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How governments can be more effective by reallocating their resources

Scrutinizing past expenditures and radically challenging cognitive biases can help governments cut costs and create better outcomes for citizens.

Tera Allas, Rima Assi, Jules Carrigan, and Roland Dillon

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In the private sector, the best-managed companies often review their finances strategically, make tough decisions about investments, and reallocate resources quickly. As a result, they tend to generate significantly higher shareholder returns than their counterparts do: companies that dynamically reallocate their resources to higher-value activities or investments deliver, on average, a 10 percent return to shareholders; those that allocate more slowly or not at all, only 6 percent.[1]

In the public sector, however, a McKinsey Center for Government analysis finds little change in spending allocations from year to year. Although some governments have successfully reallocated resources—as Chile, for example, did with its infrastructure investments—few have done so with existing programs. From 2006 to 2014, for example, 92 percent of the annual sector-level budget allocations of EU countries, adjusted for inflation, remained virtually identical from year to year (exhibit).[2]

Our experience suggests that this pattern applies to governments in most countries and at all levels—and that governments have considerable room to differentiate between their most and least valuable programs[3] when they allocate resources. This is especially true as their returns on investment vary between and within expenditure types. The benefit-to-cost ratios of different kinds of road-transport programs in the United Kingdom, for example, range from 1:1 to 25:1,[4] and the earnings outcomes of higher-education programs vary by a factor of seven.[5]

Why can't governments allocate resources more effectively? Even the best are run by people with the same cognitive biases that afflict people managing private-sector organizations. These biases, particularly those that promote continuity or stability, make us more attached to the status quo than we should be, inhibiting large reallocation decisions.[6] Other stability biases include anchoring—the powerful impact an initial idea or number has on subsequent decisions. Last year's numbers, for example, are an implicit but extremely powerful anchor in budget reviews. Stability biases also include the well-documented tendency to feel losses more acutely than equivalent gains. This discourages decisions that appear risky.

A country's finance function—in finance ministries, line ministries, regional and local authorities, and delivery agencies—has a vital role to play. These public servants know the relevant data on expenditures and oversee reallocation processes, so they are well placed to work with individual departments or agencies to analyze expenditures and to challenge costs. In other words, armed with the right data, approach, and attitude, finance professionals can effectively counterbalance a system's inherent biases and ensure that budget-allocation decisions use the best available evidence.

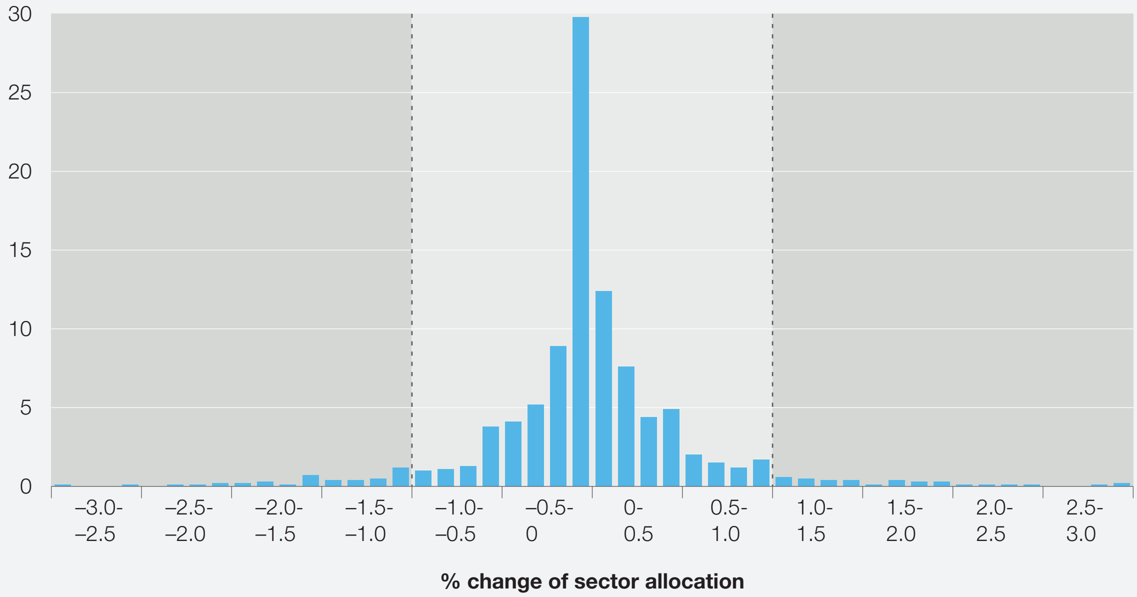
Our research[7] shows that to ensure the effective allocation of resources, finance functions must also lead more strategically. Where they've been dominated by traditional tasks of reporting, transactional, and compliance activities, they should now shift their focus to tracking and evaluating the effectiveness of spending, challenging line managers to improve productivity, and enabling tough decisions.

One tool at the disposal of finance functions is called a strategic spending review, also known as an expenditure review, or a joint-costing exercise. Such reviews involve a rigorous, detailed examination and classification of expenditures to scrutinize their efficiency and effectiveness (for example, through benchmarking) and to identify possible savings. Moreover, finance functions increasingly have access to cloud-based digital-budgeting tools that make it necessary to enter data in a disciplined way, so that subsequent analysis of expenditures becomes vastly more efficient. At one private-sector organization, for example, a cloud-based tool replaced more than 10,000 offline spreadsheets so that the finance function had the time and capacity to become more strategic.[8]

Some larger countries, including Canada, Nigeria, Saudi Arabia, and the United Kingdom, have undertaken similar strategic spending reviews, as

Exhibit **Most budget allocations in EU countries change by less than 1 percent a year.**

Number of EU governments' sector allocations that changed year on year, 2006–14,
% of the total number of budget allocations[1] across EU countries, by size of change



[1] % of total budget spending for each Eurostat sector of culture, defense, economic affairs, education, environmental protection, general government, health, housing, legislative/executive, old age, public-debt transactions, public safety and order, sickness and disability, social protection, transport, and unemployment.

Source: Eurostat government-expenditure statistics; McKinsey Center for Government analysis

have several smaller ones, such as Denmark, and some regions, including the state of Victoria (Australia). In aggregate, governments have found tens of billions of dollars of opportunities to improve their effectiveness and efficiency and to reallocate spending toward their strategic priorities. ■

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[1] Yuval Atsmon, "How nimble resource allocation can double your company's value," August 2016, McKinsey.com.

[2] Within 1 percent of the previous year's budget.

[3] In economic or social outcomes.

[4] See, for example, Figure 11 in *The case for action: Sir Rod Eddington's advice to government*, December 2006, webarchive.nationalarchives.gov.uk.

[5] See, for example, *Employment and earnings outcomes of higher education graduates by subject and institution: Experimental statistics using the Longitudinal Education Outcomes (LEO) data*, UK Department for Education, June 2017, gov.uk.

[6] Dan Lovallo and Olivier Sibony, "The case for behavioral strategy," *McKinsey Quarterly*, March 2010, McKinsey.com.

[7] McKinsey Center for Government, "The opportunity in government productivity," April 2017, McKinsey.com.

[8] Hanspeter Hueter, Carey Mignerey, and Tao Tan, "Why zero-based budgeting makes sense again," January 2018, McKinsey.com.

For detailed findings from the McKinsey Center for Government's productivity research, see "The opportunity in government productivity," McKinsey.com.

Tera Allas is a senior fellow in McKinsey's London office, **Rima Assi** is a partner in the Dubai office, **Jules Carrigan** is a partner in the Sydney office, and **Roland Dillon** is an associate partner in the Melbourne office.