Nesta...

Finance for Impact: the case for transforming public finance to better support evidence, outcomes, engagement and innovation

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Summary

This note shares ideas on a long overdue revolution in public finance that would reshape the tools used to manage public money to better meet the needs of the early 21st century.

I show the strengths and weaknesses of current models of public finance, that are primarily concerned with managing money, and raising it, rather than ensuring it achieves outcomes; I suggest some of the emerging priorities for innovations in finance in relation to evidence, innovation and impact; and I offer some thoughts on what a different landscape of public finance could look like.

I hope the note will provoke a conversation – sharing of promising practices; useful theoretical perspectives; and ideas on how research and action could move things forward. The result could be a new research or action programme for Nesta and other partners.

Background – the stagnating ideas of NPM

In handling money, governments bear some similarities to other organisations, and many differences. They should want efficiency, value for money and transparency. But they usually have many more goals; more accountability; and a different environment of risk

The standard methods used by leading governments around the world were shaped by successive waves of reform. These have resulted in models that are essentially input-based, top down controls designed to ensure money goes to agreed and approved purposes. They are – rightly – focused on the primary goals of preventing overspending and corruption. Against a backdrop of chronic public debt in many countries, these traditional aspects of public finance have not lost their relevance. It's just that they address only one part of what governments need to do.

A generation ago, a group of reformers became interested in how to use finance reform to drive efficiency and reduce waste. A wave of reforms associated with the ideas of 'New Public Management' had great influence from the 1970s-2010s. These were substantially influenced by business, and encouraged new ways of managing public services and policies: privatisation, outsourcing, co-payments, fees and vouchers. They fed into the already substantial body of theory and practice focused on issues, including optimal tax collection, or how to structure private finance and partnerships. These are still the topics dominating public finance courses, and still being promoted by consultants. What counts as the leading edge hasn't changed much in two decades.

Falling behind – what's missing

By contrast, however, much less progress has been made on many other topics that are now of great concern to many governments, in cities and nations alike. The first two issues follow on from the concerns of the last wave of reforms, and are particularly relevant to governments facing serious fiscal pressures:

i. **Understanding costs and assets:** there has been surprisingly little progress in achieving detailed understanding of the nature of costs in the public sector, including the relationship between average, marginal and variable costs, despite the pressures of austerity. It's a rare public service which can see in real time how its finances are being managed (which is one reason why so many lurch into occasional crisis); or how cuts to one service might raise costs for another; or what the true pattern of economies of scale or scope might be in different services.[i] A related point is the very limited use of balance sheets, or analysis of rates of return on assets held by governments (which require national registers of assets, preferably as open as possible). Even less use is made of intangible measures in the public sector.[ii]

ii. **Making budgets transparent**. The move towards make public finance more transparent to the public has also made only faltering progress, despite some brave attempts. In principle it is becoming easier to tag many items of spending, by geography, by beneficiary group or topic area etc. It's not hard to imagine a much more standardised set of data headers for finance, making it easier to automate analyses of how funds are being used, and to connect management information systems that make it feasible to dig down through layers of accounting information, with what is available to the public.

The next set of issues point in different directions, to how government can be more agile, entrepreneurial and effective (rather than just efficient). They include:

iii. **Funding innovation.** Very little progress has been made on the finance of innovation within the public sector. Much more has been done on financing innovation in science and business and, for example, the World Bank has sophisticated tools for assessing public spending on innovation in the economy). But as far as I am aware, no government can articulate a coherent approach to funding innovation in its own operations, and answering basic questions: what optimal levels of spending might be; how these might be divided between different activities and successive stages, such as incubation and scaling; how risk might be managed; what target rates of return should be etc.

iv. **Human investment:** as far as I'm aware (and again, I would like to be proven wrong), no governments use investment methods to assess spending on education, health and training. Highly sophisticated tools are used for assessing investment in physical things, roads, airports, rail etc. Yet spending on people is, in many cases, investment – designed to achieve returns or results many years into the future – and social science has become steadily more competent at analysing the links between actions now and long-term effects.[iii] Instead, spending on fields like health is organised year to year, with no accounting distinction between spending on a vaccination programme versus emergency care.

v. **Finance tied to outcomes:** despite several decades of experiment, there are still few established methods for linking budgetary allocations to outcomes (though some governments have made important progress in setting strategic goals, transparently assessing when these are met or not, and establishing budgetary implications). The spread of new tools for funding outcomes is providing a useful prompt for progress, including social impact and development impact bonds, payment for outcomes, and the growing field interested in analysing the long-term returns achieved by different interventions. An important part of any serious progress around both investment and outcomes will involve more intelligent use of discount rates (I've argued elsewhere that the usual approach of imposing standard discount rates is not intellectually coherent, and that these should be different for different government activities).[iv]

vi. **Evidence:** Although some progress has been made in recent years in orchestrating evidence in public services, and making more use of data, these methods have not permeated the day to day work of many officials responsible for public finance. It's interesting to observe that the Alliance for Useful Evidence and the various What Works Centres have struggled to engage public finance professionals. They're not particularly hostile, and some are enthusiastic. But they don't see this as core to their jobs. Yet in the future, finance ministries could be responsible for overseeing not only the inputs but also the impacts achieved, helped by the key budgetary and financial committees.

The failure to tie finance into evolving ideas about innovation and evidence risks becoming a major barrier to progress. There is a need for better theory, and better tools that can be applied and shared by the leading practitioners, umbrella bodiesetc., and put to use in governments at every level, whether national, regional or city and district.

Although this may appear to be a very technical issue, one lesson from business is that each major evolution of business models required a comparable evolution of methods of management accounting, to track costs and revenues across complex production systems, to handle software, branding and other intangibles. Governments need a comparable evolution.

So what could be done? I'm floating the possibility of a research programme or partnership to try to push the boundaries and link finance more closely to what matters. It might look at some of the issues mentioned above and start with the following ones:

How to design outcome based budgets

There have been many attempts to introduce outcome based budgeting, with countries such as Sweden in the forefront. Some of these have led to very specific financing tools such as Social Impact Bonds and Development Impact Bonds. Some have led to new methods of determining overall budget allocations with explicit assessments of evidence and outcomes. A synthesis of best current practice and a roadmap to the future would be hugely helpful, whether for health systems wanting to prevent future obesity, or school systems trying to address poor performance.

How to finance innovation

Many governments provide small allocations to finance labs, experimental programmes and experiments. But most of these are invented on an ad hoc basis. There are few established equivalents to funding allocated for traditional R&D; for venture capital type investment. The aim of this part of the programme might be to map current practice; to work with lead practitioners in designing a set of practical tools that can be used by i-teams and labs, for example covering exploratory projects, stage-gate funding, and finance to encourage adoption. Nesta has a lot of experience of these methods – from staged funding, through investment, to pooled budgets like the Innovation Growth Lab.

How to integrate budgets and evidence

A third strand could look at the links between evidence and finance. For example, recent approaches linking grants and investments to support moving up the ladder of evidence; evidence embedded into spending reviews and allocations; and, of course, requirements for evidence of outcomes tied into contracts and commissions. This could form part of the next stage of work for the Alliance for Useful Evidence and the various What Works Centres in the UK.

How to open public finance to the public

We now have the benefit of several decades of experience of participatory budgeting. Famous pioneers like Porto Alegre in Brazil showed that thousands of citizens could take part in quite complex discussions. At one point, the UK alone had well over a hundred PB pilots underway. In Paris, the Mayor has committed to opening up 5 per cent of the budget to PB. The challenge faced by all of these experiments is how to make budgets comprehensible: how to show the current balance of spending; how to help deliberation on the impact of shifts of budget from one category to another; and how to get the right mix of numbers, visualisations and prose. Exactly the same challenge, of course, applies to helping committees of politicians. The PB wave came slightly ahead of the wave of open data and rapid advances in visualisation. Yet together these offer the prospect of making budgets significantly more comprehensible. But wider public engagement will make it even more obvious that some of the categories used by governments are obsolete. It forces attention to questions like: where is the balance sheet – how should a city decide on selling assets, or, for that matter, investing in new ones? Where is the treatment of long-term actions like schooling? How should a city show benchmarks? For example, what do comparable cities spend on similar services, and what results do they get?

How to purchasing, procure and commission

Another possible element could investigate the roles of procurement in both encouraging innovation and improving efficacy. What lessons can be learned from the use of procurement to drive innovation in countries like Denmark or Finland? What impacts are achieved by SBIR-type schemes? How feasible is outcome-based purchasing.

What research methods could be used?

My guess is that the best way to achieve progress in these fields is to closely link emerging practice with theory and systematisation, rather than purely paper-based research. So, in each of these cases, a programme might:

- Scan for emerging promising practice. All of the topics described above are being thought about, and acted on, by pioneers around the world. But as far as I'm aware their work isn't systematically organised, made sense of or shared.

- Learn from past programmes and experiments. Many of the issues described have been talked about for decades, at least. So what has been learned, for example on the practical challenges of outcome-based budgeting, or what types of issue are best suited to PB?

- Design and test new tools – drawing on the results of these, the next step must be to design new methods with practitioners and experts. What would a satellite account look like that used a different approach to set out the choices in an annual budget? How could these be applied retrospectively? How then might these be tested out in practice?

- Generalise lessons into toolkits, standards suitable for the tasks of cities, departments, and national governments etc., including innovation agencies.

There are many organisations with a potential interest in this space. The OECD is an obvious candidate, and we already work closely with their public sector team. We have also partnered with Bloomberg Philanthropy on i-teams and Mayors' Challenges, and their expanding work on data and evidence in cities has obvious relevance here. The World Bank is another potential candidate, and is obviously packed with financial expertise. Within nations there are, of course, the Ministries of Finance, the professional bodies (like CIPFA in the UK), or cross-cutting bodies like the Performance Improvement Council in the US.

It's possible of course that these challenges are already being solved. If there are off-the-shelf-solutions, then let's help them get wider awareness and traction. But even if these do exist, I am pretty certain that they are not being taught in public finance courses, and are not part of the normal toolkit.

Although I studied corporate finance and have had a fairly close involvement in public budget setting, I wouldn't claim to be an expert by any stretch of the imagination, yet I'm convinced that money is too important to be left only to the accountants and finance officers. Governments need to get some of the basics right. But finance should be more strategic, and more the ally of those seeking improvement, innovation and evidence than it often is today.

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[i] I wrote a paper a few years ago setting out some of the theoretical approaches needed, including a more detailed understanding of what I called the '12 economies', including economies of scale, scope, penetration etc. I found these were very useful for public service managers needing to cut budgets, but none of these ideas have been incorporated into the practice of public finance. A few years before, I commissioned detailed research within the UK government on economies of scale in key public services. We found very little evidence of such economies, and that units of delivery could be efficient at multiple scales (the same applies to national governments). Yet most finance ministries still operate with an assumption of economies of scale that is not born out by the evidence.

[ii] Nesta has been one of the pioneers of the analysis of intangible investment in the economy through the Innovation index; but we've made little progress in applying comparable measures to the public sector.

[iii] I was part of a UK government team in the late 1990s that tried to draft a 'green book' for people: a set of approaches to guide investment appraisal of things like early years' programmes, preventive health, and urban regeneration. Despite the enthusiastic engagement of parts of the Treasury, the project faltered. The main problem then was the lack of sufficiently hard evidence on the efficacy of preventive measures – it just wasn't possible to say,

with enough certainty, that action x would lead to result y in a decade or two. The margins of error became so large that the tools were not useful.

[iv] See the argument in my book 'The Art of Public Strategy', Chapter 13, on the relevance of hyperbolic discount rates, and why societies might use different discount rates for fields such as health, defence or education.

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