CIPFA The Chartered Institute of Public Finance & Accountancy

the long downturn

implications for public service organisations

The Long Downturn

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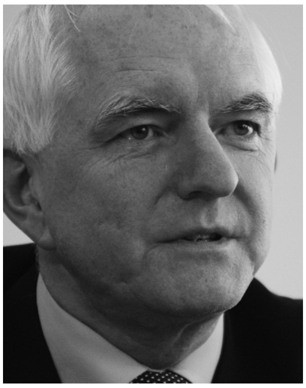


Sir Tony Redmond, CPFA
President of CIPFA

Foreword

No-one expected the challenge of rebalancing the UK economy and public finances to be easy, and so it has proved. As the Government prepares for the second half of the Parliament of Pain, the pressures are building remorselessly. The position is made considerably more difficult by the continuing uncertainties in the Eurozone.

To date the Government's plans to cut departmental spending on public services have remained impressively on track. But will that continue to be the case? As we move forward the challenge of implementing further reductions is likely to become much more tricky as electoral considerations begin to weigh heavily on the minds of both Coalition partners and their respective backbenchers.

The stalled economy is an even bigger and much more immediate problem. All of the efforts to manage down public spending are overshadowed by the absence of growth and its negative implications for tax receipts, benefits expenditure, and business confidence. Without both strands of his strategy working - austerity *and* growth - the Chancellor is still a long way from being able to proclaim victory in his quest to eliminate the annual structural deficit and reduce Government debt.

Increasingly the Government's strategy is likely to be calibrated to try to be more proactive about stimulating growth across the country. Tax incentivisation of private sector investment and increased investment in public infrastructure projects are two obvious policy levers. Politically, however, the Chancellor will want to present a programme which 'sticks to Plan A'. That may mean announcing further reductions in some spending budgets in order to create a 'stimulus fund'. But will more cuts feel fair and will they be tolerated by a public whose appetite for austerity is inevitably waining?

For public bodies the mantra is 'hope for the best, plan for the worst'. In considering their options and formulating spending plans, most organisations will draw heavily on the collective experience of the past few years. So expect to see lots of major transformation projects which aim to deliver services in new ways at significantly reduced cost. Collaboration initiatives are also likely to become more prevalent as larger numbers of public bodies act in unison, in some cases with partners from other sectors, to try to maximise efficiency. Management structures will continue to be 'delayered' and tight controls will be applied even more aggressively in relation to all discretionary expenditure.

Though their importance is rarely acknowledged, a great deal will depend upon the skill with which public sector managers and leaders play a very difficult hand. The cocktail of more cuts, major reforms (in the NHS, in policing, in local government, etc.), and ambitious change programmes is so risk-laden that things will inevitably go wrong. Unfortunately, we do not know where, when or how seriously. The skills of leaders and managers in planning and executing change, managing public expectations, and coping with unforeseen challenges will be tested to the limit.

Tony Redmond

October 2012

The Global Crisis Rumbles On

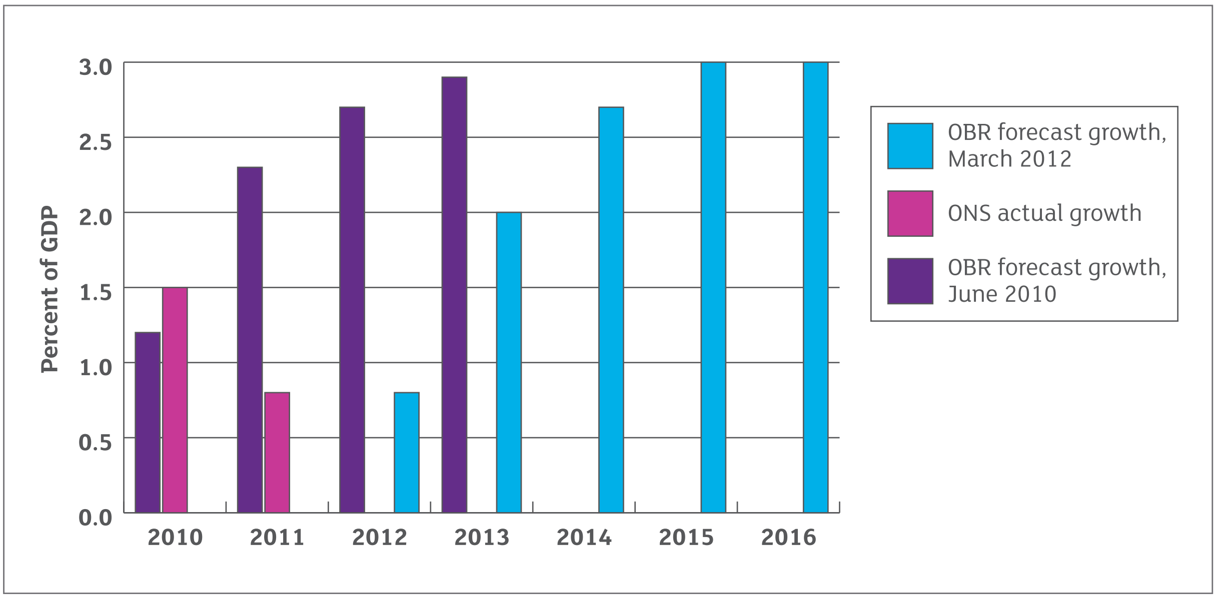
It is a chilling thought that the global financial crisis is now in its sixth year with few, if any indications that normal service is about to be resumed. On the contrary, there is still significant concern that things may get a great deal worse before they get better. Notwithstanding Mario Draghi's[1] "...whatever it takes..." intervention, the crisis in the Eurozone remains centre stage with acute fears for the financial health of governments and financial institutions across the continent as well as the potential implications of resulting tremors for global financial stability.

Whilst the UK is relieved to be a spectator rather than a player in the travails of the Eurozone, its own position remains heavily dependent on European and other export markets. Austerity and growth were intended to be the twin engines of the Coalition Government's strategy for recovery. In the event only one engine, austerity, has fired. Economic growth continues to be disappointingly elusive.

The View from 2010

Immediately following the 2010 General Election the Government's Emergency Budget set out the new Office of Budgetary Responsibility's (OBR) first independent forecasts of economic growth. Subsequently these estimates have been overtaken by a series of less positive growth statistics, culminating in the return to recession in the first quarter of 2012. Further down-rating is anticipated in the OBR forecasts which are published alongside the Chancellor's 2012 Autumn Statement.

Figure 1 UK Economic Growth – Office of Budget Responsibility (OBR) initial forecasts (June 2010) compared to Office of National Statistics (ONS) actuals and OBR latest forecasts (March, 2012)

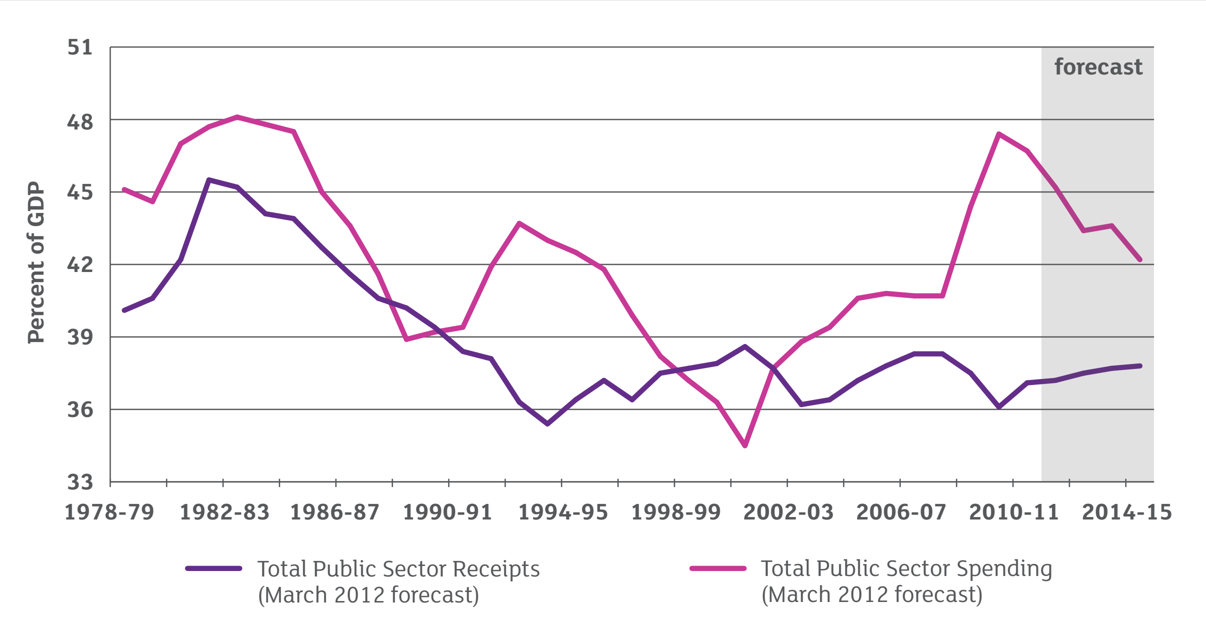


The stalling of economic growth has direct and immediate implications for the Government's finances. It has adverse implications for tax receipts as consumers purchase fewer goods and services, companies deliver smaller profits and employ fewer workers, etc. And it drives increased spending on benefits as unemployment remains higher than would otherwise be the case.

1 Mario Draghi, President of the European Bank, speaking at the Global Investment Conference in London on 26 July 2012

We can see the painful impact of these influences in the latest forecasts of public sector spending and receipts in Figure 2.

Figure 2 Total public sector spending and receipts



Source: OBR, March 2012 Economic and Fiscal Outlook

Managing Austerity

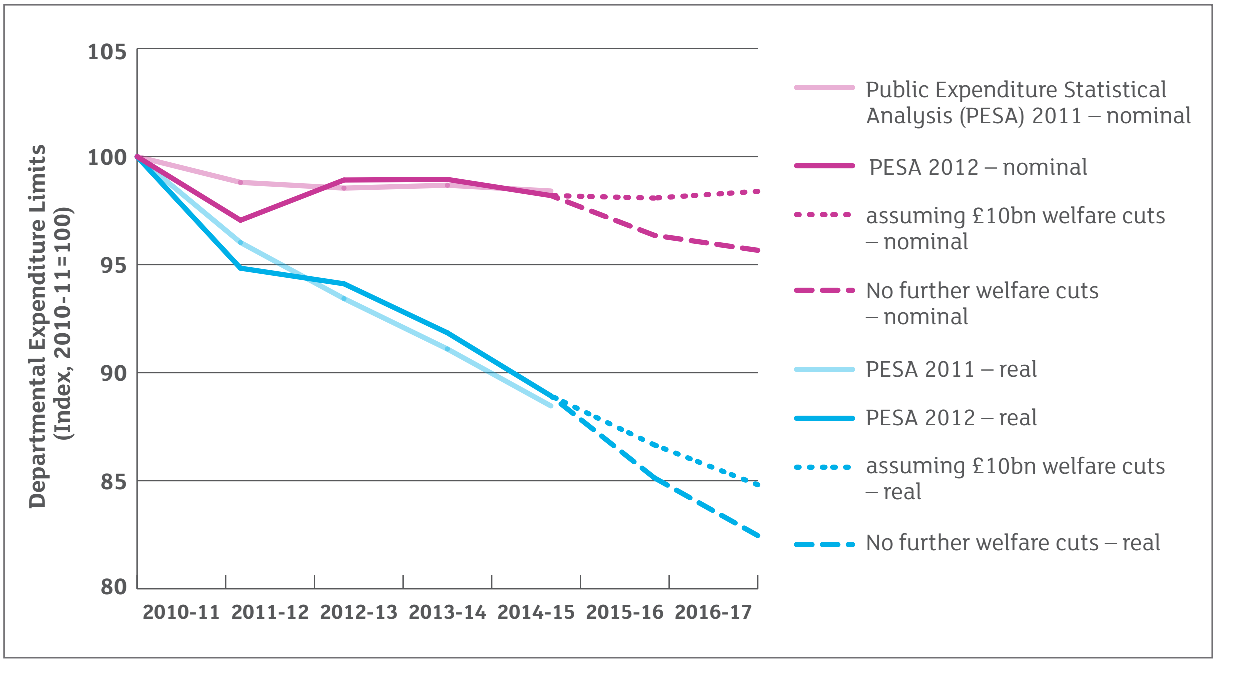
In contrast to the disappointing economic performance, implementation of the Government's austerity programme has proceeded very much according to plan, in the process inspiring a level of confidence in financial markets. The Emergency Budget assumed that this would involve a mix of approximately four fifths spending reductions and one fifth tax increases. The latter are already substantially in place following a range of tax changes, some of which were announced by Alistair Darling prior to the 2010 Election, and others which have been put in place under the Chancellorship of George Osborne.

Spending reductions are also on target although there remains some considerable distance still to travel before they are fully delivered. The cumulative nature of the challenge means that, inevitably, the hardest part of the journey lies ahead.

Over the four years from 2011-12 to 2014-15, departmental spending on public services is set to be cut in real terms by 11.1%, after accounting for economy-wide inflation. 2011-12 saw a 5.2% real terms cut in public service spending, meaning that 5.9% is to come this year and over the next two. On top of this, further cuts to public service spending are also likely to be required in the two years beyond the current spending review period. Based on current official forecasts, if no further cuts to other areas of public spending are found, a further 7.5% real terms cut to resource public service spending would be needed over 2015-16 and 2016-17. In practice it is increasingly clear that the Chancellor is determined to deliver £10bn of these reductions from further welfare benefit cuts.

We can see the scale of the forecast cuts to department spending, in both nominal and real terms, in Figure 3, together with the further cuts which may arise in 2015-16 and 2016-17.

Figure 3 Forecast cuts to departmental spending (nominal and real terms)



Notes: Figures shown are for total Departmental Expenditure Limits (DELs). Real terms figures are calculated by deflating cash spending figures by growth in the GDP deflator (a measure of economy-wide price inflation).

Forecasts for spending beyond the end of the Spending Review period (2014-15) are shown by the dotted lines. Two alternative scenarios are shown. The smaller dotted line shows the path for DELs assuming that no further cuts to non-departmental spending are made in 2015-16 or 2016-17 - these figures are taken from Table A.1 of HM Treasury's Budget 2012. The larger dashed line assumes that resource departmental expenditure limits grow in 2015-16 and 2016-17 in line with the average annual growth rate seen over SR 2010 period; this would require £10bn of additional savings to be found from non-departmental spending by 2016-17 - this was one possible scenario outlined by George Osborne in Budget 2012.

Source: IFS calculations using Tables 1.1 and 1.2 of HM Treasury, Public Expenditure Statistical Analysis (PESA) 2011; and Tables 1.1 and 1.2 of HM Treasury, Public Expenditure Statistical Analysis 2012; and Table A.1 of HM Treasury, Budget 2012.

To date the overall performance of public bodies in planning and executing cuts has been positive, helped by the fact that public opposition has, on the whole, been relatively muted. Whether this continues to be the case remains one of the critical variables in the equation. There is no room for complacency because the scale of reductions planned is unprecedented in modern times. Figure 4 illustrates this very clearly. While total public spending has increased in real terms more or less consistently over the past four decades, a completely different trajectory is planned post 2010. But public disquiet and the risk of dissent are bound to increase as public bodies are forced to consider cuts to ever more sensitive services which have direct implications for the quality of people's lives and their life chances.

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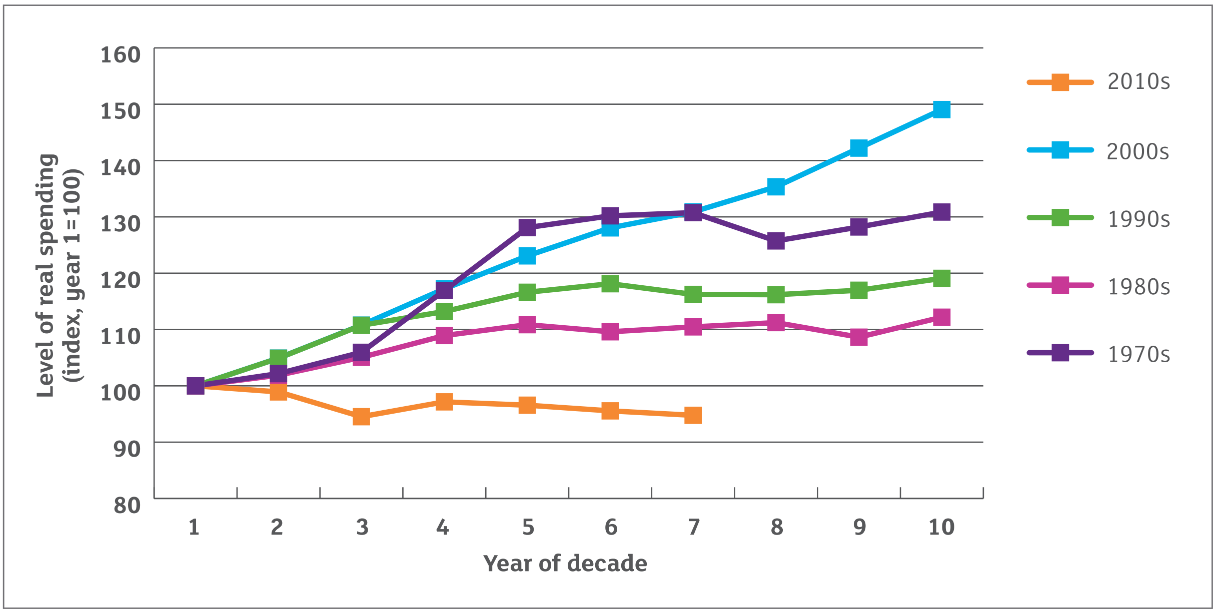
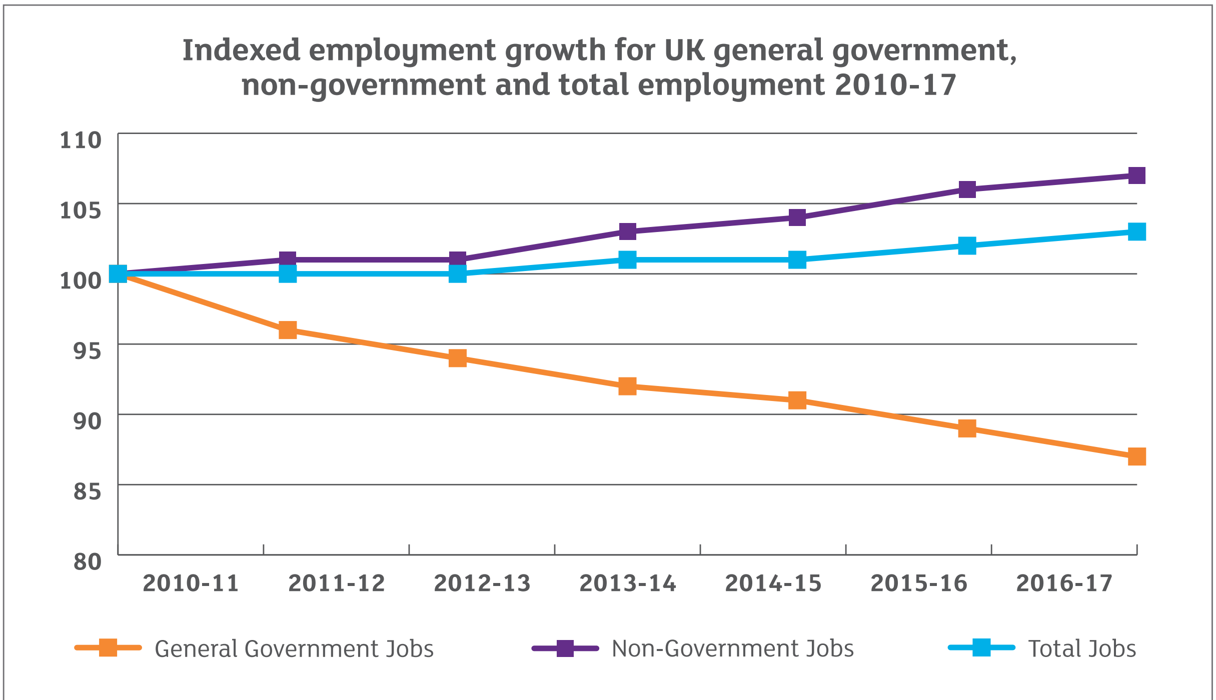
Figure 4 Real terms growth in public spending, by decade



Source: IFS

Many commentators have been very pre-occupied by the apparent conflicts between the two key strands of the Government's strategy. A significant contraction in public spending is itself damaging to economic growth in the short term. In particular job reductions in the public sector act as a downside counterbalance against any growth in private sector jobs, and lead to relatively stagnant levels of total employment in the economy (Figure 5).

Figure 5 Employment trends and forecasts

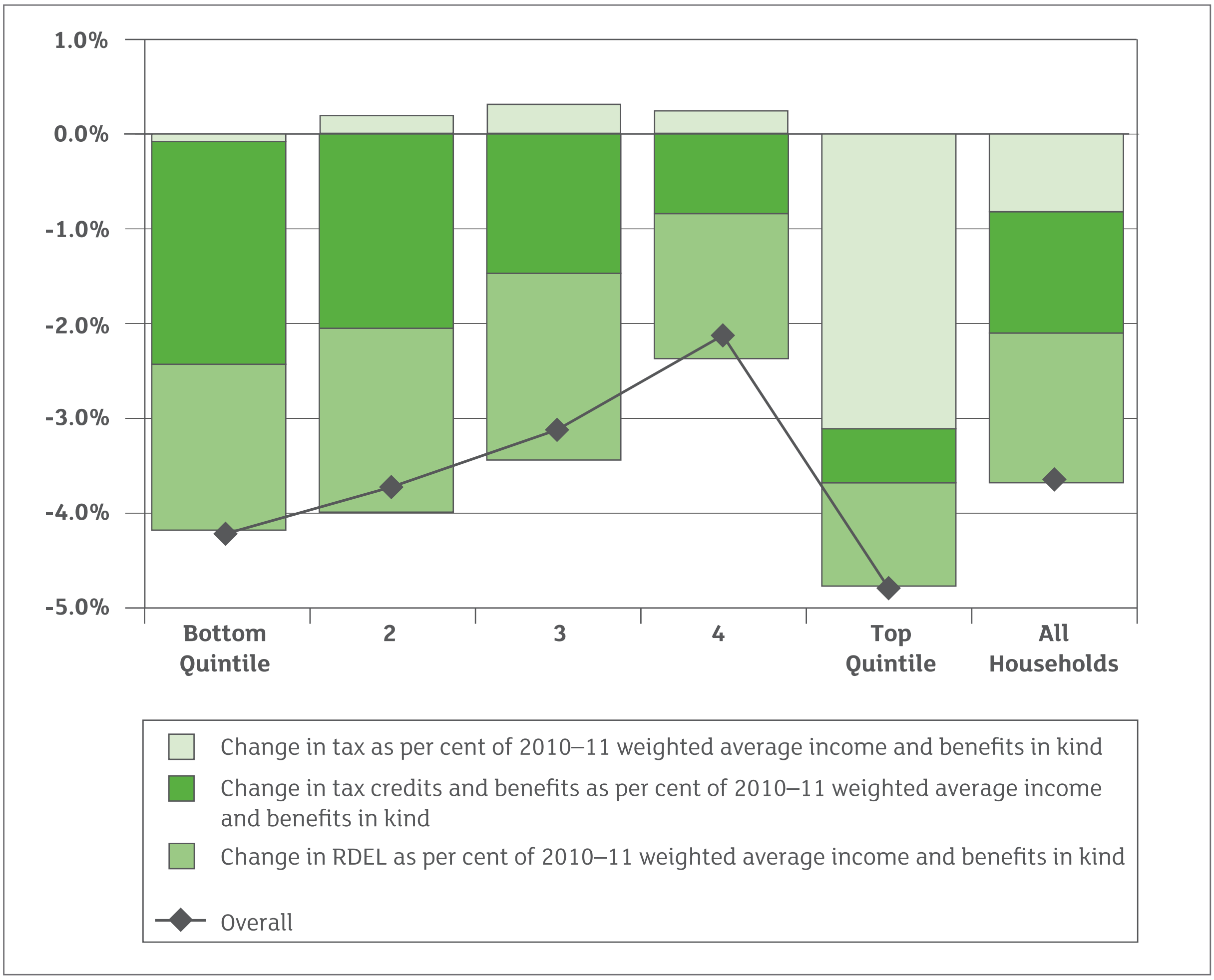


Source: OBR Employment Forecasts, March 2012

OBR Employment Forecasts March 2012 show that over the period general government job numbers are predicted to fall from 5.67m to 4.94m; non-government jobs to rise from 23.43m to 25.16m; with overall total jobs therefore rising from 29.1m to 30.1m.

Other commentators, and the Government itself, have placed particular emphasis on to the importance of "fairness" in formulating austerity plans. The Deputy Prime Minister is a particular proponent of this argument. Of course, there is no definitive methodology for measuring whether fairness is being achieved. Nevertheless it is interesting to note in Figure 6 the above average impact of spending, tax, tax credit and benefit changes to date on the bottom quintile of households. Inevitably tax credit and benefit changes impact disproportionately on less well off households.

Figure 6 Overall impact of spending, tax, tax credit and benefit changes on households in 2014-15 as a per cent of 2010-11 net income



Source: HM Treasury estimates based on a range of models and data sources.

All of the variations and developments outlined leave the Government's ambitions to eliminate the structural deficit on a somewhat longer timescale than the single Parliament originally planned. Additionally there is considerable speculation that it will also be unable to achieve its fiscal target for aggregate public debt to be falling in 2015-16.

Eurozone Health Warning

Importantly, all of the forecasts made by Government and/or the OBR, and reflected in this report, come with a significant health warning. The Prime Minister and the Governor of the Bank of England, amongst others, have emphasised the significant risks posed to the UK by continuing instability in the Eurozone. If those difficulties become more acute there is the possibility of a further wave of impacts rippling through financial institutions in a damaging re-run of the early 2007-09 stages of the global crisis. Whilst Government are no doubt attempting to prepare contingency plans to manage and mitigate these risks, they are clearly not factored into current public plans. In that context, current public plans may reflect a relatively optimistic view.

In practice the implications of a full scale crisis in the Eurozone would be multiple, potentially including any or all of the following:

- trade with European partners would diminish
- lending by banks would become much more difficult and expensive to secure
- banks with significant exposures in the Eurozone would require emergency support
- the UK economy would fall further into recession with significant adverse implications for business confidence
- either Government borrowing would need to increase to finance an increased deficit or public spending plans would have to be cut back sharply
- public bodies would face significant budgetary, treasury management and demand challenges

In April 2012 the Chief Secretary to the Treasury announced a new framework for improving spending control in Government Departments, Devolved Administrations and Arm's Length Bodies. This included a requirement "...to identify around 5% of their resource budget that could be re-prioritised if new spending pressures emerge or new policies have to be funded...". One interpretation of this announcement was that it reflected thinking in Government about the kinds of measures that might need to be put in place in the event of further significant "shocks" arising from the Eurozone or elsewhere.

There is considerable speculation that it [the Government] will also be unable to achieve its fiscal target for aggregate public debt to be falling in 2015-16.

Survival Strategies

Unless and until economic policy changes, Government as a whole and individual public bodies must continue to grapple with the difficult challenges of managing with shrinking resources, in the increasingly familiar context that "easy savings" have long since been exhausted. What remains are challenging programmes which involve higher levels of difficulty and risk to implement and/or unpalatable cuts in, or removal of, services.

In 2009 CIPFA and SOLACE[2] published *"After The Downturn: Managing a Significant and Sustained Adjustment in Public Sector Funding"*. As well as rehearsing the scale of cuts which would need to be faced after the 2010 General Election, it also considered how those reductions might be managed. In doing so it outlined three specific strategic options:

- Option 1: Redefining the relationship between the state and the individual,
- Option 2: A significant delayering of the public sector with many more decisions taken locally with minimal oversight, and
- Option 3: A major initiative to maximise economies by much more effective collaboration between public bodies.

In the subsequent period we have seen the Coalition Government and individual public bodies taking action in all three of these categories with a range of different results. We have also seen concerted action to restrain public sector pay and to reform public sector pensions, as well as a relentless emphasis on measures to ensure the tightest possible stewardship of resources and the elimination of waste.

Citizen and the State

The relationship between the state and the individual (option 1) is certainly changing. We can see that in many of the welfare benefit reforms which aim to reduce dependency and incentivise work. It is also vivid in service areas where fees and charges have been introduced or increased significantly. University fees are an obvious example. Initial expectations that " Big Society" initiatives and organisations might emerge, enabling Government to shrink the scope of its activities without adverse impact on communities and users of public services, have to date failed to materialise on any significant scale.

These are some of the areas in which questions of fairness, including intergenerational equity, are apparent. There are obvious resentments associated with being the first generation to pay for a previously free service or make higher contributions to a pension scheme which offers less generous benefits.

Delayering the public sector and localism

'Delayering' (option 2) has been evident in initiatives like those to reduce the number of quangos, abolish regional development agencies and to change the structure of the NHS. Frequently these involve significant one-off costs of change as well as the need to reassign responsibilities to other continuing organisations. In many cases this leads to additional costs and disruption to services in the short term in pursuit of medium term improvements and savings.

The Government has also espoused a strong commitment to 'localism', placing greater confidence in decision making at local level, free from or subject to minimal oversight. However, it is too early to draw the conclusion that this model will necessarily be implemented on a sufficient scale to drive significant efficiency gains.

2 SOLACE is the Society of Local Authority Chief Executives and Senior Managers.

At the most practical level 'delayering' is also being widely implemented as the vast majority of public bodies adjust their organisation structures in pursuit of savings. A recurring theme is the removal of tiers of management and the shortening of chains of command to effect economies.

Efficiency through collaboration

Collaboration initiatives (option 3) have also been prevalent but again results have been mixed. Organisations have experimented with shared top management structures, shared front- and back-office services, pooled budgets and a number of other forms of cooperation. Many have taken longer to put in place than originally anticipated, and some have been abandoned along the way. A proportion also seem to have worked well and to have delivered reasonably significant savings, usually from rationalisation of staffing structures. In general, savings appear to be delivered with greater certainty where organisations or elements of them are formally merged, as compared to arrangements which rely upon softer, more informal collaborative working between separate entities.

The Government has taken a relatively cautious approach to date in relation to the initiative which was initially branded "Total Place" and subsequently styled as "community budgets". The Local Government Association in particular continues to champion the significant efficiency and service improvement opportunities which might arise from a more radical commitment to and implementation of this policy, involving aspects of both delayering – greater delegation from Whitehall – and collaboration – across Whitehall and across local public bodies.

Learning Points

A number of very clear learning points emerge from these concerted efforts to deliver savings and reduce public spending:

- if there was ever any doubt, it is clear that there are no easy "silver bullet" solutions. The business of reducing public spending is more marathon than sprint, requiring very careful planning and rigorous attention to implementation detail;
- high profile transformation programmes are particularly difficult to mobilise and sustain on a whole organisation, let alone a sector-wide basis. Though the theory may be compelling, the practice is sometimes slow and frustrating;
- initiatives which require collaboration between separate entities pose their own distinct and significant challenges including alignment of agendas, calibration and assignment of risks, rewards and incentives, and integration of processes;
- many 'unfashionable' stewardship or housekeeping measures like tight cost control, reduction of overhead spending, and freezing of specific categories of spending, such as use of temporary staff or consultants, continue to play an important part in organisational strategies. Whether these have any longer term downside consequences such as failure to invest appropriately in the maintenance of assets remains to be seen:
- control of staffing costs, by reducing headcount, removing layers of supervision and freezing or tightly controlling pay levels, has been critically important because of the labour intensive nature of most public services. Again, however, there may well be a negative longer term effect in relation to the recruitment and retention of high quality staff. This includes the challenge to recruit and retain staff with skills in disciplines such as commissioning and contract management;

A return to stability and previous growth norms remains almost unimaginable for some time to come

- maintaining good communications with, and managing the expectations of stakeholders, are critically important activities especially in the area of gaining acceptance for significant changes to services. Perceived fairness also remains a very important performance measure, as does the ability to maintain popular support for the overall balanced judgements reflected in spending programmes, albeit that they may reflect a number of tough and individually unpopular decisions.

Looking Ahead

What happens next is likely to depend upon two key variables which, though capable of being influenced by UK Government, are in large part beyond its control. The first is developments in the global economy, particularly in the Eurozone. The second is public patience and the level of support for or opposition to cuts in public services. These factors will loom larger as the Government moves into the second half of the current Parliament and electoral considerations become more prevalent.

Of course, what the Government can control is its economic policy. Whether that changes significantly is likely to continue to be a subject of significant conjecture. For as long as economic growth remains elusive, pressure on the Chancellor of the Exchequer is certain to mount with vocal support for alternative strategies such as increased investment in public infrastructure projects and tax incentivisation of private sector investment. As the Autumn Statement approaches it seems increasingly inevitable that measures of this type will come to the fore, albeit that they will need to be deployed judiciously and in a manner which does not undermine the financial markets' confidence in the Government's determination to continue to prioritise deficit and debt reduction. One possible scenario would be further spending cuts explicitly linked to a number of new, carefully selected initiatives focused on kick starting growth.

For public sector organisations and their leaders the prospects for the short, medium and perhaps even long term are likely to be more of the same. A return to stability and previous growth norms remains almost unimaginable for some time to come. Austerity and managed retrenchment – deploying the same three strategic options identified in *After the Downturn* in 2009, underpinned by very tight stewardship – will continue to be the order of the day.

Increasingly leaders of public bodies will face pressures to bias their strategies towards initiatives which are likely to stimulate growth. This will particularly be the case in local authorities where leaders will be expected to prioritise economic development activities, in part incentivised by national policies such as retention of local business rates, and in part responding naturally to their responsibilities for the general well-being of the area and communities within it.

Finance leaders will focus their energies on four key activities: leading innovation, adding value, managing risk, and cutting costs.

All of the learning points outlined above will be highly relevant to the strategies and detailed plans which organisations develop. Major transformative projects – in some cases undertaken with partners – will grow in importance and prevalence. Very few public bodies are likely to manage through this unprecedented transition without recourse to radical 'game-changing' initiatives. But proper resourcing, detailed and realistic planning, robust forecasting and excellent project management will be required to ensure their successful delivery. Organisations which are unable to provide these ingredients will fail to achieve the financial and/or service outcomes to which they aspire and some will experience difficulties which threaten their viability.

At the same time, stewardship or housekeeping initiatives will remain critically important for all public bodies. As well as helping to contribute to efficiency savings, such initiatives will play an important role in maintaining the tone of austerity within organisations in line with public expectations. Tight cost control including close control of staffing numbers will remain a high priority. The most successful organisations will be those which can embed this practice within their culture and embrace it as a distinctive and positive hallmark of modern public services.

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