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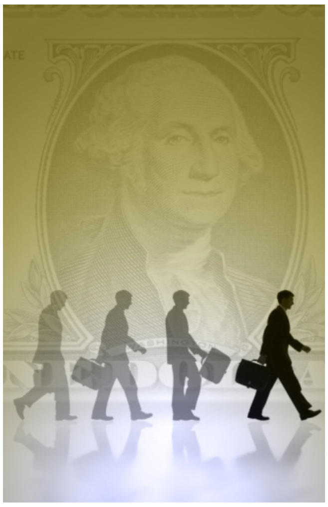

The public-sector productivity imperative

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The budgets of many advanced economies are seriously under strain. Reduced tax revenues due to the global recession combined with stimulus packages to kick-start growth have resulted in precariously high debt and budget deficits. Even before the recession, governments knew their aging populations spelled budgetary trouble, with the predicted sharp rise in demand for medical and social care unmatched by growth in the tax-paying workforce. But their predicament is now considerably worse.

In response to immediate budgetary pressures, many countries have instituted or proposed cuts in government services and increases in taxes. While both measures are necessary if budgets are to be balanced, there is a third that can make a substantial contribution to easing the current crisis, while also helping to preserve essential services such as health care and defense in years to come. This entails providing more public services for less money—in other words, raising productivity.

The public sector is the largest employer in all advanced economies, yet its slow productivity growth has long made it a drag on the economy. Even without the crisis, it would be important to increase public-sector productivity as part of an overall growth strategy. The recession and growing demographic headwinds now make it imperative.

A tried and tested approach

McKinsey's work with hundreds of public-sector clients in more than 50 countries around the world has shown the effectiveness of a four-step approach to improving productivity. The first step defines and measures productivity—a prerequisite for managing it. The second organizes the sector in such a way that there is pressure to improve productivity. The third identifies the most effective drivers of productivity, while the fourth secures sustainable transformation.

Measure productivity

Productivity is defined as the amount of output in relation to the level of input required. Companies raise productivity by increasing their output (more goods or services) and/or reducing their input (less capital, labor, or material).

The same process applies in the public sector. But public-sector managers can be skeptical of efforts to improve productivity, arguing that you cannot measure what constitutes a good education or good hospital care. In truth, many public-sector activities—processing health insurance claims, say, or procurement—are similar to private-sector ones, which means the same measures of productivity can be used. And even when it comes to harder-to-measure, intangible goals, our experience shows that while perfect, quantitative productivity measures may not be available, good ones often are. If no productivity measures currently exist, it is an urgent task to create them.

It is often not possible to capture a public-sector organization's mission with a single productivity measurement. Schools, for example, want their students to perform well and might choose to measure productivity in terms of students' test scores (output) relative to the cost per student (input). Many would argue, however, that test scores are only a partial indicator of a school's success, and might want to look also at the percentage of students going on to college or the incomes of those entering the workforce. In fact, all the key elements of an organization's mission should be measured. Then, if it is necessary to limit the scope of productivity improvements, their relative importance can be considered.

Organize for productivity

The McKinsey Global Institute (MGI) has shown how, in the private sector, competition encourages and even forces managers to raise productivity. The harder they have to fight to earn profits, the harder they strive to do what they do efficiently, often by emulating best practice elsewhere.

The same incentives do not exist in the public sector. Some government departments, such as defense, provide services that are not amenable to the use of conventional market forces. Even where public and private provision coexist, factors such as regulation or inadequate information tend to hamper competition and hence productivity gains. In the case of health care, patients are seldom well-enough informed to decide their own treatment and generally pay only a fraction of its cost, so they lack much incentive to choose the most cost-effective option.

Public-sector organizations must therefore create an environment in which there is pressure to perform and raise productivity. Where possible, giving citizens the freedom to choose between service providers will help. But in the absence of market mechanisms, governments can create pressure to improve performance by putting in place effective performance-management mechanisms, including

Box 1

Organizing for productivity—the RGPP initiative in France

Shortly after taking office in 2007, President Nicolas Sarkozy's government launched a reform program known as La Révision Générale des Politiques Publiques (RGPP). Its aim was to achieve structural reductions in the country's public expenditures, but also to modernize government, improve services for citizens and companies, ensure greater recognition for the work of civil servants, and promote a "culture of results." Prime Minister François Fillon dubbed it a program to "do better with less."

The RGPP has now launched more than 450 initiatives in all 15 government ministries, including structural reforms such as the merger of France's tax and collections agencies; changes in governance models, including a performance-based funding system for universities; service improvements such as a faster naturalization process for those seeking French citizenship; and improvements in support functions such as IT and human resources.

In order to set targets the government and its employees would be expected to meet, a quality-of-service barometer was published that identified 15 indicators of citizen satisfaction with public services. The government then committed itself to support the relevant ministries in delivering greater satisfaction.

One such indicator was waiting times at hospital accident and emergency (A&E) departments—something that 83 percent of French people felt was an important measure of a good service. The government worked in a number of hospitals and reduced waiting times by an average of 28 percent.

Another example concerned "life events"—for instance, getting married, having a child, hiring an employee, or losing an official document. The goal was to simplify procedures for citizens. The government assessed the complexity level and frequency of each life event to determine priorities for action, conducted diagnostic studies to identify ways of simplifying procedures, and committed to a program to come up with 100 simplification measures.

Both examples show how the government focused its transformation efforts on what it saw as "demonstrators"— high-visibility service areas where it felt it could have rapid impact, thereby winning support.

accountability for meeting productivity targets. The efforts made by the French government to create this kind of performance pressure are described in Box 1, "Organizing for productivity—the RGPP initiative in France."

Identify the drivers of productivity

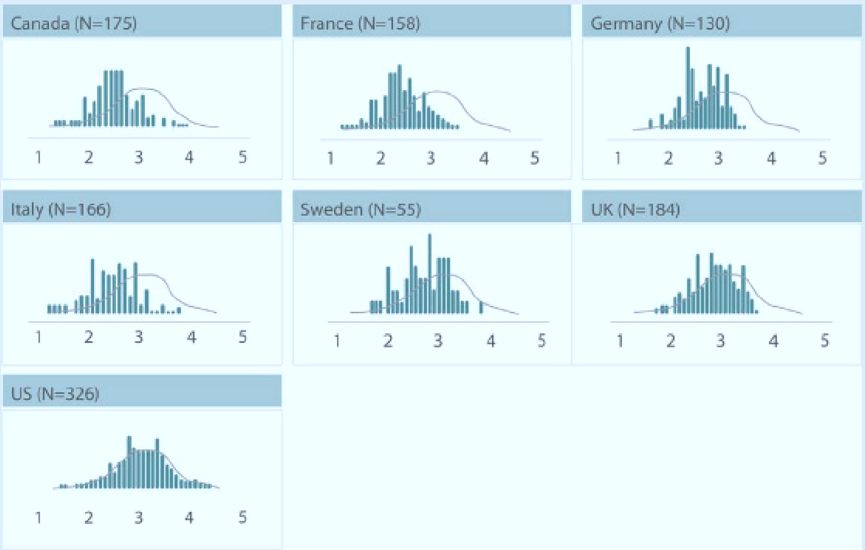
Having defined and measured productivity, how do managers figure out how best to improve it? A relatively simple yet powerful tool is benchmarking. Early MGI studies revealed large differences in productivity between the same sectors of business and industry in different countries, raising the obvious question of why this should be. Examining the way services and goods were produced in each country—what was happening in offices and factories, how production processes were organized, how capital or technology was deployed—provided the answers, and pointed to where best practice might lie.

McKinsey has since carried out similar cross-country comparisons in several important segments of the public sector, yielding equally powerful insights into productivity. These studies have revealed opportunities to unlock productivity gains by applying best practice not only to relatively straightforward public services such as tax administration, but also to administrative and operational aspects of more multifaceted public services such as health care, education, and even collective services such as defense.

Our work uncovered performance differences not only between countries, but between states or provinces within a country, between jurisdictions within a state, and even between units within an organization. Exhibit 1 shows how an international benchmarking study of management practices in hospitals revealed wide performance differences both between and within countries. Benchmarking studies can therefore start at the country level, identifying the best practices used by organizations operating under the same rules and conditions. Often, managers need only to look next door to find opportunities for cost savings or service improvements. In well-run private-sector companies driven by competition, CEOs work

Exhibit 1

There are variations in hospital performance both within and across countries.[1]



1 The graph shows distribution of the raw management scores across countries. The height of a bar represents the proportion of hospitals of each management score within a country. 1= lowest management score and 5 = highest management score. The dark line is the US (highest average country) "bell curve" (kernel density plot).

Source: Stephen Dorgan, Dennis Layton, Nicholas Bloom, Rebecca Homkes, Raffaella Sadun, John Van Reenen, "Management in health care: Why good practice really matters," CEP/LSE and McKinsey & Company, 2010

constantly with leaders of business units to share ideas and spread best practice. This should happen much more in the public sector.

The best-performing public service providers have already discovered that, despite the complexity of their organizations, core administrative and operational functions are amenable to productivity analysis. And they have used productivity-driving practices and techniques honed in the private sector—lean principles, data analytics, performance tracking, talent management, and smart procurement practices—to powerful effect. The way that an international benchmarking exercise showed the key drivers of productivity in tax administration is demonstrated in Box 2, "Insights from international benchmarking in taxation."

Drive sustainable transformation

It is one thing to institute a program of productivity improvements, quite another to transform an organization into one that continuously strives for and achieves improvements. Decades of research have found that 70 percent of organizational change programs end in failure—but there are noteworthy exceptions. Notwithstanding its recent problems, the Toyota production system embedded a long-standing culture of continuous productivity enhancement, propelling the company to a position of global leadership.

Some governments have created a small, high-caliber delivery unit dedicated to productivity improvements to help secure the transformation.[1] One of the unit's most important tasks is to establish and maintain routines: regularly scheduled opportunities to review performance and make decisions that will keep improvements on track. Monthly, quarterly, and biannual reports and meetings ensure frequent assessments and collaborative problem-solving sessions. A biannual delivery report enables the organization's leadership to review progress and reallocate resources if necessary. Routines work because they create

1 This approach was first developed by the UK government in 2001, and has since been adopted by other governments seeking to raise their productivity. It is described in detail in Michael Barber, *Instruction to Deliver: Tony Blair, the Public Services and the Challenge of Achieving Targets,* Politico's, 2007.

Box 2

Insights from international benchmarking in taxation

In June 2008, McKinsey embarked on a yearlong study of the performance of 13 federal tax authorities.[1] The study examined two measures of productivity: efficiency, expressed by the cost per dollar of tax revenue collected, and effectiveness, expressed by the proportion of taxes payable actually collected. Performance was compared across and within countries, revealing considerable variations. The study estimated that the 13 authorities together could collect an additional $86 billion in direct tax revenues and save almost $6 billion in costs if every tax-collecting agency were to perform as well as the top one-third.

The study also revealed several powerful drivers of productivity. One is demand management, which aims to limit the volume of work for tax administrators—for example, by encouraging taxpayers to use automated services. Another is the segmentation of taxpayers to gauge which ones are most likely to make errors or misstate liabilities. This helps target which tax returns should be reviewed. Top-performing tax agencies drew on the segmentation expertise of the consumer-goods and financial-services industries to understand taxpayers better.

Streamlining operations is the third important driver. The best-performing authorities invest strategically in IT, automating repetitive, labor-intensive tasks, and implement lean techniques learned from private-sector industries. The fourth driver is performance tracking. Best-practice authorities track performance extensively in terms both of output and intermediate outcomes. In one tax authority, team leaders listen in on selected calls between employees and taxpayers and provide immediate feedback to employees on ways to improve the quality of the information exchanged. This reduces the number of errors made on returns and can minimize the number of disputes over the amount of tax to be paid.

1 Thomas Dohrmann and Gary Pinshaw, “The road to improved compliance: A McKinsey benchmarking study of tax administrations 2008–2009,” McKinsey & Company, 2009. Countries included were Australia, Belgium, Brazil, Canada, Chile, Denmark, France, Ireland, Norway, South Africa, Spain, Sweden, and the United States.

deadlines, which in turn create a sense of urgency and, once established, change the culture of an organization so that improving productivity is the norm.

Other organizations that have undergone successful transformations have used a “five frame” approach to focus their efforts and drive change.[2] Key to applying the approach in the public sector is recognition that government reformers must lead from the front if transformation is to get the attention it requires. Moreover, only leaders can inspire the workforce to change the way they work. That said, if change is pushed through only from the top, the changes will stick only as long as those at the top stick around. Leaders need to build a cadre of change-savvy senior managers and develop capabilities throughout the organization, embedding change that will outlast their own tenure many times over.

New directions

McKinsey has been researching productivity in the private and public sectors for two decades, helping many organizations transform their performance. Building on that work, it is now set to embark on a comprehensive, international analysis of public-sector productivity in developed countries.

The new research will analyze productivity in areas such as health care, education, defense, tax, social security, labor,

2 The framework identifies five stages of a successful transformation: aspire, assess, architect, act, advance. See Nick Lovegrove, Garrett Ulosevich, and Blair Warner, “Making it work in government,” *McKinsey on Government,* Spring 2011.

and public infrastructure. Using McKinsey analysis and a growing body of external research, it will demonstrate how all countries can improve their overall productivity by emulating the practices of the highest performers in each of these areas.

Although the research will focus on developed economies, the findings will be relevant to governments in emerging economies, which increasingly need to allocate scarce resources and skills to public services. In the developed and developing worlds alike, higher productivity delivers valuable prizes: economic growth, the attainment of social goals such as improved health care or reduced poverty, and citizen satisfaction. The public-sector productivity imperative is one that all governments must address, and one that—with the requisite data and tools—none need shy away from.

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