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Public expenditure management in a time of fiscal constraint seminar series:
The spending reviews and the operational efficiency programme

Summary

The Spending Review system, used to control and plan public expenditure which has been in operation since 1998 sets firm and fixed 3 year Departmental Expenditure Limits (DEL) with end-year flexibility. These reviews occur on a rolling basis (with the exception the current year), typically every two years.[1] These reviews are intended to promote sound public expenditure management and are designed on the basis of principles of aggregate fiscal discipline, allocative efficiency and operational efficiency. This note proceeds by reviewing the purpose of the spending review framework and considering its effectiveness in these three areas. It concludes by identifying several features of a system which might improve the cost effectiveness of government.

Introduction

The state of the public finances and the anticipation that real terms cuts are expected throughout Whitehall has drawn increasing attention to the spending review system and the scope for efficiency gains. In Parliament, Gordon Brown and David Cameron are debating each other's plans (or lack thereof) for spending cuts, Whitehall departments are taking stock and recently released data from Ipsos-mori are capturing the state of public attitudes towards spending cuts.[2] The Ipsos-mori polls carried out in late June 2009 indicate that 63% agree with the statement that 'there are many public services that are a waste of money and can be cut', and 79% agree with the statement that 'Making public services more efficient can save enough money to help cut government spending, without damaging services the public receive.' In the context of rising concern over public spending and plans for the development of cutbacks, this note reviews the purposes behind the spending review framework and its effectiveness in regard to aggregate fiscal discipline, and allocative and operational efficiency. It then suggests a number of areas which could improve the scope for cost effectiveness.

Aggregate fiscal discipline

The key principle behind aggregate fiscal discipline is to ensure that budgetary totals are determined prior to individual spending decisions and sustainable for the medium-to long term. The government has adopted two fiscal rules in this regard.[3] First, over the economic cycle, the Government would borrow only to invest and not to fund current spending; and second, other things being equal, public sector net debt as a proportion of GDP would be maintained over the economic cycle below 40 per cent of GDP (sometimes referred to as the 'sustainable investment rule').

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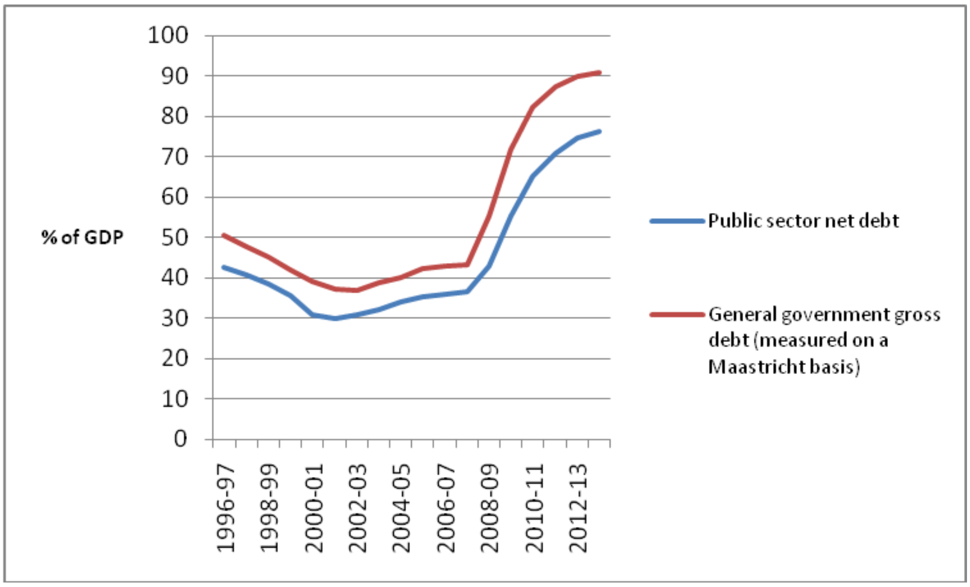
[1] The reviews have occurred in the years 1998, 2000, 2002, 2004, and 2007.
[2] Ipsos MORI (2009) MORI Public Spending Index 22 June 2009 Available http://www.ipsos-mori.com/Assets/Docs/Polls/poll-public-spending-charts-june-2009.pdf
[3] HM Treasury (2009) Fiscal Policy Index http://www.hm-treasury.gov.uk/ukecon_fisc_index.htm

During the period from 1997-98 to 2006-07, these fiscal rules were met during which time government spending as a proportion of GDP increased from 36.3% of GDP to 41.1% and net debt remained at approximately 40% of GDP. In November 2008 the government suspended these fiscal rules and adopted a temporary operating rule 'to set policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full.'[4] By 2010-11 government spending as a proportion of GDP is set to increase to 48.1% and drop back down to 43.5% of GDP by 2013-14. However, by 2013-14, net debt is projected to be 76.2% of GDP (and measured on Maastricht basis at 90.7%). This has led some commentators including the Institute for Fiscal Studies to question whether 'falling debt at the end of the forecasting period' is a sufficiently constraining fiscal target.

Figure 1: Public sector debt



Public Finance Databank June 2009

The government has cited the global economic downturn as the key factor driving the need for modifying its position with respect to aggregate fiscal discipline. A cross-national comparison of G7 countries, suggests that Britain is not unique in its highly leveraged position.[5] At present, Britain is in a similar position to Germany, the United States and France, and with lower net debt than Italy and Japan. However, looking at the policy choices that were made during a period of economic growth raises some concern. In order to avoid long term spending growth, a policy to stimulate the economy during periods of recession requires spending to be curtailed when the economy is growing. Hood, Emmerson and Dixon (2009) find that the growth of public spending since the mid-1950s in times of prosperity has not been proportionately checked to compensate for spending increases in adverse economic conditions[6]. As a result of the prioritisation on spending on public services (rather than debt repayment or cutbacks) during the period 1997-2008, the stimulus

[4] IBID
[5] IMF World Economic Outlook April 2009
[6] Hood, Christopher Emmerson, Carl Dixon, Ruth (2009) Public Spending in Hard Times. Published by ESRC Public Services Programme. ISBN: 978-0-9562858-0-5

package to deal with the effects of the global economic downturn will need to be funded by further borrowing and accruing greater public debt than would have otherwise been necessary.

In a recent review of the UK economy, the OECD[7] commented 'although the deficit should be allowed to support activity in the near term, the government has set out an ambitious consolidation plan for when the recovery takes hold. The delivery of the consolidation will require specifying the 'value for money' savings beyond 2011-12 in the upcoming Spending Review. This would signal the commitment to getting the public finances back onto a sustainable and prudent footing. Further action may be required if the economy does not recover as quickly as anticipated.'

Allocative efficiency

The public expenditure principle related to allocative efficiency is that expenditure should be allocated to support government priorities with funds distributed to support effective programs. One of the principles of the spending review system is 'the judgement of success by policy outcomes rather than resource inputs'.[1]

Public Service Agreements, first introduced in 1998, set out the government priority objectives to be delivered through the expenditure of public money. The thirty 2008-11 PSAs fall under five overarching objectives including 'fairness and opportunity for all', 'a better quality of life', 'stronger communities' and 'a more secure, fair and environmentally sustainable world'. Examples of PSAs include commitments to [2]:

- Halve the number of children in poverty by 2010-11, on the way to eradicating child poverty by 2020
- Improve children and young people's safety
- Deliver a more effective, transparent and responsive Criminal Justice System for victims and the public
- Lead the global effort to avoid dangerous climate change

Each PSA is underpinned by a 'delivery agreement' shared by all contributing departments as well as a set of performance indicators, used to measure progress . The PSA framework is linked to the local performance framework through a National Indicator Set for Local Authorities and their partners comprising 188 indicators. Each local area signs a Local Area Agreement specifying up to 35 of the national indicators that they will prioritise for delivery. The intention of the spending review system is for government to set itself meaningful strategic and medium-term goals and to establish 'quasi-contractual' arrangements between the Treasury and spending departments, and between central and local government. As the Treasury states, a further principle underpinning the spending review system is to create 'strong incentives for departments and their partners in service delivery to plan over several years and plan together where appropriate so as to deliver better public services with greater cost effectiveness'.[3] Collaborative working is supported by having all PSAs now formally cross-departmental, while at the local level there is a "duty to cooperate" imposed upon councils and key partners such as Primary Care Trusts.

[7] OECD (2009) Economic Survey of the United Kingdom, Policy Brief http://www.oecd.org/dataoecd/4/59/43037700.pdf

[1] HM Treasury (2005) Public Expenditure Planning and Control in the UK http://www.hm-treasury.gov.uk/spend_plancontrol.htm

[2] HM Treasury Public Service Agreements 2008-11 http://www.hm-treasury.gov.uk/d/psa_2008-2011_200409.pdf

[3] HM Treasury (2005) Public Expenditure Planning and Control in the UK http://www.hm-treasury.gov.uk/spend_plancontrol.htm

In the 2005-08 spending period 65% of joint PSAs were not met, suggesting that the spending review framework was not encouraging effective joint-working. Major reforms to the performance framework at the Comprehensive Spending Review have provided clearer incentives for collaboration on delivery by making each of the 30 outcome-focused PSAs formally cross-departmental. At the local level there is a “duty to cooperate” imposed upon councils and key partners such as Primary Care Trusts.

In practice, it is unclear to what extent performance information is used in spending reviews to support expenditure decisions. Questions are also raised by the government’s shift of emphasis to outcome rather than output measures – seen as the remedy to Whitehall’s perceived tendency to ‘hit the target but miss the point’. Time lags and attribution problems may create obstacles for a meaningful resource allocation dialogue between HM Treasury and line departments in Whitehall. As a result, some have suggested a move towards output-based measures of performance. Alternatively, many departments across government are working to improve their understanding of the links between expenditure and outcomes to better drive value for money.

A further puzzle is raised by Boyne, James, John and Petrovsky (2007) who find that local government performance based on Comprehensive Performance Assessments does not create proportionate political payoffs for incumbents in well performing local authorities. This work has found support for a ‘negativity bias’ in politics where incumbents are punished for poor performance but not equally rewarded for good performance.[8] Ongoing work by Gwyn Bevan has found similar results in which significant improvements in the NHS in England did not pay political dividends for the Labour Party under the Blair government.[9] This raises interesting questions about the political incentives for using transparent performance information. If politicians are blamed for poor performance and not rewarded for ‘good’ performance, objectively measured by performance information - how much support are these key decision makers likely to have for the integration of performance information into budgetary decisions?

[8] Boyne, George, James, Oliver, John, Peter & Petrovsky, Nicolai (2007)Satisfied consumers, loyal voters: voter reaction to incumbent performance in English local governments, 1999-2006 Paper revised for presentation at the Public Administration Committee Annual Conference, Belfast, September 5, 2007 and at the EPOP Conference, Bristol, September 9, 2007http://www.ipeg.org.uk/papers/boyne_james_john_petrovsky_2007_PACEPOP_final_satisfied_consumers_loyal_voters.pdf.

[9] Bevan, Gwyn (2009) Did transforming National Health Service in England pay political dividends for Labour Party under Blair? Seminar Presentation to the Institute for Government 30 April 2009

Table 1: Expenditure and performance

Department	Expenditure	Performance	
	Departmental Budget	Performance Targets	Performance Sub-Targets
	2008/09 Projected Spending (DEL + AME, £m)	2005-08 Public Service Agreement targets fully met (%)	2005-08 Public Service Agreement sub-targets met (%)
Attorney General's Office	725	100	100
Department for Business, Innovation & Skills	19,189	40	50
Communities and Local Government	4,864	10	63
Cabinet Office	9,311	0	0
Department for Culture, Media and Sport	5,483	33	33
Department for Children, Schools and Families	58,047	27	47
Department for Energy and Climate Change	n/a		
Department for Environment Food and Rural Affairs	2,918	44	50
Department for International Development	5,224	17	48
Department for Transport	10,336	57	57
Department of Health	108,594	50	60
Department for Innovation, Universities and Skills	16,592	100	100
Departmenf for Work and Pensions	138,877	30	54
Foreign and Commonwealth Office	1,880	11	40
Her Majesty's Revenue and Customs	n/a	40	60
HM Treasury	34,196	60	62
Home Office	9,609	100	100
Ministry of Defence	40,377	17	17
Ministry of Justice	9,464	40	50
Northern Ireland Office	1,472	100	100
	546100		
	AVERAGE	40%	54%

Expenditure Data: HMT, Public Expenditure Statistical Analysis, 2008 and PSA Performance scores: Departmental Annual and Autumn Performance Reports, 2008

Operational Efficiency

An organisation can be more efficient if it produces the same outputs with fewer inputs or produces better outputs for the same level of inputs. However, as the NAO points out, 'efficiency is not about reducing costs if it compromises the quality or quantity of outputs'.[10] Conventional public finance wisdom suggests that organisations should produce goods and services that are in constant pursuit of efficiency gains with regard to the quality and equity of public services.

By focusing on workforce reduction and relocation, the 2004 Gershon Spending Review looked at five workstreams including procurement, 'back office' (corporate services), transactional services, public service policy, funding and regulation, private sector policy, funding and regulation, and

[10] National Audit Office What is efficiency
http://www.nao.org.uk/what_we_do/other_specialist_expertise/efficiency/what_is_not_efficient.aspx

productive time. The government reported £26.5 billion of annual efficiency gains against a target of £21.5 billion (see table 2).

As part of the 2007 Comprehensive Spending Review, a new 'value for money' target of saving £30bn by 2010-11 was established, subsequently raised to £35bn in the Pre-Budget Report. As the new target is all cashable (as against 60% in Gershon) and net of set-up and ongoing costs (unlike Gershon) it is highly ambitious. The final report of the Operational Efficiency Programme suggested potential savings of £4 billion on back office operations, £3.2 billion on IT, £6.1 billion on collaborative procurement and £1.5 billion on property by 2013-14. Among the recommendations for achieving the savings are benchmarking of corporate functions (IT/HR/Finance), operational reviews, shared services and the standardisation of IT systems. The report also recommends HM Treasury assemble a value for money review group, to support and challenge departmental performance, and for cabinet to encourage greater discussion of value for money and operational efficiency in relevant committees.

Table 2: Efficiency targets and workforce reduction

	Efficiency Targets			**Workforce Reduction**		
	Target	**Actual**	**Score**	**Target**	**Actual**	**Score**
BERR	380	721	190%	-1280	-1762	138%
CLG	620	1444	233%	-400	-1170	293%
CO	25	35	140%	-150	-190	127%
CPS (incl AGs Depts and Law	34	99	291%	-50	-60	120%
DCMS	260	298	115%	-30	-76	253%
DCSF (DFES)	4350	4460	103%	-1960	-2208	113%
DEFRA	610	752	123%	-2400	-2122	88%
DfID	310	561	181%	-170	-295	174%
DfT	6470	7057	109%	-650	-850	131%
DH	785	973	124%	-720	-805	112%
DWP	960	1446	151%	-30000	-40153	104%
FCO	120	132	110%	-310	-512	165%
HMT (Chancellors Depts)	550	680	124%	-13350	-19718	121%
HO	1970	2645	134%	-2327	-2406	103%
MoD	2830	3045	108%	-15000	-24107	161%
MoJ	290	455	157%	-1473	-1880	128%
NIO	90	93	103%	-130	-668	514%
Average/Total			147%			
Total				-70600	-99182	

2004 Spending Review: final report on the efficiency programme, HM Treasury

The public sector encounters substantial measurement problems related to outcomes as the identification of what is publicly valued is often a 'value-base' judgement. In the context of a Principle Agent framework, there is a complex relationship between policy makers and service providers ('agents') and others ('principals') in the system including the Prime Minister and cabinet, HM Treasury, other spending departments, clients and the broader voter interest. The management of a diverse set of interests presents challenges to allocate budgets in accordance with policy objectives, particularly where relationships change and the importance of interests fluctuate depending on external events.

In the private sector, with a relatively clear objective and metric, there may be greater scope for operational efficiency. Concerns related to equity, fairness and broader social outcomes are typically secondary.[11] Irrespective of this, it is important to ensure that value for money and operational efficiency is integrated into the way that government operates. Traditionally, the private sector has been seen to have greater capacity to be operationally efficient and its focus and ability to conduct measurement of its activities may be one lesson for public sector efficiency savings.

As a result, some important questions need to be posed by public managers in departments. First, on the question of delivery, senior Whitehall officials should continue their efforts at identifying what departments are trying to achieve, i.e. what is publicly valuable. Second, public sector leaders need to improve the capacity for measuring the costs per unit of delivering a good or service. Third, leaders need to strategize about how to make services more effective for citizens. Finally, the question on how to maintain or improve quality yet reduce the cost of the service needs to be integrated into all areas of planning and operations.

On the first of these questions, the PSAs provide a framework for developing consensus on government priorities. The government's capacity to develop strategy is the highest scoring element of the three capability scores and there are a growing number of initiatives to focus on client or citizen focused service delivery (attempts to provide entitlements for citizens is one aspect of this). However, on measuring the costs (and benefits) of providing a good or service, there is very little publicly available information.

Measuring government activity

Given some of the measurement problems associated with public sector activity, a potential first step could be to focus on activities that are comparable across departments (and to some extent) across sectors. Corporate functions such as finance, HR, IT and legal services are used by all organisations, however, a recent report by the Public Accounts Committee (2008), found that 'there are no definitive figures on the operating cost of finance and HR in government'.[12] The final report of the OEP estimated the costs of back office functions (excluding IT) to be approximately £20 billion, with the caveat that a margin of error of approximately 20% exists.

Several measures for benchmarking corporate functions that use proportional headcounts and budget allocations as the key variables being developed have been advocated by the Value For Money project in the Public Audit Forum.[13] Recent (albeit limited) work on benchmarking of corporate functions suggests that there is wide variation in the 'cost effectiveness' of various

[11] On the other hand, the private sector faces its own unique challenges, for example private companies typically have less knowledge and certainty about future cash flows than public sector organisations.

[12] Committee of Public Accounts (2008), Improving corporate functions using shared services . 18th Report of Session 2007-08 Available http://www.publications.parliament.uk/pa/cm200708/cmselect/cmpubacc/190/190.pdf p. EV14

[13] HR indicators include cost of the HR function as a percentage of organizational running costs (expenditure), cost of the HR function per employee, and Ratio of employees (FTEs) to HR staff. Finance, ICT, procurement and estates management indicators include total cost of the function, total cost of the function as a percentage of organisational (expenditure or non-pay expenditure). Total property costs per square metre or total accommodation (square metre) per staff FTE have also been proposed.

corporate functions.[14] The PAC estimates that the ratio of HR staff to number of employees in the central civil service is between 1:25 and 1:33 and the wider public sector is between 1:70 and 1:85.[15] However, it is unclear what the ideal balance is and whether public sector organisations reflect this balance.

Given that such back office functions represent a relatively small amount of public expenditure (approx. 5-7%), it would be imprudent to place too much emphasis on this as a source of efficiency gains. Moreover, rather than identifying individual elements for savings, it may create a lack of systemic/whole of government approach to improving public sector productivity. Indeed, by simply reporting what the system wants it does not change behaviour. A system that asks individual departments to focus on efficiency may 'hit the target but miss the point'. As more 'effective' corporate services would have greater impact on the rest of spending, to the extent possible, it would be important to measure its effectiveness.

Measuring the productivity of the public sector as a whole also encounters substantial measurement problems. However, ongoing work by the UK Centre for the Measurement of Government Activity (UKCeMGA) is attempting to provide better clarity around the costs of public services and their productivity. A recent UKCeMGA report[16] indicates that in the period 1997 to 2007, the output of total public services rose at an annual average growth of 2.9 per cent while total GDP also grew by an annual average of 2.9 per cent. The level of inputs used to provide these services grew by an annual average of 3.3 per cent with the result that the total public service productivity index fell over the period by 3.2 per cent.

Productivity does not rise at the same rate in all areas of the public sector. It is important to recognize that the characteristics of different sectors (transport, health, defence, etc) (and indeed different functions within sectors) means that each will be different in terms of extracting productivity gains and cutting less necessary expenditure. Value for money considerations need to take this into account in order to avoid the politically attractive 'salami-slicing' of departmental budgets.

From 'efficiency' to 'cost effectiveness'

These lessons suggest that the key challenge for policymakers is to design an incentive structure that promotes self assessment of productivity and encourages individual organisations to measure and capitalize on opportunities for productivity gains. Such a system would need to reward innovation in service delivery while placing importance on the quality and equity of services being delivered. The incentive structure would need to be designed carefully, taking into account the full range of incentives such as 'public service motivation', transparency and reputation, and higher powered incentives including financial and career motivations. A system that encourages public sector performance improvements by allocating resources from low to high performing programmes is likely to have a number of features.

First, the system needs to encourage better collection of information on program effectiveness and costing. For some of the reasons outlined earlier, this will be a difficult undertaking. However, this

[14] Public Audit Forum (2008) Value for money in public sector corporate services http://www.public-audit-forum.gov.uk/VfMprojectflyer.pdf
[15] PAC (2008) Data from PWC Saratoga.
[16] UK Centre for the Measurement of Government Activity (2009) Total Public Service Output and Productivity Office for National Statistics June 2009 http://www.statistics.gov.uk/articles/nojournal/TotalPublicServiceFinalv5.pdf

work could build on the ongoing work at UKCeMGA, the National Audit Office and individual departmental initiatives to measure, track and report on value for money. As a first step, departments could select a set of programmes for this measurement which share a set of characteristics that make them more amenable to being measured including tight linkages between inputs, outputs and outcomes, with minimal time lag and attribution problems.

Second, the system should share the proceeds of cost savings with those finding the costs to cut. This provides a direct incentive to encourage cost reductions and while there may be a temptation to claw back cost saving across years, this temptation must be avoided in order to ensure that the departments view the commitment as credible.

Third, cross-departmental, peer review of data, analysis and recommendations are likely to reinforce discipline. Sanctions are typically more effective when coming from colleagues rather than over-seers.

Fourth, leaders should take steps to reduce the tendency for equating the size of budgets with quality. This may include ensuring that career structures reward managers who are managing within limited resources and achieve similar or better performance than peers. A culture that encourages departments to 'punch above their budget weight' could reinforce this.

Finally, building on the introduction of cross-departmental Public Service Agreements, there appears to be a need to have greater encouragement for departments to work across boundaries. This may be achieved through global budgets where single consolidated appropriations are used in which relevant departments can access the 'pooled' source of funds. For example, pooling funds between health and social care to ensure that funds are targeted to appropriate PSA outcomes may drive up improvements.

The state of the public finances has drawn attention to the need to improve the process for achieving aggregate fiscal discipline and increasing allocative and operational efficiency. It is a complex issue without any easy solutions, however, a process which encourages better cost effectiveness could go a long ways towards improving confidence in government. If there was ever an opportunity for public sector spending reform, it may be now.

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