

The Deficit

A longer term view

The short run is bad...

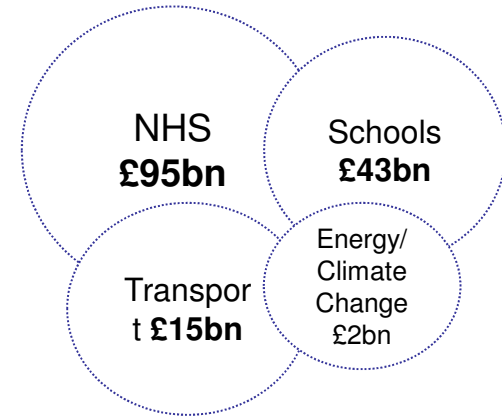


The Coalition has agreed to a “*significantly accelerated reduction*” of the structural deficit over the course of this parliament. The main burden of deficit reduction will be borne by reduced spending rather than increased taxes.



Government borrowing
(2010/11)
£155 billion

Equivalent to sum of:
(2008/09 budgets)



Post-crisis Consensus

This year the gap public sector net borrowing is forecast to be £155 billion (OBR, 2010). The stock level of public sector net debt is forecast to peak at nearly **80% GDP in 2014-15**, up from approximately 45% in 2007.

...but the long run looks even worse...



But the **problem is even more serious** than the current debate would suggest. There is little mention of the longer term cost drivers that are only adding to the size of the fiscal black hole.

Even HM Treasury's projections acknowledge that the **costs of our ageing society** will push up public spending.

Total age related spending is expected to increase from **20.4% GDP in 2008 to 24.1% (2020)** and 26.1% by 2030.

Work for 2020 PST by LSE Professor Howard Glennerster (2010) shows an **additional 6% GDP** will be needed by 2030 to meet the social costs of ageing while meeting existing cross-party commitments (e.g. reducing child poverty).

Alongside HM Treasury forecasts, this would increase the **share of national income spent by government to over 45% by 2020** and nearer 47-48% by 2030.

Given public tax receipts have rarely risen above 40%, Glennerster argues that our current welfare funding arrangements are **not sustainable**.

On further analysis, the UK's fiscal situation is graver still

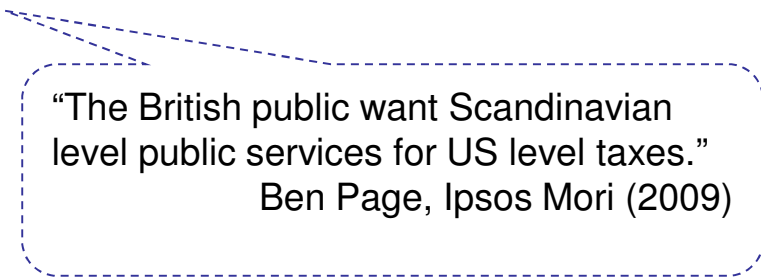
But even taking the additional costs of ageing into account, we must be careful in basing our calculations on Treasury projections. They do not give us a complete picture of the size of the deficit in the long run.

While the Treasury acknowledges some increase in age-related spending, they assume that 'other spending' will decline as proportion of total expenditure.

But how realistic is this assumption? How sensitive are spending figures to fluctuations in the rate of predicted GDP growth? Ernst & Young examine the numbers to paint a **much more realistic picture** of the real scale of the fiscal challenge ahead.

If the tax take remains fairly constant and the costs of public services rise (e.g. through ageing, climate change, depreciation of infrastructure) then the funding gap will only get worse.

Whilst GDP growth and productivity improvements will fill some of this, we might have to **reconsider the nature of our welfare settlement**. How much are we prepared to pay in tax? What do we expect from the state in return?



"The British public want Scandinavian level public services for US level taxes."
Ben Page, Ipsos Mori (2009)

Future trends are expected to push up the costs of public services

A report for 2020 Public Services Trust, 'Drivers for Change' identified 5 overarching challenges for public services in the future:

1. **Demographic driven demand** – increased demand for public services because of ageing and, potentially, a larger than expected number of young families in the population.
2. **Shifting identities** – individuals are geographically more mobile and single person households much more common, creating new identities and communities across neighbourhood, local and national levels
3. **Meeting diverse demands** – increasingly diverse demands make it difficult to find consensus on some policy areas, especially where there are fundamental differences in value and priorities between sections of society. A 'one size fits all' approach will not suffice.
4. **Rising citizen expectations** – we will expect more from public services, demanding service standards that meet the best that the private sector can offer.
5. **Technology** – a driver of change, a solution and as a problem, technology is changing the way we live, work and interact with each other in fundamental ways. This has implications both for the types of public services that will be needed and the ways that they are delivered.

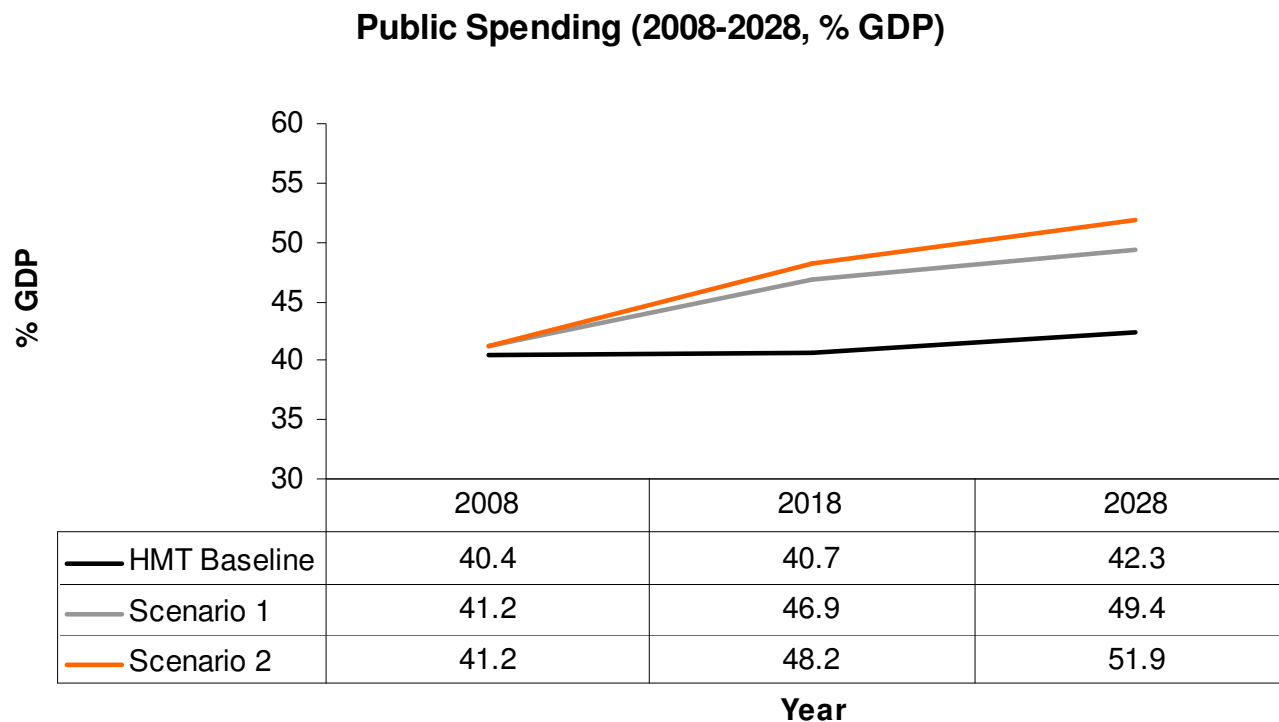
Plus:

Estimated cost of infrastructure investment
– up to **£500 billion** by 2020 (IoD)

Estimated cost of mitigating climate change
– 1% GDP over the next 20 years (Stern Review)

Public spending is likely to keep rising

If we consider the impact on age-related and 'other' types of public spending, we can show that forecasts are sensitive to the rate of economic growth between now and 2020. Using an array of scenarios (see Appendices), Ernst & Young illustrate the fact that public spending is likely to keep rising up to above 50%. Two most likely/plausible range of scenarios (set against the HM Treasury baseline) are illustrated below:

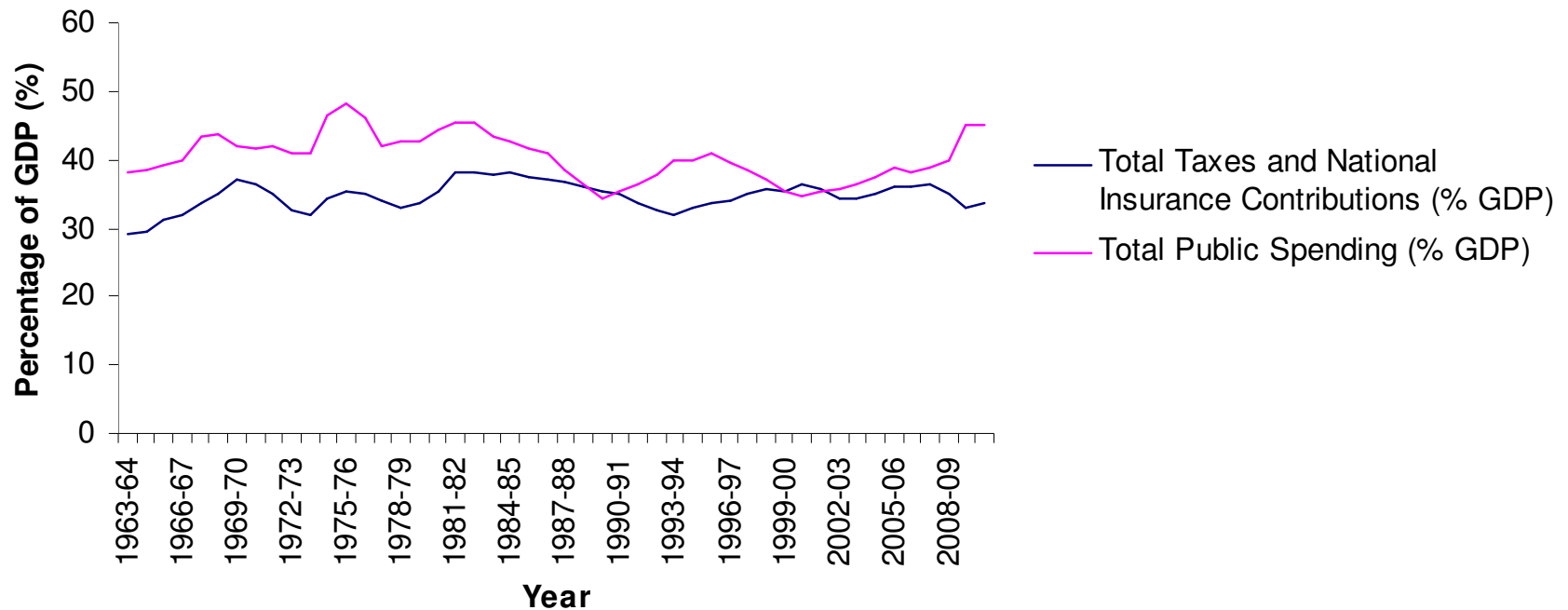


Source: Ernst & Young based on HMT data and IFS forecasts of GDP (2010)

But tax receipts have tended to remain fairly constant

Since the mid/late 1960s total tax receipts have remained fairly constant between 33-38%, peaking in 1984-85, but UK public spending has fluctuated between 34% in 1989-90 and 48% in 1975-76.

Public Spending and Tax Revenues (since 1963-64)



We are a relatively low tax country...

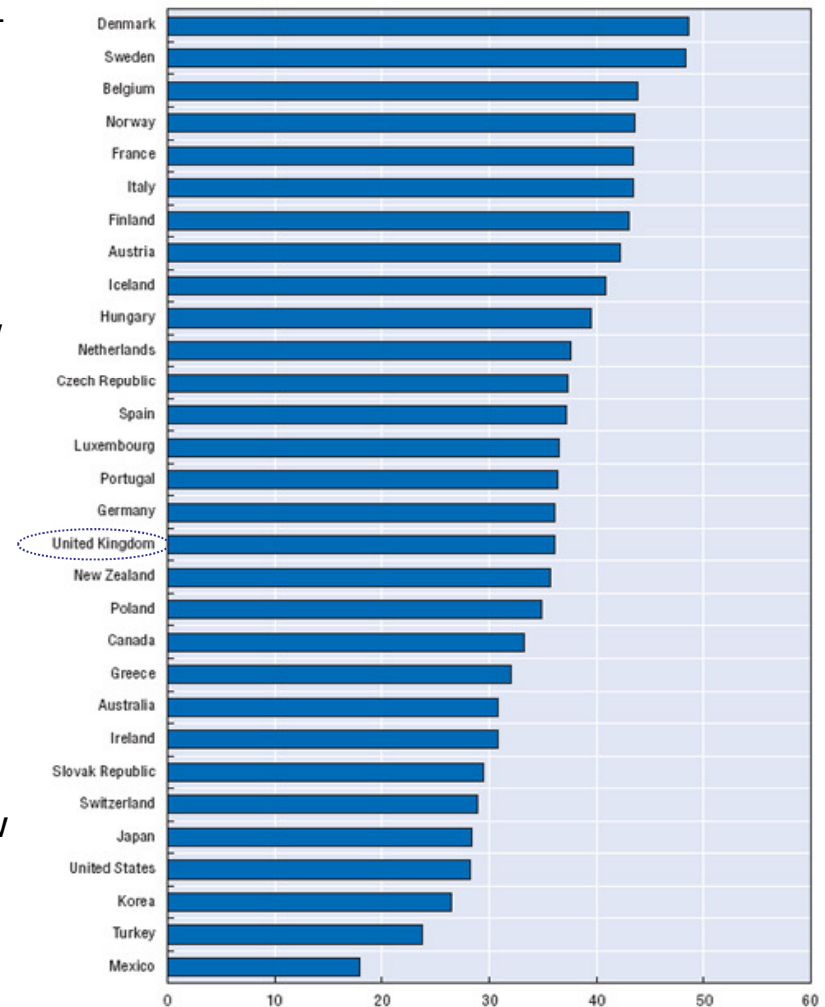
In the early post-war years the UK was a relatively high-tax country. The large increases in the UK's tax burden during the 1960s meant that it remained so into the 1970s.

In most other industrial economies the size of tax burden increased into the 1980s and often beyond. But the absence of a similar trend in the UK means it is now a relatively low-tax country in comparison with the G7 and EU averages.

Latest comparative statistics from the OECD (2009) show that the UK is the lower half of the rankings for total taxes as a proportion of GDP. Denmark and Sweden top the charts with nearly 50%, while the USA and Japan are fourth and fifth from bottom (each with just under 30%).

The UK's tax take is similar to that of Germany and New Zealand, but highest among the English speaking post industrial economies.

Total tax ratio as percentage of GDP (2007)



...so should we expect Scandinavian levels of welfare?

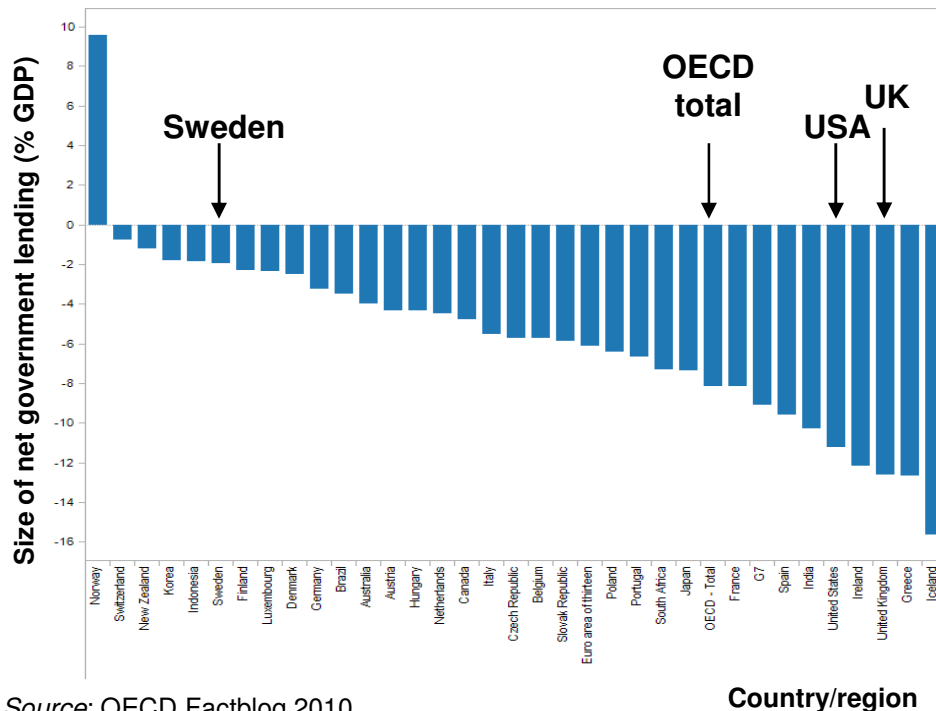
	Health	Education	Social	Spending (% GDP)	Revenue (% GDP)
Sweden	Government responsible for 81.5% of total health spending (9.2% GDP).	Primary/secondary education accounts for 4.2% GDP. Public spending at tertiary level is 1.6% GDP.	Social expenditure amounted to 29.4% GDP (similar to France, 29.2% GDP, and Germany, 26.7% GDP).	54.3%	56.5%
USA	Total health expenditure is 15.3% GDP but only 7 percent of GDP is publicly financed.	Primary/secondary education spend equals the OECD average (3.8%), but tertiary spending (2.9% GDP) is nearly double the OECD average (1.5%).	Social spending (in cash/kind) was 15.9% GDP in 2005, well below OECD average (21% GDP).	34.3%	36.4%
UK	Public spending (7% GDP) accounts for 87% of total.	Primary/secondary expenditure is significantly above the OECD average at 4.6% GDP. At the tertiary level it is just below at 1.3% (2005).	21.3% GDP spent by government on social benefits or programmes.	44.2%	41.6%

Sources: OECD Government at a Glance (2009) – data refers to 2006. General Government Expenditure refers to both public spending on transfers, programmes and capital investment. General Government Revenues includes all tax receipts and income from the sale of assets. See [here](#) for full definition.

Is our current welfare settlement sustainable?

The five drivers for change present additional costs on public services. We know that the UK's public finances will already be under strain from the cuts/tax rises needed to reduce the deficit. Our deficit is forecast to be the highest in the OECD by 2011 (as % GDP).

Size of government deficits across the OECD (2009)



Source: OECD Factblog 2010

In our global market place, we cannot afford to ignore concerns about product/labour market competitiveness in trying to fill the gap through personal and/or corporate tax increases.

In the face of the fiscal deficit...mounting government debt... additional costs on public services...

...is the current settlement sustainable?

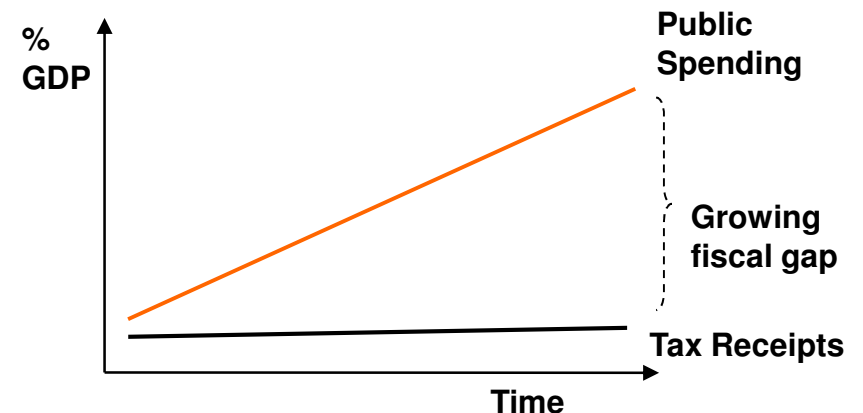
The scale of the problem

Public spending already at a 29 year high (45.2% GDP, Budget 2010) and is set to continue rising in the face of additional demand drivers, including:

- Climate change
- Infrastructure (e.g. transport, clean energy)
- Ageing population
- Increasing citizen expectations
- Changing household structures and new social risks

Tax receipts have stayed fairly constant (approx 35%) since the 1970s – we have relied until now on borrowing to fill the gap between public spending and revenues.

BUT as net **public debt heads towards 80% GDP**, the gap between revenue and spending is becoming increasingly unaffordable.



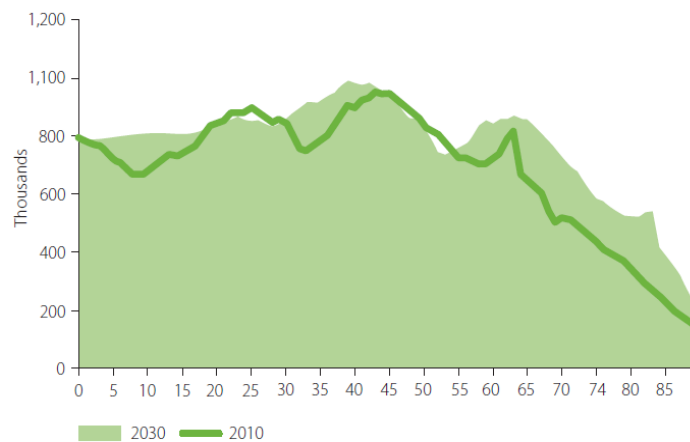
In answer to calls from the IFS, OECD, IMF, other respected institutions and wider commentariat, **all three main political parties have pledged to cut the deficit**. The timing of this cut will be important, but the most difficult question is perhaps not when, but **how, at a what cost for our public services?**

We have to make difficult policy choices despite real constraints

The scale of fiscal deficit and likely future costs on public services present us with the need to make important policy choices as to the nature of our welfare settlement.

However, there are **real constraints** at work. In addition to the problems inherent in raising taxes to fill the funding gap, problems arise when certain services are cut. E.g. if we reduce the provision of publicly funded childcare, we risk forcing women out of the labour market and lose their valuable contribution to the economy.

With known demographic changes (e.g. ageing and a spike of younger families by 2020 – see graph below) age-related spending (education, pensions and healthcare) will increase unless we can find cheaper ways of delivering more.



Source: 2020 Public Services Trust (2010) using DWP actuarial data (2006); PESA data.

However, if we seek to reduce ‘other spending’ – as the Treasury assumes – the relative small size of these budgets (e.g. environmental protection or public order/safety) will do little to fill the widening fiscal gap caused by increasing costs and fairly constant government revenues. The menu of options for cuts seems to be quite small.

We therefore need a **solution that squares the circle** of short/medium term fiscal constraints with long term cost pressures.

Squaring the circle

This heuristic suggests seven ways that might help to think about public spending through the lens of the Commission's three shifts (in culture, power and finance – see 'Beyond Beveridge'):

1. **Prioritise** – How do we prioritise spending so that it is aligned to the patterns of risk citizens face in 21st century (as opposed to 1940s) Britain?
2. **Parameter shifts** – Which assumptions can we challenge that would enhance the long term fiscal sustainability of the public services settlement? For example, what if the pensionable age was automatically linked to increased longevity?
3. **Partnership approaches to financing** – Where are there opportunities to share more of the costs between private individuals and the collective public? For example, where the benefits of a service are predominately private (as opposed to public) there may be scope (e.g. in health) to introduce or develop user-charging, 'top-ups' or insurance-based alternatives.
4. **Productivity** – How can systems be designed so that they squeeze the most out of monetary and non-monetary resources? For example, what opportunities are there for more radical applications of segmentation, participation, place-based integration, and prevention?
5. **Participation** – How can citizens and service users be encouraged/enabled to work with, and alongside, formal public service providers? For example, how can services build on established and emerging models of co-production?
6. **Place-based integration** – How can service delivery, funding and accountability mechanisms capitalise on local knowledge and resources to achieve better outcomes? For example, a localised approach to worklessness could cut across traditional, vertical 'silos' and integrate the full range of relevant policy areas (e.g. skills, housing, information, job search, benefits).
7. **Prevention** – Where can spending be shifted from 'reactionary' expenditure to preventative investment (e.g. youth intervention projects, health and social care)?

Policy options and estimated savings

Policy Area	Description	Estimated Savings (% of GDP in parentheses)	Example	Impact
Parameter change	The assumptions used to generate future cost projections are challenged (e.g. increase in retirement age, migration quota).	~ 2.2bn – 10bn (0.15% - 0.7%)	One year rise in State Pension Age (IFS and NIESR).	HIGH
Placed-based integration	Local areas able to integrate services and pool budgets to meet local needs more effectively and efficiently.	~ 1.2bn (0.09%)	Local areas find extra 2% savings on locally controlled spending (per annum, by 2013/14).	LOW
Prevention	Spending focussed on preventative (rather than curative) investment (e.g. early years education, public health information)	~ 10bn (0.7%)	Croydon Total Place pilot commitment to preventative spending (by 2023/24).	HIGH
Partnership funding	The cost of services is shared between the state, families and individual service users (e.g. tuition fees, prescription charges, other user charges).	~ 11bn (0.7%)	Higher education partnership funding	HIGH
Productivity	Cost efficiency programmes.	~ 3bn – 15bn (0.21% - 1%)	Operational Efficiency Programme Report	MEDIUM
Participation	Service users and citizens are required/encouraged to bring their ' social resources ' (e.g. community mutual takes on delivery of certain services).	~ 0.4bn (0.03%)	Parent-run nurseries - saving an average 28% per childcare place (per annum)	LOW
Prioritisation	Selection of public services priorities .	~ 3.8bn (0.27%) [over 10 years]	If ID cards, the National Identity register and fingerprints were abandoned. (Kable, 2009)	MEDIUM

Source: Ernst & Young (2010) based on Total Place and PESA/HEFCE data unless otherwise stated.

Together we must decide

The 2020 Commission is committed to **finding new ways of delivering quality public services**, which help us achieve - for ourselves and each other – things that we value and cannot achieve on our own. 2020 public services make us more secure today and more confident about tomorrow, and encourage us to take responsibility for ourselves and for others.

As a society, we also need to think about **what collective outcomes and actions we want in our society**. We also need to consider how much we are prepared to pay for these in taxation.

We have described the forecasts that on current trends and policies public services and policies are likely to require up to 52% of GDP (by 2030) in taxes to fund them. If we want more or better services, we will need to pay more unless we can find alternative ways of delivering the same for less.

In the short run, at least, this is likely to require **difficult choices about the level of spending** on big ticket items such as health, education, social security (especially pensions) and defence. And, more importantly, **difficult choices about how this money is spent**. Two questions to keep in mind include:

1. Impacts over time

- What will be the impact on individual citizens and society over time?
- Will this make citizens more reliant on public services in the future or enable them to take greater responsibility for themselves and others?

2. Distributional impacts

- Who will this cut affect? What will be the consequence?
- Will distributional consequences generate unsustainable costs in the long term?

Questions for discussion

Many fundamental questions underpinning these policy choices:

- What are the new boundary lines of the state? Who gets to paint them?
- What role for citizens, households, communities, and local government?
- Who should hold the purse strings of the future (e.g. participatory budgeting and/or local autonomy)?
- Who is ultimately accountable for ensuring quality public services? (Citizens, communities, professionals, local or central government?)
- Can we make a case for increasing taxation as a proportion of GDP?

The Commission on 2020 Public Services is currently grappling with these, and other similar, questions. It reports later in the year, but there is still time to engage in our debate. Find out more at www.2020pst.org.



“In its interim report, Beyond Beveridge, the Trust suggests...a threefold shift – in culture, power and finance. It all sounds quite dynamic and exciting.... **Here is a project that people can take part in...**”

Deborah Orr, Guardian

Appendix 1: HMT Baseline

HM Treasury Baseline | Public Expenditure as a share of GDP (%)

	2008	2018	2028	2038	2048	2058
Education	5	5.6	5.8	5.6	5.5	5.6
Pension	7.6	8.1	9	9.9	9.9	11
Health	7.4	7.9	8.6	9.2	9.6	9.9
Total age-related spending	20	21.6	23.4	24.7	25	26.5
Other spending	20.4	19.1	18.9	18.6	18.1	18
Total spending	40.4	40.7	42.3	43.3	43.1	44.5

Source: HM Treasury (2008) Long Term Public Finance Report: an analysis of fiscal sustainability

Note: this projection does not take into account the 5% drop in GDP for year 2009.

Approach:

► **Bottom-up:** individual spending and revenue items projection | It identifies pressures in the future

► **Top-down:** high level constraints to ensure sustainability | It identifies the resource availability

Constraints: 1) Golden Rule – borrowing to finance investment only; 2) Sustainable Investment Rule: Debt equal to 40% of GDP

Assumptions

1. **Demographic:** ageing patterns for given observed fertility and mortality rate, as well as migration rate

2. **Labour market:** participation rate and age structure of active labour force

3. **Discount rate:** real interest rate observe in the economy and projected

4. **Domestic economy performance:** productivity growth and GDP growth

5. **Policy settings:** current and expected fiscal and welfare policy stance

6. **Tax to GDP ratio:** it remains constant

HMT Projections March (2008)

HM Treasury | Public Expenditure as a share of GDP (%)

Baseline						
	2008	2018	2028	2038	2048	2058
Education	5	5.6	5.8	5.6	5.5	5.6
Pension	7.6	8.1	9	9.9	9.9	11
Health	7.4	7.9	8.6	9.2	9.6	9.9
Total age-related spending	20	21.6	23.4	24.7	25	26.5
Other spending	20.4	19.1	18.9	18.6	18.1	18
Total spending	40.4	40.7	42.3	43.3	43.1	44.5
"Low Migration" Scenario						
	2008	2018	2028	2038	2048	2058
Education	5	5.6	5.8	5.6	5.5	5.6
Pension	7.6	8.1	9.1	10.1	10.3	11.3
Health	7.4	7.9	8.6	9.4	9.7	10.1
Total age-related spending	20	21.6	23.5	25.1	25.5	27
Other spending	20.4	19.1	19	18.7	18.2	18.1
Total spending	40.4	40.7	42.5	43.8	43.7	45.1
"Old" Scenario						
	2008	2018	2028	2038	2048	2058
Education	5	5.4	5.3	5.2	5	5
Pension	7.6	8.2	9.3	10.7	11.6	13.6
Health	7.4	7.9	8.5	9.3	9.8	10.4
Total age-related spending	20	21.5	23.1	25.2	26.4	29
Other spending	20.4	18.9	18.7	18.7	18.5	18.6
Total spending	40.4	40.4	41.8	43.9	44.9	47.6

Source: HM Treasury (2008) Long Term Public Finance Report: an analysis of fiscal sustainability

"Low Migration" Scenario: baseline fertility rate, baseline life expectancy, low migration flows.

"Old" Scenario: low fertility rate, high life expectancy, low migration flows.

Appendix 2: Scenario I

Assumptions:

- ▶ GDP real long term growth: **HMT 2009 lower bound assumption at 2%**.
- ▶ Age related spending: ONS projections.
- ▶ Other spending: growing at HMT 2008 assumptions.
- ▶ **Debt service growing at 9.4% in real terms on average** over the period from 2010-11 to 2014 -15 (based on IFS projections) and then at historical trend.

	2008	2020	2030
Public Expenditure as a share of GDP			
(%)			
Age related Public Expenditure			
Education	5.5%	6.4%	6.7%
Pension ¹	7.7%	9.3%	10.6%
Health	7.2%	9.1%	10.1%
Total Age related spending	20.4%	24.7%	27.4%
Other Spending			
General Public Services ²	3.6%	4.5%	4.0%
Defense	2.4%	2.5%	2.5%
Public Order and Safety ³	2.2%	2.3%	2.3%
Economic Affairs	2.8%	2.9%	2.9%
Environmental Protection	0.7%	0.7%	0.7%
Housing and Community Amenities	0.9%	0.9%	1.0%
Recreation, Culture and Religion	0.9%	0.9%	0.9%
Social Protection ⁴	5.5%	5.7%	5.8%
Accounting Adjustments	1.9%	1.8%	1.9%
Total Other Spending	20.7%	22.2%	21.9%
Total Public Expenditure	41.2%	46.9%	49.4%

Source: HMT and Ernst & Young calculations.

Scenario II

Assumptions:

- ▶ GDP real long term growth: **IFS 2010 lower bound assumption at 1.75%**.
- ▶ Age related spending: ONS projections.
- ▶ Other spending: growing at HMT 2008 assumptions.
- ▶ **Debt service growing at 9.4% in real terms on average** over the period from 2010-11 to 2014 -15 (based on IFS projections) and then at historical trend.

	2008	2020	2030
Public Expenditure as a share of GDP			
(%)			
Age related Public Expenditure			
Education	5.5%	6.5%	7.1%
Pension ¹	7.7%	9.6%	11.2%
Health	7.2%	9.3%	10.6%
Total Age related spending	20.4%	25.4%	28.9%
Other Spending			
General Public Services ²	3.6%	4.7%	4.2%
Defense	2.4%	2.5%	2.6%
Public Order and Safety	2.2%	2.4%	2.5%
Economic Affairs ³	2.8%	2.9%	3.0%
Environmental Protection	0.7%	0.7%	0.7%
Housing and Community Amenities	0.9%	1.0%	1.0%
Recreation, Culture and Religion	0.9%	0.9%	1.0%
Social Protection ⁴	5.5%	5.8%	6.1%
Accounting Adjustments	1.9%	1.9%	2.0%
Total Other Spending	20.7%	22.8%	23.1%
Total Public Expenditure	41.2%	48.2%	51.9%

Source: HMT and Ernst & Young calculations.