

TESTING NEW COMMISSIONING MODELS

*A guide to help policy makers learn
about publically funded markets*

TESTING NEW COMMISSIONING MODELS

*A guide to help policy makers learn
about publically funded markets*

Contents

About the authors	5
Acknowledgements	5
Executive summary	6
Introduction	8
The questions market appraisals should answer	12
Ways of testing markets	27
Risks when testing publically funded markets	35

1. About the authors

Kate Blatchford

Research Analyst

Kate joined the Institute in December 2009 after graduating from her MSc in Public Management and Governance at the London School of Economics in September 2009. She works on the Institute's [public service reform](#) programme, looking at contemporary innovations in the UK and worldwide. Her research interests include innovative approaches to public management and methods of public participation in policy making and public service design.

Tom Gash

Programme Director

Tom joined the Institute in January 2008. He leads the Institute's work on [public service reform](#), looking at contemporary innovations in the UK and worldwide. Tom is particularly interested in assessing the impact of changes to government accountability arrangements (for example, the introduction of [elected mayors](#)) and attempts to incentivise public service innovation and efficiency through the use of choice and competition.

Tom was previously a strategy consultant at the Boston Consulting Group and a senior policy adviser in Tony Blair's Strategy Unit, where he advised on crime policy and developed new commissioning models in immigration services. He speaks and writes widely on public management and crime policy and has worked as independent consultant to governments in Europe and the Middle East.

2. Acknowledgements

We are grateful to all the participants who contributed to our roundtables on 'Piloting payment by results', 'Piloting individual budgets' and 'Methods of testing public markets' and to those who agreed to be interviewed as part of this project. We are also grateful to Jill Rutter for her contributions to the drafting process, and Andrew Murphy for his support throughout the publication process.

3. Executive summary

*“Wherever possible we are increasing choice by giving people direct control over the services they use”.
“We will... open up public services to new providers and new ideas...it shouldn’t matter if providers are from the state, private, or voluntary sector – as long as they offer a great service.”*

David Cameron, July 2011

“At times it was like ‘oh my... no one had ever done it before.”

Senior civil servant, November 2011

Government officials currently face a difficult task. At a time of rapid expenditure reductions and falling departmental headcounts, they must expose more public expenditure to competitive tender, experiment with new commissioning models, and tally the development of public service markets with drives to decentralise power.¹

The Government is already experimenting widely, often embracing the prudent view that new commissioning models should be rigorously tested before they are widely implemented. In principle, such testing offers many benefits: methods of implementation can be investigated, contract designs can be perfected, and costly mistakes can be minimised.

Market testing is a complex task however – particularly for the many policy makers we encountered who are developing new market-based delivery models with limited experience in either piloting (the current default testing method) or commissioning. And the task is made still harder by the shortage of opportunities to learn from others. Our research suggests that formal training in market testing is rarely (if ever) provided, opportunities for cross-departmental knowledge sharing have (until recently) been limited and there is little practically focused literature on ways of testing policies and delivery models. The amount of literature that does exist tends to focus on a single method of appraisal or offers generic advice about managing risks when implementing a policy and therefore does not provide insight into specifically what learning market tests should generate.²

This document attempts to fill some of these gaps and reassure those developing new commissioning models that there is a growing pool of knowledge about what works in market testing. Through interviews and workshops with policy makers and commissioners, we have:

¹ New commissioning models include ‘payment by results contracts’ and ‘individual budgets’

² For examples see: HMT (2004) The orange book: management of risk – principles and concepts; NESTA and Think Public (2011) Prototyping framework: a guide to developing new ideas, and Government Chief Social Researcher’s Office (2003) Trying it out: the role of ‘pilots’ in policy making

- 1) developed a framework of political and practical challenges that need to be explored and addressed when testing new market mechanisms and commissioning models
- 2) outlined different ways of testing publically funded market models, their strengths and weaknesses, and the stages at which they might be used in the testing process
- 3) captured how civil servants are adapting the ways they work in order to test and develop publically funded markets more effectively.

There are a number of lessons that have emerged from our research.

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.³

³ For a fuller discussion of what it means to steward a policy area see Hallsworth, M. (2010) *System Stewardship* Institute for Government

4. Introduction

Policy context

The Open Public Services white paper tasks 'market making'⁴ policy makers and commissioners with increasing the use of choice and competition in the provision of public services.⁵ Of course, many public services and goods are already competitively tendered and provided by a range of public, private and voluntary sector providers whilst being paid for with taxpayers' money. Indeed, in the UK approximately one third of total managed expenditure is already procured through competitive tender.⁶ Similarly users can already exercise at least some choice across a range of different services including social care, health and schools.

Today, the scale of ambition has increased. The Coalition government wants to go further still and not only increase the percentage of expenditure on public services that is competitively tendered (as opposed to directly funding services 'in house'), but also introduce innovative new commissioning models such as paying providers only for the results they achieve and allowing individuals to hold budgets from which they can purchase services. Examples of the new commissioning models currently being tested across government can be found in Figure 2.

The way in which these market makers initially design mechanisms which expand the use of choice and competition across public services is critical to their long-term success. As we argued in *Making policy better* getting policy design right at the early stages – by rigorously testing whether a policy is realistic and addressing common implementation problems before policies are rolled out at scale – will help ensure policies deliver value for money in the long term.⁷ Market-based policies are no different. Initial decisions about the way contracts are designed, how to make a market responsive and how to enhance supply and demand conditions, will all affect how the publically funded market develops over the longer term. It is important therefore that market makers seize the opportunity to test and learn about different approaches to designing publically funded markets before choice and competition is rolled out at scale.

This paper looks at ways in which market makers can seize this opportunity and learn about how publically funded markets are likely to work.

⁴ A definition of market makers can be found in Box 2

⁵ Cabinet Office (2011) *Open Public Services white paper* available at <http://www.cabinetoffice.gov.uk/resource-library/open-public-services-white-paper>

⁶ More information on government expenditure through procurement can be found in HMT (Feb 2012) *Expenditure on services*, Table 9 'Public sector expenditure on services by economic category, 2006-07 to 2010-11' Available at http://www.hm-treasury.gov.uk/pespub_natstats_feb2012.htm

⁷ Hallsworth, M, and Rutter, J (2010) *Making policy better* Institute for Government

Purpose

This paper aims to capture the growing body of knowledge held by those who have been involved in testing and implementing new commissioning models. By capturing this knowledge in a structured manner, it is hoped that this document will enable more effective market tests across government. The paper is intended to be useful for the wide range of people involved in market tests but will be particularly useful to those who are relatively new to either commissioning or testing methodologies, such as piloting.

This paper also highlights ways in which the civil service in particular will need to operate differently to enable more effective market testing. It is therefore relevant to all those with an interest in improving government effectiveness and particularly those in position to influence working practices.

Figure 1: Definition of terms

Market testing: Investigating how a market-based policy is likely to work in a controlled environment and creating an opportunity to amend or stop the policy before it is mainstreamed.

Market makers: Policy makers, procurers, and commissioners all have a role to play in creating markets. Often their roles and responsibilities overlap and making distinctions between these groups can be artificial and unhelpful. We refer to any civil or public servant with a role to play in creating markets as 'market makers'.

Publicly funded markets: Publicly funded markets refer to any attempt to introduce competitive tendering or user choice for services. In such markets services could be provided by the state, voluntary or private sector.

Market stewardship: Departments have a greater role in supporting publicly funded markets than just commissioning services. They also have to ensure the markets' 'health' by stewarding it towards being vibrant, resilient and producing desirable outcomes.

Market readiness: New markets are unlikely to be vibrant and resilient from their conception. As part of their stewarding role, market makers will need to assess whether markets are on a trajectory towards 'readiness', i.e. being sufficiently vibrant and resilient to deliver value from a greater share of public expenditure. When markets do not demonstrate a positive trajectory towards readiness market makers will need to intervene.

Method

The paper is based on:

- the existing literature about contracting out public services and testing public policies
- the insights generated through a series of three roundtables held over the course of October to November 2011 at the *Institute for Government*
- 15 interviews with senior civil servants with responsibilities for public service reform.

The three roundtables brought together practitioners from Payment by Results pilots, Individual Budget pilots and experts in different ways of testing policies respectively.

Figure 2: Selection of publically funded market pilots ongoing or planned in England and Wales, 2011	
Payment by results pilots	
<ul style="list-style-type: none"> • Local authority pilots aimed at families with multiple problems (led by Communities and Local Government) • 'Supporting people' pilots which provides housing support for 21 different client groups, including learning disability, older people and women fleeing domestic violence (led by Communities and Local Government) • Pilots to increase mobility in the social rented sector (led by Communities and Local Government) • Pilots to reduce incidence of rough sleeping in London by paying by results (led by Communities and Local Government) • Piloting a paying by results element to funding of Sure Start children's centres (led by Department for Education) • European Social Fund for Families with Multiple Problems (led by Department of Work and Pensions) • Drug and alcohol addiction pilots (led by Department of Health) • Social impact bond (SIB) pilot at HMP Peterborough (led by Ministry of Justice) • Paying HMP Doncaster for its reducing reoffending results (led by Ministry of Justice) • Applying payment by results to the management of offenders serving sentences in the community (led by Ministry of Justice) • Joint Ministry of Justice and Department of Work and Pensions Work Programme pilots • Other innovative ways of using payment by result contracts are being explored across the country 	
Individual budget pilots	
<ul style="list-style-type: none"> • Right to control pilots which allocates a single budget to disabled people to choose who delivers their services and how they receive their services (led by Department of Work and Pensions) 	

- Families with disabled children pilots to test whether the 'individual budgets' concept and approach worked in practice, and to what extent the approach was cost effective (led by Department for Education)
- Pilots for special educational needs which brings together 'personal health budgets' with 'individual budgets' for children and their families
- Personal health budgets in the NHS (led by Department of Health)
- Individual budgets for social care (piloted 2006-2007, led by Department of Health)
- Individual budget pilots for housing vulnerable people (December 2005 to December 2007, led by Communities and Local Government)
- Other innovative ways of using individual budgets are being explored across the country

5. Areas of focus for testing publically funded markets

There are many different ways of delivering public services. Ultimately, the decision that there is a 'market failure'⁸ – which in turn justifies the use of commissioning and market-based policies – is a ministerial decision. Once this decision has been made the civil servants' task is to expose ministers to the likely costs and benefits of market based policies and consider ways of implementing publically funded markets that maximise the chances of desirable outcomes and value for money being achieved.

The factors that will determine the effectiveness of a market are complex, overlapping and will transpire at different stages of the marketisation process. It is often difficult to get a handle on this complexity and to know how to start learning about public markets. To help provide focus for market tests, we suggest that the factors that will determine the effectiveness of the market can be grouped into five areas:

- political appetite for risk and variance
- accountability mechanisms
- contract design
- market readiness
- skills, capacity and mindset

There is a window of opportunity before market based policies are rolled out at scale for market makers to consider whether markets are designed to perform well across these five factors.

However, it is worth highlighting that market tests are unlikely to *a priori* fully expose whether a market will operate effectively at scale. Marketisation will always require a 'leap of faith' and the insights generated through the tested process may not be replicated at scale. Nevertheless, these leaps of faith can be minimised if market makers learn about markets and develop a process through which market tests can inform market roll out.

⁸ Market failure refers to a situation where the allocation of goods in a free market is not efficient, meaning that someone could be made better off (normally from a societal perspective) without someone being made worse off. Incidents of market failure normally justify some form of state intervention in the market. A more detailed discussion of market failure can be found in Appendix 1

Political appetite

The development of publically funded markets is unlikely to be quick and easy. Through the course of our roundtables we heard many market makers say they were struggling with the slow emergence of 'market conditions'. For example, it was reported that:

- users took time to start exercising choice
- competent providers did not always emerge immediately
- practitioner and union support for some market based approaches was often lukewarm.⁹

We were told, for example, that rolling out the Work Programme at scale we not have been possible without the long history of developing the supplier base and reiterating the policy framework which underpins the market.¹⁰

Market makers should therefore use market tests to make political decision makers (ministers, councillors and local government council leaders) aware that market development can be time consuming (often requiring more than one parliamentary term) and that specific risks will need to be managed. This will create an opportunity for political decision makers to develop a strategy for dealing with these risks, and may ultimately allow them to decide early on to that the expansion of market-based policies is not advisable.

As well as testing political appetite for challenges as markets develop, market tests also provide an opportunity to clarify what politicians expect the market to deliver. Being clear about political expectations will be important for subsequent market design. For example, if ministers value punishment for criminals highly, they might want to constrain the types of rehabilitative interventions that providers could offer to prisoners to reduce their reoffending rates – rather than saying that they care only about results.

To help politicians form a clear view about what market-based policies should achieve, it is necessary to expose them to the different views user groups, practitioners, unions and commissioners have of publically funded markets through the testing process. Doing so will allow politicians to make informed decisions about how the market should be designed to meet the interests of different groups, respond to legitimate concerns about how the market will operate, and judge the extent to which they are comfortable with opposition to introducing a market.

Exposing stakeholder perspectives is of particular salience when different groups have different objectives, and these objectives may also conflict.¹¹ One interviewee captured the tension by suggesting that:

⁹ The slow uptake of user choice has also been experienced amongst those who have managed personal budgets for social care, see Ipsos Mori (2011) *Users of social care personal budgets* p.2 available at http://www.ipsos-mori.com/DownloadPublication/1443_sri-nao-users-of-social-care-personal-budgets.pdf

¹⁰ The work programme can be seen as a continuation of a long history of market development dating back to the 1987-96 Training and Enterprise Councils which were contracted by the then DfE to deliver local employment and skills provision, through to the New Labour reforms including the New Deal, Flexible New Deal and 15 'Employment Zones' which were introduced in 2001 to deliver employment support.

One of the defining characteristics of good public services is that it is clear who they are accountable to. This can happen in different ways. Services can be strongly accountable upwards [i.e. to ministers] or they can be strongly accountable to the commissioner and market. One of the problems for public service markets is that they will have to take into account a range of stakeholders.

Market tests provide an opportunity to explore with politicians ways of managing the complex, politically charged, and often overlapping perspectives involved in delivering public services through a market.¹² Indeed, we would be concerned if a decision was made to use a market at scale without first exposing and addressing stakeholder views about the widespread implementation of markets.

In addition to developing a clear view about the specific objectives of political decision makers, market tests provide an opportunity to test political appetite for the more general implications of fully scaled markets. These implications include allowing provider failure and potentially embracing greater geographical or social divergence in the types of services provided. Decision makers who do not accept the underlying implications of marketisation may distort the way markets function. A minister, for example, who repeatedly intervenes in a publically funded market to bail out failing providers might encourage other providers to take excessive risks and undermine the credibility and effectiveness of the market. Ultimately, if politicians change their position after markets have been rolled out at scale, reforms necessary to expand publically funded markets may have to be reversed at significant cost.

By testing political attitudes early on in a relatively controlled environment, costly mistakes can be minimised and it will be possible to ensure that markets are designed to more accurately reflect political and wider stakeholder preferences. To ensure political appetite for risk and divergence is reflected in market design (or any policy design for that matter), civil servants need to ensure that ministers and/or local leaders are involved in the testing process, and that these decision makers are exposed to the likely consequences of implementing publically funded markets.¹³

Examples of the risks that political decision makers should be exposed to through market tests are summarised in Figure 3.

¹¹ For an insight into debate about the accountability tensions created by markets see: Brown, T., Potoski, M, Van Slyke, D (2006) 'Managing public service contracts: aligning values, institutions, and markets' *Public Administration Review* Vol 66 (3) pp. 323-331; Denhart, R and Denhart, J (2000) 'The new public service: serving rather than steering', *Public Administration Review*, Vol.60(6) pp.549-559; Hefetz, A, and Warner, M (2004) 'Privatisation and its reverse: explaining the dynamics of the government contracting process' *Journal of Public Administration Research and Theory* Vol. 22 (1) p.p. 171-190; Klinger, D, Nalbandian, J, Romzek, B (2002) 'Politics, administration and markets: conflicting expectations and accountability' *The American Review of Public Administration* Vol. 32 (2) pp.117-144

¹² Brown, T, Potoski, M, Van Slyke, D (2006) Managing public service contracts: aligning values, institutions, and markets public administration review Vol 66 (3) p.p. 323-331 p.323

¹³ Hefetz, A, and Warner, M (2004) 'Privatisation and its reverse: explaining the dynamics of the government contracting process' *Journal of Public Administration Research and Theory* Vol. 22 (1) pp. 171-190, p.174

Figure 3: Examples of risks and variations that political decision makers should be exposed to before markets are rolled out at scale

	Risks: do ministers have the appetite to accept that...	Variation: do ministers have to accept that...
Market development	<p>Users might not take up individual budgets</p> <p>Unions and other groups might vocally oppose competitive tendering</p>	<p>Users in Manchester don't get access to services being piloted in Nottingham</p>
Market at scale	<p>They may not be able to respond immediately to public dissatisfaction with a service due to contractual/legal constraints – or will need to pay a premium for contract variations.</p> <p>The public may not accept some of the consequences of market design, such as:</p> <ul style="list-style-type: none"> • provider profit, particularly above an 'acceptable' level • lack of specification on provider means of delivery (e.g. the public may be attached to a particularly physical location for delivery of certain services – such as a local hospital – but the commissioning framework does not require this) • Over-prescription of provider approaches (e.g. older people might want at-home care but the market design only provides or incentivises residential care services) 	<p>Ex-offenders receive peer-to-peer support in Manchester whereas in Nottingham they have access to apprenticeship training</p> <p>Citizens in a local area are not able to access services available elsewhere</p>

Accountability mechanisms

Once political decision makers have developed a clear view of what they want markets to achieve, the market maker's task is to explore how the market can be made to operate as those who are ultimately accountable for the use of taxpayers' money intended. Two issues are important here.

First, market makers need to use the testing process to explore who in government is responsible for ensuring that actors in the market (commissioners, providers, policy makers, ministers) are accountable to the views of different stakeholders. Participants at our roundtables were particularly concerned to clarify the role for departments in ensuring that these mechanisms operate effectively – but clarifying the role of regulators, providers and service users is equally important. One way of exposing and stress testing the division of responsibility for public markets might be to develop an 'accountability map' for each publically funded market. These maps would set out the main responsibilities of ministers, departments, users and commissioners in holding markets to account.¹⁴

Second, market makers should explore the ways in which actors in the market can be informed and incentivised to act as decision makers intended. Market makers will need to consider how providers, users and commissioners can be enabled to play a constructive role in ensuring markets work effectively. Failure to consider the long-term system incentives can eventually lead to markets developing unhealthy characteristics (such as the monopolistic tendencies)– which government will be less able to respond to after the fact. Some examples of feedback mechanisms which market makers might want to explore include:

- release of government data on provider performance
- user-led reviews of provider performance
- more 'formal' mechanisms such as regulation.

Market makers should explore whether these feedback mechanisms work, and if not, what needs to be done to improve their effectiveness before markets are rolled out at scale.

¹⁴ We recommend a similar exercise for decentralised services in Wood, J, and Moyes, B (2010) *Nothing to do with me: modernising ministerial accountability for decentralised public services* Institute for Government p. 11

Contract design

Contracts are a fundamental tool that market makers have at their disposal to shape markets. Even choice-based commissioning models are usually underpinned by a contract between service users and providers, or a public agent operating on the user's behalf.

Getting contract design right was the concern market makers raised most frequently through the course of our roundtables. Key areas of importance include:

- taking a whole-systems view
- commissioning the right outcome
- deciding how tightly contracts should be specified
- agreeing the price for services
- assessing how contracts are measured and enforced.

Taking a whole-systems view

The market makers at our roundtables emphasised that contract design should start with an understanding of public and service user needs. Understanding user needs requires both sophisticated predictions of the likely level of demand for services, as well as more qualitative assessments of users' perspectives. We heard of examples of commissioners who had spent considerable amounts of time talking to local communities about the services they received which had, in turn, led to completely rethinking the services that they commissioned. Only when market makers understand user needs can they be in a position to design contracts which fulfil these needs.

The system of commissioned public services then needs to be designed to reflect this understanding of user needs. Concerns were raised through the course of our roundtables about whether enough attention is being paid to the overlap and synergies between commissioned services. A user of mental health services, for example, may also require social, welfare and other health services. Commissioning these services in separate departmental silos may result in:

- service users having unnecessarily frequent interactions with providers and a duplication of effort on the part of providers¹⁵
- difficulties when attempting to decide whether a provider's actions can be attributable to outcomes¹⁶
- a provider delivering an excellent service to reduce reoffending but because the local police force heavily targets its enforcement activities on ex-offenders, reoffending rates will be

¹⁵ Ian Moss (2010) *The state of commissioning* Institute for Government p.4

¹⁶ A provider's success (say in reducing reoffending) may have been the result of actions in an overlapping market (say in reducing the time it takes to provide an ex-offender with social housing), but without understanding the overlaps and joining up these markets, the provider may get paid for outcomes they have not caused.

higher than they might otherwise have been and the provider will be 'underpaid' relative to their effectiveness.

We suggest therefore that market tests should start with a whole system approach which addresses:

- how services can be commissioned to take the users' perspective into account
- whether services can be commissioned to simplify the challenge of attributing outcomes to particular providers.

Commissioning the right outcome

Market makers need to write contracts which have clearly defined objectives that realistically reflect the services that the Government wants to provide and what the market can achieve.¹⁷ To some extent the wider policy making process will provide market makers with ideas about what should be commissioned. For example, a policy decision will be taken about whether market makers should commission prisons to focus on punishing or reoffending or, if both, the value that should be placed on each.

But market makers will also need to look to the market to determine whether the services and outcomes that the Government wants to commission can realistically be delivered. Many of the market makers we spoke to highlighted the difficulty of writing clearly specified contracts in new markets as the outputs and outcomes providers could accomplish were not yet fully appreciated. As a result, there is a risk that overly ambitious outcomes are commissioned, or the market is not sufficiently challenged.

In such circumstances the market testing process can be used to develop a constructive dialogue with providers and appraise what outcomes the market can offer. Indeed, many councils already undertake a competitive dialogue process as part of their assessment of whether the market could better provide services. As part of this process, selected providers are challenged to put forward new ideas and show how they could deliver the improvements for which commissioners are looking.¹⁸ This conversation can then be used to build an understanding within government of what types of services can realistically be commissioned.

Deciding how tightly contracts should be specified

Market makers face a choice about the extent to which they link payments to the completion of specific activities or pay providers only on the completion of certain outcomes. There are a number of factors market makers should take into account considering the balance of 'tight' versus 'loose' contract design:

¹⁷ Palma, A, Leruth, L, Prunier, G (2009) Towards a principal-agent based typology of risks in public-private partnerships IMF Working Paper p.13

¹⁸ Office of Government Commerce (2006) *Competitive dialogue procedure in new procurement regulations* available at <http://www.barnet.gov.uk/guide-competitive-dialogue.pdf>

Linking payments to the completion of activities may be appropriate when:

- there is a strong 'theory of service', for example, when there is substantial evidence that suggests a particular drug treatment works
- when innovation happens elsewhere (for example, through commissioned government research) which subsequently feeds into the commissioning process.

But linking payments to the completion of activities might:

- create an incentive to focus on 'what works now' and might constrain incentives to experiment, innovate and improve provision beyond existing frontiers.

Outcomes based payments might be appropriate when:

- the government wants providers to innovate and experiment with different approaches
- the government wants providers to carry a greater share of the risk and reward for performance.¹⁹

But outcomes based payments might:

- increase the cost of provision when providers who are only paid for the completion of outcomes want greater reimbursement to offset the risk that they might not be paid due to circumstances beyond their immediate control (such as changes in the economy or labour market)
- increase the cost of provision if the amount providers have to pay to borrow capital because they are borrowing against uncertain revenue streams
- result in only organisations with sufficient working capital to operate through the period of non-payment will be able to compete²⁰
- make contracts hard to measure, especially when outcomes are only measureable in the long term – here, contract designers may have to use proxy inputs and outputs measures to assess performance.

Commissioners will need to ensure that contracts balance encouraging innovation and commissioning for what works, which will often require a sophisticated (but not excessively complex) contract that pays for both outcomes and outputs. To address the risk created by transferring too much risk to providers too quickly, market makers might want to phase the amount of risk it transfers to providers by constructing schedules which pay some money upfront and for activities, at least to cover early start-up and running costs.

¹⁹ A fuller discussion of the strengths and weaknesses of outcomes based commissioning can be found in Sturgess, G, and Cumming, L (2011) *Payment by outcome: a commissioner's toolkit 2020* Public Service Trust; and UK Commission for Employment and Skills (2010) *Outcome based commissioning: lessons from contracting out employment and skills programmes in Australia and the USA*

²⁰ <http://www.economist.com/blogs/leviathan/2011/12/changing-state>

Agreeing the price for services

Market makers need to agree a price that they are willing to pay for the completion of contract objectives. Determining price is a fine art. Agree a price that is too low and outcomes, quality and the continuity of service are likely to suffer. But agree a price that is too high and taxpayers' money will be wasted.

In new markets both providers and commissioners have limited or no historical precedent from which they can determine the likely costs of producing a certain outcomes.²¹ Market makers therefore face the challenge of overcoming the limited information available about what price they should accept for services. One interviewee captured the dilemma by suggesting:

The government has a 'first mover' problem in the sense that it has to set a tariff that will incentivise providers, create a viable market and also deliver value for money for the taxpayer, but has limited knowledge and data on which to make decisions about tariff prices. Once it has set the tariff it then has to go into negotiation with the private providers who know a lot more about the true risks and costs of provision. Faced with this asymmetry there is a danger that providers will pass the risk back onto the public sector.

Setting the price for services is made more complex by the various dimensions of competition. In markets where providers compete on price, as providers may only have a limited understanding of the true costs of production they may submit a price at tender which will squeeze margins too much, thus increasing the risk of failure, or allowing for excessive profits. Where commissioners want to incentivise providers to compete on quality or invest in innovative approaches, they may want to set a fixed price for services which are above the marginal cost of production.²² This will give providers money to invest in improving quality or developing new approaches. Here, commissioners need to develop an understanding of the marginal costs of production which will similarly be difficult in new markets will little information about cost.

To minimise the risk that commissioners accept the wrong price for services, interviewees suggested that commissioners in nascent markets should build their own understanding of the costs of services. Ways of doing this include expecting providers to operate open book accounts²³ and modelling the costs of in-house provision.

Assessing how contracts are measured and enforced

For markets to develop effectively, contracts need to contain appropriate and measurable input, output and outcome indicators that can be monitored, evaluated and enforced by credible

²¹ Brown, T and Potoski, M. (2003) 'Managing contract performance: a transaction cost approach' *Journal of Policy Analysis and Management* Volume 22 9 (2), pp. 275–297, p. 277

²² OFT (2010) Choice and competition in public services: a guide for policy makers p.8

²³ Open book accounts provide government access to information about the cost base for their services http://www.stradia.com/docs/HAN_Fact_Sheet_PR_3.pdf

sanctions.²⁴ If contracts are not measurable, it will be difficult for commissioners to determine whether objectives specified have been achieved and whether providers have underperformed against objectives stated in contracts.²⁵ Further, contracts need to be measurable in a way that highlights any incidence of perverse provider behaviour but which does not excessively raise the costs of monitoring contracts. A fuller explanation of these perverse behaviours can be found in Figure 4.

When providers are being paid on the basis of their performance against predicted trends, these outcomes should be measurable against a counterfactual of what would have happened had the provider not delivered the service. For example, if providers are being paid for the extent to which they reduce reoffending in an area, it is essential that commissioners can estimate what the reoffending rate would have been without the provider's intervention.

In addition to exploring ways of measuring performance, market tests should also explore different enforcement mechanisms. Enforcing contracts is important as even if contracts are well specified, perverse incentives can still be created if providers believe that poor performance will be missed by the Government. The appropriateness (including their relative costs) of a range of monitoring options, including citizen feedback, complaints, audit and inspection should be considered.

Figure 4: Possible perverse provider behaviours

Cream skimming: Providers are 'cream skimming' when they show a preference to treat users of higher value (e.g. users for whom they receive a higher payment) or lower risk (i.e. users who are less likely to have complicated conditions). Here, not only is there a loss of value for the taxpayer but providers that cream skim are also discriminating against certain users. This may not be acceptable in a publically funded market where there is a desire for all users to have equal access to services or for providers to target the hardest to reach.

Parking: Providers may take payment for higher-risk customers but then might 'park' them, meaning that they continue to focus on the easiest to treat or most profitable customers. Again, this discrimination may not be acceptable in publically funded markets. There is also a risk that the government becomes a 'provider of last resort' and that the public purse has to be opened again to help service users who have been parked by providers.

Deadweight: Deadweight refers to a situation where the government's allocation of resources is not 'allocatively efficient' i.e. more people could benefit and no one would lose out if the resources were used in a different way. In the context of commissioning services, a deadweight loss to the government can occur when the government pays for activities or an outcome which would have occurred anyway. Here, the government could have allocated these resources more efficiently if it had used them to pay for socially productive activities that do not occur without providers' intervention and help.

²⁴ Palma, A., Leruth, L., Prunier, G. (2009) Towards a Principal-Agent Based Typology of Risks in Public-Private Partnerships IMF Working Paper p.13

²⁵ Brown, T and Potoski, M. (2003) Managing contract performance: A transaction cost approach *Journal of Policy Analysis and Management* Volume 22 9 (2), pp. 275–297, p. 277

The way contracts are initially designed will affect the way the market evolves. There are a range of considerations to take into account including where services are commissioned. These considerations are summarised in Figure 5. It is worth remembering that it may not be possible to design the perfect contract before markets are implemented at scale. As markets develop it is important therefore that market makers allow for the possibility of contract redesign.

Figure 5: Aspects of contract design that will affect the way markets develop

Aspect of contract design that can affect future market performance	Consideration
Has the whole system been taken into account when contracts are designed?	<ul style="list-style-type: none"> • Contracts are more likely to address service user needs if they are designed to take user perspectives into account. • Commissioning overlapping services separately may make it difficult to account for provider performance and result in the same outcomes being paid for twice, or providers not being paid for their contributions (and going out of business).
How tightly should contracts be specified?	<ul style="list-style-type: none"> • The degree of specificity about the activities that providers should deliver will affect the extent to which the market will innovate.
What price should be paid for services?	<ul style="list-style-type: none"> • There is a risk of service failure or a loss of value for the taxpayer when commissioners lack an understanding of the true costs of services. • Overpayment or underpayment risks undermining market credibility. • The dynamics of competition (competition on the basis of cost or competition on the basis of quality with fixed costs) will affect the way providers behave and ultimately the outcomes that are achieved.
How can a credible enforcement mechanism be designed?	<ul style="list-style-type: none"> • The system of redress will affect the way providers behave. • Perverse incentives may be created when contracts are not measurable and when providers do not believe they will be appropriately rewarded or punished for performance levels.

Market readiness

For markets to operate effectively certain 'demand' and 'supply' conditions need to be in place. Market makers should use market tests to assess whether markets are on a trajectory towards 'market readiness' i.e. those choosing and providing services are sufficiently prepared for the market to operate effectively at scale.

Demand conditions

In markets driven by user choice (such as health, social and welfare services), demand conditions refer to the 'ability' of services users, or a service user representative, to choose between providers. Without ensuring users (or their representatives) are able to choose effectively there will be limited incentives on providers to compete for, or seek to maintain, customers and ultimately the credibility of the market may be undermined. The ability of users to effectively exercise choice depends on a number of factors including:

- users having an awareness of choice
- users overcoming 'information asymmetries' and being able to assess information about different providers
- users having the capacity to choose the provider which will best meet their needs
- there being providers who can meet user needs.²⁶

When demand-led markets are introduced for the first time the conditions that allow users to exercise choice may not yet be in place. For example, individuals may lack motivation or capability to choose between providers, may not be willing to make the change to choice-based provision. There may be high 'transaction costs' (such as the time it takes to choose between providers that discourage users from exercising choice). Or there may be geographical or supply side constraints that prevent users from acting on their choice.²⁷

We suggest that when demand-led markets are being developed, market tests should assess the extent to which demand conditions, such as using choosing different providers, are emerging. If tests signal that demand conditions are slow to emerge, this should trigger consideration of ways to promote choice (including how government and intermediaries should present information to help frame choices). Communication exercises which raise awareness amongst user groups that they can choose between providers and providing information about the services different providers offer might be potential options for enabling user driven demand.

Supply conditions

Supply conditions are important in both markets driven by user choice and markets driven by commissioners. Supply conditions refer to the vibrancy of the market. A market is vibrant when there is:

- a range of providers which are in competition with one another
- the possibility for these providers to enter, exit, and expand in the market
- providers are being incentivised to compete on appropriate dimensions.

²⁶ OFT (2010) Choice and competition in public services: a guide for policy makers

²⁷ OFT (2010) Choice and competition in public services: a guide for policy makers

To ensure that there are different providers who are in healthy competition with one another, market makers will need to consider whether contracts are being designed which will incentivise providers to compete on appropriate dimensions.²⁸ As discussed above, the way services are specified, the price set for the completion of objectives, the payment schedule and the way contracts are enforced, will all affect provider incentives and ultimately the vibrancy of the market. It is also important that providers are aware of opportunities to compete for contracts, and that government clearly communicates live and future tenders.

Market tests provide an opportunity to assess the state of supply conditions and consider ways to encourage the development of a vibrant market.²⁹ In some instances, for example, the supplier base may be at an immature stage of development and there may not be a diverse range of providers from which to commission. Using the testing process to highlight that a range of providers are slow to emerge should trigger market makers to consider and address the factors preventing providers from entering the market. The regulatory burden being placed on small providers being too high, prices are being set too low, and outcomes not being sufficiently clearly specified all may emerge as reasons why providers are slow to enter the market.

Market makers need to ensure that supply conditions, such as provider entry, exist and competition can be balanced against wider societal considerations. For example, the exit of poor-performing providers may be an important issue for market makers when exit and closure has real social costs.³⁰ In such circumstances, market makers may need to use the testing process to consider not only whether a market is developing which allows exit, entry and expansion, but also to consider what an appropriate failure regime looks like which minimises the impact of provider failure on service users.

We suggest therefore that market tests are used to assess barriers and progress towards a vibrant market. Evidence that progress is not being made towards 'market readiness' should trigger consideration of ways to address the barriers that are preventing demand and supply conditions from emerging.

Skills, capacity and mindset

Through the course of our roundtables, participants emphasised that introducing a publically funded market requires new skills in government. These views were echoed by many of our interviewees who, when asked:

What do you know now that you wished you had known when you started to introduce publically funded markets?

suggested that they wished they had been better prepared for both the changes in mindset and skills required to test and expand publically funded markets. These attitudes are supported by a growing body of empirical evidence which suggests a key determinant of whether services are

²⁸ OFT (2010) Choice and competition in public services: a guide for policy makers

²⁹ Moss, I (2010) The state of commissioning: preparing Whitehall for outcomes-based commissioning Institute for Government

³⁰ OFT (2010) Choice and competition in public services: a guide for policy makers

successfully contracted out depends on government capacity, namely the skills of commissioners and market makers to 'steward' the market.³¹

Some of the necessary skills have already been indicated through this paper. In concrete terms, market makers and commissioners will need to be able to plan and specify joined-up services, negotiate with providers, monitor contracts, and have specific technical skills such as writing contracts.³² This will require skills in data analysis, the law, contract design and the procurement process. More intangible, market makers will need to be able to 'steward' the market by assessing whether it is on a trajectory towards 'readiness', i.e. being competitive, vibrant and resilient if rolled out at scale.

Increased reliance on private sector provision can also create wider capacity challenges. The infrastructure, systems and processes required for some market-based approaches can be radically different. New ICT systems might be required to monitor and enforce contracts, government's physical infrastructure may need to be decommissioned or sold and new regulatory functions may need to be performed – perhaps requiring the set-up of new public bodies.

Market tests provide an opportunity for the government to assess and improve its capacity to manage publically funded markets. Addressing any gaps may require specific interventions such as investing in the development of commissioning training programmes or developing career structures which incentivise the brightest and best talent to work on public service markets.³³ Senior leaders may also need to consider the implications for the role and structure of their departments as they move from directly providing services to ensuring the health and vibrancy of publically funded markets. Questions such as whether traditional operational distinctions between policy making and procurement are still fit for purpose may need to be addressed.

The mindset required to develop publically funded markets is likely to be different to the traditional policy making approach of direct delivery from Whitehall. We argue in System stewardship that policy makers need to think of themselves as overseeing the ways in which the policy is being adapted, and attempting to steer the system towards certain outcomes.³⁴ Markets are no different. Market makers need to shift from seeing themselves as a deliverer of public services to seeing themselves as stewarding the long-term development of the market.

Market tests provide an opportunity for market makers to start thinking differently about the nature of public service delivery. This may require departments to secure an internal coalition of senior civil servants to create a wider acceptance of the risks on government in doing novel things.

³¹ Brown, T, Potoski, M, Van Slyke, D. (2006) Managing public service contracts: aligning values, institutions, and markets public administration review Vol 66 (3) pp. 323-331 p.325

³² Brown, T, Potoski, M, Van Slyke, D. (2006) Managing public service contracts: aligning values, institutions, and markets public administration review Vol 66 (3) pp. 323-331 p.325

³³ Brown, T, Potoski, M, Van Slyke, D. (2006) *Managing public service contracts: aligning values, institutions, and markets public administration review* Vol 66 (3) pp. 323-331 p.325

³⁴ System stewardship

Summary

So far we have suggested that market makers need to devote significant resources to the design, implementation and operation of publically funded markets to achieve desired results.³⁵ We have suggested that market tests provide an opportunity to consider the best way to design, implement and operate markets before they are rolled out as the prevalent way of delivering a public service. Doing so will allow market makers to develop a critique and understanding of how markets are likely to operate, which in turn may prevent costly mistakes occurring at scale. We have suggested that market makers and commissioners should use market test to assess how confident they are that:

- there is political appetite for risk and divergence
- markets will be responsive to stakeholder preferences
- contract design will have a positive impact on market development
- there is a positive trajectory towards market readiness
- public servants have the necessary skills, capacity and mindset to support the operation of a market at scale.

The paper now turns to consider some of the methods that can be used to provide insights into these five dimensions of market effectiveness.

³⁵ DTI Economics Paper No.14 (2005) Public policy: using market-based approaches p.15

6. Ways of learning about publically funded markets

Through the course of our research we spoke to many market makers who were using different methods to learn about the ways in which publically funded markets work. These methods include systematic reviews, external advisers, prototypes, simulations and pilots, as well as more informal discussions and ways of sharing knowledge.

This paper now turns to consider which of these methods will provide insights into the five dimensions of market effectiveness described in the previous chapter and their relative strengths and weaknesses. It is important to note that the methods we identified are not exhaustive and that different methods are appropriate for different stages of the testing process. Whilst we make suggestions about which methods are best to use for what and when, we also recognise that there is more work to be done to comprehensively explore alternative methods of testing delivery mechanisms.

Systematic reviews

Interviewees suggested that systematic reviews, which appraise previous attempts to introduce markets, can be a useful way of avoiding past mistakes and replicating historic successes. The review process involves collating and assessing evaluations of markets elsewhere and speaking to and learning from practitioners involved in other markets. For example, in the build-up to the launch of the Work Programme, the Department for Work and Pensions conducted number of reviews of welfare markets in other countries including a report commissioned from PWC which looked at New York's experience of the prime provider model.³⁶ We were told these reports helped to inform the design and rollout of the Work Programme.

This suggests that systematic reviews are a useful and often underused method of learning about how a publically funded market could work and the likely difficulty of marketising a service. For example, if a service with seemingly strong public good characteristics has been successfully marketised elsewhere, the lessons can help to inform the steps market makers should take to replicated successes domestically.

A particular advantage of systematic reviews is that the focus can be adapted depending on the type of market being tested. For example, the impact of different market mechanisms (such as an individual budget or a new payment schedule) on a particular policy area could be reviewed, which may be helpful if market makers are interested in testing different forms of choice and competition across a range of services. Alternatively, if market makers are more interested in introducing a

³⁶ <http://research.dwp.gov.uk/asd/asd5/rports2009-2010/rrep614.pdf>

particular market mechanism across a range of different policy areas, the review could focus on assessing the impact a particular market mechanism has had in different policy settings.

However, systematic reviews do have weaknesses. The usefulness of systematic reviews of market evaluations depends on the quality of the initial evaluations which, in turn, will be affected by the skills and expertise of evaluators, the scope of the evaluation, and whether they were sufficiently independent of government to provide an unbiased assessment. Further, historic evaluations may have not factored in or controlled for the conditions that will affect how markets will operate in the UK such as political appetite for risk and divergence. Extrapolating lessons from abroad or from previous attempts to marketise a service can therefore be hazardous if insufficient attention is given to the contextual factors that explain why a market may have previously operated successfully or have failed. Systematic reviews can also be time consuming and expensive, especially when they are commissioned, and the need for rigour needs to be balanced with the need to quickly develop an understanding of how markets operate.

Nevertheless pulling together international and historic lessons is a necessary part of due diligence in the policy making process even if it is done in a light touch way. Market makers need to have a justifiable rationale for why they are introducing a market mechanism in one area where there is evidence which suggests the mechanisms has not worked elsewhere.

External advisers

Through the course of our research we encountered a few examples of external 'expert' advisers (who had previous experience of developing publically funded markets) joining a policy team to advise on market development – for example, Ken Anderson, who was recruited as a commercial director to oversee the introduction of independent sector treatment centres having worked in a similarly market-based system in Texas.

Using external advisers is a method that can help to suggest ways of tackling the more systemic challenges, such as how to ensure that a diverse range of providers are likely to enter the market. Furthermore, advisers can be used to inform the design of other methods. For example, academic consultants can be hired to inform the design of pilots, including the sample size and the metrics to use. When used in this way, independent advisers can be a good, albeit short-term way of overcoming limited internal expertise in ways of testing markets.

Nevertheless, market makers should be aware that external advice may not be representative, and will be limited to the adviser's previous experience. Furthermore, advisers should not be used as an alternative to developing government's internal capability to learn about markets.

Prototypes

A prototype is where market makers quickly try a wide range of different approaches to a particular aspect of market design, such as ways to design contracts, at a small scale. Prototypes allow for

early failures and risks to be managed by starting small and designing out problems early.³⁷ Once an idea has 'passed' the prototyping stage it may then be subject to a pilot.

The National Endowment for Science Technology and the Arts' (NESTA's) prototyping framework provides a useful list of general questions which will help market makers decide whether it is appropriate to use a prototype. These questions include whether:

- there is senior management backing
- there is commitment to persisting when things get difficult
- market makers are comfortable that the idea might not work.³⁸

As prototypes tend to bring different groups together to generate and test ideas at a small scale, they may be useful for testing the feasibility of a particular aspect of marketisation such as whether providers could cope with a particular payment schedule or whether there would be likely investment in a social impact bond. Furthermore, as prototyping encourages a range of options to be considered before deciding on an approach to test more fully, we suggest that prototypes are particularly useful when a decision has been made to test and develop a publically funded market but the appropriate next steps are unclear.

However, given their small scale, prototypes may not provide insight into the more systemic aspects of developing a market, such as how a department needs to build capacity and adapt, and whether a significant supply side response will emerge from the introduction of a new commissioning model. Prototypes should not be seen as a reliable way of testing the likely impact and cost of a market or market mechanism if it were to operate at scale. What happens in a prototype may not be replicable at scale.

Simulation

A simulation involves different actors playing out how they would react to the introduction of a market in a safe learning environment. These could be the actual actors who would operate in the market (such as providers or commissioners) or policy makers could adopt these roles. In 2011 the King's Fund, for example, has conducted simulation exercises to allow senior managers and thought leaders from across the NHS, local government and the third sector to test out a remodelling of the health and social care system in a safe learning environment.³⁹

In addition to testing how providers would react to a particular contract design, when they involve politicians, we were told that simulations are a useful way of testing the political appetite for risk and the reaction of the market. Furthermore, simulations can be a useful way of bringing a complex mix of different interests together to negotiate trade-offs and broker solutions to problems, such as

³⁷ Lambeth, G and Szebeko, D (2011) 'Prototyping public services' (Article written for the *Guardian Public Leaders Network*) available at <http://www.guardianpublic.co.uk/prototyping-public-services>

³⁸ <http://www.nesta.org.uk/library/documents/PrototypingFramework.pdf>

³⁹ http://www.kingsfund.org.uk/publications/social_care_routes.html

to whom markets should be primarily accountable.⁴⁰ Simulations can also provide insights into aspects of 'market readiness,' such as the information that would need to be available for consumers to make informed choices.

However, simulations do have weaknesses. They often require expert facilitation and there is no guarantee that the way actors behave in a simulation exercise will be repeated when a market is introduced in reality. Simulations should therefore be combined with other, more practically focused market tests before markets are widely introduced as a delivery mechanism.

Pilots

Pilots come in different forms and have different objectives. Two types of pilots that are commonly identified are 'impact' pilots, which test the likely effects of new policies, measuring or assessing their early outcomes, and 'process' pilots which are designed to explore the practicalities of implementing a policy and assess what methods of delivery work best.⁴¹

At its core piloting involves a process of taking an idea and refining it slowly before a final version is delivered.⁴² Preceding the full-scale introduction of a market with closely monitored pilots can help to ensure that implementation issues (such the way in which contracts are designed, and the skills and capabilities of commissioners to manage markets) are addressed.⁴³ Furthermore, pilots provide an opportunity to expose users, providers and ministers to the likely way in which a full-scale market will operate and test the extent to which, in practice, a range of parities are comfortable with how the market is likely to grow. As one interviewee suggested:

Pilots provide an opportunity to fail, and an opportunity to say that policies which we initially thought were a good idea will lead to x technical problem. Pilots provide space to identify risks and issues, to work through changes in local contexts and react.

It is this practical focus of pilots which make them valuable. Through the course of our research we were frequently told that there is no substitute for testing how a market is likely to operate through a pilot.

To extrapolate the most value from pilots, market makers should ensure a number of conditions are in place.

Pilots need to be undertaken in a spirit of experimentation. Different approaches should be adopted in different areas, and ministers need to be willing to respond to findings that emerge from a pilot. The issue of how to be experimental in an era of decentralisation and localism was raised through

⁴⁰ Denhart, R and Denhart, J (2000) 'The new public service: serving rather than steering', *Public Administration Review*, Vol.60(6) p.p.549-559 p.553

⁴¹ Cabinet Office (2003) *Trying it out: the role of 'pilots' in policy making*

⁴² The Young Foundation's briefing note on pilots and prototypes is available here:

<http://www.youngfoundation.org/our-work/local-innovation/strands/local-government-innovation/innovation-methods-local-government/14>

⁴³ Cabinet Office (2003) *Trying it out: the role of 'pilots' in policy making* p.5

the course of our discussions. One interviewee suggested that their recent pilots had adopted a 'looser' approach rather than systematically testing different approaches in different areas. They were supporting others to experiment and learn through their experiences. Another suggested that this 'looser' approach has meant that:

We want to adopt a thousand flowers bloom approach and not be too specific about what local areas should test, but this means we have to fight a desire to be tighter and more rigorous about what it is that is being tested. It would be good to be a bit tighter but this is not the direction of travel.

The implication is that decentralisation requires market makers to challenge traditional notions of experimental design and formally designed experiments where participants are randomly assigned to different groups. Piloting in an era of localism requires market makers to embrace the idea of natural experiments which assess the outcomes and impacts of market mechanism in different areas.

Pilots need to be independent, free from real or perceived pressure to deliver 'good news', and be designed to bring out rather than conceal any problems with a policy. Participants raised concerns that pilots can be used for tactical and political reasons rather than to learn about policy. We were told that pilots can be used to "kick a mad policy idea into the long grass", to attract media attention to a policy, to get money from the Treasury, or to begin the rollout of a policy when there is little intention to stop even in light of negative findings. The result can be conflicting expectations about the purpose of the pilots and raised (and dashed) stakeholder expectations. Market makers should be aware of and try to minimise the extent to which pilots can be used for tactical reasons.

Departments need to think about how different pilots coordinate with each other. Leigh Lewis (ex-Permanent Secretary at the Department for Work and Pensions) has suggested that at the height of the Pathways to Work and Flexible New Deal programme that:

*The in-house joke in DWP for many years was that we had more pilots than British Airways. There was undoubtedly times when we just had too many.*⁴⁴

Running a large number of pilots can create a number of problems beyond the obvious financial implications. The same issues can be tested through different pilot programmes creating unnecessary duplication and the risk that common insights are not shared. Local areas may get 'initiatiVIOUS' and lack the dedication to make the pilot worthwhile. It is important therefore that pilots are not set up in isolation from an understanding of other learning exercises occurring across government.

Pilots need to run for long enough for valid findings to emerge. This may take several years.⁴⁵ For example, the individual budgets for social care pilots, which were viewed by some people we spoke to as being rolled out before completion, ran from a start-up phase in late 2005 through to the end

⁴⁴ Leigh Lewis speaking at the Institute for Government's event on Welfare Markets 20th February 2012. Podcast available <http://www.instituteforgovernment.org.uk/events/learning-history-markets-welfare>

⁴⁵ Cabinet Office (2003) Trying it out: the role of 'pilots' in policy making government p.5

of 2007.⁴⁶ The length of time needed to run a pilot can pose challenges for market makers who are coping with short political timelines and ministerial pressures to make things happen.

There are ways of making pilots work within political timelines or constraints. There was general enthusiasm for getting better at feeding emerging findings into the decision making process through the lifetime of the pilot. As one interviewee currently working on a pilot suggested:

The evaluation will constantly drip lessons about what has worked well and what's going badly. There cannot be a hiatus between piloting and the final evaluation. These interim findings will be used for communications purposes, offering feedback to the wider sector and to generate support.

Building clear 'decision points' into the pilot design – which ministers and other stakeholders recognise and agree – can provide an opportunity to reflect on the evidence emerging from the pilot.

Even when pilots are well designed, they still have limitations. Pilots have a relatively narrow scope and therefore provide answers to questions about the changes that would need to take place if markets were to operate at scale. As one interviewee suggested:

The problem with the piloting approach is that it only takes you so far. Eventually you will have to answer some of the big questions about what commissioning models will be used across the board and what structural changes need to take place.

Many of the market makers we spoke voiced similar views and were struggling with how to make the shift from prudent pilot to scaled market. Whilst some of this thinking is occurring in some departments, further work needs to be done which considers how early feedback from pilots can be used to develop a strategy for making the necessary changes to scale up markets.

Pilots may also elicit a different market response to a market which is operating at scale. For example, large providers may not be willing to play a role in a pilot if there is no guarantee that a market will be created at the end of the process, whereas they would bid for large contracts in a scaled market. One interviewee articulated the issue by suggesting:

Piloting a market is not like testing a pharmaceutical. If you test a drug on 1000 people you can be pretty confident that the effects will be replicable and methods of delivery will not affect outcomes that much. The evaluation of a small scale public service pilot is very different in the sense that findings observable at a small scale may not be replicable at scale.

Market makers need to be aware that the way providers behave and the provider landscape that emerges through a pilot may not therefore be replicated at scale.

⁴⁶ Glendinning, C, Challis, D, Fernandez, J, Jacobs, S, Jones, K, Knapp, M, Manthorpe, J, Moran, N, Netten, A, Stevens, M and Wilberforce, M (2008) *Evaluation of the individual budgets pilot programme: final report* (Social Policy Research Unit, University of York) p.4

Given these limitations, pilots need to be supplemented with other methodologies which allow market makers to generate insights into broader, cross-cutting issues, such as whether the market as a whole is on a trajectory towards being able to play a greater role in service delivery.

Pathfinders

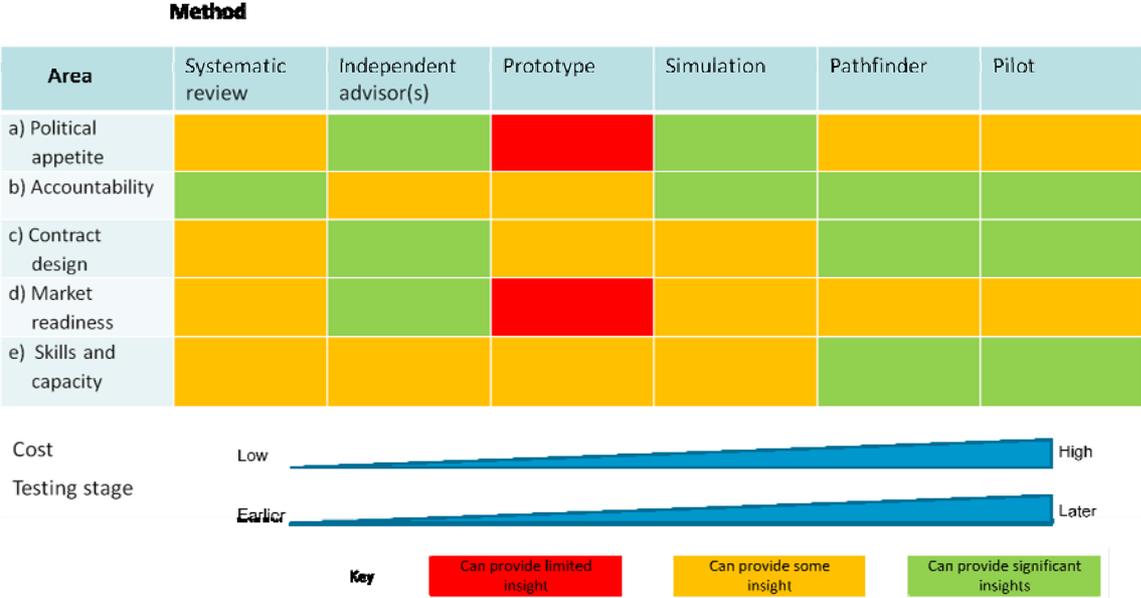
Pathfinders are similar to pilots in the sense that they both test how a policy will work in practice in different areas before the policy is rolled out at scale. The difference, in theory, lies in the extent to which there is an explicit commitment to rolling out the policy. Pathfinders provide an opportunity to learn about implementation issues before policies to which the government is committed are rolled out. Leigh Lewis has suggested pathfinders are a useful way of learning about the way in which a policy is likely to work in practice when:

...you were intent on doing something but before rolling it out with a big bang you started with a smaller number of places to see what the practical issues and problems you were going to find were. If you only find these out when you roll things out nationally and it's a problem everywhere, it becomes a very big problem to solve.

Pathfinders therefore can be a useful way to manage expectations when learning about a new contracting model or market based policy. If managed appropriately stakeholders will be aware that the insights generated from pathfinder programmes will be used to inform policy rollout rather than be used to decide whether or not to implement the policy in the first place. Pathfinders can also be a useful way of generating momentum and attracting support for a policy.

The applicability of the different methods to the six 'knowledge areas' is summarised in Figure 6. As no method provides insights into all six knowledge areas it is important that market makers utilise a range of different methods as part of the testing process. We suggest that market makers should combine practical methods, such as pilots and prototypes, with more theoretical approaches such as simulation exercises and systematic reviews.

Figure 6: The applicability of different market testing methods



Source: Institute for Government assessment

7. Ways of working to effectively test markets

Through the course of our research we encountered groups of civil servants who were adopting new ways of working which allowed them to get the most out of their publically funded markets tests. These ways of working included:

- building teams with a blend of expertise
- working collaboratively across departments
- defining cross-government roles and responsibilities
- planning for the future
- disseminating best practice.

In this section we highlight some of the tools, techniques and approaches the market makers we spoke to are using to improve the effectiveness of market testing.

Building teams with a blend of expertise

As discussed above, introducing a market requires public servants to develop a new set of skills. Market makers who are responsible for directly testing markets will, at the very least, require expertise in data analysis, the law, contract design and the procurement process. Ensuring this expertise is in place can be a challenge, not least because many policy makers are working with markets for the first time and will often work on a range of different projects, rather than developing expertise in market implementation through the course of their career.

Many of the market makers we spoke to emphasised the importance of departments recognising early on in the development of a market the need for a 'step change' in their departmental skill mix and proactively starting to build appropriate expertise. Of particular importance is utilising expertise in frontline delivery when initially designing market mechanisms. Without doing so, departments may not be able to fully explore all the factors which will affect how their markets develop and important aspects of market design may be considered too late.

However, there is a default position in some departments to regard market making as a generic policy making skill which does not require any specialist training. This position is underpinned by an expectation that policy generalists will be effective because they will pick up knowledge and understanding of markets on the job. In some cases, when a skills gap emerges, more senior civil servants are relied upon to fill the gap, but these senior civil servants may not have the appropriate skills. For example, we were told of one pilot where

the director had to determine how big the pilot should be, and what outcome measures to use to assess the effect of the new commissioning model being tested, because no one else had the necessary analytical skills. The lack of a range of skills meant that important aspects of market design – such as the legal framework that surrounded the new contracts being tendered – were addressed too late in the piloting process.

There may well be expertise in the department which can help with the initial market making process. However, this expertise (such as expertise in procurement) is compartmentalised into a specialist areas of the department and is not integrated early enough into the design of new publically funded markets.

Mixed teams and external advisers

It is impossible for one person to have all the necessary skills needed to test markets. In order to ensure that the cross-functional market testing teams are in place, departments testing markets need to develop multidisciplinary teams and recruit market makers with a range of different backgrounds – including people with experience working outside the civil service. The Ministry of Justice has adopted this approach by creating a payment by results team consisting of policy makers, legal professionals and procurement experts. We heard enthusiasm for more flexible pools of resources where expertise can be drawn upon to suit the specific challenges thrown up by the market test.

In addition, teams might also use external expertise to shed light on a particular challenge. Using independent advisers (as discussed above) could fulfil this role.

Working collaboratively across departments

Many of the civil servants we spoke to highlighted the risk that departments develop markets in departmental silos and do not consider the synergies between markets. A lack of cross-government collaboration could result in:

- lessons about common implementation issues not being shared
- markets being fragmented
- services not joining-up around the needs of users
- different pilots overlapping in local areas.

A government that is joined-up is also more appealing for providers as they will have fewer, more productive interactions with market makers, and are likely to be more confident that the work of one department will not run counter to their investment in another department's market.

Under pressure to expand the use of choice and competition in the provision of public services there is a risk that departments focus on developing their own publically funded market without considering the synergies that could result from collaboration with other departments. Some of the civil servants we interviewed were concerned this situation was developing. As one interviewee suggested:

We are concerned about the overlap between different pilots that are currently being conducted. We are concerned that this will create confusion for local authorities when it comes to prioritising a particular delivery mechanism.

Another interviewee similarly highlighted the risks created by a lack of cross-Whitehall collaboration.

The Government needs to share lessons, make better assessments of value for money and seek to improve current practice. At the moment departments are doing lots of different things and are not sharing their lessons in a transparent manner.

Nevertheless, there are encouraging examples of departments working collaboratively to test new commissioning models. For example, the Ministry of Justice is currently working with the Department for Work and Pensions to explore the potential to establish a pilot to test the integration of a reoffending outcome into the DWP Work Programme. It is important that departments seek to increase the extent of cross-departmental working by exploring ways in which they can work collaboratively to test ways in which publically funded markets can develop.

Cross-government networks

To minimise the risk of departments not joining up their market tests, a number of cross-government networks have been established. These networks aim to coordinate approaches and share lessons about the operation of publically funded markets. There are a range of approaches to cross-departmental networks, and indeed one of their advantages is that they can be developed to suit the nature of the cross-government challenge. We encountered examples of 'steering' networks where:

- market makers who were working in advanced markets were sharing lessons with colleagues working in less advanced markets
- groups of market makers were working in 'action learning' groups to address common challenges, such as designing outcome based contracts, and in cross-government market-based projects.

Keeping networks alive requires a significant amount of administrative and secretariat support and can be time-consuming for participants. There can also be diminishing returns from attending network meetings, especially when meetings become a 'talking shop' and substitute for practical progress. There are alternative 'lighter touch' approaches to cross-government networks such as virtual networks, repositories of expertise and contact databases which can be effective at spreading relevant learning about market making. But these approaches do still need someone to coordinate activities across government. When cross-government networks maintain a practical and relevant focus they can be a useful way to share lessons across government and highlight opportunities for departments to develop markets collaboratively.

Defining cross-government roles and responsibilities

As different parts of the central government machinery adjust to their role in testing and developing markets, there is a risk of widespread uncertainty within the civil service about where responsibilities for market development lie. Many of our interviewees suggested it was not clear who was responsible for focus of market tests, the quality of evaluation or disseminating lessons. As one interviewee commented:

The role for central government in market development is not clear, beyond it needing to be more strategic and adopting the broad role of enhancing the market. We haven't worked out what the strategic as opposed to the contractual role of departments looks like.

The lack of clarity about responsibility is particularly apparent for cross-government challenges such as ensuring the departments are equipped with commissioning skills, and ensuring there are common standards of evaluation that all departments should uphold. Without being clear about which part of government is responsible for which aspect of the market making process there is a danger that some responsibilities are overlooked, or that similar responsibilities are duplicated across government.

Interviewees were clear about where responsibilities for some aspects of market testing should lie. For example, there was agreement that departmental 'accounting officers' should have to assure that a new commissioning model will deliver value for money and that the Treasury should be responsible for holding departments to account for whether their pilots tested how markets would deliver value for money. Furthermore, as one interviewee noted, there was general agreement that the centre of government should seek to uphold evaluation standards:

It is the strategic responsibility of the centre [No.10, the Treasury and Cabinet Office] to ensure that there is a proper evaluation in place and to share knowledge across government.

As we suggest in *Making policy better* the Centre of government could get better at ensuring that rigorous standards of evaluation are in place across government and sharing examples of best practice.⁴⁷ For other roles and responsibilities, such as improving market making skills, participants were less clear where responsibilities should lie. This suggests more work needs to be done to consider who in government should take the lead in addressing cross-cutting market-making challenges.

Planning for the future

Some of the market makers we spoke to were concerned that the testing process was distracting departments from addressing more systemic questions about the steps

⁴⁷ Hallsworth, M, and Rutter J (2010) *Making policy better* Institute for Government

departments need to take into order to embrace their role in overseeing fully developed markets.

We were told that knotty design issues (such as what metrics to use to evaluate a pilot) often supersede considerations of what departments need to do to prepare for the implications of a positive market test. Two concerns were particularly salient.

First, by focusing too heavily on knotty design issues, there was concern that departments themselves would not be sufficiently prepared to adapt to any new role when markets are rolled out at scale (such as moving to overseeing the overall health of the market).

Second, there were concerns that departments may not give sufficient attention to external factors that may ultimately derail a publically funded market such as a lack of support amongst practitioners, users, public representatives, local commissioners, and unions – groups whose support is needed to make market a reality at scale.

When testing markets there is a risk therefore that insufficient time is given to developing a 'model of change' which will help ensure that, if appropriate, departments and stakeholders are able to successfully roll markets out at scale.

Creating space to think strategically and spending time building relationships

We have suggested earlier in this paper that a vital role of the testing process is to expose political decision makers to a range of stakeholder views about the way publically funded markets should work. Doing so will allow these decision makers to:

- make informed decisions about what they want the market to achieve
- respond to legitimate concerns about moving to market-based service delivery
- judge whether they have the political appetite to roll out a market in the face of potential opposition.

Participants at our roundtables were keen to emphasise that building markets that reflect the ambitions of different stakeholder groups should be approached as an ongoing process. Building relationships over time is important not only because legitimate stakeholder concerns are unlikely to be resolved through single interactions, but also because views may change as markets develop.

The advice therefore to future civil servants developing markets is not to underestimate the extent to which they would need to spend a significant proportion of their time developing an understanding of stakeholder concerns, responding to these concerns, and ultimately building relationships which will support the operation of a market at scale.

The role of ministers in building relationships with stakeholder groups and preparing them for widespread use of markets is a matter of debate. Some interviewees suggested that ministerial involvement in the testing process – and particularly ministerial visits to pilot sites – could be a useful way of maintaining momentum behind market tests,

communicating the case for and benefits of the market-based policy, and building a coalition of support. As one policy maker currently working on a pilot suggested:

Ministers have a 'rah rah ting' role to play in hosting events, building momentum and getting political backing for the policy.

However, some of our interviewees were concerned that ministerial involvement at the testing stage could unduly raise expectations that a market would be rolled out regardless of the insights generated through the testing process. We suggest therefore that any use of ministers to build momentum behind a market test should not threaten the spirit of independence, experimentation and freedom to evaluate results free from undue pressures.

Disseminating evidence about what works

A strong theme that emerged from our roundtables was that even when market testing occurs in a local area there is still an important role for departments. In particular, there is a role for central government in ensuring good standards of evaluation, and collecting and disseminating evidence about 'what works', both in terms of market mechanisms, and the types of interventions that should be commissioned to deliver certain outcomes.

To do so, central government needs to develop ways of capturing the lessons from local evaluations in a way which does not stifle local innovation. Many of the civil servants we spoke to were enthusiastic about departments developing common frameworks for collecting data, central and local networks to help interpret data, and common ways of thinking about problems. As one interviewee suggested:

Localism is not inconsistent with good evaluation. What is needed is a framework within which data can be collected. Responsibility needs to be taken for having certain standards of evaluation, and local areas need to be willing to share knowledge of what works.

As markets develop, there is a role for government in providing a body of evidence to commissioners about what types of services will deliver desirable outcomes.

However, participants amongst the provider community were concerned that central government attempts to be more rigorous about what works would stifle local experiments freedom to try new approaches. As one interviewee from a provider organisation working on a pilot suggested:

It would be great to be given more freedom. I know it is important to prove whether we are successful but the level of rigour that surrounds our pilot seems disproportionate to the size of expenditure.

The role of government development in disseminating evidence about 'what works' across local areas needs to therefore allow for local innovation and flexible approaches to work.

Potential solutions might be to use an arm's length organisation to develop guidelines for market testing and act as the depository for knowledge about what types of interventions

commissioners should consider. Doing so may reduce the departmental incentive to become heavily involved in the details of local market tests, and would create more time to consider the role of departments in scaled markets. NESTA's Alliance for Useful Evidence is exploring ways in which this idea can become a reality.⁴⁸

⁴⁸ More information about the Alliance for Useful Evidence can be found here http://www.nesta.org.uk/areas_of_work/public_services_lab/alliance_for_useful_evidence

8. Putting it into practice

There are a number of key lessons that have emerged from our research.

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 a market.

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. In doing so, they should remember to be precise about what they are testing.

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 teams. Policymakers must work closely with political staff, operational managers, commissioners 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 expose the concerns of stakeholders whose support is essential for the effective operation of publically funded markets is pivotal to the long-term success of publically funded markets.

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.⁴⁹

We hope this paper provides some guidance for how to test publically funded markets.

⁴⁹ For a fuller discussion of what it means to steward a policy area see Hallsworth, M (2010) *System Stewardship* Institute for Government

9. Resources

On methods of testing policies

NESTA and Think Public (2011) Prototyping in Public Services

http://www.nesta.org.uk/events/assets/features/prototyping_in_public_services

Cabinet Office (2003) *Trying it out: the role of 'pilots' in policy making*

<http://webarchive.nationalarchives.gov.uk/+http://www.cabinetoffice.gov.uk/media/cabinetoffice/strategy/assets/rop.pdf>

Rondinelli, D (1993) *Development projects as policy experiments: an adaptive approach to development administration*, London: Routledge

Harvey, S McMahon, L, Humphries, R (2011) *Routes for social and health care: A simulation exercise*

http://www.kingsfund.org.uk/publications/social_care_routes.html

The Young Foundation's briefing note on pilots and prototypes is available here:

<http://www.youngfoundation.org/our-work/local-innovation/strands/local-government-innovation/innovation-methods-local-government/14>

On publically funded markets

OFT (2010) *Choice and competition in public services: a guide for policy makers*

http://www.oft.gov.uk/shared_of/business_leaflets/general/oft1214.pdf

DTI Economics Paper No.14 (2005) *Public policy: using market-based approaches*

<http://www.bis.gov.uk/files/file14759.pdf>

Brown, T, Potoski, M, Van Slyke, D (2006) 'Managing public service contracts: aligning values, institutions, and markets', *Public Administration Review* Vol 66 (3) p.p. 323-331

Denhart, R and Denhart, J (2000) 'The new public service: serving rather than steering', *Public Administration Review*, Vol.60(6) pp.549-559

Hefetz, A, and Warner, M (2004) 'Privatisation and its reverse: explaining the dynamics of the government contracting process', *Journal of Public Administration Research and Theory* Vol. 22 (1) pp. 171-190

Klinger, D, Nalbandian, J, Romzek, B (2002) 'Politics, administration and markets: conflicting expectations and accountability', *The American Review of Public Administration* Vol. 32 (2) pp.117-144

Palma, A, Leruth, L, Prunier, G (2009) *Towards a principal-agent based typology of risks in public-private partnerships* IMF Working Paper p.13

On commissioning

- [Commissioning Support Programme, *Good commissioning: principles and practice*](#)
- Cabinet Office (2010) Modernising Commissioning green paper
<http://www.cabinetoffice.gov.uk/resource-library/modernising-commissioning-green-paper>
- Office of Government Commerce (2006) Competitive dialogue procedure in new procurement regulations available at <http://www.barnet.gov.uk/guide-competitive-dialogue.pdf>
- Sturgess, G, and Cumming, L (2011) *Payment by outcome: a commissioner's toolkit 2020*, Public Service Trust; and UK Commission for Employment and Skills (2010) *Outcome based commissioning: lessons from contacting out employment and skills programmes in Australia and the USA*

On commissioning skills

- Academy for Justice Commissioning
<http://virtual.nationalschool.gov.uk/AJC/Pages/HomePage.aspx>

10. Appendix 1: An overview of market failure and state intervention

There are a series of decisions that ministers need to take before market makers begin to test publically funded markets. These decisions include whether the state should intervene in the market and, if so, what form this intervention should take. These decisions are beyond the scope of this paper (which focuses on the questions that should be answered once a decision has been made to test a market).

Nevertheless, there is a significant amount of literature which can guide decisions about whether state intervention in a market is justified and, if so, what type of intervention is appropriate. This appendix summarises some of this literature and therefore might help to inform initial decisions about whether or not a publically funded market should be tested.

It starts with an overview of when state intervention and provision of goods and services might be justifiable.

When a public service is being provided

Without government, certain goods may not exist at all. In the economic jargon these tend to be 'public goods' which are 'non-rivalrous' and 'non-excludable'. This means respectively that the amount one person uses the good will not affect how much others can use the good, and that it is difficult to prevent other people from using the good.⁵⁰ Air is a good example of a public good as it is non-rivalrous and non-excludable. A morning jogger's heavy breathing does not mean the passing dog walker cannot breathe, and, without force, it is difficult to prevent people from consuming air.

There are numerous reasons why public goods are likely to be underprovided in a market. First, as everyone will benefit from the good regardless of whether or not they have paid for it there will be an incentive to 'free-ride' i.e. to use the service without paying for it. If all consumers free-ride then there will be insufficient payment for the good and it will therefore be under-provided.⁵¹ Second, as it is difficult to exclude people from consuming a public good, the price that can be charged for an extra unit of the good is likely to be close to zero. Providers driven by profit are unlikely to compete in markets where the price they can charge is near to zero. Therefore there will either be under-provision or a market dominated by too few players.

When a good has a 'public' nature then state intervention may be justifiable to compensate for under-provision in the market.

⁵⁰ Samuelson, P (1954) 'The pure theory of public expenditure' *The Review of Economics and Statistics* Vol. 36 (4)

⁵¹ Of course, this assumes that consumers are all rational, self-interested actors who, if left to their own devices, would not collectively act in the wider public interest.

When a service has a social objective

State intervention may also be justifiable when there is a social objective which may not be achieved in a free market. Education, for example, is not a classic public good as it is 'rivalrous' in the sense that the more students are in a classroom, the more ineffective teaching is likely to be. However, if the provision of education is left to the market, only pupils whose parents can pay are likely to find themselves a place in the classroom.⁵²

In addition, whilst healthcare is also not a classic public good, if left to the market those with the means to pay, or those who have lived healthy lifestyles, may find it easier to be treated. In the economic jargon providers are 'cream skimming' when they show a preference to treat high-value (e.g. those who can pay more) or low-risk (i.e. those who are less likely to have complicated health conditions) customers. Alternatively, in a market providers may take payment from higher-risk customers but then might 'park' them, meaning that they continue to focus on the easiest to treat or most profitable customers. In a society that believes everyone should have equal access to healthcare, cream skimming would not be considered socially acceptable and therefore state intervention may be justified to ensure everyone has access to the service.

When a service has negative externalities

Whilst public goods might be under-produced in a market, in other cases a market may over-produce a service or the by-product of a service. One of the reasons why over-production occurs is because producers do not internalise all the cost of their production (the 'negative externalities' of production).

For example, if left to her own devices a factory owner will not bear the costs of pollution emitted from her factory as her neighbours and society more generally will share the burden of pollution. If no factory owner bears the costs of pollution this may lead to pollution levels rising greater than is socially acceptable.⁵³ Such instances of negative externalities create a case for government intervention to either produce the service itself, or to regulate the market to control and restrict, for example, the amount of pollution farmers are allowed to emit.

When providers have excessive market power

There is a case for state intervention when providers have a 'monopoly' (i.e. a single provider) or 'oligopoly' (i.e. only a few providers) position in the market. In such circumstances providers are likely to have excessive market power, meaning that they can act independently of market pressures – by resisting any downwards pressure on price or upwards pressure on quality – because their position is not threatened by any competitors. In this situation, providers can take advantage of their market power by charging unfair prices for their services or offering a poor-quality service which consumers have to accept as there is no alternative. In such cases of monopoly or oligopoly, there is a case for state intervention to protect consumers from abuses of market power.

⁵² DTI Economics Paper No.14 (2005) *Public policy: using market-based approaches* p.14

⁵³ DTI Economics Paper No.14 (2005) *Public policy: using market-based approaches* p.15

When services are highly specialised

When services are highly specialised and require infrastructure, technology, knowledge, or skills that can only be acquired through on-the-job experience or highly specialised investments, there is a case for state intervention.⁵⁴ A hospital, for example, requires huge capital investments in the building and equipment, and investment in training doctors, nurses and managers. Once these investments have been made it is difficult to use the goods and experiences purchased in other ways. It is difficult to see, for example, how an x-ray machine could be used for activities other than x-raying bones. The non-transferability of these specialised assets means it is very costly to enter the market and start to compete, thus potentially limiting the competitiveness of the market.⁵⁵ In such circumstances, services may be underprovided or there may be a few providers who dominate the market.

In sum, there are a range of different types of 'market failure', all of which can justify state intervention in the market. Once a government has identified a case of market failure, the question then becomes what form of state intervention should be used to address the market failure.

What form of state intervention should be used?

There are many different forms of government intervention to address the sources of market failure described above. These include:

- regulating a private market
- the state funding and competitively tendering a mixed market⁵⁶,
- the state funding users to choose different services in a mixed market
- users privately funding public provision
- the state both funding and providing a service.

There is no hard rule about which intervention to use and often political ideologies and historical precedent determine the form of state intervention.

Nevertheless, a useful starting point is to consider which form of state intervention, in theory, best addresses the particular market failure. This matching exercise is conducted below and is summarised in Table 1.

A regulated private market

In many cases goods and services can be provided in private markets but require some form of regulation by the state. As a rough guide, regulating a private market is appropriate when:

⁵⁴ Brown, T, Potoski, M, Van Slyke, D (2006) 'Managing public service contracts: aligning values, institutions and markets', *Public Administration Review* Vol 66 (3) p.327

⁵⁵ Nelson, M (1997) 'Municipal government approaches to service delivery: an analysis from a transaction cost perspective' *Economic Inquiry* Vol.35 (1) pp.82-96 p.82

⁵⁶ Mixed markets are those which include public, private and voluntary sector providers

- services do not aim to achieve fundamental social objectives
- services are excludable and rivalrous (i.e. 'private' service)
- there is likely to be negative externalities
- there is likely to be excessive market power.

In cases where services are not likely to be under-provided, the price mechanism (i.e. a person's ability to pay) is seen as a fair and effective way to allocate resources, and if there is not a fundamental concern about social objectives then services can be provided by a private market.

But when a private market creates negative externalities, regulation can be used to encourage providers to internalise the costs of production. One form of regulation is to impose limits on the amount negative externality that can be produced. In the case of pollution, for example, the government would determine the amount of pollution that a firm could produce and fine them for going over this limit. Another common way to regulate negative externalities is to introduce tradable permits. Here, the government sets the overall total level of, for example, emissions it deems socially justifiable and issues permits up to this limit. Firms are allowed to trade permits, incentivising firms to reduce their emissions (so they can sell on their extra allowance).⁵⁷

Regulation is also appropriate where one or a few providers are in a position to abuse their position in the market by indulging in anti-competitive practices. Regulatory mechanisms might include legal provision to prevent merger and acquisitions.

Publically funded, competitively tendered

A second way to address market failure is to publically fund and competitively tender services. Competitive tendering refers to the government paying for services from money collected from tax receipts and commissioning a range of public, private and voluntary organisations to deliver services. Kelman defines this delivery model as:

*...business arrangements between a government agency and a private entity in which the private entity, in exchange for money, delivers certain products or services to the government agency or to others on the government's behalf.*⁵⁸

Advocates suggest that competitive tendering brings a range of benefits including accessing economies of scale⁵⁹, pressures to improve quality and reduce costs, and management flexibility.⁶⁰

⁵⁷ DTI Economics Paper No.14 (2005) Public policy: using market-based approaches p.17

⁵⁸ Kelman, Steven (2002) 'Contracting' in the tools of government: a guide to the new governance (Lester Salamon, Oxford University Press)

⁵⁹ Economies of scale are said to be achieved when more units of a good or a service can be produced on a larger scale, yet with (on average) less input costs.

Read more: <http://www.investopedia.com/articles/03/012703.asp#ixzz1igY1yR00>

⁶⁰ Brown, T, and Potoski, M (2003) 'Contract-management capacity in municipal and county governments *Public Administration Review* Vol. 63 (2) pp.153-163 p.154; Ostrom, E, and Ostrom, V (1977) *Public goods and public choices*, Workshop in Political Theory, Indiana University available at <http://theworldbuilders.witesman.com/v372/Ostrom%20public%20goods%20and%20public%20choices.pdf>

But competitive tendering will not be appropriate for all services. As a rough guide, competitive tendering is appropriate when:

- services are non-excludable and non-rivalrous
- services aim to achieve social objectives
- there is likely to be an excess of market power
- competition within the market is inappropriate or not possible
- when services require specialised investments.

Competitive tendering can be used to compensate for the likely under-provision in the market of 'public goods'. By publically funding these goods government can ensure they are supplied, but can also harness the incentives to improve performance which are provided by competition. In addition, government can specify contracts to ensure that provision is made for users who might not be provided for in the market either because they do not have the ability to pay, or because they have circumstances which are too complex. Social objectives can thus be achieved through competitive tendering.

Competitive tendering also provides a means to address excesses of market power. The government can prevent monopolistic practices by commissioning a range of different providers and can write contracts which serve to protect the interests of consumers, for example, by negotiating a fair price for services.

Competitive tendering allows competition *for* the market, which means that when contracts are tendered providers compete to win contracts, but once the contract is won they effectively 'own' the market for the lifetime of the contract. Competing for the market is appropriate when economies of scale can be gained and when it is inappropriate for providers to compete for consumers within the market. When contracting for prisons, for example, there is limited scope for user (i.e. prisoners) choice so competitive tendering prisons may be appropriate.⁶¹ Similarly, when services require significantly upfront and specialised investments, competition for the market may be appropriate to make these investments worthwhile.

Public payment, user choice

A third way to address market failure is to publically fund users to choose their services from a mix of public, private and voluntary suppliers who in turn compete for their custom.⁶² This form of delivery creates competition *in* the market between different suppliers of publically funded services. In such cases, users are normally entitled to a 'voucher' or individual budget that can be

Boyne, G. A. (1998) 'Bureaucratic theory meets reality: public choice and service contracting in US local government', *Public Administration Review* 58(6); Savas, E (2000) *Privatisation and public-private partnerships* (New York: Chatham House) p.122; Van Slyke, D, Hammonds, C (2003) 'The privatisation decision: do public managers make a difference?' *The American Review of Public Administration* Vol.33 (2) p.p.146-163, p. 146

⁶¹ DTI Economics Paper No.14 (2005) *Public policy: using market-based approaches* p.17

⁶² DTI Economics Paper No.14 (2005) *Public policy: using market-based approaches* p.17

used to 'purchase' services.⁶³ The most recently articulated arguments in favour of user-driven markets centre on the possibility of increasing user choice and responsiveness to individual user needs.⁶⁴ As a rough guide, user choice is appropriate when:

- services are non-excludable and non-rivalrous
- services aim to achieve social objectives
- there is likely to be an excess of market power
- competition within the market is appropriate and possible.

Publically funding services through user choice addresses the same market failures as providing services through competitive tendering. A government may choose user choice over competitive tendering when it is legitimate for users to choose different services. For example, it's socially acceptable for the elderly to have a say over their social care provider, thus explaining recent moves to facilitate user choice over social care through market mechanisms such as individual budgets. In contrast, prisons are competitively tendered because it's not acceptable for a prisoner to choose their prison.

Private payment, public provision

A fourth way to address market failure is to privately fund services through user fees, but have the state provide the service either directly or through competitive tender. Often hospital car parks, roads, swimming pools and museums, are provided in this way. As a general rule privately funded but publically provided services are appropriate when:

- the service produces negative externalities
- the service does not address fundamental social objectives.

If a government wants to encourage consumers of a service to avoid 'free-riding' and internalise the cost of consuming the service they may introduce a user charge. Users' charges can be fixed to ensure that the more someone consumes the service the more they pay, thus incentivising consumers to limit the amount they consume. Congestion charging is a good example of a user charge. By introducing congestion charges an incentive is created to limit the amount the road is used which, in turn, limits the negative externalities of congestion and pollution. User charging is also a way in which the government can raise extra revenue. This may be appropriate when the government is not too concerned about social objectives or ability to pay.

Publically funded, publically provided

A fifth way to address market failure is for the state to provide a service directly. As a general rule, services should be publically funded and publically provided when:

⁶³ DTI Economics Paper No.14 (2005) *Public policy: using market-based approaches* p.18

⁶⁴ See for example David Cameron's speech on the Open Public Services white paper <http://www.number10.gov.uk/news/speech-on-open-public-services/>

- the service is 'non-rivalrous' and 'non-excludable'
- the service addresses a fundamental social objective.

National armies are in most countries publically funded and publically provided. Economic text books justify armies being provided in this way because they are a classic example of a 'non-rivalrous' and 'non-excludable' good. It is very difficult to prevent someone from enjoying the benefits of being protected by a national army and one person's protection does not prevent another from being protected. In such circumstances a market is likely to under-produce the good and therefore state provision is justifiable.

In addition, publically funded and provided services may be advisable when the service addresses a fundamental social objective. In such circumstances there may be no appetite to expose the service to the forces of the market, such as provider failure, cream skimming, parking and under-provision.

Publically funded and publically competitive (quasi-market)

Publically provided services can be excessively costly or of poor quality if the incentives on public providers to minimise costs and quality are weak. Incentives may be weak because in the absence of a price signals it may be difficult for a government to know whether enough, too much, and the right goods are being provided.⁶⁵

In such circumstances the state can provide public services and use 'quasi-market' incentives to drive performance where units of state provision compete to win funding from state purchasers. For example, the internal market in the NHS (1991-1997) split purchasers (GP fundholders) and providers (NHS Trusts) of health care in the UK in order to promote competition between providers within the NHS.⁶⁶

Table 1: The types of state interventions which in theory address market failures

State intervention	Type of good	Market failure
Regulated private market	Rivalrous	Negative externality
	Excludable	Market power
		Not a fundamental social

⁶⁵ DTI Economics Paper No.14 (2005) *Public policy: using market-based approaches* p.15

⁶⁶ For an overview of the internal market in the NHS see Propper, C, Burgess, S, Gossage, D (2003) *Competition and quality: evidence from the NHS internal market 1991-1997* CEPR Discussion Paper No.4026

		objective
Publically funded, competitively tendered	Non-rivalrous Non-excludable	Market power Social objectives User choice not appropriate Services require specialised investments
Public payment, user choice	Non-rivalrous Non-excludable	Market power Social objectives User choice appropriate Services require specialised investments
Private payment, public provision	Rivalrous Excludable	Negative externalities Not a fundamental social objective
Publically funded, publically provided	Non-rivalrous Non-excludable	Fundamental social objective
Publically funded and publically competitive (quasi-market)	Non-rivalrous Non-excludable	Fundamental social objective, competitive incentives needed