

Counting the cost Using cost reduction to drive sustainable government



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Executive summary

With one year remaining until the last date for a general election, the United Kingdom continues to face significant uncertainty across its economy. So far, targeted fiscal stimulus and continued spending have shielded public finances from corresponding pressure. But the public debt that has funded this investment has reached startling levels, and while actual cuts to services are unlikely before the election, what follows may include a sustained period of austerity in public spending. The challenge of reducing costs is made more complex by the impact that ten years of high levels of investment in public services has had on citizen expectations.

Despite political difficulties however, this challenge must be confronted. Beyond 2010 government professionals will face choices over resource allocation, headcount, capital programmes and the need to align their service delivery planning more closely to their minimum statutory commitments. The long-term solution to this challenge lies in the ability of public bodies to implement strategic transformation of their largest and most expensive businesses, and apply new models of operation and funding to key public services.

But fundamental change of this scale and complexity takes time. Ahead of strategic transformation that may take place after 2010, there is a series of more immediate actions public bodies can take to reduce costs. They could:

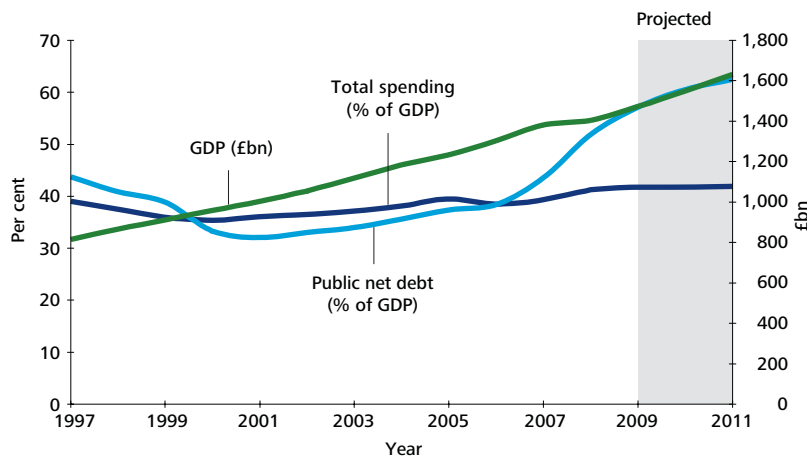
- Tackle hidden costs that lie between core support services and frontline delivery by interrogating process efficiency at every step in the delivery chain, improving the value for money and compliance rates among suppliers, and adopting a more commercial approach to managing risk. Public bodies that manage large numbers of arm's length organisations may need to consider options for consolidation of non-essential organisations.

- Strengthen property management capabilities, grasp opportunities for collaborative working in property and facilities management, and take action to make legacy assets more attractive to buyers.
- Broaden the scope of asset categories that can be sold and take steps to improve the process of taking assets to market, including by engaging appropriate expertise at an early stage, establishing fit-for-purpose governance and removing constraints to competitiveness.
- Reduce payroll costs by introducing greater flexibility into contracts to aid redeployment, 'backfilling' to manage down headcount and developing new capabilities in direct response to the new spending climate. Public bodies could also establish lasting performance management regimes to provide the starting point to reduce headcount in a sustainable way.
- Expand collaborative working by broadening the scope of shared services and developing partnerships that set measurable outcomes-based targets for exploiting efficiency. Public bodies could also transpose the principles of strategic commissioning models used in the health and social care domains into other areas.
- Optimise tax arrangements by taking opportunities to reclaim value added tax (VAT) on large procurement and service expenditure, improving tax reporting processes, and approaching tax liabilities in a more strategic way (although these actions would not produce cost savings for government as a whole).

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Context: Looming choices

Figure 1: UK GDP, public spending and net public debt, 1997-2011



Source: HM Treasury, April 2009

The downturn that began in 2008 has engaged the Government's policymaking, fiscal and monetary capabilities as it seeks to manage economic contraction and confront a series of crises across specific sectors. Few axioms exist amid this uncertainty but one exception, driven by some startling arithmetic, is that current expenditure on public services cannot continue without either unprecedented efficiency gains, tax rises or service cuts.

In the 2009 Budget, the Chancellor confirmed that public debt is expected to climb to 79 per cent of Gross Domestic Product (GDP), some £1,370 billion by 2013 as a result of increased spending relative to falling national output.¹ This position, which excludes £550 billion of bank lending and investment, public-sector pensions liabilities and the underwriting of £600 billion of bank assets, represents the largest ever peacetime budget deficit (Figure 1).²

There are some signs that the United Kingdom's economic outlook may improve over 2009-10. But because of the lag time between economic performance and spending cycles, and distortions created by the 2010 general election, pressure to reduce spending may not be reflected in settlements until 2010-11, with the impact on actual services to follow soon after.

Against this forecast are government figures which suggest that public expenditure will grow by an average of 0.7 per cent in real terms with net investment moving to 1.25 per cent of GDP by 2013-14, and total managed expenditure rising from £620.7 billion in 2008-09 to £701.7 billion by 2010-11.³ Yet the election and the next Comprehensive Spending Review may alter these plans significantly. In this uncertain environment, it is especially difficult for public managers to plan effectively.

The Operational Efficiency Programme (OEP), which has a savings target of £9 billion per annum, will represent the next step in government efficiency savings.⁴ Independent assessments from Reform and the Institute for Fiscal Studies suggest that for the government to make inroads into public-sector net debt, between £30 billion and £45 billion (4-5 per cent of total spending) needs to be saved or cut from public spending each year until debt reaches sustainable levels.⁵

This paper is primarily concerned with tactical cost reduction measures in government, but we should acknowledge that efficiency measures may not, by themselves, be enough to penetrate the longer term shortfall in public finances. The next government may have to expend significant political capital on a series of actual service cuts which, even if targeted, will involve painful, tough and unpopular choices.

One paradox of public services – and some private-sector organisations – is that productivity can fall even as greater resources are invested. The converse, that productivity and efficiency improve as budgets contract, may act as a catalyst for reform in future. Public-sector operating cultures may need this 'burning platform' environment to implement change, to close programmes that have been ineffective and to build consensus to make tough choices on resource allocation. The real opportunities for government lie in using the seriousness of its financial position as a mandate to drive through transformational change to the delivery models of its most expensive services.

While the transformative potential of ‘first-principles’ delivery model reform is significant, this paper focuses on six areas for immediate action that public-sector leaders could take to begin the process of cutting costs in an effective and sustainable way. Some of the ideas put forward are not new. Techniques such as pooling corporate functions or improving performance management frameworks are already widely recognised, and have been applied sporadically across the public sector for a number of years. Within the context of a new period of public-sector austerity, however, proposals that may have been previously disavowed may resurface in combination with innovative ideas. The actions in this paper reflect that mix.

The new baseline of citizen expectations established over the last ten years makes it neither politically nor economically appealing to ‘slash and burn’ frontline public services. But the public debt problem is not going to go away. The actions set out in this paper represent the beginning of the reassessment of government finances.

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Six areas for action

Drawing on evidence from public-sector finance directors and Deloitte's own expertise, we have produced a series of actions for public bodies to consider. But ahead of implementing these actions, public bodies may need to strengthen their leadership capabilities and build a corporate culture that creates incentives and a mandate to embrace efficiency at all levels. To reap the cashable savings from these actions, it will be important for public-sector managers to drive individual engagement in efficiency across all levels and business areas. To be implemented effectively, efficiency programmes must be seen to be important to line managers, and responsibility for implementation must be given to individuals who have played an active role in programme development.

Similarly, leadership, as a function and a competency, will influence the success of cost reduction initiatives across the public sector. Effective leaders will be those who take personal ownership of executing efficiency programmes, engage their political and official colleagues at an early stage and drive through difficult choices. Critical to success will be engagement within secondary and tertiary tiers of leadership across corporate services and frontline delivery businesses. Complex change such as organisational consolidation, decommissioning of key programmes and functions, and outsourcing will depend on grassroots understanding of the 'invest to save' mindset, and a commitment to see through programme implementation in full.

The steps set out below are important, but they cannot take place without a corporate mindset that embraces efficiency and develops the leadership capabilities necessary to drive cost reduction.

1. Extract hidden costs

The OEP identified a series of common categories for cost savings, and further work to support the *Public Value Programme* may include allocative efficiency measures and zero-based reviews to analyse costs at every level. An additional tier of costs that public bodies need to consider includes hidden costs that lie between core support services and frontline delivery, or are brought about by the particular constraints of public-sector risk management, where profits are substituted for costs and reputation.

To address these, public bodies could:

- Carry out an end-to-end review of the most expensive supply chains and capital expenditure programmes. This review would interrogate process efficiency at each step between commissioning a project or service, through to operational costs over a sustained period. It could also examine major outsourced contracts, even those ostensibly locked into long-term agreements.
- Improve efficiency in managing suppliers. Local government spends around 50 per cent of its revenue on goods and services purchased from third parties. In 2007-08 the 'Public Services Industry' represented 6 per cent of GDP, employed over 1.2 million people, and generated revenues for firms worth £45 billion.⁶ As public bodies' relationships with third parties become more fragmented and complex, there is an increasing need to assess contract compliance and take action if rebates or price adjustments are necessary. By conducting independent reviews of supplier costs and pricing mechanisms, public bodies could build a clearer picture of the cost effectiveness of their suppliers. These reviews could also help to strengthen existing service level and compliance mechanisms, which in many cases are managed by the supplier and are not independent. They could improve risk assessments of specific partners' financial positions, the maturity of the relationship and the adequacy of governance and controls. They could also strengthen contract monitoring, the degree of self-reporting and the importance of the service provided to overall business operations.
- Remove management tiers and intermediary organisations. For bodies that manage a number of arm's length organisations, this could involve a review and consolidation where appropriate to remove extraneous organisations altogether. In the same way that non-essential programmes may be terminated or merged with others, removing expensive Non-Departmental Public Bodies (NDPBs) and agencies that offer little support for statutory services could present opportunities for savings.

- Improve approaches to risk management. Public bodies often seek to eliminate, not manage, risk. This can add an additional layer of processes, planning and cost to commissioning or procurement. To provide a better sense of risks across a programme, and to save money, public bodies could increase emphasis on actually monitoring risk. For example, gateway reviews could be used not to verify 'business as usual' but to highlight critical issues with projects. Managers could develop a more integrated approach to assurance to remove duplication caused by using different assurance providers.

2. Property management

Despite the difficulties across the current property market, the OEP cites estate management as a major opportunity for public bodies to cut costs. As with information technology and change programmes, using estate rationalisation to generate cost savings often requires initial investment that can distort business cases and question programme affordability. To encourage longer term approaches to estate management, therefore, policymakers could consider changes to departmental and local authority capitalisation rules. These could be supported by a series of proactive steps within public bodies themselves that could include:

- Establishing a portfolio management career path to professionalise property management and attract high flyers. This could be supported by a competency framework that develops operational and legacy property management skills, and promotes better understanding of potential conflicts between short- and long-term property requirements.
- Grasping opportunities for collaborative working in property and facilities management. There are a number of regional clusters where traditional boundaries and attitudes restrict government bodies from pooling their property and facilities management requirements. Public bodies could increase engagement with appropriate neighbours to explore efficiency opportunities through joint facilities management, utility and IT contracts, and consolidation into shared accommodation. Based on previous work, Deloitte estimates savings from joint procurement of facilities management services could exceed 10 per cent on previous arrangements.

- Taking action to make legacy assets more attractive to buyers. A number of organisations interviewed held portfolios of land or property that they assessed had limited market value. Ahead of property market revival, public bodies could take steps to refurbish or reclaim brownfield sites in preparation for future sale.

3. Savings through improved asset management

As a baseline principle, any public asset that has no policy function could be assessed for possible sale. Assets that do fulfil a policy function are likely to be more sensitive, but in challenging financial conditions, all options need to be considered. As the OEP notes, the public sector as a whole needs to reverse its mindset from one of having to justify asset sales to one of justifying ownership. Additional actions public bodies could take include:

- Building capability in the commercial and finance functions to prepare for potential asset sales. In developing business cases to assess options for public assets, rigorous commercial and financial disciplines need to be applied, together with an independent challenge function and an assessment of the full breadth of possibilities. At present this level of expertise is missing from many public bodies apart from the Shareholder Executive.
- Ensuring an asset is fit-for-purpose before taking it to market. If the asset is a trading organisation, there will be a need to ensure it is fit to compete by introducing commercial disciplines and capabilities ahead of sale. It is not enough to assess an asset's commercial potential. Assets that have been managed in the public domain may have underdeveloped management and commercial capabilities, weak governance, and poor pricing and risk management expertise. Sponsors also need to take account of possible risks and costs to government if the new entity fails or is constrained from effectively competing in markets.

- Reviewing the accounting arrangements early in the project. In previous instances of sales or part privatisations, the accounting framework that drives the budgeting has sometimes been overlooked at the early stages of the sale. Occasionally, this approach can lead to inappropriate accounting treatment where an asset remains on the balance sheet with cash receipts being matched by the recognition of a liability. In an organisational context, any third-party debt subsequently raised becomes an additional government liability. Other discrete elements of sales, such as pension arrangements, may warrant particular attention. The solution is to engage accounting expertise at the earliest possible stages of a sale to optimise the budgetary outcome, which is often different to the cash outcome.
- Establishing fit-for-purpose governance. Governance of public-sector organisations can be confused by the conflicting responsibilities of accounting officers and the board, and the governance model adopted by sponsoring departments. Introducing private-sector governance techniques can provide benefits such as clearly defined accountabilities for each board member. A wide range of approaches could be considered including governance through the Shareholder Executive, whole or partial privatisation, or the creation of 'GovCos' or 'GoCos'. Each option needs to be assessed in the context of each asset.

4. Managing headcount reduction

Effective performance management and action against poor performance will be central to reducing headcount and managing down departmental and local authority pay bills. The public sector has traditionally struggled to institute robust, meaningful performance management regimes and grow new capabilities to meet evolving requirements. However, in light of the pressure on costs managers could seek to:

- Introduce greater flexibility into standard contracts to aid the process of redeployment. On the understanding that redundancy may be politically unattractive at both local and central level, it will become increasingly important that managers have the contractual powers to redeploy personnel to meet the ebb and flow of workload across different business areas.
- Freeze external recruitment and manage down organisational headcount by 'backfilling'. Backfilling describes the redeployment of existing staff into vacant posts as an alternative to external recruitment, although the practice can become less viable as the specialism of the role increases. For a large proportion of clerical and administrative roles, however, a complementary programme of training to equip redeployed staff with necessary skills would be cheaper than the recruitment and pay bill costs of taking on new personnel from outside.
- Close down roles that are vacated. As a variation of backfilling, public bodies could also explore the possibility of closing down roles in programmes that are ineffective or that have become surplus through consolidation. These roles could again be redeployed, but over time natural wastage would drive the net headcount downwards, without the need to confront the political tensions and costs of a large-scale redundancy programme.
- Develop new capabilities in response to the financial environment. The pressure on public finances will increase the need to attract managers who have experience in leading organisations through uncertain times and who can manage budgets, workforces, asset portfolios and customer expectations downwards. The emphasis may change from building up businesses to deconstructing them. Public bodies may need to review and adapt their corporate capabilities in response.
- Establish lasting and effective performance management frameworks. A common observation among public bodies interviewed for this paper was that departments and local authorities reform their performance management regimes too frequently for changes and improvements to take effect. Public bodies could develop frameworks that improve links between individual and organisational performance and increase emphasis on hard delivery objectives in each role. They could also increase mandatory induction and refresher training to enable line managers to hold effective performance conversations. Building on the need to establish a culture that embraces efficiency programmes, managers could strengthen career and pay incentives to stimulate engagement in the cost reduction agenda.

5. Embracing collaborative working

The OEP recommended a series of measures to increase collaborative working between public bodies and with third parties, including expanding the categories of common spend, and introducing new accountability mechanisms and specific targets. However, to be implemented effectively, centrally-agreed objectives may require better engagement among public bodies to encourage collaborative working. For example, they could consider more innovative approaches, such as business case competitions that include collaborative working as a requirement. In addition public bodies could:

- Extend the categories of corporate services that could be shared to utilities, food, accommodation, facilities management and information technology. The starting point to develop collaborative programmes is to create working groups that bring together neighbouring organisations and that have clear milestones for business case development and implementation strategies. Previous Deloitte work indicates that sharing services is up to 20 per cent cheaper than funding corporate functions unilaterally.
- Set measurable outcomes-based targets for exploiting efficiency through collaborative working. Sharing corporate services, or collaborating on service delivery, is futile unless latent efficiencies are actually converted into cashable savings. Some public collaborations focus on the process of partnership and fail to set measurable targets of efficiency.
- Establish clear understanding of what constitutes a 'partnership'. Some collaborations in the public sector have failed because the concept of partnership was misunderstood. At the outset, each party needs to understand the strengths and weaknesses of their partners, their motivations and mutual interests, as well as possible areas of difference. Establishing a governance model that enables this understanding, and the role and function of passive partners, is essential.
- Take strategic commissioning to the next level. Within service delivery businesses, there is scope to transpose the principles of strategic commissioning models that have worked across health and social care into other functions of government such as benefits, employment support, education, waste management and housing. Public bodies must aggressively seek to seize opportunities as they arise and engage with partners and neighbours to develop strategic commissioning across a wider group of business areas.

6. Optimise tax compliance

New approaches to tax cannot save money for government as a whole. But in meeting their tax accounting obligations, public bodies can sometimes experience additional and unnecessary costs. Within the context of existing government guidance, Her Majesty's Revenue and Customs' (HMRC) approach to tax compliance, and the challenging financial climate, public bodies need to become more confident that they are paying the right amount of tax. Where appropriate, they also need to ensure that all opportunities for legitimate tax-related cost savings, as encouraged by HMRC, are realised. There may also be opportunities to test aspects of tax policy in respect of government procurement and services, particularly on expenditure on large capital programmes. In addition:

- There are often opportunities for improving compliance through the recovery of VAT payable on capital investments and procurement, as well as on sales and charges. Deloitte's experience in working with National Health Service Trusts, universities and Further Education colleges to improve VAT compliance on capital investment suggests that significant savings are possible by taking this approach.
- Additional savings can be achieved by taking a more strategic approach to tax-intensive functions such as fleet management and capital infrastructure investment. This approach involves changes to cash-flow and payment structures to ensure the correct amount of VAT is reclaimable. Deloitte has worked with a number of local authorities to improve VAT compliance by structuring their procurement and delivery arrangements across education and social care to ensure VAT entitlements are claimed – in some cases saving up to £2 million on investment programme costs. By considering tax implications at the start of infrastructure programmes or service agreements, public bodies can save significantly more over the life of the contract.
- Further tax opportunities across the payroll bill include the introduction of 'smart benefits' for employees as an alternative to salary increases. Salary sacrifice schemes could improve the overall offer to existing and prospective employees, encourage 'green' commuting policies for employees and save significant pay bill costs, which can total over £1 million per annum.

Conclusion: Preparing for change

The outlook for public finances beyond 2010 is challenging. The application of wide-ranging efficiency programmes across public bodies may not be enough to prevent significant reductions in spending that must entail service cuts. Given the length of time independent economists have assessed it will take to bring public debt back down to sustainable levels, it is reasonable to assume that public finances will remain under significant pressure for at least five years following the next election.

How to manage services cuts in a sustainable way is a major strategic question for individual organisations and public finances as a whole. It may be that the departments and local authorities that are prepared to 'think the unthinkable' and introduce radical transformation of their underlying purposes and operating models will emerge from the uncertainty as leaner entities that are best equipped to weather a sustained period of austerity.

But while public bodies are contemplating such steps, there are a number of immediate actions they can take to begin the process of change. First, they could carry out forensic assessment of key aspects of business supply chains to understand hidden costs and improve the way suppliers are managed. This work could be taken forward in parallel with a review of management tiers and intermediary organisations that do not support public bodies' core business areas. Second, public organisations need to consider how key strands of the OEP have a bearing on their work, and how they can respond by improving their approaches to property and asset management and collaborative working. Finally, public bodies could concentrate on improving effective performance management and tax compliance obligations which, as well as improving productivity, can achieve cashable savings for the organisation.

The ideas put forward in the OEP are important, but they need to be supported by a programme of implementation. The steps set out in this paper could help to prepare the ground for this implementation and longer term transformational change.



Notes

1 2009 Budget Report, HM Treasury, April 2009.

2 Ibid.

3 Ibid.

4 Operational Efficiency Programme, HM Treasury, April 2009.

5 Back to Black, Reform, April 2009; Two Parliaments of Pain, Institute for Fiscal Studies, April 2009.

6 Public Services Industry Review, Department for Business Enterprise and Regulatory Reform, July 2008.

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