6

Conclusions

Introduction

Support for an efficiency incentive

6.1 During the inquiry, there was widespread support for the concept of agencies seeking to be as efficient as they could. After all, agencies are spending taxpayers' funds and they have a responsibility to be as efficient and effective as they can be.[1]

6.2 However, the details of this support differed from group to group. For example, the Community and Public Sector Union (CPSU) argued that the dividend should be abolished and efficiencies should be delivered through workplace bargaining:

> The CPSU maintains that good faith bargaining around productivity at the workplace level has been severely undermined by the 'top-down' imposition of measures such as the efficiency dividend… One practical alternative to the efficiency dividend is already operating within the public sector. Workplace bargaining is only one example of a consultative, negotiated approach to achieving workplace efficiencies. APS employees are willing to engage with the government to find efficiencies that suit local circumstances if the government is willing to engage with them.[2]

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1 Australian Public Service Commission, sub 54, p 2.

2 Community and Public Sector Union, sub 58, p 13.

6.3 Some agencies supported the operation of the dividend, but requested that it be applied to only a proportion of their funding. For example, the Federal Court of Australia stated:

> From our perspective we understand the logic of the application in a universal way of the efficiency dividend as a mechanism to promote efficiency.[3]
>
> The inability of the Court to apply the efficiency dividend to a majority of its costs indicates that the Court should have a lower efficiency dividend applied to it or alternatively the efficiency dividend should not be applied to that portion of its appropriation that is used to fund its fixed expenditure such as judicial remuneration, its purpose built property operating costs, and items such as depreciation.[4]

6.4 There was also a reasonable range of agencies that recognised that the dividend gave them an incentive to find efficiencies. They supported the principle of the dividend albeit with the proviso that it should apply to them in a modified way. Examples were the Department of the House of Representatives,[5] the National Archives of Australia[6] and the Office of the Official Secretary to the Governor-General.[7]

6.5 On balance, the Committee decided that there is value in retaining a 'top-down' efficiency incentive for agencies. Not only did agencies report that they have found efficiencies over time, but it is likely that, under an efficiency incentive like the dividend, they will continue to find efficiencies in future. The Australian Public Service Commission (the Commission) stated:

> Productivity is not something that is ever totally exhausted: there are always new technologies and new skills and knowledge that allow greater efficiency, effectiveness and higher quality, some of which can be manifested as cost savings. The efficiency dividend has played an important role in driving reform and also maintaining budgetary and resource management rigour.[8]

6.6 The Department of Finance and Deregulation (Finance) also took this view:

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3 Mr Warwick Soden, transcript, 8 September 2008, p 36.

4 Federal Court of Australia, sub 65, p 3.

5 Department of the House of Representatives, sub 10, p 1.

6 Mr Ross Gibbs, transcript, 21 August 2008, p 7.

7 Office of the Official Secretary to the Governor-General, sub 59, p 8.

8 Australian Public Service Commission, sub 54, p 2.

> … too many people think of the efficiency dividend as aimed at static efficiency; if you like … cutting existing fat, cutting fat that has always been there. Of course, existing fat must ultimately be exhausted. But that is not really what the efficiency dividend is about. The reality is that technological and organisational change constantly throws up new ways of doing things and of improving productivity, the concept of dynamic ones, not static ones, and of exploiting those dynamic efficiencies is exactly what the efficiency dividend requires and expects CEOs to do. Agencies have long argued in various ways that possible efficiencies are exhausted or close to exhausted or running out, yet they have managed to keep finding ways that are apparently acceptable to government to meet the ongoing requirements of the efficiency dividend. They do it partly by taking advantage of new ways of doing things.[9]

6.7 The Committee accepts these observations in favour of dynamic efficiency and supports some type of efficiency incentive for all agencies.

Small technical agencies

6.8 As noted throughout the report, small agencies' efficiency incentive depends on a number of factors, including:

- the gap between indexation rates (increasing by 2%) and inflation in the cost of agencies' inputs (generally 4% for skilled staff, rent and office supplies);[10]
- the efficiency dividend itself; and
- the effect of new policy funding.

6.9 The key point to this inquiry is whether there is a particular group of agencies that find it difficult to comply with the efficiency incentives as they currently stand and, if so, whether the current mechanisms are adequate to address this.

6.10 In establishing the inquiry, the Committee was concerned about the situation of small agencies and initially defined them as having annual departmental expenses of less than $150 million. The reason was that small agencies have poorer economies of scale.

6.11 In evidence, Finance challenged this. Firstly, it stated that only micro-agencies (20 staff) could make a case that they were disadvantaged due to

9 Dr Ian Watt, transcript, 19 September 2008, p 1.

10 Australian Public Service Commission, sub 54, p 3.

their size.[11] However, a number of larger agencies (for example, with 100 or more staff) stated that their size affected how they could find efficiencies.[12]

6.12 Secondly, Finance argued that agencies should be exploring more operational innovations such as shared leases in regional areas, coordinated purchasing and combined back office functions.[13] The Committee's response is that it would be better if these innovations were driven by Finance because it can:

- use its position as a central agency to coordinate these arrangements;
- develop the expertise to ensure they are effective; and
- build up considerable purchasing power to deliver additional efficiencies.

6.13 Unfortunately, Finance appears to have adopted the practice that it will harvest the gains from such coordination and leave agencies with no benefit.[14] In the view of the Committee, what is most efficient for the public sector generally (Finance managing coordinated procurement) should also make financial sense to the agencies. The Committee supports Finance in generating these efficiencies but believes that the agencies involved should also receive a proportion of the benefit.

6.14 The recent Gershon review of IT procurement came to a similar conclusion. This review recommended that there should be greater central coordination of agencies' IT purchasing, which would generate significant savings. Peter Gershon then recommended that 50% of the savings generated by his suggestions should be placed in a central fund for additional IT procurement especially targeted at improving efficiency and effectiveness.[15]

6.15 The Committee agrees with the thrust of this idea and believes that it can be extended to where Finance coordinates procurement more generally.

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11 Ibid, p 10.

12 For example: High Court of Australia, sub 14, p 6; Australian National Maritime Museum, sub 15, p 2; Australian National Audit Office, sub 60, p 2.

13 Dr Ian Watt, transcript, 19 September 2008, p 2.

14 This is occurring with the coordinated procurement initiative: Family Court of Australia, sub 2, p 3.

15 Sir Peter Gershon, *Review of the Australian Government's use of Information and Communication Technology* (2008), pp 68-69.

Recommendation 6

6.16 **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.**

6.17 Given the strength of the evidence from agencies, who are speaking from their own experience, the Committee is satisfied that size is an important factor for agencies when delivering efficiencies.

6.18 Finance has also made the point that agency function can be an important factor.[16] There was considerable support for this view throughout the inquiry. In particular, the Committee noted that many of the agencies that reported financial hardship had precisely defined technical functions. This means they have less scope to reprioritise activities because any decrease in a long-standing activity will quickly be identified as a drop in a core function by their stakeholders. The Commission stated:

> Small agencies are often established to provide a focussed approach to a specific function or purpose, or to provide a degree of required independence. As such, the scope of the small agency's outcome is tightly defined, and may limit the capacity to reprioritise and/or make functional changes or to seek new funds for expanded activities. In addition, if such agencies are required to absorb new functions, the costs of doing so may appear small, especially when compared to larger agency proposals, but can represent a large proportion of the total agency budget.[17]

6.19 Further, agencies with tightly defined functions are less likely to be able to put convincing cases for new policy funds during the Budget. Continued success with new policy proposals (NPPs) gives agencies greater mass, more functions and makes it easier for them to balance competing priorities. Insolvency and Trustee Service Australia stated:

> Smaller agencies, particularly those with well-established operational responsibilities, can have limited scope for new policy initiatives (NPPs) and, hence, less scope for generating a broader funding base. Major NPPs (greater than $10m) ordinarily will not be possible when total revenue is only 3.8 times that amount, and when there is a general policy that portfolio departments or

16 Senate Standing Committee on Finance and Public Administration, Additional Budget Estimates, 19 February 2008, Dr Ian Watt, transcript, p 114.

17 Australian Public Service Commission, sub 54, p 5.

> agencies will absorb minor NPPs or relatively small program changes.[18]

6.20 In fact, difficulties with obtaining new policy funding were an almost universal complaint from the agencies during the inquiry. Broadly, small technical agencies found they could rarely get NPPs approved. If they could get them approved, they often had to offer savings and in some cases had to completely absorb the proposal. At other times they have been required to absorb new proposals originated by government.[19]

6.21 As the Commission observed above, while the amounts involved appear small in the context of a multi-billion dollar Budget, these costs are significant to a small agency.

6.22 What small technical agencies tend to face is an accumulation of many small functions and adaptations without a matching funding process. Each individual task may not be significant, but the cumulative effect is substantial. The Institute of Public Administration Australia (IPAA) made this point,[20] as did the Australian Society of Archivists:

> Over time demands are made on the agency, which are additional to the original functions… Such demands usually occur on a creeping basis and cover not only specific functions of an agency but represent requirements general to all agencies as, for example, with additional requirements for occupational health and safety. Equally significantly, the business processes in an agency gradually change due, for example, to new technologies and the overall expectations by government and the community for the agency. For instance, if cultural agencies have objects in their collections it is now expected by most these should be able to be viewed on-line. But changing or improving the operating model is not cheap to do and rarely these changes are directly funded. Twenty years of efficiency dividends and technological and environmental change mean that agencies can no longer meet the set-down functions in their legislation – let alone new expectations of users or the community generally.[21]

6.23 Therefore, the Committee concludes that there is a definable group of agencies that are being placed in financial difficulty by the combined effect of the efficiency dividend, the indexation measures and the NPP process.

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18 Insolvency and Trustee Service Australia, sub 13, p 5.

19 See the discussion of the Newcastle courts in chapter 4; Australian Communications and Media Authority, sub 56, p 2; Australian National Audit Office, sub 60, p 3.

20 Mr Andrew Podger, transcript, 19 September 2008, p 39.

21 Australian Society of Archivists, sub 7, p 2.

This group is defined by their smaller size and their technical, well-defined roles.

Finance's perspective

6.24 Before considering the unintended effects of the efficiency dividend and the other efficiency incentives, it is worth noting what Finance and government gain from it.

6.25 Firstly, as previously discussed, it gives managers an incentive to look for efficiencies. Secondly, it allows government to redirect the savings to higher priorities. Finance stated in evidence that new policy money tends to be lower in jurisdictions that do not have an efficiency incentive.[22] The Committee accepts these arguments. They imply that there should be an efficiency incentive, but they do not determine where that incentive should be set.

6.26 Finance's third argument is that the efficiency incentives are less arbitrary than government requesting Finance to find and excise fat from individual agencies.[23] In the view of the Committee, a set of efficiency incentives that go beyond what is being achieved in the wider economy is at least as arbitrary as a Finance raid. As IPAA noted in evidence, 'current arrangements lack any clear policy coherence'.[24]

6.27 There is also the question of whether Finance would find efficiencies that agencies could not themselves find. IPAA doubted this would be the case and suggested that Finance would instead find lower priority functions that agencies could drop:

> … I do not think Finance will be able to go into agencies and find lots and lots of efficiency gains that the agency cannot find. I think what they could well do is find functions which they do not think are high priority… I think there is an element of arrogance in Finance saying: if you do not do it this way, we will have to come in and we could find efficiencies. I do not think they could find much efficiency. They would find functions and priorities that they think the government ought to drop.[25]

6.28 Finance's fourth argument is that the efficiency arrangements reduce the amount of work required in budget setting:

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22 Dr Ian Watt, transcript, 19 September 2008, p 3.

23 Ibid, p 2.

24 Mr Andrew Podger, transcript, 19 September 2008, p 38.

25 Mr Andrew Podger, transcript, 19 September 2008, p 35.

> What I agree is this: first, yes, it is a difficult task master for an agency, and it is a broad based, indeed blunt, instrument. But there is nothing in this area that is not. You will not set different efficiency dividends for this group, that group and the other thing. You will be driven mad. There are not enough public servants to regularly review everyone's funding; there just is not. So, as I said, yes, it is broad all right, but it does actually force people to reconsider priorities. Secondly, if you do feel genuinely that you have a problem with the efficiency dividend, go to your minister. That is the first thing you have to do: talk to your minister and say, 'Look, Minister, you have to bring a new policy proposal; here is the case.' The minister will sometimes say, 'Yes,' and he will sometimes say, 'It does not stack up to me.'[26]

6.29 In other words, it appears that Finance is prepared to 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. It appears that Finance's preferred method of managing this is that agencies ask their Minister to approach his or her colleagues to make the case for extra funds.

6.30 One difficulty the Committee has with this approach is that it does not manage the risk of disinvestment. The Australian Society of Archivists summarised this process:

> For an agency, the usual strategy when faced with an Efficiency Dividend or other budget cut is to try and protect what it sees as its core functions – i.e. those functions which it was established to administer. In this situation agency savings are often found by making cuts in the common service areas such as in staff training, purchasing operations, and the like. These types of activities may not be cut directly but rather are 'delayed' or 'postponed' such as through a failure to fill vacancies when they occur. Direct consequences of such cuts to an agency include line staff being burdened with tasks which more efficiently are performed by specialist areas. For example, as is the situation with the purchase of goods and services. More problematic than just inefficiency are

26 Dr Ian Watt, transcript, 19 September 2008, p 9.

> the consequences of staff not knowing what is legally required when undertaking these types of tasks…[27]

6.31 The longer these processes continue, the less effective an agency will be in future and the more expensive it will be to rebuild the agency. For example, the National Measurement Institute reported that it is almost impossible to recruit measurement scientists in mid-career due to their scarcity. If it laid-off scientists and later recruited to replace them, they would have to recruit graduates and train them from scratch.[28]

6.32 The Commission observed that agencies are reluctant to report financial difficulties because they are concerned it would appear that poor management was to blame.[29]

6.33 Finance supports agencies approaching their Minister to argue the case for additional funding. Finance said the low incidence of ministers making these requests suggested that the efficiency incentive was not a significant issue:

> They always have the opportunity to talk to their minister and the minister to bring a case to government. The fact that we have not seen very many of those suggests that perhaps they are not as much of a priority as the agency head thinks.[30]

6.34 The Commission referred to such requests for extra funding as a 'safety valve'.[31] In the view of the Committee, this safety valve is not working. If it were functioning effectively, then either the Committee would not have started the inquiry or it would have received fewer submissions. However, this inquiry has generated a considerable number of submissions and attracted media interest.[32] The inquiry has itself become the safety valve for small agency funding.

6.35 In summary, the Committee agrees with an efficiency incentive in principle, but does not believe that Finance has made a clear case that the current settings should remain. Rather, it appears that current arrangements place the highest premium on ensuring that agencies do not build up fat and other risks are secondary. This raises the question

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27 Australian Society of Archivists, sub 7, p 2. See National Measurement Institute, sub 57 (attachment D), p 4 for an observation that skilled scientists are diverted from research due to budget cuts.

28 National Measurement Institute, sub 57 (attachment D), p 3.

29 Ms Lynelle Briggs, transcript, 19 September 2008, p 46.

30 Dr Ian Watt, transcript, 19 September 2008, p 6 and to similar effect on p 22.

31 Australian Public Service Commission, sub 54, p 9.

32 For example, Verona Burgess, 'Finance stands firm on efficiency slug', *Australian Financial Review*, 3 October 2008, p 56.

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 achieved between efficiency and effectiveness in the Budget process. Both are required for agencies to be performing at a high standard.

Unintended consequences of the dividend

6.36 In making the case for a change in the way small technical agencies are funded, the Committee presents below a list of examples of unintended consequences of the Budget process.

Regional impacts

6.37 The Committee noted that a common response by agencies when attempting to balance their budget was to scale down regional activities. For example, chapter 3 noted how cultural agencies were cutting back their touring exhibitions. The National Archives of Australia stated:

> So, while we have had five shows on the road, two things are happening: firstly, they are looking very tired, and, secondly, they are coming off. As they come off, we will go from being a major touring exhibition program equal to the other institutions, or similar, to being a very bit player with perhaps just one exhibition on the road, and it will become apparent to users what the impact has been…
>
> With the other area of outreach, as I said earlier, we uniquely have an office in each state and territory capital… What is happening in a small but annoying way is that we are unable to participate in taking the state offices out into the country. Queensland is a big state… We used to run very good collaborative programs with the state library and with the state archives and go out to distant sites. We do it in a very minimal way now… our impact in Queensland is being diminished all the time because it is one of the areas where we are doing those attrition savings behind the scenes.[33]

6.38 In chapter 4, the Administrative Appeals Tribunal stated that its most likely method of meeting its budget in future would be to scale down hearings, especially in regional areas. The Tribunal noted that dealing with parties face to face was an important part of the justice process and

33 Mr Ross Gibbs, transcript, 21 August 2008, p 30.

that the chances of it meeting the public's expectations would be reduced in future.[34] On the other hand, the Federal Court of Australia was able to take a different approach. It spread the reduction in its registry budgets equally across all locations.[35]

6.39 In chapter 5, the CSIRO explained to the Committee how it recently closed four regional research centres to stay within budget. The CSIRO regretted the decision, but felt that under the circumstances it needed to make these cuts.[36]

6.40 The Australian Communications and Media Authority (ACMA) stated that it had been closing its regional operations for some time:

> Over the past few years, ACMA, and before it the Australian Communications Authority (ACA), has been significantly streamlining its approach to field operations. This has resulted in considerable savings from the downsizing and closure of regional operations' centres, and the centralisation and rationalisation of a number of functions… ACMA's direct regional presence is disappearing.[37]

6.41 The Committee accepts that management, when faced with budgetary pressures, must examine all expenditure areas and that this sometimes includes regional offices. However, the Committee is concerned that the various efficiency incentives have combined to become a hidden rationalisation policy. If it becomes government policy to close regional offices to generate savings, then it could be subject to debate. But current arrangements appear to be driving the same result without any public consideration of whether this is necessary or useful.

Disparities in pay rates

6.42 One of the CPSU's key themes is that the efficiency dividend has led to large gaps in pay rates between agencies and that small agencies, on average, tend to have lower rates of pay.[38]

6.43 Combined with this is the CPSU's argument that these disparities do not reflect any underlying rationale, such as productivity. Rather, they only reflect ability to pay:

34 Mr Douglas Humphreys, transcript, 8 September 2008, pp 37-38.

35 Mr Warwick Soden, transcript, 21 August 2008, p 36.

36 Mr Allan Gaukroger, transcript, 19 September 2008, p 84.

37 Australian Communications and Media Authority, sub 56, p 9.

38 Mr Stephen Jones, transcript, 20 August 2008, p 37.

> I think that it would strike the employees in the Australian Institute of Aboriginal and Torres Strait Islander Studies, the Federal Magistrates Court, the Human Rights and Equal Opportunity Commission [etc] and all of those small agencies as somewhat insulting to learn that they were somewhere between four and 10 per cent less productive than the average employee in the Australian Public Service. I would suggest that there is a different story to be told here. It is not about relative productivity; it is about the capacity of an agency to pay…[39]

6.44 The Commission agreed with the CPSU's observation that small agencies tended to have lower rates of pay and that their size was a factor:

> It is not surprising. If you have less money washing around in your system, then you have less to work with. You cannot access the sorts of efficiencies that a larger agency might be able to access. For example, a larger agency might be able to manage a cheap, in unit cost terms, IT acquisition; we cannot. A larger agency might be able to manage a cheaper unit rental cost because they might cover a whole building and a lessor may well take them in on that basis; we cannot. We operate in our regional offices at a portion of a floor in a building… and in Canberra, two floors in a building. Your opportunities to make those kinds of tradeoffs are far fewer in an agency such as ours, leaving far less room to remunerate new staff.[40]

6.45 The Commission also suggested that function was relevant:

> I suspect… when you look at the group of agencies in the lower paying area, a lot of them are like us: small statutory bodies with their functions pretty well set out in legislation. That is another constraint on their activity, if you like, or changing it. But there is a combination of factors, and it has been traversed in the evidence about the efficiency dividend, the supplementation, the function and the nature of the actual organisation and its funding base. Collectively, together, those forces have led to where you might sit in the paying scales.[41]

6.46 Lower pay rates in small agencies present a number of risks. The CPSU suggested that it increases the chances that small agencies may be churning staff, with the result that more of their resources are diverted to

39 Mr Stephen Jones, transcript, 20 August 2008, p 37.
40 Ms Lynelle Briggs, transcript, 19 September 2008, p 47.
41 Ms Lynne Tacy, transcript, 19 September 2008, p 48.

recruitment.[42] The Commission's data, however, suggested that small agencies were not more likely to have unacceptable turnover rates than medium or small agencies.[43]

6.47 The CPSU also argued that small agencies have proportionally smaller training budgets,[44] which is a form of remuneration for staff. The Commission agreed with this point, although it was unsure whether this difference was inherently due to the way small agencies operate.[45] In the view of the Committee, the expectation would be that small agencies would spend the same pro-rata amounts on training as large agencies.

6.48 Similar to the issue of regional cutbacks, this disparity in pay rates between agencies would be less of an issue if it were government policy and open to debate. But it has evolved over time from the interaction of various administrative and legislative factors, few of which were specifically aimed at pay rates.

6.49 The CPSU raised the related issue of female pay rates. It noted that small agencies with a large proportion of female employees were more likely to have lower wages.[46]

6.50 The Commission noted this was a complex area. For example, women sit at the bottom of pay scales more than men because women tend to be promoted more quickly. Without controlling for length of time at a classification rate, this would increase the gender pay gap. The Commission acknowledged that lower paying agencies tend to have a higher female representation. It stated that this issue requires further investigation[47] and the Committee agrees.

6.51 The Committee recognises that another Parliamentary inquiry is under way that touches on this point. The House of Representatives Standing Committee on Employment and Workplace Relations is conducting an inquiry into gender pay equity more generally.[48] This Committee does not wish to pre-empt the findings or recommendations of that inquiry.

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42 Mr Stephen Jones, transcript, 20 August 2008, p 43.

43 Australian Public Service Commission, sub 54, p 5.

44 Community and Public Sector Union, sub 58-1, p 6.

45 Australian Public Service Commission, sub 54, p 6.

46 Community and Public Sector Union, sub 58, p 4.

47 Ms Lynne Tacy, transcript, 19 September 2008, p 48.

48 The Commission presented the same evidence to the House Committee on this point: House of Representatives Standing Committee on Employment and Workplace Relations, Pay Equity and Increasing Female Participation in the Workforce, Ms Nicole Pietrucha, transcript, 16 October 2008, p 2.

6.52 However, this Committee believes that gender pay equity is an important issue for the Australian Public Service, especially in the context of agency size and function. In order to facilitate better management of the Service and a deeper understanding of how small agencies operate, the Committee would like to see the Government conduct further research in this area. Given the need to coordinate the various areas of expertise within Government for this work, the Committee believes that the Department of Prime Minister and Cabinet should be the lead agency on this project.

Recommendation 7

6.53 **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.

Growth in receipts

6.54 One way in which agencies might be able to cushion themselves against the effect of the efficiency dividend is by increasing the receipts they receive that they are entitled to spend on their operations. For most agencies, this process is governed by section 31 of the *Financial Management and Accountability Act 1997*. Following the 1994 review into the efficiency dividend, *Stand and Deliver*, these receipts were exempt from the dividend, which increased their value to agencies. Recent changes to legislation and guidance have placed further caps on how agencies may use these receipts.[49] However, the Committee did not receive evidence that these receipts are now subject to the dividend.[50]

6.55 The main requirement that an agency must meet to be able to spend its receipts is that the Minister for Finance and Deregulation must approve the spending of the receipt. This will be evidenced in the agreement between the Minister (often signed by a delegate within Finance) and the agency CEO.[51] Without this approval, receipts must go directly to consolidated revenue.

6.56 Many agencies advised the Committee that section 31 receipts played only a marginal role in their cash flow. There were a range of reasons for this. For example, the fees that an agency receives may go directly to consolidated revenue,[52] increasing the fees collected may be incompatible with their function (such as access to justice issues for a court),[53] or meeting their core functions may preclude fee collection (such as for the Australian Electoral Commission).[54]

6.57 Some agencies, however, do collect significant amounts of receipts that they are entitled to spend. The most extreme case is the Australian Institute of Health and Welfare, whose revenue history is displayed in figure 6.1 on the next page.

6.58 Over 20 years, the Institute has evolved from being almost fully funded by appropriation to being approximately one third funded by appropriation. Much of these receipts come from Commonwealth Government agencies. Unfortunately, they are to fund new projects, rather than the Institute's core business of maintaining national datasets and producing its biennial reports.[55]

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49 Australian National Audit Office, sub 60, p 6.

50 Finance Circular 2006/04, *Net appropriation agreements (Section 31 Agreements)* included a template agreement that stated that receipts are not reduced by the efficiency dividend. This has been replaced by Finance Circular 2008/07, *Relevant Agency Receipts – FMA Regulations 15 and 16*, which does not include a template agreement and does not refer to the dividend.

51 Section 31 of the *Financial Management and Accountability Act 1997*.

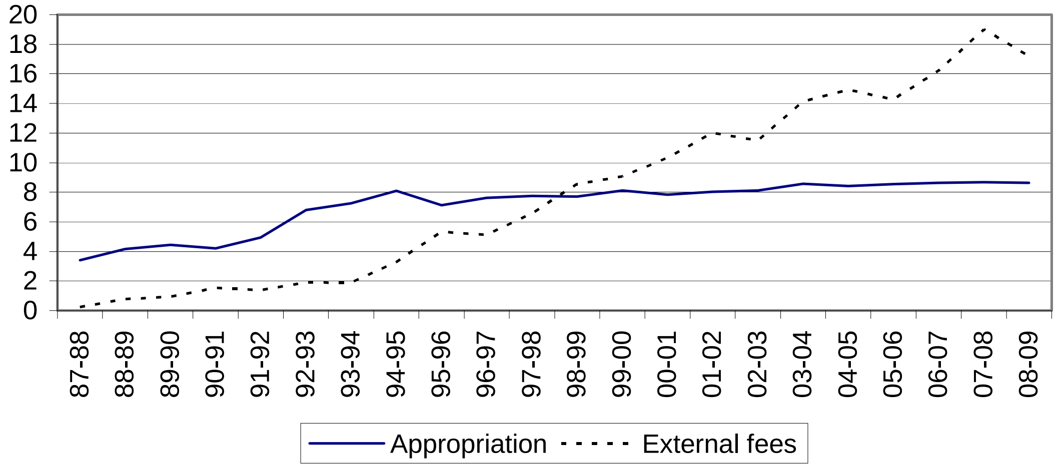
52 Administrative Appeals Tribunal, sub 17, p 5.

53 High Court of Australia, sub 14, p 7.

54 Australian Electoral Commission, sub 42, p 8.

55 Australian Institute of Health and Welfare, sub 40, p 2.

Figure 6.1 Australian Institute of Health and Welfare – Revenue history ($m)



Source *Australian Institute of Health and Welfare, sub 40, p 2.*

6.59 This funding arrangement also restricts the Institute's ability to operate as an independent body, as mandated by its legislation:

> Project specific income is not a substitute for appropriation income because it limits our ability to independently report on Australia's health and welfare… For example the AIHW has not had sufficient funding to fulfil its legislated function of undertaking health technology assessments or to undertake analysis around the mix of public and private health funding.[56]

> The board makes some tough decisions about what we can no longer do, but it has not for many years been in a position to say, 'We think this is a really high priority piece of work that the institute should be doing. Let's apply some resources to it.'[57]

6.60 The Institute advised the Committee that it had started cutting services and functions approximately 10 years ago.[58]

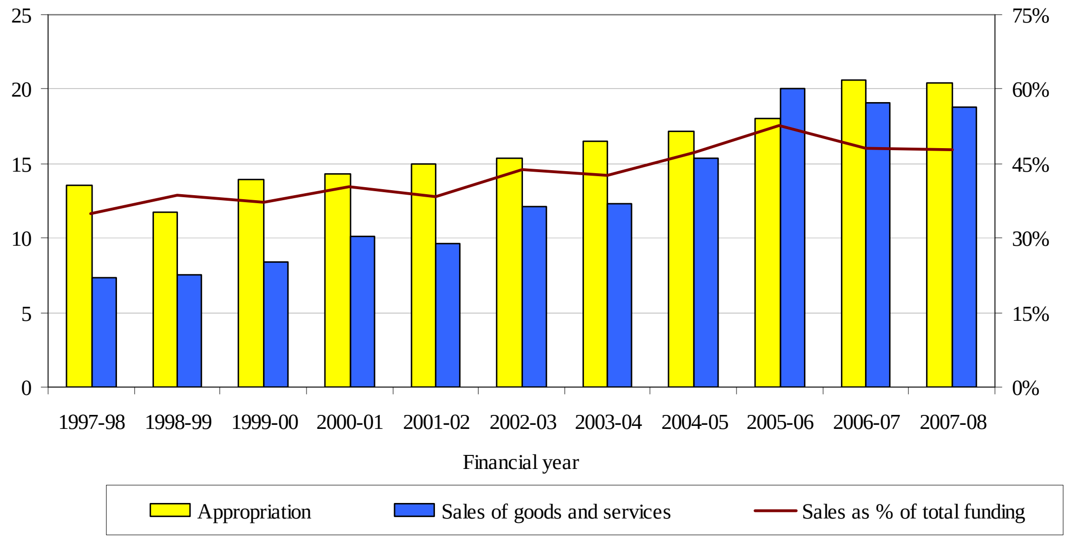
6.61 The Commission is in a similar, but less extreme position. Figure 6.2 shows how the Commission's budget had evolved over the past 10 years.

56 Ibid.

57 Dr Penny Allbon, transcript, 20 August 2008, p 71.

58 Ibid, p 73.

Figure 6.2 Australian Public Service Commission – Revenue history ($m)



Source *Australian Public Service Commission, sub 54, p 8.*

6.62 Over the past 10 years, the proportion of the Commission's budget to come from fee-for-service work has grown from approximately 35% to approximately 50%. These receipts mainly come from other Commonwealth agencies purchasing training from the Commission. Increased revenue from fee-for-service work increases risk for the Commission. If there is a general drop in demand for training, this could compromise the Commission's statutory function to coordinate and support learning and career development in the Australian Public Service.[59]

6.63 The Commission also stated that an increased reliance on receipts poses additional challenges for management in protecting their core services:

> What I think you would find is that the agency heads of those agencies would try to protect their core services.
>
> What you have to do is run this merry dance… where you try to balance your revenue raising activities, if they fluctuate year on year, and maintain appropriate flexibility with your staffing to deal with that and protect the core functions that should not be used for revenue raising purposes.[60]

6.64 The Australian Institute of Criminology is another agency that is placing an increasing reliance on fee-for-service work. Its receipts have grown

59 Australian Public Service Commission, sub 54, pp 8-9.
60 Ms Lynelle Briggs, transcript, 19 September 2008, p 49.

from approximately $1.4 million in 2001-02 to approximately $2.5 million in 2007-08.[61]

6.65 As discussed previously, the Committee's concern with the growth in receipts in some agencies is that policy outcomes are being driven by funding arrangements. For example, the Australian Institute of Health and Welfare is becoming a consultancy for Commonwealth agencies, rather than serving its legislative functions. If a Minister had publicly stated in the past that it was now government policy that this was to occur, it could at least be subject to debate. But the intent of the legislation has been compromised due to budget rules and financial legislation that are well divorced from health policy.

Conflict with cultural agencies' mandate

6.66 Chapter 3 comprehensively covers this issue, but it is restated here for completeness. In the enabling legislation for the cultural agencies, they are generally required to grow and to disseminate their collections in the national interest. For example, section 6 of the *National Library Act 1960* states that the functions of the Library include:

- to maintain and develop a national collection of library material, including a comprehensive collection of library material relating to Australia and the Australian people; and
- to make library material in the national collection available to such persons and institutions, and in such manner and subject to such conditions, as the Council determines with a view to the most advantageous use of that collection in the national interest.

6.67 Section 6 of the *National Gallery Act 1975* states:

- The functions of the Gallery are:
  - ⇒ to develop and maintain a national collection of works of art; and
  - ⇒ to exhibit, or to make available for exhibition by others, works of art from the national collection or works of art that are otherwise in the possession of the Gallery.
- The Gallery shall use every endeavour to make the most advantageous use of the national collection in the national interest.

6.68 In the view of the Committee, using a collection in the national interest includes conducting regional tours. Chapter 3 notes how the cultural agencies are winding back their regional activities.

61 Australian Institute of Criminology, sub 23, p 4.

6.69 Apart from capital grants, these agencies have generally received very little in the way of new funding. Therefore, their budgetary regime has largely comprised indexation increases of approximately 2%, the efficiency dividend decrease of 1%, and increases in wages and supplier costs of 4%. These add up to a real funding decrease of 3%. In comparison, productivity in the general economy is increasing by approximately 2%.[62] The Committee does not see how the cultural agencies can fulfil their growth mandate in these circumstances.

Innovation

6.70 A typical comment from agencies during the inquiry was that, as funding becomes tight, they have fewer resources available for innovation. The Federal Magistrates Court of Australia summarised this as follows:

> My concern, as I look over the horizon—certainly for the Federal Magistrates Court's situation and I suspect for the [Family Court and Federal Court] as well—is that there is going to be no capacity to invest in innovation. The discretionary funding will just not be there. We will be simply scratching to make ends meet …[63]

6.71 The problem with this development is that innovation is a key source of efficiencies. If agencies are not innovating, their capacity to find efficiencies is reduced.

6.72 The other benefit of innovation is that it creates new services. A key example of this in the inquiry was the cultural agencies digitising their collections. The advantage of digitisation is that it is no longer necessary to visit the institution or arrange a physical loan of a piece or document in order to view or enjoy it. Access is as close as the nearest computer and Internet connection.

6.73 The cultural agencies explained to the Committee that they have been able to plan and establish high quality digitisation programs, but they have not been able to implement them as they have wished. The National Library stated in evidence:

> …I think we are rating up there in terms of the approaches, the degree of innovation and the work we have done with others in harvesting web resources and also in things like digitising

62 Australian Public Service Commission, sub 54, p 3.

63 Mr John Mathieson, transcript, 8 September 2008, p 46.

> newspapers. We are struggling in terms of the volumes and quantities…[64]

6.74 The restrictions on agencies' ability to innovate are raised throughout the report. The Committee's point here is to reinforce the fact that a substantial number of small agencies are foregoing opportunities to improve their effectiveness and efficiency due to the efficiency incentives.

False economy

6.75 If an agency is well funded, the Committee is confident that its management would be able to find efficiency improvements rather than take the option of cutting services. However, the Committee expects that most agencies would eventually examine cutting services if, over an extended period, they had received very little in new policy funding and needed to find annual efficiencies of 3% when the rest of the economy was finding efficiencies at the rate of 2%.

6.76 Once agencies are making cuts to meet their budgets, then the efficiency dividend and its associated budget rules become a false economy. At many stages throughout the inquiry, the Committee asked agencies when they thought that the efficiency dividend stopped being a process in finding efficiencies and became more about deciding which services to cut. Examples of responses are:

- the High Court stated that it started cutting services 10 years ago;[65]
- the Australian Institute of Health and Welfare also moved to cuts 10 years ago;[66]
- the Australian National Audit Office will reduce the number of performance audits by six and the number of better practice guides by one in 2008-09;[67]
- the National Library of Australia stated that it started cutting services 10 years ago;[68] and
- the Department of the Attorney General in Western Australia stated that its Family Court started making cuts two years ago.[69]

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64 Dr Warwick Cathro, transcript, 21 August 2008, p 16.
65 Mr Andrew Phelan, transcript, 20 August 2008, p 73.
66 Dr Penny Allbon, transcript, 20 August 2008, p 73.
67 Australian National Audit Office, sub 60, p 5.
68 Dr Warwick Cathro, transcript, 21 August 2008, p 40.
69 Mr Liam Carren, transcript, 22 October 2008, p 6.

6.77 Signs of false economies have become more evident as agencies respond to meet the additional 2% efficiency dividend. This extra measure accelerated the process that agencies have been undergoing now for many years.[70]

6.78 One example of these false economies is that some agencies are starting to shift costs. In other words, they are seeking to charge other agencies for services they previously provided for free or they are asking other agencies to do their work for them. Examples are:

- the National Capital Authority charging cultural institutions $250,000 annually for upkeep of their grounds;[71]
- the Family Court of Australia starting to charge the Family Court of Western Australia for computer services;[72] and
- other agencies using the National Archives of Australia to meet information requirements.[73]

6.79 The Committee is not making an assessment of the correctness of any of these measures. Some may be supported by good process. The point is that, as budgets become tight, agencies question whether providing a certain service is part of their core functions and whether they should charge for it or not. But when the agencies involved are all funded from the same source, it is a zero sum game for them to start charging each other for various tasks.

6.80 Another sign of false economies is that agencies are changing recruitment practices to meet their budget, rather than their operational requirements. For example, the CPSU conducted a survey of its members and found that the most common management response to meeting the additional dividend has been natural attrition (92% of respondents). The other most common responses were cancelling or not renewing contracts (79%) and offering redundancies (65.3%).Less common responses were cancelling projects (under a half) and shortening projects (over a third).[74]

6.81 This data suggests that agencies are cutting staff more than they are reducing workloads. This implies that staff will be working longer hours. The Commission has confirmed this is the case:

70 For example, Department of the House of Representatives, sub 10, p 12.

71 Australian War Memorial, sub 26, p 1.

72 Mr Gavan Jones, Western Australian Department of the Attorney General, transcript, 22 October 2008, p 5.

73 Community and Public Sector Union, sub 58, p 7.

74 Community and Public Sector Union, sub 58, p 9.

> The impact of the efficiency dividend is reflected in staff working long hours in some agencies. I expect this is to pick up the slack when people leave, or when non-ongoing employees' contracts are not renewed. I hear many stories of increasing workloads and longer hours becoming the 'norm' in the workplace. Staff accept that vacant positions are not automatically filled - each position is being examined once it is vacated and on-going positions are not automatically advertised for permanent filling.[75]

6.82 Further, the Commission notes that one of the attractions of working in the Australian Public Service is that staff are more likely to maintain a good work and life balance. Longer hours will erode this attractiveness and may present problems in the long term:

> It is important in a time where there is increasing pressure on agencies to do more with less, that extra efficiency is not gained at the expense of impacting adversely on employees' ability to achieve a work-life balance. One of the advantages the APS has in a tight labour market is its reputation as an employer that enables people to balance their work and personal commitments. Given remuneration in the APS at most classification levels is not on par with that in the private sector, agencies need to manage excessive workloads in a strategic, yet practical, manner…[76]

6.83 In the view of the Committee, one of the reasons why the additional 2% efficiency dividend has prompted agencies to react by cutting services or work is that the decrease in resources has happened too quickly for them to respond with efficiencies. The Australian Communications and Media Authority provided the following insight:

> … to get the efficiencies… business analysis is the key. It is not so much building an IT system; it is actually thinking long and hard about your underlying business processes and whether they are structured in the right way to do that. That really does require quite intensive drilling down. We would like to do that in lots of our other areas. There is probably some scope for looking at things but when you are in a very constrained environment you have a reduced ability to devote the intellectual capacity to figure out ways of being more efficient. It is kind of ironic.[77]

6.84 In other words, it takes an organisation's time and attention to find and implement efficiencies. Applying an additional one-off dividend of 2% did

75 Australian Public Service Commission, sub 54-2, p 6 and see also sub 54-5, p 3.

76 Australian Public Service Commission, sub 54-5, p 8.

77 Mr Chris Cheah, transcript, 8 September 2008, p 28.

not give organisations the time to find efficiencies. They instead responded with cuts, which is a false economy.

Summary

6.85 The theme in this discussion is that while the various budget and funding rules have encouraged agencies to look for efficiencies, it has also driven some other less desirable consequences. The Committee's difficulty with this is that these unintended consequences have not generally been subject to broad debate.

6.86 Rather, agencies' budgets have evolved from year to year and the agencies themselves have made decisions as best they can. This delegation away from ministers was opposed by IPAA[78] and the CPSU:

> … we are seeing a continued trend for the delegation of what I would consider to be key government, parliamentary, if not executive decisions from those governmental bodies, from the parliament, from the executive—decisions about what services are delivered and how they are delivered—away from the parliament and down to the front-line operational level. That delegation is not occurring overtly…[79]

6.87 While each Budget is approved by Cabinet, the Committee is less convinced that Cabinet or its committees assess the accumulated effect of the various budget and funding rules. For example, Finance stated that budgets concentrate on funding agencies at the margin.[80] This practice would foster budgetary evolution.

6.88 Given the lack of coherence about current arrangements and their unintended consequences, the Committee believes that some changes are desirable. As stated earlier, some efficiency incentive is warranted. The Committee's goal is to reduce its arbitrariness while still making it a useful financial tool, both in terms of protecting public funds and being easy for Finance to implement.

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78 Mr Andrew Podger, transcript, 19 September 2008, p 37.

79 Mr Stephen Jones, transcript 20 August 2008, pp 35-36.

80 Dr Ian Watt, transcript, 19 September 2008, p 6.

Improvements to current processes

New policy proposals – the benefits to agencies

6.89 A considerable number of the agencies involved in the inquiry expressed concern about their ability to obtain funding through NPPs.[81] Generally, the process for NPPs is that each department of state coordinates and prioritises the budget submissions for the agencies in its portfolio. Proposals for less than $10 million will be referred to the Minister for Finance and Deregulation alone, whose decision will be ratified by the Expenditure Review Committee of Cabinet (ERC). Proposals above this amount are decided by ERC.[82]

6.90 In an environment where agencies are required to find productivities of 3% when the wider economy is achieving 2%, agencies are likely to view NPPs as an attractive way of supplementing their budget and giving themselves greater financial mass. The Auditor-General stated in Senate Estimates:

> The smaller agencies traditionally have less access to new policy opportunities than the bigger agencies. The bigger agencies with access to new policy often are able to utilise the resources gained to be able to manage ups and downs within the organisation. But, if you are a small organisation without the access to new policy, it means that the efficiency dividend is resulting in a reduction each year and it is more difficult to manage in those circumstances.[83]

6.91 It even gives them a way of increasing the size of their agency relative to others, as some Australian academics have observed:

> In other words, Cabinet would have had fewer resources to reallocate in the absence of the [efficiency dividend]. The [dividend] therefore represented an across-the-board form of 'offsets' on running costs, but one which also increased the scope for 'gaming' around NPPs. It encouraged agencies to invent ways to recover the amounts lost to the [dividend] through new policy

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81 For example, Australian National Maritime Museum, sub 15, p 2; Australian Communications and Media Authority, sub 56, p 3; and Australian National Audit Office, sub 60, p 3.

82 Dr Ian Watt, Department of Finance and Deregulation, transcript, 19 September 2008, p 15. An NPP that exceeds $10 million in one or more of the Budget and forward years is classified as major and goes to ERC: Department of Finance and Deregulation, sub 25-1, p 2.

83 Senate Standing Committee on Finance and Public Administration, Budget Estimates, 28 May 2008, Mr Ian McPhee, transcript, p 5.

> measures or even capture a greater share of the pool of clawed-back resources.[84]

6.92 As Finance noted, the potential difficulty with this argument is that new policy money is almost always given for a specific purpose that must be implemented, rather than as supplementation.[85] Further, Finance argued that its costings nowadays are generally accurate and do not have much padding,[86] a view supported by IPAA.[87]

6.93 The way in which new policy money appears to assist agencies is that they are able to compromise to a certain extent on the new policy for which they are being funded and then divert some of these resources to established programs. IPAA stated in evidence:

> Just on the issue of prioritising, when you are under pressure, what are the things that are easiest to drop off? One of the easiest is the latest new thing, not to do quite as much with the new thing or as quickly as you were going to do. So, you have a little bit more flexibility to handle a pressure on you when you have a bit of extra money given for an extra thing…
>
> All I am saying is it may not be a formal padding; it may be that it has just given you another degree of freedom, if you like, in the management of it. Finance will do its best to limit that capacity, but no doubt when you have new policies, you have an extra bit of flexibility in the way you manage.[88]

6.94 The Committee accepts that access to funding through NPPs assists agencies in meeting their financial obligations. The next question is whether small agencies are particularly disadvantaged by the process.

New policy proposals – the problems for small agencies

6.95 In evidence, Finance did not identify any particular structural problems with the NPP process. Rather, Finance noted that the Minister and ERC approve many small NPPs, which are listed in the Budget Papers.[89] Finance also stated that the $10 million threshold on NPPs that was raised in submissions was only a classification issue. It only determined whether

84 John Wanna, Joanne Kelly and John Forster, *Managing Public Expenditure in Australia* (2000), pp 209-210.

85 Dr Ian Watt, transcript, 19 September 2008, p 3.

86 Ibid.

87 Mr Andrew Podger, transcript, 19 September 2008, p 36.

88 Ibid.

89 Dr Paul Grimes, transcript, 19 September 2008, p 16.

ERC considered a proposal or whether the Minister made a decision that was ratified by ERC. It did not affect the outcome.[90]

6.96 However, most other parties participating in the inquiry believed that small agencies were disadvantaged by the process. The Australian Institute of Health and Welfare stated that the process for NPPs is geared towards larger agencies.[91] The Australian Institute of Aboriginal and Torres Strait Islander Studies gave its perceptions on this:

> The NPP process is highly competitive, so that smaller agencies are pitted directly against larger departments who have more resources to devote to the process, have ready access to internal and inter-departmental forums to advocate their own proposals, and have policy mandates which favour them against the claims of smaller agencies.
>
> Statutory authorities are largely reliant on the degree of advocacy portfolio departments are prepared to commit to during the assessment and evaluation of NPP bids across the APS. The potential for conflicts of interest in these situations cannot be discounted.
>
> An additional contrast between AIATSIS and larger agencies in the NPP process is that larger agencies are more able to absorb the human resource costs of the preparation process within their agencies. Whilst the AIATSIS is able to identify and locate such costs in the preparation stage, it usually requires significant resources be diverted from core functions.[92]

6.97 The Committee has a number of observations here. Firstly, the issue of small agencies having fewer economies of scale has already been acknowledged. It suggests that small agencies are less likely to be able to compete in the 'game' of securing new policy funds.

6.98 The second issue is the treatment of agencies by portfolio departments. The bulk of the evidence was not as clear on this point. The Commission stated that departmental secretaries usually have good knowledge about the finances of the agencies in their portfolio.[93] IPAA gave the example of the Department of Health and Ageing having good coordination processes in place. It also stated that, while secretaries are prepared to examine ways

90 Mr David Nicol, transcript, 19 September 2008, p 15.

91 Dr Penny Allbon, transcript, 20 August 2008, p 76.

92 Australian Institute of Aboriginal and Torres Strait Islander Studies, sub 57 (attachment B), pp 3-4.

93 Ms Lynelle Briggs, transcript, 19 September 2008, p 46.

to assist their smaller agencies, there was a risk that their smaller requirements may not capture a secretary's attention.[94]

6.99 Finance argued that letting an agency within the portfolio suffer a significant financial shortfall could become problematic very quickly:

> Perhaps I can reflect upon my own experience when I was secretary of the Department of Communications which in those days had a large number of small agencies attached to it. Some were bigger than the department as a whole, but nevertheless they were called small agencies. I would have found it very hard, frankly, given the political clout, to use a crude term, to use those small agencies as a way of offsetting my funding costs; I really would have. It was more likely the reverse: I was hoping to help them find their way out of trouble.[95]

6.100 On this evidence, the Committee concludes that small agencies could 'fall between the cracks' within a portfolio department, although it is unlikely that this occurs systematically.

6.101 The Institute's third point is that governments are more likely to be able to achieve their policy goals through larger agencies, which means larger agencies are more likely to get new policy funds. This is consistent with Finance's observations that the process for NPPs was largely a political one:

> … if an agency, big or small, does not get new policy funding, is the issue one of size or cabinet decision making processes or ministerial or government priorities? It is always difficult to have to tell an agency head that his or her agency is not or was not a priority for their minister and/or the government when push came to shove around the cabinet or ERC table. But in my experience, priorities do matter enormously, and rightly so in government decisions, particularly about existing or new funding, and they matter much more than the formal rules themselves.[96]

6.102 Departments of state do the bulk of the policy work in each portfolio and would therefore be able to present a strong case at each Budget for NPPs.

6.103 IPAA agreed that agency size and a greater policy profile would assist agencies in securing funding and the amount granted. For instance, the sort of proposals that most small agencies would put forward would be

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94 Mr Andrew Podger, transcript, 19 September 2008, pp 40, 41, 42.

95 Dr Ian Watt, transcript, 19 September 2008, p 16.

96 Dr Ian Watt, transcript, 19 September 2008, p 3.

under the threshold and go to the Minister. Finance usually takes a strict line with these:

> I did hear Dr Watt talk about this $10 million threshold, and he is quite right: there is no threshold of being able to put forward proposals, but with respect to proposals that come under the minors list, Finance is usually far firmer and requiring offsets for those than elsewhere.[97]

6.104 Similar sentiments were expressed by the Equal Opportunity for Women in the Workplace Agency,[98] the Insolvency and Trustee Service Australia,[99] and the Australian Communications and Media Authority.[100]

6.105 The Committee received a number of examples from small agencies of proposals that were not funded sufficiently or had to be absorbed entirely:

- the Family Court of Australia had to pay an extra $500,000 for the total cost of conducting a strategic review of the Newcastle courts;[101]
- the Human Rights and Equal Opportunity Commission had its $1.8 million of funding withdrawn for handling complaints under Work Choices (the discontinued industrial relations policy), even though it is still receiving the extra complaints;[102]
- the Ombudsman has had higher than expected demand for its services from the Northern Territory intervention amounting to $1 million;[103] and
- the Australian National Audit Office absorbed government initiatives such as green power and information security requirements totalling $1 million.[104]

6.106 On a proportional basis, these are significant impositions on small agency budgets. On the other hand, IPAA argued that agencies making proposals with a political priority could put a much better case to ERC.

> … for big ones, ERC may well still say: you have to find offsets, but ministers are more likely to be able to argue that this is an

97 Mr Andrew Podger, transcript, 19 September 2008, p 41.
98 Ms Anna McPhee, transcript, 8 September 2008, p 18,
99 Insolvency and Trustee Service Australia, sub 13, p 5.
100 Australian Communications and Media Authority, sub 56, p 2.
101 Mr Richard Foster, transcript, 20 August 2008, p 57.
102 Ms Susan Roberts, transcript, 8 September 2008, p 3.
103 Prof McMillan, transcript, 20 August 2008, p 17.
104 Australian National Audit Office, sub 60, p 3.

election priority or something of that sort, in which case I think the government would be willing to offer up some more money.[105]

6.107 Assessing this evidence, the Committee concludes that there is probably a bias in favour of large agencies in the process for NPPs. The Committee accepts that Finance is accurate in stating that small proposals are funded. However, it appears that small technical agencies receive new funds less often and for proportionally smaller amounts than other agencies.[106]

6.108 In order to test this finding, the Committee examined the Portfolio Budget Statements for 2007-08 and 2008-09 for all agencies. The aim was to compare the amount of funds large agencies and departments of state received compared with small technical agencies. This is an extension of the exercise conducted for the courts in chapter 4. Table 6.1 presents the results.

6.109 The table values NPPs in two ways. The 'Budget year' columns give the value of the NPP in the Budget year as a proportion of estimated expenses in the Budget year. The 'four year' columns give the value of the NPP, averaged over the Budget year and three forward years, as a proportion of estimated expenses in the Budget year.

Table 6.1 New policy funding as a proportion of total budget, all agencies (%)

Agency type	**2007-08**			**2008-09**		
	No.	*Budget year*	*Four years*	*No.*	*Budget year*	*Four years*
Departments	17	6.6	5.7	18	5.1	4.1
Large agencies	19	3.7	3.1	18	1.0	0.6
Small agencies	100	2.0	2.0	102	-0.4	-0.1

Source *All Portfolio Budget Statements for 2007-08 and 2008-09. Large agencies are defined as having departmental expenses of over $150 million and not being a department of state. Small agencies have departmental expenses of less than $150 million and are not a department of state. Total budget is defined as the estimated expenses for the Budget year.*

6.110 The table corroborates the oral evidence received by the Committee. Departments of state are the winners in the NPP process, receiving substantially more on a pro-rata basis than other agencies. Large agencies do better than small agencies in receiving NPP funding, as well as having better economies of scale with which to manage the efficiency incentives. The differences between the types of agency remain under both measurement methods.

105 Mr Andrew Podger, transcript, 19 September 2008, p 41.

106 See Australian Electoral Commission, sub 42, p 3.

New policy proposals – is change useful?

6.111 Agencies made a number of recommendations suggesting how small agencies might be able to better access new policy money, including:

- allowing agencies to submit for additional funding for items that are not necessarily NPPs but are more in the way of supplementation, for example to continue to pay competitive salaries;[107]
- allowing agencies to bundle proposals together to meet the $10 million threshold;[108] and
- reducing the $10 million threshold for small agencies.[109]

6.112 On balance, the Committee has decided against recommending changes to the NPP process. Firstly, features such as the $10 million threshold are there for operational reasons to assist the production of each Budget. ERC is a major strategic committee of Cabinet. It makes sense for ERC to delegate the consideration of relatively small amounts to the Minister.

6.113 Secondly, the suggestion that agencies be able to make bids for supplementation is very similar to Finance's preferred approach of ministers requesting baseline reviews of funding for agencies in their portfolio. It is difficult to see how such a modification would work differently from current practice. Possibly, agencies are requesting a change in perceptions. That is, requesting a baseline review does not reflect management failure. This matter is dealt with later in the chapter.

6.114 The third and most important reason is that the process for NPPs is a political one. Governments are elected on their policies and a key aspect of implementing policies is funding them through the Budget. The Committee concurs with Finance that ERC should remain a political forum.

6.115 It appears to the Committee 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. The extra funding through the NPPs gives them the added flexibility and mass with which to respond to the various efficiency incentives.

6.116 Given that billions of dollars are involved in these NPPs, designing the budget rules for larger, more policy-oriented agencies is appropriate. This

107 Department of the House of Representatives, sub 10, p 15.

108 Australian Communications and Media Authority, sub 56, p 9.

109 Administrative Appeals Tribunal, sub 17, p 7.

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 being used to support policy outcomes.

6.117 The other side of the Budget is the small technical agencies that are outside mainstream policy development. They do not receive a regular supply of new policy funds. The Committee believes that the Budget rules are applied to them inappropriately. They are not involved in a changing policy environment and so there is no need to ensure that their 'policy funds' are kept up to date because they do not have any, or very few at the most. Compared with departments of state, their roles are static. Almost all of the agencies that made submissions to the Committee fit into this category.

6.118 In the view of the Committee, it would not be beneficial to adapt a political process (NPPs) to ensure that administrative rules designed for large policy agencies do not strip resources from small technical agencies. However, the Committee does accept that these agencies are disadvantaged by funding processes. The Committee next examines whether the indexation rules should be adapted to meet the policy neutral character of small technical agencies.

Indexation

6.119 Agencies' appropriations are adjusted each year for inflation. Finance uses two indexes to represent agencies' main inputs: staff and other supplies (rent, utilities and so on). In order to adjust for wage costs, Finance uses the federal minimum wage. For other supplies, Finance uses the consumer price index (CPI). Finance averages these two indexes to develop a wage cost index (WCI) to apply to an agency's appropriation. This average is not strictly a 50/50 weighting between the two indexes. Instead, Finance has a handful of set weightings that it applies (a commonly used one is 60/40 in favour of staff), depending on the proportion of staff costs in an agency.

6.120 An issue commonly raised in submissions was that the indexes fall significantly short of the price movements faced by agencies.[110] The Commission summarised the situation as follows:

110 For example, Australian Electoral Commission, sub 42, pp 3-4; High Court of Australia, sub 14, pp 3-4; National Capital Authority, sub 47, p 4.

> In addition to the 1.25%, (3.25% for 2008-09) per annum efficiency dividend, the wage cost indexes applied to departmental funding incorporate an assumption of productivity gains by agencies to finance remuneration increases. This approach has resulted in funding for increases in wage costs of around 2% per annum over the last 10 years. Given that wage increases have averaged around 3.75% to 4% per annum over recent years, agencies have needed to find ongoing cost savings of around 1.75% to 2% per annum to help meet wage increases.
>
> The efficiency dividend (1.25%) must also be managed, with that amount being even higher in the final quarter of 2007-08 and for 2008-09 (3.25%)…
>
> Whilst a direct comparison between the level of cost savings in the APS and labour productivity growth in the rest of the Australian economy is not possible, productivity improvements in the APS do appear to compare favourably with annual labour productivity growth in the economy more broadly. Over the last decade average labour productivity has increased by 1.8% per annum in the Australian economy generally and by 2.2% per annum in the market sector.[111]

6.121 In other words, labour productivity is improving by 2% per annum in the wider economy, whereas that expected of agencies is 3%. Compounding this are increases in office rents, which is a significant supply for small agencies. Figures quoted to the Committee during the inquiry for rent increases include:

- 8% annually for the Ombudsman;[112]
- 4% annually for the Australian Law Reform Commission;[113] and
- over 10% annually for the National Archives of Australia.[114]

6.122 There were also instances of high increases for individual properties. For example, the Federal Court of Australia stated that the rent on its Perth premises was expected to increase by 200%.[115] The National Measurement Institute reported that the rent on its Lindfield site was expected to increase by 16%.[116]

111 Australian Public Service Commission, sub 54, pp 3-4.
112 Mr Ron Brent, transcript, 20 August 2008, p 18.
113 Australian Law Reform Commission, sub 3, p 2.
114 Mr Ross Gibbs, transcript, 21 August 2008, p 6.
115 Mr Gordon Foster, transcript, 8 September 2008, p 42.
116 National Measurement Institute, sub 57 (attachment D), p 4.

6.123 The reason for this ‘indexation gap’ is that the indexes that Finance uses do not represent price movements in the types of supplies that agencies use. For example, the Management Advisory Committee in 2005 reviewed the type of work commonly performed in Commonwealth agencies and concluded:

> All these types of work increasingly require employees with communications, problem solving and ICT skills commensurate with those of the average tertiary graduate.[117]

6.124 This appears to be particularly so in the case of the agencies involved in this inquiry because many of them were established for their technical expertise. Finance is using a benchmark for low skill labour (the minimum wage) for Commonwealth agencies that are becoming more reliant on high skill labour.

6.125 The CPI is an index designed for the use of consumers (that is, individuals). It gives greater weight to items such as food, clothing and the rent of houses, rather than renting office space. This mismatch between the indexes that Finance uses and the inputs purchased by agencies is an in-built productivity requirement. However, as the CPSU noted, it lacks transparency.[118]

Indexation – Finance’s arguments

6.126 Finance did not so much argue in favour of the current arrangements as argue that there were no better alternatives. In particular, it stated that the indexing system needs to be broad in order to be workable:

> … we try to compensate for a broad basket of goods and services rather than compensating for individual items. If you get into compensating for individual items, you get much more complex budgetary circumstances, so you have an index of rents for firms in Western Australia, for example; it does not work.[119]

6.127 Finance’s most pertinent comment about agencies’ cost increases was that it is important to examine costs across the whole range of supplies and not concentrate on one, such as rent. Finance noted that the costs of IT and telecommunications have been decreasing, which to some extent balances cost increases in areas such as rent.[120]

117 Management Advisory Committee, *Managing and Sustaining the APS Workforce* (2005), p x.
118 Mr Stephen Jones, transcript, 20 August 2008, p 36.
119 Dr Ian Watt, transcript, 19 September 2008, p 14.
120 Dr Paul Grimes, transcript, 19 September 2008, p 14.

6.128 However, Finance's response to wage indexation was less convincing. It acknowledged that agencies have ambitious targets set for them but was not able to comment because it was following government policy:

> I can agree that it is hard to meet those productivity targets. It is not easy and requires agencies to work very hard to do so. But it has long been government policy about the level of wage cost indexation, and that is very hard for me to comment on that…[121]

6.129 Finance's final comment was that it did not consider 1.25% annually to be sufficiently large to seriously compromise an agency's financial position. In relation to the six agencies that were subject to Finance health checks over the past five years, Finance stated:

> Outsiders sometimes think that any financial difficulty is the fault of the efficiency dividend. In our experience, the efficiency dividend has not played a major role in these financial problems agencies have found themselves in. I cannot say it has played no role, but it has certainly not played a major role. Generally speaking, issues that have been much more important have been project and/or financial management, outdated or inadequate funding models, or over-promising to government and not having the resources to deliver on the promises.[122]

6.130 The Committee's response to this point is that the agencies involved in the inquiry have not been subject to overwhelming financial distress. Rather, they are subject to the eroding effect of various funding rules that are designed for larger policy agencies. This erosion is affecting them in various ways, in particular disinvestment, service cuts and a reduced ability to take advantage of new opportunities.

6.131 In summary, the competing arguments are that the system lacks coherence against the need to maintain a workable system. In the view of the Committee, it is feasible to establish a system that is less arbitrary but still workable.

Indexation – reforms to applying the efficiency dividend

6.132 The first issue is the overall design of any new system. Probably the most common recommendation in submissions was that small agencies, or particular types of small agencies, should be exempt from the efficiency

121 Dr Ian Watt, transcript, 19 September 2008, p 12.

122 Dr Ian Watt, transcript, 19 September 2008, pp 3-4.

dividend.[123] The Commission and IPAA also believed that this approach was more workable than exempting certain categories of expenditure.[124]

6.133 One option would be to exempt all small technical agencies from the efficiency dividend. Technical agencies would be those that have precise, narrowly defined functions (often legislated) and exercise technical expertise. Small agencies could be defined as having total expenses below a certain level, be it $50 million, $100 million or $150 million. While this may give relief to a large number of agencies and would be workable, it would still be arbitrary to some extent. A modest increase in expenses for an agency just below the threshold would be enough to apply the whole 1.25% efficiency dividend to it.

6.134 A more nuanced approach would be to exempt a fixed amount of agencies' revenues from the dividend. For example, the first $50 million of all agencies' appropriations for departmental expenses for the ordinary annual services of the Government ('eligible appropriations') could be exempt.[125] 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.

6.135 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 would be 0.625%.

6.136 An agency with eligible appropriations of $250 million would pay 0% on the first $50 million and 1.25% on the remaining $200 million. The practical efficiency dividend for this agency would be 1%. A large agency such as the Australian Taxation Office would pay an efficiency dividend of 1.23%. In short, the larger the agency, the closer its efficiency dividend will be to 1.25%. Figure 6.3 illustrates the effect.

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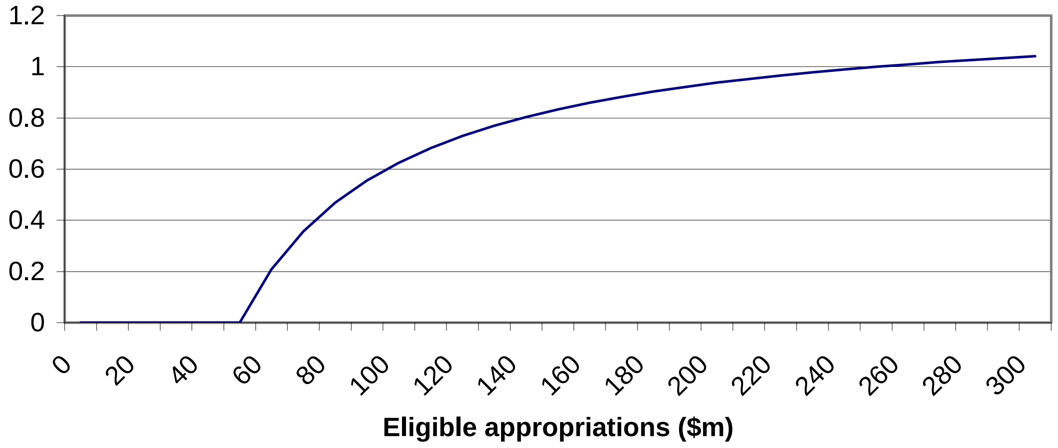
123 For example, Australian Academy of the Humanities, sub 11, p 5; Inspector-General of Intelligence and Security, sub 24, p 3; National Capital Authority, sub 47, p 5.

124 Ms Lynelle Briggs, transcript, 19 September 2008, p 49; Mr Andrew Podger, transcript, 19 September 2008, p 39.

125 The efficiency dividend is not applied to agencies expenses. It is applied to their departmental appropriations in Appropriation Bill Numbers 1, 3 and 5 (ordinary annual services of the Government). Agency funding provided through receipts, special appropriations or for NPPs is not officially subject to the dividend.

Figure 6.3 Agencies' efficiency dividend when first $50 million of appropriations is exempt (%)



Source *Australian Government, Budget Paper No. 4, 2008-09 and JCPAA analysis.*

6.137 There are a number of observations to make about this proposal. Firstly, it is designed to give relief to agencies that have difficulty in obtaining NPPs. Table 6.1 shows that departments of state have the most success in gaining NPPs. Therefore, the Committee is of the view that departments of state should be subject to the full efficiency dividend.

6.138 Secondly, the Committee accepts that the $50 million exemption is itself arbitrary. Despite this, the Committee supports this approach because it is less arbitrary than current practice. At the moment, small technical agencies are having their funding base eroded through a set of funding rules that are designed to extract funds out of agencies that receive regular top ups through NPPs. However, these small agencies receive a lower proportion of funding through NPPs because of the technical nature of their work. Rather than allowing disinvestment, service cuts and lost opportunities to trigger a baseline funding review, it makes sense to the Committee to fund them more generously, taking into account their reduced access to NPPs.

6.139 Thirdly, the Committee notes that large agencies will receive some benefit from the proposal. All agencies with eligible appropriations above $50 million will receive a benefit of $625,000 (1.25% of $50 million). Some observers may not agree that large agencies should benefit as well.

6.140 However, this is the tradeoff for making the system simple. If large agencies were to be subject to the full dividend, then the system would need a cutoff point, such as $150 million. This would increase the arbitrariness of the system in return for saving approximately $10 million per annum.[126] The Committee's preference is for a simple system as it would minimise distortions and perverse incentives on agencies. For example, an agency just below the $150 million threshold may avoid seeking an NPP. But the Committee accepts that some may prefer a threshold and the Committee is prepared to make a threshold an alternative for consideration.

6.141 Finally, the Committee notes that some observers may prefer to set the threshold at a level different to $50 million. The Committee accepts that a threshold lower or higher than this can still help small agencies. Once again, there is a tradeoff. A higher threshold will take more money out of the budget but give more protection to more small agencies. The reverse applies for a lower threshold. But given the scale of agencies' budgets and the evidence received, the Committee is of the view that setting the threshold at $50 million is a good starting point.

6.142 In order to assess the cost to the Budget of these various policy settings, the Committee conducted its own preliminary costing of them based on the information in Appendix D. Table 6.2 gives the results.

Table 6.2 Costings of exempting the first amount of agencies' budgets from the dividend

Threshold ($m)	Cost to the Budget ($m)		Proportion of the dividend (%)	
	All agencies	*Small agencies*	*All agencies*	*Small agencies*
10	11.0	8.8	5.3	4.2
20	18.5	14.2	8.9	6.8
30	25.2	18.7	12.1	9.0
40	30.7	22.1	14.8	10.7
50	35.3	24.6	17.0	11.9
60	39.3	26.5	19.0	12.8
70	42.9	28.0	20.7	13.5

Source *Calculations based on information in Budget Paper No. 2, 2008-09. 'Small agency' defined as having annual departmental expenses of less than $150 million. Calculations exclude departments of state, which are assumed to be subject to the full 1.25% efficiency dividend.*

6.143 The figures are based on 1.25% of agencies' eligible appropriations (for the ordinary annual services of the Government). The Committee is satisfied that this is a reasonable basis for a preliminary costing. The total eligible appropriations in the 2008-09 Budget were $23 billion. Calculating 2% of this amount gives $460 million. Although this is somewhat above the figure of $411.9 million that the Government stated it saved from the one-off 2% dividend,[127] it suggests that the costings are conservative.

126 See the fifth row of table 6.2.

127 Australian Government, Budget Paper No. 2, p 348.

6.144 The table shows that the Committee's preferred option of exempting the first $50 million of eligible appropriations will cost $35.3 million, or 17% of the amount that the efficiency dividend returns to the Budget. Restricting the exemption to small agencies (those with departmental expenses of under $150 million) reduces the cost to $24.6 million, or 11.9% of the amount that the dividend returns to the budget. The Committee believes that these amounts are an affordable way of maintaining the sustainability of small agencies.

Recommendation 8

6.145 **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.

6.146 In its submission, Finance expressed concern that a recommendation of this nature would reduce the incentive for small agencies to find efficiencies:

> The imperative for smaller agencies to make efficiency and productivity gains is as important as it is for larger agencies. Consequently, the efficiency dividend is applied equivalently to large and small agencies, as a percentage of their expenses.
>
> This recognises that the capacity for smaller agencies to make efficiencies need not be any less than the capacity of larger agencies.[128]

6.147 The Committee's response to this is twofold. Firstly, the recommendation still requires small technical agencies to make efficiency improvements because of the gap between indexation and the higher cost increases faced by agencies. Secondly, the recommendation is acknowledging that small technical agencies do not have the same access to NPP money as other, more policy-oriented agencies, rather than an inherent difference in finding efficiencies. The Committee has focussed on adjusting the

128 Department of Finance and Deregulation, sub 25, p 5.

efficiency dividend rather than NPPs because the latter has a significant political dimension. Trying to use a political process such as NPPs to achieve administrative ends is unlikely to succeed.

Baseline reviews

6.148 Finance's preferred solution to agency funding problems was for an agency's Minister to approach Finance's Minister and request a funding review. Finance noted that this was a relatively rare event. Finance has conducted approximately one such review per year over the past five years.[129]

6.149 As stated earlier, the difficulty with this approach is that there is a perception that requesting such a review is an admission of failure by management. The Administrative Appeals Tribunal stated:

> The current system of 'financial health checks' seems to predicate itself on the fact that in order to ask for a financial health check, managers of agencies must have failed.[130]

6.150 The Commission confirmed this perception in evidence.[131] This perception may account for Finance's observation that the agencies it has reviewed have been in the sort of difficulty that cannot be explained simply by the efficiency dividend. Finance stated:

> Generally speaking, issues that have been much more important have been project and/or financial management, outdated or inadequate funding models, or over-promising to government and not having the resources to deliver on the promises.[132]

6.151 If the management in agencies do not wish to take the risk of being labelled incompetent because they are requesting a funding review, then they are only likely to do so in extreme financial difficulty. The low level of requests that Finance is observing for funding reviews is a product of this reluctance, rather than an indication that the various funding rules are not creating problems.

6.152 The Commission's opinion is that requesting a funding review under the right circumstances is a sign of good management:

> The performance of agencies is also fundamentally dependent on the sustainability of the funding base provided by government. A

129 Dr Ian Watt, transcript, 19 September 2008, pp 3, 6.

130 Administrative Appeals Tribunal, sub 17, p 7.

131 Ms Lynelle Briggs, transcript, 19 September 2008, p 46.

132 Dr Ian Watt, transcript, 19 September 2008, pp 3-4.

> high-performing agency will put a strong emphasis on managing its operations in an efficient and cost-effective way, and in pursuing continuous improvements in productivity. Nevertheless, where funding for the agency is not sustainable, whether for front line policy development, regulation and service delivery, or for support services, such as information management, a high-performing agency will be proactive about raising such issues with central agencies and with government. This is not a sign of failure, but a sign of an agency that puts a high priority on maintaining its corporate health.[133]

6.153 The Committee supports this statement.

6.154 During the inquiry, a number of agencies either requested a regular review of funding or noted that such a mechanism did not exist.[134] The Commission itself suggested such a mechanism on a five year basis:

> A regular 5 yearly review of an agency's funding could be undertaken to ensure that it is viable and able to perform its core functions on an ongoing basis. The current system is designed so that a small agency with no new policy additions, not matter how efficient, will eventually be unable to meet normal increases in running costs and require assistance from the Government to continue to operate.[135]

6.155 Although this suggestion has merit, the Committee was concerned that automating these reviews every five years would lead to a large number of unnecessary reviews. Ultimately, the Committee concurred with Finance's view that instigating a review of an agency's baseline is a matter best agreed at the ministerial level.

6.156 However, evidence tendered to the Committee showed that there are ways in which these reviews can be optimised from the perspectives of both Finance and the agencies. For example, the Commission stated that management's track record in seeking efficiency improvements should be taken into account.[136] The House of Representatives Standing Committee on Banking, Finance and Public Administration also made this point in its 1994 report.[137] In the view of the Committee, it would be better practice for

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133 Australian Public Service Commission, sub 54, p 10.

134 For example, Administrative Appeals Tribunal, sub 17, p 7; National Measurement Institute, sub 57 (attachment D), p 5; Australian Communications and Media Authority, sub 56, p 9.

135 Australian Public Service Commission, sub 54-3, p 1.

136 Australian Public Service Commission, sub 54, p 9.

137 House of Representatives Standing Committee on Banking, Finance and Public Administration, *Stand and Deliver: Inquiry into the Efficiency Dividend Arrangements* (1994), p 19.

agencies wishing to have their funding reviewed to demonstrate proper systems in reviewing their own expenditure. Any such systems would depend on the agency's size and functions.

6.157 In relation to how agencies review their expenditure, the CPSU made the observation that agencies do not make enough use of their own workforce. Staff often have useful ideas about finding efficiencies across the whole range of agency operations. Their expertise is not limited to back office functions:

> We would like to propose to government that there be some bottom-up approaches to the way efficiencies and productivities are gained within agencies. I guarantee that, if you put a group of Centrelink workers into an office, perhaps here in Canberra, for a day or two and talked about not only the administrative costs but the program costs of running a number of the government services, they could come up with pages and pages of ways that greater efficiencies could be made…
>
> Rarely are there forums that enable us to get to the heart of the matter. To the extent that they exist, they generally focus on administrative arrangements. They really focus on the paperclip end of the office as opposed to the big picture. Our members are keen to get into talking about the big picture and not about how we more efficiently purchase paperclips and photocopying paper.[138]

6.158 The Committee believes that staff involvement is a potentially valuable method of finding efficiencies and that agencies' expenditure review systems should include staff liaison.

6.159 As discussed earlier in the chapter, one of the unintended consequences of the various funding rules is that agencies often look to their regional presence and regional services as a source of efficiencies. The Committee does not regard this as acceptable and believes that reduced regional activity needs to be subject to serious analysis.

6.160 The final point is that these reviews should take into account an agency's history in receiving NPPs. This chapter has discussed how new policy funds give agencies additional economies of scale and more capacity to prioritise their work. The corollary of this is that an extended period of not receiving any NPPs can erode an agency's funding base. The Committee notes that any such argument would need to be supported by performance and costing information. An agency could also argue that an

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138 Mr Stephen Jones, transcript, 20 August 2008, p 44.

NPP was insufficient if the projected workload under-estimated actual workload. This occurred with the Ombudsman's work for the Northern Territory emergency responses.[139]

6.161 In summary, the Committee believes that Finance should take the following into account when small technical agencies request a review of their baseline:

- 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.

Sharon Grierson MP
Committee Chair
December 2008

139 Professor John McMillan, transcript, 20 August 2008, p 17.