

# Spending Review 2015

What next for government services?

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By Sean Worth

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### About Westminster Policy Institute

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# Executive Summary

As the Government prepares for the November spending review, the job of managing growing demand for public services and infrastructure with even less money looks set to be the great public policy challenge of this parliamentary term. This report analyses the outlook for government departments and what could be done to keep quality of service provision high. In summary, our analysis shows:

## The simpler options for reducing spending are diminishing

The Chancellor has ambitions to cut £20bn from departmental spending over this parliament, a huge challenge, given that demand for the services those departments manage is not static, but in many areas is rising rapidly. Even in protected areas, such as the NHS and schools, population growth and ageing means any money put into those services must provide for an ever-expanding number of people.

Elsewhere, the Chancellor has asked departments to model for cuts of 25-40%, which is actually the same ask as was made before the 'emergency' cuts of 2010. Then, the scenario was a Treasury negotiating position, from which it would settle for less. This time, it is a much harder ambition.

The only way to manage this is to increase efficiency radically. Problematically for the Government, however, the simpler options for making large efficiency savings, particularly via public sector pay, has diminished. In fact, the National Living Wage, while welcome, will make the cost of doing most things more expensive. Completely new thinking is required.

## There is no political mandate for radical service reform, so we expect much more outsourcing

While many commentators point to the need for a radical redesign of government activity to fit the spending outlook, no mandate has yet been set out for this. That does not prevent radical reform, but does mean it is much more difficult to achieve politically and will also take longer to implement.

For these reasons, our prediction is that much more outsourcing will be used, transferring the pressure for innovation and efficiency to external providers. Industry figures indicate that the public sector uses at least £80bn of business services a year and that services are delivered on average at 10-30% lower cost at the same or better levels of quality. We expect that outsourcing could increase by more than 50% by 2020.

Local government, however, has greater scope for more radical redesigns of service provision, especially via the devolution route. Outsourcing in that sector will also see strong growth, though innovative partnerships and joint ventures with private sector partners could also flourish.

### **If more private sector outsourcing is the answer, trust and reputation issues must be tackled**

The use of the private sector is delivering real value and we expect it to accelerate. Some high-profile ethical and performance failings in the last parliament on the part of contractors, however, have led to some harsh criticism of outsourcing from politicians. Many want to see more regulation and also keeping the private sector's role out of some areas – which perversely reduces transparency as well as value – but action is clearly needed to build public trust and dispel misplaced fears over external provision.

Government and business must work together to communicate stronger ethics and value from contractors and also take steps to improve the reputation of the practice of outsourcing itself.

### **Considerations for policymakers**

Industry data on the efficiencies and quality improvements to be gained by outsourcing services to competitive providers speaks for itself. Outsourcing will help deliver the savings government needs.

Concern over the ethics and transparency of providers, however, does need to be tackled. Lack of trust is leading to often ill-judged calls for an increased degree of regulation or protectionism. The perverse result of this situation will be to put off innovative providers from helping the public sector and it can lead to politicians withdrawing services from open competition, meaning less accountability as well as value.

First, there needs to be political action to build more trust in opening up provision for public services:

- More public scrutiny about what goes on: taking forward and building on the transparency agenda set out at the end of the last parliament, but ensuring that the reporting of finances and performance is as rigorously sought after from state-run as outsourced providers;
- More totemic, political action: reassuring the public that valuable public services are very closely protected while under contract to outsourcers:
  - Explicit guarantees are needed to dispel public anxiety stemming from misleading claims that services are being ‘privatised’ simply if a contractor helps deliver them. There should be explicit guarantees that assets like schools and hospitals cannot be sold to providers, also curbs on ‘profiteering’ and guarantees of service protection in the event of provider exit – not because these are always needed in technical reality, as provisions can be (and usually are) put into contracts, but simply because they are never explicit, which leads directly to reform inertia due to stoked-up and misplaced fears. Privatisation, in particular is a term that needs to be clarified.
  - Government should also make a virtue of contracting with providers who demonstrate visibly strong ethics, in order to build public trust but also incentivise providers. The Social Value Act allows for this within competition law, and while individual contracts often stipulate measures, the public never see them. Explicit measures should be used in procurement policy, such as preferring bids from providers who do not use involuntary zero hours contracts.

Once new safeguards are more visibly in place, openness and competition is key to delivering greater value:

- More competitive tendering: more public services and functions should be opened progressively to external providers, as progress on improving commissioning skills expands.
- More market diversity: ministers’ ambitions for a more thriving diversity of SMEs delivering contracts have been stifled because too great a degree of financial risk is being transferred to providers – even large

ones – which limits market entry. A fairer balance of risk must be struck.

- The devolution agenda should be used to encourage contracting at greater scale, using the city region mayoral office as a means to bring together strategically important commissioning of services that can be shared across different councils.
- The localism agenda of the last government helped innovative councils make savings once given greater freedoms. However, there should now be stronger central pressure on those struggling to make progress to adopt proven best practice, e.g. over service sharing and outsourcing.

# 1. Analysing the Policy Environment in the New Parliament

At the most fundamental level, we can see already that the biggest driver of public services policy will be reducing spending and the greatest challenge will be maintaining value. At the July 2015 Budget, the Chancellor set out a course to balance the current budget and eliminate the deficit by 2019-20. While this represented a softening of plans he had set out prior to the general election, they still mean that over the decade since 2010, government spending will have fallen overall by around a third.<sup>1</sup>

The Budget set out cuts to welfare and tax credit budgets of £12bn by 2020 and also measures to restrict public sector pay rises to 1% for four years. There were £6.5bn of net tax increases forecast, but the need for cuts in departmental spending will still reach £20bn by the end of the parliament. As a result, the Chancellor recently instructed departments to find savings of between 25-40%.

There are 'protected' budgets where cuts will not fall, such as health and schools, but these look set to be under great demand pressure, meaning the money pledged to those areas will need to stretch ever further.

## Managing rising demand

The big issue with the debate over public spending and service provision is that it is framed largely in terms of a static picture of actual demand for public services, which we know is in fact elastic.

While demand is difficult to predict precisely into the future, we can be confident of at least one major trend: upward pressure on demand caused by demography. Problematically for the Government, rising numbers of very young and very old people in the population will put its greatest pressure on precisely the most expensive service areas – those they are pledging to protect:

- The population of England and Wales alone grows by 1,000 people a day
- There are now 400,000 more under-fives than there were a decade ago
- The number of people aged over 85 will double in just the next 20 years
- The cost of providing services for 85-year-olds is around 3 times greater than for a person aged 65

The only effective way to manage rising demand as spending falls is to increase productivity and this has been a huge challenge, historically. According to the Office for National Statistics, there was zero annual growth in public sector productivity for the entire decade preceding 2011, followed by a small spike of 2.5% and 1.2% productivity growth caused by reducing staff and pay.<sup>2</sup>

The biggest issue facing politicians over the new parliament is that the scope for such efficiencies has diminished. Most progress has been obtained via fairly basic measures like freezing pay and payments to suppliers, not service redesign, and the scope for the former is far less than in the 2010-2015 term.

### Impact on government service provision

The big message we see from our analysis is that further cuts beyond the £38bn that was achieved over the last parliament will require more radical thinking as the 'low hanging fruit' has already been picked. Freezing public sector pay, for example, which did save lots of money over the last parliament, is likely to be much harder to implement politically now that private sector pay is firmly back on the rise. The paybill for public services will also increase at the lower end (e.g. in social care) due to the National Living Wage.

It is local government, however, where we expect some of the greatest pressure to fall, but also where there is greater scope for potential innovation. The summer Budget did not make further in-year local government funding cuts, but the environment was already difficult and looks to become even more so. The LGA's post-Budget analysis stated that:<sup>3</sup>

- By the next financial year, core central government funding will have been cut by 40% since 2010;

- Councils have to find £2.5 billion in savings this financial year and they say “these are proving the most difficult savings to find yet”;
- Councils will face a further £3.3 billion reduction in central government funding in 2016/17, equivalent to 12% of their total budgets;
- This will progress to a funding gap of £9.5 billion by 2020.

In addition to central cuts, council tax revenues did not offset these as they rose over the last parliament by an average of just over 3%, according to the Institute for Fiscal Studies.<sup>4</sup>

Despite this, local government has delivered some huge efficiencies. The Joseph Rowntree Foundation has analysed the overall average service spending reduction across English councils in the last parliament. Their data shows that councils reduced spending by an average of 27% in real terms<sup>5</sup> with London boroughs and metropolitan districts reducing spending the most.

Recent analysis by the Institute for Fiscal Studies<sup>6</sup> narrows the picture to a regional level by looking at reductions in spending at a per person level, thereby accounting for differences in population size and finding areas with greatest success in making reductions. This analysis shows that London boroughs, the North East and the North West delivered the largest average reductions in per-person terms:

- London boroughs cut spending per person on average by 31.4%;
- Spending per person was cut by 26.5% in the North East; and
- The North West saw cuts of 25.7%.

The IFS also show that these regions already had the highest level of spending per person in 2010, so the overall effect is to have brought the average level of local authority spending per person across regions close together over the last five years.

## 2. Is Outsourcing the Most Attractive Option?

The major problem with squaring the circle of rising service demand and falling service funding is that the political appetite for any radical reshaping of state services has receded. Following the controversies that followed some of the cuts and reforms of the 2010-15 Parliament, none of the main parties were saying at the last election how they would deal with the challenge for fear of exposing themselves to the political risk of having a difficult debate about the consequences of the spending plans for public services.

**The upshot of this was that none of the political parties prepared any radical reform mandate.**

This leads us to expect that the practice of outsourcing will be adopted far more quickly as a means to manage departmental spending cuts than any more structural redesign or reform of services, however pressing the need for the latter might be. Indeed, industry figures show exactly why, finding that **public services can be delivered, on average, at 10-30% lower cost at the same or better levels of service quality, from outsourced providers.**<sup>7</sup>

Given the spending plans for this parliament, these kinds of figures start to look increasingly attractive, especially as outsourcing allows for big efficiencies without the need for government to undertake major phases of centrally-planned restructure and reform of the kind that can prove difficult politically.

According to Oxford Economics, the public sector uses at least £80bn of business services in a year.<sup>8</sup> Outsourcing has in fact been on the increase over successive governments, but rose significantly in the last parliament when departments and local government were forced to accept unprecedented reductions in budgets.

**Outsourcing saves 30%: how the efficiency is typically achieved**

- faster technology uptake and transfer
- organisational transformation happens more quickly and smoothly
- leadership tends to be more dynamic and incentivised

As well as the efficiencies achieved for the taxpayer, there have been other major benefits:

- **Major role in driving growth in all areas of the country:**
  - 3.3m jobs and growing;
  - a major focus for exporting UK expertise;
  - UK now has the second biggest global outsourcing market.
- **Growing contribution to UK government:**
  - Over a third of the industry's activity is now provided for the public sector;
  - 30% efficiency gains at same level of quality or better;
  - Outsourcing contributes £14bn in tax to the UK Treasury.

In terms of government/public service outsourcing, such figures do of course balance the fact that both public sector recruitment and wages have been curtailed over the last parliament.

## 3. Political Debates and Reputation Issues

While using external providers to deliver government services yields proven savings, and has clearly been progressing apace since 2010, the practice does attract a degree of political debate and controversy.

In particular, concerns are raised repeatedly by politicians over such issues as the degree of competition in the market for outsourced services (particularly market access for SMEs), the ethics of providers and the transparency of contracts.

### The use of external contractors in public service delivery

The presence of private sector providers is controversial in the eyes of some politicians, which although ideologically driven in some cases, is underpinned by a worsening public perception of providers.

The CBI's research, for example, has shown a trend of progressive decline in public support for outsourcing to the private sector, even when polls use statements about better private sector performance: they found that agreement with the statement, "if a private sector company can provide public services more effectively than central government or local councils it should be allowed to do so" fell from two thirds in 2001 to half in 2014.<sup>9</sup>

Worsening public opinion has been seized upon by campaign groups wishing to end external contractor involvement in public services. The trade union-funded campaign group, We Own It, for example, has produced research backed by the pollsters, Survation, which showed half of the public (50%) believe that more public services should be run in-house by the public sector while less than a quarter (22%) think more public services should be outsourced to the private sector.

If the Government were to expand outsourcing as a solution to the budget pressures identified above, there needs to be more trust and confidence built at public and political level between providers and their end customers. To

understand this issue more fully, we undertook several interviews with people from the industry, political and regulatory fields.

### Principal themes emerging from interviews

- Providers of outsourced public services and infrastructure projects believe they face higher public and media scrutiny than do in-house government providers, and that reputation therefore matters to them more as unlike in-house providers they can be easily replaced if they lose the trust of the public.
- Politicians and their advisers feel under great voter pressure to condemn or punish perceived poor ethics or performance of private sector providers in the media spotlight and some can feel that providers do not do enough to improve their own reputations.
- There is ideological opposition to private provision, specifically, among some political figures, but reputational problems most often lead to calls from politicians for more transparency and also for reshaping the market in favour of more competition and a diversity of smaller providers.
- Underlying this is the issue of accountability to the end user: in other major service markets, including utilities, performance or ethics issues are more often 'policed' by switching to other providers. Not in public services where the commissioner is usually in control.
- Calls for more competition (SMEs) and new regulations reflects the absence of customer policing of the market and politicians therefore are put under pressure to provide this policing and reach for regulatory measures as the solution.
- Perversely, however, industry experts point out that this in fact puts off new and smaller entrants, and also leads politicians to withdraw services from open markets, where they are open to much less scrutiny.

We are clearly in need of practical ways industry and politicians can work together to build greater public trust in the practice of outsourcing more services.

## 4. Conclusions and Considerations for Policymakers

Our analysis predicts that the outsourcing industry will expand its remit and continue to play a major role in helping government deliver projects and services. The efficiency and quality it can deliver for the UK taxpayer simply has to be exploited as public sector austerity continues.

Given that the Government set out no mandate to change significantly either the level of government provision or to reform services, outsourcing would appear to be the logical and necessary means to achieve the value transfer ministers will need when implementing tight budgets.

Concern over issues of the ethics and transparency of providers, however, presents a major political stumbling block to rapidly achieving widespread efficiencies across government. It is leading to calls by politicians for an increased degree of regulation and restriction which, perversely, could simply lead to a less open public sector, where services are provided less efficiently and under less scrutiny.

More openness and more competition go hand in hand as the answer to this problem. Policymakers should be opening more public services markets up to competition from a wider market of suppliers. However, more constructive and proactive industry responses to some of the key concerns over the transparency and benefits of what they do are also needed.

### **In short, we first need more, not less competition:**

- More public services and functions should be opened to external providers. While there is debate over the use of the private sector specifically in the NHS, it is in the NHS where their help has arguably been most useful and where it is most needed in future to manage rising demand.

- Fair approach to risk: of late, the Treasury is transferring too much risk to providers as a condition of contracts, which is limiting the ability of smaller, newer and charitable providers from entering the competition. We still have a long way to go before a more diverse market of the kind all politicians appear keen to see is established.
- Improving skills in procurement and commissioning, including outsourcing these functions themselves, made good progress in the last Parliament and those efforts must now be accelerated.
- The devolution agenda should be used to encourage contracting at greater scale, using the city region mayoral office as a means to bring together strategically important commissioning of services that can be shared across different councils.
- There should be stronger central pressure on councils struggling (or unwilling) to make savings to adopt best practice seen in other councils, for example over service sharing and outsourcing.

**More crucially, however, and before an expansive outsourcing programme is put in place, there needs to be action to build more trust in opening up provision for public services:**

- More transparency and public scrutiny about what goes on. Policymakers have begun this, with plans for open book accounting and more reporting against performance, and this should go for the reporting of performance of state-run as well as outsourced services. Industry providers need in turn to recognize they now operate in an environment of stronger scrutiny and put more effort into communicating their ethics and performance.
- More totemic, political communications are also needed to reassure the public that valuable public services are in fact still very closely protected in terms of quality while under contract:
  - There should be explicit guarantees, for example, to prevent privatisation of some more sensitive services, not because these are needed in technical terms, but simply to put paid to any misplaced fear in the public's mind that services simply delivered under contract are somehow then 'privatised.'
  - The same might be true of guarantees against 'profiteering' or what happens if a provider fails; there is simply too little communication of the fact that while under contract to outside

providers, our public services are still under very close scrutiny and protection.

- o Government should also make a virtue of contracting with providers who more visibly communicate strong ethics, such as good staff treatment. The Social Value Act was meant to facilitate this, but more proactive measures might be sought, such as government positively discriminating in favour of bids that do not use zero hours contracts unless they are proven to be essential or are voluntarily entered by staff who want flexible working.

Once such safeguards are much more visible, more competition is the key to improving services in a tight spending environment as well as improving the public's trust in the practice of outsourcing.

## Endnotes

<sup>1</sup> Institute for Fiscal Studies, Post-Budget Briefing, June 2015

<sup>2</sup> Public Sector Productivity Estimates, ONS, February 2015

<sup>3</sup> Budget Day Briefing, Local Government Association, 8 July 2015

<sup>4</sup> 'Sharpest cuts to local government in poorest areas', Institute for Fiscal Studies, 6 March 2015

<sup>5</sup> 'Cost of the cuts: the impact on local government', Joseph Rowntree Foundation, March 2015

<sup>6</sup> 'Sharpest cuts to local government in poorest areas', Institute for Fiscal Studies, 6 March 2015

<sup>7</sup> Business Services Association, Annual Report, December 2014

<sup>8</sup> The UK Market for Business Services, January 2015

<sup>9</sup> CBI: Our Future Public Services: a challenge for us all. November 2014