The Parliament of the Commonwealth of Australia

Report 413

The efficiency dividend and small agencies: Size does matter

Joint Committee of Public Accounts and Audit

December 2008
Canberra

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ISBN 978-0-642-79134-4 (Printed Version)

ISBN 978-0-642-79135-1 (HTML Version)

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Foreword

One of the Committee's roles is to scrutinise the proposed budget of the Australian National Audit Office (ANAO) each year and make recommendations on it to both Houses of Parliament. Most years this has been a straightforward process for the Committee and the Auditor-General. However, this year the Committee needed to express concern about the ANAO's resources. In particular, it had reduced its planned number of performance audits by 10%.

The Committee's interest and responsibility in ensuring that the Auditor-General had sufficient resources to fulfil his mandate led to this inquiry. This investigation appears to have struck a nerve among agencies and their stakeholders gauged by the high number of submissions received. The National Library of Australia, in particular, was well represented in the submissions.

In meeting these agencies face to face, the Committee noted that agencies take their financial responsibilities very seriously. However, the Committee also received a great deal of evidence of agencies scaling back their activities, maintaining service levels at the expense of sustainability, and foregoing opportunities and innovation.

One of the most concerning aspects of this development is that it has occurred because agency budgets have evolved under the Budget funding rules. These place a strong emphasis on agency efficiency and it appears that agency effectiveness has been suffering as a result. Another problem is that there are no guarantees in the system that ministers will undertake any strategic stocktake of agencies' finances and how these relate to their function, performance and risks.

The Committee's broad conclusion is that the system favours larger agencies and agencies with a stronger policy focus over small agencies. This latter type of agency usually has a technical, precisely defined function that gives them reduced discretion over how they manage their operations. They have poorer economies of scale. Further, they have fewer opportunities to top up their funding through new policy proposals because they are rarely involved in new policy.

The various funding rules focus on the major financial and political issues for the Government. In a sense, this is very reasonable. The problem is that they do not take into account the particular circumstances of small agencies.

Although the process for funding new policy appears to be part of the problem, the Committee has declined to recommend changes to it because it is inherently political. Rather, the Committee has recommended a formula for exempting small agencies from the efficiency dividend. The Committee believes this recommendation is workable and reasonable and commends it to the Government.

I would like to thank the agencies and organisations that gave their time and knowledge to the Committee. In particular, the Committee found the evidence of the Department of Finance and Deregulation, the Australian Public Service Commission and the Institute of Public Administration Australia to be very valuable. Their global perspective greatly assisted the Committee.

I would also like to thank my colleagues on the Committee whose deliberations and views helped shape the report. The Committee was firmly of the view it should report in December 2008 in time for the 2009 Budget. I am pleased that through the dedication of committee staff and the professional commitment of committee members we have met this deadline.

The Committee appreciates that there are many more demands on public spending than there are dollars available. Governments need a strong finance agency to keep control of the Budget. Indeed, the Committee would be worried if the Department of Finance and Deregulation did not take a robust approach.

But in this case, it appears that these small agencies, many of whom define our cultural outlook or protect our rights and freedoms, are being devalued through a focus on the big financial picture. This report asks governments to recognise that small agencies are different. With a minor modification to the Budget rules, they will be much more likely to achieve their potential.

Sharon Grierson MP
Committee Chair

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Secretary	Mr Russell Chafer
Inquiry Secretary	Mr David Monk
	Dr Kris Veenstra
Research Officer	Ms Jennifer Eddie

Terms of reference

Inquiry into the effects of the ongoing efficiency dividend on smaller public sector agencies

Since 1987-88 an annual 'efficiency dividend' has been applied to the operational appropriations of Commonwealth public sector agencies. The rate of the dividend now stands at 1.25 per cent, with the Government imposing an additional one-off 2 per cent efficiency dividend for 2008-09 appropriations (with a pro-rata reduction in 2007-08 appropriations).

The Joint Committee of Public Accounts and Audit will inquire into and report on the effects of the ongoing efficiency dividend on smaller public sector agencies, including:

- whether the efficiency dividend has a disproportionate impact on smaller agencies, including whether or not smaller agencies are disadvantaged by poorer economies of scale or a relative inability to obtain funding for new policy proposals;
- whether the efficiency dividend is now affecting the capacity of smaller agencies to perform core functions or to innovate;
- what measures small agencies are taking to implement the efficiency dividend, and the effect on their functions, performance and staffing arrangements;
- any impact of the efficiency dividend on the use by smaller agencies of "section 31" agreements to secure non-appropriation receipts (eg through user charges and cost recovery) – noting that these receipts are not subject to the efficiency dividend;
- how application of the efficiency dividend is affected by factors such as the nature of an agency's work (for example, cultural, scrutiny or regulatory functions) or the degree of discretion in the functions performed by smaller agencies; and

- if appropriate, alternatives to an across-the-board efficiency dividend to encourage efficiency in the Commonwealth public sector, including consideration of whether certain agencies should be exempted from the efficiency dividend, or whether the rate of the dividend should vary according to agency size or function.

For the purposes of its inquiry the Committee defines 'smaller agencies' as those with an operational budget (that is to say, departmental as distinct from administrative appropriations) of $150 million pa or less, and may particularly focus on a selection of such agencies as case studies. However submissions relevant to the terms of reference will be accepted from other agencies.

List of abbreviations

AAT	Administrative Appeals Tribunal
ABC	Australian Broadcasting Corporation
ACMA	Australian Communications and Media Authority
ADB	Australian Dictionary of Biography
AEC	Australian Electoral Commission
AIATSIS	Australian Institute of Aboriginal and Torres Strait Islander Studies
AIHW	Australian Institute of Health and Welfare
AMOS	Australian Meteorological and Oceanographic Society
ANAO	Australian National Audit Office
ANMM	Australian National Maritime Museum
ANSTO	Australian Nuclear Science and Technology Organisation
APSC	Australian Public Service Commission
ARC	Australian Research Council
ASADA	Australian Sports Anti-Doping Authority
AWM	Australian War Memorial
CEA	Commonwealth Electoral Act 1918
CPI	Consumer Price Index

CPSU	Community and Public Sector Union
CSIRO	Commonwealth Science and Industrial Research Organisation
DPS	Department of Parliamentary Services
EOWA	Equal Opportunity for Women in the Workplace Agency
ERC	Expenditure Review Committee of Cabinet
FCWA	Family Court of Western Australia
Finance	Department of Finance and Deregulation
FSANZ	Food Standards Australia New Zealand
IPAA	Institute of Public Administration Australia
IT	Information Technology
ITSA	Insolvency and Trustee Service Australia
NAA	National Archives of Australia
NCA	National Capital Authority
NGA	National Gallery of Australia
NLA	National Library of Australia
NMI	National Measurement Institute
NPP	New Policy Proposal
NSLA	National and State Libraries Australia
NTR	National Tally Room
OIGIS	Office of the Inspector-General of Intelligence and Security
ROMTIC	Return of Materials to the Indigenous Communities
SBS	Special Broadcasting Service Corporation
Viclink	Victorian Public Library and Information Network
VTR	Virtual Tally Room

WCI	Wage cost index

List of recommendations

Recommendation 1

In addition to being adequately funded for other assurance activities, the Australian National Audit Office be funded to conduct the number of performance audits that is determined by the Auditor-General and endorsed by the Joint Committee of Public Accounts and Audit.

Recommendation 2

The Government establish a parliamentary commission co-chaired by the Speaker of the House of Representatives and the President of the Senate and comprising elected representatives to recommend funding levels for the parliamentary departments in each Budget.

Recommendation 3

The Department of Finance and Deregulation, the Australian Public Service Commissioner and each cultural agency jointly develop a new funding model for cultural agencies. This model should recognise the importance of funding the mandate for growth and development of collections and the proportion of their expenses apportioned to depreciation. The Committee notes that recommendation 8 will also apply to these agencies.

Recommendation 4

The Attorney-General establish an independent body to recommend funding levels for the Commonwealth courts. The courts should be treated as a separate 'portfolio' under the Attorney-General in the Budget process and in the Budget papers.

Recommendation 5

The Government investigate whether the courts' appropriations should be included in the appropriation bills for the ordinary annual services of the Government.

Recommendation 6

Where Finance generates savings through coordinated procurement, 50% of the savings should be made available to the agencies for investment in projects designed to lift their efficiency and effectiveness.

Recommendation 7

The Department of Prime Minister and Cabinet convene a taskforce with membership from key agencies, including the Australian Public Service Commission, to conduct and publish further analysis on:

- the relationship between gender wage disparities and agency size and function;
- the relationship between wage disparities generally and agency size and function; and
- whether staff classifications continue to represent equivalent levels of skills, responsibility and experience across agencies.

If collecting further data or enhancing databases is required, the agencies involved should receive supplementary funding.

Recommendation 8

The Government either:

- exempt the first $50 million of all agencies' appropriations from the efficiency dividend, excluding departments of state (the preferred option); or
- exempt the first $50 million of the appropriations of all agencies that have departmental expenses of less than $150 million, excluding departments of state.

These benchmarks to be indexed over time.

Executive summary

Introduction

The efficiency dividend was first introduced in the 1987 Budget. It was part of a package of reforms in the 1980s designed to introduce managerial flexibility within the public service. The other side to these reforms was greater focus on agencies' results and performance.

The current rationale for the efficiency dividend is to give agencies an incentive to find efficiencies; to redirect funds to higher priority activities and to publicly demonstrate efficiency improvements in the public service. In 2008-09, the ongoing 1.25% efficiency dividend returned approximately $250 million to the Budget. At the same time, the Government imposed an additional one-off 2% efficiency dividend, which returned approximately $412 million.

The efficiency dividend is just one component of setting agencies' budgets and it only applies to some of their funding. Functions administered on behalf of the Government are largely exempt from the dividend. It usually only applies to revenues for departmental expenses. Further, some of these appropriated revenues are exempt from the dividend, in particular external receipts, special appropriations[1] and funds for new policy proposals in their first year. The dividend generally applies to agencies' appropriations for the ordinary annual services of the Government[2] ('eligible appropriations').

Agencies that are more reliant on receipts and the other sorts of appropriations tend to be less affected by the dividend. This includes regulators and commercial research agencies that are funded from industry levies. The agencies that are more affected by the dividend include the courts, cultural agencies, oversight agencies and departments of state. For these agencies, eligible appropriations can comprise almost 100% of their funding.

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1 These are funds appropriated when certain factual circumstances laid out in legislation apply. Special appropriations are made through Acts other than the general Appropriation Acts.

2 This is the wording used in section 54 of the Constitution.

The Department of Finance and Deregulation (Finance) also adjusts agencies' eligible appropriations for inflation. It uses a range of wage cost indices (WCIs) to do this. Agencies reported that these indices were often insufficient. Agencies' costs were generally increasing at 4% per annum, whereas the WCIs increased at approximately 2%. Adding the efficiency dividend meant that agencies had to find annual efficiency improvements of at least 3%, whereas efficiency improvements in the wider economy were approximately 2%.

Previous reviews of the efficiency dividend in the early 1990s did not raise the issue of indexation – it did not appear to be an issue for agencies. This could imply that the difference between indexation and actual cost increases was not as large as it is today. The system also appears to have been more reasonable in other ways: a greater number of agencies received exemptions from the efficiency dividend, and Finance offered budget adjustments to compensate for increased workloads.

Agency budgets are also adjusted for new policy proposals (NPPs). For each Budget, ministers put forward new policy ideas to be considered by the Expenditure Review Committee of Cabinet (ERC). Small agencies stated that they had a low success rate with NPPs. They suggested this occurred because of their clearly defined functions, which are usually laid down in statute.

The Committee accepted that there was a number of reasons why small agencies faced greater financial challenges than larger agencies and departments of state. Firstly, they have poorer economies of scale. Secondly, they are occasionally requested to absorb NPPs. Due to the agencies' size, the dollar amounts are small so a request to absorb does not appear unreasonable. However, a small dollar amount can be large to a small agency. Finally, smaller agencies are often established to fulfil a specific function or purpose. This limits their capacity to reprioritise or trim discretionary activities.

Non-executive agencies

This term is used to describe those agencies that are specifically established to be independent of the executive.

Perhaps the most important of these agencies from the Committee's perspective is the Australian National Audit Office (ANAO). The Auditor-General reported that financial statement audits have become more complex, leading to increased costs. Between 1998-99 and 2007-08, the ANAO's spending on financial statement audits increased by 11.5% in real terms. However, this has resulted in a drop in spending on performance audits of 4.5%. This translates to five fewer performance audits annually.

The ANAO stated that NPPs for extra funding to meet this complexity have had limited success.

This state of affairs concerns the Committee. The ANAO saves the Australian taxpayer significant sums of money each year through reduced opportunity for fraud, better accountability and improved agency performance. Saving small sums on the ANAO's budget only costs the Government larger sums later on. The Committee recommends that the ANAO's budget be increased so that the Auditor-General can conduct the number of performance audits he/she deems appropriate and that is endorsed by this Committee.

Parliamentarians are assisted by three Departments: the Senate, the House of Representatives and Parliamentary Services (DPS). The Department of the House of Representatives and DPS advised the Committee that they will be soon considering service cuts if current circumstances continue. Since 2000-01, their budgets have decreased in real terms by 11% and 19% respectively.

The Department of the House of Representatives raised concerns about the separation of powers. Current arrangements have been developed by the executive and give little chance for the Parliamentary departments to negotiate additional funding. The Committee has suggested that an independent commission be established to recommend funding levels for the Parliamentary departments. This practice is common in other Westminster countries.

The Committee took evidence from other non-executive agencies such as the Ombudsman, Insolvency and Trustee Service Australia, the Inspector-General of Intelligence and Security, and the Australian Human Rights Commission. These agencies have responded to tight financial circumstances through a combination of service cuts, disinvestment and foregone opportunities.

The Committee also took evidence from the Australian Electoral Commission, which argued that the prescriptive nature of the *Commonwealth Electoral Act 1918* precluded it from innovating and finding efficiencies. The Committee notes the Parliament has established the Joint Standing Committee on Electoral Matters (JSCEM) to specifically examine these issues. Therefore, the JSCEM is the preferred forum for addressing them.

Cultural agencies

Many of Australia's flagship cultural institutions are Commonwealth entities. These include the National Library of Australia, the National Gallery of Australia and the Australian War Memorial. The Committee received a significant number of submissions about these agencies, especially about the National Library. In evidence, the National Library stated that it had started cutting services 10 years ago in order to balance its budget.

These agencies made a strong case that current funding arrangements are not appropriate for them. First, most of them have a legislated mandate to grow and develop their collections. This does not sit well with the efficiency dividend's goal of harvesting their resources for government priorities. Second, they have large asset holdings, which means a lot of their expenses are tied up in depreciation. Since depreciation amounts are not indexed, these agencies must find additional efficiencies from their operating expenses to pay for efficiencies they cannot find in their depreciation.

The Committee has recommended that the Government develop a new funding model for these agencies to take into account their growth mandate and their high levels of depreciation.

The courts

A special category of the non-executive agencies discussed in chapter 2 is the courts. The four Commonwealth courts, the Family Court of Western Australia (funded by the Commonwealth), and the Administrative Appeals Tribunal made submissions to the inquiry.

All these bodies demonstrated signs of financial stress. Indeed, they were all running deficits. The exception was the Family Court of Australia, which has been in deficit and expects to soon return into deficit. The courts also expressed concern about their IT resources. They tended to fall into one of two categories. Either they had benchmarked themselves and found they were well below acceptable levels, or they did not believe they would have the necessary funds to innovate in future.

Similar to the Parliamentary departments, the High Court raised the issue of separation of powers. For example, the Budget rules allow the Attorney-General to switch funds between the bodies in the portfolio to meet priorities. This could include shifting funds between an executive-style agency such as the Australian Federal Police and the High Court.

Although there was no evidence that this has occurred, the Committee accepts that it is a risk. Further, the Court has made significant cuts to services due to a process that is controlled by the executive. The Court stated that it started making cuts to services 10 years ago. The Committee therefore suggests that the Attorney-General should establish an independent body to recommend funding for the courts.

Scientific agencies

The Committee received the views of a number of scientific agencies through the Department of Innovation, Industry, Science and Research. This included the

CSIRO, the National Measurement Institute, the Australian Institute of Marine Science and the Australian Nuclear Science and Technology Organisation (ANSTO).

A common theme in their submissions was that there is a combination of increasing demand for their products (for example, relating to climate change) and increasing complexity in their work. These factors have led to budget pressures resulting in a number of opportunities foregone. For example, the National Measurement Institute advised that its progress in biological measurement was limited compared with other developed countries. ANSTO stated that it has scaled back research into atmospheric modelling (understanding past climate change) and radiopharmaceuticals.

Generally, the scientific agencies estimated that financial pressures had led them to start cutting services 10 years ago.

Although the Committee did not believe that the scientific agencies warranted recommendations in addition to those in chapter 6, it did note the special case of the CSIRO. Previously, 70% of its appropriation was exempt because this proportion of its funding was for research and considered to be similar in nature to a grants program. However, the efficiency dividend was applied to all of its funding in 2008-09.

This represented a significant additional burden on the organisation, one that resulted in the closure of regional facilities. The Committee would hope that such seemingly arbitrary and unfair decisions will not be imposed in the future. Furthermore, should any further 'one-off' efficiency dividend or an increase to the existing 1.25% efficiency dividend be imposed in the next financial year, the Committee believes that the CSIRO warrants special consideration.

Conclusions

The Committee agrees with Finance that some sort of efficiency incentive for agencies is warranted. Technologies and people's preferences change as time progresses, meaning that there will always be new and more efficient ways of doing things. The Committee notes that, with current indexing arrangements, abolishing the efficiency dividend for all agencies would still leave the great majority of them with an efficiency incentive. This is because the WCIs are lagging behind increases in the costs of agencies' inputs at a rate similar to productivity increases in the wider economy.

During evidence, Finance argued that many agencies have not explored options for finding efficiencies through joint procurement. The Committee believes that Finance is much better placed to manage joint procurement through its position as a central agency. Currently, Finance appears to be harvesting all the efficiencies when it manages joint procurement, leaving nothing for agencies.

The Committee would like to see Finance implement something similar to that recommended by Sir Peter Gershon in his review of IT procurement. This review suggested that 50% of the savings generated by central procurement be retained in a central fund to be reinvested in agencies' efficiency and effectiveness. The Committee has made a similar recommendation for when Finance coordinates procurement more generally.

The Committee noted that Finance has set an aggressive efficiency incentive for agencies (more than 1% higher than the private sector achieves). This is an effective way of managing the risk that excess resources might build up in an agency. The other risk is that agencies might be under resourced from the cumulative effects of the dividend. Finance's preferred method of managing this is for agencies to ask their Minister to approach his or her Cabinet colleagues to make the case for extra funds.

One difficulty the Committee has with this approach is that it does not manage the risk of disinvestment. This is a real risk because agencies are reluctant to report financial difficulties. They are concerned it would appear that poor management was to blame when the problem may really be insufficient funding.

Current arrangements place the highest premium on ensuring that agencies do not build up fat and other risks are secondary. This raises the question of whether Finance is placing a higher priority on agencies' efficiency at the expense of their effectiveness. What the Committee would prefer to see is a greater balance between efficiency and effectiveness in the Budget process. Both are required for agencies to be performing at a high standard.

There is a number of unintended consequences from the efficiency dividend and the associated Budget rules:

- some agencies tend to view reducing their regional presence as a source of convenient efficiencies;
- disparities have developed in pay rates between agencies, which may reflect nothing more than an ability to pay;
- some agencies have become very reliant on external receipts when this may not have been the intention when they were established;
- cultural agencies' funding does not support their legislated mandate to grow and develop their collections;
- agencies' capacity to innovate has diminished over time; and

- agencies have implemented false economies to meet their financial targets, including service cuts and cost shifting.

One of the reasons these unintended consequences have arisen is that governments budget at the margin. Each year, agencies have their budget from the previous year adjusted for inflation and the efficiency dividend. They then apply for NPPs. From an annual perspective this may be an efficient process. However, it means that Cabinet is unlikely to conduct a strategic stocktake of an agency's financial position.

Another concern for the Committee is that ministers and the Parliament effectively delegate some decisions to officials that should be made at higher policy levels.

Small agencies argued during the inquiry that they received less funding on a pro-rata basis from NPPs than other agencies. NPPs are important to agencies because it offers them a way of growing. Increased size gives them better economies of scale. Although agencies that receive NPPs are meant to implement new policy, the Committee accepts that they can use the new funds to cross-subsidise old activities.

Small agencies argued that, because they often had a precise technical function instead of a policy role, they tended to get less NPPs. The Committee compared how different agencies fared in receiving NPPs in the 2007 and 2008 Budgets. departments of state, which have the strongest policy role, were the clear winners. They received 6% and 5% of their budgets in NPPs for the respective years. Of the other agencies, those with budgets over $150 million received 3% and 1% respectively. Small agencies received 2% and 0%.

Although small agencies are disadvantaged by the NPP process, the Committee decided against recommending changes to it. Budgets are largely political processes and are intimately tied to Government policy.

The Committee concluded that the various Budget processes and rules work reasonably well for large agencies and departments of state. While they are subject to tight efficiency requirements through the dividend and the indexation rules, these are offset by a steady supply of NPPs.

Given that billions of dollars are involved in these NPPs, designing the budget rules for larger, more policy-oriented agencies is appropriate. This is the area of greatest financial risk. Finance has developed a set of administrative rules that continually extracts a small proportion of these policy funds and redirects them to the highest priority use. In other words, for these agencies the Budget rules are a way by which policy funds are kept up to date. Administrative rules are supporting policy.

It would be more practical to adjust the efficiency dividend. The Committee has recommended that the first $50 million of agencies' eligible appropriations (excluding departments of state) should be exempt from the dividend. The 1.25% dividend would then apply to all of an agency's appropriations above this amount. The practical effect of this is an agency with eligible appropriations of less than $50 million would have a zero efficiency dividend. The old system should continue to apply to departments of state due to their success with NPPs.

Agencies with eligible appropriations over $50 million start to pay the efficiency dividend, but this is graduated over the size of the appropriation. For example, an agency with an eligible appropriation of $100 million would pay nil dividend on the first $50 million and 1.25% on the second $50 million. This means that the practical efficiency dividend for this agency would be 0.625%.

Although this system would return some money to large agencies, its advantage is its simplicity. By avoiding a 'carve-out', the Committee has reduced the chance of managers facing perverse incentives to stay within thresholds. The estimated cost of this proposal is $35.3 million, or 17% of the amount that the dividend returns to the Government. The Committee's less preferred option would be to only allow this exemption to agencies with budgets under $150 million. This would cost $24.6 million, or 11.9% of the dividend amount. The Committee believes that this improved workability and simplicity is worth $10 million.

Finally, there will still be a need for some agencies to apply for baseline reviews. The Committee believes that these reviews can be improved in a number of ways, to the benefit of both Finance and the agencies. In particular, the following should be recognised:

- requesting such a review is appropriate when supported by good quality performance data and evidence of systematic expenditure review within the agency;
- systematic expenditure review can include staff involvement;
- the efficiency dividend, without top-ups from new policy proposals, can erode an agency's funding base; and
- downgrading regional services and regional presence needs to be subject to cost-benefit analysis, rather than regarded as a source of convenient efficiencies.