



GOVERNMENT

Tough Choices Ahead

The Future of the Public Sector

KPMG INTERNATIONAL



Contents

Foreword	5
Executive Summary: the global debate on public services	6
A three-stage journey to public sector transformation	7
How has recession affected the public sector?	9
A catalyst for change	11
Political bravery is crucial	12
Stage one – short-term cost reduction	13
Stage two – efficiency improvements	15
Stage three – strategic transformation	19
Redefining the role of the public sector – leading the debate	26



John Herhalt
Global Head of
Government Sector
KPMG in Canada



Alan Downey
Head of KPMG's global Government
committee on Performance
KPMG in the UK



Foreword

The public sector is at a major turning point. It could embark upon another round of short-term measures to try to reduce costs and improve efficiency. Alternatively, it stands on the brink of change that could redefine the sector and fundamentally change its role.

The objective of this report is to stimulate debate around public sector transformation. We cover the tough issues involved in reconciling government performance in an era of austerity with the expectations of citizens who demand value and the commitment of public servants who strive to deliver it.

We highlight the difficulties, the trade-offs and examples of industry leading practices in addressing the financial challenges faced by public sector organizations around the world. We draw upon in-depth interviews with 17 public sector leaders from Australia, Canada, Germany, Netherlands, UK and the US. These findings, coupled with desk research and insight of partners and directors from member firms of KPMG International Cooperative (KPMG International) worldwide, offer a contemporary and global perspective from the 'front line.'

Our aim is to lead the debate, share success stories and help our public sector peers redefine and transform their sector.

Tough Choices Ahead: The Future of the Public Sector further explores the results of our previous research, *The Wolf is at the Door*, published in 2009. That is a quantitative survey, based on the insights of 124 public sector leaders and captures a global perspective on the impact of recession on the public sector. This follow-up research probes these views in greater detail, with a focus on how to build on success and achieve fundamental change for the future.

Executive Summary



The time has come to hold a debate on major change. Concerns over global financial conditions; research demonstrating government willingness to change strategies; and openness among citizens to address their country's financial health all point to an overwhelming need to redefine the role of the public sector.

Background

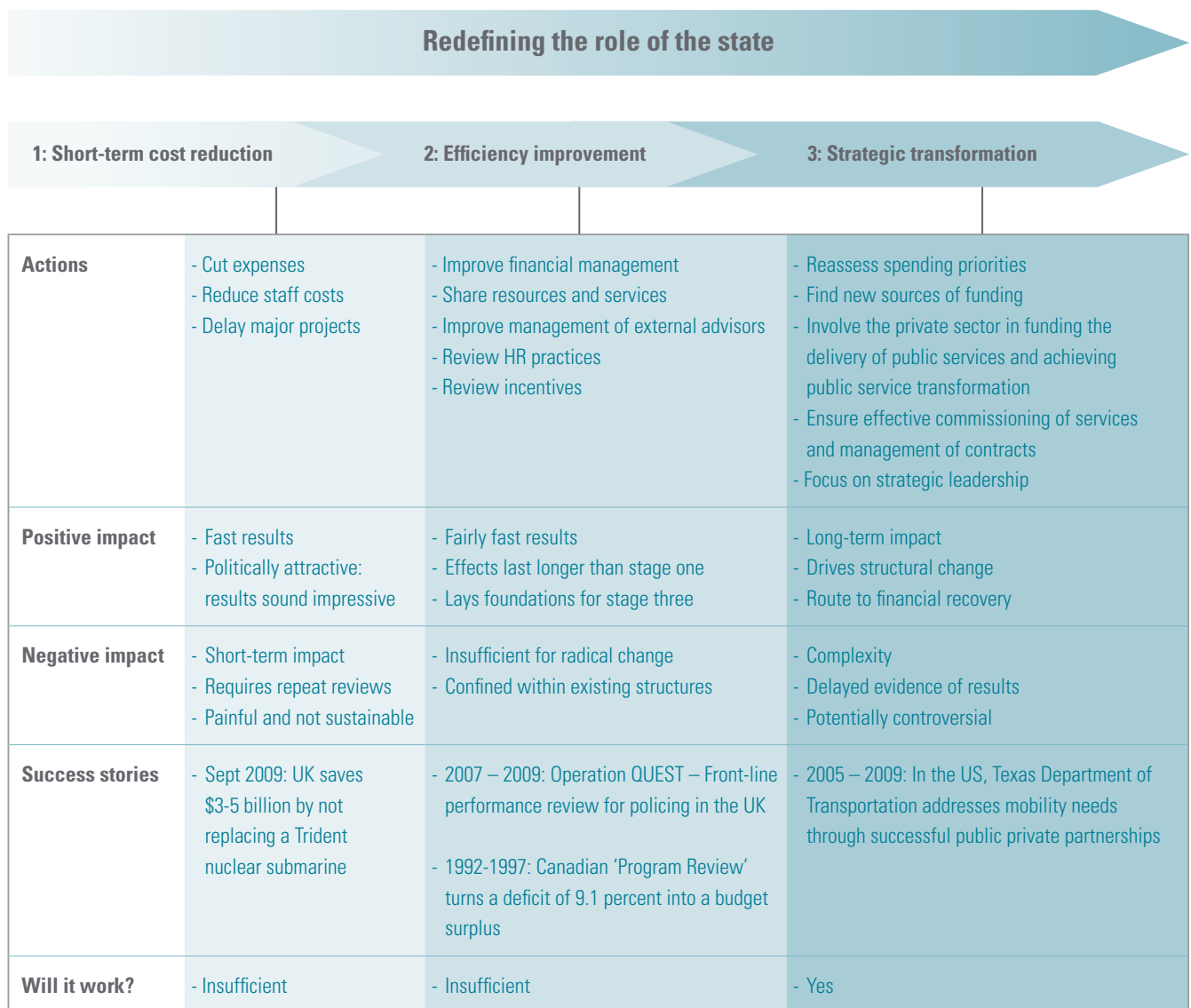
- Recession has placed an enormous strain on public finances in many countries worldwide.
- Public sector reform has been attempted but much remains to be achieved.
- Public opinion and resistance from staff and trade unions are among the ongoing barriers to transformational change.

This report

- Seeks to highlight the challenges, the trade-offs and industry leading practices in reforming public services.
- Is based on 17 in-depth interviews with public sector leaders in Australia, Canada, Germany, Netherlands, UK and the US.
- Shares insight from KPMG member firms' partners and directors worldwide.
- Proposes a three-stage approach to transforming the public sector. This should be implemented within the context of a debate between the public sector's policy and decision makers and the public regarding the role of the public sector.

This debate takes two major forms. First, we advocate that governments should demonstrate their commitment to eliminate low-value, non-core programs and services and improve efficiency. Secondly, we assert that, on its own, this is insufficient to make the financial impact required and that there is a bigger challenge – specifically, how to achieve the strategic transformation required in this new economic era.

A three-stage journey to public sector transformation

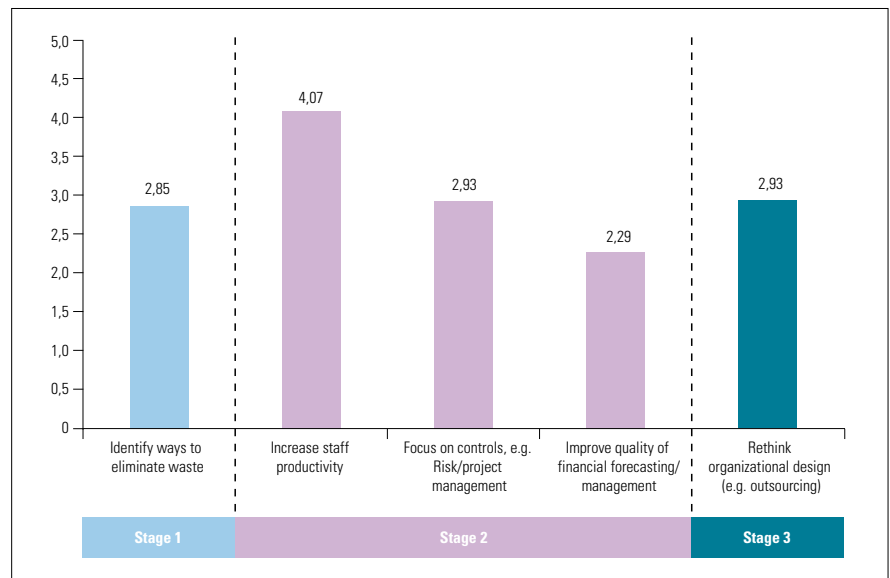


Alan Downey, UK partner and head of KPMG’s Global Government Committee on Performance summarizes the journey, “In the first stage, governments have to adopt short-term measures to save money very quickly to buy time to focus on longer-term issues. Once they have addressed short-term cost reduction and efficiency improvement, the long-term focus needs to be on the role of the public sector: what it should be doing and what it should stop doing because it is no longer affordable.”

He adds, “At this stage, all governments are facing tough, political choices which will be controversial. They should explore the issues around spending, funding and the role of the private and not-for-profit sectors in the transformation of public services.”

The outlook for significant and long-lasting change is good. Many public sector leaders do not foresee organizational rethink as the most challenging area for improvement. Instead, the public sector officials we interviewed (see Chart 1) cite their main challenge as productivity – against a backdrop of low morale, reduced budgets, growing complexity and underlying change. A positive appetite for rethinking organizational design suggests that there is broader acknowledgement of what needs to be done and that strategic transformation is on the agenda. The debate centers on one critical question. How can this be achieved?

Chart 1: Most challenging areas for improvement



X axis shows rating of 0-5 on extent of severity, where 5 is the most severe challenge. Figures in the chart show the average ratings among all 17 senior public servants interviewed for this study.

How has recession affected the public sector?

“The impact comes in a myriad of ways. We are still receiving a reasonable amount of growth money, but the amount of pressure on our system has been increasing.”

CEO of an NHS primary care trust, UK

The effect of the recession has been felt across the public sector worldwide, particularly in many of the larger Western economies, where government spending sought to keep pace with demographic challenges, technological developments and a more informed population. While hopes for global economic recovery feature prominently in the media, many commentators still strive to understand the longer-term effects of the downturn.

Governments globally have seen a decrease in tax revenue across the board, a rise in demand for public services and have pledged billions of dollars in fiscal stimuli to help regenerate their floundering economies. The result is a depletion of public funds and threats to future borrowing. Some governments, such as Queensland, Australia, and the province of Ontario, Canada, have lost their AAA rating and Standard & Poor’s cut its ratings for Ireland, Greece, Portugal and Spain following the economic slump.

However, with the short-term focus on spurring economic expansion, the G20 agreed in November 2009 to continue stimulus programs, inevitably adding to budget deficits, which in the US reached a record US\$1.42 trillion in fiscal year ending September 30¹. With pressure mounting, the US Treasury Department is selling unprecedented amounts of debt, as the US government borrows to fund stimulus plans such as ‘cash for clunkers’ vehicle rebates and tax credits for home buying. However, some economic commentators in the US insist that these are short-term policies that promote excess spending and that spending on education and job training would be a wiser investment.

Medium to long-term issues – such as the demographic time-bomb of aging populations – indicate that many governments will be faced with post-recession funding challenges. The demographic time-bomb poses a dual challenge. First, there are significant implications for pension provision, which is widely recognized. Second and less well recognized, is the diminishing pool of public servants, which is creating ‘hotspot challenges’ for the future. For example, in the US, where procurement is more commonly described as ‘acquisition,’ the government’s acquisition workforce has declined by nearly 50 percent since the mid-1990s and the government is now faced with the impending retirement of its most experienced people. More than 60 percent of nearly US\$450 billion acquisition dollars in 2009 was used for the procurement of services from contractors supporting government activities; knowledge and understanding of the evolving acquisition system is therefore critical in order to avoid costly errors. And in the UK, retirement and succession is an issue in the education sector, which is facing a lack of readily-identifiable, strong, second generation leaders coming through, against a backdrop of political pressure on schools to provide sufficient places.

Country	Total public debt as percent of GDP
UK	60.6%
Netherlands	50.2%
United States	40.4%
Germany	38.9%
Canada	28.6%
Australia	5.1%

Source: OECD StatExtracts, 17/09/09

¹ BBC News - October 8, 2009.

Faced with the task of addressing imminent skills shortages as well as balancing their budgets, our public sector interview respondents agree that significant change is needed for the public sector to try to meet the challenges of the future. Some steps have been taken to attempt to eliminate non-core programs and services and raise efficiency, but many commentators suggest that deeper, more fundamental change needs to follow. This will, and can, take time. *KPMG in the UK Partner Alan Downey* points out that “the public sector’s protracted downturn does not require the same immediate response as that of the private sector. Indeed, public organizations have already had more than a year to plan their reform strategies, allowing for the green shoots of economic recovery to be nurtured.”

The public sector should this time look to address one of its biggest challenges. It must gain the support of its employees, the trade unions and citizens to strive for structural transformation. There is one key advantage that the public sector has at this point: citizens understand that the economic downturn has put huge pressure on public expenditure and they therefore have reduced expectations about the services their governments can afford to provide. With the electorate arguably prepared like never before to engage in the hard debates about transformational change, politicians and senior civil servants have an obligation to present the facts and exhibit strong leadership to help define the best strategies and make the right decisions.

A catalyst for change

“The downturn acts as a bit of a catalyst, provides some reason to make some tougher calls on things that would not have been made when times [were] good.”

Director, State Government,
Australia

Senior public servants are increasingly aware that the economic downturn provides a significant opportunity for major change in two fundamental areas: first, the way public services are funded and delivered, and subsequently, the relationship between the government and its people – in essence, redefining the role of the public sector.

In many countries, politicians have promised more extensive public services than they can feasibly deliver. They must now decide which policies and programs are absolutely necessary and which can be eliminated. As *Alan Downey* comments: “Shaving five percent off every government policy and program is not going to do the trick...We need to take a hard-nosed look at our spending priorities - which policies we can afford and which matter to us most.” This view is shared by several public sector leaders in support of significant reform: “Our economic situation provides a great opportunity to renegotiate with the [general] public on how they perceive the role of the state. The biggest issue is that of the public taking more responsibility for its own health,” comments *the CEO of an NHS primary care trust in the UK*.



Redesigning the role of the public sector will involve some devolution of responsibility from the government to the individual, requiring a fundamental shift in the collective mindset of the electorate. In countries where the government has played a prescriptive role, citizens will need to adapt to a different future, with significant exposure to the thinking and fundamental drivers shaping the debate.

Political bravery is crucial

“The recession makes this kind of conversation necessary, but it also makes it impossible to have a conversation about cutting jobs.”

Provincial Deputy Minister of Finance, Canada

It is clear why the public sector has been struggling with inefficiencies for so long – major change requires real political bravery to make tough choices. Public sector organizations will now have to reverse policies they had championed previously, while also managing the expectations of civil servants and the public.

In many countries, public spending has snow-balled over recent years and the prospect of now announcing cuts to public services will not be received sympathetically by the electorate. As *KPMG in Australia's Director, Mark MacDonald* comments: “Once the tap has been turned on, it is very, very difficult to turn it off”. Unlike private businesses, public organizations have a statutory duty of care to the public and are required to provide certain core services. Making radical amendments to the scope of existing services is difficult when they had previously been recognized as state necessities.

Against this backdrop, *KPMG in US Partner, David Dennis* reminds us that, “The public sector should be commended on the changes it has succeeded in implementing so far. It has coped with a surge in demand for services as well as fierce scrutiny from the public. It now needs to build on these successes by demonstrating the bravery and conviction needed to implement controversial change.” This will require public debate to inform the electorate and reshape its relationship with the public sector, while strengthening the ability of public servants to prioritize and deliver essential services.

Many commentators are skeptical that this negotiation process will be successful. However, the debate can no longer be delayed if we are to make the journey from waste elimination, through efficiency gains to strategic transformation.

“I don't think that politicians have the strength to reshape the public sector. There are only two ways of doing this – either I reduce my outgoings, in particular in terms of public spending, or I increase taxes. Both ways mean that politicians won't be re-elected.” *Municipal Treasurer, Germany*

Stage one – short-term cost reduction

This first step towards public sector reform has been attempted by many public organizations. But eliminating costs from one department can shift the financial burden to another, so savings can be superficial. However, this measure is an important first step, as it produces some immediate savings and rapid, politically-compelling results that can be attractive to the electorate. Our public sector respondents have concentrated on the following areas:

1) Cutting expenses

In many parts of the public sector, cuts are being made without any negative impact on services. For example, a *Director in a State Government, Australia* indicates that his department has cut travel expenses considerably, noting that, “For a large country like Australia, with significant overseas ties as a Commonwealth member, this can represent some fairly significant savings in a short space of time.”

2) Reducing employment costs

Implementing large-scale redundancies is economically and politically fraught. Not only would this contribute to soaring unemployment levels, but it may not even be possible. Job security among civil servants is defended by powerful trade unions and in some countries protected by generous redundancy packages.

One approach to retaining employment levels is the imposition of a pay freeze, such as that under consideration by the UK government. A backdrop of low inflation, low interest rates and pay freezes in the private sector means that a pay freeze could be accepted, albeit grudgingly, resulting in substantial future savings.

Our research shows that even in so-called ‘straight forward’ areas of cost containment, responses differ. These range from “Increasing the contract hours of employees,” at a *Further Education college in the UK*, to “Implementing forced redundancies in confined areas” in *Australia*, to “Cutting back on contractors and temporary staff severely” in a *Department of Transport in Australia*.



3) Delaying major projects

The Netherlands and UK governments have both announced cutbacks to major defense projects. The Netherlands is chasing huge savings through scaling back overseas campaigns, while the UK is reducing the Trident nuclear armament program. However, spending on major projects needs to be reviewed in light of international relations and long-term implications. Scaling back major infrastructure projects can have a long-term impact on a country's competitiveness, for example, the possible delay of the new Crossrail railway service in the UK, a subject of digital commentary in September 2009 in the *Financial Times*.

Where the competitive implications are negligible, the delay of large-scale projects provides a viable, short-term solution, as a *Senior Executive in the Department of Transport of Australia* explains: "We have been delaying a lot of our major infrastructure projects, some by several years. The available funds have been limited, so we just don't have the funding in the time frame we had planned."

Stage two – efficiency improvements

Efficiency improvement is the second stage of the journey to strategic transformation. Our research participants agree with the *Principal of a Further Education College in the UK* that, “There is still scope for huge efficiency in the public sector.”

1) Efficiency reviews

Several high-profile efficiency reviews have achieved significant cuts in public expenditure with little impact on the services provided. One example is Canada’s 1992-1997 “Program Review” profiled in Case Study 1 which claimed to have transformed the country’s budget deficit of 9.1 percent into a surplus, with no loss of essential services. Case Study 2 focuses on performance improvement, combining efficiency savings with achieving performance targets, in this case, to improve the delivery of policing processes and reduce crime in the UK.

Case Study 1:

‘Program Review’ improves financial management in Canada

1992-1997: the Canadian Liberal party eliminated all government spending that could not be justified:

- Range of public services reduced, although all essential services retained
- Federal departmental budgets reduced by 20 percent, on average within 4 years
- Sharp reduction in real spending by 9 percent of GDP, while taxes rose by just 0.3 percent

The program is generally regarded as a success: the 1992 budget deficit of 9.1 percent was transformed into a budget surplus in 1997. Growth recovered from -2.1 percent (1991) to 2.8 percent (mean 1992-1997).

Critics challenge that the results are over-stated: responsibility for many Federal services was shifted to provincial governments, which also acquired the costs from the Federal budget.

Like short-term cost reductions, efficiency reviews attract criticism for transferring costs to other departments. Perhaps more significant, sustainable cost containment programs include improving financial management, reviewing benefit packages and revisiting performance incentives: all of which lay significant foundations for strategic transformation.

Case Study 2:

Front-line performance improvement for policing in the UK

KPMG in the UK has helped fourteen police forces identify and deliver significant front-line performance improvement and efficiencies to their core operational policing processes – 10 since March 2007. This work has brought about a genuine step-change in the way the police service thinks and operates, embedding core disciplines of performance improvement, change management and organizational redesign.

Based on established KPMG process methodology, QUEST teams examined local front-line policing processes, quantified key issues, then designed and implemented practical strategies that could be delivered quickly to bring immediate benefits – often achieving a return on investment in excess of 5:1 within 12 months.

Strategies have included new ways of handling calls from the public, new approaches to recording and investigating crime, greater speed and efficiency in dealing with those in custody, and more effective ways of capturing and processing intelligence. QUEST also assists forces in developing their capability to pursue improvement opportunities independently.

The program's success is reflected in endorsements from the Home Secretary and by KPMG's recognition in the Home Office awards.

2) Improving financial management

The public sector is often criticized for its financial complacency. A determined effort to provide accurate management information will be crucial in determining investment decisions and tracking productivity improvements. Our participants point to the need for long-term budget forecasting and specific management practices, such as better auditing of overtime claims.

"We need to reform the budget so that we are forecasting for the long-term and not just thinking about the year ahead," *Deputy Chief of Staff to a State Governor, US.*

"We need better supervision of the rosters and the overtime claims of police, prison officers, ambulance crews, and fire brigades." *Ex-State Premier, Australia.*

3) Sharing resources and services

Creating a closer relationship between public sector organizations using similar resources and delivering similar services is beneficial on several levels particularly in the sharing of back-office and front-office services.

Sharing resources can reduce administrative costs as well as improve service quality. In the Netherlands, for example, the government is increasingly looking to centralize services, such as creating one datacenter to replace the current thirty.

The extent to which the pooling of resources and services is viable depends largely on the culture of the country and region concerned. As a *German Municipal Deputy Treasurer* says, "You can't imagine a town in Germany without a town hall, maybe in Holland and in the UK, but not in Germany. The people would be against it."

4) Ensuring a better return on investment from external advisors

Use of external advisors is also coming under greater scrutiny and is viewed by some with skepticism, particularly in a downturn. A *Provincial Deputy Minister of Finance in Canada* comments, "When we get into trouble we tend to outsource our thinking. A better option might be to weather the downturn and review the skills of our team and how these could be upgraded in future. Or, make our work with management consultants more collaborative, so that our teams are able to capture best practice and build on it in the future."

It is not just the engagement of external advisors, but the use of 'external managers' that is being reviewed. In the United States, 2009 saw record numbers of statutory and regulatory changes intended to impose more discipline on the procurement system. For example, in both enacted and pending provisions, the government is taking back authority that allowed contractors to perform work that some view as inherently governmental. This affects the lead system integrator contracts, whereby the government asks a lead contractor effectively to develop a new system - such as the Army's Future Combat System - and which will be prohibited from October 2010 in the US.

Rather than 'outsourcing the thinking,' what is needed is 'collaborative thinking' to enable the assimilation of expertise among public sector executives. This is part of the challenge to secure a better return on investment from external advisors, with the onus falling on both parties. This calls for greater public sector expertise in managing advisory services and designing the relationship around outcomes - including ROI metrics - captured in a framework jointly developed with the experts.

5) Reviewing benefits packages

In the past, public sector organizations have typically attracted and retained new talent with attractive benefits, including index-linked pension plans, flexible working hours and generous holidays. However, as the baby boomer generation reaches retirement age, our participants are in agreement that current pension plans are probably not sustainable over the long haul – and prevent the government from being nimble.

The public sector's tentative reaction has been to make "modest changes in the administration of state pension schemes" with "no more talk of early retirement," says an *Ex-State Premier, Australia*. Many of our participants cite pressure from trade unions as a barrier to reforming public sector pension schemes. Nevertheless, it is widely acknowledged that further change is needed, such as raising the retirement age or reducing the value of pensions.

6) Revisiting performance incentives

The number of seniority levels and grading systems of some governments results in a tendency to view people as a commodity. However, our participants insist that a more personalized, motivated workforce can have very positive effects on productivity.

"You can only increase productivity if you have good people in the first place. You can only improve productivity when you assess the knowledge and abilities of staff. You need to motivate them, draw upon their abilities and delegate responsibility. It's not necessarily to do with money," *MD of a public transport company, Germany*.

By shifting their focus towards motivating and incentivizing the workforce, public sector organizations can maximize their investment in training and recruitment programs, as well as attract future talent. As the *Principal of a UK Further Education college* comments, widespread unemployment is having a positive impact on public sector recruitment: "We advertised a post recently and had so many applicants that we could have appointed half a dozen excellent people." A tightening job market for talented executives is a rare opportunity to attract, train and retain future leaders in the public sector.

We explore this in stage three of our journey.

Before we get there, are efficiency gains enough?

Statistics provided by the UK and Canadian governments following their efficiency reviews are compelling, citing impressive savings to the public purse. However, as *KPMG in Australia's Director, Mark MacDonald* indicates, short-term efficiency gains as measured by budget deficit or surplus levels have too often involved shifting responsibility to lower levels of government or deferring necessary investments through stop-gap strategies. "This is not a sustainable solution and doesn't address core issues of lasting reform."

Now is the time for deeper, longer-term, more fundamental change. To try to ensure the long-term health of the public sector, there needs to be a serious review of its size and scope, its role and what can be done to achieve strategic transformation for the future.

Stage three – strategic transformation



Cost reduction and efficiency reviews have improved short-term financial health, at least superficially. Now, how can long-term financial health be achieved?

A radical change requires a radical shift in public expectation. In the UK, the welfare state has been regarded as a universal right since its inception over 60 years ago – at best, providing the most admired set of services in the world, at worst, inviting long-term dependency. However, successful provision must be recognized and commended as a basis for further achievement in delivering public services.

The success of strategic transformation lies in the hands of senior public sector leaders and managers. The ‘Culture of concentrating on steering and not rowing’ first introduced in 1992 by Osborne and Gaebler in their book on public sector transformation entitled, ‘How the entrepreneurial spirit is transforming the public sector,’ can only be cascaded down if it is introduced by capable and innovative leaders. What does that mean? It means reviewing the skills profile of senior executives to secure deeper, more long-term expertise, particularly in the areas of finance and procurement. *KPMG in the UK partner, Neil Sherlock* says, “We must recognize the need for a clear financial career path for finance director equivalents in each department, because they are managing big money. And in the key areas of procurement you need professional procurement, because that is what they will do day in and day out.”

In this section, our senior public sector participants and KPMG firms’ partners explore these areas and suggest tactical ways that support a strategic approach in pursuing a brighter future for the public sector.

1) Reassessment of spending priorities

It is clear that the public sector will not be able to deliver the same range and level of services it has in recent years. Several governments have initiated major reviews of spending priorities. According to the *Financial Times*², the UK Chancellor of the Exchequer’s public spending proposals already represent the biggest departmental budget reductions in a generation. After unavoidable debt interest and social security payments, Treasury figures show departments will have to slice 8.6 percent from their budgets in the three years from 2011.

Many politicians are looking at Canada’s imposition of spending cuts of up to 20 percent in the 1990s. It was claimed to be brutal, effective and fair with some heavy duty thinking about what government should and should not be doing. Some commentators think the UK could learn from Canada but not everyone is convinced.

² Financial Times, ‘Darling set to reveal spending Cuts’ 5 October 2009

2) Finding new sources of funding

Given that traditional sources of funding to the public sector have declined over the past year, an era of austerity is likely without major structural and funding changes. Tax revenues have plummeted across the board, with a *Municipal Treasurer in Germany* noting, "a reduction in industry tax of 80 percent." Public sector organizations have reacted by pursuing a number of alternative tactics for raising funds, notably private finance initiatives, user-pays schemes, shared resources and outsourcing.

a) PFIs and PPPs

Case Study 3 demonstrates how public-private partnerships (PPPs) have been used in the US to address the ever increasing transportation challenges of the state of Texas. Initially developed by the British and Australian governments, PPPs and private finance initiatives (PFIs) have been pursued by most of the countries in this report.

Securing private funding for public projects is economically attractive, particularly in the short term. As a *German Municipal Deputy Treasurer* comments, "Lots of public-private partnerships exist because it's a means of getting credit." Furthermore, PFIs transfer risk management from the public to the private sector.

However, collaboration with the private sector can incite ideological opposition and some critics doubt whether such projects are more efficient.

Our respondents highlight that a climate of trust brought about by tighter regulation is needed to make these initiatives succeed: "In public-private partnerships, private companies often put their own interests to the fore - the law has to be tightened so that they deliver their commitments for the next 10 to 20 years." *Municipal Deputy Treasurer, Germany.*

b) User-pays

A stronger commitment to 'user-pays' schemes can cushion the financial shortfall resulting from decreased tax revenue. Numerous examples are emerging in policy fields such as transportation, education, pension reform and increasingly, health.³

However, political opposition is to be expected if the public is asked to pay for a service which had previously been delivered through the tax system – too often mis-characterized as "free". As *KPMG in Australia's Director, Mark MacDonald* indicates, "Opposition parties will often rail against the proposal, claiming to protect the public interest. But not many will decide to roll back the decision once they themselves are in government. In fact, user-pay systems tend to work very well in practice, once the political games have been played out."

³ How Best to Pay for Ever Higher Expectations of our Public Services. KPMG in the UK research, January 2009.

Case Study 3:

Infrastructure development in Texas through successful PPPs

In the US, the Texas Department of Transportation (TxDOT) is leading the nation in identifying and applying innovative solutions to address the ever increasing transportation challenges of this state.

One such approach has been the use of public-private partnerships (PPP) to harness the ingenuity, efficiency and financial strength of the private sector to expedite the delivery of much needed infrastructure. Another benefit of the PPP model is that much of the development, implementation and operational risk associated with complex, multi-billion dollar engineering projects are transferred to the private sector.

Throughout 2009, TxDOT reached commercial close on an unprecedented three PPP transactions. Two of these projects are full concessions that will provide over US\$6.5 billion worth of improvements and new capacity in the Dallas/Fort Worth area for less than \$1 billion of state funds; the other uses a design-build delivery model to deliver another billion dollars worth of necessary improvements. With KPMG firms' help, the department has structured these PPP deals not only to deliver new highway capacity far sooner than would be possible using the traditional 'pay as you go' approach, but also to ensure that the key public policy interests of the state (and the traveling public) remain protected. In addition, with the delivery of these three projects accelerated, TxDOT is now able to address other necessary transportation needs across the state far sooner than would have been possible if the department had been required to fully fund these projects with traditional means.

Looking ahead, several other potential toll road projects are being assessed for their PPP feasibility – as well as for development using other non-traditional delivery models.

There are many examples of how user-pays schemes can become a significant source of revenue once initial criticism has dissipated. A 'congestion charge' was introduced to Central London in 2003, aiming simultaneously to reduce traffic and increase Transport for London's (TfL) revenue. Both were achieved, with TfL's 2006-07 annual report stating a net income on congestion charging of UK £89.1 million.

c) Sale of assets

The sale of government assets is back on the political agenda. In the UK, it is hoped that selling assets such as the Channel tunnel rail link and Tote bookmakers will raise funds of around UK £16 billion. According to the European Services Strategy Unit, as governments and cities confront continuing service needs with plummeting resources, a 'new threat' of privatization and asset monetization is gathering global momentum. Cities in the US, such as Chicago, New York and Los Angeles join several states in planning to sell off existing assets; elsewhere, countries such as Russia and Poland have also announced privatization plans.⁴

While this represents a nominal percentage of total government debt, it is a strong indicator of shifting attitudes: public sector success is no longer defined by the breadth and depth of its services. Instead, the focus has shifted to the outcomes from public expenditure: how effectively the general public is served balanced against individual accountability for personal welfare.

The focus on outcomes is crucial. As *Alan Downey* points out, "the key question here is: are we just talking about the sale of assets, or the transfer of functions which will enable efficiency gains to be extracted for more focused and more professional management of the services?" The asset sale issue is linked directly to outsourcing and privatization.

3) Outsourcing to the private sector

As the debate surrounding PFIs and PPPs indicates, strengthening links between the public and private sectors is a controversial issue. However, it must be carefully considered, if the public sector is to make significant improvements to its debt levels.

Alan Downey comments, "It is difficult to see how the challenges the UK government faces will be addressed without a substantial shift to involving the private and not-for-profit sectors in the delivery of services, whether by joint venture, conventional outsourcing, PPP or PFI. This is an issue that the government will have to pursue more seriously." As *KPMG in the Netherlands partner, Paul Dijcks* says at the heart of the debate is the role of Government itself. "We currently expect it to raise funds, set policy and deliver services. The question now being asked in the Netherlands is whether the private sector is better suited to provide the latter?"

It's not a straight forward solution. "It is no good contracting out if you don't set up contractual arrangements properly and manage those in a professional, concentrated way," as *Alan Downey* explains.

⁴ *Global Auction of Public Assets: public sector alternatives to the infrastructure market and public private partnerships*, published November 2009, by Dexter Whitfield, director of the European Services Strategy Unit and Adjunct Associate Professor, Australian Institute for Social Research, Adelaide



“However, that’s not to say this isn’t already happening. In parts of public sector the role is shifting from being a provider of services to a commissioner and manager of public services. It is a question of enabling the public sector to get the best out of the private sector relationships they have. This has not always gone smoothly, but it is not a reason to step back from doing it now.” In some instances, there are natural advantages. Despite his ambivalent stance towards the issue of outsourcing, a *German Municipal Deputy Treasurer* agrees that, “building control works better in the private sector. In the financial arena, private companies are better equipped to deal with complicated financial arrangements as they have the personnel.”

The UK’s public services industry is considered to be one of the most developed in the world. The government has been a particularly strong advocate of outsourcing to the private sector and outsourcing companies such as Serco and Capita have flourished as a result. The government seems keen to build on this success. In mid-December 2009, *The Sunday Times* ran a report on “secret plans” to create at least two public sector “outsourcing giants” – privatizing up to a quarter of the public sector to help slash the UK £187 billion deficit. The plan endows the in-house corporate finance arm of the Treasury with the power to take businesses out of different departments and combine them into new companies run by professional managers. Like FTSE 100 companies Capita and Serco – worth UK £4.5 billion and UK £2.5 billion respectively – the ‘new companies’ could ultimately be listed on the public market.

Many of our respondents share a positive view on outsourcing. “We are actively looking at whether we can outsource more services, like heavy vehicle license testing and issuing,” says the *CEO of a state road infrastructure and licensing department, Australia* and “Outsourcing is definitely important and we are doing it to some extent for account functions, and so on, because it’s cheaper. We’ve had good experiences,” comments the *MD of a public transport company, Germany*.

It is clear that the private sector outperforms public organizations in certain areas. Ideological reservations aside, a closer working relationship between the two can foster a culture of skill-sharing from which both parties can benefit.

On a smaller scale, other innovative forms of funding can include successful collaborations with local businesses, such as the revenue-generating initiative created to fund the restoration of the Indian River Lagoon in the US, detailed in Case Study 4.



Case Study 4:

Innovative approach raises funds for Indian River Lagoon, US

The Indian River Lagoon National Estuary Program (IRLNEP) is a public initiative to protect and restore the Indian River Lagoon in Florida. This body of water provides 19,000 jobs and its economic impact is estimated at US\$731 million.

January 1993: IRLNEP-branded license plate was developed as part of a public awareness campaign. McDonald's restaurants in the local area managed petition forms and collected the 12,000 signatures needed for state approval.

An IRLNEP investment of US\$15,000 paid for administration fees and marketing strategies required by Florida State. Local business donations helped fund advertising campaigns.

IRLNEP receives US\$15 for every sold or renewed license plate, generating approximately US\$400,000 a year. This sustainable source of income funds habitat restoration and environmental education projects.

Such initiatives can be a lucrative source of revenue for public organizations with a strong brand. They also raise the organization's public profile, ensuring a competitive position within the marketplace.

Transformation drives the need for strategic leadership

The need for strategic leadership stems from three developments: increasing collaboration between the private and public sector; a move to collaboration and group accountability; and the traction gained by the commissioning model. Combined, these all lead to greater complexity, a changing skills profile and structural innovation.

Increasing collaboration and cross-fertilization between the public and private sectors is expected to have a profound and positive impact on the public sector's leadership ethos. *Beverley Steel from Odgers Berndtson* predicts an imminent need for, "High-quality strategic leaders with a system-wide perspective who can bring organizations together and build a coalition around change."

Collaboration and group accountability is a major theme in discussions around strategic leadership. In the UK, this is, in part, prompted by the 'Total Place' initiative, which looks at how a 'whole area' approach to public services can lead to better services at lower cost.

A senior councilor explains, "Total Place presents significant opportunities for local government to set the direction for the next phase of public sector reform. Success will depend on strong leadership, innovation and strong partnerships based on an expert understanding of the needs of residents, customers and citizens." These leaders will need to take a collaborative approach, working across structural boundaries and creating 'Chief Executive Teams' made up of Chief Executives from both private and public backgrounds. One of the biggest challenges will be group accountability and owning the delivery outcomes jointly. Another step change is the 'commissioning model,' whereby a reduced senior leadership team operates as a small, strategic purchaser of services that are delivered by 'arms-length' providers, for example, in healthcare. Commissioning the best organizations from the public, private and not-for-profit sectors for service delivery requires professional procurement expertise and a thirst for global industry best practice.

Alan Downey comments, "Beyond the need for strategic leadership skills is the need for good commissioners of services and managers of contracts. An essential dimension to the work of external advisors is to ensure the effective commissioning and supply of contract management."

For example, *Downey* points to the UK government's 'Flexible New Deal,' which involves the private sector in delivering services to the unemployed – designing the architecture and structuring the contracts to deliver on promises in the 'New Deal'. Similarly, the UK's National Health Service initiative on 'world class commissioning' requires expert knowledge in creating the architecture to generate efficiency and continue to deliver services and outcomes to support demographic needs. The future of the public services industry will therefore be highly complex, requiring public servants to distill complex information and complex drivers in lots of different sectors and understand how they overlap.

Ultimately, the need for strong leadership is at the heart of public sector reform. Short-term cost reduction and efficiency gains will be delivered by junior and middle managers, but strategic transformation can only be implemented by senior decision makers, some of whom have historically resisted major change. However, as several interviewees confirm, this reluctance is now being replaced by an acceptance that the public sector must be fundamentally redesigned.

Redefining the role of the state – leading the debate

The next step is to create a platform where public sector leaders worldwide can share their plans for strategic restructuring to foster confidence that it can be successfully implemented.

Pressure is mounting for the public sector to recognize and act on the major turning point it has reached. How this economic backdrop will affect the public sector in the long term remains to be seen. Will it merely 'evolve,' implementing reviews to cut short-term spending? Or will spiraling levels of debt prompt governments to make fundamental, controversial changes to their policies? The three-stage journey towards public sector reform, detailed in this report, describes how senior public servants can build on success to drive the strategic transformation the sector needs to secure long-term financial health.

In KPMG's opinion, the time has come for deeper, longer-term, more fundamental change. For the public sector to meet the changing needs of society, a fundamental review of its role, size and scope, informed by debate between the government and the people it serves, is needed.

We invite readers to share their comments and insights by going to www.kpmg.com.

KPMG Member Firms' Contacts

Global Head of Government practice

John Herhalt
Tel +1 416 777 8778
jherhalt@kpmg.ca

Australia

Michael Hiller
Tel +61 7 3233 3299
mhiller1@kpmg.com.au

Canada

Craig Fossay
Tel +1 416 777 3394
cfossay@kpmg.ca

Canada

Jeffrey M Smith
Tel +1 416 777 8409
jmsmith@kpmg.ca

Germany

Astrid Göbel
Tel +49 30 2068 4549
astridgoebel@kpmg.com

Netherlands

Paul Dijcks
Tel +31 70 338 2202
dijcks.paul@kpmg.nl

United Kingdom

Alan Downey
Tel +44 20 7311 6541
alan.downey@kpmg.co.uk

United States

David Dennis
Tel +1 407 563 2227
ddennis@kpmg.com

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