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## Withholding Dividends: Better Ways to Make the Public Sector Efficient

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## Executive Summary

During the 2000s, agency running costs in the federal government grew from \$32 billion to \$52 billion (23% in real terms), despite an efficiency dividend of at least 1% applying to departmental appropriations.

Going back further, the public service in Australia has grown top heavy since the early 1990s. The Senior Executive Service (SES) has grown by over 50% and the number of Executive Level (EL) employees has more than doubled.<sup>1</sup> In 1991, managerial employees (EL and SES) constituted 15% of the public service; today they constitute 30%.<sup>2</sup>

There are far more managers at the top drawing large salaries, and fewer at the bottom delivering services. Those of the public service who are delivering services are doing so at higher pay grades.

In addition, salaries have grown significantly, particularly at the top end of the public service. Base remuneration for SES level workers has grown between 25% and 35% in real terms since 2004.

The efficiency dividend, which is an across-the-board cut to the funding that agencies receive for running costs, has fundamentally failed to drive efficiency in the public sector.

It has also failed to stem rising costs in the public sector, but the efficiency dividend has further problems:

- The efficiency dividend is a blunt instrument for driving efficiency as it applies equally to efficient and inefficient agencies.
- More than larger agencies, smaller agencies are put under greater pressure because they have difficulty achieving economies of scale, and have fewer resources to apply for additional funding (outside the reach of the efficiency dividend).
- The efficiency dividend encourages gaming, where instead of cutting back on running costs, as is the intention of the dividend, agencies will submit new policy proposals so that the funding granted for these proposals can be used to cover existing as well as new costs. This also fuels the growth of unnecessary and ineffective programs.
- New policies, programs and agencies are a fundamental driver of the growth of government.

Getting greater efficiency out of the public sector depends on getting better value for money out of essential services, but it also requires decommissioning inefficient or ineffective programs and agencies. The efficiency dividend does not address this significant problem. In fact, it allows ministers to sidestep the important decisions about which programs and agencies the government needs, and which should be cut. The decision as to where savings are made is instead left to the heads of departmental/agency managers.

The government needs a more targeted approach to driving efficiency and reducing costs in the public service. This report recommends two solutions:

1. The government should look to increase competitive pressures in providing public services. The type of competition will depend on the service:
  - a. greater private sector involvement through the use of vouchers for public services
  - b. competitive tender, where private companies compete for the right to provide public services for a designated period
  - c. greater contestability, where the performance and efficiency of public sector agencies are benchmarked against the private sector so that if agencies do not deliver on outcomes, or are too inefficient, government can contract with the private sector.
2. Conduct regular review of agency functions and programs through an independent body (such as the Productivity Commission's Review of Government Services) to determine which agencies/programs are meeting objectives and how they can become more efficient. These reviews should also be used to cull programs and agencies that are continually failing their objectives, operating at too high a cost, or more appropriately provided for by the private market. This process will require greater measurement of outputs and outcomes, and so the build-up of performance indicators will aid in benchmarking across government services.



## Introduction

Whether in providing for defence, public infrastructure, health care or welfare, Australians rely on government to provide necessary public services. But the manner in which those services are provided, and the cost those services impose on the community, needs close attention.

In the last half century, government (particularly, the federal government) has grown significantly relative to the size of the economy. This has happened despite the microeconomic reforms during the 1980s and 1990s reducing the role of government in managing the economy. Tariffs were reduced to open up product markets, financial deregulation opened up capital markets, and the labour market has been partially deregulated. In addition, the federal government sold off state-owned enterprises such as Qantas and Telstra, and state governments sold off utilities. But at the same time, government has embarked on a wider social agenda focusing on health, welfare and education.

Australia's ageing population will put continued stress on federal and state budgets. The 2010 *Intergenerational Report* projects that by 2049–50, total federal spending will increase by approximately \$60 billion in today's terms.<sup>3</sup> Two-thirds of the projected increase is expected to come from health costs.<sup>4</sup> Spending on pensions and income support payments is projected to rise from 6.5% of GDP to 6.9% on a 'no policy change' basis, and economic growth is forecast at an unimpressive 2.7% per year.<sup>5</sup> At the same time, a lower proportion of the population will be working-age contributors to the tax system. In short, government will be facing a new era of budget scarcity, and the public service will be expected to deliver its services with fewer resources.

Since the late 1980s, federal and state governments have used the efficiency dividend as one of the chief instruments to control costs in the public sector. This report analyses the effectiveness of the dividend as a driver of efficiency in the public service and suggests other means of pursuing efficiency gains in the public sector. The report focuses on the operation of the federal efficiency dividend as it has been applied to federal budgets longest, and has been subject to several reviews. But the recommendations apply equally to state and territory governments.

### Efficiency in the public sector

In the private sector, competitive forces and the profit/loss motive create powerful incentives to reduce costs. Public sector administrators do not face the same incentives and pressures. However, taxpayers rightly expect value for their tax dollars, and government departments and agencies cannot expect to draw upon an ever-increasing pot of budget appropriations. These pressures imply a need for some form of cost control. In addition, as technological innovations lower costs in the private sphere, it follows that if these innovations are applied in the public sector similar efficiencies can be gained and costs lowered for government.

An efficient public sector has always been a goal of the Australian government, as was evident in the parliamentary debates on the legislation that established the public service in 1901.<sup>6</sup> As pressures on the government's budget become more acute, achieving greater efficiency in the public sector will become a common feature in public debate.

But the public sector operates quite differently to the private sector, and these differences make it more difficult to pursue improvements in efficiency.

In most instances, the public sector operates as a monopoly. The absence of output prices and a 'market' in the conventional sense means consumers do not get a valuation of services. Consumers (or taxpayers, rather) cannot exercise preference for one type of service over another because there are no service providers competing with the government.<sup>7</sup> Where government acts as a monopoly service provider, there is no basis for comparison with industry best practice, and little means of distinguishing which methods are most efficient.<sup>8</sup> Inefficient practices can persist longer without the interruption of bankruptcy because the government can, and does, simply allocate more money to programs and agencies as they become more costly.

Measuring public sector performance is fundamentally difficult since there are seldom output prices and often no competition. In the private sector, the presence of prices for products and services means statisticians can compare the cost of inputs (capital, wages, rent, etc.) to the price of outputs (final product/service). The ratio of outputs to inputs—productivity—is readily identifiable in the private sector and is used to compare the performance of firms within a given sector or across sectors. That same comparison cannot be made in the public sector for two reasons. First, the lack of output prices makes it impossible to get a measure of productivity. Second, no comparisons can be made where government is a monopoly service provider. Having said that, there have been some improvements to measuring the efficiency of specific services, such as public health and education, which have more readily identifiable outputs.<sup>9</sup>

### Exceptions to monopoly in the public sector

There are important exceptions to the aforementioned monopoly issues in providing public services.

#### 1. Where government provides a service already provided for in the private market, and is competing with private enterprise.

Prime examples are the ABC and SBS, which compete with private free-to-air channels, particularly in broadcasting news and current affairs. It is much easier for government to benchmark performance and cost efficiency of the public broadcasters since there are obvious comparable inputs and outputs to measure.

**2. Where governments 'marketise' the provision of government services.** Though much of government operates as a monopoly, some functions can still be subjected to limited market pressures. For example:

- a. State governments have the sole responsibility for prisons but contract out the operation of individual prisons to private companies.
- b. States also run hospitals but occasionally outsource patient care to private hospitals.<sup>10</sup> Public hospitals often have private wings, and medical practitioners working in these hospitals are often contractors.<sup>11</sup>
- c. Governments also have franchising arrangements for public transport services whereby private companies are contracted for maintenance and operations, such as the ferries in Brisbane, or the trains and buses in Melbourne.<sup>12</sup>

### What is the efficiency dividend?

The efficiency dividend is 'the most readily acknowledged across-the-board budget mechanism for promoting improvements in agencies' efficiency.'<sup>13</sup> It is designed to create general pressure on the budgets of government agencies so that administrators continually look for cost savings and efficiencies, and redirect funds to higher-priority activities. The rationale is that:

As the public service continually becomes more productive, there is room for cutting public sector inputs by the rate of increase in productivity (or something less) without changing the level of output.<sup>14</sup>

Essentially, government expects that over time, agencies should deliver to the public the same quality and quantity of service (or perhaps greater) with fewer resources. The efficiency dividend has been applied, at various rates, until today since it was introduced by the Hawke government in the 1986–87 Budget.

Since 2008, the government has introduced two additional one-year rates. The public service has been generally operating on a base 1.25% efficiency dividend since 2008. There was an additional impost of 2% applied in the financial years 2008–09 and 2012–13.

### Scope and application

As mentioned earlier, the efficiency dividend is an across-the-board cut, in real terms, of the funding that agencies receive for their overall running costs.<sup>15</sup> Agencies may receive money either from appropriations handed out in the budget, or from taxes and other fees levied on industry. Some agencies do not receive any of their funding from budget appropriations, and are exempt from the dividend. In 2011, the Commonwealth efficiency dividend applied to 66% of agencies.<sup>16</sup> Roughly 30% of agencies were not subject to the dividend because they did not receive budget appropriations.<sup>17</sup>

The agencies that receive appropriations from the budget receive appropriations for departmental expenses and administered expenses.

Departmental expenses refer to an agency's running costs and include employee wages, supplier expenses, depreciation/amortisation, and other operational expenses.<sup>18</sup> Administered expenses relate to funding within programs such as grants (e.g. for the arts); subsidies (e.g. industry assistance); and benefit payments (e.g. pensions).

The efficiency dividend is applied to departmental expenses, not administered expenses. This is because the dividend is not designed to cut into funding designated for government programs but to affect the funding that government agencies use to administer those services. Agencies have little control over which programs and payments they administer on behalf of government, but do have control over the resources they use to administer programs.

Each year, the appropriations agencies receive for departmental expenses are adjusted. This is based on the previous year's appropriations, and is adjusted for changes to the agency's functions (in terms of the

**Table 1: Annual rates of Commonwealth efficiency dividend since 1987**

Period	Annual rate
1987–94	1.25%
1994–2005	1.00%
2005–08	1.25%
2008–09 (base rate of 1.25% + additional single-year 2% impost)	3.25%
2009–11	1.25%
2011–12	1.50%
2012–13 (base rate of 1.25% + additional single-year 2% impost)	3.25%
2013–14	1.25%

Source: Nicholas Horne, *The Commonwealth Efficiency Dividend: An Overview* (Parliamentary Library, 2012), 7.

policies and programs they administer) and indexed for minimum wage growth. The dividend is applied to this portion of appropriations. It has been in place for roughly 25 years at the federal level, but most state and territory governments also apply, or have applied, efficiency dividends to their budget appropriations.

Apart from agencies that receive revenue exclusively from taxes and other fees, some agencies, despite receiving budget appropriations, have been exempted from the efficiency dividend. These include the ABC and SBS, due to electoral commitments to 'maintain the real level of funding for each broadcaster,' and Safe Work Australia, due to co-funding by federal and state/territory governments.<sup>19</sup> Other agencies with partial exemptions include:<sup>20</sup>

- Commonwealth Scientific and Industrial Research Organisation (CSIRO)
- Australian Institute of Marine Science (AIMS)
- Australia Council for the Arts
- Australian Customs and Border Protection Service
- Australian Nuclear Science and Technology Organisation (ANSTO)
- Department of Defence (DoD)

After accounting for exempted agencies and scope, the efficiency dividend applied to approximately 6.5% of total federal budget outlays in 2011.<sup>21</sup>

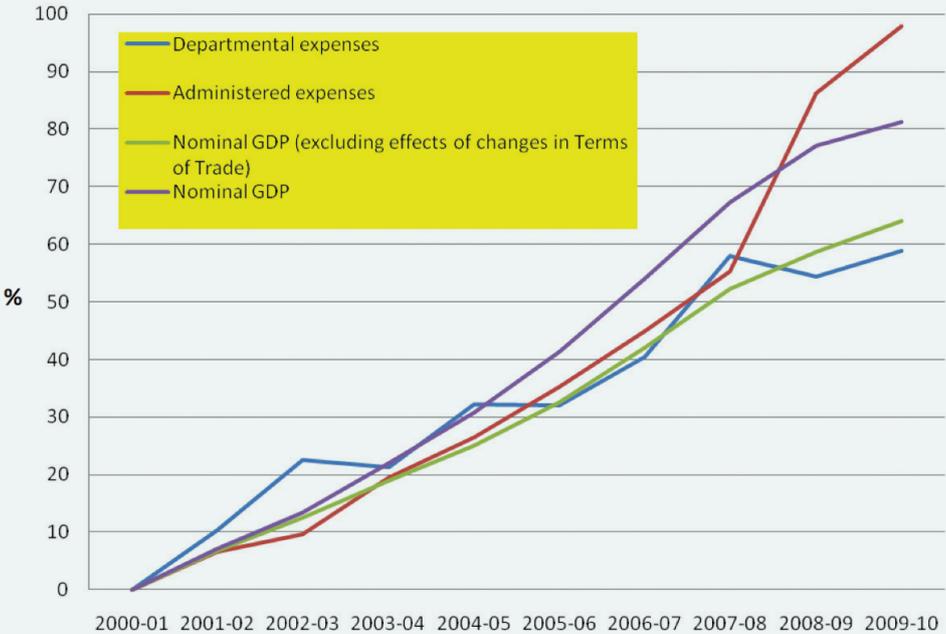
### Trends in federal expenses

The Commonwealth Review of the Measures of Agency Efficiency in 2011 found that departmental expenses (the part of agency expenses subject to the dividend) grew from \$32 billion to \$52 billion (59%) between 2000–01 and 2009–10.<sup>22</sup> Administered expenses grew from \$147 billion to \$292 billion (98%). Until 2007–08, growth in departmental and administered expenses was roughly in line with growth in nominal GDP (Figure 1). When the effects of changes in the terms of trade are accounted for, the trends are even closer.

However, things changed after 2007–08 when there was a large run-up in administered expenses. The review points to the government’s fiscal stimulus response to the global financial crisis as the key driver of the spike in administered expenses since 2007–08. The proliferation of spending initiatives, and the large amounts spent on those programs (cash grants to families and individuals as well as other initiatives such as the Building the Education Revolution (BER) program) during the global financial crisis, accounts for the growth in administered expenses.

Once again, the statistics show a large departure in administered expenses coinciding with the global financial crisis. More so, the growth in nominal administered and departmental expenses has grown substantially over the past decade. Despite continual operation of the efficiency dividend, departmental

**Figure 1: Cumulative growth in nominal expenses (departmental and administered) compared to GDP (2000–01 to 2009–10)**



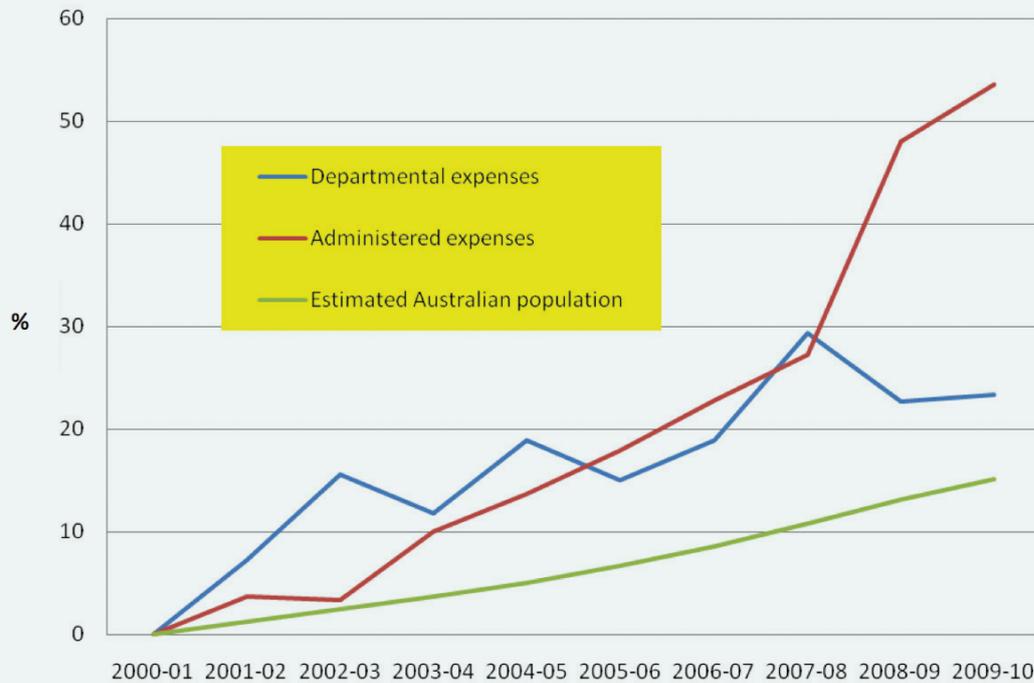
Source: DoFD (Department of Finance and Deregulation), *Report of the Review of the Measures of Agency Efficiency* (Canberra: March 2011), 14.

expenses have still grown 23% in real terms over the decade, and administered expenses grew at roughly the same rate before spiking during the global financial crisis.<sup>23</sup>

New programs and initiatives appear to be driving the need for more and more spending. Indeed, at the onset of the global financial crisis, when the Rudd government gave large one-off cash payments

to households (in addition to other spending), administered expenses grew much faster than departmental expenses. The cash payments required minimal additional public service resources apart from the actual grants being paid. Developing and implementing an entirely new program would have meant a far greater impost on the public service. Instead, the main cost was the actual grants to families, which is reflected in administered expenses.

**Figure 2: Cumulative real growth in nominal expenses (departmental and administered) compared to population growth (2000-01 to 2009-10)**



Source: DoFD (Department of Finance and Deregulation), *Report of the Review of the Measures of Agency Efficiency* (Canberra: March 2011), 14.

**Figure 3: Number of ongoing and non-ongoing APS employees (1990-2013)**



Source: APS (Australian Public Service), *Statistical Bulletins* (Canberra: 1991 to 2013).

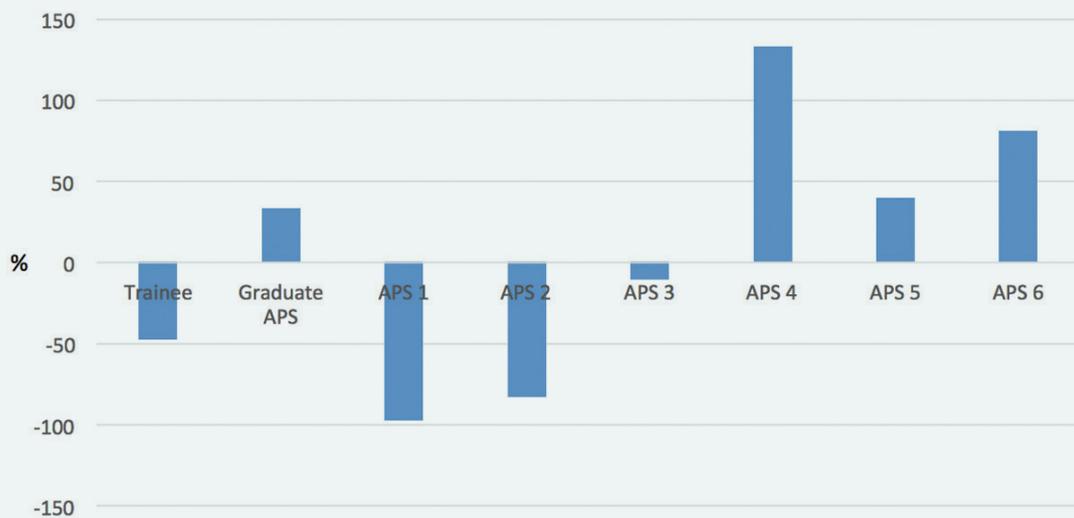
## Has the efficiency dividend curbed the cost of the public service?

The federal public sector employs 248,000 people, 67% (or 167,257) of whom belong to the Australian Public Service (APS).

Since the mid-1990s, the size of the APS has changed considerably. Large cuts in the service enacted in the 1990s by the Keating and Howard governments were completely reversed from 2000 to 2007. The ongoing workforce decreased by approximately 30% from 1992 to 1999. By 2007, employee numbers had risen back to 1992 levels, but with one distinct difference.

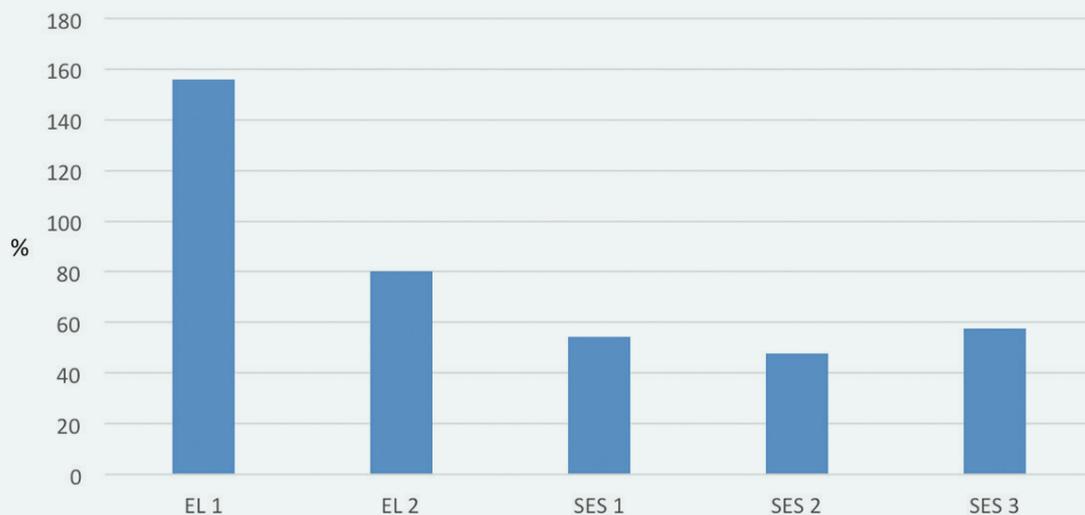
The composition of the ongoing (i.e. permanent) APS workforce has changed significantly since the early 1990s (Figure 4). Entry-level positions such as trainees and APS classifications 1 and 2 dropped precipitously throughout the 1990s, and continued to decline until 2013. Since 1991, the number of APS1 employees has reduced from 30,437 to 776 (98%) and the number of APS2 employees has shrunk from 18,983 to 3,282 (83%). Higher up the APS, the trend is reversed. The number of APS6 employees grew from 18,172 to 32,837 (81%) over the same period.

**Figure 4: Growth of ongoing APS1 to APS6 employees (1991–2013)**



**Source:** APS (Australian Public Service), *Statistical Bulletins* (Canberra: 1991 to 2013).

**Figure 5: Growth of ongoing EL and SES employees (1991–2013)**



**Source:** APS (Australian Public Service), *Statistical Bulletins* (Canberra: 1991 to 2013).

The growth is even more pronounced in the executive level (EL) and special executive service (SES) classifications. Over the same period, EL1 classifications grew from 11,191 to 28,634 (156%) and EL2 classifications from 7,262 to 13,087 (80%). SES classifications grew from 1,788 to 2,736 (53%).

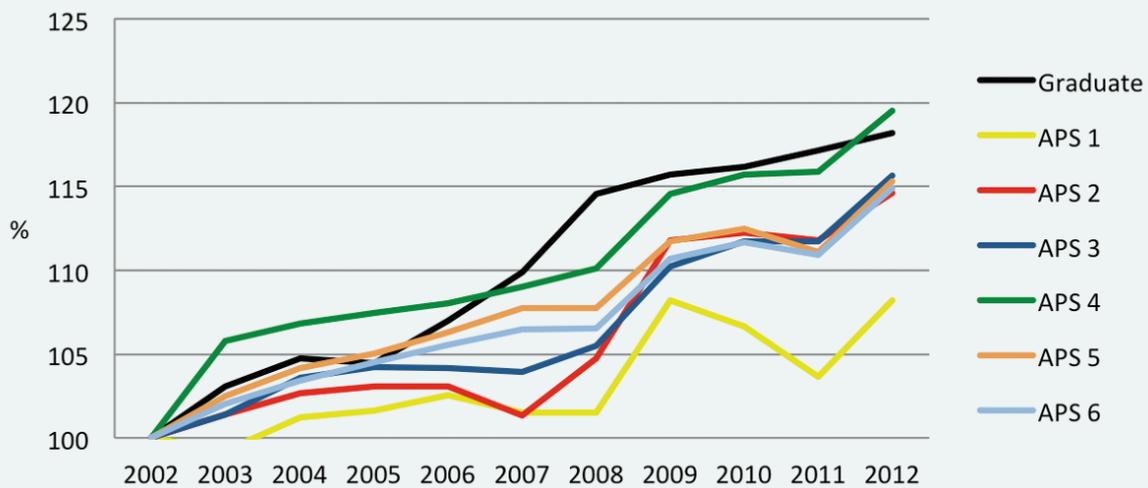
So while the lower levels of the APS have been hollowed out, outgoing employees have been replaced by higher-grade workers earning larger salaries. The public service has become top heavy. There are many more managers, more highly trained executives, and fewer entry-level employees. This has big implications for the public services' wage bill. While Australian taxpayers are not necessarily paying for many more

public employees compared to two decades ago, they are paying far more for those public servants.

Lindsay Tanner, then shadow minister for finance, highlighted the problem in 2007:

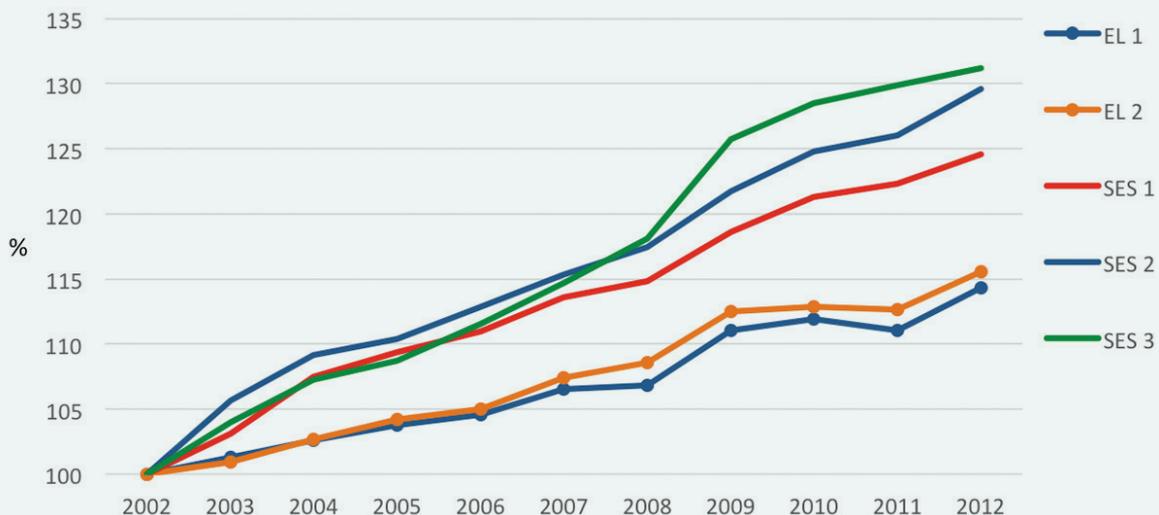
The government have expanded the Public Service back out to where it was but with one important caveat, and that is that there are fewer workers, fewer people actually delivering services on the ground, and a lot more chiefs, a lot more fat cats, a lot more people at the top end earning very high salaries.<sup>24</sup>

**Figure 6: Cumulative real growth in median base salary (2002–12)**



Sources: APS (Australian Public Service), *Remuneration Report 2012*; ABS, 'Consumer Price Index,' Cat. No. 6401 (March 2012).

**Figure 7: Cumulative real growth in median base salary (2002–12)**



Source: APS (Australian Public Service), *Remuneration Report 2012*; ABS (Australian Bureau of Statistics), Consumer Price Index (various years).

The changes in the composition of the APS go some way to explaining why, for example, between 2007–08 and 2012–13, the total number of employees in the federal public sector increased by 4.8% while employee wages and salaries rose by 28.7%.<sup>25</sup>

But there has also been growth in employee remuneration. Complete data on remuneration does not trace as far back as employee head counts gathered in the *APS Statistical Bulletins*. However, data show that in the 10 years from 2002, employee base salaries for graduates and APS classifications grew between 15% and 20% in real terms (adjusted for inflation).<sup>26</sup> The only exception was APS 1 classifications, whose base salaries grew by 8%.

Again, the most significant story is at the higher classification level. While base salaries have grown at a healthy pace for EL employees (each around 15% in real terms), SES salaries have grown much faster (Figure 7).

Base salaries for SES employees have grown between 25% and 30% in real terms over the past decade. Not only has the number of high-grade employees grown at an alarming rate, but the growth of their salaries is also a worrying trend. The combination of these two trends has significant implications for the budget.

At first glance, there is no obvious reason why the APS requires so many more high-level employees. The 2010–11 *APS State of the Service* report notes that from 1984 to 2002, the size of the SES was relatively stable with minor variations reflecting budgetary changes or organisational change.<sup>27</sup> Since 2002, the SES has risen by 53%. The public service played an important role in policy formation and giving advice to the government during the microeconomic reform era of the 1980s. But as Professor Stephen Bartos, former deputy secretary of the finance department, notes:<sup>28</sup>

The numbers of senior executives we needed during 18 of the most turbulent years of APS history (microeconomic reform, the recession we had to have, opening up the economy to international competition, sales of large government assets, APS reform, devolution, market-testing) remained more or less the same ... But, in the comparatively easier eight years since 2003, the number of senior executives has blown out by 50 per cent.

A review of the SES in 2011 found strong links between the growth in the SES and the growth in the number of programs administered by the APS.<sup>29</sup> The review also pointed to other factors such as the heightened national security environment, the complexities of climate related issues, the global financial crisis, and immigration.<sup>30</sup>

However, the report also found:

Growing regulation, increasing scope and use of judicial review, increasing frequency of cabinet meetings outside Canberra, increasing number of high-level negotiations

associated with an ambitious Council of Australian Governments reform agenda, and an increasingly fraught and complex international environment.<sup>31</sup>

So while more is expected of the public service, there are also unnecessary programs and regulations (and unnecessary staff) that continue to consume valuable resources. Bartos also points to easy money and a lack of ministerial oversight as important contributors.<sup>32</sup>

One possible explanation for the growth in APS 5 and APS 6 (and the decline in APS 1 and APS 2) classifications is that employees at lower classifications are being promoted as a means of giving them a pay rise over and above wage caps. Governments impose a restriction on wage increases for the public sector—no wage increases over and above inflation (CPI or another wage index) without productivity improvements. An employee must apply for a job at a higher classification to get a substantial wage increase. If this is happening on a larger scale, it means the wage cap is being gamed, and that tasks that used to be performed by workers at APS 1 and APS 2 classifications are now being performed by workers on higher pay classifications.

## Problems with the efficiency dividend

The efficiency dividend is a relatively simple instrument governments can apply to appropriations. This is perhaps its chief advantage. It is predictable and the savings made are obvious insofar as they affect the budget bottom line. The dividend applies pressure indirectly, rather than directly, and provides incentives to managers to find savings in areas of their choosing.<sup>33</sup>

Despite these advantages, the efficiency dividend has several flaws.

1. **Scope and size:** The efficiency dividend is applied to appropriations for an agency's departmental expenses (see p. 4). It is also not applied to all agencies. In 2011, it applied to roughly 66% of federal agencies, which equated to just 6.6% of the federal budget.<sup>34</sup>
2. **Indiscriminate:** Perhaps the chief criticism of the efficiency dividend is that it does not specifically target wasteful, unnecessary or inefficient agencies. It is applied to most agencies without taking into account differences in funding arrangements.<sup>35</sup> Instead of cutting back known inefficiencies or irrelevant agencies, the efficiency dividend applies to efficient and inefficient agencies alike. It has the perverse effect of punishing agencies that have already achieved efficiencies, and rewarding those that can hide additional savings to use at a later time, such as during 2008–09 or 2012–13 when an additional single-year impost was applied to the baseline dividend percentage.<sup>36</sup> This fact is simply part of the dividend's design and the difficulties that exist in measuring productivity and efficiency in the public sector. If it were possible to measure productivity in the public

sector the way it is measured in the private sector, it would be possible to apply different efficiency dividends for different agencies, or to different departments. It would also be much easier to compare productivity levels with the private sector. As it stands currently, there is no clear connection between the dividend and any actual efficiency measures.<sup>37</sup>

One of the efficiency dividend's positives is that it forces some accountability on agency managers while still allowing them the flexibility to prioritise functions and expenses. However, this also allows the responsible minister to avoid making tough decisions about which programs are working more efficiently than others, which programs are not meeting objectives, and which programs are not worth the resources they are consuming.<sup>38</sup> The dividend allows the minister to simply outsource these decisions to agency heads and let them make the cuts. That may be successful if there are obvious cuts to be made, but not so easy if entire programs or even entire agencies ought to be cut. In addition, the priorities of the minister may not always align with the priorities of the agency manager. The manager of an agency that has outlived its usefulness will not easily suggest abolishing the agency when it means eliminating their own job, and those of their colleagues. Nor will they easily abolish programs they favour.

3. **Revenue base:** An agency's revenue comprises budget appropriations and proceeds from other taxes and fees. Since the efficiency dividend is applied to budget appropriations and not to other forms of an agency's revenue, there can be quite large differences between the proportion of an agency's revenue that is subject to the dividend.

An agency will feel more pressure from the efficiency dividend if a large part of its revenue comes from budget appropriations. Agencies who receive most of their revenue from taxes, levies and other fees will find themselves to a greater extent immune from the cutbacks made via the efficiency dividend. This means through no fault of their own, and from factors entirely out of the agency's control, certain agencies will find themselves under much greater fiscal pressure than others.

4. **Agency size:** An agency's size can have considerable effect on the agency's ability to find efficiencies and deal with a cutback in budget appropriations. Smaller agencies have two distinct disadvantages compared to larger agencies:
  - a. Poorer economies of scale
  - b. Lower ability to obtain funding for new policy proposals.

In a submission to an inquiry into the effects of the efficiency dividend on smaller agencies, the Australian Electoral Commission (AEC) noted that for some smaller agencies, 'Overheads such as IT, property and security comprise a disproportionate share of their budget.'<sup>39</sup> As a result, a large proportion of expenses are fixed. They then have a very small amount of their budget from which they must try to create savings to cope with the efficiency dividend.

So while a sizeable cut in appropriations may be easily managed by larger agencies with larger economies of scale and more manageable overheads, smaller agencies are under greater pressure. In circumstances where agencies have been unable to find additional efficiencies, some have responded by reducing services and laying off workers.<sup>40</sup> Reducing services via staff reductions is not the intention of the efficiency dividend. It may be the case that some agencies are overstaffed, but if that were the case a reduction in staffing should not compromise service obligations.

5. **Gaming:** The efficiency dividend is prone to gaming by agencies unable or unwilling to drive efficiencies. Agencies can obtain additional funding for new work/programs the government seeks to implement by submitting new policy proposals. The opportunity to advance new policy proposals is available to all ministers and the agencies in their portfolio.<sup>41</sup> If approved, these new proposals will be granted with additional funding. The agency can then use at least part of these funds to help alleviate pressure from the efficiency dividend. This has two negative effects: negating the intention of the efficiency dividend, and leading to a raft of policies and programs that are not genuinely pursued.

## Measures for greater public sector efficiency

Though the efficiency dividend has advantages in its simplicity and pressure on management, it is unlikely to be the most appropriate means of driving efficiency in the public sector.

The growth in the cost of the public service has several drivers, and government will need to tackle these drivers if agencies are to continue to find efficiencies. It is clear that one of the major drivers of the cost of the public service is the growth in new programs and policies. While the public service has a pivotal role in the formulation of new policies and services, not all new programs will be successful, and not all will be worth the resources required to fund them. Some programs should not have government involvement at all. If the growth of new policies and programs is also driving up the demand for high-skilled (and high-salaried) employees, then these new proposals require initial and ongoing scrutiny.

### Efficiencies through enterprise bargaining?

As early as 1992, some of the shortcomings of the efficiency dividend had been highlighted. The report *The Australian Public Service Reformed: An Evaluation of a Decade of Management Reform* noted that the dividend failed to consider the difference between agencies.<sup>42</sup> It suggested that the future of the efficiency dividend lay in resource agreements and enterprise bargaining, rather than arbitrary annual reductions in appropriations for running costs.<sup>43</sup> This proposal was echoed in the 1995 report *Keeping the Customer Satisfied: Inquiry into the Devolution of Running Costs Flexibilities*.<sup>44</sup>

Government policy in several states stipulates that the government will not award wage increases over and above a specific percentage for inflation indexing unless offset by efficiency or productivity improvements. Those productivity improvements would be compensated by additional wage increase above indexation. The approach of attaining productivity/efficiency gains through enterprise bargaining negotiations comes from attaining savings by removing restrictive work practices, or adopting new technologies/work practices.

The government's primary objective here may be to keep costs under control, but motivating the union and the workforce to embrace a productivity agenda would allow departments to change workplace practices with less resistance.

The problem with this strategy is enforcing agreed productivity improvements. Enterprise bargaining as means for driving efficiency has been used in several states, and in practice agreed efficiency improvements do not eventuate. Part of the problem here may be that those involved in the bargaining process are far removed from the day-to-day workings of lower level public servants, and thus, do not know where savings can be made. Public servants have their own

incentives, and unsurprisingly, will not easily offer up solutions that will lead to the termination of their own (or their colleagues') jobs. In addition, the inability to accurately measure productivity in the public sector creates additional problems for administrators looking to enforce agreed productivity improvements. This does not mean any attempt to improve productivity/efficiency through enterprise bargaining negotiations should be abandoned. Rather, it is not a suitable substitute for the efficiency dividend.

### Competition in public service delivery

One of the ways government can drive greater efficiency in the public sector is to introduce greater competition. Even where government has the sole responsibility for delivering public services to its citizens, it can inject competitive pressures into the delivery of these services via different means. Gary Sturges points to three different types:<sup>45</sup>

1. **Choice based markets:** Customers (or taxpayers) use funds provided by government to select from a number of approved suppliers. These schemes operate essentially as vouchers, such as the Medicare card used locally to purchase health care services, or for the proposed National Disability Insurance Scheme.
2. **Commissioned markets:** Private companies bid for the right to provide services to taxpayers through a tender. The winning company secures a contract and operates as a monopoly for a defined period of time, after which the government can re-tender.
3. **Contestability:** The performance of service providers is benchmarked and they face the threat that the government will source alternatives if the providers fail to deliver results.

Not all of the above options will be applicable to all public service agencies. The appropriate option will depend on the service in question. For example, health care or education options can be served by vouchers, since consumers can choose from a range of private sector options using public funds. This option is not possible for the provision of national defence equipment (fighter jets, armaments, submarines, etc.) since government must be the sole purchaser and provider of national defence. A commissioned market for defence equipment may be more appropriate.

Increasing the role of the private sector in providing public services has been a growing trend in recent decades, both nationally and internationally. But it should be noted that there are already various areas of our economy with significant private sector involvement. At home, around 17% of Australian prisoners are held in privately managed correctional institutions.<sup>46</sup> In Victoria, that proportion is 34%. In health, there are 768 public and 556 private hospitals,

with 40% of inpatients treated in private hospitals.<sup>47</sup> There are often privately financed hospitals where state governments have contracted a private company to design and construct a new hospital, or to manage the operations of a public (or private) hospital.<sup>48</sup> Roughly 35% of Australian children attend a private school, and 39% of secondary school students go to private schools.<sup>49</sup>

In sectors where public and private providers deliver similar services, it is possible to make meaningful comparisons regarding performance and cost between private and public provision.

- In the realm of public transport, a study comparing like-for-like rail services between international operators and Sydney's CityRail (NSW government owned and operated) indicated operating costs were 23% lower for international operators.<sup>50</sup>
- The Productivity Commission conducted a comprehensive study comparing 368 public acute hospitals in Australia and 122 private hospitals (for-profit and not-for-profit).<sup>51</sup> It found that 'In 2007–08, the general hospital cost per "casemix-adjusted separation" was about 30% higher in public hospitals compared to private hospitals.'
- In 2005, the NSW Parliament's Public Accounts Committee released a report titled *Value for Money from NSW Correctional Centres*. This report found that health services in the privately operated prison in Junee were less than half the cost of those in publicly managed prisons.<sup>52</sup> It also noted that the average daily expenditure on an inmate was half the cost in Junee than in the public prisons. Though Junee had cost advantages over the public prisons, the cost differential was still quite stark.

Government should extend competitive pressures further into the public service than traditional areas such as health and education. This does not necessarily mean contracting with the private sector for providing government services. Governments should explore benchmarking the performance of public sector agencies to compare them with private sector equivalents. Sometimes this step is enough to kick-start better performance since agencies know that if their services are consistently more expensive than private equivalents, or if they consistently fail to deliver adequate results, the government will go elsewhere.

There are two main benefits to introducing greater competition and choice into the public service, and not all relate to cost.

First, it motivates measurement. If the government is to consider contracting services to a private company, or at least to benchmark public agencies against private sector counterparts, it must focus attention on outputs and outcomes rather than inputs. The government is forced to come up with a specific definition of the services it wants if it is to outline its expectations to a prospective private contractor. These outputs and

outcomes become the indicators the government looks to when deciding who or which agency to contract – private, public or a combination of the two.

Second, involving the private sector in public service provision will stimulate greater innovation. As companies compete for the rights to provide public services, or as several contracted companies compete to outperform each other, they will experiment both with new approaches to delivering services or novel ideas for reducing costs. There are incentives both to increase quality and to reduce costs. Though innovation is possible in the public sector, it is less likely than in the private sphere, just out of the sheer size and number of competing firms in the private sector.

## Regular agency review

The government should also look to conduct comprehensive yearly audits of agencies/portfolios for efficiency by an external and independent body, such as the Productivity Commission's Review of Government Services. Regular review was proposed in the government's review of efficiency measures to develop alternative ways of promoting efficiency.<sup>53</sup>

Having regular review agency efficiency helps collect performance literature and provide an evidence base that ministers and policymakers require to make an informed decision. By giving greater attention to measuring results and outputs (rather than inputs), the government can build a narrative around both the efficiency and effectiveness of programs and policies. It would also act as an opportunity to reassess the merits of spending initiatives, and decommission programs that are not meeting objectives or are consuming too many resources.

For agencies that perform similar functions, such as those producing research or regulatory oversight, the gradual build-up of performance metrics could allow agencies to benchmark performance against each other, and for best practice to be replicated. The benchmarking process could also assist the government in making decisions about possible private sector involvement.

Regular review would help overcome some of the major criticisms of the efficiency dividend. First, it would eliminate the indiscriminate nature of the dividend by giving a performance appraisal specific to the agency. This would mean that smaller agencies with fewer options to increase efficiency would not be put under the same funding pressure as larger agencies that can use economies of scale. Second, because the review would assess the effectiveness of new policies, it would also reduce the ability of the agency to 'game' the new policy proposals system.

The audits would report to the relevant minister, and the agency head tasked with providing information for the audit process would also be responsible for implementing the review's recommendations. Some additional resources would be required to increase the capacity of the Review of Government Services such that it is able to conduct the sort of comprehensive review that is needed.

## Conclusion

Pursuing efficiency in the public sector is difficult. In the private sector, competition creates ongoing pressure on businesses to reduce costs and pass on those savings to consumers. The public sector lacks these important incentives.

Australians expect government to deliver high-quality public services; however, they are also acutely aware of the share of their income they sacrifice for these services.

The efficiency dividend has been the central instrument in government's attempts to drive efficiency and deliver value for money in the public sector. But it has fundamentally failed to contain costs in the public service, particularly in relation to the workforce itself.

Since the early 1990s, the public service has become top heavy. After the public sector cuts of the mid- to late-1990s, the number of EL and SES employees has ballooned. There has also been significant growth in salaries, particularly at the top end. There are now many more high-skilled, high-salaried executives in the public service and fewer on-the-ground workers. This has serious implications for the cost of the public service.

Several reviews of the efficiency dividend have come back with the same conclusion—the government needs more targeted and confronting measures to drive efficiencies in the public service.

Government should where possible increase competition in providing public services by involving the private sector. This may take the form of publicly funded vouchers for taxpayers to buy from the private market, involve contracting out some government services to the private sector, or simply mean a contestable market where public agencies continue to provide services, but where their performance and efficiency are benchmarked against private sector equivalents. This additional measurement and competitive threat will help motivate better use of public resources.

Comprehensive yearly reviews of government agencies/portfolios are an essential part of ensuring value for money for taxpayers. The government needs quality, independent advice to make informed decisions about which agencies and programs are worthwhile, which can become more efficient, and which should be scrapped.

The public sector is fundamentally different from the private sector. Private businesses will grow and decline, and this ongoing process of renewal brings regular change. The public sector on the other hand requires constant reform to keep it effective and efficient. It is incumbent upon government to continually review its functions to ensure taxpayers are getting their money's worth.

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## REDUCING THE BURDEN FOR FUTURE GENERATIONS

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