

The new coalition government: Cuts, taxes and the chance for radical public service solutions

Queen's speech over, new Members sworn in, the full parliamentary process can now re-start. With so much speculation and noise surrounding the plans to tackle the budget deficit, it's a good time to look at precisely what's happened so far, what we think may happen in the short and long-term and – crucially – what opportunities this brings for investors and business.

This commentary brings together some of our recent observations with some new and longer term thoughts. It:

- evaluates the recent £6bn cuts announcement;
- reviews the upcoming milestones in the coalition government's deficit reduction plan and likely trouble-spots; and
- argues that the economic and political environment make this a time of opportunity for those in the public service sector.

Cuts, cuts, cuts

So the new coalition government – forged on the proviso of the need for stable government able to take quick action – has taken its first steps to reduce the towering £156 billion budget deficit only 10 days after entering office.

Chancellor George Osborne and (now former) Treasury Chief Secretary David Laws identified savings of £6.243 billion to be made in 2010-2011. The majority is to be used to reduce the budget deficit, with £500 million to be reinvested in education, apprenticeships and social housing.

Most of the specific cuts were unsurprisingly focused on 'action to cut Whitehall waste' (the title of the official Downing Street release), including reducing costs from major suppliers, ditching I.D

cards and costly IT projects, and scrapping numerous quangos.

As we have already commented, however, on closer inspection, the bulk of this "waste" package is in fact reductions in discretionary spending (on consultancy, advertising and travel) and £1.7bn from renegotiating contracts. It is also remains unclear how these savings divide between stopping or delaying new contracts, and requiring contractors to renegotiate margins on existing contracts.

Moreover, the overall savings are relatively modest in total spending terms but the cuts required in some Departments are considerable – largely as a result of some of the biggest areas of spending being "protected". So the total fall in Departmental Expenditure is only 1.7% but the fall in unprotected DELs is 8.2%. In four Departments, the real terms fall in DEL compared to 2009/10 is more than 10%, and one (the Communities budget) falls by 27%.

Although Osborne and Laws also created a new 'Efficiency and Reform Group' to force departments to work together, and announced that all spending signed off since 1 January 2010 will be re-examined, the significant detail is still to come. More politically dangerous casualties are also sure to arise too, with the Child Trust Fund being the only really contentious programme to fall foul of the cuts this far – and this was well signposted in opposition manifestos and in the run up to the election.

More detail will be given through the emergency budget on 22 June, before the Comprehensive Spending Review in the autumn paints a fuller picture.

Striking the balance

While cuts to public services may well take the brunt of the budget reduction plan, the new coalition government will look to increase tax revenues. Although George Osborne's public 'rule of thumb' is that the ratio of spending cuts to tax rises to achieve deficit reduction should be broadly 80% from cuts and 20% from tax, there are reasons to believe the balance will be much closer. As we have noted before, it is much easier – especially in the short-term – to raise taxes. Moreover, there are fresh political reasons that may force his hand.

First among these is Cameron's desire to change the image of the Conservative Party. This has been his central mantra, and provides reasoning for everything from NHS budget ring-fencing to central involvement with the candidate selection process. Cameron will not want to be tarnished with having slashed and burnt public services. This is dealt with in part by a key tenet of his leadership, the 'Big Society' – an idea that convinced neither media commentator nor door-stepped voter, but one that is set to remain at the heart of his social policy. A shift in the ratio toward favouring tax revenue may well bring short-term gain while this big idea is given time to bed in.

Secondly, the Lib Dems will undoubtedly be pushing for tax revenue to take a larger share of the weight – and they have already proven their ability to gain tax concessions from the Tories, in the form of Capital Gains, Inheritance and Income tax thresholds.

Much should become clearer after the emergency budget on 22 June. While the weeks from now until then will be filled with speculation and rumour, the most consistent at this stage is of a hike in VAT to 20% – something neither party in the coalition ruled out in the pre-election rignarole. Other likely prospects for increases include changes to 'non-dom' rules and a tightening up of private residence

relief to ensure those with more than one home can't wriggle free of Capital Gains Tax.

Comprehensive Spending Review

Now confirmed, the Comprehensive Spending Review will report in the autumn following consultation with all tiers of Government, the private and voluntary sectors and, unusually, the general public. We are promised a "once-in-a-generation" re-examination of the way the government works. Yet it is still markedly unclear what will happen in the review, especially after a review of pre-election promises and coalition agreements.

To take an example we've highlighted before, the Conservatives only promised protection of two budgets: to raise health spending 'in real terms' and to increase our level of international aid to 0.7% of Gross National Income. As a result, schools would be the largest unprotected budget. Yet, as the coalition agreement makes clear, the Lib Dem proposal of a 'pupil premium' will be implemented through the use of budget reductions in other departments, effectively pledging significant extra money for education spending.

To take another, the government has already cut back local government DEL which will put pressure on local authorities. At the same time it has proposed a Council Tax freeze for at least one year and wants to devolve more power to local level. These proposals are not necessarily incompatible, but they will require a highly skilled balancing act.

The government is citing Canada in the 1990's as an example of the sort of radical reappraisal of public spending that it is looking for, yet one key difference from Canada is immediately apparent. In their case, no area of government was "protected" and therefore off limits. Unless the government retracts commitments to protect health spending in

particular, a similar scale of reduction will be hard to achieve.

Need for change

Decision makers across the public sector fear years of relative famine ahead after close to a decade of record growth. Yet, opportunity remains – there is now both economical need and political will for radical ideas in public service delivery.

The most fundamental aspects of Conservative social policy have survived the journey into government. Notably these include driving forward two concepts tentatively explored by the former government: personalisation of service through more individual control of budgets and provider choice; and greater linking of funding to outcomes (coined ‘payment by results’).

Going further than previous governments, the Conservative’s ‘Big Society’ wants to fundamentally change people’s relationship with public services. The Big Society is asking big questions that go far beyond simple axe-wielding: ‘How can we change society so that public services aren’t needed as much?’ ‘How can we improve standards without just letting go?’. In other words, it’s not just about reducing the state but reducing demand from the state.

As we have argued previously, companies willing to offer solutions to solve the £156 billion question – how to get more for less from public services – have a real opportunity to prosper. The Government is desperately seeking practical and deliverable answers, and ways in which to fund them.

Funding the solution

The economic realities now facing the government also mean increased scope for innovative approaches to funding. Expansion of invest to save models and the use of private investment to increase capex capability could play important roles.

Invest to save

(I2S) is a concept well understood and reasonably well practiced in government. In opposition, the Conservatives had explicitly supported this principle, setting out in their proposed Work Programme:

“There is at present no linkage between DEL and AME expenditure. The Government does not consider the cost of effective employment support (DEL spend) against the fiscal gain of a year-long move into employment (AME savings).”

“The amount of money that can be spent on programmes for getting people into work is limited and takes no account of the money the Government could save by getting someone off benefit and into work.”

The new coalition government is continuing to uphold this principle, as the coalition agreement outlines:

“We will reform the funding mechanism used by government to finance welfare to work programmes to reflect the fact that initial investment delivers later savings through lower benefit expenditure, including creating an integrated work programme with outcome funding based upon the DEL/AME switch.”

The agreement also highlighted the intention to increase the use of I2S across other departments:

“We will introduce a ‘rehabilitation revolution’ that will pay independent providers to reduce reoffending, paid for by the savings this new approach will generate within the criminal justice system.”

There is international precedent for the role of I2S in reoffending too. One example, the Maryland Opportunity Compact, includes a programme offering prison leavers home-based support to aid re-entry into their community. Addressing underlying issues that can cause youth re-offending – family, school, community, peers and others – funding is built up through future cost savings. In one year alone, the programme reduced re-arrests by 43%.

Yet, despite much promise and international example, the Treasury will need to be further convinced. Having seen mixed results from Labour's I2S Budget in 1998, there will need to be a greater emphasis on tight, forecastable and significant savings – or other ways in which to protect government from the risk of investment.

Social Impact Bonds

One fledgling new investment instrument is the use of Social Impact Bonds. A SIB is a contract between a public sector body and an investor, in which the former commits to pay for improved social outcome.

It's an attractive idea: offering government the means to implement social programmes without the risk of upfront investment.

The concept was developed by Social Finance (initially set up to cycle dormant account monies into social investments) and the first pilot SIB funded programmes were announced in the last Budget in March 2010.

The Ministry of Justice has agreed to a bond being issued to finance interventions aimed at reducing re-offending rates of short sentence prisoners at HM Prison Peterborough. The bond return is designed on a ratchet linked to the savings derived from the successful reduction in re-offending rates. The greater the savings the higher the returns to investors.

As a result, bond investors will receive both a financial and a social return while Government gains new funding aimed at improved social outcomes, with the risk taken by bond holders.

In the same Budget announcement, an SIB approach to improving health and social care outcomes in Leeds was announced. This is at an earlier stage of development and is aiming to save money by improving community based services to lower demand for hospital admissions and stays.

The potential to fund interventions aimed at specific social outcomes in this way, often using third sector providers that are highly effective but constrained by limited resources, is great. The Conservatives have shown support for the concept; potential investors now need to come up with the ideas.

The way forward

In contrast to pre-election delay and obfuscation, the new coalition government has made a quick start in addressing the depths of the deficit and spelling out the implications of the challenge we face. The emergency budget has to go further – both to set the baseline for the fiscal reduction plan and especially to offset out proposals for increasing tax revenue – before the CSR reveals the detailed, longer term picture.

For the public service sector this is an opportunity to provide solutions and answers, not problems and questions. While there are many issues, not least with procurement contracts and specific targets, there is both economic need and political appetite for radical approaches.

If the models can be carefully balanced to reflect the gain and/or pain effectively, innovative service delivery fuelled by private investment and funding could offer the government the means to implement social policy and bring desired social change even during these economically trouble times.



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