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Introduction

History of the efficiency dividend

1.1 The Australian Public Service has been serving the Government and people of Australia for over a hundred years. Throughout its long history, the public service has often been encouraged, through policies and funding arrangements, to be as efficient as possible. As early as 1901, parliamentarians were placing strong emphasis on the need for economy and efficiency in the public service.[1]

1.2 The efficiency dividend was introduced in the 1987-88 Budget as an annual 1.25% reduction of agencies' departmental funding.[2] It was intended that the efficiency dividend would give managers more responsibility for the efficient use of their staffing and administrative resources. Along with this greater responsibility came greater flexibility and autonomy for agencies.

1.3 According to the Department of Finance and Deregulation (Finance), the objectives of the efficiency dividend have been to:

- provide managers with a financial incentive to continually seek new or more efficient means of carrying out ongoing government business;
- allow Government to redirect a portion of efficiency gains to higher priority activities; and

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1 Public Service and Merit Protection Commission, *Serving the Nation: 100 years of public service* (2001), p 8.

2 The Department of Defence and the Australian Broadcasting Corporation were initially exempt. See John Wanna, Joanne Kelly and John Forster, *Managing Public Expenditure in Australia* (2000), p 207.

- clearly demonstrate public service efficiencies resulting from improvements in management and administrative practices and return these gains to the Budget.[3]

1.4 The efficiency dividend was not a completely new idea. It followed years of arbitrary annual percentage cuts that the Government imposed on departments. [4] The Committee notes that the efficiency dividend improved upon this by establishing a process and setting a consistent rate. This consistency would have assisted agencies in their budget planning.

1.5 The efficiency dividend was reduced to 1% in the 1994-95 Budget. It remained at 1% for 11 years until it was increased to 1.25% in 2005-06. The efficiency dividend remained at 1.25% for the 2008-09 Budget.[5]

1.6 In 2008, the new Government applied a one-off 2% efficiency dividend on top of the ongoing efficiency dividend. This was part of its election commitment to responsible economic management. A pro-rata adjustment was applied for the 2007-08 year, with the full year impact of 2% applied in 2008-09.[6]

1.7 The 1.25% ongoing efficiency dividend returned approximately $250 million to the 2008-09 Budget and the one-off 2% efficiency dividend returned an additional $411.9 million.[7]

1.8 All agencies, with a few exceptions, are subject to the efficiency dividend. Agency size or the capacity of an agency to achieve efficiencies is not taken into account.

1.9 Agencies are only exempt if they have received an explicit agreement from Government that they are not subject to the ongoing efficiency dividend. Three agencies are currently exempt from the ongoing efficiency dividend: the Australian Broadcasting Corporation (ABC); the Special Broadcasting Service Corporation (SBS); and the Australian Nuclear Science and Technology Organisation (ANSTO).[8] The ABC and SBS are exempt because they are subject to a triennial funding arrangement.[9]

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3 Dr Ian Watt, transcript, 19 September 2008, p 1, and Department of Finance, *Running Costs Arrangements Handbook* (1995), p 7.

4 John Wanna, Joanne Kelly and John Forster, *Managing Public Expenditure in Australia* (2000), p 207.

5 Department of Finance and Deregulation, sub 25, pp 1-2.

6 Department of Finance and Deregulation, sub 25, p 2.

7 Commonwealth Budget 2008-09 and JCPAA analysis.

8 Department of Finance and Deregulation, sub 25, p 3.

9 Dr Ian Watt, transcript, 19 September 2008, p 11.

1.10 Three other agencies have the efficiency dividend applied to only a percentage of their departmental funding: the Australian Institute of Marine Science (12%); the Commonwealth Scientific and Industrial Research Organisation (30%); and the Department of Defence (11.2%).[10] Defence has traditionally been entirely exempt from the dividend, but in recent years, the dividend has been applied to its 'administrative services that [do] not contribute directly to Defence capability'.[11] Some scientific agencies have received exemptions due to the nature of their work.[12]

1.11 The Government granted special exemptions from the additional 2% efficiency dividend to the following five agencies: the Australian Trade Commission; the Australian Fair Pay Commission Secretariat; the Workplace Authority; the Australian Prudential Regulation Authority; and the Australian Sports Commission. These exemptions were granted because these agencies were significantly affected by other election commitments.[13]

1.12 The efficiency dividend was introduced in 1987 as part of improved managerial arrangements. The Government of the day expected that agencies would meet efficiency dividend requirements by 'improving their administrative procedures, making better use of improvements in technology and in the use of human resources'.[14]

1.13 Agencies can and do achieve productivity gains through better use of technology, clever purchasing and improved people management. According to the submission from the Institute of Public Administration Australia, gains made across the public service would be close to the average gains made in the Australian economy: between 1.5% and 2%.[15]

1.14 After 20 years of the efficiency dividend, however, many small agencies report that they are no longer able to find genuine efficiency savings. To meet the efficiency dividend requirement, many small agencies have resorted to reducing or discontinuing activities that they consider to be lower priority or discretionary.[16] For some agencies, their ability to deliver on core functions has been restricted.[17]

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10 Department of Finance and Deregulation, sub 25, pp 3-4.

11 Dr Ian Watt, transcript, 19 September 2008, p 11.

12 Dr Ian Watt, transcript, 19 September 2008, p 11.

13 Department of Finance and Deregulation, sub 25, p 4.

14 Mr Bob Hawke, House Hansard, 25 September 1986, p 1448.

15 Institute of Public Administration Australia, sub 66, p 2.

16 Institute of Public Administration Australia, sub 66, p 3.

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

1.15 Some agencies have advocated for the retirement of the efficiency dividend. According to the Department of Finance and Deregulation, however, the absence of an efficiency dividend would require Finance to take a more interventionist approach to assess the efficiency of agencies and reallocate efficiency gains to other priorities.[18]

Overview of the Budget process

1.16 The efficiency dividend applies to departmental expenses that represent the ordinary operating costs of government departments. These costs were called 'running' costs when the efficiency dividend was introduced, but are now referred to as 'departmental' expenses. These departmental expenses include salaries, operational expenses and depreciation.[19] The efficiency dividend is not applied, however, to receipts governed by section 31 of the *Financial Management and Accountability Act 1997*, such as interest income or receipts from other sources.[20]

1.17 While the efficiency dividend reduces the level of resources available to agencies, the indexation process provides agencies with additional funding. The Government uses the indexation process to adjust agencies' budgets to account for inflation.[21]

1.18 Agencies calculate their own budget estimates for submission to the Department of Finance and Deregulation. Agencies develop these estimates based on instructions from Finance. In simple terms, an agency takes the figure that represents their departmental expenses from the previous budget and applies the efficiency dividend to this figure. After applying the dividend, the agency then indexes that funding for inflation using the relevant Wage Cost Index.[22]

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18 Department of Finance and Deregulation, sub 25, p 2.

19 It is worth noting that although depreciation expenses are subject to the efficiency dividend, they are not indexed.

20 Under section 31, the Finance Minister decides which receipts an agency may retain for its operations. This is documented in an agreement with the head of the agency. See Department of Finance and Deregulation, sub 25, pp 2-3.

21 Department of Finance and Deregulation, sub 25, p 4.

22 A number of wage cost indices are used by government departments. These indices are weighted averages that reflect changes in both labour and non-labour costs. Some of these indices are weighted more heavily for labour costs than others. See Department of Finance and Deregulation, sub 25, p 4.

1.19 The average indexation rate has been about 2% in recent years. This is lower than actual cost increases, which has been about 4% for most agencies.[23] It appears that agencies need to find an additional 2% savings to make up for this difference. This, along with the ongoing efficiency dividend, means that agencies actually have to find savings of 3.25% each year. In 2008-09, with the addition of the one-off efficiency dividend, agencies needed to find 5.25% in savings. This is more than is expected in the private sector. Over the past decade, average labour productivity has increased by 1.8% per year in the Australian economy generally and by 2.2% in the market sector.[24]

1.20 Previous reports on the efficiency dividend did not mention the indexation process—it did not appear to be an issue for agencies. This could imply that the difference between indexation and actual cost increases was not as large as it is today. The system also appears to have been more reasonable in other ways: a greater number of agencies received exemptions from the efficiency dividend,[25] and Finance offered budget adjustments to compensate for increased workloads.[26]

1.21 Agencies can request additional funding through the new policy proposal (NPP) process. NPPs are classified as major or minor. Minor NPPs are proposals with a financial impact of $10 million or less. They go to the Finance Minister, whose decisions are endorsed by the Expenditure Review Committee (ERC). Major NPPs have an impact of more than $10 million. They go directly to the ERC for consideration.[27]

1.22 In addition, NPPs (major or minor) are more likely to receive endorsement if they are offset by genuine savings. If requested by the Government, offsetting proposals brought forward by ministers can be drawn from anywhere in their portfolios. The Budget Rules do not require the agency that proposed the new policy proposal to bring forward the offsets itself.[28]

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23 National Gallery of Australia, sub 6, p 1; Australian Public Service Commission, sub 54, p 3; and Community and Public Sector Union, sub 58, p 1.

24 Australian Public Service Commission, sub 54, pp 3-4.

25 By mid-1994, over 40 agencies were exempt from the efficiency dividend. See John Wanna, Joanne Kelly and John Forster, *Managing Public Expenditure in Australia* (2000), p 211.

26 George Rothman and Brian Thornton, ‘Management of Budgetary Expenditures: the Commonwealth Running Costs System’ in *Budgetary Management and Control* (1990), John Forster and John Wanna (eds), p 93.

27 Department of Finance and Deregulation, sub 25-1, p 2; and Australian National Audit Office, sub 60, p 3.

28 Department of Finance and Deregulation, sub 25-1, p 1.

1.23 Through their submissions, many small agencies expressed difficulties in securing NPP funding. According to Insolvency and Trustee Service Australia, this is because smaller agencies often have well established operational responsibilities and thus have limited scope for new policy initiatives.[29] The National Library of Australia reported that it has not received any new policy funding for its operations in the last 20 years.[30]

Smaller public sector agencies

1.24 Smaller agencies face particular challenges in relation to the efficiency dividend. One issue is that smaller agencies are often established to fulfil a specific function or purpose. This limits their capacity to reprioritise or trim discretionary activities. Also, such agencies are occasionally required to absorb new functions. The cost of one additional activity may appear small, but it could represent a large proportion of a small agency's total budget.[31]

1.25 A smaller agency is often disadvantaged by poorer economies of scale and limited bargaining power. This affects an agency's ability to achieve savings in the procurement of goods and services or the negotiation of rental agreements.[32]

1.26 All government agencies have reporting obligations, such as publishing annual reports and financial statements. Skilled staff are required to complete these complex tasks. Large agencies might be able to reduce staffing levels in corporate areas, but small agencies might have only one staff member to complete these critical tasks. This gives small agencies fewer options in finding efficiencies.

1.27 Smaller agencies tend to be lower paying for most, but not all, classifications. Achieving efficiencies by decreasing salary costs is problematic as many of these agencies already find it difficult to attract and retain staff.[33]

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

30 The NLA did, however, receive funding for two capital building projects. See National Library of Australia, sub 41, p 3.

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

32 Australian Law Reform Commission, sub 3, p 2.

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

Previous reviews

1.28 This is not the first time the efficiency dividend has come under scrutiny. In September 1990, the House of Representatives Standing Committee on Finance and Public Administration tabled a report entitled *Not Dollars Alone: Review of the Financial Management Improvement Program,* which discussed the efficiency dividend. The Committee concluded that most agencies found achieving the efficiency dividend difficult. It recommended that Finance improve its marketing of the dividend and take careful account of the merits of exceptional cases in applying the efficiency dividend. The Government accepted this recommendation.[34]

1.29 In December 1992, the Commonwealth Government's Management Advisory Board published *The Australian Public Service Reformed: An evaluation of a decade of management reform,* which included a section on the efficiency dividend. It expressed concern that the efficiency dividend did not take into account the differences between agencies. It concluded, 'the future of the efficiency dividend lies in resource agreements and workplace bargaining, not in fixed arbitrary annual reductions in running costs'.[35]

1.30 In March 1994, the House of Representatives Standing Committee on Banking, Finance and Public Administration tabled a report entitled *Stand and Deliver: Inquiry into the efficiency dividend arrangements.* The Committee made seven recommendations, which included the recommendations that the dividend be reduced from 1.25% to 1% and that agencies' external receipts be exempt. In effect, the Government accepted all seven recommendations.[36]

Background of inquiry

1.31 The *Inquiry into the effects of the ongoing efficiency dividend on smaller public sector agencies* was prompted by budgetary concerns about the Australian

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34 House of Representatives Standing Committee on Finance and Public Administration, *Not Dollars Alone: Review of the Financial Management Improvement Program* (1990), p 37; and Management Advisory Board, *The Australian Public Service Reformed* (1992), pp 243-244.

35 Commonwealth Government's Management Advisory Board, *The Australian Public Service Reformed: An evaluation of a decade of management reform* (1992), p 250.

36 Mr Kim Beazley MP, Government Response to the Standing Committee on Banking, Finance and Public Administration's report: *Stand and Deliver: Inquiry into the Efficiency Dividend Arrangements (1994),* 31 May 1994.

National Audit Office (ANAO). In May 2008, the ANAO informed the Joint Committee of Public Accounts and Audit that, for the first time, its budget situation would necessitate a reduction in their planned audit program.[37] In a subsequent statement to the House of Representatives, the Committee Chair stated that decreased funding was affecting the ANAO's capacity to provide comprehensive oversight of the public sector.[38]

1.32 The Committee discussed looking into how the efficiency dividend might be contributing to the ANAO's situation. They also considered whether the ANAO's challenges in meeting the efficiency dividend might be indicative of difficulties facing other small public sector agencies.

1.33 On 4 June 2008, the Joint Committee of Public Accounts and Audit resolved to review the effects of the ongoing efficiency dividend on smaller public sector agencies. The Committee defined 'smaller agencies' as those with operational budgets of $150 million or less. The Australian National Audit Office and over 70 other public sector agencies fall into this category.

1.34 The purpose of this inquiry is to review the effects of the efficiency dividend on smaller public sector agencies with a view to recommending improvements to the efficiency dividend process and related budgetary processes.

Conduct of inquiry

1.35 An invitation for written submissions and the inquiry's terms of reference were advertised in June 2008. The Committee also wrote to a number of organisations seeking submissions.

1.36 There was a large response from government agencies, individuals and community organisations. The inquiry received a total of 68 submissions and one exhibit. Lists of submissions and exhibits can be found at appendices A and B respectively.

1.37 The Committee held public hearings in Canberra and Sydney. A list of hearings and witnesses can be found at appendix C.

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37 Australian National Audit Office, sub 60, p 5.

38 Ms Sharon Grierson MP, *Report by the Joint Committee of Public Accounts and Audit on the 2008-2009 Draft Estimates for the Audit Office* (13 May 2008), p 3.

Structure of report

1.38 The report comprises six chapters. Chapter 2 covers non-executive agencies, including the Australian National Audit Office, the Commonwealth Ombudsman, the Department of the House of Representatives and the Australian Electoral Commission. Chapter 3 outlines how the efficiency dividend has affected cultural agencies such as the National Library of Australia, the Australian War Memorial and the National Gallery of Australia. Chapter 4 discusses the experience of the courts and chapter 5 focuses on scientific agencies. Chapter 6 provides a conclusion and general recommendations.

1.39 The Committee makes a number of recommendations for the improvement of the efficiency dividend process. A full list of these recommendations is at the beginning of the report.