The state of the public finances

Introduction

Some seven years after the global financial crisis, the UK continues to deal with its consequences for the public purse. While economic recovery is well established, public sector austerity will remain throughout this UK Parliament as the Government strives to eliminate the deficit that the crisis created. Beyond 2020, once the deficit has been eliminated, the longer-term challenge of reducing public sector debt back to pre-crisis levels could take decades. In the meantime, signals of financial distress have started to emerge from some organisations in the local public services. This chapter explores the state of the public finances.

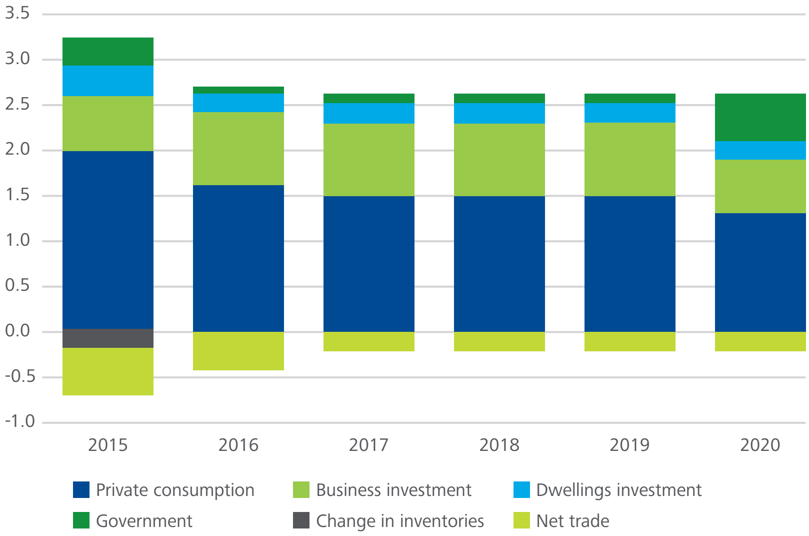
From recession to growth

After the 2008 global financial crisis, the UK entered its deepest recession since quarterly data was first published in 1955.[6] But after returning to its pre-crisis level last year, the economy looks set for continued, steady growth. The Office for Budget Responsibility (OBR) forecasts 2.4 per cent GDP growth this year and every year to 2020, with a slight dip to 2.3 per cent in 2016 to account for fiscal consolidation measures.[7] That outlook is also reflected in Deloitte research that suggests chief financial officers in UK companies are among the most optimistic for revenue growth in Europe.[8]

Figure 2 shows elements of expenditure that the OBR expects to drive growth over the next five years. The resurgence of government spending as an element of growth is notable in 2020 when it is expected to grow again in line with national income.

Sustaining this economic growth is of course a significant preoccupation for the Government. The International Monetary Fund (IMF) has warned that the UK needs to contain financial stability risks from housing and mortgage markets to protect growth. But more fundamentally, for some years it has argued that improving productivity should be a policy priority.[9] The UK's weak productivity is well documented: our economy has the second lowest in the G7 and for every hour of work, the US produces almost one third more output.[10] This is such a complex and deep-rooted problem that even the Bank of England has acknowledged there is no single, credible explanation for the UK's 'productivity puzzle'.[11]

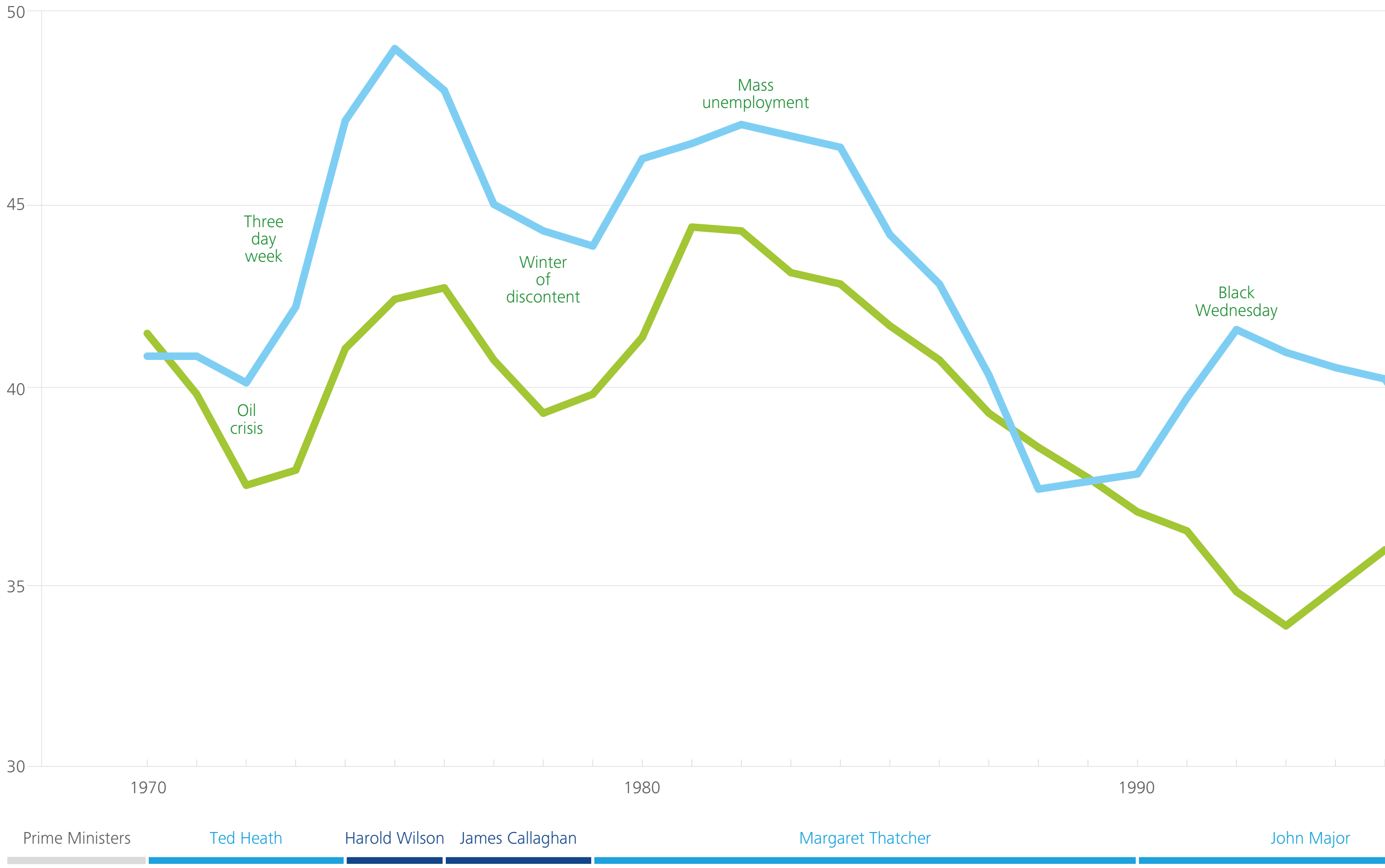
Figure 2. Where wil the growth come from?
Percentage points



Source: Economic and Fiscal Outlook, Office for Budget Responsibility, July 2015

In July 2015, HM Treasury published a wide-ranging analysis of productivity's main drivers and set out an improvement programme that encompasses tax, workforce skills, transport, digital infrastructure, regulation and more. These interventions will require focus and energy over years to drive change, and the full impact of the Government's productivity plan may not be evident until beyond 2020.

Figure 3. Fifty years of UK public finances
Per cent of GDP



Sources: Office for Budget Responsibility, National Archives

Eliminating the deficit

The global financial crisis in 2008 hit the UK's public finances hard. Figure 3 shows the relationship between tax and spending for the past 50 years, including the impact of key economic events.

The recession that came in the wake of the crisis pushed tax income down and public spending up. The gap between what the Government was earning and what it was spending – the deficit – grew to a post-war record in 2010, when the Government spent £154 billion more than it earned. Elected that year, the UK Coalition Government's defining aim was to eliminate the deficit, closing the gap between its income and spending to make the public sector more affordable.

After a five-year programme of deficit reduction, broadly 80 per cent through public spending cuts, the deficit is expected to stand at £69.5 billion this financial year. The Coalition ultimately reduced it by half, leaving the remaining half to be reduced in this UK Parliament. Under the new Conservative Government, the target date for the deficit's elimination and a shift to a surplus is now 2019-20.

Policy decisions continue to make a substantial difference to the deficit. The OBR reports that higher than expected receipts from income tax, VAT and stamp duty, along with in-year Whitehall cuts, plus decisions to increase the insurance premium tax rate and delay the introduction of tax-free childcare, have reduced the deficit by £5.8 billion.[12]

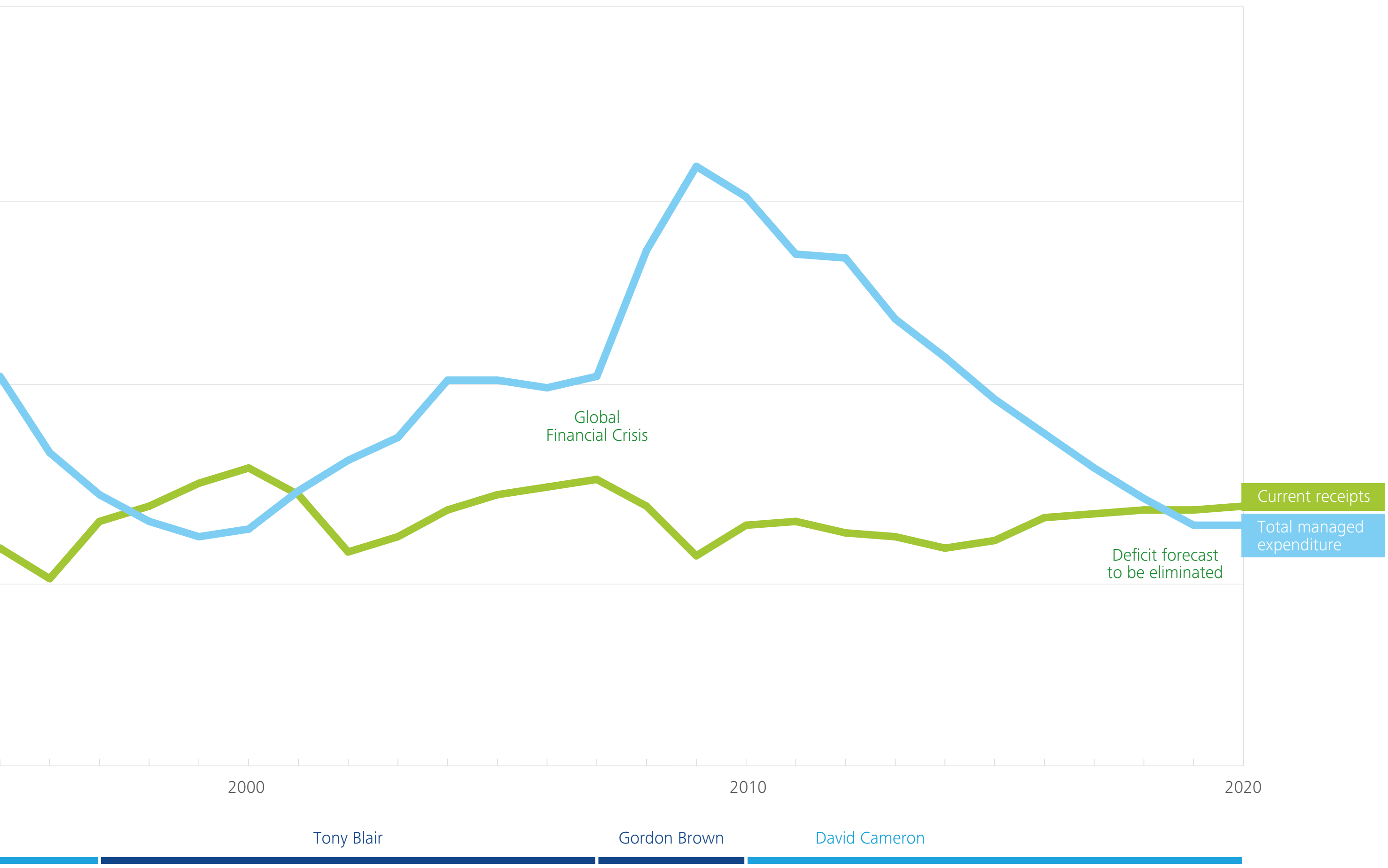
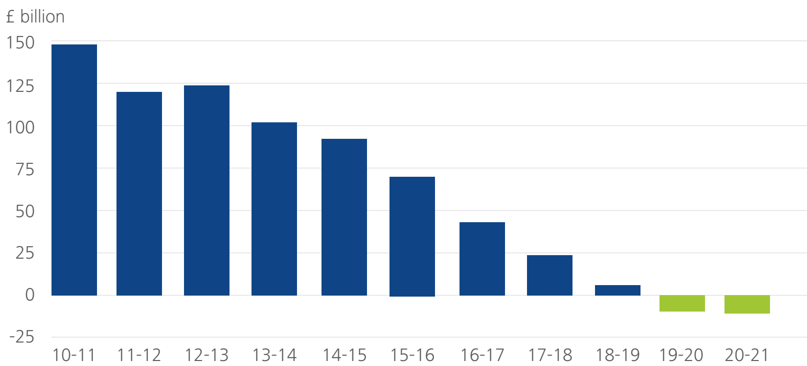


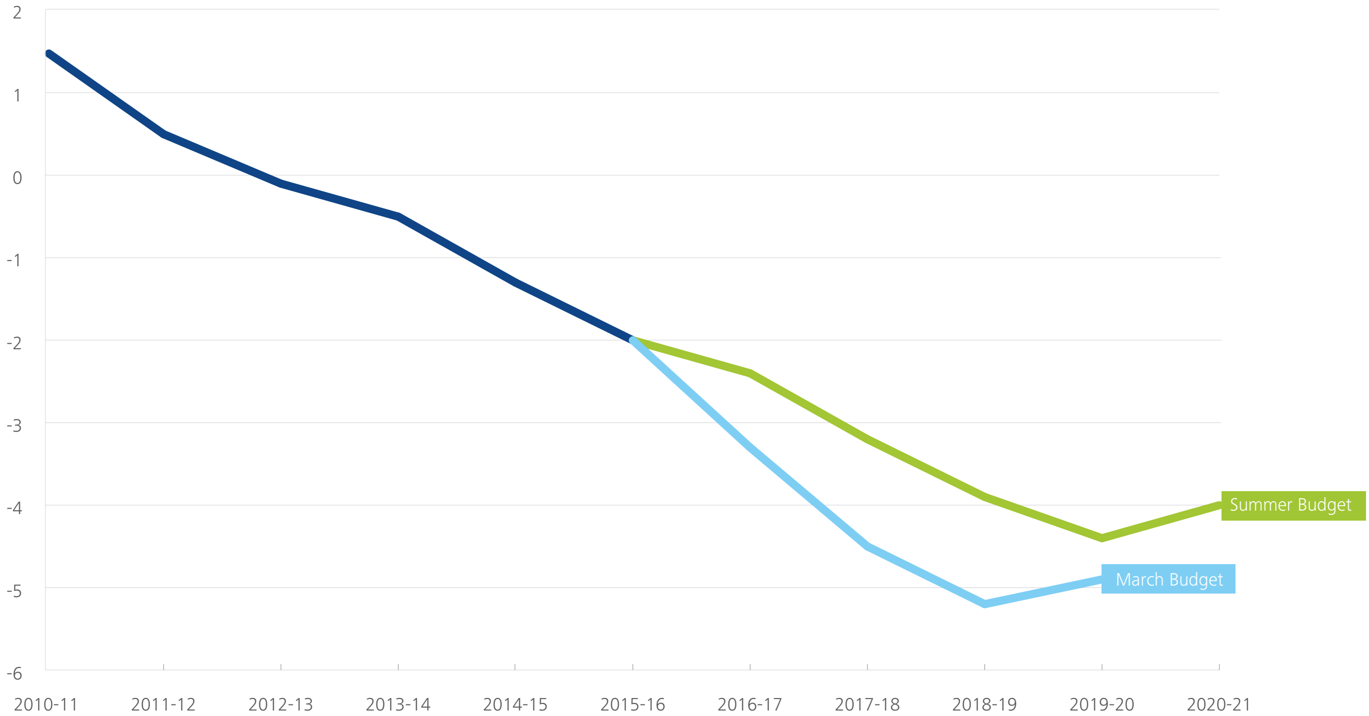
Figure 4 shows deficit reduction in the last UK Parliament and the forecast for its continued reduction to 2020-21. The remaining deficit amounts to 3.7 per cent of GDP, and official forecasts suggest that eliminating 2.4 per cent is likely to come from cuts to public spending and administration.

Figure 4. The deficit
Public sector net borrowing



Source: Office for National Statistics

Figure 5. The austerity decade
Change since 2007-08 (per cent of GDP)



Source: Office for Budget Responsibility

Figure 5 shows the outlook for Resource Departmental Expenditure Limits, a good guide for spending on public services and running the state, for this UK Parliament.

As the figure also shows, that outlook changed substantially between the Coalition's March Budget and the Conservative's July Budget. In March, spending cuts scheduled for 2016-17 and 2017-18 were twice as deep as the deepest annual cuts in the previous parliament, which would have eliminated the deficit by 2018-19.

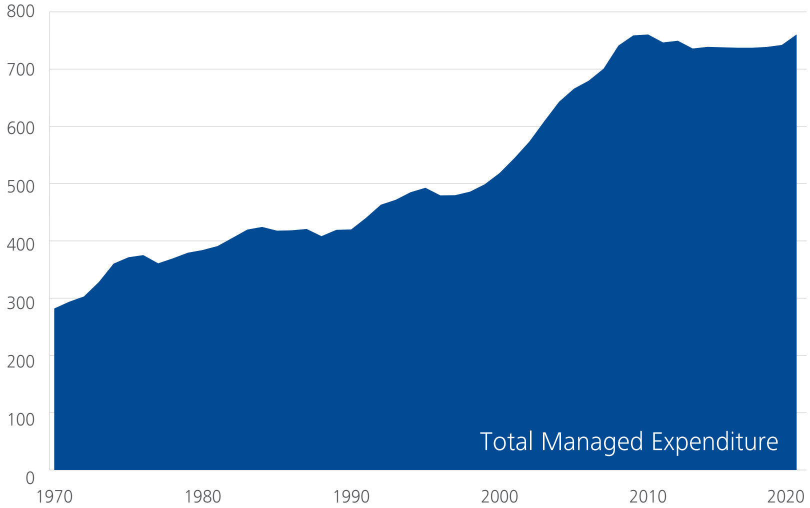
By July, with the election returning a Conservative majority government, the Chancellor delivered a new Budget that effectively cancelled £83.3 billion of spending cuts from the March Budget. But the Government is making that possible by running a deficit for one further year, eliminating it by 2019-20.

This smoother public spending profile does not mean that austerity has ended, but spending cuts will continue in this Parliament at the same rate as last. Figure 5 also shows how those cuts are accumulating to a substantial shift in the UK's level of government spending. An even longer perspective in Figure 6 shows how all governments of the past 50 years increased public spending, but that trend was reversed by the last Government and public spending will not return to growth until 2019-20.

Figure 7 shows a global perspective of how the UK's public spending level changes in comparison to this peer group. While the G7 governments as a whole reduce their public spending by 9.6 per cent as a share of their GDP over this decade, the UK is set to reduce its spending by 19.5 per cent.

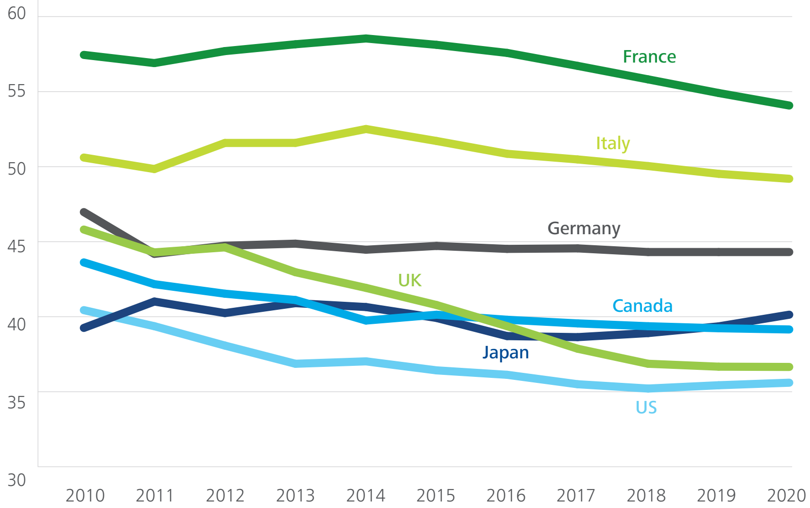
The figure shows that the UK is the only G7 government making such a fundamental shift of spending level through fiscal consolidation. Looking beyond the G7, IMF data shows that UK government spending was the 16th highest of the 37 most advanced economies in 2010, when measured as a percentage of GDP. The UK has since dropped to the 21st and is projected to be the 26th highest by 2020 – a drop of ten places in ten years that will see our closest public spending peers change from Norway and Spain to the US and Australia.[13]

Figure 6. Fifty years of public spending growth
£billion at 2013-14 prices



Source: Public Finances Databank, Office for Budget Responsibility

Figure 7. Public spending in the G7
Per cent of GDP



Source: World Economic Outlook database, IMF, April 2015

Paying down the debt

Reducing the deficit is the first and most pressing challenge for restoring the UK's public finances. Once that remedial action is taken, the next challenge is to reduce the substantial level of debt that the deficit has created. Just before the global financial crisis, UK government debt was £562 billion, or 37 per cent of GDP. But when governments run a deficit, they borrow to make up the shortfall by issuing gilts, so since 2010-11 public sector debt has increased by £403 billion. This financial year, UK public sector net debt reached £1,506 billion, or 81 per cent of GDP. By the EU's Maastricht Treaty definitions, UK debt was 89 per cent of GDP at the end of the financial year ending in March 2015. Either measurement places the UK well beyond the EU's 60 per cent limit for any country wishing to join the euro.[14]

Government debt currently equals £23,428 for every UK resident, and every income tax payer would hypothetically need to contribute £50,943 to pay off the full amount immediately. Such a high level of debt exposes the UK to risk in the event of further financial crises, vulnerability to fragile external forces such as interest rates and a burdensome level of debt service payments for the taxpayer. This financial year, the Government's net debt interest bill will be £36 billion, taking into account the effect of the Bank of England's Asset Purchase Facility. That is more than the police and criminal justice system's annual budget.

HM Treasury modelling published alongside the Summer Budget suggests that debt will remain higher than before the financial crisis for at least the next 20 years, even in a best case scenario where successive governments run a continued budget surplus and no adverse events harm the economy.[15] Children born at the height of the financial crisis may still be able to see its debt legacy on the Government's balance sheet into their adulthood.

Further analysis of the Government's debt position follows in the next chapter.

Distress signals from the local public sector

In the past year, signals have emerged that some local public sector organisations – councils, NHS bodies, police forces and further education colleges – could be facing financial distress as a result of funding reductions and shifting patterns of demand for their services.

For local government in England, the past five years have seen a 37 per cent real terms reduction in funding according to the National Audit Office (NAO).[16] While the Welsh Government shielded its councils from austerity for much of that period, councils in Wales have faced a three per cent reduction this financial year. In Scotland, the national audit body identifies a reduction in funding for councils of 8.5 per cent in real terms from 2010-11 to 2013-14. In Northern Ireland, the 11 newly-amalgamated councils have raised concerns with the Executive over funding levels.

At the same time, demand for services including social care, social housing and concessionary fares has risen and will continue to rise.[17,18] Since 2005, the number of people aged over 85 – and most likely to need social care support – has gone up by a third, and two out of every five councils in England will have more children ready to start primary school in 2016 than they have places.[19,20] The Welsh Local Government Association (WLGA) has noted that council spending on schools and social services continues to put pressure on budgets and Audit Scotland warns of increasing demand for social care and education, driven by changes in Scotland's population.[21,22]

The NAO reported concerns in 2014 whether 52 per cent of single and upper tier local authorities would be able to deliver their medium-term financial plans.[23] There is no precedent for financial failure in local government, because councils are legally required to set balanced budgets and are therefore prevented from running deficits – in other words, they cannot become insolvent. That means financial difficulties in individual councils might only become evident when services fail, with potentially distressing consequences for the public.

A similar picture has emerged in Further Education (FE), which remains integral to local skills and employment strategies even if it is no longer technically part of the public sector. Between 2010-11 and 2013-14, the number of English colleges reporting a deficit doubled to 110, and the number deemed to have inadequate financial health doubled to 29, from a total of 244 institutions.[24] The Skills Funding Agency (SFA) believes that 70 colleges will face serious financial difficulties by the end of this current financial year.

Different commentators suggest a variety of forces at play in FE. The 157 group of colleges has pointed to a systemic problem caused by funding reductions and a legacy of debt from capital building projects.[25] Parliament's Public Accounts Committee has expressed concern that colleges are taking tough decisions on their finances without having the right financial management skills in place.[26] A letter from the Further Education Commissioner in March 2015 urged colleges to look for signs of financial inadequacy that include inaccurate financial forecasts, excessive staff costs and low class sizes.[27]

Distress signals have also emerged from the police. Forces in England and Wales have faced a 25 per cent reduction in funding over the last UK parliament and cuts expected in the years ahead look set to increase financial pressure. Lincolnshire's police chief constable has warned that his force's budget will be unsustainable by 2018, causing it to "fall over".[28] Northumbria's chief constable has said that his force will need to "completely change our set up" in the years ahead.[29] That echoes the Chair of the National Police Chiefs' Council, who has described the need for a "re-imagination of policing" ahead.[30]

In Scotland, the unified police force faces sustained budgetary pressure. While savings of £1.1 billion by 2026 that formed part of the original business case to merge eight forces look set to be realised, further cost pressures mean yet more savings need to be delivered.[31] After this financial year, a reform fund of £70 million will no longer be available and the Scottish Police Federation has warned of a "stark financial challenge" ahead.[32]

In Northern Ireland, the chief constable of the Police Service of Northern Ireland (PSNI) reported that balancing the service's budget for 2015-16 "has only been possible by making decisions that will have significant operational impacts, both this year and into the years ahead". He added that even a flat budget in subsequent years would mean "very significant gaps" in funding.[33]

For police forces across the UK, rising demand pressures are particularly sensitive to provision in other areas of the public services. In an inquiry into police sustainability, the Public Accounts Committee heard that 78 per cent of police emergencies in 2013-14 were concerned with anti-social behaviour, or other incidents such as mental health-related issues, rather than crime. The Permanent Secretary of the Home Office told the committee that the police picked up a "disproportionate burden of mental health cases… particularly after hours".[34]

In the NHS, continued ring-fencing has not kept it immune from funding and demand pressures. England's NHS trusts and foundation trusts ended the 2014-15 financial year with a record deficit, driven by a combination of high costs for agency staff, rising patient demand and financial plans that proved inaccurate. Some 40 trusts and 77 foundation trusts reported a combined deficit of £822 million compared with £115 million the previous year, and the situation is expected to get worse. Monitor, which regulates foundation trusts, has forecast a deficit of £989 million for 2015-16 which its chief executive has warned is unaffordable.[35] The King's Fund describes this financial year as the most challenging for NHS providers this century.[36]

These financial distress signals suggest a turbulent period ahead for our local public service organisations

While NHS Scotland's finances are not as visibly distressed, health bodies are grappling with increasing demands and Audit Scotland has warned of increasing strain on services at a time of tightening budgets and the need for focused, long-term financial planning.[37]

In Wales, an additional £225 million is being made available this year to address imminent spending pressures. Nuffield Trust modelling points to a shortfall of £2.5 billion in NHS Wales funding by 2025, with the same demand issues arising in Wales as throughout the rest of the UK.[38]

In Northern Ireland, rising pressures triggered temporary measures that included recruitment restrictions, ward closures and the cancellation of some non-urgent surgeries last winter.

Aggregating these sector-wide warnings suggests that more than 200 frontline public sector organisations in the NHS, local government, police and further education could be at risk from financial distress and require intervention in the course of this UK Parliament. Around half of those are NHS trusts.

These financial distress signals suggest a turbulent period ahead for our local public service organisations and some may require performance intervention from within their sector or remedial financial support from central government. While mergers can be a workable solution in many cases, organisations with long-standing, multiple problems may not be attractive propositions for merger with high-performing peers unless central governments provide incentives and support. Each of the UK's administrations need to be clear on the risk of financial failure across the public services and plan for intervention.

Rising demand from an ageing population

Pressure continues to increase on the public finances as a result of the UK's ageing population. Official population projections suggest that the number of people in the UK aged over 85 will increase from 2.4 per cent to 7.4 per cent of the population in the next 50 years.[39] As the King's Fund observes, people born in the post-war baby boom will reach their 80s by 2035, and are more likely to reach that age than their parents.[40]

The ageing population is a very welcome trend, but it comes at a cost for the public purse. A House of Commons report found that the costs of hospital and community services for people over 85 are three times greater than for a person aged 65 to 74.[41] Over the next 50 years, the OBR projects that spending on health will increase by ten per cent, spending on long-term care will double and spending on state pensions will increase by a third in relation to GDP as a result of age-related pressures.[42]

A 2015 study by the European Commission found considerable variety in levels of age-related spending predictions across Europe. It forecast that France, Italy and Greece would see less pressure on public spending by 2060 than the UK, while countries including the Netherlands, Germany and Norway would experience greater pressure. However, the Commission warned against complacency, noting that the impact of ageing on public spending is expected to be high across the EU, with effects becoming increasingly apparent in the next decade.[43]