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# Put to the test

Gary Sturgess originally published this article in Ethos magazine in 2010. He discusses the benefits of competition in driving large initial cost-savings for public services as well as the impact of buyer's choice on enduring cost-efficiency, innovation and quality from public service suppliers.

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Gary L Sturgess

## Put to the test

**‘Suppose the amount expended in the purchase of a given service to be a certain sum, and that an individual equally capable of rendering this service should offer to render it at less expense. Is there any good reason for refusing such an offer?’**

An unassailable proposition, surely? An idea whose time has come? These words were uttered 200 years ago by the British philosopher, Jeremy Bentham, and yet there is still discomfort at the idea of market-testing public services.

The notion that competed services are more efficient than monopolies (and more responsive to their customers) has instinctive appeal. We all understand the virtues of competition over monopoly from the everyday experience of life.

And yet some folks are uncomfortable with the idea that providers might make a profit out of public services, even if they are delivered at much lower cost. Some fear that, by accident or design, the public might get less for less.

However, one of the most common sources of discomfort with market testing lies in the difficulty of knowing whether services are actually being rendered at lower cost. Since public services are (in general) not traded in the marketplace, the challenges of measurement are real.

In a recent study of contractor logistics support in the US Air Force, the North American think tank, RAND, noted that statistical analysis of the comparative efficiency of in-house and outsourced provision is difficult because the data required to standardise the diverse characteristics of different programmes does not exist.

There are problems in comparing the same programme over time because of changes in key characteristics such as age, usage and fleet size. Contrasting public and private is compounded by the way in which overheads are allocated in the public sector, and performance metrics are often not directly comparable.<sup>1</sup>

Of those studies that do exist, many are based on a comparison of an artificial ‘public sector comparator’ and the estimated cost of delivery by a contractor (rather than the actual cost). Writing of public-private partnerships, Professor Paul Grout of Bristol University has repeatedly argued that ‘private suppliers are damaged by a dearth of information . . . no-one ever keeps a record of the whole-life cost of the public alternative.’<sup>2</sup>

Having said all that, there is still a considerable body of evidence showing that, if done well, competition and contracting are capable of delivering much greater productivity.

A literature survey of competitive tendering in English local government throughout the 1980s and 1990s, reported that costs were lower as a result of competition, with most studies showing no change in quality.<sup>3</sup> A more recent survey, undertaken by Paul Grout in 2008 for the Julius Review of Britain’s public service industry, reported

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**30%**

*“The 2008 Julius Review reported savings as a result of competition of up to 30% - with similar or even improved service quality”*

<sup>1</sup> Michael Boito, Cynthia R. Cook and John C. Grasser, ‘Contractor Logistics in the US Air Force’, RAND, 2009, pp.39-40.

<sup>2</sup> Paul Grout and Pete Alcock, ‘Supply Side Futures for Public Services’, London: 2020 Public Services Trust, June 2010, pp.9-10.

<sup>3</sup> George SA. Boyne, ‘Competitive Tendering in Local Government: A Review of Theory and Evidence’, Public Administration, Vol.76, Winter 1998, pp.695-712 at p.702.

<sup>4</sup> DeAnne Julius, ‘Public Services Industry Review’, London: Department for Business Enterprise & Regulatory Reform, July 2008, pp.25-26. The survey was undertaken by Professor Paul Grout of the University of Bristol.

savings of up to 30 percent, noting that while the evidence on quality change was weaker, the few rigorous studies available pointed to similar or improved service quality.<sup>4</sup>

An international study conducted by Australia's Industry Commission (a government think-tank) in 1996, also reported savings of 10 to 30 percent, and an academic survey four years later concluded that there were real cost savings of around 8 to 14 percent.<sup>5</sup>

In 2004, two more Australian academics found that 'while there is still some ongoing debate about the magnitude of the cost change associated with outsourcing, there seems to be some consensus about the direction of the change'.<sup>6</sup>

## Contestability

Recent European surveys have also reported savings in the order of 10 to 16 percent.<sup>7</sup>

One of the more comprehensive surveys in recent years was undertaken by The Serco Institute, drawing on 198 studies from 12 different countries over 30 years, across five sectors – defence support, hospital services, prisons management, municipal services and refuse collection.

One of the ways in which this survey differed was that, where possible, studies were used that considered the impact of competition and contestability, rather than public versus private ownership.

The results differed from sector to sector and from country to country. In defence support, studies from Australia, New Zealand and the United States reported savings in the range of 20 to 30 percent. Financial benefits in excess of 20 percent were reported from the competition of health support services in England, Australia and Denmark, but were lower in other jurisdictions.

Of the ten methodologically robust studies of prison contracting in the US, all but one found savings, mostly in the range of 5 to 15 percent. In England, the first-round savings from competition in prison management were 11 to 15 percent, but a series of competitions based on design, construction and management brought further cost reductions (in capital and operating costs) of 38 percent.

Studies of refuse collection, across several different countries, have sparked a robust methodological debate, and the financial gains cluster around 20 percent. On the other hand, the evidence from the contracting for other municipal services is mixed, ranging from 5 to as much as 25 percent.<sup>8</sup>

## Quality matters

It would be helpful to know what accounts for these differences, and while the evidence on this is not extensive, we have enough to extract some insight.

Unsurprisingly, the quality of procurement and contract management matters. For example, savings tend to be somewhat less when there is only one bidder and government discloses its comparator, as Kentucky discovered with the tender for the Otter Creek Correctional Facility in 2005.<sup>9</sup> That much is obvious.

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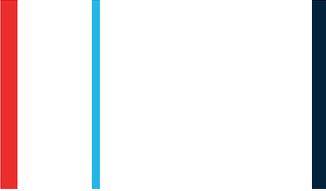
<sup>5</sup> Industry Commission, 'Competitive Tendering and Contracting by Public Sector Agencies', Report No.48, 24 January 1996, Chapter B3 and Appendix E; Graeme A. Hodge, *Privatization: An International Review of Performance*, Boulder, CO: Westview Press, 2000, pp. 128-129.

<sup>6</sup> Paul H. Jenson and Robin E. Stonecash, 'The Efficiency of Public Sector Outsourcing Contracts: A Literature Review', Melbourne Institute Working Paper No.29/04, October 2004, p.9.

<sup>7</sup> Liisa Kähkönen, 'Costs and Efficiency of Quasi-Markets in Practice', *Local Government Studies*, Vol.31, No.1, February 2005, pp.85-97.

<sup>8</sup> Gary L. Sturgess, et al, *Competitive Edge: Does Contestability Work?*, London: Serco Institute, 2007.

<sup>9</sup> Auditor of Public Accounts, 'Assessment of Kentucky's Privatization Efforts: Performance Audit', Frankfort, KY, October 2006.



Less obvious, but just as real are the benefits that come from specifying outcomes or high-level outputs. Where commissioners use detailed input measures, they are demanding that providers deliver the service the way as it has always been done, denying themselves the opportunity for innovation.

Market design also matters. In North America, there are two different kinds of prison market – regional markets based on a single government buyer procuring services from a multitude of suppliers through competitive tendering, and a national market where public and private sector providers build prisons on a speculative basis, and sell places to state governments urgently in need of additional facilities to relieve their overcrowding.

The available evidence suggests that the spot market is less efficient than the markets where services are commissioned, in part because facilities built on spec are smaller and thus more expensive, in part because it has been a sellers' market, and providers have been able to dictate monitoring levels and thus influence quality standards.<sup>10</sup>

The way in which the service was organised prior to competition will also have an effect. This has been true of contracting for defence support: uniformed personnel are significantly more expensive to deploy than civilians, partly because they are more highly trained, and partly because their military duties require them to be diverted into training or transferred more quickly to other jobs. In this case, contracting has been a vehicle for the civilianisation of support services.

And it matters whether the service in question has already been subjected to competition. Unless the scale or scope of the service changes over time, or there has been technological innovation, it will be difficult for future tenders to capture additional savings of the same magnitude.

However, the UK Ministry of Defence has progressively expanded the size and range of its base support contracts over several decades, allowing providers to exploit scale economies, and explore synergies between a wider variety of functions. In prison contracting, the expansion of contractual responsibilities under the 'Private Finance Initiative' enabled providers to deliver new operational efficiencies through innovation in design and the introduction of new technologies.

## Gaining success

All of this suggests that over the medium-term, governments have the potential to bring down the cost of delivering public services considerably – much more than the two or three percent they might hope to gain by renegotiating existing contracts.

Whether or not providers succeed in reducing costs will be heavily influenced by such matters as market design, the nature of performance specification, and, the customers' willingness to explore alternatives in scale and scope. In Britain, it seems that the new government is sensitive to these considerations, although, as always, the devil will lie in the detail of execution.

Success will also depend, in part, on the ability of providers to meet the challenges associated with new markets and innovative new contracting models such as payment by results. Capacity and capability are real constraints: they will find it much harder to deliver the 30 percent if their best people are caught up trying deliver the three percent.

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<sup>10</sup> Douglas McDonald and Carl Patten, Jr., 'Governments' Management of Private Prisons', Cambridge, MA: Abt Associates, Inc., 15 September 2003.

