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IPAA SUBMISSION TO JCPAA INQUIRY INTO THE EFFECTS OF THE ONGOING EFFICIENCY DIVIDEND ON SMALLER PUBLIC SECTOR AGENCIES

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BACKGROUND

Mr David Monk, the Inquiry Secretary, wrote to the IPAA National President on 15 July 2008 inviting IPAA to make a submission to the Joint Committee of Public Accounts and Audit's Inquiry into the effect of the efficiency dividend on small agencies.

This submission has not been formally endorsed by the IPAA National Council, but has been prepared by me as the National President, drawing on my experience as a former Public Service Commissioner and Secretary of various Australian Government Departments.

OBJECTIVES OF CURRENT ARRANGEMENTS

The current arrangements for adjusting agencies' "departmental expenses" are presumably aimed at ensuring agencies can continue to deliver the previous year's level and quality of outputs, while also providing firm incentives for achieving ongoing productivity improvements. In some cases the arrangements involve a formula to adjust for planned or expected changes in workload, measured by the level of outputs.

The precise details have changed over the years, but the idea of applying an efficiency dividend has operated for nearly twenty years. It is not a bad idea; indeed, it fitted well with the then move to reduce input controls and to give agencies more flexibility to manage within broader running cost (now 'departmental expenses') budgets and to 'focus on results'.

Over the years, however, the measure has become increasingly crude particularly in its interaction with the other elements for adjusting departmental expenses. In addition, over time any set of rules become prone to 'gaming' by both sides. The truth is, even good ideas are not necessarily good forever, and it is time to re-think the way in which to meet the twin objectives of funding agencies to deliver the outputs expected, and to achieve optimum productivity gains.

"EFFICIENCY" CONTRIBUTIONS AND GENUINE PRODUCTIVITY LEVELS

Australian Government agencies, large and small, are currently required to achieve "efficiency" gains in a number of ways:

1. The efficiency dividend itself involves a reduction every year of 1.25 percent of departmental expenses.

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2. The indexation factor, ostensibly to represent the changing costs of inputs, in fact involves an additional dividend every year. This is because the factor applying to employee costs, the major input to departmental expenses, has as its numerator the annual adjustment to the minimum wage and as its denominator average earnings, which is nearly twice the minimum wage. As a result, if the minimum wage is adjusted for inflation, the indexation factor applied to agencies' employee costs is around half the actual costs. As a result, the indexation arrangements require additional ongoing efficiencies of between 1 and 2 percent a year if employee wages are maintained against average earnings.
3. Agencies are frequently not funded for the departmental expenses associated with new policy measures, but are expected to "absorb" these. The 2008-09 Portfolio Budget Statements reveal many initiatives across the Commonwealth whose departmental costs have not been provided for.
4. This year, the Government imposed a further once-off efficiency dividend reducing departmental expenses by a further 2 percent from 2007-08.

These requirements are cumulative. Accordingly, the total "efficiency" contribution every year is at least 2.25 percent and mostly around 3 percent, and this year the contribution is around 5 percent not counting the impact of having to absorb the costs of some new initiatives.

Government agencies can and do achieve major productivity gains including through better use of information technology, clever use of purchasing through outsourcing, and better people management such as better trained staff and improved performance management of individuals and businesses. These gains are not easily measured, but there is no reason to believe they would not broadly match the gains made across the economy which generally average around 1.5 percent a year. Such gains are not, of course, achieved evenly or constantly, but in small and large amounts from time to time.

There is clearly a big gap between this average actual productivity gain, and the contribution now required of agencies every year. And the contribution required each year may or may not correspond to the gains actually achievable in any given year by a particular agency.

Well managed agencies will do their best to identify areas internally with capacity that year to deliver gains beyond the average requirement, in order to ease the pressure on areas with less or no capacity to limit increases in output prices.

Some agencies, however, are known to have "padded" the departmental expenses associated with their ministers' new policy proposals to offset the impact of these requirements. Finance is diligent in trying to limit this, and departments must have Finance agree to the costings of both administrative and departmental expenses associated with new policy proposals. As mentioned, this year the Government has gone further requiring agencies to absorb the costs of some new measures. Moreover, this limited opportunity is restricted to agencies that are involved in new policy measures.

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More commonly, agencies respond not just through genuine efficiency measures but by reducing or dropping lower priority activities, or activities that appear to be discretionary, at least in the short term.

WHO SHOULD AND WHO DOES BENEFIT FROM PRODUCITIVITY GAINS?

It is reasonable to expect the budget, and hence taxpayers, to benefit from productivity gains amongst government agencies, and indeed to expect that agencies achieve such gains. But just as productivity gains in the private sector are shared amongst shareholders, employees and consumers, so in the public sector the gains should benefit employees and the consumers of government services as well as taxpayers.

For the most part, employees have gained as agencies mostly adjust pay in line with labour market demand and not just according to the CPI; but they then adjust downwards their staffing levels to meet their budgetary requirements. As a result, it is the consumers of government services who are least likely to share in the productivity gains unless the Government decides through the new policy process to redirect the savings to the budget to improve or extend services. Where there are no new policy measures, it is most likely that services to consumers will be cut back in order for agencies to meet their budget requirements and to pay competitive wages.

SMALLER AGENICES AND THE INQUIRY'S TERMS OF REFERENCE

(a) Does the efficiency dividend have disproportionate effect on smaller agencies?

As Public Service Commissioner, I addressed aspects of this question in 2003 and 2004 in connection with the funding of pay increases. My initial view set out in the 2002-03 State of the Service Report (p81) was that there was no evidence that the levels of base salary had fallen behind in smaller agencies.

In the 2003-04 State of the Service Report (pp98-99), however, I suggested that there could be an emerging problem for smaller agencies' ability to maintain competitive pay rates, and that there may be an argument for case-by-case exemptions from the total productivity gains required each year. At that time the efficiency dividend was 1 percent per annum, and the same price index as now applied.

On further reflection, this may well have understated the problems caused by the efficiency dividend and indexation arrangements for smaller agencies, particularly in terms of the impact on their client services which was not addressed in the State of the Service Reports. If the smaller agencies are more likely to be squeezing wages notwithstanding the labour market pressures they face, it is even more likely that they will be squeezing their client services.

There are several reasons why this is likely to be the case:

- larger agencies are more likely, each year, to have one or two business areas achieve substantial gains (for example from new technology or new competitive

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processes) which can be used to contribute to the agencies' total dividend requirements;

- larger agencies are also more likely to have some new policy measures to introduce, and *may* have the opportunity to gain more resources than actually required (but see earlier comments on the reduced capacity to do this in recent years);
- larger agencies may also find it easier to reduce discretionary spending or change priorities, though these actions still impact on their clients and/or their future capacity.

(b) Impact on smaller agencies' capacity to perform core functions

The evidence here is anecdotal rather than research-based. Both large and small agencies appear to be substantially limiting "discretionary" spending which typically includes research and training and development. These may not affect core functions at present, but are likely to limit future capability and innovation, and may put at risk future core functions.

(c) Measures being taken by smaller agencies to implement the efficiency dividend

Agencies are pursuing genuine productivity measures such as improved use of information technology and outsourcing, but are also looking to:

- reduce the number or quality of lower priority outputs (such as certain ABS publications, subsidised museum exhibitions, Botanic Gardens' community events);
- reduce 'discretionary' expenditures as mentioned above;
- limit pay increases to staff; and
- shift costs to clients or other agencies.

As mentioned, it seems that smaller agencies are more likely than larger ones to be both limiting pay increases and reducing lower priority outputs and 'discretionary' expenditures.

Surprisingly, some larger agencies, particularly departments, appear to have not only maintained pay levels but increased more senior staffing numbers and hence increased average pay further. It is not clear what is driving this given the tough financial situation: perhaps it reflects in part the increased pressures from the political arm of government (ministers and the Parliament) and from the media that are genuinely affecting workloads at more senior levels, or perhaps it also reflects the relevant agency heads' undue concern for immediate pressures on themselves rather than the broader pressures on their organisations.

(d) Any impact on the use of 'section 31' agreements

IPAA has not studied any data on growth in non-appropriation receipts, but I would be surprised if there was not continuing real growth over an extensive period. This is not necessarily a bad thing, as some services should have user charges given the personal benefits the users involved receive and the usefulness of market pressures to encourage improved responsiveness. But there is a risk of inappropriate cost-

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shifting and obstacles to access. Whether the growth in such receipts is greater for small rather than large agencies is not known.

(e) Effect of the nature of an agency's work

Again, I do not have any direct evidence, but would expect the impact of the various dividends required to vary with the nature of an agency's work. Those whose services are easily automated may find it easier to tap into the continued productivity gains available from new technology. Other small agencies with less frequent opportunities for genuine and significant productivity gains will rely more heavily on the measures identified under (c) above. Those with fees for services – such as many regulatory bodies and some cultural organisations – may rely more on section 31 revenue increases. The non-regulatory agencies, of course, are more limited here by market considerations (i.e. whether visitors are willing to pay higher charges).

(f) Alternatives to an across-the-board efficiency dividend

The current arrangements have almost no relationship to genuine productivity gains, nor is there any coherence about who should share the gains when productivity is increased. They reflect a lazy grab for budgetary savings in the absence of careful policy review and the courage to identify publicly the functions and activities being curbed.

I strongly suggest the Inquiry revisit the nature of productivity gains and the principles behind how they should be shared.

In 2000, Ian Castles was asked to arbitrate between the Commonwealth and the States and Territories on the indexation factor for the Australian Health Care Agreements. The index was intended to reflect movements in the price of outputs of hospitals but, in the absence of such a specific measure, the Commonwealth applied a similar index to that applying to departmental expenses (without an additional efficiency dividend). In his report, rejected by the then Commonwealth Government, Mr Castles noted that, in the absence of a specific measure of the price of hospital outputs, consideration should be given to using a broader outputs measure. He drew attention to the fact that the CPI itself is in fact an index of the price of outputs – the ABS's basket of goods – for the economy as a whole. He suggested that, because service industries make less use of the productivity potential of capital, an outputs price index for them would generally be the CPI plus a margin while, for capital intensive industries, an outputs price index would generally be the CPI less a margin.

The Castles recommendation was rejected by the Commonwealth because of the costs involved, but the logic was hard to dispute. It still is, and it is relevant to departmental expenses as well.

If the principle behind indexation and the efficiency dividend is to reflect the price of *outputs*, including the impact of productivity (and an incentive to achieve productivity improvement), the best approach is either a benchmark of the relevant output prices or, if that is not available, the CPI plus or minus a margin. This would obviate the need for an efficiency dividend as such, while keeping pressure on agencies to achieve efficiencies as the index would be less than their most important input price viz. wages.

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An alternative is to allow a genuine *input* price index and then apply an efficiency dividend. That was the original approach in the 1980s when running costs were adjusted for movements in (centrally controlled) wages and administrative costs, and the efficiency dividend was first introduced. One disadvantage of this approach is its reliance on centrally determined pay arrangements.

Castles' distinction between capital intensive and service-oriented industries may be less relevant these days given advances in technology, and perhaps it would be better simply to use the CPI as the index factor (with no separate efficiency dividend). But allowing a small margin beyond the CPI might provide agencies with the capacity to offer their clients a small share of the gains from productivity as well as the budget and the employees. Ministers could be held responsible for ensuring this extra share is not just captured by employees. (Current central controls over pay increases could also limit this risk.)

This approach might still disadvantage small agencies vis-à-vis larger ones because it is harder to find genuine productivity measures every year, and because they have fewer opportunities for additional funds for new policy measures. One possibility to address this would be:

- for smaller agencies to receive CPI plus (say) 1 percent adjustments each year
    - with the requirement to provide additional dividends in the event of a significant investment in IT or other efficiency measures, perhaps by performance reviews every five years or so; and

- for larger agencies to receive CPI only adjustment of departmental expenses
    - noting their more frequent access to new policy measures that allow increases in service levels or quality;
    - but with no expectation that they should absorb the costs of new policy measures, unless the Government explicitly identifies room for re-prioritising the agencies' outputs, or specific areas for additional efficiency measures.

Portfolio ministers would always be able to decide if some reallocation between agencies within the portfolio was justified.

The obvious reaction of Finance to these suggestions is that they would add significantly to the forward estimates without any increase in levels of services. My response to this is that:

- it would remove the current disguised way in which the Government is cutting back service levels;
- it would put the onus back on the Government to honestly and openly identify genuine budgetary savings:
    - this could include, on occasions, across-the-board cuts where the Government explicitly directed that lower priority activities agreed by Ministers be curtailed.

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RECOMMENDATION

The Inquiry should consider options to replace not only the efficiency dividend but the broader process for adjusting departmental expenses of Australian Government agencies. A better approach, more justifiable on the basis of genuine productivity requirements and a fair sharing of productivity gains, would be to use the CPI as the basic index. An option consistent with this which would address the additional problems of small agencies is to apply to smaller agencies the CPI plus,say, 1 percent, and to all other agencies the CPI.