

Discussion paper



# Better for less: Improving public sector performance on a tight budget

July 2011

McKinsey & Company

# Better for less: Improving public sector performance on a tight budget

The pressure on governments to improve their performance has reached a new intensity that is unlikely to abate any time soon. Our experience shows that government leaders can indeed rise to the challenge they face—and make improving public sector performance a critical means to improve the quality of public services and reduce deficits.

François Bouvard  
Robert Carsouw  
Eric Labaye  
Alastair Levy  
Lenny Mendonca  
Jaana Remes  
Charles Roxburgh  
Samantha Test

July 2011

# Preface

---

Global academic, political, media and business leaders gather in Aix-en-Provence on July 8–10, 2011 for the 11th Rencontres Économiques d’Aix-en-Provence, convened each year by Le Cercle des économistes. The theme of this year’s conference is “The States of the World”. Previous meetings have tackled topics such as growth, financial imbalances, new capitalism and resource scarcity. A focus of this year’s session is the recognition of the urgency of transforming the public sector, in a context of evolving roles and expectations towards governments, under increasing budgetary constraints.

As background to this discussion, the McKinsey Center for Government and the McKinsey Global Institute have prepared this position paper in order to foster debate among participants. The paper provides a set of principles and proposals for action. These are based on our experience and research into performance improvement programs, primarily in private organizations, but also in the governments of more than 50 countries.

We hope that these perspectives will contribute to nurturing thoughtful discussions at the Rencontres and beyond and welcome comments and reactions. As with all MCG and MGI work, we would like to emphasize that this paper is independent and reflects only our Firm’s perspective.

Dominic Barton  
Global Managing Director, McKinsey & Company

July 2011



The McKinsey Center for Government (MCG) is McKinsey & Company’s government performance research arm. Its mission is to be a focal point for advanced thinking for government leaders on strategy and transformation, with the objective of helping them dramatically improve the impact of public expenditure and government policy on people’s lives.

The McKinsey Global Institute (MGI) is McKinsey & Company’s economic research arm. Its mission is to help business and government leaders develop a deeper understanding of the evolution of the global economy and provide a fact-base that contributes to decision making on critical management and policy issues.

# Contents

---

Introduction	1
Potential impact of improved public sector performance	2
Governments must improve public sector performance	3
Core principles for improving public sector performance	4
1. Public sector performance can indeed be measured	6
2. Benchmarking against peers in the public and private sectors helps drive performance	7
3. Improving performance depends on understanding what drives it	10
4. Increased quality and lower costs can go hand-in-hand	11
5. IT is not a silver bullet	12
6. Radical change should focus on people, not just organization charts	14
7. Sustained improvement requires a culture of performance	16
8. Far-reaching improvement in public sector performance is possible	17
Actions for government leaders	19
1. Set clear, long-range aspirations for public sector performance	19
2. Intensify efforts to measure public sector performance	20
3. Put smart data at the heart of government decisions on tradeoffs and priorities	20
4. Hold regular, collaborative dialogues on performance with those accountable for progress	20
5. Establish comprehensive, sustained programs of change and lead them from the front	22

# Better for less: Improving public sector performance on a tight budget

---

## Introduction

Developed economies around the world have reached a day of fiscal reckoning: simply put, they no longer have a choice about improving public sector performance. Burdened with debt and still dealing with the aftermath of the global financial crisis, governments of advanced economies now face soaring obligations for health and pension costs of their aging populations.<sup>1</sup> Cutting services and raising taxes is an obvious response—but, as has been made clear in the streets of Athens as well as in political battles in legislatures around the developed world—there are limits to what citizens will tolerate.

To get out of this fiscal and political trap, governments need to improve the performance of public services—doing more and better with less, as private sector organizations have done for years. The potential rewards are immense. We calculate that if the G8 nations could improve performance—for example by increasing public sector productivity by 1.5 percent annually in line with what private industries have done over the past three decades—they could generate benefits worth \$1 trillion a year.<sup>2</sup> That's equivalent to roughly 1.5 to 2.5 percent of their combined GDP. Some of those benefits could take the form of debt and deficit reduction, improved services, or lower taxes.

We are confident governments around the world can rise to the challenge before them. There is reliable evidence to show that governments can simultaneously improve the quality and lower the costs of their activities. And, while public sector institutions differ greatly in size and scope, we have seen that political and civil-service leaders at all levels of government can deliver improvements on par with those achieved by private sector enterprises. This can be achieved by:

- Setting clear, long-range aspirations for public sector performance
- Intensifying efforts to measure public sector performance and comparing performance within and across countries
- Putting performance data at the heart of decisions about making policy and delivering public services
- Holding regular, collaborative discussions on performance with those accountable for delivering progress
- Establishing comprehensive, sustained performance improvement programs that are led by deeply engaged public leaders—both elected officials and professionals

Meeting this performance imperative will be difficult for political leaders of all stripes. Delivering change on this scale is inevitably complex, and particularly so in government, where accountability is not always clear and where change leaders must address concerns of many stakeholders. These difficulties explain why there have been too many failed or abandoned improvement projects, and insufficiently frequent instances of sustained performance gains, leading to a lack of credibility for

government reform efforts. However, our experience of performance improvement efforts in the public and private sectors of more than 50 countries convinces us that—with the right tools and practices—these challenges can be overcome.

In this paper, we demonstrate the potential fiscal impact of improving public sector performance and lay out the case for acting now. Then we offer eight principles for improving public sector performance that are drawn from our work and research. Finally, we detail the five priority actions for improving public sector performance.

## Potential impact of improved public sector performance

Many governments are addressing their fiscal deficits with “top-down” measures, including tax increases and reductions in transfer payments.<sup>3</sup> Although these measures can entail highly contentious economic, political and social tradeoffs, they are relatively straightforward in concept, which often make them the default solutions.

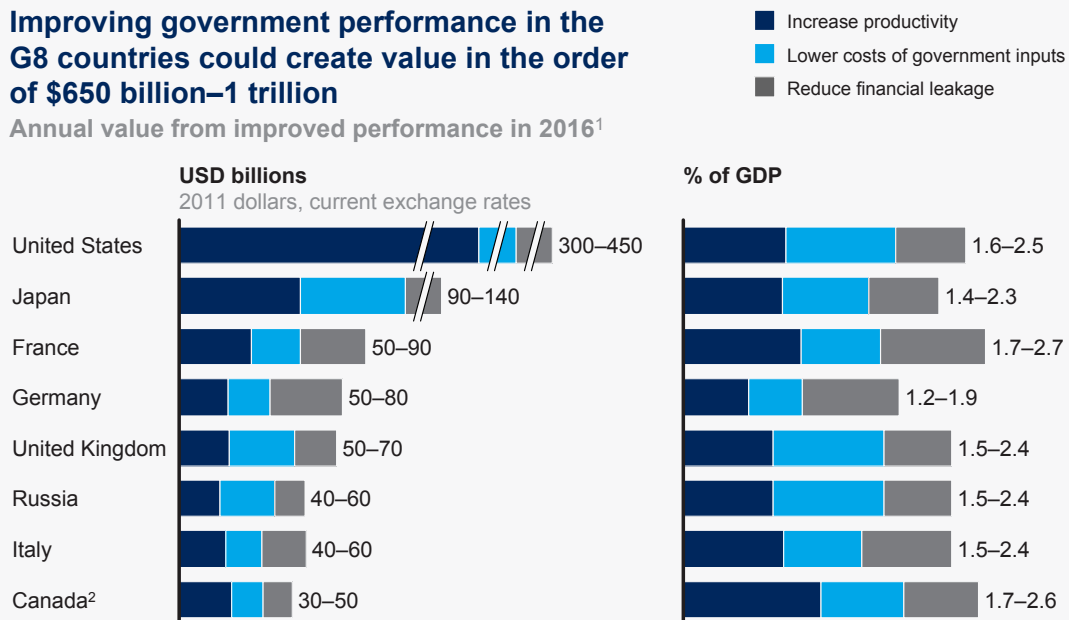
Improving the performance of the public sector, by applying proven best practices to cut costs while improving service delivery, offers policymakers another option. Performance improvement can relieve the financial pressure of shrinking budgets while better serving communities and citizens.

Implementing targeted improvement measures would allow the G8 governments to realistically set a goal for annual performance improvements of 1.5 percent, essentially mirroring the productivity growth rate achieved by private sector service businesses over recent decades.<sup>4</sup> By achieving this level of improvement, by 2016, G8 governments could create benefits on the scale of \$1 trillion a year, equivalent to 1.5 to 2.5 percent of their combined GDP (Exhibit 1). Every year, portions of this \$1 trillion could be directed towards reducing deficits, addressing debt, extending or enhancing public services, or reducing taxes. To put that in perspective, the United States' share of that benefit is equivalent to 30 to 40 percent of its projected 2016 fiscal deficit.

### Exhibit 1

#### Improving government performance in the G8 countries could create value in the order of \$650 billion–1 trillion

Annual value from improved performance in 2016<sup>1</sup>



1 Assumes annual increase in productivity of government operations (1.0–1.5%), lower costs of inputs through better procurement practices (1.0–1.5%), and better financial management, for example through fraud prevention (0.1–0.2%).

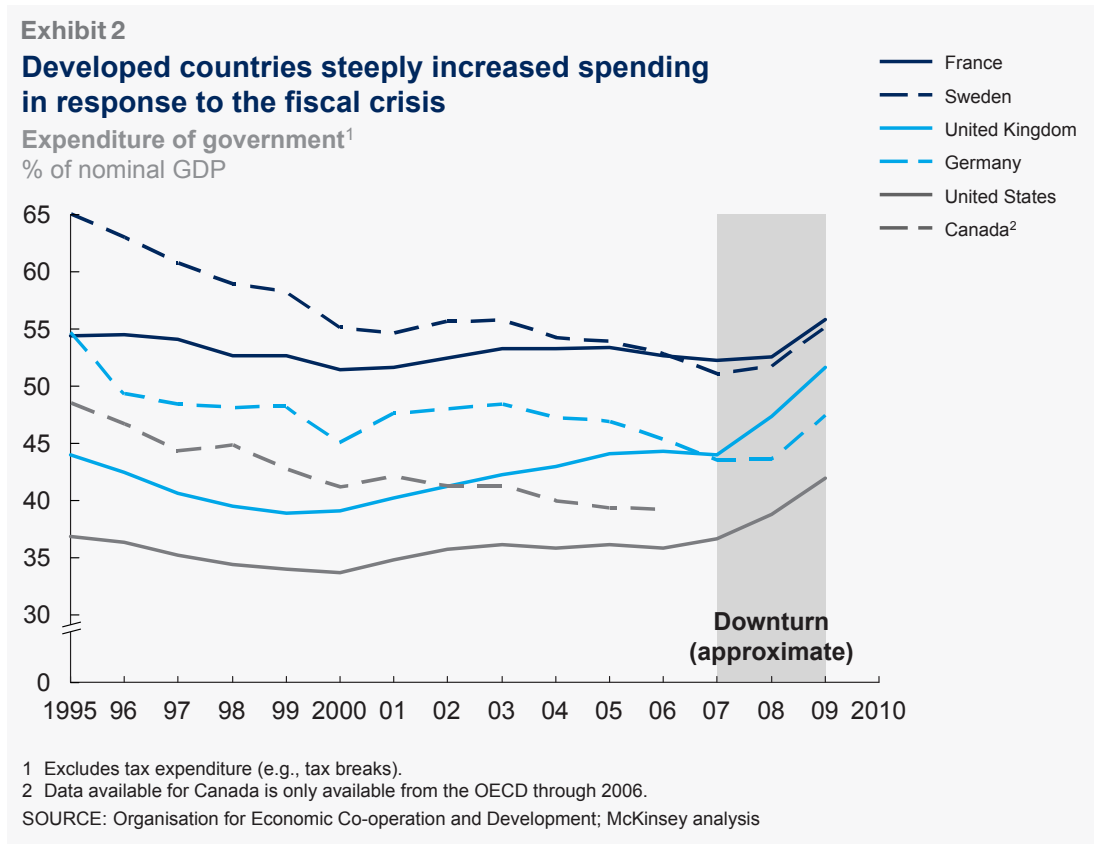
2 Canada does not report a breakdown by type of spend to the OECD; calculation assumes the breakdown is the same as in the United States.

SOURCE: International Monetary Fund; World Economic Outlook; Organisation for Economic Co-operation and Development; McKinsey analysis

## Governments must improve public sector performance

Improving public sector performance has benefits beyond addressing the short-term spending pressures triggered by the financial crisis. Countries with large public sectors that continue to grow without achieving the productivity gains seen in the wider economy will inevitably find their public sectors are a serious drag on overall growth.<sup>5</sup>

Over the past four decades, public spending as a percent of GDP has grown in many developed countries for a variety of reasons, most recently because of the global financial crisis.<sup>6</sup> From 2007 to 2009, government spending in countries which are members of the OECD increased by an average 13 percent (Exhibit 2). States funded those additional expenses largely with sovereign borrowing, pushing up OECD government debt from 53 percent of GDP in 2007 to 73 percent in 2010,<sup>7</sup> levels high enough to dampen overall economic growth.<sup>8</sup> Many government leaders now face enormous pressures to control debt and reign in budget deficits—not only from within their nations, but from regional economic partners. The most obvious example of this is the European Union’s struggle to stave off financial contagion from member countries.



While governments focus on the budget strains arising from the financial crisis, they must also consider the effects of looming long-term structural deficits. In Europe, 42 million more people will retire from the workforce than will enter it over the next two decades,<sup>9</sup> resulting in a lower proportion of taxpayers to beneficiaries. By 2050, EU governments will need to spend an additional 4.6 percentage points of their combined GDP on old-age pensions, healthcare, and long-term care of the elderly.<sup>10</sup> In the United States, demographic changes alone will increase public health spending by 1.7 percent per year between 2005 and 2030,<sup>11</sup> leaving less money for all the other services that citizens expect, from education to infrastructure to waste collection.

Even as aging populations drive rising demand for public services, there may be fewer government workers to administer them, because the public sectors in many developed countries employ a disproportionately large share of older workers. In Sweden, for example, 44 percent of central government workers were over 50 years of age in 2009.<sup>12</sup> The aging public sector workforce also is likely to be an opportunity for some countries, which may be able to use natural attrition to gradually reduce the scale of government spending and generate productivity improvements. This benefit must be balanced against the potential challenges of lost expertise, as the most experienced civil servants depart.

Between demographic changes that simultaneously increase demand for public services and reduce the ability to deliver them and the realities of significant debt and persistent deficits, governments are left with an imperative to improve performance. We turn next to eight principles that can help governments succeed in this effort.

## Core principles for improving public sector performance

From our research and experience serving governments in more than 50 countries around the world, we have developed eight core principles for government leaders who hope to effect far-reaching improvements in public sector performance. While these principles apply broadly across developed economies—and to many emerging ones—it is important to bear in mind that public sector reform programs also must be rooted in each government’s specific context (see Box 1, “Differences and similarities between public sectors”).

### **Box 1. Differences and similarities between public sectors<sup>13</sup>**

Whether measured in terms of level of expenditure, number of employees, or value added, public sectors are large in all developed countries.<sup>14</sup> Across the OECD public sectors, including education and health care, comprise around 20 percent of GDP on average and are the largest employers. When social transfers and “indirect spending” through selective tax breaks or loan guarantees<sup>15</sup> are taken into account, total public sector activity forms an even greater portion of the economy. In 2007, France led the OECD in public expenditure, with 53 percent of GDP—54 percent including tax benefits related to social protection.<sup>16</sup> In the United States public sector activity accounts for 42 percent of GDP once indirect spending is taken into account (Exhibit 3).

Governments vary widely in how much they spend on social protection and how these programs work. The United States spends nearly 8 percentage points less than the OECD average and France almost 7 percentage points more.

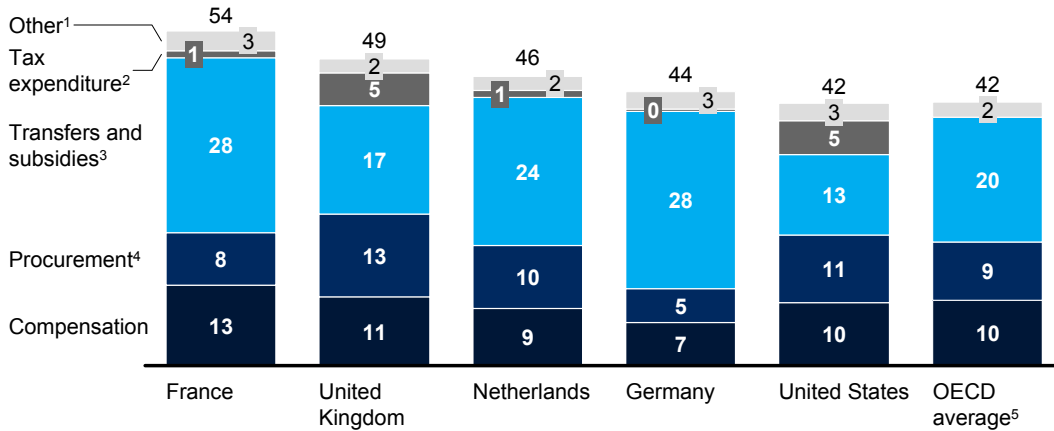
More than 85 percent of spending by OECD governments on social protection is in the form of transfer payments, while most other government spending directly supports operations. In Germany, nearly all of the healthcare budget goes to transfers because of its payor-provider system, while most of the United Kingdom’s healthcare budget is spent on procurement and wages in the national health system.

Countries also vary in how centralized their public sectors are (Exhibit 4). As a rule, countries with relatively centralized government spending can execute top-down, coordinated change more easily than those with more autonomous states or provinces. Less centralized models may allow greater natural experimentation and connection to local affairs. In larger countries and more mixed environments, leaders need to determine if performance improvement efforts will work better with the flexibility and focus that comes with local leadership or through centralized programs. Nations also vary in the degree to which decision-making authority is divided between the center of government and ministries. Such variations complicate not only the measurement of public sector performance but also questions of how best to improve it.



**Exhibit 3**  
**Size of the public sector**

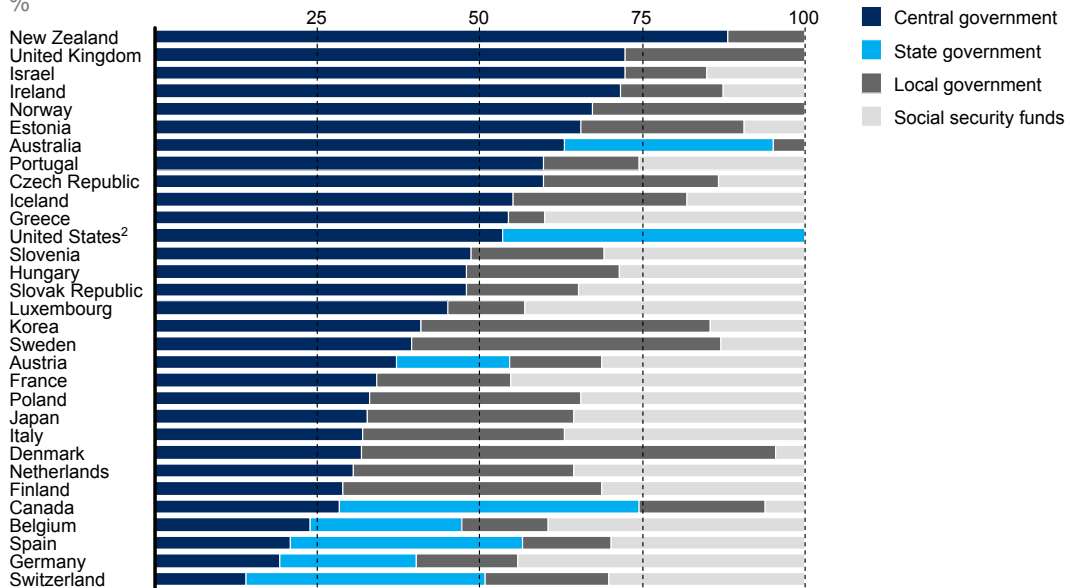
**Average total public spend across countries**  
 Spend by classification as % of GDP, 2007



1 Other includes other taxes and property income.  
 2 Tax expenditure is income tax expenditures for health, retirement, education, R&D, and business excluding capital income.  
 3 Transfers include subsidies, other current transfers, capital transfers, social benefits, and social transfers in-kind.  
 4 Procurement is intermediate consumption and capital formation.  
 5 OECD average is an unweighted average of country expenditure as a percent of their GDP. The OECD average does not include tax expenditure due to data availability.  
 NOTE: Spend is inclusive of national, regional, and local levels. Figures may not equal totals due to rounding. Tax expenditure estimates are based on data availability: data for France is for social protection only (including elderly, family, and housing); data is for most recent years available (2006 for the UK, 2006 for Germany, 2008 for the US, 2006 for the Netherlands).  
 SOURCE: Organisation for Economic Co-operation and Development; McKinsey analysis

**Exhibit 4**  
**The level of government centralization varies greatly across countries**

**Total expenditure by level of government 2009<sup>1</sup>**  
 %



1 Data for 2009 or latest year available.  
 2 Breakdown between state and local governments is unavailable for the United States; social security funds are included in central government in the United States, New Zealand, Norway, and the United Kingdom.  
 SOURCE: Organisation for Economic Co-operation and Development; McKinsey analysis

## 1. Public sector performance can indeed be measured

Unlike in the private sector, where profit and share price provide handy metrics of performance, in the public sector gauging performance is complex. Governments need to understand their inputs (such as budgets and headcount), their outputs (such as number and quality of surgeries performed), and outcomes (such as improvements in public health). Unfortunately, there are few well established international metrics in any of these areas. Public policy outcomes—the eventual impact on society of government activity—are particularly difficult to quantify and are affected by multiple factors, some of them beyond government control.

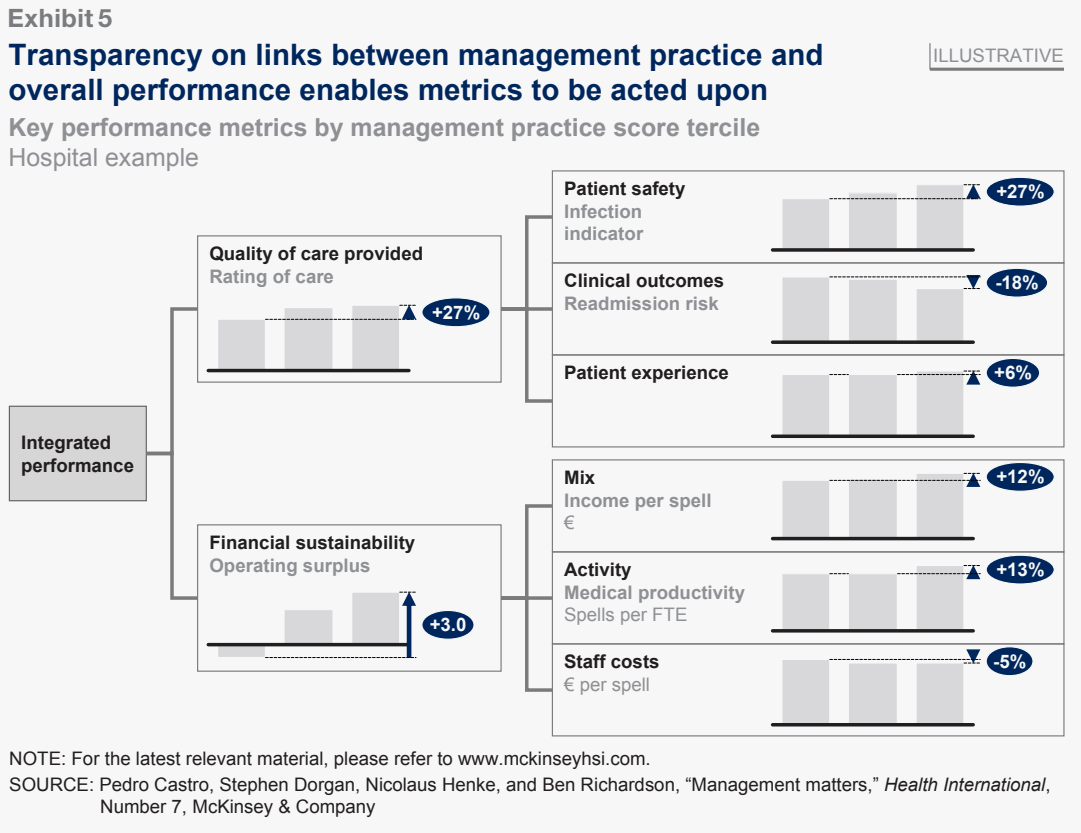
Nevertheless, in our experience, we have seen that it is possible to identify appropriate measures to track every element of public sector performance: inputs, outputs and outcomes. For instance, to gauge the quality of care in healthcare for the elderly, the Swedish government tracks “number of falls per resident” in old-age homes—amongst a multitude of other indicators. While not a complete measure of the outcome of care policy, it is a good indicator—a high rate of falls is associated with poorer overall care. Importantly, it is also one that front-line workers can affect directly.

Qualitative metrics such as the perception of the workforce are also important indicators of performance. For example, tracking “organizational health”—including dimensions such as motivation, fulfillment of mission, and the strength of a performance culture—is critical to informing where to prioritize efforts to change ways of working and how to enhance the organizational culture of public sector organizations.<sup>17</sup>

Moreover, not all private sector activities have perfect measures for tracking their performance either. The true outcome of advertising, for example, is a difficult thing to measure. How do you assess the return on a roadside billboard? Yet marketing managers continually identify and collect partial measures such as number of impressions delivered or advertising recall rates, which clients accept as proxies for performance.

Systematically collecting and adapting performance measures—even those recognized as partial or imperfect—can enable rapid improvements in government performance. For instance, as part of its CitiStat program, the City of Baltimore began to collect information about absenteeism and overtime in 2000, leading to change programs that cut overtime and absenteeism by 40 percent and 50 percent, respectively, in three years. The city then extended the program to cover more performance measures and the CitiStat program saved Baltimore more than \$350 million in its first seven years, while improving the quality and quantity of service. Basic city services such as pothole repairs were delivered faster and more reliably and improved services contributed to increasing demand. Through CitiStat, the city maintained a service-level standard of 48-hour repairs, despite a quadrupling of requests between 2002 and 2006.<sup>18</sup>

A major challenge is to isolate data that directly relates to performance from an ocean of government data. In the United States, for example, the public sector held nearly 850 petabytes (850,000 terabytes) of stored data in 2009.<sup>19</sup> That cache includes a wide array of “floating” metrics that are not tied to any changes in management or performance, but which may be used to buttress a political stance or justify a budget change. For metrics to be useful in driving improvement, they must have a direct link to actions that policy-makers and managers can take. So, a first step in performance improvement for many governments will be to extract the smart data from their big data to identify improvement opportunities. Then the data must be shared with those who can make the change. For example, in English hospitals doctors, nurses and managers use multiple metrics that show how various factors affect quality of care and cost; help them assess how their hospitals or wards perform relative to others; and clarify personal accountability for improving performance (Exhibit 5).



As we will discuss elsewhere in this paper (see principle 7, "Sustained improvement requires a culture of performance," page 16), measures can only work when they are part of a rigorous performance-management system, with agreed-upon performance goals, formal monitoring and regular dialogue with the people accountable for meeting the goals. Different governments may prefer different styles of performance management. For instance, the previous UK government managed performance through a system of "Public Service Agreements." Each government department established performance targets and performance metrics as part of the budget allocation process and the targets were published. The current coalition government has a new approach that emphasizes cost management and aims to increase accountability of managers by publishing performance data online.

## 2. Benchmarking against peers in the public and private sectors helps drive performance

Despite the differences between governments and between the public and private sectors, there is enough commonality in how these organizations run to make meaningful comparisons. Understanding the relative cost, quality, and quantity of services delivered by different institutions is enormously valuable. Comparing different government departments in the same country, similar government activities in different countries or comparable activities in the private sector can provide the insights needed to shape performance improvement efforts.

First, comparisons help define performance ambitions. For example, when the OECD's Programme for International Student Assessment (PISA) was introduced in 2000, Germany's lower-than-expected ranking came as a surprise to many Germans. "PISA-shock" sparked a national debate and significant reform, which has led to rising PISA scores each year, driving Germany from 20th in reading in 2000 to 16th in 2009, and from 16th in mathematics in 2003 to 10th in 2009.<sup>20</sup>

Second, detailed comparisons of similar operations across different public and private organizations show how different institutions operate and which practices yield superior results. For example, the functions of a tax department—receiving submissions, examining them, collecting the tax and providing taxpayer services—are similar across the range of tax regimes. A McKinsey benchmarking study of 13 tax administrations around the world found that none was best in class across all activities, so all the administrations had something to learn from studying tax practices employed elsewhere—from segmenting taxpayers to deploying self-help tools for taxpayers (Exhibit 6).

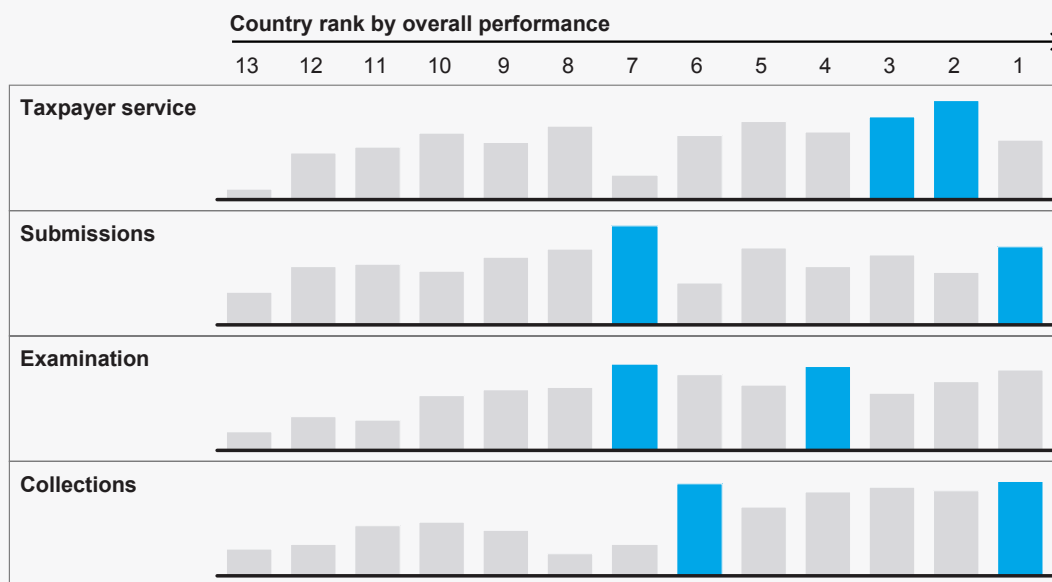
Similar functions in quite distinct areas of government can also be compared to yield insights. Management is one such function. For example, quality of management was the reason for enormous variations in performance across hospitals in each of seven countries assessed (where hospitals in each country operated under identical policies).<sup>21</sup> (See Box 2, “Quality of management matters”). Other general operating capabilities—IT, external procurement, or use of office space—can be compared across government departments and agencies in the same country to identify areas where cost savings can be made.

### Exhibit 6

## Even the top performers can learn from other countries in benchmarking

■ Top 2

### Indexed performance score of 13 tax administrations



NOTE: Performance scores were indexed to 50 for each category.

SOURCE: Thomas Dohrmann and Gary Pinshaw, *The road to improved compliance: A McKinsey benchmarking study of tax administrations 2008-2009*, McKinsey & Company, 2009

Finally, understanding how peer nations or organizations perform helps leaders identify possible performance-improvement approaches and tailor them to their specific economic and political contexts. McKinsey, for example, created a data set comparing the long-term performance of school systems in different countries based on PISA scores and selected national measures of performance. This data prompted an in-depth investigation into some 600 interventions used in the most improved educational systems, to see which worked best in particular contexts. The analysis became the basis for a guidebook for education policy leaders in the countries involved.<sup>22</sup>

**Box 2. Quality of management matters**

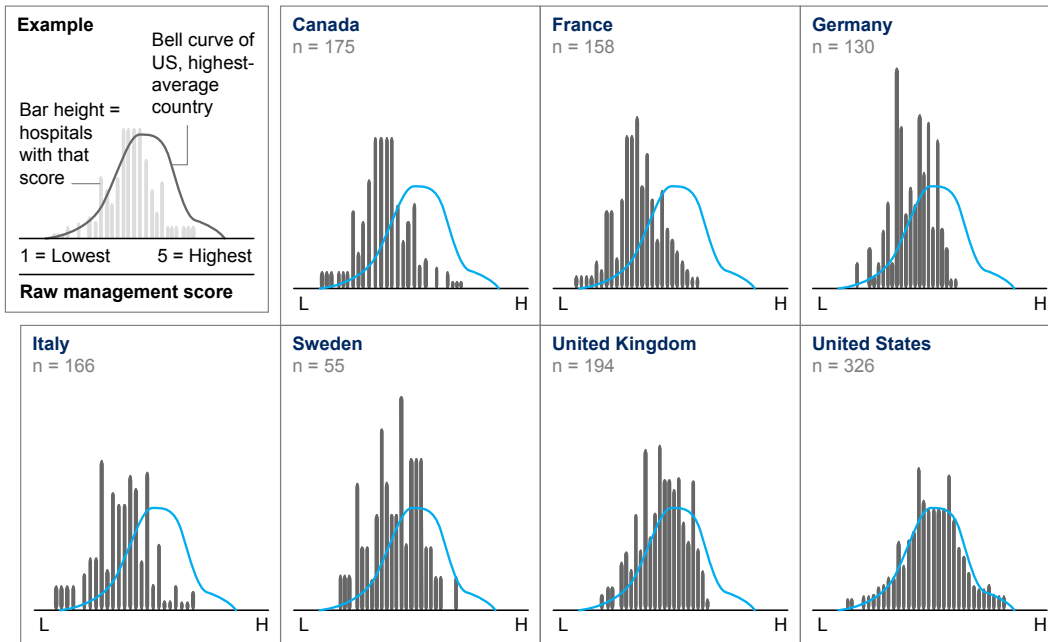
McKinsey and the London School of Economics (LSE) created a benchmarking system that clearly establishes the relationship between the quality of management—as assessed by a scorecard covering operations management, performance management, and talent management—and organizational performance in both the private and the public sectors.

An initial study of manufacturing companies in 2002 found a positive correlation between a company’s management practice score and its commercial performance. In 2006, the methodology was applied to hospitals, starting in the UK and later in the United States, Canada, Sweden, Germany, France, and Italy. In all, 1,194 hospitals were studied and a wide variance in the quality of hospital management practices was observed within each country. Institutions with high scores also had better clinical outcomes, higher patient satisfaction, and stronger financial performance. Specifically, better management practices were associated with significantly lower mortality rates.

The study found wide variance in the quality of hospital management practices across countries (Exhibit 7). But management quality did not seem to be linked to financial resources. UK hospitals, for example, were found to have particularly effective management practices, but did not have exceptionally large budgets. Even more striking were the variations in the quality of hospital management practices within countries, which suggests that countries could boost the performance of their health sectors by bringing all hospitals up to the level of those with the best management practices.

**Exhibit 7**

**There is a wide distribution of management-practice scores within countries—all countries have excellent and poorly performing hospitals**



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

### 3. Improving performance depends on understanding what drives it

Once policy makers have the relevant performance comparisons, the next step is explaining the underlying causes for differentiated performance. Government leaders need to understand the relative importance of each causal factor or performance driver to decide where and how to intervene to improve performance and to prioritize scarce resources.<sup>23</sup>

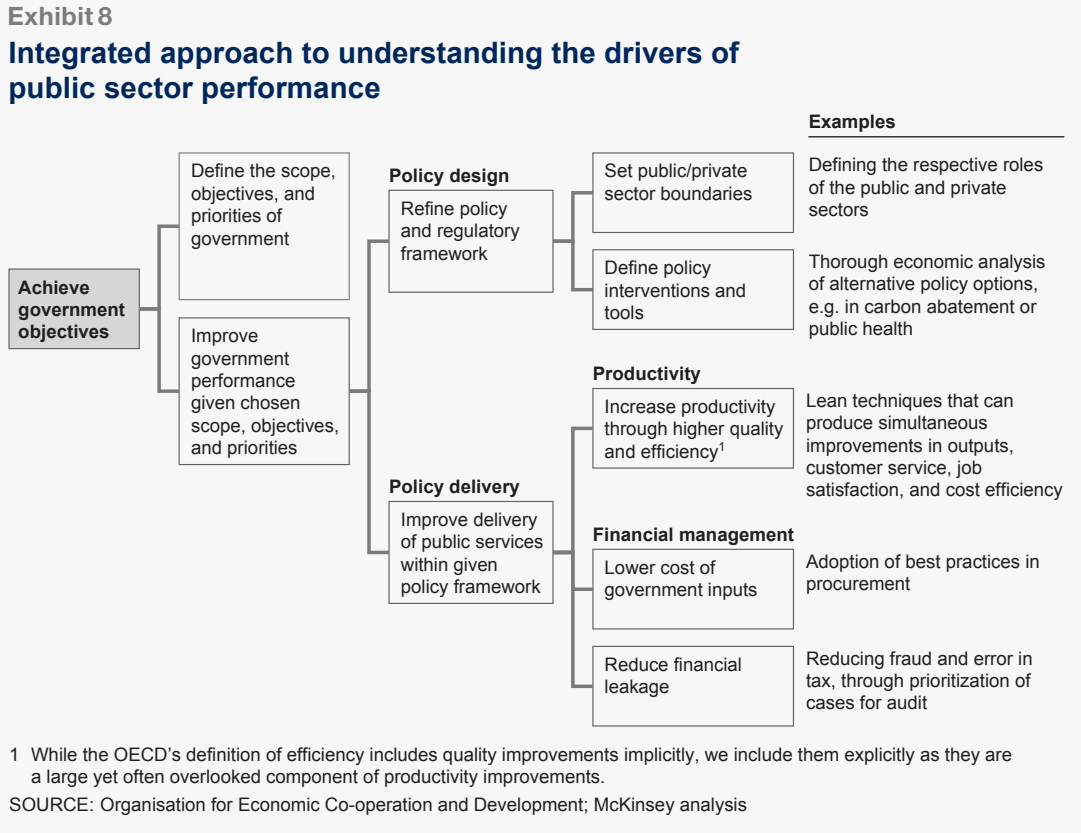
Our experience of government reform around the world also emphasizes the critical importance of taking an integrated approach to making policy and delivering public services. Policies developed without considering execution can fail to account for the resources or changes in the organization required or how they must reflect citizen behavior and needs. At the same time, excellence in the delivery of government services can be just as important to performance improvement—and to citizens' perception of government performance—as large-scale policy changes.

To begin planning an intervention, it is critically important to separate the effects of various interrelated drivers of performance to isolate the ones that can be addressed most effectively. For example, the German Federal Labor Agency analyzed vast amounts of historical data to see which types of support in helping people back to work had the greatest impact and which jobseekers were most likely to find employment as a result of a specific type of training or job placement. Without having to introduce any change in policy, the agency focused on those services with greatest impact and saved €10 billion a year in program spending.

The delivery of public services can be improved in two ways, by improving either productivity or financial management. These performance drivers are often conflated, but each is measured in a different way and each requires different improvement tactics.

*Productivity* gains in a public service can be realized as improved outputs—for instance, by saving time for service users or improving the quality of the service—or by reducing the inputs required, such as labor or material. Productivity improvements can be achieved through a range of measures including better training, adopting lean processes, and more precisely segmenting and prioritizing citizens' needs.

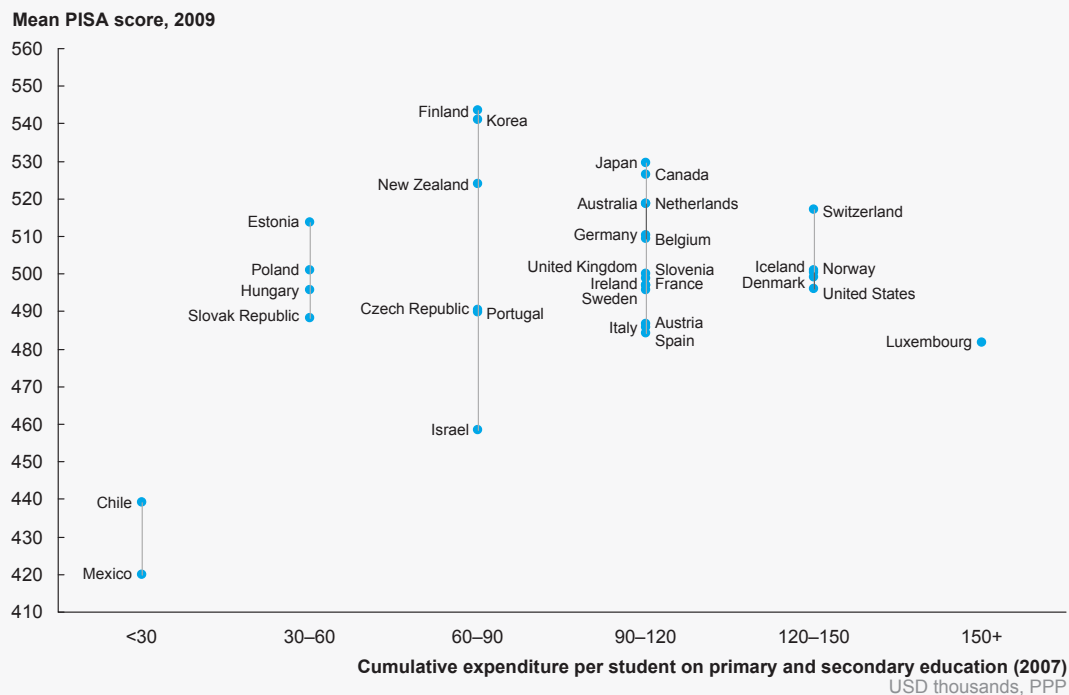
In contrast, sound *financial management* can be realized through changes in pricing or better procurement practices, or by reducing revenue “leaks” through better fraud detection. Distinguishing between different drivers of performance in this way equips public sector decision makers to make better decisions on how to improve performance, and determine where to focus scarce time and resources. A systematic view for understanding the different drivers of public sector performance at a government-wide and departmental level is a valuable starting point (Exhibit 8).



#### 4. Increased quality and lower costs can go hand-in-hand

It is widely assumed that lower public spending inevitably leads to fewer or lower-quality public services. However, comparative research suggests this need not be the case. Cross-country comparisons of public sector functions show striking variations in outcomes achieved for a given level of expenditure. In some services, notably education, there is no clear correlation (Exhibit 9). In others, such as health care, greater spending can lead to better outcomes but not always: in these areas, there are pronounced outliers, suggesting that spending more does not guarantee superior public service outcomes, or vice versa.

Although we don't have enough data to explain this phenomenon completely, we do know enough to say with certainty that governments can do a great deal to boost performance without additional spending. For example, applying "lean" methodologies that were originally developed in the manufacturing industry and then adapted for the private service sectors, can simultaneously improve outputs, customer service, job satisfaction and cost efficiency. One OECD tax administration that applied lean methodologies was able to process 75 percent more returns while cutting assessment errors by 40 percent and processing turnaround times by 80 percent. Similarly, a lean approach has been applied to nursing. Hospital nurses in the United Kingdom and the United States can spend up to 60 percent of their time doing nonpatient work. Streamlining some of their nonpatient processes has allowed nurses to increase the time they spend on direct patient contact significantly, thus improving patient care, reducing the average length of stay and lowering errors in administering drugs. Similar approaches have also succeeded in improving outcomes at lower cost in areas of government as diverse as employment services, defense and immigration.

**Exhibit 9****Educational outcomes are largely uncorrelated with expenditure**

SOURCE: PISA survey 2009, OECD; Government at a Glance 2011, OECD; McKinsey analysis

Better financial management practices can also make tight budgets go further while maintaining high service levels. For example, reducing the financial leaks that occur through fraud or error in both revenue collection and the distribution of transfer payments can boost overall performance significantly. The McKinsey benchmarking study of tax administration productivity mentioned above found that more than 90 percent of the combined potential performance gain across the 13 agencies would come from stopping revenue leaks—including such simple steps as analyzing taxpayer data to prioritize cases for audit that would have the best odds of finding underpayment. The research implies that there are areas of tax administration where a substantial performance gain can be achieved by employing more people in the most valuable tasks, rather than by cutting staff.

Procurement is another financial management process that can be optimized to produce rapid savings without diminishing levels of service. Purchased goods and services account for one-third of total public spending in OECD countries, but the public sector tends to lag the private sector in purchasing practices. From printer cartridges to military equipment, governments pay far more for goods and services than they need to, despite their considerable buying power. In addition, different agencies in the same government often pay vastly different prices for the same things. Fortunately, savings can often be realized very quickly and simply by introducing better procurement practices, making procurement one of the most tangible areas for reform for cash-constrained governments. Indeed, in just over eight months one European central government saved €65 million—or about 40 percent—in a targeted program to test better procurement policies.

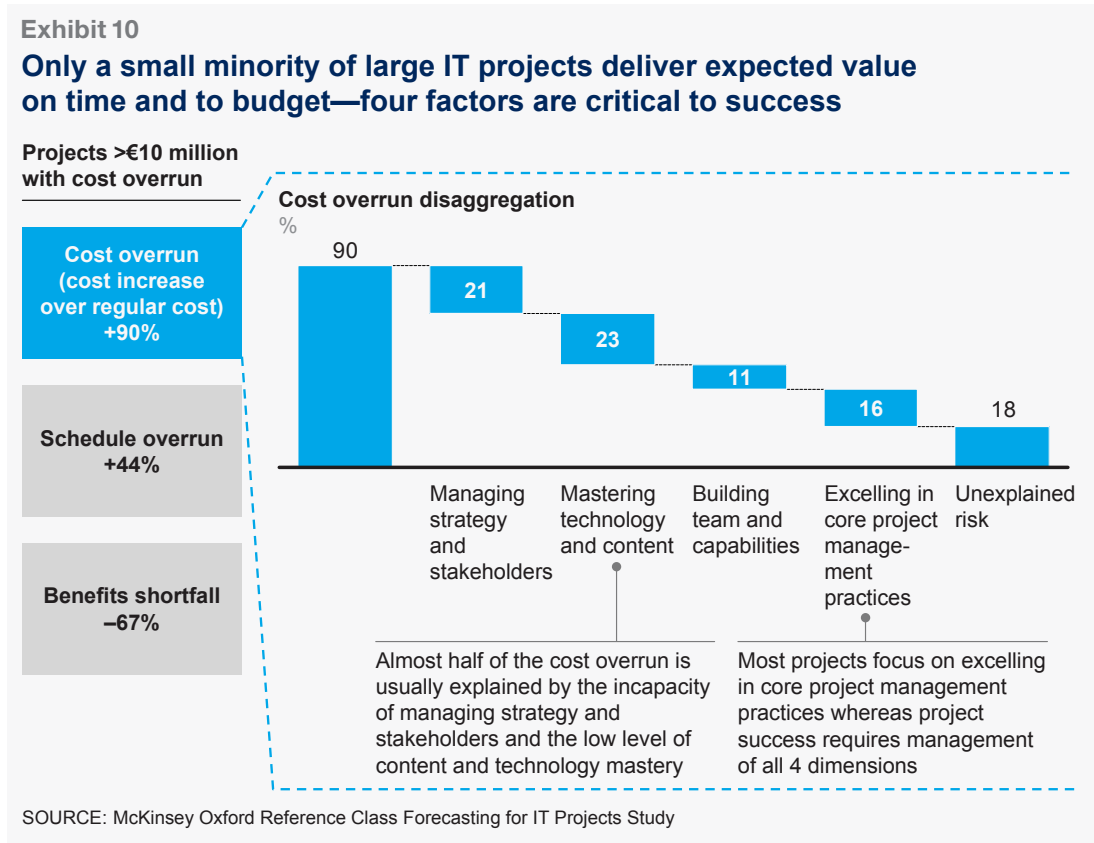
## 5. IT is not a silver bullet

As in the private sector, IT is a critical enabler of public sector productivity—but can be a productivity drain if applied or managed incorrectly. The McKinsey Global Institute (MGI) studied the impact on productivity in the US private sector of increased IT investments in the late 1990s<sup>24</sup> and found that IT did indeed enable productivity growth—but only when accompanied by managerial and process



innovations. IT investment alone was never sufficient for better productivity. Moreover, those related managerial and process innovations often need to be made in advance of focused technology investment to reap the maximum performance benefits.

These findings help to explain why the history of both public and private sector performance improvement programs is littered with examples of spectacular IT spending disasters. According to recent estimates by McKinsey and Oxford University, a large majority of IT projects—both public and private—exceed their budgets and around one in five is 80 percent over budget (Exhibit 10). So today, as governments sensibly explore wider use of Web-based services and “e-government” initiatives to serve citizens better at lower cost, they need to consider related non-IT processes and the capabilities of the people who are responsible for them to get the best yield on their IT investments.



Still, while the failures grab the headlines, some well-managed, large-scale public IT projects have indeed helped to deliver big productivity gains—both by national agencies or through local innovation. Understanding the project management practices used to deliver such successes can help public sector leaders decide how to structure and run future IT projects to get the most value from them.<sup>25</sup> One major European public sector organization had to replace an IT backbone consisting of approximately 50 legacy systems as part of a large-scale information management project. Using best project management practices, the organization completed the project within budget, on time, and according to quality standards and technical specs. In a comparable project for a major North American government agency, a review of IT architecture and strategy enabled the agency not only to reduce claims turnaround time by 50 percent and significantly increase stakeholder satisfaction, but also to reduce the number of IT systems from more than 25 to 5 and databases from 68 to 10. It also halted two major projects that were off-track and gained significant savings by renegotiating major contracts.

Getting the most out of IT investments is not just about managing large projects. Examples of successful IT investments by public sector organizations include finding ways to enable smaller scale innovation in IT and simply making some basic changes to operating practices to make existing systems more productive. For instance, many local governments are shifting motor vehicle licensing and registration online, using a popular private sector strategy: rather than investing in an expensive, fully automated back-end system, they create public websites that gather the necessary information from the motorist and feed the data to existing back-end systems. The customers see only a user-friendly front end—and avoid the trip to the licensing office.

## **6. Radical change should focus on people, not just organization charts**

Top leaders in the private sector know that a financial crisis is an opportunity to make changes that may be impossible during boom times. While they take immediate steps to improve performance, they also look for ways to use the crisis atmosphere—when everybody recognizes the need for change—to restructure or push through fundamental reforms. In the public sector, fiscal crises create comparable opportunities for radical changes to policy or for fundamental organizational change. To yield performance improvements, these changes must go far beyond redrawing the lines and boxes on the organization chart; they must be broad-based, involving how everyone in the organization works on a day-to-day basis. In some cases this will require rethinking job mobility for public sector workers—to ensure talent is able to move across agencies, functions and geographies as necessary to best serve the public.

Governments have a particular opportunity as they respond to their fiscal challenges to reduce the complexity of public sector organizations, while simultaneously reaping the benefits of the public sector's scale. For example, the UK government, spurred by the deficit crisis, has centralized procurement, IT and property activities of central government departments and agencies. This allows the government to achieve significant savings through coordinating purchasing of goods and services across departments to get better prices, while also enabling the consolidation of teams across departmental boundaries. Thanks to the urgency of the crisis, the center of government is now able to mandate how contracts are procured, an approach that departments and agencies had resisted before the crisis.

Governments can also push related functions to work more closely together for the benefit of both workers and the public. For instance, France is working on merging its tax-filing and collections departments, which will improve the flow of information between the two functions and make it easier to detect fraud or respond to taxpayer inquiries. Citizens will gain a single point of contact concerning similar services.

Service Canada, created in 2005, serves as a model for organizing a single point of contact for public services—from finding a job and starting a business, to planning for retirement or having a baby. It now has more than 600 physical locations across the country and provides online as well as telephone access. In addition to gaining high scores in satisfaction surveys, Service Canada saved the government \$300 million in its first year of operation.<sup>26</sup>

Under the new coalition government, the UK has initiated a radical restructuring of its welfare system—merging more than 30 social security benefits and tax credits for people of working age (which are currently administered by two central government departments and more than 350 local authorities) into a single, centrally run benefit called Universal Credit. The objectives of the newly designed benefit include increasing work incentives for very low earners. If executed according to plan, it should also lead to substantial improvements in efficiency and customer service.

One of the largest public sector endeavors in most nations is health care. Here, developed nations can learn from health systems in emerging economies, where the need for efficiency is great and the barriers to change are modest. For example, in some nations healthcare professionals have

agreed to deal with initial primary-care contacts by phone, standardize processes for acute care, and remotely monitor patients with chronic conditions. In many cases, these steps not only reduce costs, but improve patient care and satisfaction. Conservative estimates suggest that applying similar innovations to a healthcare system in an OECD economy would potentially save 16 percent of current healthcare costs. That money could be used to improve access to the system, raise quality, respond to rising demand, or reduce deficits.<sup>27</sup>

Whatever the rationale, restructuring an organization is unlikely to deliver sustained value unless the right changes are made, both to formal roles and responsibilities and, more importantly, to underlying mindsets and behaviors. For a structural change to achieve and sustain a transformation in performance, it needs to take into account the health of the organization and the motivation of its workforce (see Box 3, “The people side of transformations”). Achieving both requires the sustained engagement of public sector leaders.

### **Box 3. The people side of transformations**

Organizational “health” is a measure of how well an organization functions to deliver sustainable performance and, in particular, its ability to align its people around a vision, execute its mission effectively, and renew itself over time. Strong organizational health is therefore critical to day-to-day performance and essential to successful performance transformations.<sup>28</sup> This is the central finding of McKinsey research that includes input from 6,800 senior executives from more than 500 organizations, case studies of change initiatives, and dozens of interviews.

We also have seen that the organizational health of private and public organizations can vary in meaningful ways.<sup>29</sup> On the plus side, 60 percent of government managers say they understand and embrace the direction and vision of their organizations and are motivated to make a difference—versus 55 percent in the private sector. Government, however, lags the private sector in the operational elements of organizational effectiveness such as fostering employee engagement, talent management and accountability.

This research also yields insights into the nature of successful transformations. Organizations that focused on both health and performance during a transformation were twice as successful as those focusing on health alone and three times more successful than those focusing just on performance. On the flipside, 72 percent of transformation failures are due to health factors such as employee resistance and management behavior that is inconsistent with the desired change.

Companies that transformed themselves successfully paid close attention to staff mindsets, ensuring that individuals felt they “owned” change initiatives, and were committed to them. Addressing mindsets that will cause people to resist change was a key element of success, too.

One government organization’s experience is a good example of how a close look at mindset can have surprising results. It had a strong track record of excellent performance delivering a high-profile mission. However, there were signs of organizational weakness in talent management, poor core skill development, performance management, and retention. Ultimately, the agency’s leadership realized that their own mindsets were the root of this organizational health challenge—and changing them would be a lever for improvement.

Specifically, senior managers had a mindset that long experience, rather than actual leadership skill, made them leaders. To remedy this, they established new leadership competencies, better feedback opportunities and stronger accountability mechanisms. Supervisors across the organization have conducted self assessments and have shared their development goals to solicit feedback, support and accountability. Although the overall effort is still under development, early indicators of performance impact include a systematic push to streamline operations by clarifying leaders’ roles within offices and reducing the approval hierarchy for actions.

## 7. Sustained improvement requires a culture of performance

Improving performance involves persuading people to change how they work, rarely an easy task. In most parts of the private sector, competition provides a constant spur to change and research by MGI has demonstrated how different levels of competitive intensity play a critical role in the different rates at which productivity in industry sectors improves.<sup>30</sup> Organizations with low levels of competition—including public sector institutions—generally have low rates of productivity improvement.

Even so, governments can find other ways to persuade people to perform better, some of which use elements of competition. For example, a systematic approach to performance management can be effective in driving improvements, especially when reinforced by collaborative discussions about performance. In France, President Sarkozy and Prime Minister Fillon established a committee referred to as Le Comité de Suivi (CdS) to accompany the major reform program they launched, la Révision Générale des Politiques Publiques (RGPP). Each minister reports to the committee twice annually, reviewing the progress of reforms they are leading. The committee addresses not only that progress but also resource evaluation and public communication. This offers ministers a supportive, but probing forum in which to discuss and solve common issues and build alignment behind government objectives. It also maintains pressure on them to keep delivering results.

“Performance budgeting” is another means of creating pressure to improve public services. Future budgets can be linked to past achievement of outcomes and performance goals. However, while many countries experimented with performance budgets over the past decade, most of these initiatives remain at a very early stage, so their effectiveness is not well documented.

One way to introduce competitive pressure is for governments to establish managed markets where public, semipublic, nonprofit, or even regulated private entities compete to provide services to individuals. Examples include charter schools, and public or private sector hospitals that are independent of central control. The charter school or hospital has an incentive to improve its services in order to attract and retain students or patients. Selected public services may also be outsourced to providers from the private sector. Service quality can improve as experienced providers increase capacity and deploy specialized talent that may not exist in government. If such service contracts are open to competitive bidding and the vendors’ performance is carefully managed, these arrangements can also prove less costly.

In all cases, performance pressure and the underlying performance culture should be underpinned by transparency—sharing performance data with a defined internal or external audience to whom the results matter. Performance data may be shared with internal audiences through impact tracking and performance reviews, or it may be published externally, and can range from national statistics that would be useful to global investors to the performance data of individual schools, which would be of interest to local residents.

Whether internal or external, transparency will only create pressure for improvement if the metrics themselves are robust and clear to the audiences and variations in performance—good or bad—entail consequences and accountability for those consequences. These consequences range from fewer patients electing to seek treatment in a poorly run hospital to promotion for a stellar public employee. But in all cases, change happens when an individual or a small group is held responsible for performance and empowered to do something about it.

The change that competition spurs in the private sector includes not just the adoption of known best practices, but also innovation. If they are to meet the performance challenge ahead, governments also need to encourage innovation in the delivery of public services. Acknowledging that some innovations

will succeed and others will fail can increase the rate of innovation and prevent failures from being concealed. Innovation entails risk—50 percent of new private businesses in the United States, for example, fail within the first five years.<sup>31</sup> Governments should complement innovation from within—including harnessing ideas from front-line teams—by fostering experimentation in their private and social sectors and then adapting and bringing successful innovations to scale in government.

A structure for adopting and adapting experiments that work and acknowledging and abandoning policies and services that don't is essential to public sector performance improvement. MGI research shows that most of the benefits from innovation in the private sector come through large-scale adoption of innovation once it has been proven. Innovation in the public sector is likely to work the same way.

## 8. Far-reaching improvement in public sector performance is possible

Without question, governments face extraordinary challenges in transforming performance because of their scale and complexity. They have enormous workforces and must coordinate public services across organizational and geographic boundaries. They have obligations to protect public safety, educate the young, maintain infrastructure, care for the sick, and support pensioners. And they face almost unprecedented fiscal constraints.

Across developed nations, governments also face barriers to change. There are capability gaps and outdated mindsets among public servants, regulatory barriers, and inflexible workforce policies that limit how staff can carry out assignments or implement new ideas. Governments also operate under constant scrutiny from the public, press and elected officials and must balance long-term reform aims with shorter-term electoral pressures.

Nevertheless, in the past 25 years a number of countries have overcome these hurdles to achieve major government reform programs that can serve as models for today's reformers. These include government-wide initiatives, some of which are described below, as well as many examples of substantial improvements in the performance of individual ministries and agencies.

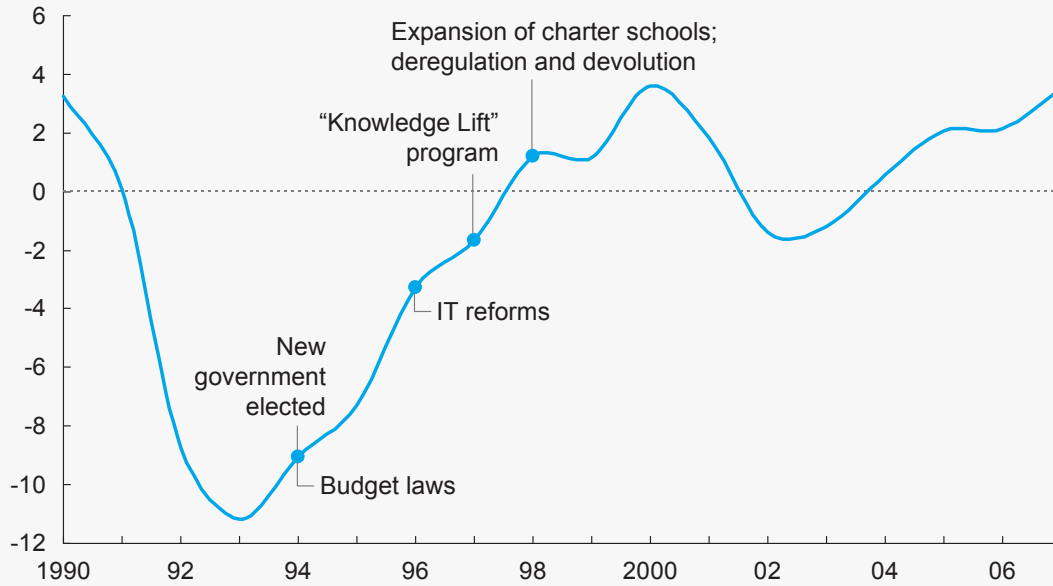
- **Canada.** During the mid-1990s, the Canadian federal government's Program Review reduced government spending by about ten percent by reviewing each government spending program against six criteria.<sup>32</sup> A new Expenditure Management System (EMS) was put in place to assess roles, programs, priorities and performance across government. The EMS remains active today.
- **Sweden.** From 1994 to 1998, following an economic and banking crisis, Sweden eliminated a fiscal deficit of more than 10 percent of GDP by applying efficiency targets to all government departments, but then allowing the departments to decide how best to achieve their targets. Efficiency measures were combined with policy initiatives aimed at fostering economic growth. These included a major program to increase the skills of people already in the workforce. The scheme offered people who had not completed their school diplomas funding to finish them, with their jobs being covered in their absence by someone who was unemployed. Ten percent of the workforce joined the scheme, demonstrating the government's ability to provide valuable new services (Exhibit 11).
- **United Kingdom.** In 2001, the UK government established a small Prime Minister's Delivery Unit with a dual mission—to provide transparency on performance in the government's reform priorities and to work with stakeholders, from ministries to the front line, to dismantle barriers to change. The new UK government in 2010 created a new role of government Chief Operations Officer to lead action on efficiency and reform across central government.

- France.** A major reform program was initiated in 2007 to effect comprehensive improvements to performance across all areas of the state at once. The program covered 15 ministries and addressed cost-cutting, improvement in the quality of services, and the working experience of civil servants (see Box 4, “The RGPP initiative in France”).

### Exhibit 11

## Sweden turned an 11 percent budget deficit into a surplus in 5 years

Government net borrowing/net lending as a percentage of GDP



SOURCE: McKinsey analysis

#### **Box 4. 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 aims were to reduce public expenditure by replacing only half of all retiring civil servants, modernize government operations, improve services for citizens and companies, ensure greater recognition for the work of civil servants, and promote a "culture of results." The Prime Minister, François Fillon, dubbed it a program "to do better with less."

The RGPP has now launched more than 450 initiatives across the 15 ministries, coordinated by a small central team, the Direction Générale de la Modernisation de l'Etat (DGME), which reports to the Minister of Budget and Reform. Its focus spans structural reforms, such as the merger of France's tax-filing 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 information technology and human resources.

To set the targets that the government and its employees are expected to meet, a quality-of-service barometer was published that identified 15 indicators of citizens' satisfaction with public services. The government then committed itself to supporting the relevant ministries in delivering greater satisfaction as measured by the barometer. One indicator was the waiting time at hospital emergency departments—an important measure of healthcare quality for 83 percent of French people. A program across a group of hospitals reduced waiting times by an average of 28 percent.

Another focus is satisfaction relating to "life events"—getting married, having a child, hiring an employee, or losing an official document. The goal was to simplify associated government procedures. The government assessed the complexity level and frequency of each life event to decide priorities for action, conducted diagnostic studies to identify ways of simplifying the related procedures, and launched a program to introduce 100 simplifications.

In these examples, the government deliberately focuses on what it called "demonstrators"—high-visibility service areas in which it felt it could have rapid impact. New operating standards are tested and the impact established before rolling them out across departments.

## **Actions for government leaders**

So far we have set out the scale of the performance challenge facing government leaders, the benefits to be gained from improving public sector performance, and principles on which to base any improvement effort. But where should government leaders start on such a complex challenge? How do they mesh the myriad technical and change-management issues with their political priorities and deadlines? In this section we set out five actions that government leaders at every level can take to guide performance improvement efforts. They start with setting the aspiration for change, followed by four actions to achieve that aspiration.

### **1. Set clear, long-range aspirations for public sector performance**

Government leaders will recognize that they cannot deliver the scale of performance improvement required to meet today's fiscal challenges through incremental changes or within a single electoral cycle. To create the momentum and focus needed to achieve far-reaching, sustained improvement,



governments need to set high aspirations and put in place mechanisms to achieve and sustain those improvements over the long term. For example, during Sweden's fiscal crisis in the mid-1990s, government departments were legally bound to link their productivity to levels of improvement in the private sector.<sup>33</sup> This gave weight to the annual 3 percent efficiency goal and helped communicate the rationale for the targets used.

## **2. Intensify efforts to measure public sector performance**

In many areas, government leaders still lack the long-term, comparative performance data and insights that business leaders rely on when making critical decisions. Such metrics are essential both for defining the appropriate goals for individual government bodies and public services and for selecting the most effective course of action for each organization.

To address this gap, governments need to identify which measures of inputs, outputs and outcomes can form the basis of effective performance management and provide transparency about government performance both inside and outside government. This is not a plea for more unnecessary bureaucracy, but rather a call to identify and focus on the set of metrics that matter to public sector performance, and to refine and improve those metrics over time.

Multilateral organizations have a critical role to play in this endeavor, by intensifying their efforts to develop and share data on government performance across countries. The work of the OECD in helping to measure and improve school performance across member countries provides an example of best practice in collaborative, international measurement of public service.

## **3. Put smart data at the heart of government decisions on tradeoffs and priorities**

As soon as government leaders have a richer and more focused set of data, they need to use it in decision-making processes and performance management systems. A solid, widely accepted set of facts about public sector performance will also help leaders to communicate the difficult decisions and tradeoffs that lie ahead as they prioritize scarce resources and select which actions will do most to improve citizens' lives.

Basing all decisions on robust data will require a change in culture and capabilities for many public sector organizations. "Floating" metrics should no longer be allowed to swing decisions.

## **4. Hold regular, collaborative dialogues on performance with those accountable for progress**

Government leaders need to put in place a new approach to performance management based on effective dialogues on performance with those accountable for progress at all levels of government. Carrying out such performance dialogues effectively is a core role of government leaders, and one for which they need critical skills: being able to pose the questions that reveal the true state of performance at each level of government and the most important drivers of that performance, and to identify ways to generate the greatest performance improvements (Exhibit 12). For this to work, the right people must be available to answer those questions in detail and with sufficient data, and leaders must create an atmosphere that enables frank, constructive discussion and sound decisions.<sup>34</sup>



Exhibit 12

**Key performance questions for public sector leaders**

EXAMPLES

<p><b>Define the scope, objectives, and priorities of government</b></p>	<ul style="list-style-type: none"> <li>▪ What are your government's or organization's most important priorities for reform?</li> <li>▪ Which current activities do you want to continue, which do you want to stop?</li> <li>▪ How should you allocate resources against priorities?</li> </ul>
<p><b>Refine policy and regulatory framework</b></p>	<p><b>Set public-private boundaries</b></p> <ul style="list-style-type: none"> <li>▪ Which activities should be best played inside government, and which transferred to the private or nonprofit sectors?</li> <li>▪ Are there opportunities to establish or better manage mixed markets for provision across the public and private sectors?</li> <li>▪ How effectively does government interface with the private sector—whether as regulator, shareholder, purchaser or payor?</li> </ul>
	<p><b>Define policy intervention tools</b></p> <ul style="list-style-type: none"> <li>▪ How does the cost-benefit analysis of new policies compare to next best alternatives?</li> <li>▪ How do you think about your portfolio of policies (considering lead time and uncertainty)?</li> <li>▪ Do your policy choices reflect evidence of alternative approaches and their impact from around the world?</li> </ul>
<p><b>Improve delivery of public services within given policy framework</b></p>	<p><b>Increase productivity</b></p> <ul style="list-style-type: none"> <li>▪ How has your productivity changed over time, and how does it compare to other countries/jurisdictions?</li> <li>▪ What are the main outputs from your operations?</li> <li>▪ Do you have a clear understanding of how inputs and outputs are linked?</li> <li>▪ What mechanisms do you have in place to track implementation of government priorities and drive continued productivity improvement?</li> </ul>
	<p><b>Lower cost of government inputs</b></p> <ul style="list-style-type: none"> <li>▪ Do you have a consolidated view of purchasing spend and supplier relationships across the whole of government?</li> <li>▪ Do you apply best-practice purchasing techniques such as Total Cost of Ownership analysis?</li> <li>▪ How do you manage demand and systematically bring down the cost of goods and services you purchase?</li> <li>▪ Do you have the capabilities and levers of control you need to optimize external spend?</li> </ul>
	<p><b>Reduce financial leakage</b></p> <ul style="list-style-type: none"> <li>▪ Do you actively manage your tax gap (the gap between expected and actual tax receipts)?</li> <li>▪ Do you track and manage transfer payment accuracy and fraudulency rates?</li> <li>▪ How do you go about segmenting customers to minimize leakage?</li> </ul>

## 5. Establish comprehensive, sustained programs of change and lead them from the front

The extraordinary performance pressures on governments today call for extraordinary measures. Governments need to establish programs to improve their performance at a government-wide, ministry and agency level to achieve far-reaching and sustained progress and consistently do more and better with less.

A variety of approaches to comprehensive, large-scale public sector performance improvement is available. (See Box 5, “Approaches for designing reform programs”.) But all of them depend on the shared desire to improve the government’s activities based on performance data, whether this data is shared internally or externally. These approaches also require that leaders pay close and sustained attention to building capabilities and changing the way that thousands—and, in larger countries, millions—of public sector employees work. And all of them require their leaders to lead change from the front—through sustained, visible engagement with employees and citizens.

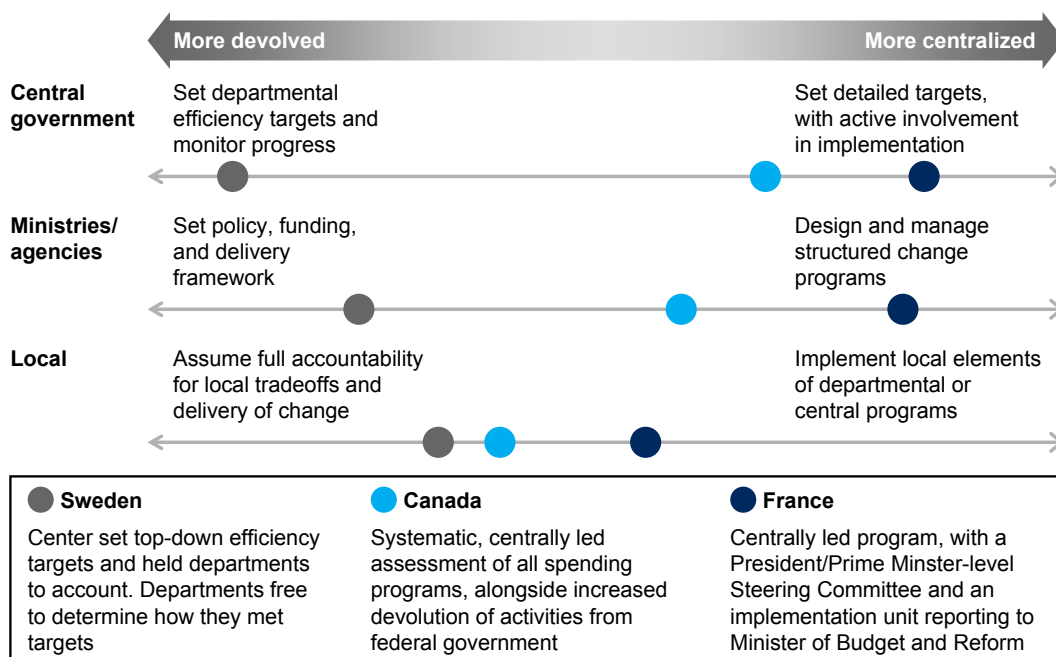
### Box 5. Approaches for designing reform programs

While the need for systematic programs of reform to improve performance is common across the public sector, government leaders have multiple choices to make in the design of those programs and how they tailor them to their specific context (Exhibit 13). This includes defining the role of the center of government (or of a ministry or agency) in leading change. The cross-government reform program initiated in France in 2007 had a strong central team from the start that coordinated reforms across ministries and reported to the president and prime minister. By contrast, during reforms in Sweden in the 1990s, the center of government set efficiency targets, but then left it to ministries to determine how to meet them.

#### Exhibit 13

### The design of reform programs is linked to the level of centralization

ILLUSTRATIVE



SOURCE: McKinsey analysis

Whether they are politicians or civil servants, government leaders will need to decide the scope and shape of reform programs, mobilize the public sector workforce, and courageously communicate the tough tradeoffs to the public. Only strong, sustained leadership, visible both inside and outside of government, will deliver improved public sector performance on a tight budget.



The aim of this paper has been to synthesize research and experience relating to public sector performance improvement and to provide a set of guidelines for public leaders. As we have described in the paper, much more needs to be done to provide government leaders with the insight, data, and tools that their private sector peers have used to drive their performance improvements.

Achieving this goal will require agreeing to methodologies for measuring public sector productivity and developing an authoritative and consistent set of international benchmarks. Robust performance data will allow prime ministers, ministers of finance and leaders of departments and agencies to assess their performance and identify where they should focus efforts to improve their productivity. In addition, governments will need access to case studies that show how other nations have improved public sector productivity at all levels of government.

Addressing these goals is one of the major areas of focus for the McKinsey Center for Government. It is by its nature a multiyear endeavor that will require the involvement of governments, multilaterals, academics, and practitioners from around the world.

## Notes

1. This paper focuses on developed economies. Developing economies also urgently need to improve their public sector performance. However, many of their public sector performance challenges are quite distinct and have different roots from those of more developed economies.
2. In estimating the potential benefit from public sector performance improvement, McKinsey analyzed tax revenue and the component parts of government expenditure, applying different performance improvement assumptions to each based on analysis of international private sector productivity trends and past experience and research in both public and private sector improvement. For example, in the area of social transfer spend, performance improvement is based on potential gains from reduced error and fraud. The analysis relied on 2016 forecasts of revenue and expenditure from the International Monetary Fund and the OECD's data on expenditure by type. The analysis included spend at all levels of government—central, regional, and local—based on the assumption that while the ease and method of capturing the benefit would differ by level, the potential for performance improvement likely would not.
3. Most governments are also seeking to improve the macroeconomic environment—the most attractive way to reduce deficits as rising GDP increases tax receipts and declining unemployment reduces expenditures. However, for most nations, these efforts alone have not been sufficient.
4. During 1980–2007 the combined aggregate economic productivity for US and EU 15 private service sectors grew at a 1.6 percent compound annual growth rate (CAGR). Total private sector productivity grew about 2 percent CAGR and total aggregate productivity growth averaged 1.8 percent CAGR. Productivity was calculated by dividing value added by the number of labor hours. For this analysis, the following sectors were considered to be private sector services: wholesale and retail trade; hotels and restaurants; transport; storage and telecommunication; financial intermediation; real estate and business activities; social and personal services; and private household services.
5. Measuring productivity in public services is inherently difficult: the output of services such as defense or education is hard to define. The United Kingdom's UK National Statistics has started using direct quality-adjusted indicators of output, such as the number of medical consultations or the number of children taught. The effort is still partially experimental, but there are indications that public sector productivity may actually have fallen in the decade from 1997 to 2007.
6. Government spending as a percentage of GDP has slowly increased over the last four decades in many developed countries. There are a range of theories as to the underlying causes. One suggests an income effect in the demand for government services; as taxpayers grow wealthier, they demand more public services. Another, the public choice theory, holds that the size of the state is determined by the contest between ordinary taxpayers and special interest groups seeking privileges (e.g., retirees seeking more generous healthcare and benefits, car manufacturers seeking quotas on imported cars). As privilege seekers become more adept at outmaneuvering other taxpayers, the public sector expands.
7. Government at a Glance, OECD, 2011.
8. Gross government debt above 90 to 100 percent of GDP usually results in lower long-term growth, and the impact is sometimes felt when debt reaches 70 to 80 percent. Cristina Checherita and Philipp Rother, *The impact of high and growing government debt on economic growth: An empirical investigation for the euro area*, Working Paper Series Number 1237, European Central Bank, August, 2010.
9. United Nations, Department of Economic and Social Affairs, Population Division (2011). *World Population Prospects: The 2010 Revision*.
10. The impact of aging on public expenditure: projections for the EU25 Member States on pensions, health care, longterm care, education and unemployment transfers, Economic Policy Committee and the European Commission (DG ECFIN).
11. This projection isolates the impact of demographic changes by assuming that in the period 2005 to 2030, average public healthcare spending per individual by age band, remains constant at 2004 levels. *Health International* (McKinsey & Company), Number 7, The Health Care Century; United Nations, Department of Economic and Social Affairs, Population Division (2011). *World Population Prospects: The 2010 Revision*.

12. *Government at a Glance*, OECD, 2011.
13. Data used for sizing purposes in this paper are from 2007 in order to avoid distortions in spending that came about during the recessionary period. More recent data are available from the 2011 release of the OECD's *Government at a Glance*.
14. Gross value added is defined as the difference between output and intermediate consumption for any given sector or industry. The measurement of government value-add is widely accepted to be imperfect in its current form due to difficulties in measuring public sector outputs. Until recently, most OECD countries measured the volume of public services in their national accounts by assuming that the public sector's output was equal to its expenditure. Efforts are now under way in many countries to use direct measures of output. The United Kingdom has made concerted efforts in this direction: it now has direct quality-adjusted output measures covering around two-thirds of its public sector activities. Similar progress has been made in Denmark. The United States continues to assume that output is equivalent to input in the calculation of government productivity.
15. Tax breaks are one type of non-expenditure government activity—activities that are not reflected in public sector budgets and can be quite difficult to capture and measure. These include foregone tax revenues (referred to as "tax expenditures," which include items such as tax incentives) and loan guarantees. Tax expenditure is the larger of the two, though loan guarantees are also important. Data on loan guarantees, however, are not readily available and are complicated by complex considerations of valuation that have not been fully explored. Much additional work would be required to fully account for loan guarantees and for the purposes of this report they are excluded. The magnitude of tax expenditures is reported based on available data largely from the OECD.
16. The OECD estimates that France spent €20 billion (1.1 percent of GDP in 2007) on tax expenditure for social protection (housing, education, family and elderly). The Commission des Finances estimated total tax breaks to be approximately €73 billion in 2008 (3.7 percent of GDP).
17. *Driving federal performance: Overview of survey results* (McKinsey & Company, 2009) shows how this approach can be applied in the public sector.
18. Perez & Rushking (2007), *The CitiStat Model: How Data-Driven Government Can Increase Efficiency and Effectiveness*; Center for American Progress.
19. *Big data: The next frontier for innovation, competition, and productivity*, McKinsey Global Institute, May 2011.
20. PISA, 2010 (*Strong Performers and Successful Reformers in Education: Lessons from PISA for the United States*).
21. Research by McKinsey and the London School of Economics on hospital performance demonstrates the direct correlation between management practice and performance of hospitals operating in the same policy context. See "Management in Healthcare: Why good practice really matters," McKinsey and LSE, 2010.
22. *How the world's most improved school systems keep getting better*, Mona Mourshed, Chinezi Chijioke, and Michael Barber (McKinsey & Company, October 2010).
23. McKinsey Global Institute has conducted 20 years of research into the underlying drivers of productivity and competitiveness in 20 countries and 28 industrial sectors. Research is available at [www.mckinsey.com/mgi](http://www.mckinsey.com/mgi).
24. *How IT enables productivity growth*, McKinsey Global Institute, October 2002.
25. See article on best practices in managing large-scale IT programs, to be published in the Autumn 2011 issue of *McKinsey on Government*.
26. Service Canada Annual Reports, Service Canada, 2005–06 and 2008–09.
27. *Unlocking productivity through healthcare delivery innovations*, McKinsey & Company, 2010.

28. More detail can be found on how organizational health can help establish and maintain excellence in *Beyond Performance: How Organizational Health Delivers Ultimate Competitive Advantage*, by Scott Keller and Colin Price (2011).
29. See *Driving federal performance: Overview of survey results* (McKinsey & Company, 2009).
30. More than 100 sector level studies over 15 years. See *Growth and renewal in the United States: Retooling America's economic engine*, McKinsey Global Institute, 2011.
31. Bureau of Labor Statistics, 2010.
32. See "Toward a more efficient public sector," *McKinsey on Government*, 2011.
33. See "Reforming the public sector in a crisis: An interview with Sweden's former prime minister," *McKinsey Quarterly*, 2009.
34. See "Shall we talk? Getting the most out of performance dialogues," *McKinsey on Government*, Number 6, Spring 2011.

## About the authors

**François Bouvard** is a Director in McKinsey's Paris Office.

**Robert Carsouw** is a Principal in McKinsey's Amsterdam Office.

**Eric Labaye** is Chairman of the McKinsey Global Institute and a Director in McKinsey's Paris Office.

**Alastair Levy** is a consultant in McKinsey's London office.

**Lenny Mendonca** is a Director in McKinsey's Washington, DC office.

**Jaana Remes** is a Senior Fellow of the McKinsey Global Institute in San Francisco.

**Charles Roxburgh** is a Director of the McKinsey Global Institute and a Director in McKinsey's London Office.

**Samantha Test** is a Fellow of the McKinsey Global Institute in San Francisco.

This paper is the result of a collaboration between the McKinsey Center for Government and the McKinsey Global Institute. The authors are grateful for the contributions of wider members of the team who worked on the paper: Karen Croxson, Karl Murray, and Andrew Nipe. They would also like to acknowledge contributions from external advisers on the paper, notably Martin N. Baily and Diana Farrell, as well as from multiple McKinsey and external experts who have provided input on specific aspects of public sector performance.

For further information on this paper or the McKinsey Center for Government, please contact: [mcg@mckinsey.com](mailto:mcg@mckinsey.com).

Further information about MGI and copies of MGI's published reports can be found at [www.mckinsey.com/mgi](http://www.mckinsey.com/mgi).

