National Audit Office

REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL

HC 1788
SESSION 2010–2012

2 FEBRUARY 2012

Cabinet Office and HM Treasury

Cost reduction in central government: summary of progress

Key facts

2.3%	**19%**
(£7.9 billion) real-terms fall in spending within departments' control from 2009-10 to 2010-11	planned real-terms fall in spending in 15 departments from 2011-12 to 2014-15

In 2010-11

0.1 per cent (£0.7 billion)	**increase** in real terms in government's Total Managed Expenditure – to £689 billion in 2010-11
2.3 per cent (£7.9 billion)	**decrease** in spending within departments' direct control (Departmental Expenditure Limits) in real terms – to £336 billion
	Figure 1 on page 11 explains the difference between Total Managed Expenditure and Departmental Expenditure Limits. Figure 5 on page 18 explains the difference between the figures
£3.75 billion	estimated savings reported by the Efficiency and Reform Group
£406 million	**cost** to departments of compensation payments for early departures from the civil service this year
21,200 staff	**reduction** between 2009-10 and 2010-11 in average number of full-time equivalent staff employed by departments (including permanent and temporary staff)

From 2011-12 to 2014-15

3 per cent	real-terms fall in forecast Total Managed Expenditure to 2014-15
12 per cent	planned real-terms fall in Departmental Expenditure Limits
19 per cent	planned real-terms fall in Departmental Expenditure Limits in departments other than Health and International Development, which are protected

Summary

1 The Government's spending plans require most government departments to reduce their spending in real terms over the years to 2014-15. For 2010-11, departments needed to reduce spending by £5 billion compared with the plans announced in the March 2010 budget. Over the period from 2011-12 to 2014-15, the budgets of departments other than Health and International Development are falling by 19 per cent in real terms.

2 The scale of cost reduction means that departments need to look beyond short-term cost-cutting measures and make major organisational changes. To minimise impacts on services, departments and the bodies they fund will need to identify and plan for sustained cost reductions, and deliver them as part of a well-managed change programme. This is an initial report on progress with cost reduction across central government. It provides an overview of how departments reduced costs in 2010-11 and gives a snapshot of progress with longer-term planning, based on National Audit Office examinations in 12 departments.

Key findings

On 2010-11

3 **Despite the short timescale, departments successfully managed within their reduced spending allocations for 2010-11.** This meant they reduced the spending within their direct control (Departmental Expenditure Limits) by 2.3 per cent in real terms compared with 2009-10. The main reductions were as follows:

- Administrative (back-office) spending fell by £1.5 billion.
- Capital spending in departments fell by £1.6 billion, which is partly the result of spending being brought forward to 2009-10.
- There was a further net fall of some £4.8 billion in Departmental Expenditure Limits. Policy decisions to protect spending in some areas meant that 11 departments needed to cut programme spend. The largest fall was in grants paid by the Department for Communities and Local Government to local authorities.

4 Government spending moratoria and efficiency and reform initiatives have contributed more than half of the overall cost reductions achieved in 2010-11. These aimed to help departments meet as much as possible of the 2010-11 reductions by cutting back-office and avoidable costs. In July 2011, the Cabinet Office's Efficiency and Reform Group reported to the Public Accounts Committee that it had helped save some £3.75 billion through these initiatives. Our analysis of the audited accounts of the 17 main departments confirms that spending in the areas targeted was reduced on this scale. In particular, large reductions have been made in spending on consultants, temporary staff, property and information technology. Departments reduced their staff by the equivalent of 21,200 full-time posts in 2010-11, including permanent and temporary posts in departments and their agencies. However, the reduction in spending in the year is partly offset by in-year cash costs of early departures included in departments' accounts which we estimate at £406 million for early departures from the civil service in 2010-11. Larger savings in staff costs are likely in future as the impact of the pay freeze and further staffing reductions take effect.

5 Around £1.6 billion of the spending reduction we have identified is in capital spending. While some of these reductions are likely to reduce the cost base in the long term, for instance by reducing the size of the government estate, other reductions may not be fully sustainable. The fall of 35 per cent in IT capital spend is partly the result of decisions to permanently halt or reduce spending on specific projects, and partly the result of action to reduce the costs of IT products and services including through contract renegotiation. However, it is unlikely that IT capital spending will remain at this lower level in total, given the key role of IT and online services in increasing productivity.

6 We cannot say how these changes affected value for money in 2010-11. Some departments and arm's-length bodies have systems that relate costs to activity levels and outcomes, but there is no consistent way of identifying whether specific savings measures have improved efficiency or affected services. The system of Public Service Agreements used by the previous administration to measure overall departmental performance has been replaced. From 2011-12, departments are publicly reporting their performance quarterly using a new system of input and impact indicators. This will allow more consistent performance tracking in due course. In most departments, some of the new impact and input indicators are linked but not all of them, or similar areas are covered but there is no real link between inputs and impacts. It is, therefore, too early to draw conclusions as to whether performance has been adversely affected.

7 Departments will need to change business practices to prevent spending patterns reverting to their previous form. The 2010 Spending Review assumed that the reductions required in 2010-11 would continue, and requires most departments to reduce spending by an average of 19 per cent over four years to 2014-15. Cost reductions made to date need to be sustained or replaced with further savings if departments are to meet their Spending Review allocations.

Looking forward

8 **Departments need to make more fundamental changes to achieve sustainable reductions of the scale demanded by the Spending Review.** Short-term measures, though successful to date, will not be sufficient. Departments will need to have a clear vision of how they and their delivery partners will operate with a permanently lower cost base. They need a clear map of the changes needed to move to this model, and rigorous processes for realising the resulting savings.

9 **Most departments have yet to develop a clear picture of their future state or a detailed plan based on a strategic view across the business.** Most of the departments we examined have started to design new target operating models, and some have cost reduction strategies, although initial spending reductions were made before coordinated plans were in place. Where departments have developed change programmes, they also have good governance arrangements and systems to track progress in reducing costs.

10 **Departments' financial data on basic spending patterns is sufficient to manage budgets in-year, but information about the consequences of changes in spending is less good.** There are few examples of systems that link costs to performance. Without improvements in impact measurement, departments will not be able to track or manage the impact of cost reduction on service provision. Not understanding the factors driving cost and the consequences of spending cuts makes it difficult for departments to forecast future spending.

11 **Cost reduction plans need to build in contingency.** Our experience of previous savings programmes is that an average of 20 per cent of gross annual savings targeted are not realised. In managing within spending plans, departments have to manage a number of risks, including fluctuations in income (such as volatile rail revenues in the case of the Department for Transport). The plans we have examined do not have sufficient contingency to cover either the risk that savings are not realised or the impact of external uncertainties. Departments therefore depend on finding greater savings in future years to fill any gaps.

12 **Departments do not always understand the cost drivers and cost value ratios of devolved bodies sufficiently to make good decisions about changes in funding.** Nine departments spend more than 50 per cent of their budget through arm's-length or devolved bodies. Departments that deliver through others need to have a coherent strategy to deliver their objectives at lower cost, which takes into account the value delivered by different funding streams. The departments we have looked at do not have full capability to do this. Generally their strategy combines cuts to lower priority funding with an expectation that delivery bodies will manage their own costs down. However, some are working towards increasing their understanding of these costs. By delegating cost reductions, departments place much reliance on financial and change management capability in the devolved bodies. Departments need to manage the resulting risks.

Conclusion on value for money

13 Central government departments took effective action in 2010-11 to reduce costs and successfully managed within the reduced spending limits announced following the 2010 election. This resulted in a 2.3 per cent real-terms reduction in spending within departments' control, compared with 2009-10. Some £3.75 billion or around half the reduction was in areas targeted by the Efficiency and Reform Group for cuts in back-office and avoidable costs.

14 Most departments need to cut spending much more – by a further 19 per cent over the four years to 2014-15. Departments are less well placed to make the long-term changes needed, partly because of gaps in their understanding of costs and risks. From our reviews to date, departments have not yet developed new lower-cost operating models. Departments cannot achieve long-term value for money until they identify and implement new ways of securing their objectives with a permanently lower cost base.

Recommendations

For departments

a **The forward plans we have examined are not based on a strategic view across departments' business.** When examining cost reductions in the next year, we will be looking for:

- whether departments have considered alternative delivery arrangements and have a clear vision (target operating model) setting out how to deliver services with significantly reduced resources;
- cost reduction portfolios which include change initiatives to achieve target operating models;
- leadership commitment to the target operating model and change portfolio;
- whether change programmes and initiatives are well designed with robust plans, realistic resource requirements, clearly defined organisation and roles, effective and integrated project and programme management processes, and clear responsibilities and milestones to monitor progress;
- changes to working practices where necessary to deliver the target operating model and processes to realise savings;
- contingency plans to manage risks to the change portfolio, including a pipeline of potential additional savings measures;
- evidence that cost and performance information is used to identify ideas for cost reduction and continuous improvement; and
- testing, evaluation and implementation of the resulting innovations.

b **Few departmental systems can link costs to outputs and impacts, making it difficult to evaluate the effect of cost changes on what departments deliver.** Departments should make progress in developing a fuller understanding of the costs of the activities and services they deliver and of the outcomes they achieve, as well as the consequences of cost base changes.

c **Departments do not have good enough information on devolved bodies' costs and performance to secure value for money when funding is reduced.** Departments use a range of approaches in relating to the bodies they fund, as indicated in Figure 12 in Part Three. Where there are major changes in the delivery landscape and new delivery models for local services, departments must understand how such arrangements will secure value for money across the system. When working with existing delivery bodies, departments should assess their cost-effectiveness and the risks of change. In particular:

- departments need to sufficiently understand costs and performance to then allocate funds across business areas based on assessing value obtained from funding;
- to share cuts evenly across delivery bodies, department should assess those bodies' financial and change management capability; and
- where confidence cannot be derived from such an assessment, departments should work with delivery bodies to identify where to make efficiencies and support bodies in doing so.

For the Cabinet Office and Treasury

d **It is not clear how far spending reductions represent year-on-year changes in efficiency, or whether front-line services are affected.** The Treasury and Cabinet Office are developing common reporting formats for accounts and other departmental performance information. They need to establish consistency between:

- the data available for the public to assess departmental performance, including outcome measures;
- central departments' information requirements; and
- the programme and administrative spending reported by departments and their arm's-length bodies in the resource accounts audited by the National Audit Office.

e **Departments do not consistently adopt good practice in taking a structured approach to cost reduction.** The Treasury monitors departments' overall spending while the Efficiency and Reform Group intervenes in specific areas that benefit from a common approach. The central departments should work together to form a shared understanding of progress and gain an overview of departments' strategic capability. The Treasury and Cabinet Office should develop mechanisms to challenge, intervene or provide more support for weaker departments, including using experts across departments. They should agree how to align these across their respective roles and work with cross-government governance structures where possible.