

“The Future of Government Contracting”
an Address by Professor Gary L. Sturgess
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Introduction

My wife and I returned yesterday from a week of roaming around the south of England, exploring some of the well-known gardens, and I found myself reflecting, once again, on that great poem by Rudyard Kipling, ‘The Glory of the Garden’, which is about a great deal more than gardening.

Since his days in India – indeed, because of his days in India – Kipling was interested in management, and in particular, management under delegated authority.

And while Kipling wrote a number of times about corruption in government contracting, ‘The Glory of the Garden’ is of particular relevance to contractors, because it is concerned with the delegation of responsibility for delivery. Let me read the most relevant parts:

Our England is a garden that is full of stately views,
Of borders, beds and shrubberies and lawns and avenues,
With statues on the terraces and peacocks strutting by;
But the Glory of the Garden lies in more than meets the eye -

For where the old thick laurels grow, along the thin red wall,
You’ll find the tool- and potting- sheds which are the heart of all
The cold-frames and the hot-houses, the dung-pits and the tanks,
The rollers, carts, and drain-pipes, with the barrows and the planks.

And there you’ll see the gardeners, the men and ‘prentice boys,
Told off to do as they are bid and do it without noise. . .

Our England is a garden, and such gardens are not made
By singing:- ‘Oh, how beautiful,’ and sitting in the shade
While better men than we go out and start their working lives
At grubbing weeds on bended knees with broken knives. . .

One of the reasons who service contracting and contractors suffer as much opprobrium as they do, is that they operate, almost exclusively, at the front end of government, where the law of entropy prevails – where things break, all the time, and need to be repaired. They spend their times amongst the potting sheds and the dung pits of the public service economy.

Mark asked me to speak this afternoon on the future of government contracting: I propose to do that, in part, by turning to the past. That is not a paradox – if I want to see the large patterns and to makes sense of the long trends, I find that it is enormously helpful to get up high and look down on the layout of the garden as a whole. That is not always an easy thing to do.

I moved to London in 2000, to advise the Serco board and then to run the Serco Institute, after writing a report for the board on the future of public service contracting under a possible Labour Government. At the time, Labour were saying that they intended to significantly wind contracting back.

After a series of meetings with politicians, advisers and union officials, I concluded that Labour would continue to develop the public service market, but they would do it differently.

When that reading of the goat's entrails turned out to be correct, I was asked to switch from being a non-executive director based out of Sydney, to take up a quasi-executive role, running the Serco Institute here in London.

In 2008, following the global financial crisis, I expected that the public service market would be significantly wound back by the Brown administration, and I warned the chief executives of the Public Services Strategy Board of the CBI (which I had helped to establish in 2003 and to whom I had continued to serve as an adviser) that there was no law that guaranteed the market would continue to grow. I was wrong about that – Labour chose not to significantly change the diverse public service economy they had created.

I did not anticipate the huge damage that the Conservatives would do to the market by massively expanding it but doing it in such a manner that it would become politically and commercially unsustainable. But it was obvious to me by late 2010, at which time I resigned from the Serco Institute and returned to Australia.

You get some right, and you get some wrong – because unlike markets, governments are purposive – they are dominated by a relatively small number of people who are capable of deciding future directions without particular reference to external conditions.

A Labour Opposition is once again saying that they will significantly wind back the scale of public sector contracting and nationalise a number of utilities that were privatised decades ago. And this time, I think that they mean it.

That does not mean, however, that were they to come to office, things would turn out quite as they expected.

- so let me spend a few minutes talking about the large patterns, within which politicians and civil servants work.

Ideology

When it comes to the make-or-buy decision, governments are driven by ideology: but not the ideology that most of us think.

The private sector has long played a key role in the creation, development and delivery of public services. Indeed, it is difficult to think of a key public service that was invented by government.

This is not a criticism of government and there is no need for us to be apologetic about it. Government specialises in equity. Key elements of the NHS were copied

from the integrated health and health insurance service established by the Great Western Railway at Swindon (and other such institutions). What government brought was universality, which the GWR was unable to do.

The public service sector was traditionally dominated by churches and charitable organisations, and some European military historians now refer to the 17th and 18th centuries as the age of 'the contractor state', referring to a time when governments relied on private contractors in delivering the core functions of the 'nightwatchman state' – defence and criminal justice.

This did not suddenly change in 1946. The shift had been underway since the early 19th century, and in some public services, much earlier. The underlying drivers and enablers of this shift are complex, but having studied the question for some years, I have come to the conclusion that above all else, it was the Industrial Revolution which transformed our thinking about in-house versus contracted delivery - in particular, the emergence of large industrial enterprises and the development of the managerial, financial and accounting technologies capable of controlling firms of such a large scale.

In short, the state went industrial. There were good reasons at the time for doing this, but in a post-industrial age, the concept of scale economies hangs on an ideology.

Throughout my career, I have had numerous conversations with policymakers about the so-called economies of scale in the delivery of public services, and I always ask for the graph. Because if someone doesn't have a graph showing where the scale economies disappear, then we are talking about ideology and not economics. In 30 years, I have only ever had one public servant produce such a graph.

The shift away from the use of contractors began in earnest in the early part of the 19th century. We see it in the writings of Samuel Bentham, Jeremy's brother, who was a management adviser to the Admiralty for several decades, and did a great deal of work on the naval dockyards, the largest industrial enterprise in Britain at the time.

It was Samuel and not Jeremy who developed the panoptic principle. Jeremy saw it as a tool that would enable him to manage a large prison that he proposed to design, construct and operate, on the banks of the Thames, roughly where the Tate Britain now stands. Samuel came to see the panoptic principle as a vehicle for more effective in-house management.

You can see the growing confidence in direct management, in the public and private sector, throughout the 19th century, as increasingly larger enterprises were built. By the end of the century, it had become ideological with the development and proselytization of 'scientific management' by Fred Taylor and his followers.

The Progressive Movement – a movement of the Left – was deeply influenced by Fred Taylor. They were also convinced that the debates over wealth creation were resolved, and that it was now up to the management class to make rational decisions about the allocation of resources. They perceived public service contracting as old-fashioned and corrupt.

We are still deeply influenced by the intellectual patterns of that period. A couple of quick examples to illustrate when I mean:

James O. McKinsey, the founder of the firm which still bears his name, was one of Fred Taylor's leading followers. For him, budget accountability was the key to improved performance, an article of faith that is still pursued by central agencies around the world. It was unsurprising that when he left government, Blair's performance guru, Michael Barber, chose McKinsey's as his next employer.

The Brookings Institute began its life in 1916 as the Institute for Government Research, one of the pioneering institutions of the Progressive Movement, dedicated to improved in-house management through measurement.

Lenin had huge admiration for the work of Fred Taylor and the principles of scientific management – the Americans had demonstrated how a centrally planned economy could be run. In the UK, there was a huge struggle within the socialist movement between guild socialism and state socialism, and it was the latter which triumphed.

Sidney and Beatrice Webb's multi-volume series on local government is one of the best sources for the history of government contracting in this country, but it was written to demonstrate the inevitability of the industrial state, and the need to move beyond the delegation of managerial responsibility to local government and private contractors.

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The world that Fred Taylor and Beatrice Webb inhabited no longer exists. We live in a globalised, post-industrial world, where much of what they assumed as foundational or inevitable no longer applies.

The massive joint stock corporations of the 21st century look nothing like the production lines created by Henry Ford to turn out the Model T. They are virtual organisations like Benetton, which manage global supply chains, drawing on the expertise of multiple suppliers, partners and delivery channels.

Over the past two or three decades, we have seen the emergence of entirely new industries to provide these corporations with support services – facilities management, logistics, business process management and ICT.

It is not that there is not still a need for performance accountability when responsibility for delivery is delegated, but that we have developed models of contracting that, in some places are as effective as, and in some cases better than, direct control.

I'm not saying that all of this would be immediately obvious to an incoming Labour government. Nicolas Maduro proves that political leaders can persist for some years with mad and outdated ideas, but Maduro also demonstrates that, in this day and age, the brute realities of a global economy and the financial constraints on politicians in a democratic society cannot be ignored for long.

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The big trends in nationalisation and privatisation, of outsourcing and insourcing, were influenced much more by technological innovation and the changing nature of risk, than by the fashions of political ideology - or rather, that ideology adapted itself to those changes.

Let me use the example of urban water supply, an industry where I did some detailed research several years ago.

The origins of the water industry lie in the private sector. In part, that was because of the technological risks associated with pumps and pipes: we might not think of water transportation as a particularly risky business, but the earliest water companies in London were using hollow logs as pipes. There were also significant managerial and financial risks associated with ventures that were, in the 17th and 18th centuries, relatively large and complex – some of the earliest joint stock corporations in London were water companies. And there was significant market risk – until well into the 19th century, competing water companies would run pipelines down your street and compete for your custom door by door. It isn't the most cost-effective way of providing water services, but at the time, it seemed to be the only alternative to exploitive monopolies.

As the management, financing and accounting technologies settled down, governments were able to imitate them, and once it was realised that competing water systems were not a particularly bright idea, the balance shifted in favour of government. In countries such as the United States and Australia, large-scale dams became the cutting edge of technological innovation, and given the risks, the need for compulsory acquisition, the advantage shifted substantially in favour of government. Even then, some countries, such as France, persisted with a model which relied on two or three large private franchisees.

Over the last couple of decades, the changing nature of risk has shifted once again in favour of private provision. In part that was because of a growing awareness of just how inefficient the public sector monopolies had become (it turned out that the management of water utilities was more complex than had been thought); in part it was because the private sector was more willing to finance research and development of the new membrane filtration technologies; in part it was because the era of dam-building had come to an end, and democratically-elected politicians found it easier to side with environmentalists.

When you look at the big patterns and the long trends, ideology doesn't feature a great deal.

Support Services

Private companies outsource for a very different reason than governments. The research indicates that overwhelmingly, firms contract with other firms in the pursuit of competitive advantage. Even when they are cutting costs, they are usually doing it to stay ahead of their competitors; and they will spend more money if that is what it takes.

With the limited exception of defence support, governments do not often do that. Governments are overwhelmingly driven by value-for-money (but not necessarily cost-cutting), and sometimes by the need to access specialist skills and new technology.

But when it comes to support services, that may not make a great deal of difference. In democracies, politicians are driven by the endless need to find new discretionary spend to buy votes from new constituencies. This means that they have become increasingly focused on the middle – the efficiency with which services are managed – rather than raising taxes or cutting services, which offend the old constituencies.

The Yellow Pages Test

As I mentioned earlier, over the past 20 or 30 years, we have seen the emergence of entirely new industries which specialise in providing support services – FM, logistics, business processes, ICT. Three decades ago, these services were largely provided in-house.

For these functions, the economics of make-vs-buy have radically changed. There will sometimes be very good reasons why these support services should be provided in-house, but the onus has shifted. Today, you need to explain why you wouldn't outsource functions such as these.

In their pursuit of new discretionary spend, governments have followed. When it comes to support services that are commonly outsourced in the private sector, the so-called 'yellow pages test' now applies.¹

Supply Chains

Private companies – large, global companies in particular – now design, construct and manage supply chains rather than outsourcing in the traditional way. More often, they construct and maintain their own ecosystems rather than simply sourcing goods and services in the marketplace.

In the supply chain literature, Benetton has been something of an exemplar, retaining only those core functions in the chain of design, production and distribution which were necessary. Zara's supply chain looks different, with more of its production done in-house, but there is no question that Zara is a supply chain rather than simply being a manufacturing conglomerate.

The concept of the supply chain has had very limited application in the public sector – it is well-developed in parts of the NHS, but almost nowhere else. Across the English-speaking world, at least, governments tend to speak of markets, although (it seems to me) many of these so-called markets more closely resemble supply chains.

¹ A term which emerged in the United States in the early 1990s, the 'yellow pages test' argued that if a service was so widely commercialised that it was advertised in the business pages of a telephone directory, then government needed to ask it was delivering that function itself.

Contracting

Private companies use contracting in a range of different ways. Outsourcing – the externalisation of a service or function which was previously delivered in-house – is undertaken, but this is not the only way in which contracting is used. It is often difficult, because it involves the displacement of employees, but it is not ideological. In government, the concept of outsourcing is ideological: it usually carries with it the concept of ‘private good; public bad’.

In the private sector, contracting is a neutral tool, sometimes used for insourcing and sometimes for the creation of joint ventures.

Joint Ventures

On which subject, it might be added that joint ventures (and other collaborative arrangements) are used much more extensively in the private sector than they are in the public sector. We do see the occasional JV in government, but they are rare.

Joint ventures are risky and they are expensive, and private firms have increasingly turned to them, not because they are fashionable, but because they offer the potential for competitive advantage.

Competitive Tendering

In the private sector, companies don’t feel bound to use competitive tendering. They don’t feel an obligation to re-compete a service when providers or partners are doing a great job. The notion that they would ignore past performance when selecting a new supplier is risible.

We all know why governments feel obliged to employ competitive tendering, and to undertake it in such a cumbersome and counter-productive way. But this means that the public sector uses the instruments of contracting in a fundamentally different way to the private sector.

Relational Contracting

And when it comes to business-to-business arrangements, the private sector places a great deal more emphasis on the quality of interpersonal and interfirm relationships than the public sector does. It is more than half a century since Stewart Macaulay pointed out that business practitioners used contracting in a very different way from how legal theory said they did.

A substantial academic literature on so-called ‘relational contracting’ has emerged since the first of Macaulay’s articles was published in 1963, but it has had limited impact. In the private sector, that is because corporate executives didn’t need to be told to ignore the theory – that is what they had been doing all along. In the public sector, it is because civil servants formalised the theory into a set of legal and regulatory prescriptions; and they embraced practices that the private sector used in the procurement of highly commoditised articles and applied them to complex business-to-business relationships.

Once again, we find that the two sectors are using contractual tools in very different ways. I wonder how long this gulf can continue, and we are now seeing the first bridges being built in the ICT sector.

Given the profound implications for their business systems, large corporations don't just outsource their ICT requirements; they deliberately construct ecosystems, with distinct niches which they populate with a diverse range of suppliers, who are managed collaboratively over time. Old-style procurement is described as 'waterfall' – a steady flow of process which inexorably carries all of the participants in the one direction. That is contrasted with 'agile sourcing', where an ecosystem – a network much more intimate than a traditional supply chain – is constructed and managed in a more dynamic way over time.

Some governments are experimenting with agile sourcing, but thus far their efforts have been faltering, at best. The challenges are immense – if agile ecosystems are to be adopted in government, it will require a complete rewrite of our procurement regulations, a rethink of competition policy and a new approach to probity.

But given the changes taking place in the IT sector, I find it difficult to see how government will not be obliged to follow if it wants to take advantage of the new technologies.

Front Line Services

There is another way in which governments' use of contracting differs profoundly from the private sector – the exposure of front-line services to competition. No private corporation would willingly do this: they exist in a market environment, and they seek out the niches where they have a competitive edge.

A famous economist once described the corporation as an island of conscious power in a sea of unconscious cooperation. Conceptually at least, government is a continent, 'entire of itself', with competition lapping at the edge.

And yet for the past four or five decades, we have seen governments across the developed world consciously breaking up their monopolies and privatising, outsourcing or market-testing public services. Why have they done that?

(i) In my experience, central agencies like competitive tendering because it exposes the efficiency frontier of public services, and with an uncontested monopoly, that is remarkably difficult to do. It is not just that front-line managers are hiding the true cost of delivering their services (although in centrally-planned systems, that is often a sensible strategy for them to pursue), but that in the absence of competition, or the credible threat of competition, they have little reason to explore that frontier themselves.

The ongoing search for value-for-money, driven by the endless search for new discretionary spend, tells us that governments will continue to be interested in the efficient frontier.

(ii) Economists (who are often attracted to central agencies in proportionately greater numbers) are sensitive to the challenges involved in planning and managing large complex systems from the centre.

Economists are inclined to think that commodity markets are the only alternative to central planning. They are wrong about that, but the lessons they learned from five decades of studying the Soviet economy still need to be kept front and centre.

The challenge is the eternal one – we need to break these large delivery systems into manageable chunks, but we must also ensure that they work at a systemic level. We are obliged to grapple with delegation and integration at the same time.

Done well, contracting is a useful form of delegation which, whilst taking advantage of contestability, also enables commissioners to manage their systems as a whole. Choice-based (or voucher) schemes are another, and in the UK and Australia, we have seen a number of left-of-centre governments embrace choice-based models in recent years, not least because the voting public likes to have choice.

(iii) When it comes to social services, the notion that governments have a monopoly on public service delivery is deeply flawed in any case. I have lectured and spoken on the concept of the public service economy in a number of English-speaking countries – the UK, Ireland, Australia, New Zealand, Canada – and in each of these countries, the proportion of public services delivered by external providers, is roughly the same – around one-third.

As I indicated earlier, when we look at the history of these services, we find that government is a relative late comer.

And if we look overseas, we discover a great deal of diversity in the way in which different services are delivered. The state plays almost no role in the delivery of hospital services in Germany. The vast majority of fire and emergency services in Denmark are delivered by a private for-profit company, as they have been for more than a century.

While the UK always had a much richer tradition of non-government provision, and has been much more active in creating diversification in its public service economy over the past three or four decades, Australia still has more private hospitals in its public hospital system, it has more private schools (around one third of Australian children finish their schooling in a private schools), proportionately, we hold twice as many prisoners in privately-managed prisons, and we have many more private tollroads than you.

Conclusion

To summarise:

- We live in a globalised, post-industrial world, and Fred Taylor has much less to say to us today. Contracting is one of the defining tools of that post-industrial world, and I find it difficult to see how government can long stand apart from these developments.

- The private sector will continue to outsource support services, and new industries will continue to emerge. While governments are not generally driven by competitive advantage (when it comes to public services), they have been able to take advantage of these new support service industries in their pursuit of value-for-money. Whatever disruptions there may be to the market for front-line services, the contracting of support services will continue.
- The use of competition and contracting in front-line services will be more contested. But these are large complex systems that cannot simply be managed through command and control. Value for money will continue to be of major concern to central agencies. Competitive tendering and contestability are still some of the most effective tools for revealing the efficiency frontier, and performance contracts have proved to be one of the most effective forms of performance management and accountability.

Individual governments and individual ministers may slow down the use of contestability and contracting, and some may even engage in significant insourcing, but I find it difficult to understand how these policies can survive for long.

In all of this, we need to remember that the debate over the relative merits on public versus private provision is not a recent one. As long ago as 1659, the British naval administrator, John Holland, observed:

It hath been an old and great dispute which is the best way of victualling, whether by particular men as contractors, at a certain rate, or by the state.