

Invest to Save – it’s a good answer, so why is it so hard?

Introduction

Public finances in the UK are in a poor state as measured by growth in the structural deficit to more than 5% of GDP. This means that UK taxpayers and the public services they fund face a ‘generation of pain’ (to quote the Financial Times, November 2009).

Necessity is the mother of invention and, with this backdrop, there will be almost certainly be a burst of innovation in the way public services are delivered and financed.

This is the first in a series of ‘blue touch papers’ designed to explore the issue further and generate debate within public services and financial communities.

This first paper looks at one key area of innovation – “invest to save”. It explains the concept and explores some of the issues surrounding its introduction, with a focus on welfare to work – the first area in which this approach is being properly (or formally) modelled and piloted.

The second blue touch paper will assess the opportunities for applying invest to save across a wider range of public sector spending areas, as well as the different and innovative social outcome funding models that have been proposed.

Background

Invest to save (I2S) is a straightforward concept well established in the business world. Here the notion of an investment case, under which an initial outlay is justified on the basis that future savings will accrue, is well understood. The concept of spending today to save tomorrow is also well understood by most ordinary people. They apply it in their personal lives to everything from “buy one get one free” offers in supermarkets to investing in house repairs.

For government, the concept is just as simple to understand. It is frequently advocated across a wide range of programmes where the idea of “prevention rather than cure” appears to make both economic and social sense. Indeed the tone of much public debate suggests that many people believe that I2S is already a well established and widely used policy tool.

It is not - and the practical application of I2S on any thing other than a limited scale is fraught with difficulty.

This paper explores I2S in more detail and the barriers that will need to be overcome in persuading government policy makers, the Treasury in particular, that I2S is a solution to achieving better value for money from public expenditure

The I2S concept in government

I2S has been part of government policy for some years.

An I2S Budget was introduced by the present Government with its first Comprehensive Spending Review in 1998. The objective of this funding has been to provide seed funding for innovation in public services:

“The [i2S] budget is about joined up government, forging new alliances, creating partnerships and promoting innovation by sharing risks involved in new types of delivery so that the public can get the benefit of a more integrated package of services.”

Government bodies (including Departments of State, local authorities, health trusts and third sector organisations) are able to apply for funding to pilot and implement innovative, preferably joined up, services which can demonstrate an invest to save payback. Around £460m had been spent by 2007 on over 400 different projects.

Some of this has been spent on projects focused on addressing issues associated with welfare and longer term unemployment. These were targeted at specific groups, e.g. young people, ex-offenders, individuals with low skills etc. Welfare to work is, on the face of it, well suited to I2S type arrangements because the cost of intervention to help people find work are manageable and limited, and the costs of people not having work are high. In FY2009, total expenditure on unemployment, incapacity, tax credits, related housing and other welfare payments is projected to reach over £70bn out of a grand total £620bn (or 12% of total government outgoings).

Tony Blair used to describe welfare and related social security expenditures as the “costs of failure” and the Conservatives now use similar language. It is very obvious to most people that money invested by government in policies that prevent such “costs of failure” means that the public expenditure bill will be lower overall in the future. This assumption is borne out by the outcomes of two ISB programmes that have been implemented and evaluated:

- Building Jobs for the Future Ecosystem offered pre- and post-employment support for ethnic minorities in London. The evaluation found that for every £1 invested, £5.21 was generated in benefit savings, tax generation, and economic activity.
- WorkOut Pecan which provided employment support services to ex-offenders had a 70% success rate leading to savings of £6.4 million or more than three times the funding grant.

Despite being around for over 10 years now, ISB has only ever been targeted at smaller scale programmes such as these and has mainly been used in situations where there is a direct and early payback - similar to that which would apply in a normal investment case. The possibility of a more far - reaching approach to I2S in social policy had hardly been discussed in the UK before a much larger scale I2S programme was advocated by David Freud (now Lord Freud and a front bench spokesman for the Conservatives on welfare) in his eponymous Review of 2007.

The Freud Review

In his Review, Freud refined the notion of welfare spending representing the costs of failure. He produced more detailed analysis to show that investment in finding work and addressing worklessness would lead to future savings and effectively become self-funding.

He calculated that getting a lone parent into employment and helping them stay there for a year would benefit the Exchequer by £3,900 per annum. Moving an average recipient off incapacity benefit into work would generate £5,900 and if wider exchequer gains (offsetting direct and indirect taxes paid with additional tax credits) are included this figure rises to £9,000.

Based on his analysis, and the then three million lone parent and incapacity benefit claimants, Freud proposed that a larger scale I2S programme be developed. This has become known as the AME-DEL or DEL-AME approach (Labour tends to use the former while the Conservatives use the latter). DEL stands for “Departmental Expenditure Limit” and AME for “Annually Managed Expenditure”. These technical terms are explained in the box below

A Departmental Expenditure Limit (DEL) comprises spending which “can sensibly be controlled”. It is a “firm limit” for the department’s spending set over a three-year period following a Spending Review. For example, the Department for Work and Pensions’ (DWP) DEL includes its own running costs (notably on JobCentre Plus) as well as its expenditure on its various Welfare to Work programmes.

Annually Managed Expenditure (AME) covers spending which the Treasury argues cannot sensibly be planned in advance, and which is set annually in the relevant Budget. The DWP’s AME – benefit and pension payments – is the single largest element of AME across government and indeed the single largest budget across both AME and DEL.

Freud argued that there should be an up-front increase in the DWP’s DEL so that it can “invest” in welfare to work programmes that will pay back through future reductions in the DWP’s AME. As a result, in March 2008 the DWP announced some large scale I2S pilots. These will be tendered early in 2010 and are due to run for three years from March 2011.

Pathways to Work contracts

An illustration from A4e's own experience shows that considerable AME savings can be achieved. We have used Pathways as an example even though these contracts are deemed to be underperforming against contractual targets as, despite this, there are still AME savings being generated.

A4e has been delivering Pathways to Work services in four regions across England and Wales since December 2007. In the period up to November 2009, some 52,800 clients have been on the programme. Of these, over 10,900 have left into employment and, at the time, of our analysis, 40% of these had been in work for more than six months. This proportion continues to rise over time.

The cost to DWP has been around £30m over the period. The payback in terms of reduced benefit payments and tax revenues exceeds £40m based on average pay rates at 15% above the minimum wage. The payback is over £60m if wages approach anything like the average level. DWP has published its own research (Report 498) into the costs/benefits of Pathways which indicated a return to Treasury of over £3 per £1 invested.

So why is it so difficult to implement I2S policies?

Although DEL-AME is about to be piloted in welfare to work, there are a number of reasons why there may be resistance to DEL-AME and I2S on any significantly wider application.

The most important are probably cultural in that I2S runs counter to how Treasury likes to manage and control public expenditure. In particular I2S runs counter to three main tenets of Treasury policy, namely:

- tight control of DEL;
- opposition to hypothecation of tax and spending; and
- the need to measure effectiveness and prove additionality and lack of "deadweight".

We discuss these further below.

Treasury control of DEL and public finances

In order to understand the background to this it is important to know something about how UK public finances have been managed in the past.

Prior to the introduction by the present Government of the DEL and AME system, public expenditure was managed annually on a cash accounting basis. This meant that spending limits were agreed annually and actual spending was listed in a department's budget in the year in which it took place.

In 1998, the government decided to change from cash-based budgeting to resource accounting and budgeting (RAB), and also to introduce three year spending plans (sometimes reduced to two years) covering the DEL element of public spending.

This move took place in two stages. In 2000 the DELs were given on an "accruals" basis, where costs and revenues were matched to the years in which they occurred, as opposed to the years in which the cash entered or left the department. The second stage was the incorporation of non-cash costs, such as depreciation and "cost of capital" charges into resource DELs. This happened in 2002.

These changes were a big improvement on annual cash accounting and spending control, because they moved government accounting onto a similar basis to commercial organisations. They also allowed Departments more discretion to plan spending (and carry over underspends) over a 2-3 year period.

However end-of-year carry over is still limited and the Treasury still has control of annual spending. In addition, there is very tight control of the three year "spending envelope", with no carry over at its end. This is understandable given that control of overall public spending and borrowing remains critical to the health and sustainability of the UK's fiscal position.

I2S is therefore unpopular with the Treasury because it reduces their control of DEL. It explicitly requires Treasury to accept an increase in a Department's DEL in the current fiscal year in exchange for less certain future AME savings falling in future financial periods. Even if Treasury believe the payback projections – of which more below – it

is congenitally wary of allowing any increase in DEL that might not be recoverable in the future.

Hypothecation

The second and related reason why Treasury is reluctant to contemplate DEL-AME is that in general it is strongly opposed to hypothecation, the technical term for explicitly linking specific taxation or other income to specific expenditure.

While hypothecation does exist – the TV licence fee being a prominent example – the Treasury almost always opposes it because it leads to arguments about where, how and how much money is spent. An example of such an ongoing argument is that surrounding the Road Fund Licence. Despite its name, the Road Fund Licence raises far more money than is spent on roads. This leads to calls for increased investment to match what the motorist “pays”. These calls are resisted on the grounds that revenue is not hypothecated, and all revenue from whatever source is part of general taxation to be spent wherever it is most needed.

Although Freud’s DEL-AME proposals did not involve taxation directly, they do effectively ring fence future income from AME savings and hypothecate that income to current DEL expenditure. This is another reason why it has taken some considerable time and energy to negotiate between Treasury and DWP for the I2S pilots.

Measurement and additionality

The third reason why it is difficult in practice to get DEL - AME programmes (or indeed any major I2S programme) approved by Treasury is that the future savings need to be measurable and capable of being directly attributable to the original investment. In this case, Treasury needs to be assured that the actions funded by this year’s DEL expenditure are directly and measurably responsible for the future AME savings that accrue.

This gives rise to two separate issues. The first is the general issue of measuring the level of benefit which accrues and, as a start, agreeing a baseline to measure improvements against. Clearly, where benefits accrue across different government

departments and over long time frames of many years, this adds to the complexity. It is difficult to prove that any government intervention leads directly to a specific outcome, since there are so many other factors which can influence that outcome. In the case of welfare to work, the impact of overall economic conditions is clearly an obvious factor which can have an impact on employability.

The second issue is the need for the Treasury to ensure that no expenditure is unnecessary and that all spending delivers outcomes that would not otherwise have been achieved. The technical term for this is “additionality” – i.e. all spending achieves something that would not have happened anyway. The opposite, spending which is not additional, is sometimes called ‘dead weight’. This applies particularly to new programmes where scrutiny of value for money is greatest.

With respect to welfare to work programmes, the obvious concern is that all job outcomes should be additional to what would have been achieved if the intervention programme had not existed.

Implications

For all these reasons, it is difficult to get significant I2S schemes off the ground. While the principle of spending on prevention rather than cure may be common sense to most people, Government has to be accountable and able to defend its actions and decisions in the face of public scrutiny.

Treasury is ultimately responsible for ensuring that public spending is managed well and measurability is a key consideration in how funds are allocated, monitored and evaluated. Furthermore, extending the principle of hypothecation is viewed as inherently undesirable and likely to lead to major political difficulties if the principle is breached.

The difficulties of accepting the “common sense” implied by an I2S approach are evident in many public sector programmes. For example it is widely argued that increased investment in health prevention would reduce future health costs, but prevention accounts for only around 4% of total health spending

The Treasury's suspicion of I2S and DE-AME is reflected in the approach it is taking to the current DEL- AME pilots. It has:

- firmly contained their scope to some initial pilots, so that the link between spending and net saving can be more easily made.
- explicitly transferred the risk to DWP. The basis of the agreement for funding of the pilot I2S projects is that DWP is being given an increased DEL to fund the pilot programmes. This must be offset and received from future DEL, albeit funded by AME savings. The risks of the pilot programmes have thus been, de facto, passed to DWP such that if they fail to produce the anticipated savings, then DWP's future DEL allocations will have to absorb the costs.
- built a 10% allowance into the calculations for assumed deadweight. DWP and its contractors will therefore get no "credit" for the first 10% of job outcomes achieved within the pilot areas, on the basis that at least this proportion of outcomes would have been achieved anyway.

The Conservative Party's approach

Given the imminence of a general election it is important to understand the Conservative Party's views on I2S and DEL – AME. Conservative Party shadow ministers have made policy commitments that either explicitly or implicitly apply DEL-AME principles. These suggest that they will want to extend the principle much more widely – we will address this further in the next paper in the series.

As explained above, Lord Freud, now a Conservative spokesperson, was instrumental in raising the debate about DEL- AME in the UK. Conservative proposals for reform of the welfare system are explicit about extending the DEL-AME principle. In their recent policy paper, setting out their proposed "Work Programme", the Conservatives say:

"There is at present no linkage between DEL and AME expenditure. The Government does not consider the cost of effective employment support (DEL spend) against the fiscal gain of a year-long move into employment (AME savings). Instead, per capita DEL

limits are set and managed in isolation. So the amount of money that can be spent on programmes for getting people into work is limited and takes no account of the money the Government could save by getting someone off benefit and into work.

This is short-sighted, since the total AME cost of a long-term unemployed individual is significant."

Clearly, the Conservative Party accepts the concept and its direction of travel is clear with respect to welfare to work programmes. The main issues it will face, should it win the next general election, are the practical reality of accounting properly for public monies, and measuring AME savings adequately. Indeed there may continue to be strong opposition to the Conservatives' proposals from Treasury officials, notwithstanding the shadow Chancellor's apparent support.

Conclusions

Invest to save is common sense and the difficulties which government faces in implementing I2S policies will be baffling to most casual observers.

As ever with public money (our money) its management and control are overriding concerns.

Welfare to work is providing the first larger scale test bed for I2S's wider application and its results will become clear during the next government's term of office (whatever its persuasion).

With welfare to work programmes, there has been a significant shift of risk onto the private sector providers with up to 80% of their revenues now dependent on successful outcomes as measured by numbers returned into sustainable employment. Should the I2S programmes prove successful, we believe that private financing and risk capital will be attracted to future programmes across other areas of government expenditure, as well as welfare to work.

In the next paper in our series, we will:

- explore I2S's wider application at international, national and local levels and the potential role of innovative financing models to put it into effect;
- review new PFI and PPP models, social bonds and other outcome focused financing models in detail;
- analyse the issues faced by procurement teams in contracting for social outcomes especially where this explicitly allows for 'black box' models and greater degrees of consumer choice in the design of public services.

Finally, we will argue that genuine savings in public expenditure are realisable although it will require significant bravery and trust on the part of both governments and suppliers if they are to share the risks and rewards.

About A4e Insight

A4e Insight is the Research and Consultancy arm of A4e, a market leader in global public service reform and in the design, development and delivery of front-line public services that benefit individuals, organisations and communities.

A4e Insight provides a range of research and consultancy services which draw on the expertise and experience of A4e and its associate network. We give clear advice and opinions based on hard evidence and the expertise of more than 3000 people with real front line experience. We therefore focus on what works, not dogma or pre-conceived notions.

Our core team is backed up by a wider pool of expertise from across A4e which supports assignments as required. It includes a specialist social research team and a number of recognised experts in fields such as active labour market policy, alternative education and the personalisation of health and social care.

A4e Insight works at the boundary between the private and public sectors. We help:

- **the private sector understand the public sector:** We provide commercial due diligence of businesses supplying into public services markets. We also help companies position themselves to win business with the public sector - through market analysis, market entry advice, and support to public sector sales and business development;
- **the public sector make best use of both public and private resources:** We help the sector to secure additional funding and investment and make best use of private and third sector expertise by devising strategies for commercialisation, partnering and outsourcing;
- **public sector organisations implement strategy:** Our expertise is in working with UK public bodies to turn policy into practice, especially in complex areas where public service provision is difficult. We draw on A4e's practical experience in designing workable solutions that deliver 'more for less', while at the same time driving up quality and outcomes; and
- **governments across the world with their economic inclusion agenda:** We advise on what governments can learn from each other as they develop social policy through the transfer of our international expertise and experience across similar public policy and implementation challenges.

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