

Public Sector Practice

Spending reviews: A more powerful approach to ensuring value in public finances

Spending reviews have the potential to provide significant insight into budget allocations, enabling higher productivity and greater operational efficiency.

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Governments around the world face an imperative to manage their resources efficiently and provide services at the lowest possible cost. For some governments, this has involved going beyond traditional budgeting and taking a more innovative approach to managing public finances: spending reviews.

Spending reviews have the potential to provide significant insight into budget allocations, leading to recommendations that can enable higher productivity and greater operational efficiency. They also boost transparency, offering citizens more insight into why and how money is spent.

There is no single formula for spending reviews, and governments can tailor their frameworks based on their own priorities. However, there are approaches that can help support sustainability and increase the chance of ongoing benefits. These include establishing granular financial and operational baselines, understanding the underlying drivers of costs, benchmarking the efficiency of spending to identify opportunities for improvement, and making recommendations to improve efficiency or reallocate resources.

Governments that put in place these strategic foundations are likely to succeed in creating a new generation of structured spending reviews that are reliable, effective, and rewarding.

Spending reviews: A powerful tool to manage the budgetary process

Spending reviews can help governments better understand spending and identify opportunities for efficiencies. However, they are distinct from traditional top-down budgetary targets and the political negotiations that are still common in the countries in the Organisation for Economic Co-operation and Development (OECD). Instead, they are detailed assessments of specific areas of spending, with aims of increasing transparency, improving efficiency, and, where necessary, reallocating resources.

Several governments have used spending reviews to enhance expenditure performance.

The UK government has carried out spending reviews every two to five years as part of the budget-setting process. In 2015, HM Treasury, in partnership with government departments, created a new costing unit to conduct rapid six- to eight-week reviews of areas of public spending. The unit has since completed a number of reviews focused on operating expenditure in areas ranging from vocational education to criminal justice.

Denmark has conducted more than 50 spending reviews in services from policing to back-office functions across the government. Reviews have also been integrated into the annual budget process. The Ministry of Finance typically identifies several spending reviews a year. These become the bases for resource reallocation and spending programs, and they inform budget negotiations.

Sweden's spending reviews have primarily focused on capital efficiency (for example, in highways and rail) and delivery of services (for example, through the migration agency).

These spending reviews have had significant impact. In the United Kingdom, they have provided transparency into more than £20 billion of annual spending reviewed and a new approach to visualizing public spending across 25 departments. In Denmark, they have helped to deliver combined annual savings of €1 billion from several cross-government and ministry programs over five years.

Designing a spending review process: Key decisions

There is no blueprint for spending reviews, and governments have formulated their own approaches, reflecting differing priorities and organizational structures. There are, however, three broad areas where governments should make design decisions:

— **Institutional setup.** Governments must decide which ministries or teams are responsible for spending reviews. The entity responsible for the review should be located in an institution with sufficient formal and informal power to coordinate the process. Countries that have conducted reviews have taken a variety of approaches. In the United Kingdom and Denmark, spending reviews have been led by HM Treasury and the Ministry of Finance respectively, working in partnership with other departments. By contrast, Spain and Italy have assigned responsibility to an independent fiscal authority and a politically appointed commissioner, respectively. Teams tasked with conducting reviews are typically small and comprise a combination of ministry and departmental personnel. In the United Kingdom, HM Treasury's team, consisting of about ten people, often conducts two or three reviews in parallel. It is also helpful to define up front whether review recommendations will be advisory or mandatory.

— **Scope.** Governments must decide on the range of the review body and the subject of the review. Scope is important because it affects the nature of the analysis and recommendations. Reviews of operating costs typically focus on labor costs, external spend, and back-office processes, and reviews of capital projects cover the volume, specifications, timing, and delivery efficiency of projects. Reviews of transfer payments, meanwhile, often look at issues such as eligibility, fraud, and error. Depending on the scope, a different set of skills and capabilities are required: a review of external spend and procurement is clearly different than a review of transfer-payment fraud and error. Countries have chosen to focus spending reviews on different areas of public spending. In the United Kingdom, reviews have mainly dealt with operating expenditure; the government has sought to make 30 to 40 percent reductions in

operating costs in some ministries since 2010. In Sweden, reviews were initially focused on capital projects but recently have had a broader scope.

— **Individual-review-selection criteria.** Governments typically conduct up to ten individual spending reviews a year but may use different criteria to select reviews. One important decision is whether to focus on a single ministry/agency or on cross-cutting issues that span multiple areas of government (for instance, criminal justice and social care). Cross-cutting reviews can address more complex issues—including frictional costs resulting from coordination among ministries—but are more challenging to carry out and implement. Governments also need to decide the size of spend being reviewed: too small, and the review is unlikely to be material; too large, and it may be impossible to generate real insight in the time available. In the United Kingdom, most reviews have focused on areas of at least £1 billion in annual expenditure.

There is no right answer to these design choices, and they should reflect national priorities, governmental structures, and political realities. However, it is important to ensure that the design choices are aligned with each other so that the team conducting the reviews generates useful insight and recommends meaningful changes.

Conducting a spending review

Despite different choices about the institutional setup, scope of, and selection criteria for reviews, governments have converged on a common approach for conducting a spending review. Establish granular financial and operational baselines, understand the underlying drivers of costs, benchmark the efficiency of spending to identify opportunities for improvement, and make recommendations to improve efficiency or reallocate resources.

Reviews are typically conducted by agile teams of five to ten people drawn from both the finance ministry and the ministries delivering services in the area being reviewed. Timelines between six weeks and six months are reasonable, depending on the size and complexity of the review, and there are typically four key stages.

1. Establish granular financial and operational baselines

A spending review is often the first time that comprehensive financial and operational baselines are produced for an area of public spending. In simple terms, the financial baseline shows how much is spent, by whom and on what, while the operational baseline casts light on activities funded by public spending and their outputs.

The first task is to **agree on a standard taxonomy of inputs, outputs, and outcomes** and how the government measures these, allowing for like-for-like comparisons and potentially revealing conflicting targets across ministries or a lack of defined outcomes. Understanding the difference between funding/budget and costs, for example, can reveal deficits or surpluses. The inputs are the funding or budget provided and costs incurred at the levels of cost category (for example, labor, property, and external spend) and cost center (such as an operating unit like a school, hospital, or immigration center), while the outputs are the direct impacts of the spending. Outcomes focus on indirect or more long-term effects.

When the United Kingdom's HM Treasury reviewed the further-education system in England in 2015, it established a common set of cost categories that could be compared across institutions and analyzed at the level of the individual educational institution (that is, the cost center). The Treasury then defined the immediate outputs (such as delivery of a lesson) and the outcomes (for instance, student attainment of qualifications and increase in lifetime income), creating a holistic view of the relationship among inputs, outputs, and outcomes.

The next step is to **develop a comprehensive and granular financial baseline**. This should include all the costs incurred in a particular area of public spending, often across multiple ministries, and should be at the most granular level possible. The financial baseline may reveal that the government is spending significantly more than thought in a particular area. In addition, a comparison of costs and budgets over time can identify structural deficits or surpluses. The review can also be designed to generate a forecast of future costs, based on predictions for underlying drivers (for example, migration figures, criminal levels, and infrastructure-construction projects).

Still, there are significant challenges. In federal systems, a common complexity is in understanding the costs incurred by national and local government entities in a particular area. Outsourced services and public-private partnerships (PPPs) are also more difficult, requiring a level of detail about actual costs incurred rather than just the headline unitary charge paid by the government. Analysis of the accounts of outsourced and PPP arrangements can help provide some of the detail required.

In the United Kingdom, all departments have been asked since 2015 to produce a "value map" that breaks down annual spending into cost categories and cost centers, providing a basis for a granular financial baseline. The Danish public sector, meanwhile, has developed a new approach to understanding the total cost of ownership in the transport sector, taking into account the maintenance costs of any given strategy.

In parallel to developing the financial baseline, spending review teams must **develop a clear operational baseline**, which is a map of the activities conducted and outputs generated by public spending. Operational baselines help identify areas of greatest volume and complexity, as well as handoffs and potential points of friction in complex cross-government spending. When HM Treasury conducted a spending review of the criminal-justice

Spending reviews can provide ministries with a deep understanding of the drivers of costs and how to manage them.

system in London, it produced an end-to-end map of activity, outcomes, and key performance indicators that included policing, prosecution, the courts service, custody, and resettlement.

2. Identify underlying cost drivers

One of the key benefits of spending reviews is that they can provide ministries with a deep understanding of the drivers of costs and how to manage them.

The first step is to **build cost-driver trees** for the main cost categories. For example, the cost of supporting a fleet of military vehicles will include manpower to drive and maintain, fuel, spare parts, basing, and storage. The cost of spare parts will be determined by the volume of parts consumed and the price of each part. The volume of spares will be determined by the number of vehicles, the distance they travel, maintenance policy, and the mean time between failures. It is possible to model each of these factors to provide a detailed understanding of what drives the costs of supporting the fleet and, in particular, where small changes in a cost driver may have a large impact on overall costs.

Part of the process of understanding cost drivers is to **disaggregate fixed and variable costs**. For military vehicles, the costs of basing and manpower may be fixed, while the cost of fuel is variable. One common challenge is distinguishing between contractually fixed costs (for example, a one-year fuel-purchasing contract) and physically fixed costs. In some services, there may also be fixed cost steps—for example, the number of bases required to

support vehicles may only change when the number of vehicles rises or falls beyond a certain threshold. An understanding of fixed and variable costs is particularly important in outsourced and public–private support arrangements, where departments need to know how costs vary with usage to determine how much they should pay.

Governments with a detailed understanding of cost drivers are able to **develop unit costs for the provision of services**. Unit costing allows ministries to compare effectively the cost of providing a service either through government or externally. This level of visibility is similar to that expected of the product-level profitability from a private company. When the United Kingdom’s HM Treasury reviewed the cost structure of further education, it worked with vocational institutions to understand their cost per qualification hour—the “fully loaded” cost of delivering one hour of a specific qualification—which could then be compared across institutions.

Cost-driver analysis is critical to both assessing the efficiency of public spending and making policy and operational choices. It also allows departments to put a cost on the impact of policy changes—for example, a requirement to teach a specific qualification—or operational changes, such as a decision to conduct additional military exercises.

3. Benchmark spending efficiency and identify opportunities for improvement

Spending reviews can help ministries make more informed decisions about efficiency and productivity improvements.

Armed with a granular picture of costs and cost drivers, review teams can **benchmark efficiency internally and externally** to identify improvement opportunities. Where the same or similar services are provided by a number of different institutions, there is significant potential to benchmark internally. The prior cost analysis allows spending-review teams to standardize costs (for example, on a unit-cost basis) and compare performance across schools, hospitals, universities, and other institutions. In the United States, the requirement to publish the costs of certain medical procedures at individual hospitals could allow patients to make direct comparisons. Governments also often have the opportunity to benchmark costs and performance across regions or localities. In the United Kingdom, the government has defined local authorities that are “statistical neighbors”—those with similar demographic and socioeconomic characteristics—to allow regional comparisons, particularly in education and healthcare. Benchmarking internationally, and to the private sector, can also be helpful in identifying opportunities. The US government publishes faulty-payment rates at paymentaccuracy.gov, allowing other countries to compare fraud and error in payment streams. Similarly, the US Department of Defense publishes the prices it pays for a range of military parts, identified by NATO Stock Number, allowing other militaries to compare prices.

Once spending-review teams have identified the potential opportunity through benchmarking, they can **find levers to realize improvement**. This process is typically complex, requiring a combination of financial and operational analysis, detailed discussions with practitioners, and subject-matter expertise.

There are, however, productivity levers that are proven to be effective. Where the focus is on operating costs, the application of automation at scale—particularly in corporate functions such as finance and HR—is widely used to cut labor

costs. For external spend, some ministries use a combination of demand management, contract renegotiation, and consolidation in procurement frameworks. In the United Kingdom, Crown Commercial Service is establishing frameworks for different spending categories.

Where the focus is on capital expenditure, ministries seeking to improve productivity can combine reviews of cross-government pipelines, improvements to specifications of individual projects, and value engineering of projects during their delivery. In the United Kingdom, Infrastructure and Projects Authority maintains a single view of the government’s major capital programs. In Sweden, the government has achieved significant efficiencies in highway spending through a standard set of requirements for road projects.

Spending reviews examining transfer payments often focus on levers to reduce the levels of fraud and error in payments.

Using a combination of benchmarks and efficiency levers allows spending-review teams to help ministries locate potential productivity improvements, size the scale of the opportunity, and define actions to deliver efficiencies that can be tested and refined.

4. Agree on recommendations, prioritize actions, and ensure delivery

The ultimate aim of spending reviews is to make a set of recommendations that improve the efficiency and effectiveness of an area of public spending.

In order to have an impact, the spending-review team should **agree on a set of recommendations** with the ministries that are going to implement them. Recommendations often include changes to policies, funding arrangements, and operations, but without clear stakeholder agreement, they are unlikely to be implemented.

Once the spending-review team has made a set of recommendations, it can work with the relevant ministries to **prioritize actions**. This process can include defining a road map for the next three, six, and 12 months and beyond. Recommendations may also require additional funding—for example, capital investment in automation to deliver ongoing operational efficiencies. These funding arrangements may take the form of a performance contract between the finance ministry and the line ministries responsible for delivery.

Finally, spending reviews are most effective when the spending-review team **follows up to ensure delivery**, based on frameworks that define key performance indicators and include timetables for

subsequent reviews and annual reviews of review-team impact across the portfolio of projects.

Spending reviews—as pioneered in Australia, Denmark, Italy, and the United Kingdom—offer a powerful new approach to ensuring value in public spending. Deploying a small, mixed team over a fixed period to review a defined area of public spending has consistently been able to provide deep insights into the cost base and identify efficiencies. For countries that have yet to seize this opportunity, reviews offer a realistic and attainable route to getting more value from public spending.

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