BRIEFING

THE LONG VIEW

THE LONG VIEW

PUBLIC SERVICES AND PUBLIC SPENDING IN 2030

Rick Muir

June 2012

Institute for Public Policy Research

ABOUT THE AUTHORS

Rick Muir is associate director for public service reform at IPPR.

ACKNOWLEDGMENTS

We are very grateful to the Confederation of British Industry for their generous support for this project, without which it would not have been possible.

The author would also like to thank Andy Bagnall, Graeme Cooke, Kayte Lawton, Nick Pearce, Amna Silim and Alex Van Besouw for their assistance and advice. Thanks especially go to Will Cavendish for speaking at the IPPR and CBI seminar that helped to shape the content of this paper.

ABOUT IPPR

IPPR, the Institute for Public Policy Research, is the UK's leading progressive thinktank. We produce rigorous research and innovative policy ideas for a fair, democratic and sustainable world.

We are open and independent in how we work, and with offices in London and the North of England, IPPR spans a full range of local and national policy debates. Our international partnerships extend IPPR's influence and reputation across the world.

IPPR
4th Floor
14 Buckingham Street
London WC2N 6DF
T: +44 (0)20 7470 6100
E: info@ippr.org
www.ippr.org
Registered charity no. 800065

This paper was first published in June 2012.

IDEAS to
CHANGE OPINIONS

CONTENTS

INTRODUCTION

The dominant question in British politics since the 2008 economic crash has been about how the country can balance its finances while at the same time generating economic growth. On one side there are those who argue that market confidence requires a rapid process of deficit reduction largely focused on spending cuts. On the other side are those who believe that moving too fast on fiscal consolidation will choke off demand and postpone economic recovery.[1] It is generally accepted that whichever party wins the next election the state of the public finances will remain precarious: the next spending review will entail further cuts to public spending and possible tax rises stretching well into the next parliament.

What is less-often remarked upon is that Britain faces a longer-term fiscal challenge. The Office for Budget Responsibility (OBR) has estimated that by 2030 Britain will once again move into deficit because of long-term trends that look set to increase the demand on public services while restricting future tax revenues. This means that whoever wins the next or future general elections will be faced with difficult choices. Will taxes have to rise to pay for rising health, social care and pension costs? In a tight fiscal climate, which services should be prioritised and which not? How can we improve the productivity of public services over the long term?

This paper seeks to address these questions. It follows a seminar organised by IPPR and the Confederation of British Industry (CBI) during which we asked a group of leading experts in demography, public policy and public service delivery to look forward to 2030 and consider the likely choices that politicians will have to make. Although there was no consensus about the solutions, there was agreement about the scale of the challenge and the need for policymakers to start addressing it now. This paper draws on those deliberations, setting out:

- the nature of the long-term trends that will shape the health of the public finances over the next two decades and beyond
- the impact of those demographic, economic and social trends on the overall envelope of government revenues and expenditure
- the kind of choices that policymakers, whether on the left or right, will have to confront over the next two decades.

The paper does not make the case for particular solutions but rather describes the broad contours of the challenge and the nature of the choices that are likely to shape the debate.

It also calls on politicians to start a public debate now about these choices. The only way to achieve a legitimate and sustainable settlement on the overall balance in terms of what we spend as a country and how much tax we each pay is by engaging the whole country in the process. Given the importance of these decisions for all of us, the debate needs to involve as many people as possible, reflecting the views of people from different walks of life. And given the magnitude of the task, it needs to start now.

1 There are in addition those also who occupy a middle position, arguing for bringing forward some additional cuts now in order to fund growth-friendly measures such as infrastructure investment. See Mulheirn 2012.

1. LONG-RUN TRENDS

We cannot predict the future with any degree of certainty.The man who has been described as David Cameron's favourite philosopher, Nassim Taleb, has argued that human beings tend to underestimate the likelihood of random and high-impact events. Such events – or 'black swans' as Taleb describes them – might seem rare, but collectively they have a much larger impact on human affairs, he argues, than regular and predictable occurrences (Taleb 2010). One only has to consider a number of 'black swan' events to understand the truth in this: the second world war, the 9/11 attacks, the invention of the internet and the 2008 financial crash have all shaped our world in transformational ways that could not have been anticipated in advance.

Nevertheless, there are some long-term trends which we can predict with greater confidence. In order to scope out which things we can predict with greater or lesser certainty, it is useful to return to Donald Rumsfeld's often quoted distinction between known knowns (the things we know we know), known unknowns (the things we know we don't know) and unknown unknowns (Taleb's 'black swans', which we cannot predict in advance). Here, we set out the main trends of each kind that we can expect to affect the UK's fiscal position in 2030.

The known knowns

The demographic trend we can predict with the greatest confidence is that the British population will age over the next two decades. In part this is due to the continuing transition of the particularly large baby boomer generation into old age. But it is also because we are all living longer: the Office for National Statistics (ONS) projects that the average (median) age will rise from 39.7 years in 2010 to 39.9 years in 2020 and to 42.2 years by 2035. The number of people aged 85 and over is estimated to rise from 1.4 million today to 3.5 million by 2035. By 2035 there will have been an eightfold increase in the number of people living beyond their 100th birthday (ONS 2011).

This trend is relatively predictable and will have a significant impact on the public finances of almost every advanced society. But there are other trends that we can predict with relative confidence. Economic power is clearly shifting eastwards, with China expected to overtake the US as the world's largest economy before 2030, with huge implications for Britain's place in the global economy. We know that the climate is getting warmer: this is a trend that politicians have so far been unable to stabilise and which could either be controllable or potentially catastrophic in its impact particularly in the developing world. Closer to home, we know that the birth rate has recently increased in the UK, largely due to migration, and that there will therefore be a growth in the numbers of young children, which the ONS estimates will plateau around 2030 before falling back (ibid). Finally we can be fairly confident that there will continue to be a rise in the prevalence of chronic diseases such as diabetes, cardiovascular disease and hypertension that are linked to relatively affluent but unhealthy lifestyles.

The known unknowns

There is a second set of trends that we know will be important but whose scale and impact are hard to predict with any precision. In this category we can place long-term morbidity rates, for example, which could have a huge impact on the public finances. In this particular case there are two potential scenarios in play: in one we could all live longer in relatively poor health, while in the other we could live long but relatively healthy lives, with most of the health and social care costs coming in the very last years of life. Which of these scenarios prevails will have an enormous impact on long-term fiscal sustainability.

A further area of unpredictability is in economic projections. For example, if the UK managed to raise its long-term growth rate then many of our concerns about the affordability of current ongoing commitments would be resolved by growing affluence. The employment rate is crucial: if we can get more people into work, this would widen the tax base and strengthen the public finances. There are a number of ways of attempting to do this. We know from the Nordic countries that investment in more-extensive childcare and family support systems helps to increase both the female employment rate and tax revenues over the long-term. Separately, an increase in migration would increase the number of workers relative to retired people in the population, and thereby increase the proportion of the population paying tax.

Another predictable area of uncertainty is the productivity of the public sector. There has been considerable debate about how to measure productivity in public services. The ONS has estimated that during the 2000–2008 period productivity in the vital areas of health and education fell. Although outcomes improved, they did not rise as fast as investment was coming in (ONS 2011 and 2012). We should note that commentators have critiqued these findings, with Professor Nick Black arguing that many measures of quality that improved considerably were not included in the health productivity estimates (cited in Ramesh 2012). Nonetheless, if public sector productivity were to increase significantly over the coming decades, this would take considerable pressure off the public finances. NESTA has estimated that if productivity growth from 1995–2007 were the same in the UK public sector as in the private sector, the UK government would be spending £63 billion less every year (2008–09 figures)(Bunt et al 2010).[2]

The unknown unknowns

Finally, there are some events (Taleb's 'black swans') that are impossible to predict in advance but which have huge consequences. Some of the areas that could generate black swan candidates and so affect the public finances include:

- **Disruptive technological innovation:** No one fully anticipated the invention of the internet or the microchip, nor the impact of both innovations. There is clearly a very high chance that further high-impact technological change will occur in the years and decades ahead. For example, the more we know about the genetic make-up of individuals, the more we are able to design preventative measures to stave off likely ill-health and disease. This could potentially transform the way health services are delivered (Topol 2012).
- **Behaviour change:** Individual behaviour could shift in unexpected ways that policymakers cannot anticipate. For example, it is only recently that we have seen consistent falls in tobacco use among the general population and in the level of car usage by younger cohorts. Neither of these was predicted in advance but each has significant implications for the public finances.
- **Unanticipated policy decisions:** The OBR's 2011 long-term fiscal projections take the long-run policy framework as fixed and do not allow for future policy decisions that will have an effect on the public finances.

2 It should be noted that there are good reasons why it may be harder to achieve the kind of productivity gains in the public sector that we have come to expect in the private sector. These include, for example, that most public services are labour-intensive, that services cannot be allowed to fail, and that those spending public money need to be held to account democratically in a way private firms and entrepreneurs are not.

2. LONG-RUN PROJECTIONS OF REVENUES AND EXPENDITURE

Based on a set of assumptions about long-term demographic, economic and behavioural trends, the Office for Budget Responsibility (OBR) has made projections about the likely long-term trajectory of the public finances.

The OBR projects that total non-interest public spending will rise from 36.3 per cent of GDP at the end of 2015/16 to 41.7 per cent of GDP by 2060/61, an increase of 5.4 percentage points of GDP – equivalent to £80 billion in today's terms. The main drivers of this increase in expenditure are health, state pensions and long-term care costs, due largely to an ageing population (OBR 2011).

The OBR projects that:

- health spending will rise from 7.4 per cent of GDP in 2015/16 to 8.5 per cent in 2030/31 and 9.8 per cent in 2060/61
- spending on long-term care will increase from 1.2 per cent of GDP in 2015/16 to 1.5 per cent in 2030/31 to 2.0 per cent by 2060/61
- state pension payments will increase from 5.5 per cent of GDP in 2015/16 to 6.1 per cent in 2030/31 and 7.9 per cent in 2060/61, driven largely by demographic trends and the maturing of state second pension entitlements
- gross public service pension payments, however, are projected to fall from 2 per cent of GDP in 2015/16 to 1.8 per cent in 2030/31 and 1.4 per cent in 2060/61. The switch of baseline for uprating public sector pensions from RPI to CPI has had a significant impact on public sector pension costs.

Figure 1 shows that age-related spending constitutes the most significant long-term public services cost driver, while figure 2 shows the OBR's projected growth in spending on services and transfers to older people over the coming decade. By contrast, the government predicts that education spending will remain broadly flat over the long term, with a small rise up to 2030/31 due to higher birth rates which is then reversed in later years.

Figure 1
Projections of age-related spending, 2010/11–2060/61 (% of GDP)

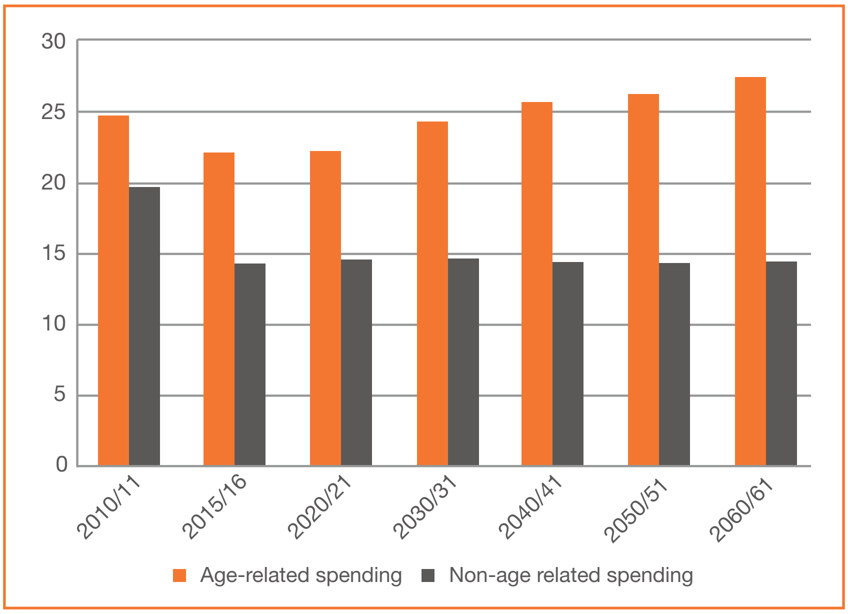
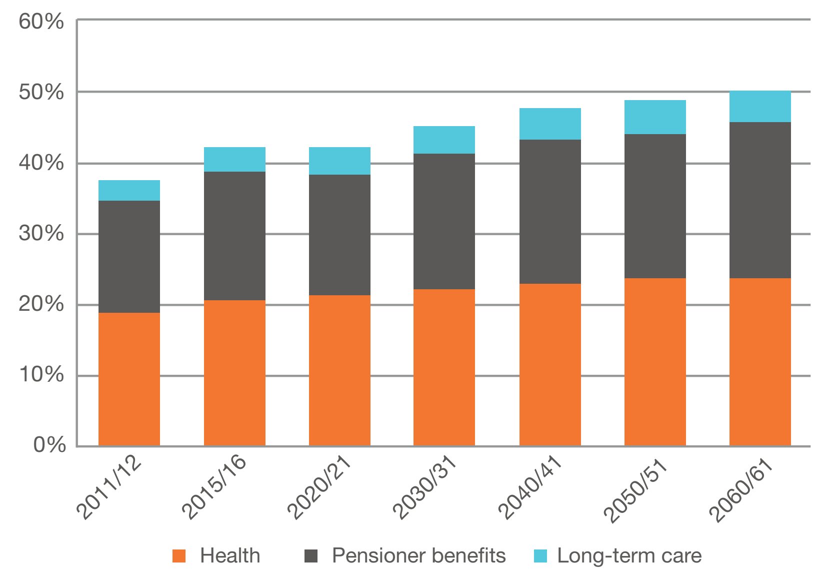


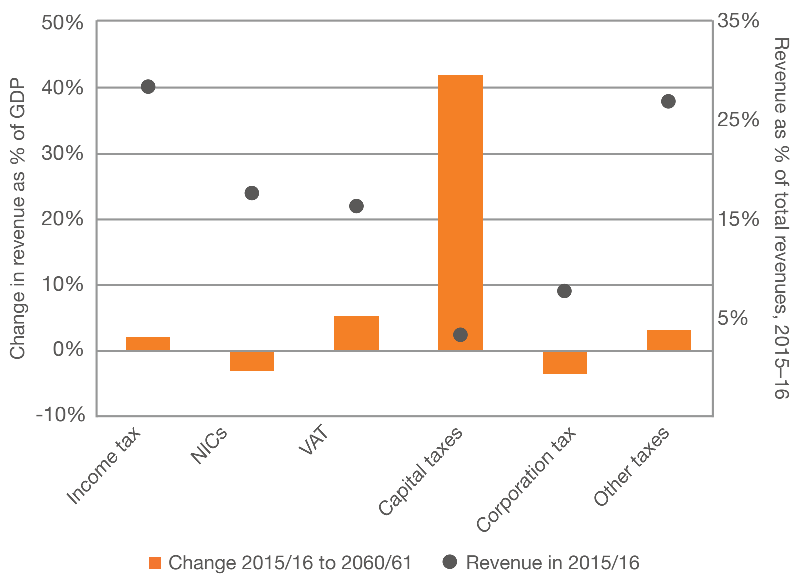
Figure 2
Projections of spending on health, pensioner benefits and long-term care, 2011/12–2060/61 (% of total spending)



In contrast to growing demand on spending, tax revenues are projected by the OBR to increase just very modestly from 37.6 per cent of GDP at the end of 2015/16 to 38.2 in 2030/31 and 38.5 per cent in 2060/61, an increase of just 0.9 percentage points of GDP – equivalent to £13 billion in today's terms. This reflects a number of factors shown in figure 3:

- a rise in income tax, VAT and capital taxes as a proportion of GDP, because these are taxes paid proportionately more by older people
- a fall in the share of national insurance contributions (NICs) because pension income is exempt
- falls in revenues from fuel, oil and gas, and tobacco duties.

Figure 3
Trends in revenue



As a consequence of this large rise in demand and relatively stable revenue position, the primary budget balance is projected to move from a surplus of 1.3 per cent of GDP in 2015/16 to a deficit of 0.6 per cent of GDP in 2030/31 and 3.2 per cent of GDP in 2060/61: a deterioration of 4.5 percentage points of GDP or £66 billion in today's terms (see figures 4 and 5).

Figure 4
Public spending and tax revenues, OBR projection, 2010–2060 (% of GDP)

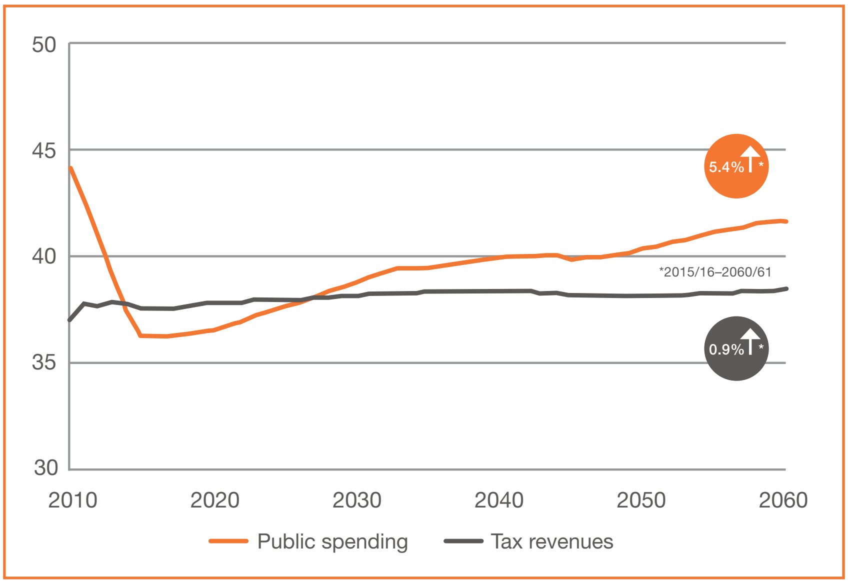
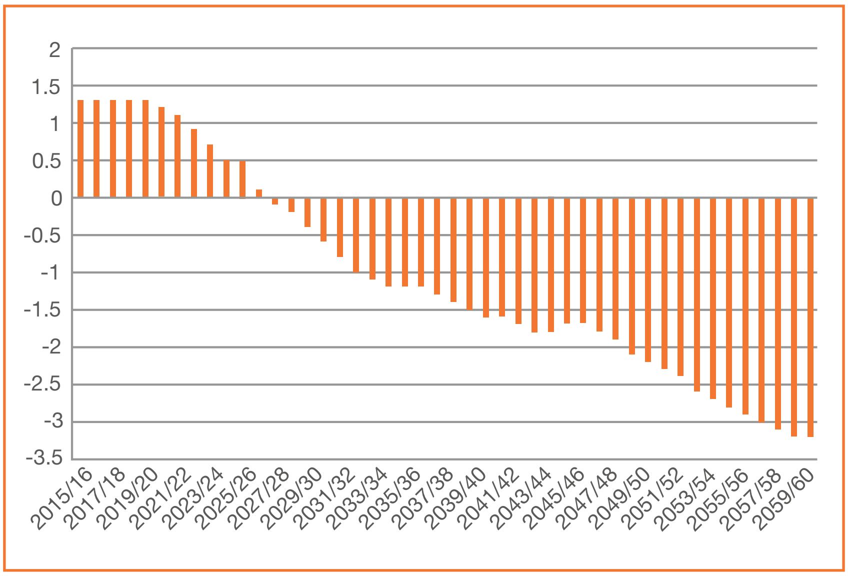


Figure 5
Primary balance to 2060/61, OBR projection (% of GDP)



Of course, as outlined in the previous section, there are considerable uncertainties in such projections over a long time period. Relatively small changes to big numbers have massive implications. For example, we don't know how healthy we will be as we age, a variable which has a huge impact on the projections. Similarly, an increase in immigration could compensate for the costs of ageing by bringing in younger workers to pay tax and add to economic growth. Moreover, the OBR projections are based on current policy decisions, but there will unquestionably be policy decisions in the future that will have an impact on the public finances, such as future tax increases, spending reductions and new spending commitments.

3. BIG CHOICES AHEAD

Whichever party is in power over the next two decades the fiscal environment will remain tight and will impose upon our leaders the need for difficult and unpopular decisions. They would be wise to lead a public debate now on the kind of choices that will confront us. These pressures are not unmanageable, still less an excuse to retreat from providing high-quality services. Nevertheless, with more people living longer and a smaller relative number of taxpayers to fund older people's pensions and services, something will have to give.

This section sets out some of the big choices policymakers will have to make to ensure long-run fiscal sustainability.

Prioritisation

Politicians will have to make strategic choices about which areas of spending to prioritise. These should relate to key national strategic objectives. We should want public spending and investment to help us achieve our goals of long-term sustainable growth and a fairer society. So, for example, we could look to find a better balance between revenue and capital expenditure. Capital expenditure is often the easiest thing to cut but it is crucial to strengthening the key national economic and social assets that will help the UK to compete in the global economy. Investment in the transport and energy infrastructure can help to directly create jobs and also to enhance the long-run growth prospects of the economy. In another area, we could shift housing expenditure away from revenue spending on housing benefits and towards building more affordable homes, boosting construction and helping to rebalance the housing market.

We could also choose to prioritise those services that raise the employment rate and thereby create a broader tax base. A key lesson of the Nordic countries' success is that investing heavily in affordable childcare and labour market activation policies has increased the labour supply, particularly among women, and generated higher employment rates and broader tax bases as a result.

Furthermore, we could start to see our public services as key national strategic assets that enable us to pay our way in the world. Some of our public services have the potential to become important sources of national comparative advantage. For instance, higher education is one of Britain's largest industries, bigger than advertising or pharmaceuticals, generating £59 billion of output a year. Britain has four universities in the global top 20 and 15 in the top 100. In a future where the UK's prosperity will depend critically on competing in high-value markets, excellent university research and teaching will be vital. As a result of this international reputation, Britain is the second most popular destination in the world for international students, who bring in a vital source of revenue for our home institutions. Some of our universities are also now opening up campuses abroad, which will help to finance student support and research back home. Higher education should be treated as an area of strategic economic importance: for example we could give the research budget relative protection and ensure that universities can continue to attract international students by no longer capping student immigrant numbers.

Policymakers should be thinking about how our other public services and public service providers could export their services abroad. Britain has an extremely high international reputation in professional services, such as education and healthcare. These are the largest sectors of global GDP and can be expected to grow further: historically, as countries have gotten richer they have always tended to spend a greater proportion of their income on health and education. This could be an opportunity for Britain to develop its health and social care sectors into highly competitive global leaders, with providers thinking about the degree to which they could sell their services to governments and citizens abroad to help finance their operations at home.

Prevention

It is commonplace to assert that 'prevention is better than cure', and yet the vast bulk of public services are generally reactive, responding to often acute social problems once they have occurred rather than preventing them from occurring in the first place. If one looks across the majority of mainstream services, they are generally of this reactive kind: the police service is mainly focused on solving crimes and catching criminals, hospitals are about treating and caring for people once they have become sick, and prisons effectively warehouse offenders, successfully rehabilitating only a minority.

If we were to focus investment 'upstream' at the preventative end then we could see shifts of the following kind:

- from acute hospitals to community-based health and social care provision and public health programmes to tackle obesity and alcohol consumption
- from prescribing antidepressants to supporting those things that promote mental wellbeing
- from penal institutions to community-based programmes aimed at reducing Britain's chronically high rates of reoffending
- from policing and antisocial behaviour interventions to whole-family support programmes to tackle problems like poor parenting at source.

There are, however, a number of barriers to this preventative shift that will need to be overcome.

- It runs against the heavily ingrained ethic of rescue that motivates many people to do good, including the state. 'Failing to prevent harm' does not yet carry the same moral weight as helping someone in need and for it to do so will require a challenge to public attitudes as well as professional cultures. It will also require the development of new knowledge and skills among public service professionals.
- Solving problems once they have manifested themselves tends to have tangible and immediate results, while preventative work has longer-term and less visible payoffs. Given the cycle of elections, this creates a strong political bias against preventative investment.
- Prevention saves money in the long term but there is always an upfront cost. There have been experiments in instruments such as social impact bonds, whereby money is raised from private investors who are then paid back once a preventative programme bears fruit and begins to save government money. However, these are in their infancy and it remains to be seen whether enough private investors will be attracted to this fledgling market.

Productivity

One of the best ways of meeting the long-term fiscal challenge would be to raise productivity across the big public services, such as hospitals, schools and the police service.

One possible avenue would be to think much more strategically about which areas of public services would be suitable for much more extensive automation – this would allow staff costs to be reduced in order to finance those areas that are essentially labour-intensive, where rapid productivity gains are much harder to make. In schools, for instance, classrooms are typically set up in much the same way they were 100 years ago, with one teacher facing 20 to 30 pupils. There may be some areas of learning, such as mathematics, that could be organised much more cheaply through the use of computer software, yielding much higher pupil:teacher ratios at no cost in terms of quality. There are other areas, by contrast, such as reading recovery for individual pupils who have fallen behind, where a one-to-one or small-group approach is essential.

There are some international examples, particularly from the developing world, of 'frugal innovation' that are salutary here. At the Avarind Eye Hospital in India, for example, routine cataract operations are performed at a rate that is much more productive than than the same operations in the developed world (Singh et al 2012). Are there areas of routine high-volume exchanges in our health system that could be carried out more efficiently, so as to help finance other areas, such as personal home care or mental health care, that require more intense relationship-building between professionals and users?

The key to unlocking higher levels of productivity is to unlock innovation: in order to do more for the same amount of money, services will have to be delivered differently in some way. The government's *Open Public Services* white paper argues that a greater role for the third and private sectors will encourage the development of new approaches. Another route is to give frontline professionals greater autonomy and flexibility to take risks and try out new ideas and practices.

Finally, we need to look at how we recruit, develop and reward professionals so as to encourage excellence. In terms of recruitment, there are some areas of public services that have found it hard to attract high-performing graduates. One way around this is to allow forms of 'direct entry' in services like the police that currently have a single point of entry at the lowest pay grade. Another possibility is to extend the 'Teach First' model, which has brought thousands of the highest-attaining graduates to work in some of the most disadvantaged schools in the country. IPPR is currently exploring how this model could be applied to the area of child social work, for example, which has been plagued by high levels of turnover and major recruitment problems.

In addition to recruitment, we could also look at how public service professionals are rewarded. For example, could pay be aligned collectively with the overall improvement in the performance of a service through so-called 'profit sharing'? This might incentivise innovation, unlock collaboration and bring about closer peer-to-peer professional development and performance management.

4. CONCLUSION

This paper has set out a major challenge facing Britain and one which has yet to be the subject of serious public debate. The OBR estimates that by 2030, on current trends, Britain will sink back into deficit unless we take some action in the next 10 years to raise the growth rate, contain expenditure or increase taxes. The political left and the right will have different views on how to tackle this problem. Some will call for public spending as a proportion to GDP to be scaled back further. Others will argue that to pay for valuable public services we as a country will have to pay more in tax.

In times of plenty Britain did not have to address these questions, because buoyant revenues from the City and rising house prices meant that we could invest more in public services without paying much higher rates of personal tax. Those days are now over and as a country we will have to choose. The point of this paper has not been to propose a solution but to shine a necessary light on the scale of the problem, on how certain (or uncertain) we can be about our long-term projections, and on the nature of the choices that confront us. What is clear is that Britain needs to start debating those big choices *now* so that whatever course is taken carries with it the support of the British people.

Bibliography

Bunt L, Harris M and Westlake S (2010) *Schumpeter comes to Whitehall: Cuts and Innovation in public services*, London: NESTA

Mulheirn I (2012) *Osborne's Choice: combining fiscal credibility and growth*, London: Social Market Foundation

Office for Budget Responsibility [OBR] (2011) *Fiscal Sustainability Report*, London

Office for National Statistics [ONS] (2011) 'Public service output, inputs and productivity: Healthcare', London. http://www.ons.gov.uk/ons/rel/psa/public-service-productivity/healthcare-2011/index.html

Office for National Statistics [ONS] (2012) 'Public service productivity estimates: Education 2010', London. http://www.ons.gov.uk/ons/dcp171766_261175.pdf

Ramesh R (2012) 'NHS productivity has risen in 10 years, undermining Lansley's case, says study', Guardian, 13 February 2012. http://www.guardian.co.uk/society/2012/feb/13/nhs-productivity-risen-lansley-study

Singh SK, Gambhir A, Sotiropoulos A and Duckworth S (2012) *Frugal Innovation: Learning from Social Entrepreneurs in India*, London: Serco Institute

Taleb N (2008) *Black Swans: The Impact of the Highly Improbable*, London: Penguin

Topol E (2012) *The Creative Destruction of Medicine: How the Digital Revolution Will Create Better Health Care*, New York: Basic Books