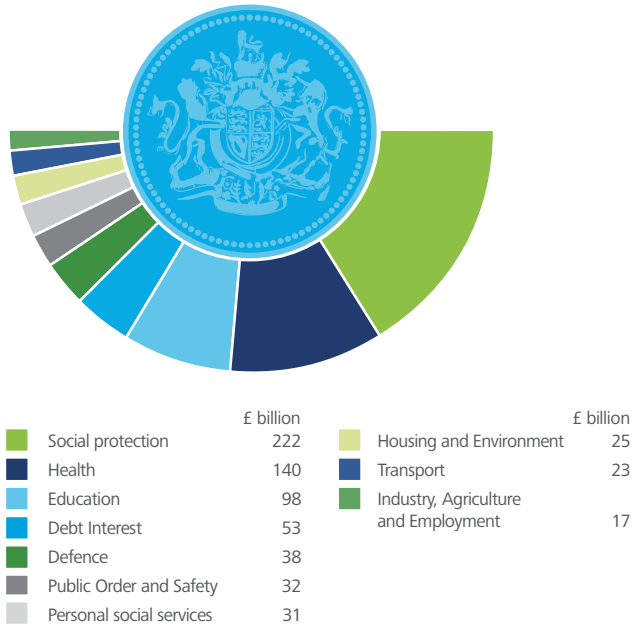
Some 65 per cent of those electors turned out for the 2010 UK General Election. Turnout for the most recent devolved assembly elections was 55 per cent for the Northern Ireland Assembly, 50 per cent for the Scottish Parliament and 42 per cent for the Welsh Assembly.<sup>3</sup> The Scottish Referendum surpassed them all with a turnout of 85 per cent.

As well as national government in Westminster, the UK is governed by three distinctive administrations based in Belfast, Cardiff and Edinburgh. Nine political parties are currently parties of national and devolved government across the UK, with 149 ministers acting as political decision makers.

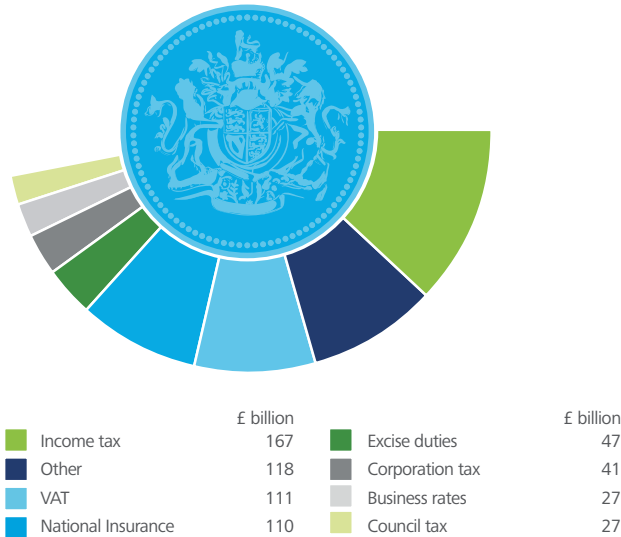
A total of 947 elected representatives currently legislate and scrutinise government in our elected assemblies, along with 777 members of the House of Lords acting as a second chamber of the UK parliament. A further 73 UK members of the European Parliament scrutinise EU legislation that affects the UK and more than 21,000 councillors hold 433 local councils to account.

The UK public sector employs 5.394 million people. That is 282,000 less than a year ago and 898,000 less than in 2010.<sup>4</sup> Fewer than one in five working people in the UK is currently employed by the Government, operating in a total estate that covers 8,716,015 square metres.

**Figure 1. Where the money goes**  
In 2014-15, government will spend £732 billion



**Where the money comes from**  
In 2014-15, government income will be £648 billion



Source: Budget 2014, HM Treasury

In the 2014-15 financial year, the UK Government is expected to raise £648 billion and spend £732 billion as illustrated in figure 1.<sup>5</sup> For every UK citizen, the Government spends £11,419, receives £10,108 in tax revenue and is servicing £22,343 of public sector debt.

The Government's balance sheet shows £1.26 trillion of assets including offices, the road network and military equipment. It shows liabilities of £2.89 trillion including a £1.2 trillion liability for public service pensions.<sup>6</sup> The state's net liability – the difference between what the Government owns and what it owes at an accounting year end – was £1.63 trillion at last count in 2012-13. That is an increase of £283 billion since the previous financial year and the largest increase since the start of public sector-wide accounts in 2009-10.<sup>7</sup>

The entire UK public sector's debt now stands at £1.4 trillion, which is about 79 per cent of Gross Domestic Product (GDP). That has risen from £1.3 trillion, or 77 per cent of GDP, at the same point last year.<sup>8</sup>

By the European Union's Maastricht treaty calculations, UK general government gross debt now stands at 90.6 per cent of GDP, which is the ninth highest in the EU as a percentage of GDP.






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# Reporting against our 2013 indicators

*The State of the State* reports on ten indicators to measure the Government's success over a range of criteria.

They combine the Government's commitments with our own indicators to assess the state's progress in ten critical areas.

Indicator	Progress	Measurement criteria	Traffic light
<b>Encourage corporate sector spending to support growth</b>	<p>The UK economy has returned to its pre-crisis level and Deloitte's UK Futures research suggests that UK business will invest £197 billion over the next two years.</p> <p>Government initiatives have included cutting corporation tax, introducing incentives to invest in machinery and national insurance changes intended to boost employment.</p>	Evidence that UK corporates are investing cash	Green 
<b>Drive significant public sector headcount reductions</b>	<p>The Civil Service reduced by 17 per cent between 2010 and 2013, contributing to £2.3 billion of workforce savings in 2013-14.</p> <p>At 5.394 million, total public sector headcount is at its lowest level since the current series of records began in 1999 and 898,000 lower than at the time of the 2010 General Election.</p>	Progress according to Civil Service Reform Plan and continuous reduction in permanent headcount towards target	Green 
<b>Meet efficiency targets of £20 billion per year</b>	<p>The Cabinet Office Efficiency and Reform Group (ERG) have generated savings of £14.3 billion in 2013-14, up from £10 billion in 2012-13 and £5.5 billion in 2011-12. The ERG is on track to realise its target of £20 billion per year from 2015.</p> <p>This is a major achievement, but given that 2013-14 savings were less than two per cent of public spending, the ERG should build on its success, raise its ambition and continue to implement National Audit Office (NAO) recommendations to develop its measurement of savings across all areas.</p>	Meeting Efficiency and Reform Group targets	Green 
<b>Save cash through Payment by Results</b>	<p>Managed effectively, outcome-based commissioning could help focus public spending and engage innovative providers in public service delivery. But its potential is yet to be realised.</p> <p>As the National Council of Voluntary Organisations (NCVO) found, outcome-based commissioning can cause cashflow issues for providers, unintended consequences and perverse incentives where contracts are inflexible and ineffective.<sup>9</sup></p> <p>Government needs to continue working with suppliers to develop outcome-based commissioning, especially through evaluation and best practice, to build and shape a more thriving market.</p>	Save cash and improve outcomes with evidence of increasing use of results-orientated commissioning	Amber 
<b>Support social innovation and transfer one million public sector workers into mutuals by 2015</b>	<p>The number of mutual spin-outs including joint ventures from the public sector has grown from nine in 2010 to 100 in 2014, employing 35,000 people and delivering £1.5 billion of public services. While short of the Cabinet Office aspiration for one million public sector workers to form mutuals, UK Government has fast become a global trailblazer for social innovation in the public sector.</p>	Evidence of innovation and alternative delivery models as well as number of staff transferred to mutuals	Amber 



Indicator	Progress	Measurement criteria	Traffic light
<b>Save cash lost through fraud</b>	<p>The Government's Fraud, Error and Debt Taskforce report detection and prevention savings of £6.5 billion in 2012-13.<sup>10</sup> For perspective, estimates suggest there was £20.6 billion of fraud against the public sector and £22 billion of overdue debt owed to central government in 2013.<sup>11,12</sup></p> <p>The closure of the National Fraud Authority means that an annual fraud figure is not available for 2014, but the expected inclusion of fraud, error and debt figures in future Whole of Government Accounts will allow for annual comparison.</p> <p>Ongoing initiatives to set up a cross-government debt service and bring the data-led National Fraud Initiative within the Cabinet Office show significant potential for the future.</p>	Evidence of reductions in fraud and debt losses	Red
<b>Manage cash more effectively</b>	<p>Government's cash management operation aims to make best use of net cash surpluses through joint efforts by HM Treasury and the Debt Management Office (DMO).</p> <p>The Debt Management Account ended every day in 2013-14 with a positive balance except on three occasions.</p>	Meeting cash management targets	Green
<b>Target net liabilities</b>	<p>Government accounts show that net liabilities rose by £283 billion in the year to 2012-13.</p> <p>While the Government has made significant reforms that should reduce some elements of liability in years to come, it needs to make clear how new policies will be assessed for their impact on state liabilities.</p> <p>As noted by the Public Accounts Committee, Government should not ignore the impact of policy and spending decisions on the Government's balance sheet.<sup>13</sup></p>	Evidence that the impact of new policies on liabilities is assessed	Red
<b>Support an economy-wide focus on productivity</b>	<p>UK productivity is currently 16 per cent below its pre-crisis level and the second lowest in the G7. The Bank of England acknowledges that there is no accepted and credible explanation for the UK's 'productivity puzzle'.<sup>14</sup></p> <p>In the public sector, productivity gains in the areas of talent, policy, process and technology have significant potential for future reform.</p>	Development of a plan to improve public sector productivity	Red
<b>Drive localism through council funding</b>	<p>While the Government allows councils to keep a proportion of business rate revenue, much more needs to be done to devolve fiscal power to local government so they can respond to local needs and stimulate growth.</p> <p>Recasting the UK's governance in light of the Scottish referendum could have significant implications for local devolution as well.</p>	Evidence of support for localism and councils' ability to support growth	Red

# The state of the public finances

The global financial crisis and subsequent deficit reduction measures have put historic levels of strain on the UK economy and public finances. But while the economy has left recession and returned to its pre-crisis level, public sector austerity must remain if the budget deficit is to be eliminated during the next UK Parliament.

This chapter explores the state of the public finances and their outlook for beyond the 2015 General Election.

## The return of economic growth

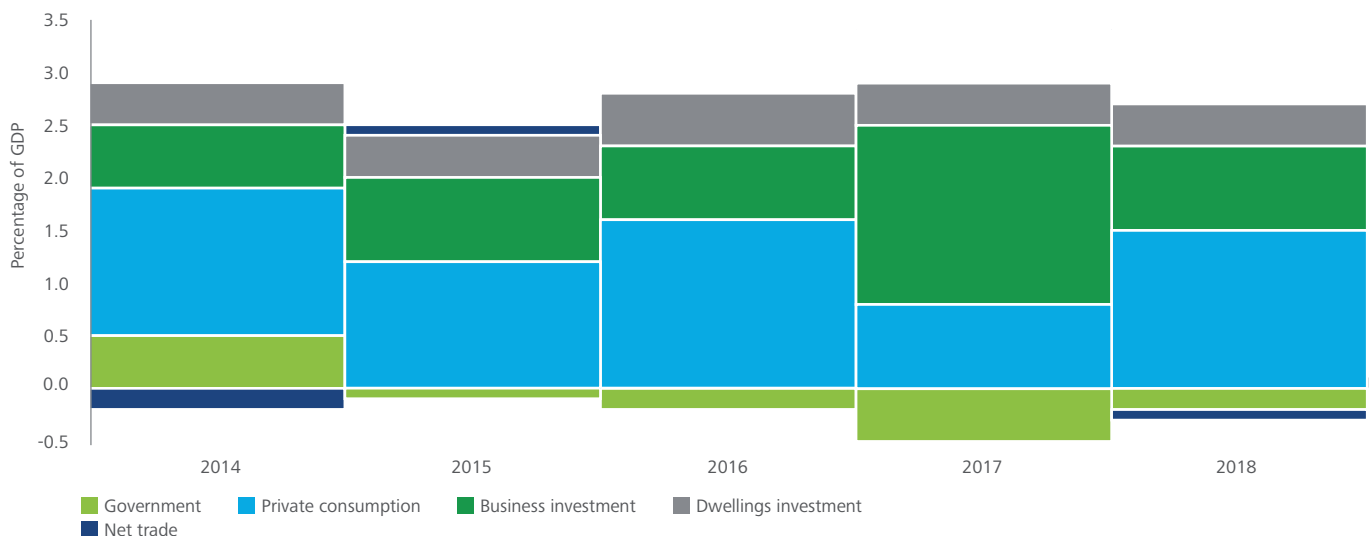
In the wake of the 2008 financial crisis, the UK entered a six-year recession that was its deepest since quarterly data was first published in 1955.<sup>15</sup> The economy gained momentum in 2013 and returned to its pre-crisis level in the second quarter of 2014. UK economic growth is now outpacing every other major advanced economy and the outlook for the coming years is positive.

The Office for Budget Responsibility (OBR) has revised up its forecast for GDP growth to 2.7 per cent in 2014 and 2.3 per cent in 2015, and figure 2 identifies where that growth is expected to come from. The forecast points to the relative importance of business investment to drive the UK's success in the coming years, which reflects Deloitte's own analysis. Our latest *UK Futures* research suggests that big businesses will boost growth by investing around £197 billion over 2014 and 2015.<sup>16</sup>

Government initiatives since 2010 to support growth include a cut in the main rate of corporation tax from 28 per cent to 23 per cent, and a further reduction to 20 per cent by 2015-16. A new employment allowance will take 450,000 employers, mainly small and medium enterprises, out of national insurance contributions this year and changes to the investment allowance will double the amount that businesses can invest in equipment and receive tax relief.<sup>17</sup>

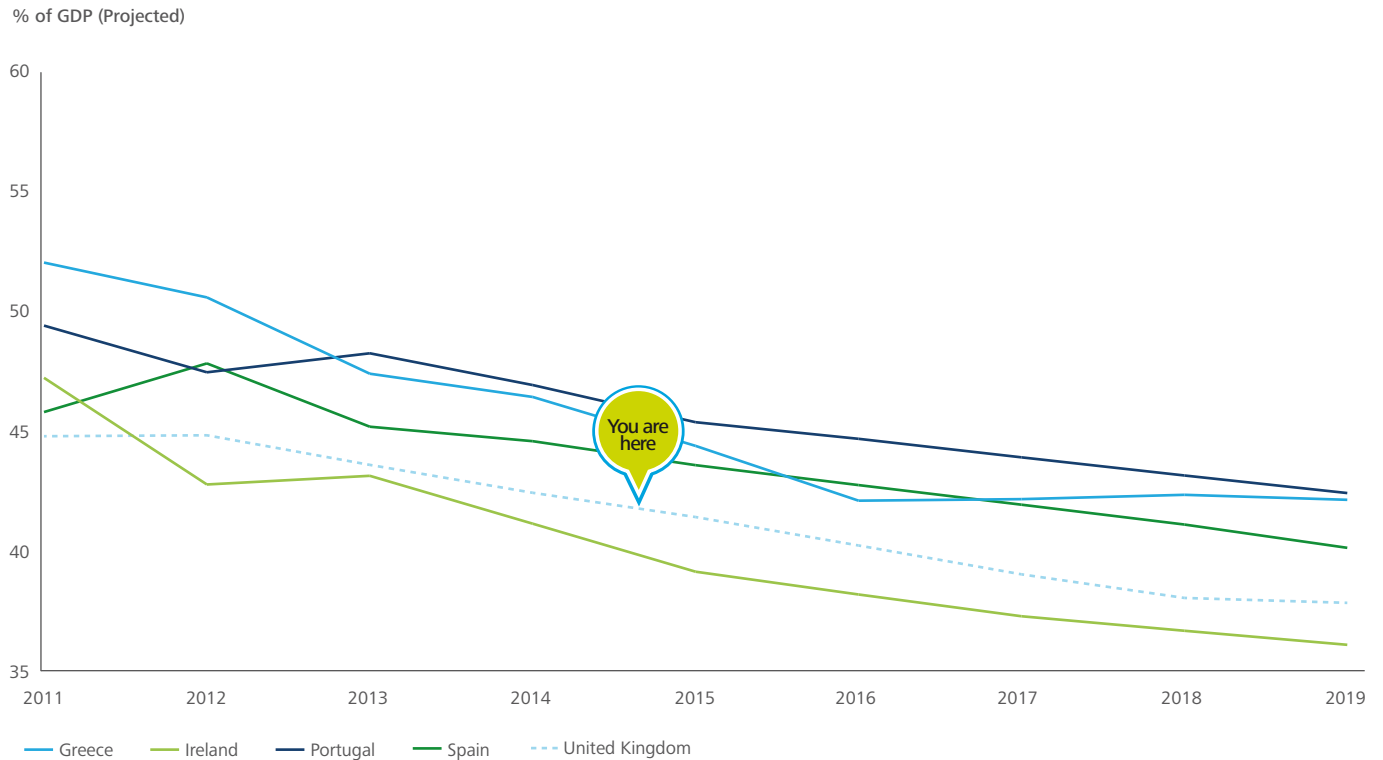
The International Monetary Fund (IMF) suggests that productivity improvements in the UK are vital to sustain momentum in our economic recovery, adding that transport, energy, and education are also priority areas to shore up our long-term growth potential.<sup>18</sup> UK productivity, the second lowest in the G7, currently languishes 16 per cent below its pre-crisis level and even the Bank of England acknowledges there is no widely accepted and credible explanation for the 'UK productivity puzzle'.<sup>19</sup> Clearly, the Government has a leading role to play in supporting business – as well as the public sector – in turning around the UK's productivity.

Figure 2. Where will growth come from?



Source: Economic and Fiscal Outlook, Office for Budget Responsibility

**Figure 3. Government scales back**  
Public spending cuts around the world



Source: International Monetary Fund, World Economic Outlook 2014

**Fiscal consolidation: Coping with the global financial crisis**

The 2008 global financial crisis hit economies and governments around the world hard. The economic downturn that came in its wake reduced tax incomes, pushed up welfare bills and forced governments to spend a combined \$7.1 trillion to bail out financial institutions. Many public sectors, including the UK, were already spending beyond their means but the crisis widened the gap between income and expenditure. The UK’s deficit – the shortfall between what the government earns and what it spends over one year – reached a post-war record of £159 billion in 2010 and the UK state effectively became unaffordable.

For that reason, the UK Coalition Government set a target in 2010 that has come to represent the defining measure of its success: to eliminate the deficit and balance the Government’s current account by the end of a rolling, five-year period. In practical terms, that means the deficit needs to be eliminated and the current budget needs to show a surplus by 2018-19. The target is known as the fiscal mandate and the Government’s plan to achieve it is known as fiscal consolidation. It is essentially a programme to stop the state spending more each year than it is prepared to tax its citizens, and it is largely being achieved by spending cuts and reforms to mitigate the impact of those cuts.

Of course, the UK is not alone in undertaking a fiscal consolidation. Figure 3 compares such programmes across five notable countries.

The chart shows that the UK state will effectively shrink by 16 per cent over the fiscal consolidation period. While that is less than the major readjustments in Ireland and Greece – where the public sectors will shrink by 24 and 19 per cent respectively – the UK’s reduction is the deepest in the G7.

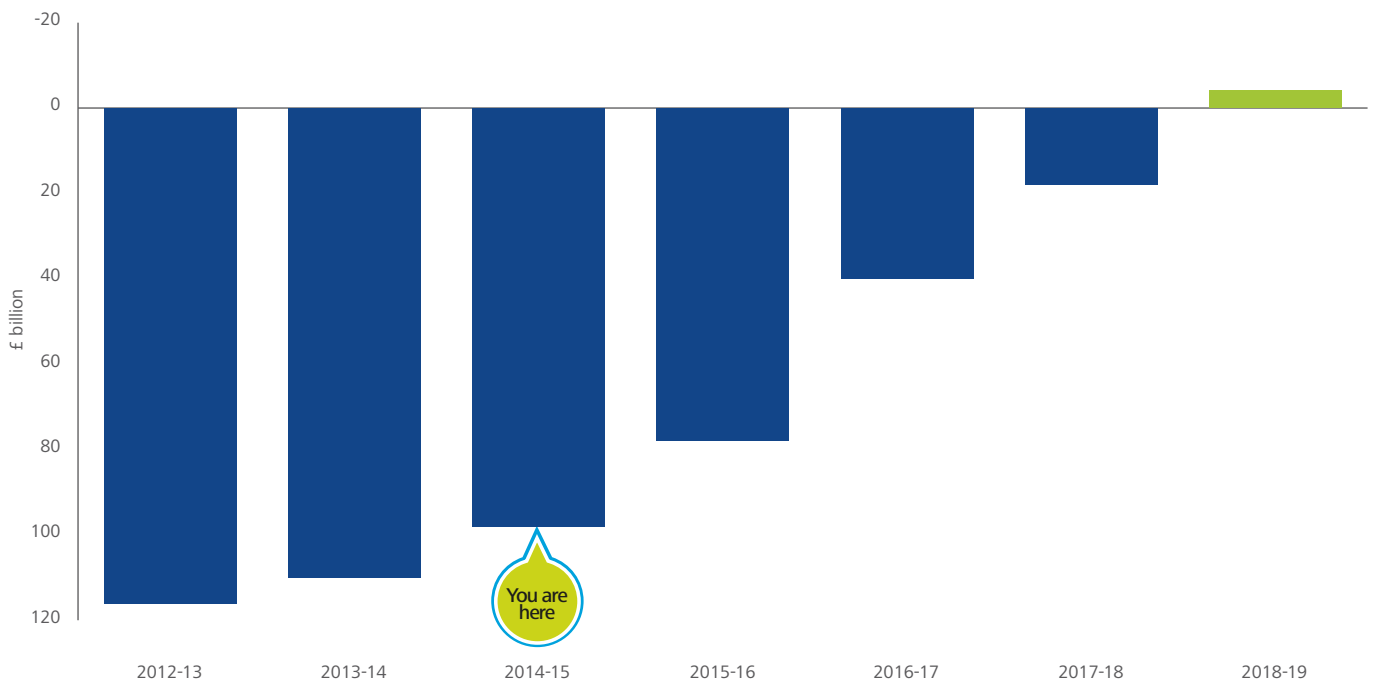
As figure 3 shows, the UK is only at the half-way point of its fiscal consolidation programme and of the countries shown, only Ireland has further still left to travel to reach its 2019 size as forecast by the IMF.

### Eliminating the deficit

Current forecasts suggest that the deficit now stands at £96 billion and is expected to return to surplus by 2018-19 as shown in figure 4. The reduction has progressed slightly better than expected this year because higher house prices have produced higher stamp duty receipts than expected and low inflation has led to lower debt interest than expected.<sup>20</sup>

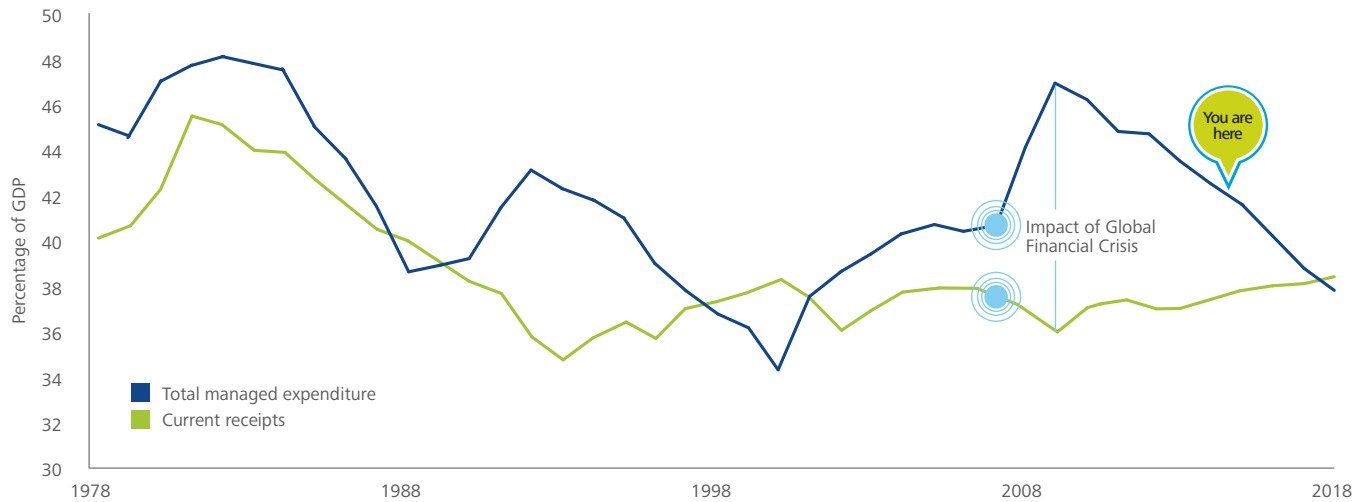
The public finances are therefore on track to meet the Government’s fiscal target and its income is on track to exceed its expenditure by 2018-19. Again, figure 4 also shows that the deficit reduction is at the half-way mark and how much more needs to be done before the deficit is eliminated.

**Figure 4. Eliminating the deficit**  
Public sector borrowing



Source: Economic and Fiscal Outlook, Office for Budget Responsibility

Figure 5. Public sector spending and receipts since 1978



Source: Office for National Statistics and Office for Budget Responsibility

Figure 5 provides a historical perspective by showing the relationship between tax and spending for the past forty years. It shows the forecast that by 2018-19, tax revenue is expected to exceed spending for the first time in eighteen years when the deficit is eliminated.

Improving the public finances to this point has been a major achievement and, if it proves successful by the target date, the deficit reduction will have been substantial step towards an affordable public sector.

Figure 6, overleaf, is the Office for Budget Responsibility's (OBR) official view of how the Coalition has reduced the deficit since 2010-11 and how, according to its plan, it is expected to keep reducing until it delivers a surplus in 2018-19.

The chart shows that 80 per cent of the entire programme is to be achieved by cuts to public spending. The dark green sections are Public Sector Current Expenditure elements of Resource Departmental Expenditure Limits (PSCE in RDEL), described by the OBR as "day-to-day spending on public services and administration".<sup>21</sup>

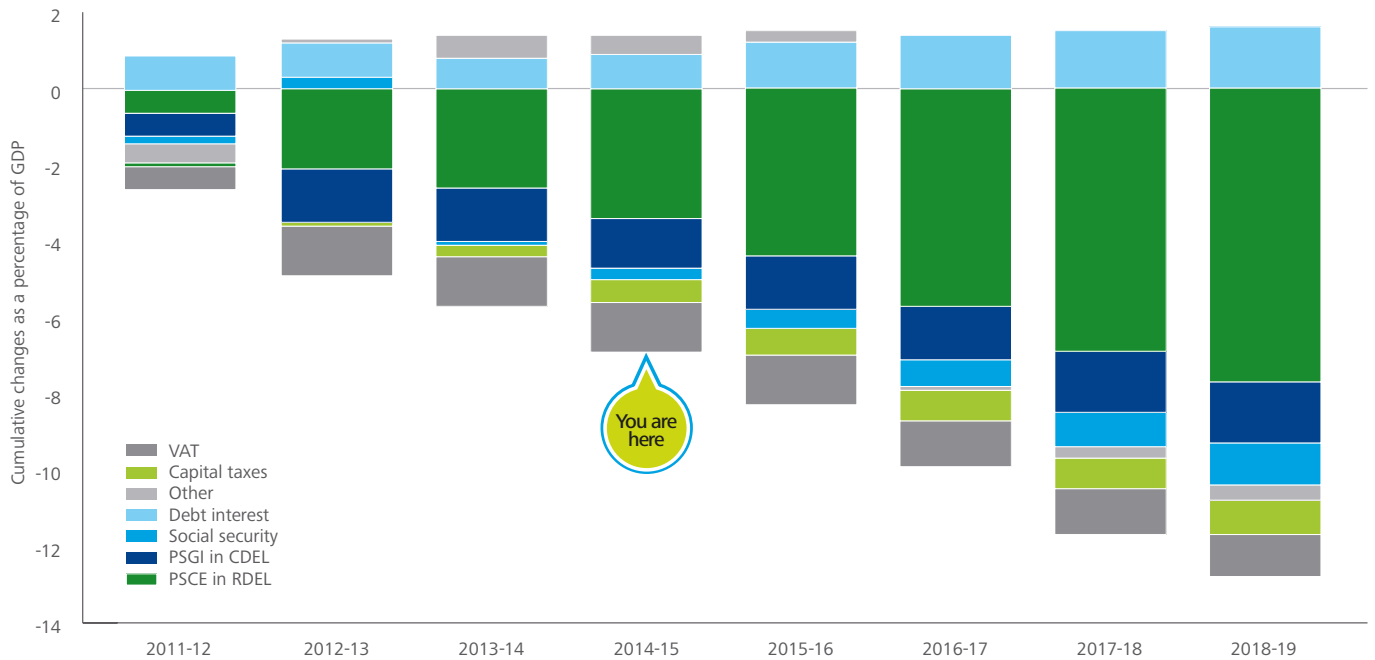
The first wave of UK austerity measures were announced in October 2010 and a second wave, announced in the 2013 Spending Round, will take the cuts to just over the half way mark in 2015-16. But the remaining 43 per cent of the cuts to public service spending and administration budgets will need to be made in a 2015 Spending Round by the next Government.

Those cuts will lead many public bodies to rethink their operations and services, causing profound levels of change across the public sector.

If the fiscal consolidation target is met, spending reductions over the nine year deficit reduction period will take public spending as a percentage of GDP back down to its 2001 level in terms of how much of the UK's wealth is spent on its public sector.

In real terms, the total amount spent by the Government has reduced by £10.4 billion since 2009-10<sup>22</sup>. Over the same timescale, health spending has gone up by almost the same amount and central government debt interest has risen by £18 billion in real terms.<sup>23</sup> While total public spending has decreased marginally, continued increases in certain areas have magnified the pressure of cuts on others. That trend looks set to continue as all three UK political parties have committed to increased spending on health.

Figure 6. Where is deficit reduction coming from?



Source: Economic and Fiscal Outlook, Office for Budget Responsibility

### Fifty years of spending growth

Even though the fiscal consolidation period will bring public spending down to more affordable levels, it will fall short of making the public services completely sustainable. Continued reform will be needed to restrain public spending to sustainable levels in the longer term in the face of spending pressures from the UK's ageing population.

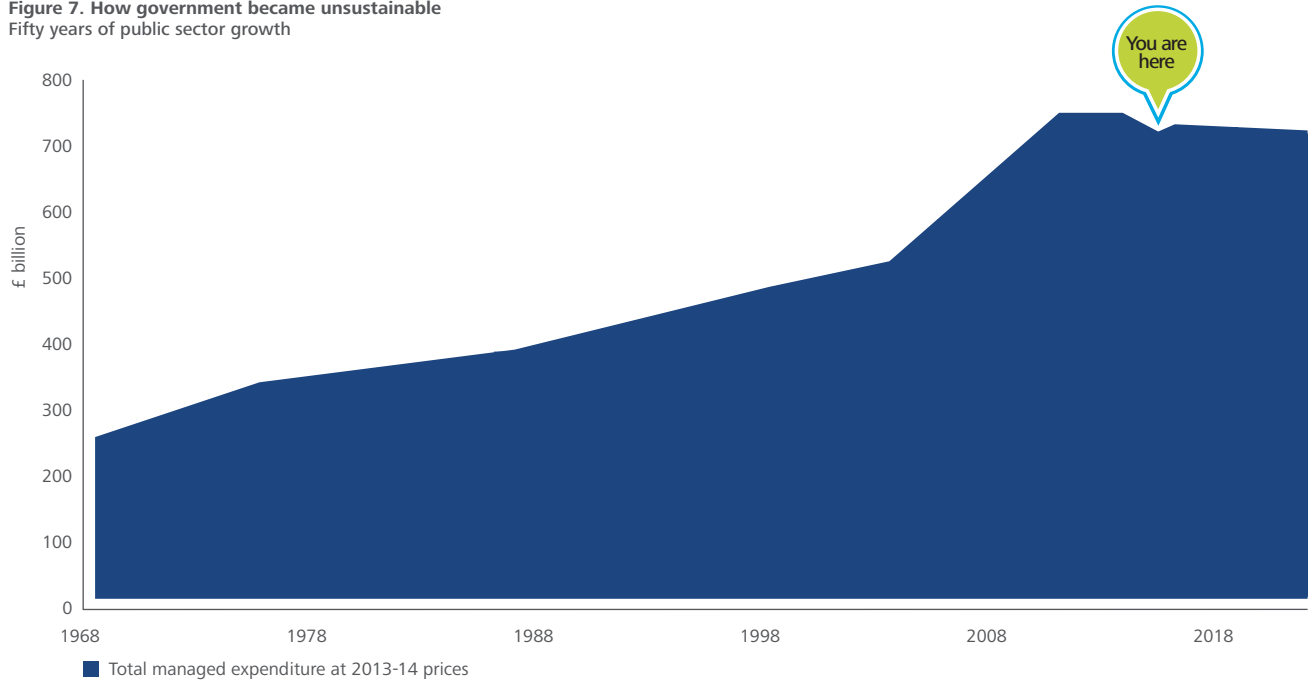
As figure 7 shows, the UK Government spent £13 billion in 1964 – about £190 billion at today's prices – which equalled 38 per cent of GDP. Fifty years later, it will spend £730 billion which equals 44 per cent of GDP.

The last decade saw particularly striking increases in public spending, driven by demand. Some elements of social security increased by 45 per cent in real terms, health spending doubled and the cost of providing adult social care – not part of the original welfare state as defined in the Beveridge report – increased by 50 per cent.<sup>24, 25</sup>

Public sectors grow to meet demand but also to meet economic and social needs. For example, since the Elementary Education Act of 1880 first required children to attend school from the age of five to ten, governments have repeatedly raised the school leaving age. In England, young people are now expected to remain in education or training until their 18th birthday. That clearly demonstrates the importance of government in driving social change, but it also shows that the scope and cost of government has grown over time.

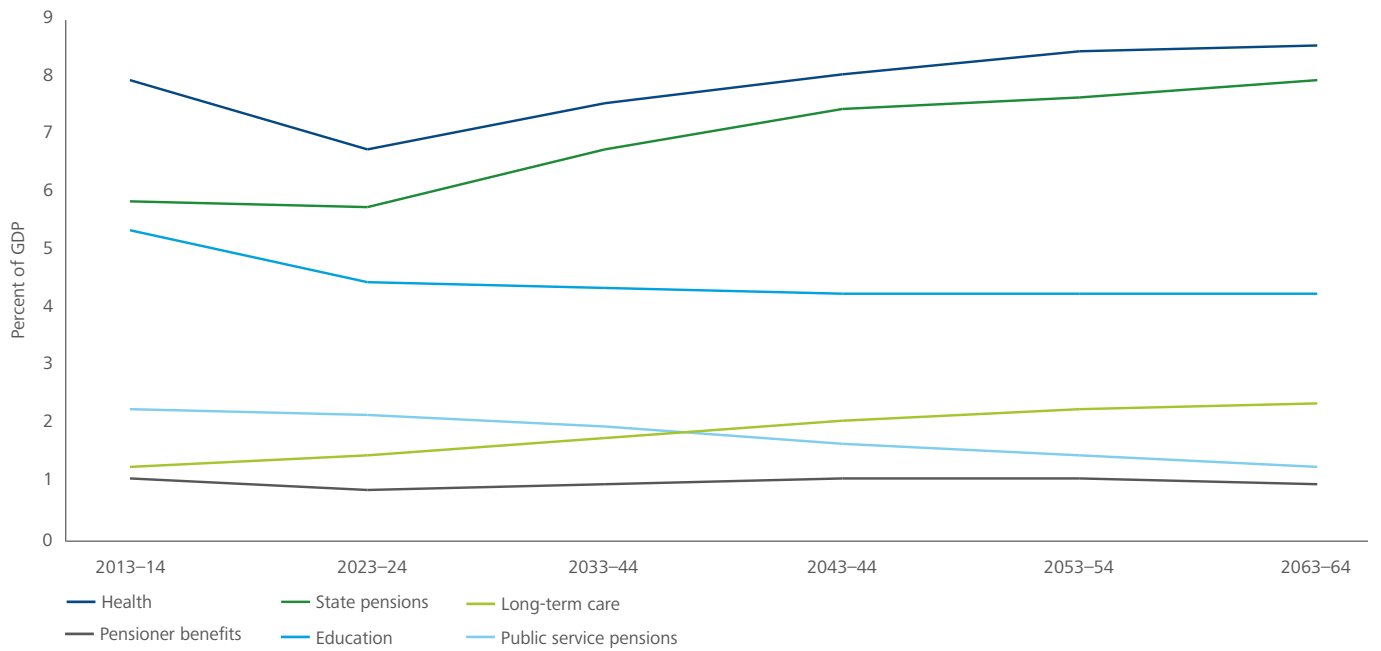
Figure 8 shows age-related spending projections for the next 50 years which illustrate how state approaches to pensions, healthcare and long-term care will need to change if they are to remain sustainable. The chart shows that policymakers will need to take action to address the significant increases in health, long-term care and state pensions over time.

**Figure 7. How government became unsustainable**  
Fifty years of public sector growth



Source: Public Finances databank, Office for Budget Responsibility

**Figure 8. Spending pressure from the ageing population**



Source: Fiscal Sustainability Report, Office Budget Responsibility

The state pension, as an example, was originally introduced for people over 70 years old at a time when the average life expectancy was 48 years.<sup>26</sup> That shift is due to our improved living standards and the success of the public sector. But the state pension cannot continue to provide a full income for increasing numbers of people without major reform or major increases in its funding.

### From deficit to debt

While the deficit has been coming down, the state's debts have inevitably been increasing. When a government runs a deficit, it needs to borrow to fund the shortfall in its spending and it does that by issuing gilts. The accepted debt measurement – Public Sector Net Debt – records financial liabilities issued by the public sector less its liquid assets, including bank deposits.

In the past decade, UK government debt has trebled to £1.4 trillion, as shown in figure 9. That equals £54,253 per UK household. As a percentage of the UK's GDP, our debt has risen from 33 per cent to 79 per cent.<sup>27</sup>

The current debt picture is even worse if measured using the European Union's Maastricht criteria that defines how effectively member states are converging towards economic and monetary union. By the Maastricht treaty calculations, UK general government gross debt now stands at 90.6 per cent of GDP, well beyond the treaty ratio of 60 per cent and the ninth highest in the EU.<sup>28</sup> In other words, the UK state's financial position would not meet the EU's original criteria to join the euro until its debt-to-GDP ratio begins to decline over successive years.<sup>29</sup>

Figure 10 shows how government debt has increased in five notable countries. It shows how the effect of the global financial crisis caused a severe upturn in state indebtedness in many advanced economies as governments needed to borrow to continue funding their spending.

Such excessive debt levels expose the UK to an unacceptable level of risk in the event of further financial crises and vulnerability to fragile external forces such as changes to interest rates.

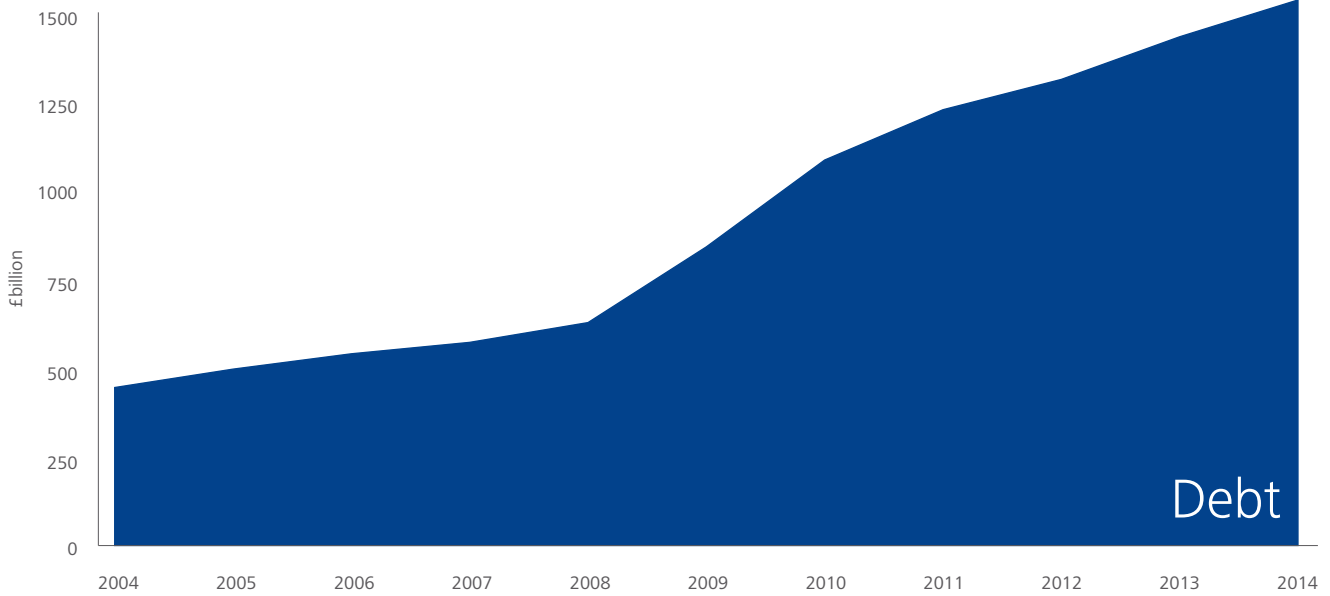
It also burdens the taxpayer. In this financial year, interest payments on central government debt reached £1 billion a week and are forecast to keep rising from £52.1 billion this year to £75.2 billion in 2018-19.<sup>30</sup> The UK Government now spends more on servicing debt than it spends on education, which equals three times as much as it saved last year in efficiencies or roughly the same amount it spends on public services in Northern Ireland and Wales combined.

As well as the fiscal mandate to reduce the deficit, the Coalition Government set a further, supplementary target in 2010: for public sector net debt as a percentage of GDP to be falling by 2015-16. Current forecasts suggest that it will miss that target by one year.

In the event that the deficit was not eliminated and debt continued to rise, by 2023 the Government would be spending three times as much on debt interest as it spends on defence. By 2044, it would be spending more on debt interest than on public services. Fortunately, forecasts suggest that debt levels will begin to decline during the next UK Parliament, and HM Treasury modelling suggests that running a one per cent surplus would return debt as a percentage of GDP to pre-crisis levels by 2030.<sup>31</sup>

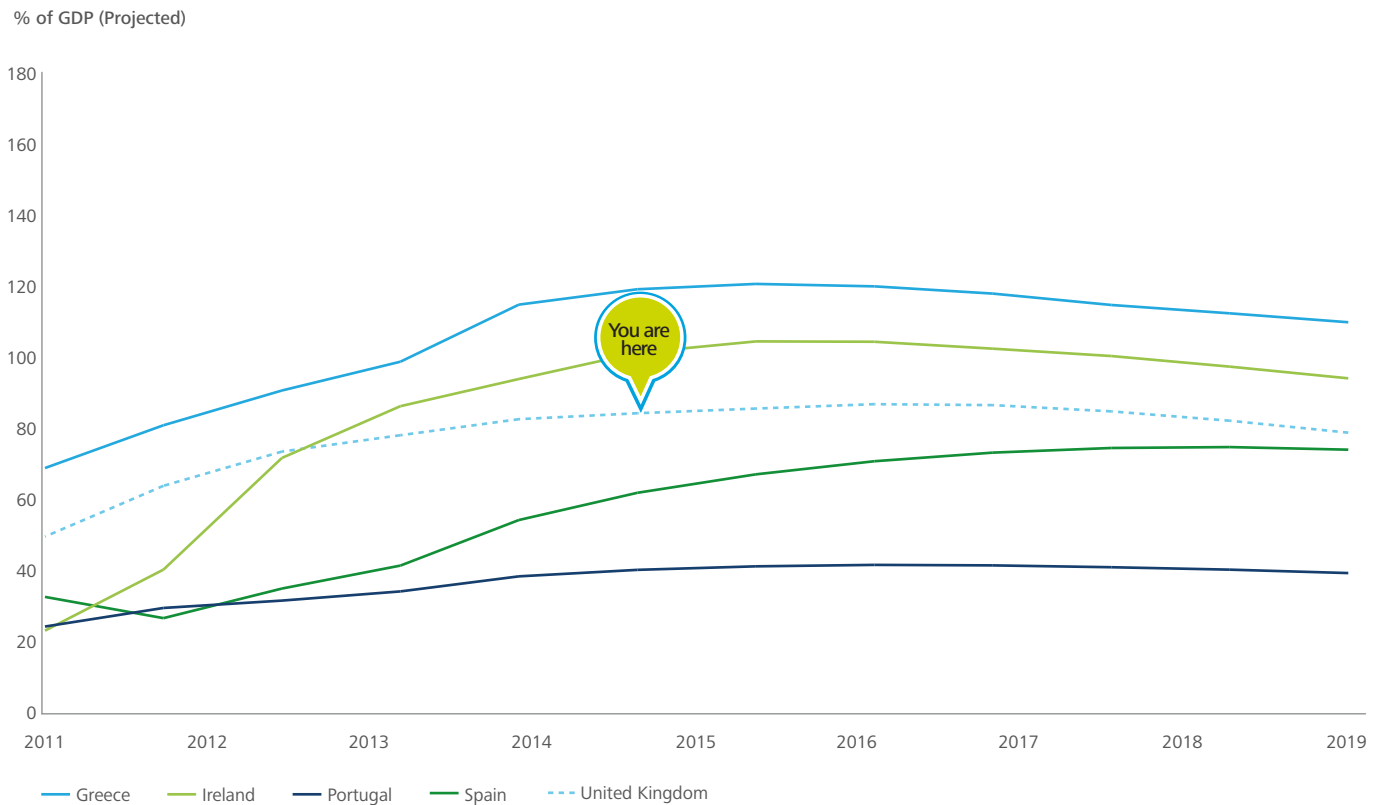


Figure 9. Public Sector net debt



Source: Economic and Fiscal Outlook, Office for Budget Responsibility

Figure 10. Government debt



Source: International Monetary Fund, World Economic Outlook 2014

### The state's balance sheet

HM Treasury has now produced four successive sets of annual, consolidated accounts for the UK public sector. Whole of Government Accounts (WGA) combines information from 3,800 UK public sector organisations including central and local government across all four of the UK's administrations. As the largest consolidated public sector accounts in the world their creation constitutes a significant achievement by HM Treasury. They provide a unique perspective on the underlying financial health of the state.

While each set of the annual accounts has been qualified by the Comptroller and Auditor General, primarily for technical accounting reasons, their usefulness will continue to grow as each successive year of WGA allows for longer trend analysis, and HM Treasury continues to make progress towards removing the qualifications. A short form of the latest accounts, for 2012-13, is shown in figure 11.

Reading the accounts raises two notable issues. First, they show how Government's liabilities keep rising. The state's liabilities rose by £276 billion to £2.9 trillion in 2012-13, which is the largest year-on-year increase since these accounts began. Liabilities that year include £1,172 billion for public service pensions, £996 billion of government debt and £131 billion of provisions for events that are likely to cost money in the future.

While the UK Coalition Government has put into motion a series of reforms that should reduce liabilities, such as an increase in the age at which most public sector workers can receive their pensions, the impact of those reforms will not be evident in WGA for some years. The accounts highlight that policy and decision-making has not historically been undertaken with due regard to their impact on liabilities.

Second, the accounts highlight some considerable risks concerning provisions for spending that the state may need to incur. Over the four annual sets of WGA, provisions for nuclear decommissioning have risen by 23 per cent to £70 billion and provisions for clinical negligence claims have risen by 53 per cent to £24 billion, reflecting an 11 per cent increase in negligence claims against the NHS in 2012-13. As Parliament's influential Public Accounts Committee suggested, HM Treasury should use WGA as a mechanism for identifying such significant risks to public money and making sure that programmes to manage down those risks are in place.<sup>32</sup>

### Debts owed to the government

At the end of March 2013, the Government was owed £22 billion in legally collectable, overdue debt. Some £15 billion was owed to Her Majesty's Revenue and Customs (HMRC), and almost all of the remaining £7 billion was owed to the Department for Work and Pensions (DWP) and Ministry of Justice (MOJ).<sup>33</sup>

That £22 billion equals four per cent of the Government's income in the preceding financial year and double the amount the UK spent on overseas aid. A House of Commons report found that weaknesses in how overdue debt figures are collected, confusing targets, inaction and the lack of a central strategy were all hampering effective government debt collection.<sup>34</sup> However, the Government is now making improvements. In the Autumn Statement 2013, the Chancellor announced that the increased use of debt collection agencies by HMRC will aim to collect an additional £500 million of overdue debt.

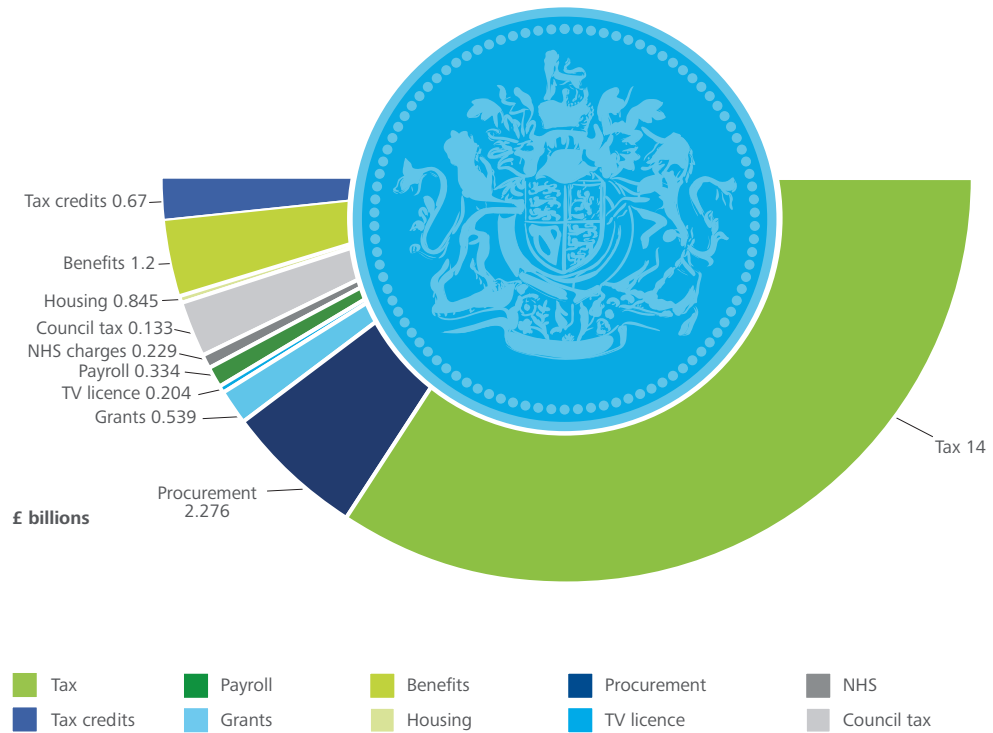
Significantly, the Cabinet Office is also establishing a cross-government debt collection service. The Debt Market Integrator (DMI), conceived as a joint venture with a private sector partner, will offer a single route to debt services that include collection, analytics and enforcement for all government departments. That reflects the US Department of the Treasury's Bureau of the Fiscal Service that works with federal government agencies as well as states on debt management and collection. Since 2009-10, its approach has increased the amount of debt collected from \$5.45 billion to \$7.02 billion. Comparable performance improvements in the UK could save the taxpayer an additional £12 billion per year.<sup>35,36</sup>

**Figure 11. The state's balance sheet**  
**Whole of Government Accounts 2012-13**

	2009-10 £billion	2010-11 £billion	2011-12 £billion	2012-13 £billion	Explanatory notes to the 2012-13 accounts
Assets	1,249.5	1,234.3	1,270.6	1,263.8	Assets – what the state owns – include £348 billion of land and property, £274 billion of infrastructure and £36 billion of military hardware.
Liabilities	2,477.4	2,420.0	2,617.5	2,893.4	Liabilities – what the state owes – include £1,172 of public service pension liability, £996 billion of government borrowing and £131 billion of provisions for events that are likely to cost money in the future.
Net liability	1,227.9	1,185.7	1,346.9	1,629.6	Net liability – the difference between assets and liabilities – rose by £283 billion in 2012-13, mainly due to an increase in borrowing through gilts to finance the deficit and the Funding for Lending scheme.
Revenue	(583.4)	(614.0)	(616.6)	(620.7)	The main source of revenue – what the state receives – is taxation. The state raised £524 billion in taxes in 2012-13. Most non-tax revenue is from the sale of goods and services including £22.5 billion charged by local authorities.
Direct expenditure	619.5	663.3	647.8	665.8	Government's direct expenditure covers all of its costs, including £215 billion of social security benefits, £148 billion in staff costs and £163 billion to purchase goods and services.
Other operating expenditure	47.7	(38.4)	67.3	51.5	Other operating expenditure includes £16 billion worth of impairment of assets and £35.2 billion of pension scheme costs and actuarial revaluations.
Net financing cost	78.6	83.2	88.1	79.4	Net financing cost includes interest on government borrowing as well as finance charges in respect of leases and PFI contracts. In 2012-13, £9.8 billion was for local government financing and £69.6 billion for central government.
Net expenditure for the year	162.7	94.4	185.3	178.7	Net expenditure describes the shortfall between the government's income and its expenditure in accounting terms.

Source: National Audit Office analysis of whole of Government Accounts. Years prior to 2012-13 are all restated for comparability

**Figure 12. Where the money is lost**  
 Fraud against the public sector



Source: Annual Fraud Indicator, National Fraud Authority

**Fraud against the government**

The public sector counter-fraud landscape has changed significantly in the past year, somewhat clouding the publicly-available statistics. The National Fraud Authority’s closure in March 2014 means that the most widely-recognised measure of fraud, the Annual Fraud Indicator, is only available up to 2012 when the state was defrauded of £20.6 billion. The most recent figures are illustrated in figure 12. The Cabinet Office has also begun work to improve grant programme efficiency and to reduce grant fraud. As figure 12 shows, that is a significant fraud area and some 41 per cent of government spending is through grants.<sup>37</sup>

HM Treasury has committed to including fraud, error and loss figures in future Whole of Government Accounts which will be a valuable and transparent way for the public to gauge government performance as the Cabinet Office Efficiency and Reform Group (ERG) works towards a target of £10 billion savings through such programmes.<sup>38</sup>

Considerable efforts are underway to reduce fraud rates but their success is yet to be clear. HM Treasury plans to produce guidance for government departments along with key performance indicators, and the Audit Commission’s National Fraud Initiative (NFI) is moving into the Cabinet Office. The NFI, which cross-references datasets from 1,377 organisations across the UK to detect fraud against the public sector, will be well-placed to continue supporting cross-government initiatives.

### Reducing the public sector workforce

Since fiscal consolidation began in 2010-11, the public sector's people have been more affected than any other dimension of government. Their numbers have gone down by 282,000 in the last year and by 898,000 since 2010 to reach 5.394 million people.

Of course, workforce reductions deliver considerable savings. In the Civil Service, headcount reduced by 76,000 people between June 2010 and December 2013, saving £2.4 billion in 2013-14. Savings through reform to public sector pensions equalled an additional £2.3 billion, so together those workforce reforms saved £4.7 billion last year. That was by far the largest single saving by the UK Government and almost twice the amount saved by cancelling, re-scoping or reducing costs on major projects.<sup>39</sup>

At the same time that the official public sector headcount is declining, some media analysis suggests that government departments have spent more than £300 million per year on temporary staff.<sup>40</sup> However, as the Chief Secretary to the Treasury told Parliament in 2014, off-payroll staff help government departments meet short-term needs for specialist advice and interim service for commercial reasons.<sup>41</sup>

The impact of workforce reductions on budgets has been particularly striking in the UK's local councils where the number of employees has gone down by 552,000 or 19 per cent since 2010.<sup>42</sup> The NHS, with a protected budget, has been less affected with an overall loss of 23,000 employees since 2010 bringing the total NHS headcount to 1.57 million people.

Public sector headcount has reduced inconsistently across the four UK administrations. In England, 760,000 left public sector employment between 2010 and 2014 compared to 36,000 in Wales, 83,000 in Scotland and 13,000 in Northern Ireland.<sup>43</sup>

### Managing public sector cost reduction

The fiscal consolidation programme can be viewed in two distinct halves, divided by the 2015 General Election. The spending cuts in each half will drive different cost reduction activities in the public sector. The first half has seen cuts to public services and administration that were typically managed through pay freezes, contract renegotiations, savings realised through shared service arrangements and workforce reductions. At least 95 per cent of English councils, for example, are now involved in some form of shared service arrangements.<sup>44</sup>

The second half of the programme will be substantially more challenging. As the cuts reduce budgets, public sector organisations will not be able to cope in the same ways. Those faced with particularly deep budget reductions will need to rethink how they operate, the services they provide and the outcomes they can deliver. In local government for example, councils are likely to focus on services targeted towards people in particular need and move away from the services they are not legally required to provide such as leisure facilities.

While the first half of the consolidation period has seen public sector organisations cut costs and deliver tactical improvements, the second half will see many redefine themselves and move to lower-cost models in order to cope with the next wave of budget reductions.

## Spending plans for 2015-16

Annual figures are total departmental expenditure limits.

	International Development	Energy and Climate Change	Environment, Food and Rural Affairs	Culture, Media and Sport
2015-16	£11.1 billion	£3.3 billion	£2 billion	£1.2 billion
2014-15	£10.3 billion	£3.3 billion	£2.2 billion	£1.4 billion
	While maintaining aid funding at 0.7 per cent of national income, DFID will make £115 million in departmental savings.	Includes £83 million of savings through shared services, renegotiating contracts and new IT systems.	Includes investment in flood protection and £54 million savings through better coordination of delivery agencies.	Includes a five per cent reduction to national museum funding along with a pilot of operational freedoms for the sector.
	Work and Pensions	Scotland	Wales	Northern Ireland
2015-16	£5.2 billion	£28.6 billion	£15.1 billion	£10.7 billion
2014-15	£5.7 billion	£28.4 billion	£15.1 billion	£10.6 billion
	Includes £420 million in efficiency savings and £530 million to implement major welfare reforms such as the single-tier state pension in 2016.	The Scottish Government will also receive £296 million of capital borrowing powers.	The UK and Welsh Governments are to explore continued fiscal devolution.	An additional £100 million will be available from 2014-16 to fund housing and education projects.
	HM Treasury	Cabinet Office	Education	Health
2015-16	£0.1 billion	£0.3 billion	£57.7 billion	£115.1 billion
2014-15	£0.1 billion	£0.4 billion	£57.3 billion	£113 billion
	Includes funding to continue the deficit reduction programme along with efficiency savings through workforce changes and IT contract renegotiations.	Includes £56 million to encourage the Big Society and £148 million to pay for the 2015 General Election.	Includes a real terms protection of the schools budget and pupil premium as well as a £33 million saving on departmental administration.	Includes real terms growth and funding to join up health and social care as well as a ten per cent cut to administration budgets.
	Transport	Communities and Local Government	Local Government	Business, Innovation and Skills
2015-16	£12.7 billion	£4.3 billion	£54.5 billion	£15.5 billion
2014-15	£12.3 billion	£6 billion	£54.8 billion	£15.7 billion
	Includes a 5.5 per cent real terms increase in capital provision for infrastructure but a 9.3 per cent reduction to be met through efficiencies.	Includes a 10 per cent reduction to the administration budget and a 7.5 per cent overall reduction to fire and rescue authority budgets.	Includes a £100 million collaboration and efficiency fund. Additional funding will be available for councils who freeze council tax.	Includes a £400 million reduction on higher and further education spending and a cut to the departmental administration budget of £50 million.
	Home Office	Justice	Defence	Foreign and Commonwealth Office
2015-16	£10.3 billion	£6.6 billion	£32.6 billion	£1.2 billion
2014-15	£10.8 billion	£7.1 billion	£32.7 billion	£1.3 billion
	Includes a £50 million innovation fund and a cut to administration budgets of 50 per cent compared to 2010-11.	Includes savings of £200 million on courts, £220 million on legal aid and £130 million on administration across the department and its arm's length bodies.	Includes one per cent real terms growth in the equipment budget but £1 billion savings that include reductions to the MOD civilian headcount.	Includes efficiency savings of £5 million through collaboration by departments based overseas and further savings through office relocation.

Source: Spending Round 2013, HM Treasury

# The public sector productivity challenge

Productivity in the UK is weak compared to most advanced economies. Improvements in private sector productivity are key to securing long-term economic growth while improvements in public sector productivity are key to maximising value for taxpayer money.

This chapter considers the potential for public sector productivity gains.

## Productivity matters

UK public sector productivity is widely believed to have remained flat from 1997 to 2010.<sup>45</sup> However, since many public bodies have maintained services while reducing headcount since 2010, productivity will invariably have risen in the past four years. As citizen expectations shift towards demanding greater transparency and greater value for taxpayer money, future government reform is increasingly likely to focus on productivity gains to support the public sector in delivering as much value as possible through cost-effective processes. In the US, enhancing government productivity is a central plank in the President's second term management agenda.<sup>46</sup>

Every one per cent of public sector staff time saved through a productivity measure is worth £1.64 billion a year to the public purse. Across the UK that equates to £1.3 billion in England, £64 million in Northern Ireland, £164 million in Scotland and £95 million in Wales.

In the private sector, continuous productivity improvements are the natural consequence of seeking profitability in a competitive environment. A supermarket, for example, will compete with others by keeping its running costs low so it can keep prices low for customers and deliver greater rewards to shareholders and staff. Those pressures drive improvements in productivity so that employee activities become increasingly effective in relation to their cost. In the public sector, similar competition, profitability and performance incentives are limited and other incentives are required. Ultimately of course, high-performing businesses are also prepared to recast their business models to keep pace with competitive, societal and technological developments.

The public sector is diverse in terms of its organisations and their functions. In addition, outsourced and commissioned arrangements mean that non-public sector organisations are increasingly delivering public services. Government productivity reforms would need to recognise these complexities, but could be structured around the four common themes of talent and ways of working, technology, policy delivery and process:

## Talent and ways of working

- **Talent management** – Exploring the full range of recruitment, reward and recognition activities that the public sector can undertake could help make it as attractive as possible to talented employees.
- **Accountability changes** – Devolving accountability so that employees are better able to make decisions, within agreed parameters, is a key element of leaner working that can help staff be more productive.
- **Remote and flexible working** – Our interviews with local public sector chief executives outlined in the next chapter suggest that many want to balance flexible working patterns for staff with the need to ensure employees work together as a team.
- **Workplace design** – Environments that can support productive working patterns at lower costs help employees improve their productivity and also have a role in making the workplace as productive as possible.
- **Alternative deployment** – Exploring alternative deployment models such as matrix working, in which individuals are given flexible, multiple roles that fit their capacity and capability could help make sure that people's talents are used to best effect.

## Policy delivery

- **Alternative delivery** – Form needs to follow function in delivery models to maximise productivity. Outsourced arrangements, mutuals, joint ventures and other models can all have a role to play in public service delivery. Their inputs and outcomes need to be recognised in measuring and managing public sector productivity.

- **Incentivisation** – In the absence of a competitive environment that drives productivity, government could create incentives so that productivity improvements within public bodies are recognised and celebrated. Competitive environments have of course emerged with the open public services agenda, where non-public sector providers are in competition.
- **Outcome-based commissioning** – Commissioning mechanisms that focus funding on outcomes have a key role to play in increasing productivity. They introduce incentives for providers to operate with high levels of productivity whilst maintaining agreed outcomes, and they stimulate innovation.
- **Policy alignment** – Basing policy on evidence and data can help government refine policies to make sure they are as targeted and cost-effective as possible. The Troubled Families programme, for example, has worked with more than 111,000 of the 117,000 families identified as in need of support since 2012. Councils can spend up to ten times as much on a troubled family as an average family.<sup>47</sup>

#### Technology

- **Mobile working** – Better exploitation of mobile technology allows field workers and caseworkers such as police or social workers to make best use of their time. A Deloitte study in the US found that better exploitation of mobile technology can result in a 45 per cent increase in caseworkers' – such as social workers – productive time.<sup>48</sup>
- **Exploiting IT** – Better IT, taken up and used effectively across an organisation, can deliver significant productivity gains that warrant initial investment.

- **Data analytics** – Government collects a wealth of data which can be exploited to drive decision-making, planning and resource allocation.
- **Digital by default** – Deloitte research suggests that 88 per cent of UK citizens are open to conducting more of their interaction with the state online and the Government Digital Service (GDS) continues to push the Digital by Default strategy forward.<sup>49</sup> Government has historically been built on analogue processes – like letters, forms and phonecalls – that digital can transform and has more to gain from embracing digital than any other sector.

#### Process

- **Measurement** – Measuring productivity in the public sector is inherently difficult as it generates goods and services that cannot easily be assigned a value. However, the Office for National Statistics operates a detailed methodology to provide a sector-wide measurement and principles could be established to allow for sector-wide or organisational level measurements to help manage and monitor improvement. An ideal measurement system would need to recognise that public services delivered by non-public providers have an impact on total public sector productivity.
- **Lean approaches** – Using lean techniques help organisations recognise the value they aim to create and structure themselves around that end result, eliminating inefficiency and waste as they do so to maximise productivity.
- **Citizen engagement** – Ensuring that citizens are engaged in the public services they receive, through feedback and even co-design, can help make sure they are responsive to customer needs.



- **Demand management** – A combination of budget reductions and demographic pressures has led many in the public sector to explore how demand can be reduced. Demand management approaches can include lowering citizen expectations or eligibility, channelling demand to other providers such as the third sector, or preventative, early intervention measures.
- **Performance management** – While no single performance management system would work across the entire public sector, principles and expectations could be established from the centre to help all public bodies manage and drive up performance.

### The public sector's people

Committed frontline staff are one of the public sector's hallmarks. Police and fire officers, NHS medical teams and teachers are rightly the heroes in many of our TV programmes. Other public sector employees – from newly-started administrators to seasoned permanent secretaries – may not receive such popular acclaim but should also be celebrated for the commitment they bring to public service.

Exclusive research shows that the public sector's popularity as a career destination for students has fallen in recent years. The percentage of UK business students describing government as one of their top five ideal employers fell from nine per cent in 2010 to six per cent in 2014, placing the UK 13th in a survey of 23 markets.<sup>50</sup>

Part of the longstanding public view of working for the government is that it offers job security as a trade-off for a lower salary. While public and private sector comparisons show a mixed picture, public sector salaries are typically lower in leadership positions. The chief executive of an engineering company employing 12,000 people might earn 60 per cent more than the chief executive of a large NHS Trust with a comparable number of employees.<sup>51</sup>

## High-performing organisations recognise that their success rests on their people's talent.

### Global ranking: is the public sector your ideal employer?

1	South Africa
2	Canada
3	Sweden
4	Indonesia
5	Denmark
6	United Arab Emirates
7	Singapore
8	Hong Kong
9	United States
10	Austria
11	Australia
12	Belgium
13	UK
14	Netherlands
15	Germany
16	Switzerland
17	Middle East
18	Italy
19	Ireland
20	India
21	Czech Republic
22	France
23	Japan

However, workforce reforms as a result of the fiscal consolidation have shown that job security can no longer be taken for granted in the public sector and has plummeted in the past decade. In 2011, just 47 per cent of public sector workers felt secure in their jobs compared to 65 per cent in 2004, as a result of the spectre of workforce reductions. For comparison, the figure for private sector workers has remained unchanged over that period at 66 per cent.<sup>52</sup> That illustrates how public sector employment has fundamentally changed in the past four years.

Many high-performing organisations recognise that their success rests on their people's talent, generally defined in this context by an individual's impact, potential or the operation-critical nature of their skills and experience.<sup>53</sup> As a result, they undertake systematic talent management activities to identify, recruit, engage, retain and deploy talented individuals.

This year, the Cabinet Office produced a Talent Action Plan that introduces measures to make sure that the best people advance in the civil service, regardless of gender, ethnicity, sexuality or disability.<sup>54</sup>

It represents a significant step towards a government talent management agenda. But the state can go further in future reform to make some of its most challenging and hard-to-fill roles more attractive to talented people.

Pay is of course one factor. Europe-wide Deloitte research this year suggested that public sector pay scales for central government finance roles may be limiting the pool of talent from which such professionals are drawn.<sup>55</sup> In addition, a report from the NAO this year recognised that salaries for the 4,000 procurement specialists in government that collectively administer £40 billion of contracts for goods and services are not attractive enough.<sup>56</sup>

Talent management approaches in the public sector need to differ significantly from the private sector. Distinctive public sector talent management strategies could exploit government's brand and its values to best advantage. They could explore existing flexibilities in pay and other rewards to make sure they are being used to best effect, or could allow for business cases where additional payments might be needed to secure specific individuals for specific programmes. Strategies could also explore more agile and flexible working environments that can help attract, recruit and retain talent.

# In the words of public sector executives

The UK's local public service executives – council and health chief executives, chief constables, chief fire officers, service directors and key civil servants – are uniquely placed to provide an accurate view of the state. Guided by political decision makers, their roles require a mix of strategic insight, organisational leadership and managerial capability. The success of their organisations often defines citizens' views of the state.

This chapter explores how the people who run our public services have coped with the funding reductions and reform agendas of the past five years as well as their outlook for the next five.

## In the words of public sector executives

For *The State of the State*, Deloitte commissioned Ipsos MORI to interview executives spanning the full range of public services across England, Northern Ireland, Scotland and Wales.<sup>57</sup> The research provides five overarching insights that describe the state of the local public services in 2014-15, brought to life by quotes from our interviews.

## Insight one: Pride and pragmatism

Faced with unprecedented budget reductions, public sector organisations have adapted significantly since 2010, with less impact to their services than some feared. Many of the executives we interviewed confirmed that they had been able to maintain standards in service delivery and, in some cases, make improvements as budgets were cut.

As a result, most interviewees described a real sense of pride in their organisations. Many also shared a pragmatic view that even though some changes were unwelcome, their organisations had improved as a result of austerity pressures.

Interviewees told us that some of the most common changes in recent years included merging directorates, cutting headcount numbers, streamlining or sharing back-office functions, reducing lower priority services and collaborating more effectively with other sectors.

A significant number spoke about pushing accountability down, which they felt improved efficiency but made frontline and middle management roles more challenging.



### Insight two: Risk, uncertainty and crises lie ahead

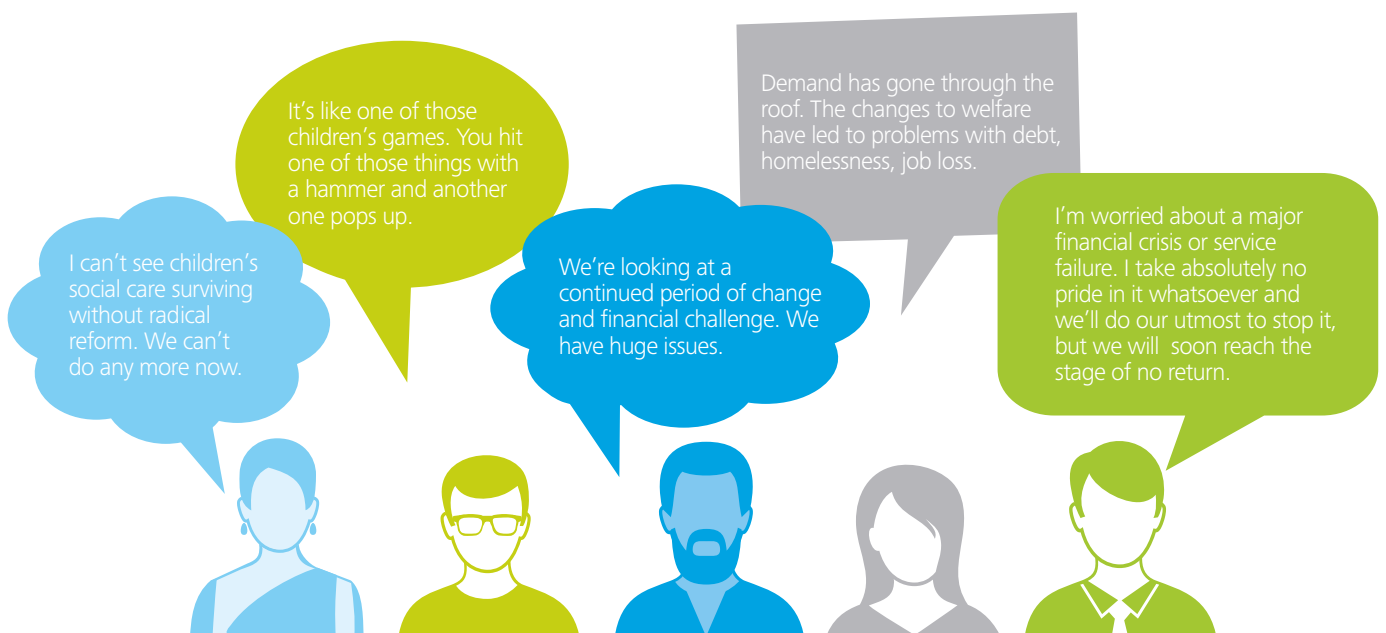
While the executives we interviewed were generally upbeat about their change management and resilience over the past five years, most were less optimistic about the next five. Some told us about a sense of fatigue and many expressed a real worry that their organisation or its wider sector would not be able to cope with continued austerity beyond the next UK General Election.

Most recognised that the cuts to come would be more challenging than those already achieved. They told us that the 'low hanging fruit' has been exhausted and that their approaches to cost reduction in the past five years will not be sufficient for the next five. The changes they expect to make to cope with further funding reductions will have increasingly profound implications for their organisations and the services they deliver.

In addition to budget cuts, many interviewees spoke about increased demand for their services created by cuts in other areas of the public sector including welfare reform.

Some interviewees described their tactics going forward, which typically included changing delivery models, ceasing some non-statutory services and rethinking how funds could be pooled and spent in area-based initiatives.

While almost all of our interviewees shared a concerned outlook for the future, some felt that the level of challenge facing their organisation made a crisis inevitable in the next few years – and that was particularly the case for local government in the UK's less affluent areas where the challenge is made greater by social and economic circumstances. Many commented that local politics or local economics presented significant barriers to some of the more ambitious initiatives for dealing with budget cuts.



**Insight three: The public sector craves a more constructive political narrative**

Politics is omnipresent in the public sector. Ministers regularly introduce legislation that reforms and reorganises the state and local politicians understandably stand up for their constituents’ interests in how public services are delivered on the ground.

Our research suggests that those running our public services are craving a more constructive and collegiate political narrative, both nationally and locally. Public sector chief executives believe that national politicians could do more to lead a national debate in what citizens should expect from the public services and local politicians could do more to engage citizens in what they should expect locally. At present, there is a perception that both national and local politicians often criticise public services but rarely help citizens appreciate that spending reductions may lead to reduced levels of service.

The result is that citizens may have unrealistic expectations about state provision at a time when citizens are expected to take more responsibility for themselves. A further consequence is that public sector employees feel exposed and unsupported by their political leadership – which our interviews suggest is exacerbating the sector’s recruitment and retention challenges.



**Insight four: Talent management is a new public sector priority**

People are an organisation's most important asset – whatever the sector. But in local public services, the commitment of its people is vital given the critical importance of many of their roles.

Our interviews found that people issues have begun to preoccupy many public sector chief executives. They told us about difficulties in attracting, recruiting and retaining people for a range of key jobs.

Some interviewees described specific recruitment difficulties for nurses, teachers, social workers and public health analysts. The most-often cited causes were that the area struggles to attract people, that some professions are in limited supply and that the public sector cannot compete with the private sector on pay and conditions.

Many chief executives told us that workforce reductions had lowered staff churn and they were beginning to feel the effects of not having new staff to bring new perspectives and ideas. Others commented that morale had been affected by cuts and continued criticism of the public sector. A further specific issue raised by many interviewees was the need for more training in change-management for middle managers.

The three most commonly-cited factors influencing retention were stress, weak career progression opportunities, and pay and conditions.

Our interviews suggest that recruitment for senior leadership roles is particularly challenging. Many people felt that internal pressures and external criticism made senior public sector roles unattractive – a difficult issue given that effective leadership in the public services will be more vital than ever in the years ahead.



**Insight five: Executives have varied outlooks on technology, estates and ways of working**

Our interviews suggest that attitudes to technology, ways of working and estate management differ across the local public services.

Many interviewees discussed how working practices in their organisations affect employees. Some said that they were reticent to introduce flexible working patterns, while others recognised they could have a role to play in attracting and retaining talented staff.

Similarly, some chief executives felt they had reduced their organisation’s estate as far as they could, but others felt there was more they could do. Typical activities undertaken in recent years include the closure of unviable schools, consolidation of office space and the sale of unused buildings. Some of those interviewed told us that the potential for cost reductions were more limited in their area, where land and property is less expensive. Many cited public and political issues as barriers to change, noting that closing police stations and hospitals is invariably unpopular.

One interviewee noted that moving administrative staff to new offices can be unpopular too if portrayed as indulgent – even where it is actually part of a downsizing exercise that will save money.

Most executives felt that their organisations were making progress on technology but had some way to go before it was exploited to its potential. The interviews suggest that they tended to prioritise technology where it can enable front line delivery, such as mobile working for social workers. Many cite the barriers to the effective use of technology as budget, reticence among staff, inflexible IT contracts, concerns over data security and weak local connectivity that makes mobile and remote working unfeasible.

Overall, the interviews suggest that the most ambitious local public sector executives are working to make better use of technology, recasting their estates to maximise the potential of fewer physical locations and thinking through how best to empower their staff with remote and mobile working options.



# The new United Kingdom

The UK state and its public services have never been homogenous. But since devolution in the late 1990s, policies and public spending patterns have diverged across the UK. Those divergences are set to grow wider in the years ahead as new devolution settlements are forged in the wake of the Scottish Referendum.

This chapter explores how public spending differs across the UK and issues surrounding further devolution.

## Our diverging state

The story of devolution in the UK is as long as UK history, but the current devolved arrangements began in the late 1990s with the Good Friday Agreement of 1998, Scotland Act of 1998 and Wales Act of 1998. The next stage in the history of devolution is currently in flux and under considerable scrutiny since the Scottish Referendum in September 2014.

Devolution of further powers to Scotland alone would require considerable legislative, operational and constitutional change. But the referendum triggered wider debates on the governance of the UK. Devolution to Wales and to Northern Ireland will clearly need to be rethought in the interests of equity across the UK, and issues regarding devolution to England are now live.

The timetable agreed by leaders of the Conservative, Labour and Liberal Democrats just prior to the Scottish Referendum vote promised a draft 'Scotland bill' by January 2015 – not a complete draft 'UK devolution' bill. Perhaps that reflects the priority of a settlement for Scotland in the wake of the referendum result, but the need for a wider settlement that includes England, Northern Ireland and Wales is also vital.

The Scottish Referendum has effectively triggered a project to reconstitute state responsibilities across the UK which has grown in scope and complexity since the poll. Sir William McKay, whose 2013 commission considered the legislative impact of devolution, suggested that parliamentary reform and devolution of powers are too significant to be undertaken at the same time. Fiscal devolution to cities or councils within England, also mooted after the referendum vote, would bring additional strain to the system even though there are compelling arguments for greater localism.

Current devolved responsibilities are illustrated in figure 16.

The current devolution debates come at a time when powers are already shifting to devolved administrations and country-specific reforms have been growing in significance. They include the creation of a single police force in Scotland, the reduction of Northern Ireland's councils from 26 to 11 and plans for voluntary local authority mergers in Wales. Even before the referendum, plans were in place for the Scottish Parliament to be able to set a Scottish income tax rate from 2016-17. Fiscal devolution is also progressing for Wales in light of the Silk Commission, and in Northern Ireland, the Executive is pressing for the power to set corporation tax in order to align it with the Republic of Ireland's lower rate and help make the country's tax regime more attractive for international businesses.

The UK Spending Review 2013 confirmed that the resource budgets for all three devolved administrations will be reduced by ten per cent in real terms in 2015-16, though more funding will be available for capital spending.

In Northern Ireland, the October Monitoring Round revealed that the Executive was over-committed by £215m, some £125m of which was related to inescapable departmental pressures and £87m was a penalty imposed by the Treasury for the Executive's failure to agree to implement the UK Government's welfare reforms. A short term, interest free loan of £100m has been made available from National Reserves, which is repayable in 2015-16. There are conditions associated with provision of this loan, including the requirement for the Executive to fully implement the 4.4 per cent baseline reductions indicated in the June Monitoring Round and the need to agree a credible budget for 2015-16 by the end of October 2014.

## Spending per head across the UK

Analysis of public spending, along with an assessment of plans in the devolved administrations, reveals the current divergences across the UK.

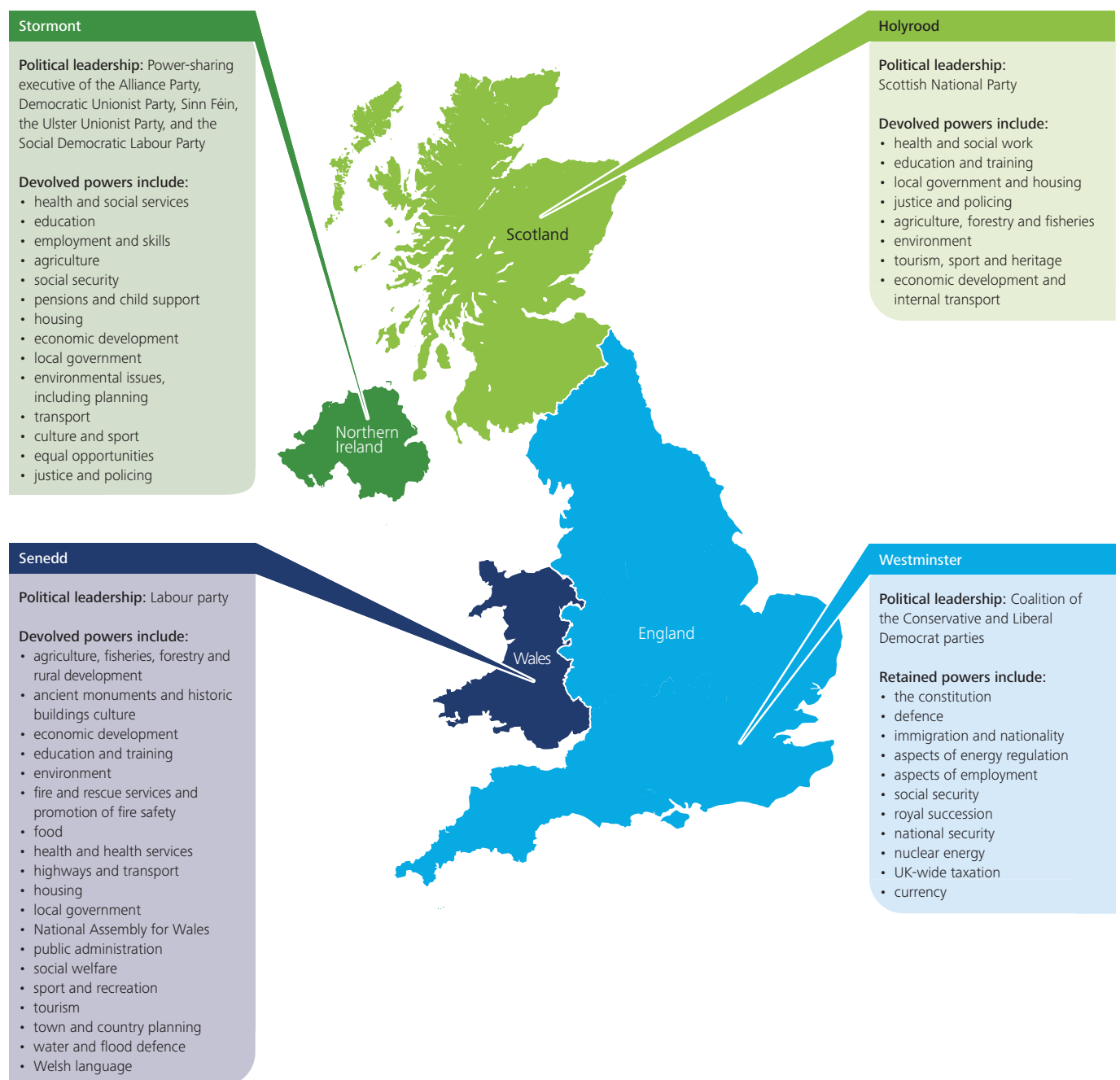
Overall public spending per head (2012-13) <sup>58</sup>	
England	£8,529
Northern Ireland	£10,876
Scotland	£10,152
Wales	£9,709



It is important to note that the different levels in public spending around the UK illustrate different priorities, different approaches, different population concentrations and different levels of demand for services. They are not indicative of different levels of public sector efficiency.

Our analysis points to six major spending divergences across the UK, illustrated overleaf in figure 17.

Figure 16. Devolved powers



Source: www.gov.uk

### 1. Public order

Public order costs – policing, prisons and courts – are significantly higher per head in Northern Ireland due to its security needs, with spending levels broadly the same in England and Wales but slightly lower in Scotland.

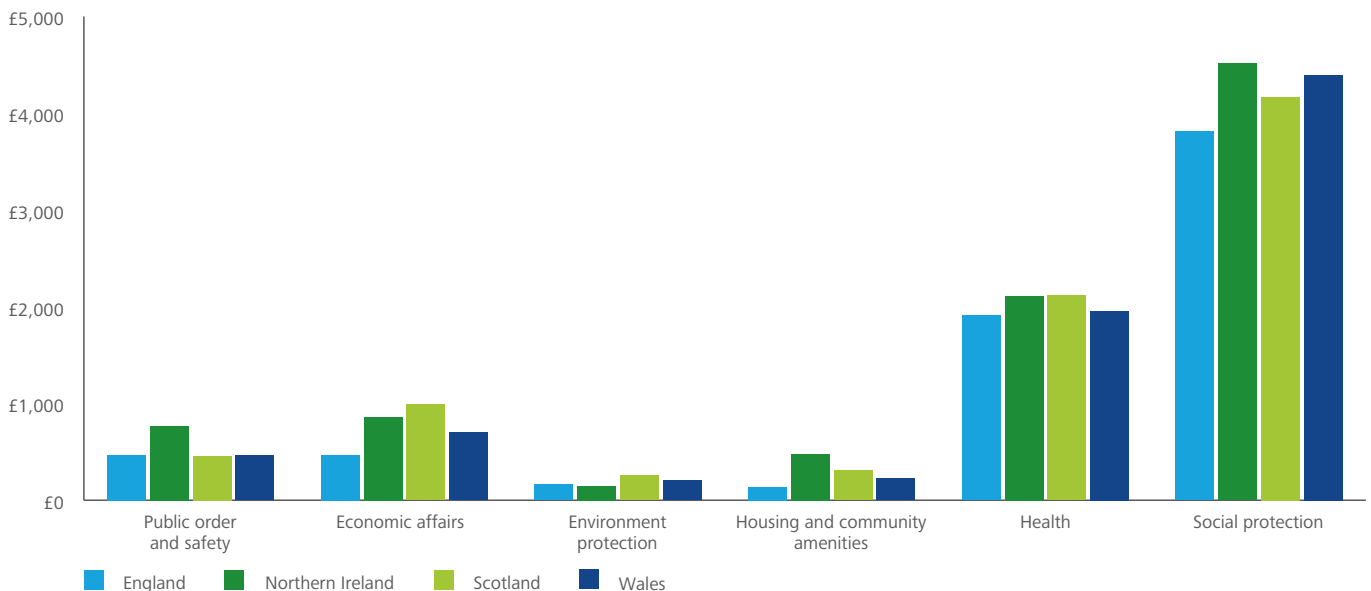
### 2. Economic affairs

Spending on economic development issues is significantly lower in England than in the rest of the UK. Scotland spends more than twice as much on these areas as England, with Northern Ireland spending the second most. This shows how devolution has brought a practical benefit to Northern Ireland, Scotland and Wales by supporting a strong focus on regional economic development. The programmes for government in each of the devolved administrations are characterised by their extensive plans for capital spending, support for businesses and measures to attract inward investment.

Scotland's Government has for some time argued for increased capital spending, shaping its spending plans accordingly within its settlement from Westminster. UK-wide plans set out in the 2013 Spending Review confirm more significant investment in infrastructure across the UK from 2015-16 and this divergence is likely to continue along the same trend under further devolution.

In the shorter term, the Scottish Government has an additional £296 million of capital borrowing powers for 2015-16 as part of the Scotland Act 2012. An additional £100 million of capital borrowing is available for 2014-16 for the Northern Ireland Executive to fund housing and education projects.

Figure 17. UK spending per head  
Country comparisons



Source: Public Expenditure Statistical Analysis 2014, HM Treasury

### 3. Environment protection

Spending on environmental issues is highest in Scotland at £254 per head, second highest in Wales at £206 per head and lowest in Northern Ireland at £148 per head. The figure for England is £162 per head. Scotland has a particularly high level of spending on biodiversity and landscape protection.

While the Scottish Government places significant emphasis on green issues in its programme for government, geographical differences play a role in levels of environmental spending. Scotland's population is relatively sparse at 67 people per square kilometre compared to 133 people per square kilometre in Northern Ireland.<sup>59</sup>

### 4. Housing and community services

Northern Ireland's local authorities spend £477 per person on housing and community services compared to £138 in England. This trend is likely to continue to 2015 to fund an extensive programme of building 8,000 affordable homes, improving the thermal efficiency of existing housing stock and a £40 million regeneration programme.

### 5. Health

Health spending is highest in Scotland at £2,115 per head, with Northern Ireland second at £2,109 per head, Wales third at £1,954 and England lowest at £1,912.

Those differences have not arisen from policy divergences between the four UK countries, but reflect the varying health needs of the populations, according to an NAO study.<sup>60</sup> Additional spending is also required to deliver health services in more remote and rural settings.

### 6. Social protection

Social protection spending comprises funding for social services, state pensions, welfare benefits and other forms of social support. It represents a major divergence between the four countries of the UK, driven by devolved policies and local economic conditions. Welfare spending is also a key part of debates over further devolution. Universal Credit is to be introduced in Scotland in the face of Scottish Government concerns that it should be delayed until new powers are agreed for Holyrood. In Northern Ireland, the Executive is accruing fines as a consequence of failing to implement Westminster's welfare reforms due to political disagreement.

In England, spending per head on social protection is the lowest in the UK at £3,813. The highest spending is in Northern Ireland at £4,515 per head – a difference of £702 per person. That gap has widened by £49 since the previous year.

#### Public sector employment across the UK

Levels of public sector employment – and the scale of workforce reductions – also differ considerably across the UK. The table below sets out public sector headcount in the four UK countries, the percentage of the total workforce they constitute and change over the previous year. Northern Ireland remains the largest public sector employer as a proportion of total employment and its reductions remain considerably lower than the rest of the UK's countries.

A mixed picture of public spending and public sector employment is also evident across the English regions. Figure 18 shows levels of public sector employment reductions and spending differences per head across the UK.

	England	Wales	Scotland	Northern Ireland <sup>61</sup>
Total public sector headcount (thousands)	4,292	315	544	214
Proportion of total workforce (per cent)	18.2	25.4	23.0	27.6
Change over the previous year (per cent)	-4.9	-5.7	-6.2	-1.9

**Figure 18. Unequal regions**  
Public spending per head and public sector employment

Scotland	2012-13
Public order	£455
Health	£2,115
Education	£1,441
Social protection	£4,169
<b>Total</b>	<b>£10,152</b>

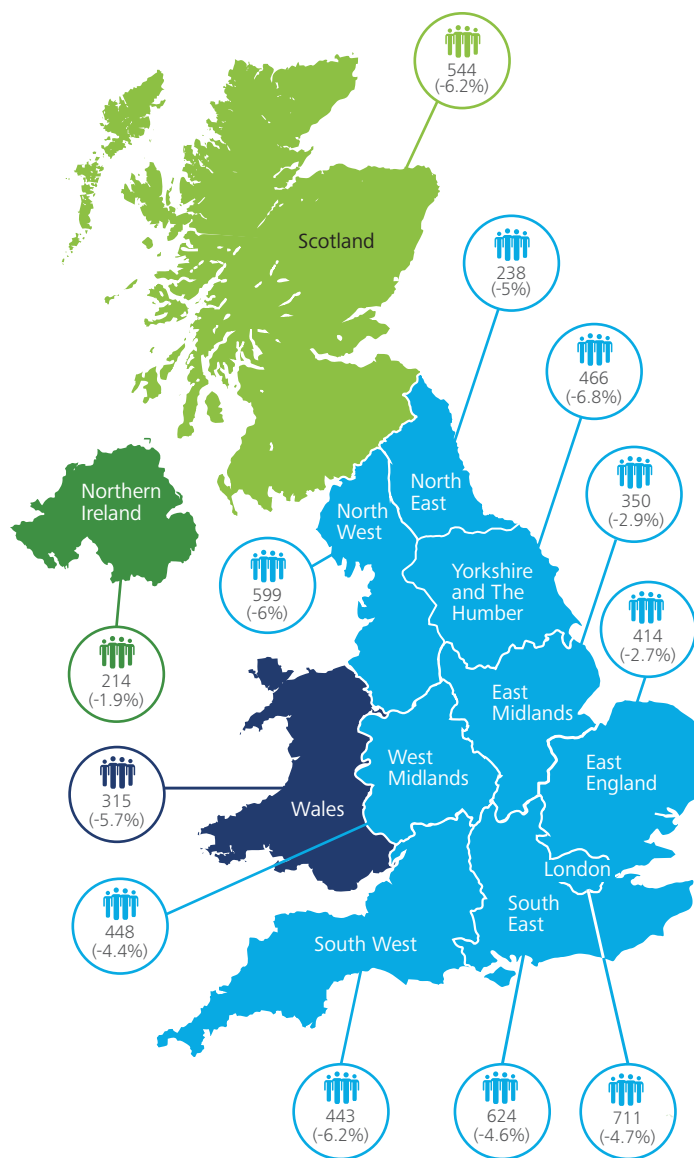
Northern Ireland	2012-13
Public order	£765
Health	£2,109
Education	£1,558
Social protection	£4,515
<b>Total</b>	<b>£10,876</b>

North West	2012-13
Public order	£499
Health	£2,127
Education	£1,355
Social protection	£4,165
<b>Total</b>	<b>£9,252</b>

West Midlands	2012-13
Public order	£434
Health	£1,937
Education	£1,380
Social protection	£3,920
<b>Total</b>	<b>£8,498</b>

Wales	2012-13
Public order	£465
Health	£1,954
Education	£1,365
Social protection	£4,396
<b>Total</b>	<b>£9,709</b>

South West	2012-13
Public order	£373
Health	£1,803
Education	£1,236
Social protection	£3,896
<b>Total</b>	<b>£8,219</b>



North East	2012-13
Public order	£492
Health	£2,150
Education	£1,382
Social protection	£4,362
<b>Total</b>	<b>£9,419</b>

Yorkshire/Humber	2012-13
Public order	£460
Health	£1,972
Education	£1,397
Social protection	£3,873
<b>Total</b>	<b>£8,610</b>

East Midlands	2012-13
Public order	£374
Health	£1,850
Education	£1,322
Social protection	£3,725
<b>Total</b>	<b>£8,118</b>

East England	2012-13
Public order	£345
Health	£1,737
Education	£1,307
Social protection	£3,611
<b>Total</b>	<b>£7,865</b>

London	2012-13
Public order	£738
Health	£2,019
Education	£1,594
Social protection	£3,708
<b>Total</b>	<b>£9,435</b>

South East	2012-13
Public order	£364
Health	£1,731
Education	£1,231
Social protection	£3,491
<b>Total</b>	<b>£7,638</b>

Public sector employees in 2014 (thousands) with percentage reduction since previous year.

Spending figures are from 2012-13.  
Totals include spending in other areas than the ones shown.

Source: Public Expenditure Statistical Analyses 2014, HM Treasury; Public Sector Employment Statistics, Office for National Statistics

# Government's toughest challenges to 2020

The final months of the current UK Government and the years to come for its successor will be marked by four major challenges for the UK state.

## 1. Recasting the UK's governance

The Scottish Referendum has sparked a multi-faceted debate on the future of the UK. While the vote may have been intended to resolve the issue of Scotland's independence, it has exposed constitutional dilemmas, implementation complexities and ramifications for all countries of the UK not least in relation to the Barnett formula of allocating public spending. Given the complicated politics and legislative difficulties, it appears unlikely that the UK's governance will be fully resolved before the 2015 General Election and the next UK Government may inherit a devolution programme.

Scotland's Parliament and citizens will expect new powers to be delivered according to the timetable set out in advance of the referendum, with new powers over tax and welfare to be delivered within six months. Wales' First Minister Carwyn Jones has made clear that Wales' interests need to be reflected in the devolution debates. In Northern Ireland, the political spectrum of the Executive's five-party coalition makes devolution a fundamentally different issue. More salient is the need to resolve the political disputes that stymie operational challenges. First Minister Peter Robinson's view that arrangements for devolved government at Stormont are "no longer fit for purpose" has piqued debates on leadership in critical issues such as welfare reform.<sup>62</sup>

Further governance debates might arise beyond the 2015 General Election over the UK's relationship with the EU, particularly if it is contested in a referendum.

## 2. Finishing the fiscal consolidation

The 2015 General Election comes mid-way through the nine-year fiscal consolidation programme and the Government elected in May 2015 will face an immediate choice to continue the programme or offer an alternative, credible routemap to improve the public finances.

The UK's international credibility – which has been boosted by the Government's focused approach to consolidation – could suffer from a significant change of course that shifted the source of deficit reduction away from spending cuts, or prolonged the consolidation timetable. But as the Budget 2014 document notes, "it would, of course, be possible to do more of this further consolidation through tax instead".<sup>63</sup>

Meeting the fiscal consolidation target will require spending cuts that, as shown earlier, will require many public sector organisations to rethink their operations and the services they deliver.

Public spending allocations for 2015-16 were made in the 2013 Spending Round. But allocations beyond that date – the final three years of the fiscal consolidation – have yet to be made. The next Government will need to set out its spending plans, realistically, by the autumn/winter of 2015, which is within six months of coming into office. The cuts that Spending Round 2015 sets out could lead to a reshaping of substantial elements of the UK public sector. While complex enough for organisational leaders, two factors will add a further layer of strategic complexity.

The first factor is political. Where the early waves of spending cuts took place in a recession, the coming waves will take place in a period of economic growth. That will make the need for cuts counter-intuitive to many citizens, and they are likely to be more difficult to explain locally as a result. Cuts to local government, the most pervasive of all parts of the public sector on day-to-day life, are likely to be felt most keenly. Where local authorities are not able to find operational solutions to reduced budgets, citizens are likely to experience roads that fall into disrepair, dirtier streets, unkempt parks, and fewer civic amenities such as pools, leisure centres and libraries. Some citizens that rely on more personal council services such as social care may find that they lose eligibility or face charges to maintain the same level of support.<sup>64</sup> Operational solutions should include much greater joint working between local authorities and other public services, especially the NHS.

The second factor is sustainability. Central government appears to view public spending reductions as a permanent resizing of the state and will need to support local public bodies to drive permanent organisational change. Otherwise, some public bodies could view cuts as a temporary crisis and reduce budgets accordingly, rather than change. The use of reserves, for example, could alleviate the impact of spending cuts in the short term but is not sustainable. Demographic trends also point to the need for change that can flex to increased demand.

### 3. Driving continued economic growth

The UK economy has bounced back to its pre-crisis level after six years in recession. But recovery can be fragile and more balanced growth requires a significant rise in corporate investment rather than reliance on consumer spending. Our recent *UK Futures* survey found that the UK's big businesses plan to invest almost £200 billion over 2014 and 2015. Half of those firms appear to be expanding their horizons to overseas markets in ways that could generate £486 billion of new revenue.<sup>65</sup> That is an encouraging picture for UK economic growth.

However, continuing this positive trajectory will require action from government across a range of policy areas. At a macro level, maintaining consistent economic policy through and beyond the UK General Election would provide stability for business and encourage continued investment decisions. At sector level, support through the Department for Business, Innovation and Skills (BIS) and UK Trade and Investment (UKTI) could also help businesses realise their international aspirations, if focused.

Government also has a role to play in improving productivity, which remains a persistent weakness in the UK's private and public sectors. While there is no widely-accepted explanation for our 'productivity puzzle', the Bank of England puts forward two hypotheses. The first is that productivity is dampened when organisations hold on to more capital or staff than they need, often because they suspect that reduced demand levels are temporary. The second is that underinvestment or inefficient deployment of resources can slow productivity growth.<sup>66</sup> Both of these hypotheses could form constructive starting points for a plan to support UK-wide productivity.

### 4. Bolstering national security and community cohesion

The UK's national and domestic security needs are changing as rapidly as social, global and technological developments.

Widespread and pervasive use of the internet by individuals, financial institutions, businesses and governments makes cybersecurity a major modern concern that is now recognised as a military issue by many states.<sup>67</sup>

At the same time, immigration is a contentious but vital issue for many governments, including the UK. Policy needs to balance effective border control while remaining attractive to inward investors, entrepreneurs and innovators as well as overseas students and genuine refugees. Border control could continue to be developed but a more coherent and rounded political view on migration would go some way to alleviate citizen concerns.

Tragic events in recent years also evidence the internal extremist threat to the UK. Reports claim that as many as 300 radicalised Britons who have fought in Iraq and Syria may have returned to the UK, representing a major domestic security risk.<sup>68</sup>

Community cohesion also remains a challenge in some areas of the UK, and recent controversy surrounding schools in Birmingham highlights some of the difficulties in maintaining thriving and diverse communities. Local and national political leadership can go a long way to support genuine and sustained cohesion.

These varied but critical issues suggest that bolstering national security and supporting community cohesion should be a priority for the Government in the years ahead.

# Conclusion and recommendations

*The State of the State 2014-15* finds UK Government heading towards an inflection point.

Since 2010, the state has been working through a plan to eliminate its budget deficit by 2018-19, largely through cuts to public spending. The Government is now half way through that plan. The second half, to take place after the 2015 General Election, will require the deepest cuts yet to public spending to be announced in the next Spending Round. As a result, the UK public sector is likely to change significantly. At the same time, new devolution settlements will recast power across the UK. The next five years will be historic for the UK, its governments and the wider public sector.

Fortunately, the UK public sector is at the global cutting edge of reform in many ways and has become accustomed to change. The Government's work on digital, HM Treasury's financial management review and social innovation driven through new forms of commissioning are just three examples of UK reform that public sectors around the world are watching.

Deloitte and Reform's analysis suggests that the next UK Government should view its programme through three strategic lenses. They are:

## **The debt reduction lens**

As *The State of the State* sets out, public sector debt has reached £1.4 trillion which exposes the UK to unacceptable financial risk and burdensome interest levels. The UK Coalition Government recognised the importance of reducing debt when it set a secondary target to its original fiscal mandate: for public sector net debt to start falling as a percentage of GDP.

Beyond the deficit, a programme to reduce government debt would restrain public sector growth and viewing policy decisions through a debt reduction lens would make sure that decisions are made with regard to their impact on the state's long term liabilities. That would ensure that our current, difficult era of austerity is followed by a more stable era of public spending prudence from 2020.

## **The productivity lens**

UK productivity is weak in comparison to other G7 countries and is lower than before the global financial crisis. *The State of the State* recommends that Government provides leadership and focused support for the business community at sectoral level to help companies assess and improve their productivity levels. At a more macro level, the Government could incentivise investment in business areas such as technology to encourage productivity gains.

While public sector productivity is also widely believed to be low in the UK, it is likely to have increased since 2010 as a result of austerity pressures. The next stage of public sector reform could rest on productivity gains that continue to help forge a more sustainable and cost-efficient sector overall.

*The State of the State* suggests that four areas of public sector productivity can be explored: talent and ways of working, technology, policy delivery and process. Much can be done to make productivity gains by making sure that public bodies have the right people with the right skills in the right jobs; that technology is used to good effect; that policies provide the right incentives for change; and that processes are focused on delivery.

Alternative delivery models and public sector delivery by non-public sector players should also continue to be explored where they can improve taxpayer value-for-money as well as generate other economic and social benefits.

### **The talent lens**

*The State of the State* recommends that the Government supports distinctive talent management approaches to ensure that the public sector makes the most of its people. At a time when headcount is being reduced, having the right people with the right skills in the right jobs is even more vital.

Public sector talent management should exploit the sector's unique qualities. Many roles make a profound difference to the lives of UK citizens and deliver projects on a scale that is not possible in the private sector, making them attractive and exciting propositions for many.

Government could explore using new or existing employment rules to tweak pay where it needs to attract high-cost skills and could consider agile or flexible working patterns where appropriate to help attract and retain the right people.

Public bodies might also consider changing their deployment models to cope with headcount reductions and seek out productivity gains. For example, moving away from hierarchical reporting lines and into matrix patterns of working – where individuals perform multiple roles that fit their skills as well as their organisations' needs – could boost retention and productivity.

Viewing the state through these three lenses – the debt lens, the productivity lens and the talent lens – would allow the next government to focus on essential criteria for successful reform and stable public finances.



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Designed and produced by The Creative Studio at Deloitte, London. 38539A