The State of the State 2013
In search of affordable government

UK Public Sector

Thinking people.

Contents

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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 2013*. Now in its second year, this annual report aims to provide independent and accessible analysis of the UK public sector.

The State of the State is the UK's only publication that brings together material from a myriad of public sources – such as Whole of Government Accounts, the Budget, and the Treasury's Public Expenditure Statistical Analyses – into a single snapshot.

Deloitte LLP and Reform have once again collaborated to produce this report based on research that included one-to-one meetings, roundtable discussions, and interviews with top public service executives, politicians, policy thinkers, professionals, civil servants and public policy journalists. We have also studied hundreds of datasets and the Government's accounts.

We hope that the result is again an original, thought-provoking and constructive report that can be used as the basis for objective debate on the nature and performance of the modern UK state.

Our analysis suggests that the time is right for a national discussion on where the state begins and ends. Government in the UK has grown significantly over the past 50 years, and demand for public services is set to continue growing in the 50 years to come. With pressure from the global financial crisis, the UK state as we knew it became unaffordable and is now reshaping its limits; the Government – of whatever political mix – cannot simply 'keep calm and carry on'.

That means our politicians – in Cardiff, Holyrood, Stormont and Westminster, as well as in council chambers and police commissioners' offices – need to continue making tough choices about what the state should provide and how it should fund its activities.

Our 2013 report explores the state of local public services through exclusive interviews with chief executives and other executive leaders from local government, the police, education and health. Conducted by Ipsos MORI, and commissioned for *The State of the State*, the interviews are a testament to the professionalism, determination and values of the people in the UK public services.

While recognising the serious challenges that come from funding cuts, the executives that were interviewed were equally focused on the opportunities that come from new ways of working. Amid the difficulties for the Government and challenges for the public sector, there is cause for optimism in the future.

We hope that *The State of the State* stimulates your thinking on government now, and in the future. Please do get in touch and tell us what you think.

Mike Turley
Public Sector Leader,
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Andrew Haldenby
Director, Reform

The Government – of whatever political mix – cannot simply 'keep calm and carry on'.

Executive summary

The State of the State analyses public data, government figures and key reports to present a snapshot of the UK government and public sector.

The report also introduces new research, conducted by Ipsos MORI, which explores attitudes among leaders of the local public services.

The UK state is shrinking

In 2008, the global financial crisis hit the UK economy and public finances hard. Our deficit – the annual difference between government spending and government receipts – reached a post war high of £159 billion just ahead of the 2010 election. Three years later, the underlying figure has reduced to £120 billion and looks set to fall below £96 billion in the next three years.

The Government's balance sheet shows its more structural problems. The state's liabilities exceed its assets by £1.3 trillion, including a £1 trillion liability for public sector pensions. Last year the UK spent £46.5 billion to service public sector debt. This year it will spend £49.5 billion and by 2017-18 the UK can expect to spend £71.3 billion on debt interest. Overall public sector debt now stands at £1.2 trillion, or 74.5 per cent of GDP, compared to £1.1 trillion, 71.1 per cent of GDP, last year.

This financial position illustrates why tackling the deficit and improving the public finances have been the defining aim of this Government. We believe that tackling the country's long-term liabilities should be one of the defining aims of the next Government.

Seventy per cent of the Government's fiscal consolidation measures have been drawn from inflation-adjusted spending cuts rather than tax rises. As a result, the UK state will effectively shrink by ten per cent in the next five years as public spending as a proportion of our GDP goes down. That is a significant change in the size of our state, though other European countries need to do more; Greece is forecast to reduce by 19 per cent and Ireland by 27 per cent.

Government as we used to know it is unaffordable

The State of the State finds that government spending has increased steadily over the past 50 years. In 1963, Government spent £12 billion which was 38.5 per cent of GDP. Fifty years later in 2013, it is spending £720 billion, some 45.2 per cent of GDP. Taking inflation into account that is a fourfold increase in actual spending and a 17 per cent increase in the proportion of GDP spent by government.

Under pressure from the global financial crisis, government as we knew it became unaffordable.

Demand for public spending will continue to grow because of our ageing society. So while the Coalition Government's fiscal consolidation programme is reducing public spending in the short term, demand on health, long-term care and pension spending will force it back up again unless the depth of spending cuts are matched by equally deep reform. According to the UK's official fiscal watchdog, current patterns of demand and supply would require public spending to rise by four per cent of GDP by the time today's 30 year olds are 80. That is £61 billion at today's prices.

Creating a sustainable model for public services will require deeper reform

The State of the State suggests that the Coalition Government has taken some bold and unprecedented steps to tackle some of the UK's most intransigent public policy issues. Pension reform, welfare spending and social care funding have all traditionally been seen as uniquely difficult issues for politicians to reform, each of which the Coalition has begun to address.

However, our report argues that while the existing reforms are crucial first steps, more profound change is still required to create the necessary impact on the UK's balance sheet. No area of state activity can be considered taboo for reform. That includes public sector productivity, which has become a critical issue for the UK state. Our national productivity – both private and public – is second lowest among the G7. In the public sector, productivity has been flat for 15 years and the level of activity in the public services goes up and down according to levels of funding. Breaking that link is now vital. If not, public sector productivity will stay tied to funding and outputs will fall significantly.

Our study shows the scale of the challenge. The Institute for Fiscal Studies (IFS) estimates a fall in departmental spending of 18.6 per cent between 2010-11 and 2017-18.[51] If outputs fell by that amount, the productivity increase required for the public sector to maintain its current level of activity would be the equivalent of an additional 42 working days per year for every public sector employee, all other factors remaining constant.

A mixture of workforce reform, more effective use of technology, focused performance management and efficient ways of working will be required to meet this productivity challenge.

Leaders of our local public services are determined and focused on opportunities

It is therefore encouraging that local public sector leaders see opportunities in austerity. A series of in-depth interviews for *The State of the State*, conducted by Ipsos MORI, show that the people running our local public services are determined, focused and relishing the use of creativity rather than just resources to deliver for the people they serve.

However, the research also cast a light on their fears. Some interviewees suggested that the weakened state of local economies had become a more central concern for their organisations. A number of those interviewed expressed particular worries about the local impact of the national welfare reforms; they are concerned that lower incomes for vulnerable people will increase demand on local services.

The UK state is diverging, politically and economically

The State of the State is a UK-wide study. Analysis of Westminster is no longer adequate to provide a picture of government and the public services; the continued development of devolution since the late 1990s has created a divergent state. Nine political parties are now parties of UK government, and the political and economic differences between the countries of the UK will continue to grow.

The same is true when regions of England are also factored into this analysis. Our report shows that public spending between parts of the UK can vary by as much as 40 per cent per head.

Under pressure from the global financial crisis, government as we knew it became unaffordable.

Ten indicators for the Government

Our 2012 report identified ten indicators on which the Government could be measured, which we assess for this year's report. They show that the Government has performed well in some areas, for example, in driving headcount reduction and making efficiency savings. Other areas present a more mixed picture. Net liabilities remain too high, productivity remains too low, and some specific reforms such as public sector mutualisation are progressing at a slower pace than expected. The indicators are:

- Transfer one million public sector workers into mutuals by 2015
- Save cash through lost fraud
- Target net liabilities
- Support an economy-wide focus on productivity
- Encourage corporate sector spending to support growth
- Save cash through Payment by Results
- Drive localism through council funding
- Manage cash more effectively
- Drive significant public sector headcount reductions
- Save cash through value for money

Government in 2013

The UK state is a complex patchwork of interwoven public bodies, democratically accountable to 47 million electors, supporting a population of 63 million people.[1,2]

As well as the national Government in Westminster, the UK is governed by three distinctive administrations based in Belfast, Cardiff and Edinburgh, each held to account by a unique elected assembly. Nine political parties are currently parties of national and devolved government.

Government accounts identify 3,536 bodies as the UK public sector, not counting individual workplaces such as hospitals.[3] Together, they employ 5.697 million people. Almost one fifth of the UK's working population work for the state.[4]

This year, the UK Government will raise £612 billion, mainly in taxes, and will spend £720 billion.[5] The state spends an average of £8,745 of public money per person.[6]

The Government's balance sheet shows £1.27 trillion of assets including offices, the road network, and military equipment. It shows liabilities of £2.61 trillion including a £1 trillion deficit on public sector pensions and £966 billion of central government borrowing. The state's net liability – the difference between what the Government owns and what it owes at an accounting year end – was £1.35 trillion at last count. That is an increase of £161 billion since the previous financial year.[7]

The entire UK public sector's debt stands at £1.193 trillion, which is 74.5 per cent of GDP. That has risen from £1.111 trillion, or 71.1 per cent of GDP at the same point last year.[8] Compared to the 17 Eurozone countries, the UK's debt levels are the seventh largest.[9]

Figure 1. Where the money goes
In 2013-14, Government spend will be £720 billion

	£ billion		£ billion
Health	137	Defence	40
Welfare	220	Housing and Environment	23
Social services	31	Public Order and Safety	31
Industry, Agriculture and Employment	16	Debt Interest	51
Transport	21	Other	53
Education	97		

Figure 2. Where the money comes from
In 2013-14, Government income will be £612 billion

	£ billion		£ billion
Income tax	155	Corporation tax	39
National Insurance	107	VAT	103
Excise duties	47	Business rates	27
Other	107	Council tax	27

Source: Budget 2013, HM Treasury

The UK in context: Government spending reductions worldwide

In the past five years, many governments around the world have faced unprecedented financial difficulties that have led them to rethink their size and scope.

Immediately after the 2008 global financial crisis, governments around the world spent £7.1 trillion to support financial institutions. After that, the ensuing economic downturn substantially reduced their tax income, widening the gaps that already existed between government spending and government income in many states.

At the same time, the sovereign debt crisis threw a new spotlight on how governments manage their citizens' money and how expansive governments had become.

In the UK, the Coalition Government elected in 2010 set a clear strategy to reduce the deficit – the gap between its income and its spending – mainly through substantial cuts in government spending. Those cuts are now reducing the size and scope of the UK state.

Figure 3 compares the UK's reduction against a number of other states, showing spending levels for the past two years and projections for the next five.

As a benchmark, Germany in the centre of the chart shows that its austerity programme, by some standards, offers relative stability. After cuts of €5 billion in 2014, Germany is set to balance its budget by 2015 – one year before required by its constitutional debt-brake, a legal equivalent to the UK Government's self-imposed fiscal mandate to balance its books by 2015.

The United States, already a relatively low-spending government, is currently forecast to reduce its spending by 2.3 percentage points from 2011 to 2018, against International Monetary Fund (IMF) warnings that the 2013 budget cuts are poorly designed and could hamper growth.

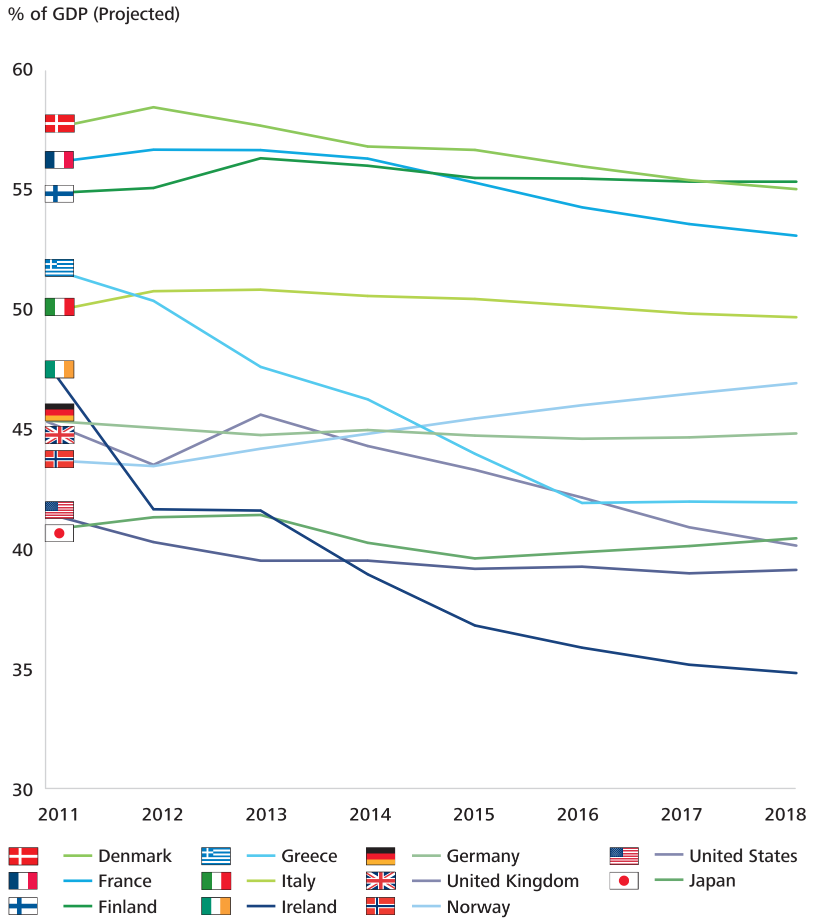
This analysis shows that the UK state has grown slightly since 2011 but is projected to shrink by ten per cent in the next five years. By comparison, Greece is forecast to shrink by 19 per cent and Ireland by 27 per cent between 2011 and 2018 as a result of their distressed economies.

Norway is one of the few advanced economies that bucks the global trend, with public spending set to rise by three percentage points. Finland also expects to see a modest increase of half a per cent. Both of these countries retain the Nordic social democratic model of high taxes and high public spending.

A 'nordification' of the UK state – with more taxes to pay for more government – is an unlikely proposition for the future of the UK given the scale of difference between the models of government. By way of contrast, our top rate of income tax is 45 per cent and public sector spending is 45 per cent of GDP. Nordic Denmark has a top rate of income tax of 60 per cent and spends 56 per cent of GDP on its public sector.[10,11]

In the past five years, many governments around the world have faced unprecedented financial difficulties that have led them to rethink their size and scope.

Figure 3. Shrinking states
Government spending reductions around the world



Source: International Monetary Fund projections

The public's perception of the UK's economic situation in the aftermath of the financial crisis is relatively negative. Just 19 per cent of respondents to the Ipsos Global Advisory Economic Pulse thought that the economic situation in Britain was 'good'.[12] But more holistic measurements that look beyond economic success show a different perspective. This year, the Social Progress Index, supported by Deloitte, measured 50 countries in terms of how well they provide for the social and environmental needs of their citizens. Across 52 indicators, the Index examines factors ranging from basic human needs, through foundations of wellbeing such as access to basic education, to issues of life opportunities. Using this index, the UK ranked second out of 50 countries, just behind Sweden.[13]

Reporting against our 2012 indicators

Last year's report identified ten indicators to measure the Government's success over this parliament in a range of activities. Here is the status of those indicators one year later, along with refreshed indicators that will be assessed in *The State of the State 2014.*

This mixed picture is consistent with expectations at three years into a five-year parliament.

Figure 4. Ten indicators

2012 indicator	Progress	Traffic light	Indicator for the year ahead
Encourage corporate sector spending to support growth	GDP growth is forecast to improve in the year ahead. While UK corporates continue to retain £708 billion in cash, Deloitte's UK Futures research suggests that 60 per cent of the largest UK companies are planning to invest significantly this year. Further details are on page 8.	Amber	Encourage corporate sector spending to support growth, measured through evidence that UK corporates are investing their cash balances.
Drive significant public sector headcount reductions	Government plans to reduced Whitehall staff numbers by 23 per cent for 2015 are on track and public sector employment as a percentage of total employment is at its lowest since 1999. Further details are on page 13.	Green	Progress according to Civil Service Reform Plan and continuing reductions in permanent headcount.
Save cash through value for money	Government efficiency programmes saved £10 billion in 2012-13 by tackling spending areas that included temporary staff costs, IT and digital services, and advertising. The Government target is now to save a further £20 billion per year to 2015. Further details are on page 13.	Green	Meet efficiency targets of £20 billion per year to 2015.
Save cash through Payment by Results	Payment by Results creates a link between public funding and outcomes and has emerged as a form of commissioning in the UK and around the world. Early examples include the Work Programme and pilots to reduce reoffending. Official figures show a success rate for the Work Programme of 13.4 per cent in the year to March 2013, an improvement from 3.4 per cent in the previous year.	Amber	Save cash and improve outcomes with evidence of increasing use of Payment by Results.
Transfer one million public sector workers into mutuals by 2015	This Government target is unlikely to be met according to current indications – and was always an ambitious target. However, the growth in mutuals is gaining pace, from nine in 2010 to 66 in 2013. Further details are on page 14.	Red	Support social innovation in public service settings and transfer one million public sector workers into mutuals by 2015. Continued evidence of social innovation and the use of alternative delivery models.
Save cash through lost fraud	The official public sector fraud rate has gone up by £300 million – possibly due to better methodology in its measurement rather than increased fraud. However, new policies have increased the risk for more fraud against the public sector. Further details are on page 18.	Red	Evidence of reductions in fraud and debt losses.
Manage cash more effectively	Evidence points to an improved focus on the way the Government manages cash. HM Treasury has set an objective to ensure that sufficient funds are available to meet any daily shortfalls and that surpluses are used to best advantage. Further details are on page 12.	Green	Development of an explicit target for cash management.
Target net liabilities	According to the latest Government accounts, for 2011-12, the UK's net liability rose by £161 billion from 2010-11, taking it over the £1.3 trillion mark. The Government has made a series of reforms that should, over time, reduce the state's liabilities but their impact will not be evident on net liabilities for some years. Further details are on page 13.	Red	Target net liabilities, including consideration of the impact of new policies on overall liabilities.
Support an economy-wide focus on productivity	UK productivity – both public and private sector – is the second lowest in the G7. Public sector productivity has been flat for the past 15 years and private sector productivity has fallen. Further details are on page 17.	Red	Development of a plan to improve public sector productivity.
Drive localism through council funding	Since 2010, central government has removed ringfencing from £7 billion of local government funding and given councils the ability to keep 50 per cent of business rates they collect.	Amber	Further evidence of support for localism and councils' ability to support local economic growth through multi-year spending settlements.

The state of the public finances

The Government's finances have come under a spotlight since the global financial crisis and subsequent austerity measures. This chapter explores the state's financial position through its accounts, historical data and official forecasts.

Government's role in economic growth

Our analysis of the UK's finances begins with the Government's role in shaping a successful economy. Since the global financial crisis five years ago, the UK's growth has varied from little to none and GDP is yet to reach levels last seen in 2007.

Since 2010, the Government's economic plans have majored on spending cuts and interventions to rebalance the economy away from reliance on the public sector for growth and jobs.

Its deficit reduction plans have been based on forecasts of modest economic growth to boost tax receipts and dampen demand on welfare spending. The arithmetic has been finely balanced and, unfortunately, the economy to date has not performed as well as expected.

The Office for Budgetary Responsibility (OBR) revised down its original forecast for GDP growth in 2013 from 1.2 per cent to 0.6 per cent, and revised its forecast for 2014 from 2.0 per cent to 1.8 per cent.[14] Those significant revisions illustrate both the weakness of growth and the inherent difficulties in economic forecasting. However, more recently the Office for National Statistics (ONS) estimated that growth between the first quarters of 2013 was 0.7 per cent and the consensus among economists is that more significant growth is on the near horizon.

Figure 5 illustrates the OBR's predicted sources of growth for the years ahead. There is a clear trend: Government will be spending less and business investment and private consumption are seen as the potential drivers of growth for the coming years.

The State of the State last year pointed to high levels of liquidity among UK corporates but a reticence to invest the estimated £708 billion cash piles currently sitting on their balance sheets.[15] While that caution has persisted to date, Deloitte analysis this year suggests that optimism is returning – and it will be backed with corporate investment.

According to our UK Futures research, major firms based in the UK plan to invest £13 billion this year in growth-related initiatives, with two in three senior executives expecting a period of growth in their business for the next three years.[16] This could help create a turning point for the economy which will have a significant positive impact on the public finances.

Government led-growth initiatives include a reduction in the main rate of corporation tax by one per cent in 2015, an increase in capital spending by £3 billion per year from 2015-16, and £1.6 billion of support for industry strategies.[17]

A further crucial lever for growth in the wider public sector is higher education. As well as its domestic impact, the Department for Business, Innovation and Skills (BIS) estimates that education exports are worth £17.5 billion annually to the UK economy, with international students alone contributing £10.2 billion in tuition fees and living expenses.[18]

The Government has set out plans to use the UK's brand to allow for transnational education in ways that allow students overseas to benefit from the UK's education resources. Each devolved administration is able to sculpt its own approach.

However, the higher education sector's view of government policy towards international student recruitment is predominantly negative. A Deloitte survey of finance directors in higher education found that 37 per cent of respondents thought the Government's policy had a significant impact on their international student recruitment.[19]

Debt and deficit

Just ahead of the last general election in 2010, the UK's deficit – the difference between what the Government receives in revenue and what it spends over one year – reached £159 billion. That is its highest level since the Second World War.

After the election, the newly-elected Coalition set itself a target that has become its defining characteristic: to reduce the deficit and balance the Government's books by 2015-16.

This so-called 'fiscal mandate' is an ongoing measurement, so the books will need to stay balanced at the end of a rolling five-year forecast for the Government to keep to its new fiscal rule.

Figure 6 shows how the deficit has been reduced over the past three years and expectations for the next four.

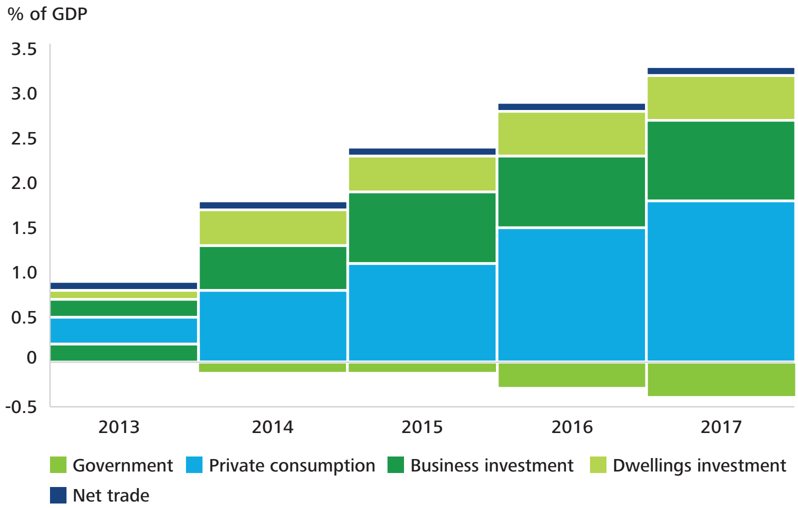
As well as this first target, the Coalition set itself a second: for Public Sector Net Debt (PSND) to be falling as a share of GDP in 2015-16. PSND shows the public sector's financial liabilities less its liquid financial assets including bank deposits.[20] In July 2013, PSND – excluding the temporary effects of financial interventions – was £1,193.4 billion, equaling 74.5 per cent of GDP. That is an increase from £1,111.9 billion or 71.1 per cent of GDP from the same month last year.[21] The UK's debt amounts to £18,847 per person.[22]

The OBR currently forecasts a 50 per cent likelihood of the Government achieving the fiscal mandate in 2015-16 but warns that, looking at current figures, the second target is likely to be achieved two years late.

In 2013-14, the UK will spend £49.5 billion on debt interest – that equals £952 million per week – and current forecasts suggest this annual burden will rise to £71.3 billion by 2017-18.[23]

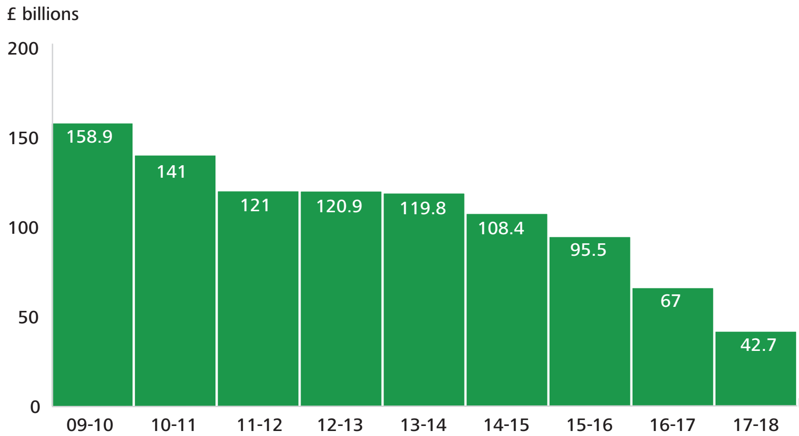
The Government's strategy to reduce the deficit – known as fiscal consolidation – comprises a blend of public spending cuts and tax increases. The next section illustrates why.

Figure 5. Sources of economic growth
Where growth is expected up to 2017



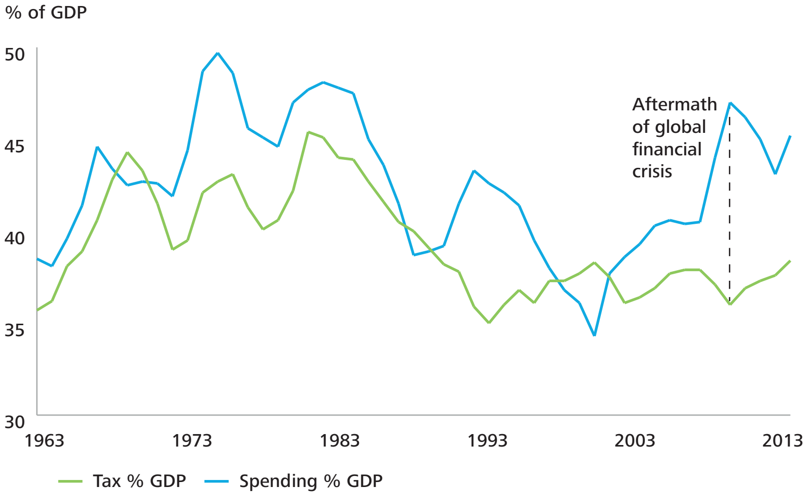
Source: Economic and Fiscal Outlook, Office for Budgetary Responsibility

Figure 6. Public Sector Net Borrowing Forecast
The annual difference between income and expenditure



Source: Economic and Fiscal outlook, Office for Budgetary Responsibility

Figure 7. Fifty years of tax spending
The state's tax income and expenditure since 1963



Source: Historical public finances data, Office for Budgetary Responsibility

In 2010, the UK's deficit – the difference between what the Government receives in revenue and what it spends over one year – reached £159 billion. That is its highest level since the Second World War.

Tax and spending

Government revenue is largely generated through taxes, as shown in figure 2. But to assess the public finances, it is crucial to understand the relationship between tax and spending.

Figure 7 illustrates the relationship between tax and spending by UK governments in the past 50 years. It shows that during recessions, tax income dips and greater demand is placed on the public purse. The aftermath of the 2008 global financial crisis is particularly striking to see on this graph, where an unprecedented gap emerged between tax income and government spending.

The UK Government has been narrowing the gap, and aims for public spending to equal 40.5 per cent of GDP by 2017-18. That would return public spending to 2004-05 levels as a share of GDP.

This year, 70 per cent of the Government's fiscal consolidation measures will be drawn from cuts rather than tax rises. It is an approach that has won the Government significant international credibility compared to other countries struggling with debt issues.[24]

Earlier this year the IMF recommended that the Government should take steps to boost growth through capital investment and reduce corporate tax rates – advice which the Chancellor appears to agree with: from 2015-16, capital spending plans will increase by £3 billion per year and the main rate of corporation tax will be reduced to the joint lowest level in the G20.[25]

The IMF also advised the UK to reform property taxes and broaden the VAT base. While the Chancellor has introduced some new property taxes, the changes do not constitute widescale reform, and VAT has not been changed.

The Government elected in 2015 may choose to heed the rest of the IMF's advice and enact those suggestions. Tax increases are always an alternative to spending cuts in balancing the Government's books. As the Budget 2013 document warns: "it would, of course, be possible to do more of this further consolidation through tax instead".[26]

Historic growth in public spending

The past 50 years have seen a steady rise in public spending. The UK Government spent £12 billion in 1963, which represented 39 per cent of GDP. Fifty years later in 2013, it will spend £720 billion, representing 45 per cent of GDP. Figure 8 shows that rise in real terms.

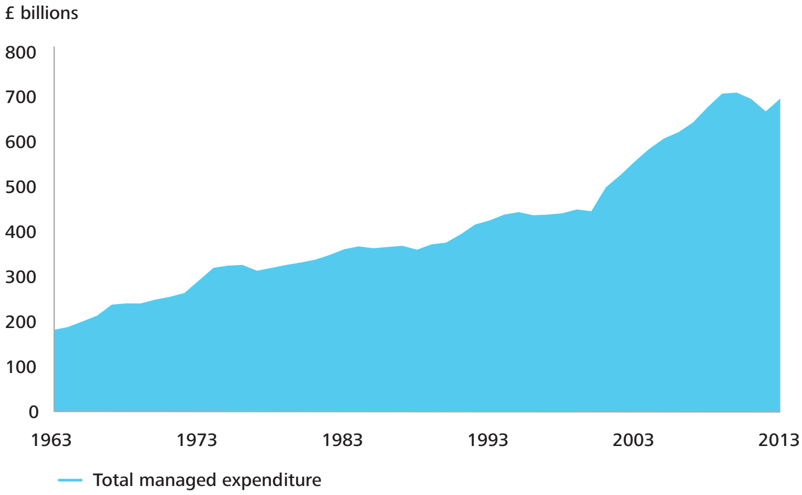
The last decade saw particularly striking growth in public spending. Some elements of social security spending increased by 45 per cent in real terms.[27] The cost of providing adult social care increased by 50 per cent and health spending doubled. In fact, the King's Fund predicts that if health spending continued to rise at the same rate as it did over the last decade, it would equal almost 100 per cent of GDP within 60 years.[28]

These unsustainable rises have been building since the creation of the welfare state in the early part of the twentieth century. As the UK's population grew and our prosperity increased, our public service institutions thrived. Demand for public services grew and so did the limits of the public sector. Adult social care, for example, was not part of the original welfare state as defined by William Beveridge in his 1942 report.

Spending demands will continue to increase, accelerated by our ageing population. In the next 20 years, the number of people over 65 is expected to grow by 50 per cent and the number of people over 90 is expected to treble. By 2030, men aged 65 can expect to live for a further 23 years and women for a further 26 years.[29] As has been observed for some time, this represents a profound demographic shift across the UK which is set to place unprecedented demands on public spending in the medium and longer term.

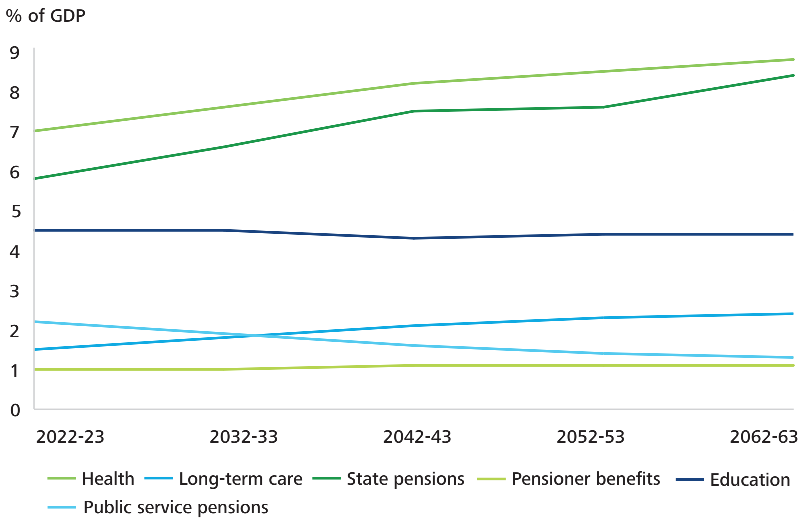
Figure 9 shows how age-related spending – on health, long-term care and state pensions – will need to increase dramatically from 2020 to meet the demands of the next decade and those to follow.

Figure 8. Fifty years of government growth
Real-terms public spending at 2011-12 prices



Source: Historical public finances data, Office for Budgetary Responsibility

Figure 9. Age-related spending projections
Public spending demand for the next 50 years



Source: Fiscal Sustainability Report, Office for Budgetary Responsibility

Figure 10. The state's balance sheet: Whole of Government Accounts

	2009-10 £billion	2010-11 £billion	2011-12 £billion	Comment
Assets	1,249.5	1,234.3	1,267.6	State assets have increased, largely due to an increase in property, plant and equipment assets which includes the road network and military hardware.
Liabilities	(2,477.4)	(2,420.0)	(2,614.6)	The largest element of this is £1,008 billion of public sector pension liability, which increased by £47 billion in 2011-12.
Net liability	**(1,227.9)**	**(1,185.7)**	**(1,337.0)**	The difference between the state's assets and liabilities at year-end has changed from £1.2 trillion to £1.3 trillion.
Revenue	583.4	614.0	616.6	Revenues have increased, helped by the VAT rate rise to 20 per cent which is estimated to raise £13 billion per year.
Direct expenditure	(619.5)	(663.3)	(647.8)	The decrease between the last two years shows the impact of cuts in public sector staff numbers.
Other operating expenditure	(47.7)	38.4	(67.3)	Expenditure on impairment of assets and pension charges changed from a gain to a loss.
Net financing cost	(78.9)	(83.5)	(86.8)	Financing costs, including investment revenue, have risen.
Net deficit for the year	**(162.7)**	**(94.4)**	**(185.3)**	The significant rise in the difference between the state's spending and income is mainly due to a change in the pension index rate and an impairment to council housing.

Figures for 2010-11 and 2009-10 have been restated for comparability.
Source: WGA and NAO analysis of WGA

According to OBR projections, public spending will fall in the next five years. But age-related demand will then push public spending up by four per cent of GDP between 2017-18 and 2062-63. That equates to £61 billion at today's prices.[30]

While the far end of this projection may seem distant, it relates to current adult generations; the 80 year olds of 2062 are now in their thirties.

Scotland provides an example of how care costs can increase over medium timescales. Free personal and nursing care was introduced in Scotland in 2002. The cost to local authorities doubled from £219 million in 2003-04 to £458 million in 2011-12.[31]

In addition to the additional pressures from an ageing population, the UK birth rate is also rising and the 813,200 births from June 2012-13 was the largest number for 41 years.[32]

Ultimately, this means that while the Coalition's fiscal consolidation measures may balance the state's finances in the short term, demographic pressures make them unsustainable in the longer term.

Improving cash management

The Government's cash management activities – having the right amount of cash available at the right time, and doing so cost effectively – have been the source of reform since the National Audit Office (NAO) noted that Whitehall departments hold more cash than necessary in commercial bank accounts.[33]

HM Treasury provides a daily forecast of net flows in and out of its central account – the National Loans Fund – which the Debt Management Office uses to inform market transactions. Since recognising the need for reform, the Treasury set itself an objective to ensure that sufficient funds are available to meet any daily shortfalls and that surpluses are used to best advantage.

Saving through efficiencies

Government efficiency programmes saved £10 billion in 2012-13 by tackling spending areas that included temporary staff costs, IT and digital services, and advertising. The NAO confirmed that the methodology to calculate this official figure was sound. However, it suggested that the Government should make clearer that it includes "a mix of reduced spending, plans to reduce spending, one-off receipts and costs transferred to others".[34]

The Cabinet Office's Efficiency and Reform Group aspires to save a further £20 billion per year to 2015 – in part by tackling fraud and error as recommended in last year's *The State of the State* report.

The Government's accounts: Liabilities

Figure 10 shows a short version of Whole of Government Accounts (WGA). They show that for 2011-12, the UK's net liability rose over the £1.3 trillion mark.

The largest single liability on the state's balance sheet is £1.008 trillion for public sector pensions. This figure has risen by a significant £47 billion since the previous year because of changes in actuarial assumptions on issues including mortality rates and projected pay rises. Other major liabilities on the Government's balance sheet include £966 billion in central government borrowing, up from £908 billion in 2010-11, and £64.3 billion in provisions for nuclear decommissioning.

The Government has made a series of reforms that should, over time, reduce the state's liabilities. As well as the austerity programme, the measures include public sector pension reforms such as an increase in the age at which most public sector workers can receive their pensions, and a shift in decommissioning responsibilities for future nuclear power stations to the private sector operator. However, the impact of these reforms will not be evident on net liabilities for some years.

The Government's accounts: Provisions

The Government's provisions – obligations that it may need to meet as a result of past events – have increased significantly in the three years of WGA. Provisions for nuclear decommissioning have increased from £56.7 billion in 2010 to £64.3 billion in 2012. Provisions for NHS clinical negligence have increased from £15.7 billion to £19.4 billion over the same timescale.

Triggered by incidents at Stafford Hospital, and explored in the Keogh report into hospitals with high mortality rates, this past year has seen a particular focus on NHS care quality. This heightened intolerance of care failures could mean that NHS medical negligence provisions go up further in the years ahead and present an increased burden on the state's liabilities.

Headcount

The public sector employs 5.697 million people, which is 19.1 per cent of everyone in employment in the UK. The percentage of people employed by the state is now at its lowest since 1999.

The Civil Service Reform Plan suggests that by 2015, Whitehall staff numbers will be 23 per cent lower than in March 2010. Latest figures suggest that this reduction plan is on track, and the Cabinet Office alone has reduced staff numbers by 28 per cent.[35] Research by the Institute for Government (IfG) suggests that non-payroll staff numbers in Whitehall have risen in the past year by more than 2,000 Full-Time Equivalents (FTE), but this is outweighed by a reduction in payroll staff of almost 14,000 FTEs.[36]

In the wider public sector, employment fell by 200,000 in the past year. One area of the public sector bucks this trend: in the year to Q1 2013, with a protected budget, NHS staff numbers grew by 5,000.[37] However, there are considerable variations between countries and regions of the UK. In England, 18.4 per cent of total employment is in the public sector compared to 28.1 per cent in Northern Ireland, 25.6 per cent in Wales and 23.2 per cent in Scotland.

As part of headcount reduction plans, the Coalition originally aimed to move one million public sector workers into mutuals. The target was always ambitious, and is unlikely to be met. A recent survey illustrated why: 70 per cent of civil servants said they had no interest in forming a mutual. The Government could do more to raise awareness of the potential of mutualisation for them, as 46 per cent of the survey's respondents pointed to a lack of knowledge about the mutual model as a barrier.[38]

However, the growth in mutuals is gaining pace, from nine in 2010 to 66 in 2013, and failure to meet the original stretch target should not detract from the programme's progress. A report to Government by its Mutuals Taskforce highlighted significant developments in empowering public sector employees, supporting established mutuals, and developing a pipeline of emerging mutuals.[39]

From bold steps to deep reform

Our analysis has shown that public spending has increased significantly over the past 50 years, mainly driven by social security, health, and social care spending, and that the UK state faces even greater demands on its resources in the years ahead.

Since 2010, the current UK Government has begun to tackle a number of the issues underlying these increases, which are among the most intransigent difficulties for states around the world.

By beginning to reform social care funding, welfare spending and pensions, the Westminster Coalition has taken bold steps. From 2016, a cap on social care funding in England begins to reform the system, and means that people who require social care will not face unlimited liability for the cost. The change may stimulate the insurance sector to provide social care products, but in the meantime, the cap is expected to cost an additional £3.7 billion per year by 2025-26.[40] While this begins to address fairness issues in England's social care funding, it does not resolve the underlying problem of long-term affordability for an ageing population.

The cap on welfare spending does begin to address affordability in the medium term. This year, the Government introduced a cap on working-age benefits as part of wider spending control on Annually Managed Expenditure (AME) – the demand-led part of public spending that has continued to grow while other elements have been cut.

Savings generated by the AME capping measures are expected to reach £640 million by 2015-16 and £865 million by 2017-18.[41] While this aims to restrain growth on significant elements of the welfare budget, it does not affect the state pension which, as our analysis shows, is set to grow with increasing demand from the ageing population.

The state pension dates back from the early part of the twentieth century, when it was introduced for people over 70 years old. At the time, the average life expectancy was 48 years.[42] That average is now 81 years. Such is testament to our improved living standards and the success of the UK public services. But it also illustrates an inherent problem in the state pension system. Originally conceived as a minimum safety-net for those in need, it cannot continue to provide a full income for ever-increasing numbers of older people without major reform or major increases in its funding.

The Government has taken a bold step to introduce a single-tier state pension from 2016-17 and an even bolder step to increase the state pension age to 67 from 2026. But further pension reform remains a critical issue for the long-term financial sustainability of the state, as we shall see in the next chapter.

The reforms of the past three years have begun to change the size and limits of the state. Capping working-age benefits, widening the number of people subject to council tax, proposals to limit legal aid, stopping child benefit for more affluent households, and library closures driven by council cuts are all examples of the shifting limits of government.

However, the state's longer-term affordability issues mean that the Government of 2015 will need to move from a period of 'bold reform' to one of 'deep reform' to affect the underlying issues on the Government's balance sheet.

Examples of deep reform in the UK public sector are increasingly evident:

- **Police and fire reform in Scotland**
  In April 2013, the eight Scottish police forces, along with the Scottish Police Services Authority and the Scottish Crime and Drug Enforcement Agency, merged into a single police service. On the same day, Scotland's eight regional fire and rescue services also merged.

  The change followed an announcement from Scotland's justice secretary who argued that budget cuts had made the country's model unsustainable. The reforms aim to make savings of £1.7 billion over the next 15 years.

- **Public sector reform in Northern Ireland and Wales**
  In Northern Ireland, fundamental reform of the local government system will see a reduction in the number of councils from 26 to 11 by April 2015, along with a transfer of powers that will include planning, road, housing and regeneration.

  In Wales, a Commission on Public Service Governance and Delivery is undertaking a fundamental and unrestricted review of how the country's public services are delivered in light of funding cuts.

- **Whitehall transformation**
  In 2012, the Government published the Civil Service Reform Plan to change the size, shape and capability of Whitehall. One year on, analysis by the IfG suggests that departments are on track to meet their reform objectives – but they will need to "pick up the pace" to reduce staff numbers to target levels by 2015.[43]

  The Ministry of Defence (MOD) provides a strong example of deep reform. The department is moving to a fundamentally different model of strategy and financial management, which will come into full operating capability in April 2014. Progress to date includes a reduction of 24 per cent full time equivalent posts since 2010.[44]

More fundamental defence reform includes the move to a different operating model for Defence Equipment & Support (DE&S), the organisation that buys and supports the UK's Armed Forces equipment. In summer 2014, the Government will decide whether to change the organisation to a restructured form of the DE&S, or a Government-Owned, Contractor-Operating (GOCO) model. The current assessment phase will allow the Government to make an evidence-based decision about an organisation that will manage the MOD's £160 billion, ten-year equipment programme.

The Government of 2015 will need to move from a period of 'bold reform' to one of 'deep reform'.

Reform: Through a business lens

Government is not the same as business. But looking at the public sector through a business lens allows for new thinking on some key reform issues. This chapter explores how some private sector approaches could help shape public sector reform.

Corporate centre

The shape of the UK 'centre of government' has been the subject of considerable recent debate, much of which focuses on ways to ensure that ministerial decisions are enacted. While that is important – for accountability and to drive change – a corporate-style centre of government could also have a significant impact on the effectiveness of the state.

In the United States, the Office of Management and Budget drives efficiency from the centre of government, based in the White House. It comprises:

- **Office of Federal Financial Management** – which provides government-wide strategic direction on financial management and reporting

- **Office of Federal Procurement Policy** – which provides government-wide procurement support as well as development for the procurement workforce

- **Office of E-Government and Information Technology** – which develops digital technologies to save money and help citizens engage with federal government

- **Office of Performance and Personnel Management** – which coordinates performance management across the entire federal workforce of more than two million people working in more than 120 departments and agencies.

Many of these functions already exist in different teams in each of the UK's administrations. Lessons from this US model are worth exploring in each of our civil services to provide a business-style corporate centre that can drive change in financial management, procurement, IT and performance management.

Strategic planning

High-performing businesses tend to follow multi-year strategic plans, but they also plan for the longer term in ways that governments rarely do, if at all. The impact of our ageing society on public spending is a particularly potent example of how successive UK governments – in common with others around the world – have failed to plan ahead.

This year, a House of Lords Select Committee concluded that the UK is "woefully underprepared" for society's changing demography and warned of a "series of miserable crises' on the horizon".[45] Yet evidence for an ageing population is readily available given the quality of birth and death data.

Political cycles tend to drive short-termism in policymaking and there is little electoral incentive for governments to make long-term investments.

Governments do have the ability to build review cycles into long-term issues. The Coalition Government is introducing five-year reviews of the state pension age from 2015 which will be based on analysis by the Government Actuary's Department and a new independent body with a mandate to produce a report on the wider factors to take into account, such as life expectancy.[46] This could be a powerful model for legislation in other areas.

To support more effective strategic planning, the force of Parliamentary scrutiny could also be used to hold the Government to account over its long-term plans. The Public Administration Select Committee and Public Accounts Committee have, this Parliament, put parliamentary scrutiny of public management and public spending in the public eye through a series of high-profile inquiries. These and other select committees have a crucial role to play in asking ministers and officials about future trends to encourage strategic planning and diffuse the political effect of elections on policymaking.

Productivity

UK productivity – both public and private – is markedly lower than in other G7 countries, except Japan. One key factor is working hours. The most recent comparison suggests that UK employees work an average 135 hours a year less than their US counterparts. That is the equivalent of more than three weeks at 40 hours per week.[47]

Official figures suggest that public sector productivity has remained virtually flat from 1997 to 2010. In the private sector, productivity rates have fallen in recent years.

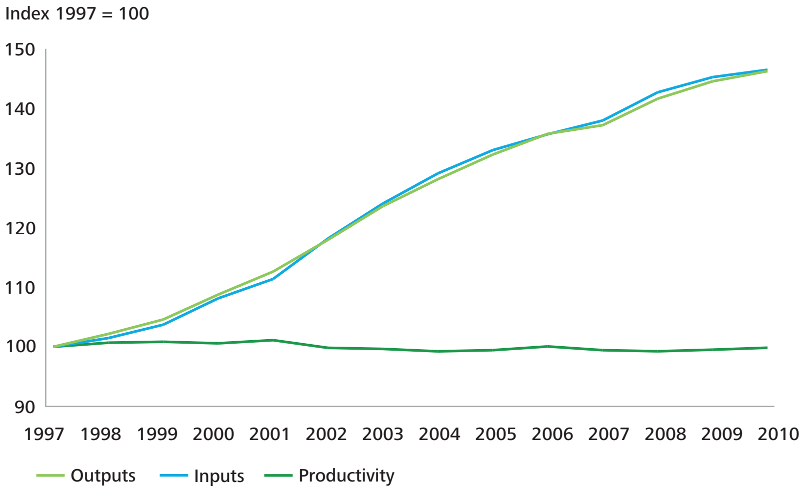
Government measures public sector productivity by comparing inputs – labour, goods, services and capital used to deliver services – against outputs, which are the quantity of activities and services. Different measurement techniques are used for different service areas.

Official data, set out in figure 11 shows that in the public sector, outputs go up and down at broadly the same rate as inputs. So in periods of increased public spending on services – notably between 2000 and 2005 – more activity took place when more money was being invested in the public services.

While these figures are UK-wide, there are considerable country and sector variations in the key factors that affect productivity. For example, the Northern Ireland Civil Service reported a sickness absence rate of 10.1 days per staff year, compared to an average of 7.9 days across the rest of the UK public sector. The cost of that sickness absence in Northern Ireland is estimated at £28.6 million.[48, 49]

The average sickness absence rate across the entire UK workforce is 4.5 days; ONS figures show that public sector workers lost 2.6 per cent of their working hours to sickness compared to 1.6 per cent in the private sector.[50]

Figure 11. Public sector productivity
Inputs and outputs



Source: Office for National Statistics

Current approaches to productivity in public services have created a direct link between funding and activity. This points to a central challenge for the public services in 2013: decouple that relationship so that the public sector workforce produces more output for the same, or less, input.

If outputs remain bound to inputs – with no improvements in productivity – levels of delivery in the public services could decline at the same rate as funding cuts. This presents a clear risk for the UK and our public services.

The Institute for Fiscal Studies (IFS) estimates a fall in departmental spending of 18.6 per cent between 2010-11 and 2017-18.[51] If outputs fell by that amount, the productivity increase required for the public sector to maintain its current level of activity would be the equivalent of an additional 42 working days per year for every public sector employee, all other factors remaining constant.

Measures to boost productivity in the public sector workforce can be controversial – but will be a necessary part of maintaining an affordable state. Reforms might include better use of technology, rethinking processes, improvements in management approaches, changes to the working environment and workforce reforms.[52]

UK countries need not look far for an example of widescale workforce reform. In Ireland, the Government is aiming to agree a package of workforce reform that includes different working arrangements, better performance management and changes to sick leave arrangements.

Better exploitation of mobile technology could make a particularly profound productivity difference. A global study by Deloitte in the US suggested that if the federal government doubled its adoption of mobile technologies, additional value generated in terms of output would be $50 billion annually. The report – *Gov on the Go: Boosting public sector productivity by going mobile* – identified three areas in which the public sector could use mobile technology to drive productivity improvements. First, field workers including police and social workers could be empowered with field technologies that would make the best use of their time. Second, mobile innovations can help citizens interact with the public sector in ways that use less time and money. Third, at a time when the public services need to better engage with citizens, mobile technology can offer new ways for them to collaborate with government over the way services are designed and delivered.[53]

Fraud and loss

Last year, the UK public sector was defrauded of about £20.6 billion. That figure has gone up from £20.3 billion since 2012, though continued innovation in measuring fraud rates makes year-on-year comparisons difficult. Figure 12 shows a breakdown of fraud against government.

Public sector fraud is likely to rise significantly in the next five years, for three reasons.

First, benefit changes that levy council tax on people with low incomes are widely expected to lead to mass non-payment.[54]

Second, as public services explore the potential of charging fees for some services, new opportunities emerge for fraudsters to avoid payment.

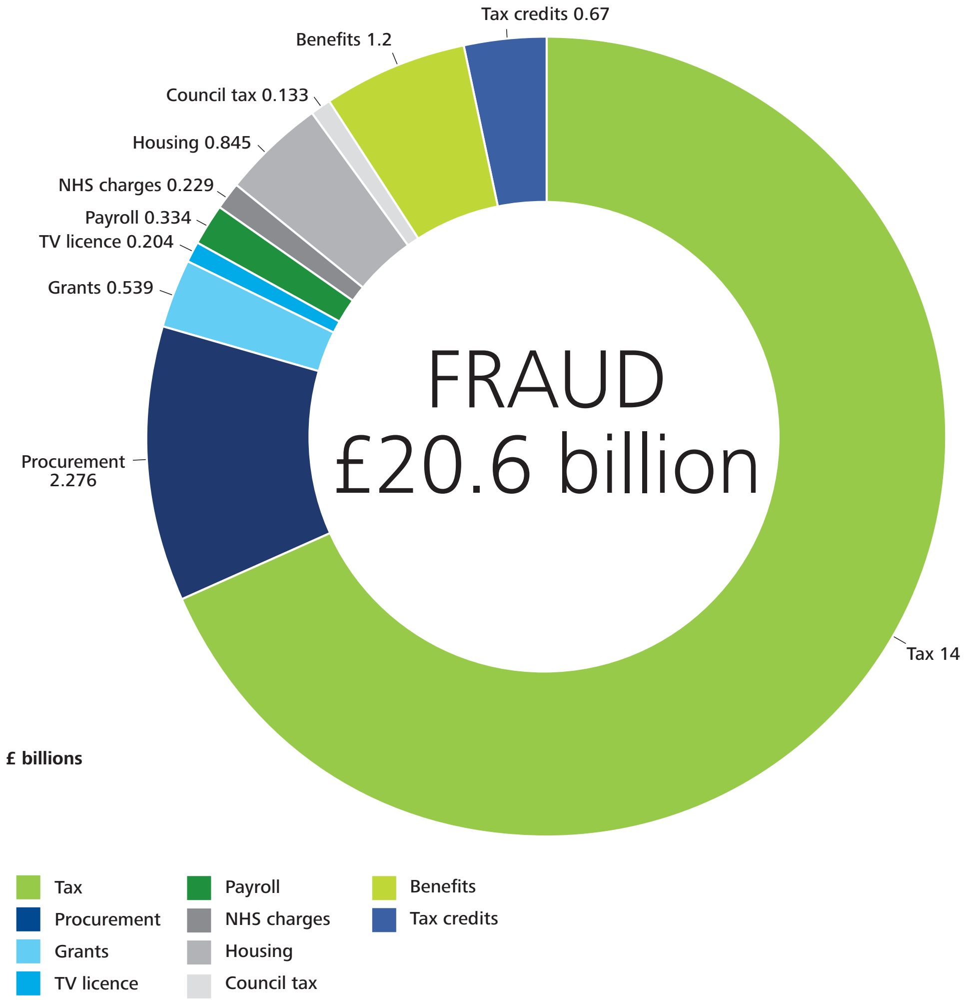
And third, the growing diversity of public service provision increases the number of transactional opportunities for fraud.

Detection rates are a key issue; estimates of undetected fraud are ten times higher in the public sector than the private sector.

Our analysis suggests that if Government could detect fraud to the same standard as the financial services industry, it would save £8.5 billion a year. While we recognise that the operation of the state is clearly very different from financial services, the figure shows the scale of the potential saving.

Tax evasion and tax avoidance have been high-profile issues in recent months, with the Prime Minister using the UK's presidency of the G8 this year to lead an international response. HM Revenue & Customs (HMRC) estimates that criminal attacks costs the exchequer £5 billion, tax evasion costs £4 billion, the hidden economy costs £5 billion and tax avoidance costs £5 billion.[55] Clearly reform in these areas could make a significant difference to the public finances.

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



Source: Annual Fraud Indicator, National Fraud Authority

Last year, the UK public sector was defrauded of £20.6 billion.

Debt recovery

Central government incurs losses of around £7-8 billion every year on uncollected debt.[56] Government is taking steps to improve its debt recovery rate. The Department for Work and Pensions (DWP), for example, recovered £320 million in the last financial year compared to £177 million in 2000, with further improvements underway.[57] However, more improvement might be possible by learning from other countries, some of which have centralised approaches to debt collection.

In Denmark, all debts owed to government – including tax, welfare and court fines – are legally transferred to its tax authority who takes on the creditor rights. It has the power to deduct directly from peoples' earnings based on an assessment of their financial circumstances and dependents.

In the US, federal agencies refer debts to the Treasury for recovery. Their collection activities include intercepting benefit payments and traditional debt collection techniques such as letters, phonecalls and the use of private collection agencies. The latest available figures show that in 2011, the system collected $6 billion, recovering $52 for every dollar spent in doing so.[58] That same success rate would equal a reduction of £260 million in the amount of debt written off by the UK Government every year.[59]

Student loans represent a notable debt risk for government, as it cannot withhold loans to students with low credit ratings, or ask for collateral. The accounts show that in 2011-12, Government issued £33.1 billion in student loans, an increase of £3.5 billion on the previous year. It estimated some £3.9 billion will not be recovered. However, collection methods through the PAYE tax collection process do help recovery rates.

Technology and data analytics

Government is generally slower to adopt new technologies than the private sector – though not because it lacks the will to innovate.

As Microsoft point out, major change in government can involve legislative and regulatory hurdles, and it operates on scales that can dwarf the private sector; a government department-wide IT project can be bigger in scale than a comparable project for a global company.[60] DWP, for example, employs 105,000 people in the UK – that is 12,000 more people than Coca Cola employs worldwide.[61]

Opportunities to exploit technology exist at every tier of government. One specific area on which reform should focus is data analytics.

The Government first recognised the value of public data in a 2009 paper on smarter government, and the Westminster Coalition has done much to advance the publication of its datasets since 2010. Doing so has shown a commitment to transparency and to stimulate the data economy by allowing third parties to use government data.

The use of data as a tool for better public services remains underexploited. Many public bodies are yet to start realising the potential of analysing the data they already collect.[62]

But the vast majority of public sector organisations have much to gain by harnessing their own data, as well as data from other sources. A Deloitte UK study of the potential for data analytics in the public sector suggested that organisations should begin their data analysis journey by:

- **understanding the purposes of data analytics** – assessing what data is available and how it relates to organisational priorities
- **understanding what 'good' looks like** – reviewing examples from the UK, as well as from pioneering countries including the US and Canada
- **starting simple** – Deloitte's experience suggests that incremental investment and manageable projects are crucial in the complex and data-rich public sector
- **thinking about customers** – focusing on customers, whether internal or service users, is vital to make sure that data analytics provides meaningful insights
- **developing a new culture** – the potential of data analytics will be realised when staff at all levels recognise how data can empower their work and inform their decision making.[63]

The UK Government has shown significant commitment to the publication and use of its data, and should continue exploring how its own data resources can be used for better policymaking, operational efficiencies and innovation.[64]

Major IT change in government can involve legislative and regulatory hurdles, and it operates on scales that can dwarf the private sector.

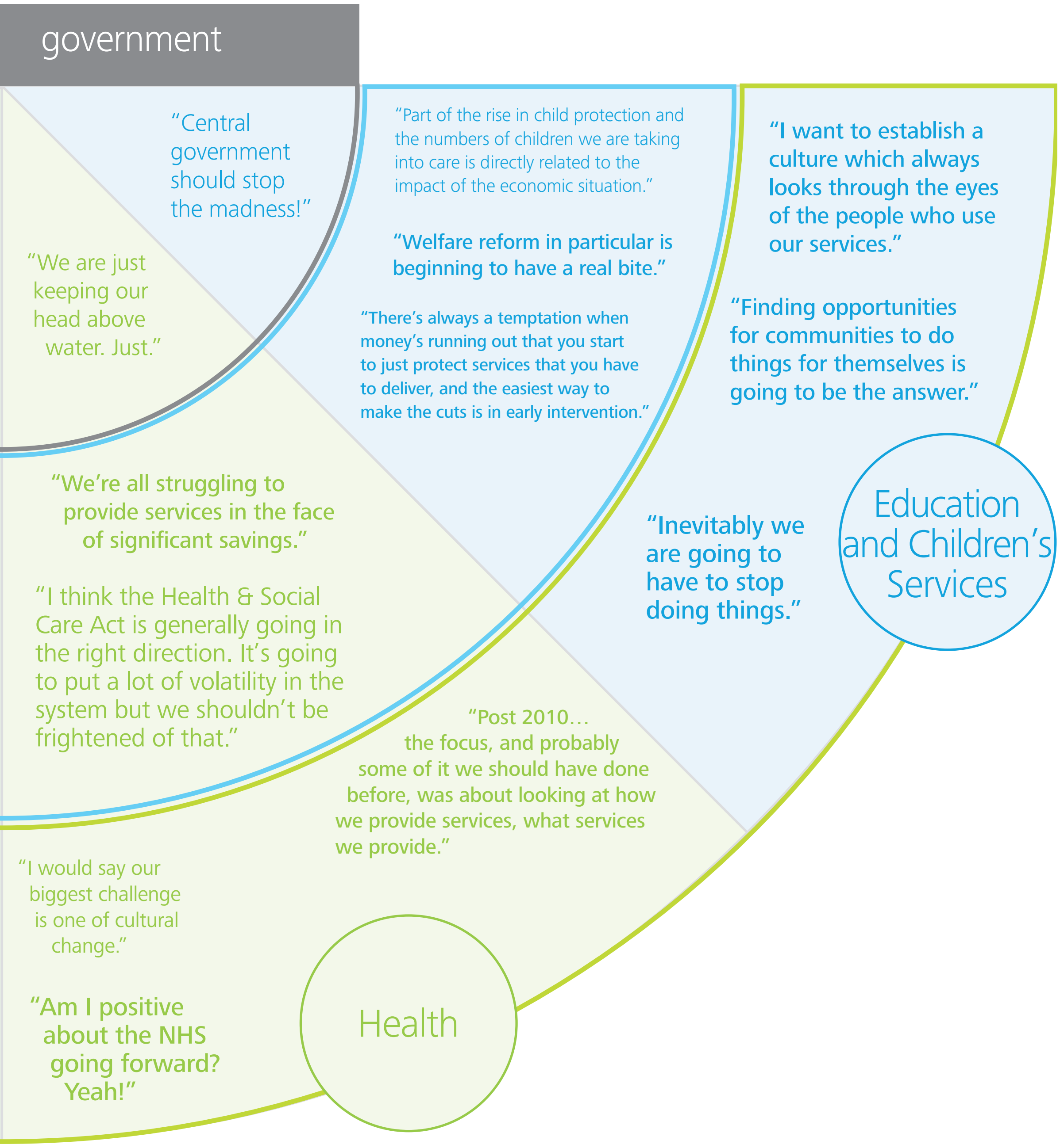
The state of local public services

The UK's top public service executives – chief executives, chief constables, key civil servants and service directors – are uniquely placed to provide an accurate view of the state of the state. Guided by political decision makers, their roles require a mix of strategic insight, organisational leadership and responsibility for delivery.

For *The State of the State*, Deloitte commissioned Ipsos MORI to interview top executives spanning the full range of public services from across England, Northern Ireland, Scotland and Wales.

Our research provided a wealth of information on each area of the local public services. Five key insights for *The State of the State* are set out in this chapter along with some indicative quotes from our interviews.

Figure 13. In the words of local leaders


government
"Central government should stop the madness!"
"We are just keeping our head above water. Just."
"Part of the rise in child protection and the numbers of children we are taking into care is directly related to the impact of the economic situation."
"Welfare reform in particular is beginning to have a real bite."
"There's always a temptation when money's running out that you start to just protect services that you have to deliver, and the easiest way to make the cuts is in early intervention."
"I want to establish a culture which always looks through the eyes of the people who use our services."
"Finding opportunities for communities to do things for themselves is going to be the answer."
"Inevitably we are going to have to stop doing things."
Education and Children's Services
"We're all struggling to provide services in the face of significant savings."
"I think the Health & Social Care Act is generally going in the right direction. It's going to put a lot of volatility in the system but we shouldn't be frightened of that."
"Post 2010… the focus, and probably some of it we should have done before, was about looking at how we provide services, what services we provide."
"I would say our biggest challenge is one of cultural change."
"Am I positive about the NHS going forward? Yeah!"
Health

1. The link between local economies and local services has moved up the agenda

Combined with cuts, the recession has put the health of local economies high on the agenda for public service executives; never before has the importance of the symbiotic relationship between the state of the local economy and the state of the local public sector been so evident.

Weak economic growth and unemployment have put increased pressure on the local public sector as demand for spending has increased.

One police respondent reported that while crime is down overall, shoplifting for food has increased. A local authority interviewee said that rent arrears have increased dramatically. Some interviewees said that making redundancies from their own organisations to cope with spending cuts exacerbated problems of unemployment in the local economy.

The clear theme was that public service executive leaders are concerned about the state of their local economies and the impact it has on demand for their services – particularly at a time when cuts are reducing their capacity to provide.

2. Public service executives fear the impact of welfare reforms

Our research suggests that public service leaders are particularly concerned about the fallout from welfare reform. Some wondered if central government has assessed whether savings on welfare spending will be counterbalanced by increased demand on local services. This was a particular concern for directors in children's services, where interviewees described rises in child protection cases.

Many interviewees also expressed concern that cuts will affect their ability to invest in preventative services.

Figure 14. Opportunities and challenges

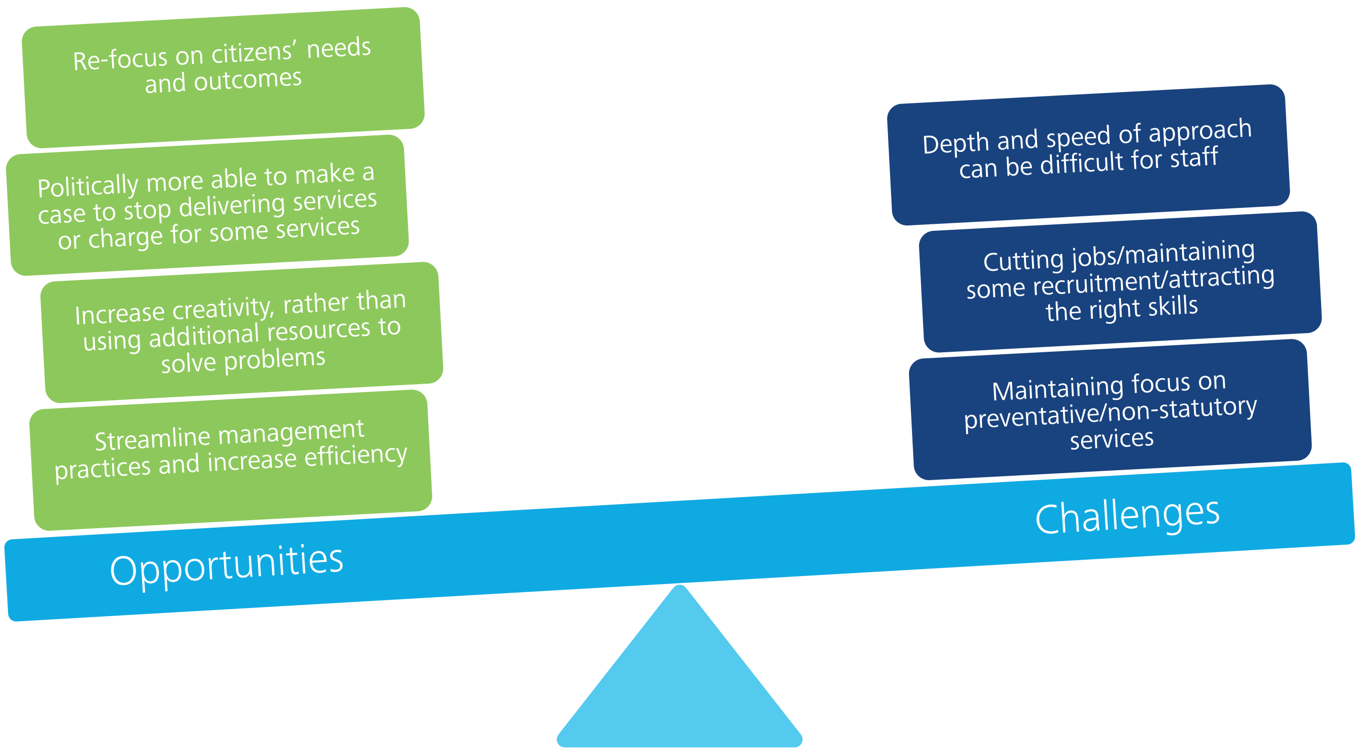


Figure 15. Leadership priorities

3. The people in our public services are focused on opportunities – not just challenges

Our interviews suggest that the people in our public services remain focused on delivering for the people they serve.

Amid the serious challenges of austerity, our research shows that public service executives see the current climate as an opportunity to refocus their services on citizens' needs and outcomes, as well as to use creativity rather than resources to solve problems.

One police respondent told us that in the past, additional finance would have been used to deliver change – but now, the force explores service redesign. Another interviewee said that rather than "chop bits off", they were trying to change their fundamental approaches.

On balance, interviewees felt that the opportunities of the coming five years outweigh the challenges – described in figure 14.

4. The game has changed – so have leadership priorities

The interviews tell us that executive leaders have changed their priorities. Figure 15 illustrates the new priorities that executive leaders told us they are adopting.

When interview responses were collated, a striking trend emerged: organisational leaders are focused on their people and how they can be empowered to rise to their organisation's challenges.

Public value is a notably important issue; a number of executives mentioned values – such as caring, fair and trusted – as being central to the public service ethos. At a time of public sector headcount reductions, some interviewees spoke of the importance of attracting staff with the right skills.

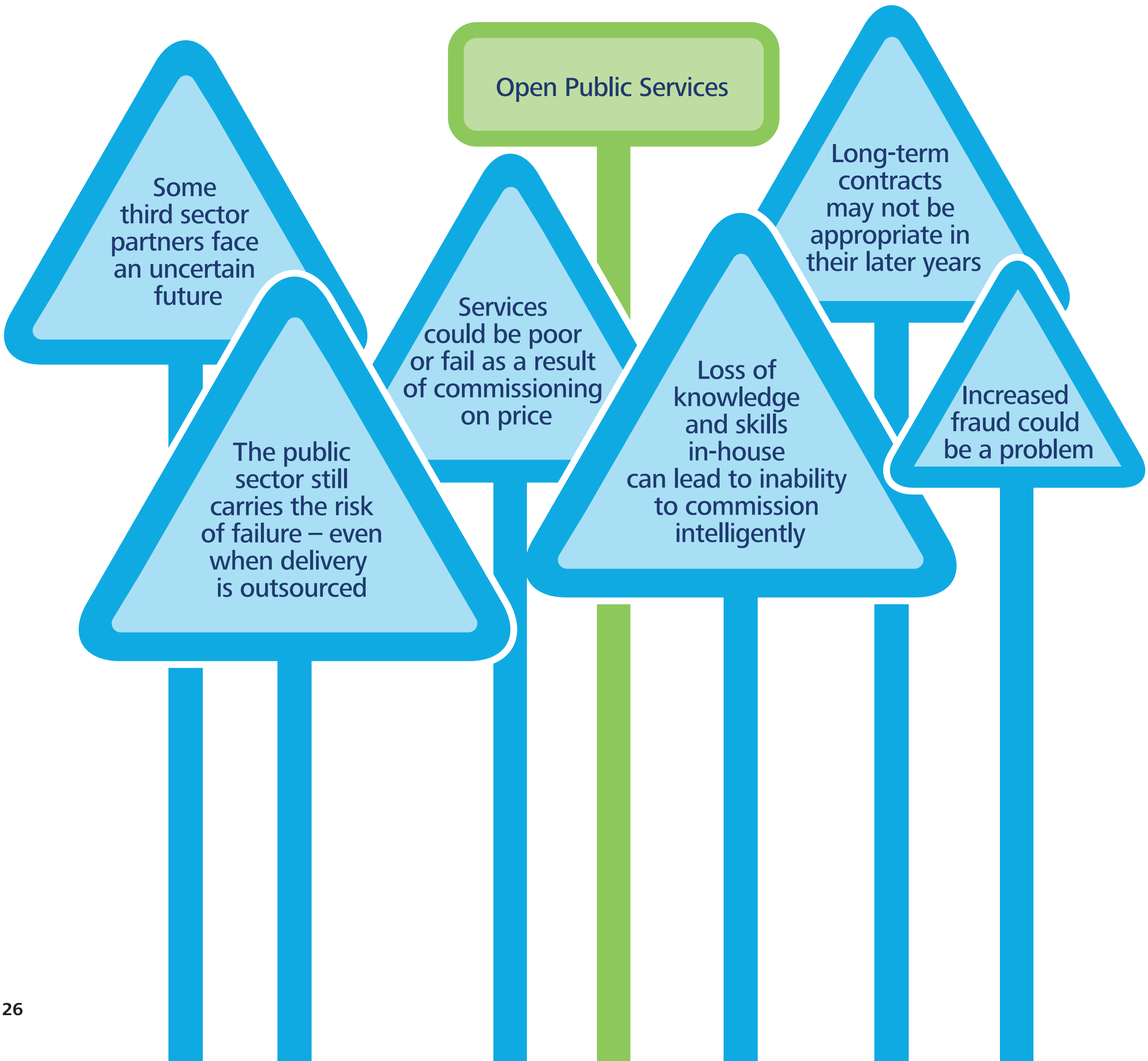
5. A new public services landscape has brought a new set of risks

A number of interviewees told us about the advantages of public sector partnerships in delivering joined-up services, transferring knowledge, and generating savings.

Most thought that partnerships with the private and third sectors were also beneficial. They thought that cross-sector working brought specific benefits including exposure to new ideas and new delivery models, efficiency and quality from the private sector, and local knowledge and niche services from the third sector.

But many interviewees also recognised that commissioning and partnerships outside the public sector brought new, critical risks that needed to be managed – as shown below.

Figure 16. Risks emerging from partnership working with other sectors



The divergent state

The UK state and its public services have never been homogenous across its territory. But more than ever, government and the public sector differ significantly from place to place – not just between the four countries of the UK but increasingly between local areas.

These divergences are an inevitable outcome of devolution and localism and are set to grow wider as the devolved administrations in Northern Ireland, Scotland and Wales stretch their powers and councils adapt to new funding arrangements.

Figure 17. Devolved powers
The diverging union

Northern Ireland

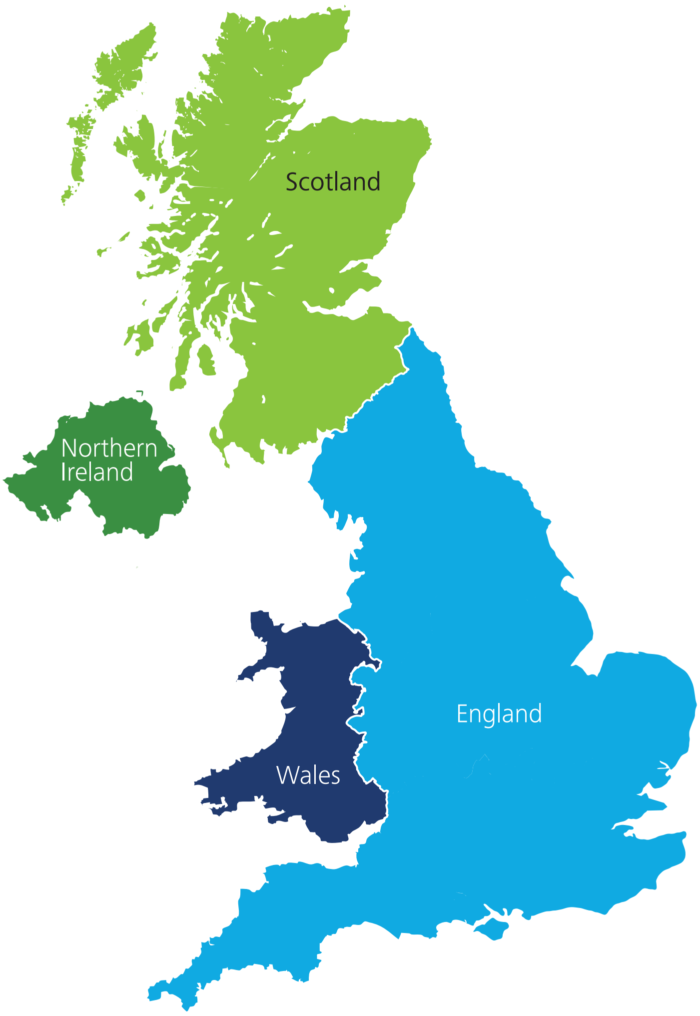
Political leadership: Power-sharing executive of the Alliance Party, Democratic Unionist Party, Sinn Féin, the Ulster Unionist Party, and the Social Democratic Labour Party

Devolved powers include:
- health and social services
- education
- employment and skills
- agriculture
- social security
- pensions and child support
- housing
- economic development
- local government
- environmental issues, including planning
- transport
- culture and sport
- the Northern Ireland Civil Service
- equal opportunities
- justice and policing

Wales

Political leadership: Labour party

Devolved powers include:
- agriculture, fisheries, forestry and rural development
- ancient monuments and historic buildings culture
- economic development
- education and training
- environment
- fire and rescue services and promotion of fire safety
- food
- health and health services
- highways and transport
- housing
- local government
- National Assembly for Wales
- public administration
- social welfare
- sport and recreation
- tourism
- town and country planning
- water and flood defence
- Welsh language



Scotland

Political leadership: Scottish National Party

Devolved powers include:
- health and social work
- education and training
- local government and housing
- justice and policing
- agriculture, forestry and fisheries
- environment
- tourism, sport and heritage
- economic development and internal transport

England

Political leadership: Coalition of the Conservative and Liberal Democrat parties

Retained powers include:
- the constitution
- defence
- immigration and nationality
- aspects of energy regulation
- aspects of employment
- social security
- royal succession
- national security
- nuclear energy
- UK-wide taxation
- currency

Source: www.gov.uk

Our diverging state

The story of devolution in the UK ultimately dates back hundreds of years. 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.

By definition, devolution has opened up policy and spending differences between the countries of the UK. The powers now devolved to the Northern Ireland Executive, Scottish Government and Welsh Government are illustrated in figure 17.

Powers continue to be transferred from Westminster to the devolved administrations, so the divergences will continue to widen. From 2016-17, the Scottish Parliament will be able to set a Scottish income tax rate. Fiscal devolution is also expected for Wales in light of the Silk Commission, and the UK Government has indicated that the Welsh Government should have greater autonomy, funded through a mixture of block grant and self-financing. In Northern Ireland, the Executive is currently pressing for the power to set corporation tax in order to align it with the lower rate in the Republic of Ireland 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, but more funding will be available for capital spending.

Analysis of public spending, along with an assessment of plans in the devolved administrations, throws a spotlight on the key divergences across the UK.

Figure 18. Public spending

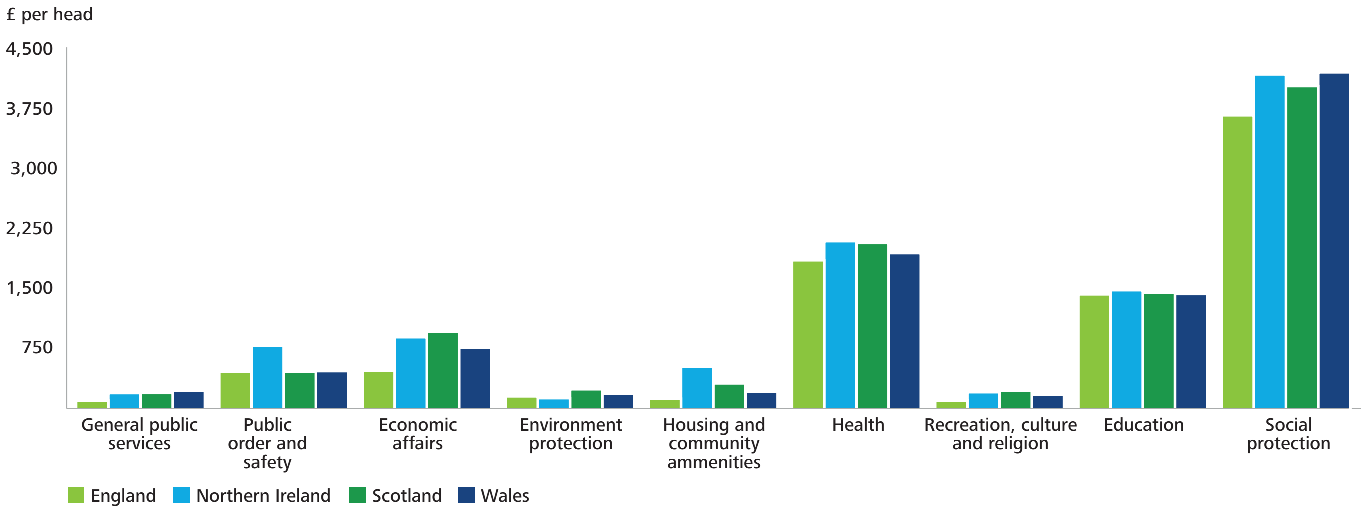
Overall public spending per head 2011-12[65]	
England	£8,491
Northern Ireland	£10,623
Scotland	£10,088
Wales	£9,740

Public spending varies by as much as £3,058 per person between regions and countries of the UK, where the average spending per person is £8,745.

It is important to note that the different levels in public spending in the four countries of 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 seven major spending divergences across the UK, described below and illustrated in figure 19.

Figure 19. UK spending per head
Country comparisons



Source: Public Expenditure Statistical Analyses 2013, HM Treasury

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 among the other countries.

This divergence is likely to widen in the short term as a further £31 million has been made available in 2015-16 to strengthen the NI police service's counter-terrorism capabilities.

2. Economic affairs
Spending on economic development issues is significantly lower in England than in the rest of the UK. Scotland spends 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 to stimulate economic recovery, 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.

This divergence is likely to continue along the same trend. The Scottish Government has been granted £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.

3. Environment protection
Spending on environmental issues is highest in Scotland at £253 per head, second highest in Wales at £194 per head and lowest in Northern Ireland at £141 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.[66]

4. Housing and community services
Northern Ireland's local authorities spend £400 per person more on housing and community services than authorities in England – largely on local authority housing development. 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. In addition, the capital spending mentioned above will continue to keep Northern Ireland spending relatively high compared to its neighbours.

Further devolution is anticipated in Wales to allow Welsh authorities greater flexibility to manage their housing revenue.

5. Health
Health spending is highest in Northern Ireland at £2,114 per head, with Scotland second at £2,091 per head, Wales third at £1,964 and England lowest at £1,874.

A report from the NAO concluded that the key drivers behind the variances are the level of priority given to health spending by the respective administrations and the health needs of the populations and they do not illustrate the effectiveness of the respective health services.[67]

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.

In England, spending per head on social protection is the lowest in the UK at £3,696. The highest spending is in Wales at £4,236 per head – a difference of £540 per person.

Two trends suggest that this divergence is likely to widen in the years to come. First, differing approaches to health and social care integration are likely to be reflected in spending profiles. Northern Ireland's health service already delivers integrated care. Distinct plans exist for NHS England, NHS Scotland and NHS Wales to work with local authorities and other providers to offer integrated care.

Second, different age profiles of the four countries point to different levels of demand in the years ahead. The population of Wales is significantly older than the rest of the UK, with 19 per cent of its citizens over the age of 65. The population of Northern Ireland is significantly younger than the UK average with 15 per cent of its population over the same age. The figure for England and Scotland is 17 per cent.[68]

Figure 20. Public spending and staff cuts by region

Region	Spending cut or rise per head from 2010-11 to 2011-12	Public sector staff cuts from 2011 to 2012 (%)	Public sector staff cuts from 2012 to 2013 (%)
Scotland	+£116	-4.5	-1.4
Northern Ireland	+£95	-2.0	-0.4
South West	+£86	-7.0	-2.2
South East	+£66	-4.6	-0.2
Wales	+£28	-1.5	-1.6
East of England	-£29	-7.2	-3.8
East Midlands	+£5	-4.3	-3.9
England	-£41	-5.0	-2.0
North West	-£44	-4.7	-1.5
Yorkshire & Humber	-£61	-5.0	-1.4
West Midlands	-£66	-4.9	-3.5
North East	-£83	-6.1	-2.3
London	-£237	-3.3	-1.4
UK overall	-£21	-4.5	-1.9

Source: Office for National Statistics and HM Treasury

7. Public sector employment

Levels of public sector employment differ considerably across the UK, and the gaps look set to widen. In Northern Ireland, 28 per cent of the workforce are public sector employees, compared to 26 per cent in Wales, 23 per cent in Scotland and 18 per cent in England. Further detail is provided on page 31.

Job losses driven by spending cuts are widening these gaps. While some English regions cut public sector staff numbers by more then three per cent last year, the average cut across the devolved administrations was one per cent.

Regional divergence

As well as divergences between the countries of the UK, regional differences exist across the English regions. The map on page 31 sets out spending in key areas as well as the latest public sector employment figures.

The Treasury's Public Expenditure Statistical Analyses (PESA) allow for analysis of actual spending on public services per head. The latest PESA figures, covering up to 2011-12, show which regions were affected the most by the UK Government's initial spending cuts, as shown in figure 21.

Figure 20 also shows public sector staff cuts – both for the same year as the PESA figures and the year after. It shows significant differences in the levels of staff cuts across the regions.

A study by the Centre for Regional Economic and Social Research at Sheffield Hallam University suggests that the Government's welfare reforms will widen economic gaps between areas. Its report argued that a number of seaside towns, older industrial areas, and certain London boroughs would be hit much harder than the South and East of England. The study suggests that the impact of welfare reforms in Blackpool will equal a loss of £910 per working age adult per year, compared to a loss of £250 per adult in Cambridge.[69]

Figure 21. Around the UK
Spending per head and public sector employment

Scotland	2010-11	2011-12
Public order	£511	£473
Health	£2,075	£2,091
Education	£1,473	£1,466
Social protection	£3,937	£4,063
Total	£9,972	£10,088

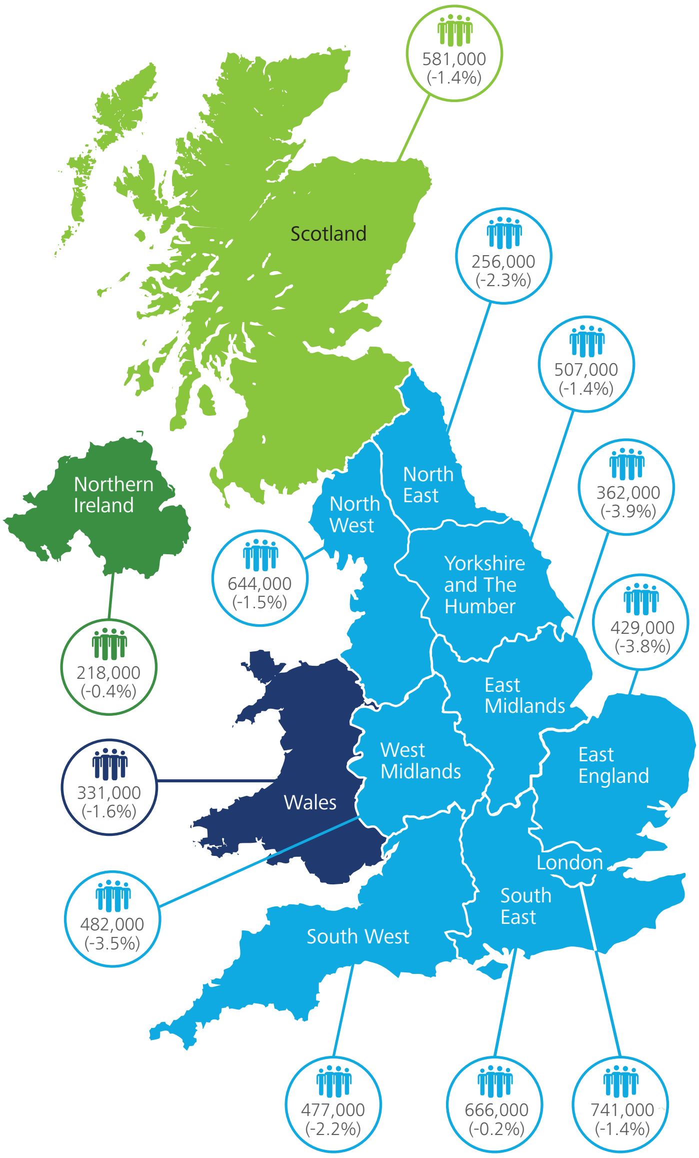
Northern Ireland	2010-11	2011-12
Public order	£806	£799
Health	£2,097	£2,114
Education	£1,528	£1,498
Social protection	£4,032	£4,210
Total	£10,528	£10,623

North West	2010-11	2011-12
Public order	£520	£511
Health	£2,035	£2,029
Education	£1,525	£1,481
Social protection	£3,908	£4,048
Total	£9,224	£9,180

West Midlands	2010-11	2011-12
Public order	£451	£449
Health	£1,871	£1,865
Education	£1,495	£1,449
Social protection	£3,700	£3,814
Total	£8,464	£8,398

Wales	2010-11	2011-12
Public order	£476	£481
Health	£1,989	£1,964
Education	£1,457	£1,450
Social protection	£4,108	£4,236
Total	£9,712	£9,740

South West	2010-11	2011-12
Public order	£381	£384
Health	£1,761	£1,771
Education	£1,359	£1,352
Social protection	£3,594	£3,762
Total	£8,085	£8,171



North East	2010-11	2011-12
Public order	£512	£525
Health	£2,110	£2,095
Education	£1,527	£1,487
Social protection	£4,092	£4,223
Total	£9,472	£9,389

Yorkshire/Humber	2010-11	2011-12
Public order	£477	£465
Health	£1,941	£1,905
Education	£1,496	£1,476
Social protection	£3,651	£3,669
Total	£8,600	£8,539

East Midlands	2010-11	2011-12
Public order	£395	£394
Health	£1,739	£1,728
Education	£1,405	£1,401
Social protection	£3,453	£3,597
Total	£7,780	£7,785

East England	2010-11	2011-12
Public order	£360	£365
Health	£1,730	£1,711
Education	£1,327	£1,368
Social protection	£3,347	£3,597
Total	£8,013	£7,984

London	2010-11	2011-12
Public order	£790	£752
Health	£2,142	£2,102
Education	£1,709	£1,646
Social protection	£3,558	£3,631
Total	£9,850	£9,613

South East	2010-11	2011-12
Public order	£388	£369
Health	£1,699	£1,702
Education	£1,294	£1,328
Social protection	£3,216	£3,354
Total	£7,499	£7,565

Public sector employees in 2013
(% change since 2012)

Spending figures are from 2011-12.
Totals include spending in other areas than the ones shown.

Source: Public Expenditure Statistical Analyses 2013, HM Treasury; Public Sector Employment Statistics, Office for National Statistics

Conclusions

The State of the State creates a snapshot of UK government at a time of unprecedented challenge.

The global financial crisis, coming after decades of unsustainable rises in public spending, created an exceptional set of circumstances for many advanced economies around the world. As a consequence, the UK state will be shrinking by ten per cent in the coming five years to become more affordable.

The political choices made in the past three years to reform some sensitive areas of public spending have been bold. However, *The State of the State* also concludes that the Government elected in 2015 will be faced with tough decisions to move from the 'bold reform' of the past three years to the 'deep reform' needed to improve the UK state's balance sheet by tackling our liabilities.

The State of the State explores some private sector approaches to public sector issues by looking at government 'through a business lens'. The report finds that productivity has become a particularly notable issue. Official figures show that public sector productivity is flat because levels of output from the public sector depend on levels of input. Our study concludes that this link needs to be broken. Some public bodies are already addressing productivity issues and others should follow. Otherwise, levels of activity could fall along with funding levels over the next five years.

It is therefore encouraging that interviews conducted for *The State of the State* suggest that the people leading our local public services are steeled for the challenges they face. But while they remain determined and focused, they shared a number of concerns in the interviews. Many expressed worries that welfare reforms will increase demand on their local services; the recession that has come in the wake of the financial crisis has already put pressure on many families.

The State of the State also explored public services and public spending in the context of devolution. Our report finds that the UK is diverging, politically and economically, and that spending cuts are widening the gaps between local economies.

In conclusion, *The State of the State* shows that the UK Government is at a decision point in its history. For UK citizens, the state is going to become smaller in increasingly noticeable ways. For people working in the public services, productivity improvements will be key to mitigating the spending cuts. And for the UK's politicians, the tough decisions of the past three years will need to be followed by tougher decisions in the coming years in order to create a new, lasting model for the UK state.

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