False Economies

BANG FOR OUR BUCKS

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This paper is the final in a series looking at the false economies that result from short-term, narrow-minded thinking on Australia’s public services. It incorporates updated versions of the previous two reports in the series ‘Decoding efficiency’ and ‘Doing less with less’. Be part of our ongoing public sector discussion on Twitter #falseeconomies #ozpublicservice #ozbigsociety
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Summary

This paper examines the evidence on the efficiency Australia’s public sector; asking the question: ‘how much bang do we get for our bucks?’ It first compares our public sector with those of similar nations and finds clear evidence that Australian public sector efficiency is above average and may be amongst the very best in the OECD. Compared to other OECD countries we are a low taxed nation, and yet we are rated by the World Bank and other international bodies as having one of the more effective governments. Our public sector turns small resources into big results, its efforts are well targeted and it has been sufficiently adaptable to maintain this performance over changing times.

The paper then turns to comparison with the private sector. Discussion of the difficulties in obtaining data to answer this question is followed by a presentation of the evidence that exists. The conclusion is that Australia’s public sector has a similar level of efficiency to the private sector, but the relative efficiency of the two sectors in any particular case will vary depending on activities and organisations.

Acknowledging that Australia’s public sector is efficient does not mean denying that improvement can be made. However, efforts to improve public sector efficiency should start from the understanding that such reforms should be a process of refining an already generally efficient set of organisations.

Box 1: Three kinds of efficiency

The following aspects of efficiency are discussed in more detail in the paper ‘Decoding efficiency’.

Technical efficiency: Undertaking work using the fewest possible resources, getting ‘more for less’ or ‘value for money’. So that every item that is produced, or service that is provided, is done with the least expenditure of time, money, materials, etc. Example: Building a road using the best mix of labour and capital. Using picks and shovels when machinery can do a lower-cost job is technically inefficient.

Allocative efficiency: Undertaking the right work. This is allocating resources to produce and provide items and services of the highest total value. Example: Building a road where it’s most needed. Even if a road is built with the optimal labour-capital mix and no waste, if it is in the wrong place, or if a more heavily trafficked road is neglected, that’s inefficient in an allocative sense. Those resources could have been used elsewhere with better outcomes.

Dynamic efficiency: Finding new ways to fill needs. This is ensuring that new technologies, new ways of operating, and new ways of thinking are able to be used. Example: Attending to transport needs as opportunities change over time. That may mean taking on new modes – such as high-speed rail or intelligent roads.
How efficient is our public sector?

Previous papers in this series have shown the strong views that many politicians hold with regards to efficiency of government activities. The continuing interest of politicians in efficient government is demonstrated by the commission of audit set up by the Abbott government. The commission’s terms of reference state five goals, three of which are concerned with increasing efficiency (the other two relate to removing duplication which is arguably also an efficiency issue). But what is concerning is that there is no mention in the terms of reference of any attempt to establish how efficient government activities currently are, before attempting to improve them. There is a very large difference between seeking to reform a highly inefficient government, where fundamental changes may be required, and reforming a very efficient government which involves refinement of existing activities. Although it is difficult to precisely measure efficiency of the activities of government, it’s clear that Australia’s public sector is among the most efficient in the world. This might seem like a bold claim, but data from respected international organisations make a clear case that Australia performs very well compared to similar nations on all three kinds of efficiency discussed in the previous paper ‘Decoding efficiency’. And this should not be a surprise given the kinds of expectations Australians have of their government. We tend to compare ourselves to the high-taxing nations of Northern Europe when considering the performance of our public sector in areas such as health and education. And yet our taxation levels are far closer to low-taxing nations such as the USA and Korea. Australians expect Northern European services on a US budget, and largely this is what they receive.

There is often a false assumption that all government bureaucracies are inefficient. This kind of thinking would argue that international comparisons merely show Australia to be the best of the worst. However, the assumption that the private sector is always necessarily more efficient than the public sector is not supported by theory or evidence. A common misconception is that belief in ‘private sector primacy’ is supported by economics findings that markets always drive efficiency. In fact markets have been shown repeatedly by economic analysis to fail to deliver efficiency in a range of circumstances. So, given that the private sector is not necessarily more efficient, it is worth comparing the efficiency of the two sectors. The limited evidence available in Australia shows there is little difference in overall efficiency between the sectors.

The commission of audit terms of reference state that a thorough review of government functions has not been undertaken in twenty years. In which case it is unfortunate that the commission has been given only five months to undertake a once in two decades ‘thorough’ review. Finding genuine efficiency improvements in the Commonwealth public sector will be a complex task. As shown in this paper our public sector is already very efficient in general, and so the ‘low hanging fruit’ efficiency improvements have mostly already been ‘picked’.

However, the fact that the Australian public sector is highly efficient does not mean that there is no room to improve. Even the most efficient organisations may have areas or work or aspects of activities that could be improved. There are still areas where significant improvements can be made, but correctly identifying the barriers to efficiency and designing effective solutions will not be quick and simple. What this report shows is that when considering the efficiency of public sector organisations it is important to keep in mind the broader context. In general our public sector runs efficiently and the potential reforms discussed here represent ‘fine-tuning’. While striving for improved performance is important, previous achievements should not be taken for granted, or worse, reversed.

International comparison

The difficulties in measuring government efficiency largely come from problems in quantifying the results of government activities. Quantifying the resources used is generally straightforward since they can be expressed as dollars in a budget. It is the results which are frequently difficult to measure since, unlike many markets in which a straightforward measure of profit can be applied, their value is based on a range of different factors many of which a difficult to directly price. Objectives such as equality and the provision of public goods are difficult to precisely value, and even concepts such as economic growth can be measured in a number of ways each emphasising different values (e.g., employment, wages, consumption, or investment). These difficulties also apply when comparing across nations.

Technical efficiency: Resources and results

While there are some complexities in comparing the amount of revenue different countries gain from taxation, it is possible to get a clear picture of Australia’s relative level of taxation (see Box 2.1). Contrary to some common perceptions Australia is a low-tax country. In 2010 we were the 5th lowest taxing nation out of 34 in the OECD.
Despite common perceptions, Australia actually has a low level of taxation compared to nations with similarly structured economies. Comparing taxes internationally is complex because most countries, including Australia, have a mix of numerous different taxes, and every country’s mix is different. However, the OECD provides comparative data on wage taxes and total taxation that give a good understanding of our position. The data referred to here are from 2010 as this was the most recent year with complete information.

When comparing taxes on wages, some confusion can be caused by the fact that many countries impose a separate “social security tax” on wages, in addition to “income tax”. Because Australia does not, our “income tax” is higher than in most other OECD countries, but the total tax we pay on wages is lower. The percentage of wages taxed in all OECD countries depends on income and family circumstances, so comparative statistics are given for a number of cases. Across all cases, Australia is in the bottom 8 out of 34 OECD countries in terms of percentage of tax imposed on wages.

Because there are a number of other types of taxes apart from those on wages, it is also worth looking at Australia’s total taxation as a percentage of GDP. This again shows that Australia is a lower taxed nation than most other OECD countries, as depicted in the following graph, we are the 5th lowest taxing nation out of 34.

The achievements of the different governments are harder to quantify. A number of international organisations have created different measures of various aspects of government performance. The World Bank has aggregated several of these measures to create an indicator for “government effectiveness”. It also has indicators of “regulatory quality”, “rule of law”, and “control of corruption”; Australia ranks highly in all of these, and all could potentially be regarded as part of the outcomes of government. However, we will focus on government effectiveness as the most relevant indicator. Comparing Australia with the same set of OECD countries in the same year as the tax revenue comparison, places us as 9th most effective government in 2010.

Combining these two data sets we find that amongst the OECD nations, we are the only one to be in the top ten most effective governments, but the bottom five lowest taxing governments. This is strong evidence that we have a far more efficient government than most of our peer nations.

The follow scatter diagram illustrates this by plotting rank in effectiveness against reverse rank in taxation. The nations plotted closest to the top right hand corner are the most efficient.
The precise position of different nations on the graph could be debated. The particular methodologies of the measures making up the government effectiveness indicator could be argued over, as could the methodology of the World Bank’s aggregation. Also, superannuation payments are not counted as a tax because they provide personal benefits to the contributor, and it could be argued that this boosts Australia’s apparent efficiency in one area of public services. This means the above graph is indicative rather than precise. However, the clear indication it gives is that Australia does well in technical efficiency terms, delivering high outcomes for low inputs.

Further support for this assessment of Australia’s public sector efficiency is provided by a 2003 paper by Afonso, Schuknecht and Tanzi. It came to similar conclusions when examining the efficiency of the public sector in 23 OECD countries, including Australia. The paper used a variety of socio-economic measures as indicators of different aspects of government’s performance. Performance included administrative, education, health, and public infrastructure outcomes; as well as government ability in regards to income distribution, economic stability, and economic performance. These indicators, along with public expenditure were used to give an overall public sector efficiency score. Of the 23 nations, Australia ranked third in efficiency.

**Allocative efficiency: Doing the right work**

Assessing the allocative efficiency of Australia’s public sector is more difficult, but there are positive indications. Australia is well regarded by the OECD for having a well “targeted” welfare system; this means that a greater proportion of government-provided benefits and subsidies go to those who are disadvantaged. For example, in 2005 Australia had the lowest level of government transfers going to the wealthiest half of the

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population, only 18.6%; the OECD average was 45.4%. Of course, it should be noted that some of the countries that hand over more of their money to higher earners have deliberately chosen a universal approach, where benefits or subsidies are an entitlement attached to citizenship and participation, not poverty. This approach inflates the OECD average transfers to the wealthy. Regardless, Australia’s level of targeting is an indicator of its ability to direct its resources to where they are most needed.

The analysis by Afonso, Schuknecht and Tanzi also takes into count allocative factors in its calculation of public sector performance. Australia was above average on this measure.

**Dynamic efficiency: Efficiency over time**

The extent to which the public sector takes advantage of new modes of operating, its dynamic efficiency, is particularly difficult to assess. However, if a public sector is maintaining or improving its efficiency relative to that of other nations then this is an indicator of dynamic efficiency, since if its dynamic efficiency were poor it would be falling behind other nations with greater dynamic capability. Examining Australia’s taxation revenue and government effectiveness, we can see that the ranking in these has improved over time, meaning we are not being over-taken by other nations. This provides a good indication that the Australian public sector has been adapting well to changes as they occurred.

**Figure 3 - Australia’s OECD Rank in effectiveness and low taxation over time**

![Graph showing Australia’s OECD Rank in effectiveness and low taxation over time]


**Sector comparison**

Despite the difficulties of measurement there is sufficient data to make the case that Australia’s public sector compares well internationally to other public sectors. There is far less data available on the relative efficiency of Australian public and private sector organisations, but the indications from the evidence available is that Australia’s public and private sectors have similar levels of efficiency.

**Limited Australian data**

An obvious way to compare the sectors is to look at situations where services provided by government are partially or completely privatised. The means that private and public organisations doing, theoretically, the same job could be easily compared. Although Australia has had a large number of government functions privatised, very few cases have sufficiently good data to compare government provision with private and community sector provision.

Two brief examples demonstrate the difficulties:
Box 3: Privatising Australian Government legal services

Over the past 15 years the legal services required by Australian government departments and agencies have increasingly been supplied by private providers. For much of the 20\textsuperscript{th} century, public sector legal demand was primarily supplied by the Attorney-General’s Department (AGD), in particular the Australian Government Solicitor (AGS).\textsuperscript{12} Adopting the recommendations of the 1996 Logan Review, which concluded that the role of government legal service providers should be confined to legal matters in the public interest, the Coalition Government transformed the AGS into an independent Government Business Enterprise, operating as a private entity.\textsuperscript{14} It also expanded use of a user-pays model, which enabled government departments and public authorities to choose to offer their litigation matters and legal advice to private law firms.

At the time, the Government justified the privatisation of legal services largely on the basis of cost-effectiveness.\textsuperscript{15} However, there are indications that after these reforms the level of expenditure on legal services rose substantially.\textsuperscript{16} This might seem to indicate that privatisation has led to an increase in legal costs. However, there are likewise indications that over that time the level of legal costs in the private sector has increased. In both cases the data have serious flaws. The private sector data come from a series of ABS surveys, and the report specifically warns that changes in methodology of the survey mean that comparisons between years are not reliable.\textsuperscript{17} In the public service the estimate comes from comparing four different sets of reports conducted at various times, and it is acknowledged that none are likely to be comprehensive.\textsuperscript{18} Also, there has been little research on the drivers of the increased demand for legal services, so it is unclear whether the sectors can be compared at all, or whether their demand is responding largely to different drivers. The result is that it is impossible to tell from the limited evidence whether privatisation has partially restrained rising legal costs for the public service, or if it has added to them.

Box 4: Public and private employment services

In May 1998, the Coalition government instituted a comprehensive overhaul of employment services in Australia. The public Commonwealth Employment Service (CES) was replaced by the Job Network, later readjusted, and renamed as, Job Services Australia (hereafter, jointly referred to as JSA), a collectivity of over 100 for-profit and non-profit organisations that tendered bids to offer employment services within Australia. The rationale for privatising the CES was fourfold: by increasing competition, it was thought that labour market assistance programs would operate more flexibly, at lower cost, whilst delivering more personalised service, and above all, giving rise to more sustainable employment outcomes.\textsuperscript{19}

The most visible sign of JSA’s success has supposedly been the maintenance of a low headline unemployment rate, particularly during the Global Financial Crisis.\textsuperscript{20} Over the past decade, the headline unemployment rate has averaged roughly 5.4\%.\textsuperscript{21} By contrast, the mean unemployment rate between January 1990 and December 1997 was approximately 9\%.\textsuperscript{22} However, difference in economic conditions certainly affected this, since the JSA was introduced at a time when Australia was enjoying a sustained period of economic growth, corresponding to an inevitable decrease in unemployment.\textsuperscript{23} Moreover, the weight given to unemployment obscures the high rate of underemployment under JSA. The number of people identified as underemployed since 1994 has increased by 50\%.\textsuperscript{24} At 7.2\% of the work force, Australia’s rate of underemployment is currently the highest in the OECD.\textsuperscript{25} The effect of this, as Monash University researcher Veronica Sheen states, is that ‘where hours of work are insufficient, even though the hourly minimum wage is relatively high, the financial situation of such job-seekers remains unaltered.’\textsuperscript{26}

Research into the achievements of the JSA has given mixed results. A study conducted on long-term outcomes for JSA participants by the Department of Education, Employment and Workplace Relations (DEEWR) in 2008, found that 78\% of program participants who had retained a job for three months went on to remain in work 16 months later. DEEWR however noted that at the end of 16 months, only 50\% of participants had been successful in obtaining full time work.\textsuperscript{27} Various commentators state that little research has been conducted on job placement outcomes in the long term, that is, how quickly the unemployed swing between employment and income support benefits.\textsuperscript{28} Within the JSA system, job placement outcomes are measured on a time scale of three to six months following commencement of a role, which is of limited utility as a measure of sustainable employment.\textsuperscript{29} A Government evaluation of JSA prior to 2006 found a 10.1\% impact by labour market programs in assisting long-term unemployed individuals obtain employment over and above what might have occurred without assistance.\textsuperscript{30}

Regardless of whether these achievements are taken to indicate the success of the JSA, there is no comparable data from CES operations. This means there is no way of determining whether the JSA has been more of less successful than the public sector entity it replaced.
As well as indicating the difficulties in obtaining data on the relative performance of public and private sector service delivery, these cases also show privatisation being imposed without any evaluative framework. When a procedural change is implemented, there should be an evaluation procedure to answer the question: ‘how will we know if the change has succeeded?’ This should involve some data-capture techniques to confirm or reject a hypothesis – the hypothesis in this case being that the private sector provider is cheaper or more effective.

Cost savings from structure not sector

Although Australian data is limited, looking at international studies of privatisation gives an answer to the question of how well public sectors generally compare to the private sector in terms of efficiency. Advocates for privatisation have made strong claims about its ability to generate efficiency, but such claims in many cases do not stand up to rigorous analysis. One study, which examined over a hundred case studies and reports of outsourcing, provides clear empirical evidence on the question of sector efficiency.\textsuperscript{31} It found that there was, on average, a cost saving from contracting out. However, the saving was similar regardless of whether it was private contracting, or in-house contracting by competing units in the public service. Competition can, but does not necessarily, drive efficiency. In these cases it did, but it did so regardless of whether organisations were publically or privately owned.

What this means is that under similar structural conditions, public sector organisations in general perform similarly to private sector organisations. The differences in efficiency between the two sectors has been overstated. This provides a good indication that Australia’s public sector, which is more efficient than many similar public sectors internationally, would likewise perform as well as the private sector.

A further ramification of the findings on contestability and efficiency, is that the gains from complete privatisation can equally be achieved by introducing contestability while keeping the work within the public sector, or by only partial privatisation. And while the gains are the same, there can be additional losses from failing to keep some level of public sector capacity in provision of services. A good example of these losses are the additional costs borne by the States with low public works capacity in the course of implementing the Building Education Revolution (BER) program.

The BER was the biggest single program of school building upgrades in Australia’s history and, despite largely negative media coverage about waste, was successful in its objective of economic stimulation thereby reducing the waste caused by a weaker economy.\textsuperscript{32} Leaving aside the broader economy efficiencies of the program, some States did get worse value for money than others, and the evidence is that a significant factor was the different State governments’ public works capacities. Less expertise meant less ability to get the best value from the large number of private contractors employed. This meant States like Queensland, where the government had maintained a core of expertise in public works within its public sector ended up paying less for similar work. So, for example, Victoria spent an average of 13% more than Queensland on each square metre of public works undertaken as part of the BER. Extrapolating this finding out to all public works indicates that the savings from greater value for money in public works are nearly three times the estimated costs of maintaining public sector skills; a potential saving of hundreds of millions of dollars a year.\textsuperscript{33}

The data on contracting out indicates that while competition can drive efficiency, private sector involvement isn’t necessary to obtain these gains. So it is not that organisations in one sector or another are more efficient, all organisations can have their efficiency influenced by the structures in which they operate. The data also indicate that private sector dominance can lead to inefficiency.

Taking into account different jobs

Another overseas study looked at a number of British nationalised industries in comparison with leading British private industries and similar foreign industries. Initially over two decades these did better than they had when privately owned.\textsuperscript{34} However, a follow-up study ten years later found some of the industries performing very poorly.\textsuperscript{35} One of the reasons for this (there were also very difficult economic conditions during this time), was the government imposing ‘national interest’ policies on the enterprises. These made them serve the national interest through activities such as keeping unprofitable operations open to prevent unemployment, at a cost of being less competitive and keeping costs down for consumers.

This example raises another potentially complicating factor in the comparison of public and private sectors. Even where they may seem to be doing the same job, public sector providers of services often are expected to fulfil objects beyond simply providing the core service. And thus they are actually doing a harder job.

An Australian example of this is in our Vocational Education and Training sector. Here the publically owned TAFEs and private RTOs (registered training organisations) both provide vocational education. Superficially both types of training organisation are doing the same work. However, there are critical differences.\textsuperscript{36} Nationally TAFEs have 7\% of students with a disability or long-term condition compared to 4\% for private providers. In addition, 20\% of TAFE students are living in rural and remote areas, the proportion is 14\% for the RTOs. Also, TAFE does more training towards skills in shortage, e.g. in Victoria, 29\% of TAFE students
are training to fill jobs in areas suffering from skill shortage, while less than 20% of students at private
training providers are gaining skills that address industry shortages.

All three differences mean greater expenses for TAFEs. Providing education in regional areas means smaller
numbers of students and lower economies of scale. And providing disabled access and support is an
additional cost (TAFEs are much more likely than RTOs to provide support services for their students such as
counselling, careers assistance, childcare, and indigenous or multicultural assistance). And the industries
where skills are in shortage (such as: Mining; Information, Media and Telecommunications; Electricity, Gas,
Water and Waste Services; and Construction) tend to have more expensive training requirements due to the
need for large-scale machinery, expensive IT equipment, specialised tools, or costly consumables such as
lumber.

The likelihood that public sector organisations are doing additional work to their private sector equivalents
means that to compare the sectors needs a sophisticated approach. Some of the difficulties can be seen in a
report by the Productivity Commission’s on public and private hospitals. Although the two sectors operate in
the same industry, the report detailed a number of differences in the jobs they perform. The public sector ran
more very large and very small hospitals, ran more hospitals in remote areas, engaged in more palliative care,
did more teaching, did the vast majority of accident and emergency work, and had more children and young
people as patients. The Productivity Commission report attempted to statistically take into account these
differences in its comparison, and the findings were that the efficiency of each sector is very similar, with both
having areas of strength compared to the other. It is important to note that the Productivity commission
report acknowledged some weaknesses in its analysis, and it is not possible to be certain that all the additional
responsibilities of public sector hospitals were fully taken into account.

Conclusion
On the evidence we have it seems that Australia’s public sector is relatively efficient. It compares very
favourably to public sectors in similar countries. Our public sector is ‘lean and keen’, operating on fewer
resources than those of many nation’s public sectors which it outperforms. In terms of technical efficiency
Australia compares extremely well. There are similarly positive signs regarding the public sectors ability to do
the right job; its allocative efficiency is high. Lastly, the ability of Australia to maintain a position amongst
OECD nations as highly effective and low taxing, maintaining high efficiency over changing times, indicates
that our public sector is dynamically efficient since it is not being over-take by more dynamically efficient
countries.

Some differences in interpretation of the data are possible, and so it would be difficult to precisely establish
where Australian sits when compared internationally. However, it seems that the Australian public sector has
at least above average efficiency and may be one of the more efficient in the OECD.

Our public sector also has, at least in some cases, a similar level of efficiency to that of the private sector. The
international literature shows that the differences between the efficiency of the public and private sectors are
not large and may be non-existent. Given Australia’s efficiency by international standards this is a positive
indication. Sophisticated comparisons of similar public and private sector activities are rare, but one such
investigation has shown a similar level of efficiency overall between the sectors. It is likely that in any
particular case the efficiency of the two sectors relative to each other will depend on situational factors
relating to the work being done and the organisations involved.

Australia’s public sector is highly efficient and any attempts to improve its efficiency must start from this
understanding. However, this positive assessment should not be taken to imply that no improvements can be
made to public sector efficiency. Further public sector efficiency improvements should be continually sort in
order to ensure the most possible public value is gained from public funds. There are a number of areas where
opportunities for significant efficiency gains exist and future reports in this series will address such areas of
opportunity.
References

4 C Stone, Decoding efficiency, 2013.
5 Ibid.
18 Ibid.


*Ibid*, pp. 4-5.


