Your choice:

how to get better public services

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CENTREFORUM

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Foreword

If the government is to succeed in its ambition to eliminate the deficit, it must embrace public sector reform. Both the coalition parties have accepted that reform means giving increased choice to those who use public services and extending competition among those who provide them. The last Labour government took a broadly similar view.

Despite this consensus over the direction of travel, each step of the reform journey is fraught with potential controversy and difficulty. To avoid being blown off course, the government needs to apply a set of clear and consistent principles that will underpin a successful programme of public sector reform. This paper seeks to define these principles. It stresses five key requirements:

- High quality information – to guide the choices made by the users and commissioners of public services
- Effective regulation – to protect citizens from failings in the imperfect markets within which public services are provided
- A rigorous approach to deciding on the transfer of risk – to ensure that the government obtains value for money from its contractual relationship with service providers
- The creation of sound investment propositions – to open up the provision of public services to voluntary as well as private sector organisations
- Competitive neutrality between public, voluntary and private sector providers – to deliver greater diversity of provision and to ensure a good match between the ownership structure of the provider and the nature of the service to be provided.

An overriding principle is that the government should proceed with care – by evolution not revolution – in order to deliver reforms that are evidence-based and sustainable.

KPMG is glad to have supported the production of this paper. We believe it represents a major contribution to a debate that is of crucial importance to all of us – whether we pay taxes, make use of public services or work in organisations that provide them.

Alan Downey
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Executive summary

The coalition government has placed the introduction of choice and competition at the heart of its programme of public service reform. This builds on and extends the work of the previous Labour governments, particularly under the premiership of Tony Blair. But the furore over the NHS reforms has shown that there is still much controversy over how this should be done.

There is emerging evidence from the health and education reforms which have already taken place that introducing competition and choice does drive up performance and quality. This paper argues that it is right that these reforms are continued and extended – but that government cannot seek to impose a perfect market system. Markets by their very nature are flexible and develop. Hence, it is important that reforms are introduced in an evolutionary not revolutionary way.

To enable choice and competition to drive performance there are basic elements of a choice and competition infrastructure which are required. The first element is good information to enable public service users to make informed choices and to enable providers to make value for money bids to provide services. Government has given far too little emphasis to ensuring good information is available both to service users and to public service providers. The issue features barely at all in the NHS white paper. It receives much greater prominence in the recent higher education white paper, but this is rather late in the day given that fee levels have already been set.

There is information that government already holds which should made available to help inform choice. Government also needs to involve experts in consumer choice, such as the originators of comparison websites such as moneysupermarket.com and gocompare.com to identify the information required to inform user choice and how this can best be presented.

In some cases, simply providing information will be insufficient. Users will need advice to make informed choices. In the case of health, such advice is readily available through GPs. Similar advisory services need to be developed and/or strengthened across other areas of public service.

Drawing analogies from consumer services, development of public service 'brands' may also facilitate choice as users make choices based on 'brand reputation'. So, for example, in education we could see the development of brands such as 'Harris schools' or the 'ARK schools'. Such developments will help enhance choice and competition.

Improved information is also required to help ensure value for money from the private and voluntary providers which provide services commissioned by government. Poor information provided to bidders for services such as welfare to work and re-offending reduction risks their bids being worse value for money than they would otherwise be.

A second necessary part of the infrastructure promoting choice and competition is 'regulation' – whether by an independent regulator such as Monitor in health or by contract where government commissions services. This is necessary not only to protect the user or purchaser but also to promote competition where it is appropriate. Whilst a clear regulatory framework has been developed in health (although this is still subject to considerable political debate) the framework is less clear in other sectors.

We consider that current limited competition in the higher education sector may mean that economic regulation is required until stronger competition develops. Government has both a regulatory and a funding/commissioning role in public services. Bitter experience from the rail industry, shows that establishing strong procedures for consultation between the funding/commissioning body and the regulatory body is vital.

An important function of a regulator is to ensure that there is a service continuity/failure regime in place for those services which are essential, such as hospital A&E and acute services. However there is a danger that this only picks up very poor performance. Consideration is given to whether there should be a 'right to bid to takeover' mediocre or poorly performing providers, and it is recommended that government explores such an approach.

In commissioning services from private and voluntary sector providers, government should only transfer risks which the private/voluntary sector is able to manage. Doing so will achieve value for money. Experience from some Payment by Results contracts, especially in welfare to work, showed that government has failed to learn some of the lessons from PFI about what risks are appropriate to transfer. There is evidence that some of these lessons have now been learnt in the Work Programme contracts.

It is proposed that a more rigorous analytical framework be adopted as to which risks should be transferred and which should be retained in the public sector. This leads to a recommendation that a cautious and staged approach to the introduction of Payment by Results contracts is advisable (particularly in the light of poor information) if good value for money is to be achieved and risk of unnecessary failure minimised.

A vibrant supply side of providers (public, private, mutual and voluntary sector) is necessary to ensure high quality public services. An examination has been made of whether there are any constraints in terms of access to finance which might inhibit the development of mutual, voluntary and private sector providers.

The conclusion is that currently there is no strong evidence to suggest that there is such a constraint. There is impressive financial innovation already occurring, some of it promoted and facilitated by government through entities such as Social Investment Business and in the future the Big Society Bank. But government needs to be careful to ensure that its interventions do not inhibit the development of a viable social finance infrastructure.

The government sometimes claims that it is ownership blind in its approach, but this is clearly not the case. 'For profit' companies are not able to run schools, 'social enterprises' in the form of Foundation Trusts are prioritised in running hospitals, employee owned companies are being given priority in taking over some public services through the 'right to provide'.

There are particular political sensitivities with respect to private provision of health services and schools because of the fact that there is a privately funded, privately provided sector in both these cases. There is frequent conflation of these two things in public discourse.

Yet it is perfectly possible to have private provision of health services and schools whilst the service itself is funded by government and

free at the point of use. Such restrictions, whilst understandable for political and historical reasons are unfortunate. There are reasons to believe, for example, that banning 'for profit' providers in education is unduly impeding the development of high quality educational provision of the type that has appeared in Sweden.

Government should be clearer in setting out the basis and the criteria on which it favours one type of provider over another in particular areas. For example, it is understandable why government might wish initially to favour through the 'right to provide' the development of employee owned enterprises in provision of some front line services. This gives professionals greater freedom to innovate (though such 'favouritism' should be time limited).

In other areas the government's stance is confused and lacks logic. For example, it is unclear why government is forcing 'joint ventures' in certain areas of public services such as My Civil Service Pension (MyCSP). There is a very strong likelihood that ventures such as this will end up being entirely privately owned, and the government should recognise this from the outset.

Government must also be careful that a wish to promote employee owned enterprises and mutuals does not lead to a bias against large corporates. There are good reasons (access to capital, scope for investment in service development and training, quality processes and control, economies of scale and brand) why large corporates will in many cases be the more appropriate providers.

Introducing greater choice and competition has the potential to ensure high quality public services for the 21st century. However if this programme is to succeed, the government, through its 'Open Public Services white paper' and white papers covering specific sectors such as health, schools, higher education and reducing reoffending, needs to give greater priority to the issues outlined in this report:

- Much better information and advice to enable user choice to be meaningful and drive up standards
- Strong and clear regulatory frameworks to ensure high quality services at an affordable cost and to promote choice and competition where appropriate
- Consideration of a 'right to bid to takeover' to help deal with problems of mediocre performance
- A more rigorous approach to deciding which risks to transfer to the private sector when commissioning public

services. Currently in some services there is a danger that the government is seeking to transfer too much risk, particularly in the case of some services being considered for Payment by Results contracts

- A more logical approach to types of ownership in public services and one which is less guided by politics and 'fad and fashion'.

: 1 Introduction

The political context

The coalition government has made reform of public services one of the key planks of its programme of government. It wishes to introduce greater choice for citizens and competition and diversity in the provision of public services, with greater democratic accountability where appropriate. The coalition agreement spoke explicitly of combining thinking on markets, choice and competition with a belief in advancing democracy at a much more local level to generate a radical vision for public services

On public service reform, David Cameron has said:

> "…most important is the principle of diversity. We will create a new presumption…that public services should be open to a range of providers competing to offer a better service….instead of having to justify why it makes sense to introduce competition in some public services – as we are now doing with schools and in the NHS – the state will have to justify why it should ever operate a monopoly.
>
> This is vital to give meaning to another key principle: choice. Wherever possible we will increase it, whether it is patients having the freedom to choose which hospital they get treated in or parents having a genuine choice over their child's school.
>
> And to give our principle of choice real bite, we will also create a new presumption that services should be delivered at the lowest possible level. Working from this presumption, we will devolve power even further. For example, we will give more people the right to take control of the budget for the service they receive. In this new world of decentralised, open public services it will be up to government to show why a public

> service cannot be delivered at a lower level than it is currently; to show why things should be centralised, not the other way round."[1]

The intention to increase diversity of provision was also clearly enunciated in the Conservative Party's 2010 election manifesto which stated:

> "We will raise public sector productivity by increasing diversity of provision, ...extending payment by results and giving more power to consumers."[2]

Nick Clegg had expressed similar sentiments two years earlier after winning the party's leadership elections:

> "The state must intervene to allocate money on a fair basis, to guarantee equality of access in our schools and hospitals and to oversee core standards and entitlements. But once those building blocks are in place, the state must back off and allow the genius of grassroots innovation, diversity and experimentation to take off. Whitehall should get out of the business of the day to day running of public services in Britain. There is no liberal reason why those who deliver public services must always work directly for the government - so long as we are absolutely clear about the principles under which those services operate."[3]

The focus on public service reform is largely a continuation of the approach to public services adopted by Labour, particularly in its second and third term. The Labour government had recognised that top down control and target setting in public services, whilst sometimes effective in the short term, did not lead to long lasting change:

> "The old monolithic provision has to be broken down. The user has to be given real power and preference. The system needs proper incentives and rewards. The purpose should be so that public services can adapt and adjust naturally—self-generating reform—rather than being continually prodded and pushed from the centre. Public-sector unions can't be allowed to determine the shape of public services.

1 D Cameron, 'How we will release the grip of state control', The Daily Telegraph, 20 February 2011.
2 Conservative Party Election Manifesto 2010.
3 N Clegg, Speech to Liberal Democrat Conference, London, 14 January 2008.

> In Britain we have put huge investment into our public services. But we are also opening the health service to private and voluntary-sector partnerships, introducing a payment-by-results system, creating competition and allowing hospitals to become self-governing trusts. The new academies and trust schools will have the freedom to develop as independent but non-fee-paying schools, with outside partners like businesses, universities and charities able to sponsor and run them."[4]

All three main parties therefore, prior to the 2010 general election, broadly supported the central principles of choice, competition and diversity of provision in public services. However in the first year of the coalition government public service reform has proved to be one of the areas of greatest party political controversy.

It is perhaps not surprising that political opposition should increase, as some of these changes have been taken forward and even accelerated, within the context of substantial real cuts in public expenditure across a wide range of services. Opposition has come not just from the public sector unions who have criticised such changes throughout but increasingly from Labour and also from some elements of the Liberal Democrats.

This is surprising given the very strong historical strand of thinking within the Liberal Democrats in favour of choice and the role of markets:

> The state owned monopolies are among the greatest millstones round the neck of the economy…Liberals must stress at all times the virtues of the market, not only for efficiency but to enable the widest possible choice". (J Grimond, The future of liberalism, 1980.)

The preamble to the constitution of the successor party to the Liberal Party, the Liberal Democrats, builds upon this:

> "We want to see democracy, participation and the co-operative principle in industry and commerce within a competitive environment in which the state allows the market to operate freely where possible but intervenes where necessary."

The present paper, as befits a liberal think tank, approaches the issue of open public services from these perspectives rather than

4 T Blair, 'What I've learned', The Economist, 2007.

from a 'neo-liberal' view that markets should 'be allowed to let rip' within public services. It is clear that the state has a very important role, not only as a regulator of the public service market, *intervening where necessary*, but also as the funder of most, if not all, public services.

The government's approach to open public services

The political controversies around reforms to education and particularly health have played a major part in delaying the publication of the overarching Open Public Services white paper. Initially due to be published in February 2011, the paper was then delayed to May, then to July.

The government's broad approach to open public services can nevertheless be discerned from speeches and newspaper articles as well as the white papers on schools[5] and health and social care[6]. The approach distinguishes between accountability of public service providers through:

- **Personal choice of individual citizens/users**

  This is clearest in personal services, where as far as possible individual citizens choose how to exercise their entitlement, including in education; early years, schools, FE and skills, higher education and SEN and in health and adult social care; primary care, elective secondary care, dentistry, adult social care. In these cases the government intends that money will follow the individual user and in some cases how the money is spent will be determined by the user – personalisation of budgets. The amount of money per user may vary in order to counteract initial disadvantage e.g. the pupil premium.

- **Commissioning using, wherever possible, Payment by Results**

  This will typically occur in services where personal choice may not be appropriate – e.g. welfare to work services, reducing re-offending or where services are particularly complex or inappropriate for personal choice – e.g. Accident and Emergency (A&E) admissions in health; or where there are particularly complex health packages.[7]

5 'The Importance of Teaching' Schools White Paper, Department of Education, November 2010.
6 'Equity and excellence: Liberating the NHS', Department of Health, July 2010.
7 Dash and Meredith, 'When and how provider competition can improve health care delivery', McKinsey Quarterly, 2010.

Economists sometimes refer to this distinction as 'competition in the market' and 'competition for the market' (or Demsetzian competition after the economist Harold Demsetz[8]). Both types of competition will ensure not only accountability but also competitive pressures for price and quality. Overlaying all of this is democratic accountability (accountability by voice), whether at local or national level.

A second strand of the government's approach to public services has been to stress principles of competitive neutrality between service providers (whether public, private or third sector). However the government's approach in this regard has been rather more schizophrenic. 'For profit' private providers have been excluded from provision of free schools and a bias has been given to mutuals, employee owned and social enterprises in providing certain public services, through a 'right to request' in community health services, now extended to a 'right to provide'.

This paper does not go back to first principles in making the case for reform or make new detailed proposals for how specific public services should be reformed. Rather, it focuses on certain key themes and approaches which must be got right if reform directed at open public services is to work effectively. In doing so it draws upon liberal principles around the role of choice and competition in delivering high quality public services, some of the key issues in current policy debates, as well as the author's personal experience of advising on, and witnessing the implementation of, public service reform by successive governments.

Section 2 starts by considering the extent to which government can 'design' public service markets or whether a more evolutionary approach is advisable. Section 3 highlights the importance of information, both to enable good choices to be made by users but also for providers wishing to provide public services. Given the complexity of some of the services concerned, it also highlights the importance of good advice to inform choice as well as the role which providers' reputation and brand may play in informing choice.

As noted earlier public service markets will not work perfectly, and so Section 4 outlines how regulation will have a role to play in ensuring high quality services are provided and to facilitate choice and competition where appropriate. And for services where individual choice is not possible and government commissions the service, Section 5 looks at how contracts should be designed to optimise the distribution of risk between public and private sectors.

8 H Demsetz, 'Why regulate utilities?', Journal of Law and Economics, 1968.

Section 6 examines whether constraints in the availability of finance will impede new providers, particularly from mutuals and the voluntary sector. Section 7 looks at the extent to which marketisation of public services necessarily leads to a trend to non-public sector provision and suggest that government's approach to forms of ownership is rather confused and illogical. Section 8 sets out the paper's conclusions and recommendations.

: 2 Evolution not revolution – the best approach to public service reform

Whilst being an advocate of the liberal principles of choice, competition and the benefits of market forces, CentreForum has always placed a strong emphasis on evidence based policy research. This is one of a number of reasons why this paper argues that there are considerable benefits from evolutionary change within public services rather than revolutionary change. The coalition agreement rightly rejected top down reorganisation of the NHS but then proceeded to try to design a 'market system' and impose it.

The notion that you can plan a market in advance was tried by the Hungarian and Yugoslav governments in the Soviet era as part of their 'road to market socialism,' and it failed. Markets are by their very nature dynamic and unpredictable, guided by Adam Smith's 'invisible hand'. The best that government can do is to shape them over time as problems emerge or as new objectives are required, and for this reason the role of regulation will be critical.

With this in mind some ministers in 2010 might have spent their time usefully reading recently published books by two of our leading public policy commentators 'Obliquity' by John Kay and 'Capitalism 4.0' by Anatole Kaletsky, before drafting the NHS white paper.

As Kay argues:

> "The most complex systems come into being, and function, without anyone having knowledge of the whole" and "While it seems to make sense to plan everything before you start, mostly, you can't: objectives are not clearly enough defined, the nature of the problem keeps shifting, it is too complex, and you lack sufficient information. The direct approach is simply impossible."[9]

9 J Kay, 'Obliquity: why our goals are best achieved indirectly', Profile, 2010.

> "Obliquity is the best approach whenever complex systems evolve in an uncertain environment and whenever the effect of our actions depends on the ways in which others respond to them. There is a role for carrots and sticks, but to rely on carrots and sticks alone is effective only when we employ donkeys and we are sure exactly what we want donkeys to do. Directness is appropriate when the environment is stable and the objectives are one dimensional and transparent, and it is then possible to determine when and whether goals have been achieved. And only then."

Kaletsky argues:

> "Instead of believing that markets are always right and governments always wrong (or vice versa), voters now realise that governments and markets can both be catastrophically wrong. While this may seem a depressing and paralysing conclusion, it need not be. In fact, the perception that both markets and governments are prone to error can be empowering, both for politics and business, since the imperfections of both create scope for leadership, initiative and imagination.
>
> What Britain will need in the next five years is not less government and more market or vice versa, but a whole new agenda of policies combining and adapting the principles of market and political competition to promote objectives ranging from stable financial markets and clean energy to efficient social services that neither markets nor bureaucratic institutions can achieve on their own."[10]
>
> "The ability to operate by trial and error, to correct mistakes before they do too much social harm, is the greatest virtue of the market system. A similar pragmatism will have to be extended in the years ahead to political decisions and to the interaction of government with business."[11]

10 A Kaletsky, 'The old politics is dead. But where is the new?' The Times, 14 April 2010.

11 A Kaletsky, 'Capitalism 4.0: The birth of a new economy', Bloomsbury, 2010.

So with these strictures in mind is there evidence to justify the claims that choice, competition and diversity amongst providers are driving up performance within key public services? Such evidence would be required to justify continued evolution towards greater choice, diversity in provision and the continued pursuit of 'any qualified provider' within the health sector.

In education, Machin and Vernoit (2011) find improved attainment in the academy schools themselves as well as those schools in the surrounding areas.[12]

In health, Zack Cooper[13] and Prof Carol Propper[14] have shown that hospitals in more competitive areas perform better on quality and efficiency than those in less competitive ones. Propper also argues that competition on price leads to quality dropping whereas competition on quality leads to quality rising – providing justification for the government's decision to remove the ability to compete on price from the proposed NHS reforms. Nick Black et al at the London School of Hygiene and Tropical Medicine find that (whatever the criticisms that can be levied at the contracting mechanisms used) Independent Sector Treatment Centres (ISTCs) in carrying out elective operations such as cataracts and hernia treatments produced work of equal or better quality than carried out in the NHS.[15]

As Julian Le Grand has recently noted with respect to the government's health reforms:

> "...because of Labour's legacy, the essential elements of choice and competition were already there, and most of the bill's aims can be achieved simply by continuing previous reforms".[16]

This emerging evidence justifies a continuation and extension of the pro market reforms in health. The government is already

12 S Machin and J Vernoit, 'Changing school autonomy: academy schools and their introduction to England's education', London School of Economics, April 2011.

13 Z Cooper et al, 'Does hospital competition improve efficiency? An analysis of the recent market-based reforms to the English NHS', CEP Discussion Papers, June 2010.

14 C Propper, 'The operation of choice and competition in healthcare: A review of the evidence', 2020 Public Services Trust, July 2010.

15 N Black et al, 'Case-mix & patients' reports of outcome in independent sector treatment centres: comparison with NHS providers', BMC Health Services Research, 2008.

16 J Le Grand, 'A much maligned reform of hospitals is working', The Financial Times, 25 May 2011.

shifting its approach towards a more evolutionary stance with respect to GP consortia commissioning, just as Michael Gove has adopted a more gradualist approach to free schools and academies than originally planned. In other areas of public services the paper argues that a gradualist approach is also merited. For example, a staged approach to the application of Payment by Results to reduce re-offending is advocated alongside a gradual approach in other areas of commissioning as well.[17]

As issues or problems emerge the government needs to be sufficiently fleet of foot to make rapid adjustments. For this reason there are attractions in some cases of market regulators who can respond rapidly to changing circumstances. This is considered further in Section 4.

17 C Nicholson, 'Rehabilitation works: ensuring Payment by Results cuts re-offending', CentreForum, February 2011.

3 The importance of information

In public services if choice is to be meaningful and is to provide incentives to improve quality – and, where relevant, to drive down price – there needs to be good information made available. Moreover, it needs to be in an easily accessible form so that individual users or purchasers of services can make the right choices.

In economic theory, one of the reasons that markets do not always lead to optimal outcomes, and therefore may need to be corrected by regulation, is information asymmetry. This is where one party to a transaction has imperfect knowledge about what he or she is buying or choosing and hence cannot make an informed decision. This is particularly a problem when one party has more information about a transaction than the other – which is why there are laws against insider trading in the City.

This is not to say that when making purchasing decisions we always know all the attributes of the goods or services which we purchase, particularly if they are infrequent purchases. If I buy a new model of a new car I cannot investigate personally all its various attributes. I can look at *Which?* or *What Car?* magazine, but much of the information in that may not mean very much to me either. So very often I will go by brand and reputation. A Volvo is dependable but unexciting; a Porsche will go fast but has dreadful fuel consumption and is very expensive.

If I am choosing a school for my child, I am unlikely to be able to spend weeks observing the lessons in the school, looking at the written work, analysing the exam results and taking account of the ethos of the school. As Julian Astle et al argue:

> "information will increasingly need to flow downwards to parents as well as up to government: in the former case, to ensure the schools market functions properly; in the latter case, to put pressure on schools where market forces are weak or non existent and to alert regulators when markets fail."[18]

18 J Astle et al, 'School choice and accountability: putting parents in charge', CentreForum, 2011.

Readily accessible information will help this decision, and government has a role to play in identifying information which would be useful to parents making decisions and in requiring the collection of this information - for example, on destination of school leavers.

However not everyone will be able to make sense of all this information. Hence there is a role for the development of school 'brands' such as ARK or Harris academies. The explicit recognition in the schools white paper of the development of federations of academies as successful academies have oversight of less successful ones is welcome. These developments will be positive in facilitating informed choice.

Much good progress has already been made in providing information on school performance in public exams and the schools white paper sets out well the sort of information required. The benefits of this sort of information in driving performance is illustrated by the situation in Wales where such a requirement has been dropped; as a result the proportion of Welsh pupils in each school achieving a minimum of five good GCSE passes fell by 3.4 percentage points after 2001.[19]

In general, however, there has been too little attention given by government to this aspect of the necessary infrastructure for choice and competition to be effective. The Consultation paper on Regulating Service Providers as part of the NHS white paper 2010 contains just two sentences devoted to the issue when in theory patient choice already exists!

> "It will be necessary to take proactive steps to make patient choice a reality. This needs to include providing patients with information to make informed decisions and making it easier for new providers to offer services."

Burge et al (2005) found that when offered a choice 35 per cent of patients chose a local hospital and 65 per cent chose an alternative provider with a shorter waiting time. So contrary to what is sometimes alleged, patients do value having a choice and do not simply choose their local hospital.

19 S Burgess et al, 'A natural experiment in school accountability: the impact of school performance information on pupil progress and sorting', Centre for Market and Public Organisation, University of Bristol, 2010.

As the second part of the above quotation makes clear, good information is important not only to enable users to make informed choices but also for providers to have the information on which they can decide to offer services and/or bid against incumbent providers.

Three examples of the inadequacy of existing information to inform choice from, health, social care and higher education are considered. There is then consideration of the role of advisory services in informing choice. Finally, these is an examination of how poor information can cause problems for providers when bidding for contracts.

Health

Ironically, given that patients are to be granted the ability to choose their GP and GP consortia are to be given responsibility for purchasing, the amount of monitoring of GPs' performance and information about their performance is sadly lacking.

It is common for general practice to measure symptoms, diagnoses and treatments rather than outcomes. Survey data on patient experience and satisfaction are available for general practice via the NHS Choices website, but overall, outcome measures are not readily available at present.

A recent report by The King's Fund suggested three key areas where better information needs to be collected on GPs:

- patient safety
- clinical effectiveness
- patient experience.

The report also recommended greater use of qualitative methods in assessing quality for GPs relating to the 'therapeutic relationship' between GPs and patients, or examining whether patient care is being co-ordinated effectively across the range of health units.[20] The report suggests that hard-to-measure aspects of general practice should be included in quality frameworks but recognises that a more creative approach may be needed to assess these than is used in hospitals, where success rates, infection rates and re-admittance rates provide operational metrics.

20 The King's Fund, 'Improving the quality of care in general practice', 2011.

It recommends that national, quantitative quality measurement initiatives are supplemented by locally tailored approaches to information gathering such as practice audit, critical appraisal by peers, and the use of qualitative measures of performance.

However the information also needs to be presented in readily accessible ways for people looking to gain an insight into the performance of individual GPs' surgeries and hence to exercise their choice.

Information around secondary care is somewhat better, partly because the NHS Information Centre entered into a joint venture with Dr Foster Intelligence who was better able to present information in a user friendly format. There may be lessons here for how other parts of government work with the private sector to make information available to facilitate choice (notwithstanding the controversy over the commercial terms of the Department of Health's deal with Dr Foster Intelligence).

Nevertheless the NHS white paper consultation on transparency in outcomes commented, with respect to measures of patient care, that "initial options available for developing an overarching indicator are currently constrained by the existing national survey arrangements and the limited availability of standardised national data."

Social care

Publicly-available information on social care is particularly scarce, and it is not covered on NHS Choices.

Care homes within the NHS are regulated by the CQC, which also regulates hospitals. The CQC website has a care directory that allows users to search for various care services, including care homes, but there are no metrics on quality or performance for comparison. Users are able to view previous reports for care homes on the CQC reports page, but the information is qualitative and detailed, making quick comparison difficult.

An independent website 'comparecarehomes.com' allows comparison of care homes along several lines, such as price, availability of Alzheimer's care, policy on pets etc. Where this information is available it has the potential to be useful for members of the public; however, the vast majority of the homes listed do not provide this information so scope for comparison is limited.

Higher Education

As a result of constrained supply and very limited information on which students make choices, many universities rely almost entirely on their reputation. Recent CentreForum efforts to try to establish what students get in terms of teaching face-time from universities by course, size of typical classes and lectures have been met with a very limited response from universities.

Secondly, even information which government holds which might help inform decisions by students is not made available. For instance HESA information on those universities which might be at financial risk is withheld for three years and the Student Loan Company has until now withheld information on future earnings of students by course and university.

Lecturers in many universities set the exams for the courses they have taught, which leads to a loop of self monitoring. The QAA which is responsible for inspection has no easily comparable metrics and no easy interface by which institutions can be compared. The TQI does publish more useful information on the Unistats website, but this only enables comparison of up to three institutions.

Of the independent guides, the Times Higher Education University guide gives research a weighting of 62.5 per cent in its rankings which means it has limited use for potential undergraduate students. The Guardian University Guide has more comprehensive information, but it is still limited.

Given this paucity of information, it is no wonder that universities have taken the view that quality will be judged by price and so have set fee levels at the maximum level.

The higher education white paper recognises these problems and proposes a charter for students setting out what they can expect from universities, as well as making available information on post graduation earnings of students.[21] This is welcome but rather belated. The fact that it is only being proposed after Universities have set their fee levels (in most cases at the maximum level of £9000 per year) reinforces the view that the issue has consistently being given insufficient attention by government.

Current plans are that HEFCE would be responsible for ensuring that such data will be collated and presented by universities but

21 'Students at the heart of the system' Higher Education White Paper, Department of Business Innovation and Skills, June 2011.

it is not yet clear that this will be done in a form which enables an easy comparison to be made on a single website. Experience from the health sector (with the joint venture with Dr Foster) has been that there is benefit from involving the private sector in this work rather than relying on a government agency to do the work. It is recommended that this approach should be considered in the higher education sector as well.

Advisory services

Whatever the quality of the information made available there will be certain decisions where professional advice is required to guide an individual's decisions. This will become more common as budgets become more personalised and where more vulnerable people are making decisions. In the case of health GPs will be the main source of professional advice.

But in other services the role of the professional e.g. the social worker may need to change towards more of an advisory role. In these instances it is particularly important that the advisory role is separate from direct service provision so that there is no possibility of conflicts of interest. This has been a consistent trend over the past two decades as - for example - adult and social care provision has been increasingly provided by the private and voluntary sectors rather than local authorities.

Advisory services aimed at facilitating choice in social care are currently available to some degree but are often under the aegis of local authorities rather than being independently-run. Stockport County Council, for instance provides its FLAG (For Local Advice and Guidance) service to make people aware of the services available to them, from local providers.[22] Leicestershire LA provides a 'care brokerage' service that not only helps people choose their services, but also helps them manage their relationships and involvement with different social care providers.[23] Services like these may need more resources diverted towards them as people are freed to allocate their own personal budgets.

In education advisory services have also been under-used. Although many schools and colleges have structures in place to assist students in choosing degree courses, the availability and level of advice given does not always meet pupils' needs. Around 20 per cent of young people surveyed by the Sutton Trust in 2010 said

22 www.stockportflag.org.uk
23 'Choosing Your Support', Leicestershire County Council.

they were 'unlikely' or 'very unlikely' to go into higher education. Of these young people, one in four stated that a key reason they were unlikely to attend was that they did not know enough about the process.

Seven in ten young people express an interest in knowing more about what they could earn in the future with degrees in the same subject but from different universities. With this in mind, three in five (60 per cent) think that if different universities requested varying tuition fees for the same course, it would be worth paying a higher tuition fee if there was information suggesting that it increased their chances of getting a well-paid job in the future.[24]

BIS said it aimed to "ensure better information for students before they apply" to university in its higher education white paper. Nevertheless the white paper, whilst devoting much attention to how information could be better published, does not mention how pre-university advisory services could be improved. The Russell Group, in its response to the white paper has cited "poor advice on the best choices of A-level subjects and university degree course" as a major problem that the plans fail to address.[25]

Information for providers

It is not just in areas where users and citizens make choices that the lack of robust information inhibits open public services. 'Rehabilitation works' highlighted the problems which relatively poor information on outcomes and the success of interventions have posed for implementing Payment by Results in welfare to work (currently the Work Programme) as well as for future programmes to reduce re-offending.[26] Poor data will inhibit at least, in the short term, the value for money which will be obtained because of the resultant uncertainty premium which service providers will put on their priced bids.

Experience from PFI was that poor information was one of the factors which led to some of the early deals being relatively poor value for money resulting in criticism of PFI. Payment by Results contracts will typically be much shorter (perhaps 5-7 years) than PFI contracts (20-40 years) so the problems caused by poor information will be less acute. In addition when contracts are re-tendered there will be

24 The Sutton Trust, 'Young People Omnibus Survey Wave 16', 2010.
25 The Russell Group, 'Russell group response to higher education white paper', 28 June 2011.
26 C Nicholson, 'Rehabilitation works: ensuring Payment by Results cuts reoffending', February 2011.

much better information on which bids can be made. Nevertheless if government wishes to avoid similar criticism to that of PFI in respect of Payment by Results regimes it would be well advised to seek to improve the quality of information on which providers can base their bids.

Conclusion

Lack of information on service outcomes is a major block to the success of open public services and has been receiving insufficient attention within government. It is recommended that this deficiency be addressed urgently with the advice of experts in consumer choice.

As The Times public policy commentator Camilla Cavendish recently argued that there is great scope for information to facilitate choice:

> The surprising thing is that more citizens don't push for change. We voters tend to be scared of change and to assume that the professionals and those who speak for them are on our side. This is partly because we lack information. That is about to change: a new website, WebMD.com, connects patients with similar conditions, letting them compare their treatment. There is also software to track every aspect of a pupil's progress and check it against others from similar backgrounds. Watch out for a battle as unions try to stop such data being released. In the end, information is power. Business knows that it cannot hide. Public services should not be able to either.[27]

Alongside proposals for opening up public services and introducing choice government should specifically propose a plan to ensure the provision of information/advice to ensure that choice is well informed. There will also need to be further development of the role of some public service professionals as information and advice providers, a role that must be very clearly separate from that of service provision.

If information provision is not improved, user choice will not drive the quality and efficiency improvements expected, an unlevel playing field will inhibit development of new providers and poor value for money will be obtained from those bidding for service contracts.

27 'We must not let vested interests stall reform', The Times, 23 June 2011.

: 4 Regulation

The purpose of regulation

The role of the proposed economic regulator, Monitor, in the NHS reforms has been a matter of controversy. It begs two questions: why is regulation needed in open public services, and what is the appropriate role for the regulator?

Conceptually there are two types of regulation which are relevant to public services to deal with 'market failure'. The first is regulation of service quality to help to compensate for the information asymmetries between user and provider discussed in Section 3. This helps to assure users that the service being provided is safe and in line with good practice. The second type of regulation is often referred to as "economic regulation" and is designed to prevent the adverse consequences of monopoly or quasi-monopoly power in a market, which will typically arise through economies of scale or scope.

In the case of the health and social care sector, the Care and Quality Commission (CQC) is designed to deal with the first type of regulation and Monitor, the second. However, an economic regulator will only be appropriate in certain areas of public services.

Where government is the sole purchaser and there is only one or a small number of providers in an area then the relationship between the purchaser and the provider can be governed by contract. This will be the case for Payment by Results and other public service contracts.

Where there is one or a small number of providers and many 'purchasers', a different form of control is generally required through a licence or regulatory contract.

This has been the experience with utility regulation where regulators have been established to prevent monopolistic or oligopolistic providers exploiting their market power by increasing

prices or reducing service quality for consumers. Utility regulators have also had requirements to ensure service continuity by setting price controls in a way that enables the service provider to finance their licensed services, and to promote competition "where appropriate".[28]

It can be argued therefore that an economic regulator is needed in those areas of public services where individual service users are able to exercise choice, or where there is a large number of individual purchasers (GP Consortia purchasing healthcare or local authorities purchasing social care) but a limited number of providers. Hence in the health service it was proposed that Monitor should be established as the economic regulator with duties to

- license providers
- regulate prices
- promote competition where appropriate, and
- support service continuity (including the monitoring of financial viability of trusts and service providers where they provide monopoly services).[29]

In the case of publicly funded services, there is an additional complexity as the decisions of the regulator may affect public expenditure, and government in general would not wish to let a third party, that is, an independent regulator, determine government spending.

This caused considerable problems in the early post-privatisation years in the rail industry where it was considered that the rail regulator was making decisions which affected the subsidy which government had to pay for the rail industry. There was considerable change in the arrangements as government sought to get the structure right – initially the commissioning body was OPRAF, then SRA then DfT. Finally a mechanism was established: a formal process of consultation between the regulator and the department whereby government set out the scale of subsidy available which the regulator then took into account in its decision-making. Likewise, in the proposed establishment of the regulator Monitor, it is stated that Monitor and the NHS Commissioning Board should work closely together.

28 Ofgem, 'About Us' (www.ofgem.gov.uk).
29 'Equity and excellence: Liberating the NHS' Department of Health White Paper, July 2010.

In other sectors such as higher education and schools, where choice and competition are also seen as important drivers of quality, it seems that a rather different approach is being adopted with the funding agencies, HEFCE and the Education Funding Agency, appearing to have regulatory as well as funding roles. The precise roles are still unclear. However, it appears that the nascent regulatory function of these bodies may be being given insufficient attention and that the framework of economic regulation needs further development.

As noted earlier the proposed role of Monitor as economic regulator of the NHS has come under particular scrutiny as part of the controversy over the NHS reforms. It is unfortunate that this should be the case as a result of largely political failings in presentation. For, in most respects, the elaboration of the roles of Monitor is a model for how regulation should be run in an open public services world and should be a starting point for other sectors.

The major failing with respect to the presentation of the role of Monitor was to ascribe "promoting competition where appropriate" as one of its primary duties. The author recalls, what at the time seemed like esoteric, discussions with civil servants in the early 1990s about whether "promoting competition" should be a primary or secondary duty of a postal services regulator when considering the potential privatisation of Royal Mail. The author argued that it should be a secondary duty as promoting competition was the means to an end, the delivery of a high quality designated service at the lowest economic price. Civil servants argued that promotion of competition was a primary duty for the telecoms regulator and so for consistency it should be the same for post. If principle had won over consistency in discussions about the primary duties of Monitor, Andrew Lansley might have been saved a lot of grief!

How might economic regulation apply to some of the other parts of public services where it might be appropriate and how should service continuity/failure regimes be tackled? Section 5 examines how 'regulation by contract' should apply to areas of public services governed by contracts.

Higher education

In the higher education sector the government has vastly increased the scope for individual universities to increase fees at a time when supply of places is constrained. The constraint on the supply of places (for public expenditure reasons) means that the sector as a whole has monopoly power and individual institutions, partly

as a result of information asymmetries, have considerable market power. Given this it is no surprise that institutions have drastically increased their fees as they have limited competitive pressure to keep fees down.

The government in its higher education white paper has sought to introduce more competitive pressure through allowing institutions to take any student with AAB grades without breaching their quota as well as introducing competition for places with fees at less than £7500 per annum. But there are still doubts as to whether this will lead to sufficient competitive pressure on fees.

In the absence of stronger market mechanisms to put competitive pressure on the institutions concerned to reduce their fees (See 'Universities Challenged' by Tim Leunig for one way in which this might be done)[30] there is a case for considering whether an economic regulator is required to stop universities exploiting their oligopolistic power and to help bring down fee levels. It is recommended that the government investigate whether HEFCE's role should be explicitly extended to include this regulatory function.

Social care

In the social care sector it has been assumed that the presence of a mature competitive market with many providers and many purchasers has meant that an economic regulator is not required. The sole economic aspect of regulation has been the responsibility of the Care Quality Commission (CQC) for monitoring the financial position of providers to ensure that service providers "take all reasonable steps to carry on the regulated activity in such a manner as to ensure the financial viability of the carrying on of that activity".[31]

It is appropriate, given the distress which might be caused to care home residents through financial failure of a care home provider, that providers are required to be financially monitored. It may be the case in the light of the recent difficulties of Southern Cross and before that of Four Seasons that further action is required to ensure continued provision – perhaps through powers to constrain the financial structure of the corporate. It seems logical for this monitoring role in the future to be undertaken by Monitor as the economic regulator rather than the CQC as it is understood that the government is proposing.

30 T Leunig, 'Universities challenged: making the new university system work for students and taxpayers', April 2011.

31 Care Quality Commission (Registration) Regulations 2009.

Service continuity/failure regime

Risk of failure is an integral part of how a market works. It acts as an incentive for managers to provide a high quality service and to reduce costs. However in many public services it is important that service continuity is maintained whilst the fear of failure for individual service providers is not removed. Where there is a single contract from the public sector to the service provider then measures can be written into the contract providing 'step in' rights, either for the public sector itself or for an alternative contractor.

There is well-established practice in Private Finance Initiative (PFI) contracts for an alternative contractor to step in, often triggered by the provider of finance, to avoid them risking some or all of the finance they provided. Another way of dealing with this is the solution adopted by the Work Programme, where there are at least two contractors (as well as other approved contractors) who can step in if a provider fails.

However, where there are many purchasers it becomes more difficult to secure through a contract. Continuity on site may be seen as critical e.g. a school, the A&E dept of a hospital or a care home where it would be harmful for the frail resident to be moved. In such cases ensuring service continuity through a contract is less attainable. In such cases there may need to be greater monitoring and if necessary intervention by a regulator.

The outline in the NHS white paper of the role of Monitor, the economic regulator of the health and social care sector, sets out a process for doing this based on designation of services where the regulator will act to ensure continued provision.

The existence of designated services would require quite sophisticated regulatory accounts so that there is accounting separation between designated services and non-designated services. It would also require cost allocation/transfer pricing guidelines to ensure that there is not cross-subsidy between designated services and non-designated services.

However in the proposed changes to the NHS Bill it has been suggested that the designated services approach may be dropped and that greater discretion will be left with the Secretary of State to decide when intervention is justified to ensure continuity of provision. This may be a more politically realistic and flexible approach, but means that managers have less certainty than is ideal as to whether the service would be 'rescued or not'.

Whilst risk of failure is one of the mechanisms through which a market works in driving efficiency a complementary factor is financial market pressure. For listed companies if the share price drops there will be the risk of takeover with new management being installed or shareholders putting on pressure for management to be replaced.

It is recommended that government should consider whether there are any analogous mechanisms which might be introduced in public service markets. It should be recognised that in some public service areas real choice is limited e.g. schools or hospitals in a small town, and hence it would be appropriate for quality as well as financial performance to be a factor in triggering replacement of management. One possibility might be to introduce a 'right to bid to takeover' by other public service providers when performance of an existing service provider drops below a certain level (both financially and in quality).

For example, Monitor currently has a Red, Amber, Green risk weighting with respect to hospital foundation trusts. Perhaps other providers should have a 'right to bid' if the risk weighting hits Amber. If such an approach were to be adopted quality as well as financial factors should influence the 'right to bid'. Such an approach could be adopted in a range of sectors – schools, hospitals and higher education.

5 Risk transfer in public service contracts

As discussed in section 4, where public services are provided directly to the public sector, the 'regulation' of the service is provided through the contract. One of the consequences of this is that there is a transfer of risk to individual organisations (whether public, private or voluntary sector) which previously was borne, and managed, by the public sector. The contract will embody the allocation of risks between the parties. In analysing these risks and when it represents value for money to transfer these risks to the private sector there is a well established methodology from the Private Finance Initiative which can be applied to public services more generally.

These risks typically include:

- design risk (e.g. designing the policy interventions to reduce re-offending)
- performance risk (e.g. whether a welfare to work programme gets someone back into work)
- demand risk (e.g. the number of unemployed people who the contractor is trying to get into work)
- operating cost risk (e.g. the cost of interventions to stop someone re-offending)
- financing risk (e.g. being able to finance the working capital for a PbR regime)
- termination (failure) risk (e.g. the risk of going out of business as a result of mispricing the contract).

The guiding principle in assessing value for money should always be who is best able to manage the risk and at what cost, rather than simply to assert that certain risks, such as design and performance, should be transferred as is assumed under pure payments by results regimes.

Lessons from the Private Finance Initiative and from early Payment by Results schemes in welfare to work suggest the following:

- In general for public services, delivery and outcome risk ultimately resides with government, as it cannot be indifferent to failure of a public service. For this reason acceptance of a 'black box' approach when letting a contract has risks. A 'black box' approach is where government says it is indifferent to how a service provider provides a particular public service. It is only concerned with the outcome and will pay purely for the achievement of the outcome.
- It is rarely enough to say that if the service is not provided, the government will not pay. Experience from IT PFI and other IT contracting has been that government should assess design and delivery plans of the system when deciding whether to award a contract. Ultimately, if there is failure, government has to take responsibility and may bear a substantial cost. Examples include the BA/POCL contract as well the Courts Service IT contract.

  The government is in general adopting a 'black box' approach to awarding contracts in Payment by Results regimes. There are plentiful examples from IT contracts – in particular, where system design is by its nature bespoke – of contractors over-promising in terms of outcome and cost and failing to deliver. The DWP has to some degree mitigated this risk for the Work Programme by ensuring that all contract areas have more than one contractor.
- Analysis of the experience of the health sector is that the more complex the service offered the more wary the purchaser should be of competition by price rather than quality. Hence as services subject to Payment by Results become more complex the more wary government should be of simply accepting the lowest cost bidder.[32]
- The public sector is often in the best position to manage the demand risk for a service. Seeking to pass this to the contractor may not represent good value for money. It is important to distinguish between demand risk which arises purely from choice and/or the good/bad performance of the contractor and total demand risk. The former is clearly

32 Dash and Meredith, 'When and how provider competition can improve health care delivery', McKinsey Quarterly, 2010.

something which should lie with the contractor, the latter generally not.

- Particularly in the early stages of a Payment by Results programme the uncertainties and risks will be such that contractors may place a high risk premium leading to relatively poor value for money. It was argued in 'Rehabilitation works: ensuring Payment by Results cuts re-offending' that when there is uncertainty about the nature and characteristics of those entering the programme, the success and costs of particular interventions as well as the external environment, (e.g. in the case of welfare to work the condition of the labour market) a pure Payment by Results regime is likely to be prohibitively expensive. Discussions with some of those bidding for the Work Programme support this view.

  The external finance which was available from private equity was seeking a 20-30 per cent Internal Rate of Return (IRR). The decision by DWP during the procurement process to introduce an 'attachment fee' (an upfront payment for each individual it was contracted to help find work) to mitigate the risk was sensible.[33] In general it is not good value for money in the early phases of programmes to adopt a 'pure' Payment by Results approach.

It is recommended that government use a more rigorous analytical methodology in assessing the risks to be transferred in service contracts than has been used hitherto. In particular whilst the application of Payment by Results across a range of public services is a promising initiative there is a danger that enthusiasm (and public expenditure constraints) overcomes a sense of commercial realism. There are real concerns about how far Payment by Results can sensibly be applied to early intervention programmes as set out in the Graham Allen Review (except where intermediate outcomes are used as payment metrics).[34] The longer the period before success can be measured the less applicable are Payment by Results models.

33 C Nicholson, 'Rehabilitation works: ensuring Payment by Results cuts re-offending', February 2011.

34 G Allen, 'Early intervention: smart investment, massive savings' Cabinet Office, 4 July, 2011.

: 6 Financing

A consequence of the move towards open public services is that more of the burden of financing public services will be passed from the public sector to the private and voluntary sectors. The term financing does not mean the funding of public services which will continue to be predominantly provided by the public sector. Where there is a difference in timing between expenditure and revenue, either because of working capital requirements as a result of a Payment by Results regime or because of capital expenditure, there will be a financing requirement which will need to be borne by a private or voluntary sector provider.

One of the concerns about the combination of a move to Payment by Results and greater involvement by mutuals and the voluntary sector is that they would have a particular financing constraint. The kind of risks being transferred under Payment by Results are 'equity' risks which mutuals and the voluntary sector may be less able to absorb except through reserves due to their inability to access external equity finance.

This section focuses on whether there is a financing problem for mutuals and the voluntary sector. Section 7 looks at how financing and other issues will affect competitive neutrality between public, private and voluntary sector providers.

Size of financing requirement

It is as yet unclear to which areas of public services Payment by Results will apply. However, set out below are some of the areas where Payment by Results may apply and the estimated total annual expenditure on each of those service areas over the next five years.

Areas for expansion of Payment by Results

Reducing re-offending in prisons	£60m per annum
Reducing re-offending through probation services	£785m per annum
Welfare to work programmes	£2-3000m per annum
Drug and alcohol rehabilitation	£797m per annum

The working capital requirement will depend on how outcomes are defined. In welfare to work, for example, providers might start to be paid once they have got someone into work, whereas in reducing re-offending they will only be paid if someone has not re-offended for two years. Hence the period that they will have to wait before revenue accrues could vary considerably. The precise form of the payment mechanism will also substantially affect the working capital requirements. It is estimated that the total working capital requirement for the work programme would amount to around £200m across a programme with annual spend of £2 billion.

One successful Work Programme contractor interviewed said that the decision to introduce an 'attachment fee' during procurement halved the working capital requirement and meant that it could be funded through normal corporate credit. If that had not been the case the contractor would have needed to attract external equity finance which would have required a 20-30 per cent IRR.

For the contractor the problem was not access to finance –there was apparently a number of potential providers – but rather the cost which the contractor would have had to have passed on to the client. This would inevitably have led to a bias towards larger contractors with greater capacity to finance the programme from their corporate balance sheets.

Similarly it is too early to say what the financing requirement will be for those services which are subject to mutualisation as this will depend on the extent to which public sector workers take advantage of the 'right to provide' but also whether there are substantive changes to how, for example, foundation hospitals are financed in the future. Whilst foundation hospitals have in theory the 'right to borrow' they are severely constrained meaning that none has, to any significant degree. At least initially social enterprises exercising

the 'right to provide' will be able to lease assets from the public sector and so will have very limited financing needs.

The mechanism for providing access to capital will significantly affect the extent to which there is a level playing field for competition in parts of the health economy, such as secondary health care. At one extreme if there is severe rationing of public sector finance, public sector providers might be at a competitive disadvantage compared to the private and voluntary sectors. On the other hand, the cost of new hospital buildings would make the private sector uncompetitive with a public sector hospital whose finance is provided by the public sector.

How capital is charged for in provision of public services between public, private and voluntary sectors may have a significant influence on the ability to compete. This is discussed further in Section 7.

Availability of finance

New Philanthropy Capital in research for NESTA "Understanding the demand for and supply of social finance" identified a number of gaps in finance which they considered that the Big Society Bank should seek to fill.[35] They concluded that "the absolute amounts needed from a funder like the Big Society Bank total hundreds of millions rather than billions of pounds" and that "the majority of demand for capital is for soft capital – patient, semi-commercial capital and grants. Indeed much of the finance covered in this research was that needed for smaller scale social enterprise initiatives rather than for enterprises involved in services which are currently provided by the public sector.

There has been considerable innovation in the social investment market over the past decade with finance providers such as Triodos Bank, Bridge Ventures, Big Issue Invest and Social Investment Business playing a significant role and the proposed Big Society Bank will further increase capacity.

Interviews were carried out with government departments, private and voluntary sector service providers, lenders and equity providers and various social finance intermediaries. Based on these discussions it is not considered that there is a shortage of available finance for sound investment propositions in the provision of public services. The proviso of sound investment propositions is important.

35 New Philanthropy Capital, 'Understanding the demand for and supply of social finance', NESTA, April 2011.

If there is insufficient information available on which to assess the potential risks and rewards from the investment then commercial finance capital will not be available. Only 'philanthropic venture capital' will therefore be available for some of the most innovative initiatives in the field of social capital such as the Peterborough Prison Social Impact Bond.

As discussed earlier, a concern is whether the need for equity or quasi-equity finance to deal with the equity type risks being transferred under pure Payment by Results regimes would impose constraints on the ability of mutuals and the third sector to compete with the private sector.

However, the social investment market has developed products which provide quasi-equity finance for third sector organisations. For example Bridges Ventures provided Hackney community Transport (HCT) with a £3m 'social loan' where the return to Bridges Ventures was determined by a percentage of the increase in HCT's turnover arising from the investment.[36]

Several of the funds designed to provide equity or quasi-equity finance reported that there is a shortage of good investment propositions in which to invest. Evidence of this is Triodos' exit from its social enterprise fund because it was unable to generate sufficient deal flow on acceptable terms for its investors.

There are worries amongst finance providers that government intervention may be impeding the development of a sustainable finance market serving the public service mutual sector. Firstly the availability of grants risks crowding out equity and quasi-equity finance. Secondly, the relatively favourable terms – e.g. on payment, on which mutuals and employee owned enterprises are being allowed to take over initial public services – has meant that there has been very limited demand for external finance.

There is a risk that in trying to foster the development of mutuals and social enterprises government frustrates the development of the underpinning commercial financing infrastructure which will be important for its long term sustainability. As a result when mutuals have to start bidding to retain their public service contracts or wish to finance new capital investment which the public sector will not authorise, there may not be the fully developed financial infrastructure to service them.

36 Bridges Venture news release, '£3m investment in HCT heralds new approach to financing social enterprise', 22 February 2010.

Whilst it would be wrong to be complacent about the ability of the financial markets to provide finance for sound investments the range of innovative products being developed is impressive. With the additional capacity of the Big Society Bank to promote and foster such developments, and to act as a cornerstone investor in funds where appropriate, the judgement is that there is not currently a gap in the financing market which requires further government action.

Government's role

Nevertheless government has a significant role to play in ensuring that access to finance and assets does not inhibit diversity of providers in public services. In relation to existing assets this can be as simple as ensuring that social enterprises exercising the 'right to provide' are able to lease assets from government which enable them to carry out their activities and that subsequently this also applies to other bidders seeking to provide the service (with appropriate asset locks in place).

The real challenge arises when new investment is required. But with the use of PFI in the provision of assets, there are already many examples of splits between Operating Companies (OpCos) and Property Companies (PropCos). In some cases new PFI projects have been instituted after the award of operating contracts to the private sector (e.g. the National Physical Laboratory where the management contractor Serco, was involved in working with the Department of Trade and Industry to specify the requirements for new laboratories which were subject to a separate PFI).

It is already apparent that the private sector is gearing up to take advantage of these new opportunities. For example, the former Chief Executive of Building Schools for The Future, Tim Byles, has announced his intention to establish a new company, Cornerstone, to invest in the new social infrastructure required for healthcare, education and residential social care. Circle Health financed the construction of their (private) hospital in Reading through Ropemaker Properties, the Real Estate Investment arm of BP's Pension Fund.

There is clearly much detail which will need to be worked out over time to facilitate these developments, (e.g. the extent of guarantee for the future capital element of funding which government is prepared to make) but conceptually there is no reason to believe that this could not be achieved.

: 7 The consequences of open public services for ownership

Many of the objections to the opening up of public services are that this is in effect privatisation. In much popular discourse about 'privatisation' there is often confusion (sometimes deliberate) between private delivery of a service and private funding of a service. So, for example, in the NHS there is no disagreement between parties that the NHS should continue to be largely free at the point of use (prescription charges in England means that one cannot argue that the NHS is completely free at the point of use) i.e. the funding of NHS is from the taxpayer. However this does not mean that provision of health services has to be by the public sector. Indeed GPs, who are the bedrock of the NHS, are private contractors; they are not NHS employees.

None of the three main parties is advocating that there should be any change in most public services being free at the point of use and with equal access for users (prior to the general election the Liberal Democrats had advocated that university access should be free at the point of use but this was not the policy of either of the other parties). Neither was there any substantive difference between any of the parties in their attitude to diversity of provision within public services in education, health, welfare to work etc (although once again the outlier was the Liberal Democrats, who were opposed to the academies programme).

Yet past experience suggests that if diversity of provision and competition is introduced into public services there is likely to be a long term (20-30 years) tendency towards private (or third sector) sector provision. There are numerous examples of this in the past including the effects of Compulsory Competitive Tendering (CCT) in local authorities, deregulation of bus and postal services, or competing research in central government. Unless there are definite measures taken to prevent it (or to remedy any disadvantages faced by public sector providers) this is likely to be the result.

Experience has been that public sector providers face a number of constraints in competing with the private sector:

- Capital rationing. This is likely to be a particular problem over the next few years due to public expenditure constraints. As a result the private (and voluntary) sector have greater freedom to invest
- Constraints on public sector workers terms and conditions. This renders the public sector less able to vary terms and conditions (up or down) and to manage the business
- A different approach to risk management based on skills but also incentives for management. As a result public sector managers are less able to manage the service than their private or third sector counterparts.

In principle the form of ownership should be immaterial to 'open public services' particularly if there is competitive neutrality. However in practice the government has expressed preferences about ownership.

In schools there is an explicit prohibition on 'for profit' providers which *de facto* has the effect of making all providers subject to at least a degree of capital rationing. In the case of NHS foundation trusts there is currently a strong bias towards 'social enterprises' in terms of their constitution and the asset locks that are in place.

Government is also currently encouraging employees to take over public services through a 'right to provide' where it is permitted to do so by EU Procurement and Competition Law. Initially many of these employee owned enterprises are being allowed to take over these services without competition, though they will then have to compete for the service after an initial period of 3-5 years. So to date government is not adhering to competitive neutrality in the provision of public services.

It is right that such bias should be time limited (generally three to five years). If, as some argue,[37] there are real economic benefits from mutuals and co-operatives then ultimately they should be required to show this through competing in the open public services market.

The precise form of private ownership of an enterprise can also have a significant impact on its future. The experience of deregulation in

37 For example see Matrix Evidence, 'The employee ownership effect: a review of the evidence', 2010; and D Kruse, 'Research evidence on prevalence and effects of employee ownership', NCEO, 2002.

bus services and CCT in local authority services is instructive. In the case of municipal bus services many were privatised to free them from public sector constraints to enable them to compete. A large number were privatised in the form of Management Buy Outs (MBOs) or Management and Employee Buy Outs (MEBOs). Twenty or more years later hardly any still exist in that form (see box overleaf).

There are good reasons why there has been this pattern of change in ownership in the bus industry. Typically MBOs and MEBOs are at least partially financed by private equity providers as well as management and employees. In such cases private equity will want an 'exit' after typically 3-5 years. If the exit is through a trade sale the trade buyer will usually wish to buy 100 per cent of the company. Hence the management/employee stake will be bought out. Even if this is not the case management and employees will very often be keen to realise the value of their investment.

A distinction should be drawn between those enterprises which are primarily people businesses, such as social work partnerships and community health workers, and those where substantial capital investment and assets are required. In the former case, employee ownership may well prove to be a long term sustainable ownership model.

However once enterprises requiring substantial investment (or those where aggressive Payment by Results approaches are used requiring substantial working capital) are subject to real competition maximising the prospects of employee ownership as a long term model may be more complex. Unless the entities are constituted as partnerships or co-operatives then we think there will be an inevitable tendency towards concentration and we suspect private ownership.

For entities where significant transfer of assets from the public sector has taken place, e.g. hospitals or schools, then there will need to be asset locks in place to ensure that they are not simply sold on to the benefit of the initial recipient

A number of approaches (see Section 6 on financing) can be adopted to deal with the capital investment needs of mutuals/ employee owned enterprises. A particular approach which has been promoted by government is to form joint ventures between employee enterprises and private companies. Francis Maude, the cabinet office minister, in a recent speech said that the government would seek to promote joint ventures in the future rather than a

Ownership change in the bus industry

Of the 60 principal bus and coach related subsidiaries of the National Bus Company:

- 35 were sold to management teams
- 2 were sold to management and employees – Luton & District, Provincial
- 22 were sold to trade buyers
- 1 was transferred to London Transport – Victoria Coach Station

Of those sold to management teams, just three remain in control of the same teams today, some 20+ years later. The rest have been sold on, as have the two MEBOs. Some of the trade buyers were the early management teams, who bought businesses that were sold later in the process. A few of the management teams e.g. First Group and Go Ahead, later grew into big groups and converted to PLC status.

The eight metropolitan county (PTE) businesses went as follows:

- 3 to management – West Yorkshire, Manchester North, Manchester South
- 3 to employees – South Yorkshire, Merseyside, Glasgow
- 2 to ESOPs – Tyne & Wear, West Midlands

All of these are now owned by large groups.

The ten large London Buses subsidiaries went as follows:

- 6 trade sales
- 3 to management
- 1 MEBO

Again all have passed on from management hands.

Source: Analysis by Ian Barlex, Chadwell Associates

more traditional outsourcing.[38] Such an approach could also help to inject commercial management expertise

However the experience of joint ventures in the private sector is that they are a transitional form of ownership structure. The median life of a joint venture is three years, and they are frequently part of a staged acquisition/sale. Studies have found that when entering a joint venture it is vital to be clear about what the 'exit strategy' will be: "to ensure that joint ventures will be successful the most careful planning should focus on how to end them".[39] In general the experience of joint ventures of this type is likely to be similar to that of MBOs and MEBOs in the bus industry, unless they are explicitly structured at the outset in a way to avoid this.

The joint venture between the NHS Information Centre and Dr Foster Intelligence bears this out. The venture was originally formed in 2005 as a 50:50 joint venture, but government recently announced that it would look to sell its stake, at least in part, because of the investment required for the joint venture to respond to the new challenges of the health market which the government could not afford.

The first joint venture of this type which has been announced is My Civil Service Pension (MyCSP). The government has advertised for a joint venture partner for this entity where there will be a substantial employee owned stake. It is understood that the precise structuring of this deal is yet to be determined.

There are two concerns with this approach. The first is that it is unclear why the government is seeking to impose this form of ownership on this entity when there are not such strong arguments for employee involvement as there are in the case of front line staff such as social work partnerships or community health workers. Secondly pension administration is an area where the private sector has already proven itself to be adept at managing schemes cost effectively as shown by the teachers' pensions scheme administered by Capita.

In this instance government is departing from its avowed policy of competitive neutrality for no good reason. A joint venture is likely to be a staging post to full private sector ownership rather than a permanent arrangement.

A potentially more useful model is that of Circle Healthcare which combines employee ownership with private investors. It is a

38 F Maude, Speech to Supplier Summit, 1 December 2010.
39 Deloitte, 'A study of joint ventures: the challenging world of alliances', July 2010.

company which is 49.9 percent owned by healthcare staff and 50.1 percent owned by private investors (initially predominantly private equity and now listed on AIM). The corporate structure of Circle has been carefully designed to maximise employee involvement and control whilst attracting private investment. The fact that the employee shareholding - which in effect acts like a partnership and votes as a bloc - and the private investors are in separate corporate entities means that there is less chance of the wishes of private investors outweighing those of management/employees in the manner of the bus companies.

Whether this turns out to be the case in the long term is more open to question. Circle Healthcare is still relatively early in its existence and if it expands rapidly with associated substantial capital investment requirements the current corporate structure may come under greater pressure.

The Circle Partnership[40]

The Circle Partnership is an organisation of consultants and healthcare professionals which describes itself as a "John Lewis-style" partnership "co-founded, co-run and co-owned" by its staff.

The group operates a collective ownership structure where every employee "from the consultant to the cleaner" becomes a shareholder in Circle Partnership, with shares allocated according to seniority and performance.

The group already runs a new-built hospital in Bath, offering a wide range of treatments, and is in the process of building a second hospital in Reading. Circle also runs treatment centres on behalf of the NHS in Burton-on-Trent and Nottingham, where the group claims to have raised productivity by 22 per cent.[41]

Recently Circle has bid for contracted management of full NHS units. It has won 'preferred bidder' status in a ten-year contract with NHS Hinchingbrooke hospital where Circle could become the first private provider in the UK to run maternity and A&E services. The group is looking to bid for further contracts in Manchester and Liverpool.

40 The Circle Partnership, 'Circle Story' (www.circlepartnership.co.uk).
41 'Social enterprise's plans for NHS hospital', BBC News Health, 26 May 2011.

Employees at Circle-run NHS facilities remain NHS staff classed as 'seconded' to Circle, and ownership of NHS facilities remains with the state. Currently all employees, including seconded NHS staff, are allocated proprietary shares where possible. The Partnership has handed out 40 million shares to date and, under current plans, will continue to hand out shares up to 100 million. If an employee leaves Circle Partnership they retain their shares in Circle. Circle is considering establishing an internal market as one of a number of options to enable Partners to realise the tangible benefits of direct ownership.

Unlike the John Lewis Partnership, Circle did not have an initial capital endowment and has had to raise funds from outside investors. This has been arranged through an equity-sharing agreement whereby the Partnership owns just under half of Circle Health PLC, the operating company, and just over half is owned by private investors via an investment company, Circle Holdings. The group recently raised additional capital through a flotation on the Alternative Investment Market, though the Partnership's overall equity stake in Circle Health PLC remains constant. Members of The Circle Partnership vote on key issues, the Partnership then takes its judgements forwards and votes as a bloc on the board of Circle Health PLC.

The triad of organisations is arranged so that, at present, any takeover bid launched for Circle Health PLC would only be feasible for the half that is owned by the investment company, Circle Holdings. The management of Circle Partnership is committed to retaining employee control and, as it also maintains strategic shares in Circle Holdings, any hostile takeover would have to persuade Partnership management to sell before it could gain a controlling share.

Circle works closely with a sister company, Health Properties Ltd, who own and have financed a number of Circle's properties under a lease back arrangement. Due to the ongoing weakness of the property development sector Health Properties now works in conjunction with an in-house property team who looks to source capital for fixed assets either through re-investing profits or, as with the latest property in Reading, through *ad hoc* arrangements. Circle secured £50m of funding from Ropemaker Properties, the real estate investment arm of BP's Pension Fund, for the Circle Reading facility.

Conclusions

Past evidence suggests that once a public service is open to competition there are forces which over time will lead to increasing conventional corporate ownership, even if initially there has been substantial employee ownership. Government has been inconsistent as to whether it is genuinely 'sector blind' when it comes to the role to be played by the public, private, mutuals and voluntary sectors.

Government has a wish to promote mutuals and employee involvement and clearly the 'right to provide' has helped to facilitate this with initial contracts being awarded non-competitively to mutuals. This stance is sensible as where professional and front line workers are involved there are particularly strong reasons for maximising employee involvement in the same way as accountants, lawyers, architects and GPs are frequently organised as partnerships. However they should only be 'sheltered' from competition for a limited period

It is unclear why government should seek to impose joint ventures between employee ownership and corporates in sectors where the private sector already has a strong track record as in MyCSP or as has been suggested in prisons. In such cases, and without robust identification of the exit strategy this is likely to be a staging post to full private ownership.

Government should be clearer than it has been hitherto as to the criteria by which it judges when positive initial bias should be given to employee ownership and mutuals and when it should be more ownership blind.

: 8 Conclusions and recommendations

The government has embarked on a strategy of opening up public services to choice and competition. If properly implemented it offers the opportunity to make public services more user responsive, dynamic and flexible. In seeking to achieve this goal government should adopt an evolutionary, rather than a revolutionary approach, recognising that a perfect system cannot be designed from the outset.

There will be a continuing role for active government, either directly through commissioning or through independent sector regulators, in shaping public service markets. Given government's continuing role in funding or co-funding many public services it cannot take a laissez-faire approach.

If choice and competition is to be made real, government needs to ensure that there is the information available on which public service users can base their choices and new providers can base their bids. Hitherto government has given insufficient attention to the needs of public service users for relevant information and advice on which to base their choices. If it does not remedy this failure urgently, the success of the public service reforms could be jeopardised. In developing an information and advisory infrastructure to facilitate choice it would be well advised to work closely with private sector experts in consumer choice.

Economic regulation will be important in areas where individuals exercise personal choice, such as health and social care and higher education. Regulation helps to ensure that competition, where appropriate, is encouraged if it helps to secure high quality services at an affordable cost. Regulators also have an important to role to play in ensuring service continuity. Government should examine how far it can introduce a 'right to bid to takeover' services which, whilst not failing, are providing a mediocre service.

Where government commissions services directly (rather than users exercising choice) a more rigorous approach should be adopted towards deciding which risks should be transferred to the private

sector. In particular there is a concern that government is seeking to transfer too much risk, at least in the early phases, in nascent Payment by Results programmes. It is recommended that in most cases a staged approach is used. In particular government should be very careful when seeking to introduce Payment by Results to programmes such as early intervention for children where the benefits may only accrue many years later.

It is not considered that availability of finance is currently, or in the immediate future, a significant constraint on new providers and employee and mutual spin outs from the public sector where there are sound investor ready propositions. There is an impressive array of new financial products being developed and government has already been active in sponsoring new financial institutions such as the Big Society Bank. Where there has been difficulty in attracting finance it is usually a result of the lack of a sound investment proposition or one where the payment terms proposed by the public sector render the finance available poor value for money.

The government sometimes claims that it is ownership blind in its approach, but it is clear that this is not the case. Government should be clearer in setting out the basis and the criteria on which it favours one type of provider over another in particular areas.

It is understandable that government wishes to favour the development of employee owned enterprises in provision of some front line services so giving professionals greater freedom to innovate but such 'favouritism' should be time limited. In other areas the government's stance is confused and lacks logic. For example, it is unclear why government is forcing 'joint ventures' in certain areas of public services such as MyCSP. The very strong likelihood is that ventures such as this will end up being entirely privately owned.

Whilst in certain service areas employee owned enterprises and mutuals may be beneficial, government must be careful that this does not lead to a bias against large corporates. There are good reasons (access to capital, scope for investment in service development and training, quality processes and control, economies of scale and brand) why in many cases large corporates will be the most appropriate providers.

Introducing greater choice and competition has the potential to ensure high quality public services for the 21st century. However if this programme is to succeed, the government needs to give greater priority to the issues outlined in this report:

- Much better information and advice to enable user choice and drive up standards
- Strong and clear regulatory frameworks to ensure high quality services at an affordable cost and to promote choice and competition where appropriate
- Consideration of a ‘right to bid to takeover’ to help deal with problems of mediocre performance.
- A more rigorous approach to deciding which risks to transfer to the private sector when commissioning public services. Currently in some services there is a danger that the government is seeking to transfer too much risk, particularly in the case of some services being considered for Payment by Results contracts.
- A more logical approach to types of ownership in public services and one which is less guided by politics and ‘fad and fashion’.