

ACTU Submission

to the National Commission of Audit

November 2013



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Introduction & summary

The ACTU welcomes the opportunity to comment on the work of the National Commission of Audit review of Commonwealth government activities.

We represent nearly 2 million working Australians and their families. Many more have their pay and conditions of employment shaped by the activities of our affiliates. Some of those we represent are employed by the Commonwealth government and related organisations. All have an interest in public services that are efficient, effective and accountable to those who pay for them.

The ACTU has always taken the view that high quality public services are vital to the development of a fair, sustainable and competitive economy. We therefore have a long record of engaging with successive Commonwealth governments in relation to how such services should be funded, operated and held accountable for the work they do.

The National Commission of Audit (the Commission) has been set an enormous task by the Federal government and relatively little time to complete it. It is hard to see how a rigorous set of evidence-based recommendations relating to all the matters raised by your Terms of Reference can be generated in the time available. There is a high risk of ill-informed proposals that, if acted upon, will actually increase the costs and undermine the quality of services to our community.

In our view it is incumbent on the Commission to make clear in its reports to government where it has not had sufficient time and resources to reach conclusions based on thorough evaluations of the relevant evidence and consultation. In those areas where such conclusions cannot be reached, but where the Commission believes there may be potential for reform, the Commission should call for the government to establish appropriate evidence-based inquiry processes that allow for informed public comment and debate before any action is initiated.

To help build public confidence in the present inquiry process we believe the Commission should recommend to government that its first phase report be published. While the Commission may not have time to engage in further consultation, the public availability of the first phase report will at least help to inform public understanding and debate about the work of the Commission and the potential implications for public services.

We welcome the decision of the Commission to invite submissions, and this document is our response. However, given the wide ranging Terms of Reference that the Commission has been set, and the absence of an 'issues paper' that provides some insight into what the Commission regards as its priorities and likely options for reform, those who make submissions have been put into the position of having to guess what issues and arguments the Commission regards as particularly relevant to its work. This runs the risk of rendering many submissions mostly

or entirely irrelevant to how you intend to interpret your Terms of Reference. It invites the suspicion that the public consultation is a largely symbolic exercise with little substantive policy significance.

Having invited submissions it is standard practice for subsequent inquiry reports to frame their discussions and recommendations by reference to the arguments and evidence generated by the consultation process. Therefore we expect that in its reports to government the Commission will engage with the content of our submission and those made by other organisations and individuals.

Engagement with the full range of submissions is particularly important given that unions, community organisations and welfare advocacy groups are not represented within the leadership of the Commission. Yet these organisations have important experience and understanding of how our public services operate and how they can be made more effective. It is therefore vital that the Commission pays particular attention to submissions from these organisations and engages fully with the arguments and evidence they offer.

In summary, this submission makes the following evidence-based arguments:

- Australia's governments are among the smallest in the OECD (measured as revenue or expenditure as a share of GDP) and the size of government has not grown significantly;
- The debt we accumulated by implementing fiscal stimulus is modest, appropriate and far preferable to the alternative of higher unemployment. Significant progress has already been made in tightening fiscal policy. Tightening more rapidly would reduce growth and harm employment;
- The Commission has been asked to make recommendations to achieve a surplus of 1 per cent of GDP by 2023. Projections by the BCA and Treasury already have us on track to meet this target based on current policy settings. This target cannot be used to justify large short-run cuts to spending;
- To the extent that Australia has a fiscal policy challenge, it is related to insufficient revenue, not excessive expenditure, and it is a medium-long term challenge, not one suited to short-term solutions;
- As recent experience from the UK demonstrates privatisation and outsourcing of government services often fails to deliver expected cost-savings and efficiency increases;
- Factors such as 'vendor dependency', 'provider concentration' and 'gaming' can mean that the private provision of public services becomes more expensive than public provision, less flexible and diverse, and more prone to perverse and unintended outcomes for service users;
- Many private corporations who have experimented with outsourcing in recent years have come to regard it as an obstacle to the efficiency and higher quality outputs they were seeking, and have begun to bring work back in-house again; and
- The experience of the UK government, and many private companies, should lead policymakers in Australia to question the common assumption that privatisation and outsourcing offers a quick and easy path to better and more efficient public services.

The process

The Commission has been asked to conduct a wide-ranging review of the activities of the Commonwealth Government. These activities encompass some \$350 billion in expenditure, the employment of tens of thousands of Australians across the country, and complicated intra-federation financial and regulatory arrangements. The ACTU is concerned that the Commission has not been given sufficient time to undertake a task of this magnitude. To produce two reports in the next five months will be almost impossible if the Commission is to take an evidence-based approach to its task, rather than making recommendations from pre-conceived judgements. We urge the Commission to abstain from making recommendations where it feels it has not had sufficient time to contemplate the issue, and/or to adequately consult stakeholders in the area. Many of the issues that the Commission has been asked to consider, such as the fiscal pressures arising from an ageing population, are ones that require a long-term focus and the building of consensus among social partners. They are not amenable to short-term, quick fix solutions.

We are also concerned about the lack of representation for unions or community groups on the Commission. Given the lack of such representation, we urge the Commission to meaningfully consult the ACTU, our affiliates, and community groups with an interest in public policy. The task that the Commission has been asked to undertake concerns all Australians, not just big business.

The context

The ACTU believes that the Commission should base its work on an accurate appraisal of the country's fiscal and economic circumstances. We are concerned that some of the context provided by the Government to the Commission in its Terms of Reference could give a misleading impression. If the Commission's work is based on false premises, it will not arrive at sound recommendations or provide accurate information to the public.

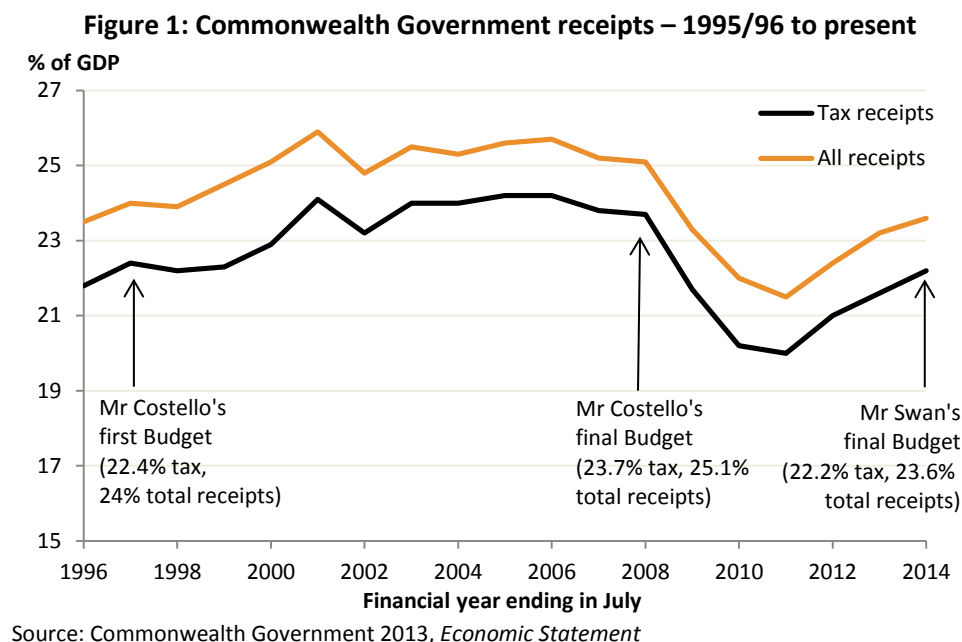
The size of government

The Terms of Reference open with the following paragraph:

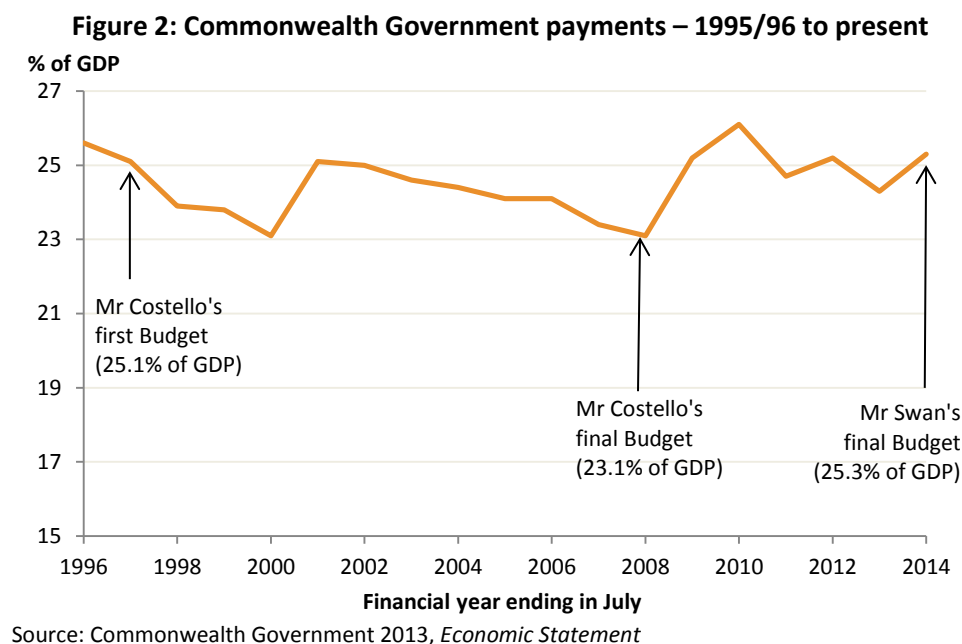
It is almost 20 years since there has been a thorough review of the scope, efficiency and functions of the Commonwealth Government. During this time the size of the Commonwealth Government has expanded significantly, as has the remit of some of its activities.

Expenditure and payments have increased, as has the size of the economy and the population. There has not been a significant expansion in the size of Commonwealth expenditure or revenues as a proportion of the economy. Commonwealth revenues as a percentage of GDP are slightly lower than they were in the 1996-97

Budget, at the time of the last Commission of Audit, and substantially below the level of the 2007-08 Budget, the last handed down by Mr Costello.



Commonwealth expenditure, as a share of GDP, is only 0.2 percentage points higher than it was in 1996-97, when the last review was undertaken.



The Commission should also be aware that the size of government has not “expanded significantly” if its size is measured by reference to government employment. In June 1996, the Commonwealth employed 354 800 people in the general government sector.¹ As at June 2012, the number stood at just 250 000.² Around 30% of those

¹ ABS, *Wage and Salary Earners, Public Sector, Australia*, Catalogue number 6248.0.

² ABS, *Employment and Earnings, Public Sector, Australia*, Catalogue number 6248.0.55.002.

general government employees work for the military and reserves.³ Commonwealth government employment is lower now, as a share of the population or total employment, than it has ever been before. ABS statistics show that the number of people employed in the general government sector (across all levels of government) fell in 2011-12 for the first time since 1998-99.

Figure 3: Commonwealth general government employment as a share of total employment

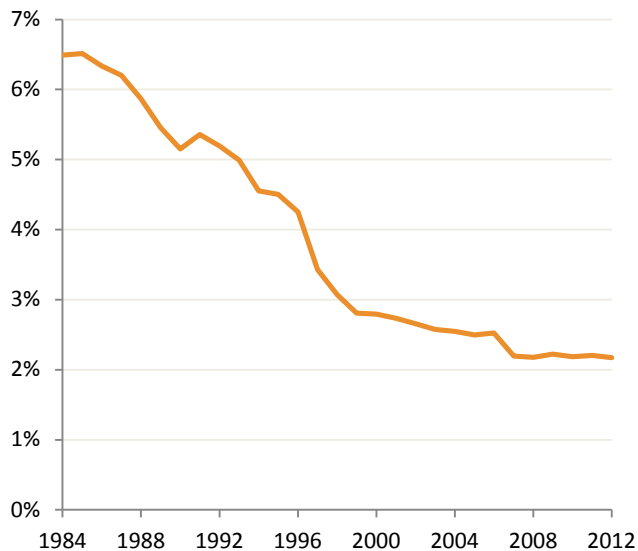
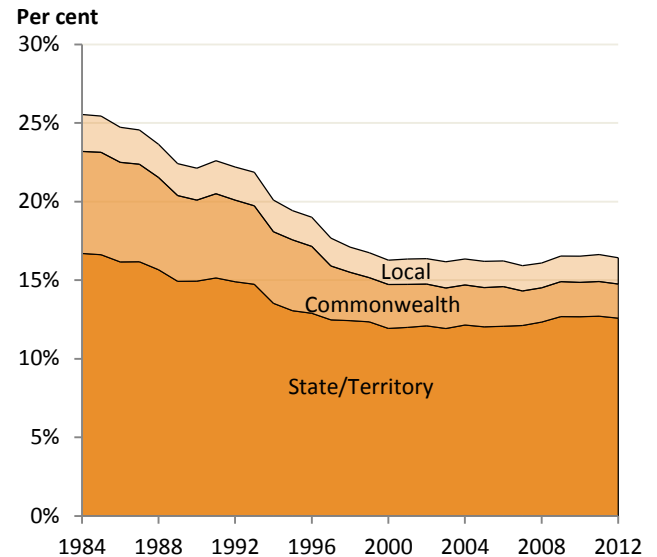


Figure 4: General government employment (all levels) as a share of total employment

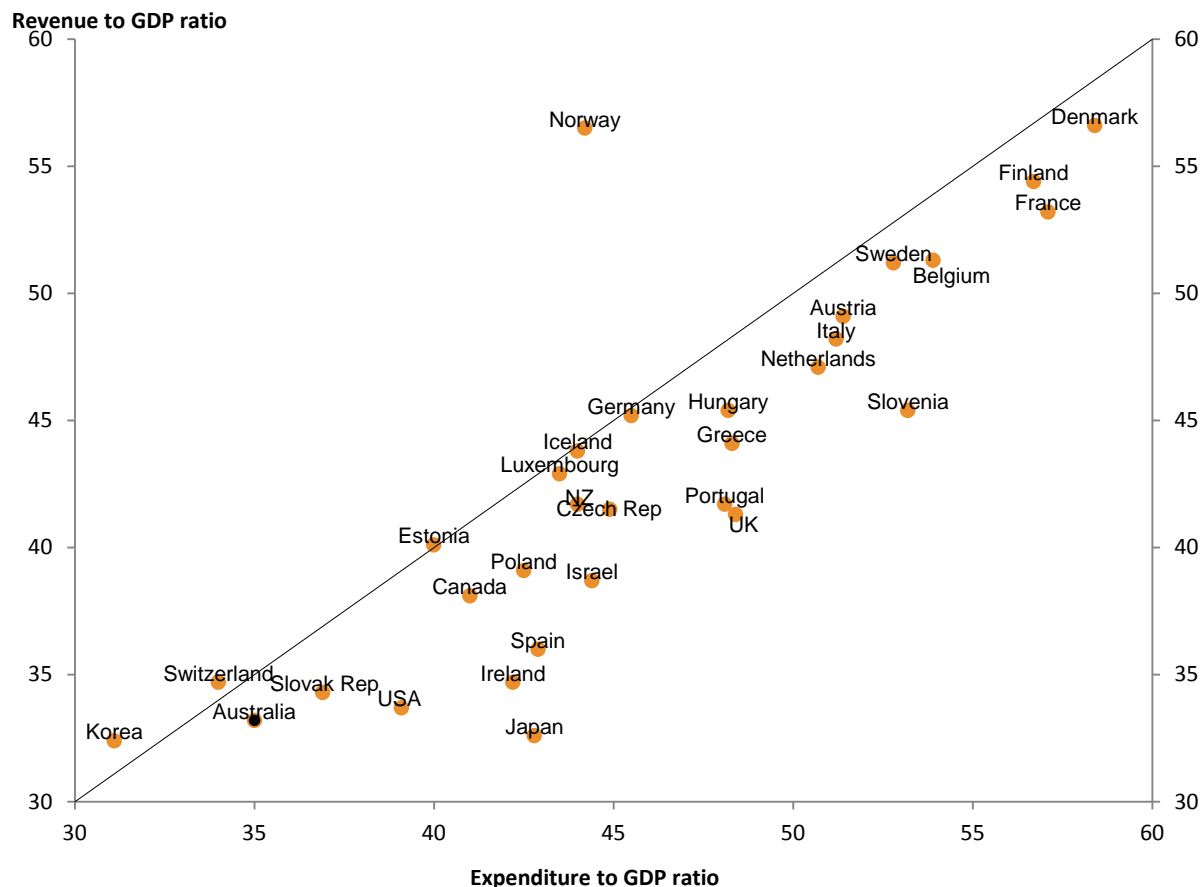


Source: ACTU calculations based on ABS 6248.0, ABS 6248.0.55.002, ABS 6202.

It is clear that the size of the Commonwealth Government has not expanded significantly. The Commission should also be aware that Australian Governments, taken together, are smaller as a share of the economy than the governments of almost all the other OECD advanced economies. Figure 5 shows the revenue and expenditure of the governments of all levels in each OECD country, as a proportion of the country's GDP. On both dimensions, Australia's governments are smaller than those of most other advanced economies.

³ Based on annual average staffing levels over the fiscal year 2012-13 of 79 132 Military and reserves employees and 182 505 in the rest of the general government sector.

Figure 5: Revenue and expenditure as a proportion of GDP in OECD countries in 2013



Source: OECD Economic Outlook, Annex tables 25 and 26. Includes national, state, and local governments.

Australia's governments, including the Commonwealth, account for a very modest proportion of economic activity by advanced economy standards, and this proportion has not grown significantly in recent years. If the Commission begins its work from the premise that "the size of the Commonwealth Government has expanded significantly" then it is likely to arrive at conclusions not supported by the facts.

Recent fiscal policy

The Commission's Terms of Reference state that

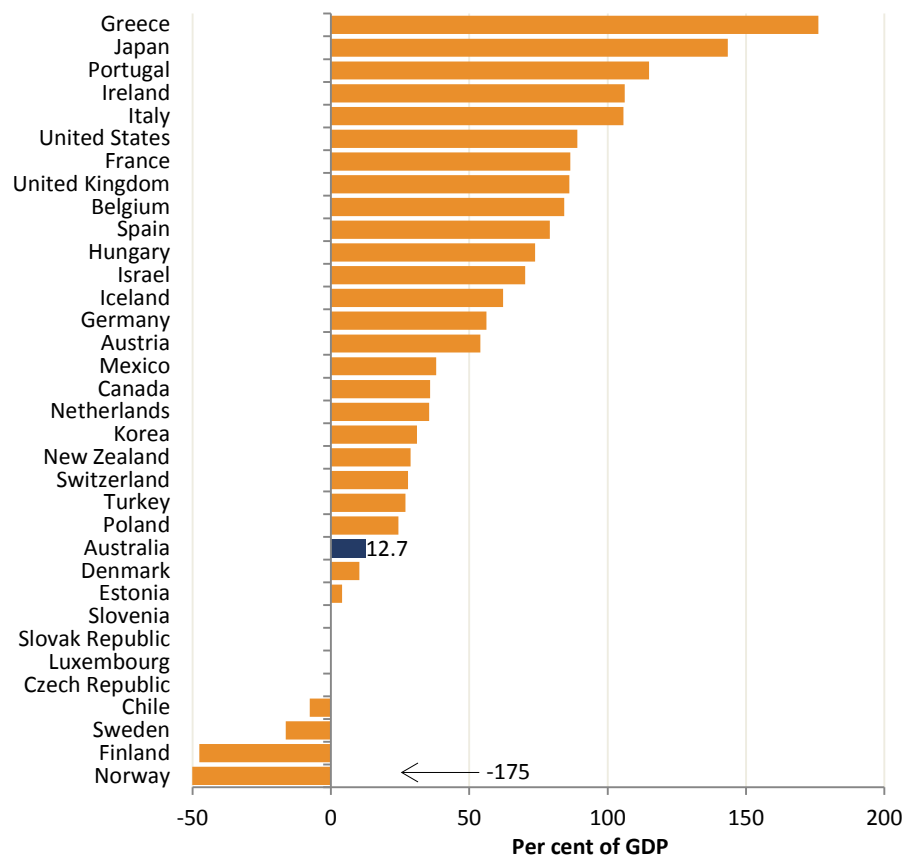
"it is also essential that the Commonwealth government live within its means and begin to pay down debt."

This implies that the Commonwealth has not been 'living within its means' and that no efforts have been made to pay down debt. This is a false premise. It is entirely appropriate that the Commonwealth allowed the automatic stabilisers to function in the wake of the global financial crisis, and also implemented discretionary fiscal stimulus, described as "one of the best-designed Keynesian stimulus packages of any country in the world" by Nobel Prize-winning economist Joseph Stiglitz.⁴ Doing so entailed the accumulation of some public debt, but this was far preferable to the alternative of accumulating larger numbers of unemployed people, with the social and

⁴ Stiglitz, J. 2010, 'The Crisis Down Under', Project Syndicate, August 5. Available from: <http://www.project-syndicate.org/commentary/the-crisis-down-under>

economic costs that entails. The presence of some public debt should not be construed as an indication that the country has been 'living beyond its means'. The Commission should also be aware that Australia's stock of net public debt is much smaller than those of most other OECD advanced economies, as shown in Figure 6.

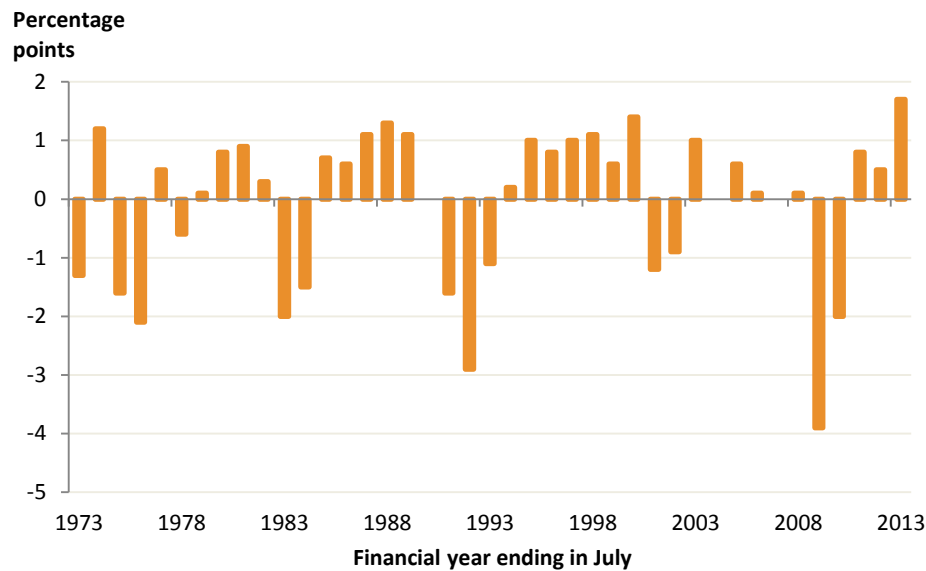
Figure 6: Net government debt as a proportion of GDP in OECD countries



Source: IMF World Economic Outlook database. Figures include sub-national (state and local) governments where applicable.

The task of tightening fiscal policy has already begun. The Final Budget Outcome for 2012-13, released in September by Treasurer Hockey and Minister Cormann, shows that the fiscal position improved by 1.7 percentage points of GDP. This is the largest single-year tightening of fiscal policy for at least the past 40 years.

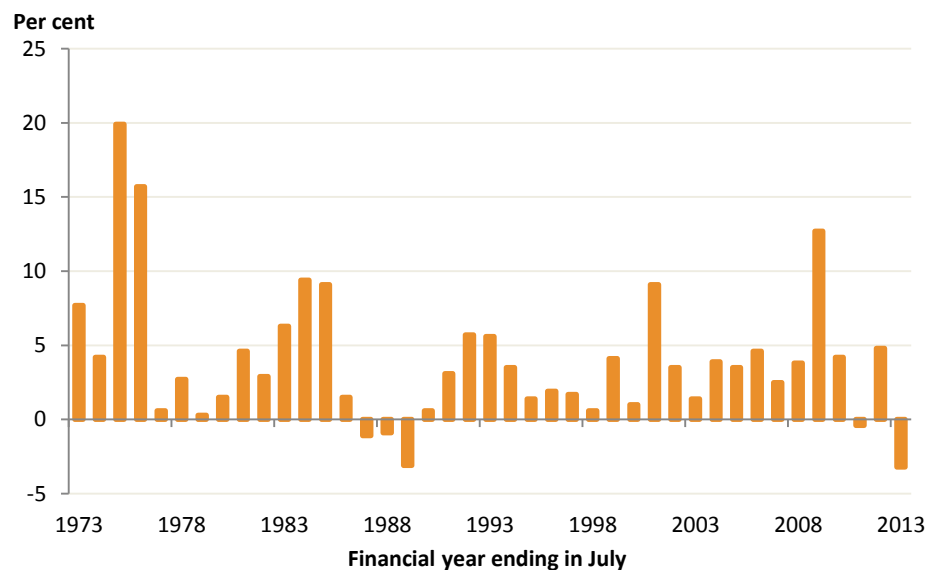
Figure 7: Change in fiscal position of the Commonwealth (as a % of GDP)



Source: Commonwealth Government 2013, *Final Budget Outcome 2012-13*.

2012-13 also saw the largest fall in inflation-adjusted expenditure by the Commonwealth on record, with records going back to 1970. Real payments fell by 3.2%, a significant reduction in expenditure.

Figure 8: Growth in real payments by the Commonwealth



Source: Commonwealth Government 2013, *Final Budget Outcome 2012-13*. 'Real' here means deflated by the CPI.

It is not accurate to suggest that the Commonwealth has not been 'living within its means', nor that there has been no move to tighter fiscal policy to reduce debt. Tightening in excess of that already experienced would likely have reduced economic activity and employment in Australia. The Commission should not approach its task with the belief that fiscal policy requires rapid and severe tightening in excess of its current short-run trajectory.

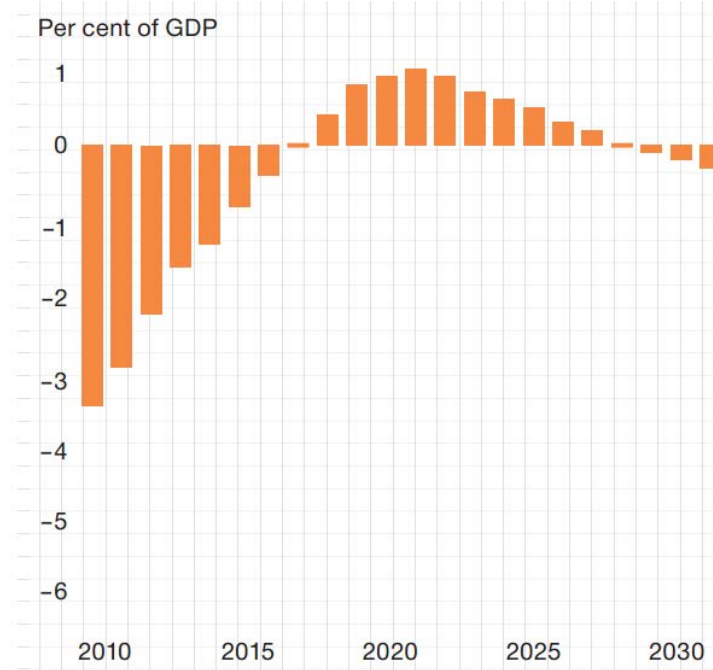
The Commission should be aware that the OECD, in its November 2013 *Economic Outlook*, found that “it will... be important to avoid any additional tightening of fiscal policy in the short term above that already factored in.”⁵ Cutting expenditure or raising revenue faster than is already envisaged will reduce economic growth and employment. We ask the Commission to heed the OECD’s warning and not make a recommendation for tighter fiscal policy in the short run.

The fiscal outlook

The Commission has been asked to “make recommendations to achieve savings sufficient to deliver a surplus of 1 per cent of GDP prior to 2023-24”. Achieving this task will not require cuts to expenditure or increases in taxation beyond currently-enacted policy. Projections of the underlying cash balance ten years hence already envisage a surplus of around 1 per cent of GDP being achieved.

For example, the Business Council of Australia’s *Action Plan for Enduring Prosperity* includes a projection of the fiscal balance derived from Deloitte Access Economics’ work. This projection includes a surplus approximately equal to 1 per cent of GDP in 2023.

Figure 9: BCA’s projection of Commonwealth fiscal balance

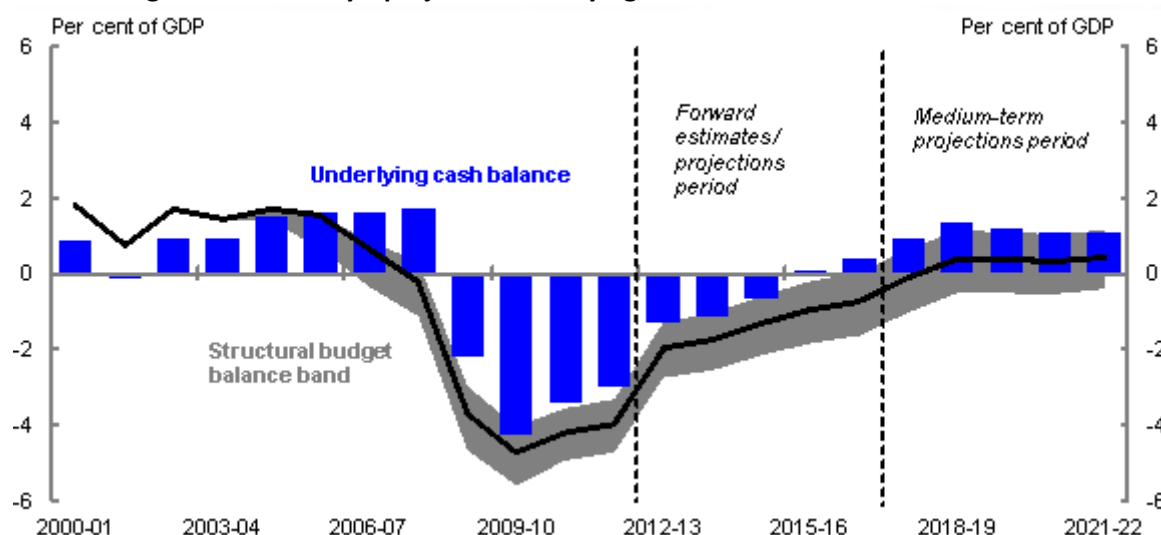


Source: Deloitte Access Economics, as reproduced in BCA (2013) as Figure 27. Cropped to focus on the period the Commission has been asked to consider.

Another projection of the budget balance over the next decade comes from the Treasury. The Treasury projects an underlying cash balance of around 1 per cent of GDP in 2021-22 and for each of the three years prior to that. It also expects the Budget to be in structural surplus at this time.

⁵ OECD 2013, ‘Australia: Economic forecast summary’, *Economic Outlook*, OECD, Paris.

Figure 10: Treasury's projected underlying cash balance and structural balance

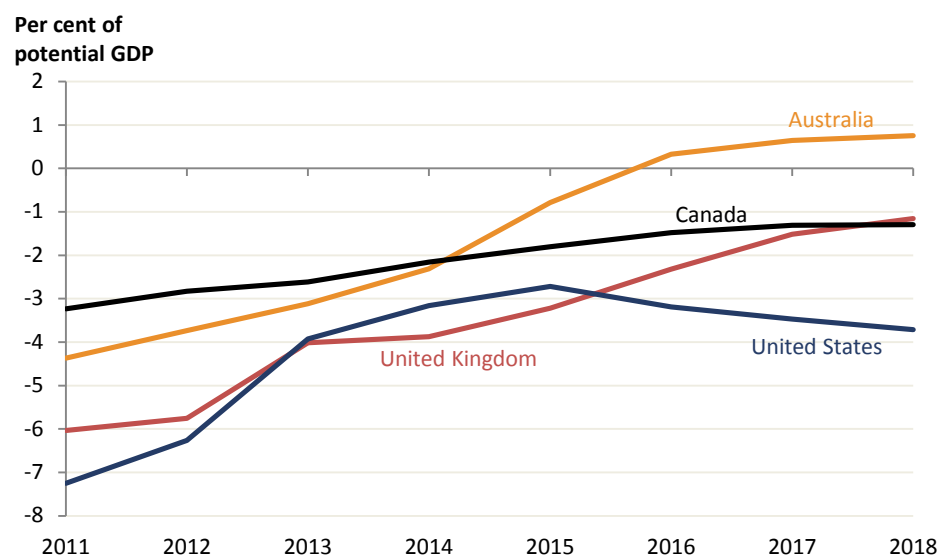


Source: Treasury Working Paper 2013-01, Chart 3.

The Commonwealth Budget is already on track to hit the target of a 1% surplus by 2023 that has been set for the Commission. If the Commission is to justify additional tightening of fiscal policy in order to hit this target, it must explain why its projections are more pessimistic than those of the BCA/Deloitte Access Economics and the Treasury.

Australia's fiscal outlook is also much more positive than the outlook elsewhere. The IMF, its latest *World Economic Outlook*, estimates that Australia's general government sector (which incorporates State and local governments) will have net lending equal to 0.75% of GDP by 2018 (the final year of its current projections) and a structural surplus equal to 0.755% of potential GDP by the same year. This is a fiscal outlook quite unlike those of many other advanced economies. Figure 11 shows that, unlike Australia, the governments of Canada, the UK and the US are projected to be running structural deficits of at least 1% of GDP in 2018.

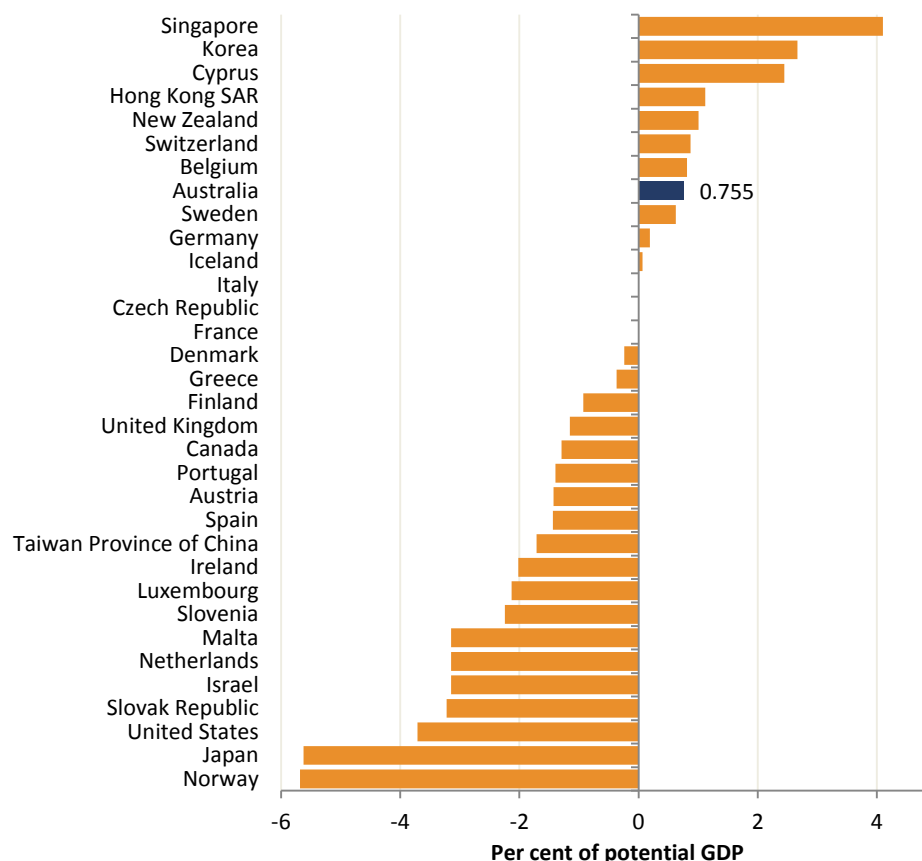
Figure 11: IMF's projected general government structural balance



Source: IMF *World Economic Outlook* database 2013.

Australia is one of only a handful of advanced economies for which the IMF is projecting a structural government surplus in 2018. Of the 33 advanced economies for which the IMF database includes a projection, the Fund expects just 12 to be running a structural surplus in 2018, with 20 running structural deficits and one (the Czech Republic) in structural balance.

Figure 12: IMF's projected general government structural budget balance in 2018 in advanced economies



Source: IMF *World Economic Outlook* database 2013.

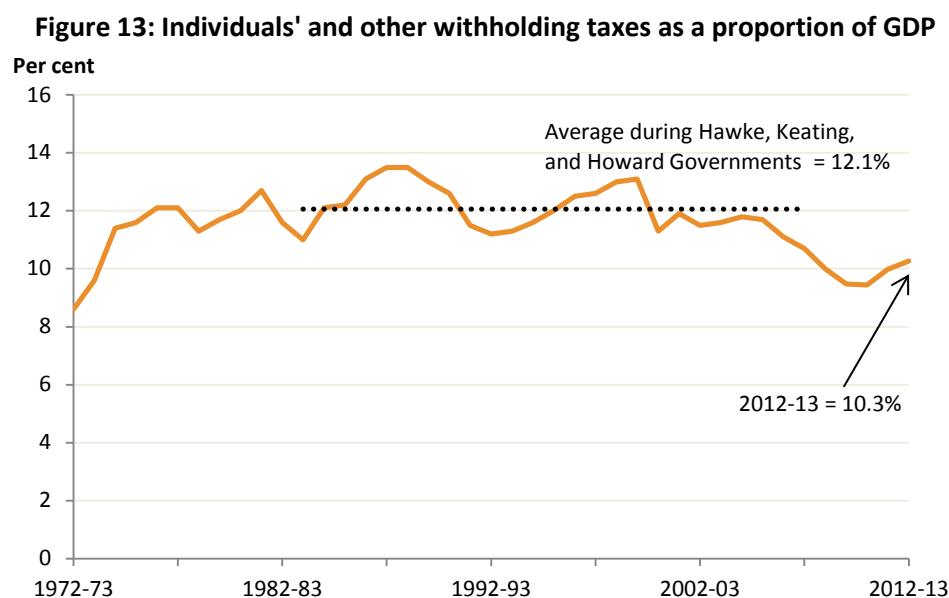
To the extent that Australia has a fiscal policy problem, it is a long-run challenge that will result in deficits from 2030 onwards, as illustrated in the BCA's projection reproduced as Figure 9. This challenge will not be best addressed through a rapid review process with recommendations for short-term cuts. If the Commission's analysis accords with the BCA's projection – ie., if it finds that the challenge is largely a long-term one – it should make this clear in its report to Government and should recommend that an inquiry process be initiated with an appropriate amount of time available to properly consider the long-term reform options.

The revenue challenge

As is clear from the analysis above, Australia does not have a 'budget emergency'. We are on track to meet the target set for the Commission in its terms of reference, without any changes to the current policy settings. Nevertheless, to the extent that tighter fiscal policy is desired, this should be achieved through increasing tax receipts, not by reducing expenditure.

The Parliamentary Budget Office recent estimated that between 2002-03 and 2011-12, “the structural level of [Commonwealth] receipts fell by around 5 percentage points of GDP” while the structural level of payments (excluding GST) rose by around 1 percentage point of GDP. The bulk of the deterioration in the structural fiscal position has therefore come about because of a decline in revenues, not an increase in expenditure. Of that decline in revenues, the PBO estimates that “over two thirds... was due to the cumulative effect of the successive personal income tax cuts granted between 2003-04 and 2008-09”.⁶

During the Hawke, Keating and Howard Governments, individuals’ and other withholding taxes (of which personal income tax is the largest component) averaged 12.1% of GDP.⁷ Revenue from this source has been below 12.1% for every fiscal year since 1999-2000. In 2011-12, this source of revenue took in just 9.4% of GDP, the lowest figure since 1972-73. In 2012-13, individuals’ and other withholding taxes accounted for 10.3% of GDP.



Source: Reinhardt and Steel, ‘A Brief History of Australia’s Tax System’ to 2006-07; ACTU calculations based on ABS 5204 and Budget papers thereafter.

Even if no income tax cuts are implemented in the coming years, the latest Budget forecasts only anticipate individuals’ and other withholding taxes reaching 11.6% of GDP in 2015-16, below the Hawke/Keating/Howard average. It is clear that revenue from this source has been deficient relative to its typical levels of the past three decades. As the PBO found, this deficiency is largely due to unsustainable tax cuts, rather than the state of the economy. In 2012-13, if individuals’ and other withholding taxes had taken in the Hawke/Keating/Howard average (12.1%), this would have meant an additional \$27 billion in Commonwealth revenue.

⁶ Parliamentary Budget Office 2013, ‘Estimates of the Structural Budget Balance of the Australian Government: 2001-02 to 2016-17’, Parliament of Australia, Canberra.

⁷ “Individuals’ and other withholding taxes” including personal income tax,

The effect of personal income tax cuts since 2004-05

As outlined above, substantial personal income tax cuts were implemented in the mid-2000s. These cuts were far in excess of the amount that would have been necessary to compensate for bracket creep arising from inflation. To further examine the effect of personal income tax cuts on the budget, the ACTU has undertaken some analysis using NATSEM's STINMOD static microsimulation model of Australia's income tax and transfer system. We have used the model to answer the following questions:

- If the 2004-05 personal income tax rates had remained unchanged to 2012-13, and the thresholds had been indexed, how much additional personal income tax revenue would the Commonwealth have collected in 2012-13?
- In the scenario described above, how much of the additional revenue would have come from high-income households?

We answered these questions using two alternative scenarios. In the first, the personal income tax thresholds were indexed in line with the CPI (which rose by 25.8% between September 2004 and September 2012).⁸ In the second, the thresholds were indexed in line with the average weekly ordinary time earnings (AWOTE) of full-time adults, which rose 44.5% over the same period. For example, the threshold for the top marginal tax rate was \$70 000 in 2004-05. If this had increased in line with the CPI, it would have been \$88 084 in 2012-13, or \$101 180 if it was indexed to AWOTE. Instead, the threshold was increased to \$180 000.

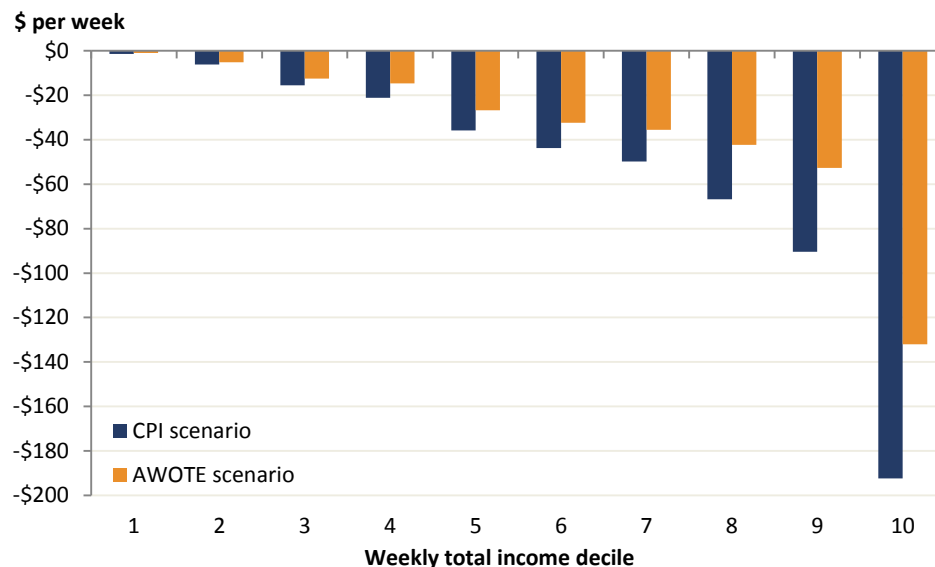
By comparing the 2012-13 tax parameters with those of 2004-05, indexed by either prices or wages, we are measuring the effect of the *real* tax cuts since 2004-05, ie. tax cuts in excess of bracket creep. We find that if the tax thresholds had been indexed to the CPI, rather than being raised as dramatically as they were, then Commonwealth tax revenues would have been \$32.9 billion higher in 2012-13 than they actually were. If the thresholds were indexed in line with AWOTE, the revenue gain would have been \$22.3 billion.

We estimate that 36.7% of this extra revenue (37.2% in the AWOTE scenario) would have come from the top 10% of households, ranked by weekly total income. The disposable incomes of the top 10% of households are \$192.30 per week higher, on average, than they would have been if the 2004-05 thresholds had been indexed to CPI (\$132 in the AWOTE scenario). Households in the bottom 10% are \$1.50 per week better off (\$1 in the AWOTE scenario) than they would have been if the thresholds had been indexed.

⁸ In both scenarios, the personal income tax rates are held constant from 2004-05. The personal income tax thresholds are indexed, as are the Low Income Tax Offset amount and thresholds. All other tax-transfer parameters remain as at actual 2012-13 policy.

The additional personal income tax that would have been paid by high-income households in 2012-13 if the 2004-05 thresholds had been indexed far exceeds the additional amount that would have been paid by low-income households. The real tax cuts since 2004-05 have been skewed towards higher income households.

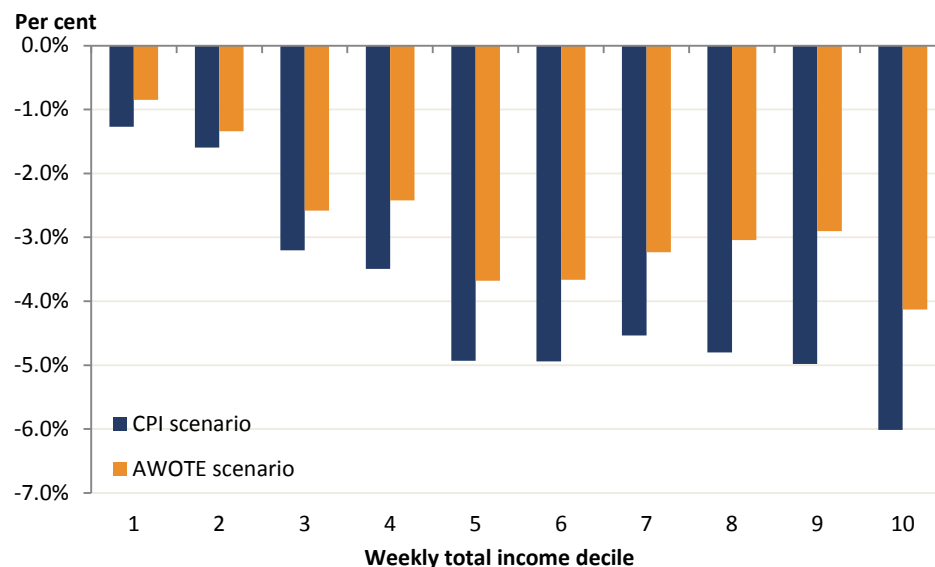
Figure 14: Change in family disposable income in 2012-13 if the 2004-05 tax thresholds had been indexed (\$)



Source: ACTU calculations using NATSEM's STINMOD static microsimulation model.

The skew in the tax cuts towards higher income households remains evident if the change is expressed in percentage, rather than dollar, terms. The family disposable income of the top 10% would have been 6% lower in 2012-13 in the absence of the real tax cuts since 2004-05 (4.1% in the AWOTE scenario) – this compares to 1.3% for the lowest income decile (0.8% of AWOTE).

Figure 15: Change in family disposable income in 2012-13 if the 2004-05 tax thresholds had been indexed (%)



Source: ACTU calculations using NATSEM's STINMOD static microsimulation model.

Real tax cuts since 2004-05, in excess of bracket creep, have reduced revenue by \$32.9 billion per year (\$22.3 billion in the AWOTE scenario). These tax cuts were a major factor in the deterioration of the structural budget position, as noted by the Parliamentary Budget Office. They were skewed towards higher income households. If the Commission wishes to address the real cause of the structural deterioration in the Commonwealth Budget, it

should examine the effect of these personal income tax cuts. It should not be assumed that future tax cuts will be implemented to preserve the real value of these unsustainable cuts.

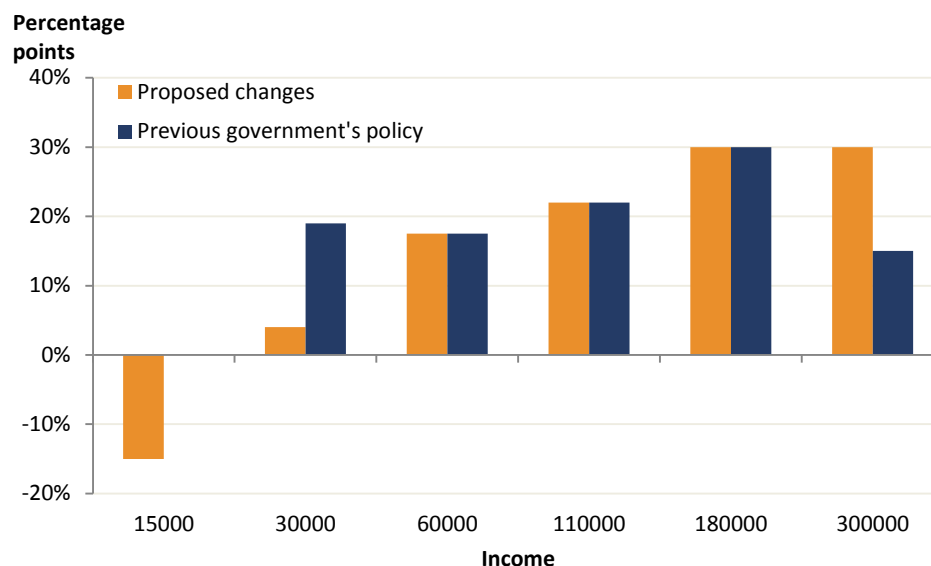
Superannuation tax expenditures

The short time frame for submissions does not allow a comprehensive analysis of other tax policy measures that the Commission should consider. However, there is one area that we believe is particularly worthy of consideration: the size and distribution of superannuation tax concessions.

The present system for taxing superannuation contributions is blatantly inequitable. An individual with an income of \$60 000 faces a marginal tax rate of 32.5% (not including the Medicare Levy), and pays 15% on super contributions. This is a concession of 17.5 percentage points. A high-income earner on \$180 000 or more receives a tax concession of 30 percentage points.

The system will be rendered more inequitable as a result of the Government's abolition of the Low Income Superannuation Contribution (LISC) and the abandonment of the plan to reduce the super tax concession for individuals with annual incomes greater than \$300 000. The LISC effectively refunds the tax paid on super contributions by individuals with incomes below \$37 000 per year. The abolition of this measure will mean that an estimated 3.6 million low income earners will pay 15% tax on their super contributions, while facing a marginal tax rate on ordinary income of 0% or 19%.

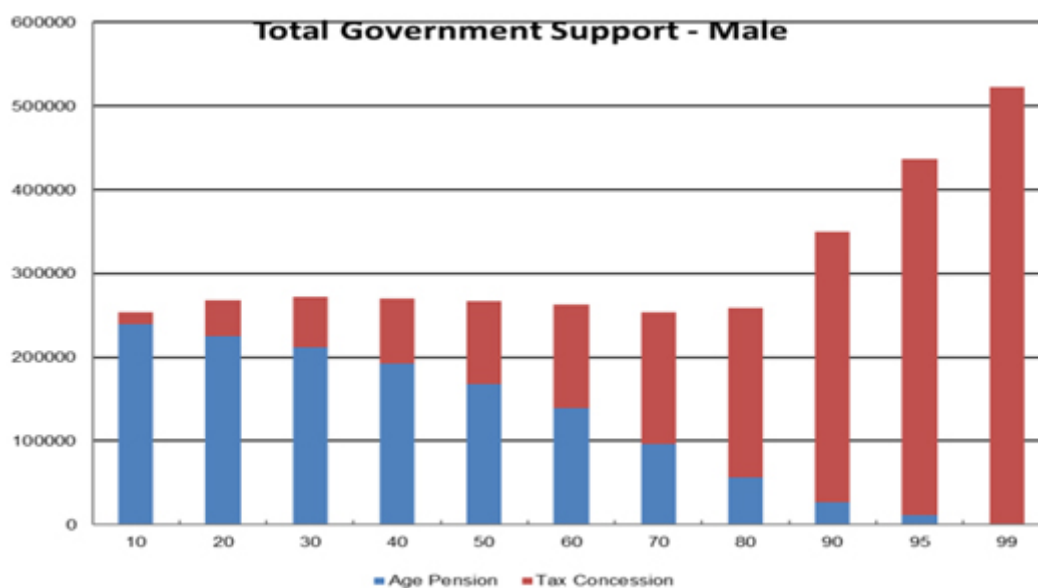
Figure 16: Tax concession on superannuation contributions



Source: ACTU calculations.

Analysis by the Treasury shows that high income earners benefit more than low-income earners from superannuation tax concessions (including those associated with contributions, earnings, and withdrawals).⁹ It shows that the top decile of income earners received 38.2% of superannuation tax concessions in 2009-10. This is more than the share of the bottom 70%, combined. The bottom decile received a negative share of the total, as they paid more on their super than on other income. The analysis also shows that the support given to high income earners in the form of superannuation tax concessions exceeds that enjoyed by lower income earners in the form of the age pension. The Treasury found that “the top 1 per cent of income earners received the most combined support,” taking both the age pension and super concessions into account.

Figure 17: Treasury estimate of total government support for retirement by income level



Source: The Treasury 2012, 'Distributional Analysis of Superannuation Tax Concessions'.

Tax expenditures associated with superannuation are estimated to be worth \$31.8 billion in 2012-13, rising to \$44.8 billion by 2015-16. Unions support the concessional taxation of superannuation, but these concessions must be sustainable and equitably distributed. This is not currently the case. The Commission must examine the size and distribution of these tax expenditures if it is to seriously grapple with the medium to long-term budget pressures facing the Commonwealth.

⁹ The Treasury 2012, 'Distributional Analysis of Superannuation Tax Concessions'. Available online: <http://www.treasury.gov.au/Policy-Topics/SuperannuationAndRetirement/Superannuation-Roundtable/Distributional-analysis-of-superannuation-taxation-concessions>. [Accessed 25 November 2013].

Assessing Privatisation and Outsourcing

Introduction

In its Terms of Reference the Commission is asked to consider the scope of Commonwealth government activities as part of its work. In particular, the Commission is asked to identify:

‘...whether there remains a compelling case for the activity to continue to be undertaken; and if so, whether there is a strong case for continued direct involvement of government, or whether the activity could be undertaken more efficiently by the private sector, the not-for-profit sector, the States, or local government.’

Related to this review of scope is the question of increasing the efficiency and effectiveness of expenditures. The Terms of Reference specify potential options for doing so, such as increasing the contestability of services and the privatisation of Commonwealth assets.

As we note in the introduction to this submission, this is a very demanding agenda in the time available. In keeping with the conventions of evidence-based policymaking,¹⁰ any proposed privatisation or outsourcing will need to be justified by reference to a detailed assessment of the long-term costs, risks and impacts specific to each case.

In the absence of transparent evidence-based recommendations the Commission will invite the suspicion that it exists merely to rubber-stamp pre-existing preferences for private sector ownership and provision. This will undermine public trust in the policy process and be likely to generate considerable opposition to changes in government activities that appear to be driven by ideology rather than evidence.

If the Commission identifies what it believes to be the potential for increasing the role of the private sector in the ownership and provision of central government services, it is vital any steps in that direction are subject to thorough and transparent processes of public discussion and evidence-based evaluation. The Commission has the discretion to recommend that such evaluation processes are implemented beyond March 2014, and it is clearly in the interests of good governance and the public that they are.

In the view of the ACTU, a predisposition for further privatisation and outsourcing, if replicated and reinforced by the work of the Commission, would make for poor public policy. The private sector has always played a valuable role in supplying goods and services to all levels of Australian government. That will and should continue. However, our focus here is on the argument that work which is currently performed by central government

¹⁰ On the importance and components of evidence-based policymaking see Banks, G. (2009) *Evidence-based Policymaking: What is it? How do we get it?* ANZSOG/ANU Public Lecture, 4 February, Canberra.

departments and agencies can be made more productive, cost-effective and efficient if it is privatised or outsourced to private providers. We do not agree that private provision can be assumed to be superior to public provision. We explain why below.

Firstly, we review the recent experience of the privatisation and outsourcing of central government services in the UK, including the recent so-called 'Big Society' initiative. This experience is important because the UK, more than almost any other advanced industrial democracy, has been privatising and outsourcing large parts of central government operations for several decades. There is much that should be learnt from that experience before any further attempts to replicate it here are made.

Secondly, we examine some of the reasons why in recent years an increasing number of private sector organisations, often held to be ideal models for public sector organisations to emulate, have begun to turn away from outsourcing as a solution to their operational problems. In short, after an initial and often uncritical enthusiasm for outsourcing in the 1980s and 1990s, many private firms and corporations have come to realise the pitfalls of such an approach. This is now leading some to embrace 'insourcing'.

Recent UK experience

The privatisation and outsourcing of government services became central to the UK's public sector strategy during the course of the 1980s. Compulsory Competitive Tendering was applied to parts of local government in 1980. In the early 1990s all central government departments and agencies were required to outsource their IT systems, aspects of service delivery, and many of their properties and related support services such as security, catering and cleaning.¹¹

In response to concerns that tendering based on the lowest immediate cost was leading to significant falls in service quality, for both tendering departments and many groups of service users, the pace of privatisation and outsourcing slowed between 1997 and 2010. The Labour governments for much of this period adopted a 'Best Value' approach to improving public sector efficiency, arguing that cost should be only one of a number of criteria that senior government managers take into account when deciding if work could be better performed by a private sector provider.¹²

Following the change of government in 2010 a renewed enthusiasm for privatisation and outsourcing has emerged. This has often been couched in the language of the 'Big Society'. Whereas earlier changes were advocated mainly on the grounds of efficiency and cost, current moves to increase the role of the private sector in

¹¹ Dowding, K. (1995) *The Civil Service: theory and practice*, Routledge, London.

¹² Ludlam, S. and M. Smith (2003) *Governing as New Labour: policy and politics under Blair*, Palgrave, Basingstoke.

operating and delivering public services is often presented as being primarily concerned with promoting diversity, choice and the empowerment of service users.

The Big Society agenda has been subject to considerable criticism, mainly for promising diversity, quality and empowerment at the same time as deep cuts to budgets have made such promises extremely difficult or impossible to deliver. This increasingly obvious contradiction has led one former high profile supporter of the agenda, Sir Stephen Bubb, to declare that the Big Society is 'effectively dead'.¹³ Despite this, the UK government remains intent on privatising and outsourcing more central government activities in the name of efficiency and value-for-money.

The UK experience of privatisation and outsourcing across government over the past three decades has been complex and diverse. However, while the rhetoric used to justify the greater involvement of the private sector has sometimes varied, the core rationale has remained constant: private firms can be assumed to be more efficient and cost-effective than the public sector when it comes to operating and delivering public services. This is, at base, the principal justification for increasing the role of the private sector.

And yet evidence in support of this assumption is hard to find. One advantage of three decades of extensive privatisation and outsourcing in the UK is that there have been numerous attempts to evaluate and quantify the assumed benefits for taxpayers. Earlier this year the non-partisan think-tank, The Institute for Government, reflected on this experience and evidence. It offered the following conclusion:

'In truth, the evidence on whether a more diverse and competitive landscape of public service provision has improved standards is extremely limited...It is clear, however, that the shift to competitive public service provision has not been a panacea for public service performance and productivity.'¹⁴

The Institute notes that all organisations occasionally struggle with performance. However, it argues that the problem is more systemic than explanations which highlight occasional failures by particular firms allow. Their report continues:

'What taxpayers and service users should be far more worried about is a series of research reports which suggest that there are entire service areas where government is consistently failing to get the best from a large number of independent suppliers. Since 2010, independent research and select committee enquiries have roundly criticised contractual arrangements for electronic monitoring of offenders, housing provision, and back-to-work support, to

¹³ 'Big Society is effectively dead, Sir Stephen Bubb tells PM', *Third Sector Online*, 7 January 2013.

¹⁴ Gash, T. et al. (2013) *Making Public Service Markets Work*, Institute for Government, London, p. 11.

name just a few. These problems have not, however, prompted government to systematically re-examine its overall approach...¹⁵

Among advocates of privatisation and outsourcing such problems are argued to be the contingent result of failures by particular public sector managers and firms to design and execute appropriate contracts. Learning from past mistakes will make for better outcomes next time. Critics reply that the problems often generated by privatisation and outsourcing (poor performance, unexpected cost-escalations, fraudulent claiming and reporting, government bail-outs of failing providers, the emergence of market oligopolies) have been too pervasive over too many years to be explained simply in terms of contingent contractual mistakes.¹⁶

We agree with critics that there are structural trends at work which explain why governments and service users repeatedly fail to receive expected efficiencies and better quality outcomes. Driving these trends is the profit-maximising nature of many of the organisations that the government seeks to engage as service providers.

Real world competition

For advocates of privatising and outsourcing central government activities it is precisely the profit-maximising nature of private service providers that makes them superior to the public sector. The relentless pressure to compete for customers, revenues and profits allegedly makes such organisations highly efficient, innovative and flexible.

If government creates a market for public services profit-maximising firms will compete for government business, driving down costs in the interests of shareholders while generating more efficient and innovative outputs in the interests of service users. The prospect of losing government business to a competitor will help to ensure performance remains high. Failure to meet targets and expectations will mean non-renewal or termination of contracts.

This ideal model of service provision is intuitively appealing to many policymakers. It appears to offer a win-win solution to the problem of securing budget discipline while meeting voter expectations for more and better services. However, it abstracts from the real dynamics of profit-maximising firms and how they often behave when performing work for government. Extensive experience of such dynamics and behaviours in the UK context has led researchers to identify the following obstacles to the ideal model being realised in practice:

a) Vendor Dependency

¹⁵ Gash, T. et al. (2013) p. 11.

¹⁶ Funnell, W., R. Jupe and J. Andrew (2009) *In Government We Trust: Market Failure and the Delusions of Privatisation*, Pluto Press, Sydney.

‘Vendor dependency’ arises when the bargaining power in a principle-agent relationship shifts significantly toward the agent. This can be for a number of reasons. Over time, as the contract matures, it is common for the principle (e.g. the government department) to lose the internal skills and knowledge it needs to effectively monitor, check and evaluate the activities of the agent (e.g. the contracted service provider). This can make it difficult for the principle to challenge the alleged necessity of cost increases or other changes to the original contract terms.

Vendor dependency is not a natural or accidental by-product of privatisation and outsourcing; it is actively cultivated by vendors. It has become common to under-price bids for government tenders, on the basis that once they are won and the government department becomes reliant on the service provider, costs can be significantly increased at a later date. In the words of one public sector contract manager in their evidence to the *Institute for Government* research:

‘After two years of contracts, the costs go ballistic.’¹⁷

In theory, the principle can insist on the original agreed terms and prices. In practice, ‘closed book’ contracts make it difficult to question claimed changes to cost structures, and government managers are often wary of incurring the additional expenses and risks to services and reputation that can accompany the early unilateral termination of contracts. In reality, many UK government departments, when faced with escalating costs and poor performance, persevere with established service providers, partly because they have become reliant on the knowledge and goodwill of their agents and do not believe changing providers is a practical or cost-effective option.

b) Provider Concentration

Related to vendor dependency is the tendency toward the concentration of service provision: the temporal reduction in the numbers of firms able and willing to participate in markets for particular government contracts.

This concentration has become a matter of considerable public controversy in the UK. Despite widespread expectations among policymakers and economists that privatisation and outsourcing would result in government simultaneously promoting and benefiting from competition the reality has been the emergence of oligopolistic markets dominated by a small number of very large and powerful providers. In the UK the markets for a wide range of ‘back office’ and ‘frontline’ services, such as IT, bulk processing, prison management and nuclear weapon supervision, has become dominated by just four multinational corporations: Atos, Capita, G4S and Serco.

¹⁷ Gash, T. et al (2013) p. 13.

A recent assessment of the power of these corporations by the UK National Audit Office (NAO) found that many within government who had come to rely on their knowledge and scale now regarded these major providers as 'too big to fail'.¹⁸ These companies have become so central to the provision of a vast array of services that government now has an interest in ensuring their viability and profitability as providers, substantially weakening the bargaining power of public sector contract managers and effectively ensuring the continuous renewal of major contracts.

In short, the markets in which these companies operate have become characterised by 'high barriers to exit'.

Furthermore, the NAO found that it was impossible for contract managers, and MPs, to judge if these companies were receiving a reasonable return for their work because they refuse to supply the information on unit-costs and profitability needed to reach informed conclusions. There was a pervasive lack of transparency which made it impossible for contract managers to negotiate and manage contracts in the interests of taxpayers and service users.¹⁹

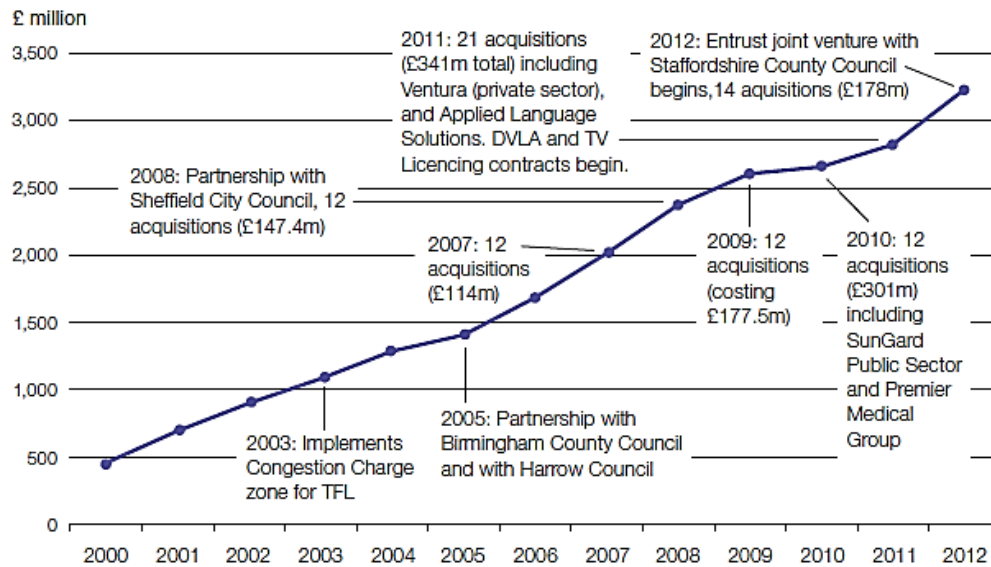
But the emergence of oligopolistic markets and 'too big to fail' service providers is not the contingent outcome of circumstances particular to the UK. It is the logical result of contracting to profit-maximising companies. On the government side, a key driver of contracting is to secure lower immediate costs. This generates strong preferences for large contractors who can offer significant economies of scale.

On the provider side, all profit-maximising corporations routinely implement product, pricing and acquisition strategies with the intent of reducing or eliminating competition. The widespread use of acquisitions to increase supply-side concentration is illustrated by the recent history of Capita, aspects of which are summarised in Figure 14. Such trends are common for all major private providers of public services, reducing competition for contracts while enhancing their status as being 'too big to fail'.

¹⁸ National Audit Office (2013) *The Role of Major Contractors in the Delivery of Public Services*, The Stationery Office, London, p. 10.

¹⁹ National Audit Office (2013), p. 15.

Figure 14: Capita growth and acquisition trends



Source: National Audit Office

In sum, over time the combination of preferences for scale and the strategic elimination of competitors in the context of high barriers to exit will tend to generate oligopoly structures that strongly favour a small number of large corporate suppliers to the detriment of the public interest.

c) Gaming

Gaming involves activities by corporate suppliers designed to increase revenues above those formally agreed or intended by the contracting party. This can take place in the context of agreeing and executing the contract, or in the context of delivering end-services to particular client groups.

In relation to the contract, one aspect of gaming has already been identified: the deliberate under-pricing of tender bids in the expectation of charging excess costs at a later date. Other aspects of 'contract gaming' involve using contract opacity and complexity to disguise additional costs and charges that will only become apparent once the contract is fully operational. Another is relying on changes in government policies, and the resulting need to vary contract terms, to charge high variation fees well in excess of the real cost of implementing such variations.

In sum, experienced corporate contract negotiators rely on the relative inexperience of public sector managers to insert loopholes and ambiguities in contract provisions that will significantly increase profitability once a degree of vendor dependency has been established.

But the most well-known form of gaming in recent years has taken place in the context of delivering services to particular client groups such as job seekers. In this context a set of fees will be established that the service

provider can legitimately charge to the government for performing particular types of work, such as helping the long-term unemployed to find work.

In theory, a large number of diverse, innovative and flexible service providers, more attuned than public sector bureaucracies to local conditions and needs, will be better able to help those in need of support. In practice, economies of scale mitigate against diversity in supply, with smaller providers tending to lose contract tenders. Commercial providers tend to prioritise revenues over outcomes, gaming the system of fees and incentives in ways that maximise profit.

The predictable result is what has become known in the corporate welfare business as ‘creaming and parking’: creaming the easy to serve in large numbers (such as those who have only recently lost their job and live in soft urban labour markets), while parking those with complex and resource-intensive needs (such as the long-term unemployed with few qualifications who live outside the large urban centres). Those in most need of assistance become those least likely to receive it.

When fee and incentive structures are changed to better align policy intent with outcomes, strong incentives are then created to game the system in other ways, such as falsifying claims, overcharging and misreporting costs. A contracted employment advisor gave the following evidence to *The Institute for Government*:

‘If providers cannot make money by doing the thing you expect them to do, then they will make money by doing the things you don’t want them to do.’²⁰

In the context of providing employment services this experience has not been unique to the UK. In recent years there have been well publicised cases of gaming, both ‘creaming and parking’ and fraudulent claiming, within Australia’s Job Network system. This led previous Australian governments to effectively re-regulate the sector, contradicting the promise that market mechanisms would be effective, and to then pump millions of additional dollars into the Network to make sure providers supplied necessary services.²¹

That the private provision of public services in the UK and Australia has generated very similar problems should lead policymakers to question whether such provision can ever deliver the efficiencies and outcomes claimed for it.

²⁰ Gash, T. et al (2013) p. 50.

²¹ Whelan, J. (2012) *Big Society and Australia*, Centre for Policy Development, Sydney.

Beyond outsourcing

For much of the past three decades it has been the shared common sense of business that outsourcing offers the prospect of lower costs, flexibility and better quality. Those who know most about a particular business function, such as IT, are best placed to supply it in a low cost and innovative manner. This 'common sense' has then been used by policymakers to justify extensive privatisation and outsourcing across the UK public sector since the early 1980s. A similar logic has been evident within some parts of Australian government since the early 1990s.

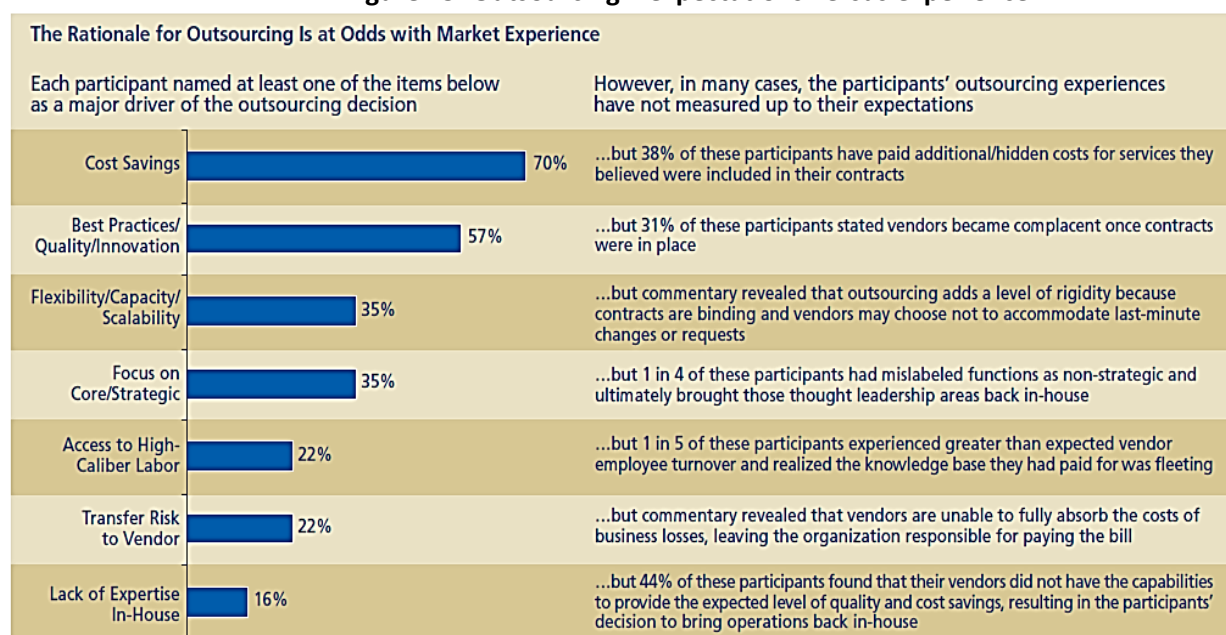
However, in recent years there has been a growing recognition among private sector companies that outsourcing is not the panacea it was once thought to be. This has provoked a radical re-thinking within many corporations. A similar re-thinking is now overdue within government.

Deloitte, a company at the forefront of advocating various forms of outsourcing, has conducted research into the real experiences of those corporations who have adopted the outsourcing business model. Figure 15 summarises some of their key findings. The body of their report includes the following observations:

a) In many cases outsourcing simply fails to deliver. Deloitte concludes:

'...contrary to the optimistic portrayal of outsourcing by vendors and the marketplace, outsourcing is an extraordinarily complex process and the anticipated benefits often fail to materialise...The world's largest organisations in this study are calling into question its efficacy in today's economy.'²²

Figure 15: Outsourcing – expectations versus experience



Source: Deloitte

²² Deloitte (2005) Calling a Change in the Outsourcing Market: the realities for the world's largest organisations, Deloitte Consulting LLP, New York, p. 2.

b) Many corporations report similar problems: loss of power, skills and control to the vendor; unexpected costs and charges after contracts have been finalised; significant cost inflation if standardised processes are tailored to particular business needs; operational rigidity imposed by long service contracts; further sub-contracting by vendors that undermines service quality; lack of cost and performance transparency making the benefits of outsourcing difficult to quantify and the contracts difficult to manage; vendors become complacent about quality and targets once a contract is in place.

c) Some corporations have found themselves 'trapped' in outsourcing relationships with vendors who underperform and charge more than expected, partly because the costs and risks involved in switching suppliers are regarded as being too great.

d) As a result of these problems two thirds of the large corporations that took part in the Deloitte survey decided to bring outsourced functions back in-house.

A subsequent research report by Deloitte confirmed this trend toward 'insourcing', particularly in the field of IT services.²³ The key drivers that were leading a growing number of corporations to insource their IT included:

a) Cost reduction. Because of unexpected costs and charges, and the additional expenditures generated by dealing with poor quality performance, 77 per cent of survey respondents stated it was cheaper to bring their IT back in-house.

b) Improve customer service. Voice-based functions, such as customer-facing call centres, had been widely outsourced over the past 20 years. However, service quality declined generating a loss of custom. For some corporations having a high quality in-house call centre function was viewed as a valuable means of cultivating customer loyalty.

c) Improve controls. Loss of control over key business processes was found to have undermined the operational and strategic capacities of companies. They became increasingly uncomfortable that important and commercially sensitive aspects of work were subject to rigid contractual relationships over which they have little direct control.

²³ Deloitte (2013) From Bangalore to Boston: the trend of bringing IT back in-house, Deloitte Consulting LLP, New York.

Conclusion

Among other things, the government has asked the Commission to consider if activities currently performed by government could be better performed by the private sector. Some ministers have expressed a preference for privatisation and outsourcing in the apparent belief that private companies can be assumed to be more efficient and effective than public sector providers.

The argument in this part of our submission has been that there is considerable cause to doubt such a belief. The experience of privatising and outsourcing central government services in the UK over several decades has generated significant evidence of powerful structural obstacles to realising the purported benefits of markets, competition and choice. In practice, government has become increasingly dependent on a small number of powerful corporate actors who have become almost immune to the consequences of their poor performance, escalating costs and lack of transparency.

To the extent that Australia has already pursued the privatisation and outsourcing of public services, such as job seeker support, it has experienced problems very similar to those the UK has been struggling with for nearly three decades and is very far from resolving. It would make poor public policy to proceed further down the road of increasing private sector involvement in the operation of our government when we can already see the likely results.



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