Australian Government
Productivity Commission

SHIFTING THE DIAL

5 YEAR PRODUCTIVITY REVIEW

# SUPPORTING PAPER NO. 15

## CORE BUSINESS AND CAPABILITIES

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### Publications enquiries

Media and Publications, phone: (03) 96 53 2244 or email: maps@pc.gov.au

### The Productivity Commission

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The Commission's independence is underpinned by an Act of Parliament. Its processes and outputs are open to public scrutiny and are driven by concern for the wellbeing of the community as a whole.

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## Key points

- Continued attention to sound targeting, design and implementation of public policy is needed to improve the living standards of all Australians.
- Several recent reviews have highlighted avoidable mistakes in programs resulting in significant costs and harm, a reflection of poor policy design and/or delivery.
- Problems typically arose where standard due diligence processes, such as stakeholder consultation and policy appraisal, were not adequately undertaken, often due to haste.
- Other themes from recent reviews include a culture of excessive risk aversion in public services, the centralisation of decision-making at senior levels of the public service, and the need to improve the core skills of staff in policy development and program delivery.
- Some effort has been made to re-orient public sector management frameworks to focus more on capabilities and the prudent management of tasks and risks (and less on compliance with rules per se), but significant change is hard to discern.
  - Ultimately, Ministers and agency heads need to encourage — indeed, require — the sort of organisational change that is needed to obtain sound policy advice and administration.
  - There is also a need for greater accountability for advancing already accepted public sector reform initiatives.
- Budget disciplines help to allocate resources efficiency, and more efficient government contributes to the broader efficiency of the economy.
- There has been a deterioration in national finances, largely driven by the Commonwealth's financial position. Notwithstanding that unusual economic conditions have made revenue forecasting difficult, there are measures that can be taken to assist budget management.

# Core business and capabilities

## 1 Background and focus of this paper

The quality of what emerges from government depends significantly on the quality of intangibles used to produce its outputs — the human and knowledge capital, governance structures within governments and between levels of government, and processes for policy development, delivery and review. These go to how decisions are made on the scope of government activity, and how specific interventions are chosen, designed and implemented, which are key determinants of governments' own productivity and how well they set policy affecting others'.

This paper considers public service capabilities and performance with respect to two key disciplines on governments — due diligence requirements on proposed and existing policies, and budgets (box 1). The former draws on a review of recent reports on government performance, including reports by audit offices, reviews of the capability of agencies, and commissioned reviews following concerns about administrative or policy outcomes (box 2). Budget disciplines are considered in the context of their role in allocating resources efficiently as well as broader concerns about the sustainability of public finances.

The picture provided by reports are necessarily indicative of current practice. They do, however, highlight some core features of, and trends in, practice, particularly at the Commonwealth level, the main focus of this paper.

## 2 Policy development and evaluation

The Commission is conscious that few comment when governments function well and the reverse occurs when things go wrong. However, there is sufficient evidence from recent reviews of government performance to indicate that the continuation of approaches in several areas will not serve us well.[1] Of particular importance is evidence of non-adherence to standard requirements for due diligence on policies (box 3), and a culture of excessive risk aversion in public services leading to the belated discovery of mistakes and centralisation of decision-making.

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1 The focus of this section is predominantly on Commonwealth administration, where there is comparatively more information on sector-wide performance.

## Box 1 Key disciplines on governments

**Due diligence requirements** on proposed policies and the impact of policies are, simply put, aimed at ensuring government interventions achieve their intended effect, and do so in a way that increases overall community welfare.

They thus oblige policy makers to consider, among other things, the nature of the problem; whether it is amenable to (and sufficiently large enough to warrant), government intervention; if so, alternative ways of achieving desired policy objectives — having regard to the relative costs and benefits of proposals, and changes in markets and players' incentives that policy change and design might prompt; how risks will be managed; and, over time, whether the policy intervention remains suitable.

Critical supports for these considerations are consultation with stakeholders and use of evidence to the extent possible.

Policy appraisal disciplines are important also because most public sector bodies are subject to weak threat of failure or takeover, and few price signals to help align demand and supply of services. With muted incentives for performance, there is significant reliance on transparency — the opening of decision-making processes and the basis for final decisions to public scrutiny — to prompt improvement and hold governments and the public service to account.

**Budget disciplines** require similar considerations in support of requests for funding of programs. At an aggregate level, the strength of budget constraints influences government productivity via the incentives created to improve program design and efficiency. They affect the efficiency of the economy more broadly as public spending translates into current and future tax burdens.

*If budget and policy due diligence processes work well*:

- they increase the prospects for effective and efficient government and therefore genuine improvements in community welfare, a rational allocation of resources among the many tasks governments must undertake, and sensible choices about what should be undertaken by the private sector
- at the macro level, they ensure more efficient government, which contributes to the broader efficiency of the economy. Internal disciplines further help to ensure that governments run a balanced budget over the macroeconomic cycle, which reduces upward pressure on interest rates and Australia's vulnerability to external shocks.

The potential benefits from achieving even small improvements in policy design and delivery are highlighted by the sheer size of government budgetary expenditure — $429 billion in 2015-16 for the Commonwealth alone, and $560 billion for all governments combined (net of federal-state transfers). (Australian Government 2017a, 2017c)

## Box 2 Selected reviews of performance and capabilities

**Blueprint for Reform of Australian Government Administration (Ahead of the Game) (2010)**

The Advisory Group looked at ways to improve Australian Public Service (APS) performance in the provision of services, programs and policies for the Australian community. It recommended greater citizen involvement in design of government services. Also, that the APS strengthen its capacity to provide strategic policy and delivery advice, invest in capability through improved human resource management, strengthen the focus on efficiency and quality by building a reliable evidence base on the efficiency of public agencies, and remove red tape. The Government accepted all of the Advisory Group's recommendations.

**Report on large government policy failures (Shergold review) (2015)**

The review was asked to recommend ways to enhance the capacity of the Australian Government to design and implement large public programs and projects following a series of major failures. The review made 28 proposals relating to the provision of robust advice, supporting decision making, improving risk culture, enhancing program management, greater public service diversity and adapting to changing policy environments. The review confirmed findings from the *Ahead of the Game* report regarding the need to improve experience through mobility programs, and the concerns of capability reviews regarding public sector project management skills and program management practices. The Government did not formally comment on the specific proposals but instructed Secretaries of Departments, through the Secretaries Board, to consider the report and its conclusions. (More detail in box 4)

**Independent Review of Whole-of-Government Internal Regulation (Belcher review) (2015)**

The Belcher review found that many internal Commonwealth regulatory requirements were appropriate and efficiently administered but there was also evidence of over regulation, inefficient regulation, and unclear and inaccessible regulations and guidance. It also observed that there was a culture of risk aversion, which is reflected in a disposition towards over-regulation of both the public sector and regulated industries. Recommendations to address these issues included removing duplication of reporting, improving access to information, clarifying guidance and better ways of engaging with risk. The Review confirmed the findings of many capability reviews (below) regarding excessive risk aversion and centralised decision-making. The Secretaries Board agreed to implement all 134 review recommendations, although it noted that some required consideration by the government. (More detail in box 5)

**Capability Reviews of Commonwealth agencies (2011–2016)**

Capability reviews of all departments and key agencies arose out of a recommendation of the *Ahead of the Game* report. The reviews were to be conducted on a regular basis to assess strategy, leadership, workforce capability, delivery and organisational effectiveness. Common findings included significant levels of risk aversion and centralised decision making at senior levels, which restricted innovation. Many departments were observed to struggle with project management. While some agencies collected vast amounts of data they failed to use that data profitably because they lacked the skills or because of dated IT systems.

**Independent reviews of recent programs (various)**

Reports by Commonwealth and State audit offices, commissions of inquiry and parliaments on programs including: the (VET) FEE-HELP scheme; Victorian East West Link Project; Queensland's shared IT services; New South Wales' Learning Management and Business Reform project; Centrelink Online Compliance Intervention system; the Home Insulation and Building the Education Revolution programs, and management of contracts.

Box 3 **Policy development rules**

Policy development rules generally ask for justification for the proposed policy direction (including the canvassing of options); an assessment of the impact of the policies on those affected; the views of stakeholders; information on how policies will be implemented; key sensitivities and risks and an assessment of regulatory, regional and financial implications. In most jurisdictions, there is also a requirement for cabinet submissions to include a Regulation Impact Statement which, among other things, requires assessment of the net impacts of the proposal.

Generally, all major policy or expenditure proposals are considered by Cabinets and/or their committees. Cabinet processes usually oblige cross-portfolio consultation on the merit and impact of proposals, input from central agencies for a whole-of-government perspective and compliance with due diligence standards.

Specifically, common causes of avoidable mistakes or circumstances where the costs of programs were significantly reducible included:

- cabinet processes not being adequate (for example, the Home Insulation Program, where decisions were made by a cabinet subgroup that did not include the minister responsible for the program)
- unnecessary haste leading to poor planning and inadequate stakeholder consultation (as occurred with the National Broadband Network tender process)
- proper appraisals not being undertaken or advice offered by them not being heeded (for example, the Vocational Education and Training (VET) FEE-HELP scheme, where strategic and operational risks, which ultimately led to extensive fraud, were known but not adequately addressed in the scheme's design)
- the complexity of issues not being matched by staff capabilities (as occurred with many information technology contract projects)
- excessive risk aversion on the part of staff, leading to, among other things, the non-reporting of risks or mistakes for fear of being blamed, or the provision of advice presumed to be what governments want to hear (for example, as observed in the case of the Victorian East-West Link Project).

While the reviews represent only a partial picture of government activity they suggest some underlying risks to policy design and delivery.

- The Australian Government review *Learning from Failure* (Shergold Review, box 4) found that pressures to respond quickly to policy problems are not uncommon, which can override proper planning and the usual safeguards provided by cabinet processes.
- Many of the 21 capability reviews of Commonwealth departments and agencies reported excessive risk aversion leading to the centralisation of decision-making and suppression of policy innovation and ideas at lower staff levels. With limited experience of judging the taking of risk when the costs are small and predictable, the ability to handle crisis (when they are large and unpredictable) is increasingly challenging.

## Box 4 2015 Shergold Review

The Shergold review *Learning from Failure* was commissioned to provide an independent assessment of government processes for the development and implementation of large public policy programs and projects. It examined recent large public policy failures and made 28 proposals for improvement in six areas: providing robust advice; supporting decision making; creating a positive risk culture; enhancing program management; improving exchanges between the Australian Public Service, private sector and academia; and embracing adaptive Government.

Among the main proposals:

- Cabinet submissions should include a ministerial statement outlining the policy's purpose, expected outcomes and anticipated implementation risks. Ministerial staff standards should be tightened and Ministerial staff should have regular joint forums with public servants to build understanding of their respective roles.
- Public services should embrace experimentation by undertaking controlled trials on how best to deliver government programs. Demonstration projects would allow different approaches to be tested with programs fine-tuned, scaled up and rolled out more extensively in response to the findings. This would be a reversal of the default position that new policies lead directly to large scale roll-out.
- Public services must become more agile, not just in responding to immediate crises, but in planning for the longer-term future. Evaluation must be recognised as an ongoing process rather than being regarded as an end-of-process sign-off.
- Institutionally, talent and expertise should be brought in from outside the public services and, conversely, senior public administrators should spend time in the private, community or academic sectors. Public servants also needed to work collaboratively with business and the not-for-profit sector sharing evidence and expertise.
- Government structures should be more adaptive and organisationally flexible. Where services are delivered by outside providers, the public service should allow contractors more flexibility to take their own approaches to service delivery against agreed outcomes.

The Australian Government responded to the report in February 2016 and tasked the Australian Public Service Commission (through the Secretaries Board) to ensure the Australian Public Service had the capability to design and deliver major policy initiatives effectively, efficiently and safely.

*Sources*: Hunt (2016) and Shergold (2015).

- The Belcher review of Commonwealth public sector internal red tape found a proliferation of public sector rules to be symptomatic of deeper attitudes of risk aversion and a regulatory stance characterised by a default to regulation as a policy lever (box 5). Perhaps unsurprisingly, the review's overarching recommendations for the public sector were similar to that required of governments' regulatory approach toward other sectors, including that regulation be the minimum needed to achieve objectives, proportional to the risks to be managed, and regularly reviewed. Red tape imposed on regulated sectors remains an area for improvement (box 6 and appendix B).
- Several reviews have highlighted gaps in policy development and program management capabilities, and further noted that the sheer workload demands on public

servants, including that arising from the expanding number of cabinet submissions dealing with increasingly complex problems, leaves little room for strategic thinking.

It is apparent that it is not for want of guidelines and procedural rules that poor policy development and mistakes in implementation occur. Problems arise when rules are not adhered to. But it is clear also that rules are only good if they are able to be applied and applied *well* — a function of will, capabilities and their practical use.

The sections below consider further:

- the themes arising from reviews
- some measures to support advancement of public sector reform, and policy development and delivery.

Box 5 **Belcher review of Commonwealth internal regulation**

The Belcher review was commissioned by the Secretaries Board in 2015 in response to a perceived proliferation of regulation in the Commonwealth public sector. Regulation was defined as any mandatory requirement applying to public sector agencies or any guidance, practice or procedure that is treated as such.

The review observed that the level and volume of internal regulation was growing (its complexity was not measured). It measured 8000 separate requirements in over 600 documents printed on more than 14 000 pages. The review considered that this trend reflected a regulatory stance characterised by a default to regulation as a policy lever and an absence of a proportional approach to regulation.

It found, for example, that 'regulatory creep' has resulted from failure to adjust compliance activity thresholds to levels of risk. For instance, if the threshold for reporting procurement contracts (originally set in 2005) was increased to match international obligations, the compliance burden of contract reporting would be reduced by almost 70 per cent while the value of contracts reported would only fall by 3.7 per cent.

There were some examples of good practice. For example, the Australian Taxation Office had reduced its external consultation arrangements from 68 committees to 8, internal management committees from 45 to 22, operational risks from 270 to 106, staff practice policies from 178 to 55 and internal compliance documentation by 87 per cent since 2013.

However, the review found systemic evidence of internal over-regulation, inefficient regulation, unclear and inaccessible regulation; and a culture of risk aversion. Risk aversion was seen as a common cause of over-regulation, with agencies taking on additional regulatory tasks because they viewed policy guidance material (such as from the Australian National Audit Office) or requirements set by regulators as a minimum compliance standard.

The Belcher review made 134 recommendations, directed primarily at the Departments of Finance, Prime Minister and Cabinet and Attorney-General, and the Australian Public Service Commission. The Secretaries Board agreed to implement all recommendations, noting that some required consideration by Government.

*Source*: Belcher (2015).

Box 6 **The compliance costs of external red tape**

Much of the focus of the Commonwealth's recent red tape reduction program has been on reducing business compliance costs — achieving the objectives of the regulation at least cost to business. The most recent report on progress claimed an estimated $4.8 billion in cost reductions from the introduction of the program in 2013 to the end of 2015 (Australian Government 2016). But inquiry participants suggest that red tape burdens remain significant (for example, Institute of Public Affairs, sub. 15, p. 12).

Compliance costs are only part of the burden imposed by regulation. Unintended distortions, such as changes in incentives to invest or innovate, or the introduction of barriers to adopting new business models, can be more costly to the economy. Indeed the costs of regulation can be many and varied.

Governments need to ensure that harmful regulation is amended or removed and the costs imposed are minimised. But the more challenging task is to find the right balance between the costs imposed by regulation and the benefits that it delivers to the community, workers, consumers, and to the efficient functioning of the market, which is of benefit to business. Digital technologies can offer new ways to improve this balance (SP 13).

The Regulatory Impact Statement (RIS) process, undertaken by governments in relation to new regulation that imposes compliance costs on business and the community, is meant to test the net benefit of a regulation as well as identify the least-cost regulatory approach to achieve the stated objective. But past practice suggests that RISs may sometimes be offered as justifications after the event, or avoided (PC 2012).

Regulators that minimise the costs imposed while effectively managing the risks would provide firms with a competitive advantage relative to their international peers. This can be achieved by regulators taking both a:

- risk-based approach — this is a proportionate approach to compliance and enforcement which includes targeting those activities and firms that pose the greatest risk
- education approach — seeking to ensure firms know what they need to do and providing the flexibility to let firms try new ways of doing business.

## Public sector capabilities

### A cultural shift seems to be needed

Reviews have highlighted that due diligence rules are crucial but not sufficient for managing projects well, which also requires skills to match the complexity of issues, sound judgment, and initiative — especially in averting risk or dealing with unexpected consequences. These attributes would have been far more effective in dealing with the risks posed by policies such as the Home Insulation Program (HIP) where, according to the Shergold Review:

> DEWHA's development and implementation of the HIP coincided with a significant expansion of the department's responsibilities. It had little experience of delivering programs. It was unprepared for the task. Post-implementation reviews of the HIP identified problems with the department's governance structures, program design capability, corporate administration, risk

> management behaviours, audit and compliance mechanisms, and effective monitoring. (Shergold 2015, p. 10)

Some governments (including New South Wales, Victoria and the Commonwealth) have sought to formally rebalance guidance in favour of supporting capabilities and better managing risks.

For example, New South Wales' *Government Sector Employment Act 2013* has sought, among other things, to reform the structure and management of its public sector by providing for greater devolution of responsibility and increased flexibility in staff deployment to improve service delivery efficiency and effectiveness. Agencies are still transitioning from practices under the previous legislative framework, so the impacts are not fully apparent (NSW PSC 2016).

At the Commonwealth level, the *Public Governance, Performance and Accountability Act 2013* (PGPA) has sought to promote high standards of performance and accountability by balancing planning and reporting obligations with greater scope for agencies to manage tasks and risks in a way that suits their operating environments (Belcher 2015). The Act and its associated regulations enshrine a notion of 'earned autonomy', which ostensibly creates an incentive for agency heads to institute better risk practice and culture in their organisations. However, it appears yet to produce significant discernible change. The Shergold Review noted that:

> … if the PGPA Act is to achieve its objectives, APS risk culture needs to evolve. Legislation will not change culture: people and their actions do. As recently noted by the Chair of the Australian Prudential Regulation Authority, good risk practice is about behaviour, not structure.' (Shergold 2015, p. 37)

The PGPA Act itself was instituted alongside a range of other procedures, manuals and policies specifying in detail how agencies should conduct their operations, which may have filled a gap but also seems inimical to the purpose of the legislation.

Governments and agency heads have largely accepted the proposals of the review reports we have scrutinised. At least at the Commonwealth level, however, it is hard to discern significant change.

This is not to say that there are not examples of good practice or improvement — inquiry participants have pointed to alternative service delivery models emerging in the social services sector as exemplars of innovative collaboration among stakeholders (some are described in box 10), and several agencies have sought to change their internal cultures by reducing decision approval points and increasing the degree of delegation.

There has been little in the way of public commitments on what will be done in response to the sector-wide and agency-level capability reviews, however, or follow-up to determine their impacts. Recent reports clearly indicate that more needs to be done across the public sector. That said, it is reasonable to assume that progress reflects, at least in part, the risk appetites and operating preferences of Ministers.

### Core skills

A major sector-wide review of Australian (Commonwealth) Public Sector (APS) capabilities, the 2010 *Ahead of the Game* Blueprint for the Reform of Australian Government Administration Report, noted that strategic advice requires specific skills, including in quantitative modelling, statistical data analysis and stakeholder engagement, that policy delivery relied on sound program design, risk management and program evaluation skills, and leadership was needed to foster creativity and ideas. Benchmarked against these skill attributes, the report commented that:

- there was a lack of comprehensive evidence about current APS strategic policy capacity and efficiency of public sector agencies
- policy and implementation needed to be better linked through engaging front line staff in policy design
- there was concern about whether the APS was attracting and retaining the best people.

In accordance with recommendations of the *Ahead of the Game* Report, the Australian Government instituted reviews of the capabilities of agencies in areas such as strategy, delivery and organisational operations.

To date, 21 capability reviews have been undertaken. Around half of the reviews conducted to date have noted that departments and agencies struggle with project management skills and program (particularly multiple project) management. In addition, they have found that while some agencies collected vast amounts of transactional and program data on business and individual clients, they failed to use that evidence base either because they lacked the skills or because their dated IT systems were not capable of effectively manipulating or interrogating the available databases.

Other reports suggest gaps or diminution in skills:

- Successive Auditor-General reports at both the Commonwealth and State levels have found evidence of poor program and project management capability, particularly on more complex initiatives. Contract management is a core activity of most agencies, yet often poorly understood and managed (box 7).
- Complaints about the quality of cabinet submissions for new policy proposals were raised by Ministers and Ministerial advisors in the Shergold Review.
- The Shergold Review also noted that ‘The APS needs to build a strong cohort of skilled and experienced program and project managers rather than relying on the ‘accidental’ practitioners who are often selected when no-one with greater ability is available. Some experts already work in the APS, but their experience and qualifications are not sufficiently recognised and their professional status and career development rarely receive the attention they deserve’ (Shergold 2015, p. vii)

## Box 7 Contract management

A prominent area that has been a challenge for all governments is the management of contracts. This is part of the core business of most agencies, yet an area where reports suggest there are significant, persistent weaknesses. Problems seem most prominent in the management of contracts for major information technology (IT) and construction services.

According to the ex-head of the Australian Government's Digital Transformation Agency, the Australian Public Service has been stripped of its IT skills through decades of reliance on private sector contractors (Towell 2016). In his view, this has been exacerbated by a lack of technical and contract management expertise in government. The ex-head commented that, compared with the United Kingdom, there was a much greater 'disconnect' between policy making and policy delivery, with ideas passed on to junior staff, the States or non-government organisations to deliver without proper evaluation of the cost or effectiveness of the relevant programs.

As one example at the State level, the Queensland Health payroll system and associated information and communications technology projects took over 10 years to complete and was more than four times the original estimated cost. The development of the $100 million system began in 2002 as part of Queensland's Shared Services Initiative to centralise administrative systems. When the system was implemented in 2010, it was reported to have contained numerous serious flaws.

Risks attaching to IT projects have been heightened by a tendency to create larger IT projects. According to the (OECD 2014), the Australian government had 52 IT projects larger than $10 USD million in 2014 — the second highest number in a survey of 39 countries (with only 17 respondents to that question). The average duration of Australian projects was 24-30 months, representing high duration risk for successful delivery.

Some other countries have introduced constraints on IT contracts to reduce risk. For example, the Netherlands has capped the value of IT projects at $10 USD million and their duration to a maximum of 12 months. In other countries, such as Estonia, large projects are sub-divided and sequenced into smaller sub-projects. According to (McKinsey & Company 2017):

> Limiting the size of IT projects can also curb the scope and objectives of each project and provide clear boundaries. This limitation helps ensure the project is aligned with government strategy — both at the outset and throughout the project's lifetime. Well-defined objectives can also help avoid shifting requirements during project rollout, and a smaller scoped project can clarify ownership and accountability (McKinsey & Company 2017, p.107)

Of course, IT is only an enabling medium and the repercussions of failure in this area are felt more broadly in less efficient service delivery.

A recent report commissioned by the United Kingdom Business Services Association highlights that contract management problems are not unique to Australia (Sturgess 2017). The report emphasised that the procurement and contract management tools (and capabilities) that are appropriate for purchasing highly commoditised, easily specified goods and services are not appropriate for commissioning complex support services and front-line human services. It noted that the former suits a transactional approach to contracting while the latter requires a more relationship-based approach. The report also differentiated the capability requirements associated with the separate stages of contract commissioning, design, procurement and contract management, and recommended greater attention be given to each through training in applied public service contracting and the operation of public service markets.

In a broader performance context, a comparison of workforce capability and capacity indicators found the APS lagged other public and private sector organisations internationally in most areas in 2013 and 2014 (APSC 2014). In recognition of the need to rebuild public sector capability, the Australian Government has been undertaking so-called modernisation initiatives targeting specific areas of weakness. Examples of the most recent initiatives are described in box 8.

As noted, some effort has been made to address concerns raised in reviews, including through greater devolution of decision-making responsibility. Other areas merit further consideration, and are considered below.

### Box 8 APS capability initiatives in the 2017-18 Budget

The Australian Government announced a range of initiatives to improve public sector capabilities in the 2017-18 Budget. The package of measures is estimated to cost around $480 million over three years, which is to be funded through the continuation of a 2.5 per cent ‘efficiency dividend’ on the public sector. The following initiatives are a part of the Public Service Modernisation Fund:

- *Transformation and innovation* — the Budget allocates $350 million to advance the collection and use of government data in the development of evidence-based policy. The measure is also aimed at further developing whole-of-government service delivery platforms, supporting digital capability and systems to improve collaboration across the APS. The stream further provides funding to accelerate the consolidation of shared corporate services arrangements and modernise the administration of business and community grants.
- *Agency sustainability* — $130 million will be spent over three years to upgrade outdated information and communications technology systems and other assets, and support more modern operating models. Improvements in heritage assets such as the National Maritime Museum, National Film and Sound Archive and Old Parliament House are covered in this stream.

*Source*: Australian Government (2017b).

## Building a capability evidence base

The *Ahead of the Game* Report noted that there was limited accountability for individual agency performance. Unlike countries such as Canada, New Zealand and the United Kingdom there was, at that time, no mechanism that would allow systematic measurement of agency capabilities in areas such as strategy, delivery and organisational operations.

The capability review program was intended to establish a comprehensive evidence base for future agency performance evaluation (Australian Government 2010). The Australian Public Service Commission (APSC) was tasked with managing the reviews, which were to be selected on the basis of risk management principles, led by eminent external reviewers, use a consistent methodology and be conducted at least every five years.

According to the APSC (2015a), the strategic objectives of the program were:

- Agency Capability Assessment – conducting independent reviews of key agencies to assess their ability to meet the Australian Government's objectives and future challenges
- Agency Capability Improvement – working with individual agencies to ensure that the findings of reviews are translated into explicit capability improvements over time
- APS-wide Capability Building – developing a view of capability across the APS and using this to realise solutions for systemic challenges.

The reviews were to inform agency-level capability improvement plans (devised by the Department Secretary or Agency Head in consultation with the APSC), with the Secretary or Agency Head accountable for progressing the plan through a performance agreement with the Secretary of the Department of Prime Minister and Cabinet.

The review program commenced in 2011 but review activity slowed significantly after 2014. There have been three reviews completed since that time. To the Commission's knowledge, there have been no follow-up reviews. The apparent stalling of the review program has meant that an evidence base on which to evaluate agency performance is now again lacking.

A mechanism is needed that identifies areas where capability (and other) problems remain unresolved, provides reasons why those problems persist, prompts change, and allows evaluation of progress over time. The Commission understands that the APSC is currently assessing the capability review program with a view to designing a new review framework:

> The APSC is currently undertaking an assessment of the capability review program in the light of findings from whole of government reviews. The assessment is now also looking at other public sector review programs such as the New Zealand Performance Improvement Framework. The object is to draw lessons that could inform the design of a subsequent review framework with a strong future focus. (APSC, pers. comm., 18 July 2017)

CONCLUSION 15.1

The Australian Government should re-commit to building a sound evidence base for evaluating, and thence building, public sector capabilities.

## Attracting and building skills

The Shergold Review argued that APS recruitment processes should better recognise the strategic links between policy design, delivery and evaluation in order to promote more diverse experience and capabilities among senior executives — but this could apply to staff generally. Staff selection and management criteria could accordingly place more weight on such program leadership and management capabilities.

In response to the *Ahead of the Game* Report (Australian Government 2010), the APSC developed a formal APS Human Capital Framework in 2012 to help agencies adopt strategies to improve workforce capability (knowledge, skills and abilities) and capacity (application of this capability).

Evidence on APS adoption of these strategies is mixed.

- Over 60 per cent of APS employees reported access to effective learning and development programs in 2015-16.
- Just 20 per cent of agencies had developed agency-wide talent management programs targeting high potential employees in that year. [2]
- Only 44 per cent of employees considered that senior APS leadership encouraged innovation and creativity in 2015-16.
- Over three quarters of ongoing APS employees had worked with only one agency.
- Turnover rates for the APS are low by private sector standards (less than 7 per cent in 2015-16), implying access to new ideas is limited.
- Most respondents to exit surveys in 2015-16 reported a lack of career opportunities as the main reason for leaving highlighting retention barriers (APSC 2016).

These observations suggest some room to improve.

Mobility of personnel is an important avenue for existing cohorts to gain broader experience, new skills and improved collaboration, and many reviews recommended greater two-way secondment activity.

On structural barriers to greater mobility, there is a relatively low proportion of agencies actively encouraging staff exchange, as indicated by the existence of policies to promote such exchange. In 2016, only 17 per cent of APS agencies reported having a policy in place to promote exchanges with the private sector. The existence of policies promoting exchanges with other public sector (non-APS) agencies was a little higher at 28 per cent, and with other APS agencies the figure was around 40 per cent (APSC 2017). Comparative metrics from equivalent state and territory surveys are not readily accessible.

To promote greater levels of exchange, the APSC recently launched a pilot program (Operation Free Range), which enables interested employees to nominate for inter-APS transfer in areas with critical skills gaps. Other objectives of the program include skill development, retention of APS staff and greater awareness of whole-of-government priorities.

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[2] In 2014-15, 65 per cent of APS agencies indicated they would deploy agency-wide talent management systems over the next three years (APSC 2015b). Fifty per cent of agencies used relationship-based opportunities (such as mentoring, coaching and peer support) to develop talent in 2015-16.

Approaches to achieving better outcomes in skill development could generally be informed by an APSC evaluation of the effectiveness of the APS Human Capital Framework, human capital strategies more generally and barriers to their adoption.

CONCLUSION 15.2

Public sector skill development could be improved through an evaluation by the Australian Public Service Commission of the effectiveness of human capital strategies and barriers to their adoption.

## Accountability for change

The PGPA Act aimed to improve governance partly by requiring all public sector entities to report, through annual performance statements, results that would enable assessment of how well agencies are achieving their purpose. While the Department of Finance has issued guidance requiring entities to report on measures arising out of any review or evaluation the entity has committed to undertaking (DoF 2017a), that guidance does not specify whether agencies are obliged to report progress against commitments made at a whole-of-government level or as a result of external review.

A recent review by the Department of Finance (DoF 2017b) on the first annual performance statements produced in 2015-16 found that a significant number of agencies did not report against all performance criteria, they reported against modified criteria to suit actual outcomes, and more generally that the quality of performance information contained in corporate plans and portfolio budget statements was poor.

The DoF review also highlighted that the focus of PGPA requirements is on high-level outcomes. While outcomes are an important focus, many public sector reform recommendations also go to the inputs of policy development and program management including workforce capacity and capability, the effectiveness of stakeholder engagement and quality of risk management processes, which may not show up in annual performance statements.

Ultimately, workforce capabilities and management processes are the responsibility of department and agency heads and, at the sector-wide level, the APSC. There would be merit in more effort being made to ensure there is progress on identified problems, and to prompt and provide support for change where this is needed. To this end:

- the APSC should evaluate what has been done in response to reviews, and the impacts of changes. If progress is found to be poor, an educative process should be put in place, for example, in conjunction with the Australian and New Zealand School of Government, or similar body, to re-authorise and train public servants in better managing programs and supporting innovation
- in agreeing (either in part or whole) to the recommendations of reviews, responsible entities should commit to specific deadlines for delivery.

The Commission understands there may be concerns that the above proposals will add to internal red tape. But a focus on priority reform areas and how progress can be *advanced* (rather than reporting for its own sake) will improve public service accountability for progressing reform without imposing an unnecessary burden on public sector entities.

The above measures could also be complemented by the issuance of charter letters by the Secretary of the Department of Prime Minister and Cabinet to department heads stating expected capabilities, leadership qualities and reform priorities to lift those (for example, to counter risk aversion, and support evidence and stakeholder input-based policy).[3]

Charter letters to department heads would fulfil a function similar to letters sent by the Prime Minister to portfolio Ministers at the start of every government term, which specify the policies and priorities that Ministers are expected to observe or deliver. Statements of Expectation issued to statutory authorities fulfil this task for statutory/independent authorities. In the latter case, each authority responds with a Statement of Intent that outlines how it proposes to achieve the government's expectations. The same undertakings in reply should be expected of department heads.

The Joint Committee on Public Accounts and Audit (JCPAA) has in the past reported on progress in implementing the recommendations of public sector reform initiatives. The JCPAA could be tasked by parliament to oversee progress on agreed sector-wide reforms on an ongoing basis.

3 The Commission is not aware that any such arrangements are currently in place.

CONCLUSION 15.3

Progress on public sector reforms would be aided by:

- the APSC evaluating what has been done in response to reviews to rectify identified gaps in skills
- entities responsible for implementing public sector reforms committing to and reporting against specific deadlines for delivery
- charter letters from the Secretary of the Prime Minister's Department outlining expected capabilities and public sector reform priorities
- the Joint Committee on Public Accounts and Audit overseeing progress on agreed sector-wide reforms.

## Sound policy making

Policy due diligence requirements are only one of the conditions that need to be satisfied for policy development, but a critically important one, with their importance highlighted by the many prominent instances of avoidable failure. Given the complexity of some policy problems and the inherent risks involved in policy change, due diligence requirements do not guarantee success, but do increase the likelihood that policies will work as intended and of smaller costs or harm arising from mistakes. Commenting on the importance of Cabinet processes, the Shergold Review noted, for example:

> Cabinet processes support government decision-making. When functioning properly they provide an important safeguard against rushed, uninformed or poorly conceived decisions. Individual ministers have ownership of the proposals that they bring to Cabinet. They need strong support both from their staffers (on the one hand) and their public service departments (on the other). (Shergold 2015, p. v)

The focus should be on making the case for good policy, however, rather than simply adhering to rules. Appraisal processes can have little effect when there are political exigencies. And a common complaint is that Regulatory Impact Statement (RIS) requirements are applied or policed dogmatically, with the policy object lost for the compliance trees.

A clear lesson on the handling of situations under time pressure is that risk management needs to be given even greater importance. An important element of this and a safeguard for governments is consultation with stakeholders on policy ideas and how they could be implemented, which helps better identification and understanding of risks.

More generally, several reviews have highlighted the importance of close collaboration between the public service, service delivery agents and stakeholders in designing and implementing programs. These are tasks that necessarily cannot be wholly undertaken by senior executives, and point to considered devolution of responsibility to lift agency capabilities and ensure that enough effort is being devoted to identifying, monitoring and correcting the potential for things to go wrong.

On risk appetites and management, particularly in dealing with new or intractable problems, experimentation or pilots could help. They are a practical way of informing the better design of policy, but as a sanctioned part of ‘good’ policy development processes could help:

- better define acceptable levels and avenues of risk (in a systemic sense) for the department or agency given the insights that they can bring into service users’ behaviour
- departments and agencies develop better management responses over time to the materialisation of risks (and in doing so providing some predictability on how issues will be managed when they arise, and by whom)
- by encouraging and providing an avenue for innovation in policy and program design — and recognising that good ideas can come from any person — help to change attitudes of risk aversion and over-caution in the public service
- ensure that policy risks, when they do not pay off, do not result in considered experimenters being punished.

And, as discussed in chapter 6, lessons from trials can be taken from elsewhere.

The Commission considers that there should be an explicit guarding against the creation of ‘sacred cow’ policy areas that are exempted from the normal consideration of likely costs and benefits, alternatives and trade-offs. In this context, participants have raised concerns that policy settings in areas such as national security and climate change mitigation do not receive the same level of scrutiny as some other areas. This, to an extent understandably, reflects a desire to mitigate or control risks. As the now Governor of the Reserve Bank of Australia has observed, however:

> … it is appropriate occasionally to ask whether we have got the balance right. Reducing risks is not always cost free – resources need to be devoted to the task and this means that these resources cannot be used for other tasks. And perhaps even more importantly, it might also be the case that a more risk-averse society is naturally less inclined to support and finance innovation, to implement new processes and to apply new technologies. If this is indeed the case, it has implications for future productivity growth. (Lowe 2014)

A reality is that following good regulatory practice is challenging, and takes specific kinds of analytical skills. A common challenge is measuring the scale and hence cost of a problem, and the costs and benefits of possible interventions. Some practical advice in light of experience is set out in box 9.

## Box 9 Some practical advice on decision-making

- It is crucial that there be clear justification for policy goals. Would the public be willing to pay for investments (and other costs) required to achieve these objectives, or might investments be better made elsewhere?
- There should be clear articulation of targets. What will progress toward achieving objectives and success look like? How will progress and success be measured?
- In relation to means of achieving goals, governments should seek evidence and input on what works, risks (in implementation and the external environment), and options.
  - Evidence is critical, as is its proper use. ‘Expertise is often … about nuance and ‘it depends’ rather than absolutes. And for this reason, it is essential to enabling us to make progress on difficult policy problems’ (Sullivan 2017).
  - Cost-benefit appraisals are important in judging proposals. While quantification is ideal, many things are hard to quantify with any confidence. Nevertheless, the framework should be used as it can show the hurdle that less tangible costs and/or benefits need to clear for a policy to produce a net benefit.
  - Policy advisors should be open to ideas/contest from ‘outside’. Similarly, they should be open to drawing on evidence and/or lessons from policy in other jurisdictions. Policy questions are rarely new.
  - Policy decisions should incorporate a proper understanding of distributional consequences.
  - Trials can be useful where policy problems are amenable, both to increase the evidence base and as a catalyst for change.
  - Public consultation on policy directions and design is critical. It also helps governments to anticipate and better deal with uncertainties that accompany implementation and the consequences of reform.

It should be recognised that policy arguments are rarely simply narrow technical questions. Analysts need to consider competing values, different views on how the world works, non-quantifiable costs and trade-offs, and how these different perspectives would influence the decision. This analysis is needed to prepare for effective advocacy for the reform.

CONCLUSION 15.4

No policy areas should be immune from proper appraisal. But RIS processes should emphasise sound policy-making rather than simply adherence to rules.

Reviews suggest the particular importance of building a sound evidence base on public sector capabilities, and increased collaboration between the public service, service delivery agents and industry stakeholders in designing and implementing programs.

## New ways of addressing policy challenges

Concerns about the decline in traditional social services delivery outcomes in Australia have led to alternative service delivery models emerging, though these are on a very small scale compared to the size of government program spending in this area. Some examples are described in box 10. They commonly rely on strategic alliances between business, philanthropy, government and the not-for-profit sector to use evidence as the basis behind testing, implementing and scaling new social services initiatives. They have also influenced the establishment of corporate foundations to grow support for new ways of addressing policy challenges and scholarships for innovation courses aimed at building skills and career paths in not-for profit-activities.

## Program evaluation should be standard

Evaluating the efficiency and effectiveness of government programs is critical to evidence-based policy formulation. Done well, evaluation can provide information about program performance to aid decision-making and prioritisation in the annual budget process. It can also strengthen accountability by providing formal evidence of a program manager's oversight and management of program resources and assist those program managers to improve the performance of the programs under their administration.

From a public policy perspective, successful program evaluation strategies share a number of key elements. They rely on the availability of robust program performance information. They require strong analytical and research skill capabilities in the departments (or the contracted or independent reviewers) that conduct the evaluations. They benefit from the involvement of both central agencies and the engagement of line departments managing the programs, and are often most effective when they are formally established by the executive government or through legislative instrument, and link to some process of higher-level scrutiny and decision-making. Last, evaluation results must be made public to enable broader scrutiny and transparency (Mackay 2011).

At the Commonwealth level in the decade to the mid-1990s, all budget funded programs were required (by statute) to be evaluated every 3 to 5 years, with evaluations integrated into the budget process. This period was associated with extensive evaluation activity (530 evaluation reports were published between 1993 and 1997) and there is at least qualitative evidence that evaluation findings made a substantial contribution to Cabinet debate and the development of policy options. For example, surveys conducted by the Department of Finance show that across the 1990-91 and 1994-95 budget years, the proportion of new policy proposals influenced by the findings of an evaluation rose from 23 per cent to 77 per cent (Mackay 2011).

## Box 10 **Innovation in social policy**

There have been a number of recent initiatives addressing specific social policy issues in Australia that have been based on venture philanthropy and involved linking alliances and skill sets to develop new ways of addressing social policy problems. These alliances have involved collaborations between government, private business, individual philanthropists and not-for-profit sectors to build evidence-based approaches to delivering impacts.

### Centre for Social Impact

The Centre for Social Impact was established in 2008 as a collaboration between three universities — University of New South Wales, Swinburne University of Technology and the University of Western Australia. The Australian government contributed a $12.5 million endowment to the Centre matched by four corporate investors — Macquarie Group Foundation, AMP, National Australia Bank and PwC — and supported by individual philanthropic contributions. The Centre aims to improve the delivery of social impacts in Australia through research, teaching, measurement and promoting public debate. This is based on collaboration between business leaders and organisations, government and social purpose sectors to build evidence-based, sustainable and scalable approaches to improving impact.

### Social Ventures Australia

Social Ventures Australia (SVA) is a not-for-profit private organisation established in 2002 by The Benevolent Society, The Smith Family, WorkVentures and AMP Foundation. It provides venture philanthropy grant funding, expertise and networks to support organisational transformation and the development of new ways to tackle social change. Its focus is on overcoming disadvantage in Australia, including through education, sustainable employment, stable housing and appropriate health, disability and community services. Initially focusing on funding social entrepreneurs through a venture philanthropy model, SVA subsequently engaged with government to reallocate resources to new and potentially more effective models of service delivery. SVA's range of services are designed to assist business, government and philanthropists to be more effective funders and social purpose organisations to be more effective at delivering services.

SVA pioneered the introduction of social impact bonds in Australia, which are an innovative approach to financing social programs that combine outcome based payments with market disciplines. Social impact bonds are designed to raise private capital for intensive support and preventative programs which address areas of social need. Private investors provide the initial capital to fund the cost of a social service provider and the government pays the private investors a financial return if the agreed social outcome is achieved. They are currently being used or trialled in several Australian jurisdictions including New South Wales, Victoria, Queensland and South Australia.

### Goodstart Early Learning

Goodstart Early Learning is a not-for-profit, for-purpose social enterprise that aims to address poor early childhood experiences. It is Australia's largest provider of early childhood education and care, with 13 000 staff caring for 73 000 children across 641 centres. It commenced in 2009 as a consortium of four of Australia's leading charities — The Benevolent Society, the Brotherhood of St Laurence, Mission Australia and Social Ventures Australia. With the support of Australia's financial, legal, business, government, and philanthropic sectors, it made a successful bid for 660 of the child care centres formerly operated by ABC Learning (which had gone into voluntary liquidation in 2008). All profits (surpluses) are re-invested into educational activities and outreach to disadvantaged communities.

There is also evidence that evaluation findings were used by line departments to improve operational and internal management systems. For example, a review conducted by the (ANAO 1997) found a high level of evaluation utilisation by line departments with the most significant impact on operational efficiency and a lesser impact on resource allocation decisions and service quality improvements.

Elements of this model currently operate in all jurisdictions. However, one of the key features — the linking of evaluation processes with explicit decision-making — is not universal. In some cases, the legislative requirement for review of programs has been subsumed by more modern requirements for periodic review of policy settings (such as through sunset clauses in legislation). But the integration of evaluations into formal decision-making processes — most obviously for budget-funded programs in the construction of governments' annual budgets — would be a significant improvement on current practice. Reflecting on the benefits of integrating evaluation into budget processes a previous Commonwealth Auditor-General commented:

> … the success of evaluation at the Federal level of government was largely due to its full integration into the budget processes. At least where there was a resource commitment, some form of evaluation was necessary to provide justification for virtually all budget bids (Barrett 2001, p 13).

The evaluation system operating prior to the mid-1990s was dismantled partly because of concerns from line departments about the administrative burden of planning and conducting evaluations and also due to a lack of program evaluation skills. The change also reflected a shift toward greater contestability in policy advice that lessened the demand for systematic use of evaluations in the budget process (Tune 2010).

Taking into consideration the lessons from the past, a more effective program evaluation system would include the following features:

- the greater use of sunset clauses on programs with a fixed deadline for the completion of an evaluation before new funding is committed, an approach similar to that used for assessing the efficacy of regulatory instruments
- similarly, governments should consider making the continuation of program funding conditional on completion of an evaluation and the rectification of significant problems identified, where this would be an effective incentive
- evaluation priorities should be risk-based, with larger programs subject to the earliest scrutiny. This is the approach in performance audits by every jurisdictional audit office.

*Who should conduct evaluations?*

Evaluations of programs can serve multiple objectives, including assessing their efficiency (are they being delivered at the lowest cost), effectiveness (are they achieving their stated objectives) and outcomes (are community impacts still worth pursuing). Evaluations with different objectives require different methodologies, tools and evaluation skills. They also rely on adequate management information systems that monitor program inputs and results. The control of those information systems has implications for who should undertake or be involved in evaluating program performance.

As a general principle, it is desirable that judgements on the effectiveness of policies in achieving their objectives be reached independently of agencies that administer them. These would necessarily be informed by the input of, including the data that can be provided by, agencies (the involvement of departmental staff can also overcome resistance to the sharing of performance information with external parties).

Agencies should also ideally have the capabilities to support, and a culture of internal evaluation to enable, ongoing improvement and the meeting of new challenges.

The experience of New South Wales suggests external or arms-length evaluation structures, on their own, do not guarantee success. The NSW Government established a Centre for Program Evaluation in 2013 to conduct rigorous evaluations of large and significant NSW Government programs. It also aimed to build evaluation capability across the NSW public sector, and more closely align the processes of evaluation and program/policy design. Despite the intention, the Centre has not publicly released any reviews or evaluations after more than four years of operation. According to one commentator:

> The NSW Centre for Program Evaluation was a product of the NSW Commission of Audit in 2012. Active for three years now, it has not released any publication on any NSW policy initiative. In fact, a review of the NSW liquor and lock-out laws was completed last year, but in a sensitive political climate it has not been released (Gruen 2016).

The Commonwealth's former evaluation system did not prescribe who should conduct evaluations but relied on the responsible entity to either conduct or commission evaluations. This is the current approach in New South Wales, where agencies (or agency clusters) are expected to steer periodic evaluations of new and existing programs in line with guidelines issued by the Department of Premier and Cabinet.

Importantly, New South Wales' guidelines identify the need for Departments and agencies to invest in training and development to improve their own evaluation capability and capacity (NSW Government 2016). Governance arrangements involve agency clusters preparing annual evaluation schedules for approval by the Cabinet Expenditure Review Committee.

Complementing internal evaluation, the Commission envisages that jurisdictional audit offices would continue to conduct systematic reviews of program efficiency and effectiveness for large and high-risk programs.

> CONCLUSION 15.5
>
> Evaluations should be standard practice and linked to the decision-making processes of government (including budgets).

# 3 Overarching budget disciplines

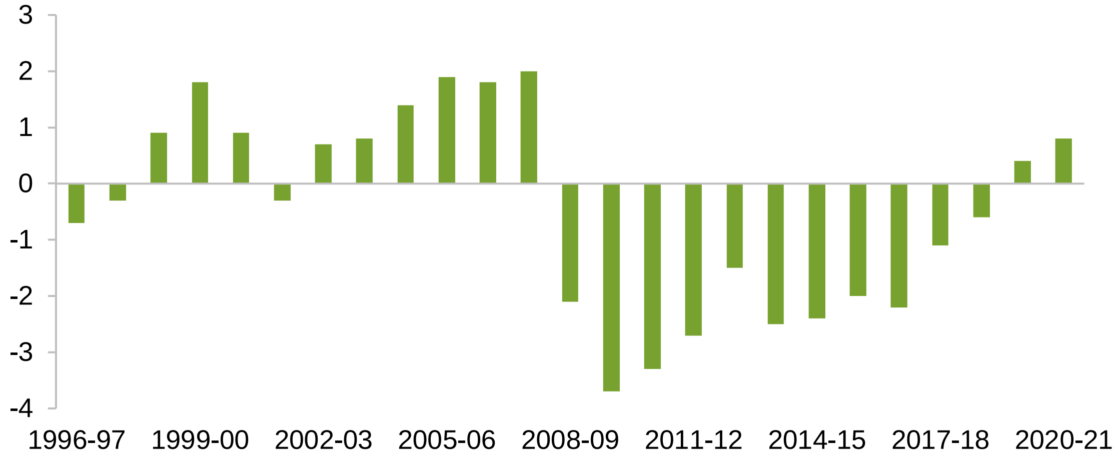
Current fiscal circumstances vary widely across jurisdictions and reflect differences in industry structures and tax bases as well as approaches to budget management.

The Commonwealth's expenditure is almost double that of the States and Territories ($429 billion in 2015-16, compared to $237 billion) (Australian Government 2017a, 2017c), thus its fiscal circumstances have a major bearing on overall national outcomes.

The Commonwealth has been running budget deficits since 2008-09 (figure 1). As a result, the ratio of Commonwealth net debt to GDP has gone from -3.3 per cent in 2007-08 to a projected 18.6 per cent in 2016-17.

Figure 1 **Commonwealth Net Operating Balance[a]**

Per cent of GDP




[a] Data for 2016-17, 2017-18 and 2018-19 are estimates. Data for 2019-20 and 2020-21 are projections.

*Source*: Australian Government 2017a.

The national net debt position has shifted from -6.8 per cent of GDP in 2007-08 to 21.2 per cent (est.) in 2016-17, 88 per cent of the latter generated by the Commonwealth. At this stage, the Australian Government is seeking to return to a surplus position in 2020-21.

The Commonwealth’s surplus target has been revised five times since the 2010-11 budget. In recent years, the worsening in the Commonwealth’s fiscal balance has significantly reflected over-optimism embedded into a system that inherently favours a return to past performance after a shock (box 11). A consequence has been that at times both revenue and expenditure forecasts have been astray and persistent borrowing has been required.

The Budget has not been helped by the national tax system, considered to be one of the most complex in the world and increasingly under pressure from structural factors such as technological change; highly mobile investment and multinationals’ intra-firm purchasing and lending arrangements; and greater international labour mobility (box 12).

Ultimately, economic forecasts are simply a basis for constructing budgets and one way of assessing the contingencies to which policy might need to respond. As discussed in chapter 6, a key question, given the persistent uncertainty of revenue forecasts, is whether expenditure can be subject to better mechanisms that heighten the likelihood of targets being met and longer-term pressures being prudently managed. The remainder of this section provides background information on fiscal management disciplines discussed in the chapter.

## Fiscal strategies

Governments have been making efforts to ensure public finances are on a sustainable track, with States and Territories generally having more success than the Commonwealth.

A distinction between most States and the Commonwealth is that the former have specific fiscal targets (table 1). The types of targets adopted vary from jurisdiction to jurisdiction but typically limit growth in expenses and net debt to specific or calculable levels. Every State except Queensland and Western Australia achieved their fiscal target either at or within the target time frame.

## Box 11 Commonwealth budget forecasts

Projections of the federal budget position have been optimistic in recent years (figure 2). In part, this is the result of the economic forecasting methodology. A key assumption of this methodology is that nominal Gross Domestic Product growth converges to its long-term trend within five years after the forecast period (first two years after the Budget year). Where actual GDP falls short of this expectation, there will be lower than forecast government revenues and a worsening budget position. According to the most recent review of the budget forecasting methodology:

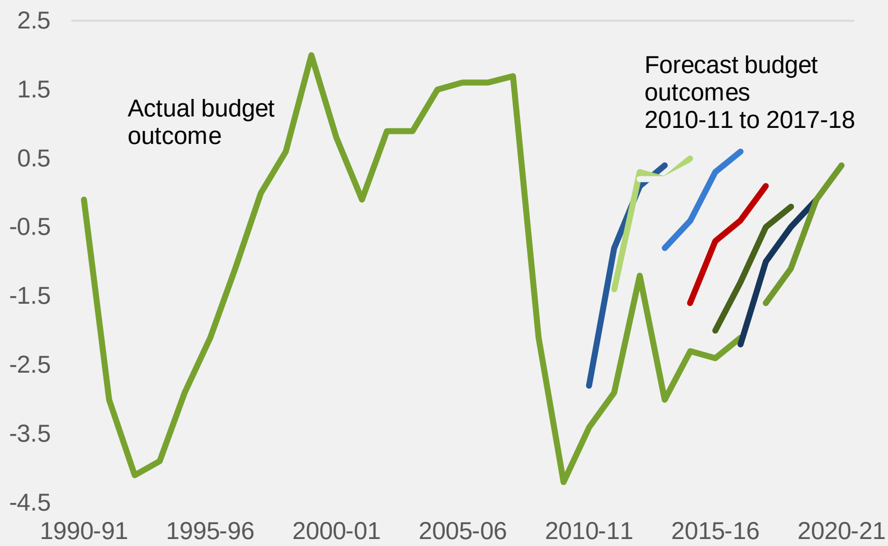
> Treasury's approach is likely to generate reliable forecasts at times when economic conditions are normal but will be challenged at other times. By construction Treasury's forecasts are weighted toward achieving trend-like, consensus outcomes. This increases the risk of persistent errors being made in Treasury's forecasts. Errors at turning points are almost inevitable. (Tease 2015, p. 5)

The Parliamentary Budget Office has observed that deteriorations in the Commonwealth's budget position have predominantly reflected over-optimism in forecast revenues (PBO 2016). The Federal Treasury has reported that this reflects difficulties in forecasting both the real and nominal economy in the wake of the Global Financial Crisis, and domestic and international changes in the structure of economies (Australian Government 2012).

In response to several reviews since 2005, the Treasury has continued to refine its forecasting models, develop better information sources and staff capabilities, as well as improve reporting on the sensitivity of central forecasts to assumptions and external events. Comparisons of the accuracy of Treasury's forecasting with that of equivalent agencies in other countries and private forecasters indicate that results are, on average, on par with peers (Tease 2015).

### Figure 2 Underlying cash balance and forecasting errors

Per cent of GDP




*Source*: Australian Government Budget Papers 2010-11 to 2017-18.

## Box 12 Australia’s tax system – expensive and outdated

There are over 100 different Commonwealth taxes, but the majority of revenue is derived from just a few taxes. In 2013-14, 50 per cent of revenue came from personal income tax, 22 per cent from corporate income tax, 15 per cent from the Goods and Services Tax and remainder from other indirect taxes. Australia’s reliance on income tax is projected to increase to close to 80 per cent by 2024-25. States and Territories’ main sources of tax revenue are stamp duties and payroll tax. Local government’s main own source of revenue is municipal rates.

The 2015 *Re:think* Tax White Paper noted that the tax system is performing poorly on core criteria.

***Efficiency***. The economic costs of raising revenue are high and rising due to Australia’s particular mix of taxes. The most costly taxes are considered to be company tax due to the mobility of capital and the relatively high tax rate (30 per cent) and stamp duties, because they have a narrow base, and discourage investment and exchange of property. Company tax provides around 20 per cent of Commonwealth revenue and is estimated to cost 50 cents in reduced welfare for every $1 raised (the marginal excess burden). Stamp duties raise around 22 per cent of revenue for the States, and are estimated to cost around 70 cents for every dollar raised. Lower-cost taxes include consumption and land-based taxes because they are less distortionary and more stable sources of revenues, but these make up only a small proportion of revenue.

Efficiency costs also arise from the reliance of States and Territories on the Commonwealth for a large proportion of their revenue (Supporting Paper 14). The Commonwealth raises around 80 per cent of total tax revenue in Australia. Some states have responded to their limited revenue raising options and rising fiscal pressures by proposing taxes that are likely to be highly costly. For example, South Australia recently announced it intends introducing a levy on its share of liabilities held by Australia’s five largest banks. The distortionary potential consequences of this proposal highlight structural weaknesses in the tax system, and without a change in this structure, incremental tax decisions simply add to the inefficiencies.

***Equity***. Fairness is inevitably a value judgment but, on various levels, the system is unsatisfactory. On vertical equity — current rate structures are likely to result in taxpayers facing higher average tax rates over the next decade, largely due to tax thresholds not keeping up with inflation or wages growth (bracket creep). While bracket creep exists because of the progressivity of the personal income tax system, it affects lower and middle income earners proportionally more than higher income earners. For example, an average ordinary full time wage earner in 2013-14 was subject to an average tax rate of 22.7 per cent, and is expected to face an average rate in 2023-24 of 27.4 per cent. In contrast, someone with half that income would have faced an average tax rate of 10.3 per cent in 2013-14, increasing to 17.8 per cent by 2023-24. Bracket creep also erodes the rewards for effort over time and can affect workforce participation, particularly for those with lower levels of income.

(continued next page)

Box 12 **(continued)**

***Simplicity***. Australia's tax system is regarded as one of the most complex in the world, partly reflecting the desire to keep up with complex global business models and tax planning, but also reflecting 'new treatments and concessions added in a piecemeal fashion, usually to assist a particular group or otherwise correct for un-intended outcomes'. The costs of complexity are not trivial; Commonwealth tax administration and compliance costs alone are estimated to cost over $43 billion a year (of which compliance costs are $40 billion); in addition, the time and resources devoted to tax planning are estimated to be very large.

Australia has a relatively low overall tax burden compared to other countries. However:

- Australia relies more on corporate and personal income tax than other developed countries.
- Corporate and income tax rates are among the highest in the developed world and significantly higher than some key regional competitors.
- Australia has a lower reliance on consumption taxes (a more efficient tax) than most developed countries.

*Sources*: Australian Government 2015b; Murphy 2016.

At the Commonwealth level, the framework for budget discipline is based on a legislated Charter of Budget Honesty (in place since 1998), which provides principles for the development of fiscal strategies.

The Government's current fiscal strategy seeks the achievement of fiscal surpluses, on average, over the economic cycle, including through reducing the ratio of payments to GDP and stabilising and then reducing net debt over time.

The Commonwealth has relaxed its fiscal strategies over the years (box 13). In part, this may reflect that unforeseen events have prevented commitments being achieved. But it has also softened the discipline that the strategies may once have imposed on aggregate expenditure.

Fiscal targets are not prerequisites for achieving fiscal sustainability. And they are, by nature, crude tools. There is no neutral answer to the question of the optimal size of government, and shocks may occur that prevent achievement of targets. But credit ratings affect the cost of debt, and large debt positions increase vulnerability to shocks, so the size of debt — which need not necessarily correlate to the current size of government, of course — cannot be ignored.

Table 1 **Jurisdictional fiscal strategies 2017-18**[a]

| *Jurisdiction* | *Fiscal targets* | *Compliance reporting requirement* | *Is target being met* |
|---|---|---|---|
| *Australian Government* | *Budget surplus on average over the course of the economic cycle. Reduce payments to GDP ratio over time. Stabilise and reduce net debt over time. Achieve budget surpluses of a least 1 per cent of GDP as soon as possible.* | *Yes* | *No* |
| *New South Wales* | *General government expense growth less than average long run general government revenue growth. Eliminating unfunded super liabilities by 2030.* | *Yes* | *Yes* |
| *Victoria* | *Sustainable general government sector net debt to Gross State Product ratio over the medium term. Fully fund super liabilities by 2035. Net operating surplus consistent with sustainable general government sector net debt level over the medium term.* | *Yes* | *Yes* |
| *Queensland* | *Ongoing reductions in general government sector debt to revenue ratio. Target operating surpluses to fund general government sector capital investment through recurrent revenue. Keep general government sector own-source revenue below 8.5 per cent of nominal Gross State Product. Growth in full-time public employment not to exceed population growth.* | *Yes* | *Partial* |
| *South Australia* | *Achieve general government sector net operating surplus every year. General government sector expense growth limited to household income growth. Maximum ratio of general government sector net debt to revenue of 35 per cent.* | *Yes* | *Yes* |
| *Western Australia* | *General government sector expenditure growth limited to revenue growth. Cash surplus from general government sector operating activities of at least 50 per cent of infrastructure spend and 5 per cent of receipts for the total non-financial public sector. Total non-financial sector net debt at or below 55 per cent of revenue.* | *Yes* | *Mostly No* |
| *Tasmania* | *General government annual expense growth less than average long run revenue growth. Servicing cost of general government debt and superannuation liabilities less than 6 per cent of general government cash receipts.* | *Yes* | *Yes* |
| *ACT* | *Achieve an operating balance over the medium term.* | *Yes* | *Yes* |

(continued next page)

Table 1 **(continued)**

| *Jurisdiction* | *Fiscal targets* | *Compliance reporting requirement* | *Is target being met* |
|---|---|---|---|
| *Northern Territory* | *Achieve general government sector net operating surplus (so general government capital investment funded through revenue rather than borrowing) over the medium term. Maintain general government infrastructure spending consistent with depreciation expense over the medium term. Maintain a competitive tax environment. Net debt as a percentage of revenue returns to long-term average of 40 per cent.* | *Yes* | *Mostly No* |

**a** Fiscal strategies relate to 2017-18 budgets except with respect to Western Australia. The latter's strategy is based on its 2016-17 budget.

*Source*: Jurisdictional Budget Papers.

## Box 13 Evolution of Commonwealth fiscal strategy

| Budget year | Budget outcome (Percentage of GDP) | Net debt (Percentage of GDP) |
|---|---|---|
| 2007-08 | 1.7 | -3.3 |
| 2008-09 | -2.1 | -0.8 |
| 2009-10 | -4.2 | 3.8 |
| 2010-11 | -3.4 | 6.5 |
| 2011-12 | -2.9 | 10.4 |
| 2012-13 | -1.2 | 10.5 |
| 2013-14 | -3.0 | 13.3 |
| 2014-15 | -2.3 | 15.3 |
| 2015-16 | -2.4 | 18.5 |
| 2016-17 | -2.1 | 18.6 |
| 2017-18 | -1.6 | 19.5 |

**2007-08**

**Fiscal strategy**

- Maintain budget balance, on average, over the course of the economic cycle
- Maintain budget surpluses over the forward estimates period
- Not increasing the overall tax burden from 1996-97 levels
- Improve the Government's net worth over the medium to longer term

**2008-09, 2009-10, 2010-11, 2011-12**

**Fiscal strategy**

- Achieve budget surpluses, on average, over the medium term*
- Keep taxation as a share of GDP, on average, below the level of 2007-08
- Improve the Government's net financial worth over the medium term

**2012-13, 2013-14**

**Deficit exit strategy****

- Hold real growth in spending to 2% a year until the budget returns to surplus

**2014-15, 2015-16**

**Fiscal strategy**

- Achieve budget surpluses, on average, over the course of the economic cycle
- Reduce ratio of payments to GDP
- Pay down debt by stabilising then reducing Government securities on issue
- Improve net financial worth over time

**Budget repair strategy**

- Deliver budget surpluses building to at least 1% of GDP by 2023-24
- Offset new spending measures with spending reductions elsewhere

**2016-17, 2017-18**

**Fiscal strategy**

- Achieve budget surpluses, on average, over the course of the economic cycle
- Reduce ratio of payments to GDP
- Stabilise then reduce net debt over time
- Improve net financial worth over time

**Budget repair strategy**

- Deliver budget surpluses building to at least 1% of GDP as soon as possible
- Offset new spending measures with spending reductions elsewhere

**Note:** Budget outcome figure refers to underlying cash balance as per cent of GDP. Net debt figure is per cent of GDP. Data for 2016-17 and 2017-18 are estimates

* In 2009-10 the fiscal strategy involved achieving budget surpluses, on average, over the course of the economic cycle.

** There was no deficit exit strategy in 2008-09.

*Source*: Australian Government Budget Papers (various years).

There are risks on the upside (over-reaching the target) as well as the downside. The Business Council of Australia has noted that the number of countries with fiscal rules (impliedly specific limits, which it advocates) has grown from six in 1985 to 85 in 2014 (BCA 2017). Supported by transparent accounting and monitoring, the adoption of more specific targets could be a useful public policy tool to help alert the parliament to developing imbalances.

Recent changes to fiscal reporting by the Australian Government have sought to improve transparency and align federal budget reporting with approaches in the States and Territories. Specifically, the Treasurer announced that the 2017-18 budget would begin reporting the net operating balance — a measure of revenues less expenditures (including depreciation). Unlike the traditional cash balance measure, the net operating balance does not include net new capital investment, such as infrastructure or defence spending, and provides a better indication of whether the government is meeting its recurrent obligations from its annual revenues. The Treasurer noted that this change would bring the Australian Government into line with the States and Territories and key international counterparts like New Zealand and Canada. (Morrison 2017).

CONCLUSION 15.6

Supported by credible budget parameters and transparent accounting, the adoption of fiscal targets by the Australian Government could help budget management.

## Budget parameters

Concerns about optimistic budgets (box 9) have raised concerns about the independence of advice given to the Australian Government on economic forecasts. For example, both the chief executive of the Grattan Institute and a former Reserve Bank Board member have recently suggested that Treasury's forecasting function should be moved to an independent body to improve accuracy and transparency (Potter 2017). The Commission notes, in the first instance, that forecasts underpinning revenue and expenditure projections are determined by the Government on the advice of the Treasury, rather than being independently set. As such, the question is whether there would be merit in removing responsibility for setting budget parameters from the government.

In principle, as budgets inherently reflect the priorities and commitments of the government of the day, removing responsibility for budget forecasting from governments would seem to be unhelpful in holding them to account for outcomes (that is, there is a risk of externally-produced forecasts being blamed for results rather than there being a focus on the fiscal strategies devised by governments in response to these necessarily indicative parameters).

There is little evidence to suggest that economic forecasts would be substantially more reliable if undertaken by another party, assuming current efforts by the Treasury to improve its systems and methods are implemented. And Treasury's role in providing advice on economic conditions to the Treasury Secretary[4] and Government would presumably require a retention of forecasting capabilities, which would mean that shifting the forecasting function would result in duplication of forecasting systems across Treasury and the new forecasting body.

## Better understanding the underlying drivers of budgets

Fiscal pressures are anticipated to increase with demographic change. Chapter 2 discussed the need for a longer horizon (10 years) for the reporting of the projected impacts of selected major programs to better inform decision-making, and the merits of a whole-of-nation intergenerational report (IGR). Further information on the latter is contained in box 14.

### Box 14 **Intergenerational Report**

The Intergenerational Report (IGR) was established under the *Charter of Budget Honesty Act 1998* primarily to raise public awareness about the budgetary challenges associated with an ageing population. The Act stipulates that the IGR is to be produced every five years. The latest report was published in 2015, and followed reports in 2002, 2007, and 2010.

The IGR assess the long-term sustainability of current Government policies and how changes to Australia's population, age profile and other factors may impact on economic growth, the labour force and public finances over the coming 40 years. The report presents projections of a range of economic and fiscal variables based on a set of simplifying assumptions, which include no change to current stated government policy settings. As noted in the most recent report:

> All projections are inherently uncertain particularly over long timeframes. … The projections of the budget position take into account how [government] spending per person is likely to change for different age groups based on current policy, and then uses the expected structure of the population to work out total spending, which in turn can be used to work out the overall budget position over the next 40 years. (Australian Government 2015a, p. xxv)

The Charter of Budget Honesty Act does not specify the content or the format of the Commonwealth report other than indicating that it is to assess the long term sustainability of current government policies.

Several commentators and participants have suggested shifting responsibility for IGRs at the federal level from Treasury to the statutorily independent Parliamentary Budget Office (PBO) for example (Daley 2015; OECD 2012; Pearson 2015; Watt, D and Anderson 2017). This would help to ensure that the IGR is a non-partisan report and help practically in achieving a consolidated view of governments' fiscal sustainability.

4 Particularly to support the Secretary in their role as a member of the central bank board.

A shift in responsibility for the IGR to the PBO would require that office to be able to make long-term projections. This could be helped (and duplication avoided) by the sharing of some aspects of budget forecasting systems with Treasury, as occurs in the United Kingdom.

## Is there a case for greater independence in monitoring and supervision?

At a broader level, a number of countries have introduced Independent Fiscal Institutions (IFIs) to provide greater transparency in fiscal policy making (Koptis 2011). The functions vary from country to country but can include assessing compliance with fiscal rules or targets, macro-fiscal evaluation, sustainability of public finances, forecasting economic and budget outcomes, costing policy proposals and formulating fiscal policy advice. A comparison of the functions of selected IFIs is presented in table 2. More detail on the operation of three of the institutions is at box 15.

Although they may undertake different functions these institutions share common features. They are all responsible for forward-looking analysis and assessment of budget-related bills or other legislative provisions in the fiscal area (including consistency with fiscal rules or targets, where they exist). They perform real-time costing and forecasting to determine the fiscal consequences of policies. They have no decision-making authority and no power to enforce fiscal rules or targets. Apart from these common attributes, the design, structure and role of IFIs has reflected the particular circumstances and needs of each country. In the words of the OECD:

> … in each case there are features [of IFIs] that are specific to each country's needs, legal traditions and initial historical context at the time of establishment. These features, of course, evolve over time, as the institution acquires experience. (Koptis 2011, p. 3)

Table 2 **Functions of independent fiscal institutions**

Selected countries

| *Country* | *Institution* | *Year established* | *Functions* | | | | |
|---|---|---|---|---|---|---|---|
| | | | Compliance | Evaluation | Sustainability | Costing | Advisory |
| United States | Congressional Budget Office | 1975 | | X | X | X | |
| Netherlands | Central Planning Bureau | 1986 | Rules | X | X | X | |
| Belgium | High Council of Finance | 1989 | Targets | X | X | | X |
| Korea | National Assembly Budget Office | 2003 | | X | | X | |
| Sweden | Fiscal Policy Council | 2007 | Rules | X | X | | X |
| Canada | Parliamentary Budget Officer | 2008 | Targets | X | | X | |
| Hungary | Fiscal Council (former) | 2009 | Rules | X | X | X | |
| United Kingdom | Office of Budget Responsibility | 2010 | Targets | X | X | X | |
| Australia | Parliamentary Budget Office [a] | 2012 | | X | X | X | |

[a] Australia's Parliamentary Budget Office may research and report on matters relating to the budget cycle, fiscal policy and financial implications of proposals, but it is not directed to do so under its legislation.

*Sources*: Koptis 2011, *Parliamentary Service Amendment (Parliamentary Budget Officer) Act 2011* (Cth).

There do not appear to be features of other independent fiscal institutions that should clearly be imported to Australia. The legislation establishing Australia's PBO provides considerable flexibility with respect to its functions, including that the PBO can, on its own initiative, research and analysis of fiscal policy settings. We have suggested in the Report that the PBO be explicitly requested to annually monitor the ability of budgets to achieve (more specific) fiscal targets (Recommendation 2.3), and this measure is consistent with its remit.

One notable difference between the PBO and some other IFIs is that it must use the Government's official economic and budget forecasts in the conduct of its functions and is prevented from developing its own forecasts and fiscal parameters (though it may comment on the Government's). This contrasts with the arrangements in the United Kingdom, where the Office of Budget Responsibility produces its own medium-term economic and fiscal forecasts. (As discussed above, the duplication of budget forecasting tasks in Treasury and the PBO seems unlikely to offer significant net benefits).

Recent reviews of the PBO have concluded that it has been a successful institutional development in Australian governance and is a trusted and independent source of budgetary and fiscal policy analysis that has filled a significant gap in Australia's public policy landscape (ANAO 2014; Watt and Anderson 2017). In terms of improvements, the recommendations from these reviews have largely focused on operational issues (in areas such as priority setting and the accuracy of timeliness of policy costings), aside from a recommendation to shift responsibility for the IGR from Treasury to the PBO (see above).

At a jurisdictional level, New South Wales introduced its own parliamentary budget office in 2010 but its role is restricted to providing election policy costings and budget impact statements of all costed policies. The NSW PBO operates in the lead-up to general elections but remains inactive at other times. Victoria recently announced a similar agency, but with a wider remit that covers election and general policy costings and the provision of technical assistance to members of parliament on matters of fiscal and financial policy. Unlike NSW, the Victorian PBO will operate throughout the term of parliament (Pallas 2016).

## Box 15 Independent fiscal institutions

Internationally, specialist budget agencies such as Australia's Parliamentary Budget Office are collectively known as Independent Fiscal Institutions (IFIs). Most have a role in preparing or assessing macroeconomic assumptions and analysing long-term fiscal sustainability. Of the 17 IFIs in OECD countries, those in Australia, Canada, Korea, Mexico, the Netherlands and the United States have no mandated role in monitoring compliance with fiscal rules (although Australia's PBO is not prevented from doing so and the United States' Congressional Budget Office reports against the Statutory Debt Limit); two have no role in producing macroeconomic assumptions (Australia and the Slovak Republic); and only two prepare election policy costings (Australia and the Netherlands). A brief description of selected independent fiscal institutions is presented below.

### United Kingdom

The United Kingdom Office of Budgetary Responsibility (OBR) was created in 2010 to provide independent analysis of UK public finances. The OBR's main roles involve 5 year economic and fiscal forecasting to accompany the UK Budget, evaluation of the government's performance against its fiscal targets, assessing the long-term sustainability of public finances (a similar function to Australia's Intergenerational Report), analysing the public sector's balance sheet, evaluating fiscal risks and scrutinising the UK Treasury's tax and welfare policy costings at each budget. The OBR has a corporate structure with board oversight. The OBR operates under a Charter for Budget Responsibility, which proscribes the organisation from commenting on or assessing the particular merits of government policy.

### United States

In the United States, the Congressional Budget Office was established in 1974 to provide independent analysis, costings and projections of budgetary and economic outcomes over a 10 year time horizon to support the Congressional budget process. These reports compare current with historical projections, compare the official economic forecast with those of other forecasters and show budgetary effects of alternative policies. Longer term forecasts out to 30 years model the effects of demographic trends, economic developments and rising health care costs on federal expenditure, revenue and deficits. The Congressional Budget Office also provides cost estimates of nearly all bills approved by Congressional committees.

### Australia

The Parliamentary Budget Office is a statutory, independent government agency established under the *Parliamentary Service Act 1999*. The PBO commenced operations in July 2012. Its role is to provide independent analysis of the budget cycle, fiscal policy and the financial implications of policy proposals. However, under the legislation, the functions of the PBO do not include the preparation of economic forecasts or budget estimates (whether at the whole-of-government, agency or program level). The PBO's legislation explicitly directs it to use the economic forecasts and parameters and fiscal estimates contained in the most recent relevant reports including the Budget Report, Intergenerational Report and Post-election Economic and Fiscal Outlook Report.

*Sources*: *Parliamentary Service Act 1999*, ANAO 2014; Frankel 2011.

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