

Diversity and Contestability in the Public Service Economy

Gary L. Sturges



Gary L. Sturgess is Adjunct Professor of Public Service Delivery at the Australian School of Business (University of NSW), based at the Australia and New Zealand School of Government. He also holds an Adjunct Professorship with the School of Government and Public Policy at Griffith University.

Gary has previously been Executive Director of the Serco Institute, a corporate think tank established by the British public service company, Serco Group plc. Before that he was the Director-General of the NSW Cabinet Office.

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Foreword

Governments across the globe are facing tougher economic times, and NSW is no exception. Traditionally, the policy solution has been one of reduced spending, reduced services, and/or increased fees, taxes and charges.

The NSW Business Chamber thinks it's time to change the approach, and to challenge the seemingly unavoidable trade-off between getting less or paying more. The call on Treasury's coffers is set to increase in coming decades and with the high cost portfolios of health and education taking more than half the total budget, something needs to be done, and now.

In our 10 Big Ideas to Grow NSW advocacy campaign, we called for reforms to improve the efficiency and effectiveness of the NSW government's economic performance, starting with an audit of government services and performance. The first phase of that audit found a low level of importance had been given to financial, people and asset management; a situation, which if continued, would hinder the government's long term strategic planning.

In addition, there are a number of related activities that could contribute to the increased effectiveness and efficiency of the NSW public sector, resulting in improvements to the overall performance of the NSW economy. The key question in relation to the government's record in service delivery remains unanswered. Are we getting what we need, and at a reasonable cost?

Over the past two decades, governments have opened some of their services to competition and contracting, with recent research indicating that competition has made a positive difference in financial performance and productivity across a number of portfolios, including health, defence, prisons, the collection of household waste, transport and infrastructure.

The debate should now be taken further. While public-private partnerships have been around for a while, the delivery of services should be about more than the building of roads and rail. It should also reflect a broader ambition than government simply outsourcing so-called back office functions. Is it right that government continues to be a monopoly provider of all public services? We think it's time to start the conversation about other areas of the

public sector which could be open to competition, forming new and viable markets, and improving service delivery for all NSW citizens.

The NSW Business Chamber has commissioned Gary Sturgess (a thought leader in public sector reform and innovation), to examine the different models of contestability and competition that might be applied in the NSW public sector.

This paper does not provide a prescriptive set of recommendations, but is, rather, a discussion starter. In the context of both the O'Farrell Government's second budget, and the final report of the Commission of Audit into government expenditure, we believe debate can:

- help improve the prospects of more competition in service delivery;
- enhance the quality of service delivery for all NSW citizens;
- improve successful delivery by identifying which contestability models work for different services;
- expand the thinking of policy makers to the range of activities where contestability can deliver benefits; and
- reduce the call on tax revenues and deliver a more productive NSW economy.

We need a debate about the means to build a diverse, mixed and sustainable NSW economy, by providing competition and capacity building for private, not-for-profit/non-government, and contracted service providers to engage in service delivery.

Ultimately, the government will decide which services and portfolios are more amenable to competition than others, and their decision will undoubtedly be based on the complex mix of social, economic and political considerations. The debate is critical. We encourage the Government to be brave and determined. It is time to move the NSW economy forward.



Stephen Cartwright
Chief Executive Officer

Executive Summary

Few public services in Australia are delivered exclusively through a government monopoly. In most sectors, there is a mixed economy of public, private and third sector providers, supplying services to government and direct to the public through a variety of different arrangements. The question for state and federal governments today is not whether they should engage with external providers for the delivery of public services, but how.

Policymakers have given little thought to the appropriate mix of providers (public, private and not-for-profit) in most sectors, and the extent to which they can or should be exposed to user choice, competitive tendering and performance benchmarking. Many of our public services are delivered through silos that have been structured for administrative convenience, without sufficient regard for the needs of service beneficiaries.

In large parts of the public service economy, managers have been denied permission to experiment with new service models: there is no search for the 'efficient boundaries' of service delivery organisations and little experimentation with scale and scope. 'Economies of scale' has been elevated to an ideology and far too often, decisions about how to structure public services are made by former judges in the course of a formal inquiry or political advisers in the midst of a ministerial reshuffle.

Lack of competition and performance benchmarking means that governments have only a limited understanding of productivity in the public service economy. Indeed, this issue has been studied so little that policymakers have not yet developed meaningful measures of productivity for this sector. In Australia, only the Auditor-General of Tasmania has made the attempt.

The limited evidence that is available suggests that the potential for productivity improvement is considerable – perhaps as much as 20-25% where services have not been previously exposed to competition. This matters not only to taxpayers but to the nation as a whole, since the public service sector makes up 15-20% of the national economy and perhaps as much as 25% of the nation's workforce.

Public services have been structured so that it is difficult for best practice to be packaged for export, and there is little importation of innovative new delivery models from overseas. In the one or two areas where governments have facilitated export, Australians have proven to be adept at exploiting the opportunities. The exemplar is the education sector where, after a shift in thinking from 'aid to trade' in the late 1980s and early 1990s, commercialisation occurred at such a pace that education is now Australia's third largest export after iron ore and coal. In NSW, it is the second largest export.

The Public Service Economy

This report proposes that the NSW government must undergo a similar shift in thinking across the entire public service sector. Politicians and public servants should embrace the concept of a 'public service economy'. They should plan for greater innovation and contestability in the design and management of public services (recognising that these principles will have different application in different sectors). Governments should facilitate a trade in public services across state and national borders.

This is not an argument for the privatisation of public services. It does not imply a philosophy of 'private good, public bad', and neither is it concerned with simple outsourcing. The success of our education exports makes it clear that Australia's public service sector has capabilities that other countries would like to access, particularly amongst the emerging economies of Asia. The problem lies not in the technical capabilities of public sector employees, but the way in which they are managed.

Front-line public service managers lack the competitive discipline faced by their private sector counterparts. They are obliged to work with confused and often conflicting objectives. They lack the benchmarks that would tell them how well they are performing by comparison with their peers. Managers are denied the flexibility to manage their staff to reflect local conditions. They are obliged to bend the rules if they are to find better ways of meeting their customers' needs.

Few of the public services discussed in this report are amenable to outright sale and light-handed regulation. In a complex modern society, government has to commission the vast majority of public services, ensuring that fundamental issues of access and equity are addressed and making certain that they are integrated for the convenience of service users.

Contestability

This report proposes the introduction of greater competition into the supply side of the public service economy, exploring three models through which this might be done:

(i) Choice-based models, where service users themselves select from a range of alternative providers, financed through government vouchers. Examples include choice-based lettings in public housing, personalised budgets in disability care and Australia's Medicare card.

(ii) Commissioning models, where public officials purchase services on behalf of the community through competitive tendering and contracting. While this option

includes simple outsourcing models, it also encompasses public-private partnerships, public-private joint ventures and integration contracts, among others.

(iii) Contestability, where service providers are benchmarked and failing institutions face a credible threat of competition (although perhaps not actual competition).

There has been a growing interest in choice-based models amongst Australian governments in recent years, although there are limits to where they can be applied. Contestability has also been employed occasionally and to good effect, although a comprehensive benchmarking and intervention framework has not been pursued. However, commissioning models have the widest application, and are discussed at length in this report.

Diversity

The second major theme of this report is the need for greater diversity in service models. As noted above, there is already a mixed economy in many public services but, until recently, policymakers have not been particularly concerned with increasing the diversity of the supply side. Diversity serves a number of functions:

a. *Choice.* Diversity increases the effective choice available to the beneficiaries of public services, at the individual and the collective level.

b. *Adaptability.* The public service economy is better able to adapt to changing circumstances when there is greater institutional diversity. It gives us a deeper 'gene pool' from which to fashion new institutional forms for an uncertain future.

c. *Innovation.* Different kinds of service providers with different backgrounds bring different perspectives to the challenge of delivering better and more cost-effective public services. Diversity allows for experimentation and problem-solving in parallel rather than in serial (trying one solution and only after it has been tested, trying another).

Simple outsourcing increases the diversity of business models, although not by very much. In the past couple of years, innovative new models have begun to emerge in the public service economy in the UK, as public sector commissioners have embraced the concept of a mixed economy. These include public-private joint ventures which bring together the technical expertise of the public sector with the commercial and managerial expertise of the private sector; integration contracts that employ private firms to work with small community-based organisations in delivering social services; public service mutuals, where public sector employees are assisted to establish themselves as social enterprises still delivering public service delivery; and social benefit bonds, which

draw upon social finance to invest in early intervention where providers are paid depending upon their success in delivering agreed social outcomes.

Contracting for outcomes rather than inputs or outputs, and paying providers based upon their results, also serves to increase the diversity of service models, since commissioners are not specifying the ways in which inputs are to be connected to outputs and outcomes. Payment-by-results has increased the amount of experimentation with alternative service models, although the benefits of this diversification have yet to be established. In seeking to access a wider range of contracting models, public sector commissioners will discover that there is now a wide range of models for introducing competition and contestability in public services.

Building a Mixed Economy

Over recent decades, governments have employed a variety of different models for introducing competition and contestability into public services. Some of these, such as compulsory competitive tendering, were effective in increasing competitiveness among the public authorities to whom it was applied, but were accompanied by unfortunate side effects. Others, such as the 'retained savings' model adopted in NSW in the 1990s, failed to make any significant impact.

1. This report proposes that the state government should adopt a 'mixed economy' model for the reform of its public service economy, similar to that developed by the UK government from 1997. This would seek to introduce greater competition into the public service economy, whilst also building a more diverse supply side.

There may be sectors where government will elect to withdraw from the market rather than seek to deliver services itself, because of technological or market developments. There may be services where political and policy considerations mean that contestability will be the most appropriate model. Decisions about what services should be opened to competition from the private and not-for-profit sectors, what contractual and market models should be employed, and whether support activities, front-line services or entire agencies should be identified for competition are matters that must be decided by policymakers with reference to specific social, economic and political considerations. These are not matters that are resolved in this paper.

However, this report does propose that government should explicitly adopt a policy of diversity and competition in the public service economy, and that principal departments and other bodies develop the capabilities to carry such a policy into effect.

2. A great deal more effort should be invested in measuring the productivity of the state's public services, benchmarking them against interstate and international equivalents and comparing their cost and performance with similar services delivered in a competitive or contestable environment. This should be of primary concern to Treasury and the Department of Finance and Services, however, it is suggested that the Department of Trade and Investment, Regional Infrastructure and Services, might also have a stake in benchmarking the state's public service industries.

3. The Department of Trade and Investment, Regional Infrastructure and Services, should include public services in the development of export strategies for the state. This might begin with the study of past successful public service export strategies.

4. The state government should adopt a 'commissioning' approach in the future procurement of public services from public, private or not-for-profit providers. Commissioning is concerned with high-level decisions about what to buy and how, rather than the actual process of making the purchase. In some public service industries, it will involve the design and management of markets. These are new skills that will need to be developed.

5. To ensure a diverse supply side, government will need to provide support and assistance to public and not-for-

profit providers in developing the capabilities required to succeed in competitive tendering and managing the complex contractual arrangements that follow. This assistance might be provided directly by public officials, although some of the new contractual models will also assist in this regard. It will also be necessary to engage with private providers in a strategic way so that they understand government's expectations of those engaged in delivering public services.

6. Public services cannot succeed in human or financial terms, unless providers employ quality staff imbued with a strong public service ethos. In any program involving a significant degree of uncertainty and change, it is vital that the government engages with its employees early to address their concerns. In the pursuit of a more diverse and contestable public service economy, discussions should be initiated with Unions NSW, with a view to developing consistent and workable rules governing the transfer of staff. A clear policy framework protecting the terms and conditions of staff during transfer will also assist in reducing costs to government and deepening the market.

7. Done well, competition and contracting will have the effect of increasing transparency and accountability, but consideration should be given to granting the Auditor General greater powers to 'follow the dollar' in auditing some aspects of public services delivered under contract.

1. A Public Service Economy

Throughout the industrialised world, most public services – health and education, social housing and emergency services, public transportation and water supply, among others – are delivered through a mixed economy of public, private and not-for-profit providers. In Australia, some of these arrangements date back to the earliest days of European settlement; others have been called into existence by federal and state policymakers only in very recent times.

The concept of a 'mixed economy' in public services will be unfamiliar to some. We do not usually think of public services being part of the economy, with a supply side and a demand side. We are inclined to overlook the diversity of the supply side, and underestimate the contribution made by the private and voluntary sectors. Of course, this is not the only way of thinking about the delivery of public services, but in approaching the sector as an economy in its own right or as a major element of the national economy, we open up a range of issues that have been traditionally overlooked.

For example, once we conceive of a demand side that is distinct from the supply side, we open up the possibility that the economies of scale and scope may be different on both sides – the national government may procure services from a small not-for-profit provider, while a local authority may contract with a multinational corporation.

If we recognise a separate demand side, policymakers will be less inclined to view public services through the eyes of producers, and more likely to structure public services so that they make sense to the customer. They will focus more on the effectiveness with which providers are delivering primary outcomes, rather than just measuring the outputs of the production process.

Once we acknowledge that public services are part of the economy, we can appreciate the diversity of the institutional arrangements through which they might be delivered, and this will expand the range of tools available to policymakers. It also raises the prospect of supplier innovation in the development of new service models, rather than just relying on policymakers who are far removed from the front line of delivery.

Recognition that the public service sector makes up a significant proportion of the national economy raises questions about the scale of its contribution to national wellbeing and the productivity of the various industries that make up this part of the economy. It also challenges us to explain why public services are not making a larger contribution to export income.

The public service economy may or may not be a market. In some cases, the contractual arrangements that have emerged are overwhelmingly government-to-government, but this does not mean that they cannot be analysed in economic terms.

NEHTA Ltd

Consider the National E-Health Transition Authority (NEHTA), established by Australian Health Ministers in 2005. NEHTA has been created to develop a national system of personally-controlled electronic health records, but because federal and state governments have shared responsibility in this sector, the agency has been established under the Corporations Act as a not-for-profit company limited by guarantee, NEHTA Ltd, with Health Ministers as the shareholders and Secretaries of state and federal Health Departments as the board of directors.

NEHTA is funded through a variety of grants from the Commonwealth Government and from the Council of Australian Governments, and it contracts in turn with a number of governmental agencies, private corporations and other providers for the delivery of policy and technological capabilities.

Once we adopt a systemic approach, recognising that the public service sector is already a mixed economy with a variety of different providers, questions of regulatory design and the application of competition policy acquire much greater significance.

This report explores the concept of a public service economy and its implications for government. In particular, it develops the concepts of competition and contestability and their application to the delivery of public services. It does not take the view that the private sector is inherently superior to the public sector, or that market competition is always the best approach. However, it does start with the assumption that, in most situations, competition (or a credible threat of competition) is better than monopoly.

It also explores the diversity of institutions that make up the supply side of the mixed economy, the contribution that competition and contracting have made to that diversity, and the new contracting and service models that have emerged in recent years.

1.1 Conceiving a Public Service Economy

The origins of the term 'public service economy' are to be found in research undertaken by North American economists in the early 1960s into the rich 'variety of organizational patterns and institutional arrangements' employed in water management. Vincent and Elinor Ostrom led this work (although they were by no means alone), arguing that the concept of a 'public service industry' was useful 'in being able to identify areas of productive activity involving interrelationships among many different agencies and units of government concerned with the provision of similar public services'.²

The water industry, for example, is composed of a very large number of highly independent federal, state, and local governmental agencies operating side by side with large numbers of private utility companies, co-operative associations, and individual proprietorships. . . The American educational system can be conceptualized as an industry composed predominantly of many independent public enterprises and non-profit private enterprises ranging from kindergarten and elementary schools through universities specializing in professional training and graduate studies. . .

The concept of an industry can also be applied to the provision of police services by the many local, state, and federal agencies who use closely related production methods to attempt to control similar sets of events in relation to similar objectives or intended outcomes.³

Each of these 'industries' reflected a diversity of interests, with significant divergence in the perspectives of consumers and producers, and different scales of economy on both parts. They concluded: 'The concept of the single self-sufficient public firm producing all of the public goods and services for its resident population is no longer a tenable concept for understanding the structure and conduct of the public service economy'.⁴

The Ostroms and their associates were much more interested in the diversity of the demand side than they were in the supply side, the diversity that already existed and might yet be created in collective consumption units, shaped by such factors as physical geography, political representation and local self-determination.⁵

They explored the scale economies in consumption, a concept that has little meaning in the private sector where the unit of consumption is an individual or a household. In the public service sector, the scale of organisation on the demand side had a great deal to do with the economies of consultation and representation. Collective consumption units could range in size from small municipalities to national governments and even international regimes. They might be single-purpose or they might undertake a wide variety of task, and they might not always be organised as governments.⁶

The Ostroms advocated a robust form of federalism and what they described as 'polycentricity'. They recognised that in federal systems, politicians and policy entrepreneurs compete over the boundaries of life's responsibilities. They were much less concerned than others about overlap and duplication, which they saw as essential elements of a vigorous public service economy.⁷

They also recognised that the concept of a public service economy implied that someone must bear the responsibility for market design, for regulation and for adjudication. But they also understood that there would be difficulty in ensuring that competition between governments was fair and efficient.⁸

This report builds on the Ostroms' work, focusing more particularly on the supply side, and the conditions under which competition and contestability can be employed in making providers more responsive to the concerns of customers, in stimulating innovation and in driving productivity reform.

1.2 Economic Importance

It is difficult to estimate the dimensions of the public service economy from the statistics published by the Australian Bureau of Statistics, but based on available data, and information from comparable overseas jurisdictions, it is probable that this sector accounts for 15% to 20% of the Australian economy. As a proportion of GDP, the public service sector is larger than the mining and manufacturing sectors combined.⁹ As a percentage of the workforce, it is higher again – around 25%.¹⁰

Of course, this understates the significance of the public service economy to the nation as a whole since the fundamental nature of the services involved – education and community safety, health care and social welfare – means that they impact on economic, social and personal wellbeing in fundamental ways. If these services are not effective and productive, then the consequences will be manifest across the community as a whole and have adverse impacts on future generations.

1.3 Productivity

In spite of its significance to the Australian economy, the efficiency and the effectiveness of the public service sector is almost never discussed in the debate over national productivity. Indeed, this question has received such little attention that government auditors and statisticians have great difficulty in agreeing on what productivity means in this sector and how it should be measured.

Much of the discourse over public services focuses on inputs rather than outputs – police numbers, hospital bed numbers and spending on infrastructure – and to the extent that outputs are reported, governments have progressed little beyond the measurement of activity – the number of patients admitted or students enrolled. Virtually nothing has been done to assess the impact that the expenditure of society's resources has on ultimate outcomes.

The former Chinese Premier, Zhou Ziyang wrote of the Chinese economy in the 1980s: "Often we have fallen into the situation of 'good news from industry, bad news from sales'".¹¹ In the public service economy, we usually do not even recognise an increase in output: for the most part, politicians and the media celebrate the construction of a new bridge or the recruitment of additional staff.

Among Australian state governments, only Tasmania has attempted to measure productivity on a systematic basis, with a report by the Auditor-General in October 2010 concluding that over the previous decade, 'output per FTE* has increased, but... output per employee dollar has decreased'. However, the report acknowledged that a great deal remained to be done in developing meaningful measures of output. The lack of a robust system of specifying and measuring outputs meant that they had found it necessary to measure activities – the number of patients admitted to hospital, the number of students enrolled in the education system, the number of criminal offences cleared – and they struggled to ascertain an appropriate system for weighting these various activities.¹² The report was not welcomed by the Tasmanian government, and no other state has attempted a similar exercise.

In NSW, the Council on the Cost of Government (later renamed the Council on the Cost and Quality of Government) was established in 1995, with the intention of focusing on 'lowering the cost of running public sector operations, and improving the efficiency and effectiveness with which the public sector provides services to the people of New South Wales'. The Council's review methodology was overhauled in late 1999 when a new chair was appointed. He changed the reviews from largely accounting analyses to management capability assessments.

The Council was shut down in 2007 after conducting 25 major capability reviews of small to medium sized departments. These had resulted in significant changes to the priorities, strategies, structures, processes and systems of these agencies, and delivered estimated savings of more than \$276 million. It also produced an annual compendium of performance indicators on each of the policy areas of the general government sector, but this initiative was terminated by government in 2004.

Significant work has been done by the Office for National Statistics (ONS) in the United Kingdom in developing a sound methodology for measuring public service productivity, and while this will be important in the ongoing development of meaningful measures, to date the ONS has not progressed much further than the Tasmanian Auditor-General. For more than one-third of public services, outputs are simply defined as inputs. The ONS concluded that in the ten years from 1998 to 2008,

multi-factor productivity of the public service economy declined, on average, by 0.3 percent a year. Over the period from 2000 to 2008, labour productivity as measured by gross valued added, declined by an average of 0.1 percent a year, although when measured by gross output, it was found to have increased by an average of 1.2 percent a year.¹³

Despite a general lack of interest in the measurement of productivity, a number of studies have estimated the size of the potential gains from reform. Appendix A summarises some of these studies, which seek to measure the productivity gap in public services that are provided under monopoly conditions – by benchmarking the performance of comparable services across the public and private sectors, comparing performance before and after competition, and studying what happens when public service providers are faced with the threat of competition (otherwise known as contestability). While the research points to a wide range of outcomes, cost reductions in the order of 20% to 25% are not unusual when services are first opened up to competition.

At the time of writing, the NSW Government was in the process of establishing a NSW Statistical Council which will be concerned with performance measurement and might be employed to undertake this kind of research.

A great deal more effort should be invested in measuring the productivity of the state's public services, benchmarking them against interstate and international equivalents and comparing their cost and performance with similar services delivered in a competitive or contestable environment. This should be of primary concern to Treasury and the Department of Finance and Services, however, the Department of Trade and Investment, Regional Infrastructure and Services, might also have a stake in benchmarking the state's public service industries.

1.4 Diversity

As noted above, the Australian public service sector has always been a mixed economy, with a diverse range of providers delivering services in somewhat different ways. The extent of this diversity, and the benefits that this brings to service users and to the economy as a whole, are not generally appreciated. For example:

- Across the nation, there are 768 public and 556 private hospitals, with the latter servicing around 40% of all hospital inpatients. Public hospitals have private wards, private hospitals deliver services on behalf of the public system, and for the most part, the medical practitioners working in public hospitals are private contractors.¹⁴

*Full Time Equivalent

- One-third of Australian children attend a private school, with a somewhat higher proportion (39%) among those involved in secondary education. While the vast majority of Australian universities are public institutions, around 15% of their income is derived from the sale of services to international students studying in Australia or foreign students studying at Australian campuses overseas. The export of education services is now Australia's third largest export industry.
- Around 17% of Australian prisoners are held in correctional institutions managed by private providers, and in Victoria, this figure is 34%.¹⁵ Prisoner escort is provided by the public sector in NSW and Queensland, and by the private sector in Victoria, South Australia, Western Australia and New Zealand.
- The independent sector also dominates the provision of many social services. Around 60% of residential aged care is provided by the not-for-profit sector, with the private sector providing 35%, and state and local governments accounting for the rest. In the case of community care, around 84% is delivered by not-for-profit providers and the remaining 16% by the public and private sectors.¹⁶ In NSW, the state government spends in excess of \$1.5 billion annually in purchasing community-based services from non-governmental organisations.¹⁷

Some diversity in service models is essential if competition and choice are to have any significance, and its existence might be regarded as precondition for institutional innovation. While a mix of service providers can already be found in some parts of the public service economy, it seems likely that the widespread existence of monopolistic provision and the centralisation of authority under traditional delivery models means that there is much less diversity than would be desirable.

1.5 Innovation in Scale and Scope

In the private sector, a great deal of time and money is invested in the search for 'efficient boundaries' between firms. Organisational economists have described the ongoing process of aggregation and disaggregation of service offerings, the acquisition and divestment that takes place in capital markets, and the contracting out and the in-sourcing that organisations undertake, as part of a search for optimal scale and scope.¹⁸

Under traditional models of public service delivery, the boundaries of provider organisations are established by policymakers who are well removed from the front line of provision. All too often they are laid down by lawyers during a formal commission of inquiry, or by political

advisers during a ministerial reshuffle. There is little experimentation with scale and scope amongst suppliers and the capacity to make adjustments to accommodate changes in the external economic and social environment is extremely limited.

One of the consequences of the more concerted move towards a mixed economy in recent years is that front-line managers have begun to experiment with their organisational boundaries, through joint ventures (public-private, private-voluntary and public-private-voluntary), through management buyouts and through mergers and acquisitions within the public sector.

1.6 Customer Focus

Under the bureaucratic model, where the supply side and the demand side of the public service economy are conflated, the interests of service users are often secondary to those of producers – managers, staff and front-line professionals. Most of the men and women who work in this sector are deeply imbued with a public service ethos, but when supply and demand are inseparable, the only way that beneficiaries can communicate their preferences lies in lobbying their elected representatives.

In the United Kingdom, this approach was idealised in the statement of Aneurin Bevan, one of the architects of the National Health Service (NHS), that the NHS had been designed so that the sound of a bedpan dropping in Tredegar Hospital (in South Wales) would resound in the Palace of Westminster (the Houses of Parliament). This may help parliamentarians to feel important, but it is not the best way of making sure that bedpans are not dropped in Tredegar Hospital.

In the English-speaking world, the recognition of a distinct demand side began in the 1980s with the Citizen's Charter in UK public services. It was reflected in the so-called purchaser-provider split in public sector outsourcing and in people-centred care in disability services. It has contributed to the emergence of choice-based lettings in social housing and the extension of patient choice in health care.

Separation of supply and demand side has also driven recent attempts to reinstate outcomes at the heart of service commissioning.[†] The renewed focus on primary outcomes, as opposed to service outputs, is evident in the experiments with social benefit bonds and contracting through payment-by-results, in the 'Open Public Services' White Paper released by the British government in July 2011, and in the 'Better Public Services' paper released by the New Zealand government in March 2012.¹⁹

[†] The term 'commissioning' has been adopted in the UK to describe the high-level policy questions that must be addressed prior to the commencement of a formal procurement.

1.7 Internationalisation

Failure to recognise public services as a key part of the economy has also resulted in valuable human capital being locked up in structures that are not amenable for export. The suggestion that governments should be exporting their public services may be challenging to some, but in several industries, Australia has been a world leader in this regard. Education services are the most obvious example.

1.7.1 Education Services

In 2010-2011, the sale of education services accounted for \$16.3 billion in export income (NSW, \$5.8 billion), down from \$18.6 billion the previous year. It is Australia's largest service export, accounting for more than one-third of the total, and its third largest export overall behind iron ore and coal. For NSW, it is the state's second largest export. The leading markets are the emerging economies of China and India, followed by Korea, Malaysia and Vietnam.²⁰

These numbers do not include income from services provided to foreign students through offshore campuses. In 2006, Australian education providers were providing education and training in 48 overseas countries, and for every four international students undertaking studies in Australia, there was one studying in an Australian institution located overseas. More recently, a franchising model has emerged, so that in 2011 (for example), Murdoch University franchised more than 20 courses to Kaplan Higher Education in Singapore, under the Murdoch@Kaplan brand, from which it will collect royalties.²¹

The growth of this industry has been extraordinary. Between 1982 and 2007, education exports grew at an average annual rate of 14%, compared with growth in total exports of around 6 percent. Over the decade to 2010, export income from these services almost quadrupled. As a share of Australia's total services exports, they increased over the two decades from 1982 to 2011 from less than 4 percent to around 33%.²²

Australia was well-positioned because of its active participation in the Colombo Plan in the post-war years, but it took a shift in focus from aid to trade in the 1980s to recognise that this economic miracle was possible. In particular, the Jackson Report on Australian overseas aid, published in 1984, recommended that education should be regarded as 'an export industry in which institutions are encouraged to compete for students and funds'.²³ This was reinforced by the Dawkins reforms in the early 1990s, which reduced government funding and obliged the universities to seek alternative sources of finance.

By 2002, a fundamental shift in thinking had taken place within Australian higher education, so that it was often referred to as an 'industry' rather than a 'sector'. Universities and other institutions of higher learning quickly acquired marketing capabilities and an entrepreneurial outlook. However, much of the reason for the industry's early success arose from a change in mindset on the part of government. The prospect of earning export income facilitated this shift in thinking from sector to industry, from aid to trade, and government support in the form of quality regulation, trade liberalisation and direct assistance through the Department of Industry was crucial to success.²⁴

1.7.2 Health Services

Most of Australia's health care is delivered by sole practitioners, small group practices or state-owned hospitals, none of which is suited for export. That Australia has capabilities that are amenable to export is evident from the fact that Ramsay Healthcare, a private hospital provider established in Sydney in 1964, now operates 40 private hospitals and day surgery centres in Britain, with other facilities in France and Indonesia. Since 2004, it has won several contracts to operate treatment centres for the NHS.

1.7.3 Tollway Services

Toll roads, tunnels and bridges are relatively common throughout the industrialised world, but Australia was one of the world leaders in toll roads constructed, financed and operated through public-private partnerships. Several Australian companies have exploited this 'first-mover advantage' to become significant players on the international stage and Australia remains a leader in the field.

Macquarie Bank became involved in the financing of Sydney's PPP toll roads in the 1990s, and used the expertise developed in this market to become a major international player in infrastructure financing, including 11 toll roads in seven different countries around the world, including the United Kingdom, the United States and Canada. In 2006, Transurban, which developed its business model working on Melbourne's CityLink tollway, commenced operations in North America, with a toll road concession in Virginia and it now has several other projects under way in that country.

1.7.4 Welfare-to-Work

Several Australian providers of job placement services took advantage of this country's pioneering role in that market to secure a place in emerging European markets. The best known of these is Ingeus, now the largest

provider of welfare-to-work services in the UK. Ingeus was founded in 1989 by a Queenslander, Therese Rein, to work in the rehabilitation of sick and injured workers, but with the development of the job placement market in the 1990s, the firm moved into assisting the long-term unemployed. It was one of the earliest private providers of employment services in France and Germany, and now has contracts in Poland, Sweden, Switzerland, Saudi Arabia and South Korea.

In 2006, Mission Australia acquired an interest in Working Links, one of the leading providers of welfare-to-work services in the British market. Working Links is now the third largest provider of services under the United Kingdom Government's 'Work Programme' initiative. Other Australian providers who have prospered in the UK are Sarina Russo and Wise Employment.

Maximus, a large North American service company, is also a significant player in the British welfare-to-work market, but interestingly, their expertise was imported into the UK from Australia, where Maximus had already delivered welfare-to-work services for some years.

1.7.5 New Zealand State Enterprises in Australia

New Zealand's meteorological bureau, MetService, was established as a state-owned enterprise in 1992. It sells weather forecasting services in the Australian market and graphical presentation systems elsewhere throughout the world, through a commercial subsidiary. As a result, the meteorological service makes a small profit each year, rather than operating at a cost to the taxpayer. Over the years, the MetService has repeatedly invoked Australia's National Competition Policy framework to break into the local market. In 2010, it lost a bid to supply weather services to the BBC.

Quotable Value is the NZ government's corporatised valuation service, established as a state-owned enterprise in 2005. It now has subsidiaries in three Australian states, and among other things, conducts valuations on behalf of the NSW Valuer General.

Australia enjoys a significant competitive advantage in the emerging economies of Asia by virtue of its geographic location and its multicultural population. It would be unfortunate if we did not exploit this advantage in developing an export market for our public services. Given that such services are overwhelmingly commissioned by the states, NSW should be the national leader in developing robust and responsible strategies for the development of an export market. The Department of Trade and Investment, Regional Infrastructure and Services, might begin this process with a study of where public service exports have succeeded in the past.

1.8 Cross-Fertilisation

While there is currently some international dissemination of new ideas amongst policymakers, it does not happen as a matter of routine, and it is not the best way of encouraging the cross-fertilisation of innovation in the delivery of public services. The introduction of international providers into the local public service economy and exposure of local providers to overseas jurisdictions through export would assist in the process of cross-fertilisation.

The French water companies have played a major role in the development and dissemination of membrane technology (for water filtration). They started investing in research and development several decades ago, in large part because they were never nationalised and thus retained a commercial model. They were among the first water companies to export their services around the world. Sydney Water has never been permitted to invest in technological innovation in this way, but it has been able to benefit from international developments by opening up its supply side to external providers.

1.9 Benefits of this Approach

This report argues that there will be social and economic benefits in reframing the way in which we look at our public services. Instead of merely considering them as part of the 'Public Sector', we should view them as an integral part of the national economy, with a distinct supply side and demand side, a diversity of business models and different economies of scale and scope on both sides. There will be a number of benefits from adopting this approach:

i. Productivity. It will contribute to a vigorous debate over the productivity of this part of the national economy. In the absence of meaningful performance benchmarks and competitive tension, the drive to reduce waste and inefficiency will be impossible to sustain.

ii. Customer Voice. Formal recognition of the demand side and increased choice will strengthen the voice of customers in the public service economy and reveal outcomes that matter to service users that have been largely overlooked by providers.

iii. Diversity. Failure to acknowledge the potential for diversity has meant less scope for innovation and learning. Competition and choice are meaningless if there is not some supply-side diversity.

iv. Efficient Boundaries. The ideal structure of a public service industry cannot be fully understood in advance, and it will change over time as external conditions change. Acknowledging the public service economy will facilitate the search for efficiency boundaries.

v. *Internationalisation*. Australian governments have overlooked the potential for exporting their public services. The rapid growth in Australian education exports over the past decade and a half is evidence of what is possible.

vi. *Cross-fertilisation*. There is also a great deal that Australian public service providers can learn from abroad. Commercialisation of the public service economy will strengthen international linkages on the supply side, and lead to the discovery of innovative new models of delivery that can be adapted and applied here in Australia.

This report explores the prospects for reform of the public service economy, and in particular, the scope for greater diversity and contestability.

2. Diversity and Contestability

2.1 Competition on the Supply Side

Few would disagree with Adam Smith's observation that 'Monopoly... is a great enemy to good management'. User choice – sometimes defined as the right to say 'No' – is a powerful driver of improvements in service quality. It enables users to benchmark alternative offerings, which in turn contributes to increased productivity and lower prices. Competition stimulates the discovery of entirely new goods and services that have the potential to improve individual and collective wellbeing.

Producers don't particularly like competition. It forces them to rethink how they do business and to re-invest hard-won profits in the development of better goods and services that will attract new customers and retain existing ones. Indeed, suppliers are forever searching for places in the market where competition is constrained so they can charge higher prices.

The suppliers of public services are reluctant to embrace competition for much the same reasons – from where they stand, competition seems to be inefficient. It makes it difficult for them to achieve economies of scale, it results in redundant capacity and it demands unnecessary spending in adjustment to change.

However, many public services have characteristics that make it difficult to adopt competition models directly from the private sector – so-called market failure and issues of equity, access and affordability. There are, nevertheless, forms of competition that are not inconsistent with the pursuit of these objectives. The credit for rediscovering this insight is usually given to an American economist Harold Demsetz, in a paper written in the 1960s, but it was first developed by an English social scientist and health reformer, Edwin Chadwick, in the middle of the 19th century.

In a paper delivered in 1859, Chadwick distinguished between 'competition within the field of supply', where a plurality of providers compete for the custom of individual service users, and 'competition for the field of service' where, following a competitive tender, government awards a firm the right to deliver a public service as a monopoly for a defined period of time. Chadwick was particularly concerned with competition between the providers of urban water supplies which had resulted in 'strict monopoly, bad and deficient supplies at high charges to the public, with low dividends to the shareholders'. He had stumbled across the problem of natural monopoly, but the same problem arises with core public services such as the management of prisons, where competition in the field is not feasible for reasons of public policy. Chadwick also suggested a refinement to his model, where competition for the field might be sustained by dividing the service between two or three

providers. In this way, service users could choose between a limited number of suppliers and government could benchmark ongoing performance.†

Thus, governments are not faced with a stark choice between privatisation and producer monopoly. They have available to them a suite of alternative models with varying degrees of government control. This report discusses the three principal alternatives:

- i. choice-based markets*, where service beneficiaries are free to select from a number of approved suppliers using funds that have been supplied by government
- ii. commissioned markets*, where providers tender their services to government through a competitive process, and are contracted to deliver a public service as a monopoly for a term of years
- iii. contestability*, where the performance of service providers is benchmarked and they face the threat of competition if there is persistent failure to deliver.

2.2 Competition in the Service

The vast majority of private services are subject to competition in the field of supply, so that individual consumers, families or firms can freely choose among a range of alternative providers. Some public services, notably utility services such as telecommunications, electricity and gas, operate under this model, where governments will impose some form of regulation on suppliers to prevent the exploitation of a natural monopoly and ensure that fundamental social, economic and environmental outcomes are addressed.

More often, where governments introduce competition in the field of service, they are concerned with the creation of a voucher market, where individuals and families are provided with money or 'money's worth' by some government agency, enabling them to choose among a number of government-approved suppliers.

Politicians and policymakers are often reluctant to use the term 'voucher' in public discourse because of its association with the American economist, Milton Friedman, who in 1955, floated the idea of introducing vouchers in public education. However, vouchers are a flexible tool, just as capable of being used for the advancement of social inclusion as the introduction of provider competition and the enhancement of user choice. The Medicare card, an object that is carried around by the vast majority of adult Australians, is a voucher introduced by a Labor government to facilitate the nationalisation of health insurance.

In recent years, governments on both sides of the political spectrum have been exploring the prospect of greater

† It was in this same article that Chadwick used the term 'a contract for the attainment of results'. While the concept had been developed by his mentor, Jeremy Bentham, Chadwick seems to have been the first writer to speak of 'payment by results', a contract model that is discussed at greater length below.

user choice in areas such as vocational education and disability services. It is one of a suite of options that commissioners have available to them as they seek to inject competition into public service monopolies.

2.3 Competition for the Service

Competition for the service is delivered through competitive tendering, with services purchased from public, private or not-for-profit providers under contract for a term of years. This may involve franchising a service delivered directly to the public (such as a bus service), a public-private partnership for the design, construction, financing and maintenance of a physical facility that will be operated by government employees (such as a public hospital), or a contract for the delivery of support services (such as information technology).

It is a highly flexible model that leaves governments with a significant degree of control over how services are delivered. Commissioners can write contracts that specify the inputs in significant detail (so that government retains control over the design of business processes), or outputs (so that the provider assumes responsibility for these high-level management decisions), or outcomes (where the provider is required to experiment with alternative service models). They can contract for back office functions (such as IT support), or for front-of-house services (such as the operation of a call centre). They can procure just support services (cleaning and maintenance), the management of an entire facility (such as a prison) or the operation of a complete government service (such as a national research laboratory).

In the past, this model has often been described as 'contracting out' or 'outsourcing', but those terms are now largely inappropriate since they fail to capture the wide variety of alternative instruments that are available – GOCOs⁵, public-private partnerships, joint ventures and social impact bonds, to mention a few. Under some of these arrangements, the provider may enjoy a great deal of autonomy, operating at arm's length from commissioners. In other cases, commissioners and contractors will work closely together in an ongoing relationship that is better described as a partnership or a joint venture.

Sometimes, government will be the only purchaser of these services within its jurisdictional boundaries (which is the case with prison contracting in the Australian system of government), but in other cases, a multitude of governmental organisations will negotiate with a multiplicity of suppliers (which is the case with municipal waste services).

In some public service industries, such as municipal waste collection, the supply side will be dominated by private

sector suppliers, while in other cases, such as the education market, not-for-profit providers will account for the majority of supply. In yet other sectors, such as community safety, the public sector will retain control of core functions, with the private sector being confined to a supporting role.

2.4 Contestability in the Service

Economists now recognise that competition is not always necessary in motivating producers to deliver better services at lower cost – it is sufficient that they face the credible threat of competition from new entrants. The term 'contestability' has been coined to describe a market with low barriers to entry and exit, in which a monopolistic supplier will behave as though it is facing actual competition.

In the public sector, contestability assumes that there is a performance regime that is capable of identifying a failing provider long before failure becomes catastrophic. It requires some kind of intervention regime to replace senior management or otherwise rectify poor performance once it has been identified. However, it also assumes that, in the end, it will be possible to expose a failing service to competition from alternative providers. This implies that there are public suppliers with the flexibility and capability to take over the operation of a failing service, or that there are private and voluntary sector providers that would be capable of stepping into the breach at relatively short notice.

The UK government has done a great deal of work in exploring the concept of a contestable public service economy, however, one of the best examples is to be found in NSW. In that case, the performance of a contract prison was used to benchmark the financial performance of the rest of the NSW prison estate, and the outsourcing of a second establishment was used to create a climate of contestability. On this occasion, the threat of competition was used to address poor financial management; in the UK, it was employed to drive service improvement.

2.5 Diversity on the Supply Side

As briefly discussed in Section 1.4, and at greater length in Appendix B, there is already a great deal more diversity on the supply side of the public service economy than is generally recognised. This is sometimes discussed as though it were an historical anomaly or driven by ideological concerns, but diversity in the provision of public services offers a number of potential benefits:

i. Choice. Service users value choice. In part, this is because the act of choosing gives the user a greater sense of control, but it is also because one size does not

⁵ Government Owned-Contractor Operated', a model that is explained in detail in Section 5.4.5.

fit all – different people and different communities have different needs. Diversity matters because it increases the effective choice available to the beneficiaries of public services, at both the individual and collective level. British research has shown that people at the lower end of the socio-economic scale value it more than those who are better off.

ii. Adaptability. Institutional diversity is desirable for much the same reason as biological diversity. It means that public services as a whole are more flexible. They are better able to adapt to changing circumstances. Diversity provides us with a measure of redundancy, which can be extraordinarily valuable in a rapidly changing world. It gives us a deeper 'gene pool' from which to fashion new institutional forms for an uncertain future.

iii. Innovation. Different kinds of service providers, with different backgrounds, bring different perspectives to the challenge of delivering better and more cost-effective public services. They are inclined to see the problem in different ways. They bring fundamentally different approaches to the search for solutions, and they bring different forms of human, social and financial capital to the task of service delivery. Organisations and systems characterised by greater diversity are better at solving problems than homogeneous ones. Diversity allows for experimentation and problem-solving in parallel rather than requiring that it be done in serial (trying one solution and only after it has been tested, trying another).

Opening up the public service economy to competition from private providers will increase the diversity of the supply side, however simply privatising or outsourcing these functions will not increase the range of service models by very much. If serious attention is not given to encouraging the development of a mixed economy, there is a danger that commissioners will replace public bureaucracies with private ones. A truly mixed economy will involve a range of public, private and third sector providers, as well as a variety of hybrids, but the transition from a service monoculture will require careful planning. We can picture the shape of a mixed economy by referring to the public service economy in the UK, where successive governments have sought to develop a more diverse supply side over the past decade or more.

i. Third Sector. Some not-for-profit organisations are large enough to bear the financial risks involved in engaging in a competitive tender and the management responsibilities associated with delivering a complex public service. While having a great deal that they can contribute to the improvement of public service delivery, many small community organisations are not equipped for such a model.

Government will need to engage with third sector providers to assist them in developing the skills that will be necessary to engage in a competitive tender successfully, and to assume significant operational risk. Where a significant amount of performance risk is to be transferred to providers, it may also be necessary to broker partnerships.

ii. Public Sector. In many cases, the relative inefficiency of traditional public service providers arises from the way in which they have been organised and the lack of competitive tension, rather than disadvantages that arise from public ownership as such. In the pursuit of a mixed economy, governments should explore the scope for developing more commercial models for public service providers.

iii. Social Enterprises. A variety of social enterprises have emerged in recent decades that are entrepreneurial and profit-seeking, but re-invest all of their profits in the pursuit of the public purposes for which they were established. In the UK, the government passed legislation enabling the creation of community interest corporations with the intention of encouraging social enterprises to become more involved in the delivery of public services.

The current UK government is actively encouraging front-line public servants to establish 'public service mutuals', assisting staff to establish themselves as social enterprises independent of government, capable of delivering social services under contract. While some commentators have been dismissive of this model, many professional services in the private sector are organised in this way, including a majority of legal, accounting and consulting firms. A number of public services possess the structural characteristics that seem to make this an efficient form of organisation.

iv. Public-Private Joint Ventures. Over the past two or three years, a number of public-private and public-private-third sector joint ventures have emerged in the UK, delivering middle and front-line functions such as business support for local authorities, pathology testing for public hospitals and (most recently) the management of prison and probation services. Many public sector organisations possess the necessary technical expertise but lack the commercial know-how to adapt to a more commercial environment. In other cases, they may possess the requisite expertise in front-line services, but they will benefit from a partnership with a facilities management or a business process outsourcing firm.

v. Private-Third Sector Joint Ventures. Some of the social services now being contracted in the UK, such as the rehabilitation of prisoners and job assistance for the long-term unemployed, cannot easily be delivered by management companies or community organisations on

their own. Joint ventures have begun to emerge, and while these have proved difficult to manage because of the different cultures of these two sectors, providers from both sides are learning to adapt.

It is important for policymakers to be aware that increased diversity and contestability does not imply wholesale privatisation or outsourcing to the private sector.

2.6 Diversity on the Demand Side

While this report is overwhelmingly concerned with transformation of the supply side, it must be noted that policymakers are also experimenting with reform on the demand side. Choice-based letting in public housing and personal budgets in disability services involve a shift in the authority (and the responsibility) for purchasing public services from collective consumption units to individual service users (and/or their advisers). Choice-based markets are discussed in Section 7 below.

Important changes are also taking place within the Australian system of government in the level at which markets are organised and services are commissioned. The Federal Government is increasingly intervening in the design of public service systems. For example, it is working with the states in laying down a national certification regime for social housing providers, and moving to a case-mix approach in funding hospital services that will be indifferent to public or private ownership of the facilities. At the same time, state governments are delegating commissioning authority to the regional level (most notably in NSW with the establishment of and transfer of significant decision-making power to health district boards).

Some 'tax expenditures' – which allow tax deductions for donations made to a charitable organisations or charge lower rates of taxation on investments in superannuation schemes or payments to a health insurance fund – might be viewed as an attempt to encourage diversity on the demand side. One way of interpreting these concessions

is that they are an acknowledgment on the part of government that some public services are capable of being commissioned through alternative institutions such as churches or charities, and that it may be more efficient to encourage a diversity of risk pools rather than relying solely on the state for the delivery of social insurance.

Across the English-speaking world, public services have long been commissioned through a variety of non-governmental institutions. Examples include business improvement districts and home owner associations in the United States and garden squares in London and street associations throughout England and the United States. In paying their property tax bills, the citizens of the Canadian province of Ontario are given the option of allocating a proportion of their tax dollars to 'public' schools or 'separate' schools. Those who elect to have their children educated in the Catholic system would point out that this is only partial compensation for the full cost of an education, nevertheless, it is an interesting example of a system where the public is given an election in the funding of public services at the point where they pay their taxes. The United States has a long tradition of enabling the creation of special improvement districts to commission and fund new public infrastructure and services.

As noted in Section 1.1 above, there is also a school of thought within the federalism debate that focuses on diversity and competition in the commissioning of public services. This is particularly active in North America, but in recent decades, it has acquired much greater salience in some quasi-federal systems in Europe (evident, for example, in the debate over Scottish devolution in Britain).

There has been less interest in this particular federalist tradition in Australia, and while this report does not deal with demand-side diversity, it lies at the heart of the Federal Government's reforms to the health system and recent proposals to establish a national disability insurance scheme.

3. The Benefits of a Mixed Economy

In England, lighthouses and other seamounts are managed by a private not-for-profit corporation, largely because that is how it has been done for the past 500 years. In Denmark, a private for-profit corporation provides most of the country's fire and emergency services because, in the 1920s, local authorities did not trust central government to respect their authority in the modernisation of these services. In the United States, some of the leading defence laboratories, such as Los Alamos and Sandia, have been managed by non-government contractors since the Second World War, because scientists who were regarded as essential to national security were not prepared to work directly for the military.

The military has always relied heavily on contractor support, because it must call upon surge capacity in times of crisis. In some jurisdictions, responsibility for escorting prisoners to and from court has been handed over to private companies because the police wanted to get back to their core business. Government departments contract out logistics support because there is now a well-established industry, so that warehousing and transportation services no longer need to be provided in-house.

The range of potential benefits from a mixed economy is extremely wide, but there are a number of explanations that recur with such frequency that they are deserving of closer attention.

3.1 Value for Money

Value for money is the most common explanation for competition and contracting. There are a significant number of academic and government studies that point to cost reductions in the order of 20% to 25% when competition and contestability are first introduced. The most comprehensive research has been conducted in a relatively small number of service areas – municipal waste collection, facilities management in local government, prison management and defence support. (See Appendix A for a summary of this literature.)

Of course, if service quality has also declined, then a reduction in cost may not amount to an improvement in productive efficiency. Qualitative outcomes are much more difficult to measure than cost outcomes, and many of the studies cited in Appendix A do not satisfactorily answer this question. Nevertheless, what evidence is available suggests that, done well, competition is capable of delivering significant improvements in value for money.

Transaction costs are also overlooked in many of these studies – the cost of conducting a competitive tender and monitoring performance throughout the life of the contract. Again, those studies that have been done on

transaction costs suggest that if they are managed well, they will not outweigh the financial gains over the life of a contract.

3.2 Improved Quality

In some cases, competition and contracting has been a vehicle for improving service quality. This may be the result of increased accountability and transparency that often accompanies a competitive tender and the negotiation of a legally-enforceable contract (discussed further below).

However, governments have sometimes used competition and contracting as a way of raising service standards, and introducing qualitative reforms that might otherwise have been difficult to implement.

3.2.1 Prison Contracting (UK and Queensland)

In the UK and Australia, prison contracting has resulted in a significant reduction in operating costs, however, that was not the principal reason why this model was originally adopted in either case.

United Kingdom: In the UK, the Prison Service had been attempting to introduce a new model of prison management known as 'dynamic security', where staff and prisoners interacted closely within discrete living units, and prison officers were actively involved in managing inmate behaviour on an ongoing basis. This model had been pioneered in the United States by the Federal Bureau of Prisons, and promoted in the UK by Ian Dunbar, the former Governor of Wormwood Scrubs, in a 1985 publication, *A Sense of Direction*.

That same year, a Home Office working party visited some of the 'new generation' prisons in North America founded on these same ideas. These principles were built into the physical design of the new prisons being commissioned by the British government at that time, however there was union resistance to the introduction of dynamic security, and for senior officials in the Home Office, contracting offered a relatively pain-free way of transforming prison culture. The publication of the Woolf Report in 1991 reinforced this new approach, so that with the introduction of the first privately-managed prison the following year, both commissioners and contractors placed considerable importance on what would become known as 'the decency agenda'.³¹

There is strong anecdotal evidence of systemic improvement as a result. Martin Narey, who was Director-General of the Prison Services from 1998 to 2003, has stated on several occasions that contracting was central to delivering the government's 'decency agenda'.³² The National Audit Office has also reported that 'Competition

has been important within the prison system for improving both management and conditions for prisoners'.³³

Australia: Queensland was the first Australian jurisdiction to introduce contract management into its prison system, following a review of the corrections system chaired by a local businessman. The Kennedy Report, published in 1988, provided a number of reasons why the management of a new prison, then under construction, should be subjected to competition. Benchmarking of performance and cost was foremost among them. Quality was even more of an issue when management of the next contract prison was being negotiated by the recently-elected Labor government, since the new facility was seen as a replacement for the infamous Boggo Road Gaol.³⁴

3.2.2 Failing Local Education Authorities (UK)

The performance model for Local Education Authorities (LEAs), introduced in the UK in 1999, is discussed at some length in Section 8.4 below. Under this model, twenty failing LEAs were identified for intervention and, of these, nine were reformed through partnerships with private management companies, appointed after a competitive tender. Educational outcomes in each of these local authority areas improved, and at a faster rate than the national average. While value-for-money was certainly a consideration in awarding these contracts, it was not what drove the decision to intervene, and it was not the criteria against which performance was judged.

3.3 Better Customer Service

Choice-based reforms (such as personal budgets in disability care) are deeply infused with a belief in the need for greater customer responsiveness in the delivery of social services. In its recent report on disability care, the Australian Productivity Commission offered the following justifications for user choice:

- Australian social norms have created an expectation that people should be able to run most aspects of their lives;
- Service beneficiaries have different and changing preferences about what matters in their lives and there are not easily observable by others;
- Lack of real choice results in poorer quality and more expensive services, and less diversity and innovation. 'In contrast, consumer control of budgets through self-directed funding, or even the option of controlling budgets, creates incentives for suppliers to satisfy the needs of consumers, given that they would otherwise lose their business. That in turn typically leads to more complex markets, with suppliers developing differentiated products for different niches...'

- The capacity to exercise choice is a good in its own right.³⁵

However, competition and contracting can also be employed to enrich the sense of customer service. This was evident in the contracting of prison services in the UK. The contracts specified longer hours out-of-cell than was conventional at the time, and for this reason, some of the earliest supporters of prison contracting were the prisoners themselves. The operator of the Wolds, the first privately-managed prison, insisted that prison officers call prisoners by their first names, a practice that was immediately adopted in other contract prisons but not adopted by the Prison Service for another decade or more.

Contracting through payment-by-results is now being used to drive this focus on the service beneficiary further. The latest generation of prison contracts in the UK have a strong focus on rehabilitation, with a significant part of the performance fee based on a reduction in re-offending. At HMP Doncaster, the first prison to be contracted on this basis, prisoners are assessed and assigned a case manager upon induction, and interventions are tailored to meet the individual's requirements. These are highly diverse and they are sequenced differently for different prisoners, with a structured handover to a community-based team six weeks prior to release. This is radically different from traditional programs, which were centrally mandated or adopted by prison governors because they came with additional funding rather than because they suited the needs of the prisoners themselves. A similar approach is now emerging in other public services, such as assistance for jobseekers and chronic disease management, where payment-by-results has been adopted.

3.4 Enhanced Accountability

Competitive tendering and performance contracting are founded on the principles of transparency and accountability. Indeed, this is one of the main reasons why central agencies have generally supported this model. Studies of the compulsory competitive tendering regime introduced in Victorian local government in the 1990s concluded that 'councils are now more open and transparent'.³⁶

In the United Kingdom, the performance regimes developed for the monitoring of contract prisons laid the foundation for the 'weighted scorecard' and the 'performance ratings' later adopted by the Home Office for the system as a whole. The Woolf Report had recommended the adoption of a national system of performance standards in 1991, with accreditation the reward for successful establishments. But the structure and content of the accountability framework

grew out of the performance regime developed for the contract prisons.³⁷

The principal reason why HM Treasury drove the Private Finance Initiative in infrastructure procurement in the mid-1990s (the British equivalent of public-private partnerships) was the potential that it offered for making the commissioning of major new infrastructure projects much more transparent. There are other criticisms of how the Private Finance Initiative was implemented, but there is no question that it served this purpose well.

Policymakers involved in the development of outcome-based commissioning (through payment-by-results contracts and social benefit bonds) are also aware that one of the potential benefits of this model is much greater scrutiny of the linkages between service outputs and policy outcomes, an area that has not been closely scrutinised in the past.

Competition and contracting generate a great deal of additional information that is useful to commissioners in their pursuit of increased efficiency and effectiveness. Indeed, one of the greatest challenges in trying to establish the value-for-money benefits of competition and contracting lies in the lack of information about the counterfactual. Jensen and Stonecash observed:

...the case for outsourcing on the grounds of efficiency enhancement (and cost reduction) is not easy to substantiate. Much of the difficulty can be attributed to the lack of data on operating costs and outputs. This is partly a result of the fact that, unlike the private sector, cost minimization has not been until relatively recently a priority in the public sector. But it can also be attributed to the fact that cost allocation techniques are difficult to apply in the public sector, because many outputs are joint products. This has changed in recent times with the introduction on activity-based costing, but the underlying problem is still pervasive.³⁸

A 2007 study of Australian PPP projects by Allen Consulting made the same observation: 'Rich data was obtained for the majority of completed PPP projects, but the availability of data for traditional projects was limited'.³⁹

Private contractors are subject to independent occupational, environmental and public health regulation where public sector monopolies often are not. In private conversations, most well-established contracting firms can provide examples where they have had to urgently upgrade the standard of physical assets, or provide additional training so that they could secure certification for transferred staff. They are not prepared to tell these

stories in public out of concern at causing offence to their customers.

There is also considerable historical evidence that legislators, regulators, judges and juries have been prepared to impose liabilities on private providers that they were reluctant to extend to government. In Britain, the tort of negligence was restructured over the course of the 19th century, as the parliament and the courts extended the civil liability of railway companies, at the same time as they refused to make local authorities and turnpike trusts liable for neglected roads.

The role that contestability can play in driving increased accountability and transparency is evident from studies of newly incorporated cities in southern California which purchase their services from Los Angeles County rather than providing them direct. (These so-called Lakewood cities are discussed in some detail in Section 3.4 and Appendix B.3). In 1971, the City of Los Angeles hired consultants to undertake a review of the contract system, which concluded that the contract cities were not paying enough for their policing services (and thus that non-contract cities such as Los Angeles were subsidising them). The Contract Cities Association hired its own consultants who confirmed that these services were indeed under-priced: the fundamental issue in dispute was how to account for the department's obligation to service all areas of the county, including those covered by independent police departments. These negotiations contributed to a further debate over the Sheriff's Department's reluctance to expand the use of one-man cars, and in the end, the police made significant concessions to the contract cities, resulting in lower price increases than had been originally proposed.⁴⁰

Government suppliers also benefit from this system. Mehay and Gonzalez found that county sheriff departments in California that sold their services under contract to other municipalities had significantly lower costs:

...a county department that sells services to cities under the Lakewood Plan is forced to 'cost-out' each service and to sell the service at a per unit price that covers cost... In order to retain existing customers, or attract new ones, county departments must sell at a price that is less than it would the purchasing city to produce the service itself in-house. This constraint on the price that can be charged to cities creates a pressure for county departments to control production cost. Furthermore, the price charged to cities conveys information to unincorporated area residents and to the county board of supervisors on the true cost of producing the

service. Hence, contracting reduces the lack of information that impedes the monitoring of bureau heads by voters and/or by elected officials.⁴¹

The criticism that is sometimes levelled at public service contracting for a lack of accountability arises principally from a concern about commercial confidentiality. In a competitive or contestable environment, providers will be reluctant to share details concerning their service models and certain information about their profit margins and the cost of capital.

A distinction should be made between the information that will be made available to public officials and what will be released to the public at large. There is little doubt that effective contracting will result in a great deal more disclosure of vital information to those commissioning public services, including details that are commercially sensitive. How much of this is released to the wider community is a matter for politicians and public officials, but in general, there is no reason why the vast majority of the contract, and (once the competition has run its course) the details of the service model should not be made available. In the same way, information about contractual performance should generally be released, preferably benchmarked against other providers.

3.5 Transfer of Risk

One of the most useful explanations as to why governments have turned to the private sector is to be found in the management of risk. Governments have traditionally relied on private firms where they are better positioned to manage the technological, market, financing or operational risks associated with delivery. When these risks are low, governments are more often prepared to manage these services themselves.

Urban Water Supply

Private enterprise played a major role in the early development of water supply in the larger cities of Europe and North America, partly because of the fragmented and largely voluntary nature of local government at the time, and the risks involved in managing pioneering technologies and raising the large sums of capital necessary to finance these undertakings. Under the market models that developed in the early 19th century, at a time when the problem of natural monopoly was not yet understood, the private sector was better positioned to respond to competition.

The comparative advantage of the private sector declined as the technology matured, and the benefits of monopoly provision became obvious (either

under municipal ownership or through municipal franchise). As governments came to rely increasingly on dams for the storage of large quantities of water, the private sector's ability to fund investments in water infrastructure was inferior to that of the public sector.

In recent decades, the balance has once again tipped in favour of the private sector. In part this is due to the re-emergence of technological innovation, particularly in water treatment. Environmental concerns and construction costs have slowed the rate of dam construction. Furthermore, the operational challenges involved in managing a monopoly have also become more apparent.

At the same time, the public and private sectors have developed more sophisticated contracting models, enabling governments to franchise out the management of water facilities, including their design, construction, financing and ownership.⁴²

Public-private partnerships were originally introduced in the United Kingdom by HM Treasury as a means of managing risk in large capital works projects, in particular the risk of optimism bias on the part of proponents, and failure in project management during the course of construction. In the UK and Australia, there is clear evidence that PPPs have been highly successful in this regard. Two of the more robust studies were published in this country in 2007 and 2008.

The Allen Consulting Group reviewed 21 PPP projects and 33 traditional projects, and arrived at the following conclusion:

- Traditional projects had cost overruns of 11.6%, while the additional costs of the PPP projects were only 1.2 percent;
- On a time-weighted basis, traditional projects averaged 23.5% in time overruns, while the PPP projects were in average slightly ahead of time.

Associate Professor Colin Duffield of the University of Melbourne later published another study looking at 25 PPP projects and 42 traditional ones which arrived at broadly the same conclusions.⁴³

There are limits to how much risk can be transferred from commissioners to providers (whether they are from the public, private or not-for-profit sectors). The objective must be to optimise risk transfer not to maximise it. But this is another reason why HM Treasury proceeded with public-private partnerships in the early 1990s – they saw it as a mechanism for opening a debate about the allocation of risk, which they recognised would take some years to mature.

3.6 Core Business

In some cases, government agencies advocate the outsourcing of ancillary services as a means of freeing up resources to enable them to focus on core business. In the defence sector, they speak of changing the 'tooth-to-tail' ratio.

Much the same applies in policing. The 'Ministerial Audit of the NSW Police Force' conducted last year by retired Assistant Commissioner Peter Parsons, offered this as a reason for contracting out the transportation of adult and juvenile prisoners, referring to evidence that 'the privatisation of prisoner transport in Western Australia released around 200 police officers to core policing duties'. The Parsons Report also identified a potential weakness in agency-to-agency contracting within the public sector. In 2008, the NSW Police Force and the Department of Juvenile Justice entered into an agreement whereby, when Juvenile Justice Centres were unable to receive a young person due to overcrowding, the police would hold him or her, being compensated for the associated costs. Among other things, this involved the police in the transportation of juvenile detainees. However, at the time of the report, the Department of Juvenile Justice had not paid any of its invoices since July 2009.⁴⁴

Head teachers have been some of the strongest supporters of the PPP model in schools. In Queensland, the Association of State School Principals welcomed the announcement of contract award in 2009, since 'school leaders will be able to focus on curriculum leadership while [the facilities management provider] will focus on facilities and maintenance'.⁴⁵ NSW had a similar experience, where one of the principals reported to a Ministerial Council meeting on the way in which the service contract had liberated her from the detailed concerns of facilities management. While they have never been prepared to do so in public, the NSW Teachers Federation was privately supportive of the way in which the contracts had worked.

3.7 Increased Innovation

The incremental nature of service innovation makes it difficult to study, but where providers are given the freedom, it seems that competition and contracting can create a climate where innovation flourishes. In part, this is because of the change in motivation that competition brings, but there is also some evidence from former public service managers that the contractual framework creates a hotspot where new ideas are more likely to be tried and implemented.

British Prisons

There is considerable anecdotal evidence concerning the innovation that competition and contracting brought to prison management in the UK. This was most evident in the design and construction of the early PPP prisons, which resulted in a 45% drop in delivery times for new establishments and a marked reduction in construction costs.⁴⁶ There was also technological innovation, with CCTV cameras, magnetic key cards and drug detection machines in managing inmates. Privacy locks were another radical initiative, allowing prisoners to have keys to their own cells.⁴⁷

In terms of day-to-day operations, the National Audit Office concluded: 'A key innovation by the private sector has been in promoting a more constructive staff/prisoner relationship. PCOs [prison custody officers] are encouraged to treat prisoners in a more positive manner, for example through the use of first names and mentoring schemes.'⁴⁸

Contracting was deliberately used by the Home Office as a way of accelerating the introduction of direct supervision into prison management. The creation of an alternative system of prison management, with staff recruited from outside the sector, covered by different unions, made it easier to introduce a radically different culture into prison management. Among the many changes that accompanied prison contracting, perhaps the most striking was an increased reliance on female prison officers. Around one-third of officers recruited for the first contract prison were female, compared with an average in the Prison Service at that time of around three percent.⁴⁹

3.8 Importing Best Practice

As the Australian public service sector is presently structured, there is limited spread of best practice across international borders (at least in so far as management is concerned), and what little cross-fertilisation does occur largely takes place within the policy community. Liberalising the supply side and facilitating international and cross-sectoral partnerships and joint ventures would undoubtedly result in a great deal more diversity in service models.

This was evident to some extent in the emergence of the prisons market in the UK. While the Home Office was prepared to experiment with new designs and a radically different service model that had been pioneered in the United States, the unions were resistant to change and prison managers did not have permission to innovate. Contracting provided a convenient vehicle for the

implementation of this model, as British companies worked in partnership with North American prison operators and other specialists who were familiar with 'dynamic supervision' so that this new approach could be adapted to the local environment. In recent years, British prison contractors operating in this country have exported best practice from the Australian custodial system back into the UK.

A similar process appears to have occurred in the welfare-to-work market in the UK, where a 'work first' approach has been adopted as the dominant service model. 'Work first' is based on the view that in assisting the long-term unemployed to return to work, the greatest priority should be given to finding them jobs, rather than providing counselling to overcome the barriers to work-readiness. According to senior officials from the Department for Work and Pensions, this approach was heavily influenced by American and Dutch providers, who became involved in the early stages of the 'welfare-to-work' market in the UK.⁵⁰

While the Australian public service has models and capabilities that it can export to the emerging economies throughout Asia, there are innovative new models emerging in those countries that may have a powerful impact on the delivery of public services here in Australia.

Social Entrepreneurship in Indian Hospitals

In particular, India has seen the emergence of social entrepreneurs who are seeking to meet the growing expectations of the public in a country where government cannot afford to fund the vast majority of public services through taxation. This has resulted in the development of public purpose enterprises that are operated for profit (since they have no alternative if they are to attract funds from private investors), and an outbreak of 'disruptive innovation' that is delivering high quality public services at a fraction of what they would cost in the Western economies.

Narayana Hospital in Bangalore, for example, is providing open heart surgery for the equivalent of US\$2,000, with mortality rates that are comparable to those in North American hospitals. Dr Devi Shetty, the founder of the Narayana chain, proudly describes his initiative as 'the Wal-martization' of healthcare' and the people of India are getting comparable health outcomes for one-tenth of the cost.⁵¹

It is unlikely that the Narayana model would be directly adopted by an Australian hospital, but if these cost differentials persist, it is likely that entrepreneurial hospital managers will study the innovations being developed by Dr Shetty and his peers, and adapt them to our conditions.

3.9 System Effects

Under some circumstances, competition and contracting deliver benefits well beyond the service or function in question. The Lakewood Plan delivered transparency and cost savings not only for the contract cities but also for the provider government, Los Angeles County.

Once again, the sector where there is the best evidence of systemic gains from competition and contracting is prison management. In the United States, three studies sought to compare overall spending on corrections across a number of states, with the number of prisoners kept in privately-managed facilities. All three found a negative correlation, which suggests some kind of relationship between the introduction of prison contracting and lower spending on corrections more broadly. However, these studies did not establish that the relationship was causal.

There is, however, strong anecdotal evidence of the effect. The Australian criminologist Richard Harding, (who was, for some years, the West Australian Inspector of Custodial Services), documented a number of examples where the public sector embraced reforms that had been initiated by the private sector, a process he described as 'cross-fertilisation':

In the United States, the state of Louisiana required ACA accreditation by its private prison but not for its own public sector prisons. This requirement soon worked its way into the fabric of the public sector system. . .

In the United Kingdom, an example related to the standards required of the private operators of a new remand prison, The Wolds. The mandated minimum standards far exceeded those of comparable public prisons: for example, out-of-cell hours, visits, access to showers, out-of-doors time, telephone usage, and so on. While The Wolds was starting up, the Prison Service was developing its new Model Regime for Local Prisons and Remand Centres. The standards approximated those earlier required of the private prison operator – a quantum leap. Commenting on this, Bottomley et al state that 'the threat of market testing [i.e., opening up more remand prisons to private sector operation]...acted as a powerful spur to innovation.'

In Queensland, current research being carried out by Harding and Rynne has identified clear cross-fertilization effects with regard to health care system, where the standards required of the private sector were initially far higher than the standards the public sector required of itself. Within a few years the public sector found it necessary to equal those standards...

The same research project has also identified substantial cross-fertilization in the area of prisoner programs. Borallon Prison avowedly set out to integrate programs into the daily lives of inmates through a unit management approach. The cognitive programs directed at addressing offending behaviour were different from anything else found in the public system... These fresh approaches were picked up by the public sector quite quickly.⁵²

In the United Kingdom, a 2001 report into the prison system by Patrick Carter (now Lord Carter) concluded:

It is widely accepted by management and unions alike, that the competition offered by the new private prisons and the market testing of existing establishments has made the prison system more efficient and effective as the public sector has sought ways to improve its working practices and become more competitive.⁵³

The process by which cross-fertilisation occurs has been little studied. In some cases, those responsible for managing an individual facility or the system as a whole use the threat of competition as a lever to introduce changes that were previously not possible. This was the case with the 'Way Forward' prisons in NSW, where reforms were initiated in parallel with departmental negotiations with public sector unions. It was only once a new industrial award had been finalised that the

government agreed that the public sector would operate these new facilities without the need for actual competition.⁵⁴ In the UK, the Governor of Woodhill Prison, a public facility opened at roughly the same time as The Wolds (the first contract prison in the UK), used the threat of competition as a way of introducing a performance culture into his prison⁵⁵.

In some cases, senior managers use the new establishments as exemplars, demonstrating that desired reforms are capable of being implemented without risk to prisoners or staff. The introduction of significant numbers of female prison officers into the contract prisons may provide an example of this. Prior to The Wolds, the first privately managed prison in the UK, the ratio of female custody officers throughout the Prison Service was around three percent. When The Wolds opened, around 30% of its prison officers were female, and later contract prisons have also adopted this gender ratio. Once it was established that a prison could be safely managed with such high levels of female staff, the public sector followed.⁵⁶

In other cases, the changes necessary to introduce competition and contracting provide policymakers with new tools for the implementation of reform initiatives. The obvious examples in the English prison system are the 'Weighted Scorecard', a performance management tool adapted from the measurement regime developed for the contract prisons, and Service Level Agreements (or quasi-contracts) for prisons managed by in-house teams after market-testing.⁵⁷

4. The Limits of Competition

It has been said that as America's first astronaut, John Glenn, was hurtling through space, one thought kept crossing his mind: that every part of his capsule had been supplied by the lowest bidder. The story is no doubt apocryphal, but it illustrates rather well a concern that is widespread in society, that competition and contestability will be used to drive low-price bids without regard to the consequences for public services.

Contracting is not a panacea. It has its limitations, not only *where* they can be applied but *how*. In deciding what tools are to be employed in developing a mixed public service economy and when, service commissioners need to understand the deficiencies of competition and contracting as well as their strengths.

4.1 The Inherently Governmental

Some functions are so close to the core business of government that contracting with external providers would be extremely unwise. In the case of the military, the police and the courts, this is principally because they involve the use of force which for reasons of national security and public confidence, must remain closely circumscribed. There are also powerful social conventions concerning the exercise of such powers for mercenary ends.

In some cases, it is proximity to the policy-making heart of government that constrains the use of competition and contracting; in others, it is some kind of market failure, or the difficulty of specifying the required tasks in advance and monitoring performance afterwards. Few would disagree that there are some public services that should be exempt from competition and contracting, and yet there is surprisingly little agreement as to where that boundary line should be drawn.

Few governments have attempted a definition of the 'inherently governmental'. In part, this is because there are few definitions that can be sustained beyond the boundaries of a particular time and place. Most Australians would strongly disagree with the employment of mercenaries in the armed services, and yet most regard the Ghurkhas, who served in the British Army at Gallipoli and later in Malaya (among many others), as highly professional soldiers. Nepal was never part of the British Empire, and the Ghurkhas are employed under government-to-government contracts that are little different from the arrangements through which Hessian soldiers were hired by the British during the American War of Independence.

Front line policing seems like core business, and yet San Francisco has its 'patrol specials' – neighbourhood patrols that are bought and sold as a kind of property right – a model that has been in existence since the mid-19th

century. And private bail bondsmen are relatively commonplace in some parts of the United States.

These are not precedents that Australia would want to follow, but they remind us that what is 'inherently governmental' is determined as much by cultural and historical factors as it by functional or ideological ones. The only jurisdiction to have attempted such a definition is the US federal government, under its A-76 program, first developed in the 1950s: '[A]n activity that is so intimately related to the public interest as to mandate performance by government personnel'.

The circular provided a non-exclusive list of functions that would be included within its definition:

1. binding the United States to take or not to take some action by contract, policy, regulation, authorization, order or otherwise;
2. determining, protecting, and advancing US economic, political, territorial, property or other interests by military or diplomatic action, civil or criminal judicial proceedings, contract management or otherwise;
3. significantly affecting the life, liberty or property of private persons, or
4. exerting ultimate control over the acquisition, use, or disposal of United States Property (real or personal, tangible or intangible), including establishing policies or procedures for the collection, control or disbursement of appropriated and other federal funds.⁵⁸

More comprehensive 'illustrative lists' of inherently government functions have been published from time-to-time, reflecting the philosophical perspectives of different administrations. The latest list, published by President Barak Obama in 2010, details the:

1. direct conduct of criminal investigation.
2. control of prosecutions and performance of adjudicatory functions (other than those relating to arbitration or other methods of alternative dispute resolution).
3. command of military forces, especially the leadership of military personnel who are members of the combat, combat support or combat service support role.
4. conduct of foreign relations and the determination of foreign policy.
5. determination of agency policy, such as determining the content and application of regulations, among other things.

6. determination of Federal program priorities or budget requests.
 7. direction and control of Federal employees.
 8. direction and control of intelligence and counter-intelligence operations.
 9. selection or non-selection of individuals for Federal Government employment.
 10. approval of position descriptions and performance standards for Federal employees.
 11. determination of what Government property is to be disposed of and on what terms (although an agency may give contractors authority to dispose of property at prices with specified ranges and subject to other reasonable conditions deemed appropriate by the agency).
 12. In Federal procurement activities with respect to prime contracts:
 - (a) determining what supplies or services are to be acquired by the Government (although an agency may give contractors authority to acquire supplies at prices within specified ranges and subject to other reasonable conditions deemed appropriate by the agency);
 - (b) participating as a voting member on any source selection boards;
 - (c) approval of any contractual documents, to include documents defining requirements, incentive plans, and evaluation criteria;
 - (d) awarding contracts;
 - (e) administering contracts (including ordering changes in contract performance or contract quantities, taking action based on evaluations of contractor performance, and accepting or rejecting contractor products or services);
 - (f) terminating contracts;
 - (g) determining whether contract costs are reasonable, allocable, and allowable; and
 - (h) participating as a voting member on performance evaluation boards.
 13. approval of agency responses to Freedom of Information Act requests (other than routine responses that, because of statute, regulation, or agency policy, do not require the exercise of judgment in determining whether documents are to be released or withheld), and the approval of agency responses to the administrative appeals of denials of Freedom of Information Act requests.
 14. conduct of administrative hearings to determine the eligibility of any person for a security clearance, or involving actions that affect matters of personal reputation or eligibility to participate in government programs.
 15. approval of federal licensing actions and inspections.
 16. determination of budget policy, guidance, and strategy.
 17. collection, control, and disbursement of fees, royalties, duties, fines, taxes and other public funds, unless authorized by statute, such as title 31 USC 952 (relating to private collection contractors) and title 31 USC 3718 (relating to private attorney collection services), but not including:
 - (a) collection of fees, fines, penalties, costs or other charges from visitors to or patrons of mess halls, post or base exchange concessions, national parks, and similar entities or activities, or from other persons, where the amount to be collected is easily calculated or predetermined and the funds collected can be easily controlled using standard cash management techniques; and
 - (b) routine voucher and invoice examination.
 18. control of the Treasury accounts.
 19. administration of public trusts.
 20. drafting of Congressional testimony, responses to Congressional correspondence, or agency responses to audit reports from the Inspector General, the Government Accountability Office, or other federal audit entity.
- The circular also included another 'illustrative list' of functions 'closely associated with the performance of inherently government functions where close supervision would be required if they were not performance by federal employees:
1. services that involve or relate to budget preparation, including workforce modeling, fact finding, efficiency studies, and should-cost analyses.
 2. services that involve or relate to reorganization and planning activities.
 3. services that involve or relate to analyses, feasibility studies, and strategy options to be used by agency personnel in developing policy.
 4. services that involve or relate to the development of regulations.
 5. services that involve or relate to the evaluation of another contractor's performance.

6. services in support of acquisition planning.
7. assistance in contract management (particular where a contractor might influence official evaluations of other contractors' offers).
8. technical evaluation of contract proposals.
9. assistance in the development of statements of work.
10. support in preparing responses to Freedom of Information Act requests.
11. work in any situation that permits or might permit access to confidential business information and/or any other sensitive information (other than situations covered by the National Industrial Security Program described in FAR 4.402(b)).
12. dissemination of information regarding agency policies or regulations, such as attending conferences on behalf of an agency, conducting community relations campaigns, or conducting agency training courses.
13. participation in any situation where it might be assumed that participants are agency employees or representatives.
14. participation as technical advisors to a source selection board or as nonvoting members of a source evaluation board.
15. service as arbitrators or provision of alternative dispute resolution (ADR) services.
16. construction of buildings or structures intended to be secure from electronic eavesdropping or other penetration by foreign governments.
17. provision of inspection services.
18. drafting of legal advice and interpretations of regulations and statutes to government officials.
19. provision of special non-law-enforcement security activities that do not directly involve criminal investigations, such as prisoner detention or transport and non-military national security details.⁵⁹

The Obama administration undertook a review of the meaning of 'inherently governmental' because previous definitions had proved inadequate during the conflicts in Iraq and Afghanistan.

Historical understandings of core business are also being challenged in the UK where the Ministry of Defence is investigating the possibility of contracting with a private provider for the management of its procurement capabilities. This option was first raised in an independent

review of defence acquisition conducted on behalf of the Defence Secretary in 2009, which found that the current procurement system was not able to flush out the real costs of defence equipment at an early stage of procurement, and it did not create strong incentives for effective prioritisation. The report concluded that the most effective way of managing these tensions within the defence establishment was 'a partnership with a private sector programme management organisation, of the type operating in civil engineering and other complex engineering fields'.⁶⁰ A similar model is being pursued in the UK's Defence Infrastructure Organisation.

4.2 Market Depth

Successful competition relies on there being a sufficient number of bidders, which may be difficult where a service has traditionally been delivered as a public monopoly. Most of the advantages of a mixed economy outlined in Section 3 assume that there is sufficient market depth to sustain competition tension during the tender and throughout the life of the contract.

However, if the lack of an existing supply side were an insuperable challenge, then it would never be possible to open up public sector monopolies to competition, and public sector commissioners have dealt with this problem in a number of ways:

- a sole producer might be broken up into a number of competing firms, with ownership diversified through divestments, management buy-outs or public-private joint ventures. To a considerable extent, this is how India's business process outsourcing market was built.
- competition can be invited from interstate or international providers, whether publicly or privately owned. In both Australia and the United Kingdom, this is how the market for prison management was first built.
- capability can be developed over time by contracting support services for which a market already exists, and then expanding the scale and scope of services over time.
- in some cases, providers can be attracted from industries or sectors that have characteristics similar to the service in question. In the UK and the US, defence contractors have broadened their capabilities to deliver social services, but business consultancies, IT providers and facilities managers have expanded into public service markets in this way. In a similar way, not-for-profit providers have adapted to take on the commercial risks associated with public service contracting.

- small specialist providers and not-for-profits may work in partnership with management contractors through joint ventures or prime contracting arrangements that enable them to deliver services within a highly competitive environment. There are examples of this in the education and welfare-to-work markets in the UK.

Market depth can remain a problem because of features that are inherent to the public service economy. For example, procurement processes are more protracted and thus more expensive; intellectual property in service models will generally not be protected; commissioners may cancel or significantly delay a tender late in the process when substantial costs have already been incurred; contractual documentation and performance reviews will often be made public; or providers may find themselves caught up in political controversies that have little to do with the manner in which they are delivering the service.

Public officials may regard these features as inevitable, but they act as a substantial barrier to entry, since many private firms will be reluctant to expose themselves in such operational or financial ways. Over the years, these concerns have surfaced repeatedly in surveys of supplier attitudes to public service markets.⁶¹ One of the most revealing studies was conducted by the NSW Independent Commission Against Corruption in 1999, involving interviews with 204 private contractors and management consultants:

The NSW public sector was perceived by most respondents to be more difficult and less profitable to deal with than the private sector. Compared to the private sector, the public sector was perceived to be overly bureaucratic, slower and less service-oriented. Being service-oriented was perceived to be indicative of higher ethical values. This resulted in almost one in five respondents perceiving that the private sector had higher ethical values than the public sector because of the private sector's greater emphasis on service provision.⁶²

The inherent conservatism of procurement officials means that they may expect providers to have an extensive track record in the field, which also serves as a barrier to new entrants. If the scale and the scope of contracts are larger than necessary, if contract duration is longer than justified, if the service being put to market is highly specialised, if incumbents control key physical or human assets or if the contract involves a significant transfer of risk, then it will be more difficult for commissioners to attract sufficient interest from potential bidders.

With careful design, most of these problems can be overcome, although it does require commissioners to

accept the responsibility for market design and management, rather than just conducting a succession of seemingly unrelated procurements.

4.3 The Winner's Curse

Procurement specialists have identified a problem with tenders where bidders have an imperfect understanding of the service that is on offer, and competition is intensively focused on price and/or risk transfer. Under these conditions, the winner will often be the bidder that takes the most optimistic view about the value of contract in question, a scenario that has come to be known as 'the winner's curse'.⁶³

From the bidder's perspective, there is no way of winning a 'winner's curse' competition and the only successful strategy is to bid less aggressively or withdraw. From the commissioner's perspective, the solution lies in understanding the conditions under which a winner's curse can be created, and either working to develop a common understanding of the service that is the subject of competition, and where that is not possible, alleviating some of the intensity by placing less emphasis on price. The economists' solution is a Vickery auction, where the bidder with the lowest price is awarded the contract at the price offered in the second lowest tender.

The problem is comparable to the 'optimism bias' that sometimes occurs in tenders for infrastructure projects, and urban transportation systems in particular, where traffic forecasts are typically overestimated and construction costs underestimated. Sydney's cross-city tunnel is an example of a tender where the contracting authority failed to manage 'optimism bias'. Much the same occurred with the original competition for the operation of Melbourne's trams and trains, where public officials acknowledged the Government generated 'bid fever'.

In the construction industry, the practice of offering an uneconomic price is referred to as 'suicide bidding'. It is sometimes motivated by the desire to retain skilled workers during an economic downturn, but it is also caused by managers who, for one reason or another, have come to regard turnover as more important than profitability. There may sometimes be an element of gaming, with bidders expecting that they can renegotiate the terms of the contract at a later stage.

From government's perspective, these problems arise because procurement officials have too much faith in the market, failing to appreciate that under certain conditions, bidders can be induced to act in ways that are detrimental to the firm's long-term interests. There is also a well-known bias in favour of price-based competitions, since public officials find it easier to justify their actions based on a simple comparison of the raw numbers.

However, procurement officers are responsible for understanding market conditions, and the circumstances under which a 'winner's curse' is likely to emerge. If the lowest bid is substantially different from the others, then they have a professional and, in Europe, a legal obligation to conduct further investigations.

Norwich Social Housing (UK)

Norwich City Council awarded a contract for the maintenance of its social housing to Connaught Partnerships in November 2009. Shortly thereafter, the incumbent provider, Morrison Facilities Services, sought an injunction to prevent the council from awarding the contract, arguing that the council had failed to scrutinise what amounted to an 'abnormally low price' and refused to disclose its evaluation criteria.

Morrison claimed that the price submitted by Connaught (£17.5m) was simply unsustainable. Tender documentation had declared that a sum of £28.9m had been budgeted for the contract in 2010/11, and most other bids were in the range of £23m to £26m (with one as high as £47m).

The court agreed that when faced with what appears to be an abnormally low tender, a contracting authority has a duty to investigate, a duty which is owed not only to the low tenderer but to the other bidders as well. It was decided that damages would be an inappropriate remedy and granted an injunction.⁶⁴

The case did not proceed to final resolution after an agreement was reached between the Morrison and the council. However, in September 2010, Connaught was placed in administration following a succession of wins that were regarded in the industry as suicide bids.

In other cases, the 'winner's curse' may be manifest in the willingness of bidders to assume unsustainable levels of risk. This will be more difficult to detect, although if the providers who are willing to accept the most risk are specialist providers with no alternatives to the market in question, and providers with a wider range of market options have bid more conservatively, then procurement officers probably should make further inquiries.

4.4 The Contractor's Art

'The contractor's art' is a term coined in 18th century England to describe the way in which government contractors constructed their tenders so as to maximise their returns without breaching the terms of their agreement.⁶⁵ Economists now refer to it as 'gaming'.

Designing and managing performance incentives so as to avoid strategic behaviour on the part of providers is one of the central challenges of service contracting, and for this reason it might well be described as the 'commissioner's art'. Given the successful use of contracting for the procurement of complex public services over many years, it is obviously not an insuperable challenge. In part, the answer lies in careful design of the performance regime, so that financial incentives are aligned with the ultimate outcomes that the commissioner hopes to achieve.

However, much of the solution lies in designing a performance management regime that does not rely exclusively on financial rewards and penalties. This can be achieved through retrospective qualitative assessments, and an increased reliance on reputational rewards and penalties.

In the UK prisons market, the Ministry of Justice relies on qualitative assessment by the Prisons Inspectorate, whose reports are made public and thus impact on corporate reputation. Where there is an ongoing series of competitions, and where reputation is given sufficient weight in the procurement process, qualitative assessment of this kind can have a powerful impact on provider behaviour.

4.5 Kelman's Paradox and Other Pathologies

Some would argue that the persistent failure of public officials to manage commissioning and procurement arises not from deficiencies in the capabilities of the individuals concerned but from flaws inherent to the public sector which cannot simply be overcome through process redesign. From this perspective, competition and contracting are problematic not because of market failure, but rather because of government failure.

- *Kelman's Paradox*. In 1990, a Harvard academic, Steven Kelman, published a study of IT procurement in the US federal government, in which he identified (and strongly criticised) a policy of deliberately ignoring past performance, based on the assumption that this would give an unfair advantage to incumbents. Kelman showed that this had resulted in the bizarre outcome that contractors who had done an outstanding job in serving their customers were replaced by firms who were prepared to submit low bids and were incapable of meeting the customer's needs. In the private sector, a contractor who had gone above and beyond the terms of the contract would be given high priority in any subsequent review of the arrangement.⁶⁶

For the most part, procurement officials in Australia and the UK have avoided Kelman's Paradox, although it is sometimes assumed that past performance can be addressed through a superficial screening at the RFP ('Request for Proposals') stage. In the UK's welfare-to-work market, the Department of Work and Pensions elected not to reference past performance during the latest round of procurements, which seems to have resulted in some of the most effective providers being marginalised in the Work Programme. The recurrence of this pathology, despite the well-known consequences of ignoring past performance, suggests that the problem may be cultural.

- *Price versus Value.* The temptation of procurement teams (or their superiors) to select winning tenders based on lowest price rather than value-for-money is also well understood, and in spite of repeated warnings about the resulting consequences on service quality, and an explicit reassurance by commissioners that competitions will not just be based on price, the behaviour persists. There appears to be something in the culture of public sector procurement that motivates public officials to default to price as the key selection criterion.
- *Winner's Curse.* The 'winner's curse' has been discussed above. The fact that the lessons are not learned by public service commissioners does suggest that the problem may be institutional.
- *Whales not Dolphins.* A 2001 report by the OECD on e-government warned that public sector budgeting and political decision-making tend to result in the production of 'whales' – projects that are 'large, expensive and spectacular' – rather than 'dolphins' – projects that are smaller and more tractable.⁶⁷ This seems to be a particular problem with technological innovation, and is widespread in IT contracting.

However, it was first identified as a pathology more than a century and a half ago by a consultant to the British Admiralty in reflecting on the Royal Navy's dismal record in experimenting with steam-powered vessels: 'Government have made all their experiments on a large scale, while the private man has been content to make his first essays in a petty way.'⁶⁸

- *Stop-Start Procurements.* Government surveys of private providers rarely fail to report delayed, deferred and restarted procurements as a source of deep frustration. Apart from the obvious cost implications, these practices have consequences for the careers of private sector executives involved in leading these bids. The persistence of these behaviours points to

them having underlying causes that are inherent in the nature of the public sector.

While these problems are widespread, they are not universal, which means that the underlying conditions are capable of being anticipated and overcome.

4.6 Total Service Failure

It is sometimes argued that, with key public services, it is impossible to shift the ultimate risk of performance to an external provider. If the management of a prison or a hospital is failing to such an extent that lives are at risk, or fundamental levels of service are compromised, then government must intervene. This is obviously the case, and while it may have implications for the kind of contract models that are employed, it does not mean that contestability is fatally compromised.

Any private corporation with a complex supply chain (an automotive manufacturer, a nuclear power station or a private hospital provider) faces the same challenge. The simple answer is that, short of total or substantial service failure, it is possible to shift a great deal of intermediate risk to providers.

However, it is necessary for government to have an intervention regime to address performance failure as it occurs, and some form of rescue strategy should the provider fail completely. In practice, this usually involves a change of senior management, and there are numerous examples of where public sector managers or alternative private sector providers have stepped into the breach until a long term solution can be found.

4.7 Corruption

Corruption and collusive tendering may create severe constraints on the use of competition and contracting in the public sector, where the complexity of the services prevents the use of reverse auctions or sealed envelope, fixed-price bids, which are highly transparent and thus allow procurement officers very little discretion. The qualitative dimensions of a service contract mean that the inability to trust the judgement of procurement officers can result in perverse outcomes.⁶⁹

In the past, the NSW Government has had serious problems with corruption. The Independent Commission Against Corruption has recently reported:

Each year, approximately 12% of complaints received by the Commission include allegations of corruption in NSW government procurement, and approximately 30% of our public inquiries make findings of corrupt conduct related to

NSW government procurement. Almost half of the 1,515 government suppliers that responded to a Commission survey reported that they believe corruption in public procurement in NSW is a moderate to major problem.⁷⁰

These are matters that must be taken very seriously, but there are now a significant number of public service contracts in Australia, and corruption has not surfaced as a significant issue. It is usually less of a problem where public services are concerned because of the relatively small number of suppliers with strong brands and a deep investment in their corporate reputations, and the prospect of repeat business for companies that perform well.

However, the specialised nature of public service contracting does mean that post-separation employment – the so-called ‘revolving door’ – may be an issue.

5. Commissioned Services

The most common form of market in the public service economy involves the purchase of services from private and not-for-profit providers through competitive tendering. This is Chadwick's 'competition for the field of service', where government commissions a public service on behalf of the community, and providers are contracted to deliver a monopoly service for a term of years. It is often referred to as 'outsourcing', but this term is inadequate for describing the complexity of contractual models now being deployed. In making decisions as to the services that might be exposed to greater diversity and competition, commissioners need to have regard to the range of contractual instruments now at their disposal.

5.1 Input-Output-Outcome

5.1.1 The Evolution of Public Service Contracting

The development of public service contracting over the past 30 or 40 years has seen a movement from simple 'body hire' contracts – where staff were sourced from the private sector but supervised by public sector managers – to models where providers are paid based on their performance.

Input-based contracting was used at an early stage of market development, where commissioners were unsure about supplier capability, and uncertain as to how contractual instruments might work in the management of providers. Contracting for inputs is still appropriate where these constraints apply, and in some situations (such as the guarantee of basic human rights in custodial environments), process is outcome, and detailed specification may still be necessary. However, input-based contracting narrows the scope for innovation, since the commissioner is imposing its own management processes and service solutions onto the provider.

Over time, there has been a discernible shift from the specification of inputs to the specification of outputs, with providers being paid more on the basis of measurable results. Payment on performance or 'payment for results' is not a new idea. Edwin Chadwick wrote in 1877 of 'the great master principle of administration...of making interest coincident with duty – by only paying for results.'⁷¹ He was deeply influenced by the political philosopher, Jeremy Bentham, who in 1796 had negotiated a contract with government to design, build and operate a penitentiary on the outskirts of Westminster, with financial penalties for recidivism and deaths in custody.⁷² It was only with the return of performance contracting in the 1980s that this model has been fully explored.

The relative success of performance contracting has led policymakers to ask whether it is possible to contract for

outcomes, and this approach is now being explored in a variety of different ways throughout the English-speaking world, and under a variety of names – 'outcome-based commissioning', 'payment by results', 'pay for success' and 'cash on delivery' to mention a few. Social impact bonds and social benefit bonds are also examples of procurement focused on outcomes.

5.1.2 Payment by Results

'Payment by results' is not new to the private sector. 'No cure, no pay' has long been one of the leading contracting models in ocean salvage, and 'power by the hour', a concept developed in the aviation industry and later applied in the energy sector, bears many of the same characteristics. 'Value-based pricing' has been employed in the pharmaceutical industry for several decades in the roll-out of expensive new drugs. This model seems to have been pioneered in the United States in the 1990s in drugs for male pattern baldness, schizophrenia and cholesterol. It was successfully piloted in the National Health Service in 1999 with a new branded statin, with the manufacturer committed to refund all costs if the drug failed to reduce LDL [low-density lipoprotein] cholesterol to safe levels. In Australia, this model was adopted in the treatment of pulmonary arterial hypertension.⁷³

The concept of 'payment by results' was first explored in the public service sector in the 1970s, with the introduction of contractual regimes in US state and federal schemes for case management of the long-term unemployed. The first comprehensive program was the 1982 US Federal government's *Job Training Partnership Act*. Since that time, a number of jurisdictions have pursued the same approach, starting with Australia's 'Working Nation' in 1994, followed by Britain's 'Employment Zones' in 2000. Each of these models has become more sophisticated over time, and the model has been adopted in France, Germany, Poland, Sweden, Switzerland, Saudi Arabia, Japan and South Korea, to name a few.

The United Kingdom. The Labour government was developing the concept of 'outcome-based commissioning' prior to the 2010 national election, but since the change of government, the Coalition has pursued the principle much more extensively, most notably in offender management and social services. The most advanced pilots are being conducted by the Ministry of Justice with the objective of reducing reoffending rates.

- a pilot at a privately-managed prison, HMP Doncaster, which commenced on 1 October 2011
- another with a public prison, HMP High Down, the details of which will be released November 2012

- a third at a public prison, HMP Leeds, which will include a private or voluntary sector partner, to be announced in November 2012
- two justice reinvestment pilots that are underway with local authorities in Greater Manchester and five London boroughs, where if future demands on the Ministry of Justice are reduced, they will share the savings
- two community pilots with probation trusts (Wales and Staffordshire and West Midlands), announced January 2102
- two innovation pilots, to be based on proposals submitted by the market.

In addition, the Ministry of Justice is working on several pilots in conjunction with local authorities and other departments:

- four youth custody pathfinder pilots, encouraging local authorities to reduce reoffending and prevent young people at risk from escalating through the justice system
- two pilots testing the inclusion of a reoffending outcome into the Work Programme (the British equivalent of Job Services), in conjunction with the Department of Work and Pensions – in this case, the outcome payments will be made in the form of a bonus
- eight drug and alcohol recovery pilots with a reoffending outcome, in conjunction with the Department of Health.⁷⁴

The Minister for Housing and the Mayor of London recently announced £5 million in grants to charities in a campaign against homelessness, where the providers will be paid based upon their success in reducing the number of regular rough sleepers in London, increasing the number in settled accommodation and employment, and reducing admissions to accident and emergency units of hospitals.⁷⁵

A recent contract with a private provider for the delivery of community health services in Suffolk is (in part) concerned with the better management of long-term conditions. In this case, the provider will be paid a bonus based on their success in reducing hospital admissions.

The Department of Communities and Local Government is developing a system of grants to local authorities for family support on a payment-by-results basis, and this will also be additional (that is, paid by way of a bonus).

Australia. Some of the earliest experiments with payment by results in this country were in the case management of employment services. The Victorian and NSW governments experimented with counselling and outreach

services using community-based providers in the late 1980s, followed by the Federal Government's 'Skill Share' program in 1989. The private sector was first engaged under the 'Working Nation' agenda in 1995, and it was through this latter scheme that the earliest elements of outcome-based commissioning first appeared.⁷⁶

Western Australia contracted out the maintenance of its roads between 1999 and 2002 under outcome-based contracts designed to maintain roads in good condition and reduce costs. While the first generation of contracts was somewhat flawed due to inadequate methodologies for measuring road conditions, a new set of contractual arrangements based on the principle of partnering have recently been implemented.⁷⁷

There is currently strong interest in payment-by-results in Australia. The Council of Australian Governments (COAG) has adopted this approach with payments to states made under National Partnership Agreements. Under some of these agreements, the states are remunerated through 'reward payments', 'where the achievement of pre-determined milestones or performance benchmarks is required before a payment is made to a state or territory...following receipt of a recommendation from the COAG Reform Council'.⁷⁸

The Commonwealth Department of Health and Ageing is tentatively exploring payment-by-result funding in chronic disease management through the Diabetes Care Project.

The Diabetes Care Project (Australia)

The Australian Department of Health and Ageing has embarked on a three-year pilot in diabetes care which is trialling an element of 'payment by results'. The project will involve around 150 GP practices across three states (Queensland, Victoria and South Australia), involving around 10,000 sufferers of Type 1 or Type 2 diabetes.

It is estimated that one in eight Australians has diabetes or pre-diabetes. The disease costs more than \$3 billion a year, with health care along costing more than \$900 million, and it accounts for nearly a quarter of all avoidable hospitalisations.

The pilot will compare two intervention groups and a control group, and participating practices will be randomly allocated to either group. It will implement and evaluate four initiatives: (i) electronic patient records with up-to-date monitoring of outcomes; (ii) a new funding model, with a lump sum payment per patient made to General Practices and quality improvement support payments; (iii) the use of 'care facilitators' to work with GPs, practice nurses and other healthcare professionals to ensure timely, risk-based interventions; and (iv) education and training for participants. Group 1

participants will test initiatives (i) and (iv), while Group 2 will pilot all four at once.

It had originally been proposed to implement this funding model across the nation as a whole, with this scheme replacing existing Medicare benefits for regular GP visits for diabetes sufferers. Following strong opposition from the Australian Medical Association, a pilot was proposed, with upfront funding of the additional costs of care planning and more funds for patients with more complex needs. Separate funding will be made available for a wide range of allied health professionals. The pilot is also offering a great deal more support for participating GP practices.

The majority of the payments are made in two streams. Flexible funding (\$150-350 per patient per year, depending on the complexity of the case) are to compensate for care planning, and simplify existing payments under the Medical Benefits Schedule for planning and administration. Quality improvement support payments of up to \$150 per patient per year for complying with certain process requirements and delivering an improvement in clinical indicators. Twenty-five percent of these payments are based on clinical performance.⁷⁹

But the most adventurous experiment in payment-by-results funding in this country is the Social Benefit Bond pilot initiated by the NSW Treasury, discussed in greater detail at Section 5.4.12 below.

New Zealand is somewhat ahead of Australia in the adoption of payment-by-results in offender management. It was incorporated rather late in the competition for an existing public prison, Mt. Eden, with the private provider committed to move from output specifications to reoffending targets over the first three years of contract. Mt. Eden prison transferred to private management in May 2011. However, the Department of Corrections embraced the concept in the design of the performance framework for Wiri, a new PPP prison, with the preferred bidder announced in March 2012. The performance regime for Wiri relies on a combination of availability payments, charges for serious incidents and incentive payments for reductions in reoffending rates above that of the prison system as a whole.

5.2 Back Office-Front Office

A second notable development has been the progression from contracting for back office functions to middle and front office services, and increasingly to the contracting of entire public sector agencies. The detailed narrative is actually somewhat more complex than this – whole-agency outsourcing first emerged in North America

during the Second World War, but it has certainly become more commonplace in recent years as governments have become more confident in using the tools at their disposal.

5.2.1 Support Services

In most markets, the first services to be subjected to competition have been relatively straightforward support services such as cleaning and maintenance. These are the services that were first market-tested under compulsory competitive tendering, but they also formed the heart of base support contracting in the defence sector in the US, UK and Australia. Over time, government agencies have extended the scale and scope of these contracts. In defence support, for example, contracts for individual services evolved into multi-activity contracts, and base support was broadened to garrison support.

At the same time as these developments were taking place in the public sector, a facilities management industry was developing in the private sector, with providers bringing together a wide range of services in support of physical facilities – building and grounds maintenance, cleaning and waste management, catering and laundry, security, reception and help desk, tendering and lease negotiation. In the United Kingdom, contracting for social infrastructure through the Private Finance Initiative** ensured that this became a familiar model within the public sector.

5.2.2 Business Process Outsourcing

In the wake of facilities management contracting, public and private sector organisations next began to outsource the management of their business processes. In the private sector, this was led by companies such as Coca Cola, who contracted out significant parts of its supply chain, and British Airways, which facilitated a management buyout of its business support functions, which were then relocated to India. In the public sector, it was the third phase of compulsory competitive tendering in the United Kingdom, which mandated the market-testing of white-collar services, that stimulated the emergence of specialist business process outsourcing (BPO) providers in that country.

In the beginning, these were back office functions such as property management, finance and accounting, IT support, and human resource management, but over time the range of services has spread to front office services such as the management of revenue and benefits on behalf of local authorities or the operation of the Criminal Records Bureau on behalf of central government. In the UK, the government is presently conducting a competitive tender for the management of the helpline for the Equality and Human Rights Commission to advise people of their legal rights in discrimination cases.⁸⁰

** The Private Finance Initiative (or PFI) was the UK equivalent of public-private partnerships for infrastructure procurement.

Business process outsourcing has come to be closely associated with offshoring of back and front office services to developing economies. Political considerations have limited the extension of this model to the public service sector, and the emergence of global BPO providers in countries such as India has been more characteristic of the private sector.

Facilities management (FM) providers and BPO providers have both expanded the range of their service offerings over time, so that they will increasingly find themselves in competition with each other. Indeed, some public service companies have already combined these functions into a generic support service platform, although this poses some difficulties for business development staff since potential customers may still distinguish sharply between these two business models.

5.2.3 Front Line Services

Contracting of front line services can be dated back to the outsourcing of municipal waste management in the United States and the United Kingdom in the 1970s and early 1980s, and while this is now regarded as a relatively simple activity that is ideally suited to management under contract, it was highly controversial at the time.

However, it was the contracting of prison management, which emerged in the United States in the late 1980s and in Australia and the United Kingdom in the early 1990s that first raised major philosophical questions about the appropriateness of employing private providers to deliver front line public services. While this continues to be a controversial issue, there is now a wide range of examples where private and not-for-profit providers are delivering such services.

5.2.4 Whole-Agency Contracting

The outsourcing of entire public sector agencies dates back to the early years of the Cold War when the US government contracted out the operation of key defence laboratories such as Los Alamos and Sandia under the GOCO – government-owned, contractor-operated – model (discussed below). However, it did not emerge as a significant element of public service contracting until the 1990s, when the British government adopted the GOCO model. The Atomic Weapons Establishment and the National Physical Laboratory were the first two prominent examples of whole-agency outsourcing in the UK.

5.3 Diversity in Market Models

Where public services have previously not been open to private or not-for-profit provision or where there is a mixed economy but it has been tightly controlled by

government policymakers, then public officials will need to address questions of market design early in the commissioning process.

Given that choice-based models are part of the commissioner's toolkit, consideration of whether individual service users (or their agents) will be permitted to purchase services on their own behalf, funded in whole or in part by government through some kind of voucher, is now required. In the Australian federal system, it will also necessitate a decision as to whether or not a national market will be more efficient, and whether procurement will take place at a state, regional or local level.

An explicit decision will also need to be made as to whether the market will be structured so that there are a number of buyers and sellers, or whether the state government will establish a monopsony and manage providers as part of a dedicated supply chain. In the United States, there are two separate prison markets which operate in parallel in most jurisdictions – commissioning markets similar to those which operate in Australia and the UK, where government decides when and where a new prison will be constructed and the terms under which it will operate, and a national spot market, where counties and private corporations build prisons on a speculative basis, and contract with prisoners from interstate.

In the case of infrastructure services, the decisions that commissioners make about the range of services to be included and the length of service contracts will determine the kind of market that evolves.

The range of variables capable of being adjusted in the development of alternative market models is quite broad and not subject to detailed exploration in this paper. What commissioners do need to understand as they move towards the creation of a more diverse and contestable public service economy, are the variety of tools now available to them.

5.4 Diversity in Contracting Models

Much the same applies to the contractual models at their disposal. Over recent decades a number of alternative arrangements have emerged that require us to rethink how competition and contracting might be applied in different circumstances.

The list that follows is by no means exhaustive, either in terms of the history of public service contracting or its future development, but it does include most of the prominent models of recent decades.

5.4.1 Through-Life Management of Physical Assets

Through-life management emerged in the defence community in the late 1990s and involves the inclusion of

ongoing service support contracts for the purchase of equipment. Its origins have not been fully documented, but in the UK, the policy was formally launched as part of the Strategic Defence Review in 1998. Since that time, the Ministry of Defence has continued to develop and formalise the concept in procurement decision-making, and to extend the concept beyond the acquisition of military equipment.

The Ministry of Defence defined 'through life management' as including the delivery of a fully integrated technological capability, management of the project throughout its lifecycle, and the management of the cost of ownership and accounting for all the longer-term implications of acquisition.⁸¹ The challenges involved in managing projects on a through-life basis have been identified by the National Audit Office, and in 2007, the Defence Procurement Agency and the Defence Logistics Organisation were merged to facilitate the sharing of information and the transition of responsibilities from acquisition to sustainment.⁸²

In the same year, the concept was merged into a broader initiative, 'through life capability management', which also incorporated the ambition of managing acquisition on a unified basis across the defence community. The whole life concept is now embedded as a fundamental principle of defence procurement, evident in its incorporation at the heart of major programs such as the Tornado combat aircraft and future aircraft carriers.

In the United States, the term 'contractor logistics support' has often been used to refer to contracts for sustainment support covering multiple tasks over the life of a weapon system. While organic (in-house) maintenance remains the overwhelming preference of the US Air Force (reinforced by Congressional limits on the extent of outsourcing), over the period FY2000 to FY2006, the use of contractor logistics support in the Air Force increased by more than 150%, while spending on weapon system operations and support increased by less than one-third over the same period.⁸³

Through-life support has also been fundamental to major defence contracts in Australia, such as those for the maintenance of the Collins class submarines and, more recently, support for the C-130J Hercules and the Wedgetail Early Warning and Control aircraft.

Over this same period, there has been growing recognition of the importance of a life-cycle approach in the procurement of physical infrastructure, such as accommodation and training facilities. In this case, the transformation from ownership to access has not been confined to the defence sector, but has been developed across the public sector more broadly, and it has been

particularly evident in the models developed for public private partnerships.

5.4.2 Availability Contracting

Availability contracting is a form of output contracting where commissioners pay for access to facilities and equipment rather than acquiring ownership. It is the principle upon which many public-private partnerships are based, so that (for example), governments in the United States, the United Kingdom, Australia and New Zealand now commission the design, construction and operation of prisons from private providers, with base payments made for the availability of these facilities for a specified amount of time at a specified level of quality.

This concept has long been employed in the private sector. 'Power by the hour' or 'wet-leasing' being employed in the civil aviation industry for more than 30 years, with manufacturers leasing aircraft engines to airline operators on the basis of availability. The model was pioneered by Rolls Royce and a recent study based on five years of maintenance records at Rolls Royce concluded that the reliability of commercial jet engines improved by between ten and 25% under performance-based contracts.⁸⁴

In the 1970s, a similar concept was pioneered in the energy sector by a Texas-based company, Time Energy, which sought to improve the acceptability of energy-saving devices by offering to pay for installation and recoup its costs from the savings. While the model has taken some time to develop, 'energy service companies' or ESCOs, offering invest-to-save performance-based contracts are now commonplace in the energy sector. Since the 1980s, the same concept has also been employed in the rail sector – leasing locomotives and rolling stock so that service providers pay based on availability.

5.4.3 Public-Private Partnerships

'Public-private partnerships' is a generic term, but in most parts of the world it has come to refer to a specific model in which government contracts with the private sector for new or refurbished infrastructure, with providers designing, building, financing, owning, maintaining and in some cases, operating all or part of the facility over an extended period (usually 25 or 30 years, but sometimes as much as 50 years). In Australia, the model had principally been used for economic infrastructure such as roads and railways, but in the United Kingdom, where the model was used extensively until quite recently, social infrastructure such as hospitals and prisons was procured in this way.

NSW was one of the pioneers of the PPP model in the late 1980s, under the somewhat clumsy title of 'Design-Build-

Finance-Operate' (DBFO), commencing with the Sydney Harbour Tunnel and the M4 and M5 tollways before other roads were also funded under PPP models. Indeed, Australia remains a world leader in PPP tollways.

With the introduction of the Private Finance Initiative (PFI) as a formal policy in 1992, the UK government became the world leader in the development of PPPs with more than 900 PPP/PFI contracts subsequently being signed by UK central and local governments, having a capital value of more than £64 billion. When the Private Finance Initiative was first introduced, the policy was seen by HM Treasury as a vehicle for imposing much greater discipline into the procurement of major infrastructure. As explained by the Second Permanent Secretary of the Treasury, Steve Robson, in 1995, PFI was introduced with the objectives of firstly reducing optimism bias on the part of project proponents (the inclination of line agencies to underestimate risk and over-estimate benefits in proposed projects); secondly driving a whole-of-life approach to maintenance; and lastly, opening up a more sophisticated debate about the allocation of risk.⁸⁵ For the most part, the PPP model has been highly successful in this regard.⁸⁶

However, successive Ministers (on both sides of the political spectrum) saw PFI as a vehicle for off-budget funding of major capital works, and the UK experience with this model has resulted in a significant increase in contingent liabilities. Australian governments did not make this mistake, and with one exception, the only projects in this country that are not on government balance sheets are the toll roads where the providers carry market risk.

PPPs have their limitations. The scale and the risk transfer involved in these projects and the length of the contracts means that tendering costs are high. This makes them unsuitable for smaller projects and it has the effect of reducing market depth (both in the number of bidders and the length of time a competitive tender can be maintained). The length of PPP contracts (necessary in order to secure private finance for major infrastructure investments) also reduces contestability in the service elements of the contract (unless arrangements are made for benchmarking or market-testing services at various points throughout contract life). Further, the necessity of specifying requirements up front and the contractual rigidity associated with such an extensive transfer of risk also makes them unsuitable for projects involved significant technological innovation (including information technology).

In the UK and in Australia, public sector commissioners have not always exploited the potential for service innovation through PPPs. For example, in the procurement of NHS hospitals under PFI, commissioners

were inclined to specify the hospital they had always wanted to build, rather than letting service design drive technology and building design. In Australia, investment banks often led the consortia that were submitting bids, which meant there was greater focus on financial engineering rather than service innovation.

For all of their limitations, PPPs still offer a great deal of potential. They have been used to great effect in the custodial sector in the UK, and the incentive regime for a new PPP prison being procured by the New Zealand Department of Corrections shows that there is still considerable scope for innovation in the way this model is used to drive improvements in public services.

According to the NSW Financial Audit published in 2011, PPPs have the potential to provide value for money outcomes if projects have some or all of the following attributes:

- *Scale*. Projects with a total contract value of \$50 million or more
- *Measurable outputs*. The services required should be capable of specification of measurable outputs that can be translated to a performance contract
- *Non-core activities*. Significant non-core services and support activities that currently divert management and skilled staff in the public sector
- *Innovation*. The project is of sufficient complexity to encourage innovative approaches (in terms of design and technology) that can deliver value for money
- *Whole-of-life optimisation potential*. The project involves significant maintenance and operating costs that can be better handled by the private sector
- *Technology*. Scope for cost savings and improved services through new technology
- *Risk allocation*. Capacity to allocate appropriate levels of risk to the private sector
- *Complexity*. Complexity and other features that encourage innovative solutions
- *Market appetite*. A real business opportunity that will attract a number of proponents involves bid costs, for both government and the private sector. PPPs require government and bidders to obtain advice from a series of professional advisors, such as accountants, banks, builders, lawyers, engineers and quantity surveyors. According to the *Benchmarking Study into Alliancing 4*, government can save time and money by pursuing PPPs. The value of PPPs may be less clear for the private sector, and these engagement costs can be significant, but they gain the advantage of having an informed client.⁸⁷

5.4.4 Alliance Contracting

It is generally acknowledged that project alliancing was developed by British Petroleum in the North Sea oilfields in the early 1990s, when it introduced a 'painshare-gainshare' model for the exploitation of the Andrews Field.

This contracting methodology, ultimately named Project Alliancing, involved complete open-book accounting, sharing all 'uninsurable' risk between all project members, and setting an initial target cost generated by the whole project team. This target cost would then be compared to the final cost generated by the whole project team and the under or over-runs would be shared by all project participants. In other words, the team would win or lose financially as a group depending on the overall project performance.⁸⁸

Alliance contracting was first employed in Australia by the oil and gas industry in developing the East Spar and Wandoo projects on the North-West Shelf, and then in 1994 by the Western Australian Water Corporation with maintenance contracts. The first time that alliance contracting was used in NSW government was in 2003, when Sydney Water employed it for the construction of the Northside Storage Tunnel.

By 2009, alliance contracting accounted for one-third of the total value of infrastructure projects, with a value of some \$8 billion. A study commissioned by the Victorian Treasury found that the most common reason for using alliancing was the desire to achieve early project commencement. Unsurprisingly, this focus on timeliness rather than price meant that financial control was not as strict as it is under public-private partnerships. Of the projects studied, the average increase in cost from business case to actual out turn was between 45 and 55%. The report concluded, 'As a collaborative delivery method, alliancing has demonstrated its ability to avoid disputes, improve non-cost outcomes and commence projects earlier than by traditional methods'.⁸⁹

While alliancing has been employed in contracting for maintenance services, it is better suited to construction projects where early commencement or timely completion is of significant importance. Infrastructure for the Olympic Games is a classic example – there can be no prospect of the project being completed late.

5.4.5 GOCOs

The GOCO (Government-Owned, Contractor-Operated) model was originally developed in the United States during the Second World War, primarily as a means of accessing research capability without compromising scientific independence. The model was further

developed during the Cold War, when leading nuclear physicists refused to be directly employed by the military and some alternative management model was required to accommodate their concerns. In the early years, the contractors were, for the most part, negotiated with leading universities. There was little competition and contracts were renewed without close scrutiny. When AT&T took over the management of Sandia National Laboratories in 1949, it had to be persuaded by President Truman, and the arrangement was based on a one-page letter to the company president.

From 1961, the Atomic Energy Commission adopted a policy of increased competition in its contracts, and from that time, the AEC also began to reduce the independence of the research establishments. With the advent of performance contracting in the US federal government in the early 1990s, the GOCO model was transformed, with departments (such as the Department of Energy) intervening deeply in the specification and monitoring of contractual conditions, and the periodic use of competition (with some long-standing contractors being replaced).⁹⁰

The GOCO model was first adopted in the United Kingdom in 1993, when contracting with a private consortium for the management of the Atomic Weapons Establishment, and two years later, it was also employed in contracting out the management of the National Physical Laboratory, the UK's national measurement institute. In 2009, the same model was adopted in contracting the National Nuclear Laboratory. All three facilities continue to deliver national policy objectives, with the private sector managers working in close collaboration with their public sector counterparts.

The National Physical Laboratory (UK)

The National Physical Laboratory develops and maintains the national measurement standards for the UK, and as such, is the largest applied physics laboratory in that country. It is responsible for the standards governing time, mass and distance, and lies at the heart of the UK's quality system.

In 1995, the Department of Trade and Industry called for proposals from the private sector to manage the laboratory under contract, employing the GOCO model. All staff and scientists transferred to the new management company, NPL Management Limited.

An independent study in 1998 concluded that the change from Agency to GOCO status resulted in significant savings and better utilisation of staff and resources without compromising NPL's core values or its high international standing. A significant proportion of

profits had been ploughed back into scientific research, contributing to an influx of younger scientific staff. But at that stage, it had not changed deeply-rooted cultural factors nor significantly improved the organisation's image of being slow to respond.⁹¹

One of the distinctive features of the GOCO model as it has been adopted in the UK is that scientists and staff are all employed by a management company, in which the government holds a 'golden share' that would enable it to assume direction of the facility in case of a national emergency. Should the contractor lose the management contract upon rebid, scientists and staff would continue to be employed by the same company, and only the shareholders would change, along with a thin layer of senior management. This ensures employment stability for a group of workers whose specialist expertise, individually and collectively, means that they are a unique national asset.⁹²

5.4.6 Urgent Operational Requirements

In some circumstances, governments are obliged to contract under conditions of uncertainty, and a different range of models have been developed to cope with this challenge. For obvious reasons, some of the best examples are to be found in the defence sector, but the fundamental principles might well apply to other public services.

While there is an underlying preference for competitive tendering and fixed-price or incentive-fee contracts, defence agencies have always recognised that the uncertainty of war means that there is not always time for full and open competition. In emergencies, where an urgent response is required – such as logistics support for military operations or assistance in the immediate aftermath of a natural disaster – there will not be time for a full risk assessment. Where conditions are changeable and a high degree of flexibility is required, the level of uncertainty may be such that pricing the contingencies in advance is made extremely difficult.

In the UK, capability gaps for equipment and services arising from current or imminent operations have traditionally been dealt with under a policy governing 'Urgent Operational Requirements' (UORs). Competition remains the foundation, albeit with reduced timescales and less formality. However, it is recognised that competitive tendering is not always feasible, and the policy relies on exemptions under European competition law for security and 'warlike stores'.

Given the relative informality of these arrangements, contracts have historically been restricted to twelve months duration, although with the ongoing pressures of

recent operations, extensions have been required. The policy also recognises the need to consider intellectual property rights prior to contract signature, so that equipment suppliers do not thereby obtain an unfair advantage.

While there remains a preference for firm or fixed pricing, there is also recognition of the need for pragmatism in circumstances where full competition and risk transfer are not always feasible. The preferred alternative involves the use of a target cost incentive fee, which requires agreement on a 'challenging but achievable' target cost, and sharing of cost savings and overruns. This in turn demands agreement on assumptions about risk, a high level of transparency and constraints on profit. However, where justified, cost reimbursement arrangements can be employed, or prices can be fixed following contract award. All of these alternative pricing models are regulated by government policy.⁹³

5.4.7 Framework Contracting

Framework agreements are umbrella agreements that lay down broad terms and conditions (price, quantity and quality) under which individual contracts can be 'called off'. They are used to narrow the field of potential bidders, so that commissioners can more quickly choose from a panel of approved providers that have been selected following a competitive process. In Europe, they provide a means of bypassing the cumbersome procedures required under EU procurement law.

In the United States, framework agreements known as Indefinite Delivery Indefinite Quantity (IDIQ) contracts are widely used in the defence and security sectors. They are particularly useful when agencies cannot determine in advance what quantities of particular goods and services will be required or at what times. They reduce costs and allow for expedited procurement within an overarching competitive framework.

In Australia, framework contracts are now widely used in the procurement of IT support and the purchase of basic goods and services. But in the UK, they are now being applied more broadly, for example, in contracting for health and disability assessments.

5.4.8 Contingency Contracting^{††}

Contingency contracts are another kind of umbrella agreement intended for use in emergency situations where rapid response and a great deal of flexibility are required. They are a type of framework contract that allows for the awarding of tasks to the contractor or contractors selected through competition. Contingency contracts have been employed by the military for logistics support and by civilian agencies in crises such as

^{††} Sometimes referred to as 'emergency contracting' or 'responsive contracting'.

Hurricane Katrina. The best known contingency contracts are the 'logistics capability' contracts for the US Army (LOGCAP).

LOGCAP (USA)

LOGCAP was established in 1985 to pre-plan for contingencies and to leverage existing civilian resources, although it was not employed until three years later, when the Army Corps of Engineers (ACE) used it to contract for the construction and maintenance of two petroleum pipelines systems in Southwest Asia. ACE also awarded the first LOGCAP contract to Brown and Root Services (later KBR) in 1992, to support the United Nations forces in Somalia. This contract was subsequently used to support forces in Bosnia, Kosovo, Macedonia, Hungary, Saudi Arabia, and Rwanda.

Following re-competition, DynCorp was awarded the second contract in January 1997, and the Army Materiel Command took over management of LOGCAP from the Corps of Engineers. From 1997 to 2001, DynCorp supported US forces in the Philippines, Guatemala, Colombia, Ecuador, East Timor, and Panama.

LOGCAP III was awarded to KBR in 2001, shortly before the declaration of war in Iraq and thereafter, it was used to support the US Army in Iraq, Afghanistan, Kuwait, Djibouti and Georgia. LOGCAP III was highly controversial, in part because of the massive scale of the task orders awarded to KBR under the umbrella contract, but also because of inadequate accounting and monitoring.

As a result of these criticisms, LOGCAP III was terminated, replaced by LOGCAP IV, which included a panel of three contractors – KBR, DynCorp, and Fluor Corporation – with the potential for some measure of competition for future task orders and the opportunity for benchmarking performance.

The US Air Force and Navy employed similar programs, the Air Force Contract Augmentation Program (AFCAP), the Navy Global Contingency Construction Contract (GCCC), and the Global Contingency Services Contract (GCSC).

5.4.9 Public-Private Joint Ventures

Joint ventures are relatively commonplace in the private sector, where companies with complementary strengths combine for competitive advantage in a particular project or enterprise. While some joint ventures are confined to a term-limited project, there are examples that have lasted for some decades, even on a large scale.

This model may have particular application in the public services sector, where government agencies have high levels of technical expertise but lack the commercial skills to translate that expertise into an efficient and effective service. The joint venture thus offers the opportunity to celebrate excellence within the public sector and to market those capabilities in interstate and international jurisdictions.

GSTS Pathology LLP (UK)

In 2009, Guys and St Thomas's Hospital Trust, a foundation trust comprising two of London's leading teaching hospitals, was seeking to transform its pathology services, partly in the expectation of delivering greater value for money within the trust, but also with a view to marketing its capabilities to other NHS hospitals. This followed the release of a major report recommending the rationalisation of diagnostic services across the NHS.

After a competition between several providers, Guys and St Thomas's selected Serco, a public service company with generic management skills, over specialist diagnostic service providers. The hospital already possessed high quality pathology services: what was most needed was management expertise.

GSTS Pathology subsequently incorporated King's College Hospital, another leading NHS hospital trust, in the joint venture and now provides pathology services under contract to other parts of the NHS. In-house services in two hospital trusts have been combined and commercialised and their leading-edge technological capabilities are now marketed across the nation. GSTS Pathology is now the UK's leading provider of pathology services, and in June 2011, it was named the 'diagnostics provider of the year' by Health Investor Magazine.⁹⁴

Another advantage of the joint venture model is that by confining the competition to a search for management expertise, commissioners are able to deepen the market very quickly, particularly in specialist fields where private providers may not possess the relevant technical skills. By seconding technical specialists into the joint venture, rather than transferring them, public sector partners retain leverage over one of the core assets of the business, strengthening their commercial position in future negotiations.

In the UK, the Prison Service has established a joint venture with a facilities management company and a large not-for-profit provider to compete for contracts under the Ministry of Justice's program of market-testing prison

management, and the Durham Tees Valley Probation Trust has joined up with another FM provider to bid for prison and probation services.⁹⁵

5.4.10 Integration Contracts

Prime contracting is not unusual in the private sector, where a major company signs the contract with the customer and assumes responsibility for completion, whilst sub-contracting with smaller, specialist providers for the actual delivery of the project or the service in question. This model has been employed from time-to-time in the public sector, but one particular form of prime contracting, known as the integrator model, has emerged in the welfare-to-work sector in the UK.

Under the UK's 'Flexible New Deal' and the subsequent 'Work Programme', two of the contractors elected to deliver none of the services themselves, sub-contracting with not-for-profit providers who have strong social capital and deep local knowledge. These 'service integrators' have absorbed the considerable financial risk associated with the welfare-to-work contracts, which contain a significant element of payment-by-results. They have established sophisticated management information systems capable of generating data in real-time about how services are being delivered. This information is made available to the Department for Work and Pensions, so that there is a high degree of transparency under this model. One of these companies has also established a system of 'support and challenge', coaching underperforming providers so that high performance levels are sustained.⁹⁶

Senior officials in the Department for Work and Pensions take the view that under this model, the prime contractor (or integrator) has, in effect, assumed responsibility for part of the commissioning process. Under such an arrangement, the government is able to engage not-for-profit providers and small-to-medium enterprises in the delivery of public services, whilst still transferring a significant amount of performance risk and implementing a capability-building program at the same time.

5.4.11 Lead Systems Integration

Lead systems integration is a highly sophisticated model of contracting that has, for the most part, not been a success. This model has been most actively pursued in the US federal government in the acquisition of defence and homeland security assets. This 'system-of-systems' approach has been pursued where it is necessary to integrate new and existing systems that are operationally and managerially independent.⁹⁷ The US Army's Future Combat System, for example, originally

consisted of 18 principal systems and numerous other supporting systems.

From around 2000, several US federal departments and agencies contracted with private consortia to undertake this role in the procurement of major new defence and security systems, most notably, the Coast Guard's Deepwater program (2002) and the Army's Future Combat System (2007). Both were extraordinarily complex programs, and both experienced major difficulties, resulting in political and media controversy, and the termination of the integration contracts.

In the case of Deepwater, the Coast Guard's mission changed fundamentally in the aftermath of 9/11, and Congress has questioned whether, in that case, the systems integration contract had not delegated functions that were core to the agency in question (or 'inherently governmental'). Supporters of integration contracting have argued that the fault lay not in the concept but rather in its execution.

The Army seems to have managed these risks better than the Coast Guard, delegating a narrower range of responsibilities and retaining veto rights over selection of subcontractors and other key decisions. However, significant concern has remained over the complexity and the ambition of the program, and the possible lack of transparency and control in inherently difficult circumstances.⁹⁸

The explanations given for contracting systems integration are several. Firstly war-fighting and homeland security systems are becoming increasingly complex and interconnected, with information technology assuming an ever-greater role. The Army and the Coast Guard argued that they lacked the resources and the capability to plan and manage programs of this complexity. Secondly, some analysts have argued that a contractor is better positioned to manage across the stovepipe structures of traditional government agencies, and achieve early integration. Thirdly, it has also been suggested that the Coast Guard might have adopted a contractual solution in the belief that a firm commitment to a comprehensive program would receive greater political support than a case-by-case approval of the same assets that would tend to follow if the Coast Guard were the integrator.⁹⁹

5.4.12 Social Benefit Bonds

Social Benefit Bonds (or Social Impact Bonds) are payment-by-result contracts where the contractor finances and delivers an intervention service. Bonds are funded by the subsequent savings to the government from the reduced demand for public services. The NSW Treasury has defined the Social Benefit Bond as:

...a new financial instrument that pays a return to private investors on the achievement of agreed social outcomes. Under a SBB, an investor provides upfront funds to a partner (not-for-profit organisation – NFP – or intermediary) to provide services. Part of the government savings are used to repay this investment and provide a reward payment commensurate with the outcomes achieved.¹⁰⁰

Taken to its extreme, a Social Benefit Bond is a service PPP, with the private and social sectors carrying all of the risk of delivering agreed social outcomes, such as reduced recidivism.

The concept was developed in 2009 for the Council on Social Action, which had been established by the British Prime Minister in 2007 to examine innovative ways of addressing social issues.¹⁰¹ Detailed development work was undertaken by Social Finance, a think-tank and financial institution established to help create a social investment market in the UK. Its ground-breaking report on social impact bonds was published in August 2009.¹⁰²

United Kingdom. The first Social Impact Bond pilot, for prisoners released from HMP Peterborough, a privately-managed prison in the UK, was announced by the then Justice Secretary, Jack Straw in March 2010 and formally launched in September of that year. Social Finance raised £5 million to finance case management of young offenders released from the prison over a two year period, and were to be paid for a 7.5 percent reduction in recidivism rates in the 12 months after release. Several reports have been published on the initiative, but it is still too early to know whether it has made any impact.¹⁰³

In March 2012, Essex County Council announced that it will use social impact bonds to finance 'multi-systemic therapy teams' to work with vulnerable young people. In addition, Manchester City Council announced a pilot directed at moving young people from residential care into foster care, with the provider paid on their results.¹⁰⁴

United States. Barack Obama announced funding of up to \$100 million for 'pay-for-success' bonds in his 2011 budget, and in January 2012, the President announced the first two pilots: the Department of Justice will give preference to 'Second Chance Act' programs that include a social impact bond element, and the Department of Labor is making \$20 million available to pilot pay-for-success funding.¹⁰⁵

Several states have also taken the initiative. Massachusetts issued 'Requests for Response' in January 2012 to explore pay-for-success contracts and social impact bonds in the areas of chronic homelessness and juvenile justice, in the hope of attracting federal grants. Minnesota has passed legislation providing US\$10 million in pilot funding for 'Human Capital Performance Bonds', and New York is proposing pay-for-success funding for adolescents in the juvenile justice system. Interest has also been reported in Indiana, Michigan, Virginia and parts of California.

Australia. Outside of the Peterborough pilot, the most advanced trials anywhere in the world are in NSW. The concept was embraced by the NSW Labor government prior to the state election in March 2011, and a brief study was commissioned from the Centre for Social Impact at the University of NSW. The Coalition Government embraced the proposal and NSW Treasury issued a request for proposals on 30 September 2011 for two pilots to explore the capacity for Social Benefit Bonds to:

- increase funding for prevention and early intervention programs in a sustainable manner
- catalyse the development of the social finance sector
- harness the innovation capacity of both investors and service providers
- improve the evidence base for, and focus on measuring the impact of, social services.¹⁰⁶

On 20 March 2012, the Treasurer, the Attorney-General and the Minister for Family and Community Services jointly announced the selection of three proposals to enter the joint development phase:

- Social Finance and Mission Australia to develop a pilot in recidivism, which aims to assist 500 repeat offenders released from Junee and Parklea prisons
- A consortium of the Benevolent Society, Westpac Corporation and the Commonwealth Bank of Australia in a proposed bond to support 550 families in out-of-home care over five years
- UnitingCare Burnside who will work with children aged 0-5 years and their parents across ten locations, over seven years.¹⁰⁷

Canada. There is significant interest in social impact bonds in the Canadian federal government, and a recent report on the reform of Ontario's public services also recommends pilots in the use of social impact bonds.¹⁰⁸

6. How Competition Works

Productivity improvements are delivered in different ways, but in the service sector, where human interaction lies at the heart of the productive process, they are necessarily associated with more effective use of people. In the public service sector, it is common for labour costs to make up some 60-70% of the total, so it is inevitable that major productivity improvements will be manifest in the use of fewer people to deliver the same outputs, or in having the same numbers of people deliver more and better services. This is one of those brute facts that it is impossible to avoid.

Service innovation generally comes through a myriad of relatively small initiatives rather than major breakthroughs following deep investment in research and development, as sometimes happens with technological innovation. This is particularly so in the public sector where government finds it difficult to protect the intellectual capital invested in new service models.

Because innovation is incremental, and because it tends to occur through the exploration of alternative business processes, it is often difficult for outsiders to observe how productivity improvements occur. Union leaders have sometimes insisted that savings can only come by cutting workers' terms and conditions, while business leaders claim that they arise from the inherent superiority of the private sector. Both explanations are wrong. This section canvasses some of the research that suggests how competition and contestability work.

6.1 Better Management

Few of the studies into the value-for-money gains from competition and contracting have sought to explain how those benefits are obtained, and those that do so tend to focus on detailed management initiatives that might also be obtained through traditional management reform. They do not explain what contribution competition and contracting make. Nevertheless, there is some value in describing some of these findings first, since it will assist the reader in understanding the kind of changes that managers undertake when faced with the threat of competition.

6.1.1 Service Redesign

Delegation of authority. A study of US cities reported that contractors were much more likely than municipal agencies to make front line supervisors responsible for hiring and firing and for the maintenance of equipment.¹⁰⁹ This study contrasted high cost and low cost cities regardless of whether they were managed under contract or in-house. The findings were later summarised as follows:

Cities with low costs (either contract or in-house) tended to require managers to be responsible for availability of personnel and serviceability of equipment. Integrated responsibility apparently reduced the tendency to 'pass the buck' when support services or equipment are not delivered in a timely, efficient manner, or when sufficient work crews were not available.

Cities with high costs tended to release managers from many direct personnel supervision responsibilities such as hiring, firing, and assessing penalties for tardiness, thus making the managers less accountable for performance.

Cities providing a service through in-house production were more likely to fall into the high cost, less-accountability group of cities because the use of more formal and elaborate personnel procedures carried over from their inherently governmental functions...

Cities with in-house agencies also tended to utilize a government-wide central equipment maintenance system with its own set of government managers. This may have further weakened accountability of the managers of individual government service agencies by removing equipment readiness from their control. In this regard, the [report's] authors concluded that cost savings from economies of scale in the communities studied were less important in restraining costs than in delineating clear lines of authority and responsibility.

The few cities with in-house production that organised themselves to preserve management lines of responsibility were better able to provide equivalent services at costs much closer to those of contract cities.¹¹⁰

6.1.2 Restructuring the Task

Flatter structures. Supervisors working for contract street cleaners in Los Angeles were found to have a significantly greater span of control (an average crew of 13.6) than those working for municipal street cleaners (6.86). This was also reflected in a flatter management structure (1.3 layers between street workers and contract head, compared with 1.9 layers between street workers and department head). Municipal work teams also had more layers of management between the worker and the department head.¹¹¹

Multi-skilling and specialisation. In some sectors, multi-skilling has been a significant part of service innovation, as managers explore how to make better use of the available

human resources. This is an example of 'economies of scope', where producers exploit the synergies between different elements in a contract of bundled services.

But in other cases, providers pursued increased efficiency through greater specialisation. The US study of municipal government reported above found that private contractors working for municipal government in Los Angeles were 20% more likely to give workers specialised assignments.¹¹²

Scheduling. Contractors often pursue flexibility in the scheduling of labour and services, enabling them to better optimise the use of resources. Research into compulsory competitive tendering in the Victorian local government sector in the 1990s found 'a marked trend towards more flexible working hours, involving increases in the spread of ordinary working hours and the maximum number of hours worked per day'.¹¹³ In the UK, in-house teams and private contractors introduced annual hours agreements in grounds maintenance, so that the working week was longer during the summer months and shorter during winter, including a compulsory two-week holiday at Christmas.¹¹⁴

Scheduling and rostering played a significant part in the improvements to Adelaide's bus services. Among other things, companies experimented with the placement of depots to reduce unproductive down-time.¹¹⁵ A study of vehicle maintenance contracting in the US Air Force found that external providers used the contract negotiations to secure greater freedom in scheduling repair work. In-house providers complained that they were obliged to repair vehicles immediately.¹¹⁶

Overgrading. Unit costs are sometimes lower following the awarding of a contract because of a previous failure to review job specifications and closely scrutinise whether incumbents are overqualified for the required tasks. A study of base support contracting for the US Department of Defense reported that 'In most instances, this action was taken after in-house management engineers had conducted a thorough analysis of the work performed and determined that some positions were graded at a higher level than required'.¹¹⁷

Some US research indicates contractors having a younger workforce than in-house service providers in municipal government contributing to an overall lowering of costs.¹¹⁸ Research undertaken for the Prison Service Pay Review Body in the UK established that this is one of the reasons why unit costs are lower in privately-managed prisons. Among other things, younger workers tend to have fewer accumulated benefits.¹¹⁹

Turnover rates. Contract prisons in England and Wales also have much higher turnover rates than the Prison Service in general. At 24%, turnover rates in the privately-managed prisons were significantly higher than the private sector average (15%); while the three percent turnover in the Prison Service was well below the public

sector average (eight percent). An excessively high turnover rate will compromise the quality of service and increase training and recruitment costs, while an excessively-low turnover rate can lead to over-grading and an older workforce, both of which have the effect of pushing up labour costs.¹²⁰

Full-time/part-time work. Contractors and successful in-house teams both employ part-time workers more often where the job does not require full-time staff.¹²¹ They also rely much less on overtime, and a reduction in overtime seems to have been a significant feature of the changes introduced as a result of compulsory competitive tendering in the UK and Victoria.¹²² However, this pattern is by no means universal. A study commissioned by the US Department of Defense found that contractors were relying much more on overtime 'to allow for reductions in manpower hours'.¹²³

Local work agreements. It is not uncommon for competition and contracting to contribute to a breakdown in national wage bargaining, particularly where a new service is being established on a Greenfield site. In the UK, private prison management companies set their terms and conditions with reference to local labour market conditions, while (for the most part) the Prison Service remains committed to national pay scales. This means that Prison Service labour costs right across the country are unduly influenced by the high cost of living in the metropolis.¹²⁴

When establishing the terms and conditions for the 'Way Forward' prisons, the NSW government negotiated distinct operating arrangements and a different approach to sick leave and overtime than applied under the state award.

6.1.3 Use of Technology

Technological innovation is another way in which managers seek to improve labour productivity. At Forth Valley Hospital, a new PPP facility in Scotland, bidders offered service solutions based on the introduction of robots for delivering linen and meals. In part, this was driven by concerns about infection control, but it also had the effect of freeing-up some of the porters, who could be trained for a wider range of duties. In the design of new PPP prisons in the UK, providers experimented with CCTV cameras and electronic keys. A study of contracting at the Trentham army base in New Zealand found that in warehouse operation, the contractor achieved significant efficiencies through the introduction of carousels controlled by a computerised inventory management system.¹²⁵

Standardisation. Contract street cleaners in cities in Los Angeles were found to rely on a more standardised vehicle fleet (of sweepers, flushers and so on) than municipal street cleaners (1.2 different types for contractors compared with 1.8 for the latter). 'The fewer

different types of equipment, the more familiar vehicle operators and mechanics can be with the equipment on hand. Also, the number of different spare parts that must be kept on inventory is minimized.¹¹²⁶

Economies of scale. In many cases, private firms can spread the costs of technical improvements across a number of clients. This can give them a significant advantage over local and provincial governments, which face legal and political obstacles to offering services outside their jurisdictions. John D. Donahue gave the example of a US garbage contractor which 'undertakes joint ventures with equipment companies to improve the design of garbage trucks, an investment that would not be rational for any but the largest municipal sanitation departments, no matter how dedicated they were to cost control.'¹²⁷ When the French water companies first entered the Australian market in the late 1980s, it was evident that they had invested much more deeply in research and development (particularly in membrane technology) than the state-owned water utilities.

6.1.4 Morale and Incentives

Sick leave is usually much better managed by in-house or external providers following market-testing or where public providers are exposed to the threat of competition. This was evident in the 'Way Forward' prisons in NSW, and in the British contract prisons, where sick leave was observed to be less than half the public sector comparators.¹²⁸ In UK local government, absentee levels were brought down rapidly in the Direct Service Organisations (DSOs) that won contracts under compulsive competitive tendering, 'and were frequently well below those for the rest of the [same] authority.'¹²⁹

Method of payment can act as an incentive for or disincentive against better performance. For example, the UK Audit Commission found that the 'task and finish' payment scheme being used in refuse collection had become an obstacle to greater productivity. (Under 'task and finish' schemes, workers remuneration was based on the estimated time to complete a round.) This was because they had not been regularly reviewed and changes in routes had altered the workload over time.¹³⁰

Input versus output controls: In the US the General Services Administration traditionally managed its cleaners through detailed input controls that were inconsistent with industry best practice available using new technology.

The corridor stripping procedures contained in GSA cleaning guidance require dust mopping of the corridor, application of a stripping solution, agitation of the solution with a floor scrubbing machine, and wet vacuum pickup of the agitated solution. A mop is then used to rinse the floor

twice with clear, cold water. After the floor dries it is ready for the first of four coats of floor finish. The GSA production rate of 1,700 square feet for this procedure is based on performing each of these steps separately. Machines are available that will perform several steps simultaneously... at a production rate, depending on machine size, of between 22,300 square feet and 51,500 square feet per 8-hour day.¹³¹

6.2 Competition

If contracting and contestability amounted to nothing more than a series of management initiatives, this would not provide a reason for adopting such a disruptive instrument of reform – managers could simply study the changes that had been made elsewhere around the world and implement them incrementally.

Competition and contracting matter because they change the urgency that front-line management and staff place on questions of value-for-money and service improvement. They transform the environment within which service delivery takes place. They provide motivation for change.

6.2.1 Information

It is generally recognised that price competition generates invaluable information for consumers as well as the owners and managers of private firms about the relative cost of goods and services and indirectly about the quality of management. This is also true of competitive tendering for public services, although the process is somewhat different.

Under traditional (monopolistic) delivery, those commissioning public services are severely limited in their ability to ascertain the true cost of providing a specified quantity and quality of service and providers have little incentive to reveal that information. Market-testing is one of the ways in which commissioners can generate a significant amount of additional information. That is the point of auctions, to force bidders to reveal more information about their price threshold than they would like. Even where more complex services are involved and procurement cannot operate as a simple auction, modern commissioning processes such as pre-tender consultation and competitive dialogue can be used by smart purchasers to glean a great deal of additional information about the qualitative aspects of provision.

The process of conducting a competition and drafting a contractual framework also forces the commissioner to reveal information about service requirements that are often not obvious when services are commissioned in the traditional way. In competitive dialogue, a European procurement model which permits an ongoing

conversation between commissioners and bidders throughout the tendering process, potential providers are able to interrogate commissioners so that they understand their requirements better. Good procurement practice will actively involve potential providers in the design of service specifications.¹³²

6.2.2. Motivation

Of course, competition also forces the providers of public services to acquire more information about themselves. If done well, a competitive tender provides them with comparative information about the quality and cost of the services they are providing, and this serves as a driver of organisational change.

An open tendering process demands that competing providers develop innovative solutions in a competitive environment, where each bid team knows that other experienced providers are at the same time developing alternative solutions for the very same set of requirements. In the case of public service contracting, where competing providers are responding to a common 'statement of requirement' issued by public sector commissioners, the tendering process is a period of intense research and development, as bid teams bring together existing technologies, processes and capabilities in new and innovative ways.

The threat of competition continues to have an influence throughout the life of the contract as management and staff know that if performance falls to an unacceptable level, the commissioner may terminate the contract, refuse to extend it beyond the minimum term, or award the service to another provider upon rebid.

When an organisation faces the prospect of losing a contract based on its performance against established criteria, this is likely to concentrate the mind. Economic theory suggests that the threat of liquidation is one of the strongest incentives through which competition impacts upon managerial performance.¹³³

6.2.3 Matching

Among other things, competition is a search process through which commissioners and providers seek each other out and set about to establish a new commercial relationship. Drawing on the analogy of marital relationships, economists and game-theorists have explored the role that 'matching' plays in the establishment of employment contracts. Since there is no one man that will be right for every woman – 'a good partner for one may be bad for another' – competition and choice is a search process that increases the likelihood of finding the best organisational fit.¹³⁴

Much the same applies in competitions for the management of public services. In this case, providers are offering a bundle of goods including the motivations and capabilities of an established workforce already organised into a business structure and encoded with an organisational culture. Instead of engaging in the expensive and time-consuming process of searching out each individual worker and constructing a new organisation from scratch, commissioners engage in a courtship ritual with a small number of firms that have done much of that work already.

If done well, competitive tendering allows commissioners to explore the qualities of alternative providers and decide not only who will deliver the best value-for-money, but who will make the most reliable and trustworthy partners.

6.2.4 Diversity

Some of the benefits may come simply from introducing heterogeneity into the process of commissioning or re-commissioning a service. Some organisational theorists have argued that a modest level of personnel turnover in an organisation has the effect of increasing the amount of exploration and improving aggregate knowledge. This is because it introduces participants who are not as deeply socialised by prevailing norms. From this perspective, it may matter less that the new market entrants are experts in the field than that they bring a different perspective. The most significant gains to the system come from their diversity.¹³⁵

This may help to explain why prison contracting resulted in so much innovation when it was first introduced in the UK. Experienced (i.e. well-socialised) prison administrators took the view that it would be unwise to encourage a close association between prisoners and prison officers, opposing suggestions that prison officers should eat their meals with prisoners, wear name tags or call inmates by their first names. It was widely believed that it would be unhelpful to introduce significant numbers of female prison officers into male prisons. Group 4 introduced each of these reforms into the first contract prison, contributing to a radical transformation in prison culture, and many of these initiatives have since been adopted by the Prison Service more broadly. The team that Group 4 brought together to bid this contract and oversee its implementation was a combination of seasoned prison managers and outsiders who challenged traditional ways of thinking about the task.¹³⁶

A 1985 Rand study into the US federal government's A-76 program found that private contractors won competitive tenders more often than in-house teams. In trying to determine why this was so, RAND focused (among other things) on the ability of contractors to design a solution

tailored to the task as described in the statement of work (SOW), rather than being influenced by traditional work practices (as in-house teams often did).

For example, at two bases we were told that government employees often do poorly in bidding because they tend to bid on the task of maintenance as they have always done it, whereas contractors bid on the task as it is described in the SOW. The task described in the SOW generally requires less work than government employees understand to be customary for vehicle fleet maintenance. As a result, government employees bid to do more work than do contractors, at a consequently higher price than the contractors bid...In addition, it is difficult for government managers to drastically rethink the staffing requirements they have been using for years. In many cases, this will mean loss of jobs for highly valued employees. Finally, although the designers of performance work statements talk in terms of 'throwing away the rule book' when preparing bids, long-time government employees are sceptical that this can be done with impunity.¹³⁷

6.2.5 Mandate

Even where an in-house provider wins the tender, the fact that the management team has secured (or refreshed) its right to manage seems to generate a mandate for change. This aspect of tendering has not been studied, but it is possible that the ritual of engaging in and winning a formal contest bestows upon management the authority to renegotiate the custom and practice that tends to accumulate over time in mature organisations through a process of accretion.

Organisational theorists speak of 'psychological contracts' in employment relationships, defined as 'a series of mutual expectations of which the parties to the relationship may not themselves be even dimly aware but which nonetheless govern their relationship to each other'. These expectations are largely implicit and usually develop outside the formal contract of employment.¹³⁸

Psychological contracts are essential to the effective working of a complex organisation. The written contract of employment is simply too cumbersome to allow management and staff to adapt to changing circumstances day to day. However, if they are not periodically reviewed, they will result in organisational sclerosis, and management may find itself incapable of refreshing the organisational structure and culture over time. Competition may be vital to the periodic refreshment of the psychological contract.

6.2.6 Commitment

The process of deliberately choosing a partner and entering into a formal contract imposes obligations on both parties. The provider makes a commitment to deliver an agreed level of service, but the commissioner also acquires a moral obligation to make the arrangement work. As Noel Pearson has argued in relation to the management of Aboriginal communities, choice is a responsibility as well as a right:

You made the choice, now you own it. You now have a responsibility to make your choice work for you. Take care because you will wear the consequences. And as many times as you make choices that work out, you will fail. You therefore need to learn from the choices you made and try again.

The notion that choice is a freedom is well understood. You should have as wide a range of choices available to you as society and your own capabilities can provide to you. The greater your capabilities, the more freedom of choice you have.

The flip side of freedom of choice is an aspect I had not fully appreciated until we reflected upon it: choice is also a discipline. You had the freedom to choose from a wide range of choices, but now you have chosen, and your choice represents a discipline.¹³⁹

It is unclear what contribution each of these qualities makes to service improvement. Latent competition (contestability) is capable of delivering some of these benefits – motivation and perhaps information – however, it is unlikely that it will contribute as much in terms of 'constitutional' benefits – diversity, matching, commitment and mandate.

6.3 Contracting

Whilst contracting is almost always linked to competition in the reform of public services, it does somewhat different work, and in theory it should be possible to secure some of the benefits without exposing services to external competition.

A decade ago, the author commissioned a qualitative and quantitative study of contract managers who had previously managed similar services within the public sector, namely prisons, support services within the hospital sector, and defence establishments. These were the same people undertaking the same jobs, but in two very different organisational environments. The outstanding differences lay in the clarification of performance expectations, and the significant increase in managerial autonomy and personal accountability.¹⁴⁰

6.3.1 Mission

Social scientists now recognise the importance of mission in successful organisations, particularly in not-for-profits and public sector agencies. The American social scientist, James Q. Wilson wrote:

*A sense of mission confers a feeling of special worth on the members, provides a basis for recruiting and socializing new members, and enables the administrators to economize on the use of other incentives. . . having a sense of mission is the chief way by which managers overcome the problem of shirking in organizations that (like most government bureaus) cannot make the money wages of operators directly dependent on the operators' observed contribution to attaining the goals of the organization.*¹⁴¹

Some of the academic literature suggests that organisational mission is particularly important as a motivating factor in public services, and that intensive monetary incentives will be less appropriate or less reliable as a motivating factor. The conclusion might be drawn that contracting with external providers will compromise this sense of mission and result in inefficient allocation of resources.

However, it might also be argued that formally negotiating the performance specifications of an agency through competition and contracting will result in a clearer sense of mission, and authorise service managers to push back when policymakers seek to expand the range of tasks and overload the agency. Typically, public service companies do not cascade performance incentives down through the organisation, and front-line staff working for external providers probably have no more interest in the profitability of the business than public servants do in the budgetary envelope within which agency chiefs have been given to work.

6.3.2 Autonomy

Many observers over the years have commented on the inefficiencies that flow from not delegating proper authority to front-line managers. Most famously, US Vice President, Al Gore, commented in 1993:

The problem is not lazy or incompetent people; it is red tape and regulation so suffocating that they stifle every ounce of creativity. . .

The federal government is filled with good people trapped in bad systems: budget systems, personnel systems, procurement systems, financial management systems,

*information systems. When we blame the people and impose more controls, we make the systems worse.*¹⁴²

In the UK, a succession of reports described the lack of authority by prison governors as 'the confetti of instructions descending from headquarters' (1991); the 'blizzard of paperwork' (1995); the 'deluge of paperwork' (2000), resulting in the absence of senior management from the front line.¹⁴³

It appears that the fact of winning a competitive tender and then negotiating and signing a formal contract creates management space within which the manager has discretion to operate. The contract serves as a shield, giving managers greater scope for innovation and the authority to respond quickly to new challenges when they arise. They are also able to build their own teams, hiring is quicker and easier and management tends to be much more personal.

This was the experience of Vicki O'Dea, the director of a privately-managed prison in the UK when she was interviewed in 2007:

Betraying scant nostalgia for her 19 years in the Prison Service, she says that she finds working for a private company 'liberating'. 'Don't get me wrong, there is a lot that's good about the public service: staff training and development, race relations, offending behaviour programmes. And it does teach you to use your resources well, human or otherwise. But everything is made so difficult. If you need something, you spend time writing a business plan, persuading the area manager, and so on. Now, I just go and buy it.'

*At first, such spontaneity seemed odd. O'Dea recalls a seminal moment soon after her arrival when she was showing around a [company] board member and mentioned how she'd love to soften the staff uniform. 'Why don't you?' he asked. 'Only then did it sink in that I no longer had to consult the Prison Service,' says O'Dea, whose hands-on senior managers also now wear the uniform.*¹⁴⁴

Contracting demands that policymakers make a clear decision about their desired outcomes from a service, and then to step back to allow room for providers to deliver. While there may still be a need to address urgent and unexpected issues, with a contractual shield, the opportunity to intervene on a daily basis is considerably circumscribed. The contract has become a powerful tool in the devolution of management authority.

6.3.3 Accountability

For this same reason, accountability is also heightened. Contract managers know that the buck stops with them, whereas in the traditional public sector model, accountability is somewhat like a layer-cake. As one former public servant explained:

*It's significantly more challenging in the private sector, and you can't hide behind anything... whereas, I think in the [public sector], you're just one of the many layers and it's very easy to blame the layer above you or the layer below.*¹⁴⁵

By contrast, a contract is relatively self-contained, like a bubble, with only one way in or out, through the contract manager. It is unsurprising that contract managers report that they feel much more personally accountable than they did in the public sector.

Another important source of transparency lies in the establishment of key performance indicators, with identifiable rewards and penalties. Even when the performance measures are virtually identical, under a contractual regime, there are direct financial consequences for the failure to perform.

This means that managers need to understand what is driving performance so that they can implement remedial change.

*Because the management information systems are far superior in this [contract] than any other [comparable service] in the public sector, I have far more information about the performance of what is going on, so if I do want to put some time and energy into focusing on one specific area I know exactly where to look.*¹⁴⁶

6.4 Commercialisation

Academic research tells us that: 'Public versus private matters, but competitive versus non-competitive matters more.'¹⁴⁷ Ownership may not be a significant factor, but there are some benefits that seem to come from engaging external providers or public service providers with significant commercial freedom, in the delivery of public services.

6.4.1 Transfer of Best Practice

International public service companies may have a greater capacity to transfer best practice in public service delivery from one country to another. In the early stages of the prisons market in Australia and the UK, North American firms played a significant role – both prison management corporations and smaller firms specialising in innovative

design – in the dissemination of the new models of delivery. In more recent years, however, British prison management companies have played an important role in the dissemination of best practice from the UK to Japan, Germany, South Africa and Australia, and more recently, from Australia back to the UK.

6.4.2 Scaling-Up Innovation

Commercialised entities similar to private corporations may also have advantages in their ability to scale up service innovations without taking on the risk of introducing a new model across the whole system. A number of writers have commented on the difficulty that the public sector traditionally has with scaling-up.

The history of efforts to replicate, sustain, and scale up from effective programs is dismal...Scaling up effective services requires conditions that are still exceedingly rare.

*That is why effective programs have flourished only under some sort of protective bubble, outside or at the margins of large public systems. Protective bubbles can be created by foundation funding, by a powerful political figure, by a leader who is a wizard, by promises that the effort will be limited in scale and time, or by some combination of all of these. The problems arise when the successful pilot program is to expand and thereby threatens the basic political and bureaucratic arrangements that have held sway over decades.*¹⁴⁸

The existence of two or more providers (public or private) within a system of public administration, means that there are intermediate structures that can assume the responsibility for scaling up without compromising or challenging the system overall.

6.4.3 Brands

Finally, there are benefits associated with employing an organisation with a brand, and having stakeholders with an investment in the company's reputation. In the UK, prison contractors are held to account both through their profit and loss statement (that is, through financial penalties for non-performance) and through the share price (as the Chief Inspector of Prisons delivers public reports on the performance of individual establishments). It is difficult to replicate this particular discipline in organisations that are wholly government-owned.

6.5 Other Explanations

6.5.1 A Fresh Start

Some of the benefits of competition and contracting may come from the opportunity that they provide for an organisation to press the reset button and make a 'fresh start' with a service that was performing poorly or just coasting. In this sense, competition and contracting appears to be a successful example of 'zero-base budgeting' which was pursued, largely unsuccessfully, in the 1980s.

One study has suggested that in prisons, which tend to be extremely conservative institutions, change is faster 'when sufficient numbers of new staff are transferred en masse from the training college or from another establishment'.¹⁴⁹ This may be one of the reasons why competition and contracting seem to deliver transformation in organisational performance and culture.

In Australia and the UK, prison management companies elected to recruit their custodial staff in the local community, rather than drawing on professional prison guards from the public sector. This enabled them to introduce a radically different culture into the contract prisons from the outset, one that was immediately

identified by prison inmates. Prisoners in privately-managed prisons referred to the public facilities as 'POA prisons'¹⁵⁰, an allusion to the prison officers' union which had strongly opposed managerial and cultural reform. Indeed, one prisoner spoke of the 'humanistic change' that accompanied the introduction of prison contracting as 'Maggie Thatcher's fresh start'.¹⁵⁰

6.5.2 Selection Effect

In some public services, such as prison management, private providers have relied heavily on experienced public sector executives to manage their contracts. Often, these are highly motivated men and women who were deeply frustrated working within a traditional public service environment, so it is possible that one of the reasons why competition and contracting have delivered better results is that the prospect of greater managerial autonomy has attracted reforming public service managers.

An alternative way of looking at this phenomenon is to argue that contracting has created high performance hotspots, a reform strategy that should not be lightly overlooked. But if so, then government might achieve similar results by offering managers greater autonomy within a public sector environment.

¹⁵⁰ The POA is the Prison Officers Association, the union with a virtual monopoly on coverage of the public sector prisons.

7. Chosen Services

As previously noted in this report, policymakers are increasingly looking to choice-based markets in public services, where users are empowered to choose between alternative providers using money or money's worth provided to them by government. The concept of choice has wide support in the community, and much broader application in the public service economy than has been traditionally perceived. Around the world, governments on both sides of the political fence have been pursuing choice-based models, although there are obvious limits to its application in some public services (such as defence and criminal justice).

Australians have always had a significant degree of choice in their health services, but in the UK, where *de facto* zoning systems were in place for primary healthcare, patient choice has been a significant source of innovation over the past decade. In both countries, there has been a clear focus on school choice, although in this area too, Australia is somewhat ahead of the UK. In the United States, school vouchers have been a vexed issue, but choice has been extended nevertheless through independent state-funded schools known as 'charter schools'. Choice-based letting has also been the catch-cry in social housing for several decades and 'person-centred' approaches first emerged in disability care in the United States in the 1980s.

The Australian Productivity Commission described some of the benefits of individual choice in its recent report on disability services, noting that 'There is widespread and compelling evidence that it leads to good outcomes (in life satisfaction, confidence in their care, feelings of control, health, employment, a variety of other wellbeing dimensions, and potentially all at lower cost)'.¹⁵¹

While the majority of this report is concerned with commissioned markets, where public officials collectively purchase services from providers on the public's behalf, it is important to recognise the growing interest among governments and service users in reforms that would significantly increase the choice of individual beneficiaries.

7.1 Public Service Vouchers

The voucher is a useful conceptual tool for exploring the design and operation of choice-based models of public service delivery. It is not necessary that beneficiaries are provided with a physical artefact such as a piece of paper, a token or a plastic card. It is enough that funding follows choice. Thus, Australia's system of funding school education is a partial voucher, since some government funding follows the parents' choice to send their child to a non-state school.

Vouchers are an instrument for improving or preserving choice in public services that must be funded by the state.

In some cases, the primary objective may be the enhancement of choice on the part of service beneficiaries, but in other cases they are used as a mechanism for preserving choice when government intervenes in a market by providing greater financial assistance to those in need.

User Choice. Choice has an intrinsic value, since it honours the individual and empowers the beneficiary of state action, placing them as consumers (rather than the producer) at the centre of the service relationship. Increased user choice in disability services has contributed to the recognition of outcomes that matter a great deal to those requiring such services, including the right of granting access to our home, the dignity of selecting the individual who will deliver often quite personal homecare services, and the flexibility of deciding when such services will be delivered.

Of course, choice (individual or collective) is also a necessary precondition for competition, which can lead to lower costs, higher quality and more flexible services and an increase in the amount of innovation. Contrary to what has sometimes been claimed in the academic literature, public service beneficiaries value choice, women value it more than men, and those with less education and lower incomes place a higher value on it than those who are better off.¹⁵²

One participant in the Productivity Commission's recent consultation on disability care made the following comment on its proposed National Disability Insurance Scheme which proposes significant increase in choice through 'self-directed funding': 'This scheme is for people with disability, not for service providers. Not for governments, not for empires, not for private agendas. This scheme is for people who are as individual as their fingerprints'.¹⁵³

Public Value. Vouchers have sometimes been employed as a way of increasing social equity, whilst preserving choice and protecting program effectiveness. Australia's Medicare card is an example of a voucher being used to protect patient choice within a system of national health insurance that made primary health care free (or at least heavily-subsidised) for the vast majority of Australian residents. France has a similar system of patient choice and supply-side competition, with more than three-quarters of medical costs reimbursed by government (and full coverage for low-income earners).

In 2009, the British government used a physical voucher to avoid the stigma of welfare dependency when it introduced a program for providing school children in low-income families with computers and internet connectivity at home. Parents were given a stored value card issued through a High Street bank, which resembled

an ordinary debit card or credit card, so that they could purchase the computer and the associated support services through a local supplier, without the indignity of being identified in the check-out line as the beneficiary of government support.

Whether or not a public service is suited to funding through vouchers will depend on a number of factors, including the nature of the service in question, the capacity of service users to make informed choices, and the reason for the policy intervention in question.

7.2 Australian Case Studies

Voucher schemes are extraordinarily common throughout the industrialised world, and examples could be drawn from numerous countries and a variety of different service sectors. The following examples illustrate how well established choice-based public service markets already are in this country.

7.2.1 Medicare

Australia's Medicare card is a voucher, enabling citizens to purchase primary and secondary health care that is wholly or substantially funded by government. In many cases, services will be bulk-billed, so that patients make no payment themselves and doctors are directly compensated by Medicare.

Payment is assigned by a unique numerical identifier, and while most Australians are issued with a plastic card as identification, it is not necessary for the card to be produced in order to benefit under the scheme. All permanent residents of Australia and not merely Australians citizens are eligible for the card.

The Medicare card was introduced by a federal Labor government in 1995 (under the title of Medibank) as the centrepiece of a universal health insurance system.

7.2.2 School Choice

Federal government funding of private schools in Australia amounts to a partial voucher, in the sense that funding follows the student. Payments are based on the average recurrent cost of educating a student in a government school, which was \$9,070 in 2010 for primary school students and \$11,393 for secondary school students. This is a differential voucher, in the sense that schools serving disadvantaged communities receive 70% of this sum, while schools in communities with a more favourable socioeconomic profile receive as little as 13.7%. States also provide funding for non-government schools according to different formulae. As a result, the level of government assistance provided to students differs significantly amongst providers, with Catholic

schools receiving 72% of their funding (on average) from government, and independent schools receiving only 42%.¹⁵⁴

Australia's system of school funding has grown and adapted over several decades, and has been characterised as 'complex, lacks coherence and transparency and involves a duplication of funding effort', but it also represents one of the most comprehensive education voucher schemes anywhere in the world.¹⁵⁵

7.2.3 Vocational Education and Training

In 2008, the Victorian government introduced a 'Victorian Training Guarantee' (VTG), with funding centred on students rather than institutions. In effect, this removed the cap on the number of subsidised training places, thereby creating a 'student entitlement' (or voucher) which follows (eligible) students to any registered training organisation. Prior to that time, the government capped the number of funded places, and these were allocated on the basis of first-come, first-served.

At the same time, the government deregulated the VET market, opening up the supply side to all providers who could meet the government's regulatory requirements. Over the next three years, there was a 50% increase in the number of training providers offering government-subsidised places, and a 29% increase in the number of enrolments for government-funded places.

This massive take-up of the voucher had not been anticipated by the designers of the VTG, and several reviews of the scheme have been undertaken with a view to constraining the costs. Both the NSW and South Australian Governments are said to be investigating the model, and will be studying the lessons from these reviews.¹⁵⁶

7.2.4 Disability Services

In recent decades, a significant number of governments around the world have moved to provide disabled persons with a great deal more choice in the range of services that they can access using government funds and the selection of the providers. These schemes have a variety of different names including people-centres services, self-directed support, self-determination, consumer-directed services, personalised budgets and self-directed budgets, to name a few.

This movement appears to have begun in the United States and Canada in the early 1980s. By 2002, 43 American states already had some form of individual funding, and most Canadian provinces have some such scheme underway. In the United Kingdom, personal budgets have been in development since 1996, although

they have been actively developed only recently. Western Australia was the first Australian state to adopt this approach, followed more recently by Victoria.¹⁵⁷ Small trials had been conducted in NSW, but since 2011, the government has actively pursuing a policy of ‘person-centred disability services’.

The so-called National Disability Insurance Scheme developed by the Productivity Commission and adopted by the Federal Government is also based on user choice. As explained in the report:

The Commission proposes an ‘individual choice’ model in which people with a disability (or their guardians) could choose how much control they wanted to exercise. There would not be one model that forced people to take full control or none. So people could:

after consultation and assessment, receive a package of supports (not a budget amount) from the NDIS. People would be able to choose their service providers, and, if they wished, have the support of disability support organisations acting as brokers. People could switch disability support organisations and service providers if they did not meet their needs well. They might choose one service provider for one support need and another service provider for another need, or choose one provider to meet all their needs. They might ask a disability support organisation to bring together the package of supports and the best service providers on their behalf. A disability support organisation or service provider would only act for a person with a disability where that person had chosen to assign them that responsibility...

have the choice (subject to some conditions...) to cash out their support package and manage it at the detailed level, allocating it to specific supports they assemble themselves (so-called ‘self-directed funding’). Under self-directed funding, people could employ the support workers they want (and when), and choose to trade off some services against another. For example, the Commission knows of one case where a person with an intellectual disability used some of her funding to go to a movie weekly as her form of community access (replacing much more expensive and less enjoyable specialist day services). Self-directed

funding is already partly implemented in some Australian states, and common in the United Kingdom and the United States...¹⁵⁸

7.3 Diversity in Choice-based Models

As noted above, voucher models can be constructed in a variety of different ways, depending on the particular outcomes that policymakers are seeking to deliver and values they feel obliged to protect. The key elements of voucher design are threefold:

7.3.1 Means of Payment

Explicit. The voucher may consist of a physical coupon entitling the holder to the service and the provider to reimbursement from government (such as food stamps in the United States or the Medicare card in Australia).

Implicit. However, there may not be a physical artefact, and eligible recipients may choose from approved providers and the government will pay the provider direct based on the numbers served (e.g. school choice in Australia and Sweden).

Reimbursement. Alternatively, beneficiaries may choose from approved providers and pay them direct and then apply to government for reimbursement (for example, healthcare in France and, in some cases, Medicare in Australia).

7.3.2 Eligibility

Universal. A voucher may be accessible by the whole population (such as Medicare in Australia).

Targeted. Or it may only be available for identified groups of disadvantaged persons (e.g. housing vouchers in the United States).

7.3.3 Financial Coverage

Full. Government may cover the full cost of the service, with a prohibition on top-up fees (e.g. school choice in Sweden).

Partial. Or the voucher may only cover basic costs, with top-up fees permitted or mandated (e.g. Australia’s Medicare card).¹⁵⁹

Commissioners are able to construct a choice-based public service market based on these basic elements. There are numerous studies dealing with particular voucher schemes, exploring these design elements and the consequences of combining them in different ways.

8. Contestable Services

The third kind of competitive discipline raised at the beginning of this report is contestability, and while the term is often used as though it were a synonym for competition, contestability is latent as opposed to actual competition. It is concerned with the behaviour of monopolistic providers when confronted with a credible threat of competition from new market entrants. Actual competition may not be necessary.¹⁶⁰

The principal obstacles to contestability are high barriers to entry and exit. In the bus sector, ownership of the vehicles themselves is generally not a barrier to exit since, if an operator loses a competitive tender, they can be employed elsewhere; however, the depots may well act as a barrier to entry when they are owned by an incumbent, since in an urban environment, it will often be difficult for a new entrant to acquire alternative sites.

Where government owns the depots, or is prepared to acquire them if the incumbent loses a competitive tender, a bus market may be made contestable. Of course, bus services that are publicly-owned or franchised to private operators under arrangements where they are never exposed to competition are not contestable.

8.1 Contestability in the Public Sector

There has been discussion of the possibility of employing contestability in the public service economy since 1993.¹⁶¹ The following year, a leading British policy thinker, Geoff Mulgan raised the possibility that contestability theory might have some application in government, but downplayed the implications, limiting its application to the dismissal of quangos and the use of recall mechanisms in local government.¹⁶²

In 1996, a leading health economist, Chris Ham, raised the possibility of contestability being used as a 'middle path' between central planning and market competition in the NHS. Commenting on difficulties experienced with the NHS internal market, he argued:

While competition as a reforming strategy may have had its day, there are nevertheless elements of this strategy which are worth preserving. Not least, the stimulus to improve performance which arises from the threat that contracts may be moved to an alternative provider should not be lost. The middle way between planning and competition is a path called contestability. This recognises that health care requires cooperation between purchasers and providers and the capacity to plan developments on a long term basis. At the same time, it is based on the premise that performance may stagnate unless there are sufficient incentives to bring about continuous

improvements. Some of these incentives may be achieved through management action or professional pressure, and some may derive from political imperatives.

In addition, there is the stimulus to improve performance which exists when providers know that purchasers have alternative options...

The essence of contestability is that planning and competition should be used together, with contracts moving only when other means of improving performance have failed. Put another way, in a contestable health service it is the possibility that contracts may move that creates an incentive within the system, rather than the actual movement of contracts. Of course for this to be a real incentive then contracts must shift from time to time...¹⁶³

Mulgan picked the concept up again when he became head of the Performance and Innovation Unit in the British Cabinet Office. The concept was developed further in a background paper written in January 2001:

Policies for contestability aim to ensure that it is possible for new entrants to enter the field. According to the theory, the possibility of newcomers entering the market encourages existing providers to improve performance and innovate. With the right design, contestability arrangements can achieve many of the benefits of competition without the substantial costs associated with quasi-markets. The policy on failing schools, failings LEAs and the use of the private sector in the New Deal and ONE are good recent examples of how the threat of competitive entry can serve as a spur to performance in the public sector.

In practice, contestability doesn't work in all circumstances: in particular, there needs to be sufficient private sector (or voluntary sector) capacity to provide a credible alternative, and there needs to be accurate information to underpin judgements about success and failure.¹⁶⁴

The principle was discussed at greater length in a report on public-private partnerships published that same year by the centre-left think-tank, IPPR:

Allowing for diversity could go hand in hand with efforts to make public services (or components of them) more contestable: that is, creating the possibility that new providers can be brought in to replace those who are not performing adequately in running a service.

Contestability differs from the forced use of competition within public services (for example, the former Compulsory Competitive Tendering regime in local government) in a key respect. Compulsory competition insists on regular market testing of services (usually favouring the cheapest bidder) which inhibits the development of collaborative relationships and creates an adversarial relationship between purchasers and providers. In contrast, contestability provides the purchasers with the *option* of going to an alternative provider if they feel that this will provide citizens with a better service. Whether or not this choice is exercised is not determined according to a rigid formula.

There will always be restrictions on the extent to which this approach can take hold in the public sector: poorly performing businesses will go bankrupt in a way that government agencies will not and should not. But the issue remains of whether it would be desirable to introduce a *degree* of contestability within services, or the management of services. Our view is that there are areas in which contestability should be a lever available to public managers involved in commissioning services.

Contestability has been applied in different ways around the world. It often involves providers agreeing long-term contracts with public purchasers on the basis that the contract remains in place if the quality of the service is maintained and improved at a reasonable rate. The key point about contestability is the *latent* but real possibility that services can be switched to other organisations, acting as a continual incentive for providers to consider how they can improve their performance. This can have real impact. Citizens within a locality benefit if a failing provider is evicted and a contract transferred to a new provider; citizens elsewhere can also benefit from the knock-on effect that this has on providers in their locality.¹⁶⁵

The IPPR mentioned the prison sector, where around ten percent of establishments were managed by private providers, observing that this seemed to have been sufficient to create true contestability.¹⁶⁶ Interestingly, in its 'General Council Statement on Public Services' in late July 2001, the Trades Union Congress made favourable reference to contestability theory, acknowledging that 'there are examples of public sector involvement where some services are procured from the private sector and can help to prevent the emergence of cartels that fix prices at the taxpayers' expense.'¹⁶⁷

8.2 Contestability as Benchmarking

At one level, contestability might be regarded as a form of performance benchmarking, relying on the publication of information about the relative performance of service units such as hospitals and schools. This enables service users to contrast the performance of their provider with others nearby, and it enables managers to compare their own organisations with that of their peers. In the private sector, it has been described as a systematic process of identifying a benchmark, comparing the organisation against that benchmark and identifying practices that enable the organisation to become the new best-in-class.¹⁶⁸

Benchmarking was widely promoted in the private sector throughout the 1990s, although it had originally been developed by Rank Xerox a decade or more earlier. Thus, when the Blair government was developing its policy of contestability in the UK in the late 1990s, best practice benchmarking represented the latest thinking about management reform from the private sector.

The Blair government's commitment to performance management was evident from an Education White Paper, 'Excellence in Schools', published shortly after the 1997 election. As the framework developed, it was apparent that the government proposed to benchmark the performance of schools and Local Education Authorities through examination results and independent inspections. Competitive pressure would be applied by parents and the media who would be able to compare the performance of schools with their peers, but the government also proposed to intervene in institutions that were identified as failing.

At the same time, a benchmarking approach was also being developed for local government as an alternative to compulsory competitive tendering which had been rejected by the Labour Party. The 'Best Value' regime came into effect in 2000, with local authorities obliged to conduct their own benchmarking reviews and competitive tendering listed among the potential tools. Their performance was to be scrutinised by the Audit Commission, with rewards for local authorities that performed well and intervention for those that were seen to have failed.¹⁶⁹

8.3 Benchmarking Case Studies

In the private sector, it is the threat of financial failure that causes managers to benchmark themselves against their peers and then undergo the painful process of restructuring in order to remain competitive. This same incentive does not exist in a public service monopoly, where there is no prospect of competitive failure in this same sense.

Nevertheless, public service managers are motivated by a sense of professional pride, and if their performance is clearly identified as failing, they are vulnerable to being replaced. There is evidence from a number of academic studies suggesting that public service monopolies are sensitive to benchmark competition where service units can be readily compared with their peers, and where service providers are clustered close together so that comparisons can be easily made.

Water utilities. Walstein and Kosec studied more than 53,000 community water systems in the United States, comparing contaminant violations and monitoring and reporting violations under the EPA's Safe Drinking Water Information System from 1997 to 2003. They concluded:

While ownership, per se, does not appear to matter much here, the evidence suggests that benchmark competition makes some difference. We find that water systems in counties in which each water system tends to serve a smaller share of the county population have fewer violations. Likewise, regulatory compliance with respect to contaminant violations is better when water systems are required to disclose test results to consumers and consumers can easily compare performance to nearby systems.¹⁷⁰

Secondary schools. Bradley et al looked at school efficiency, as measured by school performance tables, including exam results and truancy rates, of all English secondary schools over the period 1993-1998. They were interested in the determinants of efficiency and change in efficiency over time. One of their strongest findings was the impact of competition (measured by the number of rivals within a two kilometre radius). They concluded:

...as the number of schools in the immediate neighbourhood increases, so the efficiency of the school under observation also increases during the period. . . More proximate rivals exert a stronger effect on efficiency compared to their more distant rivals. Compared to county schools, grant maintained and voluntary assisted schools have experienced the greatest increase in relative efficiency, which may be a reflection of their greater independence over resource allocation and admissions policies.¹⁷¹

Public hospitals. In 2010, Bloom et al studied 100 acute hospital trusts in England, comparing data from a management survey and information about hospital performance with a competition measure based on geographic proximity (the number of hospitals per person within a defined catchment). They found that management quality was 'strongly correlated with

financial and clinical outcomes such as survival rates and emergency heart attack admissions', and 'that higher competition (as indicated by a greater number of neighbouring hospitals) is positively correlated with increased management quality. . . Adding another rival hospital increases the index of management quality by one-third of a standard deviation and leads to a 10.7% reduction in heart-attack mortality rates'.

In their discussion of the mechanisms through which this might have occurred, they considered the impact of yardstick competition, the possibility that there was greater competition for patients in these hospitals and that there might have been a more attractive labour market.¹⁷²

8.4 Intervention

However, governments have not simply relied on the motivational effects of yardstick competition when designing contestability regimes for public services. In the United States throughout the 1990s, and then in the United Kingdom from around 2000, governments experimented with intervention regimes, which serve as a more explicit threat to underperforming service providers. In some cases, they have employed competition as part of this threat.

8.4.1 Intervention in Failing School Districts (USA)

Beginning in the early 1990s, a number of state and local governments in the United States adopted a policy of intervening in the management of school districts that were perceived to be failing to the point of 'academic bankruptcy'. North Carolina and Texas had been singled out for having achieved rapid improvements in educational outcomes throughout the 1990s, following a strategy of setting state-wide standards, applying state-wide assessment tests, rating schools and rewarding those with good performance and intervening in those with sustained poor performance, increasing local control, and shifting resources to schools with more disadvantaged students.¹⁷³

By 2003, 24 states had implemented a policy of intervention in local school districts. By that stage, takeovers had occurred in 19 states and in the District of Columbia, although a variety of intervention strategies had been employed:

- in some jurisdictions (such as Philadelphia), failing schools were converted into charter schools (state-funded independent schools).
- Maryland and Pennsylvania employed private (for-profit and not-for-profit) education management organisations to take over the operation of low-performing schools.

- Florida's 'A+ Plan' granted vouchers to the students of failing schools. Schools with large numbers of students failing the Florida Comprehensive Achievement Test in reading, writing and math were given an 'F' grading. Any schools with an 'F' grading two years out of four were opened to competition. Parents of children attending these schools were able to transfer their children to higher performing schools, or apply for a \$3,400 scholarship (or voucher) to send their children to a private school. Failing schools were provided with additional state assistance to improve.¹⁷⁴
- Chicago assigned external partners (or consultants) to the schools that had been placed on probation that worked with them in the improvement of educational outcomes.
- in several cases, the states took over entire school districts, appointing new boards and chief executives.
- in New York, a number of failing schools were simply closed.
- New York, Chicago and San Francisco reconstituted schools, replacing principals, reassigning teachers or otherwise reorganising management.
- in California and North Carolina, intervention teams were sent into the schools to evaluate performance, recommend strategies and assist with implementation.
- in some states, teachers were evaluated and might be transferred, demoted or dismissed, or required to undertake remedial training.
- a variety of less disruptive interventions were also employed in all states – improvement grants, professional development, extension services for students (summer schools and after-school), school construction and repair.

In 2001, the US government introduced the *No Child Left Behind Act*, which used the lever of federal funding to mandate state intervention for persistently failing schools.

Academic research suggests that the academic benefits of intervention were mixed. One study comparing 14 different school districts concluded that mayoral takeovers had been more successful than state takeovers, and that these had the greatest impact in the lowest performing schools and for students in the elementary grades.¹⁷⁵

In Philadelphia, state and city governments collaborated in appointing a three-member School Reform Commission, replacing the nine-member school board and appointing a new chief executive. Intervention took a variety of forms. In 45 of the lowest-performing schools, management was handed to for-profit and not-for-profit organisations, along with additional funding. Another 21

failing schools were provided intensive staff support and extra funding, while a further 16 schools that were seen to be improving were given additional funding but no other form of intervention. A 2007 study by the RAND Corporation concluded that:

Philadelphia has seen substantial district-wide gains in the proportion of students achieving proficiency since the 2002 state takeover. But after four years, the gains of its low-achieving schools (constituting most of the schools in the district) have generally not exceeded the gains of low-achieving schools elsewhere in Pennsylvania.

Improvements in the privately-operated schools and in the 16 'improving' schools were, on average, no different from the district-wide gains, while the restructured schools outperformed the rest in all three years of the intervention.¹⁷⁶ However, a separate study by the Harvard Kennedy School found that schools managed by for-profit providers had significantly outperformed those managed by not-for-profits in maths (but not in reading). Moreover, 'the math performance of students at the for-profit schools was 35% of a standard deviation higher than would have been the case had the schools been under district management'.¹⁷⁷

Comparison of the different intervention strategies across various jurisdictions has also reported mixed results. No single strategy was universally successful, and over time, states and cities retreated from the more severe sanctions, with greater emphasis being placed on supportive measures.

Why this turn from pressure to support? Some suspect that states shrink from the responsibility and political costs that the heavy hand of sanction entails. This is one plausible explanation, but other research suggests that political costs notwithstanding, the pressure strategy is a double-edged sword and not as promising as originally perceived.¹⁷⁸

8.4.2 Intervention in Failing Education Services (UK)

Following his appointment in 1997 as the Education and Employment Secretary, David Blunkett, and one of his special advisers, Michael Barber, set about to implement a performance management strategy relating to literacy and numeracy, consisting of the following elements:

- *Specific and measurable performance targets.* These had been spelled out in considerable detail in Public Service Agreements announced by central government as part of the 1998 Comprehensive Spending Review (such as: 'an increase in the

proportion of those aged 11 meeting the standard of literacy for that age (level 4 in the Key Stage 2 test) from 63% to 80% by 2000’.

- *Political accountability for targets.* Blunkett stated publicly that he would resign if key targets were not met (although he later declined to do so).
- *Measurement.* The Department for Education and Employment put into place a comprehensive skills-testing program, with the results published annually in the form of league tables.
- *Remediation.* There was a significant increase in funds for teacher training, and the results of skills tests were fed back so that specific teaching capabilities could be improved.

The intervention model for Local Education Authorities (LEAs) and schools built on this approach. In January 1999, Blunkett asked the independent schools inspectorate, Ofsted, to inspect all LEAs by 2001 to identify failing authorities. It was made clear at the time that this could open the way for intervention in LEAs that were failing to provide adequate support to teachers and pupils. The elements of this model were:

- *Independent inspection.* Schools and Local Education Authorities were to be inspected once every four years by Ofsted.
- *Public reporting.* Ofsted published lists of good performing (‘beacon’) schools and poor performing (‘failing’) schools and LEAs.
- *Intervention.* The School Standards and Framework Act 1998 gave the Secretary of State new powers to intervene in failing LEAs. In February 1999, the Education Standards Minister stated that she expected 15 major interventions in failing LEAs. Educational institutions would be given the opportunity to respond to Ofsted reports and remedy reported deficiencies, with a clear understanding that intervention would follow from failure. The range of options included replacing management and staff, through to ‘Fresh Start’, which involved closure of the school and replacement of management. Teachers would be required to reapply for their jobs. Schools failing to meet government targets three years in a row would be considered for a ‘fresh start’. The Education Secretary and the (then) Minister for School Standards, Estelle Morris, made it clear that private management was an option for failing LEAs (but not for schools).

Local Education Authorities. Blunkett first signalled his willingness to use new powers to let outside organisations run some Local Education Authorities (LEA) functions in a speech in early 1999. He flagged the possible involvement

of private firms, but stated that the government would only consider contracting out services where it was clear that an LEA could not or would not do its job effectively. Within days, advertisements appeared inviting contractors to register expressions of interest for consultancy work and for the delivery of LEA functions. In this first round, six organisations were awarded framework contracts to undertake consultancy work related to LEA interventions and ten organisations were placed on the list of service providers to LEAs.

Expressions of interest were again sought in February 2000. At the same time, the Minister for Education Standards arranged to be interviewed by the *Financial Times*, inviting companies to participate in the emerging market, and made herself available to meet interested organisations, stating ‘The private sector wants to know we have the backbone to carry this policy through – and we have.’¹⁷⁹ Conferences and seminars were subsequently organised by the Department for Education and Employment (DfEE) to bring together LEAs and private education service providers. By September 2001, the government reported that it had intervened in 20 LEAs, with nine of them having been opened to management by private providers.¹⁸⁰

A study commissioned by the Confederation of British Industry in 2005 compared the performance of these nine LEAs where management had been outsourced with the eleven where departmental intervention had occurred, a control group that had similar levels of educational attainment and organisational dysfunction but no intervention had occurred, and all LEAs in England. It found that student performance in the outsourced LEAs had improved more than in all of the other cohorts.¹⁸¹

In spite of this success, the political controversy surrounding these interventions resulted in gradual abandonment of the policy. Contracting was not used again as a means of intervention (although a number of voluntary partnerships have since been established between LEAs and private providers), and LEA interventions became much less visible.

Schools. In June 2000, the Parliamentary Select Committee on Education and Employment reported in favour of intervention in schools:

We believe that private sector organisations can play an important role in providing high quality education services where there is clear evidence of long term under-performance to provide these services to an acceptable standard...We consider that a long history of under-performance should automatically trigger serious consideration [of] the contracting out of the management of an LEA’s education service.¹⁸²

However, the government proceeded cautiously. Up to February 2001, when a new Education Green Paper was released, only 15 schools had been given a 'fresh start', and the program faced considerable challenges with a number of the new head teachers having resigned shortly after appointment. In that paper, the government signalled its willingness to extend the intervention model to secondary schools on a more comprehensive basis:

We intend to develop a new model which would enable an external private or voluntary sector sponsor to take responsibility for a weak or failing school against a fixed-term contract of, say, five to seven years with renewal subject to performance.¹⁸³

Days after her confirmation as the new Education Secretary in June, Estelle Morris announced plans to expand the involvement of private firms in the running of state schools. The announcement made it clear that private involvement would extend beyond failing schools.¹⁸⁴ The Education White Paper, released in September 2001, pursued this agenda further, albeit with more cautious language following union criticism:

We will make it easier for weak or failing schools to benefit from the leadership and management of good schools. This might include enabling the head or some of the management team of the successful school to support or take responsibility for the failing school, allowing the governing body of the successful school to support the governance of the failing school; or sharing staff and facilities.

Finally, whenever a failing school needs to be turned around, we will expect the LEA, as now, to draw up an action plan to submit to Ofsted and the Secretary of State. In parallel, they will also invite proposals from external partners – including successful schools and partners from the public, voluntary and private sector – to help turn around the school. . . .¹⁸⁵

In the result, this policy was implemented through the establishment of City Academies (later School Academies), allowing failing schools to be granted significant independence with financial sponsorship and management advice from business, faith and voluntary organisations. The first three School Academies were opened in 2002, followed by another nine the following year and five more in 2004. (Under the Coalition, any school may apply for Academy status.)

Research into the performance of City Academies has reported mixed results. Some studies have found insignificant improvement, or concluded that any

improvements in examination results were attributable to changes in student intake, or that improvements in some schools were offset by poorer performance in others nearby.¹⁸⁶ However other research has reported significant performance improvement under the Academies program.¹⁸⁷

8.4.3 Extending the Intervention Model (UK)

Apart from LEA and school interventions, there was discussion about its possible application across a number of other public services although, for a variety of reasons, none of these strategies were subsequently implemented.

Hospitals

An intervention model for public hospitals was first raised in 1999 when the government announced that it would be establishing a Commission for Health Improvement (publicly known by the acronyms CHI or CHIMP) to focus on 'variations in performance across the country between (NHS) Trusts, hospitals and doctors.' The Prime Minister's aides were quoted as saying that CHI would be given the information to 'sort out the sheep from the goats.' It would have the authority to remove chief executives and replace boards with hand-picked substitutes. While not ruling out private management, they downplayed the possibility.¹⁸⁸

In June 2000, the then Health Secretary, Alan Milburn announced the government's intention to name failing hospitals and subject the management to 'special measures'. Hospitals that were performing well would be given greater freedom to organise their services. The plan for reforming the NHS would include a system for 'scoring' hospitals, health authorities and primary care providers. 'The Commission for Health Improvement will publish "annual report cards" setting out how each part of the NHS is performing.' The government would also publish league tables giving patients clear information about the quality and efficiency of care. Targets would include quality of service, equity of access, efficiency of care and levels of patient satisfaction.

All health organisations in the UK would be classified green, amber or red. Green providers would be given greater management freedom; red providers would face 'a sequence of escalating interventions'. Management would be given 'new expert external advice, support and where necessary intervention to help frontline staff redesign services from the patient's point of view.' Failing organisations would get funding and support to reform, but it would be 'cash with strings attached' with poor performing hospitals receiving help from 'intervention teams' made up of successful NHS managers or the private sector.¹⁸⁹

The first comprehensive League Tables for hospitals were published in July 2000, showing the differences in waiting

times and cancelled operations by hospital.¹⁹⁰ In mid-November, the Department of Health was reported as having threatened to take over financial control of, or send in 'a hit squad of managers' to take over the Queen Alexandra hospital in Portsmouth, after ten surgeons called for all emergency operations to be stopped because of the lack of sterile instruments. Routine orthopaedic surgery had been stopped for the same reason in September.¹⁹¹

In media interviews, Milburn said that unpublished data on waiting times, cancelled operations, length of stay and delayed discharges for each hospital would be made public within the year. These would be published independently by CHI and by the Audit Commission.¹⁹² Milburn also spelled out his reform strategy in greater detail, demonstrating his heavy reliance on intervention, and the government's intention to use the lack of consistency in quality care as a way of driving reform:

The solution, he reckons, lies in customers gaining information and the introduction of inspectors to put pressure on hospitals to 'ratchet up standards'. Without that, he concedes bluntly, we will 'perpetuate the lottery of care and great unfairness' that has been identified. 'One of the most glaring faults is the huge variation in performance between parts of the service.'

The new openness will reveal which hospitals are failures, and Milburn is seeking powers to replace their managers. 'We have to deal with failure, which we have never managed to do inside a state monopoly. It would be absurd to close a hospital, but there is no reason why it couldn't be taken over by another hospital,' he said.

'Make no mistake: the bottom line is that if I see persistent failure I will not hesitate to exercise those powers.'¹⁹³

Instead of the traffic light system, the government finally opted for a less controversial system of stars, with twelve NHS trusts being awarded no stars at all in 2001. Of these, 'those with long-serving chief executives will get three months to show improvement. . . Trusts with newly appointed chief executives will be allowed up to a year to turn themselves around.' According to reports at the time:

If any fail to do so, the chief executives will be sacked and their jobs 'franchised' to senior managers from successful hospital trusts who may be offered salaries of £200,000 or more to run two operations simultaneously.¹⁹⁴

At the same time, the government indicated that the best performing hospitals would be allowed to set up spin-off companies to sell catering and laundry to the private sector, in an attempt to give NHS trusts greater freedom to run their own affairs. The 25 best performers would also be given freedom to exploit the commercial potential of inventions in their laboratories.¹⁹⁵

But in an important speech in January 2002, the Health Secretary indicated for the first time that he was prepared to contemplate franchising the management of failing hospitals to private firms and not-for-profits (as well as successful public hospitals).

In those local services where there are persistent problems – which are more often than not organisational and cultural – the management could be franchised. Within this new definition of the NHS, the franchise could go not just to another public sector health organisation but in time to a not-for-profit body such as a university or a charity or to some other external management team. As franchising progresses it is possible to imagine a number of local health organisations all being run by a single team of successful public service entrepreneurs. The assets, of course, of the franchised local hospital or PCT [Primary Care Trust] will remain within public ownership. It is the management that will be franchised. This is not privatisation in any way, shape or form.¹⁹⁶

The star rating system, which operated from 2001 to 2005, scored NHS trusts on their performance against a number of different criteria – a small number of key targets laid down by central government (mostly concerned with waiting times); a few clinical indicators; measures of patient satisfaction; and assessment of management performance. These hard indicators were also moderated by qualitative assessment of clinical governance by CHI.

Most of the attention at the time, and in the subsequent academic literature, was concerned with the effectiveness of central targets in driving improvement in the government's key targets. This research appears to suggest that the initiative had a positive impact on waiting times without a negative impact on patient health.¹⁹⁷ It is much more difficult to obtain information about the intervention regime, although the media did pay some attention to the removal of six chief executives of trusts given zero stars in 2001.

Advertisements were placed in the papers in May 2002 calling for expressions of interest for inclusion on a register for the improvement of failing NHS hospitals, and it was clear that the invitation was open to private and

voluntary organisations as well. However, it is unknown how much the private sector was subsequently employed in the intervention regime.

Prisons

The first indication that the government might be prepared to adopt a similar approach with prisons followed a report by the Chief Inspector of Prisons into HMP Brixton in July 2000. Responding to the report, Paul Boateng, the Prisons Minister, described it as a 'failing institution' with standards that could not be tolerated. The governor of Brixton prison immediately resigned his position and the former contract manager was appointed as governor.¹⁹⁸ Boateng subsequently confirmed that private companies would be asked to compete: 'People must shape up or ship out. For too long there has been a willingness to tolerate failure in the Prison Service.'¹⁹⁹

While no failing prisons were market-tested, the government continued to threaten competition. For example, in January 2001, Boateng announced that the Prison Service had won a competition for the management of HMP Manchester, and won back the management of Blakenhurst, a privately-managed prison. He issued a strong warning:

This result shows what the Prison Service can do when under the pressure of competition. There can be no more excuses for failing prisons . . . The in-house teams . . . must deliver all that is promised and within costs. If they fail to do so they will be contracted out again without an in-house bid being allowed.²⁰⁰

The private sector was subsequently invited to bid for the management of Brixton prison, but for a number of reasons, including in particular, the difficulties of managing staff transferred from the existing prison and the Prison Service's refusal to finance necessary capital improvements, none of the private prison managers submitted a bid.

The commitment to expose failing prisons to competition was repeated in the Comprehensive Spending Review in July 2002, but then less than a week later, the Home Office confirmed that it had abandoned market-testing of Brixton because no private sector company had expressed an interest. A review of the prisons estate was announced, with the expected outcome being that out-dated jails were likely to be closed rather than market-tested.²⁰¹

Police Authorities

In June 2001, days after his appointment as Home Secretary, David Blunkett warned that poorly performing police authorities would be named publicly. The Home Office Standards Unit would record detection and clear-up rates for publication and it would be used to

promote best practice.²⁰²

In early December, Blunkett published detailed performance tables for each neighbourhood in every constabulary area. He said that he was proposing to allow Her Majesty's Inspectorate of Constabulary and the Home Office Standards Unit to take over police command units that were not considered to be performing adequately. Chief Constables indicated their concern at the implications of this for police independence.²⁰³

The 2002 Comprehensive Spending Review, released the following July, announced the establishment of a Police Standards Unit to drive through performance accountability, although the Home Secretary made it clear that central government would not intervene in failing policing bodies and this power was left with local police authorities. Of course, there was no suggestion that management might be open to competition from the private sector.

Social Services

In October 2001, the Secretary of State for Health announced that social services departments in local authorities were to be ranked according to a simple three star system. (The Department of Health already published annual performance tables for social services departments, and in 2001 published lists of the best and the worst.) Where departments persistently failed, they would be taken over by managers from top-rated authorities, and external specialists would be brought in to turn the services round.²⁰⁴

The first league tables were published in May 2002, with eight councils receiving three stars, 50 two stars, 82 one star and ten no stars at all. The Health Minister, Jacqui Smith announced that private sector consultants would be sent in to work with four of the social services departments that rated no stars. She denied this was privatisation, saying that public sector consultants had applied to be on the approved list but did not have the necessary range of expertise.²⁰⁵

8.4.4 A Framework for Intervention

Typically, governments have lacked the early warning signals of institutional failure. In the private sector, management and shareholders are able to witness falling sales figures, falling margins and falling share prices. Objective indicators of performance are often difficult to obtain for core public services.

In the private sector, intervention exists in the form of sale of a failing business to another firm, and among publicly-listed companies, it operates by way of a hostile takeover. The failing management team is replaced, the organisation is restructured, and the strengths of the organisation are once again directed to value-creation.

Government has traditionally found it difficult to replicate this kind of discipline. As Alan Milburn once declared, 'We have to deal with failure, which we have never managed to do inside a state monopoly.'

Drawing on the British and North American examples above, an effective intervention model seems to require the following elements:

- i. the existence of separate and clearly identifiable service units
- ii. performance standards that enjoy a significant level of support within the sector
- iii. objective methodologies for measuring performance
- iv. independent inspection to report on the qualitative dimensions of performance
- v. the publication of results (and thus, the identification of failing institutions)
- vi. the capacity and willingness of central government to intervene
- vii. a system of escalating interventions based on responsiveness to prior reform initiatives.

The greatest challenge with this model lies in finding credible and sustainable means of intervention. The very term implies that the action is being taken by an external agency with higher authority, but in many cases, government is so closely identified with the management of these services that intervention will amount to an admission of failure.

But a sustainable intervention model must rely on a great deal more than 'naming and shaming'. The British and North American experience confirms that punitive and disruptive interventions are difficult to sustain and while they may still be necessary in extreme cases of service failure, a successful performance regime will rely on more constructive forms of intervention.

8.5 Contestability Case Studies

It is often difficult to study contestability at work, because governments are not always explicit about their decisions to adopt such an approach, and sometimes because it emerges unintentionally. The following are four known examples where this approach appears to have worked.

8.5.1 Market-testing (UK & Victoria)

While the British Conservative government intended compulsory competitive tendering in local government to drive a significant shift towards private provision, the majority of tenders were won by in-house teams (or Direct Service Organisations), and since this pattern was much more apparent among Labour-controlled councils,

commentators concluded that much of this was due to political opposition.

Nevertheless, some local authorities seem to have used the threat of competition as a way of securing productivity reforms from their own workforce. In a detailed study of the first round of compulsory competitive tendering (CCT) in 1991, Painter concluded:

Where firms expressed an interest but failed to finally submit a tender, the authority is recorded as having no competitors. However, this is not strictly the same as no competition, since local authorities may use the threat of competition to force the workforce to accept deterioration in terms and conditions of employment. In a number of cases this occurred even when there was no interest from private contractors at all. It seems clear that some authorities are using CCT not as a means to privatize their services, but as a way of introducing organizational change which would otherwise have been more strongly resisted by the workforce.

He gave the example of the London Borough of Harrow which retained its school meals contract in-house following a competition by reducing the wages of its workforce by 20%.²⁰⁶

When market-testing was introduced in central government agencies from 1991, a similar response was observed. Of those activities that had been market-tested by 1994 with an in-house bid, almost two-thirds were awarded to the in-house team, and even where in-house teams won, staff numbers were still reduced by around 24%.²⁰⁷

There is some evidence of similar effects under the CCT regime introduced in Victorian local government in 1994. Once again, the vast majority of contracts were won by in-house teams but, even in these cases, significant changes were observed in the flexibility of working hours, reduction in overtime payments, the abolition of supplementary allowances (such as early start and travel time allowances) and the rationalisation of pay bands. In one council, all services were retained in-house following tender, but the initiative resulted in significant structural changes, including the separation of commissioning and supply activities in council, corporatisation of the service provider, introduction of profit-sharing with staff and a 28% reduction in staff numbers.²⁰⁸

8.5.2 Services for the Elderly (Sweden)

Roland Almquist studied changes in the management of social services in Stockholm following the introduction of compulsory competitive tendering in 1993. The 17 districts in the city were required to expose all of their social services to competitive tendering over a period of

five years (that is, 20% each year). Subsequent research reported savings of around ten percent without any decline in quality, but Almquist was interested in the impact of services that had not yet been obliged to proceed to competition but had nevertheless been subjected to the threat of competition.

He found that service units that had not yet been put to tender still delivered relatively large savings, and that these were between five and six percent greater than in groups who did not perceive themselves as subject to any competitive threat. The impact of latent competition was confirmed by the language used by management during interviews.²⁰⁹

8.5.3 Prison Management (NSW)

For some years, the NSW government has used the threat of private sector competition as an instrument in reforming prison management. In this case, the potential for competition came from a privately-managed prison at Junee which, according to successive Auditor-General's Reports, was operating at a significantly lower cost than its publicly-managed counterparts. By 2002-03, the last year detailed information was published, Junee was being managed at around 45% below the average cost of medium security prisons in the state. While it was recognised that there was the need for some moderation of this differential to reflect the age of the facilities (among other things), it seems to have been generally accepted by the NSW government that Junee was delivering a comparable service at a significantly lower cost, and that the differential was growing.²¹⁰

In 2003, there was speculation that two new correctional facilities at Kempsey and Dillwynia might be opened to competition and contract management and, at the same time, the Department of Corrective Services opened negotiations with the union over a workplace reform package, known as 'Way Forward', which included performance agreements, leaner staff-to-inmate ratios, and a targeted reduction in sick leave and overtime. Under the threat of competition, the union agreed to these changes and once a new award was signed for these establishments, the government announced in March 2004 that they would be publicly managed. The fact that private firms were employed to design, construct and/or maintain these facilities would have served to maintain the competitive pressure.

In 2005, the Public Accounts Committee reported that contestability had 'resulted in significant cost savings when compared to correctional centres operating under the traditional model'. The these two centres had significantly lower sick leave and overtime levels, contributing to operating costs that were closer to those

under which Junee was delivered.²¹¹

This model was extended to two other Greenfield sites, Wellington in 2007 and Nowra in 2009. The Auditor-General reported from 2007 to 2009 that the Department was negotiating with the union to extend the reform package to the remainder of the publicly-managed system, but it would appear that negotiations had stalled.²¹²

In November 2008, the government announced its intention to open up the management of two existing prisons – Parklea and Cessnock – to competition, and to conduct a feasibility study into the replacement of Grafton prison with a PPP facility. According to evidence before a NSW Legislative Council inquiry, this decision had been influenced by a number of factors:

- i. NSW Treasury had received independent advice that market-testing these facilities could result in significant improvements in cost effectiveness
- ii. the Department of Corrective Services wished to establish benchmarks against which to compare the publicly-operated prisons
- iii. a desire to encourage innovation through competition.²¹³

In the result, Parklea prison was contracted to a private operator, but Cessnock prison was not openly subjected to competition and the PPP prison at Grafton did not proceed. Given the circumstances at the time, it seems likely that the NSW government was using the competition for Parklea prison to increase the credibility of its threat to expose the management of the prison estate to competition.

8.5.4 Independent Sector Treatment Centres (UK)

Independent Sector Treatment Centres (ISTCs) and Diagnostic Treatment Centres (DTCs) were launched by the NHS in 2003 as a way in increasing capacity and reducing waiting times for elective surgery and diagnostic procedures. The former were, in part, a strategy to separate elective procedures, which are generally routine and thus amenable to rational forward planning, from emergency care, where demand is highly unpredictable and thus impossible to plan.

The Department of Health also made clear that there was a strong element of contestability built into the model. It was anticipated that the introduction of competition would stimulate NHS providers to improve their own services, particularly in relation to increased productivity and reduced waiting times.²¹⁴ While privately owned and operated, these centres provided services exclusively for the NHS.

In 2006, it was envisaged that the proportion of elective procedures undertaken by the ISTCs would rise to around

15%, but it would appear that it never rose above two percent (although in some areas, all elective care was provided by an ISTC). Thus, they made only a small contribution to increased capacity.²¹⁵

ISTCs were one of a number of initiatives announced by the UK government from 2002 to increase patient choice and reduce waiting times, and according to a presentation given by Patricia Hewitt, then Health Secretary in 2006, the policy had already had an impact before the first ISTC became operational. The number of patients waiting more than six months for surgery fell from 250,000 in September 2002, when the government announced that patients waiting more than six months would have a choice of provider to around 150,000 when the first ISTC was opened in December 2003. By the time 18 ISTCS were operational in December 2005, the waiting list was close to zero.²¹⁶

There is some anecdotal evidence to support the view that ISTCs changed surgeon's behaviour. In June 2008, the Audit Commission reported:

The impact of ISTCs on other local providers is hard to judge. Our research identified that some health economies felt that the fear of real competition presented by ISTCs had resulted in changes and increases in efficiency. They spoke of how the threat of a private facility and subsequent viability of their hospital or speciality had been a useful tool to engage clinicians and worked with them to deliver change.²¹⁷

8.6 A Contestability Framework

What might a contestability model look like in the public services sector, and what are the conditions under which it would make a difference? Contestability relies on the credible threat of competition from new entrants which implies low entry and exit barriers. In the public sector, the obstacles have as much to do with government policy settings and the lack of alternative suppliers as with sunk costs. So what are the barriers to entry in the public service economy?

8.6.1 Lack of a policy framework which ensures that existing providers face a credible threat of competition.

There can be no sense of contestability amongst incumbents unless there is a policy, clearly articulated, regarding government's expectations of service providers, and the circumstances under which intervention will occur. This will require a shared understanding of performance requirements, a credible mechanism for monitoring performance, a willingness on the part of government to acknowledge failure, a process for

facilitating internal improvement, a mechanism through which intervention can occur and a readily available source of alternative supply.

8.6.2 Failure to identify core service units around which accountability for performance will take place.

Departments and agencies are often structured on hierarchical lines, with responsible managers at regional, district and local levels. A contestability framework demands a clear decision about which of these will have priority, and the level at which performance will be specified, budget responsibility will be allocated and intervention will occur.

One of the factors to be considered in deciding this question is the level at which a ready source of alternative provision might be found.

8.6.3 Failure to establish clear performance standards.

Providers might be given a set of performance objectives tailored to their particular service units, with a firm budget within which to deliver these results. These objectives must be capable of being independently measured and if they are to be held accountable under such a model, senior managers must have an opportunity to challenge findings prior to settlement, so that both sides are satisfied as to their viability.

Alternatively, government might benchmark all service units against a defined level of best practice, intervening in those that fail to deliver. These might be absolute standards or 'distance travelled' measures along a path of service improvement. Alternatively, service units might be benchmarked against each other, with intervention in the worst performing.

8.6.4 Lack of a true chart of accounts.

Reliable cost information must be available for the service units (however defined). It will be impossible to benchmark performance, or to compare the cost of provision with potential alternative suppliers unless there is a meaningful set of accounts.

8.6.5 Failure to delegate real management authority to the managers of service units.

Service managers cannot be held accountable for the operational and financial performance of their units unless they are permitted to make the decisions necessary for the delivery of agreed results. In some cases, this will involve a significant delegation of authority, but it will also require policymakers to abstain from imposing additional demands without negotiation and adequate funding.

8.6.6 Lack of alternative providers who could readily step in to manage the service unit.

In order for there to be a credible threat of competition, alternative providers must be able to take over the management of the service unit at relatively short notice. These may come from elsewhere in the public sector or from outside.

It is a pre-condition of such a model that alternative suppliers are capable of offering an alternative – that they have the freedom to innovate in the management of the unit in question and thus have the capacity to deliver better value for money. In the case of publicly-owned service providers, this would imply a significant degree of commercial independence, and possibly access to independent sources of capital.

It may be necessary to open up a proportion of service sector to external providers, or to public-private joint ventures, for there to be credible alternatives. In the UK, there was discussion of a 10-15% threshold, below which it was thought independent providers might not have the capacity to pose a serious threat.

8.6.7 Absence of a mechanism to trigger an intervention.

If services are periodically exposed to tender and alternative providers are permitted to bid, this will serve as a powerful source of competitive tension. However, government may elect not to conduct regular competitions, in which case they will require some kind of mechanism to trigger an intervention in an under-performing service unit.

Service providers must have a clear understanding of how well they are performing against their agreed budget and benchmarks and they must have confidence in the integrity of the process for monitoring and reporting performance. They must be provided with an opportunity to turn around the under-performing service unit, and they should be provided with assistance in doing so. However, it is vital that there is a proximate and clearly visible end-point to this process.

Ministers will also require a credible process for monitoring and reporting, so that they have the confidence to identify under-performing service units and to initiate the process of intervention. This is sometimes a politically difficult course of action, so it is vital that the Minister is not identified too closely with the incumbent providers, and that the monitoring function is relatively independent.

Intervention might take a variety of forms – the replacement of senior management from within the public sector; a ‘fresh start’ under an entirely new team; takeover by another public service unit; external competition for the management of the unit, possibly through a joint venture with an independent management specialist; or a competitive tender in which independent providers would be invited to manage the facility for a term of years or until the under-performance has been corrected.

The NSW prisons example would suggest that government must actually intervene from time-to-time in order for the threat to remain credible.

9. Building a Mixed Economy

Many public services have for a very long time operated as producer monopolies, with no distinction between supply and demand. It is therefore not surprising that there is resistance to change to the introduction of competition, actual or latent. Structural reform requires careful design on the part of policymakers, with processes that permit the status quo to be challenged, whilst also assisting providers to make the transition.

Over the years, governments have employed a variety of different models in driving competition and contestability into public services. Not all of these were entirely successful; some managed to introduce a form of competition, but with unfortunate side effects. Others appear to have been highly successful.

9.1 Mandatory Outsourcing

In some cases, governments have insisted on mandatory outsourcing, that is, competitive tendering in circumstances where the in-house team is not permitted to bid. This may arise from a philosophical commitment to privatisation, although there are other reasons why governments have sometimes adopted this approach.

9.1.1 Technological Innovation

Where service support is closely linked to a new technology, it would often be unwise for government to develop in-house capability. It is likely that private providers will have a great deal more experience in the maintenance and operation of the technology in question, and will be in a much better position to manage the risks. Governments often contract with private firms for IT support services for precisely this reason.

RAF Fylingdales (UK)

In the late 1950s, at the height of the Cold War when the British and American governments were collaborating on the establishment of a Ballistic Missile Early Warning System, an American firm, RCA, was awarded the contract to design and construct the state-of-the-art radar system. Three sites were selected, in Alaska, Greenland and an air force base, RAF Fylingdales, on the Yorkshire moors in the north of England. When the British Ministry of Defence made a decision about operation and maintenance of Fylingdales, the contract was awarded to the European services division of RCA, which already possessed the technical expertise.²¹⁸

9.1.2 The 'Yellow Pages Test' (US and Australia)

Governments have sometimes withdrawn from delivering services themselves because supply has become so commodified that the required capability can be procured more easily from the market. Logistics support is an industry that has developed so much over the past two or three decades that governments no longer need to maintain large storehouses of their own.

The 'Yellow Pages Test' – a reference to the business pages in old telephone directories, where subscribers were listed according to their service type – emerged in the United States in the mid-1990s. As the Governor of California, Pete Wilson, expressed it in 1996:

If a service provided by government is advertised by private companies in the yellow pages, it is a good candidate for privatization.²¹⁹

The following year, the 'Yellow Pages Test' was adopted into public administration in this country when the then Federal Minister for Administrative Services, David Jull, used the concept in announcing a root-and-branch review of his department. Jull argued that if government could find half a dozen existing suppliers of a service, then there should be a presumption against government providing that service itself.

While there may be some debate at the margin, this is a principle with which few would disagree. No one seriously suggests that state governments today should be involved in the business of insurance or banking, or the supply of printing services.

9.1.3 Franchising and Public-Private Partnerships (UK)

When capital investment is involved, governments sometimes exclude in-house teams from bidding because of financial constraints. When the Conservative government in the UK franchised rail passenger services in 1995, British Rail was excluded from bidding. Tenders were only sought from private firms. This approach may have been adopted because the franchising of passenger services was seen as a form of privatisation, but there is also some evidence to suggest that capital constraints and concerns at resistance to reform with British Rail may also have been significant factors.²²⁰

When the Blair administration decided to adopt and extend the Private Finance Initiative shortly after it was elected in 1997, the public sector was precluded from competing for these contracts. The reasons have not been made clear, but it appears that this was partly because the policy had originally been adopted with the intention of transferring construction and availability risk to the private sector and private finance was regarded as essential in that process, and partly because the

government wished to keep these projects off the government's balance sheet.²²¹

9.2 Mandatory Competition

Alternatively, governments may seek to create a competitive market with a diverse supply base. The objective is not to privatise or outsource, but rather to subject suppliers – public, private and not-for-profit – to the discipline of ongoing competition. In some cases, this might be because there is already a mixed economy, but one is not subject to effective competition. In other cases, it may be part of a strategy to 'market-test' public services that were previously supplied under an uncontested monopoly, with the objective of improving productivity.

9.2.1 Compulsory Competitive Tendering (UK, Sweden and Victoria)

Compulsory competitive tendering (CCT) imposes a statutory obligation on local authorities or other independent or semi-independent government agencies to subject their services to competitive tender. This approach was adopted by the UK government in local government and the National Health Service between 1980 and 1997, and by the Victorian government in local government from 1994 to 1999.

Britain. If the in-house team is permitted to bid, as they were in the United Kingdom, then this does not amount to compulsory outsourcing, but is rather a form of market-testing. The 1979 Manifesto of the Conservative Party declared that the objective of this policy was to reduce waste, bureaucracy and over-government. There was a sense of frustration among ministers that despite clear evidence that voluntary competitive tendering (VCT) had delivered savings, most notably in refuse collection, councils were still reluctant to expose their services to competition.²²²

Compulsion was introduced through the *Local Government Act*, which declared in the preamble that the purpose of the legislation was 'to secure that local and other public bodies undertake certain activities only if they can do so competitively'. Local authorities were prohibited from carrying out certain functions in-house unless they had subjected them to tender. Councils were obliged to accept the lowest price (unless there were clear reasons for not doing so), and they were prevented from taking 'non-commercial' criteria into account, such as an insistence on union coverage or the payment of national wage rates.

Legislation in 1980 had required local authorities to tender construction and maintenance. An additional seven services were opened up for competition in 1988 – refuse collection, building cleaning, street cleaning, schools and

welfare catering, staff canteens, grounds maintenance and vehicle maintenance, and in 1989, sports and leisure centres. This was extended in 1994 to housing management, legal services and construction and property services, and then in 1995 to information technology, finance and personnel services. At each stage, tendering was phased to ensure greater market depth.

Studies of VCT and CCT confirm that competition did result in a reduction in expenditure, although these studies were mostly focused on refuse collection and the evidence was mixed in terms of the impact on service quality.²²³ There was evidence that the policy had contributed to a more commercial culture in the management of these services and a greater sense of customer awareness, although not all regarded this as a positive outcome.²²⁴ Even the opponents of CCT acknowledged that it provided some benefits: the Association of Direct Labour Organisations (or DLOs, representing in-house teams) conceded that the initiative resulted in a focus on outputs rather than just inputs.²²⁵

However, there was strong opposition in local councils, even among Conservative-controlled authorities, who saw it as meddling by central government. Trade unions saw it (rightly) as an attack on their power. Critics claimed that lower costs were delivered through a reduction in quality and a direct assault on the terms and conditions of unskilled workers. Subsequent research has shown that, in some sectors, management reform did result in real productivity gains, but there was clear evidence of deterioration in workers' terms and conditions, resulting in strong opposition from the unions and concern among some private sector providers at the adversarial nature of the process.

Three quarters of first-round tenders were won by in-house providers, and in some parts of England, significantly more. In Labour-controlled councils, almost none of the competitions were won by external providers. The private sector argued that this suggested bias in the procurement process, so they were wasting resources in bidding. There is little doubt, however, that in some cases, DLOs won by reducing their costs, but the fact that in-house wins were so much more common in Labour councils does suggest that competitions were not always fair. In the mid-1990s, the Department of the Environment (which then had responsibility for local government), sought to regulate the market by establishing a complaints procedure for disgruntled bidders, with the prospect of Ministerial intervention, but this was rarely used.²²⁶

Privately, Labour politicians would acknowledge that CCT had brought benefits, but they were also aware of the many downsides. When the Blair administration was elected in 1997, CCT was abandoned and replaced by a

new policy of 'Best Value', which relied on performance benchmarks and exhortation in extending the use of competition, rather than competition.

Sweden. The municipal government of Stockholm introduced mandatory market-testing of social services in 1993, following a severe budgetary crisis. A budgetary directive of 1992 stated: 'The public monopolies are to be abolished as far as possible. There must be competition between activities conducted by the city and those under private auspices.' The following year, the district departments of the city were directed to expose their social services to competition through tendering over a five-year period.²²⁷

Victoria. The range of public services delivered by local government in Australia is significantly narrower than in the UK, and when CCT was introduced in Victoria in 1994, the threshold was applied to the totality of council expenditure – 20% was to be market-tested in 1994-95 and 50% by 1996-97. While councils were allowed considerable discretion as to how competition was conducted, the pressure on them to deliver savings was reinforced by rate-capping and rate reductions. Research suggests that basic wages were not reduced and that changes to terms and conditions resulted in increased flexibility in working hours, a reduction in overtime payments, the abolition of supplementary allowances (such as early start and travel time allowances) and the rationalisation of pay bands.²²⁸

9.2.2 Market-Testing (UK & NZ)

United Kingdom. In 1991, the UK government introduced a similar mechanism for central government, under which agencies were subjected to 'market-testing'. Because these agencies were under the direct control of government, no formal legislative intervention was required. The policy had been flagged as early as 1989 as an element of purchasing policy, but it was expanded in 1991 as part of the Citizen's Charter initiative. It was formally launched in a Treasury White Paper, *Competing for Quality*, in November 1991:

In recent years, private sector businesses have increasingly chosen to concentrate on their core business. They stick with what they know best. And they buy in specialist contractors to provide new ideas, more flexibility, and a higher level of expertise than could exist in a purely in-house operation. Public sector bodies are increasingly doing the same.

Competition does not mean invariably choosing the cheapest service: it means finding the best combination of quality and price which reflects the priority of the service.²²⁹

The Government's *Guide to Market Testing*, published in 1993, listed the following benefits of the program:

- competition helps ensure value for money
- focusing on performance outputs will produce clearer standards and improved quality of service
- an explicit customer/supplier relationship
- external and in-house bidders will be given an opportunity to be more innovative in their field
- monitoring of contracts and service level agreements will focus on the outputs, objectives and targets required in improving the efficiency and effectiveness of targets.²³⁰

By 31 December 1993, 389 individual services had been subjected to market-testing, resulting in annual savings of at least £135m. The government reported that of these 389 tests:

- 25 resulted in a decision to abolish all or a substantial part of the activity
- three activities were privatised
- 113 activities were contracted out as a result of a strategic decision to employ an outside supplier. No in-house bid was permitted in these cases
- where there was an in-house bid, 82 activities were contracted out and 147 were awarded to the in-house team
- six activities were restructured without a formal test
- 13 tests were withdrawn and efficiency gains made internally.

The report documented quality improvements and significant staff savings: for example, where in-house teams won, staff numbers were reduced by some 24%.²³¹

Market-testing has recently been adopted for the Prison Service. In July 2011, the government released its 'Competition Strategy for Offender Services', which announced its ambition to compete all offender services unless there was a compelling reason not to do so. As the Secretary of State for Justice stated in his introduction to that report:

...competition will apply to all services not bound to the public sector by statute, rather than as a means to select providers for new services or to address poor performance.²³²

The strategic principles underlying this staged program of market-testing were as follows:

- competition activity should be focused on achieving mid to long-term savings, not finding the cheapest solution at the expense of quality
- competition should be used to deliver public sector reforms, ensuring providers are more effectively held to account for the outcomes they deliver
- providers should be involved early to identify where efficiencies could be realised in national or process-based functions through competition
- small and medium sized enterprises (SMEs) and the voluntary and community sector (VCS) should be encouraged to participate to drive innovation
- competition should be widely applied, with public sector providers allowed to bid where they are competing for local services and robustly held to account where successful.²³³

The Prison Service has partnered with a private facilities management company and a third sector provider to bid for these contracts. Phase 1 of this program involved the re-tendering of two prisons that had been subjected to competition before, both of which were won by the incumbents (the Prison Service and a private company), a competition for a new PPP prison, and the market-testing of an existing public prison, which resulted in the first transfer of a publicly-operated prison into private management. The Ministry of Justice has reported that Phase 1 reduced the cost of provision of these establishments by 17%. Phase 2, launched in October 2011, will cover nine prisons, one of which is already managed under contract, and it is the department's objective to reduce operating costs by 11%.²³⁴

New Zealand. A report commissioned by the New Zealand from a 'Better Public Services Advisory Group' consisting of departmental secretaries and other senior figures from the non-government sector was published on 15 March 2012. Among other things, this recommended: 'a much clearer requirement for government agencies to market test their services, starting in areas where competitive pressure is likely to offer significant benefits (eg, where there are interested alternative providers, or where the scale of change is potentially large).'²³⁵

9.3 Incentives to Competition

Rather than making market-testing mandatory and driving reform from the centre, some administrations provide strong incentives to line agencies to improve their performance through competition.

9.3.1 Retained Savings (NSW)

In June 1995, the NSW government adopted a 'service competition policy' with the objective of delivering better services and better value-for-money in budget-sector agencies. As described in a memorandum by the then Premier, Bob Carr:

...service competition policy harnesses competitive forces to drive performance improvement and is one of a range of tools available to public service managers. It involves identifying and market testing suitable activities currently performed in-house and, where there are clear benefits in doing so, contracting with other parties to provide the services.

The memorandum was clear that contracting was not compulsory, although market-testing should be undertaken as part of formal business planning. In-house providers would be given 'every opportunity to compete on an equal footing' and preference would be given to external providers who provided employment opportunities for existing staff. Ministers were asked to ensure that the policy was appropriately applied and progress was to be monitored by the Premier's Department.²³⁶ Not a great deal of market-testing occurred under this policy.

9.3.2 Best Value (UK)

Following the election of the Blair government in 1997, compulsory competitive tendering was replaced with a policy of benchmarking local authority performance. The 'Best Value' framework, which came into effect in 2000, imposed a duty on local authorities to deliver economic, efficient and effective services. They were obliged to conduct internal reviews to demonstrate the fulfilment of their duties by comparing their performance with other public and private providers and challenging their methods of provision, including the consideration of competition. Local authorities were to be scrutinised by the Audit Commission, with rewards for those that performed well and intervention in those that were perceived as failing.

This was accompanied by a number of central government initiatives aimed at improving local government confidence and capability in the use of contracting and partnerships. A Local Government White Paper in 2006 stated the government's view that competition and contestability were key drivers of improvement, and encouraged local authorities to adopt a 'commissioning' approach to public services.

'Best Value' was only of limited success in encouraging

local authorities to expose their services to competition. A study in 2007, conducted on behalf of the Audit Commission, reported that council officers 'consistently rated the test of the competitiveness of services as the weakest element of their council's Best Value reviews'.²³⁷

9.4 Competition Policy

Where there is already some measure of independent sector provision, governments can assist in the development of a mature public service economy through the application of competition law and policy. Australia has been one of the world leaders in this regard, but over recent years, the UK government has begun to adopt a similar approach.

9.4.1 National Competition Policy (Australia)

National Competition Policy, introduced by the Council of Australian Governments in 1994, explicitly declared that each government was 'free to determine its own agenda for the reform of public monopolies'. However, where a service was already partially open to competition, or where competition was introduced into a sector traditionally supplied by a public monopoly, then governments agreed to be bound by a nationally-consistent policy.

In particular, where they decided to introduce competition into a market traditionally supplied by a public monopoly, or before they privatised such a monopoly, governments agreed to undertake a review into the:

- i.* appropriate commercial objectives for the public monopoly
- ii.* merits of separating any natural monopoly elements from potentially competitive elements of the public monopoly
- iii.* merits of separating potentially competitive elements of the public monopoly
- iv.* most effective means of separating regulatory functions from commercial functions of the public monopoly
- v.* most effective means of implementing the competitive neutrality principles set out within this Agreement
- vi.* merits of any community service obligations undertaken by the public monopoly and the best means of funding and delivering any mandated community service obligations
- vii.* price and service regulations to be applied to the industry
- viii.* appropriate financial relationships between the

owner of the public monopoly and the public monopoly, including rate of return targets, dividends and capital structure.²³⁸

Two other elements of the National Competition Policy were important in driving reform. Article 6 laid down a framework for Commonwealth legislation to establish an access regime for 'significant infrastructure facilities'. This enabled third parties to challenge public or private monopolies to provide access to key facilities such as ports, railways and water systems, where it would not be economically feasible to duplicate the facility.²³⁹

State governments also agreed to establish mechanisms for ensuring competitive neutrality where the public sector was engaged in 'significant business activities' and in so doing, competed with private organisations. In the years following the implementation of this Agreement, the competitive neutrality principle was invoked to challenge a number of public services, including the provision of meteorological services and the operation of nature reserves.²⁴⁰

9.4.2 The Office of Fair Trading (UK)

In the UK, competition law is set against the background of legal developments within the European Union. Public bodies are subject to the provisions on anti-competitive agreements and abuse of a dominant position when they are carrying out an 'economy activity'. The test for ascertaining whether an undertaking falls into this category does not rest on its legal form but the nature of the activity being undertaken.

Non-profitmaking activities can fall within the definition of 'economic activity' where they are 'commercial' in nature and they are or could be provided by the private sector. On the other hand, when a body is exercising public powers or undertaking activities that are exclusively 'social' in nature, then European competition law does not apply. Case law does not provide a clear definition of when an activity will be regarded as exclusively social, but the fact that private companies do not presently undertake that function does not preclude it from being considered commercial in nature. In a case involving 'employment procurement', German law prohibited parties other than public bodies from providing these services. These services were held to be an economic activity as they had not always been and did not necessarily have to be undertaken by public bodies.²⁴¹

While European competition law has no direct application in Australia, it does help to frame the ways in which British competition regulators view the public service economy, and that may have relevance here.

Since 2009, the Office of Fair Trading (OFT), one of two

competition regulators in the UK, has published a series of reports on competition in the public service sector. These reports have gone well beyond the usual questions of fair and open tender processes, and have addressed such issues as market design (including barriers to entry and exit), ensuring genuine choice, competitive neutrality and the application of competition law to public bodies. The OFT has become involved in this field because 'successive governments have made moves to open up greater choice for users of public services'. In one of its first publications in this series, it made clear that:

This report does not aim to comment on whether particular decisions to open up public service markets have been right or wrong, or provide a critique of government policies to date. Instead, the key aim is to identify general lessons that can be learnt from the experience so far. Drawing on these it then provides a framework for policy makers to help identify critical success factors when designing market mechanisms in public services.²⁴²

There is some evidence that the OFT's work has had some influence on the government's willingness to embrace competition and contestability. The Ministry of Justice's 'Competition Strategy for Offender Services' refers to its research in justifying a policy of market-testing offender services.²⁴³

9.4.3 The NHS Cooperation & Competition Panel (UK)

In 2007, the NHS laid down a statement of 'Principles and Rules of Cooperation and Competition' to assist in managing an increasingly complex system in which patients were being given choice of provider, NHS organisations were being given greater autonomy, and an increasing range of services were being procured from external providers. The ten principles were as follows:

- i. Commissioners must commission services from the providers who are best placed to deliver the needs of their patients and population
- ii. Providers and commissioners must cooperate to ensure that the patient experience is of a seamless health service, regardless of organisational boundaries, and to ensure service continuity and sustainability
- iii. Commissioning and procurement should be transparent and non-discriminatory.
- iv. Commissioners and providers should foster patient choice and ensure that patients have accurate and reliable information to exercise more choice and control over their healthcare

v. Appropriate promotional activity is encouraged as long as it remains consistent with patients' best interests and the brand and reputation of the NHS

vi. Providers must not discriminate against patients and must promote equality

vii. Payment regimes must be transparent and fair^f

viii. Financial intervention in the system must be transparent and fair

ix. Mergers, acquisitions, de-mergers and joint ventures are acceptable and permissible when demonstrated to be in patient and taxpayers' best interests and there remains sufficient choice and competition to ensure high quality standards of care and value for money

x. Vertical integration is permissible when demonstrated to be in patient and taxpayers' best interests and protects the primacy of the GP gatekeeper function; and there remains sufficient choice and competition to ensure high quality standards of care and value for money.²⁴⁴

The following year, the government established the NHS Cooperation and Competition Panel to apply these rules, chaired by Lord Carter of Coles, who had conducted a number of reviews on behalf of government into the structure of public services and scope for increased contestability. The panel reviews proposed mergers and acquisitions, joint ventures and other transactions between NHS organisations, it investigates complaints about the conduct of service providers and commissioners, including the impact on patient choice and competition, and it addresses procurement disputes. It also provides the Department of Health with advice on policy issues related to competition and cooperation.²⁴⁵

9.4.4 Other Competition Regulators (UK)

Other competition regulators have involved themselves in the public service sector from time-to-time. In 2006, for example, Ofcom, the communications regulator, initiated an inquiry into the cost of in-bound calls to bedside telephones in NHS hospitals, following a number of public complaints. On its own initiative, Ofcom broadened the investigation into the full range of services provided under the concessions granted by the NHS to two providers of pay-per-use personal bedside television and telephony in public hospitals. The cost of outgoing calls was capped and some television services (such as children's television) were to be provided free of charge, so providers were obliged to charge more for incoming calls to cover their investments (up to 49 pence per minute). Ofcom heard evidence that in some cases, providers had applied to

^f The rationale behind this and the next principle were to ensure a 'fair playing field' for all providers.

have limitations imposed on the use of mobile phones within the hospitals.

Ofcom did not make a formal finding as to whether or not the agreements were in breach of competition law, but following discussions with the Department of Health, the latter agreed to review the terms of its concessions. Among other things, parties were exploring the addition of a recorded voice message at the commencement of each call, advising users of the cost.²⁴⁶

9.4.5 The General Agreement on Trade in Services (GATS)

From around 2000, Australia used the negotiations under the General Agreement on Trade in Services (GATS) to drive the internationalisation of the education sector, although such support for free trade in education services was not without its critics:

Critics focus on the threat to the role of government, the 'public good' aspect of higher education, and the need to safeguard high-quality education. It is also argued that there are considerable dangers in education policy issues being increasingly framed in terms of trade and economic benefits. Supporters of freer trade in education service, on the other hand, highlight the benefits that more trade can bring in terms of innovations through new providers and delivery modes, greater student access, and increased economic gain for providers and their countries.²⁴⁷

9.5 Supply-Side Initiatives

9.5.1 The 'Mixed Economy' (UK)

Tony Blair and his advisers had used the term 'mixed economy' long before they were elected to government in 1997.²⁴⁸ But it was not until after the 2001 election that the term began to be widely used by New Labour modernisers to describe their ambition for a public service economy populated by a diverse array of private, voluntary and public sector providers.²⁴⁹

The term was employed by the then Health Secretary, Alan Milburn in 2003, to explain the government's proposal to create NHS Foundation Trusts for the management of public hospitals, and thereafter embraced by the Prime Minister. Tony Blair wrote around the same time:

We must be far more radical about the role of the state as regulator rather than provider, opening up healthcare for example to a mixed

economy under the NHS umbrella, and adopting radical approaches to self-health. We should also stimulate new entrants to the schools market, and be willing to experiment with new forms of co-payment in the public sector.

'In achieving reform, we need to clarify the balance between bottom up reform, and command and control approaches in restructuring public services. For example, the principles underlying Alan Milburn's espousal in the UK of community-owned Foundation hospitals need to be applied far more systematically across the public sector.'²⁵⁰

The concept of Foundation Trusts had originally been raised as a form of 'earned autonomy', a means of devolving power to front-line and rewarding high-performing hospitals. It arose out of a meeting that Milburn had with the chief executives of three-star NHS Trusts who had graphically described the red tape under which they operated, and the model was initially promoted as a third way between state-run hospitals and shareholder-owned private enterprises. Whilst still part of the NHS, Foundation Trusts are free-standing legal entities with boards of governors drawn from the local community and staff. They are managed with a great deal more financial autonomy than traditional NHS hospital trusts, and less onerous reporting requirements and they are authorised and monitored by an independent regulator.

School academies, a kind of 'independent state school' that had been launched by the then Prime Minister prior to the 2001 election, were quickly identified as yet another example of a social enterprise that would contribute to the mixed economy.

Around 2004, the government also began to promote a new form of not-for-profit institution, the 'community interest company', as a vehicle for facilitating the entry of social enterprises into the public service sector. Enabling legislation was passed in 2005. CICs were designed to enable social enterprises to take advantage of the corporate form. Unlike charities, their directors could be paid a salary, and they did not benefit from tax exemptions. Government assistance was also provided to voluntary sector organisations to assist them in developing the capability to participate in competitive tenders and comply with the demanding performance conditions of service contracts.

This period also saw the emergence of the first joint ventures. Working Links was established in 2000, a public-private-voluntary joint venture delivering services in the welfare-to-work market. The government share is held by the Shareholder Executive, the private owners are Manpower and Capgemini, while the voluntary sector

partner is Mission Australia. Private-voluntary joint ventures have since been established in offender management, and public-private joint ventures in the NHS.

9.5.2 Public Service Mutuals (UK)

Prior to the 2010 election, the Conservative Party issued a policy in which they committed themselves to the establishment of employee-owned cooperatives in the public service sector.²⁵¹ The 'Open Public Services' White Paper released by the government in July 2011 developed the model further:

We are giving public sector staff new rights to form new mutuals and bid to take over the services they deliver, empowering millions of public sector staff to become their own bosses. This will free up the often untapped entrepreneurial and innovative drive of public sector professionals.

Ownership and control, through mutualisation, empower employees to innovate and redesign services around service users and communities, driving up quality. We will not dictate the precise form of these mutuals; rather, this should be driven by what is best for the users of services and by employees as co-owners of the business. Options include wholly employee-led, multi-stakeholder and mutual joint venture models.²⁵²

In early 2011, 21 'pathfinder' public service mutuals were announced and a 'Mutuals Taskforce' was announced to develop the concept and the evidence, chaired by Professor Julian Le Grand of the London School of Economics.²⁵³ In December 2011, the Cabinet Office launched a £10 million fund to assist employees in developing the business case for mutualisation and addressing organisational, financial and legal issues.

9.6 Supplier Initiation

In some jurisdictions, public, private and voluntary sector providers have been provided with an opportunity to submit formal proposals for market-testing or public services or for otherwise challenging traditional provision through a public sector monopoly. There are two known examples:

9.6.1 Market-testing (Japan)

In 2004, the Japanese Prime Minister, Junichiro Koizumi, established a 'Council for the Promotion of Regulatory Reform', made up of leading figures from the private

sector and the academic community to consider the 'opening of government-driven markets to the private sector'. One of the Council's proposals, later endorsed by government, was a system of market-testing, in which 'the list of the targeted services for each year [would] be decided based on a wide range of applications from the private sector'.

Submissions were to be scrutinised by individual offices or ministries, with an obligation to provide reasons for any proposals rejected. If accepted, a competitive tender would be held between public and private sector organisations, with the entire process overseen by an independent monitor.²⁵⁴ It is unclear how widely this process was used.

9.6.2 'Right to Provide' (UK)

In its 'Open Public Services' White Paper, released in July 2011, the UK government announced that it was creating a 'right to provide' to public sector workers (and NHS staff in particular) who wished to form mutuals or cooperatives to deliver public services. Under this scheme, NHS staff have a right to submit an expression of interest to the board of the organisation by whom they are employed which, if accepted, would entitle them to prepare a business plan demonstrating financial viability. In some cases, though by no means all, it would be necessary for the board to conduct a competitive tender.²⁵⁵

And in November 2011, the *Localism Act* established a 'right to challenge', obliging local authorities to consider expressions of interest from voluntary (not-for-profit) and community bodies, and council employees, to establish a mutual organisation to deliver identified public services. Local authorities are obliged to give consideration to such expressions of interest, with the options of acceptance, rejection or (subject to the agreement of the proponent) modification. If accepted, a procurement exercise must be carried out in accordance with the law relating to the awarding of contracts. Limited grounds for rejection are to be laid down in regulation.²⁵⁶

9.7 Conclusions

There is now little support amongst policymakers and public service companies for compulsory competitive tendering. It is a crude instrument which encourages gaming behaviour on the part of reluctant procurement authorities and thus wastes the resources of companies that prepare bids. In the UK, it had the effect of driving down the terms and conditions of workers rather than encouraging innovation in management and service delivery, and it resulted in political controversy that altered public perceptions of competition and contracting for the worse.

Given the framework of diversity and contestability adopted in this report, it will come as no surprise that the author prefers a 'mixed economy' model for reform, similar to that adopted by the Labour government in Britain following its election in 1997. This would introduce greater competition into the public service economy, whilst seeking to build a more diverse supply side. It would concentrate on building the capacity of public and not-for-profit providers, whilst also educating private suppliers about government's expectations of them in delivering social services.

For the reasons mentioned above, there may be services where government will elect to withdraw from the market rather than seeking to compete. And there may be

services where policy considerations mean that contestability will be the most appropriate model. Decisions about what services should be opened to competition from the private and third sectors, what contractual and market models should be employed, and whether support activities, front-line services or entire agencies should be identified for competition are matters that must be decided by policymakers with reference to social, economic and political considerations.

However, this report does recommend that governments adopt an explicit policy of moving to increased diversity and competition in the state's public services, and that central agencies develop the capabilities to carry such a policy into effect.

10. Effective Commissioning

Over the years, there have been a great many reviews of competition and contracting, and even more post mortems of unsuccessfully executed procurements. A substantial literature has been generated by practitioners and academics about what needs to be done if competition is to be done well. It is not proposed to republish that advice in particular detail, however, there are a number of issues that must be addressed if government is to set about building a mixed economy.

10.1 The Demand Side

10.1.1 The Art of Commissioning

The term 'commissioning' has been used frequently throughout this report. It is not a term that has great currency amongst Australian policymakers, but if competition and contracting are to be done well, then the concept needs to be properly understood by public officials and fully embraced.

Commissioning is not just a synonym for procurement. The term came into use in the United Kingdom around 2002, at a time when public officials were starting to take a more strategic view of public service markets. It emerged from a conversation about long-term capacity planning and the design of markets that were more competitive and sustainable.

The Office of Fair Trading has defined commissioning as including strategic needs assessment, decisions about program objectives and the priorities attached to them, and the design of models for service provision. They note that commissioners may include ministers and senior policymakers, while procurement officers are those concerned with the actual purchasing of services.²⁵⁷

The Third Sector Research Centre has described it as 'a broader set of service delivery processes which involve consultation, needs assessment and service planning and design. If procurement is about shopping, commissioning is about deciding what to buy and how'.²⁵⁸

Commissioning involves making decisions about the outcomes which public services are expected to deliver, the level at which they will be procured and delivered (local, state or national), the system through which they will be obtained (competition, contestability or monopoly), and whether or not they will be purchased within a single agency or commissioned across departmental boundaries.

If competition is involved, then commissioners must decide what kind of market it will be (competition in or competition for the service). They must establish what steps will be taken to ensure that the market has sufficient depth and diversity.

They will also be responsible for other aspects of market design – whether there will be a single public authority purchasing services in bulk from suppliers under term contracts, or whether suppliers will be permitted to offer their services in a spot market; or whether instead of outsourcing, they will organise a competition for a joint venture partner, or assist existing providers to establish a public service mutual.

Commissioners are responsible for designing the overall procurement strategy. What weighting will be given to price and quality, the extent to which reputation will be taken into account, and what kind of procurement methodology will be best suited to the service in question.

They must assume also the responsibility for designing the ongoing management regime, and ensuring that the contract remains appropriate as external conditions change. Adrian Benepe, Commissioner of the Department of Parks and Recreation in New York City, which engages in a range of innovative public-private partnerships in that city, has argued that a commissioner must serve as a champion of the partnership within government, as well as an agent of government in overseeing its delivery.²⁵⁹

The UK's Institute for Government has coined the term 'system stewardship' to describe the key challenges involved in the commissioning process. They incorporate within its reach the extent to which a service will be devolved, the need for uniformity in delivery and the complexity of the service in question.²⁶⁰

Competition and contracting cannot be done well if serious attention is not given to commissioning. The state government should embrace the concept of commissioning, develop a comprehensive understanding of the issues that are involved and ensure that those responsible for these functions are appropriately trained and empowered to exercise these functions.

10.1.2 Market Design

As public service contracting has become more complex, in terms of scale, complexity and proximity to the front line, commissioners have found it necessary to focus on the design and management of markets, rather than just individual procurements and contracts. This was first evident in the UK around 2002, as public officials began to recognise the advantages of taking a more systemic approach to the development of the public service economy.

In fact, policymakers and procurement officers had been grappling with these questions for some time, but there had been a reluctance to admit that government was responsible for the design and management of these emerging markets.

Britain's First PPP Prisons

In 2001, when the first two PPP prison contracts were let, officials in the Prison Service understood that they were making a market rather than just conducting a procurement. So when one consortium offered the lowest price for both prisons, the commissioners elected to award the second prison to the bidder with the second lowest price. This decision was later endorsed by the National Audit Office, since it would result in lower costs in future competitions for PPP prisons.²⁶¹

In 2002, the Office of Government Commerce was tasked by the Chancellor of the Exchequer with investigating how to improve competition and encourage long-term capacity planning in markets where government had significant purchasing power. Its subsequent report, which followed extensive consultation across government and industry, was the first time that government had squarely addressed the question of market design and management:

...we believe that the public sector needs to take a much more systematic and strategic approach to the markets in which it operates, and not just to focus on individual procurements. That requires much greater exchange of information between different departments and other parts of the public sector than generally happens at present, both about likely demands on industry capacity and about the performance of individual suppliers. It also requires a greater willingness to take a view about the market structures best suited to competition and security of supply, and a willingness to use legitimate ways of influencing those structures.²⁶²

This approach was soon adopted across the rest of government. For example, in 2006, the Department of Communities and Local Government published a report on 'Developing the Local Government Services Market to Support a Long-Term Strategy for Local Government', and the Department for Education and Skills commissioned a series of reports analysing the various markets for children's services.²⁶³ In July 2008, the Department for Business Innovation published a report on the 'public service industry' estimating its contribution to the national economy and around the same time, the Office of Fair Trading started publishing a series of reports on the application of competition policy to the public service economy.²⁶⁴

In a recent review of the challenges involved in market design, Blatchford and Gash arrived at the following conclusions:

- implementing choice and competition requires market makers to make a mental shift from being in direct control of a policy to stewarding markets and enabling them to function
- market tests need to expose and address both political and practical challenges of implementing new market-based models
- market makers should use a wide range of methods to test new commissioning models and should experiment with different ways of designing markets. An escalated approach – whereby cheaper 'light-touch' appraisal methods are used to flush out issues that are then investigated with more rigorous tests – can be helpful here. It is important to be precise about what is being tested throughout this process
- market makers need to embrace radically new ways of working. Testing and implementing new commissioning models requires a far higher level of cooperation across departmental functions
- policymakers must work closely with political staff, operational managers, commissioners, procurers and legal, financial and IT professionals – often in mixed teams
- some of the most thorough market tests have involved heavy engagement with the provider community, service users, other government departments and local government. Openness to wider experience appears to be essential for success
- using the appraisal process to develop relationships and clarify and respond to the concerns of stakeholders whose support is essential for the effective operation of publically funded markets is equally essential for long term success
- market makers should not underestimate the scale of time and resources needed to test the applicability of new commissioning models
- once new market-based models have been introduced they will still require ongoing assessment or 'stewardship' to ensure that they are delivering value.²⁶⁵

10.1.3 Procurement

Contracting for complex public services using the diverse range of business models discussed in this report will demand a great deal more of government procurement officers than in the past. There continues to be criticism of procurement officers for the way in which they manage tender processes, even where complex contracting models have been employed for many years. For the most

part, this is not because the lessons have not been learned, but that the complexity of the services in question and the contract models employed has continued to develop over time.

The extent to which these high-level capabilities should be centralised (as they were, for example, with Partnerships Victoria) is a second-order issue that should be resolved case-by-case. Where it is government's intention to develop more competitive public service industries, it will be necessary to develop procurement and commissioning capabilities within line departments, but there are certainly some commercial capabilities that do not need to be replicated across government. In instances where public service companies increasingly cover more than one sector, there will also be advantages for government in managing relationships with major providers at a strategic level.

Career advancement is often a problem for procurement specialists, and government needs to consider this question from a whole-of-government perspective. Consideration might be given to establishing a 'procurement service' within the Public Service as a whole, or at least creating a professional network of procurement officers within the state government. There are core capabilities, such as the design and management of performance incentives that are central to the success of service contracting, and these deserve to be studied and the lessons disseminated across the procurement service as a whole.

10.1.4 Contract Management

There is a temptation, in the private sector as well as in government, to assume that because a function has been contracted out, the responsibility for successful delivery has been shifted to the provider. This might be possible with simple support services, but such an approach will not work for complex public services, particularly where the external environment is changing.

The discipline of contract management must be better developed within government, and where complex public services are involved, commissioners must accept their ongoing obligation for ensuring that government policy is given effect. While they must not meddle in the management of the service to the extent that they become responsible for its performance, it is vital that they retain an active oversight.

The conditions for successful delivery must be kept firmly in mind in the final stages of the procurement process when negotiations become highly adversarial and fall under the influence of legal advisers. Important though these aspects of the procurement process are, they should not be allowed to compromise effective service

delivery and the ongoing relationship between commissioner and provider.

10.2 The Supply Side

If public service markets are thought of as 'free markets', then government has few obligations in relation to the development of the supply side. Its obligations will extend little beyond licensing and regulation.

If, on the other hand, these markets are viewed as government's supply chain, operating in much the same way as the suppliers to a large automotive manufacturer, then commissioners must have an active interest in the design and management of the supply side. This will particularly be so where the services in question are not commoditised and thus are not readily available in the wider market.

In many public services, the relationship between commissioner and provider is a partnership rather than an arm's length commercial relationship, and the contract is primarily relational rather than merely transactional. The term 'public-private partnership' is entirely appropriate for such relationships, and it is unfortunate that this term has acquired a specific meaning associated with the delivery of physical infrastructure, crowding out a richer discussion of these complex relational contracts.

10.2.1 Private Sector

Much of the concern about private sector involvement in the public service economy is based on an assumption that companies will adopt aggressive commercial strategies that will compromise broader social policy objectives and undermine their ability to work with clients who are often highly vulnerable.

This caricature overlooks the ability of corporate executives to understand the need for a public service ethos in the delivery of public services and their capacity to adapt their organisations to suit. Successful public service industries in Australia and the UK have seen the emergence of specialist public service companies that draw heavily on former public servants for their workforce. This is particularly the case where robust transmission of business laws are in place, facilitating the transfer of a large proportion of the former workforce.

In some sectors, such as corrections, where contractors have recruited overwhelmingly in the private sector, they have still been able to create a public service ethos that matches and in some ways exceeds that of their public sector counterparts.

Whether or not private firms respond in this way depends to a considerable extent on the success with which government communicates its expectations and the

approach that public service commissioners take in managing their supply chain. Commissioners are entitled to expect that private sector providers will develop a public service ethos, and that they understand the expectations of accountability and integrity that prevail in a public service economy.

In the search for suitable partners, commissioners have a responsibility to explain to potential providers the qualities that will be expected of them and their employees whilst they are involved in delivering core public services. In the selection of a preferred bidder, they have an obligation to speak to the company's existing public sector customers, and to take into account past experience and corporate reputation. In the ongoing management of service delivery, they have a duty to punish poor performance and unacceptable behaviour. Private providers will respond to reputational incentives and adjust their business models accordingly.

10.2.2. Voluntary Sector

There are many public services where community sector organisations will be central to successful delivery, whether as the agents of government, the partners of private companies or as service contractors in their own right. In the author's opinion, this has less to do with culture and ethos than with the unique skills and capabilities that they bring to the delivery of social services, in particular, their understanding of and connection to particular communities.

Some large community organisations have little need for government assistance in making the transition from a grant-based model to a contractual one. But many small providers will require significant assistance in the development of management information systems and in building financial and administrative capabilities in order for them to successfully cope with a performance contracting regime.

Government may develop these capabilities in-house, or they may assist in their development through joint venture and integrator models as discussed in this report. Whichever approach is adopted, commissioners must accept their responsibility for developing these capabilities among community providers if they wish to build a diverse supply side.

10.2.3 Public Sector

Much the same applies to public sector organisations. If government wishes to build or maintain a mixed economy, then consideration must be given to building their commercial capabilities. Where in-house teams will be invited to participate in a tender, they may need assistance and training to prepare a competitive bid.

Other options include conversion to a social enterprise, management or staff buy-outs with a period of exclusivity (including public service mutuals discussed in Section 9.5.2), and public-private joint ventures.²⁶⁶

10.3 Transition Issues

The transition from public to private management following a competitive tender, or from one private provider to another, is often critical to the success or failure of a public service contract. In some cases, this is because there are unique human or physical assets that must be transferred between providers if competitive tension is to be maintained throughout the life of the contract. However, with complex public services, where people are the heart of the business, the manner in which staff are consulted and their concerns addressed will sometimes be central to success or failure of the service itself.

10.3.1 Staff Relations

In the private sector, the quality of service delivery (and thus commercial success) is heavily influenced by the quality of the people employed in working with the customer. In the public service sector, where 'customers' or beneficiaries are often vulnerable, the quality and the morale of the teams engaged in front-line delivery matter so much more. It follows that responsible providers will not want to shed skilled workers, weaken staff morale or undermine the commitment to client service that are fundamental to the delivery of high quality services.

Policymakers have an obligation to design commissioning and contract management processes that reinforce this commitment to quality people. There is always scope for innovation in the deployment of staff and the admixture of terms and conditions, but in the pursuit of greater efficiency, commissioners must be careful not to design a competitive and contractual environment where providers are forced into a 'race for the bottom' in relation to workers' terms and conditions.

In the design of an overarching policy framework for competition and contestability, government must have regard to staff and workplace relations. This is not to say that the human resource issues should be allowed to act as a barrier to reform, but rather, that communication with workers and their representatives, and the transmission of terms and conditions and union coverage, should be seen as strategic issues to be addressed well in advance.

The protection of employee entitlements upon the acquisition or transmission of a business (whether in the public or private sector) has traditionally been an important part of Australia's workplace relations

framework. For this reason, transfer of business legislation also plays a prominent role in comparable international jurisdictions, such as the United Kingdom and New Zealand. Without such protections, employee and union resistance to the transfer of operations between companies, and the contracting of services and functions, would be deeply disruptive of commercial operations and customer service.

There are, however, other reasons why governments should be concerned about the protection of workers' entitlements during a transmission of business:

- i. Unless there is a clearly-stated policy on this issue, governments face the prospect of paying higher prices, since bidders will include a contingency for possible redundancy payments should they lose the contract at the end of the first term. If, as is usually the case, the majority of workers continue their employment, then government will have financed a windfall for workers whose jobs were never seriously at risk. If, as is often the case, the incumbent wins the contract again at rebid, then the contingency charge will flow through to the contractor's bottom line
- ii. In the case of specialised public services, key workers might be regarded a unique asset, so that without some kind of transmission policy covering the rebid, there could never be another competition. In those circumstances, it would be better if government did not contract the service in the first place.

The National Physical Laboratory (UK)

The National Physical Laboratory (NPL), the UK's national metrology laboratory, employs 300 or 400 of Britain's top scientists. If, when that facility was first contracted, these scientists had irrevocably transferred to the private provider who won the tender, there could never have been an effective re-competition.

However, because of Britain's transmission of business laws and the GOCO model adopted for NPL, if another company had won the rebid, ownership of the legal entity which employs the scientists would have transferred to the new contractor, with their terms and conditions intact. The only personnel changes would have been a thin layer of management at the top. In this case, transmission of business laws enabled government to market-test public services that should otherwise not be opened up for tender.

The Australian federal government introduced comprehensive 'transfer of business' laws in 2009 as part of the *Fair Work Act*, which serve to protect employees' terms and conditions where:

- the business (or part of a business) that employees work for is transferred from one employer to another
- there is an outsourcing of an employer's workforce
- an outsourcing arrangement has ceased, and employees return to work for the employer who originally outsourced the work.

These provisions are broader in their effect than the previous law since the event that triggers the protection framework is the transfer of work (and employment), rather than the formal transmission of a business. The *Fair Work Act* does not, however, apply to the majority of employees engaged by the NSW government. This is because most state government employees are employed directly by the Crown in right of NSW, which is not subject to the provisions of the Commonwealth legislation.

NSW legislation (specifically, the *Industrial Relations Act 1996*) does contain provisions protecting employee entitlements during a transfer of business, but it does not apply to non-NSW government entities, as they are now bound by the provisions of the *Fair Work Act*. Accordingly, if the state government were to outsource certain operations to a private sector organisation, any transferred employees would fall into a gap between the two systems of law. The *Fair Work Act* applies only to workers who transfer between two employers in the national system, and the *Industrial Relations Act* cannot impose obligations on private and not for-profit organisations who take on the transferred employees. Any transfer of NSW government employees falls outside of state and federal transfer of business legislation.

In the past, this question has been dealt with case by case. Further, as the transmission of business has occurred so infrequently in the NSW public service sector, there appear to be no general rules governing the process. For example:

Parklea Prison. When the management of Parklea Prison was contracted in 2009, the incoming provider was obliged under the terms of the contract to offer all existing staff to participate in the selection process, and existing staff were given priority over external applicants of equal merit. Existing staff who were accepted by the contractor were required to resign from the department, and were paid any recreation and long service leave entitlements, along with a 'transitional payment' based on length of service (up to 30 weeks' pay for six years or more of service). Their salaries were protected for a period of 12 months, and the department paid the new operator of the prison a 'recruitment support payment' reflecting the difference between the base remuneration paid to staff by the contractor, and the base salary that would have been paid by the department. Staff unsuccessful in securing a

position with the new provider were offered a position elsewhere in the department, although they could accept voluntary redundancy. There was a brief dispute between the Miscellaneous Workers Union, which already covered the new provider's staff at Junee, and the Community and Public Sector Union, the federally-registered union affiliated with the Public Service Association, which had previously represented the prison staff, which was settled without any impact on services.²⁶⁷

Sydney Ferries. Negotiations between the Ministry of Transport and Unions NSW over Sydney Ferries have resulted in the protection of employment and terms and conditions for skilled, front-line workers for a period of two years. Back office workers not be covered by this arrangement will receive redundancy payments. In this case, the principal award was due to expire before the tender process had been completed and the government elected to renegotiate the award early in order to provide bidders with greater certainty as to their labour costs. Union coverage will not be affected by the transmission of business to the new provider.

If the government were to enter into a more extensive program of competition and contestability, then it would be desirable to negotiate for the establishment a universally applicable framework for the protection of employee entitlements, and for the transfer of union coverage. A range of possible frameworks are available and include:

United Kingdom

In the UK, the *Transfer of Undertakings (Protection of Employment) Regulations 2006* (TUPE) impose certain obligations on employers where an undertaking is transferred from one employer to another. In particular, TUPE requires that, on every transfer:

- employment contracts with an old employer 'shall have effect after the transfer as if originally made between the person so employed and the [new employer]'
- collective agreements that applied to an old employer (in respect of transferring employees) are deemed to apply to the new employer
- unions recognised by the old employer as representatives of the transferring employees must be recognised by the new employer to the same extent
- where an employee objects to the change of employer, the employee is not taken to be employed by the new employer. However, the employee is also not deemed to be dismissed by the old employer (thus avoiding the operation of unfair dismissal legislation)
- employees whose employment is transferred to a new employer can agree with the new employer to vary

their contract of employment to take into account economic, technical or organisational reasons pertaining to changes in the workforce.

The effect of the TUPE regulations is that, upon any transfer of an undertaking, employees are automatically transferred across to the new employer – regardless of the intention of the employers. The employee's contract remains on foot, and is automatically deemed to constitute a contract of employment with the new employer.

New Zealand

In New Zealand, all employees in specified 'vulnerable' groups are afforded protections upon a transfer of business pursuant to the *Employment Relations Act, 2000*. The protected groups include employees engaging in cleaning services and food catering services in any place of work; laundry services for the education, health or age-related residential care sector; orderly services for the health or age-related residential care sector; and caretaking services for the education sector.^{***}

These identified groups have a *right* to transfer to a new employer if:

- they will no longer be required to perform all or part of their work for their existing employer because of a restructuring, and
- the new employer will perform the same type of work, or work that is substantially similar, to the work performed by the old employer.

Employees are able to choose whether to transfer to the new employer on their existing terms and conditions or stay with the current employer.

Where employees decide not to transfer to the new employer, this may result in the existing employer making the employees redundant. Where employees have transferred, and the new employer does not require their services, the new employer will be required to make them redundant. These provisions apply equally to New Zealand public sector and private sector outsourcing and restructuring.

Australia (Fair Work Act)

Unlike transfer of business legislation in New Zealand and United Kingdom, the *Fair Work Act* does not require a new employer to engage any employees of the existing employer, whose business has been transferred (or work outsourced). It is entirely a matter for the new employer to determine who will be made an offer of employment. Where a 'transfer of business' is deemed to occur, the legislation:

- specifies that the terms of any enterprise agreements or enterprise awards (that is, awards which name

^{***}Why these groups should be considered vulnerable is far from clear, and it is probable that the list was influenced by political issues at the time.

particular employers as respondents to the award) which applied to transferring employees prior to a transfer of work, continue to apply after the transfer. As such, the new employer automatically becomes bound by such enterprise agreements or enterprise awards in respect of transferring employees

- does not provide for any transfer of contracts of employment from an old employer to a new employer. Rather, any employees who transfer to the new employer must terminate their contract with the old employer (whether by way of resignation or dismissal) and commence employment with the new employer pursuant to a new contract of employment
- does not compel new employers to hire the workforce of the old employer. Where employees choose not to accept employment with the new employer, the existing employer will be obliged to make the employees redundant (unless the old employer wishes to continue to employ the employees).

However, the Act exempts an existing employer from the obligation to make severance payments in respect of redundancies where:

- there is a transfer of business; and
- an employee refuses to work for the new employer; and
- the new employer has made an offer of employment to the employee on terms and conditions that are, on an overall basis, no less favourable than the employee's existing terms and conditions; and
- the new employer has offered to recognise the employee's service with the existing employer as continuous service with the new employer for the purposes of calculating any future redundancy entitlements;
- ordinarily has the effect that a new employer must recognise service with existing employers as continuous service with the new employer for the purpose of service related entitlements such as annual leave, personal leave, long service leave (this is required in order to ensure that the offer of employment is on 'no less favourable terms').

The *Fair Work Act* does not automatically permit new employers to renegotiate the terms of an enterprise agreement or enterprise award after a transfer of business. If employers wish to alter the terms of such industrial instruments, they are required to comply with the Act's enterprise bargaining framework (which requires, amongst other things, the majority of the employees covered by an enterprise agreement to approve changes to the agreement in order for any variations to the

agreement to be made). The prevalence of statutory instruments in Australia (such as enterprise agreements and enterprise awards) requires a strict statutory process to be adhered to in order to amend such instruments. For instance, there are legislative requirements regarding how proposed changes to instruments are to be notified to the workforce, how voting is to be conducted on the variation, and the quantum of votes required to approve a variation to an industrial instrument.

New South Wales

No NSW collective agreements or awards will be binding upon a new employer, given the lack of transfer of business provisions relating to NSW public sector transfers. However, given that protection of employee entitlements are now commonplace in the private sector and federal public sector, the state government will need to make a binding commitment to relevant trade unions, agreeing to protect employee entitlements, in order to facilitate potential competitions. Any such commitment will be complicated by the large number of specific awards or collective agreements which apply to the employment of NSW government staff.

In any particular competition, tenderers will need to be informed of the specific industrial instruments ('pre-existing instruments') applicable to those government staff whose work is to be tendered, so that the cost of employee entitlements can be calculated. Indeed, this will form a critical part of any due diligence.

There are three broad ways in which entitlements might be protected:

1. Enter into an enterprise agreement following the competition

The government might commit to maintain employee entitlements by making it a condition of the service contract that the successful tenderer:

- takes practical steps to enter into an enterprise agreement with its workforce in terms which are identical to the pre-existing instruments; and
- enters into contracts of employment which match terms and conditions of employment under the pre-existing instruments for the period from the commencement of work for the successful tenderer and the time when a new enterprise agreement is approved. During this period, the new employer would need to ensure that any federal awards which might apply to the workers were complied with. (Awards cannot be contracted out of, but do not apply once an enterprise agreement applies to a workforce).

Provided that an enterprise agreement could be negotiated following the transfer, the employees would

have transitioned their state-based terms and conditions of employment into the Federal workplace relations system.

There are a number of potential problems with this approach. Concerns would arise if, following contract award, a successful tenderer was unable to reach agreement on the terms of a new enterprise agreement. If a majority of employees were dissatisfied with the progress of negotiations, they might commence legally protected industrial action in an attempt to force agreement with their demands.

To avoid the potentially crippling effect of industrial action on key public services, the government would need to reach an accord with all relevant unions prior to any tender, in respect of the terms and conditions of employment that would be negotiated with the new tenderers. The government would then need to rely upon the unions to encourage employees to approve the new enterprise agreement and to discourage industrial action.

2. Introduce an enterprise agreement prior to transfer

If the contractor already has a relevant workforce, they might seek to make an enterprise agreement with existing staff in respect of the transferring work (that is, the work currently performed by the government). The agreement would need to be made prior to transfer, and expressed so as to cover all employees who performed that work. If there were no existing staff that could perform the work, the new employer might engage employees to perform the work, so that an enterprise agreement could be formally implemented.

This approach would ensure that, once employees transferred from the government to the new employer, the employees would:

- automatically be covered by the enterprise agreement already in place in the new employer's business; and
- be unable to take protected industrial action against the employer for the duration of the enterprise agreement.

Where an enterprise agreement regarding the transferring work is not already in operation within a successful tenderer's business, the timing of the implementation of the enterprise agreement will be critical. In practice, it can sometimes take a considerable period of time to implement an enterprise agreement within a business (it is not unusual for the bargaining and approval process to take up to eight weeks even for straightforward bargaining processes). Accordingly, a timeframe will need to be allocated within the tender process to ensure that an enterprise agreement can be effectively implemented

into the successful tenderer's business prior to the transfer of employees taking place.

Importantly, the new employer must ensure that any enterprise agreement implemented in its business creates terms and conditions of employment that are no less favourable overall than those the government employees presently enjoy. If not, then any employees who refused to accept employment with the new employer would be entitled to redundancy payments from the government. This approach would provide the smoothest transition of the public sector workforce.

3. Enter into common law contracts with employees

Another way in which the government might commit to maintain employee entitlements would be by making it a condition of any service contract that the successful tenderer entered into ongoing contracts of employment with employees which match existing terms and conditions. This approach would not require the negotiation of new industrial instruments, however it has some complications:

- It would leave the new employer exposed to the ongoing threat of industrial action.
- The employer would need to continually ensure compliance with any underlying federal awards (which cannot be contracted out of).
- There would be little capacity to amend contracts of employment after their implementation, as such contractual amendments would require re-negotiations with the workforce on an individual basis.

Union coverage

One source of uncertainty during a transition of business is the question of union coverage, and while this will be a concern for workers, it is perhaps of greater concern to union leaders who fear a loss of membership. There are a number of unions in Australia who already cover both the public and the private sectors, but in other cases their constitutions may require amendment. Many NSW government employees are represented by the Public Service Association of NSW (PSA), whose constitution confines representation to 'employees of the Crown'.

However, the *Industrial Relations Act 1996* (NSW) makes provision for the alteration of union rules and it is clear from the PSA's present constitution that its rules have been previously amended to accommodate the privatisation of public sector work (particularly in relation to irrigation companies).

Moreover, in order to have standing to appear in courts and tribunals administering Australia's federal workplace relations laws, the PSA may also be required to register as

an employee organisation under Federal workplace relations laws, This would be a new step for the PSA, which has previously only operated within NSW. Alternatively, it might negotiate some arrangement with its affiliate, the Community and Public Sector Union (CPSU). These two unions have a longstanding cooperative relationship.

10.3.2 Physical Assets

There are particular problems associated with effective competition where unique physical assets are controlled by one of the potential bidders. The example often provided is the London bus market, where the first generation of non-government providers following privatisation acquired ownership of the depots. In a densely populated city such as London, there is no realistic prospect of alternative providers developing alternative depots, and repeated attempts by Transport for London to attract competition have failed.

Similar problems are said to exist with the publicly-owned linen service for Sydney's hospitals. In the latter case, assuming that this is, indeed, a key asset, the solution lies in government retaining ownership of the facility and merely market-testing its operation. In the case of London's buses, the answer is to be found in government either acquiring the depots, or in mandating their transfer to any new provider at fair value.

10.4 Accountability and Integrity

As noted in Section 3.3, contracting and contestability generally have the effect of significantly increasing performance accountability that is of interest to policymakers and senior managers. But what of accountability to the general public?

It is difficult to understand why the Auditor General should not have the authority to scrutinise public service contracts, at least as far as the commissioners, procurement officers and contract monitors are concerned. While there is no need for the Auditor General to investigate the details of the contractor's

business operations, Parliament is entitled to be reassured that business and accounting processes are in place to justify performance payments under the contract. In the Federal government, and in Queensland and Tasmania, Auditors General have 'follow the dollar' powers that permit them to inquire into compliance with the conditions of grants and contracts.

The NSW Auditor General does not presently have the authority to 'follow the dollar', and this might be accomplished without the need for legislative amendment, by inserting appropriate clauses in the service contracts signed with private and not-for-profit providers. This approach would also allow the government to experiment in finding the most effective approach without the need for legislative amendment.

While it is appropriate that administrative law should extend to the procurement process, and the conduct of commissioners throughout the life of the contract, there is no case for a general extension of judicial review to contractual performance. Administrative law is overwhelmingly concerned with process, and it is difficult to see how that body of law might be employed to scrutinise performance. Indeed, one explanation for the re-emergence of contract law in the public service sector in recent decades is disillusionment among policymakers at the cost and the limitations of administrative law.

The problems of corruption, collusive tendering, conflicts of interest and the so-called 'revolving door' have already been discussed. Public officials in NSW are sensitive to the probity issues involved in competitive tendering and contracting, although there has been a tendency to deal with these issues through an excess of regulation and a heavy reliance on probity auditors.

The NSW Independent Commission Against Corruption recognises the changing nature of public service delivery and the need to delegate authority in the conduct of effective procurements. In recent years it has adopted a systemic approach in its corruption prevention work, rather than simply advocating more regulation. This offers a solid platform from which to build a more diverse public service economy.²⁶⁸

Appendix A: Evidence of Productivity Gains

The potential for productivity gains from competition appears to be a difficult subject. In part, this is because of ongoing debates over methodology and data quality – over the evidence about what works and under what circumstances. But there is also a reluctance to speak frankly about the high price that society pays for persisting with the traditional form of delivery where public services are delivered through an uncontested monopoly.

There are, however, a number of studies which suggest that the productivity gap is substantial and that competition and contestability has the potential to deliver significant value-for-money gains if well implemented. There is clear historical evidence in NSW of the substantial benefits that structural reform can deliver, at least in so far as financial matters are concerned. It is not always a case of 'some butterflies were caught, no elephants stopped'.²⁶⁹

The reform of NSW government trading enterprises, which commenced in 1989, was based on five core principles:

- i. clarity of management objectives, directed at increased accountability for performance. Social obligations were to be addressed through explicit agreements or contracts with government
- ii. delegation of managerial authority, recognising that 'externally-imposed controls stifle managerial innovation and dilute and diffuse responsibility'
- iii. performance monitoring, based on 'rigorous independent monitoring and assessment'
- iv. rewards and sanctions – the failure to reward performance or sanction poor performance would undermine the effectiveness of monitoring
- v. competitive neutrality, removing the special advantages or disadvantages of public ownership.²⁷⁰

Where possible, monopolies were to be broken up or otherwise exposed to competition as an incentive to productivity reform, and where trading enterprises retained a significant degree of market power, they were to be subject to external regulation on the price and quality of services. In the case of the State Bank and GIO, these reforms resulted shortly thereafter in their sale; in the case of the Electricity Commission, it led to the creation of a national electricity market and the disaggregation of the monopoly provider.

A number of reports have studied the financial impact of these reforms. Most recently, the NSW Financial Audit reported in September 2011:

Prior to the corporatisation and commercialisation reforms of the 1980s and early 1990s, the commercial PTE sector had a general history of operating deficits and a

mixture of commercial and non-commercial functions, including regulatory functions, and a general lack of transparency. The corporatisation and commercialisation reforms have delivered a turnaround in financial performance through full separation of commercial and non-commercial functions, the establishment of competitive neutrality principles and full transparency.

In 2010-11, the commercial PTE sector is projected to deliver an operating surplus of \$5 billion and payments to government of \$5.6 billion (comprising dividends of \$4.5 billion including the special dividend of \$3.4 billion, tax equivalent payments of \$630 million and government guarantee fee payments of \$435 million).²⁷¹

A.1 Benchmarking Alternative Providers

In sectors where public and private providers deliver comparable services, economists have been able to benchmark performance, which provides us with some idea of the scale of potential gains from productivity reforms.

A.1.1 Public Transportation

Several studies have been undertaken in recent years of public transportation in NSW. These point to possible financial gains in rail passenger, buses and ferries in the range of ten to 24%.

Rail passenger services. A study undertaken by LEK Consulting for the NSW Independent Pricing and Regulatory Tribunal in June 2008 concluded:

A like-for-like comparison against comparable Australian and international operators has indicated that CityRail operating at benchmark would result in operating costs approximately 23% (~\$610m) lower than projected in 2011/12, equating to a growth of 1.7 percent p.a. in operating costs.

Approximately 6 ppts [percentage points] (~\$160m) of this cost difference are the result of specific decisions by the State with regards to customer service such as the presence of guards or staffing of very low patronage stations. These costs are not incurred by benchmark operators. The remaining ~17 ppts (~\$450m) cannot be explained by these policy choice and are primarily to be found in overall station staffing, rolling stock maintenance as well as overheads.²⁷²

Buses. The comparative cost of operating Sydney's four largest bus regions by the State Transit Authority regions was analysed by IPART in September 2009. The STA's performance was compared with a weighted average of private operators in metropolitan Sydney, Melbourne, Perth and Adelaide, adjusted to take into account the differences between those regions – traffic congestion, passenger density, geography and so on. The report found inefficiencies of around ten percent in the STA's operating costs, principally due to:

- relatively generous leave provisions for drivers
- less than efficient driver utilisation around sign-on/ sign-off, Work as Directed and meal breaks
- more generous working conditions for administration staff and mechanics
- more onerous procurement practices with higher compliance costs
- significant governance costs in writing ministerials, preparation of an annual report, participation in inter-agency activities and undertaking internal and external audits, including the parliamentary Estimates Committee.²⁷³

Ferries. In 2011, IPART commissioned a study of Sydney Ferries from LEK Consulting. The report, which was published in January 2012, benchmarked operating costs against seven domestic and international passenger ferry operators, and relied on the advice of a technical expert comparing outsourced repair and maintenance activities against in-house performance.

The review concluded that if Sydney Ferries were to operate as efficiently as its domestic and international benchmarks, it could deliver savings in the order of 24%. The principal reasons for the cost differential were higher staffing and higher remuneration levels on the ferries, significantly higher costs of wharf operations and higher overheads, including government compliance costs.²⁷⁴

A.1.2 Hospitals

There is a massive literature comparing the relative efficiency of public and private hospitals, and different studies have arrived at different conclusions. In 2010, the Australian Productivity Commission undertook one of the most comprehensive studies to date, involving some 368 public acute hospitals in Australia and 122 private hospitals (for-profit and not-for-profit).

Consistent with earlier Australian studies, the Commission found that private hospitals were less costly than public hospitals when medical costs were excluded: 'In 2007-08, the general hospital cost per casemix-adjusted separation was about 30% higher in public hospitals compared to

private hospitals.' To a large extent, this was because of greater expenditure on ward nursing. Medical and diagnostic costs are somewhat higher in private hospitals, although they are directly charged by doctors and not under the control of hospital management.²⁷⁵

Comparison of labour productivity between public and private hospitals was problematic because of teaching and research functions and non-inpatient services provided by many public hospitals, however the scale of the difference (from 80% to 130%) was a matter of comment, and the fact that public sector productivity had declined over the period 2003 to 2008, while that of the private sector had improved.

Measured in terms of patient days per bed, the public sector was more productive than the private sector, although the trend over the period from 2003 to 2008 showed declining productivity in the public sector and improvements in private hospitals. On the other hand, when measured in terms of case-mix adjusted separations per bed, the private sector was 16% more efficient.²⁷⁶

A.1.3 Fire and Emergency Services

As described in some detail in Appendix B, most of Denmark's emergency services are provided by a private, for-profit corporation. Research in the past has concluded that Denmark's emergency services are more cost-effective than those in similar countries and that within Denmark, Falck's fire services are more efficient than those provided by municipalities. The most comprehensive of these studies, a survey of 275 local governments conducted in the early 1980s, reported that Falck was up to 36% less expensive than public fire departments and where the company provided fully professional fire services (staffed by full-time employees), as much as 65% less costly.²⁷⁷

A.2 The Competition Effect

A third source of information about the scale of the productivity deficit associated with traditional public service delivery is to be found in the study of what happens when the monopoly is challenged. While this literature is sometimes framed in terms of public vs private, it is better approached in terms of the difference that competition can make.

A.2.1 Literature Surveys

In 2008, Paul Grout of the Centre for Market and Public Organisation undertook a literature review for an inquiry into the public service industry commissioned by the UK Department for Business Enterprise. Grout concluded that savings from competition were in the order of 20%.²⁷⁸

After reviewing a number of quantitative studies, Jensen and Stonecash (2005) came to the conclusion that:

Overall, the majority of empirical research supports the conclusion that outsourcing results in reductions in government expenditure. . . while there is still some ongoing debate about the magnitude of the cost change associated with outsourcing, there seems to be some consensus about the direction of the change.²⁷⁹

They were heavily influenced by a meta-analysis undertaken by Hodges of 28 studies (covering the period from 1976 to 1994), which found an average cost reduction of between eight and 14%, with a high degree of statistical significance. The savings differed a great deal across different services, and virtually none of these comparisons included transaction costs.²⁸⁰

The last time that value-for-money from competition and contracting was comprehensively studied in Australia was the 1996 Industry Commission Report, 'Competitive Tendering and Contracting by Public Sector Agencies', which concluded:

Despite the heterogeneity of the studies, approximately 75% estimated that contracting reduced the costs of delivery. Findings of no savings or cost increases were restricted to only a few of the services examined. Furthermore, the size of any estimated cost increases tended to be smaller (ranging from zero to 28%) than the range of cost savings (zero to 84%).

Although most studies estimated cost savings, the range and variability of the estimates are large. Such diversity in the size of the estimated cost changes would appear to demonstrate that no useful 'rule of thumb' exists on the size of the probable impact of contracting on the costs of delivery. Rather, it appears each instance contains unique characteristics which influence its success or otherwise (in cost terms).

Despite the wide range of estimates, just over half of the 200 individual services examined yielded estimated cost savings of between ten and 30%. The remaining estimates were distributed reasonably evenly on either side of this range. Despite institutional and other differences between the United States, the United Kingdom and Australia, the evidence does not suggest substantial variations in the cost impacts across these countries.²⁸¹

A.2.2 Refuse Collection

Competition and contracting for residential refuse collection has been studied more closely than any other sector, in part because it was one of the first public services to be put to market in the United States (from the 1970s) and in Canada and the United Kingdom (from the 1980s), and because this approach has subsequently been adopted in other countries around the world. Municipal waste collection is also amenable to study since service levels and service quality are relatively easy to measure.

A recent survey of 33 studies in the USA and Canada, the United Kingdom, the Netherlands, the Republic of Ireland, Spain, Sweden and Switzerland, found cost reductions that clustered around 20%, with little if any impact on service quality or workers' terms and conditions.²⁸²

A.2.3 Municipal Services

The contracting of municipal services has also been much studied across the industrialised world. One survey of 34 studies from North America, the UK, Denmark and Australia, ranging from 1979 to 2007 (excluding municipal waste collection), found considerable variability in the results, ranging from cost increases of six to reductions of 25%.²⁸³

A.2.4 Prison Management

Prison contracting has also been the subject of extensive research, although the quality of the studies in this field is mixed. The author undertook a comprehensive literature survey in 2007, reviewing 43 studies, mostly case studies drawn from North America. Unlike refuse collection, the value-for-money gains from contracting custodial services is difficult to study since there is no agreed system of classifying prisons, no two prisons are alike, and there is a paucity of data about the costs involved operating public facilities.

Of ten North American case studies that were sufficiently robust to warrant inclusion in the survey, all but one reported cost reductions, with most falling in the range of five to 15%. The most comprehensive research was undertaken in the United Kingdom in the 1990s, comparing four privately managed public prisons with selected benchmark facilities. The average cost of the contract prisons was 11% to 15% below their public sector comparators, although a subsequent program of PPP prisons resulted in further cost reductions over time (in both capital and operating costs) of around 30%.²⁸⁴

A.2.5 Hospital Support Services

Nineteen studies of contracting for hospital support services – cleaning, catering, laundry portering and the like – in the UK, Australia and Denmark have been

reviewed. Cost reductions of more than 20% were not unusual, in some cases significantly more.²⁸⁵

A study of competition for hotel services in three NSW hospitals in the period 1989 to 1992, found that an in-house team had delivered improved services in one hospital at a cost that was 21% less, and an external provider in a second hospital reduced costs by 30%. However, in the third hospital, the external provider failed to deliver the promised savings and the contract was terminated.²⁸⁶

A.2.6 Defence Support

While the contracting of defence support services is not directly relevant to Australian state governments, it is yet another area where a significant amount of research has been done, principally in North America, Britain and Australia. The cost reductions tend to be greater in this sector, typically in the range of 20% to 30%. Civilianisation is one of the principal reasons for this – it is generally much more expensive to have uniformed personnel undertaking support services, both because of the greater investment in training and the reduced capacity for specialisation.²⁸⁷

Australia's 'Commercial Support Programme', initiated by Defence Minister Kim Beazley in 1990, was addressed in several reports. McNamara (1995) reported cost reductions in the order of 33% on those services that had been market-tested, while a submission to the Industry Commission investigation into competitive tendering and contracting the following year found savings (from outsourcing and from in-house wins) of the same order of magnitude.²⁸⁸

A.2.7 Public Transportation

A 2005 survey of 18 studies of competitive tendering for subsidised bus transportation, in ten developed countries covering more than 20 cities in the period since 1985, found significant cost reductions:

Net of administrative costs, these savings are frequently quoted to lie between 20% and 30%, net of administration costs. On closer inspection the savings are associated, in the main, with services previously provided by the public sector under a public monopoly and are typically the outcome of a first-time tendering process.²⁸⁹

A study of competitive tendering and contracting of Adelaide's bus services found that over two rounds of competition, between 1994 and 2001, cost per bus-kilometre declined by 38%. Transaction costs amounted to around six percent. Over the same period, there had been little change in the average cost of providing tram and train services, leading the authors of this study to

conclude that there remained considerable scope for technical efficiency gains in those services.²⁹⁰

A.3 The Contestability Effect

While the impact of latent competition has not been studied to the same extent as competitive tendering, there are a number of studies that seem to confirm that contestability is capable of driving down costs by significant amounts.

Competition in municipal services in Los Angeles County. During the 1950s and 1960s, around 30 cities in Los Angeles County were established under an arrangement (known as the Lakewood Plan) where most of their public services, including policing, were purchased under contract from the county.

This model was highly contestable since cities retained the right to contract with other municipalities or private providers, they could associate with neighbouring cities and negotiate collectively with the county, or as a last resort, they could self-provide. While there were practical and political constraints on the freedom to contract, there was clear evidence that some cities were prepared to negotiate vigorously over cost and quality, and that county officials responded to this competitive pressure.²⁹¹

Deacon examined 64 cities in Los Angeles County for the year 1970, approximately one-third of which were Lakewood Plan cities. The remaining cities produce the vast majority of their services. The distinction between the two groups of cities was stark: 'most "purchasing" cities spent over 20% of budgeted outlays on county contracts, while none of the "producing" cities [allocated] more than three percent to such purchases.' Three categories of expenditure were considered: total expenditure on all municipal services, expenditure on policing and street maintenance. (As already noted, purchasing is concentrated in street maintenance, police protection and engineering.) Deacon concluded:

Purchasing municipalities spend about 86% as much on all services as do their producing counterparts. Figures for police protection and street maintenance are 58% and 70% respectively...[But] in the absence of quantifiable output measures, firm conclusions regarding the relative magnitudes of the two effects, output versus cost reducing, cannot be drawn...

The magnitudes of percentage differences on expenditures between supply alternatives are remarkably large...If observed, expenditure differences on street maintenance were entirely due to cost factors (i.e. if demand differences were absent) then the point estimate would

indicate that competitive supply of street maintenance services is about half as expensive as bureaucratic supply.

With police protection, however, the only significant seller of services is a public enterprise, although potential competition from city departments certainly exists. Thus, the magnitude of the estimated expenditure difference for this service is surprisingly large. Although no satisfactory procedure was found to test for economies of scale, such considerations are an obvious source of potential cost reduction...²⁹²

Miller looked at total municipal expenditures as a percentage of total assessments in 1960 and 1970, for 45 pre-war cities and 32 post-war cities (in 1970; 21 post-war cities in 1960). All of these 32 post-war cities had been incorporated under the Lakewood Plan (although one was not a contract city). Miller found that the older cities 'not only taxed their resource bases more heavily than the newer cities but the degree to which they taxed their bases increased dramatically in a single decade.'²⁹³ His explanation for this pattern was that older cities had experienced 'service creep'.

If bureaucracies produce a gradual 'incremental' expansion of government budgets, then older cities should have budget levels beyond their demand levels, and younger cities should not. As it turns out, municipal age is the most important variable associated with the residuals from the demand model.²⁹⁴

Mehay and Gonzalez (1985) hypothesised that one of the consequences of contract negotiations under contractual arrangements such as the Lakewood Plan would be that county officials would also have a much clearer understanding of the true cost of producing services, and that this should be reflected in their expenditure on services such as policing. Their sample consisted of 53 counties in California, 15 of which supplied a significant amount of law enforcement services to municipalities under contract. They found that average costs were nine to 20% lower in the supplier counties.²⁹⁵

Waste management in Vancouver. A 1987 study of two municipal waste services in Greater Vancouver – one subject to periodic competition, the other a public monopoly – found significant improvement in crew productivity in both. In the municipal monopoly, productivity measured as tonnes per man day increased by 52% over a three year period, principally by moving from three-man to two-man crews. The authors concluded:

The case study findings suggest that increasing the efficiency of residential solid waste collection services is not synonymous with privatization. North Vancouver District made important changes through a process of negotiation and experimentation that involved the union, city engineers, and elected officials. There was no intra-city competition between the public and private sectors...

There was, however, competition for the existing solid waste collection in North Vancouver District. Unsolicited offers from private firms served as a stimulus to do something about the collection system. The threat of contracting out was very real.²⁹⁶

Facilities Management in US Federal Government.

In a report to a Congressional Committee in 1994, the Government Accounting Office reported on the extent of contracting out for real property management services by the General Services Administration, in particular for cleaning and general maintenance, over the period 1982 to 1992. They found that 'low contractor bids for activities contracted out were 39% less than the government's cost estimate'. However, for activities retained in-house, 'the low contractor bids were about 33% higher on average than the government cost estimates for providing the same service'. Moreover, the average difference between the bids submitted by contractors and the government cost estimates declined over the 11 year period.²⁹⁷

Prison Management in NSW. As discussed in Section 9, the NSW government pursued a policy of contestability in the management of its prison services between 2003 and 2009, using the threat of outsourcing to negotiate with the unions in an attempt to secure more efficient operating arrangements in three new prisons. This delivered significant advantages to the state. According to the then Minister of Corrective Services, John Robertson, in December 2009:

Since 2004/2005, through the Way Forward Workplace Reform strategies, Corrective Services NSW has reduced operating costs by \$21 million per annum and established more efficient workplace practices in new correctional centres. Overall, the estimated savings are expected to realise approximately \$63 million per annum.²⁹⁸

While the detailed costs associated with the management of the 'Way Forward' prisons have not been released, based on the published costs for managing June Correctional Centre, it seems likely that an annual saving of \$21 million would represent a productivity improvement of around 15-20%.²⁹⁹

A.4 Qualitative Issues and Transaction Costs

The fact that competition and contestability have reduced the direct cost of delivery does not mean that they delivered value for money. Few of the studies referred to above incorporated the transaction costs associated with competitive tendering and contracting – the cost to government of conducting the procurement and monitoring performance.

While there may be occasions where a reduction in the quality serves the public interest, if this was the only way in which contestability was delivering cost reductions, it would not amount to an improvement in productivity. Quality in service delivery is notoriously difficult to measure, in large part because no two services are alike. Before and after comparisons are also problematic because of the changing nature of services over time.

Grout acknowledged that the evidence concerning quality was weaker than the evidence regarding costs, but the few rigorous studies pointed to similar or improved

service quality.³⁰⁰ In his meta-analysis, Hodge concluded: 'as best we can tell from the small amount of currently available international evidence, average quality changes under contracting are not significantly different from zero'.³⁰¹

In Australia and the United Kingdom, it is generally agreed that the quality of service in privately-managed prisons is comparable to the public sector, albeit somewhat different in emphasis: the contract prisons score better on so-called 'relationship' measures (respect, humanity, support, relationships and trust), and not quite so well on 'regime' measures (fairness, order, safety, wellbeing, prison development, family development and decency).³⁰²

And recent studies of PPP hospitals in the UK have concluded that quality has not suffered (although costs were not significantly different either). The National Audit Office reported in 2010 that there was 'strong enough evidence to say that most contracts are delivering the value for money expected of them...Available information shows the cost and performance of PFI hotel services are similar to those services in non-PFI hospitals'.³⁰³

Appendix B: The Mixed Economy

It has been observed several times throughout the body of this report that across the industrialised world most public services are delivered through a mixed economy of public, private and not-for-profit providers. Not all of these services are open to competition, but in one way or another, the supply side is usually composed of a diversity of suppliers.

One way of measuring this diversity lies in estimating the extent to which different kinds of services are procured from the private and independent sectors. This approach was adopted by a study of the 'public service industry' (in this case, defined as the private and voluntary sectors) undertaken for the UK Department for Business Enterprise and Regulatory Reform in 2008, which made the following findings:

- *Managed services* (services supplied directly to users). These accounted for 44% of the public service industry
- *ICT services* (building and management of IT and communications systems). Total expenditure of around £12.4 billion
- *Business process outsourcing* was estimated at £5.3 billion, although this included some IT elements
- *Construction services* - £34 billion had been spent on construction and £6 billion on PPPs in 2006. The review estimated that services accounted for around five percent of this, that is, £2-3 billion
- *Facilities management* (support services, building operations and maintenance, environmental services and property management). The public sector accounted for some £5.2 billion
- *Professional services* (consultancy and advisory services in human resources, financial, legal, management and policy). Estimated at £2.8 billion.³⁰⁴

No comparable study has been made in this country, and the following analysis has brought together some of the available evidence concerning the diverse mix of public, private and voluntary sector providers by service sector. Given the scale of the task and the limited time available for the preparation of this report, this should not be regarded as a comprehensive survey.

B.1 Criminal Justice

B.1.1 Policing

For obvious reasons, the independent sector has had a limited role in policing, although recent developments in the UK suggest that there is greater scope than previously imagined for contestability in support services. Of course, if we broaden our definition of the sector to include the

full range of crime prevention and investigation services, then it is evident that this, too, is a mixed economy, with government employing a range of instruments, from direct delivery to contracting and regulation, to meet its ultimate policy outcomes.

Australia

There is little evidence of Australian policing agencies using the private sector for support services, although such partnerships are by no means unknown. NSW Police contract with the Division of Analytical Laboratories, part of the Department of Health, for DNA testing, although since 2008, around 5,500 samples a year have been analysed by an accredited private provider under contract.

The South Australian government has built six new police stations and court houses using public-private partnerships, with the service provider responsible for utilities and facilities management, cleaning and waste management and safety and security.³⁰⁵

In 1998, the Victorian police contracted with a private company for installing and maintaining traffic cameras. A separate company is responsible for the enforcement of penalties, including debt collection and the execution of warrants. Western Australia has also investigated outsourcing this function.

United Kingdom

Britain has a devolved policing system with services delivered through 43 regional police forces as well as a number of national agencies. While central government has some capacity to influence local decisions through funding and high-level policy settings, the question of competition and contracting in support services is one that has had to be resolved by each authority on its own. The result is that different constabularies adopt different approaches to the use of the private sector.

The Private Finance Initiative provided policing authorities with a new way of updating tired infrastructure, and with a growing reliance on information and communications technology, partnerships with private firms became increasingly important. However, it is financial constraint that has been driving police forces to pursue competition and contracting in the services supporting front-line policing.³⁰⁶

Physical Facilities. Since 1998, a number of facilities have been delivered under public-private partnerships – local police stations, divisional headquarters, custody suites, integrated justice centres, laboratories, training facilities, helicopter bases and stables. Over time, many of these contracts have included the ancillary services.

Support Services. Policing agencies in the UK have also engaged with external providers for the supply of support services: the Metropolitan Police first contracted the

management of payroll and pensions in 1998. Other policing authorities have taken advantage of shared service centres established by local councils. For example, in 2008, Avon and Somerset Police joined a joint venture with two local councils and IBM, known as Southwest One, to create a shared service centre managing finance, human resources, procurement, ICT, facilities management and revenues and benefits. Staff are seconded from the partner organisations rather than transferred.³⁰⁷ Police forces across the UK are currently reported to be organising competitions for the management of their 999 emergency control centres, and the Metropolitan Police has already outsourced this rather important function.³⁰⁸

Airwave, an integrated digital radio network for Britain's police, ambulance and rescue services, was delivered under a PPP contract which went live in 2005. Private providers manage and maintain the infrastructure as well as delivering command and control solutions. A number of police forces have also banded together to purchase fleet management and air services.

Evidence Storage. PPP and facilities management contracts have sometimes included evidence storage among the suite of services. For example, a contract let by the Serious and Organised Crime Agency included secure storage, collection and distribution of evidentiary material.

Custodial Services. Custody suites were introduced to replace police cells, in large part because of the requirements of the *Police and Criminal Evidence Act 1984 (PACE)*, which placed new demands on the police in the management of suspects. Most custody suites have been designed, built and financed under the Private Finance Initiative, with private providers being assigned an increasing range of services. One major provider manages 30 custody suites in three counties, with services that include transportation to custody; operation and maintenance of the facility; detainee welfare, including catering; cleaning, laundry and waste management; reception duties; searching, fingerprinting and photographing of detainees, management of visual identification; statutory drug testing; and forensic sampling.

Prisoner escort has been undertaken by private contractors since 1993, a process that was overwhelmingly welcomed by police, since it freed up officers for front-line duties. When the Scottish government first contracted this service in 2003, it was estimated that 300 police officers had been freed up, 200 from escorting and 100 from court duties. In 2005, police in Cheshire contracted the transportation of detainees from the scene of arrest to custody suite, under a highly innovative performance model where the provider was to be paid in part based on

the timely collection and delivery of detainees. Unfortunately, this proved to be too innovative, and the contract was terminated because of the difficulty in meeting these output specifications in uncertain traffic conditions.

Medical and Forensic Services. Traditionally, police surgeons were General Practitioners who worked part-time for police authorities under contract. Following a recommendation by the Audit Commission in 1998, Wiltshire Police was the first authority to contract with a company established by experienced forensic medical examiners to deliver that service. The Association of Police Surgeons also established a trading company to prevent what it described as 'piecemeal privatisation'. Other police forces have contracted with local NHS Trusts.

Essex Medical and Forensic Services Ltd was formed in 2004 by a former police surgeon to bid for a contract being let by four police forces – Bedfordshire, Cambridgeshire, Essex and Suffolk. It quickly added several other forces to its stable of contracts, becoming one of the largest providers of forensic and medical services in the country. In 2009, the business was acquired by a large public service company.

The commercialisation of forensic science began in 1991 when the state-owned Forensic Science Service (FSS), which had been a pioneer in the application of DNA technology to forensic analysis, was transformed into an executive agency and obliged to charge for its services. It ceased to be the preferred supplier for policing agencies in 2002 and three years later it was corporatised to facilitate its survival in an increasingly competitive market. By 2010, its market share had fallen to 60%, with the next largest provider, LGC Forensics (formerly the Laboratory of the Government Chemist, which had been privatised some years earlier) having 20% of the forensics market. However, with police spending under pressure, this was seen to be a shrinking market, and by 2010, the FSS was losing £13 million a year, around 12% of revenue. In 2011, the government decided to close the service. A parliamentary committee subsequently reviewed the decision and raised concerns about the loss of research and development capability, and the capacity of private providers to meet the demand. Nevertheless, the Forensic Science Service was finally closed in March 2012.³⁰⁹

Criminal Record Checks. Legislation introduced in 1997 imposed statutory obligations on organisations working with vulnerable people, particularly children and young people, to check the criminal background of staff being hired for this work. The Criminal Records Bureau was established in 2000 to facilitate and to regulate criminal record checks, and in August of that year, a contract was signed between the Passport and Records Agency and a private company, for the delivery of the IT system,

application processing and the operation of a call centre. Assessment was undertaken by government employees. There were early problems with the contract, but by 2003, these had been resolved. The Scottish Criminal Records Office signed a similar contract with BT in 2002.

Recent Developments: In February 2012, Lincolnshire Police signed a £200 million ten-year contract with a private company to design, build and operate a state-of-the-art police station that will incorporate 30 custody cells and a two-storey office block. The company will provide a range of services including management of the custody suites, administering drug tests, licensing firearms, and well as back office services such as human resources, IT support and fleet management. Almost half of the civilian workers employed by the force will transfer to the company. Savings of around ten percent were to be delivered under the contract, and a framework agreement has been signed with ten other small police authorities to deliver business support (HR, payroll and finance) from a shared services centre, which is expected to generate further savings.³¹⁰ Staff employed by the private provider will wear epaulettes badged with 'Lincolnshire Police' as well as the company logo.³¹¹

The following month, two English police forces, West Midlands and Surrey, created some controversy when they jointly invited tenders for a support contract that will include even more non-core functions (guarding crime scenes, searching woodlands, preparing routine witness statements, collecting evidence from CCTV cameras and providing intelligence analysis in criminal investigations).

Following erroneous reports in the media, Ian Blair, the former Commissioner of the Metropolitan Police, commented in the *Guardian* that in light of 20% budget cuts, police forces were reviewing the management of 'routine and repetitive tasks':

Once the straitjacket of officer numbers is removed, police forces can modernise their budgets in the way any other institution would do, namely by reducing unit costs. The correct question that should have been asked by the Home Office is, which functions currently carried out by sworn, fully warranted trained police officers do not need to be? On this, swaths of police tasks...swing into view. Many forces have employed their own non-police staff to undertake this sort of task but have been unable to do so in sufficient numbers because of the need to employ a fixed and ever increasing number of officers within a set budget.³¹²

The City of London Police (which is responsible for policing in the financial heart of London or the 'Square Mile', as it is known) has secured £8.2 million for a dedicated team to tackle insurance fraud, and in April, the Commissioner announced that the force would establish an academy teaching investigators from around the world how to fight fraud, an initiative that is expected to deliver around £2 million per annum.³¹³

B.1.2 Court Support

Australia

Melbourne's County Court building, opened in 2002, was designed, built and operated as a public-private partnership. Services provided under the contract include facilities management, security and IT support. Administrative services are provided by the state government.

Much more comprehensive are the service elements of the contract for the West Australian District Court and Central Law Courts in Perth, opened in 2008 and designed, built and constructed under a public-private partnership. They include:

- custody services within the court buildings
- court security and user management (including uniformed front-of-house security, checkpoint duties, operation of control rooms, gallery guard and court orderly duties)
- court recording and transcription
- hard and soft facilities management
- courtroom booking services.³¹⁴

B.1.3 Corrections

The management of prisons under contract was commonplace throughout England in the 18th century, and until 1801, the convict hulks were managed entirely under contract. Almost all of the vessels that transported convicts to Australia were merchant ships, and until around 1800, the contractors had a wide range of responsibilities including the management and security of the prisoners.

Contract management re-emerged in the United States in the 1970s, for community correctional centres and juvenile facilities. By 1983, two-thirds of juvenile facilities in the United States were operated by independent sector providers. However, modern prison contracting is usually dated to 1984, when a detention centre commissioned by the Immigration and Naturalization Service and the Federal Bureau of Prisons was opened in Texas.³¹⁵

Prison Management

Australia

Australia was the second country in the world, following the United States, to employ private companies in the management of correctional institutions. This approach was recommended by the Kennedy Report in Queensland in 1988, which proposed that the management of a prison then under construction be contracted out by way of a benchmark. When Borallon Correctional Centre opened in January 1990, it was managed by the Australian subsidiary of one of the leading American prison providers. Since that time, every state except Tasmania has established at least one privately-managed prison, and in Victoria, more than one-third of prisoners are managed under contract.³¹⁶ After 22 years with very little controversy, it might be said that this is now an established feature of the Australian correctional environment. In March 2012, the West Australian government announced that it had awarded a contract for the management of a Young Adult Facility, the first time that such a facility has been outsourced in Australia.

The escorting of detainees between prisons, and between the prisons and the courts, is contracted to private companies in Victoria, South Australia and Western Australia. The NSW government raised the possibility of market-testing the Court Escort Security Unit (CESU) in 2008, but apparently as an exercise in contestability, since shortly thereafter it was announced that this initiative would be delayed to give CESU time to find \$5 million in savings.³¹⁷

New Zealand

New Zealand contracted for the management of a prison in 1999, but this arrangement was terminated by a new government in 2005, once the contract had expired. In May 2011, following another change of government, the management of an existing public sector prison was transferred to a private company following a competitive tender, and in March 2012, the Minister for Corrections announced that a consortium had been appointed as preferred bidder for a new PPP prison, with performance incentives based on reducing reoffending rates.

The United Kingdom

Prison contracting was first debated in England around 1984, but it was not until 1988 that the government resolved to open up the management of some new prisons to private management. The first contract prison, The Wolds was opened in 1992, and from around 2002, the government adopted a policy of commissioning all new prisons through public-private partnerships.

Around 15% of prisoners in England and Wales are held in establishments managed by private sector providers under contract. However, the current government has a

policy of market-testing the management of all prisons, and in a consultation paper released in March 2012, it announced its intention to use legislation passed under the previous government but never effectively implemented, 'to significantly open more probation services to competition, including some aspects of offender management'.³¹⁸

Prisoner escort was first opened to competition in 1991, and all escort services in Britain are now provided under contract. This has seen operating costs reduced over time, and in the latest round of tenders, costs were reduced by a further 20%.³¹⁹

United States

On the latest available census data, private companies operate around 415 correctional facilities in the United States (23% of the total), although this represents only around seven percent of the total number of prisoners in custody.³²⁰ Prison contracting has been much more controversial in the United States than it has been in Australia, New Zealand and the UK. In part, this is because some correctional services are traded in a spot-market, where there is less monitoring and service quality has suffered as a result.

Other Countries

France attempted to contract prison management in 1987, twelve months before the model was first being discussed in Australia. Adopting a benchmarking framework, it was proposed to contract with the private sector for 21 facilities, with another four to be delivered in-house. However, following strong political opposition to the contracting of custodial functions, only ancillary services (including vocational training) were included in the contracts. A second round of contracts, employing this same model, was announced in 2001.

In recent years, Germany and Japan have also employed the private sector in the design, construction and maintenance of prison establishments, adopting a model that is similar to the one developed in France. In Japan, the service providers are responsible for perimeter security, but not for custodial services involving direct interaction with the prisoners.

Community Supervision

Australia

Community-based offender services are dominated by public sector organisations, however in all states, not-for-profits play a significant role in pre and post-release programs, including case management, housing assistance, employment and training, residential rehabilitation, mentoring and drug counselling.

Home detention was introduced in NSW in 1997, although the numbers supervised at home through electronic

monitoring are small (less than 200). Other states also employ electronic monitoring, but unlike the UK, no Australian jurisdiction has used contractors to install the equipment or supervise detainees.

United Kingdom

Probation services in England and Wales are provided through 42 Probation Boards, whilst in Scotland, they are the responsibility of local social services. While the not-for-profit sector has played a significant role in this sector, they have largely been confined to post-release resettlement, accommodation, employment and training and drug rehabilitation programs. However, following the establishment of the National Offender Management Service in 2004, a number of pilots were conducted, exploring the possibility of using the independent sector under payment-by-results arrangements. In the east of England, a private-voluntary partnership was used to focus on placing offenders in sustainable employment. In London, the Criminal Justice Board initiated a project working with young people post-release.³²¹

There was limited progress in reform of the Probation Boards until the last twelve months, when the government raised the prospect of the private sector playing a much more significant role in the management of probation services. In March 2012, a consultation paper was released in which the government announced its intention to open probation services to competition, including some aspects of offender management.

We expect over time to compete, where possible on a payments by results basis, a range of services which, together with central IT and estates contracts, amount to around 60 % of the £1 billion per year budget for community offender services. These include:

Community Payback (Unpaid Work); Electronic Monitoring; Bail Accommodation and Support Services (subject to contract review); Approved Premises; Attendance Centres; Victim Liaison; Accredited Programmes; Activity Requirements; Supervision; and some aspects of Offender Management. . .

Over time we intend that the majority of a Probation Trust's current business would be opened up to competition, apart from advice to court and the management of higher risk offenders.³²²

A pilot involving the private sector in electronic monitoring of offenders under home detention was first attempted in 1989, although it was not until 1995 that the policy was finally adopted. In England and Wales, electronic monitoring of prisoners on home detention is a

function that has never been directly delivered by the public sector itself.

Secure Mental Health

It is widely acknowledged that mental health is a significant problem in the prison population, and some have estimated that up to 70% of prisoners suffer from two or more mental health problems. While many of these can be managed within the mainstream, there is a significant minority who require more intensive care.

New South Wales

It appears there are 90 identified mental health beds in the state's prisons, and an additional 135 beds at the Long Bay Forensic Hospital (although not all of these are identified as mental health beds), which operates separately from the prison.³²³ Some public hospitals also operate secure units. While these services are provided within institutions that are owned and operated by the state, the Long Bay Forensic Hospital was designed, built and is operated as a public-private partnership. It was opened in late 2008. The private sector partner has a wide range of responsibilities, including hard and soft facilities management, perimeter security, identification and screening of visitors and escorting services. The management of physical recreation programs is supplied separately under contract.

United Kingdom

The NHS is the sole supplier of high security beds in the UK, however the independent sector is responsible for around 40% of medium security mental health places. Many of the contracts with the independent sector (private and not-for-profit providers) were spot contracts, resulting in higher costs, although in recent years there has been a movement toward block contracts.³²⁴

B.2 Health

The independent sector plays a somewhat greater role in the Australian health sector than in the rest of the OECD. In 2009, government funding of health expenditure accounted for 68% of the total here in Australia, compared with a median of 75% for all OECD countries. In the United Kingdom, this is as much as 84%, while in the United States it is as little as 48%.³²⁵

B.2.1 Primary Care

Australia

In 2010, there were around 24,000 General Practitioners in Australia. Around half of all clinicians (including those employed in hospitals and in community medicine) were employed in private practice and, of these, 70% were in group practices.³²⁶ Outside of the hospitals, the vast

majority of health services in Australia are delivered by private providers:

Non-government providers deliver most non-hospital health care in Australia, among them private medical and dental practitioners, other health practitioners (such as physiotherapists, acupuncturists and podiatrists) and pharmaceutical retailers.³²⁷

Individuals contract directly with General Practitioners on a fee-for-service basis, although the majority of services are bulk-billed, and most of the costs are covered by Medicare under national health insurance, which operates as a kind of public service voucher. Patient co-payments make up about 12% of GP revenue.³²⁸

United Kingdom

There are around 35,000 publicly-funded General Practitioners in the UK, of whom some 85% are independent contractors. From 2004, it was possible for companies and social enterprises to contract with Primary Care Trusts to deliver primary care, and several hundred GP practices were established, the vast majority of them GP-led. In 2008, the largest of these providers was a national GP-led business with 38 clinics, with two regionally-based practices with 11 and nine clinics respectively.³²⁹

Following a new round of contract negotiations in 2004, the overwhelming majority of English and Scottish GPs opted out of providing out-of-hours services, and it was necessary for Primary Care Trusts to deliver these services in-house, or to procure them from GP co-operatives, community benefit societies or commercial providers. In 2008, commercial providers held around 20% of this market.³³⁰

From 2001, the UK government facilitated the construction of more than 200 new GP premises and shared social service centres using public-private partnerships, with service companies providing facilities management.³³¹

B.2.2 Secondary Care

Australia

The mixed economy is plainly evident in hospital services, where Australia has 753 public hospitals (which account for 67% of all beds) and 573 private one (33%). Private hospitals account for more than 40% of all hospital separations, although as a proportion of total hospital expenditure, the private share is around 22%.³³²

The two sectors deliver somewhat different services, although the Productivity Commission was inclined to downplay the differences.

Public and private hospitals are similar in a number of ways. A comparison of the types of diagnoses most frequently treated by public and private hospitals indicates that the two sectors offer many of the same hospital services, particularly chemotherapy, renal dialysis and medical obstetrics. More broadly, a number of large metropolitan private hospitals offer a range of services on par with large public hospitals including, in some instances, accident and emergency treatment and clinical training.

- Differences between public and private hospitals in terms of hospital size, location and services are, in part, a function of their business models, government requirements and community expectations.

- The public hospital sector handles the majority of acute care separations and accounts for most regional and remote hospitals, while private hospitals are more concentrated in metropolitan areas and are more likely to treat patients of higher socioeconomic advantage.

- The public sector's activity is concentrated on medical cases (including those typically admitted through emergency departments) while the private sector's activity is more concentrated on surgical (typically elective) procedures.

- The overall relationship between the two sectors is not clear cut, especially as the sectors do not operate in isolation, as exemplified by co-located hospitals sharing resources and medical staff working across both sectors. Although differences between and within the sectors make valid comparison difficult, Australia's robust and well-established system of public and private hospitals – and the overlap in their services – enables a comparison of their respective performance to be considered.³³³

The complexity of the public-private boundary is further demonstrated by the fact that 10 percent of funding for public hospitals comes from private sources (private health insurance, individual payments and purchases through mandatory insurance schemes), and in some states, a significant proportion of private hospital revenue comes from public patients. In Western Australia, this is almost 20%, although in other states it is less than one percent. The NSW government does not publish this statistic.³³⁴

In New South Wales, the public-private boundary is even more complex again, since there are 17 institutions owned and operated by not-for-profit providers that are formally counted as public hospitals (the 'Schedule 3' hospitals). Some of these, such as St Vincent's Public at Darlinghurst, are key elements of the state's public hospital system.

The Chris O'Brien Lifehouse at RPA

The complexity of the public-private divide is illustrated by Lifehouse, a new integrated cancer centre presently under construction at the Royal Prince Alfred Hospital where a wide range of services will be provided under a patient-centric model of care. It was conceived and developed by the late Professor Chris O'Brien, a practising oncologist widely known from his role in the reality TV medical program, RPA. Construction has begun on a nine-storey facility at Camperdown which will be fully integrated with the existing Radiation Oncology Centre at the Royal Prince Alfred Public Hospital. The facility will open in 2013.

The Chris O'Brien Lifehouse at RPA is an independent not-for-profit benevolent institution, raising more than \$3.5m a year through donations. However it has also received \$160m from the Federal government, and assistance from the NSW government in the lease of the site at a peppercorn rent and funding to assist in development of a business case. It is also attempting to raise \$35m from investors through charitable bonds.

There are also a number of public hospitals that are managed, in whole or in part, by private providers under public-private partnerships. With only one or two exceptions, Australia has not opted for full private management of public hospitals. The NSW government adopted this model at Port Macquarie Hospital in the early 1990s, but it is seen not generally to have been a success (although detailed information has never been published). On the other hand, Joondalup Hospital in WA, now managed by the Ramsay Group, is widely regarded as a success, and it now has what is probably the busiest emergency department in the state. In December 2011, the WA government announced St John of God Health Care as preferred bidder for the design, construction and management of the new Midland Health Campus. While construction has been funded by state and federal governments, it will be operated on the same model as at Joondalup.

Several state governments, including NSW, have procured new hospital facilities under PPP arrangements, where the service provider is responsible for hard and soft facilities management, including building maintenance, grounds maintenance, utilities, cleaning and domestic, waste management, catering, linen distribution, portage and security. The Mater Hospital redevelopment in Newcastle, Sydney's Royal North Shore Hospital, and the Orange Hospital have been procured under this model.³³⁵ The PPP for the Mater Hospital is complicated by the fact that it is a Schedule 3 hospital, built and operated for many years by the Sisters of Mercy, but recently acquired by the

Catholic health provider, the Little Company of Mary's. The Royal Women's Hospital in Melbourne was also procured on this basis.

A number of public hospitals have contracted with private providers for the supply of support services for many years, including pathology and radiology in some cases.³³⁶ However, the West Australian government recently contracted for the management of a recently-completed public hospital, Fiona Stanley, with a much more extensive range of support services. In addition to the usual soft and hard FM, the private sector partner will be responsible for electronic and health records management, human resource management, the management of medical equipment, ICT, supplies management, internal logistics, sterilisation, waste management, patient catering, patient entertainment, patient transportation, scheduling and billing.³³⁷ Around 40% of doctors working in NSW public hospitals are Visiting Medical Officers, appointed under five-year contracts with local health districts.³³⁸

Western Europe

It is widely understood that the private sector plays a major role in the health sector in North America. What is not often recognised is that private providers are also significant actors in the social democracies of Western Europe. Britain and Sweden both introduced significant choice and contestability into their health systems in the early 1990s, with the principal objective of reducing waiting lists for elective surgery, and despite some reversal of these policies in the middle of the decade, these reforms have continued to be developed in both countries.³³⁹

United Kingdom

While the creation of the NHS resulted in the nationalisation of health services, Britain's health sector remained a mixed economy. In the late 1980s, around 20% of elective surgery was undertaken in private institutions, and from the early 1990s, NHS Trusts were increasingly selling their services into the private sector.³⁴⁰

Since 2001, the majority of NHS Trusts have been granted 'foundation' status, a semi-independent status similar to corporatisation that gives them significant commercial independence. Mergers between hospital trusts are encouraged, although they are regulated by the NHS Cooperation and Competition Commission Panel, which scrutinises the costs and benefits for patients and taxpayers.

PPP hospitals. From 1997 until 2009, the NHS procured 76 facilities (most of them hospitals) under the Private Finance Initiative, with a value of around £900m. The National Audit Office concluded in 2010 that most were delivering the value for money expected of them.³⁴¹

Management of NHS Hospitals. As discussed in Section 8.4.3, from around 2000, the UK government canvassed the possibility of bringing in private management to turn around the performance of failing NHS hospital trusts. There are no known examples of where this model was adopted.

However, in 2011, Hinchingbrooke Hospital in Cambridgeshire contracted with a private sector firm to take over the management of the entire hospital. The trust adopted this strategy after incurring debts of £40m (with an annual turnover of £90m). The press reported that the Department of Health had identified 20 underperforming NHS trusts.³⁴² In March 2012, it was reported that another public hospital, George Eliot in Nuneaton, was in discussions with private companies about taking over the management of the entire facility.³⁴³

Elective surgery. In 2000, the UK government announced its intention to establish a number of Independent Sector Treatment Centres (ISTCs) and Diagnostic Treatment Centres (DTCs) outside of the existing NHS hospitals. The underlying assumption was that delivering elective surgery through hospitals resulted in conflict with the competing demands of emergency care, which resulted in significant inefficiency due to the delay and cancellation of operations that should be capable of rational planning months in advance.

ISTCs would deliver an increase in capacity, which would assist in clearing the backlog, but it was expected that the introduction of independent providers would motivate existing hospitals and surgeons to improve their own services. The NHS was already buying elective care from private providers, but through ad hoc 'spot contracts', which were expensive, and the ISTCs represented a move to bulk purchase, with the potential for significant savings.

There were two waves of procurement, with the first ISTC opening in 2005. Under the first wave, 25 fixed-site centres were opened, and two chains of mobile units. Wave 2 was originally to cover 24 schemes (each covering multiple sites), but this was scaled back to ten after the Department of Health announced that the extra capacity was no longer required.

It was originally expected that the ISTCs might eventually account for some 15% of elective surgery but by 2008, the ISTCs still accounted for less than two percent, and with the scaling-back of Wave 2 and the abandonment of further contracting, it is unlikely that they now perform more than three to four percent.

The ISTCs offered a wide variety of different services:

Some offer only a narrow range of services while others cover multiple specialities and offer outpatient care, diagnostics and day

surgery. Specialities commonly provided include orthopaedics, ophthalmology, and various forms of surgery. ISTCs do not provide high-level intensive care.

Support services. The market-testing of facilities management in hospitals was a key element of the CCT agenda in the late 1980s and early 1990s. The public services union, Unison, has estimated that the private sector has around 35% of the market for soft facilities management.³⁴⁵

Following a review undertaken in 2006, the NHS has been seeking to rationalise the number of pathology providers across the system. In 2008, Guys and St Thomas's Trust formed a joint venture with a private management company and the Kings College Hospital Trust to take advantage of this rationalisation, and it has since contracted with several other hospital trusts.

B.2.3 Community Care

Australia

Community health care in Australia is yet another mixed economy, with federal and state governments, private and community providers all playing a role. This is one of many public services originally established by community sector organisations. Around 13% of community nurses are employed in the non-government sector (compared with around 33% of nurses overall).³⁴⁶

However, in Queensland and north NSW, the Blue Nurses (now Blue Care) are a publicly-recognised institution. This service was established by the Methodist Church in 1953 and now operates 260 centres in 80 communities, with more than 10,000 staff and volunteers and almost 1,500 vehicles. In Western Australia, the equivalent is Silver Chain, founded in 1905.

United Kingdom

In recent years, a number of primary care trusts have initiated pilots involving commercial providers with a view to the management of long-term conditions in the community. For example, in 2007, the London Borough of Newham contracted with a private provider for a team of community matrons to visit patients in the home, with the objective of reducing hospitalisation rates. It was originally proposed that this pilot might explore the possibility of payment by results.³⁴⁷

Most recently, NHS Suffolk has announced that it has appointed a private company as the provider of community health services to around 600,000 patients within its jurisdiction, which will include the management of district nurses and community hospitals. The company will act as the prime contractor, working in partnership with a nearby NHS Foundation Trust, a community dental

care provider, and a charity providing nursing care for the terminally ill. This is yet another contract with a payment-by-results regime, focused on better coordinated treatment in the community, with financial rewards based on reductions in hospital admissions.³⁴⁸

At the time of publication, NHS Devon and Devon County Council was deciding which of two private companies would be contracted to deliver children's health services, including treatment for the mentally ill, respite care and palliative nursing.³⁴⁹

B.2.4 Non-Emergency Patient Transportation

Australia

As a result of changes introduced in the late 1990s following a National Competition Policy review, Victoria liberalised the market for non-emergency patient transportation, so that by 2005, this sector could accurately be described as a mixed economy. According to a report at that time, the supply side was dominated by four large private services and seven smaller ones, with at least four hospitals operating their own NEPT ambulances. The demand side included the Metropolitan Ambulance Service, which contracted out the operation of its non-emergency services, as well as hospitals, the Department of Veterans Affairs, the Transport Accident Commission, the Workcover Authority and private health insurers.³⁵⁰

It appears that Western Australia also opened up this market in the mid-1990s, and South Australia has done so more recently; however, NSW and Queensland have remained generally resistant to reform. In NSW the Ambulance Service still dominates the sector, although some public hospitals provide their own services, and it is understood that some private providers may have begun to make inroads into the market.

B.3 Education

In most parts of the industrialised world, non-government providers play a substantial role in the supply of primary and secondary schooling, and while Australia is among the leaders, it is by no means the furthest advanced.

B.3.1 Private Schools

Australia

Australia has a strong independent schools sector, representing around 29% of total school numbers and 34% of student numbers. The independent sector has significantly expanded since 1964 when state funding was first made available to non-government schools and per capita grants (in effect, partial school vouchers) were introduced in the 1970s.³⁵¹ The Gonski Review recently reported:

Catholic and independent schools had the largest overall proportional increase in students over the last five years with six and 14% increases respectively. Students attending government schools increased over the same time by less than two percent.³⁵²

While there is a debate over the fairness of funding arrangements, the overwhelming majority of Australians accept the mixed economy in schooling and the associated choice which many enjoy as an inevitable and, indeed, beneficial arrangement. As the Gonski Report noted:

The prominence of non-government schools in Australia, all of which receive some level of government funding, sets it apart from many Organisation for Economic Co-operation Development (OECD) countries. . . . government schooling is the dominant model for most OECD countries. There tends to be more variation in the senior years of schooling, with more schooling systems having larger numbers of government-supported and non-funded non-government schools in upper secondary education.

The large number and types of non-government schools in Australia provides parents with a high degree of choice in schooling options for their children. This choice is a value supported by many – non-government schools may provide an education that is consistent with a family's values, or may be regarded as providing a quality education, fostering strong academic and non-academic outcomes.³⁵³

United Kingdom

On a superficial analysis, the UK education sector appears to have much less diversity than its Australian equivalent, but to some extent this reflects the way in which government schools have been defined. For example in 2008, 56% of all secondary schools (public and private) were community schools, where a local authority owned the facilities and employed the staff. The remainder was made up of:

- Foundation schools (15%), where the governing body employed the staff and was primarily responsible for admissions. Physical assets were owned by the governing body or a charitable trust
- Voluntary aided schools (13%), where the assets were owned by a charitable foundation and the governing body contributed to the capital costs of the school. Staff were employed by the governing body and they made the admissions arrangements. Around 90% of these were church schools

- Independent schools (ten percent). These were founded by charitable organisations and funded by parent's contributions. Private companies operated a number of these schools
- Voluntarily controlled schools (three percent), where the local authority employed the staff and had primary responsibility for admissions, but a charitable foundation owned the assets
- Academies (then at one percent), a new model created by the Labour government, established with business, faith or community sponsors, to turn around poorly-performing schools.³⁵⁴

Since the change of government in 2010, the Coalition has encouraged all British schools to seek academy status, freeing them from local authority control, and giving them the autonomy to determine pay and conditions for staff, and change the length of terms and school days. As of 1 April 2012, there were 1,776 academies in England.

Western Europe

In Germany, the right to create private schools is constitutionally protected, although only a small proportion (around six percent), actually attend non-government institutions. The Netherlands has a long-established system of state-funding of non-government schools, for much the same reasons as Australia – the need to accommodate religious differences: around 76% of Dutch children attend a non-government school. Sweden introduced school vouchers in 1991 and around six percent of students now attend non-government schools.³⁵⁵ In France, some 15% of children attend private schools, in Spain, more than 35%, and in Belgium as many as 60%.

North America

In the United States, a small proportion of students attend private schools (less than five percent), however, another five percent of students attend independent public schools known as charter schools. Canada appears to have a much smaller independent sector (representing some four to five percent of students), but like the United Kingdom, some religious institutions are counted as state schools, so the true story is somewhat more complex than it first appears.

B.3.2 PPP Schools

United Kingdom

The use of PPPs in the provision of school infrastructure was pioneered by the British government in 2004. Under a program entitled 'Building Schools for the Future', it was proposed to rebuild 50% of the secondary schools in England, structurally remodel 35% more and

refurbish the rest. A comparable program for primary schools was launched two years later. In 2010, the new government announced that all projects that had not reached financial close would be abandoned. While it had been originally intended to use the design and construction of these new facilities to drive service reform, in the result, the service element was largely confined to traditional facilities management.

Australia

NSW pioneered the use of public-private partnerships in the schools sector, with the construction of two groups of new schools between 2001 and 2008 (nine schools in the first phase and ten in the second). Services included hard and soft facilities management, the latter covering cleaning, janitorial and grounds maintenance. A subsequent review by the Auditor General concluded that the costs of the PPPs were less than the public sector comparator by seven and 23% respectively.³⁵⁶ The Victorian government has opened 11 new schools that were procured through a public-private partnership, with the usual contractual obligation for building and grounds maintenance, and cleaning services. And seven new schools have been opened in Queensland under this same model.

B.3.3 Vocational Education

Australia

The most detailed analysis of the market for vocational and educational training comes from Victoria where, in 2008, the government removed the cap on the number of subsidised places, and created a 'student entitlement' which follows the student. A government report on the market concluded:

*By the end of 2011, 768 providers were delivering government-funded enrollments... in Victoria. Private providers now hold a 40% share of the government funded training market in 2011, up from 14% in 2008...
...When measured in terms of government funded student numbers, 2011 figures show that private RTOs [registered training organisations] now have a student share of 44%.³⁵⁷*

Comparable figures are not available for NSW, but the Board of Vocational Educational and Training advises that there were 1,086 RTOs at June 2011, and another 1,137 from interstate (under mutual recognition arrangements). 582 NSW-registered RTOs were delivering training in other states, but the Board provides no information about market share.³⁵⁸

B.3.4 Universities

The vast majority of universities in Australia are public institutions, although they operate with significant autonomy. However, most of the leading universities across the English-speaking world are non-governmental institutions – in the United States, Harvard, Stanford, Yale and MIT; in the United Kingdom, Oxford and Cambridge.

B.4 Social Housing

Australia

Around 15% of Australia's social housing is provided by around 950 community housing organisations and 400 Indigenous providers. This growth has occurred since the 1980s as a result of a variety of federal and state policy initiatives.³⁵⁹ Australia's Housing Ministers have agreed that community providers should manage 35% of social housing by 2014.

In NSW, the proportion of community management is somewhat higher, due to an initiative of the previous government commenced in 2007. NSW has a system of accreditation for providers with regulation undertaken through the Registrar of Community Housing, and the sector is quickly acquiring the characteristics of a mature service industry. Housing Ministers have recently agreed a blueprint for a national regulatory regime for the industry.³⁶⁰

In spite of significant interest amongst politicians and policymakers, choice-based letting has not been widely on any scale in Australian jurisdictions, with the only known pilot in Whyalla, South Australia.³⁶¹

United Kingdom

By 2008, around half of the social housing provided by local authorities in England had been transferred to non-profit organisations known as housing associations (or registered social landlords, as they are formally known). Housing associations were originally created in the 19th century as philanthropic institutions, but during the 1980s, many local authorities transferred their housing stock to such bodies to take advantage of government subsidies.

They are regulated by the Tenant Services Authority which, from 2010, has regulated all social housing providers, including those operated by the public sector. Until recently, they were regarded, in England at least, as non-governmental bodies, which meant that their borrowings fell outside the 'public sector borrowing requirement'. However, in 2008, following a disputed eviction, a divisional court judge ruled that the sector was heavily subsidised by the state for the implementation of government policy, and 'this was a clear case of "the injection of capital or subsidy into an organisation in

return for undertaking a non-commercial role or activity of general public interest"'. On appeal, the court criticised the judgement of the division court for focusing on the character of the association itself (which they described as a 'hybrid public authority'), and maintained that the focus should have been on the act of terminating the tenancy. This was not a private act and as such it was subject to judicial review.³⁶²

The structure of the social housing sector is somewhat more complicated than this. Around 25% of local authorities in England contract the management of their social housing to arms' length management organisations (ALMOs), companies limited by guarantee which actively engage tenants in management decision-making. They are owned by local authorities and under certain conditions they can benefit from the authorities' tax exempt status.³⁶³ Only two private companies have been accredited by the social housing regulator to manage social housing. One of these manages around 22,000 social housing homes.

There has been somewhat more private sector involvement in the maintenance of social housing, and in 2007, it was estimated that around one-third of these services had been contracted out.³⁶⁴

The UK was a pioneer in choice-based letting in social housing, whereby applicants are able to apply for accommodation that suits their needs rather than being forced to accept or reject whatever housing is allocated to them by a social landlord. Local authorities started to adopt the so-called Delft model from the Netherlands in 2000, and by 2003, 80 local councils in England claimed to be pursuing choice-based letting in some form. The national government formally adopted the policy in 2001, with the objective of having all local authorities operating on that basis by 2010. 27 pilot schemes were commissioned by the national government between 2001 and 2003.³⁶⁵ By 2008, choice-based letting was used in 30% of all social housing lettings.³⁶⁶

Western Europe

Similar patterns of involvement by municipal and not-for-profit organisations are evident throughout Western Europe, although with significant differences in some countries. Social housing in the Netherlands was transferred from local authorities to not-for-profit housing associations in the 1980s and 1990s. Under the German system, there are no specifically-identified social landlords:

Grants are provided to commercial and non-commercial parties who intend to let dwellings under certain prescribed conditions to the target group for the agreed period. When the grant period lapses, the dwellings lose the label 'social'.³⁶⁷

Germany also has more than 2,000 housing cooperatives, whose objective is to provide housing at cost. Municipalities or departments dominate the social rental sector in France, although there are also a number of not-for-profit housing associations that date from the 19th century when employers were active in supplying low-cost accommodation for their employees. In Flanders (Belgium), the social housing sector is small, and dominated by not-for-profit housing associations, although municipal councils are the largest shareholders.³⁶⁸ Choice-based letting was first introduced in 1990 in the Dutch city of Delft and has since been adopted in 80% of municipalities in that country.

B.5 Community Services

Non-governmental organisations were usually the pioneers in developing new social services and where they have retained a significant role, albeit with government funding. There has been an increasing reliance on not-for-profit providers in recent years – in a survey by the Productivity Commission, 70% of agencies reported such an increase.³⁶⁹ The Australian Bureau of Statistics reports that of the \$5.9 billion spent on personal and social support, \$4.3 billion, or 73%, was spent by not-for-profit providers.³⁷⁰

Significantly, open or selective competition is already a significant feature of the community services sector, with 60% of services provided by not-for-profit organisations having been subjected to some kind of competition.³⁷¹

B.5.1 Children's Care

Australia

South Australia contracted out most of its children's services functions in the 1990s, and other states have progressively followed. At present, around 17% of foster placements in NSW are managed by non-governmental organisations, and the state government has recently signed contracts with NGOs to transfer almost all of the rest over the next five years.³⁷²

United Kingdom

The private sector dominates the market for residential care in the UK, accounting for around 50% of beds, followed by local authorities (35%) and the voluntary sector (10 percent). In 2006, there were 1,237 private homes, with the largest provider accounting for only 65 of these.³⁷³

Independent Fostering Agencies play a significant role in organising foster care in the UK, and have increased their share significantly in recent years (33% by 2010). Over the period 1998 to 2009, the number of agencies increased from 62 to 289.³⁷⁴ The leading fostering agency in the UK,

Foster Care Associates, is owned by Core Assets Group Ltd, which consists of a number of for-profit and not-for-profit providers. However, the market is very fragmented, and FCA has around three percent of the national market.³⁷⁵

United States

Kansas was the first US state to outsource its adoption and foster placement services in 1997, using payment-by-results incentives, and it has been followed by a number of other states.

B.5.2 Aged Care

Australia

Private and not-for-profit organisations are the major suppliers of residential aged care in Australia. According to the Australian Institute of Health and Welfare:

Not-for-profit and private organisations were the main providers of residential aged care services nationally, with 60% and 29% of facilities, respectively. However, the distribution varied markedly among the states and territories. Private ownership of facilities was highest in Victoria (39%); this state also had the lowest proportion of not-for-profit facilities (36%) and the highest proportion of government-owned facilities (25%). Not-for-profit services dominated in the smaller jurisdictions, accounting for 79% of facilities in Tasmania, 85% in the Australian Capital Territory and all facilities in the Northern Territory. Religious organisations were the most common not-for-profit owners in all jurisdictions except Victoria.³⁷⁶

Home care is also dominated by independent sector providers. There are around 3,400 agencies across Australia supplying services under various state and Federal governments' Home and Community Care Programme, almost all of which would be operated by private and voluntary sector providers. In the case of the community care packages provided to older people to assist them to remain in the community, 84% are provided by not-for-profit providers and the remaining 16% by commercial organisations.³⁷⁷

United Kingdom

Residential care for the aged has been progressively privatised since the 1980s, with more than three quarters of places not provided by the private sector, with the rest provided by local authorities and the third sector. The market is highly fragmented: a 2005 survey by the Office of Fair Trading reported that 54% of providers were single home businesses and eight percent were part of a small business owning two homes.

Increases in the purchase of home care by health and social services in recent decades have been largely accounted for by independent providers, with the number of hours provided by local authority services declining. In 2004, there were more than 3,000 registered home care providers in the UK. The market is fragmented, with relatively few large providers and many small ones.³⁷⁸

B.5.3 Disability Services

Aged and disability care account for the vast majority of residential care in Australia. Of those in 'high care', provision is dominated by the not-for-profit sector (50%) and the private sector (47%), with the remainder being accounted for by government organisations. An even larger proportion of 'low care' facilities (72%) are managed by not-for-profits.³⁷⁹

B.5.4 Counselling Services

Throughout Australia, a wide variety of counselling services are operated by non-government organisations. The crisis support and suicide prevention hotline, Lifeline, is a prominent Australian example, two-thirds funded by government and one-third from charitable donations and other sources.³⁸⁰

Another notable example is the 65 Family Relationship Centres established by the Federal government in 2004 to provide advice and assistance to families under stress, particularly post-separation. All are operated by non-government organisations, with funding tied to performance indicators.³⁸¹

B.6 Municipal Services

United Kingdom

In the UK, local government provides a much wider range of public services than in Australia and, for that reason, it has been the subject of a great deal of restructuring.

Contracting of municipal services commenced in the early 1980s, prior to the introduction of compulsory competitive tendering, and by 1985, 75 local authorities had already subjected some of their services to competition. As a result of CCT, the scale and scope of contracted services significantly increased. In a 2007 survey of local authority executives, 38% reported that outsourcing was a major part of their council's approach to service delivery, while 45% reported that it was not.³⁸²

There is a great deal of variation in the extent to which municipal services are commissioned from external providers. A study of the municipal services market prepared for the Department for Communities and Local Government in 2006 reported that roads, highways and

transport, childcare, children's homes and household waste collection were primarily commissioned services, while leisure, foster care, street cleansing and libraries were primarily delivered in-house.³⁸³

In household waste management, a significant number of local authorities continue to self-provide collection services (52% by tonnage in 2005). Local government's market share had fallen from around 90% in 1998. Among the external suppliers, there was significant concentration, with four accounting for 27% of the market, and small providers accounting for the rest.³⁸⁴

The leisure industry was also dominated by in-house provision, with the private sector accounting for 17% and not-for-profit trusts around 20%. In this case, the market share held by the private sector remained constant, while the leisure trusts had expanded at the expense of in-house provisions.

Australia

Recent estimates of the extent of competition and contracting in the local government sector are not available, however, research public a decade ago by Worthington and Dollery makes it clear that this is yet another mixed economy:

In NSW, between 70 and 85% of councils used contracting for refuse collection, sanitation and road and bridge maintenance, and had already been doing so in 1988/89, compared to around five percent in 1960/61. Studies suggest that by the early 1990s, some ten to 20% of total aggregate council expenditure was contracted out, without any degree of compulsion. In a 1990 survey, the Evatt Research Centre found the most commonly contracted services (with percentage of councils contracting out the selected service in brackets) to be:

- (i) recycling (60%)
- (ii) household garbage collection (55%)
- (iii) cleaning of kindergartens (42%)
- (iv) cleaning of community centres (35%)
- (v) drainage (21%)
- (vi) road, bridge and footpath maintenance (17%)
- (vii) operation of child care centres five percent
- (viii) elderly care services (four percent)
- (ix) social workers (one percent).³⁸⁵

United States

The outsourcing of municipal services has remained a controversial issue in the United States, and yet, as always, there is a great deal of diversity, and there are a number of cities in that country which outsource all of their services. The best known are the Lakewood Plan cities in

southern California, discussed in Section 3.4 and Appendix B.3, however, five more have been established in Georgia in recent years.³⁸⁶

B.7 Emergency Services

At first glance, emergency services would appear to have somewhat similar characteristics to policing, so that we might expect that there would be little evidence of non-state provision. However, this is not the case, partly for historic reasons, partly because these are services where social innovation plays a significant role and partly because of the peaky nature of demand.

B.7.1 Rescue Services

Australia

Ambulance Services in NSW. As in most other states of Australia, emergency ambulance services are provided by a government service provider. However, the situation with non-emergency transfers is somewhat more complex. A dedicated patient transfer service (PTS) within the Ambulance Service of NSW was only created in 2003, in response to growing demand. However, over subsequent years, some individual hospitals and Area Health Services developed their own transport services outside of the PTS, resulting in something resembling an internal market.³⁸⁷

Ambulance Services in Western Australia are provided by a not-for-profit provider, St John's Ambulance, and have been since 1922. They have been partly funded by government since 1933, and financial support is now provided through five-year contracts. Until 2010, the state government was responsible for less than 20% of the ambulance service's total income. Except for senior citizens, St John's charges a fee for use of its services, but a government inquiry in 2009 reported:

There appears to be a widespread belief in the community that ambulance services are (or should be) free, and this may have contributed to the bad debt in emergency ambulance services. SJA's 2007/08 annual report noted bad debts of \$9.6 million (11%) for the metropolitan area and \$4.0 million for country areas. . .³⁸⁸

The review was established following a 'Four Corners' program which claimed that four patients had died in that state as a result of inadequate ambulance care. Whilst recommending reforms, including increased state funding, 'the Inquiry found that the model of an external service provider rather than a state-run system was considered the most cost effective for WA'. Overall, St John's was meeting its contractual obligations to the state

government, and in many areas it was exceeding expectations.³⁸⁹³

At the time of the inquiry, Western Australia's ambulance service was costing \$52 per capita, well below the national average of \$95 per capita (of which state governments paid \$62). The inquiry recommended additional funding and, in May 2010, the WA government announced an additional \$150 million over four years. Some of this was capital funding, but the government subsidy more than doubled to \$45 million a year, representing some 26% of revenue.³⁹⁰ St John's also provides ambulance services in the Northern Territory.

Independent sector providers play a significant role in the provision of helicopter rescue services in Australia. The pioneer appears to have been a service initiated by the Surf Life Saving Association in South Australia in 1973, followed by Sydney's CareFlight in 1986. Since 2007, helicopter emergency medical services (which provide transportation rather than rescue) in the Sydney Greater Metropolitan Area have been provided by a private company, CHC.³⁹¹

CareFlight

CareFlight demonstrates the benefits that the people of Australia have obtained from taking a pragmatic approach to the public-private question. The now familiar aeromedical service was established in 1986, based at Westmead, one of Sydney's leading public hospitals. It was an innovative new model of service delivery pioneered by a medical practitioner and a chief pilot with a background as a medical technician.

That highly innovative approach to the provision of air ambulance services has continued in the 25 years since its establishment. Among other things, it has conducted a 'Head Injury Retrieval Trial', with financial support from the Ambulance Service of NSW and the Motor Accidents Authority (MAA).

CareFlight (NSW) Limited is a public company limited by guarantee, a registered charity and a public benevolent institution. While it does make a profit, its constitution precludes the payment of any dividend to its members. The current chairman is Dr Andrew Refshauge, the former (Labor) NSW Minister for Health.

In 2011, it raised more than \$11 million in donations, whilst being paid \$37 million under agreements with governmental healthcare agencies throughout Australia and the region. In that year, it was paid more than \$3 million by the Ambulance Authority of NSW and \$1 million by the MAA, although in 2010, the MAA provided an additional capital grant of \$2.2 million.

It has recently won a major contract with the Northern Territory government for aero medical services, and another with the Department of Defence to provide medical training services to the Australian Defence Force.³⁹²

Western Europe

Emergency services in Denmark: Some 60% of fire protection and 85% of ambulance services in Denmark are provided by a private, for-profit corporation, Falcks Redningskorps A/S, as they have been for more than 80 years. Among the Danes, Falck is regarded as a public service: in local directories, the company is listed after the emergency services number (112) and ahead of the police.

When Denmark's first social democratic government introduced mandatory national standards for fire protection in 1926, it permitted municipal governments to contract with private companies for their delivery. At first glance, this seems to be an unlikely concession by a social democratic party, particularly in one of the Scandinavian countries. But it was driven by a belief that core public services should be provided equitably across the country as a whole. Since fire protection was the domain of municipal government, and since local politicians would have resisted intervention by the national government, allowing these services to be delivered by a large-scale private provider such as Falck meant that the government could achieve its objectives more quickly. There was another benefit from having the private sector involved: these new services were not paid for by the state. Until the reform of local government in the 1970s, Falck was largely funded by the insurance industry. In rural areas, the insurance companies paid two-thirds of the expenses associated with turning out for a fire.

Once every three to five years, Falck negotiates a new framework agreement with the National Association of Local Authorities, which lays down service levels and the cost of a standard fire brigade with standard equipment. Individual municipalities are then free to purchase the basic package or negotiate additional services with additional staff and specially-equipped vehicles. Ambulance services are the responsibility of county-level governments, and Falck has contracts with all 14 councils, covering around 85 % of emergency medical services throughout the country. These contracts are negotiated under the umbrella of framework agreements signed every three years with the Association of County Councils.

United Kingdom

Fire Services. Professional fire-fighting in England (and in Australia) was pioneered by the insurance industry, being gradually municipalised and nationalised from the middle

of the 19th century. However, private companies are now being involved in providing support services.

The London Fire and Emergency Planning Authority recently contracted with a private company to operate its 999 emergency control service, the first fire brigade in the country to do so. The Fire Brigade said that the contract would deliver a new high-tech system and enable the service to concentrate on its core business of putting out fires and saving lives.³⁹³

In September 2011, the British government released a consultation paper, exploring options for greater private sector involvement in the operation of the Fire Service College, the national training facility for the fire and rescue service. The options included a GOCO arrangement and the closure and sale of the 150 hectare site in Gloucestershire, with training being delivered at a range of sites across the country. Recent news reports suggest that the government may have elected for privatisation.³⁹⁴

Ambulance Services. In Britain, the concept of a civilian ambulance corps was invented in the late 19th century by a private charity, the St John's Ambulance Brigade, which remained the dominant service provider until the 1920s when local governments began to enter the field. The creation of the National Health Service in 1948 made it increasingly difficult for St John's to attract donations and retain members and the government gradually acquired its stores and stations.

United States

Ambulance Services. In recent decades, private companies have played a more significant role in the provision of paramedic services and medical transportation in the United States. Today they account for almost half of these services in major cities, significantly more than municipal fire departments, up from a little as one-fifth in 1995.³⁹⁵

From 2000, non-profit hospitals in New York – which had long been part of the city's 911 emergency call system – were permitted to contract with private companies for the provision of emergency services. This reinforced a perverse incentive already built into the system, for drivers to divert insured patients to their sponsor's hospitals.³⁹⁶ The flaw lay not in the use of private ambulance services, but in the system for allocating jobs operated by the City Fire Department. There was nothing wrong with the public service ethos of the independent providers - around 40% of the ambulances at Ground Zero on 9/11 were private or not-for-profit providers, and several of their crew members lost their lives.³⁹⁷

Other

Ambulance services. St John's established branches throughout the British Empire and in some parts of the

world, such as New Zealand and Western Australia, where the charity continues to deliver emergency medical services, albeit with significant government funding. In other parts of the Commonwealth – England, Canada, Malaysia and in several states of Australia – St John's Ambulance continues to provide first-aid training and non-emergency transportation.

Ambulance services in Germany are financed through taxation and user-charges levied on health insurers, but they are actually provided by voluntary medical aid organisations such as the Red Cross, the Samaritans and St John's. The German Red Cross delivers these services through subsidiaries organised on commercial lines which distribute any surpluses to the parent charity. The private sector also plays a major role in Norway, Finland and the Netherlands. In Italy, a religious charity, the Misericordia, provides ambulance services throughout much of the country.

B.7.2 Ocean Rescue

Private institutions also play a significant part in the field of ocean rescue, particularly in the English-speaking world. America's beach lifeguards and Australia's surf lifesavers are volunteers, sustained by private donations of time and money. In Britain, the Royal National Lifeboat Institution, which undertakes the vast majority of ocean rescues, is a private charity which raises around £100m a year in funding and prides itself on not accepting government support. In an age when membership in charitable organisations is no longer fashionable, the RNLI boasts more than a quarter of a million members.

B.7.3 Lighthouses

England's lighthouses and seamarks are managed by the Corporation of Trinity House, a not-for-profit corporation established by Henry VIII in 1514. From the time of Elizabeth I, it was also empowered to erect seamarks, although the actual construction and operation of lighthouses was long undertaken by private entrepreneurs under licences issued by the Corporation. Starting with the legendary Eddystone Light in 1807, a number of these leases reverted to Trinity House, and in 1836, legislation was passed compulsorily acquiring all of the nation's lighthouses and placing them under the Corporation's management. The colourful history of Britain's lighthouses is, in fact, the history of a public service corporation: Grace Darling, the young Victorian heroine who helped to rescue survivors from the wreck of the steamer *Forfarshire* in 1838, was the daughter of the keeper of the Longstone Lighthouse, who was a Trinity House employee.³⁹⁸ The Corporation still manages the nation's seamarks, as well as operating homes for elderly seaman and granting scholarships in the field of maritime education.

For many years, Trinity House was funded through the rights of ballastage, a monopoly granted in the late sixteenth century over the shingle dredged from the floor of the Thames and used as ballast in seagoing ships. But its lighthouses were funded by the Light Dues, a levy imposed on all ships leaving English ports and collected on its behalf by customs officers. Trinity House continues to manage the nation's lighthouses, even today, financed by shipping levies collected by the customs service.³⁹⁹

B.8 Research Establishments

As noted above, since the Second World War, the US federal government has undertaken much of its most sensitive research in the defence and energy sectors through GOCOs, with the laboratories managed by universities and private corporations. These include Los Alamos, Oak Ridge and Sandia.

A recent study by the Liberal-Democrat think-tank Centre Forum looked at 17 public sector research establishments (PSREs) in the UK, seven of which remained as GOGOs (Government-Owned, Government-Operated), and three were now managed as GOCOs. Over recent decades, three had been privatised as non profit-distributing concerns and four as profit-distributing enterprises. Against the criteria of the extent to which government was getting what it wanted at the required level of quality, the report concluded that all 17 organisations appeared to be performing well.

The main difference in performance between the organisations turns out to be how they perform financially and organisationally. Here there are significant differences in efficiency and growth rates.

Of the GOGOs, one (the Forensic Science Service) was performing badly and making significant losses in a competitive market, and was in the process of being closed. Some of the others were facing substantial reductions in government funding, although they had performed well in the past. The study concluded management may have been adversely affected by the traditional constraints of public ownership.

All the GOCOs had met their financial targets and returned consistent surpluses. Two of the non-profit-distributing laboratories had experienced a significant decline in turnover since privatisation, while the two private equity-based concerns had grown profitably since privatisation. One (LGC, formerly the Laboratory of the Government Chemist) had grown 800%.

One of the notable differences was the extent of technology transfer – the government-owned PSREs (GOGOs and GOCOs) had registered patents and established spin-offs, but with the privatised laboratories, this was core business.

The government-operated laboratories, and to a much lesser extent, the contractor-operated facilities, still faced the structural, procedural and cultural constraints typical of traditional public management – slower decision-making, higher overheads, unnecessarily burdensome accounting rules, lack of customer focus and lack of access to capital.⁴⁰⁰

B.9 Public Transport

B.9.1 Rail Services

Private sector involvement in the management of light rail systems is so commonplace that it is not necessary to provide examples. Sydney residents are familiar with the light rail system which until March 2012 was owned and operated by a private company, Metro Rail Sydney, and managed by a private transport operator under contract. It was acquired by the state government as part of a strategy to extend the network.

Private management of heavy rail passenger services is less common, but examples are to be found in several countries throughout the industrialised world. The franchise model adopted in the UK and Victoria is not seen to have been a financial success.⁴⁰¹ However, there are private railways in Germany and Japan that have not experienced the same problems. In Europe, state-owned rail companies also operate outside of own jurisdictions.

B.9.2 Bus Services

A number of countries around the world privatised or contracted their urban bus services in the 1990s, including Britain, Denmark, Norway and New Zealand. A number of cities in the United States have also contracted the operation of their buses, and in Australia, Melbourne, Adelaide and Perth.⁴⁰²

Sydney's bus services are delivered by a mix of public and private providers under contractual arrangements with the NSW government. Until 2004, private bus operators enjoyed a significant amount of autonomy in service levels, and following a review, new seven-year contracts were implemented which established service levels. These contracts were negotiated using cost and profit benchmarking rather than competitive tendering.⁴⁰³

B.10 Road Services

B.10.1 PPP Toll Roads

While toll roads are relatively common in parts of Europe, in the United States and Japan, privately-owned and operated tollways such as Sydney's PPP toll roads are more unusual. Indeed, Australia (and NSW in particular)

has been a world leader in this regard. France and Spain pioneered this approach in the 1970s, and there are isolated examples in the US, Canada and the UK.

Interestingly, a number of small private toll bridges and one toll road from the late 18th and early 19th centuries survive down suburban and country lanes in the UK, a reminder of the fact that Britain's national road system was built by a public-private hybrid known as the Turnpike Trust.

B.10.2 Road Maintenance

Western Australia has also been a pioneer in contracting for road maintenance using outcome-based performance measures. Between 1999 and 2002, Main Roads Western Australia contracted out the management of all its roads under eight contracts for ten-year terms. While the first generation of these contracts were somewhat flawed, the agency has been rolling out a new set of 'integrated service arrangements' which rely much more heavily on a partnership approach.⁴⁰⁴ VicRoads employs a mixed approach: for routine maintenance, almost all roads in urban areas have been outsourced and around 50% in rural areas.

The Roads and Traffic Authority in NSW contracted with a private provider in the early 1990s for the maintenance of roads in northern Sydney under a long-term performance contract, but until recently there has been no further development of this model. The government is currently examining the potential for greater contestability in the provision of road maintenance.

B.11 Urban Water Supply

Several jurisdictions, most notably England and Wales, have privatised their water supply, but in general this is not a model that has been widely adopted throughout the industrialised world. Glas Cymru (Welsh Water) was established in 2000 as a company limited by guarantee, without shareholders and operated entirely for the benefit of its customers.

In 2008, Scottish Water opened up the retailing of water to non-domestic customers to competition. The publicly-owned water company maintains its monopoly on bulk supply and distribution, and has established its own retailer, Business Stream, to compete in this market. Within two years, around 40% of the market had switched to an alternative supplier.

A majority of French municipalities contract for the management of their water supply with two large private corporations, Compagnie Générale and Lyonnaise des Eaux. These companies have been operating since the middle of the 19th century, under several different contractual arrangements (leases and concessions).

Competition is limited, a matter which the European Commission is currently investigating. Spain also has a longstanding tradition of private water companies.

In South Australia, the operation and maintenance of water and wastewater services has been contracted to two private corporations. Melbourne contracts out the maintenance of its distribution network. Sydney's water supply is a complex mix of public and private, competition and monopoly, which illustrates rather well the diverse range of service models that are available, and the ways in which these can be combined. The extent of private sector involvement in the sector is considerable: over the past five years, around 80% of the utility's capital and recurrent expenditure has been delivered by private sources.⁴⁰⁵

Sydney Water

Sydney Water, a corporatised state-owned entity, retains tight control over the distribution network, but the bulk water supply is managed by the Sydney Catchment Authority which provides water from Warragamba and other dams, and the desalination plant (currently owned by Sydney Water but expected soon to be leased to a private provider under a long-term contract).

In principle, there is scope under the NSW Water Industry Competition Act (2006) for other providers to sell bulk water to Sydney Water (through the capture and treatment of waste water), but no applications have yet been made. However, there is scope for the supply of non-potable water by licensed private suppliers, although at present, this is only being done for individual buildings or developments.

Around 95% of the city's water is treated in plants that are operated under PPP arrangements or private management contracts. Some front-line functions, such as meter reading, are also contracted out.

There has been ongoing discussion about the scope

for water distribution in Sydney's growth centres to be owned and operated by private providers: the difficulty with such a model is that it would expose the differences in the cost of distribution across the city and necessitate some other form of cross-subsidy.⁴⁰⁶

While Sydney Water has outsourced much of its maintenance services over time, it was recently announced that all of its remaining electrical and mechanical services will be contracted out (without the scope for an in-house bid). This has been driven by constraints on price increases demanded by the Independent Pricing and Regulatory Tribunal.⁴⁰⁷ It is understood that other maintenance services will continue to be delivered in-house but subjected to a contestability regime.

B.12 Other Services

B.12.1 Audit

It is not unusual for auditors-general to contract out some of their audit functions. In Victoria and the ACT, around half of audits are undertaken by external providers. In NSW, the figure is around 10 percent, while in the Northern Territory almost all audits are provided under contract.⁴⁰⁸

In NSW, around 30% of spending on internal auditing is through contractors, with larger organisations doing more in-house. Around half of all agencies undertake all of their internal auditing through external providers, while another 38% partially obtain these services through contract.

B.12.2 Valuation

Many of the valuations undertaken by the NSW Valuer General are undertaken by external providers, including the subsidiary of a corporatised entity owned by the New Zealand government, as well as private firms. This system has recently been the subject of some controversy in NSW.⁴⁰⁹

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NSW Business Chamber

140 Arthur Street
North Sydney NSW 2060

ABN 63 000 014 504

Locked Bag 938,
North Sydney NSW 2059

DX 10541 North Sydney

t 13 26 96

f 1300 655 277

e business.hotline@nswbc.com.au

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