

PAYMENT FOR SUCCESS

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1. INTRODUCTION

Public services across Europe face enormous challenges – how to deliver more for a lot less; how to protect what the public really values in their services, rather than just what they're used to getting; how to re-motivate demoralised public service staff and providers; how to create a sustainable culture of bottom-up, fast paced and ambitious reform. The presenting issue is about levels of spending, but the real issues are about shifting control from providers to their customers and from bureaucrats to enterprising professionals. This is the only way we can enable people get what they need from public services, albeit for less. It could allow us to move on from the traditional often dysfunctional debate about public services - where politicians compete on how much money is spent on this service or that, rather than what is achieved; where providers with poor efficiency can only envisage making savings by slashing frontline output; where change is something imposed top-down and against resistance. This paper outlines the problems in existing public sector reform and an integrated approach to solving them through a strategy called "Payment for Success". Payment for Success offers the chance to fundamentally change what is achieved out of spending on public services – if it is implemented aggressively, consistently and systematically. Given the fiscal problems, politicians across Europe face a tough time, whichever party they are from. In the UK, there is also a particular need to replace the approach to managing public services, which has grown up under successive governments over the last two decades. Payment for Success allows politicians to decide on what they want to fund and achieve (the results). It sets competitive prices for those results (the funding). It puts power in the hands of the right customers and makes their satisfaction what matters (the accountability) And it gives suppliers the requirement and the freedom to make whatever changes, however hard, to deliver the desired results for the prices on offer (the freedom to deliver).

Payment for Success has been designed to address our apparent inability in the UK, which includes 7 linked problems:

- *We are paying a lot more, but the extra money is buying less.*
- *If the average UK public service provider was as efficient as the top quartile, there would be a 20 to 30% saving in the £250bn cost of most public services.*

- *Instead of challenging public service providers to do more for less through tougher prices and more freedom to respond, we have tried (and failed) to solve the efficiency problem from Whitehall.*
- *Public sector reform has failed to link good ideas with financial consequences (and vice versa), so there has been very limited reform.*
- *Performance management has significantly improved across public service providers (whether public, private or voluntary sector), but it has focused on eliminating the worst performers, rather than liberating the best to thrive and grow.*
- *Public service reform has not been radical – the underlying structure and culture of public service professions, institutions and management has not been fundamentally challenged.*
- *Performance management has, in most cases, been undermined in most cases by its disconnect from financial management, which remains poor in many parts of the public sector.*

This means that public service providers lack the incentives and the autonomy to grasp the huge productivity improvements that are possible in the public services. It is why productivity has not improved over the last decade – payment has been disconnected from results and accountabilities have been confused.

To address these problems, Payment for Success is based on 3 principles which are outlined and explored in the paper:

(i) Three distinct customer roles should be created for each of the different types of service – personal, local and national – with each of these customers radically empowered to decide what they want and from whom.

(ii) Payment by results should be implemented across the public sector without exception – where it exists already, it should be made more forceful and sophisticated, where it does not exist, it should be introduced with very limited transitional periods.

(iii) Public service providers (whether public, private or voluntary sector) should be given almost total freedom to respond effectively to their customers and the PBR regime, supported by the active divestment of public sector staff into independent providers in control of their own future.

The strategy is not about original ideas – there isn't time for brand new ideas. It's about getting off the fence in public service reform and committing to a clear direction, based on ideas which have been around for some time but which haven't been implemented radically or consistently. The alternative to the strategy is too ugly and unnecessary to consider – crude cuts in historical budgets, handed down to unreformed providers, who, without new inspiration and trapped by rigid rules, cut value output rather than reduce unit costs, causing



outrage from disempowered individuals and communities. Payment for Success is about tapping the initiative of millions of people to solve the fiscal deficit, rather than imposing on them a bureaucratic, top-down solution.

2. THE CURRENT PROBLEM – TOO OFTEN PAYMENT IS DISCONNECTED FROM RESULTS AND ACCOUNTABILITIES ARE CONFUSED.

2.1 We are paying a lot more, but the extra money is buying less.

According to the ONS, over the period from 1997-2007 UK private sector productivity went up by 20% in the services sector, whilst public sector productivity in fact fell by over 3.4%. If the public sector had matched private sector productivity over the period, then it would be nearly a quarter more productive. This is equivalent to now spending £60bn more than we need to, every year, due to the failure to match average private sector productivity. This sum is of the same magnitude as some estimates of the underlying structural deficit in Government's finances.

The most recent ONS report shows that the unit cost of output in the public services grew by 45.5% between 1997 and 2007 – an annual average increase of 3.8%. This was about one-third faster than the wider economy – caused by the public sector's greater cost increases and slower rise in output. This annual increase appears built into public sector upward inertia in costs. This is why in 2010 when the NHS has seen its annual funding increases limited to 5.5%, it has already begun to feel the financial squeeze with many NHS bodies already in deep financial trouble. In the years ahead, even a freeze in funding (let alone a reduction) will feel like a substantial cut given the upward cost drift. It is likely that public service providers will cut back on output, meaning that each year a unit of output is costing them more to produce and a freeze in funding means they deliver less. For example, in local government 60% of costs are in support functions, compared to 40% of costs in frontline core service delivery. And yet, many councils believe it's inevitable that the bulk of cuts will have to fall on the 40% that is frontline core delivery. Just changing this ratio to 60:40 in favour of frontline core delivery would mean halving the support function cost, taking out 30% of cost.

One example of the productivity problem is policing. Over the last 10 years, we have increased central funding for the police by 39% in real terms (nearly £5bn per year). In addition council-tax funding for the police has also risen sharply – up 250% in the case of Surrey, for example. In 2007, the cross-party Home Affairs Committee concluded that the “reduction in crime levels does not seem to have been directly related to additional resources”, citing that most of the reductions happened between 1995 and 2001 when resources were tight, whilst most of the extra resources were added between 2001 and 2005. The public remains highly concerned about whether it gets good value out policing – only 50% of the public are satisfied with policing. In 2008, Sir Ronnie Flannagan's report “The Review of Policing” concluded that there was an urgent need for an “objective analysis” of what the Police achieve with the money they receive:

“If this was implemented for police forces in a consistent and mandated format, it would provide, *for the first time*, a basis of comparison between forces that would allow for an informed debate to take place about costs, staffing, numbers and performance ... Questions could then start to be asked about the relative levels of staffing and costs involved in, say,

Intelligence or Neighbourhood Policing and the relative levels of performance and satisfaction in those areas.”

It is remarkable that we are still trying to reach a point where ‘questions could then start to be asked...’

In many cases, extra government funds have been used to pay more for the same output. A good example is in health where spending in the last 8 years increased three-fold in cash terms and double in real terms. The independent Kings Fund calculated that 45% of the new money was consumed by self-inflicted inflation, where more was paid for the same output.

The best way to tackle this productivity problem is to only fund public service providers for each unit that they deliver and to squeeze those unit costs through downward pressures on prices paid for each unit delivered.

2.2 If the average public service provider was as efficient as the top quartile, there would be a 20 to 30% saving in the £250bn cost of most public services.

In most public services (e.g. health, education, home affairs, local government, central government agencies with regional offices, etc) , there are many providers and there are major variations in unit costs across these providers. Two-thirds of public service spending (c£250bn) fits readily into this category. Where unit costs are available, they consistently indicate a 20-30% difference in unit cost between the average provider and the most efficient 25th percentile. This means that if the future average provider did as well as the current top quartile, 20-30% savings could be made and either contribute to financial reductions or be re-invested in better services . Examples include:

- if the average NHS hospital was as efficient in its treatments as the top quartile, the NHS could provide 27% more treatments for patients, which would otherwise cost £12bn extra to provide
- In probation, if the average provider was as efficient as the top quartile performers there would be a saving of nearly 40% in supervising unpaid work sentences
- The cost of collecting the council tax across local authorities has ranged from £4 to £47 per household.

One of the services seen to be under most financial pressure is social care. Over recent years, a great deal of energy has been directed at dealing with the financial pressure. And yet, an in-depth analysis of social care shows typical 20-30% variations in unit costs between the average and the top quartile. This is true even between providers facing the same local area cost pressures. In a budget approaching £18bn per year, eliminating this variation is a major prize. This is illustrated looking at one of the geographical areas where market costs should be similar – “area cost adjustment areas”. There is a 18% difference in the cost of an hour of home care against a national spend of over £1bn; a 25% difference in the weekly cost of place in a local authority residential home for adults; a 100% difference in weekly cost between independent and local authority residential homes for adults; a 33% difference in the cost of a meal from meals-on-wheels; a 22% difference in the weekly costs of a place in children’s homes.

The scale of these variations in unit costs is supported by many efficiency studies done across government. For example, the Government's Operational Efficiency Programme review in 2009 consistently pointed to potential savings of up to 30% - based on benchmark comparisons. It reported that frontline lean programmes had shown in pilots that they could reduce costs by 30% or more, whilst protecting customer service. For example, the NAO has recently said that DWP can reduce costs by 15-30% via its lean programme. Similar figures have been identified by pilots in justice, defence and HMRC. The OEP reports that Government uses 31% more office space per head than good practice and that public sector case studies show the potential for 30% reductions in back office costs. Given that the Gershon review 5 years earlier identified similar potential savings, there is clearly a problem about realising such potential savings.

Looking across the c£250bn of services where there are many providers a 20% improvement in the average unit cost of these services could save £50bn per year. Whilst there is a need for more innovation and radical change in public services, the greatest low hanging fruit is to copy the existing cost efficiencies of other providers delivering a traditional service. Setting funding at the top-quartile unit price would drive out these savings, based on proven UK experience of the best providers delivering more for less than their colleagues in other areas.

2.3 Instead of challenging public service providers to do more for less through tougher prices and more freedom to respond, we have tried (and failed) to manage the efficiency problem from Whitehall.

In effective markets, there is downward pressure on prices, competitive pressure to maintain quality and freedom for suppliers to respond to the market in the best way they see fit. Together these features combine to create the right balance of pressure and freedom for suppliers to deliver more for less, year after year. This can be seen readily in the improvements in value for money enjoyed by consumers of cars, computers and domestic telecoms.

However, in recent years, Governments too often withdrew the freedoms of suppliers, neutered competition in supply, put an upward pressure on prices and tried to manage local efficiency from on high in Whitehall. The frontline delivering more from less was inhibited through extensive top-down blundering. It is worth listing out the scale of this top-down interference in the frontline's ability to manage its own affairs and deliver competitive quality for a better price:

- *Specifying in great detail what professionals should do in their core service – e.g. mandating in great detail the literacy and numeracy hours in schools; prescribing police record keeping;*
- *Making top down decisions about precisely how funds should be allocated – e.g. money for schools had to go on new buildings rather than into the classrooms of existing schools; police funds had to be spent on PCSOs, rather than say forensic science;*

- *Focusing on reducing inputs rather than what is achieved for the money* – e.g. HMRC has had to focus on reducing administrative staff even though, according to the NAO, it has lost more money than it saved by having to reduce the tax it collects.
- *Taking national control of individual inputs* – e.g. the disastrous attempt to take IT investment away from local health providers and impose on them a national £12bn NHS IT system which has failed badly; similar failures in prisons and probation IT were described by the PAC in 2009 as a shocking example of wasting money and denying staff the right tools for the job;
- *Imposing blanket pay deals onto public sector bodies* – e.g. the last GP contract which paid a lot more for rather less services from some of our most important public sector professionals; national pay and conditions settlements for teachers, removing most HR freedom from schools; national pay levels for jobs which mean that staff are overpaid in some regions and underpaid in others.
- *Forcing top down, ill thought-out structural change onto the public sector* - failed nationalisation of long-established local services (e.g. probation, magistrate courts, careers services); chaotic re-organisations (e.g. the creation of PCTs and then scrapping half of them; merger of Inland Revenue and Customs and Excise; creation of and abolition of DIUS within less than 2 years).
- *Locking people into inflexible and expensive PFI deals* – e.g. committing public service providers into 20 to 30 year deals, which often reflect traditional ways of delivering the service and then get in the way of innovative new approaches, e.g. in hospital based health services and over large traditional schools.
- *Forcing contracts onto local areas* – e.g. the private sector treatment centres where local health buyers (PCTs) were obliged to buy services from nationally appointed private providers for more than they could buy it within the NHS.
- *Failing to connect performance management with the money* – performance management (driven by inspectors, targets, plans and bureaucracy) has often had little or no link with the allocation of resources (often allocated out in a historic way irrespective of what is delivered for the money).

There are two major savings dividends to be had in this area – the savings which the frontline can make if they are empowered to do so and the reduction in central government’s policy, funding and regulation (PFR) overheads. Whilst the major prize lies in empowering and requiring the frontline to deliver more for less, PFR costs could also be substantially reduced from Central Government’s current 80,000 FTE staff and annual cost of up to £6bn billion. It has been suggested that this direct cost of PFR is smaller than the compliance costs for public service providers on the other end of Whitehall’s requirements.

2.4 Public sector reform has failed to link good ideas with financial consequences (and vice versa), so there has been very limited reform.

Recent UK reform has tried to ‘marketise’ much of the public sector – creating buyers and sellers, transacting around defined services for annual funding. This includes: competition in the health service; money following the pupil, student and patient; a mixed economy of providers in social care; competitive tendering in blue collar and support services; transfers of social housing to new landlords; creation of executive agencies in the Civil Service; £10bn of services bought from the third sector; creation of PFI and other asset based PPPs. But these reforms have a more limited impact than many hoped (and some feared). The reality is that the ongoing income of the majority of providers has been guaranteed, even if their status has changed (to foundation trust, academy, RSL, outsourced care service, etc).

Public sector funding is far too sticky – once providers have funding, in reality they tend to keep it and have it increased every year. This means that new provision can only be funded by additional spending – rather than recycling funding out of savings in existing funding. The fragmentation of total funding into rigid departmental boundaries and traditional establishments that expect last year’s budget plus more mean that the budget is often locked into balkanised silos, which are incentivised to hold onto their existing budgets. This means that spending is fragmented, conservative and under pressure to stand still. There are four current types of resource allocation set out below. They range from the indefensible to the highly rational, but in all cases their impacts have been dampened to avoid funding instability for existing providers.

Firstly and indefensibly, many budgets are simply historic budgets – adjusted incrementally to add something for new costs or initiatives or to subtract something for assumed efficiencies. There is no real rationale for why the spend is at one level or another. Many Civil Service budgets, for example, fit into this category. The funding level (nationally and locally) is anchored in the historical budget - whatever it was, rather than what it should be (e.g. prisons, job centres, courts, defence agencies, national roads and railways, tax and benefit processing, etc).

Secondly, a wide range of other budgets are funded on assumed demographic need in the area (e.g. numbers of old people, numbers of poor people, etc). Most services which were traditionally provided through local government are funded on this basis (e.g. police services, children services, fire & rescue, local highways, primary health care, etc). This funding is received irrespective of success, e.g. a poor police service receives the same funding as an excellent one. However, even the responsiveness of funding to local needs (e.g. a growing or more needy population) is heavily dampened to avoid losers, so that those with greater needs can only receive more if the total quantum of funding is increased and even then more is still often given to the losing areas (e.g. the use of floors and ceilings for local government grant). A simple example of this problem is in offender management, where the budgets for probation services have been so dampened that they have very little relationship to the levels of convictions or demand for probation services – meaning that high crime areas (e.g. inner

cities) are comparatively under-resourced to avoid reductions in the traditional budgets of rural shire areas. In addition to the allocation of these general budgets by needs formulae, there has been a great deal of ring-fenced funding over the last decade or so – in most cases, this has been targeted against perceived need (e.g. heavily skewed to deprived areas) rather than by the rate of return that the Government can achieve from the funding (e.g. allocating it to those who can deliver the best bang for the buck).

Thirdly, there are a range of budgets which are allocated (to varying extents) on a per capita basis, where the funding is intended to follow the choices made by individuals (albeit the degree of choice is currently limited). This includes schools, further and higher education, hospital services and adult social care. These services equal one-third of all public services expenditure. This approach ought to have driven fundamental marketised reforms – with the best providers rapidly expanding, new entrants in the market places, consumer preferences driving what is provided, less popular providers going out of business, etc. However, the impacts have in reality been very muted. In most cases, the Government (through its various policy, funding and regulatory bodies) has dictated what the providers should do, not the consumers. Consumer control of budgets is very slight – e.g. only 3% of adult social care clients have direct control over the budgets after 10 years of this being Government policy, with strong support from the profession. Education is still a planned economy – e.g. with the HE funding body deciding which departments in which universities can expand (and fining popular departments whose desire to meet student demand steps outside its central control). There can be perverse incentives – e.g. universities receive more money if they fail to retain students (to help them pay for retention initiatives). Often key inputs are controlled centrally – e.g. paying for GP premises, funding new IT – rather than expecting providers to manage their own investment as they think best to achieve future success. This can be seen in the Building Schools for the Future programme which controls the capital resources for new schools, focusing on replacing the current pattern of schools with the same pattern for the future. In health, whilst money follows the patient for hospital services, the impact of this is muted by PCT block contracting with hospitals, the effective local monopolies of many hospitals and the political resistance to change in many health providers.

Fourthly, there are, or should be, ‘spend to save’ budgets. Although it sounds counter-intuitive, the key to improving the fiscal deficit can be to spend more money – on things which improve the Government’s revenues, reduce its social security bill, reduce future costs or reduce budgets in other departments. But there are too few opportunities for public service providers to win funding to improve other budgets. For example, the Treasury has been deaf to requests for extra ‘administration spend’ for tax raising schemes (such as reducing debts to HMRC) which would pay back the investment several times over. Instead, administration budgets in HMRC have been squeezed in spite of the threat to tax yield. Given that the tax administration budget costs 1p for each £1 raised, there are real opportunities to link payment with yield, where it may equally sensible to either halve or double the administration spend depending on the impacts on the yield. Similarly, social entrepreneurs have not been funded for proven interventions out of future savings in social costs (e.g. benefits and prison costs). Generally, budgeting is done on an annual and departmental basis, where the pressure to fund

the increasing costs of social, economic and (increasingly) environmental failures removes the opportunity to fund the very schemes which might reduce those costs. One can understand the institutional scepticism of the Treasury to proposals for ‘spend to save’ as historically such schemes have been much better at spending than saving – e.g. spend on new IT projects, regeneration projects, etc. There is clearly a need to transfer at least some of the risk of investment out of government, but this will require the Government to be able to offer substantial rewards for success – out of cross departmental budgets and future years.

Whilst public sector reform has not been closely enough linked to financial consequences, unfortunately the opposite is also true. In most cases, there have been large increases in funding over the last decade without a requirement for deep reform. Given the stickiness of funding, this has meant that many providers have received more for doing the same, leading to public sector inflation and limited incentives for cost efficiency. The sad conclusion on reform is that without stronger financial consequences being linked to good ideas, the impact of the (often highly energetic) reformers has been limited.

2.5 Performance management has significantly improved across the UK public sector, but it has focused on eliminating the worst performers, rather than liberating the best to thrive and grow.

One of the success stories of the last decade or so is the significant improvement in performance management in the public sector – all organisations are much more aware of and accountable for what they are doing. There has been a cultural shift as the top-down pressure for external performance reporting has institutionalised internal performance management. This has been largely driven by public sector funders and regulators – the inspectorates, the funding councils, the league table makers, etc. These regimes have lifted the ‘floor’ in public services – the numbers of failing schools, councils, colleges, police forces, etc have been transformed, at the same time that the bar for minimum acceptable levels of performance has been lifted. This has been most true where the regulatory regime has been most independent and challenging (e.g. in local government and schools). It has been much less true where independent challenge has been limited (e.g. in the civil service). The proven approach has been to name and shame (e.g. star ratings, etc) the lowest performers and to replace the management of those organisations.

But it has not really changed the pattern of provision. In a more real market, one would have expected the best organisations (e.g. the best child protection services, the best planning services, the best clinical teams, etc) and the best functions (e.g. the best customer access services, the best IT departments, the best property managers, etc) to increase their market share of public services. But they have not become independent providers serving many places. Instead, it has led to an inflationary war for management talent as successful individuals move to less successful organisations. Star ratings have come to equal transfer values in the public sector – it has stimulated the labour market rather than provider market.

The impact of the performance management regime has been less successful on the better performing organisations. Indeed, it may have bred complacency. Whilst the internalisation

of performance management has sharpened up their control of existing ways of doing things, it has often been about polishing traditional approaches, rather than stimulating new ways of working. The external challenge to the better providers has been limited. They have taken comfort from their performance rankings and over time the value of the rankings has been devalued as more and more organisations have reached top status. Even for ambitious organisations, this is a recipe for complacency. A good example is the Audit Commission's assessment of financial management in local government. The best financial directors in local government are given top ratings too easily as 'great for local government' when leading private sector finance directors would be surprised that current local government practice is claimed as excellence. In general, whilst the 'floor' in public services has been undoubtedly moved upwards by performance management, the ceiling has been not.

2.6 Public service reform has not been radical – the underlying structure and culture of public service professions, institutions and management has not been fundamentally challenged.

The pattern of public service providers is still largely very traditional in structure and culture. It is still fundamentally based on professions demarcated in Georgian times (the constable, the school teacher, the turnpike engineer, the social worker, the surgeons versus the apothecaries, the secular academics, the nurse, etc) which are organised into Victorian institutions (the library, the police station, the town hall, the city universities, the free school, the hospital, the charitable housing, etc) and which are funded and governed in a 1940's settlement (the welfare state, the NHS, national control over local services, education entitlements, social housing, etc). This tri-fold structure (of set professions employed in traditional institutions funded under the post war welfare state) has of course many strengths, in that it provides stability of structure, culture and expectations. However, it can also be a source of inflexibility and resistance to change, as well as becoming disconnected from the changing world in which it exists (given technology change, the greater affluence of citizens, etc). The tri-fold has seen change in the last couple of decades through a mix of: managerialism (e.g. the New Public Management agenda and the creation of performance management and agencies); the use of IT (e.g. through e-government); and some privatisation (e.g. outright privatisation in the utilities and the development of a mixed economy in social care and blue collar services). However, the general traditional pattern of public services remains distinctly intact. One example is children services, where there has been a great emphasis recently on co-ordination amongst the many professionals. Success is often defined as having up to 10 different professionals from maybe 6 organisations around a table to discuss a family's situation (e.g. a social worker, an educational psychologist, an education welfare officer, a police officer, a pastoral teacher, a health visitor, a doctor, a housing officer, a community worker, a youth worker, a probation officer, etc). Better outcomes and value for money could well come from forging new professions which blend together skills and reducing the number of organisations involved, rather than yet more bureaucracy to manage the fragmentation.

2.7 Performance management has, in most cases, been undermined by its disconnect from financial management, which remains poor in many parts of the public sector.

One major failing in the performance management regimes of the last decade is that (outside the NHS acute sector and Further & Higher Education) it has failed to integrate the performance management of activity with money. This requires a focus on unit costs – what is delivered for what cost. This is the essential core of any productivity improvement. Large swathes of the public sector have no focus on their unit costs and many more have limited insight into the cost structure that underpins their unit costs. In part this has been driven by the public sector being given its obligations to deliver from one party (e.g. standards and targets being set by inspectorates or policy staff) and its budget from another party (e.g. giving a historic budget plus a bit for inflation). In central government one often finds disintegrated management of performance – with a performance monitoring unit collecting activity data, a finance function checking that agencies stick to spending limits and economists academically calculating whether over the long run spending is delivering value for money. Managing for compliance rather than value is a symptom of providers disconnected from their real customers, serving the state not society.

2.8 Conclusion about the problem.

These 7 factors have undermined the recent reform of the UK public sector over the last two decades. They have meant that public service providers lack the incentives and the autonomy to grasp the huge productivity improvements that are possible in the public services. It is why productivity has not improved over the last decade – payment has been disconnected from results and accountabilities have been confused.

3. SOLUTIONS THROUGH “PAYMENT FOR SUCCESS”

3.1 Principles for “Payments for Success”

There are 3 principles to this strategy:

(a) Three distinct customer roles should be created for each of the different types of service – personal, local and national – with these customers radically empowered to decide what they want and from whom

(b) Payment by results should be implemented across the public sector without exception – where it exists already, it should be made more forceful and sophisticated, where it does not exist, it should be introduced with very limited transitional periods.

(c) Public service providers should be given almost total freedom to respond effectively to their customers and the PBR regime, supported by the active divestment of public sector staff into independent providers in control of their own future.

Each of these principles is developed in the following sections.

3.2 Three distinct customer roles should be created for each of the different types of service – personal, local and national – with these customers radically empowered to decide what they want and from whom.

Clear accountability is everything. Payment by results will only work if there is clarity about who is the decision-making customer – i.e. who decides on the results required and giving them the power to make those decisions. . This can’t just be Whitehall trying to decide everything, nor can it just be the existing providers deciding what to offer. There should be different customers for each of the 3 types of service – personal, local and national. The changes need to be black and white – so that Whitehall establishes clear empowerment and accountability, getting beyond the current rhetorical fog which masks half-baked empowerment and confused accountabilities. The 3 ways splits should be:

- In personal services, the funding [c. £200bn or over half of public services funding] should be in the hands of individual consumers, in education, health, and adult care. Money should follow the choices made by parents, patients, students and those receiving care. Central Government’s role should be to decide how much can be afforded, how individuals co-fund, how to set a tariff and to make sure that the customer has access to useful and reliable information, choice of quality providers and the chance to shape the service to their own needs.
- For local services, the funding (c. £50bn or 15% of public services funding] should be unequivocally given to local communities to decide without any strings from Whitehall. Elected local people should be able to shape real local priorities and to pursue innovation in the services, accountable to local communities not Whitehall. This will include community safety, local environment, leisure, social housing and children services. Central Government’s role should be to equalise the tax base

between areas and to offer local areas incentives for reducing national costs (e.g. dependency on benefits).

- For national services, there should be a consistent purchaser / provider split in central government so that the funding (c. £100bn or 30% of public services funding) is put under the control of a customer, rather than the provider. The national services include national security, justice, administration of tax and benefits, international services, national transport, national business and social programmes, environment and agriculture and national cultural institutions.

3.2(a) Personal services – where the individual consumer should be in charge.

Where personal choice is the dominant policy, then it could be argued that there is no need for the Government to define and reward success, because the consumer will exercise free choice about who provides the service and will decide on their own satisfaction. This argument could cover all personal services where people choose how to exercise their entitlement including:

- Education – early years, schools, FE & skills, higher education and SEN.
- Health and adult social care – primary care, elective secondary care, dentistry, adult social care.

In all these areas, publicly funded provision is complemented by real and thriving markets where consumers pay for their own services – e.g. private schools, private training, private social care. It seems desirable to replicate the way that these real consumer markets work, albeit that the consumers would be state-funded and those in most social need would receive positive discrimination to ensure that the market meets their need.

In this argument, where there is a genuine choice for well-informed individual customers, those providers who attract customers must be the most valued and therefore they should be funded simply for attracting customers and gaining their satisfaction for the service delivered. For example, in private education the fees charged to parents are not linked to the success of the individual (e.g. there are no variable fees linked to exam results), but the earning of fees reflects (over time) the perceived success of the institution. This example shows the difficulty of setting one measure of value for public services – there are some very popular and successful private schools with relatively weak exam results, but exceptional reputations for personal development, sport, etc. In higher education, there are clearly very different academic standards between, say, Imperial College and Thames Valley University and yet they receive similar public funding for teaching the same subjects. In both cases, the state is funding an entitlement to subsidised higher education, leaving it to the individual to choose the most appropriate course at the most suitable institution, save that all eligible courses and institutions are accredited as worthy of state funding.

There would need to be deep and rapid change to make a consumer market approach really impact, including:

- The use of a tariff to determine, as simply as possible, how much funding should be given to a customer to spend on their entitlement and to set the going price for providers. The tariff, e.g. X thousand per pupil, should include all the funding available, including any premiums for additional needs and any capital funding;
- An accreditation system to ensure that providers meet minimum standards (which should be narrowly defined) and are suitable recipients of public money;
- Excellent consumer information about providers, including both formal data and consumer-opinion sharing;
- Willingness to let existing providers shrink or fail if they cannot compete;
- Intervention to improve the choice available to consumers and the price / quality competition (e.g. funding over-supply; reducing barriers to entry and exit; stimulating mergers and acquisitions, encouraging staff and management buy-outs, etc).
- Premiums attached to less attractive customers (e.g. socially excluded pupils, hard to serve rural areas, etc).
- A transitional means of linking at least part of the payment to consumer satisfaction with what is delivered.

There are, at least, three major challenges to be managed:

- There are a range of externalities to and asymmetries within these increasingly private interactions (e.g. getting treated by the NHS) which bear consideration. For example, if preventative work is ineffective (e.g. early years education or primary care diagnosis) then the state may have to spend more as result (e.g. on unemployment benefits or advanced surgery). Consumers may favour services which conflict with the perceived national interest (e.g. arts rather than engineering degrees). Similarly, with the best will in the world a range of consumers will remain weak customers and may have low aspirations for the service. There is a balance to be struck between what the individual values and what the state values, along ensuring a reasonable symmetry of power between customers and providers. The answer lies in creating behavioural incentives to do the right thing (e.g giving nudges, varying subsidies, etc) rather than resisting consumer choices.
- It seems very credible that, over time, this type of market can deliver the public expenditure savings necessary. The effectiveness of the regulated market and the “devolved tariff” should protect what is valued and drive up productivity. The challenge is how to manage the transition before the ideal situation is realised. During this transition period, there is a risk that provider interest dominates and value (the output and outcomes) is reduced rather than cost and that providers begin to fail, rather than respond to the challenges. It is important therefore that tariffs are urgently either created (where they do not exist – e.g. in social care) and made stronger (where they do exist – e.g. in schools). This will protect value (i.e. providers will need to do the valued activities to get any revenue at all) and reduce cost (e.g. the unit prices in the tariff would be deflated over time to ensure that it is cost that is reduced, not value).
- There are a wide range of planning, providing and commissioning functions which currently intervene in these consumer markets at present and reduce the interaction of individual consumers and providers. This includes, by way of examples: HEFCE deciding on which universities will grow in which subjects and

by how much; local authorities running in-house children's centres; PCTs placing block contracts with hospitals; GPs placing work directly with themselves; local authority block contracts for SEN; etc. To the extent that a vibrant consumer market needs to be nurtured and maintained, there is a need for a new approach to market shaping, based on competition regulation and successful procurement – rather than planning, providing and commissioning.

3.2 (b) National services – where central government should be a strong national customer, but not necessarily the provider.

There are a limited range of domestic services where the national government is the customer. These would be the federal functions in many countries – e.g. national security, tax and benefits administration, justice, etc. They are mostly very suitable for unit-based payment and contestable supply. In some cases, there has been a degree of commercialisation which broken the ground for further reform. However, by and large, these functions are less commercialised than some of the NHS and local government run services.

At the heart of this issue is the creation of separate and powerful customer functions, whilst empowering genuinely independent delivery bodies which are incentivised to behave as and become real businesses, whether for profit or not. The fruitful areas for this policy include:

- **HMRC** – the right approach here is to base the unit funding of HMRC on the tax yield achieved for amount spent, coupled with customer service measures. The yield would need to be assessed independently, including defining how much was easy and low-cost (e.g. PAYE) versus how much was harder and higher-cost (e.g. corporation tax).
- **Prisons and probation** – whilst the private prisons have established a way of contracting, this has not really extended into the 90% of provision in the public prisons. Both here and in probation (which together equate to offender management), the real “customer” is actually the sentencer (the magistrates for most of it, the crown court for the most serious). This throws-up the issue of potentially setting budgets for sentencers and / or holding them to account for what they achieve in deciding on punishments and remedial treatments.
- **Courts and tribunals** – Where the net cost to government (over and above the fees charged) could be unitised into a common price schedule (e.g. for collecting a fine or organising a hearing). This could then incentivise providers to respond with new solutions – e.g. switching buildings, centralising processes, etc. This would require a greater diversity of providers than the current monopoly – but even 2 would be better than one.
- **Local tax collection** – Where councils provide council tax and NNDR collection to national specification, the current huge variation in cost could be reduced by clarifying that this is an agency function on behalf of central government, operating a national tariff and introducing contestability of supply.
- **National public protection** – The national elements of policing, fire and emergency responses could be separated from the local level and nationally commissioned. This would complement the locally elected customers for police and fire services. It would

mean that providers had two customers for different roles – with the local customer being the biggest purchaser. The national purchasing could be about getting better value from existing forces (e.g. the Norfolk force in Norfolk) but it could also be about diversification (e.g. that a force with real specialism in economic crime takes on the contract for a whole region or more, as a force or as commercialised management spin-out).

- **Borders and immigration** – A tariff could be created to cover both transactional work (e.g. the issuing of a visa) and the preventative work (e.g. border patrols paid for reducing unwanted immigration). This ought to allow potential outsourcing and / or multiple supply of some functions.
- **National roads** – where the operation of DBFO and super-agent contracts has created a currency of unit prices and contractualised accountabilities, which could be extended to cover all the work of the Highways Agency and its suppliers. This could mean that Ministers can make explicit decisions about the maintenance and operational standards which can be afforded and to test the unit cost of those standards through active competition.
- **Welfare programmes and administration** – A clear separation of the customer and provider roles for these programmes would ensure that there was full contestability and much more diversity of solutions across all of this area. This would include benefits processing (national and local) , job centres, 3rd sector schemes and local partnerships. Funding would through a mix of best practice transaction unit payments and, over time, more payment by success in reducing welfare.
- **Ownership and identity functions** – An integrated buyer separate from provision could take a creative approach to licensing and buying services here, such as the Land Registry, the Ordnance Survey, the Valuation Office, DVLA, Passport Services, Government asset management, etc.
- **International facing services** – Having a customer / provider split would allow the Government’s customer to buy greater integration, both within the UK’s provision (e.g. between FCO, BIS and DFID in supporting British business interests) and with allied countries (e.g. joint defence provision with the French; combined diplomatic missions in particular countries; etc).

There will be a need for cross cutting political decisions to enable these agencies to be efficient. For example, there will need to be political support for the agencies to shift customer access to more modern and cheaper channels. Central government has fallen behind the rest of the world on the use of new technology. It has spent the money on IT, but it has failed to achieve the results. According to the UN, the UK is not even in the top 10 countries for e-government and continues to be overtaken by other countries who are moving fast. The pace-setters for transforming government through IT are in Scandinavia, North America, Australia and Korea. The UK is no longer a world leader A striking example lies in our tax administration. The rest of the world is rapidly moving towards online tax filing. Indeed some countries (e.g. Denmark, Italy, Netherlands) are achieving 100% e-filing. Not only is the UK well behind the leaders, it is falling further behind. For example, in 2004-7, the percentage of personal income tax filed online rose from 10% to 72% in Austria and from 43% to 83% in Korea, whilst in the UK it grew from 17% to 33%).

3.2(c) Local community services – where the buck stops with local authorities as the customer, but they should devolve further to the most local level wherever possible.

There are a range of services where local communities need to make decisions collectively. In these areas, it cannot be left to the individual consumer to decide, because there are trade-offs to be made between what different groups want (e.g. on the environment), the council is stepping in to protect vulnerable people (e.g. children's social care) or it's about shaping the local area (e.g. regeneration). On the other hand, in these areas, there are limited knock-on consequences for other areas – e.g. what one borough decides about minor planning applications does not substantially affect another borough, nor does it often matter from one part of a borough to another. So, it seems most appropriate that these decisions are made by local elected authorities. There are a variety of Local authorities – councils at different levels (county, district, parish, unitary, etc), single purpose authorities (e.g. fire or waste) and potentially new people such as police commissioners or elected members of PCTs.

The services in this category include:

- Local environmental services (planning, highways, waste, public realm, parking, etc)
- Leisure and cultural services (sports, libraries, arts, etc)
- Children services (social care, youth service, preventative programmes, etc)
- Local economic development (regeneration, tourism, business support, community development, etc)
- Housing (social housing, homelessness, new housing, etc)
- Community safety (local policing, crime prevention, local fire, etc)

For these services, there should be:

- Maximum devolution and deregulation – so that central government gives almost total discretion to the local level;
- Local funding for the service (over time) – so that central funding is only to equalise between different tax bases;
- Financial flexibility – so that authorities have maximum freedom over capital, revenue and borrowing, so long as they stay within prudential limits and the existing S151 / external auditor regime;
- Accountability for these services sitting unequivocally at the local level – they specify them, commission them, often deliver them and assure the quality. So, in one of the most contentious areas, that of protecting the most vulnerable children, councils would be expected to have independent assurance that their arrangements work, but it would be their responsibility to put this in place, rather than relying on a national inspectorate.

By definition, this absolute devolution would drive a diversity of approaches to payment by results. However, part of the deal on devolution should be that local authorities run a transparent payment by results approach, so that local people can see what they get for their money. It is also worth considering whether central government should accelerate the impact of payment by results in local services by requiring a structural separation of provider from purchaser – e.g. in the recent arms-lengthing of PCT provider bodies – or require competitive

regimes to be run – e.g. in the former CCT system. When Community Care was introduced in the early 1990s, for example, the Government required that 80% of all new provision was from the independent sector. This led to the massive and vibrant voluntary and private sector market for care. There was no micro-management by Whitehall, but the simple rule and strong market signal caused a revolution in supply.

But devolution to local government is not the end of localism. A “local big state” is no more desirable than a “central big state”. Local government should seek to devolve to the most local level possible and to encourage communities to take over services. One example would be libraries. Libraries face funding challenges – in that they are more discretionary than other services, usage has declined, the unit cost of lending a book can be more expensive than the wholesale price of a book and customers have new book and information media and services (e.g. Amazon, social networking sites, etc). The level of community resistance to closing a library is usually disproportionate to the level of local usage, because communities believe that a local library belongs to them, not the council, and they believe in the future potential of the library to do great things. Devolution can allow new ideas to develop. For example – in North America libraries are often run by volunteers not paid council staff, whilst in the UK charity shops often have waiting lists of volunteers wanting to help them with book sales; much of the public space in a library is badly used storing infrequently used books; e-government has put libraries on line, but they still focus on a buildings based service; too many community groups are spending scarce resource on premises; where some councils have handed the library back to the community, they have often turned it into a much more vibrant community organisation and space. Giving councils total freedom on libraries could mean that they create huge social value from engaging a community in running its own library, backed up with some modern technology, whilst also saving large amounts of money on over-skilled paid staff, poor use of space and unnecessary stock.

3.3. Payment by results should be implemented across the public sector without exception – where it exists already, it should be made more forceful and sophisticated, where it does not exist, it should be introduced with very limited transitional periods.

It is proposed that a payment for results approach is introduced consistently across all public services, without exceptions. It would have these features:

- It is needed whoever is the customer – PBR is necessary to allow consumers to control their spending on personal services, for local authorities to get VFM from devolved funding for local services and for national services to buy from the best providers at the best prices
- All public service providers (whether public, private or voluntary sector) should be funded on a PBR basis.
- Resources for public sector providers would no longer be allocated based on historical or block budgets. All resources would be earned for what is delivered – including funding for capital, additional needs and contingencies.
- All public services would have a separate paying customer (whether in central government, local government or the direct consumer or community). The customer would buy the service through tariffs of unit prices, paying for what is delivered (e.g.

number of operations in health, getting claimants into work, collecting hard-to-collect taxes, operational availability of military equipment, etc). This makes the market transparent and allows new entrants. Suppliers could better the prices in the tariffs but generally they would be expected to compete on quality against given price points, as happens in many private sector markets.

- Initially at least, the payment would be for fairly straightforward output, rather than complex longer term outcomes. This would be partly for the quantity achieved (e.g. number of cases handled) and partly for the immediate quality achieved (e.g. the timeliness of completing those cases effectively).
- Unit prices paid would be based on best practice prices, thus driving up efficiency across each sector (e.g. benefits administration) and across each cost area (e.g. property costs).
- The tariff should allow competition amongst providers, within the public sector and with the third and private sectors too.
- Over time, providers will be able to supply wider outcomes – e.g. reducing benefit dependency or meeting the medium term needs of a cohort of social care users. This will cut across departmental boundaries and budget years, but create opportunities for real innovation and the transfer of risk for substantial reward.
- The financial regime for all public services would be based on every budget holder having a P&L account, with a top line for revenue earned by activity, monitoring of costs against the revenue earned and a surplus or deficit as result. Surpluses and deficits would be retained by the provider. There would be a requirement to achieve a surplus to provide for investment, working capital and contingencies. This replicates the current situation for Foundation Trusts.
- Where public sector providers get into deficit, their respective funding customer would intervene (like Monitor does in health) to: tackle the short-term cashflow; to agree what needs to be done to be keep the provider viable; to activate the failure regime.
- There would be a ‘clear line of sight’ from the Treasury through each department into any provider, transparently showing financial performance at all levels in terms of the return on spending.

Where payment by results exists it should be made enhanced and where it does not exist it should be hurried into existence, even if it is crude to start with.. It is possible to describe a maturity path for PBR and to use this as a framework for moving forwards. The current funding systems in the UK can be characterised as 5 levels:

- **Level Zero** – *Historical budgets incrementally adjusted, usually based on potential need and / or historical costs of the services for an area or from a provider*

This includes: most funding to and from local government; most home affairs services; most tax and benefit services; most transport services; most international facing services; community and ambulance health services; most national environmental services; most business support schemes.

- **Level One** – *Activity based funding, determined by complex funding formulae, including a unit price but other factors too.*

This includes: most education services; much of primary healthcare; social housing; national cultural services; agricultural support; most international facing services.

- **Level Two** – *Activity based funding, determined by a target unit price, which is regularly updated based on good practice efficiency or market-tested prices, etc*

This includes: the acute health sector; FE and skills. In these cases, there is an immediate opportunity to ratchet up the target prices (e.g. moving the NHS tariff from a historic average unit cost to a top quartile price or even very best practice level).

- **Level Three** – *Payment for results, where a price is paid for an output and reflects, at least in part, a significant transfer of the risk of success to the supplier.*

This includes: a range of PFI projects (e.g. MOD availability contracts); some outsourcing deals (e.g. the Child Maintenance and Enforcement Commission's contract with Vertex).

- **Level Four** – Payment for better outcomes, where a supplier takes on a broadly defined outcome, probably over a number of years, and is paid by overall outcome, rather than by specific outputs.

Although much discussed, there are limited examples of Level 4 in practice, including some of the new welfare to work contracts, where payments depend on successfully moving and sustaining people off benefits.

The cost efficiency agenda requires that all funding is moved rapidly to at least a demanding version of Level Two, so that low hanging fruit can be picked (such as the 30% variation in costs between average and top quartile for traditional services). The public service reform agenda and the deeper changes it requires in both efficiency and effectiveness mean that all services should be on a path over the next few years to Level Three. Level Four is a logical and attractive destination for this strategy, but in reality it is undeveloped and there is likely to be a 'bleeding edge' in getting it right, as both the customer and the provider explore how to manage complex risks and rewards and the boundaries of cross-government and multi-year spending are transcended. There is a need for a managed programme of experiments to push this forward –e.g. in areas like reducing reoffending, reducing public health problems like obesity or maintaining the independence of frail older people.

3.4 Giving almost total freedom to public service providers to respond to their customers and PBR, supported by the active divestment of public sector staff into independent providers in control of their own future.

When public service providers currently ask for greater freedom, it is often remarkable how little freedom they request. It has mostly been about seeking day-to-day relief from Government's micro-management of their internal affairs. Recently, there has been more ambition in initiatives like Total Place, but this has been more about the integration of commissioning powers than a revolution in the supply side. There is a real need to lift ambitions about the potential scale of change in how services are provided, how professions

need to change and how the boundaries between public, private and third sector provision can melt away.

Fundamental change is something to be stimulated, not implemented top-down. It is about separating purchasers and providers so that the providers are incentivized and free to organize themselves effectively, rather than being trapped in one particular institution. It will be for politicians to revisit the 1940s funding and governance settlement – to decide on what the State can and should pay for in the future and for whom. The managerial revolution needs to come in releasing the professionals to regroup themselves around the outcomes they need to solve (e.g. community safety is a multi-disciplinary problem) and to encourage enterprising staff and managers (from whichever sector) to regroup the institutions into new businesses (whether for profit or not) which can focus effectively on delivering required outputs or outcomes (e.g. child protection services that can work for many councils not just one).

There will have to be an aggressive programme of liberalization to give public service providers the incentives and freedom to respond. This should include a new set of rules to accelerate progress, including:

- A right to bid – where any public service provider (from any sector) can make a proposal to take on a service from another organisation
- A right to own – where staff and managers are able to propose a staff and / or management buy-out or mutualisation of their service, with or without external investors and joint venture partners
- A right to merge and acquire – where successful public service providers (from whichever sector) can propose mergers, demergers, acquisitions or disposals
- A right to manage – where public sector organisations are free to decide on resources issues (e.g. capital spending, workforce issues, IT, multi-year surpluses and deficits, etc).

Such a set of rights will need to be actively promoted and supported by Government and (counter-intuitively) empowerment will need to be forced onto public sector organisations in the early stages to break the tendency to structural inertia. History shows that just offering the freedom is not enough – e.g. the Government is still trying to persuade schools to take the freedoms as academies that they could have taken 20 years ago as grant maintained schools. However, over time, this should create an enterprising, flexible and fluid market place for public services, where professionals and managers are empowered to do the right thing and control their own destiny. There are great examples of this in sensitive public services – whether it is GP practices which are profit-making businesses or housing associations which are not-for-profit bodies.

This is about emulating the disciplined freedoms enjoyed by the private and voluntary sectors in real markets – where organisations are financially disciplined (by the need to earn their living from paying customers by beating the competition) but are then much more free than

most public sector organisations to determine their success (e.g. to merge and acquire with other organisations, to reward and reshape their workforce, to decide on the processes to produce their service, to invest in their future, etc). All too often these disciplined freedoms are not available to public service providers – even when they are private or voluntary sector bodies, let alone public sector organizations.

It also goes beyond the freedom to operate – into the freedom for staff and managers to own their organization, either on their own or jointly with the community they serve or with external investors. There are a wide variety of options (mutuals, employee co-operatives, joint ventures, management buy-outs, etc) but they all focus staff on their ongoing need to meet customer requirements to stay in business.

The freedom regime will be challenging and public sector bodies need to be freed to respond. This should include:

- Dismantling much of the current Whitehall policy, funding and regulation functions (in departments, agencies and NDPBS) and actively de-regulating existing (e.g. the school curriculum, local government performance assessment, etc);
- Empowering all public service staff and managers to launch management and / or staff buy-outs of their services, whether that is whole organisations or parts of them – creating a whole new raft of enterprising public service providers;
- Inviting local authorities, social enterprises and enterprising public sector professionals to bid to take over any centrally controlled locally delivered services (e.g. offender management, welfare to work, mental health, etc) as ‘new agents’.
- Freedom for providers to choose their own delivery processes, so long as they achieve the outputs or outcomes required of them.
- A new settlement with Local Government based on a model of being a free agent for local services (e.g. children services), a real agent for national customers (e.g. local tax and benefit services) and a reagent to shift municipal control to consumers for personal services (e.g. adult social care).
- Regrouping of agencies to make more effective businesses as part of an active divestment programme – e.g. clustering agencies who work on identity or carving out common specialist functions such as call centres to create new cross-departmental businesses.
- Freedom for external investors and suppliers (both not-for-profit and for-profit) to propose taking stakes in public service delivery, whether through taking equity stakes, insourcing expertise, etc.
- Financial flexibility through less ring-fencing, relaxing capital / revenue rules and having a permanent and predictable regime of end-of-year carry-forwards.

- Devolved decisions on resources (e.g. pay structures and levels, IT, property usage, improvement budgets, etc.)
- Ability to merge or demerge, subject to regulatory consideration of the impact on the market, and ability to take on new services where they can provide better value.

4. CONCLUSION

This paper has tried to outline the need for a consistent and radically applied approach to payment for success across the UK public sector. It has suggested an integrated solution – allocating funding to 3 distinct customers, implementing a progressively more challenging regime of PBR and giving providers almost total freedom to deliver what the customers are requiring. It has been done in a holistic and systematic way – to cherry pick bits and pieces of the agenda will leave us the same current public sector reform frustrations listed in this paper. It will not be easy to implement Payment for Success and the radical change required will present many risks and create a lot of turbulence. But given the need to make major financial savings and empower public service providers to find and deliver the solutions, it seems urgent to get on with it. The alternative is too ugly and unnecessary to consider – the default path of old-fashioned crude cutting. This will be the politically hard, managerially easy route which we have seen before in public services. It is the default route in times of spending restraint. There is a managerially hard, politically easier route, which is set out in this Payment for Success strategy. This needs strong political leadership to put it in place, but it will shift decision-making about solving the fiscal problem from Whitehall to the millions of people who produce and consume public services. They then can find the best way to protect what matters most in those services, not just in the short-term but sustainably over the next decade and beyond.