TAMING THE BEAST
CUTTING GOVERNMENT COSTS SUSTAINABLY

By Florian Frey, Rainer Minz, and Christian Schmid

THE PRESSURE ON GOVERNMENTS to cut fiscal budgets is a global phenomenon. From Europe, where austerity measures were embraced after the financial crisis of 2008, to the United States, where battles rage over the federal budget, to Australia, where the newly elected government is committed to implementing ambitious cost reductions in order to achieve a budget surplus, public-sector leaders are looking for ways to address spending imbalances.

Ultimately, however, most cost-reduction efforts fail to achieve their targets. Typically governments are able to maintain lower spending levels for only a short period, after which costs resume their relentless upward march. In the UK, for example, the National Audit Office has estimated that cost savings programs have, on average, fallen 20 percent short of gross annual savings targets. And a survey of 633 federal managers in the U.S. by the Government Business Council identified the management of cost reduction efforts as one of the key challenges to increased efficiency.

Still, meaningful cost reduction *can* be sustainable. Through our extensive work advising governments and government departments, we have identified seven factors that underlie success—as well as the common traps that often undermine progress. At the core of our approach is the recognition that an effective cost-cutting program must be rooted in a clear understanding of the major drivers of costs based on carefully managed input from key stakeholder groups, and it must be directed with a relentless focus on execution. The degree to which each factor is critical to an effective cost-cutting effort depends on the specific history and circumstances of the organization involved. But in our experience, the following steps raise the odds of success significantly.

Communicate the Need for Efficiency Improvements
The private sector has an obvious and powerful motivation to increase efficiency and reduce costs: boosting profits and enhancing competitiveness. In the public sector, however, cost-cutting programs are frequently

tied to a budget cycle and are imposed centrally with little thought devoted to creating support for the effort. In the absence of a clear message regarding the benefits of reduced spending and a clear rationale for the cuts, there is little momentum for change.

This challenge can be compounded when governments take an incremental approach to cost cutting. Reducing spending by 2 percent in each budget cycle for ten years, for example, is very different from taking 20 percent out in just a year or two. In the former case, the savings are often not sustainable, whether because fundamental changes to core processes that drive costs have been ignored or because the moment eventually arrives when deferred investments can no longer be postponed. Governments aiming to achieve significant savings in a relatively short period must embrace bolder steps—ones that can lead to sustainable cost reduction.

It is critical to create a strong motivation or rationale for such cuts. The goal may be to achieve a balanced budget, increase service quality, or expand services without increasing the cost base. But whatever the reasons, they must be clearly articulated.

Consider the case of a European army that needed to reduce information and communications technology costs. These expenses had been rising 7 percent annually, with much of the spending going to the operation of existing systems, tying up funds that could have been devoted to much-needed investments. Once the military stakeholders understood how reductions in operating spending could generate funds for crucial investments, the organization rallied behind the effort.

Build a Program Based on Solid Evidence

It may seem obvious that a clear understanding of an organization's cost structure should be at the heart of any reduction plan, but often this is not the case. Instead, decisions are made on the basis of conventional wisdom or general impressions about which areas are ripe for cost cutting.

Indeed, close scrutiny of popular cost-reduction initiatives often reveals that the savings are neither as significant as envisioned nor sustainable over time.

To avoid such pitfalls, governments should undertake a clear assessment of the existing cost baseline in order to identify the main cost pools and their significant drivers—and, therefore, where real cost-cutting opportunities lie. In our work with the European army, the process began with a complete overhaul of how costs were allocated. A new cost-allocation system was created that pulled together all the expenses for services such as radar systems and telephone and mobile communications. The major benefit of the new allocation system was that it allowed users to see how these services affected the organization's overall costs. This, in turn, helped in identifying the best cost-reduction measures. The result: a 14 percent reduction in IT costs in the first year—cuts that were fully supported by stakeholders across the organization—with even larger reductions in the two years that followed.

Share the Pain

When significant cost reductions are urgently needed, it may seem expedient to make deep cuts quickly in one or two areas. But this approach creates the risk of a paralyzing backlash. The more political the environment—such as in situations where cost reductions require a vote by legislators or the public—the greater that risk becomes.

The key is compromise. And that means developing a large number of possible cost-reduction measures from which the right combination of cuts can be chosen. The goal is to arrive at the right balance so that all parties feel that what is required of them is politically acceptable.

In a recent cost-reduction program within a European regional government, the goal was to permanently cut 7 percent from the cost base over a three-year period. (This target was made more challenging by the fact that a large portion of the total budget, including the costs of health care and social benefits, were excluded, as well as by the decision not

to allow the deferral of investments or other temporary fixes.) At the outset of the program, a large number of potential cost-reduction measures were generated, which together would save double the amount required. This allowed for a robust, fact-based discussion and prioritization of cost-cutting steps. The result: a program that spread the burden over a wide base of departments.

Manage All the Stakeholders in the Process

In the public sector, unlike the private sector, there is rarely a single person or unit that can make a decision—but many can block action. And some stakeholders, such as labor unions, are outside the jurisdiction of the government body driving the cost reduction process, making management of those groups all the more challenging.

Public-sector leaders should develop a plan to identify the critical stakeholder groups and involve them at those points in the process where their support and input are critical. In our work with the regional European government mentioned above, it was crucial to ensure broad support from both the elected officials running the departments targeted for reductions and elected representatives concerned about constituent reaction to the cuts.

The solution was to draw both those groups into the process sequentially. First the departmental leaders came up with a large number of potential cost-reduction measures. Then a think tank made up of elected government representatives reviewed those plans and contributed revisions and new measures. After some negotiation between the two groups, a final plan was settled upon. This was then presented to the broader elected body, which approved it, and to the public, which registered its support by passing a referendum on the program.

Make People Accountable for Results

Cost reduction measures in the public sector are often the responsibility of a committee or an agency. As a result, when a measure falls behind schedule or is headed for fail-

ure, it is unclear who is responsible for finding a solution. And this problem is exacerbated when cost reduction efforts extend over a multiyear timeframe and therefore require long-term, committed management.

In our work with the army, we first identified those responsible for each area of the cost base, from computer hardware to applications to radar systems. These 40 leaders and their teams were tasked with identifying cost reduction measures. After approval by the top military officials, these plans were incorporated into the budgets and annual financial targets for each area. And responsibility for executing the plans clearly rested with those 40 individuals.

Track Progress Relentlessly

The public sector often lacks the culture, skills, and resources to track progress closely and devise mechanisms for adjusting the plan over time. And almost inevitably, the facts underpinning a cost reduction program will change, requiring a modification of the original program.

A disciplined focus on execution is required. In the case of the European regional government, a project management office (PMO) was established. With a dedicated staff, the PMO tracked the progress of the cost reduction measures by monitoring a number of key performance indicators, information that was visible to the PMO staff and passed on to government officials. The PMO held biweekly meetings with the project's leaders—the government managers responsible for the individual reduction measures. In cases where progress was slower than expected, the PMO devised plans to fix problems or create new measures to offset the shortfall.

Master the Challenges of the Budget Process

A number of budgeting realities and perverse incentives can undermine publicsector efficiency. In many governments, for example, there is a "use it or lose it" rule whereby departments that don't spend their full budget by year-end lose the remaining money—and face the possibility

of a cut in future budgets to reflect that lower spending. The result is that many government agencies ramp up spending unnecessarily at the end of the fiscal year.

One way to address this issue is to identify the elements of the existing system that yield poor spending decisions—and then create processes to mitigate them. In a project with a European government agency, a modified budgeting process essentially earmarked the entire budget for specific items, from spending on maintenance to investments in new systems. If money designated for a specific category was not spent by a specified date, it could not be shifted to another area in order to use up the budget. The result was more disciplined and effective spending practices.

Another option is to change the budgeting process itself. In Switzerland, for example, a new approach, expected to be implemented by 2016, will provide government units with more discretion in how to spend their budgets, potentially including the option to create reserves to fund spending in future years.

THE FINANCIAL PRESSURES on governments globally are mounting. But the evidence clearly shows that cost-cutting efforts often fall short of their goals because of poor planning, weak execution, or both. And too often, even when cost reductions are delivered, the savings are not sustained over the long term. But failure is not inevitable. When a fact-based approach is used to craft a bold, transformative cost-reduction plan, and when key challenges such as political complications or implementation roadblocks are anticipated, cost savings can be significant and enduring.

About the Authors

Florian Frey is a partner and managing director in the Zurich office of The Boston Consulting Group and a core member of the Public Sector, Information Technology, and Financial Institutions practices. You may contact him by e-mail at frey.florian@bcg.com.

Rainer Minz is a senior partner and managing director in the firm's Cologne office and a founding member of the global Information Technology practice. You may contact him by e-mail at minz.rainer@bcg.com.

Christian Schmid is a partner and managing director in BCG's Zurich office and a core member of the Public Sector, Financial Institutions, and Insurance practices. You may contact him by e-mail at schmid. christian@bcg.com .

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