National Audit Office

Cabinet Office and HM Treasury

Cost reduction in central government: summary of progress

Detailed Methodology

FEBRUARY 2012

Detailed Methodology

1 In January 2011 the National Audit Office published its report *Cost reduction in central government: a summary of progress*.[1] Appendix One of the report contains a summarised methodology. This document provides a more detailed description of the data sources and research methodologies used during the study.

Scope

2 This is an initial report providing an overview of how departments reduced costs in 2010-11 and gives a snapshot of progress with longer-term planning, based on recent NAO reviews of the management of cost reduction in 12 individual departments (Appendix One) and our analysis of the audited accounts of the 17 main central government departments.

3 In planning our work we identified the following key research questions:

- Have departments stayed within their spending allocations agreed by Treasury and Parliament for 2010-11?
- Does the available data support the savings reported by the Cabinet Office?
  - Have cost reductions been made in administration or programme spend?
  - Have they been made in the areas targeted by the government for efficiency and reform savings?
  - Do departments have adequate data on service impacts?
- Have departments taken a structured approach to cost reduction in the 2010 Spending Review period, meeting the expectations set out in our *Guide to Structured cost reduction* (2010)?

Review of published documents on public expenditure

4 To identify changes in Government's plans for 2010-11 spending, and forecast spending and plans for deficit reduction up to 2015-16, we analysed key public documents (available from the Treasury and Office of Budget Responsibility websites). The key documents provided us with the following information:

- Annual Budget Reports 2008 to 2011 identify changes in actual and planned Total Managed Expenditure for 2010-11.[2] Budget 2011 also forecasts overall spending to 2015-16. During the period of these Budget Reports, the Treasury has introduced some changes in how spending is analysed (Clear Line of Sight project). These changes will remove some inconsistencies between Budgets, departmental Estimates and outturn expenditure. However, this means that comparisons between years need to be carried out with care.

1 Comptroller and Auditor General, *Cost reduction in central government: a summary of progress*, Session 2011-12, HC 1788, National Audit Office, February 2011.

2 See http://www.hm-treasury.gov.uk/2011budget.htm and http://webarchive.nationalarchives.gov.uk/20100407010852/http:/www.hm-treasury.gov.uk/budget2010.htm for earlier Budgets.

- HM Treasury Spending Review 2010 report set detailed annual departmental expenditure limits up to 2014-15 covering administrative, programme and capital spending. Departments carry out detailed analysis of their spending programmes and negotiate with HM Treasury for funds within the overall spending envelope set by the Budget.

- The Office of Budget Responsibility, *Pre-Budget Forecast – June 2010*[3] forecast overall expenditure to 2014-15 if existing policies and trends continued, and is the baseline against which overall cost reduction performance can be assessed. The Office, whose functions were formerly carried out within HM Treasury, was set up in May 2010 in order to provide a more independent assessment of Government's spending plans and the economy.[4] Its latest fiscal and economic forecast was incorporated into the Treasury's, *Autumn Statement* 2011.[5]

- Annual Main and Supplementary Estimates, issued by HM Treasury for each major department, detail departments' budgets, setting out Departmental Expenditure Limits and Annually Managed Expenditure.[6]

- The *Public Expenditure Outturn White Paper* reports outturn figures against planned expenditure for the financial year.[7]

- Other key Government announcements on the cost reduction planned for 2010-11, and the increased role of the Cabinet Office's Efficiency and Reform Group[8] can be found on the Cabinet Office website.

Analysis of Departments' resource accounts 2010-11

5 To assess the overall level of cost reduction achieved in 2010-11, we analysed the published resource accounts for the 17 main central government departments. The accounts show actual and committed spending in 2010-11 and 2009-10, in some cases restated to show the impact of government reorganisations and major changes in accounting policy implemented during the year. However, changes in working practices are not adjusted for as they do not have a material impact on the account, but may significantly affect some individual analyses.

6 The accounts are prepared under international accounting standards and are intended to confirm that Parliamentary approval has been given for any expenditure or commitments made during the year. The 2010-11 accounts were subject to independent testing and review by the National Audit Office.

3 Office of Budget Responsibility, Pre-Budget Forecast – June 2010, June 2010 (http://budgetresponsibility.independent.gov.uk/wordpress/docs/pre_budget_forecast_140610.pdf).
4 HM Treasury Press Notice, PN 01/10, dated 17 May 2010 (http://www.hm-treasury.gov.uk/d/press_01_10.pdf).
5 HM Treasury, Autumn Statement 2011, Cm 8231, November 2011 and Office of Budget Responsibility, Economic and fiscal outlook, Cm 8218, November 2011.
6 Further details can be obtained from the HM Treasury web site (see http://www.hm-treasury.gov.uk/psr_estimates_index.htm).
7 HM Treasury, Public Expenditure 2010-11: Provisional Outturn, Cm 8133, July 2011.
8 Cabinet Office Press Notice 24 May 2010 (http://www.cabinetoffice.gov.uk/news/cabinet-office-and-treasury-join-forces-drive-out-waste).

7 We examined changes in aggregate outturn Departmental Expenditure Limits from 2009-10 to 2010-11. We focused on Departmental Expenditure Limits for this overall analysis as Annually Managed Expenditure is difficult to predict from one year to the next and contains items such as welfare costs and tax credits which are more strongly influenced by macro-economic factors than by in-year departmental management.

8 We analysed overall spending on administration activities and on programme delivery (front-line services). To allow a better comparison between the two years we sought to eliminate one-off or other unusual items which might distort the underlying trend in expenditure. We therefore excluded:

- The costs of early departure for permanent staff. In some cases we used unpublished working papers collected during our audit work as the published accounts do not separately identify the full costs incurred or the total payments made during the year.
- Non-cash costs. These vary widely between years and represent a wide range of factors including cash paid in 2010-11 for commitments approved by Parliament in previous years, a charge made in the current year to represent the benefit obtained from cash payments made in previous years (including a depreciation charge for the consumption of capital goods, or falls in an assets market value), and adjustments made in-year to estimates of future costs which are of uncertain value and or timing (for example, for the ongoing costs of decommissioning nuclear power stations or the recoverable value of student loans).

9 The accounts generally[9] show costs in cash terms: i.e. the actual amount which has or will be paid to settle a liability or obligation which has been incurred. However, due to price changes, interest rate costs, economic growth and subjective factors such as time-preference, the real cost of a future payment is less than an identical payment made today. There is a range of specific price and cost indices which can be appropriate depending on the particular costs being analysed (e.g. Consumer Price Index, Retail Price Index).

10 Our preferred index for assessing public spending is the Gross Domestic Product Deflator (GDPD), a measure of changes in UK output and prices.[10] To compare the real terms change (i.e. the true volume of goods and services used by departments) we increased 2009-10 cash spending by 2.7 per cent. This was the assumption used by Treasury in setting departments' spending limits for 2010-11 and therefore provides a reasonable basis for comparison with outturn expenditure in 2010-11. The latest estimate of actual GDPD is 2.75 per cent.[11]

9 Some long-term provisions for future costs are shown on a discounted basis to reflect the time delay.
10 GDPD is produced by the Treasury from data on a wide range of separate deflators for individual industries provided by the Office for National Statistics (ONS). (See http://www.hm-treasury.gov.uk/data_gdp_guide.htm).
11 Figure is accurate as at 25 November 2011. Latest estimate can be found at http://www.hm-treasury.gov.uk/data_gdp_fig.htm.

Savings reported by the Cabinet Office for 2010-11

11 In July 2011 the Cabinet Office reported to the House of Commons Committee of Public Accounts (PAC) that departments had realised savings of £3.75 billion during 2010-11 in the spending areas targeted by Ministers in May 2010 that were influenced by the activities of its Efficiency and Reform Group.[12] The savings had been reviewed by its internal audit service to ensure that the figures were drawn accurately from reliable data sources and any assertions made in describing the savings were reasonable.[13] We reviewed the internal audit assessment, commented on emerging findings and compared the methodology with our own criteria for assessing reported efficiency savings (see Appendix Two).

12 We compared reported savings against spending reductions in real terms extracted from our analysis of the audited accounts. There are limitations to this analysis:

- because departments do not classify expenditure consistently at the level of detail required. While the main tables of individual departmental accounts follow a standard pattern with certain key figures always shown, the detailed breakdown of administrative and programme spending is not on a consistent basis as each department designs a unique analysis to suit its own needs and accounting systems. The Economic Secretary to the Treasury announced in August 2011 that a common account format would be developed which will apply to central government bodies in future years.
- We were unable to analyse expenditure of arms-length bodies which were not consolidated into the main accounts.

13 We also drew on unpublished departmental returns which will form the basis of audited Whole of Government Accounts for 2010-11. These accounts present income and expenditure for all of government. They are consolidated (inter-departmental transactions are netted-off to show the true underlying costs). As the returns are prepared using a standard format, they provide a more consistent breakdown of capital spending and grants than do individual departments' resource accounts. However the returns were undergoing audit at the time of our work and did not always fully reflect the audited accounts, and have not yet been adjusted to reflect inter-departmental transactions. As the audited Whole of Government Accounts for 2010-11 were not available at the time of our examination, we could not use them to comment on changes in total government expenditure from 2009-10.

12 HC Committee of Public Accounts, T*he Efficiency and Reform Group's role in improving public sector value for money*, Forty-nineth Report, Session 2010-2012, HC 1352, October 2011. Ev 18-23.
13 The final report is at http://www.cabinetoffice.gov.uk/resource-library/savings-audit-report.

Measuring impact on service delivery

14 To establish whether we could track changes in departmental performance between 2009-10 and 2010-11, we examined the performance indicators in Business Plans published for the 17 major departments. There are 249 indicators in these Plans, of which 110 are input indicators (for example on the costs and resources used) and 131 address the impact or outcomes achieved. We looked at whether the indicators were based on new data, or data which had been published before. We checked all the indicators back to the previous Public Service Agreements and our knowledge of the departments for comparison. Most of the indicators – 175 – are based on data which to the best of our knowledge is new.

15 We compared the areas covered by the impact indicators to the areas covered by the input indicators, to see if you could connect results with resources. We performed a qualitative analysis. Because of the varying size and relative importance of both the priorities and the indicators, any quantitative analysis would have been hard to standardise, and not comparable across departments. We grouped the results into three categories:

a Impact indicators can be linked to substantively all input indicators;

b Some substantive indicators are not linked, or indicators cover the same field but do not connect resources to results; or

c Most impact and input indicators are not linked.

Analysis of departments' cash withdrawals from the Consolidated Fund

16 One of the main risks we identified in our planning was that departments might be forced to live within their 2010-11 spending allocations by delaying spending wherever possible into 2011-12. We therefore examined departments' net cash requirements[14] for the period April to October in 2009, 2010 and 2011. Departments' cash is drawn from two main sources:

- The Consolidated Fund, administered by the Bank of England, acts like government's current account: tax (and miscellaneous) receipts are paid in, as well as the proceeds of debt issues. Departments regularly transfer funds into their own bank accounts to meet immediate cash costs as they arise.
- The National Insurance Fund, administered by HM Revenue & Customs, collects employees and employers contributions and are then issued as required to the Department for Work and Pensions for payment of contributory benefits and the Department for Business, Innovation and Skills for some redundancy scheme payments.

14 Some of departments' income from fees and charges and other sources can be used, with Parliament's agreement, to fund services up to a specified maximum. Receipts above this level must be surrendered to the Consolidated Fund.

17 We also compared the cash data with Office of National Statistics monthly data on overall public spending. We have highlighted the Consolidated Fund data in the report as this measure is a closer approximation to spending within departmental management control in the year. Cash is not always a good measure of underlying expenditure as it can be influenced by large one-off transactions, for example HM Treasury's intervention in the financial sector in the second half of 2009-10. However, departments' cash drawings give some assurance that they are on target to deliver the further spending reductions required in 2011-12.

Assessment of departments' structured cost reduction strategies

18 To assess how departments were planning for costr reduction over the Spending review period from 2011-12 to 2014-15, we reviewed the results of 12 NAO examinations relevant to departments' cost reduction plans and future actions, including reports on reducing costs, financial management and overseeing front-line bodies. We used a thematic framework to code the report findings. The categories within this framework were drawn from:

- the *NAO's Short Guide to Structured Cost Reduction;*[15]
- the framework for good practice we have produced for examining departmental cost reductions;[16] and
- the lessons for cost reduction we identified in our 2010 review of Progress with VFM savings and lessons for cost reduction programmes.[17]

The framework we used to code results of NAO departmental cost reduction examinations

Planning	**Capability**
1.1 Strategy	2.1 Understanding of current costs
1.2 Future state planning and target operating model	2.2 Measuring costs and value
1.3 Selection of cost reduction measures	2.3 Change programme
1.4 Contingency	2.4 Governance
1.5 Risk management	2.5 Financial management
1.6 Choice of initiatives	**Measuring impact**
1.6.1 Tactical savings	3.1 Monitoring progress with cuts
1.6.2 Efficiency	3.2 Measuring impacts on services
1.6.3 Continuous improvement	3.3 Stopping services
1.6.4 Delegating cuts	3.4 Sustainability
1.6.5 Transferring costs	**Managing cost reductions in other bodies**
1.6.6 Transformational change	4.1 Planning cuts in devolved bodies
	4.2 Monitoring devolved bodies

15 *A short guide to structured cost reduction,* National Audit Office, 2010.
16 Published at www.nao.org.uk in Methodology annexes to *Reducing costs in the Department for Work and Pensions*, National Audit Office, June 2011 and *Reducing costs in HM Revenue & Customs*, National Audit Office, July 2011.
17 Comptroller and Auditor General, *Progress with VFM savings and lessons for cost reduction programmes*, Session 2010-11, HC 291, National Audit Office, July 2010.

Appendix One

The overview report draws on the following departmental examinations:

On cost reduction in departments

Reducing costs in the Department for Work and Pensions, Session 2010-12, HC 1089, National Audit Office, June 2011.

Reducing costs in the Department for Transport, Session 2010-12, HC 1700, National Audit Office, December 2011.

Reducing costs in HM Revenue & Customs, Session 2010-12, HC 1278, National Audit Office, July 2011.

Spending reduction in the Foreign and Commonwealth Office, Session 2010-12, HC 826, National Audit Office, March 2011.

Ministry of Defence: Managing change in the Defence workforce, National Audit Office [forthcoming].

Department of Health: Delivering efficiency savings in the NHS, Briefing for the House of Commons Health Committee, National Audit Office, September 2011.

On financial management

Department for Culture Media and Sport: Financial Management, Session 2010-11, HC 821, National Audit Office, March 2011.

Department for International Development: Financial Management Report, Session 2010-12, HC 820, National Audit Office, April 2011.

Ministry of Justice: Financial management report 2011, Session 2010-12, HC 1591, National Audit Office, November 2011.

We also drew on our 2011 cross-government overview report on financial management, *HM Treasury: Progress in improving financial management in government,* Session 2010-11, HC 487, National Audit Office, March 2011.

On overseeing front-line bodies

Department for the Environment, Food and Rural Affairs: *Managing Front line delivery costs*, Session 2010-12, HC 1279, National Audit Office, July 2011.

Department for Business, Innovation and Skills: reducing bureaucracy in further education in England, Session 2010-12, HC 1590, National Audit Office, December 2011.

Department for Education: Oversight of financial management in local authority maintained schools, Session 2010-12, HC 1517, National Audit Office, October 2011.

Appendix Two

Good practice for accurate public reporting of savings

Risk	Comment
Data quality	Data on quantity and unit costs should be taken from a reliable source, or cautious estimates used.
Properly calculated	Savings should be calculated using an appropriate economic or cost-accounting methodology and checked internally before publication.
Net of costs	All transitional costs and any additional ongoing costs should be netted off from savings reported in the year in which the costs are incurred. Adverse effects on other programmes should also be recognised.
Impact on services	Any adverse effect on service quality should be reported. Any reductions in planned activity/outputs should be demonstrated not to have a material impact on overall outcomes.
Calculated against a realistic baseline	Baseline should be a realistic forecast rather than a worst-case scenario. Ideally, departments should compare actual spending against previously approved spending plans e.g. at the beginning of the spending review period (the counterfactual).
Costs have not been reallocated	Savings should not be reported if spending has been reallocated to another similar activity either internally or in another publicly funded body. However, savings may be used for approved new services which would otherwise have been funded by Parliament.
Cash-releasing	Financial or cash releasing savings will reduce departments' annual expenditure. Efficiency savings should represent the same output at less cost. Non cash-releasing savings and other benefits, e.g. increased output or reductions in services should be clearly distinguished.
Realised	Reported savings should clearly distinguish between savings achieved to date and those anticipated in the future. It should be possible to reconcile the saving to budgets and to financial or management accounts, after allowing for planned new services.
Sustainable	One-off or time limited savings should be reported separately from on-going reductions in annual spend. One-off savings may be sustainable if they are part of an on-going programme of similar savings.
Scored only once	Savings should not be double-counted under separate categories or by different bodies. Savings reported under previous initiatives should not normally be reported again.

Source: The National Audit Office

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