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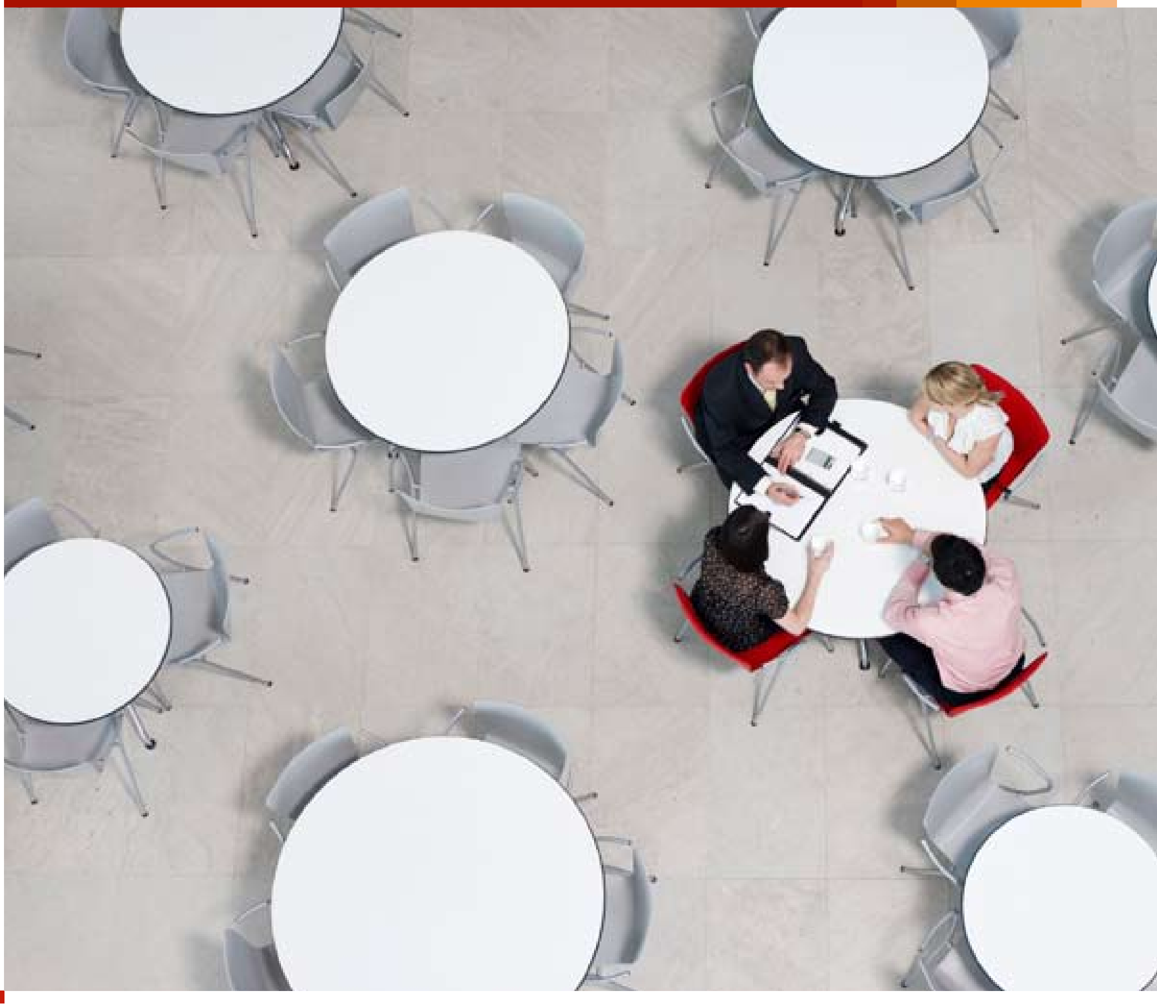
Sectoral and regional impact of the fiscal squeeze

An economic analysis of the impact of spending cuts and tax rises.



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Executive summary

The government is planning a fiscal squeeze building up to around £113 billion per annum by the end of this Parliament (6.3% of GDP in 2014/15). The main thrust of this will be through public spending cuts of around £84 bn, with the remaining £29 bn coming from tax rises, most notably around £13.5 bn from the VAT increase to 20% from January 2011.

Impacts on regions and sectors

Around half a million public sector jobs may go by 2014/15[1] as a result of this fiscal squeeze and there will clearly also be significant effects on private sector companies supplying goods and services to government. This is unlikely to be sufficient to derail the economic recovery altogether, but it will dampen the pace of growth over the next 4-5 years.

In total, we estimate that the public sector spending cuts could have knock-on effects on private sector gross output of around £46 bn p.a. in 2014/15 due to the impact on suppliers to the public sector (and their suppliers in turn). Almost half a million private sector jobs could be lost as a result – as great an impact as on the public sector – with nearly a million job losses in total, although this could be mitigated by increased labour market flexibility on wages and hours worked, which was a feature of the 2008-9 recession. On the other hand, evidence from the 1993-99 fiscal consolidation showed a net rise of around 1.2 million in private sector employment during those years.

Although the recovery may not be as strong this time, we would expect at least some rise in private sector employment over the next five years despite the fiscal squeeze, bearing in mind that this squeeze should allow interest rates to remain lower for longer. But quantifying these positive impacts is more difficult than assessing the negative impacts of the public spending cuts.

1 For the purposes of this report, we have adopted the OBR's estimates of likely public sector job losses of around half a million by 2014/15 (rising to around 0.6 million by 2015/16). Our focus has been on estimating the private sector output and employment losses arising from the public spending cuts.

The business services sector faces the largest impacts in absolute terms with potential 4% output losses and over 180,000 job cuts due to reduced public sector demand in current areas of operation. However, this may also be the sector that, based on historic trends, will create the greatest number of new private sector jobs to offset the squeeze on the public sector. In addition, there are signs that the Coalition Government may move the boundary between the public and private sectors thereby opening up new opportunities for business services companies, in some cases working with voluntary sector organisations.

The construction sector could see even larger relative cuts with an output loss of around 5% leading to around 100,000 job cuts. This reflects the greater exposure of this sector to cuts in public sector capital investment, which are particularly severe. Other smaller sub-sectors, such as office machinery and computers or weapons and ammunition, could see even larger relative cuts in output and jobs given their heavy reliance on public sector customers. The challenge for these businesses will be to diversify into other markets, both in the UK and overseas.

Our analysis shows that the regions that are likely to suffer the most are the devolved administrations of Northern Ireland, Scotland and Wales as well as the North East of England, due to their relatively heavy dependence on the public sector for employment.

For the UK as a whole, as the table below shows, total job losses including knock-on multiplier effects on the private sector and household spending might amount to around 3.4% of total employment (around 943,000 jobs in absolute terms) in 2014/15. For Northern Ireland this might rise to around 5.2% (around 36,000 jobs in absolute terms), compared to only around 3.1% in London and the South East. However, the latter two regions could see around 230,000 job losses in absolute terms given the larger size of their economies. Scotland might see job losses of around 95,000 and Wales around 52,000. Impacts will also vary within regions – within Yorkshire & Humberside, for example, our analysis shows that Leeds may suffer less than Hull due to its stronger private services sector.

Summary of estimated public and private sector employment effects of public spending cuts by region (in 2014/15)

Region	Absolute number of public and private sector job losses (000s)	% of total jobs in region
London	122	3.1
South East	112	3.1
North West	108	3.7
Scotland	95	4.1
Yorkshire & Humberside	82	3.7
South West	81	3.5
West Midlands	80	3.6
East	74	3.2
East Midlands	58	3.2
Wales	52	4.3
North East	43	4.1
Northern Ireland	36	5.2
UK total	**943**	**3.4**

Source: PwC analysis

These effects relate to public spending cuts, but there will also be material impacts from planned tax rises that will build up to £29 bn p.a. by 2014/15, although these are harder to quantify at regional and sectoral level[2].

As noted above, however, this analysis also excludes the positive impact of interest rates being lower for longer as a result of the fiscal squeeze, which is not easy to quantify (particularly at sectoral or regional level), but could nonetheless turn out to have a very material impact in the medium term. The fact that the public spending cuts will, considered in isolation, imply large job losses in both the public and private sectors should not therefore be taken to imply that the situation would be better had this fiscal squeeze not taken place: on the contrary, it is likely that the long run performance of the economy would have been even worse in that case due to higher interest rates and a greater risk of financial crisis.

Agenda for action

Notwithstanding the alternatives possibly being worse, there is no escaping the fact that the fiscal squeeze will have a significant adverse effect on many sectors and regions, even in areas with some discretion on how they implement the cuts passed down to them through their overall funding arrangements e.g. devolved administrations in Scotland, Wales and Northern Ireland[3]. But the government can take some action to address the impact on public sector organisations through innovative workforce reforms such as:

- Developing partnerships with private sector manpower providers to performance manage and retrain staff, to find new employment for them where possible, and to manage redundancies where it is not.

- Redesigning national public sector pay structures so that they relate to the skills and experience needed to deliver services at local/regional level rather than reflecting organisational hierarchies.[4]

A casualty of spending cuts will also be capital investment, notwithstanding that infrastructure is critical to enabling a modern, competitive economy. Government obviously needs to make capital cuts with an eye to the impact on future growth potential. Where public investment has to be cut, clearly this needs to be done selectively taking particular account of the impact on regions: if not done strategically, current cuts will risk perpetuating existing imbalances or creating new ones. A review of economic development spending is needed to protect areas with the highest economic return and make better choices as to where to place the investment of much reduced public funds. This importantly also applies to spend on key programmes underpinning long term economic performance, such as on skills, innovation and R&D.

As well as being sensitive to the regional impacts, cuts in capital spending should also be made in ways to maximise the chances that the private sector will act to bridge some of the consequent investment gap. The creation of stable regulatory frameworks is critical for success in this regard, so that the private sector can make decisions on investments with a greater degree of certainty, particularly in infrastructure where there are long payback periods.

Government needs to:

- Design policy instruments which will maximise the ability of the private sector to take up the investment burden by providing a stable policy environment which makes investment commercially viable.

- Tackle the financing gaps e.g. through measures such as the proposed Green Investment Bank (GIB) for climate change measures, and focus investment in areas where it will have a catalytic role in growth[5].

- Consider the acceptability of charging for services related to investments e.g. for road use, and so increase the incentives for business to invest through diversifying and increasing revenue streams.

2 The largest single tax rise is the increase in the standard rate of VAT to 20% from January 2011. The economic impact of this change will be assessed in more detail in the November 2010 issue of our UK Economic Outlook report.

3 The impacts of cuts in the devolved administrations will be a combination of both national and devolved measures.

4 Recognising that in the short-term this may exacerbate the impact of cuts in certain regions where pay rates might fall, leading to a further reduction in consumer demand.

5 For instance, a major role for the GIB will be to tackle financing gaps e.g. for offshore wind development, but unless there is some focused early intervention by the public sector e.g. encouraging investment in the supply chain and ports infrastructure, the accelerated rate of development which could create this financing gap will not be achieved.

These measures, together with simplification and shortening of the planning process, are critical to avoid creating an even greater infrastructure deficit, which would inhibit future growth.

Whilst important, we also question whether the Regional Growth Fund (RGF), and equivalent measures in the devolved administrations, will provide a large enough incentive or access to funds to make a material difference[6] and whether local authorities and the newly created Local Enterprise Partnerships (LEPs) will have the resources, fiscal powers and capacity to mitigate the impact of cuts and promote growth locally.

This raises important issues which merit further investigation such as whether more consideration should be given to the effectiveness of fiscal incentives to attract and retain new business investment in those areas particularly hard hit. More radically, what would be the costs, benefits and wider implications of handing the devolved administrations greater powers to vary their fiscal policies according to local circumstances e.g. setting differential corporation tax rates in their countries? Although raising some constitutional and economic difficulties, these are important questions to consider further in the light of the relatively high exposure of Northern Ireland, Scotland and Wales to the public spending cuts.

There will also be challenges for the private sector as business prepares for a tougher climate for public procurement with even more price sensitivity on new projects and pressure to renegotiate the terms of existing contracts. On the other hand, there will also be new opportunities for private sector companies in supporting the public sector's transformation over the next 4-5 years, notably in areas such as back office rationalisation and outsourcing. But the market will be much more discriminating than over the past decade, with only those suppliers offering real value for money and, in many cases, bringing the investment capacity that the public sector lacks, being able to prosper.

Although the fiscal squeeze will be painful, it should help to keep interest rates lower for longer than would otherwise be the case, which may also help to keep the pound at a competitive level and so support exports. A sounder fiscal position should also reduce the risks of future financial market and currency shocks and avoid crowding out private sector activity later in the recovery process. It will be a difficult journey, but the aim must be to provide a stronger foundation for growth which is financially, socially and environmentally sustainable in the long run.

6 For instance, the proposed scale of the RGF is less than 25% of the annual Regional Development Agency (RDA) outturn for 2009/10.

Introduction

The outlook for the UK economy remains in the balance. The Emergency Budget focused on delivering a fiscal consolidation plan to 'significantly accelerate the reduction of the structural deficit over the course of the Parliament'. The fiscal squeeze announced, with £40 bn of additional tax rises and real spending cuts over and above the previous government's plans, will continue to act as a drag on medium term growth[7] with fears remaining of a 'double dip' recession, although our main scenario projects that the UK economy will continue to grow modestly at around 2% in 2011.

Much of the debate since the Emergency Budget has been on which part of government will bear the brunt of the cuts. But how will the combination of tax rises and spending cuts impact on the UK economy more widely? This publication contributes to the debate by assessing the impact, and implications, of the fiscal squeeze on private sector industries and on different regions.

We investigate in detail the impact of the planned tax and spending proposals on current regional and sector imbalances which sets the context for our future programme of research and engagement on the government's growth agenda.

Report structure

This report is structured as follows:

- ***Section 1*** sets the scene by reviewing the implications of the Emergency Budget and anticipating the changes in spending plans by area to be announced on 20th October in the Spending Review.
- ***Section 2*** identifies the implications of the Emergency Budget for private sector industries.
- ***Section 3*** assesses the impacts regionally for both public sector and total employment.
- ***Section 4*** considers the agenda for action, for government as well as some of the implications for business, and looks forward to our next phase of research.

7 'UK Economic Outlook, PwC, July 2010.

1

The government's fiscal plans

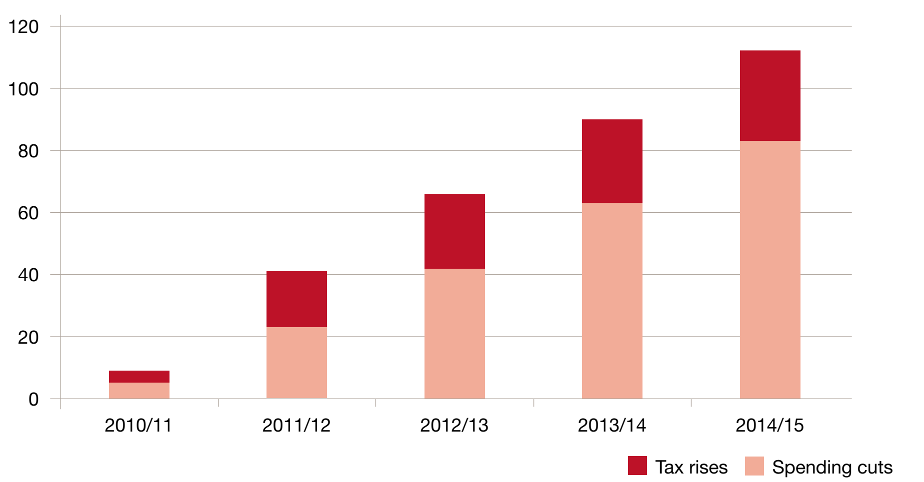
The Coalition Government set out its plans for fiscal consolidation in the Emergency Budget in June 2010, building on the plans inherited from the previous government. In this Section, we review the deficit reduction programme, the key tax measures and our assumptions about the likely spending plans by area before going on to assess the implications for public sector employment and growth.

Budget deficit reduction – tax and spending plans

In the Emergency Budget[8], the new administration announced its plans for deficit reduction, which included tax rises and significant spending cuts. **Figure 1** sets out the scale of the fiscal squeeze in the five years to 2014/15.

Total discretionary consolidation is forecast to be approximately £113 bn p.a. by 2014-15 (around 6.3% of GDP in that year), of which around £84 bn p.a. (73%) comes from spending reductions and £29 bn p.a. (27%) from net tax increases, the latter being more heavily

Figure 1: Total discretionary consolidation (£ bn)



8 HM Treasury Budget, 22nd June 2010.

Table 1: Summary of tax changes

Rise in 2014/15 (£ bn p.a.)	Inherited from previous government	New measures in Emergency Budget	Total tax changes
Income tax	9.7	-3.9	5.8
National insurance	7.9	-3.7	4.2
VAT	0	13.5	13.5
Fuel, alcohol, tobacco and other indirect taxes	2.9	0.5	3.4
Corporate tax (including bank levy)	-0.6	1.1	0.5
Other tax changes	1.1	0.7	1.8
Total net tax rise	**21.0**	**8.2**	**29.2**

Source: HM Treasury estimates in Budget Red Books for March 2009, March 2010 and June 2010

front loaded over the five year period that we are considering. Around £73 bn of this fiscal tightening was already planned by the previous government, with around £40 bn of additional tightening being announced in the Emergency Budget in June.

The Office for Budget Responsibility (OBR) has judged that there is around a 60% chance of the Government achieving its fiscal mandate to eliminate the structural current budget deficit by 2015/16[9]. The package therefore appears to meet the test of fiscal prudence, but we now need to consider how much pain this process of consolidation will cause to particular sectors and regions of the economy.

Key tax measures

Table 1 shows how the £29 bn p.a. tax rise breaks down by area, distinguishing between measures inherited from the previous government and those introduced in the Emergency Budget.

We can see from this table that:

- The tax rises inherited from the previous government were focused primarily on income tax rises for higher earners (the 50p rate, restrictions on pension tax relief and the personal allowance for those earning over £100,000) and more general rises in both employer and employee National Insurance Contributions (NICs).
- The Coalition Government has instead put more focus on indirect taxation, with the VAT rise to 20% being the dominant measure announced in the Emergency Budget, offset by higher personal allowances and an increased employer NIC threshold to moderate the extent of previously planned direct tax rises.
- The main rate of Corporation Tax will be reduced from 28% to 24% over the course of four financial years from April 2011, but this will be largely offset by reduced capital allowances. After allowing for the projected £2.4 bn revenue yield from the new bank levy, the net effect of the Emergency Budget appears to be a small rise in corporate taxation by 2014/15.

Key assumptions on public spending plans

Although at the time of writing we are still awaiting the announcement of the Spending Review, due for publication on 20th October, we can already anticipate that not all government departments will be subject to the same level of cuts[10]. In particular, Health and International Development have been ring-fenced, whilst it has been indicated that Education and Defence will face less severe cuts than the majority of departments, at approximately 10-20%[11].

9 The OBR's central forecasts also show the mandate and debt targets being met a year early in 2014-15.
10 For this analysis, we have adopted a neutral stance on the extent to which the cuts impact equally on both programme and administrative spend.
11 In the analysis that follows we assume a 15% real cut in defence spending in the four years to 2014/15, but also allow for changes planned in 2010/11 since we take 2009/10 as our base year throughout this analysis.

Spending on Health will likely see small real increases year-on-year, although these increases are likely to be low, particularly compared to the last decade, at less than 1% p.a.. International Development will see a significant rise in order to reach the UN target of 0.7% of Gross National Income (GNI) spent on overseas aid by 2013. However, the absolute amount is low and represents a relatively small (although politically significant) amount of government spending.

Other government departments, as well as local authorities and devolved administrations, will be facing severe real cuts, of 25% or more. As such, total departmental spending is estimated to fall by around 14% in real terms between 2010/11 and 2014/15, with a smaller fall in the current fiscal year. There have been strong indications that spending cuts across all departments will be focussed heavily on capital spending, as illustrated by the cancellation of the Building Schools for the Future programme.

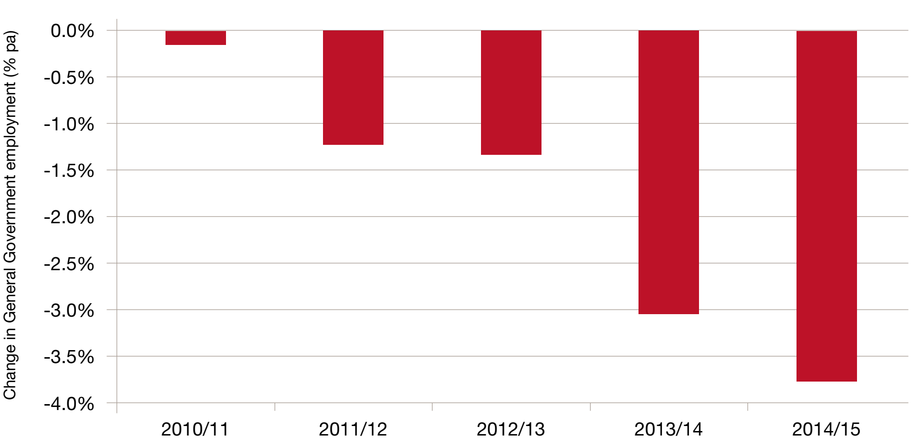
In addition to departmental spending, welfare benefits will also be cut by around £11bn p.a. by 2014/15[12]. Indeed, this amount seems likely to increase by around £4bn when final details of the Spending Review are announced, in order to alleviate some of the pressure on the more politically sensitive departmental budgets like Education.

Details of these additional welfare cuts (and any variations in the devolved administrations) are not available at the time of writing, however, so they have not been taken into account in our estimates, which are based on those in the June 2010 Budget Red Book. In any event, additional cuts in welfare benefits will also have adverse impacts on private sector output and employment through their impacts on consumer spending power.

Implications for public sector employment

The implications of the Emergency Budget for public sector employment have already been reviewed by the Office for Budget Responsibility (OBR). The OBR's published forecast for annual changes in government employment is shown in Figure 2[13]. This forecast, which we adopt in this report given OBR's access to detailed information on likely public sector employment effects, suggests government job cuts totalling around 500,000 by 2014/15[14], mainly back-loaded in 2013/14 and 2014/15. This back-loading is due in large part to the announced two-year pay freeze for all public sector workforces earning more than £21,000 a year, which formed part of the Emergency Budget and reduces the necessary job cuts in 2011/12 and 2012/13.

Figure 2: **OBR forecast of reduction in central and local government employment**



12 Budget Red Book Table 2.1, June 2010.
13 These figures are for general government, which is defined as central and local government, but omits public corporations such as the Post Office and BBC Worldwide whose business is conducted on a commercial basis.
14 Rising further to around 0.6 million government job losses by 2015/16, but this would take us beyond the horizon of the current Spending Review and the current Parliament and so are less certain. We therefore focus in this report only on the period to 2014/15, taking 2009/10 as our base year for comparison throughout.

Could public sector job cuts derail the recovery?

We looked at this issue in the July 2010 issue of our regular UK Economic Outlook publication[15] and concluded that this level of public sector job losses will be a drag on the pace of the economic recovery, but should not derail it altogether.

This conclusion, which still seems to hold in the light of subsequent economic data, reflected the fact that:

- cumulative planned public sector job cuts in the four years to 2015/16 still represent less than 2% of total UK employment;
- as noted above, these job cuts will be back-loaded and so should not have too severe an impact on the economic recovery in the short term, when it is likely to be most fragile;
- consequent private sector employment cuts may be mitigated to the extent that UK labour markets are more flexible than in past economic cycles, allowing adjustments in wages and hours worked to take more of the strain than employment numbers;
- tighter fiscal policy should, in the medium term, allow interest rates to be kept lower than would otherwise be the case, which should support private sector demand and employment; and
- based on the experience of the 1993-98 recovery period, private sector job gains in an upturn might be expected to offset public sector job cuts by a significant margin, although the more severe fiscal squeeze this time around, and the weaker state of our key export markets in the US and Europe, may make this conclusion less clear in the current economic cycle.

Conclusions

The government is planning a fiscal squeeze building up to £113 bn p.a. by the end of this Parliament (around 6.3% of GDP in 2014/15). The main thrust of this will be public spending cuts of around £84 bn, with the remaining £29 bn coming from tax rises, most notably around £13.5 bn from the VAT rise to 20% from January 2011.

Around half a million public sector jobs may go by 2014/15 as a result of this fiscal squeeze and there will clearly also be significant effects on private sector companies supplying goods and services to government.

This is unlikely to be sufficient to derail the overall economic recovery, although it will dampen the pace of growth and the risks are still weighted to the downside for the UK economy. However, some industry sectors and regions are likely to suffer more than others and we consider these differential growth and employment effects in more detail in the next two sections of this report.

15 Available to download from: http://www.pwc.co.uk/eng/publications/ukeo_jul2010_complete.html

2

Implications for private sector industries

Government is planning to withdraw, through the combination of spending cuts and tax rises described in the previous section, a significant amount of demand each year from the UK economy over the course of this Parliament. In this section, we review the main sub-sectors dependent on public spending and then assess the impact that planned reductions in this spending will have, through the supply chain, on the output and employment of private sector industries and which private sector industries might generate new jobs to offset the impact of public sector cuts. We conclude by reviewing briefly the potential sectoral impact of planned tax rises.

Our approach to assessing the sectoral impact of public spending cuts

In order to estimate the impact of public spending cuts on the demand for the output of individual private sector industries, we have based our analysis on the latest available ONS Input-Output tables[16]. These tables identify the inputs and outputs for around 120 sub-sectors in the UK economy and capture the way in which the output from one sub-sector draws inputs from a range of other sub-sectors.

The **first step** is to identify the sub-sectors in the Input-Output analysis that are primarily funded by the public sector and which comprise a significant market for private sector industries, as identified by DeAnne Julius (***see Box 1***).

These are:

- **Public Administration and Defence:** this sector is assumed to be 100% funded by the public sector. For the purposes of our analysis, however, we have separated out certain 'defence-specific activities' given that defence is expected to face somewhat less severe cuts than 'public administration'.

16 ONS, Input-Output tables (National Statistics website), 2007.

Box 1: Public services as an industry

If we just focus on the public services that government buys in rather than providing itself, then analysis conducted for the DeAnne Julius review[20] shows that the public services industry (PSI) in 2007/8:

- **Accounted for nearly 6% of GDP**
- **Employed over 1.2 million people**
- **Had revenues totalling around £79 bn.**

The largest sectors for PSI spending were Health (£24.2 bn), Social Protection (£17.9 bn), Defence (£10.1 bn) and Education (£7.3 bn).

More recent figures from the Treasury's Public Expenditure Statistical Analyses for 2009/10, although not fully consistent with those above, indicate:

- **Net current procurement by the public sector was £138 bn p.a.**
- **Net capital procurement was £40 bn p.a..**

So this is a very significant sector of the economy that will inevitably be cut back severely as the fiscal squeeze gets underway in earnest from next April.

- **Education:** 88% of this sub-sector is assumed to be funded by the public sector[17], with the rest comprising privately funded education.
- **Health:** 83% of this sub-sector is assumed to be funded by the public sector[18], with the rest comprising privately funded healthcare.
- **Social work:**[19] in the absence of readily available official data, we have assumed the share of publicly funded activity in social work is 80%, broadly similar to that in health.

The **second step** is to identify how much public spending might decrease in each of these four sub-sectors, based on what we know so far about the government's plans. **Table 2**[21] below sets out the assumptions we have made here. We focus on the five year period to 2014/15 relative to a 2009/10 base (given that some spending cuts are already being introduced in 2010/11, albeit on a relatively modest scale compared to plans for later years). We focus on real terms spending cuts after adjusting for whole economy inflation as measured by the GDP deflator, which is in line with normal Treasury practice.

Table 2: Assumed real changes in public spending by sub-sector

Sectors (estimated % publicly funded)	% real spending change (relative to GDP deflator) in 5 years to 2014/15
Defence (100%)	-14.0
Public administration (100%)	-31.4
Education (88%)	-16.7
Health (83%)	+4.5
Social work (80%)	-24.5

Source: PwC assumptions based on OBR/Treasury projections in June 2010 Red Book

17 Estimate of UK public/private education funding split from OECD, Education at a Glance, 2009.
18 Estimate of UK public/private health funding split from OECD Health Indicators, 2010.
19 'Social work' refers to sub-sector 118 in the Input-Output tables, which covers both adult and children's social care.
20 http://www.berr.gov.uk/files/file46938.pdf
21 Estimated cuts for each sector are shown when measured in terms of real cuts, and relative to a constant share of GDP. The estimated dependencies for each industry sector on public spending are shown in brackets.

The **third step** is to estimate the impact of these cuts on the public sector's demand for inputs from private sector industries, using data on these inputs from the ONS Input-Output tables. So, for example, these tables showed that the Education sub-sector used around £3.7 bn of inputs in 2007 from the 'other business services' sub-sector. If the 88% of the Education sub-sector that is publicly funded sees its spending cut by 16.7% in real terms, then the direct impact on annual inputs from the 'other business services' sub-sector might be assessed as:

£3.7bn x 88% x 16.7% = £0.54 bn

By repeating this exercise for each private/public sub-sector pair and then summing across public sub-sectors, we can calculate the estimated total direct effect of spending cuts on each private sub-sector. On the basis of these total losses, we identified the 30 private sub-sectors which were most dependent on public sector spending in order to apply further analysis. This includes all sectors for which direct 'first order' losses represent 1% or more of total gross output.

As a **fourth step**, we then calculated the indirect 'second order' losses of suppliers to these top 30 sub-sectors[22], which gives us an indication of the subsequent 'knock-on' effects of public sector spending cuts. For the following analysis we consider the total losses for each sub-sector, obtained by summing these first order and second order effects.

These estimated private sector losses can be expressed either in absolute terms (£bn p.a. at 2007 prices) or as a percentage of sub-sector gross output. Although the analysis we performed was done for 116 individual private sub-sectors, it is useful to aggregate results across broader sector groupings for ease of presentation and discussion, as shown in **Table 3**.

The business services sector has the largest losses in absolute terms although our analysis is based on the current penetration of business services companies in the public sector. There are signs that the Coalition Government may consciously shift the boundary between the public and private sectors in some areas, so opening up potential new areas for business services, possibly working with voluntary sector organisations e.g. on offender rehabilitation.

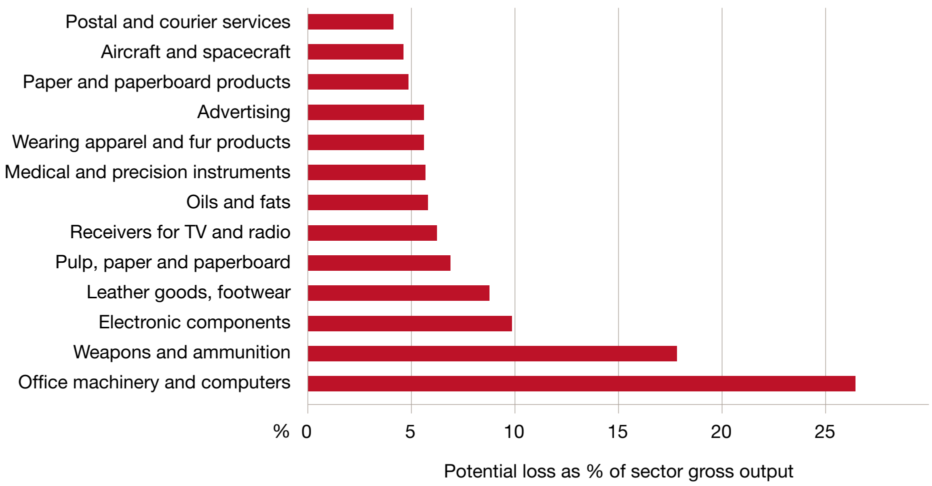
Table 3: Estimated private sector output losses in 2014/15 due to reduced public sector demand

Sectors	Estimated gross output loss (£bn at 2007 prices)	Loss as % of gross output in sector
Business services	11.9	3.9
Construction	10.6	5.1
Manufacturing	9.3	2.0
Transport and communications	3.2	1.9
Distribution, hotels and catering	1.1	0.4
Financial services	2.0	1.1
Other sectors	8.3	1.5
Total private sector	**46.4**	**2.1**

Source: PwC analysis

22 Second order losses were not material for suppliers to sub-sectors outside of this top 30.

Figure 3: Estimated output losses at detailed sub-sector level



Therefore, whilst the business services sector will employ fewer people in existing areas of public sector work, new areas may be created over time, resulting in offsetting employment opportunities, although we have not sought to quantify the net effect given current uncertainties on this policy direction.

The construction sector has the largest losses relative to the size of the sector at around 5%. This reflects the relatively high exposure of construction companies to cuts in public sector capital spending, which will be particularly severe.

We can also compare losses as a share of gross output at more detailed sub-sector level, as shown in **Figure 3**. It can be seen that 'Office machinery and computers' is the most affected sub-sector on this basis, which is perhaps unsurprising given the close correlation between jobs and the related office requirements.

Given its dependence on public sector defence contracts, 'Weapons and ammunition' is also heavily affected (as will be the UK aerospace sector given its high dependence on defence contracts).

An example of a less expected sub-sector to be impacted heavily is 'Leather goods and Footwear'. A potential explanation might be that such sub-sectors are very small in the UK, and as such contracts from some public sector bodies like the Armed Forces represent a large part of sector demand.

Private sector job losses

We can provide rough estimates of potential job losses from public spending cuts, based on aggregating the results from our Input-Output analysis across broader sector definitions for which we have recent data on the ratio of employment to gross output in each sector[23]. **Table 4** summarises the results of carrying out this analysis based on the assumption that the ratio of output to employment remains unchanged as a result of the spending cuts[24].

We can see that business services, by virtue of having the largest share of employment of any sector, also has the highest potential job losses from public spending cuts of around 186,000. This could be everything from cleaners to IT consultants as it is a very broadly defined sector.

The construction sector has smaller potential job losses in absolute terms at just over 100,000, but the largest relative to the size of sector. Some manufacturing sectors, such as defence contractors and suppliers of office machinery and computers, will also suffer significantly as the public sector shrinks. Although subject to the vagaries of exchange rates and purchasing patterns by overseas government, some sectors like aerospace, medical and precision instruments, and pharmaceuticals[25], being global in orientation, could look to export markets to re-balance portfolios.

But this will require a greater focus on fast-growing emerging markets by UK manufacturers, who at present still tend to sell primarily to markets in the EU and North America[26].

The transport and communications sectors will also be affected by declines in public spending, particularly on infrastructure projects. Distribution and financial services appear to be less vulnerable on this analysis, although sub-sectors such as hotels could be affected more than indicated by the broad sector aggregates due to loss of public sector demand for public sector events and conferences.

Where will the new private sector jobs come from?

If jobs shed from the public sector and its suppliers are to be replaced, where will these come from in the private sector? A number of commentators have identified businesses in 'Clean Technologies' as having high growth potential. Whilst this may be the case, the absolute size of such sectors as a source of employment is relatively small at UK level[27]. Compare this with financial and business services where even small percentages of growth convert into large numbers of jobs.

Table 4: Estimated private sector employment losses in 2014/15 due to reduced public sector demand

Sectors	% loss of employment	Implied employment reduction (000s)
Business services	3.9	186
Construction	5.1	104
Manufacturing	2.0	51
Transport and communications	1.9	47
Distribution, hotels and catering	0.4	25
Financial services	1.1	11
Other sectors	1.5	44
Total private sector	**2.1**	**468**

Source: PwC analysis assuming employment declines proportionately to output in each sector

23 It is difficult to quantify the employment effect of the tax changes discussed earlier so these effects are excluded from Table 3.
24 This may not necessarily be true, but in practice it is difficult to assess whether employment might change proportionately more or less than output at the sectoral level, so this seems a reasonable simplifying assumption to make here. The recent recession did see a smaller fall in employment relative to output than past downturns, but this relationship may not continue to hold over the next few years if the scope to cut hours worked and real wages has been largely exhausted. This is, however, an important source of uncertainty with the estimates: greater labour market flexibility now may be a reason for the ultimate job losses to be somewhat smaller than we have estimated here, or for other private sector employment to increase further to offset losses of public sector employment.
25 NHS spending on these latter two areas may be protected from real cuts, but will certainly grow much less rapidly than over the past decade.
26 In 2008, only 7.5% of UK goods exports went to the fast-growing BRIC economies, as compared to around 70% going to rest of the EU and North America.
27 As noted by McKinsey Global Institute in its research on 'How to compete and grow: A sector guide to policy'. However, the effects could be larger for particular regions (e.g. Scotland in the case of renewable energy).

Table 5: Private sector employment changes during last fiscal consolidation in 1993-99

Sectors	Absolute employment change (000s of jobs)	% employment change
Finance and business services	998	23%
Distribution, hotels and catering	386	6%
Other private services	323	23%
Transport and communications	77	5%
Manufacturing	-172	-4%
Construction	-137	-7%
Agriculture, mining, utilities	-261	-26%
Total private sector	**1214**	**6%**

Source: ONS

Indeed, finance and business services generated around a million jobs during the last period of fiscal consolidation in 1993-98, which was be far the largest contributor to the total rise in private sector employment over that period, as shown in Table 5.

Despite the strong impact of spending cuts in absolute terms on business services, the impact is not that large (3.9%) compared with total sector output and it would be surprising if this sector did not continue to generate further jobs oriented to the private sector which will help fill the hole in public sector demand. A good example is the outsourcing market which is likely to continue to have significant business opportunities as more public sector activity is outsourced, although the market will be much more discriminating than over the past decade, with only those suppliers offering real value for money, and in many cases bringing the investment capacity that the public sector lacks, being able to prosper (see Box 2).

Other sectors may benefit from longer term demographic trends and ageing, like social care, which is also labour intensive.

Manufacturing, construction and other primary industries seem likely to continue to decline in terms of employment, although manufacturing output could nonetheless rise due to productivity growth, which has been the historic pattern in recent decades.

Box 2: Outsourcing and corporate support services: a growth opportunity

A sector likely to continue to see growth opportunities from spending cuts is outsourcing, and not only in back office services. As government and public sector organisations look to reduce their non-core, fixed cost operations, and increase the use of private and voluntary sector organisations in the delivery of front-line public services, organisations such as Serco are already highlighting opportunities for new business in their financial statements.

Many are also seeking to form alliances with voluntary sector organisations.

Similarly, organisations with flexible supplies of labour, such as manpower service providers, will have new opportunities in future such as partnerships between government and private sector manpower providers to performance manage and retrain staff, to find new employment for them where possible, and to manage redundancies where it is not.

Which sectors will be hardest hit by tax rises?

In the Emergency Budget, there were a number of tax reforms which will have differential impacts on private sector industries, although these are difficult to quantify. These changes are briefly outlined below and summarised in **Table 6**.

- VAT (Value Added Tax) will be raised from 17.5% to 20% from January 2011[28]. This has a direct effect on household spending power although sectors such as food that are zero rated or exempt from VAT are not affected. As a result, the sectors most affected by the rise in VAT will be non-food retailers and domestic service providers; in contrast, many food retailers and manufacturers, as well as exporters, will not be directly affected.

- The Corporation Tax rate will be reduced gradually over the next few years, but this is largely offset by reduced capital allowances. The latter changes will be felt most by those industry sectors that are more capital intensive, such as manufacturing and telecommunications. This could compound the problems faced by sub-sectors facing large percentage losses of their gross output due to public spending cuts, such as 'Office machinery and computers' and 'Electronic components'.

  However, labour-intensive sectors, which include most services, will be relatively unaffected by the reduced capital allowances, and will benefit from lower Corporate Tax rates.

- National Insurance Contribution (NIC) rates will increase from April 2011 for both employees and employers, but the effect on low earners will be offset by higher thresholds to start paying NICs (and also higher income tax personal allowances). The benefits of this change in thresholds will be largely limited to those companies that are either employing low earners or targeting markets comprising mainly low earners. Other companies will lose out from higher NIC rates.

- Those companies that are either employing, or selling to, high earners – such as luxury goods manufacturers and retailers – will be negatively affected by the 50p higher rate of income tax, a higher capital gains tax rate of 28% and pension tax relief restrictions for high earners.

- Finally, there are some other indirect tax rises, such as those on alcohol, tobacco, and potentially air transport in the future, which will adversely affect companies operating in these sectors.

It is difficult to quantify these sectoral impacts of tax rises, but their effect could nonetheless be material for many sectors.

Table 6: Tax rises and relative sector impacts

Tax changes	Most affected sectors	Not/least affected sectors
VAT rise	Non-food retailers and manufacturers and domestic service providers	Exporters, food retailers and food manufacturers
Corporate tax reforms (lower CT rate, reduced capital allowances)	Capital-intensive sectors (manufacturing, telecoms)	Labour-intensive sectors (most services)
50p top rate, restricted personal allowance, pension tax relief changes	Luxury goods manufacturers and retailers; employers of many high earners	Other companies less affected
NIC rise with offset by higher personal allowance	Other companies lose out	Companies selling to or employing low earners gain
Other indirect tax rises	Alcohol, tobacco, possibly air transport in future	Other companies

Source: PwC assessment

28 A more detailed analysis of the economic impact of the VAT rise will be included in the November 2010 issue of our UK Economic Outlook report.

Conclusions

In total, we estimate that the public sector spending cuts could have knock-on effects on private sector gross output of around £46 bn p.a. in 2014/15 due to the impact on suppliers to the public sector (and their suppliers in turn). Almost half a million private sector jobs could be lost as a result. On the other hand, evidence from the 1993-99 fiscal consolidation showed a net rise of around 1.2 million in private sector employment during those years, so we might expect at least some rise in private sector employment over the next five years despite the fiscal squeeze.

The business services sector faces the largest impacts in absolute terms with potential output losses of around 4% and over 180,000 job cuts due to reduced public sector demand in current areas of operations. On the other hand this may also be the sector that, based on historic trends, will create the greatest number of new private sector jobs to offset the squeeze on the public sector. In addition, there are signs that the Coalition government may move the boundary between the public and private sectors in certain areas thereby opening up new opportunities for business services companies, in some cases working with voluntary sector organisations.

The construction sector could see even larger relative cuts with an output loss of around 5% leading to around 100,000 job cuts. This reflects the greater exposure of this sector to cuts in public sector capital investment. Other smaller sub-sectors, such as office machinery and computers and weapons and ammunition, could see even larger relative cuts in output and jobs given their heavy reliance on public sector customers. The challenge for these businesses will be to diversify into other markets both in the UK and overseas.

These effects relate to public spending cuts, but there will also be material impacts from planned tax rises, although these are harder to quantify at the sectoral level. There will also, however, be positive effects from the fiscal squeeze in terms of interest rates remaining lower for longer and a reduced risk of a major financial crisis associated with a bond market revolt of the kind seen in Greece and elsewhere in the euro zone earlier this year.

Quantifying these more positive effects is difficult although in general we would expect based on the experience since the early 1990s to see labour-intensive service industries being the main source of new private sector jobs in the coming years, so helping to compensate for negative employment growth in the public sector and more traditional areas such as manufacturing, energy and utilities, and construction. The geographical distribution of these job shifts will also be important, however, and we therefore now turn to the regional implications of planned spending cuts and tax rises.

3

Implications for different regions

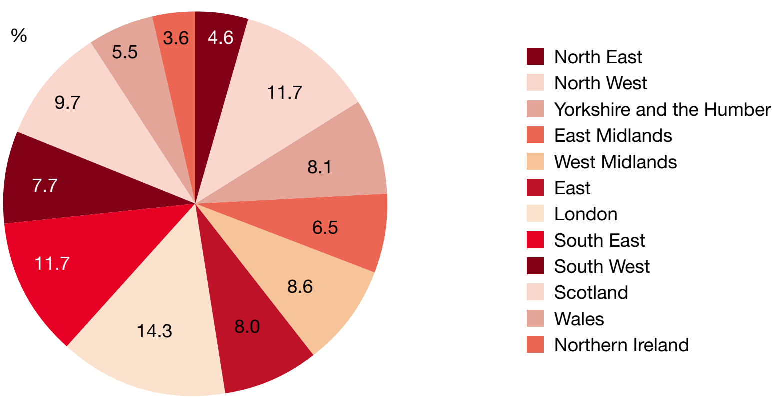
An important theme running through both the Programme for Government of the Coalition and the Emergency Budget[29] was the judgement that previous UK economic growth had been insufficiently balanced (i.e. not enough growth in the regions and nations beyond London, South East and East of England, or in manufacturing and services beyond the financial sector). In this section, we analyse public sector spending and employment by region and then assess the impacts of spending cuts on regional income and employment.

How is public spending and employment split by region?

Some public sector expenditure (e.g. on national defence) cannot be meaningfully split by region, but the Treasury does publish a split of that part of spending that can be allocated to regions, including Scotland, Wales and Northern Ireland. The latest figures for 2009/10 are shown in **Figure 4**.

Public sector employment by region follows broadly similar patterns overall, but it is more informative to look at the share of employment in each region in the public sector, as shown in **Figure 5**.

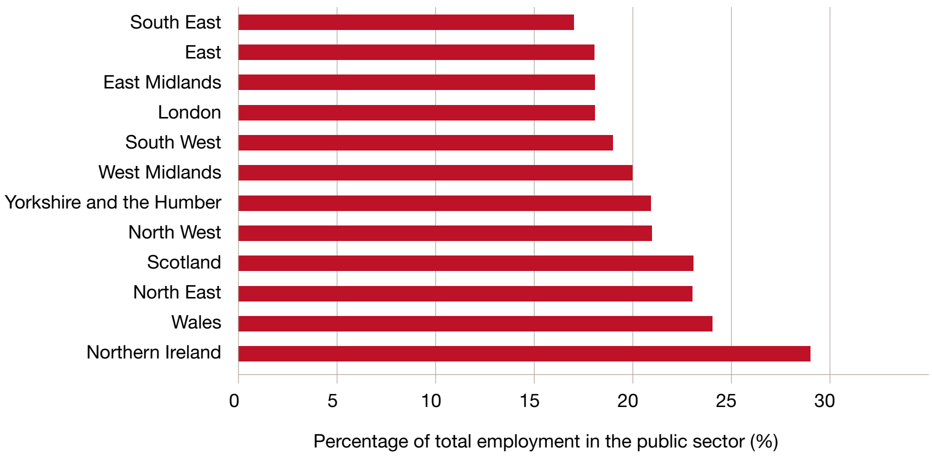
Figure 4: Public spending split by region in 2009/10



Source: HM Treasury, Public Expenditure Statistical Analyses (July 2010)

29 "Growth in all parts of the UK", HM Treasury June 2010, Budget 2010, London, paras 1.86-1.89.

Figure 5: Share of public sector in total employment in each region (2009)



Source: ONS

This shows that Northern Ireland has the highest share, with nearly 30% of total employment coming from the public sector. Of the English regions, it is the North East which yields the highest percentage of employment from the public sector.

Given that the OBR's forecast of public sector employment losses provided no indication of the regional impact, we have assumed in the analysis that follows an even distribution of these losses and applied these forecasts to the most recent regional employment data from the quarterly ONS Public Sector Employment Statistical Bulletin.

Regional impact of public spending cuts

There are two key ways for us to look at the regional impact of spending cuts:

- We can examine the financial losses across regions, which can be expressed in absolute terms or as a percentage of regional Gross Value Added (GVA). The latter is generally a more significant measure, as the impact of losses on the region depends on the size of that region's economy.
- We can also look at the potential regional employment effects, including possible multiplier effects.

The estimated scale of spending cuts by economic function[30] is shown in **Table 7**. As set out earlier, of these estimates the only functions to see an increase in real spending are Health and International Development.

Table 7: Spending cuts by economic function

Economic function	% real spending cut
Public & common services	-31.4
International development	+65.3
Defence	-14.2
Public order and safety	-31.4
Economic affairs	-31.4
Environmental protection	-31.4
Housing and communities	-31.4
Health	+4.5
Recreation, culture etc	-31.4
Education	-16.7
Social protection	-9.4

Source: PwC estimates based on HM Treasury data (PESA, July 2010)

30 To assess the regional splits of public sector spending by region, we used the latest available Public Expenditure Statistical Analysis data (2009/10).

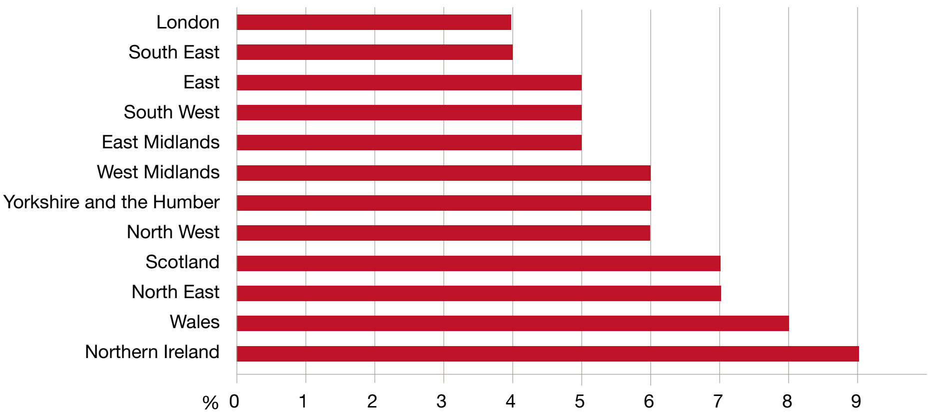
Implications for regional GVA and total regional employment

Figure 6 shows the estimated scale of public sector spending cuts[31] in real terms as a share of total GVA (public and private sector) in each region.

As can be seen, Northern Ireland is the most affected region, facing cuts of around 9% of GVA over the next 5 years. This means average public spending cuts over the next five years in Northern Ireland will amount to approximately 1.8% of GVA p.a. in that region. London and the South East are the least affected with average yearly spending cuts forecast at less than 1% of GVA p.a. for each region.

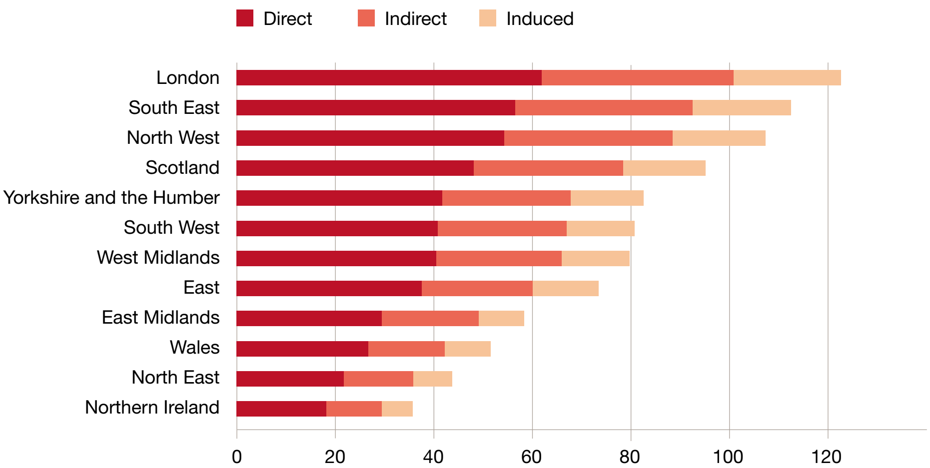
Figure 7 goes further and shows not only the direct impact of spending cuts in terms of public sector employment but also the 'indirect' and 'induced' multiplier effects on private sector employment[32]. This shows that the greatest number of jobs in absolute terms will be lost in London (around 122,000), which is due to the high number of civil servants in the capital and the fact that streamlining the civil service is a key part of the government's spending reductions. In absolute terms, the next hardest hit regions would be the South East, with around 112,000 job losses, and the North West (around 108,000).

Figure 6: Estimated scale of spending cuts as % of GVA in each region by 2014/15



Source: PwC analysis of ONS data

Figure 7: Estimated total job losses by region by 2014/15



Source: PwC analysis

31 Measured by region, in the five years to FY2014/15, relative to a FY2009/10 baseline, and expressed as a percentage for each region's GVA.
32 Indirect effects refer to job losses among suppliers to the public sector, while induced effects refer to reduced spending by those losing their jobs in both the public and private sectors. For more details, see this description by the Scottish Government: http://www.scotland.gov.uk/Topics/Statistics/Browse/Economy/Input-Output/Mulitipliers. Their employment multiplier estimates are used as a starting point in our analysis but are then scaled to match the results of the UK-wide sector employment impact analysis shown in Table 3.

It is notable that we estimate here that Scotland could suffer around 95,000 job losses by 2014/15. This is towards the middle of an estimated range of 64,000 to 126,000 in a recent more detailed analysis of impacts on Scotland by the Fraser of Allander Institute[33], with the precise outcome depending in particular on the flexibility of the private sector response to the fiscal squeeze. In practice, all estimates of the kind shown in **Figure 7** will be subject to similar margins of uncertainty, but they appear broadly plausible in terms of orders of magnitude.

If we look at the percentage of jobs lost by region due to public sector cuts including potential multiplier effects on employment in **Figure 8**, the results tell a slightly different story.

Analysing this data we can see that Northern Ireland will be facing the largest potential reduction in employment with over 5% of jobs lost in total across the five years. This could mean a significant increase in the unemployment rate over the 5 year period or require a significant shift in the growth rate for the private sector (see **Box 3**).

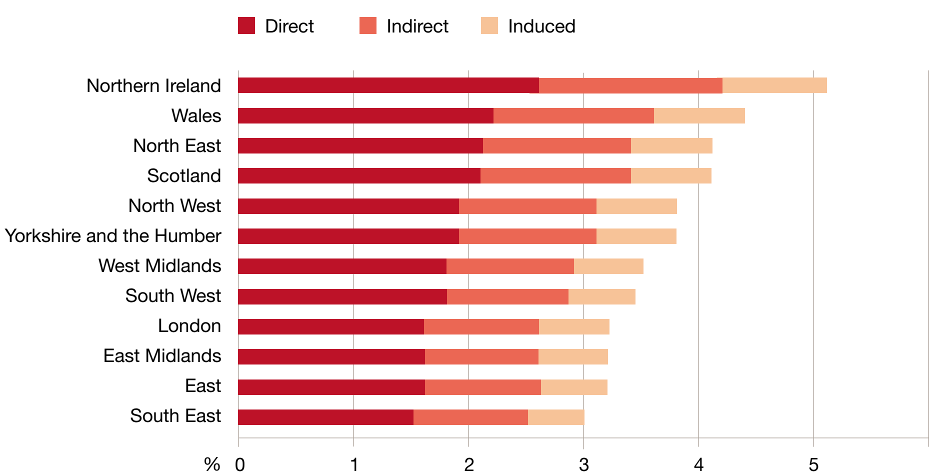
Regional impact of tax and benefit changes

Increases in the taxation of higher earners will impact most heavily on affluent areas such as parts of London and the South East, with a lesser impact on lower income regions (although this will include some Inner London boroughs). It is also possible that the impacts by industry sector of other tax changes will have different regional impacts, but this is likely to be of second order significance in general.

A range of welfare benefit cuts outlined in the Emergency Budget, including changes to child benefits and tax credits, will tend to affect poorer regions such as Northern Ireland, South Wales, the North East and parts of Scotland more on average than affluent parts of the South. However, these adverse effects should be offset in part by increased personal allowances and partial protection from National Insurance Contribution increases for low earners.

There also seem to be some potential offsetting due to regional growth funds and related initiatives, but these seem to be of relatively small scale in relation to the scale of public spending cuts regionally.

Figure 8: Estimated % of total jobs lost by region by 2014/15



Source: PwC analysis

33 http://www.strath.ac.uk/media/departments/economics/fairse/Latest-Fraser-of-Allander-Economic-Commentary.pdf

Box 3: Northern Ireland and other devolved administrations: impact of the cuts and possible policy responses

A consideration of the impact of spending cuts on Northern Ireland is particularly important given that it is the UK region with the largest public sector in proportional terms (equivalent to more than 70% of GDP and about 30% of employment). It is hardly surprising that the cuts are likely to have a disproportionate effect.

If public sector employment drops by 10% over the next five years that would be equivalent to around 20,000 jobs in Northern Ireland (and, as we have shown above, further negative "multiplier" effects are likely taking total estimated job losses to around 36,000). Given that the total private sector employment in Northern Ireland is currently 550,000, private sector growth of more than 1% p.a. would be required for each of the next four years to compensate for the decline in public sector employment. The Northern Ireland private sector did experience growth rates of about 1% annually during 1998-2008 but it will be much harder to replicate that experience in the much more constrained macroeconomic climate likely after 2010. This suggests the need for policy makers to take a novel approach. For instance, should consideration be given to the effectiveness of fiscal incentives to attract and retain new business investment in those areas particularly hard hit? In particular, what are the costs and benefits of handing the devolved administrations in Northern Ireland[34], Scotland and Wales[35] greater powers to vary their fiscal policies to local circumstance e.g. setting differential corporation tax rates in their countries?

Indeed, the Programme for Government (May 2010) of the new Coalition proposed offering the Stormont Assembly flexibility to vary the rate of corporation tax (and possibly wider business tax flexibility), giving Holyrood the power to raise and administer some Scottish taxes and guaranteeing Wales a referendum on greater devolution and a review of Welsh Assembly Government's tax-raising powers.

Conclusions

Our analysis shows that the regions that are likely to suffer the most from public spending cuts are the devolved administrations of Northern Ireland, Scotland and Wales as well as the North East of England, due to the heavy dependence on the public sector for employment.

For the UK as a whole, total job losses related to the public spending cuts[36] including knock-on multiplier effects on the private sector might amount to around 3.4% of employment (around 943,000 in absolute terms), but for Northern Ireland this might rise to around 5.2% (around 36,000 in absolute terms), compared to only around 3% in London and the South East. However, the latter two regions could see job losses of around 230,000 in absolute terms given the larger size of their economies. Scotland might see job losses of around 95,000 and Wales around 52,000. **Table 8** summarises these and other results for the regions.

Of course, as illustrated in **Box 4**, the scale of the effects could vary between cities. Leeds, in this example, may suffer less than Hull or Exeter[37] due to its greater strength in private sector services.

34 Economic Reform Group May 2010, The Case for a Reduced Rate of Corporation Tax in Northern Ireland, Belfast.

35 In 2008/09 public spending as a share of GDP was estimated at 73% in Northern Ireland, 70% in Wales and 56% in Scotland, compared to a UK average of 48%, although it should be recognised that these were cyclical peak levels and include social security benefits and other transfer payments that are not included in GDP.

36 As with the sectoral impact analysis in Section 2 above, we should stress that the estimates in Table 7 relate only to the direct and indirect impacts of public spending cuts. They do not include the less easy to quantify negative impacts of planned tax rises, or the positive impacts of the fiscal squeeze in terms of interest rates remaining lower for longer and a reduced risk of a Greek-style financial crisis if the deficit is not reduced fast enough to satisfy current and potential future investors in UK government debt.

37 Leeds and Hull chosen to show intra-regional differences, whilst Exeter was chosen to illustrate a comparison with a different part of the UK.

Table 8: Summary of estimated public and private sector employment effects of public spending cuts by region (in 2014/15)

Region	Absolute number of public and private sector job losses (000s)	% of total jobs in region
London	122	3.1
South East	112	3.1
North West	108	3.7
Scotland	95	4.1
Yorkshire & Humberside	82	3.7
South West	81	3.5
West Midlands	80	3.6
East	74	3.2
East Midlands	58	3.2
Wales	52	4.3
North East	43	4.1
Northern Ireland	36	5.2
UK total	**943**	**3.4**

Source: PwC analysis

Box 4: A tale of three cities

Whilst whole regions may suffer, there will also be important sub-regional differences in the total employment impact of public spending cuts. This box takes the examples of Exeter, Hull and Leeds and explores the picture at a sub-regional level in order to derive implications for government's local economic development policies.

We have undertaken an estimate of the local impacts by using the national spending changes by industry forecast in Section 2 above and applying them to local jobs and earnings data linked to the individual industrial and occupational mixes of these cities.

Our assessments find a noticeable difference in terms of the relative impact between the three. Whilst Leeds as the largest city stands to have the greater absolute loss of jobs and output, its larger share of private sector activity, especially in business and financial services, helps to cushion the impact. The public sector expenditure cuts would result in a 4.6% decline in total earnings which would equate to a 5.1% loss of jobs if there is no downward adjustment in earnings. Hull would see 6% of jobs lost and Exeter 6.5%. However, because of the weaker private sectors in Hull and Exeter, this would lead to overall earnings declining by just under 6% in both these cities.

If half of the private sector adjustment (though not the public sector) is through across-the-board reductions in wages instead of job losses, there would be 2,500 fewer jobs lost in Leeds, 775 in Hull and 500 in Exeter. This highlights the need to consider both the employment levels and wage adjustments which could be linked to public spending cuts sub-regionally.

	Jobs lost	% change	Earnings lost	% change
Exeter	6,250	-6.5%	£134mn	-5.8%
Hull	8,100	-6.0%	£176mn	-5.9%
Leeds	21,500	-5.1%	£481mn	-4.6%

Source: PwC estimates using ONS employment and earnings data; this analysis could be extended to other cities in future research. Note that the results shown for % employment changes are not directly comparable to those for the regions in Table 7 since our primary concern here was to compare these three cities only.

4

Agenda for action

The preceding sections have set out the implications of the government's austerity measures for different sectors and regions. Clearly, the Coalition is trying to strike the right balance between the spending cuts and tax rises needed to achieve fiscal consolidation over the long term whilst promoting private sector growth in the short to medium term, which is ultimately the route by which to restore the public finances. This section sets out our views on the agenda for government beyond the Spending Review, along with some important actions for business.

Government's agenda

We believe that if government is to meet its stated aim of creating 'a fairer and more balanced economy'[38], there are some important areas to address as set out below.

Managing the transition through innovative approaches to workforce reform

There is no escaping the fact that the fiscal squeeze will have a significant adverse effect on many sectors and regions, even in areas with some discretion on how they implement the cuts passed down to them through their overall funding arrangements e.g. the devolved administrations in Scotland, Wales and Northern Ireland. But the capacity of the regions and sectors most affected by the Coalition's fiscal consolidation varies greatly.

For instance, whilst the number of employees most likely to lose their jobs is highest in London, this is also the UK's most vibrant labour market and probably best placed to generate new jobs naturally for those out of work. In contrast Northern Ireland, with its recent history of high dependence on the public sector and low rates of private sector growth, may need more support.

38 'The Coalition: our programme for government', 2010

In the past, the reflex approach of public sector bodies to efficiency drives and spending cuts has been to start by getting rid of secondees and contractors, then relying on recruitment freezes and natural wastage to reduce numbers as far as possible and introducing redundancy schemes to deal with the bulk of the problem. This approach reduces headcount, but it:

- costs a lot of money in the form of redundancy payments (even under planned new rules) and consequently intensifies pressure on other spending in the relevant year;
- means that the remaining staff members are not necessarily those needed for the future; and
- has potentially significant negative social and economic knock-on effects, by making people unemployed without equipping them to find new employment.

In our view, government needs to be more active in planning its workforce strategy, both in terms of retaining key talent as well as managing reductions in a way which minimises the impact on unemployment by reskilling and redeploying displaced public sector employees. Government can take action to address the impact on public sector organisations through innovative workforce reforms such as:

- Developing partnerships with private sector manpower providers to performance manage and retrain staff, to find new employment for them where possible, and to manage redundancies where it is not.
- Redesigning national public sector pay structures so that they relate to the skills and experience needed to deliver services at local/regional level rather than reflecting organisational hierarchies. More flexibility in terms and conditions locally may also enable businesses (such as outsourcers) to relocate activities to areas where there are people with public service skills looking for work. These potential employees could be a valued target for recruitment by voluntary organisations and social enterprises, enabling the latter in turn to expand.

Leveraging private sector investment to fill the infrastructure funding gap

A casualty of spending cuts will also be capital investment, notwithstanding that infrastructure is critical to enabling a modern, competitive economy. Government obviously needs to make capital cuts with an eye to the impact on future growth potential. Where public investment has to be cut this clearly needs to be done selectively, taking particular account of the impact on regions: if not done strategically, current cuts will risk perpetuating existing imbalances or creating new ones.

A review of economic development spending is needed to protect areas with the highest economic return and make better choices as to where to place the investment of much reduced public funds. This importantly also applies to spend on key programmes underpinning long term economic performance, such as skills, innovation and R&D.

As well as being sensitive to the regional impacts, cuts in capital spend should also be made in ways to maximise the chances that the private sector will act to bridge some of the consequent investment gap. The creation of stable regulatory frameworks is critical for success in this regard, so that the private sector can make decisions on investments with a greater degree of certainty, particularly in infrastructure where there are long payback periods. Charging for services arising from the infrastructure developed e.g. for road use, could also be considered further.

Government needs to:

- Design policy instruments which will maximise the ability of the private sector to take up the investment burden by providing a stable policy environment which makes investment commercially viable.

- Tackle the financing gaps e.g. through measures such as the proposed Green Investment Bank (GIB) for climate change measures and focus investment in areas where it will have a catalytic role in growth. For instance, a major role for the GIB will be to tackle financing gaps e.g. for offshore wind development, but unless there is some focused early intervention by the public sector e.g. encouraging investment in the supply chain and ports infrastructure, the accelerated rate of development which could create this financing gap will not be achieved.

- Consider the acceptability of charging for services related to investments and so increase the incentives for business to invest through diversifying and increasing revenue streams.

These measures, together with simplification and shortening of the planning process, are critical to avoid creating an even greater infrastructure deficit, which would inhibit future growth.

Whilst symbolically important, we also question whether on its own the Regional Growth Fund (RGF), and equivalent measures in the devolved administrations, will provide enough incentive or access to funds to make a material difference, as the proposed scale of the RGF is less than 25% of the annual Regional Development Agency (RDA) outturn for 2009/10. We also question whether local authorities and the newly created Local Enterprise Partnerships (LEPs) will have the resources, fiscal powers and capacity to mitigate the impact of cuts and promote growth locally.

This raises important issues such as whether more consideration should be given to the effectiveness of fiscal incentives to attract and retain new business investment in those areas particularly hard hit. More radically, what are the costs, benefits and wider implications of handing the devolved administration greater powers to vary their fiscal policies to local circumstance e.g. setting differential corporation tax rates in their countries?

The agenda for business

As well as government intervention, there is a range of actions which should be considered by private sector organisations. In the very short term, businesses need to establish their exposure to the public sector either directly or indirectly (as suppliers to companies with large public sector exposures, such as large capital projects). Having done so, businesses must assess the likelihood of existing contracts being stopped, the extent of contractual protection from immediate termination and the effect on cash flows.

Businesses then need to consider a number of strategic actions including:

- Shifting strategy to reduce dependency on public sector customers over the medium term (both in the UK and other countries where major fiscal consolidations are expected over the next five years).
- Rebalancing portfolios towards exports in high growth markets, especially Brazil, India and China rather than the US and Europe.
- Taking advantage of opportunities created by public sector outsourcing, back office restructuring and other value for money initiatives.
- Preparing for a tougher climate for public procurement with even more price sensitivity on new projects and pressure to renegotiate the terms of existing contracts.
- Looking for opportunities to collaborate with partners in the private and voluntary sectors to deliver services more efficiently and effectively.

Looking forward

The ultimate solution to the country's fiscal imbalances is a robust return to growth but in our view this should not be growth of any kind or at any cost. As recognised by the Coalition, growth in the UK has been imbalanced for many years across sectors and regions and it would be desirable to correct these imbalances where possible. This is supported by considerations of fairness and economic and environmental sustainability.

The last thirty years witnessed enormous growth in knowledge-intensive services such as hi-tech manufacturing, green technology, financial and business services, telecommunications, health and education services. Fostering innovation – a keystone in the foundations of a knowledge economy – is vital to creating competition and promoting growth. This requires amongst other things well-functioning markets, low corporate taxes, appropriate R&D incentives, links between funding and performance and support for higher education and foreign direct investment[39].

Promoting prudent and sustainable growth is critical to securing the long-term recovery of the economy. However, whereas the fallout from the financial crisis brought economic issues to the centre of public debate, notably less attention has been paid to the pressing question of how to achieve robust and durable growth in the future, that is, growth which is financially, socially and environmentally sustainable. We will be undertaking a research programme to capture what it is that the public, and business, think is important in the way that wealth is created in this country and how this can be used to inform future public policy decision making.

39 See 'Innovation: Government's many roles in fostering innovation', PwC (July 2010).

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Nick Jones is the Global Director of PwC's Public Sector Research Centre (www.psrc.pwc.com) and has authored, and contributed to, reports on a wide range of public services issues, including co-authoring with John, the previous Dealing with Debt and Dealing with (even more) debt reports. He is a member of the Editorial Team for PwC's Annual Global CEO Survey, commenting on the relationship between business and government. As part of this role, he is also responsible for commissioning and directing PwC's input into major research studies with think tanks.

Ian Murray, Paul Dinkin, Esmond Birnie and Charles Tarvin also contributed significantly to the research and analysis in this report.

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