

# **'Reflections on the Public Service Economy'**

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## ***1. Introduction***

For fifteen years – from 1796 until 1811 – the political philosopher, Jeremy Bentham, held a draft contract with, and a substantial monetary advance from, the Treasury to design, build and operate a prison on the banks of the Thames, roughly where the Tate Britain now stands.

'Panopticon' – as his imagined penitentiary came to be known – was never built, in part because of war, and in part because an alternative method was found of managing overcrowding in British gaols – Botany Bay.

I grew up in rural Australia and not in Macclesfield because of Botany Bay.

Towards the end of his life – having spent more than three decades reflecting on the business of public service contracting – Bentham wrote:

Public opinion is but little favourable to the system of contracts. The savings which result to the state are forgotten, whilst the profits reaped by the [contractors] are recollected and exaggerated.

One way or another, I have been involved in the public service economy in this country for almost two and a half decades, and in the spirit of Jeremy Bentham, although not with the same intellectual authority, I propose to spend some time today reflecting on the business of public service contracting.

I joined Serco's parent board as a non-executive director back in 1993, when the 'Gang of Four' who founded the company was still intact, and I spent the next seven years flying back and forwards between London and Sydney for board meetings and AGMs.

One of the most memorable board dinners was held on Kadoorie Hill in Hong Kong – served by Gurkhas – in late 1996, shortly before the handover. Serco was winding down the logistics support contracts for the British military in Hong Kong and preparing to bid for the operation of a major new toll bridge.

With the imminent arrival of a Labour government in Britain – whose leaders were proclaiming their firm opposition to public service contracting – I spent a great deal of time investigating the underlying policy environment, speaking to political advisers (such as David Miliband and Peter Mandelson) and union leaders (such as Jack Dromey), seeking to understand what a Blair administration would actually do.

We concluded – correctly as it turned out – that in spite of what they were saying in the run-up to the election, Labour would press on with the use of competition and contracting – although they would do it differently from the outgoing Conservative administration.

I moved to London in January 2000, initially as board adviser and then as director of the Serco Institute, to try to make sense of the changing political and policy environment, and to seek to influence its development as far as competition and contracting were concerned.

And in the immediate aftermath of the 2001 election, I wrote a paper for the new chairman, Kevin Beeston, arguing that the company should adopt a more strategic approach to shaping the market.

Let me quote a couple of paragraphs from that document, since they provide historical context to some of the issues facing the industry today, issues that I will return to later in my address:

The available research indicates that in the UK, there is little support for the principle of private, for-profit companies delivering public services, even among Conservative voters. Only 25 percent of voters support ‘public-private partnerships’. The overwhelming majority of media commentators, even those on the centre-right, are highly critical of private provision. . .

The debate throughout the election campaign over the extension of PPPs has been one-sided. There are few willing or able to argue the case for private provision. Ministers and public officials are constrained in their ability to put the case, and individual companies are reluctant to attract attention, and in any case, it would appear self-interested. The nature of the news media is such that they are attracted to bad-news stories. . .

As PPPs move closer to core services, private contractors are less often operating in an environment where they can be given clear and non-conflicting performance objectives. Increasingly, they will need to manage more of the contextual issues that have always made public sector management so difficult. This will require contractors to deal with multiple stakeholders and the kind of uncertain and changeable environment that politicians and senior public servants face. It is far from clear that private sector firms can do better than the public sector in such an environment. . .

The service contracting industry faces a serious threat to its public sector market; it is not well organised and it is by no means clear that it has the capacity to organise to defend this market. In a discussion about the impending debate on the extension of PPPs, a senior union official recently commented that it was unfortunate that the service contracting industry did not have a spokesperson who could put the case on behalf of service contracting.

It was here that I first raised the possibility of the company working with its competitors to establish a ‘Public Services Association’:

It is difficult for individual companies to speak out on behalf of the public service contracting sector as a whole. Serious consideration should be given, as a matter of some priority, to the establishment of an industry association (in the first instance, perhaps, involving the leading players – say, Serco, Capita and Amey) which can conduct a responsible debate within Whitehall and Westminster and in the media.

To give you an idea of how radical that paper was, it had not been possible, to that point in time, to mention Capita in internal meetings within Serco. The former chairman's view was that the company should focus on its customers, not its competitors.

To give you some idea of the long game we came to play, I also suggested a strategy of working with the Department of Trade and Industry (as it then was) to help ministers understand that the public service industry was a significant employer, a substantial part of the national economy and a major source of export income and taxation revenue – wherein lie the origins of the Julius Report on the public service industry, published seven years later.

In the result, Kevin made contact with Rod Aldridge, then chairman of Capita, who had begun to think about these issues himself, and by December 2001, following a series of meetings with other chief executives and with Digby Jones, the CBI's Public Services Strategy Board was born.

For a variety of reasons, that institution had run its course by 2010. Mark Fox had taken over as chief executive of the BSA, and was seeking to expand its involvement in the public services sector. The Serco Institute quickly became an associate member with the company itself following thereafter.

I returned to Australia in 2011, partly for family reasons, but also because I was increasingly concerned at developments in the public service market following the global financial crisis and the change of government.

On my return, I took up the NSW Premier's Chair of Public Service Delivery at the Australia and New Zealand School of Government, an academic institution owned by the state and national governments of those two countries, which works in the space between thinking and doing.

Most of the ensuing five years has been spent adapting best practice in public service commissioning and market design from here, translating those principles into an Australian context and trying as much as possible to avoid the mistakes.

I have returned to the UK twice a year ever since, for 3-4 weeks at a time, to study ongoing developments. And while I cannot profess to be as familiar with the market today, I have followed the major developments, and I continue to have contact with colleagues across a wide range of providers.

The public service industry in this country is, without doubt, the most developed in the world. Yet again, the UK has exported its policy framework, providing significant (and largely unrecognised) opportunities for British enterprise abroad.

However, the industry is also experiencing a number of serious problems, and I propose to speak about some of those today.

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I propose to speak as an Australian. One of differences between Australians and the British (you might have noticed) is that we are more inclined to say that the parrot is dead rather than describing it as a Norwegian Blue that's pining for the fiords.

But as an academic who is now living on the other side of the world, with no ongoing ties to the industry here, I also have the freedom to say things that colleagues still in the business are unable to say, for fear of offending their customers.

So after speaking privately to a number of friends and colleagues about the current state of the public service market, I finally decided that I should stand forth as a critical friend, to speak truth to power, as it were.

I begin with some 'brute realities' about public service contracting – fundamental issues that seem to resurface whenever governments contract with the private sector for the delivery of public services. I will then make a few comments about what these mean for government and the public service industry – and in the interests of brevity, these must necessarily focus on a small number of issues that I have concluded are of the greatest significance.

## **2. Some Brute Realities**

As some of you are aware, I have a longstanding interest in the history of public service contracting. Among other things, I am in the final stages of writing a book on the transportation of convicts to Australia, which – for good and bad – was all done by private contractors.

Contracting is not a recent phenomenon in the delivery of public services. Historians studying public administration in Europe throughout the 17<sup>th</sup> and 18<sup>th</sup> centuries, and particularly the military, now refer to government of this period as 'the contractor state'.

One of the striking insights that emerges from such a study, is that many of the issues that we grapple with today were also an issue in the late 18<sup>th</sup> century.

This is not the occasion to expand on those issues at length, but I want to focus on several that I believe have particular relevance today.

*2.1 Hostility to profit:* The first of these is the point that Bentham made in 1825 – success in transforming public services and delivering significant cost savings is quickly forgotten, and the profits that companies make in the process, even quite modest profits, are quickly condemned.

Jeremy's brother, Samuel – who was a management consultant to the Admiralty for 17 years, and in many ways the more interesting of the two – observed that government seemed to be incapable of taking account of the time value of money – the need for a return on capital that would justify investors taking their money out of the bank and risking it in the market.

As you well know – politicians and media commentators are only too willing to focus on the contracts that make a healthy profit, glossing over those that make a significant loss.

With the benefit of perfect hindsight, governments tend to assume that the upsides were inevitable and the downsides were caused by a failure on the part of management that should have been anticipated.

Government would like greater innovation in public services, but refuses to recognise the necessity of compensation for the risks involved in innovation.

As you all know, the current government is deeply uncomfortable with the notion of profit. From the outset, there has been a stated preference for not-for-profit providers and social enterprises – and providers who give a good impression of operating as social enterprises.

Several ministers have shown sustained hostility to the large providers, while seeking to transfer risk on a scale that only large corporations can bear.

As someone explained to me a couple of years ago – it is not that these ministers are opposed to the corporate sector, it is just that they would like them all to look like Californian start-ups.

Of course, this concern about excess profits, and the corrupting effects of the profit motive is not new. It was there in 2001 when I wrote that memorandum to Kevin Beeston. It was there in 1791 when Jeremy Bentham first began to promote his concept of Panopticon.

But in private at least, previous governments – including the Blair and Brown administrations – understood the need for investors to expect a reasonable return on capital and the importance of potential rewards for the risks involved in developing new ideas.

The late 18<sup>th</sup> century politician and political philosopher, Edmund Burke, spoke of the need for governments to allow contractors an 'honourable profit'. In his famous speech, 'On Economical Reform', delivered in Westminster Parliament in 1780, Burke argued:

An honourable and fair profit is the best security against avarice and rapacity; as in all things else, a lawful and regulated enjoyment is the best security against debauchery and excess. . .

*2.2 The utility of suspicion:* My second fundamental 'truth' has to do with accountability. Over time, Bentham, who was a younger contemporary of Burke, had come to realise just how unpopular contractors were:

Every contractor is a child of Mammon: a contracting manager of the poor is a blood sucker, a vampire; a contracting jailer . . . must be the cruellest of vampires.

And after thinking about this for a long time, Bentham arrived at the conclusion that suspicion was a good thing: it contributed to increased accountability.

Jealousy is the life and soul of government. Transparency of management is certainly of no avail without eyes to look at it. Other things being equal, that sort of man whose conduct is likely to be the most narrowly watched, is therefore the properest man to choose.

This is one of those elemental truths that is not widely understood, although is painfully evident to those who work at the interface between policy and delivery: government is often prepared to impose higher standards on private contractors and to insist on higher levels of accountability than it is willing to demand of itself.

It is not by accident that the origins of cost-benefit analysis lie with the French Corps des Ponts et Chaussées, created in the early 18<sup>th</sup> century. This pioneering institution – later copied in the US Army Corps of Engineers – was established to manage the concessions awarded to private firms for the construction of civil infrastructure.

It is not by accident that the term ‘civil service’ was adopted from the East India Company, which developed an excellent public service in its later years. Or that merit promotion was established in the EIC decades before it was introduced in Whitehall. Government was willing to impose standards on the East India Company that it was not yet willing to impose upon itself.

It is not by accident that the first civil court case in Australian history involved a convict and his wife (successfully) suing one of the ships’ captains for the loss of their property on the outward voyage. If the Royal Navy had transported the convicts, Henry and Susannah Kable would not have been able to bring this action, since the captain would have pleaded Crown immunity. It was only because government had used a private contractor that they had a defendant against whom they could proceed.

I can think of a number of contemporary examples where public service contractors have been subjected to levels of accountability and legal liability well above those imposed on their public sector predecessors. And I am confident that if we went around the room, we might quickly gather half a dozen more.

In fact, we wouldn’t, because the contractors in the room would not be prepared to speak up and embarrass their customers. These stories will never be told because it is not in the interests of government to do so.

Of course, there is yet another reason why accountability is so much more obvious when private contractors are involved – brand.

There are a number of public service companies that were significant players in the market when I left five years ago, that have been taken over and their brand has

disappeared because of the impact that public scrutiny and political controversy had upon their reputation in the market.

Others have taken a massive hit to their market value, resulting in fundamental changes to senior management.

We can debate whether all of that criticism has been entirely fair. What cannot be denied is that reputational incentives - brand - are an extraordinarily powerful discipline.

We do see high-profile public servants who are named and shamed – Sharon Shoemith is an infamous example of recent years – but that is quite different from the discipline imposed on an organisation by a damaged brand and a spiralling share price.

*2.3 The virtues of the quotidian:* My third 'brute reality' is that a significant proportion of the criticism directed at public service contractors is, at its heart, a lack of respect for those involved in providing support services.

The delivery of complex public services, and the support functions that facilitate their delivery, is necessarily an untidy process, marked by insufficient resources, relentless demand from service beneficiaries, and the inevitable challenges involved in managing human beings, with all of their imperfections, day-in and day-out.

When I first returned to Australia, I initiated a research project looking at the managers of front-line public services – local area police commanders, prison general managers, hospital general managers, the regional directors of the ambulance service and so on.

Their perception of the policy process is profoundly different from that of the policy class. When I asked the general manager of one of Sydney's largest public hospitals about the difference between his world and the world of policy, he responded: 'My world is dirty'.

His world was full of people who vomited or bled or had a drug-induced fit at the most inconvenient moment. Their world was not. The delivery environment as it was imagined by policymakers when they drafted the rules rarely resembled the world in which he worked. They rarely provided him with sufficient resources to meet demand, and he knew they rarely would.

While the managers of privately-managed public services are in a somewhat better position because of their contracts, they share with public sector managers this relentless focus on the quotidian.

I was struck by this one day when I was studying the logistics of convict transportation. A number of historians have praised Captain Arthur Phillip, the commodore of Australia's First Fleet, and the Governor-elect of the new colony, who made a decision, several days after leaving Portsmouth, to have all of the convicts released from their irons.

It was a courageous decision, not without its risks, but one that made it much easier to keep the convicts and their quarters clean, and thus contributed to the low mortality on that founding voyage.

But as I reflected on Phillip's instruction, it struck me that none of these historians had thought to ask – who actually struck the irons from the convicts' legs? Who cooked their meals? Who cleaned the prison?

Historians had failed to see the central role performed by the convict contractors and their agents on board these ships because they had no interest in how these routine, day-to-day functions were performed. It was only when one focused on the role of the contractors that we asked these questions, and the answers began to emerge.

And it is down at the front line – where human beings interact with other human beings in wonderfully complex and necessarily untidy ways – that things tend to go wrong, and on occasion, terribly wrong.

By and large, politicians and policymakers are not interested in the quotidian. They are unforgiving of the untidiness of that world. And public service contractors suffer along with other front line staff as a result.

To their great credit, I note that the Health Service Journal, supported by one of the public service companies, has begun to focus on non-clinical staff, which it refers to as 'the invisible half of the NHS workforce'.

*2.4 'To encourage the others':* Public service contractors enjoy significant advantages over those charged with traditional in-house delivery.

They have a much clearer understanding of the results they are expected to deliver, the timescale over which they will be required to achieve those results, the resources they will be given to deliver them, and the consequences for success or failure. And these settings – anticipated results, resources, accountability and consequences – are broadly fixed for the duration of the contract.

The process of contract negotiation enables them to clarify the issues – and walk away if they are not satisfied. Providers have an opportunity to conduct a 'due diligence' review of potential customers, and if it is done well, procurement can operate as a matching mechanism, where both sides have an opportunity to decide whether they are suited to each other.

Contract managers have a great deal of autonomy, with significant freedom to choose their own management teams, authority to negotiate with staff, and generally some access to capital to invest in service improvements.

The managers of publicly-delivered public services almost never enjoy these same advantages.

They have multiple, inconsistent and even conflicting objectives. They are never given sufficient time, money or people to deliver all of those objectives. They suffer from layers of process accountability, designed to insulate their superiors from blame, and limited performance accountability.



There are few rewards for delivering an outstanding quality of service, and highly politicised sanctions for perceived underperformance.

Indeed, one of the striking features of traditional public sector management is the absence of a stable, predictable and proportionate consequences to accompany the byzantine systems of accountability.

Sharon Shoesmith is the modern equivalent of Admiral John Byng, who was executed on the quarter deck of his ship for not pursuing the French quite hard enough after the Battle of Minorca. Commenting on this incident in *Candide*, Voltaire famously remarked that the British shot their Admirals from time to time, 'pour encourager les autres' – to encourage the others.

The price that we pay for this, for the absence of a coherent managerial environment, is immense – based on the research that we did when I was at the Serco Institute, I believe that it is around 20% of cost. It is impossible to measure the impact that it has on service quality and innovation.

Many of the advantages of good public service contracting come from the vastly improved managerial environment created in the process of negotiating the contract, not from any inherent superiority of the private over the public sector.

This is not generally understood – by politicians, civil servants or private contractors – and in recent years, governments have been demanding, and private firms have been signing, contracts that give away many of the fundamental preconditions for success.

This is not a new phenomenon. This is what I was referring to when I wrote in June 2001 that:

. . . private contractors are less often operating in an environment where they can be given clear and non-conflicting performance objectives. Increasingly, they will need to manage more of the contextual issues that have always made public sector management so difficult. This will require contractors to deal with multiple stakeholders and the kind of uncertain and changeable environment that politicians and senior public servants face. It is far from clear that private sector firms can do better than the public sector in such an environment. . .

The situation has deteriorated significantly since, and it is hardly surprising that providers have found it difficult to deliver significant value-add under some of these contracts.

Nor it is surprising that contractor managers and senior executives have begun to find themselves in the same bizarre world as Sharon Shoesmith. Select committee appearances are career defining almost as much as the quality of service delivery.

*2.5 The outsourcing of public value:* The last of the broad themes that I want to raise today was also mentioned by Edmund Burke in that great speech on 'economical reform'.

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

Burke was not opposed to the use of public service contractors: he was making the point that government cannot contract out its responsibility for delivering public value.

Rabbi Sacks was making the same point in his critique of outsourcing in the acceptance of the Templeton Prize last week:

On the face of it, nothing could be more innocent or productive [than outsourcing]. It's the basis of the modern economy. It's Adam Smith's division of labour and David Ricardo's theory of comparative advantage that says, even if you are better than me at everything, still we both gain if you do what you're best at and I do what I'm best at and we trade. The question is: are there limits? Are there things we can't or shouldn't outsource?

He raised concerns about the outsourcing of jobs to foreign workers and the supposed outsourcing of risk by the banks – challenging subjects in themselves. But Sacks went on to raise even more fundamental concerns about Western societies – the way in which we have outsourced mortality to the market and social responsibility to the state.

He has touched upon an aspect of public service contracting that I have always found deeply disquieting, although I have lacked the insight and the eloquence of Jonathan Sacks to give voice to my concerns.

I have always been uncomfortable with the terms 'contracting out' and 'outsourcing' because they imply a denial of responsibility that is, I believe, embedded in the use of the word 'out'.

Governments cannot outsource the responsibility for delivering public value, and yet all too often, the process of organising a procurement and negotiating the terms of a contract seems to encourage this very mindset.

There is no necessary connection between contracting and outsourcing. But the frequency with which one is accompanied by the other, in the private sector as well as the public sector, suggests that we need to be extremely careful in how these tools are used.

The way in which some government agencies have sought to maximise risk transfer is evidence of an outsourcing mindset, the frequency with which price becomes the principal driver in contracting, the manner in which questions of quality and flexibility are so often sacrificed.

I have the same concerns when politicians and policymakers speak of 'public service markets' – the use of this term seems to carry with it an underlying assumption of 'laissez faire' – simple consumer markets of the kind that are studied in first-year economics.

I have battled this repeatedly in my home country, where our national government is constructing a massive voucher scheme for disability support services. It is a reform that has bipartisan support – it was initiated by a Labor government – and the prospect of choice has been warmly embraced by people with a disability and their carers.

But until very recently, when questions concerning the design and stewardship of the supply side were raised, policymakers responded: ‘oh, the market will fix that’. The problem is that there is no market – that is the challenge that policymakers have set. And there is no reason why the market will address supplier failure in a timeframe that will be relevant to a person with a severe disability.

In my lectures on system or market design, I take my students through a range of different market models – commodity markets, matching markets, voucher markets, competition and contracting, contestability and corporate supply chains which combine aspects of contestability.

I think many so-called public service markets are much more like corporate supply chains than commodity markets. If Ford mismanages its supply chain, so that its vehicles burst into flames, there is no point blaming their suppliers. It is Ford that will face the cost of recall. It is Ford’s brand that will be trashed. It is Ford’s share price that will suffer. And while Ford may lay off some of the blame on its suppliers, it is Ford that will bear the vast majority of the reputational and financial cost.

But what if – as Rabbi Sacks seems to suggest – outsourcing is not simply a technical process through which goods and services are procured from external providers, but part of the cultural coding of Western society? What if – whenever governments turn to the use of contracting and contestability – the default position is an outsourcing mentality? What if – whenever they use the word ‘market’ – policymakers automatically think of a market for pencils and lightbulbs, not an integrated system for delivering complex human services?

If Sacks is right, then it means that those of us who have a more complex view of public service contracting are faced with a never-ending struggle to ensure these instruments are understood and used well.

### **3. Some Implications**

*3.1 Sir Roger Scratcherd:* One of the lessons of recent years, is that public service companies need to be modest about their accomplishments. They should look as though they make profits to deliver public services rather than the other way round.

In a play first staged in London in 1765, entitled ‘The Commissary’, Lawrence Dundas, a very famous (and fabulously wealthy) military contractor of the day was pilloried as a character named ‘Fungus’.

Towards the end of his life, one newspaper correspondent acknowledged the efficiencies Dundas had brought, but added – ‘still such a man fattens upon the spoils – and thrives on the ruin of his country’.

Such sudden fortunes gained out of the public purse are among the heaviest weight of war: they not only burden the fortunes, but gall the feelings of every individual of either honor, credit, or affection for his country.

In *Doctor Thorne*, the third in his *Chronicles of Barsetshire* series, Anthony Trollope wrote this of his fictitious railway contractor, Sir Roger Scratcherd:

He had become a contractor, first for little things, such as half a mile or so of railway embankment, or three or four canal bridges, and then a contractor for great things, such as government hospitals, locks, docks and quays, and had latterly had in his hands the making of whole lines of railway. . .

There had been a time when the government wanted the performance of some extraordinary piece of work, and Roger Scratcherd had been the man to do it. There had been some extremely necessary bit of railway to be made in half the time that such work would properly demand, some speculation to be incurred requiring great means and courage as well, and Roger Scratcherd had been found to be man for the time. He was then elevated for the moment to the dizzy pinnacle of a newspaper hero . . . He went up one day to court to kiss Her Majesty's hand, and came down to his grand new house at Boxall Hill, Sir Roger Scratcherd, Bart.

One of the lessons that we have learned over the last three or four years, is that government would prefer their public service contractors to look rather like civil servants. They don't want to see sudden fortunes and a grand new house.

**3.2 *The winner's curse:*** Politicians and civil servants seem reluctant to accept that they are responsible for the quality of government's supply chain. But the lessons of history are evident: they cannot outsource their responsibility for public value. When it comes to public services, government is ultimately responsible for the culture that emerges in the marketplace.

Everyone involved in the procurement of public services needs to understand that it is possible to create markets in which companies, even large and experienced companies, act against their own interests; where bid teams motivated by contractual closure and win rates dominate internal discussions at the expense of service managers who care about long-term delivery.

In auction theory, this is known as 'the winner's curse' – a competition where the winner always loses by being induced to bid an uneconomic price.

Competitive tendering is such a powerful tool for driving down price that government officials must be extremely careful how it is used. If they place too much emphasis on price in the tender evaluation, if e-auctions are used to establish the price for complex public services, if in the course of procurement, we simply fail to give sufficient attention to quality, they will unwittingly create a race to the bottom.

This bias in favour of price is not a recent phenomenon. In 1848, the great civil engineer, William Cubitt, wrote in a report about a collapsed rail bridge in Yorkshire:

The first false step or proximate cause which led to the falling down of this viaduct was inviting tenders by public advertisement, and then taking the lowest without first being assured whether the work could be well executed for

the money or not, or whether the contracting parties were really experienced in the execution of such works.

And here we are, a century and a half later, still having the same conversation.

The most consistent concern that colleagues have expressed to me over the past two and a half weeks is that companies, even large and experienced companies that should know better, are being induced to bid for contracts where they cannot seriously expect to make money. This is not to excuse the companies that stupidly bid for these contracts. They must accept the financial and reputational consequences of their decisions.

When I was at the Serco Institute, I had one of my people do some research on the winner's curse. He concluded that in a winner's curse environment, there was only way to win – and that was not to play. Simply walk away.

In a thin market, it takes a great deal of courage to no-bid a major contract. But I have seen clear evidence on this visit that companies are becoming more discriminating. Several major companies have pulled back, particularly from central government. Experienced bid directors told me that they are no-bidding procurements that place too much emphasis on price – on the basis that it will only end in tears.

*3.3 Distributed authority/concentrated liability:* On my visits to the UK in the mid-1990s, I had frequent conversations with Steve Robson, the then second permanent secretary of the Treasury, who was responsible for the design (or more strictly, the redesign) of the Private Finance Initiative.

As it was originally conceived by the Treasury, PFI was not about shifting capital spend off balance sheet. As Steve explained it, they were interested in it for three reasons: (i) it would stop government agencies lying about the costs and benefits of major projects until after the minister had made the announcement (today that is politely referred to as 'optimism bias'); (ii) they would finally introduce whole-of-life asset management, which they had attempted and failed to do on numerous occasions; and (iii) they would open up a debate about who was best positioned to manage risk.

They understood that this debate over risk would take years to play out – but from a Treasury perspective, there were perceived long-term benefits from getting this debate underway. There is little doubt that PFI did make a significant contribution on each of these fronts, but it is far from clear that the debate over risk has matured in the way that Steve might have expected.

Providers have been induced to assume responsibility for managing risks that are not within their control. In some cases, that has been under the guise of new payment-for results contracting models; in other cases, it is because, with complex and interconnected public services, success is heavily influenced by the performance of other players in the system who do not necessarily have the same priorities.

And with complex services, it is often difficult to recognise these interdependencies in advance, or to understand how they might change over time. As someone described it to me the other day – it is a case of distributed authority and concentrated liability. Contracting cannot succeed those circumstances.

And while I do not, for a moment, excuse the companies who accept the responsibility for managing risks they cannot control, politicians, political advisers and public officials must understand that ultimately, they are responsible for a market that is full of lies and half-truths about what is possible in terms of price cuts and risk transfer.

*3.4 Corporate Memory:* It is fundamental to the ongoing success and development of any organisation or closely-integrated system that it is capable of learning the lessons of the past and making ongoing improvements. This is partly about institutional memory, but it is also about a capacity for dialogue and debate, for scrutiny and renewal.

Together with some of my colleagues at ANZSOG, I have recently done a statistical analysis of what drove down mortality rates on convict ships in the late 18<sup>th</sup> and early 19<sup>th</sup> centuries. It used to be thought that mortality rates did not significantly fall until the end of the Napoleonic Wars, when naval surgeons could be spared for managing the convicts on the outward voyage.

Our research has shown that the largest fall in mortality rates, by far, occurred fifteen years earlier, when government introduced changes to the way in which ships' surgeons were appointed, monitored and rewarded. Contracting could be made to work, as long as it was designed and executed well.

This learning might have happened much earlier among the convict contractors, if government had designed a system that rewarded investment in service improvement. But by accident or design, it created a market with high turnover on the supply side, so that there were few opportunities for lessons to be learned and institutionalised.

For the system to make significant improvements, it was necessary for someone on the commissioner's side to figure out what was going wrong, and what systemic changes were necessary to change the incentives. That it happened at all was largely serendipitous – it occurred because of the appointment of a remarkable individual as the inspector of convict ships, with the support of a departmental under-secretary and his minister. There is no institutional explanation for what happened.

Having studied this question over two and a half decades, and engaged with successive waves of public officials, I have arrived at the conclusion that government is incapable of the sustained institutional learning necessary to support a mature system of public service contracting.

There is no shared body of knowledge about how public service contracts work. There is no literature that explains what has happened in this country over the past three or four decades since the early days of compulsory competitive tendering. The

NAO aside, there are no very few honest and informative case studies about what works and what doesn't.

In spite of the fact that governments have continued to engage in the design (and redesign) of public service markets, there is no recognised and readily-accessible literature on the variety of different markets, how they work and when.

We are still in a situation where ministers believe that they are qualified to meddle, deeply, in market design. There is no academy where civil servants can go to learn the deep arts of commissioning – the Commissioning Academy was never authorised or resourced to perform that role with the seriousness that the endeavour requires.

#### **4. Conclusion**

Somewhere around 2006 or 2007, I wrote another paper, entitled, 'How the PPP Market Ends'. Unfortunately, I wasn't able to locate a copy in the archives on my laptop, but I drew upon the lessons from the history of private utilities in Europe and North America.

As most of you will be aware, these services were originally created and developed by private entrepreneurs – electricity, water and gas – but because of the amount of sunk capital, by the early 20<sup>th</sup> century, governments were able to lean on these companies to reduce prices – to the point where they were no longer economically viable. There came a point, where many of these companies were happy to be nationalised or municipalised, just to stop the pain.

The question I asked in this paper was whether public service companies might not eventually find themselves in a similar position – where governments would fail to appreciate the value that these enterprises brought, and the companies would be so beholden to government that they would no longer be able to negotiate.

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So having reflected on these questions at great length over the past few years, and most intensively over the past couple of weeks, I have arrived once again at the beginning.

The public service industry cannot expect government to tell its story. It cannot rely on the public sector to develop a corporate memory, to develop institutions capable of deep learning and ongoing improvement.

Government must be engaged, but the initiative must come from industry itself. I understand that the market has gone through difficult times in recent years, and that there isn't a great deal of spare cash around.

But what is at stake here is the industry's very existence.