EXTERNAL ECONOMIC REVIEWS

FOR SCOTLAND

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Summary

Scotland's economy has been performing badly compared to others in the UK. It is heavily dependent on the public sector, and the possible revision of the Barnet Formula could have a serious impact. An improvement in economic efficiency is needed within the next year or two.

Most countries have a programme of annual Economic Reviews, of the economy, of sectors, of industries, and of individual projects and initiatives. These are strongly supported by the World Bank, the United Nations, etc.

These reviews concentrate on improving economic efficiency. They move resources to where they produce a higher payoff. Typically the impact is very big and can be realized in the short to medium term. It would be reasonable to expect the Reviews to identify improvements of 15% in the economic efficiency of public service organizations within two years.

The Economic Reviews complement the work of Government economists, not duplicating it or substituting for it. They do not duplicate on-going work on improving technical and managerial efficiency. Technical efficiency is not economic efficiency: organizations may be very efficient in doing the wrong thing.

The Economic Review process makes very little demand on the Department being reviewed and is not disruptive. The cost of the economist doing the review is small.

This note is based on my experience as a civil servant in governments which had constant reviews covering all their activities, and as a consultant doing independent Economic Reviews in countries around the world. I have written the only in-depth analysis of an economic consultancy in *The Economist's Tale.*

Economic efficiency

Economic efficiency exists when you cannot increase the payoff by shifting resources to other uses, when, for instance one extra pound spent on A & E gives the same payoff as one extra pound spent on eye tests.

Economic reviews aim to increase economic efficiency by

1. Identifying or validating ways in which the impact of existing policies, projects, etc can be improved. For example, bottlenecks may be removed or policies simplified.
2. Identifying or validating new policies, projects, etc which will have greater impact than existing ones.
3. Identifying which policies, projects, etc. have low payoffs, so that resources can be diverted to ones which make better use of limited resources.

Economic Reviews cover the impact the Government action has outside the organization. Often the cost to Government is a tiny proportion of the total cost to the country, or is insignificant compared to the benefit.

Economic Reviews do not have the improvement of managerial or technical efficiency as their primary aim, though inefficiencies are often identified. Organizations may be doing the wrong thing perfectly efficiently. Similarly, targets and conformity to a specific management system are strictly outside the scope of an Economic Review.

Doing economics

An economist doing an economic review uses a wide range of economic theory to build up practical, realistic, models of the sector, industry, or organization being examined. These models incorporate other economic models that have been produced and information obtained from many stakeholders. They have to be rigorous, coherent and realistic. These are tested for coherence, and unexpected results checked. It is then possible to examine the impact of various components. Is this subsidy producing any benefits? What would happen to the food industry if government hygiene and food safety inspections were discontinued? (Disaster!) Bottlenecks are identified and the need for infrastructure is considered. For example, the export of fresh salmon might be limited by the non-availability of chiller space at airports.

Doing this in the limited time available requires an economist with an excellent knowledge of the economic theory available, and experience of applying this theory to a wide range of markets and sectors.

This does not in any way overlap with the work of a management consultant or accountant. It uses completely different techniques to produce different outputs.

Payoffs from Economic Reviews

The payoffs from Economic Reviews can be enormous. It would be reasonable to expect that a programme of Scottish Economic Reviews would cut the expenditure of the Executive by at least 15% or increase the benefits it produces by this amount.

No limits to what is considered

An Independent Economic Review examining Britain's Third World Aid would ask the unthinkable:

1. Why not close down the Department for International Development completely? Instead send 30 cheques to the 30 poorest countries. They desperately need the foreign exchange for fuel, fertilizer and medicines. Potentially, this immediately trebles the benefit from the aid budget.

2. If, for political reasons, the money must be spent in the Third World Country, ask for each project, "Would the benefit be greater if you drove through the villages chucking money out of the window? The people could then spend it on what they really wanted, not what a government committee in Britain thought they ought to want." Potentially, this might dispose of 90% of British aid projects.

3. Why not identify the small number of projects where the payoff is over 100 times the cost, and replicate them? There are projects that produce payoffs 500, 5,000 or more times the cost. Scrap the rest.

Clearly this approach would have a dramatic effect on our aid programme.

Economy-wide Reviews

Independent economies expect quarterly reviews by the World Bank, IMF, etc. These cover macroeconomic issues, but also incorporate the results of sectoral and industry reviews.

Unquestionably the Scottish economists would take issue with some of their conclusions and recommendations, but the important issues would at least be aired.

Sectoral Reviews

Economic Reviews of sectors aim at improving the performance of the sector as a whole. In sectors like Food and Agriculture or Trade and Industry, the primary objective is creating an environment in which the private sector can operate efficiently. In these cases the costs of the Government department running the policy may be miniscule in relation to the benefits produced by a good policy.

Sometimes the Economic Review results in policy reform. Typically, sectoral policy has been built up over the years, with new policies introduced as circumstances change, and with new Ministers introducing new initiatives. Often many of these old policies are ineffective or produce an effect opposite to what is intended. Often different polices cancel each other out. (The Common Agricultural Policy is a well-known example). The Economic Review can then produce a new, simpler, cheaper, system which achieves Government objectives. Economic Reviews at sectoral level normally produce such changes. In some cases the payoff is measured in percentage of the GNP.

In one such case I did indeed suggest that one Ministry and much of another were redundant, and the suggestion was accepted.

That is “decluttering” at its best.

Economic Reviews of Industries

Some Economic Reviews are concentrated on the needs of one industry. For example, they may identify infrastructural constraints or bureaucratic obstructions which Government can remove. They may say that Government should concentrate on establishing and nurturing a market in which the private sector can operate.

Again, this results in “decluttering”.

The output of an Economic Review may be completely unexpected, and far more important than anyone could have thought. In one economic evaluation of a small industry-based research organization for the UN, I found that the world’s second biggest commodity market was about to be hit by a change which would be disastrous to the market as a whole and would harm producers around the world.

Government as a provider

With the NHS, the prison service, etc. Government is a direct provider of the services, rather than the organization that helps the private sector operate efficiently. Again the Economic Review identifies ways of increasing economic efficiency. This may involve identifying technical and managerial inefficiencies. An outsider inevitably sees problems and opportunities that insiders miss. An economist inevitably sees problems and opportunities that an accountant or MBA would miss (and vice versa). I was able to halve the cost of one state organization over six months without reducing output. I identified losses of £60m per year from maladministration in another.

All organizations are inefficient

In my experience, the managers of the most efficient organizations, public or private, say that the organizations are perhaps 66% efficient, and that they have to work as hard as they can to keep them that efficient, as circumstances change. The least efficient managers claim that their organizations are 90% efficient or better. To some extent this is a confusion between technical and economic efficiency.

Organizations, projects, initiatives etc. rapidly become economically and technically inefficient over time. The environment changes. The justification becomes obsolete. Objectives, priorities have changed. Some have achieved much of what they set out to and are no longer priorities. Objectives can be met at less cost in other ways. Often the management has lost sight of objectives and the survival of organization becomes main objective.

It is sometimes said that 20% of all projects, initiatives, etc. should be scrapped or fundamentally changed each year, to account for this.

Who can do the job?

Experience

The economist should have very wide experience outside Scotland and outside the UK, and should be able to say:

- “Some other governments have tackled this problem differently.”

- “Some other governments have tackled this problem in the same way and have encountered the same difficulties. They have tried the following ways around it . . .”

- “Some other governments have decided that this is not something they should deal with at all.”

- “In some other countries the private sector has tackled it for themselves in the following way . . .”

Scotland cannot afford the sort of consultant who says, “My country is richer than yours, so I am smarter than you.” Nor can it afford the consultant who says, “My country did x, y and z. We have a faster growth than yours. Therefore if your very different country does x, y and z, you will get the same growth rate.” These are the consultants who destroyed the Russian economy in the 1990s, cutting its GDP by two thirds in three years.

Most of the ideas foisted on Russia were ones that had already been tried in the extreme conditions of poor countries and had proved to be disastrous. A very rich country can afford to have some disastrous projects, and to hush up the consequences; a poor country cannot.

Scotland cannot afford the sort of consultant who says, “What your economy should look like is . . .” There is no shortage of people who can design utopias. The difficulty is getting from here to there, and that is where help is needed.

The economist should have experience of working with and within governments, and have an appreciation of what is practical and what can reasonably be implemented.

Economic qualifications

The economist should have sound economic skills. While a list of academic publications is a help, not all consultants publish. Ideally the skills should be different from those of most Government economists. Economists with identical specialisms will tend to see the same things.

The economist should have particular skills in refutation and critical thinking and ideally should have published critical comments and refutations. A lot of the task requires the ability to challenge the justification for existing policy and projects.

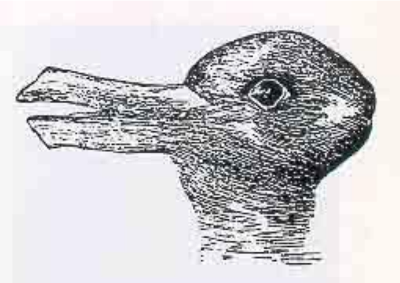
The economist should have the rare ability to apply high theory to the real world and produce practical, implementable, solutions. Many academics who are otherwise excellently qualified cannot do this.

Why outsiders?

There are many reasons for using independent outsiders to carry out the Economic Review. I have been a civil servant in several countries, as well as being an outside consultant, and I recognize the different pressures on them, the different tasks they have to use, and the different economic tools they must use.

The big picture

The outsider has a different point of view, and can see the big picture, without being influenced by detailed knowledge of some parts. The outsiders employed should have a wide experience of different governments and administrative systems.



As with the duckrabbit, two people looking at the same picture may have a different interpretation.

Preserving internal relationships

Government officials are keen to improve the system. Often the biggest constraint to reform is that the reforms will be hugely unpopular with some people. Nobody is pleased to hear that the programme they were working so hard on has been abolished because it is redundant or inefficient. And some powerful people will lose their powerbase. Economists and others have to maintain good relationships with their colleagues and with stakeholders, and may prefer that some of these difficult decisions are referred to outsiders who do not have to live with the backlash.

Outside validation

Insiders who are pressing for change are pleased to get outside validation for their proposals. A proposal that comes from one source in a Department carries little weight, but after outsiders such as the World Bank and the United Nations have validated it, it may be accepted. Conversely, outsiders are useful to kill unworkable ideas put up by vocal groups.

Long-term relationships

Outside economists typically do Economic Reviews for governments around the world, and so do not rely on repeat business from one client to make a living. This means that they are not afraid to speak their mind. Economists within the organization know that to be effective they have to build up longer term relationships within their organizations. They have to establish trust. And they have to be, and to be seen to be, committed to their teams, their colleagues and their organization. And they have to think of their careers. There are strong pressures on them not to rock the boat.

Economists within the organization are put in a difficult position when they have had any input into the programme that is to be reviewed, not least if they had opposed it.

No duplication of existing economics

The Economic Review does not duplicate the work done by the permanent economic staff. There is not the time nor the money for this, nor is it likely to be productive

Implementation

Knowing what should be done is one thing. Getting the changes implemented is another. Permanent staff work on the implementation. Officials know that there will be another economic review in a year, which will ask what implementation has been done.

Cost of external reviews

Cost to the organization

Independent Economic Reviews do not disrupt the work of the organization being reviewed. They do not require the organization to generate paperwork. The papers, statistics, etc. required should be readily available.

The economist will carry out interviews of up to one hour with people inside and outside the organization. A few people will be interviewed several times.

Often the Government will allocate a junior economist to work with the independent reviewers, to arrange appointments, locate reports etc.

Consultancy costs

Depending on the size of the task, the Independent Economic Review should take from one person-month to 24 person months. The time elapsed should be a maximum of four months. After this the consultants become too identified with the organization they are reviewing.

For bigger jobs it is worth employing several economists. Economists vary in experience, in their preferred economic approach etc. so one may identify opportunities that others have missed.

It should seldom be necessary to have more than four economists. For some projects, technical experts such as IT specialists, engineers, architects or agriculturists work with the team.

One person has to write the final report, presenting it as a coherent, cohesive, logically consistent, whole, and that person has to know what everyone in the team thinks. Communication becomes a major problem as the team increases in size, so a team of six is probably the maximum. I have done major sectoral policy reviews by myself.

Selection of Consultants

Moral Hazard

Independent Economic Reviews can only be successful if the outside economists feel that it is safe for them to tell the truth. There are winners and losers in any transfer of resources, and inevitably the losers are going to feel aggrieved, and they may try to take it out on the consultant.

A moral hazard exists if the consultants feel that they would suffer if they told the truth. They may believe that they will not be paid if they produce an unpalatable report, or that they will be paid but will never get another Government contract. They may believe that if they produce an unpalatable report they will be asked to rewrite the report, "toning down" some criticisms, moving them to an appendix or deleting them altogether – all meaning that they have to do unpaid work. And a request to "tone down" criticisms is perceived as a threat.

The moral hazard is greater for consultancy firms. There is a fear that if one consultant produces an unpalatable report, the firm will lose other contracts, even if that consultant is not employed on the other contracts. The consultant feels pressure from the firm, and the firm will censor reports. Universities often censor reports which might offend organizations that might finance research or consultancy.

The danger is particularly serious if the consultancy firm has had an input into the programme that is being reviewed, or to the administrative units that run it.

Big consultancy firms expect that if they can get one consultant into an organization, they can use that person to identify a lot of projects which they can then sell to the organization. This means that the consultant must not do anything to upset anyone important in the organization, not speaking about gross incompetence for instance. A consultant who transgresses will lose his job.

Some universities have committees which censor research publications and consultancy reports, suppressing anything which might affect funding organizations or clients.

This moral hazard exists even if all civil servants act with perfect rectitude.

Arm's length recruitment of consultants

For these reasons, Treasury Guidelines say that consultants should be recruited by arm's length recruitment units. In practice, the individual civil servants whose work is to be reviewed may select the people who are to review it. Indeed, sometimes Government employs a firm to implement an initiative, and that firm employs the consultants who are to evaluate it.

For Economic Reviews to be successful, the Scottish Executive or Scottish Parliament must set up an independent unit for arm's length recruitment.

Which consultants?

For the reasons set out above, a large consultancy firm with a lot of public service contracts would be reluctant to supply the economists who might produce a powerful Economic Review. Indeed, I have never seen any of the large consultancy firms doing this sort of work anywhere in the world.

Consultancy firms do not do consultancy: individuals do. Care is needed to ensure that consultancy firms supply the right people for the job. Consultancy firms are employment agencies who supply clients with consultants. Sometimes they provide specialist experts, who are likely to be independent consultants. These have unusual skills which no one firm can use all the time, so they subcontract. Sometimes the consultancy firms supply their own employees, generalists who they can employ throughout the year. They make most money when they supply their own employees, and there is a temptation to supply any permanent employee who is not currently working on a contract, instead of the appropriate experts. Firms frequently make last minute substitutions, after the selection process has taken place. The people who sell consultancy are seldom the ones who do it.

For effective Economic Reviews, Scotland must use the right consultants. Neither the firm nor the individuals should do sufficient public sector work in the UK to produce a moral hazard. They should have a wide experience. They should have the right approach and economic skills. They should have integrity. There are economists who do this internationally, and there are consultancy firms who will supply them.

Active procurement of consultants

Neither the economists who do these reviews nor the consultancy firms who market them are likely to bid for this kind of work in the UK under the present procurement system. It is expensive to bid for a public sector contract, and it is financially ruinous to bid for work when you are not likely to get it. There is a perception that only a favoured few firms have any chance of being considered. Some independent consultants believe that they have no chance whatsoever of success, regardless of their qualifications, experience, track record or knowledge of the subject of the consultancy.

It is recommended, therefore, that the Scottish Executive set up a small, arm’s length, unit which will actively search for appropriate individuals with a track record of doing effective Economic Reviews. These may be independent consultants, or be supplied by consultancy firms. The consultants for any task will be provided from a list of approved individuals.

The unit would also have the function of protecting consultants from inappropriate pressures, and of intervening if individual civil servants prove obstructive.

RECOMMENDATIONS

A programme of Independent Economic Reviews should be implemented. There should be Reviews at sectoral and industry level, and Reviews of programmes and initiatives. Reviews of state and parastatal organizations which deliver goods and services should also be carried out.

The reviews should be carried out by outside economists who are truly independent. Employment of consultants should be structured to minimize moral hazard.

The economists should be selected from people with wide experience of public organizations, with experience of this sort of work, with appropriate qualifications, and with a track record of provoking change.

An arm’s length procurement unit should be established. This will actively search for qualified economists, who may be employed as individuals, or through a consultancy firm. The unit will protect the economists from inappropriate pressures, and will arrange for intervention if some individuals are obstructing the Review.

APPENDIX: “THE BUDGET REVIEW GROUP”

“Choices for a purpose”, the report of the Budget Review Group, has aroused enormous expectations which it does not deliver.

Unlike the External Economic Reviews, it was not conducted by outsiders with a very wide experience. It was conducted by insiders, people whose experience is of the public sector in Scotland. This narrowness is reflected in the very narrow range off issues examined, and the very narrow range of recommendations.

The authors were managers who had risen to the top in a bureaucracy. They know how to manage a certain type of public sector organization in Scotland. The efficiency savings they have made in the past have been doing the same thing more efficiently, not making radical changes.

There is no sign of deep, rigorous analysis of the sort one would expect from an Economic Review. Instead, the Budget Review Group report concentrates almost entirely on bureaucratic processes and management systems. It pushes one particular management approach, Best Value, which is not universally admired. More narrowness. Obviously good bureaucratic systems are desirable, and can produce substantial results, BUT

1. The improvement in systems that is recommended will not be complete within the lifetime of this parliament.

2. Improving the systems is time consuming.

3. Efforts spent on improving the system distract from the major changes that can produce a large impact in the short run.

4. Experience suggests that every time the Secretary calls for action on something, or a major cut in costs, the response will be, “Yes, we will certainly do that, but we cannot take action until the new management system or accountancy system is in place”. Any experienced bureaucrat should be able to postpone action for at least ten years. I have seen it in the European Commission and in many national governments.

The Budget Review Group does not produce the carefully identified and costed savings that the newspaper reports suggested they do. Unrealistic expectations have been aroused.

Nearly all the actual savings mentioned had already been identified by the Executive, and were being implemented.

The Budget Review Group’s own identification of savings is nearly all, “If you adopt our management approach, you should be able to cut costs by 7%”. Or “If you amalgamate some very different organizations, you should cut costs by 10%”

The Budget Review Group concentrates on technical and managerial efficiency within Government, largely ignoring economic efficiency. There is little appreciation that, for most Government activities, the overwhelming majority of the economic costs and benefits do not come into government accounts – they are costs and benefits to the private sector and to the taxpayer. There is a failure to emphasize the dangers of Government doing the wrong thing but doing it very efficiently.

The Budget Review Group does not produce the “big picture”, much less a coherent model.

Quite a few of the recommendations are “odd”.

1. It is suggested that borrowing £50 million at commercial rates rather than paying the £50 million out of taxes is a saving.

2. It is suggested that the Freedom of Information Act is an external cost imposed by politicians, rather than being by far the most cost-effective implement for improving public sector efficiency.

3. It is suggested that expensive universities like Edinburgh should be closed down and replaced by HE colleges, because they teach degrees at a lower cost per student.

4. It is suggested that if several universities who are now in cut-throat competition with each other share their administration, they should cut costs by 10%.

5. It is suggested that 3-year degrees should replace 4-year degrees, as they are cheaper. Well, yes, but why not save even more with 1-year degrees? Why not close down all Universities and HE colleges and save even more? The cost to the 10 million or so people whose 4-year degree has been downgraded is not considered. Nor the damage to the brand of Scottish Degree.

The Report did not set out specific, clear, implementable, unequivocal savings or improvements in performance.