

# Country focus — United Kingdom

KPMG INTERNATIONAL

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The United Kingdom faces a major fiscal challenge over the coming years, with the budget deficit having reached 11 percent of GDP in 2009, a post-war record. Although the UK entered the global recession with a relatively low stock of debt of around 60 percent of GDP, this is forecast to approach 90 percent of GDP by 2013<sup>1</sup> — the level identified in some studies as a ‘threshold’ beyond which significant negative effects on economic growth may result.

The IMF estimates that to reduce the debt/GDP ratio to 60 percent by 2030 requires the structural primary balance (the balance adjusted for the effects of the economic cycle and net of interest payments) to improve by some 9 percent of GDP by 2020, with this improvement to be then maintained for a further decade.<sup>2</sup>

Like other industrialized countries, the UK also faces a major medium-term challenge from an aging population. IMF estimates suggest age-related spending on health and pensions will rise by around four percent of GDP by 2030. Some estimates suggest the UK’s unfunded pension liabilities exceed £1.1 trillion or 80 percent of GDP.<sup>3</sup>

**The UK’s budget problems arguably predate the global financial crisis, and have their root in rapid spending growth in the preceding years.** At the height of the global boom in 2007, the UK was running a budget deficit of almost 3 percent of GDP (see chart 1), with the structural deficit even larger at 3.5 percent of GDP.<sup>4</sup> The expansion of the public sector from 1999 – 2009 saw the workforce rise 16 percent with especially large growth in health (34 percent) and education (23 percent) (see chart 2). Pay growth in the public sector also outstripped that in the wider economy in the period leading up to the global recession, by some 15 percent.<sup>5</sup>

**The election of a new Conservative-Liberal Democrat coalition government in May 2010 has been followed by an acceleration in the pace of planned fiscal tightening.** The June budget outlined a further £40 billion of fiscal tightening on top of that previously penciled in, taking the fiscal adjustment by financial year 2014/2015 to around 10 percent of GDP. The overall tightening consists 80 percent of spending cuts and 20 percent of tax rises, in line with the ‘best practice’ revealed by studies of past fiscal adjustments. Capital spending is

<sup>1</sup>IMF, op. cit. (2009), Oxford Economics

<sup>2</sup>IMF, op. cit. (2009)

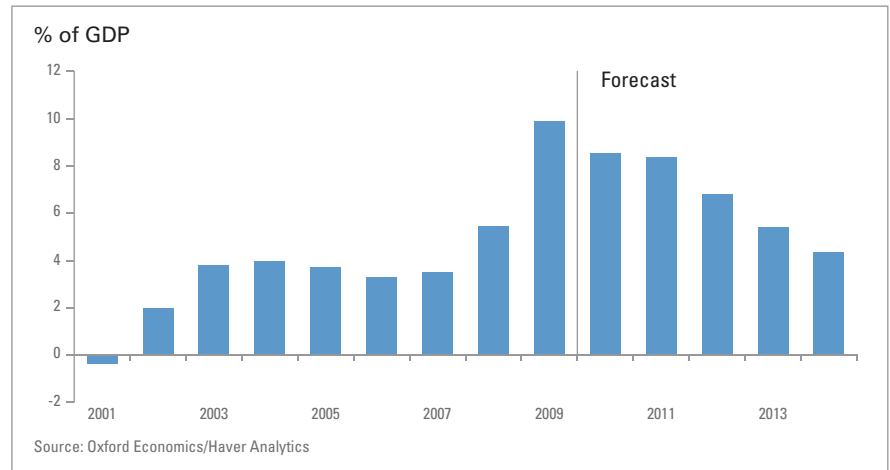
<sup>3</sup>IMF, op. cit. (2009)

<sup>4</sup>OECD, op. cit. (2010)

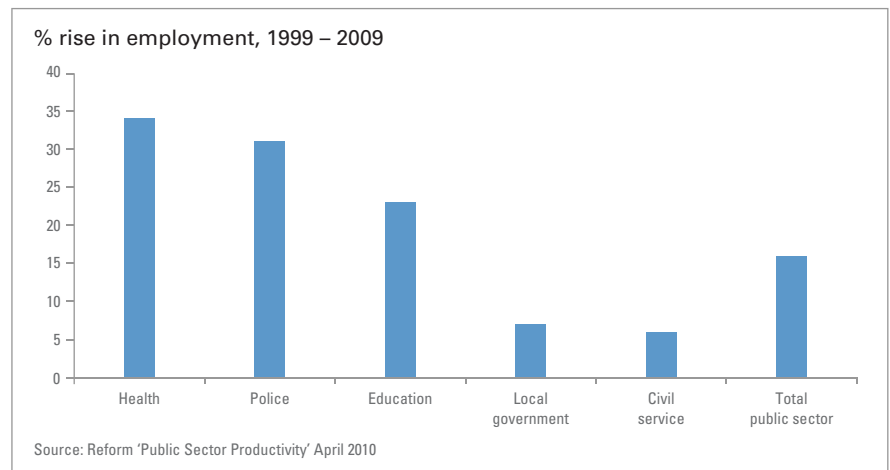
<sup>5</sup>Reform, op. cit. (2010)

expected to be cut by some 60 percent by 2013/14, and around £11 billion will be trimmed from the welfare budget. Departmental spending will fall on average by 25 percent in real terms over four years with only health and overseas aid protected. On the tax side, a net £8 billion of increases was announced in June, mostly resulting from a rise in VAT to 20 percent from 17.5 percent.

**Chart 1: UK structural budget deficit**



**Chart 2: UK rise in public sector workforce**



With public spending having risen so rapidly in recent years, the concentration of adjustment on the expenditure side makes sense. *A senior UK policymaker* notes "It is the government spending to GDP ratio that looks high rather than the tax to GDP ratio looking low." **A particular target may be the public sector workforce**, the costs of which account for some £200 billion or 29 percent out of public spending of £675 billion.<sup>6</sup> A reduction of employment in the public sector of 15 percent would save an estimated £30 billion or 2 percent of GDP.

<sup>6</sup>Reform, op. cit. (2010)

**Social transfers, accounting for a further 40 percent of spending, are another likely target for economies.** A senior UK policymaker argues for an “attack on the middle class welfare state,” focusing benefits more on providing a social safety net. The authorities also plan to sharply curb capital expenditure over the next five years. Among the possible ‘low hanging fruit’ that the authorities can target are bodies such as the Regional Development Agencies, which cost over £2 billion per annum<sup>7</sup> and whose effectiveness has been widely questioned.

**On the taxation side, there is still scope for further increases in revenue from VAT,** which at present only covers 50 percent of consumer spending with major exemptions for food and other items. Reducing these exemptions by half would raise over 3 percent of GDP on IMF estimates, although the distributional aspects of this would be controversial.<sup>8</sup>

**In order to underpin fiscal improvement over the medium-term, the UK also needs to confront the problems of weak productivity growth in the public sector.** From 1997 – 2007, public sector productivity declined by 0.3 percent per annum while private sector productivity rose more than two percent per annum according to the Office for National Statistics. Tellingly, productivity in private services — also labour intensive and thus ‘hard’ to improve productivity in by substituting capital for labour — also rose 2 percent per annum in this period.<sup>9</sup>

**Examination of a number of subsectors within the public sector in the UK reveals the potential for substantial efficiency gains** from ironing out wide variations in performance among different units — *KPMG partner in the UK, Paul Kirby* argues the top 25 percent of units often have unit costs 25 percent or so below the average for their sector. *Kirby* notes that in the healthcare sector, the tariff for payments to hospitals for acute treatment is now set at the average unit cost recorded in the previous year. If it was instead set at the level of unit costs achieved by the top 25 percent of hospitals, the resultant saving out of the £40 billion annual care cost could be £11 – 12 billion.<sup>10</sup>

A similar situation exists in the adult social care sector, where unit costs vary greatly. Moreover, as *Paul Kirby of KPMG* argues, of the £12 billion currently spent in this sector, a third is spent on deciding which services to purchase. A radical approach would be to give individuals seeking care their own budgets to spend as they see fit, which could see the elimination of a large chunk of existing spending.

<sup>7</sup>Centre for Cities ‘Regional Development Agencies: the facts’ December 2009

<sup>8</sup>IMF, op. cit. (2010)

<sup>9</sup>Office for National Statistics, op. cit. (2010)

<sup>10</sup>See KPMG UK *Payment for Success — How to shift power from Whitehall to public service customers.*

**The extension of unit cost analysis and its use to improve efficiency levels across the public sector in the UK is likely to be a key feature of fiscal adjustment efforts over the longer-term.** In this respect, the coming fiscal squeeze may look somewhat different from that in the 1990s, which was more focused on simply cutting public sector output. *A Senior UK policymaker* argues that public sector managers have been under little pressure to achieve efficiency gains in recent years, so that this is a key area where consolidation can be achieved.

Seeking improved productivity performance over the medium-term can be made more politically feasible by marrying the search for efficiency gains with the devolution of operational choices to public sector units and, more radically, shifting the ownership of services to the workforce for example via employee co-ops.

In practice, transforming public services in the ways described above is unlikely to take place overnight, and may indeed involve significant time, effort and in some cases set-up costs. **As a result, the UK authorities are likely to have to try to ride two horses at once initially**, engaging in a major 'conventional' fiscal squeeze while also laying the foundations for a step change in productivity performance that will help underpin the public finances in the medium-term.

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