National Audit Office

REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL

HC 1089
SESSION 2010-2012

23 JUNE 2011

Reducing costs in the Department for Work and Pensions

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Reducing costs in the Department for Work and Pensions

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Amyas Morse
Comptroller and
Auditor General

National Audit Office

21 June 2011

The Department for Work and Pensions has the largest annual expenditure of any central government department and so its cost reductions will be central to the Government meeting its priority objective.

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This report can be found on the National Audit Office website at www.nao.org.uk/dwp-cost-reduction-2011

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Key facts

£535m
Target for running cost reductions in 2010-11

£2,669m
Target for running cost reductions 2011-15

£17 billion	The cost reductions required in benefits and pensions between April 2011 and March 2015
23 per cent	The Department's share of total public spending
£155.6 billion	The Department's settlement for expenditure on benefits and pensions in 2011-12
£7.8 billion	The Department's settlement for expenditure on running costs in 2011-12
£455 million	The cost reductions to be achieved in benefit and pensions spend in 2011-12
£1,451 million	The reduction in running costs the Department has to achieve in 2011-12

Summary

The Department for Work and Pensions has to make significant cost reductions

1 Reducing the budget deficit is a Government priority. The June 2010 Budget and the Spending Review in October 2010 announced significant spending reductions across government departments. The Department for Work and Pensions (the Department) has the largest annual expenditure of any central government department and so its cost reductions will be central to the Government meeting its priority objective.

2 The Department has already signalled its commitment to securing cost reductions. Since 2007, the Department has reported reductions of £2 billion in its running costs, and initial outturn data show that the Department met the target set in the June 2010 Budget to reduce its running costs by a further £535 million in 2010-11. This latter reduction had to be achieved in the nine months remaining of the financial year. It was largely delivered through a ministerial decision to close the Future Jobs Fund and the implementation of Cabinet Office requirements to introduce moratoria on consultancy and marketing expenditure, plus a freeze on recruitment.

3 Despite these successes, a much tougher challenge lies ahead. The Spending Review outlines the expected cost of benefits and pensions each year and the Department's budget to administer these payments and its other functions. By the end of 2014-15 the Spending Review settlement will result in cost reductions of nearly £20 billion (**Figure 1**). As with all the figures in this report, to allow reconciliation to the 2010 Spending Review, we have not adjusted costs to take account of forecast inflation.

Figure 1
The cost reductions to be delivered by the Department under the 2010 Spending Review

	2011-12 (£m)	2012-13 (£m)	2013-14 (£m)	2014-15 (£m)	Total (£m)
Cost reductions in benefits and pensions	455	2,495	5,860	8,150	**16,960**
Cost reductions in running costs	1,451	442	403	373	**2,669**
Total cost reductions	**1,906**	**2,937**	**6,263**	**8,523**	**19,629**

Source: National Audit Office analysis of Department data

4 The vast majority of the reductions will be to expenditure on benefits and pensions, rather than administrative spending. These payments are not within the Department's direct control as they must be paid to those who apply and are eligible. The reductions therefore depend upon the policy changes announced in the June 2010 Budget, the subsequent Spending Review and the March 2011 Budget, reflecting for the most part adjustments in benefit rates and entitlements.

5 The Department is directly accountable for the reductions in running costs. The Department's 2011-12 Delivery Plan notes that the reductions will be delivered largely through the rationalisation of existing support functions, increased self-service and automation of benefit delivery procedures, and reductions in workload as the economy is expected to recover. Compared to the cost reductions required in benefits and pensions, the majority of the savings in running costs have to be delivered earlier in the Spending Review period. While the reductions in running costs represent only a small proportion of the total, these changes can have a wider impact on the cost of benefits and pensions. For example, the payment by result contracts for the Work Programme, introduced in June 2011, reflect the Department's recognition that expenditure in this area should be more than offset by an associated reduction in benefits. The relationship between running costs and welfare expenditure also means that poorly executed cuts could have an adverse impact. Any deterioration in the accuracy of benefit decision-making or levels of fraud, for example, could increase the risk of overpayments in benefits and pensions which the Department has already estimated to have cost £3.3 billion in 2009-10. It is therefore crucial that the Department executes reductions in running costs in a structured way so as not to undermine the reforms to the benefit system.

6 This report is the first in a series by the National Audit Office on how departments are implementing their cost reductions. Our examination of the Department for Work and Pensions has focused on its planned reductions to running costs between 2011-12 and 2014-15.

7 Securing value for money from cost reductions involves more than just implementing planned cuts. Uniform top slicing of budgets or indiscriminate cost-cutting can leave an organisation at risk of building up higher costs in future. The Permanent Secretary, who took up post in January 2011, has taken a close personal involvement in how the cost reductions might be achieved. The Department has recognised that expenditure cuts can generate long-term sustainable efficiency savings only as part of a fundamental reform of its existing work practices, such as restructuring to remove layers of administration, focusing more on service delivery, and by changing behaviours to raise awareness of the need for cost control in future.

8 We have assessed the performance of the Department against the following criteria:

- The need to fully understand how costs are incurred at present and their relationship to service delivery value. (Part Two)
- A clear vision of how the organisation can be restructured to reduce unnecessary costs in the future. (Part Three)
- A clear plan for how this vision can be achieved. (Part Four)

9 The Department is only at the start of its new cost reduction challenge, and we will continue to monitor progress. Our examination was based on the state of the plans as at May 2011, but they continue to evolve.

Key findings

Sustained efficiency savings will depend upon the Department basing its plans more on the cost and value of its activities

10 Departments should have a good understanding of the distribution and profile of costs in their business, and the links between costs and the delivery of value (outputs such as claims processed and outcomes such as reducing reliance on benefits). Information on the distribution and profile of business costs enable rational choices about what to stop, what to change and what to continue. Without this information, cost reductions are less likely to lead to efficiency savings.

11 The major operational businesses within the Department have developed plans to live within their 2011-12 budgets. The development of these plans included modelling exercises and some benchmarking in order to establish what cost reductions might be made. The analysis was largely based on quantifying the potential reduction in full time equivalent staff numbers, for example using data on the expected further headcount reductions to be generated during the Spending Review in Jobcentre Plus and the Pension, Disability and Carers Service through streamlining processes and the increased use of online services. At the time of our audit, the plans for each business area were not sufficiently developed to enable us to confirm that any inconsistencies and duplications had been resolved.

12 In setting operational budgets for 2011-12, the Department did not make sufficient use of its activity-based costing model to drive performance improvements. Since 2007, the Department has been developing an activity-based costing model which is now sophisticated and versatile. The model has previously been used to determine staffing requirements in the Department’s two agencies, the Pension, Disability and Carers Service, and Jobcentre Plus. However, the tool has not yet been used sufficiently to identify differences in the unit cost of activities across offices so that the gap between the best and worst performers can be reduced.

13 The Department has not been able to quantify the impact of cost reductions on service delivery in sufficient detail to measure efficiency savings. The Department recognised that in order to respond quickly to the Government's priority objective by reducing costs in 2010-11, it would not be able to demonstrate long term efficiencies and would need to find savings wherever it could. The moratoria on consultancy and IT projects, for example, generated an immediate cost reduction, impact, but it is not clear to what extent costs will be deferred or displaced elsewhere. Establishing a causal link between a cost reduction instigated by a department and any changes in service delivery is difficult but important. External factors are difficult to isolate and the change may impact on a range of different activities and outcomes, but the Department should nevertheless attempt to consider effect on value to identify waste. The Department does measure overall changes in productivity by comparing changes in its costs against changes in an index of outputs. The Department noted that, at the request of the new Permanent Secretary, the management team in Jobcentre Plus had started monitoring its productivity each month from April 2011, and that there were similar plans for the Pension, Disability and Carers Service. However, there are, as yet, no such arrangements in place for corporate centre functions.

14 The Department recognises that it has to improve its understanding of the value of its activities and the associated costs. It previously relied on its Investment Committee to challenge proposals. However, an internal review in 2010 concluded that staff still placed more value on achieving targets within the resources available than pursuing cost effectiveness. The Permanent Secretary has recognised the importance of behavioural change in this area. As a first step, the Department is introducing Performance Agreements to specify the services to be delivered as well as the budget available for each business area.

The Department does not yet have a sufficiently detailed model of how it wants to run in the long term

15 Through having a clear vision of how the organisation will operate in future, senior managers are more likely to be able to prioritise what changes are needed and to explain to staff what their role might be. The approach can be referred to as defining a Target Operating Model. The model is, in effect, a vision of how an organisation will look in future given its objectives and will enable the Department to identify those areas that can be trimmed to reduce costs. The model should be supported by a detailed outline of how it will operate in practice. At the outset the model can be defined in broad terms and include some areas of uncertainty, such as how Universal Credit might be implemented. Such a model should then be refined through regular iteration as the Department's analysis of information develops. For example, the confirmation in May 2011 that Universal Credit will initially be delivered by staff from the Department and HM Revenue and Customs means that the model can be refined further.

16 Despite the uncertainties over how the implementation of Universal Credit would affect business processing, Jobcentre Plus has developed its model of how it will operate in the future to a greater extent than other parts of the Department. The development work started in Summer 2010. The model involves a reduction in the number of contact centres, benefit delivery centres and Jobcentres, and a greater reliance on online services. The plan acknowledges that any changes in how Universal Credit will be implemented would affect the model, but Jobcentre Plus was right to press ahead to develop a broad model anyway.

17 The Department's full model for how it will operate is taking longer to develop. In April 2010, the Department's executive team approved an Organisational Design Review that outlined a proposed rationalisation of corporate functions in the Department and its agencies, such as Finance, Legal Services and Human Resources. The review outlined a headcount reduction of approximately 5,300 posts by April 2014, although much of the detail of how services would be reorganised had yet to be resolved. The savings from the review do not readily reconcile with the reductions required under the Spending Review. Following his appointment in January 2011, the Permanent Secretary has instigated reviews of the Department's corporate functions. These reviews, including the associated headcount reductions, are due to be completed by March 2012. In the meantime, the Department does not have an operating model as clearly defined as that for Jobcentre Plus.

18 The Department has not developed sufficient contingencies to mitigate uncertainty. In order to manage the unknowns in the implementation of welfare reforms and the possibility that some cost reductions might not materialise, the Department and its agencies should build contingencies into the plans. The Department confirmed that it plans a regular programme of 'deep-dive' examinations to scrutinise the progress of each business unit in securing their cost reductions. We consider that it is prudent to plan for an extra 50 per cent of the value of cost reductions required. Jobcentre Plus confirmed that it had built some contingencies by reducing its anticipated savings from headcount reductions by 20 per cent. The business plans for the Department did not include explicit contingencies, although the Permanent Secretary has brought forward the planned headcount reductions in the Department's corporate functions.

The Department will have to strengthen its oversight of progress if it is to maximise sustainable reductions

19 The fundamental reorganisation of a department to secure cost reductions depends upon the successful implementation and management of a transformation programme. By following a step-by-step process of incremental change within an overall strategy, an organisation should be able to restructure its activities without disrupting ongoing service delivery. A transformation programme will typically involve a suite of projects and initiatives to restructure existing processes, a communications strategy to convince and assure staff of the need for change, and a measurement system to monitor progress and evaluate impact.

20 The Department has recognised the need to raise staff awareness of the requirement to reduce costs. The Department had nearly 98,000 full time equivalent permanent employees at 31 March 2011. The executive team has a crucial role in helping staff to deal with the potential consequences of cost reductions and to remain focused on service delivery. Many of the initiatives implemented in 2010-11, such as a restriction on first class travel, should encourage staff to be more prudent with public funds. Jobcentre Plus and the Group Finance Directorate had also posted information on the Department's intranet and held discussions with staff to listen and respond to their concerns and suggestions for savings, although this approach is not consistent across all corporate service functions.

21 The Department has not yet developed detailed plans beyond 2011-12 to meet the Spending Review reductions in running costs. Existing delivery plans only cover 2011-12, although Jobcentre Plus has a more detailed plan up to 2014-15. The Department's Transformation Programme Board, which first met in May 2011 and comprised members of the executive team, will oversee the corporate centre redesign and the broader cultural change required, but the plans beyond March 2012 are not yet specified.

22 While the Department has agreed the budgets for 2011-12 with each of its business areas, individual responsibilities had not been finalised at the start of the year. By April 2011 the Jobcentre Plus management team had clarified accountabilities and responsibilities with each director, but this process had not been adopted across the whole of the Department. The Department noted that each manager understands their role in securing cost reductions, but until accountabilities are clearly specified, ambiguities increase the risk that cost reductions will not be achieved. Performance Agreements have been agreed with each Director General and are being cascaded down through the organisation.

23 The introduction of revised governance arrangements should help to improve programme oversight. The Department did not monitor progress in reducing costs adequately in 2010-11 and there were insufficient data collated on unit costs or the quantity and quality of service delivery. The Department has introduced a Transformation Programme Board from May 2011 to oversee planned changes to the design and culture of the organisation. From October 2011, it will be supported by a Portfolio Management Unit whose role will be to monitor progress in delivering the Department's change programmes.

Conclusion on value for money

24 The Department's challenge of securing a £2,669 million reduction in running costs in four years, at the same time as implementing substantial welfare reforms and a £17 billion reduction in benefits and pensions, requires a good understanding of its expenditure, a clear vision, and a coherent, well informed plan. Work is under way but three months into the Spending Review period, there is some way to go before the Department can demonstrate it has a strategic and structured approach to its cost reductions. The Department cannot rely on uncoordinated annual savings plans for sustained cost reductions, particularly given the challenges posed by the major benefit reforms it must implement. There are emerging signs of progress, but unless these materialise as part of a structured approach, there is a risk of not achieving substantial savings, and therefore value for money.

Recommendations

25 We make the following recommendations:

a To improve its understanding of the cost and value of its activities, the Department should:

- Use the activity-based costing model to compare performance across the different offices in Jobcentre Plus and the Pension, Disability and Carers Service to identify potential efficiencies.
- Adapt the activity-based costing model for use in the corporate centre and set a clear timeline for its implementation.
- Develop clear plans for changing staff attitudes to cost control. These plans should include tying in the Performance Agreements with the staff appraisal system so that managers can be held to account and encouraging each business area to link unit costs with value in their proposals by demanding such information in any written submissions.

b **The Department has not yet developed a detailed model for how it expects to deliver services in future.** The Department should:

- Task the Transformation Programme Board to complete the development and refinement of a Target Operating Model.
- Cross-check the Performance Agreements for each business unit against the Target Operating Model for consistency and to ensure that there are sufficient contingencies in case some cost reductions do not materialise.

c **Without a clearly specified overall plan to deliver the cost reductions by March 2015, the Department cannot monitor progress effectively.** The Department should:

- Establish clear programme management arrangements, including a timeline of key steps in the process and formal governance arrangements so that progress can be monitored.
- Specify responsibilities for delivering the savings and determine a clear reporting line. Each manager should have an accountability statement setting out what changes they are expected to implement and by when.

Part One

The challenges facing the Department for Work and Pensions

Departmental spending and its role in the budget deficit reduction plan

1.1 The Department for Work and Pensions (the Department) has the largest annual expenditure of any central government department; its settlement for 2011-12 is £163.4 billion, equivalent to 23 per cent of public spending. This total includes £155.6 billion for payments to pensioners, the unemployed, the disabled and carers, plus £7.8 billion for running costs.

1.2 Reducing the budget deficit is a Government priority. The June 2010 Budget and the October 2010 Spending Review outlined significant reductions in spending across the public sector. The Department's settlement in the Spending Review increases from £163.4 billion in 2011-12 to £171.5 billion in 2014-15 (**Figure 2** overleaf).[1]

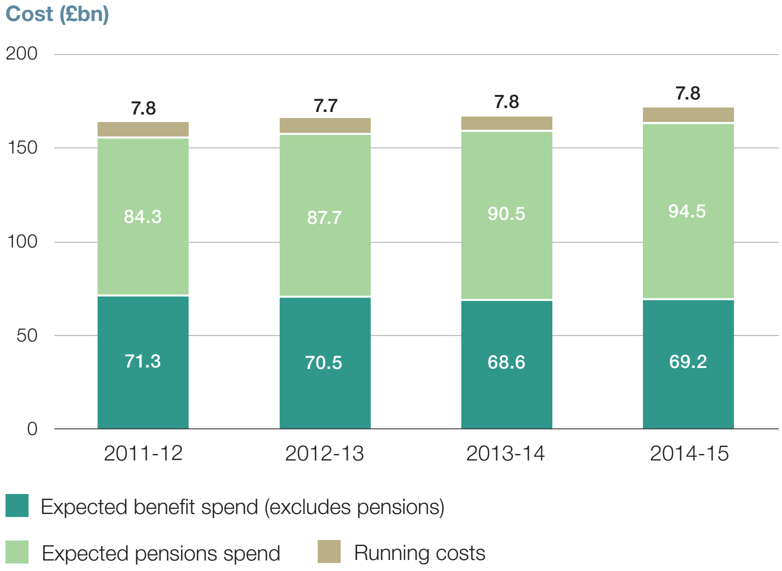
1.3 The Spending Review specifies the Department's settlement each year, but it does not explicitly state the cost reductions required. The Department has estimated the cost reductions amount to £1,906 million in 2011-12, building to nearly £20 billion by 2014-15 (**Figure 3** on page 15). The cost reductions comprise the following areas:

a The Department has to secure a £2,669 million reduction to its running costs through improvements in administrative efficiency, encouraging more customers to self-administer benefits online, and reductions in workload as the economy is expected to recover.

b Welfare changes outlined in the June 2010 Budget, October Spending Review and the March 2011 Budget are expected to slow down the rate of increase in the cost of benefits and pensions, saving £17 billion by 2014-15. The changes include switching from the Retail Price Index to the Consumer Price Index to calculate the inflation of benefits each year, and the introduction of maximum time limits for eligibility for Employment and Support Allowance.

1 As with all the figures in this report, to allow reconciliation to the 2010 Spending Review, we have not adjusted costs to take account of forecast inflation.

Figure 2
The Department's settlement under the 2010 Spending Review for 2011-12 to 2014-15



NOTE

1 The figures do not take into account the effect of forecast inflation.

Source: Spending Review 2010, HM Treasury, October 2010 (Cm 7942)

1.4 The vast majority of the reductions are in the cost of benefits and pensions, rather than administrative efficiencies. The payments on benefits and pensions are not directly within the Department's control as they must be paid to those who apply and are eligible. The reductions largely depend upon changes in benefit rates and entitlement. Changes in demographics or economic conditions such as variations in the unemployment rate will also affect how many people are entitled to claim benefits.

Figure 3

The cost reductions to be delivered by the Department during the Spending Review period

	2011-12 (£m)	2012-13 (£m)	2013-14 (£m)	2014-15 (£m)	Total (£m)
Running cost reductions					
Savings in administration baseline required each year	536	350	229	179	**1,294**
Expected savings due to recovery from recession required each year[1]	915	92	174	194	**1,375**
Total running cost reductions each year	1,451	442	403	373	**2,669**
Pensions and benefits reductions					
Reductions from measures announced in the June 2010 Budget	410	1,100	3,000	4,670	**9,180**
Reductions from measures announced in the October 2010 Spending Review	45	1,360	2,805	3,400	**7,610**
Reductions from measures announced in the March 2011 Budget	0	35	55	80	**170**
Total pension and benefit savings	455	2,495	5,860	8,150	**16,960**
Total reductions in running costs and pensions and benefits	**1,906**	**2,937**	**6,263**	**8,523**	**19,629**

NOTE

1 The savings relate to the forecast reduction in running costs associated with an expected drop in claimants for Jobseeker's Allowance as the economy recovers.

Source: National Audit Office analysis of Department data

1.5 The Department's estimates of reductions in the cost of benefits and pensions carry a degree of uncertainty. The implementation of the Universal Credit from October 2013 will replace a number of the Department's existing benefits and those of HM Revenue and Customs with a simplified benefit that will directly take into account an individual's earnings each year.[2] Until the Government finalises how it will deliver the Universal Credit, there are uncertainties over how quickly people will transfer from existing benefits, although the budget for Universal Credit is fixed at £2 billion for this Parliament.

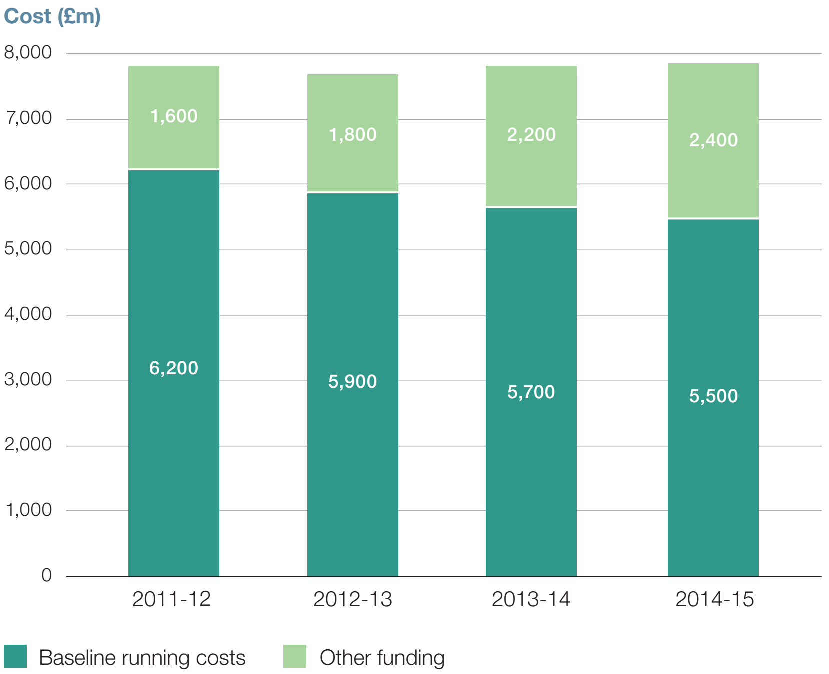
1.6 The Spending Review emphasised the importance of the connection between administrative activity and the aim of reducing dependency on benefits by encouraging more people back into work or training. For example, the payment by result contracts for the Work Programme introduced in June 2011 reflect the Department's recognition that expenditure in this area should be more than offset by an associated reduction in benefits. While the reduction in running costs is only a small proportion of the total, cuts in this area can impact on reductions in the welfare expenditure. For example, any deterioration in the accuracy of benefit decision-making or levels of fraud could increase the risk of overpayments in benefits and pensions, which the Department estimated to have cost £3.3 billion in 2009-10.[3] The Department's ability to implement reforms to the benefit system depends on how it manages the balance between reducing staff numbers and increasing automation.

1.7 To focus attention more on the impact of administrative activity on benefits paid out, the Department has reshaped its running cost budget to differentiate more clearly between front-line activity and back office support. Between 2011-12 and 2014-15 the Department's budget for running costs remains around £7.8 billion a year (**Figure 4**). However, these amounts include ring-fenced funding to implement the Universal Credit and other welfare changes; extra resources to cope with the additional workload from the recession; and extra funding to reduce the cost of overpayments in benefits and pensions due to fraud or error. When these amounts are excluded, the Department expects its baseline running costs to reduce from £6.2 billion in 2011-12 to £5.5 billion in 2014-15. The reductions required in running costs are directly within the Department's control. Compared to the cost reductions required in benefits and pensions, the majority of the savings in running costs have to be delivered earlier in the Spending Review period.

2 The Welfare Reform Bill states that the Universal Credit will replace Income Support, Jobseeker's Allowance, Employment and Support Allowance, Housing Benefit (which is administered by Local Authorities), as well as Child Tax Credit and Working Tax Credit (which are administered by HM Revenue and Customs).

3 *Fraud and error in the benefit system, April 2009 to March 2010,* Department for Work and Pensions, March 2011.

Figure 4
The Department's running costs 2011-12 to 2014-15



NOTES
1 The figures are rounded and do not take into account the effect of forecast inflation.
2 Other funding includes funding for Universal Credit, extra resources to cope with the recession and funding to reduce the cost of overpayments due to fraud and error.

Source: National Audit Office summary of Department data

Experience in reducing costs to March 2011

1.8 The Department has reported savings of over £2 billion in response to previous HM Treasury spending reviews (**Figure 5** overleaf). We have commented in the past on the savings reported by other departments. In July 2010[4], we reviewed the reported cost reductions for five major departments.[5] We found that only 38 per cent of the reported cost reductions fairly represented sustainable cash releasing savings. While this exercise did not cover the Department for Work and Pensions, we consider that any reported reductions should be treated with caution. With this caveat in mind, we have nonetheless seen evidence that the Department has managed to secure major cost reductions in this period. In 2008, for example, the introduction of contact centres contributed to a headcount reduction of approximately 15,000 full-time equivalents, leading to a substantial reduction in staff costs and the release of 200,000 square metres of office accommodation.[6]

4 Comptroller and Auditor General, *Progress with VFM savings and lessons for cost reduction programmes*, Session 2010-11, HC 291, 20 July 2010.
5 Department for Transport, Home Office, HM Revenue and Customs, Ministry of Defence and the Department for Education.
6 Comptroller and Auditor General, *The roll-out of the Jobcentre Plus Office network*, HC 346, Session 2007-08, 22 February 2008.

Figure 5
Cost reductions previously reported by the Department

Planned reductions

July 2004
Comprehensive Spending Review announces that by March 2008 the Department will deliver £960 million savings, a 30,000 headcount reduction and redeploy 10,000 staff to customer facing posts

October 2007
Comprehensive Spending Review announces that by March 2011 the Department will save £1.2 billion and receive £550 million for modernisation. It will reduce its estate by 20 per cent – 400,000 square metres. The Department introduced the Change Programme to drive further headcount reductions

November 2008
The pre-budget report announces an additional £1.3 billion over two years for the Department to deal with increased pressure from the economic downturn. The funds will increase the workforce and suspend the closure of Jobcentre Plus offices

2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010

Reported reductions

March 2007
The Department announces that 10,000 staff were redeployed to customer facing roles

November 2008
The assessment of the Comprehensive Spending Review 2004 reported that by March 2008 the Department had met its targets by saving £1,446 million and reducing its headcount by 31,101

June 2009
The Department announced that in 2008-09 it had delivered a £581 million net cash reduction towards the 2007 Comprehensive Spending Review

July 2010
The Department reports that by March 2010 it had saved £1.0 billion in response to the 2007 Comprehensive Spending Review target

NOTE
1 The reported reductions have not been validated by the National Audit Office.

Source: National Audit Office summary of Department publications

1.9 While the Department has not yet presented its financial statements for 2010-11 to Parliament, it is likely to have met the £535 million reduction target for that year specified in the June 2010 Budget. This reduction was introduced three months into the financial year and represented a reduction in addition to the Department's savings commitments from the 2007 Comprehensive Spending Review. The Department recognised that in order to respond quickly to reduce costs in 2010-11 it would need to secure savings where possible part way through the financial year. The ministerial decision to close the Future Jobs Fund and associated programmes, on the basis of the indicative financial outturn figures for 2010-11, led to a cost reduction of £370 million compared to the original budget for the year. Expenditure on general administration was £775 million less than originally budgeted. In response to Cabinet Office initiatives, the Department had instigated a freeze on recruitment, a restriction on first class travel, reduced the number of buildings in its estate, deferred or stopped consultancy and IT projects, and reduced its general office expenditure, such as on postage and telephone costs. The initiatives have continued in 2011-12.

Scope and Methodology

1.10 This report is the first of a series on how different departments are implementing their cost reductions. Our examination is based on the premise that securing value for money from cost reductions involves more than just implementing planned cuts and that expenditure cuts should generate long-term efficiency savings. Uniform top slicing of budgets or indiscriminate cost-cutting can leave an organisation unprepared for future challenges and at risk of building up higher costs in future. Our examination of the Department for Work and Pensions has focused on its planned reductions to running costs between April 2011 and March 2015.

1.11 The Spending Review covers the period until March 2015. As the Department is only near the start of the process in reducing its costs, we would expect to report on its progress at regular intervals over the timescale of the Spending Review. This is an opportune time, however, for the National Audit Office to examine the progress made by the Department in developing and implementing its plans. The report covers:

- Part Two: Understanding costs and value
- Part Three: Establishing the vision for the future
- Part Four: Achieving the vision: managing change to secure cost reductions.

1.12 The Department's cost reduction plans continue to evolve. Our examination is based on the information available in early May 2011. We have assessed performance against a framework available online at www.nao.org.uk and by drawing on advice from our consultants, Amtec and Deloitte. Our methodology is summarised at Appendix One.

Part Two

Understanding costs and value

2.1 Robust information on the profile of an organisation's costs, and relating them to value delivered, increases the likelihood that cost reductions will lead to efficiency savings. Without a clear understanding of the use of resources, including cost drivers and unit costs of activities and processes, together with an understanding of how they link to outputs and outcomes, an organisation cannot make rational choices about what to stop, what to change, and what to continue.

2.2 The major operational business units within the Department have developed plans to live within their 2011-12 budgets. The development of these plans included modelling exercises and some benchmarking in order to establish what cost reductions might be made. The analysis was largely based on quantifying the potential reduction in full-time equivalent staff numbers. For example, the Change Programme, introduced in 2007, was expected to generate further headcount reductions during the Spending Review in Jobcentre Plus and the Pension, Disability and Carers Service through streamlining processes and the increased use of online services. At the time of our audit, the plans for each business area were not sufficiently developed to enable us to confirm that any inconsistencies and duplications had been resolved.

Past performance

2.3 Previous Capability Reviews by the Cabinet Office noted that the Department had successfully delivered through a period of significant change and rated it as one of the highest performers. One area where it had been relatively weak, however, was at understanding the value of its activities and the associated costs. The Cabinet Office's 2006 Capability Review rated 'Plan, resource and prioritise' as an 'Urgent Development Area', although progress had been made by the 2008 Review update, when it was measured as a 'Development Area'.[7] Previous National Audit Office reports identified a lack of robust data on the cost and value of activities. For example, our reports on administrative and customer error found that the Department lacked the quality of information needed to target initiatives effectively.[8] The report on the Management of Benefit Overpayment Debt found that the Department had limited data on the relative costs and success rates of particular recovery routes and lacked indicators to allow it

7 *Capability Review of the Department for Work and Pensions*, Civil Service, July 2006 and July 2008.
8 Comptroller and Auditor General, *Minimising the cost of administrative errors in the benefit system*, Session 2010-11, HC 569, 25 November 2010 and Comptroller and Auditor General, *Reducing losses in the benefit system caused by customers' mistakes*, Session 2010-11, HC 704, 21 January 2011.

to calculate the costs of recovery.[9] Our report on the Community Care Grant found that the Department had underestimated its average cost of administering each grant by not including IT costs or other overheads in its calculations.[10]

2.4 Our review of the Department's savings from the June 2010 Budget found that there were insufficient data to confirm to what extent the reductions have led to longer-term efficiencies. For example, there is no information on whether the moratoria of expenditure on IT and management consultancy led to savings or resulted in the deferral or displacement of costs elsewhere, nor any information on the resulting impacts on service delivery. Even where savings appear to be long-term reductions in cost, such as closing the Future Jobs Fund, the Department had not established the extent of increased costs elsewhere, for example by providing alternative support through other programmes. The Department plans to undertake an impact assessment of the Future Jobs Fund by Spring 2012.

2.5 In 2009, the Department commissioned public sector financial management specialists to carry out a review of its financial management arrangements. The review was completed in May 2010. **Figure 6** overleaf shows a selection of scores from the review in areas particularly important for successful cost reduction. The results are subjective, but they suggest that, while there have been some areas of improvement, other areas (such as increasing financial literacy and increasing the value placed on financial management and understanding in the Department) have not moved forward since 2008. According to the review, staff still placed more value on achieving targets within the resources available than pursuing cost-effectiveness.

Opportunities to improve the data available on cost and value

2.6 A cost-effective business depends on high quality data with well-understood links to outputs and outcomes. The need to instil a value-for-money culture to achieve sustainable cost reductions in an organisation is well understood by private sector business (**Figure 7** overleaf).

9 Comptroller and Auditor General, *Department for Work and Pensions: Management of benefit overpayment debt*, Session 2008-09, HC 294, 1 May 2009.
10 Comptroller and Auditor General, *The Community Care Grant*, Session 2010-11, HC 286, 22 July 2010.

Figure 6
The Department's assessment of its financial management performance in 2008 and 2010

	2008	2010	Change
Financial management used in assessing future business needs	2.0	3.0	+1.0
Financial management capacity and transformation	1.5	2.5	+1.0
Financial management role in strategic decision-making	2.5	3.0	+0.5
Financial management supports organisational change	2.5	3.0	+0.5
Managers deliver cost-effective services and are held accountable	1.5	2.0	+0.5
Medium-term financial planning	3.0	3.0	0
Integration of business/financial planning and performance management	2.5	2.5	0
Financial management and project/change management	2.5	2.5	0
Financial literacy is diffused throughout the organisation	2.0	2.0	0
Managers responsible for value for money	2.0	2.0	0

NOTE

1 A score of 1 represents unsatisfactory; a score of 4 represents excellence.

Source: A summary of the internal review undertaken by the Department in 2010

Figure 7
The importance of detailed and sophisticated financial and costing information for sustainable cost reductions

Action	Description
Clearly articulate the link between cost management and strategy	Business strategy must drive cost reduction, and not vice versa. To create value through cost-cutting, managers need to understand the best ways to allocate operating expenses through understanding at the most detailed possible level the return on invested capital.
Use more granular cost data than generated from accounting systems	Companies must continuously track in detail the expenses behind its accounts to identify areas of underperformance. Identifying, measuring, and controlling their most important drivers is vital. Each junior manager should use a standard costing template related to the accounting system.
Treating cost reductions as an ongoing exercise	It is necessary to use the initial cost reduction programme as an opportunity to build a competency and capability in cost management. Better communication, cost information and performance management and incentives can embed better cost management and a cost reduction culture.

Source: National Audit Office summary of McKinsey Quarterly article, Five ways CFOs can make cost cuts stick, May 2010

2.7 The Department has a stable financial management system to record its expenditure, but cannot readily use the system to underpin structured cost reduction. The establishment of an Investment Committee enabled the Department to challenge proposals. However, the Department has recognised that it still needs to improve the quality of its management data. The Department's internal review of financial management in 2010 notes that: "the 'prize' for the Department is in obtaining a detailed understanding of the financial impact of core delivery activities, which drive the majority of its costs", and that "the Department is only at the start of gathering data which will need to be turned into information…to answer…questions such as [what are] the financial implications of changing performance levels or delivery models".

2.8 Since 2007, the Department has been developing an activity-based costing model to cost activities and processes, drawing on data from the general ledger. The model is flexible and can be used to cost activities in different ways, for example, at whole benefit, local office or at task level. Better use of the model will enable more informed decisions, such as which overpayment debts are cost effective to recover.

2.9 The model is widely used by business units for specific or discrete projects. For example, it was previously used to determine staffing requirements in the Pension, Disability and Carers Service and to redesign benefit processing in Jobcentre Plus. However, the tool is not yet used routinely to drive performance improvements, such as by identifying differences in the unit cost of activities across offices. The activity-based costing model had not been used in many of the corporate service plans, such as estates management.

2.10 The activity-based costing model does not link cost to value and so the Department has limited information on the relationship between its costs and their impact on service delivery value. The Department does have an accredited methodology for measuring overall changes in productivity. The approach involves measuring changes in expenditure against changes to a weighted index of outputs to assess whether efficiency has increased or reduced over time. The analysis has not been extended to every element of the Department's business, although the Department noted that, at the request of the new Permanent Secretary, the management team in Jobcentre Plus had started to monitor its productivity each month from April 2011. There are similar plans for monitoring productivity in the Pension, Disability and Carers Service, but there are currently no such arrangements in place for corporate centre functions. In addition, the Department confirmed in June 2011 that the introduction of Performance Agreements for each business area would include productivity analysis, linking the budgets agreed to outputs and planned gains in productivity.

2.11 In a workshop in November 2010, members of the Department's executive team agreed on 12 areas to improve its management information (**Box 1**). If addressed, these areas will go some way to enhance the Department's use of cost and financial management, which should in turn provide the basis for achieving structured cost reduction in the medium and long term. We have not been able to establish how these tasks have been taken forward or what progress has been made.

Box 1

Areas for improvement identified by senior staff in the Department

- Closer linking and understanding of financial and performance information.
- Costing the implications of alternative service delivery models and improving business intelligence.
- Closer understanding of the relationship between running costs and welfare spend.
- Improving project planning in terms of costs, savings, timings and capturing benefits.
- Role of finance in responding rapidly to change, and leading and managing the expected Spending Review 2010 financial climate.
- Improving the perception of support available to non-qualified finance staff.
- Improving non-finance manager skills and accountability.
- Full exploitation of the risk management system.
- Improvements to the accuracy and robustness of financial forecasts.
- Standardisation of best practice processes and freeing up finance staff from transactional processing.
- Determination of minimum financial standards and frameworks.
- Improving communication between financial stakeholders, corporate finance, devolved finance, economists, operational researchers, and non-finance managers.

Source: National Audit Office analysis of Department information

Part Three

Establishing the vision for the future

3.1 To meet the scale of the cost reductions required by 2014-15, the Department has to look beyond short-term budget reductions and consider more radical options. Changing the way services are delivered can enable an organisation to streamline functions and eliminate unnecessary layers of administration. Unless large-scale cost reductions are introduced as part of wider structural changes to the focus and operation of an organisation, they are unlikely to be sustainable, risking service delivery disruption.

3.2 Achieving large scale cost reductions is dependent on defining a Target Operating Model. This is, in effect, a vision of how an organisation will look in the future given its objectives, supported by a detailed outline of how this will operate in practice. Such a model should be defined at the outset in broad terms and then refined through regular iteration as the analysis of information develops. By drawing on an analysis of the cost and value of existing activities and comparing these to the Target Operating Model, an organisation can then start to prioritise where it uses its resources and to identify those areas to be trimmed.

Determining a Target Operating Model

3.3 In April 2010, the Department's executive team approved an Organisational Design Review which outlined a proposed rationalisation of corporate functions in the Department and its agencies such as Finance, Legal Services and Human Resources. The review outlined a headcount reduction of approximately 5,300 posts by April 2014, although much of the detail for how services would be re-organised had yet to be resolved. It is important, for example, to retain sufficient staff experience when implementing headcount reductions. In November 2010, the Government published Business Plans for each government department. The Department's Business Plan set out its vision which focuses on the Government's values of freedom, fairness and responsibility and to put welfare spending on a sustainable footing. Most of the document focuses on the timeline for proposed reforms, but it does set out a vision which could provide the basis for a Target Operating Model. The plan specifies the Department's ambition to improve cost effectiveness by:

- Creating a single virtual contact centre network and dealing with 80 per cent of telephone enquiries at the first point of contact.
- Reducing the cost of corporate functions through centralisation and optimising the use of estates.

- Further developing the Shared Services function as a cross government provider of back office services.
- Reducing avoidable contact by keeping customers better informed.
- Using the internet much more for processing services.
- Embedding Lean techniques to eliminate unnecessary activity.

The Department will need to be careful not to damage its relationship with its customers when implementing these changes.

3.4 Despite the uncertainties over how the implementation of the Universal Credit would affect business processing, Jobcentre Plus has developed a model of how it will operate in future. The development work started in Summer 2010. The model involves a reduction in the number of contact centres, benefit delivery centres and Jobcentres, and a greater reliance on online services. The plan acknowledges that any changes in how the Universal Credit will be implemented would affect the model, but Jobcentre Plus was right to press ahead to define a model in broad terms anyway.

3.5 The Department has recognised that expenditure cuts can generate long-term sustainable efficiency savings only as part of a fundamental reform of its existing work practices. As the plans set out in the Organisational Design Review were relatively high level and did not clearly reconcile with the Department's settlement under the Spending Review, in February 2011 the Permanent Secretary initiated a major review of the Department's corporate functions that will help to define its future operating model. The review aims to simplify accountabilities and policy development and to rationalise administrative functions. The Department is also reviewing the role of its Shared Services function. As these reviews, including the associated headcount reductions, are not due to finish until March 2012, the Department's overall model for how it will operate is taking longer to develop than that for Jobcentre Plus.

3.6 The time the Department will take for these reviews reduces the time left before the end of the Spending Review. During our examination, the Department did not have clear arrangements in place to coordinate each of the reviews. In May 2011, however, it established a Transformation Programme Board to refine the Target Operating Model. The Department also plans to establish a Portfolio Management Unit in October 2011 to improve programme oversight.

Dealing with uncertainties

3.7 As the Target Operating Model is dependent on iterative refinements, earlier versions will include considerable uncertainties. It is therefore prudent to include contingencies in any planning in case some of the proposed cost reductions cannot be realised. This is especially true for the Department, as uncertainties over the timing and impact of welfare reforms, such as the implementation of the Universal Credit, have yet to be resolved.

3.8 There is uncertainty as to what each budget holder will be able to deliver in practice. The Department confirmed that it plans a regular programme of 'deep-dive' reviews to scrutinise the progress of each business unit in securing cost reductions. Our consultants advised that even top private sector businesses over-estimate how much cost reduction plans will actually save. Best practice is also to have a constant pipeline of new ideas, so that the programme can be recharged if those ideas currently planned start to under-deliver. In view of the level of uncertainty around the welfare reforms, it would be prudent to plan for an extra 50 per cent of the value of cost reductions needed.

3.9 The Department's plans for 2011-12 did not consistently have contingencies built in. Jobcentre Plus confirmed that its plans did include some contingencies to counter over-optimism, for example, it reduced the projected savings from its headcount reductions by 20 per cent. Jobcentre Plus' operational finance division also reviewed project forecasts on a monthly basis to challenge any optimism bias. The business plans for the corporate functions of the Department did not include explicit contingencies. Within the Group Finance Directorate, for example, the Finance Director tasked each strand to identify additional 'stretched' targets of at least a further 5 per cent annually, but progress was slow, as the relevant managers raised concerns over the potential adverse impacts of further cost reductions. However, the Permanent Secretary has brought forward the planned headcount reductions to March 2012 from April 2014.

Part Four

Achieving the vision: managing change to secure cost reductions

4.1 The structural changes required to secure cost reductions depend on the successful implementation and management of an organisational transformation programme. A transformation programme typically involves a suite of projects to restructure existing processes, a communications strategy for key stakeholders and a measurement plan to monitor progress and impact. The transformation programme will involve a step-by-step process of incremental change to restructure activities while maintaining service quality. Plans will address the whole of the business change, not just the individual components and must be closely aligned with the overall vision of the Department. There needs to be strong leadership and oversight to implement the difficult decisions.

Planning for organisational change

4.2 In April 2011, the Department and its agencies published Delivery Plans that described how they will start to implement the reforms, improve customer services and reduce costs. Each of the business units has identified where cost reductions might be secured in 2011-12 and has agreed targets with the Planning and Performance Management Directorate accordingly. The plans specify the budgets available for 2011-12, but not what structural changes are needed or the steps involved. Until each manager clearly understands their role in securing cost reductions, ambiguities increase the risk that cost reductions will not be achieved. Within the Group Finance Directorate[11], for example, there are baseline targets for each major strand in the Directorate, such as estates management, encashments and contracts.

4.3 We reviewed the supporting business unit plans in May 2011, examining in detail those for Jobcentre Plus and the Group Finance Directorate. We selected these two plans to review as they are likely to be central to the Department's vision to simplify customer contact and to reduce the cost of its corporate functions. The plans for 2011-12 continue to pursue savings in the same areas as those for the June 2010 Budget. There are also plans to go beyond short-term cost reductions. For example, the planned headcount reductions in the Department's corporate functions and the expected closure of selected Benefit Processing centres in 2011-12.

11 The Group Finance Directorate covers the financial functions of the Department, including accounting, contract management and procurement.

4.4 At the time of our audit, the Department's plans were not sufficiently developed to enable us to identify whether opportunities to make savings have been maximised and any inconsistencies or duplications have been resolved. Any requirements to cut back on activities may have an impact elsewhere. For example, the Cabinet Office moratorium on IT spend as a result of the June 2010 Budget resulted in a delay to the programme to make online or self-service telephony the default contact method from customers.

4.5 The Department's Delivery Plan covers 2011-12, although Jobcentre Plus has a more detailed plan up to 2014-15. Plans for the remainder of the Spending Review period have yet to be finalised as they are dependent in part on the Department determining a cost-effective future business model. This model will depend partly upon the implementation of the Universal Credit. Development work is under way so that the implementation can begin from October 2013.

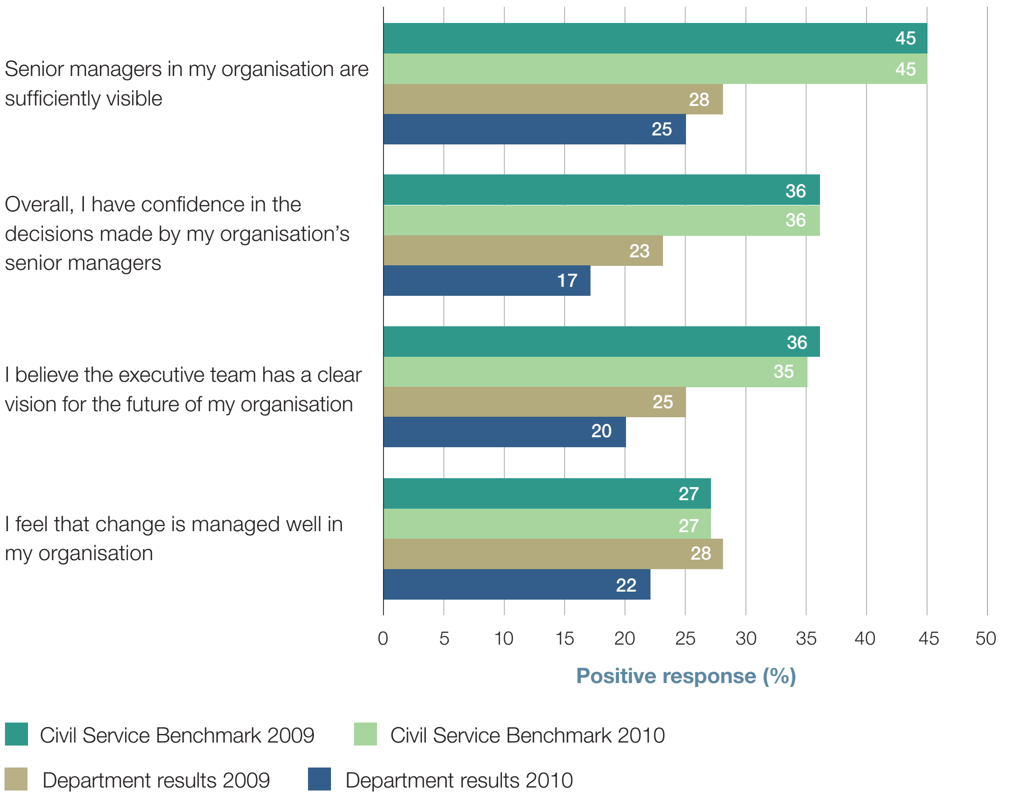
Managing change through strong leadership

4.6 The Department's executive team has a crucial role in supporting managers to implement their cost reduction initiatives but the challenge is increased by previous staff perceptions of their performance. Managers must understand their own role in securing cost reductions and help staff to deal with the consequences while remaining focused on delivering the organisation's services. It is important, for example, to maintain morale in order to keep administrative errors to a minimum. The Department reported that its Transformation Programme Board is responsible for a programme of change to culture and behaviours to raise awareness of the need for cost control in the future. The board, which comprises members of the Department's executive team, first met in May 2011 and is responsible for the process and infrastructure that will be required to deliver this transformation programme, but the plans beyond March 2012 are not yet specified.

4.7 The Department employed nearly 98,000 permanent full-time equivalent staff at 31 March 2011. In past years, staff in the Department have typically reported less confidence in their executive team than those elsewhere in central government (**Figure 8** overleaf). Staff surveys are not necessarily a good indicator of the performance of an executive team, but staff perceptions are important.

4.8 The Department has recognised the need to inform staff of the requirement to reduce costs and there are examples within the Department of effective communications to update staff and third parties on progress. This approach is not consistent throughout the organisation. Since the Spending Review announcement, communications with Jobcentre Plus have included publishing a 2015 vision statement, and both Jobcentre Plus and the Group Finance Directorate have published '*what the future holds*' information on their intranet sites, as well as running a regular series of events where senior staff set out their vision, invite comments and discuss concerns and suggestions for savings from staff. The Permanent Secretary noted that, since February 2011, he has held similar events with his senior staff. There is not yet a coordinated programme of communication covering all grades in the corporate centre. The Permanent Secretary explained that a series of face-to-face briefings for corporate centre staff are planned for Summer 2011.

Figure 8
Staff confidence in departmental leadership



NOTE

1 Some 77,500 staff in the Department responded to its People Survey in 2010, a response rate of 68 per cent. A similar number responded in 2009.

Source: National Audit Office analysis of the Department's People Surveys in 2009 and 2010

Suitable oversight arrangements

4.9 For the cost reductions in 2010-11, the Department devolved planning and target setting to middle managers. The executive team did not regularly review progress. Although the Department has not yet refined its Target Operating Model, the extent of organisational change required during the Spending Review is likely to be substantial. It is important, therefore, that robust, formal oversight arrangements are in place. The Department has already established its Transformation Programme Board. From October 2011 it will be supported by the introduction of a Portfolio Management Unit, combining staff from finance and delivery disciplines, to monitor progress in delivering the Department's change programmes.

Governance

4.10 The Department's executive team has been closely involved in setting the financial budgets and agreeing targets for the first year of the Spending Review. The head of each business unit is the Senior Responsible Officer for their individual cost reduction plans and they have adopted their own oversight arrangements. The Chief Executive of Jobcentre Plus, for example, allocated specific time each month to oversee directly his agency's cost reduction plans. Due to time pressures, the Director General for Finance delegated responsibility for day-to-day programme management to the Finance Director, who estimated that he has typically spent around 30 hours a month on this role. The Department's Permanent Secretary, who took up post in January 2011, has taken a close personal involvement in how the cost reductions might be achieved. In March 2011, he announced plans to rationalise his senior team, including the appointment of a Chief Operating Officer, who is responsible for leading all of the Department's services to the public, including the implementation of the Universal Credit.

4.11 Each Director General has an accountability statement, referred to as a Performance Agreement, which has been agreed with the Permanent Secretary. These plans are being cascaded through the Department. We found, for example, that each director in Jobcentre Plus has agreed an accountability statement setting out their key deliverables in 2011-12. The Department confirmed that the introduction of Performance Agreements across the Department in 2011-12 will specify services to be delivered alongside budgets available and would help to define roles and responsibilities. The plans were largely based on headcount reductions however, and it is not clear how or when the headcount reductions will translate into financial savings to the Department or how directors in Jobcentre Plus should work with the Human Resources department to secure them.

Project management

4.12 To be effective, those undertaking programme management roles should be appropriately skilled and supported. By April 2011, the programme management arrangements in the Group Finance Directorate and Jobcentre Plus were very different. In particular:

- The Programme Management Office in Jobcentre Plus comprised 14 full-time equivalent members of staff. As a group, they have substantial project management experience and knowledge of the business, including leading the Spending Review 2007 programme. There are clear procedures and sufficient resources in place to scrutinise and challenge cost reduction plans, report on progress to senior staff and manage risks to delivery.
- The Programme Management Office for Group Finance has three full-time equivalent members of staff and two part-time staff. The manager has substantial project management experience but does not have a background in the Department's finance functions. The team is developing appropriate oversight, risk management and reporting processes. Senior finance professional time will contribute to the running of the Programme Management Office, but as the day-to-day resources available are lighter than those in Jobcentre Plus it will not be able to provide the same degree of scrutiny.

4.13 The Planning and Performance Management Directorate would expect to escalate any risks to the Permanent Secretary where appropriate. However, the focus of the team is on the variances between the budget and the forecast outturn and it does not currently collate performance data on the impact of cost reductions on service delivery.

Appendix One

Methodology

The main elements of our fieldwork, which took place between October 2010 and April 2011, were:

Method	Purpose
Departmental Questionnaire: call for evidence	To inform our understanding of the Department's cost reduction programmes.
Financial/quantitative data analysis	To understand the Department's budget allocation, expenditure to date and budget forecasts and to identify the savings achieved from in-year cost reduction programmes.
Interviews: we conducted semi-structured interviews with a range of staff in the Department	To gain an understanding of the processes for planning, monitoring and delivering savings.
File review: we reviewed departmental literature and research relating to the cost reduction programmes	To understand the current position of the Department's plans for delivering the cost reductions.
Literature review: we reviewed private sector literature and research relating to the successful delivery of cost reduction programmes	To provide good practice examples and lessons learnt from other cost reduction programmes.
External input: we commissioned consultants Deloitte and Amtec to provide advice on the maturity of the Department's plans	To review the progress made by Jobcentre Plus and Group Finance Directorate towards developing business plans for the Spending Review period.

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