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Executive Director's Note

Welcome to the thirty sixth issue of *Economic Issues*, a series published by the South Australian Centre for Economic Studies as part of its Corporate Membership Program. The scope of Economic Issues is intended to be broad, limited only to topical, applied economic issues of relevance to South Australia and Australia. Within the scope, the intention is to focus on key issues – public policy issues, economic trends, economic events – and present an authoritative, expert analysis which contributes to both public understanding and public debate. Papers will be published on a continuing basis, as topics present themselves and as resources allow.

The contributors are **Professor Gary Banks AO**, Dean of the Australia and New Zealand School of Government and **Professor Gary L Sturgess AM**, NSW Premier's ANZSOG Chair of Public Service Delivery, University of New South Wales.

In the first paper, Professor Gary Banks AO, reinforces the importance of pro-productivity, pro-competitive policies to achieve higher incomes and associated government revenue to allocate to social programs. In examining the "drivers and enablers" to improve productivity performance he stresses the requirement for good policy-making processes – as time well spent – for informed decision-making, to maximise public trust and to develop a shared understanding of sensible and necessary proactive policy.

In the second paper, Professor Gary Sturgess AM, first argues that we need to view the public services sector "as an economy" in its own right – with a demand and supply side – and from that standpoint it is highly instructive to view how public services are delivered by front line staff and management, compared to the policy-maker and the "guidelines for policy implementation". He presents a way of re-thinking the role of the public sector and hence potentially new ways to benchmark and measure productivity. Contestability through strategic commissioning and the threat of competition are essential for diversity and innovation in service delivery.

The views expressed in the report are the views of the authors.

Michael O'Neil
Executive Director
SA Centre for Economic Studies
April 2013

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South Australian Centre for Economic Studies: 30th Anniversary

Overview

On Friday, 22nd March 2013 the South Australian Centre for Economic Studies (SACES) held a business luncheon to thank as many people as possible who have supported SACES since its establishment in 1982.

Over the 30 odd years we have had on-going support from the South Australian Government, from all political parties, from government agencies and businesses across all sectors of the economy. The Corporate Membership program has enabled the production and publication of the now bi-annual Economic Briefing program. It is SACES "flagship publication" – always independent and dispassionate about the current state of the economy, future prospects and possible policy options.

The occasion was also an opportunity to acknowledge those individuals from the two Universities, the Chairs of our Executive and Management Advisory Committees, members of those Committees, former staff of the Centre and many other who have contributed to the organisation. We thank you all for your support.

The Economic Issues Paper series – now number 36 publications – are meant as a contribution to public policy debate and discussion. This Economic Issues paper includes the speeches of our two guest speakers on the day, Professors Gary Banks AO and Gary Sturgess AM. There is much "food for thought" in each of the papers.

Public Policy in the 21st Century: Remembrance of Things Past

Gary Banks
Dean, The Australia and New Zealand School of Government

"Those who cannot remember the past are condemned to repeat it."
(George Santayana, Life of Reason)

Introduction

At the dawn of the 20th century, Australia's economic future looked very bright. Our per capita GDP was the highest in the world – the product of abundant natural resources that the rest of the world valued highly. We were indeed a 'lucky country,' riding confidently into the future on 'the sheeps' back': two metaphors that have become embedded in Australia's historical narrative.

As is also well known, this comfortable position was not to last. In the pursuit of what might today be called 'spreading the benefits', our governments created institutions and implemented policies that ultimately eroded this country's capacity for sustained economic growth. In short, we became an increasingly regulated society – but regulated in ways which supported poor performance, robbed incentive and suppressed innovation.

As a result, Australia's relative productivity performance was weakened – as was per capita growth in GDP and incomes and, in turn, the capacity to support a welfare system that was nevertheless becoming more expansive.

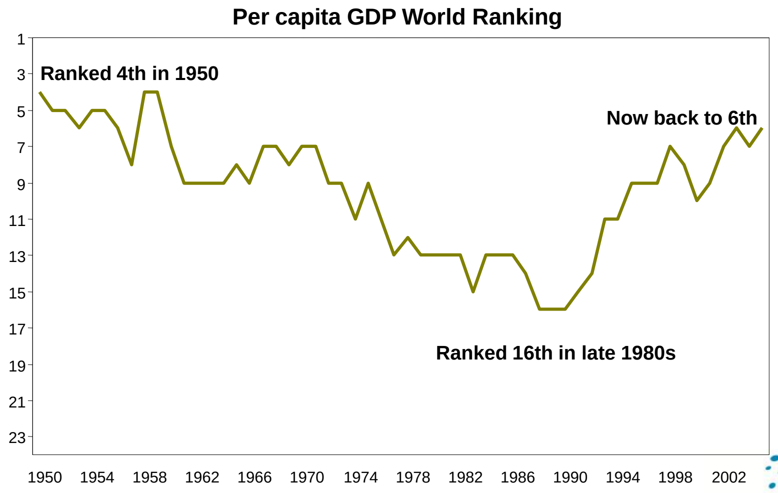
By the 1980s, Australia's position in world 'prosperity' rankings had declined greatly. Our lack of competitiveness, burgeoning external and fiscal imbalances, with mounting inflation, led to Treasurer Paul Keating's celebrated comparison of Australia with certain tropical fruit-growing countries in Latin America (with some of whom we had shared top billing early in the century).

Australia's subsequent structural reforms and the (consequent) turnaround in our economic performance have been well documented and internationally recognised particularly within the OECD and IMF.

But have the lessons of our decline and rise been sufficiently well learnt at home? A decade into this new century, it is possible to hear an echo of our distant past – in which surging terms of trade and resource-based wealth breed complacency and even negligence in public policy, with the danger once again of us squandering what has been an excellent starting point.

If we are not, therefore, to provide further empirical support for Santayana's maxim (the header quotation for this paper) with the adverse consequences for the next generation that follow from it, we must take corrective policy action, and we must do so sooner rather than later.

Australia's economic ranking declined … and rebounded



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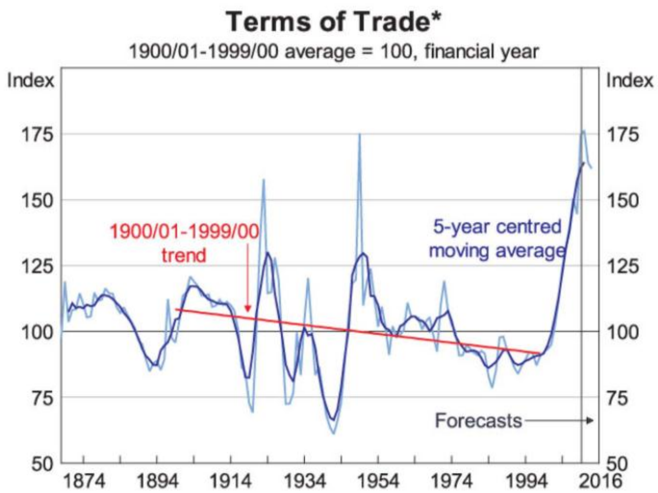
Our biggest boom (and smallest bust?)



* RBA estimates for 2011/12 onwards
Sources: ABS; Gillitzer & Kearns (2005); RBA

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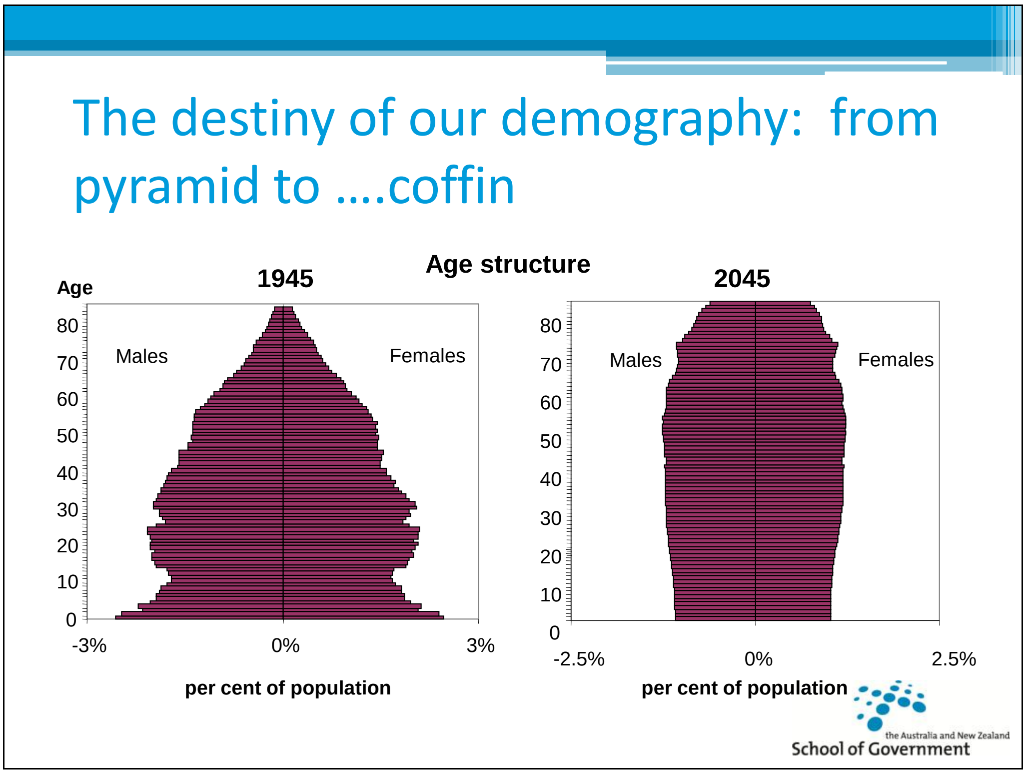
The challenges

The challenges facing our society and economy in the 21st century are arguably at least as great as they were in the 20th. To the ongoing competitive pressures and opportunities of globalisation and the Information Revolution – among others – are being added new pressures from environmental sustainability and an ageing population, along with rising societal expectations of government as provider of welfare and social services.

Among these, population ageing seems likely to become a defining feature of the century ahead.

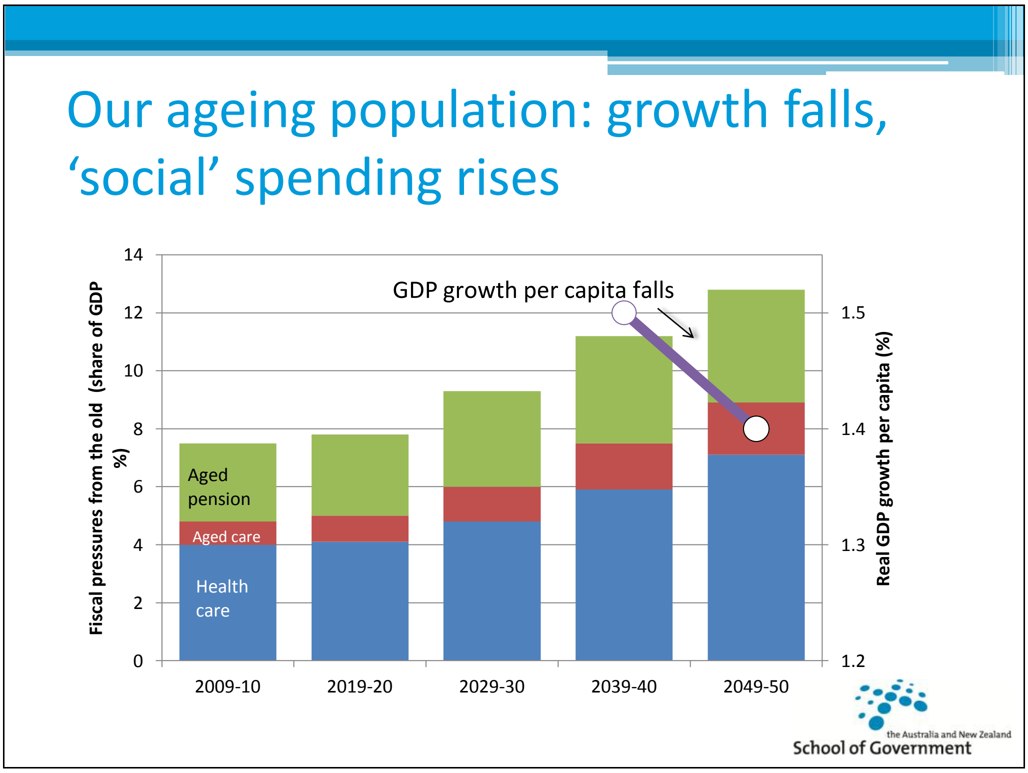


This is not because the forces behind our demographic transformation are *new*. On the contrary, rising life expectancy, which is the main driver of the ageing demographic profile (not lower fertility), has been present for several decades. The difference is that in the latter 20th century its effects were masked by the post war '*baby boom'*.

The long-term economic and fiscal implications of ageing that seized public attention with the release of the first IGR in 2002, have become overshadowed by the fiscal consequences of the Global Financial Crisis and its aftermath. But these more recent cyclical problems have only added to the secular imperatives confronting us.

As you know, these are the consequence of a largely inevitable decline in workforce participation, dragging down per capita growth and taxation revenue – GDP per capita being around $10,000 lower than otherwise by mid-century – at the same time as expenditures on aged care and especially health care accelerate.

The result is fiscal pressure (expenditure growth above revenue growth) that is projected to build up nationally to around 5 percentage points of GDP by 2050, and quite considerably more – a situation made more difficult by our adverse fiscal position in 2013 relative to what it was when the first IGR appeared.



Of course, these are projections, not forecasts – and thus they don't allow for mitigating policy actions. The policy choices confronting governments in this regard have not changed.

Policy responses

There are essentially two broad stances that could be adopted, the reactive and the proactive.

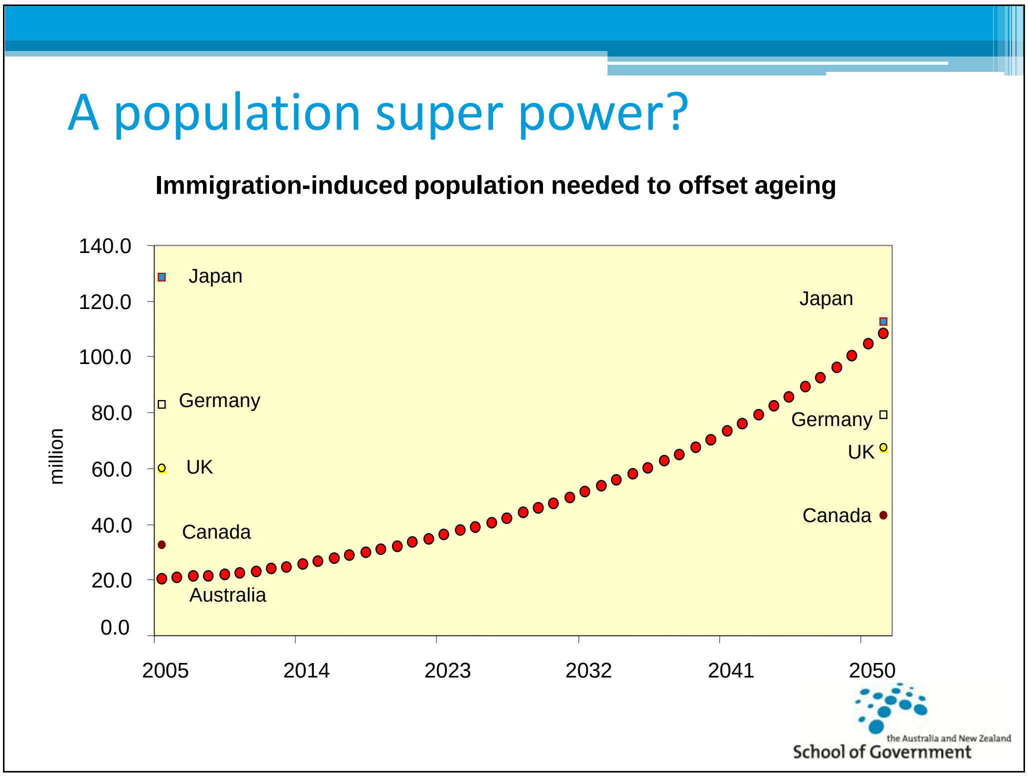
Reactive policies, such as borrowing more or taxing more to cover the widening gap between expenditure and revenue, are likely to be unsustainable, at least as major ongoing measures. According to earlier Productivity Commission calculations, if the fiscal gap were progressively debt financed, then by 2044-45, borrowings would need to reach some $5.4 trillion (that's trillion not billion) or double our then GDP, or if the gap were to be tax-financed, average tax rates would need to rise by around 20 per cent.

Cutting services or reducing service quality would go against the current of public expectations. Greater reliance on user charging has more potential, but it would require that value commensurate with the charges be demonstrated and, in some areas, like healthcare, could subvert the underlying social objectives of public funding.

Cutting the costs of service delivery (raising the productivity of provision) in the public sector has more appeal and ways of doing this will need serious consideration. The ANZSOG sponsored research that my fellow panellist Gary Sturgess is undertaking, into innovative use of private providers and market incentives, occupies this space. It leads us to a wider set of *proactive* policy choices that can more effectively and sustainably address or mitigate the forces at work.

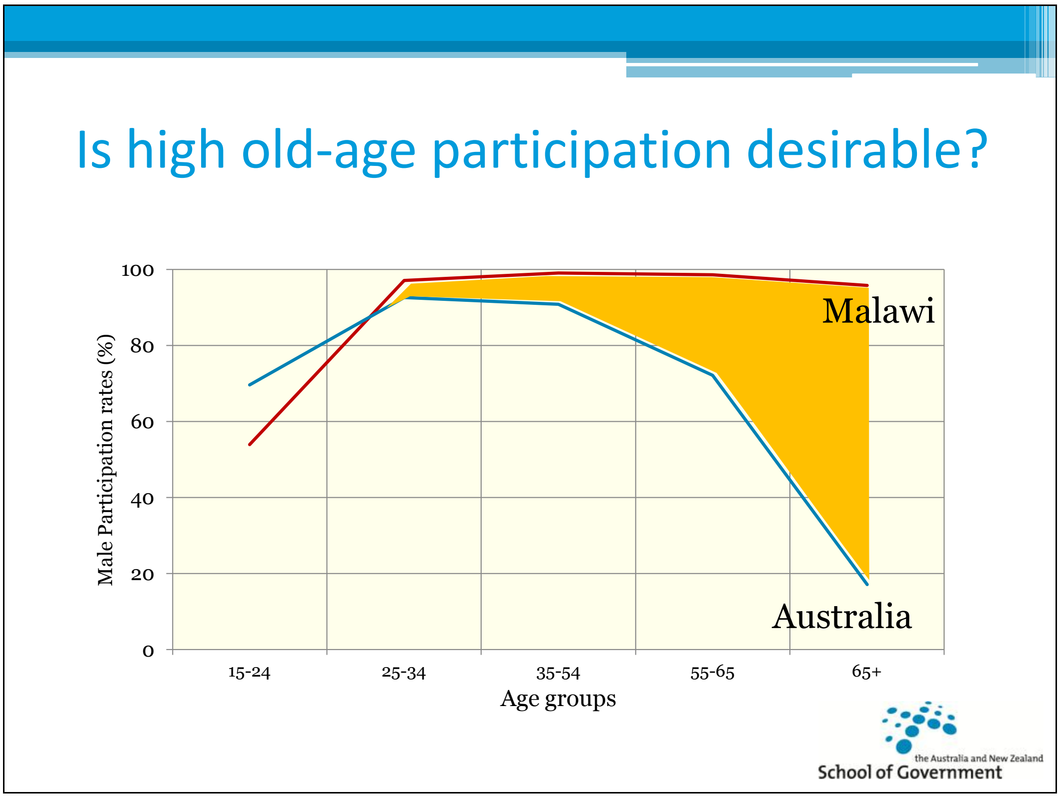
The so-called 3 Ps – population, participation and productivity – have become established as the organising framework for such policy considerations. But for reasons previously elaborated, the first two Ps have limited potential and can be dealt with here in short order.

In the case of *population*, it is important to recall that the main source of ageing is increased life expectancy. If we put aside any notion of reversing that welcome development, we are left with fertility and migration as demographic influences. Any feasible incremental changes to current fertility produced by policy, if indeed these are possible, could not come close to redressing the ageing of our population, as again has been demonstrated by Productivity Commission research. Equally, migration increases that were able to target a younger overall age group can only have a temporary effect unless migration could be sustained at very high rates, the reason being that migrants age too. But this would have implications for our population's size that would dominate the effects on its age. To take an extreme scenario, fully offsetting the forces for ageing would need to involve a net migration rate of around 3½ per cent, five times greater than its already relatively high rate. We would indeed become a 'Big Australia'!



From an economic perspective, migration policy is better directed at raising average skill levels than lowering the average age level. 457 visas and working visas for foreign students graduating from our universities and TAFE colleges have proven to be effective and indeed, despite some recent hyperbole, equitable ways of supplementing the permanent intake. They have also acted as an effective screening device for permanent migration itself.

Offsetting the impact of ageing through policy measures that serve to raise labour force participation (regardless of ageing) is a more promising strategy. And since IGR1 a number of such measures have been introduced, including in relation to pension and welfare (including DSP) eligibility, and wider and deeper education and training. That said, there is a limit to which participation rates can be increased by policy without it effectively involving a degree of 'forced labour' that might serve to increase an economy's output, but at the cost of societal wellbeing. The capacity to stop 'working' in older age is one of the dividends of economic progress.

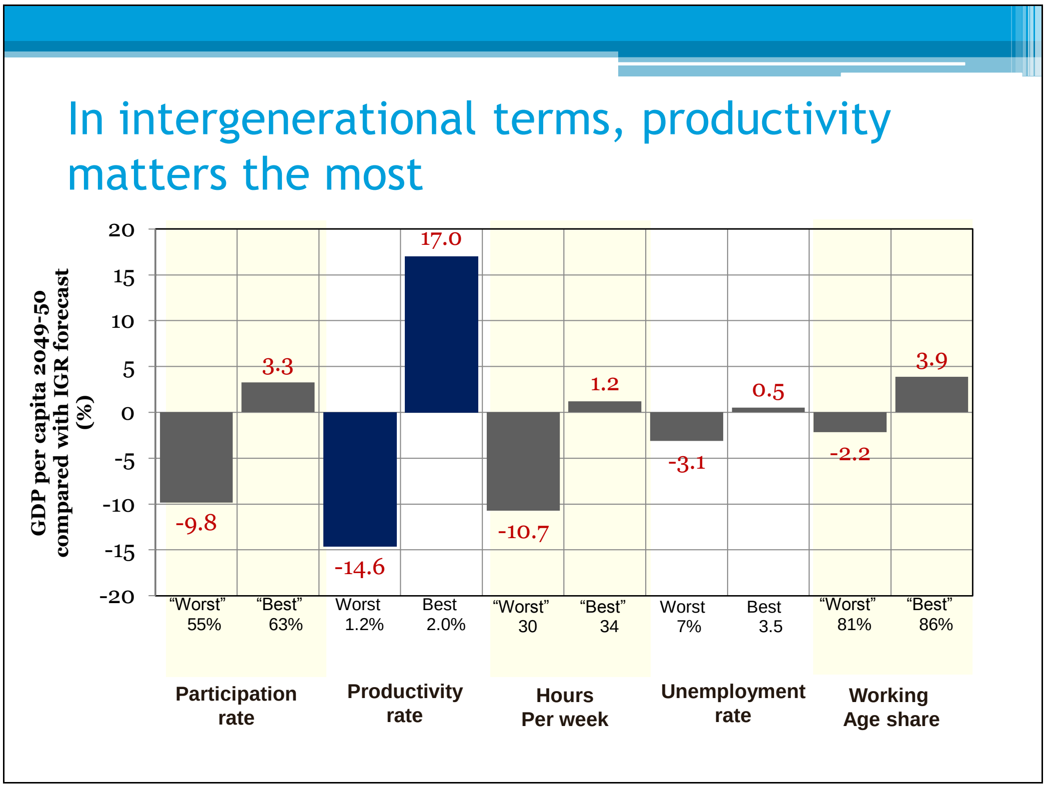


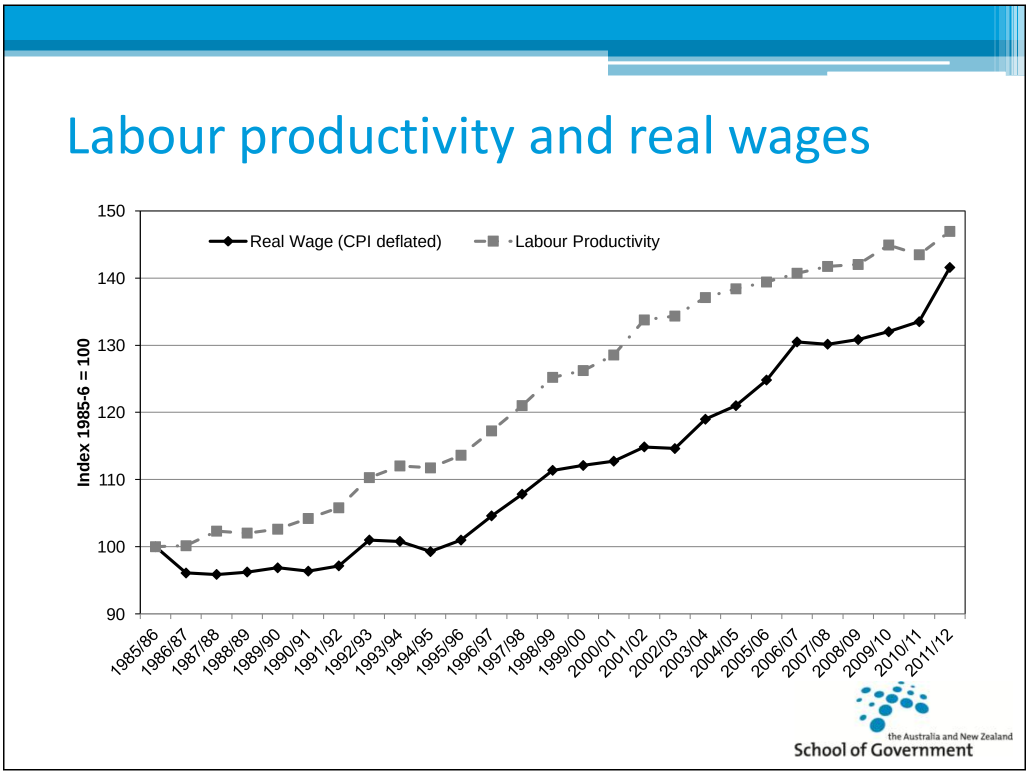
The third P is, of course, productivity. In essence it can be expressed roughly as 'achieving more with less', which sums up the ageing challenge itself. The impacts of productivity growth on GDP, incomes and revenue, unlike the other two Ps, are ongoing and cumulative. The incremental impact of even small differences in average productivity growth for our economy can be significant. For example, looking out to 2050, the difference between the IGR3's base projection for productivity growth of 1.6 per cent and the IGR1 rate of 1.75 per cent amounts to some 6 per cent of GDP.

The importance of productivity

Comparing the differential consequences for future GDP of best and worst case scenarios for each of the three Ps under IGR3, it is apparent that we have much more to lose if productivity growth falls short than if this occurs for population, participation and employment variables. (As Daryl in 'The Castle' might put it: "It's not the hours worked, it's what you do with them".)

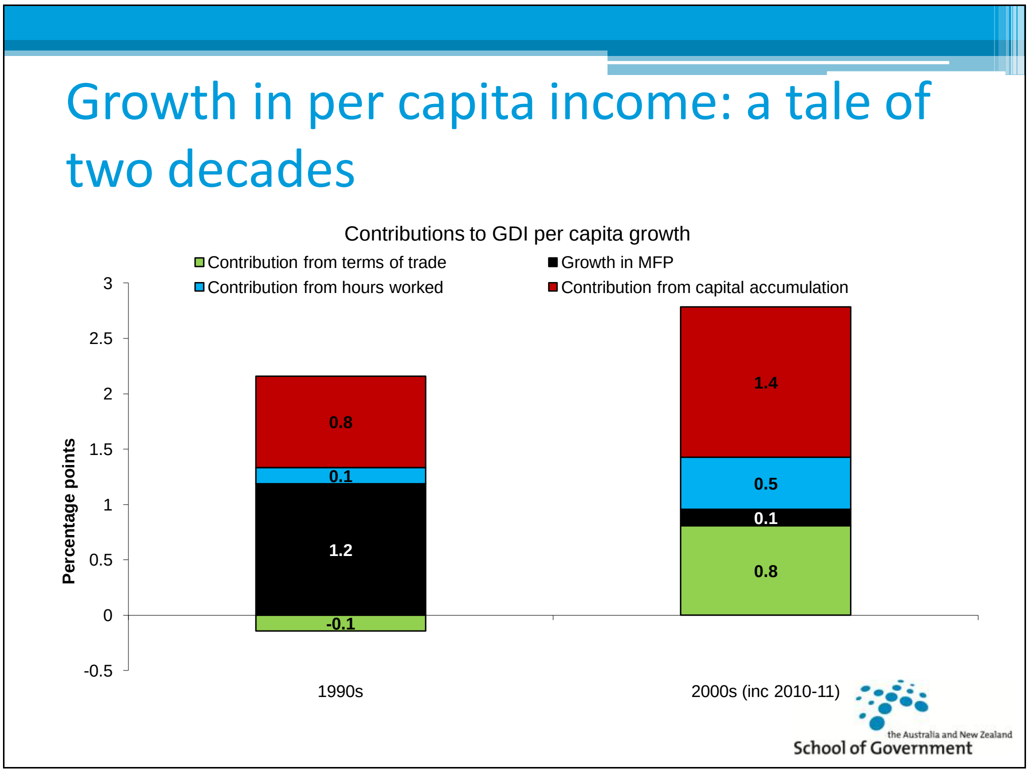
Thus Krugman's aphorism that, in the long run, "productivity is nearly everything" appears well founded according to these projections. And, looking backwards, it has been estimated that around 80 per cent of the per capita growth in incomes in Australia over the past five or six decades is attributable to (labour) productivity growth. Indeed, productivity growth in Australia has supported not only higher wages than otherwise, but also higher employment, contrary to some urban mythology.





It follows that raising our economy's productivity is not something that is desired for its own sake, but rather for the higher incomes it yields the community and for the associated government revenue that makes higher levels of spending on 'unpriced' social programs possible. Productivity growth not only underpins wealth creation, it creates the wherewithal for reducing disadvantage and pursuing other social objectives. No matter what policy challenges lie ahead in the 21st century, the productivity performance of our economy will be a crucial determinant of how well we respond.

That is the long term story. The short-term story is another matter. As is well known, Australia's productivity performance thus far this century has been poor not only by the exceptional standards of the last decade of the last century, it has been poor compared even to our previous mediocre performance. However, it is important to recognise that this did not stop Australia achieving exceptionally high growth in per capita incomes in this period.



That growth was driven by higher foreign prices, not domestic output growth. And the subsequent growth in inputs (investment and workers) to enable production to respond to those rising prices was reflected in lower measured productivity growth in the meantime. In other words (and I am simplifying a more complicated, though now well documented, story) much of Australia's poor productivity performance in the 2000s was related to the adjustment of the economy to our elevated terms of trade, and what followed structurally from that. At least for the period that this can be reliably analysed, to the end of the last "productivity cycle" (2007-8), its origin can be found more in what statisticians would call the "usual suspects" than from failings in public policy or managerial performance. This also means that it is likely to be a temporary phenomenon, at least in part.

The Productivity Commission was considered by some to have been misguided in this evidence-based assessment. But there are signs of vindication emerging in the most recent data, at least for labour productivity. The period of what the Commission has called 'unrequited input growth' may be finally coming to an end.

More important questions for today's purposes have to do with the *extent* of any given recovery from the depressive influence of any 'temporary' factors. There is little cause for optimism that *all* of the decline might be of this character, or that productivity will again rise above its long-term average. For one thing, only one-half to two-thirds of the decline to the end of the last cycle could be 'explained away' analytically. And since then, productivity growth sunk lower (indeed MFP actually became *negative* for the first time on record).

There are also a number of more tangible reasons for being concerned about our productivity outlook. One is that higher cost practices adopted expediently by some firms and industries during the Boom years may have left a legacy that is hard to reverse in these less abundant times. A second is that, while private capital investment in this period is beginning to yield productivity benefits as outputs come on-stream, and this could be expected to continue, some major investments within the public sector – in utility industries such as energy, water and telecommunications in particular - will do so to a lesser degree. Even on broader social cost-benefit grounds, some major investment spending may prove to have been wasteful.

Thirdly, there have been a number of other policy initiatives in recent years, including ones intended to achieve social and environmental ends, that could be deleterious to industry's productivity performance in the years to come. While some of those may have involved trade-offs informed by careful analysis and consultation, some clearly have not.

Given the importance to our future living standards of even small increments to productivity growth, it is crucial that policies with such adverse effects be removed, or at least reformed so as to meet their objectives in less damaging ways. It is also important that any new policies be productivity-enhancing, or at least not damaging to our productivity performance.

Productivity policies

The need for policies and reforms that are 'pro-productivity' has been recognised in both the main parties' policy platforms – with Labor's 'five pillars' to support improved productivity, and the Coalition's 'six point plan'.

The parties' productivity agendas

Labor's 'Five Pillars'	Coalition's '6 point plan'
• Infrastructure • Deregulation	• Infrastructure • Red Tape
• Innovation • Tax • Skills	• Welfare • Public administration • Monopoly power • (Incremental) IR changes

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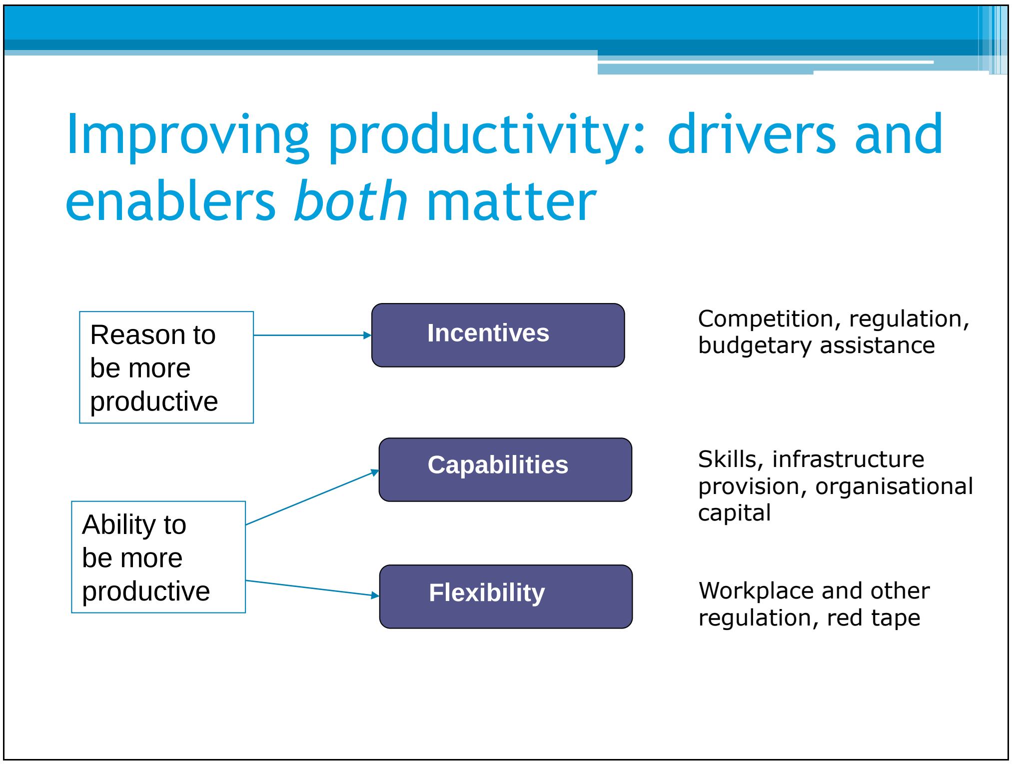
Both identify infrastructure and red tape/deregulation as key elements. Beyond that, there is little explicit overlap, with Labor emphasising innovation, taxation and skills, and the Coalition identifying welfare, public administration, monopoly (or monopsony) power and aspects of industrial relations.

The relevance of these lists is hard to dispute. What is lacking is detail about the specific measures contemplated and why they could be expected to make a difference. More fundamentally, there is no unifying framework into which the items in the list can be considered. And, taken together, little basis for assessing priorities; those policies where the biggest payoffs could be achieved. Moreover, many policies or proposals with economic effects are being described as 'productivity reforms', whether they are likely to enhance it or not.

As a result, public understanding about the need for and nature of the policies and reforms needed to enhance Australia's productivity performance remains confused. And questions remain unresolved about where policy can really help.

This has been evident even in more 'policy literate' communities. At the Prime Minister's Economic Summit last year, a question to RBA Governor Glenn Stevens prompted him to direct people to a 'to do list' of (so far) unimplemented Productivity Commission recommendations. His point was that Commission inquiries had produced a range of evidence-based recommendations that were still 'on the shelf' and, with sufficient political will, could be readily implemented.

These and other policy options for promoting productivity reflect the reality that productivity outcomes at the economy-wide level depend on productivity performance at the enterprise level – by the individual businesses and organisations that comprise our economy. How well they do depends on the incentives each faces to be more productive, their capabilities and their flexibility to deliver. Both the policy 'drivers' and 'enablers' are important.



A key related insight is that productivity growth comes not only from improvements within individual firms, but also from better performers displacing weaker ones, raising the average productivity of industries as a whole. Policies need to have both dimensions in view.

This is the antithesis of most assistance policies that have been identified for reform in the 'incentives' area, such as tariffs, anti-dumping and local sourcing measures, which generally deliver most support to the poorest performers. These were reduced or curtailed during the 'Reform Era' of the 1980s and 90s, but some have been emerging again.

In relation to building capability, which has attracted most policy attention and government expenditure in recent years – particularly for skill development and infrastructure provision – the quality of the spend counts more from a productivity perspective than does its quantity. The lack of cost-benefit analysis and ongoing deficiencies in institutional governance cast significant doubts on the potential productivity dividend from much of this spending.

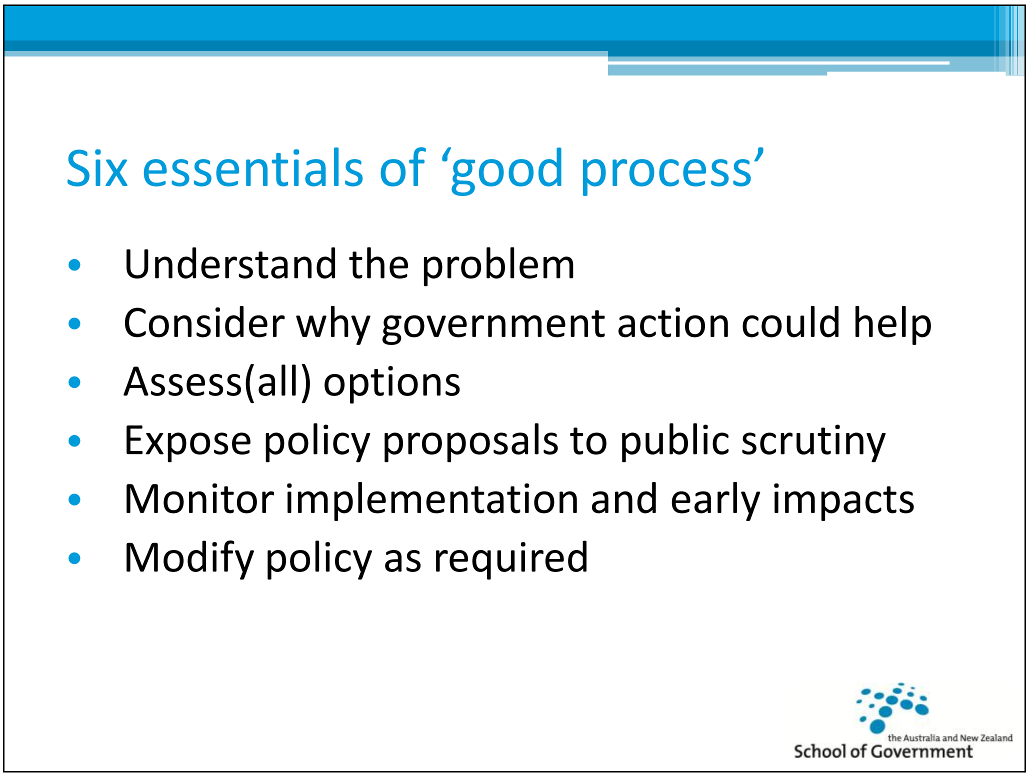
But it is in the third area – the flexibility that firms need to innovate and adjust – where some of the biggest policy challenges currently arise. The problem here, once again, is regulation. Reducing red tape and interjurisdictional regulatory variations that raise transaction costs for firms have been a focus for reform efforts, and may yield significant benefits (particularly for firms operating nationally). But arguably the more costly impediments in the long run are those regulations which constrain or distort management decision-making and the changes in organisational design and work processes needed for all firms to 'meet the market'. Here there has been much less progress and, in some areas, significant backsliding.

The most pervasive potential category of regulation in this respect is industrial relations. Many labour market regulations are both extensive in their reach across the economy and intensive in their influence on managerial discretion and the scope for organisational innovation. The tradeoffs between perceived gains in 'fairness' for certain workers and potential losses in productivity need to be carefully considered. However, this has not been a feature of policy development in this important area.

Considered within the framework of the 'drivers' and 'enablers' of productivity, it seems clear that there is much that government policy can do in all three areas of incentives, capabilities and flexibility. Moreover, there is a need for greater consistency in policy actions across these areas. For example, policies to enhance workforce skills or to promote research and development can have little impact if regulatory constraints prevent managers making the best use of the resulting skills and technology.

'Good process' matters

If Australia is to realise its productivity potential in the 21st century – and achieve the higher living standards and quality of life that depend on that – it is fundamentally important that policy development be attuned to potential impacts on productivity. That practice has been falling short in this respect led me to conclude my last speech as Productivity Commission chairman with a plea for the restoration of good policy-making processes – processes that can achieve clarity about problems, reach agreed objectives and ensure the proper testing of suggested solutions *before* implementation.



This is not a radical idea. The key elements of good process have long been embedded in Regulation Impact Assessment requirements to which all governments have now signed up. The problem, as the Productivity Commission found in a recent review, is that these have been honoured in the breach when it comes to more significant and 'sensitive' policy matters.

Lack of due process needed for informed decision-making weakens public trust in the resulting policy decisions and makes those policies vulnerable to reversal. The ongoing controversies surrounding the recent initiatives in such important policy areas for Australia's future as industrial relations, (mining) taxation, climate change, telecommunications and immigration -- the list goes on – can be attributed in large part to the lack of a shared understanding of the problem or that proffered policy solutions will actually *improve* things.

Perhaps the most important lesson from the Reform Era of the late 20th century for policy in the 21st, therefore, is that time devoted to good process is time well spent. It not only yielded policies that have greatly benefitted the community, it also brought electoral benefits to those governments that took the trouble.

In short, good process makes not only for good policy, but ultimately for good politics too. Governments ignore this at their peril.

Thank you

Diversity and Contestability in the Public Service Economy

Gary L. Sturgess
NSW Premier's ANZSOG Chair of Public Service Delivery
University of New South Wales

Introduction

Traditionally, we have regarded the public service sector as something like a craft guild, where professionals delivered services under an exclusive arrangement that paid little attention to wishes of service users. I would argue that particular way of looking at public services has been replaced by two competing paradigms.

One, which has strong support in the business community, regards the public service sector as a vast corporation, to be structured and managed by the Premier (or in some versions, the Prime Minister) as chief executive.

The other – which I would argue has much greater utility – views the public service sector as an economy. It may or may not be a market, but even where it is a monopoly, public services form an economy with a supply side and a demand side, individual firms or production units, and discrete industries each with their own particular structures.

I propose to explore that concept in some detail, but let me first say something about a research project which I initiated immediately on my appointment to the NSW Premier's Chair, which is closely related.

Front Line Management

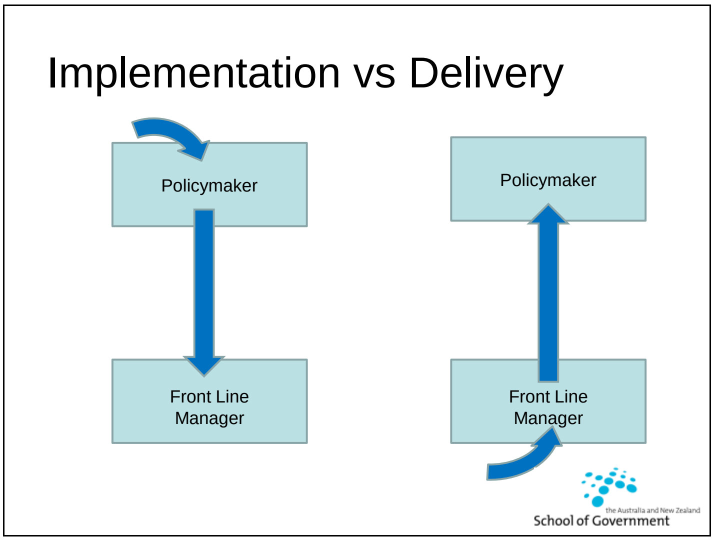
As you might have noticed, my chair is in 'public service delivery' – the choice of that title was deeply influenced by my time in England throughout the Blair years, and the seventeen years which I spent working on questions of service delivery.

When, following my appointment, I re-read the academic literature, I discovered that it was dominated by the concept of 'policy implementation'. It is profoundly different from the approach I am taking in my research.

Policy implementation looks at the question of delivery through the eyes of the policymaker and asks why those folks who are responsible for delivery aren't doing as they were told.

A service delivery approach starts at the bottom, looking at how public services are delivered day-to-day by front line staff and management – how policy consultation and implementation looks from their perspective.

In our current research project, we are looking at delivery through the eyes of front-line managers – those who manage front-line service units, such as hospitals, schools, prisons and local area police commands.



I am interested in this layer of management because I believe they do much of the heavy lifting when it comes to delivery. They are close enough to the front line to see the whites of the customers' eyes, but far enough back that they can be given clear performance objectives and a firm budget and held to account. That is true of almost no other layer in the system.

We have done an extensive literature search, and as it turns out, there have been almost no studies on this layer of management. There is a small but very good literature on 'street level bureaucrats' – the teachers, social workers and police officers right at the front line – but virtually nothing about their managers.

We completed a scoping study late last year and we are presently in the process of interviewing around 70 or 80 of these front line managers in an attempt to understand their world. We have discovered that they encounter the world in very different ways from the policy class.

To start with, they don't see themselves as Public Servants. They do see themselves as serving the public, but as one of them explained to us, the Public Service is the bureaucracy.

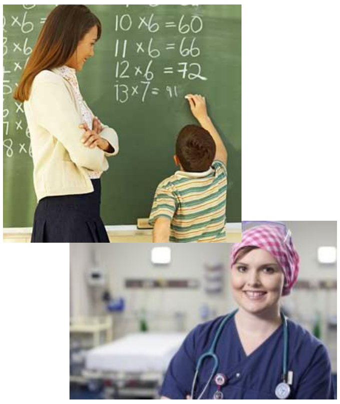
Their ambitions are often quite different from the traditional Public Service. Most of them have no desire to ascend the bureaucratic ladder. They enjoy the operational. They enjoy leading a (relatively) small team out at the front line. As one manager of a large public hospital told us – 'I enjoy the patient contact. I enjoy the staff contact. I enjoy being part of a team.' Another said: 'I have a commitment to human service delivery ... This role has a capacity to have an impact on people's lives day-to-day.'

They see accountability in fundamentally different ways from those at the top end of government. When we ask them which group of stakeholders takes up most of their head-space when it comes to accountability, they say they are overwhelmingly concerned about the patients, the students and the local community. Traditional upwards accountability to commissioners and funders occupies very little of their time.

Public service

"I don't think of myself as a Public Servant."

"They think of the Public Service as the bureaucracy."



Accountability: *"Who do you think your primary stakeholders are?"*

"99% the people of [this community]. That's my focus. That's my job. It's the group that I'm connected to and feel a responsibility for."

They are frustrated by the lack of trust in them as managers, by the lack of authority they are given to get on and deliver the services in question . From that perspective, the selection of staff looms large in their consciousness. One school principal told us: 'You've got to choose your own staff. One size doesn't fit all.' Another front-line manager told us that at the time of the interview, there was a selection process underway for the layer of management immediately below himself, and he would have absolutely no influence over who was selected. He was reluctant to disagree with head office, but wondered how he could have a significant impact on organisational culture if he could not select his own team.

Policy implementation

"Last year, there was something like two or three policy changes every week ... It got to a point where people had just switched off."

Front line managers are frustrated by the process of policy consultation. One of those we interviewed last year said that in the previous year, there had been two or three policy changes a week. It got to the point, he said, where his people had just switched off.

When we turned to the question of innovation, we discovered that there is a great deal of experimentation going on out at the front line, but much of it is taking place in spite of and not because of government policy. Many front line managers find that they have to break or bend the rules in order to innovate. As one of them explained, there are the written rules and then there is the way the world really works.

Innovation

"So there's written rules and then there's how the world really works."

Which brings me to the last question that we ask in our interviews – what is the difference between your world and the world of policy? I was particularly struck by the response given by the manager of a major public hospital in the Sydney region. When I asked him this question, he responded immediately: "My world is dirty".

His world is full of people bleeding and vomiting at the most inappropriate moments. Patients have drug-induced psychotic incidents. He never has enough resources to do his job, and he knows he will never have enough. The world as it was imagined by policymakers rarely resembles the world as he encounters it with all of its untidiness and complexity. His world is dirty.

There is a great deal that can be done to address the red tape and bureaucracy that afflicts the front line manager, and much of it lies in reconstructing the way in which we view the public service sector and thinking of these front line units as firms within a larger economy.

The Public Service Economy

My work on the public service economy has grown out of a paper I wrote for the NSW Business Chamber last year. They originally asked if I would write a paper for them on outsourcing. I told them that I didn't want to write about that rather narrow and somewhat dated approach, but to write instead about diversity and contestability in the public service economy, and to their great credit, they let me have my head.

The academic framework for this project lies in the work of two North American economists, Vincent and Elinor Ostrom. Elinor won the Nobel Prize in Economics several years ago for her work in the management of common pool resources. She was the first woman to win a Nobel Prize in Economics, and it is perhaps unsurprising that she won it in cooperation theory and not in competition theory. I note with sadness that they passed away in June last year, within weeks of each other.

The public service sector *is* an economy

"A public economy need not be an exclusive government monopoly. It can be a mixed economy with substantial private participation."

- Vincent & Elinor Ostrom

My concern in this project is not with common pool resources, but an earlier body of work – in the 1960s and 1970s – on the public service economy. The Ostroms recognised that a public service economy does not need to be a government monopoly, that it is often organised as a mixed economy with substantial participation of the private and voluntary sectors in the production of those services.

In their field work in the water, education and policing sectors, they had noticed that these services were composed of a mixture of local, state and national delivery, with a variety of providers, individual and community, public and private. And just as in the private sector, in each of these industries this mix of providers was structured in very different ways.

They recognised that the public service economy had a supply side and a demand side, just as in the private sector, except that the consumption of public goods and services was collective and organised through what they called 'collective consumption units'.

And once you thought of the public service economy in that way, it quickly became obvious that you did not need to have the same economies of scale and scope on both sides. The national government could buy services from a small local provider, and a small local government could buy services from a multinational corporation. And, just as in the private sector, there was scope for significant diversity in production methods.

The Ostroms and their colleagues were much more interested in the organisation of collective consumption than in questions of supply. Private and not-for-profit providers often played a major role in production, but collective consumption was (almost entirely) the exclusive domain of government.

Why it Matters

I find the concept of a public service economy to be an enormously powerful way of rethinking the structure and operation of public services. There are several reasons why:

(a) The public service economy comprises a significant element of the national economy – around 20 to 25 per cent, depending on how you measure it. That is larger than mining and manufacturing combined.

And I suspect that, in spite of periodic cutbacks, it will continue to grow as a proportion of GDP, because as we grow more prosperous as a nation, more of the goods and services we desire are collective in nature. Health and the environment are the obvious examples.

(b) We have virtually no evidence about the productivity of the public service economy, and with the notable exception of the Tasmanian Auditor General, no one in this country is doing any work on figuring out a methodology that would enable us to measure productivity (although this is about to change).

This arises almost entirely out of how we have organised the public service economy – with no information about the value of outputs, the cost of inputs, and very limited capacity to shift spending from inefficient service units to those that are more productive.

(c) What evidence we have – from benchmarking studies and from market testing – suggests that there is massive scope for productivity improvement. Having surveyed a number of those studies, I think that the potential gains over the short to medium term are (on average) in the order of 20-25 per cent.

> Value: What evidence we have from benchmarking and competitive tendering suggests potential productivity gains of 20-25%.
>
> *"Last year, there was something like two or three policy changes every week ... It got to a point where people had just switched off."*

(d) The way we have structured our public services means that they are not suitable for export – with the emergence of a significant middle class in Asia, a window has opened. We are going to see a boom in demand for public goods and services. But unless we in this country fundamentally change our outlook, that window will close without us having exploited this opportunity.

One of the great joys of this project was the opportunity it provided to study the emergence of education exports in this country. I had been overseas while much of this was going on, and had failed to give it serious attention.

Education is our nation's third largest export. It is Victoria's largest export, and in NSW, it comes second. And yet, 25 years ago, when Jackson delivered his report, education was just another public service, focused on aid rather than trade with overseas markets. Australia did a brilliant job of exploiting those opportunities, and harnessing the energy of the second GATT round to serve our national interest.

Unless we fundamentally change our mindset, we are going to miss these opportunities to export our expertise in public service delivery.

(e) We already have a mixed economy for public services. On my estimates, somewhere around 30-40 per cent of public services in this country are delivered by private or not-for-profit providers. In aged care, it is around 95 per cent. One in three hospital admissions in any one year is made to a private hospital. Around 30 per cent of school students go to a private school. In prisons – one of the core functions of government – around one in five prisoners are managed by a private operator.

There is bipartisan support about this kind of involvement by the private and voluntary sectors in the public service economy. The right of centre may be willing to contemplate greater involvement by external providers, but no one is arguing that this 30-40 per cent should be wound back.

So we already have a mixed public service economy. The problem is that it is not well organised. There are too many public and private monopolies and there is far too little innovation.

Contestability

As the title of my presentation suggests, I argue that there needs to be a great deal more contestability in the public service economy. I probably need to explain this term, because I find that often when I use that word, my audience hears the word 'outsourcing' – and that is not what I mean.

As the economists among you will recall, contestability is not actual competition but the credible threat of competition. A quarter of a century ago, William Baumol recognised that monopolists will behave as though they are subject to competition if there are low entry and exit barriers – if producers are subject to the threat of competition, and that threat is real.

So this is not about 'private good, public bad'. It is about 'monopoly bad and contestability good'. A public official in the UK Ministry of Justice explained to me last year that Ken Clarke, then Justice Secretary, who was promoting a policy of contestability in prison services, didn't care about public or private. He just hated monopoly. That's what I am speaking of here.

Alternative modes of contestability:

- Choice
- Commissioning
- Contestability

There are three different ways in which governments can make public services more contestable. One lies in handing money or money's worth to individual service users and allowing them to select the provider that best suits their needs. Economists refer to these instruments as vouchers, but since Milton Friedman, vouchers have become the policy instrument that dare not speak its name.

We already use vouchers for the delivery of public services in this country. We just don't call them vouchers. The Medicare card is a voucher. Individual budgets – the approach being pursued in the NDIS – are vouchers. After years of languishing in backwaters, vouchers are now mainstream, on both sides of politics.

The second broad approach to contestability lies in the collective commissioning of services from public, private and not-for-profit providers. This is where outsourcing comes in, although it is only one in a wide range of possible models now available. I don't have time to go into them here, but I include government-owned, contractor-operated models (GOCOs), social impact bonds and public private joint ventures as examples.

Finally, there is contestability itself – using a credible threat of competition to drive reform. There have been a number of examples of this around the world over recent years, but one of the best comes from NSW, where the previous Labor government used the threat of competition to overhaul work practices in public sector prisons. When that threat no longer seemed credible, they outsourced Parklea prison, a longstanding public facility.

Diversity

The other half of my report was concerned with the lack of diversity in our public service economy. Once again, let me park the question of outsourcing. Outsourcing to private corporations introduces some additional diversity, but not much. A robust public service economy will be characterised by a great deal more diversity and innovation in institutional design than we observe in the sector at present.

Diversity serves to increase individual and collective choice. There cannot be real choice unless service users are capable of choosing amongst a range of real alternatives. Increased diversity allows public services to be more adaptable. It means that we have a deeper gene pool from which to fashion new solutions in an uncertain world.

The uses of diversity

- Increases individual and collective choice
- Makes public services more adaptable
- Gives us a deeper 'gene pool' from which to fashion new institutional forms for an uncertain future
- Allows for innovation in parallel rather than in serial.

And diversity allows for innovation in serial rather than in parallel. By and large, governments innovate by trying one big idea and only coming back to revisit it after it has become tired or manifestly failed. Innovation takes place one experiment after another. By and large, that is not how innovation occurs in the private sector – private entrepreneurs are trying lots of different approaches at once, stealing ideas from each other, and exploring solutions at a much higher rate.

Someone has used the term 'recombinant governance', which seems to apply here – mutation and natural selection. Policy and institutional mutation occurs through innovation and experimentation. The great engine room of public service innovation over the centuries has been the not-for-profit sector.

I have a game that I sometimes play with audiences, where I ask them to name a public service that was invented by government. Actually, I don't play it much anymore because it always turns out the same way. Under the rules of this game, they are asked to exclude any services that rely on the exercise of violence – defence, policing, criminal justice, regulation or tax collection – since in our society, private institutions are not permitted to exercise violence.

Over three or four years, no one has been able to name a single service. Not fire brigades – they were invented by London's insurance companies. Not the ambulance service – that was invented by small not-for-profits and developed by St John's Ambulance. Not probation – that was invented by the London Police Courts Mission.

The first modern police force was not the Metropolitan Police Service, established by Sir Robert Peel in 1829, but the Thames River Police Establishment, a joint venture established in 1798 by the West India shipping merchants and two reforming magistrates.

Someone once suggested town planning – but the first garden cities, Letchworth and Welwyn – were private towns established by Ebenezer Howard. Someone else raised the NHS – but the social equity elements of the National Health Service arose out of the tax system, and the concept of integrated insurance and managed care was borrowed from a medical fund established by Great Western Railway at Swindon.

There has always been some scope for institutional innovation in government, but the range has been narrow. Since we have been open to greater diversity in the public service economy, there has also been scope for greater innovation.
I can't go into the details here today, but I am particularly interested in public-private joint ventures, public service mutuals (employee-owned cooperatives delivering public services by former public servants on a not-for-profit basis), and entirely new institutions known as 'service integrators' that have begun to emerge in the welfare-to-work sector in the UK.

The other part of recombinant governance is natural selection – burning off grotesque mutations that are not fit for purpose. Contestability is one of the means by which this is done, but we have a wide variety of other tools, including certification systems and robust accountability and auditing regimes.

Commissioning

Since the report was released, I have worked closely with a number of government agencies in the application of these ideas in practice. I have noticed a number of patterns in the responses of public servants to the concept of contestability.

There are those who come back with half a dozen usual reasons as to why the status quo cannot change. There are those who put forward corporatist solutions, arguing for large, centralised shared service centres based on the assumption that there are significant economies of scale. My response to this group is to ask for evidence. 'Economies of scale' has become an ideology. It is simply assumed that bigger is better, without any concern about where the possibilities of diseconomies of scale. (This is another area where Elinor Ostrom did some ground-breaking work.)

The third response – often following immediately from the first – is to lurch in the direction of crude privatisation or outsourcing, on the assumption that that is what government meant when they referred to contestability.

Strategic commissioning provides a way of responding to each of these responses. Commissioning is one of the principal reasons why contestability isn't just about procurement or outsourcing. Strategic commissioning lies in exploring why public services are being delivered, why they are clustered in a particular way and why they are delivered through a particular configuration of programmes and at a particular level of government. It consists of unpacking the relationships between outputs and outcomes, working out how performance will be measured, and what consequences there will be for providers who fail to deliver. It is concerned with the social equity and network dimensions of public services. It involves the exploration of alternative service pathways, alternative sources of funding and alternative service models.

It is as much applicable to publicly-provided public services as it is to those that are delivered through grants or contracts. But the need for good commissioning skills is particularly evident in a contestable economy because of the need to sort through these strategic issues up front. There is a much more limited capacity to tinker with policy over time.

Conclusion

Commissioning is about systems design. In some cases, that might involve the design of markets. In many cases it will not. One of my favourite examples of the difference between commissioning and procurement is provided by C3PO – not the robotic character from Star Wars, but NASA's Commercial Crew and Cargo Program Office.

C3PO is the US government's response to the current round of the space race, where other countries are investing heavily in space exploration at a time when the US government is no longer prepared to underwrite a replacement for the shuttle program. In simple terms, they have turned to the market.

The objectives of the Commercial Crew and Cargo Program are:

- To implement US Space Exploration policy with an investment to stimulate commercial enterprises in space;
- To facilitate US private industry demonstration of cargo and crew space transportation capabilities with the goal of achieving reliable, cost effective access to low-Earth orbit; and
- To create a market environment in which commercial space transportation services are available to government and private sector customers.

Note that the US government is playing an active role in stimulating the development commercial enterprises in space. It is not playing a passive role. Government is creating a market, not just undertaking procurement to find the cheapest provider. Interestingly, when this was being debated before Congress, the Republicans argued for a low-cost procurement, while the Democrats persisted with their commitment to building a market.

Thus far, this program has been a huge success. In December 2010, SpaceX became the first private company to successfully launch, orbit and recover a spacecraft. And in May last year, SpaceX, became the first company to send a cargo to the International Space Station.

Thank you