

# Public services: meeting the productivity challenge

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**Public services:  
meeting the  
productivity challenge**

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### **HM Treasury contacts**

For enquiries about this publication or to obtain further copies, contact HM Treasury Public Enquiry Unit:

Public Enquiry Unit  
HM Treasury  
1 Horse Guards Road  
London  
SW1A 2HQ

Tel: 020 7270 4558

Fax: 020 7270 4574

E-mail: [public.enquiries@hm-treasury.gov.uk](mailto:public.enquiries@hm-treasury.gov.uk)

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# EXECUTIVE SUMMARY

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**E.1** The Government's central economic objective is to achieve high and stable levels of growth and employment. Previous Treasury papers have set out the Government's strategy for raising productivity in the private sector, including policies that increase investment in physical and human capital, promote innovation, strengthen competition and encourage enterprise. This paper discusses the challenge of raising productivity in the public services.

**E.2** As Chapter 1 explains, raising public services' productivity is important for a number of reasons. Not only do public services directly account for a significant proportion of national output, they are also a key determinant of society's welfare. Taxpayers are also entitled to value for money in health, education and the full range of public services they finance. Furthermore, high quality public services provide the conditions that enable private businesses to grow and realise their full potential, thereby raising the productivity and prosperity of the economy as a whole.

**E.3** However, measuring the productivity of public services is difficult. By placing too much emphasis on resource inputs, past approaches have overlooked the primary concern of government and citizens alike which is that public services should achieve certain specified results. A better approach is to focus attention on public services' outcomes, such as levels of health and literacy within society. Looked at in these terms, and compared internationally, the available evidence suggests that, while UK public services perform well in certain areas and show signs of improvement in other areas, there remains considerable scope for further progress to be made. This is the challenge of raising public services' productivity.

**E.4** This challenge requires the efficient delivery of high quality customer-focused services, that offer value for money to taxpayers. In the right circumstances markets can provide the best means of delivering services upon which people rely. Well-functioning markets can ensure services are delivered in a customer-focused and efficient manner, as is the case with utilities such as electricity and gas. Where markets fail to function well, government can sometimes intervene to address specific market failures through competition policy or regulation. However, when market failures are profound, or where there are issues of equity that cannot be addressed through the market, these services need to be provided directly by the public sector.

**E.5** Chapter 2 considers the circumstances where markets can deliver services efficiently, but goes on to examine the limits to markets and demonstrates, with special reference to the NHS, the circumstances where it is more efficient and equitable for the public sector to fund and provide a public service. It looks at the market failures and equity considerations associated with public services and the justification they provide for government involvement in their provision. It also considers the scope for markets and demonstrates that with Public Private Partnerships, for example, it has been possible for the Government to utilise private sector suppliers and use market disciplines to deliver real improvements in public services. The chapter concludes by describing the generic problems that must be overcome if the productivity of publicly provided services is to be raised.

**E.6** Chapter 3 sets out the building blocks of the Government's policy for meeting the public services' productivity challenge. The first building block is a focus on outcomes - performance of the public services should be assessed on the basis of results. The second involves devolving responsibility for the delivery of public services to local providers, subject to appropriate minimum standards and regular performance monitoring. The final building block is about improving the governance of public services, by reforming institutions to reflect the importance of clear objectives, appropriate incentives and good performance information in the achievement of higher productivity.

**E.7** These building blocks have been translated into a four-point framework to guide public service reform:

- clear long-term goals, expressed as desired outcomes;
- greater discretion for local service providers, constrained by effective governance structures;
- improved information about performance; and
- better incentives for service providers to meet users' needs.

**E.8** Chapter 4 looks at the reforms the Government has put in place based on this framework for raising public services' productivity. Examples of reforms in four key policy areas – health, education, transport and criminal justice – demonstrate the progress made since 1997.

**E.9** The paper concludes by looking ahead to the challenges of the next stage of public services' reform, and the implications of the public services' productivity agenda for future policy decisions on the efficient and effective use of resources. The continued focus on seeking better value for money from public spending is highlighted, together with the need to secure responsive public services at every level – local, regional and national – and to tackle inequalities in service delivery. These reforms will help the Government achieve higher productivity in the public services and a Britain of opportunity and security for all.

# PUBLIC SERVICES' PRODUCTIVITY PERFORMANCE

## INTRODUCTION

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**1.1** The Government's central economic objective is to achieve high and stable levels of growth and employment. This requires progress on two fronts: a bigger, more skilled workforce; and higher productivity in both the public and private sectors.

**1.2** The Government has adopted a range of policies designed to improve the quantity and quality of the workforce. There are 1.5 million more jobs since 1997 and over 810,000 previously unemployed or inactive people have gained employment through the New Deal. Increased spending on education and training is boosting standards throughout the school system and helping to deliver life-long learning.

**1.3** Alongside this, achieving high economic growth requires increased productivity. In *Productivity in the UK: The evidence and the Government's approach* (2000), the Government set out its strategy for improving productivity in the private sector by implementing policies to increase investment in physical and human capital; to promote innovation and research and development; to strengthen competition and encourage enterprise and entrepreneurship.

**1.4** But raising the productivity of public services is also an essential element of this ambition. Improved performance in public services such as healthcare, education, transport and criminal justice is crucial to achieving the outcomes that society wants, including greater prosperity, security and health.

## WHY PUBLIC SERVICES MATTER

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**1.5** The performance of the UK's public services matters for a number of reasons. Government expenditure on the public services currently represents approximately 22 per cent of UK Gross Domestic Product (GDP)<sup>1</sup>. Improved productivity in the public services will therefore contribute significantly to higher productivity within the economy as a whole.

**1.6** Taxpayers rightly expect value for money from the public services they finance. People are willing to fund public services that promote the public interest by advancing opportunity and security for all, but they are not inclined to pay taxes that simply finance wasteful expenditure.

**1.7** Additionally, public services are direct determinants of economic prosperity and personal welfare, not only for those people who use them, but also their families, communities and employers. For example, families gain from the education of their children and from health and social services' provision for the sick and elderly. The UK's most disadvantaged communities also benefit significantly from services such as policing that effectively tackle crime and other causes of social exclusion.

**1.8** High quality public services also create the conditions that enable private businesses to grow and realise their full potential – thereby raising the productivity and prosperity of the economy as a whole. Strong health and education systems, plus an integrated transport network, will deliver an environment in which enterprise can flourish, not least by promoting a healthy, skilled and mobile labour force. For example, the CBI estimate that workplace absences due to sickness cost UK businesses around £11 billion in 2001.

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<sup>1</sup> Departmental and Devolved Administration expenditure on public services, 2001-02. Source: HM Treasury.

**I.9** Improving public services' productivity is therefore an important element of the Government's strategy for raising the rate of sustainable growth, tackling social exclusion and improving quality of life. It requires that the resources provided to the public services are used as efficiently as possible. This means first that individual service providers, for example schools and hospitals, use the resources they receive as efficiently as possible in delivering more and better *outputs*, such as medical treatments and school lessons. It also means that the *outcomes* of public services, their beneficial impacts on society more generally, such as better health and literacy, are maximised.

### MEASURING PUBLIC SERVICES' PRODUCTIVITY

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**I.10** Although public services are of critical importance, their productivity is very difficult to measure. This is for a number of reasons, all related to the measurement of outputs and outcomes<sup>2</sup>.

**I.11** In the private sector, the value of services provided by a company is determined by the price at which they are sold in the market. This enables measures of productivity, such as output per worker, to be calculated relatively easily. But since public services are rarely traded in a market, the outputs of service providers cannot be quantified using prices. A further complication is the distinction between outputs and outcomes. Public services' performance is ideally measured in terms of outcomes, since these are the primary concern of citizens, but it is often hard to identify to what extent these are caused by the services' outputs as compared with other, external, factors. The time-lag that can often exist between improvements in the quantity and quality of outputs and the better outcomes they achieve is another complicating factor.

**I.12** As a result of these difficulties, the measurement of public services' productivity has historically tended to ignore outcomes and outputs to focus instead on the magnitude of inputs. Both in statistical publications and general debate, increased expenditure on the public services has historically been regarded as equivalent to an identical increase in output. Such an assumption is no longer tenable, and efforts are currently being made across Government to produce more meaningful estimates of public services' productivity.

**I.13** Progress has already been made in evaluating aspects of public service performance at several levels, for example by looking at comparisons of performance internationally, across local areas in the UK and between different service providers. This chapter now looks at each of these comparisons of public services' performance in turn.

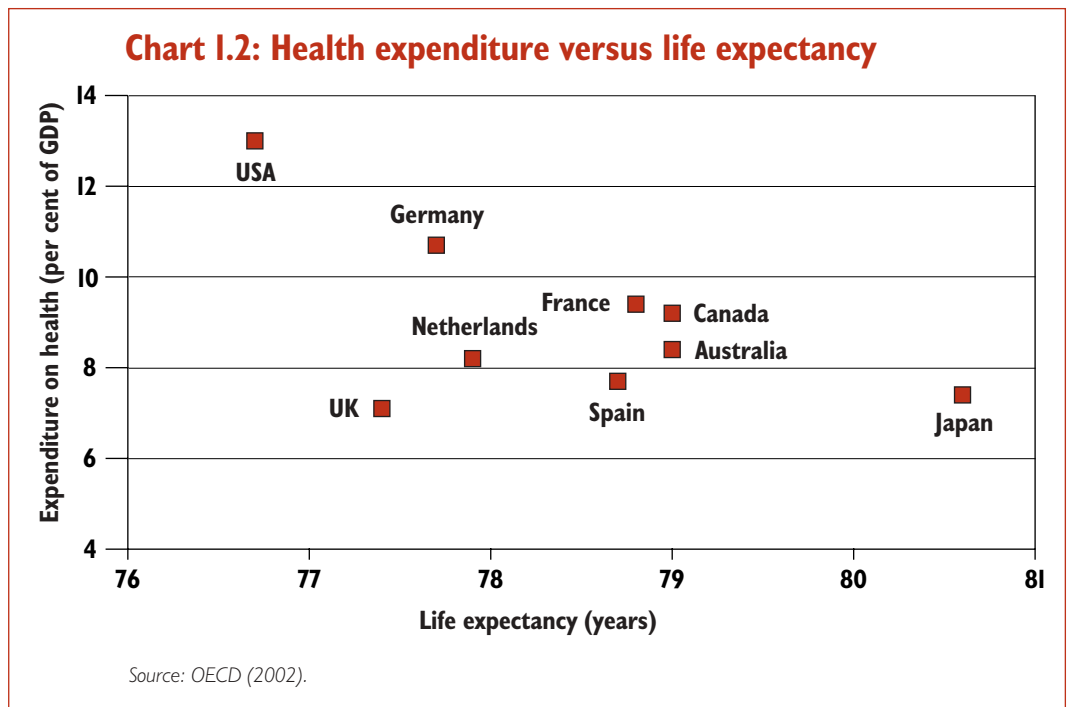
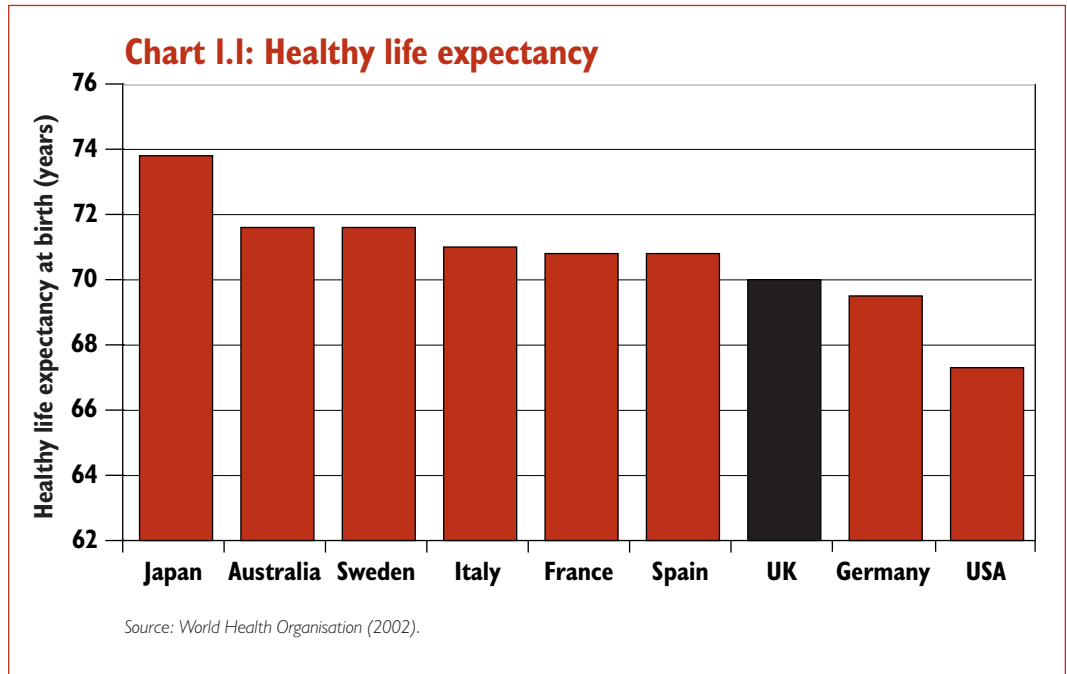
### International comparisons

**I.14** Few outputs or outcomes are measured in the same way across countries, so comparisons have to be treated with caution. Nevertheless, when used carefully, they can give helpful perspectives on UK public services' performance, serving to point out countries where best practice can be learnt, or where the UK has strengths worth preserving.

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<sup>2</sup> Annex A describes in greater detail the concept of public services' productivity, and the difficulties encountered in measuring it.

**I.15** An example of such research comes from the World Health Organisation, which compares the performance of health systems across the world using a number of indicators. Chart 1.1 below depicts the UK's performance against other developed countries on one of these indicators, average life expectancy, adjusted to take into account levels of disability and ill-health.

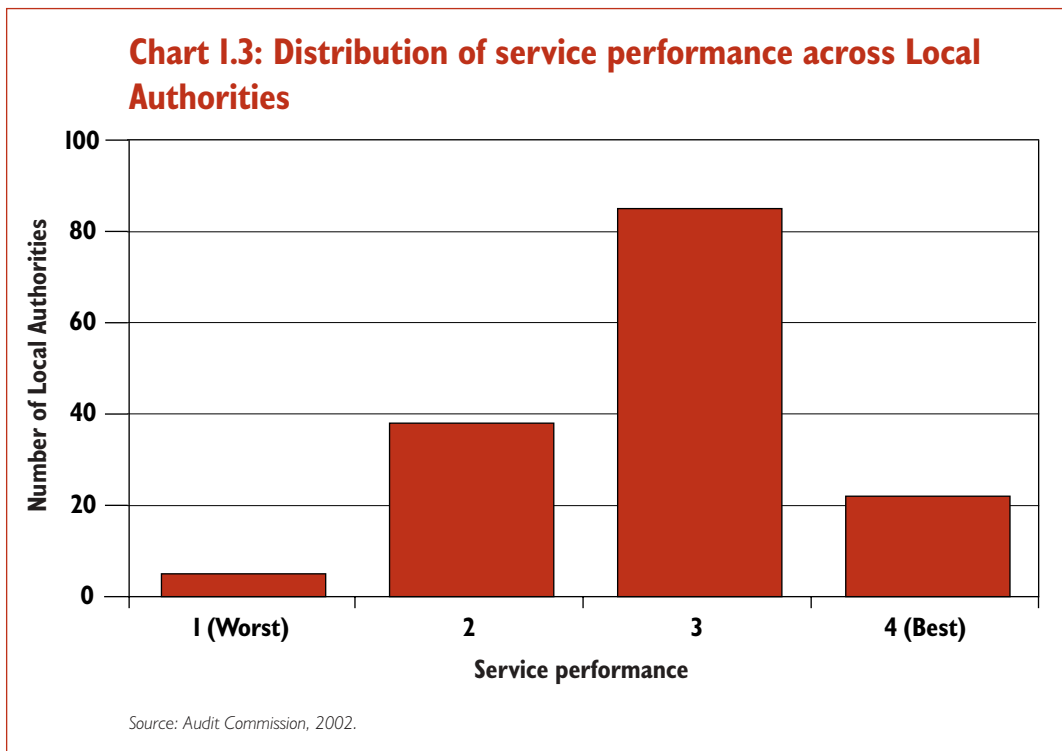


**I.16** Life expectancy is, of course, affected by many other factors apart from the efficiency and expenditure of the health service, including the quality of the environment, the state of housing and sanitation facilities, plus general cultural attitudes to diet and exercise. Nevertheless, the World Health Organisation found a wide variation in performance in life expectancy and other indicators, even among countries with similar levels of income and health expenditure.

**I.17** Increased expenditure on healthcare is an essential precondition for achieving improved health outcomes but, as Chart 1.2 illustrates, by itself it is not sufficient. For example, despite devoting 13 per cent of its GDP to healthcare, life expectancy in the USA is lower than in many other developed nations. Maintaining and enhancing the productivity of health care services that allows the UK to produce better results than the USA at lower cost is therefore an equally important goal.

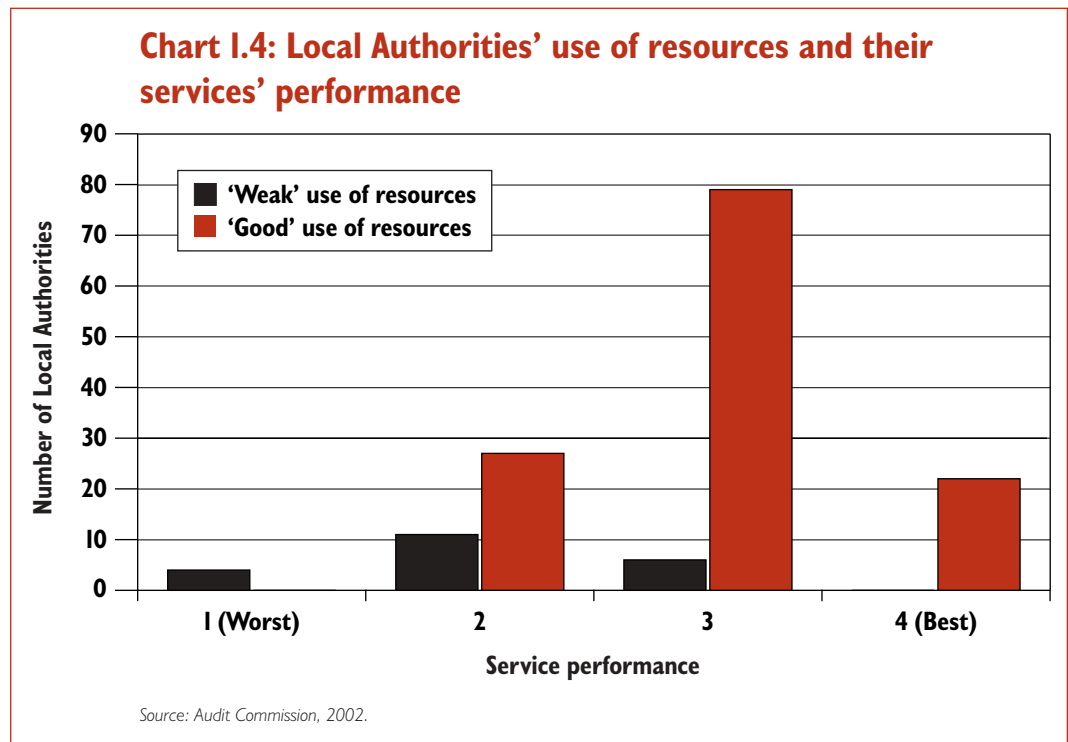
**Local variations in performance**

**I.18** In addition to international comparisons of public services' productivity, there is much to be gained from assessing variations across areas within the UK. Where appropriate and robust performance data by area exists, this acts to energise commitment to improvement. A notable form of this is the local authority Comprehensive Performance Assessment, developed by the Audit Commission and applied to all single-tier and county councils in England. This exercise brought together the existing performance information held by Government departments, auditors and inspectors, to make an informed judgement on the performance of every top-tier local authority.



**I.19** Using information on the quality of education, housing, social care, environmental and other services provided by each local authority, the Audit Commission was able to make an overall assessment of their quality of service. Chart 1.3 below summarises the findings, and shows that the majority of councils are achieving good performance, though a significant number of local authorities have scope for improvement.

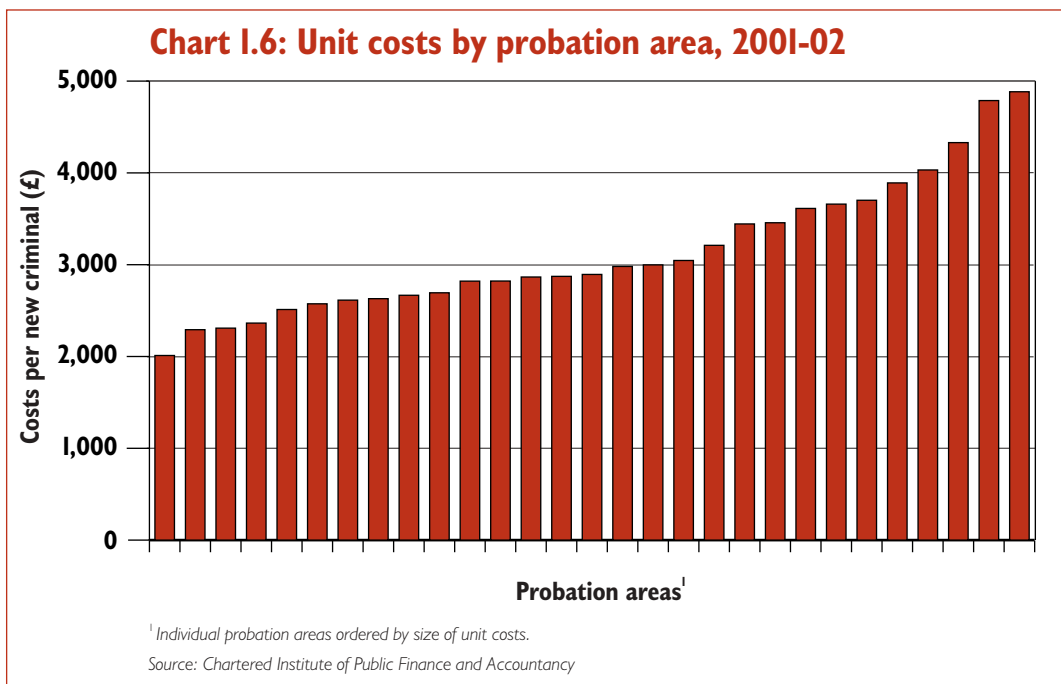
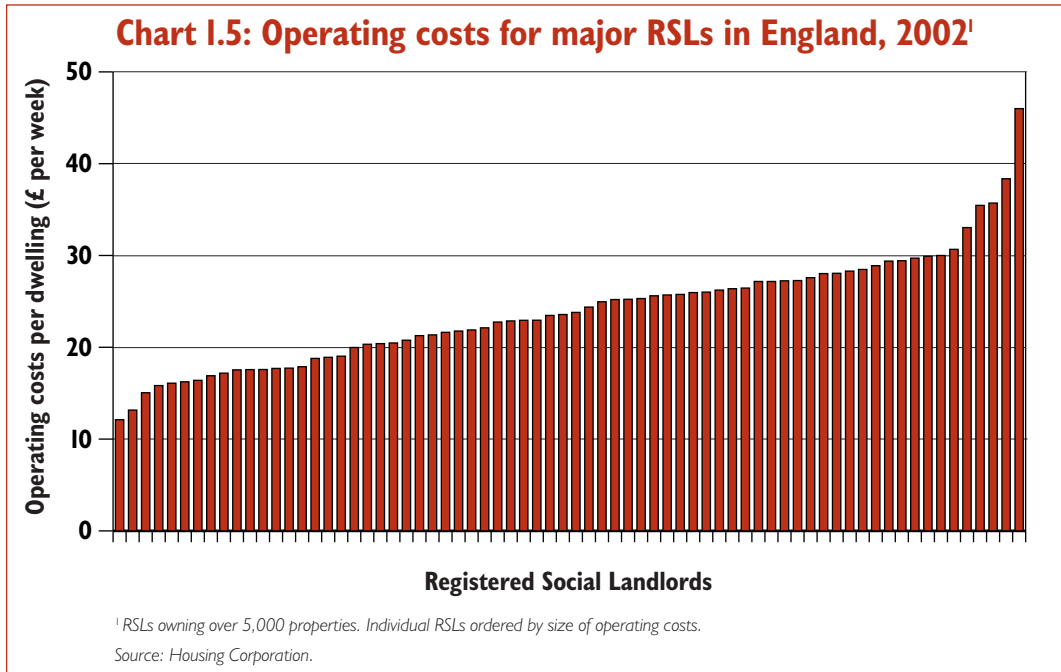
**I.20** The Comprehensive Performance Assessment also included a judgement on local authorities' use of resources, based on how well they manage their budgets and direct them at priorities. The results show that a local authority's ability to use resources is closely correlated with its overall performance. As Chart 1.4 shows, all councils providing excellent services to the public make good use of their resources, while all councils with poor service scores make poor use of their resources.



### Individual service providers

**I.21** As well as international and local comparisons, public services' productivity also needs to be assessed at the level of the individual service provider. If efficient institutions can be identified, other institutions can be encouraged to improve their performance towards that achieved by the best. As a result, the performance of public services as a whole would improve significantly. This approach, known as *benchmarking*, is increasingly being applied across the public services.

**I.22** For example, Chart 1.5 compares the operating costs of different institutions in the area of social housing. It shows a three-fold variation in operating costs among major Registered Social Landlords (RSLs) in England. Similar variations occur in many other services. Chart 1.6, for instance, compares the unit costs of probation services in different areas and indicates that they experience a similar order of variation in the cost of punishing and rehabilitating new criminals.



**I.23** It is important to put the results above in context. For example, higher costs may be justified where a higher quality of service is being provided. Furthermore, even where the quality of service is the same, variations in cost may well be a function of factors outside managers' control, such as the location of dwellings or the needs of tenants in the case of social housing. But where analysis identifies variations in the costs of individual public service providers that cannot be explained by external factors alone, the task for Government is to uncover and resolve their underlying causes. Only then will the productivity of public services be raised across the board.

## CONCLUSIONS

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**I.24** This chapter has explained why raising the productivity of public services is an important part of the Government's agenda to achieve high and stable levels of growth and employment. Public services not only account for a significant proportion of national output in their own right, but also help create the conditions in which private enterprise can flourish, thereby raising productivity across the whole economy. Achieving higher productivity in the public services will produce additional benefits, including giving taxpayers better value for money and delivering higher quality services for users.

**I.25** Comparisons of public services' expenditure and outcomes across countries, and between areas and providers within the UK, illustrate that it is not just the level of resources that matters in generating improved outcomes for the public, but also the way those resources are used. In addition to tackling areas of under-investment, therefore, the task for the Government has been to identify the underlying problems that constrain public services' productivity and devise an effective strategy to overcome them.



# 2

## UNDERSTANDING THE PUBLIC SERVICES' PRODUCTIVITY CHALLENGE

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### INTRODUCTION

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**2.1** This chapter looks at the challenge the Government faces in raising the productivity of public services. It begins by describing why private sector firms operating in well-functioning markets are typically able to provide high quality goods and services to consumers. The special characteristics of public services mean, however, that the wholesale introduction of markets for their delivery would be neither efficient nor equitable. The challenge for the Government, therefore, has been to develop an approach for raising public services' productivity that respects these two critical considerations of efficiency and equity.

### THE BENEFITS OF MARKETS

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**2.2** Markets exist wherever consumers and suppliers interact freely to buy and sell goods and services. When they function properly, markets have two key benefits:

- **efficiency** – markets ensure that goods and services are produced at the lowest possible cost, so offering consumers value for money; and
- **customer-focus** – the goods and services that firms produce will be designed to meet consumers' needs and preferences.

**2.3** Well-functioning markets will produce these desirable outcomes because:

- firms are subject to an objective of maximising profits for their owners and shareholders. This requires them to minimise their costs and so continually seek the most efficient production methods; and
- profit-maximising firms operating in a competitive market must produce goods and services consumers will buy if their businesses are to survive.

**2.4** Consequently, in many circumstances markets are the most effective means of delivering efficient, customer-focused goods and services. In these cases, which include the markets for utilities such as electricity and gas, the key role for government has been to strengthen the drivers of efficiency through competition policy. But markets can often fail, and the efficient, customer-focused outcomes described above are then put at risk. Markets also distribute goods and services solely on the basis of ability to pay, and therefore do not take account of considerations of equity (social justice). Equity is a particularly important factor in the public services, given the Government's commitment to ensuring that key services such as healthcare are provided free at the point of use on the basis of need and not ability to pay. The following section describes more fully the market failures and equity considerations associated with public services, and the justification they provide for government involvement in their provision.

### EFFICIENCY, EQUITY AND PUBLIC SERVICES

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**2.5** The Government is committed to serving the public interest, by promoting opportunity and security for all. This means public services should be both efficient and equitable, providing support to those in need and offering value for money to taxpayers. This section explains that while markets may often be the best method of delivering goods and services, the special characteristics of public services justify varying degrees of public sector intervention to preserve equity, efficiency and the wider public interest.

## Efficiency

**2.6** Efficiency is one of the Government's key objectives for the public services. It means that the taxes people pay must be translated as effectively as possible into high quality public services. As discussed above, profit-maximising private firms operating in well-functioning markets can be expected to provide efficient, customer-focused services.

**2.7** Market mechanisms can be expected to produce desirable outcomes when certain conditions are met. In particular:

- consumers must possess **good information** about their needs and the quality of service available from alternative suppliers. In such circumstances, they can use their income to purchase a mix of services that will maximise their welfare;
- firms are operating in a **competitive** environment (i.e. many suppliers and few barriers to potential new entrants), forcing them to provide high quality products at least cost to generate custom and stay profitable;
- there are **no externalities**, so that the production and use of a good or service affects no one other than the firm that provides it and the individual who directly chooses to consume it; and
- the product is **not a public good**, so that firms are able to identify the individuals who use the service they provide, and are able to measure each person's consumption of it.

**2.8** When these conditions are met there is no efficiency justification for government intervention in markets. But should any one of these four conditions not be met, markets cannot be expected to produce efficient outcomes. These **market failures** distort the market mechanisms that produce clarity about objectives and priorities, clear information about costs and prices and reward well-judged innovation and risk taking. These distortions can lead to consumers facing excessively high prices, inadequate levels of provision and other inefficiencies. Importantly, many of these market failures would arise if private providers were given unrestricted freedom to deliver key public services<sup>1</sup>. For instance:

- consumers often lack sufficient **information** to make an accurate assessment of their needs and of the quality and value for money of alternative suppliers' services. This could lead them to purchase services not appropriate to their needs, and would allow inefficient, low-quality suppliers to remain in the marketplace. Information problems are particularly severe in health care, where patients typically wish to consult a professional in order to accurately judge their medical needs, the range of alternative treatments available or the quality of care they ultimately receive;
- effective competition between different suppliers is not always present. Often public services have natural monopoly characteristics, meaning that only a single firm, or very few firms, could engage in least-cost production. Left unchecked, these firms would wield **market power**, enabling them to charge excessive prices and restrict their output in order to make excessive profits. Major transport networks typically exhibit natural monopoly characteristics, as do many services supplied to particular localities, such as neighbourhood refuse collection and hospital emergency services<sup>2</sup>;

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<sup>1</sup> Barr (1998) describes the market failures that arise for key public services in greater depth.

<sup>2</sup> Domberger and Jensen (1998).

- **spillovers**, or *externalities*, arise when consumption of a service affects the wider community in addition to those people who directly use it. Individuals making their own personal choices are unlikely to consider the wider social effects when deciding how much of a service to consume, which would lead to an inefficient level of consumption from the perspective of society as a whole. Examples of externalities include medical treatment for contagious disease, or an individual's education that raises not only their own productivity but also that of people working with them<sup>3</sup>; and
- if there are no limits on the number of people who can simultaneously use a service and if it is hard to prevent people benefiting from it, then the service fulfils the *non-rival* and *non-excludable* characteristics of a pure **public good**<sup>4</sup>. These services will be under-supplied by the market, since every individual will have an incentive to free ride on the provision funded by other users. National defence and the criminal justice system are two services that fulfil the characteristics of a pure public good, since it would be difficult for a private supplier to calculate or charge individuals a price that accurately reflected their use of them.

**2.9** As described above, public services generally exhibit various markets failures that would lead to inefficient levels of price and output if they were bought and sold in unfettered markets. Government intervention in such circumstances can make markets work more efficiently, by addressing the market failures. A further option for government is to provide public services itself, instead of relying on markets. The circumstances where public provision represents the most efficient policy option are discussed more fully below. Before that, the second of the Government's objectives for the public services – equity – is considered.

## Equity

**2.10** In addition to the need for the Government to tackle market failures the pursuit of equity (social justice) provides a second justification for public sector involvement in the provision of certain services. The Government is committed to ensuring that public services such as education and health care, which have a significant impact on people's opportunities and quality of life, are provided in an equitable way.

**2.11** Private firms operating in markets provide goods and services on the basis of consumers' ability to pay. But equity considerations suggest that ability to pay is an unacceptable basis for the distribution of services such as medical treatment or education that meet basic human needs. These services should be distributed in a more equitable way, using criteria that reflect need. It is obviously equally important that public services are of sufficiently high quality to meet these needs satisfactorily.

**2.12** The Government is therefore committed to ensuring that everyone has access to high quality public services. This translates into specific equity objectives for the key public services:

- a comprehensive, high quality, National Health Service available free at the point of use on the basis of clinical need and not ability to pay;

<sup>3</sup> Le Grand, Propper and Robinson (1992).

<sup>4</sup> Bailey (2002).

- an education system that improves opportunity for all;
- a criminal justice system that builds a safe, just and tolerant society;
- a better experience for all users of our transport system; and
- a decent home for everyone, irrespective of income.

**2.13** Equity objectives such as these are the reason why varying degrees of public sector involvement are undertaken in public services delivery. Ensuring access is based on need alone requires government to fund all or part of the costs incurred by those supplying public services. It can do so by negotiating contracts with private providers, or by giving individual consumers the resources they need to purchase services for themselves. An important third option is for the public sector to both fund and provide a public service, as with the NHS. The circumstances where equity considerations require public funding to be accompanied by public provision are described below.

### The limits of markets

**2.14** The paragraphs above explained why concerns for efficiency and equity can justify government involvement in the delivery of public services. The exact type of intervention required will depend on the extent of the market failures needing correction for markets to work efficiently, and the Government's precise equity objectives for the service in question. So for every public service a central question is whether the public interest can best be advanced by government intervening to make markets work better, or by directly providing the service itself.

**2.15** It is therefore vital for the Government to recognise the limits of markets. Those circumstances where it can be both more efficient and more equitable for the public sector to fund and provide a public service include:

- when there are severe market failures or important equity considerations that would require extensive intervention by government in the conduct of private suppliers to avoid undesirable outcomes. A regulator of private health care provision, for instance, would be required to overcome serious information problems by undertaking extensive and detailed monitoring of service providers, which would be both difficult and expensive. In such circumstances, the high **regulatory costs** that would be incurred mean that public provision represents a more cost-effective method of delivering efficient and equitable services<sup>5</sup>;
- where services suffer from **multiple market failures**, Lipsey and Lancaster (1956) suggest that government intervention which is able to remedy only some of the distortions they create can actually lead to more inefficient "third best" outcomes. Public provision, which bypasses these market failures altogether, will be more effective at raising efficiency in these circumstances;
- when it would be extremely difficult for government effectively to write and enforce a contract with a private sector service provider. This situation can arise, for example, if for reasons of equity the government is trying to ensure users will receive a certain quality of service that cannot be accurately specified in a contract. In this situation of **non-contractable quality**, profit-maximising private suppliers would have an incentive to reduce quality if it

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<sup>5</sup> Discussed further in Bailey (2002).

could not be observed or measured by government<sup>6</sup>. Public provision, in contrast, ensures that high standards of quality are not sacrificed to raise profits, by allowing dedicated public servants to put duty, obligation and service before profit or personal reward. This public service ethic is discussed more fully in Box 2.3 at the end of this chapter; and

- where contracts may leave private suppliers insufficiently **responsive** to unforeseeable changes in government's requirements for the provision of certain public services. This situation arises if government's objectives for the service change frequently, due to uncertainties about the exact specifications of the service required. Public sector provision, therefore, enables government to ensure that services, such as the armed forces, are able to respond rapidly to unforeseeable demands. Public provision also ensures service providers are highly accountable to government for their actions, allowing early identification and rectification of poor performance. This is particularly important for key public services, such as health and education, where poor-quality service can often have severe, long-term consequences for welfare.

**2.16** Box 2.1 illustrates how these problems justify a publicly-funded, publicly-provided National Health Service. Similar considerations also establish a strong case for the public funding and provision of other key public services, notably school education, national defence and the criminal justice system.

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<sup>6</sup> The problem of non-contractable quality is described more fully in Domberger and Jensen (1998).

### **Box 2.1: Efficiency, equity and the National Health Service**

A number of deeply entrenched market failures, plus the Government's equity concern that access to health care should be based on clinical need and not ability to pay, are reflected in the design of the NHS – public funding matched by public provision.

Private insurance for health care suffers from the fact that people are typically unable to predict their future health care needs, and are naturally concerned about its potentially high cost. In addition, market failures exist in private insurance markets, notably information problems, that can lead to inefficient and inequitable outcomes:

- insurers may fail to cover some people or conditions at all;
- insurers may set excessively high premiums for 'bad risk' clients, such as those suffering from chronic medical conditions;
- incentives are created for people to under-insure to demonstrate that they are 'low risk' clients; and
- high premia arise due to the costs incurred when insurers conduct risk profiling and attempt to manage uncertainty.

Social insurance can avoid most of these problems but creates efficiency losses by loading all the costs of health care onto one group of taxpayers – employers and their employees. Additional administrative costs are also created under social insurance schemes because they duplicate the existing tax system. Combined, these factors create a strong case for tax-funded health care.

The case for public provision of health care, meanwhile, rests on the presence of extensive market failures on both the demand and supply side that could not be effectively or efficiently resolved by government regulation alone:

- **price signals do not always work** – consumers may lack sufficient information to make optimal choices about their health care needs;
- **the consumer is not sovereign** – asymmetries of information between consumers and health care providers can create a risk of supplier-induced demand;
- **there is a potential abuse of monopoly power** – economies of scale resulting from the clusters of specialisms required to deliver emergency care can create local monopolies, while high barriers to entry and self-accreditation can lead to professional monopolies;
- **it is hard to write and enforce contracts** – the non-standardised, patient-specific nature of medicine makes it hard to judge or contract for specific outcomes; and
- **it is difficult to let failing hospitals go bust** – individuals are entitled to expect continuous, high quality, health care wherever they may live.

The case for a publicly-funded, publicly-provided NHS does not, however, justify a wholly centralised, unreformed service. Substantial extra investment in the NHS is being matched with reforms to ensure it delivers real improvements in performance. These reforms will devolve power to front line organisations, establish new financial incentives to improve performance and deliver more responsive services with greater choice for patients.

## The scope for markets

**2.17** Despite private provision and markets being inappropriate for many key public services, in some cases where services are publicly funded it has been possible for the Government to utilise private sector suppliers in order to deliver real improvements. Public Private Partnerships, for example, have enabled the Government to harness effectively the expertise of many private sector contractors to deliver cost-effective high-quality investment in the infrastructure supporting a range of public services (See Box 2.2 below). The National Health Service is also taking advantage of spare capacity in the private sector to secure faster treatment for patients requiring routine procedures without jeopardising efficiency or equity.

**2.18** Where the Government is committed to public services free at the point of use and available to all on the basis of need, it is important to ensure that choice is not promoted at the expense of equity or efficiency, particularly where there are market failures and capacity constraints. Consumer choice can be efficiently and equitably introduced into those aspects of the public services where users possess sufficient information about their needs to make optimal choices, and where it is efficient to have more than one service provider operating in a given locality. In education, for example, the Government is enabling more pupils and parents to have a wider choice of schooling by working directly with LEAs, poor-performing schools and the local community to address weak leadership and raise standards. The NHS has also sought to increase the choices available to patients by introducing booking systems for hospital appointments, creating NHS Direct and establishing walk-in health centres.

**Box 2.2: Public Private Partnerships**

Public Private Partnerships (PPPs) are a key element in the Government's strategy for delivering high quality public services and a more competitive economy. Drawing on the best of the public and private sectors, PPPs are helping to ensure that new investment is both managed efficiently and delivering better public services, with high standards locked-in for the long-term.

Private sector investment through PPP contracts typically accounts for around 10 per cent of total investment in public services in any one year. Over the next three years, the Government expects that contracts worth at least £12 billion will be signed, with many other deals in procurement. PPP contracts are only pursued where they represent the best value for money option. Where this is the case, they offer a number of important benefits. By putting substantial levels of private capital at risk and requiring the companies involved to deliver clear levels of service over the long term, PPPs tie payment more closely to performance and ensure that public assets are delivered on time and to budget. Moreover, by focusing attention on the outcome that a service should deliver, PPPs allow new scope for private sector innovation in the way those outcomes are delivered.

PPPs are already being utilised to deliver successful projects, including:

- **delivering new hospitals.** Since 1997, PFI has already provided 40 new hospitals, and 60 more are currently in procurement. Successful projects to date include the new Dartford and Gravesham hospital – an acute general hospital on the Darent Valley site, which consolidates services from three hospitals into a single modern, flexible accommodation. Like the great majority of PFI projects, it was delivered on time and to budget;
- **funding of the Ten-Year Transport Plan.** Around £56 billion is expected to be funded through private sector finance, including PPPs. Successful projects to date include the extension of the Docklands Light Railway, which was completed in 1999. This project had a capital value of £200 million, and was delivered within budget and two months early; and
- **improving schools.** 51 schools PFI projects have been signed, with a total value of £1.3 billion, and covering over 560 schools. Successful projects to date include the Barnhill Community School in Middlesex – a new school providing state-of-the-art facilities to educate 1,450 children.

**GENERIC PROBLEMS FACING THE PUBLIC SERVICES**

**2.19** For those public services that, on grounds of efficiency and equity, are rightly provided by the public sector, the task for the Government is to overcome any barriers that may prevent them achieving higher productivity. Several studies have highlighted a number of generic problems encountered by public service providers. Identifying and resolving such problems is an essential step in improving the outcomes of public services – as important as tackling areas of under-investment.

**2.20** Evidence suggests that those public service providers who ensure they have a clear understanding of the **objectives** they are expected to be pursuing can achieve greater consistency in the cost and quality of services they deliver. For instance, the Audit Commission (2001) found that those local service providers that have identified a small number of core goals have been most successful in achieving large and sustained improvements in performance. A National Audit Office (2001) report on value for money within the public sector also found that a failure to specify the required outputs properly in advance was the root cause of cost overruns in many information technology-related projects.

**2.21** The Audit Commission (2001) study also identified inadequate **prioritisation** as a further factor that can compromise service delivery. This analysis, which was based on the Commission's extensive experience of inspecting local councils, found that prioritisation presented a special challenge for those charged with delivering public services, since they were often trying to achieve a number of objectives at the same time. This finding is supported by academic research. Dixit (2000), for instance, lists the multiple goals of education as imparting children with basic skills, preparing them for work, instilling ideals of citizenship and fostering emotional growth. Although they are not contradictory, these goals compete for resources and the attention of teachers<sup>7</sup>. Clear prioritisation in such circumstances is crucial.

**2.22** Public service providers also frequently encounter **information** problems. Complex health services, for instance, can be provided only if those managing and delivering the services have access to reliable, well-structured and timely information. The Commission for Health Improvement (2002), drawing on its reviews of clinical governance in 175 NHS Trusts, however, found that doctors and nurses sometimes lack ready access to the information they need to treat patients effectively.

**2.23** Robust **accountability** structures, with clarity about roles and responsibilities, are also essential to the delivery of high quality public services. A recent Public Services Productivity Panel (2002) report, however, found that the absence of well-designed accountability structures in the public services has often undermined efforts to achieve top performance.

**2.24** If society's high expectations for the public services are to be met, it is vital that service providers remain focused on the needs and aspirations of those they serve. But the Public Services Productivity Panel (2001) report on 'Customer-focused government' found that there is currently considerable ambiguity within the public services around who their main **customers** actually are, and a consequent lack of clarity about what these people expect from the services they receive.

**2.25** In short, public service providers must guard against a range of problems associated with:

- **objectives** – service providers should be clear about their precise aims, in order to prevent inconsistencies in the quantity, quality and type of service they deliver;
- **prioritisation** – even where objectives are explicit and well-defined, the presence of multiple objectives, poorly-prioritised, could mean that resources are sometimes allocated on an *ad hoc*, inefficient basis;
- **information** – service providers could lack information on the costs and benefits of alternative delivery methods, which would lead to an inefficient allocation of resources;
- **accountability** – poorly designed accountability structures would frustrate service providers' efforts to achieve high performance; and
- **customer-focus** – insufficient attention to the needs and aspirations of customers would generate dissatisfaction with the public services they receive.

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<sup>7</sup> Dolton (2003) discusses the multiple tasks facing teachers in greater detail, while Smith, Mannion and Goddard (2003) consider the numerous objectives of health care.

**Box 2.3: The public service ethic**

The public sector employs around five million people, of whom the largest groups work in the key public services of education and health. Understanding the motivations of these people is essential to designing incentive systems that are appropriate and effective in encouraging top performance. Deci and Ryan (1985), for instance, describe how solely financial incentives or crude threats of punishment can actually impair performance, by driving out the so-called *intrinsic* motivations that encourage people to undertake activities “for their own sake.” It is equally vital to recognise any special attributes required of those who provide certain public services when making a judgement between public and private modes of provision.

A recent Audit Commission report (2002) on recruitment and retention in the public services found that for 42 per cent ‘making a positive difference’ was the first or second most important reason for pursuing a career in the public services. 39 per cent also cited the opportunity to serve people – especially children – as a significant motivating factor. These responses reflect a wider set of values that have traditionally been held by public sector employees. Often referred to as the ‘public service ethic’ it includes:

- *a commitment to furthering social welfare*, rather than maximising personal gain, so employees will not sacrifice quality of care to raise their firm’s profits;
- *a dedication to meeting the needs of service users*, irrespective of their ability to pay;
- *recognition of a duty to use professional expertise responsibly*, so building a relationship with service users based on trust – such as that which exists between doctors and their patients; and
- *valuing co-operation rather than competition* between different providers of the same service, such as teachers.

In short, those services that require both public funding and public provision to deliver efficient and equitable outcomes also gain from a workforce motivated by an ethic of public service that, at its best, places duty, obligation and service before profit or personal reward. Equally, pay systems must take into consideration the intrinsic motivations reflected in the public service ethic. They need to be transparent, fair and non-discriminatory, and need to reward good performance irrespective of what is motivating people to perform.

**CONCLUSION**

**2.26** This chapter has set out the public services’ productivity challenge. While properly functioning markets can provide efficient, customer-focused services, the characteristics of key public services such as health make public funding and provision a more efficient and equitable alternative. The task for the Government, therefore, has been to identify the problems faced by public sector organisations providing public services, and develop an approach for overcoming them. The next chapter sets out the framework underlying the Government’s approach.

## INTRODUCTION

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**3.1** The previous chapter identified some of the fundamental problems faced by public service organisations and explained why they arise. For many key public services there are strong arguments that public funding and provision will produce more efficient and equitable outcomes than markets could deliver. This requires the Government to have a robust and coherent framework for ensuring that improvements in the performance of these public services are achieved. This chapter sets out the three building blocks that provide the underpinning, and then shows how they combine into the Government's framework for raising public services' productivity.

## THE BUILDING BLOCKS OF POLICY

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**3.2** The Government's framework for meeting the public services' productivity challenge is constructed from three 'building blocks':

- **a focus on outcomes**, placing improvements in public services' outcomes as the central aim of policy, rather than focusing solely on inputs;
- **constrained discretion for local service providers**, increasing their freedoms and flexibilities, subject to appropriate minimum standards and regular performance monitoring; and
- **improved governance of public services**, reforming institutions to reflect the importance of clear objectives, appropriate incentives and good performance information in the achievement of higher productivity.

### A focus on outcomes

**3.3** At the heart of the Government's approach is the proposition that public services' performance should be judged on the basis of the outcomes they achieve. This means that decisions between alternative methods of delivering public services should be based solely on an assessment of the option which will effectively deliver improved outcomes, and not be tied to a particular set of inputs, type of output or mode of provision.

### Constrained discretion for local service providers

**3.4** The current structure of the public services reflects a legacy of 'command and control', where central planners imposed uniform solutions on the providers of public services to suit all circumstances. But this approach has limitations, making it unsuitable for many key public services<sup>1</sup>:

- local initiative is suppressed, which may constrain innovation and undermine employees' morale; and
- local needs and circumstances are ignored, potentially leading to the delivery of unsuitable services to diverse communities.

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<sup>1</sup> Le Grand (2003) describes the command and control approach to the management of public services in greater depth.

**3.5** The weaknesses of the command and control approach arise because it detaches those responsible for the design and delivery of public services from the local communities they serve. A more productive approach to the management of many public services is to grant more responsibility for operational decisions to those individuals best placed to deliver the highest standards of service.

**3.6** A growing body of literature<sup>2</sup>, which has become known as the ‘new localism’ school, argues that those best placed to deliver services will often be at the local level, since:

- empowered local service providers have the flexibility to tailor services to reflect the needs, preferences and circumstances of the communities they serve;
- greater discretion over their use of funds enables local providers to develop innovative approaches to service delivery;
- increased responsibility for the services they deliver can generate a greater commitment among local providers to achieving improved outcomes in their area; and
- a number of autonomous local service providers can improve the ability to monitor performance, by allowing comparisons to be made between the achievements of different providers operating in similar circumstances.

**3.7** A move away from centralised, top-down decision making in the public services offers many potential benefits, and is a key component of the Government’s strategy for raising public services’ productivity. But increased local flexibility in delivery must be undertaken in a disciplined way, to avoid creating unacceptable local variations in the quality of public services. Additional *discretion* for local service providers must therefore be *constrained* by appropriate accountability mechanisms that define acceptable service standards and effectively monitor service providers’ performance.

**3.8** Constrained discretion is therefore the second building block of the Government’s strategy for raising public services’ productivity. As Box 2.2 describes, the Government has already applied the concept of constrained discretion to its framework for monetary policy.

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<sup>2</sup>The advantages of greater local flexibility in the provision of public services were initially explored by Tiebout (1956). Contemporary advocates of greater localism in the UK include Balls (2002) and Corry and Stoker (2002).

**Box 3.1: Constrained discretion and the monetary policy framework**

The concept of constrained discretion underpins the Government's framework for monetary policy, which was introduced shortly after it entered office in May 1997.

The Bank of England has been granted operational independence to set interest rates, but must exercise this power to meet an inflation target set by the Government. The framework recognises that the economy can be subject to unexpected events which can cause inflation to depart from its desired level, but the onus is on the Bank's Monetary Policy Committee (MPC) to explain how it proposes to return inflation back to target. Should inflation deviate by more than one percentage point below or above the target, the Governor of the Bank of England is required to write an Open Letter to the Chancellor of the Exchequer, explaining why the divergence has occurred, the action being taken to deal with it, the period within which inflation is expected to return to target, and how this approach is consistent with the Government's objectives for growth and employment.

Under this framework, the Bank of England is *constrained* by the Government's inflation target and the requirement for the MPC to account for its actions, but the Bank is also granted *discretion* to respond flexibly to changing economic conditions. The Government's strategy for raising public services' productivity offers similar constrained discretion to local service providers, by enabling them to exercise greater operational autonomy but subject to constraints such as minimum service standards and regular performance monitoring.

## Improved governance of public services

**3.9** Robust and well-functioning accountability arrangements are at the heart of the constrained discretion model. More generally, the outcomes achieved by public service providers will be enhanced if the governance structures they are subject to are re-designed to overcome the generic problems identified earlier in this chapter. Economic theory provides an established body of thought, known as principal-agent theory, which addresses the issue of organisational governance<sup>3</sup>.

**3.10** Principal-agent theory provides three key insights into the characteristics of effective governance structures that have informed the Government's framework for raising public services' productivity<sup>4</sup>. In particular:

- **objectives** must be specified to ensure that providers are clear about their strategic direction and can identify their priorities correctly. They also provide a benchmark for performance assessment;
- **incentives** for public service providers are necessary to ensure they pursue their objectives. Well-designed incentive systems recognise the ethos that motivates public service employees, reward success and expose poor performance so that it can be addressed; and
- **information** is required for objectives to be established and for incentive systems to be designed. Performance also needs to be monitored so that service providers can be rewarded or sanctioned accordingly, while local communities are entitled to clear information about the performance of their public services.

<sup>3</sup> Discussions of organisational governance exist within both economics and management theory but concur with principal-agent theory on the importance of objective setting, appropriate incentives and good information in achieving top performance. See, for example, Drucker (1955) and Cole (1996).

<sup>4</sup> Principal-agent theory and its application to the public services is discussed more fully in Annex B.

**3.11** The Government is committed to ensuring public services are subject to governance structures which support the setting of clear objectives, the design of appropriate incentives and the effective utilisation of information. It is therefore essential to identify the governance structures best suited to perform these crucial functions. In particular, to what degree should public service providers be held to account nationally, regionally or locally?

**3.12** Central government may be well suited to governing certain public services, especially where nationwide objectives and standards are required to:

- ensure consistently high quality of service wherever people may live;
- provide clear standards by which services are judged, allowing incentives to be offered on the basis of performance against targets; and
- provide a clear focus for public service providers, and inject an ambition and urgency for improved performance.

**3.13** But national governance structures also have their weaknesses. So, while centralised objective setting and performance management may be appropriate for services such as national defence, in other areas it can lead to excessive central control over the objectives and conduct of public services so that they fail to reflect the priorities or circumstances of the communities they actually serve.

**3.14** The task is therefore to identify those public services where performance could be improved by devolving more responsibility for governance to democratic institutions at the regional or local level. In particular, strengthened regional or local governance offers the prospect of:

- improved objective setting for public service providers, to reflect more accurately the needs and priorities of those they serve;
- more appropriate incentive schemes for service providers, for instance by taking account of local labour market conditions;
- better monitoring of public services' performance, by creating greater opportunities for service users and other stakeholders to provide feedback on service quality;
- more effective coordination of numerous local service providers to meet each community's full range of needs;
- better coordination of monitoring and inspection regimes to reduce the burdens on local public service providers; and
- greater citizen participation in the management of local public services, encouraging greater social cohesion and community identity<sup>5</sup>.

**3.15** But the potential benefits of governance being based on greater local accountability must be weighed against its potential problems, including the creation of unacceptable variations in the quality of services across the country, and the duplication of unnecessary bureaucracy. It would also be vital to ensure that regional or local bodies granted new responsibilities for the governance of public services had sufficient powers, expertise and information to perform their new role effectively. Success would also depend on the active and informed participation of the communities they represent.

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<sup>5</sup> Chen (2003) describes in greater depth the benefits of more active citizen participation in the management of public services.

**3.16** So, while increasing regional and local involvement in governance has many potential benefits, there are a number of important issues that have to be considered. The governance structures for particular public services must be carefully designed to ensure that the regional and local bodies involved have the capability to perform their task effectively.

## **THE FRAMEWORK FOR RAISING PUBLIC SERVICES' PRODUCTIVITY**

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**3.17** The building blocks set out above represent the basis of the Government's strategy for raising productivity within the public services. They can be translated into a four-point framework to guide those designing and implementing policy:

- clear long-term goals, expressed as desired outcomes;
- greater discretion for local service providers, constrained by effective governance structures;
- improved information about performance; and
- better incentives for service providers to meet users' needs.

### **Clear long-term goals, expressed as desired outcomes**

**3.18** Acknowledging service providers' need for well-defined objectives, the Government is committed to setting clear long-term goals for the public services. Instead of focusing on the quantity of resources they receive, public services' objectives must be focused on the outcomes that the public care about, such as better health, educational achievement, and lower levels of crime. Clear objectives provide a comprehensive statement of priorities and sense of direction for all those involved in the delivery of public services.

### **Greater discretion for local service providers, constrained by effective governance structures**

**3.19** Greater discretion provides local service providers with more opportunities to innovate, design and develop services around the needs and priorities of their communities, helping to ensure that the highest quality public services are available, not just to a few but to all. Greater local discretion for providers must, however, be constrained by effective governance structures to ensure accountability and value for money. And while decentralisation of the governance of public services may not be desirable or practical in all circumstances, it is likely that many public services will be more effectively governed by regional or local bodies with better knowledge about providers' performance and the needs of the communities they serve.

### **Improved information about performance**

**3.20** High-quality, reliable information on public services' performance is vital if sustained pressure for improvement is to be created. Independent and effective arrangements for audit and inspection, for instance, are an important means to ensure departments' and agencies' performance is closely monitored and reported. The Government is determined to ensure that those who govern and use public services receive regular, externally validated, information on their performance.

## **Better incentives for service providers to meet users' needs**

**3.21** The prospect of greater operational flexibility and extra funding are a key element of new incentive structures designed to reward the most successful public services providers and support continuous improvement in standards. Where public service providers are not meeting required standards, the Government will intervene to ensure that action is taken to improve performance.

## **CONCLUSIONS**

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**3.22** A central part of the public services' productivity challenge for Government is to raise the productivity of those key services where public funding and public provision remain in the public interest. This chapter has set out the Government's strategy for meeting this challenge. It is based on three building blocks that stress the importance of a focus on outcomes, constrained discretion for local service providers and improved governance structures. These building blocks translate into a four-point practical framework for raising public services' productivity:

- clear long-term goals, expressed as desired outcomes;
- greater discretion for local service providers, constrained by effective governance structures;
- improved information about performance; and
- better incentives for service providers to meet users' needs.

**3.23** The following chapter illustrates how this framework has informed the Government's policies towards the key public services.

# 4

## DELIVERING HIGH QUALITY PUBLIC SERVICES

### INTRODUCTION

**4.1** Since 1997 the Government has increased the resources going into the public services significantly:

- between 1997-98 and 2002-03, average real-terms growth in spending on health was 6.3 per cent a year; and
- between 1997-98 and 2002-03, spending on education increased by an average of 5.1 per cent a year in real terms.

The 2002 Spending Review built on this and ensured that investment in the public services will increase further over the coming years – in total an additional £61 billion will be available for the public services in 2005–06 compared to 2002–03. The greatest increases are targeted on the priority services:

- spending on the NHS will increase by an average of 7.4 per cent a year in real terms over the five years to 2007-08;
- UK education spending will rise to 5.6 per cent of GDP by 2005-06 from 4.6 per cent in 2000-01; and
- spending on UK transport is rising at an average of 8.4 per cent a year in real terms.

**4.2** As well as providing more money, the Government has also set up and implemented new public spending rules. Building on a macroeconomic framework that is delivering greater economic stability, and the firm fiscal rules which are part of that framework, fixed three-year Departmental Expenditure Limits (DELs) give departments certainty to plan over the medium term. Departments are now also able to carry any under-spend in one year forward to the next, removing the inherited culture of wasteful end-of-year spending. Resource accounts and budgets, which reflect full economic costs, have also been introduced, giving departments new incentives to maximise benefits from their assets and manage liabilities more effectively. The Government has also established a National Asset Register and produced Departmental Investment Strategies to ensure that new investment and existing assets are used to achieve its objectives.

**4.3** As discussed in Chapter 1, adequate resourcing is a necessary but not sufficient condition for raising public services' performance. For this to be achieved, and for resources to be translated into outcomes, the additional investment must be matched by a programme of public service reform.

**4.4** Chapter 3 set out the Government's strategy for achieving progress in the performance and productivity of the public services. This is based on a framework comprised of:

- clear long-term goals, expressed as desired outcomes;
- greater discretion for local service providers, constrained by effective governance structures;
- improved information about performance; and
- better incentives for service providers to meet users' needs.

This chapter looks at how this framework has been implemented across the public services since 1997.

## PUBLIC SERVICE REFORMS

**4.5** Table 4.1 sets out key reforms in four public service areas: health, education, criminal justice and transport.

**Table 4.1: Major public service reforms since 1997**

	Health	Education	Criminal Justice	Transport
<b>Clear long-term goals, expressed as desired outcomes</b>	Ten Year Plan with objectives to be delivered with increased resources.  Target to reduce inequalities in health outcomes by 10 per cent as measured by infant mortality and life expectancy.	National targets for attainment.  Floor targets for every school and LEA.  Refocused National Curriculum.  Ambition to renew all secondary schools by 2020.	Five year crime reduction targets.  New target to reduce the gap between the best and worst performing Crime and Disorder Reduction Partnership areas.	Ten Year Plan with targets to be delivered by 2010.  Minimum service standards for train operating companies and London Underground.
<b>Greater discretion for local service providers, constrained by effective governance structures</b>	Primary Care Trusts introduced from April 1999 onwards.  Foundation Trust proposals announced in December 2002.	Greater local flexibility on pay and recruitment in schools and less ring fencing of budgets.  Increase in School Standards Grant paid to each head teacher in SR 2002.	More funding to be allocated to the frontline through police Basic Command Units (BCUs) to address local priorities.	Local transport plans introduced.  Local transport PSAs.
<b>Improved information about performance</b>	NHS hospital cost and quality benchmarking.  New independent Commission for Healthcare Audit and Inspection.  Publication of star ratings for all NHS organisations.	National league tables of school performance.  Increased frequency of OFSTED inspections for weaker schools and new inspection framework from 2003.	Police Best Value Regime.  League tables of police force performance.  Consolidating and developing the role of new Police Standards Unit.	Local congestion benchmarks.  Strategic Rail Authority established.
<b>Better incentives for service providers to meet users' needs</b>	High performing hospitals rewarded with greater autonomy, less monitoring and automatic access to discretionary capital funds.  New hospital funding arrangements will sharpen incentives, support patient choice, encourage contestability and improve value for money.	Head teachers can earn more autonomy in return for strong performance.  Leadership Incentive Grant.  Top performing FE colleges to be given higher funding, and receive lighter inspection.	Police funding to be linked to performance against PSA target.  New management for failing prisons through contracting out.	Local delivery incentives through local transport plans give greater long-term focus and stability.

## Clear long-term goals, expressed as desired outcomes

**4.6** The cornerstone of the Government's approach to clarifying public services' objectives and setting firm standards is the system of Public Service Agreements (PSAs), established in 1998 as a means of linking objectives, outcomes and funding. PSAs are negotiated between the Treasury and spending departments at each Spending Review, and are structured so that a statement of aims is cascaded down into a series of objectives. Objectives are matched by targets stating the outcomes and outputs that spending departments agree to deliver in return for funding.

**4.7** PSAs create a powerful framework for translating high-level aims into practical policies for change, and provide a judicious constraint on the behaviour of service providers. They consequently represent a fundamental innovation in the way Britain funds and manages its public services, replacing a system where goals were imprecise and funding was tied only loosely, if at all, to delivery. Their particular strengths include:

- **providing direction and focus to service providers' efforts**, by clearly setting out the Government's objectives;
- **nurturing ambition within the public services**, by setting challenging targets and raising expectations;
- **increasing public services' accountability**, by tying resources to the pursuit of specific objectives; and
- **enhancing equity**, by setting national service standards and establishing floor targets for every provider to exceed.

**4.8** As part of the 2002 Spending Review, new PSA performance targets were agreed for all of the public services for 2003-06. Key examples are described in Box 4.1.

### Box 4.1: New Public Service Agreements for 2003-06

New PSAs were published as an integral part of the Government's spending plans in SR2002. New or revised PSA targets include:

- **Education** – to raise standards in schools and colleges so the proportion of those aged 16 who get qualifications equivalent to five GCSEs at Grade A\* to C rises by two percentage points a year, and in all schools at least 20 per cent of pupils achieve this standard by 2004, rising to 25 per cent by 2006.
- **Health** – to reduce the maximum waiting time for an outpatient appointment to three months, and the maximum waiting time for an inpatient treatment to six months by the end of 2005; and to achieve further reductions with the aim of reducing the maximum inpatient and day case waiting time to three months by 2008.
- **Crime** – to reduce crime and the fear of crime; improve performance overall including by reducing vehicle crime by 30 per cent from 1998-99 to 2004; domestic burglary by 25 per cent from 1998-99 to 2005; and for robbery in the ten Street Crime Initiative areas by 14 per cent from 1999-2000 to 2005.
- **Housing** – by 2010, to bring all social housing into decent condition with most of this improvement taking place in deprived areas, and to increase the proportion of private housing in decent condition occupied by vulnerable groups.

**4.9** PSA targets have played a key role in achieving change, for example in relation to literacy and numeracy in schools and waiting times in hospitals. They are most successful where:

- they focus on outcomes rather than process, thus empowering providers to develop their own approach to service delivery;
- they are stretching but achievable;
- service providers are selective in their use – the trend in successive spending reviews has been towards fewer rather than more targets;
- they are part of a coherent package of mechanisms to drive up performance – targets complement but cannot substitute for good management; and
- front-line service providers are fully involved at the target-setting stage, maximising ownership and minimising perverse incentives.

**4.10** The Government is committed to strengthening the PSA regime further ahead of the next Spending Review. The 2002 Pre-Budget Report reaffirmed the need to consult delivery bodies at the formulation stage. Steps are being taken to provide an even greater outcome focus, with improved data systems and a stronger evidence base. Local Public Service Agreements are also being extended and strengthened. Local PSAs involve local authorities agreeing with central government a number of targets, some determined by central government and others by local priorities, with reward money if targets are met (see paragraph 4.16 below).

**4.11** As PSA targets begin to be achieved and national standards established, the Government is also considering how the role of local communities can be further strengthened. For example, one model would allow them to set local standards, choosing their own performance indicators alongside nationally determined indicators. This could increase autonomy while still providing for national intervention as a last resort should service standards slip back below a given level.

**4.12** The Government has also built on the existing system of PSAs by implementing a number of policies designed to clarify the objectives for specific public services and particular localities. Some of these, including the Ten Year Plans for transport (described in Box 4.2) and health represent major strategic statements. The Ten Year NHS Plan, for instance, was published in July 2000 and sets out a series of objectives to be delivered with the significant, sustained increases in resources that the NHS is receiving.

**4.13** Other policy initiatives, such as the refocused national curriculum for schools, can be seen as national reforms that make their operational impact at a more local level. An objective for every public service is to improve its average level of performance by raising standards among the worst performers towards those of the best. This is the rationale behind the setting of new floor targets for each school announced in the 2002 Spending Review, since they will ensure that minimum standards are being met in every school in every area.

**4.14** Currently, an acceptable average for an area often conceals a long tail of underperformance – and the social deprivation that tends to go alongside it. This is not consistent with the high standards the Government wants to achieve in education, or with its desire to tackle social injustice. Fixing the target at school level locates the performance issue where the service is actually delivered and where failure to deliver can do most damage. A similar rationale lies behind other new floor targets, including that to reduce the gap between the best and worst performing Crime and Disorder Reduction Partnership areas.

**Box 4.2: The Ten Year Plan for Transport**

The Ten Year Plan for Transport, which came into effect in April 2001, is central to the delivery of the Government's transport objectives. It represents an integrated approach to transport policy to tackle the problems of congestion and pollution, and to deliver improvements for passengers, motorists and business – while addressing concerns over safety and a better environment.

The Ten Year Plan identifies a number of clear delivery objectives, which were reflected in the Department for Transport's (DfT) PSA agreed during the 2002 Spending Review. It includes specific measurable performance targets including:

- to reduce congestion on the inter-urban trunk road network and in large urban areas in England below 2000 levels by 2010;
- to secure improvements in rail punctuality and reliability with a 50 per cent increase in rail use in Great Britain from levels of 2000 by 2010;
- to secure improvements to the accessibility, punctuality and reliability of local public transport (bus and light rail), with an increase in use of more than 12 per cent by 2010 compared with 2000 levels; and
- to reduce the number of people killed or seriously injured in Great Britain in road accidents by 40 per cent and the number of children killed by 50 per cent, by 2010 compared with the average for 1994-98.

The Government is making an unprecedented commitment to sustained levels of new investment in transport, with over £120 billion of public spending projected over the lifetime of the Plan. The focus now is on delivering the Plan and making the necessary reforms to achieve this. These include enabling local authorities to set their own objectives and targets in Local Transport Plans, as long as they are consistent with national objectives. Monitoring and accountability of local authorities' performance will also be enhanced by the publication of local congestion benchmarks by the DfT. DfT will seek to improve its own performance by improving its analytical and modelling capabilities, and by developing an integrated approach to investment appraisal.

The Ten Year Plan is already delivering improvements:

- The first phase of the Channel Tunnel Rail Link – the first major new line for over 100 years – is nearly complete, and work has started on the second phase into London.
- 116 major local road and public transport schemes have been approved or provisionally approved, including ten light rail lines.
- In the first year of the Plan construction industry output for both road and rail sectors rose significantly, with the biggest year-on-year increases on record.

The Ten Year Plan is currently being reviewed and rolled forward to 2015 to take account of progress made so far and the challenges that still have to be met. The results of the review will be announced in 2004.

### **Greater discretion for local service providers, constrained by effective governance structures**

**4.15** The Government's framework for public service reform focuses on giving local service providers more freedom and flexibility to take forward delivery of agreed PSA targets. This constrained discretion aims to ensure that service providers have the freedom to innovate and improve the services they provide, within governance structures that enforce high standards. A decentralised approach to providing public services facilitates greater flexibility and innovation in delivery, producing services that are more responsive to consumer demands and better tailored to local circumstances.

**4.16** Local authorities have a key role in delivering more than 40 of the Government's PSAs, either as the lead frontline agency or as a principal partner of other agencies. As already discussed above, local PSAs are being negotiated between central government and individual unitary authorities and county councils. Each council commits to achieving 'stretched' performance across about a dozen targets that reflect a balance of central government PSAs and local priorities. As a result, every local PSA is different. Typically, local PSAs include targets on educational attainment, employment, social services, health, housing, waste, transport, crime reduction; and bespoke negotiation means they can be focused on those areas most in need of improvement.

**4.17** Local PSA targets are outcome-focused, leaving how they are achieved as a matter for the local authority. Central government may, however, agree to provide specified freedoms and flexibilities in order to facilitate delivery. A substantial reward grant is payable for achieving targets, along with pump-priming funds to kick-start the process.

**4.18** The first round of local PSAs was piloted from April 2001 and is more than halfway through roll-out to all the unitary authorities and county councils. In the 2002 Spending Review the Government announced that it was committed to a second round of local PSAs. Building on local government's enthusiastic response to the first round, central government is now working with local authorities and the Local Government Association in developing the shape of Round Two to achieve a further step-change in local service delivery.

**4.19** For transport, delivery centres on the Ten Year Plan. The plan includes enabling local authorities to set their own objectives and targets in Local Transport Plans. The Department for Transport will continue to review and strengthen the mechanisms for delivery of Ten Year Plan outcomes and related targets. This will include strengthening the connections between national objectives and local delivery, ensuring that progress against the Government's objectives for transport can be effectively monitored.

**4.20** Major changes in the structure and funding of the NHS have been made in order to shift resources and decision-making closer to local people. The establishment of Primary Care Trusts (PCTs) is a key component in the plans for decentralising and devolving power in the NHS down to local communities. These trusts have been introduced in phases since April 1999 and, with the establishment of 138 new PCTs in April 2002, there are now just over 300. PCTs are run by GPs, nurses and other health and social care professionals, together with representatives of patients and the community. PCTs are now responsible for around 75 per cent of the total NHS budget.

**4.21** PCTs are responsible for determining the health needs of local people and commissioning the right mix of services to meet these, including hospitals, dentists, mental health care, walk-in centres, NHS Direct, patient transport (including accident and emergency), population screening, pharmacies and opticians. In addition, they are responsible for integrating primary and community health care so the two systems work together for patients.

**4.22** Through reforms such as the expansion of the School Standards Grant (SSG), which gives money directly to head teachers without restrictions, the Government has devolved much flexibility and responsibility in education to the front line. In 2003–04 the SSG will be worth £50,000 to a typical primary school and £165,000 to a typical secondary school. This enables head teachers to become increasingly responsible for managing the balance of teachers, school assistants and other educational inputs to maximise the effectiveness of their school.

**4.23** The 2002 Spending Review also looked carefully at how key Government policies impact on regions, and ensured that spending will be fairly distributed and targeted at those regions, localities and neighbourhoods where it is most needed and will be most effective in delivering the Government's objectives. Box 4.3 describes how the Government's new regional economic policy is being taken forward.

**Box 4.3: Advancing the new regional economic policy**

The Government's commitment to ensuring all regions share in the UK's economic prosperity is set out in a joint PSA target between the ODPM, DTI and HM Treasury "to make sustainable improvements in the economic performance of all English regions and over the long term reduce the persistent gap in growth rates between the regions, defining measures to improve performance and reporting progress against these measures by 2006".

In addition to this, a number of other PSAs have a regional dimension, to help ensure that all regions share in the Spending Review's aim to improve public service delivery. This regional dimension is explicit, for example, in the ODPM housing target "to achieve a better balance between housing availability and the demand for housing in all English regions while protecting valuable countryside around our towns, cities and in the greenbelt and the sustainability of existing towns and cities". One instrument for taking this policy forward is the establishment this year of Regional Housing Boards to bring together housing, investment and planning, and make the necessary links to other policies supporting regional economies.

The 2002 Spending Review reflected the Government's commitment to tackling regional and local inequalities:

- promoting economic development in all regions by strengthening the Regional Development Agencies (RDAs), including increasing expenditure by 4.5 per cent a year in real terms over the three years to 2005-06; and by
- providing for an increase in the Neighbourhood Renewal Fund (NRF) allocations to England's 88 most deprived local authorities – the fund will grow from £400 million in 2003-04 to a total of £525 million by 2005-06.

The Government has already taken important steps towards greater devolution and delegation to more local levels, for example:

- at regional level, through giving the RDAs freedom to allocate their Single Pot according to their own priorities to meet their agreed targets;
- at local level, through giving local authorities freedoms and flexibilities in return for the delivery of high quality services; and
- at the front line, through funding being paid direct to schools, health Primary Care trusts and police Basic Command Units.

The Government's White Paper **Your Region, Your Choice: Revitalising the English Regions (2002)** included proposals for elected regional assemblies in those regions where people wish to have them. Elected assemblies will have greater capacity to take effective action on improving the regional economy, and pursue the region's particular priorities on planning, housing, transport, culture and other key regional issues such as employment.

## Improved information about performance

**4.24** In the reformed environment of clear goals and firm standards for public service delivery, high quality, reliable information on public services' performance is vital if those who govern and use services are to be sufficiently knowledgeable to exert sustained pressure for improvement.

**4.25** The Government has used the last five years to develop a system of benchmarking for a number of key public services, including schools, housing, prisons and local transport. This allows the outcomes achieved by particular public service providers to be compared against the best performers in their field. Benchmarking increases the information available to those monitoring public services' performance and holding them to account.

**4.26** In education, schools that were failing or facing particularly challenging circumstances are being made subject to more frequent inspection by OFSTED. This has enabled action to reduce the number of failing schools by more than one half since 1997.

**4.27** In health care, the Government is committed to providing comprehensive and easy-to-understand information on the performance of local health services. An important step towards this was taken in September 2001 when, for the first time ever, the Government published information on the relative performance of all NHS trusts providing acute hospital services. This information was updated in July 2002. There is a considerable programme of work underway to expand and improve the range of performance information available which will be reflected in future annual publications of NHS performance ratings and will be published annually. In addition to making the NHS more open and accountable, the performance ratings will enable the public to see the impact of the extra funding for the NHS on their local health services.

**4.28** League tables for schools and the police performance monitors have also improved the quality of information available to service users. The Home Office, in collaboration with police forces, police authorities and other key stakeholders, is constructing the Police Performance Assessment Framework that will measure performance to ensure national delivery of a consistent first-class service. Police forces also participate in Best Value reviews, designed to challenge the way they deliver their services, and present their conclusions to their local Police Authority and the public.

**4.29** In the Spending Review 2002 the Government announced a series of new reforms designed to improve the information available on public services' performance. Independent and effective arrangements for audit and inspection will hold departments and agencies accountable for performance against agreed targets. The new arrangements will split responsibility for setting standards from responsibility for assessing whether they are being achieved.

**4.30** Star ratings will be published for all NHS organisations. School league tables will be enhanced to show a measure of value added, which will highlight those schools that perform better than other schools in similar circumstances. The establishment of new independent regulators will also strengthen the monitoring of performance in local health and the social care services, by equipping them with statutory powers to audit and inspect providers and scrutinise patients' complaints. They will also have a duty to report to the public how money has been spent and the standards that have been achieved.

**4.31** The previously separate inspections of local authority housing by the Audit Commission and of Registered Social Landlord housing by the Housing Corporation are being brought together from April 2003 under a new single housing inspectorate. The aim is to ensure that all social tenants receive a consistently good and improving standard of service, whoever their landlord may be.

**4.32** The Strategic Rail Authority (SRA) was established in 2001, following the passage of the Transport Act 2000. The SRA is responsible for providing overall strategic direction and leadership for Britain's railway, letting and managing passenger franchises, developing and sponsoring major infrastructure projects, and providing some aspects of consumer protection. The SRA published its first Strategic Plan in January 2002, setting out the strategic priorities for Britain's railway over the next ten years, which include growth in rail passenger numbers and improvements in train punctuality and reliability.

**4.33** The development of value-added league tables for schools is enhancing the information available on schools' performance and facilitating the spread of best practice. Schools are implementing a consistent method of financial reporting, supported by £35 million capital expenditure on new management information systems. This enables the benchmarking of schools' costs and outcomes, so that from late 2002 every school can begin to compare its expenditure on inputs and pupils' attainment with those achieved by other schools with similar local circumstances.

#### **Box 4.4: The National Institute for Clinical Excellence**

The National Institute for Clinical Excellence (NICE) was established in 1999 to provide the NHS and patients with clear standards, based on the best evidence of effective clinical practice. NICE guidance provides the NHS with the tools to achieve care of a high standard across the country, helping to remove the significant variations in access to treatments that had begun to develop. Its guidance applies in England and Wales and is also used by the NHS in Scotland.

Since 2000, NICE has produced around 70 guidelines covering individual treatments, such as drugs for treating cancer, heart disease and mental health problems and surgical procedures for obesity and repairing hernias, and on broader aspects of clinical practice, such as schizophrenia and diabetes. Over the next year around 90 pieces of guidance will be issued, including a new series of the safety and efficacy of new interventional procedures, such as those using keyhole surgery.

Independent research\* has demonstrated that NICE is having an impact. Treatments, such as the drugs called taxanes used for treating breast cancer, which were hardly used at all in the NHS before NICE guidance was issued, are now used extensively – extending life for many of the women who receive them.

\*Sheldon (2002).

### **Better incentives for service providers to meet users' needs**

**4.34** A number of policies introduced since 1997 have aimed to reward success and increase the incentives for public service providers to achieve good performance and innovate.

**4.35** For example, the Spending Review 2002 announced three years of funding – £175 million in 2003-04 – for a new Leadership Incentive Grant to back good leadership and help schools in the most challenging areas. Partnership between all schools in a locality will be developed, with funding for the strongest made conditional on their contribution to improved leadership in weaker schools in the locality.

**4.36** In total, the 2002 Spending Review provided an extra £1.2 billion over three years for further education colleges. Top performing colleges will be given a higher-than-average rate of per-student core funding and be subject to lighter touch inspection. Further education colleges that deliver good outcomes for their students will be able to expand as Learning and Skills Councils request increased provision from them. Colleges that fail will see their unit of funding rise only in line with inflation. Where necessary, poor performing colleges will also receive additional support or intervention until they improve.

**4.37** The Department of Health is now able to reward high-performing hospitals across the country with greater autonomy, less monitoring and automatic access to discretionary capital funds. NHS Foundation Trusts will replace central control with greater local public ownership and accountability, so removing the Government from day-to-day performance management and allowing services to be more responsive to local needs.

**4.38** A critical component of delivering public service reforms is to ensure that every public service has sufficient numbers of motivated employees with the right skills in the right place at the right time. This will be a theme in the Government's forthcoming skills strategy to be published in June. Box 4.5 below describes additional steps the Government is taking to secure a well-skilled, responsibly-paid workforce.

**Box 4.5: Pay and workforce strategies**

**In order to achieve real improvements in the performance of public services it is vital for the Government to ensure those responsible for delivery have sufficient numbers of motivated employees with the right skills in the right place at the right time. To ensure departments are putting plans in place to secure the workforces they need, departments have been asked to prepare pay and workforce strategies. These strategies will need to set out:**

- **the staffing needed, in terms of both numbers of people and skills, to enable the department to meet its key service delivery priorities;**
- **the plan to reach this staffing level, including recruitment, retention, training and workforce development strategies;**
- **the risks involved, and how these will be managed; and**
- **a timetable and set of milestones against which progress can be measured.**

**Pay is clearly one item that will be addressed in these strategies, as it is a key lever in recruiting, retaining and motivating workers. To ensure stability and value for money in public services, public sector pay rises, just as in the private sector, must be set at a sustainable rate and be justified by productivity. Public sector pay represents a significant element of spending on public services. The Government is determined to ensure that these resources are used effectively and that pay policy supports reform and delivery of public services. Wherever possible, pay responsibility should be delegated as close as possible to the point of delivery, to ensure it is responsive and appropriate to prevailing market conditions.**

**4.39** In housing, high-performing local authority Arms Length Housing Management Organisations can access increased funding for capital investment to bring their stock up to a decent standard. The introduction of the Comprehensive Performance Assessment scheme for local authorities, meanwhile, allows successful councils to be identified and their high performance rewarded (see Box 4.6).

**Box 4.6: The Comprehensive Performance Assessment**

Comprehensive Performance Assessment (CPA) is a key element of the Government's agenda for raising the performance of local government. CPA will support improvement planning in local authorities and lead to co-ordinated and proportionate audit and inspection and increased freedoms and flexibilities for local government.

The Audit Commission has formed a judgement on the performance and proven corporate capacity of every unitary authority and county council in England. Published in December 2002, these CPAs provide the public with a rounded assessment of the quality of local services delivered by every council and whether they will improve, and how well the council is run. The CPA provides for the first time a scorecard showing a council's overall result (excellent, good, fair, weak or poor), plus separate results for key local services.

The Audit Commission is working with central government departments, the Local Government Association (LGA), the Improvement and Development Agency (IDeA) and other inspectorates to develop CPA for district councils and refresh the first round scores.

In November 2002 the Government announced a range of freedoms to allow local authorities to focus their attention on delivery. Some of these will be available to all authorities, whilst others depend on their CPA. The very best authorities will be freed almost entirely of ring-fenced grants, requirements to submit plans for government approval and annual inspections in order to release their abilities, energy and commitment to deliver better public services in innovative ways.

Linking CPA and Local PSAs is the new Innovations Forum. It will bring together those authorities classified as 'excellent' and senior Government representatives within which central and local government will explore ways of eliminating bureaucratic barriers to local innovation and excellence.

**4.40** Public Private Partnerships (PPPs) are a key element in the Government's strategy for delivering high quality public services and a more competitive economy. Over the next three years the Government expects that contracts worth at least £12 billion will be signed, with many other deals in procurement. PPP contracts are only pursued where they represent the best value for money option. Where this is the case, they offer a number of important benefits. By putting substantial levels of private capital at risk and requiring the companies involved to deliver clear levels of service over the long term, PPPs tie payment more closely to performance and ensure that public assets are delivered on time and to budget.

**4.41** The Prison Service has a comprehensive modernisation agenda, including developing a purchase-provider split for the service. Under-achieving prisons will be identified and set stretching performance targets that must be met. Failure to meet these targets will result in the management of the prison being contracted-out without the option of an in-house bid.

## CONCLUSIONS

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**4.42** This chapter has demonstrated how, in practice, the Government is building on the environment of long-term stability to implement a framework for public services' reform that will raise performance and productivity. This is the route to achieving the outcomes for public services that the Government has promised.

**4.43** The system of Public Service Agreements has helped establish clear long-term goals across the public services, while the Government is ensuring service providers have the freedom and flexibility to deliver within agreed quality standards. The creation of Primary Care Trusts provides one example of the Government's commitment to increased local discretion, while new inspectorates for health and social services illustrate how the Government is establishing new mechanisms to improve information about public services' performance. Better incentives are another important element of the Government's framework for reform, as shown by the measures it has announced that will provide extra freedoms and flexibilities for top performing local authorities.

**4.44** These main themes of clear long-term goals, greater discretion for service providers constrained by effective governance structures, plus improved information on performance and better incentives have therefore been central to reforming public services since 1997 and will continue to shape the policy agenda in the years ahead.

**5.1** This paper has set out the Government's approach to addressing the challenge of raising public services' productivity, within the wider context of achieving high and stable levels of growth and employment. The scope for markets in delivering high quality customer-focused public services has been discussed, together with the efficiency and equity arguments for publicly funded and provided public services.

**5.2** The Government's framework for ensuring improvements in the performance of public services has been outlined. This framework, which has guided policy reforms and innovations across the key public services, has four elements:

- clear long-term goals, expressed as desired outcomes;
- greater discretion for local service providers, constrained by effective governance structures;
- improved information about performance; and
- better incentives for service providers to meet users' needs.

**5.3** This framework and its essential building blocks – a focus on outcomes, constrained discretion for local service providers, and improved governance of public services – have influenced major reforms across all the key public services. Innovations such as Public Service Agreements (PSAs), local transport plans, independent inspection and school league tables provide good examples of public services' reforms which are improving delivery and raising productivity.

**5.4** The challenge ahead will be for the Government to build on these reforms to ensure that sustained improvements in the performance of public services are achieved. This will require continued efforts to achieve better value for money from public spending, greater focus on securing responsive public services at every level – local, regional and national – and further steps to tackle inequalities in service delivery. This agenda will help the Government achieve higher productivity in the public services and a Britain of opportunity and security for all.



# A

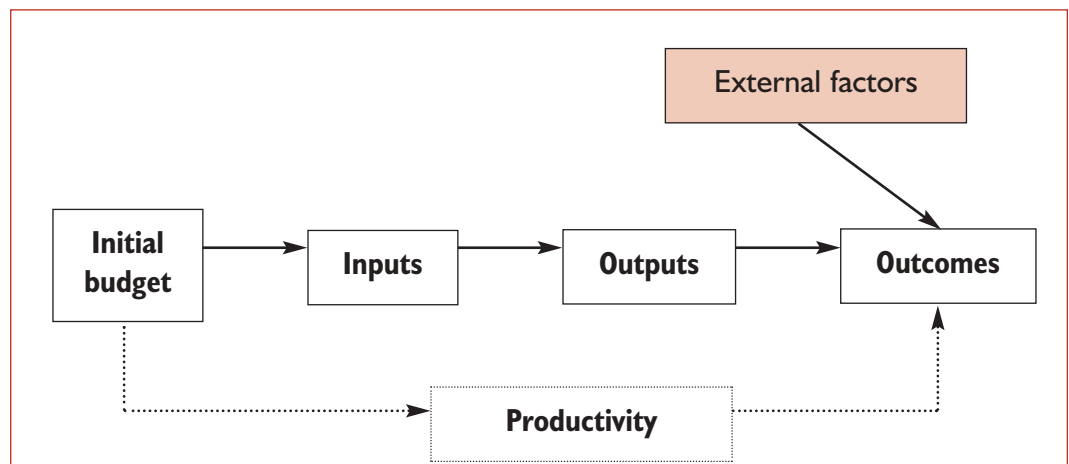
## TECHNICAL ANNEX: MEASURING PUBLIC SERVICES' PRODUCTIVITY

**A.1** This annex describes how the concept of productivity can be applied to the public services, and explains the practical difficulties in measuring productivity. It then outlines some key approaches to overcoming the problems that have recently been undertaken.

**A.2** Productivity refers to how well an organisation uses the resources it has available to achieve the goals it is pursuing. In the case of public service institutions the goal is to maximise their outcomes – the beneficial impact on society of their activities – given the funding they receive. The UK's schools, for example, aim to deliver a better-educated society using the budgets they receive, and their effectiveness at doing so represents their productivity.

**A.3** There are various stages in the process of converting resources into outcomes, as Figure 1 illustrates. Initial budgets are used by service providers to purchase labour and capital *inputs*, for example, doctors, hospital buildings and medical equipment. These inputs, in turn, are used to produce *outputs*, which are the services they actually provide to the public, such as hospital operations and GP consultations. These outputs, together with external factors that are outside the influence of public service providers, such as peoples' lifestyles, then determine the outcomes that are achieved. Improved performance may be possible at each stage of this process, thereby raising the overall productivity of a public service.

**Figure A.1: The productivity process**



**A.4** While the theory is clear, the development of robust measures of public services' productivity is far from simple. This is primarily due to the difficulty of measuring their outputs and outcomes. For example, since there are no market prices for the outputs of public services, placing an explicit value on them is very difficult – especially one which takes account not only of the quantity but also the quality of the services they provide. The nature of the relationship between public services' outputs and the outcomes they achieve creates further difficulties. Not only is it often hard to identify to what extent an outcome can be attributed to a particular service provider's outputs, as opposed to external factors, but there is also frequently a time-lag between improvements in the quantity and quality of outputs and the better outcomes they achieve.

**A.5** Notwithstanding these difficulties, efforts are being made across the Government to adopt a common approach to measuring public services' productivity. This should facilitate more robust statistical assessments of the economy, and lead to sharper performance management.

**A.6** The Office for National Statistics (ONS) is at the forefront of international efforts to produce more reliable measures of the volume of public services' output, as a means of producing better estimates of GDP. Such indicators of output, when compared against measures of the inputs used to produce them, allow us to estimate changes in productivity.

**A.7** Last year the ONS published data indicating that NHS productivity fell by 8 per cent between 1995 and 2000. However, some delay between increased expenditure and higher output is to be expected, since it takes time to train new medical staff and build new General Practitioner surgeries and hospitals. Furthermore, as an illustration of the issues involved, it can be argued that this data underestimated productivity growth because:

- the methodology does not yet take into account quality improvements, such as the significant reduction in mortality rates following elective and emergency surgery between 1999–00 and 2000–01; and
- new and growing forms of treatment (such as the nurse and physiotherapist-led outpatient clinics) are yet to be fully accounted for in the estimates of NHS output.

**A.8** A further issue relates to the use of such data for performance management, as opposed to national accounts, purposes. The figures above measure direct outputs of service providers, such as operations carried out. But illness prevented through health promotion equally enhances well-being in society, even though it fails to show up as the direct output of a service provider. By contrast, performance management measures must take the broader perspective of looking at the outcomes within society, assessing what activities work best, as well as how much activity is undertaken.

**A.9** To complement ONS's work, other areas of Government are taking steps to derive improved approaches to measurement. The 2002 Spending Review, for example, introduced a significantly more robust defence productivity measure, while an important development has been the production of schools value-added data which takes into account the initial aptitudes of the students in its assessment of achievements in exam results.

**A.10** Whether for national accounts or performance management purposes, a broad approach to measuring public services' productivity is desirable. This should take account of the quality and quantity of outputs, and their effectiveness at delivering improved outcomes.

# B

## TECHNICAL ANNEX: PRINCIPAL-AGENT THEORY

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**B.1** This Annex describes principal-agent theory, an established body of economic literature that provides a number of insights into institutional design that have informed the Government's framework for raising public services' productivity. The Annex begins by introducing the theory and what is regarded as the 'classic' principal-agent problem, and sets out how the key insights of principal-agent theory can be applied to the public services. It then discusses recent developments of the theory, which identify appropriate responses to more complex principal-agent scenarios that can arise in particular areas of the public services.

**B.2** Principal-agent theory was originally used in the context of the private firm to explore the economic relationship between an owner or manager (a *principal*) and an employee (the *agent*). The classic principal-agent problem, as stated by Holmstrom (1979) and Mirrlees (1976), has the following structure:

- the principal has only one *objective* – profit maximisation;
- all agents have identical skills;
- it is the actions of agents that generate profits for the principal – but these actions are unobserved by the principal; and
- the principal designs an *incentive* scheme which links the agent's rewards to the amount of profit they generate.

The more *information* the principal can obtain about the agent's unobserved actions, the more effective will be the incentives the principal is able to offer the agent.

**B.3** Despite its original application to the private sector, the principal-agent problem can also inform institutional design and performance management within the public sector. Like private sector managers, governments try to organise, fund and motivate their employees to achieve an objective – the provision of high quality services to the public. Yet governments are not able continuously to observe the actual delivery of services and neither are they able to judge whether the quality of services is satisfactory, since they are not directly the recipients of services. Hence governments need to obtain information about the behaviour of service providers and the quality of service they deliver. This corresponds closely to the principal's need for information about the agent's action in the private firm context.

**B.4** The classic principal-agent model offers three key insights that can be applied to the public services. These are:

- **objectives** must be specified to ensure that providers are clear about their strategic direction and can identify their priorities correctly. They also provide a benchmark for performance assessment;
- **incentives** for public service providers are necessary to ensure they pursue their objectives. Well-designed incentive systems recognise the ethos that motivates public service employees, reward success and expose poor performance so that it can be addressed; and
- **information** is required for objectives to be established and for incentive systems to be designed. Performance also needs to be monitored so that service providers can be rewarded or sanctioned accordingly.

**B.5** Further analysis of principal-agent theory has been undertaken in the academic literature which builds on Holmstrom and Mirrlees' original model. As described below, this work investigates the correct approach for principals to take in more complex situations than Holmstrom and Mirrlees first envisaged, and may have an application to particular areas of the public services.

**B.6** Holmstrom and Milgrom (1991) analysed the **multi-tasking** problem, which arises when an agent is responsible for producing a number of different outputs – a common situation in the public services. Police officers, for example, may be simultaneously responsible for apprehending criminals, maintaining public order and promoting road safety. The agent's multiple outputs may vary in the extent to which they are affected by solely their own effort or additional factors, such as external social, economic or environmental conditions. Holmstrom and Milgrom conclude that agents need strong incentives to devote high effort to tasks whose outcome is strongly determined by factors beyond their control.

**B.7 Competition between agents** occurs when many agents are working on similar tasks. Public sector examples may include consultants working in different hospitals, yet responsible for treating patients with the same condition, while teachers at different schools commonly teach pupils the same academic syllabus. Holmstrom (1982) points out that the outputs produced by any one agent in these circumstances enable the performance of other agents to be assessed, because this output provides an example of what can be achieved. A relative performance reward is the appropriate incentive mechanism in these circumstances, since it will take account of other agents' performance, i.e. a 'benchmark'.

**B.8** Public services also encounter situations where **multiple principals** are pursuing the same objective. Dixit (1996) points out that each principal in this situation has an incentive to free ride on the effort induced from the agent by the other principals, and will therefore tend to offer weak, inadequate, incentives. Principals may even have conflicting objectives and therefore risk setting conflicting incentives.

**B.9 Implicit incentives**, meanwhile, arise when an agent has incentives other than those constructed by the principal, for example, the agent expects to work for a different principal at some point in the future. Under this scenario, the agent will face explicit incentives to perform well in their current job and an implicit incentive to behave in a way that attracts potential new employers. Such future career concerns and implicit incentives may well arise for agents in the public services (Dewatripont, Jewit and Tirole, 1999). The end of the job-for-life culture and the development of contracting-out, for instance, require public sector principals to adopt a more sophisticated approach to motivating their agents.

**B.10** Tirole (1986) has applied principal-agent theory to a model with a three-tier **hierarchy**. Rather than one principal and one agent, he assumes there is a third individual in the middle who acts as agent to the principal on top and principal to the agent at the bottom. This situation creates a risk of collusion between the bottom two layers of the hierarchy, and the top principal will need to design incentives that take account of this possibility. This analysis has a clear application to public service institutions, which may involve national, regional and local administrative tiers.

**B.11** The classic principal-agent model, and its subsequent developments described above, consequently provides a number of crucial insights on institutional design that can be used to inform the Government's strategy for raising public services' productivity.

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