

The long awaited Spending Review will finally happen this summer and autumn. How will it be different from previous reviews, and what will it mean for public service providers?

The 2010 Spending Review process started in earnest on Tuesday June 9 when the Chancellor made a speech and the Treasury released a document – “The Spending Review framework” – setting out how the Review would be conducted.

Much of the press attention has focused on the idea of consulting the public as part of the review. But there is much more to it than that and it is clear from reading the document that this will certainly be the most radical process attempted since Spending Reviews were first introduced – not of itself a huge deal, since the first Spending Review was conducted by New Labour only in 1998. Arguably, however, it will be more radical (at least in intent) than anything in living memory, including the changes in Mrs Thatcher’s early years which led to annual public expenditure planning and the concept of annual spending rounds.

This radicalism is appropriate to the scale of the challenge, and perhaps reflected in some interesting semantics. Everyone (including us) was expecting a *Comprehensive* Spending Review – like the first one conducted in 1998 and the last one in 2007. Instead we have a simple Spending Review (SR). New Labour ran plain SRs in 2000, 2002 and 2004, intending in all cases to signal business as usual and broadly increased spending with a nudge on the tiller – hardly what we have now. Perhaps the government thinks that the 1998 and 2007 reviews were anything but comprehensive, and it did not want this review to be confused with them.

For what we have so far is certainly different in both tone and content to anything we have seen before. To begin with, you will look in vain for an equivalent document to the Spending Review framework describing how any previous review would be conducted – comprehensive or otherwise. The government archive of previous spending reviews is extensive, but the documents all report conclusions and findings after the fact. Before and during the C/SR process, the usual veil of Whitehall secrecy was everywhere. This time things are different.

So because we have a more open process we know when things will happen and can take a much more considered view of the likely impact of the SR. In addition, the more consultative approach means that providers of, and investors in, public services have the opportunity to influence the SR and demonstrate innovation.

So this commentary considers:

- how the review will be conducted – the process and timetable;
- the key features of the SR as set out in the framework, and their implications; and
- the opportunities and risks within the SR, and its aftermath, for the public service industry.

Process and timetable

The process that the SR will follow and its relationship to other key events is usefully summarised in a high level timetable within the SR framework document. This timetable is reproduced, in different form, in Figure 1 below.

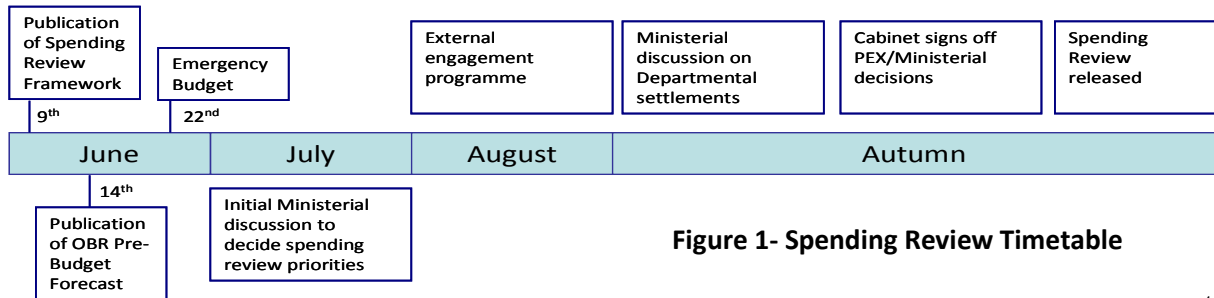


Figure 1- Spending Review Timetable

We have added to our timetable one important milestone which is not in the Treasury's version and which has already happened – the publication of the first report from the Office of Budget Responsibility (OBR) on June 14. This did not paint quite as gloomy a picture of the public finances as it was perhaps expected to, and did in fact revise down the estimates of total borrowing requirement to 2014. But its estimate of the size of the structural deficit rose slightly, and since this is the number which the government is focusing on, it has plenty of justification to pursue the SR with vigour. Certainly it does not seem to be the case (as opposition politicians and some commentators have been arguing) that the OBR's conclusions somehow mean we do not have to take early action on the deficit. It was after all the current opposition which passed a law requiring it to halve said deficit by 2014.

For what it is worth, the Institute of Fiscal Studies has initially estimated that the government will need to reduce spending or increase taxes by £34bn p.a. more than Labour was already planning – or a total of £85bn a year. However this figure is based on various assumptions about the government's plans which will almost certainly have to be changed after the budget, when Mr Osborne will (we think) set specific targets for reducing the deficit to £Xbn or by Y%; and possibly announce further tax rises which will offset the scale of spending reduction needed. So we will wait to see what the Budget brings before analysing the scale of the challenge for the public sector in more detail.

But whatever spending target the government may have in mind, it seems set to separate achievement of that target (at least in part) from the conduct of the Spending Review. By this we mean that the government will not simply set an expectation of cuts of X% for each Department, an approach that would encourage every budget

holder from the Permanent Secretary downwards to work to that figure. While Whitehall insiders will no doubt have a target figure in mind for every budget head, it seems from the criteria which it has set (see box on next page) that the government will this time try to pursue a genuinely bottom-up process and start from a blank sheet.

Against this backdrop three aspects of the SR process are particularly interesting. These are:

- The programme of External Engagement which is scheduled to take place during August. As observed above, this part of the process has already received much (mainly negative) comment for its intended involvement of the public. But it is also an opportunity for many other stakeholders, including service providers, to make their views known. We comment further on this later.

- The process of Ministerial discussions and agreement which is loosely timetabled for the Autumn. Central to this process will be the role of a new senior Committee of Ministers which will add a new piece of jargon to the lexicon (PEX – the acronym for the new Public Expenditure Committee) and see the return of an old cliché – the Star Chamber. This is not just media shorthand, but the government's own chosen designation for this committee, since its press release on the SR says that it will *“establish a new Star Chamber chaired by the Chancellor and Chief Secretary and drawing on the expertise of other senior Cabinet Ministers to ensure that the Government challenges every department's spending plans”*.

This part of the process is almost certainly essential if real progress is to be made, but it is not the first time that there has been such a Star Chamber. We had one in the days of annual, tough spending rounds in the 1980s, and the risk – than as now – is that departments will over-bid for what they need in order to give the Star

Chamber something to bite on. This is harder to do when whole programmes are under scrutiny, rather than the negotiation being around a percentage rise or fall in programme budgets; but almost certainly each Department will have lists of “soft” programmes that can be sacrificed as part of the PEX review process.

■ Thirdly, the government has said that it will “form a Spending Review Challenge Group of experts – both from within government and outside – to act as independent challengers and champions for departments throughout the process.” Apparently this will include “the brightest and the best”. It will be interesting to see where this goes, and much will depend on who the experts are. The previous government did itself become adept at using external experts and their reviews to justify its decisions (Gershon, Lyons, Varney, the five advisors to the Operational Efficiency Programme etc.) and the Conservatives had already poached Peter Gershon and Martin Read (not to mention Lord Freud) when in opposition. At best, the government will benefit from independent and, hopefully, evidence-based perspectives on the choices which it faces. At least, we may find difficult and largely political decisions justified by reference to independent expert advice.

Key review features

Aside from the process itself, there are some features of this SR which are especially noteworthy and markedly different to what has gone before. In our view the three most important are:

- the criteria against which departments will be asked to prioritise (and presumably justify) their spending programmes;
- the broad scope and duration of the SR; and
- the treatment of cross-cutting programmes and complementary reviews.

The SR framework document sets out nine “tough criteria” against which spending programmes will be judged (see box). Some of these are fairly obvious, but others are innovative and interesting.

First, one should note that the criteria appear, in

The nine review criteria

1. Is the activity essential to meet Government priorities?
2. Does the Government need to fund this activity?
3. Does the activity provide substantial economic value?
4. Can the activity be targeted to those most in need?
5. How can the activity be provided at lower cost?
6. How can the activity be provided more effectively?
7. Can the activity be provided by a non-state provider or by citizens, wholly or in partnership?
8. Can non-state providers be paid to carry out the activity according to the results they achieve?
9. Can local bodies as opposed to central government provide the activity?

our view, to be in approximate sequential order, ranging from whether the activity should be done by the public sector, to whether it could be done better or cheaper within the public sector, to whether it could be done by a third party. This encouragement to start with the most basic question – should the activity be done at all? – has echoes of previous review criteria including the “Prior Options” criteria used by the Conservatives in the early 1990s to review government Executive Agencies (which required reviewers to question the need for the Agency); and Labour’s Best Value criteria (the first of which was “Challenge” and designed to question the need for the activity or service). As argued in our commentary on Labour’s last Budget <http://www.i-a4e.com/blog/wp-content/uploads/2010/03/A4e-Insight-Budget-Briefing-2010.pdf> departments have to bite the bullet of stopping doing things if they are to achieve the level of spending reductions



required – so the inclusion and prioritisation of this criterion is to be welcomed.

Some of the other criteria are innovative and interesting, and worth a commentary in themselves. In particular we would highlight Criterion 2, which makes the distinction between provision by the state and funding by the state, and invites wider consideration of the potential for new ways of funding public services; and Criterion 8, which reinforces various statements made by the Conservatives in opposition and by the coalition about the use of payment by results and invest to save mechanisms to improve efficiency and effectiveness. Our recent Blue Touchpaper <http://www.i-a4e.com/blog/wp-content/uploads/2010/06/Invest-to-Save-2.pdf> offers further commentary on both these areas.

The second area of note about the SR is its scope and duration. With regard to the latter, no Labour C/SR was longer than three years and some only lasted two – usually when they were interrupted by elections. This SR will run for the full Parliament – i.e. a fixed term five years. This not only reinforces the commitment of the coalition to govern for a full term, but increases the credibility of the deficit reduction plan and gives Departments more time to implement spending reduction plans which are dependent on investment or wholesale change. Indeed, the framework document says that *“The Government will also consider whether there are areas of spending for which funding allocations should be set on a longer-term basis than the life of the Parliament to provide greater certainty to service providers, users and investors”*.

On scope, all Labour’s SRs were restricted to Departmental Expenditure Limits (DELs) and excluded Annually Managed Expenditure (AME) – spending definitions which Labour introduced alongside SRs. The oft-used shorthand for the latter is spending which is “hard to control”, but as many have argued this does not mean that it cannot be reduced. So this SR will be different,

and will have in scope significant elements of AME, including social security; tax credits; and public service pensions. This clearly signals that spending reductions in these areas – for example by freezing or additional means testing of benefits - are under consideration. Such cuts in AME will in turn require there to be less draconian reductions in DELs. It also mean that the government will be better able to set targets for invest to save programmes in welfare which depend on the “DEL-AME Switch”.

The third area of real difference from previous reviews is the encouragement of *“joint Spending Review submissions on crosscutting issues”*, notably in cases which “may involve additional spending by one department to realise savings in another department’s budget.” This addresses directly a major block to change – the silo-based nature of Whitehall and other public sector budgets – and it will be interesting to see whether departments are willing and able to use this new freedom effectively.

Finally, the SR will take account of all or, when not complete, the initial findings of no fewer than eleven independent reviews that are running in parallel to the SR. These range from the fundamental and far reaching (the Strategic Defence and Security Review) to the highly specific (review of the terms and conditions for police officer employment). It seems unlikely that some of the more complex reviews (e.g. the Commission on long-term care) will be done and dusted by the autumn, so the pressure on their early/interim findings will be considerable.

Opportunities and risks for service providers

To sum up, the SR appears to be truly different from anything which has give before in scope, breadth and radical intent. For current providers of public services there are, as ever, both opportunities and risks. However both are potentially greater than before.

On the upside, there are opportunities for all providers to contribute expertise to the SR, either in response to a formal call for contributions or by simply weighing in to the debate with their public sector clients. At the most basic and obvious level there will be opportunities to drive further externalisation of services either to improve value for money or to meet some of the specific criteria set by the government. However the government is inviting a truly radical, bottom up debate and we think it unlikely that Ministers will be impressed by simplistic arguments that it should “outsource more” (any more than it will be impressed by contra arguments that it should keep everything the way it is, or even take services back in house). Instead and in line with its own criteria, it will want to see providers coming up with new ideas which take the debate to a new level. Examples of the sort of things it will want to see are:

- proposals for alternative funding models;
- appetite for risk and new ways of achieving payment by results and invest to save;
- proactive and innovative ways in which the private and third sectors can help the government join up services and achieve cross-cutting objectives, especially if they involve pooling or transferring silo-based budgets.

On the downside, there are a number of risks that providers will need to monitor and manage throughout and beyond the SR process. In particular:

- in addition to the savings already made in the initial £6bn savings package, it is clear that the pressure to drive down costs through smarter procurement – and therefore squeeze margins – will be maintained. Section 2.3 of the SR framework document says that *“The new Efficiency and Reform Group will support departments to deliver savings in specific areas, including renegotiating contracts, maximising*

collective buying power and using benchmarking to improve performance.”

- there are various statements in the framework document which hint that the government wants to broaden and open the supplier base in some areas of service delivery. In line with its Big Society proposals, this is likely to include increased competition from in-house providers who take advantage of proposals to allow them to become independent.

- the SR will include a review of capital spending priorities, which may be good news given the level of capex reduction which the previous government had already pencilled in. However spending is already tightening in some areas (e.g. Building Schools for the Future) and the list of projects cancelled or suspended this week suggests that capex remains in the firing line. Unfortunately it will not be clear for some time where the winners and losers will be.

Perhaps most of all, there will be much general uncertainty until the SR is complete. In the meantime, there will be countless leaks and media stories which will range from the authoritative through the speculative to the entirely fictitious, and will be inspired by a wide range of people and organisations seeking to protect their own interests. Companies and investors should treat most of what they read and hear as coming with a general health warning



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