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When to contract

Which service features affect the ease of government contracting?

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Summary

This working paper identifies six questions that those introducing, adapting or overseeing contractual mechanisms in public services should ask to gain a better understanding of their costs and benefits.

We draw on the well-established 'theory of the firm' literature to identify a set of questions that can help policy makers and commissioners assess the suitability of using contractual mechanisms in any given service or function.

A 'yes' answer to any of the following questions creates challenges for 'in house' management but generates particularly acute risks when using contractual mechanisms. We argue therefore that policy makers and commissioners should not introduce contractual mechanisms in these areas without putting in place a clear strategy for mitigating these risks.

1. ***Is it difficult to measure the value added by the provider?***

   If a service lacks objective or quantifiable measures of the value added by the provider, it will be more difficult to price contracts and monitor performance.

2. ***Are service outcomes highly dependent on the performance of other services?***

   If services that depend on one another to achieve their outcomes are contracted out to competing organisations, it may be more difficult to incentivise and secure the necessary cooperation between providers.

3. ***Does delivering the service require investment in highly specific assets?***

   If a service requires investments in highly specialised physical or human resources, government may find it costly to attract providers and, over time, could be left vulnerable to an incumbent provider with excessive market power.

4. ***Is the service characterised by high demand uncertainty?***

   If demand for a service is not known in advance, or subject to unpredictable variation, government may find it costly to incentivise investments and/or may be left vulnerable to 'hold-up' situations.

5. ***Is the service characterised by high policy uncertainty?***

   If there are politically motivated changes in policy direction or service specification, the government may find it costly to renegotiate contracts.

6. ***Is the service inherently governmental?***

   If a service involves making key policy decisions, is central to government's law and order capability, or intimately related to government's duty to protect the public, contractual mechanisms are unlikely to be appropriate.

We outline some strategies that can help mitigate the above mentioned risks in the main body of this paper. We also note, however, that such mitigations typically entail additional costs, which policy makers and commissioners must factor in when making judgements on the respective value for money of contractual mechanisms and 'in house' service delivery.

We argue that policy makers and commissioners must also consider the costs and risks of transition in service areas where contractual mechanisms are being introduced for the first time, or where they are being significantly extended or adapted. A 'yes' answer to any of the four questions below indicates that transitioning to a contractual-based delivery model may potentially be easier to manage.

7. ***Is there an existing supply of high-quality providers?***

8. ***Is there an existing workforce (either in the public or private sectors) with adequate skills and capabilities to deliver high-quality services?***

9. ***Does the government have the organisational capability to design and monitor the use of contractual mechanisms?***

10. ***Does the government have enough information about cost and quality to measure provider performance?***

To help us 'test and develop' this paper further and turn it into a useful guide for commissioners and policy makers about when and how to contract public services, we would be grateful if you could consider and respond to the key questions posed at the end of this paper.

Background

Since the 1980s, successive governments have seen contractual mechanisms (see box 1) as a route to more efficient and effective public services.[1] As a result, the role of private and voluntary sector organisations in service delivery has increased significantly. In 2008, the *De Anne Julius Review* suggested that the UK public service industry accounts for over 6% of GDP, generating some £80 billion (bn) in revenue while employing well over 1.2 million (m) people.[2]

The Coalition Government has set out a programme of public service reform which seeks to continue and accelerate this trend. Contractual mechanisms are currently being introduced or accentuated in education, healthcare, employment – indeed, in almost every major policy area.[3] Often, private and voluntary sector providers are being asked to play an even greater role in service delivery, as seen in healthcare, prisons and probation services.

It is clear that contractual mechanisms can at times reduce costs and drive improvements in service efficiency, quality and innovation, resulting in better value for money.[4] For example, in local government, the Audit Commission estimated that up to £80m of efficiency improvements in corporate services stemmed from the use of contractual mechanisms.[5]

But the rollout of contractual mechanisms across different public services has not been an unqualified success. It is reassuring then that the coalition partners and the Labour Party agree that they should only be used where they are appropriate and in ways that genuinely improve public service performance.[6] What is less reassuring, however, is the considerable disagreement there is about where exactly the lines should be drawn. There are many reasons for this, but one is that there is little knowledge or awareness of the factors that should influence decisions about where and how contractual mechanisms should be applied.

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[1] T Gash and T Roos, 2012, *Choice and competition in public services* at: http://www.instituteforgovernment.org.uk/publications/choice-and-competition-public-services

[2] HM Treasury, Public Expenditure Statistical Accounts 2011, available at: http://www.hm-treasury.gov.uk/pesa2011_section2.htm; DeAnne Julius, (2008), *Public Service Industry Review.* Department for Business, Enterprise and Regulatory Reform, available at: http://www.bis.gov.uk/files/file46965.pdf

[3] Open Public Services White Paper (2012), available at: http://files.openpublicservices.cabinetoffice.gov.uk/OpenPublicServices-WhitePaper.pdf

[4] Office of Fair Trading (2010), *Choice and Competition in Public Services.* London, p.19

[5] Audit Commission (2007), *Healthy Competition,* London, p. 2, available at: http://www.audit-commission.gov.uk/SiteCollectionDocuments/AuditCommissionReports/NationalStudies/HealthyCompetition2007_27Nov07.pdf

[6] Open Public Services White Paper (2012), available at: http://files.openpublicservices.cabinetoffice.gov.uk/OpenPublicServices-WhitePaper.pdf

Box 1: Contractual mechanisms

We use the term 'contractual mechanisms' to describe measures that introduce contracts between government and public, private and voluntary sector providers of public services. Government funds competing organisations to provide services or deliver specified outcomes. It rewards high performers (usually with additional workload and/or funding) and penalises low performers (usually with reduced workload and/or other penalties). There are many ways in which contractual relationships can be designed and managed. For example, government funding can be almost completely tied to a provider's ability to attract and retain users, as in social care and academy schools. In other cases, funding can be based on the performance of specific activities or the creation of certain outcomes, as in 'payment by results' for finding people sustainable employment in the Work Programme.[1] In some areas, only public sector organisations are permitted to provide contracted services (e.g. certain acute care services), while in others public, voluntary and private sector providers can all compete to provide services (e.g. waste management).

Approach

This working paper aims to support decisions about whether, where and how to apply contractual mechanisms in public services by highlighting:

- the different ways in which contractual mechanisms can be applied to public services
- the service characteristics that make it likely that contractual mechanisms will create additional costs or risks
- the factors that will affect the transition from monopoly public provision to contractual-based delivery models.

We then apply these criteria to a selection of public services and outline some strategies that can be used to mitigate the risks of applying contractual mechanisms, where there are any.

This paper draws on the 'theory of the firm' literature which explains the existence and boundaries of organisations (the so-called 'make or buy' decision). We build on two slightly different approaches to examining where organisational boundaries should be drawn:

- the 'transaction cost model', which identifies the service characteristics that make the management and governance costs of using contractual mechanisms higher than if the service was retained in-house[7]
- the 'resource based model', which looks at the bundle of resources, knowledge and capabilities that underlie an organisation's (or government's) 'competitive advantage' and long-term performance.[8]

Since this literature focuses on outsourcing decisions in the private sector, we have reinterpreted the theoretical principles where necessary to make them more applicable to the government and public service context.

[7] Ronald Coase, (1937), 'The Nature of the Firm', *Economica,* Vol. 4, Issue 16; Klein, Crawford and Alchian (1978), 'Vertical Integration, Appropriable Rents, and the Competitive Contracting Process'*, The Journal of Law and Economics*, Vol. 21, No. 2; Oliver Williamson, (1975), *Markets and Hierarchies: Analysis and Anti-trust Implications,* New York: The Free Press; Oliver Williamson, (1998), 'Transaction Cost Economics: How it Works; Where it is Headed', *De Economist,* Vol. 146, No. 1.

[8] Edith Penrose, (1959), *The Theory of the Growth of the Firm,* New York: Wiley; C Prahalad and G Hamel (1990), 'The Core Competence of the Corporation', *Harvard Business Review*; B Wernerfelt, (1984), 'A Resource-Based View of the Firm'*, Strategic Management Journal*, Vol. 5.

Ways in which contractual mechanisms can be applied to public services

The decision to use contractual mechanisms in the delivery of public services clearly does not boil down to a simple 'yes' or 'no' choice. Rather, contractual mechanisms can be used in various ways and can often be supported by a range of regulatory and managerial tools.

Three of the most important factors to consider while evaluating whether to apply contractual mechanisms are:

- the functions or 'service' which might be covered by contractual mechanisms
- the geographic level at which contracting should take place
- the degree of choice that should be devolved down to individuals.

Defining the service, the geographical level that contractual mechanisms operate at, and the degree of choice devolved to individuals often requires complex choices and trade-offs, which are discussed in the Annex. For example, the desire to achieve efficiencies and retain coordination between related services may lead the government to bundle together a number of functions into one large national service contract. However, this in turn may affect the ease of specifying and pricing contracts (see Question 1) and could limit competition – particularly if government is the sole purchaser of these services and only a few providers have the scale, expertise and capital to deliver the service.

Choices over service specification, geography and levels of user choice can (and should) often evolve over time to reflect developments that have impacted on the most cost-effective ways of organising services – for example technological change or management innovations. Such changes are often seen in practice. In the 2000s, for example, the Department for Work and Pensions (DWP) largely took over and nationalised contracting of employment services and has since frequently changed its definitions of the 'services' that it is contracting for.[9]

There is likely to be an iterative process between specifying the service and assessing the suitability of contractual mechanisms. For example, there are proposals to unbundle 'offender management' services into two separate services so that the government can contract out the management of 'low-risk' offenders, but not 'high-risk' offenders, thereby retaining public sector control over 'inherently governmental' functions (see Question 6). This decision will affect the number of functions performed by the government and thus its organisational boundaries.

Service characteristics that will make it likely that contractual mechanisms will create additional costs and risks

Contractual mechanisms can at times drive improvements in service efficiency, quality and innovation resulting in better value for money.[10] Government, however, must consider whether these benefits are likely to outweigh the costs and risks of applying contractual mechanisms. This is likely only to be the case if they are applied appropriately – which we argue will be highly dependent on the nature of the service. Below, we draw on well-established literature to identify a set of questions that will determine the likely costs and benefits of using contractual mechanisms in any given service or function. These all fall under one or both of the following categories:

- **Value for money considerations:** There are features unique to certain services that can make using contractual mechanisms costly and difficult, ultimately undermining rather than improving value for money. Practitioners must therefore evaluate whether the benefits of contractual mechanisms are realistically likely to outweigh their costs.

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[9] See Gash and Roos (2012), *Choice and Competition in Public Services,* available at: http://www.instituteforgovernment.org.uk/our-work/new-models-governance-and-public-services/public-service-markets-and-commissioning/market

[10] See Le Grand, Julian and Will Bartlett (eds) (1993), *Quasi-Markets and Social Policy,* Basingstoke: Macmillan.

- **Strategic considerations:** Applying contractual mechanisms has long-term strategic implications beyond the service in question. Practitioners must consider whether applying contractual mechanisms may limit the government's control over core functions and lead to a loss of capabilities that are critical for the government's long-term performance.

A 'yes' answer to the questions below indicates that contractual mechanisms may be more costly or risky to apply, thus necessitating extra bureaucratic controls, mitigating interventions or direct public sector management.

Q1. Is it difficult to measure the value added by the provider?

There are some services which lack objective or quantifiable measures of the value added by the provider, making it more difficult to price the service contract. This complexity is related to two separate considerations.

a) **Is it difficult to measure the service outcomes?**[11] Some service outcomes are difficult to observe, measure or quantify making it difficult to specify what 'quality' consists of and how performance should be measured. For example, in mental health services, the linkages between inputs and outputs are unclear and 'quality' cannot simply be measured by the number of 'cured' cases. Instead, a range of 'proxy' indicators need to be developed (i.e. unplanned hospital readmission rates) which is a complex and resource-intensive process. Furthermore, there is the risk that providers will be encouraged to excessively focus on these proxies to the detriment of actual desired outcomes.

b) **Is it difficult to attribute the service outcome?** In some services, it is difficult to assess whether the outcome was generated by the provider, would have happened anyway or was generated by the actions of other service providers. For example, in employment services, there is a risk that the government will end up paying a provider for an outcome (i.e. employment for jobseekers) that may have occurred due to improvements in the economy, or because of the actions of other services such as a major investment in free adult education services.[12] In these cases, it will be difficult for the government to distinguish and reward the performance of different providers. Therefore, the government will have to invest substantial resources into developing data and a robust counterfactual model to understand what would have been likely to happen without the intervention of the provider.

If service outcomes are difficult to measure or attribute, the government may find it difficult to decide what it wants from providers, the value they add and the price it should pay for the service. This will make it difficult to write contracts that describe what providers must do and how performance will be monitored, leaving the government vulnerable to opportunistic providers who could seek to lower service quality and quantity within the limits of the contract.[13]

To minimise this risk, the government must incur high upfront transaction costs by clearly specifying the values sought in performance measures, generating data to underpin robust counterfactual models and writing detailed contracts. It could also monitor provider quality through regular inspections increasing ex-post transaction costs.

The difficulty of measuring outcomes in advance may be less of a problem in those services where individuals can ascertain the quality of provision through repeated use and change providers if dissatisfied (e.g. GP services).[14] In these situations, the government can use individual choice as a proxy for the quality or value added by the provider.

This will only work in services that lend themselves to a choice-based model of provision (see Annex) and will be most effective if individuals are well informed, regularly purchase the service or can be informed by others' experience of the market. However, in some services, it is difficult or even impossible for users to ascertain quality even after they have used it many times (e.g. financial products).[15]

Q2. Are service outcomes highly dependent on the performance of other services?

Some service outcomes cannot be solely controlled by one organisation, but instead depend on a range of organisations to perform a set of related activities. For example, a health professional treating a patient with a history of drug abuse will be highly dependent on the quality of housing, counselling support and employment services. The way any one of these services is delivered will affect the outcomes the health professional is able to achieve.

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[11] The transaction cost economics literature refers to this as 'ambiguity'.
[12] Paying for outcomes that would have happened anyway are known as 'deadweight' payments.
[13] LeGrand and Bartlett refer to this as 'moral hazard'.
[14] These are known as 'experience goods'.
[15] These are known as 'credence goods'.

Where multiple organisations contribute to achieving a particular goal (or set of goals) it will not only be difficult to distinguish and reward performance (see Question 1), but also difficult to ensure that their activities are effectively coordinated. Indeed, this has proved challenging even when all organisations involved operate within the public sector due to organisational silos and misaligned policy cycles and objectives.[16] It is, however, generally possible to improve coordination (and therefore outcomes) within the public sector by appealing to the wider common purpose of government or by mandating regular interactions, collaboration and information sharing.[17]

Contracting out these services to multiple organisations will make it harder to coordinate them, particularly if these organisations have different ownership. It is often difficult to identify the necessary behaviours and values conducive to cooperation and write them into a contract, especially if the types of collaboration required can only be built over time and depend on long-standing relationships. Attempts to write, monitor and enforce them will add to the costs of contract design and oversight.

The inclusion of profit-making providers in this system may further diminish the government's coordinating capabilities. Although we recognise that this is a contested assumption, the drive to compete, promote efficiency and control costs tends not to be conducive to cooperation. Profit-making providers may, for example, be tempted to withhold information that is costly to share or could financially disadvantage them. Likewise, public sector organisations may hijack the efforts of profit-making organisations and obstruct their performance, if they mistrust their intentions or would like to be seen as more effective than them.

To minimise the risk of losing coordination between services, the government could re-specify the service by bundling together a number of highly interdependent services together into one large aggregate contract. Or it could regularly monitor providers on the degree to which they integrate services and cooperate with others (through peer feedback), rewarding those who do (through additional workload) and penalising those who don't (through reduced workload or even contract termination). Both strategies however entail additional strategic and value for money costs. For instance, bundling functions together into large contracts may be at odds with other objectives (e.g. allowing small, local providers to enter the market), while regularly monitoring providers on how effectively they integrate services will increase ex-post transaction costs.

Q3. Does delivering the service require investment in highly specific assets?[18]

Asset specificity refers to the need for highly specialised investments in physical infrastructure, human capital, land sites or technology that have limited use outside the service area or cannot be readily translated to other economically valuable activities. A manufacturing plant is an example of a highly specific asset since it is impossible to relocate and very difficult to adapt to another use.

Since investing in a highly asset specific service is regarded as a sunk cost (a cost which cannot be recovered quickly), providers are only likely to make that investment if there is low uncertainty around future demand or policy (see Questions 4 and 5 below) and/or the government guarantees a long-term contract.

In service areas that are prone to a natural monopoly situation (e.g. rail, utilities and waste processing), providers who win the first contracts will develop a monopoly over the assets raising barriers to market entry and constraining future competition.[19] For instance, it would be difficult to re-tender waste processing services if one of the bidders controlled key landfill sites and waste processing plants. This leaves the government vulnerable to a single supplier who may threaten to withdraw from the contractual relationship, raise prices or reduce quality.

The government can curtail opportunistic behaviour by owning the assets and only contracting out the management or operation of the service (as it did in the case of the human assets central to the operation of the National Physical Laboratory).[20] It can also negotiate and write contracts that describe clearly what the provider must deliver. This, however, will raise the transaction costs of shifting to the new system.

High asset specificity also makes it difficult for providers to expand or contract easily to accommodate increasing or decreasing demand for their services. In schools, for example, a popular provider may not have the capacity within its existing estate to expand thereby limiting the choices students and parents have in practice. At the same time, the closure of a poorly-performing school may not be feasible if there is little or no alternative provision in the area as this could lead to service disruption or inequity in provision. As a result, the government may have to

[16] K Blatchford and T Gash (2012), *Commissioning for Success: How to avoid the pitfalls of open public services,* available at: http://www.instituteforgovernment.org.uk/publications/commissioning-success

[17] This is a core organisational competence of the government. For a detailed discussion of organisational competencies see Wernerfelt, B (1984), 'A Resource-Based View of the Firm', *Strategic Management Journal*, Vol. 5, p. 172

[18] Brown, Potoski and Van Slyke, *Managing Public Service Contracts: Aligning Values, Institutions and Markets;* Oliver Williamson, (1998), 'Transaction Cost Economics: How it works; Where it is Headed', *De Economist*, Vol. 146. No. 1.

[19] A natural monopoly is a type of monopoly that exists as a result of the high fixed or start-up costs of operating a business in a particular industry.

[20] Gary Sturgess, (2012), *Diversity and Contestability in the Public Service Economy,* Sydney, NSW Business Chamber, p. 82.

replace the management, allow mergers or invest more resources in the provider. In both cases, high asset specificity can weaken the incentives on providers to perform well and increases the risk of opportunism (and associated costs).[21]

Q4. Is the service characterised by high demand uncertainty?

These are services in which a) there are likely to be unpredictable variations in demand or b) where demand for the new service is unknown in advance.

a) **Unpredictable variations in demand:** In situations where there is an unexpected spike in demand that is likely to be followed by a downturn in the near future, government is usually obliged to make additional investments to avoid service disruption or inequity in provision. Providers, however, are likely to be unwilling to commit to large irreversible capital investments either due to the inability to secure extra finance or desire to maximise profits. The government may therefore have to negotiate further payments to incentivise providers to increase the scale of their provision raising ex-post transaction costs.

   This is, however, likely only to be a problem if the assets cannot be readily deployed to another activity when demand stabilises again (see Question 3 on asset specificity). In these situations, the government could retain ownership of the assets and only contract out the management of the service, mitigating the need for provider capital investment to accommodate unexpected changes in demand.

b) **Demand for the new service is unknown in advance:** In situations where it is uncertain what the level of demand for a particular service will be, future revenue streams will also be uncertain. Providers will therefore price this risk in their bid, making it more expensive for the government. Unknown demand not only increases a provider's risk but can leave the government paying more for a service than necessary. For example, the government may be contractually obliged to pay a provider to deliver 100 operations per month (based on forecasted demand), but may find that demand is much lower than expected and only 75 operations are delivered on average.

In these situations, the government can negotiate payment caps (which protect government from making unnecessary payments above demand) and minimum income guarantees (to incentivise providers to take on risk), increasing ex-ante transaction costs.

Q5. Is the service characterised by high policy uncertainty?[22]

In some services, there is a high risk of politically motivated changes in policy direction or service specification which could result in a service being discontinued, scaled back or dramatically reconfigured. Due to the higher security of its funding streams and wider portfolio of activities, government is often better placed than external providers to manage such risks. If these types of services are contracted out, the government will likely have to pay providers a 'risk premium', which will need to be off-set by commensurate (or greater) performance gains through competition. High degrees of risk may also deter smaller providers who are typically less able to finance risk, which in turn may reduce levels of competition in the market.

Policy uncertainty can also raise the costs of contracting in the long term. Changing and adapting contracts so that they reflect new policy priorities can be both time-consuming and expensive, increasing ex-post transaction costs.

To minimise the risks of policy uncertainty, it may be helpful to build a broad political consensus around policy goals and use of contractual mechanisms prior to their use. Where this is not possible, the government may find it prudent to negotiate shorter-term contracts which will lessen the likelihood of policy change during the short life of the contract. This will have to be traded-off against longer-term contracts which are more likely to inspire provider confidence and incentivise investment. Alternatively, the government can retain the service in-house and thereby maintain the flexibility to respond to changing circumstances.

Q6. Is the service 'inherently governmental'?[23]

There are certain services or functions that are by nature central to the stated mission of the government making it inappropriate to apply contractual mechanisms. Unfortunately, however, there is little explicit guidance on where to draw the boundaries of the government. Drawing on academic literature and the US Office of Management and Budget interpretation, we suggest that the government needs to consider the following characteristics to identify an 'inherently governmental' service.

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[21] National Audit Office (2012), *Delivering Public Services Through Markets: Principles for Achieving Value for Money*, London, p.22-24.
[22] Transaction cost economics literature refers to this as 'volatility'.
[23] Felipe Santos and Kathleen Eisenhardt (2005), 'Organisational Boundaries and Theories of Organisation', Organisation Science, Vol. 16, No. 5; US Office of Management and Budget (2011), Performance of Inherently Governmental and Critical Functions, available at: http://www.whitehouse.gov/omb/procurement_index_work_performance

a) **Does it involve making key policy decisions?** For example, decisions to wage war, award contracts,[24] make regulations, impose taxes or set the budget. The government cannot wholly delegate these decision-making functions as they are central to its entire raison d'etre of expressing policy preferences on behalf of the electorate.

b) **Does it constitute the government's law and order capability?** Central control, oversight and accountability for the armed forces and police provide the government with the coercive authority to maintain law and order. Contracting out these services would indicate a removal of formal oversight structures and could lead to a critical shift in power away from the government to providers who may use it to challenge the government's ultimate authority.

c) **Is the service intimately related to the government's duty to protect the public?** There are certain services in which low-quality provision, underperformance or outright failure risks placing the larger population in danger undermining the governments core public protection mandate.[25]

If a service has any one of the above characteristics, contracting it out will substantially limit the government's control and authority over core functions. Therefore, it might generally be prudent to retain these types of services in-house.

Factors that will affect the costs of transition

We suggest that there are at least four factors that will affect the costs (and risks) of the transition from a fully government owned and delivered service to one based on contractual mechanisms.[26] How these are addressed and managed will often be critical to the success of the new system.

Q7. Is there an existing supply of (high-quality) providers?

Markets vary significantly in both size and maturity. Some services have a number of providers with the requisite skilled staff and capabilities to deliver high-quality services, which offers the opportunity for healthy competition.

In contrast, diversity and quality of supply may be limited in some sectors (e.g. offender management) or geographic areas (e.g. rural areas). An inadequate supply of viable providers jeopardises the potential gains derived from competition, increases the likelihood of opportunism from the provider over time and limits the choices the government and users can make in practice.

If the market is relatively young, the government will have to take an active role in stimulating the market and must often be willing to accept dips in service performance during this transitional period. The public's appetite for variation in the quality of service provision may, however, be low and therefore the government must consider the degree to which it is willing to bear these costs.

Q8. Is there an existing workforce (either in the public or private sectors) with adequate skills and capabilities to deliver high-quality services?

Related to the question of diversity and quality of supply, is the question of whether providers have an existing workforce with the necessary skills and capabilities to perform the contracted function. This is particularly crucial for services that require highly specialised staff that are in short supply.

Contracting out to a provider which does not yet have this capacity is highly risky. The capacity may never develop, or it may develop in ways that do not necessarily improve service outcomes. The government could overcome this problem by transferring the existing public sector workforce to the contractor or spinning them out through a mutual.[27] During this transitional period, service performance may deteriorate below acceptable standards, and as above, the government must consider the degree to which it is willing to bear these costs.

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[24] Although the government should retain control over awarding contracts to a prime provider or consortium for the delivery of infrastructure projects and services, these prime contractors can then select and manage sub-contractors in a supply chain to deliver the specified project or service.

[25] Public acceptance of private and voluntary provision in these services is also likely to be low with the government being viewed as trying to abrogate its responsibility to protect the public if it introduces contractual mechanisms.

[26] These factors will also affect the costs and risks of transitioning from one contractual model to another, for example after having re-specified the service or introducing greater elements of user choice.

[27] Mutuals Taskforce, (2011), *Our Mutual Friends: Making the Case for Public Service Mutuals,* available at: http://mutuals.cabinetoffice.gov.uk/documents/mutuals-taskforce-evidence-paper-our-mutual-friends-making-case-public-service-mutuals

Q9. Does the government have the organisational capability to design and monitor the use of contractual mechanisms?

It is critical to assess whether the government has the organisational capabilities to design, apply and oversee the effective use of contractual mechanisms. This includes the ability to select the right provider, design and negotiate contract terms, set tariffs/prices that represent value for money, monitor and evaluate outputs and outcomes, reward performance and penalise failure. Throughout, the government must have the capability to regularly assess whether contractual models are delivering the required outcomes, and, where necessary, adapt the way they are used or test new delivery models.

This capability depends on developing institutions with clearly designated roles and responsibilities that are staffed by personnel with the required skills, experience and knowledge to ensure the effective functioning of the system.[28] If this capability does not exist or too much of it is outsourced, the government will fail to understand what providers are doing which will undermine its ability to be an intelligent purchaser and thereby increase the risk of provider opportunism and low-quality services.

Although the government should address analytical and commercial skills gaps early on, it is likely that the necessary capability and institutional processes will only be developed through repeated experience of the market and an iterative process of trial and error, making it possible that service performance and quality may dip during this period.[29]

Q10. Does the government have enough information about cost and quality to measure provider performance?

The government's organisational capability to design and oversee the use of contractual mechanisms is highly dependent on whether it has sufficient and reliable information about the cost and quality of providers. This will enable it to make informed decisions about who to award contracts to as well as regularly monitor and measure performance.

Access to reliable information is also critical if the government plans to introduce elements of user choice in the provision of services. Information will need to be framed in a simple and accessible way and be made readily available to individuals to help them make informed and meaningful choices between providers.

Developing sufficient and reliable information (and then making it accessible to users) is a resource-intensive task that requires investment in data collection and systems. Therefore, the government must consider whether it has this capability and, if not, how quickly it will be able to develop it. During this transitional period, the government (and users) may have limited access to, or an inadequate amount of, information to assess provider quality and performance increasing the risk of low-quality services.

Case studies

In this section, we apply our criteria to a selection of functions and services in order to consider the comparative costs and benefits of using contractual mechanisms as opposed to in-house provision in different public services. We recognise that there are a number of different ways to measure and operationalise the criteria[30] and thus making judgements about each service is a highly subjective exercise. Therefore, table 2 is used for illustrative purposes only.

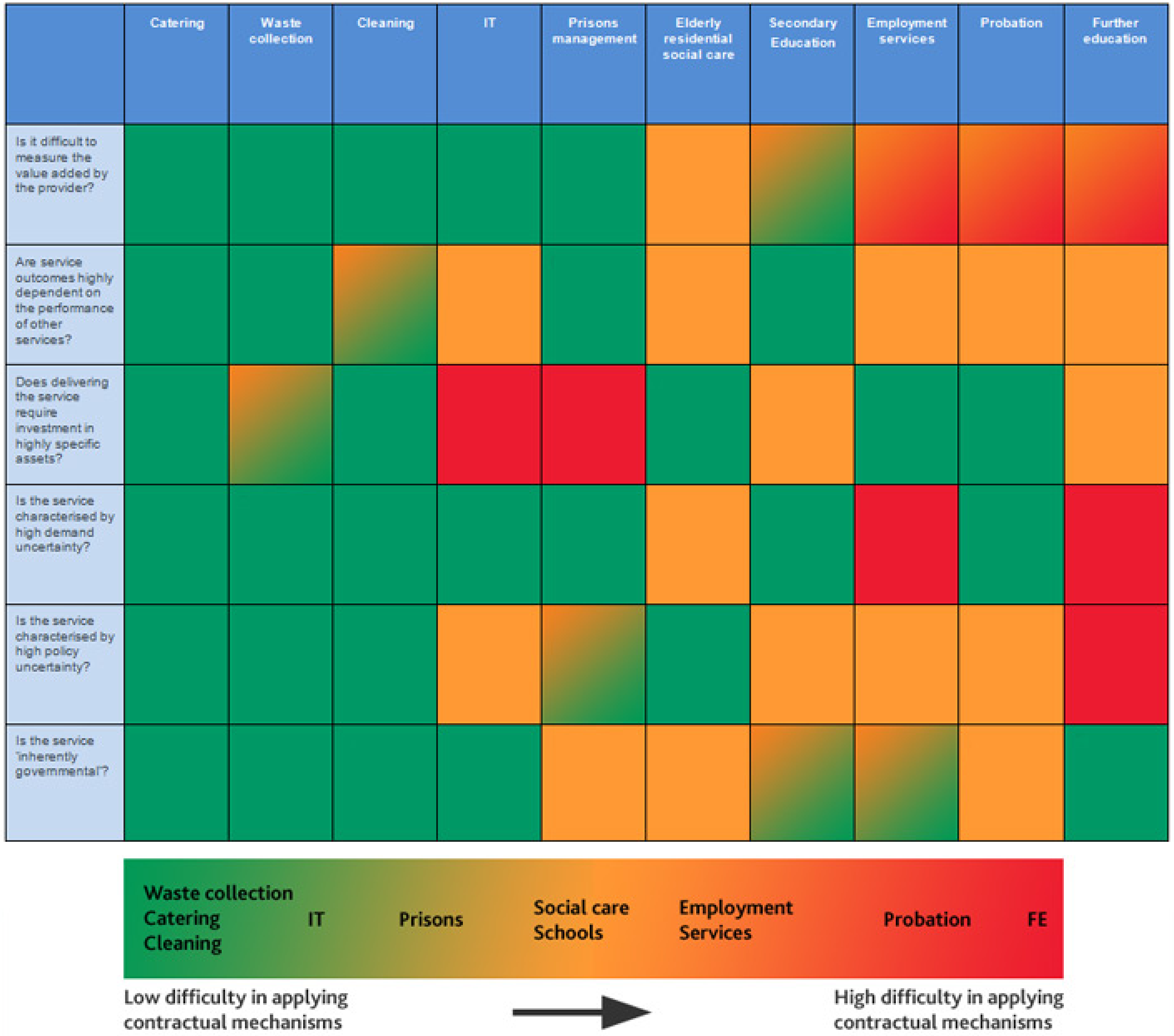
It is clear that as we move from discreet individual functions (e.g. catering) to broader service offerings (e.g. probation services), it becomes more difficult (and riskier) to apply contractual mechanisms making the case for extensive risk mitigation or direct government control over provision. For example, waste collection is an obvious candidate for contracting as, among other characteristics, outcomes are easy to measure (i.e. collection of rubbish on a daily basis) and there is low risk around future demand. As we move to services such as prisons management, introducing contractual relationships becomes slightly more difficult and raises strategic and value for money costs. Although outputs are quantifiable (e.g. number of cells, amount of out-of-cell time, number of meals provided), it is closely related to the 'inherently governmental' function of protecting the public and is characterised by a degree of policy uncertainty (e.g. at times, the government has cancelled the procurement of prisons during or after a costly bidding process).[31] Towards the far end, applying contractual mechanisms in further education is arguably still more challenging and potentially increases the need for direct government

[28] T Gash and T Roos (2012), *Choice and Competition in Public Services: Learning from History*, available at: http://www.instituteforgovernment.org.uk/sites/default/files/publications/Choice%20and%20competion%20in%20public%20services_0.pdf
[29] K Blatchford, and T Gash (2012), *Commissioning for Success. How to Avoid the Pitfalls of Open Public Services*, available at: http://www.instituteforgovernment.org.uk/publications/commissioning-success
[30] Developing reliable proxies for each of the criteria is a complex and highly subjective task which is outside of the scope of this paper.
[31] N Panchamia, (2012), *Competition in Prisons,* available at: http://www.instituteforgovernment.org.uk/publications/competition-prisons

management. It is difficult to measure the value added by providers due to the lack of consensus between the government, employers and learners about what constitutes high-quality provision.[32]

[32] N Panchamia, (2012), *Choice and Competition in Further Education,* available at: http://www.instituteforgovernment.org.uk/publications/choice-and-competiton-further-education

Table 2: The criteria applied



Mitigations and testing

If a service is marked as 'amber' against one or more of the criteria, it is often possible to partially overcome the associated costs and risks of using contractual mechanisms by either specifying the service differently (see Annex) or applying mitigation strategies (Figure 3). For example, degrees of policy uncertainty can occasionally be reduced through placing contracted functions at arm's length from political influence or better managed through shorter contracting cycles. The risks of not being able to measure the value added by providers can equally be reduced, for example by retaining a public sector provider whose performance can be compared to that of private and voluntary sector organisations.[33] These mitigations, however, typically entail additional costs – again underlining the fundamental point that these factors should carry significant weight when deciding whether to contract for or directly manage services.

It is also important to recognise that assessment of the factors highlighted is not a substitute for thorough testing and measurement of the effectiveness of in-house versus contractual models of provision. There are very few experiments which robustly assess the effectiveness of contractual versus in-house service provision, partly due to their expense and technical difficulty. However, testing different models can be highly valuable and there are a wide range of less resource-intensive approaches to testing the likely suitability of different contracting models, which are outlined in the Institute's publication, *Testing New Commissioning Models*.[34]

Figure 3 identifies a non-exhaustive list of possible mitigating actions.

[33] J Le Grand, (2007), *The Other Invisible Hand: Delivering Public Services Through Choice and Competition*
[34] K Blatchford and T Gash, (2012), *Testing New Commissioning Models: A Guide to Help Policy Makers Learn about Publically Funded Markets*, http://www.instituteforgovernment.org.uk/publications/testing-new-commissioning-models

Figure 3: Mitigation strategies

Question	If 'yes', consider retaining the service in-house or the following actions
Q1: Is it difficult to measure the value added by the provider?	• Assess whether users are active and well informed and, if this is the case, use individual choice as a proxy for service quality • Retain a public-sector comparator to understand production costs and technologies • Collect data to generate reliable performance and counterfactuals models
Q2: Are service outcomes highly dependent on the performance of other services?	• Identify functions that facilitate coordination and keep them in-house • Bundle functions together into one aggregate contract • Specify and reward desirable collaborative behaviours ex ante or ex post
Q3: Does delivering the service require investment in highly specific assets?	• Own the asset required to deliver the service and only contract out operation • Negotiate long-term contracts that enable the provider to recover any sunk costs • Minimise risk of policy and demand uncertainty
Q4: Is the service characterised by high demand uncertainty?	• Negotiate payment caps and minimum income guarantees • Make capital investments and only contract out service operation
Q5: Is the service characterised by high policy uncertainty?	• Achieve a broad and cross-party consensus • Design short, flexible contracts that minimise risk of policy change and trade-off with long contracts that incentivise provider investment • Keep contracted function at arm's length from political influence, where appropriate
Q6: Is the service 'inherently governmental'?	

Questions

You are invited to submit responses to the following questions in order to help the Institute for Government develop a better understanding of how the theoretical criteria presented in this working paper resonates with practical experience. This will inform future guidance and/or products for commissioners and policy makers about how to identify and manage the inherent costs and risks of contracting in certain service areas.

1. What are the key challenges of applying contractual mechanisms in the sectors you work in?

2. Do the criteria developed by IfG in this paper help to explain these challenges?

    a. If yes, please could you provide some practical case examples of how these have been managed?
    b. If not, which factors do you feel help to explain these challenges?

3. Do you think this paper provides a helpful guide for policy makers and commissioners on where and how to contract public services?

    a. If yes, which aspects do you find most useful?
    b. If no, in what ways can it be developed? Which gaps do you feel need to be addressed? Where should we focus more attention?

4. Based on the material in this paper, what type of framework, tool or product do you think would be useful for commissioners and policy makers?

To contribute to this debate, please email your views and ideas to

nehal.panchamia@instituteforgovernment.org.uk

Annex: Ways in which contractual mechanisms can be applied to public services

The following section demonstrates that the government has a range of tools and approaches that can be tailored when applying contractual mechanisms in public services.

How a service is unbundled

Decisions around which services or functions to perform within the boundaries of a particular organisation or government can vary significantly and depend on a variety of considerations such as a desire to achieve efficiencies, coordinate services or enable certain types of providers to enter the market.

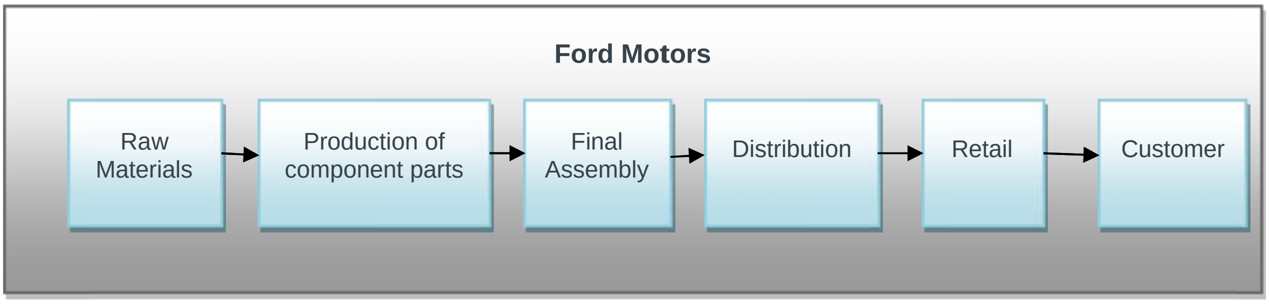
This is demonstrated clearly by drawing on examples in the private sector. For instance, in the automobile sector, a typical supply chain would include raw materials, production of component parts, final assembly, distribution, retail and customers. Related functions include product development and engineering at the early stages of production, logistics throughout and final assembly and advertising at the end.

In the 1920s, when Ford Motors began to expand, it owned and controlled virtually every aspect of its business (this is known as full 'vertical integration') with the overall goal of reducing the level of risk and uncertainty throughout the supply chain. This involved, among other things, building its own railroad, controlling coal and iron ore mines, 700,000 acres of timberland, rubber plantations and acquiring a fleet of freighters to ship out finished vehicles. This allowed Ford to control the raw materials it needed to produce mass amounts of automobiles, eliminate product and delivery mistakes made by suppliers and ensure all of the components were ready for assembly at the right time. This strategy is widely regarded to have facilitated Ford's dominance of the automobile sector.[35]

By the late 1960s, however, Japanese manufacturers began to challenge the dominance of US firms through a different supply chain management structure, namely the outsourcing of raw materials production and component parts. US companies soon realised that the high degree of vertical integration achieved by the industry had actually resulted in inefficiency and waste in their supply chains. During the 1960s, therefore, Ford motors began to outsource activities in its supply chain shifting away from direct control over production, which significantly changed the boundaries of the firm.

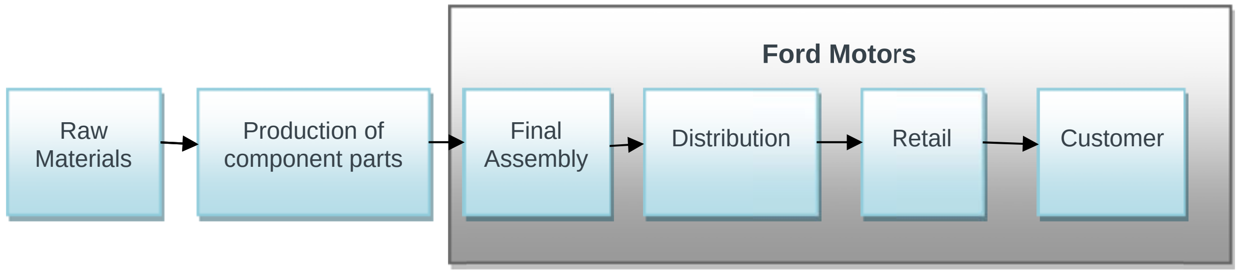
The following diagrams illustrate the impact of the two different supply chain management models on the organisational boundaries of Ford Motors.

Ford's vertical integration model during the 1920s



[35] *Economist*, 'Vertical Integration. Moving On Up: Is the Recession Heralding a Return to Henry Ford's Model?' 27 May 2009, available at: http://www.economist.com/node/13173671

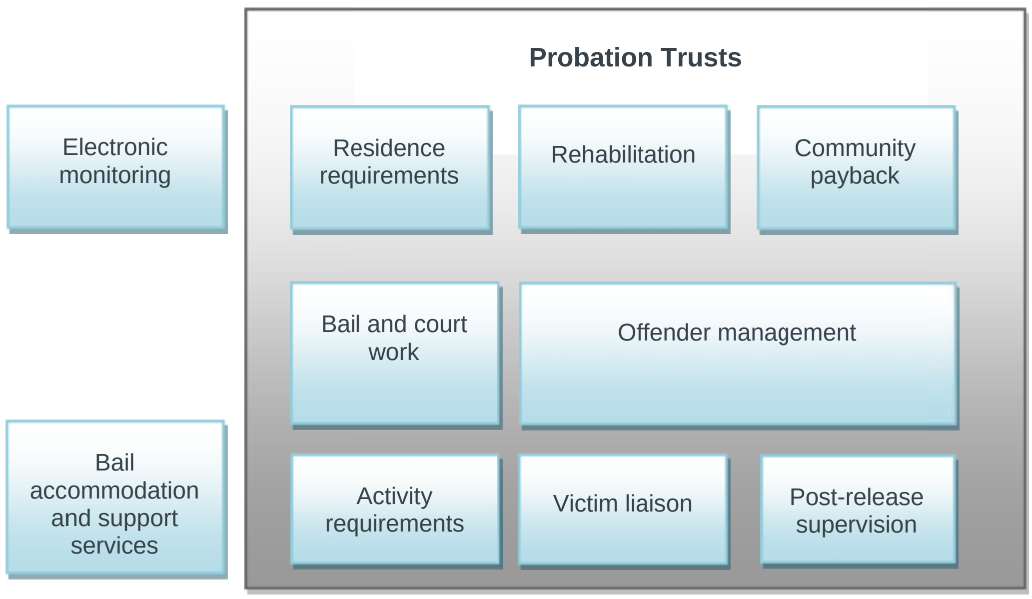
Ford's supply chain model from the 1960s onwards



In the public sector, specifying or 'unbundling' a service is often more complex than this and involves making a judgment about where the boundaries of different functions lie. For instance, in the case of probation services, there are a number of activities that are performed in relation to punishing and reforming offenders which are managed in the community. These include bail and court work, offender management, post-release supervision, residence requirements, rehabilitation (e.g. mental health, drug or alcohol treatment), assessment and reports, supervision, activity requirements, offending behaviour programmes, community payback, approved premises, victim liaison, electronic monitoring and bail accommodation and support services. Related support functions include back-office functions (IT and administration), estates and facilities management and HR (recruitment and training).[36]

Currently, public sector probation trusts deliver all these services except electronic monitoring and bail accommodation and support services, which have been outsourced to external providers. There are plans, however, to open up more visible and sensitive frontline services to competition such as offender management, rehabilitation and community payback. Elements of bail and court work (providing advice to courts) and offender management (managing high-risk offenders) will remain within the public sector. If implemented, the number of functions that are directly performed by probation trusts will decrease and, as a result, their organisational boundaries and capacity will change.[37]

Current organisational boundaries of probation trusts



[36] Ministry of Justice (2012), *Punishment and Reform: Effective Probation Services*, p. 10.
[37] See Ministry of Justice (2012), *Punishment and Reform: Effective Probation Services*.

Proposed organisational boundaries of probation trusts

The way a service is specified or unbundled will affect whether it is appropriate to introduce contractual models of provision. In this working paper, we identified six main questions that should help policymakers consider the likely costs and benefits of applying contractual mechanisms to either an individual or bundle of functions within a public service area.

There is likely to be a feedback loop between unbundling the service and assessing whether it is appropriate to apply market mechanisms. Policymakers may find that after considering the answers to the questions certain functions cannot be contracted out without incurring substantial risks and costs. Therefore, it may be useful to review whether the service has to be unbundled further or specified differently until the conditions for contractual mechanisms to work effectively are fulfilled.

The geographic level of contractual mechanisms

How a service is specified will not only determine whether it is appropriate to apply contractual mechanisms, but at which geographic level they are introduced. For instance, in employment services, if a number of functions are bundled together (e.g. skills training and job placement), it is likely that only large national or regional providers would have the scale, expertise and capital to provide all the specified services. This may produce efficiencies and strategic coordination between services, but will prevent smaller providers from entering the market. Conversely, if the service is unbundled into a number of individual functions (e.g. specialist skills training is kept separate from job placement), smaller private and voluntary sector providers at the local level would be able to compete for contracts. This is likely to result in more locally responsive and specialist service provision, but possibly at the expense of achieving efficiencies and strategic coordination.

The degree of choice devolved

When introducing contractual mechanisms, the government will also need to consider the degree to which it will introduce elements of user choice, whether significant oversight procedures need to be established and the institution that holds responsibility for this. At one extreme lies the commissioning approach whereby the government has a direct contractual relationship with the provider specifying how much of a service it requires and the terms under which it is to be delivered (e.g. prisons and employment services). At the other extreme lies the individual choice model in which the government’s contractual relationship with providers is managed through individual service users. Instead of directly paying a provider, the government funds (or partly funds) users (or their agents) to purchase services themselves through a voucher system (e.g. social care and schools). Within this spectrum, there are a number of variables that can be adjusted when designing the market.

Decisions around the degree of choice that is devolved down will depend on factors such as whether user choice is morally and politically appropriate (e.g. it might be judged inappropriate to give offenders a choice over their probation provider); whether the service area is characterised by low user engagement or motivation (e.g.

employment services); whether the service is used or chosen infrequently (e.g. acute medical care); and the nature of the goods being produced.

Collective goods should be provided directly by the government while individual goods are highly suitable for a choice-based model of provision. Merit goods fall somewhere in between and can be provided by a combination of choice-based, contractual and bureaucratic mechanisms. The following provides extended descriptions of each type of good and the implications for the choice mechanism.

Collective goods (also known as public goods) are those services in which use by one individual does not reduce the amount available for another individual. Once these goods are provided, they are available to everybody to use whether or not an individual pays for them (e.g. the army, fresh air and a flood control system). None of these services could be purely delivered by a free market based on individual choice without undermining the social objective of providing the service. For example, if the government did not provide an army, a private supplier may decide to raise an army and require each individual to pay for it. However, some individuals may decide not to pay for the army on the assumption that there will be enough individuals who would pay, thus enabling them to 'free-ride'. That is, they will be defended by the army regardless of whether they pay or not. The private supplier may find, as a result, that their predicted revenues are not sufficient to run a full national defence system and may give up. This is known as 'market failure'. The key point is that if individuals are given a choice as to whether to pay for a collective good or not, it is likely that the service may not be delivered. Thus, the government will have to intervene and provide these goods directly, making choices at the national level about the level and type of provision required.

Merit goods are services that both have a private benefit as well as positive externalities for society as a whole (e.g. schooling and health). There are disagreements as to which 'goods' fall under this category, demonstrated by the recent debates over whether higher education actually benefits society as a whole and thus is deserving of government subsidy.[38] The degree of choice individuals should have over the provision of merit goods is also subject to heated debate. It is argued that if these types of services are completely based on individual choice, the total supply will be insufficient to achieve a socially efficient level of consumption. This is because individuals may not recognise the private benefits of consuming merit goods such as regular health checks or schooling, especially since there is likely to be a considerable time lag between consumption and any potential future rewards. They are also unlikely to take the external benefit into account when evaluating whether it is worth consuming a merit good or not. Therefore, if the costs of consumption are perceived to be too high, people may decide not to consume at all. However, society needs a certain amount of people to be educated and healthy so that all individuals can receive the maximum external benefit.

If these services are opened up to individual choice and competition, there is a risk that the government and individual may have different preferences on what service is to be produced, what amount should be consumed or what values should be weighted in choosing the service.[39] Therefore, there are ongoing debates as to who will drive more 'efficient' allocation of resources (individuals or government), and thus the level of choice that should be devolved to individuals.

Individual goods (also known as private goods) are services that yield a private benefit for the user, and once consumed reduce the amount available for another individual. They cannot be used by those who have not paid for them (e.g. food, clothing and subscription-based services). These types of goods lend themselves most clearly to a free-market model based on individual choice, albeit with regulation to ensure consumer interests are protected.

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[38] Sandy Baum and Michael McPherson, *Is Education a Public Good or Private Good?* 18 January 2011, available at: http://chronicle.com/blogs/innovations/is-education-a-public-good-or-a-private-good/28329

[39] David Lowery refers to this as the "preference substitution problem". See David Lowery, (1998), 'Consumer Sovereignty and Quasi-Market Failure', *Journal of Public Administration Research and Theory,* Vol. 8. No. 2.

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