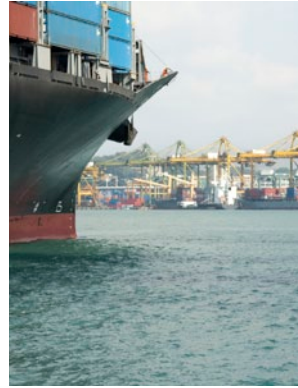
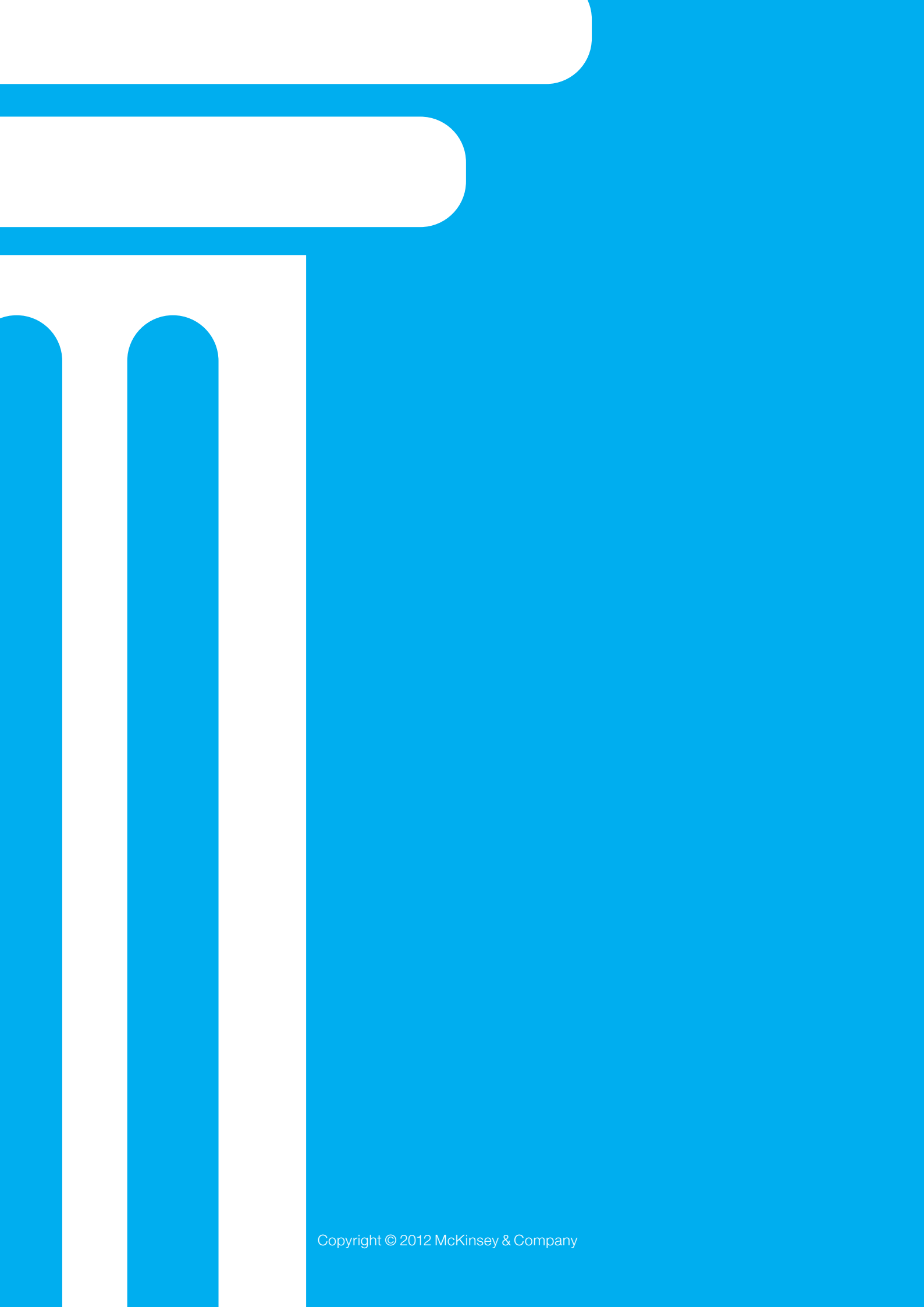


## McKinsey Center for Government



# Government designed for new times

In challenging times, the government we need is rarely the government we inherit. Instead, government must be deliberately designed and managed to make progress on solvable problems.



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Diana Farrell  
Director, Washington DC,  
Global leader and co-founder of the McKinsey Center for Government

July 2012



# Foreword

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We at McKinsey believe that government matters – and never more so than now. In every country Government is a large percentage of GDP; a critical enabler of citizen prosperity, health and security; and as we have seen in recent years, government plays a vital role as risk-taker in times of crisis.

In Asia, governments face many of the same issues as those in other countries, but many that are specific to the region. The emergence of Asia as a global economic powerhouse, with rapid urbanization and growth, has created unprecedented prosperity. Of the 1.8 billion new consumers set to join the global economy over the next 15 years, more than 75 percent are likely to be in Asia.

However, with rapid transformation come new challenges. Many governments across Asia are grappling with the pressures of high growth, including increasing income inequality, rising demand for infrastructure and services, and spiraling complexity in public sector management. At the same time, they face rising citizen expectations around participation, government support and delivery.

Like others, governments in Asia also face some important constraints, including the need for fiscal discipline, demographic challenges as their populations age, growing scarcity in resources, and pressure for greater public sector productivity.

That is why we have created the McKinsey Center for Government (MCG). It is a dedicated center of expertise to support governments in achieving greater and lasting performance. Our mission is to help leaders understand these forces that are driving change, design strategies for success and develop the tools and capabilities needed for effective execution.

Uniquely, the center will forge a dialogue within governments at all levels – from prime minister through agency leader to departmental officials – and between governments around the world. It will take a global perspective at all times and work in partnership with practitioners, experts and other organizations to enrich the insight and the conversation.

The McKinsey Center for Government will be the first of its kind in Asia. With a regional hub in Singapore, it will bring the best of McKinsey's global insights and expertise to governments in the region at a time when they need it most.



Andrew Grant  
Director, McKinsey Singapore  
Leader, Global Public Sector Practice



# Government designed for new times

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Rarely has the need for effective government been greater than now – and rarely has the ability to produce it been more constrained. After the recent wave of storms and disasters – both natural and financial – the need for leadership and a concerted response from national capitals is acute. Adding to the pressure, many governments are managing the implications of an unprecedented degree of fiscal and monetary intervention. They are preoccupied with the urgent tasks of getting banks to lend again and demonstrating fiscal credentials to the bond markets. The crisis mode of the past few years endures in several countries, while in others there is no more than cautious optimism.

In addition, leaders must confront long term, fundamental questions too: from the size and role of the state, to how best to stimulate growth; from profound and surging demographic imbalances, to tackling growing unemployment and welfare bills; from solving the extent and nature of regulation necessary to protect the public, to forging a new relationship between citizens and government services. Thus, many governments confront a daunting paradox: an expanded set of major policy imperatives in a constrained and almost precarious fiscal position.

On these subjects, however, there is little agreement. The policy debate is becoming more polarized at arguably the worst possible time. There is a real risk that in the face of big choices and much disagreement, paralysis reigns. Leaders thus spend their energy on policy fights and battles for the hearts and minds of the public – at the expense of making progress where it is possible to do so.



It is at times like these that government matters most.

We believe it is possible to make huge strides in addressing critical challenges, even without resolution of the many ideology and policy dilemmas. From government spending to tax collection, education improvement to health outcomes, and welfare reform to job creation, we see scope for meaningful improvement to do more and better with less. What is needed is government management by design, built to fit these difficult times: government that identifies the most critical solvable problems, reorganizes where necessary to deliver the right solutions, and abandons the tools and approaches that no longer work.

In this effort, governments can draw heavily on the mission driven mindset of employees – a real comparative advantage for the public sector over the private sector. Too often, leaders insufficiently tap into this valuable asset. And leaders can do far more to mine the evidence of what works elsewhere. International peers, often trying to solve exactly the same problems, provide invaluable roadmaps and lessons. Unlike the private sector – where companies spend millions of dollars trying to understand secret competitor strategies and replicate their achievements – the public sector is open, thereby easier to mine for successful practice and lessons learned.



## Government by design

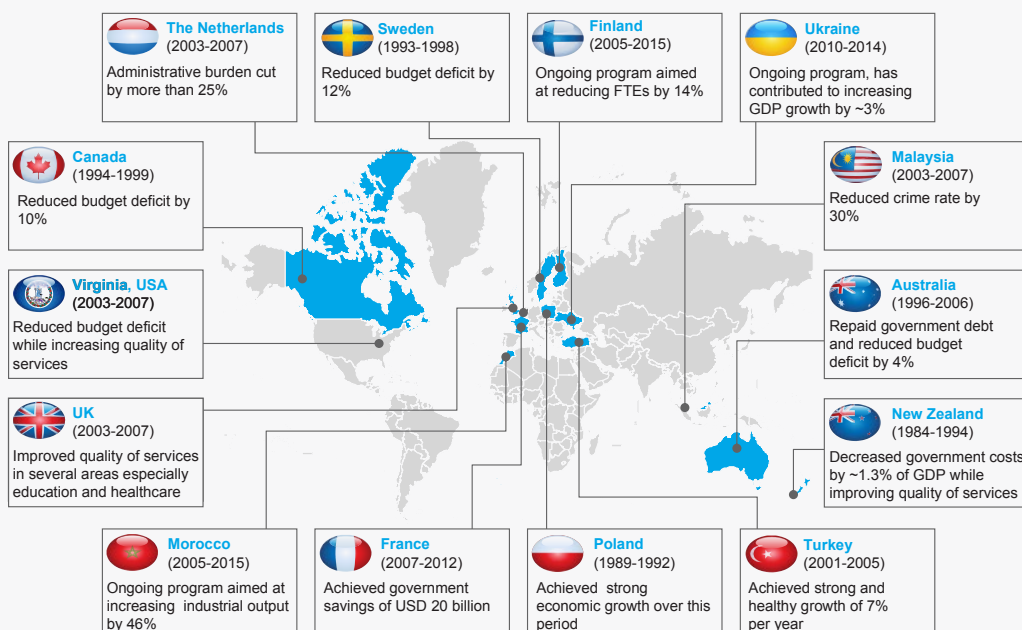
Political leaders rarely campaign for office on a platform of government effectiveness. For some it fails to capture their imagination or, they suspect, the imagination of voters. For others, tackling the bureaucracy is perceived as high risk and low reward compared to passing new laws in the legislature. Yet few succeed without achieving some reform. Many departing presidents, prime ministers and cabinet secretaries reflect on how the engine of government itself was at the very heart of their successes or failures.

### What it takes

To truly transform government requires fresh thinking and substantial investment of both resources and political capital: business-as-usual, or modest or occasional improvement is inadequate. Those that have achieved sustainable and significantly higher levels of government performance did so by explicitly designing and executing multi-year reforms that push beyond everyday initiatives designed to improve management capability. In our research, we identify 40 such programs that have been enacted around the world in the past two decades. There were a number of objectives these programs were designed to achieve: significant fiscal consolidation, better outcomes across multiple public services, and economic growth. Exhibit 1 outlines some of these programs.

Analyzing these programs and interviewing the leaders involved reveals a valuable set of lessons for other government leaders facing major challenges. The first is being clear and ambitious about what the government is trying to achieve. Many transformations achieved what appeared to be impossible targets. Sweden for example, moved from an 11 percent deficit to a fiscal surplus in the 1990's, having been close to default and an IMF bailout. A second lesson is the need to make big

**Exhibit 1: Global examples of government transformation programs**



SOURCE: McKinsey analysis



– not incremental – shifts in terms of the amount of time, energy and resources required. On average, the programs in our sample lasted for 6 years, with 1,300 staff involved in each.

### Fit for purpose

Beyond this clear focus and investment of time and resources, government by design also means investing in those capabilities needed for success. Some of these are common and enduring across the public, private and non-profit sectors – such as employing best practices in technology and operations, organization and human resources, and budgeting and finance, as well as operating across geographic and stakeholder boundaries and making use of large data sets for better performance and policy. Other capabilities will be specific to the government sector, including risk management in regulation and segmentation for welfare-to-work interventions.

Increasingly, the intense pressure for reform combined with a new operating environment, makes innovation a critical capability. In many areas, government agencies around the world are reimagining how services are delivered, for example, through one-stop shops and e-portals, by providing greater data availability, and through mobile services that allow citizens to get instant help and support. They are also migrating to a new paradigm where non-state actors – private companies, nonprofits and citizens themselves – play an increasingly important role in designing and executing policies and services.

*To truly transform government requires fresh thinking and substantial investment of both resources and political capital*

## Finding answers to the solvable management questions

Governments that are willing to reform and build these crucial capabilities are better able to achieve major breakthroughs in the most fundamental policy areas, even in the absence of new policy or legislation.

### Fiscal management

Take fiscal management, arguably the most daunting of all issues today. According to the International Monetary Fund, most OECD governments need to improve deficits by 4 percent or more of GDP to achieve long-term debt targets<sup>1</sup>. Of course much of this involves policy debate. Entitlement reform, public spending reductions and increased taxation are highly-charged politically. However, operational reforms designed to improve efficiency can make a meaningful difference now and set the stage for more-successful policy implementation over time. In particular, spending reviews undertaken agency by agency – even if initially focused only on non-core functions such as technology, procurement or travel – can yield meaningful savings that will increase credibility and flexibility as fiscal constraints increase. Similarly, improved tax collection, drawing on international best practice, can produce real revenue growth within the existing tax structure.

### Spending Reviews

A number of governments are taking a more strategic and evidence-based approach to achieving fiscal sustainability by launching multi-year spending reviews. The review helps to establish priorities and clear paths to deficit reduction. Almost without exception, these spending reviews

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1 IMF Fiscal Monitor April 2011

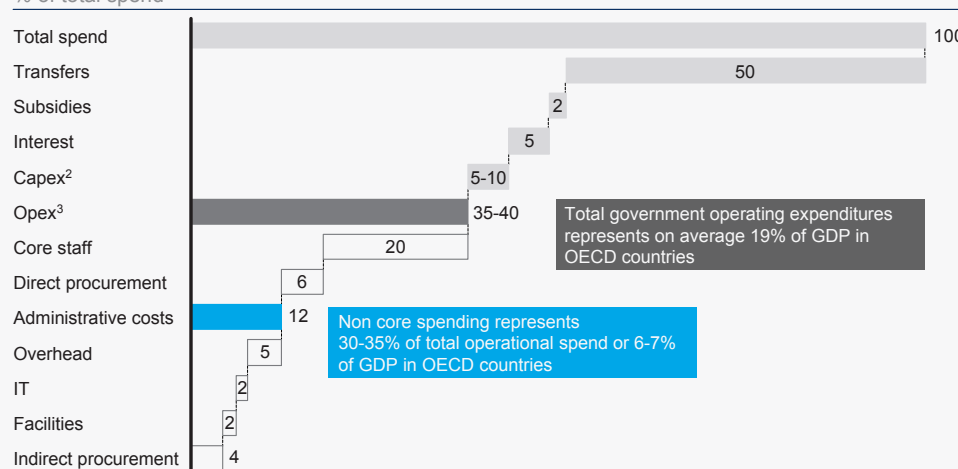
uncover huge opportunities for improving effectiveness, decreasing costs and increasing revenue by improving the efficiency of administrative, non-core activities. To size the prize, consider that our global benchmarking research indicates that operational expenditures represent 35 to 40 percent of total government expenditure; on average, 19 percent of GDP for OECD countries. Within that operational expenditure, roughly a third is spent on overhead functions, representing 6 to 7 percent of GDP in OECD countries (see Exhibit 2).

To date, we have reviewed ten countries that have conducted such spending reviews during the past 5 years and discovered that there is currently little standardization in approach<sup>2</sup>. Four governments have imposed top-down spending cuts, from the center to agencies, while six have developed a bottom-up understanding of the potential savings opportunities. Of the six using a bottom-up approach only New Zealand, the UK and Denmark have used clear baselines and intra-government or external benchmarks to estimate the savings potential – even though this is clearly an opportunity to drive success.

Drawing on benchmarks from different governments, we estimate a potential to save 5 to 10 percent of operational costs through overhead categories without compromising core programs. This represents a savings in the range of 0.3 to 0.7 percent of GDP – some 10 percent of the adjustment countries are required to make in order to achieve their long-term debt targets. This is a significant contribution, given that it requires no compromise on core programs, no reduction in social programs, and no additional costs to tax payers. And it ultimately sets the stage for better policy implementation in the future.

## Exhibit 2: Governments spend 30-35% of their operational expenditures (6-7% of GDP) on administrative cost categories

### Total government spend<sup>1</sup> % of total spend



<sup>1</sup> Considers 24 countries (Austria, Bulgaria, Cyprus, Czech Rep, Denmark, Finland, Germany, Greece, Estonia, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Norway, Poland, Portugal, Slovenia, Spain, Sweden, U.K. and US)

<sup>2</sup> Capex includes investment in land & structures

<sup>3</sup> Includes production personnel, overhead personnel, IT, Facilities, Procurement

SOURCE: OMB Budget for USA 2011, PESA Report for UK Treasury 2011, Government of Canada Public Accounts 2011, MTEFs, Government websites, Laws, McKinsey analysis

### **Tax Collection**

Meanwhile, as governments grapple with increasing social obligations and projected declines in the relative size of labor workforces, tax administrations are under even more pressure to collect every dollar of tax payable. They need to ensure that every dollar they spend collecting taxes yields the maximum benefit for citizens. Tax administrations also have broader significance: the interface and effectiveness of a tax administration often becomes a watermark of public confidence in a government.

In this quest, tax administrations can learn a great deal from each other. But our indepth research at federal tax administrations in 15 OECD countries uncovered wide variability not only in the performance of tax authorities across countries, but also within countries across different functions – submissions processing, examinations, collections, and taxpayer service.

We estimate that, in aggregate, the tax administrations in our study can collect an additional US\$86 billion in direct tax revenues if they adopt the practices of the top third. Four major design elements stand out as avenues for achieving improvements: proactive demand management that smoothes tax collection across the year and avoids the end-of-year bottleneck, sophisticated taxpayer segmentation to prioritize which taxpayers to target with which approaches, streamlined operations, and rigorous performance tracking. And these savings apply only to direct taxes.

### **Balance Sheet Management**

Beyond undertaking spending reviews and improving tax collection to manage the operating budget, governments have a major opportunity to take an end-to-end capital management approach to their balance sheets at both the agency and the government-wide level to improve fiscal health. This includes identifying and measuring material risks, incorporating the knowledge of risk into operations, and ensuring the integrity of the internal assessments over time. Even simple approaches to improving the inflow of accounts receivables or outflow of accounts payable can yield meaningful improvements.

### **Jobs**

Along with fiscal management, unemployment dominates the landscape across most of the OECD. Here too, fundamental differences in ideology and vision on how to solve rising unemployment risk stasis. Stimulus programs and other legislative actions to increase growth and create jobs may or may not get through legislatures, but other government interventions to improve demand, supply, and the matching of skills to jobs can provide significant improvement to the jobs picture.

Many governments are now adapting vocational education to better fit employment prospects, for example by involving employers more closely in both its design and delivery. Employment agencies themselves are doing a better job of matching supply and demand through improving their market information and by producing more comprehensive, specific and up-to-date data on vacancies, jobseekers and required qualifications. They are also segmenting the jobseeker population to better understand which segments can be processed in quick and automated ways, and which merit deeper intervention and support.

### **Regulation & Enforcement**

After a series of catastrophic events, government bodies that protect the public – such as industry regulators, law enforcement and disaster preparedness agencies – are receiving more scrutiny

of their actions, their impact, and their overall effectiveness. But they are not necessarily receiving larger budgets. In stark terms, society is asking whether regulators are most effectively anticipating the next threat and protecting the public. Here too, policy debate can become quickly polarised around the trade-off between more protection for the public and consumers, and the potentially negative impacts of more aggressive regulation for economic growth.

Agencies can make great progress by focusing on optimal resource allocation and redesigning how they organize and plan. They can place more emphasis on outcome-based regulation and on predicting, preparing for, and mitigating “tail risk”. The most significant assaults on the public’s sense of safety and security have come from events that seemed unlikely *ex ante*. Tail events are difficult to predict because they often require multiple things going wrong. Examples include the attacks of September 11th, the financial crisis of 2008/2009, Hurricane Katrina’s damage to the New Orleans levees or the recent earthquake and tsunami in Japan causing a nuclear power plant meltdown. But improved risk-based systems can improve governments’ ability to prevent and respond to such events.

### **Core Public Services**

In fact, across core public services – in areas such as infrastructure, education, healthcare and policing – government by design can also better enhance outcomes and manage cost. In these areas, the political discourse is often dominated by significant and legitimate ideological differences. Despite that, governments that focus on what really works operationally in driving outcomes can yield gains. Governments that systematically embrace the latest proven project management approaches and tools can dramatically improve the value of infrastructure investments, at the same time reducing errors and time to completion. In education, school systems can learn from peers at a similar stage of evolution or performance about the right levers to use for improvement – be it better use of pupil data, revision of standards and curriculum, or deep professionalization of teaching careers. The escalation of healthcare costs across all systems is provoking significant political debate. Yet the best systems are already beginning to make progress in healthcare productivity through a number of steps such as the prediction of patients most at risk and the adoption of subsequent prevention strategies; delivery of care at home and in capital-light settings rather than hospitals; and technology innovations to boost clinician effectiveness and efficiency. Government services can and should build off the evidence of successes around the world.

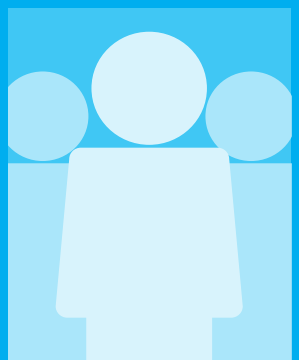
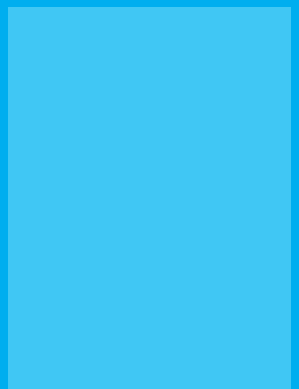
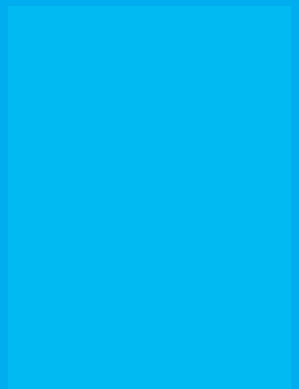
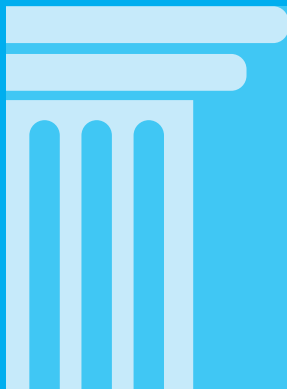


There is a real prize for governments that need to make progress even as the policy and fiscal environment threatens inaction. But it does mean designing government to fit the challenges of today and applying best practices from around the world.

In challenging times, the government we need is rarely the government we inherit. Instead, government must be deliberately designed and managed to make progress on solvable problems.

Diana Farrell is a Director in the Washington D.C. office of McKinsey & Company. She is the global leader and co-founder of the McKinsey Center for Government.

# MCG research in action



## Our research topics



### Capabilities for Execution

The execution issues that plague governments are highly visible: IT programs that cost too much and take too long, infrastructure projects that are poorly managed, inefficient processes that lead to unsatisfactory levels of service. At the same time, governments everywhere are under pressure to perform increasingly complex functions with fewer resources.

Our practitioners are continually generating new insights into core functional capabilities such as technical excellence in IT and operations, as well as cross-cutting capabilities such as leadership effectiveness, performance management, and talent management.

In collaboration with 20 advanced-learning companies and experts in the fields of memory research and behavioral psychology, McKinsey has developed a series of training modules (including e-learning sessions and videos) on capability building. At McKinsey's experiential learning environments, including "model offices" and more than 10 capability centers around the world, leaders can deepen or refresh their understanding of how to drive lasting change.



### Education

Education and professional training are vital to boosting a nation's economic growth and to creating opportunities for individuals. But education systems worldwide are facing enormous challenges—including budget pressures, low graduation rates, declining research productivity, and increasing numbers of graduates ill-equipped to enter the workforce.

MCG works with education leaders and experts worldwide to understand the ways in which educational systems and institutions can deliver measurable, meaningful change. Through our partnerships and alliances, we are developing detailed case studies

of best practices, building robust benchmarking databases, and producing unique insights into the most complex education challenges. For example, McKinsey's education experts recently collaborated with the International Finance Corporation and Islamic Development Bank on an exploration of youth unemployment in the Arab world.



### Employment for Growth

When labor markets fail, the financial and social consequences are enormous, whether in developed or developing countries. We estimate that the annual social cost of labor-market issues, in direct and foregone GDP, is approximately €1.8 billion in Europe, the Middle East, and Africa alone. Unemployment was one of the major drivers of the Arab Spring; while in several European countries, mass protests by unemployed youth have put pressure on governments to react. Additionally, there are costs that cannot be quantified, such as social unrest, decreased personal well-being, and rising health-care expenditures. Combating labor-market failure is therefore a top priority for governments—but it is no easy task.

We are continually broadening and deepening our understanding of labor markets by collaborating with public-sector bodies and leading experts around the world. We invite labor ministries and agencies to explore how our insights into demand, supply, and market clearance might apply in their own labor markets. We also invite government leaders to engage with us in discussions about labor-market initiatives they have undertaken. Perspectives from different geographies and contexts contain valuable lessons for governments across the globe, allowing them to learn from others' missteps and successes.



### Fiscal Management

Governments around the world are under intense pressure to improve their fiscal positions. According to the International Monetary Fund, most countries in the Organisation for Economic Co-operation and Development (OECD) will need to reduce deficits by at least 4 percent of GDP by 2020 to meet their long-term targets for public debt. As they strive to simultaneously increase revenue and cut costs, government agencies can learn a great deal from each other. But they have historically invested little effort in comparing their performance against their counterparts in other countries, or exploring how other agencies have overcome financial challenges and achieved fiscal stability.

We are continually broadening and deepening our understanding of excellence in fiscal management by collaborating with public-sector bodies and leading experts around the world. We are committed to building a knowledge base that will empower governments everywhere to tackle their most complex fiscal challenges. One of our research initiatives, for example, is an extensive survey that provides cross-country comparisons of taxpayers' perceptions, interactions, and level of satisfaction with their tax authorities. We are also developing the McKinsey Government Budget Benchmarking (MGBB) database, a comprehensive resource that offers a standard budget taxonomy to facilitate comparisons across public agencies in all categories of operational expenditure.



### Government Transformation

In both the developing and the developed world, governments are responding to increased demands and shrinking budgets by launching large-scale transformation programs. These concerted, multiyear efforts aim to improve and sustain government performance through coordinated programs of initiatives and interventions. Typically spanning multiple departments and agencies, such programs are inherently ambitious. As a result, many do not live up to expectations.

We have undertaken detailed studies of 40 large-scale national or regional transformation programs in both developed and developing countries and we are continually adding to our knowledge base in government-wide transformation. In the next phase of our research, we plan to study less successful cases to identify the factors that cause transformation programs to underperform. We are also developing tools to support transformation leaders (such as the heads of delivery units and key public servants) in the implementation process. To deepen our understanding of agency-level transformation, we surveyed more than 1,000 US government leaders about their experiences with change programs—a dataset that we have compared with responses from more than 5,000 private-sector leaders.





## Healthcare

Advances in health care have dramatically increased life expectancy, and new medical treatments are helping many people improve their quality of life. Yet progress has created daunting economic challenges: in most of the industrialized world, health care spending has consistently exceeded GDP by two percent per year. Health care has become the world's largest industry—with a value and cost three times greater than the banking sector. Governments and health care leaders, aware that ever-increasing health care expenditure is an unsustainable trend, are looking for ways to boost efficiency: how can health organizations care for more people, with better results, at a lower cost?

McKinsey supports primary health care research and leads global health care initiatives. For example, McKinsey's health care practitioners host the annual Forum for Health in Geneva, which brings together leaders of health care systems to engage in discussions and learn from each other. Additional resources include the Leading Systems Network, a membership-based community convening leaders from forward-thinking health systems; and the Center for US Health System Reform, which undertakes original research and develops tools to help US health care leaders navigate in a post-reform era.



## Innovation in an ever-changing world

In both the developed and developing world, many governments face a number of urgent challenges—one of which is that the rising demand for services is running headlong into the reality of limited resources. In many nations, demographic shifts are creating increased demand for public services like healthcare, pensions, and urban infrastructure. At the same time, natural resources are becoming scarcer; public budgets are shrinking; and citizens, now accustomed to new technologies and constant connectivity, have higher expectations as to the speed and quality of public services. The emerging answer—from various places across the globe—is bold, rapid management innovation.

Together with contributing partners, such as the Overseas Development Institute and Princeton University's Innovations for Successful Societies program, our experts are building a repository of research and case studies on how governments have tackled their most complex challenges through innovation. The Innovation Navigator (currently in beta release) is an interactive online database that allows users to explore examples of bold ideas, spanning both developed and developing economies and nearly all government functions. We invite users to contribute case studies and use the Navigator to share knowledge with the global community of innovators.



## Regulation & public protection

Protecting the public is the core task of many government bodies—in particular, regulatory and law-enforcement agencies. Today, these agencies are coming under increasing scrutiny, and the public's expectations of them are higher than ever. Are they doing enough to anticipate threats? What are the costs to taxpayers of the protection these agencies offer? Are there unintended consequences in terms of lost sector output, slower rates of innovation, or invasion of privacy? Structural changes in the global economic and political environment have made threats more dynamic and uncertain, which in turn has made answering these critical questions more difficult.

We regularly convene round tables and knowledge-sharing sessions on regulation and public protection. In addition, we collaborate with respected thinkers worldwide to generate unique insights into these complex topics. Our current research efforts include in-depth studies of two areas critical to protecting the public: cybersecurity and food and drug regulation.

## **McKinsey Center for Government (MCG)**

The McKinsey Center for Government (MCG) is a dedicated center of expertise and innovation within McKinsey & Company's Public Sector Practice to support government leaders in their goal to achieve greater and lasting performance.

An increasingly complex environment requires government leaders at all levels to do more and better with fewer resources. Therefore MCG's mission is to help them understand the forces that are driving change, design the best strategies for success and develop the tools and capabilities needed for effective execution.

We focus on the critical and common challenges that governments around the world face and create opportunities for government leaders to learn from successful experiences, innovations and different contexts. Our unique set of global perspectives and best practices is accessible through our research, knowledge, publications and tools. And we offer a forum of experts around the world where exciting new ideas and innovative models for government can be debated, codified and shared.

[www.mckinsey.com/mcg](http://www.mckinsey.com/mcg)

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## **McKinsey & Company**

McKinsey & Company is a global management consulting firm dedicated to helping the world's leading organizations make distinctive, lasting and substantial improvements in their performance. With consultants deployed in more than 50 countries around the globe, McKinsey advises on strategic, operational, organizational and technological issues. For more than eight decades, the firm has helped a diverse range of business, government institutions, public administrations and non-profit organizations address their most critical challenges.



