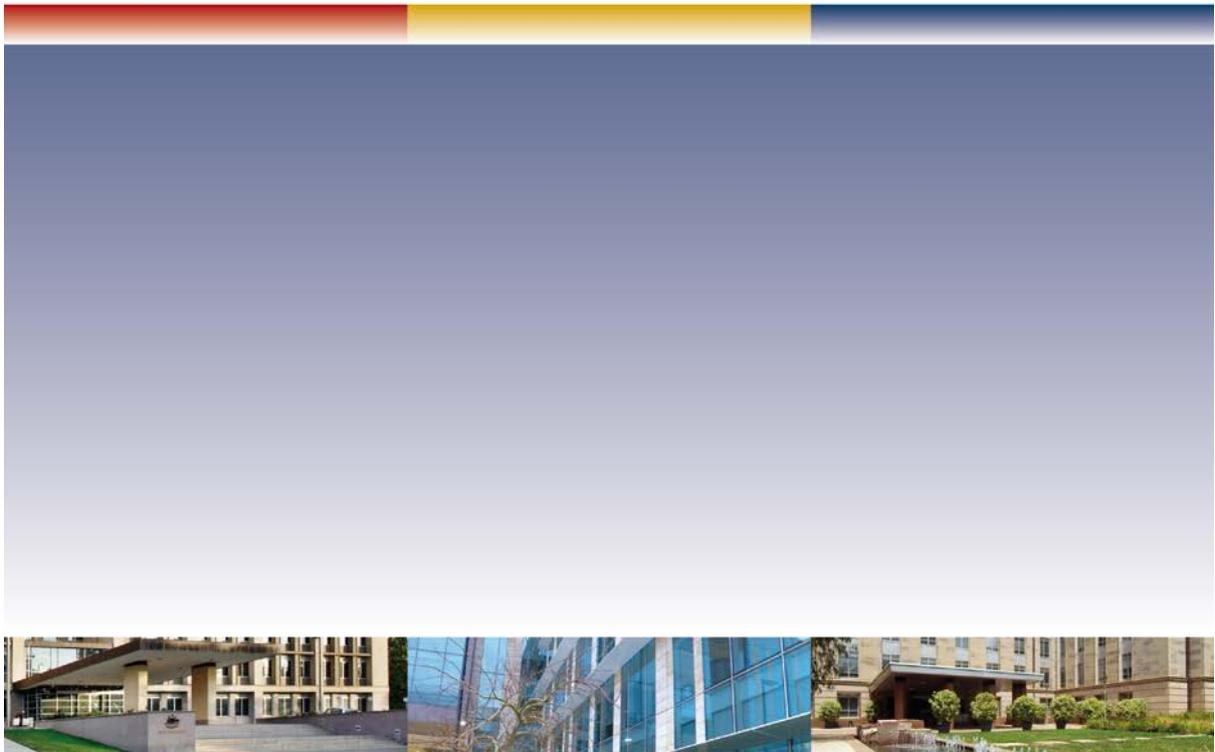




Australian Government

Report of the Review of the Measures of Agency Efficiency

March 2011



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From a purely technical point of view, a bureaucracy is capable of attaining the highest degree of efficiency, and is in this sense formally the most rational known means of exercising authority over human beings. It is superior to any other form in precision, in stability, in the stringency of its discipline, and in its reliability. It thus makes possible a particularly high degree of calculability of results for the heads of the organization and for those acting in relation to it. It is finally superior both in intensive efficiency and in the scope of its operations and is formally capable of application to all kinds of administrative tasks.

——Max Weber

The key problems in public administration—legality—and public management—efficiency—refer to contractual difficulties between the principal and the agent, resulting from incentives, asymmetric information and incomplete contracts.

——Jan-Erik Lane

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Summary

The Review of the Measures of Agency Efficiency was asked to consider two primary questions:

- What is the best way of promoting efficiency in government on a continuing basis?
- Are there suitable alternatives to the Efficiency Dividend that would return at least an equivalent level of savings to the budget?

The Efficiency Dividend has been a feature of the Australian Government's budget framework since 1987–88. It aims to do the following:

- give managers the incentive to continually seek new or more efficient means of carrying out continuing government business
- allow government to redirect a portion of efficiency gains to higher priority activities
- clearly demonstrate Public Service efficiencies resulting from improvements in management and administrative practices.

Notwithstanding reasonable expectations of increases in productivity over time, providing to agencies gradually decreasing funding for, in theory, the same level of output and quality remains a contentious policy within government, particularly in view of other budgetary pressures such as cost and wage increases.

Consultations

The review consulted widely with interested parties throughout the Australian Government: it had more than 40 face-to-face discussions, held teleconferences and distributed a questionnaire to more than 160 government bodies. The purpose was to gain an understanding of what promotes efficiency and the budget behaviours associated with the Efficiency Dividend. The review also canvassed views on possible alternatives to the existing policy.

The consultations confirmed that within government agencies there are strong feelings about the Efficiency Dividend and, although these feelings were often negative (not surprisingly given that the Efficiency Dividend puts pressure on agencies to achieve operating savings), there was a high level of acceptance of the need for government to seek efficiencies from public service activities.

Beyond government, the review held a consultation with the Community and Public Sector Union as well as two major private sector businesses in order to obtain a private sector perspective on efficiency.

The measures of efficiency

There is no accepted or reliable way of measuring the relative efficiency of the public sector. This problem is acknowledged internationally and is a crucial factor when considering **alternatives to the existing Efficiency Dividend or how to encourage efficiency more broadly**. Some of the main obstacles to measuring public sector efficiency are the difficulty of accounting for changes in quality and lack of a market price for many public sector outputs.

Benchmarking of common functions and services offers some opportunity to develop better measures of efficiency. Many agencies consulted during the review noted the value of benchmarking services or activities common to a group of agencies as a way of encouraging efficiency through sharing information about best practice. **The review proposes that the benchmarking of common functions be pursued in a more coordinated manner**. This is a difficult but necessary task, since the devolved nature of the Australian Government has over time led agencies to develop different business systems and processes.

What promotes efficiency

Overall, the review found that agencies were pursuing efficiency as a matter of necessity, so that they can continue to improve services, retain and attract staff, manage the impact of the Efficiency Dividend, accommodate general increases in costs, and respond to emerging ministerial priorities. Although departmental outlays have grown in real terms since 2000–01, agencies argued that growth in actual workloads has been higher still.

The review notes that generally agencies have flexibility in terms of their outputs and outcomes—in particular, in policy, coordination and research areas. In the public sector this means managers tend to maximise the quality of outputs for a given price, rather than reducing the price for a given output, as is more likely to occur in the private sector. Given this paradigm, an external mechanism is required if a reduction in the cost of a output is the desired outcome.

Barriers to efficiency

Agencies reported that efforts to promote efficiency were in some contexts constrained by the lack of funding to manage upfront business re-engineering costs (typically in relation to information and communications technology and finance systems), the limited ability to work collaboratively with other agencies, and growth in financial management and other government-mandated reporting, possibly reflecting sub-optimal risk management.

The primary question is whether the current framework provides suitable incentives for achieving efficiency. Because of the complexity of the overall budget framework, incentives might run counter to each other or have more complex interactions than is generally desirable for encouraging appropriate behaviour. The competitive nature of the budget framework, where Ministers and agencies compete for limited funding, is also likely to give rise to the perception of inequitable treatment, as agencies seek to

maximise access to resources. It is some of these interactions between elements of the framework that underpin attempts at ‘gaming’ activity whereby agencies seek to exploit one element of the system to offset other elements—particularly by drawing in additional funding through the new policy proposal process.

The options

The review was asked to consider whether alternatives to the Efficiency Dividend would generate at least an equivalent level of savings to the budget. Most agencies the review consulted could identify the problem but, importantly, could not suggest an alternative that would readily improve existing arrangements when taking account of the criteria set for the review—particularly the requirement to consider budget neutrality.

The review examined a range of options in relation to the Efficiency Dividend:

- Consider modifications to the application of the Efficiency Dividend with a view to improving its presentation and moderating its impact on agencies that are most likely to be disproportionately impacted by its current application.
- Apply the Efficiency Dividend at a portfolio level and give portfolio ministers flexibility to determine the specific agency contributions.
- Introduce a sliding scale for the Efficiency Dividend that would result in smaller agencies (determined by size of appropriation) contributing proportionally less to the overall target and larger agencies more.
- Replace the Efficiency Dividend with a departmental funding framework whereby overall departmental funding is both more tightly constrained and more closely connected to the maintenance of real value.

Beyond these options, the review identified several strategic directions for promoting efficiency, as set out in the following section.

Some of the agencies consulted raised the perceived disproportionate impacts on smaller agencies as the aspect of the Efficiency Dividend worth most attention. There was, however, general acknowledgment that the size of an agency is not the sole determinant of its ability to find efficiencies.

A move away from the near-universal application of the Efficiency Dividend would have implications for the robustness of the existing budget framework. Indeed, such modifications might even remove an incentive for efficiency in some agencies. Similarly, providing relief to a group of agencies would necessitate bigger contributions from other agencies if budget neutrality were to be maintained.

The rationale for bigger agencies making a bigger contribution to the overall budget savings generated by the Efficiency Dividend is not strong and could potentially generate arguments about where the threshold should be set, although such an idea has some appeal as a way of redressing current perceived inequities. On balance,

however, the review does not support a sliding scale as there is no strong evidence that all smaller agencies are disproportionately affected by the Efficiency Dividend.

Both short-term and longer term actions are needed in order to ensure that incentives are well targeted towards agency efficiency.

In the short term the review proposes keeping the Efficiency Dividend but improving its presentation and providing flexibility for it to be applied at the portfolio level.

Although the feedback the review received from agencies, and the history of the Efficiency Dividend itself, show that there is no immediate need for any fundamental overhaul of the current system, that does not mean that there is not scope for improvement or that any system remains optimal forever. A main concern is that a proportion of nominal efficiency gains may be gamed out through a budget process which links new funding to new activity in a financial management framework that provides a high level of discretion to agencies over how resources are ultimately allocated, and without a way of measuring efficiency. Another concern is that the Efficiency Dividend provides only a limited incentive for agencies to generate substantial and strategic efficiencies.

In the longer term it is worth considering whether more fundamental changes to the budget framework would offer scope for improving resource management. The review found that agencies were very open about attempting to game the current system, and this should be taken as an invitation to think seriously about the primary frameworks—that is, the Efficiency Dividend, indexation and supplementation for new policy—and their interactions. **The review proposes that work be commissioned to explore in greater depth possible changes to the budget framework** that specifically target improvements in agencies' resource management and provide a better set of incentives for all agencies—including through a revised system of departmental funding and gain-sharing arrangements.

The types of changes to the budget framework which would need to be considered are likely to be substantial and to require tradeoffs to predictability and sustainability in resource management. Improvements in this area would also likely have flow-on benefits for risk management across government. It is important that any changes be consistent with the Government's fiscal strategy. For example, if the Efficiency Dividend was abolished, there would be a significant fiscal impact.

Development of a more strategic efficiency agenda

The Efficiency Dividend constitutes only a limited incentive for agencies to pursue ongoing efficiencies. This was confirmed by responses to the questionnaire the review circulated. **The review proposes the development of a more strategic efficiency agenda** that builds on efforts to date in recent whole-of-government approaches to procurement, accommodation and information and communication technology.

There remain opportunities to encourage substantial efficiencies that will allow the Australian Government to continue to provide to the public high-quality services that

represent value for money. The fact that there are major opportunities for efficiency that have been little touched is a striking feature of the current system. This is particularly the case in relation to back-office functions and the scope for exploiting the experience and skills of other public sector agencies. **The review proposes that an Australian Government model for standardising common processes and making greater use of shared services be developed.** The purpose should be to take advantage of scale and common business systems and processes to support more efficient operations.

Consideration of the most suitable shape of government could also offer important opportunities for promoting efficiency in the Australian Government. In particular, **the review proposes the setting of long-term objectives for rationalising the number of agencies.** Small agencies are not able to achieve the economies of scale available to larger entities. The review recognises that some small agencies already rely on larger portfolio services for some corporate support, but there is probably further scope for merging agencies and substantially reducing reporting overheads.

Rationalising the number of Australian Government bodies would necessarily be a long-term objective that could be difficult and contentious. Setting a long-term objective and creating appropriate incentives would facilitate efforts in this regard.

Recommendations in brief

1. The review recommends that, to maintain budget integrity, government retain the current Efficiency Dividend framework in the short term, with variations to allow more flexibility to re-allocate its impacts at agency level:
 - a. The Efficiency Dividend should be applied at portfolio level, from the 2011–12 Budget onwards.
2. The review recommends that consideration be given to improving the public presentation of the Efficiency Dividend and its role in the current budget framework.
3. The review recommends continuing work to develop and assess alternative ways of promoting efficiency, taking into account the broad range of incentives that operate within government and across the budget and financial frameworks. This work would also consider the impact of related processes, including strategic reviews, agency health checks, costings processes, and operating losses, noting that:
 - a. Particular consideration should be given to the feasibility of alternative models of agency resourcing, such as improving the interaction of indexation with other elements of the budget framework, including detailed study of the potential behavioural responses of Ministers and agencies to such approaches; and
 - b. Alternatives along these lines should be developed for consideration in the 2013–14 Budget, subject to a progress report from Finance and Treasury to Ministers in the 2012–13 Budget on the opportunities for further developing holistic approaches consistent with the Government's fiscal strategy.
4. The review recommends that a deliberate strategy be put in place to manage costs across government:
 - a. Such a strategy should be intended to meet, to a significant extent, the financial demands of the Efficiency Dividend;
 - b. The Secretary of the Department of Finance and Deregulation develop and promote a continuing efficiency agenda for the Australian Government; and
 - c. The Department of Finance and Deregulation should report biennially on progress with and opportunities for a continuing efficiency agenda, commencing in the 2012–13 Budget context.
5. The review recommends that actions to address efficiency and reduce cost structures into the medium term include:
 - a. Benchmarking of common functions;
 - b. Rationalisation of the number of agencies, including promotion of a set of principles to help government develop the most suitable structures; and
 - c. The development of a road-map for standardising common processes and making greater use of shared services models across the Australian

Government, taking advantage of scale, and focusing on business processes and systems, rather than organisational structures.

1 Establishment of the review

On 8 May 2010 the then Prime Minister accepted all the recommendations put forward in *Ahead of the Game: blueprint for the reform of Australian public administration*, referred to as the APS Blueprint. Recommendation 9.1 in that report called for the three central agencies—the Department of Finance and Deregulation, the Department of the Prime Minister and Cabinet and the Treasury—to review the current mechanisms used to promote agency efficiency in the Australian Public Service.¹

On 14 July 2010 the then Minister for Finance and Deregulation agreed to terms of reference for the review and the composition of a steering committee consisting of officers from the central agencies (see Appendix A). Following the federal election the new Minister for Finance and Deregulation, Senator the Hon. Penny Wong, confirmed that the review would proceed as planned.

Scope and focus of the review

The review's terms of reference ask it to consider how best to promote efficiency in the Australian Government on a continuing basis. They specifically ask the review to report on the impact of the Efficiency Dividend and on potential alternatives to it. They also ask the review to consider the relationship between the Efficiency Dividend arrangements and wage cost indexation.

The terms of reference provide criteria against which the review is to assess the relative merits of approaches to achieving continuing efficiencies:

- appropriateness
- equitable treatment of agencies
- administrative efficiency
- behavioural effects—including potential for 'gaming'
- ability to implement for the 2011–12 Budget.

In considering alternatives to the existing Efficiency Dividend arrangements, the review was mindful of the government's medium-term fiscal strategy and its objective of bringing the budget back into surplus by 2012–13. Importantly, the review was asked to consider whether any new arrangements 'would generate at least an equivalent level of savings to the Government Budget'. If the Efficiency Dividend had been abolished in the 2010–11 Mid-Year Economic and Fiscal Outlook the negative impact on the bottom

¹ The APS Blueprint recommendation refers to the 'Australian Public Service', but it is concerned with the reform of 'Australian Government' administration: 'The reforms outlined in the Blueprint seek specifically to improve the APS as the institution with the closest legal, administrative and financial relationship with government. However, the proposed reforms are also expected to produce improvements across non-APS agencies, particularly those prescribed under the *Financial Management and Accountability Act 1997*' (p. 5).

line would have been about \$3.2 billion over four years.² For the purposes of this review, alternatives to the Efficiency Dividend therefore need to demonstrate they can generate a substantial level of savings to the budget.

Although it is appropriate to consider efficiencies as ‘savings to the budget’, the review did not approach its task as a savings exercise. Savings and efficiencies are distinct concepts, and the government’s budget rules reflect the differences. An efficiency cannot, by definition, involve a reduction in the level of agreed output or quality for the same resourcing. Savings, or cutbacks, are ‘neutral in relation to efficiency and inefficiency in the public sector’.³

The terms of reference required the review to consult widely with affected parties. Appendix B provides details of those consulted. In summary, the review’s consultation consisted of the following:

- briefings of the Management Advisory Committee Agency Chief Financial Officers Forum on the review on 23 September 2010 and 2 December 2010
- a briefing of the Community and Public Sector Union on 5 November 2010
- meetings with two major Australian companies on 15 December 2010
- a meeting with the Organisation for Economic Co-operation and Development on 21 December 2010
- discussions with all portfolio departments during November 2010 and January 2011
- face-to-face discussions or teleconferences with a representative sample of 23 portfolio agencies between November 2010 and January 2011
- a questionnaire distributed to 164 Australian Government bodies⁴
- consultation with the Portfolio Secretaries Board on 2 March 2011.

The review’s steering committee met three times between June 2010 and February 2011.

² This figure is based on the government’s 2010 election commitment to increase the Efficiency Dividend rate from 1.00 per cent to 1.25 per cent from 2011–12 onwards.

³ Lane, Jan-Erik 2000, *The Public Sector: concepts, models and approaches*, Sage Publications, London, p. 149.

⁴ The questionnaire was not distributed to Commonwealth companies limited by shares and a small number of bodies that are subject to only certain provisions of the *Commonwealth Authorities and Companies Act 1997*.

2 Understanding efficiency in government

What is efficiency in government?

Efficiency in government is about the change in the relationship of inputs to outputs at current prices in specific areas of public service. Put simply, improvements in the relationship can be claimed as efficiencies if proportionally less of a resource is used to deliver a particular service and if there is no decline in the quality of relevant services or outputs or there are improvements in the quality or quantity, or both, of output.

The UK Office of Government Commerce defines efficiency thus:

Efficiency in the public sector involves making the best use of the resources available for the provision of public services. This review has defined as 'efficiencies' those reforms to delivery processes and resource (including workforce) utilisation that achieve:

- reduced numbers of inputs (e.g. people or assets), whilst maintaining the same level of service provision;
- lower prices for the resources needed to provide public services; or
- additional outputs, such as enhanced quality or quantity of service, for the same level of inputs; or
- improved ratios of output per unit cost of input; or
- changing the balance between different outputs aimed at delivering a similar overall objective in a way which achieves a greater overall output for the same inputs('allocative efficiency').⁵

The Productivity Commission defines the concept of efficiency as having several dimensions:

Overall economic efficiency requires satisfaction of technical, allocative and dynamic efficiency:

- technical efficiency requires that goods and services be produced at the lowest possible cost
- allocative efficiency requires the production of the set of goods and services that consumers value most, from a given set of resources
- dynamic efficiency means that, over time, consumers are offered new and better products, and existing products at lower cost.⁶

⁵ UK Office of Government Commerce 2005, *Procurement Efficiency and Value for Money Measurement*, http://www.ogc.gov.uk/documents/Procurement_Efficiency_and_Value_for_Money_Measurement.pdf, viewed 9 February 2011, p. 5.

⁶ Steering Committee for the Review of Government Service Provision 2010, *Report on Government Services 2010*, Productivity Commission, Canberra, p. 1.18.

Why efficiency in the Australian Government matters

Our notions of good government embrace the proper management of public money and public property. It is the taxpayer's legitimate expectation that governments should manage public resources prudently by constantly seeking to improve the efficiency and effectiveness of their operations. The goal of efficiency permeates the Australian Public Service's legislative foundations, the budget process, and accountability arrangements for Australian Government agencies (see Appendix C). The Advisory Group established for the APS Blueprint review noted that a high-performing public service:

- meets the needs of citizens
- provides strong leadership and strategic direction
- contains a highly capable workforce
- operates efficiently at a consistently high standard.⁷

The Government has stated its objective of returning the budget to surplus by 2012–13, consistent with its medium-term fiscal strategy since the global financial crisis. As part of this strategy, the Government has committed to holding real growth in spending to 2 per cent a year, on average, until surpluses are at least 1 per cent of GDP and continued to offset all new spending since the 2010 Pre-election Economic and Fiscal Outlook.⁸

In this environment, and with increased pressure on public expenditures, obtaining value for every public dollar spent will be crucial to ensuring that agencies can continue to respond flexibly to emerging priorities. The Government's fiscal strategy also puts a premium on the redevelopment of priorities for existing expenditure as a way of accommodating new demands.

What promotes efficiency

Efficiency in the Australian Government can be understood to be promoted by a variety of factors, some endogenous and some external:

- an underlying ethic of good public management
- demands by government and expectations on the part of the community for higher levels of service
- the need for agencies to make up for any shortfall in funding as a result of the existing indexation arrangements in order to compensate for increases in costs (e.g. finding productivity gains to fund wage increases over and above the rate of indexation provided by the government)

⁷ Department of the Prime Minister and Cabinet 2010, *Ahead of the Game: blueprint for the reform of Australian Government administration*, PM&C, Canberra, p. xii.

⁸ *Mid-Year Economic and Fiscal Outlook 2010–11*, p. 23–4.

- whole-of-government efficiencies—including new travel arrangements, ICT arrangements and accommodation guidelines
- the need to deliver a given amount of services within the constraints of a limited budget which includes the application of the Efficiency Dividend.

When the framework for managing public resources is being set, a central challenge for government is getting the right tension between efficiency and effectiveness. This is by no means straightforward. The study of public choice reveals that the disconnection between a principal and a designated agent is a source of government inefficiency. This disconnection is further expressed through the principal-agent model, which provides a conceptual basis for understanding aspects of the relationship between a principal (for example, the budget-setting centre of government) and its agents (implementing agencies):

The agent is the person who works for the principal, who puts up the remuneration for the agent's effort against the value that the agent hands over to the principal in the form of a product of some sort. Thus, principal-agent interaction is fundamentally a contracting problem concerning how much of the value that the agent produces should go back to him/her in the form of a payment. However, what makes the principal-agent model distinctive is the additional assumption of asymmetric information, meaning that the agent knows more than the principal about the service in question in a manner that affects the contracting outcomes.⁹

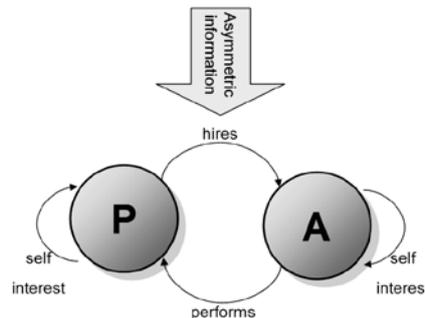


Diagram source: http://en.wikipedia.org/wiki/File:Principal_agent.png, viewed 15 October 2010.

In the public sector, asymmetric knowledge arises between the budget-setting centre of government as principal and implementing agencies as agents. “The traditional forms of contracting between government and bureaucracy only reinforce the knowledge advantage of the agent: long-term contracting, incremental budget-making, development of a unique expertise, etc.”¹⁰ In resourcing deliberations, such as funding reviews, the impact and relevance of the principal-agent model is particularly important. The Australian Government’s devolved budget and financial management framework is likely to accentuate the asymmetry of information.

⁹ Lane, Jan-Erik 2009, *Relevance of the Principal-Agent Framework to Public Policy and Implementation*, University of Geneva & National University of Singapore, <http://www.spp.nus.edu.sg/docs/wp/wp29.pdf>, viewed 9 February 2011, p. 2.

¹⁰ *ibid.*, p. 10.

Barriers to efficiency

The financial and budget frameworks can provide disincentives for promoting efficiency in the Australian Government.

The absence of upfront investment was often raised with the review. In particular, agencies said investment in IT systems was of concern. The agencies could not offset these costs, and some were reluctant to put forward proposals in case they were asked to absorb the costs. Further, agencies subject to the *Financial Management and Accountability Act 1997* (FMA Act) no longer have the same scope to make internal investments for capital because of the changes made to the net cash arrangements, which mean they have to seek funding in the budget.¹¹

The devolved financial framework might in some cases be an obstacle to cooperation between agencies, including in relation to encouraging efficiency. In discussions about why the opportunities presented by shared services were not being exploited, many agencies queried the compatibility of such models, from a governance perspective, with the responsibilities of chief executives set out in s.44 of the FMA Act. The review notes the legislative framework does not hinder the pursuit of shared services arrangements. Some agencies consulted during the review acknowledged this was likely to be a cultural issue rather than a framework issue.

Some agencies felt that the absence of a generally understood framework for risk management led to over-specification and inefficiency.

The current budget framework provides incentives and disincentives for agencies to pursue substantial efficiencies. Agencies noted aspects of the framework that can give rise to a short-term approach to resource management: the annual appropriation mechanisms and the operating loss process were cited as examples.

The concern relating to operating losses was that in order to avoid having to seek authority from the Finance Minister to budget for an operating loss, agencies might take sub-optimal resource management decisions. Agencies variously argued there is a stigma attached to seeking an operating loss or that there were risks in having a request to budget for a loss rejected.

Consideration of operating losses are handled through a process where Portfolio Ministers are required to write to the Finance Minister to seek approval for an agency in their Portfolio to budget for an operating loss in the current or future years. In January 2011 the vast majority of applications for operating losses were approved. Of these loss applications, 98 per cent of the quantum of losses were approved. Of the 33 requests, 36 per cent were associated with timing differences between revenue and expenses, for example an agency may have been asked to perform additional duties to be funded in another budget year.

¹¹ Estimates Memorandum 2009/55, *Operation Sunlight – Net Cash Appropriation Arrangements: Cash and Appropriation Receivable Reconciliations and Capital Budgets*, Department of Finance and Deregulation, issued 2 November 2009.

Budgets tend to be set annually for each functional area—be it at agency or operational unit level. Agencies consulted noted a perception that under-use of the current year’s budget can lead to a smaller budget being provided for in future years, which effectively removes any incentive for saving funds in the current year and is a rational response to current budget processes and forms of parliamentary scrutiny. This focus on balancing annual budgets can, however, be at odds with strategies that call for longer term investment decisions that can span many financial years.

Gaining access to new funding from new policy proposals can be a strategy to offset the financial pressures on an agency, including impact of the Efficiency Dividend. New Policy Proposals (NPPs) are costed with care by the Department of Finance and Deregulation, but the figures remain estimates based on specifications and levels of activity at a moment in time. There is no automatic financial reconciliation for most NPPs during their implementation phase. Under the Australian Government’s devolved financial framework responsibility for managing agency resources is vested in chief executives, and it is entirely legitimate for reallocations to be made.

While not dismissing the possibility that short-term approaches hampered innovation, the review also heard from some agencies that these were likely to be behavioural rather than framework issues.

The need to be able to respond to emerging priorities without, or before, budget supplementation is an endogenous inducer of efficiency for agencies. In practice, however, it can also provide an incentive for agencies to maintain low-priority programs until the need to redeploy resources arises.

In a tight fiscal environment, and given a budget process that has a short-term focus, managers are likely to have fewer incentives to favour longer term efficiencies that can potentially produce larger gains. Some agencies said major building works with the potential to lead to significant savings in operating costs were not pursued. Efficiency exercises often have lumpy expenditure patterns and agencies are under the impression that they might lose future savings but be left bearing the costs (which are often upfront).

The harvesting of whole-of-government efficiencies on the basis of centrally determined reductions in expenses with no benchmarking can be a ‘double hit’ for agencies that might be operating as efficiently as possible. In some circumstances this can be a disincentive for agencies to promote internal efficiencies in areas that could be subject to whole-of-government efficiency exercises.

Private sector approaches to efficiency: perspectives from two large Australian companies

The review sought insights into what generates efficiency in the private sector and met with representatives of two large multinational companies operating in Australia. In particular, it sought information about how large organisations promoted efficiency in activities that were not priced directly through a market. Two major themes arose from these discussions:

- the management of back-office functions
- the management of people.

Both companies saw the integration of common functions that did not directly affect contact with customers as a major component of the cost-efficiency challenge. Such integration was said to reduce costs and facilitate the production of better information for decision making.

Centralised collection and production of reports was seen as vital to the companies' sustainability because it allowed a timely, coordinated and standardised reporting framework. Two further benefits were that centralising common activities could release line managers to get on with the job of delivering services to their customers and that decision making was firmly based on common and standardised information and performance reports. This was expressed as a 'single truth' approach.

People management focused on two main aspects. Strong emphasis was given to staff engagement in the organisation's vision since both companies valued staff retention in a competitive labour market. They attached high importance to capturing the corporate knowledge and enthusiasm of labour because buy-in was assessed as central to the success of the company.

Both companies also gave strong emphasis to their board's monitoring projects. Potential activities—particularly new investments—were judged on three basic criteria:

- How will the change be beneficial for the consumer of their business?
- How will the change contribute to making things more efficient or effective?
- What will the financial impact be on the business—that is, will it generate a profit?

Company representatives were initially surprised at the implied level of efficiency Australian Government agencies were expected to find in order to pay for salary increases, accommodate increases in supplier costs not offset by indexation, and meet the Efficiency Dividend. When the budget framework—specifically the availability and significance of new funding—was explained, however, they understood the context of the implied efficiency figures. This experience highlighted that the Efficiency Dividend and other elements of the budget framework should not be viewed in isolation. They can be fully understood only in the context of the Australian Government's flexible resourcing framework.

3 Measuring efficiency in government

If it were possible to accurately measure productivity in the public sector it would be possible to use this information to assist budget decision making, including determination of the rate for the Efficiency Dividend. The challenges associated with measuring efficiency in government are widely acknowledged and have been the subject of studies in Australia and elsewhere.

The main limitations in measuring output in the public sector are overwhelmingly due to a lack of market prices. Measurement is also affected by the difficulty of accounting for changes in quality when measuring productivity (which is also difficult for market sectors). These fundamental problems are unlikely to be overcome in the foreseeable future. Significant improvements in measuring the efficiency of specific government outputs can be made, but these are likely to occur in areas of activity that are more amenable to measurement—for example, public health and education.

The current approach

Like its international counterparts, the Australian Bureau of Statistics (ABS) currently assumes that inputs equal outputs when estimating value added in the public sector. This means the ABS does not take into account productivity growth in the public sector when it prepares Australia's national accounts. Most statistical authorities view this as a serious shortcoming, and some countries, such as the United Kingdom, are exploring other options for measuring public sector productivity. Their efforts tend to focus on public sector activity in education and health, where there is more scope to collect meaningful and consistent data.

The United Kingdom has made a significant effort to provide better measures of public sector productivity. The UK Centre for the Measurement of Government Activity was set up within the Office of National Statistics in July 2005 with a remit to implement the recommendations arising from Sir Tony Atkinson's Review of Measurement of Government Output and Productivity for the National Accounts and to provide information on the outputs, inputs and productivity of public services for the whole of the United Kingdom, working with government departments and the devolved administrations.

The Centre for the Measurement of Government Activity has focused on health care and education measurements because these two areas account for half of all public spending in the United Kingdom and because there is some output and price data available for these sectors. The centre notes that the estimates of productivity it provides are experimental statistics and that 'it has not yet been possible to develop satisfactory quality measures for the smaller spending areas'.¹²

¹² Kamarudeen, Sophia, Mills, Katherine, Phelps, Mike & Wild, Richard 2010, *Total Public Service Output, Inputs and Productivity*, UK Centre for the Measurement of Government Activity, <http://www.statistics.gov.uk/cci/article.asp?id=2488>, viewed 7 February 2011.

Little work has been done on developing a framework for measuring public sector productivity in Australia. In April 2010 the House Standing Committee on Economics released the report of its Inquiry into Raising the Productivity Growth Rate in the Australian Economy. The report noted, among other things, that ‘Given the size and importance of government service provision in its own right and as an input into the production processes of other businesses, it is important that any national productivity agenda includes public sector service provision’.

The government has not yet responded to the committee’s report, although this present review notes that the Treasury provided the following evidence to the committee:

Improving productivity in the public sector and improving public sector efficiency may or may not show up in measured productivity, but it would clearly be an area where relatively little work has been done. I think that will be an important area of work, one way or another, into the future.¹³

The review sought from the ABS advice on how it would approach the task of measuring productivity in the Australian Government context. The ABS said this would necessarily be approached as a long-term project considering the importance of longitudinal data to allow it to smooth out factors relating to economic and electoral cycles. A first step would be to assess the data sets currently collected.¹⁴ The ABS noted that in its experience current public sector data sets are rarely of high statistical quality.

For the purposes of the ABS national accounts, growth in the nominal level of output in the economy (or a sector of it) is the net effect of the growth in the volume of output in the economy (or sector) and the implied change in the price of that output. The concept of real output in the national accounts is, however, broader than simply physical quantity (the number of widgets produced) and includes improvements in the quality of goods and services.

For example, by any reasonable measure the quality of a car produced in 2010 is substantially higher than that of a car produced in 1980. Conceptually, this should be (and is) reflected as an increase in the volume of output of cars. Similarly, the processing power of personal computers has increased exponentially in recent decades and this should be reflected as an increase in the real output of PCs—although whether this is the case has been the subject of much debate.

This means that from a national accounts point of view the productivity gain resulting from producing the same physical quantity of output at a higher level of quality and with the same level of inputs is conceptually equivalent to producing a higher quantity of output of unchanged quality and with the same level of inputs.

¹³ Evidence provided by Tony Macdonald, General Manager, Macroeconomic Policy Division, The Treasury, to the House of Representatives Standing Committee on Economics *Inquiry into raising the level of productivity growth in the Australian Economy* (Official Committee Hansard, 23 October 2009, p.70).

¹⁴ The ABS noted that public sector activity in health and education was most likely to be measurable.

A central question here concerns whether this assumption of the implied substitutability of physical and quality productivity is valid when assessing productivity in the provision of public services.

Many public sector agencies do not have an effective choice in relation to the form in which they deliver or achieve productivity gains. Experience suggests that the effective minimum community standard of public services rises incrementally with time. This means that agencies do not make cost savings as a result of quality-driven productivity gains. To assume that they do would necessarily result in a trend decline in the physical volume of public services provided.

Use of a private sector proxy

Recognising these difficulties for measuring public sector efficiency, the review considered the possibility of using a proxy for public sector productivity within the private sector, since this approach would have the advantage of data availability. Using productivity rates from the private sector (for example, the finance and insurance areas) as a proxy for public sector productivity is, however, still problematic because of the differences between the sectors and the lack of data sets and an ability to account for changes in quality.

The ABS releases estimates of national income, expenditure and production about two months after the end of each quarter, although industry-level productivity estimates are only published annually. That is, the ABS estimates productivity that has happened in the past, rather than estimating or forecasting the level of activity in the future. This means that, even if an appropriate ABS measure is identified, its application in determining budget allocations for agencies and programs would be based on past rather than forecast gains.

Treasury does not currently provide information at this level of disaggregation. Productivity is a derived series in the national accounts, and hence the accuracy of forecasts of productivity growth rests on the accuracy of forecasts for both employment (hours worked) and output growth. These component series are volatile at the economy-wide level over short forecasting horizons—let alone at the sectoral level.

International comparisons

As part of developing the evidence base for the APS Blueprint reform process, in November 2009 KPMG produced an international benchmarking report, *Benchmarking Australian Government Administration Performance*. The report quoted OECD data showing that Australia is broadly comparable with other countries in the processes instituted for gathering performance information¹⁵, but it did not offer any conclusions about relative efficiency.

¹⁵ KPMG 2009, *Benchmarking Australian Government Administration Performance*, KPMG, Canberra, p. 75.

There is no agreed measure of efficiency for government services at the aggregate level. This is largely because it is hard to determine an accurate price for the outputs since there is no market for these services.

International academic work on government efficiency has focused on areas of major impacts on national productivity—such as health and education—which, as noted, tend to be inherently more measurable. In Australia, however, these areas tend to be the responsibility of state and territory governments, although attempts have nevertheless been made to generate broad international comparisons.

In a working paper produced by the European Central Bank Australia's public service (at both federal and state and territory levels) was ranked fourth of 23 industrialised OECD countries for the 2000 calendar year for input efficiency and seventh for output efficiency.¹⁶ It should be noted that this study used socio-economic indicators as a measure, which are geared more towards measuring state and territory government services.

Australia's input efficiency score was 0.99, meaning that the same output should have been able to have been achieved with 99 per cent of the actual inputs. This compares favourably with the average for the 15 European Union countries, which had an input efficiency score of 0.73, and was behind only the United States, Luxembourg and Japan, all of which scored 1.00.

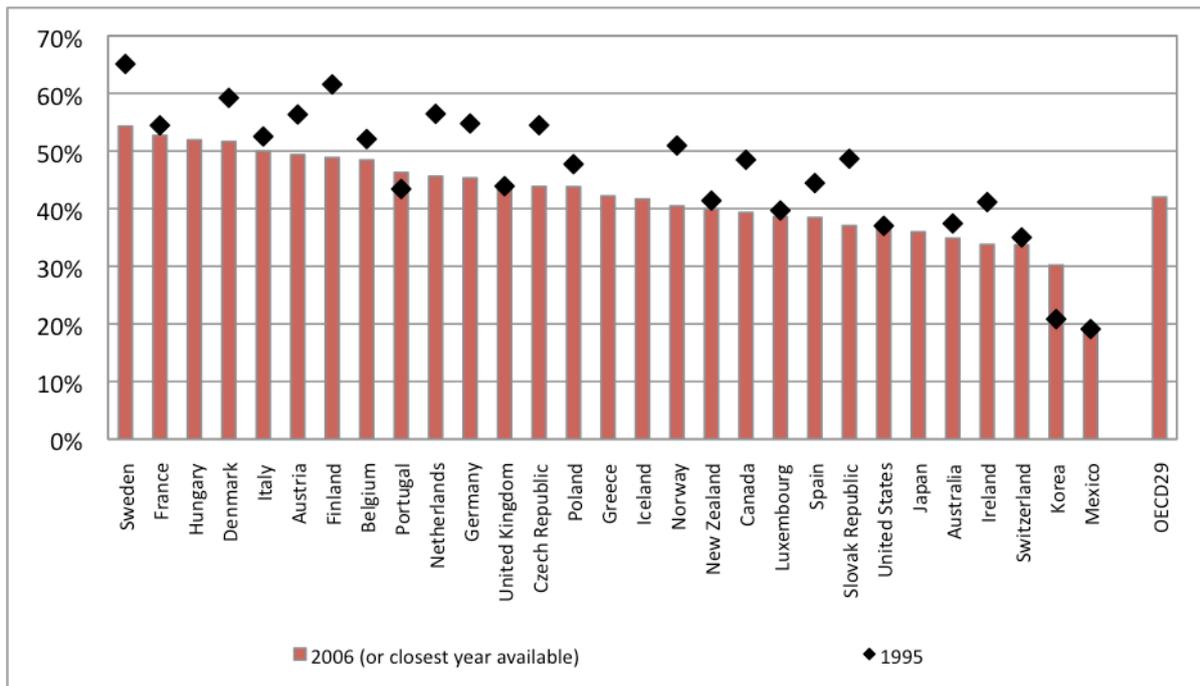
Australia's output efficiency score was 0.92, meaning that Australia produced 92 per cent of the possible production frontier with its given inputs. Again, this was better than the 15 EU countries, which scored 0.82. Australia was again behind the United States, Luxembourg and Japan, all of which scored 1.00, and also just behind Switzerland (0.94), Norway (0.93) and Ireland (0.93).

The European Central Bank assumes that the highest performing countries are at optimal efficiency, which is unlikely and cannot be proved. It does, however, provide a measure of Australia's performance in comparison with other countries.

In a paper produced by the International Monetary Fund the authors noted that 'the most resounding conclusion is that higher expenditure relative to GDP tends to be associated with lower [public sector] efficiency'.¹⁷ By this limited measure Australia's public sector (combined Commonwealth and state and territory) can be seen to be reasonably efficient in comparison with other OECD member states (see Figure 1). But, by itself, this broad measure of relative efficiency does not tell us anything of the outcomes achieved.

¹⁶ Alfonso, A, Shuknecht, L & Tanzi, V 2003, 'Public sector efficiency: an international comparison', Working paper no. 242, European Central Bank, July.

¹⁷ Hauner, D & Kyobe, A, 'Determinants of government efficiency', IMF working paper (WP/08/228), p. 4.



Source: OECD 2009, *Government at a Glance*, OECD, Paris.

Figure 1 General government expenditures as a proportion of GDP, 1995 and 2006

Continuing this line of analysis, it is still relevant to consider the pattern of growth in Australian Government departmental expenditure in the past decade.

Figure 2 shows that Australian Government departmental expenses grew by 59 per cent in nominal terms between 2000–01 and 2009–10. During the same period, nominal administered expenditure grew by 98 per cent and nominal GDP grew by 81 per cent. When the effects of the improvement in terms of trade over this period is removed, nominal GDP grew by 64 per cent over the same period.

As can be seen from Figure 2, the growth in both types of government expenses and in nominal GDP (excluding the effects of the change in terms of trade) were all very similar up until 2007-08.

Caution should be taken in analysing the trends after that, as the impact of the global financial crisis, a once-in-a-generation occurrence, distorts all the elements.

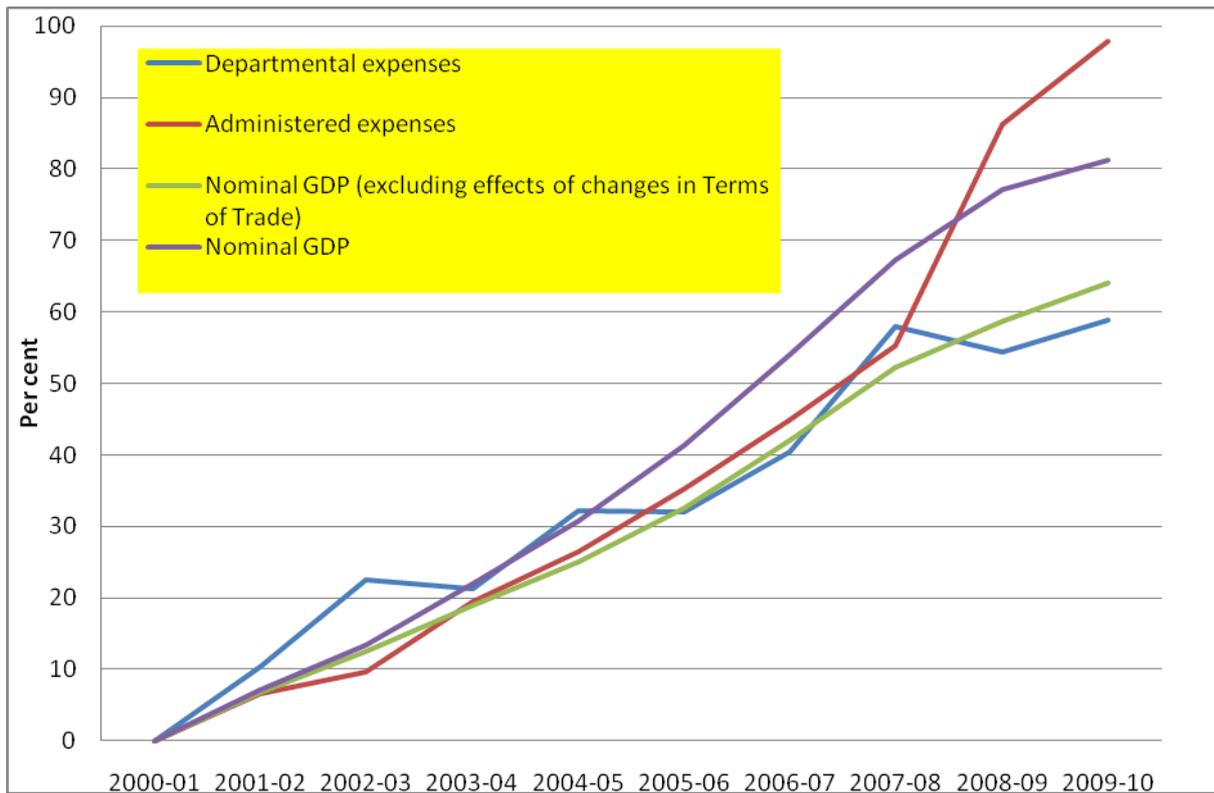


Figure 2 Nominal growth rates of government departmental and administered expenses compared with nominal GDP, 2000-01 to 2009-10

Figure 3 shows that, despite the impact of the Efficiency Dividend, in the same period departmental expenses grew by 23 per cent in real terms¹⁸ across the public service as a whole. Departmental expenses grew at a very similar rate to administered expenses, for the period up to 2007-08, after which administered expenses grew at a much faster rate—largely reflecting the Government’s response to the global financial crisis. Between 2000-01 and 2009-10, the population grew by 15 per cent.

¹⁸ Applying the Consumer Price Index to determine changes in real value.

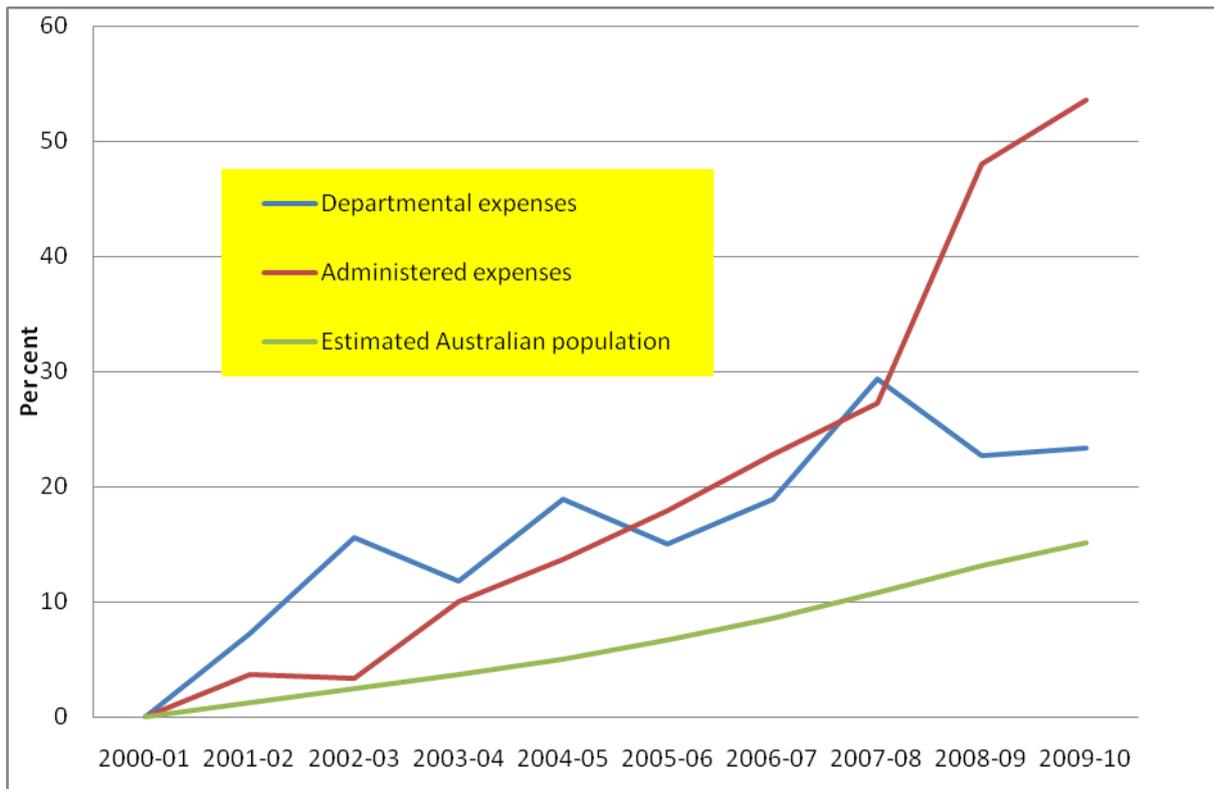


Figure 3 Real growth in Australian Government departmental and administered expenses compared with Australian population growth, 2000–01 to 2009–10

As Figure 4 shows, from 2000–01 to 2009–10 Australia’s GDP grew from \$709 billion to \$1,293 billion, or by around 81 per cent. When the effects of the improved terms of trade are removed, the growth in nominal GDP was in the order of 64 per cent. During the same period Australian Government departmental expenses grew at a slower rate, from \$32 billion to \$52 billion, or by about 59 per cent. In contrast, Australian Government administered funding grew more rapidly, from \$147 billion to \$292 billion, or by about 97 per cent. The growth of departmental expenses, administered expenses and nominal GDP (with the effect of the change in terms of trade removed) were very similar up until 2007–08 and the advent of the global financial crisis. A large amount of the growth in administered expenses happened in the final two years, which can be accounted for by the Government’s response to the global financial crisis (during these two years administered expenses grew by \$63 billion compared with \$82 billion for the preceding seven years).

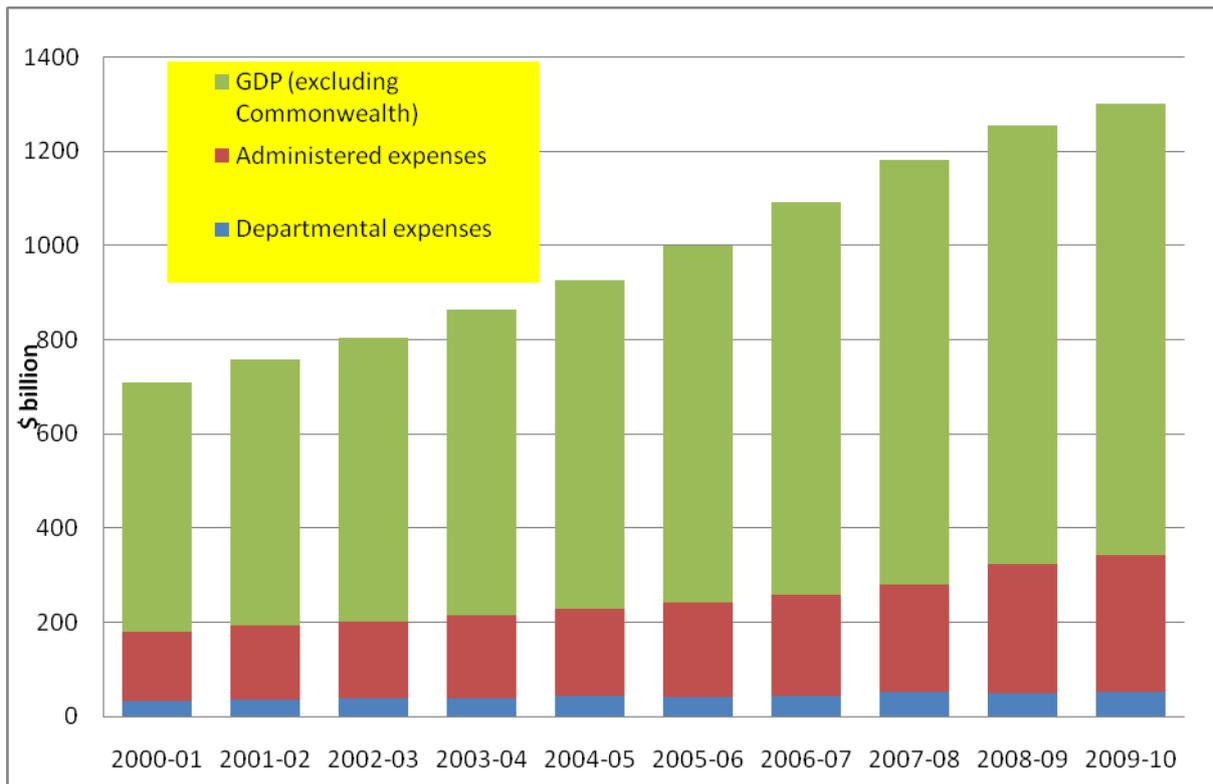


Figure 4 Australian Government departmental and administered expenses compared with Australian nominal GDP, 2000-01 to 2009-10

Australian Government departmental expenses as a proportion of nominal Australian GDP (with the effects of the change in terms of trade removed) remained reasonably constant during the decade, being just under 5 per cent. As Figure 5 shows, Australian Government departmental expenditure remained between 4.5 and 5.0 per cent of nominal Australian GDP (with the effects of the change in terms of trade removed) for the whole decade. When the Defence component is removed, the remaining departmental expenses grew over the first four years of the decade (from around 2.2 per cent to 3.0 per cent), before falling slightly over the remaining years.

During the same period total government expenses (both departmental and administered) fell steadily in the first seven years, from 25.4 per cent of nominal GDP in 2000-01 to 23.7 per cent in 2007-08. In the final two years total government expenses grew to be 25.8 and 26.5 per cent of nominal GDP, this was a result of the slowing in growth of GDP, the effect of federal automatic stabilisers and the government's response to the global financial crisis in the form of (temporary) discretionary spending as a fiscal stimulus.

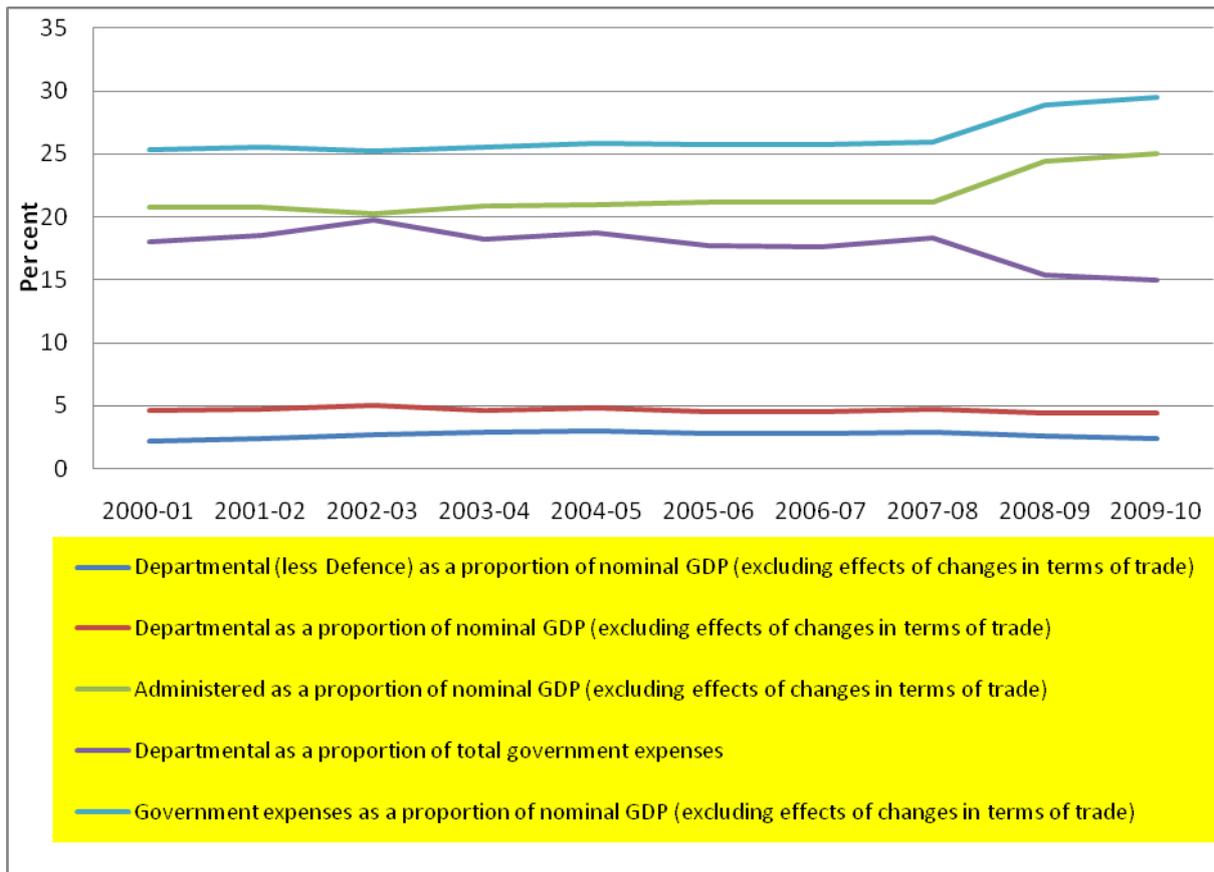


Figure 5 Ratios of Australian Government departmental expenses to total government expenses and nominal GDP, 2000-01 to 2009-10

Summary

There is no currently accepted way of measuring productivity in the public sector. Among the main constraints to such measurement are the lack of meaningful data sets and a methodology for measuring changes in quality. If the quality of inputs and outputs is not properly accounted for when measuring efficiency, any estimation of efficiency is likely to be inaccurate.

In the absence of a statistically valid approach to the measurement of public sector productivity, it is difficult to be more scientific when determining the Efficiency Dividend rate.

Measures of productivity developed by the Australian Bureau of Statistics for the market sector do not provide a satisfactory proxy for public sector productivity for the purpose of estimating an Efficiency Dividend. By nature, the services are simply too different to allow for valid comparisons, and projections of productivity growth would be unreliable. If it were used to validate the rate of the Efficiency Dividend, such an approach would be open to the valid criticism that it simply replaced one arbitrary figure with another.

The absence of reliable data and of an accepted way of measuring productivity in the Australian Public Service poses a serious obstacle to developing a robust estimate of

efficiency gains over time; it therefore also hampers the development of policies that allow government to share the benefits of efficiency gains.

There are, however, indicators that the Australian Government is reasonably efficient in comparison with other jurisdictions. Australia compares favourably with other countries in terms of the proportion of total government expenditure as a proportion of GDP (including state, territory and local government expenditure) and in terms of input and output efficiency according to the European Central Bank methodology—fourth and seventh respectively in a study of 23 industrialised OECD countries in 2000.

Although departmental expenses have increased in real terms during the past decade, they remained relatively constant compared to overall government expenses and to nominal GDP (with the effects of the change in terms of trade removed) until 2007-08. Departmental expenses have fallen as a proportion of nominal GDP in the final two years, but this is explained by the advent of the global financial crisis.

Until 2007-08 administered expenses fell at a similar rate, from 20.8 per cent of nominal GDP to 19.4 per cent. In the final two years, however, administered expenses grew substantially—up to 22.4 per cent of nominal GDP in 2009-10—mainly because of the government's response to the global financial crisis. Departmental funding did not match this growth because many measures involved substantial increases in administered expenses—for example, one-off payments to pensioners and transfers to the states and territories for the accelerated Nation Building Agenda—without a significant departmental increase.

4 The Efficiency Dividend: concept and practice

At present the most readily acknowledged across-the-board budget mechanism for promoting improvements in agencies' efficiency is the Efficiency Dividend. Introduced in 1987–88, it aims to do the following:

- give managers the incentive to continually seek new or more efficient means of carrying out continuing government business
- allow government to redirect a portion of efficiency gains to higher priority activities
- clearly demonstrate Public Service efficiencies resulting from improvements in management and administrative practices.¹⁹

The Efficiency Dividend is based on a simple rationale: 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. This can allow the derived efficiency gains to be redirected to higher priority areas, as determined by government.

When goods are traded in a private market, competition and the need to make profits provide incentives for price reductions resulting from efficiency gains. Public services are not subject to such incentives. In the public sector efficiency can be understood to be motivated by the goal of increasing the quality or level of services. The Efficiency Dividend is therefore a way of putting pressure on Australian Government agencies to use the results of efficiency gains to reduce prices in the absence of price signals.

The Efficiency Dividend has been the subject of several parliamentary inquiries and other reviews (see Appendix D), but its basic concept and application have changed little since its introduction.

Current policy in relation to the Efficiency Dividend

During the 2010 election campaign the government announced a commitment to maintaining the Efficiency Dividend at 1.25 per cent, rather than reverting to 1.00 per cent in 2011–12, as had been previous policy. Table 1 shows the current estimates and the estimated impact of the Efficiency Dividend assuming implementation of the government's election commitment.

¹⁹ Department of Finance 1997, *Running Costs Arrangements Handbook*, Department of Finance, Canberra, August.

Table 1 Estimated budget impact of the Efficiency Dividend: current budget year and forward estimates

Budget impact	2010-11	2011-12	2012-13	2013-14	Total
Current Efficiency Dividend					
Rate (per cent)	1.25	1.00	1.00	1.00	
Amount per annum (\$m)	310.0	260.0	260.0	290.0	
Cumulative (\$m)	310.0	570.0	830.0	1,120.0	2,830.0
2010 election commitment					
Rate (per cent)	1.25	1.25	1.25	1.25	
Amount per annum (\$m)	310.0	320.0	330.0	360.0	
Cumulative (\$m)	310.0	630.0	960.0	1,320.0	3,220.0

Several exemptions from the application of the Efficiency Dividend have been granted (see Appendix E). The most significant exemption is that provided to the Department of Defence, which has a separate overall funding formula applied to it. At present the Efficiency Dividend is applied to 11 per cent of Defence’s departmental funding; the result is that Defence’s cumulative contribution to the Efficiency Dividend is about \$320 million over four years. If the Efficiency Dividend were applied to all Defence departmental funding, Defence’s total contribution would increase to about \$2,870 million over four years—an increase of \$2,550 million, or 80 per cent of the total Efficiency Dividend applied under the Government’s election commitment.

How the Efficiency Dividend is applied

Application of the Efficiency Dividend results in an annual reduction in the amount of funds available for purchasing resources required to deliver an equivalent level of output.

The Efficiency Dividend predominantly applies to departmental appropriations that cover the ordinary operating costs of government departments. These costs were called ‘running costs’ when the Efficiency Dividend was introduced but are now referred to as ‘departmental expenses’. Departmental appropriations—about \$43.3 billion in 2010-11—include salaries and operational expenses and account for about 12 per cent of total budget outlays.²⁰

The Efficiency Dividend can also be applied to administered appropriations²¹ where they involve payments for outsourced programs that could have been managed within the Australian Government (that is, they are departmental-like in nature). This policy was formalised in 2010 and is being implemented in the context of the 2011-12 Budget.

The nature of administered expenses presents different challenges for government from the perspective of encouraging efficiency. Agencies have less discretion in

²⁰ The dividend applies to about 6.5 per cent of total budget outlays once exemptions are accounted for.

²¹ Administered appropriation items are those administered by an Australian Government agency on behalf of the government. They are normally related to activities governed by eligibility rules and conditions established by the government or parliament—such as grants, subsidies and benefit payments. Administered expenses represent the bulk of Australian Government annual budget outlays (about 85 per cent of \$343 billion in 2010-11). The largest administered items relate to benefit payments, payments to the states and territories, and grants.

relation to how administered operating costs are incurred. The actual benefit payment or grant cannot be made more efficient since the payment or grant is the amount determined to be appropriate. In the case of a grant, the payment is determined by a grants assessment process; in the case of a benefit payment, the payment is normally determined through legislation. A payment to a non-government body could be determined through a contractual negotiation to provide services.

In 2010 the Government agreed to change its guidelines for program indexation to specify that administered programs should not be indexed when the government provides a discretionary level of funding, independent of the goods and services produced. This change to the guidelines recognises that there is no rationale for maintaining the real value of such payments. The government has also agreed that programs subject to review or renewal or that are brought forward for consideration in the new policy proposals process should have their indexation arrangements reviewed by the Department of Finance and Deregulation in the light of the revised guidelines.

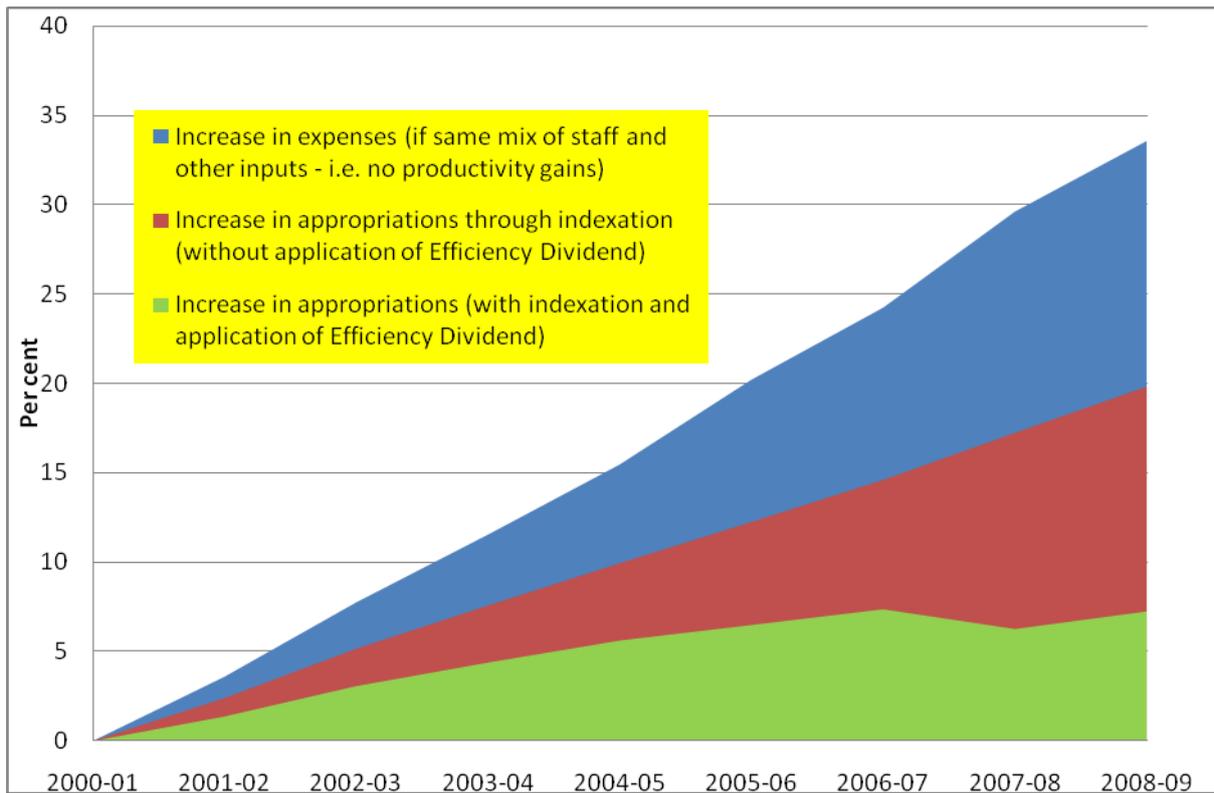
Since the 2010–11 Mid-Year Economic and Fiscal Outlook update, total net departmental appropriations (including funding for depreciation/amortisation, Departmental and Administered Capital Budgets and Collection Development Acquisition Budgets, but excluding relevant agency receipts, in accordance with section 31 of the *Financial Management and Accountability Act 1997*, such as interest, income or receipts from other sources received) are subject to the Efficiency Dividend.

The intended impact of the dividend is that the agency is required to manage its resources by improving financial and budgetary controls, improving management and administration processes, deciding on whether the uptake of new technologies is more cost effective, and negotiating and implementing improved (mutually beneficial) labour-management relationships.

The Efficiency Dividend and indexation

Under the indexation framework agencies' appropriations are generally adjusted each year by wage cost indices. The indices comprise a component to reflect wage increases (in accordance with movements in the safety net adjustment) and a component to reflect changes in the prices of goods and services (as shown by the consumer price index).

Figure 6 shows the estimated impact of supplementation arrangements under the current budget framework for agencies' activities. It shows the impact of wage and price increases on the cost of an activity (assuming the level and quality of service provided remain static and that the efficiency or productivity rate is the same, i.e. the mix of inputs does not change) and the impact of wage cost indexation alone and a combination of this and the Efficiency Dividend on the appropriations agencies receive. It does not account for new policy, which is deemed additional activity.



Note: 'Increase in expenses (if same mix of staff and other inputs – i.e. no productivity gains)' represents a combination of the average wage increase (60 per cent) and the CPI (40 per cent) based on same mix of staff and other inputs. 'Increase in appropriations through indexation (without application of Efficiency Dividend)' represents the level if appropriations were only indexed using the wage cost index. 'Increase in appropriations (with indexation and application of Efficiency Dividend)' represents a combination of wage cost indexation and the application of the Efficiency Dividend.

Figure 6 Estimated changes in expenses and appropriations for funded activities, 2000–01 to 2008–09

The top line in Figure 6 represents the increase in expenses over the period 2000–01 to 2008–09 if the same mix of staff and goods and services are used to provide all agencies' outputs. This increase is derived from the average annual Australian Public Service wage increases²² and the change in the CPI²³, the split being the average across the Australian Government—60 per cent and 40 per cent respectively. The middle line represents the increase in appropriations if it was increased by the wage cost index (using wage cost index 3, which is the most common wage cost index used in the Australian Government), and without any application of the Efficiency Dividend. The bottom line represents the increase in appropriations provided by indexation arrangements, but includes the impact of the Efficiency Dividend. Appropriations actually decreased in 2007–08 because the Efficiency Dividend for that year was greater than the wage cost index. This was in response to the application of the one-off additional 2 per cent Efficiency Dividend.

The blue area in Figure 6 represents the hypothetical efficiency or productivity gain that agencies would have to have made during this period to meet the actual increase

²² Australian Public Service Commission 2009, *State of the Service 2008–09*, APSC, Canberra, p. 146.

²³ Consumer price index, ABS, average for end of June quarter each year.

in wages, which was higher than that provided through the indexation (assuming that appropriation was matched with the expense at the start of the period). This, in theory, should be consistent with the increased productivity gains that underpinned the increase in wages negotiated through workplace agreements.

The red area in Figure 6 should represent the efficiency or productivity gain that agencies have to return to the budget through the impact of the Efficiency Dividend. This is the budget's 'share' from the gains in efficiency or productivity.

The combination of these two areas should represent the agreed efficiency or productivity gain under the current framework. This involved an average efficiency gain of 2.6 per cent each year. In contrast, growth in Australia's average annual labour productivity from 2000 to 2008 was 1.6 per cent for the entire economy.²⁴

Why the Efficiency Dividend works

Australian Government agencies must have the ability to respond flexibly to emerging priorities for which they might never receive funding.²⁵ Public servants are generally interested in and often committed to their particular area of work—for example, public health, environmental concerns or developing infrastructure. The combination of these two factors means that, in the absence of an intervention, public servants are likely to work to ensure that gains from efficiencies are channelled towards a higher level or quality of service in a particular area, rather than a reduction in price for a particular output.

Central intervention is required if some of the savings from efficiency gains are to be returned to benefit the budget as a whole. The Efficiency Dividend has proved an effective tool to use for this purpose because it is simple, predictable and reasonably equitable owing to its near-universal application.

Under the devolved responsibility model of the FMA Act and the *Commonwealth Authorities and Companies Act 1997*, responsibility for managing the resources of agencies resides with the chief executive officers of the agencies. These officers are essentially responsible for the full revenue received by the agency and make the decisions about how that revenue can be most effectively allocated. The Efficiency Dividend does not interfere with this responsibility, even when it reduces the amount of appropriation available.

A range of countries—among them Denmark, Finland and Sweden—use efficiency dividends to provide an incentive for public sector bodies to improve the efficiency of their operations. New Zealand does not formally have an efficiency dividend, but it keeps operational expenses to a fixed nominal baseline. The net effect of these arrangements is similar to an Efficiency Dividend: 'given that the inflation rate has been around 2.5 % for the last few years, this implies that ministries had to keep a

²⁴ 'Raising the level of productivity growth in the Australian economy': Treasury submission to the House of Representatives Standing Committee on Economics Inquiry into Raising the Level of Productivity Growth in the Australian Economy, August 2009, p. 53.

²⁵ It is also true that agencies cease to perform or scale back some functions they have been funded for. This is part of the flexible and devolved financial budget framework.

focus on productivity in order to keep up with the desired level of output'.²⁶ The review understands that every Australian state apart from Victoria currently applies an efficiency dividend to at least some of its expenditure. The methods vary between jurisdictions: some jurisdictions specify exemptions (for example, front-line services) or limit the application of the dividend to a class of expenditure. The rates are often set politically but typically range between 1 and 2 per cent.

Agencies' views about the Efficiency Dividend

Criticisms of the Efficiency Dividend are well known and, as noted, have been explored by successive federal parliamentary inquiries. Among the criticisms levelled are the following:

- The dividend is blunt in that it is applied at the same rate to virtually all agencies (with only a few exceptions) that receive departmental budget funding, regardless of how efficiently they are operating.
 - Smaller agencies that have not historically received new funding are disproportionately affected because they have less flexibility in their budgets.
 - It is an expedient way of promoting efficiency because governments do not need to make decisions about what activities should cease.
- The rate is arbitrary and generally considered too high. It is set by governments as a headline number and is not underpinned by a formal assessment of the potential for efficiencies to be found.
- The dividend erodes programs and leads to job losses. Agencies told the review the dividend was managed by reducing output rather than through genuine efficiency measures.
- Agencies attempt to game the dividend by putting forward new policy proposals in order to gain new funding that is then to some extent used to offset the cumulative impact of the dividend. Some agencies consulted during the review put this forward as a strategy, however there is little tangible evidence to confirm the extent of this behaviour.
- There is no clear connection between the dividend and any actual efficiency measures.

Considered in isolation from other elements of the budget framework, the criticism that the Efficiency Dividend does not sufficiently distinguish between agencies' relative ability to deliver productivity gains would appear to be a valid one and a problematic aspect of the dividend's application. But the Efficiency Dividend is only one part of a budget framework, and it cannot be considered in isolation from the other elements that affect agency resourcing.

²⁶ OECD 2009, *OECD Efficiency Study* (GOV/PGC/SBO(2009)4), OECD, Paris, p. 51-4.

Many of the agencies consulted acknowledged that a top-down Efficiency Dividend worked well in some ways:

- It provides budgetary pressure, which is an incentive for agencies to operate more efficiently—if for no other reason than necessity.
- It is administratively efficient, being applied through a simple adjustment to agency estimates.
- It is predictable from both a budget and an agency perspective. This allows government to manage the pressure on the bottom line and helps agencies plan to manage the dividend's impact.

The Efficiency Dividend and smaller agencies

In its 2008 report entitled *The Efficiency Dividend and Small Agencies: size does matter* the Joint Committee of Public Accounts and Audit explored the impact of the Efficiency Dividend on smaller agencies.²⁷ It concluded that the dividend worked reasonably well for large agencies but should be modified to cater for small agencies because, in its view, size was an important factor for agencies seeking to deliver efficiencies.

The committee agreed in principle with an efficiency incentive but took the view that the current arrangements placed the highest premium on ensuring that agencies do not build up unnecessary resources and that other risks (that is, the possible reduction in effectiveness or quality of outputs) were secondary. For the committee this raised the question of whether higher priority was attached to agencies' efficiency at the expense of their effectiveness. The committee said it would prefer to see a better balance between efficiency and effectiveness in the budget process, since both are required if agencies are to perform at a high standard.

From the committee's perspective there was a definable group of agencies that were being placed in financial difficulty as a result of the combined effects of the Efficiency Dividend, indexation and the new policy proposal process. During this present review's consultations smaller agencies pointed to the relatively high proportion of fixed costs in their budgets, saying this gave them less flexibility in how they seek efficiencies. The committee argued that this group of agencies was defined by their smaller size and their technical and well-defined roles.

In its primary recommendation relating to the Efficiency Dividend the committee proposed that government either:

- exempt the first \$50 million of all agencies' appropriations from the Efficiency Dividend, excluding departments of state (the preferred option)

or

²⁷ Joint Committee of Public Accounts and Audit 2008, *The Efficiency Dividend and Small Agencies: size does matter*, Report no. 413, JCPAA, Canberra, December.

- exempt the first \$50 million of the appropriations of all agencies that have departmental expenses of less than \$150 million, excluding departments of state.²⁸

The government did not accept either of these recommendations in its formal response:

The Government considers that it is reasonable to expect agencies to pursue efficiencies which enable the Government to consider priorities for reallocating resources. In response to the claim that efficiencies have generally been delivered by small agencies and that the impact of the efficiency dividend is now resulting in reductions in outputs, the Government considers that the pursuit of efficiencies is an ongoing process, and there is an imperative for both small and larger agencies to contribute.²⁹

The review considered the option of using a sliding scale, rather than complete exemptions based on a threshold, in applying the Efficiency Dividend.

The review notes that those smaller agencies that have a high ratio of non-discretionary costs and/or that have not historically attracted new funding are likely to be disproportionately affected by the Efficiency Dividend.

But, rather than size, an agency's ability to find efficiencies is perhaps more clearly linked to where that agency is situated on an efficiency spectrum. Current limitations in how we measure efficiency in the public sector prevent meaningful or accurate assessment of where agencies are placed in this spectrum. With these limitations in mind, the review does not share the committee's view that there is at present a definable group of smaller agencies that are universally disproportionately affected by the Efficiency Dividend.

The examples of smaller agencies' budget pressures provided to the Joint Committee of Public Accounts and Audit need to be considered in the context of government priorities and whole-of-government resourcing. The current budget framework seeks to provide the flexibility to allow managers to manage but at the same time to apply downward pressure on resourcing to encourage efficiency.

How agencies manage the Efficiency Dividend

There is no formal and regular reporting on how agencies manage the impact of the Efficiency Dividend. During its consultations the review heard how agencies factored the dividend into their budget planning and handled the dividend's impact in different ways. The review did not form a view about what was the best method because there is no 'single-best' approach to planning and priority setting.

The Australian Public Service Commission reported on how 85 agencies responded to the additional 2 per cent Efficiency Dividend in its 2007–08 *State of the Service Report* (see Appendix F).

²⁸ With these benchmarks to be indexed over time.

²⁹ Government Response to Report 413, *The Efficiency Dividend and Small Agencies: size does matter*, http://www.finance.gov.au/publications/efficiency-dividend/docs/GovernmentResponse_JCPAA_413.pdf.

The review also heard from many agencies that application of the Efficiency Dividend in an environment of constrained access to new funding is more likely to lead to reductions in output and quality. Agencies typically sought to shield service delivery from these impacts, but some agencies told the review this was becoming difficult.

Several agencies noted that managing the impact of the Efficiency Dividend without reducing their output was becoming more difficult because of whole-of-government efficiency measures—for example, travel, information and communications technology, property and coordinated procurement. The agencies did not argue that they could garner these efficiencies acting alone, but they noted that whole-of-government efficiencies reduced their budget flexibility.

The proposal to create an efficiency pool

In November 2010 the APS 200 Public Sector Innovation Project³⁰ presented to the Portfolio Secretaries Board³¹ a set of recommendations that arose from the Australian Public Service Management Advisory Committee's *Empowering Change: fostering innovation in the Public Sector* report.³²

The Secretaries Board asked the Department of Finance and Deregulation to explore the possibility of a one-off use of the Efficiency Dividend (or part thereof) once the budget is back in surplus in order to establish a pool in each agency to be used for innovative activity. The pool would become a revolving fund—replenished through savings achieved or returns on investment—that might need topping up from time to time.

Many agencies the review consulted identified the lack of upfront investment as a constraint on innovation. Several explored the possibility of establishing a funding pool to support innovation. Proposals included a centrally held pool or an agency pool that could be established by diverting a portion of the budget savings from the Efficiency Dividend.

The review is not convinced that a centralised funding pool obtained from a redirection of funding from the application of the Efficiency Dividend and supplemented each subsequent year is appropriate. Creating a specific innovation pool would set a precedent for potentially similar approaches to other areas of the budget and would reduce the government's flexibility to develop priorities for spending.

Agencies already have the ability to allocate departmental resources to support innovation, and proposals to invest in innovation can be brought forward in the budget context. In addition, the funds associated with the Efficiency Dividend have

³⁰ The APS 200 Project on Public Sector Innovation is sponsored by the Secretary of the Department of Innovation, Industry, Science and Research. Membership comprises the Secretaries Board, SES Band 3 and selected agency heads.

³¹ The Secretaries Board is chaired by the Secretary of the Department of the Prime Minister and Cabinet and comprises all Secretaries and the Australian Public Service Commissioner. The board was established as the pre-eminent forum for the discussion of matters affecting the Australian Public Service.

³² The Management Advisory Committee is a forum of Secretaries and agency heads established under the *Public Service Act 1999* to advise the Australian Government on matters relating to management of the Australian Public Service.

never been appropriated, and a specific allocation to a pool, when expensed, would hit the bottom line of the budget in the absence of a corresponding reduction in new policy outlays.

5 Consultation: responses to the questionnaire

The ‘Driving Efficiency’ questionnaire (see Appendix G) was issued to 164 Australian Government agencies—all 20 portfolio departments, the 84 agencies governed under the Financial Management and Accountability Act, and 60 of the 87 bodies governed under the Commonwealth Authorities and Companies Act.³³

The questionnaire was designed to elicit information on how current arrangements for promoting efficiency are working and provide an opportunity for agencies to suggest alternatives to the current Efficiency Dividend, noting the review requirement that alternatives need to return at least the same amount of savings to the budget.

The secretariat received 61 completed questionnaires (a response rate of 37 per cent), of which 20 were from organisations the secretariat had also consulted either in a face-to-face meeting or through a teleconference.

The two main messages from the responses to the questionnaire were as follows:

- Overwhelmingly, but not unsurprisingly, agencies are dissatisfied with the Efficiency Dividend. Only three respondents said they were ‘satisfied’ and none said they were ‘very satisfied’.
- Most agencies consider that the Efficiency Dividend has only a modest or minor effect in promoting efficiency. The three main drivers respondents identified were to meet new or emerging priorities, to improve levels of service, and to fund pay increases to staff.

Other important messages were that the majority of respondents saw the Efficiency Dividend as an unsuitable instrument for promoting efficiency; that the respondents considered that the dividend affected agencies inequitably, that it was easy to administer, and that it provided an incentive for agencies to seek additional funding through new policy.

Many respondents (39 out of 61) suggested partial or full alternatives to the current Efficiency Dividend framework. Interestingly, there was no consistent alternative: more than 15 different alternatives were put forward. Some of the more popular themes were using program or agency reviews to determine funding, multi-year funding agreements, and exempting categories of departments (most often small agencies) from the dividend.

³³ The CAC agencies that were not sent a questionnaire were the 24 Commonwealth companies and the three agencies subject to only certain CAC Act provisions—namely, the Australian National University, the National Transport Commission and the NEPC Service Corporation.

6 Options for promoting efficiency through the budget framework

At present the Efficiency Dividend provides an incentive for agencies to bring forward new policy proposals. The departmental funding arrangements are such that agencies that receive additional resourcing have greater flexibility in their efforts to meet increases in costs and wages across the range of new and existing programs and services they provide. Some agencies consulted readily acknowledged that of necessity they game the framework.

On the basis of the review's consultations and analysis, several alternatives to the current arrangements for encouraging efficiency and sharing those gains emerge. The possible options range from retaining the Efficiency Dividend to amending the current arrangements to a major change to the budget framework. The last option (Option 4) is to develop and assess alternative ways of promoting efficiency, taking into account the broad range of incentives that operate within government and across the budget and financial frameworks. A worked example of a model that addresses the interactions of elements of the budget framework more holistically, in order to optimise incentives for efficiency, is provided. Such models could involve major changes to the budget framework and agreed approaches to the measurement of agency efficiency, and therefore require further development. Each option (including the worked example) was assessed against the criteria set in the review's terms of reference.

The four options

Option 1 Retain the Efficiency Dividend.

Sub-option 1(a)

Provide limited exemptions to the Efficiency Dividend to agencies that have not received increases in appropriations from new policy proposals in the last four budget years.

Sub-option 1(b)

Allow ministers to identify their portfolio's lowest priority administered expenditure—the bottom 5 per cent of the total administered budget. Ministers' proposals must consist of complete programs and include the associated departmental appropriations. If the government agrees to terminate an identified administered program the agency would retain the associated departmental funding, but this would be capped to an amount that did not exceed their annual contribution to the Efficiency Dividend and would apply for no more than three years (budget year and forward estimates 1 and 2).

How might it work?

In the case of Option 1, the Efficiency Dividend would operate as it does at present. The Efficiency Dividend is arguably the most equitable approach because it applies as a flat rate to all agencies, with few exemptions. This option would not, however, address concerns that the dividend has a disproportionate impact on agencies that have not historically attracted new funding and on those that have less discretion over their funding owing to statutory responsibilities or the need to maintain expensive assets that account for a significant proportion of their budget. However, this is consistent with the Government retaining discretion for the allocation of new funding to its identified priorities.

If the Efficiency Dividend is retained, consideration could be given to improving its public presentation and its role in the current budget framework. The aim would be to show how the Efficiency Dividend allows governments to manage budget pressures and priorities. This could counter some of the criticism of the Efficiency Dividend which focuses exclusively on the reduction of resourcing, not on what it actually allows the governments to do.

Sub-option 1(a) recognises that agencies that have not received new funding for a lengthy period may be more likely to be disproportionately affected by the Efficiency Dividend. The flexibility of *not* applying the Efficiency Dividend to agencies that have significant departmental appropriations would be at the discretion of government. This sub-option would reduce the need for core budget supplementation for a definable group of agencies that can more readily claim to have been disproportionately affected by the cumulative impact of the Efficiency Dividend.

It could be necessary to consider exceptions to exemptions under Sub-option 1(a) since some agencies might not have sought new funding after substantial changes to their resourcing in earlier budget measures. The aim of the exceptions would be to recognise the disproportionate impact of the Efficiency Dividend on agencies with more static resourcing profiles. All agencies with an existing partial exemption to the Efficiency Dividend would automatically be excluded from further exemptions.

Sub-option 1(a) would provide an incentive for agencies not to seek new funding when they were close to, or already in, the four-year threshold—that is, a similar incentive to the no-claim bonus offered by insurers.

Sub-option 1(b) recognises that there remains considerable scope for finding savings in administered programs that have departmental funding associated with their delivery.³⁴ Administered appropriations represent over 85 per cent of annual budget outlays. This sub-option effectively gives agencies an opportunity to seek a rebate on the applied Efficiency Dividend from the termination of low-priority administered programs. The rebate would be available only as departmental funding to the agency responsible for the administered funding that was terminated, and it would be time limited. This option is likely to benefit those agencies with significant administered

³⁴ The Canadian Government has a program of Strategic Reviews which aims to assess all direct program spending and performance over a four-year period. Canadian agencies identify the lowest-priority and lowest performing 5 per cent of programs (reallocations) and propose higher-priority, higher-performing programs for reinvestment.

appropriations that do not align with the government's priorities. It might also crowd out savings that could be made by simply stopping that activity in the first instance.

Sub-option 1(b) would add an additional burden to the budget process, which would need consideration through submissions and costings. This would increase Cabinet's workload. The sub-option requires more development and would be better implemented in a subsequent budget.

Option 2 Maintain the Efficiency Dividend but allow portfolios the flexibility to use differential rates for agencies within the portfolio on the condition that the aggregate contribution by each portfolio over the forward estimates period remains equal to what would be obtained through the current arrangements. If a portfolio minister wanted to apply differential rates, the rates would need to be approved by Cabinet.

(Sub-options 1(a) and 1(b) can also be considered with Option 2.)

How might it work?

Portfolio ministers would be given the flexibility to determine, subject to confirmation by Cabinet, whether to apply differential rates to portfolio agencies in order to reach their portfolio target.

Finance would calculate and apply the Efficiency Dividend to each agency as is currently the case. Portfolio Ministers could then bring forward proposals to amend the impact of the Efficiency Dividend on their portfolio agencies provided that there is no impact on the underlying cash balance for the portfolio as a whole. Ministers' proposals would in effect not alter the rate of the Efficiency Dividend but provide a process to shift departmental funding among portfolio agencies.

Portfolio ministers' proposals to apply differential rates would need to be brought forward in portfolio budget submissions and would need to confirm that they would not lead to a reduced level of service delivery.

Allowing portfolio ministers to recommend to Cabinet the application of differential rates within their portfolios responds to the criticism that the Efficiency Dividend is a blunt instrument. It offers flexibility in that it would acknowledge that each agency might not have the same capacity to find efficiencies consistently. It vests responsibility for proposing specific contributions to an overall target in the portfolio minister.

This option does not, however, guarantee treatment of agencies that might from agency viewpoints be seen as equitable. Any change to the current arrangements (the application of a flat rate) would be for the portfolio minister to recommend. The requirement for the portfolio minister and Cabinet to agree to any differential rates provides an assurance that agencies would be treated appropriately.

The simplicity of a centrally set Efficiency Dividend base rate would be retained. Government would still set a headline rate with a known budget impact. A small additional effort would be required from a central budget perspective—namely, briefing of Cabinet on proposals for differential rates.

If portfolio ministers opted to maintain a flat rate for all agencies, there would be no additional workload from a portfolio perspective.

Portfolios might game the process by proposing the application of higher rates to portfolio agencies that receive new policy proposal funding in the budget. This would be problematic only if portfolio ministers failed to demonstrate that proposals for differential rates did not affect the budget bottom line over the budget and forward estimates years.

It would be possible to implement this option in time for the 2011–12 Budget.

Option 3 Introduce a sliding scale for the Efficiency Dividend that would reduce the contribution from smaller agencies but return a similar level of savings to the budget.

How might it work?

This option would introduce a sliding scale for the Efficiency Dividend rate. For example, the Efficiency Dividend calculation could be:

- 0 per cent for appropriations up to \$10 million
- 0.5 per cent for appropriations between \$10 and \$30 million
- 1 per cent for appropriations between \$30 and \$50 million
- 1.25 per cent for appropriations between \$50 and \$100 million
- 1.4 per cent for appropriations above \$100 million.

If such a scale was introduced, the negative fiscal impact would be \$1 million over four years. If the current Efficiency Dividend was applied to appropriations above \$50 million, without a higher rate for agencies with annual appropriations greater than \$100 million, the proposal would have a four-year cost of \$300 million, with the cost in the fourth year being \$120 million and increasing annually by around \$30 million every year.

For agencies that enjoy a partial exemption under the current arrangements—the Australian Nuclear Science and Technology Organisation, the Australian Institute of Marine Science, CSIRO and the Department of Defence—the Efficiency Dividend would continue to be applied only to the existing eligible proportion of their funding. For example, for CSIRO the Efficiency Dividend would be applied to 30 per cent of the organisation’s appropriation, using the rates just shown. Existing full exemptions—the ABC and SBS—would be maintained unless government reconsidered them.

The perceived disproportionate impact of the Efficiency Dividend on smaller agencies has been a recurrent criticism of the policy. Introduction of a sliding scale could validate this criticism for which there is little evidence to support and which the Government has not accepted to date. Setting a different efficiency expectation for smaller agencies ultimately provides an incentive to maintain, or indeed develop, governance structures that could be sub-optimal.

This option could be made to be budget neutral since larger agencies would pay more and smaller agencies would pay less.

Although it would reduce the impact of the Efficiency Dividend on smaller agencies, this option is arguably less equitable than existing arrangements because it cannot be demonstrated satisfactorily that the Efficiency Dividend disproportionately affects all smaller agencies.

As noted, such an approach does not respond to the question of the current status of agencies in relation to efficiency—that is, how efficient agencies are now. It just responds to the Efficiency Dividend's impact on smaller agencies by increasing the burden on larger agencies. In this respect it would encourage gaming by creating a further incentive for the larger agencies to offset the impact of the Efficiency Dividend through new policy proposals. It would also provide an incentive to create a greater number of smaller agencies.

This option retains the basic simplicity of the current system in that it applies a formula to the appropriation and new policy process. There could, however, be difficulties when agencies receive new policy funding but are approaching a threshold for paying a higher dividend.

None of the gaming in the current system would be avoided by this approach, although it would alleviate some of the effects for agencies that have the least capacity to game the current system, and these tend to be the smaller agencies. This is especially the case for agencies that have a specific set task, further reducing their flexibility to find efficiencies.

Option 3 could not be implemented for the 2011-12 Budget.

- Option 4** Develop and assess alternative ways of promoting efficiency, taking into account the broad range of incentives that operate within government and across the budget and financial frameworks. This work would also consider the impact of related processes, including strategic reviews, agency health checks, costings processes, and operating losses, noting that:
- a. Particular consideration should be given to the feasibility of alternative models of agency resourcing, such as improving the interaction of indexation with other elements of the budget framework, including detailed study of the potential behavioural responses of Ministers and agencies to such approaches; and
 - b. Alternatives along these lines should be developed for consideration in the 2013–14 Budget, subject to a progress report from Finance and Treasury to Ministers in the 2012-13 Budget on the opportunities for further developing holistic approaches consistent with the Government’s fiscal strategy.

How might an example of a holistic model work?

The outline of key elements of an example of a more holistic model (Box 1) seeks to address more the interactions of various elements and incentives in the budget framework. It would need further consideration to ensure that the various elements (including new policy, indexation and efficiency measurement) were appropriately integrated and could deliver the desired outcomes. It and any other holistic model would benefit from testing of the behavioural responses that it might produce.

The key concept behind such an approach is the concept of efficient price. Where a government perceives that an efficient price is being paid for a given basket of services, no case would be considered for departmental supplementation. Where an efficient price was not perceived to have been achieved, government would have the option of extracting savings, or adding delivery requirements without additional departmental resources. Access to additional departmental resources would only be given where an efficient price was being achieved and there was a significant increase in the basket of services.

A holistic approach would build on benchmarking to determine whether efficient prices are being achieved. It would also rely on an ability to undertake targeted reviews of levels of efficiency, which might themselves be disconnected from decisions about new policy. Incentives to pursue new policy in order to obtain departmental funds would therefore be reduced, as agencies face the risk that additional funding would not be forthcoming, in the short term at least.

Box 1: Outline of key elements of an example of a more holistic model

Remove the Efficiency Dividend as part of the introduction of a budget framework that caps overall departmental appropriations within a tight but realistic envelope. Such a model would aim to:

- a. Provide a greater level of certainty around realistic departmental funding levels;
- b. Break the nexus that currently exists between new policy proposals and departmental funding bids; and
- c. Strengthen the ability of government to push responsibility for the management of cost pressures back onto agencies.

Some of the attraction of the new policy process as a way to augment departmental expenses would be removed by such a proposal.

The link between such an approach and the aggregate budget strategy is largely determined by two factors:

- a. Aggregate savings or offsets; and
- b. A decision to allocate new resources consistent with the strategy, for example by the difference between CPI, representing real growth, and a wage cost index applied to departmental funds.

To work through an example of a more holistic model, we assume that current overall expenditure on Australian Government departmental activity is, in the main, at an appropriate level, with some variation at the margins and in terms of individual agencies. To maintain the agreed level of government services overall departmental funding would be managed within similar real levels into the future.

In order to do this, the cap or envelope could be indexed using change in the CPI.³⁵ This envelope would specifically exclude the Department of Defence, which already has an overall funding formula applied to it, on the basis that Defence has had a comprehensive review and has had its budget set until 2029–30.

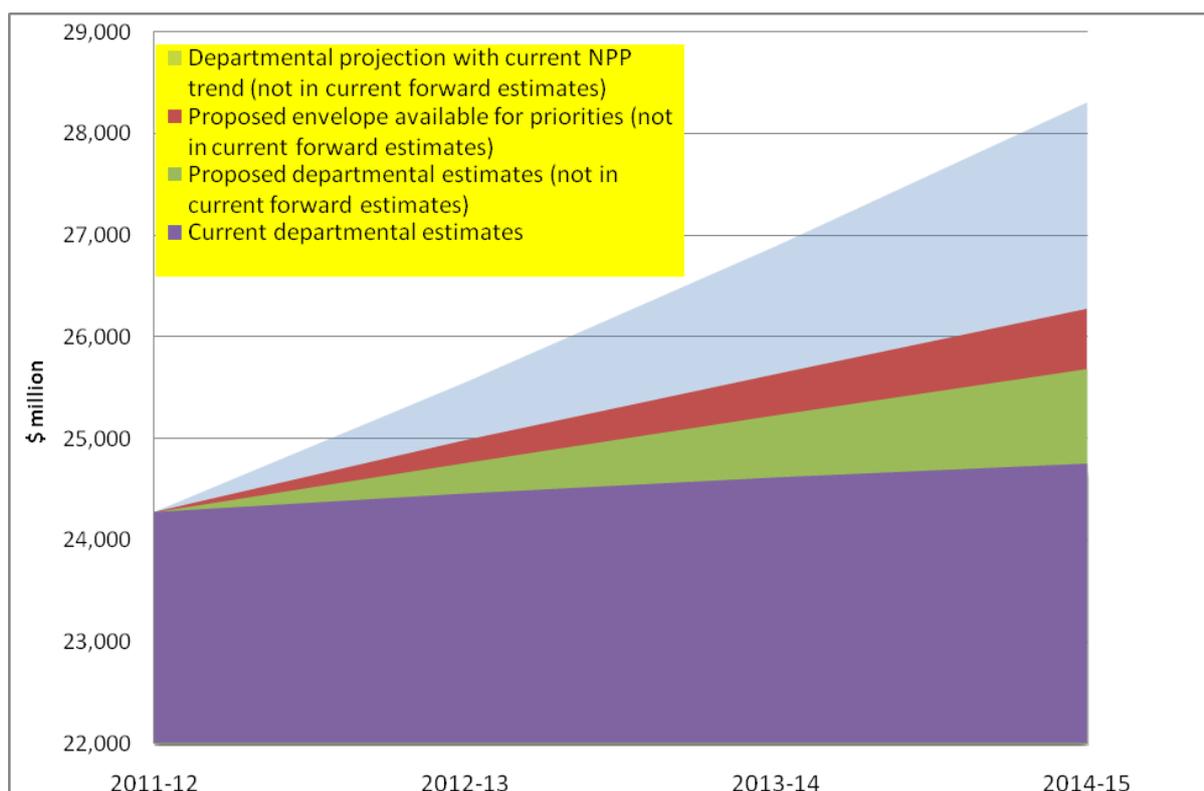
The envelope could also exclude funding that is subject to an activity-based funding model—for example, certain Centrelink funding. Such funding already takes into account changes in activity, much of which is counter-cyclical to the economy as a whole.

In effect, this worked example links the amount of public funding provided for departmental activity more closely to how prices are rising in the general economy.

³⁵ The 2008–09 Budget historic series shows real spending growth deflated by the CPI. Previously the non-farm GDP deflator was used. The change from using the non-farm GDP deflator to the CPI provides a more accurate depiction of real government spending growth.

This would provide a tangible and visible link between growth of the public sector at the federal level and the growth in prices in the general economy.

Each agency’s funding could be regularly increased by an appropriate wage cost index (see Figure 7 for aggregate projections). These average about 0.5 per cent lower than the CPI over the current forward estimate period. The rationale for not providing full CPI indexation is that agency costs are primarily driven by wages, and that other costs, such as capital costs, are themselves driven by market pressures that take efficiency into account.



Notes:

Blue: ‘Departmental projection with the current NPP trend’ (not in current forward estimates) is the projected growth using the average growth in departmental funding between 2000–01 and 2009–10.

Red: ‘Proposed envelope available for priorities’ (not in current forward estimates) is the difference between departmental estimates being indexed by CPI and the departmental estimates being indexed by WCI-3.

Green: ‘Proposed departmental estimates’ (not in current forward estimates) is based on an average indexation of WCI-3 without the Efficiency Dividend. Therefore the green wedge represents the current savings to the budget from the Efficiency Dividend.

Purple: ‘Current departmental estimates’ is based on an average indexation of WCI-3 and with the Efficiency Dividend applied.

Figure 7 Projections of departmental funding using various indices, 2011–12 to 2014–15 (excluding the Department of Defence)

On such a model, funding (shown in red in Figure 7) that represents the difference between the overall increase (as assessed using the CPI) and the automatic increase (using WCI-3 as an average) could be a maximum departmental pool, available for priority areas. On current projections this equates to about \$218 million in 2012–13, \$398 million in 2012–13 and \$584 million in 2013–14. This limitation, or cap, applies only

to eligible departmental funding, which represents an estimated \$24.3 billion in 2011–12, or less than 7 per cent of total government expenditure.

Under such models, the government would still have full flexibility to increase or decrease activity in terms of the non-departmental funding, which represents \$337 billion of expenses, or over 93 per cent of government expenditure. In general, agencies would be expected to meet the cost of any additional activities for new measures announced in any budget from their current adjusted budget or through savings measures.

In the three years beginning in 2012–13, if the departmental resourcing component of new policy proposals grew at the same rate as the previous decade's trend then total departmental resourcing would be in the order of \$3.9 billion higher than if it grew in line with the CPI. Of course a reduction in departmental funding below the previous trend rate of growth cannot be portrayed as a saving as it involves a projection of future discretionary funding, not currently included in the forward estimates.

A change from one system to another would involve transition issues, and these would need to be managed. For example, at the point that a decision was taken to shift from the current arrangements there would be a measure created with a negative fiscal impact of \$2.1 billion over three years (assuming the first year was a base year). If the additional departmental pool was allocated, this would increase the underlying cash deficit by a further \$1.2 billion over the same period.

It is important that any changes be consistent with the Government's fiscal strategy. Under the Government's current fiscal strategy, these amounts would need to be offset by an equivalent reduction in spending. This impact would need to be weighed against the potential effectiveness of a new approach in bringing actual departmental spending below the trend described above. That is, Government would need to form an assessment of whether the possible counterfactual benefits of a new approach outweigh the concrete negative impact on the bottom line of proposed changes such as the removal of the Efficiency Dividend. Understanding the likely behavioural impacts, for Ministers and agencies, of changes to the budget framework is therefore critical to assessing whether they are worthwhile. Any benefits of this nature would not be available to offset new spending under the Government's fiscal rules.

The priority funding (included in the envelope) would be available primarily to meet the needs of agencies that could not be managed on a business-as-usual basis, and they can demonstrate they are operating their business reasonably efficiently.

This framework largely removes departmental expenses from the new policy process, provided that the overall workload for an agency remains relatively constant.

The worked example does not preclude the government determining that an agency has a reduced overall workload and so is able to reduce an agency's resources. Offsets and savings would continue to contribute to the budget envelope. Similarly, the priority envelope would allow the government to provide additional resources if it finds the overall workload of an agency has significantly increased.

The worked example is equitable—provided the assumption that the current apportionment of funding between agencies broadly matches the current distribution of work. Specifically, the worked example spreads the growth in funding more evenly and gives agencies more certainty about their budgets (see Case Study in Box 2). Such an approach also removes much of the incentive for gaming that exists with the current framework—although it may simply change the nature of gaming rather than reduce it overall. Agencies that are able to persuade government most effectively about their needs will still benefit from access to the additional funding available above indexation, although to a lesser extent than under the current framework.

If implemented, the worked example might give agencies greater certainty over an additional \$2.1 billion over three years in departmental funding (as the Efficiency Dividend is removed), but would cap departmental funding and link it to growth in prices throughout the economy as a whole.

On initial examination, such an example appears to provide greater funding for current activity. On the basis of historical data (see Figure 3), however, as long as the cap is observed this example would result in a reduction in funding provided to government bodies in the order of 1 per cent a year, noting that any such projection is not a saving measured against what is now in the forward estimates.

The benefits of such a model can be compared with the advantages of a fixed interest rate over a variable rate. The trade off for government would be less control (currently exercised through its consideration of new policy proposals) for more predictability and sustainability in resource management, which in turn should underpin a more optimal management of risk.

Effectiveness depends on the government tightly maintaining the policy into the future. This would require public commitment to the framework, and the budget would need to report on how well the policy was working.

From a budget process perspective, the worked example would require a different approach given the need to manage resources within an envelope. It would require a more detailed assessment of agencies' current capacity to meet the activity and the capacity to reallocate from other activities (that might no longer be required). This could have a major impact on the Department of Finance and Deregulation, as the central agency responsible for costing proposals and advising on agency resourcing. The extent of such work would depend on the number of agencies bidding for this funding.

The additional work would be at least partly offset by the removal of any costing requirement for departmental initiatives that fit within current activity and therefore no longer need to be costed. Agencies that do not seek additional departmental funding through the new policy process would not need to engage in any of this activity in terms of their departmental appropriation. It would be expected that the vast majority of agencies would not seek funding through this process, especially in the short term, since they will have already received a boost through the removal of the Efficiency Dividend.

The worked example involves major changes to the budget framework. It would not be possible to implement it in the 2011–12 budget framework. Further study of the potential behavioural responses to an alternative indexation and funding model would help to determine if such a model is a viable option for the future. For example, the worked example could place some pressure on the demand for administered program funding if the ability to deliver a program is compromised. An agency might seek to respond to a policy requirement by using an administered funding arrangement with a third party, rather than performing the work in house.

Table 3 summarises the options (including the worked example) for changes to the budget framework.

Box 2: Case study of possible impact on an agency's resourcing

As can be seen in Table 2, a hypothetical agency that has a base departmental appropriation of \$100 million in 2011–12 would receive total appropriations across the forward estimate period of \$404.0 million under current arrangements, prior to any net effect of new policy.

In the last decade, there has been a substantial growth in agencies' appropriation from new policy. If the agency managed to obtain new policy at the average rate achieved across the Australian Public Service between 2000–01 and 2009–10, then its total appropriation across the forward estimates period would increase by \$28.6 million to be \$432.6 million, as total annual growth was in the order of 5.25 per cent.

Under the worked example, this agency's total estimates across the forward estimates would be \$411.7 million, a net gain of \$7.7 million from the current forward estimates. This is the effect of the Efficiency Dividend being removed. Under the worked example, the agency would not bid for new resourcing directly associated with new policy, but the agency would have access to an envelope for Government priorities. Funding under this envelope would be only available to an agency which can demonstrate it is efficient and has insufficient resourcing for its proposed workload.

If all agencies were equally efficient and had equal call for more resourcing to match their workload, this agency would receive an additional \$2.4 million in 2014–15. An agency may receive significantly above or below this average figure, but this figure represents an equal proportion of the total envelope as this agency is of total departmental appropriations (excluding Defence).

Table 2 Example of impact of worked example for an agency with a \$100 million annual appropriation in 2011–12

Budget impact	2011–12	2012–13	2013–14	2014–15	Total
Efficiency Dividend	BASE	-1.25	-1.25	-1.25	
WCI-3	YEAR	2.0	1.9	1.8	
Current Forward Estimates (prior to any NPPs) (WCI-3 less ED)	100.0	100.7	101.4	101.9	404.0
Forward Estimates with NPP trend ^a	100.0	105.3	110.8	116.6	432.6
Net effect for agency from current Forward Estimates	0.0	4.6	9.4	14.7	28.6
Proposed Forward Estimates (WCI-3)	100.0	102.0	103.9	105.8	411.7
Net effect for agency from current Forward Estimates	0.0	1.3	2.5	3.9	7.7
Average Envelope available for this agency based on proportional share of total envelope		0.9	1.6	2.4	4.9

a. NPPs based on trend from 2000–01 to 2009–10 with average total growth in appropriations of 5.25 per cent per year. This trend is speculative in that it projects discretionary spending based on historical spending patterns.

Table 3 Options for changes to current budget framework

Option	Impact on budget	Appropriateness	Equitable treatment of agencies	Effectiveness in driving efficiency	Administrative efficiency	Behavioural effects and potential for gaming	Ability to implement for the 2011–12 Budget
1	Current policy						
1(a)	\$30 million ^a a year from 2014–15	Linking NPPs to exemptions affects budget integrity	Improved and more targeted	Neutral	Marginal increase in workload	Less pressure to seek new policy	Yes
1(b)	Neutral ^b to positive	Negative as shifts resources from services to public servants	Less: benefits only agencies with low-priority administered funding	Provides real incentive to identify low-priority programs	Moderate increase in workload	Strengthens priority settings	No: 2012–13 Budget
2	Neutral	Neutral	More flexibility to respond to potential disproportionate impacts	Marginal increase	Very marginal increase in workload	Neutral	No: 2012–13 Budget
3	Neutral	Reduced: as removes a driver of efficiency in smaller agencies	No less than current arrangements	Neutral	Neutral	Less pressure on small agencies; more pressure on larger agencies to game	No: 2012–13 Budget
4 (worked example) ^c	Negative ^d	Neutral	Neutral	Positive if resourcing above indexation is limited to agencies that can demonstrate efficiency	Neutral	Positive if reduced departmental incentive for NPPs	No: 2012–13 Budget because these require significant changes to the budget framework

- a. Exemptions would reduce the estimated budget saving generated by the Efficiency Dividend. If this arrangement had been in place for the 2010–11 Budget, there would have been about 40 exemptions and the impact would be \$30 million in 2014–15, recognising that it would have an initial impact in 2013–14 given the way the Efficiency Dividend is calculated. Therefore, assuming a similar profile of agencies will not have received any appropriation for new policy proposals in the four years leading up to the 2011–12 Budget, we would estimate the budget impact to be similar in 2015–16.
- b. Sub-option would be at least budget neutral but in fact is likely to generate savings to the budget because agencies would be able to convert only an amount not exceeding three years of their estimated contribution to the Efficiency Dividend.
- c. The assessment of the worked example against the criteria does not take into account the behavioural responses of agencies under proposed changes to the budget framework. Further development of the proposal would be required to validate these assessments.
- d. See discussion on page 38.

Assessment of options

Option 1—retaining the Efficiency Dividend—is a sustainable position, and many agencies consulted during the review acknowledged that ultimately necessity (or budget pressure) was what led to efficiency.

Sub-option 1(a)—providing limited exemptions to the Efficiency Dividend based on an agency’s resourcing history—is a targeted way of providing relief to a definable group of agencies that are most likely to be disproportionately affected by the Efficiency Dividend. There would be a modest impact on the budget bottom line, but this would not occur until 2015–16 (outside the forward estimates period for the 2011–12 Budget). On balance, this sub-option is not supported because it undermines the Government’s fundamental right to allocate funds according to its priorities.

Sub-option 1(b)—allowing rebates from the Efficiency Dividend through an administered funding savings exercise—provides a real incentive for agencies to identify low-value or poorly-performing administered programs. This sub-option is not supported, though, because it would benefit only agencies with administered funding, creating an awkward trade-off between low-priority administered activity and efficiency in departmental activity. It also undermines the government’s fundamental right to allocate funds according to its priorities.

Option 2—giving portfolio ministers flexibility in applying the Efficiency Dividend—is and adjustment to the current arrangements. Portfolio ministers might see the development of differential rates as burdensome and perhaps not worth the additional effort. Smaller agencies may still not get support within their portfolio given the need to offset reduced contributions from one agency by increasing the contribution from other agencies. The option would therefore not guarantee any improvement on the current arrangements. It does, however, allow for flexibility, and it retains the efficiency, effectiveness and integrity of the current arrangements, including certainty about the level of savings to the budget.

Option 3—involving a sliding scale for the Efficiency Dividend—would reduce the impact of the Efficiency Dividend on smaller agencies, but add complexity, create perverse incentives and almost inevitably lead to further arguments about rates and thresholds. The review considers that size alone does not indicate an agency’s ability to find efficiencies, so it does not support this option.

Option 4—develop and assess alternative ways of promoting efficiency, taking into account the broad range of incentives that operate within government and across the budget and financial frameworks—would aim to address current gaming, provide a platform for more sustainable resource management, and is perhaps an approach for the medium to long term. The worked example provides details of one approach, although a range of options could be considered. An objective of a more holistic approach should be to limit gaming as a problem and to provide a framework that would allow managers to manage their agencies’ resources more optimally.

The review considers opportunities for more holistic approaches are worth exploring further as proposed under Option 4, but notes that these might require major changes to the current budget framework.

Recommendation 1

The review recommends that, to maintain budget integrity, government retain the current Efficiency Dividend framework in the short term, with variations to allow more flexibility to re-allocate its impacts at agency level:

- a. The Efficiency Dividend should be applied at portfolio level, from the 2011–12 Budget on.

Recommendation 2

The review recommends that consideration be given to improving the public presentation of the Efficiency Dividend and its role in the current budget framework.

Recommendation 3

The review recommends continuing work to develop and assess alternative ways of promoting efficiency, taking into account the broad range of incentives that operate within government and across the budget and financial frameworks. This work would also consider the impact of related processes, including strategic reviews, agency health checks, costings processes, and operating losses, noting that:

- a. Particular consideration should be given to the feasibility of alternative models of agency resourcing, such as improving the interaction of indexation with other elements of the budget framework, including detailed study of the potential behavioural responses of Ministers and agencies to such approaches; and
- b. Alternatives along these lines should be developed for consideration in the 2013–14 Budget, subject to a progress report from Finance and Treasury to Ministers in the 2012-13 Budget on the opportunities for further developing holistic approaches consistent with the Government's fiscal strategy.

7 Beyond the Efficiency Dividend: opportunities for a more strategic efficiency agenda

The review was asked to consider how best to encourage continued efficiency in the Australian Government. The Efficiency Dividend encourages efficiency indirectly through necessity—reduced estimates for, in theory, the same quality and level of output—but in a way that does not allow actual efficiencies to be identified and quantified. It is also doubtful that the dividend is the optimum way of promoting substantial efficiencies.

Since 2007 the Labor Government has pursued several whole-of-government efficiency measures that have directly led to a reduction in agencies' funding. Among these initiatives are the following:

- \$1 billion in savings over four years as a result of implementation of phases one and two of the program that was the outcome of the Review of Information and Communication Technology, led by Sir Peter Gershon³⁶
- \$160 million in savings over four years from new arrangements for the provision of domestic and international air services and travel management services to the Australian Government³⁷
- \$47.6 million over four years, increasing to about \$100 million a year by 2025, through the new property guidelines.³⁸

The Department of Finance and Deregulation is also conducting a review of the Commonwealth Financial Accountability Framework, to re-examine the financial governance, performance, risk management and compliance arrangements for Australian Government agencies. This is a long-term review, the development phase continuing during the remainder of 2010–11 and throughout 2011–12. A comprehensive development phase should ensure that the obligations of every Australian Government agency under the new framework are commensurate with the risk profile and public accountability that the agency's size and scope require.

During consultations with this present review several agencies commented positively on the whole-of-government approach to efficiency. It also became clear that many agencies recognise intuitively that there is scope for more substantial work to be done in promoting public sector efficiency, particularly in relation to the following:

- agency rationalisation
- benchmarking common functions

³⁶ Media release by the then Minister for Finance and Deregulation, the Hon. Lindsay Tanner MP, 6 November 2009.

³⁷ Media release by the then Minister for Finance and Deregulation, the Hon. Lindsay Tanner MP, 9 May 2010.

³⁸ Media releases by the then Minister for Finance and Deregulation, the Hon. Lindsay Tanner MP, 28 October 2009 and 2 November 2009.

- standardised common processes and shared services—people, property, information and communications technology, and financial management.

In the review's opinion these activities represent a solid base for a more strategic efficiency agenda. Why such opportunities have not previously been pursued is partly explained by some of the disincentives that were canvassed earlier in this report. The review acknowledges that agencies raised the lack of leadership from the centre as a reason why substantial efficiencies were not pursued; they also raised the question of risk management and its impact on change management and innovation.

Elements of a strategic efficiency agenda

The review puts forward several areas in which an interim efficiency agenda could be pursued, although it recognises that deliverables and time frames will require further development and consultation between agencies.

Efficient structures: reviewing the shape of government and identifying opportunities for rationalising the number of government bodies

Several times during consultations it was noted that the number of smaller agencies constituted a source of inefficiency in view of the duplication and increased relative costs of delivering corporate services and governance. The review did not seek to identify specific opportunities for rationalising the number of agencies but finds that this is an exercise that would be worth pursuing with the aim of achieving economies of scale in the management and administration of programs.

The review does not suggest that there should be a size threshold for agencies. There are many reasons for establishing separate agencies, and there will remain compelling reasons for having some smaller agencies. These include a need for statutory independence and the exercise of special powers. Sometimes the creation of an agency is in itself an attempt at reform when there is an obvious gap in existing arrangements. The evolving shape of government means, however, that from time to time consideration of the overall shape of government can offer opportunities for promoting more efficient structures. Under the current framework there is no obvious time to consider the shape of government until the need for a particular agency has ended.

The fiscal imperatives facing government provide a strong incentive for rationalising the number of small agencies. From a pragmatic perspective they also offer an opportunity to consider matters that can in different times escape attention.

The review puts forward the following reasons for rationalising the number of Australian Government bodies:

- to improve the efficiency and effectiveness of government administration by reducing the number of bodies and the extent of coordination required for cross-agency work
- to reduce the number of points of entry to government, so that it is easier for the public to interact with government

- to increase the use of departments rather than stand-alone bodies, which allows for flexibility through the refocusing of work when required by the government of the day without requiring amendment of enabling legislation to change a body
- to increase employee flexibility and reduce the costs associated with inter-agency transfers
- to maximise the application of accountability laws and processes—for example, freedom of information, parliamentary accountability and Public Service Act coverage
- to achieve modest savings through the reduction of overheads associated with separate governance arrangements and the oversight costs of responsible departments, central agencies and integrity agencies.

Towards better measurement of efficiency: opportunities for benchmarking common functions

Benchmarking will help with better measurement of efficiency across Australian Government agencies. It can provide to agencies information that helps them measure their relative efficiency. It can also help define best-practice enablers to assist in closing performance gaps, identify where and how practices can be improved, and provide feedback on where improvements are being realised.

During the review several agencies said they had participated in benchmarking exercises, typically for corporate services such as payroll and Human Resources. The consultations revealed support for better and wider benchmarking of common functions. Benchmarking could potentially be extended to other functions, such as grants administration and case management systems. Identifying which functions to measure and developing the necessary parameters should be done collaboratively.

Choosing functions and parameters for benchmarking is an area of cross-agency work that would benefit from greater coordination and leadership. There are within government existing forums that can be used to develop benchmarking projects—for example, the Chief Financial Officers Forum and the meetings of the Management Advisory Committee Chief Financial Officers. The review sees value in creating ginger groups through these forums to identify and benchmark common functions and services across agencies.

Shared services

During the review's consultations several agencies pointed to a common Australian Government Financial Management Information System (FMIS) as presenting an opportunity for promoting efficiency. At present each agency selects and customises its own FMIS from a range of platforms. This approach is intuitively less efficient than an enterprise-level approach to the selection of an FMIS, and many of the agencies consulted saw this as presenting a real opportunity for increasing efficiency. Consideration of the merits of adopting a common FMIS raises the broader, and potentially more significant, question of a shared services model for the Australian Government.

On the surface, the concept of shared services appears attractive: by bringing together similar functions and building on the economies of scale, efficiencies can be delivered. There have been two recent studies of the potential and feasibility of shared services within the Australian Government—the Strategic Review of Future Directions for Shared Services (2009) and the central agencies’ Shared Services Feasibility Study (December 2010).

The Strategic Review concluded that the shared services model represented untapped long-term potential to improve efficiency, consistency and reliability in the delivery of corporate services within the Australian Government. While it found a strong rationale underlying the concept of shared services, it also uncovered Australian and international experiences that suggested that successful implementation can be difficult. The report noted that shared services should not be seen to represent easy or quick savings, that effective implementation can require considerable upfront investment, and that case studies show a tendency to underestimate the cost, time and complexity involved in such a project.

Following consideration of the Strategic Review report, the Australian Government agreed that the three central agencies should embark on a study of the feasibility of establishing a cross-portfolio shared services arrangement. The study assessed three shared services delivery models against the current approach. The models covered the spectrum of potential shared services models—ranging from sharing current services with minimal changes to systems or processes to a new system-based solution and a fully integrated shared services arrangement.

The Feasibility Study found the current state model (whereby agencies management their own systems) to be the preferred one. Although all four models were seen to be acceptable, the current state model was lower risk and easier to implement, and these advantages more than outweighed the higher service delivery benefits and lower costs associated with some of the other models. The assessment found that savings from the most advanced service delivery model over the assessment period (eight years) would be only \$4.7 million, or about \$200 000 per year per agency. This represented a 5 per cent saving over the eight-year period.

The two main factors contributing to this outcome were as follows:

- lack of scale or critical mass—only transactional activities were in scope and the total client base across the three central agencies was some 4500 staff, whereas in other jurisdictions shared services typically service 20 000 staff at a minimum
- divergent systems and business processes—which significantly increased the costs associated with moving to a shared services arrangement.

The Feasibility Study found that it was likely that, had the scale or critical mass been much larger and the systems and business processes been the same across the three central agencies, the outcome would have been different. This latter factor highlights the fact that the Australian Government’s devolved management framework has allowed agencies to take different paths in developing efficient processes at the agency level.

Nevertheless, the potential to promote efficiency in the Australian Government through shared services remains. Building on the work of the Strategic Review and the Feasibility Study, this present review proposes that further work in this area focus on achieving efficiencies through scale and by considering how to overcome difficulties relating to the divergence in systems and business processes.

A shared services model would not necessarily mean that each Australian Government body would be tied to a single provider. Jurisdictions that have implemented such a model—for example, the New South Wales Government—allow critical and sufficiently large organisations to maintain their own services.

Further work on an Australian Government shared services model should look at the difficulties associated with divergent systems and business processes. The road-map for standardising common processes and making greater use of shared services models would outline its scope, design principles, operating models, and implementation strategies. In developing the road-map, particular attention should be given to the opportunities to standardise business processes.

Acknowledging the complexities of such a reform, the model would essentially be a first-pass proposal. Should government be convinced of the merits of the blueprint, a full business case would need to be developed for second-pass consideration. A two-pass approach provides a sound platform for an investment decision on a reform that would have a significant impact on the business of government.

Consultations with private sector companies as part of this review emphasised that common systems and practices across business lines was an agenda that needs to be pushed at the enterprise level. Standardisation of financial systems, service delivery practices and reporting was not only seen as beneficial in terms of cost containment: it was also seen to be useful in strategically focusing on opportunities to encourage genuine innovation.

Summary

There are opportunities to generate efficiencies through central processes, and the review proposes that a central aim of an efficiency agenda be to overcome the inertia about developing new approaches, and possibly new administrative structures, that has hitherto hampered cross-agency efforts. Establishment of a strategic efficiency agenda would also make it clear that in some cases upfront investments will be required to give rise to substantial change and long-term benefits.

The review's remit and resources did not allow it to formulate detailed responses to these potential efficiencies. The review seeks instead to illuminate a path towards a more strategic efficiency agenda, recognising that significant leadership, planning and collaboration will be required to pursue it.

The review proposes that the Secretary of the Department of Finance and Deregulation be given a formal mandate to develop a structured plan and to report regularly on the efficiency agenda.

Recommendation 4

The review recommends that a deliberate strategy be put in place to manage costs across government:

- a. Such a strategy should be intended to meet, to a significant extent, the financial demands of the Efficiency Dividend;
- b. The Secretary of the Department of Finance and Deregulation develop and promote a continuing efficiency agenda for the Australian Government; and
- c. The Department of Finance and Deregulation should report biennially on progress with and opportunities for a continuing efficiency agenda, commencing in the 2012–13 Budget context.

Recommendation 5

The review recommends that actions to address efficiency and reduce cost structures into the medium term include:

- a. Benchmarking of common functions;
- b. Rationalisation of the number of agencies, including promotion of a set of principles to help government develop the most suitable structures; and
- c. The development of a road-map for standardising common processes and making greater use of shared services models across the Australian Government, taking advantage of scale, and focusing on business processes and systems, rather than organisational structures.

8 Conclusion

It is difficult to measure efficiency in the public sector, particularly because of the problems associated with measuring changes in quality and outputs. The OECD has noted that ‘productivity gains in the public sector are very difficult if not impossible to measure’.³⁹ This poses a major obstacle to developing a budget process that focuses on inefficiency. The problem also prevents us from determining objectively what a suitable Efficiency Dividend rate should be.

The review did not gain the impression that the Australian Government was inefficient. Indeed, it heard directly from senior managers about the endogenous drivers of efficiency that in their view made efficiency imperative for their organisations. Agencies face budgetary pressures to promote efficiency, and senior managers are keen to deliver results efficiently.

Australian Government departmental expenditures as a percentage of GDP have remained fairly constant. As noted, some studies have found that higher expenditure relative to GDP tends to be associated with lower public sector efficiency. Although international comparisons of public sector efficiency are fraught with difficulty, Australia’s public sectors can be deemed reasonably efficient by this overall measure at least.

The review notes that the pursuit of efficiency is an ongoing concern in relation to the spending of public money. Pockets of inefficiency will continue; some new ones will develop. This is why efficiency is not a static goal. Some of the most important opportunities for promoting efficiency are those that involve leveraging the scale of government and managing the complexity and inefficiencies inherent in a devolved bureaucratic framework. The review proposes the formalisation of responsibility for a continuing efficiency agenda that will aim to exploit strategic opportunities for encouraging efficiency.

The review was not convinced by any of the information it gathered that the Efficiency Dividend was manifestly unsustainable in the long term. Empirical evidence strongly suggests that the dividend, which has been applied for over 20 years, is relevant in the overall context of the budget framework. Retaining it is obviously a viable option for providing a budgetary incentive for agencies to seek efficiency and to give government a share of efficiency gains. The Efficiency Dividend is simple, effective and predictable. But that is not to say that it has no shortcomings.

The Efficiency Dividend promotes efficiency only indirectly, by creating a budget pressure for agencies, and probably creates an incentive for budgetary gaming. For some agencies the dividend’s bluntness as an instrument can lead to sub-optimal consequences, which have so far been managed on a case-by-case basis. The current budgetary environment of fiscal consolidation might put more pressure on some agencies. The requirement for new policy proposals to be offset from existing spending

³⁹ OECD 2009, *OECD Efficiency Study*, Public Governance and Territorial Development Directorate, GOV/PGC/SBO(2009)4, OECD, Paris, p. 6.

is particularly noteworthy in this regard. For many agencies access to new policy funding has hitherto allowed them to manage financial pressures more easily.

Adjustments to the Efficiency Dividend policy could improve its presentation and provide some flexibility in its application. Retaining the dividend will not, however, resolve the problem of incentives for budget gaming. More ambitious changes to the budget process would be required to respond to this.

An efficiency agenda that aims to engender substantial change should form part of a long-term fiscal strategy: it would help place the Australian Government in a position where it can respond flexibly to emerging priorities and manage budgetary pressures. It is important to strike the right balance between necessity that encourages efficiency and the resourcing that allows agencies to perform effectively.

Appendix A The review's terms of reference, steering committee and secretariat

The terms of reference

The review's terms of reference were as follows:

The Review will report to Government in December 2010⁴⁰ on the following issues:

- How best to drive efficiency in the Australian Public Service on a continuing basis;
- The rationale for and design of the current Efficiency Dividend arrangements, including the relationship between the Efficiency Dividend and Wage Cost Indexation;
- The functioning of the current Efficiency Dividend arrangements, from a Budget and Agency perspective;
- Alternatives to the current Efficiency Dividend; and
- An assessment of the relative merits of various approaches to achieving continuing efficiencies, in light of criteria that include:
 - Appropriateness;
 - Equitable treatment of agencies;
 - Administrative efficiency;
 - Behavioural effects, including potential for 'gaming'; and
 - Ability to implement for the 2011–12 Budget.

In making its recommendations, the Review will:

- Consider whether alternative mechanisms to replace the Efficiency Dividend would generate at least an equivalent level of savings to the Government budget;
- Consult widely with affected stakeholders; and
- Consider the experience of other jurisdictions.

The steering committee

The review's steering committee comprised the following officers:

- Stein Helgeby, Deputy Secretary, Financial Management Group, Department of Finance and Deregulation—Chair
- David Martine, Deputy Secretary, Budget Group, Department of Finance and Deregulation

⁴⁰ The reporting timeframe was revised following the 2010 Election.

- Nigel Ray, Executive Director, Fiscal Group, Treasury
- Dominic English, First Assistant Secretary, Economic Division, Department of the Prime Minister and Cabinet.

The secretariat

The following officers made up the review's secretariat:

- Gareth Hall, Financial Management Group, Department of Finance and Deregulation
- Adrian Beekmeijer, Financial Management Group, Department of Finance and Deregulation
- Robert Janssens, Financial Management Group, Department of Finance and Deregulation.

Appendix B Parties consulted and questionnaire respondents

The review consulted and received information from the following agencies as part of its work.

Face-to-face consultations

Portfolio departments

Department of Agriculture, Fisheries and Forestry
Attorney-General's Department
Department of Broadband, Communications and the Digital Economy
Department of Climate Change and Energy Efficiency
Department of Defence
Department of Education, Employment and Workplace Relations
Department of Families, Housing, Community Services and Indigenous Affairs
Department of Finance and Deregulation
Department of Foreign Affairs and Trade
Department of Health and Ageing
Department of Human Services
Department of Immigration and Citizenship
Department of Infrastructure and Transport
Department of Innovation, Industry, Science and Research
Department of the Prime Minister and Cabinet
Department of Regional Australia, Regional Development and Local Government
Department of Resources, Energy and Tourism
Department of Sustainability, Environment, Water, Population and Communities
Department of the Treasury
Department of Veterans' Affairs

Agencies under the *Financial Management and Accountability Act 1997*

Administrative Appeals Tribunal
AusAID
Australian Communications and Media Authority
Australian Crime Commission
Australian Customs and Border Protection Service
Australian Electoral Commission
Australian Federal Police
Australian Fisheries Management Authority
Australian National Audit Office
Australian Secret Intelligence Service
Australian Taxation Office
Australian Transport Safety Bureau
Centrelink
Geoscience Australia

Medicare Australia
Office of the Commonwealth Ombudsman
Old Parliament House

Bodies under the *Commonwealth Authorities and Companies Act 1997*

Australian Institute of Health and Welfare
Australian Maritime Safety Authority
Australian Pesticides and Veterinary Medicines Authority
Australian War Memorial
Comsuper
CSIRO
Food Standards Australia New Zealand
National Library of Australia
Tourism Australia

Questionnaire respondents

Portfolio departments

Department of Agriculture, Fisheries and Forestry
Department of Broadband, Communications and the Digital Economy
Department of Families, Housing, Community Services and Indigenous Affairs
Department of Health and Ageing
Department of Human Services
Department of Infrastructure and Transport
Department of Innovation, Industry, Science and Research
Department of Regional Australia, Regional Development and Local Government
Department of Resources, Energy and Tourism
Department of the Treasury

Agencies under the *Financial Management and Accountability Act 1997*

Administrative Appeals Tribunal
AusAID
Australian Competition and Consumer Commission
Australian Crime Commission
Australian Human Rights Commission
Australian Institute of Family Studies
Australian Prudential Regulatory Authority
Australian Public Service Commission
Australian Research Council
Australian Transport Safety Bureau
AUSTRAC
Austrade
Centrelink
Commonwealth Grants Commission
Department of Parliamentary Services
Equal Opportunity for Women in the Workplace Agency
Family Court of Australia

Great Barrier Reef Marine Park Authority
House of Representatives
Insolvency and Trustee Services Australia
Medicare Australia
Migration Review Tribunal – Refugee Review Tribunal
Murray Darling Basin Authority
National Archives of Australia
National Health and Medical Research Council
National Water Commission
Office of National Assessments
Old Parliament House
Organ & Tissue Donation and Transplantation Authority
Professional Services Review
Department of the Senate

Bodies under the *Commonwealth Authorities and Companies Act 1997*

Australian Institute of Aboriginal and Torres Strait Islander Studies
Australian Institute of Marine Science
Australian Law Reform Commission
Australian National Maritime Museum
Australian Nuclear Scientific and Technical Organisation
Australian War Memorial
CSIRO
Food Standards Australia New Zealand
Indigenous Business Australia
National Film and Sound Archive
National Gallery of Australia
National Library of Australia
Screen Australia
Tourism Australia

Appendix C Elements of the Australian Government's current efficiency framework

General legislative requirements

The *Public Service Act 1999* describes its objective as the establishment of 'an apolitical public service that is efficient and effective in serving the Government, the Parliament and the Australian public'.

The *Financial Management and Accountability Act 1997* (FMA Act) requires a chief executive to 'manage the affairs of the Agency in a way that promotes proper use of the Commonwealth resources for which the Chief Executive is responsible'. 'Proper use' is defined as 'efficient, effective and ethical use that is not inconsistent with the policies of the Commonwealth'.

In relation to Commonwealth authorities, the *Commonwealth Authorities and Companies Act 1997* (CAC Act) requires an officer or employee to 'exercise his or her powers and discharge his or her duties with a degree of care and diligence that a reasonable person would exercise', 'in good faith in the best interests of the Commonwealth Authority' and for 'a proper purpose'.

Under the *Auditor-General Act 1997* the Auditor-General is empowered to provide to the Parliament an independent assessment of selected areas of public administration and assurance about public sector financial reporting, administration and accountability.

Under the CAC Act (s. 32 and r. 6a) and the FMA Act (s. 46 and r. 22c) the chief executives must each establish and maintain an audit committee.

The internal audit process facilitates the maintenance and development of a strong internal control environment through reviews of priority risk areas and other key activities. Internal audit supports and reports to an agency audit committee, which is a sub-committee of the agency's executive board. One of the audit committee's primary roles is to provide to the Secretary and executive board independent assurance on the appropriateness of its financial accountability and control framework, particularly those aspects concerning the proper use of Australian Government resources and management of risks.

Internal audit performs its role by:

- reviewing finance systems, identifying their strengths and weaknesses
- conducting audits and reviews as required by the audit committee
- conducting management assurance reviews of particular matters as directed by the executive or committee
- making recommendations for the improvement of systems both manual and information technology-based—including controls and roles and responsibilities

- reporting to the committee on progress with reviews
- coordinating reviews by external authorities.

Public scrutiny

Through the Senate Estimates process officials are questioned directly by members of a Senate committee about the objectives, operational procedures and efficiency of the programs for which they are responsible.

Agency annual reports and portfolio budget statements are the primary formal accountability mechanisms between government and departments and from departments through (or on behalf of) government to the parliament. Portfolio budget statements set out the proposed allocation of resources to achieve government outcomes. They set out performance information targets for departmental and administered programs.

Annual reports detail progress in relation to those targets and serve to inform the parliament (through the responsible minister), other stakeholders, educational and research institutions, the media and the general public about the performance of departments in relation to services provided.

Portfolio budget statements and annual reports provide to the government and the parliament detailed information about the actual performance of departments and forecasts of future needs and expectations. The clear read between portfolio budget statements and annual reports is an essential part of the accountability system, comparing budgeted targets and figures with those actually achieved, and places strong emphasis on compatibility between the two documents in relation to budget and performance information.

The Australian National Audit Office

The Auditor-General, assisted by the Australian National Audit Office, is responsible for carrying out audits of the financial statements and performance of Australian Government public sector entities. The ANAO delivers audit services and reports consistent with public sector values and adds value to public sector performance and accountability.

The *Auditor-General Act 1997* provides a legislative framework for the Office of the Auditor-General and the ANAO. It also outlines the mandate and powers of the Auditor-General as the external auditor of Australian Government public sector entities. The Auditor-General is empowered to provide to the parliament an independent assessment of selected areas of public administration and assurance about public sector financial reporting, administration and accountability.

The Auditor-General's mandate extends to all Australian Government agencies, authorities, companies and subsidiaries—with the exception of the conduct of performance audits of government business enterprises and of individuals employed or engaged under the *Members of Parliament Act 1994*.

The ANAO provides independent public sector audit and related services through two planned outcomes:

- assurance audit services—assurance on the fair presentation of financial statements of Australian Government entities by providing independent audit opinions and related reports for the information of parliament and the executive
- improvement in public administration—improving the efficiency and effectiveness of the administration of Australian Government programs and entities by carrying out a program of independent performance audits and assurance reviews for the information of parliament and the executive.

In particular, the second outcome relates to the measures of agency efficiency.

Performance audits examine governance arrangements, information systems, performance measures, monitoring systems and legal compliance. All performance audit reports are tabled in parliament.

The *Auditor-General Act 1997* authorises the Auditor-General to conduct, at any time, a performance audit of an entity, a Commonwealth authority or company, other than a government business enterprise or any of its subsidiaries. The Auditor-General may conduct a performance audit of a fully owned government business enterprise or its subsidiaries if the responsible minister, the Minister for Finance and Deregulation or the Joint Committee of Public Accounts and Audit requests the audit.

A performance audit is an independent, objective and systematic examination of the operations of a body to form an opinion on whether:

- management of the operations is economical, efficient and effective
- internal procedures for promoting and monitoring economy, efficiency and effectiveness are adequate
- improvements might be made to management practices—including procedures for promoting and monitoring performance.

In seeking to improve public administration, performance audits also identify better practices, which may then be incorporated in better practice guides produced by the ANAO for dissemination throughout the Australian Government sector.

The budget process

Each year the Australian Government formally makes decisions on investing in activities designed to help meet the Australian community's needs. In doing so, it uses a well-established budget process that sets out the rules and strategies for ensuring that decisions taken meet the challenges of operating in a fiscally sustainable environment. Within that framework each individual portfolio minister is offered the opportunity to bring forward an individual portfolio budget submission that sets out in detail how each portfolio can contribute to the goals of the government. Whether the presentation of that package is budget neutral (fully offset from already agreed

funding) or whether there is an additional cost to the budget is generally a matter for government to decide. In this way new policy directions are established and priorities are responded to.

A structured and rigorous process allows the government to appreciate the cost and benefits to the Australian economy of the decisions it takes. Adjustments are possible at any time during the year, but the budget process clearly expresses the financial position of the government through the publication of the budget, which is refined half-way through the year with the publication of the Mid-Year Economic and Fiscal Outlook.

The budget process applies a fiscal discipline on the government to operate within certain boundaries, ensuring that transparency, accountability and performance can be judged by the Australian community. Areas that are inefficient, inappropriate or ineffective, may be targeted for possible savings.

In making decisions, the government requires a certain rigour of ministers to ensure that activity undertaken meets specific principles, and these are used as guides to the decision and priority settings that make up a budget. The Expenditure Review Principles attached to the Budget Process Operational Rules require 'Government programs to be administered and delivered in the most efficient way achievable, taking into account both short and long-term economic and fiscal consequences'.

Strategic reviews

The 2007–08 Budget established an improved framework (based in the Department of Finance and Deregulation) for carrying out strategic reviews of government programs. Strategic reviews focus on major policy and spending areas across programs and/or portfolios and other priority areas of the Australian Government's activities. The purpose of any strategic review is to identify options for improving the efficiency and effectiveness of expenditure programs and their alignment with policy priorities. They also allow for resources that are identified as duplicative to be reallocated to better accommodate other policy priorities and, finally, they identify opportunities for savings in order to contribute to budget sustainability. Strategic reviews are often performed when similar policy outcomes are being achieved across multiple portfolios.

Agency functions and finances review

The current framework for the Department of Finance and Deregulation to conduct an agency functions and finance review by (in partnership with the agency in question) tends to be used sparingly and only when an agency has identified a risk of being in financial difficulty. Such a review must be agreed to by Cabinet and consists of two stages after the responsible minister makes a request for the review to be carried out.

The 'agency functions' component examines the major functions of an agency, assessing the broad cost of delivery of these functions and then identifying opportunities for reducing costs and/or rationalising some functions. The 'agency financial sustainability' component examines and reports on an agency's finances in

greater detail, including the causes of the main costs and the adequacy of the agency's financial practices and processes.

Both function and financial reviews deal with urgent and serious financial difficulties and recommendations are put before Cabinet to facilitate resolution of identified problems.

Other cabinet-initiated reviews

At times the government (rather than an individual minister) identifies a need to respond to concerns raised in relation to an agency's programs or activity. This might be the result of a desire to assess current programs and structures so that the government can assure itself that its functions and activities continue to be aligned to its policy settings. These reviews might also look at the administrative arrangements an agency provides as part of the core capability to perform the work of delivering government programs.

Programs and their administration can turn out to be duplicated elsewhere, superseded by other decisions or simply no longer a priority. This review activity is often recognised as a 'saving exercise' and is prompted by the possibility that the outcomes could be delivered elsewhere or be delivered better under new programs, structures and guidelines.

The Department of Finance and Deregulation also provides advice on the refinement and simplification of financial management policies and practices. In recommending any amendments to the framework, it can conduct an analysis of information provided by agencies on their actual and budgeted financial performance. Where appropriate, the analysis can form part of the evidence to underpin the resultant recommendations. If matters seem to be other than what would be expected of an agency, a review of activity is often recommended so that the agency's behaviour can be assessed.

Appendix D Previous reports on the Efficiency Dividend

The Efficiency Dividend and Small Agencies: size does matter

In December 2008 the Joint Committee of Public Accounts and Audit, in its report number 413, *The Efficiency Dividend and Small Agencies: size does matter*, concluded that the Efficiency Dividend worked ‘reasonably well’ for large agencies but recommended that it be modified to cater for small agencies. The government rejected this recommendation, noting that it was ‘imperative’ for both small and large agencies to contribute to ongoing efficiency improvements.

Keeping the Customer Satisfied: Inquiry into the Devolution of Running Costs Flexibilities

In October 1995 the House of Representatives Standing Committee on Banking, Finance and Public Administration tabled its report entitled *Keeping the Customer Satisfied: Inquiry into the Devolution of Running Costs Flexibilities*. The new Howard Government responded to the report in October 1996, agreeing to the recommendation that the Departments of Finance and Industrial Relations examine the options available to develop a process for measuring productivity and noting the recommendation that the Department of Industrial Relations examine the feasibility of using workplace bargaining as an alternative to the Efficiency Dividend.

Stand and Deliver: Inquiry into the Efficiency Dividend Arrangements

In March 1994 the House of Representatives Standing Committee on Banking, Finance and Public Administration tabled its report entitled *Stand and Deliver: Inquiry into the Efficiency Dividend Arrangements*. The committee made seven recommendations, including that the dividend be reduced from 1.25 per cent to 1 per cent and that agencies’ external receipts be exempt. In 1994–95 the government reaffirmed the continuing Public Service obligation to generate efficiency gains and the government’s prerogative to retain a share of those gains for the budget. The government also agreed to reduce the dividend to 1 per cent after agency heads had signed a Property Resource Agreement.⁴¹

The Australian Public Service Reformed: an evaluation of a decade of management reform

In December 1992 the Commonwealth Government’s Management Advisory Board published *The Australian Public Service Reformed: an evaluation of a decade of management reform*, which contained a section on the Efficiency Dividend. The board expressed concern that the dividend did not take into account the differences between agencies and concluded, ‘the future of the Efficiency Dividend lies in resource

⁴¹ Department of Finance 1994, *Running Costs Arrangements Handbook*, Department of Finance, Canberra, July.

agreements and workplace bargaining, not in fixed arbitrary annual reductions in running costs’.

Not Dollars Alone: Review of the Financial Management Improvement Program

In September 1990 the House of Representatives Standing Committee on Finance and Public Administration tabled its report entitled *Not Dollars Alone: Review of the Financial Management Improvement Program*, which discussed the Efficiency Dividend. The committee concluded that most agencies found achieving the Efficiency Dividend difficult. It recommended that the Department of Finance improve its marketing of the dividend and take careful account of the merits of exceptional cases when applying the dividend. The government accepted this recommendation.

Appendix E Variations to and exemptions from the standard application of the Efficiency Dividend

Variations

Programs that have administered funding are usually subject to the Efficiency Dividend only if explicit decisions in that regard have been made by government. There are six programs with administered funding that are subject to the Efficiency Dividend—four programs administered by the Department of Family, Community Services and Indigenous Affairs and two programs administered by the Department of Education, Employment and Workplace Relations.

The Department of Families, Housing, Community Services and Indigenous Affairs

The four programs administered by FaHCSIA that are partially subject to the Efficiency Dividend are as follows:

- *Services for People with a Disability*: This program provides social support and community-based care for people with disability, their carers and their families, to promote independence, self-reliance and participation in the community.
- *Parenting*: This program provides intensive, targeted and coordinated support for parents and children who are vulnerable, at risk or in disadvantaged communities, to improve child development, child safety and family functioning.
- *Community Engagement*: This program provides grants and ongoing funding to improve the responsiveness and integration of local community services to increase participation of vulnerable people in community life.
- *Youth Homelessness*: This program provides funding to support innovative prevention and early intervention initiatives to reduce homelessness and its impact, particularly on young people.

The Department of Education, Employment and Workplace Relations

The two programs administered by DEEWR that are subject to the Efficiency Dividend are as follows:

- *Job Placement, Employment and Training*. This program is aimed at helping students and unemployed young people aged 15 to 21 years who are homeless or at risk of becoming homeless. It is subject to the Efficiency Dividend at a rate of 1.25 per cent.
- *Employment Assistance and Other Services*. This is a national network of employment services dedicated to helping people with disabilities who need ongoing support in order to gain and stay in employment. The program is subject to the Efficiency Dividend at a rate of 1.25 per cent.

Exemptions

Of the 192 government bodies—104 agencies subject to the Financial Management and Accountability Act, 87 entities subject to the Commonwealth Authorities and Companies Act and the High Court—the Efficiency Dividend is not fully applied to 65 (two FMA Act agencies and 63 CAC Act entities).

Since the Efficiency Dividend applies only to expenses directly appropriated to an agency, 57 CAC Act entities are not subject to the dividend because they do not receive direct government appropriations. The dividend is also not applied to activities funded externally, such as those covered by s. 31 agreements.

Another way an agency can become exempt from the Efficiency Dividend is if the government specifically decides to partially or fully exclude it. There are at present nine such exemptions:

- The ABC (the Australian Broadcasting Corporation) and SBS (the Special Broadcasting Service Corporation) have had a full exemption from the Efficiency Dividend since 1997 and 2003 respectively and continue to do so under their triennial funding agreements, which run from 2009–10 to 2011–12.
- Safe Work Australia has had a full exemption since its inception in 2010 because it is funded jointly by the states and territories and the Australian Government. The funding arrangement is based on an intergovernmental agreement.
- CSIRO (the Commonwealth Scientific and Industrial Research Organisation) and the Australian Institute of Marine Science are partially subject to the Efficiency Dividend under their current quadrennial funding agreements, which were renewed in the 2007–08 Budget for the period 2007–08 to 2010–11. Under these agreements 12 per cent of AIMS funding and 30 per cent of CSIRO funding are subject to the Efficiency Dividend.
- The government made the Major Performing Arts organisations' funding exempt from the Efficiency Dividend. This represents about 55 per cent of the total appropriations for the Australia Council for the Arts, and this component of the Australia Council's funding continues to be exempt.
- The Australian Customs and Border Protection Service is not subject to the Efficiency Dividend in relation to its Coastwatch contractual arrangements for surveillance aircraft and helicopters. The dividend is, however, applied to the remainder of its appropriations.
- ANSTO (the Australian Nuclear Science and Technology Organisation) used to have a full exemption, but this was reduced to a partial exemption in the 2009–10 Budget, with the Efficiency Dividend applying to 15 per cent of the organisation's funding.
- A reduced rate of Efficiency Dividend, with a phase-in rate of 0.25 per cent, was applied to the Department of Defence in 2005–06. It applies to about 11 per cent of

Defence expenditure. Defence became subject to the full 1.25 per cent Efficiency Dividend rate from 2009–10.

The rationale for these exemptions is as follows.

The ABC and SBS

The ABC and SBS have been exempt from the Efficiency Dividend from the time it was introduced. In the case of the ABC, the government did not introduce the dividend on an ongoing basis when it decided to subject the ABC to a one-off 2 per cent Efficiency Dividend in 1996–97. SBS was also subjected to the one-off 2 per cent Efficiency Dividend in 1996–97, and then the dividend was introduced for the following two triennial funding agreements, in 1997 and 2000. It was removed in 2003, following a commitment made in the 2001 election campaign. Despite consideration of the Efficiency Dividend at the last two rounds of negotiations for both the ABC's and SBS's triennial funding agreements (in 2006 and 2009) the government did not apply a dividend.

Both major parties have made repeated election commitments to maintain the real level of funding provided to the ABC and SBS.

The two broadcasters receive the bulk of their funding through a global multi-year funding agreement, the funds being provided so that the broadcasters can meet their charter obligations. The funds are not easily separable so as to identify administrative components as opposed to program-like components. Any cut to the funding would be argued as a funding cut and therefore in direct contravention of the commitment to maintaining real funding levels.

The budget measures announcing the triennium funding in the past decade generally refer to maintaining the current base funding in real terms. In the 2003–04 Budget, for example, the measure outlining the continuation of the ABC's base funding stated, 'The Government will maintain base funding to the Australian Broadcasting Corporation in real terms for the period 2003–04 to 2005–06'. The measure continuing SBS's base funding stated, 'The Government will ensure that the existing level of the Special Broadcasting Service Corporation's (SBS's) triennial funding is maintained in real terms by exempting the SBS from the Efficiency Dividend. This will provide SBS with additional funding of \$5.1 million for the triennium 2003–04 to 2005–06'.

Safe Work Australia

On 13 April 2010 the then Deputy Prime Minister, the Hon. Julia Gillard MP, wrote to the then Minister for Finance and Deregulation, the Hon. Lindsay Tanner MP, seeking an exemption from the Efficiency Dividend for Safe Work Australia. This was granted on 30 April 2010.

Safe Work Australia is funded by the Australian Government and the states and territories on a 50/50 basis. Its budget was \$17 million for 2008–09 and is set by the Intergovernmental Agreement for Regulatory and Operational Reform in Occupational Health and Safety. An Australian Government Efficiency Dividend is not mentioned in the agreement. The letter from the then Deputy Prime Minister outlined compliance difficulties involved in altering the agency's funding arrangements under

the agreement. It argued that applying an Efficiency Dividend would create difficulties with the states and territories if the Australian Government was seen to be taking a proportion of their contribution.

The then Finance Minister granted a temporary exemption until a review of Safe Work Australia is carried out. The Intergovernmental Agreement sets a time frame for this review to occur no later than 30 June 2015.

CSIRO

As is the case with the national broadcasters, CSIRO is funded through a multi-year agreement (in this case four years), with the government agreeing to exempt the majority of the organisation's funding from the Efficiency Dividend. Although not specifically stated, the rationale appears to be that the Efficiency Dividend is limited to the administrative side of CSIRO, the 70 per cent of its resources that funds direct scientific research being exempt. The current four-year funding agreement is set to conclude at the end of 2010–11.

The Australian Institute of Marine Science

As is the case with CSIRO, AIMS is funded through a four-year funding agreement, with the government agreeing to exempt the majority of the institute's funding from the Efficiency Dividend. Although not explicitly stated, the rationale appears to be that the Efficiency Dividend is limited to the administrative side of AIMS and recognises the relatively high costs of administering the organisation. The current four-year funding agreement is set to run until the end of 2010–11.

The Australia Council

The government agreed not to apply the Efficiency Dividend to the Major Performing Arts program but still applies it to the remainder of Australia Council funding. This includes grants to arts organisations and artists. In its submission to the Joint Committee of Public Accounts and Audit's 2008 inquiry into the Efficiency Dividend the Australia Council argued that the dividend should be applied only to the council's operating budget, rather than its total funding.

The minister responsible for the Australia Council, the Hon. Simon Crean MP, was reported in October 2010 as being willing to support having the Efficiency Dividend lifted from the Australia Council's funding, with the caveat that this would depend on the overall budget position.

The Australian Customs Service

The only Australian Customs Service program that is not subject to the Efficiency Dividend is the Coastwatch program, which is provided under a specified contract for services.

The Australian Nuclear Science and Technology Organisation

The government applied the Efficiency Dividend to part of ANSTO's funding in the 2010–11 Budget, the measure stating:

The Government will apply an ongoing Efficiency Dividend to the Australian Nuclear Science and Technology Organisation (ANSTO) commencing in 2010–11. The standard Efficiency Dividend will be applied to ANSTO's administrative and corporate costs, which represent 15 per cent of ANSTO's total appropriation. This application of the Efficiency Dividend is consistent with the application to other Government agencies.

This measure will provide savings of \$2.5 million over four years.

Defence

The Department of Defence became subject to the Efficiency Dividend for the first time in 2005–06, with a phase-in rate of 0.25 per cent a year for some civilian and non-operational functions and activities.

The budget measure to increase the Efficiency Dividend from 1 per cent to 1.25 per cent from 2005–06 to 2007–08 also stated, 'The Efficiency Dividend will also apply to the civilian and non-operational areas of Defence, which were previously exempt, and will be phased in at the rate of 0.25 per cent per annum, commencing in 2005–06'.

In the 2006–07 Budget the Government broadened the coverage of the Efficiency Dividend to a range of civilian and non-operational areas in the department that were not at that point subject to the dividend. The measure increased the level of coverage from 8 per cent to about 14 per cent of Defence departmental expenditure, but this was subsequently reduced to 11 per cent in the context of the 2009 White Paper.

Appendix F Agency responses to the 2007–08 additional 2 per cent Efficiency Dividend

The following information comes from the Australian Public Service Commission's 2007–08 *State of the Service Report* and refers to 90 agency responses to the Agency Survey.

Seventy-two (85 per cent) of the agencies subject to the Efficiency Dividend reported taking a series of actions in response to the 2007–08 Budget measures; 13 agencies (15 per cent) said they did not need to take any action at that time.

Six themes emerged from the actions being taken by the 72 agencies:

- tighter control over recruitment action—for example, recruitment freezes and pauses, reviewing the need for positions when they become vacant, and requiring SES approval to fill vacancies
- decreasing the number of employees—for example, using voluntary redundancies, reducing overall full-time equivalents and non-ongoing contracts not being renewed
- reducing the amount and type of travel taken by staff—for example, not allowing SES employees to travel business class on some sectors and greater use of video conferencing
- developing new priorities for activities—for example, spending freezes on non-critical activities, transferring resources to activities of greatest need, changes to service delivery arrangements and program cutbacks
- re-engineering approaches and using more efficient systems—for example, automating payroll systems, using shared ICT services and relying on better ICT
- reducing the number of contractors and/or consultancies.

The most common actions taken were to place tighter control on recruitment actions (51 per cent), to decrease the number of employees (44 per cent) and to reduce the amount and type of travel taken (38 per cent).

When the data are combined, just over two-thirds (69 per cent) of agencies reported that they placed tighter control on recruitment and/or reduced the number of staff.

Appendix G Responses to the ‘Driving efficiency’ questionnaire

Overall satisfaction with the current Efficiency Dividend arrangements

The majority of questionnaire respondents were not satisfied with the current Efficiency Dividend arrangements. Thirty-four out of the 57 agencies that answered this question (just under 60 per cent) said they were dissatisfied; 20 (36 per cent) said they were moderately satisfied. Only three responded that they were satisfied, and no agency said it was very satisfied.

This is consistent with the response to possible alternatives: 39 of the 61 respondents suggested a possible alternative to the current system.

Agencies under the Financial Management and Accountability Act showed the strongest tendency to be dissatisfied with the current arrangements: 69 per cent responded accordingly (22 out of 32). This compares with less than 50 per cent for agencies under the Commonwealth Authorities and Companies Act (although it should be noted that over 20 per cent did not answer this specific question and four agencies did not have the Efficiency Dividend applied to them). If these non-answers are removed, 60 per cent were dissatisfied (nine out of 15). The portfolio departments showed the highest levels of satisfaction with the current arrangements: only 30 per cent were dissatisfied (three out of 10). Almost a quarter of portfolio departments were satisfied and the remaining 50 per cent were moderately satisfied.

To what extent does the Efficiency Dividend drive efficiency gains on a continuing basis in your agency?

For all respondents, the Efficiency Dividend had between a minor and a modest degree of driving efficiency (average of 2.3 where 2 is minor and 3 is modest). This was consistent across all types of agencies, portfolio departments averaging 2.33, other FMA Act agencies averaging 2.29 and CAC agencies averaging 2.38. It is also consistent with what agencies consider motivates efficiency, the Efficiency Dividend generally being considered a low priority in terms of leading to efficient behaviour.

The Efficiency Dividend is an appropriate instrument in achieving efficiency

As with the response for whether the Efficiency Dividend motivates efficiency, a low proportion of respondents thought the dividend is an appropriate instrument for achieving efficiency. The responses from different types of agencies varied more for this question.

Portfolio departments had a much more positive attitude: 40 per cent of the departments saw the Efficiency Dividend as an appropriate instrument. This is significantly higher than for the other FMA Act agencies, of which only 20 per cent

considered the Efficiency Dividend appropriate, and CAC agencies, of which 31 per cent found it appropriate.

The Efficiency Dividend impacts on your agency in an equitable manner

Consistent with the responses to whether the Efficiency Dividend motivates efficiency and the appropriateness of the Efficiency Dividend as an instrument for encouraging efficiency, a low proportion of respondents (25 per cent) viewed the dividend as affecting their agency in an equitable way. Again, the responses varied between the different types of agencies.

Portfolio departments viewed the Efficiency Dividend as more equitable, just under half of them responding positively to the question. This was more than twice the rate for other FMA Act agencies, of which 17 per cent of respondents thought the dividend was equitable, and exactly twice the rate for CAC Act agencies.

The Efficiency Dividend is easy to administer internally in determining internal resourcing allocations

A much higher proportion of agencies viewed the Efficiency Dividend arrangements as easy to administer: over half (60 per cent) of respondents answered this question positively. Again, the responses varied between the three different types of agency.

All but one of the portfolio departments thought the Efficiency Dividend was easy to administer (90 per cent), while just under half of the other FMA Act agencies found it easy to administer (48 per cent) and 58 per cent of CAC agencies found it easy to administer.

The Efficiency Dividend is an incentive for agencies to seek new policy proposals

The response rate for this question was similar to that for the previous question: 54 per cent of total respondents thought the Efficiency Dividend does provide an incentive for agencies to seek new policy proposals.

As with the question about ease of administration, nearly all portfolio departments thought the Efficiency Dividend provided an incentive to seek new policy proposals (seven out of 10, or 70 per cent) and about half of the other FMA Act agencies thought the same (50 per cent compared with 48 per cent for the previous question). A lower proportion of CAC agencies viewed the Efficiency Dividend as providing an incentive for new policy: only 40 per cent responded positively to the question.

Ranking the main motivators to deliver efficiency gains over the last 12 months

Agencies were asked to rank the following six possible motivators for achieving efficiency gains in their agency:

- flexibility to conduct new activities or respond to emerging priorities
- delivery of improved levels of service within existing program structures
- meeting increased supplier costs
- flexibility to fund pay increases
- the Efficiency Dividend if applied
- audit and/or performance reporting.

Across all categories of agencies the three clear motivators were the second, first and fourth ones—namely, to deliver a high level of service, to meet new and emerging needs and to fund pay increases. Although this was the same for all categories, the order varied slightly between the categories.

The clear fourth motivator, in all categories, was to meet increased costs of suppliers.

The two lowest ranked motivators were the last two—the Efficiency Dividend and audit and/or performance reporting, in that order for portfolio departments and other FMA Act agencies and in the opposite order for CAC Act agencies.

Table G.1 shows the average ranking across groups.

Table G.1 Motivators for achieving efficiency gains: ranking, by category of agency

Motivator	Portfolio department	Other FMA Act agencies	CAC Act agencies	All categories
Meet new or emerging priorities	2.00	2.83	1.75	2.58
Improved level of service	2.90	2.69	2.00	2.59
Meet increased supplier costs	4.20	3.55	3.62	3.81
Fund pay increases	2.30	2.83	3.15	2.92
Efficiency Dividend	4.40	4.21	5.31	4.63
Audit and/or performance reporting	5.50	4.50	4.25	4.76

Note: 1 represents the highest priority; 6 represents the lowest.