Government Renewal and Reform in EMEA

A Deloitte Commentary

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Reform of any public service is a significant undertaking as it involves changes to the work practices and organisational structures of the many thousands involved in the service, and impacts on the reciepients of that service. Reform always requires political commitment: it has generally only been successfully achieved by a government that had a strong political mandate to deliver it, and who was able to deal with the inevitable negative impact that certain reform initiatives can sometimes generate.

At Deloitte we understand the complexity of these changes. We have supported governments in delivering the significant changes required to successfully achieve a reform of their cost base and service delivery models.

The fallout from the financial crisis has continued unabated across EMEA with the debate moving from the implementation of austerity measures as the only option to seeking solutions that drive greater economic activity in the region. Political choices and funding strategies have driven different approaches across each country - with Ireland, Greece, Portugal and Cyprus receiving third party support from the troika and many others obtaining support in similar ways (aid to the banking sector, ECB bond-buying programme, European Commission budgetary support and so on). Other states, some considered “too big to fail”, are adopting various measures to tackle the crisis and are at different stages in their recovery. We have undertaken a focused review of Spain, France, Italy, Ireland, Greece, and Cyprus – and established that the funding required to bridge the combined deficit faced by these countries would require an overall cut in programme expenditure of 25% or an increase in tax revenue of 17%. The scale of these measures is so huge that a mixed approach is obviously required. Even then, implementing them at all - particularly at a time of low or no growth – is a daunting prospect. And clearly neither of these solutions are practicable on their own.

Deloitte’s Government Renewal and Reform programme is an EMEA initiative which brings together our global experience to support EMEA governments in tackling the current economic crisis. Deloitte has considerable experience in supporting countries and regions around the world –with the implementation of cost reduction initiatives, enhancing tax policies and/or driving economic activity.

We have specific plans in place to support Greece, Cyprus, Spain, France and Italy through 2014. We will work with those and other member firms in EMEA and with our global value proposition leaders to develop strategies and plans to contribute to government renewal and reform.

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Executive summary

Many countries in the Europe, Middle East and Africa (EMEA) region are experiencing hard times due to a large fiscal imbalance between expected revenues and committed expenditures. While this imbalance in itself is not necessarily a new feature, its scale and the general economic environment in many countries - coupled with the recent financial crises - has exacerbated the issue.

The key question for governments today is – how to go about developing the right portfolio of initiatives to structurally reduce the fiscal deficit?

> "What is the right portfolio of initiatives to structurally reduce the fiscal deficit?"

Our research has shown that countries move through a number of phases when dealing with this scale of fiscal imbalance. During the early phases, governments generally reduce programme expenditure and seek to increase revenue; however, this is neither a sustainable nor complete solution. In fact, across the seven European countries we researched, they would need to decrease programme expenditure by 25% or increase tax revenue by 17% just to establish a public fiscal balance. This is in an environment where all seven countries have increased their relative expenditure (as a percentage of GDP) since 2006, and only three of the countries have had a sustained year-on-year reduction in expenditure of more than one year (Ireland, Greece and Portugal) – i.e., general expenditure is increasing. In addition, while revenues in each country have seen significant changes since 2007, no country has achieved anything like a 17% increase. The general absence of real growth in most European economies (and occasionally real decreases in economic activity) has further handicapped governments' ability to increase revenue.

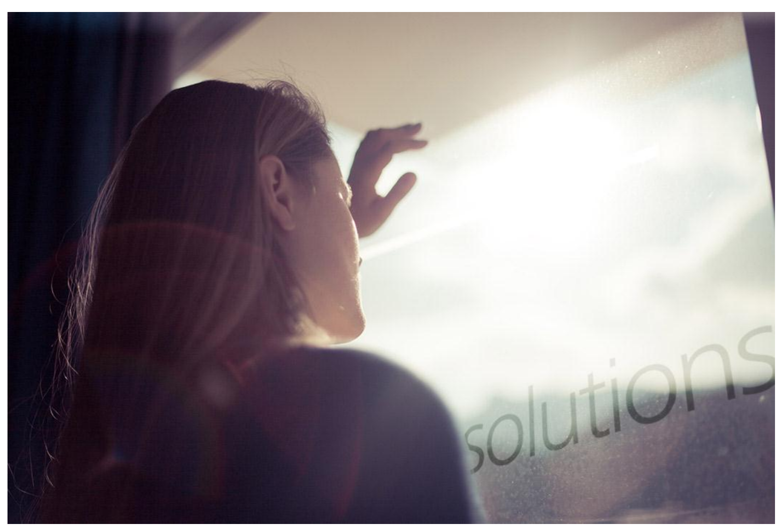
Given the evidence that reducing programme expenditure is a major challenge and that increased revenue is slow to come in, alternative means of public service delivery offer a significant new mechanism to reduce government spending. This includes a reduction in the pay and pensions costs of the government, enabled through efficiencies in working arrangements such as shared service centres, greater use of more cost-effective channels and through the better leveraging of existing data. While many states can drive efficiencies in this area, the scale of efficiency required would necessitate in excess of a 50% reduction in pay and pensions while the alternative solutions will often require capital investments. This can seem to lead to a "do nothing" strategy, and often requires an external intervention to enable action.

Developing the portfolio

The GRR lifecycle is the natural cycle that governments go through in adjusting their cost base and achieving more efficient operations. Our experience in supporting governments through this financial crisis is that most states go through five significant phases:

- Stability Phase. The economy experiences acceptable output growth, low and stable inflation, and low unemployment.
- Prelude Phase. The government recognises the underlying challenges and achieves an agreement on the magnitude of the problem.
- Fire Fighting Phase. The government crafts a workable political blueprint for moving forward, and prepares for a possible external intervention.
- Adjustment Phase. With the support of international lenders, necessary action is taken to reform policy such that a return to the bond market would be possible. Some countries make the necessary adjustments without requiring intervention.
- Recovery Phase. The governments subject to a third party intervention leave the support programme and are again entirely financed from the bond markets. Budget deficit is again below 3% of GDP.

These phases are interconnected as illustrated in the diagram below.



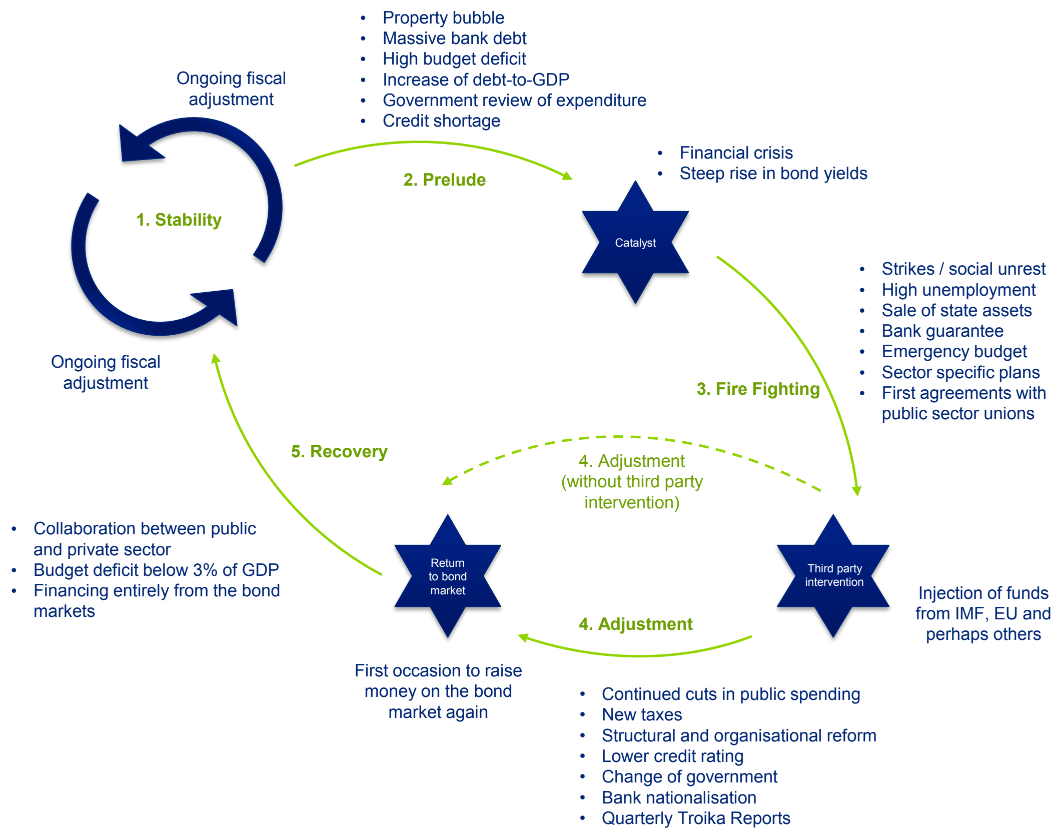


Figure 1 – Illustrating the Different Phases in the Government Reform and Renewal (GRR) Lifecycle

To identify the optimal portfolio of initiatives, we investigated the extent to which the different measures have been and are currently being used in seven European countries1 throughout the GRR lifecycle. We found that further reduction of the programme expenditure is problematic (Section 1.2.1) and that revenue increases are only occurring in a limited manner (Section 1.2.2). As a result, alternative means of service delivery need to be explored as a means of reducing costs (Section 1.2.3). Lately, governments have become even more challenged and must find new ways to fund and drive economic stimulus both to reduce costs and boost economic growth – through vehicles including private sector partnerships and strategic alignment around key growth industries.

Reducing programme expenditure is a major challenge

Programme expenditure covers the cost of programmes delivered by government and consists of operating and capital spending as well as transfer payments to individuals, not-for-profit organisations, businesses or other levels of government. Examples of programme expenditure include social benefits, health, education, and infrastructure spending.

Expenditure has increased significantly since 2006, with small pockets of reduction

[1] Ireland, Greece, Cyprus, Spain, France, Portugal, and Italy. A detailed overview of the measures taken per country can be found in Annex 1.

All seven countries have increased their relative expenditure (as a % of GDP) since 2006, and only three countries have had a sustained year-on-year reduction in expenditure of more than one year (i.e., Ireland, Greece and Portugal). In fact, all seven countries had a higher level of expenditure in 2012 than they did in 2007.

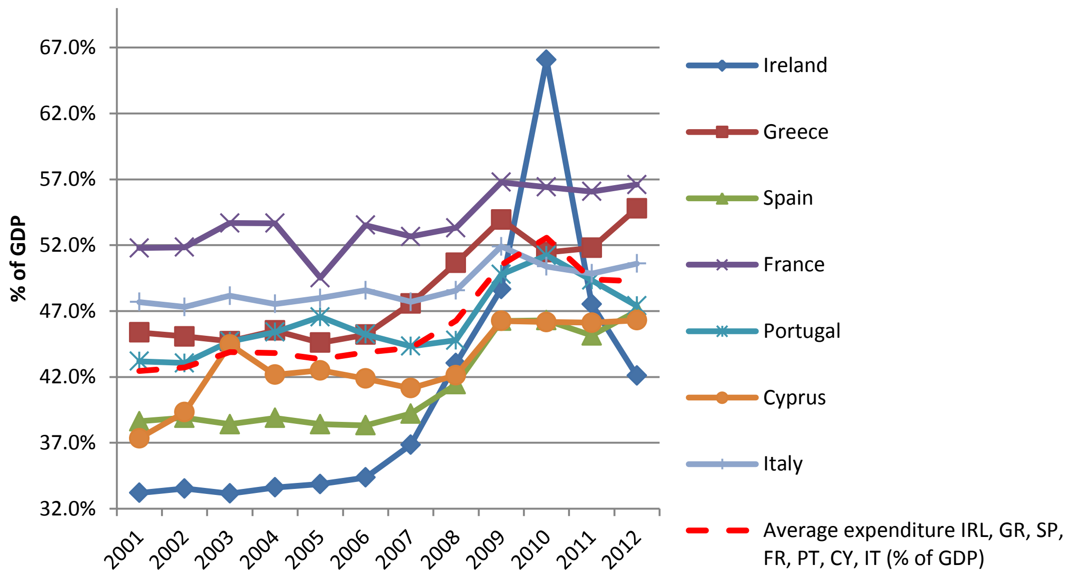


Figure 2 – Evolution of government expenditure (as a % of GDP)[2]

Programmes are entitlement-driven, making it hard to cut programme expenditure

Government programmes tend to be entitlement-driven – requiring very tough political choices and generally forcing an overall increase in expenditure:

- The rise in unemployment has exerted heavy pressure on the social benefit budget;
- Health expenditure such as entitlements to free or subsidised care and other benefits have increased as a direct result of increased unemployment;
- Demographic pressures, such as growth in birth rates, have implications for education programme expenditure;
- Most infrastructure investments are difficult to stop or reduce, as they are multi-year commitments.

Programme expenditure would need to decrease by 25% to establish a fiscal balance

In order to establish a fiscal balance by reducing programme expenditure, the average programme costs in

[2] Source: Eurostat government finance statistics (2012)

the seven countries would have to be cut by 25% (compared to the 2012 programme costs)[3]. This is a massive challenge given the above elements.

Governments have found it difficult to reduce programme expenditure, and in the current environment of low economic activity any future reduction will be very difficult to deliver.

Revenue increases are only occurring in a limited manner

Revenue can be increased in many different ways, such as expanding the tax base; reviewing existing anti-avoidance, anti-fraud and transparency laws; combating fraud; ensuring compliance with tax obligations; and improving revenue generation through better debt collection, campaigns, and tax amnesties.

However, revenue increases are only happening in a limited manner as the European Union is already a high tax zone and taxes have been raised regularly since 2009. Again, this challenge is enormous - revenue would need to be increased by 17% to establish a fiscal balance.

The European Union is a high tax zone

In 2010 the tax ratio in the 27 Member States (EU-27), averaged 38,4% of GDP which is more than 40% above the levels recorded in the United States and Japan[4]. This clearly makes it difficult to increase taxes further – without dwelling on the negative impact such a step would have on economic optimism.

Tax revenue has increased regularly since 2009

During 2007-2009, government revenue decreased due to economic recession and a shrinking tax base. As a result of additional tax measures, revenue increased again between 2009 and 2012.

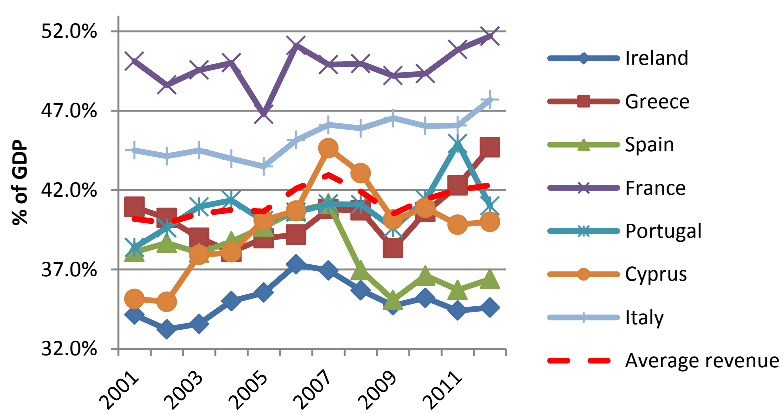


Figure 3 - Evolution of government revenue (as a % of GDP)[5]

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[3] Just for comparison purposes, government pay and pension expenditure in the seven countries would have to be cut by 59% (compared to 2012 levels) to bridge the deficit.
[4] Taxation Trends in the European Union (2012), p19
[5] Source: Eurostat government finance statistics (2012)

Revenue would need to be increased by 17% to establish a fiscal balance

In order to close the deficits through increased revenue, an average revenue increase of 17% would be required in the seven countries (compared to the 2012 revenue level). To achieve this, significant growth in the economy would obviously be required. The current austerity environment exacerbates the dilemma facing governments – how to reduce the deficit to secure affordable financing while simultaneously promoting growth. This reality makes achieving revenue growth of 17% very implausible in the medium term.

Changing government service delivery offers an alternative means of reducing costs

The cost of service delivery is a function of the different channels employed by government to deliver services (incl. general administration, health, social welfare, education, justice and defence), the number of staff required, their capability and profile and how they are organised. There are often significant latent costs, and savings can be realised through a redesign of the government's service delivery model to its citizens.

Solutions to redesign the government's service delivery model focus on shared services, asset sales, external service delivery, business process improvement, workforce planning and redeployment, etc.

Most countries started to reduce service delivery costs in 2008

Between 2001 and 2008, in most countries the average pay and pension expenditure increased significantly; in some countries (Italy, France) this expenditure remained fairly constant; and in one country (Portugal) expenditure decreased considerably. Nevertheless, from 2008 onwards, the pay and pension expenditure began to drop uniformly in all countries except Greece. Sadly, this significant effort tends not to be sustainable (see below)

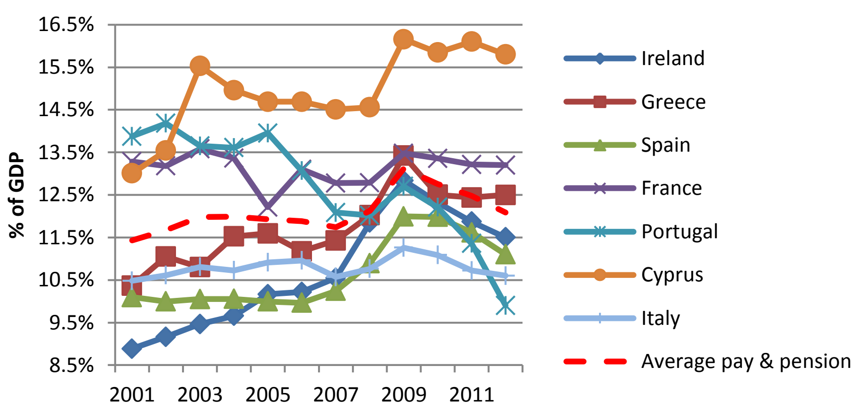

Figure 4 – Evolution of pay and pension expenditure (as a % of GDP)[6]

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[6] Source: Eurostat government finance statistics (2012)

It takes several years before the full benefits of efficiency improvements are visible

Most countries started to reduce pay and pension expenditure by using short term measures, such as cuts in wages of public servants (up to 10%), pay freeze or reductions in numbers of employees. Our research has shown that unless there is a structural redesign of service delivery, the pay and pension costs grow back to the original levels in the medium to long term. For instance, in Italy short term measures did not enable sustainable cost reduction, while in Portugal more structural measures (such as privatisation) led to a solid reduction in pay and pension expenditure.

It is through attempts to drive long term efficiency that new models of service delivery have been developed and are gaining acceptance.

A new economy?

Many of the cost management strategies outlined in the previous sections are considered to form part of countries' austerity programmes. Governments have realised that they have to go further than traditional cost reduction and revenue enhancement efforts to find and implement innovative means of service delivery – such as private sector partnerships - and support strategic alignment around key growth industries to fund and drive economic stimulus.

We are witnessing a change in how society deals with its own problems — in which government acts as just one player among many, and entrepreneurship and innovation range freely across all sectors. A new "Solution Economy" is emerging where the traditional role of public and private sector entities are becoming blurred. These new entities are filling the gap between what governments currently traditionally provide and what society requires.

This has been recently illustrated in the UK in the area of employment contracting. Deloitte and Ingeus have partnered to provide outcome-based employment services, and have been awarded contracts with the UK government as the leading supplier for the new Work Programme - the government's flagship initiative to tackle long-term unemployment. Through the programme, the government only pays its service providers if they succeed in placing people in employment. This protects the government's investment and creates a real focus on results.

Conclusion and next steps

We have noted that countries go through a number of Government Reform and Renewal (GRR) phases in responding to the fiscal crises. Typically, the earlier phases are led by the government of the country and involve many of the tactical fiscal measures referred to above. It is in the later phases, perhaps when the government of the country has less control, that changes which result in a more systemic reduction of the cost of service delivery begin to occur. The issue is often that these changes can take a number of years before they take effect, as they have a long term impact.

Our contention is that countries should adopt these measures at an earlier stage in the GRR cycle and that, combined with a portfolio of programme savings and tax policy changes, will lead to a better structure to the cost base within government in the medium term with the best chance of providing resources for investment.

Good examples of this are the Nordic countries[7] – Sweden redesigned the fundaments of the government's service delivery model to its citizens in the 1990s, including a thorough pension reform (e.g., replacing a defined-benefit system with a defined-contribution one) and allowing private companies to compete with government bodies for public contracts (e.g., in education and health). This contributed to a lowering of public debt from 70% of GDP in 1993 to 37% in 2010, while its budget moved from an 11% deficit to a surplus of 0.3% over the same period.

By lowering the overall fixed cost for delivery of government services, the need for savings from either programme cuts or revenue raising measures is reduced. Our observation is that when the decision making process is influenced by an external third party (such as the troika in Ireland and Greece) that these more structural cost saving measures are considered (see Annex 1 for more information about these measures).

Key strategies for successfully delivering renewal and reform

Once the political leadership has decided to tackle reform, there are some key considerations to ensure that it is effectively delivered. These include:

- Leveraging the mandate. A new government needs to ensure that reform is part of their mandate, as it is very difficult for an incumbent government to implement cost reductions that were not tested with the electorate.
- Establishing a clear leader. Successful public sector reform initiatives have been driven by a cabinet level leader who worked with a mixed public and private sector team seconded to their ministry. It is only by assigning a leader at this level that true change can be delivered successfully. And a mix of public and private sector expertise helps ensure that the programme doesn't suffer from the Tolstoy syndrome which has bedevilled many large public sector change initiatives.
- Creating a vision. To successfully deliver significant change, the stakeholders of that change, in this case the employees, customers and leaders of the public service need to understand the purpose of the change and what the future might look like. In Ireland, a strong vision was defined in the Public Service Reform Plan (2011), which expressed the need for more customer-centricity, innovative service delivery channels, radical cost reduction, working in new ways, and keeping a strong focus on delivery.
- Obtaining buy-in. Active stakeholder engagement is required to deliver buy-in to any initiative. Public Sector reform can conjure up negative imagery – so providing a vision that the key stakeholders (citizens

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[7] The Economist February 2˜8 2013 – Special report: The Nordic Countries

and employees) can focus on, that provides insight to the end state and a positive image to aim towards is a key contributor towards achieving buy-in. It also helps to deal with the more negative elements of the reform or cost reduction initiative. Recently, the importance of this principle was illustrated in the UK during several Whitehall transformations: in the departments where staff were most positive about change, leaders communicated directly; engaged staff in setting direction for the department; supported managers and ran redundancy selection processes that were perceived to be fair and efficient.

Reform of any public service is a significant undertaking as it involves changes to the work practices and organisational structures of the many thousands involved in the service, and can often impact on the clients of that service. Reform always requires political commitment: it has generally only been successfully achieved by a government that had a strong political mandate to deliver reform, and who was able to deal with the inevitable negative impact that certain reform initiatives can sometimes generate.

Deloitte understands the complexity of these structural changes. We can support governments to alter traditional structures and instil a positive working environment - delivering high-quality service in a sustainable way.

Appendices

Appendix A 11

Appendix A

Overview of GRR measures per phase for Ireland, Greece, Portugal, Spain, Cyprus, Italy and France

		Ireland	Greece	Portugal	Spain	Cyprus	Italy	France
Prelude		**Duration : 12 months (start in 2006)** • Property Bubble • Massive Bank Debt	**Duration : 12 months (start in 2006)** • Large structural deficit • Widespread tax evasion • Statistical Credibility	**Duration : 12 months (start in 2006)** • Structural Deficit • Massive public sector wage bill • Complex legal system	**Duration : 12 months (start in 2006)** • Property Bubble • Inflation rate above EU average • High public spending	**Duration : 12 months (start in 2006)** • Large off-shore banking industry • Low tax rate • Statistical Credibility	**Duration : 12 months (start in 2006)** • Large public debt • Low growth • Large bureaucracy • Widespread tax evasion	**Duration : 12 months (start in 2006)** • Large public debt • High public spending • Heavy regulation
Catalyst			*Financial crisis / Rise in interest rates*					
Fire Fighting	**General**	**Duration: 23 months** • Bank Guarantee • Emergency Budget • Croke Park Agreement • Establishment of NAMA • Public Protests	**Duration: 16 months** • Public Protests • High unemployment	**Duration: 29 months** • General Strikes • Bond interest rates rise	**Duration: 47+ months** • Recapitalisation of banks • High unemployment	**Duration: 24+ months** • Falls in tourism and shipping activity • High unemployment • Haircut during the Greek government-debt crisis • Emergency loan from Russia to cover its budget deficit and re-finance maturing debt	**Duration: 6+ year** • Government bond yields went above 7%	**Duration: 6+ year** • High unemployment
	Tax increases	• Changes to personal income tax • Increase in indirect taxes	• Pensioners' Solidarity Contribution • Raising of the child tax allowance • Increases in the standard rate of VAT • Excise duty increased • Personal income tax made more progressive • Tax base extended • Reductions in the tax allowed on charitable donations	• Reducing the pensions tax allowance • Increase in standard VAT rate (from 20% to 23%) • Increase in income tax rates, • Introduction of additional tax rate for top earners (above €153,300 per year), • Reductions of tax credits	• Standard rate of VAT increased from 16% to 18%, • Reduced rate increased from 7% to 8% from July 2010, • Increased taxes for top earners (over €120,000) • Increases in taxes on capital income.	• Food and medicine subject to a 5% value-added tax (VAT) rate from 2011 • Increase in water tariffs • 20% increase in the price of cigarettes • A new top rate of income tax of 35% • A new corporation tax rate of 12%	• A shift from direct to indirect taxes • Higher taxation on wealthy, especially on property and • Measures to counter tax evasion • Increased VAT and excise taxes on fuels	• 75% top income-tax rate • Increased taxes on companies, wealth, capital gains and dividends
	Programme cuts	• Jobseekers Assistance payment rates for unemployed people (under 25) sharply reduced • Reduction of welfare rates • Reductions to universal Child Benefit • Early Childcare Supplement, abolished	• Abolition of special pension payments	• Freezing of nearly all insurance benefits and pensions • Reduction in means-tested unemployment assistance, family benefit and social assistance	• Elimination of universal birth grant • Freeze of the Indicator for Social benefits • Tightening of the eligibility conditions for the Temporary Unemployment Protection Programme • Reduction of child benefit for children under 2 • Means-testing of the €400 personal tax credit	• A reduction of 10% in social benefit entitlements. • Increase in the retirement age for secondary school teachers from 60 to 63	• Cuts in social policies • Some programmes were cancelled (e.g., inclusion of immigrants and childcare services) • Changes to pensions such as progressive raising of the pension age aiming for longer term sustainability • 'streamlining' costs in healthcare and education	• Introduced a higher minimum wage • Partial rollback of previously accepted rise in pension age

	Efficiency improvements	• Cuts in wages of public servants	• Cuts and other changes to public sector pay, including abolition of the 13th and 14th month salaries	• Privatizations of energy companies • Public sector pay cuts (up to 10%) • Reductions in numbers of employees in central Government and across public admin	• Cut to pay of Civil Servants (5% average, but could be up to 9.7%) in 2010, • pay freeze in 2011	• Gradual increase of public-sector retirement age • Cutting 1000 jobs in the public sector	• Wage cuts for senior civil servants (by 10%), • Wage freeze for other public servants since 2010	• Wage freeze (2010-2012) as part of austerity package
Third party intervention		*Nov 2010*	*April 2010*	*May 2011*	*Nov 2012* [8]	*March 2013*	*Nov 2011*[9]	*Not applicable*
Adjustment	**General**	**Duration: 37 months** • Junk Credit Rating • Change of Government • Bank nationalisation • Timetable for fiscal policy & structural reform • Quarterly Troika Reports	**Duration: 44 months** • Junk Credit Rating • Severe austerity measures • National Strikes • Political uncertainty • Record unemployment • Speculation on Euro Exit	**Duration: 31 months** • Junk Credit Rating • Change in Government • Rise in unemployment	**Duration: 13 months** • Junk Credit Rating • Increase in emigration • Change of Government • Bank Nationalisation • Record unemployment	**Duration: 2 months** • Junk Credit Rating • Change in Government • Rise in unemployment • Restructuring of financial sector	**Duration: 26 months** • Junk Credit Rating • Change of Government • Severe austerity measures	*Not applicable*
	Tax increases	• New tax heads	• Measures against corruption and tax evasion • Second Bailout	• Increased taxes • Increasing personal income tax	• Increases on marginal tax rates on personal income, capital income, property sales • Extension of the lower VAT rate for property transactions • VAT increases (standard rate increased from 18 to 21%; • Reduced rate from 8 to 10%; super-reduced rate unchanged at 4%) • mortgage income tax deduction to be removed	• Significant bank deposits haircut for deposits over €100,000 for the two largest banks • Exchange control restrictions for capital movement • Taxing pensionable allowances • Increase the standard VAT rate from 17% to 18% • Increase excise duties on tobacco products, beer, energy	• Extra taxes on luxuries • Introduced a levy on bonds and shares held by investors • A 1.5% tax on capital bought into Italy last year from abroad • New property tax • Prohibit cash transactions above 1,000 euros • Increase of VAT rate	*Not applicable*
	Programme cuts	• Continued cuts in public spending • 8% cut in welfare rates (except state pension) • 17% cut in non-pay current budget • 63% cut in capital budget	• Reduced minimum wage • Unemployment benefits are being reduced • Stricter conditions are being applied to availability of unemployment benefits • Suspension of the rent subsidy programme for low-income employees • Stricter eligibility rules for old age solidarity benefit • Cuts in health and	• Controlling costs in the health sector • Reductions in costs in education by €380m • Reductions in social transfers (other than pensions) of at least €180m by tightening eligibility criteria and decreasing some benefits,	• Expenditure cuts in education and health equal to 1%of GDP • Reinstatement of a mortgage deduction for housing • Unemployment benefit reduced (with the replacement rate after six months falling from 60% to 50%), • Social security contributions reduced	• Abolition of a number of redundant social transfer schemes • Abolition of supplementary allowances under public assistance • Better targeting of child benefits and educational grants • Increase teaching time of teachers by one academic period	• Increased the pension age for women to 62 and for men to 66 • Delink pensions from inflation for all but lower payments	*Not applicable*

8 Spain got a bailout for its banks
9 French & German Governments made clear that Berlusconi policy was untenable, leading to the Monti government

			education spending		by 1% in 2013 and a further 1% in 2014			
	Efficiency improvements	• 14% cut in public wages	• Reduction of family benefits for public sector employees, • Laws that will make it easier to fire and transfer civil servants • further and severe pension cuts	• Reductions in pensions • Reductions in numbers and in wages of government employees	• Slight pension increases • Extra payment in December to civil servants suspended for 2012 (equivalent to nearly a monthly wage)	• Reduce the number of public sector employees • Privatise ports, telecom, electricity authority • Enforce immediate application of mobility within and across government entities	• PS Employee contract freeze until 2014 • Cut a number of local government functions in a bid to reduce the cost of public administration	*Not applicable*

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