

**‘To Gladden the Heart of Miss Nightingale’:
Using PPPs to Improve the Quality of Public Services**

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1. A Simple Proposition

I want to start with a simple and (I think) unchallenging proposition:

Competition and contracting provide powerful incentives for behavioural change.

I say ‘unchallenging’, because I don’t believe that left-wing critics of competition and contracting disagree with this proposition.

Indeed, I would argue that the Left’s suspicion of competition and contracting arises from a conviction that the profit motive is *such* a powerful incentive for behavioural change that it cannot be safely employed in the delivery of public services.

Private corporations (they argue) have a body but no soul. They are so strongly influenced by concerns about profitability, that it is impossible for them to deliver services that require a soul.

And public officials (they argue) lack the capability to channel these incentives to ensure that contractors serve public ends.

No one disagrees that the profit motive (or what is probably even more important, the no-loss motive) provides powerful behavioural incentives.

And few people would disagree that if they are not well-managed, the incentives created by competition and contracting can result in perverse outcomes.

My favourite example concerns the contracts for the First and Second Convict Fleets. All of Australia’s convicts were transported by contractors under PPP-type arrangements.

¹ Organised by the Australian Public Services Commission, the National Institute for Governance and Minter Ellison.

And while it was somewhat expensive, the First Fleet was an outstanding success – it had a death rate of around 3%, a remarkable figure given that only around half a dozen European ships had visited Australia before.

On the other hand, the Second Fleet had a mortality rate of around 40% and has come to be known as ‘the Death Fleet’.

The difference lay entirely in the design and management of the contract:

- The contract was awarded to the lowest bidder, without regard to background or reputation.
- The successful bidder was a firm of slave traders that brought with it practices familiar to that sector.
- The contractors were rewarded not on how many healthy convicts they landed in Australia, but on the amount of stores delivered.
- And the contractors were allowed to sell whatever food was left over at the end of the voyage.¹

Good contracting will motivate the delivery of good outcomes. Bad contracting will incentivise poor, and in some cases, perverse outcomes.

Any tool that is capable of delivering significant improvement if used well, must also be capable of causing significant harm if used badly.

And while poor competition and contracting might still deliver cost savings, they will do so by driving down service standards, cutting workers terms and conditions, compromising social outcomes and ultimately damaging public confidence.

In other words, both sides of this debate agree that competition and contracting create powerful incentives. Where they disagree is whether those incentives are capable of being channelled so as to serve the public good.

2. How do we recognise quality?

Let me clarify what I mean by ‘good’ competition and contracting in a public service market.

For me, the answer to this question lies in whether it is politically sustainable, or to use the ‘commonsense test’ captured in the title to my address – whether it will gladden the heart of Miss Nightingale.

This phrase is borrowed from an article published in 1859 by the English political economist, Edwin Chadwick. For the economists among you, this is the famous paper (popularised by Harold Demsetz) in which he distinguished between competition *within* the field of service, and competition *for* the field.

(This is the distinction between consumer markets characterised by ongoing competition between providers, and auction-based markets characterised by periodic competition for the right to deliver a monopoly.)

In a footnote to this article, Chadwick argued that with well-designed performance incentives, public services can be delivered benevolently without the need for benevolence, and ‘in a manner that would gladden the heart of Miss Nightingale’.ⁱⁱ

The political philosophers of the late eighteenth and early nineteenth century understood that public services are not the same as private services. In his famous speech on ‘Economical Reform’, Edmund Burke observed that:

The service of the public is a thing which cannot be put to auction, and struck down to those who will agree to execute it the cheapest. When the proportion between reward and service is our object, we must always consider of what nature the service is, and what sort of men they are that must perform it.ⁱⁱⁱ

Public services are different because they must (in most cases) be consumed collectively.

They are different because they raise complex issues of equity, access and affordability.

They are different because failures are judged politically and not proportionately.

Which means that competition for the delivery of public services – politically sustainable public service markets – must have regard to these complexities.

In my experience, there are four different kinds of complexity that governments and public service providers need to consider:

- *Service quality* – Competition is such a powerful incentive for driving down costs, that politicians and public servants sometimes use it without thought about the consequences for service quality. In Edmund Burke’s terms, they neglect ‘the proportion between reward and service’.

A market where competition and contracting is commonly associated with a decline in service standards, is not politically sustainable. And for that reason, it’s not in the interest of private sector companies to invest in such a market.

- *Public accountability* – One of the reasons why competitive tendering has enjoyed some measure of popularity over the years is because it delivers greater transparency. On the other hand, contracting is often

seen as resulting in lower levels of public accountability, in part because of spurious claims of 'commercial-in-confidence'.

Our research suggests that contracting is capable of delivering greater accountability, albeit accountability of a different kind. Earlier this year, the Serco Institute published the results of a survey we conducted with 96 of our contract managers who used to deliver similar public services as government employees.

84% of respondents reported that, for them, contracting resulted in greater accountability. But 89% of these men and women also reported that contracting had given them greater managerial autonomy.

Contracting raises a protective shield that reduces the capacity of politicians and officials from head office, to continuously intrude into managerial decision-making.

But in specifying performance standards and reporting performance against those standards, it is capable of delivering greater transparency than existed prior to the contract.

Under such a model, increased autonomy and increased accountability are not incompatible – indeed, our respondents saw them as two sides of the same coin.^{iv}

- *Workforce issues* – Lazy procurement strategies can deliver cost reductions by cutting the terms and conditions of workers. Of course, these are not productivity savings – they simply involve a transfer of wealth from workers to taxpayers.

In contracting for complex public services, companies will usually need to transfer the entire workforce, so that corporate memory is preserved. Not only that, but if they want to maintain service standards, then they will want their workforce to feel reassured throughout what will inevitably be an unsettling process.

It is not in the interest of companies with a long-term view of the market to undermine their effectiveness by driving away valued employees, or by creating fear and uncertainty in the minds of their potential workers. Not only is such a market politically unsustainable, I would regard it as commercially unsustainable.^v

- *Social policy* – Finally, a government customer is entitled to insist that its contractors meet its broader social objectives, such as equality and diversity in the workforce, or the use of SMEs in the supply chain.

Of course, it must strive to do so in a way that preserves the flexibility of its suppliers, but public service companies have a commercial interest in meeting their customer's needs.

In the UK, the Blair Government is introducing a 'Sustainable Procurement' policy. 'Sustainability' in this case does not just mean ecological sustainability. It also covers socially responsible procurement, including such issues as equality and diversity.^{vi}

The left-wing mayor of Greater London, Ken Livingstone, is particularly active in using contracting to drive a diversity agenda (providing further proof of the respect that some on the political left have for quality contracting).

There may well be a direct cost to government as a result of pursuing such policies, but if that is a cost which the public through its democratically-elected representatives is willing to pay, then it is difficult to see why public service contractors would not want to respond.

3. Can we buy benevolence?

But can we be confident that competition and contracting will be consistent in delivering these results? Are public service markets politically sustainable over the medium to long term?

For the early political economists, the answer was self-evident. By carefully designing performance incentives, government could harness commercial self-interest to serve public ends. As the great Utilitarian, Jeremy Bentham expressed it, contractual rewards and penalties would 'join interest with duty, and that by the strongest cement that can be found'.^{vii}

Aligning duty and interest in this way works rather well for services that are relatively simple, small in scale and self-contained, with investment in skills and physical assets that are not unique to that particular service.

The collection of municipal waste is a classic example. It is relatively uncomplicated. Outputs and outcomes are not difficult to measure, and the linkages between inputs and outputs easy to understand. The interconnections between neighbouring operations and between collection and disposal are not complicated. It is not difficult to train a new team and as long as the contractor is not also responsible for disposal, the physical assets (the garbage trucks) can be readily moved from one contract to another.

Municipal waste collection is one of the most intensively studied areas of public service contracting, and given these characteristics, we should not be surprised to learn that it has been fairly successful.

Thirty years of research in the United States, Canada, the United Kingdom, Ireland, Switzerland and Holland has confirmed that competition and contracting in waste collection contributes to lower costs. Only a handful of

studies have found that there was no difference, and only one study (from Sweden) showed that costs were higher.

So we *can* use contractual performance regimes to buy cleanliness. Can we use it to buy benevolence when the contractor is not itself particularly benevolent? Can we contract with the slave trader to deliver convicts safely to Sydney?

In principle, there is no reason why not, although it will require a performance regime that is *very* carefully designed, and a serious investment in monitoring. It's possible, but the transaction costs might well outweigh the benefits.

Complex public services raise significant challenges in design and management of effective performance regimes and as the American economist, Elliott Sclar has warned, 'You don't always get what you pay for'.^{viii}

Academic economists have written at great length about these difficulties. This is not the place to canvass that literature, but let me comment on several of the problems in passing:

(i) Complex or interconnected systems – Where organisational systems are inherently complex, or relatively simple but tightly coupled, then it can be extremely difficult to establish distinct organisational boundaries between customer and contractor, and to design (and manage) sufficiently detailed performance incentives.

Train operations are relatively simple, and the key outputs and outcomes fairly easy to measure, but the components are tightly coupled. This means that creating hard organisational boundaries between the network operator, separate franchisees of train and track management and various maintenance contractors, can be extraordinarily difficult.

Until several years ago, the balkanisation of the British rail network, combined with a poorly designed performance regime, had resulted in massive gaming behaviour on the part of the various contractors. It has been necessary to 'unitise' many of those contracts, and to reconstruct them in order to create a more rational set of incentives.

(ii) Long-term service contracts are difficult because of the challenges associated with writing performance incentives that anticipate conditions many years into the future.

This problem – known in the economic literature as 'incomplete contracting' or 'contractibility' – arises with utility franchises and PPP contracts, where large-scale capital investment necessitates long-term contracting.^{ix}

(iii) Specialised assets – A third area of difficulty arises where one of the competitors controls transaction-specific assets. The most common examples

relate to specialised physical capital, but with complex public services, similar difficulties can arise with human capital.^x

Thus it would be difficult to open up the waste collection market to competition if one of the bidders controlled key landfill sites and waste processing plants. And it would be difficult to open up the management of Britain's National Physical Laboratory to competition if the incumbent employed most of the nation's leading metrologists.

(iv) High risk systems – And finally, there is the difficulty of creating additional organisational boundaries and exercising management control remotely when the service is inherently risky. In the case of public services, political risk is of particular concern.

One of the principal reasons why bureaucratic management has survived for so long is that it *is* 'fit for purpose', in that it enables politicians and senior public servants to respond quickly to crises and demonstrate their sensitivity to public concerns.

The architect of Britain's National Health Service, Aneurin Bevan, famously quipped that the establishment of this bureaucratic monolith would ensure that a bedpan dropping in Tredegar Hospital (in South Wales) would resound in the Palace of Westminster.

There was no logical reason why the NHS needs to be tightly coupled, but Bevan wanted to be seen to respond to minor service failures in remote parts of the system.

This wasn't an accidental by-product of the bureaucratic paradigm. Writing in the 1920s, Max Weber recognised the importance of reaction times in an age of media scrutiny and the benefits that bureaucracy provided in this regard.^{xi}

Over the years, we have learned the limitations of contractual performance regimes, and yet since Jeremy Bentham published 'The Rationale of Reward' in 1825, we have also learned a great deal about better design and management.

Are we yet able to contract for benevolence? Well, we are certainly contracting for outcomes that are almost that complex.

Can we, for example, buy the dedication of hospital staff so that they continue to do their jobs through an epidemic of unknown dimensions?

- Contract staff in Hong Kong hospitals continued to go to work through the SARS epidemic, even though (in the early stages) they had no idea what they were exposing themselves to.

Can we contract to buy safety in the manufacture and storage of nuclear weapons?

- The Atomic Weapons Establishment in the UK has been managed under contract for more than a decade now, and repeatedly wins national safety awards.

Can we use contracting to buy pure science at a physics laboratory, where the results will be delivered many years after the contract has expired?

- The National Physical Laboratory in outer London has been managed under contract for around a decade, and delivers pure scientific research of international standing.

So it can be done!

4. *The contractual performance regime*

How? Well part of the answer lies in the design of the financial incentives. If you turn to the contracting literature of the late nineteenth and early twentieth centuries, you will find that the tools in use then were still very primitive.

Municipal franchises – the most sophisticated form of public service contracting around the turn of the century – were almost invariably handed out without competition, and while the performance regimes improved over time, they were still remarkably crude by modern standards.^{xii}

When Max Weber was writing in the first three decades of the twentieth century, the contractual model against which he contrasted his bureaucratic model was tax farming.^{xiii}

It is really only in the past three or four decades that we have seriously begun to explore the potential of contractual performance management and learned how to overcome some of its limitations. Let me give a couple of examples:

(i) *Contracting for results* – One of the ways we have learned to avoid the high transaction costs associated with designing detailed input measures is by contracting for outcomes. Jeremy Bentham and Edwin Chadwick both understood that ‘contracting for results’ was one way of avoiding perverse incentives.

In referring to the high death rates among soldiers transported overseas, Chadwick argued that contractors should be paid not on the basis of how many soldiers they embarked, but how many they disembarked. In this way:

. . . at least one sincere mourner would be ensured for every soldier who died, and an active sympathiser in case of sickness, determined to know the reason why, and to prevent its recurrence wheresoever prevention was practicable.^{xiv}

With more than 700 PPP contracts signed in the UK over the past fourteen years, we have made massive advances in the effective transfer of risk and the use of outcome and high level output measures.

(Of course, the difficulty with outcome measures is that the contractor must have control over the key inputs. One of the reasons why prison management companies have been reluctant to accept recidivism risk is that the management of the prison probably has very little impact on the likelihood of reoffending.)

(ii) *Contracting out entire systems* – Another way of getting around the challenge of using contracts in tightly coupled systems lies in drawing the contractual boundary at a more natural breakpoint. In some cases, this has resulted in government contracting out the management of entire systems.

That is what has happened with the Atomic Weapons Establishment and the National Physical Laboratory in the UK. The boundaries of the contract are the boundaries of the organisation itself.

(iii) Administered contracts – With long-term contracting, it is possible to establish flexible governance arrangements, with the terms and conditions of the contract (or franchise) renegotiated every 5 to 10 years in front of an independent regulator or arbitrator. This is the solution that was developed a century ago for the franchising of state and municipal utilities.

(Utility franchises are, in many respects, similar to long-term contracts. One economist has referred to them as ‘administered contracts’.^{xv})

(iv) Relational contracts – We have also seen the emergence of innovative governance arrangements that soften the boundary between customer and contractor.

The most dramatic of these are joint ventures, such as those being pursued through the LIFT and ‘Partnerships for Schools’ programmes in the UK. But there are softer structures: contract boards and quasi-constitutional arrangements such as MOUs that are intended to achieve the same ends. Open book accounting and profit-sharing are non-structural solutions to the same problems.

5. Beyond the performance regime

But some of the most important lessons we have learned lie beyond the structure of the contract and the performance regime. In contracting for complex public services, it is not enough to look to the design of the contract and the immediate financial incentives. It is necessary to look at the wider cultural and regulatory environment.

(i) Regulation – One of things that has changed fundamentally in recent decades is the external regulatory environment. Corporations are now subject to a plethora of regulations governing environmental protection, employment protection, health and safety, corporate governance and insurance.

In the UK, rules protecting the terms and conditions of transferred workers have been central to overcoming the problem of specialised human capital in contracting for complex public services.

The reason why the National Physical Laboratory could be successfully competed and re-competed was that the Transfer of Undertakings (Protection of Employment) Regulations, introduced in 1992, ensured that the entire workforce transferred smoothly from one operator to another upon the contract being signed.

(ii) Certification is another way that companies use to signal their trustworthiness. The joint venture that manages the Atomic Weapons

Establishment does so by winning ROSPA (safety) awards. The health care team from one of the privately-managed prisons has just won the Public Servants of the Year (Health) award.

In the UK, privately-managed prisons are subject to oversight by an independent prisons inspectorate. The results of these inspections are publicly released, but they have no direct impact on the financial performance regime.

The prison management companies pay attention to the Chief Inspector's reports because of their impact on corporate reputation. And in the early years, when contract prison management was a new idea, the Chief Inspector's reports were crucial in reassuring the sceptics.

(iii) Reputation is an enormously powerful incentive to improved performance. By challenging a company's reputation, a dissatisfied customer captures the attention of senior management through the share price, rather than just relying on the incentives created through the stream of contract payments.

And in a PPP market with some depth, where companies anticipate that there will be repeat business, a reputation for being responsible and responsive has significant commercial value. (Of course, this only works if government customers understand the importance of reputation and select their partners accordingly.)

But it is not only the company's reputation with the customer that matters. The contractor for Australia's First Fleet was an evangelical Christian, which (at that time) meant that he was socialising with emancipists and would have been severely condemned if it were known that he had treated the convicts badly.

The contractors for the Second Fleet must also have had a social life, but whatever their circle of friends, it clearly did not include men and woman who would have judged them harshly for trafficking in slaves or mistreating a ship-load of convicts.

The contract for the operation of the Docklands Light Rail, in London's new financial district, contains no reference to graffiti on the stations. And yet the stations are kept graffiti-free.

Why would a company do anything that its contractual performance regime did not mandate? Because of pride in the service that it is delivering. Docklands Light Rail regularly wins national awards as rail operator of the year and a concern for corporate reputation motivates the company to deliver outcomes that are not strictly required under the contract.

(iv) Professionalisation – And last, but by no means least, there is professional culture. The director of one of the UK's privately-managed prisons was recently asked by a government official whether her contractual

regime rewarded excellence as well as punishing failure. She replied that while some of the newer contracts did reward upside performance, her particular contract did not.

This created challenges, she said, when it came to letting prisoners out on work release. There were no rewards for letting these young men out on temporary licence to smooth their transition back into society; and there were serious penalties if one of them failed to return.

So why would she expose her company to such a risk when it delivered no obvious benefits to the shareholder? Because it was right. Under the right conditions, a professional culture will override the incentives created by the contractual performance regime.

That is the reason why those hospital workers in Hong Kong kept going to work day after day through the SARS epidemic. Because they had developed a sense of professional commitment to the job.

6. Can we gladden the heart of Miss Nightingale?

So are we able to contract for public services in a manner that would gladden heart of Miss Nightingale? It is agreed (I think) that competition and contracting are capable of providing powerful incentives for behavioural change. Are they capable of being used to ensure benevolence?

There is overwhelming evidence that with relatively simple public services such as waste collection, a well-designed contract is capable of joining interest with duty. However, it is also agreed that with complex public services, contracting for benevolence raises significant challenges.

Over the past three or four decades, a great deal has been learned about contracting for public services, and we now have examples of governments using contracts to deliver extremely complex services such as the manufacture and storage of atomic weapons and the conduct of pure scientific research.

In the UK and elsewhere around the world, we are now seeing governments explicitly contracting for improved social outcomes – better service standards, enhanced terms and conditions, increased accountability.

In part, this is possible because of advances in the design and management of contractual performance regimes. Much of what academic economists and economic historians told us about the challenges of asset specificity and long-term contracting have been overtaken by events. We have ‘muddled through’, learning by doing.

But a great deal of what is necessary to ‘gladden the heart of Miss Nightingale’ comes out of the wider commercial, cultural and regulatory settings. Governments need to look to the design of the broader market

environment if they want to get the best out of the private sector in the delivery of public services.

ⁱ See Gary L. Sturgess, 'Bound for Botany Bay: Contracting for Quality in Public Services', Discussion Paper No.1, London: The Serco Institute, 2005.

ⁱⁱ Edwin Chadwick, 'Results of Different Principles of Legislation and Administration in Europe. . .', *Journal of the Royal Statistical Society*, September 1859, pp.381-420 at p.408.

ⁱⁱⁱ Edmund Burke, 'Speech on Economical Reform' [1780], James Burke, *The Speeches of Edmund Burke*, Dublin: James Duffy, Sons & Co., 1853, pp.170-225, at p.212.

^{iv} Megan Mathias & Emma Reddington, 'Good People, Good Systems: What Public Service Managers Say', London: The Serco Institute, January 2006.

^v For a recent publication by the public services sector in the UK, see Confederation of British Industry, 'Working Together: Embedding Good Employment in Public Services', London, May, 2006 located at [Hhttp://www.cbi.org.uk/pdf/workingtogether0706.pdf](http://www.cbi.org.uk/pdf/workingtogether0706.pdf)

^{vi} See [Hhttp://www.sustainable-development.gov.uk/government/task-forces/procurement/index.htm](http://www.sustainable-development.gov.uk/government/task-forces/procurement/index.htm)

^{vii} Jeremy Bentham, 'Panopticon or the Inspection-House', Dublin, 1791, in John Bowring (ed.), *The Works of Jeremy Bentham* [1843], Volume 4, Edinburgh: William Tait, 2005, p.125. Bentham's 1825 paper, 'The Rationale of Reward', was the world's first handbook on contractual performance regimes.

^{viii} Elliott D. Sclar, *You Don't Always Get What You Pay For: The Economics of Privatization*, Ithaca: Cornell University Press, 2000.

^{ix} The leading writer in this area is Oliver Hart – see, Oliver Hart, *Firms, Contracts and Financial Structure*, Oxford: Clarendon Press, 1995. For an academic discussion of the application of this theory to PPPs, see Oliver Hart, Andrei Schleifer and Robert W. Vishny, 'The Proper Scope of Government: Theory and an Application to Prisons', *The Quarterly Journal of Economics*, 1997, pp.1127-1161; Oliver Hart, 'Incomplete Contracts and Public Ownership: Remarks, and an Application to Public-Private Partnerships', *The Economic Journal*, 2003, Vol.113, pp.C69-C76.

^x Oliver E. Williamson, 'Transaction-Cost Economics: The Governance of Contractual Relations', *Journal of Law and Economics*, 1979, Vol.22, No.2, pp.233-261.

^{xi} Max Weber, *Economy and Society*, Chapter XI.6, Berkeley: University of California Press, 1968, p.974.

^{xii} George L. Priest, 'The Origins of Utility Regulation and the "Theories of Regulation" Debate', *Journal of Law and Economics*, (1993) 36, pp.289-323, at pp.309-313.

^{xiii} Max Weber, *Economy and Society*, Chapter XI.6, Berkeley: University of California Press, 1968, pp.965-966. In his discussions of contracting, Bentham also defended tax farming and the farming of the poor - Jeremy Bentham, 'Farming Defended', in Michael Quinn (ed.), *Writings on the Poor Laws*, Volume 1, Oxford: Clarendon Press, 2001, Appendix B; Jeremy Bentham, *The Rationale of Reward*, London: John Hunt, 1825, Book II, Chapter XI: 'Of Trust and Contract Management'.

^{xiv} Edwin Chadwick, 'Results of Different Principles of Legislation and Administration in Europe. . .', *Journal of the Royal Statistical Society*, September 1859, pp.381-420 at p.408. Jeremy Bentham used similar concepts in his famous paper on 'Panopticon', a technologically advanced prison that he proposed to manage under contract – see Jeremy Bentham, 'Panopticon or the Inspection-House', Dublin, 1791, in John Bowring (ed.), *The Works of Jeremy Bentham* [1843], Volume 4, Edinburgh: William Tait, 2005.

^{xv} Victor P. Goldberg, 'Regulation and administered contracts', *The Bell Journal of Economics*, 1976, Vol.7, No.2, pp.426-448.