

**BERR** | Department for Business  
Enterprise & Regulatory Reform

**PUBLIC SERVICES INDUSTRY REVIEW**

Understanding the Public Services Industry:  
How big, how good, where next?  
A review by Dr. DeAnne Julius CBE

JULY 2008



# Public Services Industry Review

Understanding the Public Services Industry:  
How big, how good, where next?

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Dr DeAnne Julius CBE

10th July 2008



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## Foreword by SoS John Hutton



The Government is committed to the delivery of world class public services for all, and over the past decade has made substantial investments in order to realise this vision. Although many public services are rightly provided exclusively by the public sector, increasingly both central and local government, including devolved administrations, are engaging and working in partnership with private and third sector providers to find ways of ensuring our goals of excellent, fair and cost effective public services are achieved.

The aim of the Department for Business Enterprise & Regulatory Reform is to work to ensure business success in an increasingly competitive world. Given the emergence of a significant Public Service Industry, it is important that we examine how we can support the success and development of this industry both here in the UK and in overseas markets.

Recognising this, I was pleased to announce the launch of this Review last December and I am very grateful to Dr. DeAnne Julius for agreeing to lead this work. Ensuring that we have a thorough understanding of how we engage with the private and third sectors is critical to getting the best results for both those working in the industry and for consumers and taxpayers.

Dr Julius's review has highlighted the fact that the Public Services Industry is not only a dynamic sector which makes a significant contribution to the UK economy, but is also a world leader in many areas. It has looked at what has made the industry successful and made recommendations as to what more the government can do, as a policy maker, regulator and procurer to ensure that its full potential can be realised for the benefit of the public.

I very much welcome Dr. Julius's analysis. I will be working with colleagues across government over the next few months to consider the recommendations she has made and explore how they can be translated into a tangible programme of action in order to ensure that the benefits from engaging with and supporting this important industry are fully achieved.

A handwritten signature in black ink that reads "John Hutton". The signature is fluid and cursive, with the first name "John" being larger and more prominent than the last name "Hutton".

**Rt. Hon. John Hutton MP**

Secretary of State for Business Enterprise & Regulatory Reform

## Foreword by Dr. DeAnne Julius



**The Right Honourable John Hutton,**  
Secretary of State,  
Department for Business,  
Enterprise & Regulatory Reform

I am pleased to deliver my report on the Review of the Public Services Industry which you asked me to lead. With the support of an Advisory Panel and an in-house secretariat I was asked to examine the size and contribution of the Public Services Industry (PSI) in the UK, the lessons we have learned about private and third sector delivery of public services, and how Government can help the PSI to be more successful both at home and abroad.

It has been a voyage of discovery to define and measure this “new” industry, hidden in a statistical sense within old categories and budget codes. We have found a large and diverse collection of big and small, private and third sector enterprises which together produce nearly 6 per cent of GDP and whose 1.2 million staff are proud to be engaged in delivering high quality services to the public and best value for money to the taxpayer.

Britain’s Public Services Industry is second in size only to that of the US and is a world leader in many respects. This is thanks largely to innovative public policy over many years that has allowed the PSI to extend from basic services such as refuse collection to complex and bespoke service packages such as welfare to work. These more complex services require high quality commissioning skills and new partnership approaches. This Review concludes with 8 recommendations to help government tap the full potential of the PSI in its drive to provide world class public services for all.

I am grateful to the many organisations and individuals who contributed their ideas to this Review through the call for evidence, roundtable discussions and interviews. Commissioned work from Oxford Economics and Professor Paul Grout of the University of Bristol were of great help in unearthing the data and critiquing the evidence base on the PSI. A huge thanks is due to the project team in BERR, expertly led by Carol Murray and including Jeff Barretto, Keith Brook, Nick Forrest, Dan Mawson, Lee Newman and Claire Swadkin. My discussions with the Advisory Panel, whose members from the private and third sectors, unions, government departments and academia are listed in Annex A, were instrumental in assessing current issues for the PSI and developing recommendations to address the most widespread concerns. Those recommendations, and any remaining errors of omission or commission, remain my responsibility.

I very much hope that the baseline analysis and recommendations developed in this Review will help government and the PSI embark on a new stage of growth and closer partnership to deliver their common objective of world class public services.

Yours sincerely

DeAnne Julius

## Executive Summary

As in other advanced countries, the demand for public services in the UK is growing faster than the economy as a whole. Especially for health and education, this trend is set to continue as the population ages and the UK invests in the skills and infrastructure it needs to compete in the global economy. There will also be new challenges in providing modern services that are more personalised and meet the needs of diverse and demanding users. With government budgetary constraints likely to remain tight, it will be critical to find practical ways to deliver higher quality public services that provide the best value for money for taxpayers.

Historically most public services were provided directly by government employees. More recently, in the UK and elsewhere, the private and third sectors have been increasingly commissioned to help with public service delivery. They are now involved in a wide range of services at both local and central government levels. This has led to the emergence of the Public Services Industry.

In view of these developments, in December 2007, the Secretary of State for Business Enterprise and Regulatory Reform, John Hutton announced a Review of the Public Services Industry to be led by Dr. DeAnne Julius.

This Review defines the Public Services Industry (PSI) to include:

*'All private and third sector enterprises that provide services to the public on behalf of Government or to the Government itself'.*

This Review has examined the PSI in the UK in order to:

- define and measure the PSI, its contribution to GDP and employment and consider how this has changed over recent years;
- review the lessons learned about private and third sector delivery of public services in the UK; and
- assess how government can help the PSI to be more successful in delivering high quality public services both at home and abroad.

Overall the Review has found that the PSI has made a major contribution to the provision of better value for money public services in the UK. It has also grown to become a significant part of the economy, accounting for nearly 6 per cent of GDP and directly employing over 1.2 million people. Despite this record of success, the Review has revealed some worrying trends. The growth rate of the PSI has been slowing and the costs of bidding are rising with an increasingly complex commissioning process.

By its very nature the future of the PSI is largely in the hands of government. Unlike other industries, its growth is not self-sustaining simply by being successful. At the same time, the PSI can do more than any other industry to help government achieve its core objectives. Despite its size and importance, however, the PSI has received little focussed attention and its relatively few failures are better reported than its many achievements.

The key findings and recommendations from the Review are set out below:

## How big is the PSI in the UK and how is this changing?

- The PSI in the UK is the most developed in the world and is second in size only to that of the US. In 2007/8 its revenues totalled £79bn, generating £45bn in value added and employing over 1.2 million people.
- In terms of value added the PSI is significantly larger than 'Food, beverages and tobacco' (£23bn in 2006), 'Communication' (£28bn), 'Electricity, gas and water supply' (£32bn) and 'Hotels and restaurants' (£36bn).
- Health constitutes the largest sector of PSI spending totalling £24.2bn in 2007/8, followed by social protection (£17.9bn), defence (£10.1bn) and education (£7.3bn).
- The PSI has grown by almost 130 per cent over the last twelve years but in recent years its rate of growth has slowed. Growth was 6.8 per cent per year in real terms for the period 1995/96 through 2003/04 and has since levelled off to 2.9 per cent per year.
- The fastest growing sectors in the PSI over the last 12 years have been education (8.1 per cent per year), environmental protection (7.9 per cent) and health (7.0 per cent). The slowest growing areas were general public services (-0.3 per cent), economic affairs (2.3 per cent) and defence (3.6 per cent).
- Projections indicate that there is potential for significant further growth but without positive action by government, PSI growth may decline further.

## Why use the Private and Third Sectors to deliver Public Services?

- The evidence shows that there are clear benefits, to both users and taxpayers, in subjecting incumbent service providers to competition. The academic literature typically found the cost savings from competitive tendering to be between 10 per cent and 30 per cent (including when the in-house team won the bid) with no adverse effect, and sometimes an improvement, in service quality.
- Different firms and organisations have different strengths (and weaknesses) in delivering different types of services. This points to the benefits of a 'mixed economy' model of provision where public, private and third sectors compete to provide the best service in a given area.

## What has helped and hindered the development of the PSI in the UK?

The Review identified four key policies that have helped the PSI in the UK to develop:

1. The pursuit of **contestability** as a policy goal – initially through compulsory competitive tendering but more recently through broader procurement guidance. This allowed organisations to benefit from economies of scale and provided the incentive for the PSI to build operational capacity.
2. The move from strictly lower cost to broader '**value for money**' criteria requiring costs and benefits to be assessed over the long term.
3. Employment policies, such as **TUPE**, which have facilitated the transfer of workers from the public to the private sector while protecting their employment conditions.

4. The use of the **PFI model** to augment public sector investment funding. This has been extended from asset provision to incorporate a growing services component and newer forms of public/private partnerships (PPPs) have developed from it.

In addition to these helpful policies the Review identified six problem areas. These are inhibiting the development of the PSI and preventing its full value in delivering public services from being realised. For each of these a recommendation for addressing the problem has been made.

### **Recommendation 1: Long term commitment**

Government authorities need to reinforce and demonstrate their long-term commitment to open up public service markets and maintain effective competition.

- Departments and local authorities should develop pipelines of tendering opportunities with indicative timescales, updated annually at budget time.
- Information on these tendering opportunities should be made available to all enterprises<sup>1</sup>.

### **Recommendation 2: Clear and consistent objectives**

Commissioning objectives should be clear, consistent and balanced so that value for money (the optimal combination of quality and whole life costs) is maximised.

- Contracts should focus on outcomes or outputs where these can be measured either directly or through user surveys.
- Contracts should be less prescriptive to leave room for innovation, and payment incentives should be symmetrical so that quality improvement is rewarded as well as under-performance penalised.
- Multiple objectives for wider social and environmental goals should be used sparingly and applied consistently through the bidding process, so that requirements are clear and assessment is more transparent.

### **Recommendation 3: Competitive Neutrality**

Commissioning processes and bid evaluation should strive for a level playing field ('competitive neutrality') between public, private and third sector bidders.

- HMT should continue to provide guidance to commissioners on how to consider the following factors when evaluating bids<sup>2</sup>:
  - Tax treatment – including income tax, VAT and investment tax reliefs; and
  - Pension obligations and costs.

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1 The Glover Review to be published Autumn 2008 will contribute to this objective by specifically identifying the appropriate channels through which businesses can gain information on possible PSI projects.

2 Guidance on VAT and pensions is already available in HMTs *Improving financial relationships with the third sector: Guidance to funders and purchasers* May 2006.

- Commissioners should ensure that this guidance is followed and also that:
  - pre-qualification and bid criteria do not unnecessarily restrict SMEs or third sector enterprises;
  - information on current service levels and costs is provided to all potential bidders to avoid favouring incumbents; and
  - the costs of transition from incumbent to a new provider are clearly considered when comparing bids.

#### **Recommendation 4: Partnerships**

Partnership approaches between contractor and provider should be encouraged, especially in the post-contract monitoring stage when both parties have the common objective of delivering better public services.

#### **Recommendation 5: Commissioning Skills**

A Director of Service Delivery should be appointed for all departments and local authorities with a substantial service delivery function. This post should be at a very senior level with accountability for the delivery of public services, whether purchased from the PSI or kept in-house. Their involvement would extend through the full commissioning cycle – not just the initial procurement - and they would be the high level client interface when problems with service delivery arose. They would also ensure that their procurement and contract monitoring staff receive adequate training, supported by OGC and DCLG to accelerate ‘learning by doing’ and sharing of experience.

- For the government departments most involved with service delivery this post should be at management board level.
- For large local authorities this post should be at executive director level.

#### **Recommendation 6: Bid Costs**

Bid costs incurred by all parties should be reduced by agreeing clear and consistent objectives, simplifying bid documentation, reducing uncertainty around timing and engaging in earlier and more open communication about desired outcomes and risk allocation.

- Bidding timetables should always be published with the tender documents and actual timetables should be monitored by OGC and DCLG. ‘League tables’ of departmental and local authority performance against their plans should be published annually.
- OGC should monitor the procurement timescales under Competitive Dialogue over the next three years and take particular note of complaints to its Supplier Feedback Service from the PSI about intellectual property issues.

#### **How can the government help the UK PSI to be successful in overseas markets?**

The PSI is becoming a global industry. Many international firms already operate in the PSI in the UK and they report few barriers to entry. Service provision models that are proven to work in one country are transferred to others. Rising per capita incomes in the emerging economies are driving an expansion in their demand for services such as health,

education and transport and many of their governments are increasingly able to afford such improvements. The experience of the UK government and UK firms is often sought as countries develop their policies toward public service provision and their domestic capabilities to partner with others in bidding for and supplying them. This has put the UK PSI in a strong position to exploit overseas opportunities.

There is significant export potential in this growth industry. Encouraging and assisting UK firms to make the most of these opportunities will generate substantial benefits not only for UK firms but also for the UK economy. The Review concludes that the best way that government can support the PSI abroad is through maintaining a competitive framework for public services which fosters a dynamic and thriving PSI in the UK. In addition, a larger and carefully targeted marketing effort through existing channels would help to open doors for the PSI and accelerate its entry into new markets.

### **Recommendation 7: Raising the profile of the PSI**

Government and industry should work together to raise the profile of the PSI domestically and promote its export potential through UKTI.

- Trade missions should be mounted to key export markets promoting the success of the UK PSI in supporting and delivering public services.
- Industry should make full use of UKTI's network of contacts and information through UK Embassies, Consulates and High Commissions, especially in emerging market countries, to identify possible partners or clients for UK PSI.

This Review has attempted to provide some definitive answers to questions about the size and effectiveness of the Public Services Industry in the UK. It has also sought evidence on the factors that have helped and hindered its development, as well as those areas where policy change could make it more effective.

Further work will be necessary to shape specific plans to address the general recommendations provided. There is a clear case for action to reverse recent trends that have slowed its growth. The UK has been at the forefront of innovation in the development of its Public Services Industry. It is time to build on that foundation and use the PSI not only to save the taxpayer money, but also to spur the drive towards world-class, personalised public services for all.

### **Recommendation 8: Next steps**

Government needs a co-ordinated plan of action to take the recommendations of this Review forward and ensure that progress is made. Equally the PSI needs to make the best use of the opportunities available to it for further engagement.

- The Advisory Panel for this Review – which includes government, unions, private and third sector organisations - should be retained in some form, meeting regularly to review progress, provide feedback to the government's response and identify new issues as they arise.
- The private and third sectors should make more use of feedback mechanisms already open to them; both directly to public sector clients and indirectly through the OGC.

# Introduction

## Background to the Review

The delivery of high quality Public Services while achieving best value for money for the taxpayer is a key role of government. Over the past two decades an increasing part of public service delivery has been undertaken or supported by private and third sector organisations. This has led to the emergence of a sizeable Public Services Industry (PSI).

Although significant in size, both in the UK and internationally, and with government clearly playing a critical role in its development, the PSI has not been previously examined in a systematic way. It is not a recognised sector in the way national statistics are organised; nor is it clearly identified in local authority budgets.

Given this, John Hutton, Secretary of State for the Department for Business, Enterprise and Regulatory Reform announced the Review of the Public Services Industry in December 2007. The purpose of this Review is to further understanding of the Public Services Industry in order to identify where government can enhance its effectiveness.

Specifically this Review aims to:

- define and measure the PSI and its contribution to GDP and employment and consider how this has changed over recent years;
- review the lessons learned about private and third sector delivery of public services in the UK; and
- assess how government can help the PSI to be more successful in delivering high quality public services both at home and abroad.

## Our Approach

This Review has been led by Dr DeAnne Julius (see Annex G for a short description of her background), with input from an Advisory Panel made up of representatives from the private and third sectors, unions, academics and key stakeholders from across government (see Annex A for details). Dr. Julius has also been supported by a project team within BERR who have assisted with information gathering, analysis and production of this report.

In order to gain information and informed opinion for the Review an open 'call for evidence' was undertaken. This gave a wide set of stakeholders the opportunity to feed in their views on specific questions set out by the PSI Review and also more generally (see Annex B for the questions and a summary of replies). In addition roundtable sessions were held with private and third sector representatives and with those involved in commissioning services at both the central and local government levels. International PSI companies were also interviewed to gain information on a range of PSI markets and discussions were held with particular stakeholders on key points.

## Structure of the Report

This report is divided into six sections reflecting the key aims of the Review. Section 1 discusses the broad categories of public services and considers the various ways that they can be provided and funded. It then defines the Public Services Industry (PSI) and describes what is included and excluded by this definition.

Section 2 draws on work commissioned from Oxford Economics which looks at the size and composition of the PSI in the UK and examines how this has changed over the last 12 years. It measures its contribution to GDP and employment and also considers how the PSI may grow in the future. It discusses some of the data difficulties in this area and provides a classification of the supply side of the industry.

Section 3 looks at why government may wish to use the private and third sectors to provide services either directly to the public or to support its own activities. Empirical and academic literature is examined for evidence on where the PSI has (and has not) delivered better public service outcomes.

Section 4 considers the issues that have influenced the long term development of the PSI in the UK. It describes the policies which have helped the PSI reach its current size and then considers key factors which have been identified during the Review as preventing the PSI from delivering to its full potential. General recommendations for overcoming these difficulties are made.

Section 5 looks at international aspects of the PSI. It compares the UK PSI with that in selected OECD countries and considers how the government can support the activities of UK PSI firms operating overseas.

Finally, Section 6 draws together the key themes and messages from the previous sections to set out a vision for the future of the PSI in the UK.

## Terminology

It has become apparent that some of the terms commonly used mean different things to different people, so this report tries to be as consistent as possible with the language used. For example, in this report 'commissioning' is used to refer to the process which *'defines strategic outcomes and seeks to create relationships to ensure these outcomes are delivered'*<sup>3</sup>. Thus it covers everything from defining the objectives of a particular procurement, the formal bidding process, project implementation and post project monitoring and evaluation. 'Procurement' is one element of the commissioning cycle. It refers to the processes around drawing up tender documents and engaging a particular contractor. A glossary of terms used is included in Annex C.

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<sup>3</sup> *Commissioning and Community Leadership in Local Government – The Supply side Challenges* – a discussion paper, DCLG (Forthcoming).

## Section 1: What is the Public Services Industry?

### What are Public Services?

- 1.1 Public services may have previously been considered as services paid for by the taxpayer and delivered by government employees to members of the public. However, as services are increasingly contracted out and provided by private and third sector employees, it is clear that this definition no longer applies. Public services must be defined in terms of their intrinsic nature, rather than how they are delivered.
- 1.2 A more appropriate definition is  
*'... any service provided for large numbers of citizens, in which there is a potentially significant market failure (broadly interpreted to include equity as well as efficiency), justifying government involvement – whether in production, finance or regulation'<sup>4</sup>*
- 1.3 The type of market failure clearly differs across different public services and influences the type of involvement required. For example, in transport and utilities where there are networks and natural monopoly elements, the primary role of government is to prevent the abuse of market position. This can take the form of direct control of production and investment, or as is now more common in the utilities sector, price and quality regulation.
- 1.4 For other services the main rationale for intervention lies on the demand side. Pure 'public goods' such as law enforcement, defence and public administration are provided by government on behalf of citizens because this is the most efficient way to ensure that all citizens contribute to their cost. With services such as health and education the concern is that individuals can't or won't pay for these services themselves. Nearly all governments are involved in healthcare provision, either purchasing healthcare on behalf of all or some of the population, or in ensuring access through a social insurance scheme. This is justified both because of the benefits to the whole population ('externalities') of disease control and on the grounds of fairness in countering the random nature of illness or accidents.
- 1.5 Public services include a wide range of services, delivered at both the local and national level. Street cleaning, refuse collection and libraries for example, are delivered locally while defence, prison services and judicial systems are organised and delivered by central government.

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4 *The Assessment: Financing and Managing Public Services*, Grout, P. and Stevens, M (2003).

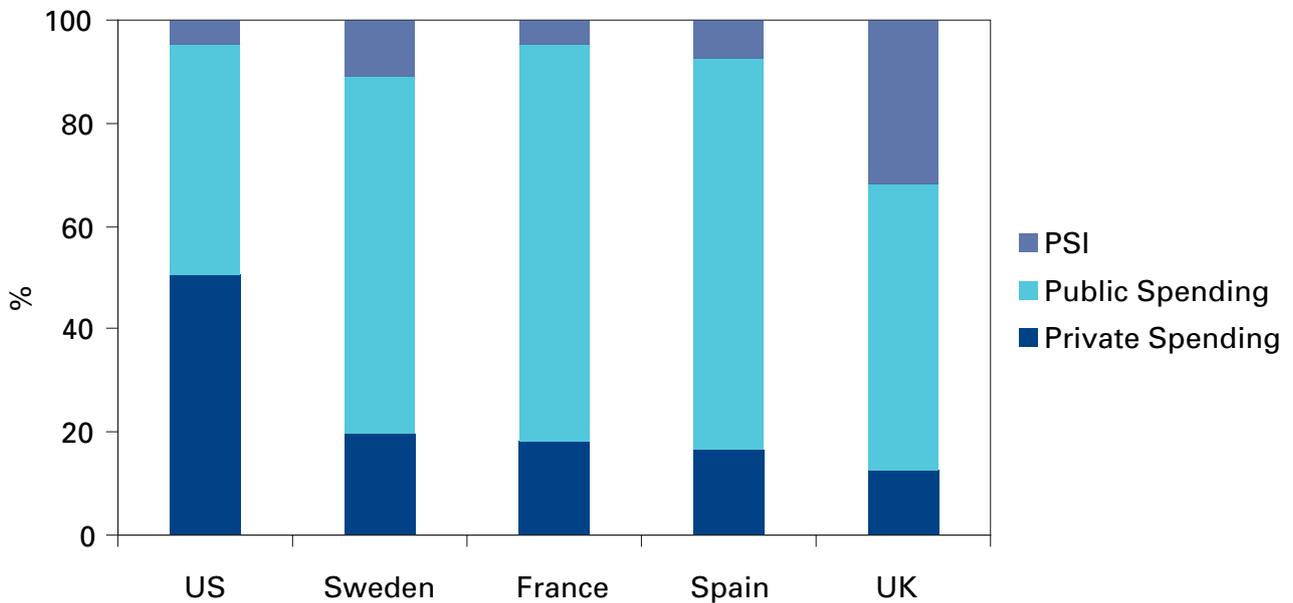
## How are Public Services Financed?

1.6 The financing of public services varies significantly from country to country. Possible options include:

- 100 per cent taxpayer financed ('free at the point of delivery')
- Partially user financed e.g. higher education
- Means tested financing e.g. social care

1.7 The choice of financing is independent of the choices around how the service is delivered and by whom. Different countries have chosen different routes. Figure 1.1 provides an example of how financing and delivery varies across countries for health care. Each country bar shows the split of total spending between private, public and PSI for that country. The lower block shows the extent of private spending on health which is largest in the US. The UK, with its comprehensive system of public health provision, represents the other extreme on that measure. The top two blocks in each column show how the government funded healthcare is divided between that delivered directly by the state and that delivered via the PSI. In this case the UK represents the largest share of PSI delivery among the comparator countries.

**Figure 1.1: Financing of health care varies across a sample of OECD countries**



Source: Oxford Economics

Notes: Private spending calculated from country IO tables. Other public spending and PSI calculated from country COFOG tables and Oxford Economics analysis.

## How are Public Services Delivered?

- 1.8 Public services can be delivered through many vehicles, from the internet (e.g. tax advice) to personal home visits (e.g. social care). This Review uses a classification according to the type of organisation that delivers them – public sector, private sector, third sector or some combination.
- 1.9 The theoretical literature (which is discussed in Section 3) has suggested that different sectors may have different strengths in delivering different types of services. This has led to various stereotypes being put forward. For example, the private sector is sometimes highlighted as being best on innovation and cost reduction, the third sector best on the delivery of personalised and local services and the public sector best on quality because of its strong ‘public service’ ethos.
- 1.10 However, in the discussions and interviews for this Review, all three sectors disputed the reputed advantages of the other two and, indeed, there is little empirical evidence to support such stereotypes. The variation within each sector is generally more striking than the variation across sectors. This supports the view that having a range of providers operating in a ‘mixed economy’ for public service provision is likely to be optimal – a view endorsed across the political spectrum in the UK.

## How is the PSI defined?

- 1.11 After discussion with the Advisory Panel it was agreed that the Public Services Industry should be defined to include:

**All private and third sector enterprises that provide services to the public on behalf of government or to the government itself.**

- 1.12 The enterprises covered by this definition of PSI depend in whole or in part on revenues contracted through government and in turn derived from taxation. For the PSI, more than any other industry, the government, as both policy-maker and purchaser, plays a central role in shaping the market.
- 1.13 There are inevitably grey areas around the PSI definition used for this Review. For example, regulated industries such as water utilities are excluded. These mostly operate in the private sector without government subsidy, although their prices and investment strategies are largely determined by the government’s regulatory policy. Where there is a subsidy to franchised services, such as trains, this subsidy element is included in the PSI. Transfer payments, such as state pensions, are excluded although they are tax-financed and may be used by the recipient to purchase services which are thus indirectly paid for by government.

- 1.14 The Review was tasked with analysing the PSI across the whole of the UK, covering purchases by local, as well as national government and by wider public sector bodies such as NHS trusts. In some cases, definitional decisions had to be taken. For example, the activities of General Practitioners (GP), whose salaries totalled £5bn in 2007/8, are treated by this Review as part of the public sector rather than the PSI despite the fact that GPs' surgeries are typically run as private businesses and GPs are considered self-employed for tax purposes.
- 1.15 It is sometimes helpful to classify PSI provision according to whether it is provided directly to end-users on behalf of government or to government itself. Figure 1.2 provides examples of both types of provision by the PSI.

**Figure 1.2: Examples of what is included in PSI**

Services provided to end users	Services provided to Government
Private sector prisons	IT and payroll services
NHS referrals to private health care providers	Consultancy services such as research and policy advice
Training of military pilots	Catering and cleaning services
Private & third sector childcare	Property management services

- 1.16 The diagram shown in Figure 1.3 shows how users receive public services through government organisations directly or through PSI providers, and how the PSI provides services both directly to users and directly to government. It also shows how other public services (non-PSI) are delivered by commercial, third sector and publicly owned bodies, but paid for by users rather than being funded from general taxation.

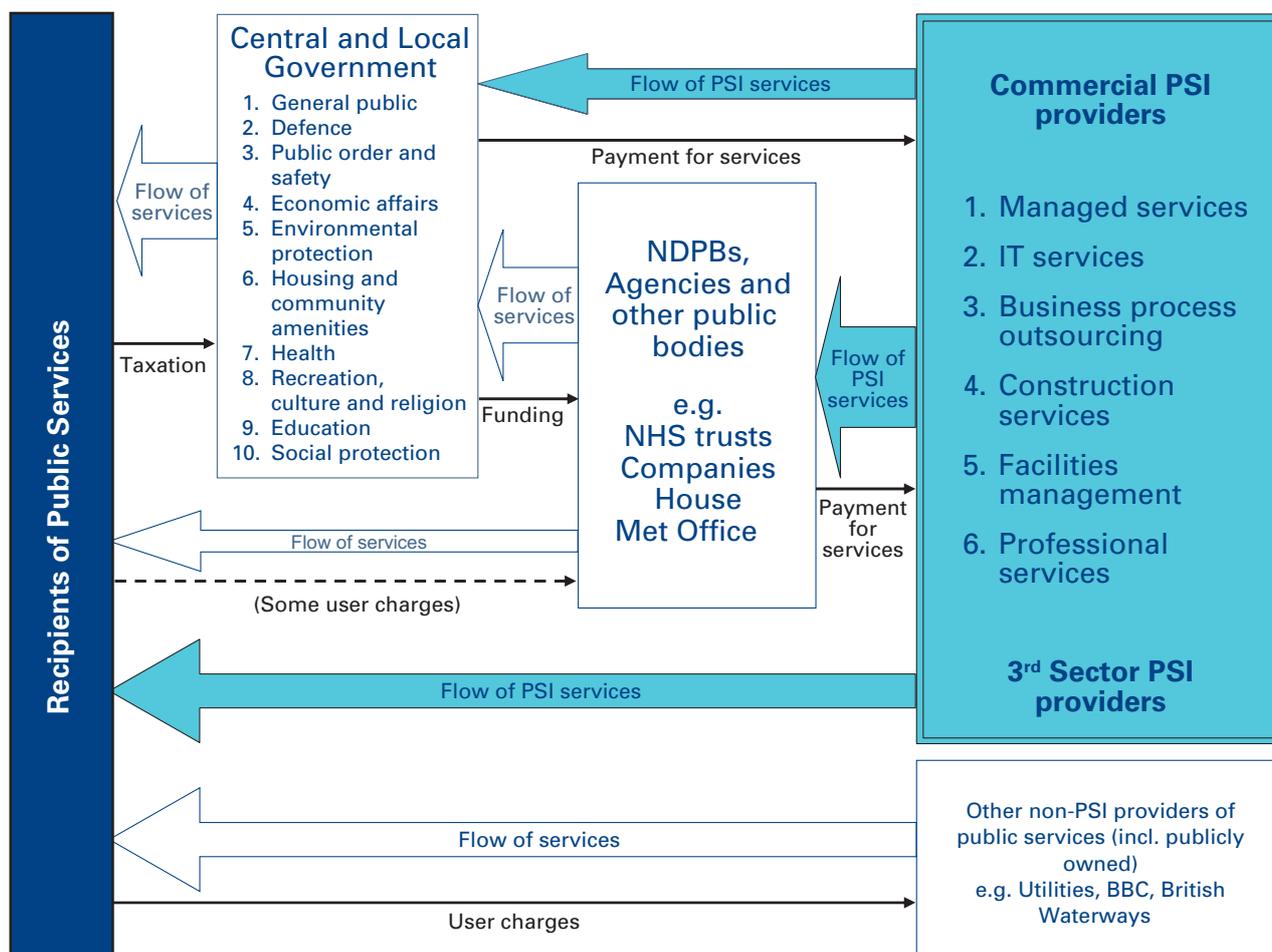
## How is demand for Public Services changing?

- 1.17 Analysis such as that carried out for the Comprehensive Spending Review has highlighted the likely future growth in demand for public services, particularly for health and education. This will be driven by the needs of an ageing population, on the one hand, and the increasing skill requirements as comparative advantage in the world economy continues to shift, on the other. As shown in Figure 1.4, there is a clear positive correlation between income (measured by per capita GDP) and expenditures on health and education. The strength of this relationship can be measured by the aggregate income elasticity, controlling for other factors. These estimates vary widely<sup>5</sup> but a recent OECD<sup>6</sup> survey of the literature found values ranging between 1.2 and 1.6. With an average of 1.4, then this would imply that for every 10 per cent growth in real per capita income (which is likely to happen over the next decade or so in the UK), the

5 There is considerable debate about the exact income-elasticity of health care demand, estimates based on data at the level of individuals or regions suggest much lower values, whilst macro level estimates tend to produce higher figures.

6 *Projecting OECD Health and Long Term Care Expenditures*, OECD (2006).

Figure 1.3: Structure of the PSI

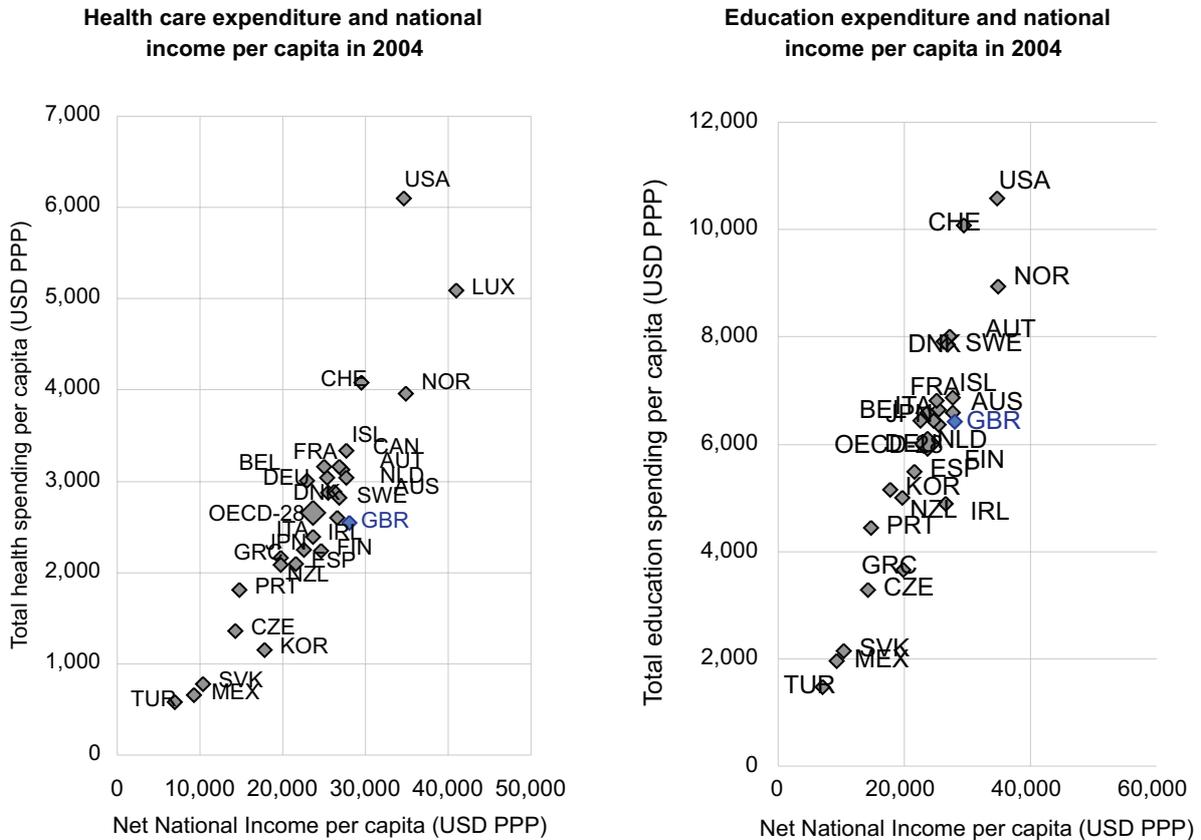


demand for spending on health and education would grow by roughly 14 per cent in real terms. The implied pressures on service levels and their funding makes it ever more imperative that value for money is achieved in the provision of public services.

- 1.18 Increasingly the public are demanding more personalised public services which are tailored to their specific needs as opposed to a 'one size fits all' approach<sup>7</sup>. Surveys have found that key drivers of user satisfaction include the speed of delivery, the amount of information they are provided with, and the professionalism and attitude of staff providing those services. Although they want more flexibility in service delivery to match their lifestyles, the public also show a strong dislike of arbitrary geographical disparities in service provision. This creates a number of tensions and tradeoffs in the provision of public services which go beyond straightforward economic considerations of effectiveness and efficiency.

<sup>7</sup> The Cabinet Office paper *'Excellence and Fairness: Achieving World Class Public Services'* discusses the issues around greater user choice and flexibility in how public services are delivered in more detail.

Figure 1.4: GDP and Health and Education Spending



Source: OECD Social Indicators 2006, Education at a Glance 2007

- 1.19 Much has been written about the ‘post code lottery’ in public service provision. The term is shorthand for the seemingly random variations observed in the quality of public service provision across the country. These disparities are almost always highlighted in negative terms, focusing on those regions where the quality of services or the level of funding, are relatively low compared to elsewhere.
- 1.20 However regional variations can also arise as an appropriate response to differing local needs. For example the NHS authority of a region with a relatively elderly population compared to the rest of the UK, might opt to shift its resources towards treatments for ailments that are more common as people get older. As a consequence the resources devoted to other areas of care will be reduced relative to the rest of the country.
- 1.21 If this situation led to variations in the degree to which health authorities met minimum standards in healthcare this would clearly be an undesirable outcome. However, over and above such minimum standards, there are benefits in allowing local decision-makers the flexibility to respond to differing local needs. This will result in regional variations in service provision which will increase the total health benefits delivered for the same cost to the taxpayer.

1.22 Another trade-off in trying to meet the growing demand for personalised services is that between universal coverage and choice. One of the primary rationales for government provision of public services is when universal coverage is desirable but would not be provided by the market. The consequence of this is that the standardised service provided by a single supplier may not meet the requirements of some users. By opening up the service to competition the user has greater choice but the public subsidy to the universal service provider may have to change since it can no longer cross-subsidise so effectively. The total public subsidy may not increase, however, if large numbers of users shift to self-financed private provision. Such trade-offs will have to be confronted if consumer demands for more personalised services are to be met.

## Section 2: How big is the PSI in the UK and how is this changing?

- 2.1 The PSI in the UK covers a huge range of services, provided at both the central and local government levels, by a wide variety of private and third sector organisations, ranging from multinational companies to small local suppliers. In terms of its diversity of providers and the range of service offerings, the PSI in the UK is the most developed in the world.
- 2.2 This section of the Review draws on work commissioned from Oxford Economics<sup>8</sup> to quantify the size and growth of the PSI in the UK.
- In 2007/8 the turnover of the UK PSI was £79bn. It generated £45bn in value added and employed over 1.2 million people. If indirect and induced impacts are included, its value-added rises to £88bn and jobs supported reaches 2.3 million.
  - Over the 12 year period for which comparable data are available the PSI has grown at an average annual rate of over 8 per cent in nominal terms or 5.4 per cent in real (inflation adjusted) terms. However, in recent years its rate of growth has slowed.

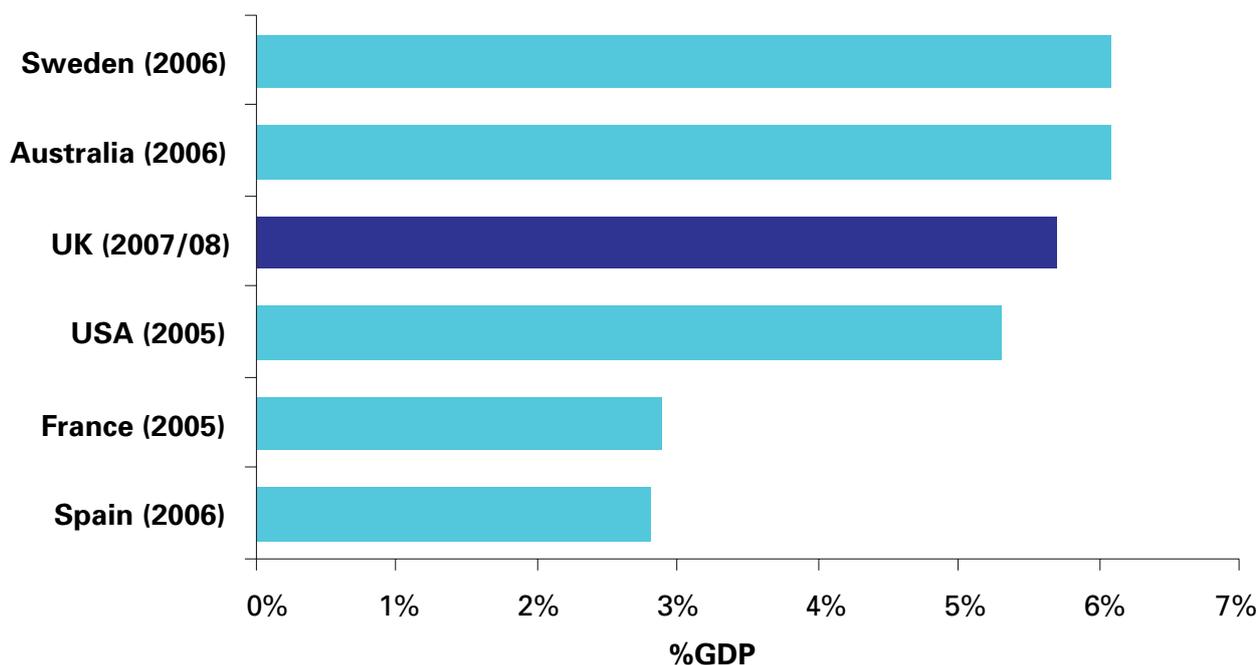
### UK's PSI leads the world

- 2.3 Given the range of areas where there is private and third sector involvement in the delivery of public services in the UK and the variety and development of commissioning methods used, the UK PSI market is generally considered to be the most developed, as well as one of the largest, in the world.
- 2.4 This is confirmed by an analysis of the size of the PSI for a sample of OECD countries. When expressed as percentage of GDP, this ranges from just over 6 per cent in Sweden and Australia to less than 3 per cent in Spain (Figure 2.1). In the UK the PSI accounts for 5.7 per cent of GDP, up from 4.2 per cent in 1995/96. This is slightly higher than its share in the US and nearly double that of France and Spain.

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<sup>8</sup> See *The public services industry in the UK* and *The Market for Public Services – International Comparisons* Oxford Economics, published alongside the Review.

**Figure 2.1: PSI as a percentage of GDP (selected OECD countries)**



Source: Oxford Economics

2.5 The UK position as a global leader in opening up public service markets to competition has also been highlighted by comments from stakeholders submitted to the Review's call for evidence:

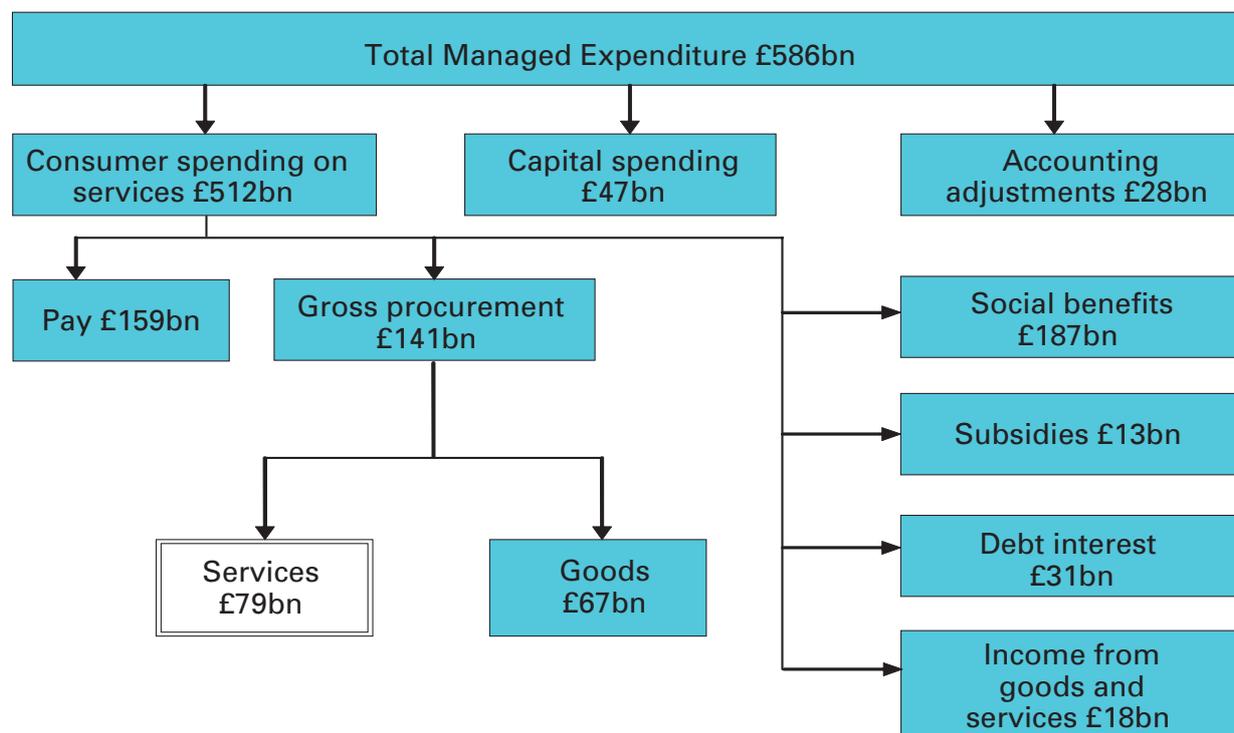
*'Unquestionably, the UK public services market is the most advanced in the world, taking into account the number of sectors where independent providers are involved, the range of functions included within the scope of such contracts, the extent of risk transfer, and the sophistication of the procurement and contract management models involved'* (Serco)

*'...on the whole public sector IT services markets outside the UK are less mature in their supplier relationships with the private and third sectors'* (BT)

*'in broad terms the UK leads the world in the development of a PSI in which the private sector can participate. The UK has applied Compulsory Competitive Tendering, PFI and PPP models more fully than any other country for delivery of public services. While other countries are starting to recognize the benefits of private sector involvement in the provision of public services this has rarely developed into the availability and service level contracting witnessed in the UK'* (VT Group)

How big is the PSI in the UK and how fast has it grown?

2.6 In 2007/08 the turnover of the PSI (across central and local government) in the UK was £79bn, an increase of 126 per cent from £31bn in 1995/96. Figure 2.2 shows how this figure is derived and Box 2.1 provides a summary of the methodology used.

Figure 2.2: The PSI in the context of Total Government Expenditure, 2007/08<sup>9</sup>

Source: Oxford Economics, based on PESA table 5.3

### Box 2.1: Methodology to estimate Government purchase of services

The data used for the analysis comes from the Public Expenditure Statistical Accounts (PESA).<sup>10</sup> However PESA does not provide a split of procurement into goods and services so this has been estimated using ONS National Accounts Supply-Use Tables (SUT). The SUTs gives information on goods and services for a number of key spending areas including public administration, defence, local government, education, health and social activities. The proportion spent on services for each of these categories was applied to the PESA data.

HMT only publish consistent PESA time-series back 5 years. As a result any changes in scope which may be introduced in a given year are not reflected in earlier years. For example, in the 2007 and 2008 PESA publications improvements were made to the treatment of NHS procurement but these have not been reported for years prior to 2002/03. From previous PESA publications Oxford Economics derived a time series from 1995/96 and included some key adjustments to improve the consistency of the procurement data before 2002/03.

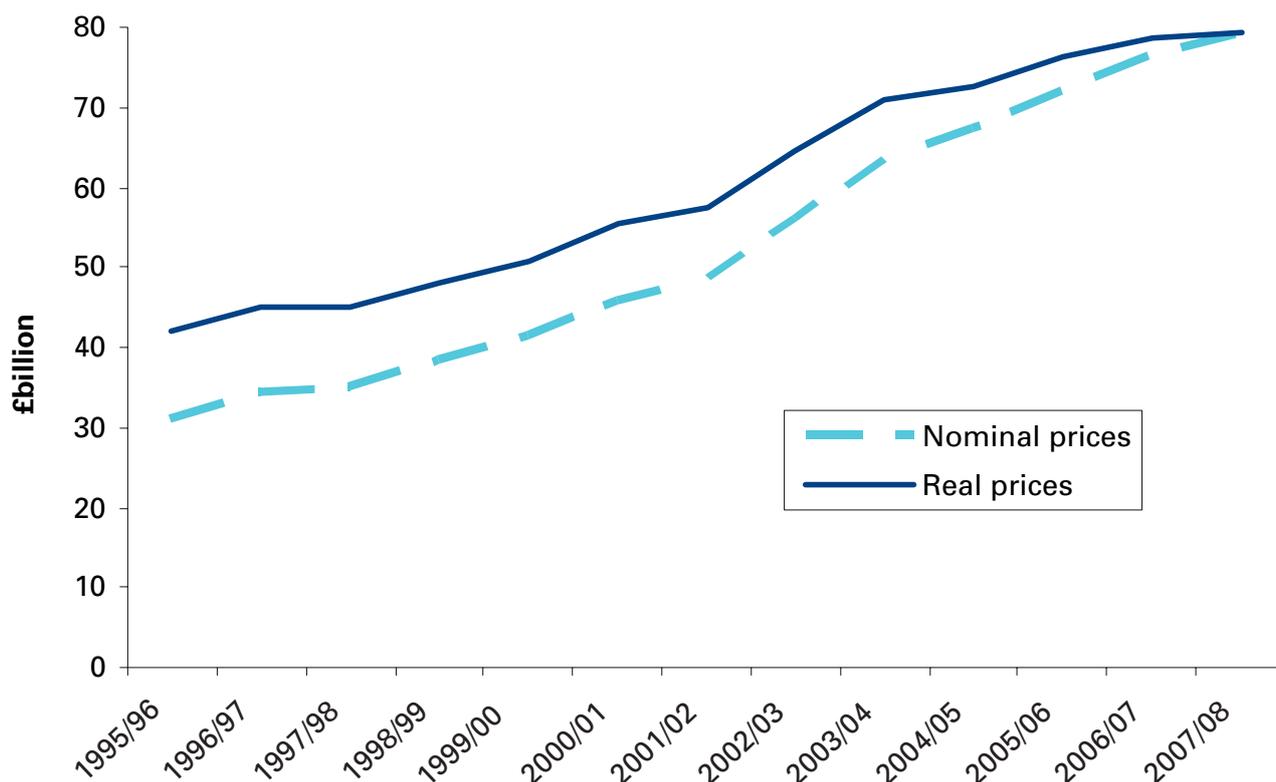
These issues mean that the data included here are best estimates and would be improved if the actual split of goods and services procured were provided by all government departments.

9 Notes: i) the procurement figures include purchases by central and local government  
ii) Pay and procurement totals are adjusted for estimated GPs' salaries (£5bn in 2007/8). The final £79bn figure excludes GPs' salaries.

10 PESA : Public Expenditure Statistical Analyses published by HMT.

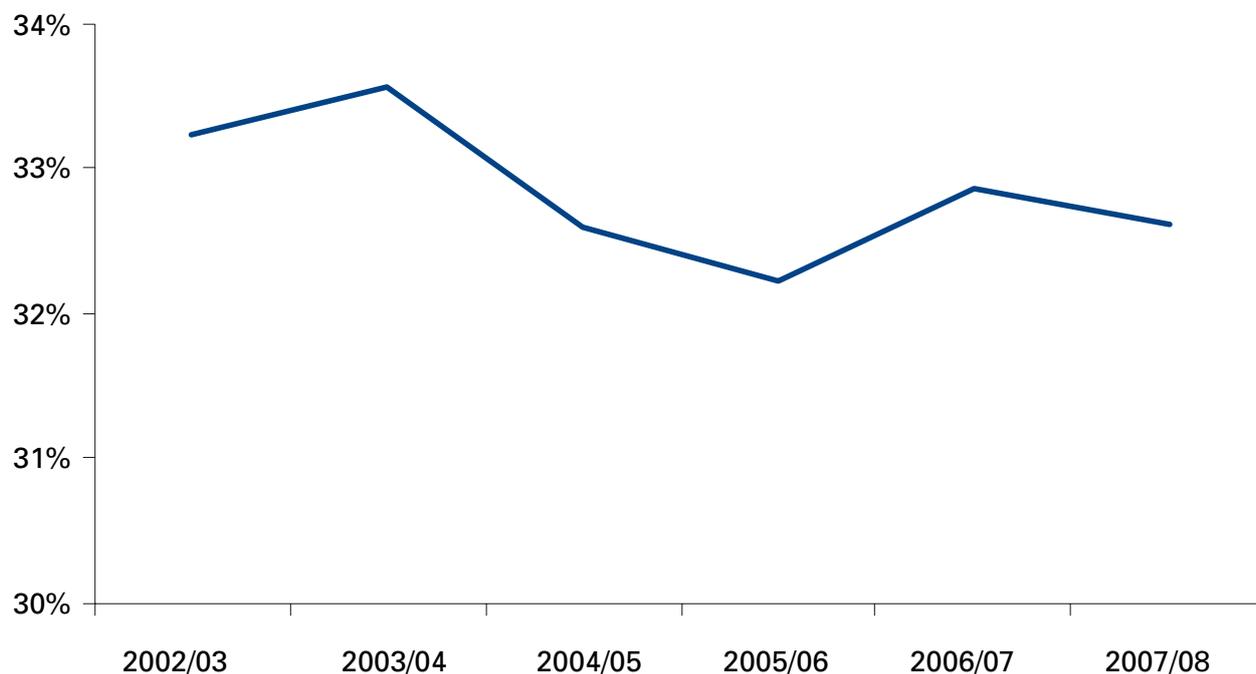
2.7 Figure 2.3 shows how the PSI has grown since 1995/96 - from £31bn to £79bn at nominal prices and from £42bn to £79bn at real prices. Over the first 8 years of the period the PSI grew by 7 per cent per year in real terms, but since 2003/4 growth has fallen to an annual average of 3 per cent. This fall partly reflects the slower growth of total government expenditure, but it also indicates a slowdown in the rate at which government is contracting with the PSI.

**Figure 2.3: Growth of the UK PSI since 1995/6**



Source: Oxford Economics

2.8 Another way to view this is to calculate the share of total public services (i.e. current spending excluding transfer payments, debt interest and procurement of goods) provided by the PSI (see Figure 2.4). This peaked at 33.6 per cent in 2003/04 and has since fluctuated around 32.6 per cent.

**Figure 2.4: Share of total public services provided by the PSI**

Source: Oxford Economics

2.9 This message from the data resonates with the views of stakeholders – many of whom have pointed to a slowing of PSI opportunities in recent years with more cancellations of bids and perceived changes in policy direction by some government departments (possible reasons for this are discussed in Section 4).

### How is the PSI split across different government areas?

2.10 At a fairly aggregated level of analysis it is possible to use the internationally recognised breakdown of sectors known as COFOG (as explained in Box 2.2) to examine government spending. This has the advantage of cross-country comparability. Section 5 also uses this classification to compare the UK's Public Services Industry with that in several comparator countries.

## Box 2.2: COFOG Categories

Procurement activity is categorised by HMT using an internationally agreed UN Classification of the Functions of Government (COFOG). This classification is used to identify the socio-economic objectives of current transactions, capital outlays and acquisition of financial assets by general government and its sub-sectors. At the highest level, the COFOG classification includes ten categories and the Review has limited its analysis to these groups. These categories are listed below with a brief description of the main areas covered by each<sup>11</sup>.

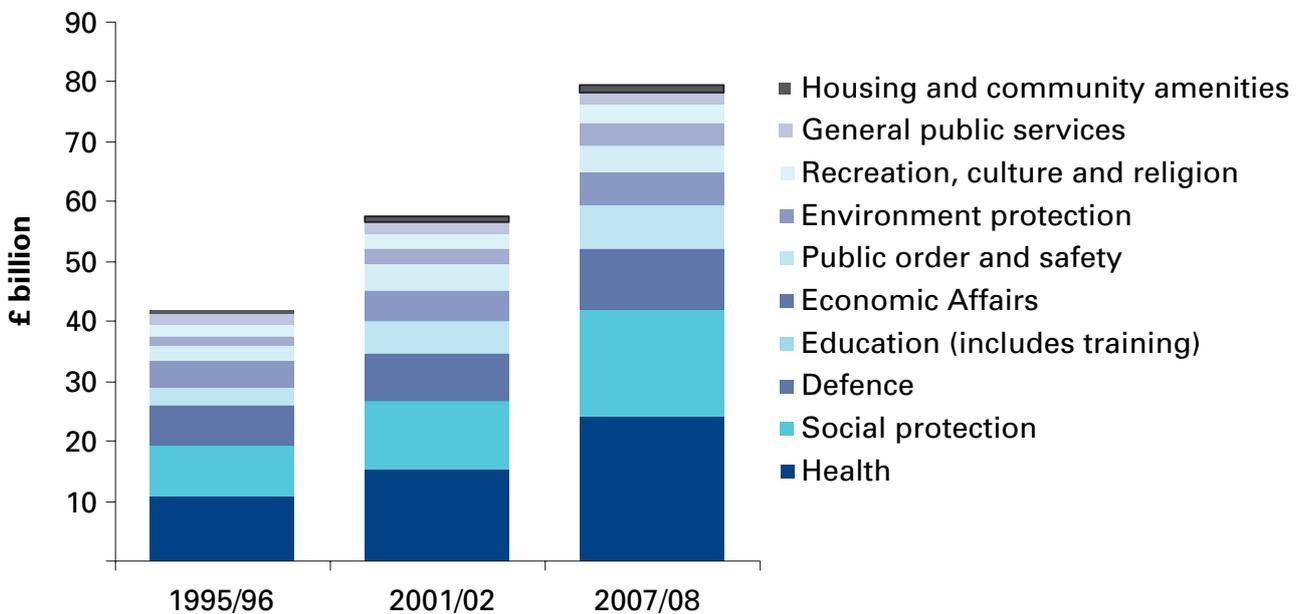
- 1 General public services**  
Executive & legislative organs, Financial & fiscal affairs, External affairs, Foreign economic aid, General services.
- 2 Defence**  
Military and civil defence and defence R&D.
- 3 Public order and safety**  
Police services, Fire-protection services, Law courts, Prisons.
- 4 Economic affairs**  
General economic, commercial and labour affairs, Agriculture, forestry, fishing and hunting, Fuel and energy, Mining, Manufacturing and Construction, Transport, Communication.
- 5 Environmental protection**  
Waste management, Waste water management, Pollution abatement, Protection of biodiversity and landscape.
- 6 Housing and community amenities**  
Housing development, Community development, Water supply, Street lighting.
- 7 Health**  
Medical products, appliances and equipment, Outpatient services, Hospital services, Public health services.
- 8 Recreation, culture and religion**  
Recreational and sporting services, Cultural services, Broadcasting and publishing services, Religious and other community services.
- 9 Education**  
Pre-primary, primary, secondary and tertiary education.
- 10 Social protection**  
Sickness and disability, Old age, Family and children, Unemployment, Housing.

<sup>11</sup> A full detail of COFOG classification is available at <http://unstats.un.org/unsd/cr/registry/regcst.asp?Cl=4&Top=1&Lg=1>.

2.11 In the UK, health constitutes the largest sector of PSI spending. It totalled £24.2bn in 2007/8, accounting for around 30 per cent of the total PSI market (Figure 2.5). In part this reflects the high proportion of government spending devoted to health, but it also results from the relatively advanced use of the PSI in this area. After health, the next largest sectors in the PSI are social protection (£17.9bn), defence (£10.1bn) and education (£7.3bn).

2.12 Growth in the use of the PSI has varied significantly across sectors. The categories with the fastest annual average growth over 12 years (in real terms at 2007/08 prices) were education (8.1 per cent), environmental protection (7.9 per cent) and health (7.0 per cent). The slowest growing areas were general public services (-0.3 per cent), economic affairs (2.3 per cent) and defence (3.6 per cent).

**Figure 2.5: Growth of the sectors that make up the PSI (2007/8 prices)**



Source: Oxford Economics: PESA

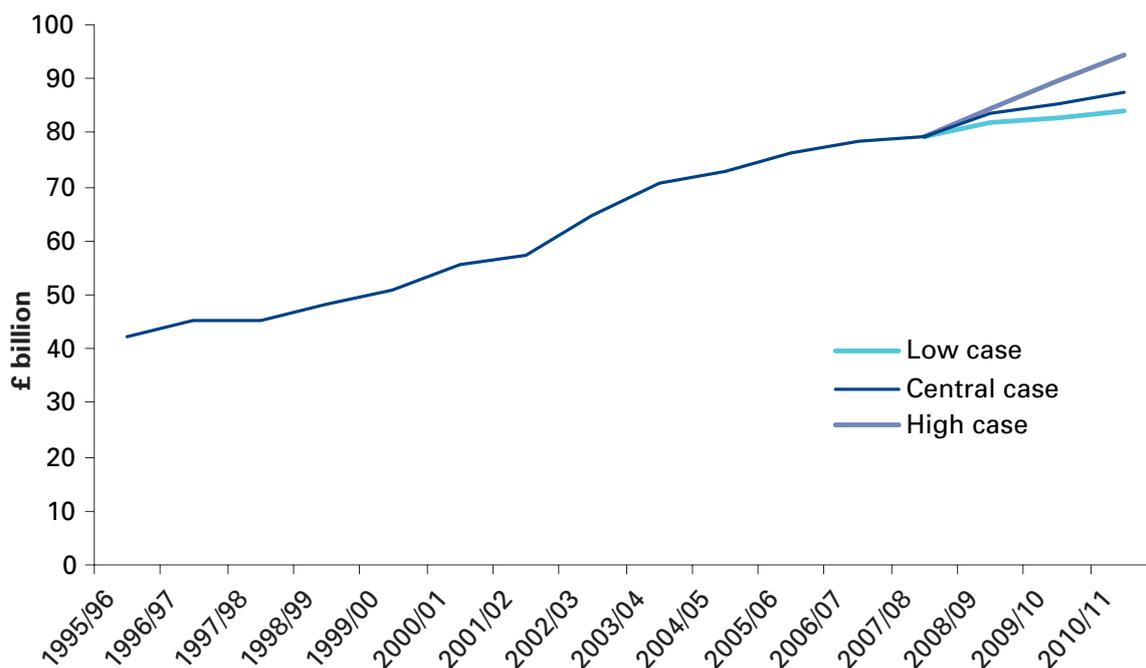
### How might the PSI grow in the near term?

2.13 Projections for the growth of the PSI have been derived from three scenarios based on the different assumptions listed below. Figures 2.6 and 2.7 summarise these results.

- A **central projection** is based on planned procurement spending for each government department as published by HMT along with an assumption that the PSI continues to grow in line with historical trends. On this basis, the PSI is projected grow at a rate of **3.4 per cent per year to 2010/11** (in real terms);
- A **high case** scenario is based on additional growth in those COFOG categories where the UK lags behind other OECD countries in terms of the share of PSI provision (see Section 5). This gives a growth rate of **5.9 per cent per year**;
- A **low case** scenario which assumes that the PSI share in total public services stays at its current level so that growth simply mirrors projected spending increases. This scenario gives a growth of **1.9 per cent per year**.

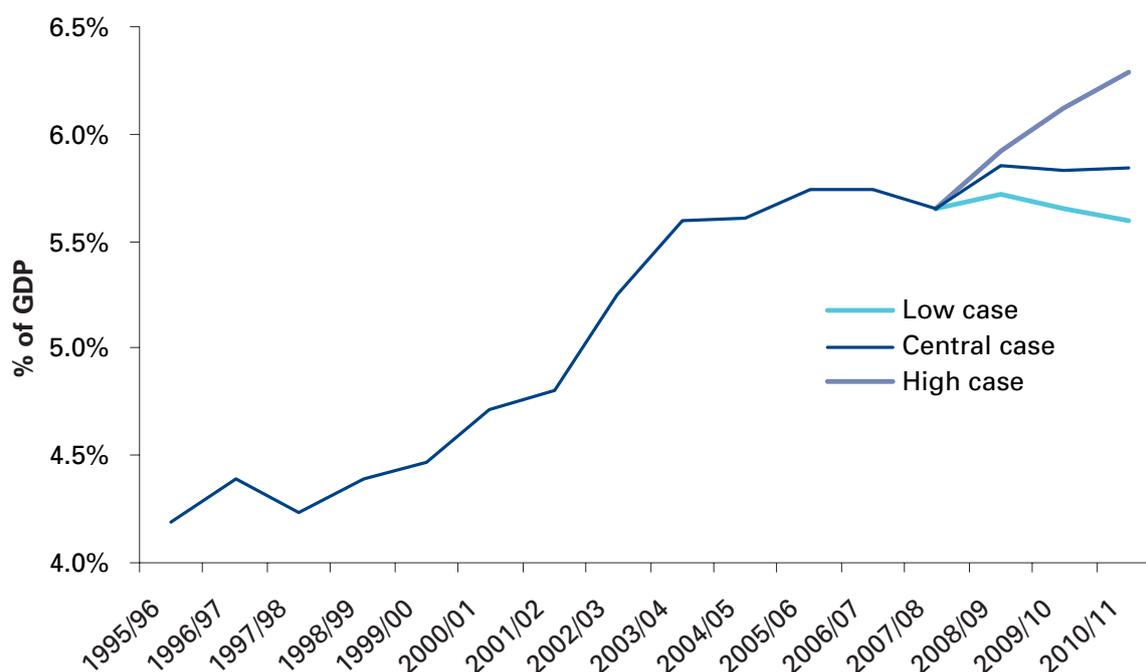
2.14 Figure 2.7 shows that PSI as a percentage of GDP has increased from 4.2 per cent in 1995/96 to 5.7 per cent in 2007/08, an increase of 1.5 percentage points over 12 years. The majority of the increase occurred in the first eight years with little increase over the last four years. Under the three different scenarios it is projected to increase to 6.3 per cent for the high case, 5.8 per cent for the central case and to show a slight reduction to 5.6 per cent under the low case.

**Figure 2.6: Projections for PSI growth (2007/08 prices)**



Source: Oxford Economics

**Figure 2.7: PSI as a percentage of UK GDP**



Source: Oxford Economics

## What does the PSI contribute in terms of value added and employment?

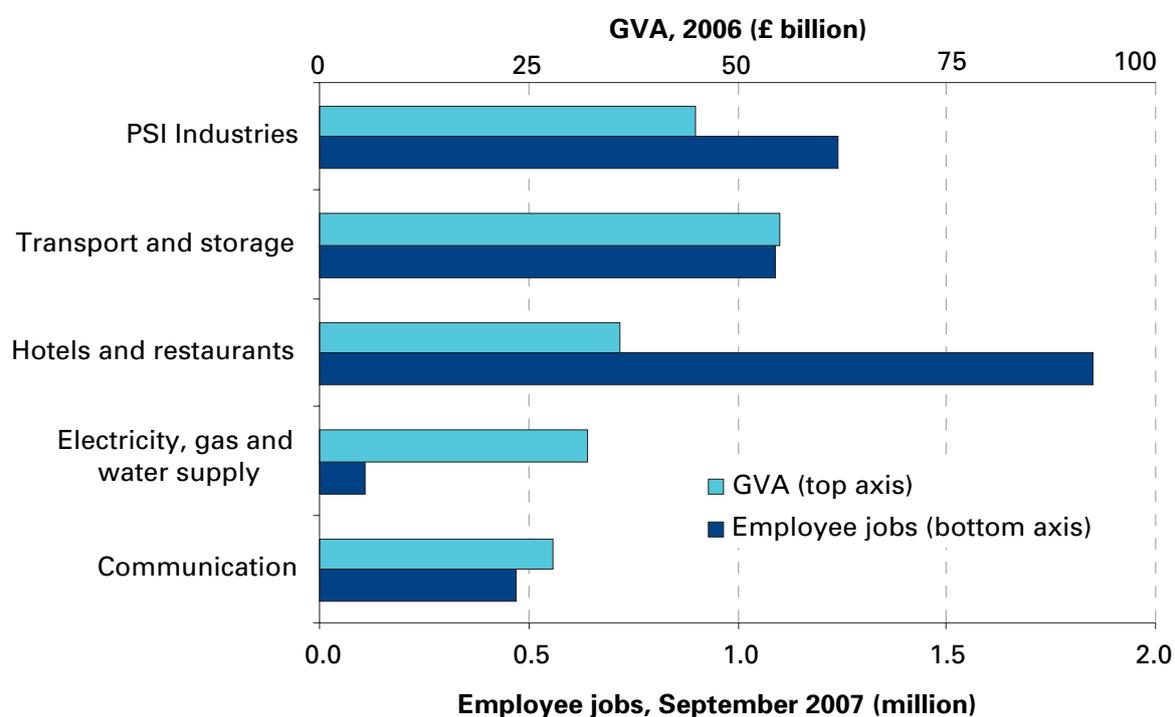
- 2.15 From an economy-wide perspective, the £79.4bn of purchases by the public sector on services from the private and third sectors in 2007/08 generated a value added contribution to GDP of £44.8bn. This has risen substantially from just £24bn in 1995/96 (in real terms) as the PSI share in GDP has grown from 4.2 per cent to 5.7 per cent.
- 2.16 The number of jobs supported by the PSI has grown by nearly half a million since 1995/96 to 1.24 million in 2007/08. By 2010/11, under the central projection, the PSI is expected to support about 4 per cent more jobs than it does today (bringing the total to 1.29 million)<sup>12</sup>.
- 2.17 For cross-industry comparisons it is sometimes relevant to include the second-round, or indirect and induced impacts<sup>13</sup> on GDP and employment. In this case the PSI contributions almost double – and the PSI accounts for £88bn of value added and 2.3 million jobs.

### How does the PSI compare in size to other sectors?

- 2.18 To put the size of the PSI into context it is helpful to consider how it compares to other industries (this is shown in Figure 2.8). In terms of GVA, the PSI output of £45bn in 2007/08 was slightly less than ‘Transport and Storage’ (£55bn in 2006) but significantly larger than ‘Food, beverages and tobacco’ (£23bn), ‘Communication’ (£28bn), ‘Electricity, gas and water supply’ (£32bn) and ‘Hotels and restaurants’ (£36bn). In terms of employment the PSI generated slightly more jobs than ‘Transport and storage’ (1.1 million in 2007) but less than ‘Hotels and Restaurants’ (1.9 million).

12 Much of this new activity in the private and third sectors will represent a simple shift from the public sector, while some activity will reflect growing demand.

13 *Indirect impacts* are caused by employment and activity supported down the supply chain to the public services industry, as a result of the public service industry purchasing goods and services from UK suppliers. *Induced impacts* are caused by those directly or indirectly employed in the public services industry spending their incomes on goods and services in the wider UK economy.

**Figure 2.8: Size of PSI activity in comparison to other UK industry sectors<sup>14</sup>**

Source: ONS Workforce jobs and Provisional National Accounts GVA

Note: The PSI employment measure includes self-employment and employee jobs, industry comparisons exclude self-employment. Where an individual holds more than one job, the employee jobs series counts each job.

## Data Difficulties

- 2.19 At the most basic level having complete and historically consistent procurement data from all government departments would improve the measurement and understanding of the PSI. Procurement data are collected and collated both by HMT and the OGC. However, these data are incomplete and some departments make no distinction between procurement of goods and services. It is claimed that a concerted effort would be needed to improve this, which may require changes to administrative systems with major resource implications. Further, the continued blurring between what constitutes a “good” and a “service” will only serve to magnify these data issues.
- 2.20 OGC plans to repeat its survey of government departments’ procurement in September 2008 and it is important to ensure that departments respond in full. OGC are also working with 16 departments to identify steps they can take to improve the required collection and provision of detailed data in the longer term. This work should be pursued with greater urgency. Some data on items such as planned spend on services (used to develop Figure 4.2) are available from departments. Where such data are produced they should be made publicly available.

<sup>14</sup> PSI is not separated out from the other data included in the chart. The majority of PSI jobs will be in business services (section K), other service industries (section O), education (section M) and health (section N).

2.21 Other changes would assist in improving analysis of the PSI and in updating and extending the work done in this Review. These include:

- Provision of more detailed COFOG analysis in future PESA publications<sup>15</sup>. This would allow PSI sectors, such as transport, to be specifically identified and quantified using the methodology described.
- Maintaining consistent time series for procurement and other key PESA data, rather than the current practice of revising data for 5 years only.
- In so far as possible, reconciling information on procurement obtained by OGC directly from departments with other published data (e.g. PESA, National Accounts).
- Ensuring that project evaluations are completed on a regular and consistent basis, either by the commissioners or by organisations such as the NAO, OGC or 4ps. Although many such evaluations are done, they are not systematically collated to produce generalised conclusions about service quality, cost savings and lessons learned.
- Building on the important work by National Statistics in measuring service quality to enable macro level estimates to be made of PSI productivity. This is a long term ambition, but would be very valuable in spurring PSI growth in those sectors where it brings greatest benefits.

## The Supply Side of the PSI

2.22 There are various ways to categorise the supply side of the PSI market and they typically differ from the demand side structure. Most of the private sector companies have both government and private sector clients. For most of the third sector PSI providers, government contracts are a source of funding alongside more traditional charitable and foundation support. Many private and third sector organisations operate in other countries as well as the UK.

2.23 The DCLG/PwC report on developing the local government services market divided supply side procurement into five sectors: professional services, construction services, IT services, managed services and products. Oxford Economics' work for the CBI<sup>16</sup> further categorised supply into facilities management, consulting and HR activities. Private and third sector organisations are also described, represented and analysed by a range of industry associations and market research firms.

2.24 For the purpose of this Review, the following six sectors have been considered although in many cases there is a some overlap between them:

<sup>15</sup> HMT has suggested that future PESA publications should include two digit COFOG analysis.

<sup>16</sup> *The size of the market for providing public services in the UK*, Oxford Economics (Commissioned by CBI) (2008).

PSI supply side activity	Description
Managed services	Managed services cover the substantial range of services provided directly to users. This diverse sector includes running prisons, providing employment services in Jobcentre Plus, medical services in NHS funded independent treatment centres, care services for pre-school children and training RAF pilots. Oxford Economics' work for the CBI estimated this segment accounted for the largest segment of the PSI at 44 per cent.
ICT services	ICT services have evolved considerably with the development of new technologies and the convergence of IT and communications. It includes both the building of IT systems and the ongoing management of databases, servers, applications and communication systems. Ovum estimate the sales of the top 20 software and IT services suppliers to the public sector were £9.2bn in 2007, up 10 per cent on the previous year and representing 49 per cent of their total sales <sup>17</sup> . OGC estimate current public expenditure of £12.4bn.
Business process outsourcing	Business process outsourcing often contains an IT component, but is distinct in that it involves the contracting out of an area of business activity, while the client retains strategic and governance control. Examples include back office outsourcing, which includes internal business functions such purchasing, payroll or records management, and front office outsourcing, which includes customer-related services such as call centres.  Kable estimates that the total spend in this area in the UK public sector during 2007 will be £5.3bn, rising to £7.5bn by 2012 <sup>18</sup> .
Construction services	Construction services are provided before and during the construction process, and include the lead contractor role on PFI projects, as well as a range of design, engineer and surveying work. In 2006, total output of the UK construction sector amounted to £114bn. The public sector accounts for some 30 per cent of this output with PFI/PPP projects contributing a further 10 per cent. These figures include the goods and services element of construction. The service component on a typical construction project is estimated to be worth around 5 per cent, so total PSI turnover in this segment is probably around £2-3bn.
Facilities management (FM)	The British Institute of Facilities Management explains FM as 'the integration of multi-disciplinary activities within the built environment and the management of their impact upon people and the workplace'. In the context of PSI it involves managing facilities after they have been built. The sector is typically divided into support services, building operating and maintenance services, environmental services and property management.  AMA estimate that the UK market for outsourced FM services was worth around £12.9bn <sup>19</sup> . The PSI component of this is likely to follow the broad construction private/PSI split of around 40 per cent.

17 Ovum, Player Rankings, UK Public Sector, 04 April 2008.

18 *ICT and business process outsourcing in the UK public sector to 2012*, Kable (July 2007).

19 *Facilities management outsourcing market UK*, AMA Research (2006).

PSI supply side activity	Description
Professional services	<p>Professional services cover a vast range of consultancy or advisory service activities in the areas of human resources, financial, legal and general management consultancy. While there is overlap between the sub-sectors, much of the advice is highly specific in nature requiring well qualified specialists. The sector contains a wide range of companies from well known global firms to smaller local providers.</p> <p>According to the Annual Business Inquiry the sector had a turnover of £76bn in 2006, mostly supplying the private sector. By way of illustration 9 per cent of PwC's UK revenues are from the government or public sector, but some companies will have a much higher proportion of public sector work, and others exclusively supply the private sector. OGC estimate current public spend on consultancy of £2.8bn.</p>

2.25 The larger companies that supply these service segments are mostly well known. The following table lists a selection of PSI providers from the commercial and third sector. Managed Services PSI providers are drawn from leaders across different areas of PSI activity. Elsewhere the largest firms by revenue are reported using publicly available sector reports.

Managed Services <sup>1</sup>	Information & Communications Technology <sup>2</sup>	Business Process Outsourcing <sup>3</sup>
VT Group	EDS	Capita
Babcock International	Fujitsu	EDS
Serco	Capgemini	Fujitsu services
Group 4 Securicor	BT	BT
Atos Healthcare	Capita Group	Capgemini
Care UK	IBM	Serco
Nord Anglia	Atos Origin	SIS
Veolia	Logica	Accenture
Working Links	CSC	Atos Origin
Rainer	Microsoft	CSC
Southern Focus Trust	Lockheed Martin	IBM
QED	Accenture	Liberata
Shaw Trust	SIS	Vertex
Thames Reach	Northgate	Mouchel
NCH	Liberata	LogicaCMG
Turning Point	BAE Systems	Unisys
Brook	Sun Micro Systems	Northgate Information Solutions
Maggie's centres	Steria	Xansa
	Serco	
	Oracle	

Facilities Management <sup>4</sup>	Construction services <sup>5</sup>	Professional services / consulting <sup>6</sup>
Serco	Balfour Beatty	Accenture
Land Securities Trillium	Carillion	IBM Business Consulting
Mitie	Laing O'Rourke	Deloitte
Sodexo	Kier	Capgemini
Rentokil Initial	Morgan Sindall	PA Consulting
Morrison Support Services	HBG Nuttall	PricewaterhouseCoopers
Mowlem Support Services	Interserve	KPMG
ISS UK	Newarthill (Sir Robert McAlpine)	Ernst&Young
OCS Group	Amey	Allen & Overy
Interserve Facilities Services	Mitie	Norton Rose

## Sources:

- 1 Managed Services: Leading PSI providers of defence, prisons, health, education, local and welfare services from both the corporate and 3<sup>rd</sup> sector. 3<sup>rd</sup> sector providers supplied by Aveco
- 2 ICT: Ovum Top 20 Public sector S/ITC suppliers
- 3 BPO: Key suppliers from Kable, ICT and business process outsourcing in the UK public sector to 2012, July 2007 and from earlier reports in same series. Excluding predominantly ICT services companies and including outsourcing companies from management consulting Top 50
- 4 Facilities Management: ACA, Facilities management outsourcing market UK, 2006
- 5 Construction: UK Top 10 Construction contractors, Construction Sector News
- 6 Professional: Top 50 UK management consultants 2006 (source [www.managementconsultancy.co.uk](http://www.managementconsultancy.co.uk)) excluding predominantly outsourcing companies. Integrated financial advisory firms (PwC, Deloitte, KPMG and E&Y) also provide financial advisory services (source: [www.accountancyage.co.uk](http://www.accountancyage.co.uk) The Top 50 Accountancy Firms 2008). Two leading global PFI/PPP legal firms (source: Dealogic)

## 2.26 The key characteristics of the supply side are:

- There are a large number of companies competing in the PSI market. While some segments are highly specialised (e.g. running defence installations or providing complex legal advice), in general, the sector has considerable depth. For example, there are 123,380 VAT-registered businesses in the category 'public admin and other services' and an additional 475,845 VAT-registered businesses in the category of 'property and business services'. These two categories account for nearly 38 per cent of all UK VAT registered businesses but many do not undertake work for public sector clients. Many are small: 51 per cent of these businesses have a turnover of less than £100k<sup>20</sup>.

20 UK Number and percentages of VAT-based enterprises.

- The sector is dynamic. Companies have moved into PSI markets from other PSI markets, from public sector ownership, from private provision of similar services and from international markets. This movement has brought project and people management skills and experience acquired in other areas. Two such examples are BT who have grown from communications into IT services and VT Group whose business has shifted from warship construction to providing mainstream PSI services, both in defence and other sectors. Many companies span a range of PSI markets, such as Capgemini who provide consulting, outsourcing and technology services and Amey, who started in construction, but now provide a wide range of integrated support services.
- The sector is international. Many of the leading companies providing PSI services are international operators. This is because the need for public service provision is global leading to transferable business models. They also report that the UK is open to international firms in this area and provides a more transparent and predictable operating environment than many other countries.
- Much of the sector operates in commercial as well as government markets. This means that innovations and efficiencies developed with private sector clients can be used in delivering services to the public sector. It also means that PSI commissioners can look to commercial markets in order to attract PSI providers. The consequence is that the public sector commissioner will need to take account of wider demand and supply pressures on the industry and be aware of the alternative private sector opportunities available to PSI providers.

## Section 3: Why use the private and third sector to deliver public services?

3.1 There is a large and growing literature on the delivery of public services through contractual processes by private, public and third sector providers. This section<sup>21</sup> reviews the theoretical and empirical literature from the UK and other countries. Four key messages from the literature are summarised and evidence is then used to assess the following questions of relevance to the Review:

- Does contracting out deliver about cost savings?
- Does contracting out affect the quality of services?
- What are the effects of contracting out on employees?
- Does contracting out increase or decrease innovation?
- What are the benefits of a partnership approach?
- Are there particular benefits associated with provider type?

3.2 The literature provides relatively clear answers to some of these questions but less so for others. The general problem is that much of the evidence is available from individual detailed case studies which limits sample size and makes it difficult to draw conclusions that can be applied generally. Robust evidence is available from some studies which cover hundreds of contracts and have sufficiently rich data on their specific characteristics to allow researchers to control for the most important differences between them. This approach lends itself well to questions about costs since they can be easily measured. Quality and, to an even greater extent, innovation are multi-dimensional so empirical evidence is less robust. There seems to be a dearth of recent case study material in the academic literature, but a growing volume of useful empirical work from the National Audit Office, other publicly funded bodies such as the National Consumer Council and privately supported organisations such as the CBI and the Serco Institute.

### Key Messages

3.3 Considering the literature as a whole, there are four general conclusions that can be supported.

#### **Competition and the contractual process bring benefits**

3.4 Competition, contestability and the process of structuring specific contracts for service provision are instrumental in achieving the potential gains (which may be in cost savings, quality improvements and/or innovation). The benefits accrue whether private, public or third sector firms win the bid. There is some evidence that mixed

<sup>21</sup> The Review team are grateful for the assistance and input of Professor Paul Grout, University of Bristol, Centre for Market and Public Organisation on whose work in surveying the literature much of this section is based.

provision raises consumer welfare (Gersbach, 2005). Evidence in Grace et al (2007) based on local government experience supported the view that under the right conditions, competition and contestability secure better performance. The important conditions included good performance management, positive partnership and acceptance across the political spectrum.

### **Cost savings can be significant**

3.5 Much of the rigorous work on cost savings relates to the early experiences with contracting. It shows savings of around 20 per cent from competitive tendering and contracting, including when the in-house team wins the bid. Domberger et al (1987) found that in the health sector costs were reduced by as much as 34 per cent by introducing competitive tendering. Elsewhere, the prison sector has experienced cost savings of over 20 per cent (CBI, 2003) and internationally, across sectors, savings are found to be between 10-30 per cent (Australian Industry Commission, 1996). Recent UK experience in contracting alternative providers of medical services found similar results.

### **Service quality does not appear to suffer**

3.6 The evidence on quality change is weaker and more limited than that on cost savings. However, the few rigorous studies available (some of which are rather dated), point to similar or improved service quality from contracting out. This is particularly the case when increased attention has been paid to quality issues during the contracting process with an explicit focus on output and outcomes. Domberger et al (1995) showed that performance was maintained or even enhanced when achieving cost savings through contracting; results that were similarly reflected in Domberger and Jensen's 1997 review of the international evidence. The Australian Industry Commission (1996) showed that improvements in quality were reported due to competitive tendering enabling a better understanding of requirements, improved performance monitoring and an increased scope for consumer choice. Walsh (1991) also supported these conclusions when assessing competitive tendering of local authority services in the UK.

### **Using Partnership Models produces real benefits**

3.7 Evidence demonstrates that partnerships typically deliver on time and although at first glance may appear more expensive than public provision this is mitigated when public sector cost overruns are taken into account. The National Audit Office (2003) found that 89 per cent of PFI construction projects up to 2002 delivered on time or early, whereas 75 per cent of traditionally procured hospitals were delivered late. The long-run nature of these relationships also helps to ensure high quality services are provided throughout the length of the contract (Grout, 1997, for example, attributes this to clear investment incentives).

### **Does contracting out deliver cost savings?**

3.8 The early impetus and justification for contracting out public service delivery was to achieve cost savings so inevitably there is stronger evidence in this area than in

others. There is a range of work which looks specifically at the cost savings which have been generated when competition is introduced in services previously supplied exclusively by the public sector. Frequently these show cost savings of around 20 per cent. However, studies do tend to concentrate in a number of specific areas where more robust comparisons can be made – typically where many similar contracts have been issued, such as by a range of local authorities. Refuse collection and prisons are examples, as illustrated in Boxes 3.1 and 3.2.

### **Box 3.1: Refuse Collection in the UK**

The 1988 Local Government Act introduced Compulsory Competitive Tendering (CCT) for a variety of local government activities including refuse collection. Prior to this, although local authorities could choose to contract out, the practice was uncommon.

CCT required local authorities to regularly compete their refuse collection contracts and laid down guidelines for how in-house providers would be allowed to participate in the tender process in order to ensure fair competition.

The introduction of CCT led to significant reductions in the average cost of refuse collection, with most estimates suggesting savings of the order of 20 per cent in the first year<sup>22</sup>. Although there is evidence to suggest that the average cost reduction was greater in authorities who awarded the contract to a private rather than the in-house bidder, the latter still delivered significant savings. This suggests that it was the act of opening up services to competition, rather than the nature of the provision (private or public) which reduced costs.

The data on the impact of CCT on service quality in refuse collection is more ambiguous, hampered by the fact that prior to its introduction service standards were often poorly specified making it difficult to compare ex-ante and ex-post measures of service quality. Analysis of what data are available suggests that there is no systematic link between cost savings generated by the introduction of CCT and quality shading by providers<sup>23</sup>.

- 3.9 Work in other areas has also found that substantial cost reductions were achieved when competition was introduced into areas where it previously did not exist. In hospital domestic services competitive tendering has been found to reduce costs by 34 per cent (Domberger et al, 1987) – and it matters little whether the bid is won in-house or by the private sector. As described in Box 3.2 competition and contracting have brought significant benefits in the prison sector as well where cost savings appear to be more than 20 per cent (CBI, 2003). International evidence also points to significant cost reductions. The Australian Industry Commission’s meta study (1996) of 203 international studies of competitive tendering found savings across sectors of between 10-30 per cent. Recent findings from the contracting of primary care services through

22 Domberger, Meadowcroft and Thomson (1986), Szymanski and Wilkins (1993) and Szymanski (1996).

23 Szymanski (1996).

APMS (Alternative Providers of Medical Services) suggested that private companies are also consistently undercutting incumbent practices on price, often by as much as 25 per cent<sup>24</sup>.

- 3.10 The bulk of the earlier evidence suggests that private provision is generally cheaper than public provision because cost savings were less when in-house suppliers won the bid. However, this result is not present in all studies. Particularly in recent years there has been more work on the specific question of the relationship between costs and the type of provider, whether private or public (e.g. Bel and Costas, (2005) and references therein). This more mixed evidence suggests that the primary benefits come from competition and the contractual process itself rather than any innate efficiency advantages of the private sector.

### Does contracting out affect the quality of services?

- 3.11 There are two problems with assessing how the contracting out of services affects quality. The first is how to measure quality – quality may be identified in terms of certain performance characteristics, but their assessment may require subjective judgement rather than an accumulation of statistics. Cleaning is a good example: what constitutes a high standard of cleanliness may vary from one observer to another. The second is that even where quality can be measured satisfactorily, researchers are frequently hampered in making ‘before and after’ comparisons because of a lack of data on service quality prior to contracts being let and monitored.
- 3.12 Much of the early literature focussed on the theoretical issues around the possible adverse impacts of contracting on quality. Shichor (1995) set out the conditions under which the quality of public services delivered by private contractors would be inferior to that delivered by public employees. Holmstrom and Milgrom (1991, 1994) showed that if agents have an incentive to pursue a single objective (such as making profits), then other objectives (such as quality) may suffer. However, Hart et al (1997) pointed out that the bulk of this literature is theoretical and does not consider specific sectors or actual experiences. Most of the rather limited empirical evidence that is available and reasonably robust negates the theoretical literature on adverse quality effects.
- 3.13 A study by Domberger et al (1995) focussed on the quality-shading hypothesis: do contractors systematically shade quality after contracts are let in order to maintain profitability in the face of reduced prices? The study was based on a sample of 61 cleaning contracts, monitored by specially trained inspectors over a 9-month period. Since performance data prior to contracting were not available, the study compared a sample of contemporaneous contracts that had been tendered with those that had not been subjected to any form of market testing to be able to isolate the effect of competition on price and quality. Controls were introduced into the model for different cleaning environments, different ownership patterns (whether publicly or privately owned), and inspector effects. The last was added to ensure that the results would not be biased by the propensities of different inspectors to judge contract performance

<sup>24</sup> Private practice, *BMJ*, 21 June 2008.

either harshly or leniently. The results showed that while competition lowered contract prices by between 35 and 50 per cent, cleaning performance was maintained or enhanced. Domberger and Jensen (1997) reviewed the international evidence and also found that savings are achievable without sacrificing the quality of service provided.

- 3.14 A more comprehensive view of the evidence on quality of service is contained in work by the Australian Industry Commission (1996). It concluded: "The improvements in quality reported after [competitive tendering and contracting] appear to arise because of a much clearer focus on what is required in the service, improved performance monitoring and the ability to choose among alternative providers". This conclusion echoes the assessment of competitive tendering of local authority services in the UK (Walsh, 1991).
- 3.15 An important factor when considering the effect of contracting on quality is whether it is possible to specify quality requirements in the contracts in a way which makes them measurable and thus subject to incentive or penalty payments. When quality can be measured then competition brings about quality improvements as well as reductions in cost. Domberger and Rimmer (1994) suggest that any quality deterioration following contracting could be a problem of contract design or implementation, and therefore be preventable, rather than an implicit problem associated with the decision to use private or third sector providers. Where quality is hard to measure and/or has not been contracted for, then there is little empirical evidence on which to draw.
- 3.16 The theoretical case has been made that the third sector should have an advantage over the private sector as they are trusted not to cut quality even when the contract does not prevent them from doing so. This idea is often referred to as the 'trust signal' which originated with Arrow (1963) and has been developed by Hansmann (1996) and others.
- 3.17 The National Consumer Council (2007) surveyed the users of public, private and third sector service deliverers in three service areas where all three sectors compete. The third sector was favoured in the delivery of employment services; the private sector was favoured for domiciliary care for older people; and there was little difference between the two for social housing services. Public sector providers trailed in all three service areas. While the NCC cautions that some of their results are not statistically significant (due to small sample sizes), this study provides an important example of using consumer satisfaction scores to measure the inherently complex attributes of certain services.
- 3.18 Another innovative approach to the issue of service quality is provided by the Serco Institute (2006). It surveyed nearly 100 former public sector managers who had transferred to the private sector under contract. Ninety-three per cent agreed or strongly agreed that "I have more autonomy than I had in the public sector" and 95 per cent said that "the transfer of the delivery of public services to the private sector resulted in improved (or significantly improved) service quality for the service users." Even accounting for some natural bias from self-selection in the sample, such a strong consensus from those with front-line experience of service delivery in both sectors is remarkable.

- 3.19 Several studies have shown the benefits of long term partnerships - for example through PFI or PPP – in delivering quality improvements. In these cases the public sector purchases a flow of services from the private partner under a long term contract which has an explicit emphasis on risk sharing. The long run nature of the relationship and payment provides an incentive for the private partner to design and monitor its investments carefully to ensure that they will provide high quality services for the length of the contract (Grout, 1997, Grout and Stephens, 2003, and Hart, 2003). KPMG (2008) found that PFI-funded schools achieved 92 per cent faster educational improvements than schools rebuilt with conventional public financing. There is also some evidence to support the view that improving quality is a key factor behind the use of PPPs (Domberger and Fernandez, 1999 and Grimsey and Lewis, 2007), but little that examines whether this is actually happening in practice.
- 3.20 There is also some evidence of wider benefits from the use of PFI. NAO (2003) suggests that the comparative operational data from PFI prisons has encouraged the public sector to improve its performance. This may be reflected by Prison Service management teams recently winning competitions with the private sector for the operation of prisons.

### What are the effects of contracting out on employees?

- 3.21 Public sector unions and others have consistently raised the concern that much of the cost savings achieved through contracting comes at the expense of workers (TUC, 2008). This concern can be separated into short-term effects, such as the impact on wages and the terms and conditions of employment, and the long-run impact, particularly on long-term unemployment.
- 3.22 On short-term effects, some early sector-specific research supports these concerns. For example, with support services in the defence industry, a survey by Uttley in 1993 found the primary source of cost savings to be labour cuts. Ascher (1987) argued more generally that contracting has resulted in reduced pay rates and worsened employment conditions. Other studies contend that there has been little impact on terms and conditions of employment (Walsh, 1991). In local government, Walsh and Davis (1993) associated the introduction of competitive tendering with an increase in productivity, largely brought about by staff reduction but also due to increased working hour flexibility. Cubbin et al. (1987) attributed savings to improved technical efficiency.
- 3.23 Internationally, the evidence continues to be mixed. Martin and Stein (1992) found no significant association in the US between contracting and employment in the provision of local government services. In New Zealand, Domberger et al (2002) attributed 58 per cent of cost savings from government outsourcing to labour cuts.
- 3.24 An important recent study by the UK National Audit Office (2008) looks specifically at the question of whether the terms and conditions of staff who moved from the public to the private sector when their function was contracted out worsened over time. It also considers the effect on overall employment levels for the contracted out service.

Its survey covers 15,400 staff who transferred from the public to the private sector as a result of 43 PFI contracts signed between 1992 and 2004 (i.e., before recent changes that broaden TUPE protections). The study showed that total employment levels in the sample increased by 20 per cent between the beginning of the contracts and late 2004 when the data were collected. The turnover rates of staff who had originally transferred averaged 7 per cent a year, compared with the average staff turnover in the public sector as a whole of 12.4 per cent. Thus the short term effect of contracting out on employment was positive in this study, although it was limited to PFI projects rather than all PSI contracting out.

- 3.25 With respect to pay differentials, the NAO study found that the rates of pay received by transferred staff were not uniformly higher than those received by other staff and over time the two tended to converge. At the time of transfer, senior managers and manual workers from the public sector had higher wages than their counterparts in the private sector provider (by 9 per cent and 3 per cent, respectively), while the wages of middle management, supervisors and clerical staff were marginally lower in the public sector than the private (by 1 per cent, 2 per cent and 3 per cent). By 2004 the transferred senior managers had retained their 9 per cent premium, the transferred manual workers had increased their premium to 4 per cent, transferred supervisors and clerical workers had caught up with and overtaken their private sector counterparts (by 1 per cent and 4 per cent) and transferred middle managers retained a 1 per cent discount to their counterparts. Finer breakdowns of staff show more variation for some categories, but the overall conclusion is that transferred staff have generally benefited in terms of pay from the shift to a private employer. Much union concern centres on conditions of employment, such as pension, sick pay, and holiday entitlements. The NAO study did not consider the latter two items but it did record the percentage of staff who took up the employer offered pension scheme. Under The Fair Deal for Staff Pensions, any transferring staff must be offered access to a 'broadly comparable' pension scheme. By October 2004 60 per cent of the transferred staff had taken up the offer to join the private pension scheme compared with 27 per cent of other staff in these companies.
- 3.26 Despite the NAO study, strong concerns remain about pay and conditions differentials and what has been described as the 'two tier workforce' (Unison, 2008). Additional safeguards have been put in place through the "Two Tier Agreement" which embraces six sub-agreements, including the Retention of Employment model, pioneered by the Department of Health, and the Best Value Code of Practice on Workforce Matters for Local Authorities which was supported as part of the Warwick agreement to ensure that "no less favourable" terms and conditions are offered to new employees on local authority contracts than their public sector counterparts. The unions welcomed the Two Tier Agreement as a major step forward but they remain concerned over its implementation.
- 3.27 There is no systematic evidence to suggest that contracting leads to an increase in long-term unemployment. Economic theory would suggest that this is more heavily influenced by economy-wide policies on education, retraining and labour market flexibility. Domberger and Jensen (1997) highlighted a move by some large UK firms to assist staff made redundant with career transition thereby taking on some of the

redeployment, retraining and relocation responsibilities that would otherwise have fallen to the state's unemployment benefit system or to redundancy pay-outs. In fact, it is worth noting that during the decade of rapid PSI growth between 1995 and 2005 the unemployment rate for the working age population fell from 8.8 per cent to 5.0 per cent, while the employment rate rose from 71.4 per cent to 74.7 per cent.<sup>25</sup>

- 3.28 In terms of the breakdown between private and public sector employment, although the latter declined as a share of total employment between 1995 and 2005, it grew by 9 per cent overall (compared to 12 per cent growth in private sector employment). It follows that if the growth in the PSI over this period contributed negatively to public sector employment, it was more than offset by other factors such as the rise in private sector employment and changes in government spending.

### Does contracting out increase or decrease innovation?

- 3.29 Innovation in the services sector can be hard to define. The Innovation in Services project, undertaken by BERR in partnership with NESTA and working closely with DIUS, which is due to report shortly, will contribute to a better understanding of service innovation. It is based strongly on business-led analysis in a number of service sectors. It specifically identifies barriers to key service innovations in specific sectors and provides a basis for practical action by Government to tackle these. The areas for action include: the key roles for public reusable information in an information society, which Government is considering in its assessment of the Trading Funds; the openness and flexibility of markets driven by information and standards - BSI is reviewing its strategy accordingly; and the need to do more to strengthen the ability to manage change/innovation and to embed this in business processes and use of ICT, particularly SMEs
- 3.30 Achieving as much innovation in public services as private services will require careful structuring. The private sector may be more likely to be innovative than the public sector but the private contractor may be constrained by detailed contract specifications based on the existing service delivery process. In addition, where innovation brings cost savings, it is likely to be more attractive than innovation that raises quality, particularly if quality improvements are hard to measure and/or not incentivised by the contract. The possibility for innovation often arises in an unpredictable way once a process is ongoing. In a competitive market a firm can implement the innovation and, if successful, reap its benefits. If there is a contract between the private supplier and the public agency then implementation of an innovation may require renegotiation. The benefits may be dispersed and the incentives to innovate dampened (for example, Hart et al, 1997). On the other hand, the Serco Institute survey (2006) found that 86 per cent of the former public sector managers now working for the private contractor agreed or strongly agreed that "I have more freedom to experiment and innovate than I would have as a public sector employee."

<sup>25</sup> *Labour Force Survey Seasonally Adjusted Employment and Unemployment rates for age group 16-59/64*, ONS Labour Market Statistics.

3.31 The evidence reviewed above has shown that significant cost savings are generally achieved when services are opened up to competition, and this itself is indicative of innovation. Domberger et al (2002) provide a good example of the way that outsourcing led to a number of work and process innovations in New Zealand. Indeed, Domberger and Jensen (1997) note 'the bulk of the savings are accounted for by better management, more flexible working practices, more efficient use of capital and greater innovation spurred by competition'. Cubbin et al (1987) and AIC (1996) support this view. KPMG (2007) found that innovation in PFI contracts can be an important driver behind contract performance improvements: new ways of working helped 60 per cent of the UK's PFI contracts in place at the end of 2006 over-deliver.

### What are the benefits of a partnership approach?

3.32 A strong theme across submissions to the Review's call for evidence (Annex B) was the importance of a collaborative approach between the commissioning agent and the provider in order to deliver best value for money. There are a number of empirical studies that support the case for partnership approaches to public service delivery. The particular types of formalised partnership embodied in PFIs and PPPs have received most attention. The National Audit Office (NAO, 2003) surveyed the PFI projects up to 2002 and assessed these against comparable traditionally procured projects. The NAO found that nine out of the eleven PFI hospitals and all seven PFI prisons were delivered on time or early. This compared very favourably with the 61 traditionally procured hospitals, of which 75 per cent were delivered late. Mott MacDonald (2002) looked at 39 UK infrastructure projects procured by conventional and PPP methods. It found that the conventionally procured projects had an average of 17 per cent overrun on completion time whereas the PPPs on average were delivered before their contractual completion dates. The conventional projects' cost overrun averaged 47 per cent while the PPPs were delivered almost exactly on budget.

3.33 Comparable results are found internationally. Thomson (2005) found in a European Investment Bank (EIB) study, that of 50 public infrastructure projects under conventional procurement, 60 per cent were more than one year late. This compared with 33 per cent of the 10 PPP projects financed by the EIB. Blanc-Brude, Goldsmith and Valila (2006) found in a study of 200 roads funded by the EIB that PPP projects were costed 24 per cent higher than the traditionally procured roads at contract signing. However, this figure is roughly equal to the expected value of cost overruns in traditional projects. This suggests that the build part of PPPs reflects actual risks incurred whereas traditional projects have been overly optimistic in their cost estimates.

### Box 3.2: An example of implementing PFI: Prison Services in the UK

The UK was one of the first countries to create a market for prison services, beginning in 1991 by contracting out the management of new prison centres. Subsequently private sector involvement was extended to include the design, build and financing of new prisons and, more recently, the market testing of underperforming public sector prisons<sup>26</sup>.

Increasing conviction rates and changing sentencing practices meant that a programme of prison construction was needed. This created a clear pipeline of future demand which was critical in attracting providers into the UK market.

In common with their public sector counterparts, most new PFI prisons experienced difficulties when first opened, but subsequently improved. The NAO reviewed PFI prison performance in 2003 and found that with one exception PFI prisons performed well relative to comparable public prisons<sup>27</sup>. The latest official review of prison performance puts 9 out of the 11 private prisons as meeting or exceeding the majority of their targets, a comparable level of performance to the public sector<sup>28</sup>.

Beneath these aggregate figures there are systematic differences in performance, with private prisons generally scoring better than public prisons in areas such as staff – prisoner relations, but worse on issues such as safety and security.

More broadly the introduction of market testing for failing prisons and the creation of a parallel pool of alternative suppliers has helped spur improvements in the performance of public sector prisons, although evidence of sharing of best practice is harder to come by.

In terms of the international market for prison services, providers have made clear that the experience they built up in the UK has been crucial in their success in overseas markets, in particular in bringing a new model of provision to the table and helping to reshape the market. These foreign contracts have also allowed them to sustain in-house expertise during periods when the UK market stopped expanding.

## Are there particular benefits associated with provider type?

- 3.34 The common stereotypes associated with public, private and third sector delivery are not borne out by the limited evidence that specifically compares the non-cost elements of provision across provider type. The National Consumer Council study (2007) discussed above showed users ranked the third sector highest in the delivery of employment services and the private sector highest for domiciliary care for older

26 Market testing essentially involves putting out the management of an existing prison to competitive tender with bids invited from both the in-house team and outside suppliers.

27 National Audit Office (2003).

28 Office for National Commissioning (2008).

people, whereas the opposite might have been expected. Other literature provides a similarly mixed picture: papers finding the third sector more efficient include Cutler and Horwitz (2000), Ferrier and Valdmanis (1996), and Wilson and Jadow (1982) on hospitals, and Nyman and Bricker (1989) on nursing homes. Finding the opposite are studies undertaken by Woolhandler and Himmelstein (1997), Becker and Sloan (1985) on hospitals, Blau and Mocan (2002), and Mocan (1997) on day care centres. Conversely, Bennet & lossa (2005) found that even if a not-for-profit firm cares more than the for-profit firm about social benefits, it may not generate the greater social benefit.

- 3.35 NIESR (2007) explored the available evidence on the performance of early years education/childcare by provider type. Although some of the findings were not conclusive or limited by data, the general findings supported the public sector's role in provision of early years education, particularly in terms of better outcomes for child development and the quality of maintained facilities compared with those in the private and independent sectors. The differences between individual providers, however, were more significant than the differences between types of providers.
- 3.36 The theoretical literature referred to above described a possible 'trust signal' for third sector providers due to a belief among users that they will not cut quality in the way that a private sector supplier might. However, this signal has less impact if customers are well-informed. Indeed, there is some evidence that less well-informed customers self-select into non-profit institutions (Holtmann and Ullmann, 1991, and Schlesinger, Gray and Bradford in 1996) although evidence is limited by the difficulty of capturing proxy indicators for the less well-informed. Where competition is low, not-for-profit organisations provide a higher level of access (see for example, Mas (2008)).
- 3.37 Huysentruyt, M. (2006), analysing DFID contracts, finds not-for-profit organisations compete most effectively where there are important hard-to-measure quality innovations. However, third sector providers are less likely to adhere to the procurer's terms of reference. There is substantial literature suggesting that the third sector will attract workers who exhibit pro-social motivation and who will donate labour because they care about the quality of the services they contribute to. Donated labour is the willingness to work more hours or harder than is contractually required even though it brings no greater career opportunities. The theoretical literature suggests that such caring individuals will not donate labour in the private sector because a private owner will take advantage of the donated labour to reduce manpower and there will be no improvement in quality. The evidence shows that donated labour as measured by unpaid overtime does tend to be higher in the third sector than the private sector. Gregg et al. (2008) find that people working in caring industries in the not-for-profit sector are 12 per cent more likely to do unpaid overtime than their equivalent in the private sector. However, they find that people do not change their unpaid overtime as they move sector. Rather it appears that the third sector attracts people who are prone to donate labour.

## Section 4: What has helped and hindered the development of the PSI Market in the UK?

- 4.1 Over the past decade there have been a number of government-sponsored reviews and reports which have touched on areas of relevance to this Review. These reports have recommended policy changes in areas ranging from procurement techniques and skills to enhancing the role of the third sector and partnership working (see Annex F for a summary of some of the most relevant work).
- 4.2 Notwithstanding the many changes underway, this section takes a longer term and broader look at the development of PSI markets in the UK. It considers, with the benefit of hindsight, what policies have helped and hindered the PSI's development, what other countries can learn from the UK's experience and how we can improve.
- 4.3 Four key policies have been identified as having helped the PSI develop and are described in this section of the report. These are:
1. The pursuit of contestability as a policy goal;
  2. The move from lower cost to more general 'value for money' criteria;
  3. Employment protection policies, such as TUPE; and
  4. The use of the PFI model.
- 4.4 Six areas which are preventing the full value of using the PSI to be realised were also identified:
1. Policy uncertainty;
  2. Poorly specified contracts;
  3. Lack of competitive neutrality in comparing bids;
  4. Inflexibility during contract delivery phase;
  5. Poor commissioning and project management skills; and
  6. Complexity and cost of the procurement process.

These are discussed in turn and recommendations are made for improvements in each area.

### Helpful Policies

#### **1. The pursuit of contestability**

- 4.5 The pursuit of contestability as a policy goal has clearly had an important role to play in the development of the PSI. The introduction of Compulsory Competitive Tendering (CCT) throughout the 1980s was a first step in this move to contestability. CCT was introduced in an attempt to bring greater efficiency to local government and health services through the use of competition. The initial phase introduced CCT

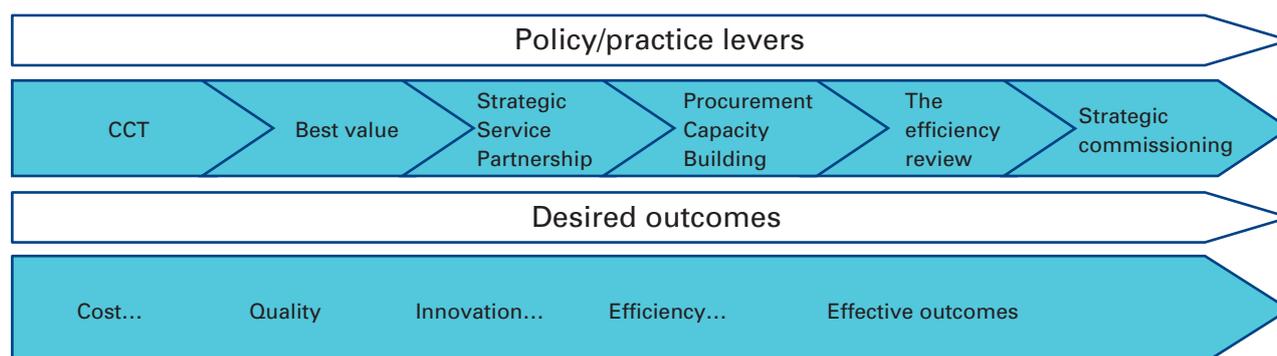
to construction, building maintenance and highways but this was later extended to virtually all blue collar jobs in local government and then yet further, to white collar and professional services and jobs including housing management, personnel, legal and financial services and information technology<sup>29</sup>.

- 4.6 Despite some early resistance by local authorities and health trusts, CCT is now widely considered to have been a key driver in the development of the PSI. CCT opened up markets to the private and third sectors on a scale that had not happened previously. This radical and highly visible step was necessary both for the supply side and the demand side of the market to develop. It allowed organisations to operate with greater scale economies and provided the incentive to make investment in capacity. The process is now sufficiently entrenched that compulsion has been removed and there is little evidence of a return to non-competitive ways of working.
- 4.7 CCT, however, was not without its problems. In particular it tended to place too much emphasis on lowering the costs associated with a particular service often to the detriment of other factors such as quality or employment conditions. Because of this, the focus of commissioning has now moved beyond this stage (Figure 4.1).

## 2. Value for Money

- 4.8 Ensuring that the quality of service is maintained or improved when competition is introduced into a market is very important, particularly as more complex services are involved. Policy has evolved<sup>30</sup> to take this into account and has moved towards a strategic commissioning approach to achieve effective outcomes over the long term, building on the concept of best value for money (Box 4.1).

**Figure 4.1: The move from CCT to a Strategic Commissioning Model<sup>31</sup>**



29 The Local Government Act 1988, and 1992.

30 Budget 2008 announced a government study of competition in a number of key public service markets where the government has committed to mixed provision. This work, being led by HMT, will examine opportunities for fair competition to deliver higher quality public services and improve value for money. The study will focus on 3 sectors – Childcare, Adult Skills and Offender Management but will also look to draw out broader insights applicable to other public service markets where appropriate.

31 *Developing the local government services market to support a long-term strategy for local government*, DCLG/PwC (2006).

#### **Box 4.1: What is value for money and how can it be achieved?**

Value for money is not about achieving the lowest initial price: it is defined as *'the optimum combination of whole life costs and quality'*<sup>32</sup>.

This can be achieved by:

- reducing the cost of purchasing and the time it takes – the processing overheads;
- getting better value for money for goods and services purchased and improved quality of services;
- improving project, contract and asset management;
- making procurement decisions on the basis of a long term view of value for money so that the focus is not on the lowest price;
- combining competition with innovative ways of procurement while managing the risks effectively;
- drawing on latest advances in electronic commerce and good procurement practice; and
- using a range of tools available which promote and can measure value for money gains.

4.9 This move towards value for money has been critical to the development of the PSI. Focusing on cost alone neglects a number of key issues and in competitive circumstances can lead to the 'winners curse' – where the lowest bidder finds that it is unable to make a profit at the price it has promised.

### **3. TUPE**

4.10 The third key policy that has been identified as beneficial to the development of the PSI is TUPE (Box 4.2). TUPE protects the rights of staff who transfer from the public to the private sector and has applied to virtually all service provision changes since April 2006.

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32 *Regularity, Propriety and Value for Money*, HMT (November 2004).

**Box 4.2: What is TUPE?**

TUPE is an acronym for the Transfer of Undertakings (Protection of Employment) Regulations adopted by the UK in order to implement the European Acquired Rights Directive. The Regulations were first passed in 1981 and then overhauled in 2006. The purpose of TUPE is to protect employees if the business in which they are employed changes hands. Its effect is to move employees and any liabilities associated with them from the old employer to the new employer.

**When does TUPE apply?<sup>33</sup>**

TUPE applies when employers:

- sell or buy part or all of a business as a going concern; or
- outsource or make a “service provision change” involving either (a) an initial transfer (e.g. where services transfer from the customer to an external contractor); (b) a subsequent transfer (e.g. where services transfer from the first external contractor to a different external contractor; and (c) the bringing back in-house (e.g. where services transfer from an external contractor back to the customer); or
- grant or take over a lease or license of premises and operate the same business from those premises.

Public bodies will generally require the provider of services to undertake to behave as if TUPE applied, regardless of whether it does apply as a matter of law.

- 4.11 TUPE has facilitated the transfer of skills from the public to the private and third sectors. In many cases this has been key to the success of the PSI as it has allowed employees with valuable experience in public service delivery to bring their skills and expertise to the private and third sectors. TUPE has also addressed the natural concerns of staff whose employment changes and, in doing so, has diffused much of the antagonism towards outsourcing public service provision.
- 4.12 Public sector unions have raised questions about whether the rights of workers protected through TUPE are declining over time especially when they are promoted or change jobs. In addition, as contracts are won by new companies and staff transfer again, a patchwork of different protection can arise. Section 3 summarises a recent NAO study that addressed this issue. It found that transferred staff generally retained or even improved their wages over time relative to their counterparts in the private company. However, it is undoubtedly true, as in the private sector more broadly, that a variety of employment terms and conditions exist for staff who joined a firm at different times and with different tenure in their jobs.

<sup>33</sup> Employees whose employment is being transferred to a new employer can refuse to transfer (or “opt-out”), but they can lose valuable legal rights if they do. TUPE states that “all the transferor’s rights, powers, duties and liabilities under or in connection with the transferring employees’ contracts of employment are transferred to the transferee”. This all-embracing concept encompasses rights under the contract of employment, statutory rights and continuity of employment and includes employees’ rights to bring a claim against their employer for unfair dismissal, redundancy or discrimination, unpaid wages, bonuses or holidays and personal injury claims etc.

#### 4. Use of the PFI model

4.13 One of the major innovations in public service delivery over the last twenty years has been the Private Finance Initiative (PFI). Under the PFI model a public sector body procures a multi-year bundle of services rather than an asset from a private contractor. The PFI supplier is responsible for provision of any assets required to deliver the service and also for raising the necessary finance. They are compensated for this through an annual service charge levied on the public sector body, and/or fees paid by users of the service<sup>34</sup>. For most PFI projects this allows the public sector to substitute a stream of annual payments over the life of the project for a large up-front capital expenditure. It does not mean that the government avoids paying in full for the service, only that the timing of its expenditures has changed (Box 4.3).

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<sup>34</sup> An example of the latter would be a toll bridge.

### Box 4.3: The History of PFI

The Private Finance Initiative (PFI) was introduced in 1992 as a means to facilitate greater investment. It represented a relaxation of the so called 'Ryrie Rules' which constrained the use of private sector funding to situations where:

- it could be demonstrated to be more cost effective than a comparable publicly funded project; and
- it resulted in a corresponding reduction in public spending.

The guiding principles of the government's PFI programme as laid down by the Chancellor at the time were<sup>35</sup>:

- the private sector must genuinely assume risk without a guarantee by the taxpayer against loss;
- value for money must be demonstrated for any expenditure by the public sector; and
- all new public sector capital projects must be tested for private sector potential before they are approved.

Following the change of government in 1997 the PFI process was reviewed and the requirement to test all capital projects for PFI potential was dropped. The review led to the establishment of the PFI taskforce within HMT to develop the appropriate expertise within government. This was superseded in 2000 by Partnerships UK, itself a Public Private Partnership jointly owned by industry and government which operates at arms length from HMT.

Uptake of PFI was slow initially, but took off dramatically after 1995. It peaked in 2000 with over 70 contracts signed that year with a combined capital value of £3.5bn. Subsequently the number of deals signed each year has fallen slightly, although their average capital value has continued to increase. HMT currently tracks 628 signed PFI deals with a combined capital value of £58.6bn<sup>36</sup>. Five areas account for two thirds of all projects and 85 per cent of the capital value. These are Transport, Health, Defence, Schools and the Scottish Government.

Current HMT guidance states that PFI should only be used where it delivers value for money and does not come at the expense of employees' terms and conditions. In particular PFI is no longer used for new IT projects or very small projects, following studies which have shown it does not tend to deliver value for money in these areas<sup>37</sup>.

35 *Private Finance: Overview of progress, News release 118/94*, HMT (8 Nov 1994).

36 *The Private Finance Initiative (PFI) : Signed Projects List*, HMT (2008).

37 For example HMT (2003) *PFI Meeting the Investment Challenge*, HMT (2006) *,PFI Strengthening Long Term Partnerships* and HMT (2008) *Infrastructure Procurement: Delivering Long Term Value*.

- 4.14 Submissions to the Review have pointed to the role of PFI projects in helping to develop the PSI market. For example, the long lived nature of the contracts coupled with an expectation of a stream of future opportunities encouraged providers to invest in the UK prison services market. Key to this was a clear political commitment to ongoing use of PFI as a procurement approach.

## Problem areas

### 1. Policy uncertainty

- 4.15 A consistent concern of stakeholders in the call for evidence and roundtable discussions was the need for a clear commitment by Ministers and local authorities to the long term involvement of the PSI in public service delivery. These comments came not only from private and third sector providers but also from public sector officials involved in the commissioning process. They expressed concern that changes in political direction risk undermining long run partnership arrangements, lead to delays in project delivery and increase the costs of commissioning. International firms that operate in the PSI across a number of countries also highlighted the importance of political will and an explicit commitment to maintain competitive public service markets to their decisions about where to invest.

- 4.16 These factors are summarised in responses to the call for evidence:

*'...most major companies will constantly review the market sectors and programmes in which to invest time and resources. The most attractive will be those in which there is an identifiable pipeline of opportunities emerging from consistent and committed policy. Companies will simply not invest in areas where there is constant change of direction or uncertainty in anything beyond the immediate horizon, particularly if there are other sectors – or other countries – that do offer more stable forward programmes. A classic example would be the acute hospital PFI market, in which the competition diminished to virtually nothing as the programme was chopped and changed. The converse is BSF (Building Schools for the Future), in which the clarity of the programme over many years has attracted many entrants, and there are multiple bidders for every opportunity. Companies are not afraid of a competitive environment, but they will only invest precious resources into a stable market.'* (Amey)

*'We select international markets due to a number of characteristics and one key area is the government's appetite for bringing about real and sustainable social reform'* (A4e)

- 4.17 Long term commitment from government authorities is important for several reasons<sup>38</sup>.
- Having a programme of work allows both commissioners and suppliers to learn from experience as the process progresses.
  - The risks to organisations entering the market are reduced as they are not linking their entire investment to a single contract. This is particularly important when bid costs are high.

<sup>38</sup> Clear visibility of a future stream of opportunities is often cited as one of the key reasons why the involvement of the private sector in prison services has been broadly successful (see Box 3.2).

- A programme of work encourages organisations to make a longer term commitment in terms of investing in the necessary people and skills. Where commitment is less clear, a higher risk premium will be included in the price offered.

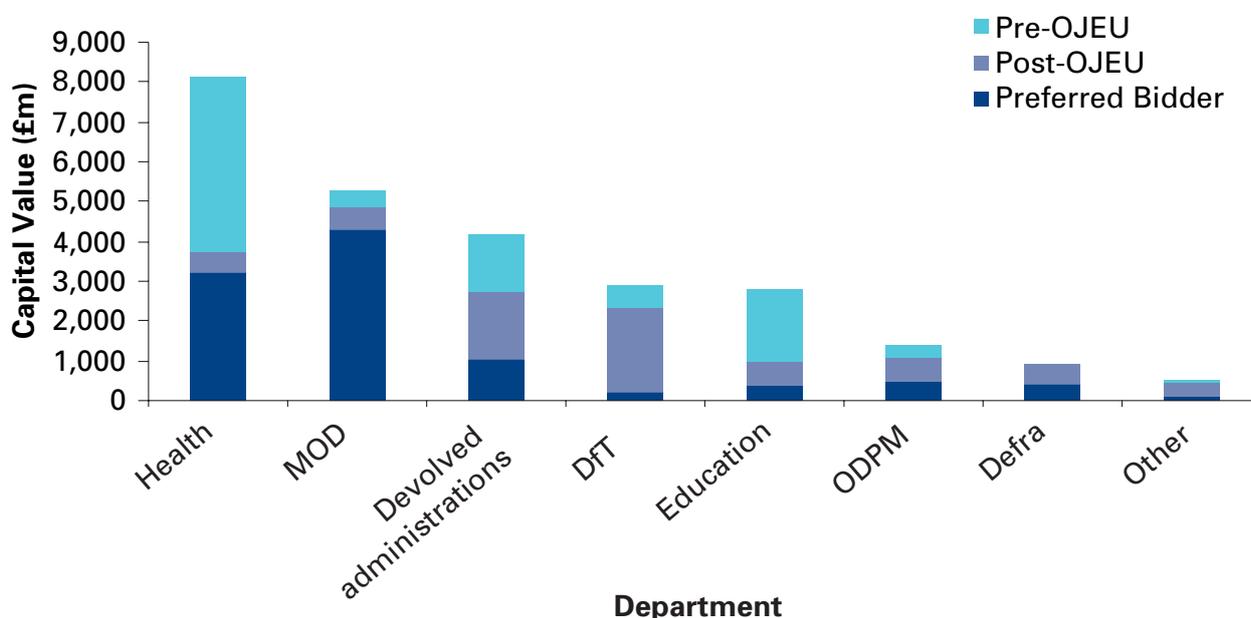
4.18 The government has on occasion published plans of procurement activity. One such example is the pipeline published in HMT's report on PFI (Figure 4.2). Some local authorities also publish such plans but the level of detail varies and the practice is not widespread.

### Recommendation 1: Long term commitment

Government authorities need to reinforce and demonstrate their long-term commitment to open up public service markets and maintain effective competition.

- Departments and local authorities should develop pipelines of tendering opportunities with indicative timescales, updated annually at budget time.
- Information on these tendering opportunities should be made available to all enterprises<sup>39</sup>.

Figure 4.2: Deal pipeline by sector department, 2006



Source: HMT, PFI: strengthening long-term partnerships, March 2006

39 The Glover Review to be published alongside the 2008 Pre-Budget Report will contribute to this objective; by specifically identifying the appropriate channels through which businesses can gain information on possible PSI projects.

## 2. Poorly specified contracts

4.19 A lack of clarity by commissioners over the outcomes desired from a project results in poorly specified contracts. This problem is well recognised and over the past few years there has been a move towards more sophisticated commissioning techniques which seek to contract for outcomes (or at least outputs). An example of this is the Department of Health's programme of 'World Class commissioning' which aims to 'deliver a more strategic and long term approach to commissioning services, with a clear focus on healthcare outcomes'<sup>40</sup>.

4.20 This focus on outcomes, although sometimes difficult to specify and monitor, is important as it means that providers do not have skewed incentives to meet process targets and that they have room to innovate. However, despite much progress in this area, most commissioners and providers consulted during this Review felt that there is still considerable room for improvement.

*'Particular issues for the private sector are...Public sector lack of understanding/ definition of required outcomes which can result in abortive work during the bid phase, and may escalate as a consequence of the EU Competitive Dialogue procurement process'* (VT Group)

*'Where commissioners have a clear vision of desired outcomes the appropriate providers from across the public, third and private sectors are more likely to be optimally engaged'* (Aveco)

4.21 If objectives are not made clear, bidders may submit unsuitable responses to tender. This may reduce the competitive pressure, require bids to be re-submitted or ultimately call into question the fundamental decision to consider private and third sector providers to deliver the service. Such consequences are costly for all parties involved.

4.22 In practice, specifying the essential outputs and outcomes sought from the procurement of public services is not always easy. Public services required to meet the needs of individuals or groups of individuals are often complex. The outcomes to be achieved will usually include a range of desired outcomes for service recipients. These need to be captured in the service requirement specification.

4.23 For this reason it is important that those involved in the commissioning process have sufficient knowledge of the market and users' requirements. Providers themselves are often the best source of this information as highlighted in an OTS report<sup>41</sup> which states that commissioners should 'Develop an understanding of the needs and communities by ensuring that, alongside other consultees, they engage with third sector organisations as advocates to assess their specialist knowledge'.

40 [www.dh.gov.uk/en/Mangaingyourorganisation/Commisioning/Wordclasscommissioning/index.htm](http://www.dh.gov.uk/en/Mangaingyourorganisation/Commisioning/Wordclasscommissioning/index.htm).

41 *Partnerships in Public services: An Action Plan for Third Sector Involvement*, OTS (2006).

4.24 Ensuring the required outcomes are made clear in contracts will need continuing endeavour. Spreading best practice – promoting and publicising examples of procurement that does capture service outcomes well – will be an important element of this. One strand of work to take this agenda forward is being financed by the HMT/ Cabinet Office Invest to Save Budget. This work is being carried out by a consortium led by the Office for National Statistics<sup>42</sup>. The aim is to construct a procurement tool based on model specifications of the multidimensional service domains sought from particular key public services. Work to date has concentrated on Adult Social Services and Pre-School Education Services but will be extended to cover other services. The interim report of this work will be published in July 2008 and the final report in December 2009.

### ***Multiple objectives in the procurement process***

4.25 A separate but related concern was that the procurement process is increasingly being used to achieve wider government objectives such as encouraging the development of small business<sup>43</sup> and contributing to environmental or social goals<sup>44</sup>. Having numerous objectives makes the process more complicated and costly both for those bidding and for those evaluating the bids. This cost should be factored into decisions on the appropriateness of such objectives. In many cases tax or regulatory instruments should be preferred.

4.26 Where procurement is used to achieve wider goals, setting minimum standards is often the best approach. For example, specifying minimal environmental requirements will clarify the objective for bidders and avoid the need for commissioners to make difficult assessments when comparing bids on a range of different factors. However, it will be important that the potential to increase costs and the impact on the number of bidders is taken into account when setting the requirements.

4.27 It was generally accepted by stakeholders that multiple objectives are likely to continue, and often for valid reasons<sup>45</sup>. Indeed these objectives are sometimes fundamental, for instance where the service is responding to specific, project-related environmental or social needs. Stakeholders' primary concerns were that these wider objectives are not always made clear at the outset and sometimes alter during the bidding process. This has led to problems for bidders as they are not able to tailor their bids to fit the final requirement and in some cases ended up bidding for work whose redefinition meant that they had little chance of winning.

42 Including the National Council for Voluntary Organisations, the National Institute for Economic and Social Research, the Personal Social Services Research Unit and Kent, Manchester and Sheffield Councils.

43 The Glover Review is for example looking into the feasibility of setting a target for Government contracts given to SMEs.

44 *Sustainable procurement in Central Government*, NAO (2005).

45 The Office of the Third Sector CO, is currently undertaking work to explore how social clauses can be used to maximise social value in procurement.

### Recommendation 2: Clear and consistent objectives

Commissioning objectives should be clear, consistent and balanced so that value for money (the optimal combination of quality and whole life costs) is maximised.

- Contracts should focus on outcomes or outputs where these can be measured either directly or through user surveys.
- Contracts should be less prescriptive to leave room for innovation, and payment incentives should be symmetrical so that quality improvement is rewarded as well as under-performance penalised.
- Multiple objectives for wider social and environmental goals should be used sparingly and applied consistently through the bidding process, so that requirements are clear and assessment is more transparent.

### 3. Lack of competitive neutrality in comparing bids

4.28 A very important but often misunderstood concept relating to public sector procurement is that of competitive neutrality. The basic idea is a simple one; that competition should be open and fair between different classes of providers – public, private and third sector. Ensuring that it is delivered in practice is much more difficult, as the policy instruments that tilt the playing field cut across competition law, procurement policy, regulation and tax.

4.29 In one sense the term competitive neutrality is a misnomer in that there will always be inherent differences between different classes of providers and some of these differences may provide them with a comparative advantage (or disadvantage) in particular types of procurement. However, where these differences are created by government policies and where they act as a barrier to effective competition, government should take steps to remove or correct for them as part of the bid comparison process.

4.30 Submissions to the review have highlighted concerns about the UK's competitive neutrality framework, including:

- **Tax Treatment**

There are inconsistencies in how taxation is applied to public, private and third sector providers. Whilst these reflect their differing roles in the economy they may also be a source of unfair advantage.

- **Pension Obligations**

Private and third sector providers must explicitly recognise pension costs on their balance sheets whereas public sector providers don't; this can give public sector bid teams an advantage due to the different treatment they receive.

- **Pre-Qualification / Bid Criteria**

Government often restricts competitions to organisations with a clear track record in the area in order to ensure they have the appropriate expertise. This can limit the ability of new entrants to break into the market.

- **Lack of Shared Information**

Where there is a lack of shared information on current service levels or the costs of providing them, incumbents are likely to have an advantage over other bidders.

- **Ability to Manage Risk**

Private and third sector organisations can only take on financial risks up to the level of their balance sheets and should only be expected to shoulder risks that they can influence, such as cost overruns.

- **Transition Costs**

A challenger to the incumbent provider of a service will incur start-up or transition costs if it wins the bid. Where these are likely to be significant, they could outweigh other cost advantages and thereby limit competition.

- 4.31 The UK government does not have an explicit competitive neutrality framework, preferring to work through a variety of policy measures such as competition law, government accounting rules etc<sup>46</sup>. Although a number of these issues lie outside the remit of this Review, there is a need to ensure that the government's strong commitment to a level playing field in procurement is being delivered.

### **Recommendation 3: Competitive Neutrality**

Commissioning processes and bid evaluation should strive for a level playing field ('competitive neutrality') between public, private and third sector bidders.

- HMT should continue to provide guidance to commissioners on how to consider the following factors when evaluating bids<sup>47</sup>:
  - tax treatment – including income tax, VAT and investment tax reliefs; and
  - pension obligations and costs.
- Commissioners should ensure that this guidance is followed and also that:
  - pre-qualification and bid criteria do not unnecessarily restrict SMEs or third sector enterprises;
  - information on current service levels and costs is provided to all potential bidders to avoid favouring incumbents; and
  - the costs of transition from incumbent to a new provider are clearly considered when comparing bids.

<sup>46</sup> For example 'Managing Public Money' contains guidance on how to ensure that public bodies selling services into competitive markets recover the full costs of providing that service.

<sup>47</sup> Guidance on VAT and pensions is already available in HMTs (May 2005) *Improving financial relationships with the third sector: Guidance to funders and purchasers*.

#### 4. Inflexibility during the contract delivery phase

- 4.32 Essentially a commissioning process has two main phases of interaction between the contractor and provider: pre- and post-contract. The pre-contract phase includes discussions around the details of the contract specification and the costs of delivery, leading to the selection of preferred bidder and contract signing. This phase is inherently and rightly competitive both among bidders and between the bidders and the commissioning authority. The second and much longer phase is post-contract delivery which involves ongoing project monitoring. During this phase the two parties need to work together to respond appropriately to any unforeseen changes that impact on the delivery.
- 4.33 Private and third sector stakeholders have commented that the working relationship is often better before contract signing than after. Once contract monitoring commences the attitude of the public sector commissioners is often inflexible towards dealing with changing conditions. This stifles innovation over the course of the contract and, in the worst cases, may jeopardise its overall success.
- 4.34 As discussed in Section 2 there is significant empirical evidence that a collaborative or partnership model of working achieves good outcomes as both parties have incentives to be pragmatic in responding to changing conditions. This view was echoed both by stakeholders in the private and third sectors and those on the commissioning side, with the proviso that relationships need to be managed so as to ensure that competitive neutrality is not compromised.
- 4.35 The term partnering is used widely within government and the private sector, but has no commonly agreed definition. It is an umbrella term to cover a variety of collaborative arrangements, behaviours and working practices. When used in this context it does not refer to formal commercial partnerships as defined by the Partnership Act 1890. Partnering arrangements can vary widely in scope, from loose working arrangements operating under agreed principles, to a formal PFI contract. The term PPP (Public Private Partnership) covers the broad range of more formal contractual partnering arrangements. A summary of the range of partnering approaches is provided in Figure 4.3, ranging from the most to least flexible arrangements.

Figure 4.3: Type of partnering arrangements<sup>48</sup>

Type of Arrangement	Description	Advantages	Disadvantages
<b>Framework Agreements</b>	An overarching document that is signed between a condensed number of suppliers/service providers and the contracting authority. Commonly used for consultancy or construction.	Aims to reduce long-term contracting costs, and encourage relationship building.	Sometimes overburdened with mini-competitions. Only suitable when a reasonable flow of service provision is required.
<b>Long-term Customer Supplier Agreement</b>	An agreement covering irregular and uncertain workflow.	Useful when demand is uncertain (and when service delivery is required quickly).	Difficult to specify requirements. If used for too long a period market is not contested.
<b>Alliancing</b>	Alliancing is a term used to describe delivery models in which the focus is on encouraging collaboration through the use of payment mechanisms that ensure that the interests of all parties are aligned with the project objectives.	Enables work to go forward, despite uncertainty. If agreements are designed intelligently, can lead to a more co-operative, less adversarial relationship between public sector and private sector partners.	All major risks continue to lie with the public sector. Demanding for public sector in terms of both negotiation and ongoing project management.
<b>Local Education Partnerships (LEP) &amp; Local Improvement Finance Trusts (LIFT) variant models of PFI/PPP</b>	A joint venture company that is majority owned by a private sector partner that delivers an initial tranche of work leaving subsequent work to be commissioned by the public sector partner. Developed partly to facilitate infrastructure development in some situations where a conventional PFI scheme might be less suitable.	Lower procurement costs over project life. Flexibility over programme delivery. Ability for public sector to retain influence over strategic direction of investment. Potential for continuous improvement throughout successive phases of work. Early commercial input from private sector partner	Conflict of interest for strategic partner. Reliance on benchmarking to ensure value for money. Strong disincentives to utilise alternative providers, however this can be mitigated by introducing competition between LEPs and LIFTs.

48 Many of these partnering arrangements are more fully described in *Building Flexibility, New Delivery Models for public infrastructure projects*, published by Deloitte (2006).

Type of Arrangement	Description	Advantages	Disadvantages
<b>Integrator Model</b>	A method of maintaining the overall competitive pressure by retaining the basic structure but separating the role of the strategic partner from that of direct delivery. Project development is carried out by a private sector partner but has less of a direct role in service provision.	Similar to LEP and LIFT models. Clarity of roles and responsibilities (less conflict of interest). Improved competitive pressure. Involvement of a wider range of organisations, including SMEs.	If the appointment of the strategic partner takes place before any fixed price tender for works there is less assurance about their skills and capacity to commission the appropriate services. The lack of an integrated supply-chain.
<b>Private Finance Initiative (PFI)</b>	The method to construct, maintain and manage public facilities by using private capital, management skills and technical abilities.	Ability to spread the cost over the lifetime of an asset. Greater predictability over cost and timing. Focus on value for money over lifetime of asset Strong performance incentives	Level of investment requires well funded corporate involvement. Length of procurement time. Inflexibility of PFI contract post-construction.
<b>Joint venture partnership</b>	A joint venture company is set up to jointly deliver a public service.	Joint accountability. Appropriate risk allocation Shared rewards.	Difficulties in ending the contract or contesting the market.

4.36 Partnership arrangements vary in the degree to which interests, incentives and rewards are aligned. In some areas it will be vital that interest between the public sector and the PSI provider are well aligned, and this may influence the type of partnership selected. In other areas of public service provision a divergence of interests may exist, but clear contracting should provide satisfactory outcomes for both client and provider.

4.37 Partnering is not a panacea, nor is it a substitute for effective competition. Many of the disciplines required for an effective partnership are common with any successful commercial relationship. However the long term nature of partnering arrangements requires particular attention to a number of factors as summarised in Box 4.4.

**Box 4.4: How to gain the most out of partnership working*****Clear Joint Objectives***

The collaborative nature of partnering means that it is only effective where the participants have a well defined common objective.

***Mutual Understanding***

Although partnering agreements are defined around a joint objective, the formal and informal arrangements put in place need to recognise that the participants will also have potentially conflicting objectives of their own.

***Developing the Ongoing Relationship***

By its nature partnering is not suited to short term or static relationships as its benefits primarily derive from a collaborative approach to proactively developing and adapting the relationship over time.

***Appropriate Risk Sharing***

In any commercial relationship risks should ideally be borne by the party best placed to manage them. The long term nature of partnering makes this even more important.

***Opportunities for Innovation***

The flexibility of a partnership is conducive to innovation because it can better accommodate changes in technology or consumer demand that make new approaches more efficient.

***Flexibility***

Without flexibility to adapt to changing conditions, new technology and emerging risks the partnering approach cannot deliver its key benefits.

- 4.38 Partnership working is not appropriate in all cases, and in some instances a simple procurement contract may be most appropriate. However, for public services the key aim is typically long term delivery of complex services in a changing market place. In these circumstances it is not possible to account for every possible eventuality in a contract specification (indeed, it would be prohibitively costly and time consuming to do so) so it is particularly important for providers and commissioners to sustain good working relationships over the full life of the contract.

### Recommendation 4: Partnerships

Partnership approaches between contractor and provider should be encouraged, especially in the post-contract monitoring stage when both parties have the common objective of delivering better public services.

## 5. Poor Commissioning and Project Management Skills

4.39 One issue which permeates all stages of the commissioning cycle is the quality of the skills and expertise within government. It is ultimately people who procure, manage and deliver public services and where these competencies are not fully developed or in short supply, it is almost inevitable that problems will arise.

4.40 People involved in commissioning and project management need a wide range of competencies in order to deliver value for money to the taxpayer. For example, in its 'Improving Procurement' report the NAO<sup>49</sup> identified the key skills of procurement staff as<sup>50</sup>:

#### *Management and Personal Skills*

- Develop relationships with customers and other professional groups in departments;
- Apply and encourage others to apply best practice; and
- Negotiate with customers and suppliers.

#### *Technical Skills*

- Apply public procurement principles and legal requirements, for example UK and European law;
- Prepare tender and contract documents;
- Understand how prices are arrived at, estimate cost, and the ability to identify and manage risk; and
- Understand markets.

4.41 Clearly the role of the procurement professional is far broader than simply managing the procurement process. Procurement staff need to understand the market in which they operate and be comfortable discussing strategic issues with policy makers, suppliers (both public and private sector) and specialist advisers such as lawyers, competition experts etc.

<sup>49</sup> *Improving Procurement*, NAO (2004).

<sup>50</sup> Note that here the NAO is using the term 'procurement' to cover the whole commissioning cycle; the studies referred to below also implicitly use a similar definition.

### **Evidence on Procurement Skills within Government**

4.42 The need to improve procurement skills has been recognised for some time within government, leading to a number of policy initiatives including the setting up of the Government Procurement Service in 1999. Despite this the NAO concluded in its Improving Procurement report that:

*“Having a well developed professional procurement capability with the expertise and commercial acumen to deal with these and other issues is, therefore, a key requirement for most departments. Until recently, however, procurement expertise has not been well represented in departments and has not usually been a competency required of senior managers.” (NAO 2004)*

4.43 This theme resurfaced in subsequent departmental and wider government reviews, for example in the gap analysis supporting its Enabling Acquisition Change<sup>51</sup> report the MOD observed that:

*“The MOD possesses skilled and highly motivated staff. There are, however, differences between Military and Civilian approaches to management of the human resource. Training is fragmented and there is a low level of interchange with industry. Reward mechanisms are insufficient.*

*The Department lacks sufficient commercial expertise, has low levels of professionally qualified staff. Staff are not managed to maximise the performance of acquisition community. Reward mechanisms are not fully utilised. Lack of means to encourage specialists to develop areas of expertise.”*

4.44 The MOD report recommended that steps be taken to reinforce the message that improving skills at every level of the acquisition process was key to improving performance. It also advocated the creation of a strong commercial directorate around the newly appointed Defence Commercial Director, with the latter having authority over the operation of the procurement process across the department.

4.45 In the first wave of procurement capability reviews<sup>52</sup> carried out by the OGC a key theme which emerged was ‘The shortage of skilled and experienced procurement professionals, with sufficient visibility’. Within this the review teams noted:

- skills issues were central to many of the problems identified;
- there is a shortage of in-house commercial expertise, particularly at senior levels of the organisations reviewed and as a result, there is an over-reliance on external advice;
- there are disparities between departments in terms of the value attached to specialist procurement skills such as contract management; and
- there was a clear link between the effectiveness of the commercial leadership in a department and its business delivery.

51 *Enabling Acquisition Change*, MoD (2006).

52 *Procurement Capability Review: Trance One Report*, OGC (2007).

4.46 Evidence of the skills gap at the local government level has been assembled by the Audit Commission<sup>53</sup> It found that out of a sample of 95 local authority inspections between 2001 and 2006, almost three quarters contained at least one recommendation concerning capacity /expertise and out of the 786 recommendations made in these reports 231 related to this theme. Drawing on survey data from the ODPM, they found that lack of staff ability in procurement systems was perceived by local authorities to be the single largest barrier to improving procurement.

### ***Reform of the Government Procurement Service***

4.47 Partly in response to these findings HMT re-launched the GPS in 2007 with the Chief Executive of the OGC as its new professional head<sup>54</sup>. The intent of this reform was to establish the GPS as a professional body similar in status to the Government Economic and Statistical services. In its new role the GPS will set the standards for procurement professionals, enable better sharing of best practice, provide career development and training as well as a greater coherence in terms of procurement roles between departments. The programme of departmental procurement capability reviews referred to above is a key component of this process. Permanent Under Secretaries will be held responsible for delivering their recommendations and progress will be assessed in follow on reviews every two years.

### ***Project Monitoring***

4.48 Compared to the vast amount of attention given to procurement, the focus on project monitoring and management has been sorely neglected. This is the longest stage of the PSI's involvement in a project and is of key importance for the effective delivery of high value public services. A clear framework for monitoring the benefits delivered, addressing issues as they arise and recording lessons learned should be a central component of any project.

4.49 This remains an area in which there is scope for significant improvement within both the public and private sectors. Submissions to the Review have stated that there can be too much emphasis on 'getting something delivered' and not enough on what happens afterwards, particularly in terms of an effective customer-supplier relationship. There is substantial evidence that a flexible and open partnership during this phase of the project delivers greater benefits than an arms-length relationship (see Recommendation 4).

4.50 Key to addressing this issue is having the right people, with the right skills on both sides of the relationships. Good project managers are in short supply and more needs to be done to ensure that best practice is spread across the public sector.

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53 *Healthy Competition*, Audit Commission (2007), *For Better or For Worse*, Audit Commission (2008).

54 *Transforming Government Procurement*, HMT (2007).

## Summary

- 4.51 The issues surrounding the recruitment, retention and development of 'procurement people' have been recognised by government in a variety of studies. However there has not been sufficient focus on the whole of the commissioning cycle, including strategic market planning, project management and evaluation.
- 4.52 The reform of the GPS is a welcome step, but needs to be reinforced by actions within departments to ensure that an effective, co-ordinated and influential commercial function is built up across central and local government. Accountability for delivering this agenda needs to be at the most senior level within government departments and local authorities to ensure that high level staff with leadership experience are recruited (from outside government if necessary) so that these changes actually happen. With this in mind the Review makes the following recommendation:

### Recommendation 5: Commissioning Skills

A Director of Service Delivery should be appointed for all departments and local authorities with a substantial service delivery function. This post should be at a very senior level with accountability for the delivery of public services, whether purchased from the PSI or kept in-house. Their involvement would extend through the full commissioning cycle – not just the initial procurement - and they would be the high level client interface when problems with service delivery arose. They would also ensure that their procurement and contract monitoring staff receive adequate training, supported by OGC and DCLG to accelerate 'learning by doing' and sharing of experience.

- For the government departments most involved with service delivery this post should be at management board level.
- For large local authorities this post should be at executive director level

## 6. Complexity and cost of the procurement process

- 4.53 A number of stakeholders commented that the costs of bidding for PSI contracts were becoming prohibitively high and this was causing them to consider exiting some PSI markets. This concern has come from both large commercial contractors who compete for major projects and from the smaller and third sector providers who generally bid for smaller contracts but who also have smaller bidding budgets. There is evidence that the situation has deteriorated in recent years and fears that it will worsen further as additional objectives are placed on procurement and with use of the competitive dialogue process which can introduce further delays.

- 4.54 The CBI conducted a survey of public procurement trends in 2007<sup>55</sup> and found an overwhelming majority felt that bid costs on like for like contracts had risen over the previous five years (52 per cent substantially, 36 per cent slightly) and that 84 per cent of respondents considered that bid costs were having a detrimental effect on competition, particularly through Small and Medium sized Enterprises (SME) participation. The most significant reason for high bid costs was “inadequate specification” (62 per cent), followed by the “absence of a standardised approach” (36 per cent).
- 4.55 Rising bid costs are not only a problem for bidders but also for government as:
- the internal costs of managing bid processes increase;
  - contract prices rise as suppliers aim to recover bid costs<sup>56</sup>; and
  - higher costs of bidding lead to a reduction in the number of bidders. This could lead to a less competitive outcome and higher costs for the project.
- 4.56 The last point is supported by a NAO report into PFI tendering<sup>57</sup> which found that 85 per cent of PFI projects included in their sample that closed prior to 2004 attracted three or more developed bids compared to 67 per cent for more recently tendered projects. One third of the projects included in their census, closing between April 2004 and May 2006 (with no differences between sectors), attracted only two bidders at the point they were requested to submit detailed bids. However, recent experience in programmes such as Building Schools for the Future (BSF) and primary healthcare services<sup>58</sup> has demonstrated significant bidder interest. This suggests that bidder interest may be higher in the early stages of a programme. As experience accumulates and the forward pipeline is shorter bidder interest may wane, as picked up in the NAO report. Commissioners will then need to be more active in promoting competition and simplifying the procurement process.
- 4.57 A comparison of tendering costs between PSI markets and private markets is difficult because of their different requirements. Perhaps the best comparison is for facilities management and IT services. PSI providers of IT services estimate that their bid costs for government contracts are often two to three times higher than for similar scope contracts for private sector clients. A recent facilities management contract for a UK Government department cost the successful PSI provider £350,000 in bid costs for an annual contract value of £10 million. A very similar contract in size and scope for a private sector client cost £180,000 to bid.
- 4.58 There may be a trade-off between maintaining competitive tension and the tendering costs incurred. This trade-off is likely to vary across markets. In mature markets, greater standardisation may allow for lower bidding costs, whereas less mature markets are likely to require a more costly commissioning process.

56 To compound the importance of managing tendering costs, it is not only the tendering costs from successful contracts that need to be recovered from those successful contracts, but, conceptually, also the costs of unsuccessful bids in a sustainable market. So if the costs of bidding for a £250m PFI contract are around £5m, but the probability of winning for any one company is only 20%, then for a sustainable market, each participant would be looking to recover not £5m, but £25m if successful in winning the contract. In this simple example this represents 10% of the overall project cost.

57 *Improving the PFI tendering process*, NAO (2007).

58 Over 50 bidders expressed interest in the St Paul's Way Medical Centre APMS tender, as reported in “Private Practice” in the BMA, June 21 2008.

- 4.59 Bidding costs will also be linked to the size and complexity of the project. At the most complex end the London Tube PPP cost bidders an estimated £275m (0.9 per cent of a total programme worth £30bn), whereas for a more standard PFI project the external advisor costs typically cost between 1.5 per cent to 3 per cent of capital costs for a commissioning process lasting just under three years. A more traditional outsourcing contract may not incur external costs, but will use significant internal resources in preparing the bid. Given the smaller size of these contracts, as a proportion of the contract cost, such costs can reach 10 per cent in many cases.
- 4.60 Some effort has already been made to reduce tendering costs. The NAO has made a number of recommendations and departments are working up best practice documentation of how long commissioning processes should take in standard PSI markets. This allows for greater transparency when commissioning processes have taken too long.
- 4.61 Further recommendations in the NAO report on PFI tendering, that have broader relevance to the rest of the PSI market include:
- obtaining commitment to the project from all key stakeholders at an early stage;
  - developing better output specifications, including greater dialogue with potential bidders about the design of assets, before approaching the market; and
  - establishing the affordability of the project before it is brought to the market and again before a preferred bidder is selected. In establishing affordability, authorities should calculate available resources against a range of scenarios;
- 4.62 Departments have also taken action to reduce procurement costs. Recent changes to the BSF programme produced a reduction in the overall procurement time from 82 weeks to 75 weeks. This was accomplished by using more comprehensive pre-qualification of bidding consortia; and selecting two lead bidders earlier in the process, after 29 weeks rather than 44 weeks.
- 4.63 Despite such positive steps, more needs to be done to reduce bid costs. Focussing on the timing of the bidding process seems to be an effective route, and this is incorporated into Recommendation 6.

### ***Competitive Dialogue***

- 4.64 The Competitive Dialogue process (described in Box 4.5) has raised concerns, in particular that it will further increase the time taken (and therefore expense) to procure services<sup>59</sup>.

<sup>59</sup> See *Unlocking the full potential of Competitive Dialogue*, CBI (May 2008) for a discussion of some of the issues identified.

**Box 4.5: What is Competitive Dialogue?**

Competitive Dialogue is a relatively new procedure which must be followed for all contracts which are considered to be particularly complex (when commissioning authorities are not objectively able to define the technical means capable of satisfying their needs or objectives and/or not able to objectively specify the legal and/or final make-up of a project). It originated from the EU Directive in 2004 and was introduced in the UK in the Public Contracts Regulations, taking effect from 31 January 2006.

Practically, competitive dialogue gives the commissioning authority the opportunity to discuss the form of the contract and technical specifications of the project before the issue of the key tender documents. The authority enters into a dialogue with potential bidders on a bilateral basis regarding any issues they may want to raise on the contract before the bidders are required to deliver their bids. The dialogue ends when the authority can identify the solution/s which meets its needs. If multiple solutions arise, authorities need suitable evaluation criteria to apply to a range of bids.

Competitive Dialogue replaces the negotiated procedure (which is now only used in exceptional cases) and is considered preferable given the possible discriminatory effects if negotiations take place after a preferred bidder has been chosen.

- 4.65 As the process is relatively new there is a limited body of evidence to judge how well it is working<sup>60</sup>. Feedback from stakeholders suggests that although potential bidders welcome the opportunity to engage in a discussion with the public sector to gain a fuller understanding of requirements they are concerned about the time a full competitive dialogue process can take and the additional costs that this imposes.

*'Some aspects of Competitive Dialogue have resulted in better engagement between commissioners and potential providers, although the prevailing view in the industry at present seems to be that in far too many cases, Competitive Dialogue is resulting in significant additional cost and delay' (Serco)*

- 4.66 There was also concern that intellectual property rights may not be respected if one bidder's suggested solution is then shared with other candidates. OCG/HMT have recently issued further guidance on Competitive Dialogue<sup>61</sup> which should go some way to addressing these concerns. In particular with regard to the protection of intellectual property they state that the contracting authority 'may not reveal to the other participants solutions proposed or any commercially confidential information communicated by a participant in the dialogue without that participant's agreement'. There have been concerns over how this will work in practice but the new guidance makes it clearer how these issues should be addressed:

<sup>60</sup> One example that has been documented and is available on the OCG website covers the work of the Olympic Delivery Authority (ODA) in 2006. *Delivery Partner Procurement using Competitive Dialogue A Lessons Learned Study*, ODA (2006).

<sup>61</sup> See *Competitive Dialogue in 2008 – OGC/HMT joint guidance on using the procedure*.

*'the Contracting Authority should set out in detail how it will undertake the dialogue process. One potential mechanism for managing the treatment of intellectual property or commercially sensitive information would be for the Contracting Authority to identify, and agree with bidders, which parts of their solutions are specific to them and should be treated as confidential, and which are of a generic nature permissible to share with other bidders. Having an agreed understanding of what constitutes bidder intellectual property allows the Contracting Authority to ensure its protection.'*

- 4.67 Where concerns remain, despite the new guidance, it is important that suppliers make use of the OGC Supplier Feedback Service to highlight these issues<sup>60</sup>. OGC can then note particular concerns and recommend further guidance or enforcement to address them.

### **Recommendation 6: Bid Costs**

Bid costs incurred by all parties should be reduced by agreeing clear and consistent objectives, simplifying bid documentation, reducing uncertainty around timing and engaging in earlier and more open communication about desired outcomes and risk allocation.

- Bidding timetables should always be published with the tender documents and actual timetables should be monitored by OGC and DCLG. 'League tables' of departmental and local authority performance against their plans should be published annually.
- OGC should monitor the procurement timescales under Competitive Dialogue over the next three years and take particular note of complaints to its Supplier Feedback Service from the PSI about intellectual property issues.

<sup>60</sup> Full details available at [http://www.ogc.gov.uk/procurement\\_policy\\_and\\_practice\\_ogc\\_supplier\\_feedback\\_service.asp](http://www.ogc.gov.uk/procurement_policy_and_practice_ogc_supplier_feedback_service.asp).

## Section 5: How can Government help the UK PSI to be successful in overseas markets?

- 5.1 As with many other industries, the Public Services Industry is becoming increasingly global. On the demand side, many governments are recognising the benefits of using private and third sector organisations to deliver public services. They look to countries with successful PSI markets to learn lessons and provide models for their own policy development. Rising per capita incomes in the emerging economies are driving an expansion in demand for services such as health and education as their citizens increasingly aspire to the standards of living found in the UK and other advanced economies<sup>63</sup>. They too are becoming part of this industry. On the supply side, private sector providers of public services compete in each other's markets and spread innovations developed in one country to others. They also make choices about where to bid for new contracts, depending in part on the reputation developed by different governments for competitive neutrality, cost of the bidding process and ability to partner effectively through the life of the contract. In this sense governments too are competing globally for the valuable project management and delivery skills in the PSI.
- 5.2 This section considers what the UK government can do to assist and benefit from the globalisation process in the PSI. This includes attracting foreign bidders for UK service delivery opportunities as well as promoting the activities of UK firms operating in overseas PSI markets. Encouraging and assisting firms to make the most of the growing export opportunities in this area will lead to substantial benefits not only for UK firms but also for the UK economy and domestic consumers of public services. Overall the Review concludes that the best way that government can support the PSI abroad is through maintaining and encouraging a dynamic and thriving PSI in the UK. Recommendations towards that end were developed in the previous section. This section adds a further recommendation related specifically to furthering the prospects of the UK PSI in overseas markets.

### The benefits of a thriving PSI in the UK

- 5.3 As mentioned above and supported in the call for evidence, the UK PSI is considered by many to be the most developed in the world. Policy towards the commissioning of public services has been innovative and has evolved to encompass a wide range of sectors and types of services. This enables UK firms to exploit the extensive skills and experience they have developed here to win business overseas.
- 5.4 Many UK companies have built their businesses by taking UK policy initiatives in areas such as welfare to work and rolling them out internationally. Experience gained in the UK has frequently been cited as key to achieving success elsewhere. There are many examples which illustrate this 'first mover' advantage stemming from policy action in public services markets:

<sup>63</sup> For example McKinsey (2006) have estimated that the demand for health care from urban Chinese consumers will grow at a rate of 12% over the next twenty years, with demand in India also projected to grow at a similar rate.

- UK companies like Serco and VT Group have used experience and skills acquired through operating in the UK PSI to become successful international businesses.
- American prison management companies dominated the first generation of prison contracts in Australia and the UK.
- Australian companies have used that country's lead in PPP toll roads to become major international players in the PPP roads market.

5.5 Companies interviewed during this Review repeatedly highlighted the importance of the UK government continuing to develop innovative ways of working with the private and third sectors as a driver for international business. Other countries have looked to the UK to learn lessons from our use of PPP and PFI. Partnerships UK, for example, frequently meet overseas representatives to discuss how the UK model can be applied elsewhere. There are also many advisory and finance firms who gained experience supporting PPPs and PFIs in the UK and who now generate significant export revenue from applying those skills abroad.

### How does the PSI in the UK compare to that in other OECD countries?<sup>64</sup>

5.6 An important determinant of the size of a country's PSI is the scale of overall public spending. Figure 5.1 presents a comparison of the UK with 5 other OECD countries where the PSI is of interest. The data are from the most recent year available in each case so are not exactly comparable. However, at this general level they are unlikely to change much from one year to the next. The lowest share of public spending among these comparator countries is Australia with 28.5 per cent while the highest are France and Sweden with over 50 per cent. The UK, at 42 per cent, falls roughly in the middle.

**Figure 5.1: Public spending as a share of GDP in selected OECD countries**

Billions	2005	2006	Per cent of GDP
US (\$)	4,536		36.5
Spain (Euros)		378	38.6
France (Euros)	919		53.6
Sweden (SEK)		1,575	54.3
Australia (Aus \$)		286	28.5
UK (£)		586	41.7

Source: Oxford Economics

Note: Overall public spending figure for the UK is a 2007/08 figure (source: PESA)

<sup>64</sup> The information here is drawn from the work undertaken by Oxford Economics commissioned as part of this Review. This study gathered information on the PSI in the US, Australia (although data here was more limited), France, Sweden and Spain to compare with the UK. Full detail is available in the report 'The Market for Public Services – International comparisons'.

5.7 Looking in more detail at the component of public spending used to procure services – which is defined as the PSI – some interesting differences emerge (Figure 5.2). Although Australia has the lowest share of public spending in GDP, the size of its PSI relative to its GDP is the same as that of Sweden. Conversely, despite spending over half its GDP through the public sector, the relative size of the PSI market in France is less than half that in Australia. The UK is towards the top end of this sample with a PSI of 5.7 per cent of GDP.

**Figure 5.2: PSI share of GDP in selected OECD countries**

Billions	Procurement of services (2005)	Procurement of services (2006)	Per cent of GDP
US (\$)	662.0		5.3
Spain (Euros)		27.9	2.8
France (Euros)	50.6		2.9
Sweden (SEK)		178.0	6.1
Australia (Aus \$)		61.2	6.1
UK (£)		79.4	5.7

Source: Oxford Economics

Note: 2007/08 UK figure (source: OE), UK GDP(2007, source: OE)

5.8 In terms of the absolute size of the PSI market in these countries, unsurprisingly the US dominates, reflecting the greater size of its overall economy (Figure 5.3). The UK is second and is substantially larger than any of the other countries considered.

**Figure 5.3: PSI spending in selected OECD countries on a comparable basis with the UK**

Countries	£bn at market rates
US	393.8
Spain	24.7
France	44.8
Sweden	16.4
Australia	32.3
UK	79.4

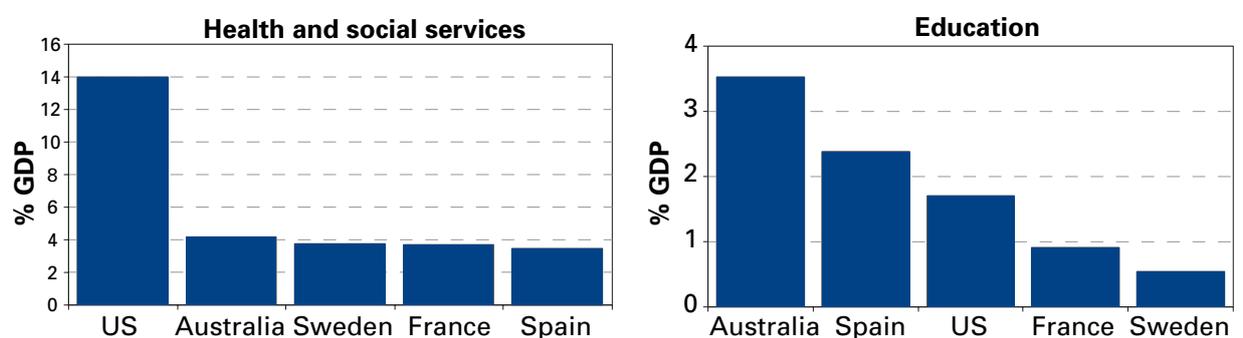
Source: Oxford Economics

Note: 2007/08 UK figure, other countries 2005 or 2006; updated to 2008 using a constant share of GDP and estimated market exchange rates.

## Health and Education

5.9 Considering specific areas of PSI spending, the most obvious difference across countries is the extent to which consumers pay privately for health and education. In the US, for example, private spending on healthcare accounts for 14 per cent of consumer spending compared with around 4 per cent elsewhere (Figure 5.4). In education there is more variation, with the proportions ranging from 0.5 per cent to 3.5 per cent of consumer spending.

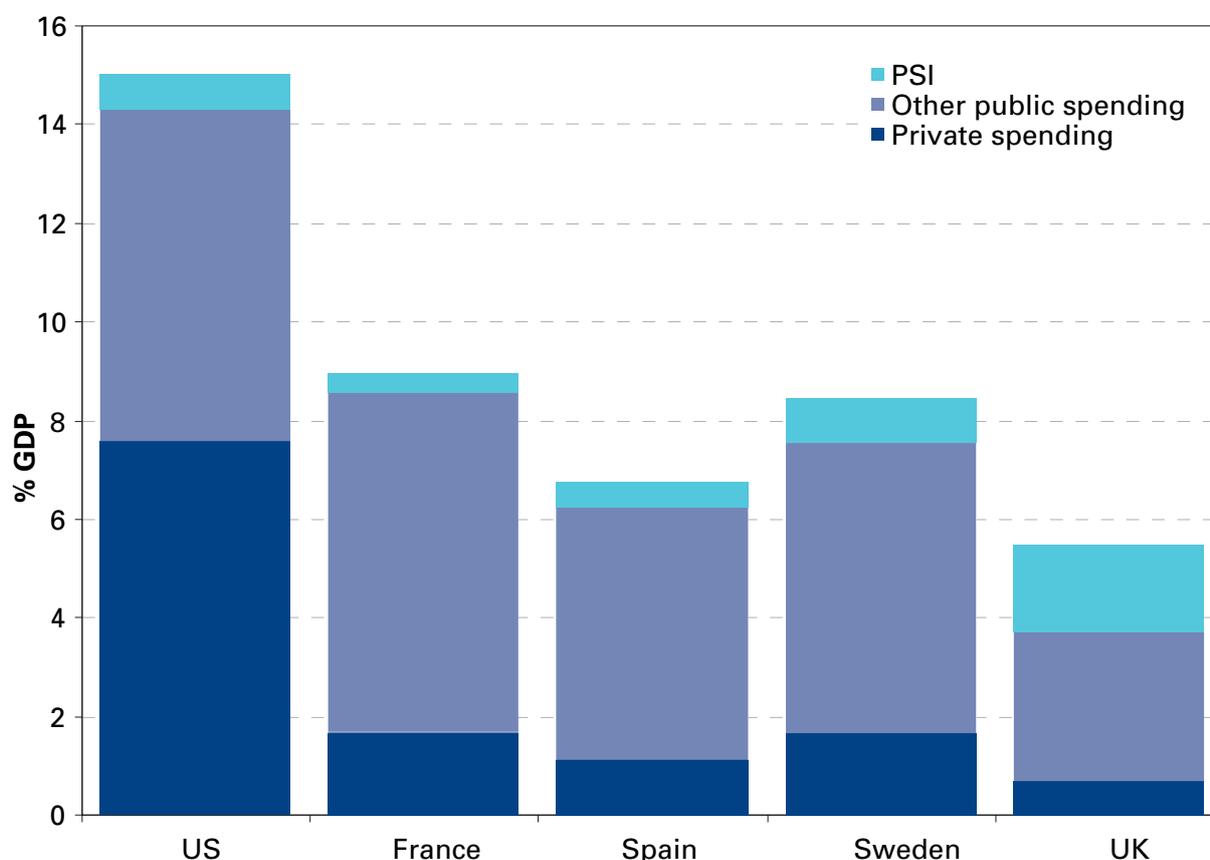
**Figure 5.4: Consumer spending on Health and Education as a Percentage of Total Consumer Spending**



Source : Oxford Economics

5.10 Figure 5.5 shows the sources of funding for health spending in each country as a share of GDP. The US stands out with the highest combined spending on health as a result of high private spending in addition to a roughly average share of public spending on health. The UK has the lowest combined spending on health as a share of GDP,

**Figure 5.5: Size of public and private spending on health as percentage of GDP**



Source: Oxford Economics

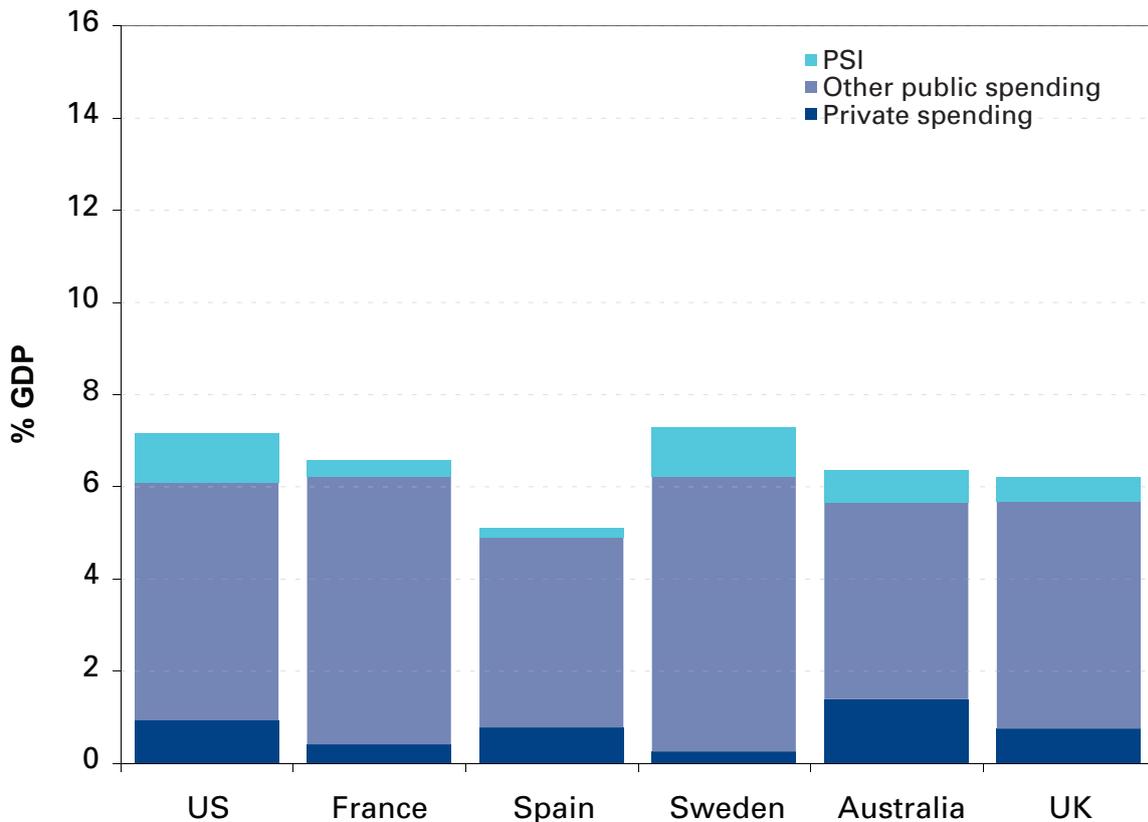
Notes: Private spending calculated from country IO tables

Other public spending and PSI calculated from country COFOG tables and Oxford Economics analysis

with very low private spending and relatively low public spending. However it has a substantially larger health PSI as a share of GDP than the other countries<sup>65</sup>.

5.11 There is less variation in funding sources for education across countries, although Spain stands out as spending substantially less on education as a percentage of GDP. Public provision makes up the lion’s share of education spending in all countries. Sweden and the US have the largest share of PSI provision of education, with the UK in third place.

**Figure 5.6: Size of public and private spending on education as percentage of GDP**



Source: Oxford Economics

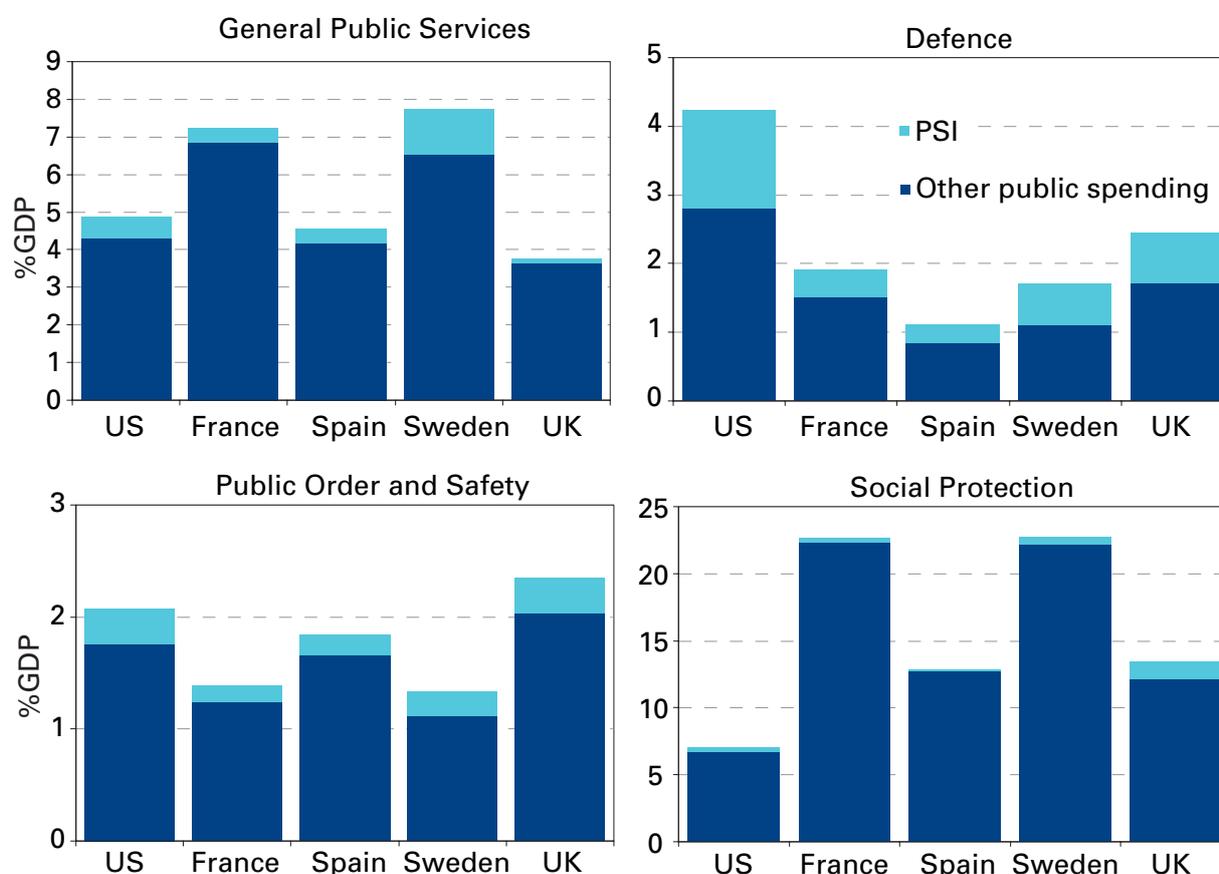
Notes: Private spending calculated from country IO tables

Other public spending and PSI calculated from country COFOG tables and Oxford Economics analysis

**Other areas of services**

5.12 Not all areas of spending are as suitable for this sort of comparison as health and education, particularly where it is less straightforward to estimate the relevant level of consumer spending. However, for some functions of government such as defence it is unlikely that there will be much consumer spending to take into account, and in these cases it is simpler to compare the PSI and non-PSI public spending across countries as a share of GDP. Some examples are shown in Figure 5.7.

65 Note that the UK figures include GPs’ salaries in public spending rather than the PSI.

**Figure 5.7: Public & PSI spending on selected Government activities as a percentage of GDP**

Source: Oxford Economics

5.13 The use of the PSI in different areas of government activity varies significantly across countries. For example, Sweden channels relatively more of its public spending through the PSI than other countries, with the exception of spending on social protection. The UK ranks close to Sweden in terms of its overall use of the PSI but is low on general public services. France and Spain utilise the PSI less than other countries across the whole range of government activities. This was reflected in the Review's call for evidence where companies mentioned the US, Australia and large developing countries – rather than our European neighbours – as the highest potential export opportunities.

### Potential Size of the PSI

5.14 It is interesting to compare the scale of the PSI in each country with how large the industry could theoretically be if the government contracted out all service provision that is currently represented by public sector pay. This is obviously an unrealistic extreme since some components of public sector pay – such as combat roles in the military – are never likely to shift to the private or third sectors. Public sector staff will always be needed for policy and parliamentary duties and, of course, to manage the commissioning and project management process. However, as a calibration and comparative exercise Figure 5.8 shows the PSI as a share of total public services (measured as PSI plus public sector pay) for the UK and comparator countries.

5.15 Australia is again in the lead with 40 per cent of its total public services delivered by the PSI. The UK and the US are next with the PSI providing about one-third of public services. France has the weakest PSI share at 18 per cent, with Spain and Sweden in the middle of the comparator group.

**Figure 5.8: PSI as a share of total public services ( per cent)<sup>66</sup>**

Countries	Per cent
Australia	40
US	34
UK	33
Sweden	29
Spain	22
France	18

### How do firms decide where to operate?

5.16 Interviews conducted as part of this Review asked international PSI firms what criteria they use in evaluating overseas opportunities. There was a wide range of answers but the most frequently cited factors were:

- How large is the market; what is the scope for future opportunities?
- What are the formal and informal barriers to foreign firms wishing to operate in the country; what costs and risks do they impose?
- Are there cultural factors which influence the scope and scale of PSI provision; what are their implications for service delivery models?
- Are there reputational risks in terms of corruption in the public sector?
- What is the extent of political involvement in the PSI, how much interference / engagement is there?

5.17 Whilst the ‘hard’ constraints on operating in a country such as formal regulation, the tax regime etc are relatively straightforward to evaluate, PSI providers have indicated that getting to grips with the implications of ‘soft’ barriers such as the informal ‘rules of the game’ is much more difficult. These are particularly important in the case of the PSI given the importance of political and cultural factors in shaping the market. A route which was often effective in overcoming local resistance to a foreign provider was the joint venture. The overseas partner brings its technical expertise and experience whilst the local partner brings its knowledge of the domestic political and commercial factors relevant to contract success. In this case, finding the right local partner is critical.

<sup>66</sup> Total public services is defined as PSI plus public sector pay.

## What more can the UK government do?

5.18 There are many examples of cases where the UK government has used the PSI to achieve tangible benefits for citizens and taxpayers. However at present these success stories are rarely advertised and, indeed, it is frequently the situations where things have not worked that attract most publicity. Spreading the message about the potential gains from using the private and third sectors to supply public services is an important lever for opening up this market internationally. As detailed in Section 4, the UK also has a wealth of experience about how - and how not - to engage the PSI in order to achieve successful outcomes; this should be shared with other governments intending to use this approach.

5.19 The importance of championing the benefits of using the PSI is emphasised in responses to the call for evidence:

*‘The most critical role the government can fulfil in improving access to overseas markets is to compile and publish the metrics that demonstrate the value for money delivered by the private sector through their involvement and commitment to the PSI. Genuine reliable demonstrations of successful service delivery may well influence other countries to change their procurement models and test private sector involvement in public service delivery particularly as their budgets come under increasing pressure in the current economic climate’. (NT Group)*

*‘The government could do much more to promote the use of the private sector in the public services industry and articulate the benefits UK companies have brought to improving services in this country to the international community’. (Babcock)*

5.20 The assistance provided by the government to UK firms operating abroad was considered to be of a high quality but, unsurprisingly, PSI firms felt that more could be done in terms of proactive engagement and at a higher level. In particular, business would welcome additional support from UKTI in providing information on developments in overseas markets and facilitating meetings with the relevant foreign officials.

*‘BERR and UK Trade and Investment have an important role to play in providing economic and political intelligence on international markets. [Company name removed] has experienced excellent advise and support from UKTI and the Foreign and Commonwealth Office in respect of its off shore business in India’. (Anonymous)*

5.21 UKTI does promote certain aspects of the PSI abroad. However, the focus is mostly on a sectoral basis covering only parts of the PSI - such as construction or PFI – rather than championing it in a systematic way. Given the distinctive nature of PSI markets and the importance of engaging overseas governments, a more coordinated approach is needed.

### **Recommendation 7: Raising the profile of the PSI**

Government and industry should work together to raise the profile of the PSI domestically and promote its export potential through UKTI.

- Trade missions should be mounted to key export markets promoting the success of the UK PSI in supporting and delivering public services.
- Industry should make full use of UKTI's network of contacts and information through UK Embassies, Consulates and High Commissions, especially in emerging market countries, to identify possible partners or clients for UK PSI.

## Section 6: A Vision for the future of the PSI

- 6.1 After two decades of rapid growth, the UK's Public Services Industry now accounts for nearly 6 per cent of GDP, employs over 1.2 million people and in 2007/08 had revenues of £79bn (Section 2). In absolute terms it is second in size only to that of the United States and, as a share of GDP, it is larger. It has been a major contributor to the increased investment that the UK has made in building new schools and hospitals, and in shrinking the waiting times for public services that were in short supply.
- 6.2 Yet major challenges remain if Britain is to develop the personalised, easily accessible, world class public services that are being demanded by its increasingly diverse population. This will require a range of providers – from the public, private and third sectors – with more autonomy for front-line staff to take decisions in the interest of users. It will require more sophisticated ways of measuring and contracting to deliver outcomes that match users' expectations, and it will require experienced public sector commissioners who are as adept at long-term market development as they are at procurement and project monitoring.
- 6.3 Previous sections developed a set of recommendations toward achieving these ends. This section concludes with the key themes that underpin the importance of government's role and future policy agenda towards the PSI.

### The importance of public services

- 6.4 The quality of a country's public services is a key contributor to the productivity of its economy and to the standard of living of its people. As countries grow richer their demand for public services – especially education, health and transport – tends to grow as a proportion of their total spending. This demand also tends to become more diverse across different regions, age groups and income classes. In poorer countries, populations are more satisfied with standardised public services since 'one size fits all' is a significant step up from limited access to public services and a private market that many could not afford. This was clearly the case in the early post-war period in Britain and other European countries when the foundations of the public welfare state were laid.
- 6.5 Today however, citizens want more varied, more immediately available, more modern (i.e. efficient and continually evolving) and, more customised and caring services. They are used to these qualities in the private services they consume - from haircuts to housing. In the private services marketplace, the diverse preferences of consumers are readily accommodated by a range of prices for different service offerings and competition amongst producers on both cost and quality. It is difficult to replicate this flexibility and choice in the public services arena, where the taxpayer foots the bill rather than the user, and where differences in services can lead to misguided complaints about a 'postcode lottery' whenever service levels appear to differ (whether for good reasons or bad). But there are many ways in which competing providers, user choice and greater 'user voice' via surveys of user satisfaction levels, for example, can

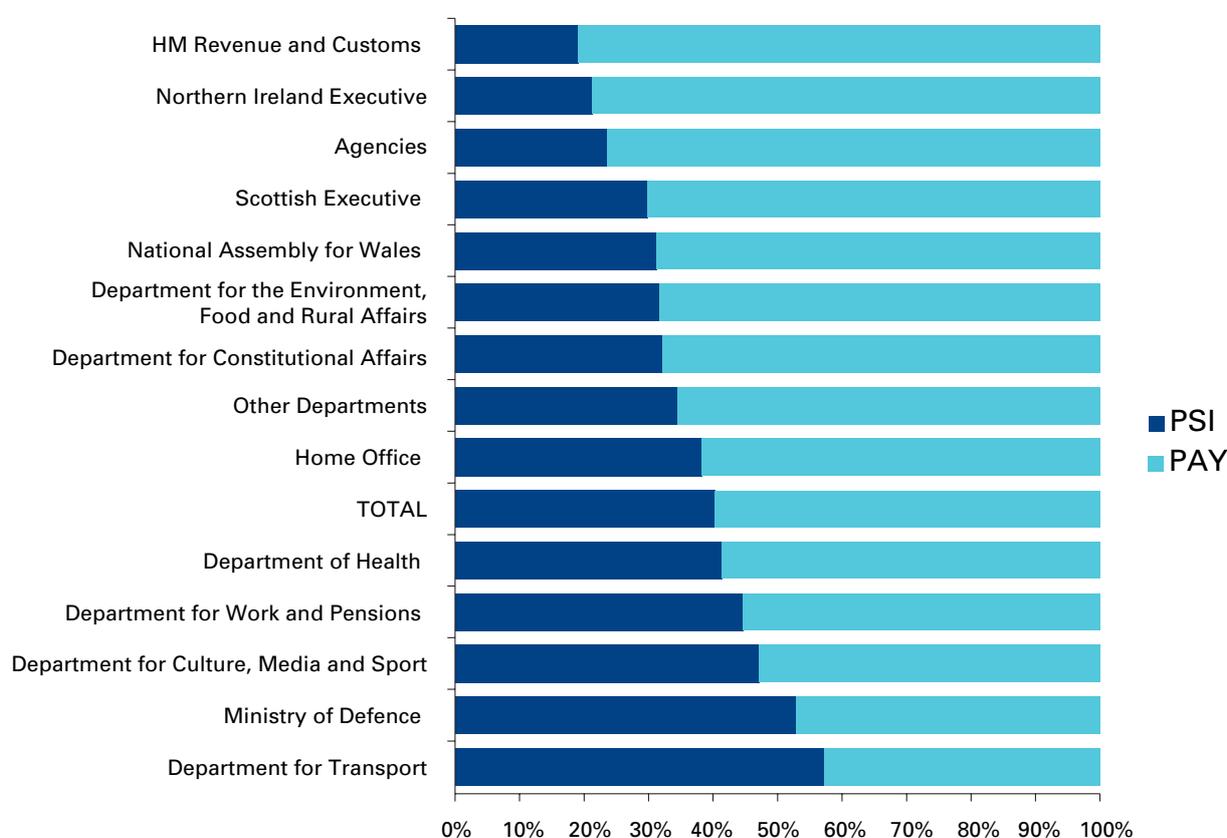
be employed to help the public services market function in a more flexible and user-focussed way.

## The role of the Public Services Industry

- 6.6 Government bears the responsibility for creating a policy environment that enables high quality public services to be provided at acceptable cost to the taxpayer. The question of who delivers them – whether it be the public, private or third sector – is essentially a practical one, that needs to be based on evidence, experimentation and fair competition. The UK has a longer history of innovation in this area than most other countries and this Review has tried to draw lessons from the accumulated experience.
- 6.7 The evidence shows that there are clear benefits, both to users and to taxpayers, in subjecting incumbent service providers to competition (Section 3). The potential for cost savings is well documented, as are the shorter time to completion of construction projects and the benefits of tapping private financial resources to accelerate public investment programmes; e.g., for schools. There is less evidence on the PSI impact on service quality, but the studies that have attempted to measure this generally find that quality has either improved or remained the same. Perhaps this is unsurprising since most contracts have shifted the cost risk onto providers – where it is carefully controlled – but they have not provided incentives for improving service quality. This will need to change if Britain is to aim for world-class quality in its public services (Recommendation 2).
- 6.8 For many public services, quality means different things to different users. Rather than try to capture this in detailed contract specifications, it will often be better to incorporate user surveys directly into the contract monitoring and payment mechanisms. The private sector has developed sophisticated customer survey techniques which it uses to drive continuous improvement and product development. These could be adapted for public services and tied to bonus and penalty payments to incentivise higher quality as defined by the user (Recommendation 2), as well as to provide useful comparative data on the effects of different modes of service provision.
- 6.9 Cost savings appear to be achieved by the contractual process regardless of which sector wins the contract, so it is the challenge and the spur of contestability that produce the gains. This implies that it would be wrong to set a target, or indeed a limit, for the role of the PSI in public service provision. The role of government policy should instead be to ensure that the competitive process takes account of the inherent differences between public, private and third sectors in order to provide a level playing field when their bids are compared; whilst ensuring that they are still able to bring the benefits of their distinctive backgrounds to the table (Recommendation 3).
- 6.10 Evidence also suggests that the gains from competition to provide a service are largest in the early years of its outsourcing. This is perhaps to be expected since that is when the scope for innovation and change is greatest. This implies that government departments and local authorities should seek to introduce competitive challenge into areas of service delivery where it has not yet been tried and consider how best to incentivise further innovation in sectors where it already exists.

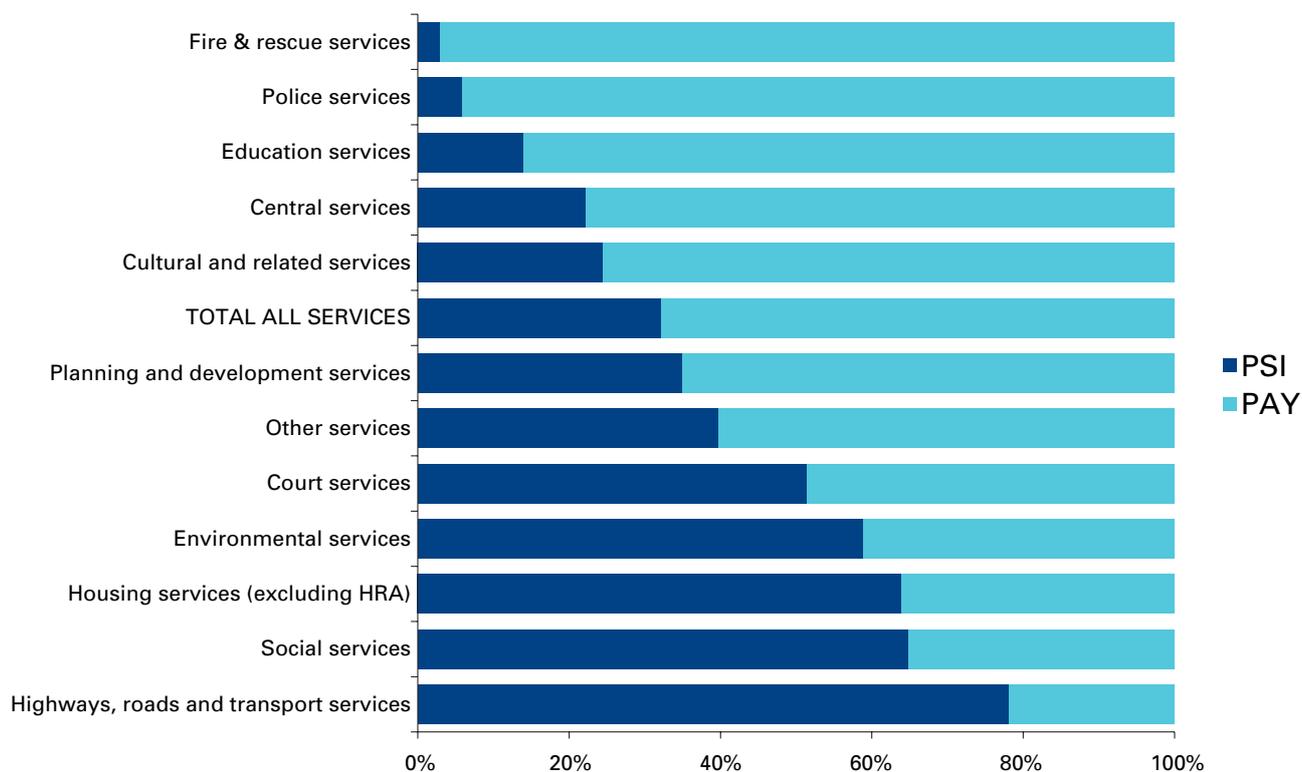
6.11 How much scope is there for such extension? This Review did not seek to identify specific opportunities. However, one way to address this question is to compare the current usage of the PSI in different central government departments and local authority activities. Charts 6.1 and 6.2 show the share of PSI in total government spending for public services (i.e. PSI procurement plus public sector pay). This could be considered an aggregate measure of the maturity of the PSI market. The theoretical extreme of 100 per cent would represent an activity or government department that had been completely outsourced.<sup>67</sup>

**Figure 6.1: The Use of PSI across selected Central Government Departments**



Source: HMT and PESA 2008 for outturn 2006/7 and Review team calculations

<sup>67</sup> These figures are drawn from slightly different sources and use slightly different approaches to determine service component to those presented in Section 2. Based on 2006/7 outturn figures, with GP salaries moved to pay, and using breakdown of PESA table 6.4 for Central Government expenditure and DCLG Table C1h: Subjective Analysis (SAR) (grossed up all England) 2006-07 for Local Government expenditure.

**Figure 6.2: The Use of PSI across Local Government**

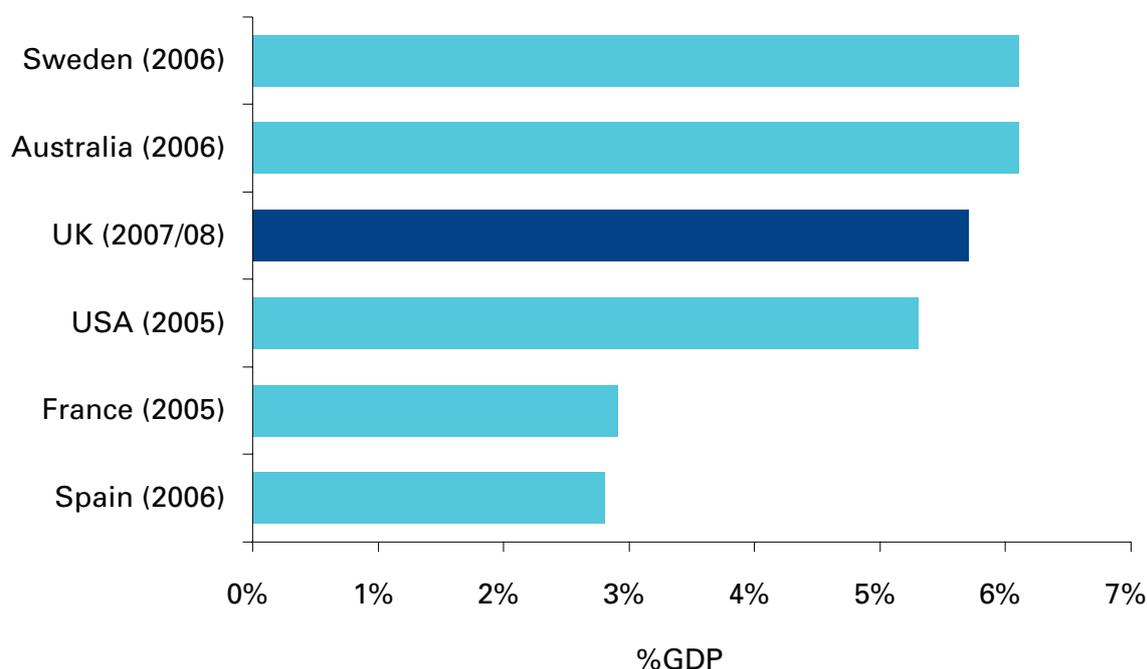
Source: DCLG 'Table C1h: Subjective Analysis (SAR) (grossed up all England) 2006-07 and Review team calculations

6.12 As shown in the charts, there is considerable variation in PSI provision. At central government level, the share of public services provided by the PSI ranges from 59 per cent for the Department of Business, Enterprise and Regulatory Reform to just 19 per cent for HM Revenue and Customs. There is even more divergence at the local authority level. Nearly 80 per cent of transport services are provided by the PSI compared to less than 10 per cent of fire and police services.

6.13 Clearly there are both substantive and historical reasons for such variation. On the substantive side, some departments are essentially about policy rather than service delivery. One would not expect policy functions to be outsourced, although there may still be a substantial input from private sector consultants and specialist advisors. On the historical side, it is instructive to compare service delivery choices across countries. In education, for example, total spending accounts for a broadly similar share of GDP (6-7.5 per cent) across a sample of wealthy countries, but the proportion provided by the PSI ranges from just 2.8 per cent in Spain to 6.1 per cent in Sweden.<sup>68</sup>

68 International use of the PSI is more extensive than the UK in some areas; for example, in Denmark a commercial company operates 60% of the country's fire service, and in Australia one third of high school children complete their education in private schools.

69 Particular areas of activity which respondents to our call for evidence considered for extended PSI involvement included the long term management of care, secondary school education (beyond the BSF programme) and some waste services.

**Figure 6.3: PSI as a share of GDP across selected OECD countries, 2006/07**

Source: Oxford Economics

- 6.14 Such a large variation across sectors and countries suggests that there is significant potential for further growth in the UK PSI. Both private and third sector contributors to the call for evidence supported this view.<sup>69</sup> They also highlighted the need for a clear long term plan on the part of government when a nascent market is opened to competition. Potential bidders from the PSI need to invest in building capacity in a new area which they will only do if there is a reasonable prospect of a pipeline of future opportunities (Recommendation 1).
- 6.15 One innovative approach to identifying areas for increased use of the PSI is to hand the question over to the private and third sector providers themselves by creating a framework for unsolicited bids to run parts of the public services. Such an idea has already been explored overseas and DWP's recent commitment to apply this in the delivery of welfare services is a welcome development<sup>70</sup>.
- 6.16 Another way of opening up new areas to competition is to involve potential bidders at a higher level thereby commissioning an overall service, rather than combinations of individual inputs and services. This allows potential bidders greater flexibility in how to combine, procure and manage inputs to deliver services. Examples include the recent MOD contracts for RAF military pilot training and air refuelling services, where the PSI partner is responsible for a wide range of asset provision and upkeep, facilities maintenance and service delivery. Another example from Australia involved specifying wider transport needs (moving people from a new residential area to the city centre), but allowing the PSI provider flexibility in the range and mixes of transport modes.

70 See speech by Secretary of State for Work and Pensions on 25 June 2008 : <http://www.dwp.gov.uk/aboutus/2008/25-06-08jp.asp>.

## The role of government

- 6.17 The role of government is absolutely critical to the development of a successful Public Services Industry, and a diverse and thriving PSI is in turn essential to improving the quality of public services, at a cost that the taxpayer is willing to bear. The evidence is clear that competitive challenge brings better value for money, not only through greater efficiency but also through innovation. Effective competition for government contracts requires multiple bidders from private, public and third sectors. Their business models must be robust enough that they can absorb the cost of bidding for the contracts that they lose in the profits on those that they win. Thus it is in the interest of all parties to keep the length and attendant cost of the bidding process down (Recommendation 5).
- 6.18 PSI providers who work for both public and private sector clients report that it takes two to three times longer to bid for a contract from the public sector. They believe that some of this is justified by the special set of rules governing public procurement. However, many of the problems relate to unnecessary delays and changing specifications. Procurement staff appear to have little incentive or accountability for minimising the time and costs associated with the bidding process. This has caused some providers to shift their strategic focus away from bidding for government business. Others have pointed out that opportunities in other countries compete directly with UK contracts since the number of staff they can afford to tie up in the bidding process is limited.
- 6.19 High bid costs are a particular problem for SMEs and third sector providers. It will be very difficult to meet government objectives for increasing their participation in PSI contracts unless bid costs can be reduced or HMT guidelines changed to permit reimbursement when major delays or cancellations occur. In a 2007 survey of providers, 84 per cent of respondents agreed that high bid costs prevent greater competition, especially from SMEs, in public procurement markets; and 52 per cent said that over the past five years bid costs on like-for-like contracts had increased substantially (CBI, 2007). Concern is growing that the 'competitive dialogue' process currently being introduced will further extend bid times (Section 4).

## An uncertain future

- 6.20 This Review has highlighted the growth of the public services industry in the UK and the contribution it has made to better value for money in public service provision. It has also revealed a number of worrying trends for the PSI and, therefore, for the prospects of attaining higher quality, more personalised public services. The industry's rapid growth of 7 per cent per year in real terms for the period 1995/96 through 2003/04 has since levelled off to just 3 per cent per year. Projections based on departmental spending plans for procurement to 2010/11 indicate a continued period of slower growth at 3.4 per cent per annum (Section 2).

- 6.21 Such a slowdown is not inevitable, nor does it appear optimal during a period of strong consumer demand for better services and tightening fiscal constraints on government spending. Comparisons of the share of PSI provision across different countries and sectors shows significant scope for expansion. But at the same time providers are finding that bid costs are increasing and the procurement process is being used to target objectives for which it was not designed and is not necessarily best placed to achieve. This will only add to the cost and complexity of the process. It will particularly disadvantage SMEs and third sector providers, and may drive more large providers to look for greener grass in offshore or private sector pastures.
- 6.22 More than any other major industry, the future of the PSI is in the hands of government; conversely, the PSI can also do more to directly affect the achievement of core government objectives than any other industry. Despite its size and importance, the PSI has received little focussed attention and its relatively few failures are better reported than its many successes. This Review has attempted to provide some definitive answers to questions about the size and effectiveness of the Public Services Industry in the UK. It has also sought evidence on the factors that have helped and hindered its development, as well as those areas where policy change could make it more effective in the future.
- 6.23 Further work will be necessary to develop specific plans to address the general recommendations provided. There is a clear case for action to reverse recent trends and create the conditions for the growth of a diverse and successful Public Services Industry and, thereby, to spur the drive towards world-class, personalised public services for all. Government also needs to effectively communicate why and how it intends to achieve this to professionals involved in the PSI – be they in the public, private or third sectors – so that they feel engaged in the process and able to contribute their ideas and know-how.

### **Recommendation 8: Next steps**

Government needs a co-ordinated plan of action to take the recommendations of this Review forward and ensure that progress is made. Equally the PSI needs to make the best use of the opportunities available to it for further engagement.

- The Advisory Panel for this Review – which includes government, unions, private and third sector organisations - should be retained in some form, meeting regularly to review progress, provide feedback to the government's response and identify new issues as they arise.
- The private and third sectors should make more use of feedback mechanisms already open to them; both directly to public sector clients and indirectly through the OGC.

# Annexes

## Annex A: Members of the Advisory Panel<sup>71</sup>

<b><i>DeAnne Julius</i></b>	<b><i>Head of Public Services Industry Review</i></b>
Neil Bentley	Director, Public Services, CBI
Andy Carty	Chief Operating Officer, Partnerships UK
Keith Coleman	Head of Public Sector for Cap Gemini Consulting UK
Sally Collier	Executive Director, OGC
Tony Donaldson	Branch Director, Economist's Office, OFT
Jane Everton	Deputy Director, Housing Care & Support, DCLG
Keith Faulkner	Managing Director, Working Links (Employment) Ltd
Simon Gallagher	Head of Productivity & Reform Team, HMT
Joe Grice	Chief Economist and Executive Director, ONS
Fergus Harradence	Deputy Director , Innovation Policy, DIUS
Noel Harwerth	Director, Logica CMG
Clare Hollingsworth	Chief Executive, Spire Healthcare
Ed Humpherson	Assistant Auditor General, National Audit Office
Ben Jupp	Senior Advisor Public Services, Cabinet Office
Paul Kissack	Head of Productivity & Reform Team, HMT
Peter Kyle	Director of Strategy & Enterprise, ACEVO
George Leahy	Director of Research & Policy, Social Enterprise Coalition
Andrea Longhi	Director , Policy & Systems Development Services, DH
Sampson Low	Policy Officer, UNISON
Campbell Robb	Director General, Cabinet Office, Office of Third Sector
Peter Rogers	Chief Executive, Babcock International Group
Nick Sharman	Managing Director, Amey Local Government
Adam Sharples	Director General , Work Welfare and Equality Group, DWP
Ray Shostak	Head of Prime Minister's Delivery Unit
Tim Stone	Chairman, Global Infrastructure and Projects Group, KPMG
Gary Sturgess	Executive Director, Serco Institute
Ian Taylor	Commercial Director, DCSF
John Tizard	Director, Centre for Public Service Partnerships, Birmingham University
Catarina Tully	Policy Adviser, Cabinet Office
Tom Wilson	Head of the Organisation and Services Department, TUC

<sup>71</sup> Others also attended the Advisory Panel meetings either in addition to or as replacements for those listed here.

## Annex B: Details of the Call for Evidence

The PSI Review website <http://psir.intelligus.net/portal/site/psir/?mode=0> was set up to enable the respondents to submit their views electronically (either attributed or anonymously) and therefore enable those who were invited to respond to share their thoughts and comments with each other. The information collected was used to highlight issues on which the Review team could focus its attention, help develop its analysis and shape the final recommendations of the Review.

The PSIR website was launched on Monday 18 February 2008, offering respondents the opportunity to submit factual information, evidence and views on a set of 10 key questions. 92 invitations were sent to companies and third sector organisations operating in the PSI, as well as government departments, academics and other key stakeholders.

On the 4<sup>th</sup> April 2008 the call for evidence closed. The PSIR website received 187 submissions from 33 respondents from organisations operating across different areas (2 respondents wished to remain anonymous).

### List of Respondents

#### Third Sector

Acevo  
NHS Partners Network  
Social Enterprise Coalition

#### Private Sector

Amey  
Andeman Advisory Services  
Babcock  
Bevan Brittan  
BT  
Business Services Association  
Compass Group  
Compass Management Consulting  
Corporate Value Associates  
GSL Global  
Hays  
Humana  
KPMG  
Liberata  
Northgate Information Solutions  
Serco  
VT Group  
Working Links

#### Government

Dept. of Health  
Office of Fair Trading  
Office of the Third Sector – Cabinet Office  
Office of Government Commerce  
Partnerships UK

#### Trade Associations and Unions

CBI  
Unite  
TUC

#### Academic

Bristol University (Centre for Market & Public Organisation)  
Cardiff University

The 10 key questions are as follows with a summary of responses:

**Q1. Does the government engage with private and third sectors to the optimal extent at present? Where is there scope for increased involvement and where is service provision best done in house?**

Respondents typically thought that government does not engage or collaborate with private and third sectors sufficiently. It was felt that greater consultation and dialogue by government commissioners at an early stage would greatly assist a better understanding of what was required and how best to achieve it. Such engagement should also be tailored for central, local and community situations and would benefit from greater cross-department involvement.

Some respondents believed the government could achieve multiple benefits such as lowering costs and improving service delivery through improved engagement with suppliers. There was a broad consensus that a mixed model of public, private and third sector was appropriate, where provision decisions are based upon value for money, capability and risk characteristics. There were suggestions for increased involvement of private and third sector organisations in the provision of education services (outside BSF), offender management, employment, health and social care. Few areas of public services activity were perceived as inherently public, such as leadership, policy and procurement strategy generally and within health secure mental health, 999 and A&E. Rather than attempting to define a permanent boundary, respondents suggested that government should have an ongoing and outcome oriented appraisal approach to determine which activities to open to PSI involvement. A minority of respondents considered that the majority of public service delivery should remain in-house.

**Q2. What current government policies and practices have been most effective – and therefore should be continued or expanded – in increasing the role of the private and third sectors in the PSI?**

Responses to this question were diverse. There were a number of specific examples provided by the respondents, where government's policies and practices have been most effective. Government reports and reviews have challenged current approaches and set targets for improvement. The establishment of the OGC and more recently Office of the Third Sector have helped to establish better links between stakeholders and promulgate best practice. The creation of a Commercial Directors in a number of departments has also helped to bring an open approach to partnership and risk and reward sharing.

Further practices that respondents consider to have helped include consultation and competitive dialogue (although in the case of the latter, responses also noted the additional time costs involved). Examples of good practice included DWP's welfare to work programme and HMT's Financial Skills Advisory Panel. On the topic of skills examples were provided where it was beneficial to involve operational experts in the market design.

Commissioning strategies were seen as helpful, especially where they consider the outcomes required from public services, the capacity of the provider base, and where they signal the extent of the pipeline of opportunities available. In terms of contract innovation,

PPP/PFI and the transfer of risk has been a key enabler for the commitment to longer term relationships and successfully delivering public service projects.

Finally, a number of respondents mentioned DH's social enterprise programme and its Social Enterprise Fund as a positive way of encouraging third sector involvement.

### **Q3. What are the biggest barriers to the private and third sectors entering and operating in the PSI?**

Respondents suggested that the biggest barriers to entering and operating in the PSI were often the reverse of those factors which had been effective, so a lack of clear objectives, a lack of a pipeline of packaged projects and increased political uncertainty all contribute to unwillingness to enter the PSI market.

The procurement process was frequently mentioned as a barrier, particularly for smaller private and third sector operators. This was often seen as long, costly, susceptible to delay (during the procurement process and awaiting final approval), and inconsistent across similar markets.

There was also a general criticism of the lack of skills, expertise and resources within the public sector and supply side commissioning teams with concerns that commissioning teams learn as they go and lessons learnt are not shared. Further skills weaknesses were in decision making and negotiation.

Responses suggested that service provision within large asset-based contracts is a barrier for smaller PSI operators, because of the significant bidding costs involved. Respondents also noted that service providers recover their bid costs over a much greater timeframe than construction contractors, amplifying the effect cost of bid costs.

Commercial barriers include service bundling not matching market capacity (e.g. IT and facilities management) and inappropriate risk transfer. Where PSI operators are expected to shoulder much of the risk, without commensurate reward opportunity, then PSI participation is likely to be constrained. There was also a concern expressed that commissioning models which require subcontractors (which may be the only way for small and third operators to engage with the PSI) can lead to excessive risk from the prime contractor.

Problems of an uneven playing field were raised as a hindrance, with examples including tax treatment and pension arrangements, and incumbent advantage.

### **Q4. Which procurement models apply best in what circumstances and why?**

The overriding sentiment from respondents was that all procurement models should be built on the principle of partnership, and the suitable contracting model should be appropriate to the specific requirements and circumstances of the procurement.

Responses described numerous procurement models, from simple contracting (e.g. Catalyst) to PFI/PPP arrangements, with a range of alternatives including alliancing, framework agreements, multi-service contracts and joint ventures. The geographical element was an important aspect of the procurement ranging from local procuring driven by the need to stimulate the local economy, regional procuring where some economies

of scale can be achieved, but local dimensions are still important, to national procuring where standardisation and scale are more beneficial. Further, the time period was another differentiator varying from short term to long term contracts.

According to respondents, the key factors which determine the appropriate procurement model include the novelty/innovation of the service and political circumstances, scale and complexity, availability of skills to carry out the procurement, the maturity of the industry and risks involved.

The Competitive Dialogue procedure has its critics as well as those who are willing to champion it from the private and third sector providers. Some believe that it is too time-consuming, resource intensive and invariably the main focus appears to be on cost savings. Although it was recognised as a way forward to make improvements at beginning of the tendering process. It was also felt the process was too rigid in the way the commissioning bodies interpret and apply procurement. On the positive side many believe that it is a step in the right direction and has the potential at least to shorten procurement timetables and to accelerate the conversation between bidders and the commissioning authority.

Finally, respondents largely endorsed the use of e-procurement, and online auctions, but felt that this has exacerbated a trend of public sector commissioners not wishing to engage directly with service providers.

**Q5. How can the government and providers achieve a clearer allocation and balance of risks?**

The majority of responses to this question said the key to allocating risk is about understanding who is best positioned to effectively manage the risk. It is crucial that the risks are fully understood; fully defined and communicated by all parties before contracts are signed. A suggestion to help meet this objective was to have open and honest dialogue during the procurement process with an approach which is more about working in partnership rather than the more traditional; procurement-led, customer-supplier relationship. Also periodic programme reviews should be undertaken to ensure that the allocation of risks is still appropriate and that any new requirements are captured.

Respondents presented the range of different risks that exist operating in the PSI. This includes demand risks, operational risks, solvency risks and political risks. With such variation, it was acknowledged that the effective allocation of risk needs to be well documented and that both HMT and OGC have produced useful guidance on the issues that parties should consider when allocating risk.

Finally, it was recognised by one respondent that any risk that reverts to government in the event of contractor default falls back to the public sector, and therefore should not be reflected in increased risk premium pricing.

**Q6. What are the key differences between different markets within PSI in the UK and how do these markets facilitate or hinder business development?**

A number of respondents thought that there were two essential strands of the PSI – those markets that are managed and procured by central government and those that are managed and procured by local authorities. Health and education markets tended to be managed and

procured on a local basis. Defence and DWP tended to be managed and procured centrally. Transport is a mix of central and local procurement.

These strands drive differences in procurement models and procurement culture, potential for standardisation and scale economies, decision making process, use of consultants, maturity and supply side competition, degrees of engagement and openness to small companies and third sector involvement. It was felt that there are often unhelpful and unnecessary differences between these markets in terms of the procurement processes, such as pre-qualification questionnaires, which often vary between different markets and for different services within the same market, creating unnecessary duplication.

Concern was raised by respondents on different requirements in different PSI markets; for some least cost is most important, for others service delivery. Further concerns were raised by a few respondents that the increased use of prime contractor models makes it harder for smaller organisations including many third sector providers to compete.

**Q7. What specific changes would you like to see in the way the government procures services which might promote competition and/or productivity in the PSI?**

Many respondents commented on the success of the UK PSI, but suggested a number of potential improvements. Private and third sector respondents felt that a key way to promote competition in the PSI would be to simplify processes. Documents and contracts are often overly legalistic, difficult to read and unclear, so further standardisation and central support for commissioning teams would be helpful. It would also be beneficial to learn the lessons from previous procurement exercises; this should enable reductions in costs of sales, time scales of procurement and resource requirements. There should be greater focus on the achievement of outcomes, rather than inputs or even outputs to encourage innovation. There was also support for flexible service level agreements with balanced responsibility that encourage innovation and reward for over-performance. PSI providers also suggested that earlier engagement and dialogue would help to scope the PSI services.

A number of respondents suggested that Commissioners could make more effective use of data, using segmentation to gain a deeper understanding of their client's needs. Such data and market intelligence should be shared among commissioning bodies, such as PCTs and local authorities. Market intelligence should lead to transparency on future market developments thereby increasing bidder interest.

**Q8. What can the government do to improve access to overseas markets for UK companies operating in the PSI?**

UK firms operating in the PSI believe there is a dual role for industry and the UK government to promote the interests of UK companies internationally.

Through greater information sharing with the PSI, respondents' consider that the government would be in a stronger position to articulate the successes and benefits of UK company PSI participation to the international community. The main areas where the UK government could help are identified as:

- broadening the knowledge of overseas administrations on the role played by UK companies in developing public services;

- communicating the successes of the UK PSI to overseas markets – there is strong evidence that overseas jurisdictions look to the UK for leadership in the management of public services and also look to adopt market models similar to those already developed in the UK. PFI/PPP is one such example – a number of UK companies have won overseas business through the adoption of infrastructure policies heavily influenced by a British model;
- compiling and publishing metrics that demonstrate the value for money delivered by the private and third sectors through their involvement and commitment to the PSI;
- working more closely with industry to improve skills and training; and
- senior ministers and senior public servants could collaborate with UK PSI companies in overseas trade missions promoting the public service industry.

**Q9. What are the key differences in market conditions outside of the UK? What could the UK introduce from these countries and what might be best to avoid?**

It was broadly felt the UK leads the world in the development of the PSI. The UK has applied Compulsory Competitive Tendering (CCT), PFI and PPP models more fully than any other country for the delivery of public services. It was suggested that if the government was to develop new PPP models that have been tried and tested abroad, it should adopt partnership models that have been successful at sharing risk and creating strong links between service design and delivery. However, there may be skills and competencies in other markets which differ and culturally might not be acceptable in the UK.

It was also suggested that Commercial Directorates could be set up within central government departments and large public bodies to ensure procurement and delivery is joined up. Other countries such as South Africa, Germany, Ireland and Italy have already established such units.

**Q10. What can the government do to promote inward investment in the PSI in the UK?**

In the majority of cases respondents said the UK PSI market is already in a good position, with adequate competition from domestic and foreign companies. It has a strong record of attracting foreign companies investing in assets, technology, training and development. Respondents said that the conditions for attracting UK investment are essentially the same as attracting foreign investment, so much of the earlier responses are relevant here. Respondents believed there was room for the government to improve particular areas such as: reducing bureaucracy; reducing the cost and complexity of the sale and having a tax system that allows firms to be competitive and innovative.

## Annex C: Public Services Industry – Glossary

<b>4ps</b>	Local Government’s Project Delivery specialist
<b>AC</b>	Audit Commission
<b>BERR</b>	Department for Business Enterprise & Regulatory Reform.
<b>BSF</b>	Building Schools for the Future – A programme that will see every state secondary school in England – around 3,500 in total – rebuilt or remodeled over the lifetime of the programme.
<b>CBI</b>	Confederation of British Industry.
<b>CCT</b>	Compulsory Competitive Tendering – Procurement tool introduced to bring greater efficiency to local government and professional services through the use of competition. See Section 4 for more detail.
<b>Commissioning</b>	The process which defines strategic outcomes and seeks to create relationships to ensure these outcomes are delivered.
<b>Competitive Dialogue</b>	Competitive Dialogue must be followed for all contracts which are considered to be particularly complex. See Box 4.5 for more detail.
<b>Competitive Neutrality</b>	Competition should be open and fair in that there should be a level playing field between different classes of providers – public, private and non-profit.
<b>CSR</b>	Comprehensive Spending Review.
<b>DCLG</b>	Department for Communities & Local Government.
<b>DCSF</b>	Department for Children Schools and Families.
<b>DIUS</b>	Department for Innovation Universities and Skills.
<b>DH</b>	Department for Health.
<b>DWP</b>	Department for Work & Pensions.
<b>EU Procurement Legislation</b>	The rules that specify procedures for advertising & awarding contracts depending on the type of contract which contracting authorities must comply with.
<b>Framework Agreement</b>	An overarching document that is signed between the supplier/ service provider and the contracting authority.
<b>FDI</b>	Foreign Direct Investment.
<b>GPS</b>	Government Procurement Service.
<b>HMT</b>	Her Majesty’s Treasury.
<b>HMRC</b>	Her Majesty’s Revenue & Customs.
<b>Incentivisation Payments</b>	The method of payments linked to supplier performance.
<b>ITT</b>	Invitation to Tender.
<b>NAO</b>	National Audit Office.
<b>ODPM</b>	Office of the Deputy Prime Minister (roles largely now carried out by DCLG)

<b>OFT</b>	Office of Fair Trading.
<b>OGC</b>	Office of Government Commerce.
<b>OJEU</b>	Official Journal European Union.
<b>ONS</b>	Office of National Statistics.
<b>PFI</b>	Private Finance Initiative – The method to construct, maintain and manage public facilities by using private capital, management skills, and technical abilities. See Box 4.3 for more detail.
<b>PPP</b>	A Public-Private Partnership (PPP), refers to a contractual agreement between a government agency and a private sector entity that allows for greater private sector participation in the delivery of public infrastructure projects. In some countries involvement of private financing is what makes a project a PPP. PPPs are used around the world to build new and upgrade existing public facilities such as schools, hospitals, roads, waste and water treatment plants and prisons, among other things. Compared with traditional procurement models, the private sector assumes a greater role in the planning, financing, design, construction, operation, and maintenance of public facilities.
<b>Private Sector</b>	Part of the economy that is owned & controlled by private individuals & business organisations such as private & public limited companies.
<b>Procurement</b>	Procurement is one element of the commissioning cycle. It refers to the processes around drawing up tender documents and engaging a particular contractor.
<b>Public Sector</b>	Part of the economic & administrative system that deals with the delivery of goods & services by & for the government, whether national, regional or local.
<b>SME</b>	SME stands for small or medium-sized enterprise - in other words a business with fewer than 250 employees. (BERR Definition): <a href="http://www.berr.gov.uk/bbf/enterprise-smes/research-and-statistics/statistics/page38573.html">http://www.berr.gov.uk/bbf/enterprise-smes/research-and-statistics/statistics/page38573.html</a>
<b>Social Enterprise</b>	A business with primarily social objectives whose surpluses are principally reinvested for that purpose in the business or in the community.
<b>Sustainable Procurement</b>	Process where organisations meet their needs for goods, services, works & utilities in a way that achieves value for money on a whole life basis in terms of generating benefits, not only to the organisation, but also to society and the economy, while minimising damage to the environment.
<b>Third Sector</b>	A range of institutions which occupy the space between the State and the private sector. These include small local community and voluntary groups, registered charities both large and small, foundations, trusts and the growing number of social enterprises and co-operatives. Third sector organisations share common characteristics in the social, environmental or cultural objectives they pursue; their independence from government; and in the reinvestment of surpluses for those same objectives.
<b>TUC</b>	Trade Union Congress.

<b>TUPE</b>	Transfer of undertakings (Protection of Employment) Regulations (TUPE). It was introduced to protect employees if the business in which they are employed changes hands. Its effect is to move employees and any liabilities associated with them from the old employer to the new employer by operation of law. See Box 4.2 for more detail.
<b>VfM</b>	Value for Money is not about achieving the lowest initial price: It is defined as the optimum combination of whole life costs and quality. See Box 4.1 for more detail.
<b>Warwick Agreement</b>	<p>“Warwick” is the name given to over 100 policy commitments included in the final report of the July 2004 National Policy Forum (NPF) of the Labour Party. It is known as “Warwick” as the meeting was held at the University of Warwick.</p> <p>The Report formed the basis of the 2005 Labour Party Manifesto and was agreed after 4 years of discussion between the Labour Government, Labour Party Members, Trade Unions &amp; Socialist Societies.</p> <p>The agreement covers the following areas; Fairness at Work; Pensions; Public Services and Manufacturing</p>

## Annex D: Governance of Public Procurement – Roles and Responsibilities

There is a plethora of organisations involved in the governance of public procurement. This annex describes the roles of the most prominent ones and graphically presents the primary role of each of these within the commissioning landscape.

The National Audit Office is the body responsible for providing the financial audits to government of all government departments and agencies and many other public bodies as per the legislative requirement. Their Value for Money reports also provide advice and evaluation of public service delivery on a wide range of issues (operations or individual projects) based on three criteria of economical resource use, an efficient input-output relationship and effectiveness of outcomes.

The Office for Government Commerce are responsible for improving value for money in procurement, programme and project management in central government. Through implementation of the Transforming Government Procurement report (HMT, 2007) OGC aim to raise procurement standards, develop the skills of procurement professionals, drive value for money through collaborative procurement and play a stronger role in the successful delivery of major projects. The report enabled the OGC's primary method of scrutiny - procurement capability reviews which assess how far procurement in government departments meets the standards required to deliver value for money services both now and in the future; the initial review is followed up after 6 months and at 12 months with a new review after 24 months. OGC's wider work includes developing practical procurement guidance, representing the UK on EU procurement policy and improving professional procurement skills through the Government Procurement Service. The OGC's other means of scrutiny is through the advice and analytical appraisal they provide to the Major Project Review Group (MPRG). MPRG is HMT-led and reviews the most complex and high value projects across the public sector at three key stages (when the business case is approved, before proceeding to Tender, prior to contract signature) to determine whether they are deliverable and highly likely to be successful. Further project management evaluation is carried out by OGC through their Gateway Reviews which examine programmes and projects at key decision points in the lifecycle to determine successful progression to the next stage. The process is mandatory in central civil government for procurement, IT-enabled and construction programmes and projects.

4ps (local government's project delivery specialist) carry out Gateway Reviews at the local government level. They also provide hands-on project support and skills development and aim to spread best practice know-how by working in partnership with local authorities to secure funding and accelerate the development, procurement and implementation of PFI schemes, public private partnerships, complex projects and programmes.

The Department for Communities and Local Government (DCLG) are responsible for national policy on local government in England which includes the transformational agenda to ensure services better meet the needs of local residents and businesses whilst using resources in the optimum way. An example of their support to local councils is through the Regional Improvement and Efficiency Partnerships programme which has a procurement workstream.

Also working for local government, The Audit Commission is the independent body responsible for ensuring value for money in England in local government, housing, health, criminal justice and fire and rescue services. Their aims include raising standards of financial management and financial reporting; encouraging continual improvement in public services to meet the changing needs of diverse communities and provide fair access for all and promoting high standards of governance and accountability.

The AC produce value for money reports for local public services. They also carry out inspections to audit local authorities' plans for improvement and assess the quality, cost effectiveness and prospects for these improvements. Their national studies programme provides research-based advice, recommendations and practical tools to implement improvements. *Healthy Competition* (AC, 2007) considered the potential for councils to use competition and contestability to generate cost savings and service improvements and makes recommendations with practical advice on ways in which local councils, local governments and central governments can individually and together make improvements.

<b>Primary Role</b>	<b>Central Government</b>	<b>Local Government</b>
<b>Policy and Legislative</b>	Office for Government Commerce	Communities and Local Government
<b>Audit and Inspectorate</b>	National Audit Office Office for Government Commerce	Audit Commission 4ps
<b>Improvement</b>	National Audit Office Office of Fair Trading	Same as Central Government Also: Communities and Local Government Audit Commission 4ps

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## Annex F: Summary of Selected Government Reports in this area

### **Excellence and Fairness: Achieving World Class Public Services: *Cabinet Office 2008***

This paper outlines the government's overall framework for driving further improvements in public service delivery over the coming years. Although there have been substantial improvements in UK public services over the last decade, when taken as a whole many services are not yet able to offer the world class service the public increasingly expects. To achieve this government needs to move beyond the top down, target driven approach it used to deliver the first phase of reform. In particular it needs to;

- Empower citizens; giving them increased choice and control as to how they receive public services as well as making those who deliver these services more directly accountable to them.
- Fostering a new professionalism across the public sector workforce, combining greater responsiveness to users with more autonomy and increased investment in skills.
- More strategic leadership from central government, with interventions focused on underperforming organisations as well as the overall direction and purpose of public services; leaving individual organisations more free to innovate and respond to the requirements of their users.

### **The National Procurement Strategy for Local Government – Final Report from *Communities and Local Government & Local Government Association 9 April 2008***

The National Procurement Strategy has led to a more strategic approach to procurement in local government and has created a platform for the realisation of efficiency gains and more sustainable procurement. Highlights from the report:

- £3.1 billion efficiency gains achieved by end 2006/07
- 46 per cent of councils now working with their Regional Centre of Excellence
- 54 per cent of councils involved in joint commissioning
- 38 per cent of councils involved in shared procurement function
- 24 per cent of councils involved in sharing of other corporate functions
- 65 per cent of councils have adopted the Small Business Friendly Concordat

### **Building Professional Skills for Government – a strategy for delivery (1 April 2008): *Cabinet Office***

The Skills Strategy, with the Professional Skills for Government (PSG) competency framework at its core, identifies the collective action which is needed to equip government's present and future workforce with the PSG skills. The objective is to raise standards and enhance individual performance, improve organisational capability and ultimately the quality of public services.

### **Evaluation of the National Programme for Third Sector Commissioning: Baseline Report: *IDeA: February 2008***

The Baseline Report is the first report from the outcome evaluation of the National Programme for Third Sector Commissioning. The baseline research centred on quantitative surveys of third sector organisations (TSOs) and of commissioning organisations. The research explored current commissioning practices and attitudes to third sector involvement in public sector commissioning.

- The research generally reflected, amongst other things, an openness amongst commissioners to work with the third sector, and a recognition that the third sector could add value to commissioning.
- There was a strong sense that commissioning organisations did not fully understand the impact of commissioning on TSOs, or the barriers to involvement that existed.
- The research also showed that skills and understanding need to be increased both in the third sector and in the public sector if third sector organisations are going to become more involved in commissioning.

### **Local Government National Report: *Audit Scotland: January 2008***

This report discusses the importance of Strategic service-delivery partnerships (long-term public private partnerships (PPPs) through which contractors deliver a service or range of services for councils). These partnerships are designed to improve value for money without some of the drawbacks associated with traditional contracting.

Councils considered in the report expected to achieve cost savings of between 1 and 15 per cent for services delivered through SSPs and most secured many (and in some cases more) of the benefits that they expected.

### **Improving the PFI tendering process – *National Audit Office 5 March 2007***

This paper provides guidance on how to manage the tendering process within a PFI project. It was written as a result of concerns expressed by the Committee of Public Accounts in 2003 that the tendering of PFI projects did not follow good practice and was not handled with sufficient skill by the public sector, incurring high costs and risking value for money. The study:

- covered the period 2004 to 2006 and included 49 projects with a combined capital value of just under £8 billion
- found that one in three projects that closed between 2004 and 2006 had two detailed bids competing for the business compared with one in six projects prior to 2004.
- commented on the length of the tendering process, change in value of the PFI contract during the preferred bidder stage, proportion of money spent on advisors, passing on procurement skills
- suggested ways for addressing the risk of PFI deals not receiving enough developed bids for viable competition and to reduce the length and cost of tendering.

### **PFI: Strengthening long-term partnerships: HMT 2006**

This paper sets out further improvements to PFI to support its ongoing important role in delivering public services.

- The total PFI deal pipeline over the next 5 years (from 2006) is around 200 projects worth £26 billion in capital value
- Evidence presented in this document shows that PFI is now meeting public service needs across more than 500 operational projects. This research concludes that:
  - Users are satisfied with the services provided by PFI projects
  - Public authorities are reporting good overall performance and high levels of satisfaction against contracted levels of service
  - The services contracted for are appropriate
  - The incentivisation within PFI contracts is working

### **Public service delivery action plan: Cabinet Office – December 2006**

Partnership in public services: an action plan for third sector involvement aims to remove barriers to third sector organisations who want to become involved in delivering and designing public services. The plan brings together opportunities for the third sector to play an enhanced role in public services. The actions in the plan cut across government departments and cover four areas:

- **commissioning** – improving the commissioning process for service providers and public funders
- **procurement** – ensuring that contracting and procurement processes are fair and proportionate
- **learning from the third sector** - supporting innovation in the sector
- **accountability** – helping the sector to hold services to account

The measures outlined in the plan include a national programme to train 2,000 public sector commissioners on involving the third sector in services, and £30 million funding for community groups to take over the management or ownership of local authority buildings.

### **Developing the Local Government services market to support the long term strategy for Local Government: *Communities and Local Government: November 2006***

Key themes:

- Commissioning and procurement should be elevated in importance so that these functions incorporate a strategic perspective so as to advance local government's wider role in 'place shaping'.
- A clear and comprehensive commissioning framework for local government needs to be established, which provides a central focal point for those involved in the development of policy, the commissioning of activities and the procurement and provision of services.

- Greater investment should be made in the development of commissioning skills and capacity in local government.
- ‘Received wisdom’ about the delivery of core services must be challenged.
- Performance, efficiency and value for money can be improved through a diverse and competitive supply community.
- The supply side of the mixed economy – the public, private and third sectors – must recognise its role in stimulating effective competition and supporting capacity planning.
- Public service suppliers and those who represent them should engage pragmatically in the future development of the local government services market.
- The market environment must be neutral between different classes of provider, and care needs to be taken to ensure that artificial barriers to entry of local government markets do not discourage new providers.
- A balance must be sought between aggregation and localism in commissioning services.
- Central and local government need to take an active approach to engaging with – and where required shaping – the local government services market.
- There should be encouragement of a more strategic dialogue between policy, commissioning and supply communities.
- There should be an investment in an on-going forensic review of local government markets so that actions are taken based upon evidence.

**Sustainable procurement in central government: *National Audit Office: September 2005***

Recommendations made by the Environmental Audit Committee: April 2005

- Improved leadership within government on sustainable procurement
- Clear progress in creating a dedicated website for sustainable public procurement
- An increased willingness within the Office of Government Commerce (OGC) to take on this agenda and move it forward
- Progress towards setting clear and measurable targets for sustainable procurement within central and local government, backed by strong policy decisions aimed at achieving them

Recommendations made by the Accounting for Sustainability Group

- On-the Ground experimentation to identify where sustainable procurement increases value for money
- Better data on procurement expenditure
- Improved skills and training
- New accounting systems which would allow for externalities to be taken into account
- Clear strategic vision provided by better targets
- Closer oversight of public bodies’ progress against targets

Some of the other recommendations are listed below

- OGC should continue to emphasise that value for money does not necessarily equate to least cost

Departments should increase uptake of training on sustainable procurement

**Wood Review: Investigating UK business experiences of competing for public contracts in other EU countries: *Alan Wood supported by the Office of Government Commerce: November 2004***

This report reviews the experiences of UK based firms in competing for public contracts in other EU countries, including concerns about unfair discrimination and different approaches to the application of Single Market procurement rules.

Main Recommendations:

- The European Commission should actively promote best practice in public procurement by member States, not only by monitoring compliance with the directives but also by encouraging the adoption of best practice structures, tools and techniques. To build a more competitive EU public procurement market, the Commission should work with Member States to identify, evaluate and benchmark the structures, tools & techniques which contribute most effectively to this outcome; and should use a scorecard approach, where appropriate, to raise Member States performance
- The European Commission and Member States should use competition policy tools to open markets in sectors relevant to public documents
- Member States should comply with new energy liberalisation directives
- Other member States should agree market-opening in the field of public transport services
- Member States should make a concerted effort at EU level to agree market-opening in defence procurement, subject to Article 296 of the Treaty
- The European Commission should apply tighter controls to large-value state aid which is more likely to distort competition in markets; and Member States should re-orient their State aid to measures which apply to firms in all sectors (e.g. support for research and development, or environmental protection)
- Member States should remove barriers in services, principally through negotiating agreement to and implementation of an acceptable Services Directive
- All Member States should eliminate systemic failings in practice, including unfair national preference
- All Member States should use tools and techniques which make purchasing quicker and more cost-effective (such as e-tendering and framework agreements)
- All Member States should develop their participation in Best Practice forums, such as the Public Procurement Network, to develop and share good practice and to identify bad practice
- OGC should press ahead with implementation of the Kelly Report Action Plan to increase competition and improve long-term capacity planning for UK public procurement across all key markets, as a complementary initiative to this Review

- DTI, supported by OGC should work to improve the clarity and accessibility, especially to SMEs of relevant practical advice on public procurement markets and opportunities within EU, links to tender notices and local rules and regulations. This work should be carried out in co-ordination with existing work on SME training recommended by the Better Regulation Task Force and owned by OGC/SBS
- Business Links and UKTI should promote the services available to exporters more effectively, with better guidance for SMEs and UKTI should ensure that it delivers relevant and appropriate advice which enables exporters to understand and successfully address the challenges involved in competing in EU public procurement markets
- OGC should provide guidance for business on the specific remedies available for breaches of the public procurement rules, and the available channels for pursuing a complaint
- OGC and DTI should press for further publicising by Business Links of informal problem-solving systems, namely the Public Procurement Network and the European SOLVIT network

#### **Improving Procurement: *National Audit Office 12 March 2004***

The following Recommendations from the 1999 Gershon Review were implemented in whole or in part:

- Creation of OGC
- OGC to develop a common process for the management of the supplier base
- OGC should with departments define common ways of recording what is bought, the associated prices and sources of supply
- OGC should with departments identify common types of transaction which have high costs and work with departments to reduce these costs through techniques such as e-commerce and procurement cards
- In departments with large procurement expenditure the Head of Procurement should be a Grade 3 Civil Servant or equivalent
- The need to raise professional knowledge, skills and seniority of procurement staff, including the percentage having a graduate procurement qualification
- Departments need to be more sensitive to the burdens which they place on suppliers: In some sectors OGC need to determine whether the base of suppliers is broad enough to maintain competition and innovation and take appropriate action to stimulate the interest of potential suppliers
- An overall value for money improvement target of £1billion set for achievement by end of 2002/03

*The following additional recommendations were made:*

- Procurement decisions need to be closely linked to the delivery of departments' core services and functions
- A well developed procurement strategy covering all commercial activity should be in place and regularly reviewed
- Departments need sound commercial awareness
- Buying arrangements should reflect the risk inherent in different types of procurement
- Procurement staff should have the appropriate professional skills Procurement performance should be measured and regularly reviewed

**Surer Funding: ACEVO Commission of Inquiry Report: 2004**

The Commission proposed the following key principles to guide reform:

- Sharing the responsibility for the risk of delivery
- Contracts are of an appropriate timescale
- Cutting waste caused by bureaucracy
- Fair costing and pricing

These recommendations were reflected in Sir Peter Gershon's 2004 review of efficiency.

## Annex G: Biography for Dr. Julius

### **Dr DeANNE JULIUS CBE**

#### **Chairman**

#### **Chatham House**

DeAnne Julius is Chairman of Chatham House and a non-executive director of BP and Roche. She also serves on the advisory boards of UK and US hedge funds, is Vice President of the Society of Business Economists and Senior Advisor at Fathom Financial Consultants in London.

From 1997–2001 Dr Julius was a founder member of the Monetary Policy Committee of the Bank of England. From 2001-2004 she served on the Court of the Bank. Prior to joining the MPC, she held a number of positions in the private sector including Chief Economist at British Airways and Shell. She has been senior economic advisor at the World Bank and a consultant to the IMF and UNCTAD. For the British government she chaired the Banking Services Consumer Codes Review Group and served on the Policy Commission for the Future of Farming and Food and the National Learning & Skills Council.

Dr Julius is a dual US/UK citizen. She holds a BSc from Iowa State University and a Ph.D in economics from the University of California.

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